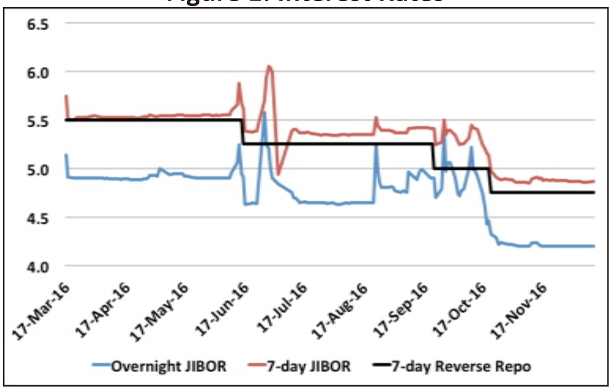
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
DECEMBER 2016

Highlights

- BI needs to keep the benchmark rate unchanged
- While growth is slightly below potential and inflation is low, BI has very limited room for rate cut due to renewed external pressures
- Banks lend much more slowly this year. Firms increasingly use capital market to raise funds.

After cutting rate six times in 2016, BI may need to maintain the benchmark rate at 4.75% (y.o.y.) on Thursday meeting. Even with slowing GDP growth of 5.02% (y.o.y.) in Q3 2016 and still-below-target inflation, several key external pressures, particularly with imminent December Fed rate hike and surprisingly promising lead on OPEC pledge to cut oil production, limit the room for easing until at least early 2017.

Figure 1: Interest Rates



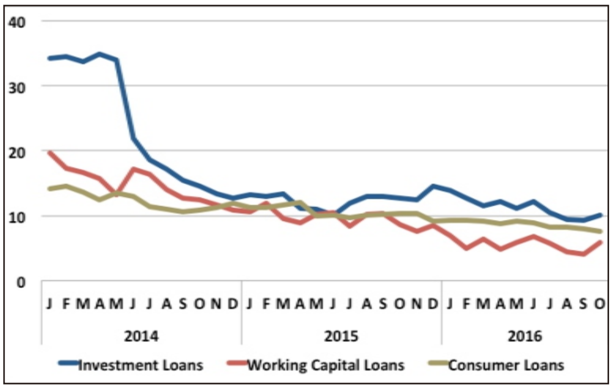
Source: CEIC

Domestic Financing

Despite the rate cut, the economic growth still drop from 5.19% (y.o.y.) in Q2 2016 to 5.02% (y.o.y.) in Q3 2016, which indicates that the economy is slightly below its potential.

While annual loan growth recovered from 6.5% in September 2016, the lowest in seven years, to 7.4% in October 2016, the loan growth is still below historical average and does not indicate meaningful pick-up in overall economic activities going forward. Recovery in investment and working capital loans are not followed by acceleration in consumer loans (10.1%, 7.5%, and 5.1%, respectively), indicating general consumer reluctance to spend.

Figure 2: Outstanding Loan Growth (y.o.y.)



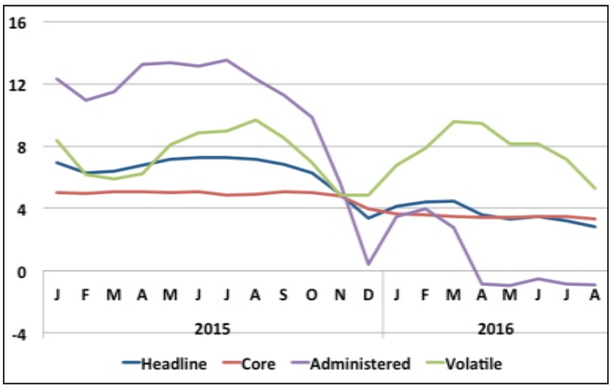
Source: CEIC

Undisbursed loan growth, both committed and uncommitted, also indicates sluggish improvement in economic activities. Disbursement of government expenditure during the second semester, which reduce undisbursed loan, is offset by muted business activities due to low global growth, which contributes to higher undisbursed loans.

Financing needs for corporate borrowers, however, are assuaged by increased activities in bond markets. Tax amnesty program, which started in July 2016, was seen positively by investors and spurred the purchase of corporate bonds. We expect that corporate bonds issuance continue to increase until the end of 2016, in line with trend of increase in outstanding government bonds for Q3 by 13.6% compared to the same period last year.

Even as prime borrowers now have more robust bank-financing substitutes in form of corporate bonds market, middle-market companies and SMEs may have harder times to finance increase in production capacity or higher working capital needs since bank loan growth is still low and may outpace demand for credits. Further liquidity injection is critical to enable increase in production and consumption and ultimately return growth to its long-run trajectory.

Figure 3: Net Issuance of Corporate Bonds and New Capital Raised (trillion of Rupiah)



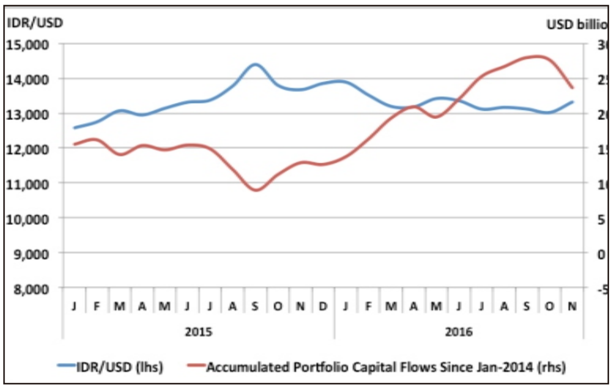
Source: CEIC

Renewed External Pressures

Despite BI's $3.5 billion intervention, Rupiah depreciated by more than 2% (m.t.m.) in November 2016, due to expectation of higher US interest rate and inflation under Trump administration, which induce worldwide exodus from emerging markets. In the next several months Bank Indonesia has limited room to further ease the monetary policy as Indonesian financial market is highly sensitive to global shocks. Furthermore, the direction of oil price following Saudi's lead to cut OPEC's oil production is still unclear as OPEC members tend to eventually violate the agreed-upon supply cut.

Given the effect of Fed rate and oil price to Indonesia's economy, BI may have to wait and see for the next few months to gauge the implication of Trump's policy direction and before resuming the much-needed policy easing.

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



Source: CEIC

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