Macroeconomic Analysis Series

LPEM FEB UI
UNIVERSITAS INDONESIA

BI Board of Governor Meeting

February 2021

Highlights

- BI should cut its policy rate by 25bps this month.
- Low inflation persists signalling aggregate demand remains muted.
- Attractiveness of Indonesia's real yields, trade balance surpluses, and substantial forex reserves have been strengthening Rupiah as capital inflow continues.

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

Indonesia's economic growth contracted by -2.07% in 2020, plunged into its first recession in two decades since the 1998 Asian financial crisis. Despite continuing a recession since Q3, economic growth was relatively better than -3.5% (y.o.y) of the global growth and was slowly recovered in Q4-2020 which was recorded at -2.19% (y.o.y). Although the impact of Covid-19 crisis is still lingering, Indonesia's economic growth is expected to gradually rebound this year on the back of massive policy support to boost households and businesses' confidence and provide adequate social assistance as well as vaccine roll out to dampen the infection rate. Inflation remains well below target and is not expected to accelerate sharply in the near term as demand remains muted on the effects of the Covid-19 pandemic that ravaged the economy and battered people's purchasing power. Surprisingly, on the other hand, the external conditions show a glimmer of hope with the continuing surge of portfolio inflows, favorable monthly trade surplus, and high foreign exchange reserves that helped to strengthen Rupiah stability. All in all, considering the current domestic and external situations, we see that now is the perfect momentum for BI to implement another policy rate cut by 25bps to 3.50% this month to support the economic recovery agenda while maintaining the financial sector stability.

Subdued Price Pressures in Early 2021

Inflation remains below BI's target range for eight consecutive months and is not expected to accelerate sharply in the near term given the challenging economic outlook. Entering 2021, we do not see any signs of improvement in inflation since January annual inflation rate was recorded at 1.55% (y.o.y), decreasing from 1.68% (y.o.y) in the previous month as demand remained muted on the effects of the Covid-19 pandemic that ravaged the economy and battered people's purchasing power. Likewise, on a monthly basis, the headline inflation rate in January stood at 0.26% (mtm), significantly lower than the same period last year which was recorded at 0.38% (mtm). The latest figure of low inflation rate was influenced by milder inflationary pressures on volatile foods and core inflation as well as deflation in administered prices.

As a major driver of inflation in Indonesia, volatile foods components recorded annual inflation of 2.82% (y.o.y), decelerating from 3.62% (y.o.y) in December last year. Similarly, its monthly rate also experienced a low inflation figure of 1.15% (mtm), lower than 1.94% (mtm) in January 2020 affected by price corrections in eggs and shallots. Overall, a trend of food price inflation has fallen amid ultra-weak aggregate demand and strong harvest despite global supply chain disruptions. Furthermore,

Key Figures

BI Repo Rate (7-day, Jan '21)
3.75%

GDP Growth (y.o.y, Q4 '20)
-2.19%

Inflation (y.o.y, Jan '21)
1.55%

Core Inflation (y.o.y, Jan '21)
1.56%

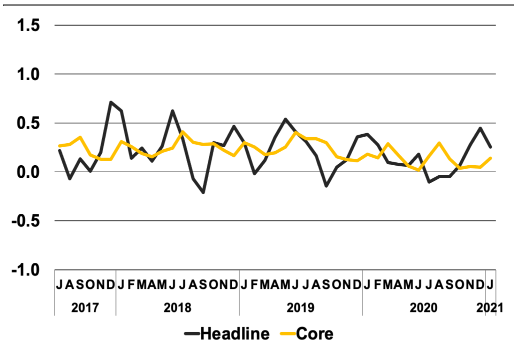
Inflation (m.t.m, Jan '21)
0.26%

Core Inflation (m.t.m, Jan '21)
0.14%

FX Reserve (Jan '21)
USD138.0 billion

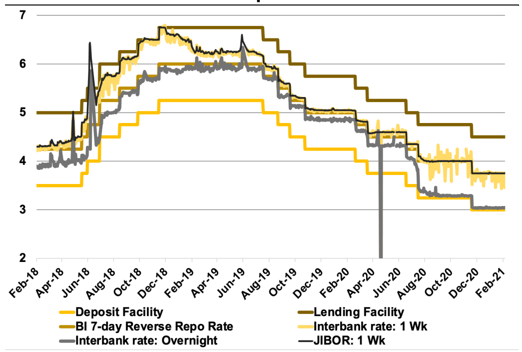
the monthly inflation rate of administered prices recorded a deflation at 0.19% (mtm), albeit slightly better than deflation of 0.28% in January last year. Deeper deflation in administered prices is relatively normal at the beginning of the year due to normalisation of transportation fares, notably airfares after the year-end festive period.

