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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

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Highlights

- Relatively manageable Rupiah depreciation in the short run and low inflation trend should prompt BI to hold interest rate for now and proceed cautiously
- Persistent current account deficit still put pressure on Rupiah over medium term, but external risks in general have largely been priced in
- Soon-to-be-introduced Special Deposit Account at BI could be a good practical move in implementing the so-called negative Tobin tax

Macroeconomic & Financial Sector Policy Research

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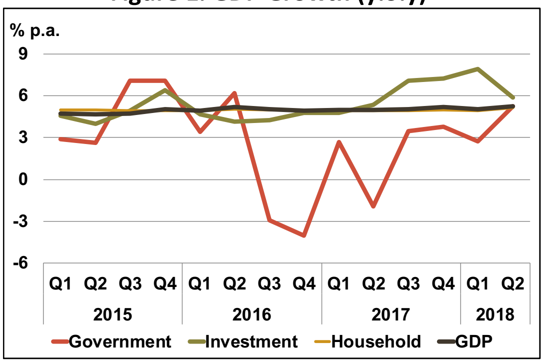
Rupiah took a paradoxical turn within the last month, where continued rapid depreciation was also followed by second monthly deflation in a row, defying conventional wisdom. Muted inflation in face of rapid depreciation might be explained by higher interest rate, which slows down the demand for durable goods consumption, and government's insistence to hold retail fuel price despite higher international crude oil price. On external side, we still see pressure on Rupiah going forward given persistent current account deficit and continued sign of monetary policy tightening around the world. Given the decrease in inflation, priced-in global shocks in the short run, and potential benefits from the implementation of the negative Tobin tax initiatives, we argue that holding interest rate on Tuesday may be the best course of action.

Inflation Fell Again Below 3% Level

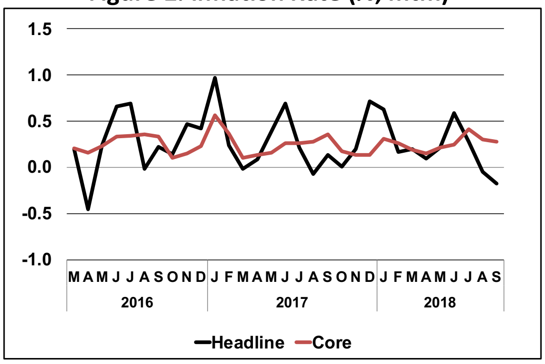
Headline and core September inflation decreased considerably to 2.88% and 2.82% (y.o.y) from 3.20% and 2.90% (y.o.y) respectively in August, which represent a noteworthy development. While subdued inflation is relatively normal around September period every year, this September's inflation represents two straight consecutive deflation and saw headline inflation fell below 3% level. Core inflation remains relatively stable on month-to-month basis, decreasing from 0.30% in August to 0.28% in September.

Figure 1: GDP Growth (y.o.y)



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

This decrease in inflation is noteworthy for at least two reasons. First, inflation actually decreased even after Rupiah depreciates by 12.04% on year-to-date basis. Given that most of Indonesia's imports are in the form of input goods and capital goods, decrease in exchange rate should have manifested itself in higher prices for most goods and services, particularly for those with higher import content. The fact that prices remain relatively under control after relatively steep depreciation might be attributed to combination of relatively subdued consumer demand and relatively low contribution of imports to overall economy, which limits the impact of depreciation for average Indonesian consumers.

Secondly, inflation decreased in the face of higher crude oil price, which briefly touched $86/barrel for Brent price; this is equivalent to about 30% increase on year-to-date basis. In the past, higher fuel prices would have pushed inflation higher as fossil fuel is used for virtually all forms of transportation. In current case, we see that government's decision to hold fuel price unchanged as the key factor that enables Indonesian economy to be relatively shielded from increase in global oil price. However, we see this form of price control as highly unsustainable in the medium run, as government will be hard-pressed to provide sufficient fiscal space for fuel subsidy, which might not be available given other budget priorities, and as keeping fuel price

Key Figures

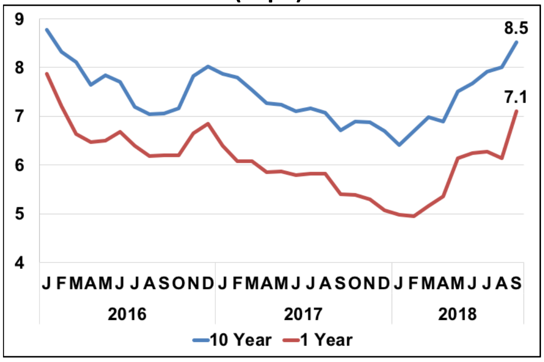
- BI Repo Rate (7-day, Sept '18)
  5.75%
- GDP Growth (y.o.y, Q2 '17)
  5.27%
- Inflation (y.o.y, Sept '18)
  2.88%
- Core Inflation (y.o.y, Sept '18)
  2.82%
- Inflation (mtm, Sept '18)
  -0.18%
- Core Inflation (mtm, Sept '18)
  0.28%
- FX Reserve (Sept '18)
  USD114.8 billion

artificially low will increase the demand for oil and thus will exacerbate the existing current account deficit problem.

