LPEM FEB UI
UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

November 2020

Highlights

- BI should cut its policy rate by 25bps this month.
- Inflation is still low even after rebounding from depreciation.
- Uncertain condition in the US during the presidential election and the attractiveness of Indonesia's real yields have been driving Rupiah to appreciate at around IDR14,000 as capital inflow continues.

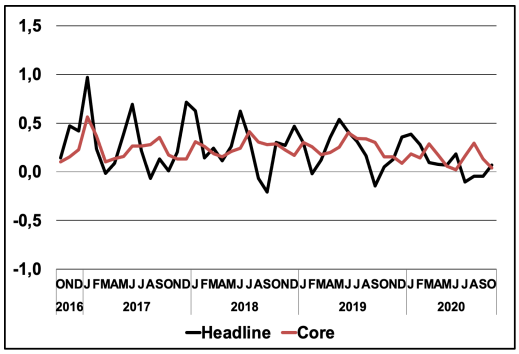
Indonesia officially fell into recession since the 1998 Asian financial crisis as the economy contracted again in Q3-2020 by -3.49% (y.o.y), albeit at a slower pace than the previous quarter. GoI indeed needs to accelerate the implementation of stimulus packages, in particular to prevent those who have lost their jobs from falling into poverty and to save businesses that are at the brink of bankruptcy, while continuing several containment and mitigation measures of the Covid-19 pandemic in order for the economy to fully rebound from its dismal growth in 2020. Inflation remains below expectations and without any signs of pricing pressures, indicating a prolonged weak of aggregate demand.

On the external sector, a larger-than-expected October trade surplus of USD3.61 billion suggesting an improvement in CAD figure will continue. Moreover, the continuing portfolio capital inflows supported by the uncertain condition in the US during the presidential election and the attractiveness of Indonesia's real yields have been driving Rupiah to appreciate. Since Rupiah has been too appreciated, therefore, any cut in the BI rate now will be less risky in order to stabilize Rupiah. With the overall current domestic and external circumstances, we view that BI should cut its policy rates by 25bps to 3.75% this month to support the economic growth in the remaining quarter of 2020 while keeping an eye on the external pressures and maintaining financial sector stability.

Weak Purchasing Power Holds Inflation Below Target

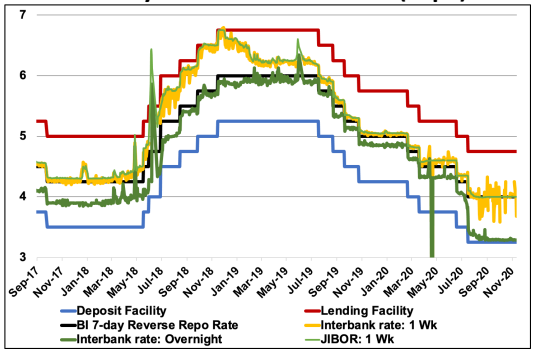
After three consecutive months of monthly deflation, inflation slowly rebound in October with a monthly rate of 0.07% (m.t.m), higher than 0.05% (m.t.m) recorded in the same month last year. Likewise, annual inflation also continuing its increasing trend after experiencing the deepest level of inflation drop in August, recorded at 1.44% (y.o.y) slightly increased from 1.42% (y.o.y) in September but still far below BI's target range of 2%-4%. Although the economy is somewhat recovering, lower trend of annual and monthly core inflation at 1.74% (y.o.y) and 0.04% (m.t.m), compared to 1.86% (y.o.y) in September and 0.15% (m.t.m) in the same month last year indicates people's purchasing power remains under pressure. Even without restrictions, many people are likely to stay away from public places like restaurants, public space, and gyms, fearing exposure to the illness. It also shows how consumers' priorities and spending habits have changed where consumers are becoming more adapted at online shopping or even shifting their money to bank accounts to have precautionary savings.

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, Oct '20)
  4.00%
- GDP Growth (y.o.y, Q3 '20)
  -3.49%
- Inflation (y.o.y, Oct '20)
  1.44%
- Core Inflation (y.o.y, Oct '20)
  1.74%
- Inflation (m.t.m, Oct '20)
  0.07%
- Core Inflation (m.t.m, Oct '20)
  0.04%
- FX Reserve (Oct '20)
  USD133.6 billion

The main driver of October inflation was influenced by higher volatile food prices, notably for red chilli and shallot along with the end of the harvest season, as well as cooking oil in line with the rise in the global CPO prices. Volatile food prices accelerated further in October by 1.32% (y.o.y), compared to 0.55% (y.o.y) in September. Similarly, its monthly rate also rose by 0.40% (m.t.m) from -0.37% (m.t.m) in the same month last year. On the other hand, the administered prices continued to drop both in its annual and monthly rates. The annual administered prices recorded at 0.46% (y.o.y), lower than its level in September at 0.63% (y.o.y) while the monthly rate also declined to -0.15% (m.t.m), down from 0.03% (m.t.m) recorded in October 2019. A relatively low administered prices was contributed by electricity tariffs exemption and discount for small-scale industries and lower-middle income households as well as the continued decline in airfare ticket prices in response to the period of a long holiday at the end of October.

