BI and Fed policy:
Hawk on the Christmas tree

Samuel Theophilus Artha
Economist/Analyst

Barra Kukuh Mamia
Head of Macroeconomic Research

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Executive Summary

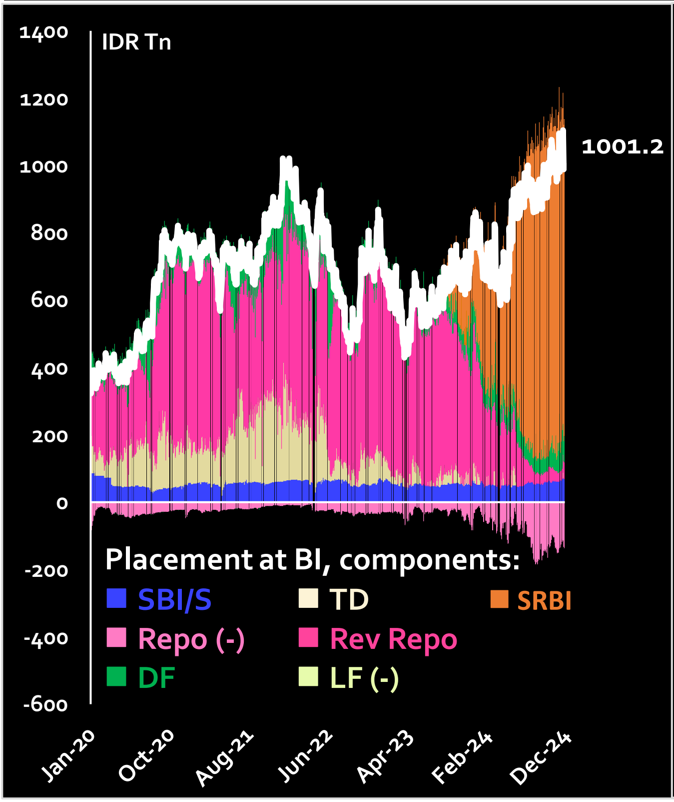
- Fed lowered the FFR by 25 bps, but with a much more hawkish outlook (only 2 cuts next year) that has led to renewed risk-off positioning in the market.
- Accordingly, BI kept its benchmark rate at 6.00% amid concerns over IDR depreciation and the limited inflows (even to SRBI) in recent weeks.
- BI's strategy to keep issuing SRBI while buying IDR 150 Tn of SBN in the secondary market next year could be quite costly and limit its maneuvering room going forward.
- Amid the new administration's expansive fiscal goals, BI is facing a dilemma between keeping a strong IDR and strong private borrowing.
- Very high real BI Rate suggests that BI is favoring the former goal, but further liquidity tightness may eventually necessitate a more pragmatic, balanced approach.

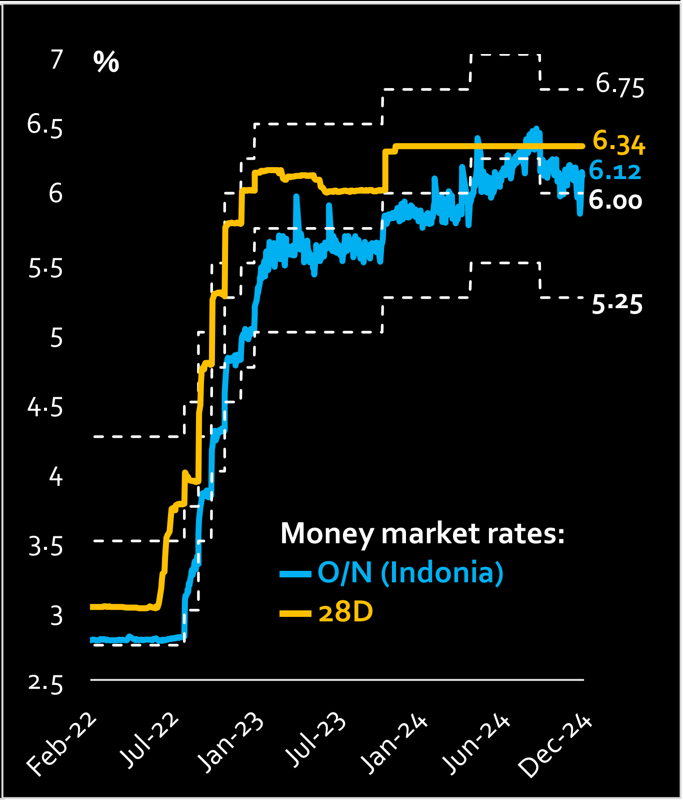
- On December 18th, the Fed decided to lower its Fed funds rate to 4.25 – 4.50%. A few hours earlier, BI announced that it kept the BI Rate at 6.00% for the third consecutive month. But despite this seemingly improved rate differentials, the Rupiah continued to weaken, while Indonesian assets ended the next trading day weaker.
- The problem, of course, is that the Fed's rate cut was the least interesting aspect of the FOMC presser. Although the Fed has now cut 100 bps in the last 3 meetings, the Fed's view of the US economy and its forward guidance almost uniformly veered in a hawkish direction—ergo, a "hawkish cut".
- Growth and inflation outlook were upgraded, while the median position in the dot plot only showed 50 bps cut in 2025. This is far slower than the 100 bps cut in the September version, and in fact matches our worst-case scenario for next year, in which the Fed's terminal rate (the rate at which the Fed stops cutting) would be at 4.00%. On top of that, the Fed is likely to continue with its balance sheet reduction (QT) at a similar pace in 2025, given the still-ample reserves among US banks.
- Small wonder, then, that the markets did not react well to this development. Almost all currencies ex-USD also recorded sharp depreciation in an echo of the "Trump trade" last month. The specter of Trump, of course, continues to hover above both the Fed's decision and the market's reaction—the tariffs, the deportations, the fiscal deficits, the geopolitical uncertainties, and now even the ongoing risk of a government shutdown.
- It is this specter, and the Rupiah's recent weakness, that explains BI's cautiousness. This is further underlined by recent capital flow trends, where foreign ownership for even SRBI—BI's go-to instrument to stabilize Rupiah in the past year—has been declining. While SRBI yields

have been rising in recent auctions (the latest at 7.24% for 12M), it still seems insufficiently attractive to foreign investors, given the worsening risk perception. The non-deliverable forward (NDF) market, for instance, is now pricing the Rupiah to depreciate by almost 400 points (or 2.5%) against the USD over the next 12 months.

