Macroeconomic Analysis Series

BI Board of Governor Meeting

June 2021

LPEM FEB UI
UNIVERSITAS INDONESIA

Highlights

- BI should hold its policy rate at 3.50% this month.
- May's inflation is recorded at the highest pace this year following the seasonal pattern of Eid-ul-Fitr festivity and holiday.
- The promising sign of recovery from the latest economic indicators might be faded in the rising of Covid-19 cases recently.

Macroeconomics & Political Economy Policy Research

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The improvement of the latest economic indicators, including headline and core inflation, CCI, PMI, and trade surpluses, shows that Indonesia is staying on track for economic recovery. However, the economic recovery agenda faces a significant threat recently due to the rising of Covid-19 cases where almost 10 thousand new daily cases taped in mid-June. Any resurgence of emergency of the health crisis in the near future will be too costly for the economy as it will put back all economic recovery progress and efforts. From the external side, the market has been enjoying capital inflow resulted from the investors' positive sentiment towards economic performance. Nevertheless, the market is also fully aware that the threat of earlier-than-expected tapering off by the Fed is still lingering. With the rising domestic uncertainty of Covid-19 transmission coupled with foreseen external pressure from the US's tapering off, we see that BI needs to maintain the exchange rate and financial market stability and hold its policy rate at 3.50% this month.

Gradual Public Confidence Recovery Will Speed Up Inflation

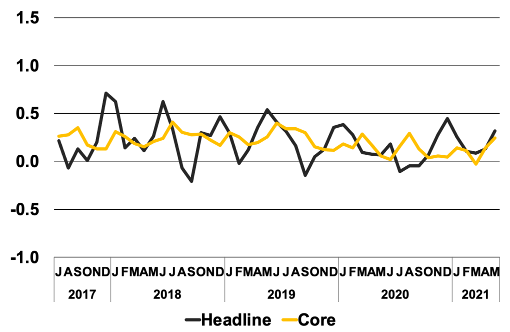
The Eid-al-Fitr festivity is used to elevate inflation figures as prices tend to increase beyond typical supply-demand conditions. The prolonged Covid-19 pandemic, however, has mildened the inflationary figure this year since people set their activities to the bare minimum due to the social mobility restrictions. This month marks 11 consecutive months that inflation is below BI's target range of 2-4%. Despite the sign of persistent weak domestic demand, May's inflation accelerated to its highest pace in five months as the Eid-al-Fitr festivity and holiday beget higher consumer spending. The Consumer Price Index (CPI) rose in almost all components compared to the last month's inflation, marking the jump in annual headline inflation to 1.67% (y.o.y) from 1.42% (y.o.y) in April 2021. May's headline inflation was largely driven by the seasonal spike of food ingredients demand for the festive needs coupled with the higher transportation prices during the holiday.

On the other hand, the annual and monthly core inflation also increased to 1.37% (y.o.y) and 0.24% (mtm) compared to 1.18% (y.o.y) and 0.14% (mtm) in April 2021. Data shows that the rise in gold jewelry prices due to the higher global prices and domestic demand during the festive was the main contributor to the inflationary pressures in core inflation. Even though May's core inflation was still below-normal inflation figure, the spike indicates that purchasing power is gradually recovering as it was in line with the early signs of public confidence and demand recovery from the latest data of Consumer Confidence Index (CCI) and Manufacturing Purchasing Manager's Index (PMI). If the signs of recovery remained, the seasonal spike of the latest inflation might be the beginning of the continual increase in inflation to settle within the target range.

Key Figures

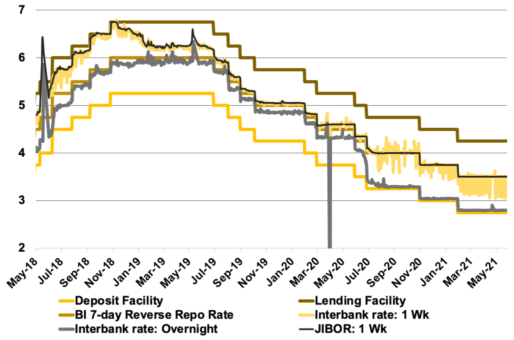
BI Repo Rate (7-day, May '21)
3.50%
GDP Growth (y.o.y, Q1 '21)
-0.74%
Inflation (y.o.y, May '21)
1.68%
Core Inflation (y.o.y, May '21)
1.37%
Inflation (m.t.m, May '21)
0.32%
Core Inflation (m.t.m, May '21)
0.24%
FX Reserve (May '21)
USD136.4 billion

