Macroeconomic Analysis Series

BI Board of Governor Meeting

July 2022

LPEM FEB UI
UNIVERSITAS INDONESIA

Highlights

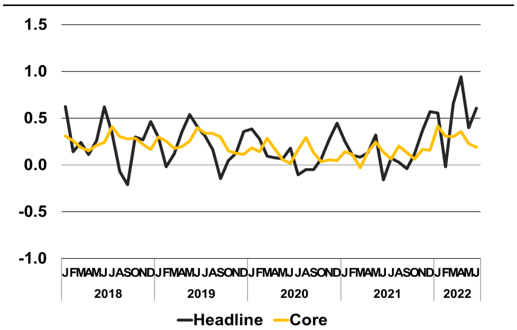
- BI should maintain its policy rate at 3.50% this month.
- Domestic inflationary pressure comes primarily from increasing trend of volatile price, while core inflation remains under-control.
- Trade surplus reported a significant increase in June 2022 as GoI lifted the export ban for CPO products.
- The ample foreign reserve helps to maintain the shock toward exchange rate, sufficient to keep Rupiah in a rather safe position.

Despite exceeding past BI's target, the surge in prices in June 2022 is mainly cost-push, primarily driven by price of volatile commodities. On the other hand, core inflation stood at a rather safe rate under the BI's target. Looking at the macroeconomic indicators, economic recovery appeared to be on track, indicated by the level of CCI, which was still reported in optimistic territory. The windfall from higher commodity prices also benefited trade performance, reflected by an immense surplus. The enduring risks from the external sector, however, continued to cast a shadow over the domestic market condition. A continuing strong performance of USD also added fuel to the heat of external pressure. The result was then quite obvious as evidenced by a substantial outflow and the depreciation of Rupiah. However, BI should not be in a rush to tighten its stance as it may delay economic growth. Therefore, we see that BI should continue to maintain its policy rate at 3.50% while closely observing the external dynamics.

Volatile Commodities Heat The Inflation

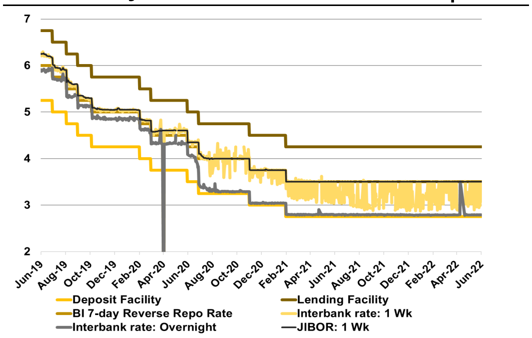
Following the rising trend of global prices for energy and food commodities, mainly driven by the disrupted global supply chain coupled with prolonged geopolitical issues between Russia and Ukraine, many countries have been experiencing rising inflation. In Indonesia, June headline inflation rate increased to 4.35% (y.o.y), substantially higher compared to 3.55% (y.o.y) in May 2022. This figure is an all-time high since June 2017 and breaching BI's target range of 3.0±1%. Among all expenditure groups, food, beverage, and tobacco prices continued their rising trend that has been recorded since February 2022 and posted an immense hike of 8.26% (y.o.y) relative to 5.62% (y.o.y) in previous month. In addition, transportation also shared an aggressive surge with 5.45% (y.o.y) compared to 4.77% (y.o.y) in May 2022. This is particularly driven by higher frequency of mobility, thanks to the relaxation of social restriction policy. Higher global and domestic prices are also recorded on monthly basis inflation, which slightly increased to 0.61% (m.t.m) relative to 0.40% (m.t.m) in May 2022.

