

BBH 

Mind on the Markets Quarterly

THE DOLLAR, THE FED, THE INDO PACIFIC

2026 Third Quarter Outlook



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The Dollar and the Fed

Insights from Elias Haddad

Making Cents of the Dollar



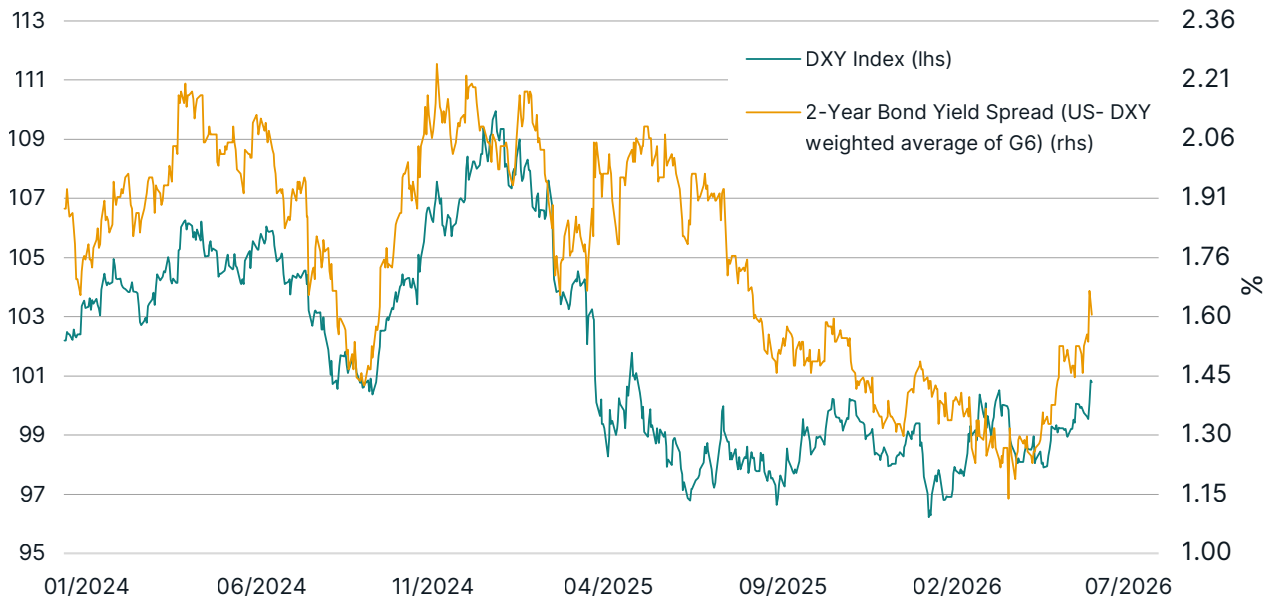
The dollar index (DXY) overshot its more than one year 96.00-100.00 range, propelled by the Federal Open Market Committee's (FOMC) hawkish hold on June 17. We see scope for DXY to edge a bit higher in the coming months.

Interest rate differentials between the US and other major economies are consistent with DXY trading closer to 102.00 and US economic outperformance should keep the dollar supported

(Chart 1). The Atlanta Fed GDPNow model estimates above trend annualized US real GDP growth of 3.0% in Q2 vs. 1.6% in Q1 while the May PMI data points to a widening US growth edge over peers **(Chart 2)**.

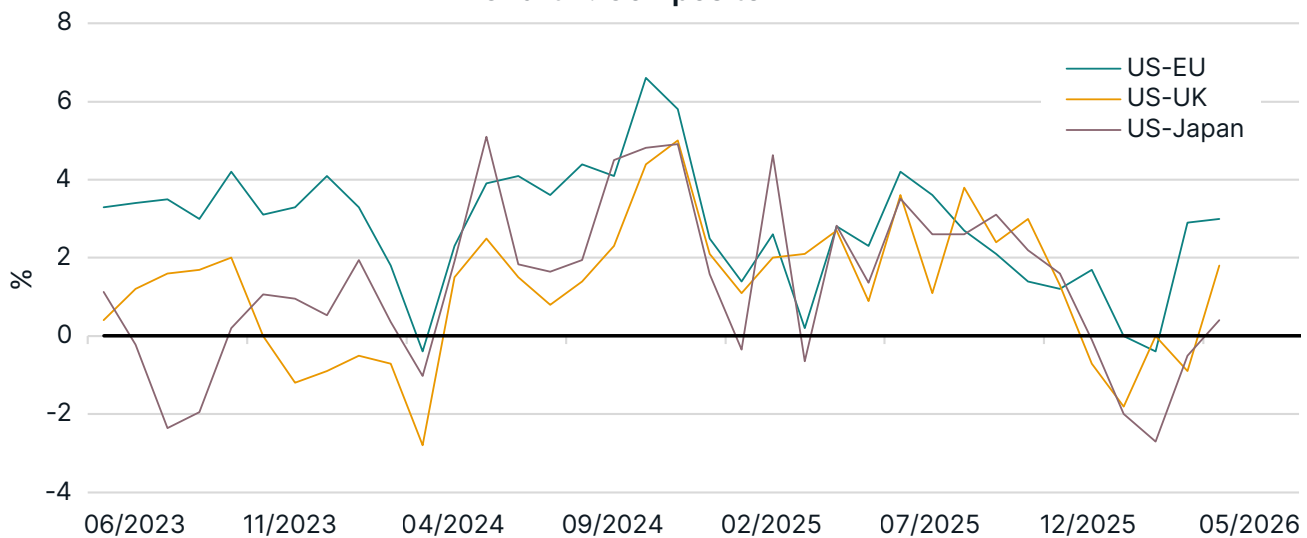
Longer term, we remain bearish on the dollar because of protectionist US trade policy and worsening US fiscal credibility.

