Macroeconomic Analysis Series

BI Board of Governor Meeting

October 2021

Highlights

- BI should continue to hold its policy rate at 3.50% this month.
- Higher commodity prices provide a windfall to the economy through robust trade balance and Rupiah stability.
- Certain factors which could elevate external uncertainty and limit potential inflows ahead are sooner-than-anticipated US monetary normalization agenda and the global energy crisis.
- Despite the emergence of domestic recovery, inflation figure is still muted; indicating a persistently weak aggregate demand.

Macroeconomics & Political Economy Policy Research

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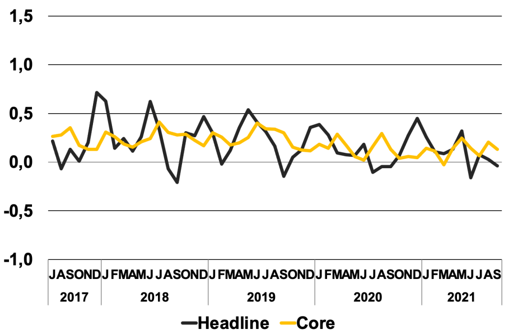
Faster and widespread vaccination programs along with accommodative policy responses through both fiscal and monetary stimulus are essential to regain growth momentum following the aftermath of the Delta outbreak. Economic activities have gradually gaining traction after government began carefully lifting the emergency public activity restriction (PPKM). The recent issuance of the law on Harmonization of Tax Regulations (UU HPP) as part of the structural reform will potentially boost tax revenue and expand the tax base as the economic recovery progresses, especially in the long term. External situations are somewhat volatile due to energy crisis that took place in China, India, and Europe, which could threaten the global economic recovery. Despite the recent shock, Rupiah has been steadily appreciating to around 14,200 from around 14,300 on the back of better domestic pandemic situation, elevated commodity prices that boost trade surpluses, and higher foreign reserves. With the downside risks remains on in the rest of 2021 and controlled inflation, we see BI should continue to hold its policy rate at 3.50% in order to maintain Rupiah stability and support national economic recovery.

Deflationary Pressure due to Seasonal Harvest Period

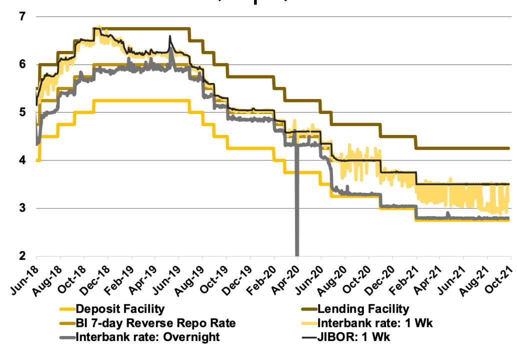
September's annual inflation rate stood at 1.60% (y.o.y), relatively unchanged from its previous figure at 1.59% (y.o.y) in August and remained below BI's target range. On a monthly basis, headline inflation recorded a deflation of -0.04% (mtm), down from inflation of 0.03% (mtm) a month earlier but nearly on a par with -0.05% (mtm) monthly deflation recorded in the same period last year. The drop in monthly inflation was attributed by a deflation in the volatile foods category and a decline in core inflation amid rising inflation in the administered price category.

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



Source: CEIC

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



Source: CEIC

Key Figures

BI Repo Rate (7-day, Sept '21)
3.50%
GDP Growth (y.o.y, Q2 '21)
7.07%
Inflation (y.o.y, Sept '21)
1.60%
Core Inflation (y.o.y, Sept '21)
1.30%
Inflation (m.t.m, Sept '21)
-0.04%
Core Inflation (m.t.m, Sept '21)
0.13%
FX Reserve (Sept '21)
USD146.87 billion

Core inflation in September stood at 1.30% (y.o.y), slightly decline from 1.31% (y.o.y) in August. Likewise, monthly core inflation also dropped to 0.13% (mtm) from 0.21% (mtm) inflation in August, while it was unchanged compared to the same period last year. A further slowdown in core inflation last month indicated that people's purchasing power remained weak despite some easing in Covid-19 curbs following a decline in daily new confirmed cases. Lower core inflation was also due to deflationary pressures on gold jewellery, in line with the global gold price correction but this was offset by an increase in house rent as the government started easing the mobility restriction. Looking at the volatile foods component, a monthly rate marked a significant deflation at -0.88% (mtm), deeper than the preceding month's deflation of -0.64% (mtm) and the same period last year at -0.60% (mtm). However, it is certainly normal that inflationary pressures on food products are typically low during August-October due to seasonal harvest period. The decline in food prices was mainly driven by cheaper staple food items (i.e. broiler eggs and horticultural commodities) in line with ample supply, thanks in part to seasonal factors. Rising CPO prices contributed to an increase in cooking oil prices, thus holding back a deeper rate of volatile foods deflation. On a contrary, administered prices component recorded an inflation at 0.14% (mtm), up from 0.02% (mtm) in the preceding month and from a deflation at -0.19% (mtm) in the same period last year. These developments were mainly driven by inflation in various cigarette commodities in line with the continued impact of the increase in tobacco excise.

