BI Board of Governor Meeting

May 2019

Highlights

- Bank Indonesia should leave its benchmark interest rate unchanged
- Inflation is under control within BI's target range but remains particularly low
- Slowing GDP growth due to slower investment and softening the commodity prices
- Rupiah weakened due to flight to safety on escalating trade war and looming CAD

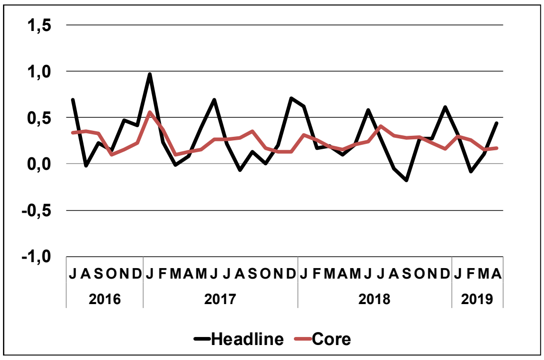
Slow investment due to the wait-and-see stance of investors amidst the general election and the trend of falling commodity prices has led to lower-than-expected economic growth in Q1 2019. By sector, lower growth was significantly contributed by the continuation of slowing manufacturing growth in the three consecutive quarters. Last month inflation figure remained low at 2.83% (yoy), compared to 3.41% inflation in the same month last year, reinforcing the notion that domestic demand has not fully responded to the democracy celebration and the upcoming Ramadhan season.

The improvement of the current account deficit in Q1 is proven to be still very fragile. Achieving the current account deficit at less than 3% of GDP for 2019 is still very challenging. In addition, the worsening trade tension between US and China is here to stay. These have increased negative sentiments towards Rupiah, causing the "flight to safety" behavior in the bond and stock markets. Once again, BI's credibility in stabilizing the exchange rate will be put to test. For now, however, Bank Indonesia will have to use its foreign reserves and leave its benchmark interest rate unchanged.

Controlled Inflation Within BI's Target Range

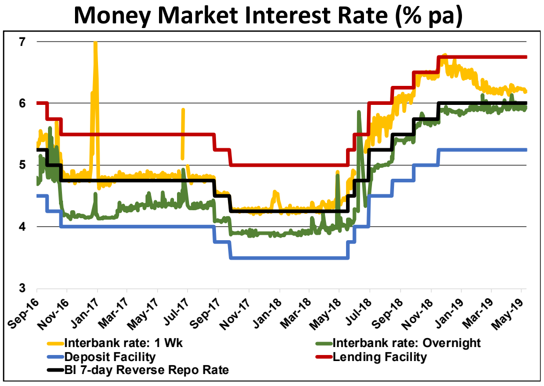
After reaching the lowest level in the last decade, annual inflation in April rose by 2.48% (yoy) to 2.83% but remained particularly low. This higher annual inflation was contributed by inflation in volatile food (2.05% yoy) amid a surge in food prices heading into Ramadhan. Rising commodity prices of red onion, garlic, red chili, tomatoes, eggs, and cayenne contributed to the pick-up in April inflation. Likewise, increased airfares also contributed to consumer inflation, which led to an inflation of 3.17% (yoy) in administered prices. Meanwhile, rice as a key commodity recorded deflation as we entered the harvest period in April. On the other hand, the monthly and annual core inflation was relatively stagnant. On a monthly basis, core inflation was recorded at 0.17% (mtm), not much different from the prior month's level of 0.16% (mtm). Meanwhile, on a year on year basis, core inflation was slightly up from 3.03% (yoy) in the previous month to 3.05% (yoy).

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

Figure 2: Interest Rate Policy and Interbank Money Market Interest Rate (% pa)



Source: CEIC

GDP Growth Worse than Expected, CAD looming

The economy grew more slowly than expected in the first quarter of this year, standing at 5.07% (yoy), lower than 5.18% growth in Q4 2018. Slowing growth occurred due to slowing down

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Key Figures

- BI Repo Rate (7-day, Mar '19)
  6.00%
- GDP Growth (y.o.y, Q1 '19)
  5.07%
- Inflation (y.o.y, Apr '19)
  2.83%
- Core Inflation (y.o.y, Apr '19)
  3.05%
- Inflation (mtm, Apr '19)
  0.44%
- Core Inflation (mtm, Apr '19)
  0.17%
- FX Reserve (Apr '19)
  USD124.3 billion

investment and softening global prices of several main commodities such as oil and coal. On the other hand, household consumption remained relatively robust. We believe the full scale of the elections' impact on consumption was not yet entirely included in Q1. Investment seemed to be in a wait-and-see stance before the presidential election. By sector, the manufacturing industry, as the biggest sector by share, slowed down further from 4.25% to 3.86% in year-on-year basis.

