

Economics

BI Rate Held At 5.75%: Balancing Rupiah Stability And Growth Support

Highlights

- **BI held rates at 5.75%, defying consensus for a hike**, citing rupiah stability, a weak domestic economy, and alternative currency-defense tools. The rupiah has been relatively stable near Rp18,000/USD amid bond-market inflows and a softer US dollar, while weak retail sales, soft consumer confidence, low private credit growth, and subdued inflation (3.28% yoy) argued against tightening.
- **BI paired the hold with looser liquidity and stronger inflow incentives.** It cut reserve requirements from 9% to 7% for conventional banks (with the KLM incentive trimmed from 6% to 5%), raised the deposit facility rate to 5.00% to curb money growth, and increased DNDF hedging discounts to 40% (6-month) and 45% (12-month) to attract foreign capital. Markets responded positively: The rupiah firmed just below Rp18,000/USD, 10-year bond yields edged lower, and the JCI strengthened.
- **The outlook is challenging, with risks skewed toward outflows and eventual rate hikes.** A possible MSCI downgrade to standalone market status, high oil prices, and rising US inflation pointing to Fed hikes in Dec 26 and 1Q27 could worsen sovereign risk premiums and pressure the Rupiah, leading to two 25 bps BI rate hikes in tandem with the Fed.

Analysis

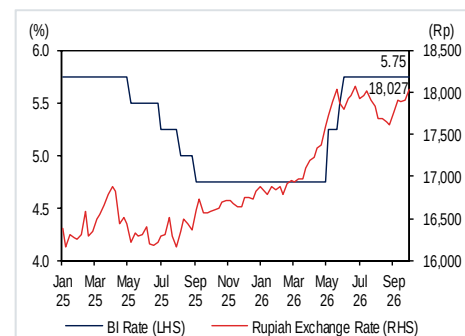
- **Bank Indonesia (BI) held its benchmark BI Rate at 5.75% at its Oct 26 Board of Governors meeting.** The decision defied market consensus, which had expected a 25 bps hike to 6.00%, but aligned with our forecast of a hold. The move represents the latest step in BI's delicate balancing act, driven by several factors.
- **First, the rupiah has been relatively stable, hovering around the Rp18,000/USD mark**, with 30-day currency volatility low compared to peers. This stability was supported by significant capital inflows into Indonesia's financial markets – mostly into the bond market following the equity market rout since the MSCI announcement – as well as by global factors such as a weaker US dollar and declining US Treasury yields as investors began buying into the US bond market. Domestically, Indonesia's external balance improved slightly, as reflected in the rising trade balance in Aug 26.
- **Second, the domestic economy remains relatively weak.** Retail sales growth remains subdued, consumer confidence has softened, and privately owned banks have reported low credit growth, signalling weak private sector activity. Domestic inflationary pressure also remains subdued at 3.28% yoy in Sep 26. Third, BI retains other tools to defend the currency, including foreign currency intervention, hedging discounts, and SRBI bond yields (which are on a declining trend). Raising the policy rate while the economy is weak would only further drag on growth.
- **Despite keeping the policy rate unchanged, BI unveiled several significant policy changes.** First, the central bank reduced the reserve requirement (Giro Wajib Minimum) from 9% to 7% for conventional banks over the next two months and lowered the maximum macroprudential incentive (KLM) from 6% to 5%, effectively reducing the reserve requirement from 3% to 2%. This should benefit the banking sector, which has experienced tighter liquidity. However, the effect is partly offset by BI's move to raise the deposit facility rate from 4.75% to 5.00%, which reduces money growth and alleviates pressure on the rupiah.

Analyst(s)

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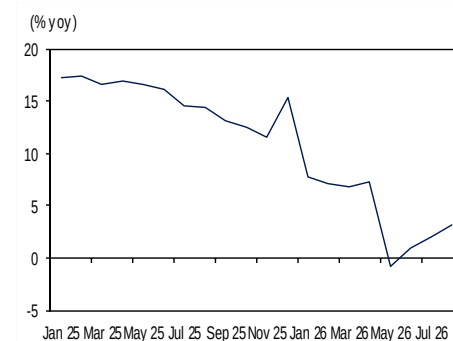
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BI Rate And Rupiah Exchange Rate



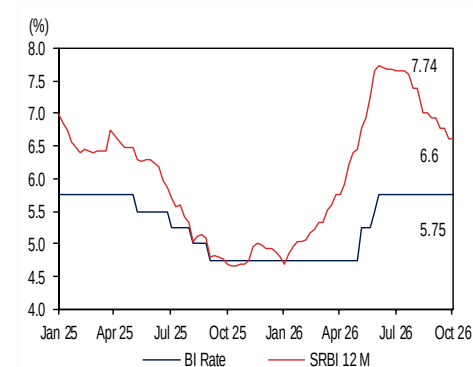
Source: Bloomberg

Credit Growth Of Privately-Owned Banks



Source: Bloomberg, UOB Kay Hian

BI Rate And SRBI Yield



Source: Bloomberg

- **Third, 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 25% to 40% for 6-month tenors and from 40% to 45% for 12-month tenors.
- **Markets greeted these policy moves positively:** The rupiah strengthened to just below Rp18,000/USD, 10-year government bond yields declined slightly, and the Jakarta Composite Index also strengthened.

Outlook

- **BI's new approach** – leveraging foreign capital inflows and keeping domestic liquidity ample but not abundant to support rupiah stability while allowing improved bank liquidity – has so far kept the balance and worked in a volatile global environment. This is largely due to the higher yields of Indonesian government bonds and SRBI, which have improved returns for foreign investors.
- **However, the outlook going forward is quite challenging.** A possible downgrade to standalone market status by global index provider MSCI is likely to increase global scrutiny of Indonesian credit ratings, as reflected in statements by global credit rating agency Fitch yesterday (20/10). This, together with still-high oil prices, may continuously push for worsening sovereign risk premiums, increasing pressure on capital outflows and the rupiah. Additionally, increasingly significant global flows into US Treasuries may well end the significant inflows into emerging market bonds, ending the mercy of global investors.
- **The situation in the US is not shining either.** Higher global prices have caused a resurgence in US inflation, both on the producer and consumer sides, pushing up US PPI and CPI inflation. This has increased the possibility of further Fed rate hikes, which we expect in Dec 26 and another in 1Q27.
- Our own research has found that one of the most significant variables determining the BI Rate is the Fed Funds Rate, which drives the rate differential. We therefore call for two 25 bps rate hikes – one in Dec 26 and another in 1Q27 – in line with the Fed.

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