Why we think BI need to raise interest rate anytime soon?

Key Takeaways

- Despite CPI rate has increased at the fastest pace in the last 5 year, majority economist expect BI to keep interest rate unchanged on July-22.
- Some economist citing BI would kick start policy rate hikes after reserve requirement increase is accomplished in Sep-22.
- However, based on our assessment, there are urgencies why BI need to raise interest rate anytime soon.
- Given the oil prices already hit USD100/bbl level; trend of IDR depreciation; strengthening consumers demand; accelerating loan growth; potentially pass on higher input price; the uptick on inflation expectation as well as probability of Fed's more aggressive tightening, we welcome BI to raise 7-day reverse repo by 25 bps this time.
- We believe it is better to start earlier (pre-emptive) in order to manage inflation expectation as monetary policy has a lag period to be transmitted.

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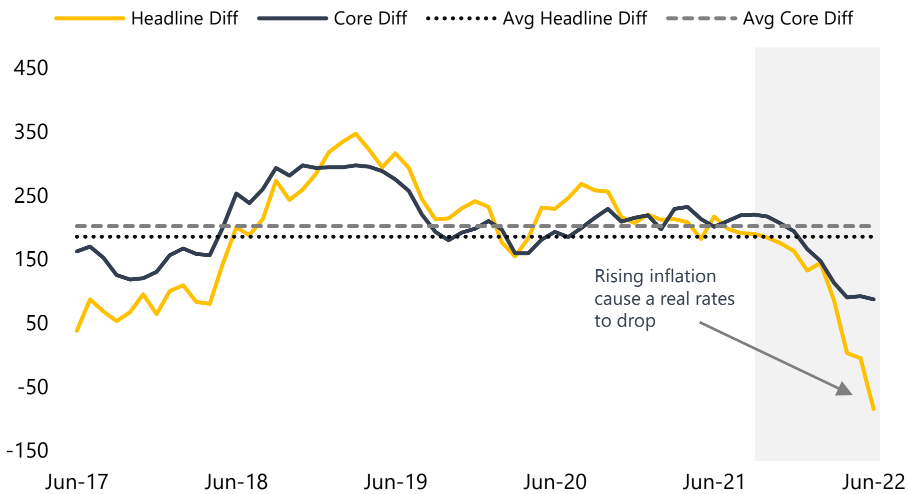
Economists view on interest rates policy

Indonesia's CPI rose +4.35% YoY in Jun-22, hitting the fastest annual pace in the last 5 years, whereas, Core CPI also increased along the way, yet still recording a modest rate at +2.63% YoY. The differential between annual headline CPI rate vs 7-day reverse repo rate turned into negative 85 bps. This marked the first negative spread since Jun-17. On average, the spread between benchmark policy rate vs headline CPI stood 185 bps. The spread has consistently narrowed throughout the year as BI kept the interest rate unchanged while inflationary pressure continued to rise. Furthermore, Core CPI rate vs benchmark policy rate also decreased, however, rate differential stood below its 5-year historical average of 202 bps.

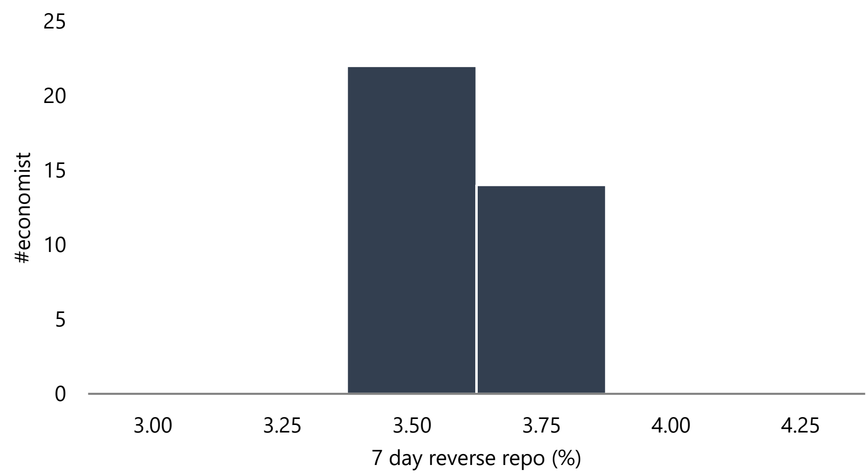
Exhibit 1. Inflation pick up and causing real rates turned to negative



