MNI Bank Indonesia – June 2022

Announcement Date: Thursday, 23 June 2022

Announcement Time: 08:20 BST/16:20 WIB

Link To Statement: https://www.bi.go.id/en/statistik/indikator/bi-7day-rr.aspx

MNI Point of View: Under Pressure

Our base-case scenario for this week's meeting is no change to the 7-Day Reverse Repo Rate, given that core inflation remains under control. However, we concede that hawkish risks have increased since the Board of Governors last met and a 25bp rate hike cannot be ruled out, as pressures are growing both domestically and internationally.

Fig 1: BI Real Policy Rate Falls Into Negative Territory

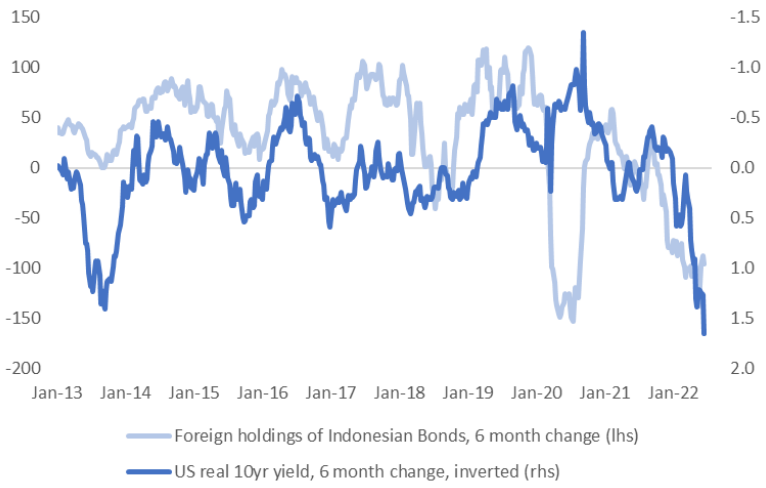

Fig 2: U.S. Real Yield & Foreign Holdings Of Indonesian Bonds

Intensifying inflationary pressures remain a common theme virtually around the globe, weighing on household budgets and amplifying the decline in Indonesia's real interest rates. The chart below plots the real yield for Indonesia, the policy rate less headline inflation. This has fallen into negative territory and will decline further given BI projects headline inflation to surpass +4.0% Y/Y, which marks the upper end of the target range. Such a backdrop comes at a time when US real yields have surged to 70bps, which is highs back to 2019.

The second chart overlays the 6 month change in U.S. real yields against the 6 month change in foreign ownership of Indonesian bonds. Note the yield change is inverted on the chart. Foreign holdings of Indonesian bonds are now back to 2017 levels. Whilst Indonesia's external position is much healthier compared to previous cycles, the current account is still expected to swing back into deficit this year, hence capital flows could become more important as the year progresses. This is likely to entail BI boosting the Indonesia yield premium as the FOMC continues to adjust rates higher.

Furthermore, the rupiah has now lost ground, in line with regional trend, after largely trading sideways through late April. Sharp appreciation in the greenback pushed USD/IDR to levels last seen in October 2020. Other measures used by BI to measure rupiah stability have also been flashing red lights, with 10-Year yield spread with the U.S. narrowing and 5-Year CDS premium trending higher. Rupiah stability is a critical part of

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broader financial stability, which is likely to take on increasing role this year, in line with the Bank's pivot from a pro-growth to a pro-stability stance. In light of this dynamic, one could expect that current market conditions would nudge the Board of Governors in the hawkish direction. For now, rupiah weakness has been addressed through an intervention in spot and domestic NDF markets announced last week, but the broader economic backdrop keeps creating headwinds for the rupiah.

Importantly though, while annual CPI growth is expected to show above +4.0% later this year, Bank Indonesia has flagged that it is paying closer attention to core inflation, which remains below the mid-point of the target range, and is not forecast to rise past the ceiling of the Bank's tolerance band.

On top of that, official communique surrounding the last meeting of the Board of Governors did not signal any sense of urgency to lift the main policy rate, with the central bank still biased towards ensuring a sustainable post-COVID recovery. The Bank's deputy chief Waluyo noted that policymakers want to get ahead of inflation, but their first tool of choice would be further RRR adjustments. Raising the key policy rate is the "second instrument" and could be used "if there's any indication that core CPI will be above our target."

