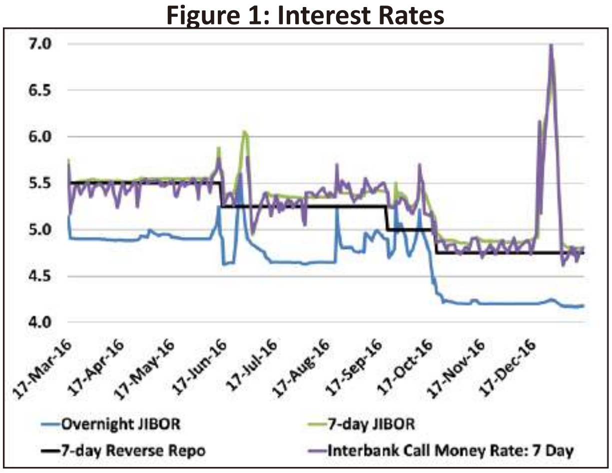
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
JANUARY 2017

Highlights

- BI still needs to hold the benchmark rate at 4.75%
- Efforts to spur economic growth and inflation are still slowed down by external risks
- Fed and US fiscal policies may spur capital outflow, geopolitical tail risks to remain real source of concern.

Despite annual inflation at its lowest level since 2010, at 3.02% (y.o.y) in 2016, and the need to drive economic growth, we still believe that BI needs to maintain the benchmark rate at 4.75% (y.o.y) in its first meeting in 2017. As the Fed decided to increase The Fed Funds Rate target (FFR) by 25 basis point to 0.50% - 0.75% and signaled the possibility to raise rate up to three times in 2017, along with increased geopolitical risks from the incoming Trump administration and moderate inflationary risks, we do not see much room for Bank Indonesia to take risks by reducing rate this month.

Figure 1: Interest Rates



Source: CEIC

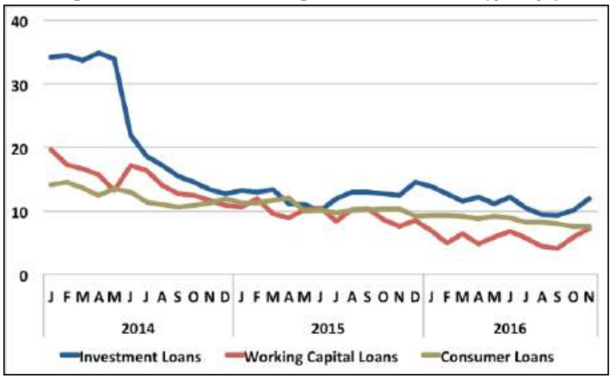
Receding Concern on Low Inflation

Even after cutting the benchmark rate by 150 bps in 2016, the annual loan growth still has not surpassed two-digit level as banks are still wary of increases in non-performing loan, thus maintaining high lending rate.

Continuing the positive trend from last month, the annual loan growth was reported at 8.5% in November 2016. This, however, is still lower compared to the same period last year (+9.6% y.o.y.). As loan growth tends to lag the economic growth by several months, to reach 9% annual loan growth is by economic growth needs to at least be more than 5.1% (y.o.y.) in order for loan growth to reach 9%.

The highest growth was reported by investment loans (+11.9% y.o.y.) while working capital loans and consumer loans lag the increase by (+7.2% and +7.5% y.o.y., respectively). This indicates that business investments are still to be the growth driver in 2017, as consumer demand remains soft.

Figure 2: Outstanding Loan Growth (y.o.y.)



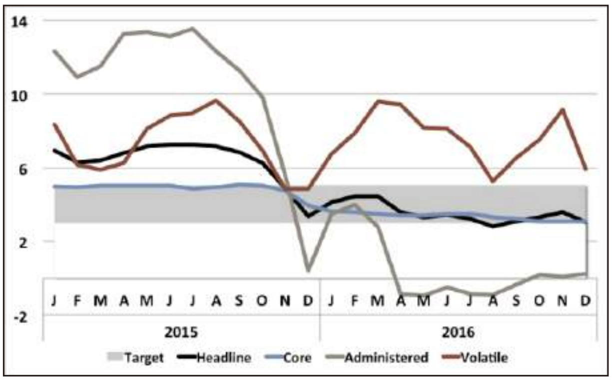
Source: CEIC

Supply-side shocks, however, will become key upside risks for inflation in 2017. While full-year inflation in 2016 reached 3.02%, we expect inflation to nudge higher to within 4%-5% range.

Apart from relatively weak demand, low annual inflation rate in 2016 was also due to low administered inflation at 0.21% (y.o.y), caused by low global oil price which translated into low fuel and electricity prices throughout 2016. In addition, the government was relatively successful in maintaining food supply throughout the year, evident in moderate inflation during Lebaran and Christmas period.

This year, however, is likely to be different. Combination of climate-change-related extreme weathers, which affects food prices, and expectation on revision in fuel and electricity prices, given the marked increase in oil and coal prices, push the inflation risk upward, which gives more reason for BI to keep the benchmark rate unchanged.

Figure 3: Inflation Rate (y.o.y.)



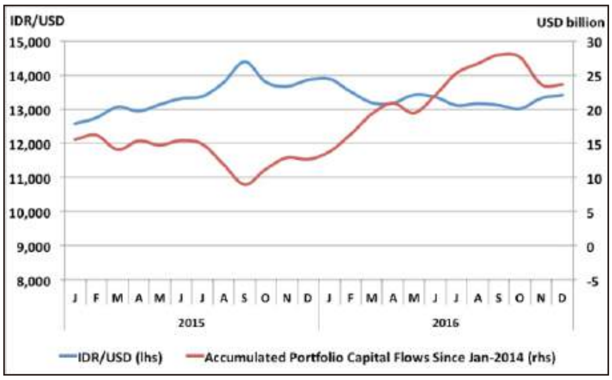
Source: CEIC

External risks

As was the case throughout 2016, we expect external risks to still be the key factor that limits the room for Bank Indonesia to conduct policy easing. Monetary easing would have been warranted if the capital flow and exchange rate are stable, which may very well not be the case in 2017. In the following months, BI has limited room to continue monetary easing, as Indonesian financial market is highly sensitive to global shocks.

We identified several factors to be the key determinant to capital outflow, which includes but are not limited to rate increase by the Fed, US fiscal policies under Trump administration, and geopolitical tail risks that should not be entirely dismissed. Combination of expected U.S. Republican-led tax cut and major infrastructure plans under Trump will be translated into higher fiscal deficit, which the Fed may expect to overheat the U.S. economy and become the reason to increase FFR several times in 2017. Capital inflow to US will cause real exchange rate depreciation for other currencies, including Rupiah.

Figure 4: IDR/USD and Accumulated Short Term Capital Flow



Source: CEIC

Another source of concern that should be taken seriously is global geopolitical tail risks. Although confusion surrounding Brexit and populists surge in 2017 European elections may also scare the global financial markets, we view President Trump as the single biggest risk to global economy in 2017. His threats of high import tariffs and protectionist promises is just as unlikely as his election in 2016.

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