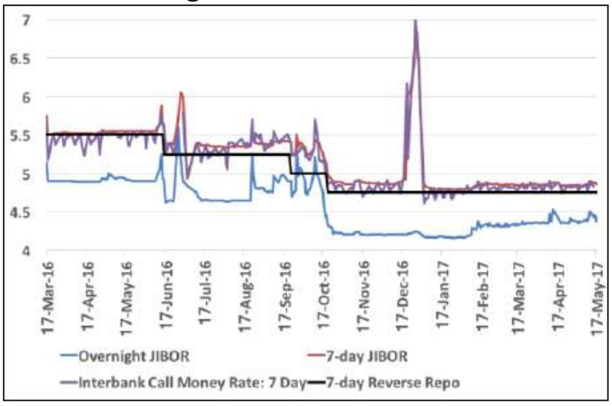
LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
MAY 2017

Highlights

- Bank Indonesia should keep 7-day RRR unchanged at 4.75%;
- The need to spur the economic activity is outweighed by the need to keep the capital inflow trend and risks of higher expected inflation in 2017;
- Rupiah moved in a stable manner during the first months of 2017.

Despite rising inflation, which currently stands at 4.17% (y.o.y.) or 1.28% (ytd), and high likelihood of June's rate hike by the Fed, we view that Bank Indonesia should still hold the policy rate at 4.75% in Thursday meeting. The fact that market participants seem to have currently priced in the chance of June's rate hike, no tangible prospect of further appreciation of oil price, and slight appreciation of Rupiah due to capital inflow further demonstrates no strong reason for BI to change the policy rate.

Figure 1: Interest Rates



Source: CEIC

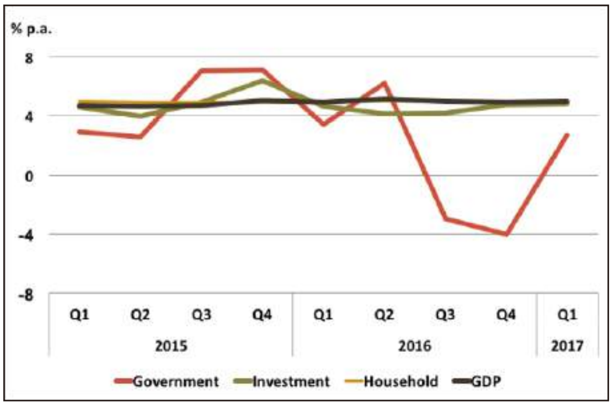
Slight Acceleration in Economic Growth and Rising Inflation

Indonesia's economic growth picked up slightly to 5.02% (y.o.y) in the first three months of 2017, compared to 4.92% (y.o.y.) in 2016 Q1 and 4.94% (y.o.y.) in 2016 Q4. This growth is driven by relatively steady domestic consumption, gross fixed capital formation, and exports with growth reported at 4.93% (y.o.y.), 4.81% (y.o.y.), and 8.04% (y.o.y.), respectively. Higher commodity prices, such as for crude palm oil and coal, helped to improve export performance.

Government spending in Q1 2017 has recovered with positive growth during the beginning of the year after two consecutive negative growth due to budget cuts in the second half of 2016. Nevertheless, it still far trails the overall growth, with growth of 2.71% (y.o.y.) in Q1 2017. Until 31 March 2017, it is reported that the state revenue was IDR 294.6 trillion, 16.8% of state budget, while the spending was IDR 400 trillion, 19.2% of state budget.

With government spending still trailing economic growth and overall growth remains persistently below target, BI might be tempted to put forward a monetary stimulus to drive growth. This would be a mistake for now since the current economic activity might be already well on track for closing in on its potential this year. Growth in the potential GDP should be brought in by more of productive infrastructure projects financed by capital inflow.

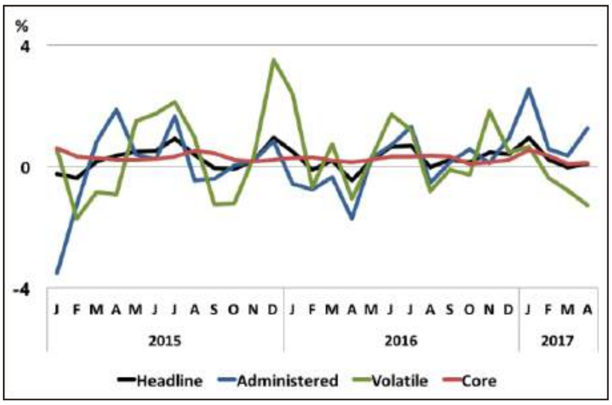
Figure 2: GDP Growth



Source: CEIC

During the first four months of 2017, inflation stands at 1.28% (ytd) or 4.17% (y.o.y.) This is attributable to rising administered price due to subsidy cuts, which make electricity price higher. High inflation is avoided by low volatile price inflation due to harvest season, which caused low food price. Nevertheless, there is a risk of upward pressure on the expected inflation to be closer to the upper bound of BI's inflation target this year. This risk of higher expected (longer-term) inflation could be fed by higher actual inflation during the Ramadhan month if not managed carefully by the government.

Figure 3: Inflation Rate (mtm)

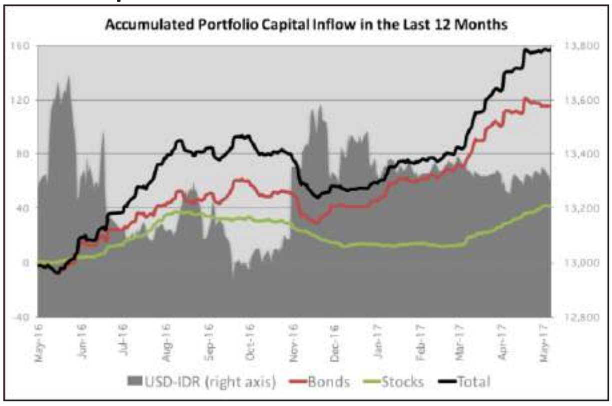


Source: CEIC

Stable Rupiah Ahead of Looming FFR

While there is slightly elevated risk of rising inflation, we still see Bank Indonesia to justifiably pay more concern on Rupiah stability. On the surface, Rupiah has shown stable performance, with year-to-date rate ranging between IDR 13,255 – IDR 13,485 per USD. Strong indications are seen that market participants have priced in the Fed's move, particularly due to clear communication from the Fed on the rate increase. Increased risk appetite from market participants also induce more inflow to emerging markets, which is evident in accumulation of capital inflow. This has given opportunity for BI to accumulate its international reserves to almost all time high.

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow in The Last 12 Months



Source: CEIC

Geopolitical and regional instabilities, however, still serve as latent risk that may suddenly put downward pressure on Rupiah. From the perspective of Rupiah performance, we do not see any need for BI to adjust the policy rate for the moment.

Macro and Financial Market Studies
Febrio Kacaribu, Ph.D., *Head of Research*
Alvin Ulido Lumbanraja, S.E., *Research Assistant*
Faradina Alifia Maizar, S.E. , *Research Assistant*