

BI Holding on for Dear (Dovish) Life

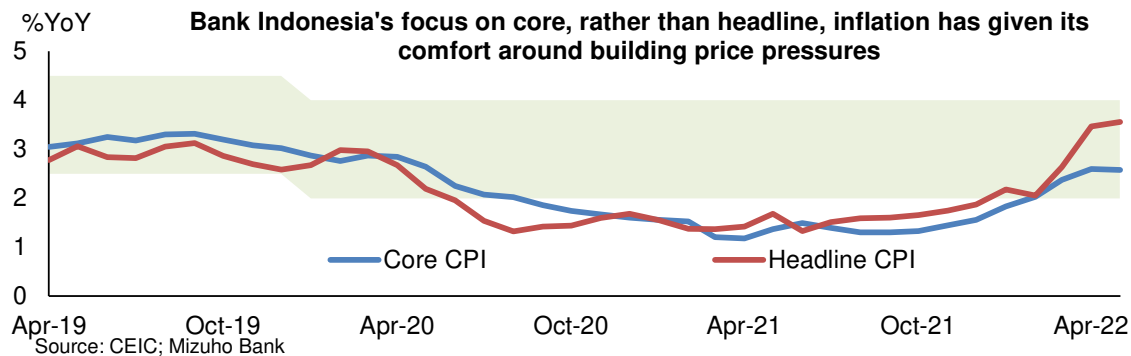
In a nutshell: BI's decision to keep its policy rate unchanged at 3.50% was in line with expectations. While our baseline was for BI to bite the bullet on rate hikes, we acknowledged it was a close call particularly given BI's emphasis on core, rather than headline, inflation as well as relative IDR stability compared to regional peers. Importantly, BI focus on bolstering growth, even in the face of rising inflation pressures and slowing global growth, makes the timing of future rate hikes more uncertain.

BI's decision to keep its policy rate unchanged at 3.50% did not surprise markets. It was, however, not in line with our forecast for a “catch-up”, albeit aggressive, 50bp hike. While we acknowledged ours was a close call, **BI's continued emphasis on core inflation and growth risks makes it hard to pin down when it will choose to bite the bullet on rate hikes.** In the interim, **BI emphasized that even without policy rate hikes, “policy normalisation” was underway** with BI selling government bonds in the secondary market (BI directly bought government bonds in the primary during much of 2020 to H1 2022) and FX intervention.

The timeline for BI to begin policy rate normalisation is obfuscated by its growth-inflation expectations and priorities. BI's inclination to support growth is clear especially since downside risks to growth have increased. **It lowered its 2022 global growth forecast to 2.9% from 3.5%** and now expects domestic GDP growth at 4.9%, which is closer to the lower end of its 4.5-5.3% forecast range. Simultaneously, its judgement around inflation risks remains that it is mainly supply-side driven and hence the breach of headline inflation above its 2-4% target range this year (end-2022 at 4.5-4.6%) is not as much of a concern **as core inflation will remain within the stipulated range.** Moreover, **BI judged that the external situation has actually improved:** it now forecasts that the current account position, as % of GDP, will range from ‘+0.3% to -0.5%’ from ‘-0.5% to -1.3%’.

Taken together, BI has set an extremely high bar for policy rate normalisation in the coming months. Core inflation for the three consecutive months has been at 2.6% YoY, even as headline inflation has risen sharply (Figure 1). While core inflation will rise given the significant upside price pressures, it is unclear if it will be in breach of 4% in the near-term given the utilities and fuel subsidies that are in place. Admittedly, demand-side pressures will remain weak on account of slowing growth. However, after major global central banks were caught wrong footed on the ‘supply-demand’ dynamics of the current inflation

cycle, increased vigilance on inflationary pressures/expectations is warranted; something BI is monitoring.



The wild card for BI will be IDR depreciation. The pace of IDR depreciation versus USD has been in line with regional peers, and at times outperforming peers, **which has been a large source of comfort for BI.** At the press conference following BI's policy rate decision, Governor Perry Warjiyo declared that IDR should be appreciating given the country's current account surplus but has come under pressure due to global events.

Notwithstanding the counter-factual, **the unabashed hawkish bias of the US Fed and other global central banks, including ECB, which will further exert depreciation pressure on IDR.** Rising interest rate differentials (vs US) risks volatile portfolio outflows especially as risk sentiment remains fragile.

The upshot is that BI will drag its feet on policy rate normalisation for as long as it can. It seems likely that **rate hikes will be triggered by two key factors** namely, a **sharp rise in core inflation and/or persistent IDR depreciation.** *This clearly puts our forecast for a cumulative 150bp in rate hikes by BI this year at risk, with BI clearly inclined to do less.*

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