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Macro Note

Indonesia: BI Rate Decision and Assessing the Impacts from Tweaks in RRR

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- **Bank Indonesia (BI) kept its benchmark rate BI 7-Day Reverse Repo Rate at 4.25% and also maintained the corridor unchanged (Deposit and Lending Facilities were kept unchanged at 3.50% and 5.00% respectively**. According to the accompanying statement, the current policy rate is consistent with the current state of macroeconomy while preserving financial system stability and aiding the economic recovery. BI official was also quoted in saying that the monetary stance remained neutral and acknowledging upside risks on inflation, notably rising food prices such as rice and other key essential food items. BI expects loans growth at 10-12% range for 2018, maintains growth estimates of 5.1-5.5% and inflation target band of 2.5-4.5%. Current account deficit is forecasted at a range of 2.0-2.5% of GDP this year. In particular, one BI official was also quoted in saying that the central bank has no preference toward stronger rupiah, adding that BI will let IDR to be market-determined and shall intervened if needed.

- This time, on top of keeping the policy rate unchanged, BI also decided to accelerate the implementation of average minimum reserve requirement ratios (RRR) as to complement its monetary policy operational framework reform. In the statement, BI indicated that such refinements were aimed to increasing the effective transmission of monetary policy, supporting banking liquidity management flexibility, while simultaneously accelerating financial market deepening.

- The measures include keeping the 6.5% IDR reserve requirement, but loosening the **average minimum reserve requirement's** from 1.5%-point to 2%-point effective 16th July 2018. This means that the minimum IDR RRR has been lowered to 4.5% from 5.0% previously (last announce in April 2017). For non-IDR RRR, the average RRR is now introduced at 2%-point out of the total 8%, effective 1st October 2018. For commercial sharia banks and sharia business units, the average RRR is set at 2%-point out of which the total minimum reserve requirement is 5% of deposit, the average reserve requirement is set at 2% of deposit. BI said in its statement that the improvement was aimed to increase the flexibility in the banking sector's liquidity management, enhance banking intermediation function, and support the financial deepening.

- To further support and encourage banking intermediation function and liquidity management, BI also decided to refine the macroprudential policy by implementing two regulations. Firstly, converting the Loan to Funding Ratio (LFR) policy for banks and the Financing to Deposit Ratio (FDR) policy for sharia commercial banks and sharia business units into **Macroprudential Intermediation Ratio (MIR)** within the target range of 80-92% while also broadening the credit/financing components which incorporates deposit components by including bank-purchased securities and broadening deposit components by including securities published by sharia commercial banks and business units. Secondly, converting the secondary minimum reserve requirement for conventional commercial banks into **Macroprudential Liquidity Buffer (MLB)** and applying MLB for sharia commercial banks at 4% of deposit, allowing 2% of deposit to be used as repo to Bank Indonesia in certain conditions to fulfill bank's liquidity needs. Both macroprudential instruments have countercyclical qualities that can be adjusted in line with economic and financial cycle. The timeline of implementation is 16th July 2018 for commercial banks and 1st October 2018 for sharia banks.

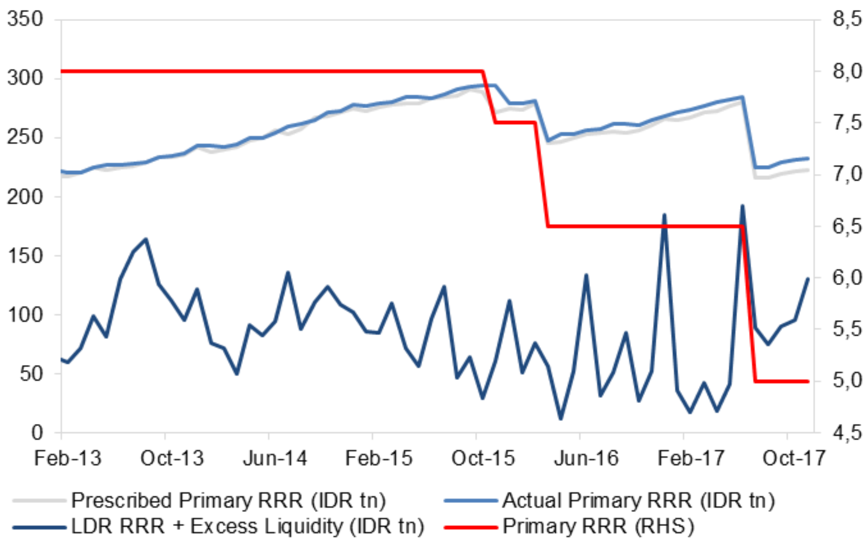
- More details can be found at: http://www.bi.go.id/en/ruang-media/siaran-pers/Documents/BoG-Jan2018-attachment.pdf

