

# Asia FI & FX Strategy Viewpoint

## Indonesia – Decoupling rates from FX

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Indonesia's high-real rates with a backdrop of low-stable inflation, below-potential growth and low macro-volatility has kept it on investors' radar for a long time as a potential duration exposure. The rate cut in January meeting raised market expectations on this front that policymakers were finally able to break-through the FX constraint decisively towards domestic priorities. However, recent policy decisions in February and March have again cast doubt on the decoupling seen temporarily between rates and FX. Since then, domestic uncertainty on fiscal policies has increased further and impacted foreign investor demand for both longer-end bonds and FX exposure.

### Bonds – front-end better placed; steeper curve

After the recent pullback, the front-end bonds have taken-out any easing expectations that had built-up after January cut. The risk-reward for front-end is skewed towards lower yields even as the timing and extent of the move remains uncertain and linked to external volatility. We maintain our forecasts for 10y bonds at 7.20% for end-1Q and rally to 6.8% at end-2025 (See report [ASEAN Year Ahead 2025: Playing defense 27 November 2024](#)). However, the uncertainty around our forecast has increased due to a multitude of fiscal changes going on at this stage. BofA economist has highlighted possible downside risks to fiscal deficit, however, the risk of meeting targeted spending cuts means an overshoot cannot be ruled out either.

We expect pivot-steepening in the near-term in response to dovish monetary and fiscal policies. Market would build term-premium in longer-end until further clarity is achieved by mid-year budget revision around July. We see scope for bull-steepening later in 2H when softer USD outlook eases IDR pressures and allows deeper rate-cuts. We also highlight tail risks of bear-steepening in case fiscal deficit limit is breached, resulting in an upward debt-trajectory.

### IDR – more flexible, less defensive

IDR has been weighed down by higher US rates and stronger USD since 2022 despite overall BoP surplus and even CA surplus at times. External volatility is likely to stay high, however, a tilt towards domestic growth has made policymakers more flexible on IDR weakness against broader USD strength. But outsized move in IDR may still prompt stronger defense given importance of USDIDR for fiscal assumptions and inflation outlook. The pressure would intensify if oil price moves higher leading to higher subsidy burden and slightly worse CAD or if the weakness is driven by Indonesia specific factors.

We paid front-end ndf points 1x3 as a low-cost hedge against further IDR volatility (See report [EM Alpha: Indonesia – Pay IDR points 25 March 2025](#)). While lower Indonesia rates would theoretically narrow the points curve, the impact of FX volatility could overwhelm that in the offshore yields, resulting in wider offshore-onshore basis.

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Timestamp: 25 March 2025 11:15PM EDT

26 March 2025

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For a complete list of our open trade recommendations, as well as our trade recommendations closed over the last 12 months, see [Global Emerging Markets Weekly: US exceptional downturn 20 March 2025](#)

### Glossary:

BI: Bank Indonesia

BoP: Balance of payments

CA: current account

DNDF: Domestic Non deliverable forward

EM: Emerging markets

FX: Foreign exchange

IDR: Indonesian Rupiah

IndoGB: Indonesia local currency government bond

MoF: Ministry of finance

NDF: Non deliverable forward

NEER: Nominal effective exchange rate

REER: Real effective exchange rate

RR: Reverse repo

YTD: Year to date

## Indonesia – Decoupling rates from FX

Indonesia's high-real rates with a backdrop of low-stable inflation and below-potential growth has kept it on investors' radar as a potential duration exposure for years now. BofA's proprietary real-money tracker shows Indonesia has one of the few mildly overweight markets in Asia as of Jan'25, while the rest were used as funders for exposure in other regions (See report: [GEMs FI & FX Strategy Watch: Real Money Tracker – Underweight bond positions in India rise, China cut 10 March 2025](#)).

But higher-for-longer US rates have been a binding factor for Indonesia's bonds and any attempts to compress real rates in Indonesia have been constrained by concerns around the impact on IDR. The rate cut in January meeting raised market expectations on this front that policymakers were finally able to break-through the FX constraint decisively towards domestic priorities. Despite historically tight rate-differentials over US yields, bonds rallied to chase the monetary easing cycle, a sign of larger domestic investor base driving the market (See Exhibit 4 and Exhibit 10).

