Inside Indonesia

Prudent Pause

Bank Indonesia holds rate but retains a dovish stance

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- **BI kept its policy rates unchanged today, as we expected. While low inflation and stable Rupiah technically give BI the room to ease today if it wants to, it decided to wait it out for now. Why?**
- **Primarily, BI is still keen to see its previous rounds of rate cuts – 100bps in aggregate – getting passed on to both deposit and loan rates. Also, even as it sees room for easing still, BI is wisely aware it is not infinite. Best to keep the powder dry.**
- **With regard to tax amnesty, BI is of the view that most of the repatriation money will only head home in December. It is also busy preparing instruments to help make sure that the initiative will go a long way towards building up the real sector, rather than turning into frothy flows.**

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Not Yet

"*Just because you can doesn't mean you should*" is a good life philosophy to have. It is useful for summoning the mental strength to resist that one more piece of chocolate cake in an all-you-can-eat buffet. More consequentially, it might well have been the frame of mind that Bank Indonesia's officials had today when they collectively decided on the country's interest rate policy. Just because they do have the space to cut rate does not mean that they should.

That was indeed our way of thinking when it comes to gauging whether BI would cut rate going into today's meeting. While most of the market watchers look at low inflation, under-control current account deficit and Rupiah stability and saw that there was room for BI to cut rate and hence they should, we were less convinced.

For one, this is a central bank that has already cut rates four times this year, with the latest easing adopted just last month. Even though the immediate economic outlook looks to remain subpar – with Q2 GDP expected to print a relatively uninspiring 4.9-5.0% yoy growth rate – there is the realization that monetary policy transmission works with a lag anyway.

From today's press conference, BI officials mentioned that out of the 100bps policy rate cut, only some portion of it has been passed on by the banks. Deposit rates have gone down by some 80bps year-to-date, while lending rates declined by just 45bps thus far. While last month's policy rate cut was done in part to quicken the pace of the pass-through, the central bank appears to adopt the stance that more time should be given to the banks to transmit the monetary easing thus far, especially for the lending rates which tend to lag the declines of deposit rates by a few months.

In taking a more gingerly approach to rate cuts, BI must also be cognizant of the fact that even if there remains space to move, it is not an infinite one. Even as inflation has stayed relatively subdued in recent months, it is still prone to upticks caused by idiosyncratic factors such as the risk of higher food and fuel prices in particular.

Moreover, with the transition to a new 7-day reverse repo rate (now at 5.25%) as the benchmark policy rate next month, replacing the 12-month BI rate (now at 6.5%), the mental room for real rates calculation has also inadvertently been narrowed. Rightly or wrongly, the transition into a nominally lower policy rate benchmark would thus leave smaller room to protect against an unexpected inflation upsurge, if the central bank cares about keeping a positive real rates buffer.

Inflation and real rates aside, another important perspective to keep in mind is the need to keep some powder dry, when it comes to room for monetary policy to support domestic growth, should the global situation turn for the worse. While the Brexit referendum results shock has not brought with any tremendous global growth shock, it may be early days still. On top of that, other factors including US presidential election remain too uncertain to rest easy. It will thus be best for Bank Indonesia to not use up all the space that it has too quickly. As we have mentioned before, the monetary toolkit is especially important when Indonesia's fiscal space is constrained by the 3% deficit-to-GDP legal cap.

Hence, taking all these into account, while we think BI is not done cutting rate yet, the pace of its move going forward will be a much more measured one. The next decision on Aug 19th will thus most likely be another pause, especially given that it will also be a time when BI officially adopts the new 7-day reverse repo rate as its benchmark rate. While the transition appears to be a smooth one thus far, the central bank might want to minimize the chance of misunderstanding just in case. Already, the officials spent some good five minutes today in the press conference to make sure that the reporters understood the nuances of the difference between existing rate and the upcoming one. Hence, we believe that the earliest BI might cut rate will be in September, once the transition is fully complete.

Meanwhile, on the hot topic of tax amnesty, BI retains its expectation that IDR560tn (~USD42.7bn) will be repatriated. Interestingly, it expects to see the majority of the repatriated money coming onshore only in December, which is basically the deadline for repatriation for assets declared in either Q3 or Q4 this year. Presumably, it takes such a view thinking that Indonesians would need time to make financial arrangements including the encashment of their assets offshore, before moving them home.

On top of that, BI also mentioned that it is coming up with instruments to better absorb and intermediate the repatriated funds, to maximize the benefits towards real sector and minimize risks of asset bubbles. This would include FX bills with tenors ranging from 1 to 3 years, matching the need to fulfil a 3-year lock-up period for repatriated funds. All in all, a rather exciting time with lots of positive development for Indonesia, even if there will not be rapid policy rate cuts to boot.

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