1. MONETARY POLICY STATEMENT

The BI Board of Governors agreed on 13th and 14th December 2017 to hold the BI 7-day Reverse Repo Rate at 4.25%, while maintaining the Deposit Facility (DF) and Lending Facility (LF) rates at 3.50% and 5.00% respectively, effective 15th December 2017. The policy is consistent with efforts to maintain macroeconomic and financial system stability, while also building domestic economic recovery momentum by considering the latest global and national economic dynamics. Bank Indonesia perceives the previous easing of monetary policy as sufficient to continue driving the economic recovery process against a backdrop of increasingly robust macroeconomic stability. Looking forward, Bank Indonesia will remain vigilant of the global risks associated with the monetary policy normalisation in several advanced countries and the geopolitical risks, as well as corporate consolidation at home along with the suboptimal bank intermediation function. Furthermore, Bank Indonesia shall continue to improve its mix of monetary policy, macroprudential policy and payment system policy to strike an optimal balance between macroeconomic and financial system stability and the ongoing economic recovery process. In addition, Bank Indonesia will also strengthen policy coordination in conjunction with the Government in order to preserve macroeconomic and financial system stability. Bank Indonesia currently believes that amidst the global economic gains and domestic economic stability achieved lies an opportunity to build stronger and more sustainable domestic economic momentum through consistent structural reforms.

The global economic recovery is becoming more balanced, accompanied by persistently high commodities prices. Global economic growth in 2017 is projected to surpass that achieved in 2016, with more balanced sources of growth from advanced as well as developing countries. US GDP growth ticked upwards on the back of increasing investment and stable consumption. Congruently, the economy of Europe posted solid gains, supported by consumption and export performance. Furthermore, consumption and exports also helped to drive China’s economy in line with the economic rebalancing process that is currently underway gradually in the country. Such developments edged up world trade and international commodities prices, including oil, which was higher than the previous year. Meanwhile, the increase of FFR in the US by 25 bps on 13 December 2017 was inline with Bank Indonesia’s estimation. Moving forward, world economic growth is expected to remain high, along with strong commodities prices and world trade volume. However, several risks will continue to demand vigilance, including monetary policy normalisation stance adopted in several advanced countries along with geopolitical factor.

Indonesia’s economic recovery occurs gradually and uneven. National economic growth is projected at 5.10% (yoy) for 2017, increased from 5.02% (yoy) in 2016. The domestic economic growth has been bolstered by a surge of commodity exports that drive the non-building investment, particularly amongst commodity-based firms. Fiscal stimuli from the Government related to infrastructure development also encourages building investment. On the other hand, investment in non-commodity sectors has not shown significant improvement. The household propensity to consume has seen only limited improvements, in particular on foods and clothing expenditures, with a shift in consumption pattern to leisure, also the preference for delaying consumption in upper-middle class society. In 2018, the economy is expected to build further momentum based on equitable investment, fiscal stimuli from the Government, and the favourable impact of global economic gains. Consequently, Bank Indonesia projects economic growth in 2018 at 5.1-5.5% (yoy).
Indonesia’s balance of payments (BOP) in 2017 is expected to register a comparatively large surplus and maintaining a healthy current account deficit of below 2% of GDP. The significant BOP surplus primarily stemmed from the capital and financial account, which increased on the position recorded in 2016, particularly in the form of direct and portfolio investments, inline with the improvement in investor perceptions of the domestic economic outlook. The controlled current account deficit was supported by a large non-oil and gas trade surplus despite a wider oil and gas trade deficit. Nevertheless, the services account and primary income account also recorded large deficits linked, others, to a large transportation services account deficit and the repatriation payments on foreign investment returns. The position of official reserve assets at the end of November 2017 stood at USD125.97 amongst billion, up from USD116.4 billion at the end of 2016. The official reserve is equivalent to 8.4 months of imports or 8.1 months of imports and servicing government external debt, which is well above the international standard of around three months. Looking ahead, Bank Indonesia projects a slightly wider current account deficit in 2018 due to the ongoing domestic economic recovery but remaining at a healthy level of 2.0-2.5% of GDP.

The rupiah remained relatively stable throughout 2017 despite the emergence of external pressures at the beginning of the fourth quarter. The rupiah was stable as of September but external factors began to erode the value of the currency in October 2017. Nevertheless, rupiah depreciation was consistent with broad USD appreciation against nearly all major global currencies after US began to normalise its monetary policy stance, confirmed upcoming tax reforms and the markets anticipated a further FRR hike towards the end of the year. In November, the rupiah rebounded in line with maintained macroeconomic stability and the promising domestic economic outlook, so that by point-to-point (ptp), the rupiah appreciated 0.27% (mtm) to close at a level of Rp13,526 per USD. Moving forward, Bank Indonesia shall continue to stabilise rupiah exchange rates in line with the currency’s fundamental value, while maintaining market mechanisms.

Inflation is maintained at the low level of 3.5% (yoy), which is still within the inflation target of 4.0 ±1% for 2017. Low and controlled inflation is mainly contributed by the low inflationary pressures on volatile foods (VF) due to adequate supply, government policy to stabilise food prices and low international food prices. The volatile foods inflation currently stands at its lowest rate in the past 14 years. Core inflation also continued to decline thanks to anchored expectations, stable exchange rates and limited domestic demand. Meanwhile, inflationary pressures on administered prices (AP) intensified mainly due to the 900 VA electricity tariff increase in the first half of 2017, as part of ongoing government-led energy reforms. The Consumer Price Index (CPI), as a measure of headline inflation, stood at 0.20% (mtm) in November 2017, bringing the cumulative and annual rates to 2.87% (ytd) and 3.30% (yoy) respectively. Bank Indonesia projects low and controlled inflation in 2018 within the new target corridor of 3.5±1%. Furthermore, Bank Indonesia will constantly strengthen policy coordination with the Central Government and Regional Administrations in order to control inflation.