External Concerns Recede, Current Account Deficit Still Put Pressure on Rupiah

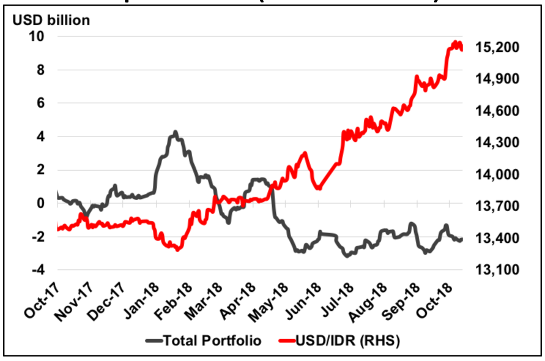
Rupiah continued to depreciate considerably throughout last month and is now hovering around 15,100-15,200 level after enjoying brief period of stability at around 14,900-15,000 in early September. Depreciation on late-September was caused mainly by market sentiment surrounding Federal Reserves' decision to raise its benchmark rate again by 25bps, which prompted foreign investors to reduce its holding of Indonesian assets again. Capital outflow by foreign investors and monetary tightening at home also drove government bonds yield to increase rapidly, with 1-year government bond yield stood at around 7.1% in September (from 6.13 in August) and 10-year yield stood at 8.5% (from 8.01% in August).

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Last 12 months)



Source: CEIC

On a more sanguine side, Indonesia's exchange rate depreciation is still relatively manageable compared to other emerging markets, particularly South Africa, Brazil, Russia, Turkey, and Argentina. On the other hand, the fact that relatively small amount of net capital outflow in September (Figure 4) was enough to trigger depreciation to 15,200 level from 14,900 suggests an acute dearth of liquidity in onshore foreign exchange market. One of the main culprits is Indonesia's persistent current account deficit and worsening trade balance position in Q2 and Q3 2018. Indonesia's current account deficit is one of the worsts among Asian emerging markets and leave Indonesia relatively vulnerable to episodes of capital outflow.

Furthermore, many exporters, who in the previous year converted some of their dollar holdings to Rupiah and thus provide dollar supply to onshore foreign exchange market become increasingly reluctant to do so now out of fear of further depreciation; they do need to pay their USD-denominated liabilities. There is fiscal incentive for the export proceeds when they are placed in IDR deposits. These incentives have not been utilized due to the non-tractability nature of the deposits by the tax authority. Bank Indonesia is working on introducing a special deposit account in attempt to alleviate this problem. This special deposit account could be effective in bringing in some of the export proceeds to begin taking advantage of the tax incentives; this could help IDR in the short run.

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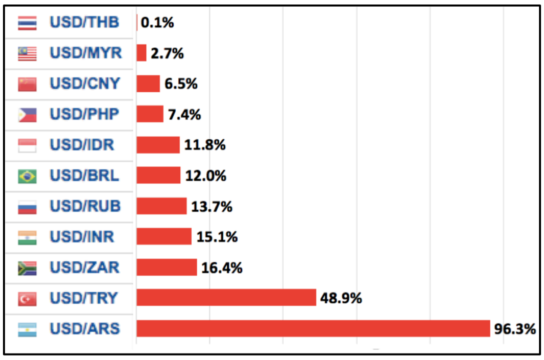
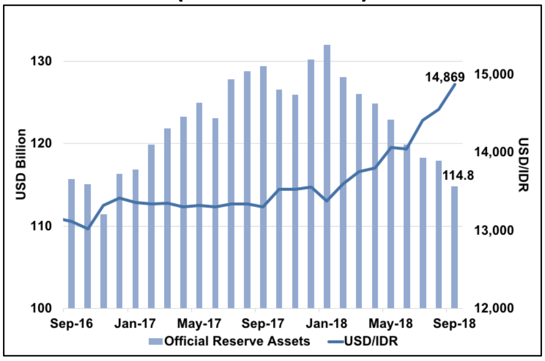
Figure 5: Year to Date Depreciation Rates of Selected EMs



Sumber: CEIC

Figure 6: IDR/USD Official Reserve Assets (Last 24 months)



Sumber: CEIC

Given continued Rupiah depreciation and eroding foreign reserves position, it might be understandable that Bank Indonesia would be tempted to hike interest rate again to stem depreciation. However, Bank Indonesia should also be aware that doing so may suppress domestic demand for durable goods and jeopardize its domestic inflation target, as shown by sub-3% inflation. As most external risks, particularly full-scale trade war between US and China, has now been priced in, we do not see the need for Bank Indonesia to increase interest rate and recommend holding interest rate on Tuesday meeting.