Sources : Bloomberg, Statistics Indonesia, MNCS Research

With consumer prices rising globally and reaching multi-decade highs, global CBs set the hawkish stance aggressively particularly Fed and BoE. Economist consensus agreed that BI is set to raise the reference rate in 2H22. Ahead of BI policy meeting on July 21-22, majority of economists surveyed by Bloomberg expect BI to hold benchmark policy rates (22/61%) and the rest (14/39%) foresee a rate hike of 25 bps to 3.75%.

Exhibit 2. Majority of economists expect BI to HOLD



Sources : Bloomberg, MNCS Research

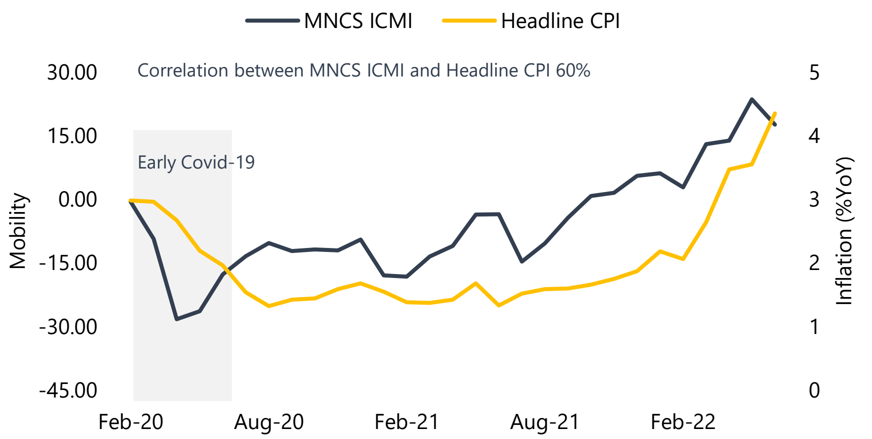
Our assessment

After conducting a macro assessment, our view is that BI need to raise interest rate anytime soon. Here we outlined our macro assessment and justification why we think **this is the time for BI to increase 7-day reverse repo rate by 25 bps to 3.75%** :

- **Gradual recovery propping up inflation**

Indonesia's economy managed to grow +5.01% YoY in 1Q22 in spite of getting hit by the 3rd wave outbreak due to Omicron variant. Less severe virus infection combined with gradual increase in public mobility on the back of loose health intervention policy measure helped the demand to continue recovering. On the other hand, domestic economy is becoming more adapted facing another wave of infection post the 2nd outbreak. It is shown that MNCS Indonesia Composite Mobility Index (ICMI) is improving overtime and we believe this has multiplier effect on demand recovery and the uptick of inflation. Recent infection cases spike due to another virus mutation will only have a limited impact as booster vaccination program is accelerated and government did not impose a strict mobility restriction, hence we also foresee the uptrend inflation trajectory going forward as our MNCS ICMI has strong correlation with CPI rate (R=60%).

Exhibit 3. MNCS ICMI has strong positive correlation with headline CPI rate

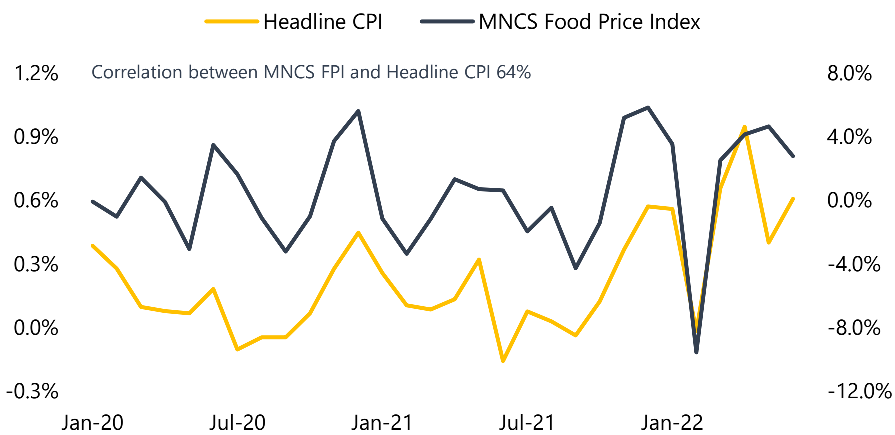


Sources : Our World in Data, Google Mobility Report, Statistics Indonesia, MNCS Research