Comments by policymakers on IDR stability being evaluated on NEER basis affirmed this view, showing willingness to overlook IDR weakness due to broad USD strength. Policymakers also expressed comfort with bilateral IDR levels vs USD at that time which were around 16,300/USD. And mentioned that IDR was seen in-line with fundamental value as inflation remains within target range, rather than previously described as being undervalued.

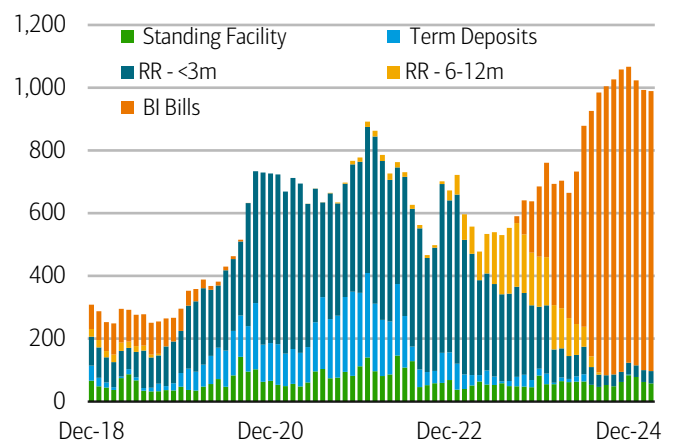
However, recent policy decisions have again cast doubt on the longevity of the decoupling seen between rates and FX. Since then, domestic uncertainty on fiscal policies and potential cabinet reshuffle has impacted foreign investor demand for both longer-end bonds and FX exposure.

### Bonds – front-end better placed

After the recent pullback, the front-end bonds have taken-out whatever easing expectations had built-up after January cut. Risk of an about-face with a rate-hike remain low. Spike in SRBI yields looks much less likely as well with ample supply of USDs from exports proceeds placements reducing the need to raise more via portfolio channel. The risk-reward for front-end is skewed towards lower yields even as the timing and extent of the move remains uncertain and linked to external volatility.

#### Exhibit 1: Large excess liquidity absorbed via SRBI issuance

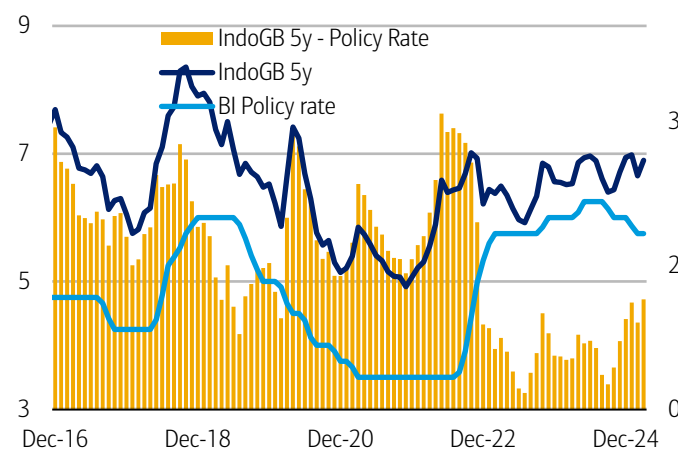
BI's liquidity absorption operations by instruments (IDR Tn)



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#### Exhibit 2: Front-end spread historically tight but much less so compared to last 3 years

IngoGB 5y, BI policy rate (% , lhs) and spread (% , rhs)



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### With further liquidity injections

In the last two policy meetings, BI has shown reluctance to proceed further with rate-cuts to avoid increasing the pressure on IDR, but liquidity injections continued via macro-prudential measures and BI's bond purchases. These would drive further compression in SRBI spreads vs policy-rate which would support front-end bonds. SRBI's outstanding amount could be reduced slightly to sterilize any outflows but we believe SRBI would remain as a key instrument for transmission of policy rates to domestic money markets (See Exhibit 1).

