IFG Progress Digest

Tracking Key Rates' Trends in Indonesia

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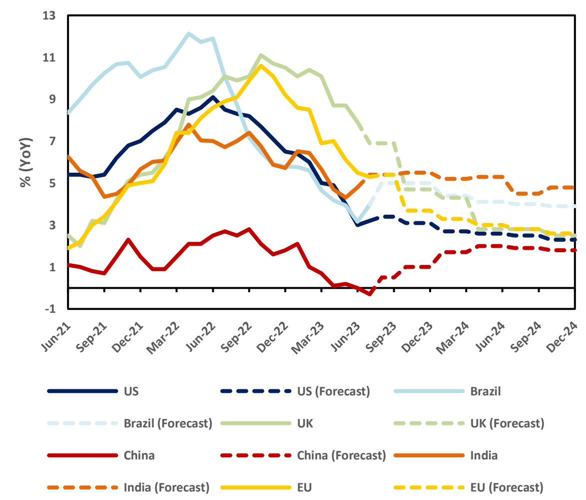
- *Global inflation is expected to moderate at the end of 2023, with the possible exceptions of China, India, and Brazil. However, upside risks for inflation remain due to rising oil price and weather-related distruptions that can affect food prices.*
- *While upside risks for inflation still persist, analysts expect the U.S. Fed to maintain its rate in 2023, with possible rate cuts in mid-year 2024 in order to boost growth and reduce unemployment. The majority of analysts view that BI will not cut its rate in 2023.*
- *As movements in BI rate and JIBOR are closely related, we expect that JIBOR 1-month rate will not moderate in 2023. Analysts expect JIBOR 3-month rate to fall as early as in Q3'23, fully closing rate margin between JIBOR 1 and 3 months.*

Global and Domestic Inflation Environment

Inflation rates are expected to moderate further in 2023 and possibly in 2024 globally, with the exception of China, India, and Brazil (Exhibit 1). China experienced deflation in July 2023 due to falling food and housing prices coupled with its economic slowdown shown in the latest CFLP's manufacturing PMI number (Exhibit 1 - red line for China). Using Bank of England's inflation projection methodology, there is a 35% probability that China's deflation will persist up to Q1'24. In the US, while CPI inflation has moderated substantially over the past year, the Fed's FOMC minutes in 25-26 July showed that "most participants continued to see significant upside risks to inflation, which could require further tightening of monetary policy". Even with slowing automobile and housing markets, higher gasoline prices and increased risk of weather-related disruptions could push CPI inflation back up in the US.

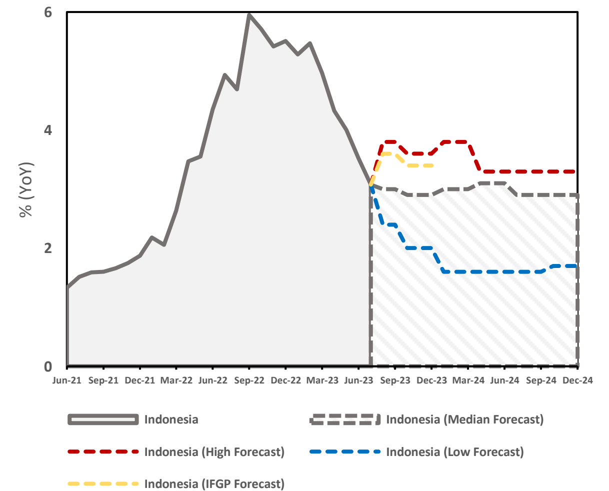
On the other hand, Indonesia's inflation has fallen back to BI's inflation target range during the past 3 months and is expected to remain so. Since May 2023, the headline inflation has already been within BI's inflation target range of 2%-4%. Moreover, core inflation also remains below 3% for the fifth consecutive month. Inflation in Indonesia has steadily declined since the beginning of the year mainly due to steep deceleration of food cost inflation. Moving towards 2024, inflation is expected to remain within BI's range, baring no food prices shock due to El Nino (Exhibit 2).