Restarting the Progress of Economic Recovery

The emergency mobility restriction (PPKM) measures have been successfully suppressed the daily Covid-19 cases from a record high of 56,757 daily cases in mid-July to the current 915 daily cases (as of October 15th). The positivity rate declined from as high as 33% in July to currently 0.5%, which is well under the WHO standard of <5%. The encouraging signs of Covid-19 indicators have driven the government to gradually and carefully relaxed the restrictions to support small businesses that had been suffering under the policy, and balanced with the vaccination pace. The easing restrictions will be expected to boost restrained consumption and investment as well as resume the progress of economic recovery.

Looking into several economic indicators, the Consumer Confidence Index (CCI) and the Manufacturing Purchasing Managers' Index (PMI) showed better performances, indicating a less pessimistic outlook in the remaining half of 2021. CCI improved to 95.5 in September from 77.3 in August, albeit it has not returned to optimistic territory (100 and above). The improvement occurred across all income, education, and age groups. A better index indicated that consumer confidence in economic

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conditions was strengthening, driven by improvement in people's mobility in line with the relaxation of mobility restrictions. Likewise, PMI stood at 52.2 in September, marking a rebound from 43.7 in August. The figure is above the threshold of 50, indicating that manufacturing activity has started to expand following a contraction in July and August when the government imposed the emergency mobility curbs.

Looking at trade statistics, a positive trade balance persists on the back of the still high commodity prices. Trade balance recorded a pleasing surplus of USD4.37 billion in September, slightly dropped from USD4.74 billion in August. This marks the 17th consecutive month of trade surpluses due to the faster growth of exports than imports. High prices of CPO and coal, Indonesia's main exports commodities, and surging demand from several trading partners including China and India heavily contributed to impressive exports performance.

All in all, faster and widespread vaccination program along with accommodative policy response through both fiscal and monetary stimulus are essential to regain growth momentum following the aftermath of the Delta outbreak. Economic activities have gradually resumed after the government began carefully lifting the emergency public activity restriction or emergency (PPKM). In terms of vaccination progress, Indonesia's vaccination rate has increased sharply, thanks to the government that secured the vaccine supply that can accommodate the whole population. The daily vaccination rate has picked up to >1.6 million per day. As of 14th Oct, around 104.3 million people have received their first dose vaccination, or equal to around 37.7% of the total population.

Regarding the fiscal policy, GoI has disbursed the national economic recovery (PEN) about 55.9% of the total of IDR745 trillion (As of October 8th), with the largest realization in the budget for business incentives (95.5% of target), wherein corporations, MSMEs, and individuals have utilized various tax incentives provided by the government. The social safety net program realization came second (65.1% of target), followed by the priority program (55.7%), the health sector (49.7%), and the MSME and corporate support (38.2%). The government aims to gradually lower the fiscal deficit under 3% of GDP by 2023. In the proposed 2022 state budget, the fiscal deficit is targeted at IDR868 trillion or 4.85% of GDP. The deficit was lower than 6.1% of GDP in the last year and this year outlook at 5.8% of GDP, marking the beginning of fiscal consolidation. Fiscal consolidation will be achieved through tax reform, spending better and efficient, as well as innovative and sustainable financing. Recently, GoI has stipulated law on Harmonization of Tax Regulations (UU HPP) as a part of the structural reform process to encourage a fair, healthy, effective, and accountable taxation system. Strengthening the taxation systems will potentially boost tax revenue and expand the tax base as the economic recovery progresses,

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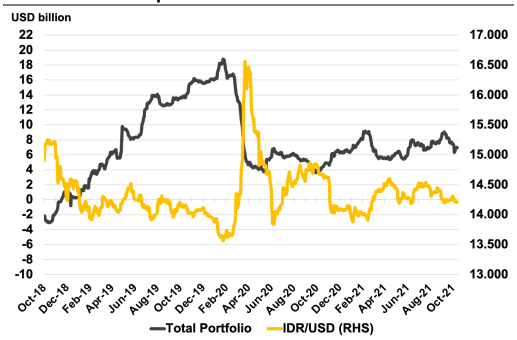
especially in the long term. Yet, the reforms should be executed carefully and timely to avoid being counterproductive to the economy. Overall, we see that GoI is generally on track in lowering the fiscal deficit back to 3% of GDP by 2023. In addition, higher commodity prices will provide a windfall to the economy, and if the pandemic continues to subside, the economy can regain full recovery, which will support stronger revenue collection.