- This complicates BI's mission to stabilize the Rupiah, especially since it is also planning an IDR 150 Tn intervention in the secondary market for government bonds (SBN) next year to offset IDR 100 Tn worth of bonds (part of the pandemic-era burden sharing) that is about to mature. Such strategy—issuing high-yielding SRBI while purchasing SBN at lower yields—could be successful, but it will come at significant cost to BI.
- It is also notable that BI already holds 25.2% of tradable SBN (net), and it will buy roughly a quarter of next year's SBN net issuance. While BI's SBN holdings are mostly acquired during an emergency, or even (in the case of SRBI operations since Sep-23) a tightening policy, such high level of ownership could limit its manoeuvring room in the future.
- At the heart of BI's dilemma is its goal to maintain a strong Rupiah (through SRBI) <u>and</u> strong private borrowing (through macroprudential policies) amid the government's expansive fiscal policy. As we will explain in our upcoming Outlook, the tradeoff between these three goals—in effect, a trilemma—is growing more difficult in this period of volatile, limited global liquidity.
- The choice is to either wring out more (forced) savings out of the private sector including households, or allowing them more breathing space by allowing the Rupiah to depreciate. By keeping real policy rate (BI Rate minus CPI inflation) at a historic height of 4.45%, we are effectively going down the first path. Loan growth may remain relatively strong at 10.79% YoY, but this is largely driven by certain capital-intensive sectors while other loans (including consumer and SME) are softening.
- Moreover, BI's assessment that the Rupiah should (fundamentally) stay below 16,000 against the USD seems to ignore the fact that the Rupiah has become overvalued against regional currencies, particularly in terms of its real effective exchange rate (REER). This could be a key vulnerability in the event of a Trump tariff salvo, whereby Asian currencies—particularly Yuan—would depreciate further, resulting in a deterioration of Indonesia's current account position and an even greater influx of imported manufactured goods.
- Given the highly uncertain situation and the unique challenges faced by the private sector in recent months, BI should probably adopt a more flexible policy framework going forward. This will reduce the cost of BI's interventions, while preventing episodes of abrupt depreciation after BI tries to maintain the Rupiah at an unsustainably strong level.
- Overall, we do not expect BI's basic policy setup—cautious monetary policies, accommodative macroprudential policies—to change all that much in the coming year, but some pragmatic "bend but not break" approach may become more apparent. Accordingly, a BI Rate of 5.25-5.50% (i.e. 50-75 bps cut) may be appropriate next year if the terminal FFR is at 4.00%, but we also suspect that BI might have to tolerate some degree of depreciation if the global fundamentals do not improve.

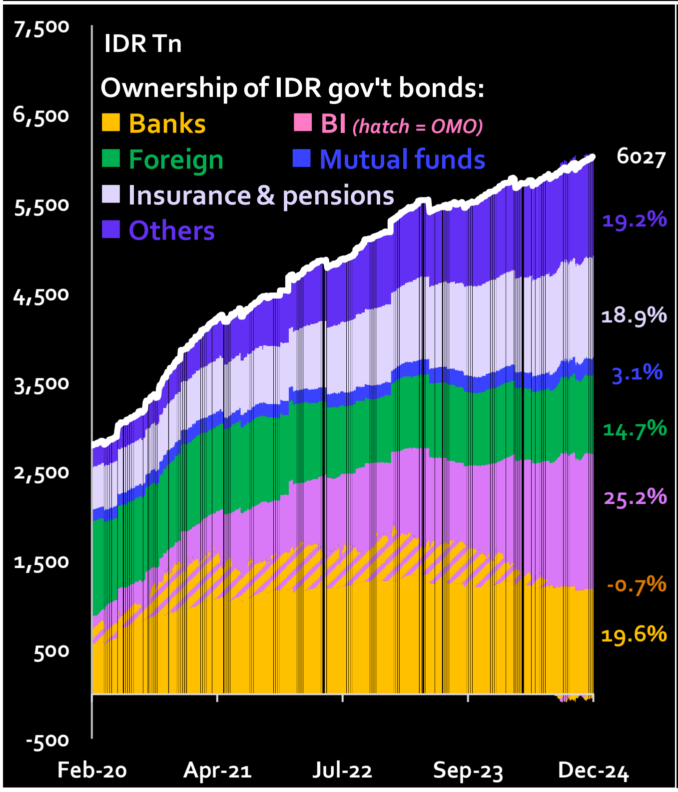
Panel 1. Domestic holding of SRBI increases while foreign ownership slips

