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Global Economics & Market Strategy

Indonesia: Optimism of Fed's Rates Cut Keep IDR Stable

- **We maintain 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 view is supported by three key factors: 1) alleviated IDR volatility over FFR cut expectation; 2) Downside risk to household consumption growth in 2H24; and 3) demand-pull inflation remains manageable.**
- **BI maintained its benchmark interest rate at 6.25% in the July meeting, in line with our expectation and the Bloomberg Consensus Forecast. In all, BI has raised 250bps since 2022.**

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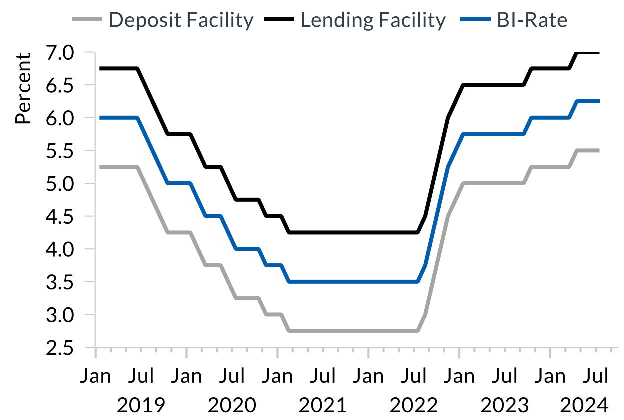
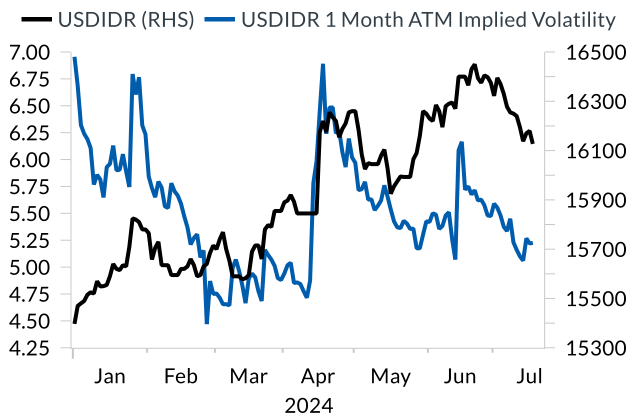
Figure 1: We maintain our view for no change in BI-rate for the rest of 2024…



Source: Macrobond, RHB Economics & Market Strategy.

Figure 2: …given the volatility of IDR has alleviated from the peak of June risk factors



Source: Macrobond, RHB Economics & Market Strategy.

BI Rate is Maintained to Support IDR Trajectory

We maintain 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%. Three key factors support our view: 1) alleviated IDR volatility over FFR cut expectation; 2) Downside risk to household consumption growth in 2H24; and 3) demand-pull inflation remains manageable.

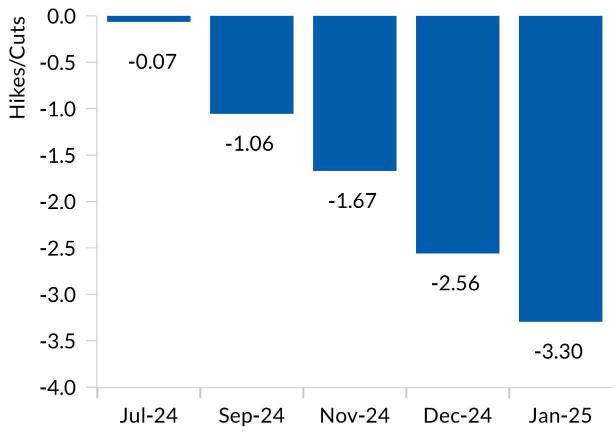
We observe that the pressure on the IDR has eased since the previous policy meeting in June, reducing the likelihood of further tightening. This improvement in the IDR's performance is primarily due to a softer US Dollar Index, as the market continues to price in an earlier-than-expected Federal Reserve rate (FFR) cut in September instead of the previously projected December. Similarly, Bank Indonesia is now adopting a more optimistic outlook, expecting an earlier rate cut in November instead of December. Despite this shift in market expectations, we maintain our base case of only one FFR cut by December, with the balance of risks leaning more towards a November rate cut. According to our weekly report, unless there is strong and sustained evidence that US core PCE inflation will move towards 2.0%, necessitating a further slowdown in US price momentum to around 0.1% MoM from July to September, we are not convinced of a September FFR cut.