Exhibit 1. CPI Inflation Rates and Forecasts, Selected Countries



Source: Bloomberg, IFGP Research

Exhibit 2. Indonesia's CPI Inflation Outlook



Source: Bloomberg, IFGP Research

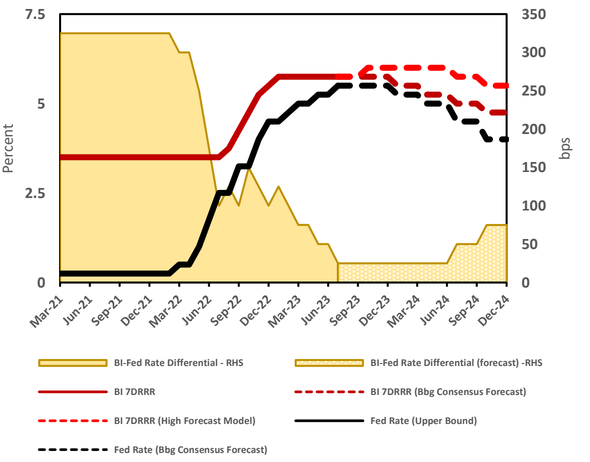
Policy Rate Trend and Outlook

The U.S. Fed Fund rate: While there is a growing concern that rising oil prices may prompt the Fed to raise interest rates, inflation-expectation data combined with Fed's reaction function show that commodity-price shock would not immediately translate into the Fed's rate increase. In the short-term, higher oil prices tend to reduce household spending, thus widening the negative output gap and raising the unemployment rate. The modest rise in the core inflation due to higher oil prices contributes to the increase in the probability of the Fed rate hike, but the rate hike probability has been offset by the rise in the unemployment rate. Therefore, while the upside risks in inflation are acknowledged, several market analysts anticipate the Fed to cut its rate to support growth. The signal of Fed's rate cut timing is still mixed, with analysts expecting the cut would happen between as early as Jan'24 to end of 2Q'24. However, if core PCE inflation's pathway persists at 3.9% in 2023, coupled with relatively stable unemployment rate data at 4.1%, the FOMC participants still expects one more rate hike with 5.75% terminal rate this year. This notion is strengthened with Powell's remark on the Jackson Hole meeting "additional evidence of persistently above-trend growth could put further progress on inflation at risk and could warrant further tightening of monetary policy". Thus, investors are left with a cloud of uncertainty as hotter than expected inflation and unemployment data may be greeted by the market as a signal of another hike (Exhibit 3 – Black line for Fed rate).

The BI policy rate: The Fed rate outlook is a critical influential factor driving policy rate decisions by global central banks, particularly in many emerging markets around the globe to maintain the domestic financial and exchange rate stabilities. Looking at the relationship between the margin gap between the US Fed Fund rate-the BI 7 Days Reverse Repo Rate/ BI 7DRRR and the Rupiah/USD exchange rate, we have found a significant inverse correlation between the two series. The relationship suggests that Rupiah/USD exchange rate tends to depreciate when the Fed rate and BI 7DRRR gap is narrower, and vice versa. The latest data showed the narrowest margin between BI – Fed rates in the past 6 years (25 bps gap). In this environment, BI will have less room to cut its rate before the Fed cuts its rate, which will happen in 1Q'24 at the earliest. Moreover, since there is still possibility of one more rate hike from the Fed this year if US core inflation is sticky, BI might even raise its rate to maintain Rupiah stability, contradicting market analysts' consensus (Exhibit 4).

