

Bank Indonesia's Fast Fading Mirage of Stability

In a nutshell: Relative IDR outperformance compared to regional peers can be attributed to a few reasons including tailwinds from commodity prices, a re-distribution in government bond ownership and fundamental improvements to growth. This has provided Bank Indonesia (BI) with a sense of comfort around its reaction function, where it has laid emphasis on growth and core inflation rather than headline inflation, which it officially targets within a 2-4% range. To be fair, BI's argument had merit given that the economic recovery was uneven and halting on account of COVID related restrictions.

However, Q2 GDP growth of 5.4% YoY from 5.0% in Q1 shows that GDP is clearly back to pre-COVID levels and the need for crisis level policy accommodation has passed. More importantly, price pressures have built significantly in the past few months with not only headline inflation exceeding the target range (July: 4.9% YoY) but also core inflation rising sharply.

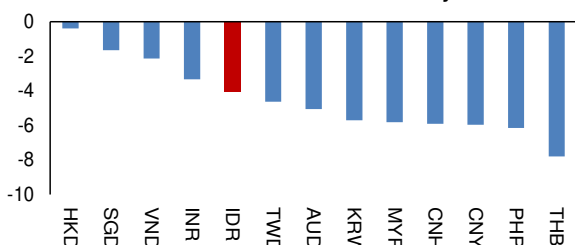
BI's insistence that Reserve Requirement Ratio hikes, FX intervention and selling bonds in the primary market are sufficient to handle these price pressures may be hitting a wall. With it, BI's mirage of contained macro stability risks may vanish. Global financial conditions will get tighter as the US Fed, ECB and other Asian central banks remain on rate hiking trajectory, exacerbating interest rate differentials and the risk of capital outflows for Indonesia. Even though Indonesia's external vulnerabilities have reduced from reduced foreign ownership of government bonds and a status change from a 'twin deficit' to a solely fiscal deficit country, it is not immune. Moreover, as stagflation pressures take hold, BI is looking increasingly behind the curve.

In any case, BI is unlikely to raise rates by our initially expected 150bp in 2022. We, therefore, trim our expectations regarding the magnitude of BI's hiking cycle to a cumulative 100bp in 2022, taking the policy rate to 4.50% by end-2022. BI's more conservative rate hiking cycle will put pressure on USD/IDR, which we expect will underperform regional peers in Q3 and Q4 2022.

IDR Stability: A Source of Comfort

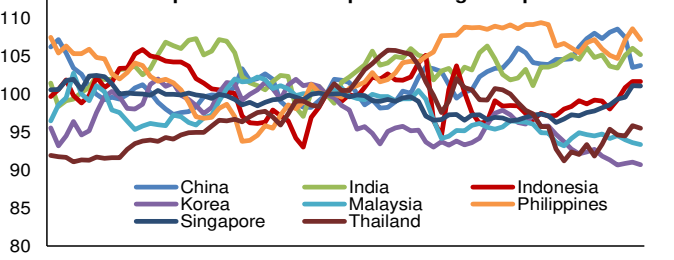
IDR has outperformed most regional peers so far this year. Given IDR's tendency to sell-off sharply during times of risk aversion, this outperformance has proved timely. External factors ranging from the Ukraine-Russia situation, the Fed's tightening drive and China's adherence to strict pandemic control policies have weighed on risk sentiment, exerted significant downward pressure on global growth, and dragging EM Asia currencies lower versus the USD. **But IDR's contained depreciation is not only noteworthy versus USD but also in REER terms, the currency basket has appreciated versus regional peers.** This has given BI a sense that associated macro stability risks have diminished.

