Monthly Economic & Finance Briefing

Economic, Banking & Industry Research of BCA Group

Fed and BI Policy: Diverging trajectories?

Executive Summary:

- **The Fed's rate trajectory appears to be steepening, with QE expected to end in Q1-22 and three rate hikes seen in 2022, amid an effort to rein in inflation.**
- **The flattening yield curve and the Fed's own lower GDP projection for next year indicates that there is a risk of economic slowdown, which may lead to a premature end to the upcoming rate hike cycle.**
- **For the moment, market reactions to the Fed might be slightly obscured by worries over Omicron variant, while real rates remain substantially negative which moderate capital flight risks for EMs.**
- **BI looks to stick to its own exit strategy despite the Fed's changing trajectory, which is plausible given the hitherto low inflation and substantial trade surplus buffer.**
- **However, this would only be a temporary delay, rather than divergence, in rate trajectories, since the current rapid recovery may raise the probability of inflation and stronger imports by mid- or late-2022.**

- The Federal Reserve confirmed a swifter reversal of its ultra-easy policy, by announcing a doubling of the pace of tapering – reducing its monthly purchase of US Treasury bonds to USD 30Bn come January 2022, **clearing the path for the first post-pandemic Fed rate hike by the end of Q2 2022 at the latest.** The dot plot signals a total of **three rate hikes coming in 2022,** a hawkish move that the market has only begun to price in, and even then, not fully, in the last few weeks (***Chart 1***) – not co-incidentally, a period marked by rather high volatility and asset price corrections.

- The Fed's rather dramatic policy pivot reflects the Central Bank's changing paradigm regarding the current surge of US inflation. The 2021 PCE inflation projection has been increased to 5.3%, while the unemployment rate is lower at 4.3% compared to 4.8% in the prior projection, reflecting a view that the US economy is close to being overheated. The Fed thus no longer saw inflation as 'transitory', and the rather aggressive three rate hikes outline could be seen as a necessity to cool the economy. The move also shows that **the Fed is willing to forego some of its growth potential to bring stability to the economy**, as the central bank lowers their real GDP growth projection from 5.9% to 5.5%.

- Market reactions are mixed, with US equity markets rallying while EMs mostly declined, as the announcement removes some policy uncertainty going forward but also raises the specter of a stronger USD **(*Chart 3*)**. However, market indicators may have been somewhat obscured by worries over the Omicron variant, which has suppressed the 10Y UST yield by about 20-30 bps recently. It is possible that the ripple effects of the Fed's move would only be fully visible once Omicron worries are lifted off the markets' neck.

- It is also notable that the longer ends of the yield curve have risen more slowly compared to the shorter end, resulting in a clear flattening of the yield curve (***Chart 2***). This could point to a possibility of slower economic activities in the medium-term as a result of tighter monetary policy – which mean that **the Fed might have to end its rate hike cycle early (shorter monetary cycle than usual) to stanch the risk of recession.**

- Meanwhile, a few hours after, Bank Indonesia kept its 7-Day Repo Rate (BI7DRR) at 3.5% as expected. Quite remarkably, **BI maintained that it would stick to its own exit strategy (rate hike starting at the end of 2022), and is in no hurry to raise the policy rate even if the Fed Funds rate does hike early.**

