LPEM FEB UI
Universitas Indonesia

Macroeconomic Analysis Series

BI Board of Governor Meeting

July 2021

Highlights

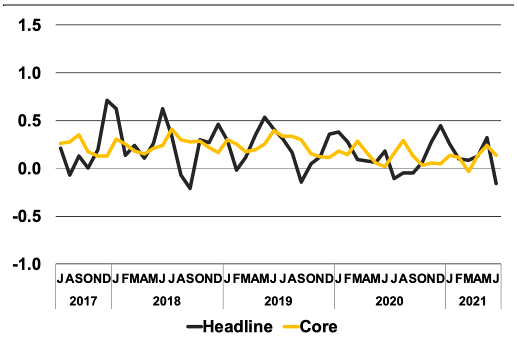
- BI should continue to hold its policy rate at 3.50% this month.
- Inflation slowed in June following price normalization after Eid-ul Fitr festivity.
- Recent rise of Covid-19 infections and partial lockdown are expected to cause the economy to contract.
- Rupiah depreciates rather erratically following the Fed hint to raise interest rate in 2023.

The rising number of confirmed Covid-19 cases is expected to put the brakes on economic recovery. All economic indicators, such as inflation, CCI, PMI, trade surplus, started to demonstrate a grim outlook. We expect these indicators to continue to plunge in July especially after the government decided to implement partial lockdown in Java and Bali. From external conditions, Rupiah moves rather sideways as investors weigh in recent development in Covid-19 cases and how major central banks' stances are. Despite the need to spur economic growth, there is simply no room for BI to change its policy as the supply side remains muted. To maintain the exchange rate and financial stability under the uncertainty of the Covid-19 crisis, we see that BI needs to hold the policy rate at 3.50% this month.

Inflation Dips as Price Normalizes Post-Ramadan Season

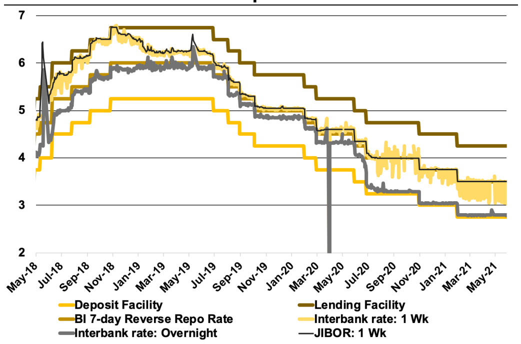
As holiday-induced pressure on food and transportation inflation eased, price pressure faded in June. Combined with subdued overall demand, June's headline inflation fell to a 10-month low of 1.33% (y.o.y) from 1.67% (y.o.y) in May 2021. Looking into expenditure group, it comes as no surprise that food inflation fell to 1.85% (y.o.y) in June compared to 3.05% (y.o.y) in the previous month. Transportation inflation also slowed to 0.09% (y.o.y) in June from 0.85% (y.o.y) in May. Oppositely, personal care and other service inflation increased to 3.53% (y.o.y) in June from 3.08% (y.o.y) in May and household equipment inflation accelerated from 1.59% (y.o.y) in May to 1.73% (y.o.y) this month. However, these two groups combined only contributed to 0.03% inflation, resulted in overall lower inflation this month. For more than a year, inflation has been below the central bank's 2 - 4% target. We expect price pressure to remain moderate in the coming months, especially after President Jokowi decided to impose stronger lockdown in response to recent spike in Covid-19 cases.

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



Source: CEIC

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



Source: CEIC

Macroeconomics & Political Economy Policy Research

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Key Figures

BI Repo Rate (7-day, June '21)
3.50%
GDP Growth (y.o.y, Q1 '21)
-0.74%
Inflation (y.o.y, June '21)
1.33%
Core Inflation (y.o.y, June '21)
1.49%
Inflation (m.t.m, June '21)
-0.16%
Core Inflation (m.t.m, June '21)
0.14%
FX Reserve (June '21)
USD137.1 billion

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Core inflation, which strips out volatile and government-controlled prices, was reported at 0.14% (mtm) this month, down from 0.24% (mtm) in May 2021. On an annual basis, the core inflation was at 1.49% (y.o.y), slightly higher than a month earlier at 1.37% (y.o.y). Slowing core inflation this month is mainly driven by demand normalization after the Eid-ul Fitr celebration, which unsurprisingly recorded relatively mild inflation compared to previous year figures due to weak demand and harvest season. Gold price, a major contributor to core inflation, fell sharply in mid-June as the Fed announced to hike the Fed Funds Rate twice in 2023. It then gradually increased until mid-July 2021. Motor vehicle retail sales, another major contributor to core inflation, reached more than 65 thousand in June 2021, a slight increase of 2.46% (mtm) compared to last month. Buyers were waiting for the official announcement of extension of tax discount on luxury goods, which happened on 2 July, before deciding on buying cars.