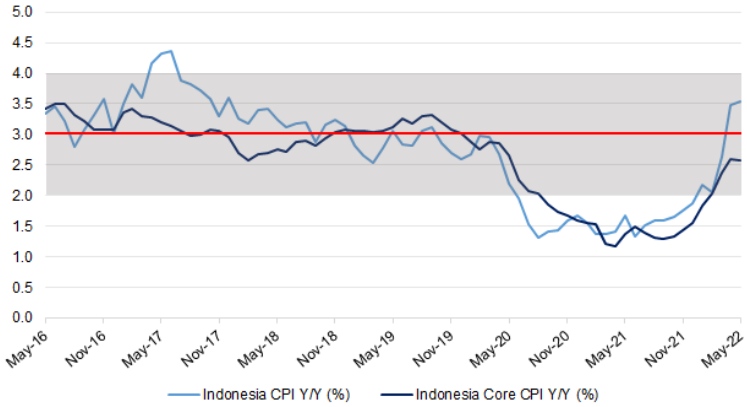

Fig. 3: Indonesia Headline Vs. Core CPI Y/Y (%)

The red line represents the mid-point of the target range (shaded region).

In his most recent public address, Governor Warjiyo reiterated the expectation that headline inflation will reach +4.2% Y/Y in 2022, but added that "core inflation and inflation expectations can still remain in the range of +2.0-4.0% Y/Y this year and next." He also contrasted Indonesia's relatively benign inflation situation with that of other countries, that are experiencing double-digit price growth rates and tipped hat to a suite of subsidies rolled out by the government to mitigate the domestic fallout from the increase in global food and energy prices.

All that considered, we suspect that Bank Indonesia will take advantage of benign core inflation outlook and stand pat this week, although adjustments to the planned RRR hikes are possible, and a 25bp hike to the 7-Day Reverse Repo Rate cannot be entirely ruled out. Still, continued acceleration in consumer price growth, capital outflows caused by narrowing yield differential with the U.S. and ongoing rupiah depreciation will keep pressuring Bank Indonesia to act, likely resulting in the beginning of the tightening cycle early into the second half of the year.

Bank Indonesia May Monetary Policy Statement:

The BI Board of Governors Meeting agreed on 23th and 24th May 2022 to hold the BI 7-Day Reverse Repo Rate at 3.50%, while also maintaining the Deposit Facility (DF) rates at 2.75% and Lending Facility (LF) rates at 4.25%. The decision is consistent with the need to manage inflation and maintain exchange rate stability, while continuing to foster economic growth amid escalating external pressures stemming from the geopolitical tensions between Russia and Ukraine as well as faster monetary policy normalisation in several advanced and developing economies. Therefore, Bank Indonesia is bolstering its policy mix as follows:

1. Strengthening exchange rate policy to maintain Rupiah stability in line with market mechanisms and economic fundamentals.
2. Accelerating liquidity policy normalisation by incrementally raising Rupiah reserve requirements as follows:
   a) Bank Indonesia will raise the Rupiah reserve requirements for conventional commercial banks from 5.0% currently to 6.0% on 1st June 2022, to 7.5% on 1st July 2022 and to 9.0% on 1st September 2022.
   b) Bank Indonesia will raise the Rupiah reserve requirements for sharia banks and sharia business units from 4.0% currently to 4.5% on 1st June 2022, to 6.0% on 1st July 2022 and to 7.5% on 1st September 2022.
   c) Bank Indonesia will provide 1.5% remuneration to banks fulfilling reserve requirements obligations after taking into account the incentives for banks disbursing loans/financing to priority sectors and MSMEs and/or meeting the target Macroprudential Inclusive Financing Ratio (RPIM).
   d) The higher reserve requirements will not affect the banking industry's ability to disburse loans/credit to the corporate sector or purchase SBN to fund the State Revenue and Expenditure Budget (APBN).
3. Increasing incentives for banks disbursing loans/financing to priority sectors and MSMEs and/or meeting the target Macroprudential Inclusive Financing Ratio (RPIM) from 1st September 2022 as follows:
   a) Relaxing statutory reserve requirements (SRR) by a maximum of 2%, namely through an incentive for disbursing loans/financing to priority sectors up to a maximum of 1.5% from 0.5% previously, with the maximum incentive for achieving the target RPIM remaining at 0.5%.
   b) Expanding the scope of priority subsectors from 38 to 46 across three categories, namely resilient sectors, growth drivers and slow starters.
   c) The incentives aim to increase the banking industry's contribution to inclusive financing and the national economic recovery.
4. Maintaining prime lending rate transparency in the banking industry with a focus on lending rates for priority sectors.
5. Maintaining support for MSME development through the Karya Kreatif Indonesia (KKI) expo to support the economic recovery, including the National BBI Movement promoting pride in Indonesian-made products and Proud to Travel in Indonesia Movement (GBWI).
6. Strengthening payment system policy to reinforce economic recovery and accelerate inclusive digitalisation by:
   a) Extending the grace period on a minimum credit card payments and late fees from 30th June 2022 previously to 31st December 2022 to support credit card transactions while mitigating credit risk.
   b) Extending the 0% QRIS merchant discount rate (MDR) for micro merchants from 30th June 2022 previously to 31st December 2022 to continue efforts to expand the digital ecosystem and boost transactions, particularly amongst MSMEs.
7. Strengthening international policy by expanding cooperation with other central banks and authorities in partner countries, promoting trade and investment in priority sectors in synergy with the relevant institutions as well as ensuring the success of the six priority agendas in the Finance Track of Indonesia's G20 Presidency in 2022 in conjunction with the Ministry of Finance.

