Macroeconomic Analysis Series

BI Board of Governor Meeting

June 2022

LPEM FEB UI
UNIVERSITAS INDONESIA

Highlights

- BI should maintain its policy rate at 3.50% this month.
- Domestic inflationary risk is still driven by cost-push inflation due to higher global commodity and food prices.
- Despite recorded a trade surplus in May, export performance was heavily disrupted due to palm oil export ban.
- Global monetary tightening triggers capital outflows and depreciation of Rupiah to around Rp14,800.

Macroeconomics & Political Economy Policy Research

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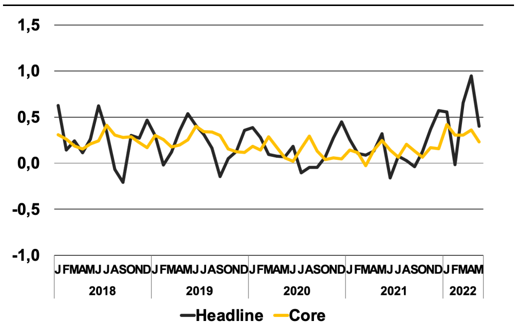
Despite rising global inflationary pressures in most countries due to soaring global food and energy prices and supply chain disruptions, domestic inflation remains under control, mainly driven by supply-side inflation underpinned by higher Producer Price Index (PPI) inflation that has been above Consumer Price Index (CPI) inflation since 2020. Domestically, we are still on a recovery path with robust economic performance and continuing series of trade balance surplus. Externally, the global economic volatility has not subdued, bringing bleak prospects for the global economy. Consequently, many central banks had already moved toward a more "hawkish" stance by raising their benchmark rates and reducing asset purchases to curb elevated domestic inflation, including the Fed, which recently raised its FFR by 75bps. This phenomenon triggers a *flight to quality* and depreciation in EM countries. Rupiah has been depreciated to around Rp14,800. Considering domestic and external circumstances, BI should remain behind the curve for the time being by keeping its policy rate at 3.50% while maintaining accommodative macroprudential measures to support economic growth.

Maintained Inflationary Level

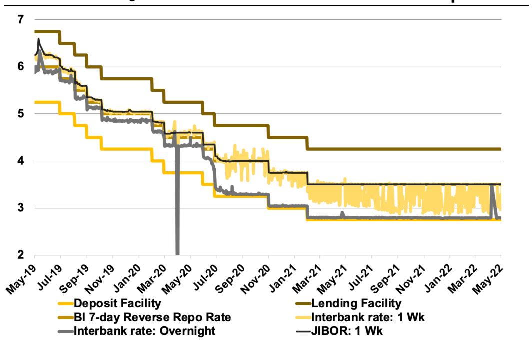
May inflation rate climbed to 3.55% (y.o.y) from 3.48% (y.o.y) in April, the highest record since December 2017. The slight increase in the annual inflation rate was mainly driven by strengthened consumption and higher mobility during the Eid-al-Fitr celebration as well as persistent higher global food and energy prices. The food, beverage, and tobacco expenditure group surged to 5.62% (y.o.y) in May 2022 from 5.20% (y.o.y) in the previous month. Additional upward pressures also came from the transportation group, which rose to 4.77% (y.o.y) due to increasing public mobility, particularly for mass annual homecoming tradition (*Mudik*) during Eid festive period as the GoI eased PPKM. On a monthly basis, headline inflation slightly declined to 0.40% (m.t.m) from 0.95% (m.t.m) in April after passing its seasonal peak during Ramadan and Eid al-Fitr period.

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



Source: CEIC

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



Source: CEIC

Key Figures

BI Repo Rate (7-day, May '22)
3.50%
GDP Growth (y.o.y, Q1 '22)
5.01%
Inflation (y.o.y, May '22)
3.55%
Core Inflation (y.o.y, May '22)
2.58%
Inflation (m.t.m, May '22)
0.40%
Core Inflation (m.t.m, May '22)
0.23%
FX Reserve (May '22)
USD135.6 billion

Looking into its components, May's inflation rate was driven by higher prices of volatile and food ingredients, respectively recorded at 6.05% (y.o.y) and 5.93% (y.o.y). The soaring strategic global commodity prices like wheat, flour, and soybean that are escalated from Russia's invasion of Ukraine continued to affect domestic food prices. In contrast, the monthly volatile food inflation rate declined to 0.94% (m.t.m) from 2.30% (m.t.m) in April, which was mainly influenced by the deflation of cooking oil prices in line with the implementation of a temporary export ban on CPO and some of its derivative products as well as food prices normalization post Ramadan and Eid festivities. Meanwhile, the annual core inflation rate barely changed in May from a month earlier, standing at 2.58% (y.o.y), slightly declined from 2.60% (y.o.y) due to the seasonality correction after Ramadan. The core inflation was significantly improved since the beginning of this year that was recorded below the bottom target of 2%. It reflects stronger purchasing power as GoI was confident in controlling Covid-19 and thus took a relaxed approach to social mobility restrictions. Lastly, administered price remained high and stable at 4.83% (y.o.y) caused by normalization of transportation prices after Eid-al-Fitr, but offset by the imposition of fuel surcharges by airlines.

