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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

February 2019

Highlights

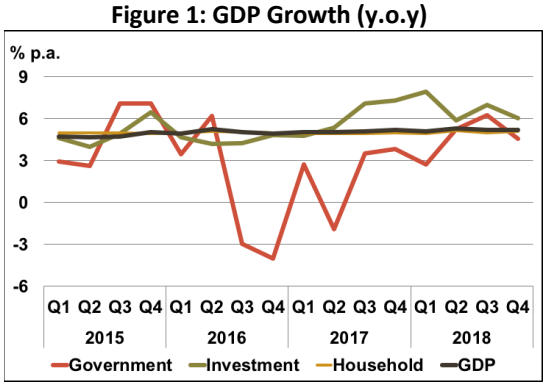
- Bank of Indonesia needs to keep its policy rates
- Better stability of volatile food prices and lower non-subsidies fuel prices are the two main drivers of deflation in January
- Rupiah continues to appreciate, recorded below Rp14,000 at the beginning of February 2019
- Weakening global economy, especially US, contributes to the portfolio capital inflow
- Crude oil price is the biggest risk for Rupiah in the medium-term

The national economy grew slightly higher than market expectations amidst global uncertainty throughout 2018 with the highest recorded growth since 2014 at 5.17% (yoy). Robust fundamental conditions were also reflected in low and stable inflation. The trend of Rupiah appreciation, with Rupiah recorded below Rp14,000 level in early February, has been driven by the strong influx of portfolio capital since October 2018. Last year's threatening external pressures have slowly subsided along with the weakening global economy that is almost certain to occur in the next two years; this will continue contribute to further lowering global commodity prices. This trend has caused challenges to the national trade balance which is mainly driven by commodities exports such as coal and palm oil. Crude oil price on the other hand will continue to be a source of uncertainty for Rupiah in 2019; the price has hit three-month high as global supply gets cut. Overall, we view that BI should maintain its current policy interest rates this month.

Subdued Inflation Within the Target Range

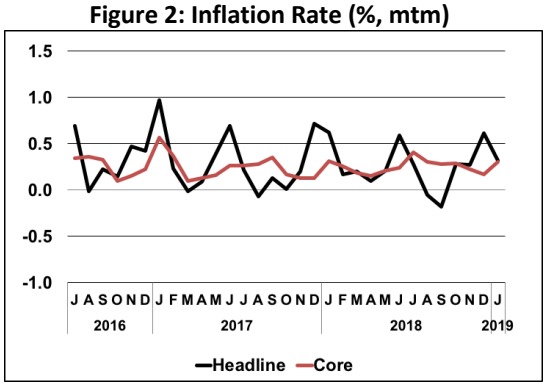
Entering the year of 2019, headline inflation in yearly and monthly basis were declined to 2.82% (yoy) and 0.32% (mtm) from 3.13% and 0.62% in December 2018. Better stability of volatile food prices and lower non-subsidies fuel prices are the two main drivers of deflation in January 2019. Even though the downward trend of inflation is quite significant, year-on-year inflation remains at BI's safe range of 2.5% - 4.5%. Meanwhile, the pattern of increasing demand for some basic household needs such as payment of house rent and salary for housekeeping at the beginning of the year has increased the core inflation to 0.3% (mtm) from 0.17% in the previous month. However, the annual core inflation did not change significantly at 3.06% (yoy) from the prior month level at 3.07% (yoy).

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Highest Economic Growth Amidst Global Uncertainty

Published Q4 economic growth reflects internal conditions that are stronger than before. The economy grew slightly higher than the Q3 2018 to 5.18% (yoy), making the national economy throughout 2018 grew 5.17% (yoy). This highest growth since the end of the commodity boom has occurred due to the positive increase from all the economic sectors in Q4 2018 with the highest growth recorded in the service sector at 9.08% (yoy). The biggest sector by share, the manufacturing industry, grew positively even but remained below 5%. Fortunately, the wholesale and retail trade sector grew significantly by 5.58% (yoy) due to robust domestic consumption growth amid economic uncertainty throughout the past year. This strong consumption thus

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Key Figures

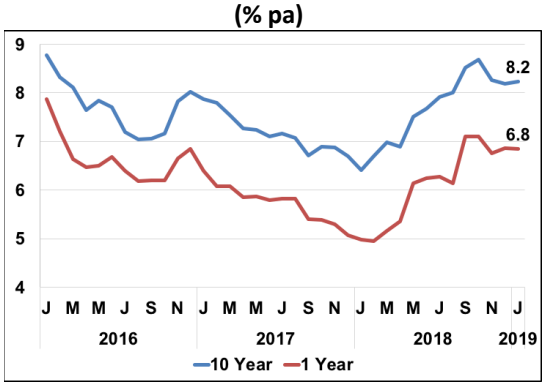
- BI Repo Rate (7-day, Jan '19)
  6.00%
- GDP Growth (y.o.y, Q4 '18)
  5.18%
- Inflation (y.o.y, Jan '18)
  2.82%
- Core Inflation (y.o.y, Jan '19)
  3.06%
- Inflation (mtm, Jan '19)
  0.32%
- Core Inflation (mtm, Jan '19)
  0.30%
- FX Reserve (Jan '19)
  USD120.1 billion

becomes one of the fundamental helpers of Indonesia's internal conditions and is predicted to remain strong throughout 2019.