- **Supply driven inflationary pressure**

Indeed, demand gradually recover, nonetheless, recent uptick in domestic inflation was largely driven by a supply side disturbance that caused food price to soar. To put some perspective, MNCS Food Price Index[1] has risen +12.7% since Jan-20 and we found a strong positive correlation between MoM inflation and our food proxy index change (R=64%).

Exhibit 4. MNCS Food Price Index showed a strong positive correlation with CPI change



Sources : PIHPS Nasional, Statistics Indonesia, MNCS Research

We expect the upside risk for food price to prevail as we found that commodities such as red onions, red chili pepper as well as cayenne pepper continue to rise due to extreme weather that affect horticulture production. We also found that egg price is also consistently increasing post Ramadhan festive momentum, whereas cooking oil price started to decline since May-22, yet still manage to rise +57% from a normal level.

Interestingly, prices for imported foods such as beef, sugar, soybean as well as wheat experience an increase. In spite of the impact on inflation is still manageable so far, however, given the ongoing geopolitical tensions (Russia vs Ukraine) and trade protectionism globally, we believe supply disruption to remain a downside risk.

Prolonging supply shock would only cause global food prices surge transmission to domestic economy. With a such condition, the upward pressure of inflation is likely. Based on a weekly survey conducted by BI, CPI is projected to increase by +0.59% MoM which imply +4.89% YoY growth in Jul-22, bringing inflation rate to break a new record if such a scenario to materialize. As a note, the actual inflation figure for Jun-22 was above BI projection and economist consensus.

Exhibit 5. Heatmap of domestic food staple prices since Covid-19

Komoditas(Rp)	Rice	Chicken Meat	Beef	Egg	Red Onion	Garlic	Red Chili Pepper	Cayenne Pepper	Cooking Oil	Sugar
Dec-19	11,750	34,500	118,250	25,800	34,350	32,250	33,050	38,650	13,350	13,850
Jan-20	11,850	33,300	118,450	25,700	37,700	34,900	45,350	51,950	13,750	14,250
Feb-20	11,850	33,500	118,300	25,250	39,950	50,450	48,600	49,050	13,800	14,600
Mar-20	11,850	32,550	118,100	25,850	38,250	44,900	38,200	39,950	13,750	16,700
Apr-20	11,950	29,200	118,400	25,900	43,600	42,700	32,100	41,650	13,850	18,300
May-20	11,950	33,000	119,150	24,500	53,900	36,250	30,200	34,500	13,750	17,600
Jun-20	11,900	38,150	118,350	25,550	52,850	28,950	29,950	33,850	13,650	16,350
Jul-20	11,900	36,100	118,500	26,350	38,350	23,650	33,200	35,050	13,650	15,100
Aug-20	11,850	31,800	118,650	26,200	32,450	23,900	33,500	35,000	13,800	14,700
Sep-20	11,850	31,400	118,300	24,950	30,950	26,600	33,300	32,650	14,050	14,500
Oct-20	11,850	32,100	118,300	24,500	33,300	26,950	42,300	34,550	14,200	14,400
Nov-20	11,800	35,000	118,450	25,700	37,800	28,500	42,500	37,350	14,350	14,400
Dec-20	11,800	35,450	118,650	27,800	37,050	28,800	51,600	49,950	14,450	14,400
Jan-21	11,850	35,200	119,550	27,300	32,850	28,300	51,550	69,250	14,550	14,450
Feb-21	11,850	34,350	119,700	26,000	32,500	28,600	48,400	71,350	14,550	14,350
Mar-21	11,850	34,700	119,500	25,500	35,150	29,700	48,650	78,100	14,650	14,300
Apr-21	11,800	36,500	121,550	25,900	34,000	30,200	48,150	66,250	14,850	14,250
May-21	11,750	37,450	125,600	26,100	33,250	30,500	40,350	54,150	15,150	14,250
Jun-21	11,750	37,200	123,800	26,350	31,650	30,150	33,350	49,500	15,300	14,200
Jul-21	11,750	33,950	124,950	25,750	33,500	30,250	37,950	57,750	15,400	14,150
Aug-21	11,700	32,550	124,150	25,650	34,900	30,700	30,400	43,450	15,750	14,100
Sep-21	11,700	34,950	124,250	23,850	30,850	29,950	29,250	37,650	16,050	14,050
Oct-21	11,700	35,900	124,300	23,200	29,800	29,650	34,500	39,150	16,650	14,050
Nov-21	11,650	35,600	124,450	24,950	28,500	29,550	40,600	39,100	18,200	14,100
Dec-21	11,700	36,050	124,750	26,950	28,950	29,650	49,400	69,850	19,450	14,150
Jan-22	11,750	38,600	124,500	28,100	30,750	30,350	41,300	59,450	20,150	14,500
Feb-22	11,800	35,650	125,000	24,400	34,650	30,550	42,300	50,750	18,800	14,750
Mar-22	11,800	36,400	127,750	25,050	36,650	31,650	53,150	58,500	20,850	14,900
Apr-22	11,800	38,000	131,600	26,150	35,450	32,900	49,350	50,600	24,400	15,250
May-22	11,750	38,450	134,350	28,000	41,450	32,250	47,500	48,550	24,250	15,400
Jun-22	11,750	37,750	134,000	29,250	51,500	30,000	68,400	75,650	23,550	15,300
Jul-22	11,750	36,750	136,750	29,300	64,150	29,350	81,400	79,750	22,000	15,200

