

Highlights

- Bank Indonesia should lower its policy rates by 25-bps
- Inflation within target, no trend of acceleration
- Global trade headwinds, need short term initiatives by GoI
- Indonesia's yield curve apparently has a quite strong predictive power of GDP growth

June's inflation rate slightly fell to 3.28% (yoy) from 3.32% in May. This could indicate stabilizing trend of expected inflation in the medium term. A seemingly increasing trend of core inflation in the last several months should not be misperceived as an improvement in the households' demand; it only reflects a seasonal pattern. From the external side, the global economic slowdown continues. GDP of the developed economies persistently showing lower expected growth rates until at least 2020. Big emerging market economies like China and India are not picking up growth either. This poses continuing challenge to Indonesia's external position. We project that the current account deficit (CAD) in Q2 2019 is going to be worse than the previous quarter. We maintain our view that achieving a substantial improvement of CAD in 2019 will remain a challenge. Current structural policies pursued by the GoI need to be bolstered further.

The massive influx of portfolio investments from mid-June can be partially explained by temporary truce in the trade war and higher probability of Fed funds rate cuts in the remainder of 2019. The inversion of 10Y-3M yield curve slope of the US Treasuries gives similar message. The probability of US recession, or at least a significant slowdown, in 2020 is getting bigger. On the other hand, the pull factor from the upgrade of Indonesia's sovereign credit rating to BBB starts showing some strength as well. On the political issues, the recent decision by the Constitutional Court in upholding the Presidential election contributes to reduced uncertainty in the market. We view that Bank of Indonesia should lower its policy rates this month and continue its easing stance that started last month.

Inflation Within Target, No Trend of Acceleration

Consumer prices remain well within BI's inflation target band, with the latest reading for June settling at 3.28%, slightly declined from 3.32% in May. This could indicate stabilizing trend of expected inflation in the medium term. Volatile food inflation settled at 1.70% (mtm), down from last month's inflation of 2.18% (mtm). The drop was affected by deflation in the price of garlic, chicken, and eggs. This was due to the end of the seasonality of rising food prices during the celebration of Ramadan and Eid al-Fitr. On the other hand, the government intervention to the airfare contributes to the deflation in the administered prices, recorded at -0.09% (mtm), significantly declined from May inflation of 0.48% (mtm). The month to month headline inflation fell from 0.68% to 0.55% from May to June.

The core inflation surprisingly accelerated to 3.25% in June, the highest since April 2017. While on a monthly basis, core inflation recorded at 0.38%, higher than 0.27% in the previous month. Nevertheless, this seemingly increasing trend of core inflation in the last several months only reflects a seasonal pattern; it should not be misperceived as an improvement in the households' demand.

**Macroeconomic &
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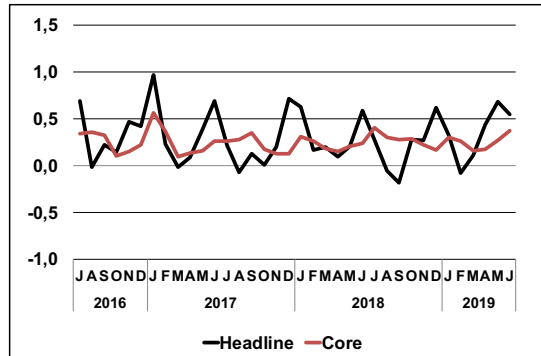
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Key Figures

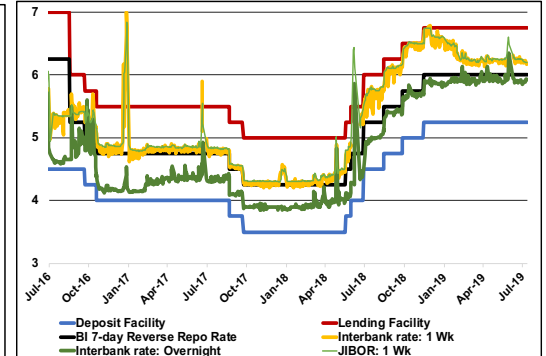
- BI Repo Rate (7-day, Jun '19)
6.00%
- GDP Growth (y.o.y, Q1 '19)
5.07%
- Inflation (y.o.y, Jun '19)
3.28%
- Core Inflation (y.o.y, Jun '19)
3.25%
- Inflation (mtm, Jun '19)
0.55%
- Core Inflation (mtm, Jun '19)
0.38%
- FX Reserve (Jun '19)
USD123.82 billion

Figure 1: Inflation Rate (% mtm)



Source: CEIC

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



Source: CEIC

Global Trade Headwinds, Need Short Term Initiatives

Trade balance in June continued to record a surplus (USD200 million), amidst global commodity price downturn, thanks to slower import growth. The decline in imports of capital goods by 25.5% contributed significantly to the last month's balance. Despite five monthly trade surpluses throughout 2019, overall trade deficit for 1H 2019 stood at USD1.9 billion, deeper than the total trade deficit in the same period last year (USD1.2 billion). Given the international trade disruption, we see that the current account deficit (CAD) in Q2 2019 is going to be worse than the previous quarter. We maintain our view that achieving a substantial improvement of CAD in 2019 will remain a challenge. Our trade remains vulnerable to the swing in global prices as our export is heavily dependent on commodities. An improvement from this will require more persistent structural reforms; unlikely to be achieved in the near future. In the short run, the government will need to quickly pursue more bilateral trade and investment agreements with our current and new potential trade partners.

Indonesia's Yield Curve Predictive Power?

