# BI Board of Governor Meeting

February 2018

## Highlights

- Bank Indonesia should maintain its policy rate despite external pressure on Rupiah
- January y.o.y core inflation further highlight still-weak demand
- The Fed may increase rate more than expected this year due to stronger economic data

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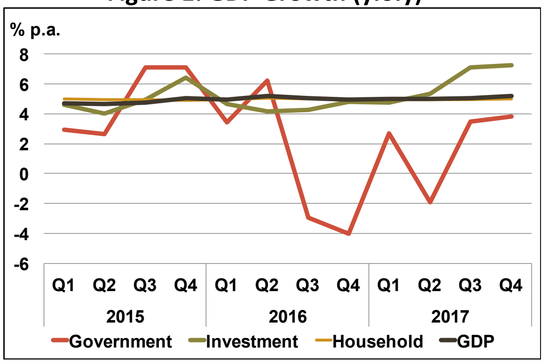
Better-than-expected US employment figures and strong GDP growth have raised concern among market participants of faster pace of interest rate hike in the US in 2018, which led to portfolio capital outflow from emerging market and riskier assets in the last month. As US labor market will remain tight, which pushes wage and inflation higher, we expect downward pressure on Rupiah to continue in the next few months. Bank Indonesia, on the other hand, still faces weak domestic demand, as evidenced by below-5% consumption growth in Q4 2017 and record-low core inflation. Given the prospect of stubbornly low core inflation for the rest of 2018, Bank Indonesia may want to hold its policy rate for now, even in the face of increasing external pressure to increase interest rate.

### Increasing Prospect of Below-3% Inflation

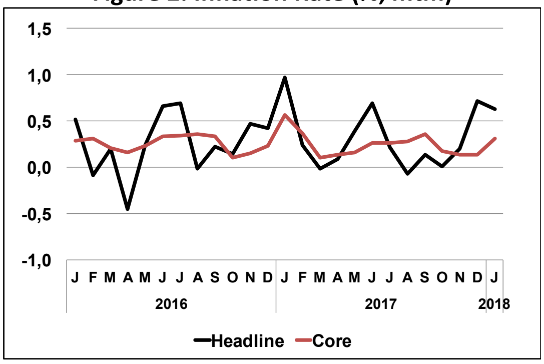
January inflation somewhat reinforced the notion that domestic demand is still soft, even after interest rate has gone down considerably. On month-to-month basis, headline and core inflation are 0.62% and 0.31%, slightly lower than January inflation in previous years. Similar trend is shown when we look at inflation on year-on-year basis, with headline inflation and core inflation at 3.25% and 2,69%. Items like foods and fuel were significant contributing factor for inflation, owing to combination of flooding and increase in international fuel prices. However, core inflation made it painfully clear that underlying domestic demand, in particular household's expenditure, is still weak.

**Figure 1: GDP Growth (y.o.y)**




Source: CEIC

**Figure 2: Inflation Rate (%, mtm)**




Source: CEIC

Household demand apparently has not responded to rate cuts and improvement in exports and investments, while real investments accelerated further to 7.27% y.o.y in Q4 2017. Disconnect between investment and consumption may be caused by high hiring costs for formal workers and/or the fact that the most recent investments are more capital-intensive. Labor market may not experience sufficient tightening to drive up wages and spur consumption. Businesses may also be reluctant to raise wage as they remain cautious of future growth prospect and tend to limit wage increase and reduce risk of being burdened by high wage bill should corporate profitability decreases.

