

## IDR: Tread Cautiously

### In a nutshell:

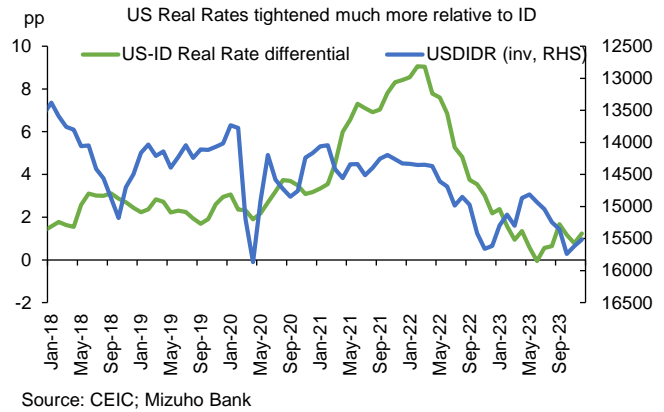
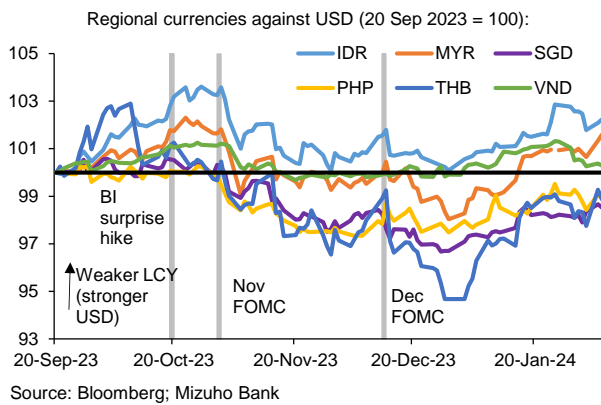
- Recent IDR weakness could be prolonged and volatility accentuated for four reasons.
- First, rupiah's real rate advantage against the USD is compromised and may even diminish.
- Second, even if (when) Fed rate cuts result in lower US real rates, economic/geo-political risks may overshadow initially, leaving IDR vulnerable to headwinds from "risk off".
- Third, subdued coal/commodity demand from lingering external headwinds, amid more pronounced China demand uncertainties, may undermine IDR on terms of trade (ToT) hit. More so, if Australia partly reclaims coal export advantage that Indonesia realized earlier amid (Australia-China tensions).
- As is, nickel prices have slumped on supply glut. And while palm oil prices get El Nino boost, that is partially offset by softer volume. In any case, the ToT dent has already triggered a reversion to Current Account deficit.
- Finally, political risk premium has stepped up amid Presidential elections. Point being, undercurrents of tensions suggest that tail risks of Cabinet fractures and coalition formation may be under-estimated; and as such could persist in the rupiah in coming weeks.

**The sluggish performance of the IDR may be far from over.** Even during the pivot-led "risk on" rally in year-end, the IDR barely covered all the ground lost against the greenback since the September FOMC; and since the turn of the year, the IDR has lost ~2.1% against the USD. There are four reasons for the weak rupiah in our view – first, the IDR faces headwinds from the diminished real rate differentials vis-à-vis the Fed; second, IDR is vulnerable to "risk off" mood should deep Fed cuts be motivated by a more severe economic downturn; third, commodity tailwinds have continued to fade as falling coal and nickel demand negates marginal gains from higher palm oil prices; fourth, political risk premium as Presidential Elections look to reveal underlying Cabinet fractures and coalition formation.

### Real Disadvantage

One key drag behind a subdued IDR is the **diminished real rate advantage against the USD**. The allure of the IDR as a carry currency has been much weaker following the lower cumulative hikes by Bank Indonesia (250bps) vs Fed (525bps) and more moderate dis-inflation process in Indonesia relative to the US. The fact that **there remains room for Indonesia to lose further real rate advantage**, given that the runway for further dis-inflation process is much more pronounced for the US (Dec: 3.4% vs 2% target) than Indonesia (Dec: 2.6% YoY vs 2.5±1% target for 2024), depresses any outsized IDR rallies.

This is especially so as **BI has been seen to be fairly reluctant to use policy rate as a tool to anchor currency stability**, preferring to use new FX instruments to stem IDR outflows. Tellingly, despite the lower cumulative hikes by BI, the central bank had declared being done and dusted with tightening in Q3'23, before a sharp IDR depreciation arguably forced BI's hand in staging the surprise hike in October. With IDR trading around levels (>15810) last when BI staged the surprise hike, the possibility of another (25bps) hike at the next meeting is certainly on the table, but this would still be unlikely to move the needle as this would likely be an one-off event as BI contemplates the tussle between policy trade-offs of higher real rates versus derailing growth prospects.



