LPEM FEB UI
UNIVERSITAS INDONESIA

Macroeconomics Analysis Series

Indonesia Economic Outlook

Q3-2022

Key Figures

GDP Growth (Q1 '22)
5.01%

Inflation (y.o.y. July '22)
4.94%

Credit Growth (y.o.y. Q1 '22)
6.27%

BI Repo Rate (7-day, July '22)
3.50%

Current Account Balance (%GDP) (Q1 '21)
0.1%

IDR/USD (July '22)
IDR14,984

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The Next Episode: Stagflation

Highlights

- *The recovery in demand coupled with the low-base effect from the previous year has led to positive growth of 5.01% growth (y.o.y) in Q1-2022.*
- *Following the gradual rebound from the pandemic, we predict GDP to continue to grow at 5.07% (y.o.y) in Q2-2022 and 5.00% for FY2022.*
- *Easing social mobility restrictions together with faster vaccination rollout supported significant growth in household consumption, which was one of the main drivers of economic growth.*
- *The annual inflation rate of 4.94% (y.o.y) in July 2022 was recorded as the highest inflation rate since October 2015.*
- *Despite the external pressures that could lead to the combination of slowing economic growth and rising inflationary pressures, Indonesia's real sector data shows that consumer and producer activities remain resilient.*
- *Commodity prices windfall has bolstered export performance, thereby cushioning the volatility in capital and foreign exchange markets.*
- *The soaring commodity prices has provided fruitful momentum to government revenue, with income reaching 58.1% of FY-2022 state budget in the first half of the year.*
- *Indonesian Rupiah depreciated over US dollar by 5.39% (ytd) to IDR15,030 in late July.*
- *Indonesia's capital outflow reached USD5.12 billion at the end of July compared to early March, with a massive net sell-off in bonds assets while the stock market continued to record net buy.*
- *The GoI may have larger fiscal space to expand fiscal stimulus in order to delay the inflation rise while the recovery momentum is building up.*

The auspicious progress in the domestic public health situation has transpired into a solid GDP growth of 5.01% (y.o.y) in Q1-2022. In the first half of 2022, Indonesia was in an advantageous position to face the latest global economic turmoil. Thanks to the combination of good policy and good luck, first, a rapid buildup of economic activity. Major economic sectors, such as manufacturing, wholesale & retail trade, construction, and ICT, contributing to around 50% of GDP, recorded a rising growth in Q1-2022. In addition, sectors relied on physical activities, such as transportation & storage and accommodation & FnB showed substantial improvement due to the relaxation of social restriction policies. The economic recovery was also reflected in household consumption with 4.34% (y.o.y) growth in Q1-2022, higher compared to the last three months of 2021. Household consumption will most likely grow greater in Q2-2022 due to the momentum of Ramadhan and Eid Al-Fitr. At the same time, total credit continued to accelerate along with demand recovery. Moreover, all other expenditure components, investment and exports, also recorded positive growths in the same period.

The investment realization in Q2-2022 was recorded at an all-time high in a decade, with the major contributor coming from manufacturing sector. It indicates that investors' confidence was still very high. The exports have also recorded noticeable improvements in the last one year, with overall trade surplus in Q2-2022 at USD15.6 billion. The soaring commodity prices brought fruitful momentum for export figures as Indonesia is net exporter of major enegry commodities. The trade surplus in goods, hence, provided sound current account surplus. Furthermore, the persistent trade surpluses have cushioned the effect of monetary tightening on capital outflow and depreciation as higher exports than imports indicate more foreign exchange liquidity in the market. As importantly, lower foreign ownership of financial assets has blessed Indonesia with adequate capacity to absorb global shock relative to other countries thus far, especially in terms of inflation and currency volatility. Even though increasing, inflation remains relatively moderate and muted than elsewhere. Indonesia's inflation was recorded at 4.94% (y.o.y) in July 2022, while core inflation was at 2.86% (y.o.y) in the same period.

Table 1: LPEM FEB UI GDP Growth Forecast (y.o.y)

Q2-2022	FY 2022
5.04% - 5.09%	4.95% - 5.05%

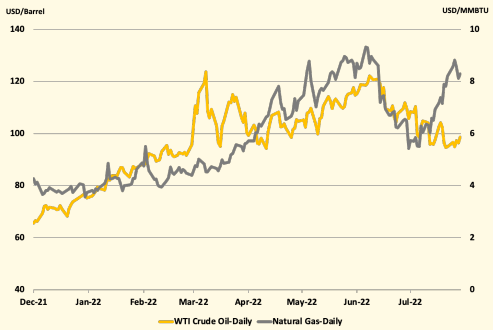
Aside from the favorable figure for economic activity in 1H-2022, the ongoing pressures stemming from escalating geopolitical tension, global monetary tightening, and rising commodity prices, have not been fully materialized yet. The inflationary pressures persist, particularly related to global commodity and food prices. The rising commodity prices and geopolitical tensions have slashed the outlook for global economic growth. It has been observed in countries across the globe that the development of economic activity and inflation data provides stronger indicatives of upcoming stagflation is getting nearer on the horizon. However, we see that the bleak outlook is somewhat less visible when observing the domestic economic condition. Massive profit windfall stemming from rising commodity prices enables the GoI with privileges to expand the fiscal stimulus in order to delay the inflation rise while the recovery momentum is building up. Therefore, the consumption and production activities will still be going safe. Thus, we predict GDP will continue to grow at around 5.07% (y.o.y) in Q2-2022 (estimate range from 5.04% to 5.09%) and 5.00% growth for FY2022.

The Toxic Mixture of Inflation and Recession

Another Episode of Precarious Recovery

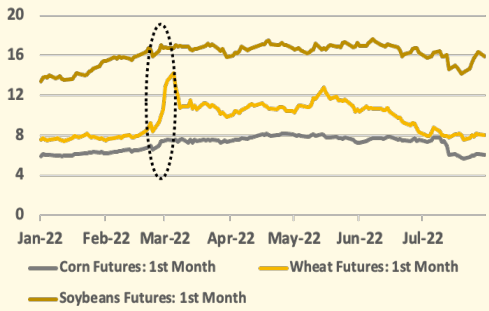
After two years of supply chain disruption, dark clouds of global manufacturing are still on the horizon. The Global Manufacturing Purchasing Managers' Index (PMI) fell from 52.3 in May to 52.2 in June 2022, being the lowest level recorded since August 2020. The subdued performance of the manufacturing sector was majorly impacted by the downturn in Chinese manufacturing output, as the new Covid-19 wave in recent months affected production in the world's largest industrial nation. There was a further decline in output in China, which resulted from factory closures during the lockdown. When China's factory activity finally started to recover in June, the slowdown actually occurred in several other countries, such as Japan, South Korea, and Taiwan. Meanwhile in other parts of the world, as conditions return to their old 'normal' once the Covid-19 pandemic begins to recede, companies are having difficulty finding new employees. As the economy reopens after the lockdown, reports of employers unable to find the workforce they need are becoming more frequent. Reasons vary from workers being afraid to return to work, moving out of the area, or being incentivized to stay out of work due to unemployment insurance. In addition, there are several current shipping issues impacting freight costs and shipping delays. The incidents of supplier delays occurring in many areas, leading to an unprecedented lengthening of global supply chains as suppliers have simply not been making and shipping goods.