Financial system stability was maintained despite a suboptimal bank intermediation function. Such dynamics were explained by a Capital Adequacy Ratio (CAR) in the banking industry of 23.2% and a liquidity ratio of 22.7% as of October 2017. Meanwhile, non-performing loans (NPL) were recorded at 2.96% (gross) and 1.25% (net). Monetary policy was successfully transmitted through the interest rate channel, as evidenced by the banks’ proclivity to continue lowering deposit and lending rates. Nonetheless, transmission through the credit channel was less optimal, indicated by limited credit growth in line with weak demand for new loans and the selective nature of banks when disbursing new loans. Consequently, credit growth in October 2017 stood at 8.16% (yoy), up from 7.86% (yoy) the month earlier. Conversely, growth of economic financing through the financial markets, including issuances of stocks, bonds and medium-term notes (MTN), surged to 45.5% (yoy) in October 2017. Meanwhile, deposit growth was observed to decelerate from 11.7% (yoy) to 11.0% (yoy) over the same period. In 2017, deposit and credit growth have expanded by 9.0% and 8.0% respectively. Congruent with increasing economic activity and
the impact of previous monetary and macroprudential policy easing, Bank Indonesia projects stronger deposit and credit growth for 2018 at 9.0-11.0% (yoy) and 10.0-12.0% (yoy) respectively.
2. ECONOMIC AND MONETARY POLICY

GLOBAL ECONOMIC PERFORMANCE

The global economic recovery has become more balanced, primarily supported by the United States, Europe and China, accompanied by persistently high commodity prices. The global economy is projected to grow by 3.6% in 2017, up from 3.2% in 2016, with more balanced sources of growth from advanced and developing economies. The US economy posted gains on the back of increasing investment and stable consumption. Nevertheless, wages have not seen any significant growth despite lower unemployment, leaving US inflation below target. Such developments precipitated a more gradual normalisation of the Federal Reserve’s monetary policy. Similar to conditions in the US, Europe is experiencing a solid recovery on consumption and exports. Meanwhile, increasing consumption and exports in China are driving economic growth despite the ongoing economic rebalancing process. The global situation has edged up world trade volume and international commodity prices beyond the achievements of yesteryear. Moving forward, several global risks demand vigilance, including the normalisation of monetary policy in various advanced economies as well as geopolitical factors on the Korean Peninsula and in the Middle East.

The US economy is expected to achieve robust growth in 2017 on consumption and investment, despite low inflation. Solid consumption has been reflected in growing consumer optimism, coupled with improvements in the labour sector (Graph 2.1). Notwithstanding the current gains, the US labour sector faces structural constraints that have stilled rising wages, leaving inflation below target (Graph 2.2). The structural constraints include an ageing population and the proclivity of US firms to favour part-time workers. Low inflation has forced the Federal Reserve to implement more gradual monetary policy normalisation this year, hiking the Federal Funds Rate (FFR) just three times and executing balance sheet reductions commencing in October 2017 using monthly caps. The Fed’s holdings of US Treasury (UST) securities and mortgage-backed securities (MBS) will be reduced through initial caps of USD6 billion and USD4 billion respectively. Thereafter, the monthly caps will be raised incrementally by USD6 billion for UST and USD4 billion for MBS to reach USD30 billion and USD20 billion respectively within 12 months. In terms of investment, most has stemmed from non-residential investment as production activities have been ramped up in the mining sector and manufacturing industry, coupled with elevated oil prices.
In Europe, the economy is predicted to accelerate on the back of consumption and exports. The average Retail PMI Markit this year has surpassed that achieved in 2016, while incomes have also risen (Graph 2.3). Labour sector improvements in the form of lower unemployment and greater job availability have raised incomes. Nonetheless, increasing labour slack is affecting Europe, which has curbed rising wages and led to below-target inflation. In addition to labour market slack, low inflation has also stemmed from weak imported inflation as the euro continues to strengthen. Such dynamics have forced the European Central Bank (ECB) to maintain accommodative monetary policy through a low policy rate and ongoing quantitative easing (QE). Meanwhile, exports from Europe this year have enjoyed stronger growth as world trade continues to recover and the euro depreciated in the first semester (Graph 2.4).

Robust economic growth is predicted in China for 2017, supported by consumption and exports, in line with the gradual economic rebalancing strategy. Consumption has been the backbone of China’s economy, especially in the first half of the year, with a vibrant labour market buoyed by lower unemployment, higher retail sales and robust household loan growth (Graph 2.5). Exports have also enjoyed significant growth on strong demand from the US, Europe and ASEAN (Graph 2.6), which has catalysed manufacturing activities and fed through to increases in the Manufacturing PMI and manufacturing industry profits. In contrast, public investment continues to subside and private investment has been subdued. Public investment has been forced to take a back seat in accordance with China’s economic rebalancing strategy to achieve sustainable economic growth. Meanwhile, muted private investment is the result of sluggish
property and manufacturing investment growth. The property investment slump was caused by tighter policy to rein in house sales, leading to a contraction, while weak manufacturing investment was also the result of stringent government policies this year to reduce capacity and control pollution.

