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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

July 2018

Highlights

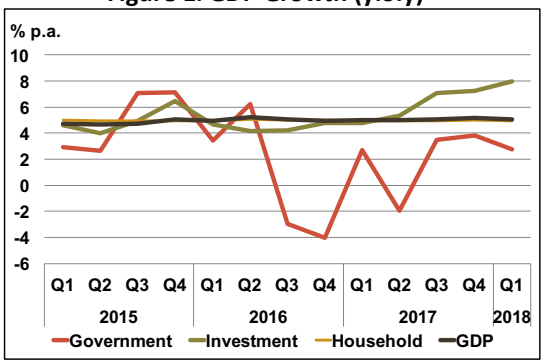
- Bank Indonesia can afford to hold 7-days RRR after raising it by 100 bps in the last 3 months
- June inflation shows that consumption is relatively weak despite improvements in key real-sector indicators
- Risk of further Rupiah depreciation is contingent upon external factors, particularly the risk of trade wars

Bank Indonesia's decision to raise 7-days Reverse Repo Rate by 100 bps in the last three months have shown meaningful results with relatively stable Rupiah in the last two weeks. Clear and strong signals from Bank Indonesia that they prioritize exchange rate stability has reduced uncertainties in the market due to Federal Reserve's decision to raise Fed Fund rate faster. With lower volatility in the global market compared to last month and absence of further negative factors, Bank Indonesia has ample room to hold its benchmark rate this Thursday, given that domestic inflation is still very low. Going forward, Bank Indonesia still needs to closely monitor potential sources of downward pressure for Rupiah, such as ongoing trade war between United States, China, and EU or price volatility of key export commodities.

Inflation Is Still Low Despite Improvement of Key Real-Sector Indicators

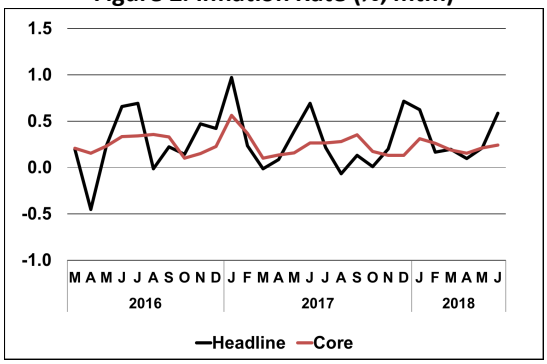
Domestic condition in June has not shown meaningful change from 2017, as consumption growth is still relatively stagnant. This trend is indirectly observed in June headline and core inflation, which stood at 3.12% and 2.72% level (y.o.y) respectively (compared to 3.23% and 2.75% last month), even when month-to-month inflation rose from previous month due to increasing seasonal demand around Ramadan and Eid Mubarak. Inflation is also still very low despite increase in global crude oil price, given that the government has decided to increase de facto fuel subsidy by keeping prices of Premium (RON 88), Solar (Diesel), and Pertalite (RON 90) unchanged.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Low core inflation also persisted despite indication of stronger purchasing power, which can be inferred from increases in several real-sector and financial indicators. Key real-sector indicators, such as decrease in unemployment rate to 5.13% in February 2018, decrease in poverty rate to 9.82% in March 2018, and decrease in Gini ratio to 0.389 in March 2018, suggest that aggregate purchasing power has increased. This is further supported by year-on-year increase in Consumer Confidence Index, which in June stood at 128.1 (122.4 in June 2017) and Manufacturing PMI, which in June stood at 50.3 (49.5 in June 2017), both of which indicate considerably higher consumption and manufacturing activities in Q2 2018.

While the available data are insufficient to arrive at strong conclusion, there are two plausible factors that explains relatively stagnant core inflation in the face of indication of stronger purchasing power and consumer confidence. First, current level of economic and consumption growth is still below its long-run equilibrium; there are still excess production capacity in the economy so that increase in consumption is not promptly responded by increase in price. Furthermore, inflationary pressure has been permanently decreased from 5 or 10 years ago due to adjustment in inflation expectation, which makes 5.06% GDP growth in Q1 2018 was not

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Key Figures

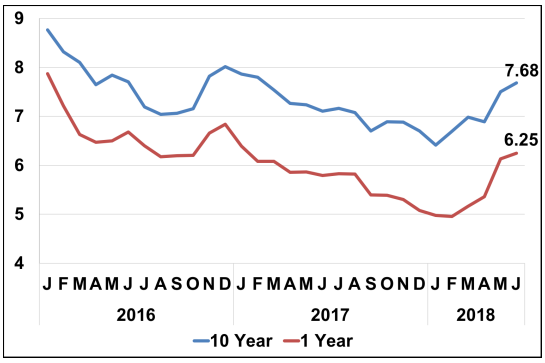
- BI Repo Rate (7-day, June '18) **5.25%**
- GDP Growth (y.o.y, Q1 '17) **5.06%**
- Inflation (y.o.y, June '18) **3.12%**
- Core Inflation (y.o.y, June '18) **2.72%**
- Inflation (mtm, June '18) **0.59%**
- Core Inflation (mtm, June '18) **0.24%**
- FX Reserve (June '18) **USD119.8 billion**

accompanied by 8.36% inflation like in Q4 2018 (when the GDP grew by 5.03%). In the short-run, these two factors reduce the concern from domestic factors for BI's interest rate decision-making process.

Pressure on Rupiah Has Eased for Now

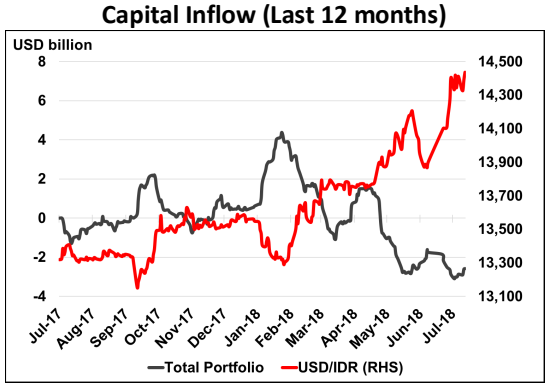
After crossing 14,400 level, movement of USD/IDR exchange rate in the last two weeks has stabilized to around 14,300-14,400 level. Relatively stable Rupiah in the last two weeks is due to Bank Indonesia's decision to increase 7-days RRR by 100 bps and active direct intervention by Bank Indonesia in forex market. Increase in benchmark rate widens yield differential between Indonesian assets and USD-denominated assets, which stems capital outflow from Indonesian capital market. This is evident from the trend of net capital inflow in June and July (Figure 4), which shows reversal from trend of capital outflow from previous months.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

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



Source: CEIC

In addition to widening yield differential between Indonesian and USD-denominated assets, higher-than-expected increases in benchmark rate by BI also indirectly affect Rupiah exchange rate. Higher-than-expected increase sent a signal to financial market that BI's vow to prioritize exchange rate stability is credible and trustworthy. This reduces investors' concern, particularly foreign investors, of further depreciation, which could reduce profit from investment in Indonesia. Given strong macroeconomic fundamental and confidence that BI will keep Rupiah relatively stable, net capital inflow going forward should be positive and will ultimately reduce pressure on Rupiah.

We see that current asset prices in financial market has reflected expectation of faster Fed Fund rate hike, which makes short-term pressure on Rupiah relatively low and allows Bank Indonesia to hold its benchmark rate this month. Nevertheless, Bank Indonesia need to closely monitor external dynamics that may have negative impact on Rupiah, particularly ongoing trade war between United States, China, and European Union that may significantly reduce aggregate global economic growth.