Macroeconomic Analysis Series

BI Board of Governor Meeting

May 2021

Highlights

- BI should hold its policy rate steady at 3.50% this month.
- Despite the prolonged pandemic, inflation in April is higher than the previous two months, recorded at 1.42% (y.o.y).
- Despite the increasing signs of economic recovery, the risk from health and external situations are still a potential threat to the current progress.

Macroeconomics & Political Economy Policy Research

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Various latest development are in the favor of economic recovery narratives. The rollout of vaccines, massive government stimulus, and gradual opening of economic activity contributes to the observed jumpstart of domestic economy. Regardless, the health risk of Covid-19 is still lingering. Reflected by the inflation figure, the relaxation of social restriction measures and Ramadan season has not yet put the aggregate demand expansion in full-throttle. On the external side, despite the inflows exuberance in early May of 2021 which was driven by positive sentiment towards domestic prospect, the episode of capital inflows is rather transient. Various issues, ranging from the potential lockdown implementation in several countries to the possibility of earlier-than-expected tapering off by the Fed following the US domestic improvement and risk of inflation, triggers capital flows reversal. With a rather volatile external pressure and the need to maintain financial and exchange rate stability, we are in a view of BI needs to hold its policy rate steady at 3.50%.

Mild Impact of Ramadan in Inflation Figure

April 2021 was an eventful month in Indonesia as the event of Ramadan period took place. Ramadan period is usually attributed to its festivities, where people spend their money to buy new clothes, foods, and merchandise as gifts to relatives. With the tendency of a period where household spending is at the highest level in a year, the Ramadan effect puts upward pressure on the April inflation figure. However, the below-normal purchasing power due to the pandemic and the momentum of harvest season put a deflationary force to the inflation figure, mildening the effect of Ramadan. Despite the prolonged pandemic, inflation in April is higher than in the previous two months. Annual headline inflation is recorded at 1.42% (y.o.y), surging from 1.37% (y.o.y) compared to March 2021. The upward inflationary trend is aligned with other early signs of demand recovery, such as the Consumer Confidence Index (CCI) and Manufacturing's Purchasing Manager Index (PMI). Regardless of the current shadowing pandemic, the latest data has painted an encouraging picture of recovery momentum emergence.

On a monthly basis, the headline inflation is telling a similar story of momentum buildup. April's monthly inflation marked the first hike in 2021, which stood at 0.13% (mtm) from 0.08% (mtm) in the previous month. The higher inflation of April is contributed by the majority of expenditure aspects. Observing further, monthly core inflation increases substantially to 0.14% (mtm) from -0.03% (mtm) in the previous month due to the hike of the gold price as the surge in demand as the Eid-Ul Fitr celebration came near, despite still lower compared to 0.17% (mtm) in April 2020 due to the current pandemic. Paradoxically, the annual core inflation rather demonstrated subduing inflation at 1.18% (y.o.y) and recorded as the lowest since

Key Figures

BI Repo Rate (7-day, Apr '21)
3.50%

GDP Growth (y.o.y, Q1 '21)
-0.74%

Inflation (y.o.y, Apr '21)
1.42%

Core Inflation (y.o.y, Apr '21)
1.18%

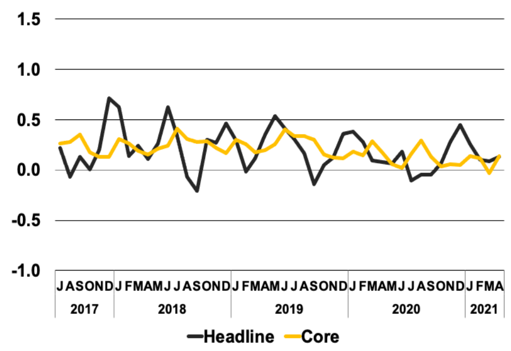
Inflation (m.t.m, Apr '21)
0.13%

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

FX Reserve (Apr '21)
USD138.8 billion

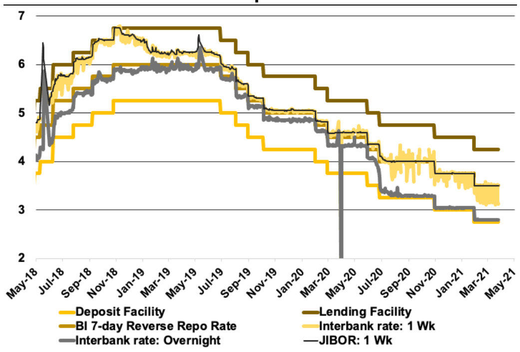
January 2021. The weakening annual core inflation indicates weak purchasing power is still dominating the full core inflation figure.

