BI Board of Governor Meeting

June 2020

Highlights

- BI should cut its policy rate to 4.25% this month.
- Higher-than-expected trade surplus in May, as the result of decline in imports outpacing drop in exports, suggesting needs of economic growth improvement in the near term.
- BI still requires its policy mix to prevent further risks of volatility in financial market.

Macroeconomic & Financial Sector Policy Research

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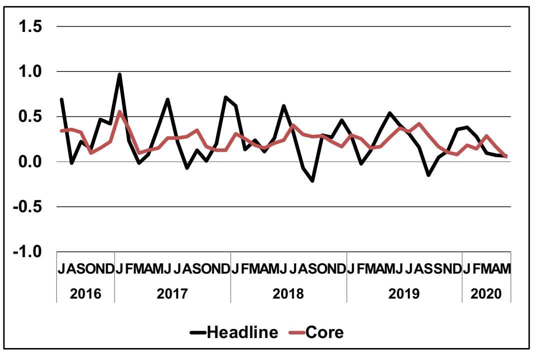
Several countries, including Indonesia, started to reopen their economies and relax their pandemic containment measures as the efforts to recover from its COVID-19 breakdown. Even though the pandemic peak and settlement are still uncertain, Indonesia has decided to gradually revive the economy by loosening the large-scale social restrictions (PSBB) towards the "new normal". To date, the pandemic has hit all aspects of the economy due to the global supply chain disruption and weakening demand. Substantial deterioration in consumptions and investments is undeniable. In addition, Indonesia's exports significantly dropped while imports plummeted at a higher pace; reflecting a gloomier outlook of the economy in the near future as a collapse in imports, which mainly consist of raw materials and capital goods, signalling a real sector contraction. Besides, inflation remains low and stable as weakening aggregate demand beat the limited cost-push inflation.

In the financial market, Rupiah has been gradually strengthening since early May, in line with the recorded net portfolio influx. However, negative sentiment due to the second wave of the pandemic in some countries has led investors to move their assets from emerging markets into safe-haven assets during the past three days. Massive "*flight-to-safety*" brought Rupiah back to around IDR14,200 from IDR13,840 last week. Since late April, however, Indonesia has been outperforming other emerging markets where the depreciation of Rupiah remains low compared to other currencies. It somewhat reflects the convincing and relatively resilient financial market in Indonesia, thanks to BI and the government's efforts in managing volatility during the pandemic. Given by manageable Rupiah, sufficient forex reserves, and limited forex demand from import activity in the near term, we see that BI needs to lower its policy rate by 25 bps to 4.25% this month to support economic growth while maintaining the financial system stability.

Persistent Low and Steady Inflation

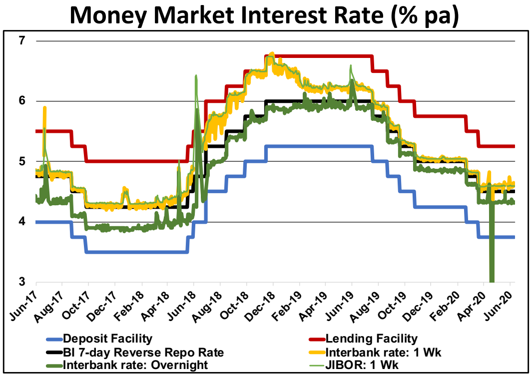
Monthly inflation in May unsurprisingly stood at 0.07% (mtm), much lower than 0.54% (mtm) recorded on the same month last year. The figure came with no surprise as the large-scale social restrictions (PSBB) have curbed household consumption even in the presence of Ramadhan and Eid-ul-Fitr celebration. The unprecedented event of the health crisis has brought the inflation rate during the Ramadhan period to its lowest level in more than a decade. Annual headline inflation also experienced a massive drop from 2.67% (YoY) in the previous month to only 2.19% (YoY). At the same time, annual core inflation recorded low at 2.66% (YoY) compared to 2.85% (YoY) last month. The muted headline and core inflation were suggesting a significant weakening aggregate demand compared to the figure last year.

