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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

March 2019

Highlights

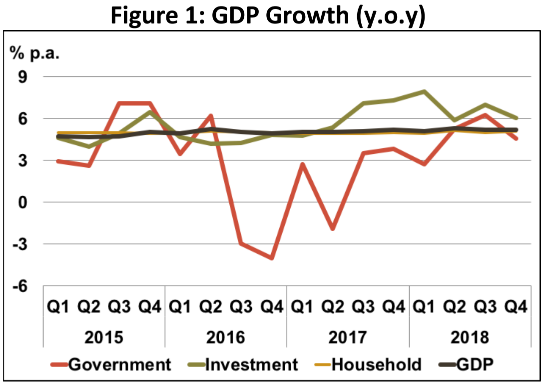
- Bank of Indonesia needs to keep its policy rates
- Inflation is now too low
- Rupiah is stable at 14,200 after some short-term profit taking by forex traders
- Current account deficit could improve significantly in 2019Q1; February's trade surplus helps

Robust economic growth last year reflects sound domestic economic performance amidst the global uncertainty. Inflation has been relatively subdued and approaching the lower bound of BI's target band of 2.5 to 4.5 percent. The trade balance surplus in February, the highest since September 2018, will contribute positively to the series of efforts for improving the current account performance. Although Rupiah trend of appreciation has slowly disappeared, with now hovering around IDR14.200, it remains safe and under control. In addition to the trade war uncertainties, the key challenge ahead is associated with the global economic moderation, causing the fall in commodity prices, which will affect trade balance. Bank Indonesia should retain a tightening bias until the government actions in taming the current account deficit starts showing some promises. On the upside, if the portfolio capital inflow continues strongly, and BI is projected to accumulate enough foreign currency reserves, we view that BI should have room to lower its policy rate this year by 50 bps. But for now, it is time to wait and see until next month.

Too-low Inflation, Approaching BI's Lower Bound

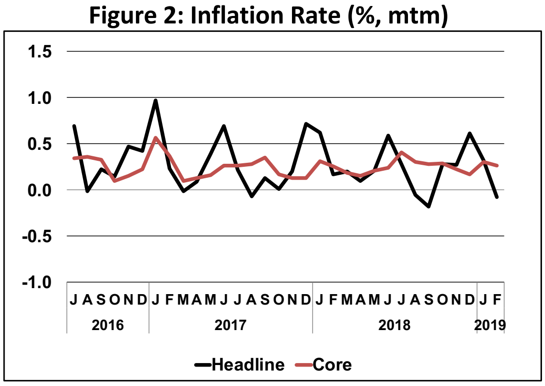
Headline inflation rate in February 2019 fell further, lower-than-expected, stood at 2.57% (yoy) from 2.82% (yoy) in January 2019. For the first time during this year inflation rate is almost reaching Bank Indonesia's minimum threshold of 2.5%. Volatile food stemmed deflation on a monthly basis to -0.08% (mtm). More specifically, this is attributable to declines in food prices due to seasonal patterns such as red chili, chicken, boiled eggs, shallots, cayenne pepper, and carrots. Moreover, inflationary pressure on administered prices was also benign due to minimum government policy changes prior to the general election. Meanwhile, core inflation remained under control with the annual basis was recorded unchanged compared to the last month's development, which was 3.06% (yoy). After showing an increasing trend since December 2018, the monthly basis of core inflation slowed to 0.26% (mtm). The consistency of Bank Indonesia's policies in directing inflation expectations, including keeping exchange rate movements has made a significant contribution to controlled core inflation.

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



Source: CEIC

Figure 2: Inflation Rate (%, mtm)



Source: CEIC

Rupiah is Stable Again After Profit Taking by Traders

After enjoying the persistent strengthening period since the previous quarter until February 2019, Rupiah slowly back to depreciate, starting at the beginning of March 2019. The currency briefly touched IDR14,300, the weakest point this year. The pressure on Rupiah was caused mainly by profit taking by traders in the midst of some global shocks. The increase of global oil price due to the US sanctions against Venezuela, increase in geopolitical risk by the failure to achieve a positive result at the US-North Korea summit, uncertainty over the future of Brexit, and other world political events all contributed to temporary halt of the portfolio capital inflow.

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Key Figures

- BI Repo Rate (7-day, Feb '19)
  6.00%
- GDP Growth (y.o.y, Q4 '18)
  5.18%
- Inflation (y.o.y, Feb '18)
  2.57%
- Core Inflation (y.o.y, Feb '19)
  3.06%
- Inflation (mtm, Feb '19)
  -0.08%
- Core Inflation (mtm, Feb '19)
  0.26%
- FX Reserve (Feb '19)
  USD123.2 billion