Going forward, we expect inflation to remain under control and gradually recover towards the lower end of BI's target range of 2.0-4.0% on the back of faster stimulus disbursement to boost the economic recovery. Nevertheless, downside risks remain as long as the consumers' confidence is yet to return to the pre-pandemic level. We see persistently subdued demand in the near future as the economy currently running at a slower pace than usual, and there is still a lack of interest from producers in raising prices when incomes are lower. Instead, most businesses offer their products with a more competitive price in order to attract demand and increase sales. With inflation remains below expectations, and without any signs of upward pressures, this condition gives ample room for BI to drive down interest rates further to stimulate demand and to stabilize prices and prevent them from falling further.

Road to the Economic Recovery

The Covid-19 pandemic has hit the country's economy hard, disrupting business and weakening purchasing power. Indonesia officially fell into recession since the 1998 Asian financial crisis as its economy contracted again in Q3-2020 by -3.49% (y.o.y), albeit at a slower pace than the previous quarter. This figure is actually worse-than-expected, in which the GoI predicted the economy would grow in the range -1% to -2.9% (y.o.y). Almost all of the GDP components contracted except the government spending, which grew 9.76% (y.o.y) driven by the rapid stimulus through high realization of social assistance and government incentives for businesses. Meanwhile, the household consumption and investment, which contributes to more than 80% of GDP, shrank -4.04% and -6.48% (y.o.y) respectively. Exports and imports respectively plunged -10.82% and -21.86% (y.o.y), reflecting the downturn in the global trade and domestic demand due to the disruption in the global supply chain.

Despite significant annual negative growth, Indonesia's economy grew positively on a quarterly basis by 5.05% (q.t.q) in Q3-2020, indicating a sign of the emergence of recovery. The total stimulus package of Rp695.2 trillion this year is crucial to control the economic damage brought by the pandemic. However, as of November 9th, the realization for the National Economic Recovery (PEN) was still considerably low, recorded at 55.2% or Rp383.5 trillion. Therefore, GoI should better have a robust and swift strategy to reallocate the budget effectively in order to revive the economy. Besides, the newly passed Job Creation Law is expected to help improving investment climate through deregulation and de-bureaucratization to attract investors participation. Through this law, GoI is trying to push those many millions of informal enterprises and workers into the formal sector, thereby giving them some basic health and legal protection. With such an effort to improve investment and business climate, it becomes an essential step

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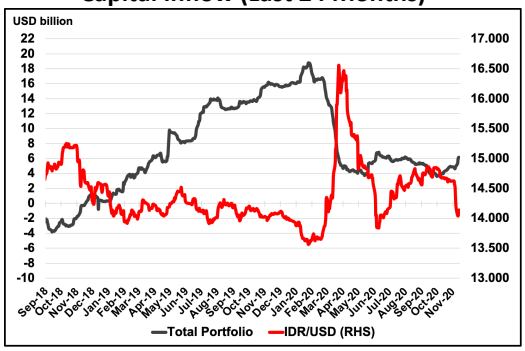
towards increasing investment, especially to accelerate economic recovery when the Covid-19 ends. All in all, GoI indeed needs to accelerate the implementation of stimulus packages, in particular to prevent those who have lost their jobs from falling into poverty and to save businesses that are at the brink of bankruptcy, while continuing several containment and mitigation measures of the Covid-19 pandemic in order for the economy to fully rebound from its dismal growth in 2020.

The Silver-Lining from the US Presidential Election

On the external conditions, numeros advanced and emerging countries fell into recession as they experienced a consecutive quarterly negative growth in Q3-2020; albeit at a slower pace than the previous quarter, indicating signs of a trajectory towards recovery phase. A glimpse of optimistic outlook regarding global growth is supported by projection from IMF that revised the global growth by 50 bps from -4.9% to -4.4% for this year, slightly less severe relative to their June forecast though still in deep recession. However, the prospect for economic recovery to shift back to the pre-pandemic level of growth trajectory highly depends on the measures to contain the pandemic. In the absence of inflationary pressures along with the weakening aggregate demand and economic activity, several major central banks have appropriately eased its monetary stance to support and fasten the recovery amidst such long and uncertain conditions.

