Bank Indonesia holds rates as scope for more cuts narrows

Bank Indonesia kept the interest rate at 5.75%, as expected. The room for further cuts is becoming more limited than before; they're dependent on twin deficit and tariff uncertainties. We believe concerns about macro stability, which led to a sharp equity market sell-off, are exaggerated

Indonesia's central bank governor Perry Warjiyo

Policy rates left unchanged

Bank Indonesia maintained the BI-rate at 5.75%, the Deposit Facility interest rate at 5.00%, and the Lending Facility interest rate at 6.50%, in line with both consensus and our expectations as it continues to prioritise currency stability. This decision was made amidst a sharp sell-off in the Indonesia equity markets on Tuesday, driven by concerns over the country's deteriorating fiscal situation and rumours of the potential resignation of the highly respected Finance Minister Indrawati. In the statement that followed the rate decision, BI reiterated banking sector resilience, high credit growth, improved monetary transmission, and a healthy balance of payments.

GDP growth forecasts for 2025 were left unchanged at 4.7%-5.5%.

FX stability takes centre stage

IDR was the weakest currency in ASEAN-5 last month as global risk-off exerted downward pressure on the rate-sensitive rupiah. The central bank likely intervened both in the spot and NDF markets to contain the volatility. Today, BI reiterated that *"the rupiah exchange rate is predicted to be stable supported by Bank Indonesia's commitment to maintaining the stability of the Rupiah exchange rate, attractive yields, low inflation, and Indonesia's economic growth prospects which remain good"*.

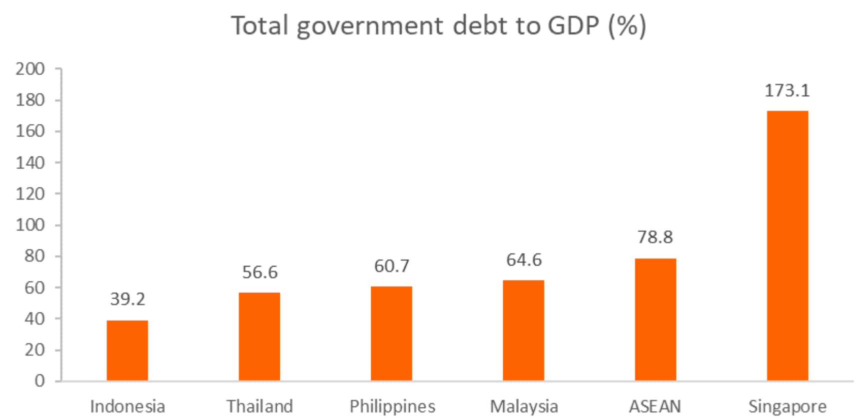
In our view, the return of USD strength in the near term is likely to be the dominant factor impacting IDR. Although Indonesia is relatively less exposed to US tariff risks, an escalation here is still likely to keep Asian currencies under pressure. This is likely to push out the next rate cut further as BI remains focused on FX stability.

Wider fiscal deficit but concerns on macro stability overdone

While we agree with BI's assessment that the country's external and domestic balance sheets are relatively stable, a larger fiscal deficit from recently announced government measures is likely. Fitch affirmed Indonesia's investment grade credit rating but warned of the fiscal uncertainty that lies ahead, as President Prabowo's decision to scrap VAT this year results in a revenue loss of around 0.3% of GDP. Our estimates suggest that the announced spending on priority projects, including the free school lunch programme (with estimated costs at 2% of Indonesia's GDP), could result in a fiscal deficit to GDP expanding to 2.8% of GDP in 2025 vs 2.3% in 2024.

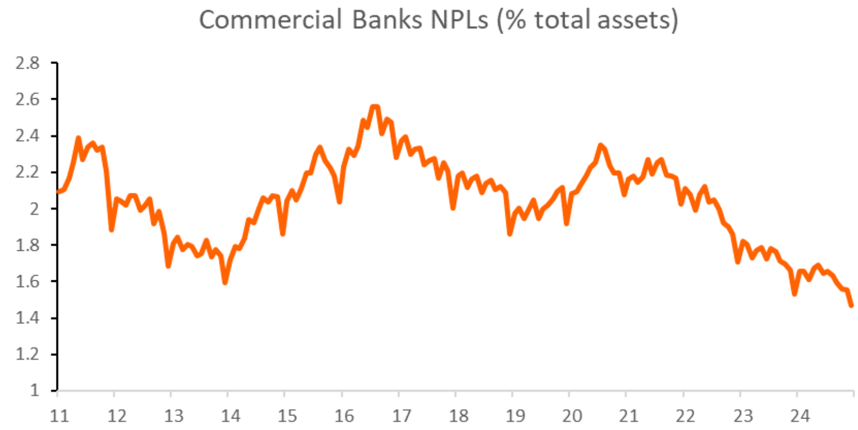
Government debt to GDP, however, remains manageable at 40% and the lowest compared to the rest of ASEAN. Moreover, external government debt has also been stable at relatively lower levels of 11.5% of GDP. Commercial bank NPAs have been declining consistently, coming off Covid peaks of 2.3% in December 2020 to 1.5% in December 2024. Inflation remains well contained and at the lower end of the central bank's target range, which re-affirms macro stability.