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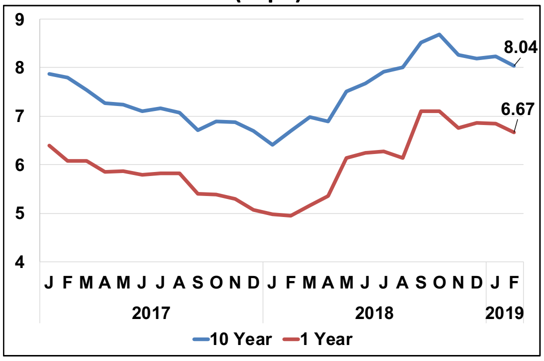
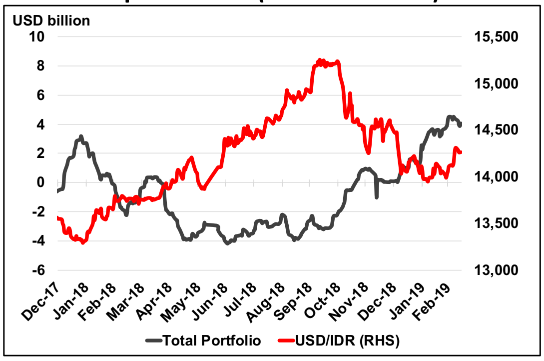
On the other hand, in line with the slower pace of Fed rate hikes and the moderate thawing of US-China trade tensions, global financial market uncertainty slightly eased and induced capital flows back to developing economies, including Indonesia. The continuing net influx of portfolio capital flow is reflected by the decline in the government bonds' yields. The average of yields of 10-Year and 1-Year government bonds in February stood at 8.04% and 6.67%, respectively.

Figure 3: Government Bonds Yield (% pa)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Since Dec-2017)



Source: CEIC

Rupiah is relatively under control compared to other emerging market currencies (it is placed on the third position after Thailand and Philippines, see figure 5). We see that this decision reflects the efforts of Bank Indonesia to reduce the CAD to the safest level while maintaining domestic financial assets to remain attractive.

The overall performance of the domestic economy is quite good. A decent macroeconomic environment is underpinned by the increasing foreign capital inflow which was recorded at IDR59.9 trillion and robust domestic demand following the preparation of presidential and legislative elections. In addition, the trade balance showing a recovery signal as the country recorded a surplus of USD 329.5 million in February, the first surplus since September last year. The surplus can be largely attributed to a sharp drop in imports (falling by 18.6%) driven by both lower oil-and-gas and non-oil-and-gas imports.

Looking further to the details, the non-oil and gas sector recorded a surplus of USD 0.79 billion. The significant decline in non-oil and gas imports was dominated by machinery and electrical equipment (HS 85), which can be explained partly by a reduction in export-oriented business expansion due to the downward trend in global commodity prices. Moreover, the completion of infrastructure projects this year also expected to contribute in the decline of non-oil and gas imports.

On the other hand, the oil and gas sector remained in a deficit (USD 0.46 Billion). The decrease in oil and gas imports was due to lower volume of crude oil imports in February by 61.45% while the amount of crude oil production in Indonesia during February fell substantially by 9.25% to 20.6 million barrels from 22.7 million barrels in January. We see that the implementation of B20 has the potential to become an alternative source for Indonesia's oil need. The trade balance surplus last month is predicted to give positive signals on the improvement of current account performance which reached -3.57% in Q4 2018; the worst ratio since 2014. Better outlook for the current account will mitigate the risk of capital outflow, i.e., the depreciation threat for Rupiah.

The US Federal Reserve's dovish monetary stance is expected to continue this month, consistent with the US' labor market tightening and constrained fiscal space. It continues providing breathing space for emerging markets' central banks including Bank Indonesia. If the portfolio

Key Figures

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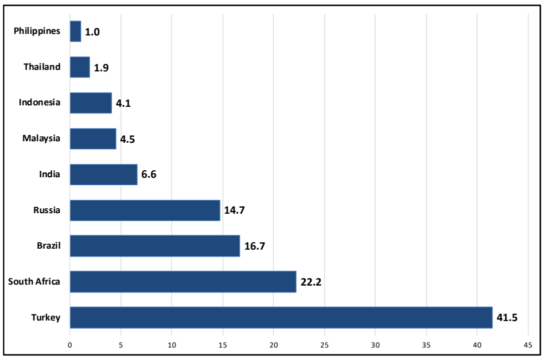
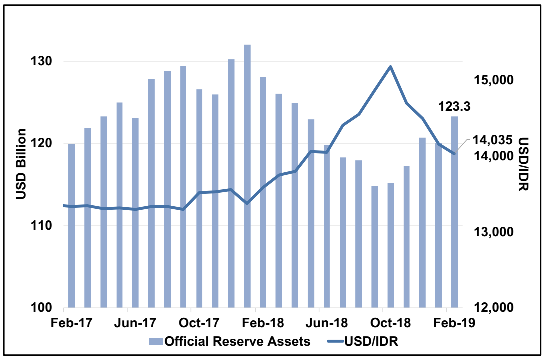
capital inflow continues strongly, and BI is projected to accumulate enough foreign currency reserves, we view that BI should have room to lower its policy rate later this year by 50 bps. But for now, it is still a time to wait and see until next month.

Figure 5: One-Year Depreciation Rates of Selected EMs (15-Mar-19)



Source: CEIC

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



Source: CEIC