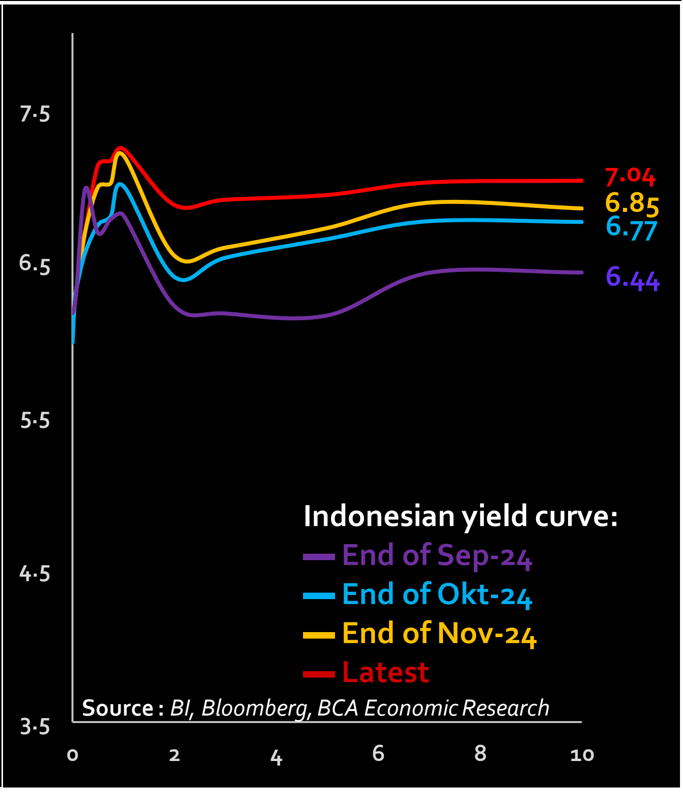




Source: BI, Bloomberg, BCA Economist

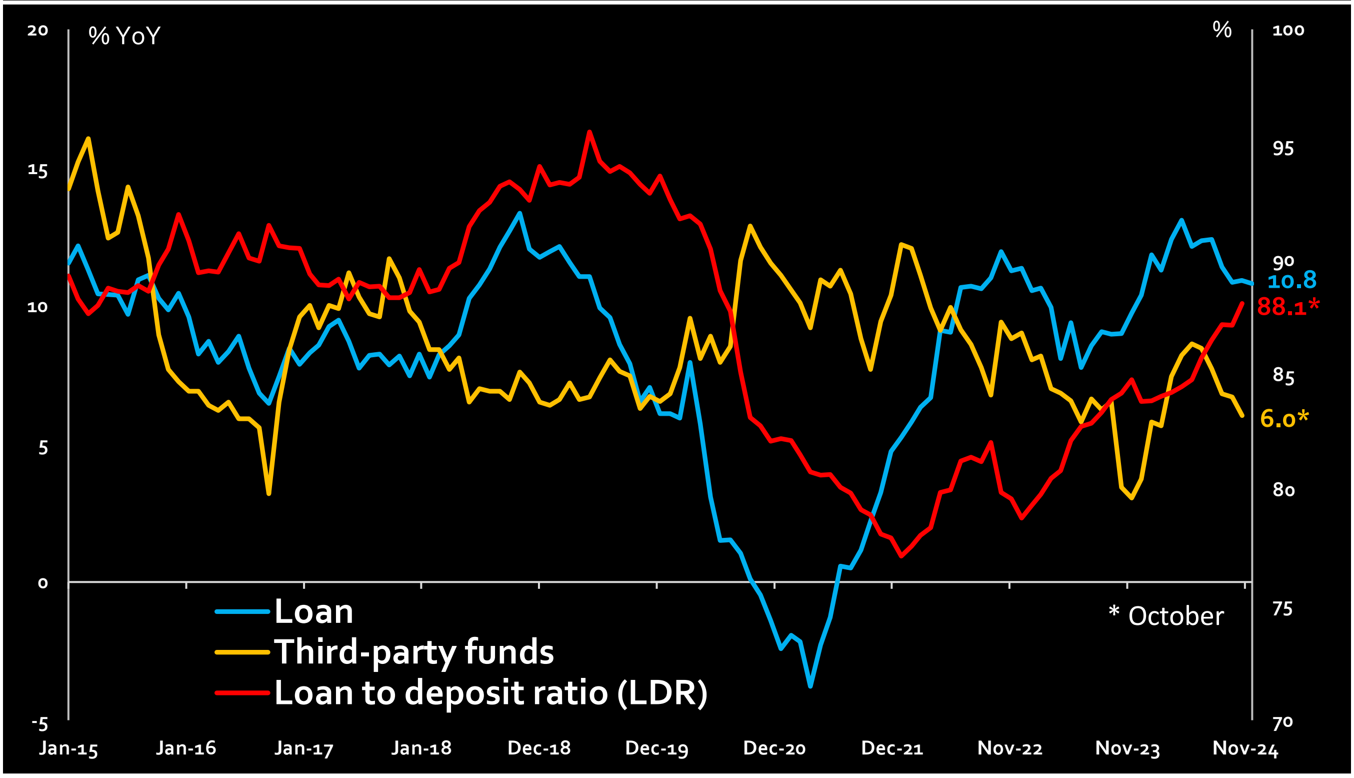
Panel 2. Hawkish cut by the Fed as global yield curves continues to inch up





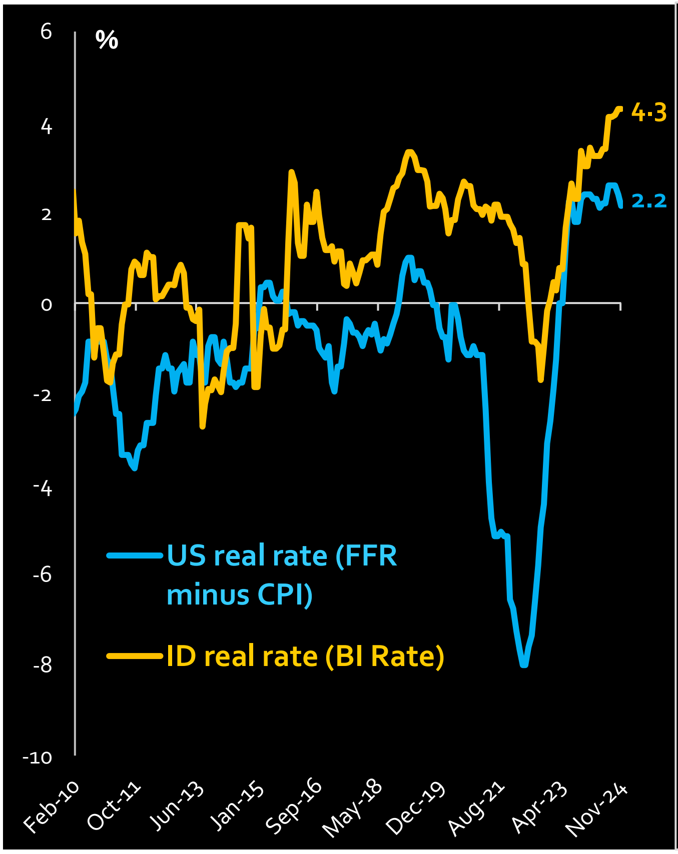
Source: MoF, BI, Bloomberg, BCA Economist

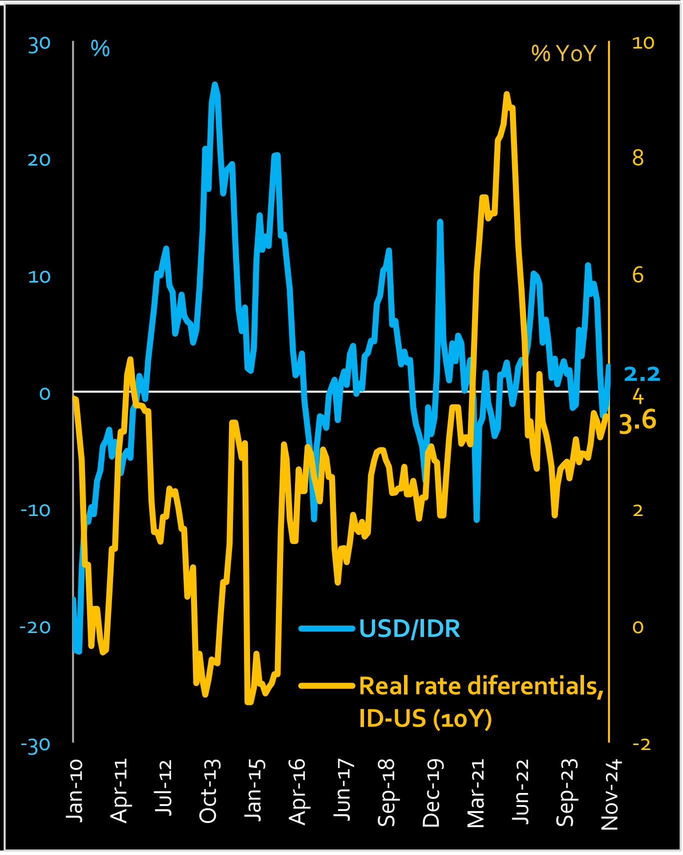
Chart 1. Loan to deposit ratio continued to increase even as loan growth slows down



