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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

January 2019

Highlights

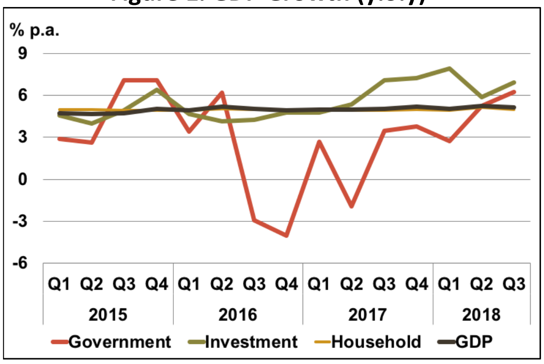
- Bank Indonesia should hold its benchmark rate this month
- Subdued inflation, albeit within the target range, signaling still soft aggregate demand
- The Fed's less hawkish stance in 2019 will help emerging markets
- Low oil price and negative Tobin Tax incentive are positive for Rupiah

Better than expected budget deficit in 2018, amidst the widening current account deficit, has positively affected the market sentiment and helped Rupiah to appreciate to around 14,000 level. Rupiah is now among the strongest emerging market currencies since October 2018 as portfolio investments are coming back, despite the Fed rate hike last month. The Fed's dovish policy stance and US-Tiongkok trade war potential truce have helped the global investors to start looking at the emerging economies' assets again. Inflation, on the other hand, is still subdued, signaling slow and steady consumption, partly due to higher interest rate in 2018. Considering the stable domestic fundamentals, the implementation of negative Tobin Tax, and the diminishing external risks, we are of the opinion that Bank of Indonesia should hold its policy rate this month.

Inflation Fairly Low Within the Target Range

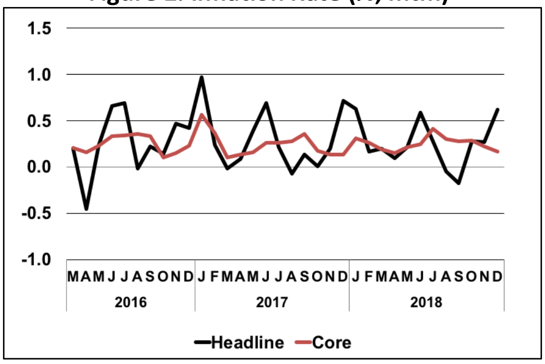
December month-to-month headline inflation rate recorded at 0.62 percent, significantly higher than the previous month at 0.27 percent. This is mainly driven by seasonal demand during Christmas and New Year celebrations. Whereas core inflation slightly dipped to 0.17 percent from 0.22 percent in November. The stable core inflation shows that aggregate domestic demand remains stable. Meanwhile, headline inflation fell from 3.23 percent year-on-year in November to 3.13 percent. 2018 inflation is fairly lower compared to inflation in 2017 which recorded 3.61 percent. Overall inflation last year has been managed adequately and comfortably subdued within the target range. There is a worry about the "hidden inflation" due to the subsidy on "premium" which could translate into an inflationary pressure sometime in 2019 if the government decides to reduce the subsidy.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Well-Managed State Budget Deficit Amidst the Widening CAD

The government's achievement in managing budget deficit in 2018, with deficit realization below 2 percent which is the smallest fiscal deficit in six years, becomes one of the main reasons why Rupiah was not further depreciated. Even though Rupiah has weakened to almost more than 12 percent (ytd) by October 2018, its performance for the full-year of 2018 ended at 6 percent (ytd).

Despite its macroeconomic resiliency, recent global turmoil has revealed Indonesia's vulnerability. Indonesia's current account deficit that has widened through 2018 remains an important concern. The deficit pressure has been reduced by the falling of the crude oil price at the end of 2018. We still believe that the elimination of the fuel subsidy, which could have many positive consequences on Indonesian competitiveness and external stability, is an important

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Key Figures

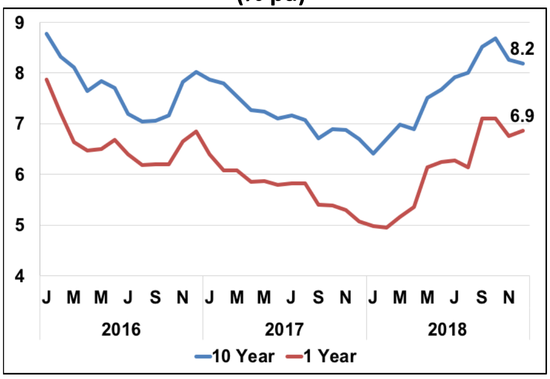
- BI Repo Rate (7-day, Jan '19)
  6.00%
- GDP Growth (y.o.y, Q3 '18)
  5.17%
- Inflation (y.o.y, Dec '18)
  3.13%
- Core Inflation (y.o.y, Dec '19)
  3.07%
- Inflation (mtm, Dec '19)
  0.62%
- Core Inflation (mtm, Dec '19)
  0.17%
- FX Reserve (Dec '19)
  USD120.7 billion

reform that the government should pursue in 2019; it would also significantly improve the efficiency of expenditure of the fiscal revenue. On the other hand, it will help Pertamina's transformation into a more competitive energy company.

