Indonesia: BI steps back from armed defensive mode; we push back our call for next BI hike to Q127

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- **We are revising up our Indonesia GDP growth forecasts after a firm Q2 report, but expect the pressure of twin deficits to act as a brake on growth in H2. As the 2027 budget plan reflects stronger ambitions for fiscal discipline, private demand and investment would play an important role in driving economic growth in 2026 and beyond, indicating limited room for BI to tighten further.**

- **After the aggressive 125bp policy rate cuts in 2025 and 100bp hikes in Q226, Bank Indonesia (BI) will likely turn to a neutral stance in the near term and extend the pause for the rest of the year, so as to strike the balance between stabilising FX and supporting growth. We are pushing back our call for one more BI hike to Q127.**

- **We maintain our end-2026 USD/IDR forecast at 17,600, as more balanced flows in the financial account would help cap the upside for USD/IDR. The IDR could play catch-up in a less strong USD environment after its weak performance YTD, but a widening current account deficit and still-lacking foreign confidence would continue to drag on the IDR.**

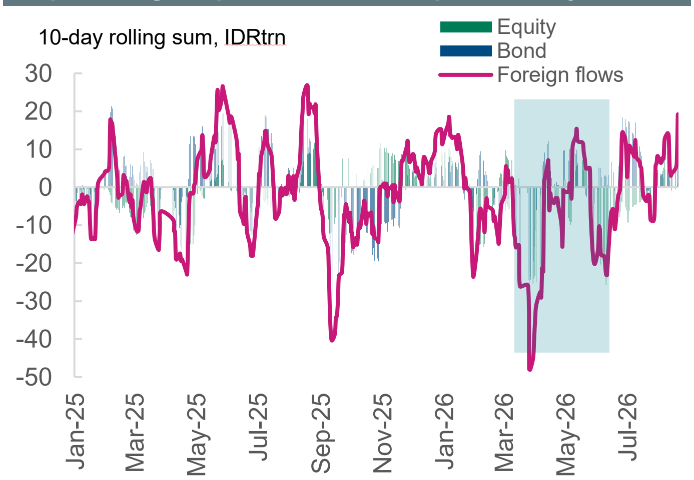
The twin deficits started to bite despite firm Q2 growth

Indonesia reported a firm Q226 GDP report amidst energy shocks and BI's monetary tightening (100bp hike in May and June), with the economy growing by 5.3% YoY, topping market consensus of 5.1%, albeit easing from the exceptionally fast growth of 5.6% YoY (the highest since 2023) recorded in Q1.

President Prabowo Subianto highlighted that Indonesia's growth could achieve 6% in 2026 in his State of the Nation address on 14 August, suggesting strong ambition to boost growth momentum in H226, up from 5.5% in H126 and 5.1% in 2025. However, we see concerns over the emerging pressure of widening twin deficits, which will be a brake on high growth ambitions in H226 and in 2027.

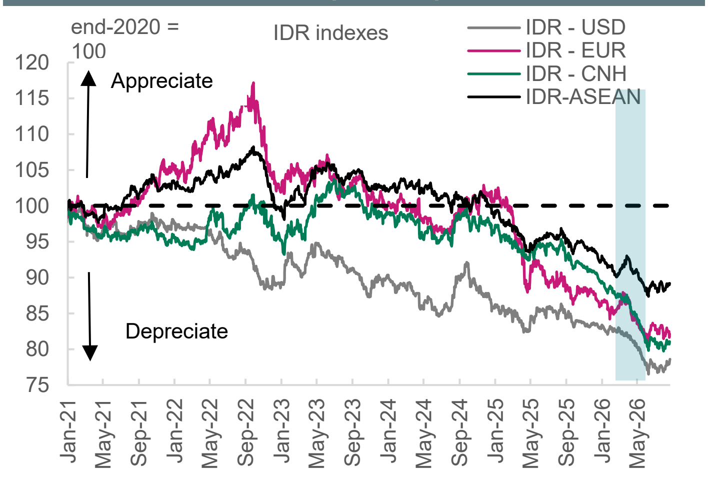
In Q226, household consumption growth stayed solid at 5.1% YoY (vs 5.5% in Q1) and remained the largest contributor at 51% of headline growth. Meanwhile, a sharp pick-up in public spending of 16% YoY has been helping to cushion the drag from worsening net exports. Public spending contributed 20% of headline GDP growth in Q2 vs 22% of contribution in Q1, and only 4% in full-year 2025.

