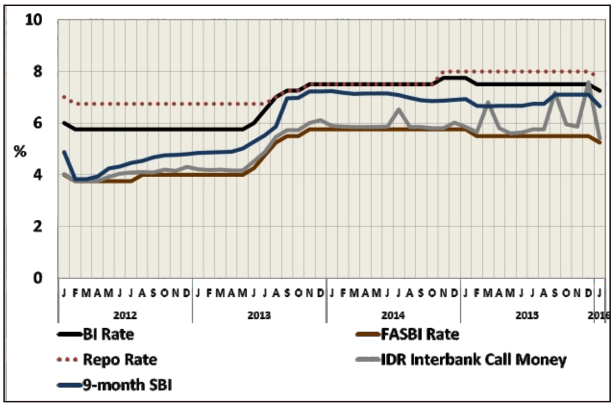
LPEM FEB UI

LPEM COMMENTARY
BI BOARD OF GOVERNORS' MEETING
FEBRUARY 2016

Highlight

After cutting its policy rates by 25 basis points to 7.25% last month, we expect Bank Indonesia to cut the benchmark rate by another 25bps in the upcoming meeting. This possible rate cut is attributable to more controllable inflation outlook in 2016 and strengthening exchange rate in recent months. Weakening global growth outlook and downward trend of interest rates globally will also ease pressures on Rupiah. These also strengthen the case for more accommodative monetary policy.

Figure 1: Interest Rates



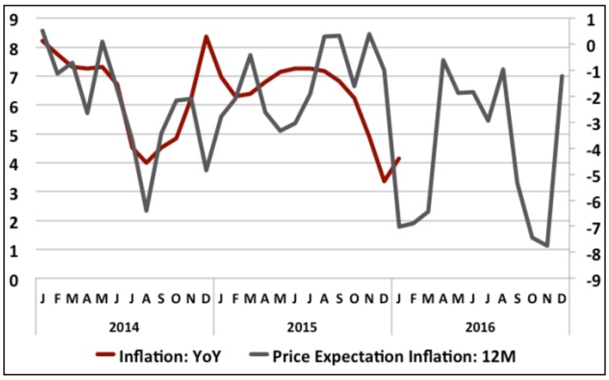
Source: Bank Indonesia

Domestic Economy: Positive Surprise

Recently released inflation and growth data suggested that economic adjustment is slightly faster than expected. This is evident in quarterly GDP growth figure, which in Q4 2015 accelerated to above 5% level. At 4.14% y.o.y and 0.51% m.t.m, inflation is also relatively low and stable, given the El Nino and recent increase in food prices, and is still within Bank Indonesia's 4% target.

In spite of expected increase in inflation rate for early part of 2016, BI survey indicates an even slightly downward trend for the expected inflation for next 12 months. We expect the inflation rate for 2016 will be around 4.5-5.0%, which is going to be well within BI's target. Stable actual and expected inflation should therefore reduce concerns of rapidly accelerating inflation and allow BI to consider February rate cut.

Figure 2: Inflation and Inflation Expectation



Source: CEIC

Global Condition Allows Further Rate Cut

Until recently, chronic current account deficits and significant Rupiah depreciation have been major factors that influence Bank Indonesia to adopt relatively tight monetary policy. This tight bias is reflected in the previous meetings, despite below-target inflation throughout last year.

We expect, however, that Bank Indonesia will readjust its policy focus to inflation and growth rate in light of recent developments. Reduction in current account deficit and strengthening trade surplus has eased concern of structural weakness in balance of payment and, consequently, improve the fundamentals of Rupiah.

Announcement by the Federal Reserves of its decision to hold the target interest rate and its recent Senate testimony, which imply Federal Reserve's realization of weakening global and US economic growth, help to set market expectation of further delay in Fed rate hike, which improve short- and medium-term outlook of Rupiah. In addition, Bank of Japan's decision to start negative interest rate policy (NIRP) and ECB's decision to extend its asset purchase program through 2017 also reversed the trend of flight to safety that ensued after market turmoil last year.

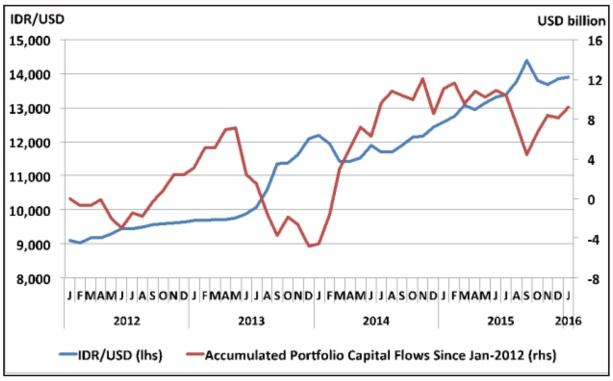
Global investors respond by shifting their capital allocation and increase their exposure to riskier emerging market asset classes, including Indonesia; in January 2016 alone, foreign investors bought IDR 578 trillion worth government securities. We expect that both short-term and long-term capital inflow to increase in the following months following reaffirmed Baa3 rating with a stable outlook by Moody's.

There is also a good chance for an upgrade to BBB- rating by S&P in the next several months. To some extent, the capital market players have priced-in Credit default swap (CDS) rate for Indonesian Government Bonds have been around 250 bps; much lower than the average of CDS rate for BB+ sovereign bonds at 300 bps.

Since its lowest point in Sep-2015, the short term capital flow has increased by USD 4.8 billion until the end of Jan-2016. This is the main driver of the IDR appreciation by about 3.5% during the same period.

These will give additional room for Bank Indonesia to continue the trajectory of policy easing. We expect Bank Indonesia to continue its monetary easing in gradual pace by cutting BI rate by another 25 bps, consistent with the previous trend of gradual rate changes by Bank Indonesia.

Figure 3: IDR/USD and Accumulated Short Term Capital Flow



Source: CEIC

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