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Economics | Indonesia

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Economics

BI Stays On Hold: Defending The Rupiah Amid Murky Global Outlook

Highlights

- **BI holds rates at 5.75% on favourable inflows and ample reserves.** Bank Indonesia (BI) paused its tightening cycle, citing capital inflows into bonds, equities, and SRBI; a modestly stronger rupiah; and reserves rising to US$146.5b in Aug 26. The hold also reflects a pro-growth tendency under Destry's leadership. BI made two notable policy tweaks: a) dropping its 10% monetary base growth reference, and b) increasing swap discounts by investment tenor to encourage long-term investment.
- **Global backdrop is murky; domestic dilemma persists.** The Fed is expected to tighten rates to 4.25% by end-26 with another hike in 2027. Oil remains elevated relative to Indonesia's export prices, causing worsening external balance. All the while US fiscal risk is keeping the dollar weak, providing only a temporary tailwind. Indonesia's twin deficits remain a constraint, and BI is expected to hike rates to 6.00–6.25% in the base case to defend the rupiah and preempt inflation.
- **The base case continues to show fragile stability, characterised by modest, short-duration foreign inflows, a still-weak rupiah, and range-bound yields.** The bear case (a reversal of the global tailwind) would force a more aggressive BI tightening, pressuring the rupiah and pushing yields higher. The bull case requires a shorter Fed hike cycle, higher commodity prices, a weaker dollar, and improved Indonesian credibility that would result in rate cuts, broader inflows, and a stronger rupiah.

Analysis

- **BI maintained its benchmark BI rate at 5.75%** at its Board of Governors meeting in Sep 26. The hold continued the pause that started last month after an aggressive tightening campaign that started at end-Ap 26.
- **The decision was driven mainly by favourable capital inflows into Indonesia's financial markets**, which have buoyed the rupiah and helped it strengthen modestly (0.19% from 19 Aug 26 to 23 Sept 26). Foreign capital inflows into the bond market accelerated in August despite rapidly rising global bond yields. This was caused by heightened market attention to worsening fiscal conditions in developed countries, leading to a rising preference for emerging-market assets. It also explains the inflows into the bond market despite the relatively thin spread between Indonesian government bonds and US Treasury bonds.
- **Two other significant reasons underpinned the rate hold.** First, it signals that BI under Destry's leadership will maintain a pro-growth tendency, in line with the government's goal of higher economic growth. The Board of Governors had stated that the decision to keep the policy rate unchanged was driven by the need to preserve domestic economic momentum. Second, foreign reserves remain relatively ample, edging up to US$146.5b in Aug 26 from US$145.3b in Jul 26, continuing an upward trend from the May 26 low of US$144.9b. The modest increase was driven primarily by capital inflows into the bond, equity, and SRBI markets, along with the issuance of foreign-currency-denominated debt.
- **Despite keeping the policy rate unchanged, BI unveiled several significant policy changes.** First, it dropped its previous reference to increasing the monetary base by 10%, which had often been cited as a way to support liquidity growth in the economy. This move should be positive for the rupiah, as lower liquidity growth is likely to reduce pressure on the currency.

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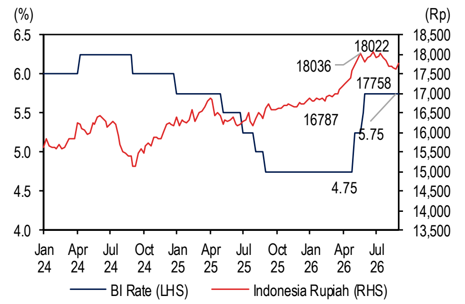
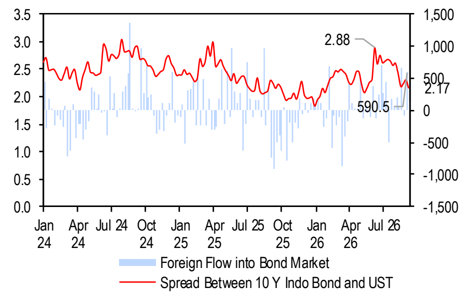
BI Rate And Rupiah Exchange Rate



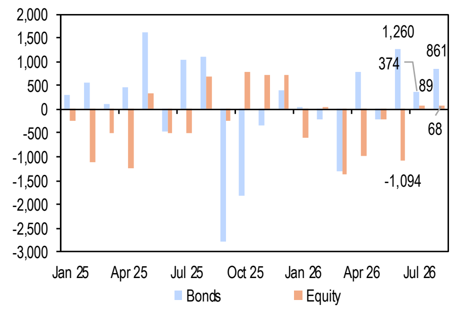
Source: Bloomberg

Rupiah Exchange Rate And US Dollar Index



Source: Bloomberg, UOB Kay Hian

Foreign Inflow Into Indonesia Financial Market



Source: Bloomberg

- **Second, the central bank further increased its swap discount** based on investment tenor, enhancing incentives and easing foreign investment in the country's bond markets, foreign direct investment, and bank foreign loans.
- **These policy moves were greeted positively by markets,** with the rupiah strengthening and government bonds holding steady. However, global factors also contributed – the US-Iran meeting during the UN General Assembly in New York caused global oil prices to plummet to around US$90 per barrel after having exceeded US$100 per barrel previously.

Outlook

- **The outlook ahead is increasingly murky,** as the volatile global environment shifts rapidly and with little notice. Under our base case, which carries a 50% probability, the overarching narrative is one of "fragile stability." The Fed is continuing its tightening cycle, driving the Fed Funds Rate to 4.25% by end-26 and delivering another 25bp hike in 2027. Oil and commodity prices remain elevated, with oil prices high relative to Indonesia's export prices, pressuring the terms of trade. However, US fiscal risk persists and the dollar remains weak, providing a temporary tailwind for emerging markets, including Indonesia.
- Consequently, BI is expected to tighten further, with a potential rise in BI rate to 6.00-6.25% to preempt inflation and defend the currency amid persistent twin deficits, even as the government maintains a pro-growth agenda. This tightening reflects the central bank's need to balance external stability with domestic momentum. Market implications point to modest, short-duration foreign inflows, a relative-value carry trade rather than a structural recovery. The rupiah is projected to end 2027 at 17,800-18,000/USD, while the 10-year SBN yield ranges between 7.30-7.60%. This baseline assumes the status quo persists – that there is no major escalation in global risk aversion, no sudden reversal in US fiscal credibility, and no significant domestic policy shocks.
- The bear case, with a 30% probability, hinges on a reversal of the baseline: US fiscal credibility improves, the dollar rebounds, higher oil prices worsen the external balance, and a stronger-than-expected US economy forces a more aggressive Fed. Under this scenario, BI raises the BI rate to 6.50% or higher, the 10-year SBN yield rises to 7.80-8.10%, and the rupiah falls to 18,300-18,600/USD. By contrast, the bull case - carrying a 20% probability = requires a fortunate mix: a shorter Fed hike cycle, higher commodity prices, a weaker dollar, and improved Indonesian credibility. If achieved, BI can cut rates to 5.50%, foreign inflows will become broad-based including the long end, the 10-year yield falls to 6.80–7.00%, and the rupiah strengthens to 17,200–17,500.

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