

Indonesia: Prospect For Further Rate Cuts

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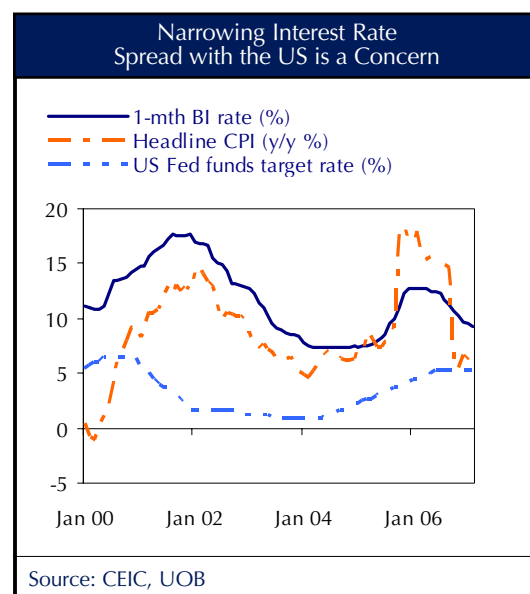
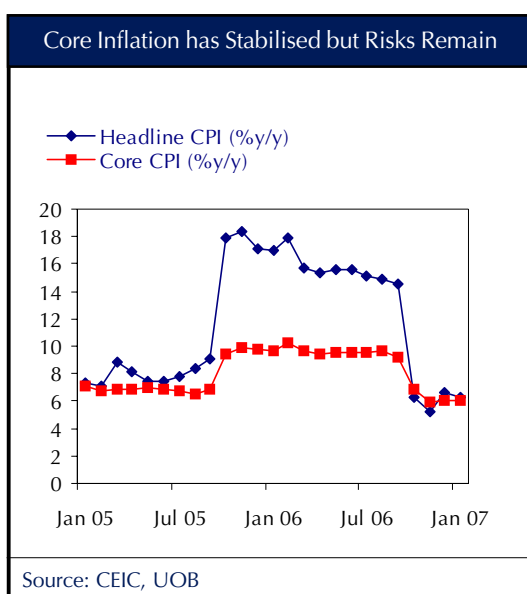
The BI cut its benchmark 1-mth rate by 25bps to 9.25% on Tue (6 Feb) as expected despite inflation fears following the heavy flooding in Jakarta which has swamped up to 70% of the city. Nonetheless, BI did warn of significant first-round effect on prices resulting from the floods in its statement. Note that food accounts for 24.7% of the CPI basket which means huge pressure on prices should the government fail to stabilise basic consumer goods prices. It also said that room for further cuts in the short-term has been reduced due to supply side constraints such as low productivity and limited capacity expansion which has created bottlenecks in the country's infrastructure and energy production. This has the potential to increase inflationary pressure before the rate cuts could have generated any substantial increase in production capacity.

There were also concerns that a faster pace of monetary easing could risk the stability in USD/IDR given that the Fed funds target rate is likely to remain at 5.25% in the near-term. We expect the first cut in the US interest rate to materialise in late 2Q07 which would have given the BI room to pause in the coming quarter.

Our Take: While there could be greater inflation risk due to the floods in the short-term, it should not divert too much attention from the need to boost domestic investment by lowering interest rates in the country. This was especially since the underlying domestic inflation trend has stabilized. Core inflation has eased to around 6% in the last two months and headline inflation is likely to remain within the BI's target of 6% \pm 1% for this year. At the beginning of the year, we have estimated 2007 average inflation at 6.3%. Current risks to our forecast are the global energy prices and the severity of the current floods.

Indeed, expectation of falling interest rates in Indonesia is one of the factors that we consider important for boosting private consumption and investment, and thus GDP growth for the country this year. We expect growth to rise to 5.7% this year from an estimated 5.3% in 2006.

Overall, we see a possibility for another 25bps rate cut in the March meeting to bring the benchmark rate to 9.00%. Although a pause is likely in 2Q07, there is certainly room for some more cuts in the



later part of the year in line with expected monetary easing in the US. For now, we expect the BI rate to end the year at 8.50-8.75%. This should still provide a real interest rate of around 2-2.5%.

On the currency front, we expect the USD/IDR to continue to moderate to 9,000 by end 1Q07 from around 9,050 currently, in line with the downtrend in USD/Asians. On trade-weighted basis, the IDR has appreciated an average 1.0% since the beginning of the year compared to average of 2.5% for the whole of 2006.

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