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Global Economics & Market Strategy

Indonesia Rupiah: Sustained Weakening Above 16,000 Mark in 2024

- **We expect USD/IDR to remain elevated above 16,000 throughout 2024, reaching its peak in 2Q24, before stabilising on a flat trajectory towards the year-end.**
- **We recently revised our forecast for Bank Indonesia to keep the benchmark policy rate unchanged at 6.25% for 2024 and anticipate three 25 bps cuts in 2025, reducing it to 5.50%.**
- **Our econometric model result affirms our view and suggests that real interest parity is pivotal in determining USD/IDR exchange rates.**

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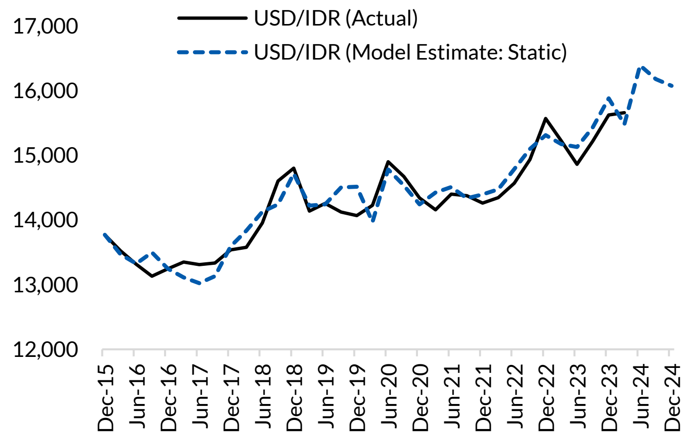
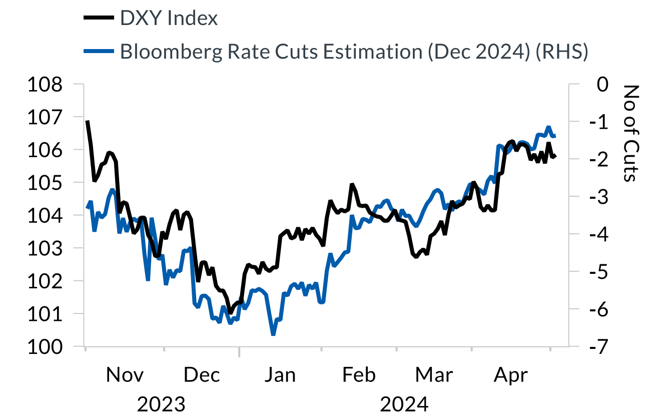
Figure 1: We expect USD/IDR to continue trading at high levels above 16,000 in 2024…



Source: RHB Economics & Market Strategy

Figure 2: … as the market pricing of FFR cuts is pointing toward fewer cuts…



Source: Macrobond, RHB Economics & Market Strategy

Delayed FFR Cuts Suggest A Strong USD Narrative to Persist

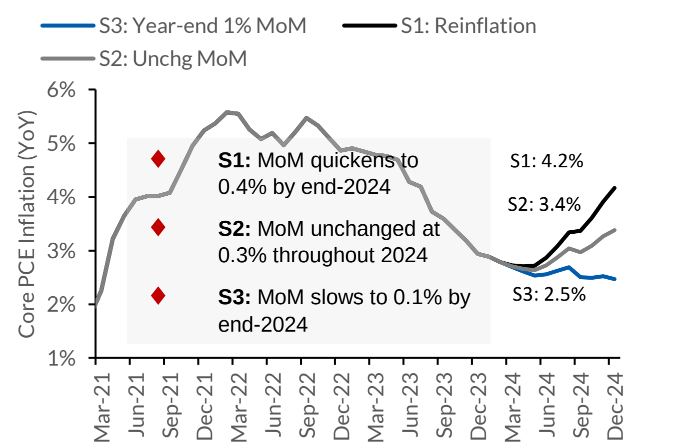
We expect USD/IDR to remain elevated above 16,000 throughout 2024, reaching its peak in 2Q24, before stabilising on a flat trajectory towards the year-end. The weakness of IDR against USD is mainly attributed to revised market expectations of fewer FFR cuts in Dec 2024 as US inflation is not in the trajectory toward the 2% target. In the latest data released for March, both US core CPI and core PCE inflation show no signs of slowing down, recording persistent prints of 0.3% MoM and 0.4% MoM, respectively. According to our US core PCE model in Figure 3, in the base case (S2), where the persistent 0.3% MoM print continues until year-end, it suggests that year-end core PCE inflation will surpass 3.0%. Even in the optimistic scenario of S3, with 0.1% MoM prints of core PCE, year-end inflation still exceeds the 2% target, reaching 2.5%. Hence, it is clear that US inflation is not on track towards the 2.0% target.