Contrasting the economic accomplishments of China, India has experienced a transient economic downturn due to the implementation of structural reforms. The slowdown was deepest during the first semester of the year after the Government applied demonetisation policy at the end of 2016 and prepared to implement Goods and Service Tax (GST) reforms. Demonetisation - pulling large denomination currency from circulation – has restricted the availability of currency in the Indian economy since the fourth quarter of 2016. Furthermore, GST reforms enforced on 1st July 2017 also left consumers and economic players less inclined to consume and restrained economic activity due to uncertainties surrounding tax rates. Weaker consumption in 2017 was substantiated by average commercial credit growth and average automotive sales, including passenger vehicles, two-wheeled vehicles and commercial vehicles (Graphs 2.7 and 2.8). Nevertheless, India’s economy is expected to rebound in 2018 as the effect of demonetisation fades and a new tax system is put in place, the impact of which has become evident towards the end of 2017.

The faster global economic recovery has stimulated world trade volume (WTV) in 2017. Consequently, WTV in 2017 is expected to surpass the achievements of 2016, when world trade plummeted to its lowest level since the global crisis, which is also in line with the projections of
several international organisations (Graph 2.9). Trade progress has been supported by stronger global economic growth, especially in the United States, Europe, China and other developing economies. Flourishing world trade has also been reflected in the upward export and import trends recorded in advanced economies (AE) and emerging market economies (EMEs). Export growth has been reflected in the New Export Order PMI, which remains in an expansionary phase, while imports are being driven by strong demand from the United States, Europe and China due to robust economic growth in 2017, as indicated by the respective Composite PMI indexes.

Global commodity prices are expected to rise in 2017, buoyed by increasing world trade volume, the upbeat global economic outlook as well as various supply and demand factors. Energy prices (oil and coal) have risen strongly in 2017 on less supply. Furthermore, supply and demand factors have elevated the oil price in 2017 (Graph 2.10). On the demand side, net demand in the oil market has edged up prices, reflected by the declining global oil inventories. On the supply side, the OPEC agreement to cut production, along with several other oil producers, until December 2018, combined with disrupted production in a few other countries, has inflated the global oil price. Coal prices, on the other hand, have remained high on robust demand from China and interrupted production in other major coal producers (Graph 2.11).

Non-energy commodities have also experienced higher prices despite failing to keep pace with energy prices. Metals (aluminium, copper, nickel and lead) have been the main contributors to rising non-energy commodity prices due to increasing demand from China and greater global economic optimism in general.

Conversely, agricultural commodities, such as crude palm oil (CPO) and coffee, have experienced slower rising prices or even falling prices as production has increased. Despite slower growth, CPO prices have remained positive against a backdrop of increasing production due to higher oil prices. Contrasting CPO, coffee prices have fallen this year after production in Latin American countries was ramped up.
Looking forward, several global economic risks continue to demand vigilance despite optimism surrounding the ongoing global recovery. The risks mainly stem from the normalisation of monetary policy in several advanced economies along with geopolitical tensions on the Korean Peninsula and in the Middle East.

DOMESTIC ECONOMIC GROWTH

Indonesia’s economy has gradually improved in 2017. After limited gains posted in the first half of the year, the economy picked up in the second semester. The national economy is predicted to expand by 5.1% in 2017 (Table 2.1), with robust commodity exports and high commodity prices expected to drive growth in line with the global economic recovery. Export performance is also expected to boost investment, particularly in the commodity-based sectors. Conversely, investment in non-commodity sectors has failed to show any significant improvements. Household consumption growth remains subdued, with households less inclined to spend on food and clothing in favour of leisure activities, while the middle and upper classes are delaying consumption. In 2018, economic growth is predicted to rebound on more balanced investment, ongoing fiscal stimuli and a surge of exports to meet global demand. Consequently, the global economy is projected to expand in the 5.1-5.5% range in 2018.

High commodity prices and stronger global economic growth are predicted to drive exports in 2017. Export gains have mainly stemmed from primary non-oil and gas commodities, while
manufacturing exports have been more muted (Graph 2.12). Exports of primary commodities have relied on vegetable oil to satiate rising demand from China and India, coupled with higher prices (Graph 2.13). In contrast, manufacturing exports have been restrained this year despite rallying in the third quarter. Chemicals, vehicles, electrical equipment and processed iron have been the main drivers of manufacturing exports, contrasting more limited shipments of textiles and articles thereof, footwear and processed rubber.

![Graph 2.12: Non Oil and Gas Export Growth](image)

![Graph 2.13: Non Oil and Gas Export Price Index](image)

**Investment has improved in 2017 but remains skewed.** Increasing realisation of infrastructure projects, greater ease of doing business and soaring exports of non-oil and gas natural resources have been conducive to investment growth. Investment has increased gradually since the second quarter of 2013, when a -2.15% (yoy) contraction was recorded. The realisation of government and private infrastructure projects has increased significantly to spur investment growth. In addition, the investment grade credit rating and improved competitiveness rating according to the World Economic Forum (WEF) as well as the ease of doing business survey published by the World Bank have reignited investment. Meanwhile, high prices and strong demand for export commodities have also prompted more investment in 2017.

**Building investment has continued to record solid growth on the back of various infrastructure projects funded by government capital spending and the private sector.** In addition, the gradual recovery of the property market has been a boon to building investment as property prices, particularly in the secondary market, have strengthened. Nascent construction activity has been reflected in strong cement sales during the second half of the year (Graph 2.14).