Figure 1: inflation Rate



Source: CEIC

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



Source: CEIC

On the other hand, core inflation continues its downward trend to 1.56% (y.o.y) and 0.14 (mtm) compared to 1.60% (y.o.y) in the previous month and 0.18% (mtm) in the same month last year. Muted core inflation came in-line with slowed economic activity after a spate of natural calamities while a spike in Covid-19 infections forced GoI to reinstate partial lockdown measures in both Java and Bali to contain the virus spread. With the still below-target inflation in recent months, we suggest BI continue to maintain an accommodative monetary stance to bolster the recovery efforts.

Signs of Economic Improvement amidst the Prolonged Pandemic

Indonesia's economic growth contracted by -2.07% in 2020, plunged into its first recession in two decades since the 1998 Asian financial crisis. Despite continuing a recession since Q3, economic growth was relatively better than -3.5% (y.o.y) the global growth and was slowly recovered in Q4-2020 which was recorded at -2.19% (y.o.y), improving from Q3-2020 of -3.49% (y.o.y), thanks to the government stimulus and gradual re-opening of the domestic and global economy. Such improvement can be seen in almost all components of domestic demand and business activities. The pace of household contraction slowed to -3.61% (y.o.y) from -4.05% (y.o.y) in the previous quarter, making the overall growth for household consumption contracted by -2.63% (y.o.y) in line with improvements in people's mobility and an increase in public spending. Similarly, a slight recovery was also seen in investment from -6.48% (y.o.y) growth in the previous quarter to -6.15% (y.o,y) in Q4-2020, making the overall growth for 2020 of -4.95% (y.o.y). Government consumption grew

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positively in 2020 at 1.94% (y.o.y) aided by the realization of stimulus, especially in the form of social assistance, health, and support for businesses as well as Transfers to Regions and Village Funds (TKDD). Likewise, net exports recorded positive on the back of improved exports in line with improving economic activities in several export destination countries amidst a significant fall in imports.

Although the impact of Covid-19 crisis is still lingering, Indonesia's economic growth is expected to gradually rebound this year on the back of massive policy support to boost households and businesses' confidence and provide adequate social assistance as well as vaccine roll out to dampen the infection rate. The timing now seems good for the newly established Indonesia's Sovereign Wealth Fund management institution or Lembaga Pengelola Investasi (LPI) to propel substantial foreign investment into Indonesia and to create more job opportunities with an overarching aim to bolster economic growth in the long-term. However, amidst looming uncertainties remain due to rising surge in Covid-19 cases, economic recovery might be constrained by the reimposing of mobility restrictions by the government and the possibility of slower-than-expected progress in the vaccine availability which would weaken consumer and business confidence and dampen economic activity longer than expected. To keep the wheels of economic activity turning, therefore, maintaining stimulus with wider coverage and better targeting to vulnerable households and firms as well as preparing an effective procurement and distribution of vaccines are the driving force and keys to a quick recovery.

Favorable External Situations

On the external side, Rupiah continues its appreciation trend since last year and stays roughly flat against US Dollar at around IDR13,900-IDR14,100 due to massive capital inflows. Compared to the depreciation rate in other emerging market peers, Rupiah is among the best performers as it has been appreciated to around 1% since the beginning of this year. Investors find it attractive to move their assets into Indonesia since it offers relatively higher returns than advanced economies. Relatively higher real yields because of low inflation amidst the persistent trend of lower US bond yields, thereby encouraging large interest rate differential and increasing the risk-taking behavior of foreign investors. A recent surge in the portfolio over this month drives 1-Year government bond yields to decrease from 4.5% in January to 4.0% while 10-Year government bond yields is relatively unchanged at 6.3%. Even though the distribution of Covid-19 vaccine will take some time, we believe a measured and well-planned vaccination program may bring more positive market sentiment towards Indonesia in the future.