% change versus USD IDR outperformance versus regional peers has been noteworthy



Source: Bloomberg; Mizuho Bank. Time period: 16 March 2022 to 3 August 2022

REER appreciation underscores currency outperformance compared to regional peers



Source: BIS; Mizuho Bank

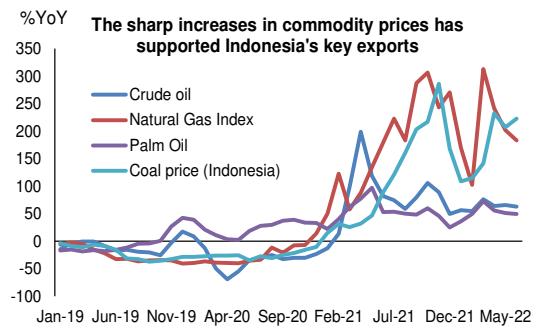
There are some important factors, which we discuss more in detail below, that are contributing to IDR stability. Top of

which is **Indonesia's status as a net commodity exporter**. This is benefitting not only the current account balance but also providing the government with windfall revenues to cushion against higher subsidy spending. Along with this, is a **shift in government bond ownership composition has reduced vulnerabilities** around portfolio outflows while **Indonesia's firm recovery out the pandemic has boosted confidence** around medium-term growth prospects.

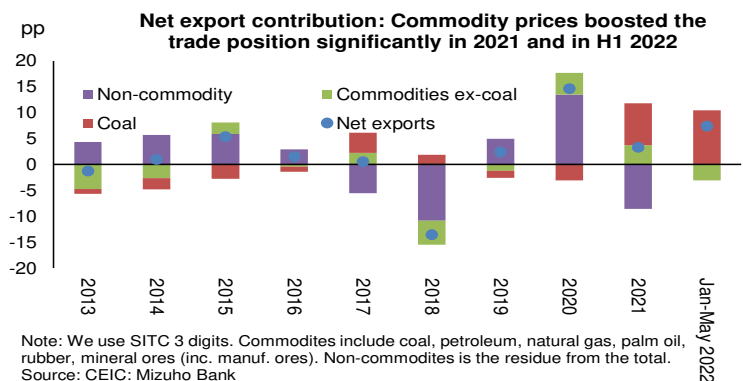
Global commodity price boost providing external support...

Global commodity prices rose in H2 2021 and into 2022, proving to be the bane of most policymakers' existence. However, **for Indonesia, this has squarely been a boon**. As a net commodity exporter, **the positive terms of trade for coal, palm oil, mineral ores and rubber exports were obvious in 2021** and has to some extent been brought forward to this year. We estimate that the contribution of net commodity export to the overall trade surplus for January to May 2022 was 7.3 out of the total 7.4 percentage points (pp) increase.

Within this, **coal was the biggest contributor (10.4pp) while petroleum shaved off 7.6pp in terms of net contribution**, highlighting Indonesia's Achilles Heel as a net commodity exporter but a net oil importer. Palm oil was a negative contributor mainly on account of the government's embargo, which lasted from 28 April to 23 May. Notwithstanding, the boost from coal was enough to push the net export contribution to above that of 2021.



Note: Crude oil is the average of Brent and WTI prices, Coal prices are from Indonesia's Directorate General of O&G; Source: CEIC, Mizuho Bank.

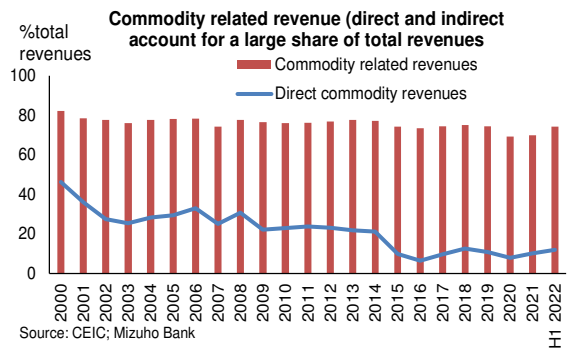


Note: We use SITC 3 digits. Commodities include coal, petroleum, natural gas, palm oil, rubber, mineral ores (inc. manuf. ores). Non-commodities is the residue from the total. Source: CEIC; Mizuho Bank

The positive terms of trade from commodity prices boosted the current account balance to 0.4% of GDP in Q1 2022 from 0.3% in 2021. With the trade surplus widening to USD15.5bn in Q2 from USD9.3bn in Q1, the current account surplus looks set to widen in Q2. This led BI to revise its forecast range for the current account to "surplus 0.3% - deficit 0.5% of GDP" from a previously expected deficit range of '0.5 to 1.3% of GDP' at its 21 July policy meeting.

