Macroeconomic Analysis Series

BI Board of Governor Meeting

February 2022

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Highlights

- BI should hold its benchmark rate at 3.50%.
- Inflation continued its upward trend. However, the recent surge of Omicron may trigger the trend to last only a temporary.
- Global sentiment is still on alert as several developed countries begin to rise its interest rate due to the soaring level of inflation that last longer than expected.
- Capital outflow and weaker trend of Rupiah occurred as the result of the Fed announcement of rate hikes in March.

Macroeconomics & Political Economy 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

Faradina Alifia Maizar
faradina@lpem-feui.org

After the Delta outbreak, Indonesia is currently facing the Omicron wave. As of 7th February, daily new cases were reported at more than 27,000 cases (7-day moving average) and many predicted it will peak at the end of February 2022. Despite rising cases, several economic indicators keep progressing, indicating recovery still remains. Similar to GDP that recorded an immense growth of 5.02% (y.o.y) in Q4-2021, yearly inflation rate also drew the same pattern with a notable pick-up of 2.18% (y.o.y) in January 2022 from 1.84% (y.o.y) in December 2022. However, the recent surge of Omicron cases is expected to slow, or even pause, the economic recovery. From the external side, inflationary pressure that continues to linger around several markets forces several central banks to raise the interest rate. As a result, contractions in domestic market are detected in the short-term, indicated by notable amount of outflow and weaker trend of Rupiah. Given these circumstances, BI should hold its policy rate at 3.50% this month while observing domestic condition and closely watching the fluctuations in the global market.

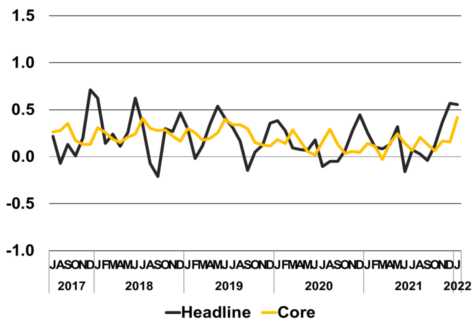
Temporary Increase in Inflation before Another Round of Outbreak

This month headline inflation stood at 0.56% (m.t.m), pushing the annual inflation to 2.18% (y.o.y) from 1.84% (y.o.y) last month. The food, beverage, and tobacco group were the main contributor with an inflation of 3.45% (y.o.y) in January 2022, an increase from 3.09% (y.o.y) in previous month. Household equipment and housing activity inflation were recorded at 3.31% (y.o.y) and 1.24% (y.o.y), respectively, following the seasonal housing trend that people usually pay rents at the beginning of the year. Looking into core inflation, it jumped to 1.84% (y.o.y) in the first month of 2022 compared to 1.56% (y.o.y) in December 2021, indicating that the economic condition continues to crawl up to the pre-pandemic level. Moreover, the impact of Omicron outbreak has not manifested completely in January inflation figure as the GoI has not decided to deploy any specific measures to limit the mobility until the end of January, which then keep inflation on a rather favorable level. Looking at administered prices, the inflation rate presented a slower trend after an accelerated performance since September 2021. It was reported at 0.38% (m.t.m) in January 2022 compared to 0.45% (m.t.m) last month. Normalization of air transportation tickets after the holiday season has become the main contributor to the easing administered prices inflation.

Key Figures

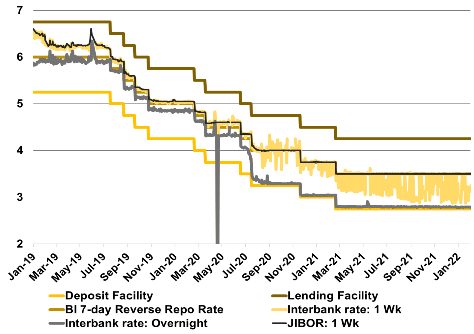
BI Repo Rate (7-day, Jan '22)
3.50%
GDP Growth (y.o.y, Q4 '21)
5.02%
Inflation (y.o.y, Jan '22)
2.18%
Core Inflation (y.o.y, Jan '22)
1.84%
Inflation (m.t.m, Jan '22)
0.56%
Core Inflation (m.t.m, Jan '22)
0.42%
FX Reserve (Jan '22)
USD141.3 billion

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



Source: CEIC

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



Source: CEIC

On the other hand, energy prices inflation rose aggressively to 0.64% (m.t.m) compared to 0.04% (m.t.m) in prior month, following the upsurge trend of global energy prices. On a yearly basis, the energy inflation also presented the same pattern with a higher rate of 0.96% (y.o.y) compared to 0.32% (y.o.y) last month. The replacement of subsidy for LPG from commodity-basis to beneficiary-basis also contributed to energy prices inflation. Looking into volatile food prices, a notable correction was presented from 2.32% (m.t.m) last month to 1.30% (m.t.m) this month along with the harvest period for several commodities such as chili. Moreover, government intervention to control commodity prices, such as CPO, combined with the subsidy program for cooking oil also shared a contribution in the slower pace of volatile food prices. On a yearly basis, the volatile food group recorded a slight pick-up from 3.20% (y.o.y) in December 2021 to 3.35% (y.o.y) in January 2022.