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



Source: CEIC

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



Source: CEIC

Looking further, the event of festive was highly contributed to the surge in volatile prices from only 2.73% (y.o.y) in April to 3.66% (y.o.y) in May. As people need more food ingredients for a festive celebration, the prices of basic necessities such as chicken meat, fresh fish, and cooking oil were soared following the seasonal demand. However, the jump of volatile prices was relatively quiet since some commodities faced deflationary pressures from the ongoing harvest season. In addition, the monthly inflation of administered prices jumped to 0.48% (mtm) from 0.11% (mtm) the month earlier, making it the highest monthly figure since January 2017. Despite the restriction of *Mudik* tradition, which means the annual homecoming exodus tradition to celebrate Eid-ul-Fitr with their families, the large expansion in the administered prices was still contributed by the spike in airfares and railway travel prices during the festive as well as holiday. Nevertheless, the hike in volatile and administered prices is most likely to be transitory for the inflationary pressure.

Slowing Down Virus Transmission to Maintain Economic Recovery

After the published data of diminishing economic contraction in Q1 2021 compared to the last quarter of 2020, the latest data of other economic indicators supports the early sign of economic recovery. The CCI, which reflects people's confidence in their income and future spending has been continuing its upward trend since early this year. The figure accelerated to 104.4 in May from 101.5 in April 2021, achieving a new high since March 2020. The higher consumer confidence not only signaled a larger spending, but also the expansion of businesses in the future. Simultaneously, Manufacturing PMI continued to mark a new high for three consecutive months at the level of 55.3 in May 2021, rose from 54.6 in the previous month. The increase suggests that the industry has been catching up with a higher consumers' demand progressively with the expansion of production activity.

Besides the sign of recovery from domestic indicators, indicators of the stronger economic pulse were also noticeable in the latest foreign trade balance data as Indonesia has recorded trade surpluses for 13 consecutive months since last year. The surplus increased to USD2.36 billion in May 2021 from USD2.19 in the previous

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month. Even though May's higher surplus contributed by the lower exports and imports due to lower commodity prices, the accumulation of exports and imports in Jan-May 2021 has improved significantly by 30.6% (y.o.y) and 22.7% (y.o.y), respectively, compared to their figures over the same period of the previous year. The jump in exports reflects that Indonesia has been benefiting from the overseas demand recovery, while the higher imports suggest the domestic recovery as most of the imports are raw and capital goods. All things considered, the economic indicators in May were staying on track for an economic recovery.

While promising, the emergence of economic recovery momentum might come with its cost, as shown by the new daily positive Covid-19 cases. The health risk is currently alarming where almost 10 thousand new daily cases were taped in mid-June, noting as the high spike since the last February. The virus transmission has been rushing by the higher people mobility during the Eid-ul-Fitr and holiday. Far worse, the new cases in some cities were dominated by the Delta variant, which was first identified in India and popularly known for its higher transmission rate as well as severe infections. If the current situation becomes uncontrollable, it is possible for the government to take another strict mobility measurement and let the economic progress and effort vanish. Any resurgence of emergency in the near future will be too costly for the economy as it will put back public confidence. To avoid such setbacks, all economic agents must focus to tackle the spread of the pandemic, particularly by tightening the health protocols and accelerating vaccine rollout.

Rapid Rupiah Appreciation driven by Ongoing Capital Inflows

Despite the recent rise in Covid-19 new cases, the latest promising figure of domestic indicators is also reflected in domestic capital markets which enjoy a strong capital inflow in the last month. From external pressure, the fear of earlier-than-expected US's economic recovery was relatively mildened as the unemployment rate is still far from its long-term figure. The Fed's assurance of staying in an accommodative policy stance until the inclusive labor gains was perceived as the clear signals to the investors. Therefore, the benign global market sentiment towards the US' tapering off contributed to the continuation of capital inflows to EM's countries since early June. In Indonesia, the positive market sentiment towards domestic assets has amplified the capital inflows to USD7.85 in the second week of June 2021 from USD6.43 billion in mid-May. The capital inflows, which is dominated by government bonds, has also brought the lower yields of 10-Year and 1-Year government bond yield to 6.5% and 3.5% in mid-June from 6.6% and 3.8% in mid-May, respectively.

