BI Board of Governor Meeting

December 2017

Highlights

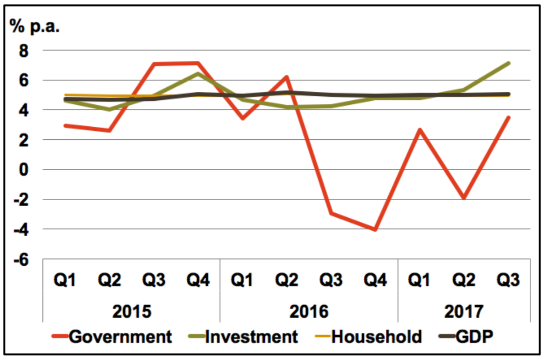
- Bank Indonesia should maintain its policy rate in coming months as major central banks push for policy tightening
- November inflation and Q3 GDP data in line with our forecast, consumption remains relatively weak
- Stable range of Rupiah to still be around 13,500 until earlier next year, BI to increase intervention to prevent large depreciation

Inflation in November virtually confirms that FY 2017 inflation will remain well below 3.50% range and will be close to 3.0-3.2%. Nevertheless, we see inflation to stabilize and 2018 inflation to remain within BI's goal of 3.5±1%, given the signs towards stronger household consumption in 2018. 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, although the overall impact on Indonesia may not be as severe as in 2015. Bank Indonesia have ample foreign reserves to defend Rupiah and Indonesian fundamental remains more robust than in 2015, so that risks of capital outflow should remain manageable. With risks of lower-than-expected inflation and capital flow to remain low in coming months, Bank Indonesia should hold its policy rate for now.

Growth in Consumption to Follow Rebound in Investment and Exports in 2018

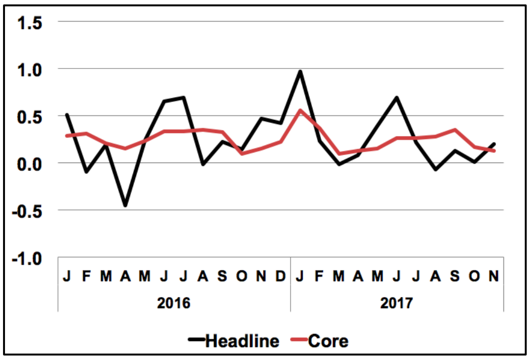
Headline inflation for the first 11 months in 2017 stands at 2.87%, and with December inflation to be lower than in December last year, inflation for FY 2017 should remain well below 3.50% level or even closer to 3% level. Low core inflation is still caused by weak consumption throughout the year. However, November data gives nascent signs that consumption growth will pick up pace next year. Throughout 2017, the portion of households' income[1] that are used for consumption is lower than in 2016, from 70,9% income in Q4 2016 to only 65.5% income in Q3 2017, which explains why consumption growth remains muted. On the other hand, households tend to be more optimistic now and more individuals expect to earn more in 2018[2], which may induce consumers to consume more and push inflation slightly higher in 2018.

Figure 1: GDP Growth (y.o.y)



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

This trend is further supported by strong increase in real investments and export, which showed a very robust growth in Q3 of 7.11% y.o.y and 17.27% y.o.y. Strong growth in real investments are largely contributed by increase in machine and equipment investments (15.18%) and other equipment (16.83%), which will significantly increase domestic productive capacity. 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. Furthermore, as inflation may increase slightly higher in 2018 and that BI's 2018 inflation target is set at 3.5±1%, we do not see strong case for rate change today from domestic side.

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[1] Survey Konsumen Bank Indonesia, November 2017
[2] Survey Konsumen Bank Indonesia, November 2017

Key Figures

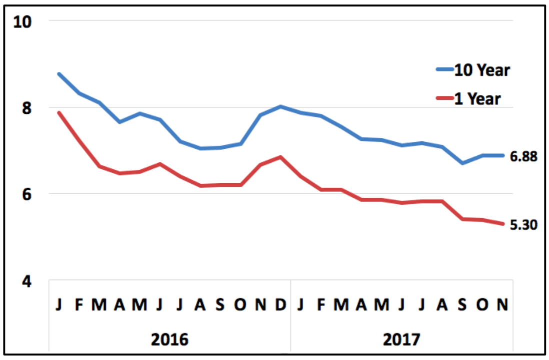
- BI Repo Rate (7-day, Nov '17)
  4.25%
- GDP Growth (y.o.y, Q3 '17)
  5.06%
- Inflation (y.o.y, Nov '17)
  3.35%
- Core Inflation (y.o.y, Nov '17)
  3.05%
- Inflation (mtm, Nov '17)
  0.20%
- Core Inflation (mtm, Nov '17)
  0.13%
- Credit Growth (y.o.y, Oct '17)
  8.05 %
- FX Reserve (Nov '17)
  $125.96 billion

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

For the last three months, USD/IDR moves at narrow range around 13,500 level and we expect Rupiah to remain relatively stable in the coming months. Concern about monetary policy normalization in US, Eurozone, and most probably Japan, seems to have receded, as shown by just slight reduction in FX reserve over the last month. We see the risk of currency volatility like in 2013 (Taper tantrum) or 2015, to be rather low, as major central banks have managed to reduce panic and the resulting volatility by announcing guidelines and timetables of policy normalization.

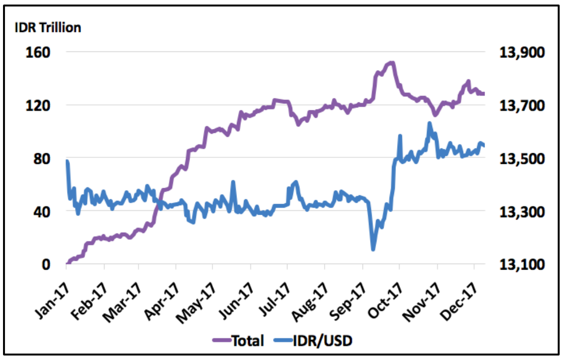
However, even if such panic occur, Bank Indonesia is now in a better position to defend Rupiah from large currency volatility should there be some unpredictable moves in coming months, given that Indonesia have sufficient level of FX reserve and that capital outflow has largely receded in the last month. Furthermore, we expect inclusion of Indonesia sovereign bonds as investment-grade securities following upgrade by S&P earlier this year will continue to provide capital inflow, as Indonesia domestic bond market still offers highest return among investment-grade markets.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

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



Source: CEIC

In a new development, oil price seems to increase in recent months, which poses some risk to inflation, particularly if the price increase worsens the budget deficit and forces government to raise the price for RON88 gas and diesel. Brent price, for example, have increased to $65/barrel due to combination of OPEC's success to control oil supply, increasing instability in the Middle East, and pipeline outage in North Sea. If the rise in oil price continues in coming months, it may also push the price of other commodities and thus can accelerate inflation, even if the effect is rather limited. Combining weak domestic case to cut policy rate and manageable external factor, Bank Indonesia will have to maintain policy rates in the next few months.