MACROECONOMIC ANALYSIS SERIES

# BI Board of Governor Meeting

October 2019

**Highlights**

- BI should cut its policy rates by 25 bps this month
- Low and stable inflation provide BI with stronger push to maintain the dovish monetary stance
- We predict CAD will be manageable at 2.5-2.7% in 2019; it reduces the IDR depreciation risks in the near future

***Macroeconomic & Financial Sector Policy Research***


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As the signs of economic slowdown in the US becoming stronger, the Fed has started to exert some efforts to alleviate the potential risk by cutting Fed funds rate target twice since July FOMC meeting. This, in turn, has provided other central banks more opportunities to take similar actions. BI has reduced its policy rates three times since Board of Governors' meeting in July. BI accommodative monetary policy is also responding to the increased concerns over the slowing down of the domestic economic activities.

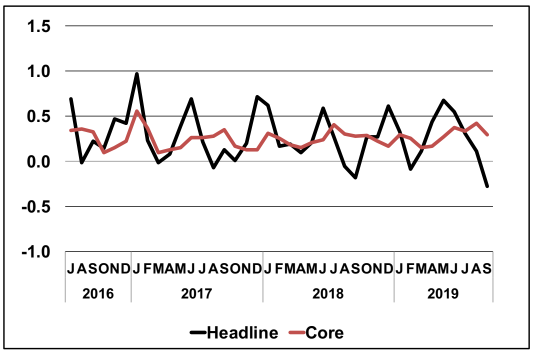
Accompanied by a significant correction in the volatile food prices, inflation is still stable within BI's corridor. On the other hand, the improvement of the recent trade balance pictures a better outlook for CAD in Q3 2019; we forecast at 2.1%, compared to 3.0% in the previous quarter. This recent development confirms our current view on the CAD performance towards the end of the year; we predict at 2.5-2.7% for 2019. Such a manageable current account balance reduces the IDR depreciation risks in the near future. This will further support the ongoing capital inflows trend due to the existing yield differential, which still favors emerging markets' assets. Overall, we see room for BI to further ease its monetary policy stance by cutting its policy rates by 25bps this month.

**Under-Control Prices, Slight Correction in Monthly Inflation**

Inflation slightly fell from 3.5% (yoy) in August to 3.4% (yoy) in September; however, it remains within the BI's target corridor of 2.5-4.5% for 2019. At the same time, consumer price index experienced a monthly deflation of -0.3% (mtm), reversing from 0.1% (mtm) inflation in the month earlier. As was the case in the previous month, September's monthly deflation was driven mainly by lower food prices. Volatile foods components recorded a deepening deflation from -0.3% (mtm) in August to -2.3% (mtm) in September due to the beginning of harvest seasons.

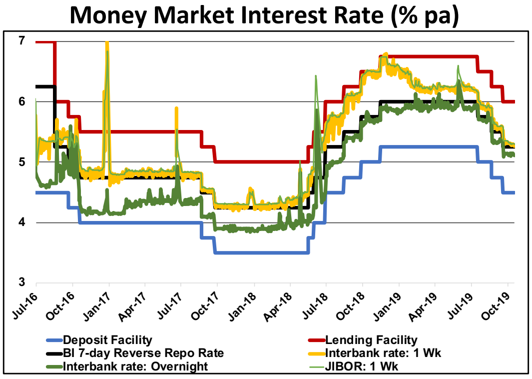
On the other hand, administered prices picked up to 0.01% (mtm) inflation, as a result of the rise in cigarette prices, after experiencing a -0.4% (mtm) deflation in August. This trend might persist, considering the potential implementation of higher cigarette excise tariff next year. Moreover, stable crude oil prices, which allows for the government's commitment to not increase subsidized fuel prices, also attributable to the manageable inflation for overall 2019. Core inflation was kept under control despite a slight correction compared to the previous period. The monthly core inflation fell to 0.3% (mtm) from 0.4% (mtm), while annual core inflation relatively stable at 3.3% (yoy).

**Figure 1: Inflation Rate (%, mtm)**




Source: CEIC

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




Source: CEIC

## Key Figures

- BI Repo Rate (7-day, Sep '19)
  **5.25%**
- GDP Growth (y.o.y, Q2 '19)
  **5.05%**
- Inflation (y.o.y, Sep '19)
  **3.39%**
- Core Inflation (y.o.y, Sep '19)
  **3.32%**
- Inflation (mtm, Sep '19)
  **-0.27%**
- Core Inflation (mtm, Sep '19)
  **0.29%**
- FX Reserve (Sep '19)
  **USD124.3 billion**

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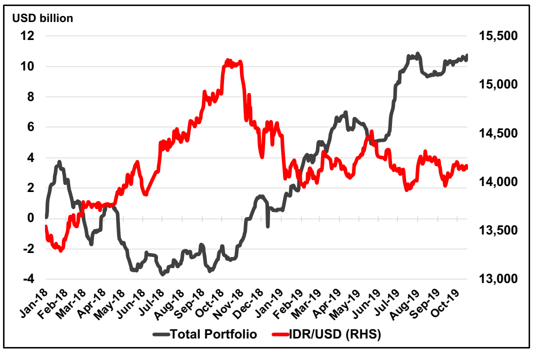
**Monetary Policy Continues to Ease**

To weather the increased concerns of the weaker global growth and uncertainties arising from the ongoing trade tensions as well as Brexit, the Fed continue its easing stance by cutting the rate to 1.75-2% during last month meeting. This has provided other central banks, including BI, more opportunities to take similar easing stance by expanding its ample supply of foreign currency. The accommodative monetary policy undertaken by BI via cutting its policy rates three times this far has been allowed by the attractiveness of Indonesia's financial market. It has recorded in the net influx of portfolio investment from January until October 2019, which is also fully reflected in the lower yields of 10-year and 1-year government bonds to 7.3% and 5.9% in October.

