MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

November 2017

Highlights

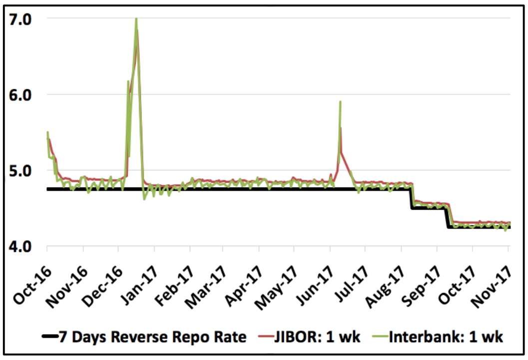
- Bank Indonesia will need to maintain its policy rate in coming months as major central banks continue with their timetable for monetary policy normalization
- October inflation and Q3 GDP data show that economy is still weaker than expected
- Stable range around 13,500 may still hold until earlier next year, BI to intervene if necessary to prevent further depreciation

Lower-than-expected October inflation and Q3 GDP growth might not seem be an ideal situation for BI to suspend rate cut, but such move (or lack thereof) may be a necessary evil for the next few months. As major central banks, such as the Fed, ECB, and Bank of Japan started to normalize their monetary policy and reduce the size of their balance sheet, we expect some degree of selloff in emerging market assets, including Indonesia. We expect the resulting downward pressure on Rupiah to be rather manageable, as Bank Indonesia have ample foreign reserves to defend Rupiah and market has priced in the planned reduction in major central banks' balance sheet. However, commitment to defend Rupiah from depreciation in coming months is directly at odds with the need to boost domestic consumption and inflation through rate cuts, and we expect Bank Indonesia to prioritize defending Rupiah. Bank Indonesia should resort to further rate cut only if inflation and Q4 GDP growth remains low.

Rebound in Domestic Demand to be Slower than Expected

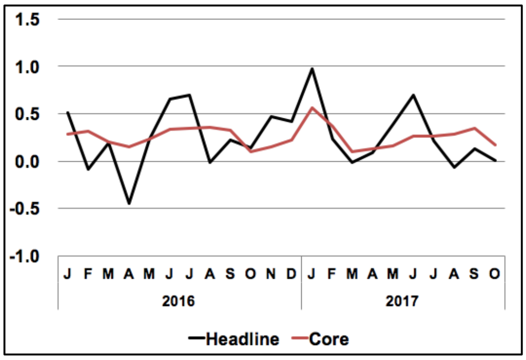
Headline inflation in October, which stands at 3.58% (y.o.y) further confirms that domestic demand is still weak and that improvement in demand is slower than what we and market predicted. While core inflation, the more reliable gauge of inflation and demand, very slightly increased on year-on-year basis to 3.07%, the year-to-date core inflation, which stands at 2.68% in October, suggests that core inflation will only barely touch 3% level by the end of year. Now there is a higher risk for inflation to be below 3.5% overall in 2017. When combined with slight reduction in consumption growth to 4.93% y.o.y (from 4.95% in the preceding quarter), the economic data clearly indicates that domestic consumers are still not confident enough to boost their consumption.

Figure 1: Interest Rate (% pa)



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

On the other hand, gross capital formation, a good measure of real investments, showed a very robust growth in Q3 with 7.11% y.o.y growth. Strong growth in real investments are largely contributed by increase in machine and equipment investments (15.18%) and other equipment (16.83%), which will considerably increase in domestic productive capacity. Contribution of exports to GDP also grew robustly in Q3, with y.o.y. increase of 17.27%.

Bank Indonesia has cut benchmark rates by 125 basis point in the last 18 months, with hopes that more accommodative monetary policy can stimulate both investments and consumption. It almost seems as if recent improvements in business climate and economic activities have yet to be translated into increase in disposable income and, ultimately, consumption.