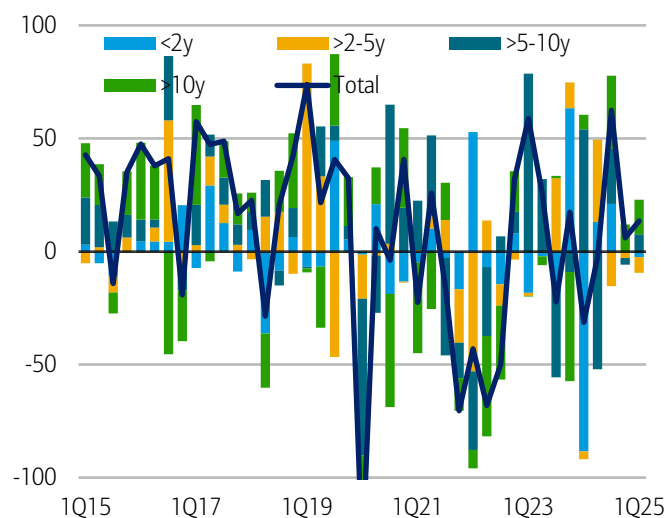
### Positioning or levels not too stretched

Valuations may look slightly rich in a longer historical context but 5y bond yield spread over policy rate is off by over 100bps compared to the tight levels seen over the last two years (See Exhibit 2). That indicates cautious pricing of easing expectations and room for further rally if rate-cuts are delivered as per our expectations (See report [Indonesia Watch: BI Review: Holding on, again and again 19 March 2025](#)).

Positioning has been marginally positive spread across the curve as per our last real-money tracker and recent client feedback (See report: [GEMs FI & FX Strategy Watch: Real Money Tracker – Underweight bond positions in India rise, China cut 10 March 2025](#)). YTD foreign debt inflows have been only IDR 13Tn after excluding official institutions flows. Monthly foreign flows breakdown by tenor shows higher proportion recently into belly and longer-end buckets as of end-Feb'25, which may have been reduced lately (See Exhibit 3).

#### Exhibit 3: Foreign inflows reallocation from front-end to belly and long-end over last 2 quarters due to steeper curve

Foreign quarterly flows by tenor bucket (IDR Tn)

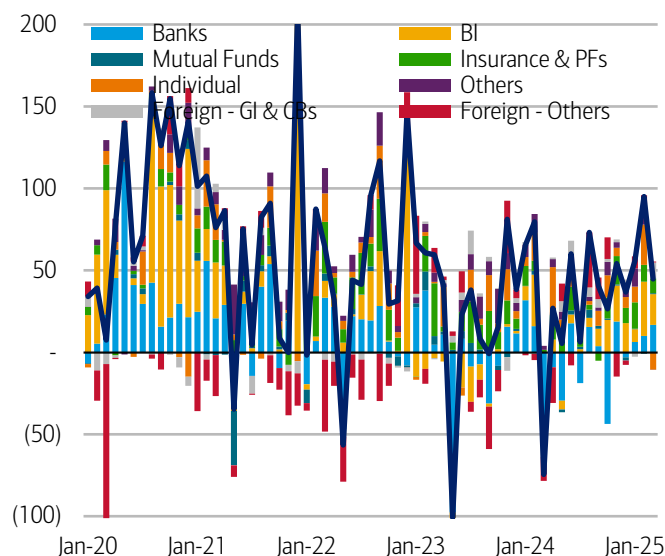


Source: BofA Global Research, Bloomberg

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#### Exhibit 4: Domestic flows remain supportive, including BI purchases

Monthly flows (IDR Tn) in IndoGB by type of investor



Source: BofA Global Research, Bloomberg

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### Supported by BI's bond purchases

BI has bought IDR 78 Tn in 2H24 and has bought another IDR 71Tn YTD as of 18<sup>th</sup> March (as per BI policy briefing), absorbing almost 30% of net supply over this period. The purchases are aimed at sterilizing FX intervention and also as part of the Triple intervention strategy to stabilize the bond markets. We believe that would continue provide a backstop against a sharper sell-off in bonds.

### But constrained by BI's tolerance on FX moves

BI's tolerance for FX volatility has since been tested as IDR fared worse than peers in the face of both external and domestic policy uncertainty. We believe such instances are likely to arise this year due to headline driven external volatility. BI would likely have to



switch policy stance during such times to avoid market attention and keep IDR broadly in line with regional peers.