Bank Indonesia constantly monitors inflation developments and institutes the measures necessary to manage inflation within the predetermined 3.0%±1% target corridor set for 2022 and 2023. Towards that end, synergy with the central and regional governments through national and regional inflation control teams (TPIP and TPID) is constantly strengthened. Seeking to maintain macroeconomic stability and accelerate the national economic recovery, Bank Indonesia continues to build monetary and fiscal policy coordination with the Government, while remaining committed to purchasing SBN totalling Rp224 trillion in 2022 to fund the health and humanitarian budgets in the State Revenue and Expenditure Budget (APBN). Similarly, coordination under the auspices of the Financial System Stability Committee as well as bilateral coordination between Bank Indonesia and the Financial Services Authority (OJK) are continually strengthened to maintain financial system stability.

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Sell-side comments:

ANZ: Bank Indonesia(BI) has signalled that its priority remains to support the economic recovery and that it is not in any hurry to raise the policy rate. It holds the view that the recent rise in inflation has been driven primarily by supply shocks and has made clear that its focus is on core inflation; the latest May print of 2.58% y/y suggests scope for patience. That said, significant pressure on the IDR could trigger a pivot given its mandate on currency stability. The IDR has been among the region's worst performers following a strong US CPI print that fuelled concerns about a more aggressive US Fed move. BI also stands out as being the only major central bank in the region outside of mainland China to maintain a dovish stance. Overall, BI's upcoming rate decision will probably boil down to how the IDR holds up. Unless the current pressure on the IDR abates in the lead-up to the meeting, we think the more prudent move is a rate hike, or at least clear signals that a rate lift-off is near. The absence of a change in stance could risk BI being perceived as the standout regional laggard and intensify pressure on the IDR.

Barclays: Bank Indonesia (BI) will likely leave its policy rate unchanged, in our view, citing still-manageable core inflation and taking comfort in its May announcement of faster and larger increases in banks' reserve requirement ratio (RRR) to absorb excess liquidity.

DBS: At the last rate review, signs of an imminent shift towards rate hikes were largely absent, premised on manageable inflation and a stable currency. In subsequent weeks, dollar appreciation and narrower trade surpluses have weighed on the rupiah, whilst pushing push risk-free yields up. We don't expect a rate hike to materialise this week, but markets will scrutinise the accompanying commentary to infer if a shift in stance is forthcoming. Bank Indonesia's policy dashboard is likely to broaden from being focused on domestic growth and inflation path, to include financial stability and outflow risks on falling real yields, paving the way for a start to the hiking cycle from July. We maintain our view for 75bp hikes in 2H22.

Goldman Sachs: We expect Bank Indonesia (BI) to keep the 7-day reverse repo rate unchanged at 3.5%, in line with consensus. Headline and core inflation in May remains within BI's 2-4% target band although headline inflation could potentially breach the upper end of the target as soon as June as pressure from high commodity prices builds and a low base from last year. We continue to expect BI to hike 50bp in Q3 and 75bp in Q4 for a total of 125bp of hikes this year and another 100bp of hikes in H1 2023. However, we acknowledge some risk that BI may start to normalize policy earlier than our expectation (i.e. hike by 25bp this coming week), given the weakening in USDIDR and pressure from expedited rate hike from the Fed, although this is not our base case.

ING: Bank Indonesia previously hinted at a pause for the forthcoming meeting, citing still manageable inflation and a steady currency. The Indonesian rupiah, however, has recently come under heavy pressure, all the more with the trade surplus shrinking considerably to $2.9 bn from $7.5 bn. We expect BI to finally deliver a rate hike although Governor Perry Warjiyo may opt to start off the hiking cycle with a token 25bp increase, citing the simultaneous increase in reserve requirements.