...and fiscal buffers

The fiscal out-performance in H1 2022 has mainly been driven by higher revenue collections. Direct commodity revenues including oil & gas income tax revenues as well as natural resources linked non-tax revenues accounted for ~10% of total revenues (1.2% of GDP) in 2021. Indirect commodity related revenues were, however, much larger at ~70% of total revenues (8.2% of GDP) as it includes non-O&G direct tax revenues (of which corporate tax is a large portion and is correlated to commodity prices) as well as higher import VAT



Source: CEIC; Mizuho Bank

(related to higher global oil prices)¹. **It is then no surprise that total revenues grew by 48.5% YoY in H1 2022, with collections at over 70% of the proposed budget.** Within this, O&G revenues and natural resources reached over 90% of the proposed target.

A revision of the budget under these circumstances is an obvious move. The government estimated windfall revenues of ~2.3% of GDP in mid-May; 1.5% from tax revenues and 0.8% from non-tax revenues. This budget 'outlook' has been revised again in August (however, we do not have a detailed breakdown). According to the May budget 'outlook', a large proportion of this revenue windfall will be deployed to allow for direct fuel and utility spending (0.4% of GDP) but also indirectly to compensate the State Owned Enterprises of Pertamina and PLN for bearing the losses on their balance sheet (1.5% of GDP). There will also be an increased budget directed towards social protection (0.2% of GDP) to help cushion against a broader increase in prices.

As such, **the fiscal deficit for 2022 will be narrower than the initially budgeted 4.9% of GDP.** The math above suggests that the deficit will shrink to 4.5% of GDP. However, given the sustained uptrend in coal, petroleum and certain mineral ore prices, the government's latest iteration has pegged the deficit to be even lower at 3.9% of GDP². Either way, the financing needs will be far reduced compared to the original budget. This reduced financing will help keep Indonesia's public debt to GDP ratio contained (2021: 40.7% of GDP).

IDRtrn	2019	2020	2021	2022				
	Actual	Actual	Actual	Proposed Budget	%YoY	H1 outturn	%YoY	% of budgeted
Government Revenue and Grant	1960.6	1647.8	2003.1	1846.1	6.4	1317.2	48.5	71.3
Tax revenue	1546.1	1285.1	1546.5	1510.0	9.8	1035.9	52.3	68.6
Income tax	772.3	594.0	696.5	680.9	10.7	562.6	72.9	82.6
O&G	59.2	33.0	52.9	47.3	3.4	43.0	92.9	91.0
Non O&G	713.1	561.0	643.7	633.6	11.3	519.6	71.4	82.0
VAT	531.6	450.3	551.0	554.4	10.5	300.9	38.2	54.3
Excises Duties	172.4	176.3	195.5	203.9	11.9	167.6	83.5	82.2
International	41.1	36.7	73.5	41.1	-19.7	46.1	49.2	112.2
Import Duties	37.5	32.4	38.9	35.2	6.0	23.1	30.4	65.7
Export Tax	3.5	4.3	34.6	5.9	-67.1	23.0	74.6	388.7
Non tax revenue	409.0	343.8	452.0	335.6	-6.1	281.0	35.8	83.7
Oil & Gas	121.1	69.1	0.0	85.9	-9.5	74.6	74.6	86.8
Government Expenditure	2309.3	2595.5	2786.8	2714.2	0.6	1243.6	6.3	45.8
Central Government	1496.3	1833.0	2001.1	1944.5	0.9	876.5	10.1	45.1
Personnel	376.1	380.5	387.6	426.5	6.8	210.3	-0.1	49.3
Material	334.4	422.3	525.4	339.7	-17.3	142.9	-19.9	42.1
Capital	177.8	190.9	241.5	199.2	-7.4	56.8	-20.7	28.5
Subsidies	201.8	196.2	243.1	207.0	-16.7	96.4	20.6	46.6
Energy	136.9	97.4	140.4	134.0	4.3	75.6	27.0	56.4
Non Energy	64.9	98.8	102.7	72.9	-39.3	20.8	2.1	28.5
Social Assistance	112.5	202.5	173.6	147.4	-21.2	71.2	-6.3	48.3
Transfer to regions & village funds	813.0	762.5	785.7	837.6	-0.5	367.7	-1.7	43.9
Government Deficit or Surplus	-348.7	-947.7	-783.7	-868.0		73.6		
% GDP	-2.20	-6.14	-4.62	-4.85				