We believe the current inflation print hinders the US Federal Reserve from considering a rate cut. For the US Fed to initiate a rate cut cycle, there must be a sudden deterioration of US labour conditions and a significant slowdown in economic activity, neither of which is evident in the current situation. **As such, we maintain our view that we should expect one US Fed Funds Rate cut by the end of this year, with the balance of risks magnified towards no cut.** Market sentiment correlates well with the US Dollar Index, as indicated in Figure 2, where the revision of market expectation from six cuts at the beginning of this year to 1.3 cuts now provides credible support for the US Dollar strength. We anticipate the market will continue to price out FFR cuts towards one cut by the end of this year. Should US inflation stay elevated, the market may adjust towards no FFR cuts for 2024. **This implies we will likely see a stronger DXY towards 110 in 2Q24, with the UST 10-year yields approaching 5.0%.**

Despite our projection of a flat trajectory for the IDR in 2H24, the risks toward no FFR cut in 2024 are magnifying, underlying a caveat toward even deeper depreciation to be seen. Under such circumstances, we expect IDR to continue under pressure as: (1) US Dollar strength is expected to persist, driven by an intensifying positive carry, potentially pushing the DXY beyond 110. (2) the narrower yield differential between US UST and Indonesian government bonds is likely to result in a higher volume of foreign fund outflows. (3) global equity markets may shift to a risk-off mode, leading to reduced equity flows into Indonesia.

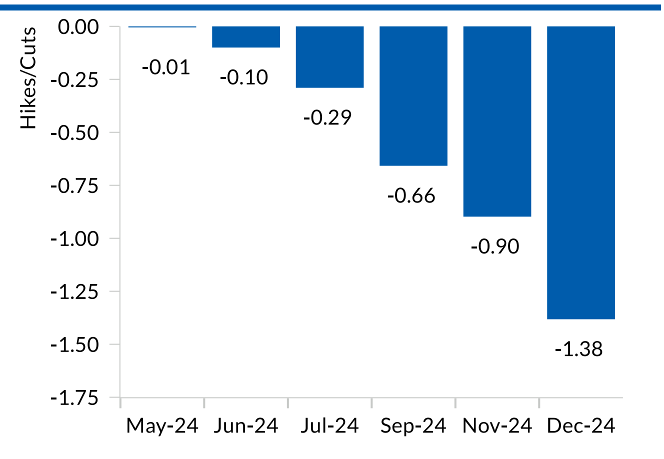
In addition, the sudden spike in USD/IDR in April is partly attributed to the escalation of the geopolitical crisis in the Middle East. After the event, net foreign capital flow turned negative as investors flocked to safe-haven commodities such as gold and the US Dollar. However, our analysis suggests that the adverse impact on the IDR resulting from the Middle East conflict is likely transient, and the direct effect on the Indonesian economy is expected to be relatively limited. This is due to the nation's minimal exposure to the conflict regions. Trade volumes, foreign investment inflows, and tourism receipts from the conflicted areas constitute a negligible fraction of Indonesia's overall economic activities. **Our observations from Figures 14 to 16 cement our view that current geopolitical risk-off sentiment is temporary as the size and duration of the impact on currency and commodity prices are relatively muted compared to previous historical events.**

Figure 3: ...this is due to the persistence of US core PCE inflation, which suggests that US inflation is not on the path towards the 2.0% target...



Source: CEIC, RHB Economics & Market Strategy

Figure 4: ...while a 'high for longer' FFR rate will translate to a strong USD narrative throughout 2024