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



Source: CEIC

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



Source: CEIC

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

Key Figures

BI Repo Rate (7-day, June '22)
3.50%
GDP Growth (y.o.y, Q1 '22)
5.01%
Inflation (y.o.y, June '22)
4.35%
Core Inflation (y.o.y, June '22)
2.63%
Inflation (m.t.m, June '22)
0.61%
Core Inflation (m.t.m, June '22)
0.19%
FX Reserve (June '22)
USD136.4 billion

Observing its component, volatile goods was the main driver of June yearly inflation as it recorded a sky-rocket level of price increase at 10.07% (y.o.y) compared to 6.05% (y.o.y) last month and 1.06% (y.o.y) in June 2021. On a monthly basis, the prices of the volatile goods increased 2.51% (m.t.m) from a month earlier at 0.94% (m.t.m) in May 2022. The rising price of volatile food commodities, such as red chili, onion, and egg, was triggered by limited supply due to excessive rain. In addition, export restriction policies for fertilizers imposed by 25 countries caused fertilizer prices to double, which partially contributed to the spike in prices of the volatile commodities. On the other hand, the administered price stood at 0.27% (m.t.m) from 0.48% (m.t.m) last month, as the impact of government subsidies for energy started to take place and subdued the inflation from airfare.

Looking at the inflation data, June's inflation was primarily cost-push, driven by the surge in volatile goods prices. GoI has made several efforts to control prices while simultaneously attempting to maintain purchasing power, such as through the disbursement of energy subsidies, which is expected to reach IDR502.4 trillion in 2022. Additionally, the windfall from commodity prices also contributed to extra income for GoI with higher tax revenue. The benefit shall allow GoI to establish an extra buffer in the form of other subsidies to keep the purchasing power intact. Aside from subsidies, the GoI has also executed a remarkable plan to control the price of cooking oil. The result was then reflected by a moderate decline of bulk and packaged cooking oil in June 2022, stopping monthly inflationary pressure with 0.02% deflation. As a result, even though the prices continued to rise, all efforts made by GoI have contributed to maintaining inflation relatively manageable.

Furthermore, core inflation, which reflects people's purchasing power, marked a slight increase to 2.63% (y.o.y) in June compared to 2.58% (y.o.y) in May 2022. On a monthly basis, however, the core inflation decreased to 0.19% (m.t.m) from 0.23% (m.t.m) last month, which was induced by a lower trend in gold price. It reflects that core inflation remains manageable and expected to display a slower pace ahead due to the rising trend of Covid-19 cases that may call for a stricter health protocol.

Economic Recovery Stays on Track

Two years on, while the Covid-19 pandemic is perhaps far from over, the ongoing economic recovery looks promising. Despite the enduring risks of the virus, as well as its new variants that followed, a swift response by policymakers along and the high vaccination rate have successfully resulted in well-arranged economic activities. Notwithstanding the low-base effect, in the first quarter of 2022, Indonesia marked a robust growth of 5.01% (y.o.y). Additionally, the considerably high-income population has become more confident toward their perception of income, future spending, and job availability, as presented in the second quarter of Consumer Confidence Index (CCI) at a relatively steady level of 123.4 compared to 114.6 in

Key Figures

BI Repo Rate (7-day, June '22)
3.50%
GDP Growth (y.o.y, Q1 '22)
5.01%
Inflation (y.o.y, June '22)
4.35%
Core Inflation (y.o.y, June '22)
2.63%
Inflation (m.t.m, June '22)
0.61%
Core Inflation (m.t.m, June '22)
0.19%
FX Reserve (June '22)
USD136.4 billion

previous quarter. On a monthly basis, while still in the optimistic territory, CCI in June 2022 experienced a benign contraction to 128.2 from 128.9 in May 2022.

Conversely, the Purchasing Managers' Index (PMI) has slowed to 50.2 in June from 50.8 a month earlier, approaching the contraction level (<50). This month's level was the lowest since 10-consecutive months of expansion period (>50) in Indonesia's manufacturing sector. Compared to other developing countries, such as Malaysia (50.4), Vietnam (54.0), and Thailand (50.7), the PMI level of Indonesia in June was the lowest. Several reasons have contributed to the lower level of PMI, but global inflation was the primary factor pushing up the cost of production through higher prices of imported materials. Further, the inflationary pressure also contributed to the shrank in new orders, especially from foreign sales. In addition, examining the domestic factor, the increasing value added tax (VAT) from 10% to 11% remarkably raised the final price, decreasing the production level because of less demand from the consumer.

