LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
JANUARY 2016: *New Year, New Uncertainties*

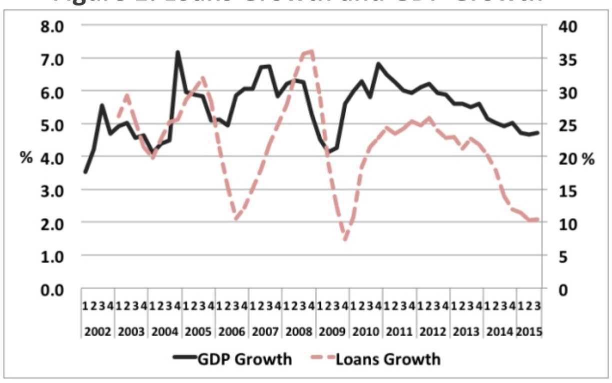
Highlight

If recent developments in the global market are any indication, Bank Indonesia is set to face yet another challenging year ahead. Current liquidity in the banking system does not necessitate a change in the policy rates while the demand for loans is still dimmed. BI should maintain its policy rates in the upcoming meeting and continue its focus on balancing between exchange rate stability and current account deficit.

Domestic Market: Sluggish, but Stabilizing

As Bank Indonesia continues its tight-bias policy, domestic banking system has recently found itself in a position where lending opportunities become scarcer. Still dimmed growth outlook discourages corporate and retail customers from taking new loan. This is evident in the significant decline of growth of loan originations in recent years and corporate action plans by large banks to acquire smaller banks, which indicate limited room for organic growth.

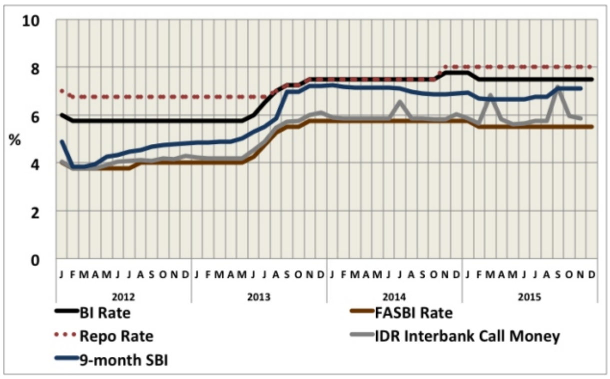
Figure 1: Loans Growth and GDP Growth



Source: Bank Indonesia

Slower loan growth also eases the demand for third-party funds and drive down the saving interest rate, as evident by the decline in time deposit rates.

Figure 2: Interest Rates

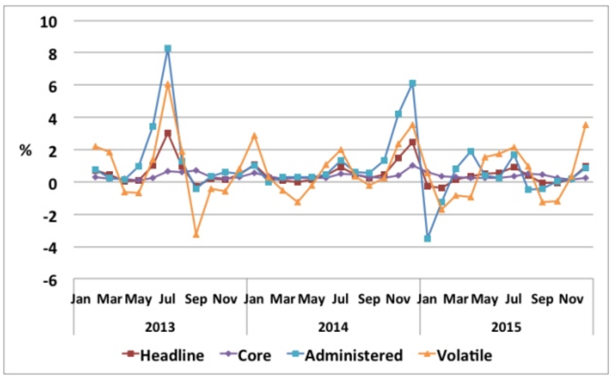


Source: Bank Indonesia

Lurking External Risks

While tight-bias policy served BI well in both achieving 2015 inflation target and staving off capital outflow, continuing such policy may pose a new risk of economic stagnation for the medium-term. Even with the talks of higher growth for 2016, persistent oil supply glut and depressed commodity prices alone are enough to keep prices down, as demonstrated by 3.3% inflation rate last year, despite the temporary meat shortage and reduced agricultural yield due to El Niño.

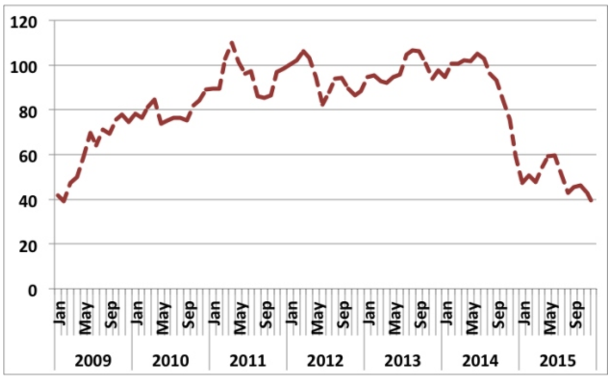
Figure 3: Inflation (m-to-m)



Source: CEIC

China will continue to be the source of downside risks to commodity prices and global financial market risks this year. With worsening growth outlook, demand growth may not be enough to absorb the increase in supply, particularly for oil, which continues as OPEC effectively abandoned its self-imposed quota. Budget deficit and economic recession in oil exporter countries would incentivize even more production to recoup lost revenue; this will further depress the price.

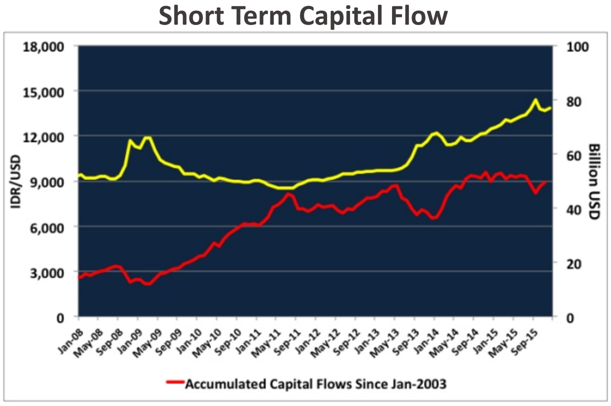
Figure 4: Crude Oil Price, WTI



Source: World Bank

Fed's move to increase interest rate help to restore some certainty in global market and spur capital inflow back to emerging markets, including Indonesia. Even so, the inflow is still sensitive to the pace of further rate increase and negative global sentiments. Hasty rate increase by the Fed may disrupt the pace of economic recovery and introduce additional risks to a market that is already saturated with uncertainties

Figure 5: IDR/USD and Accumulated Short Term Capital Flow



Source: World Bank

On the other hand, increasing uncertainties as the result of deteriorating market confidence in Chinese capital market and Chinese regulator effectively restrict the ability of Bank Indonesia to ease monetary policy. Massive correction of regional markets and flight to safety following the chaos in Shanghai bourse should serve as cautionary tale of potential short term capital outflow that may occur if Chinese economy continues to deteriorate.

As current account deficit continues to linger and foreign reserves continues to shrink, Bank Indonesia is not in the position to stand unnecessary capital outflow and ensuing Rupiah depreciation in order to prematurely ease monetary policy. We expect BI to maintain its tight bias in the near-and medium-term until global market condition stabilizes, even if it has to compromise with its own inflation target or government's growth target.

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