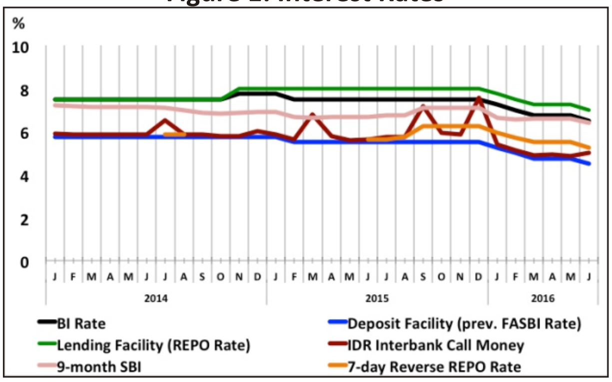
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
JULY 2016

Highlight

- BI should reduce policy rate by at least another 25bps.
- Significantly reduced external pressure on Rupiah and mild inflation in first half of 2016 provide large room for rate cut.

In line with our longstanding view that domestic conditions merit a substantially lower interest rate, we expect Bank Indonesia to cut interest rate by 25bps for July meeting. This cut is justified by reduced external pressures on Rupiah, following the relatively mild reaction on Brexit, search for yield from advanced economies, and tax amnesty program. Should inflation remain subdued in Q3, we also expect several other rate cuts by the end of 2016.

Figure 1: Interest Rates

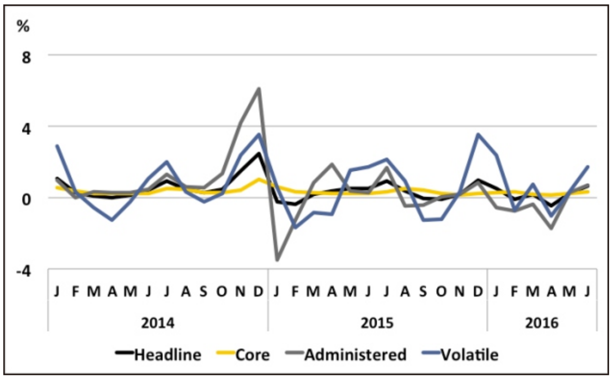


Source: Bank Indonesia

Additional Rate Cuts Ahead

Domestic macro indicators suggest that policy rates have been above its ideal level since earlier this year. Year-on-year inflation (3.45%) and year-to-date inflation (1.06%) in June 2016, even after Ramadan season, signals that the possibility of failure to achieve lower bound inflation target is not unthinkable at this point, particularly if BI retain their tight-bias policy.

Figure 2: Inflation Rates (mtm)



Source: CEIC

While there are evidences that consumers and corporations are more confident and start to increase expenditure, sub-5% growth rate and persistently low inflation indicate that aggregate demand remains subdued. Even in the case of increase in commodities prices, we do not expect the increase to be significant enough to drive inflation above BI's inflation target of 4% in 2016, thus justifying several rate cuts until the end of 2016.

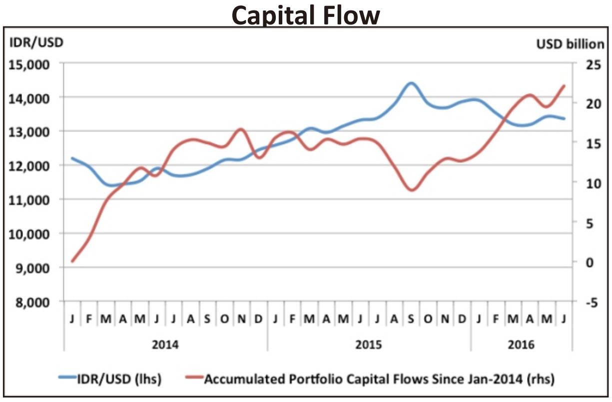
Reduced External Risks

The outcome of Brexit referendum, while causing temporary turbulence in global market, has actually eased Bank Indonesia's concern about key global economic risks through several channels. Directly, the market reaction toward emerging market asset classes following Brexit announcement, particularly Indonesia, is modest. As the uncertainties surrounding the referendum have receded, Indonesia is proven to be relatively unscathed by the outcome, thus allowing BI to focus more on domestic factors.

Indirectly, Brexit affects BI's considerations through expectations of further monetary easing in UK, Europe, and to a lesser extent, US following the vote. With UK being reluctant to trigger Article 50, businesses in UK and Europe may decide to postpone major business decisions (capital expenditures, M&A, expansion) until details of exit negotiations emerge. This will force UK into recession by end of 2016, which may bring some contagion to Europe, and trigger further monetary easing in UK and Europe.

Safe haven currencies, such as US dollar, Swiss franc, and Japanese yen, as shown recently, may see their value appreciating and also trigger easing, or in the case of US, postponement of rate hike. With many of advanced economies' interest rates already in negative territory, search for yield into EM assets will rapidly drive Rupiah appreciation, which may defeat BI's aim to help Indonesia's current account.

Figure 3: IDR/USD and Accumulated Short Term Capital Flow



Source: CEIC

Recently-enacted tax amnesty, which came into effect this July, will also drive appreciation of Rupiah should the program be successful in repatriating offshore assets of tax-evading Indonesians. Although it may be difficult to break down the capital inflow due to search for yield from developed economies or due to tax amnesty, recent data on capital inflow suggests that Rupiah may continue appreciation if BI did not intervene. Since British voters decided to leave the EU on June 23 and the Tax Amnesty Bill came into effect on 1 July, there is almost USD 1 billion net inflows to Indonesian stock market. The combination of subdued inflation, muted growth, and repercussions of rapidly appreciating Rupiah will put pressure on Bank Indonesia to continue its accommodative stance. We expect BI to employ the combination of rate cuts and sterilized intervention to prevent further rapid appreciation of Rupiah in coming months.

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