

# LPEM COMMENTARY

## BI BOARD OF GOVERNORS' MEETING

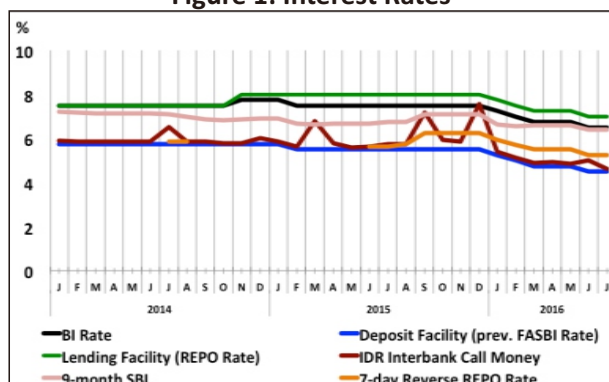
### AUGUST 2016

#### Highlights

- BI should reduce policy rate by at least another 25bps.
- Stable GDP growth at 5.18% (yoy) in Q2 2016 and lower expected inflation provide room for BI to cut the benchmark rate.

We maintain our longstanding view that Bank Indonesia should cut the benchmark rate by 25 bps on Friday meeting, despite BI's decision to postpone rate decrease for the last two meetings. This cut is justified amid mild inflation and expected inflows following muted reaction to Brexit and positive views on tax amnesty program. Higher-than-expected growth at 5.18% in Q2 2016, combined with persistently low inflation, suggests slack in consumer demand and provides the case for a rate cut.

Figure 1: Interest Rates



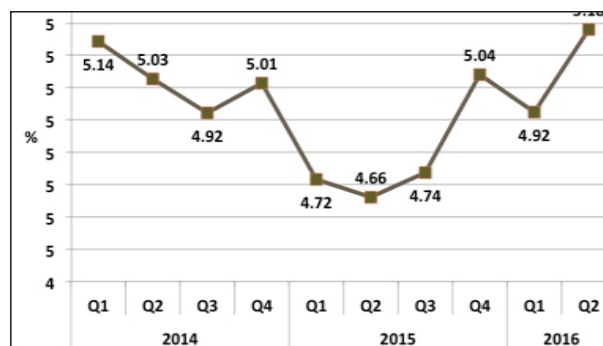
Source: Bank Indonesia

#### Room for Growth and Rate Cut

While higher-than-expected growth may not appear as the most convincing case for rate cut, Q2 2016 growth of 5.18%, coupled with record-low 3.21% (yoy) inflation rate indicate that the economy might be still operating below its potential. Further examination of growth components also indicates the persistence of this output gap; uptick in growth

is largely supported by higher commodity price and surge in government spending. Growth in consumer spending (5.04% (yoy)), that remains slower than the overall economy, was help by the seasonal factor of Ramadhan month.

Figure 2: GDP Growth (yoy)



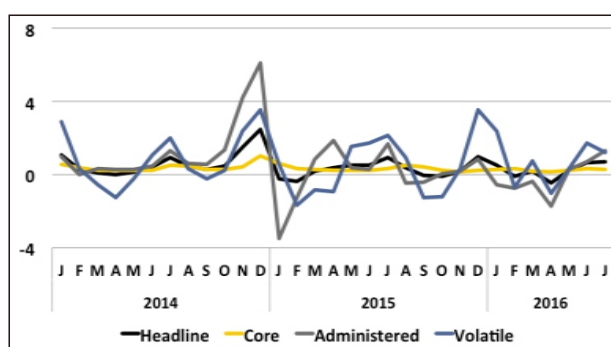
Source: CEIC

In addition to still being below full capacity, the current growth rate is also susceptible to deterioration. Although there are evidences that consumers are more confident to spend, (BI's consumer confidence index is 114.2 in July 2016, up from 113.7 in June 2016), government's plan to cut Rp133.8 trillion (around USD10 billion) of spending due to low tax collection ratio (around 40% FY2016 target in July) may reduce the FY2016 growth rate by at least 0.1-0.2%. In this case, we view benchmark rate cut as pre-emptive measure to maintain growth outlook, as the current situation of low growth/low inflation and budget cut resembles the textbook case of weakness in aggregate demand.

The trend of mild inflation, even during and after Eid Mubarak season, also stand on its own as a rationale for BI to continue reducing the benchmark rate. Year-on-year inflation stands at 3.21% while year-to-date inflation at 1.76% for the first 7 months of

2016. We reiterate our view that without significant change in policy, the risks for 2016 inflation to miss the lower bound target is significantly higher than any risk for inflation to overshoot upper bound target.

**Figure 3: Inflation Rates (mtm)**



Source: CEIC

As inflation (particularly durable goods) tend to lag the policy rate by several months, the only way to achieve 4% inflation target for 2016 is to resume rate cuts and adopt more accommodative monetary policy stance following the change in policy rate.

#### Global Case Conducive for Rate Cut

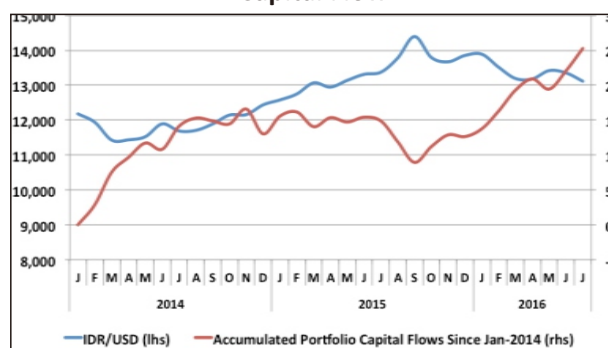
As domestic indicators have given strong signal for rate cut, the only reason BI may want to hold policy rate is to hedge against deteriorating circumstances in international market. However, judging by several key external factors, we do not expect significant deterioration in Indonesia's external position for the next six months that may necessitate measures to stem capital outflow.

The combination of shrinking current account deficit to 2.02% of GDP in Q2 2016 (from 2.19% of GDP in Q1) and trend of capital inflow reduce the pressure to balance of payment considerably, thus reducing the need for measures to maintain high interest rate differential with advanced economies. Indeed, BI has already started to contain the effect of capital inflow by means of exchange rate intervention, as indicated by increase in foreign

reserves by \$7.8 billion in the last two months.

Despite strong performance of US labor market, low US inflation and global weakening reduce the possibility of The Federal Reserve to raise interest rate in the near-term, which prompt us to maintain our view that BI can and will perform several rate cuts to prevent Rupiah from further appreciation.

**Figure 4: IDR/USD and Accumulated Short Term Capital Flow**



Source: CEIC

#### RRR and Effectiveness of Policy Transmission

The BoG meeting this month also marks the introduction of 7-days reverse Repo rate as the new benchmark rate, replacing the BI rate. We believe that implementing the new benchmark rate will enhance the effectiveness of the monetary policy transmission, as it is better in representing the money market.

#### Researchers

Febrio Kacaribu, Ph.D.  
Head of Research  
Macro and International Trade Studies  
[febrio.kacaribu@lpem-feui.org](mailto:febrio.kacaribu@lpem-feui.org)

Alvin Ulido Lumbanraja, S.E.  
Research Assistant

Faradina Alifia Maizar, S.E.  
Research Assistant