

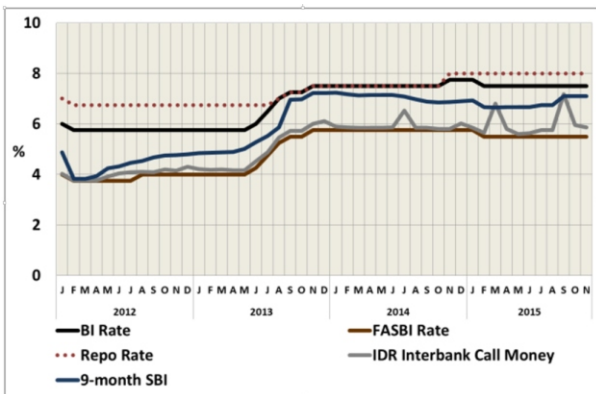
LPEM COMMENTARY

BI BOARD OF GOVERNORS' MEETING

DECEMBER 2015

With the expected interest rate hike by Federal Reserve for the first time in seven years on the horizon, we maintain our view from last month that BI will and should keep its policy rates at the current level (Repo rate at 8%, FASBI rate at 5.50%, and BI rate at 7.50%).

Figure 1: Interest Rates

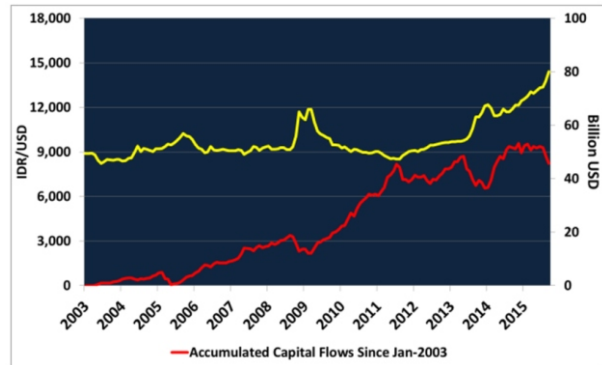


Source: Bank Indonesia

The Fed Fund Rate: Rate Hike Imminent?

Comments on FOMC meeting back in October signaled a 0.25% increase in the target of the Fed fund rate, the possibility of which has been priced in by market participants. CME Group 30-Day Fed fund future prices, indicates implied probability of 83% of December rate hike. Uncertainties surrounding Fed's December rate hike, along with increased volume foreign currency payments during end of year will put additional strains on Rupiah, as shown by recent depreciation to beyond 14,000 level. We, however, believe that Bank Indonesia will not intervene heavily as the holiday season nears.

Figure 2: IDR/USD and Accumulated Short Term Capital Flow

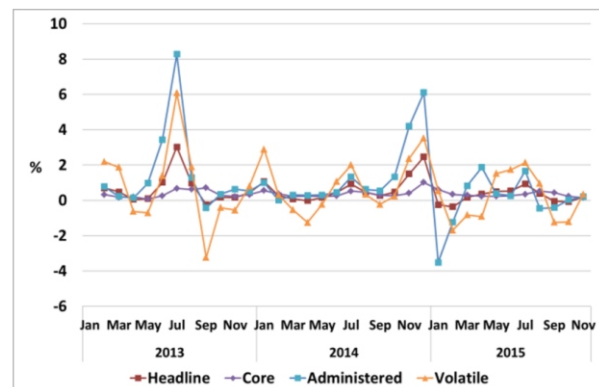


Source: CEIC

Inflation Subdued, Helped by Commodity Prices

After two consecutive months of deflation, inflation rate started to increase in November, mainly due to increase in price of food products (rice, chicken, and cigarettes). Year-to-date headline inflation of 2.36% in November was still well below BI's target of $4\% \pm 1\%$. Although holiday season will put upward pressure on December's inflation, we predict the year-on-year inflation rate by the end of the year will be subdued below 4%.

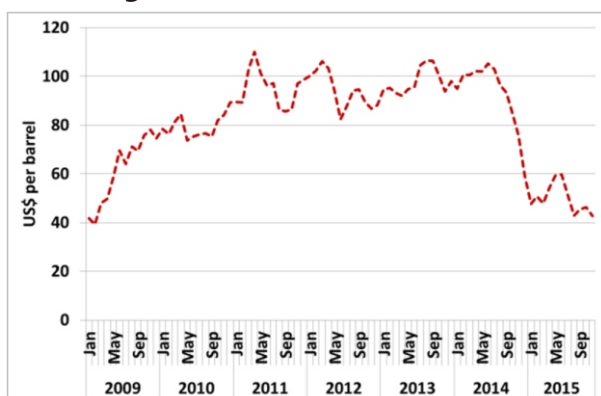
Figure 3: Inflation (m-to-m)



Source: CEIC

Global oil oversupply and persistently low global economic growth have driven the oil price to its lowest point since February 2009. With other commodities also moving in similar direction as oil and coal, we forecast that inflation, both headline and core, will remain low in the short-term. As soon as the short term market uncertainties due to Fed rate hike is removed, we believe that Bank Indonesia will adopt less hawkish stance to achieve inflation and growth target in 2016.

Figure 4: Crude Oil Price, WTI



Source: IMF

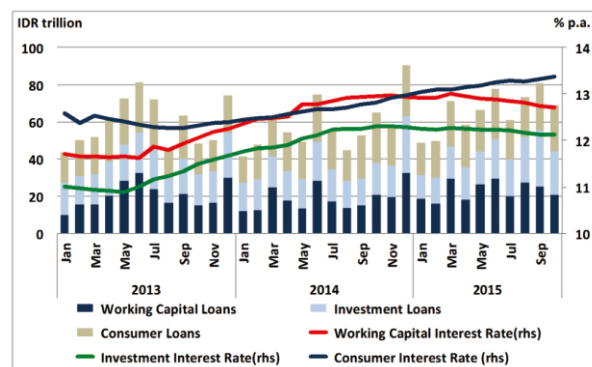
With Challenges Ahead, BI Needs to Show More Confidence

An important caveat for policy easing is the possibility of sudden capital outflow from emerging markets, including Indonesia, should Fed aggressively raise interest rate beyond current market expectation. BI's apparent eagerness to trade growth for currency stability may prompt BI to maintain its tight-bias in the near term.

It is very important for BI to show more confidence in formulating its policy; also in not

changing its policy when there is no actual need for one. This will provide a better guidance in the financial market as to limit volatility, especially when the market is reaching a new equilibrium. Any unnecessary steps could potentially send a wrong signal to the market or at least lower BI's credibility. Lowering the IDR primary reserve requirement last month is an example of these unnecessary steps. As the recent data on interest rates indicate, there is an excess liquidity – instead of a shortage – in the banking sector.

Figure 5: Loans Approval by Types and Interest Rates



Source: Bank Indonesia

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