Key Figures

- Inflation (2019)
  2.72%
- Core Inflation(2019)
  3.02%
- Inflation (2020F)
  3.0-3.2%
- Core Inflation (2020F)
  2.8-3.0%
- Consumption Growth (Q3 '19)
  5.01%
- % Current Account of GDP (Q3 '19)
  -2.7%

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**) Forecast*

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Curbed Administered Prices: Politics in Play?

Summary

Throughout 2019, we observe an overall low inflation landscape, as made apparent by its inflation rate being the lowest in 20 years (2.72%). The most important contributor of such decrease in inflation is the administered inflation, for which we have observed a decrease of 2.85 bps from last year. In addition, core inflation rate is also 0.05 bps lower than the preceding year, signifying a rather contracted economic landscape.

We view the low-inflation phenomenon as more of being a supply-side phenomenon, as opposed to the demand-side, due to the little to no correlation being observed between consumption growth and the inflation rate. We then argue that this low inflation landscape is attributable to several factors. First, the Indonesian government has made significant efforts to hold administered prices by refraining from implementing price increases. Particularly, their move to defer from implementing fuel &electricity price increases (i.e. through fixed subsidies), and notably, taxation on cigarettes has contributed to lower inflation rates, particularly those included in the administered inflation category. This can also be seen in the low inflation rates observed among transportations and telecommunications sector, which are mostly administered by the government as well. Also, the government-enacted one fuel-price policy, being implemented in late 2016, has seemingly exerted its own share of impact on price levels, possibly contributing to lower inflation rates through its reduction of price disparity between regions.

Table 1: Inflation Forecast (LPEM FEB UI)

2019		2020 Forecast	
Headline	Core	Headline	Core
2.72%	3.02%	3.0-3.2%	2.9-3.1%

Second, there seems to be indication that the above-mentioned stable administered prices lead to commensurate stability in demand levels. Such conjecture is validated by the relatively constant core inflation level throughout the year (see Fig. 1). Third, within the context of import-dependent input process in domestic manufacturing landscape, a slightly downward movement in exchange rates towards the end of 2019 has its own bearings on domestic inflation rates, provided that cheaper input goods subsequently translate into lower overall prices.

We argue that, in the year to come, we will see a slightly higher level of administered prices. Given the recently heightening geopolitical tension in the Middle East we see that there remains the possibility of rising crude oil prices in the early months of 2020 and will cease along the way. However, we also see the possibility of a countereffect of such heightened administered prices, as the fruition of massive infrastructure building under current administration might potentially take place. As such, we project a relatively modest rate of inflation in 2020, that is, ranging from 3 to 3.2%.

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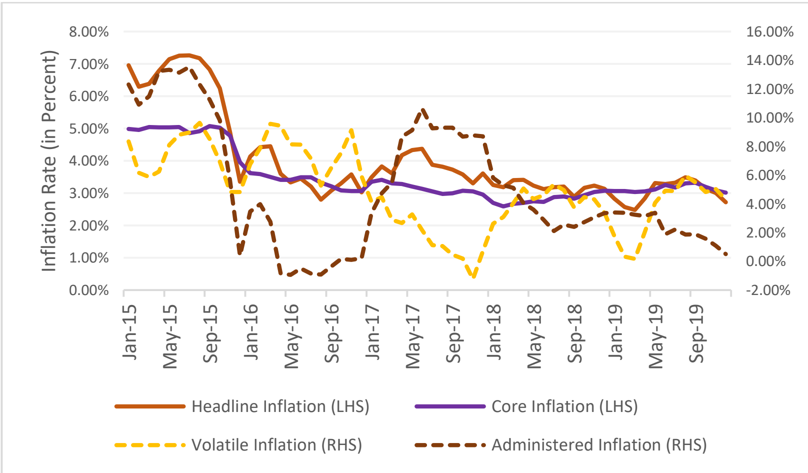
Downward Pressure in Inflation Rate, a Slowdown in Administered Goods Inflation

