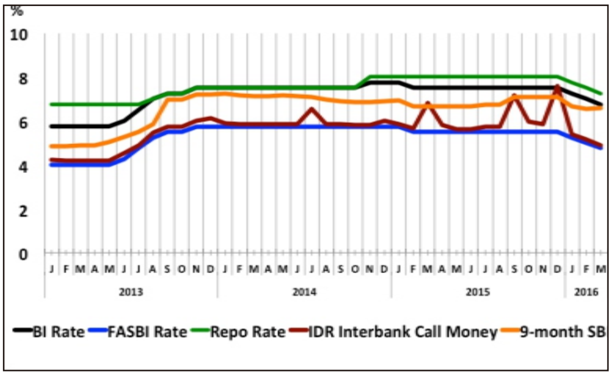
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
APRIL 2016

Highlight

- Plan to ditch BI Rate, a non-transactional policy rate, and adopting the BI 7-day Repo rate is a very good move towards a more confident and transparent guide by BI in the market.
- In the RDG meeting today, BI should keep the policy rates unchanged.

Bank Indonesia should hold its policy rates on Thursday meeting, particularly in light of slightly increasing inflation toward upper bound target and potentially increasing Rupiah volatility in the near-term. Global factors, such as slowing Chinese economy, reduced appetite for emerging market asset classes and Brexit may also compel investors to unwind, or at least reducing inflow to Rupiah-denominated securities and put downward pressures on Rupiah in the near term.

Figure 1: Interest Rates



Source: Bank Indonesia

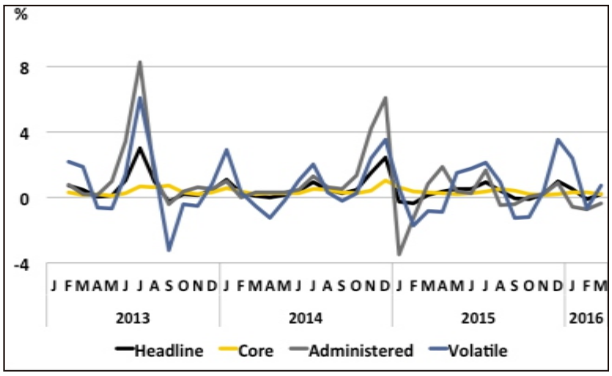
We have criticized the use of BI rate for quite some time. BI's decision to replace BI rate with 7-days reverse repo rate effective of August BoG meeting represents an important development that demonstrate BI's push to reduce lag in monetary policy transmission.

We believe that replacing policy rate with reverse repo rate, which is a transaction-based rate and better reflecting the condition in short-term money market, will make the transmission of monetary policy much more effective, although its effect will not be as significant as advocated by Bank Indonesia.

Inflation Near Upper Bound Target

March 2016 inflation, which stands at 0.65% ytd and 4.45% y.o.y, is one of the most important factors that may influence BI's decision to cut interest rate further. Given that delayed harvest season due to El Nino and upcoming Ramadan season in June may cause inflation to test BI's upper bound target on y.o.y basis, we do not believe that further rate cut, which will only be transmitted after several months, is justified.

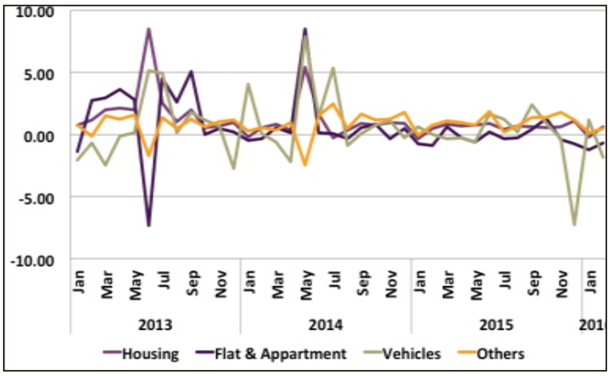
Figure 2: Inflation Rates (mtm)



Source: CEIC

While the last three consecutive rate cuts have not pushed the lending rate down significantly, slight uptick in February consumer credit growth following January rate cut shows that some consumers have already priced in the impending rate cut. As we expect credit growth to accelerate after the January-March rate cuts are fully transmitted to credit market, another rate cut this month may unnecessarily drive core inflation higher during and after Ramadan/Eid Mubarak period (which in itself also drives inflation higher).

Figure 3:Household Consumption Credit Growth (mtm)



Source: CEIC

External Factors to Induce Tighter Policy

Relatively stable Rupiah since the start of the year may create an impression that further rate cut will not significantly affect Rupiah. This apparent stability, however, depends as much on domestic fundamental as on global factors. The ability of Bank Indonesia to cut interest rate by 75bps without causing significant depreciation on Rupiah is largely supported by favorable monetary conditions abroad; Federal Reserves decided to postpone rate hike earlier this year and many advanced economies have embarked on unconventional monetary policy easing, causing dollar and other major currencies to remain weak.

Recent comment by New York Fed's President on encouraging signs of US growth and accelerating inflation, supported by 0.3% mtm wage growth in March, full employment, and increase in US labor force participation, signals that Federal Reserves may resume rate hikes trajectory in the next several meetings. Even if upcoming Brexit referendum and US election may induce Federal Reserves to avoid major policy decisions, economic signs are already too robust for the Federal Reserves to rule out resuming its path to rate normalization. High probability of US rate hike therefore leaves little room for Bank Indonesia to resume rate cut, lest it unnecessarily let Rupiah to depreciate.

Reverse Repo Rate: What's Ahead?

The decision by Bank Indonesia to switch from the non-transactional BI Rate to the transactional 7-days Reverse Repo Rate is one of the most significant developments of monetary policy in recent years. Similar to the objective of the change, we expect this change of policy rate to increase the effectiveness of monetary policy, although the increase in effectiveness may somewhat be less than what was advocated by Bank Indonesia.

Current policy rate, which represent Bank Indonesia's target of average 360-days rate, has never been effective since the end of 2008. Not only due to the fact it is a non-transaction-based rate, its inefectiveness is also contributed by the fact that most of the transactions in the interbank money market are conducted on very short-term basis (less than 30 days maturity), this created disconnect between BI rate and the prevailing money market rate, causing BI rate to be less effective than expected in moving the money market rate.

The fact that interbank money market is highly segmented does not help either. In terms of asset, the 4 biggest banks have 50% share of the banking system. These banks are the net lender in the interbank money market. They place much of the excess reserves in the Deposit Facility, currently earning 4.75%.

7-days Reverse Repo Rate will help Bank Indonesia to exert greater influence on money market rate by allowing BI to evaluate and adjust monetary policy in a more timely and accurate basis. Since market for very short-term interbank lending is also significantly more liquid, 7-days Reverse Repo Rate will also have more influence on interest rate determination in wider range of credits and securities.

Nevertheless, we do not expect the change in policy rate to accelerate monetary policy transmission and drive down interest rate rapidly. Since 7-days reverse repo rate is lower than current 360-days BI rate in normal yield curve, the apparent downward changes in policy rate after August adoption will not in any way affect the policy stance of Bank Indonesia. Furthermore, given that supply side factors are still dominant in domestic inflation dynamics, increased ability to adjust market interest rate may not necessarily make inflation significantly more sensitive to monetary policy adjustment.

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