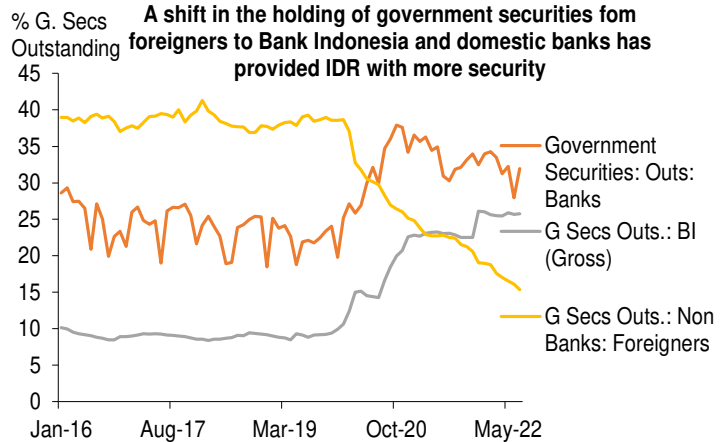
¹ Learning more, growing faster, Indonesia Economic Quarterly, June 2018, World Bank (page 18)

² The details around this iteration, also known as 'outlook', are not yet available.

Reduced foreigner ownership of government bonds

The government’s decision to directly finance the fiscal deficit in 2020 by buying bonds in the primary market has helped keep financing mainly on the domestic debt side. **It has also led to a redistribution of government debt away from foreigners to Bank Indonesia and commercial banks.**

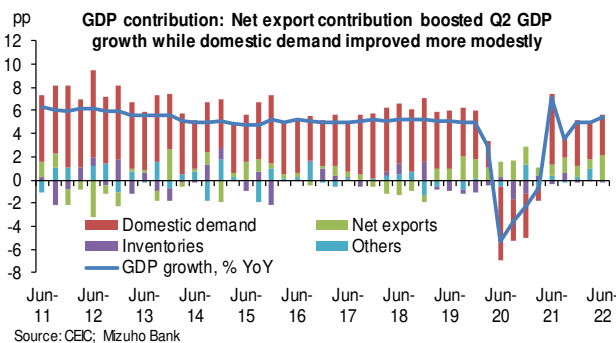
This has, to a large extent, **mitigated the volatility associated with debt outflows during times of peak risk aversion. And has supported IDR more** compared to past episodes of external stress, where the high proportion of foreigner ownership of government bonds has been a key source of vulnerability.



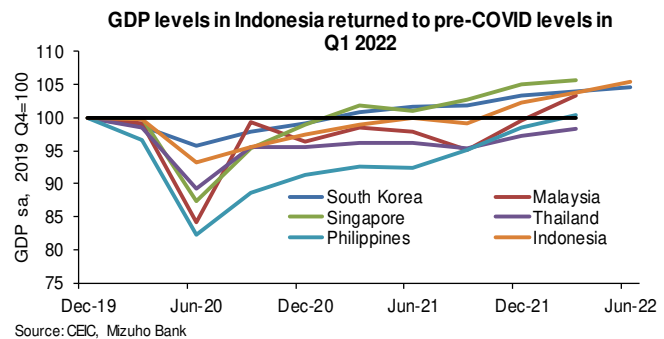
Source: CEIC; Mizuho Bank

Growth stabilising at above pre-Covid levels

More fundamentally, GDP is back to pre-COVID levels. As a corollary to the external and fiscal buffers provided by the commodity price boom, GDP growth has also been supported. The economy grew by a higher-than-expected 5.4% YoY in Q2 from 5.0% in Q1 driven mainly by a significantly higher contribution from net exports (2.1 percentage points in Q2 from 0.8 in Q1) while domestic demand improvements (3.5pp from 3.2pp in Q1) were more modest and driven by private consumption more than offsetting still weak government consumption and lower investment growth. **Looking ahead, we expect the bump in Q2 growth from commodity price tailwinds might fade slightly but growth of around 5% for H2 2022 could still imply a stabilisation of GDP levels above pre-COVID levels, by our estimates.**