Chart 1



Source: Bloomberg

Chart 2: Composite PMI*



Source: S&P Global. Bloomberg

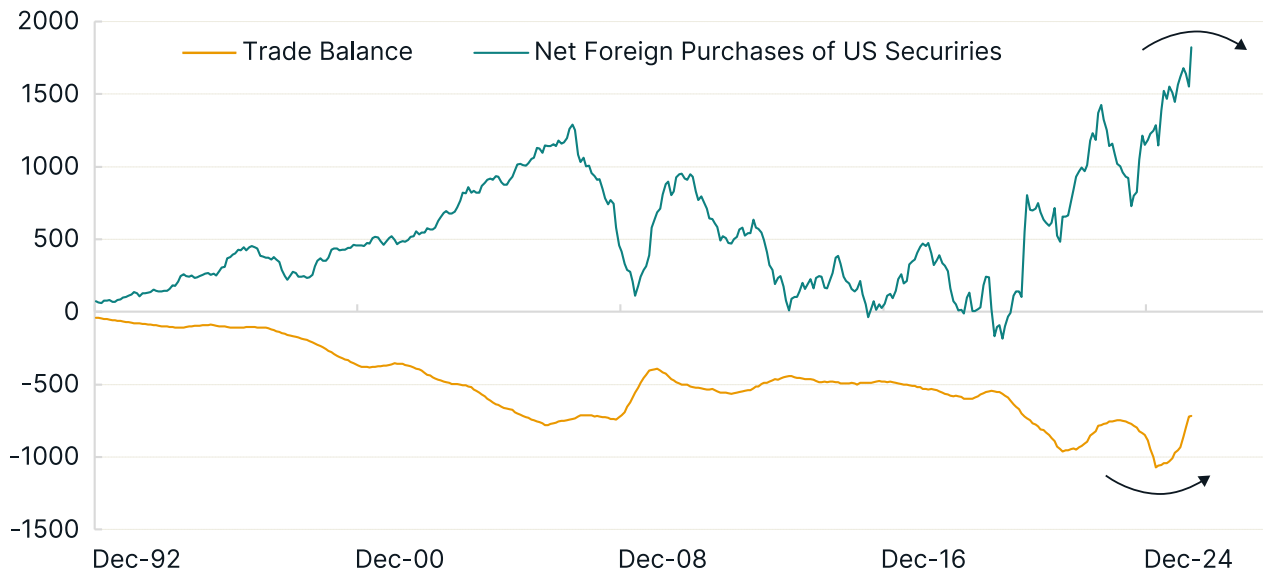
Protectionist trade policy

The Trump administration's effort to narrow the US trade deficit means fewer dollars will flow overseas, reducing the need for those funds to be

recycled back into US securities (**Chart 3**).

That's pure balance of payments mechanics and is a structural drag on the dollar.

Chart 3: US (Annual Sum, Bn of US\$)



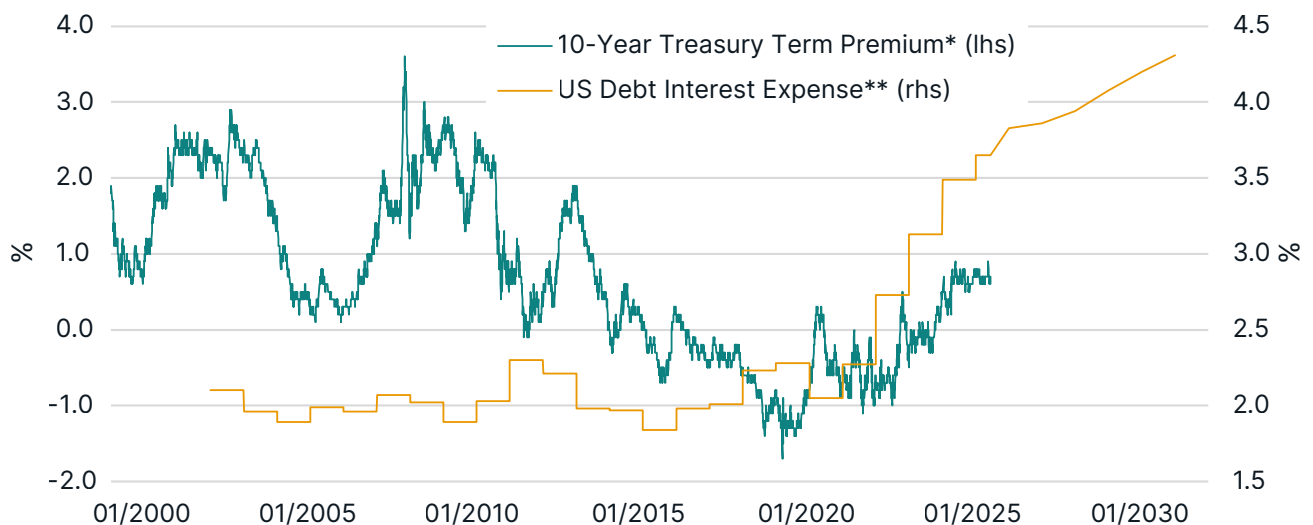
Source: US Census Bureau & Department of the Treasury.

Worsening fiscal credibility

The rise in the US Treasury term premium alongside rapidly increasing debt services costs suggests investors are demanding greater compensation to hold long dated Treasuries

(Chart 4). Over time, a widening fiscal risk premium could erode the dollar's appeal as the world's primary reserve currency by raising questions about the long-term sustainability of US public finances.

Chart 4: Worsening US Fiscal Credibility



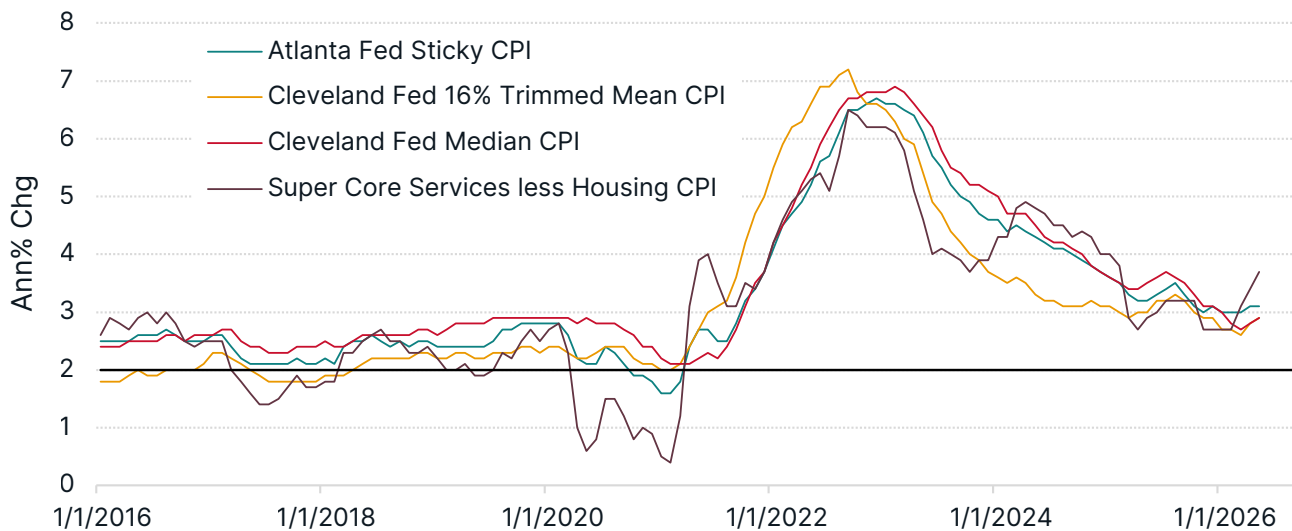
Source: *Adrian Crump & Moench. **IMF.