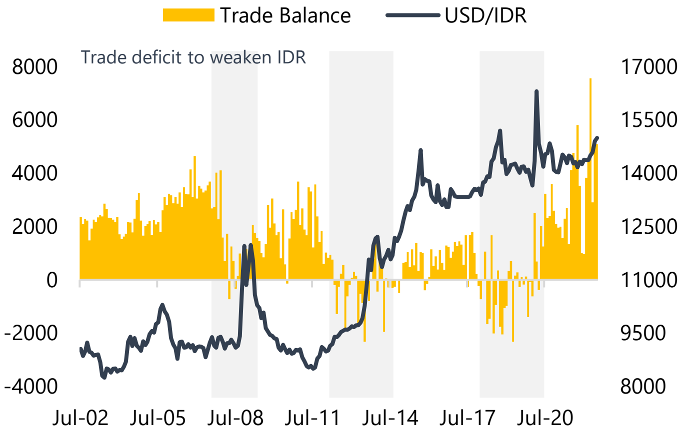
Sources : PIHPS Nasional, MNCS Research

- **IDR depreciation to watch**

Another factor that we also assess is IDR performance. Throughout this year IDR has depreciated by 5% against USD., still better performing than peers (CNY -6.15%; MYR -6.82%; PHP -10.14%; THB -10.23%). Unlike in the previous Fed's monetary policy adjustment (2013 & 2018), IDR managed to have a limited devaluation and outperforming EM currencies, thanks to 26 months straight of trade balance surplus due to high commodity prices.

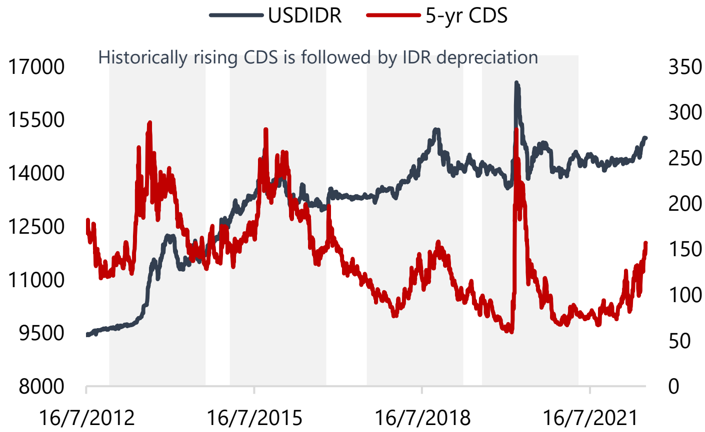
We think that IDR depreciation is triggered by deteriorating risk perception for emerging economies. Sri Lanka & Russia defaults caused EM CDS to spike and so Indonesia's CDS too. Note that Indonesia's CDS already hit above 150 bps recently, the highest since May-20.