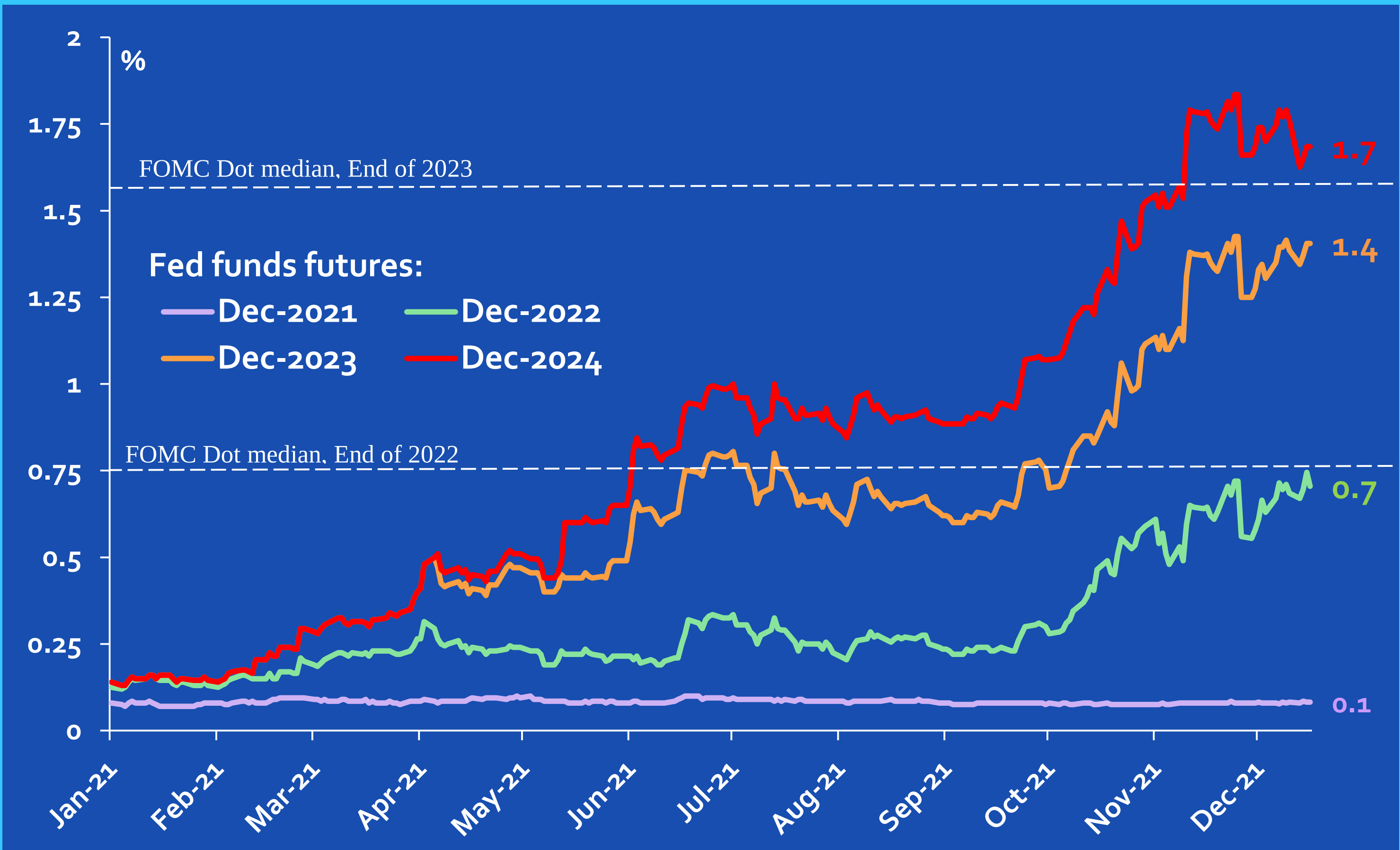
- The rationale here is clear: Indonesia is in the midst of a remarkable recovery from the recession, while inflation has remained mild at only 1.7% YoY. Meanwhile, **the Fed's new stance has not resulted in an effective tightening of global liquidity as yet, with US real rates remaining negative amid elevated inflation expectations** (***Chart 4***). And even if capital outflow intensifies, Indonesia's current account position has shown solid improvement (***Chart 5***).

- But this may not mean that BI can safely ignore the Fed's hawkishness and dance to its own tune, for two reasons. For one, **domestic energy prices have been kept low by the government, who does not wish to jeopardize the recovery momentum just to align with (potentially temporary) higher global prices.**

If the high energy prices turn out to be more permanent, however, the government may have little choice but to adjust – and preferably not too close to the political hoopla leading up to the 2024 Elections.

- Secondly, the economy might be growing above its non-depreciating potential rate, which we estimate at 4.5 – 5.0% for next year (*upcoming*). If the economy continues to run hot, as it seems to be in Q4-21, we might see a faster pace in import growth – especially for capital goods which has so far lagged behind – and this could in turn eat away at the current account buffer. Still, both the risks of higher (energy) inflation and overheating economy might only start to become salient enough in the middle of 2022, meaning that BI's policy rate trajectory might be delayed – rather than divergent – compared to the Fed's.