Hawk and Awe

The FOMC delivered a hawkish hold on June 17. As was widely expected, the FOMC left the target range for the funds rate unchanged at 3.50%-3.75% for a fourth straight meeting. The decision was unanimous, and the FOMC statement scrapped its implicit easing bias.

It was a hawkish hold largely because of the swing in the median Fed funds rate projection from a cut to a hike by year-end. Additionally, Fed Chair Kevin Warsh's unwavering commitment to the Fed's 2% inflation target, suggested a higher-for-longer policy bias given that the underlying disinflationary trend has stalled (**Chart 5**). As a result, Fed funds rate hike bets surged to imply greater odds for 50bps of tightening by year end.

Chart 5: Underlying Inflation



Source: Bloomberg

Beyond the hawkish hold, three other themes stood out:

1. A shift toward strategic ambiguity. That was underscored by Warsh not submitting his “dot plots” for the Summary of Economic Projections. Less explicit forward guidance means markets must infer both the direction and magnitude of policy changes from incoming data.

Whereas under forward guidance, the Fed signaled the direction of policy and markets mainly adjusted the magnitude of expected moves as data evolved. As such, strategic ambiguity will likely result in bigger swings to Fed funds futures especially around policy-relevant data releases.

2. A constructive US macro backdrop. The FOMC statement acknowledged the economy's resilient demand-side backdrop

noting that “economic activity is expanding at a solid pace,” but also emphasized the favorable supply-side condition, highlighting that “productivity growth and capital investment are strong.” That implies the economy can grow faster without generating inflation, reducing the need for restrictive monetary policy over the medium term.

3. The set up of five task forces to re-examine core functions of the central bank. Fed communications, the Fed's balance sheet, the use and reliance on existing data sources, productivity and jobs in an era of transformation, and the Fed's inflation frameworks.

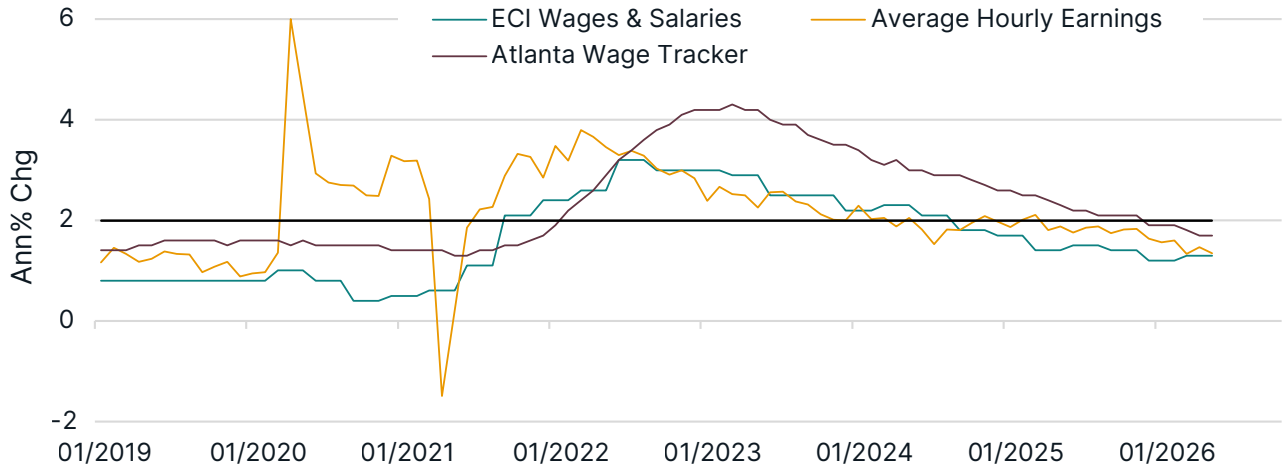
The results of the task forces are expected at the latest by year-end. Given Warsh's view on productivity, inflation, and the Fed's balance sheet, the result could steer the FOMC in a more dovish direction.

Productivity

Warsh expects the productivity boost from artificial intelligence (AI) to justify lower interest rates, noting “AI will be a significant disinflationary force, increasing productivity and bolstering American competitiveness.”¹

During the current business cycle, starting in Q4 2019, labor productivity has grown at an annualized rate of 2.1%. As such, productivity is running strong enough to keep the roughly 4% annual wage growth consistent with the Fed’s 2% target **(Chart 6)**.²

Chart 6: Productivity Adjusted Wage Growth (assumes 2.1% annual productivity growth)



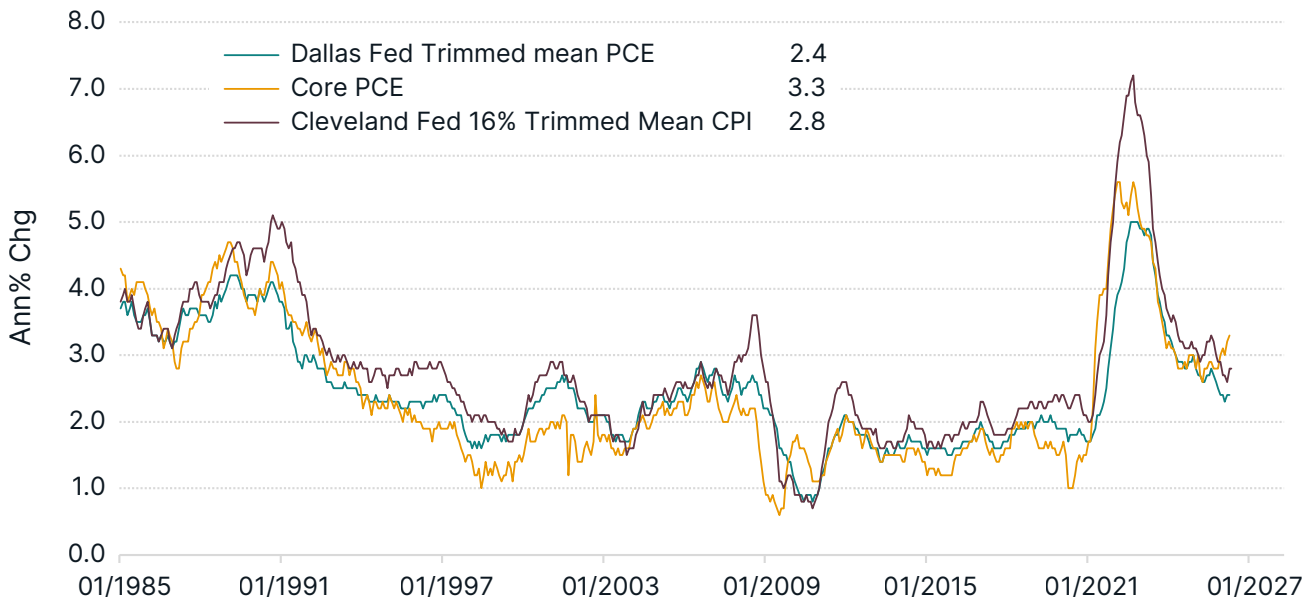
Source: Bloomberg

Inflation

Warsh said he preferred to follow “trimmed averages” inflation as opposed to core price index for personal consumption expenditures (PCE).

