Indonesia Investments

Impact of the Strong US Dollar

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OCTOBER 2022

Van Der Schaar Investments B.V.

CV Indonesia Investments

Indonesia Investments

Monthly Report – October 2022

‘Impact of the Strong US Dollar on the Indonesian Economy’

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Preface

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Our reports are intended for a diverse audience, including individual and corporate investors, financial market participants, diplomats, policymakers, decision-makers, academics, journalists, and analysts.

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Introduction – October 2022 Report

In last month's introduction I focused on the depreciating rupiah rate amid broad-based US dollar strength. It is a topic that deserves some more attention this month because all analysts (seem to) agree that the US dollar is bound to remain strong in the foreseeable future as the US Federal Reserve continues to aggressively tighten its monetary policy, although there did surface indications that the Federal Reserve may become somewhat less aggressive than earlier assumed. These indications may give some breathing room for assets in emerging economies, but should only help to ease the pain a bit, and certainly not cure the pain. And so, the US dollar is expected to continue strengthening in the period ahead (well into 2023).

It is a situation that has big implications for Indonesia. Rapidly rising interest rates in the world's top economy (in combination with a range of uncertain factors, such as the Russo-Ukrainian war, an energy crisis, a looming recession in the West, rising inflation, weak economic growth in China, and the still disrupted supply and logistics chains in the aftermath of the COVID-19 crisis) encourages capital outflows from the emerging economies (putting pressure on currencies, stocks and bonds), aggravates US dollar-denominated debt, and aggravates imported inflation. Meanwhile, when central banks (like Bank Indonesia) need to follow suit by raising their key interest rates, it further undermines economic activity. So, overall, the impact on an economy – such as the Indonesian economy – is big. Part of this report is devoted to whether Indonesia has the economic and fiscal strength to withstand these pressures.

So, what is the latest news from the US Federal Reserve (Fed)? Well, on Wednesday 2 November 2022 the Fed, again, raised its key interest rate by 0.75 percent as part of its aggressive battle to bring down inflation that is plaguing the US economy. It is the Fed's fourth-straight interest rate hike and brings the benchmark lending rate to the range of 3.75 – 4.00 percent, which is the highest it has been since January 2008.

However, American media did point something out after the latest Fed hike, namely that the Fed introduced a key change to its policy statement that Wall Street traders interpret as a sign that the Fed could soon slow its rate hikes. Contrary to earlier Fed statements, the latest one said:

"*In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which* *monetary policy affects economic activity and inflation, and economic and financial developments*."

What this statement seems to suggest is that the Fed could decide to tone down its aggressive rate increases if the impact on the economy becomes too harsh. And since there is widespread speculation over a looming recession in the US, it would mean the Fed might become a bit dovish. However, Fed Chair Jerome Powell – in his speech – presented a different tone, stating that thoughts about a potential pause in interest rate hikes would be very premature. Powell's statement seems to imply that over-tightening is better than under-tightening, and so the hard fight against US inflation would persist. Powell's statement seems to contrast the Fed's statement.

United States Fed Funds Rate (Past 12 Months):

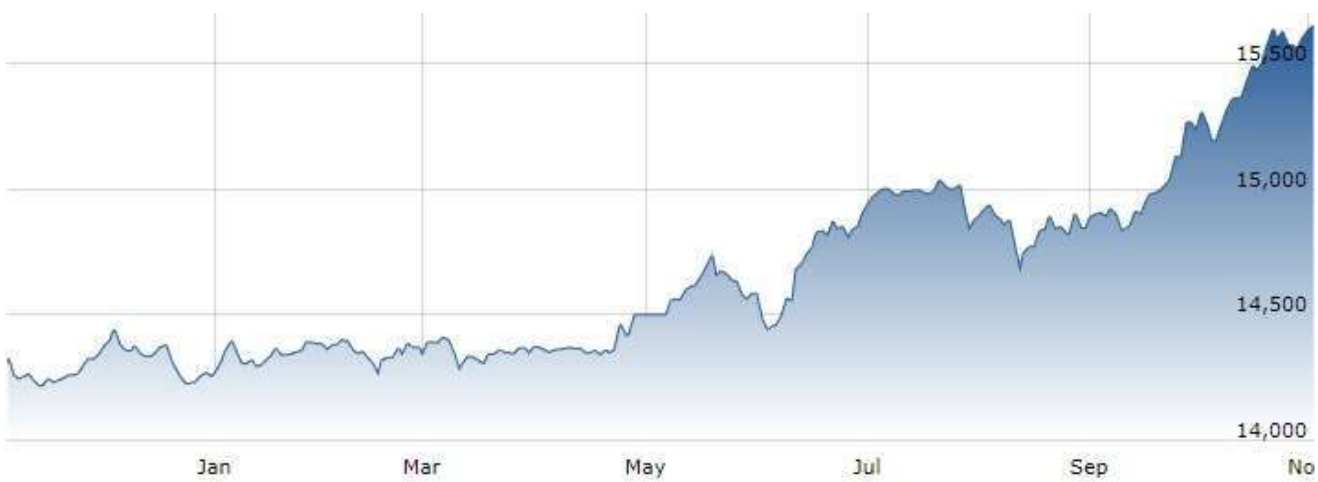
Sources: Federal Reserve and www.tradingeconomics.com

