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MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

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Highlights

- Bank Indonesia should maintain its policy rate in coming months, with bias towards looser monetary policy
- December inflation close to 4% target, although core inflation suggests still-weak consumer demand until end of 2017
- USD to be rather weak despite Fed rate hike; more capital inflow reduce concern about currency risk in 2018

Macroeconomic & Financial Sector Policy Research

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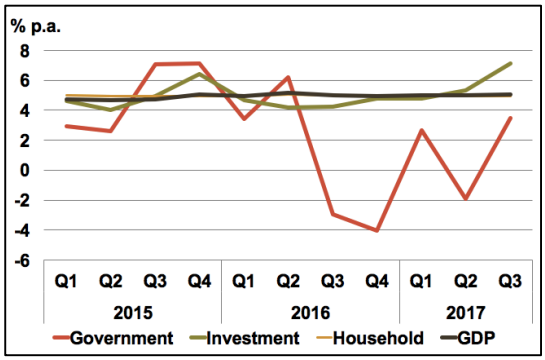
December inflation figure gave mixed signal about the exact economic condition, but overall FY 2017 result suggests that a relatively stable inflation has become the norm. Barring any move to cut implicit fuel subsidy, we see 2018 inflation to remain within BI's goal of 3.5±1%. While stable inflation and improving global growth will slightly improve 2018 growth, we still view government's growth target, as set by Ministry of Finance, to be still overly optimistic. Improvement of growth prospect also still leaves room for more accommodative policy stance, given still-low core inflation. From external side, concern about shocks to Rupiah should also be largely reduced by now, given milder-than-expected market reaction to December rate hike by Federal Reserves. For now, however, Bank Indonesia may want to maintain wait-and-see attitude and hold its policy rate.

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

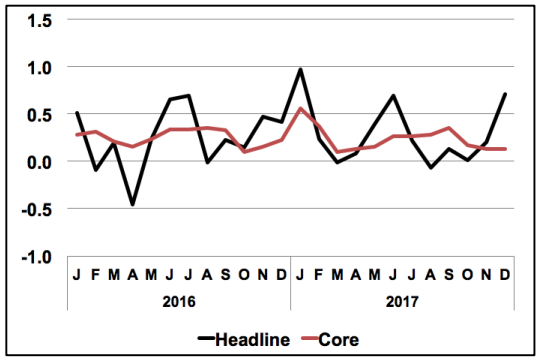
Inflation for FY 2017 tells two different stories, particularly with higher-than-expected inflation in December 2017. On the surface, headline inflation at 3.61% and accelerating December inflation suggests a remarkable policy success, as it is close to 4% target in 2017, and should be responded with relatively more cautious stance ahead. However, when we look at core inflation, the picture is slightly different; at 2.95%, core inflation seems to indicate that underlying economic conditions are still below its long-run potential. The month-to-month inflation rate tells the same message; the sum of core inflation is 2.91% in 2017. Household demand have not fully responded to improvement in economic conditions and rate cut.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

This condition may change in 2018 as strong increase in real investments and export, with a very robust growth in Q3 of 7.11% y.o.y and 17.27% y.o.y., will translate to job and wealth creation. 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, even if low core inflation still warrant some bias towards more accommodative stance.

On the other hand, higher commodity prices may pose risk to BI's 2018 inflation target. With crude oil crossing $70/barrel level recently and budget deficit is projected to still be above 2% level, there may be pressure to cut stealth subsidies (current policy to artificially set price of RON 88, 90, and subsidized diesel below market price and let Pertamina lose money on its fuel distribution business) to improve budget condition, even if such scenario may be politically

Key Figures

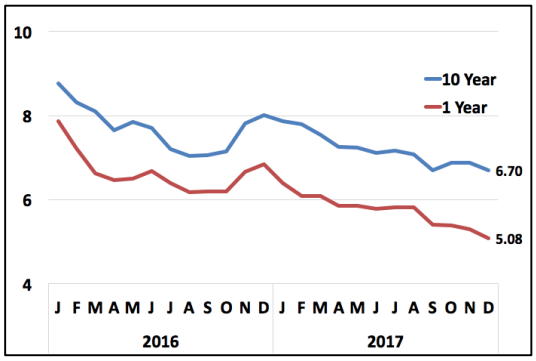
- BI Repo Rate (7-day, Dec '17)
  4.25%
- GDP Growth (y.o.y, Q3 '17)
  5.06%
- Inflation (y.o.y, Dec '17)
  3.61%
- Core Inflation (y.o.y, Dec '17)
  2.95 %
- Inflation (mtm, Dec '17)
  0.71%
- Core Inflation (mtm, Dec '17)
  0.13%
- FX Reserve (Dec '17)
  $130.20 billion

difficult. 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.

Bank Indonesia to Maintain Wait-and-See Attitude

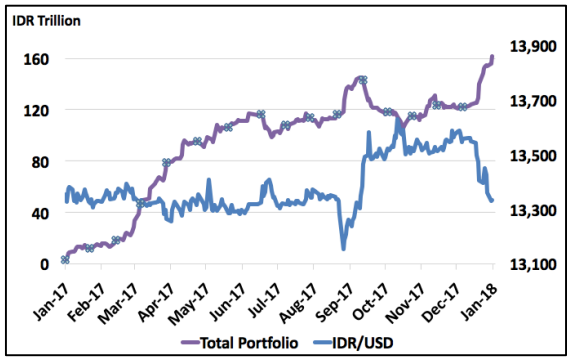
With regards to stability of Rupiah exchange rate, Bank Indonesia may breathe more easily now as USD/IDR have appreciated back to 13,300 level and we expect Rupiah to remain relatively stable in the coming months. Concern about monetary policy normalization in US, Eurozone, and most probably Japan, seems to have receded, and we are rather surprised by milder-than-expected reaction to Fed rate hike in December 2017. In fact, USD seems to have actually weakened in recent days and global investors seem to be in rather euphoric state. This is evident in strong capital inflow into Indonesia (Figure 4) and global equities, which drives Rupiah higher (Figure 4), bond yields lower (Figure 3), and Jakarta Composite Index to reach new high. Bank Indonesia apparently even tried to contain recent appreciation, as shown by record-breaking foreign reserves at $130.2 billion in December 2017.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow, in the last 12 months



Source: CEIC

The fact that USD weakens despite recent Fed rate hike, tax cut, and strong performance of US equities is remarkable and may be of interest to Bank Indonesia. Rather than caused by economic factors, recent USD weakness may be caused by US political instability, specifically Trump's isolationist rhetoric and policies. A paper by Eichengreen, Mehl, and Chitu (2017) suggests that USD holding by central banks worldwide, aside from driven by US economic dominance, is also driven by motive to seek geopolitical security through commitment to hold foreign reserves in USD. This can be seen as a *quid pro quo*; in return of a nation's commitment to hold foreign reserves in USD, which provides lower borrowing cost to US, they expect US to return the favor by continuing its commitment to guarantee its geopolitical security.

Trump's rhetoric of American First, disengagement with global geopolitical affairs, and threat to global peace (unnecessary war of words with North Korea, for example) somewhat reduce credibility of US commitment to maintain geopolitical security. This, in turn, may explain reduction in composition of USD as share of global amount of foreign reserves, from almost 66% in Q1 2015 to 63.5% in Q3 2017. As Trump's actions and rhetoric will not change in foreseeable future, there is good chance that USD may continue to weaken and further reduce risks of Rupiah depreciation in 2018. As things currently stand, Bank Indonesia may adopt wait-and-see attitude for the next few months with bias towards looser monetary policy.