The Dallas Fed trimmed mean PCE and the Cleveland Fed 16% trimmed mean CPI are currently below core PCE, implying room for the Fed to loosen policy **(Chart 7)**.

Chart 7: Inflation



Source: Bloomberg

¹WSJ “The Federal Reserve’s Broken Leadership”, November 16, 2025

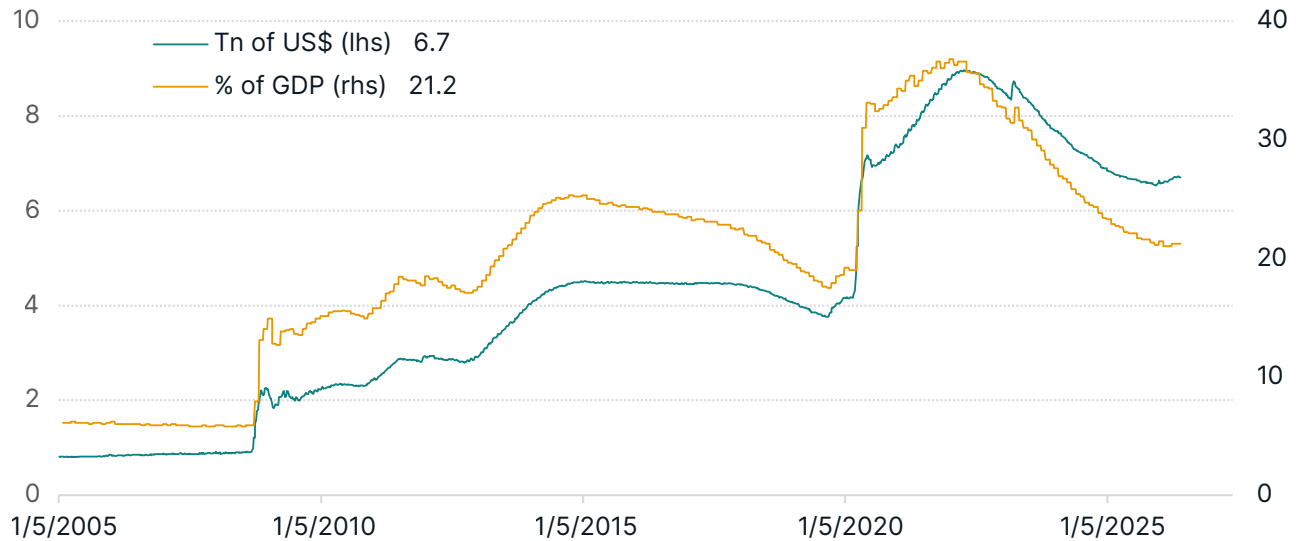
² <https://www.bls.gov/news.release/pdf/prod2.pdf>

Fed balance sheet

Warsh favors slashing the Fed's balance sheet to create scope for rate cuts (**Chart 8**). According to Warsh, "The Fed's bloated balance sheet...can be reduced significantly. That largesse can be redeployed in the form of lower interest rates to

support households and small and medium-size businesses." He has also noted "the interest rate tool gets in the cracks. It's fairer. The balance sheet tool disproportionately helps those with financial assets."³

Chart 8: Fed Balance Sheet



Source: Bloomberg

The constraints

Kevin Warsh faces two major constraints that could disappoint markets expecting a more dovish Fed tilt.

1. FOMC is not a one man show. Warsh cannot simply dictate policy, which is made collectively by 12 voting members; 7 members of the Board of Governors, the president of the New York Fed, and 4 of the remaining 11 regional Fed presidents, who vote on a rotating basis. Non-voting regional Fed presidents still participate in discussions and can also influence the debate.

The risk is if Jerome Powell leaves the Board of Governors before his term ends January 31, 2028. If so, President Trump would have the opportunity to strengthen his influence over the Fed by appointing a new governor more aligned with his unorthodox monetary policy view, like Stephen Miran. That would give Trump appointed governors a 4-3 majority on the seven-member Board (**Chart 9**).

Chart 9: Board of Governors - if Jay Powell resigns

	Term Expires	Appointed by
Kevin Warsh	January 31 2040	Trump
Stephen Miran?	TBD	Trump
Chris Waller	January 31 2030	Trump
Michelle Bowman	January 31 2034	Trump
Philip Jefferson	January 31 2036	Biden
Michael Barr	January 31 2032	Biden
Lisa Cook	January 31 2038	Biden

Source: BBH

³WSJ "The Federal Reserve's Broken Leadership", November 16, 2025

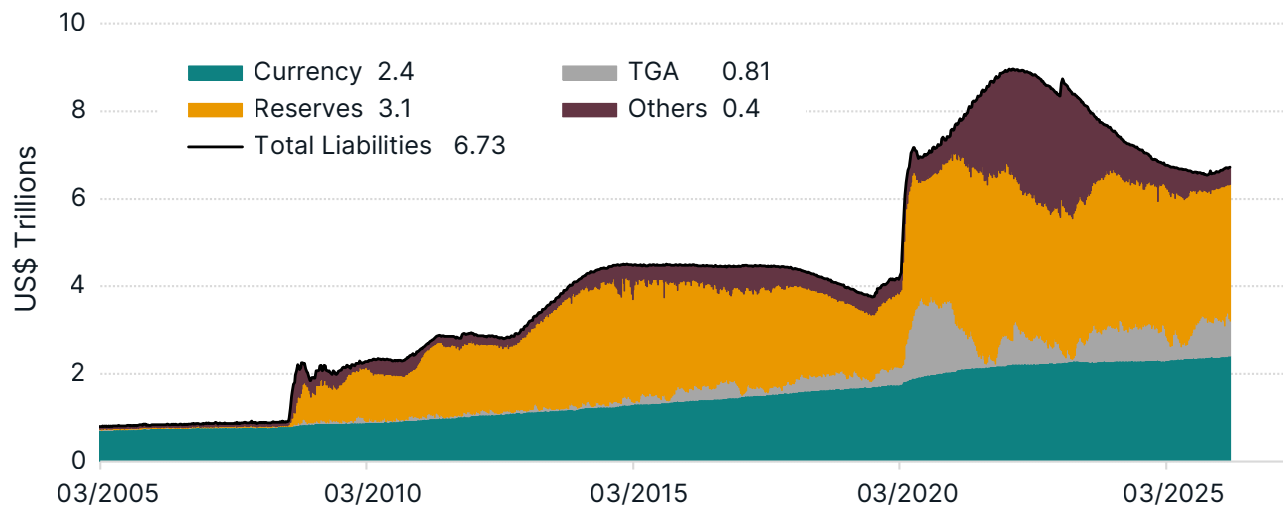
While this would not guarantee a shift in monetary policy, the perception of increased political influence over the Fed could undermine its inflation fighting credibility.