So, what is my impression after reading the Fed's latest statement and Powell's latest speech? Well, perhaps the truth is somewhere in the middle, meaning that we are likely to see more interest rate hikes in the US in the coming months but perhaps the pace of increases will be slowed. So, a 0.50 percent rate increase would be a realistic scenario for the Fed in December 2022.

Impact on Indonesia

The impact of aggressive monetary tightening in the US is most evident on the rupiah exchange rate. At the time of writing this introduction, the rupiah had weakened to IDR 15,695 per US dollar. Considering the rupiah ended 2021 at the level IDR 14,250 per US dollar, it means the currency lost slightly over 10 percent of its value (versus the US dollar) so far in 2022.

US Dollar versus Indonesia Rupiah (5 Nov 2021 – 3 Nov 2022):



Source: www.cnbcindonesia.com/market-data/currencies/IDR=/USD-IDR

It is some very heavy rupiah depreciation that makes Indonesia's central bank (Bank Indonesia) decide to take a more aggressive monetary tightening approach, too, in an effort to curb capital outflows. So, not only does the weak rupiah cause US dollar-denominated debt and imported inflation to aggravate, but Bank Indonesia's higher benchmark interest rate also undermines economic activity at home.

Meanwhile, the stronger US dollar has historically correlated to weaker commodity demand and lower global commodity prices. This would be a problem for Indonesia because in terms of its export performance (and government revenues in the form of tax and royalties), commodity exports (particularly coal and palm oil) are crucial and allow valuable foreign exchange earnings to flow into Indonesia.

And while a strong US dollar makes crude oil cheaper as fewer US dollars are needed to buy a barrel of oil, this does not help those who hold other currencies (such as the rupiah). Indonesia (being a net oil importer) is not only affected by the still relatively high crude oil price, but also the weakening rupiah (against the US dollar).

Meanwhile, if the West will indeed experience a recession (which could even trigger a global recession), then commodity prices are bound to decline further from their recent peaks.

But to end on a more optimistic or positive note, it is important to emphasize that it is not only Indonesia that is feeling these pressures that stem from abroad. Most emerging currencies in Asia even show a steeper decline against the US dollar than the rupiah has so far in 2022. There are several key macroeconomic indicators that show a positive performance including Indonesia's impressive trade surplus (even allowing a small current account surplus), expanding manufacturing activity, nearly recovered domestic consumption, strong private direct investment, a manageable inflation rate, and strong credit growth.

However, global conditions remain very challenging, and so prudent management is required. Moreover, Indonesia continues to be vulnerable as strong exports of coal and palm oil currently hide the fact that Indonesia's trade performance is vulnerable. In case global commodity prices fall, then there will be a significant decline in export earnings, foreign exchange earnings, foreign exchange reserves, and tax income and royalties for the government.

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Yogyakarta, Indonesia
3 November 2022

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Coronavirus Tips: How to Protect Yourself & Others

In case you have fragile health or a serious medical condition it is important to avoid being overly exposed to the COVID-19 virus. Unfortunately, all people are exposed to the COVID-19 virus (whether vaccinated or not, and whether wearing masks or not). But to reduce the risk of severe illness:

You can protect yourself and help prevent spreading the virus to others if you:

- **Cover your nose and mouth** with a (disposable) tissue or flexed elbow **when you cough or sneeze**. Wear a face mask when going outside (this won't stop aerosols unfortunately but should prevent larger droplets from spraying). **When not feeling well, stay home!**

- **Strengthen your immune system**; people who are healthy (which are usually young people) may not even notice that they are infected with COVID-19. The trick here is that their immune system is stronger (generally). Therefore, now is the time to take some efforts to strengthen your immune system by eating healthy (fruits and vegetables each day), and get some sunshine in the morning for your vitamin D. Also do not forget to exercise! Taking enough time to sleep and avoiding stress are also crucial to improve the immune system. Lastly, it is highly recommended to quit bad habits, most notably: smoking!

- **Ventilation**; make sure that rooms inside houses, apartments, and buildings are properly ventilated as a COVID-19 infected person can spread aerosols so small that a facemask cannot prevent them from going into the air or from going into the lungs of someone who wears a facemask. Ventilation systems need to get a good supply of fresh air from outside and/or use a good filter. It is also advised to open windows or doors in closed spaces so there is a good supply of fresh air.

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