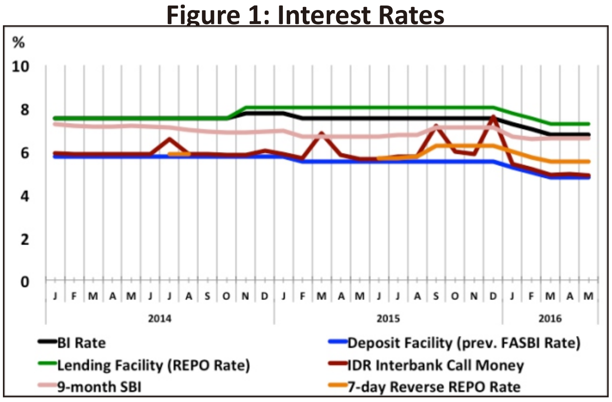
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
JUNE 2016

Highlight

- BI should keep policy rates unchanged.
- Domestic case for rate cut is offset by capital outflow risks due to potential flight to safety.
- Rate movement should be limited unless uncertainties in global economy are reduced.

With inflation declining further in May, even with report of sudden jump in food prices during the Ramadhan period, we expect Bank Indonesia to maintain its global view in setting policy rates. We expect policy rates to remain unchanged at least until reverse repo rate is introduced, particularly as pressure to ease policy following anemic Q1 growth is offset by outflow risks from possibility of US rate hike and potential turmoil from Brexit vote.

Figure 1: Interest Rates

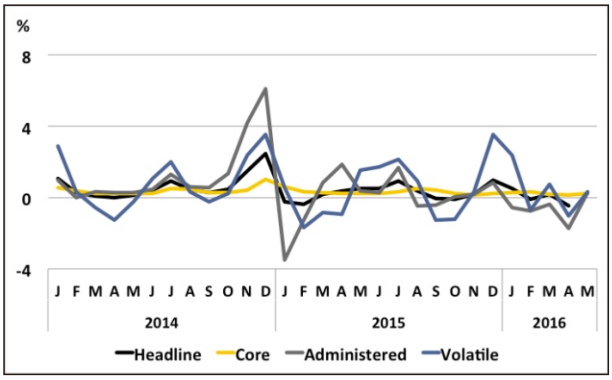


Source: Bank Indonesia

Domestic Case for Rate Cut

We maintain our view, that judged through domestic macro indicators alone, policy rates have been slightly above its ideal level since earlier this year. Year-on-year inflation, which hovers at 3.33%, is low enough that without major change in policy, we still expect inflation to be within Bank Indonesia's lower bound target even with reported price increase during this Ramadan season and oil price increase.

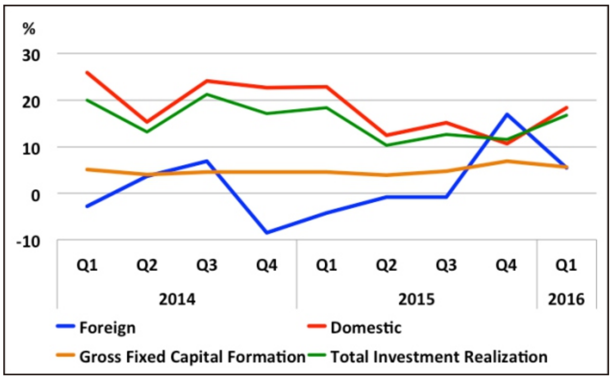
Figure 2: Inflation Rates (mtm)



Source: CEIC

Coupled with sub-5% Q1 growth rate, low inflation indicates subdued demand, a textbook case for monetary policy easing. Signal for rate cut may improve businesses expectation and encourage business fixed investments, which slowed down last quarter. However, given BI's hawkish tendencies on inflation and currency fluctuation, we believe that current policy rate has reflected BI's stance on slowing investment and overall growth.

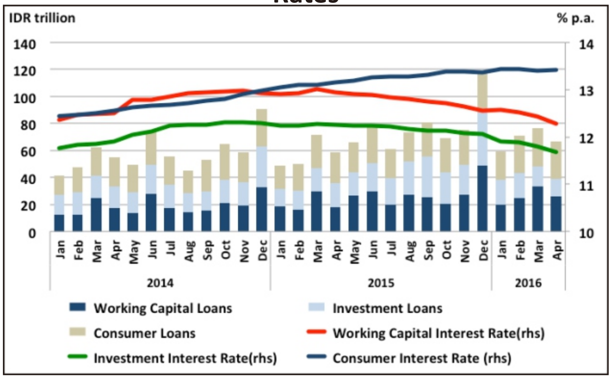
Figure 3: Investment Realization and Gross Fixed Capital Formation (yoy)



Source: CEIC

In addition to encouraging business fixed investments, rate cut may also serve to improve consumption growth, which has been soft in the last several quarters. While credit interest rate has generally trended downward, consumer credit rate remains persistently high. This unnecessarily holds back growth in durable goods spending, which will then be transmitted into lowered business expectation and investments.

Figure 4: Loans Approval by Type and Interest Rates



Source: CEIC

Slighyly Elevated Risks of Outflow

Even as domestic fundamentals suggest that Bank Indonesia should resume the path for rate cut, Bank Indonesia is better off doing nothing due to impending change of monetary tools in August and negative global short-term outlook. Rate change before August may confuse the market as discontinuity of BI Rate and reverse repo rate makes any consistent change in policy stance more difficult to observe.

We also expect BI to pay more attention to recent increase in global volatility. While market has generally dismissed Federal Reserve's plan to continue with the June rate hike, Yellen's recent embrace of constructive ambiguity make it unwise for BI not to hedge against possible Fed rate increase.

Bleak short-term global outlook, combined with possible Fed rate hike, also increase the possibility of outflow, particularly surrounding several key events this year. While not directly affecting Indonesia, potential turmoil from Brexit may trigger flight to safety and selloff in emerging market assets.

Concerns over US presidential candidates and increased cases of Chinese corporate defaults may further induce global investors to further avoid riskier assets class until early next year. 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.

Increase in general commodities prices may also dampen the case for rate cut through multiple channels. Higher gasoline price, along with government plan to further reduce diesel subsidies, may potentially increase inflation. Higher commodities price may also boost commodities extraction sectors and propel growth in the next several quarters, thus reducing the urgency for rate cut.

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