2. Funding market stress risk limits the Fed’s ability to reduce the balance sheet. To shrink the Fed’s balance sheet in a significant way would involve reducing reserve demand. Reserves are the funds that depository institutions hold in accounts at the Fed.

They are the safest and most liquid asset in the financial system and give banks greater scope to settle payments in an orderly way.

Reserve balances make up the bulk of the Fed’s liabilities and are directly controlled by the Fed (**Chart 10**). By contrast, the other two big liabilities on the balance sheet, currency outstanding and the Treasury General Account (TGA), are outside the Fed’s control.

Chart 10: Fed Balance Sheet Liabilities



Source: Federal Reserve

Reserves currently represent \$3.1 trillion of the Fed’s \$6.7 trillion in liabilities (about 10% of GDP). Before the 2008 global financial crisis, reserves totaled just \$17 billion of the Fed’s \$890 billion in liabilities. The surge in reserves reflects the Fed’s large scale asset purchases (quantitative easing), the Fed’s shift from a scarce to an ample reserve system to control short-term interest rates, and tighter bank liquidity regulations.

Reserve balances are comfortably above levels the Fed judges consistent with adequate reserves, estimated to be around 9% of GDP or \$2.7 trillion. The risk of operating at lower levels of reserves is that liquidity conditions can tighten abruptly as banks become less

willing to lend reserves into funding markets to preserve liquidity buffers. That raises the risk of spikes to short-term market rates and heightened volatility, as seen during the September 2019 repurchase agreement (repo) crisis when reserves fell below 7% of GDP.

Bottom line

The FOMC consensus driven structure and reserve-scarcity risks constrain the scope for a straightforward dovish regime shift under Warsh. In parallel, the retreat from forward guidance is likely to produce larger volatility in rates, the dollar and risk assets as markets recalibrate after each major data release.

Winds of change buffet the Indian FX market

Insights from Shannon Horrigan

While India strives for developed market status, its foreign exchange (FX) market faces challenging dynamics.

India remains the world's fastest growing major economy, although currency fluctuations recently caused its nominal GDP ranking to slip from fifth to sixth place globally.

The country is seeking developed market status in 2047, a year that also marks 100 years of independence for India. Yet despite decades of robust economic expansion, the Indian Rupee (INR) has faced significant pressure. Since 2000, the rupee has depreciated considerably, driven by structural factors, such as high inflation differentials relative to the United States, persistent trade deficits, and evolving global geoeconomic conditions.

Recently, the currency hit record lows against the US Dollar – performing notably worse than its regional peers – following the outbreak of the war in Iran at the end of February 2026. Many countries were affected by the global conflict, but India faces an acute disadvantage due to its heavy energy reliance on the Middle East and the vulnerability of the critical shipping route through the Strait of Hormuz. India also faces persistent foreign investor outflows from the Indian equity market, exacerbating the depreciation of its currency.

RBI intervenes to curb volatility

To reduce volatility and crack down on speculation against the rupee, the Reserve Bank of India (RBI) issued several circulars in March and April 2026 to tighten restrictions on the foreign exchange market, though several of the restrictions were later rolled back.

- **March 27, 2026:** The RBI issued a circular capping the Net Open Position that Authorized Dealers (ADs) could hold in the onshore deliverable market at \$100 million, with a compliance deadline of April 10, 2026.
- **April 1, 2026:** The RBI issued further restrictions on ADs, prohibiting them from offering non-deliverable forward (NDF) contracts to investors. ADs could still offer deliverable forwards, but the directive prohibited doing so if the client was offsetting transactions with an NDF.

Additionally, ADs were barred from rebooking canceled foreign exchange derivative contracts and undertaking derivative contracts involving INR with related parties.

- **April 20, 2026:** The RBI partially rolled back the April 1 restrictions, allowing the rebooking of canceled forward contracts and removing the ban on offering NDFs to clients. However, the restriction on undertaking foreign exchange derivative contracts involving INR with related parties remained in place, except for cases involving the cancellation and rollover of existing contracts or for transactions with non-related non-residents on a back-to-back basis.

These measures helped stabilize the currency in the short term, but the rupee has continued to depreciate. In May 2026, the exchange rate crossed 95-96 INR per USD.

Structural 'reforms' in capital markets

While the RBI has been concerned with stabilizing the rupee by introducing measures to tighten restrictions in the FX market, the Securities and Exchange Board of India (SEBI) remains aggressive in announcing reforms to ease access and enhance efficiency for foreign investors in capital markets to attract greater foreign investment into the country.

In October 2024, SEBI announced initiatives to make sale proceeds available to Foreign Portfolio Investors (FPIs) to repatriate on equity settlement date (i.e., T+1). Historically, FPIs could not repatriate their sale proceeds until at least one business day after the settlement date, primarily due to the time required to obtain tax clearance.

To address this, SEBI introduced a mechanism for local custodians and tax agents to expedite the tax process, with a key element of this mechanism the mandate for tax agents to issue tax certificates by 9am IST on equity settlement date. While the tax clearance process has improved since this initiative began, there is still not a widespread market solution for repatriation on settlement date. Consequently, the majority of FPIs continue to face repatriation on SD+1 at the earliest.

In April 2026, SEBI announced a new framework permitting net cash settlement for FPIs, which is scheduled to take effect December 31, 2026.

Currently, FPIs must fund security purchases on a gross basis, preventing them from offsetting purchases with same-day sale proceeds. The new framework will allow FPIs to net 'outright transactions,' defined as the purchase and sale of different securities on the same date and account. While this should appeal to FPIs, it remains to be seen how the market will implement this initiative.

Some market participants worry that SEBI is overcomplicating these policies, which tend to render them ineffective in practice. Market participants are hopeful that net cash settlement will have tangible benefits, but the stalled progress of the same-day repatriation initiative has left many skeptical.

Looking ahead

While there is much to be excited about in India – including its large, fast-growing economy and loosening restrictions on proceed availability on settlement date – there are also growing concerns over rapid currency depreciation and central bank intervention.

The government's plan to transform the country into a developed high-income economy by 2047 still seems a long way off. That said, India has proved itself to be a global player in the past several decades. The recent announcements by SEBI may indeed pave the way for a more efficient market that will further attract foreign investors, but for now, India continues to be one of the most restrictive markets for foreign investors.

Indian rupee: under pressure but undervalued

The Indian rupee's slump looks excessive relative to India's economic fundamentals.

Insights from Elias Haddad with special contribution from Priya Sharma

The Indian rupee (INR) has underperformed most currencies since 2025, though the drivers have changed.