Rapid foreign capital outflows in April and May…



Source: Bloomberg, Crédit Agricole CIB

which have leaded to sharp IDR depreciation



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The market was losing confidence in Indonesian assets and the IDR in H1 amidst the perfect storm of rising fears over fiscal sustainability (negative outlook on the sovereign rating, rising fiscal subsidies against elevated oil prices), policy shocks (new DSI on export system, shift of BI governor, concerns over flagship MBG programme), the MSCI warning on investability of Indonesian equities (result of the review in November), and last but not least the rare trade deficit recorded in Q226.

Foreign outflows in the equity and bond markets have been rapid in H1 alongside the sharp depreciation of the IDR, before showing initial signs of stabilisation following BI's "all-out" policy to support FX, with a total 100bp hike in May and June. The IDR is still among the weakest currencies in Asia YTD, with USD/IDR moving higher from 16,771 at end-February to as high as 18,178 in mid-June (+8.4%), before slightly pulling back to around 17,750. The benchmark equity index JCI declined by 29% YTD.

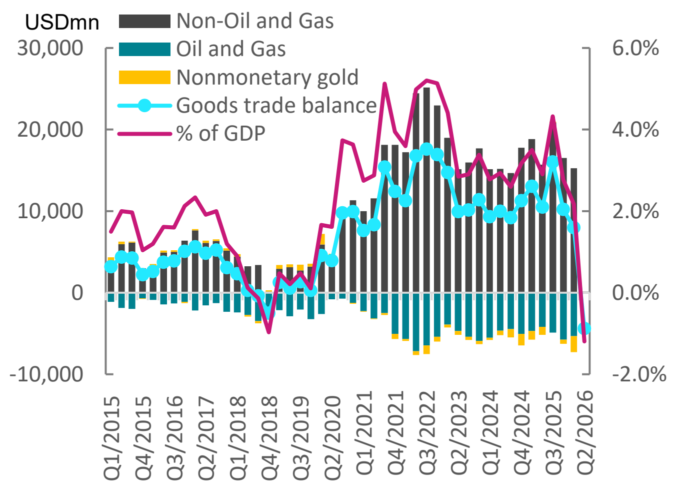
Revising GDP growth forecasts despite wider C/A deficit

We revise up our 2026 GDP growth forecast to 5.2% (from previous forecast of 4.8%), vs 5.0% in 2025, though we expect the pace of growth to slow 5.0% YoY in H2 from 5.5% in H1. We also revise up our 2027 Indonesia GDP growth forecast to 5.0% (from 4.9%) on the back of still-resilient domestic demand.

We expect a wider current account deficit, as its ratio to GDP would likely be -1.9% (vs previous forecasts of -1.0%) in 2026 and -1.7% (vs -1.3%) in 2027, from -0.1% in 2025.

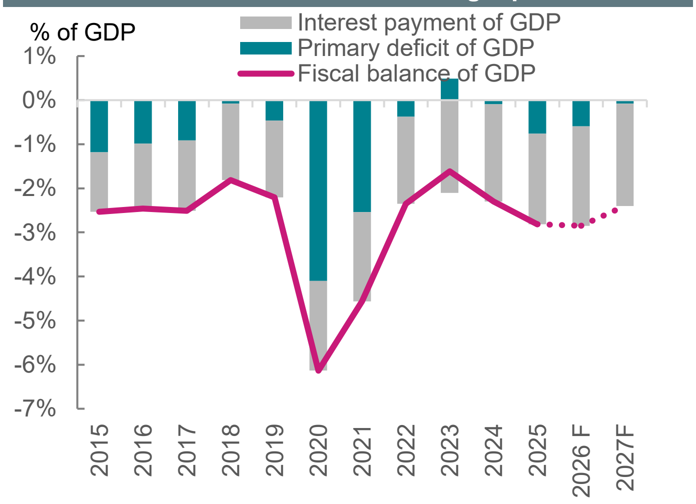
We maintain our CPI forecasts to average at 3.2% in 2026 and 2.8% in 2027, staying within BI's target range of 1.5-3.5%.