Looking at the international trade activity, the windfall from commodity prices bolstered Indonesia's export performance as it recorded another surplus of USD5.09 billion. This amount was extensively higher than last month's surplus, which stood at USD2.90 billion. Among all trade performances, exports of non-oil and gas products, such as CPO, mainly supported the surplus with an increase to USD24.56 billion in June, jumping aggressively from USD20.01 billion a month earlier. This resulted from the lifting of export restriction policy for CPO product that instantly allow the producers to increase their foreign sales, albeit the relatively lower price compared to it was in May. Import performance of non-oil and gas also drew a similar increasing pattern, which was reflected by higher growth of 16.15% (y.o.y). This indicates that recovery plans for the economy remain on track, as the import in non-oil and gas sector mostly consists of input materials. On a monthly basis, imports in the non-oil and gas sector reported a subtle growth of 13.6% (m.t.m) due to the ongoing inflationary pressure that raised input materials prices. The global inflationary pressure on energy also put an uprising trend for the import of oil and gas. Unfortunately, as imports expanded faster than exports, oil and gas experienced another deficit of USD2.14 billion in June 2022 compared to USD1.86 billion in May 2022. Overall, despite great trade surplus in June 2022, GoI should stay alert as the commodity prices, especially coal and CPO as Indonesia's main export, have started to appease while the following impact of inflation appears to last longer along with the ongoing external fluctuations.

Prolonged External Pressures

The external pressure has been shadowing the domestic situation with bleak circumstances and most likely will remain longer than many would expect. The supply chain disruption persists, exacerbated by the geopolitical tension between Russia and Ukraine that currently has no end in sight. The combination of events has

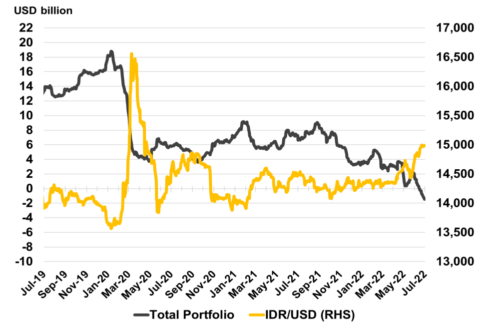
Key Figures

BI Repo Rate (7-day, June '22)
3.50%
GDP Growth (y.o.y, Q1 '22)
5.01%
Inflation (y.o.y, June '22)
4.35%
Core Inflation (y.o.y, June '22)
2.63%
Inflation (m.t.m, June '22)
0.61%
Core Inflation (m.t.m, June '22)
0.19%
FX Reserve (June '22)
USD136.4 billion

successfully put the global price on a high level of heat as it is happening in many countries. Unfortunately, it seems that inflationary pressure on a wide range of goods is only the beginning of cataclysm that follows. Many developed countries pulled an aggressive action to pick up their interest rate with high expectancy in absorbing the excess liquidity and, therefore, curb inflation. Among all countries, the specific move from the Fed is highly anticipated, especially by the developing countries that may experience the impact in the form of capital outflow. After the last FOMC meeting held in June, the Fed significantly rose the FFR by 75 bps to 1.50%-1.75%. This rate was tremendously higher than many had expected at 50 bps. Yet, even after the aggressive step, the US CPI inflation continued to crawl up and hit its highest level in 40 years of 9.10% (y.o.y), making it substantially harder to curb inflation without risking a recession.

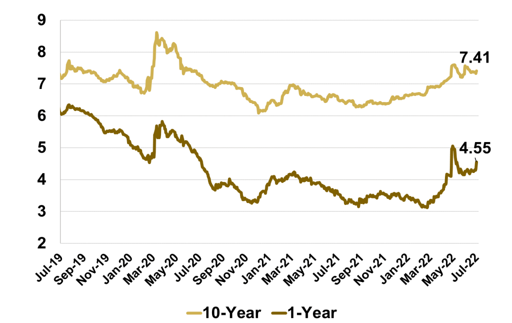
In Indonesia, the bold move from the Fed has resulted in notable outflow from mid-June to mid-July, which was reported at approximately USD3.1 billion. The outflow has mainly come from bonds, which accounted at USD2.17 billion, while the outflow from stocks was USD930 million. Examining the other macro-variables, these massive outflows contributed to the narrowing yield gap of 10-year and 1-Year government bonds, which indicates lower confidence and a rather unfavourable sentiment from investors upon longer-term investment.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