We do not foresee any need for growth-related policy rate adjustments now, expecting neither tightening nor stimulating intervention from the central bank. We anticipate that consumer sentiment will weaken in 2H24, which will likely result in slower household consumption expenditure growth due to seasonal factors as the demand from the Lebaran festivities fades. Our thematic study indicates that interest rate tightening would constrain liquidity in the banking sector, further weakening consumer spending by dampening two main drivers of retail sales: loan growth and stock market performance. Moreover, higher interest rates towards the end of the year are expected to delay consumer purchases of durable goods due to the increased cost of borrowing.

We see no incentive for Bank Indonesia (BI) to hike interest rates further to contain inflation given the current headline inflation level to remain subdued and likely align with the official target at the upper bound of the 2.5% ± 1% YoY range. Figure 9 shows that food inflation, driven primarily by weather conditions affecting domestic and external food supplies, is the main contributor to headline inflation. Given this, it would be imprudent to use policy measures to address inflation stemming from supply shortages and increased production costs. On the other hand, core inflation, which reflects demand-pull pressures, remains subdued and may experience downside risks due to anticipated weaker retail spending in 2H24.

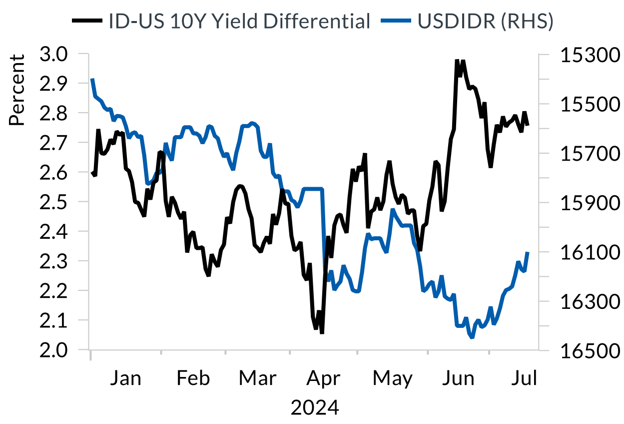
BI maintained its benchmark interest rate at 6.25% in the July meeting, in line with our expectations and the Bloomberg Consensus Forecast. In all, BI has raised 250bps since 2022. This decision reaffirms Governor Perry Warjiyo's earlier statement that the central bank will keep the policy rate unchanged until the currency stabilises, with any potential rate cut considered only in the fourth quarter. The central bank kept its GDP growth forecast unchanged at 4.7% to 5.5% and maintained its CPI target at 1.5% to 3.5% for the upcoming year. The outlook for the current account balance remains steady at 0.1% to 0.9% of GDP.

Figure 3: ... as the market expects an earlier projection of FFR cuts...



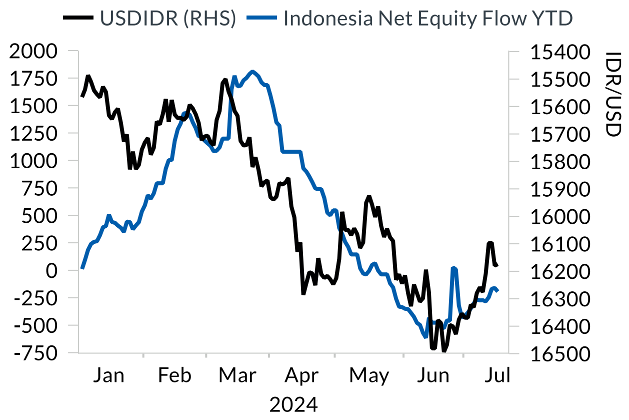
Source: Macrobond, RHB Economics & Market Strategy.

Figure 4: ... which widens ID-US yield differentials and cushion IDR's weakness...



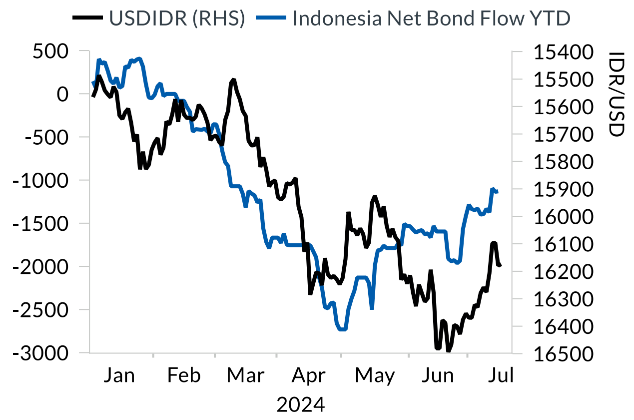
Source: Macrobond, RHB Economics & Market Strategy.

