

Bank Indonesia: Tough Call

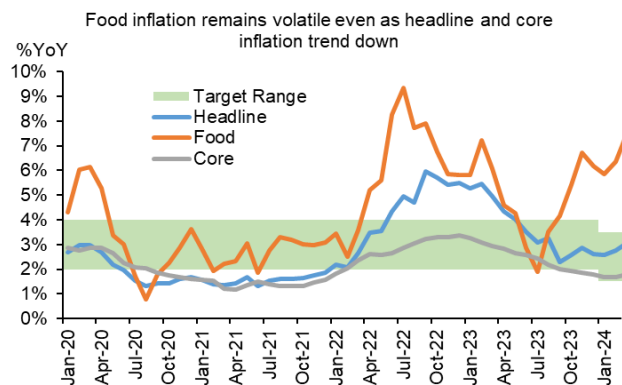
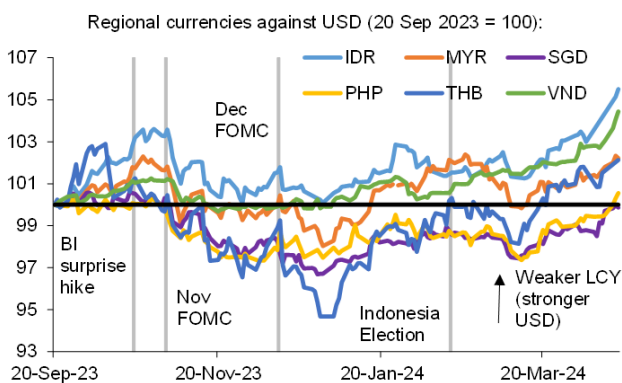
In a nutshell:

- Absent any relenting in USD strength heading into Bank Indonesia meeting, **we lean towards a hike albeit slightly**, attributing a 60% probability to a hike and 40% to an uncomfortable hold on currency stability concerns.
- A hike could alleviate part of IDR's diminished real-rate advantage amid bumpy US dis-inflation process with a higher for longer Fed; and domestic inflation ticking up on persistent food inflation.
- Meanwhile, fiscal woes cast an overhang on the IDR as well. Even as promises to keep within fiscal deficits are made, the incoming administration's spending plans are still a concern amid external growth headwinds.
- The silver lining for BI may be that domestic growth still remain supported amid ongoing festivities providing room to hike should they chose to.

The Call

The upcoming **Bank Indonesia meeting is a tough call to make**, insofar that it is influenced by the sustainability of the current bout of IDR weakness. Rupiah stability is undoubtedly at the top of BI's mind, with BI having announced two intervention episodes since the start of the month. While BI Susianto had said that the pressure on rupiah was only "temporary" during the 2nd April intervention, hawkish repricing of Fed interest-rate expectations, uninspired CNH on weak growth sentiments and geo-political undercurrents favouring haven demand, **which necessitated another round of intervention on 16 April**, test how long this episode of USD strength would last.

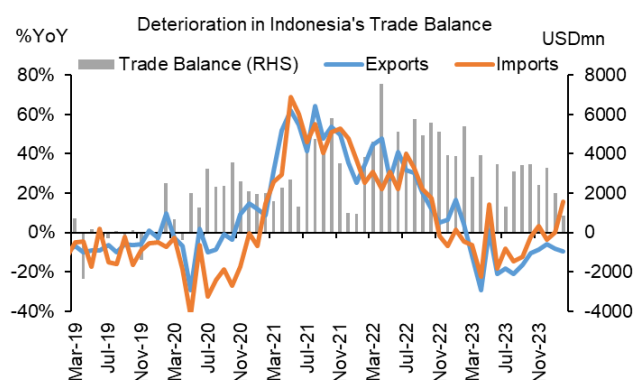
Given current USD strength, **we lean towards a hike albeit slightly, attributing a 60% probability to a hike and 40% to an uncomfortable hold**. Point being, even as BI has shown to be fairly reluctant to use policy rate as a tool to anchor currency stability, preferring instead to use FX instruments (e.g. FX-based rupiah securities) to stem IDR outflows, we think that excessive rupiah weakness might force BI's hand. Afterall, it is perhaps worth recalling that BI's surprise hike in October 2023 was on the back of USD strength from a hawkish shift in the Sep'23 Dot Plot. Considering recent Fed rhetoric, Dot Plot shifts could very well be on the table. The extent of IDR depreciation has also exceeded the October episode.