Chart 1. The Federal Reserve signals a total of three Fed Rate hikes for next year…



Source: Bloomberg

Chart 2. ...a rather drastic policy shift which brings the prospect of slower economic cycle

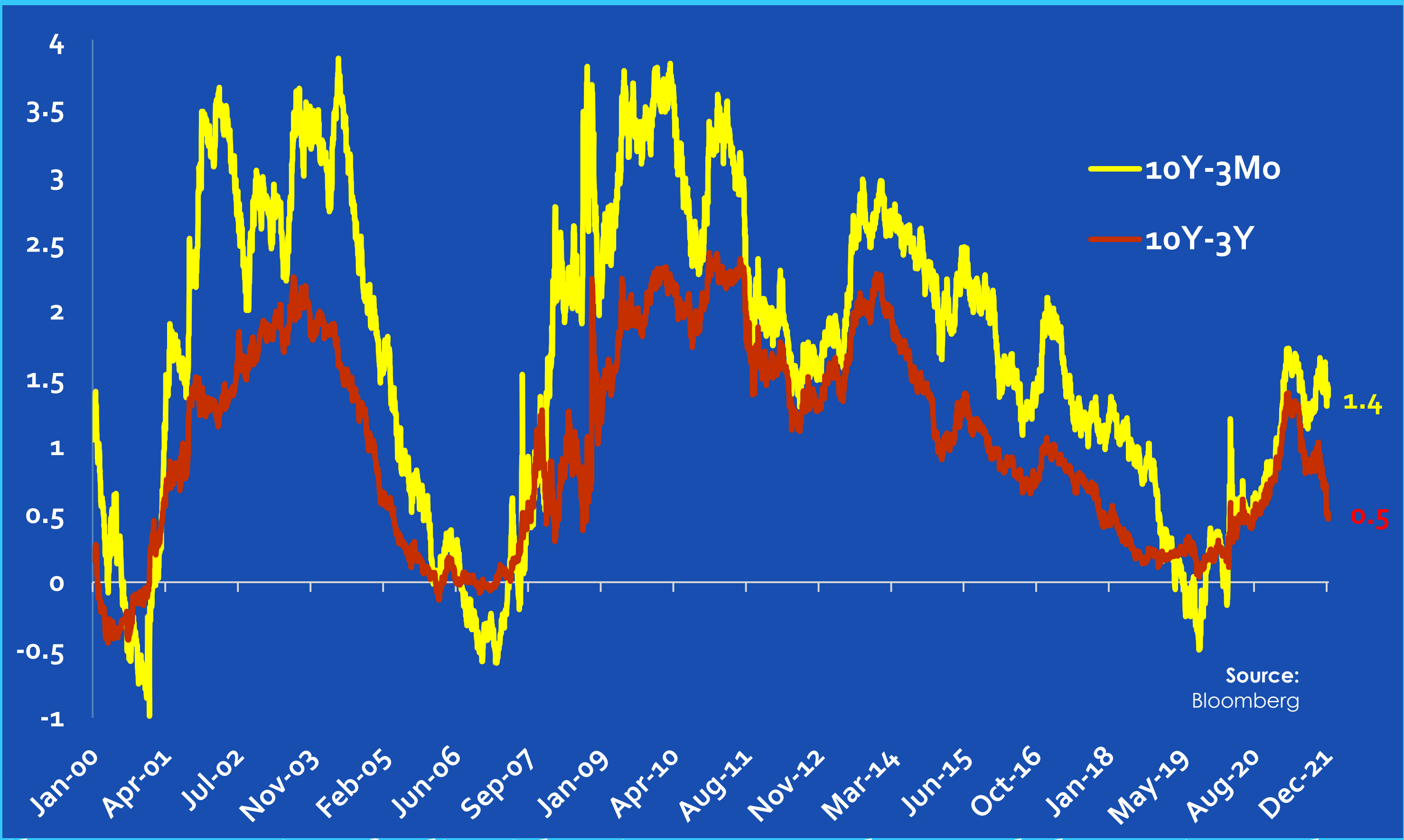


Chart 3. Expectation of policy tightening appears to have rattled emerging markets