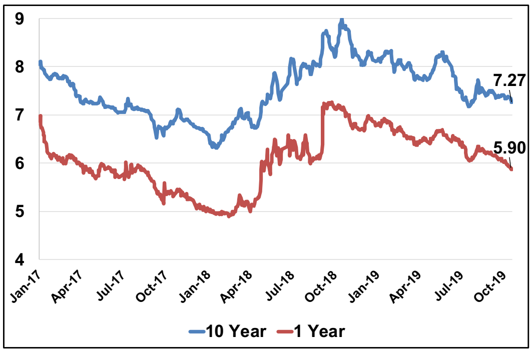
The latest development has brought the real yields offered by Indonesia bonds market to be one of the most attractive assets in Asia market. It would not be achieved without BI's active actions in managing liquidity and supporting financial market deepening through interventions in the currency and bonds market, including implementations of onshore DNDF market. Nevertheless, an improving fiscal story, as captured by the manageable fiscal deficit, has also solidify the recent Indonesia's financial market stability.

**Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Since Jan-2018)**




Source: CEIC

**Figure 4: Government Bonds Yield (% pa)**




Source: CEIC

The recent rally of capital inflows has maintained Rupiah at around IDR14,100 in October 2019. It performed rather well relative to other emerging markets (Figure 6) with the appreciation rate of around 2.0% (ytd). On the other hand, an improvement of trade deficit in Q3 2019 at USD0.1 billion from USD1.8 billion in the previous quarter has established a better picture for CAD in Q3 2019; we forecast at 2.1%, compared to 3.0% of CAD in the previous quarter. It is aligned with our current views that CAD will be at around 2.5-2.7% for overall 2019. This manageable current account balance might lower negative perception of foreign investors in the near future, thus, maintain further the IDR depreciation.

On the domestic condition, the lower-than-expected economic growth (5.05%, yoy) in Q2 2019 has prompted BI to step towards anticipating the global economic slowdown and advancing domestic growth in the short run. After cutting its policy rate three times, BI has actively done interventions in the markets, reflected by the drop of their foreign exchange reserves to USD124.3 billion, from USD126.4 billion in the previous period. This reduction is to accommodate the needs of private banks' regarding the ongoing cycle of dividend payments. Regardless of the reduction, foreign reserves remain adequate, thanks to the stability of inflation and CAD. Upbeat outlook for the domestic economy also bolsters the ampleness of foreign reserves.

## Key Figures

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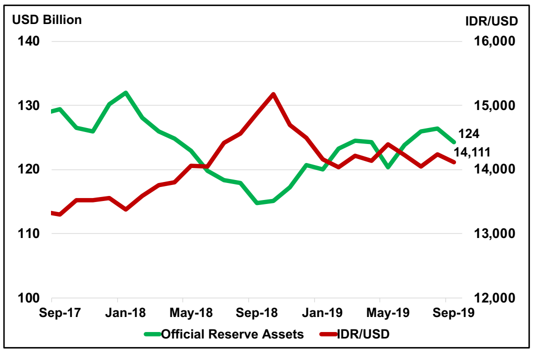
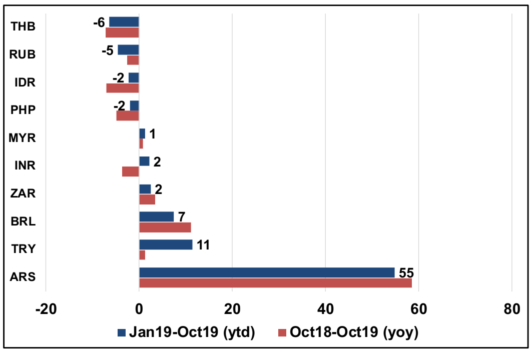
A weak US's manufacturing, services, and employment figures earlier this month have increased the probability of another Fed's rate cut at the end of October. If the data continue to come in weak, the possibility of three more rates cut until the first quarter next year will increase. On the other hand, manageable current account balance will dampen the IDR depreciation risks in the near future. The significant easing of monetary policy coupled with manageable CAD will further maintain the capital inflows trend to emerging markets due to the existing yield differential. Overall, we see room for BI to further ease its monetary stance by cutting its policy rates by 25bps this month.

**Figure 5: IDR/USD and Official Reserve Assets**




Source: CEIC

**Figure 6: Depreciation Rates of Selected EMs**




Source: CEIC