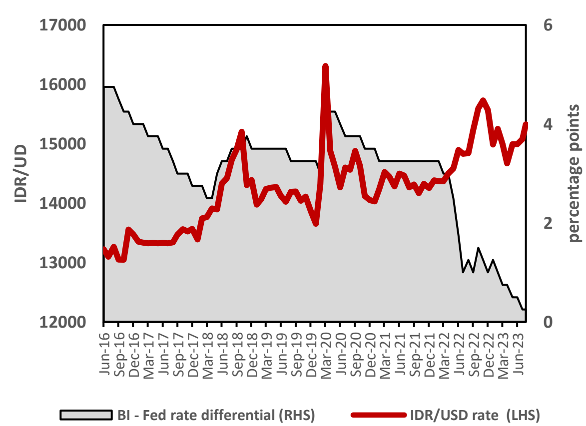
The current macroeconomic landscapes in Indonesia further highlight potential policy trade-offs. In one hand, the higher-than-expected economic growth coupled with relatively lower budget deficit suggest that there is a policy space to support growth. However, with widening current account deficit and narrow margin between BI 7DRRR and the Fed Fund rate, the short-run policy consideration may tilt toward supporting the local currency from the depreciation pressure (Exhibit 5). In another words, under the current macroeconomic landscapes, the urgency of maintaining the rupiah exchange rate (against the USD) stability through various measures, including rate hike, is potentially more dominant than efforts to

Exhibit 3. The falling Fed and BI policy rate margin



Source: Bank Indonesia, St. Louis Fed, IFGP Research

Exhibit 4. Negative correlation between Rupiah/USD exchange rate and BI – Fed policy rate margin



Source: Bloomberg, IFGP Research. Note: Spearman correlation between these two variables sits at ~-0.6, meaning modest inverse correlation exists between the two variables.

Exhibit 5. Macroeconomic conditions and possible impacts on rate decisions

Macro Indicator Considerations	Reaction Function towards BI 7DRR (hike / hold / cut)	Urgency	Comments
BI – Fed Interest Rate Differentials	Hike	High	Narrowest BI – Fed rates differential in 6 years, rate hike is necessary to maintain exchange rate stability.
CPI Headline Inflation	Hold	Modest	While inflation is getting modest over the past year, there's still upside risk due to weather related disruption on food prices.
Budget Deficit	Hold / Cut	Low	Budget deficit level is on track to be back to the <3% level, so there will be little to none pressure on the exchange rate.
BOP / Current Account Balance	Hike	High	Current account deficit is higher than expected, urging BI to rate hike in order to prevent capital outflow on financial account.
Economic (GDP) Growth	Cut / Raise	Low	2Q'23 growth is better than expected and is on track for target growth for FY 2023, leaving BI space for policy rate adjustment.

Source: IFGP Research.

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support economic growth in 2023. However, BI has firmly communicated that policy rate adjustment will be the last resort effort to stabilize the currency. Instead, BI has implemented several efforts to deal with weakening rupiah, such as through FX spot interventions, Domestic Non-Deliverable Forward (DNDF) instrument, and securitizing BI's ownership of government bonds to attract capital inflows. The effectiveness of these measures to maintain rupiah stability will, in our view, partly determine the future of the BI policy rate.

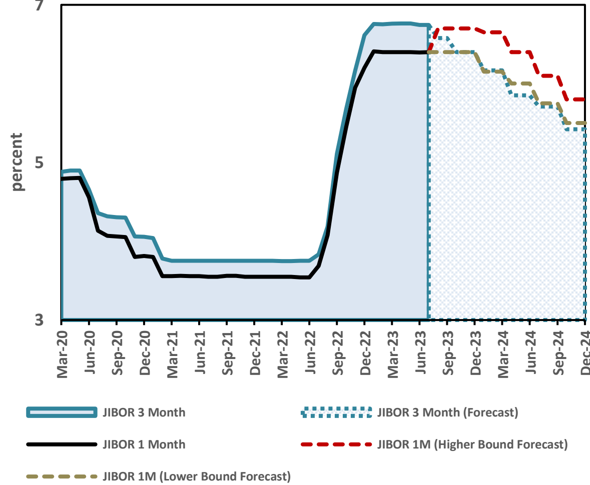
Lending Benchmark Rates (JIBOR) Outlook

In summary, inflation environment both in Indonesia and globally, with a few emerging economies exceptions such as China, India, and Brazil, is expected to moderate at the end of 2023 and possibly in 2024. However, since the upward risks in inflation can be attributed to supply shocks, such as weather disruptions affecting food prices and oil prices fluctuations, we still see a possibility of a rate hike from the Fed towards the end of 2023. On the other hand, BI is expected to employ policy instruments such as FX spot market interventions to maintain rupiah stability before ultimately considering policy rate adjustment.