Indonesia recorded trade deficit in Q226



Source: CEIC, Bloomberg, Crédit Agricole CIB

More fiscal consolidation in 2027 budget plan



Source: BI, CEIC, Bloomberg, Crédit Agricole CIB

BI steps back from armed defensive mode

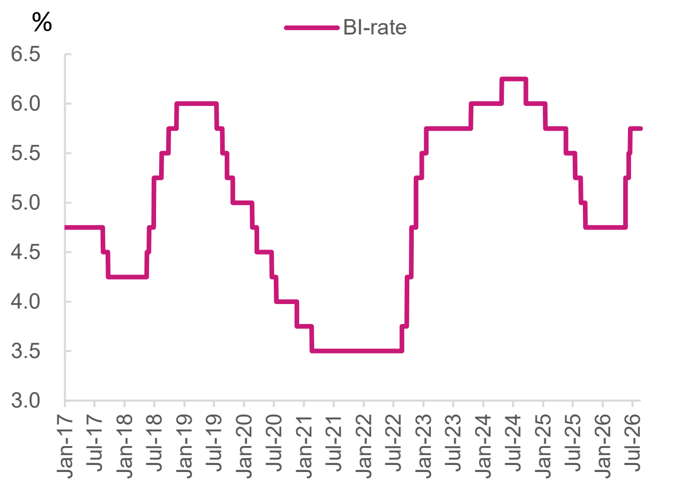
BI would keep delivering FX stability as its prime policy target, while having likely shifted away from the aggressively defensive stance of Q2. BI has kept the policy rate unchanged in July and August, after a total 100bp hike in May and June. The yields of Bank Indonesia Rupiah Securities (SRBIs), the main tools to attract foreign inflows, have also eased from their peaks alongside lower issuance volume. The 1Y SRBI yield was auctioned at 7.37% on 14 August, down 37bp from 7.74% in mid-June.

Meanwhile, BI has started to shore up non-rate policy tools to attract foreign capital inflows since June, not solely depending on higher yields. BI announced plans to expand the premium reduction incentives for hedging swaps (thus lowering hedging costs) from initially covering only foreign portfolio flows to also include foreign loans and FDI, effective from the second week of September 2026.

The initial signs of IDR stabilisation have offered flexibility for BI to stay on hold for now, as we have begun to see more balanced flow dynamics in the financial account, supported by rising yield attractiveness and hedging incentives offered by BI. Meanwhile, more constructive domestic developments have also helped to restore market confidence, including the smooth transition of BI's leadership and the government's support for fiscal consolidation. That said, the high uncertainty surrounding the MSCI review in November, Middle East tensions and uncertainty over the Fed's path should keep BI on guard.

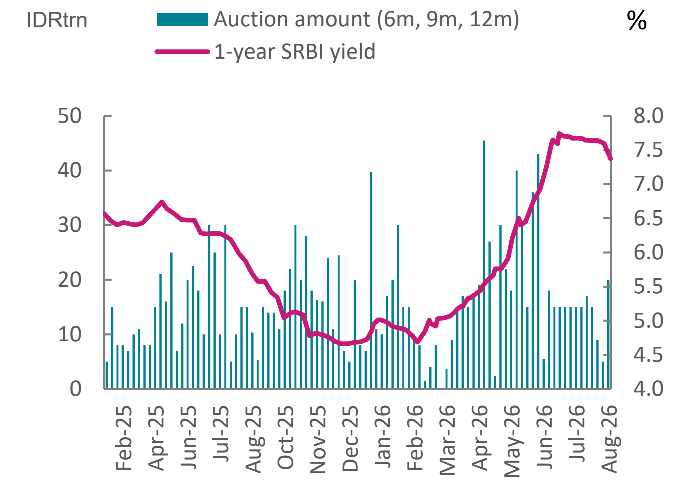
We maintain our call for one more hike from BI as a policy response to elevated external uncertainties (BI expects the Fed to hike in Q4), while pushing back the timing to Q127 from our previous expectation of Q326. We expect BI to maintain the policy rate at 5.75% for the rest of the year, before lifting it to 6.00% in 2027. Global financial conditions and capital flow dynamics would likely be the key considerations for BI's policy rate decision in the near term.

