BI Board of Governor Meeting

September 2018

Highlights

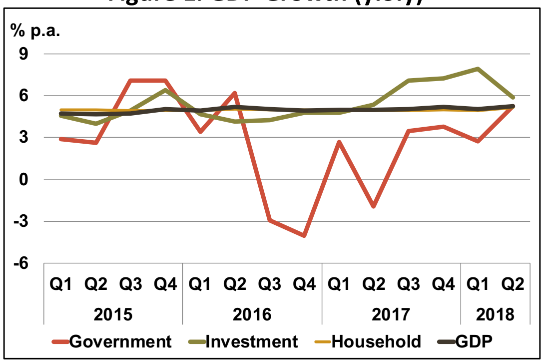
- Continued global pressure due to contagion risks from other emerging markets' currency crises necessitate increase in BI's policy rates by 25bps
- Amid exchange rate depreciation, August inflation remains low and stable; headline inflation was recorded at -0.05% (mtm)
- Considerable improvement in BI's policy credibility, particularly as market interest rate remains within policy rate corridor

Late August to early September saw rapid USD/IDR depreciation to almost 15,000 level, although the pressure on Rupiah has somewhat receded for now. This sharp Rupiah depreciation and deterioration in market sentiment is caused by external pressures. The contagion effect from currency crisis in Turkey and Argentina and recession in South Africa caused global investors to exit emerging markets and move their money to safe haven assets. Moreover, escalation of trade war between United States and China put additional pressures on Rupiah. We see that Bank Indonesia's credibility in its stabilization pledge is sufficient enough to avoid risks of currency crisis like Argentina, Turkey, or South Africa. Nevertheless, as external pressures and persistent current account deficit remain, BI should continue to anticipate potential market volatility by increasing its policy rates in the coming meeting.

Deflation in August, Annual Inflation Remains Low and Stable

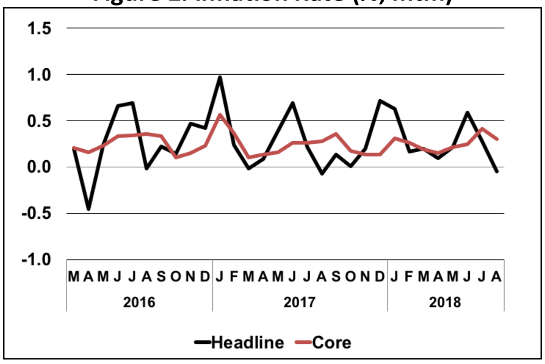
Similar to the trend in July, inflation shows only very slight increase in August. August headline and core inflation stood at 3.20% and 2.90% (y.o.y) respectively, virtually unchanged from July level, which were recorded at 3.18% and 2.87% (y.o.y) respectively in July. While monthly core inflation was stable and increased very to 0.30% (mtm), monthly headline inflation actually declined to -0.05% (mtm). This is normal, given that deflation has always occurred two months after Eid Mubarak for every year after 2015 following normalization of food prices, as indicated by volatile goods inflation of -1.24% (mtm) in August.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Low and stable inflation also shows that economic condition is relatively stable and manageable. Despite several weak points, such as weak current account condition and relatively high portion of foreign debts by private sector relative to other Asian emerging markets, Indonesia's current economic fundamentals are robust enough. Consistency of government and Bank Indonesia in managing domestic economic stability should be sufficient to keep economic growth at 5.1-5.2% in the next quarter with continued trend of low and stable inflation.

Bank Indonesia's Policy Steps and Directions Are Sufficient in Managing Rupiah Depreciation

Entering early September, USD/IDR exchange rate continued to depreciate to almost 15,000 level, or around 9% on year-to-date basis, although external pressure has receded by mid-September. Currency crisis in Argentina, Turkey, and recession in South Africa deteriorates investors' confidence in emerging market assets, which prompted capital outflow from many emerging markets including Indonesia. Additionally, USD appreciation around late August and early September was also triggered further by escalation of trade wars between US and China,

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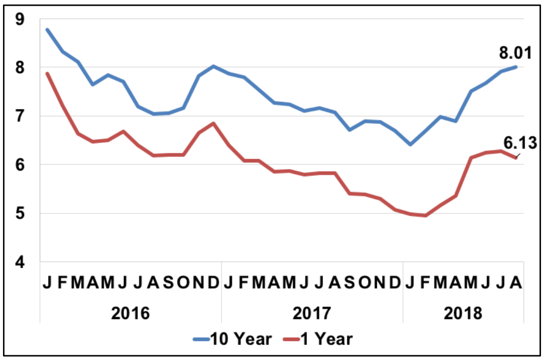
Key Figures

- BI Repo Rate (7-day, Aug '18)
  5.50%
- GDP Growth (y.o.y, Q2 '17)
  5.27%
- Inflation (y.o.y, Aug '18)
  3.20%
- Core Inflation (y.o.y, Aug '18)
  2.90%
- Inflation (mtm, Aug '18)
  -0.05%
- Core Inflation (mtm, Aug '18)
  0.30%
- FX Reserve (Aug '18)
  USD117.9 billion