For several decades, the shape of the yield curve in the bonds market, generally proxied by the 10Y-3M government bond yields, has been used as a leading indicator of recession probability in the US and other advanced economies in general (Figure 3). Normally, the short-term bond's yield is lower than the long-term bond's yield. Investors demand a higher return on a long-term investment. An inverted yield curve occurs when the short-term bond's yield surpasses those of long-term bond's yield. The occurrence of an inverted yield curve, which is very rare, significantly heightened the risk perception in the bonds market.

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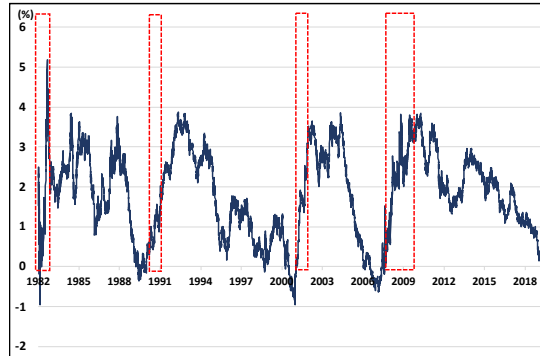
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Key Figures

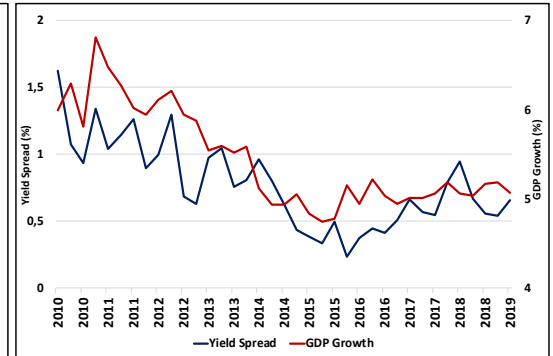
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Figure 3: Slope of US 10Y-3M Yield Curve (1982-2019)



Source: FRED St. Louis

Figure 4: Slope of Indonesia 10Y-3M Yield Curve (2010-2019)



Source: CEIC

In the US, an inverted yield curve has always been followed by a recession, with only one exception in the early 1960s. The yield curve is generally a good predictor of recessions; it is believed to contain some leading information about the near-future economic activity, especially when the country has a deep financial market. The inversion of the US yield curve, which began in March 2019, has raised a negative perception on the American economic performance in the near future.

Unlike the US' yield curve, Indonesia's yield curve is not directly connected to the real economic activity. It is usually driven by the portfolio investment inflow, which makes it more integrated to the global capital market. Despite no crisis events since 1997, the 10Y-3M yield curve in Indonesia highly explains the GDP growth rate, lagged by two quarters, with a correlation of 0.92. Apparently, Indonesia's yield curve has a quite strong predictive power of the future economic activity.

Time for Monetary Easing

Indonesia currently enjoys an increasing capital inflows of portfolio investments with a total accumulated capital inflow of about USD5 billion since May 2019. Bank of Indonesia has bought most of this influx of USD, bringing its position on the foreign exchange reserves in June 2019 increased to USD123.8 billion. Rupiah appreciates from Rp14,400 in the mid-May to Rp14,100 nowadays.

Concerns over the on-going US-China trade war tension and the Fed's dovish stance has brought capital back to emerging markets' bonds. The decreased perceived risk by investors, particularly after the improvement in Indonesia's sovereign credit rating from the S&P at the end of May to BBB, has resulted in the ongoing flow of foreign funds into the domestic market and is expected to continue. This bring the yield of Indonesian government bonds in June to be lower than in May. The yields of 10-year and 1-year government bonds have declined to 7.2% and 6.1% respectively; down from 7.8% and 6.6% in June.

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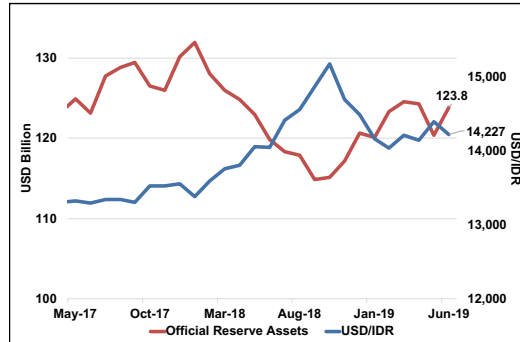
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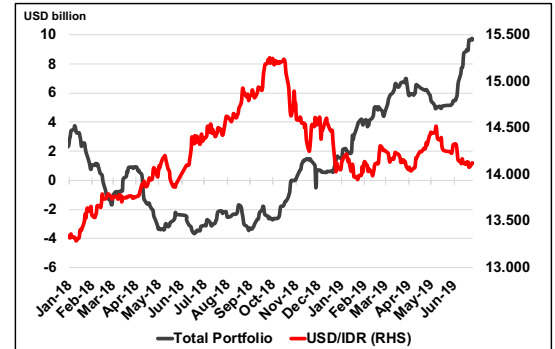
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**Figure 5: IDR/USD and Official Reserve Assets
(Last 24 months)**



Source: CEIC

**Figure 6: IDR/USD and Accumulated Portfolio
Capital Inflow (Since Jan-2018)**



Source: CEIC

BI opted to keep policy rates unchanged last month. We appreciate this decision. They lowered the reserve requirement ratio by 50 bps instead and kept accumulating more foreign reserves in the meantime, while maintaining the liquidity of the money market. However, we consider BI's policy rates now need to be adjusted this month.

The favorable trend of capital inflow, enabling BI to continue accumulating foreign reserves and maintaining the exchange rate stable at a range of IDR14,000-IDR14,300, should give more confidence to BI to cut its policy rates by 25 bps this month to 5.75%.

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