BI likely to pause in H2 after 100bp hike in Q2



Source: Bloomberg, Crédit Agricole CIB

1Y SRBI yield started to ease from the peak in June



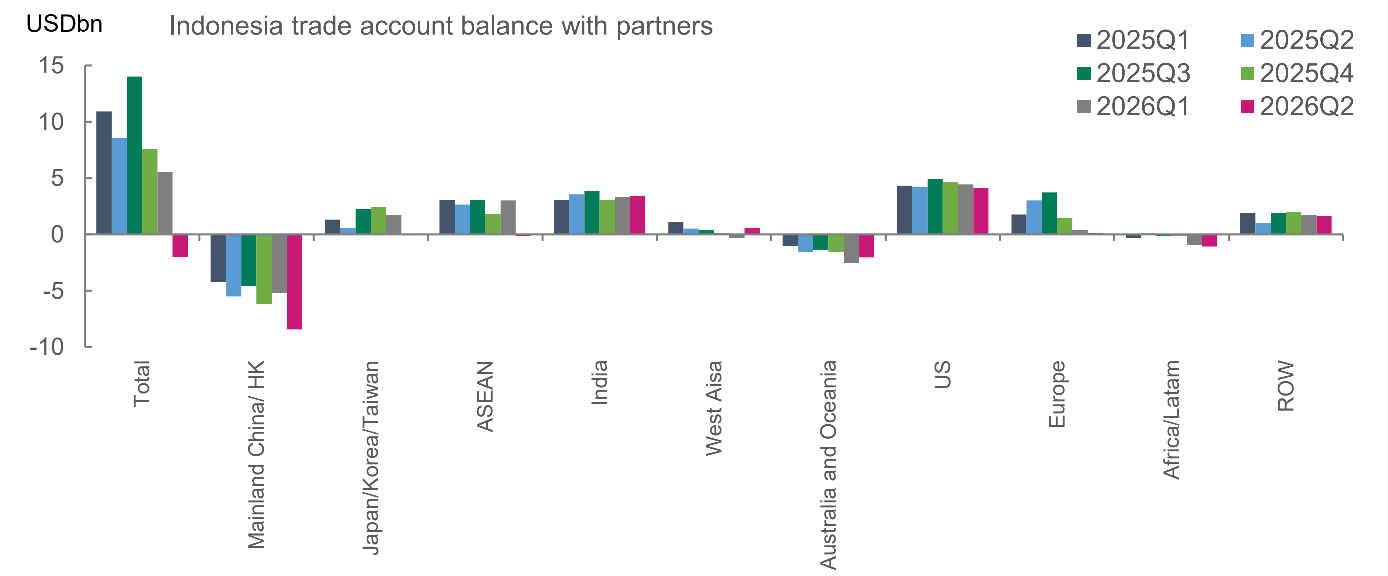
Source: BI, Bloomberg, Crédit Agricole CIB

The IDR could play a catch-up but likely not to outperform

The IDR has remained among the weakest currencies in Asia YTD, though it has started to play catch-up since August amidst a less strong USD environment. We believe that more balanced flows in the financial account after the rapid H1 outflows, together with a potentially strong policy response from BI, would help cap the upside for USD/IDR in H2 against unexpected shocks.