Morgan Stanley: We expect Bank Indonesia to lift off at its June meeting, raising the 7-day reverse repo rate by 25bp to 3.75%. Rate normalization is a likely natural next step to recent RRR hikes, which were accelerated last month and aimed primarily at absorbing excess liquidity in the system. BI has indicated that inflation and currency trends are what it would pay attention to when thinking about its policy rate decision. Our expectation of a lift-off in June is predicated on our view that headline inflation is likely to hover above the top end of BI's inflation target range of 2%-4% in 3Q22 given the cyclical recovery from reopening and positive terms of trade impact, earlier VAT hike, higher commodity prices and planned increases in electricity tariffs. On the currency side, IDR has held up better than most other AXJ currencies this year given the commodity price support. Nonetheless, with the pace of foreign capital inflows already somewhat "restrained" in recent months, BI may also take into consideration potential pressures from the Fed's aggressive moves and the policy rate normalisation elsewhere in Asia. Looking ahead, we expect a further 25bp hike in the July meeting (to bring the benchmark rate to 4.0% by 3Q22),and then another 75bps hikes in 1Q23in response to our base case assumptions of a 25% retail fuel price adjustment in early 2023. Overall, we estimate that the real policy rate would be around neutral territory in 2023,and we continue to characterize such policy moves as policy normalisation rather than aggressive tightening.

Pantheon: We expect Bank Indonesia (BI) to keep the 7-day reverse repo rate unchanged at 3.5% at its meeting next week, in line with consensus. Headline and core inflation in May remains within BI's 2-4% target band although headline inflation could potentially breach the upper end of the target as soon as June as pressure from high commodity prices builds and a low base from last year. We continue to expect BI to hike 50bp in Q3 and 75bp

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Scotiabank: Consensus is somewhat divided. Most expect a 25bps rate hike but a fair minority think it could be 50bps. Lift-off for this central bank might start off tepidly in a balance between relatively modest inflation at 3 ½% y/y with core at about 2 ½%, versus currency instability driven by the outward pull effect of Fed policy tightening on capital flows. The rupiah has fallen by 3–4% since April.

Société Générale: We expect the BI to stay put for one last time during next week's meeting, though a hike cannot be ruled out. With the peak inflation theory falling through and the Fed finally raising the policy rate by 75bp (having averred in May that it would raise the policy rate by 50bp in both June and July) as inflation spiked beyond expectations, the BI may find it difficult to continue to hold on as global risk-off sentiment rises further. However, we expect the BI to stay pat during its June meeting and eventually start raising the policy rate starting from 3Q22. For quite some time now, Indonesia's monetary policy has been less about the impact of policy action on inflation and more about its impact on bond yields and currency, with a specific focus on trying to ensure the relative attractiveness of bond yields to foreigners. Since the onset of the pandemic, IndoGBs have become substantially less attractive to foreign holders, leading foreign holdings to drop from nearly 40% to less than 20% total holdings now. While that would ideally have led to a substantial spike in bond yields, Bank Indonesia's decision to opt for a debt monetisation scheme starting in 2020, then to extend it to 2021 and eventually to 2022, has kept yields under control. Also, as a commodity and net energy exporter, Indonesia has turned out to be a rare beneficiary of the spike in commodity prices which has translated into an ever-rising trade surplus and unprecedented tax buoyancy, which has in turn enabled the government to continue to subsidise prices and incomes. With inflation still below BI's upper tolerance level of 4.0%, the central bank will likely stay pat in June. However, with a deluge of policy rate hikes across the globe, an aggressive Fed, a sharply rising dollar index, a further decline in the relative attractiveness (read real bond yield differential) of IndoGBs and tepid global demand for its bonds, BI may opt for a rate hike at the upcoming meeting despite having a positive real rate, mainly due to artificially subdued inflation. We, therefore, think that a rate hike is inevitable (likely to be delivered during 3Q22) especially in the face of a coordinated global tightening.

TD: We expect BI to deliver a hawkish hold as it just upgraded its headline inflation forecast which we think is a signal to gradually tune markets to a shift in policy stance to a likely hike in July.

UOB: According to the Bloomberg poll (as of 17 Jun), of the 8 analysts surveyed, 5 expect no change to the 3.5% policy rate while 3 analysts expect a 25bps hike to 3.75%. We keep our view for BI to start hiking after mid-2022, with two 25bps hikes in 3Q22 to 4.00%, followed by another two 25bps hikes in 4Q22, taking its benchmark rate to 4.50% by the end of 2022.