The IFG Progress Digest Issue #10 demonstrates a stable relationship between JIBOR 1-month rate movement and BI 7DRRR movement. Based on this relationship, our model indicates that JIBOR 1-month rate will keep its rate level at ~6.4% at least until the end of 2023. Market analysts forecast JIBOR 3-month rate to decrease as early as 3Q'23 and we can see rate convergence between JIBOR 3-month and 1-month rates, which also happened in 1Q-2Q'20 and 3Q-4Q'22 (Exhibit 6).

At the end of 2024, it is expected that both JIBOR 1-month and 3-month rate to decrease up to 60-90 bps. This seemingly steep decrease comes from the expected rate cuts from the Fed and BI in the second half of 2024. However, the magnitude of the fall in the JIBOR rate in 2024 depends on the inflationary risk associated with El Nino and food prices, which may warrant policy rate response by BI (Exhibit 7).

Exhibit 6. JIBOR1-month rate likely to stay the same until end of 2023 while JIBOR 3-month rate more likely to fall



Source: Bloomberg, IFGP Research. Note: JIBOR 1-m forecast is done with IFGP proprietary model while JIBOR 3-m forecast is taken from Bloomberg analyst consensus

Exhibit 7. JIBOR 1-month forecast range

- *JIBOR 1-m forecasts are based on Bloomberg's BI 7DRR forecasts along with IFGP Inertia Taylor Rule Model.*
- *BI 7DRRR are average ranges at the given quarters.*
- *Forecasts from previous periods are treated as new JIBOR.*
- *Forecast range are derived from various estimates, including from the Level OLS model, First Difference OLS model, and the average difference of 65 bps from Bloomberg's Weighted Average BI 7DRRR forecast.*

Forecast Scenarios	Current (25/08/23)	Q3 '23	Q4 '23	Q1 '24	Q2 '24	Q3 '24	Q4 '24	FY'25
As of Jan-23	6.4	6.50–6.67	6.40–6.54	6.30–6.41	6.15–6.21	5.87–5.90	5.61–5.70	5.61–5.70
As of Aug-23		**6.40–6.70**	**6.40–6.70**	**6.15 – 6.65**	**6.00 – 6.40**	**5.75 – 6.10**	**5.50–5.80**	**5.25–5.50**

Source: IFGP Research.

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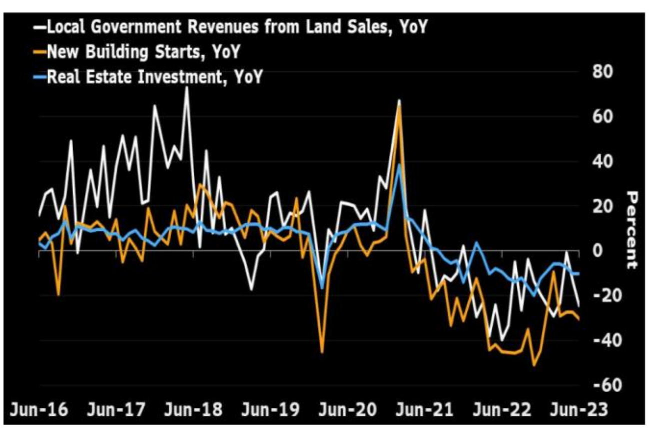
APPENDIX

Appendix 1 & 2. China's weak demand data causes deflationary pressure.