Figure A: Oil & Gas Price (USD/Barrel & USD/MMBTU)



Source: Investing.com

Figure B: Wheat, Corn, and Soybean Price (USD/Bushel)



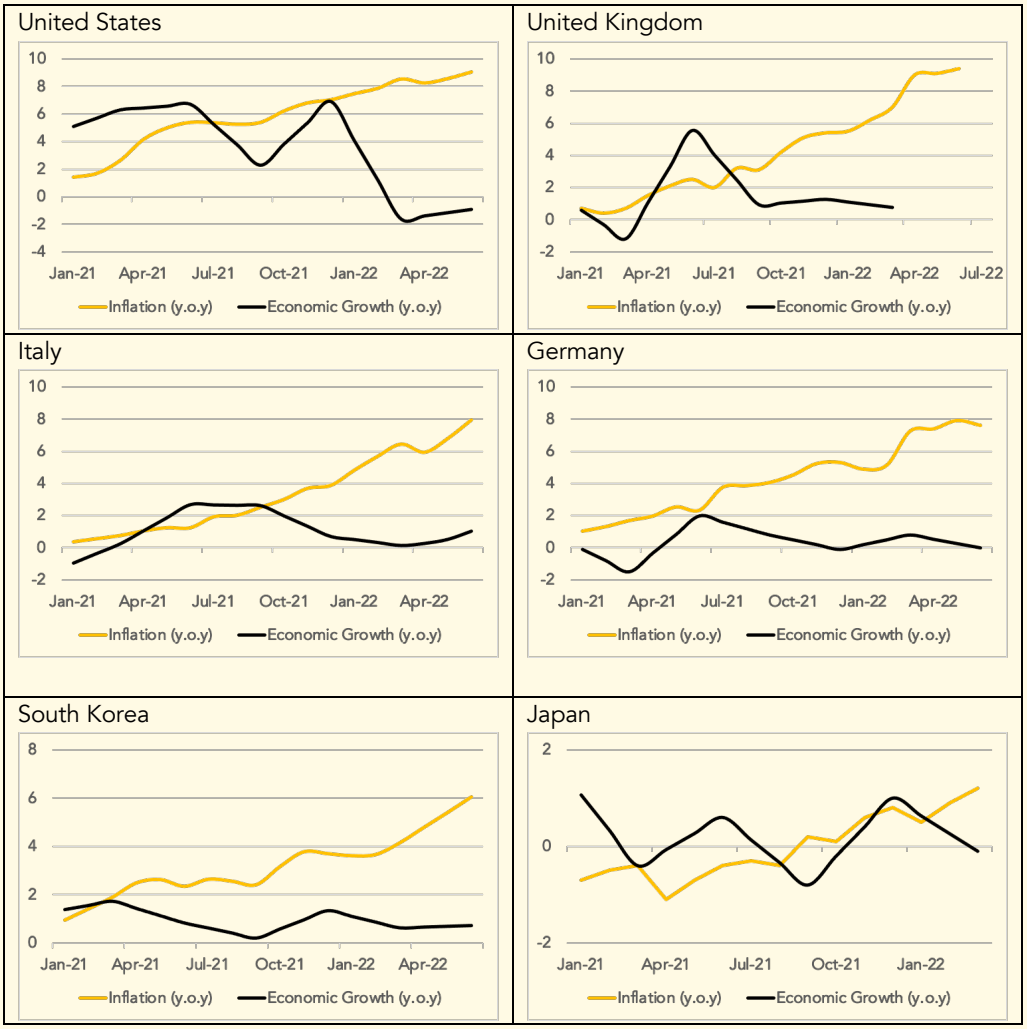
Source: Investing.com

Aside from supply-chain chaos, energy and food commodity prices have also climbed up, especially since Russia's invasion of Ukraine. There was an increase in the price of natural gas from USD5.42 in June 2022 to USD8.29 in July 2022. While still higher compared to closing price on 23 February, the day before Russia invaded Ukraine, the price of WTI Crude Oil in July 2022 was recorded at USD98.62, lower than the previous month of USD106.22. Same thing happened to the price of food commodities, such as corn, wheat and soybean. Both commodities recorded a slight decline in prices, although they were still relatively high and well above the pre-pandemic level.

With supply chain disruptions still haunting the global market exacerbated by Russia's invasion of Ukraine, which also caused worldwide energy and agricultural commodity prices to soar, many believe that the risk of stagflation, a combination of economic stagnation and rising prices, is

currently lingering. In June 2022, the World Bank slashed its global growth forecast to only 2.9% in 2022 from 5.7% in 2021, significantly lower than 4.1% that was anticipated in January 2022. Recently, IMF also cut its global growth forecast to 3.2% in 2022, 0.4 percentage point downwards from the previous forecast in April 2022. Fading pent-up demand, as well as withdrawals of fiscal and monetary stimulus of Covid-19 pandemic, are also expected to contribute to slower global growth. Apart from sluggish economic growth, the world is also facing rising inflation amid high global commodity prices as negative spillovers from the invasion of Ukraine. For instance, US inflation jumped 9.1% (y.o.y) in June 2022, a fresh four-decade high, breaching all estimates. June's CPI in the UK also rose by 9.4% (y.o.y), slightly above a consensus forecast, as energy and food prices continue to increase. Japan also saw its inflation higher than BOJ's target for a third consecutive month in June 2022 at 2.2% (y.o.y). This figure excludes volatile food costs but includes energy costs.

Figure C: Inflation (y.o.y) and GDP Growth (y.o.y) in Selected Countries, 2021 - 2022



Note: GDP growth is calculated using linear interpolation
Source: CEIC

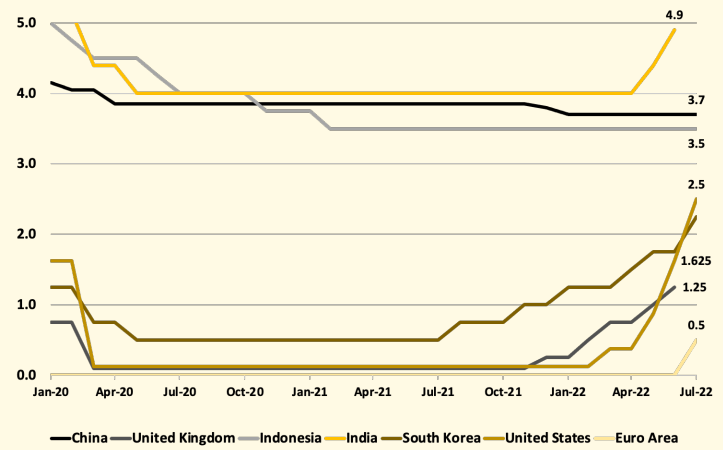
The US and Eurozone are two regions with increasing stagflation risks. Lingering supply constraints and unfavourable effects from the war in Ukraine continue to push energy and food prices up. Consumer price inflation hit 9.1% in June 2022, a 40-year high and above the consensus view. Breaking down its component, the rising prices are caused by higher energy prices (42% y.o.y) and food prices (10% y.o.y). In addition, the job market in the US indicates a

softening, suggested by rising unemployment claims as more firms announced job cuts with increasing fears of a recession. The unemployment claims application rose by 7,000 to 251,000 in the week ended 16 July, hitting an eight-month high. The rising prices and hawkish moves by the Fed to fight inflation are expected to pressure economic activities in the US. The Eurozone also tells a similar story. Due to its heavy reliance on Russian energy imports, relatively high exposure to exports to Russia, and the heightened uncertainty caused by the dangers of the war developing into a more extensive European conflict, the Eurozone is hugely exposed to the negative spillovers from the conflict in Ukraine. Russia provided about 40% of the oil and gas used in Europe in 2021, according to the International Energy Agency. If Russian energy supplies were cut off more suddenly, the EU would be forced to limit energy, which would push up energy prices and seriously harm the economy.

Responding to the soaring inflation, major central banks had no other option than to be in their aggressive stance despite the cost to economic growth and labour market. The Fed raised its benchmark rate by 75bps to a range of 2.25%-2.5% in July 2022, the biggest increase since 1994. At its meeting on 15 June 2022, the Bank of England also increased the Bank Rate by 25bps to 1.25%, a fifth consecutive rate hike to rein in soaring inflation. Similar to the two central banks, the European Central Bank also decided to raise its interest rate by 0.5% in its first rate hike in 11 years. The main borrowing rate went from 0% to 0.5% on 27 July 2022.