All in all, from the perspective of inflation, the recovery effort still remains at least until the end of January. However, the upward trend may last only temporary following the recent surge of Omicron cases. On February 7th, GoI finally implemented social restriction policy (PPKM) in several regions following the high number of daily confirmed cases. Given that decision, society are currently back to pandemic mode where most of activities, such as working and school, are conducted from home. On a more serious note, the preceding impacts will affect the short-term demand and mark another correction to consumer price index.

Longing for A Long-Lasting Rebound

After posting a slowing growth of 3.51% (y.o.y) in Q3 2021, GDP growth was recorded at 5.02% (y.o.y) in the last quarter of 2021, making the overall economy grew by 3.69% (y.o.y). This figure suggested a rebound in the economy from a pandemic slump of -2.07% (y.o.y) in 2020 and lies within the government target of 3.50% (y.o.y) to 4.00% (y.o.y). Almost all sectors reported a positive growth in Q4 2021, thanks to the easing in pandemic curbs after the second outbreak. Of all sectors, transportation & storage and accommodation & food beverages activity

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were the two sectors with the outstanding come back marked by positive growth after being contracted in Q3 2021. As the social restriction (PPKM) were slowly being lifted, business activities in those sectors gradually returned to pre-pandemic level as reflected by the growth of their GDP. Showing the same pattern, from the consumer perspective, household consumption accelerated to 3.55% (y.o.y) in Q4 2021 after being contracted to 1.02% (y.o.y) in the previous quarter.

The improvement of business activities is also confirmed by the soaring needs of import goods, which are mainly consisted of raw and capital goods, with positive growth of 29.6% (y.o.y) in Q4 2021; making annual growth for imports at 23.3% (y.o.y) in 2021. The increase in imports, however, have not dragged down the overall GDP as exports accelerated at faster pace, thanks to gradual recovery of global demand and high commodity prices throughout 2021. Growth of exports was recorded at 29.8% (y.o.y) in Q4 2021 and 24.0% (y.o.y) for FY2021. In nominal terms, the figure of exports and imports are even higher compared to the pre-pandemic level in 2019. It reflects the encouraging sign of economic recovery from the Covid-19 pandemic. At the same time, investment also experienced a significant jump of growth from 3.8% (y.o.y) in Q3 2021 to 4.5% (y.o.y) in Q4 2021 with overall growth of investment at 3.8% in 2021.

Looking at the monthly economic indicators in the beginning of 2022, several indicators continue to display a rather good performance as the rising trend of Covid-19 daily cases just started at the end of January. Purchasing Manager's Index that determines the manufacturing activity, for instance, reported another increase in January 2022 after a slight correction during November to December period. The index stood at 53.7 in January compared to 53.5 in December, signalling a meticulous move toward the reconstruction of the economy. While other countries may currently experience their Omicron peak, Indonesia is currently bracing for third wave as Omicron spreads fast, which may slow or even pause the economic recovery. As of 7^{th} February, Indonesia reported more than 27,000 daily cases (7-day moving average) and many expect that the Omicron wave to peak by the end of February. The unfavourable trend of Omicron outbreak may hamper the performance of manufacturing sector and businesses in Q1 2022. From the social restriction to the temporary halt of production activities, the channel to another hiccup in manufacturing activity may be varied but the impact will manifest as slower performance. Considering the surging trend of Omicron cases, strong rebound in the economy might potentially be disrupted in the coming months due to another pause in economic activity and social aspects.

