MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

May 2020

Highlights

- BI should keep its policy rate of 4.5% this month.
- BI should maintain yield differential to anticipate the possibility of capital flight.
- Looking at the trade balance surplus trend over two consecutive periods, we predict CAD will improve to around 1.4-1.6% in Q1-2020.

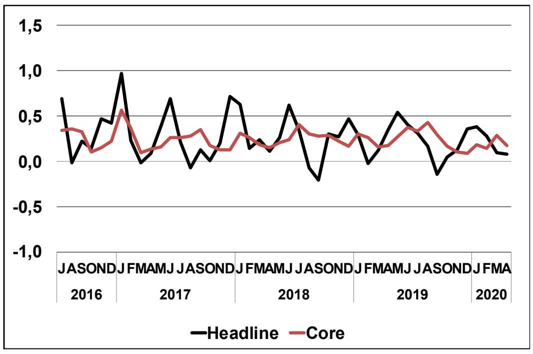
The Covid-19 pandemic has already hit Indonesia economy in the first quarter of 2020, perceived as the early-stage impact. GDP growth decelerated to 2.97% (yoy), became the slowest pace of growth since the Asian financial crisis. Household consumption and investment grew sluggishly as a consequence of the implementation of social distancing to curb the spread of Covid-19 which dampens demand and economic activities. These declines were offset partially by an increase in net export. Looking at the trade balance surplus trend over two consecutive periods, we predict that CAD will improve to around 1.4-1.6% in Q1-2020. As the pandemic peak is yet to come, the gloomy outlook for Indonesia economy prevails. Weakening demand, disruption of the global supply chain, and lower global commodity prices are expected to put further pressure on the economy in Q2 and Q3 2020. Meanwhile, we still see stable inflation as subdued demand countering the risk of a supply shock.

On the external side, global volatility is gradually subsiding, helping to improve the domestic financial market conditions. Several other countries have begun to lift the lockdown; hence, reviving the economy. Rupiah gradually strengthened to around 14,800, supported by the issuance of USD4.3 billion global bonds and improved global sentiment towards developing countries. However, high uncertainty is still looming since the spread of Covid-19 remains escalating domestically and its settlement is still unclear. Extraordinary measures taken by policymakers through monetary easing, fiscal stimulus, and credit restructuring will help in maintaining macroeconomic and financial system stability. Emphasizing the need for external resilience amidst heightened uncertainty, we suggest BI to hold the policy rate at 4.5% for this month.

An “Unusual” Low Inflation Rate

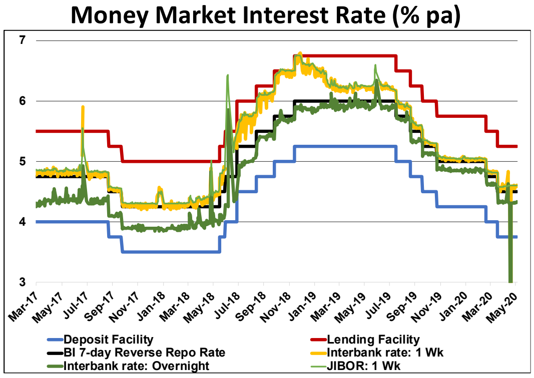
April inflation rate was lower than expected, as the inflation rate has traditionally risen during the period that coincides with the beginning of Ramadan. This monthly headline inflation rate stood at 0.08% (mtm), much lower than 0.44% (mtm) recorded in the same month last year. Annual inflation also decreased to 2.67% (yoy) compared to inflation in the previous month at 2.96% (yoy). Deflationary pressures on volatile food and administered prices, coupled with controlled core inflation, have contributed to the lower headline inflation below that of historical data.

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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



Source: CEIC

Administered prices and volatile food prices recorded deflation of -0.14% (mtm) and -0.09% (mtm), respectively. The deflation in administered prices was mainly due to a declining trend in transportation fares. The weakening of household purchasing power in line with a sufficient

Macroeconomic & Financial Sector Policy Research

Riatu M. Qibthiyyah, Ph.D.
(Director)
riatu.mariatul@lpem-feui.org

Syahda Sabrina
syahda.sabrina@lpem-feui.org

Nauli A. Desdiani
nauli.desdiani@lpem-feui.org

Teuku Riefky
teuku.riefky@lpem-feui.org

Amalia Cesarina
amalia.cesarina@lpem-feui.org

Meila Husna
meila.husna@lpem-feui.org

Key Figures

- BI Repo Rate (7-day, Apr '20) **4.5%**
- GDP Growth (y.o.y, Q1 '20) **2.97%**
- Inflation (y.o.y, Apr '20) **2.67%**
- Core Inflation (y.o.y, Apr '20) **2.85%**
- Inflation (m.t.m, Apr '20) **0.08%**
- Core Inflation (m.t.m, Apr '20) **0.17%**
- FX Reserve (Apr '20) **USD127.8 billion**

To keep you updated with our monthly and quarterly reports, please subscribe. Scan the QR code below

or go to http://bit.ly/LPEMCommentarySubscription

supply of foods triggered deflation in volatile food. Besides, a relatively stable exchange rate with lower commodity prices also materialized in a lower exchange rate pass-through and imported inflation. Overall, there is no significant pressure from cost-push inflation as the government has also managed to relax imports to secure the availability of goods.

