

INDONESIA INSIGHT: Central Bank Leans on QE to Anchor Rupiah (1)
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(Bloomberg Economics) -- Bank Indonesia's decision to hold the policy rate shows its priority is to anchor the rupiah, although the central bank appears committed to another rate cut to support growth. That task could prove more difficult in the weeks ahead, with the finance ministry concerned about increased risks to financial stability.

Recent developments around stimulus could also make markets nervous about currency debasement: the government has shed its fiscal restraints, and lawmakers are clamoring for the central bank to fund more of the stimulus. What's more, the sharp rise in virus cases delays the economy's re-opening. As such, market volatility may persist, making another rate cut unlikely before August.

* Indonesia's central bank left its 7-day reverse repo rate unchanged at 4.50% on May 19, in line with our forecast. Most in a Bloomberg News survey expected a 25 bps rate cut.

* Keeping rate cut hopes alive, though, Bank Indonesia said low inflation and weak growth provide space for the central bank to ease further.

* Governor Perry Warjiyo said the central bank is committed to financing the budget deficit. It would buy no more than 25% of the government's bond offerings in primary auctions. No limit was referenced for purchases via private placements or in the secondary market.

Bank Indonesia Extends Rate Cut Pause

Bank Indonesia is using bond purchases to support the rupiah and help fund the government's Covid-19 response. Too much quantitative easing, though, could backfire and fuel worries about the accommodation of unfettered government spending.

Critical for reassuring investors, in our view, is that the central bank stick to its pledge to cap bond purchases in the primary market at 25% and intervene only as a last resort. If these promises are broken, QE could weigh on the rupiah like a pair of cement shoes.

Emerging market central banks embarking on QE might already be skating on thinner ice than peers in developed markets. Bank Indonesia, for one, has a shorter track record for demonstrating independence from political interference.

Foreigners Have Dumped Government Bonds

Indonesia's central bank said it has injected 583.5 trillion rupiah (3.7% of 2019 GDP) of liquidity into the money market and banking industry so far this year, including purchases of government bonds in the secondary market, term repo transactions, foreign currency swaps and cuts in reserve requirements.

Bank Indonesia left its growth forecast of 2.3% for 2020 unchanged, despite 1Q GDP of 2.97% year on year being much weaker than expected. It still expects the economy to bottom in 2Q, eyeing an easing in the government's lockdown in 3Q and a recovery in consumption in 4Q.

The central bank maintained expectations of inflation in the 2%-4% range in 2020 and 2021, in line with the target. It still views the rupiah as undervalued and sees scope for the currency to rise further against the U.S. dollar.

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