BI Board of Governor Meeting

December 2020

Highlights

- BI should keep its policy rate at 3.75% this month.
- The potential stricter restrictions to maintain the virus spread will hold back any efforts in boosting economic recovery at anytime soon, while weighting more pressure on Rupiah stabilization.
- While purchasing power still below its normal level, there is a growing sign of improvement in purchasing power and economic activity compared to the previous months.

Macroeconomic & Financial Sector Policy Research

Jahen F. Rezki, Ph.D.
jahen@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

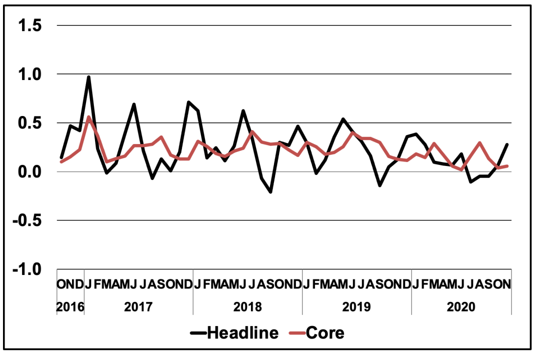
Meila Husna
meila.husna@lpem-feui.org

Bank Indonesia's rate cut last month to 3.75% as the effort of boosting economic recovery has not reflected in Rupiah depreciation, thanks to investor's confidence in the domestic market. Rupiah has been relatively manageable amidst the prolonged uncertain condition of the pandemic. However, there is still no sign of improvement in aggregate demand in the short term, as the higher inflation last month was mainly driven by the higher prices due to the lack of food supply during the rainy season. Despite the sign of recovery from the higher global demand as reflected by the higher-than-expected Indonesia's exports in November, the potential robust recovery is still uncertain as we have to see the future condition of the health issues and the effectiveness of the vaccines soon. However, the potential stricter restrictions due to the worsening pandemic all over the world since early December should be weighted on the future policy decision held by the government as well as BI. If the full shutdown happens as the efforts to reduce the potential hike in the number of virus cases during the end-year holiday, the consumer will hold back their spending, thus, aggregate demand will be muted. Further, the investor will see this movement as the bleaker outlook of economic recovery and they will hold back of flight back their assets into the haven market. Considering the prolonged uncertain condition of the health crisis and potential stricter restrictions soon, any monetary easing by cutting the policy rate will be too costly and risky for Rupiah stabilization. For now, we see that BI needs to hold its policy rate at 3.75% this month while maintaining the financial sector stability.

Slightly Higher Inflation, Prolonged Weakened Purchasing Power

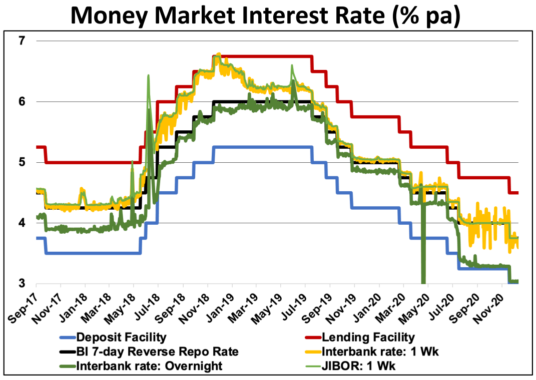
While the number of positive Covid-19 cases continue to hit the daily records, the inflationary pressures are showing a gradual increase recently. The annual headline inflation accelerated for the third consecutive month in November to 1.59% (y.o.y) compared to 1.44% (y.o.y) in October. On monthly basis, the inflation also significantly picked up to 0.28% (mtm) from the figure in the same period last year at 0.13% (mtm). Traditionally, the trend of prices in the two latest months of the year always records higher inflation due to rising consumption ahead of the Christmas and New Year celebrations. However, the jump in headline inflation in November of this year is remarkable as the pressure of the economic downturn has persistently weakened consumer demand since the beginning of the pandemic. Regardless of the sign of improvement in the inflation figure, the annual inflation is still below the BI's target range of 2%-4% (y.o.y).

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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



Source: CEIC

On the other hand, the increase in November headline inflation is not followed by a similar trend in core inflation which continues to show a declining trend. The annual and monthly core inflation

Key Figures

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  3.75%
- GDP Growth (y.o.y, Q3 '20)
  -3.49%
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  1.59%
- Core Inflation (y.o.y, Nov '20)
  1.67%
- Inflation (m.t.m, Nov '20)
  0.28%
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decelerated to 1.67% (y.o.y) and 0.06% (mtm) compared to 1.74% (y.o.y) in the previous month and 0.12% (mtm) in the same month last year. It explains that the better November headline inflation is not associated with better purchasing power, but it might be the result of the higher commodity prices and lower supply of volatile food products due to the rainy season in the past six weeks. Despite the persistent uncertainty of economic condition due to the Covid-19, we estimate that the inflation in December will be higher, thus, the overall inflation for FY2020 will be slightly below the lower-end of BI's target range of 2% (y.o.y).

