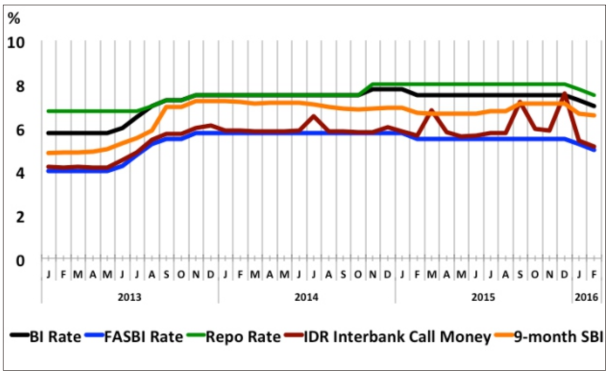
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
MARCH 2016

Highlight

We expect Bank Indonesia to maintain its policy rates in its meeting this Thursday. This is attributable to the possibility of the Federal Reserve to hike its target rates sooner than expected, which will put pressure on Rupiah. Higher than expected inflation in 2016 will also confirm that it is not the time for BI to ease monetary policy further.

Figure 1: Interest Rates



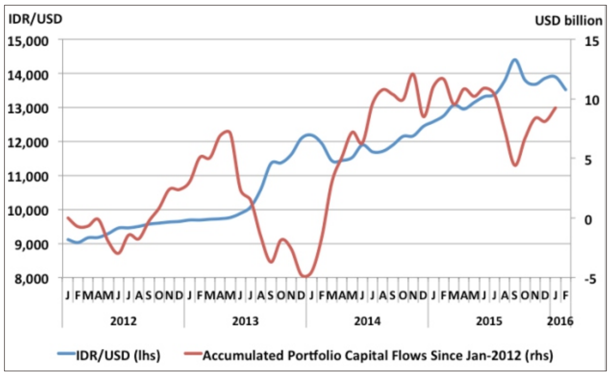
Source: Bank Indonesia

Accelerating Growth

As series of policy packages by the government start to affect the broader economy, we expect the economic growth to accelerate in Q1 2016 to 5.2% (y.o.y). Acceleration of economic growth is also supported by inherently strong fundamentals, particularly domestic consumption, which insulates Indonesia from further deceleration of global economic growth and market turbulence. More pro-reform stances and policies at home and slow growth abroad have induced capital inflow for both direct and portfolio investments and caused Rupiah to appreciate.

While strong appreciation of Rupiah helps reducing the possibility of rising inflationary concern due to increased economic activities, Bank Indonesia may be inclined to keep Rupiah from appreciating further in short term, given the experience of structural decline in export competitiveness following the episode of strong Rupiah appreciation from 2009-2011.

Figure 2: IDR/USD and Accumulated Short Term Capital Flow



Source: CEIC

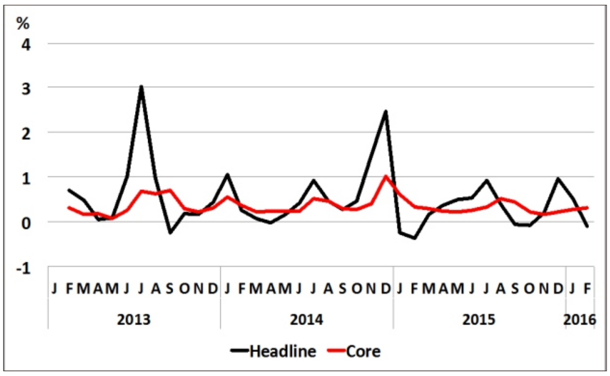
Global Uncertainty

Concerns regarding adverse effects of strong appreciation of Rupiah to export competitiveness are not unwarranted; previous episode of monetary easing by major central banks (as the response to 2008 Global Financial Crisis) were followed by strong Rupiah appreciation. This exacerbated the symptoms of Dutch disease following the commodities boom in the late 2000s, which in turn eroded manufactured goods export competitiveness and caused Indonesia to experience current account deficit for the last 17 quarters.

Unprecedented implementations of negative interest rate policy (NIRP) in several major advanced economies, such as Switzerland and Japan, and further easing by European Central Bank may therefore affect the rate consideration for Wednesday meeting considerably. These factors may prompt global investors to search for yield in strong emerging market asset classes, such as Indonesian securities, and may cause further, potentially undesirable appreciation of Rupiah. However, with the Federal Reserve signal faster than expected target rate hike, this will put pressure on Rupiah even with a massive capital inflow in 2016.

On the other hand, managing Rupiah appreciation through blunt tool, such as decrease in short-term interest rate target, may drive inflation slightly above the inflation target of 4% ± 1%, given that current inflation expectation already hovers at 4.83%. Since the last quarter of 2015, core inflation displayed increasing trend, which shows domestic demand is improving. Should Bank Indonesia focus strictly on its inflation target, this high inflation expectation, combined with potential increase in food prices (due to predicted record-breaking El Nino in 2016 and erratic policies on agricultural imports), may limit room for Bank Indonesia to cut interest rate further.

Figure 3: Inflation: Headline and Core



Source: CEIC

We therefore expect Bank Indonesia to focus on exchange rate stabilization through more direct tool, such as intervention in Rupiah spot market and to moderate its policy easing trajectory.

Researchers

Febrio Kacaribu, Ph.D.
Head of Research
Macro and International Trade Studies
febrio.kacaribu@lpem-feui.org

Faradina Alifia Maizar, S.E.
Research Assistant

Alvin Ulido Lumbanraja, S.E.
Research Assistant