Indonesia Outlook

Benchmark rate holds but what next?

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Highlights

- **Bank Indonesia (BI) held the benchmark 7 day repo rate today as expected at 6.0% as they highlighted the possibility of a moderation in global economic growth.**
- **We still believe BI will hike twice for 2019 in line with current Fed dot plot predictions but this could change if there are adjustments to the dot plots.**
- **However, down the road, if the dot plots change to indicate that the Fed will pause for 2019, we don't believe BI would consider a cut unless there are clear signs that the trade balance and current account deficit are narrowing and that growth falls below trend.**

BI held the benchmark rate today at 6.0%, in line with expectations. The decision comes as the central bank highlighted its believe of a moderation in global economic growth. The central bank had noted that "economic consolidation is expected in the United States" given a "tightening in the labour market and constrained fiscal space". Aside that, they also pointed out that "China's economy is decelerating on sluggish consumption and flagging net exports due to simmering trade tensions with the United States" as well as "reverberations" from the "ongoing deleveraging process". They mentioned that the local economy will be supported by "solid domestic demand" given preparations for upcoming elections, government social assistance and the government's procurement policy. However, they did note that "subdued export growth will persist due to a softening in the global economy and declining international commodity prices" whilst they also see "imports are also expected to begin retreating in line with the policies implemented" but that "strong import growth will remain to satisfy domestic demand". Overall, they see 2019 growth will come out at 5.0 – 5.4%. They will also work with the government to keep the current account deficit at 2.5% of GDP.

The big question now though is whether the rate hike cycle has come to an end as Governor Perry Warjiyo had earlier stated that the benchmark interest rate had "almost reached its peak". This will really depend on the IDR situation, which in turn is affected mainly by global factors. The Fed has become increasingly dovish from the end of last year as they highlighted concerns on the risk of a slowing US economy. Even so, the dot plots in December still indicate the possibility of at least two hikes in 2019. At the same time, there is still no certainty whether US – China trade tensions will recede although both sides look to be working hard at trying to strike a deal. That said, Indonesian government bond auctions for 2019 have so far attracted strong interest although yields on the 10 year and 5 year government bonds have risen recently after some initial rallying early in January. **Therefore, overall, we still believe that BI will hike twice in 2019, in line with the Fed's December dot plot predictions. However, we don't rule out that this may not be the case if the Fed's dot plot predictions are adjusted. As a note, Governor Perry Warjiyo has still reiterated that the central bank will continue to be "pre-emptive and ahead of curve monetary policy in order to guard stability".** The central bank would probably still be utilizing other tools to support the currency throughout this year.

However, down the road, if the dot plots change to indicate that the Fed will pause for 2019, we believe that BI may consider cutting although it would still depend on the situation as a lot of factors are in play. Elections uncertainty can risk resulting in outflows although this looks less likely to happen. Jokowi leads well in opinion polls as Charta Politika has reported in their latest survey (Dec 22 2018 – Jan 2 2019) that the incumbent holds an approval rating of 53.2% against his rival Prabowo who stands at 34.1%. The central bank may also want to work to maintain adequate liquidity in the lending market as the loan to deposit ratio for both commercial and state banks hit around 94% in September. Inflation was at 3.2% for 2018 and it is expected to be at 3.5% in 2019. These factors may favor a cut. However, growth is also expected to come out at 5.2% and 5.3% for both 2018 and 2019 respectively which are actually above the estimated trend growth of 5.0%. Also, as mentioned, there is the US – China trade tensions that could still be an unwanted dampener on global trade and hence, affect export levels, hurting the trade balance. This in turn means that a cut may not be ideal just yet. **Overall, we do believe that BI would only cut if it clearly appears that the trade balance and current account deficits are narrowing and if growth begins to show signs of slowing down below the trend rate.**