Economics

BI Surprises With Rate Hike to Defend the Rupiah

Highlights

- **Surprise hawkish hike**. BI raised its benchmark rate to 6.00% from 5.75% on Nov 26, defying consensus. This was done to defend the rupiah - which hit an all-time low of Rp18,264 (−8.47% ytd) - and to pre-empt the Fed's rate hikes, rising domestic inflation amid declining forex reserves (below US$100b). BI also raised DNDF hedging discounts to attract foreign inflows.
- **Negative market reaction.** The rupiah strengthened only briefly before resuming its weakening trend - the 10-year bond yield rose to 7.71% and the JCI fell 1%, as markets attributed the currency's weakness to the strong US dollar and domestic non-monetary factors (confusing policy signals, expansive fiscal policy, ballooning fuel subsidies).
- **BI's hawkish turn aims to pre-empt the Fed's tightening, which currently stands at** 96.7% odds of a 26bps hike to 4.25% in Dec 26, with more hikes in 2027. However, the repricing effect depends on 10-year bond yields reaching a justified 7.8-8.0% for a healthy spread over US Treasuries, which hinges on BI's intervention, especially at longer tenors.
- **Rupiah expected to remain under strain.** Despite the hike, the rupiah is expected to stay under pressure throughout 1Q27 due to a potential MSCI downgrade (US$10b outflows in 2027), a large current account deficit, and a still-strong US dollar amid a hawkish Fed.

Analysis

- **BI hiked its benchmark BI Rate to 6.00% from 5.75% previously at its Nov 26 Board of Governors meeting.** The decision defied market consensus, which had expected a hold at 5.75%. In our view, the move was hawkish following the central bank's easing policy over the previous several months. The shift was driven by several factors.

  a) **The rupiah has depreciated to an all-time low of Rp18,264 as of 17 Nov 26, down 8.47% ytd.** This is one of the worst performances among emerging market currencies. The depreciation was driven by global factors, including a stronger Dollar Index amid a more hawkish Federal Reserve. Global geopolitics have not helped either, with further escalations in the Middle East and Europe keeping oil prices elevated.

  b) **The foreign reserve-to-import coverage ratio has continued to decline.** Our calculations show that Bank Indonesia's (BI) foreign reserve-to-import ratio has fallen due to rapid import growth stemming from expansive domestic economic activity. In addition, net foreign reserves have fallen below US$100b by our calculations, further reducing BI's ability to intervene in the foreign currency market.

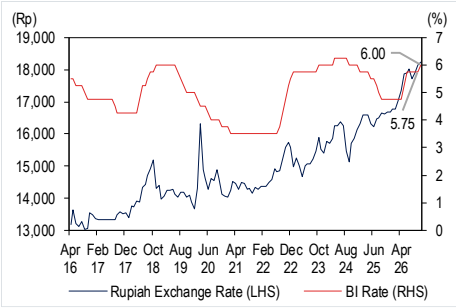
  c) **The domestic economy remains on an expansionary trend, alongside potentially higher inflation pressures.** Higher GDP growth in the third quarter was accompanied by expansive credit growth by corporates and state-owned enterprises (SOE). The rate hike is also a pre-emptive strike against domestic inflation, which is rising due to increases in volatile and administered inflation. Higher whole-price inflation (WPI) also highlights potentially higher CPI inflation pressure in 2027.