- In 2025, weakness largely reflected the US-India trade dispute which was ultimately resolved in February this year.
- In 2026, INR underperformance has been driven primarily by a negative terms-of-trade shock from higher energy prices as India imports roughly 85% of its crude oil consumption.

The Reserve Bank of India (RBI) has intervened repeatedly in the FX market to smooth INR volatility and lean against excessive weakness. The RBI also introduced temporary FX curbs on April 1 to limit speculative selling pressure on the rupee. Nonetheless, the USD/INR reached a record high of 96.9650 on May 20.

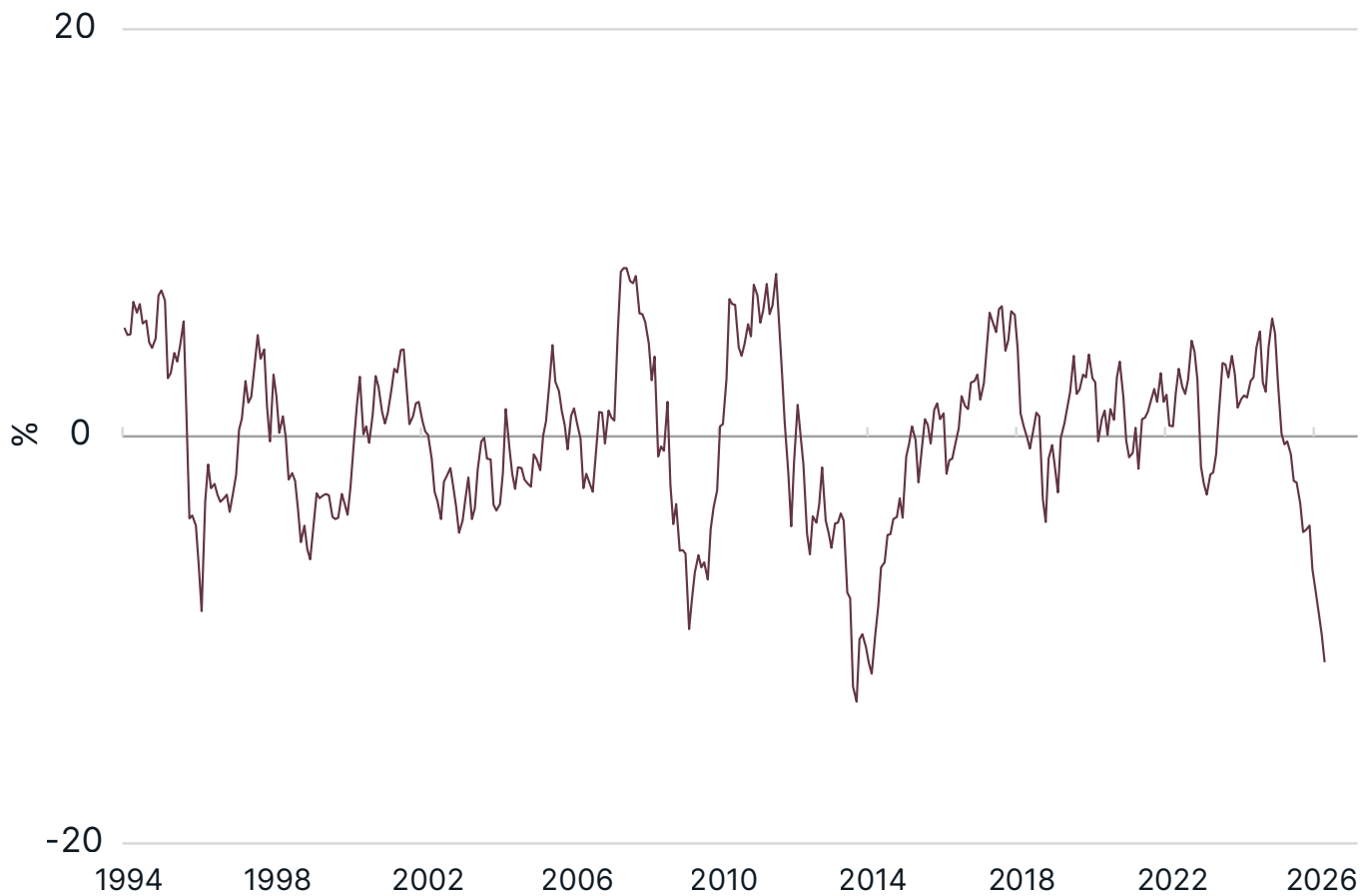
More recently, on June 5, the **RBI** alongside the **government** rolled out measures to strengthen India's balance of payments by attracting more capital flows. INR rallied broadly on the news but has since erased all its gains.

In our view, INR will likely remain under pressure until the energy shock fades and Fed rate hike expectations peak. Nevertheless, the slump in INR appears excessive relative to economic fundamentals suggesting the risk-reward from shorting INR may be less compelling.

- India's growth-inflation mix underscores the RBI's neutral stance. In Q1 real GDP growth of 7.8% y/y tracked above the RBI's 6.6% projection and headline inflation is running below the RBI's Q2 projection of 5.1% y/y.
- India's current account deficit is negligible at only -0.6% of GDP in Q1, and FX reserves are plentiful totaling over \$680 billion in May (17.4% of GDP). This is equivalent to 11 months of imports and 89.1% of external debt.

- INR is significantly undervalued. The rupee is -11% undervalued relative to its real effective exchange rate trend, the most since 2014 (**chart 1**). A cheap INR provides a buffer to India's external accounts by supporting exports and curbing imports.

Chart 1: INR Real Effective Exchange Rate* Deviation from Trend



*Source: Bank for International Settlements

EMERGING MARKETS IN THE NEWS

Taiwan balances foreign inflows and FX stability

Insights from Derrick Leonard

As tech investment surges, policymakers intervene to manage currency volatility and economic spillovers.



Taiwan has seen significant recent inflows from foreign investors related to AI related investment, and, as in South Korea, the local FX market seems to be moving in opposite direction to the explosive growth of the equity market. A lot of ink has been spilled to explain the disconnect in South Korea, but what is Taiwan doing to manage these huge inflows?

Back in 2022, the Taiwanese Stock Exchange (TAIEX) total return fell by 19%, while the Taiwan dollar (TWD) weakened from around 27.70 to around 30.73 versus US\$ (USD). The TAIEX began its recovery in November 2022 and has been on quite a roll since then, delivering annual gains of more than 30% and year-to-date returns approaching 50% in 2026. The TWD rate, however, continued to weaken through 2023 and into late April 2025, breaching the 33 level. While the rate has since settled in the 31–32 range, it remains disconnected from the dramatic equity market gains over the same period.

