Economics

DBS Flash

Indonesia: Likely end of BI tightening cycle

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- *Bank Indonesia left 7DDR unchanged at 6% yesterday on the back of stable inflation expectation and stronger Rupiah.*
- *Trade balance continued to widen in 4Q18, driven by slowdown in Non-Oil & Gas exports.*
- *A rebounding Rupiah and lower oil price will translate to narrower current account deficit.*
- *Inflation expectation remains low as oil price has come down significantly and rice price is expected to remain stable.*
- *Given Indonesia's high real interest rate and lucrative interest rate differential, **BI rate hike cycle might have ended this year, as we expect lower headwinds towards inflation, CAD and Rupiah***

Bank Indonesia (BI) kept its benchmark rate (7DDR) at 6% on Thursday, as expected. Pressure to Rupiah has eased since Nov18 as capital inflows shifted back to emerging Asia, including Indonesia. In addition, Fed's more dovish stance has set the stage for a more modest hike cycle for emerging economies including Indonesia. BI also sees that current account deficit is likely to narrow this year, lowering the pressure for further hike.

BI also reiterated its view that inflation would stay benign this year as oil price eased and volatile food price is expected to remain stable due to better supply management.

Has the cycle ended?

We think the hiking cycle has ended with the last hike in Nov18 as both external and domestic pressure has ebbed. There are three reasons:

- First, expectation of fewer Fed rate hikes this year, while Indonesia's interest rate differential still has some headroom for two more Fed rate hike;
- Second, balance-of-payment pressure will ease amidst stronger inflows back to emerging markets;
- Third, inflation is expected to remain low at 3.6% from our previous estimate of 3.8%.

Inflation was benign last year, averaging 3.2% and is expected to remain soft this year as oil price ease and domestic demand stable. We still expect inflation to pick-up slightly to 3.6% as election spending might catalyze higher private consumption.

BI has been sensitive towards widening current account deficit (CAD) on their policy rate decision historically. Yet, we see that pressure to Rupiah has become an equally important variable last year as BI emphasized concerns over Rupiah in almost all of its policy meeting.

We think pressure to Rupiah has subsided. Indonesia might benefit from the return of capital flows to emerging markets bonds which has recorded and inflows of USD675mn (equities) and USD361mn (bonds). In fact, Rupiah gained 6.8% between Nov 1, 2018 to Jan 17, 2019 thanks to higher inflows. The inflows is likely to continue this year, as risk aversion moderated while real yield differential and equity valuation has become attractive.

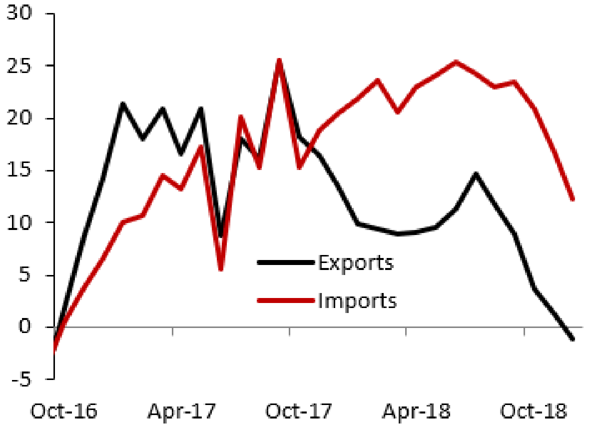
Further risk lies more on trade deficit

Worsening trade balance is the biggest risk to our view. Despite declining oil price, the trade deficit will still likely widen to USD4.6bn in 4Q18 from USD2.6bn in 3Q18. Imports have eased significantly in Dec18 to 1.2% YoY from 11.8% YoY in Nov18, but not enough to compensate the contraction of exports, recording -1% YoY in 4Q18 from 9.5% YoY in the first three quarters.

We expect imports growth to ease this year compared to last year as lagged impact of Rupiah depreciation will start to take effect, in addition to lower oil price. **Yet, the risk of exports slowdown might remain on the horizon despite the more competitive Rupiah as China and overall global trade demand fall.** In fact, exports to China has already contracted significantly starting in Nov18, averaging -0.1% YoY from 33.5% YoY between Jan-Sep.

Exports and imports growth

% YoY (3mma)



Even though terms of trade have improved with lower oil price, trade deficit might stay wide as the difference between imports and exports volume growth becomes wider. There are no short-term solutions to close this imports-exports gap. Industrialization plan to develop export-oriented industries would be beneficial in the medium run.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).