Overall, despite the rising global inflationary pressures seen in most countries due to soaring global food and energy prices and supply chain disruptions, domestic inflation remains under control within BI's target range of 2% to 4%. We see that domestic inflationary risk is still driven by cost-push inflation due to higher global commodity and food prices underpinned by higher Producer Price Index (PPI) inflation that has been above Consumer Price Index (CPI) inflation since 2020. This suggests that sooner or later, the risk of supply-side inflation will be passed through to the demand-side inflation, given that producers now face rising input prices. Yet, the GoI has decided to inject additional energy subsidies in order to "absorb" inflation in the 2022 state budget, implying that the price hike of subsidized fuel, LPG, and electricity could be delayed this year. At this juncture, this decision should lead to weaker inflationary pressure and support the economic recovery. On the one hand, as rising commodity prices will benefit Indonesia's trade position, the additional revenues from a commodities export windfall could be utilized to cover the increased spending for subsidies.

Welcoming the Optimistic Economic Recovery

We are still on a recovery path with a robust economic performance of 5.01% (y.o.y) in the first quarter of this year, considering the manageable impact of the Omicron variant at the beginning of the year. Learning from the tumultuous period of the Delta variant, the GoI has been more prepared for the Omicron variant through swift policy responses and successfully kept the cases subside. Moreover, the vaccination rate has continued to increase with more than 80% of the population has received the 2nd vaccine doses and 23.3% of population has received the 3rd doses. With the

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encouraging economic development and receding Covid-19 cases, GoI has gradually loosened the mobility restrictions (PPKM) and allowed *Mudik* tradition during Eid festivities in May to resume after a two-year delay due to the pandemic. As a result, the Consumer Confidence Index (CCI), which reflects people's confidence in their income and future spending, has been continuing its upward trend to 128.9 in May from 113.1 in April.

Yet, as we are marching towards a more robust recovery, the external pressures keep heating and might ruin the recovery track. This can be seen in the Manufacturing Purchasing Managers' Index (PMI), which was at 50.8 in May, contracted from 51.9 in the previous month. The slowdown in May's PMI figure was influenced by various factors but primarily due to supply chain disruptions. The long Eid holiday in the first week of May 2022 becomes one of the domestic factors that disrupt the supply chain of the industrial sector. From external factors, the ongoing geopolitical conflict and the Covid-19 social restriction policies in China have suppressed the flow of supplies and the delivery time of goods into Indonesia. Consequently, the manufacturing sector held back in optimizing its production capacity. Moreover, the ongoing high prices of input goods added fuel to pressure on the production activity.

The latest foreign trade balance data showed that Indonesia still recorded a surplus of USD2.90 billion in May, down from the all-time high of USD7.56 billion in April. The higher value of exports (USD21.51 billion) compared to imports (USD18.61 billion) has maintained monthly trade surpluses since May 2020. The export performance showed a slight unfavorable pattern as export growth weakened to 27% (y.o.y) compared to 47.7% (y.o.y) in April. Even harder, the monthly growth of export down by -21.29% (m.t.m). As expected, export performance was heavily disrupted by the palm oil export ban imposed by GoI between 28 April and 23 May 2022 to stabilize the domestic cooking oil prices. Consequently, the export value of animal/vegetable fats & oil declined substantially by -71.8% (m.t.m) or USD2.15 billion compared to April figure. On the one side, higher commodity prices are always a blessing for Indonesia's trade as commodities dominate our exports, particularly CPO and coal as the main commodities contributing to the windfall, thus prolonging the series of trade surplus and current account surplus. Since export performance was mainly supported by price instead of volume, the GoI should formulate structural reform to shift into highly value-added exports as the commodity boom period could be corrected anytime, especially when the Russia-Ukraine conflict ends. Meanwhile, the monthly growth of import declined by -5.81% (m.t.m) but annual growth of import increased by 30.74% (y.o.y), jumped from 21.97% (y.o.y) in April. This indicates that business activities slowed down in May compared to April, but the overall performance of imports in May reflects the ongoing domestic economic improvements compared to last year, as the majority of imports are raw and capital goods.