Exhibit 6. Trade surplus to favor IDR fundamentals



Sources : Bloomberg, Statistics Indonesia, MNCS Research

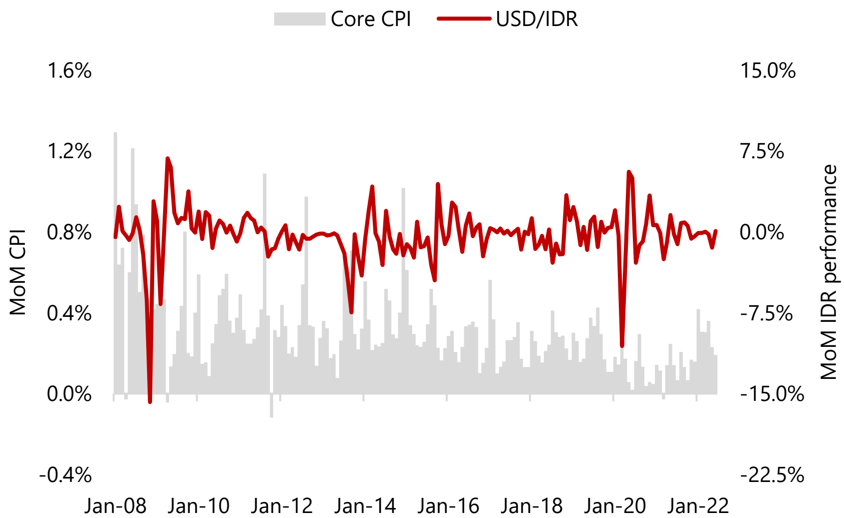
Exhibit 7. However rising CDS is another factor to anticipate



Sources : Bloomberg, MNCS Research

With IDR is nearing 15,000/USD level, further depreciation is possible in our view, let alone market participants also anticipate a more hawkish tone from the Fed as inflation breaking a new record (US CPI +9.1% YoY in Jun-22). Given the negative sentiment for EM countries; rising inflation; as well as probability of US CB to raise FFR by +100 bps on Jul-22 meeting, weakening IDR need to be taken into account as it may cause an exchange rate pass-through effect. Historically, prolonged IDR depreciation also caused core CPI to jump. Our calculation showed, for the IDR to weaken and hovering around its long term 1stdev, this could add up at least 0.6-1.0% MoM core CPI in the next 3-12 months depends on imported goods and type of industry (imported inflation).

