LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
SEPTEMBER 2016

Highlights

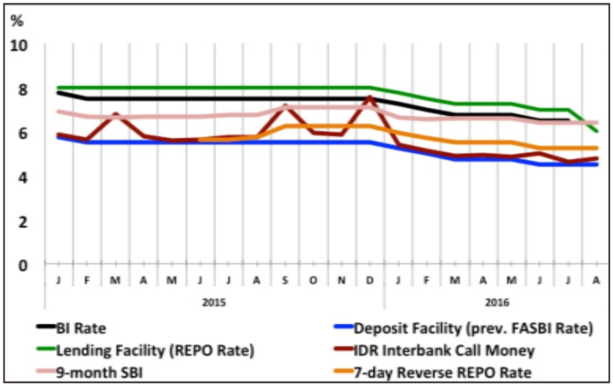
- The newly adopted BI 7-Day RR policy rate will make BI more accountable.
- BI needs to reduce its policy rate by at least 25 bps this month.
- Very low current and expected future inflation rates indicate weak demand in the economy.
- Fed funds rate hike most likely in Dec 2016.

Last month, BI adopted the new set of policy rates that consist of BI 7-Day RR accompanied by new corridor of Lending Facility and Deposit Facility, each 75 bps above and below BI 7-day RR. We applaud this move. It will make BI's direction of policy to be easier to understand by the market. Additionally, market now can evaluate whether BI acheives its short term interest target, i.e. the BI 7-day RR Rate itself every month.

After holding the benchmark rate at 5.25% since June 2016, we do not see credible justifications for Bank Indonesia to hold the rate further. BI needs to reduce the interest rate by at least 25 bps on Thursday meeting. Taking into account the lag for monetary policy transmission, further delays in cutting interest rate may jeopardize the inflation target and may attract more questions on BI's commitment to inflation targeting framework.

The need for rate cut is driven by low inflation and credit growth throughout 2016, which are well below average in the last 5 years. While economic growth in Q2 2016 was higher than consensus estimate, lower-than-target inflation indicates that there remains slack in consumer demand, which provides even more case for a looser monetary policy.

Figure 1: Interest Rates

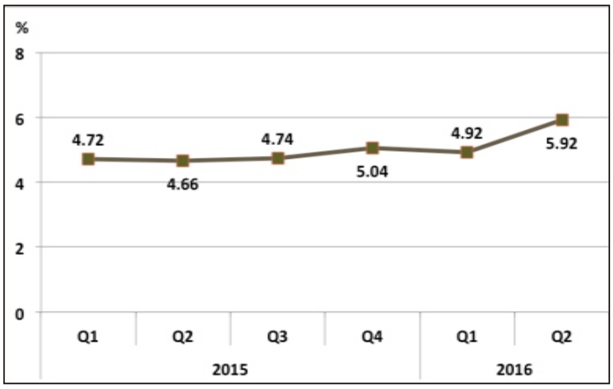


Source: Bank Indonesia

Rate Cuts Are Necessary, Long Overdue

Although the economic growth in 2016Q2 was 5.18% (y.o.y), which was higher-than-expected, we maintain our position that the economy is still running below full employment and Bank Indonesia has not done enough to stabilize output. This is evident with persistently low inflation rate at 2.79% (y.o.y) in August 2016, weakest in 7 years, despite accelerating economic growth. On the other hand, the year-to-date inflation rate is at 1.74% for the first 8 months of 2016.

Figure 2: GDP Growth (yoy)



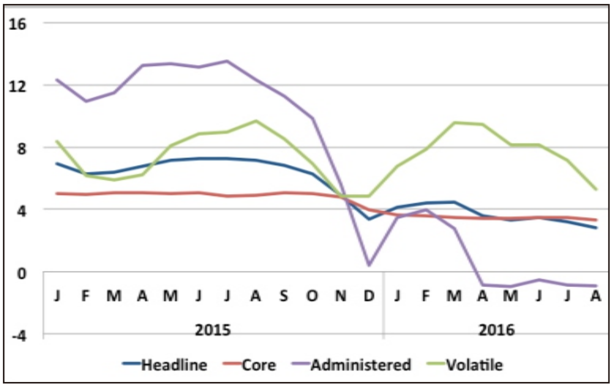
Source: CEIC

At current level, low inflation is enough to justify rate cut on its own and merit further attention. As December is the only remaining month in 2016 with significant inflationary risk, the risks for 2016 inflation to miss the lower bound target is now significantly high.

While low inflation is generally good if it is stable and in line with the market expectation in the long run. The fact that current and expected future inflation is in danger to miss the lower band of BI's inflation target could mean two things: (1) BI miscalculated the inflation target band of 3%-5%, or (2) the demand in the economy is currently below the potential GDP. We believe the second is more likely. Both however, will jeopardize BI's policy credibility further.

As monetary policy has to be forward-looking and not reactionary (due to transmission lag), it is necessary to signal that BI will take necessary steps to maintain inflation within target if BI is actually serious with its inflation-targeting framework.

Figure 3: Inflation Rates (y.o.y)



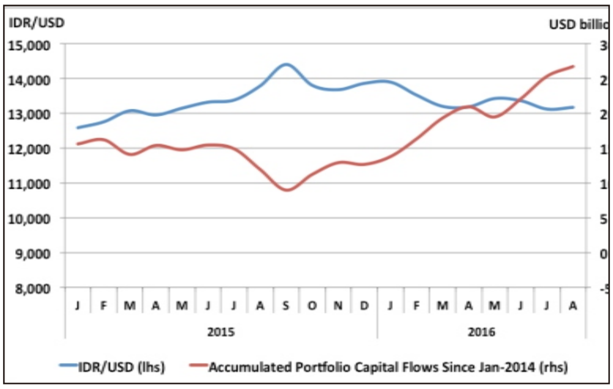
Source: CEIC

In addition to low inflation, government's decision to cut government spending by IDR 133.8 trillion (around USD 10.5 million) to comply with 3% deficit rule may slightly lower economic growth and necessitate adequate output stabilization measures from BI. Cutting the benchmark rate should be able to increase credit, which leads to increase in investments and durable goods consumption and may drive core inflation higher. Measures to accelerate credit growth is particularly important, given that y.o.y growth of outstanding credit in banking system is only 6.68%, far lower than in 2015 (9.14%) or earlier, which saw double digit outstanding credit growth.

As domestic indicators give strong signal for rate cut, the only reason that may drive BI to hold policy rate is to hedge against deteriorating circumstances in international market. However, degree of external risks that may have prompted BI to hold interest rate may very well be overblown. Even if FOMC meeting on Thursday is one of major factors on BI's rate decision, we do not expect rate hike for September. Despite solid job market, low US inflation and uncertainties over presidential election will delay the possibility of The Fed to raise interest rate in the near-term.

Even if the Fed decide to raise interest rate this Thursday, we do not expect the size of capital outflow to be anywhere near the selloff that followed 2013 “Taper tantrum” or last year's outflow over first Fed rate hike from 0% level. This is due to the fact that most other major economies' decision to further ease their monetary policies, which leaves the overall global liquidity to remain healthier than in 2013 or 2015. This is evident with persistent capital inflow trend, despite the alarm over possible September Fed rate hike for the last few months, which allows BI to accumulate adequate level of foreign reserves. As external concerns are relatively muted and RRR has been phased in since August, BI is left with practically no legitimate justifications to delay the target rate cut.

Figure 4: IDR/USD and Accumulated Short Term Capital Flow



Source: CEIC

Researchers

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

Alvin Ulido Lumbanraja, S.E.
Research Assistant

Faradina Alifia Maizar, S.E.
Research Assistant