LPEM FEB UI
UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

March 2020

Highlights

- BI should expand its intervention in the FX market and increase its policy rates by 25-bps this month.
- Fiscal stimulus is extremely needed now to cushion the economy against the fallout of the Covid-19 pandemic as the industry needs faster policy to mitigate the productivity loss.
- We see that the Covid-19 pandemic could slowdown Indonesia's Q1-2020 GDP growth rate to around 4.7% (y.o.y).

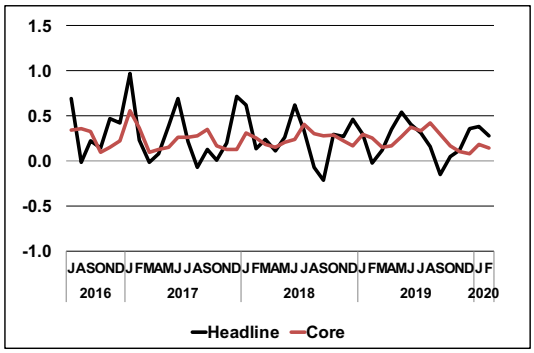
Two times emergency rate cuts by the Fed in the last two weeks due to rapidly escalating Covid-19 pandemic have led the market into a large sell-off in risky assets. Fear of uncertainties among global investors triggered capital outflows from emerging economies. Indonesia's portfolio has recorded an outflow of USD8.1 billion since the spread of the Covid-19 appeared in late January. To anticipate the economic disruption due to the outbreak in the short to medium term, central banks have put the efforts to maintain liquidity in their banking system along with cutting their policy rates. Bank Indonesia has also introduced stimulus packages, including providing some injections on forex and DNDF markets as well as lower bank's FX reserve requirements. However, the flight to safety moves has weakened Rupiah to around IDR15,200 so far. The effect on the FX stability has also shown up in the depreciation of all emerging economies' currency as the market's extreme risk aversion has led into forex shortage, especially USD, across the world. The condition has been clearly dictating financial market's trajectory into a bleak area.

On the other hand, February core inflation still represents the sluggish aggregate demand, albeit within BI's target range. Amid the risk of further weakening global economy, and significant slowdown of domestic economy, fiscal incentives are crucial to boost aggregate demand in the short run, such as the latest fiscal stimulus packages. Strategic fiscal policies are extremely important now to avoid a deep drop in productivity during the economic slowdown. Considering the lack of USD supply in FX market which has led to a 11% Rupiah depreciation in the last one month, we see that Bank Indonesia should increase its intervention in the FX market. In addition, it is time for BI to start preparing a more comprehensive stabilization strategy for the exchange rate, including increasing its policy rates.

Low-Maintained Inflation

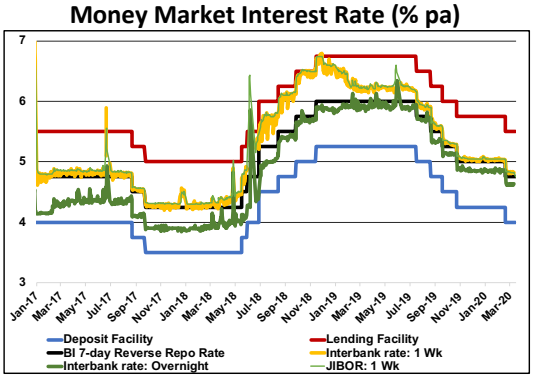
Inflation in February has continued to reflect the figure of domestic economic condition in recent months, where food prices increase faster than durable goods, resulting in higher headline inflation and lower core inflation. This pattern is clear on February annual inflation, with headline inflation rose slightly to 2.98% from 2.68% in January, whereas the annual core inflation dipped to 2.76% from 2.88%. The rise in volatile food prices, especially garlic, cayenne, and meat, were significant contributing factors for February inflation. It was attributable to the flooding in Jakarta and the Covid-19 outbreak which has disrupted the supply chain.

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

Figure 2: Interest Rate Policy and Interbank Money Market Interest Rate (% pa)



Source: CEIC

Macroeconomic & Financial Sector Policy Research

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Key Figures

- BI Repo Rate (7-day, Feb '20)
  4.75%
- GDP Growth (y.o.y, Q4 '19)
  4.97%
- Inflation (y.o.y, Feb '20)
  2.98%
- Core Inflation (y.o.y, Feb '20)
  2.76%
- Inflation (m.t.m, Feb '20)
  0.28%
- Core Inflation (m.t.m, Feb '20)
  0.14%
- FX Reserve (Feb '20)
  USD130.4 billion

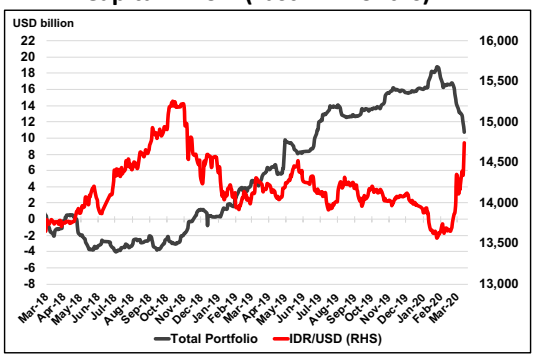
However, the core inflation figure at 2.76% (y.o.y) or 0.14% (mtm) is still disappointingly too low. The low core inflation, albeit within BI's target range, signalling the persistent sluggish aggregate demand even after interest rate has gone down to 4.75%. With the rising possibility of global economic slowdown and crude oil prices drop, we still expect the inflation to hover around 2.5-3% in 2020.