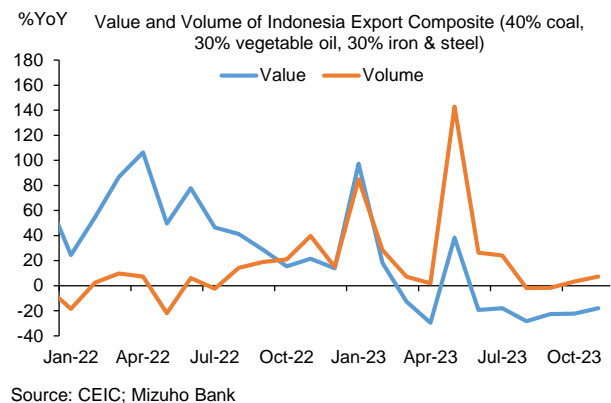
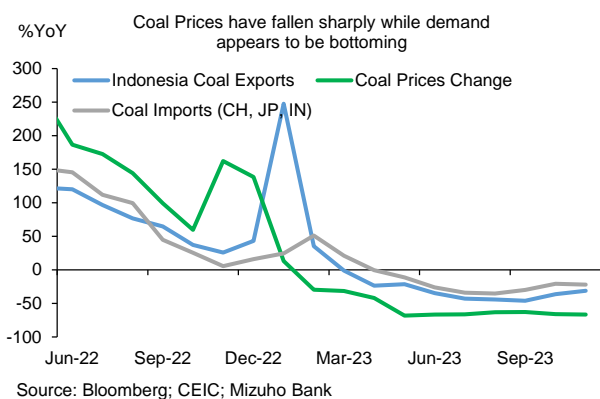
### “Risk Off” Interruptions

Even if (when) real rate advantage may be restored on sharper Fed rate cuts, any regain in IDR strength may be interrupted by “risk off”. Point being, deeper cuts, if motivated by a “hard landing scenario” of the US economy, risk sparking off a **flight to haven currencies**. As such, the **IDR could very well be much more invested in the narrow path of a US “soft-landing” scenario** than envisaged. This is further set against the context of simmering geopolitics tensions which could flare-up and see some unwinding of carry trades.

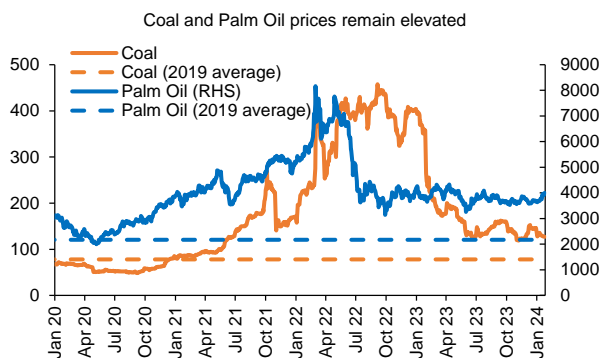
### ‘Cold’ Commodities

Adding to rupiah’s woes is the **dimmed outlook on Indonesia’s key exports, and consequentially a return to current account deficit on a lower goods trade surplus**. For one, **growth beta of Indonesia’s coal** looks to be low in the coming quarters. While **Chinese coal demand for coal has grown in 2023, plummeting demand by India and Japan dragged overall prices down**.

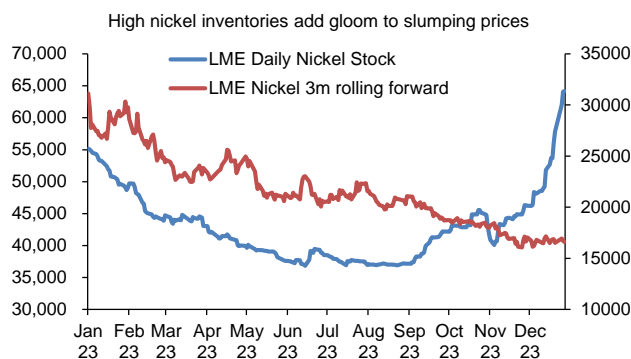
Subdued coal prices (with some room to fall further) would mean that effects of worsening terms of trade would likely outweigh any improvement in demand for coal, depressing Indonesia’s goods trade balance. Moreover, downside risks on China growth could dent coal demand while the removal of restrictions on Australian coal imports in January 2023 (imposed in late 2020) means that Indonesia could be subject to further substitution from the higher calorific Australian coal.



Meanwhile, elevated nickel inventory levels do not bode well for nickel prices amid reports of mines closing, as supply appears to be outstripping demand. While **palm oil prices could impart some support from El-Nino induced price shocks, it is likely insufficient to turn the (reversion) tide back to a current account deficit on a smaller goods balance surplus**.