Source: MoF, Bloomberg, BCA Economist

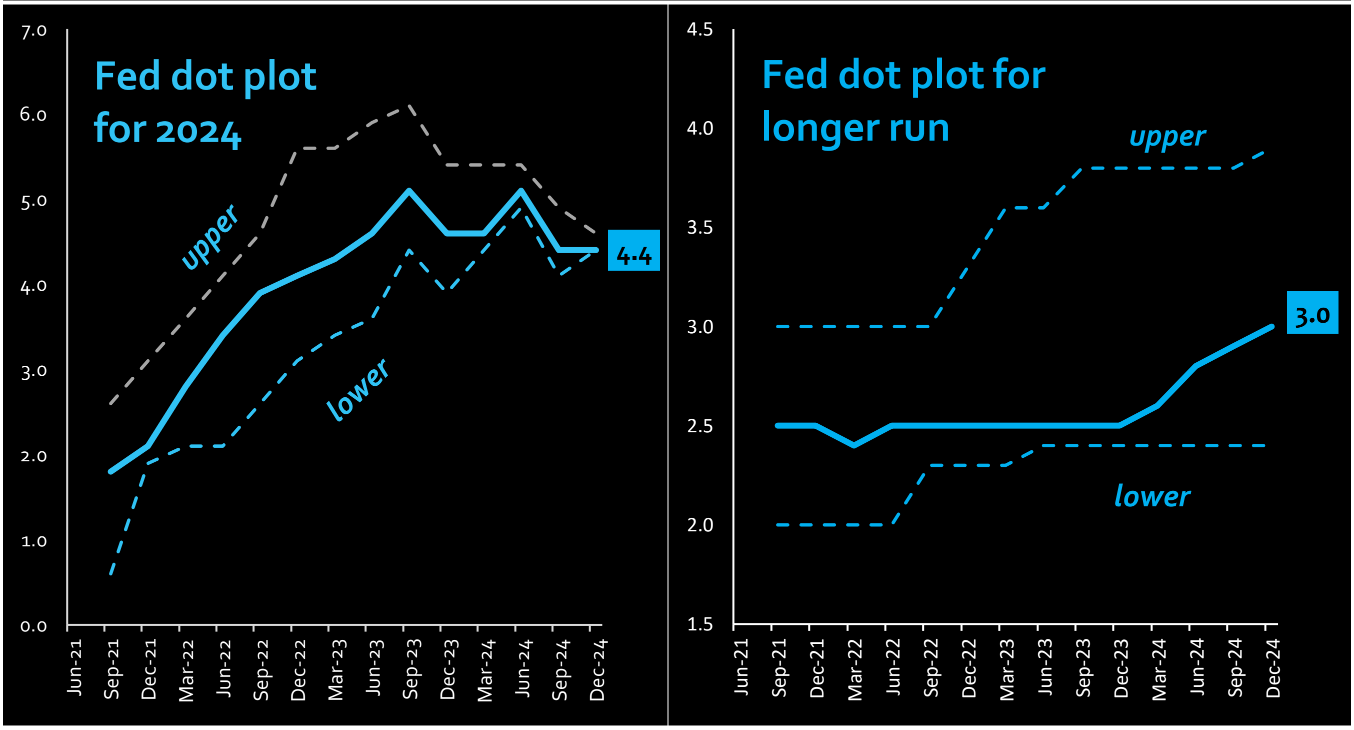
Panel 3. Very high real BI rate is implemented in order to help Rupiah's valuation





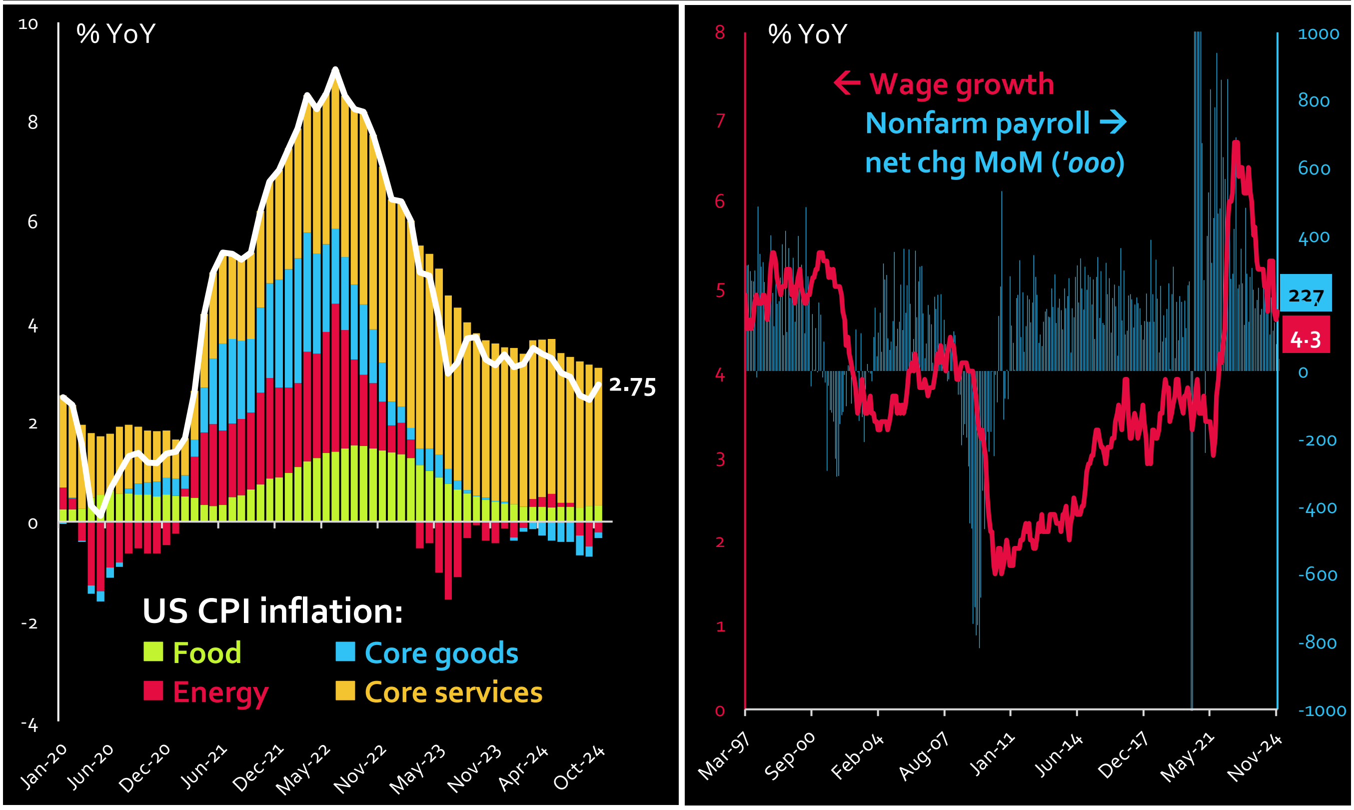
Source: BI, Bloomberg, BCA Economist

Panel 4. **The hawkish turn in Fed's dot plot is coupled with higher long-run target**



