August 31, 2017

MONETARY WATCH: BI Resumes Policy Easing

DRI Forecast for 2017

7D Reserve R. (%)	4.50
Inflation (%)	3.5 - 4.0
GDP Growth (%)	5.2 - 5.3

- Interest rates have finally been cut again. After rates were kept stable at 4.75 percent for 9 months (rates were last cut in October 2016), BI finally resumed its policy of monetary easing by lowering interest rates at its monetary policy meeting on 21 – 22 August. The 7-Day RR rate was cut from 4.75 to 4.50 percent, while the Deposit and Lending Facility rates were reduced from 4.00 to 3.75 percent and from 5.50 to 5.25 percent, respectively. The rate cuts can be expected to encourage banking intermediation which, in turn, will help to give a boost to economic growth.

- From the last week of July until the third week of August, or just before BI cut interest rates, the interbank interest rate (as proxied by the JIBOR O/N rate) moved in an upward trend. The JIBOR O/N rate rose gradually from 4.37 percent on 24 July to 4.45 percent on 21 August. However, after BI lowered the 7-Day RR rate, the JIBOR O/N rate then declined to 4.13 percent on 23 August and to around 4.10 percent presently. We expect the JIBOR O/N rate to remain stable at around this level in September as no further interest rate cuts are expected for the foreseeable future.

- In June, deposit rates (including the 3 month deposit rate) were flat. Nonetheless, the surprise decision by BI to cut rates in August will provide a catalyst for further declines in deposit rates. In addition, we also expect LPS to cut its rate. Based on our impulse response analysis, banks can be expected to cut their deposit rates by up to 15 bps with a lag of three months.

- Lending rates, meanwhile, fell 3 bps. Assets quality showed little improvement with NPLs at 3.0 percent in June. Now that the benchmark rate has been cut again, we expect credit rates to decline with a lag of two months, albeit half the decline in deposit rates.

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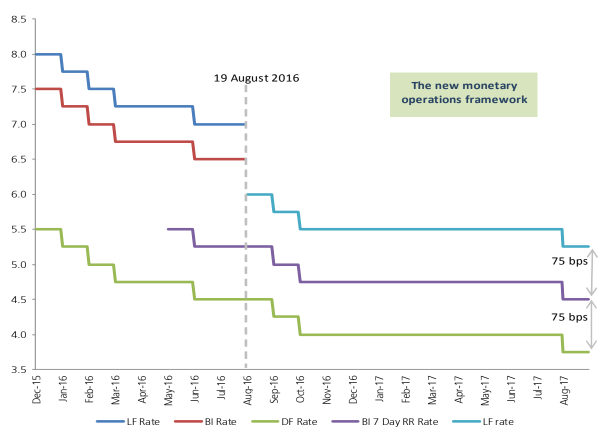
BI 7-Day RR Rate: Surprise Cut, Ahead of USA Tightening

- Interest rates have finally been cut again. After rates were kept stable at 4.75 percent for 9 months (rates were last cut in October 2016), BI finally resumed its policy of monetary easing by lowering interest rates at its monetary policy meeting on 21 – 22 August. The 7-Day RR rate was cut from 4.75 to 4.50 percent, while the Deposit and Lending Facility rates were reduced from 4.00 to 3.75 percent and from 5.50 to 5.25 percent, respectively. The rate cuts can be expected to encourage banking intermediation which, in turn, will help to give a boost to economic growth.
- In its policymaking, BI would have considered several factors, including easing concerns over FFR hikes and the Fed's balance sheet normalization plans. Indeed, the Fed appears increasingly likely to raise the FFR on only one more occasion this year (delayed to year-end) with US balance sheet normalization that would be announced in September. As such, BI took the opportunity to cut rates in August despite the expected tightening of monetary policy in the US.
- Domestically, the inflation rate slowed to 3.88 percent (YoY) in July from 4.37 percent (YoY) in the previous month. As such, inflation remains within BI's target band of 4±1 percent. Despite this, economic growth remains lackluster. Hence, with credit growth also slowing, BI's decision to cut rates is expected to give a timely boost to the economy.

