Key Figures

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  1.68%
- Core Inflation (2020)
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  2.0 - 2.2%
- Consumption Growth (Q3 '20)
  -4.04%
- % Current Account of GDP (Q3 '20)
  0.36%

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**) Forecast*

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Pandemic Slows down Everything and Optimism Ahead in 2021

Summary

Throughout 2020, we observe an overall shallow inflation landscape, as made apparent by its inflation rate being the lowest in many years before (1.68%). The most important contributor to such a decrease in inflation is the administered inflation, for which we have observed a decrease of 0.26 bps from last year. The core inflation rate also contributes to an even more significant decrease at 1.6 bps lower than the preceding year.

We view the low-inflation phenomenon as more of a demand-side phenomenon due to the impact of the COVID-19 pandemic that affected consumption growth and the inflation rate. Regarding the inflation rate, the transportation sector is the worst impacted sector by the pandemic. It recorded deflation by December 2020. The ultimate factor that can be associated with the deflation is low people mobility during the pandemic period. Moreover, there were some travel restrictions that the government applied to push down the spread of the virus. The other sectors were also impacted by the pandemic but not as severe as the transportation sector. Demand from people towards goods and services were very drowned as they faced dangerous health risks to go outside and income reduction due to business' low performance during the pandemic. Therefore, it is a definite consequence as people have fewer resources, and facing greater uncertainties will reduce their demand for goods and services and bulk saving. Figure 5 shows a decrease in consumption growth significantly.

Table 1: Inflation Forecast (LPEM FEB UI)

2019		2020 Forecast	
Headline	Core	Headline	Core
1.68%	1.60%	2.2-2.5%	2.0-2.2%

Second, we see a downward movement of the exchange rate to the lowest point in March 2020 due to the pressure on the financial market when the government announced the COVID-19 case in Indonesia. Depreciation has not increased domestic prices, but there has been a decline in imports due to weakening domestic demand. Third, the decline also occurred in the price of the Brent crude oil price, as the pandemic disrupts global demand for crude oil and the rising tensions between Saudi Arabia and Russia. Despite the low oil prices, domestic demand is already low, reflected by the low inflation rate.

We expect inflation to grow moderately at 2.2% to 2.5% in the upcoming year despite economic uncertainty during the pandemic. This expectation is based on some optimism ahead in 2021, the arrival of vaccines, direct stimulus from the government, and higher people mobility. In the exchange rate context, we estimate a manageable currency as the current exchange rate may undervalue. The ratification of the Job Creation Omnibus Law may increase the attractiveness of domestic financial assets. Lastly, we argue that global crude oil demand will start to rebound as the COVID-19 vaccine becomes widely available soon; hence, the Brent crude oil prices will start to bounce back in 2021.

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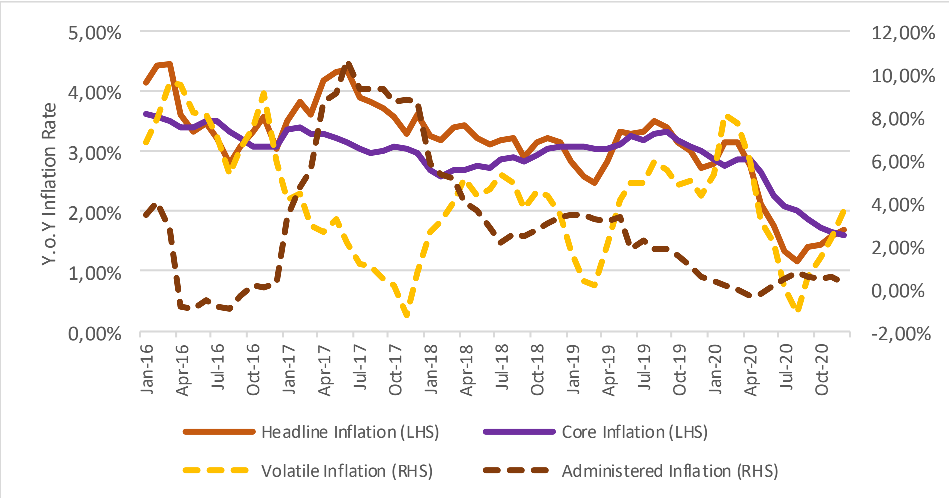
Very Low Inflation Rate, a Slowdown due to COVID-19 Pandemic

Overall, the year 2020 relatively saw a significant downward trend in the headline inflation rate, reaching its lowest level in 5 years span that we observe. Such the lowest trend has largely been contributed by the meager percentage all year long in the administered inflation rate. The administered inflation rate is, by April 2020, at its lowest peak since April 2016 – sinking to -0.39% and only 0.25% by December 2020 (Figure 1). Besides, volatile inflation is more volatile in 2020 compared to previous years. Such a phenomenon should be of the government's concern as supply might be disturbed by low prices and limited access to inputs, not to mention access to working capital.