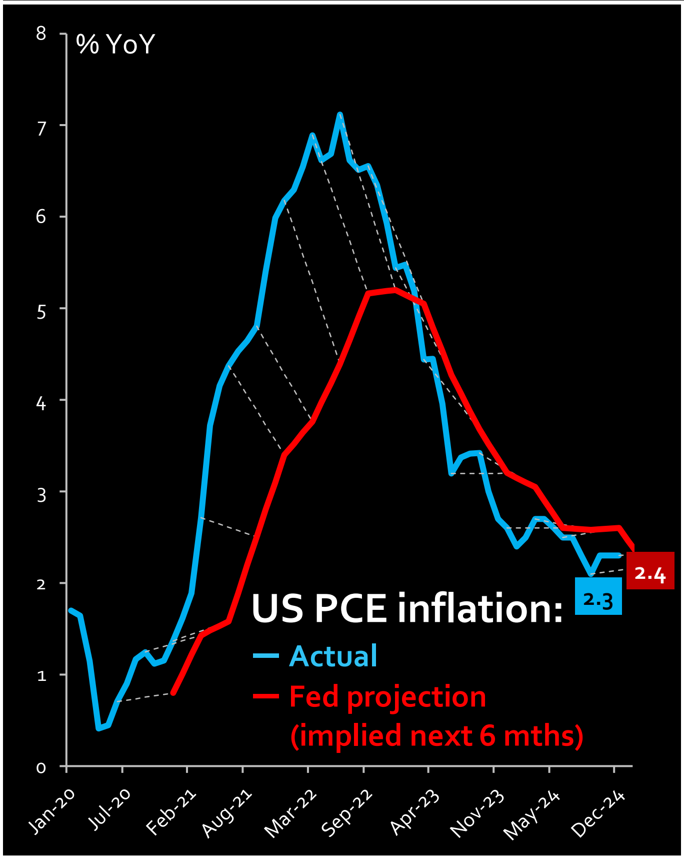
Source: Federal Reserve

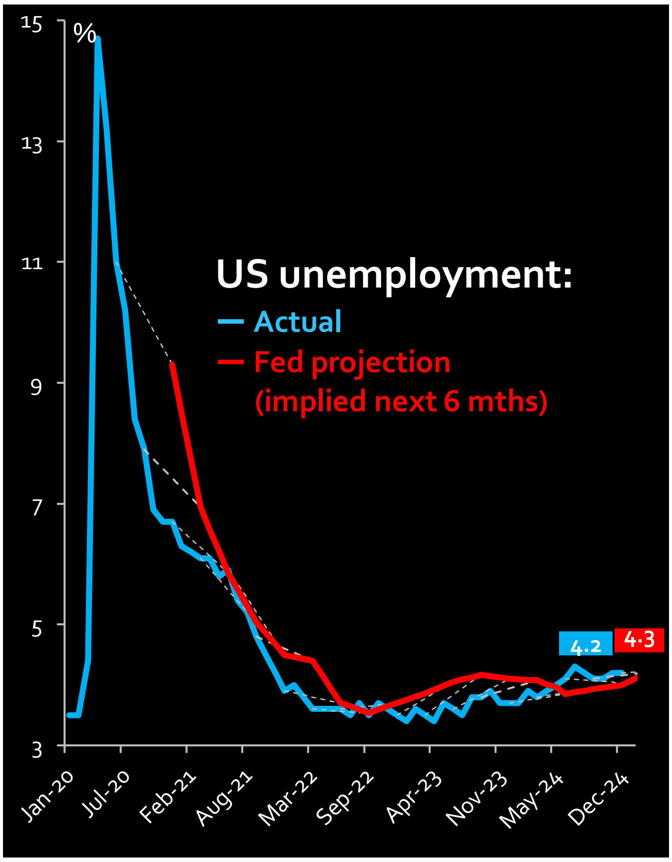
Panel 5. **US labor market have settled into Fed's target, but inflation remains elevated**



Source: US BLS, Bloomberg

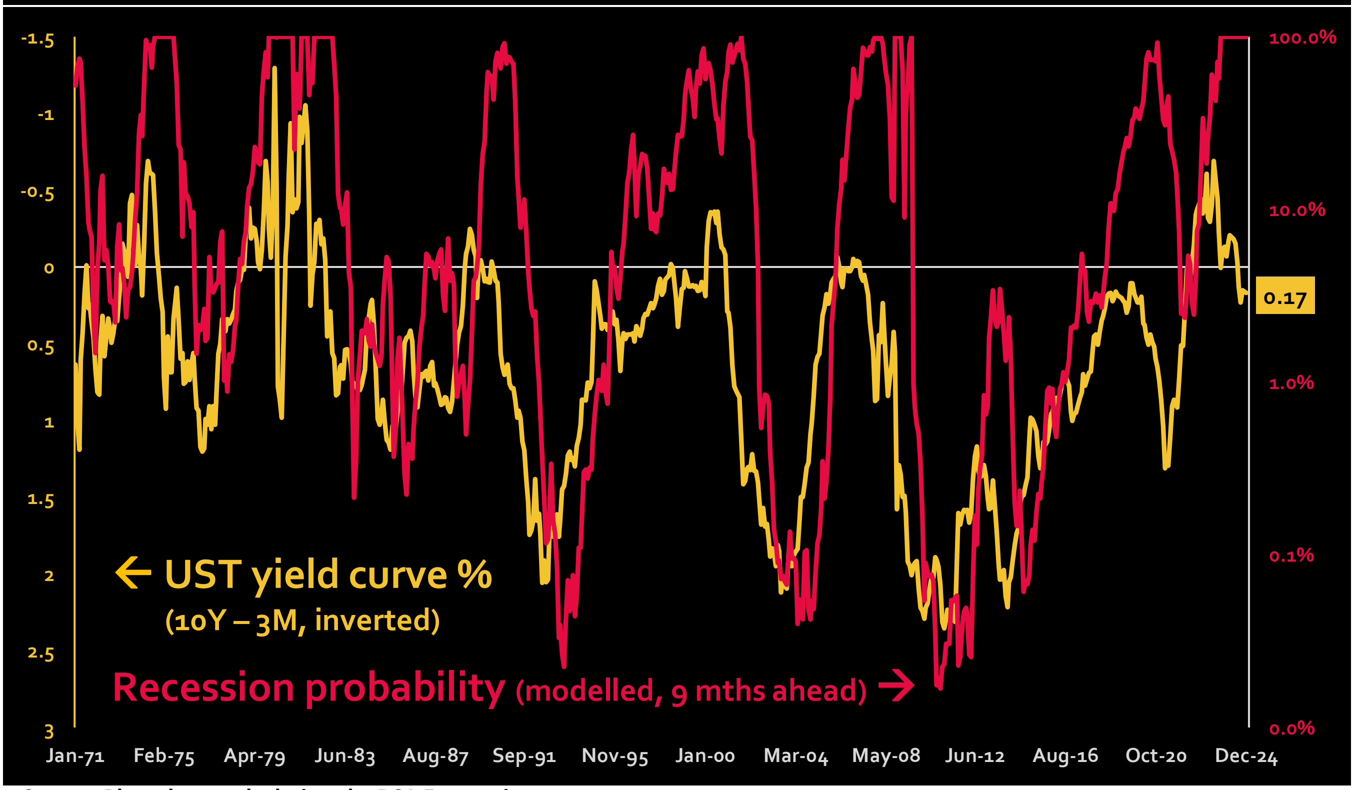
Panel 6. The Fed was caught flat-footed in 2021-22, but it's recent projections for inflation and unemployment have been closer to the mark





