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Flash Notes

Bank Indonesia Keeps Benchmark 1-Mth SBI Rate Steady at 8.00% at 3 Apr Monetary Policy Meeting

Bank Indonesia kept the benchmark 1-month SBI rate on hold at 8.00% at its monetary policy meeting, as expected, as inflation spiked up in the first 3 months of the year. BI has already kept rates steady since Jan 08, halting its easing bias (it has slashed rates by 475bps since May 2006). In the near term, rates are likely to stay unchanged despite the US Fed's aggressive easing cycle (which increases the yield differential with Indonesian interest rates and could attract speculative inflows). BI will deem soaring inflation a bigger problem than slowing growth, and don an inflation-fighting stance, given Indonesia's majority poor who will bear the brunt of rising prices. Real interest rates are currently in negative territory, far below BI's stated 1-2% comfort zone. Hence, any further decline in the benchmark rate would only exacerbate inflationary risk. We expect the 1-month SBI rate to stay at 8.00% until 3Q08, but believe that waning global inflation in 4Q08 would allow for a year-end 25bps cut to 7.75%.

March CPI jumped to a 1-and-a-half year high of 8.17% y/y, a faster pace than Jan and Feb's 7% levels. The spike in inflation this year from last is due mostly to rising prices of imported food, energy and raw materials. Going forward, inflation is given to upward bias, with other indicators pointing towards persistent inflationary pressure. Core inflation rose 8.1% (Jan: 7.1%; Feb: 7.3%) suggesting passthrough from food and energy prices to other product categories. Wholesale prices gained 24%, with producers likely to pass on higher costs to consumers. As such, BI has revised its 2008 inflation forecast of 4-6% upward to 6.5%.

The halt in BI's interest rate easing cycle might give the IDR further room for appreciation to mitigate inflation. IDR has proven more sensitive to global risk aversion and high oil prices (Indonesia is a net oil importer). Still, we expect the high-yielder to be supported by more portfolio inflows, given the increasing rate differential between US interest rates and Indonesian benchmark. IDR also stays supported by a strong domestic economy, a diversified export base boosted by commodity prices, and a slowing global economy that could bring down oil prices.