MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

June 2019

Highlights

- Bank Indonesia should lower the benchmark rate by 25-bps
- Inflation experienced an upsurge following the seasonal pattern
- The downward trend in commodities price will plague the economic growth in the first half of 2019
- The increase in Indonesia's credit rating has encouraged more capital inflows amid global uncertainty

Inflation rate experienced an upsurge to 3.32% (yoy), higher than 3.23% in the same period last year, partially reflecting an improvement in household demand throughout Ramadan and heading into Eid-al-Fitr celebration. Meanwhile, investment has not shown a significant improvement even after the end of the election. Current account deficit in Q2 2019 is inevitable and the target of overall deficit at below 3% of GDP in 2019 is still quite challenging. Moreover, the depressed export due to the downward trend in commodity prices will plague the economic growth in the first half of 2019.

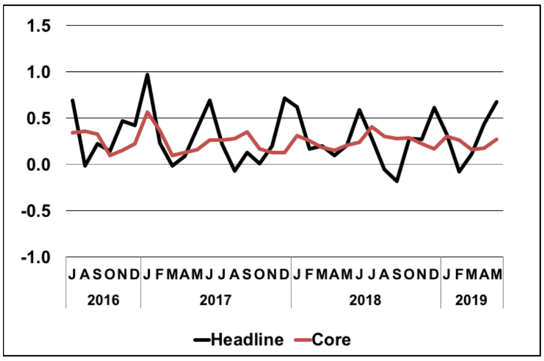
On the other hand, capital inflows have been rising, even more since the increase in Indonesia's credit rating to BBB recently, which decreases the yield on 10-year government bonds to 7.7%. This improvement is predicted to strengthen investor confidence in the Indonesian market further, giving room for BI to begin loosening its monetary policy. Moreover, the clearer signal of the Fed's interest rates cuts in the next three months can be a reference for BI to lower its benchmark rate this month by 25bps.

Higher Inflation Following Seasonal Pattern

May's annual inflation surprisingly increased by 3.32% (yoy) from 2.83% in April. The impact of Ramadan and heading into Eid-al-Fitr celebration this year is even higher than the previous year inflation of the same month, which only stood at 3.23% (yoy). Regardless of the seasonal trend, this condition reflects an improvement in domestic demand growth, which had stagnated since the beginning of 2019.

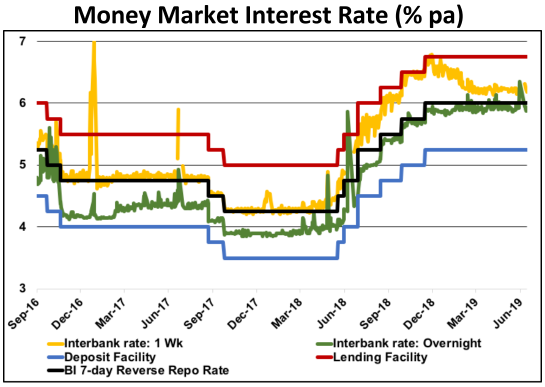
The surge was driven by higher inflation in volatile food of 4.08% (yoy) from 2.05% in the previous month. The significant increase was due to several commodities prices such as chili, chicken, garlic, fresh fish, and other vegetables. The rise in demand for transportation services during the Eid holiday coupled with the high price of airplane tickets also caused the prices in administered goods to rise by 3.38% (yoy). At the same time, core inflation was still quite manageable, increase from 3.05% (yoy) last period to 3.12%. While on a monthly basis, core inflation recorded at 0.27% (mtm), up from 0.17% in the previous month. Overall, inflation is still very managable in the near and medium term.