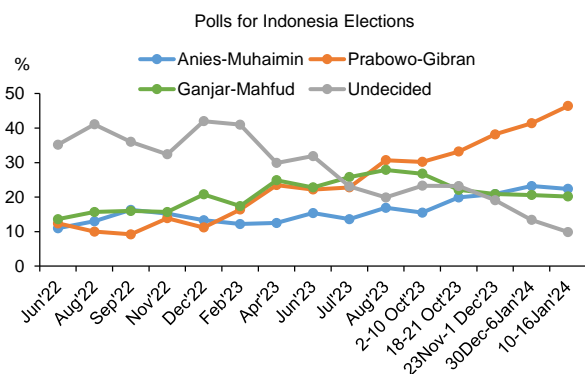
Source: Bloomberg; Mizuho Bank



Source: Bloomberg; London Metal Exchange; Mizuho Bank

### Political Uncertainty Premium

The overhang of the upcoming elections on 14 Feb could see policy and political risk premia depressing the IDR, especially in the coming weeks.



Source: Indikator Indonesia; Mizuho Bank

#### Elections Timeline

- 28 Nov'23 – 10 Feb'24: Campaign period (First round)
- 11 Feb'24 – 13 Feb'24: Blackout period
- 14 Feb'24: Voting day
- 14 Feb'24 – 15 Feb'24: Vote counting
- 15 Feb'24 – 20 Mar'24: Recapitulation of vote counting results
- 2 Jun'24 – 22 Jun'24: Campaign period (Second round)\*
- 23 Jun'24 – 25 Jun'24: Blackout period\*
- 25 Jun'24: Voting day\*
- 26 Jun'24 – 27 Jun'24: Vote counting\*
- 27 Jun'24 – 20 Jul'24: Recapitulation of vote counting results\*
- 20 Oct'24: President and Vice President sworn in

\*Second round takes place only if no candidate pair manages to secure at least 50% of votes in the first round.

On the elections, **Prabowo-Gibran pair has widened their lead to 46.4% and remains the front runner** to win the elections. Despite the lead, our base case is for elections to proceed to the second-round (i.e. no candidate pair secures at least 50% of votes), given the proportion of undecided voters in polls and adjustment for swing voters and margin of error in the polls.

Nonetheless, we think there remains a one-third possibility for **Prabowo-Gibran to win in the first round**. Should a **Prabowo-Gibran first round win materialise, IDR may stage a brief rally that dissipates quickly**. Point being, rupiah weakness arguably on rumours of cabinet rifts (including potential resignation by current Finance Minister Indrawati who had steered the budget deficit back within 3% of GDP post-pandemic) had triggered BI's FX interventions (on rupiah weakness). The fact that IDR appears vulnerable to tensions within the current government **alludes to underlying concerns on policy continuity**, as Jokowi's backing of a candidate not from PDI-P party and higher expenditure requirements of Prabowo's pledges risks **potential fiscal slippages and political friction**.

The **likelihood of second round elections on 26 June would likely imply that marginal IDR weakness will be prolonged regardless of the second placing**. Fact is, either Ganjar-Mahfud (PDI-P's presidential candidate) or Anies-Muhaimin pair proceeding to the second round could potentially lead to **divisions in the electorates along people, party and/or policy lines**. While Ganjar-Mahfud (PDI-P's presidential candidate) pair is broadly aligned with Jokowi's policy directions, especially on key projects such as the new capital city (Nusantara) project and to continue the "downstreaming" policy, Ganjar-Mahfud might

need to play on dissociating PDI-P and Jokowi in a bid to differentiate himself and his economic policy views. Consequently, underlying political fractions and cabinet fragmentation and the associated fiscal impact of pledges, would come to focus.

Conversely, Anies-Muhaimin pair proceeding to the second-round could prompt a knee-jerk IDR weakening, given Anies-Muhaimin stature as an opposition. Anies had openly voiced objections on the Nusantara project while Muhaimin had described Jokowi's "downstreaming" policy as "reckless", causing major environmental damage without significantly benefiting locals. IDR strength would likely remain subdued as we expect the debate on policy continuity to be fierce (at least in news headlines). Ironically however, if Ganjar-Mahfud drops out of the race, chances are tilted to Prabowo-Gibran pair taking the win in the second round given Jokowi's high approval rating and the pair appealing to voters who prefer continuity in Jokowi's policies.

All in, policy uncertainty could persist till the formation of the new cabinet and concrete policies are announced. In the meantime, diminished real rate advantage and "risk off" interruptions, which do not favour the rupiah, coupled with worsening external balances could see the IDR recovery underperform regional peers.

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