The current development is analogous to the early 1970s. Back then, the stagflationary period started following the global recession in 1975, just like how the global economy is currently recovering from the pandemic-induced recession. The average annual global inflation rate from 1973 to 1983 was 11.3%, more than three times the average yearly rate of 3.6% between 1962 and 1972. Other than that, the global supply shocks resemble the oil shocks in 1973 and 1979-1980, although the magnitude of price changes differs. Both then and today, monetary policy was generally very accommodative in the years leading up to these shocks. The current episode, however, also differs from the 1970s in several ways. Oil price shocks caused inflation in the 1970s due to an embargo led by OPEC, while today, both energy and food price increases due to the combination of supply chain disruptions and the Russia-Ukraine war. The price of oil rose by almost 300% by the end of an oil embargo in March 1974, compared to 32.2% (y.o.y) oil price increase as of 22 July 2022. More crucially, in contrast to the 1970s, central banks in advanced and many emerging economies now have explicit mandates for price stability, and they have developed a credible track record of hitting their inflation targets during the last three decades.

Figure D: Interest Rate Comparisons by Country (%)



Source: Trading Economics

Is Indonesia Heading towards Stagflation?

Compounding the damage from Covid-19 pandemic, the escalating geopolitical tension in the form of Russian invasion to Ukraine has exacerbated the slowdown in the global economy. Similarly, the rising global price on energy commodities since the second half of 2021 has intensified and the trend has also been spreading to agricultural products as the repercussion of the war. The combination of economic growth decline and rising inflation tension creates a toxic mixture of stagflation. It has been observed in countries across the globe that the development of economic activity and inflation data provides stronger indicatives of upcoming stagflation is getting nearer on the horizon. In attempt to soften the blow on purchasing power, more central banks has been joining the trend of monetary tightening. However, it is rather unclear whether its consequences would deliver the intended effect, which is decelerating the inflation, or rather overkilling it by bringing the recession altogether.

The bleakness of global economic picture is rather less visible when observing the domestic economic condition. Despite the mounting pressure on inflation front, the latest leading indicators on real sector shows the consumption and production activities remain resilient. As a net exporter of various main energy commodities and being rather 'behind-the-curve' on economic recovery might serve as a blessing for Indonesia during this trying time. Profit windfall stemming from rising commodity prices and the absence of excessive demand relative to supply enables the GoI with privileges to expand the fiscal stimulus in order to delay the inflation rise while the recovery momentum is building up. Thus, a relatively benign inflation pressure in comparison to other countries and growing economic activity makes the probability of heading towards stagflation is somewhat unlikely for Indonesia, at least in the near future. However, this shall not be mistaken as a sign of "everything's under control". Any complacency by policymakers could be costly. Going forward, it is imperative for Ministry of Finance (MoF) and Bank Indonesia to work hand-in-hand to ensure the rise of inflation is gradual and managable as the failure to do so could cost a substantial decline in purchasing power and risking the recession. In addition, managing the stability of currency is equally important as managing the domestic price stability.

Inflation is Picking Up but Remains Manageable

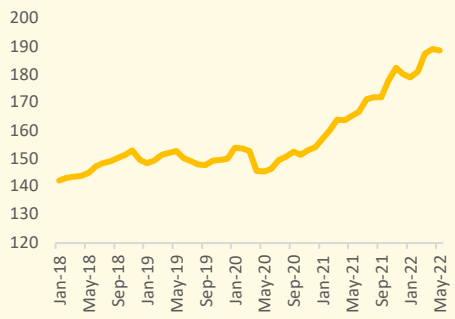
War-induced supply disruptions and escalating sanctions imposed on the Russian Federation have elevated global food and energy prices. As a result, inflationary pressures have risen in many countries. Indonesia is no exception; we are still heading towards the peak of inflation. In the midst of lack of recovered purchasing power, people have to pay for higher oil, gas, and even their food. Fortunately, energy prices are partially subsidized by GoI. Meanwhile, the hefty price of food ingredients is reflected in "lunchflation", a term currently popular around the world, defined as a condition in which the price of a portion of lunch increases eroding people's purchasing power. In Indonesia, rising prices of essential food items such as cooking oil, chillies, and onions, have pressured restaurants and street vendors to raise food prices.

After being below BI's target range from June 2020 until December 2021, Indonesia's headline inflation rate climbed for a sixth consecutive month to 4.94% (y.o.y) in July, rising from 4.35% (y.o.y) in June 2022. This level has reached an all-time high since October 2015 and standing well above the upper bound of BI's target range of 2%-4%. The faster pace of annual headline inflation continued to be stoked by rising food and energy prices stemming from choked supply chains, partly caused by Russia's invasion of Ukraine. Among all expenditure groups, the most contributing factors to the hike in inflation are food, beverage, and tobacco prices, as well as transportation prices. Annual food, beverage, and tobacco price growth, which makes up a quarter of the inflation basket, quickened to 9.35% in July from 8.26% a month earlier. In addition, with a weighting of 12.4% in the inflation basket, transportation price growth posted

an increase of 6.65%, higher than 5.45% growth in the previous month. Similarly, the aforementioned determinants of inflation were also reflected by the growth of the inflation component since the primary driver of July headline inflation was volatile good and administered prices. After soaring from 6.05% in May to 10.07% in June, the volatile good prices continued to reach a new sky-rocketing level at 11.47% in July. On the other hand, the administered prices rose in relatively moderate pace to 6.51% in July from 5.33% a month earlier due to the escalation of government subsidies for energy which already took place. By contrast, core inflation that reflects people's purchasing power remains manageable with only a slight increase to 2.86% (y.o.y) in July compared to 2.63% (y.o.y) in June 2022.

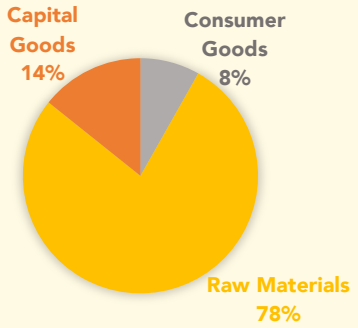
Interestingly, both producers and consumers are also reeling from the effects of the rising prices of imported goods. As seen in Figure E, Indonesia's international trade prices index has gradually hiked since mid-2020, in line with the soaring trend of energy prices, particularly crude oil. There are two main factors contributing to the surge in import prices, the global food and energy prices shock and intensifying external pressures that led to the depreciation of Rupiah. Since Indonesia's imports are primarily raw and capital goods, which contributes to more than 90% of the total imports, consequently, higher prices of imports would bring a substantial impact on the producers' prices because of high reliance on imported inputs.

Figure E: Indonesia's International Trade Price Index: Import



Source: CEIC

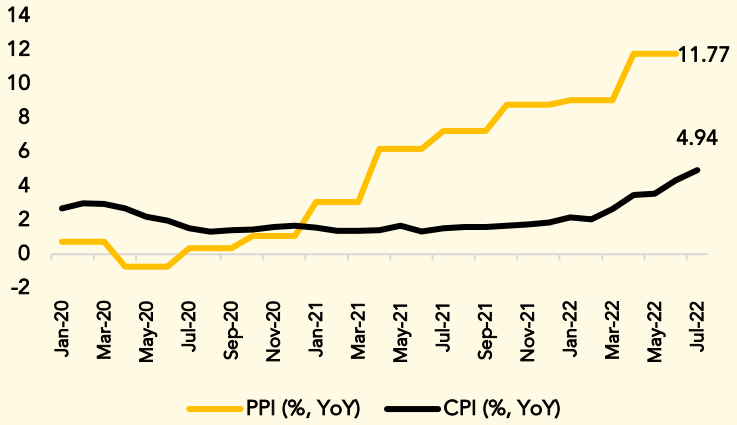
Figure F: Profile of Indonesian Imports by Goods Classification, January-June 2022



Source: Statistics Indonesia

Overall, even though inflation remains relatively moderate and muted than elsewhere in the world, the current high yet manageable domestic inflationary level is still being driven primarily by a combination of prolonged supply chain disruptions as well as skyrocketing energy and food prices, which are commonly known as "cost-push inflation" or inflation from the supply side. The trend of Producer Price Index (PPI) inflation, which was recorded at 11.77% (y.o.y) in the latest data recorded in Q2-2022, is a notable sign of cost-push inflationary pressure. Since the beginning of 2021, PPI inflation has already surpassed Consumer Price Index (CPI) inflation, and the trend is expected to continue, widening the gap between PPI and CPI inflation (Figure G). This suggests that producers are currently facing rising input prices, partly through higher prices of imported materials. Along with stronger-than-expected economic growth in the first quarter of 2022, these developments raise the prospect that higher producer prices feed more directly into consumer prices ahead. In the end, the gap between PPI and CPI inflation will close as consumers are expected to bear the significant pass-through costs.

