20 June 2024

Global Economics & Market Strategy

Indonesia: Interest Rate Intervention are Not Required at This Juncture

- **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) shift in key driver of IDR weakening; 2) Downside risk on household consumption growth in 2H24; and 3) demand-pull inflation remain muted.**
- **BI maintained its benchmark interest rate at 6.25% in the June meeting, in line with our expectation and the Bloomberg Consensus Forecast. In all, BI has raised 250bps since 2022.**

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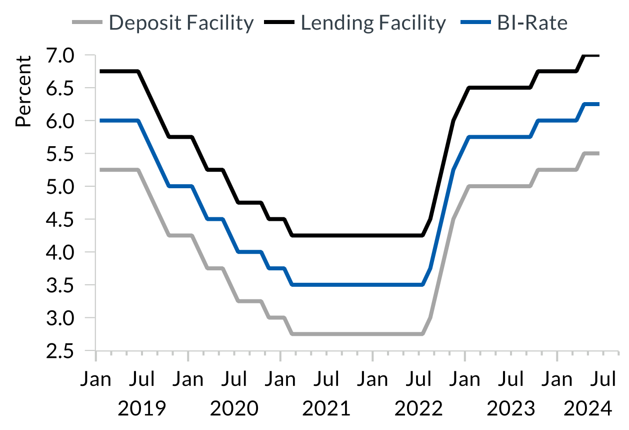
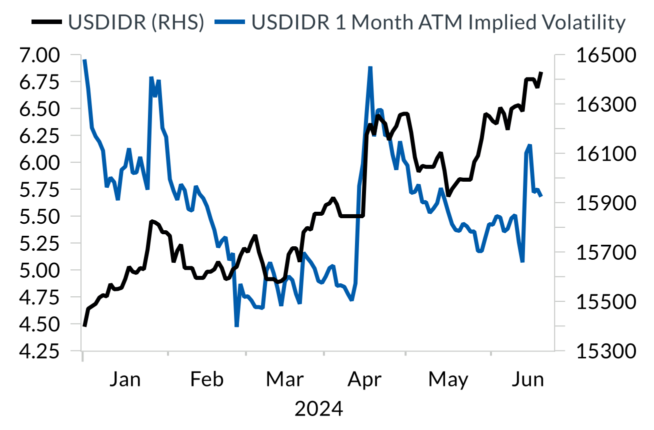
Figure 1: We maintain our view for no change in BI-rate for the rest of 2024…



Source: Macrobond, RHB Economics & Market Strategy.

Figure 2: …given the downward pressure of IDR by other idiosyncratic factors has outweighs the support from…



Source: Macrobond, RHB Economics & Market Strategy.

Rate Differentials is Not the Root Cause of June Rupiah Slump

We maintain our forecast for Bank Indonesia (BI) 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) IDR weakening despite BI's recent hike; 2) downside risk on household consumption growth in 2H24; and 3) demand-pull inflation remains muted.

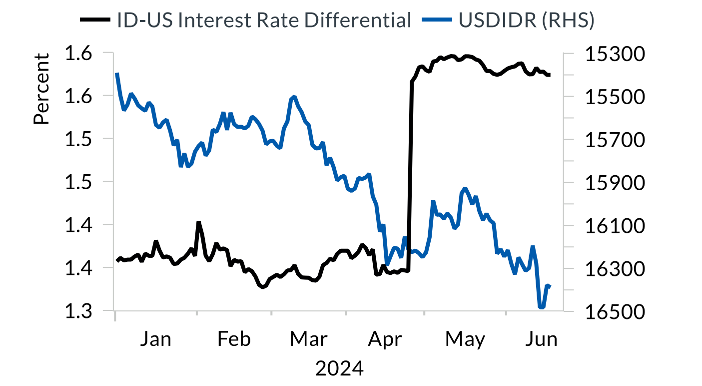
We observe that the primary cause of IDR weakening has shifted from the interest differential between the US and Indonesia to other idiosyncratic factors. Figure 2 shows that the volatility in April and June was vital to the sustained weakening of the IDR. The spike in IDR one-month implied volatility during these months was driven by the geopolitical crisis in the Middle East and the announcement by newly elected President Prabowo to raise Indonesia's debt-to-GDP ratio to 50% over the next five years, respectively. The risk-off sentiment led investors to sell off Indonesian equities, as shown in Figures 5 and 6, consequently diminishing the support from equity inflows toward the IDR. This shift in investor behaviour underscores the increased sensitivity of the IDR to geopolitical and fiscal policy developments rather than traditional interest rate differentials. Figures 3 and 4 show that the linkage between greater interest rate and yield differentials and support for the IDR has diverged since April. This explains why the policy rate hike by BI in April had limited support for the IDR during that period. Hence, we do not see a need for interest rate tweaks in response to how IDR is trending at this juncture, as the interest rate differential between Indonesia and global economies has limited influence on the recent weakening and volatility in IDR.