The volatile inflation was at the peak in March and then dropped to a negative rate once in August 2020 at -1.16%, its lowest since November 2017. Core inflation rate in 2020 also hitting its lowest in 5 years span - arguably the lowest in more than 20 years too, contributing to a shallow headline inflation rate at 1.68% by December 2020.

We argue that this shallow inflation rate is due to the massive impact of the COVID-19 pandemic. The low demand had pushed prices even lower than the government's administered price, which acted as the upper bound price. At some point in 2020, people cannot even travel using public transportation and need to stay at home and work from home for a long time. This low mobility level caused very minimal demand for some administered goods such as gasoline and transportation tickets. The demand for overall consumed goods also dropped badly, resulting in a low inflation rate for 2020.

Figure 1: Inflation Rate (Headline, Core, Volatile, Administered Goods), 2016-2020.



Source: CEIC

We then break down the inflation rate by consumption types (Figure 2). We see that throughout 2020, inflation rates have been low for most types of goods. By December 2020, there is no type of goods recorded at more than a 4% year-on-year inflation rate. Some types of goods even recorded deflation during 2020, and they are Communication and Finance, Transportation and Energy. On the other side, Food and Processed food, beverages, and tobacco recorded the highest inflation rate in 2020. However, this rate is still low relative to previous years.

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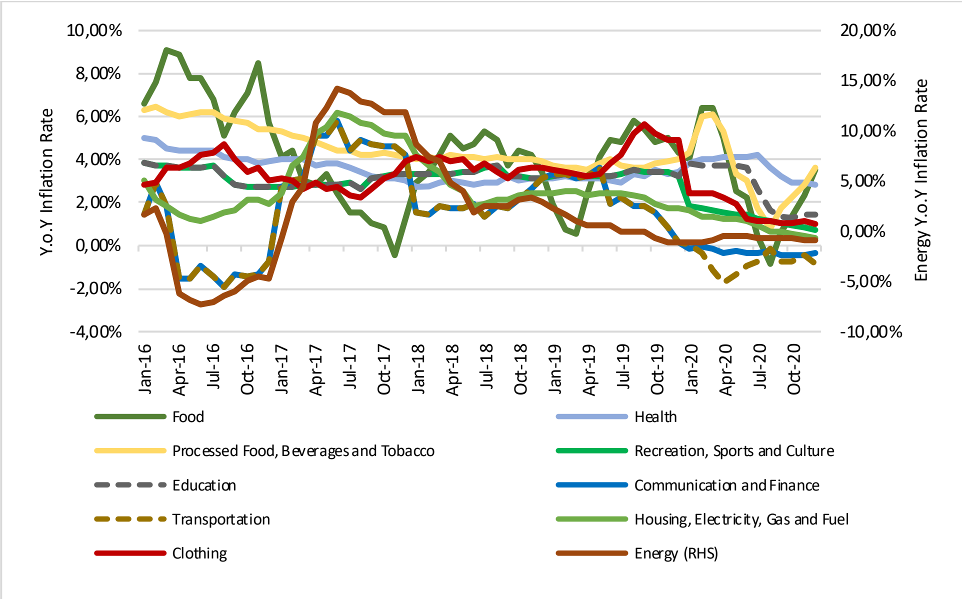
After analyzing the inflation rate by goods, we found that the COVID-19 pandemic's impact seemed less apparent for some related pandemic consumption. For goods such as food and health, the impact is not too severe. People still regularly consumed such goods. Nevertheless, the overall impact of the pandemic is unfavorable to the inflation rate. However, the severity is varied across the goods category. The transportation sector experienced the most severe pandemic impact, which recorded deflation all year long. Communication and Energy also recorded deflation in 2020.

Figure 2: Inflation Rate by Consumption Type, 2016-2020 (y.o.y).



Source: CEIC

Exchange rate and inflation experienced a somewhat fluctuation throughout 2020 compared to the previous four years (Figure 3). Indonesia's exchange rate depreciated to its lowest level at the end of March 2020 by 18.21% relative to January 2016, when the government announced the first case of COVID-19. Foreign investors tend to shift their money to safe-haven assets amid economic turmoil, making the country vulnerable to capital outflows. However, the decline in the currency value was temporary, so it did not affect the increase in domestic prices due to the increase in input prices. Even so, Indonesia recorded a decline in imports deeper than exports, making a significant surplus in July 2020. The surplus resulted from weaker domestic demand, which reflected the shrinking of the inflation rate to the lowest level for the past five years.