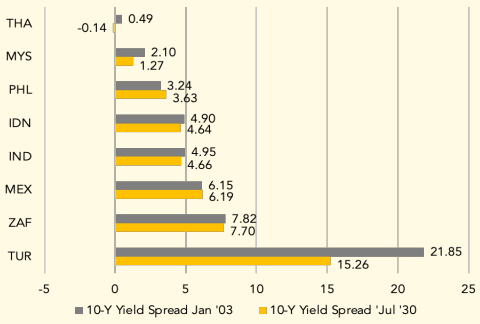
Figure G: Indicator of Inflation (%, YoY)



Source: CEIC

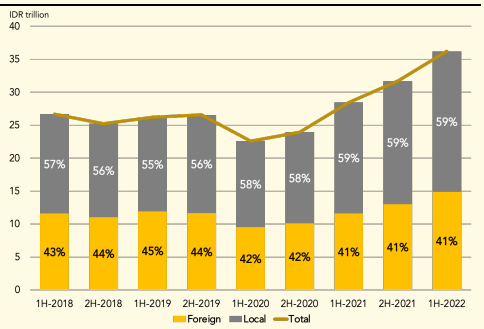
Even though the domestic inflation remains manageable until 1H-2022, the pressures from global monetary tightening due to mounting inflation persist. Several major central banks have shrunk their balance sheets and increased their benchmark rate, threatening another shock to economies and financial markets. The global monetary policy normalization has had the most significant impact on developing countries, at least since the Fed increased the interest rate in mid-March, as the yield differential between US treasury bonds and their market becomes narrow. The decreasing rate differential, thus, enticed investors to shift their capital from riskier investments into higher-yielding and ostensibly safer US assets. Indonesia recorded around USD5.12 billion capital outflow at the end of July compared to early March, with a massive net sell-off in bonds assets while the stock market continued to record net buy. The capital flights from the bonds market are fully priced in the higher 10-Year tenor and 1-Year tenor government bonds yields of 7.50% and 4.77%, respectively, at the end of July, up from 6.65% and 3.14% in early March. However, it was rather manageable with the year-to-date decline in 10-Y government bonds yield spread between Indonesia and US smaller than other emerging markets (Figure H). The amount of capital outflow was also lesser than the previous Fed's monetary tightening in 2018, thanks to current persistent trade balance surpluses and less reliance on the foreign portfolio (Figure I).

Figure H: 10-Y Gov't Bonds Yield Spread Between US and Emerging Markets



Source: CEIC

Figure I: Securities Ownership: Foreign vs. Local (IDR trillion)



Source: CEIC

The relatively manageable capital outflow yielded Rupiah as the best performing currency among other Southeast Asia developing countries. The depreciation of Rupiah was only recorded at 5.39% (ytd) in late July. The figure was even better than the 12% (ytd) depreciation in the last Fed's rate hike in 2018. The fortunate events, thus, have provided room for BI to stay

behind the curve and hold its benchmark rate to support economic recovery growth. However, taking away soaring inflation with high interest rate is not as easy as falling off a log. If the high global interest rate persists in the longer term to fight the tenacious high prices, it will leave small room for BI to stay dovish and will most likely force BI to raise the benchmark rate gradually. Once the Fed's aggressive tightening drives interest rate differentials between Indonesia-US much smaller, BI may have to raise its policy rate to curb capital outflows.

Although causing inflation to rise, higher commodity prices are a blessing in disguise to government revenue. The income received by GoI has reached IDR1,317 trillion or around 58.1% of FY-2022 state budget. The notable immense expansion in government revenue has been expected by GoI since they increased the revenue assumptions from IDR1,846 trillion to IDR2,266 trillion in the revised version of the FY-2022 state budget. Aside from higher commodity prices, the increased revenue was also contributed by the robust acceleration in economic activities, low base effect in 2021 due to massive businesses incentives, and the impact of HPP Law with the higher VAT.

Whilst the high commodities prices may generate the so-called windfall to government income, it also appears to give additional burden to the expenditure side through the rising spending on energy subsidies. In the previous state budget for FY-2022, expenditures for energy subsidies were settled at IDR134 trillion. This amount was fairly divided for fuel and electricity subsidies with the respective amount of IDR77.5 trillion and IDR56.5 trillion. In addition, GoI also allocated an implicit subsidy of IDR18.5 trillion that will be paid to Pertamina as compensation for selling the fuel below market price. The whole amount of energy subsidies and compensation are reported to be rising in the revision of FY-2022 state budget to approximately IDR502.4 trillion in correspondence to the rising ICP price. While all posts in energy subsidies and compensation record massive hikes, the compensation for fuel price gets the largest share of 50.3% or equivalent to IDR252.5 trillion. Unfortunately, the energy subsidies primarily benefit only the middle to upper-class households. In an interview, Pertamina, the main distributor for fuel and gas, confessed that approximately 80% of total subsidized fuel and diesel fuel are consumed by 60% of the middle to upper-income class. In comparison, the bottom 40% income group only enjoy the rest 20% of it[1]. Given the total subsidies and compensation for fuels and gas, which accounted for IDR401.8 trillion, approximately IDR321.44 trillion will be missed the target. The case, however, may present a different result if GoI, along with Pertamina adjusts the existing system for subsidies and establish a firm mechanism for the disbursement so that only the targeted group enjoy the benefit.

Nevertheless, it appears that the gain from the windfall in commodity prices, accompanied by other factors, such as increasing economic activity after the pandemic, will neatly cover the increased spending on energy subsidies. This is reflected by the new deficit target that has become lighter with the particular amount accounted at 4.50% of GDP relative to the prior state budget that put the deficit at 4.85% of GDP. The primary balance was even still in a surplus territory in 1H-2022 at 0.39% of GDP. As such, the GoI may have larger fiscal space to maintain the economic condition that has been more fluctuating and take the role as a shock absorber.

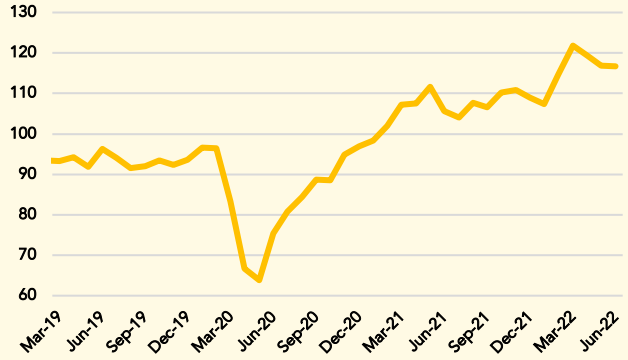
No Sign of Recession on the Horizon

Despite the outbreak triggered by new Covid-19 variants, domestic economic condition has started to adapt almost entirely to the situation. This is particularly reflected by the rising trend of CEIC leading indicator, which is basically a composite index indicating whether the economic condition is currently slowing down or expanding. Consisting of variables from market, financial, labor, trade, and industry, in the first quarter of 2022, the regarding indicator grew positively and recorded an all-time high since early 2000 at 121.8 in March 2022, notwithstanding the

[1] https://www.merdeka.com/uang/80-persen-konsumsi-pertalite-dan-solar-dinikmati-kelas-menengah-atas.html

earlier outbreak triggered by the Omicron variant. This phenomenon mainly happened on the back of the favorable condition from higher trend of commodity prices, such as CPO and coal, as well as resilient domestic recovery coming supported by accelerating vaccination rate.