Fundamentally, there are domestic considerations which make it difficult for policymakers to fully move away from USDIDR stability. Even as NEER remains stable, higher USDIDR impacts inflation outlook, albeit at only around 7bps per 1% USDIDR move as per BI's estimate. These pressures could be manageable as long as oil prices are low but simultaneous increase in oil prices could exacerbate the fiscal pressures via subsidy burden. BI's policy mandate for FX stability would make it difficult to tolerance much weaker FX in that scenario.

Considering that policymakers expressed comfort at USD/IDR around 16,300-16,400 range, we believe the pressure would become more intense if IDR gets closer to the next big figure around 17k level. Below that, IDR moves in line with broad USD volatility may be of less concern to policymakers but outsized moves due to Indonesia specific headlines would elicit a stronger response.

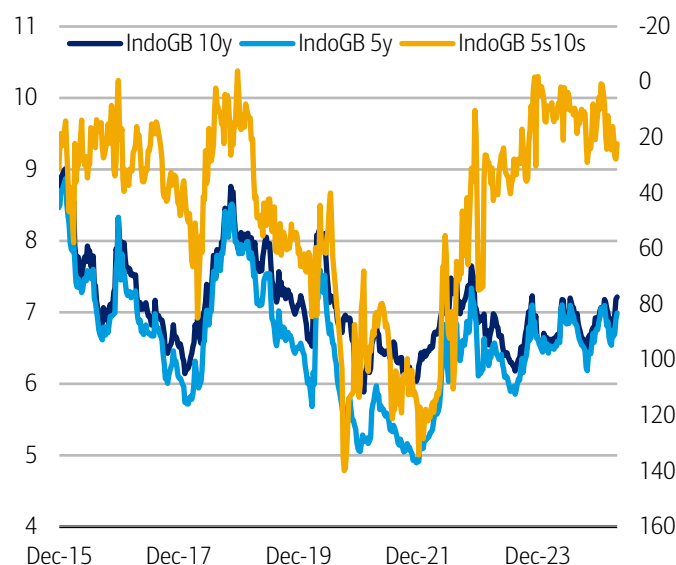
### Steeper yield curve – dovish policies, higher term-premium

The market positioning has been relatively spread across the curve so far as near-term risks on budgeted issuance for 2025 were contained. The reasons cited by investors attributed the positions to a) government's commitment to meet this year's fiscal deficit target, b) cash buffer still large enough at end of 2024, c) pre-funding for this year and d) rollover of burden-sharing bonds bi-laterally with BI, keeping issuance overall issuance in check.

We maintain our forecasts for 10y bonds at 7.20% for end-1Q and rally to 6.8% at end-2025 (See report: [Asia FI & FX Strategy Viewpoint: ASEAN Year Ahead 2025: Playing defense 27 November 2024](#)). However, the uncertainty around these forecasts has increased due to a multitude of fiscal changes ongoing at this stage. BofA economist has highlighted possible downside risks to fiscal deficit, however, the uncertainty on achieving targeted spending cuts means an overshoot cannot be ruled out either. We believe further clarity may be achieved by mid-year before the budget revision around July. Until then, investors would demand a higher term-premium in the curve even with potential for further rate-cuts (See Exhibit 6).

#### Exhibit 5: Curve tends to bull steepen during easing cycle

IndoGB 5y and 10y yields (% , lhs) and 5s10s spread (bps, inverted, rhs)

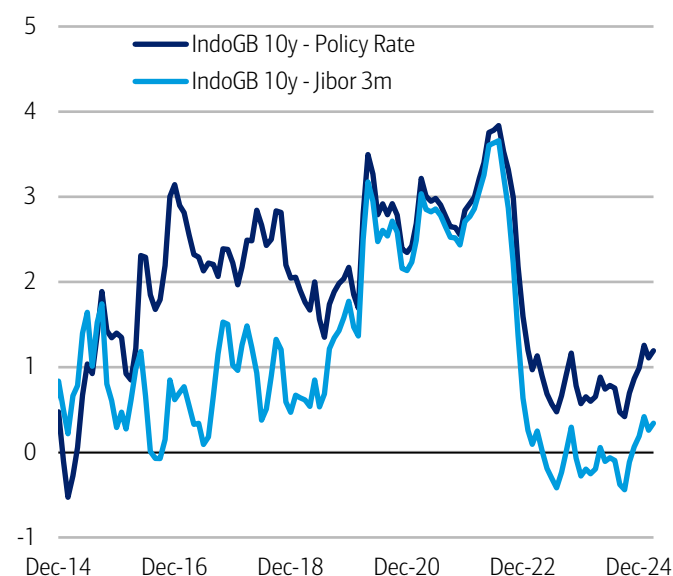


Source: BofA Global Research, Bloomberg

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#### Exhibit 6: Low term-premium compared to current policy rates