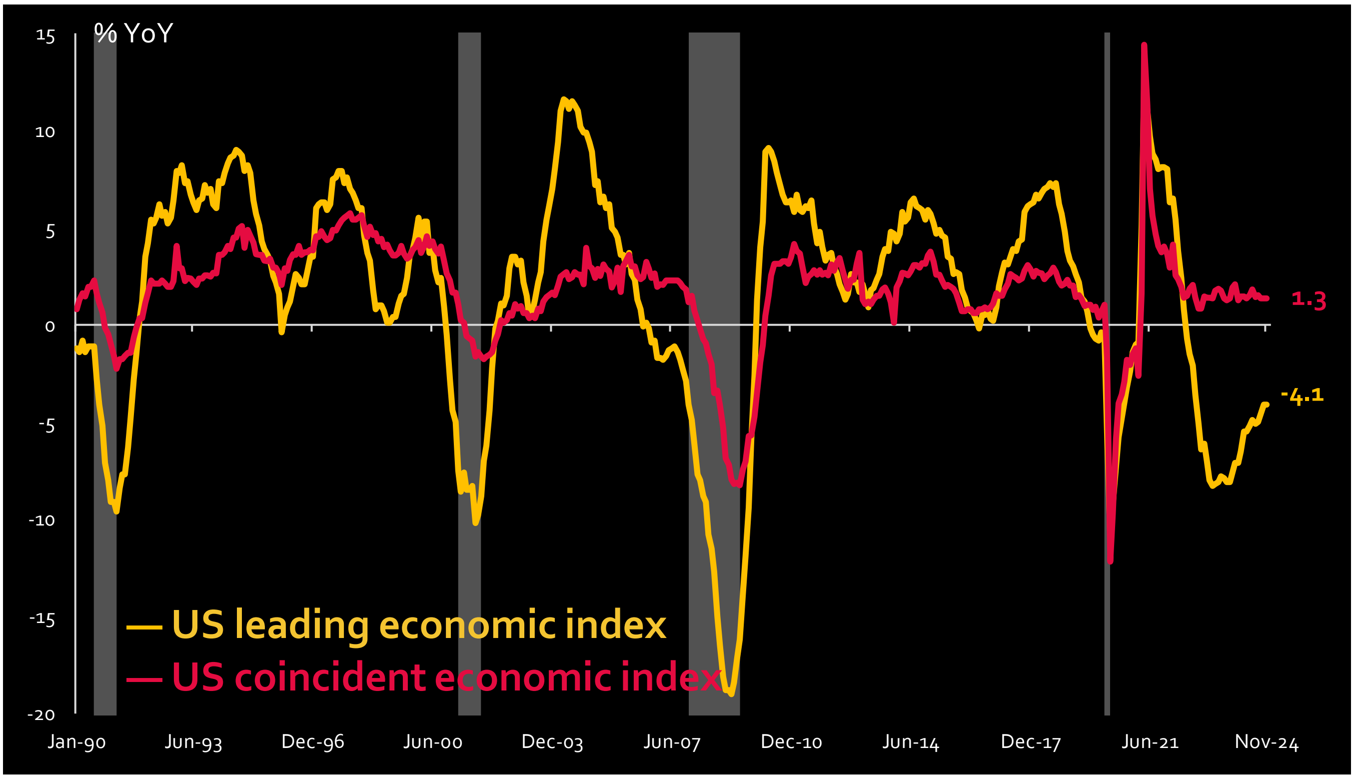
Source: Bloomberg, Federal Reserve

Chart 2. Normalizing T-bills issuance and the higher demand for safe-haven assets pushed the yield on short-term US treasuries



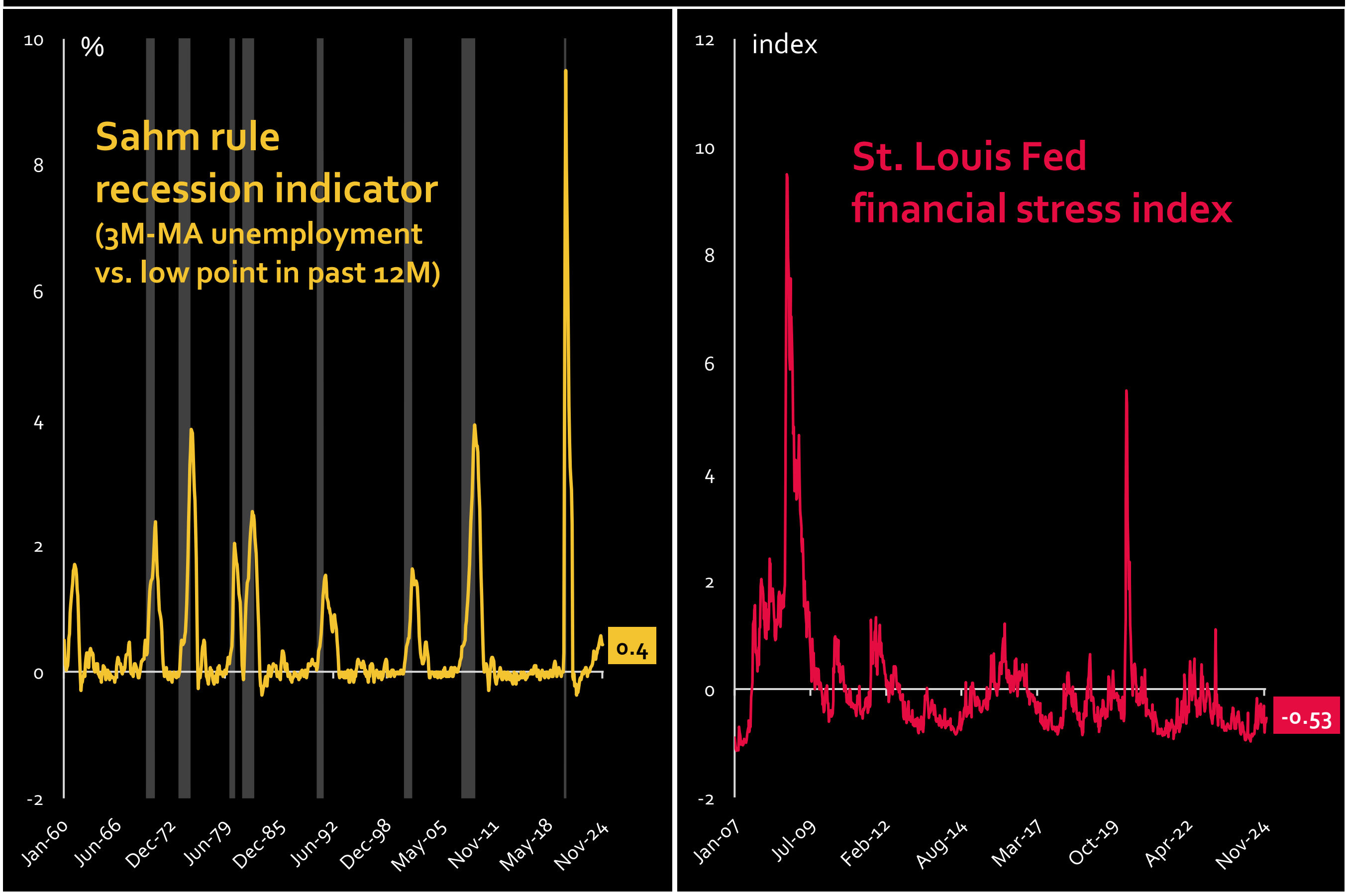
Source: Bloomberg, calculations by BCA Economist

