BI Board of Governor Meeting

December 2018

Highlights

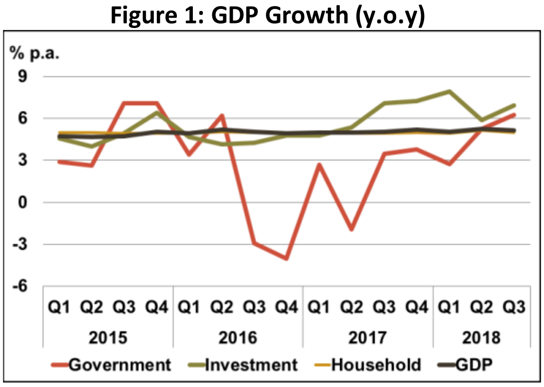
- Bank Indonesia should hold its benchmark rate this month
- Inflation is still subdued mostly dampened by government price control and relatively lower commodity prices
- Q4 and overall current account deficit are expected to continue widen above the threshold of 3 percent of GDP due to larger than expected trade deficits
- Crude oil price is a key variable to watch. Lower crude oil price helps CAD and Rupiah

Bank Indonesia's unexpected rate hike last month over widening deficits in current account as well as capital flows volatility has contributed to appreciation of Rupiah in the last six weeks. Subdued inflation despite exchange rate volatility can be explained mostly by the lower demand for consumption due to lower commodity prices, higher interest rate, and government insistence to maintain retail price of the subsidized fuel. On the external factor, we see that flattening yield curve of US Treasuries adds uncertainty to the global market. Nevertheless, except for the worse than expected trade balance data in November, most of the push and pull factors for capital inflow are working in favour of Rupiah for the next several months. Currently, by the year-to-date depreciation rate, among the emerging economies, Rupiah is among the least affected currencies by the global shocks. We view that Bank of Indonesia does not need to hike its policy rates this month.

Lower Inflation, Sluggish Demand

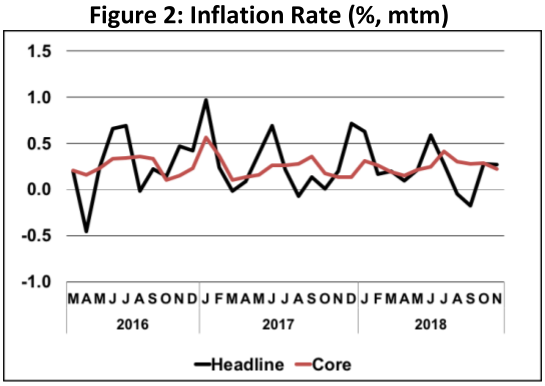
Headline and core month-to-month inflation in November 2018 slightly lower than October 2018; fell from 0.28% and 0.29% to 0.27% and 0.22% percent respectively. This movement shows unusual pattern as traditionally the inflation in the two latest months of the year always records higher inflation due to rising consumption ahead of the Christmas and New Year celebrations. Meanwhile, headline and core inflation on year-on-year basis continue to increase to 3.23% and 3.03% from 3.16% and 2,94% in previous month. The smaller upward trend of annual inflation than it does in October together with uncommon pattern in month-to-month inflation represent the signal of low and unchanged overall consumption which is mainly due to government maintained price and lower commodities price.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Subdued Inflation Despite Rupiah Volatility and Larger-than-Expected Trade Deficits

The trend of relatively subdued inflation even after Rupiah depreciates to more than 12% year-to-date can be explained by the combination of lower consumer demand, slower price adjustment from business entities, and relatively low contribution of imports to overall economy. Price of goods and services particularly for those with higher import content remain relatively low even after the price of input goods has increased. Business entities are reluctant to impose higher price as the demand for consumption has declined along with higher interest rate. The relatively small portions of Indonesian imports compared to overall economy due to low magnitude of total trade openness could also be the key point why higher cost of imports are not reflected in inflation.

Macroeconomic & Financial Sector Policy Research

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Key Figures

- BI Repo Rate (7-day, Dec '18)
  6.00%
- GDP Growth (y.o.y, Q3 '18)
  5.17%
- Inflation (y.o.y, Nov '18)
  3.23%
- Core Inflation (y.o.y, Nov '18)
  3.03%
- Inflation (mtm, Nov '18)
  0.27%
- Core Inflation (mtm, Nov '18)
  0.22%
- FX Reserve (Nov '18)
  USD117.2 billion

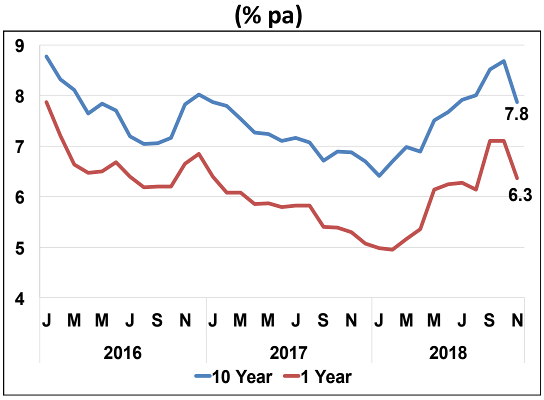
Despite the low and relatively stable inflation, trade deficit reached US$2.05 million in November 2018, recorded as the widest deficit in the last five years. Entire deficit is not only due to the oil and trade balance, but also due to the commodity export slump as the global commodities prices continue to decrease. This higher-than-expected deficits are expected to have more pressure on Q4 current account deficit as well as the value of the Rupiah. The current account deficit will be higher than 3 percent of GDP for 2018 overall. However, despite these weak points of economic condition, we estimate that overall economic growth will be still around 5.1-5.2% for 2018 overall. The financial market and the real sector to some extent have benefited from the relatively manageable macro variables despite the tumultuous global market.

