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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

August 2019

Highlights

- Bank of Indonesia should hold its policy rates this month due to the external factors
- Inflation within target and stable
- Trade deficit, and hence CAD, continue as commodity prices still depressed
- Government's fiscal policy needs to be relaxed slightly to stimulate the economy

Inflation remained stable at 3.32% in July; it remains within BI's target range. Core inflation decreased from 3.25% to 3.18%. The decline in core inflation is much affected by the upswing of the headline inflation due to the seasonal effect; it should not be misperceived as a reflection of the households' demand. Amidst rising global uncertainty, a low and stable domestic inflation provides room for BI to continue its easing stance that it started in June. In the real sector, subdued export and investment performance have been the biggest challenge to the GDP performance this year. GDP in Q2 2019 saw a 5.05% (yoy) growth rate, after a 5.07% (yoy) growth rate in Q1.

Current Account Deficit widens to 3.0% from 2.5% of GDP in the last quarter. Since Indonesian exports are still dominated by commodities, the decreasing trend of commodity prices, especially that of palm oil, has and will remain the biggest factor that pulls the export performance down. There is a potential for a small rebound for the palm oil price in the second half of 2019.

Albeit corrected in the last several weeks due to continued trade tensions, the trend of portfolio capital inflow helps Rupiah to stabilize at around 14,200-14,300 range. BI has increased its international reserves but must use some of them in the last two weeks. We view that Bank of Indonesia should hold its policy rates in the upcoming Board of Governance's meeting mainly due to external factor. Nevertheless, BI needs to keep its easing stance towards the end of the year as new data would present more opportunities for it.

Inflation Remained Under Control

Indonesia's inflation remained under BI's inflation target range in July 2019 with headline inflation slightly increased to 3.32% (yoy) from 3.28% (yoy) in previous month; similar level with May's inflation as the highest consumer prices in 2019 so far. Rise in inflation was mostly driven by upsurge in the clothing and education prices as the new season of school will be started this month. On the other hand, the end of Ramadan and Eid al-Fitr has increased consumer prices to only 0.31% (mtm), down from 0.55% (mtm) in prior month. While there is a rise in the price of education and clothing, BI recorded a decline in volatile food inflation to 0.89% (mtm) from 1.70% (mtm) due to lower prices of shallots, garlic, tomatoes, fresh fish, oranges, as well as coconuts and cooking oil. Administered prices deflation was also down deeper into 0.36% (mtm) as a result of slight adjustments to airfares price.

Both core inflation in year-on-year and monthly basis have decelerated into 3.18% and 0.33% from 3.25% and 0.38% in previous month, respectively. Still, this was contributed by the seasonal factor that should not be misperceived as a reflection in the households' demand. Overall, inflation is still manageable, but the government still needs to consistently maintain price stability as the upcoming dry season and rising global uncertainty ahead.

Macroeconomic & Financial Sector Policy Research

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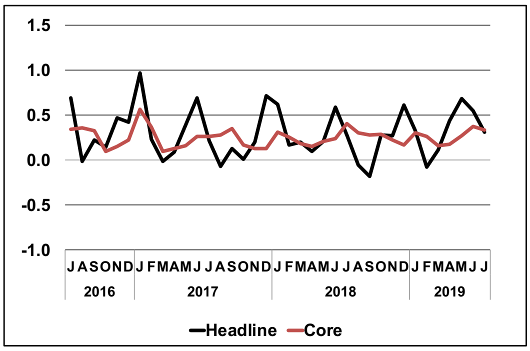
Key Figures

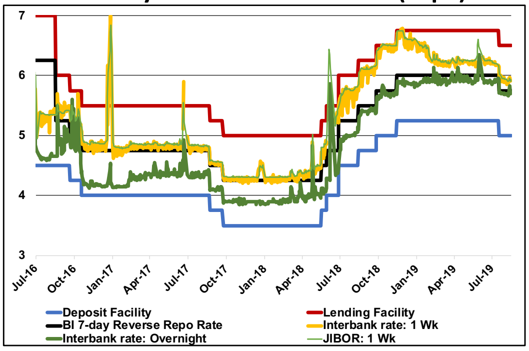
- BI Repo Rate (7-day, Jul '19)
  5.75%
- GDP Growth (y.o.y, Q2 '19)
  5.05%
- Inflation (y.o.y, Jul '19)
  3.32%
- Core Inflation (y.o.y, Jul '19)
  3.18%
- Inflation (mtm, Jul '19)
  0.31%
- Core Inflation (mtm, Jul '19)
  0.33%
- FX Reserve (Jul '19)
  USD125.9 billion

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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

