LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
OCTOBER 2016

Highlights

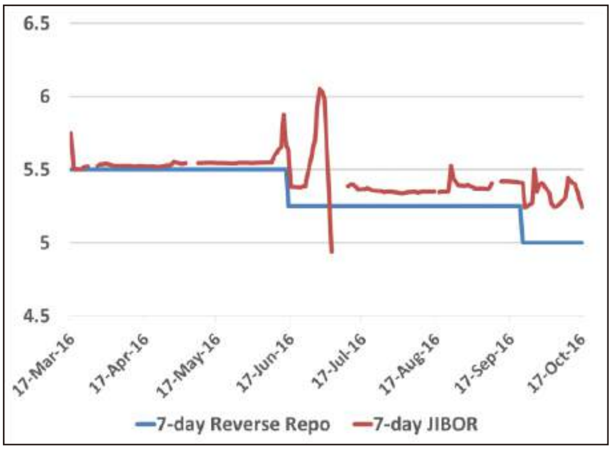
- BI needs to hold benchmark rate at 5% for now
- Inflation by end of the year to be within BI's target range but close to the lower bound
- Concern on Fed rate hike to counteract case for BI rate cut from soft inflation rate
- Reverse Repo Rate fall short of its promise in its first 6 months.

The success of first period of tax amnesty program, upward inflation observed in September 2016, and high probability of Fed rate hike in December serve as justifications for Bank Indonesia to maintain the 7-day RRR at 5% on Thursday meeting.

However, BI needs to seriously look into the fact that the market interest rate of 7-day tenor has not been responsive enough to BI's policy rate; more volume is needed to lead the market. BI needs to be more serious in building the credibility of its new policy rate for it to be the effective instrument in conveying BI's intention to the market.

Effectiveness of New Benchmark Rates

Figure 1: Interest Rates



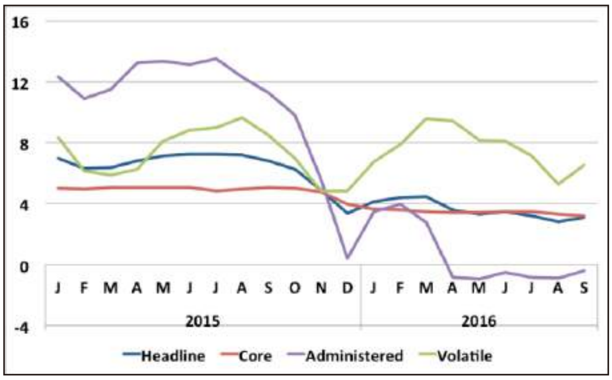
Source: Bank Indonesia

Since the introduction of new policy rate 6 months ago, we observe that 7 day reverse repo rate has fallen short of its intended purpose to align short-term interest rate closer to its target rate. This trend is evident in divergence of 7-day JIBOR from 7-day Reverse Repo Rate, particularly following the rate cut in September. While short-term interbank rate has indeed followed the trend of RRR, the reduction in short-term money market rate has been smaller than the target rate.

While larger datasets and more comprehensive studies are needed to understand the divergence between 7-day JIBOR rate (market equilibrium rate) and 7-day Reverse Repo Rate, we suggest that one of the possible causes for this divergence is the frequency of Reverse Repo auctions. As reverse repo auctions are held 2-3 times weekly instead of every business day, market participants may put a premium on readily-available liquidity, particularly as inflow from repatriation is below government target and expected outflow from December rate hike has tightened liquidity in money market.

Macro Risks to Remain Under Control

Figure 2: Inflation Rte (y.o.y.)

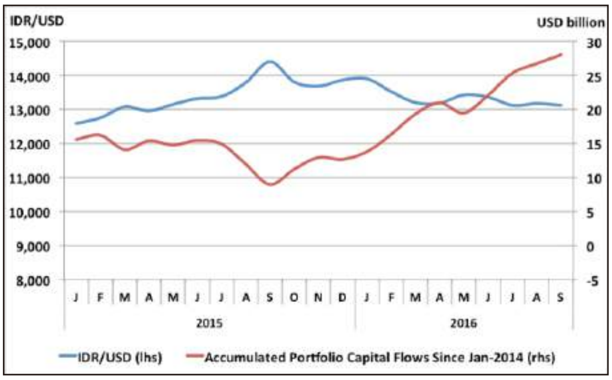


Source: CEIC

The success of Tax Amnesty program is shown by IDR 97 trillion (around USD 7.4 billion) in amnesty payment, 59% of IDR 165 trillion official target and already well above private sector expectations for the whole 9-months period. Additional revenue and budget cut of IDR 138 trillion earlier this year will keep the budget deficit below 3% rule. More realistic posture of 2017 State Budget also eases concern about fiscal risks in the near future.

Low inflation and credit growth also indicates below-capacity economy, which provide better cushion against risk of capital outflow. In fact, slowing inflation throughout the year, which has made BI to cut the interest rate five times this year, has only started to accelerate to 3.07% (y.o.y) in September 2016 (1.97% ytd). With end-of-year seasonal inflation, we expect this year's inflation is expected to be within reach of BI's lower bound target. Additionally, August year-on-year credit growth stands at 6.76%, compared to BI's credit growth target of 7% - 9%.

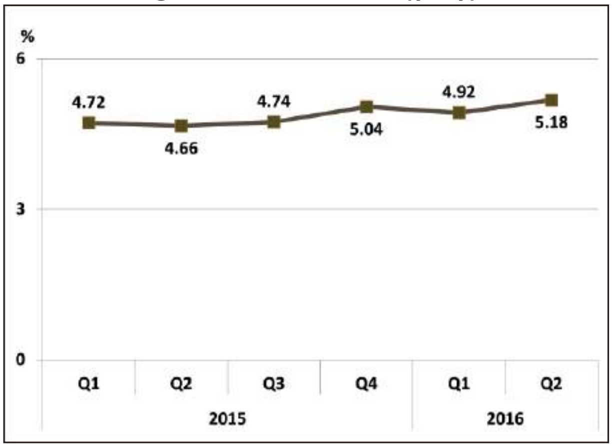
Figure 3: IDR/USD and Accumulated Short Term Capital Flow



Source: CEIC

While soft inflation and credit growth could actually give more leeway for BI to ease monetary policy further, strong indication of December rate hike by Federal Reserve counteract the case for rate cut with the need for moderation; expected capital outflow due to The Fed rate hike will counteract the case for BI rate cut, particularly since expected depreciation may increase domestic prices in the upcoming quarters and further reduction in interest rate differential with USD in any case of excessive rate cuts may exacerbate potential capital outflow in Q4 to Q1 2017.

Figure 4: GDP Growth (y.o.y)



Source: CEIC

We also expect pressure to pursue more accommodative monetary policy to be eased by pick-up in growth in the third quarter, supported by consumption. While government spending may be negatively affected by budget cut, private consumption is poised lead the economic growth for the rest of 2016, supported by improved consumer confidence. Motor vehicles sales and cement consumption in August 2016 demonstrate growth of 6.4% and 8.7% (y.o.y.), respectively, reversing negative trend in vehicle sales in recent quarter.

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