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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



Source: CEIC

Key Figures

- BI Repo Rate (7-day, May '20)
  4.50%
- GDP Growth (y.o.y, Q1 '20)
  2.97%
- Inflation (y.o.y, May '20)
  2.19%
- Core Inflation (y.o.y, May '20)
  2.66%
- Inflation (m.t.m, May '20)
  0.07%
- Core Inflation (m.t.m, May '20)
  0.06%
- FX Reserve (May '20)
  USD130.5 billion

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Based on the components of goods, both volatile, administered, and energy prices, are jointly contributed to the low inflation rate as all these figures recorded a sharp decline compared to the data in the previous year. Subdued inflation for volatile and administered prices is attributable to the slowing demand during the pandemic amid the risk of a supply shock. On administered price, the contraction in the transportation industry due to massive international and domestic travel restriction has led to four consecutive deflation figures since February 2020, with the latest rate recorded at -1.37% (YoY). We see that deflationary pressures in administered prices continue in the near term along with the government's plan to cut the prices of utilities and travel services, including transportation fare, gas, and electricity price. Further, deflation in energy prices is persisted since January 2020 due to uncertainty in global crude oil prices.

All in all, the muted inflation might continue for a longer time if the health crisis persists. However, we still see inflation will be maintained at around BI's target of 3±1% due to anchored inflation expectations and limited cost-push inflation. Thus far, the government has put efforts to safeguard the supply of goods and services for keeping the inflation rate still under control.

Larger-than-expected Trade Surplus

Since global and domestic demand collapsed, Indonesia's exports dropped by 29% while imports slumped by 42% in May compared to the figure in the previous year; making the larger-than-expected trade surplus at USD2.09 billion. The latest data has reflected a bleaker outlook for the Indonesia economy as lower imports, which mainly consist of raw materials and capital goods, signalling a real sector contraction in the near future. Along with that, exports might be sluggish as there is still no promising sign of the pandemic cessation. Consumers remain wait-and-see to return into the normal situation, thus, repressed business eagerness to restart their production.

In order to start the recovery period, the government has gradually begun to reopen economic activities by loosening the large-scale social restrictions towards the "new normal". We see that this action could be effective to prevent further economic slowdown if all stakeholders are discipline to implement all the essential health and hygiene protocols based on the COVID-19 containment measures; reducing the risks of the second wave of the pandemic. Even though we need a lot more effort to bring the economy closer to normal, with limited chances of a second wave, national economic growth is expected to rebound in late 2020.

Improved External Position Amidst Uncertainty During the Pandemic

There is no clear-cut estimation on the global market during the ongoing pandemic. Predicting the deterioration of the financial market is very challenging, as investors' behavior changes as fast as the spread of the COVID-19. However, market movements since early May are thrilling to follow as Rupiah gradually appreciated up to IDR13,840 on June 9th and weakened to around IDR14,200 on June 15th. Improvements in global sentiment, as well as relatively robust national macroeconomic indicators, account for the majority of capital inflow behavior in emerging economies. Even though mitigation measurement of the pandemic in Indonesia is still uncertain, total portfolio inflow gradually increased since mid-May; reflecting better investors' confidence.

After a significant improvement in the financial market, what is currently happening on the market is exactly the opposite of what has happened since early May; investors have been taking back their assets from emerging economies into a safe-haven market. Rupiah has weakened in the past three days due to the collapse of the US's stock markets as the fear of the second wave