Chart 3. Leading economic index begins rebound as 'imminent slowdown' ceased to materialize



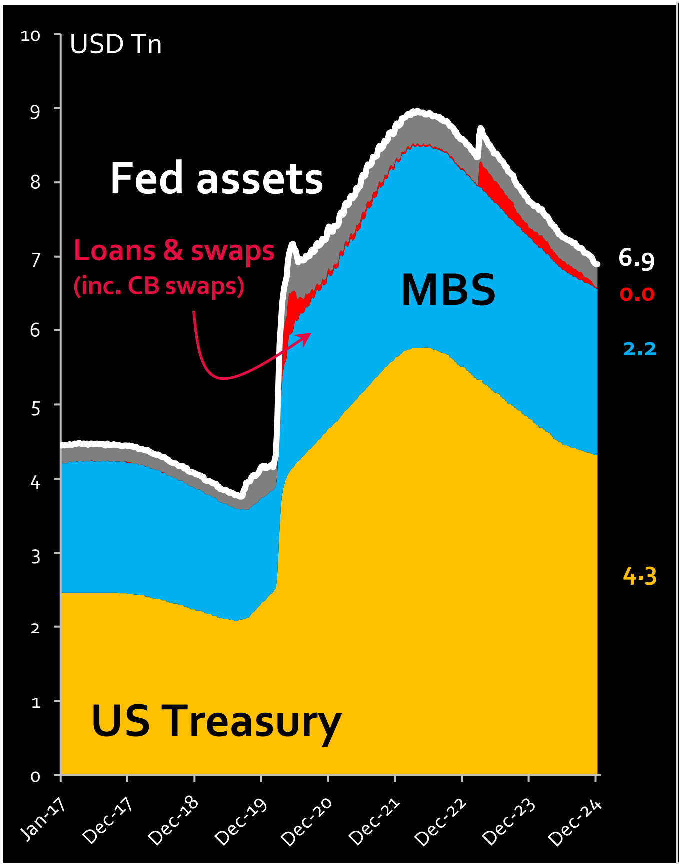
Source: Conference Board

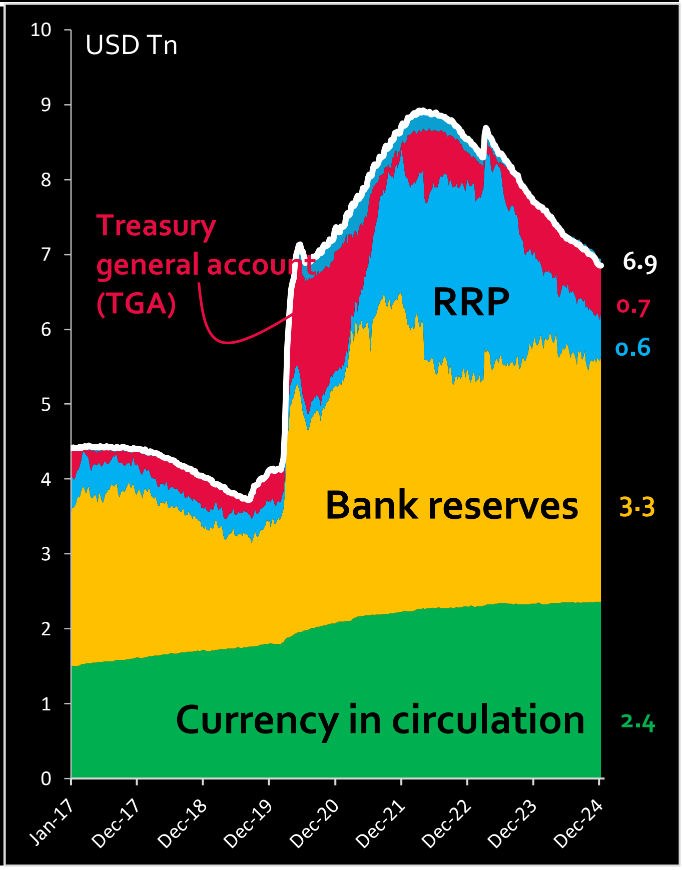
Panel 7. Sahm rule seems to be broken as Fed projects better growth prospects



Source: St. Louis Fed

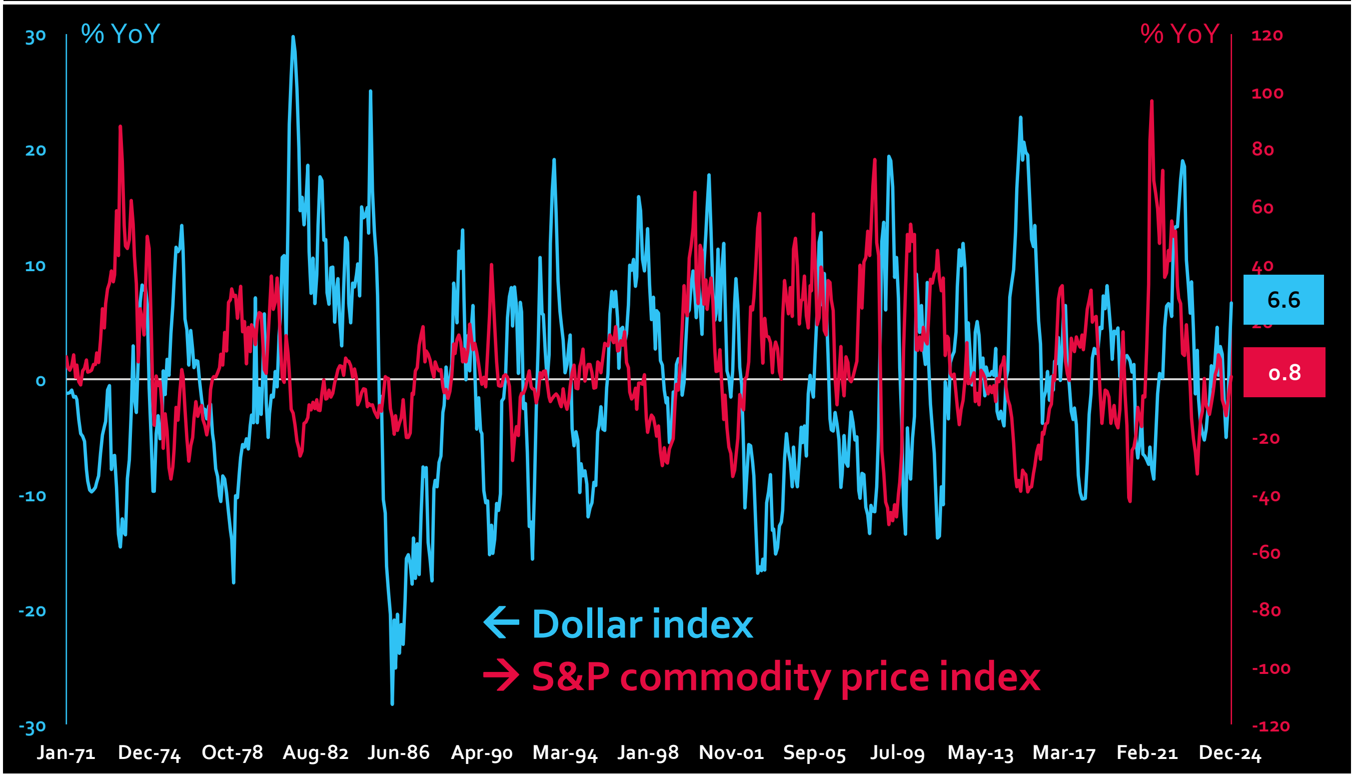
Panel 8. The Fed is set to continue its quantitative tightening (QT) at the expense of reverse repo (RRP) facilities, while bank reserves remain ample





