MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

August 2018

Highlights

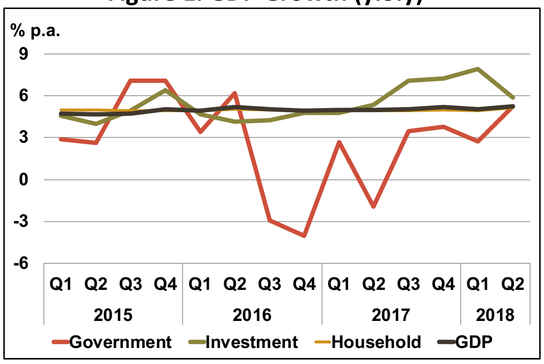
- Deterioration of market sentiment due to Turkish Lira's depreciation necessitate increase in benchmark rate
- Q2 GDP growth exceeded expectation, inextricably linked to disbursement of Eid Mubarak bonus and 13th salary
- Inflation remains low and stable following reduced pressure from food prices and stable inflation expectations

Rupiah's depreciation to Rp14,600 is driven by confluence of external factors, particularly contagion effect from Turkish Lira's rapid depreciation throughout emerging markets. Additionally, market still take into account risk of reduction of global growth due to trade war between US, China, and EU, and its negative implication on Rupiah's exchange rate. We see strength of Indonesia's economic fundamentals and credibility of BI's promise to defend exchange rate stability prevent Rupiah from experiencing rapid depreciation like other more vulnerable emerging market currencies. Nevertheless, external risks and widening current account deficit makes increase in benchmark rate this Wednesday necessary.

Inflation Remains Low and Stable, Consumption Growth Exceeded Expectation

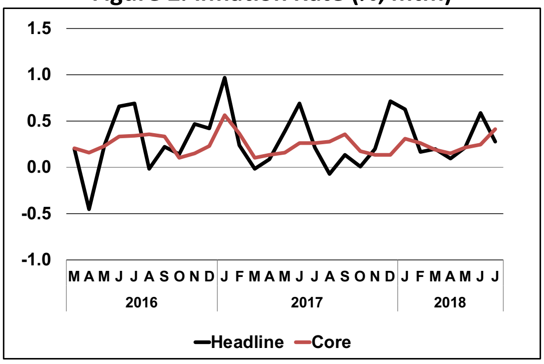
Amid increase in seasonal demand following Eid Mubarak season and approaching Eid al-Adha season, headline and core July inflation only increased slightly to 3.18% and 2.87% (y.o.y) from 3.12% and 2.72% (y.o.y) respectively in June. While monthly headline inflation was down slightly to 0.28% (mtm), core inflation increased to 0.41% (mtm), the highest since February 2017. Increase in core inflation is driven by increase in costs of various input goods due to Rupiah depreciation and commencement of new school year. On the other hand, government's decision to maintain subsidized fuel price kept overall inflation relatively stable; administered goods inflation is down to 2.11% (y.o.y) in July from 2.91% (y.o.y) the previous month.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Low and stable inflation also shows that GDP and consumption growth, which at 5.27% and 5.14% (y.o.y) exceeded market's expectation, are still below its long-run potentials. Increase in consumption growth is mainly driven by services and non-durable goods consumptions, such as hotel and restaurants and non-restaurant foods consumptions. Growth of durable goods consumption, such as household equipment, also increased from Q1 2018. These figures show broad-based improvement in household sentiment, which is inextricably linked to government's THR (Eid Mubarak bonus) and 13th salary policy. This move is evident in increase of government's consumption growth to 5.26% (y.o.y) in Q2 from 2.73% in Q1.

If consumption growth is relatively robust, manufacturing sector growth surprisingly declined to below-4% level in Q2 from around 4.5% (y.o.y) in Q1. This decrease in manufacturing growth is mainly driven by negative growth of pulp and paper manufacturing and chemical and pharmaceutical manufacturing, while growth of leather and apparels manufacturing grew by more than 11% (y.o.y). However, strong consumption growth indicated that weakness in manufacturing growth may be temporary in nature and was caused by longer-than-usual Eid

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Key Figures

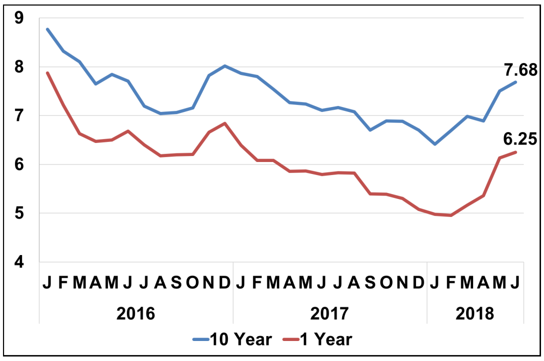
- BI Repo Rate (7-day, July '18)
  5.25%
- GDP Growth (y.o.y, Q2 '17)
  5.27%
- Inflation (y.o.y, July '18)
  3.18%
- Core Inflation (y.o.y, July '18)
  2.87%
- Inflation (mtm, July '18)
  0.28%
- Core Inflation (mtm, July '18)
  0.41%
- FX Reserve (July '18)
  USD118.3 billion

Mubarak holiday period compared to previous years. We see manufacturing sector growth to return to above 4% level in Q3.