Tweaks in RRR Has Minimal Impact on Banking Liquidity and Perhaps on Intermediation Too

- **Although the tweaking of the reserves requirements in general is a progressive step towards supporting the liquidity management of banks and also to manage the pro-cyclicality of bank lending vis-à-vis business cycles, we assess that those changes would only have limited impacts to the overall banking system liquidity.** However, we do believe that such measure would benefit smaller banks that tend to have tighter liquidity and also in meeting their end-of-day balance. This tweak would also help to instill more stability in the interbank market (JIBOR rates).

- Figure 1 shows that the actual or "what's-in-the-market" primary reserves parked at BI has above the prescribed amount (using the regulated minimum primary RRR and excluding the RRR averaging of 1.5%-point since July 2017), indicating there has never been a persistent shortfall in meeting the primary RRR. Secondly, liquidity is still relatively abundant as shown by the positive amount of loan-to-deposit ratio (LDR) RRR plus excess liquidity in the overall banking system.

Figure 1. Liquidity is abundant in the domestic banking system

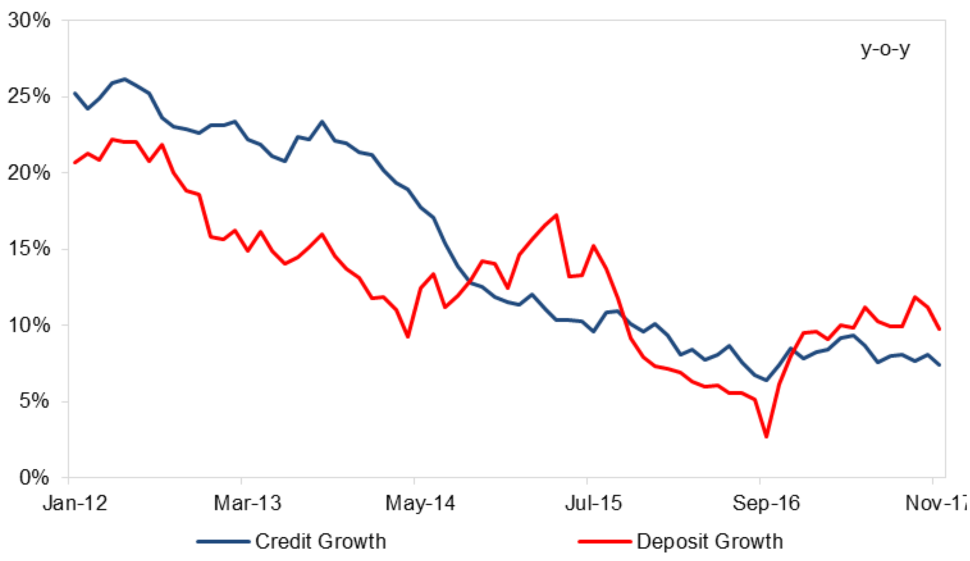


Source: CEIC, UOB Global Economics & Markets Research. Note: Since July 2017, BI implemented RRR averaging for 1.5%-point of the total primary RRR of 6.5%. This chart use the effective minimum required primary RRR since that period.

- As for intermediation of funds into lending to the real sector, Figure 2 suggests that deposit growth has been outpacing credit growth in recent times and Figure 3 further supports that banking system IDR LDR remains on the downtrend. These may imply that the channeling of credit to the real economy is not due to the tightness of the liquidity in the banking system but either there is less demand for credits, or the banks are simply refraining themselves from extending loans to businesses.

- To assess that further, we proxy loanable funds available in the system, which makes up of these components: IDR third party funds (locally known as *dana pihak ketiga/DPK*) + IDR primary reserves + IDR secondary reserves + IDR LDR reserves + IDR excess liquidity. We plot loanable funds against credit in the banking system, both in nominal and growth terms. Figure 4 and 5 reveal that there is a widening between the two and growth in loanable funds has been outpacing that of credit growth. These suggest that banks are probably refraining from extending loans to the real sector as they do not seem to face constraints from supply of funds made available to them and from what they already have in their capacity to lend. It probably coincides with the ongoing adjustments that banks are still making towards the recent rise of non-performing loans (NPLs, Figure 6).

