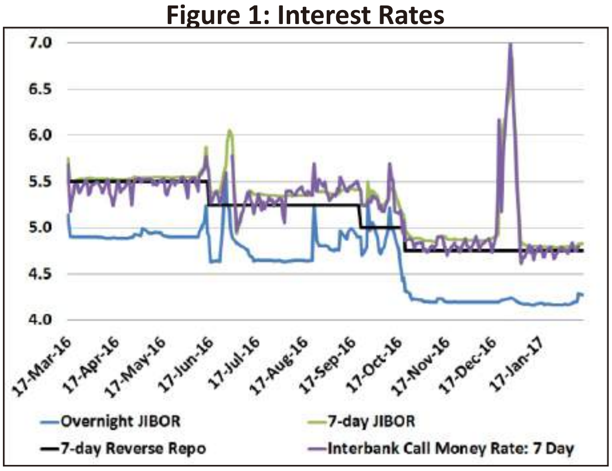
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
FEBRUARY 2017

Highlights

- BI still needs to keep the policy rate unchanged at 4.75%;
- Despite below-expectation economic growth, inflation picks up in January 2017 and core inflation signals an accelerating inflation in 2017;
- Uncertainties under Trump administration and in China's economy still remain as sources of concern.

Surrounded by global uncertainty and accelerated inflation, we expect Bank Indonesia to hold the 7-day RRR at 4.75% at the policy meeting on Thursday. Although the Q4 economic growth slowed to 4.94% (y.o.y), below most prediction, Bank Indonesia has limited room for further policy easing due to inflationary pressure and US-dominated global uncertainty.

Figure 1: Interest Rates



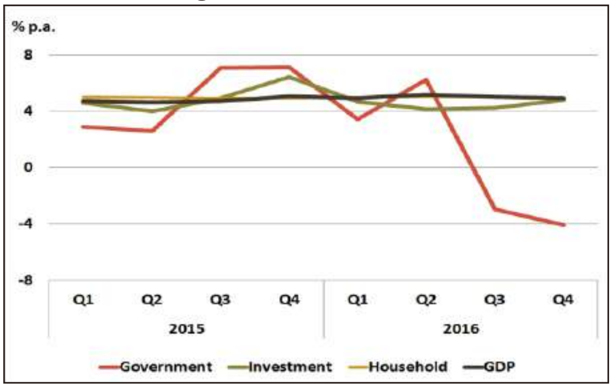
Source: CEIC

Below-Expectation Economic Growth and Accelerating Inflation

Economic growth in 2016 Q4 was reported at 4.94% (y.o.y), below market and our expectations, even as FY2016 growth is reported higher at 5.02%. Disappointing growth acceleration was attributable to big budget cuts, which effectively depressed government spending. As the result of deep spending cut, six rate cut by BI last year, eased reserve requirement rule, and mortgage requirement, were not enough to materially boost economic growth in the short run.

Negative impact of government spending is partially offset by moderate rise in commodity price and stable domestic consumption. Annual household consumption growth, government spending growth, and export growth in 2016 Q4 grew by 4.99% (yoy), -4.95%, and 4.24%, respectively. Moderate improvements of consumption and export reduce the urgency to pursue aggressively loose monetary policy.

Figure 2: GDP Growth

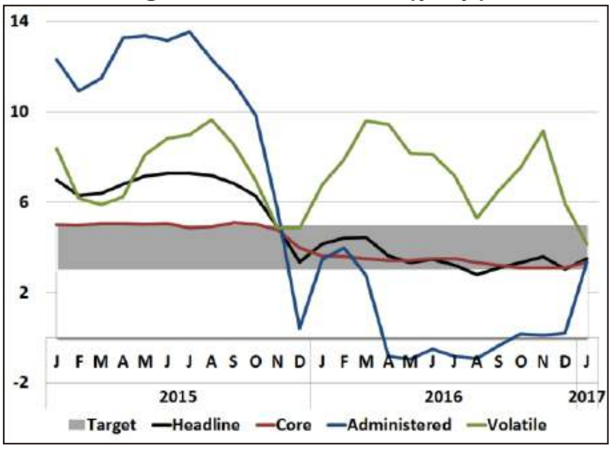


Source: CEIC

Annual inflation increased to 0.97% (mtm) and 3.49% (y.o.y.) in January 2017, might be a signal for a potential accelerating inflation in the near future. Inflation is driven higher by mainly supply-side factors; in particular, increasing administered prices, including fuel price, electricity price, and vehicle registration fee. Volatile, mainly food prices have actually eased since November 2016.

The bad news is signaled by the core inflation that accelerated by 0.56% (mtm) and 3.35% (yoy), the highest monthly core inflation rate since February 2015. Increase in core inflation usually indicates improvement in domestic demand. This is one of the reasons for us to expect inflation to be around 4% in 2017. Inflationary pressure will still be featured by supply-side factors, from climate-change-related extreme weathers, which could affect food prices, and the expected inflation further.

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



Source: CEIC

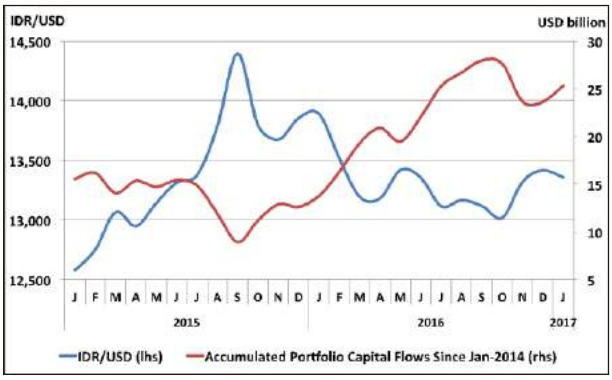
Mixed External Signals and Political Risks

Since January 2017, Rupiah was relatively stable between IDR 13,281 – IDR 13,476 per USD. We observed that on 14 February 2017, one day before gubernatorial election, Rupiah weakened by 0.80% against USD, indicating concern by international investors on the outcome of local elections, particularly DKI Jakarta gubernatorial election. The election result is expected to influence market, as the risk for large-scale demonstration and/or riot against certain candidate is not negligible. The second round of Jakarta gubernatorial election will be perceived as elevated risk for market participants.

Additionally, we see Federal Reserve officials' statement regarding potential three rate hikes in 2017 as highly credible, given that the Fed will not only take into account improvements in US growth and inflation, but also the likely US tax cut. Without any comprehensive plans to reduce spending and apparent priorities to pursue growth by Trump administration will result in larger deficit spending, which has to be preemptively counteracted by Federal Reserve to prevent the economy from overheating.

In the following months, we see that BI still only have limited room for rate cut, given that concern on domestic political scene and imminent Fed Rate hike, combined with weaker domestic case, will prompt BI to prioritize stability of Rupiah through stable interest rate.

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



Source: CEIC

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