BI Board of Governor Meeting

July 2017

Highlights

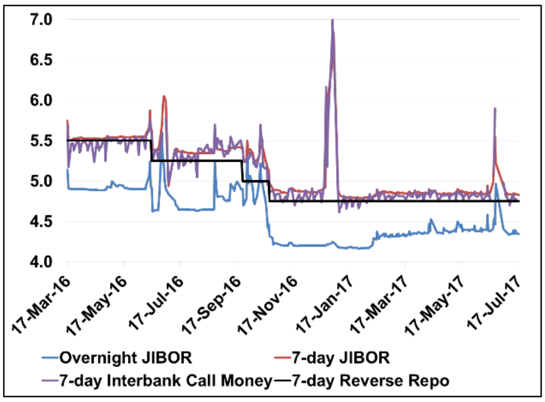
- Bank Indonesia should keep its policy rates at current level;
- Relatively high y.o.y inflation in June is due to the seasonal effect of Eid Mubarak;
- Trend of short term capital inflow should continue.

Following slightly higher inflation and uptick in economic activities, offset by slashed US growth outlook, Bank Indonesia should be well advised to keep its policy rates at current level. We still maintain a slight bias toward rate cut this Thursday, given that domestic inflationary concern is not as apparent as upward pressure on Rupiah exchange rate, which comes from both sovereign rating upgrade and reduced probability of further Fed rate hikes after US growth outlook is cut. Any rate cut by BI, however, can only be possible if monthly inflation after Eid Mubarak revert back to more stable level.

Slightly Higher Growth, Relatively Stable Inflation

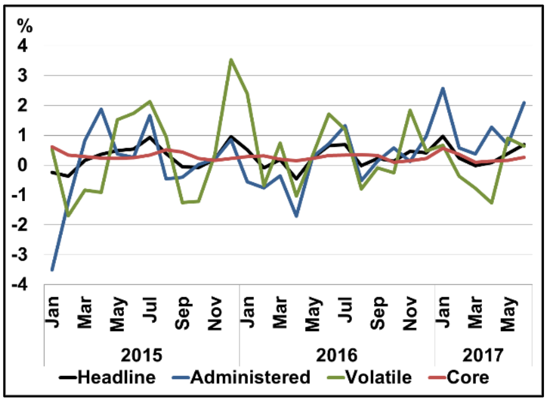
While inflation creeps higher to 4.37% (y.o.y) in June, we remain confident that inflation will remain within BI's target until end of year. Higher inflation may be temporary as June prices are recorded around Eid Mubarak, which naturally sees higher inflation, and that y.o.y. inflation measures June 2017 prices against June 2016 prices (start of Ramadan season, where prices have not risen as much as prices near Eid Mubarak). Indeed, volatile price inflation in June 2017 (0.65% mtm) is more muted than in June 2016 (1.71% mtm).

Figure 1: Interest Rate



Source: CEIC

Figure 2: Inflation Rate



Source: CEIC

It should also be noted that current inflation rate has also reflected the effect of 900VA electricity price adjustments in January, March, and May. As seen in Figure 2, spikes in administered price inflation is evident in January, April, and June. This, coupled with historically mild Ramadan period inflation as recorded by June inflation suggests more manageable underlying inflation trend than conveyed by June headline inflation.

There are two explanations to this manageable inflation. First, BI's and the government's efforts to manage price stability has shown some successes, particularly when looking at core and volatile price inflation in May and June. Second, we suspect that economic growth is still slightly below its long-term potential. We expect that additional GDP growth in the near future will not result in noticeably higher inflation.

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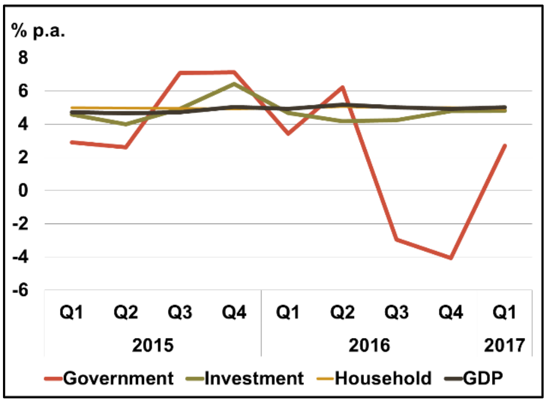
Key Figures

- BI Repo Rate (7-day, Jun '17)
  4.75%
- GDP Growth (y.o.y, Q1 '17)
  5.01%
- Inflation (y.o.y, Jun '17)
  4.37%
- Core Inflation (y.o.y, Jun '17)
  3.13%
- Inflation (mtm, Jun '17)
  0.69%
- Core Inflation (mtm, Jun '17)
  0.26%
- Credit Growth (y.o.y, Jun '17)
  10.39%
- FX Reserve (Jun '17)
  $123.09 billion

Eased Upward Pressure

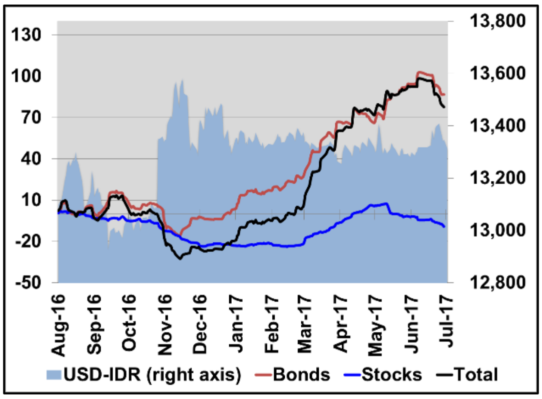
Rupiah has shown a stable performance so far, with year-to-date rate still ranging between IDR 13,255 – IDR 13,485 per USD. While upward pressure on Rupiah, which was masked by BI's intervention and its subsequent accumulation in foreign reserves, may had previously made current rate not ideal, such upward pressure is now slightly relaxed. If foreign reserves touched $125 billion in May, foreign reserves have come down to around $123 billion in June, mainly due to short term capital outflow following profit taking after the S&P action and maybe some worry about the revised budget's deficit to GDP ratio to be 2.92%. We see a more stable if not net short term capital inflow in the near term.

Figure 3: GDP Growth



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow in the Last 12 Months



Source: CEIC

However, reduction in US GDP growth outlook as forecasted by IMF may alter the course of Fed rate hike and allow BI some room for further rate cut. Cut to US growth prospect stems from inability of Republican-controlled US Congress and White House to pass meaningful legislation so far, particularly on replacement of Obamacare, which makes promised tax cut and infrastructure seem to be impossible to pass this year. With US growth forecast to just be 2.1%, instead of previous estimate of 2.3%, Fed may be reluctant to increase rate too soon, particularly when US wage growth and inflation remain muted.

With US growth prospect cut, UK growth in jeopardy with Brexit uncertainty, and Japan growth still lackluster, we expect more net capital inflow to Indonesia as Indonesian assets still and will remain relatively attractive for the rest of 2017. This in turn will increase probability of continued upward pressure on Rupiah. Given that continuous sterilized intervention is costly, and rate cut may further boost credit growth and that weaker Rupiah may further help manufacturing exports, another rate cut should be considered by Bank Indonesia sometime this year.

Move for another rate cut at this point, nevertheless, may risk disturbing what seem to be the current equilibrium point for interest rate and Rupiah. Therefore, Bank Indonesia may want to hold interest rate for a little longer, but signal that further rate cut is possible given more convincing data. A lower y.o.y. inflation in July would help.