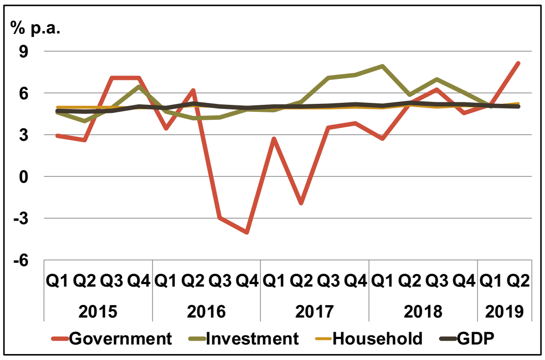


Source: CEIC

Decelerated Economic Growth Amidst Global Trade Uncertainty

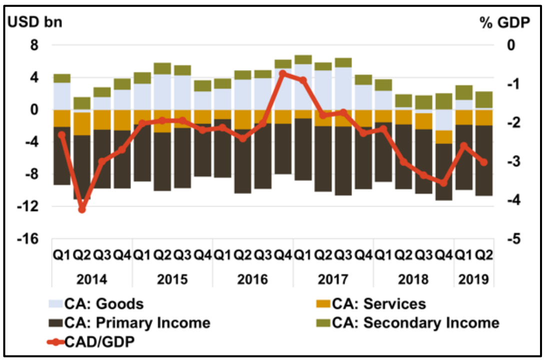
Indonesia's economic growth in Q2 2019 has slowed to 5.05% (yoy) from 5.07% (yoy) in previous quarter as exports and investment slump. Total exports of goods and services fell by around 2% (yoy) in the second quarter due to the trend of global commodity price downturn and trade uncertainty. At the same time, the growth of fixed investment decelerated to 5.01% (yoy) from 5.85% (yoy) over the same period last year. Robust household consumption due to seasonal pattern at 5.17% (yoy) has not helped to accelerate the growth. Government spending, 8.23% (yoy), helped the GDP growth rate. We view that the government can step up a little bit more this year; relaxing the budget deficit target should be considered.

Figure 3: Indonesia's Gross Domestic Product (%) (Q1 2015-Q2 2019)



Source: CEIC

Figure 4: Indonesia Current Account Deficit (USD bn and % GDP)



Source: CEIC

Indonesia's current account deficit has widened to USD8.4 billion or equivalent to 3% of GDP in second quarter from USD7 billion (2.5% of GDP) in the previous quarter. Since Indonesian exports are still dominated by commodities, the decreasing trend of commodity prices, especially that of palm oil, has and will remain the biggest factor that pulls the export performance down. There is a potential for a small rebound for the palm oil price in the second half of 2019. Deeper deficit in services, which reached USD2 billion, has contributed to worsening CAD. We maintain our view that CAD above 2.5% is still unavoidable in 2019.

The structural reforms in manufacturing sector and trade are unlikely to give results in the short term. Nevertheless, more real actions need to be taken on these two fronts. Number of

Key Figures

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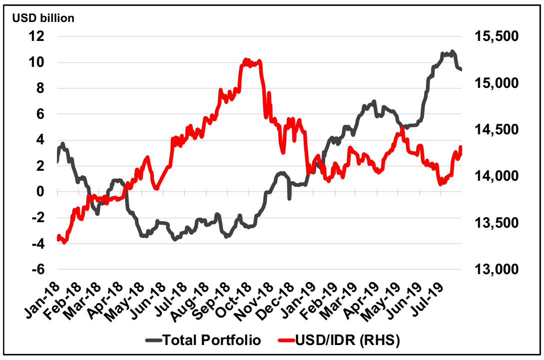
procedures and cost involved in starting a business, and most challenging of all, time and cost to export need to be cut significantly.

Capital Flows Continue to Improve

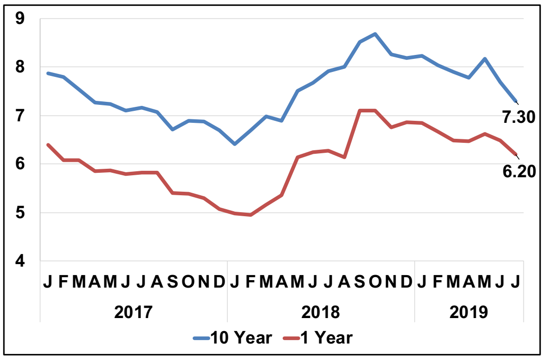
The continuing inversion of US yield curve has provided stronger signals that an economic crisis in the US would happen sometime in mid of next year. IMF global economic growth projection at 3.5% (yoy), lower by 10 bps compared to previous estimate, is consistent with the projected downturn in the US. Despite the global uncertainties, the expected GDP growth differential will continue to attract capital inflow to Indonesia. We see that the trend of portfolio capital inflow, that started since 2018Q4, will continue, even though more corrections to be expected along the way. Since 2018Q4, the portfolio capital investment has seen a net inflow of around USD13 billion. The recent average of yields of 10-year and 1-year government bonds last month stood at 7.3% and 6.2%, respectively.

Figure 5: IDR/USD and Accumulated Portfolio Capital Inflow (Since Jan-2018)



Source: FRED St. Louis

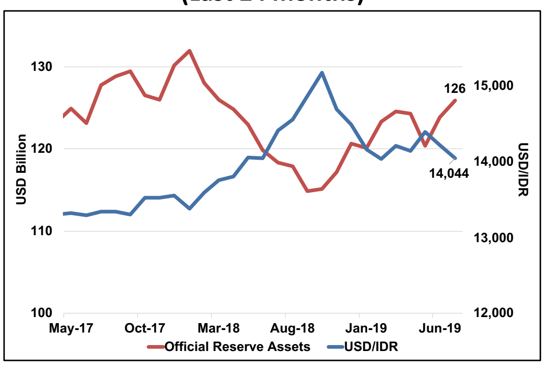
Figure 6: Government Bonds Yield (% pa)



Source: CEIC

BI's policy rate now stands at 5.75%, cut 25 bps from 6% in the previous month. BI is still considered highly conservative and slow in joining the easing tide. On the other hand, the economy does need stimulus. Nevertheless, disproportionately high share of foreign ownership of Indonesian government bonds will always serve as an extra deterrent for BI from being more responsive to easing opportunities. The correction in the bonds market in the last two weeks is a good example. For now, we view that BI should hold the policy rate at 5.75%.

Figure 7: IDR/USD and Official Reserve Assets (Last 24 months)



Source: CEIC