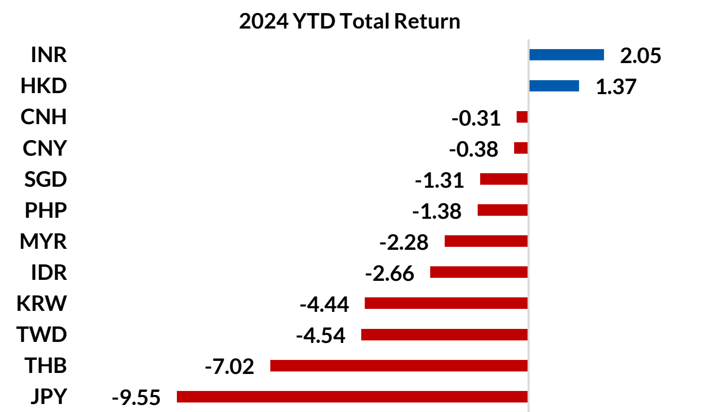


Source: Macrobond, RHB Economics & Market Strategy

Nevertheless, the strength of the US Dollar does not solely dictate our expectations of higher USD/IDR levels. We foresee several underlying domestic factors contributing to the weakness of the IDR. One primary concern is the medium-term fiscal risk arising from the newly elected Indonesian President Prabowo Subianto's emphasis on social welfare initiatives, such as free school lunches and milk. Such programs may require a restructuring of government finance and the issuance of high debt to finance them. This challenges Indonesia's fiscal prudence, as outlined in the 2003 State Finance Law, which caps the fiscal deficit and government debt at 3% and 60% of nominal GDP, respectively. The current account balance is also declining, further weakening the IDR exchange rate. This trend is primarily due to a narrower non-energy trade balance and the ongoing moderation of commodity prices. Despite a surge in the March trade balance, when viewed from a cumulative quarterly perspective, the trade balance for the first quarter of 2024 experienced a significant decline of 39.67% compared to the same period in 2023. Besides, we expect Indonesia's GDP growth in 2H24 to face downside risks from weakened household consumption due to declining purchasing power among lower-income groups and subdued business sentiment following post-Lebaran celebrations. A negative growth sentiment in 2H24 may lead to a higher risk premium in Indonesia's stock market, and investors may shift their investment to higher returns elsewhere, depreciating the currency with lower capital inflow.

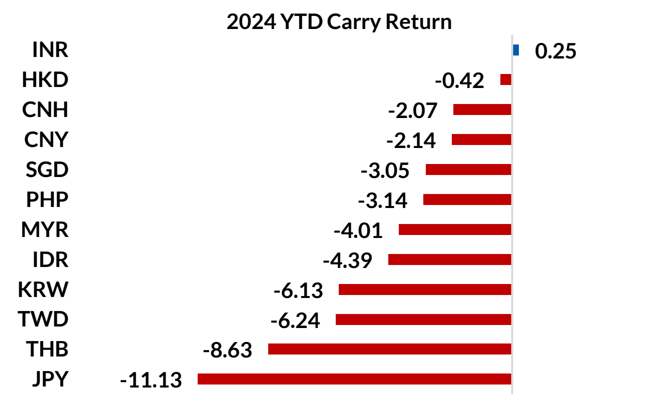
We recently revised our forecast for Bank Indonesia to keep the benchmark policy rate unchanged at 6.25% for 2024 and anticipate three 25 bps cuts in 2025, reducing it to 5.50%. While BI views the policy rate as a tool for exchange rate intervention, we anticipate no further movement on the BI rate for the rest of 2024 for several reasons. **First, Indonesia's inflation remains tame, with headline prices expected to stay within the 1.5% to 3.5% target range for 2024**. Our analysis indicates that Indonesia's headline inflation is mainly contributed by food inflation, while core inflation remains subdued as a gauge of demand-pull inflation. Hence, we see no incentive for BI to hike interest rates to contain inflation driven by supply shortages and higher production costs. **Second, higher rates may dampen loan growth and, subsequently, consumer demand.** Our thematic study suggests that Indonesia's consumption patterns may potentially slow in the second half of 2024 as Lebaran-fueled seasonal demand dissipates, with consumption demand primarily fueled by loan growth. Interest rate tightening would limit liquidity in the banking sector, further dampening already weakened consumer spending. **Thirdly, we see limited support for IDR from the rate hike.** We note the initial market reaction has been muted, suggesting that a single 25bps rate hike may be insufficient to stem IDR weakness. Thus, the April meeting's hike may merely cushion IDR's weakness and should not be regarded as evidence for a persistent strengthening of the IDR into 2024. IDR further depreciated to around 16250 per USD a week after the hike announcement.

Figure 5: Asian currency including IDR to remain under pressure



Source: Bloomberg, RHB Economics & Market Strategy.

Figure 6: …and continue depreciate against USD



Source: Bloomberg, RHB Economics & Market Strategy

IDR Model: Real Interest Rate Differential is the Key

We revisited our USD/IDR model and expanded it to include various indicators to better represent the balance of internal and external economic and financial conditions in Indonesia. Our econometric model, incorporating four key variables, suggests that IDR is primarily supported by the real interest rate differential between Indonesia and the United States, Bank Indonesia (BI) foreign currency reserves, and the flow of foreign equity capital. Conversely, it is negatively correlated with developed economies' stock market performance.

The quantitative model result affirms our view and suggests that interest parity is pivotal in determining USD/IDR exchange rates. The wider the disparity between Indonesian and US real interest rates, the more pronounced the positive carry effect exerted by the IDR, attracting a more significant influx of government bond investments as investors pursue higher yields. This variable enables us to capture the interaction between external and domestic policy rates, highlighting the significant influence of Federal Funds Rate (FFR) expectations and monetary policy reactions on exchange rate dynamics. This observation aligns with insights shared by policymakers during our visit to Jakarta, where they underscored the importance of interest rate differentials, government bond yield disparities, and the attractiveness of financial assets in other emerging economies as crucial determinants of benchmark policy rate behaviour to maintain the IDR exchange rate stability.