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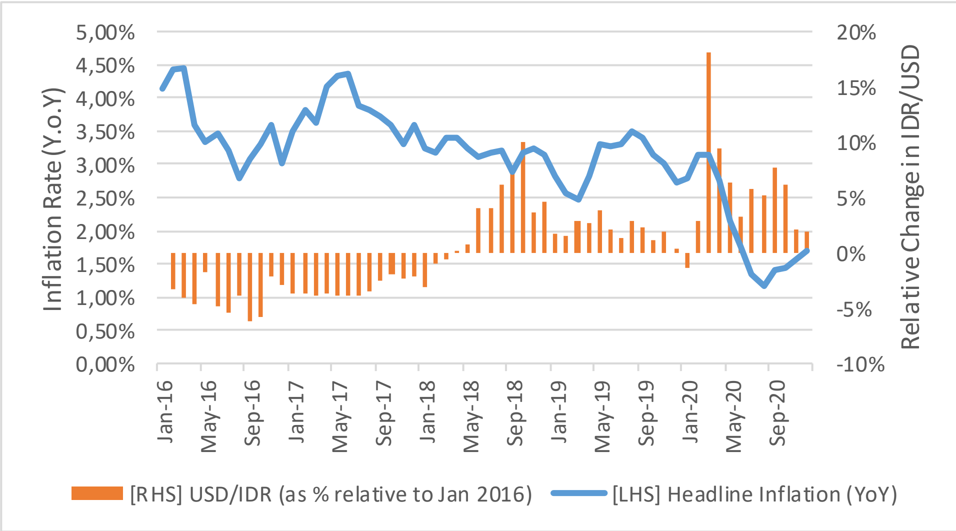
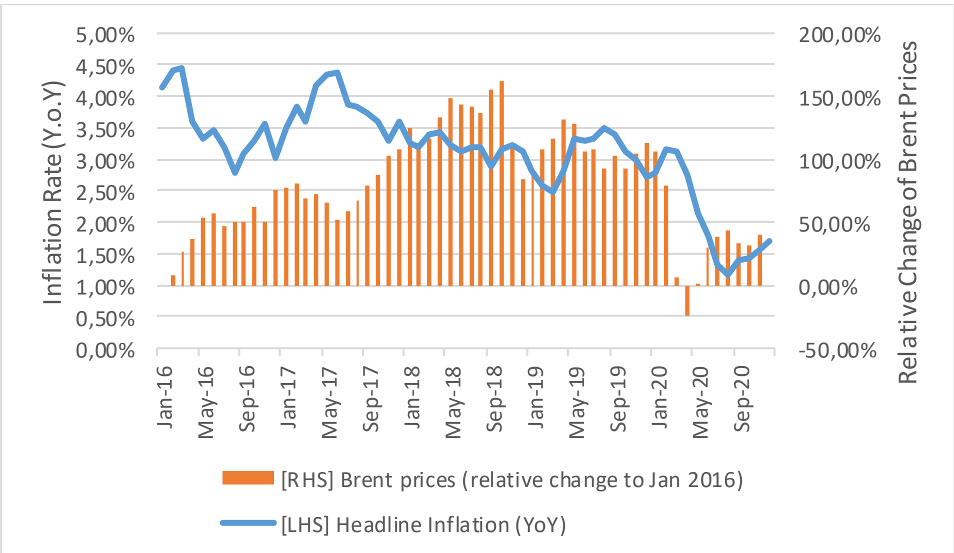
Figure 3: Inflation Rate and Relative Change in USD/IDR, 2016-2020



Source: CEIC

COVID-19 has a devastating impact on international trade. The oil price has drastically fallen and reached its lowest level in April 2020 by 24.23% relative to January 2016, accompanied by a low level of domestic inflation (Figure 4). Brent crude oil prices declined due to the price war between Saudi Arabia and Russia and sluggish global demand for oil. Many governments restrict travel and closed business to slow down COVID-19 virus transmission. As Indonesia has become a net importer of crude oil in recent years, the decline in oil prices may ease the government import burden. However, the circumstance has been complicated since the COVID-19 pandemic. Despite the low oil prices, domestic demand is already low, reflected by the low inflation rate. To that end, the government has decided to extend the oil subsidy as a cushion for Indonesia's low-income families. Oil price starts to bounce back in June 2020 with a mild inflation rate.