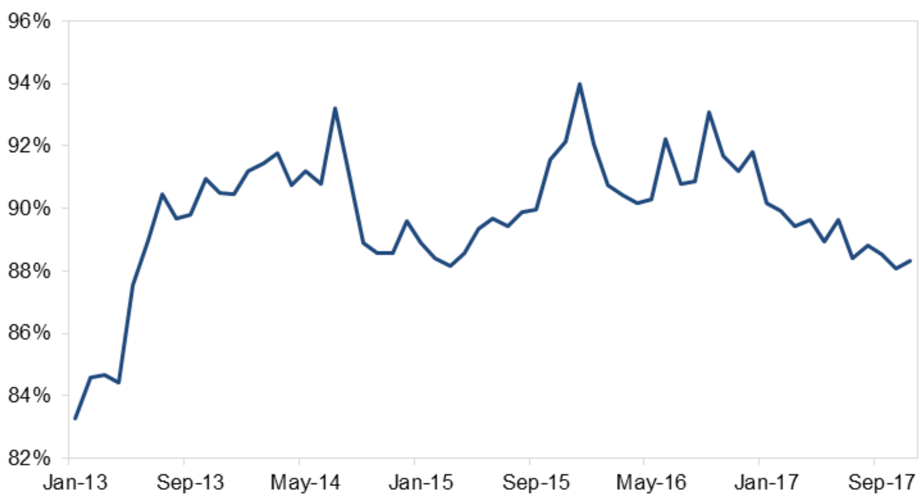
Figure 2. Deposit Growth Outpaced Credit Growth



Source: CEIC, UOB Global Economics & Markets Research.

- We think that given the strength of Indonesian banks (strong CAR and relatively wide net interest margins compared to other banks in the region), the NPLs concern would soon be addressed. Consequently, sluggish credit growth may soon bottomed out from here amidst better looking global and Indonesian economic growth prospects this year, not to mention the recovery in the global commodity prices–a boon for commodity exporter like Indonesia. Coupled with our data showing the availability of funds, it also implies there is no supply constraint in meeting the demand for credit.

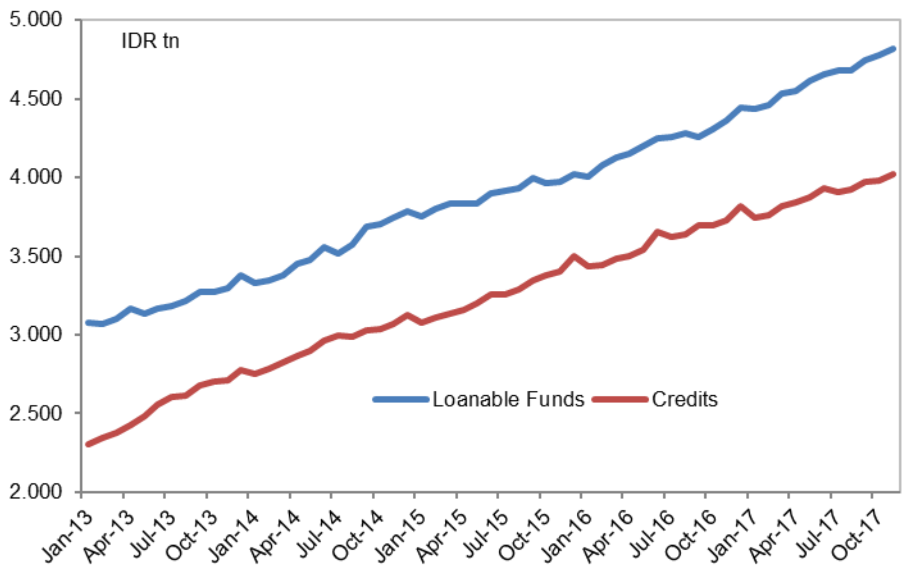
Figure 3. Rupiah LDR is Falling



Source: CEIC, UOB Global Economics & Markets Research.