Foreign exchange market intervention serves as another important tool for Bank Indonesia to maintain the stability of the IDR exchange rate, as highlighted in our model. We employed foreign currency reserves as a proxy to measure the impact of intervention on exchange rate movements. Bank Indonesia prioritises maintaining IDR stability through Domestic Non-Deliverable Forward (DNDF) transactions and government securities (SBN) in the secondary market. While these interventions are efficient and lead to a quick adjustment of the IDR to the desired level, we believe this approach may not be sustainable in the long term. Depleting currency reserves to support the currency could have a pronounced negative impact, as observed in historical events such as the Asian Financial Crisis. The current level of foreign currency reserves (end-March) remains healthy at USD 140 billion, equivalent to 6.4 months of imports, despite being on a declining trend.

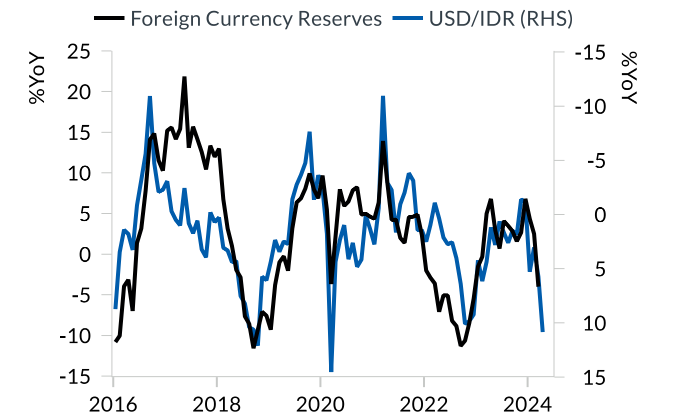
While the net inflow of foreign equity capital provides some ample support for IDR, it is outweighed by the performance of the developed economies equity market. Despite foreign investment flowing into Indonesia's equity market, drawn by its potential for higher returns, the allure of developed economies' equity markets, with their established stability and robust performance, often outweighs the attractiveness of emerging markets like Indonesia. Consequently, fluctuations in the performance of developed economies' equity markets usually carry greater weight in determining the overall direction of foreign exchange rates, thereby limiting the extent to which foreign equity capital inflows can bolster the IDR. It can be observed in Figures 12 and 13 that the Jakarta Composite Index movement seems to lead the appreciation of IDR, but when we calculate the return differential between the JCI and S&P 500 index and compare it with the IDR, the correlation turns negative. This relationship is evident in Figures 12 and 13, where Jakarta Composite Index (JCI) movements appear to lead IDR appreciation. However, a negative correlation becomes apparent upon calculating the return differential between the JCI and S&P 500 index and comparing it with the IDR. Our model suggests a similar result, indicating that the IDR is negatively influenced by the S&P 500 while receiving limited support from equity capital inflows.

Figure 7: USD/IDR Model

Dependent Variable	USD/IDR			
Independent Variables	Coefficient	Std. Error	t-Statistic	P-value
ID-US Real Interest Rate Differential (-1)	-0.657	0.144	-4.560	0.000
Foreign Currency Reserve (-1)	-0.278	0.046	-6.037	0.000
Foreign Equity Capital Flow (-1)	-0.008	0.002	-4.658	0.000
S&P 500 Index (-3)	0.148	0.034	4.334	0.000
Constant	1.300	0.503	2.582	0.015
R-Square	0.821			
Adjusted R-Square	0.796			
Standard Error	1.878			
Observation (quarters)	34			

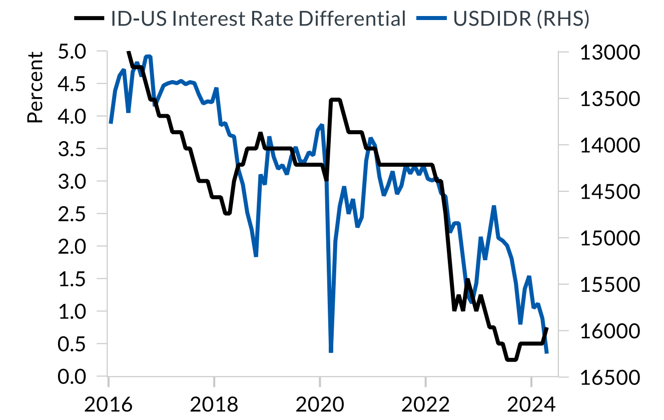
Source: RHB Economics & Market Strategy. (-x) represent the (t-x) lag of the variables.