The Slightly Better Global Demand Brought Higher-than-Expected Exports

The persistent trend of subdued core inflation can be supported by the fact of slowed economic activity induced by the continuation of pandemic measurement in several regions in Indonesia. Businesses are still reluctant to scale up production capacity to a normal level as most consumers held back their consumption. On the other hand, the global aggregate demand is gradually showing a sign of improvement as the world export is increasing. In Indonesia, the improvement of global demand is slightly reflected by the seventh monthly trade balance surplus of US$2.6 billion in November. Even though the magnitude of the surplus is lower than the October surplus of US$3.61 billion, the November surplus shows a better sign of economic activity as the surplus was not only driven by the sluggish imports due to the weak demand but also as a result of export acceleration, which is picked up by 9.54% (y.o.y) compared to its value on the same period last year. Looking in details, while imports declined sharply compared to the same figure of last year (-17.46%, yoy), the sign of stronger production pulse is apparent as the import in November 2020 is higher 17.40% (mtm) compared to the previous month, mostly driven by machinery and electrical equipment which grew up to 23.82% (mtm) during November. Furthermore, the annual growth of export is remarked as the highest figure since February this year, particularly it is higher than the 3.29% (y.o.y) drop in October export.

The higher-than-expected exports in November, however, were mainly driven by the higher prices of commodity prices other than oil and gas which is growing by 18.95% (y.o.y) compared to the aggregate prices of non-oil and gas products in the same period last year. On the other hand, the value of oil and gas exports significantly decreased by 26.27% (y.o.y) due to the trend of the lower price of crude oil. However, this figure is insignificant in driving the total exports as it is only contributed 5% of total exports. The effect of lower crude oil price is more significant on the imports figure as the oil and gas imports contribute to 10% of total Indonesia's imports. Moreover, we see that the trade surplus will be gradually narrowed due to the potential higher imports as the distribution of the Covid-19 vaccines is going to boost consumer confidence drastically, thus, improve economic activity. However, the potential robust recovery is still uncertain as we have to see the effectiveness of the vaccines, particularly related to the vaccines distribution plan, pricing scheme, availability, accessibility, as well as affordability for all people in every socio-economic class. Thus, it is crucial to weight the impact of vaccine arrival on the economic recovery. While vaccines might reduce the spread of virus immediately and could have a rather positive impact on the economic jumpstart, vaccines are not "magic bullets". There are numerous aspects that comes to play in catalyzing the economic recovery and the arrival of vaccines alone would most certainly not going to recover the economy instantly as there are distribution and implementation issues, among others.

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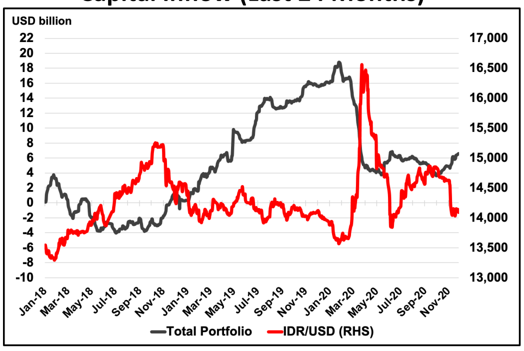
Improvement in Health Issues is The Key to the Better Economic Condition

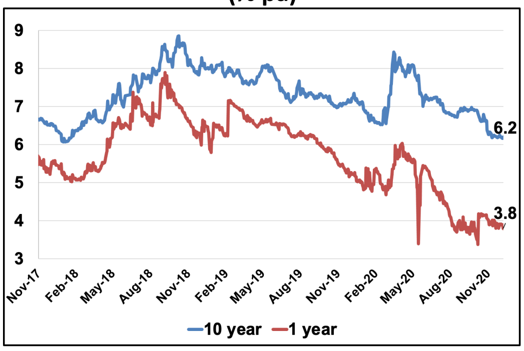
After experiencing a surprise robust appreciation from around IDR14,600 to IDR14,000 per US dollar in November due to the massive capital inflows, Rupiah is relatively manageable at around IDR14,100 on the second week of December. Despite the persistent increasing cases of confirmed Covid-19 patients in Indonesia, the first deliveries of the vaccines have brought positive shocks to market sentiment. The value of the Rupiah is even steady after BI cut its policy rate by 25bps to 3.75% last month. It might be explained by the persistent trend of lower US bond yields which has initiated investors to keep their assets in emerging markets. The steady market is in line with the relatively unchanged 10-Year and 1-Year government bond yields from 6.4% and 3.9% in mid-November to 6.2% and 3.8% in mid-December, respectively. However, the slightly narrowed yield spread of long-term (10-Year) and short-term (1-Year) of Indonesia's government bond is suggesting the shift in portfolio investment towards long-term assets as the investor's confidence improves.