Following the pace of tight monetary policy, the recent hike of FFR also adds an extra pressure to the appreciation of USD that is soaring across many countries. The highlighted phenomenon reported last week as the greenback touched the parity point with Euro after 20 years. Several developing countries are also throttled by the depreciation against USD, including Indonesia. According to the current data, Rupiah weakened to around IDR14,900 in mid-July relative to IDR14,800 in prior month. However, Rupiah still presented a relatively favorable performance with depreciation rate of 5.21% (ytd) compared to its peers, such as Malaysian Ringgit (7.02%) and Thailand Baht (10.34%). This is also supported primarily by the strong position of foreign reserve, which helps to maintain the shock toward exchange rates,

Key Figures

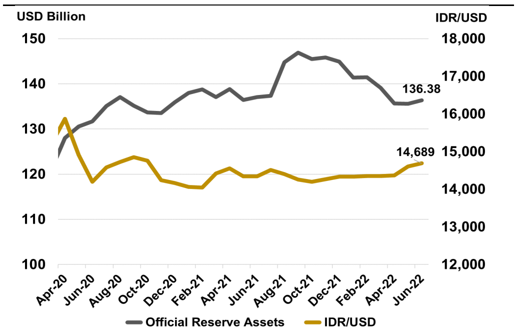
BI Repo Rate (7-day, June '22)
3.50%
GDP Growth (y.o.y, Q1 '22)
5.01%
Inflation (y.o.y, June '22)
4.35%
Core Inflation (y.o.y, June '22)
2.63%
Inflation (m.t.m, June '22)
0.61%
Core Inflation (m.t.m, June '22)
0.19%
FX Reserve (June '22)
USD136.4 billion

To keep you updated with our monthly and quarterly reports, please subscribe. Scan the QR code below

or go to http://bit.ly/LPEMCommentarySubscription

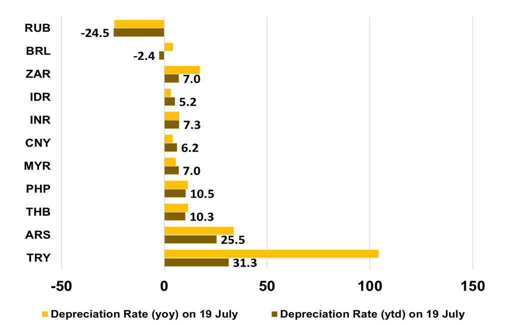
especially. The reserve position in June remained at a strong point with an accelerated trend of USD136.4 billion from USD135.6 billion in May 2022 and is equivalent to 6.6 months of imports or 6.4 of imports plus payments for the government's foreign debt.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (July 19, 2022)



Source: Investing.com

Rewinding, the series of pressure from both domestic and external have significantly formed the economic condition in June 2022. Internal factors show that the recovery effort remained on track despite a few corrections during the normalization period after Eid festivities. The inflationary pressure, despite mounting, still on a relatively better condition compared to other countries. Besides, the core inflation was still hovering at the safe level within the BI's target. From the external side, the impact of an aggressive decision from the Fed has put an additional burden that may jeopardize the domestic recovery effort. From massive amount of outflow to depreciation of Rupiah, the next move from the Fed could instantly be translated into a rather troublesome effect and, therefore, should be well-anticipated.

Considering all factors BI might have some privilege to delay a more aggressive monetary tightening. Aside from relatively manageable core inflation and robust growth in Q1-2022, the windfall from commodity prices could buffer the economic condition from a sudden shock. In addition, the adequate amount of foreign reserve may help maintaining the depreciation rate of Rupiah against other currencies. Meanwhile, to absorb the excess liquidity in the market, BI has also gradually increased Reserve Requirement Ratio (RRR) and the process will continue until September 2022. Therefore, we view that BI should maintain its policy rate at 3.50% this month to support current economic recovery momentum while carefully observing the global trend and preparing anticipatory policy measures to keep the economy growing on track.