Capital Inflows Amidst Global Growth Slowdown

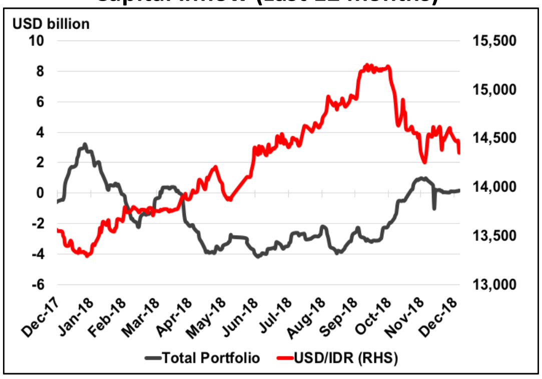
After a robust appreciation from early November, Rupiah weakened slightly to 14,481 at the end of 2018. However, as the December monetary tightening stance by the Fed was already preempted by BI's ahead of the curve action, Rupiah is now among the least fragile currencies over its regional emerging counterparts. Aside from heavy direct intervention in the forex market, BI introduced several initiatives that help improving the short term liquidity in the market. It started the strengthening the swap market in since the beginning of 2018 and also introduced the domestic non-deliverable forward (DNDF) market. When the tide turns by the end of the year, IDR, relative to other emerging markets' currencies, is reaping a bigger gain. The event of capital flow last month was also reflected in the government bond yields which recorded minor adjustment, with 1-year and 10-year government bond yield stood at around 6.9 percent and 8.2 percent (from 6.8 percent and 8.3 percent in November) respectively.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

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



Source: CEIC

IDR appreciated further against US dollar again in early 2019. Faster-than-expected appreciation is mainly driven by the market sentiment surrounding the Fed dovish policy stance to normalize and possibly pause in the near future, which prompted foreign investors to reallocate their assets into emerging market again. Along with Brazillian Real, Indonesian Rupiah is considered to be among the biggest beneficiaries of this trend of portfolio investments coming back to the emerging economies in 2019.

BI and government of Indonesia will need to be more ready this time. Influx of portfolio investments need to be given incentives to hold their IDR investments a bit longer to be less prone to sudden reversal. The government and Bank of Indonesia recently approved the special deposit account for reporting and storing the export proceeds by the exporters. The exporters from four sectors: mining, agriculture, forestry, and fisheries industries are now obligated to put their export proceeds in the domestic deposits no longer than 90 days after the export occurred. However, this is not forcing them to convert the export proceeds to IDR deposits. Nevertheless, tax authority has provided negative Tobin Tax incentives for the converted export proceeds from dollar into Rupiah and thus hold it in special deposit account; 0 percent tax for 6 months or more IDR-denominated deposits. This special deposit account could be effective in bringing in some of the export proceeds to begin taking advantage of the tax incentives which would help Rupiah in

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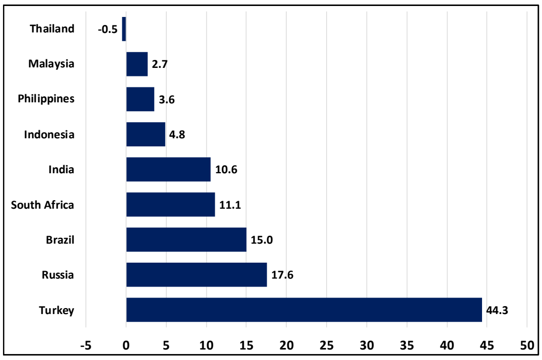
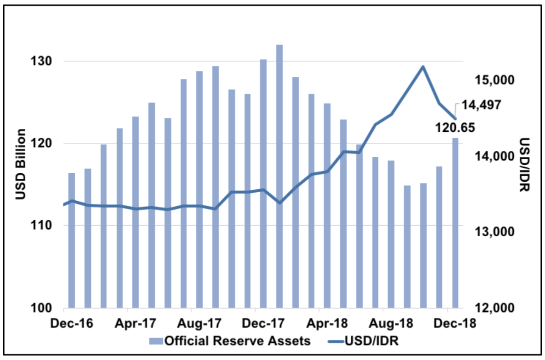
the short run. This negative tax should also help reduce the speed of "sudden reversal" if it happens again in the future. In the meantime, BI continues accumulating reserves again. USD120.7 billion reserves on December, compared to USD117.2 billion a month earlier, reflects the preference of the central bank as to how fast it will allow IDR to appreciate and how much cushion it would like to have for future potential global shocks.

Figure 5: Over Year Depreciation Rates of Selected EMs (*Last updated 12-Jan-19*)



Source: CEIC

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



Source: CEIC