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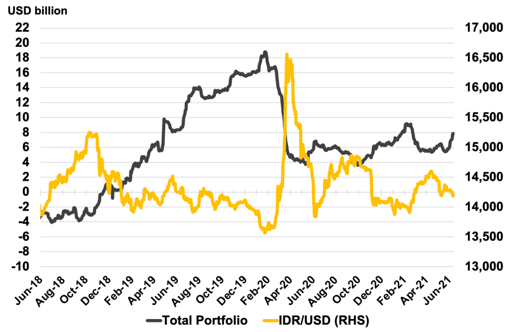
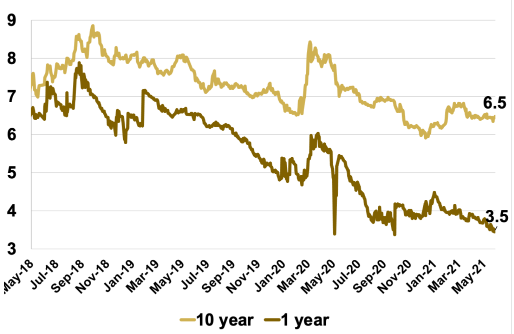
Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 36 Months)



Source: CEIC

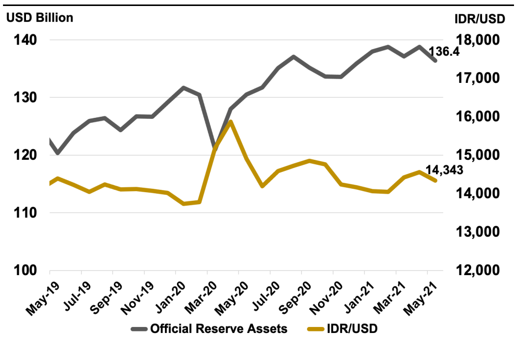
Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

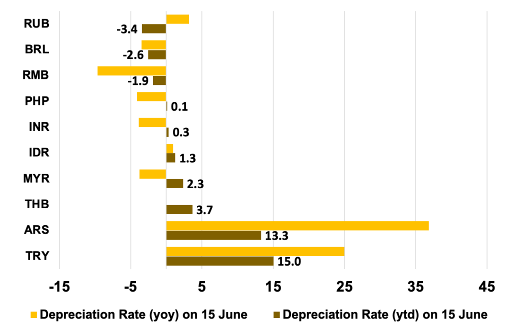
As a result of capital inflows, Rupiah has been strengthening in mid-June to a level of around IDR14.300 from around IDR14.500 in the previous month. Rupiah performed better than its peers, including Malaysian Ringgit and Thailand baht. However, the surge in capital flows has not been translated into the high increase in foreign exchange reserves last month. Conversely, the foreign exchange reserve decreased by around USD2.4 billion to USD136.4 billion due to the cycle of the government's foreign debt repayments. The latest figure of foreign exchange reserves, however, is still adequate to cushion any turbulence as the reserves are equivalent to 9.1 of imports and payments of the government's foreign debts. It is still recorded higher than the standard international reserve adequacy of around 3 months of imports.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

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



Source: Investing.com

Despite some leading economic indicators from domestic and external sides show a promising sign of recovery, the rising Covid-19 cases recently in Indonesia suggests the possibility of temporary improvement in economic condition. The surge in new daily cases put a wake-up call for policymakers to anticipate any potential disruption on the economic recovery agenda. If the condition is getting out of hand shortly, the recovery of consumers' and businesses' confidence may be faded. Also, the resurgence of Covid-19 cases will hold back investor's confidence towards Indonesia's assets and leads to capital reversal flows. On the other hand, the market

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was fully aware that the external pressure from earlier-than-expected tapering off by the Fed is still lingering. If the Fed starts the taper-off in the early second half of this year, the central bank of EM countries should weigh in the risks in any policy measurement they decide in the near future. BI should maintain the exchange rate and financial stability as the pre-emptive measures to the global uncertainties of US's tapering off, despite the current favorable monetary base than ahead of the 2013 taper tantrum. With the rising domestic uncertainty of Covid-19 transmission coupled with foreseen external pressure, we see that BI needs to hold its policy rate at 3.50% in June 2021.