**Non-building investment linked to exports has also supported investment growth.** Most investment has been in machinery and vehicles to meet corporate expansion in primary commodity-based sectors, as indicated by increasing sales of transportation equipment and heavy equipment to the mining, agricultural and construction sectors (Graph 2.15). Furthermore, growing non-building investment has also been reflected in commercial transportation equipment for commodities and imports of spare parts (Graph 2.16).
Government consumption increased on greater expenditure realisation by the central government along with transfers to regional administrations. Personnel expenditure, procurement and social assistance disbursements were the main contributors to increasing government consumption. Furthermore, government spending is expected to continue accelerating in the fourth quarter of 2017 in line with cyclical trends. By component, personnel expenditure and procurement posted positive growth, while social assistance disbursements began to pick up in the third quarter of 2017, in particular to service phase 3 of the Family Hope Program.

Household consumption growth was subdued despite low inflation and the support of government spending. Spending on food and clothing was the main drag on household consumption, accompanied by a shift in consumption trends towards leisure along with postponed consumption amongst the upper-middle class. Nevertheless, low and stable inflation helped to maintain consumption growth at around 5%. In addition, the government ramped up social assistance disbursements in 2017, which also boosted consumption, particularly amongst low-income earners. On the other hand, upbeat consumers, mainly in terms of the domestic economic outlook, were also expected to maintain household consumption (Graph 2.17).
Imports also accelerated in response to rising exports and domestic demand. Imports increased on shipments of capital goods in the form of commercial transportation equipment as commodity-based and infrastructure investment ticked upwards. Machinery imports to the manufacturing industry remained low despite an increase stemming from electricity development projects that entered the completion stage. Meanwhile, imports of construction materials also accelerated with a focus on iron and steel. Furthermore, greater investment in transportation equipment has persisted since the beginning of the year, thus supporting business operations in the plantation and mining subsectors, due to the cyclical requirement to maintain and upgrade the operational fleet of transportation and heavy equipment in both industries. Meanwhile, imports of raw materials and consumer goods also increased in line with manufacturing activities and household consumption.

**INDONESIA BALANCE OF PAYMENTS**

Indonesia's balance of payments (BOP) is expected to improve in 2017, recording a relatively large surplus and healthy current account deficit below 2% of GDP. The BOP surplus stood at USD10.6 billion in the third quarter of 2017, up from USD7.6 billion in the same period one year earlier (Graph 2.18). The wider BOP surplus was prompted by a larger increase in the capital and financial account than the requirement to service the current account deficit. Meanwhile, the current account deficit was supported by a significant non-oil and gas trade surplus despite a larger oil and gas trade deficit and services account deficit as well as a notable primary income account deficit.

A significant capital and financial account surplus is expected in 2017 in line with the encouraging national economic outlook and attractive returns on domestic financial assets. The capital and financial account surplus stood at USD23.4 billion in the third quarter of 2017, increasing from USD20.9 billion in the same period of 2016 (Graph 2.19). The surplus was bolstered by direct investment and portfolio investment, which both posted surpluses, coupled with a narrower other investment deficit. Acquisitions of non-oil and gas firms, predominantly e-commerce companies, increased the foreign direct investment (FDI) surplus along with global bond issuances through affiliates located abroad. Furthermore, issuances of long-term government debt securities and global bonds, as well as a surge of corporate global bond
issuances, strengthened the portfolio investment surplus (Graph 1.20). Finally, the other investment deficit narrowed on domestic private placements in offshore deposits.

The healthy current account deficit was supported by a significant non-oil and gas trade surplus. Cumulatively, the current account deficit stood at USD11.5 billion (1.5% of GDP) in the third quarter of 2017, improving from USD15.0 billion (2.2% of GDP) in the same period one year ago (Graph 2.20). By component, the current account deficit improved due to the larger goods trade surplus as the increase in non-oil and gas exports outstripped the corresponding increase in imports. Meanwhile, the rising global oil price exacerbated the oil and gas trade deficit. On the other hand, the services account and primary income account recorded significant deficits. The services account deficit was influenced by the transportation services account deficit in relation to import-export shipments. Meanwhile, repatriated funds paid on foreign investments increased the primary income account deficit. Consequently, the current account deficit for 2017 is forecasted at around 2% of GDP. In 2018, a healthy current account deficit is projected in the 2.0-2.5% of GDP range in line with domestic economic growth.

BOP performance in 2017 has demonstrated greater external economic resilience and, thus, supports ongoing macroeconomic stability. Solid external resilience has also been reflected in the increasing position of reserve assets in 2017. At the end of November 2017, reserve assets stood at USD125.97 billion, up from USD116.36 billion at the end of December 2016 (Graph 2.21). The position of reserve assets at the end of November 2017 was equivalent to 8.4 months of imports or 8.1 months of imports and servicing government external debt, which is well above the international adequacy standard of three months. Bank Indonesia considers the current position of reserve assets adequate to support external sector resilience and maintain sustainable economic growth in Indonesia moving forward.
RUPIAH EXCHANGE RATE

A stable rupiah persisted in 2017 despite external pressures that emerged towards the end of the year. In November, the rupiah strengthened on maintained macroeconomic stability and a sound economic outlook, thus appreciating 0.27% (mtm) to a level of Rp13,526/USD (ptp). Consequently, the rupiah has only depreciated 0.40% (ytd) this year (ptp) (Graphs 2.22 and 2.23). Rupiah exchange rate stability has also been reflected by less volatility in 2017, supported by domestic and external economic fundamentals, combined with policy to maintain the rupiah in line with the currency’s fundamental value.