Figure 8: We foresee Bank Indonesia to intervene through foreign currency reserve moving forward…



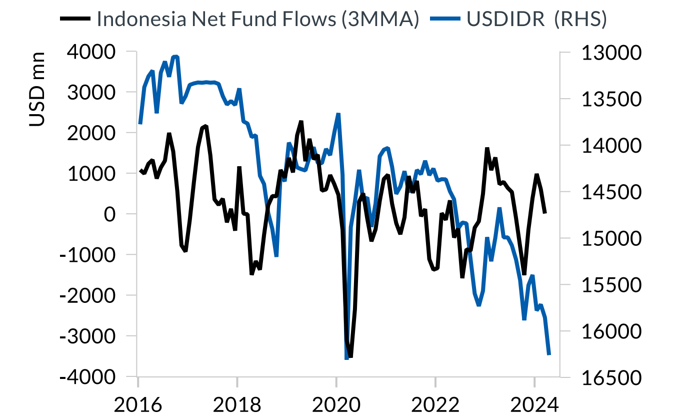
Source: Macrobond, RHB Economics & Market Strategy

Figure 9: and refrain from hiking the policy rate as the support is limited…



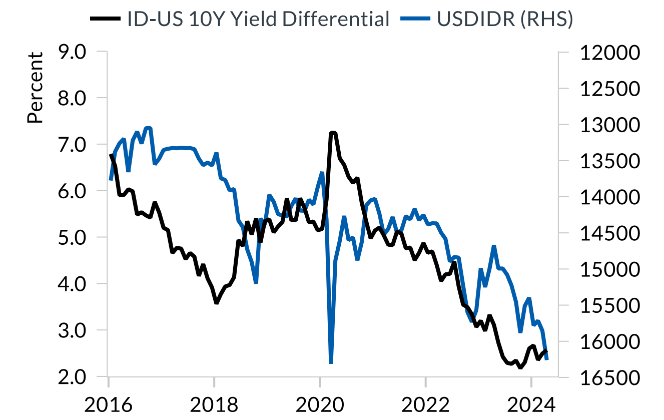
Source: Macrobond, RHB Economics & Market Strategy

Figure 10: …on the net fund inflow…



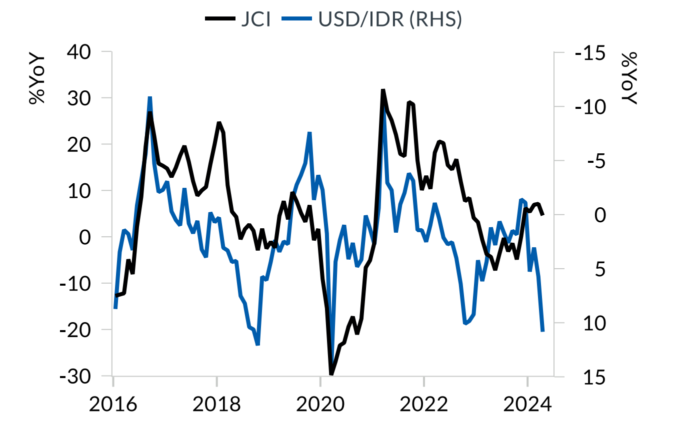
Source: Macrobond, RHB Economics & Market Strategy

Figure 11: as the foreign investors remain net seller of IDR Government Bonds YTD…



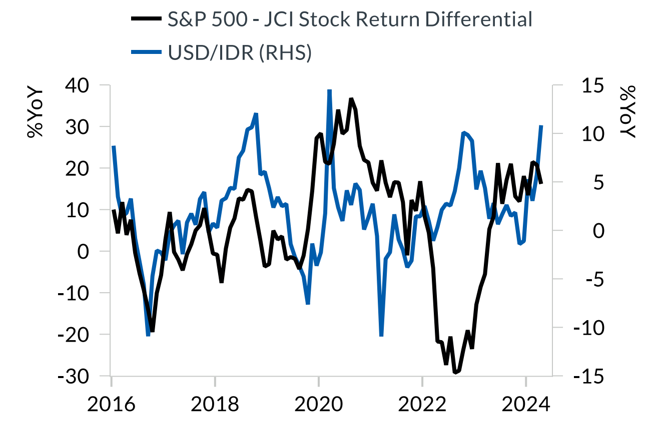
Source: Macrobond, RHB Economics & Market Strategy

Figure 12: …While JCI Performances improves since 2023, the support on currency remain subdued as…