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 robust capital inflows throughout November, BI's foreign exchange reserves have not picked up as it stood at IDR133.6 billion at the end of the month, relatively the same compared to its figure last month of IDR133.7 billion. The movement shows an unusual pattern as traditionally the capital inflows will help BI to accumulate its foreign exchange reserves. The unchanged reserves amid the robust capital inflows might represent the utilization of BI's reserves to buy the government's bond in the primary market as part of burden-sharing between BI and government to accelerate the economic recovery. As of November 17th, BI announced that they have brought IDR72.5 trillion government bonds into the primary market. Despite its steady figure, the current foreign exchange reserves are relatively ample to equip BI with enough liquidity to support Rupiah's stabilization in the case of potential shocks in the future.

Further, the future outlook for the financial sector as well as the real sector is highly dependent on the ongoing pandemic situation. If the government can implement the vaccine implementation and distribution effectively, the economic recovery will be happening soon. However, most of the government all over the world is currently grappling with rising Covid-19 cases and deaths. Some countries, such as the US, UK, and some EU countries, decided to re-implement the strictly physical and social restrictions due to the worsening pandemic cases since the early-December. A similar movement is followed by the Government of Indonesia (GoI), which is recently imposed stricter rules applied for people mobility to holiday destinations during the end-year holiday period. Some regions are also expected to reimpose the large-scale social

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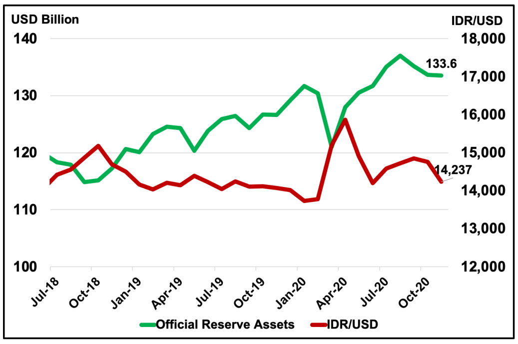
restrictions (PSBB) in the near future as an effort in reducing the potential wider spread of the virus during the Christmas and New Year celebrations.

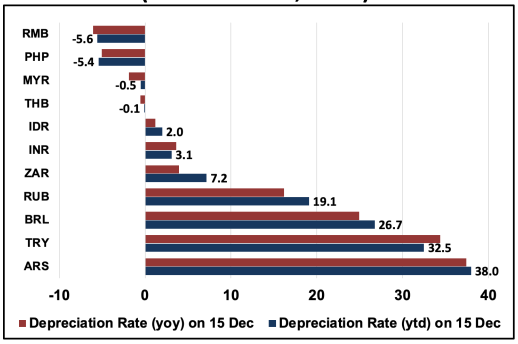
The pressure from the worsened pandemic condition and the potential stricter restrictions have been bringing down investor's confidence as reflected by the slight outflows from Indonesia's accumulated portfolio from US$6.6 billion at the end of November to US$6.1 billion on December 14th. This movement brings negative shocks to Rupiah with the slight depreciation to IDR14,100 from IDR14,000. However, the overall performance of Rupiah at least until the mid-December is relatively worse than the other Asian peers as the year-to-date depreciation of Rupiah reached 2.0% (ytd) compared to the appreciation rate in Philippine Peso, Malaysian Ringgit, and Thailand Bath, at -5.45% (ytd), -0.5% (ytd) and -0.1% (ytd) respectively.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

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



Source: Investing.com

Rupiah has been relatively manageable in the past six weeks amidst the prolonged uncertain condition of the pandemic. However, the potential stricter restrictions due to the worsening pandemic all over the world since early December should be weighted on the future policy decision held by the government as well as BI. If the full shutdown happens as the efforts to reduce the potential hike in the number of cases during the end-year holiday, the investor will see this movement as the sign of slower economic recovery, thus, they will hold back or flight back their assets to safe-haven countries. Further, if GoI also reimposes the PSBB, the improvement in aggregate demand will not happen at anytime soon in the future. When people have limited space to spend their activity outside the house, they will hold back their spending. Thus, the business will step back again their efforts to boost the production since the demand is muted. The condition will persist until the consumer feel secure to perform their normal activities and business start to recover their production. The length of this uncertain situation will depend solely on the time needed to solve these health issues.

Considering the current condition of the health problem, macroeconomic indicators, and external conditions, we see that another policy rate cut will be risky and might put financial stability at risk, while would not help much on boosting recovery. While the latest development is somewhat showing a better prospect of recovery in the near future, supported by the continuing upward inflation, a better trade figure, and arrival of vaccines, policy rate as an instrument to spur economic activity needs to be executed in a timely manner to achieve the optimal efficacy. Accordingly, while policy rate cut would be needed to accelerate the recovery, we still consider now is too soon for another policy rate cut. Thus, we see that BI needs to hold its policy rate at 3.75% this month while maintaining the financial sector stability.