The rupiah was stable as of September but subsequently depreciated in October on externalities. Solid domestic economic fundamentals and positive external sentiment reinforced rupiah stability as of September 2017 but broad USD appreciation against nearly all global currencies due to monetary policy normalisation, growing expectations of a Federal Funds Rate (FFR) hike and planned tax reforms in the United States spurred rupiah depreciation in October 2017. The rupiah subsequently rebounded in November 2017 in line with maintained macroeconomic stability and the persistently robust economic outlook.

The supply of foreign exchange from residents and non-residents also maintained rupiah stability in 2017. Non-residents sold more foreign exchange than in the previous year in line with an influx of non-resident capital flows. Attractive bond yields in Indonesia continued to draw foreign capital flows. On the other hand, residents booked more balanced buys and sales, reflecting the positive foreign exchange market trends. The role of residents in supplying the
foreign exchange market considerably bolstered rupiah stability, especially when significant sales of foreign exchange occurred, in October for instance.

**Foreign exchange flows from non-residents remained strong in the first half of the year, fading thereafter in the second semester (Graph 2.24).** Such developments were explained by US dollar appreciation in July and at the end of September/beginning of October, which stimulated demand for foreign exchange. At that time, non-resident investors booked a net buy of foreign exchange.

**Non-resident capital inflows increased in 2017 compared to conditions in the previous year.** Non-resident capital inflows in 2017 (as of 30th November 2017) stood at USD9.6 billion (Graph 2.25), primarily drawn to Government Debt Securities (SUN) and Government Islamic Securities (SBSN), representing an increase on the USD9.3 billion registered in 2016 against a backdrop of monetary policy normalisation, primarily in advanced economies. Non-resident capital inflows surged on attractive yields and improvements to the investment climate, supported by S&P’s upgrading Indonesia’s sovereign credit rating to investment grade in May 2017 as well as Indonesia’s ascent up the Ease of Doing Business rankings from 91 in 2016 to 72 in 2017.

![Graph 2.24. Foreign Exchange Net Supply-Demand in Spot Market](source: Bank Indonesia, calculated)

![Graph 2.25. Inflow of SBI, SUN and Stock](source: Bank Indonesia, BEI, Bloomberg)

Rupiah exchange rate volatility was well mitigated in November 2017 and lower than that recorded in other peer countries. Rupiah volatility as of November 2017 was observed to decline and was below the average of peer countries, including the rand (South Africa), lira (Turkey), real (Brazil), won (South Korea), rupee (India), peso (Philippines), dollar (Singapore), baht (Thailand) and ringgit (Malaysia) (Graph 2.26).
Moving forward, Bank Indonesia shall continue to implement exchange rate stabilisation measures to maintain the rupiah in line with the currency’s fundamental value and consistent with the inflation target, while reinforcing external sector resilience. Exchange rate policy is also synergised with other policies relating to mandatory rupiah use in the territory of the Republic of Indonesia and the management of external debt risk through the implementation of prudential principles. Policy synergy will help enhance the domestic foreign exchange market structure, which will ultimately support efforts to maintain rupiah stability.

INFLATION

Low inflation is predicted for 2017 towards the lower bound of the target corridor, namely 4.0±1%. Such expectations are based on the low headline rate recorded in November 2017 at 0.20% (mtm) or 2.87% (ytd) cumulatively and 3.30% (yoy) annually (Graph 2.27). Inflation was controlled with the help of low inflationary pressures on volatile foods (VF) due to adequate supply, government policy to stabilise food prices and low international food prices. Low core inflation was also achieved in line with anchored expectations, a stable exchange rate and soft domestic demand. Meanwhile, inflationary pressures on administered prices (AP) were amplified by the Government’s energy subsidy reforms. Consequently, inflation for 2017 is projected in the 3.0-3.5% range and then targeted at 3.5±1% in 2018.
Inflationary pressures on volatile foods (VF) have remained mild throughout 2017. As of November 2017, volatile foods recorded deflation of -1.71% (ytd) cumulatively and -1.24% (yoy) annually, despite a monthly rate of 0.38% (mtm) after experiencing deflation of -0.53% (mtm) the month earlier. Annual inflation in November was the lowest rate recorded for the past 14 years (Graph 2.28). Low inflation of volatile foods was attributed to adequate supply. Weather conditions were more conducive to agricultural production and placed downside pressures on prices. The major volatile foods, including red chillies, shallots and garlic recorded the largest price declines (Table 2.2). Modest inflationary pressures on volatile foods were also the result of government food price stabilisation policy coupled with close coordination to control inflation and the central and local levels. In addition, abundant global production depressed international prices, which also prompted lower food prices at home.