Contrary to core inflation, volatile prices and administered prices experienced monthly deflation of 0.21% (mtm) and 1.23% (mtm), respectively. On a yearly basis, volatile prices inflation stood at 1.60% (y.o.y), significantly less than a month earlier at 3.66% (y.o.y). Additionally, annual administered prices inflation dropped to 0.49% (y.o.y) in June from 0.93% (y.o.y) in May 2021. As previously mentioned, price normalization, particularly in food, caused volatile prices to slow down. On the other hand, transportation price normalization brings down administered prices inflation. All in all, this month, all three components of inflation, which are core inflation, volatile prices, and administered prices, induce monthly deflation of -0.16% (mtm), the deepest monthly inflation since August 2019.

Embracing The Second Wave of Covid-19 Pandemic

In June 2021, Indonesia's CCI improve to 107.4, which went up three points from previous month, suggesting optimism among consumers has continued to gain strength. Consumer confidence increases across all spending levels and all age brackets except for respondents between 41 and 50 years old. Contrary to the CCI, after four consecutive months of increase, Indonesia's PMI dropped to 53.5 in June 2021, down from a record high of 55.4 in May. This drop matches a decline in trade surplus to USD1.32 billion in June 2021 from USD2.70 billion a month earlier. With this figure, Indonesia has maintained trade surplus since May 2020. The lower surplus in June 2021 could be explained by a higher increase in imports, which grew by 21.03% (mtm), while exports only increased by 9.52% (mtm). Import expansion consists of increase in capital goods, raw materials, and consumer goods by 35.02% (mtm), 19.15% (mtm), and 16.92% (mtm), respectively. On the other hand, the rise in exports is attributed to pickup in shipment of oil and gas at 9.52% (mtm), indicating an increase in demand as global recovery taking place, as well as jump in manufactured goods exports at 7.34% (mtm).

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What originally started as a concern has become a bad reality. Started a week after Eid-ul Fitr, 19 May, the number of daily confirmed new cases (7-day moving average) has continuously gone up with no sign of slowing down. Approaching the end of June, on 22 June, the number of 7-day daily average confirmed new cases was at 12,915 cases, surpassing the previous all-time peak at 12,865 cases on 1 February this year. Many describe that Indonesia officially enters the second wave of the pandemic. To contain the highly infectious Delta variant, President Joko Widodo finally imposed a partial lockdown in 44 regencies/municipalities in Java and Bali starting from 3 July. The partial lockdown means public places, such as malls, parks, and places of worship, are closed while restaurants only do takeaways or deliveries. Grocery stores and supermarkets to limit their customers to half of their capacity and must be closed by 8 pm. Roadblocks and checkpoints were set up with officials from the military and police department deployed to impose movement restrictions until 20 July. On 19 July, the number of 7-day daily average confirmed new cases stood at more than 48,000. Just last night, President Joko Widodo announced 5-days lockdown extension until 25 July. Subject to decreasing daily confirmed cases, he will gradually ease the restriction starting 26 July.

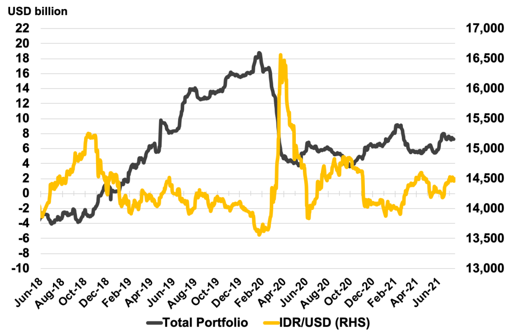
Looking into vaccine rollout data, up to 18 July, at least 41.5 million people have received a single dose of the vaccine, while more than 16.2 million people have been fully vaccinated. This figure is still below target of more than 208 million people to be fully vaccinated. Throughout July 2021, Indonesia has received 14.4 million vaccines from three pharmaceutical companies and is currently waiting for 50 million vaccines from Pfizer. With partial lockdown, we would expect the economy to contract further, perhaps reversing most if not all economic recovery progress that we have made so far. But that is completely fine. Although a little too late, the government may finally prioritize health over economy.