Source: CEIC; Mizuho Bank



Source: CEIC; Mizuho Bank

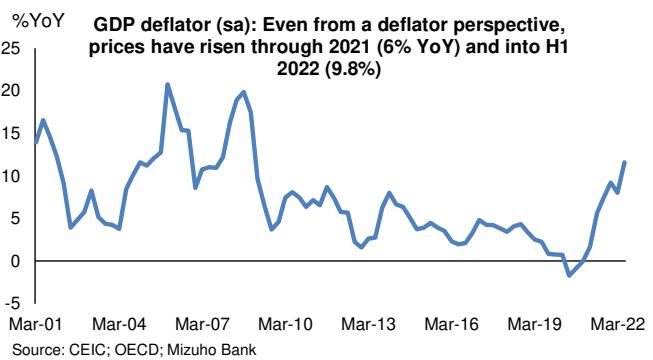
The Mirage Is Fast Fading

The strong economic recovery and uptrend in GDP begs the question around why BI has kept its policy rate at a crisis level low and has remained focussed on supporting the economic recovery. Especially since the cost of focusing on growth is sharply higher inflation and broad price pressures.

Growth focus is taking away from inflation pressures...

Headline inflation jumped to 4.9% YoY in July from 4.3% in June, well above BI’s 2-4% target range, while core

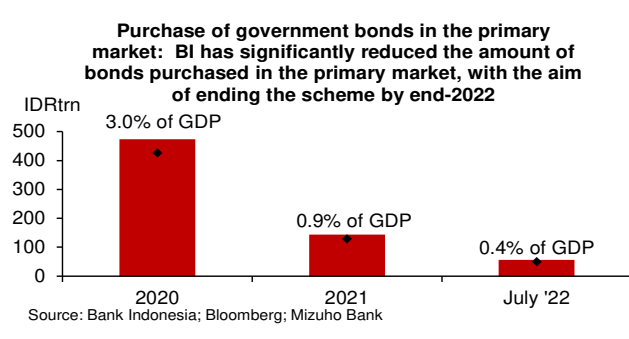
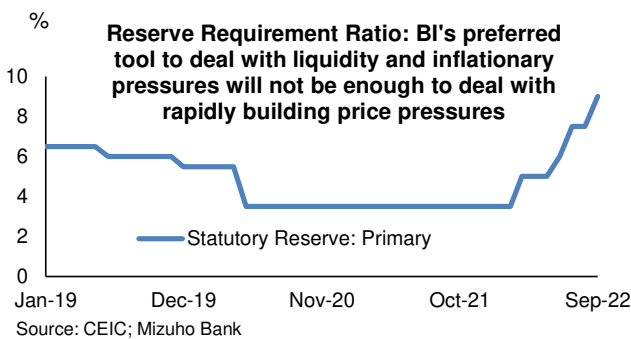
inflation picked up to 2.9% YoY from 2.6% in June. This clearly shows that price pressures are building and becoming broad-based. BI has argued that its focus on core rather than headline inflation speaks to underlying pressures as the latter is influenced by volatile food prices, which is a more a function of supply-side constraints rather than demand-side factors. While this may be true to some extent, COVID associated supply chain disruptions and the consequence of ongoing Ukraine-Russia tensions has blurred the lines between supply and demand side drivers. In fact, growth in the GDP deflator underscores that prices have been rising through 2021. Growth in the GDP deflator picked up to 9.8% YoY in H1 2022 from 9.3% in Q4, reinforcing the argument that price pressures are building.



This is to say that inflationary pressures can become broad-based and pervasive in a relatively short period of time as supply shortages feed into demand shortfalls and lead to a cycle of rising prices. For this reason, **BI cannot afford to throw caution to the wind.** Furthermore, rising price pressures will erode real incomes and hurt purchasing power, in turn hurting private consumption spending, the largest contributor to GDP growth. The point in time where such a switch happens is hard to determine.