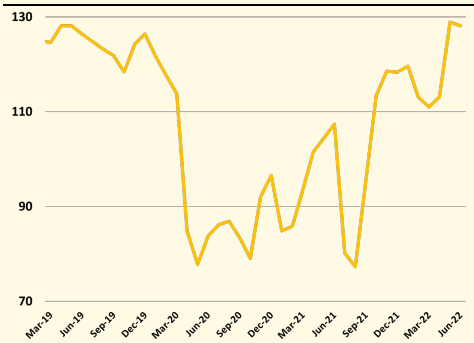
Figure J: CEIC Leading Indicator 2019-2022M6



Source: CEIC

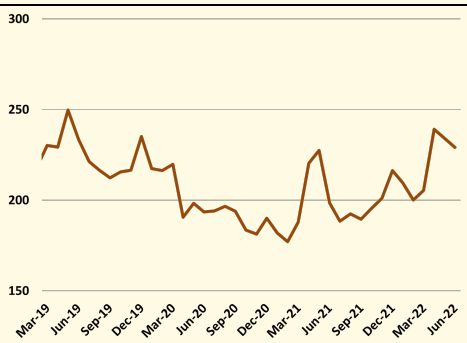
Observing the demand side, the Consumer Confidence Index (CCI), which illustrates people's confidence in their income and future spending, although showing fluctuation, it indicated a positive trend after a sharp fall at the beginning of 2020. This event was parallel with the condition of both domestic and global states. In the first quarter of 2022, the CCI recorded a decreasing trend mainly caused by the spread of Omicron variants. After the immense record of active cases has slowly decreased, the regarding indicator displayed an increasing trend and was recorded at 128.2 in June 2022, significantly higher compared to its condition in the same period last year at 107.4. Looking at other variables, the retail sales index has also slowly moved back to its prepandemic level as the retailers expected a stronger bound. After a decreasing growth pattern during the first quarter of 2020, in June 2022, the index was reported with a sky-rocketing growth of 15.4% (y.o.y) or increasing to 229.1 in real sales index. This number was high compared to the 2.9% (y.o.y) growth a month earlier. The event was mainly supported by several essential commodities such as food, beverages, and tobacco, as well as clothing. Moreover, the easing social activity restriction policy also heavily contributed to the favorable trend for cultural and recreation groups, although there was a slight correction in June 2022 due to the normalization period after Eid festivities.

Figure K: Consumer Confidence Index (CCI) 2019-2022M6



Source: CEIC

Figure L: Real Retail Sales Index 2019-2022M6

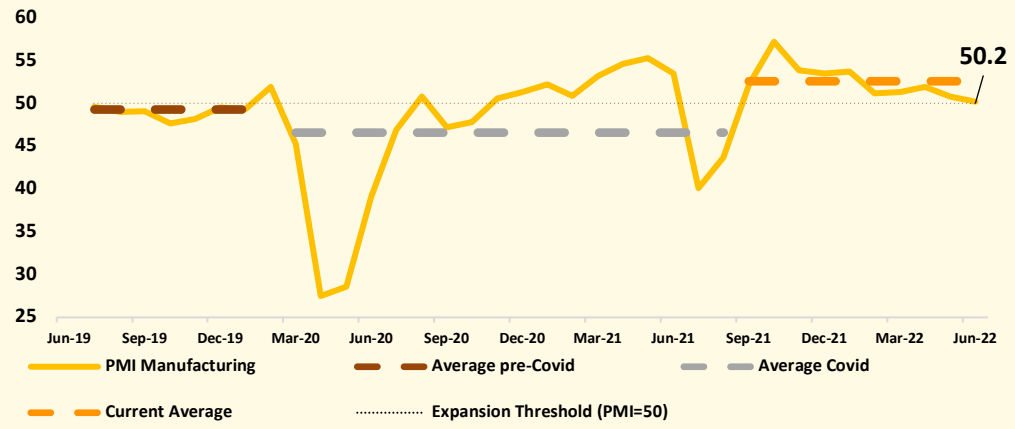


Source: CEIC

A strengthening sign of domestic economic activity could also be observed in the production activity. Purchasing Managers' Index (PMI) manufacturing, a common proxy of manufacturing production activity, has consistently recorded at beyond 50 since last September. This suggests

that the production activity of manufacturing sector has been consistently expanding from September 2021 until at least June 2022 as it persistently reached above the expansion threshold (Figure M). The current PMI manufacturing trend averaged 52.6, suggesting a robust rebound from the bleak Covid-19 era in which the average PMI manufacturing was only recorded at 46.6. This also suggests the rapid pace of recovery as it expanded well above the average prepandemic level at 49.3 from 2019 until early 2020.

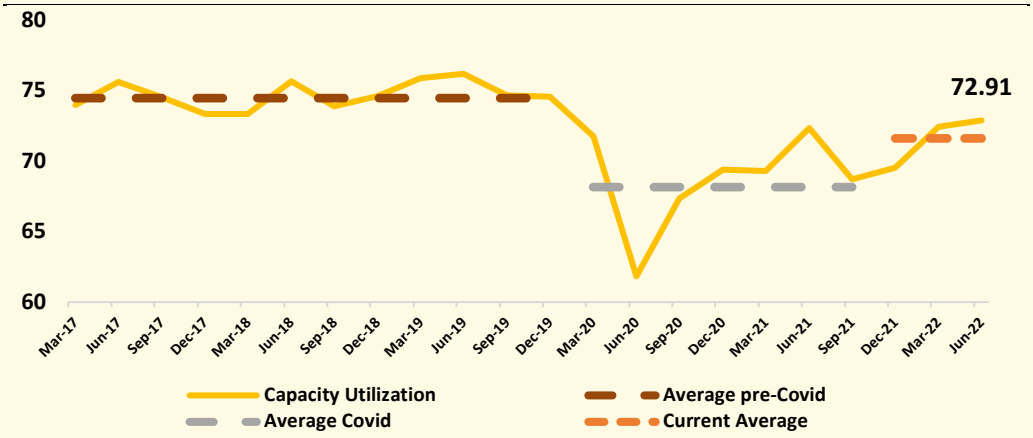
Figure M: PMI Manufacturing



Source: CEIC

The manufacturing sector's persistent expansion is also reflected in its capacity utilization (Figure N). Only utilizing the production capacity of 68.2% on average during the Covid-19 era and once even reached its lowest level of 61.8% in mid-2020, the current average of manufacturing utilization of production capacity has reached 71.6%. While it has not reached prepandemic level, the increasing trend of production capacity utilization in manufacturing sector provides a certain degree of optimism towards the short-run outlook in domestic economic activity from the producers' perspective. Since September 2021, the utilization has been gradually rising to match consumers' demand.

Figure N: Manufacturing Production Capacity Utilization (%)

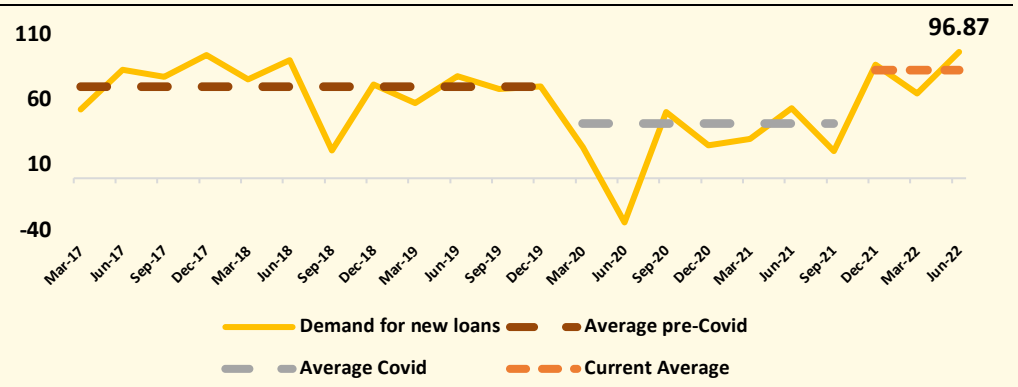


Source: CEIC

Potent progress of consumer and producer activity provides a promising sign of the current state of domestic real sector. This also transpires into a favorable manifestation in the banking sector. As the financial intermediaries in the economy, banking sector provides additional insight into

confirming the story in the real sector. As part of Bank Indonesia's banking survey, the demand for new loans (Figure O) suggests a rather impressive performance. Recorded at 96.87% in Q2-2022, demand for new loans has reached its highest level of quarterly growth in more than 20 years. With the current average of 82.9%, the latest demand for new loans growth trend has almost doubled its growth rate compared to the pandemic-era average of 41.9%. While some predict that this trend might weaken sooner, the current level of high growth of demand for new loans indicates that the optimism of consumers and producers is still immense toward the current and near-future of domestic economic prospect.