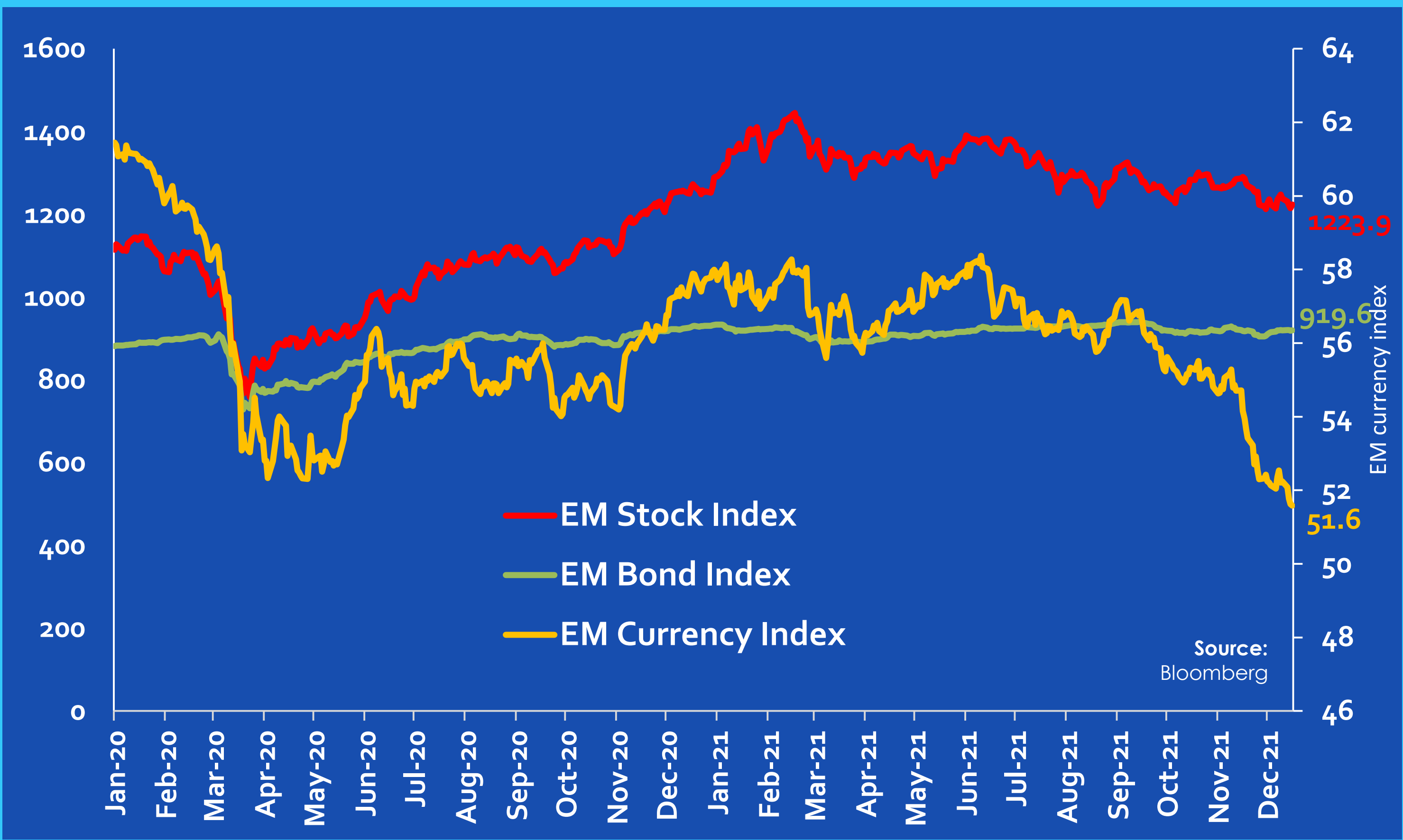


Chart 4. The negative real interest rate to remain throughout 2022 under the current Fed Rate hike timeline