Indonesia public debt is the lowest in ASEAN



Source: CEIC

Commercial bank NPAs have been on a decline



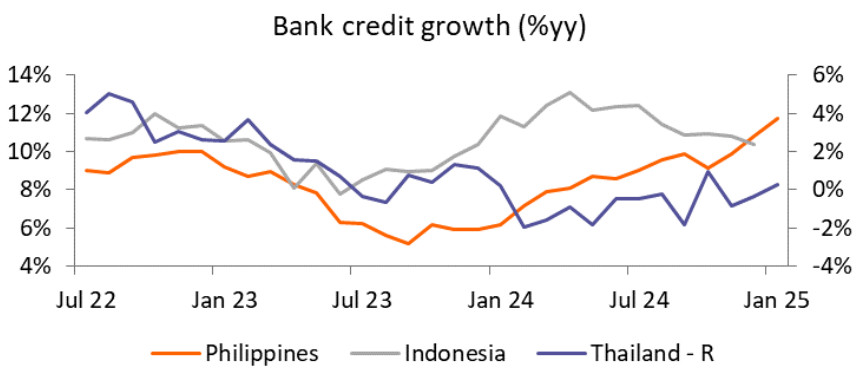
Source: CEIC

Growing concerns about slower growth

The recent rise in manufacturing PMI is likely due to higher exports from restocking ahead of tariff escalations and thus may not reflect a sustainable improvement in manufacturing growth. Weak retail sales growth also reflects tepid consumption. Additionally, the impact of the last rate cut in January 2025 has yet to be fully transmitted.

Although bank credit grew at a respectable 10% year-on-year as of December 2024, it has been declining since April 2024 despite the 50 basis points policy rate cuts implemented during that period. The larger worry about the growth trajectory is because of substantial spending cuts on infrastructure and public works to fund other priority programmes that are less efficient and productive in comparison.

Bank credit growth has not recovered in Indonesia



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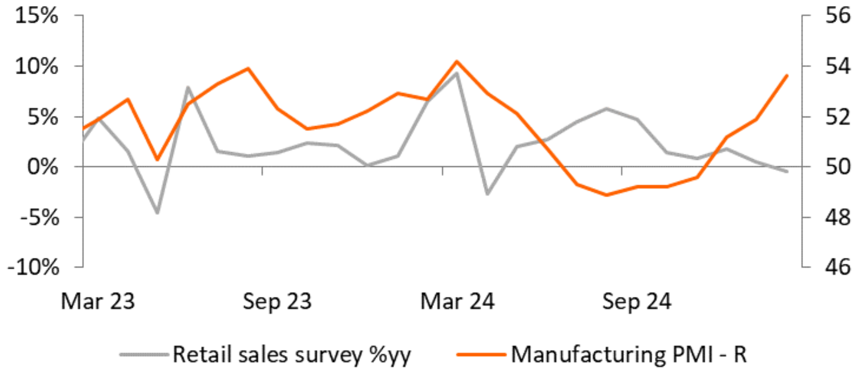
Weak retail sales growth



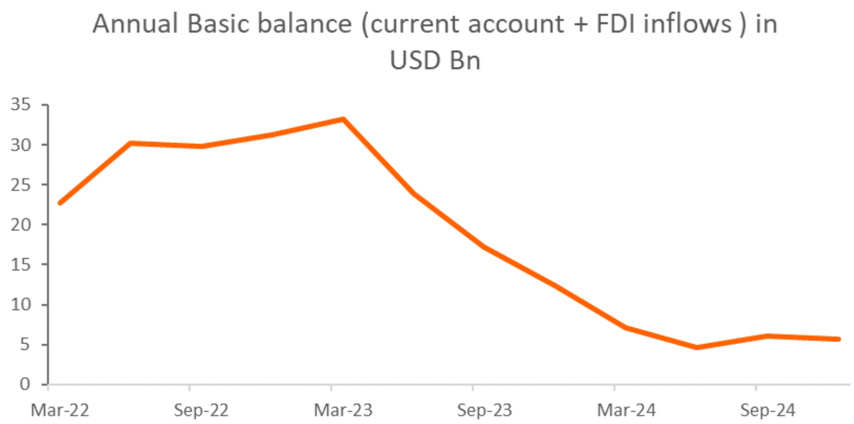
Source: CEIC

Wider twin deficits and tariff uncertainty suggest smaller rate cuts

We think there continues to be scope for further rate cuts but to a lesser extent than before. We now expect only two more cuts of 25bp each (vs. 3 earlier) in 2025, taking the BI rate to 5.25% this year. The rate cuts are likely to get pushed to the latter part of the second and third quarters as we get more clarity on tariffs in early 2Q. As we move into the second quarter and tariffs are implemented, we maintain a bullish outlook on the USD, which should exert downward pressure on Asian currencies.

From a domestic standpoint, a wider current account deficit as external demand weakens and a higher fiscal deficit from Prabowo's fiscal expansion plans are unlikely to support IDR. Moreover, FDI inflows fell sharply in 4Q 2024 and are unlikely to improve significantly amidst trade tensions and an uncertain investment climate. A combination of these risk factors will keep Bank Indonesia on edge, remaining cautious with further rate cuts.

Basic balance has deteriorated but remains positive



Source: CEIC

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