Figure 1: Inflation Rate (m.t.m)



Source: CEIC

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



Source: CEIC

In addition, the monthly volatile price component shows a slowdown from 0.56% (mtm) in March to 0.15% (mtm), driven by deflation in the horticulture commodities and rice as the harvest season took place. However, the deceleration of volatile food components is mildened by the increasing price of chicken meat and cooking oil as the demand surge amid Ramadan and the increase of global crude palm oil price. These price increases might contribute to a higher annual figure of volatile food of 2.73% (y.o.y) in April from 2.49% (y.o.y) in March 2021. On the other hand, administered price component in April increased to 1.12% (y.o.y) from 0.88% (y.o.y) in the previous month on an annual basis and increased to 0.11% (mtm) compared to -0.14% (mtm) in the same period of last year. The hike in administered prices component is attributed to the increase in cigarette prices due to the materialization of rising tobacco excise.

Maintaining the Recovery Momentum is Non-negotiable

Q1 2021 marked the fourth consecutive quarter of negative economic growth in Indonesia since the beginning of Covid-19. While technically still in a recession, Indonesia is showing signs of recovery. In Q1 2021, Indonesia recorded a growth of -0.74% (y.o.y), the highest since the emergence of the pandemic despite still in negative territory. Furthermore, the latest economic growth performance of Indonesia's GDP is somehow quite different from the quarterly 2020 GDP growth. The main difference is that, while still recorded negative, the Q1 2021 GDP growth estimation is relatively close to the realization. The better forecasts suggest that we might have a better grasp of the current pandemic situation than before. Further, many also view the progress of economic recovery is on-track. Despite the surrounding debate about the issue, various measures are in favor of economic recovery narratives. For one, CCI has been showing an upward trend since early 2021

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and peaked in April at 101.48, not only reaching its highest level since March last year but also the first time it reaches above 100 during the pandemic era, which suggest a boost in consumer confidence towards the future of the economic situation. Similarly, Manufacturing PMI in April 2021 is at 54.6, increasing from 53.2 in the previous month and marked a new high for two consecutive months. Also, the recorded Manufacturing PMI of above 50 signals an expansion of production activity. Likewise, Bank Indonesia's Prompt Manufacturing Index also implies a better prospect of economic condition as it reaches its highest level in Q1 2021 of 50.01% (above 50% indicates manufacturing expansion) since Q1 2020.

Numerous factors came into play in the improvement of the latest domestic economic condition. Vaccine rollout, massive government stimulus, and gradual opening of economic activity contributes to the observed jumpstart of domestic economy. The revival of economic activity is reflected in the GDP component. Firstly, export in Q1 2021 rose substantially to 6.70% (y.o.y) from -7.21% (y.o.y) in Q4 2020, suggesting a significant demand for domestic products from trading partners. Furthermore, import in Q12021 recorded a more significant growth from -13.52% (y.o.y) in Q4 2020 to 5.27% (y.o.y). The upsurge of import signals an increasing domestic production activity as 90% of Indonesia's import consists of raw materials and capital goods. Besides the foreign trade component, the economic improvement in the latest GDP data is also visible in the household consumption and investment components. Despite still in contraction, household consumption and investment are approaching a positive territory of growth as household consumption grew -2.23% (y.o.y) from -3.61% (y.o.y) in Q4 2020 and investment grew -0.23% (y.o.y) in Q1 2021 from -6.15% (y.o.y) in the previous quarter. It is worth noting that the negative rate of growth might be caused by the high base effect of Q1 2020 in which Covid-19 has not fully emerged.

Regardless of all the positive signals and increasing beats of economic pulse, the health risk of Covid-19 is still lingering. Several aspects, such as slow vaccination progress, the complacency of the pandemic spread risks by people, and the entrance of new mutation of Covid-19 virus from India could be more threatening than we realize and have high potential to disrupt all the economic progress and effort that has been put this far. Therefore, all components of the society (government and the people) are not in a place to afford any carelessness and loosening the focus to fight the pandemic. Without any significant improvement on the vaccine front, the risk of virus spread is the same as ever, if not worse.

