Economics

DBS Flash

Bank Indonesia pauses; likely to be temporary

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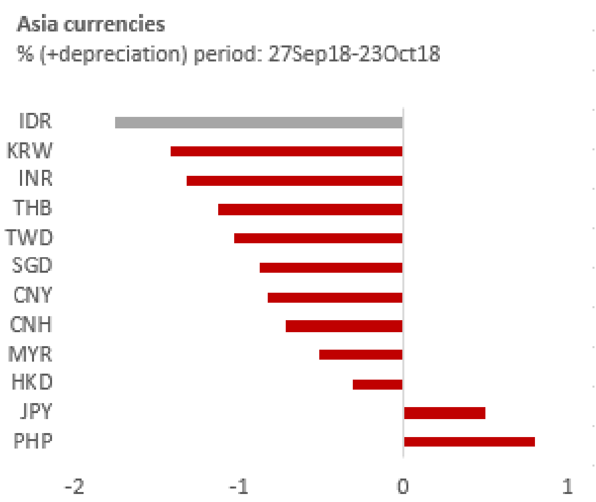
- *Bank Indonesia kept its benchmark rate at 5.75% in yesterday's policy meeting, in line with expectations.*
- *While the rupiah, equity, and bond markets have continued to be under pressure since the last policy meeting, the mildly improved September trade balance has provided some breathing space for BI.*
- *Since a full-blown fuel price adjustment is unlikely before the election next year, we think inflation will remain benign so long as food price stability is intact, especially rice.*
- *BI's pause is likely to be temporary; we see the central bank saving ammunition as further Fed rate hikes loom.*

Bank Indonesia paused yesterday, on the back of some currency stability and better trade data. In the press conference, BI's deputy governor reemphasized that as inflation remains low, current account deficit is a more important factor for the central bank's consideration. We still think that BI is likely to raise one more time this year depending on 3Q trade data (which will be published before the next meeting and Fed rate decision).

There is more to Rupiah depreciation than a strengthening US dollar. Since the last policy meeting on September 27th to October 23rd, Rupiah has depreciated more (by 1.8%) than DXY has strengthened (by only 0.5%), despite the positive developments in both fiscal and trade deficit. Rupiah has depreciated more during the same period than its twin-deficit counterparts in Asia, Indian Rupee (depreciated by 1.3%) and Philippines Peso (appreciated by 0.8%), since the last policy meeting.

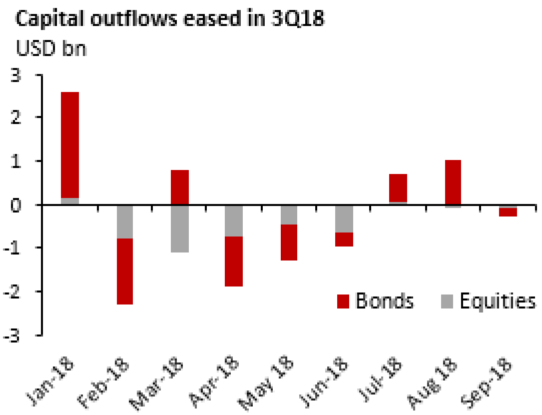
Rupiah and liquidity pressures have eased somewhat. Narrowing gap between the 1-month NDF and spot rate indicates less pressure to Rupiah. In the domestic side, the transaction-based overnight benchmark rate (Indonia) has eased to 5.6% from a peak 5.8% earlier this month, also indicating less tight liquidity.



Source: Bloomberg, DBS Group Research

Fundamental is intact, yet financial market jittery persists. The pressure to capital flows has somewhat eased in 3Q18 compares to 2Q18. However, this month, both still recorded outflows. The Jakarta stock index has dipped further by 8% on the year to IDR5800 loosing almost the full year gain as the level returned to its level in mid-Sep 17. Higher US rates have impacted bond markets, 10Y hike by 195bps this year. As a result of BI interventions in both FX and bond markets, reserve fell by another USD3.1bn in September, to USD114.8bn as BI maintain presence in both FX and bond markets.

In terms of real interest rate, Indonesia (and India) are among the highest in emerging Asia pool. However, for Indonesia, as inflation will increase next year, rates need to increase further to maintain competitiveness.

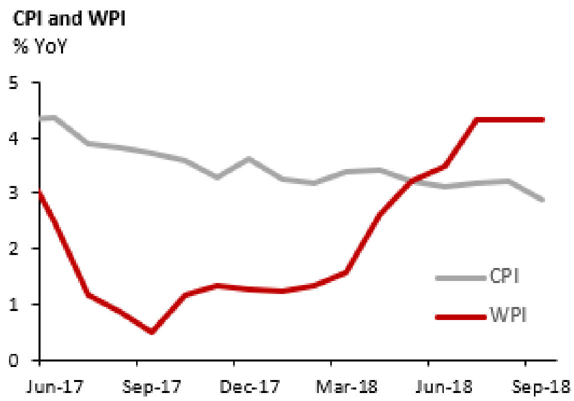


Source: Bloomberg, DBS Group Research

Near future risk: inflation

Inflation has been kept low by stable food prices and keeping fuel price fixed. September inflation remained low at 2.9% YoY the lowest since Aug 2016 as two major movers of inflation, i.e., food and transportation, have continued to soften in the past two months. **If oil price stays at the current level (or higher), we believe that domestic fuel price will eventually need to be adjusted**, at least after the general election. How this will unravel - both timing and level of adjustment - creates additional uncertainty to the 2019 inflation outlook.

Another risk to inflation relates to the higher production cost which has not been transmitted to higher consumer price due to weak demand. In the last two years, the increase of production cost, as indicated by higher wholesale prices, could not be passed on to consumers. One of the cause of this incomplete passthrough was weak domestic demand, as softening commodity price lowers real income.



Source: Bloomberg, DBS Group Research

Corporate Indonesia has likely taken the hit with profit margins. **If the currency and BOP pressures continue, we think that at some point, one of these two adjustments will take place: first, pass part of the cost to consumer hence higher CPI** or second, cost cutting which might include corporate downsizing. We think the former seemed to be more likely at this point. Both options will impact negatively on real income either through higher CPI or lower nominal income.

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