Low core inflation is expected to persist through to the end of the year. That assumption is based on actual core inflation in November 2017, which stood at 2.82% (ytd) cumulatively and 3.05% (yoy) annually. On a monthly basis, core inflation was recorded at a rate below the November average for the past three years at 0.13% (mtm). By component, weaker traded core inflation helped to control core inflation along with relatively stable non-traded core inflation throughout the year (Graph 2.29). Low core inflation was also consistent with the relatively stable rupiah exchange rate in 2017, thus minimising cost-push pressures from the external sector. In addition, restrained demand also kept core inflation under control, as reflected by stable money supply growth and moderating credit growth. Furthermore, core inflation expectations were well anchored to the inflation target, as substantiated by the results of the Consensus Forecast (CF) and Bank Indonesia Macroeconomic Indicators Forecasting Survey (Graph 2.30).
Inflationary pressures on administered prices were heightened by the government’s ongoing energy subsidy reforms in 2017. Consequently, administered prices (AP) recorded inflation of 0.21% (mtm) in November 2017, contrasting the -0.01% (mtm) deflation posted in the previous period (Graph 2.31). Cumulatively, therefore, AP inflation from January – November 2017 stood at 7.72% (ytd) or 8.76% (yoy) annually. Inflationary pressures on administered prices primarily stemmed from hikes to electricity rates applicable to 900VA subscribers in the first half of the year as part of the government’s energy reforms (Table 2.3). Nonetheless, AP inflation has recently begun to fade in line with fewer related government policies towards yearend.

Graph 2.29. Core Traded vs Nontraded

Graph 2.30. CF vs SPIME Inflation Expectation

Graph 2.31. AP Inflation

Graph 2.3. Contributors of Administered Prices Inflation

<table>
<thead>
<tr>
<th>Components</th>
<th>Contribution ytd Dec 2016</th>
<th>Contribution ytd Nov 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity Tariff</td>
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<tr>
<td>Annual fee vehicle registration</td>
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<td>0.242</td>
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<td>Fuel</td>
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<td>Clove Cigarette Filter</td>
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<td>Clove Cigarette</td>
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<td>Intercity transport</td>
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<tr>
<td>Cigarette</td>
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<td>0.041</td>
</tr>
<tr>
<td>Household fuel</td>
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<td>0.029</td>
</tr>
<tr>
<td>PAM Drinking Water Tariff</td>
<td>0.015</td>
<td>0.019</td>
</tr>
</tbody>
</table>

Source: BPS, calculated

Spasially, mild inflationary pressures have been reported in most regions of the Indonesian archipelago in 2017. Several parts of Maluku-Papua recorded cumulative inflation of below 1%, including Papua (0.17%), Maluku (0.33%) and North Maluku (0.68%) (Figure 2.2). Meanwhile, areas in Java, which receive a higher weighting to national inflation, recorded inflation at around 3% as of November 2017. Likewise, regions in Sumatra, Kalimantan, Bali-Nusa Tenggara and Sulawesi also recorded low inflation. In contrast, inflation in Riau, West Kalimantan and Gorontalo was pushed up by rising food prices and airfares, beyond the national average, during Eid-ul-Fitr. Notwithstanding the increases, inflation in those areas remained below 4% (ytd) as of November 2017. Consequently, inflation in the various regions of Indonesia supported attainment of the national inflation target, namely 4.0±1% in 2017.
MONETARY DEVELOPTMENTS

Monetary policy was successfully transmitted through the interest rate channel but transmission through the credit channel remained suboptimal. Lower interbank, deposit and lending rates were indicative of easing monetary policy transmitted through the interest rate channel. Nevertheless, transmission through the credit channel remained suboptimal in line with persistently weak demand for new loans and the selective nature of banks when lending. M2 growth, as a measure of liquidity in the economy, accelerated on the back of Net Foreign Assets (NFA) as an influx of foreign capital flowed into Indonesia in 2017. Furthermore, economic financing through the financial markets, including issuances of stocks, bonds and medium-term notes (MTN) also demonstrated robust growth.

The O/N interbank rate has decreased in line with the policy rate. In November 2017, the average daily O/N interbank rate fell 33bps on the 3.87% recorded in December 2016 (Graph 2.32). Meanwhile, the spread between the O/N interbank rate and the BI 7-Day (Reverse) Repo Rate narrowed from 55bps in December 2016 to 38bps in November 2017, indicating greater convergence with the midpoint of the policy rate corridor applied by Bank Indonesia. During 2017, money market gyrations have converged on the midpoint of the policy rate target with a flatter term structure. Furthermore, according to the Jakarta Interbank Offered Rate, yields have also declined on longer tenors.

O/N interbank rate volatility eased on maintained liquidity. The O/N interbank min-max spread stood at 16bps in November 2017, narrowing from 26bps in the previous year. Meanwhile, average interbank money market transaction volume from January – November 2017 increased to Rp12.86 trillion (Graph 2.33), with the O/N transaction volume cited as the main contributor to the gains, rising from Rp7.15 trillion in 2016 to Rp8.50 trillion in January – November 2017.
The banks continued to lower deposit rates, indicating the successful transmission of easing monetary policy through the interest rate channel. As of October 2017, the weighted average deposit rate had declined 53bps (ytd), exceeding the corresponding 50bps decline in the policy rate this year. The deposit rate offered on 1-month term deposits was reduced most significantly by 57bps, followed by 24-month tenors (45bps), 12-month tenors (38bps) as well as 3 and 6-month tenors (37bps respectively).

Monetary policy transmission through the credit channel continued, albeit more subdued. The banks have lowered lending rates by 49bps this year (January – October), outstripped by deposit rates. Based on loan type, the banks were inclined to reduce interest rates on consumer loans the most (68bps), followed by investment loans (43bps) and working capital loans (42bps) (Graph 2.34). Consequently, the net interest spread stood at 536bps in October 2017, up from 532bps in December 2016 (Graph 2.35). The banks’ response to policy rate reductions was restrained by internal conditions, namely to maintain the net interest margin (NIM), mitigate the level of at-risk non-performing loans (NPL) and reduce the relatively high risk premium.