We foresee higher interest rates may dampen consumer sentiment and slow household consumption expenditure growth. Our thematic study suggests that Indonesia's household consumption patterns may slow in 2H24 as the seasonal demand fuelled by Lebaran dissipates. This has been captured by our leading economic indicator in Figure 8, which the economic momentum for 3Q24 would likely be lower than 5%YoY. We believe that interest rate tightening would limit liquidity in the banking sector, further weakening consumer spending by slowing down the two main drivers of retail sales: loan growth and stock market performance. Higher interest rates toward the year-end are likely to delay consumer purchases of durable goods due to the higher 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. The contribution of the inflation momentum charts in Figure 9 suggests that Indonesia's headline inflation is primarily driven by food inflation, which is influenced mainly by weather conditions affecting both external and domestic food supply. Hence, policy intervention to reduce inflation driven by supply shortages and higher production costs would not be prudent. Conversely, core inflation as the gauge of demand-pull inflation remains subdued and may face downside risks due to weaker retail spending expectations in 2H24.

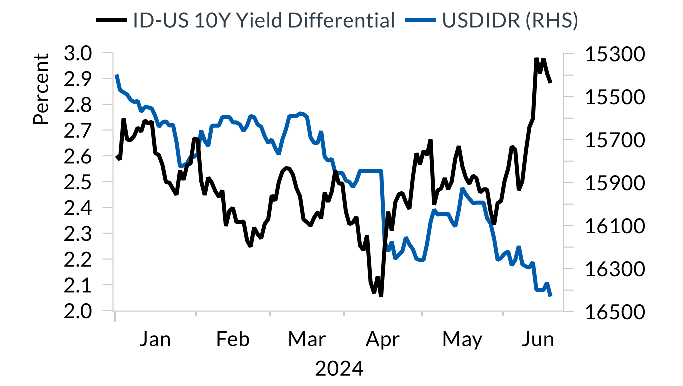
BI maintained its benchmark interest rate at 6.25% in the June meeting, in line with our expectations and the Bloomberg Consensus Forecast. In all, BI has raised 250bps since 2022. BI indicated potential room for a rate cut due to easing global and domestic fiscal risks. The central bank kept its GDP growth forecast unchanged at 4.7% to 5.5% and maintained its CPI target at 1.5% to 3.5% for the year ahead. The current account balance outlook remains steady at 0.1% to 0.9% of GDP.

Figure 3: ...interest differential as the Interest rate hike in April has proved limited support on IDR level...



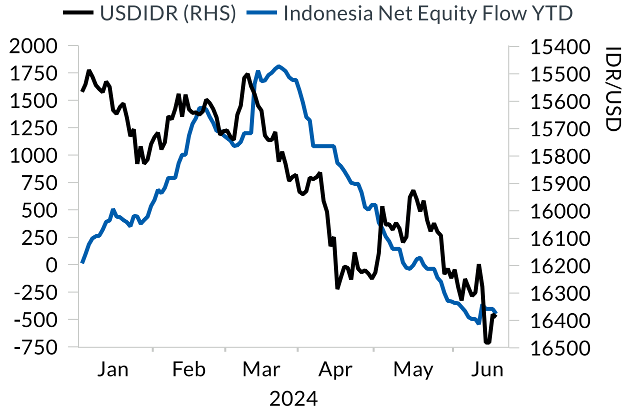
Source: Macrobond, RHB Economics & Market Strategy.

Figure 4: ...while there is a clear divergence among yield differential and IDR level...