Figure 4: Inflation Rate and Relative Change in Oil Price (Brent), 2016-2020



Source: CEIC

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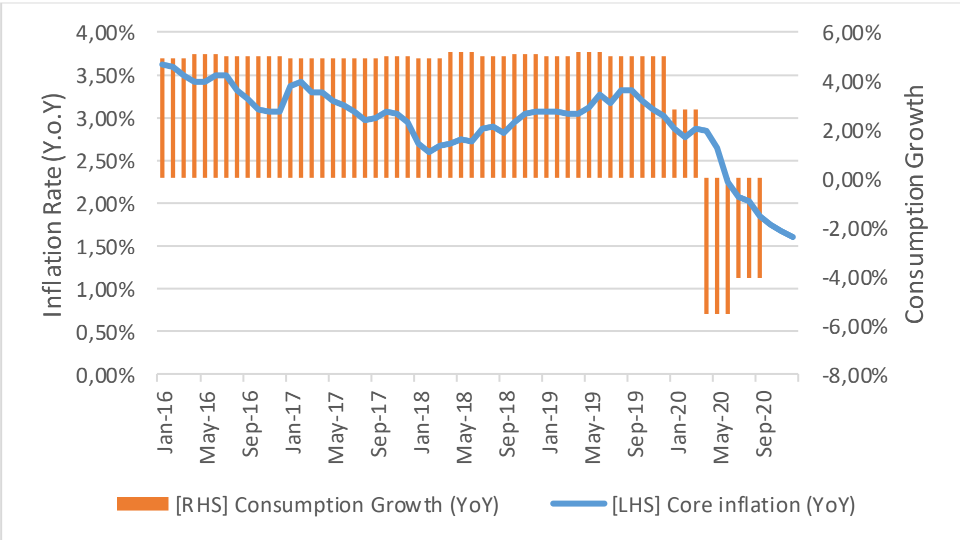
People's purchasing power is under pressure as the COVID-19 outbreak happened in 2020, pushing the lowest annual inflation rate in the last five years. Figure 5 shows that consumption growth was recorded stable in the 2016 -2019 period, yet it experienced a great shock in 2020 as the pandemic weakens consumer demand. Consumption growth began to experience a significant decline in Q1 2020, with a growth of 2.85% compared to the previous year in the same quarter. The decline in consumption growth continued in Q2 and Q3 2020 until it contracted by 5.52% and 4.04%, respectively. The decline also goes hand in hand and accelerate s the decline of core inflation during 2020.

Figure 5: Core Inflation Rate and Consumption Growth, 2016-2020



Source: CEIC

Economic Recovery, mild inflation rates that may average 2.2% to 2.5%

In 2021, we estimate the inflation to grow moderately at 2.2% to 2.5%, with core inflation expected to be around 2.0% to 2.2%. This expectation is based on some optimism ahead in 2021, the arrival of vaccines, direct stimulus from the government, and higher people mobility. However, the process of pandemic mitigation and economic recovery is a mountain to climb. It may take several years for our country to complete vaccinating people. It is also important to remember that we are still dealing with a huge wave of the pandemic. At the beginning of 2021, some local governments even tightened PSBB to press the positive case of COVID-19. It may cause a still slowing down inflation rate at the start of the year. However, 2021 still possesses many uncertainties. The dynamics of inflation is still questionable and might be barely predicted globally and locally.

Despite a global economic uncertainty due to the COVID-19 outbreak and a high vulnerability to capital outflows, we expect a manageable Indonesia's currency to range between Rp 14.000 – Rp 15.000 per USD. The current exchange rate may undervalue so that it will stabilize and strengthen. Low and manageable inflation is also supporting the central banks of Indonesia to keep a stable exchange rate. Furthermore, the ratification of the Job Creation Omnibus Law will affect the Rupiah's movement in 2021. Through this law, the government will streamline and accelerate business and investment licensing to increase the attractiveness of domestic financial assets.

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Going forward, the availability of the COVID-19 vaccine is a game-changer in determining the Brent crude oil prices. We forecast that global crude oil demand will start to rebound, and crude oil prices will increase to be $ 53 per barrel this year. This optimism emerged due to signs of improving demand for oil prices in China in Q4 2020, which was higher than in the same quarter in 2019. As the COVID-19 vaccine becomes widely available soon, we will also see an improvement in domestic oil demand.

Lastly, we expect a relatively mild consumption growth this year after shrinking in 2020 during the pandemic, by an average of 1.5 to 2.5%. Earlier this year, the government re-imposed large-scale social restrictions in Java-Bali by regulating the capacity and operating hours of public transportation, closing public facilities and socio-cultural activities, and other facilities arrangements that must follow health protocols. Given the current pandemic condition and the government's restriction to hold the COVID-19 virus transmission, it is challenging to return the consumption growth to pre-pandemic levels. However, the major challenge is how the government maintains food security from the supply side. During the pandemic, to rely on the international market would be deemed too risky as many countries have the same interest in their food security. The government tried to speed up its stimulus to generate economic activity and rebound consumption growth.