Monetary Watch
DANAREKSA RESEARCH INSITITUTE

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MONETARY WATCH: Widening CAD in the spotlight

DRI Forecast for 2018

7D Reserve R. (%)	5.75 - 6.00
Inflation (%)	3.00 - 3.50
GDP Growth (%)	5.20 - 5.30

- At its November monetary policy monthly meeting on 14 – 15 November, BI unexpectedly decided to raise the 7-Day RR rate by 25bps from 5.75 percent to 6.00 percent, while the deposits and lending facility rates were also hiked by 25bps to 5.25 and 6.75 percent, respectively. This move came as a surprise, as the consensus view was that the benchmark rate would not be changed in November. The decision to hike the 7-Day RR rate came shortly after the Indonesian Central Bureau of Statistics announced that Indonesia's trade deficit had widened in October.
- The interbank interest rate as proxied by the IndONIA and JIBOR O/N rates in the first three weeks of November continued to head higher following the hawkish trend of the benchmark rate. In the first three weeks of November, the average IndONIA rate was 5.65 percent, or slightly higher than its average in the first three weeks of October of 5.62 percent.
- In next month's governors' meeting, we expect BI to keep its benchmark rate steady. In the US, meanwhile, the expectation of aggressive FFR hikes and normalization of the Fed's balance sheet amidst encouraging US economic performance may mean that the rupiah remains volatile. The prospect of rising US Treasury yields as the US budget deficit widens may also absorb liquidity in the global markets. Other factors which continue to worry the market are concerns over US protectionism, the increasing prospect of a trade war and heightened geopolitical risks. Against this backdrop, BI will closely scrutinize economic indicators to decide whether further rate hikes are needed in the future.

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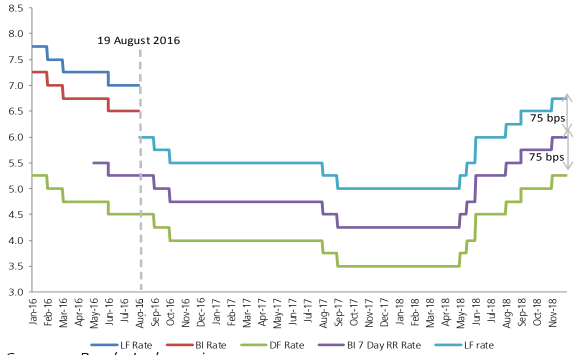
BI 7-Day RR Rate: Unexpected Tightening, Shifting the Focus toward Narrowing the CAD

- At its November monetary policy monthly meeting on 14 – 15 November, BI unexpectedly decided to raise the 7-Day RR rate by 25bps from 5.75 percent to 6.00 percent, while the deposits and lending facility rates were also hiked by 25bps to 5.25 and 6.75 percent, respectively. This move came as a surprise, as the consensus view was that the benchmark rate would not be changed in November given: the slump in global crude oil prices, Indonesia's benign inflation in October, the rupiah's ~4 percent appreciation since the beginning of November, the unchanged Fed rate in November, and Indonesia's sluggish third quarter GDP growth rate.

- The decision to hike the 7-Day RR rate came shortly after the Indonesian Central Bureau of Statistics announced that Indonesia's trade deficit had widened in October. The October trade deficit was much wider than expected - mainly due to a jump in oil and gas imports. The October trade deficit was the second-largest monthly deficit in 2018 after the July deficit and the largest deficit since July 2017. As a result, it looks less likely that the current account deficit (CAD) can be brought below 3 percent of GDP in the fourth quarter of 2018. This year, Indonesia's CAD breached the alarming threshold of 3 percent of GDP in the second and third quarters, with the CAD wider in the third quarter than in the second quarter. With a hawkish interest rates policy stance, BI is attempting to narrow the CAD in the fourth quarter onwards by maintaining the attractiveness of Indonesia's financial markets.

- Since BI's next meeting is scheduled to be held a day after the FOMC meeting, BI's decision to hike rates in November was again pre-emptive, front loading, and ahead of the curve given that the Fed is expected to hike the FFR in December. Since the beginning of 2018, BI has hiked the 7-Day RR rate on 6 occasions, by 175 bps in total, while the Fed has hiked the FFR three times this year, by 75 bps in total. As the difference between these benchmark rates has reached 100bps, we believe this is enough to attract capital inflows. Meanwhile, BI introduced rules covering rupiah interest rate derivatives - Interest Rate Swaps (IRS) and Overnight Index Swaps (OIS) - in order to expedite further deepening of the financial markets and to provide alternative hedging instruments against domestic interest rate fluctuations. The rupiah strengthened further after BI's latest rate hike.