Figure O: Demand for New Loans (%)



Source: CEIC

Good Policy and Good Luck

"...Indonesian economy is already reach its pre-pandemic normal as it was the first time since 2020 that Indonesia's GDP figure reached its baseline growth rate of 5% for two consecutive period."

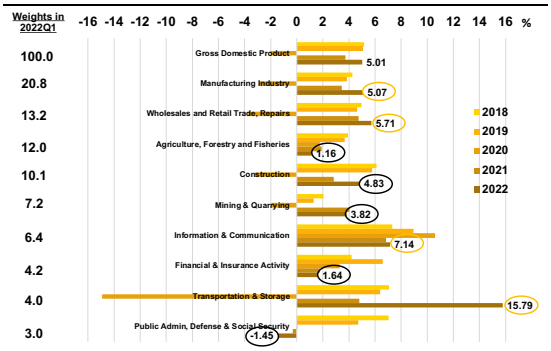
The Covid-19 crisis is broadly revolved around two main aspects, health and economic. Marching into 2022, the health and economic indicators has demonstrated a promising progress during the first quarter of this year. On the health front, the daily new cases dropped from its peak of around 64 thousand to less than 3 thousand at the end of March this year. This figure even went reached as low as around 200 new cases per day in last May. The auspicious progress in the domestic public health situation has transpired into a solid GDP growth of 5.01% (y.o.y) in Q1-2022, keeping it rather steady from 5.02% (y.o.y) in the last quarter of 2021. If recession is defined technically as having negative GDP growth for two consecutive period, the latest GDP figure might indicate the opposite as Indonesian economy is already reach its pre-pandemic normal as it was the first time since 2020 that Indonesia's GDP figure reached its baseline growth rate of 5% for two consecutive period. Despite considered as being 'behind-the-curve' on the economic recovery timeline, Indonesia was rather in an advantageous position to face the latest global economic turmoil, stemming from escalating geopolitical tension, global monetary tightening, and rising commodity prices. Thanks to the combination of good policy and good luck, Indonesia in the first half of 2022 was well-positioned to encounter global turmoil. Having a robust domestic recovery due to the momentum buildup of economic activity and the the cyclical aspect of Ramadhan and Eid Al-Fitr, a net exporter of major energy commodities, the lift-up of mobility restriction, current account surplus and lower foreign ownership of financial assets has blessed Indonesia with adequate capacity to absorb global shock

relative to other countries thus far, especially in terms of inflation and currency volatility.

The sectoral growth also tells a more detailed story of rising pulse of domestic health and economic recovery in early 2022. Several major sectors in the economy such as manufacturing, wholesale and retail trade, construction, and ICT which together contributes to around 50% of the economic activity, recorded a rising growth in Q1-2022. In addition, the prolonged contraction of public admin, defense & social security sector from -0.32% (y.o.y) in Q4-2021 to -1.45% (y.o.y) in Q1-2022 and declining growth of human health and social work activity from 10.33% (y.o.y) to 4.38% (y.o.y) during the same period suggest a substantial improvement in domestic public health situation and declining need for government spending on health and social aspects. Favorable performance of various sectors, such as transportation & storage, electricity & gas supply, business services, acommodation & FnB, and real estate also indicates a revival in economic activity, purchasing power, and consumer sentiment after around two years struggling with the pandemic and restricted social mobility. Notably, transportation & storage sector recorded a double-digit growth of 15.79% (y.o.y) in Q1-2022 from 7.93% (y.o.y) in the previous quarter, signalling the high confidence of society to travel and enganging in leisure activity, which has been severely halted in the last two year.

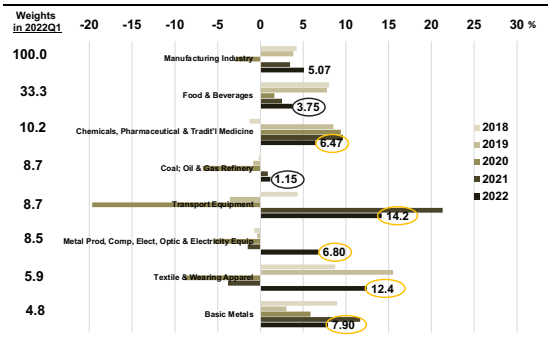
"The increasing growth of manufacturing sector prolonged since the third quarter of 2021, suggesting a steady rebound of production activity, following the recovery of health aspect and consumer demand in the domestic economy."

Figure 1: Growth of GDP and the Main Industries, 2018-2022Q1



Source: CEIC

Figure 2: Growth of Manufacturing Sector and Its Subsectors, 2018-2022Q1

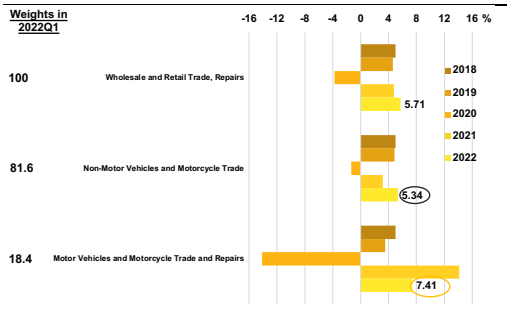


Source: CEIC

Manufacturing industry as the biggest sector to contribute to GDP recorded a relatively aligned growth with the overall economy of 5.07% (y.o.y) in Q1-2022, a rather noticable rise compared to the previous quarter of 4.92% (y.o.y). The increasing growth of manufacturing sector prolonged since the third quarter of 2021, suggesting a steady rebound of production activity, following the recovery of health aspect and consumer demand in the domestic economy. Observing its subsector, however, the robust growth of the overall sector is manifested rather varied within its subsectors. FnB, the biggest subsector within manufacturing industry with the contribution of a third, grew to 3.75% (y.o.y) in Q1-2022, a susbtantial increase from 1.23% (y.o.y) in the previous quarter and hit the highest quarterly growth rate since the pandemic began. Similarly, textile & wearing apparel subsector grew substantially to 12.45% (y.o.y) in the first quarter of 2022, compared to 5.94% (y.o.y) in the previous quarter and recorded the highest expansion since 2019. Moreover,

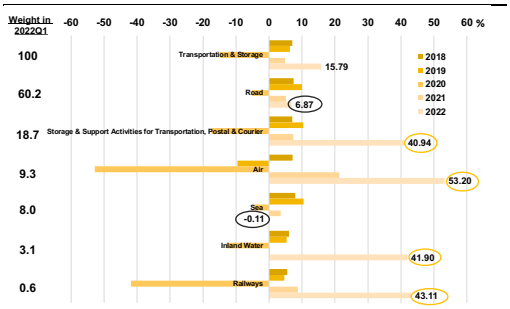
metal products, computer, & electric equipment and other manufacturing product subsector recorded a growth increase after experienced a contraction from Q4-2021 to Q1-2022, which recorded at 6.80% (y.o.y) from -0.49% (y.o.y) and 1.94% (y.o.y) from -1.81% (y.o.y), accordingly. However, some other subsectors such as transport equipment, machinery equipment, basic metal, and chemical & pharmaceuticals subsector experienced a decreasing growth despite still grew above 5%, suggesting a slower production due to the normalization after low-base effect and robust expansion in the previous quarters.

Figure 3: Growth of Wholesale and Retail Trade and Its Subsectors, 2018-2022Q1



Source: CEIC

Figure 4: Growth of Transport and Its Major Subsectors, 2018-2022Q1



Source: CEIC

"Known as the sector that prone to the dynamics of policies during the Covid-19 era, the transportation and storage marked a massive jump of 15.79% (y.o.y) in Q1-2022..."