That said, we do not yet see a pivot point for the IDR NEER to rebound from its current historically low level.

Indonesia recorded trade account deficit in Q226

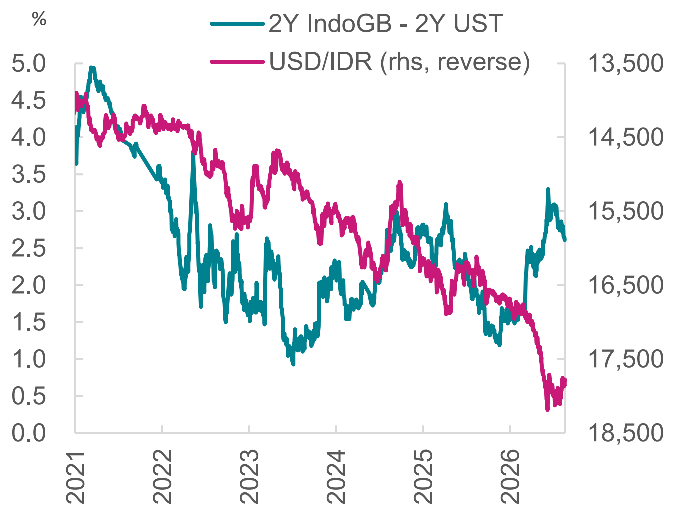


Source: CEIC, Bloomberg, Crédit Agricole CIB

The deteriorating current account balance would be one medium-term drag on FX fundamentals. In the near term, elevated crude oil prices could remain a drag for

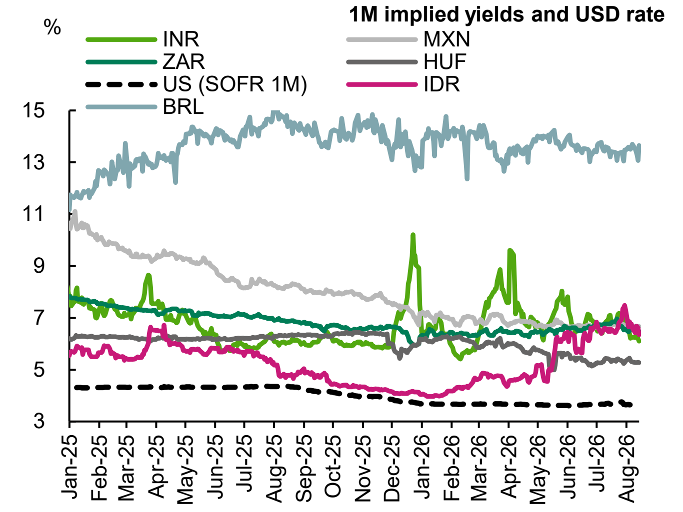
Indonesia as a net oil importer, though the recent rise in commodity prices would offer some support to export. What is more, structural factors are expected to weigh on performance over the medium to long term, highlighted by the absence from AI-related supply chains and the strong demand for importing machinery to support the industrial downstreaming policy.

Narrower USD-IDR yield spread does not favour carry trade



Source: Bloomberg, Crédit Agricole CIB

The IDR rebuilt some carry attractiveness, but not enough



Source: Bloomberg, Crédit Agricole CIB

Regarding the financial account flows, though we believe the phase of rapid foreign capital outflows is largely over, it would still take time for foreign investors to restore their confidence in the market. The IDR could still be absent from mainstream global carry trades, as an import-dependent currency with still-high volatility that erodes risk-adjusted returns. The recently narrowed USD-IDR yield spread following lower nominal yields of SRBIs is also not favouring foreign interest in FX parking at the short end of the curve. For long-term foreign investors looking at the long end of the curve and the equity market, the relatively flat curve and weak equity market performance could keep foreign flows hesitant for a while.

We are lowering our USD/IDR forecast for end-Q3 from 17,850 to 17,500, seeing room for USD/IDR to move lower from the current level in the short term, while maintaining our end-2026 forecast at 17,600 and end-2027 forecast at 17,250.

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