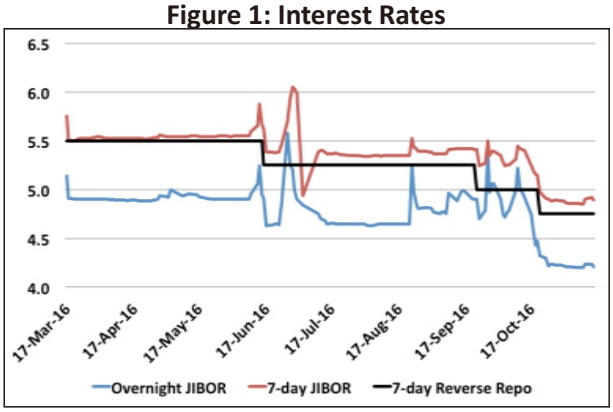
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
NOVEMBER 2016

Highlights

- BI needs to keep the benchmark rate unchanged
- Domestic case for rate cut is offset by capital outflow risks and global uncertainty
- In the midst of ongoing capital outflow pressure, BI needs to carefully target a realistic range for IDR for the next several weeks

In our Q2 and Q3 2016 outlook, we noted that the outcome of US presidential election may present significant tail risk to Indonesian economy, even if the odds of such risk is, gauged by aggregated polls, extremely low. The election of Donald J. Trump as President of the United States, therefore, triggered "Trump tantrum", which saw the episode of large-scale selloff in emerging market and purchase of safe haven assets, such as Japanese bonds.

Figure 1: Interest Rates



Source: Bank Indonesia and CEIC

The future outcome of Trump presidency, ranging from Federal Reserves' response, US deficit, to protectionism, increase uncertainties for market participants, which may reduce risk appetite of global investors. In light of uncertain short-term and long-term impact of Trump presidency, Bank Indonesia may need to maintain the 7-day RRR at 4.75% on Thursday meeting.

Trump Tantrum and Global Uncertainty

Impacts of Trump presidency to Indonesia are mixed and mostly indirect. We highlight trade policy, infrastructure policy, and Fed action in response to new US policies as key issues that warrants further attentions.

Supported by the Republican-controlled Congress, we expect Trump's fiscal plans to increasing infrastructure spending and providing tax cut to drive growth in short term. Comprehensive infrastructure spending package in particular may be passed after long gridlock in divided Congress during Obama term.

On the other hand, Trump's plan to cut tax, a popular policy among Republicans in Congress, means that the only way to finance huge infrastructure packages is through larger deficit and more debt issuance. Combined with the spending plan, the resulting debt to GDP ratio would be prohibitively high. We believe that the realization will be significantly lower that promised during Trump's campaign.

Trump's campaign platform that was on protectionism (e.g. withdrawing from TPP and NAFTA) and punishing China for being a currency manipulator increased the possibility of retaliation by US trading partners and real, while still small, risk of trade wars and reduced volume of global trade. Reduced global trade may increase prices of goods, particularly in US, and lower overall global growth, particularly in export-oriented emerging economies such as China.

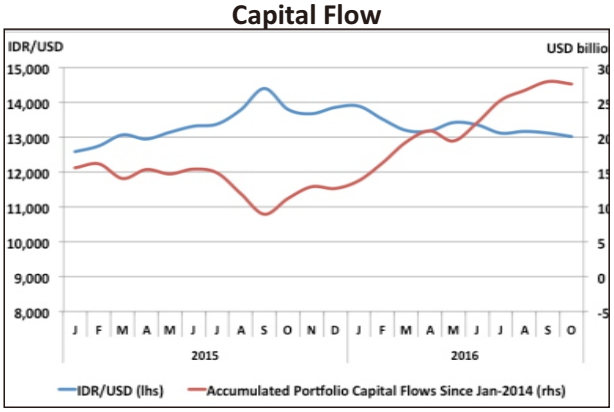
Expectations of more US government bonds supply and possibility of lower growth outlook in emerging

market if Trump follows through with his promise on trade, which reduce the attractiveness of emerging market assets, explained the shift from emerging market assets to US equity, although we view market movement throughout last week as overreaction to uncertain policies.

Given the uncertainties that are posed by Trump's unpredictability going forward, we expect the pace and trajectory of Fed's rate hike to become less certain. If Trump follows through with his major spending bills and protectionism promises, we expect demand- and supply-driven inflationary pressures in 2017 and 2018, which may hasten the pace of Fed rate hike.

Reduced risk appetite following Trump's victory on Indonesia is translated to Rupiah depreciation by 2.3% and more than IDR 10 trillion net outflows from Indonesian equities and bonds. Given the inability of market participants to make predictions with any degree of certainty on what Trump will do after assuming presidency, maintaining the interest rate at the current level will prevent Rupiah from further depreciation.

Figure 2: IDR/USD and Accumulated Short Term Capital Flow

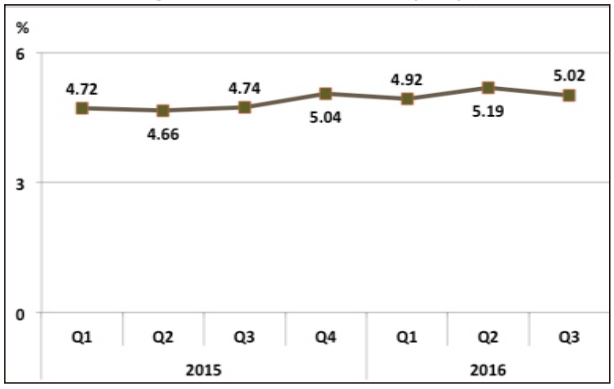


Source: CEIC

Domestic Case

Statistics Indonesia announced slowing GDP growth to 5.02% (y.o.y.) in Q3 2016, in line with what our forecast. Weakened growth is attributable to significant budget export and contraction export with (-2.97% y.o.y and -6.00% (y.o.y.). Lower government spending is due to several budget cuts to keep budget deficit on 3% rule. In Q4, government spending is expected to accelerate, as government needs to finish off their allocated budget. On the other hand, private consumption posted a stable growth of 5.01%, which still indicates slack in consumer demand. With this growth trend, we expect the economy to grow at 5.1-5.2% (y.o.y) for FY2016.

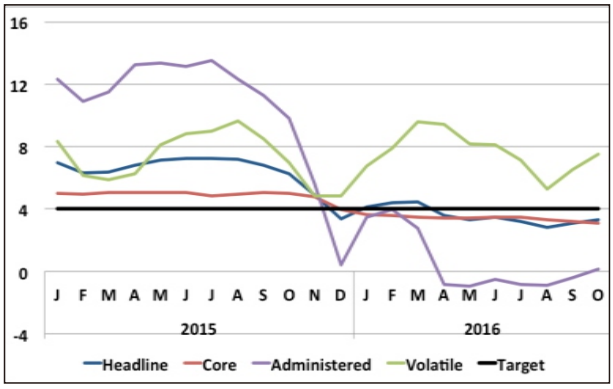
Figure 3: GDP Growth (y.o.y.)



Source: CEIC

Apart from muted growth, persistently low inflation may encourage BI to further cut the 7-day RRR, as year-to-date inflation stands at 2.11%, we still maintain our view on inflation to hover around the lower bound. Although interest rate cut may boost inflation slightly higher, we expect external concerns to dominate BI's decision on this week's meeting.

Figure 4: Inflation Rates (y.o.y.)



Source: CEIC

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