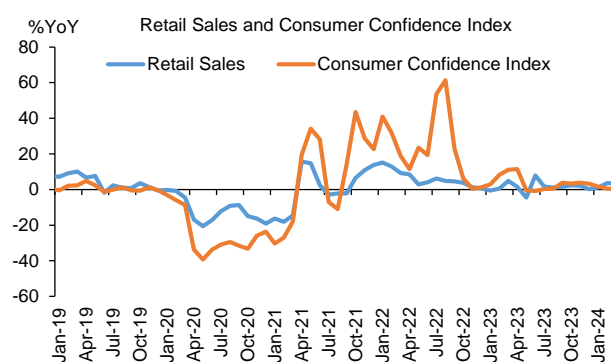
Real Reasons

A BI hike could alleviate some of the diminished real-rate advantage faced by IDR, which is set to be prolonged with a) a bumpy US dis-inflation trajectory that sees a Fed that holds for longer, and b) inflation in Indonesia potentially heading higher further (albeit still within BI's target range) on surging food prices. Rice has been one of the key drivers of inflation in past few months (contributing more than 50pp to the overall headline number since Sep'23) as Indonesia grapples with the effects of El Nino. Dry weather, which discouraged planting in Q4 23, has led to a forecasted 17.5% YoY drop in rice output for the January-April harvest period. Even as the government has boosted import quotas, price increases could very well last till at least Apr.

Meanwhile, fiscal woes cast an overhang on the currency on Prabowo's spending plans, even as Finance Minister Indrawati recently reiterated commitment to keep the deficit within 3% GDP, even after "accommodat[ing] the priority programs of the incoming administration". These fiscal risks add more headwinds to the IDR as trade balance deteriorate on continued contraction in exports, and further widen the current account deficit. Notably, IDR strength has been subdued going into election and post-results.



Source: CEIC; Mizuho Bank



Source: CEIC; Mizuho Bank

The silver lining is perhaps that **growth domestically would likely be supported despite the hike**, given increased economic activity from the ongoing Eid al-Fitr festivities. Forecasts on the Eid al-Fitr 2024 have been very encouraging. The relatively upbeat sentiment appears to be reflected in the recent data as well. Retail sales still remain supported (3.4% YoY growth in March) and consumer sentiment ticked up in March. Consequently, this provides latitude for BI to hike to assist in achieving IDR stability.

That said, should there be a meaningful pullback in USD strength heading into next meeting, alongside weak trade data (due 22 Apr) which suggests further external growth narrow headwinds on a smaller trade surplus and accelerating contraction in exports, the odds could shift back towards a hold.

Policy Trajectory

Regardless, it should be recognized that a hike **would unlikely turn the USD tide for the IDR**, although it could slow the pace of depreciation. A hike, should it be realised, is also by no means an indication of more rate hikes to come, especially as inflation is likely to remain within BI's target band and the tradeoff on growth becomes even more acute. More importantly, the **willingness to enact a hike at this juncture sends a strong signal of BI's vigilance** over the IDR and **extends credibility** of BI's commitment to stabilize the IDR. Correspondingly, a stable and material appreciation of the IDR would likely be a prerequisite of any cut in the near- to medium-term horizon.

Conversely, **should a hold materialize, the deference to use other policy tools should not be mistaken as a reluctance to raise rates** but instead **a withholding in recognition of heightened (and hopefully temporary) volatility** over the past two weeks. As such, future rate hikes remain very well on the table especially if the episode of USD strength prove to be durable.

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