Anticipate Portfolio Capital Inflow

After peaking at around 12% year-to-date depreciation rate back in October, Rupiah has enjoyed a quite strong appreciation in the last 6 weeks despite the still ongoing USD index appreciation. US midterm election results in November, a decline in global oil prices, and a potential truce in US-China trade war are among the positive shocks to Rupiah. On the other hand, domestically, GDP grows slightly above expectation, the increase on the 7-day Reverse Repo Rate in mid-November by 25 bps to 6%, and the active direct and indirect intervention by Bank Indonesia in the foreign exchange market were also key factors in the appreciation of Rupiah.

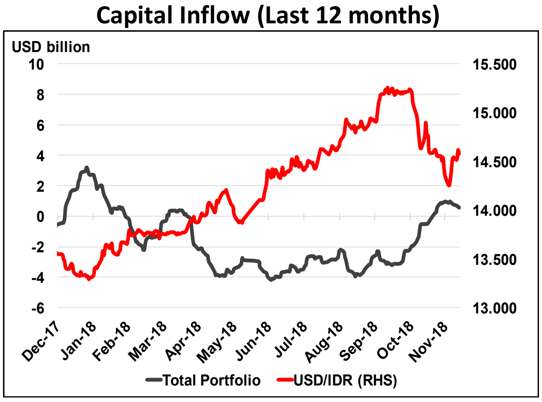
The US-China trade war, the pace of the future Fed funds rate hikes, and the dynamics of crude oil price are the dominant factors for the next several months for Rupiah. Trade war issues and the Fed funds rate will continue to be sources of uncertainty that could swing in both directions. Downward trend of crude oil price, on the other hand, is a clear positive factor for Rupiah. It helps reducing the current account deficit in the short run. Fixing the non-oil-and-gas trade deficit will take longer time and more structural reforms; weakening world's trade certainly makes this even more difficult to achieve in 2019.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

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



Source: CEIC

Given the risks above, the pull and push factors will work in Rupiah's favor in the next several months. Slightly above 5% Indonesian GDP growth rate is still above average for emerging economies. Combined with size of the market, the real sector's performance still serves an effective factor in attracting capital inflow. Prospect of slowing down of economic activity in the US for 2019 has served as the biggest push factor that would cause capital inflow again to emerging economies, including Indonesia. Inverting US Treasury yield curve has provided enough signals for global investors to start adjusting their portfolio and start buying more of EM assets

Key Figures

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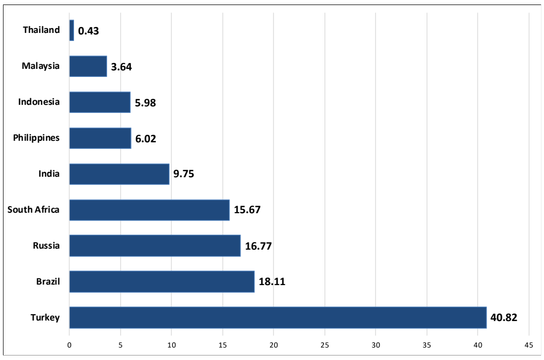
again. Bank of Indonesia will need to be ready for the "flight-to-safety" in the short run, where investors will move their money to safe-haven assets like US Treasury for the first several months after the crisis started.

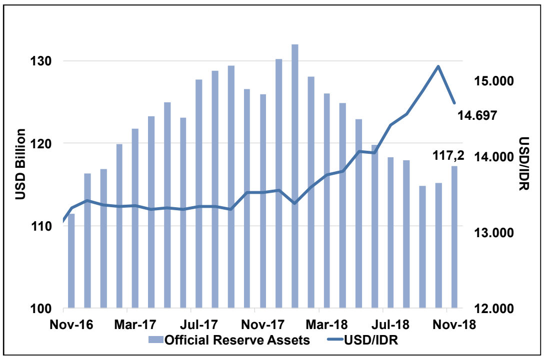
The yields of Rupiah bonds reflect the capital flow story above. After a fast increase from the beginning of the year to October, the government bond yields are experiencing a downward trend due to increased investor confidence which reduces the risk premium as a component of debt costs. Yields on 10-year long-term Indonesian government bonds fell from 8.68 percent at the end of October 2018 to 7.86 percent at the end of November 2018. A similar trend was found in yields on 1-year short-term government bonds, decline from 7.1 percent in October 2018 to 6.3 percent in November 2018.

Figure 5: Year to Date Depreciation Rates of Selected EMs (*Last updated 19-Dec-18*)



Source: Bloomberg

Figure 6: IDR/USD Official Reserve Assets (Last 24 months)



Source: CEIC

Rupiah depreciation rate (year-to-date) is now looking quite good compared to other emerging markets although it is still worse than Thailand and Malaysia. We believe that the policy of Bank Indonesia (BI) intervening in the market of recently-introduced Domestic Non-Deliverable Forward (DNDF), spot market, and Government bonds market are fairly effective in managing the liquidity in the market.

The Fed will raise its target interest rate by 25 bps in December 2018. Number of hikes in 2019 is increasingly becoming more unpredictable now. For now, we view that Bank of Indonesia has "front-loaded" enough of its policy rate hikes. To some extent, it also has moved quite "ahead of the curve." The mantra "stability over growth" has been conveyed quite effectively by both Bank of Indonesia and the government. BI's reaction function still tilted towards stability of Rupiah. The push and pull factors discussed above are working mostly in favor of Rupiah. Currently, by the year-to-date depreciation rate, among the emerging economies, Rupiah is among the least affected currencies by the global shocks. We view that Bank of Indonesia does not need to hike its policy rates this month.