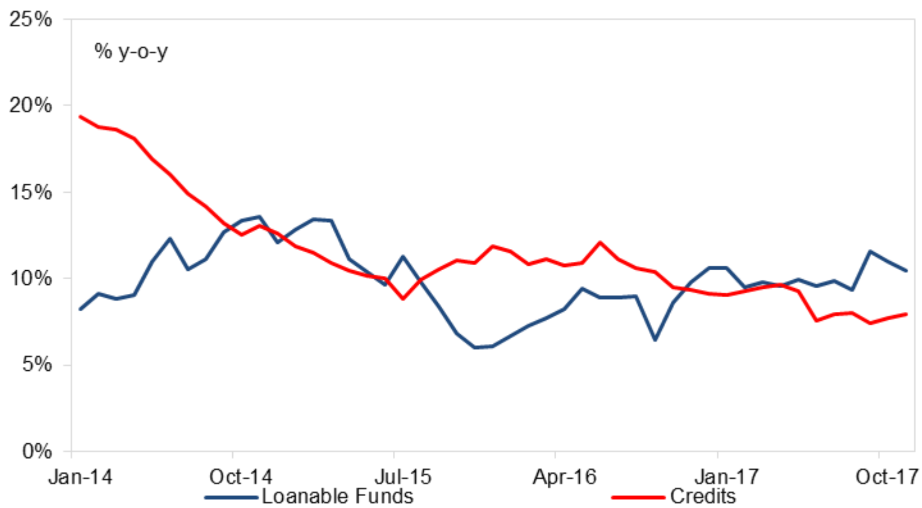
- However, loan demand itself has been weakening too. Figure 7 shows that nearly all type of loan demand for working capital, investment, property, and consumption loans have markedly grew much slower since around the middle of 2014. That period coincided with the massive collapse of the global oil prices, although broader commodity prices have actually started to end its boom super-cycle around late 2012.

Figure 4. Gap between Loanable and Credit is Widening



Source: CEIC, UOB Global Economics & Markets Research.

Figure 5. Growth of Loanable Outpaced Credit



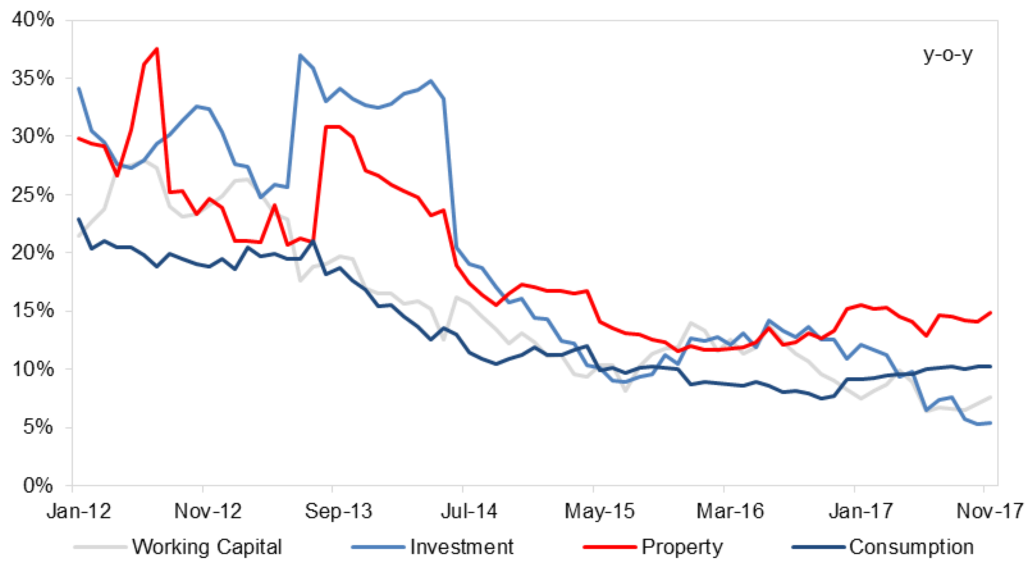
Source: CEIC, UOB Global Economics & Markets Research.

- The implications of all these are: IDR liquidity remains abundant but the intermediation of credits into the real sectors are perhaps challenged by temporary refrains from banks to extend loans as they are nursing and adjusting NPLs issue. The demand for loans have also been weakening since the middle of 2014 perhaps partially due to the weak oil and global commodity prices that also affecting domestic-oriented loans such as property and consumption loans in Indonesia. Nevertheless, we are turning cautiously optimistic for 2018. With our growth forecast of 5.3%, supported by higher domestic spending in light of *Pilkada* (regional elections), regular festivities, Asian games in H2 2018 and also IMF Annual Meeting in the same half, demand for credits would probably pick in the near future. The supply of loanable funds is more than ready to meet that demand. We forecast credit growth to be in the range of around 10% for 2018 with some upside risks.

Figure 6. NPLs is consolidating lower

Source: CEIC, UOB Global Economics & Markets Research.

Figure 7. Loan Demand may Soon Pickup



Source: CEIC, UOB Global Economics & Markets Research.