BI Reference Rates



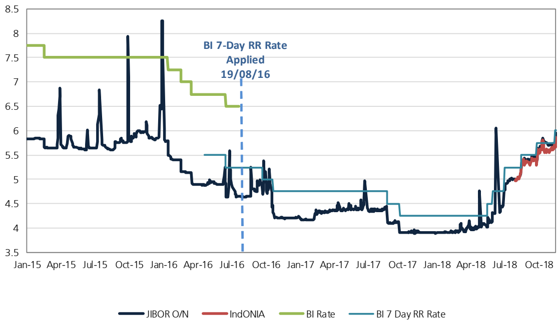
Source: Bank Indonesia

Interbank Interest Rate: Slightly Higher Volatility

- The interbank interest rate as proxied by the IndONIA and JIBOR O/N rates in the first three weeks of November continued to head higher following the hawkish trend of the benchmark rate. In the first three weeks of November, the average IndONIA rate was 5.65 percent, or slightly higher than its average in the first three weeks of October of 5.62 percent. Similarly, the average JIBOR O/N rate in the first three weeks of November was also slightly higher than its average in the first three weeks of October (5.74 percent vs. 5.72 percent). Furthermore, the volatility of both the IndONIA and JIBOR O/N rates rose slightly from 28 bps in the first three weeks of October to 31 bps in the first three weeks of November for IndONIA and from 21 bps in the first three weeks of October to 26 bps in the first three weeks of November for JIBOR O/N.

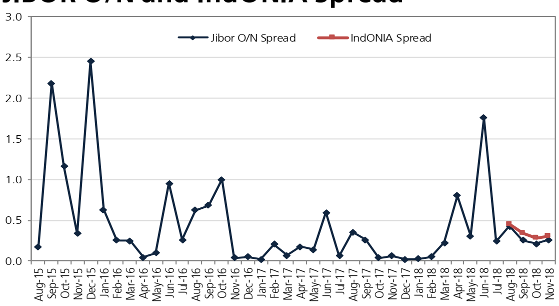
- Looking ahead to December, the IndONIA and JIBOR O/N rates may continue to head higher. The volatility of the IndONIA and JIBOR O/N rates may also increase given that a FFR hike is expected in December and because of the year-end festivities.

JIBOR O/N and IndONIA Rates



Source: Bloomberg

JIBOR O/N and IndONIA Spread



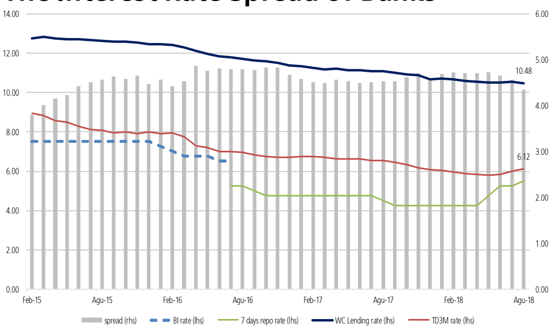
Source: Bloomberg, DRI

Deposit and Credit Rates: Credit Rates Up Significantly

- As expected, the deposit rate rose further (by 14 bps in September) after increasing by 13 bps in the previous month. In September, BI hiked its benchmark rate another 25 bps to 5.75%. After this, LPS followed BI's move by hiking its maximum guaranteed interest rate for rupiah-denominated savings in commercial banks to 6.50%. Despite higher deposit rates, deposits growth has moderated and the banking system has enough liquidity. Looking ahead, we still see room for further increases in the deposit rate given the latest developments.

- The credit rate rose 11 bps. This year, the hikes in the benchmark rate will bring an end to the downtrend in credit rates which have been evident over the past 2 years. Even though Bank Indonesia is unlikely to cut benchmark rates this year, it will still adopt certain macro-prudential policies to achieve brisker credit growth.

The Interest Rate Spread of Banks



Source: Bank Indonesia

DECEMBER BI Governors' Meeting: Overcome CAD Widening

- The rupiah strengthened to 14,611 per USD on 16 November. Earlier in October, Indonesia's foreign exchange reserves rose by 316 milliar USD to 115 bio USD. In the bond market, the 10-year government bond yield trended down to 8.1 percent in early November. However, the current account deficit climbed to USD8.8 billion (3.37% of GDP) in the third quarter of 2018, up from USD8.0 billion (3.02% of GDP) in the previous quarter. In October, the trade balance recorded a huge deficit of 1.82 bio USD. These developments might weigh on the rupiah.
- Despite these developments, Indonesia's economic fundamentals are still quite strong. In the 3rd quarter of 2018, the economy grew by 5.17 percent. Consumption growth stayed above 5 percent. Positively, inflation is well contained. It reached 3.16 percent (yoy) in October 2018 – slightly below October 2017's level of 3.58 percent (yoy). Inflation is also still within BI's targeted range. With inflation likely to remain benign in the months ahead, BI still has some room to navigate the financial market headwinds.
- In next month's governors' meeting, we expect BI to keep its benchmark rate steady. In the US, meanwhile, the expectation of aggressive FFR hikes and normalization of the Fed's balance sheet amidst encouraging US economic performance may mean that the rupiah remains volatile. The prospect of rising US Treasury yields as the US budget deficit widens may also absorb liquidity in the global markets. Other factors which continue to worry the market are concerns over US protectionism, the increasing prospect of a trade war and heightened geopolitical risks. Against this backdrop, BI will closely scrutinize economic indicators to decide whether further rate hikes are needed in the future.

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