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

Figure 2: Interest Rate Policy and Interbank Money Market Interest Rate (% pa)



Source: CEIC

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Key Figures

- BI Repo Rate (7-day, Mar '19)
  6.00%
- GDP Growth (y.o.y, Q1 '19)
  5.07%
- Inflation (y.o.y, Apr '19)
  3.32%
- Core Inflation (y.o.y, Apr '19)
  3.12%
- Inflation (mtm, Apr '19)
  0.68%
- Core Inflation (mtm, Apr '19)
  0.27%
- FX Reserve (Apr '19)
  USD120.3 billion

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Higher Uncertainty, Encouraging Incentives for Economic Growth

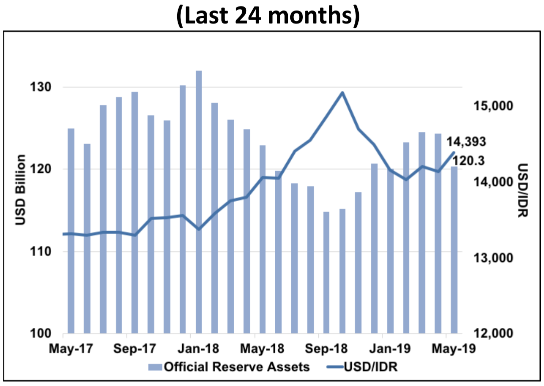
Although household consumption has increased due to seasonal patterns, other economic growth indicators, especially investment, have not shown significant improvement. Overall, recent GDP growth rate, which was only at 5.07% in the last quarter, overshadowed 2019 economic growth. The government needs to speed up reforms in the Ease of Doing Business; competing with other emerging economies trying to gain FDIs relocation as a result of the prolonged US-China trade war.

We see that the current account deficit in Q2 2019 is still inevitable, given the weakening of global commodity prices. It will continue to depress Indonesia's export that are still dominated by natural commodities. The upward trend in oil prices due to the geopolitical tension of middle east countries is burdening the efforts to achieve CAD below 3% of GDP for overall 2019.

Capital Inflows Gives Room for Monetary Easing

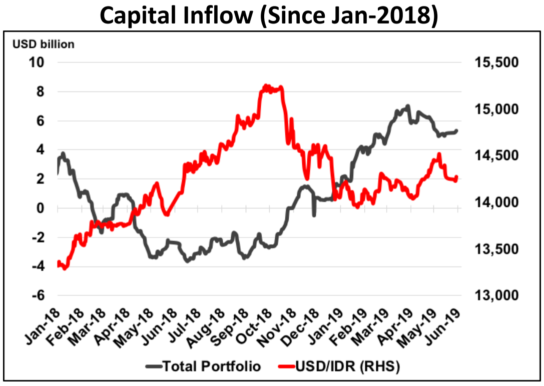
After experiencing net outflows in the mid-May, Indonesia now enjoys the net inflows of portfolio investments. It has supported Rupiah stronger in mid-June to a level of Rp14,275 with the average for overall 2019 recorded at Rp14,188. The high risk of an economic slowdown in the US, due to its business cycle and the continuation of the US-China trade war, has driven many central banks to cut their benchmark interest rates in recent weeks, resulting in more attractive yields spread between Rupiah-denominated assets relative to other currencies-denominated assets, prompted investors to move back their assets into our domestic financial market. The improvement in Indonesia's credit rating to BBB at the end of last month has also been boosting market confidence in the domestic economy, as seen from the yield on 10-year government bonds which has declined to 7.7% recently; down from 8.18% in May.

Figure 3: IDR/USD and Official Reserve Assets (Last 24 months)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Since Jan-2018)



Source: CEIC

On the other hand, external uncertainties due to trade war tension, middle east geopolitical issues, and Brexit remain as challenges for financial markets which can pose a high risk to the financial aspects either in the balance of payments or in the real sector. Therefore, Bank Indonesia still needs to maintain the resilience and sustainability of macroeconomic condition carefully. Throughout May, BI has given up its foreign exchange reserves from USD124.3 billion to USD120.3 billion as part of responding to the capital outflows and maintaining foreign currency liquidity along with the cycle of dividend payment and Eid holiday period.

Key Figures

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Regardless of the need for BI to maintain its intervention in the foreign exchange market, the positive trend on capital inflows provides room for Bank Indonesia to start its monetary policy loosening stance. After this cut, we view that there will be more opportunity for Bank of Indonesia to do another 25-bps cut in second half of 2019. We project that a 25-bps cut in the Fed funds rate by the Fed's FOMC can happen as early as July. This will help Bank of Indonesia to continue its loosening monetary policy stance.