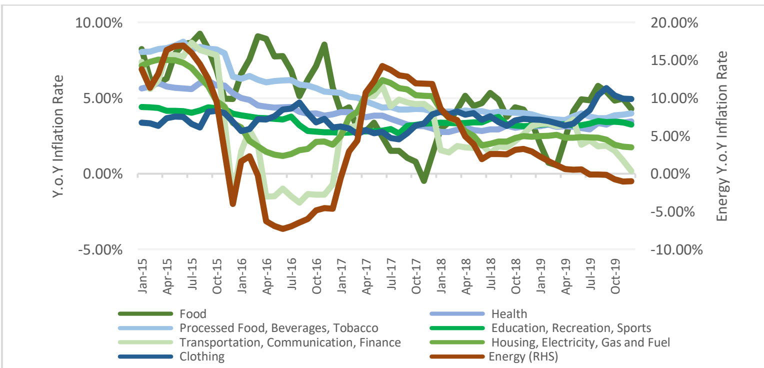
Overall, the year 2019 relatively saw a rather downward trend in the headline inflation rate, reaching its lowest level in 20 years. Such downward pressure has largely been contributed by the commensurate movement in administered inflation rate. The administered inflation rate is, by December 2019, at its lowest peak since December 2016 – sinking to only about 0.51% (Figure 1). We argue that this is partly owing to the governments' withholding of fuel & electricity prices increases, and notably, cigarettes excise, which is targeted to be implemented on 1st January of 2020. In addition, despite having higher levels of inflation, we also see the same downward movement for both core and volatile inflation rates. Albeit being relatively stable, the core inflation rate has been exhibiting a gradual downward trend of 0.3 bps since September 2019, whereas volatile inflation rate has also dropped by nearly 1.2 bps within the same period.

Figure 1: Inflation Rate (Headline, Core, Volatile, Administered Goods), 2015-2020.



When breaking down the inflation rate by their consumption types, we see that throughout 2019, inflation rates have been stable for most type of goods, except for clothing and food. These two categories of goods exhibit high seasonality patterns, as made apparent during the mid-year holiday season and Idul-Fitri, whereas inflation for both types of goods peaked at around 5.81% and 5.65% for food and clothing, respectively. Approaching the end of 2019, however, inflation rates for all types of goods have either dropped or stagnated, further contributing to downward pressures in inflation rates. Moreover, such decreases are most articulated for energy and transportation & telecommunications sector – both of which are heavily administered by the government. This could also serve as an indication of Indonesian government's infrastructure push, cutting distribution costs and thereby contributing to lower inflation rates.

Figure 2: Inflation Rate by Consumption Type, 2015-2020 (y.o.y).