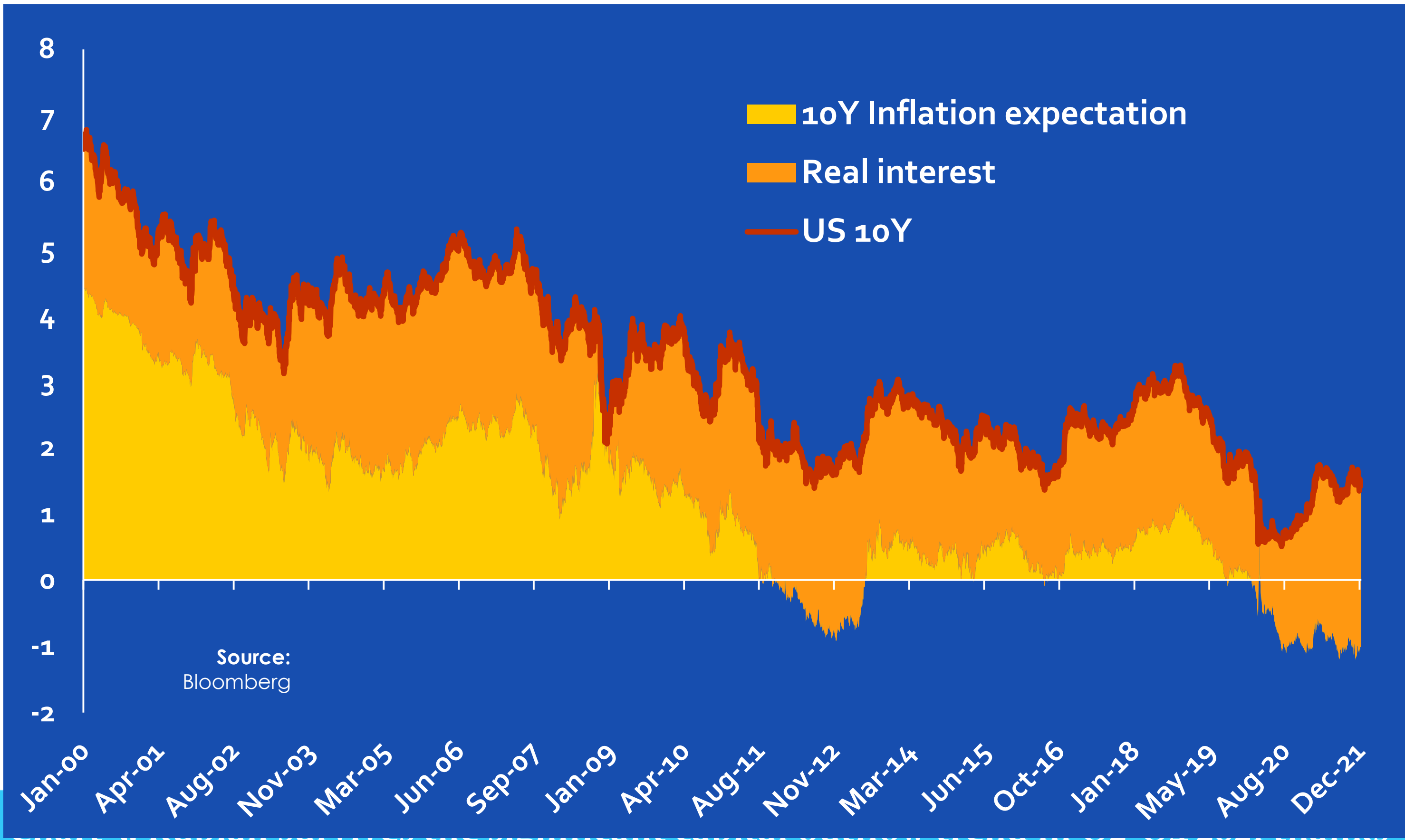