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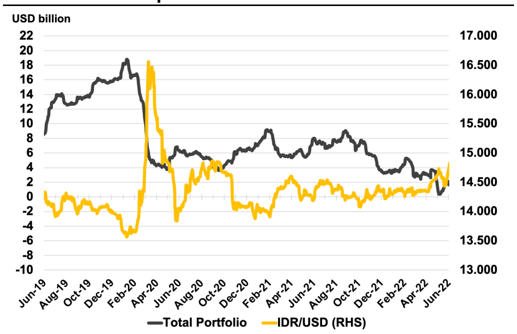
Staying Behind the Curve

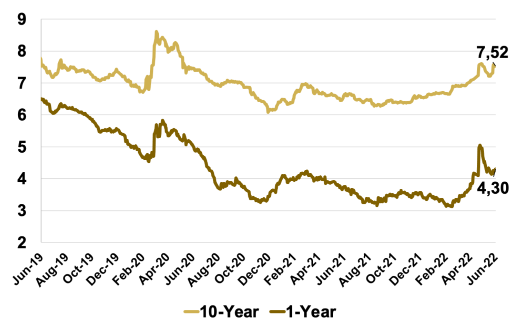
From external situations, the global economic volatility has not subdued and even unfolds, bringing gloomy prospects for the global economy ahead. The prolonged tension between Russia-Ukraine adds to the series of supply shocks that have been larger and lasted longer than anticipated. The lockdowns in China are also likely to exacerbate the ongoing supply chain disruptions. Furthermore, food trade protectionism that emerged in several countries such as India and Indonesia are also contributing to higher price pressure globally. Like seismic waves, the current unfavorable global circumstances have dire impacts, particularly creating additional upward pressure on inflation and lower growth expectations in many countries. As a consequence, many central banks had already moved toward a more "hawkish" stance by raising their benchmark rates and reducing asset purchases to curb elevated domestic inflation. As expected, the Fed takes more aggressive action to fight against high inflation by continuing to increase its FFR by 75bps from 0.75-1.00% to 1.50%-1.75% in June's FOMC meeting, largest hike since 1994 and resulting in a 150bps increase so far this year. In the global capital market, the Fed's monetary tightening has resulted in an improvement in the US treasury yields when compared to other countries. This led to a sudden stop risk, a short-term reversal of foreign assets by investors, in which they move their assets from risky investments to safer instruments (*flight to quality*). The phenomenon contributed to the continuation of capital outflows from EM countries since early June. In Indonesia, the total outflow reached USD1.82 billion in a month and rising yields of 10-Year and 1-Year government bonds to 7.52% and 4.30% in mid-June from 7.24% and 4.10% in mid-May, respectively.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

The monetary tightening initiated by the Fed and most central banks has led to exchange rate depreciation in most countries, including Indonesia. Current data showed that Rupiah has weakened to around Rp14,800 in mid-June from around Rp14,500 in the previous month. Nevertheless, Rupiah only depreciated by 4.1% (ytd), lower than the depreciation of Malaysian Ringgit (5.7%), Philippine Peso (6.1%),

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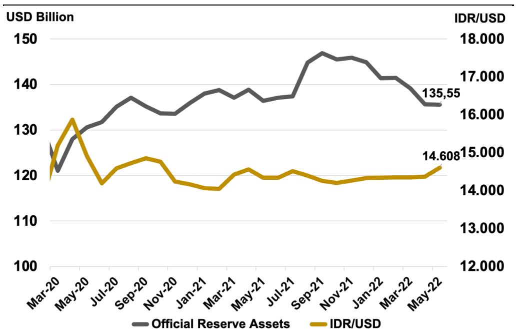
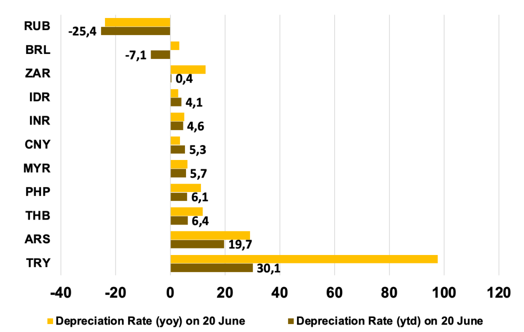
and Thailand Baht (6.4%). The relatively manageable exchange rate was supported by the high foreign reserves. Despite slightly decreasing from USD135.7 billion in April to USD135.6 billion in May, the forex reserves are still adequate to cushion any turbulence as the reserves are equivalent to 6.6 months of imports and payments of the government's foreign debts. It is also 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 20, 2022)



Source: Investing.com

Amidst the high degree of global uncertainty, domestic economic conditions appear to be going on track with improvement seen in aggregate demand on the back of increasing public mobility and production activity. Although headline inflation is gradually rising, core inflation remains benign and manageable. Despite the slight depreciation, Rupiah is currently stable, partially supported by the relatively high forex reserves and the higher commodity prices that helped to prolong the series of trade and current account surplus. Considering both domestic and external circumstances, we see that BI should not be in a rush to increase its policy rate as any monetary tightening now would jeopardize the progress of economic recovery. Hence, the right timing for BI to raise the benchmark rate is once the inflationary level fundamentally and substantially increases. Regardless, BI needs to closely monitor the Fed's and other countries' monetary tightening, which may result in capital outflows and Rupiah depreciation. Meanwhile, in order to normalize liquidity, BI gradually tightened Reserves Requirement Ratios (RRR) for banks, which went into effect on 1st June, as it seeks to withdraw excess liquidity without hurting the recovery progress. Overall, to maintain exchange rate and price stability, for now, BI should stay behind the curve by maintaining its policy rate at 3.50% while continuing the macroprudential measures to remain accommodative to support economic growth.