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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

March 2018

Highlights

- Bank Indonesia should maintain its policy rate, focus more on direct intervention in forex market rather than contemplating a rate hike
- February y.o.y core inflation is still disappointingly too low, signaling weak demand
- Market expectation of four Fed rate increases this year may put even more pressure on Rupiah

Macroeconomic & Financial Sector Policy Research

Febrio N. Kacaribu, Ph.D.
(Head of Research)
febrio.kacaribu@lpem-feui.org

Alvin U. Lumbanraja
alvin.lumbanraja@lpem-feui.org

Denny Irawan
denny.irawan@lpem-feui.org

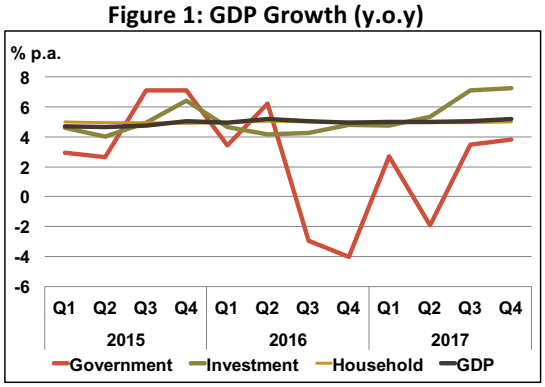
Syahda Sabrina

Expectation of faster interest rate hikes by Federal Reserves, with March rate hike deemed imminent by market participants, has initially led to portfolio capital outflow in the last month. However, market reactions to what basically is expectation of four rate hikes by Federal Reserves this year has somewhat tapered off, which shows market trust in macro fundamentals of Indonesia. Inflation also seems to have stabilized, albeit at very low level of around 3% for headline inflation and 2.5% for core inflation and expected to slightly inch higher due to consumptions related to 2019 General Election campaign spending. As risks for Rupiah at the moment comes mostly from exchange rate, Bank Indonesia may want to hold its policy rate for now and focus on defending Rupiah through direct intervention in forex market.

Too-low, Sub-3% Inflation

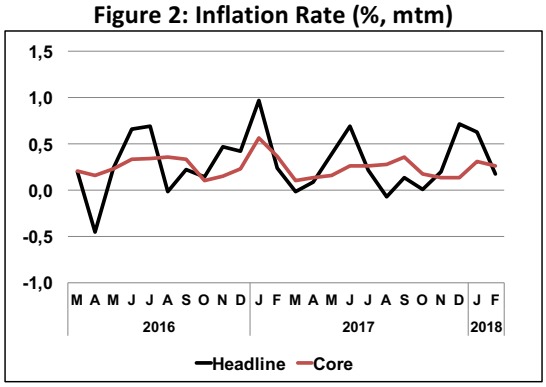
February inflation somewhat reflects the expected domestic trend where inflation this year is driven more by increases in commodity prices, whereas core inflation will remain within 2.5-3.5% level. On month-to-month basis, headline and core inflation are 0.17% and 0.26%, as effect of increase in non-subsidized fuel and cyclical trend has tapered off. Similar trend is shown when we look at inflation on year-on-year basis, with headline inflation and core inflation at 3.18% and 2.58%.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Core inflation clearly shows that aggregate demand is still low. However, consumption and inflation may get its eventual boost by three favorable factors this year. First, stronger global economic growth globally has also increased commodity prices, especially CPO, crude oil, and metals. This will particularly help sizable portion of Indonesian population who works in resource-related sectors. Second, the rise of private US shale producers has recently proven that they serve as key competitors for OPEC producers that can very rapidly increase oil production in response to higher oil price; oil price will not rise much higher than recent high of USD70/barrel. Third, 2019 general election campaign, which will start later this year, historically tends to significantly boost consumption. Overall domestic condition is therefore conducive for BI to keep policy rate as it is.

