

Prioritizing Prudence Indonesia holds rate to play safe

Jan 19, 2017

- Prudence has imbued Bank Indonesia's decision to keep its 7-day reverse repo policy rate at 4.75% today, as widely expected by market.
- Even as it has – rightly – asserted that Indonesia is relatively insulated from any threat that the incoming Trump might pose to global trade, BI is nonetheless aware that uncertainty is in the air, and stability is most precious.
- Domestically, rounds of dogged subsidy cuts and potential upticks in fuel and food prices would also inevitably lift inflation prints, and thus curb the manoeuvre room for BI too. Hence, it could well hold rate for the rest of 2017.

An Eye On D.C.

Going into today's meeting, while the market consensus was for BI to hold rate – which it did – there was some stray call that it might just cut rate, ostensibly because of the idea that the currency market has been stable enough for the central bank to do so.

To us, that particular line of thinking, while brave, appeared to have muddled up the direction of cause and effect. Specifically, we have always been of the view that currency stability is the most key of priorities that Bank Indonesia have to shoulder, and that the central bank is always keenly aware of the potential impact that any of its monetary policy easing might have on rupiah.

The corollary is thus that the remarkable stability that the Indonesian currency has displayed is also dependent on BI's prudent monetary policy framework as a crucial supporting pillar. Hence, no point risking it just for the expedience of pushing down policy rate another notch, especially since it has already brought down policy rates by a considerable 150bps last year.

Indeed, the need for patience runs even deeper now, as we count down to the impending Trump presidency. Just how the man would affect global financial market stability is still a big unknown, and no matter how closely we follow his utterance – or perhaps because of it – just how serious he is in following through on his campaign promises remains a mystery.

From Indonesia's perspective, as we highlighted in our [Weekly Wander](#) a few days ago, the impact of any rise in trade protectionism on its economy is relatively minimal, owing to the heavy domestic orientation. This is something that BI officials mentioned to in the press conference today, as well. Still, as they rightly alluded to, Indonesia should nonetheless be aware of any collateral damage that such an action can wield. In short, it would have been naïve to assume away such a risk and pretend it would not affect Indonesia's economic stability.

Turning our attention to domestic factors, BI seems to be placing more emphasis on the potential for inflation uptick than before. While the effect of rationalization of electricity subsidy has been well-flagged in prior meetings, a recent slew of factors contribute to its more guarded assessment of inflation risk, including rising commodity prices as well as

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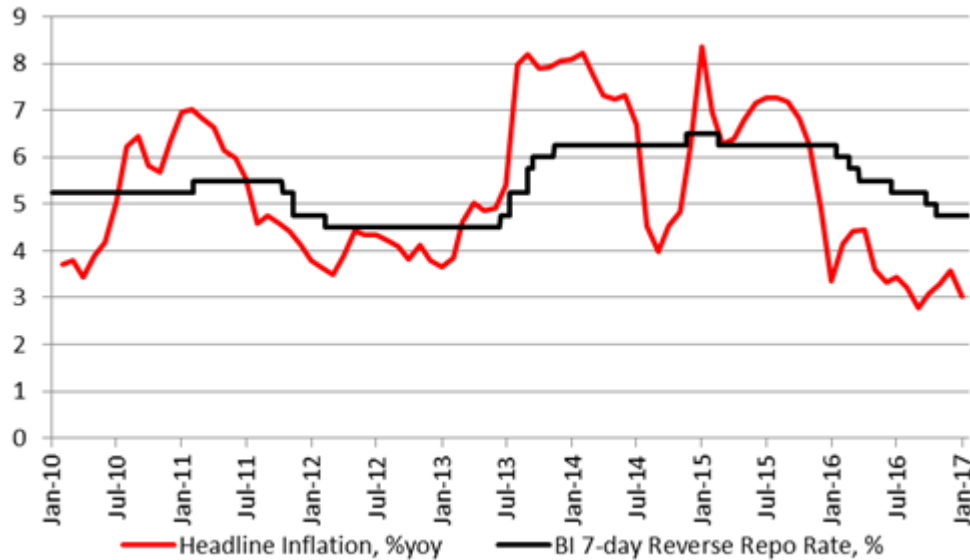
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a considerable increase in vehicle registration fees. Indeed, BI sees a good chance that inflation will reach above 4% in 2017, in line with the 4.3% that we have pencilled in. While this is still very much within the central bank's inflation target of 3-5%, it should nevertheless remind the market that the sense that BI can ease policy rate by a whole lot is not a sensible one.



Source: Bloomberg, OCBC.

A more constricted room for manoeuvre aside, it is also not clear to us that there is any dire need for the central bank to actually cut rates further to boost growth. This is because we still see a good chance that Indonesia can reach a fairly healthy growth of 5.2% this year, as the economy digests the hefty rate cuts of 2016. Of course, cutting rate further might goose up growth perhaps a tad more, but the question is always whether it would be worth it. To us, given the global context, the answer is no.

This is partly because there appears to be some more juice left, courtesy of last year's easing. While the central bank had eased rates by 150bps in total, BI said in the press conference that preliminary figures indicate that the average lending rate has declined by just 79bps through the year of 2016. Even as it is highly unlikely that banks will pass on the policy rate cuts in entirety, there is still some mileage left.

Overall, we think Bank Indonesia is most likely going to keep its policy rate on hold for the whole of this year. The economy does not really need further monetary boost at this point, and in fact, doing so when the global situation remains unsettled – and potentially more and more prone to reversals – may well be counter-productive.

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