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Bank Indonesia's policy rate: Dovishness persists

In line with our and market expectations, BI, at its recent Board of Governors' meeting, maintained its benchmark policy rate at 7.50% while the FASBI and lending facility rates were retained at 5.50% and 8.00%, respectively.

The governors stated that room for policy easing is increasing. As a result, even though the policy rate was unchanged at 7.50%, BI cut the minimum primary reserve requirement from 8.00% to 7.50% to increase the availability of financing for economic growth. However, BI plans to remain vigilant on concerns over market volatility from a possible US Fed rate hike in December 2015.

Additionally, BI mentioned that economic improvement in the US is not moving in line with growth in the EU and Japan. Hence, the ECB and BoJ are likely to continue their monetary easing while persistent weakness in China's PMI data could trigger further easing by the PBoC. Note that Bloomberg consensus indicates some Asian nations are considering further rate cuts in 2016 (exhibit 1).

As we had written in our report on CAD and trade balance about BI's dovishness, we see a lower reserve requirement ratio as part of the central bank's plan to deal with the coming era of low inflation and lower than expected economic growth which we had covered in our macro preview last month.

BI stated that the external balance continued to improve as the current account deficit (CAD) was only at 1.86% in 3Q15 (2Q15: 1.95%). Additionally, BI expects 2015 GDP growth to be at lower end of the 4.7-5.1% target range (BS: 4.72%) and that for 2016 to be in the 5.2-5.6% range (BS: 5.1%), helping to curb imports. Given BI's low 2015 inflation target of around 4+1% (BS: 4.2%), we maintain our expectation of a 25-bp rate cut in December 2015.

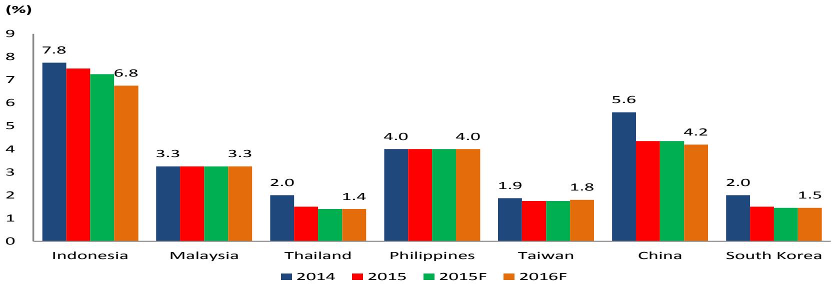
At this stage of the market cycle, we believe there is an increasing need for BI to provide monetary easing to support the current weak economic state on the ground. Meanwhile, on the banking side, BI is seeing continued well contained industry conditions with 20.4% CAR (min: 8.00%), September loan growth slightly higher at 11.1% y-y (August: 10.9% y-y) and Gross NPLs at 2.7% (August: 2.8%). This is in line with our banking analyst's expectation of higher loan growth in 2016F at 12% (2015F: 10.6%), helped by the government's infra-related projects and lower RR.

Currently, we maintain our expectation of 4.72% GDP growth in 2015 given the continued tight monetary policy this year coupled with IDR depreciation. In 4Q15, we also maintain our expectation of IDR/1USD at 14,000 as the US Dollar is likely to remain strong in the lead up to the possible Fed rate hike next month.

Furthermore, the current IDR/1USD position is supported by the central bank's tight money market rates (exhibit 2). However, going into 2016, with lower inflation, we think that a rate cut should not hurt the IDR as significantly as before.

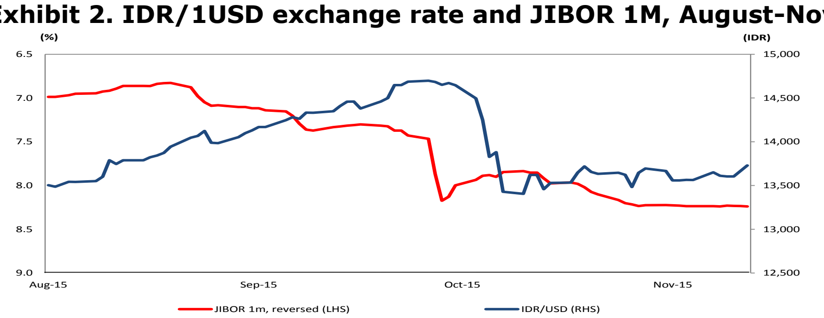
That said, the current low inflation trend and heavy reliance on the domestic economy should pave the way for BI to cut its policy benchmark rate by 75bp from 7.50% at present to 6.75% in 2016.

Exhibit 1. Interest rate expectations in some Asian countries, 2014-16F



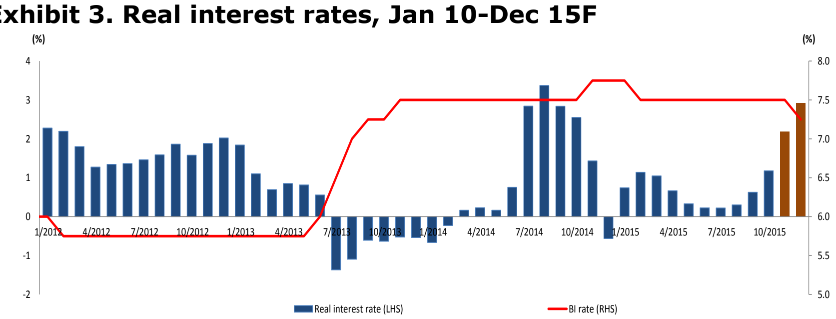
Source: Bloomberg, Bahana

Exhibit 2. IDR/1USD exchange rate and JIBOR 1M, August-November 2015



Source: Statistics Indonesia, Bank Indonesia

Exhibit 3. Real interest rates, Jan 10-Dec 15F



Source: Bank Indonesia, Bahana estimates