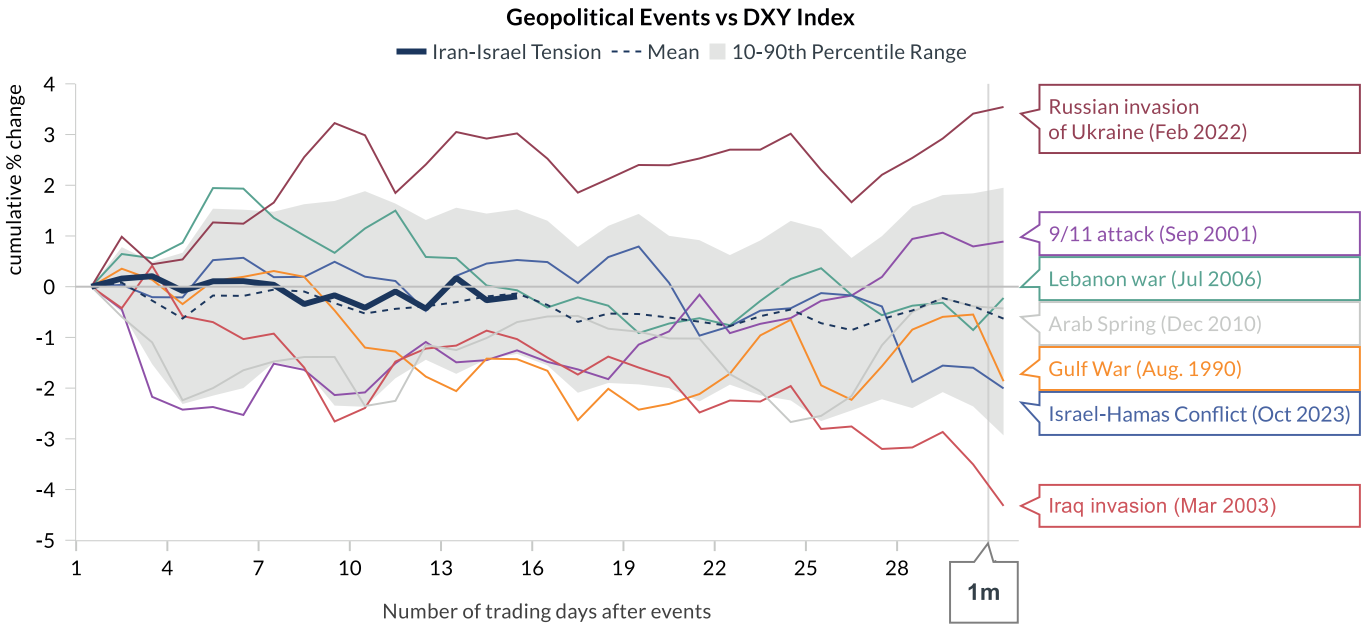
Source: Macrobond, RHB Economics & Market Strategy

Figure 13: …the DM growth are much outstanding



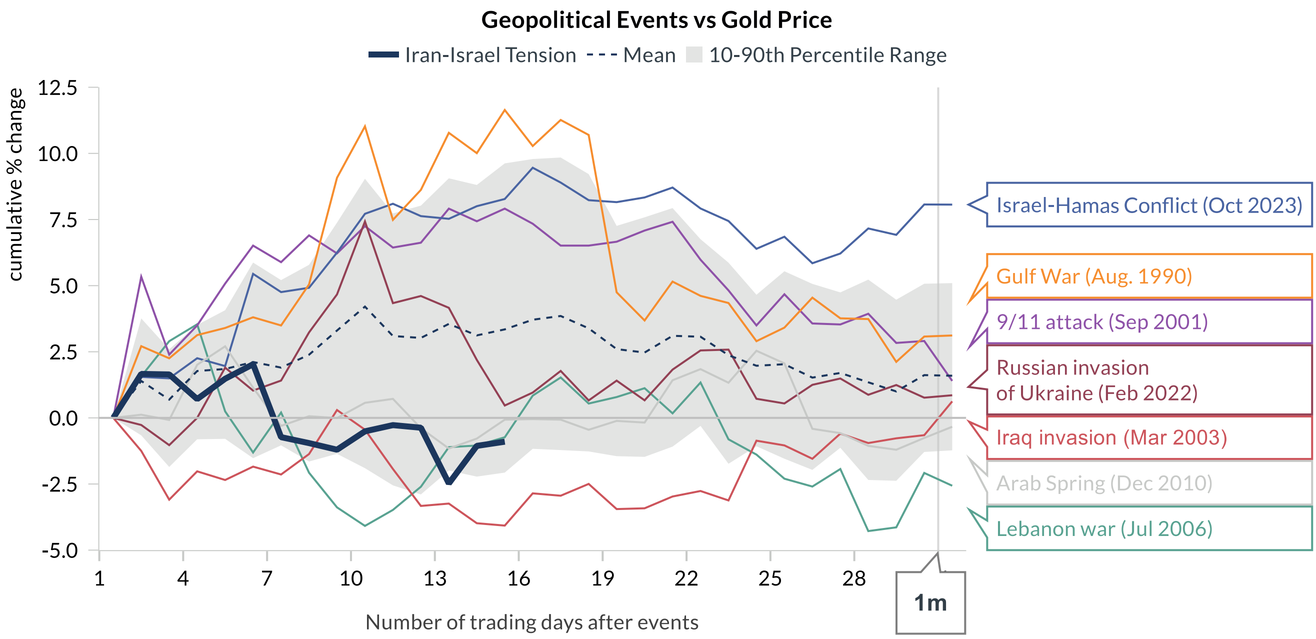
Source: Macrobond, RHB Economics & Market Strategy

