BI Board of Governor Meeting

April 2018

Highlights

- Bank Indonesia should maintain its policy rate, continuing its focus on direct intervention in forex market if needed
- March y.o.y core inflation is still low, but overall inflation increases quite rapidly
- Pressure on Rupiah due to expectation of four Fed rate increases this year has eased but may increase again as the Fed decision date nears

Macroeconomic & Financial Sector Policy Research

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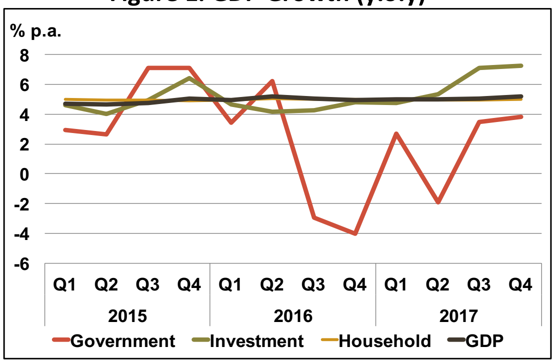
Portfolio capital flow has turned positive in the last month, signaling tapered market reactions to expectation of four rate hikes by Federal Reserves this year. Market trust in macro fundamentals of Indonesia and BI's signal of firm commitment to defend Rupiah against further depreciation also helped to improve market sentiment and stabilize USD/IDR exchange rate around 13,700 level. Headline inflation also have improved, with 3.40% headline inflation and 2.67% for core inflation signaling slow but steady improvement of consumptions. With remaining risks for Rupiah comes mostly from exchange rate, Bank Indonesia should continue its course of defending Rupiah through direct intervention in forex market and hold policy rate steady.

Improved Overall Inflation, But Core Inflation Still Disappoints

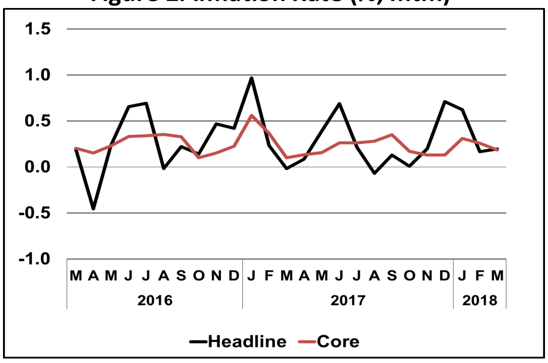
March inflation continued to reflect prevailing domestic trend in recent months where commodity prices rise faster than durable goods prices, thus leading to higher headline inflation and lower core inflation. This trend is evident on March month-to-month inflation, where headline and core inflation came at 0.20% and 0.19% (compared to 0.17% and 0.26% respectively in February). Similar trend is shown when we look at inflation on year-on-year basis, with headline inflation and core inflation at 3.40% and 2.67% level respectively (compared to 3.18% and 2.58% last month).

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Slight improvement in core inflation suggests that consumption may slightly increase this year. This is supported by key drivers of March inflation, which includes clothing and personal wearables (4.11% y.o.y) and processed foods, drinks, and tobacco (4.06% y.o.y), suggesting that non-durable, non-volatile consumptions started to pick up the pace. Despite higher market prices for energy prices, particularly crude oil, we expect government to continue its policy of keeping RON88, RON90 gasoline and diesel price at current level, the lack of merit of such action from policy perspective notwithstanding. We expect the government and Pertamina can sustain this policy in the short run from the perspective of the budget's flexibility. With manageable inflationary risk for this year, it is therefore conducive for BI to keep policy rate at current level for several months to come.

Focus on Exchange Rate Intervention Is Still Desirable

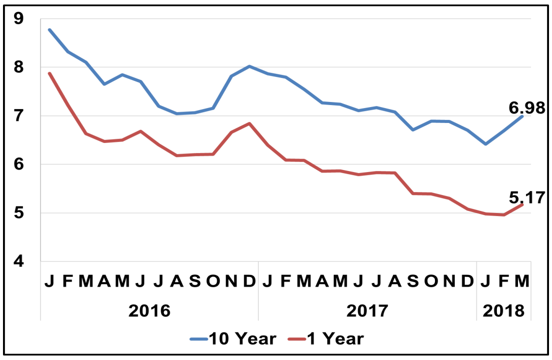
Even as 4 rate hikes by Federal Reserves this year are deemed imminent by the market, March data suggests that investors have become more comfortable with emerging market assets, particularly with Indonesia. This is shown by around $2.5 billion cumulative net inflow in the

Key Figures

- BI Repo Rate (7-day, Mar '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, Mar '18)
  3.40%
- Core Inflation (y.o.y, Mar '18)
  2.67%
- Inflation (mtm, Mar '18)
  0.20%
- Core Inflation (mtm, Mar '18)
  0.19%
- FX Reserve (Mar '18)
  USD126.0 billion

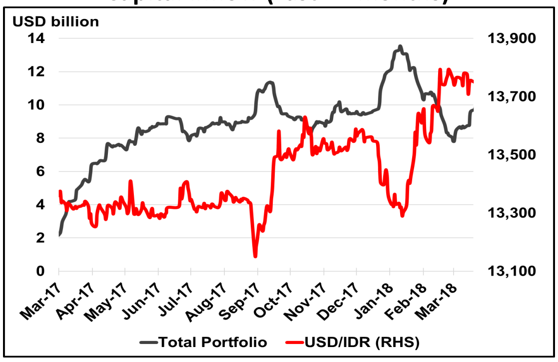
last 30 days and relatively stable USD/IDR at around 13,700. BI responded accordingly by slightly reducing intervention, as evidenced by reduction of USD2.0 billion in foreign reserves in March, compared to almost USD4.0 billion in February. The average yields of 10-yr Indonesian Government bonds significantly increased to 6.98% in March; but it has reversed direction in the first two weeks of April to around 6.75%. We expect a flat trend for the yields, if not continue slightly decreasing throughout the year.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

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



Source: CEIC

Several structural factors and new developments can be attributed to more positive market reactions in the last 30 days. First, IDR-denominated assets are comparatively attractive enough, even with rising USD interest rate. Relatively more stable inflation and higher expected GDP growth rate for 2018 means that domestic economic fundamental is now in a more robust position. Market participants are also aware that Bank Indonesia has signaled its commitment to intervene in forex market to prevent runaway depreciation by spending almost $6 billion in foreign reserves in the last two months only. Subsiding concern about possibility of trade wars between major economies, improvement in net export of goods in March, and latest rating upgrade from Moody's also serve as favorable factors for Indonesian assets, thus explaining recent capital inflow.

Stable exchange rate is crucial for improving export performance, given that Indonesia's exports are highly dependent on foreign inputs. Among several episodes of depreciating and highly volatile Rupiah, 2013-2015 is the most pronounced period. An exchange rate depreciation of 18% per year during that period was accompanied by very depressed exports and imports at the same time. The total trade (sum of export and import) value decreased from about USD400 billion to only about USD300 billion per year. Bank Indonesia therefore should continue its course of stable policy rate at current level and focus on affirming commitment for a stable exchange rate. Given the size of its foreign exchange reserves, BI should be able to manage the external pressures on IDR throughout 2018 mainly through direct intervention in the forex market.