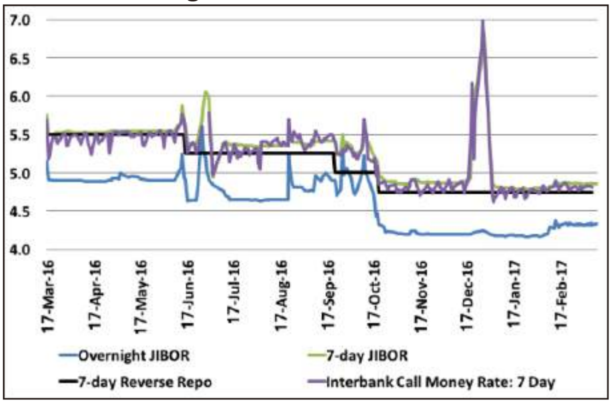
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
MARCH 2017

Highlights

- Bank Indonesia should hold 7-day RRR at 4.75%;
- The Fed is expected to raise the FFR (Fed Fund Rate) in the upcoming FOMC meeting;
- Low core inflation suggests manageable medium-term price expectation.

Dominated by how the majority, if not all, of market participants expect The Fed to increase the FFR by 25 basis points on March FOMC meeting, we maintain that Bank Indonesia should leave the policy rate unchanged at 4.75% at the Thursday governor's meeting. Combination of possible spike in volatility should Fed indicate more rate hikes to come and domestic inflation nearing 4%, we see no room for BI to lower the policy rate.

Figure 1: Interest Rates



Source: CEIC

The Fed's Imminent Rate Hike

Recent US economic data confirms the fact that The Fed has achieved their dual mandates of stabilizing unemployment and inflation. US 2016 inflation data, for example was reported at 2.07% (y.o.y.), which surpassed Fed's target of 2%. Continuing its upward trend since August 2016, The US annual inflation was recorded at 2.50% (y.o.y). US unemployment rate, another part of dual mandate, fell to 4.7% in February 2017, below the long-run unemployment rate. The current dual mandates suggest for at least one rate hike and are expected to happen in March 2017.

Figure 2: Odds of Rate Hike

Source: Bloomberg

Other major central banks, particularly Bank of Japan, The European Central Bank (ECB), and Bank of England, may not tighten the monetary policy on the next governor's meeting. Although Japan's inflation is accelerating, they are yet to achieve their 2% target. ECB has decided to leave the benchmark rate unchanged even as inflation was reported above 2% for the first time in 4 years. This is due to the fact that while ECB indicates that while they have no intention to pursue more accommodative monetary policy, they are still concerned with uneven recovery, particularly in Southern Europe.

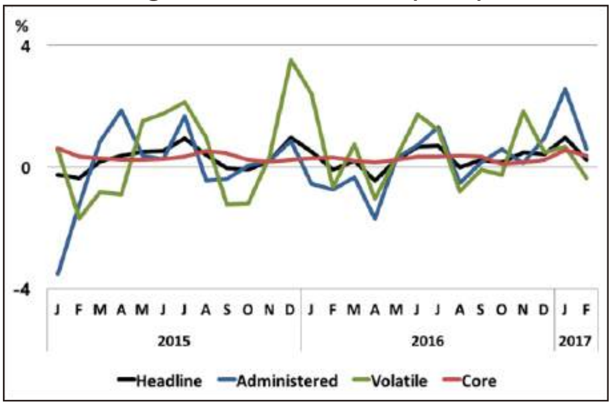
Accelerating Inflation and Growing Demand

Recent data and consumer expectation condition suggest that inflation will slightly pick up and move closer to 4% inflation target after almost 2 years of sharply slowing inflation. In February 2017, inflation accelerated to 3.83% (y.o.y.) or 0.23% (mtm). This is attributable to administered price adjustment, particularly the gradual electricity price increase for 900-VA households by around 30% that happens in three phase (January-February, March, and May 2017. Increases in fuel price and vehicle registration fee also add pressures to inflation.

While administered price shows noticeable increase, the volatile food price showed decline of -0.36%, indicating more reliable food supply as the government is relatively successful in coordinating conducive food distribution, despite anomalous, persistently high chili price. Harvest season, which usually occurs in February-March, will limit inflationary pressure from volatile food price.

After showing increasing trend since November 2016, core inflation slowed to 0.37% (mtm) or 3.41% (y.o.y) in February 2017, indicating manageable price expectation. With inflationary pressure from administered price and growing demand, we still expect inflation to hover around 4% in 2017, the more reason for BI to hold the policy rate.

Figure 3: Inflation Rate (mtm)



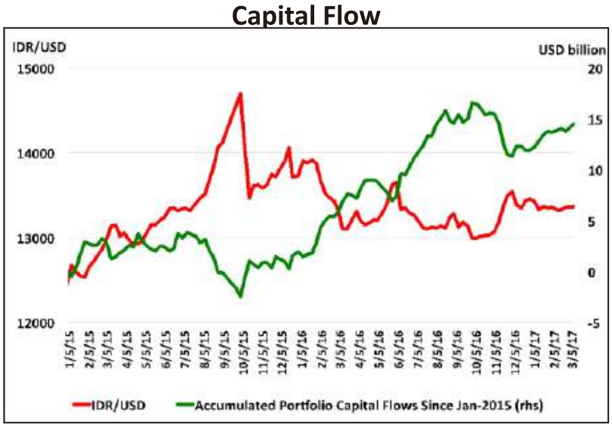
Source: CEIC

Stable Rupiah Ahead of Looming FFR

With relatively calm and manageable domestic economic condition, particularly inflation, we see that Bank Indonesia may and should focus on maintaining exchange rate stability, which is part of BI's mandate to maintain Rupiah stability. Throughout February 2017, Rupiah was hovering between IDR 13,308 – IDR 13,374 per USD. Compared to January 31, Rupiah appreciated 0.03% (mtm) in February 28, while appreciated 0.22% by 13 March 2017. This indicates that expected increase in FFR has largely been priced in and will not affect the movement of Rupiah significantly.

As possibly faster Fed rate hikes this year have been priced in, inflation rate is in their trajectory to its 4% target, and volatility has decreased, both exchange rate and inflation rate are, for now, within their equilibrium. Any movement in policy rate by BI, at least in the first semester, is therefore unnecessary.

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



Source: CEIC

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