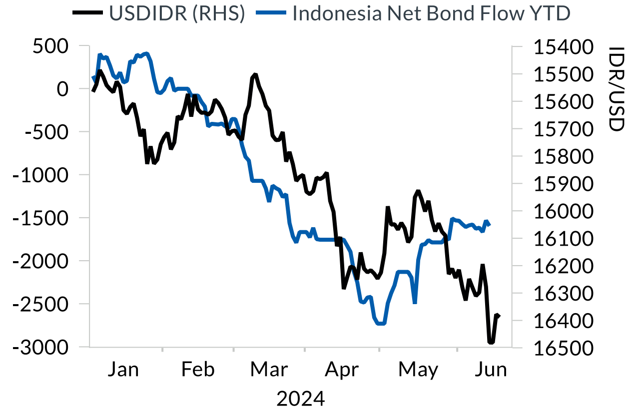
Source: Macrobond, RHB Economics & Market Strategy.

Figure 5: ...which the negative impact on IDR from JCI equity sell-off is larger than the...



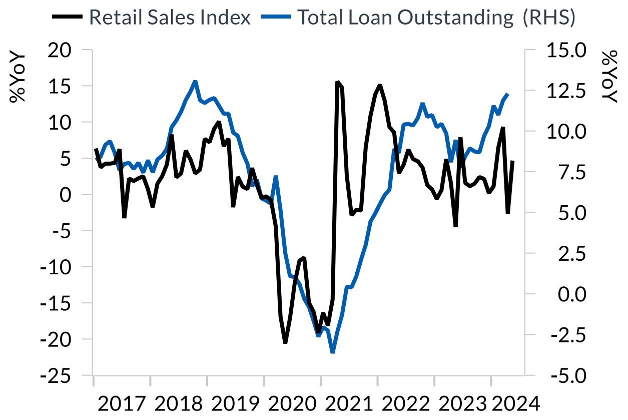
Source: Macrobond, RHB Economics & Market Strategy.

Figure 6: ...Improvement in net bond outflow



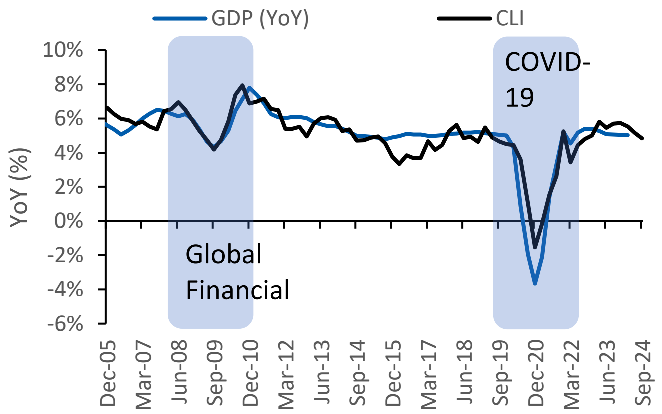
Source: Macrobond, RHB Economics & Market Strategy.

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



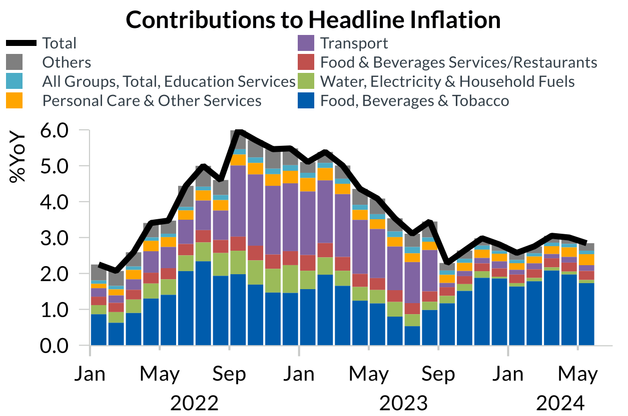
Source: Macrobond, RHB Economics & Market Strategy.

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



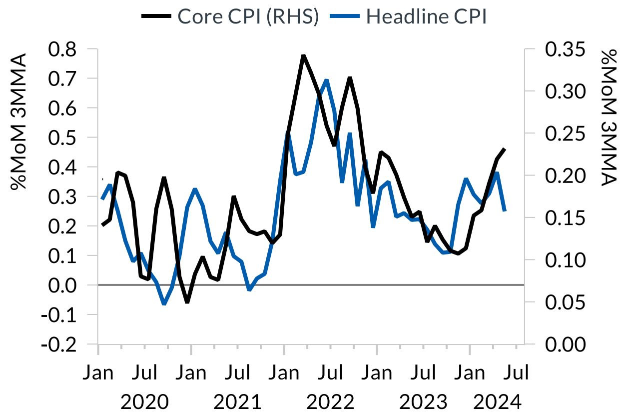
Source: Macrobond, RHB Economics & Market Strategy.

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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