...And Attendant Macro Stability Risks

To BI's credit, it has started to absorb excess liquidity through incremental Reserve Requirement Ratio increases through to September 2022. It has also begun tightening policy via non-rate means such as selling government bonds in the secondary market, with the aim of bringing the bond buying scheme to a close by end-2022. BI bought bonds worth IDR673trn (4.2% of 2019 GDP) in the primary market to support government efforts in tackling the pandemic in 2020, 2021 and YTD 2022. **Unwinding BI's balance sheet, a step in the right direction, will help mitigate risks around the mispricing of government bonds or excessive debt monetisation.**

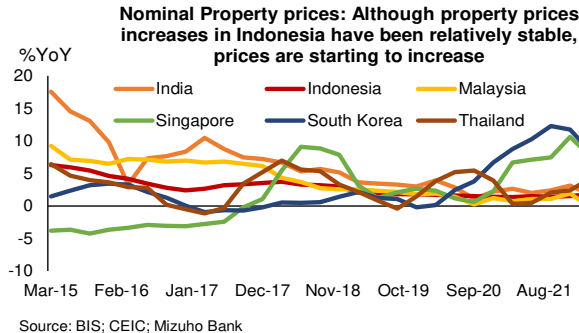
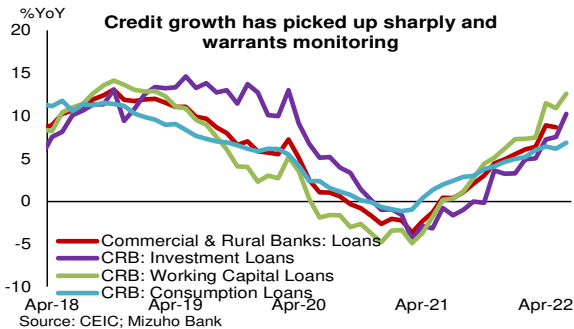


BI's argument so far has been that these non-rate measures are adequate to normalise liquidity conditions and keep inflationary pressures in check. However, **these are fast approaching their limit. Credit growth is rising in a more broad-based manner and property price increases, while still moderate, are trending upwards.** With the recovery taking hold, the unemployment rate declining and wages rising, **a low policy rate environment risks overstimulating credit growth and creating an asset bubble.**

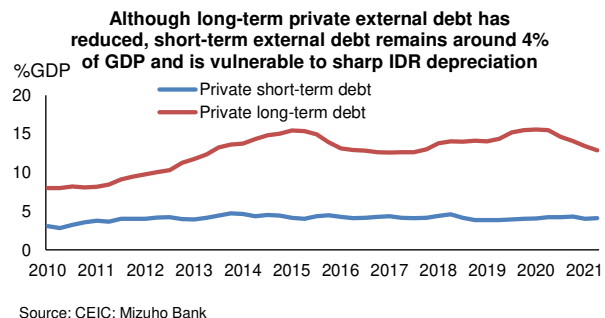
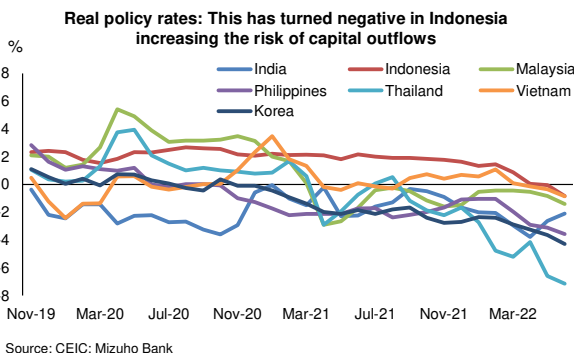
Looser macroprudential policies introduced by BI in 2020 and 2021 have to some extent contributed to this boost in credit growth, intended to a large extent. But with some of these policies having expired (on easier credit cards repayments) and set to expire by the year-end (looser property and home loans down payments), elevated levels of credit growth warrant monitoring.