Ephemeral Episode of Capital Inflows

Following the release of Indonesia's Q1 2021 GDP data earlier this May, the capital inflows has surged. In the last month, the accumulated capital inflow spiked to around USD6.43 billion in the first week of May 2021, a substantial increase of USD1.06 billion from around USD5.37 billion in mid-April. Besides a rather pleasant

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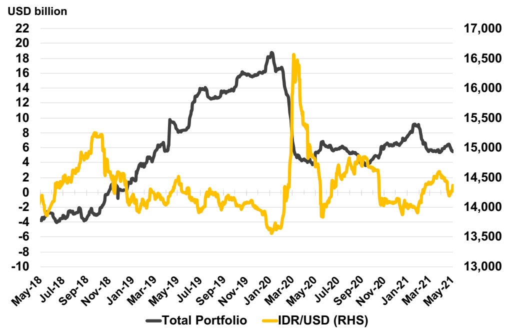
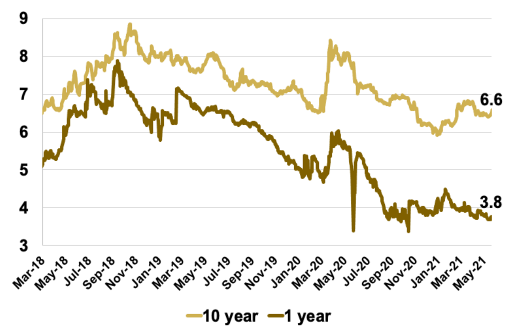
economic data release, a rising domestic economic activity during the Ramadan period also increase the investors' confidence towards current Indonesian economic progress and its future prospect. The massive capital inflows are mainly driven by the purchase of government bonds. The rise in foreign investors' ownership of government bonds is reflected in the government bond yield. 10-Year government bond yield decreased to 6.6% in Mid-May from 6.8% in the previous month. Similarly, the 1-Year government bond yield also fell from 4.0% in the second week of April 2021 to 3.8% recently.

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



Source: CEIC

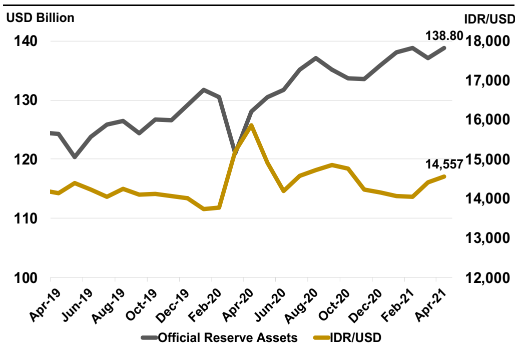
Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

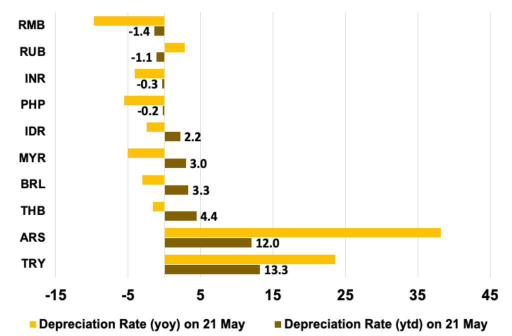
The surge of capital inflows during last month is reflected in the exchange rate as Rupiah appreciated from above IDR14,500 in the fourth week of last April to around IDR14,300 during the second week of May 2021, making it among the best performers in ASEAN during 2021. Rapid capital flows in April 2021 also accumulated foreign exchange reserves to USD138.8 billion, a surge of almost USD1.8 billion from March 2021. The level of current foreign exchange reserves is quite robust to weather any potential turbulence in the near future as the reserves are equivalent to finance ten months of import or 9.6 months of imports plus government debt repayments.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (May 21, 2021)



Source: CEIC

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Despite the inflows' exuberance in early May of 2021, which was driven by positive sentiment towards domestic prospects, the episode of capital inflows is rather transient. Capital outflows took place in the last few days, dragging accumulated capital inflows down to USD5.48 billion from USD6.49 billion (a decrease of around USD1 billion in just ten days). Various issues, ranging from the potential lockdown implementation in several countries to the possibility of earlier-than-expected tapering off by the Fed following the US domestic improvement and risk of inflation, triggers a capital flows reversal.

The current economic indicators are showing the latest development is in favor of better economic prospect. Improvement in domestic demand, increasing economic and business confidence, and expanding production activity are all valid reality checks of the recovery narratives. Regardless, there is no guarantee that today's appealing condition might last. We are still in the middle of a pandemic and remaining vigilant might be the best option to get through the crisis soon. The elevating health risks from the new mutation of the virus and slow vaccination progress, in addition to economic pressure from the risk of US' tapering off and the slowdown of trading partners' economic activity from another episode of lockdown, could add another layer of uncertainties to the future agenda of recovery. With a rather volatile external pressure and the need to maintain financial and exchange rate stability, we are in a view that BI needs to hold its policy rate steady at 3.50%.