

Indonesia: BI Set to Lift Interest Rates as Domestic Inflation Turned Higher

The BI surprised market with a 25bps hike in its benchmark one-month rate to 8.25% on Tue as the central bank moved to preempt higher inflationary pressure with the prospect of a hike in the subsidized fuel prices as early as this month. The BI has kept rates steady since the start of the year after slashing rates by a cumulative 475bps between May 2006 - Dec 2007. The last time that the BI hiked interest rates was in Dec-2005 after the government doubled the retail prices of fuel prices in Oct-2005 which brought domestic inflation rate to 18.4%/y/y in Nov that year. This time round, the government said the hike in prices of subsidized petroleum products would be capped at 30%.

Domestic inflationary pressure has intensified with the headline inflation rate rising to 19-month high of 9.0%/y/y in April and is set to remain elevated in coming months. So far, domestic inflation has been led by higher food and housing costs while the govt's subsidies on fuel consumption have helped to insulate the transport segment from the record oil prices globally. Unlike the regional central banks which were able to curb some of the imported inflation through a stronger domestic currency, the BI was dealing with a weak IDR which rose 1.9% against the USD YTD compared with 4-6% rise in the MYR, SGD and THB vs USD. The govt is expected to announce details of the cut in subsidies in gasoline, diesel and kerosene within two weeks, aimed at reining in the budget deficit which could widen to more than 2% of GDP as a result of the surge in global oil prices. The move will bring headline inflation rate to double-digit pace, probably as high as 11-12%/y/y in the next few months.

Monetary tightening will be positive for the IDR

With inflation rate well-above the benchmark one-month SBI rate, the BI is likely to continue to hike interest rates this year. Despite higher growth risks due to weaker US economy, we are expecting another 50bps hike in the one-month SBI rate to 8.75% by end-3Q08. We believe the cut in fuel subsidy and monetary tightening will be positive for the IDR which has underperformed its regional peers this year. USD/IDR has remained steady at around 9,220 today after the surprise rate hike on Tue. We expect the pair to end the year around 9,000.