Economic Analysis

Indonesia | Why BI introduced a new policy rate?

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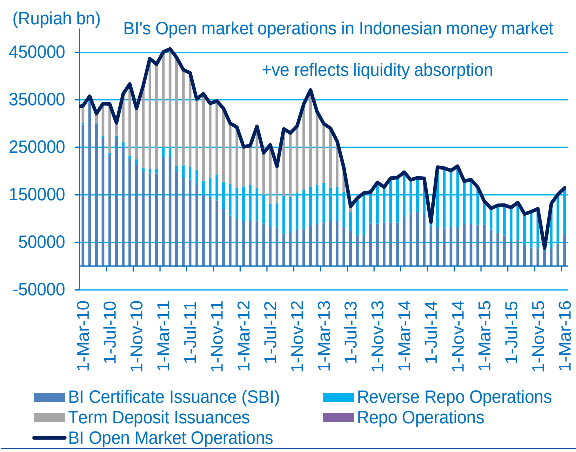
Bank Indonesia (BI) announced last week that it would, effective August 19, 2016; reformulate its policy rate from the BI rate into the 7-day Reverse repo rate. We examine the significance of this move, while noting that it does not alter BI's accommodative policy stance, with another 25 bps rate cut expected on April 21st.

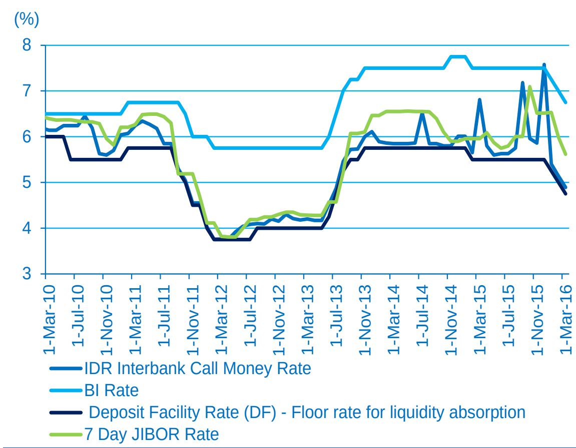
BI's existing monetary policy framework in a nutshell: BI is an inflation targeting central bank; and its key monetary policy objective is to achieve currency stability, reflected, primarily through low and stable inflation. BI sets the BI rate as the key policy instrument for influencing economic activity to achieve the desired level of CPI inflation – the current year-end target range being 3-5%. At the operational level, the BI rate should be reflected in movement in the Overnight (O/N) Interbank Rate. The BI rate is thus used as an anchor for overnight interbank rate, which is adjusted through Open Market Operations (OMO), so as to have the desired effect on economy-wide interest rates, credit, asset prices, exports and inflation expectations.

Figure 1
Excess liquidity in the post crisis period has led BI to pursue liquidity absorption OMO measures



Source: BBVA Research, Bank Indonesia

Figure 2
Disparity seen between BI rate & O/N interbank rate, which is closely tracking the floor rate (DF)



Source: BBVA Research, Bank Indonesia

Post crisis period has exposed the weaknesses of BI rate as an effective monetary policy instrument: Excess liquidity in the post 2009 credit crisis period led BI to pursue liquidity absorption OMO measures (See Figure -1) and aggressively hike the BI rate in 2013 to stem inflation pressures. Despite rate hikes, the operational target of Indonesia's monetary policy – the O/N interbank rate – has remained very low, lingering near the floor rate (DF) for liquidity absorption while also being highly volatile, in turn distorting monetary policy transmission by banks across the broader economy (See Figure – 2).

BI's new monetary policy framework should better the old in more ways than one: We believe that BI's move towards setting the 7-day Reverse Repo as its benchmark, narrowing the interest rate corridor from 250 bps to 150 bps and proposing to enhance the use of JIBOR would 1) strengthen BI's marksmanship in affecting system-wide interest rates and liquidity given that the reverse repo rate is actively traded in the money market unlike the BI rate, which is effectively a target rate, 2) BI's new rate setting rule augments price discovery in the shorter tenure of interbank money market, which is so far underdeveloped, in turn improving term structure of interest rates, 3) Improved monetary transmission and deeper money markets would enhance investor confidence over BI's ability to effectively address potential credit shocks.

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