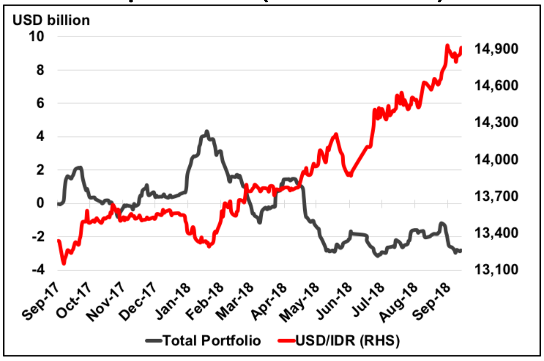
which prompted investors further toward safe haven assets. On top of external factors, current account deficit (3.0% GDP) and unstable political conditions exacerbate the depreciation of Rupiah relative to other emerging markets, and we predict that these domestic factors will cause depreciation to continue for quite some time.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

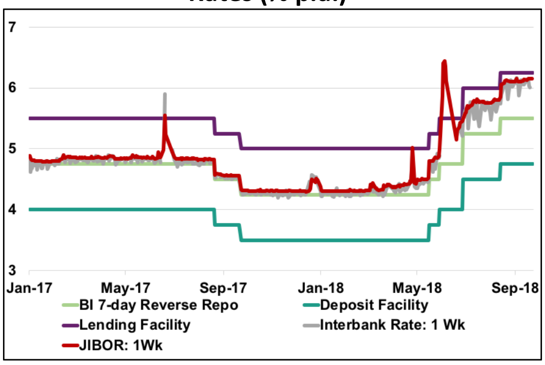
Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Last 12 months)



Source: CEIC

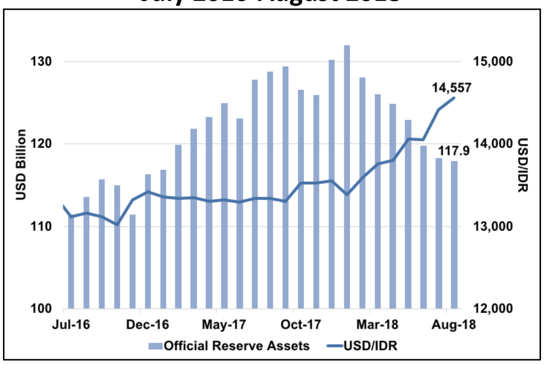
Trend of capital outflow that has happened since August is reflected in government bonds yield, where 10-year bond yield has increased to 8.01% (Figure 3) by the end of August, increased by 159.4 bps on year-to-date basis. Immense pressure on first week of September pushed this figure higher to 8.55%. At the same time, credit default swap (CDS) for 10-year government bond has also increased by 72 bps to 225.93 bps on year-to-date basis, reflecting increased perceived risks among investors.

Figure 5: Policy Rate and Market Interest Rates (% p.a.)



Sumber: CEIC

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



Sumber: CEIC

Despite immense exchange rate pressure on late August and early September, we see that exchange rate pressure on Rupiah has slightly subsided. US growth has reached its peak and will start to grow slower, while effects of trade war on US GDP will only be evident in Q3 and Q4. This prompted speculation that Fed will stop raising interest rate after this month's meeting, which reduced capital outflow from emerging market. Reduced pressure on Rupiah is shown by reduced cost of direct intervention in forex market; even in August, when pressure on Rupiah was at its greatest, foreign reserves was only reduced by USD400 million to USD117.9 billion. Furthermore, decision to use interest rate hike as preferred policy tool signals

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that Bank Indonesia is more interested in reducing volatility to manageable level rather than targeting specific exchange rate level, thus reducing speculations in forex market .

One factor behind relative success of Bank Indonesia's effort to stabilize Rupiah is that market sees BI's vow to ensure exchange rate stability as credible. BI's preemptive moves to increase interest rates by 125 bps when Federal Reserve has only raised interest rate by 50 bps this year and when the economy virtually faces no risk of inflation send a strong signal to the market that BI is ready to stabilize Rupiah from excess volatility by all means necessary. Despite continued depreciation, we see that depreciation could be far worse than it has been if BI were not proactive in raising interest rate. Moreover, reverse repo rate is also successful in keeping market interest rate (as seen by 1-week JIBOR) within the corridor of policy rate, despite increase in interest rate near lending facility rate due to shortage in liquidity in the last few weeks.

On the other hand, we still see some risk of further Rupiah depreciation in Q4, particularly if trade war between US and China continue to worsen and current account deficit continues. The near-term risk of further depreciation is evidenced by Rupiah that keeps depreciating from August level despite the fact that Dollar Index (gauge of USD strength relative to basket of several major currencies) has started to depreciate since mid-August. This signals market expectation that IDR is still relatively overpriced at this point and still have room for further depreciation. Amid reduction in foreign reserves level, BI's policy direction that emphasize increase in interest rate as primary monetary policy tool is very appropriate. Therefore, we see the need for BI to continue its hawkish stance by increasing interest rate again this month as preemptive measure to stabilize Rupiah.