IndoGB 10y spread to policy rate and Jibor 3m interbank rate (%)



Source: BofA Global Research, Bloomberg

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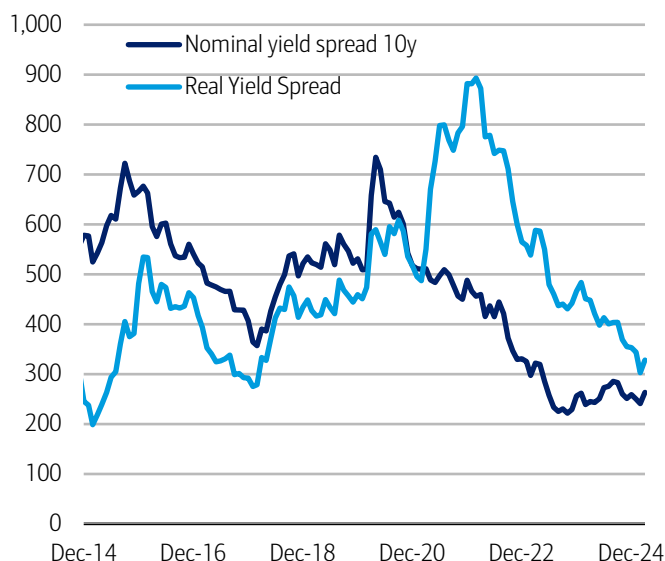
### Pro-growth policy stance – pivot-steepening

In the near-term, the risks are more tilted towards pivot-steepening as both fiscal and monetary policies stay pro-growth (See Exhibit 5). This scenario would assume that policy credibility is maintained on both monetary and fiscal fronts, and additional large policy changes are avoided. The front-end would be supported by accommodative monetary conditions but the long-end may stay under pressure to price higher term-premium for medium-term uncertainty around the fiscal outlook.

BI would avoid contraction of its balance sheet via rollover of burden sharing bonds. That would have, otherwise, added to net issuance to the market and further tightened liquidity by itself. But risk of even larger maturities over the next 5 years would linger and further commitment from BI would be needed to dispel market concerns of additional issuance from these bonds (See Exhibit 8).

#### Exhibit 7: Indogb real yield pick-up for US investors near lows

Nominal and real yield spread on 10y IndoGB vs US rates (bps)

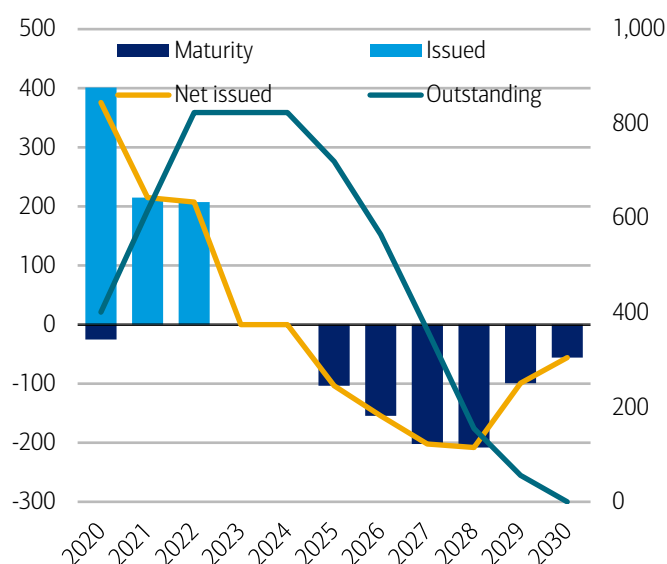


Source: BofA Global Research, Bloomberg

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#### Exhibit 8: VR bonds redemption from 2025

Annual issuance, maturity, net issuance (IDR Tn, lhs) and outstanding of VR bonds (IDR Tn, rhs)



Source: BofA Global Research, Bloomberg

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### Stable IDR, rate-cuts in 2H – bull-steepening

The bull-steepening scenario will materialize if IDR remains well-behaved, which we expect in 2H of this year as USD continues to soften. That would allow deeper cutting cycle along with tighter SRBI spreads, thus, benefitting front-end more. The market would likely have more clarity on the fiscal outlook by mid-year which may support this outlook if spending cuts are successful and fiscal deficit is not revised wider.