BI Reference Rate

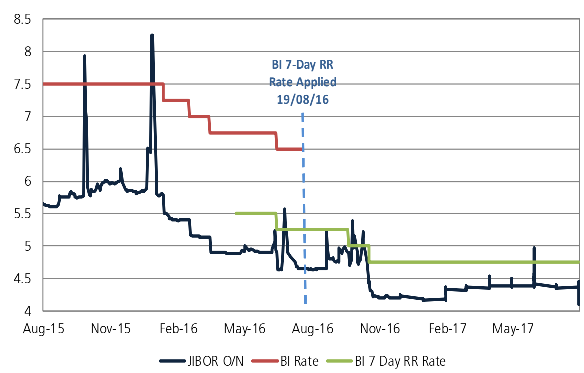


Source: Bank Indonesia

Interbank Interest Rate: Impact on the JIBOR O/N Rate

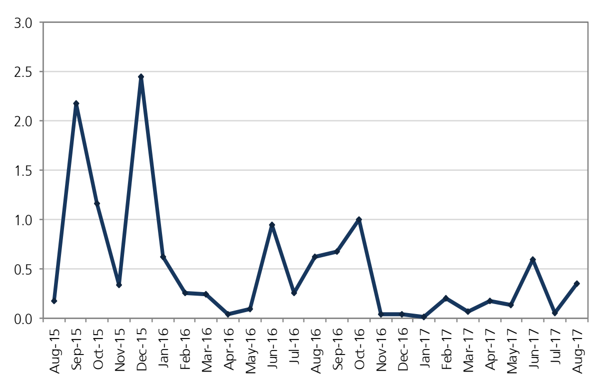
- From the last week of July until the third week of August, or just before BI cut interest rates, the interbank interest rate (as proxied by the JIBOR O/N rate) moved in an upward trend. The JIBOR O/N rate rose gradually from 4.37 percent on 24 July to 4.45 percent on 21 August. However, after BI lowered the 7-Day RR rate, the JIBOR O/N rate then declined to 4.13 percent on 23 August and to around 4.10 percent presently. As such, the average JIBOR O/N rate in August (4.30 percent) was lower than it was in July (4.37 percent). At the same time, the volatility of the JIBOR O/N rate in August (0.35 bps) was also much higher than it was in July (0.06 bps).
- We expect the JIBOR O/N rate to remain stable at around 4.10 percent in September as no further interest rate cuts are expected for the foreseeable future.

JIBOR O/N Rate



Source: Bloomberg

JIBOR O/N Spread



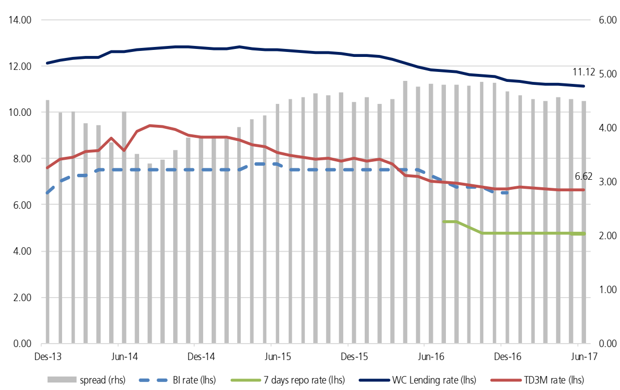
Source: Bloomberg, DRI

Deposit and Credit Rates: Stayed Right Where They Were

- In June, deposit rates (including the 3 month deposit rate) were flat. As predicted before, there was no significant change in deposit rates in either June or July since Bank Indonesia withdrew money from the banking system following Idul Fitri. However, the surprise decision by BI to cut rates in August will provide a catalyst for further declines in deposit rates. In addition, we also expect LPS to cut its rate. Based on our econometric analysis, banks can be expected to cut their deposit rates by up to 15 bps in the next three month.

- Lending rates, meanwhile, fell 3 bps. Assets quality showed little improvement with NPLs at 3.0 percent in June. Now that the benchmark rate has been cut again, we expect credit rates to decline with a lag of two months, albeit half the decline in deposit rates. Nonetheless, for July and August we don't expect any noticeable decline in lending rates given the adjustment period for transmission of the benchmark rate cut.

The Interest Rate Spread of Banks



Source: Bank Indonesia

September BI Governors' Meeting:

- Although inflation edged down in July, the ytd inflation as of July reached 2.60 percent – or slightly higher than in 2016. For the full year, we forecast inflation in the range of 3.5 - 4 percent – yet still in line with BI's target of 4±1 percent. Meanwhile, Indonesia's forex reserves have strengthened further. They rose by USD5bn to USD128bn in July. And on the currency front, the rupiah has been stable since January – trading in the range of Rp13,256 – 13,476 per USD, with only around 1 percent depreciation from the end of 2016. Nonetheless, foreign outflows were higher in July due to portfolio adjustments in relation to concerns over the Fed's future policymaking.

- Following August's benchmark cut, we don't expect another cut in the September Governors' meeting. Nonetheless, we still expect the central bank to provide a stimulus to the economy through appropriate macro prudential policies for the foreseeable future.

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