Broad money (M2) growth accelerated. M2 growth increased from 10.1% in December 2016 to 10.6% (yoy) in October 2017 on the back of quasi-money, which improved from 7.9% (yoy) to 8.7% (yoy) over the same period (Graph 2.36). Nevertheless, slower M1 growth, declining from 17.27% (yoy) to 16.0% (yoy), was the main constraint to M2 growth.
Strong Net Foreign Asset (NFA) growth edged up M2 growth in the reporting period (Graph 2.37). NFA growth increased from 14.0% (yoy) in December 2016 to 18.1% (yoy) in October 2017 due to the deluge of non-resident capital inflows during 2017. In contrast, Net Domestic Assets (NDA) stifled further M2 gains, decelerating from 8.7% (yoy) in December 2016 to 7.9% (yoy) in October 2017. The decline stemmed from slower NDA (credit) growth, falling from 7.69% (yoy) in December 2016 to 7.37% (yoy) in October 2017. In general, M2 growth was influenced more by the increase in NFA, while the contribution of NDA declined in line with moderating bank credit growth and greater government spending.

FINANCIAL SECTOR DEVELOPMENTS

Banking

Banking sector resilience was maintained, underpinned by a solid Capital Adequacy Ratio (CAR). Maintained financial system stability was reflected by the high Capital Adequacy Ratio (CAR) in the banking industry, standing at 23.2% (yoy) in October 2017, which helped mitigate potential credit risk. Similarly, the liquidity ratio of the banking industry was recorded at 22.7% in the reporting period, while non-performing loans (NPL) stood at 2.96% (gross) or 1.25% (net).

Credit growth has achieved limited gains. The banking industry reported credit growth in October 2017 at 8.16% (yoy), up on the previous period and the 7.86% (yoy) recorded in December last year. Consumer loans and working capital loans have driven credit growth in 2017, contrasting the downward trend tracked by investment loans (Graph 2.38). In general, credit growth remains below the optimal level due to limited demand for new loans. On the supply side, the banks have become more selective when disbursing new loans in line with internal consolidation. Consequently, credit growth is predicted at 8.0% (yoy) for 2017. Congruent with increasing economic activity and the impact of previous monetary and macroprudential policy easing, combined with the corporate and banking consolidation strategies, credit growth is expected to accelerate in 2018 to around 10.0-12.0% (yoy).

By sector, stronger credit growth in October 2017 was primarily absorbed by the manufacturing industry (Graph 2.39). Lending to the manufacturing industry dominated, with credit growth accelerating from 2.85% (yoy) in December 2016 to 6.93% (yoy) in October 2017. Several subsectors of the manufacturing industry posted strong performance on rising external
demand. Conversely, lending to the agricultural and construction sectors declined respectively from 11.18% (yoy) and 24.18% (yoy) in December 2016 to 8.56% (yoy) and 19.07% (yoy) in October 2017. Furthermore, the banks were less inclined to lend to the mining sector due to limited sectoral improvements.

Deposit growth accelerated throughout 2017. Deposit growth stood at 11.0% (yoy) in October 2017, up from 9.6% (yoy) in December 2016 but down on the 11.7% (yoy) posted in September 2017 (Graph 2.40). The banking industry confirmed that term deposits have been the main driver of deposit growth in 2017, while demand deposits and savings deposits have tended to slow. By currency, rupiah and foreign currency deposits have posted gains in 2017. Consequently, deposits are predicted to expand by around 9.0% (yoy) in 2017 and then accelerate in the 9.0-11.0% (yoy) range in 2018.

Nonbank Financing

Nonbank financing from the financial markets has experienced strong growth throughout 2017 (Table 2.4). Economic financing growth through the financial markets, including issuances of stocks, bonds and medium-term notes (MTN), reached 45.5% (yoy) in October 2017. Furthermore, the upward trend persisted into November 2017 and cumulatively reached Rp276.5 trillion despite a temporary slowdown compared to the previous period. Meanwhile, the portion of financing has continued to increase (primarily since 2016) against a backdrop of sluggish credit growth. The upswing enjoyed by financing from the financial sector since 2016 has been attributed to Bank Indonesia reducing the monetary policy rate by a total of 200bps, which has
fed through to stronger financial asset prices, thus lowering the funding costs borne by issuers. Furthermore, the lag with which the banks have reduced lending rates along with sluggish credit growth have also stoked corporate interest to seek funds from the financial markets.

Nonbank financing has mainly originated from corporate bond issuances and the growing contribution of non-financial issuers. As of October 2017, total funds accumulated through corporate bond issuances reached Rp151.1 trillion, growing 63.7% (yoy). The trend persisted into November 2017, reaching Rp162.7 trillion. The rapid growth of corporate bonds in 2017 has been in line with greater demand to meet maturity purposes, more competitive funding costs compared to bank loans and the promising economic outlook. In addition, increasing demand from issuers linked to government infrastructure projects has also stimulated corporate bond issuances. Consequently, corporate bonds are dominating nonbank financing, accounting for 59%, with growth outstripping all other instruments at 44.2% in 2017.

