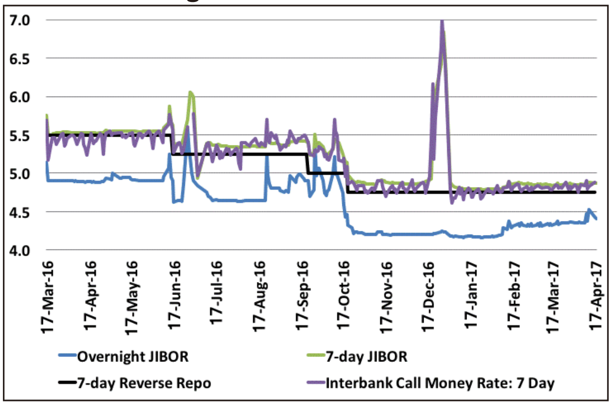
# LPEM COMMENTARY
# BI BOARD OF GOVERNORS' MEETING
# APRIL 2017

## Highlights

- Bank Indonesia should keep 7-day RRR unchanged at 4.75%;
- Inflation is expected to increase slightly in the following months;
- The market currently sees only one Fed funds rate hike left in 2017.

With administered price hikes expected to drive inflation toward its 4% target, we maintain the view that Bank Indonesia should maintain the policy at 4.75% in Thursday meeting. Short-term external risks to Rupiah have been receding, owing to the fact that market participants have priced in Fed rate hike and revised down the expected rate hikes to just another one left in 2017, allowing Bank Indonesia to maintain focus on domestic price level.

**Figure 1: Interest Rates**



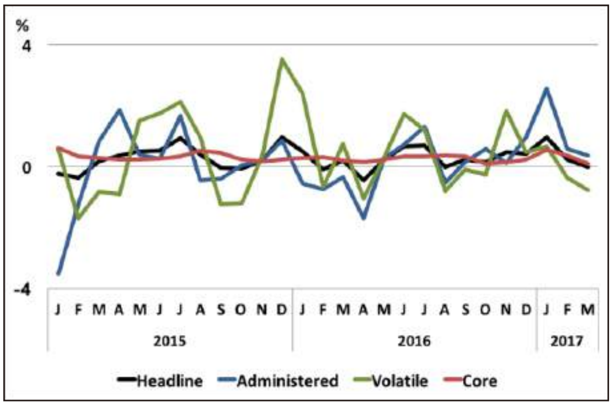

**Source: CEIC**

## Inflationary Pressure in The Coming Months

Indonesia's consumer price experienced deflation by 0.02% (mtm) or inflation at 3.61% (y.o.y.) during March 2017. Lower food prices due to harvest season offset inflationary pressure from subsidy cut as the government continue to reduce electricity subsidy. It was reported that in March 2017, administered price increased by 0.37% (mtm) or 5.50% (y.o.y.) and volatile price down by 0.77% (mtm) or up 2.89% (y.o.y.) from previous year.

Continuing its slowing trend, core inflation decelerated to 0.10% (mtm) or 3.30% (y.o.y.) in March 2017. With ongoing electricity price adjustments and seemingly brisker expected spending in the upcoming Ramadhan season, we expect inflation to be pushed further upward. We therefore maintain our inflation expectation at 4% in 2017, strengthening the case to leave the policy rate unchanged.

**Figure 2: Inflation Rate (mtm)**




**Source: CEIC**

## Stable Rupiah Ahead of Looming FFR

With year-on-year inflation nearing its target, the only reason for Bank Indonesia to change is if there are significant external risks that may provoke large-scale capital inflow or outflow and threaten exchange rate stability. However, throughout March 2017, Rupiah hovered between IDR 13,308 – IDR 13,393 per USD, indicating muted risks. Also, compared to February 28, Rupiah only depreciated by 0.11% through March 15, when The Fed announced they raised the FFR. This indicates that much of the Fed rate hike-related risks have been priced in by market participants, largely due to consistent indications from the Fed on the scheduled interest rate increase.

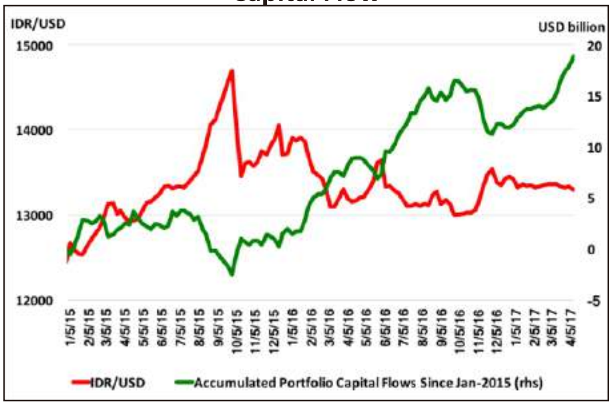
Indeed, we see interesting reversal from recent trend of downward pressures due to external risks for Rupiah. Large-scale capital inflow during the last month and stock prices hitting new high put upward pressures on Rupiah. The capital inflow, which tracks the global trend of emerging-market currency appreciation, is driven largely by revised expectation on Fed rate hike, from 3 times in 2017 to 2 times.

An important thing to remember is that previously-assumed 3 Fed rate hikes in 2017 are driven by assumptions that US economy has reached full employment and implementation of Trump's tax cut and major infrastructure agenda will drive inflation. The first assumption is somewhat refuted by lower-than-expected non-farm payrolls and inflation data, signaling that the Fed may tolerate low interest rate for longer as they can reduce unemployment without accelerating inflation.

Failure of Trump-led Republican administration to pass American Health Care Act, despite controlling all branch of governments, also cast doubt over the ability of Trump administration to push their tax cut and major infrastructure spending bill. With hostile, unified Democrats in Congress that will almost certainly reject tax cut and Freedom Caucus Republican members that will reject larger government spending, both tax cut and infrastructure bill will be delayed at best and will fail at worst.

The combination of potential failure of tax cut and infrastructure bills of Trump administration, combined with Trump's comment that US dollar is "too strong" (sic) increased expectations that the Fed may scaled back the planned rate hikes and explains the increased appetite to emerging market assets. Nevertheless, we do not expect significant further appreciation, which makes Bank Indonesia's current tools to hold the appreciation Rupiah by buying foreign assets and increasing foreign reserves to be sufficient. We therefore see that in the short-term, Bank Indonesia will not and should not revise its stance in response to key external risks (or lack thereof)

**Figure 3: IIDR/USD and Accumulated Short Term Capital Flow**




**Source: CEIC**

## Researchers

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