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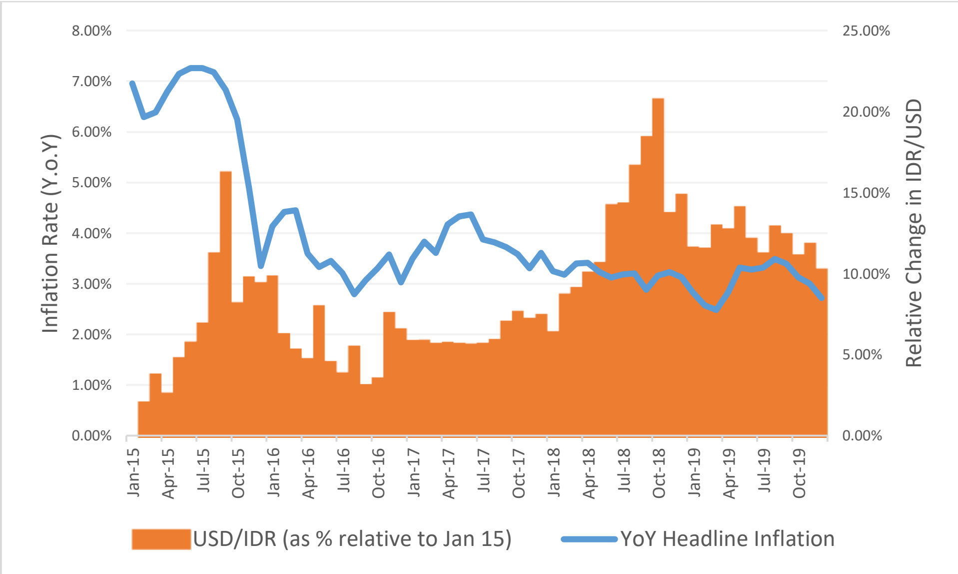
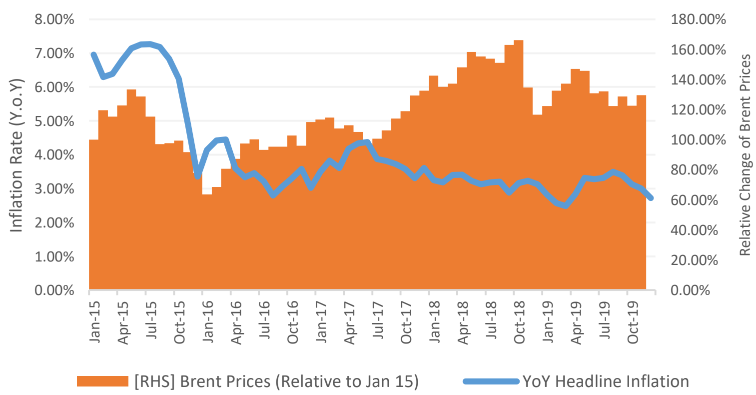
We see that several macroeconomic conditions provide their bearings on current inflation movements. As imports have played a critical role in providing inputs for domestic manufacturing landscape, strong correlation between exchange rate levels and domestic inflation rates are to be expected. Over the course of 2015-2019, we observe such pattern – of which the mid-2018 tantrum episode is an exception. Moreover, a rather stable exchange rate levels in 2019 (Figure 3) has eased the governments' effort in keeping the inflation rate low – as stable prices of input goods subsequently translates into stable prices as well.

Figure 3: Inflation Rate and Relative Change in USD/IDR, 2015-2020.



Oil price remains one of the indicators deemed to have notable contribution on price changes in the country. With the automotive sector still growing – albeit in a bearish manner – Indonesian government has been administering the oil prices in order to keep inflation low. In 2015, inflation rate interacted closely with the changes in oil price. However, in the last three to four years, little relationship is present between the indicators, suggesting that other contributors have been driving down the changes in prices whilst oil price generally rose. It is important to note that regulationary measures mandated Pertamina to bear the fluctuations of oil prices since Q2 of 2016, possibly related to the low inflationary changes commencing in around the same time of such enactment. The government is expected to carry on with such establishment into this new year of 2020.

Figure 4: Inflation Rate and Relative Change in Oil Price (Brent), 2015-2019.