Figure 14: We expect the adverse impact from the current geopolitical tension is limited which the…



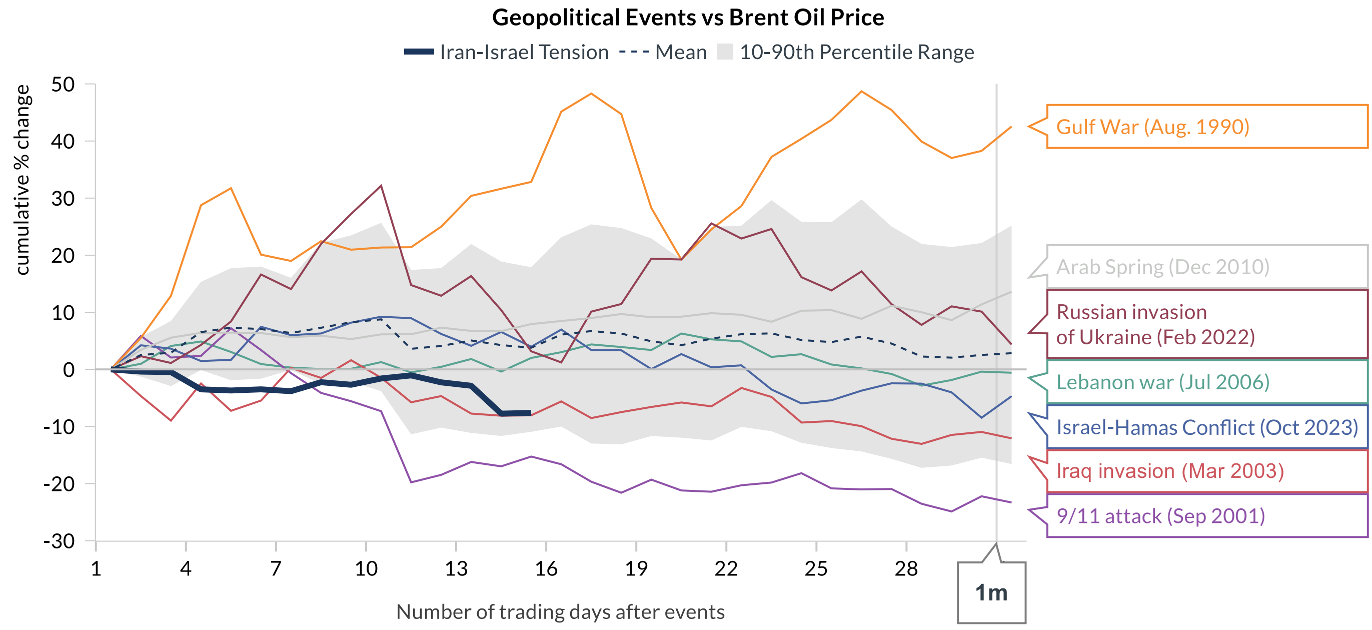
Source: Macrobond, RHB Economics & Market Strategy

Figure 15: …safe haven demand is dissipating while the…



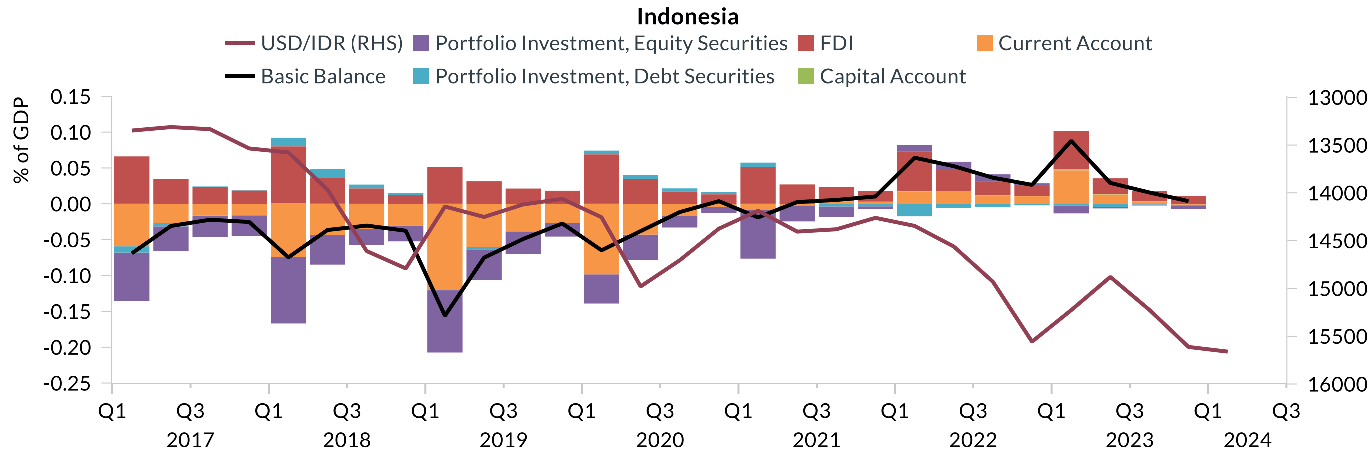
Source: Macrobond, RHB Economics & Market Strategy