Rupiah Appreciation Driven by Surging Commodity Prices

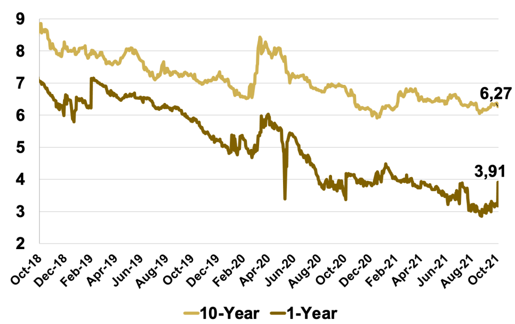
In the midst of robust domestic circumstances, external situations are somewhat volatile due to energy crisis that took place in China, India, and several parts of Europe due to the lagging rebound of supply side compared to the demand side. As a consequence, there was an aggressive outflow from around USD9.05 billion in mid-September to USD6.98 billion in mid-October. The global energy crunch triggered fear among investors, hence they took their capital foot off from emerging markets including Indonesia. Furthermore, other issues such as contagion risks from debt troubles at China Evergrande that could pose a systemic risk to Chinese economy and the issue related to the Fed's monetary stance, which may exert tapering sooner than previously anticipated further exacerbates the fear and prompted investors to flee riskier assets. This translates to an increase in both 10-year and 1-year government bond yields to 6.27% and 3.91% in mid-October from 6.17% and 3.16% in mid-September, respectively.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

On the other hand, despite the recent shock, Rupiah has been steadily appreciating to around 14,200 from around 14,300 on the back of better domestic pandemic situation, elevated commodity prices that boost trade surpluses, and higher foreign reserves. Compared to its neighbouring peers, Rupiah is one of the best performers so far with a depreciation rate of 0.2% (ytd) against USD. Foreign reserves assets continue its rising trend from last month and reported an increase to USD146.8 billion, hitting a new all-time high. An increase in foreign reserves in September was due to tax and service receipts as well as the withdrawal of government foreign debt.

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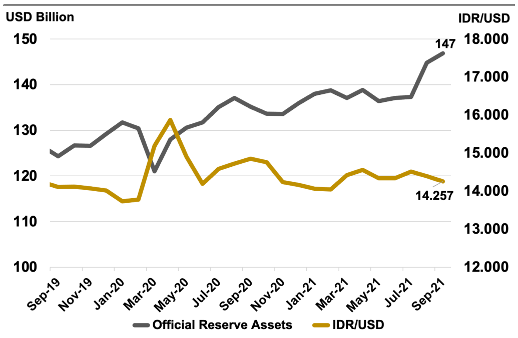
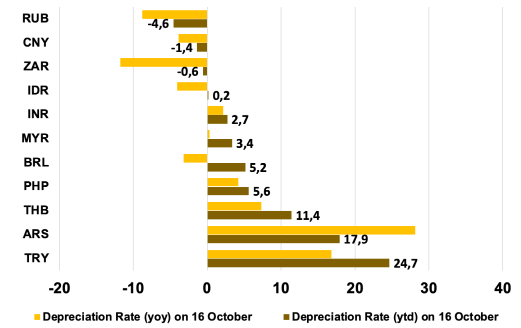
The latest reserve figure is equivalent to finance 8.9 months of imports or 8.6 months of imports and servicing government's external debt. With higher foreign reserves, BI has plenty of ammunition to support the currency if US yields rise further in the coming months.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

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



Source: Investing.com

Nonetheless, the downside risks remain on for the rest of 2021 that can put another jeopardy and uncertainty to economic stability. Certain factors which could elevate external uncertainty and limit potential inflows ahead are sooner-than-anticipated monetary normalization agenda by the Fed which can trigger a flight to quality, the scarcity of containers and obstacles in shipping goods in China that increase freight and logistic costs and disrupt the global supply chain, and the global energy crisis due to the lagging rebound of supply-side. However, should the market turn volatile once the Fed begins tightening, Indonesia is in a rather difficult position. Despite being in a better position than the 2013 taper tantrum in terms of reserves, the Covid-19 crisis still prevails and real sectors are still in halt, leaving the policymakers with virtually no space to deploy any monetary tightening anytime soon. Furthermore, the global energy shortfall would have an impact on domestic industries that rely heavily on imported raw materials from China and India, but bring opportunities for the development of domestic upstream industries and benefit coal and palm oil exporters. All in all, the decline in daily Covid-19 cases and the loosening of the PPKM policy are expected to encourage domestic economic recovery. Robust trade balance, higher position of foreign reserves, and extension on government bond-buying program help to defend the currency and strengthen bond yields; thus maintain external sector resilience. Regardless, the uncertainty is still paramount. Therefore, given the current domestic and external circumstances coupled with persisting muted inflation, indicating ongoing low purchasing power, we see BI should continue to hold its policy rate at 3.50% in order to maintain Rupiah stability and not disrupting any potential emergence of recovery momentum.