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Indonesia Economic Briefing

Monetary Policy Review: Aggressive Cut

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- Against expectation, today **Bank Indonesia has decided to cut its key policy rates by 25bps.** BI 7-Day Reverse Repo rate now stands at 4.75% whilst Deposit (FasBI) and Lending Facility at 4.00% and 5.50%, consecutively. The move was asymmetrical with the liquidity management in money market as rates for non-conventional tenors were kept relatively higher. This is amid ongoing efforts to push interbank rates closer to the benchmark rate (*please see Chart 1*).

- **Statements from the central bank that insinuate reasons behind the cut** are: 1) efforts to stimulate domestic demand, including credit. BI sees loan growth in September would come in slightly lower than the 6.8% yoy result in August, 2) better-than-expected 3Q16 current account deficit, which is projected to book below 2.0%, and 3) the fact that low interest rate also benefits non-bank financing through corporate bond issuances. Year to date, net issuances (exclude refinancing purposes) is the same size as additional bank loan within the same period.

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- We, on the other hand, would try to make a case for caution. First of all, despite having some room on real interest rate (with current spread at around 1.0%), **the outlook of inflation is on an uptrend rather than down**. Recent surge in global energy prices have not only affected domestic inflation but also to prices in major import partners. The latter would give additional inflation pressure as Indonesia is importing more consumptive goods these days.

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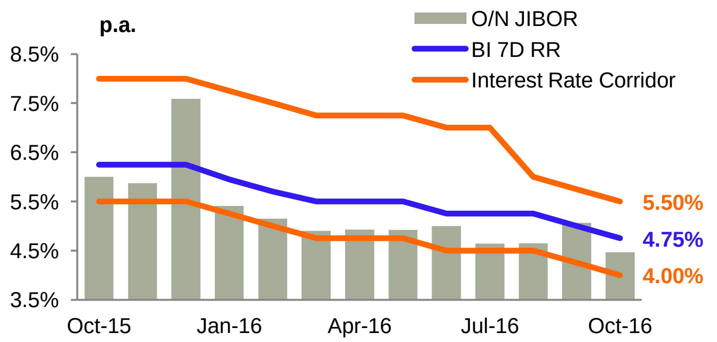
- Secondly, although low interest rate helps to consolidate banks' NPL issues at a faster pace, yet **it doesn't necessarily mean there will be high quality credit push once it's over**. From Chart 2 we can learn that negative real interest rate was followed by robust credit growth. However, these were during times when LDR was around 60%-80%, meaning that there were still excess of liquidity in the banking system to go around. If the push occurs at current condition, the impact may not only be limited but also could lead to higher risk profile in order to cover the opportunity lost of holding financial instruments. Unless, if more funds are repatriated from the tax amnesty program so that the monetary base widens and banks receive untapped liquidity.

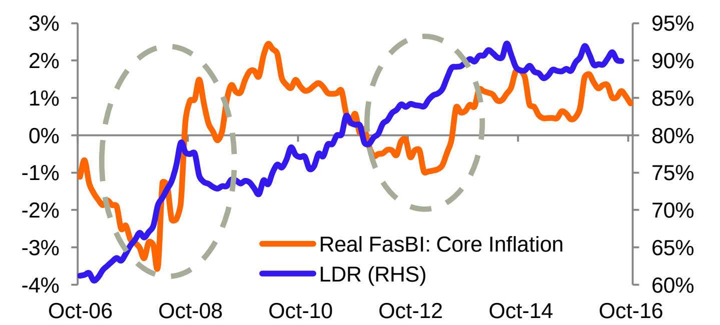
- Having said that, we are on the view that room for further monetary easing has diminished. But given the urgency of both global and domestic situations, we believe the following alternate policies are worth to put forth: **1) flattening the belly and end of term structure, and or 2) narrowing the symmetrical interest rate corridor from currently 75bps to 50bps**.

Chart 1. Policy and Market Rates



Source: Bank Indonesia, CEIC

Chart 2. Real Interest Rate of FasBI & Banks' LDR



Source: BPS, Bank Indonesia, CEIC

Indonesia: Selected Economic Indicators

	2011	2012	2013	2014	2015	2016E
National Accounts						
Real GDP (% y-o-y)	6.2	6.0	5.6	5.0	4.8	5.0
Domestic demand ex. inventory (% y-o-y)	6.1	7.7	5.0	5.4	3.9	5.0
Real Consumption: Private (% y-o-y)	5.1	5.5	5.4	5.2	5.0	5.1
Real Gross Fixed Capital Formation (% y-o-y)	8.9	9.1	5.0	4.6	5.1	4.8
GDP (US$bn) — nominal	893	918	915	890	862	893
GDP per capita (US$) — nominal	3,688	3,741	3,668	3,530	3,374	3,453
Open Unemployment Rate (%)	6.6	6.1	6.3	5.9	6.2	6.0
External Sector						
Exports, fob (% y-o-y, US$ bn)	29.0	-6.6	-3.9	-3.4	-14.8	-7.5
Imports, fob (% y-o-y, US$ bn)	30.8	8.0	-2.6	-4.5	-19.9	-6.9
Trade balance (US$ bn)	26.1	-1.7	-4.1	-1.9	7.6	6.1
Current account (% of GDP)	0.2	-2.7	-3.7	-3.2	-2.1	-2.3
Central government debt (% of GDP)	22.3	22.3	21.3	23.6	25.0	24.6
International Reserves –IRFCL (US$ bn)	110.1	112.8	99.4	111.9	105.9	103.0
Reserve Cover (Months of imports & ext. debt)	6.3	6.1	5.4	6.5	7.4	7.0
Currency/US$ (Year-end)	9,068	9,670	12,189	12,440	13,795	13,400
Currency/US$ (Average)	8,779	9,380	10,428	11,900	13,392	13.360
Other						
BI policy rate (% year end)	6.00	5.75	7.50	7.75	7.50	6.50*
BI 7-Day Reverse Repo rate (% year end)	N/A	N/A	N/A	N/A	6.25	4.75
Consumer prices (% year end)	3.78	3.65	8.08	8.36	3.35	3.20
Fiscal balance (% of GDP; FY)	-1.14	-1.77	-2.24	-2.26	-2.70	-2.50
S&P's Rating – FCY	BB+	BB+	BB+	BB+	BB+	BB+

Source: CEIC, E = Danamon Estimates, *) Up to August 2016

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