Strong global economic growth globally also poses upward risk to BI's 2018 inflation target through increase in commodity prices, although the risk of inflation above 4.5% (upper limit of 2018 target) is still very low. With crude oil crossing $70/barrel level recently, which is also highly correlated with increase in gas and coal prices, there is more pressure to cut subsidies to contain budget deficit. With more risk of higher commodity prices, particularly those that are energy-related, inflation may increase slightly higher later in 2018, especially if government

## Key Figures

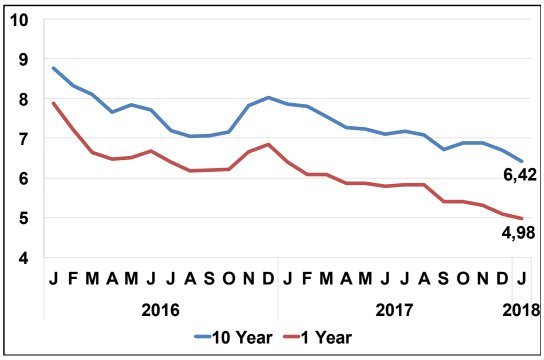
- BI Repo Rate (7-day, Jan '18)
  **4.25%**
- GDP Growth (y.o.y, FY 2017)
  **5.07%**
- GDP Growth (y.o.y, Q4 '17)
  **5.19%**
- Inflation (y.o.y, Jan '18)
  **3.25%**
- Core Inflation (y.o.y, Jan '18)
  **2.69 %**
- Inflation (mtm, Jan '18)
  **0.62%**
- Core Inflation (mtm, Jan '18)
  **0.31%**
- FX Reserve (Jan '18)
  **$131.98 billion**

eventually cut subsidies and further raise prices on key administered prices (e.g. unsubsidized gasoline and unsubsidized electricity prices). Overall domestic condition therefore necessitates BI to maintain status quo for now and keep policy rate as it is.

**Increased External Pressure to Raise Rate**

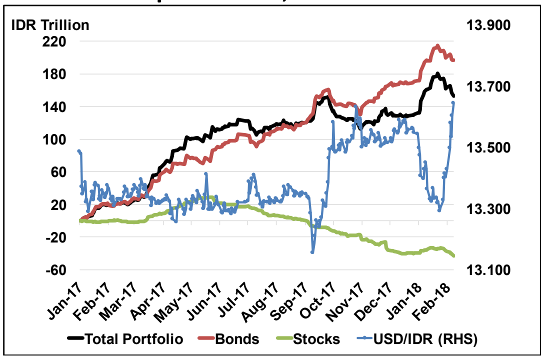
Relatively stable exchange rate at around 13,500±100 from October 2017 to early January 2018 was apparently succeeded by sudden and significant jump in volatility for the past month. While in the first three weeks of January we saw capital inflow to Indonesian securities of more than Rp40 trillion, the release of US economic data in late January and early February has sparked worldwide sell-off and push USD/IDR rate to more than 13,600. It should be noted that this episode of massive global rout is not caused by weakness in US economic condition, but rather the opposite; global market reacted negatively precisely because US economic condition is now deemed healthier and more robust. US economic grew by 2.6% in Q4 2017, while official unemployment figure currently stands at 4.1%, a 17-year low, and private sector workers' hourly earnings rose by 2.9% (y.o.y) in January, highest since 2009.

**Figure 3: Government Bonds Yield (% pa)**




Source: CEIC

**Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow, since Jan-17**




Source: CEIC

Large market sell-off following what was supposedly a positive development in United States can be attributed to market expectation of policy rate direction of Federal Reserves. As things currently stand, market participants currently expect 76% probability (as measured by price of 30-day Fed Fund futures) of 25 bps rate hike in March meeting, up from 50% probability at the end of 2017. With increasing probability of more rate hikes in 2018, market participants expect yield in US and other major economies to rise faster than expected, which negatively affect most asset prices. This in turn reduces the appeal of riskier assets, including equities and emerging market assets, thus explaining capital outflow that happened in the last two to three weeks.

While faster Fed rate hikes (we currently expect 2-3 Fed rate hikes for 2018) may induce another round of capital outflow, current domestic economic fundamental is still robust enough to withstand pressure on Rupiah, thanks to record-high foreign reserves ($131.98 billion by the end of January) and the fact that 90% of private companies have hedged their external debts. Bank Indonesia therefore may afford to hold policy rate at current level in order to push inflation higher, pending significant changes to domestic inflation and external pressure from Federal Reserves.