LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
JUNE 2017

Highlights

- Bank Indonesia should keep its policy rates at their current levels;
- Upward push for Rupiah and BI's stance to keep Rupiah at its current level result in increasing foreign reserve;
- Rupiah moved in a stable manner during the first half of 2017.

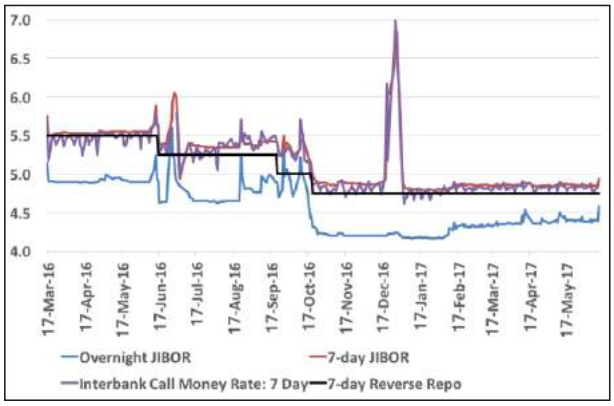
Despite the upward push on Rupiah continues even as expected Fed funds rate hike looms, we expect that Bank Indonesia to keep its policy rates.

Our view is actually a little bit biased toward a rate cut today. This measure may be necessary as combination of recent upgrade of Indonesian sovereign bond rating by S&P to investment grade and still tamed inflation.

Domestic concern may not be of highest priority, given that inflation stays largely within BI's target and has very high probability to remain so until the end of year. But, given the uncertainty from global market especially the potential impact of the Fed's plan in shrinking its balance sheet, it might be better for BI to wait for another month.

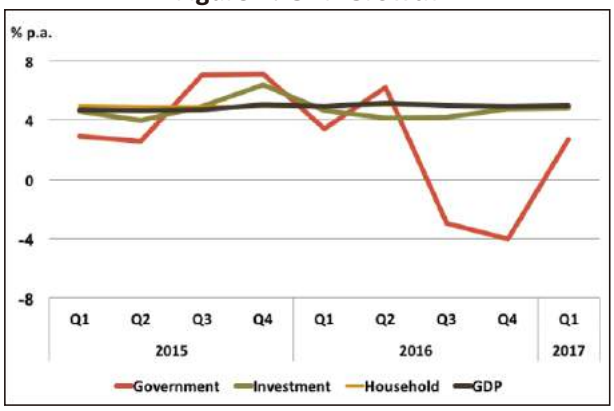
Indonesia's economic growth picked up slightly to 5.02% (y.o.y) in the first three months of 2017, compared to 4.92% (y.o.y.) in 2016 Q1 and 4.94% (y.o.y.) in 2016 Q4. (ytd). Higher commodity prices, particularly for CPO, coal, oil, and gas helped to improve export performance, which was manifested in Q1 Current Account deficit data, which was now below 1% of GDP.

Figure 1: Interest Rates



Source: CEIC

Figure 2: GDP Growth



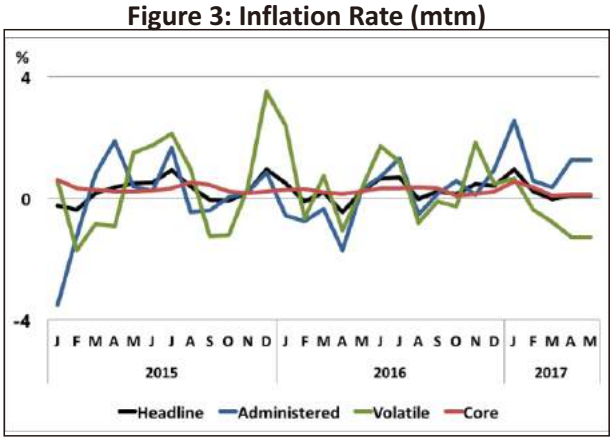
Source: CEIC

Slightly higher economic growth, however, is not fully translated into demand-driven inflation. During the first five months of 2017, inflation stands at 1.67% (ytd) or 4.33% (y.o.y.). Even as inflation may seem to pick up pace, the rise in inflation is disproportionately attributable to rising administered price due to subsidy cuts in 900VA non-subsidized household electricity price. Volatile goods experience deflation largely due to harvest season, while core inflation remains relatively low and stable. The fasting month and Idul Fitri holiday

should increase the inflation temporarily before stabilizing towards the end of the year.

As these measures of inflation remains subdued and expected to remain so until end of year, we view that growth can still go higher without accelerating inflation rate, an indication that the overall economy might still run slightly below its potential.
Government spending still trails economic growth and overall growth remains persistently below target. Nevertheless, government spending should pick up in the data for the next 3 quarters from its low base in the last 2 quarters of 2016 due to the budget cut.

Figure 3: Inflation Rate (mtm)



Source: CEIC

Rupiah has shown a stable performance so far, with year-to-date rate ranging between IDR 13,255 – IDR 13,485 per USD. This stability, however, masked the upward push on Rupiah; foreign reserves has almost touched $125 billion level, highest in history, despite the looming expected Fed rate increase. This level of international reserves is also at its highest record in terms of months of imports and short term debt repayment as shown in Figure 5.

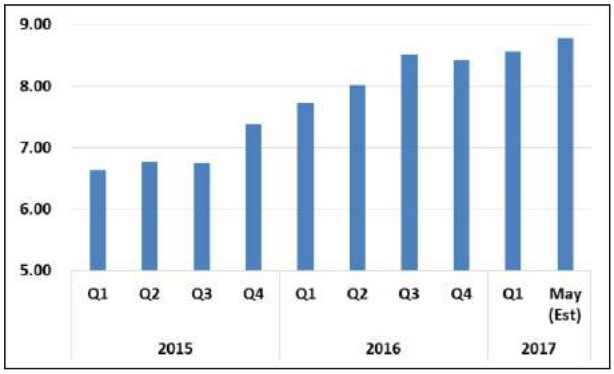
Bank Indonesia may want to keep Rupiah at stable level in order to prevent sudden depreciation if sudden reversal in capital flow happens, as short-term capital inflow into Indonesian equity continues after Indonesia's sovereign bond rating was upgraded to investment grade by S&P. Bank Indonesia may also be interested to keep Rupiah from depreciating to continue help exporters, as they have previously done before.

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

Source: CEIC

Defending Rupiah by means of accumulating foreign reserves could be relatively costly, especially when domestic condition allows for rate cut. The potentially persistent capital inflow to LCY government bonds has brought the yields for 10-yr and 1-yr yields to 7.13% and 5.86% which are at their lowest level in the last 4 years. Again, we see room for BI to adjust their policy rate lower, given the relatively low risk of doing so.

Figure 5: FX Reserves in Months of Imports and Short Term Debt Repayment



Source: Bank Indonesia

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*