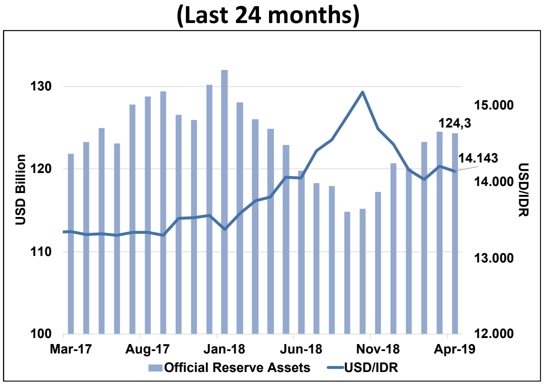
The weakening global commodity prices have depressed Indonesia's exports that are still dominated by natural commodities. The improvement on the trade balance, especially with two consecutive surpluses in February and March was responsible for the current account deficit figure at 2.6% in Q1, which was significantly lower compared to 3.6% in Q4 2018. Nevertheless, April data on the trade balance deficit at USD2.5 billion is reminding us that achieving CAD below 3% of GDP is still very uncertain for 2019.

We view that the better figure for CAD in Q1 2019 was, in the majority, an anomaly. Although there is a factor of crude oil price effect, the oil-and-gas trade deficit was deviating from the trend in February and March. April's number for the oil-and-gas trade deficit at USD1.5 billion reminds everybody that the ever-increasing trend of demand for oil products in the absence of significant effort on the alternative energy sources. We view that the government's perceived plan to reduce the oil subsidy in the second half of 2019 to be inevitable.

Trade War to Escalate, Triggering "Flight to Safety"

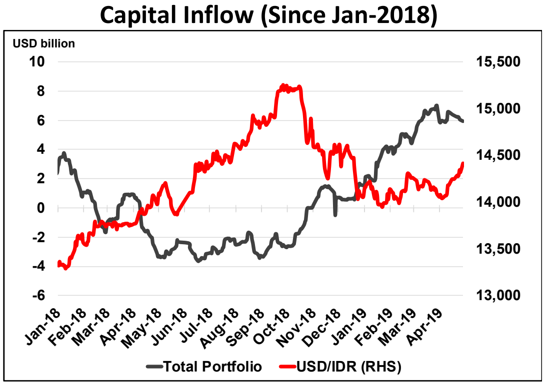
Despite a robust appreciation at least until the second week of April due to an upsurge in foreign capital flows, Rupiah slowly began to depreciate again to a level of around 14,400. The uncertainty has been primarily driven by a worsening continuation of trade war tensions as Trump's statement to increase import duties against Chinese products further disrupted market players' expectations. Amid the market perception of Indonesia's sovereign bond rating, which is still at BBB-, the phenomenon of "flight to safety" has been triggered again. Global investors' avoidance of risky assets, including the Rupiah, prompted them to move their assets back to safer investments, pushing more of portfolio capital outflow. The government bonds' yields were declining, with the average of yields of 10-year and 1-year government bonds in April were standing at 7.79% and 6.47% respectively. An about USD 1 billion portfolio net outflow in the last four weeks has brought the yields of the 10-year and the 1-year up to 8.22% and 6.66% respectively.

Figure 3: IDR/USD and Official Reserve Assets (Last 24 months)



Source: CEIC

Figure 4: IDR/USD and Accumulated Portfolio Capital Inflow (Since Jan-2018)



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Bank of Indonesia has started intervening the FX market since April. It will need to convey a signal to the market as to the level of expected depreciation rate for Rupiah in the short to medium term. For now, the policy rates will need to be kept as they are now at the current level while still maintaining the liquidity in the banking system.