Exchange Rate Intervention to be More Effective Against External Pressure

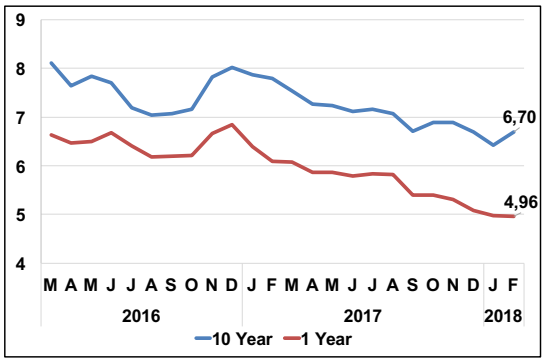
As we previously noted, most of the pressure for Rupiah in coming months will still come from external side. In particular, healthier and more robust US economic condition has created pressure for Federal Reserves to increase interest rates even faster, with most Wall Street analysts now expect 4 rate hikes this year, up from 3 rate hikes consensus in previous months.

Key Figures

- BI Repo Rate (7-day, Feb '18) **4.25%**
- GDP Growth (y.o.y, FY 2017) **5.07%**
- GDP Growth (y.o.y, Q4 '17) **5.19%**
- Inflation (y.o.y, Feb '18) **3.18%**
- Core Inflation (y.o.y, Feb '18) **2.58 %**
- Inflation (mtm, Feb '18) **0.17%**
- Core Inflation (mtm, Feb '18) **0.26%**
- FX Reserve (Feb '18) **USD128.1 billion**

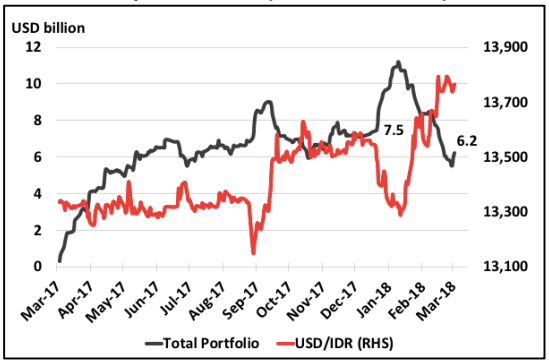
Expectation of faster interest rate hikes from Federal Reserves has triggered capital outflow throughout last month and caused Rupiah to depreciate by around 3%, from 13,300 to around 13,750 level. BI responded accordingly by providing more USD to the market, as shown by reduction of almost USD4 billion in foreign reserves during the month of February.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Last 12 months)



Source: CEIC

It is interesting to note that after initial selloff in February, Rupiah has stabilized at 13,700 level in recent weeks and net capital inflow to bond market was recorded at USD700 million in the last week alone. This could be an indication that the market has completely priced in the Fed Funds Rate hike this week. To date overall, the portfolio investment is still recording net outflow of USD1.3 billion (See Figure 4). The yield for 1-yr IDR government bonds continued to decrease, while the yield for 10-year bonds increases. There are several factors that made the market to react relatively less negatively to Fed interest rate hike as compared to 2015. First, IDR-denominated assets are comparatively attractive enough, even with rising USD interest rate. Current domestic economic fundamental is now in a more robust position compared to 2015, with lower current account deficit, higher economic growth, and low inflation. Indonesia is still among the favorite destinations for FDI in 2018. Finally, market participants are aware that Bank Indonesia is more prepared to intervene in forex market to prevent runaway depreciation, given the size of foreign reserves (USD128.1 billion)

Bank Indonesia therefore may afford to hold policy rate at current level and should avoid the temptation to increase interest rate as a response to depreciating Rupiah. Increase in policy rate is less effective than direct intervention in forex market to halt depreciation, given the adequate size of foreign reserves. Furthermore, given the adverse effects of an increase in policy rate to market interest rate, inflation, and GDP, a policy rate hike will result in a net negative impact to the overall economy. Barring significantly bigger negative external news, such as increased probability of trade war due to implementation of wide-ranging protectionist policies under Trump administration, Bank of Indonesia should be able to manage the external pressures on IDR throughout 2018.