AI-related industries, particularly Taiwan Semiconductor Manufacturing Corp (TSMC), have driven the lion's share of TAIEX gains. However, the concentrated nature of foreign investment inflows has created a challenge for the Central Bank of China – Taipei (CBC) in managing the broader economy. While the tech sector is thriving, the rest of the economy has not meaningfully benefited from the foreign capital coming in. The CBC is concerned about inflation and has taken deliberate steps to address these perceived economic imbalances through active management of the exchange rate.

Managing currency stability

As foreign capital has flooded into the tech sector, the CBC has worked to prevent excessive TWD appreciation so that the broader, export-oriented economy is not disadvantaged. A stronger TWD makes Taiwan's exports less competitive in global markets, and the CBC has a longstanding interest in keeping prices stable and the exchange rate predictable. While the CBC has broadly kept the TWD within a band over recent years, periodic bouts of volatility have proven harder to smooth out.

So, what steps has CBC taken to maintain currency stability? In May 2025, a sharp TWD appreciation followed US tariff announcements, as many Taiwanese companies repatriated USD back into TWD. In response, the CBC appeared to become notably more active in the FX market, purchasing foreign currency to manage the rate and offset USD inflows from foreign investors. Many in the market suspected the CBC of using late afternoon intervention to pare back morning currency gains. The CBC was also observed stepping in during periods of excessive weakening, working to keep the exchange rate consistent from day to day.

Beyond direct market intervention, the CBC also used informal communication channels to manage market behavior.

- **May 2025:** The CBC quietly reminded all investors that TWD FX activity should be tied to local investment, addressing rumors of speculation without changing official guidance.
- **September 2025:** The CBC went further, advising investors to avoid holding TWD balances of roughly TWD 100 million or more for longer than a day without either deploying or selling the position. This came in response to large dividend payments to foreign investors, with the central bank keen to see those funds repatriated while also maintaining downward pressure on the exchange rate.
- **January 2026:** The CBC outlined its preferred schedule for investor funding and repatriation, with the goal of keeping FX flows as orderly as possible and minimizing market volatility.

The tension in Taiwan's market is not going away anytime soon. The equity market continues to attract significant foreign investment concentrated in tech, while the FX market lags and has generally trended weaker over recent years. Policymakers are clearly trying to balance the benefits of strong sectoral investment against broader economic spillovers. Many market participants expect some TWD appreciation later in the year and beyond, but the CBC has made it clear that they will be the ones setting the pace.

At BBH, we are closely monitoring developments in Taiwan and will continue working closely with our clients to help them understand and navigate the evolving regulatory landscape.

EMERGING MARKETS IN THE NEWS

Which way next for Indonesia?

Insights from Dara O'Sullivan

Market upheaval and the threat of investment reclassification have sent shockwaves through the Indonesian economy. Now, with further change looming, can policymakers get the market back on track?

In January this year, Global index provider, MSCI, issued a stark warning that Indonesia faces a reclassification from Emerging Market to Frontier status unless several improvements in market integrity and investability are met.

MSCI also froze rebalancing of Indonesia's index, meaning it will not be adding new securities, removing old ones or adjusting weights in the market until reaching its decision on the classification.

While this has created a lot of uncertainty it has been a long time coming, as the market has slowly backslid on several market reforms. Indonesia continues to face some key challenges in the second quarter of 2026, as it tries to maintain its existing market classification and avoid a potential mass exit of foreign investment.

MSCI has voiced concerns about opaque ownership structures in the market, tightly controlled shares among a small group of insiders, and suspected distortions in trading behavior among some high-profile Indonesian stocks.

It's reported a number of these listed companies have a very low 'free float', suggesting they are tightly controlled by founders, families, or the state and have very few shares available for actual public trading.

There are also concerns about liquidity and reliability of data for the same companies, a problem of transparency that has also plagued the Indonesian FX market for years. This creates an impression among foreign investors that they may not be able to buy and sell shares easily, fairly, and transparently.

Regulatory change

Following the MSCI announcement in January, several top Indonesian regulators resigned. Authorities appeared to immediately switch into damage control mode and promised major financial reform to stave off a downgrade from Emerging Market to Frontier status.

The threat of reclassification created immediate volatility across the equity market in Jakarta, with some major capital outflows.

Indonesia shaken, but it's no 1997-1998 replay

Indonesia's markets have been volatile, but underlying fundamentals remain relatively resilient.

Insights from Elias Haddad

Indonesia's financial market has taken a sharp hit this year. The Jakarta Composite Index has fallen by nearly 40% year to date, the world's worst performance globally, while the rupiah has depreciated by more than 8% against the US dollar. The turbulence began on January 27 after MSCI flagged "fundamental investability issues" in the Indonesia Stock Exchange's data feed of publicly traded shares, adding the country could be downgraded from Emerging to Frontier Market status. This triggered the worst two-day rout in the Jakarta Composite Index since the 1998 Asian Financial Crisis.

The situation worsened following a cautious shift from debt rating agencies. On February 5, Moody's Ratings downgraded Indonesia's long-term foreign debt rating outlook from stable to negative, citing "reduced predictability in policymaking." Fitch Ratings did the same on March 4. S&P Global Ratings maintained its stable outlook but, on May 21, warned that execution risks tied to the government's move to centralize the export of key commodities could weigh on credit metrics.

Bank Indonesia under pressure

In parallel, the independence of Bank Indonesia (BI) is increasingly under scrutiny. Its mandate has been broadened to support growth, raising concerns about fiscal dominance.

It is estimated roughly \$120bn in market value was erased after MSCI's January warning as foreign investors became more cautious towards Indonesian assets. The rupiah hit near record lows, falling by 7% versus the dollar. It is estimated foreign investors have sold around \$2.2bn this year since the MSCI announcement in January.

To address the MSCI concerns, regulators were quick to implement sweeping reforms including:

- Stricter enforcement of "ultimate beneficial ownership", requiring shareholders to report ownership above 1% versus the previous 5% threshold
- Pushing for 15% minimum public ownership of companies to facilitate market driven valuations and mitigate insider manipulation
- Replacing key leaders including heads of the Financial Services Authority (OJK) and Indonesia Stock Exchange (IDX)

Despite the changes, MSCI cut six companies from its Indonesian index in May, criticizing them for a lack of transparency. Two of the six had already been flagged by Indonesian authorities for having concentrated ownership.

In June, index provider, FTSE Russell removed Indonesian shares with high shareholding concentration. In early June the Indonesian parliament also passed legislation significantly altering the mandate and governance of Bank Indonesia. While the changes were intended to empower the central bank to address market issues, there are concerns its independence could now be compromised.

The reclassification decision, expected in June this year, has now been postponed until November. The MSCI advised the postponement allows more time to see if the recent reforms implemented by local authorities are effective and sustainable. The delay in the decision, however, leaves investors feeling even more jittery.

A downgrade could likely trigger forced selling for funds benchmarked to key Emerging Market indices. The market faces potential large investment outflows and a continued lack of investor confidence that could be difficult to overcome for years.