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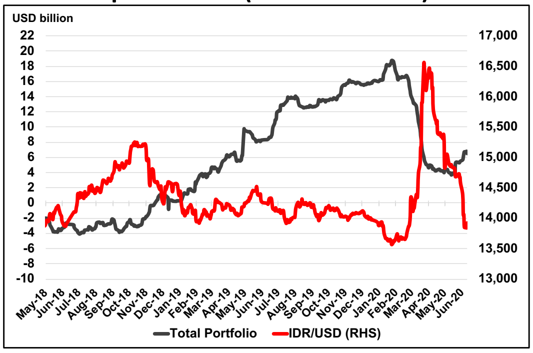
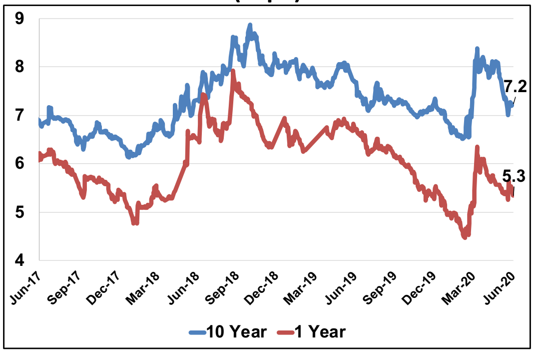
of COVID-19 looming. Investors' panic has seized the financial market and started to rise Indonesia's government bonds yield, with the latest figures at 7.2% and 5.3% for 10-Year and 1-Year tenor, respectively.

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



Source: CEIC

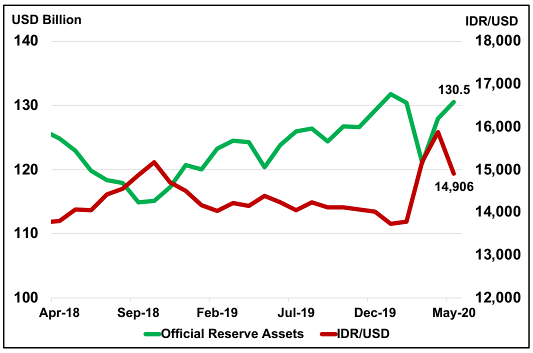
Figure 4: Government Bonds Yield (% pa)



Source: Bloomberg

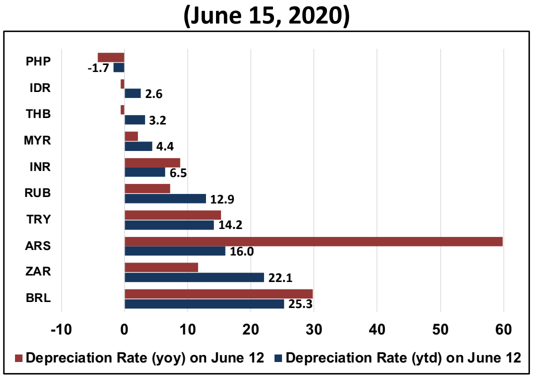
Development in the financial market in the last one month reflects the exalted volatility in investors' behavior. Indonesia's central bank has put several policy measurements to stabilize the currency and maintain the financial system stability. BI has been actively intervening spot and DNDF market to prevent a sharp drop in Rupiah. As a result, Rupiah has outperformed the other emerging economies' currency, as seen by a relatively muted ytd depreciation rate (Figure 6). In addition, numerous policies, namely SBN repo transactions, lower reserve requirements, and FX swaps, have been provided by BI to support liquidity in the banking industry. Adequate liquidity is currently required by banks to carry the loan restructuring during COVID-19 for the affected businesses, particularly MSME. Financial supports to firms will boost their confidence in restarting the economy, thus amplifying credit growth, which stood at only 5.73% in April compared to the same month in the previous year.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (June 15, 2020)



Source: CEIC

The larger-than-expected trade surplus is one of the key indications for weaker growth prospects in the near future as the decline in imports outpaced the drop in exports. On the other hand, the financial market is now relatively more stable with a sufficient amount of reserves at USD130.5 billion. Further, forex demand from import activities is limited in the near term as the consumption is still weakening. Looking at these considerations, we see that boosting business

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confidence to accelerate economic growth and maintain the financial system stability during the “new normal” is now critical. Along with the relatively manageable financial market, a policy rate cut by 25 bps to 4.25% by BI this month is appropriate to support the government’s efforts in boosting economic growth.