Another pulling factor to support the strengthening of Rupiah is the continuation of the trade balance surplus. Improvement in the global demand is partially reflected by a trade balance surplus of USD1.95 billion in January, albeit slightly lower than

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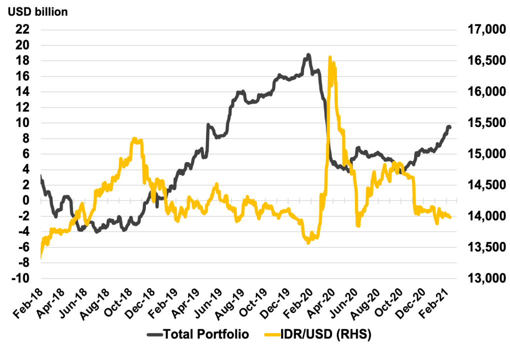
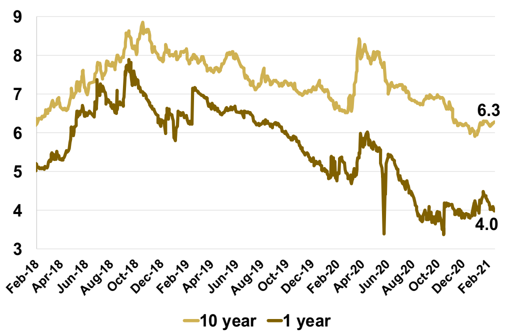
December surplus of USD2.09 billion. Trade figures in January showed that exports grew more than expected recorded at 12.2% while imports contracted again by -6.5% compared to its value in the same period last year. With exports posting strong gains while imports remain downbeat, the consecutive ninth monthly trade balance surpluses indicating that subdued demand for capital imports persists as businesses cannot operate at full capacity while the global aggregate demand is gradually showing an improvement.

Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 36 Months)



Source: CEIC

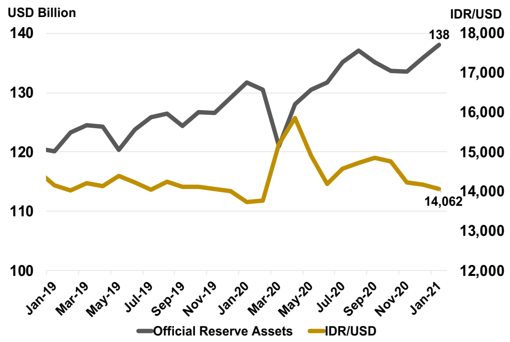
Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

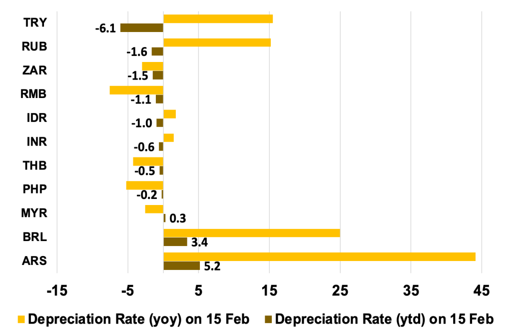
With more favorable external conditions, BI quickly has been benefitted from the robust capital inflows throughout this year through the increase in its foreign exchange reserves. This will come in handy in times BI needs to maintain external stability. In January, BI's foreign exchange reserves stood at USD138 billion, higher than USD135.9 billion at the end of 2020 and becomes the highest reserves in history. The current foreign exchange reserves suggests a sufficient amount of liquidity to equip BI in supporting Rupiah's stabilization in the case of potential shocks in the future.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (February 15, 2021)



Source: Investing.com

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2020 marked as the toughest year in history for all of us. The impact of the pandemic really hit the economy as GDP posted negative growth in 2020 for the first time in more than two decades. The policymakers have disbursed necessary amount of fiscal and monetary stimulus to help the economy weather the severe impact brought by the Covid-19 pandemic. Entering 2021, Indonesia seems to be on the right path of recovery despite the uncertainties remain. The continuation of low inflation signaling aggregate demand remains muted. Such condition provides room for BI to drive down interest rates further to stimulate demand and to stabilize prices and prevent them from falling further. Surprisingly, on the other hand, the external conditions show a glimmer of hope with the continuing surge of portfolio inflows, favorable monthly trade surplus, and substantial foreign exchange reserves that helped to strengthen Rupiah stability. All in all, considering the current domestic and external situations, we see that now is the perfect momentum for BI to implement another policy rate cut in order to accelerate economic recovery in the first semester of this year. Although the impact and effectiveness of the policy might not be optimum as long as the pandemic is not over, we believe the option to further cut the policy rate is better than to hold in the hope that it can kick-start economic activity faster instead of facing a delay in economic recovery. Thus, we see that BI needs to cut its policy rate by 25 bps to 3.50% this month to support the economic recovery agenda while maintaining the financial sector stability.