Macroprudential policies introduced by BI during 2020/2021 to support credit growth		
Sector	Policy measure	Expiry Date
Property and Housing	Maintaining looser downpayment requirements on automotive loans/financing at 0% for all types of new motor vehicle	31-Dec-22
	Maintaining a looser Loan/Financing-to-Value (LTV/FTV) ratio on property loans/financing to a max of 100% on all property types for banks meeting specific NPL/NPF criteria	31-Dec-22
Credit cards	(a) Minimum payment equal to 5% of the outstanding balance	30-Jun-22
	(b) Late payment penalty equal to 1% of the outstanding balance or a maximum of Rp100,000	30-Jun-22
Banks	(i) the Countercyclical Capital Buffer (CCyB) at 0%	n.a.
	(ii) the Macroprudential Intermediation Ratio (MIR) in the 84-94% range with a lower disincentive parameter of 80% (1st September-31st December 2021) and 84% (1st January 2022), and	
	(iii) the Macroprudential Liquidity Buffer (MLB) at 6% with repo flexibility at 6%, and the Sharia Macroprudential Liquidity Buffer (SMLB) at 4.5% with repo flexibility at 4.5%	n.a.

Source: Bank Indonesia; Mizuho Bank



Moreover, **the real rate environment has turned negative (when judged from a headline inflation basis), and with it the risk of capital outflows has risen.** So far, BI has chosen to run down FX reserves to lean against IDR depreciation pressures. To say, BI's intervention approach in limiting USD/IDR moves is hitting a limit maybe an unfair assessment at this point given that BI has successfully kept the exchange rate below 15,000. However, **historical precedence suggests that when USD/IDR comes under pressure, the rate of IDR depreciation is quick and painful pushing BI to deploy deeper lines of defence.**



This also remains a concern in terms of the external debt profile. While external debt to GDP has remained low at 35.1% of GDP, short-term private sector external debt has risen more sharply in recent quarters. Although BI has encouraged corporates to hedge and compliance around these rules are increasing, corporate balance sheets will still be impacted by undue IDR depreciation.

But Is BI Being Prescient Around Growth Risks?

The argument that the economy is running hot could turn cold if, as the authorities have started to recognise, commodity tailwinds fade, in late 2022 and Q1 2023³. Under these circumstances, fiscal and external buffers provided by elevated commodity prices will unceremoniously unwind, hitting GDP growth with risks around a recession rising. This supports BI's continued focus on bolstering the economic recovery. **However, this argument is not without serious pitfalls.**

An unwinding of the commodity price buffer, especially in the face of rising recession risks, will return Indonesia's to its 'twin deficit' status on the current account and fiscal balance. Fiscal consolidation will likely be compromised as the windfall revenue gains in 2021 and H1 2022 fade fast. This will automatically make Indonesia more vulnerable to capital outflows, especially at a time when real returns are negative (at least to begin with); exacerbating IDR depreciation pressures. Worse still, an already elevated inflation environment will have eroded consumer spending capacity, weighing on growth.

Ironically, this is the very thing that BI is trying to protect against. Hence, **while BI is being prescient in terms of assessing the rising probability of a recession, the associated 'stagflation' risk maybe more pronounced.** This will put BI squarely behind the curve in terms of addressing inflationary pressures, with rate hike 'catch-ups' proving more painful for growth.

No Time Like the Present for BI

The upshot for BI is that there is no time like the present when it comes to beginning the process of monetary policy normalisation. **But the timeline for normalisation is increasingly being obfuscated by BI's insistence that inflationary pressures, as underscored by core inflation, are low and that growth support remains a priority.** Following the elevated July CPI release, BI Governor Perry Warjiyo claimed that core inflation was still low and below BI's forecast of 3.0% (Actual: 2.9%)⁴. As such, BI seems to be digging its heel into its position that growth support is a bigger priority than inflation management at this stage.

This implies that BI is unlikely to raise rates by our initially expected 150bp in 2022. **We, therefore, trim our expectations regarding the magnitude of BI's hiking cycle to a cumulative 100bp in 2022, taking the policy rate to 4.50% by end-2022.** Given the mix of strong growth and elevated inflation, we expect BI to start hiking rates by 25bp at its 23 August meeting. BI's more conservative rate hiking cycle will put pressure on USD/IDR, which we expect will underperform regional peers in Q3 and Q4 2022.

³ Indonesia cuts 2022 fiscal deficit outlook on strong revenue, says finance minister, The Star, 3 July 2022.

⁴ Core Inflation Lower Than BI's Target, Interest Rates On Hold Again, Mr. Perry?, Voi.id, 2 August 2022.

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