### Tail risks on deficit limit or debt trajectory – bear-steepening

Risk-appetite from foreign investors could further take a hit if political changes impact their perception of fiscal prudence over medium-term. Large scale usage of off-budget funding with special government bond issuance could be another concern. Recent announcement of housing-linked special bond issuances caught investors by surprise. Some government estimates point to additional funding needs as high as IDR 130Tn, with lack of clarity on the split between liquidity measures and bond funding.

The impact is more likely to be felt on 10y part of the curve while front-end may be limited by policy anchor and would be more closely tied to IDR volatility picking-up leading to breach of key levels like 17,000/USD. Our expectations of broader USD weakness might cushion the overall impact on USDIDR and consequently limit transmission to front-end yields.

## IDR – more flexible, less defensive

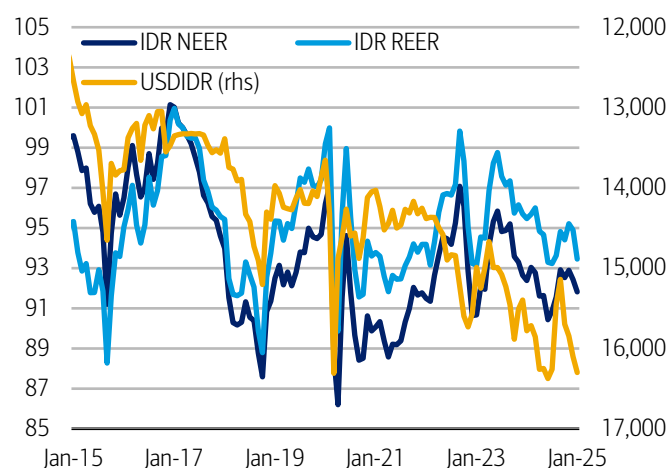
IDR has been weighed down by higher US rates and stronger USD since 2022 despite overall BoP surplus and even CA surplus at times. External volatility is likely to stay here due to tariff headlines risks and US policy rate staying elevated for longer.

However, a tilt towards domestic growth has made policymakers more flexible on IDR weakness against broader USD strength. As mentioned by BI in recent communications, IDR NEER and REER have, in fact, been around middle of the ranges over last 10 year and are not pointing to much IDR specific weakness over longer-term (See Exhibit 9).

Policymakers also see IDR as being in line with fundamentals in terms of their price stability mandate as inflation is expected to stay within target ranges. Consequently, the usual reference to IDR as being undervalued has been dropped from recent communications. Higher degree of flexibility on USD moves would imply less defensive smoothing flows unless the weakness is driven by Indonesia specific factors.

### Exhibit 9: IDR NEER and REER have been stable over longer-term

IDR NEER and REER indices from BIS (lhs) and USDIDR (rhs, inverted)



Source: BofA Global Research, BIS

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### Domestic uncertainty adds to bearish pressures

Domestic factors remain fluid and the uncertainty has contributed to bearish pressures on IDR. While many of the recent changes in policy are in line with the new administration's campaign promises and would be positive for Indonesia's long-term growth prospects, the near-term uncertainty may lead to position reduction by investors. The concerns include

- Swift changes in policy priorities, including tax policy or monetary policy stance, have challenged the market thesis of policy continuity.
- Near-term negative growth impact due to large government spending cuts and reallocation. Investors would be wary of uncertain outlook in the near-term and potential for execution risks. Or, alternatively, widening in fiscal deficit targets around mid-year revision if the spending cuts fall short of targets but spending disbursement picks-up
- Potential changes in key ministers via cabinet reshuffle increasing uncertainty on commitment to long-term fiscal limits. Market has been sensitive to any comments about breaching deficit cap or targeting higher debt-to-GDP ratios. The concern lies around financing of annual deficit even though the government debt-ratios are relatively low compared to peers.