Covid-19 Ripple Effect Drives Global Economic Downturn

The global economy is now facing the potential economic halt as the Covid-19 outbreak continues its spread to the rest of the world, including Indonesia. The massive travel restrictions and social distancing implementation have led businesses to prepare the cut in producing outputs and/or providing services; put additional pressure on the low economic activity. This situation indicates that on top of supply-side issues due to China's shut down, the worldwide pandemic would bring a shock to the demand side as well. As the negative demand effects started to materialize, the fallout could not only bring significant correction on China's economy but also drives global economic growth towards the slowest trend along with recession in some countries.

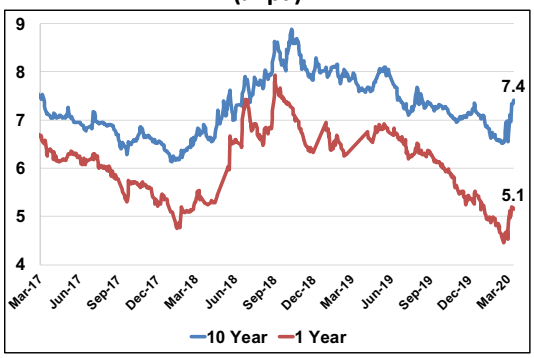
Amid the rapidly escalating confirmed cases of Covid-19, policy makers have put the appropriate measure to support the economy. Monetary authorities around the world have played its role by cutting interest rates and providing liquidity to the market to boost investment and spending. The Fed has slashed its rates two times by a total of 1.5% in the past two weeks, resulting in the lowest target range of 0-0.25% since the Global Financial Crisis in 2008. The other central banks, such as China, UK, Brazil, Canada, Mexico, and Australia, have also cut its benchmark rates to support the economy from the shock of the outbreak. The emergency actions by the central banks, particularly the Fed's early and aggressive moves, have led the market into a large sell-off in risky assets. The fear of uncertainties from global investors has triggered capital outflows from emerging economies. Indonesia's accumulated portfolio has recorded an outflow of USD8.1 billion, from USD18.8 billion in 24th Jan 2020 to USD10.7 billion in 13th Mar 2020. The investor has shifted their portfolio to safer investments like US-Treasury; making the yields of 10-Year US Treasury has dropped to below 1%. While 10-Year and 1-Year Indonesia government bonds yield have spiked to 7.4% and 5.1% respectively (Figure 4).

Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 24 Months)



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: Bloomberg

Panic in the emerging financial markets due to current pandemic outbreak has been weighted on promptly in the foreign exchange stability as all emerging currencies depreciated (Figure 6). By year-to-date depreciation rate, Rupiah is among the worst affected currencies as it depreciated

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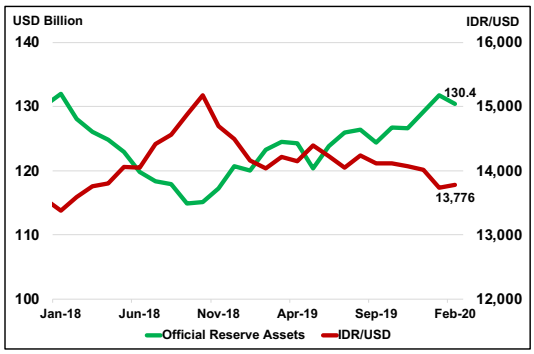
by 10% (ytd). Bank Indonesia has introduced stimulus packages for maintaining the Rupiah stability, including cutting 25bps policy rates in February, providing some injections on forex and DNDF markets as well as lowering bank's FX reserve requirements. However, USD shortage in financial markets due to extreme risk aversion of global investors is persistently widening. Rupiah depreciation to around IDR15,200 so far, has been clearly dictating financial market's trajectory into a bleak area. Likewise, several central banks have continued the efforts to maintain liquidity on top of cutting the interest rate. Besides slashing its benchmark rate to nearly zero and launching USD700 billion quantitative easing program, the Fed has let the banks to borrow from the discount window and has implemented the zero percent of reserve requirement for banks. Bank of Japan has also capped long-term borrowing costs around zero.

