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Vishnu Varathan | Head Macro Research, Asia ex-Japan

Rupiah & Unintended Consequences

"What you do in this world is a matter of no consequence. The question is what can you make people believe you have done." - Sherlock Holmes, A Study in Scarlet

In a Nutshell:

- **Aggressive rupiah stabilization measures** - from *fairly conventional monetary tightening* to *mixed/debatable* (FX and bond) *market intervention* to *draconian/contentious commodity exports surrender* - *risk not just falling short* but **could backfire badly**.
- Admittedly, **rate hikes** is a *conventional tool* to help mitigate macro-/FX-stability risks. ***But*** it is *often limited in impact* and *rarely enduring.* And **"Iran shocks"** that *amplify adverse feedback* between *low-income*, *"twin deficit"*, *credit ratings*, *asset price* and *currency* **vulnerabilities** *loops* **further accentuate the limitations of FX measures**.
- Moreover, **direct FX and/or bond intervention** (to *prop up the currency* and *suppress yields*) are not only **limited by resources** but have **conflicting objectives**. Overall, it has a **short leash on credibility**, *afterwhich it **flips to being counter-productive**.*
- The **commodity/resource/exports nationalization** approach, which intends for **constructive rupiah dynamics** from *positive income effects* (exports boost) with *fiscal enhancement* (attendant lift in tax collections) and *cashflow from realized Current Account inflows* enforced exports proceeds surrender) perversely **backfires with accentuated rupiah pressures as a crisis of confidence overwhelms**.
- The **far bigger risk** here is **rupiah risk premium demanded** for *policy unpredictability,* **abruptly escalates** *on fears of "confiscation risks" **if state overreach** into private sector profit appropriation* and *asset control **spirals out as a far greater risk**.*
- All considered, **unintended bearish consequences** are likely to cast a pall, *setting the rupiah up for more pronounced downside volatility* (18,000 USD/IDR on the cards). This, even with *our call for another 100bp of BI rate hikes* (with another 50bp front-loaded into mid-2026).

- Indonesia's **aggressive suite of FX (rupiah) stabilization measures** - spanning *conventional monetary policy tightening* (surprise 50bp hike), *debatable market intervention* (FX and bond stabilization purchases) and *highly contentious quasi-nationalization of commodity exports* (purportedly to rectify under-invoicing and presumably for effective exports surrender*) **don't just risk being ineffective**, but **could inadvertently end up backfiring**.
- For a start, **even widely-accepted/expected policy tightening** (rate hikes) to aid with FX stabilization **ordinarily only provide temporary and partial relief** for EM FX. And notably, ***at the expense of growth headwinds*** and ***balance sheet stress****.*

- Moreover, given how **pervasive** and **profound "Iran shocks"** are, **adverse feedback** between *low-income, "twin deficit", credit ratings, asset price* and *currency* **vulnerabilities** are likely to be **magnified**, **further hobbling currency stabilization efforts**.
- More problematic is the **inherent conflict of objectives embedded in direct market intervention** (FX and bonds) aimed at **simultaneously stemming rupiah depreciation pressures** and **containing rising bond yields**.
- Admittedly, the **MoF's intent is to inspire confidence in the bond market** (by being a buyer of last resort) and *reverse the tide of foreign bond selling* is **not without merit**. ***But*** this approach ***only works in a "risk on", yield-seeking environment*** - which is clearly not the current mood.
- Whereas in a **"risk off" environment**, **confidence is perversely undermined**. Fact is, **capping yield***s*, which *impede risk premium adjustments* in bond markets, **merely transfers risk re-pricing to the exchange rate** mechanism - resulting in *rupiah depreciation acting as the "pressure release valve".*
- ***Worse****, if markets sense that fiscal/financial stress* and/or *inflation/debasement* will ultimately result from in bond buying, this **could prompt front-running to price in expected currency depreciation**.
- Arguably the **contentious FX stabilization** (as a by-product) move is the **extremely concerning plan to nationalize commodity exports****. Such a brutal move (funnelling private sector production of commodities via a national agency) *risks accentuating rupiah pressures from a loss of investor/business confidence,* which is **diametrically opposed to the intent for structurally constructive rupiah dynamics** *from diminished "twin deficit" vulnerabilities.*
- In theory, forcing commodity exports (palm, coal and ferrous alloys for now) **to** only be exported via Danantara may;
  1. **tackle alleged chronic under-invoicing** (to the benefit of exports value boost as well as related tax collections), and;
  2. **improve Current Account (C/A)** inflows from effectively enforced exports surrender.
- ***But*** the **stark reality is one of inadvertent and justifiable crisis of confidence** that *overwhelms the intended simultaneous C/A and fiscal boost.* In turn, this *ends up dragging, rather than buoying, the rupiah.*
- Especially if the **risk premium** (rupiah depreciation pressures) **for compromised policy predictability/stability abruptly escalates to** become **mounting worries of "confiscation risks"** – whereby the *state may effectively claim private sector profits and control assets.*
- To this end, *if Indonesia shocks with more measures that broaden to appropriate/extract assets/value from tycoons/private sector only to be diverted to the more opaquely-managed public sector entities* (such as Danantara) the **dangers of more intense and disorderly sell-off in rupiah and rupiah assets** will be accentuated.
- **Upshot** being, while rate hikes may help mitigate (albeit not fully suppress) rupiah depreciation, **more brutal market intervention/capital controls/regulatory overreach** (into private sector property rights) may

perversely overwhelm and amplify sell-off instead. *And across exchange rate (rupiah pressures) and assets (softer equities and higher bond yields).*

- All said, the **dangers of unintended consequences amplifying self-reinforcing rupiah** (and associated rupiah asset) **loom large**.
- Accordingly, we now anticipate ***more pronounced downside rupiah volatility*** (with potential for tests over 18,000 USD/IDR) into Q3, *even as we price another 100bp of BI rate hikes; of which, 50bp is set to be front-loaded by mid-2026.*

* Other examples of exports surrender as a means to FX support/stability have typically had limited success.

** Some observers point out that the **commodity exports control plans suffer from execution risks**, associating this with rupiah sell-off. But this is misguided. In this case, if execution risks help to roll back mis-steps, it may be a relief for the rupiah.