At BBH, we are closely monitoring the developments in Indonesia and will work closely with our clients on an ongoing basis to help them navigate these challenges.

Parliamentary oversight has expanded, and the appointment of President Prabowo's nephew to the BI's board has heightened perceptions of political influence.

External shocks have compounded domestic pressures. Disruptions linked to the Strait of Hormuz have pushed oil prices higher. Indonesia is a net crude oil importer with around 25% of its oil imports passing through the Strait. As such, higher crude oil prices represent a negative terms-of-trade shock for Indonesia, that is an increase in the outflow of income to overseas economies, which weighs on both the rupiah and domestic equities.

Nonetheless, Indonesia is not at this point in a 1997-1998 style crisis, when the rupiah collapsed by roughly 80% against the US dollar at its worst point.

- **The growth-inflation mix is supportive.** Real GDP grew 5.6% y/y in Q1 2026, the fastest pace since Q3 2022, while inflation remains within BI's 1.5%-3.5% target range. By contrast, the economy was overheating in 1997, with growth near 8% and inflation in high single digits.
- **The current account deficit is negligible.** In Q1 2026, the current account deficit was just 0.4% of GDP and more than offset by net foreign direct investment inflows of around 1% of GDP. Ahead of the 1997-1998 crisis, the current account deficit averaged about -3% of GDP while net foreign direct investment inflows averaged +2% of GDP.

- **External debt is manageable.** External debt stands near 30% of GDP, versus almost 70% of GDP ahead of the 1997-1998 crisis.
- **Fiscal backdrop is not alarming.** Indonesia can sustain primary budget deficits without putting its debt ratio on an upward trajectory because nominal GDP growth (9% y/y in Q1 2026) exceeds borrowing costs (10-year government bond yields around 7.24%). Indeed, the International Monetary Fund (IMF) projects gross debt of about 42% of GDP throughout the next five years to 2031.
- **Foreign exchange (FX) reserves are ample.** Reserves totaled \$127 billion in March 2026 (8.7% of GDP), equivalent to 5.2 months of imports, above the international adequacy standard (3 months). Ahead of the 1997-1998 crisis, FX reserves totaled roughly \$20 billion.

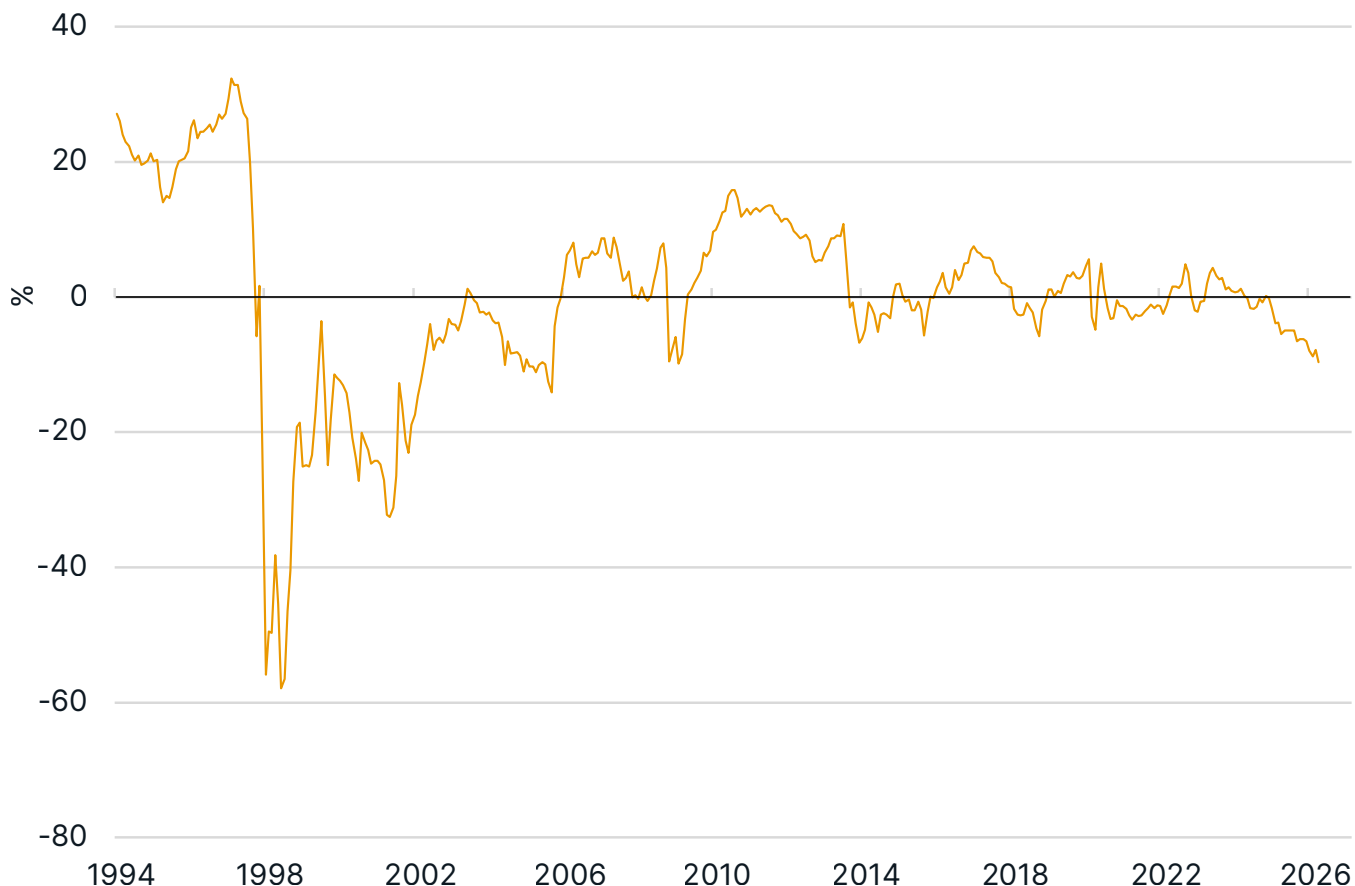
While not materially different from today, relative to GDP and import coverage, Indonesia now operates under a flexible exchange-rate, reducing the risk of a reserve depletion spiral.

- **IDR is significantly undervalued.** The rupiah is -10% undervalued relative to its real effective exchange rate trend, the most since 2009 (**chart 1**). A cheap IDR provides a buffer to Indonesia’s external accounts by supporting exports and curbing imports. By comparison, the rupiah was overvalued by a record 32% in early 1997.

Bottom line

USD/IDR overshoot looks excessive relative to domestic fundamentals. But until the energy shock fades, IDR will remain under downside pressure.

Chart 1: IDR Real Effective Exchange Rate* Deviation from Trend



*Source: Bank for International Settlements

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