Interest rate factors have catalysed curiosity in corporate bond issuances in 2017. Bank Indonesia has already lowered the policy rate by 200bps since 2016 as an incentive for issuers to issue corporate bonds. Furthermore, corporate bond rates have remained consistently below lending rates in the banking industry. As of October 2017, most corporate bond rates were consistently in the range of the weighted average lending rate. Meanwhile, the weighted average of corporate bond rates issued by the financial sector, banking sector and non-financial sector in November 2017 stood at 7.22%, 7.28% and 7.93% respectively. Lower corporate bond rates than bank lending rates have led to bonds becoming the current preferred source of financing among issuers.

Financing from the stock market through rights issues and initial public offerings (IPO) have been relatively muted in 2017. As of October 2017, total financing through rights issues and IPOs had reached Rp71.3 trillion cumulatively, up 23.9% (yoy). As of November 2017, however, that figure had increased to Rp73.8 trillion. Despite a greater number of IPO issuers, the funds accumulated in 2017 were down on the previous period. The number of issuers initiating an IPO in 2017 totalled 31, nearly doubling the 16 registered in 2016. Growing interest in IPOs in 2017 was supported by improving domestic macroeconomic conditions, lower inflation, stable exchange rates and stronger economic growth projected in the fourth quarter.

<table>
<thead>
<tr>
<th>2017</th>
<th>%</th>
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<tr>
<td>Total</td>
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<td>New Bank Financing</td>
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<tr>
<td>Bond</td>
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<tr>
<td>Other</td>
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</tr>
<tr>
<td>Total</td>
<td>10.2</td>
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</tbody>
</table>

Table 2.4. Non-bank Financing

Stock Market

The Jakarta Composite Index (JCI) has continued to rally. The JCI has consistently improved this year, closing at a level of 5,952.14 at the end of November 2017, up 12.45% (ytd) (Graph
2.41). Solid macroeconomic fundamentals, marked by low inflation and a stable exchange rate, supported by sound issuer performance, have translated into a robust JCI upswing. In fact, the JCI has regularly hit all-time highs throughout 2017. Cumulatively, the JCI has increased 12.4% (ytd) this year, while the average daily transaction value has risen despite a large outflow of foreign capital.

Nevertheless, domestic stock market performance was squeezed by a large outflow of non-resident capital. Non-resident investors booked a net sell totalling Rp18.6 trillion in November 2017, bringing the cumulative outflow to Rp135.6 trillion this year. Non-resident investors were quick to release underperforming stocks, most of which appeared on the Development Board Index (DBX). Nonetheless, resident investors absorbed the outflow due to confidence that economic fundamentals would be maintained. Consequently, the portion of non-resident investors trading on the domestic stock market reduced to 34.11% (Graph 2.42).

![Graph 2.41. JCI and Net Foreign Buy/Sell](source: BEI, calculated)

![Graph 2.42. Share of Foreign Ownership](source: Bloomberg, calculated)

Congruent with domestic developments, global bourses also trended upwards in 2017 (Graph 2.43). The majority of global stock markets rallied despite contrasting global sentiment. Vibrant global stock markets boosted the performance of most regional bourses, including the domestic stock market in Indonesia. JCI fundamentals were also considered solid in comparison to other peer countries, bolstered by improving domestic macroeconomic dynamics in 2017, which maintained JCI competitiveness.

Most sectoral indexes rallied in 2017, dominated by issuers with a large capitalisation value (Graph 2.44). The financial sector posted the most significant gains, rallying 29.2%, followed by basic industries at 17.1%. The financial sector benefitted from positive sentiment stemming from the policy rate reductions in line with market expectations. The lower reference rate brought down lending rates and reduced the cost of funds in the banking industry, thus potentially improving issuer performance, particularly bank issuers. Fundamentally, financial sector issuer performance also improved in 2017. The market capitalisation of financial sector stocks increased but additional supply on the primary market failed to materialise. As of November 2017, the market capitalisation value of the financial sector had reached Rp1,987.8 trillion, accounting for around 30% of the total.
SBN Market

Consistent with stock market performance, the SBN market also rallied. Monetary policy easing has also successfully been transmitted to the SBN market, evidenced by declining yields of large magnitude in 2017. In general, SBN yields have decreased by an average of 146bps in 2017 (Graph 2.45), affecting all tenors, particularly short-term yields (164bps), followed by medium term (149bps) and long term (115bps). Meanwhile, the benchmark 10-year yield has declined by 146bps. Lower SBN yields stem from bullish market sentiment in line with the realisation of low and stable inflation, maintained exchange rates and the surplus trade balance. Externally, US economic gains that lowered UST yields also influenced domestic SBN yield movements.

Congruent with improving conditions in the SBN market, non-resident investors booked a net buy of tradeable government securities (SBN). Non-resident investors booked a net buy of Rp139.7 trillion (ytd), increasing on the net inflow totalling Rp107.3 trillion in the previous year. Maintained domestic macroeconomic dynamics encouraged non-resident investors to bolster holdings on the SBN market. Consequently, foreign SBN holdings in November 2017 increased from 36.7% to 38.5% (Graph 2.46).
The Monetary Policy Review (MPR) is published monthly by Bank Indonesia after the Board of Governors’ Meeting each January, March, April, June, July, September, October and December. This report is intended as a medium for the Board of Governors of Bank Indonesia to present to the public the latest evaluation of monetary conditions, assessment, and forecast for the Indonesian economy, in addition to the Bank Indonesia monetary policy response published quarterly in the Monetary Policy Report in April, July, October, and December. Specifically, the MPR presents an evaluation of the latest developments in inflation, the exchange rate, and monetary conditions during the reporting month and decisions concerning the monetary policy response adopted by Bank Indonesia.

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