Strong Internal Conditions and Relief of External Pressure

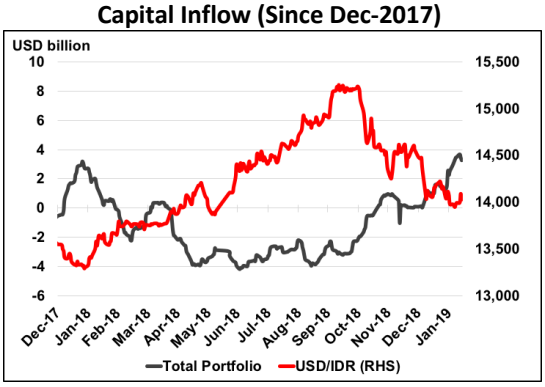
Rupiah continues to appreciate, lower-than-expected which is slightly below Rp14,000 at the beginning of February 2019. This strengthening period was mainly due to increased market confidence in strengthening Indonesia's fundamental indicators during Q4 2018. The efforts of Bank of Indonesia through swap transactions, DNDF markets, and the implementation of negative Tobin Tax on natural resource export proceeds also contribute to attracting investors to the Rupiah assets. Moreover, expectations of interest rates slowdown by the Fed in 2019 through dovish monetary stance have also significantly contributed to the portfolio capital inflow until mid-February 2019. Inflow to Rupiah bonds and stocks has more than compensated the USD7.5 billion net outflows that happened during January-September 2018. Government bonds' yields stood at 6.8% (1-Yr) and 8.2% (10-Yr) in January 2019.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Since Dec-2017)



Source: CEIC

Ahead of the FOMC meeting in March, when the implied probability of a hike is close to zero, current market condition for emerging economies assets is much more benign compared to what happened last year. US economic conditions and prospects have contributed to relatively more positive market sentiment towards risky assets.

Even though capital inflows have increased since October 2018, the weakening of foreign trade flows has not yet subsided where the trade balance deficit in January 2019 slightly widened to USD1.3 billion from USD1.1 billion in the previous month. The correction in trade balance was generally continued decrease in coal price, which is affected by the expected slowing down of global economic growth. Given that the global economic conditions will continue to weaken in the next few years, achieving current account deficit of -2.5% will be challenging. The recently trending-up crude oil price, on the other hand, is one of the big sources for Rupiah right now. The oil price increase directly affects Rupiah through the worsening the trade balance; it indirectly affects Rupiah through more negative sentiment about CAD which slows down portfolio capital inflow.

Given the recent developments in the global financial and commodity markets, we view that it is best for Bank of Indonesia to keep the policy rates this month.

Key Figures

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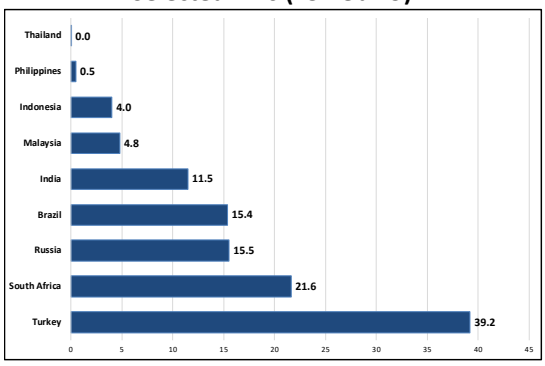
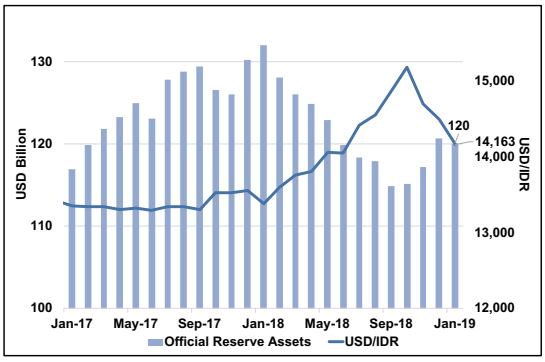
Figure 5: One-Year Depreciation Rates of Selected EMs (15-Feb-19)



Source: CEIC

Figure 6: IDR/USD and Official Reserve Assets



Source: CEIC