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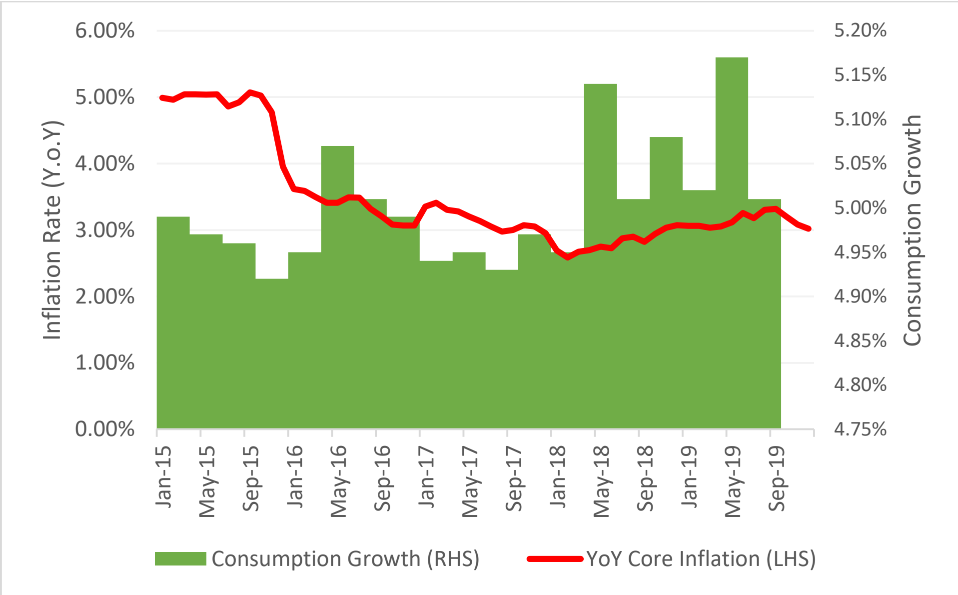
The year 2019 has been an interesting period in the context of core inflation and consumption growth. Bullish consumption growth in Q2 of 2019 amounted to 5.17%, narrowly eclipsing the growth of such period in the previous year by 0.03 pps, coincides with the consistent, upwards trend of core inflation that has been the generally noted movements in 2019 – despite the apparent drop in Q4 2019.

Figure 5: Core Inflation Rate and Consumption Growth, 2015-2019.



Manageable Inflation in 2020, Downwards Pressure with Little Upwards Push

In the coming year, we estimate the inflation to reflect the rather bearish, modest at best, consumption pattern at around 3% to 3.2%, with core inflation expected to be around 2.8% to 3%. There are several underlying assumptions that we consider in making such estimates. First, we assume that economic slowdown on the US economy to persist, despite the higher-than-expected growth in Q3 of 2019. The prolonged trade war with China under the Trump administration is expected to further hinder conducive business landscape in the country, while little changes are noted with respect to the supposed 'stimulus' of tax cut in 2018.

We assume that such condition in the States would be accompanied with a similar story from the Chinese counterparts, also mostly due to the ongoing trade war between the two countries. The slowdown in the two major economies in the world would only contribute to possible outflows of fund; however, the impacts of which have been rather indistinctive for the Indonesian perspective. One of the main rationales for such diversion of fund inflow would be attributed to the investment reforms happening at a glacial pace in the country. Rupiah is generally expected to remain at manageable level as a consequence. Further, credit ratings are recorded stagnant, hence little year-on-year changes on investment is expected.

In September 2019, the Government declared the plan to increase total government spending in 2020, as it is planned to be increased by 8.5% compared to 2019 planning. Such increased spending is expected to be allocated on infrastructure, which in turn is hoped to improve connectivity across regions in addressing volatility of prices. Government spending has also been moving towards import substitution policies, in hopes of improving deficit and exert further downwards pressure on price.

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Globally, oil prices are also expected to be manageable, with the increased global supply and reserves. However, upwards push from potential loosening of administered prices control (i.e., Pertamina) would also need to be closely monitored. Another leading indicator, BI rate, is also assumed to be cut from 5% to 4.75% to spur the demand side in the instance of prolonged slowdown in mid-2020. Meanwhile, we expect the domestic consumption to remain rather on the soft side.

In all, the downward pressure from the bearish consumption as well as government spending in designated for import substitution and infrastructure in the country is not expected to be fully offset by the possible inflow induced by the administered prices increase and external factors such as prolonged trade war and political instability. Thus, Rupiah appreciation is assumed to be incremental, if not minimal, while oil prices are also expected to at manageable level. In the absence of major external scenarios, we estimate price changes to be relatively soft in 2020.