Exhibit 8. Relationship between IDR depreciation and core CPI

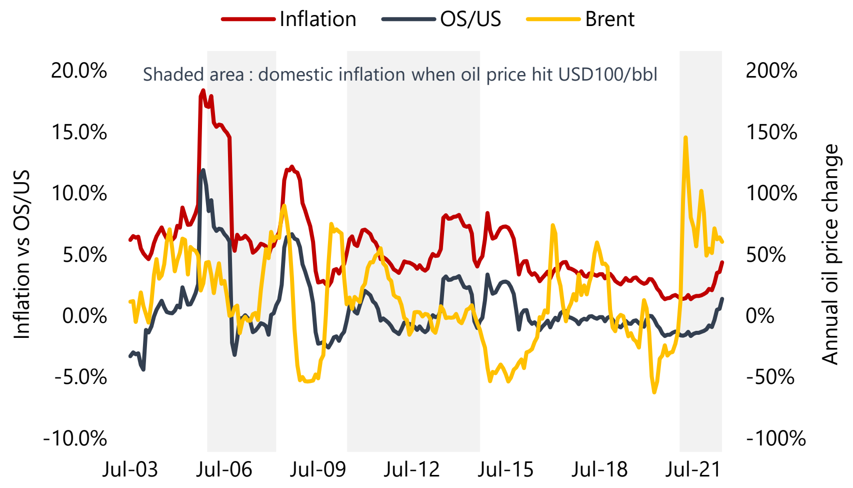


Sources : Bloomberg, Statistics Indonesia, MNCS Research

- **Oil price above USD100/bbl throughout this year**

Brent crude price hit USD105/bbl on average this year or increasing +47.9% YoY compared to 2021 average. Russia-Ukraine conflict and western countries banning Russian oil were all the root cause for surging oil price. Moreover, prior to the war, global oil balance recorded a deficit of ~1mbpd. In the last two decades, we noted that when oil prices were above USD100/bbl or increasing by +50% YoY, domestic inflation tended to overshoot from BI inflation target. We expect oil price to remain stubbornly at USD100/bbl or above (in-line with adjusted APBN macro assumption). The downside likelihood for oil price is quite limited in our view, as geopolitical tensions linger. Therefore, we foresee that inflation rate to overshoot this year.

Exhibit 9. Historically, oil price above USD100/bbl causing inflation to overshoot

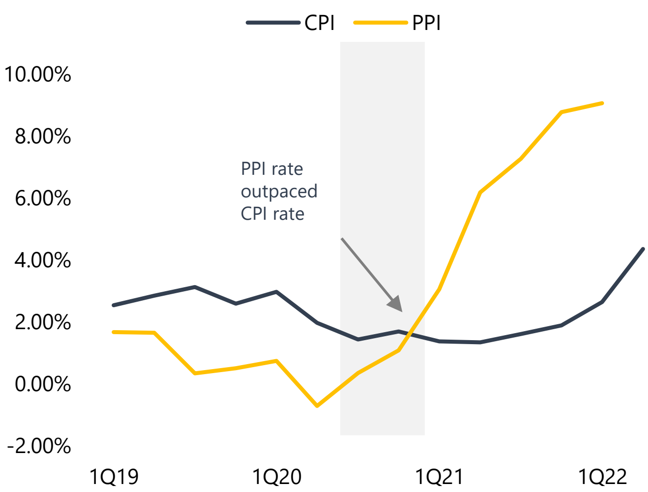


Sources : Bloomberg, Statistics Indonesia, MNCS Research

- **Pass-on higher input cost**

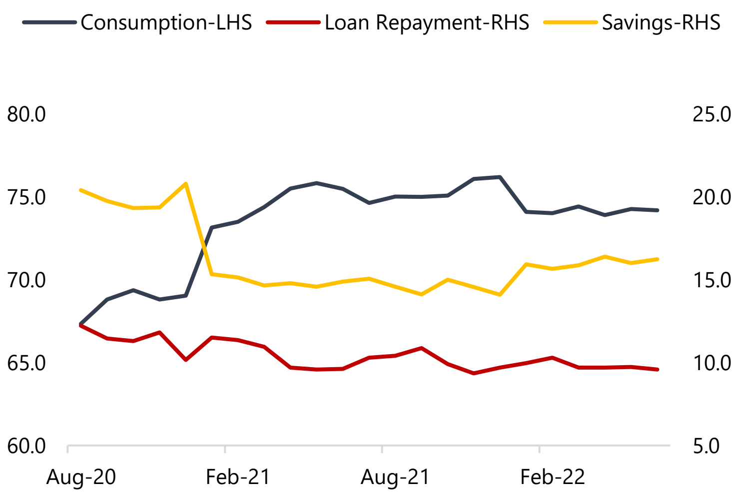
Since 1Q21, the pace of PPI increase has outpaced CPI. Even with PPI inflation recorded an increase of +9.06% in 1Q22, CPI remained lag behind. Still weak consumers purchasing power last year made producers to be reluctant to pass on higher input cost. The situation is now changing, average consumers spending has been consistently above 70% from income throughout this year, thus we expect the passing on effect would be inflationary.

