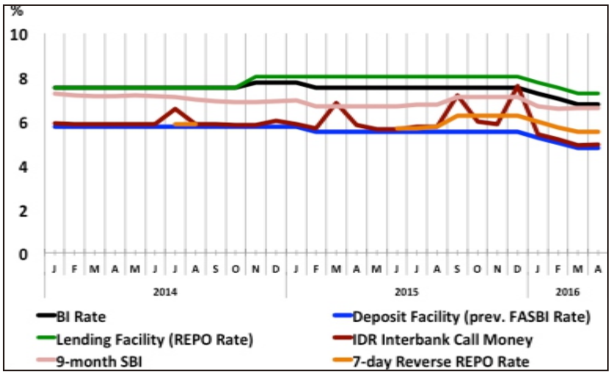
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
MAY 2016

Highlight

- BI should keep policy rate unchanged
- BI should not react too quickly on the lower-than-expected growth in Q1.
- Despite deteriorating global outlook, BI should wait for the potential investment grade rating by S&P.

With inflation declining considerably in April to the lower bound of BI inflation target, thus easing inflationary concern, we expect Bank Indonesia to remain focused on growth rate and external pressure on Rupiah in setting policy rate. We maintain our view of unchanged policy rate in the near term, since Bank Indonesia still have to face conflicting objective of maintaining Rupiah against rapid depreciation and inducing growth.

Figure 1: Interest Rates

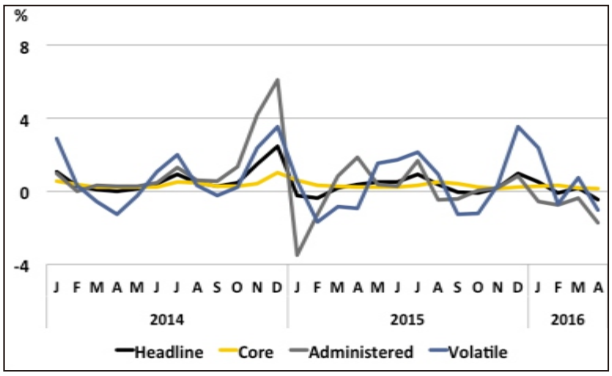


Source: Bank Indonesia

Fundamentals Conducive for Rate Cut

Deflation of 0.45% in April 2016 is mainly attributed to both recurring factor (harvest season, temporarily reducing volatile prices) and one-time factor, particularly gasoline price cut. This, along with current account deficit improvement, suggests that Bank Indonesia has enough room to resume rate cut. We expect inflation to increase moderately during Ramadan season and to be within 4.0%-5.0% band for the rest of 2016, within Bank Indonesia's target.

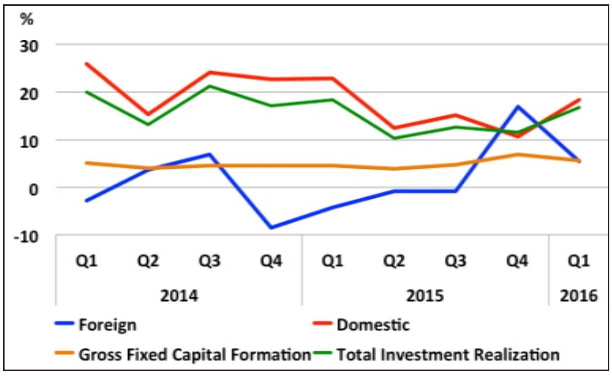
Figure 2: Inflation Rates (mtm)



Source: CEIC

Another important development that should further the case for policy rate cut is the disappointing Q1 growth rate, which, at 4.92%, was below our (and most analysts') expectation. Return to sub-5% level growth, while not a cause for apprehension, illustrate struggle for government to stimulate demand.

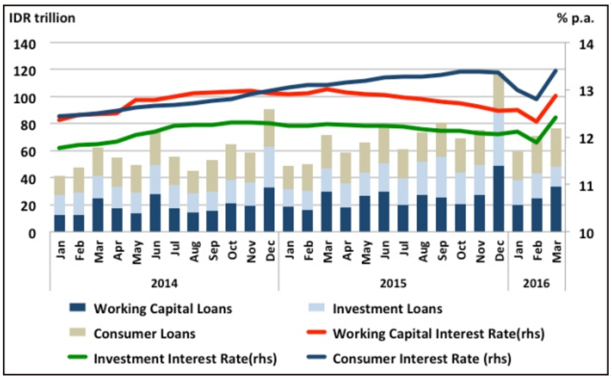
Figure 3: Investment Realization and Gross Fixed Capital Formation (yoy)



Source: CEIC

Growth in gross fixed capital formation, one of main growth drivers for Q4 2015, slowed down in Q1 2016 following the sluggish FDI growth. Domestic direct investments, while picking up pace, are not sizeable enough to stem the decline of investment growth.

Figure 4: Loans Approval by Type and Interest Rates



Source: CEIC

Credit interest rate also provide further case for rate cut, as interest rate unexpectedly increased in March for all types of loan. Interest rate increase is particularly concerning as it returned to December level, undoing the effect of rate cut since Q4-2015.

As fiscal space becomes increasingly constrained due to decreasing tax revenues, more aggressive monetary stimulus is the only logical short-term fix to cut credit interest rate and meet or exceed growth target this year. Combined with low inflation, growth concern should provide strong cases for rate cut.

BI to Remain Cautious Against External Shocks

Even as domestic fundamentals suggest that Bank Indonesia should resume the path for rate cut, we expect Bank Indonesia to pay considerable attention to recent increase in global volatility. Federal Reserve's plan to continue with the rate hike plan may put additional downward pressure on Rupiah after period of relative calm since Q4 2015.

Increase in oil price and other commodities may also weaken the case for rate cut through several channels. Higher gasoline price, which may be transmitted through fuel prices (which now are mostly unsubsidized), may increase inflation, although fuel prices in Indonesia are still well above the market price for refined gasoline. Higher commodities price may also increase revenues for commodity producers and growth in commodities extraction sectors, thus reducing the urgency for rate cut.

The case for rate cut is further weakened by reduced market appetite for risks following deterioration in global outlook. Slow Eurozone and Japan growth even after series of unconventional monetary policy, risk of Brexit, concerns over US election, and increasing risks of Chinese corporate defaults have induced global investors to unwind from riskier assets class. Should risks to global outlook increase, Bank Indonesia may not want to put the rate of Rupiah too low or it might repeat the rapid depreciation of Rupiah last year. The combination of domestic fundamentals, which point toward looser monetary policy, and global factors, which point toward tighter policy, makes Bank Indonesia better off in doing nothing for the next several meetings.

BI should also wait for the Standard & Poor's new rating on Indonesian sovereign bonds that soon to be released in June. An investment grade rating by S&P could significantly attract more capital inflow, which should bring the market interest rate lower.

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