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Indonesia Economic Briefing

Getting Thin

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- Against expectation, **Bank Indonesia cut its key policy rates by 25bps** last Friday. BI 7-Day Reverse Repo rate now stands at 4.25% whilst Deposit (FasBI) and Lending Facility at 3.50% and 5.00%, consecutively. The decision was made despite early signs of economic recovery in household consumption and definitive plans of tightening from major central banks across the globe. The monetary operation term structure will follow suit, thus lowering the cap for banks' deposit rate, accordingly.

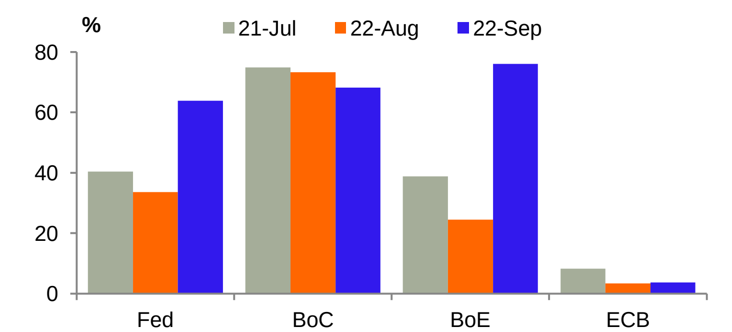
- After a September marathon of global central bank meetings that ended with the Fed, the **probability of another rate hike (ex-ECB) in December had surged above 60%** (*Please see Chart 1*). Markets are expecting that the European Central Bank may strike next around mid-2018. We reiterate our view that that there may be greater impact to local bond and currency when ECB starts its quantitative tightening, due to the fact that the current largest holder of Indonesian government bonds are European-based investors.

- We've also found another compelling argument from the way monetary policymakers manages the fundamental of Rupiah. Prior to 2014, we saw that the real effective exchange rate of Rupiah moved against the greenback and in-line with Euro. While from chart 2 we can learn that **the Rupiah moves in-line with USD and against Euro after 2014**. In a way, it highlights not only a success of managing the currency but also the significance of monetary movements in the Euro zone toward domestic financial system.

- Although BI had left room for a possibility of more rate cuts last month, the move made late last week was generally unanticipated. It would be interesting to see how market players react amid a narrowing spread against US interest rates. Yet we sense that **policymakers are getting more confident with a new normal of thin spread and more concern with pushing growth**. One certainly hopes that the cost is worth the risk.

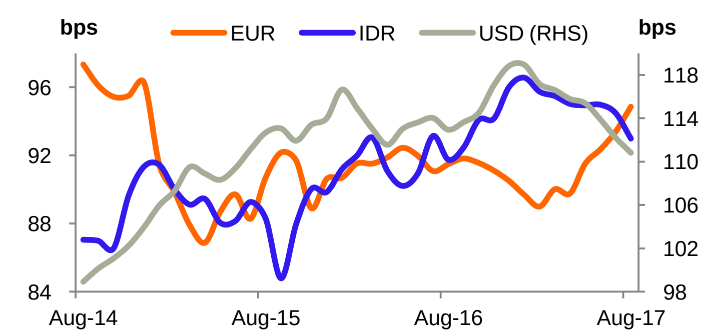
- Going forward, BI expects that 2018 inflation may be contained below their target of 3.5% vis-à-vis 3.3% (BDMN FY18 inflation forecast: 3.7%). If we impose a rule-of-thumb regarding the spread between inflation and policy rate -i.e. 50bps during monetary expansion- **then there may be room for another cut on the table**. Again, from a regulatory perspective, it comes back to what can be done rather than what needs to be done. And making use of all available options at hand.

Chart 1. Probability of Rate Hike in Dec-17



Source: Bloomberg

Chart 2. Real Effective Exchange Rate



Source: Bank for International Settlements

Indonesia: Selected Economic Indicators

	2013	2014	2015	2016	2017E
National Accounts					
Real GDP (% y-o-y)	5.6	5.0	4.9	5.0	5.0
Domestic demand ex. inventory (% y-o-y)	5.0	5.4	3.9	5.0	4.9
Real Consumption: Private (% y-o-y)	5.4	5.2	5.0	5.0	4.9
Real Gross Fixed Capital Formation (% y-o-y)	5.0	4.6	5.0	4.5	5.2
GDP (USD bn) — nominal	913	890	861	932	1,005
GDP per capita (USD) — nominal	3,648	3,529	3,371	3,604	3,838
Open Unemployment Rate (%)	6.3	5.9	6.2	5.6	5.5
External Sector					
Exports (% y-o-y, BoP Basis)	-2.8	-3.7	-15.4	-3.1	7.0
Imports (% y-o-y, BoP Basis)	-1.3	-4.5	-19.7	-4.5	6.6
Trade balance (USD bn, BoP Basis)	5.8	6.9	13.3	15.4	15.2
Current account (% of GDP)	-3.7	-3.2	-2.1	-1.8	-1.8
Central government debt (% of GDP)	21.3	23.5	26.6	27.7	30.2
International Reserves –IRFCL (USD bn)	99.4	111.9	105.9	116.4	114.0
Reserve Cover (Months of imports & ext. debt)	5.4	6.5	7.4	8.4	8.4
Currency/US$ (Year-end)	12,189	12,440	13,795	13,436	13,430
Currency/US$ (Average)	10,428	11,900	13,392	13.308	13,349
Other					
BI policy rate (% year end)	7.50	7.75	7.50	6.50*	N/A
BI 7-Day Reverse Repo rate (% year end)	N/A	N/A	6.25	4.75	4.25
Consumer prices (% year end)	8.08	8.36	3.35	3.02	3.81
Fiscal balance (% of GDP; FY)	-2.24	-2.26	-2.70	-2.46	-2.60
S&P's Rating – FCY	BB+	BB+	BB+	BB+	BBB-

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

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