Exhibit 10. CPI lagged behind PPI



Sources : Statistics Indonesia, MNCS Research

Exhibit 11. Consumption strengthen



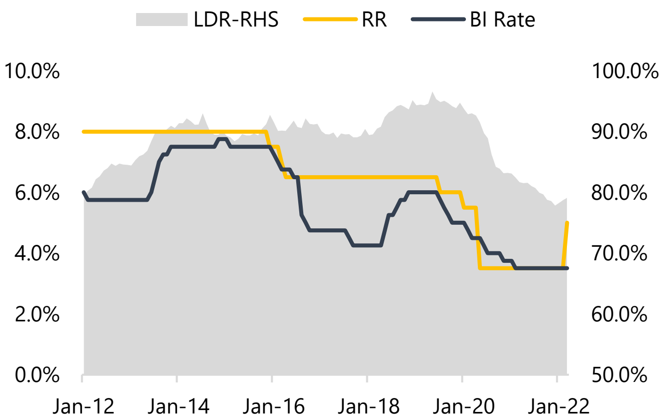
Sources : Bank Indonesia, MNCS Research

- **Loan growth & money supply**

BI has adjusted its monetary policy through increasing banking reserves requirement from 3.5% by the end of Dec-21 to 9% in Sep-22. We estimated, the increase in reserves requirement would reduce banking liquidity by IDR234-315tn. Such number is expected would not affect banks capability to perform its intermediary function as LDR remains below 80% and long term average level of 88%. Throughout this year, loan growth continue to pick up. As of May-22, loan grew by +9.0% YoY driven by working capital +11.0% YoY; investment +7.6% YoY and consumers +6.2% YoY. This also affect total money supply (M2).

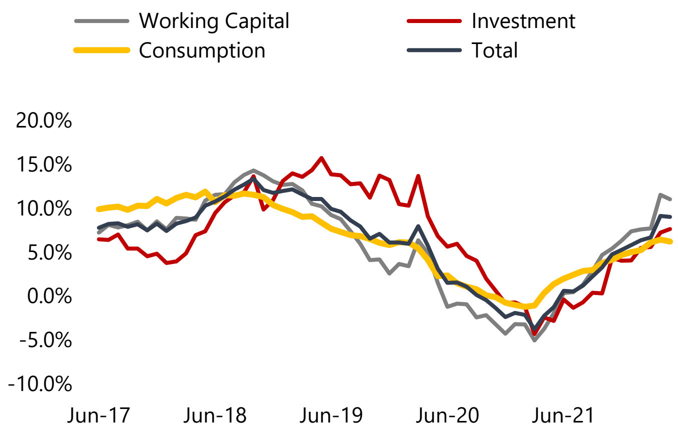
The annual growth of M2 has consistently above 10% since Oct-21 indicating adequate liquidity to support growth. Furthermore, the interest rates continue to drop as domestic CB keep the interest rate at the lowest in history. We projected a limited banking interest rates decline moving forward. However, given liquidity in the banking system remaining ample, this should be anticipated carefully due to the effect of loan disbursement to cause money supply to increase. And under current situation, risk of demand and supply gap has widened. After adjusting the volume of money through raising statutory reserves, we think that BI needs to start adjusting the price of money through interest rate hike.

Exhibit 12. BI normalize liquidity through raising banks RR



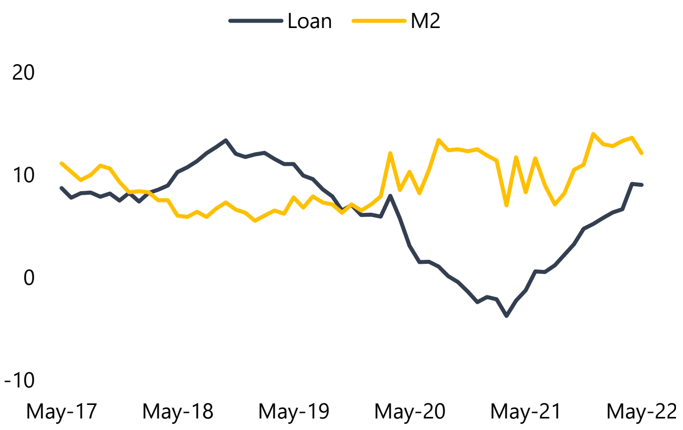
Sources : Bloomberg, Bank Indonesia, MNCS Research