Figure 5: Net equity fund flow into ID shores has rebound from previous month low…



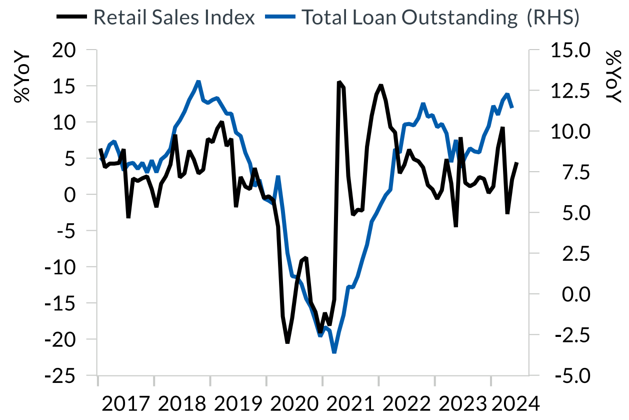
Source: Macrobond, RHB Economics & Market Strategy.

Figure 6: … while net bond outflow has also improved



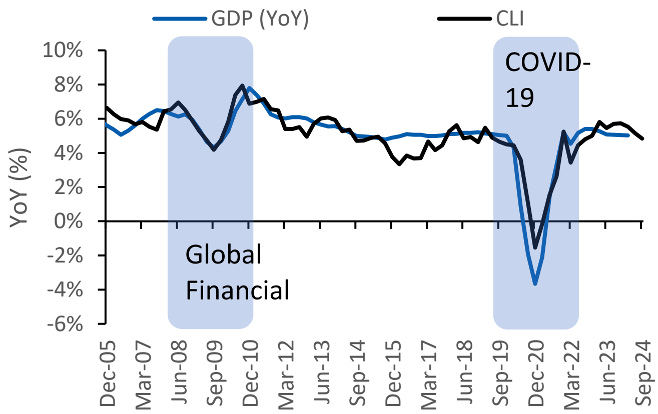
Source: Macrobond, RHB Economics & Market Strategy.

Figure 7: We do not see a need for another rate hike as it would dampen the economic momentum from loan growth perspective…



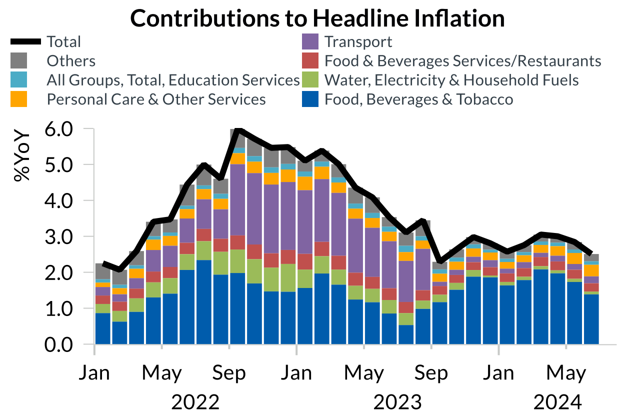
Source: Macrobond, RHB Economics & Market Strategy.

Figure 8: …which is captured in our leading indicator where the growth rate has turn south in 3Q24…



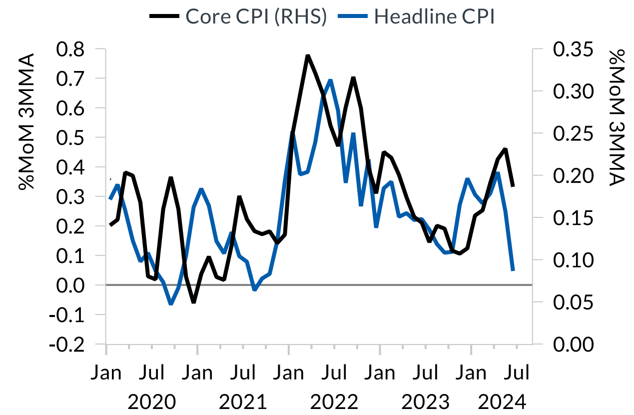
Source: CEIC, RHB Economics & Market Strategy.

Figure 9: From inflation perspective, the Inflation momentum remains mild and it is primary driven by shock in food supply…



Source: Macrobond, RHB Economics & Market Strategy.

Figure 10: …hence, there is not incentive on another rate hike as full year average inflation likely to stay between the official target of 2.5±1 …



Source: Macrobond, RHB Economics & Market Strategy.

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