Rate Hikes Following The Global Inflationary Pressure

The ongoing heat triggered by the inflationary pressure that occurs in several countries might last longer than expected. As a result, other countries, especially the emerging markets, should remain vigilant to any possibilities of rate hikes in the

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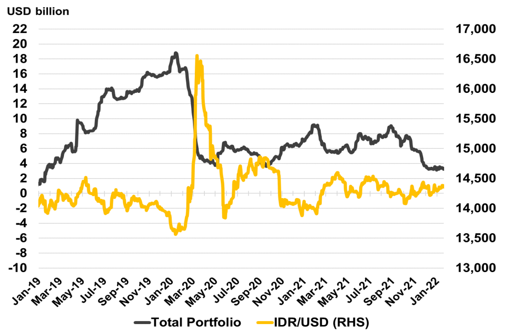
developed countries as it will impact their macroeconomic stability. The UK, for example, has started to raise its policy rate up to 0.5% to manage the mounting inflationary pressure. The European Central Bank (ECB), on the other side, kept the rate unchanged but at the same time announced to prepare several buffering strategies for the economy as they might proceed to increase the rate later this year. Following other tight measures taken by other developed countries, the Fed, at least until February, will keep the rate unchanged but many suspect that they will begin to rise policy rate in March. Jerome Powell in his remarks mentioned that price stabilization amid the soaring inflation will be the main goal of the Fed. Despite the current US labour market situation, the Fed believe that rate hikes will not be harm the US domestic labour market recovery.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)

Source: CEIC

After Powell's remarks on January 26th, a notable amount of outflow was recorded at USD3.45 billion as investors move their assets from the emerging market. The event was also reflected by the higher trend of yield for both 10-year tenor and 1-year tenor in the last week of January, indicating a selloff by foreign investors for both tenors. As a result, the episode of capital outflows pushed Rupiah to IDR14,385 at the end of last month from IDR14,350 in mid-January. As investors continue watching closely global inflation that could trigger rate hikes in major economies and crunch the capital market of developing countries, the risk of capital outflow remains.

Continuing to a weaker trend, Rupiah was still hovering around the depreciation rate of 0.91% (y.t.d) against USD until the beginning of February. The performance was slightly better compared to other emerging peers, such as Argentina or Russia. However, the current Omicron outbreak might possess a volatility pressure on Rupiah due to rising domestic uncertainty. Looking at the level of reserve, a slight correction was reported from USD144.9 million in December to USD141.3 million in January 2022. The lower reserve resulted from the payment of debt and less foreign currency placement in central bank as commercial banks continue to anticipate the higher needs on foreign exchange in the near future. The amount of reserve is equal to finance 7.4 months of imports plus the government's external debt, which is

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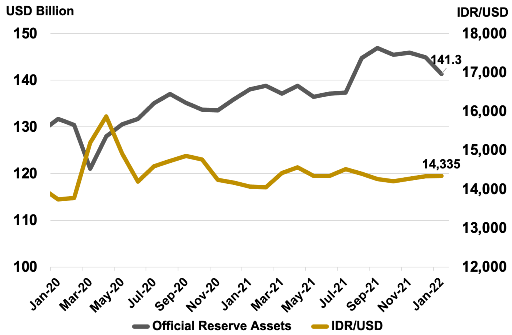
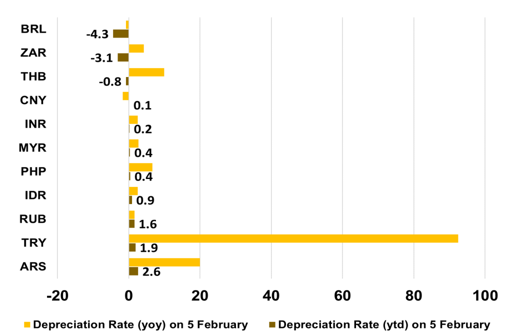
significantly higher than international adequacy standard of only around three months of imports. Considering the number, therefore, BI believes that the reserve is still adequate to weather any external shock that may hamper the stabilization of the currency.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (February 5, 2022)



Source: Investing.com

The impact of sooner-than-expected monetary normalization program taken by developed countries will likely to have a relatively manageable impact on domestic financial sector compared to 2013 taper tantrum. The ongoing tapering off has smaller impact on Indonesia's capital outflow and Rupiah depreciation due to lower share of foreign ownership of Indonesia's asset, the positive trade balance and clearer forward guidance by the Fed. Furthermore, the domestic inflationary pressure is also relatively manageable as the third wave of pandemic may restrain the progress of inflation, which has inched up to BI's target range. Inflation may need a longer time to continue its pick-up trend as restriction policy will hold back consumer confidence. On economic prospect, fortunately, the economic growth rebounded strongly in the final quarter of last year, indicating a relatively stronger domestic fundamental, and hopefully will benefit the future economic condition as a cushion to hinder another possible contraction caused by the ongoing outbreak. Given the relatively manageable impact of ongoing monetary normalization by developed countries on domestic market, temporary pick-up in domestic inflation, and relatively robust domestic fundamental, BI should continue to leave its policy rate on hold at 3.50% this month while maintaining pro-growth macroprudential setting and pro-stability monetary policy.