Meanwhile, the core inflation remained at 0.17% (mtm), unchanged from the same period last year with the annual rate of 2.85% (yoy), slightly decreased from 2.87% (yoy) in March. BI has successfully managed to tame inflation expectations. Moreover, slowing demand during the pandemic caused inflationary pressures not to be as high as usual. The slowdown in economic and social activities stemming from large-scale social restrictions (PSBB) leads to the lower demand for goods and services, while in normal circumstances, household consumption peaks during Ramadan. With the overall conditions, we still see low and stable inflation near BI's lower bound of 3±1% as subdued demand countering the risk of a supply shock.

Lower-than-expected Q1-2020 GDP Growth

The Covid-19 pandemic has already hit Indonesia economy in the first quarter of 2020, perceived as the early-stage impact. GDP growth decelerated to 2.97% (yoy) from 5.02% in Q4-2019, significantly below a number of consensuses at around 4% and became the slowest pace of growth since the Asian financial crisis. Household consumption grew sluggishly by 2.84% (yoy) as a consequence of the implementation of social distancing to curb the spread of Covid-19 which dampens demand and economic activities. Growth in investment also declined by 1.7% (yoy), far lower than 5.03% recorded over the same period last year.

By contrast, government consumption grew only by 3.74% (yoy), restrained by delays and cancellation of the government's usual business activities. Exports increased by 0.24% (yoy), while imports decreased by -2.19% (yoy). Looking at the trade balance surplus trend over two consecutive periods in February (USD2.51 billion) and March (USD0.74 billion), we predict that CAD will narrow to around 1.4-1.6% in Q1-2020. The trade surplus was partly due to the increase in exports as the spill-over effect of the closure of China's trade led to a short-term market shifting from China to Indonesia for several export commodities on the global market. However, the improvement of trade balance during Q1-2020 is not necessarily to be interpreted as an improvement of the economy in the near future, since a sharp decline in imports will lead to a further decline in exports in the coming period due to a fall in capital goods and inputs. This condition indicates a decline in economic activity in the real sector which will be further translated into slower economic growth.

By sector, wholesale and retail trade (1.6%), accommodation (1.95%), as well as transport and storage (1.27%) are the most severely affected by the pandemic. Furthermore, manufacturing sector as the largest contributor to the economy, grew only by 2.06% (yoy) due to declining demand and supply chain disruption. We forecast an even sharper growth contraction on manufacturing in Q2 and Q3 2020, especially for the labour-intensive sectors which will be hit the hardest, signalled by the fell of manufacturing PMI in April to the lowest level in history at 27.5, compared to the position in the Q1-2020 at above 45.

As the pandemic peak is yet to come, the gloomy outlook for Indonesia economy prevails. The government official's forecasts GDP to grow only by 2.3% this year, with the worst-case scenario depicting a -0.4% contraction. Weakening demand, disruption of global supply chain, and lower global commodity prices are expected to put further pressure on the economy in Q2 and Q3 2020. Amidst high uncertainty, GDP growth projection shows divergence with recovery profiles

Key Figures

- BI Repo Rate (7-day, Apr '20)
  4.5%
- GDP Growth (y.o.y, Q1 '20)
  2.97%
- Inflation (y.o.y, Apr '20)
  2.67%
- Core Inflation (y.o.y, Apr '20)
  2.85%
- Inflation (m.t.m, Apr '20)
  0.08%
- Core Inflation (m.t.m, Apr '20)
  0.17%
- FX Reserve (Apr '20)
  USD127.8 billion

To keep you updated with our monthly and quarterly reports, please subscribe. Scan the QR code below

or go to
http://bit.ly/LPEMCommentary Subscription

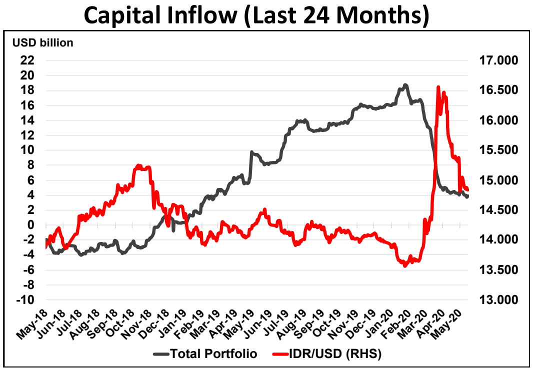
vary among institutions, whether the recovery path will be V-shaped (quick), or U and L-shaped (slower recovery). Looking at the current treatment of the Covid-19 pandemic, we see the recovery process is likely to be more U-shaped or L-shaped. However, if decisive actions to contain the health and economic impacts of the outbreak can be effectively implemented, particularly to safeguard the poor and vulnerable groups, we shall see the economy will gradually rebound to its trajectory, approaching its potential growth at around 5% next year.