- Changes to BI's mandate via Financial Sector Omnibus Law. While the changes are consistent with BI's current priorities, the timing of these changes may create more uncertainty. That would contribute to market concerns on whether BI is shifting further away from pro-stability mandate on IDR.

## But tail risks lower than 2018

USD and Fed outlook remains the key factor driving IDR. Indonesia has not been in the tariff crosshairs as yet and is widely seen as less directly exposed to the trade tensions theme. Rather the impact is indirect from USD strength and risk-off theme which could trigger portfolio outflows.

### Better external balances

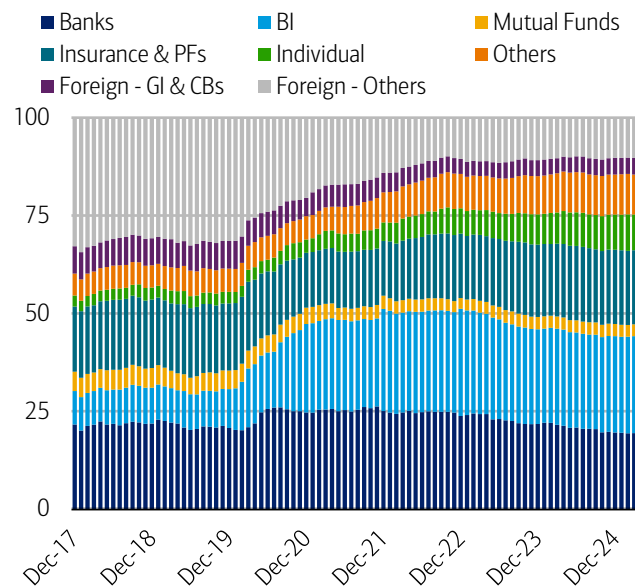
Firstly, the fundamental outlook has improved substantially in terms of macro-stability helped by policy credibility and improvement in external accounts. Current account deficit remains contained at -0.6% of GDP in 2024 vs -2.9% in 2018. And basic balance registered a surplus of 0.4% of GDP last year vs -1.7% deficit in 2018.

### With lower risk of foreign capital flight

However, if volatility indeed picks up, the magnitude may be smaller compared to previous episodes including 2018. IDR has historically been more vulnerable due to debt outflows compared to equities. Foreign ownership of IndoGBs, after excluding the official institutions, is much lower as proportion of outstanding debt (See Exhibit 10) but also in IDR terms by around IDR 150Tn from the peak and closer to early 2017 levels.

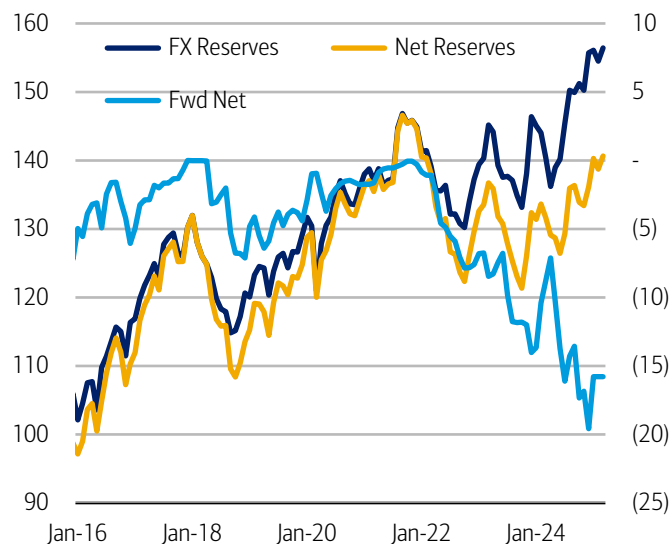
#### Exhibit 10: Foreign ownership of IndoGBs has reduced to around 10%, after excluding official institutions and central banks

IndoGB holders by type of investors (% share in outstanding)



#### Exhibit 11: BI's FX reserves are up after adjusting for forwards

BI's FX reserves on spot and net reserves (USD Bn, lhs) adjusted for forward (Fwd Net) positions (USD Bn, rhs)



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### Adequate reserves buffer

BI's reserves have also increased rapidly on spot basis to around USD 155 Bn as of Feb'25 although partly offset by a smaller increase in short forward positions (See Exhibit 11). Accretion of reserves on net basis shows that overall BoP remains in surplus. DNDF book appears to be relatively cleaner as well with overall outstanding likely around USD 3-5Bn including secondary market operations, as per our estimate.



