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Flash Notes

Indonesia: BI Slashed Interest Rates By 50bps

Bank Indonesia surprised market with an aggressive 50 bps cut to its benchmark interest rate to bring it to a fresh record low of 6.00% today. Market was divided in their expectation for the monetary policy decision today as the rout in the global market shows signs of intensifying, but was at most expecting a 25 bps rate cut. The move today was the second consecutive month of interest rate cut following 25 bps reduction in October, bringing interest rates below the level during the global financial crisis in 2008/09. With inflation easing rapidly in the past few months, the central bank also signalled that it is prepared to cut rates further if the external environment deteriorates. We think the 75bps rate cuts in the past two months were too aggressive given that the central bank was still forecasting GDP growth of 6.6% this year and 6.5% in 2012. This could increase the risk of capital outflows and affect the IDR which has been an important anchor for domestic inflation.

Inflation in Indonesia Has Been Cooling Faster Than What Market Had Expected

Headline CPI growth eased sharply from its peak of 7.02% y/y in Jan to 4.42% y/y in Oct. We now expect headline inflation to remain steady at around this level in the next 3-4 months. Bank Indonesia estimated that the inflation rate would drop to around 4% y/y by end-2011, which is at the lower end of its 4%-6% target range. Even with base effect setting in, Indonesia's monthly inflation rate would remain well-below 6.0% y/y in 2012, unless food and commodity prices spike up sharply. Our inflation forecast is 5.4% and 5.1% for 2011 and 2012 respectively. Core inflation which has been garnering more attention lately, also appeared to have peaked at 5.1% y/y in Aug as it moderated to 4.4% y/y in Oct. Against the backdrop of easing domestic inflationary pressure, Bank Indonesia has room to manoeuvre in its monetary policy but the aggressive cuts in Oct and Nov has reduced the prospects of similarly large moves in the coming months even if the growth outlook worsens.

Impact on USD/IDR

USD/IDR headed up to 9,020 following the rate announcement. Bank Indonesia was reportedly defending the 9,000 level for USD/IDR this morning amid the broad sell-off in the markets in relation to the European concerns. Besides maintaining confidence, the central bank has a preference for using IDR strength rather than higher domestic interest rate to contain the inflationary pressure in the country. The IDR is one of the best-performing currencies in Asia so far this year. Compared with losses in most other Asian currencies, the IDR is currently trading at its level at end-2010. Nonetheless, the uncertainties in the global environment will continue to hold risks for the IDR and this could increase following the unexpectedly large interest rate cuts. For now, we are still maintaining our forecast for USD/IDR to trade at around 9,000 by end of this year. It's closing high so far this year was 9,130. However, should external risks intensify, there is certainly a chance that USD/IDR could test 10,000. Recall that the IDR lost as much as 25% of its value against USD during the Lehman's failure when it slumped to a low of 12,400/USD from around 9,200.