Managing External Resilience Amid Looming Uncertainty

Global volatility is gradually subsiding. Several other countries have begun to lift the lockdown, hence reviving the economy. After a significant contraction, China economy has begun to recover, marked by an increase in China's industrial output for the first time since the outbreak. Decreased global volatility helped to improve domestic financial market conditions, with financial market turmoil began to ease since late April.

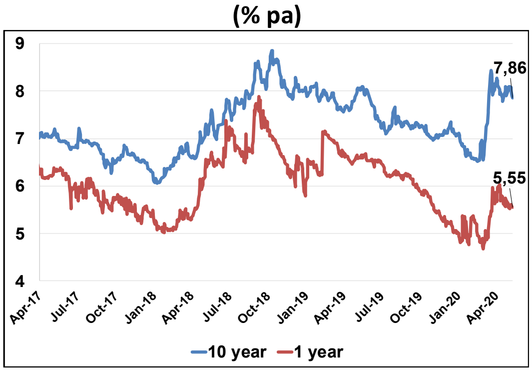
After several episodes of massive capital outflows during the last two months, which triggered the exchange rate to highly depreciate, Rupiah now gradually strengthened to around 14,800. This is supported by the issuance of USD4.3 billion global bonds and improved global sentiment towards developing countries. The issuance of global bonds successfully increased BI forex reserves by USD7 billion to USD128 billion during last month, after it had previously been eroded to stabilize the exchange rate. Steady capital inflows recently driving government bond yields to decrease by 22 and 15 bps to 7.86% and 5.55% for 10-Year and 1-Year bonds, respectively, compared to the position at the end of April.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

Despite the decreasing volatility in the financial sector, high uncertainty is still looming since the spread of Covid-19 remains escalating domestically and its settlement is still unclear. Also, its impact on the economy and financial sector heavily depends on the success of implementation of the mitigation measures. BI has injected large amounts of liquidity by a Quantitative Easing program of IDR503.8 billion since early 2020 through the purchase of SBN, the Repo Line mechanism, FX-swap, as well as a lower reserve requirement. Massive efforts by the government in the form of health supports, social safety net, and industrial incentives are expected to minimize the damage of the pandemic, meet societies' subsistence needs, and preserve affected business, both MSMEs and corporations. These extraordinary actions by policymakers through monetary easing, fiscal stimulus, and credit restructuring will help in maintaining macroeconomic and financial system stability as an effort to recover the national economy and bring it towards the "new normal".

Key Figures

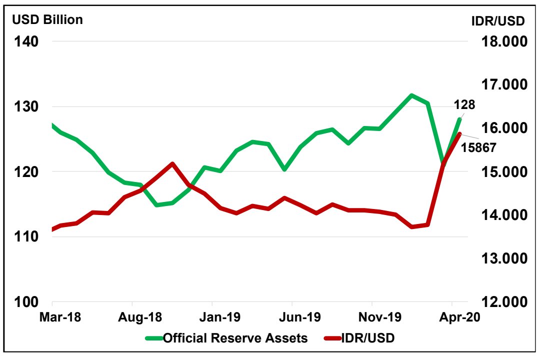
- BI Repo Rate (7-day, Apr '20)
  4.5%
- GDP Growth (y.o.y, Q1 '20)
  2.97%
- Inflation (y.o.y, Apr '20)
  2.67%
- Core Inflation (y.o.y, Apr '20)
  2.85%
- Inflation (m.t.m, Apr '20)
  0.08%
- Core Inflation (m.t.m, Apr '20)
  0.17%
- FX Reserve (Apr '20)
  USD127.8 billion

To keep you updated with our monthly and quarterly reports, please subscribe. Scan the QR code below

or go to http://bit.ly/LPEMCommentarySubscription

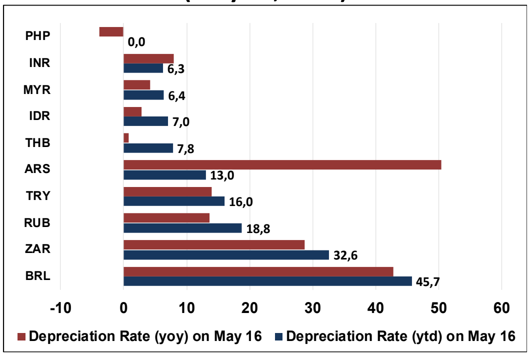
Observing the latest conditions, we see there is an adequate room for more policy rate cuts by BI in the near future, due to stable inflation and the need to stimulate economic growth given the expected decline in GDP growth in Q2 and Q3-2020. However, BI should maintain yield differential to anticipate the possibility of capital flight. Lower policy rate may induce investors to move their assets back to "safe-haven" countries, triggering Rupiah to fluctuate. Therefore, emphasizing the need to maintain Rupiah stability in the short-term amidst heightened uncertainty of the pandemic, for now, we suggest BI to hold its policy rate at 4.5%.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (May 16, 2020)



Source: Investing.com