Manulife Investment Management

Investment Note

10 Sept 2019

On 22 August, Bank Indonesia caught investors by surprise when it trimmed its seven-day reverse repurchase rate by 25 basis points (bps) to 5.5%. This was the second such move in two months and underlined the central bank's desire to boost growth in an uncertain global economic climate. In this investment note, our Chief Economist and Investment Strategist at **Manulife Investment Management Indonesia**, along with our **Asian fixed income and Asian equities teams,** look more closely at the unexpected cut and the subsequent market implications.

Indonesia's surprise rate cut in August

Macro view from Katarina Setiawan, Chief Economist at Manulife Indonesia

On 22 August, Bank Indonesia (BI) unexpectedly lowered its benchmark rate by 25 basis points (bps) to 5.5%, the first back-to-back cut since September 2017. The central bank's governor, Perry Warjiyo, said the move was a pre-emptive measure aimed at boosting growth amid the global economic slowdown. In our view, the surprise reduction reflects a vote of confidence in Indonesia's economic fundamentals, showing that BI is not overly concerned about the country's external balance or current account deficit.

Earlier in June, BI cut the reserve requirement to lift lending, as credit growth was at its lowest point in a year[1]. The move was not entirely effective, as commercial banks used the extra liquidity to buy government bonds, causing a spike in sovereign bond ownership from around 17% in early June to approximately 22% in early July[2]. August's rate cut may be more effective at boosting lending.

The central bank did not signal any further easing but the governor did emphasise a need to boost the growth of private-sector investment, which is sensitive to interest-rate movements.

In the wake of the August reduction, the Indonesian rupiah (IDR) appreciated slightly against the US dollar[3] – this was despite a weakening of the Chinese renminbi (CNY), which caused currency depreciations in Korea and India. Future Federal Reserve (Fed) policy will be a key driver of the IDR's trajectory. There is a strong likelihood that the Fed will signal further rate cuts soon. The dollar index (DXY) has been at its highest level in two years, supported by a rush to safe havens amid the market volatility. This has widened the gap between the US dollar and other currencies, including the CNY, possibly eroding the competitiveness of the US economy. As a result, the Fed could send further dovish signals, pushing the DXY index lower and helping other currencies, including the IDR.

Turning to fiscal matters, Indonesia's 2020 state budget left fuel prices unchanged, with a full year 2020 inflation target of 3.1%[4]. It is clear that the government intends to support household consumption through subsidy policy. Given the low inflation risk, there is still room for BI to reduce rates even further to boost growth through investment. The synchronised easing among global central banks should also be beneficial.

[1] Bank Indonesia. 22 August 2019
[2] Finance Ministry DJJPR, July 2019.
[3] Bloomberg, 22-23 August 2019.
[4] Finance Ministry, Nota Keuangan Tahun Anggaran 2020.

Views from Asian Fixed Income team

BI's surprise move hasn't altered our positive outlook on Indonesia. Rather, it confirms our view that the central bank is just at the beginning of its rate-cut cycle. We still expect that more reductions will potentially follow this year. While we don't foresee a large increase to our IDR FX position in the short-term, we believe the currency is evenly balanced from a risk-return perspective and we are happy to keep our position unhedged for now.

Views from Asian Equities team

While the timing of the rate cut was a surprise, the market was already expecting further reductions in the second half, and Indonesia remains attractive for equity investors. The country is still on track for 5% GDP growth this year, and the current account deficit is improving. We prefer the infrastructure sector, as the lower cost of funding will ease the burden of President Jokowi's second-term plans for a mega infrastructure buildout, including the relocation of the capital city, the MRT expansion, and a network of toll roads across the country. The consumer sector is also in better shape, as a booming middle class bolsters household spending.