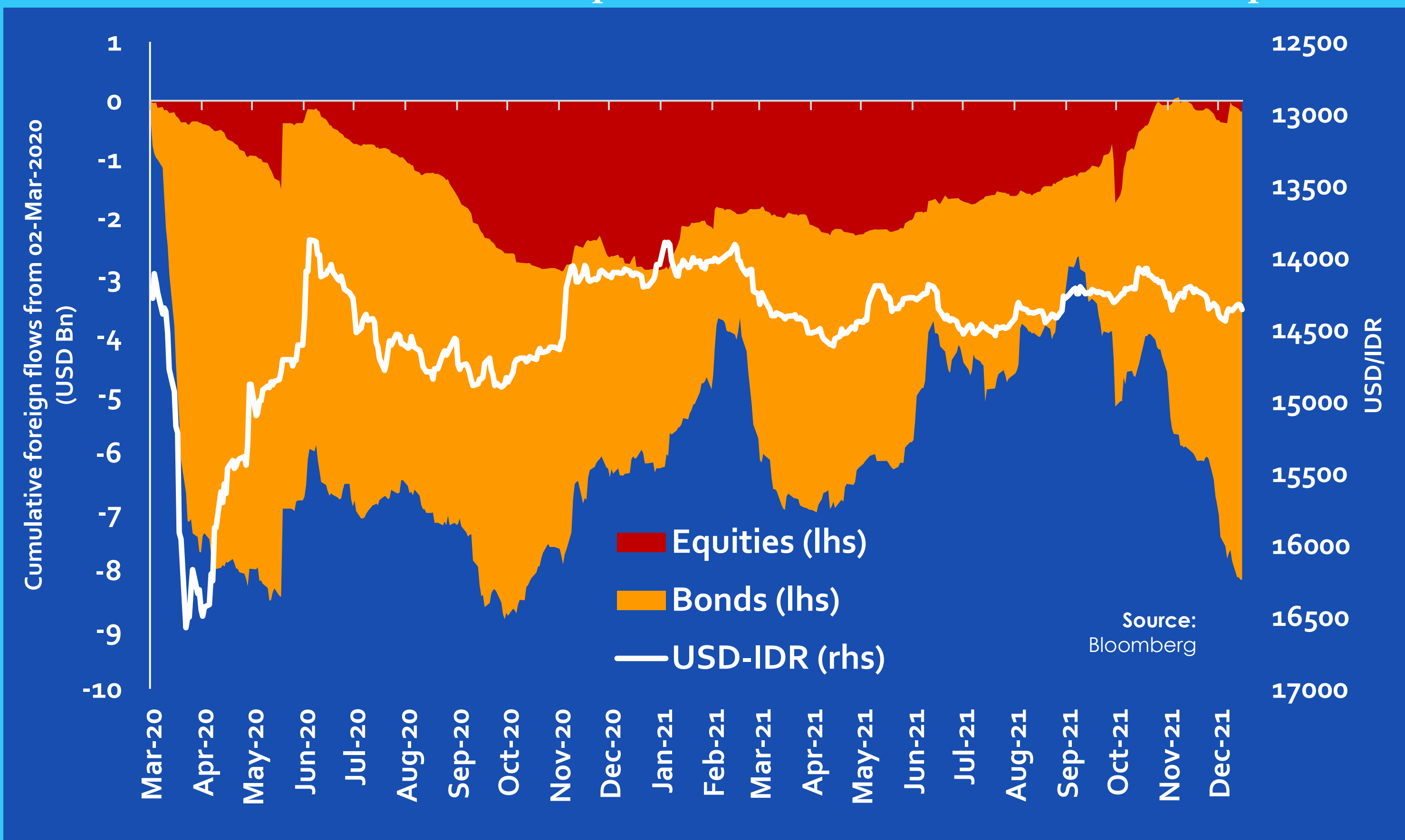