Macroeconomic & Financial Sector Policy Research

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Key Figures

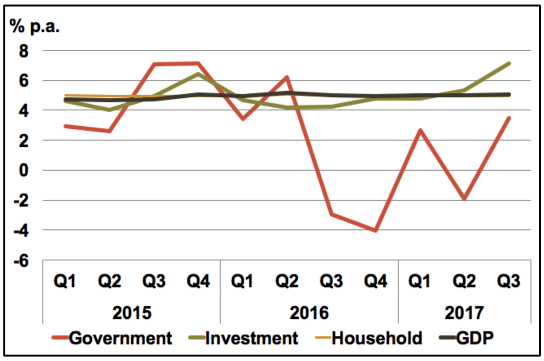
- BI Repo Rate (7-day, Oct '17)
  4.25%
- GDP Growth (y.o.y, Q3 '17)
  5.06%
- Inflation (y.o.y, Oct '17)
  3.58%
- Core Inflation (y.o.y, Oct '17)
  3.07 %
- Inflation (mtm, Sep '17)
  0.01%
- Core Inflation (mtm, Sep '17)
  0.17%
- Credit Growth (y.o.y, Aug '17)
  8.26 %
- FX Reserve (Oct '17)
  $126.54 billion

Despite weak growth for consumption, current trend of higher growth rates for investments and exports should be enough evidence for holding the policy rates this month. We view that previous two rate cuts were enough since both deposit rates, and to some extent lending rates, have started responding to rate cuts. The problem lies not so much on the rate cut but on the time lag it takes to transmit policy rate cut into decrease in deposit and loan rates, and that domestic consumption growth may accelerate by early next year. However, it is equally likely that the real problem with consumption is very likely to be unrelated with tightness of monetary policy, but more with the expectation factors. Solely judging from domestic factors, there is no strong case for rate cut today.

Bank Indonesia to Focus More on Defending Exchange Rate from Large Volatility

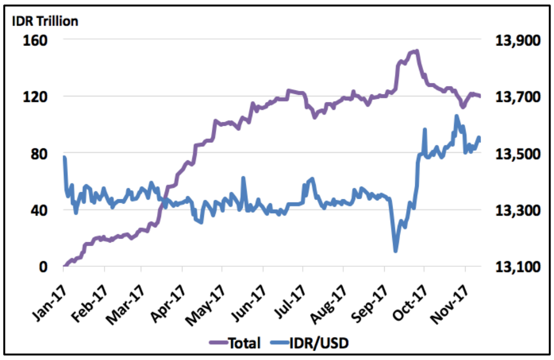
During the good part of the last two months, Bank Indonesia has sent signal that they are comfortable with 13,500 USD/IDR level and may allow relatively narrow volatility band for Rupiah in the coming months. This is evident by the reduction of almost $3 billion in foreign reserves held by Bank Indonesia. This approach is largely the result of the moves towards monetary policy normalization in US, Eurozone, and most probably Japan, which induced and will continue to induce selloff in emerging market assets, including to a certain degree, Indonesia. While major central banks, most prominently the Fed, has managed to reduce panic and the resulting volatility by announcing guidelines and timetables of policy normalization, there is still room for policy surprises. Rather than risking large currency volatility like in 2015, we expect Bank Indonesia of today to be much more vigilant of currency volatility.

Figure 3: GDP Growth (y.o.y)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow, YTD



Source: CEIC

The need to prevent Rupiah from experiencing large-scale volatility until later next year is driven as much by global monetary policy tightening as by domestic public perception. With increased talks about slow domestic growth in the media and erroneous association of currency strength with economic strength that pervades lay public, the only way for Bank Indonesia to shore up public confidence is by preventing Rupiah from depreciating fast (or from depreciating at all). While this may not make economic sense in some cases, maintaining public confidence in the economy by defending Rupiah is to some degree preferable to allowing rapid depreciation that may induce fear about crisis and prompt consumer to delay spending. Combining weak domestic case to cut policy rate and the need to maintain Rupiah level, Bank Indonesia will have to maintain policy rates in the next few months.