Indonesia Cuts it's Policy Rate for the First Time in Almost a Year as Inflation rate calms down

AKI FUKUCHI
YUMA TSUCHIYA
ECONOMIC RESEARCH OFFICE

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The Bank of Tokyo-Mitsubishi UFJ, Ltd.
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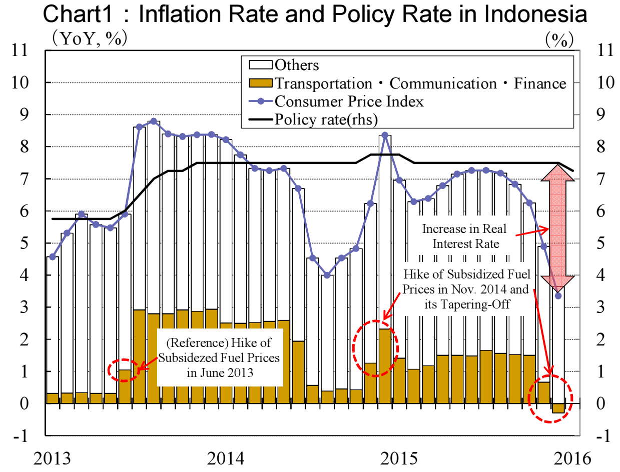
Most Asian countries have kept their policy rates despite the US raise of its Federal Funds Rate (FFR) last December which was the first time in nine and half years. Before and after the US move Thailand and the Philippines kept their policy rates unchanged, and after the turn of the year Korea and Malaysia also kept their rates untouched. On the contrary, Indonesia cut its policy rate on January 14th, the first time in eleven months since February 2015. The economy had a flat real GDP growth rate, 4.7% YoY for three consecutive quarters, mainly due to weak external demand, and the central bank had to move for an accommodative monetary policy.

Behind the rate cut by Bank Indonesia, the central bank, there has been a moderation of the domestic inflation rate. The government of Indonesia implemented in November 2014 a cut in fuel subsidies to facilitate fiscal reforms. In support of the government action, the central bank has kept its policy rate unchanged to control the acceleration of inflation rates accompanying the jump of fuel prices (Chart 1). Since July 2015, the rise in consumer price index began to slow down for five consecutive month, declining to +3.4% YoY in December 2015 due to the drop of effects of rising fuel prices. The level of the inflation rate is within the bound of central bank's inflation target of +4% with ±1% deviation. As a result, the real interest rates (policy rate – inflation rate) rose to the highest level since 2009, allowing room to lower the interest rate, which lead to cut the interest rate by the central bank this time. In addition, the stability in the financial market was another factor that pushed the central bank to cut the rate. In the financial market, the Rupiah has maintained a relatively strong underlying trend amidst the general fall of other emerging currencies that were influenced by the tumbling Chinese stock prices and falling resource prices (Chart 2). This fact suggests that the impact of the US rate hike on the Rupiah exchange rate had been taken into fact by the market ahead of the US action. Actually, the central bank pointed out in its statement that "global financial market uncertainties subsided after the Federal Reserve raised its FFR", and that "the FFR hike did not trigger shocks on global markets."

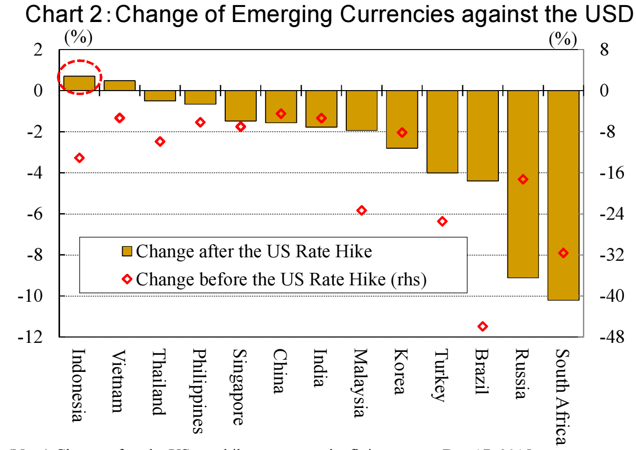
The central bank also hinted additional monetary easing. Looking ahead, the domestic economy is predicted to face downward pressure due to a stagnant external demand, which reflects a weak global demand and falling resource prices. In this context, it is expected that Bank Indonesia will watch the inflation rate and the trend of the financial markets and will decide whether to further lower the interest rate.

Chart1 : Inflation Rate and Policy Rate in Indonesia



(Source) Compiled by the Economic Research Office of the BTMU based on the statistics of the Indonesian Central Bureau of Statistics.

Chart 2 : Change of Emerging Currencies against the USD



(Note) Change after the US rate hike compares the fixing rate on Dec.17, 2015 with that on Jan. 17, 2016 and Change before the US rate hike compares those on Dec.31, 2014 and Dec. 16, 2015.

(Source) Compiled by BTMU based on Bloomberg.

For further details, please contact the Economic Research Office, Bank of Tokyo-Mitsubishi UFJ

Chief Manager Ishimaru Tel: 03-3240-3204

Directed by Shingo Takeshima <shingo_takeshima@mufg.jp>

Written by Aki Fukuchi <aki_fukuchi@mufg.jp>

Yuma Tsuchiya <yuuma_tsuchiya@mufg.jp>