Figure 16: ...commodity price reaction is muted compared to previous historical event



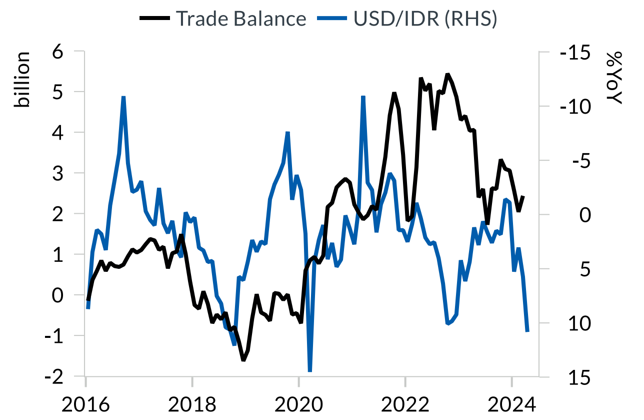
Source: Macrobond, RHB Economics & Market Strategy

Figure 17: Collectively, basic balance is facing pressure due to the widespread decline across its component



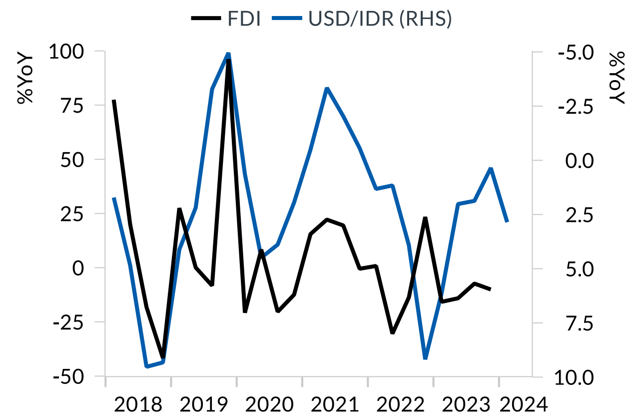
Source: Macrobond, RHB Economics & Market Strategy

Figure 18: ...lower trade balance is expected compare to last year...



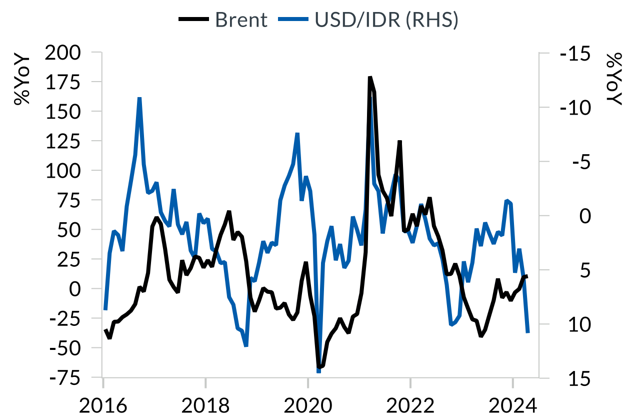
Source: Macrobond, RHB Economics & Market Strategy

Figure 19: ...while FDI could provide some support



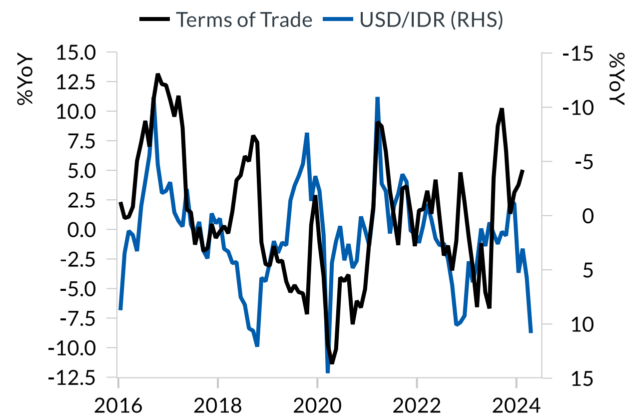
Source: Macrobond, RHB Economics & Market Strategy

Figure 20: Brent crude oil move together with IDR strength the path diverge since 2022...



Source: Macrobond, RHB Economics & Market Strategy

Figure 21: ...which is similar to the case of the terms of trades



Source: Macrobond, RHB Economics & Market Strategy

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