Stronger ⟷ Weaker

Group	Indicator	Ticker	Unit	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23
Income, Jobs	Real Disposable Income	CHNNT Index	% YoY*	6.1	-3.9	0.7	3.6	4.5	4.5	5.6	4.6	4.4	5.1	0.9	4.5	2.1	4.5	4.3
Income, Jobs	Household Saving Rate	BE Estimate	% 4Q Rolling	29.9	31.5	32.7	33.6	34.1	33.7	32.8	32.0	31.4	31.4	32.2	32.3	33.5	33.5	33.0

Group	Indicator	Ticker	Unit	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23
Income, Jobs	Non-Manufacturing PMI - Employment	CPMINEMP Index	Index	45.4	45.3	46.9	46.7	46.8	46.6	46.1	45.5	42.9	46.7	50.2	49.2	48.3	48.4	46.8
Income, Jobs	Unemployment Rate in 31 Major Cities	CNUESR31 Index	%	6.7	6.9	5.8	5.6	5.4	5.8	6.0	6.7	6.1	5.8	5.7	5.5	5.5	5.5	5.5
Income, Jobs	Youth (16-24) Unemployment Rate	CNUESA16 Index	%	18.2	18.4	19.3	19.9	18.7	17.9	17.9	17.1	16.7	17.3	18.1	19.6	20.4	20.8	21.3
Goods Consumption (Retail Sales)		CNRSCYOY Index	% YoY*	-11.1	-7	3.1	2.7	5.4	2.5	-0.5	-5.9	-1.8	5.1	5.1	3.3	2.6	2.5	3.1
Non-housing	Automobile	CHSAAUTY Index	% YoY*	-31.6	-16.0	13.9	9.7	15.9	14.2	3.9	-4.2	4.6	-3.0	-3.0	1.6	-2.8	2.1	6.1
Non-housing	Jewelry	CHSAGOLY Index	% YoY*	-26.7	-15.5	8.1	22.1	7.2	1.9	-2.7	-7.0	-10.4	12.5	12.5	6.2	3.0	2.5	7.9
Non-housing	Communication Devices	CHSACOMY Index	% YoY*	-21.8	-7.7	6.6	4.9	-4.6	5.8	-8.9	-17.6	-4.5	-1.9	-1.9	2.4	-5.3	0.4	6.6
Housing-related	Floor Space Sold	CHRESOLD Index	% YoY*	-39.0	-31.0	-18.3	-28.9	-22.6	-16.2	-23.2	-33.3	-31.5	-3.6	-3.6	-9.3	-20.1	-18.5	-17.9
Housing-related	Home Appliances	CHSAHGEY Index	% YoY*	-8.1	-10.6	3.2	7.1	3.4	-6.1	-14.1	-17.3	-13.1	5.1	5.1	-2.9	-1.9	-5.4	3.8
Housing-related	Furniture	CHSAFURY Index	% YoY*	-14.0	-12.2	-6.6	-6.3	-8.1	-7.3	-6.6	-4.0	-5.8	-0.6	-0.6	-2.8	-5.7	-4.0	-2.8
Services Consumption	Official Services PMI	CPMISERV Index	Index	40.0	47.1	54.3	52.0	51.9	48.9	47.0	45.1	39.4	54.0	55.6	56.9	55.1	53.0	52.8
Services Consumption	Services Production	CNSF Index	% YoY*	-6.1	-5.1	1.3	0.6	1.8	1.3	0.1	-1.5	-0.8	4.8	4.8	4.0	3.2	3.0	4.0
Services Consumption	Catering	CNRSVAFY Index	% YoY*	-22.7	-21.1	-4.0	-1.5	8.4	-1.7	-8.1	-8.4	-14.1	9.0	9.0	2.8	5.4	3.2	5.6
Services Consumption	Air Traffic - Domestic	CAIRPTDO Index	vs. Pre-Covid	-83	-75	-54	-36	-41	-53	-65	-74	-60	-14	-14	-6.1	3.6	2.5	
Services Consumption	Air Traffic - International	CAIRPTIN Index	vs. Pre-Covid	-99	-98	-98	-98	-97	-97	-97	-98	-95	-90	-90	-82	-73	-67	
CPI	CPI - Core	CNCPCRY Index	%	0.5	0.9	1.0	0.8	0.8	0.6	0.6	0.6	0.7	1.0	0.6	0.7	0.7	0.6	0.4
CPI	CPI - Tourism	CNCPTOY Index	%	2.4	0.9	4.1	0.5	0.1	1.9	2.4	3.8	3.9	11.2	3.0	5.3	9.1	8.0	6.4