This year has been showing an incredible sign of recovery after two consecutive years of pandemic caused by Covid-19. The relaxation of social restriction policies, following the lower daily cases and accompanied by high level of immunity, has made everything almost back to its normal stance. Not only manufacturing sector, the wholesale and retail trade sector also showed an impressive performance in Q1-2022. Notwithstanding low-base effect that still exists, the regarding sector recorded 5.71% (y.o.y) growth, up from 5.56% (y.o.y) in Q4-2021. The notable increase mainly supported by the subsector of non-motor vehicle trade that presented a massive growth of 5.34% (y.o.y) relative to its growth in previous quarter that recorded at 4.75%. The subsector of non-motor vehicle trade itself contributed to 81.6% to the overall value of wholesale and retail trade sector. Conversely, the subsector of motor vehicle trade experienced a decelerating pattern, compared to the prior growth in Q4-2021. The regarding subsector grew to 7.41% (y.o.y) in Q1-2022, meanwhile the growth in previous quarter was recorded at 9.21% (y.o.y). It appears that the global dynamics that currently happening have partially affected the performance of motor vehicle trade through the increasing pattern of material price that slowly transferred to higher final price, hence, curb the demand from either domestic or foreign sales.

Known as the sector that prone to the dynamics of policies during the Covid-19 era, the transportation and storage marked a massive jump of 15.79% (y.o.y) in Q1-2022 relative to its growth in Q4-2021 which accounted at 7.93% (y.o.y). Whilst the higher frequency of mobility has mainly contributed to the performance of transportation and storage sector, the low-base effect from a depressing negative growth in Q1-2021 also played a significant role in the sky-rocketing level of growth in Q1-2022.

Observing to its components, railways transportation continued its rising pattern of growth and ended up at 43.11% (y.o.y), more than double of its growth in previous quarter which reported at 20.68% (y.o.y). Following the railways transportation, air transportation also presented the similar pattern with growth reported at 53.20% (y.o.y) in Q1-2022 compared to 19.30% (y.o.y) in Q4-2021. Meanwhile, as the main contributor, which in Q1-2022 accounted at 60.2% from the total value of the transportation and storage sector, the road transportation grew to 6.87% (y.o.y) relative to 3.63% (y.o.y) in previous quarter. Contrary to the favourable growth of other components, sea transportation marked a negative point of growth to -0.11% (y.o.y) or down from 0.93% (y.o.y) in prior quarter. The slight correction in sea transportation was triggered by the existing logistic system that heavily relies on the road transportation (trucking) system. Last, following the higher trend of manufacturing as well as domestic trade, the subsector of storage activity also aggressively increased to 40.94% (y.o.y) relative to its growth in Q4-2021 that reported at 20.20% (y.o.y). Despite the low-base effect that still shadowing around, the recent trend of Covid-19 cases that followed by the easing stance for social restriction policy, shall provide the brighter way to facilitate the performance of transportation and storage sector ahead.

"Despite the low-base effect that still shadowing around, the recent trend of Covid-19 cases that followed by the easing stance for social restriction policy, shall provide the brighter way to facilitate the performance of transportation and storage sector ahead."

Two years of pandemic era has put many sectors in a whole another level of challenges. The economic condition has been fluctuated aggressively in accordance with the implementation of social restriction policies, which mainly generated by the ups and downs of daily Covid-19 cases. Whilst the new variants of Covid-19 have always been the biggest threats, the higher rate of immunity may be the first guard to counter the risks. This mainly resulted from the heavy effort of GoI to boost the vaccination rate. According to the recent economic performance, this year has been started by the favourable growth of 5.01% (y.o.y), notably increase from the value in the similar period last year, despite a little correction in comparison with the reported growth in Q4-2021. Aside from the relaxation of Covid-19 policy, almost all main sectors in domestic economy have also fully adapted to the pandemic situation. Still, given the negative growth in the beginning of 2021, this quarter economic performance also partially affected by the low-base effect. Nevertheless, considering the recent dynamics of Covid-19, the domestic economy may have a broader room to keep up with the recovery plans. However, one factor that should be monitored carefully in the recent time is the global market perspective that has been in the vulnerable condition, following the persistence of geopolitical tension as well as inflation that happening in many countries. This issue, sooner or later, may be negatively translated into poor domestic economic performance through several pipelines such as lower volume of output in certain sectors and therefore should be prudently prepared.

A Glimmer of Hope Around the Headwinds

Looking at the expenditure component, the economic growth in Q1-2022 was supported by recovery in household consumption, investment, and exports performance. While other expenditure components indicated positive growth, government expenditure posted a negative growth of 7.74% (y.o.y) in Q1-2022.

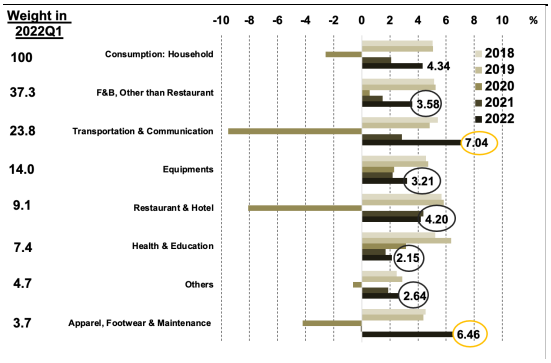
Looking at budget realization, as of end of March 2022, the expenditure realization reached IDR490.65 trillion or 18.1% of the the celing in the state budget. Compared to March 2021, the expenditure realization was down by 6.19% (y.o.y). Looking specifically into central government expenditure, it recorded a contraction of 10.3% (y.o.y) as of 31 March 2022 due to reduction in both capital expenditure and goods expenditure, which shrank by 45.3% (y.o.y) and 33.1% (y.o.y), respectively. The lower capital expenditure as of March 2022 was due to high realised expenditure in 2021 due to the realization of payments for physical works completed in 2020. The lower realization of goods expenditures compared to March 2021 is due lower budget need for vaccines in early 2022.

"Looking at the expenditure component, the economic growth in Q1-2022 was supported by recovery in household consumption, investment, and exports performance."

Paying attention to household consumption, the highest contributor to Indonesia's economic structure, it grew by 4.34% (y.o.y) in Q1-2022, higher compared to the last three months of 2021 at 3.44% (y.o.y). All consumption components recorded positive growth in the January – March 2022 period with consumption of food and beverage, transportation and communication, and equipments that accounts for 75% of total household consumption posted growth of 3.58% (y.o.y), 7.04% (y.o.y), and 3.21% (y.o.y), respectively. Easing social mobility restriction together with faster vaccionation rollout backed up the positive and significant growth of household consumption, which was one of the main drivers of economic growth in Q1-2022.

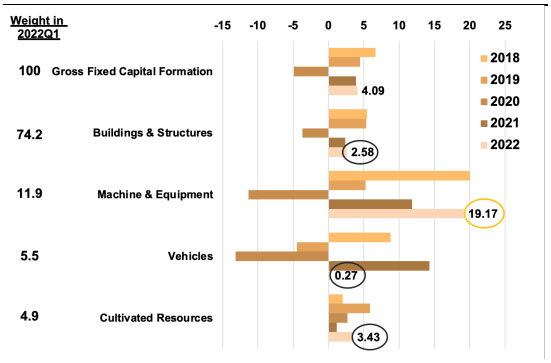
Zooming in on investment, similar to household consumption, it posted a positive growth of 4.09% (y.o.y) during the first three months of 2022, slightly lower than Q4-2021 growth at 4.49% (y.o.y). Investment in buildings & structures that accounts for 74.2% of total investment recorded a positive growth of 2.58% (y.o.y) while investment in machine & equipment that contributes 11.9% to total investment recorded a remarkable growth of 19.17% (y.o.y) in Q1-2022, suggesting continuation of economic recovery.