Market Is Running in Circles

After the Fed hinted they will have two interest rate hikes in 2023 during June FOMC meeting on 15-16 June, Rupiah experienced depreciation against USD, ranging between IDR14,220 per USD and USD14,530 per USD as investors move their capital from emerging markets. Since then, Rupiah has been relatively stable at around IDR14,500 despite the recent rise in Covid-19 infections and partial lockdown in Java and Bali. Rupiah is considered strong due to some external factors, including the Fed's stance to maintain quantitative easing although US inflation has risen higher than expected. During Semiannual Monetary Policy Report to the Congress, Jerome Powell, the Fed's chair, mentioned the US would still be short of maximum employment, suggesting it would be too soon to reverse gear. Besides, to support economic recovery, the People's Bank of China (PBOC) announced they would cut their reserve requirement ratio (RRR) by 50bps effectively from 15 July. Although some investors move their assets from emerging markets like Indonesia, others may be triggered by these two announcements to put their assets in a riskier portfolio, resulting in relatively stable Rupiah and modest decrease in net capital inflows from

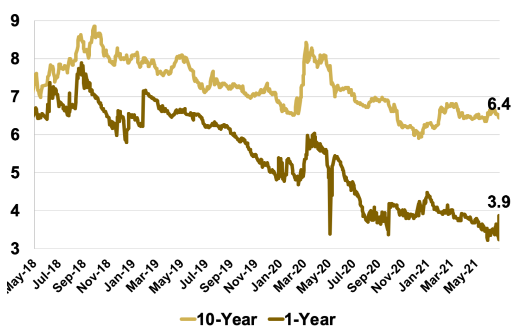
USD8.00 million in mid-June 2021 to USD7.34 million in mid-July 2021. This translates to increase in 1-year government bond yield to 3.9% in mid-July from 3.5% in mid-June while 10-year government bond yield remains stable at 6.4% between June and July 2021.

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



Source: CEIC

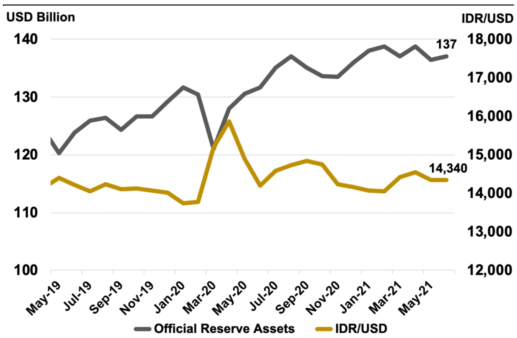
Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

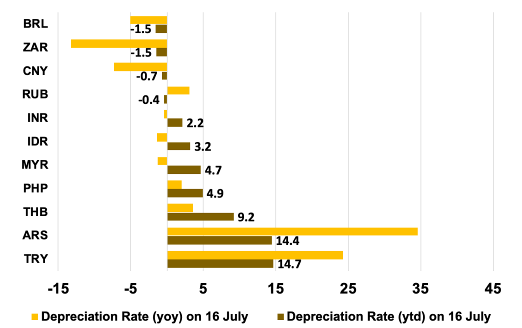
Compared to its peers, such as Brazilian Real and Indian Rupee, Rupiah performed better; it recorded an appreciation of 1.25% (ytd) against USD. However, our neighbouring countries, like Malaysian Ringgit and Thailand Baht surpassed Rupiah's performance; they recorded a higher year-to-date appreciation. Foreign reserves assets slightly increased to USD137.1 billion in June 2021 from USD136.3 billion in the previous month. Slight increase in foreign reserve assets was due to the issuance of government's Global Sukuk and tax and services receipts. The latest reserve figure is equivalent to finance 9.2 months of imports or 8.8 months of imports and servicing government's external debt.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (July 16, 2021)



Source: Investing.com

With government imposing partial lockdown in an effort to fight the devastating rise in Covid-19 infections, we see economic recovery will likely pause. Some might say there is a trade-off between the economy and public health. But we believe we cannot have a fully functioned economy without healthy people, hence, the government should prioritize addressing public health crisis. From the external side, markets are currently watching closely how the Delta variant reshapes the Covid-19

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crisis around the world while monitoring how policymakers, especially The Fed, will react. While policy rate cut is usually the main tool implemented by the central bank during low-inflation period, we view that lowering policy rate would be futile as the supply side is practically muted in this time of Covid-19 upsurge. Thus, we see that they need to hold its policy rate at 3.50% in July 2021. Maintaining the exchange rate and financial stability under the uncertainty of the Covid-19 crisis should be the main priority of the central bank.

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