- **In addition to raising the policy rate, the central bank further increased its hedging discount for Domestic Non-Deliverable Forwards (DNDF) based on investment tenor**, enhancing incentives and easing foreign investment into the country's bond markets, foreign direct investment, and bank foreign loans. The hedging discount was raised from 40% to 45% for 6-month tenors and from 45% to 50% for 12-month tenors. Furthermore, the central bank also added a new repo instrument - the cross-currency repo,

Analyst(s)

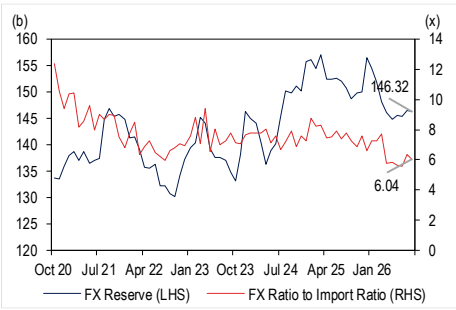
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BI Rate And Rupiah Exchange Rate



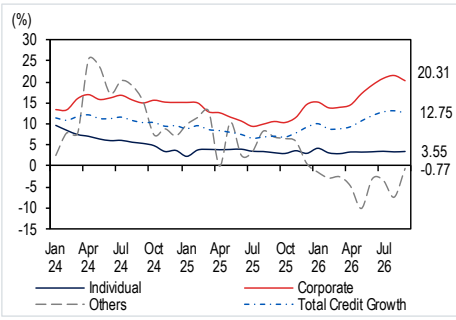
Source: Bloomberg

Foreign Reserve To Import Coverage Ratio



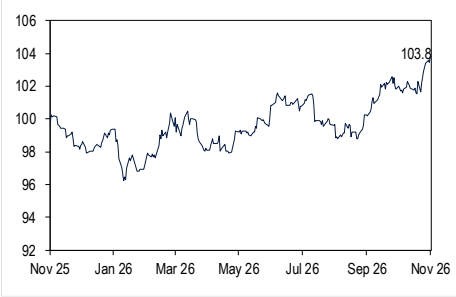
Source: Bloomberg, UOB Kay Hian

Growth In Banking Credit



Source: Bank Indonesia

Dollar Index



Source: Bloomberg

which allows banks to repo their foreign currency-denominated bond holdings to get rupiah liquidity.

- **Market reaction was negative**. The rupiah strengthened briefly but then resumed its weakening trend. The 10-year government bond yield rose to 7.71%, while the Jakarta Composite Index (JCI) declined 1% after the announcement. The negative reaction reflected the market's belief that the rupiah's depreciation was caused by a strong US dollar and domestic non-monetary factors, such as speculation on government policy statements (including Prabowo's statement that 70% of mining proceeds should go to the state), expansive fiscal policy, and ballooning fuel subsidies due to high oil prices.

Outlook

- **BI's hawkish turn represents an effort to pre-empt a rise in global interest rates, especially by the Federal Reserve.** The CME FedWatch shows a 96.7% chance that the Fed will raise its Federal Funds Rate by 26bps to 4.25% in Dec 26. This Fed rate hike is likely to continue into 2027, with further rate hikes in Jan and Mar 27.
- **However, the repricing effect of the new policy tightening will also depend on Indonesian government bond yields**, which in our view has not fully repriced to a fundamentally justified level of 7.8–8.0% for 10-year government bonds, which would result in a healthy yield spread against rising US Treasury yields. This repricing will depend on the central bank's own programme to intervene in the bond market, especially in the longer tenors.
- **This will be complemented by BI's current approach of leveraging foreign capital inflows** by increasing the hedging discount on the DNDF. So far, this policy has partially succeeded, with foreign capital flows resuming in the bond market. As of 16 Nov 26, foreign investors had bought US$3.12b in Indonesian government bonds.
- **Despite the rate hikes, we believe the rupiah will remain under strain and continue to depreciate from now till end-26 and well into 1Q27**. This is due to several factors:

  a) The looming downgrade to Standalone Market status by the MSCI, which we assume will cause US$10b in capital outflow in 2027. We calculate the rupiah's sensitivity to capital outflow and find that a capital outflow of US$1b in the equity market will cause a rupiah depreciation of Rp100-150, ceteris paribus.

  b) The relatively large current account deficit, caused by high oil prices and expansive domestic industrial activity driven by expansive fiscal and state-related activities.

  c) The still-strong Dollar Index, caused by a still-strong US economy and a hawkish Fed.

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