Turkey's Contagion Effect Drives Emerging Markets' Downturn

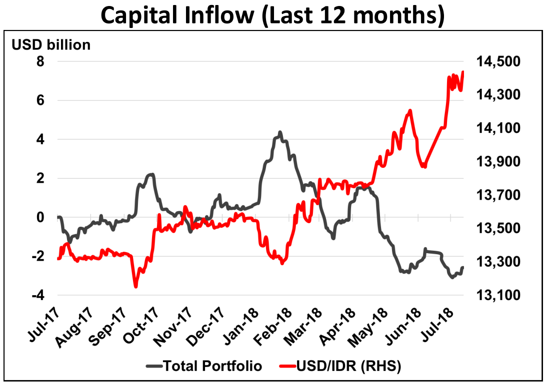
After brief period of appreciation in the first weeks of July, Rupiah began depreciating again to Rp14.600, lowest level since 2015. If previous episode of depreciation was driven by market's uneasiness following increased risk of global growth slowdown due to trade war that was initiated by US, conditions in Turkey caused further Rupiah depreciation on Monday. Turkey's fragile economic condition, high current account deficit, lack of investor's confidence in Turkey's political condition, and US sanction triggered massive selloff in Turkey, as Turkish Lira depreciated from 4.99/USD to 6.90/USD in less than 2 weeks. The selloff created contagion effect to other emerging markets, particularly those that share similar economic profile with Turkey.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

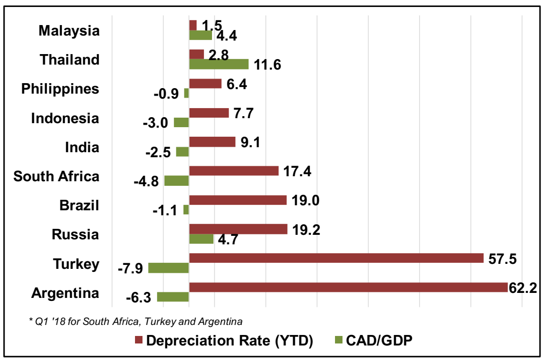
Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Last 12 months)



Source: CEIC

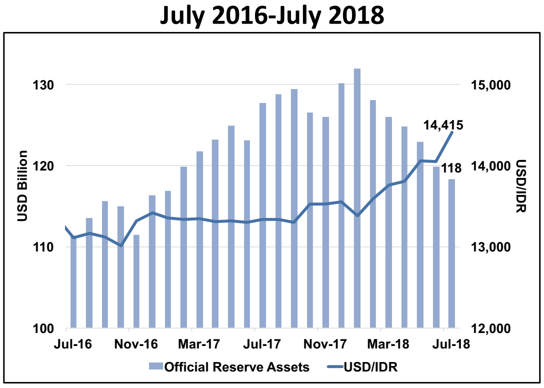
As the result, positive sentiment that resulted from announcements of better-than-expected Indonesia macroeconomic figures quickly vanished. This trend can be seen from episode of capital outflow following brief period of net capital inflow to Indonesia around late July (Figure 4). Furthermore, Indonesia's government bond yield, which briefly dropped in third and fourth week of July, increased again by Monday following selloff that was triggered by Turkish Lira.

Figure 5: Depreciation Rates and Current Account Deficit of Selected EMs



Sumber: CEIC

Figure 6: IDR/USD Official Reserve Assets July 2016-July 2018



Sumber: CEIC

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Even as Rupiah depreciated to lowest level since 2015, Rupiah's depreciation is relatively mild compared to other emerging markets (Figure 5). This is due to strong economic fundamentals, particularly decent GDP growth and inflation that is under control, and credibility of BI in stabilizing exchange rate. On the other hand, widening current account deficit in Q2 is one of the key risk in maintaining exchange rate stability, where current account deficit can exacerbate Rupiah depreciation should there be additional external pressures in the medium term.

We see that Bank Indonesia need to be more vigilant against increases in external risks in recent weeks. Should other major emerging market currencies other than Turkey deteriorate significantly, such episode might spark contagion across emerging markets like in 1997. Furthermore, if trade war between US and China continues to worsen, there is real risk of reduced global growth, which in turn will impact Indonesia's current account position negatively. Given current condition, BI should accelerate its plan to increase interest rate in order to prevent further unnecessary drop in foreign reserves.