High Frequency 2023

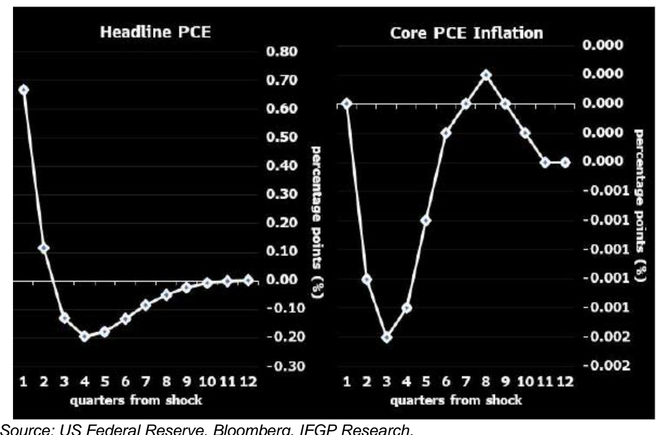
Indicator	23-Jun	30-Jun	7-Jul	14-Jul	21-Jul
Automobile	27	32	33	-8.8	-8.0
Floor Space Sold	-8.2	-6.6	-21	-24	-16
Home Appliances	36	9.3	-7.0	6.4	-27

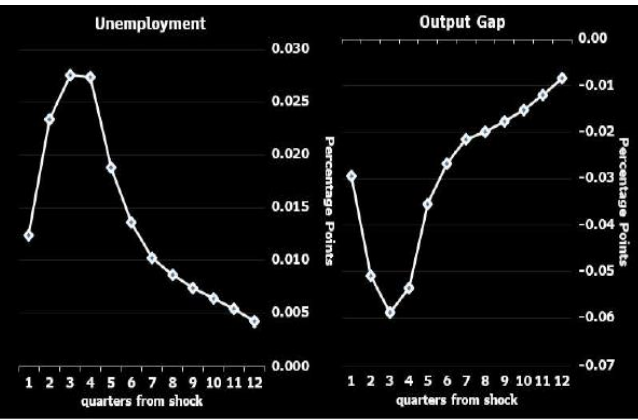
*Two-year average change for 2021 and 1H 2023 data.

Source: Bloomberg, IFGP Research.

Appendix 3 & 4. How Oil Shocks affect US inflation, output gap, and unemployment (Fed model)

- *In a scenario where oil prices rise US$20/bbl, Fed's model estimate PCE inflation (fed's preferred inflation gauge) would rise by 0.7% in 3Q'23 and 0.1% in 4Q23. However, core PCE inflation would barely be impacted.*
- *Higher oil price reduce household spending, widens the output gap, and raises unemployment rate.*
- *As a result of mild impact on core inflation and negative impact on growth, the model sees Fed to not cut rates.*





Source: US Federal Reserve, Bloomberg, IFGP Research.

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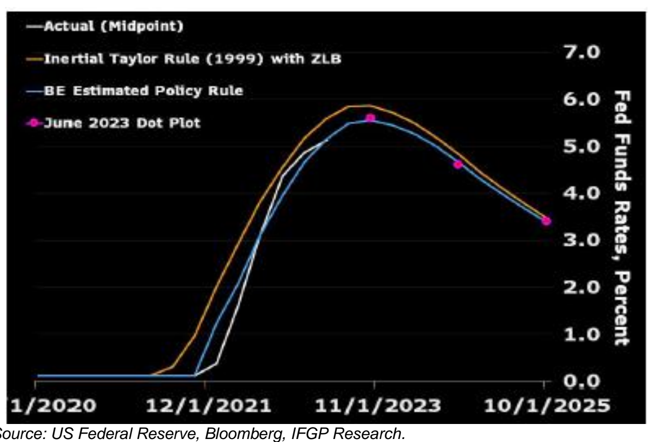
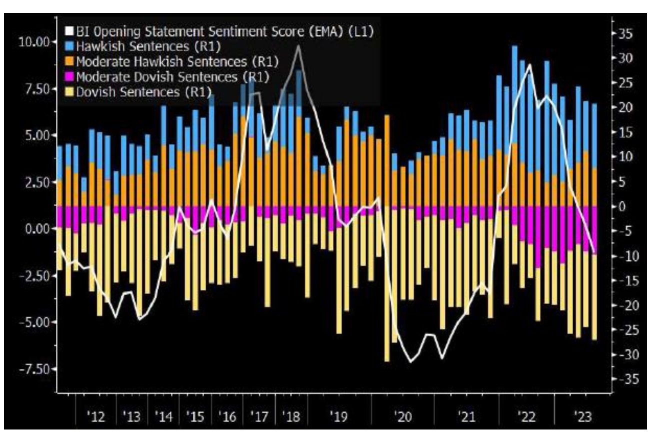
Appendix 5 & 6. Fed June '23 Dot Plot, US Taylor Rule, and July '23 FOMC Sentiments