Chart 5: Rupiah survives the significant capital outflow trend in Q1-Q4 2021 thanks to the robust current account position due to above normal trade surplus



Key Policy Rates	Rate (%)	Last Change	Real Rate (%)
US	0.25	Mar-20	-6.55
UK	0.10	Mar-20	-5.00
EU	0.00	Mar-16	-4.90
Japan	-0.10	Jan-16	-0.20
China (lending)	4.35	Oct-15	2.05
Korea	1.00	Nov-21	-2.70
India	4.00	May-20	-0.91
Indonesia	3.50	Feb-21	1.75
Money Mkt Rates	**16-Dec**	**-1 mth**	**Chg (bps)**
SPN (1M)	3.04	2.26	78.1
SUN (10Y)	6.45	6.03	42.0
INDONIA (O/N, Rp)	2.79	2.79	-0.6
JIBOR 1M (Rp)	3.55	3.55	0.0
Bank Rates (Rp)	**Sep**	**Aug**	**Chg (bps)**
Lending (WC)	8.85	8.92	-6.89
Deposit 1M	3.24	3.31	-7.36
Savings	0.73	0.76	-2.84
Currency/USD	**16-Dec**	**-1 mth**	**Chg (%)**
UK Pound	0.751	0.745	-0.69
Euro	0.883	0.880	-0.33
Japanese Yen	113.7	114.1	0.40
Chinese RMB	6.368	6.383	0.23
Indonesia Rupiah	14,362	14,202	-1.11
Capital Mkt	**16-Dec**	**-1 mth**	**Chg (%)**
JCI	6,594.8	6,616.0	-0.32
DJIA	35,897.6	36,087.5	-0.53
FTSE	7,260.6	7,351.9	-1.24
Nikkei 225	29,066.3	29,776.8	-2.39
Hang Seng	23,475.5	25,390.9	-7.54
Foreign portfolio ownership (Rp Tn)	**Nov**	**Oct**	**Chg (Rp Tn)**
Stock	2,233.2	2,248.9	-15.79
Govt. Bond	918.5	949.3	-30.81
Corp. Bond	22.4	23.1	-0.69

Trade & Commodities	16-Dec	-1 mth	Chg (%)
Baltic Dry Index	2,498.0	2,759.0	-9.5
S&P GSCI Index	546.1	579.9	-5.8
Oil (Brent, $/brl)	75.0	82.1	-8.6
Coal ($/MT)	179.1	141.1	27.0
Gas ($/MMBtu)	3.67	4.75	-22.7
Gold ($/oz.)	1,799.4	1,862.8	-3.4
Copper ($/MT)	9,524.5	9,705.5	-1.9
Nickel ($/MT)	19,739.8	19,772.0	-0.2
CPO ($/MT)	1,151.4	1,264.2	-8.9
Rubber ($/kg)	1.70	1.72	-1.2
External Sector	**Nov**	**Oct**	**Chg (%)**
Export ($ bn)	22.84	22.03	3.7
Import ($ bn)	19.33	16.29	18.6
Trade bal. ($ bn)	3.51	5.74	-38.7
Central bank reserves ($ bn)	145.9	145.5	0.30
Prompt Indicators	**Nov**	**Oct**	**Sep**
Consumer confidence index (CCI)	118.5	113.4	95.5
Car sales (%YoY)	62.4	54.1	73.2
Motorcycle sales (%YoY)	95.6	39.9	22.0
Cement sales (%YoY)	-	5.3	3.7
Manufacturing PMI	**Nov**	**Oct**	**Chg (bps)**
USA	61.1	60.8	30
Eurozone	58.4	58.3	10
Japan	54.5	53.2	130
China	49.9	50.6	-70
Korea	50.9	50.2	70
Indonesia	53.9	57.2	-330

Source: Bloomberg, BI, BPS
Notes:
*Previous data
For change in currency: **Black indicates appreciation against USD, **Red** indicates depreciation
***For PMI, **> 50** indicates economic expansion, **< 50** indicates contraction

Indonesia – Economic Indicators Projection

	2016	2017	2018	2019	2020	2021E
Gross Domestic Product (% YoY)	5.0	5.1	5.2	5.0	-2.1	4.0
GDP per Capita (US$)	3605	3877	3927	4175	3912	4055
Consumer Price Index Inflation (% YoY)	3.0	3.6	3.1	2.7	1.7	1.9
BI 7 day Repo Rate (%)	4.75	4.25	6.00	5.00	3.75	3.50
USD/IDR Exchange Rate (end of year)**	13,473	13,433	14,390	13,866	14.050	14.460
Trade Balance (US$ billion)	8.8	11.8	-8.5	-3.2	21.7	36.1
Current Account Balance (% GDP)	-1.8	-1.6	-3.0	-2.7	-0.4	0.6

** Estimation of Rupiah's fundamental exchange rate

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