Exhibit 13. Ample liquidity is channeled to loan



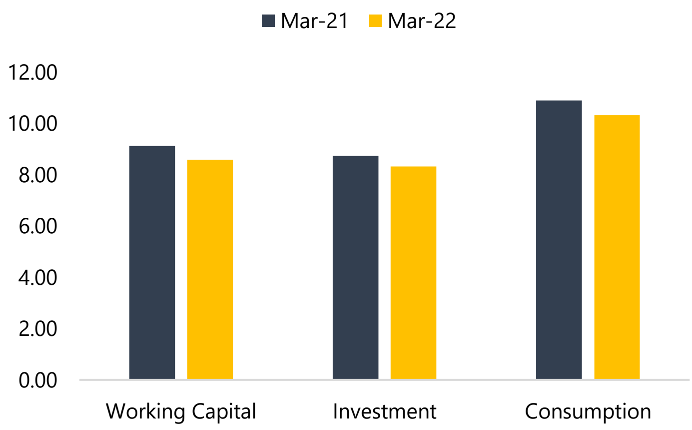
Sources : Bank Indonesia, MNCS Research

Exhibit 14. Loan growth affect money supply (M2)



Sources : Bloomberg, Bank Indonesia, MNCS Research

Exhibit 15. BI kept IR at the lowest in history, loan rates decline

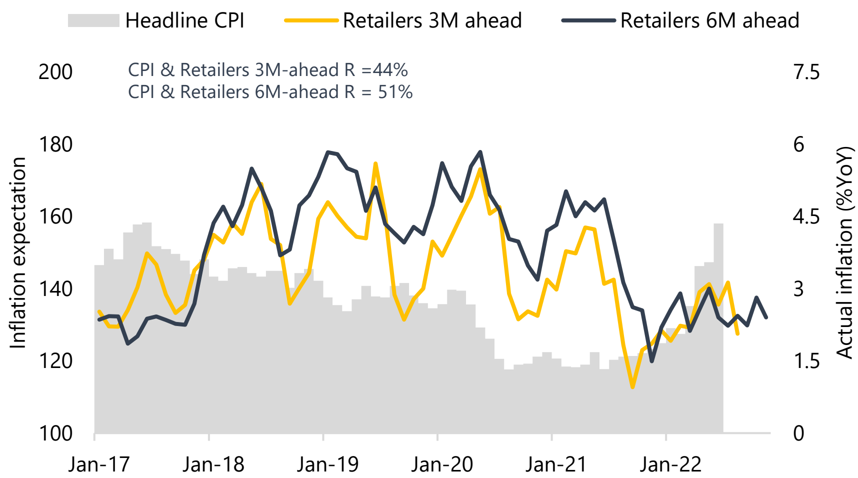


Sources : Bank Indonesia, MNCS Research

- **Managing inflation expectation**

Managing inflation expectation is a part of monetary policy objective. Stable inflation expectation help to curb harmful macroeconomic volatility. Currently, widely used data to gauge inflation expectation is through a survey based method. One that readily available and tracked periodically is from BI retail sales survey. Based on this data, BI reported that there is a strong correlation between CPI and retailers price expectation 3M ahead (R=44%) and 6M ahead (R=51%). Since Sep-21, retailers expectation for price movement has increased gradually along with the pick up in inflation rate. One that should be anticipated is that any surprise in actual inflation figure would also effect inflation expectation and potentially impact on inflation trajectory going forward.

Exhibit 16. Inflation expectation among retailers vs actual inflation



Sources : Bank Indonesia, MNCS Research

Conclusion

Potentially more aggressive Fed in raising FFR would only cause nominal rates spread to widen between two countries and this may cause a further pressure for IDR. Some also citing that BI is expected to kickstart the rate hike when reserves requirement increase is accomplished in Sep-21. However in our view, starting earlier is better as monetary policy has a lag period to be transmitted. All in all, we welcome BI to start raising 25 bps to 3.75% this time as a pre-emptive policy to manage inflation expectation.

MNC Research Industry Ratings Guidance

OVERWEIGHT: Stock's total return is estimated to be above the average total return of our industry coverage universe over next 6-12 months

NEUTRAL: Stock's total return is estimated to be in line with the average total return of our industry coverage universe over next 6-12 months

UNDERWEIGHT: Stock's total return is estimated to be below the average total return of our industry coverage universe over next 6-12 months

MNC Research Investment Ratings Guidance

BUY : Share price may exceed 10% over the next 12 months

HOLD : Share price may fall within the range of +/- 10% of the next 12 months

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Not Rated : Stock is not within regular research coverage

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