### With additional USD inflows from exports repatriation rule tightening

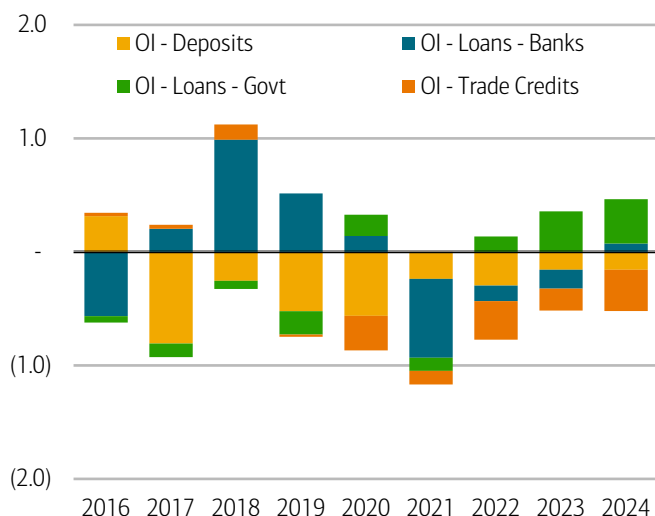
Lastly, tighter regulatory framework on export repatriation requirements would improve the supply of USDs over the next 12 months from Mar'25. Given the rolling 12-month requirement, the impact would begin to fade after the initial 12-month period. But it buys enough time to possibly ride-through the volatility around tariffs and will contribute substantially to the headline reserves, even if final amount falls short of the initial estimate of USD 80bn.

Policymakers, however, appeared content with the improved onshore USD supply, either in the banking system or as part of BI's reserves. There is much less optimism or expectations of these proceeds having any substantial impact on IDR directly, likely based on the impact seen from the previous round of tightening. Nevertheless, it would allow government to plug the holes in the BoP from outflows in the other investments categories (See Exhibit 12) or from accumulation of USD deposits onshore (See Exhibit 13).

Over the last few years, BI has fine-tuned a wider set of policy tools to manage FX volatility which could contain any tail risks on IDR. These include directly substituting USD hedging demand using DNDF, tapping banking system USDs via FX swaps or attracting more capital flows via SRBI issuance while also tightening liquidity to raise hedging costs.

#### Exhibit 12: Banking system USD outflows on deposits and trade credits

Breakdown of OI (Other investment) deposit and loan flows (% of GDP)

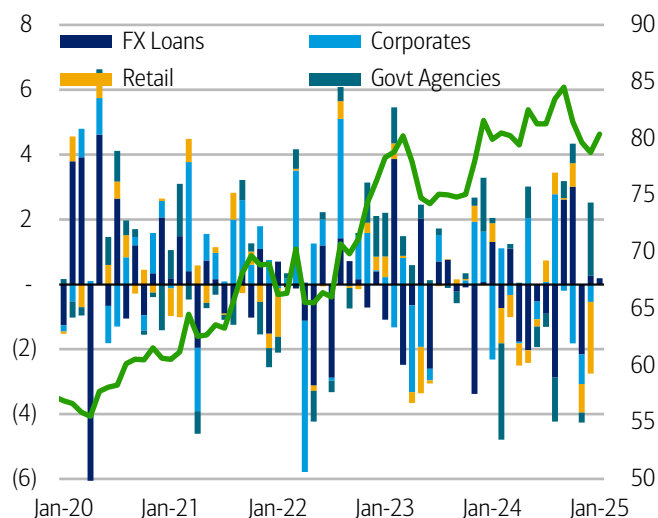


Source: BofA Global Research, Bloomberg

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#### Exhibit 13: Total FX deposits still elevated after a drawdown in 2H24

Monthly FX deposit flows (USD Bn, lhs) and total deposits (USD Bn, rhs)



Source: BofA Global Research, Bloomberg

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