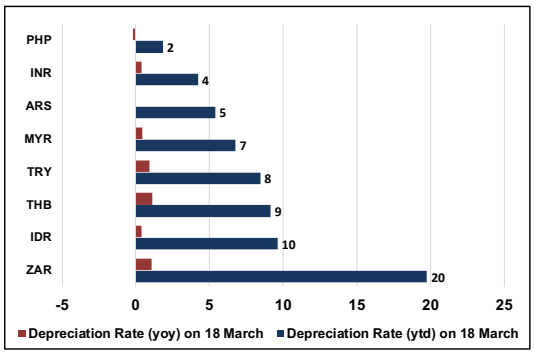
Despite more easing stances are expected, the room for central banks to resolve the disruption in supply-chains and consumers demand is seen as limited. The impacts from factory shutdowns, travel restrictions, school closings to numerous event cancellations will hit the economic activity in the short run. As it takes some quarters for credits and investments to give effect into real sector figures, another strategic and quick-acting measures for economic growth in the near future are highly required. For now, we see that fiscal stimulus shall effectively cushion the economy against the fallout of the outbreak, as industry needs faster policy to mitigate the productivity loss.

Figure 5: IDR/USD dan Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (18 March 2020)



Source: Investing

GoI has planned two fiscal stimulus packages worth 1) USD745 million for low-income mortgage subsidies and tourism-related industry incentives; and 2) USD1.6 billion for the manufacturing or export-oriented industry tax breaks as these sectors set to take big knock from the Covid-19 pandemic. While the first stimulus has failed to implement since the first confirmed case occurs, the targeted tax break programmes are seen promising. The lower corporate income tax rate and deferred import tax payments are expected to minimize the business loss, thus, avoiding the jump in the number of laid-off workers. The tax breaks will also directly support the manufacturing workers as they will be temporarily exempted from the income tax.

The fiscal initiatives are introduced recently as the confirmed cases of Covid-19 have increased in Indonesia. GoI are now preparing to accelerate the execution of social spending and pre-employment card subsidies programmes to help the most affected, especially the low-income families in the right timing. It must be noted that the motivation of giving people money in the months ahead is not to encourage them to make tertiary spending, rather to give financial cushion and secure their basic needs as this group of people lives on day-to-day income which is

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disrupted by the outbreak. For the middle to high-income groups, consumption will slow down, as people prefer to stay at home during social distancing. The restaurants, retails, and informal services sectors might be affected the most during this time. Thus, in the long run, the sound and strategic policy measures for economic recovery at the end of this health crisis are crucial to offset the productivity loss during the crisis.

Fiscal incentives have also been given by authorities in several countries, such as Australia (USD11.4 bn), Canada (USD14.4 bn), Spain (USD15.6 bn), and South Korea (USD29.8 bn). It means that the authorities around the world has agreed that fiscal stimulus is needed in the fight against this health crisis. But, the size and form of the stimulus packages are highly depend on the country's capacity. For emerging economies, prudent manner of the government to maintain fiscal deficit remains crucial. As the halt in the economy due to pandemic outbreak will bring the potential loss in the government revenue, the prudent budget spending to prevent any unfavourable risks in the future are necessary. With the latest stimulus plans of USD1.6 billion, coupled with the projected downturn in economic growth into 4.7% (y.o.y), steady annual inflation at 3% (y.o.y), Rupiah depreciation by 11% from the target, and the persistent low crude oil prices at USD30, Indonesia's fiscal deficit is predicted to widen at the range of 2.5-2.7% from GDP, significantly worse than the targeted deficit in 2020 at 1.8% of GDP. We see a very tight room for government stimulus. Adding another fiscal stimulus, say for the medical countermeasures, would bring the fiscal deficit to the 3% threshold. Worse scenarios for the assumptions above will bring the deficit to breach the 3% threshold.

Moreover, the latest trade data shows that Indonesia's exports in February still pose a positive growth (11% y.o.y) while imports slumps by -5% (y.o.y), resulting in the trade surplus at USD2.3 billion. The better-than-expected trade surpluses, however, has failed to relax the market yesterday as the increase in exports are mostly contributed by the higher prices (9.3%) due to supply disruption and uncertainty. On the other hand, the export volumes only increased by 1.5% (y.o.y). It indicates that February surpluses might not guarantee further improvement in trade activity as the export prices, which coming mainly from commodity goods, will be volatile during the outbreak. We still see the pass-through slowdown in trade performance in 1H-2020. The Covid-19 pandemic could cause a correction to Indonesia's Q1-2020 GDP growth rate, to bring it to around 4.7% (y.o.y).

While faster-than-expected Fed rate cuts coupled with another easing policies may induce another round of flight-to-safety moves from global risky assets, which triggers a continuing trend of capital outflow, we still see that the international reserves (USD130.4 billion) are adequate to counter the capital flights through direct interventions to stabilize the market. Nevertheless, considering the lack of USD supply in FX market which has led to a 11% Rupiah depreciation in the last one month, we see that Bank Indonesia needs to increase its intervention in the FX market. In addition, it is time for BI to start preparing a more comprehensive stabilization strategy for the exchange rate, including increasing its policy rates.