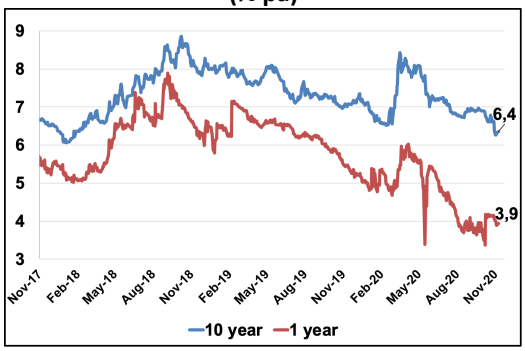
BI has cut its policy rate four times this year by a total of 100bps with the latest cut was in July. Ever since then, BI appears to remain comfortable with the current rate level and focus more on quantitative easing measures. Prolonged market uncertainty during the health crisis combined with several concerns over BI's independence had pressured Rupiah over the last four months, but the currency has surprisingly rebounded sharply since the US presidential election took place in early November. The drop in US bond yields led investors to move their assets into emerging markets including Indonesia with its relatively high-yields. As a result, Rupiah has strengthened from IDR14.830 in early October to around IDR14.000 as of 16 November, driven by a high surge of capital inflows of around USD2.4 billion, an increase from USD3.72 billion in early October to USD6.16 billion in mid-November. The recent massive inflows turned positive sentiment towards Rupiah. When comparing the depreciation rate with the other Asian peers, Rupiah becomes the top performers as it has been appreciated to around 4.19% in a month. On the other hand, massive capital inflow this month is fully reflected in the decline in both the 10-Year and 1-Year government bond yields from 6.9% and 4.1% in the mid-October to 6.4% and 3.9%, respectively.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

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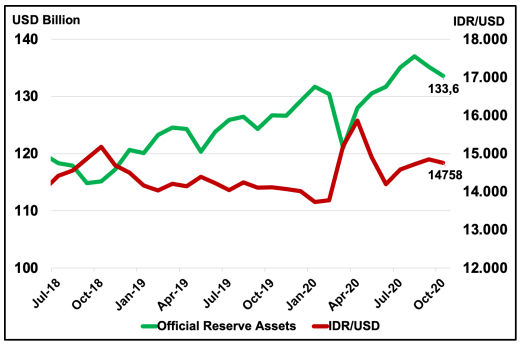
As Rupiah experienced rapid volatility in the last couple of months, BI lowered its reserves as a second line of defence towards market intervention to stabilize the exchange rate. Since the highest reserves in history recorded at USD137 billion in August, the foreign exchange reserves have continued to decrease to USD133.6 billion in October, slightly lower than the previous month at USD135 billion. Though decreasing, the current reserves are relatively ample and capable to strengthen external sector resilience and preserve macroeconomic and financial system stability. Furthermore, to ensure adequate liquidity in the market, BI continues undertaking quantitative easing measures and other macroprudential policy tools, through purchasing government securities in the primary market and stepping up intervention in the spot and DNDF markets. BI has bought IDR322.35 trillion worth of government bonds so far in the primary market this year as part of what is called a burden-sharing program to help finance government spending in order to support economic recovery.

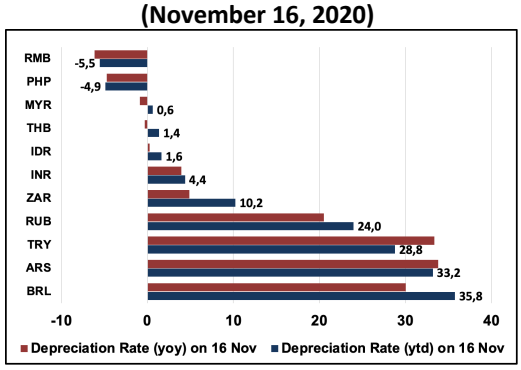
Overall, domestically, we see that low inflation trend is putting the overall year's inflation figure at the brink of falling out of BI's target range, signalling a prolonged weak of aggregate demand. Low credit growth might also hamper the economy to fully rebound in the last quarter; hence any decrease in the policy rate will encourage banks to reduce their interest expense, thereby eased lending rate and pumped liquidity into the financial market. Externally, a larger-than-expected October trade surplus of USD3.61 billion suggesting an improvement in CAD figure will continue. Moreover, the continuing portfolio capital inflows supported by the uncertain condition in the US during the presidential election and the attractiveness of Indonesia's real yields have been driving Rupiah to appreciate. Since Rupiah has been too appreciated, therefore, any cut in the BI rate now will be less risky in order to stabilize Rupiah. With the recent macro indicators discussed above, we view that BI have room to cut its policy rates by 25bps to 3.75% this month to support the economic recovery agenda in the remaining of 2020 while keeping an eye on the external pressures and maintaining financial sector stability.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

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



Source: Investing.com