Source: St. Louis Fed

Chart 4. Dollar index shoots up due to increased hawkishness of the Fed



Source: Bloomberg

Selected Macroeconomic Indicators

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	4.50	Dec-24	1.80
UK	4.75	Nov-24	2.15
EU	3.15	Dec-24	0.95
Japan	0.25	Jul-24	-3.00
China (lending)	2.00	Sep-24	4.15
Korea	3.00	Nov-24	1.50
India	6.50	Feb-23	1.02
Indonesia	6.00	Sep-24	4.45

Money Mkt Rates	19-Dec	-1 mth	Chg (bps)
SPN (1Y)	6.78	6.69	9.1
SUN (10Y)	7.06	6.88	18.1
INDONIA (O/N, Rp)	6.05	6.18	-13.0
JIBOR 1M (Rp)	6.63	6.63	0.0

Bank Rates (Rp)	Sep	Aug	Chg (bps)
Lending (WC)	8.87	8.78	8.91
Deposit 1M	4.81	4.79	2.01
Savings	0.67	0.65	1.33

Currency/USD	19-Dec	-1 mth	Chg (%)
UK Pound	0.800	0.789	-1.39
Euro	0.965	0.944	-2.22
Japanese Yen	157.4	154.7	-1.77
Chinese RMB	7.296	7.232	-0.87
Indonesia Rupiah	16,290	15,850	-2.70

Capital Mkt	19-Dec	-1 mth	Chg (%)
JCI	6,977.2	7,134.3	-2.20
DJIA	42,342.2	43,389.6	-2.41
FTSE	8,105.3	8,109.3	-0.05
Nikkei 225	38,813.6	38,220.9	1.55
Hang Seng	19,752.5	19,576.6	0.90

Foreign portfolio ownership (Rp Tn)	Nov	Oct	Chg (Rp Tn)
Stock	3,402.4	3,573.9	-171.49
Govt. Bond	872.5	885.6	-13.07
Corp. Bond	7.1	6.9	0.23

Trade & Commodities	19-Dec	-1 mth	Chg (%)
Baltic Dry Index	976.0	1,756.0	-44.4
S&P GSCI Index	535.9	538.1	-0.4
Oil (Brent, $/brl)	72.9	73.3	-0.6
Coal ($/MT)	127.8	145.1	-11.9
Gas ($/MMBtu)	3.14	2.08	51.0
Gold ($/oz.)	2,594.0	2,611.8	-0.7
Copper ($/MT)	8,770.4	8,954.6	-2.1
Nickel ($/MT)	14,883.3	15,486.3	-3.9
CPO ($/MT)	1,051.5	1,132.1	-7.1
Rubber ($/kg)	1.93	1.88	2.7

External Sector	Nov	Oct	Chg (%)
Export ($ bn)	24.01	24.41	-1.66
Import ($ bn)	19.59	21.94	-10.72
Trade bal. ($ bn)	4.42	2.48	78.56
Central bank reserves ($ bn)*	150.2	151.2	-0.66

Prompt Indicators	Nov	Oct	Sep
Consumer confidence index (CCI)	125.9	121.1	123.5
Car sales (%YoY)	-11.9	-3.9	-9.1
Motorcycle sales (%YoY)	-10.3	5.4	3.7

Manufacturing PMI	Nov	Oct	Chg (bps)
USA	49.7	48.5	120
Eurozone	45.2	46.0	-80
Japan	49.0	49.2	-20
China	51.5	50.3	120
Korea	50.6	48.3	230
Indonesia	49.6	49.2	40

Source: Bloomberg, BI, BPS
Notes:
*Data from earlier period
For changes in currency: **Black indicates appreciation against USD, **Red** otherwise
***For PMI, **>50** indicates economic expansion, **<50** otherwise

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Indonesia – Economic Indicators Projection

	2020	2021	2022	2023	2024E	2025E
Gross Domestic Product (% YoY)	-2.1	3.7	5.3	5.0	5.0	4.9
GDP per Capita (US$)	3912	4350	4784	4920	4945	4980
Consumer Price Index Inflation (% YoY)	1.7	1.9	5.5	2.6	1.6	2.5
BI 7-day Repo Rate (%)	3.75	3.50	5.50	6.00	6.00	5.00
USD/IDR Exchange Rate (end of the year)*	14,050	14,262	15,568	15,397	16,150	16,393
Trade Balance (US$ billion)	21.7	35.3	54.5	37.0	31.4	26.2
Current Account Balance (% GDP)	-0.4	0.3	1.0	-0.1	-0.6	-0.9

*Actual number
** Estimation of Rupiah's fundamental exchange rate

Economic, Banking & Industry Research Team

David E.Sumual
Chief Economist
david_sumual@bca.co.id
+6221 2358 8000 Ext:1051352

Agus Salim Hardjodinoto
Head of Industry and Regional Research Research
agus_lim@bca.co.id
+6221 2358 8000 Ext: 1005314

Barra Kukuh Mamia
Head of Macroeconomic Research
barra_mamia@bca.co.id
+6221 2358 8000 Ext: 1053819

Victor George Petrus Matindas
Senior Economist
victor_matindas@bca.co.id
+6221 2358 8000 Ext: 1058408

Gabriella Yolivia
Industry Analyst
gabriella_yolivia@bca.co.id
+6221 2358 8000 Ext: 1063933

Lazuardin Thariq Hamzah
Economist / Analyst
lazuardin_hamzah@bca.co.id
+6221 2358 8000 Ext: 1071724

Keely Julia Hasim
Economist / Analyst
keely_hasim@bca.co.id
+6221 2358 8000 Ext: 1071535

Elbert Timothy Lasiman
Economist / Analyst
Elbert_lasiman@bca.co.id
+6221 2358 8000 Ext: 1007431

Thierris Nora Kusuma
Economist / Analyst
thierris_kusuma@bca.co.id
+6221 2358 8000 Ext: 1071930

Nicholas Husni
Economist / Analyst
nicholas_husni@bca.co.id
+6221 2358 8000 Ext: 1079839

Samuel Theophilus Artha
Economist / Analyst
samuel_artha@bca.co.id
+6221 2358 8000 Ext: 1080373

PT Bank Central Asia Tbk

Economic, Banking & Industry Research of BCA Group
20th Grand Indonesia, Menara BCA
Jl. M.H Thamrin No. 1, Jakarta 10310, Indonesia
Ph : (62-21) 2358-8000   Fax : (62-21) 2358-8343