- *June's FOMC dot plot showed an anticipated 5.75% terminal rate conditional on the median participant's 4Q'23 forecast for core inflation at 3.9% and unemployment at 4.1%.*
- *According to FOMC's meeting last July, Fed Chair Powell's opening remarks were more dovish than the June meeting. There were less hawkish sentences and additional dovish sentences.*
- *If the sentiment proven to be correct, the Fed might be done hiking the Fed rate.*

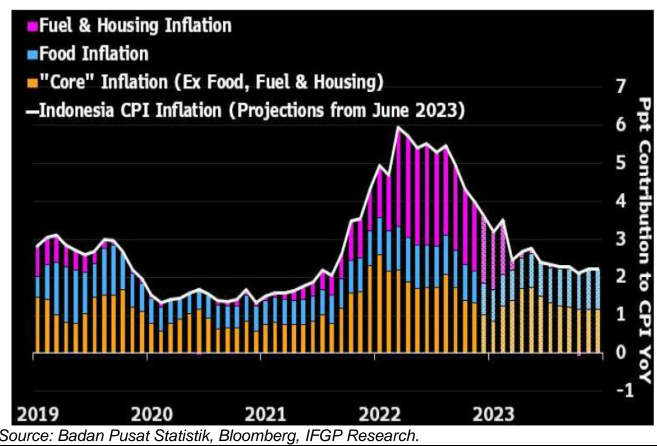


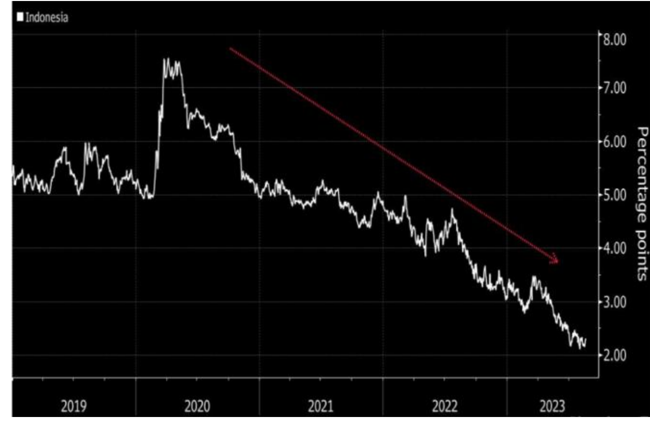


Source: US Federal Reserve, Bloomberg, IFGP Research.

Appendix 7 & 8. While Indonesia's inflation is expected to moderate, Indonesia's gov't bond yield premium over US Treasuries has eroded

- *Inflation is back within 2-4% target. BI is confident inflation will remain in target for the remainder of 2023.*
- *However, Indonesia bonds face headwinds as BI will need to maintain hawkish stance to attract capital inflows.* ***An early rate-cut now looks unlikely to support bonds.***
- *BI governor on 22/8 commented that BI would need to raise short-term bond yields to attract foreign bond inflows via BI's operation twist. This implies BI needs to delay any rate cuts.*





Source: Badan Pusat Statistik, Bloomberg, IFGP Research.

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