Economics

DBS Flash

Bank Indonesia remains on guard

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- *Bank Indonesia increased its benchmark rate by 25bps to 5.75% today, taking the cumulative rate hikes this year to 150bps.*
- *Global uncertainty and market volatility would keep the authorities' feet to the pedal.*
- *We expect another rate hike in 4Q18 if Rupiah remains under pressure, and as Fed rate hikes continue.*
- *Measures beyond policy rates are encouraging but their impact on this year's trade balance might be small.*
- *Guidance remained hawkish. We think that Bank Indonesia's challenge to maintain price and currency stability will persist in 2019 against the background of rising fuel price and US interest rates, which would warrant further tightening next year.*

Policy rate hiked today: more to come

Bank Indonesia hiked its benchmark rate by 25bps to 5.75% on Thursday, in line with consensus. BI mentioned that the rate hike was necessary as current account deficits persist, given slower export growth and higher imports. BI reiterated its GDP forecast at 5.0%-5.4% in 2018 and 5.1-5.5% in 2019. Inflation continues to be seen in 205-4.5% range. Policy guidance remained hawkish.

BI also announced plans to offer domestic NDFs using the JISDOR (Jakarta Interbank Spot Dollar Rate), instead of the offshore NDFs. The intention is to deepen IDR financial markets, while also providing options for market participants to park dollars domestically.

Despite pre-emptive policy action, market volatility remains high, owing to continuous drip of global negative catalysts for emerging markets, including Indonesia. On early Thursday, the US Federal Reserve hiked rates for third time this year and eighth since late 2015, lifting US rates and the dollar. At the same time, Brent crude prices are holding up near four-year highs. The simmering US-China trade deadlock and fallout thereof, also remains a pain point for the region. This has kept the currency under pressure, but the Indonesian rupiah's attempts to breach 14900/USD continues to run into strong FX intervention, keeping year-to-date decline at 8.9%. 10Y Bond yields are up a strong 180-200bps in first nine months of the year. Equity and debt markets recorded a net outflow of -USD0.6bn and USD0.1bn respectively, in September. The benchmark equity index, JCI has declined by more than 7% YTD of which 2.6% was in September.

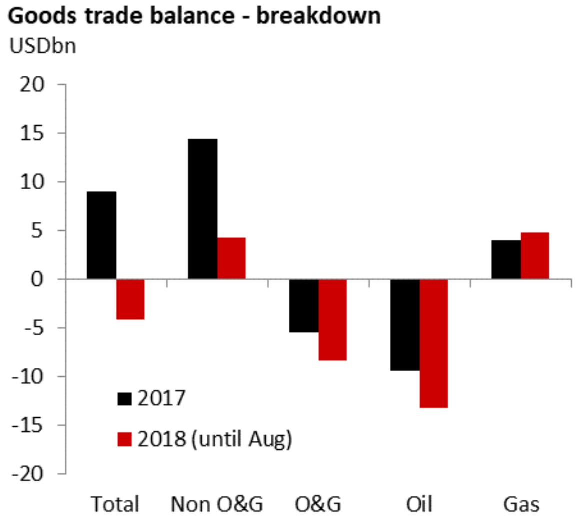
Domestically, trade performance continues to underwhelm. August trade deficit stayed wide at -USD1bn, on the back of weak export volumes. Official efforts to contain consumption imports, whilst leaving capital goods and oil imports untouched, will have limited impact on the trade balance. Oil and gas trade deficit widened to USD16.6bn in August 2018 vs USD 0.78bn same time last year, driven mostly by volumes as domestic oil prices were stable.

Policy measures have been undertaken to contain the trade imbalance:

First, the B20 regulation (refers to the mandatory use of biodiesel blended fuels for all vehicles and heavy machinery). The jury is still out on judging the impact of the regulation which became effective on Sept 1. The impact, is likely to be lower than previously estimated at USD2.3bn due to implementation lag.

Second, the government announced income tax revisions (PPH 22) on near 1,000 consumption goods, with imposition of an average 5% increase in tariffs since September 5. This list amounts to USD5bn worth imports until August or 4.7% of total imports. Accordingly, the impact on this year's imports will be less than USD 0.1bn or 0.01% of GDP.

Third, measures to lower capital goods import through postponement of several infrastructure projects, mainly related to construction and electricity projects (the exact list has not been announced thus far). This measure will hit back on growth as construction and electricity sectors were important drivers of growth this year.



Source: CEIC, DBS Group Research

Cumulatively, while these measures are encouraging, the scale of contraction in imports might disappoint. With fuel price deregulation still not on the cards, a sustained corrected in the trade balance and by extension the current account deficit is unlikely. We retain our estimate of 2018 CAD at -2.5% of GDP.

Apart from the real sector, several markets-driven measures have also been introduced in recent weeks. These included a) introduction of hedging tools, b) proposal to introduce domestic non-deliverable forwards, c) seeking exporters to keep half of their earnings in the country and convert these into rupiah, and d) considering tax benefits to attract dollar conversion. Separately, the government has also emphasised on existing bilateral currency swaps and foreign reserves buffer as available resources to defend against any escalation in global volatility.

In all, the government and the central bank have undertaken cohesive steps to ensure market and rupiah stability. The rates outlook depends on global developments and given our assumption that the markets are underestimating the fallout of the US-China trade dispute and the US rate hike trajectory. We expect one more 25bps hike in 4Q18, with more likely next year if the risk environment remains challenging.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).