Figure 5: Growth of Household Consumption and its Components, 2018-2022Q1



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2018-2022Q1



Source: CEIC

Observing details into the performance of credit, total credit continued to accelerate along with demand recovery. The overall credit growth recorded at 6.27% (y.o.y) in Q1-2022, jumped from 4.40% (y.o.y) in the preceding quarter. Based on its purpose, all types of credit have shown stronger figures with the highest growth seen in working capital credit with a steep increase from 5.45% (y.o.y) in Q4-2021 to 7.54%

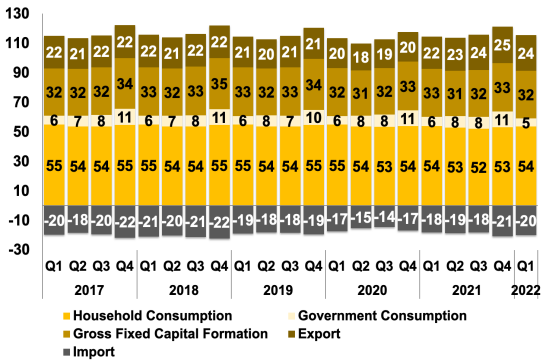
(y.o.y), indicating business recovery. Next, consumption and investment credit also picked up to 5.43% and 5.05% (y.o.y) from 4.18% and 2.86% (y.o.y) in Q4-2021. According to the latest data available in March, total credit grew by 6.67% (y.o.y), gradually rose from 6.33% (y.o.y) in February 2022. Credit growth for working capital, investment, as well as consumption credit accelerated to 7.68%, 5.59%, and 6.10% (y.o.y) respectively in March 2022 compared to 7.57%, 5.49%, and 5.21% (y.o.y) in February 2022.

Moreover, the third-party fund growth in the latest data in May 2022 was milder at 9.93% (y.o.y) compared to the preceding month's figure at 10.18% (y.o.y) in April. Nonetheless, asset quality as reflected from NPL was relatively managable since it also slowed further to 2.99% (y.o.y) in the latest data in March 2022, down from 3.08% (y.o.y) in February 2022. With these developments thus far, the banking industry has shown a favourable perfomance supported by improved asset quality and stable liquidity, reflected in the Loan to Deposit Ratio (LDR) that was still relatively low at 78.7% in March 2022.

"We predict credit growth will continue to improve in the 2H-2022 in line with domestic economic recovery."

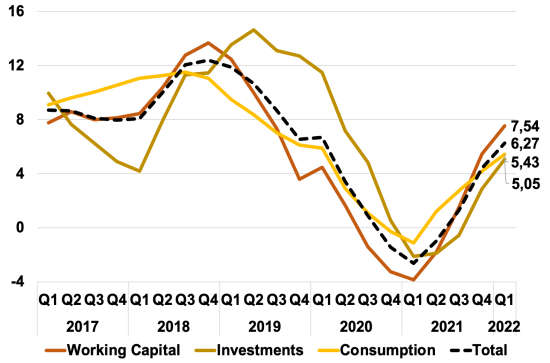
The ongoing external pressures have been force BI to gradually tighten its monetary stance; the first policy normalisation from BI is a gradual tightening of banking system liquidity by raising the Reserve Requirement Ratio (RRR) more aggressively to reach 9.0% (vs initially planned at 6.5%) by September this year. The policy expected to absorb around IDR260-300 trillion of liquidity this year. Yet, even after the RRR hikes, the excess liquidity reflected in the OMO placement is expected to be still substantially higher than normal condition prior to the pandemic, ranging between IDR200-250 trillion in 2018 and 2019. As a result, banks' ability to channel credit should be unaffected by the gradual normalisation of liquidity. Therefore, we predict credit growth will continue to improve in the 2H-2022 in line with domestic economic recovery. This optimism is driven, among other things, by relatively maintained domestic monetary and economic conditions, as well as relatively controlled risk of lending.

Figure 7: Shares of GDP Components, 2017Q1-2022Q1 (%)



Source: CEIC

Figure 8: Credit Growth by Purposes, 2017Q1-2022Q1 (y.o.y, %)



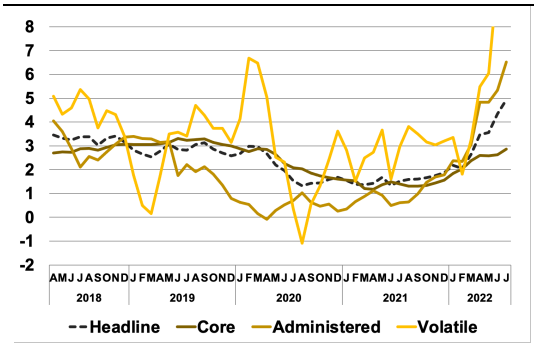
Source: CEIC

Spike in Volatile Commodity Prices amidst the Global Inflationary Pressure

The annual inflation rate of 4.94% (y.o.y) in July 2022 was recorded as the highest inflation rate since October 2015, an increase of 0.14% compared to the previous month. This was influenced by the rising trend of global prices for energy and food commodities which has to do with the disrupted global supply chain coupled with prolonged geopolitical issues between Russia and Ukraine. Core inflation also edged up to 2.86% (y.o.y), from 2.63% (y.o.y) in June 2022, indicating the strengthening of domestic demand. Besides, the annual figure of administered prices inflation grew by 6.51% (y.o.y), continuing its upward trend since June 2021, as public mobility began to return to its normal condition. As for the volatile food component, there was a spike from 10.07% (y.o.y) to 11.47% (y.o.y) in July 2022 due to the increase in horticultural commodity prices, making it the main driver of annual inflation figure this month.

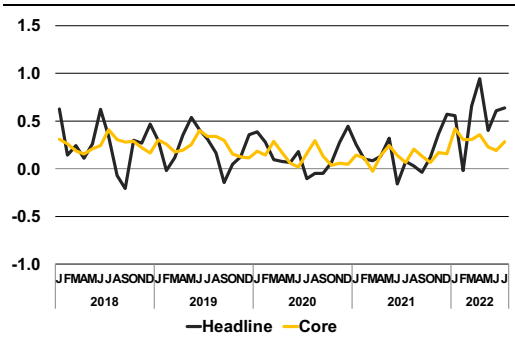
"The annual inflation rate of 4.94% (y.o.y) in July 2022 was recorded as the highest inflation rate since October 2015..."

Figure 9: Inflation Rate (%, y.o.y)



Source: CEIC

Figure 10: Inflation Rate (%, m.t.m)



Source: CEIC

On a monthly basis, July 2022 inflation rate was recorded at 0.64% (m.t.m) which continues to rise since last May. This was influenced by rising inflation in the administered prices and energy prices category, amid a decline in core inflation and volatile foods. Core inflation was recorded at 0.28% (m.t.m), up from 0.19% (m.t.m) in June 2022. The condition was mainly influenced by increases in the wages for domestic assistants and housing contracts driven by increased public mobility. The administered prices component in July 2022 recorded an inflation rate of 1.17% (m.t.m), an increase from 0.27% (m.t.m) in the previous month due to the increase in airfares and electricity tariffs. Last but not least, the volatile food component recorded inflation of 1.41% (m.t.m). By commodity, this was mainly caused by the increase in the prices of various chilies, shallots, and broiler eggs due to weather conditions that disrupted production and increases in feed prices, although not as high as last month. All in all, BI needs to continue to be aware of the risk of future inflationary pressures, particularly related to developments in global commodity and food prices, and their impact, as well as to be prepared to take the necessary policies to ensure controlled inflation.

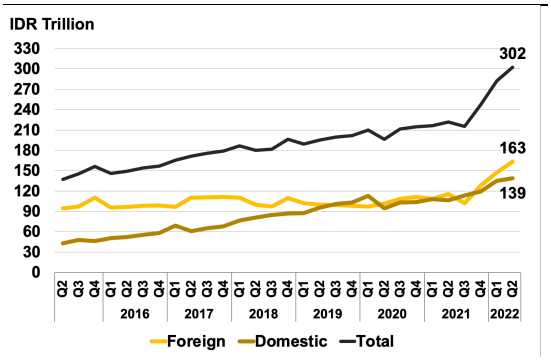
All-Time High Investment Realization in a Decade

The Investment Coordinating Board (BKPM) recorded the investment realization of IDR302.2 trillion during Q2-2022 or grew by 35.5% (y.o.y), which is the highest amount in a decade. Compared to the first quarter of 2022, it grew 7% (q.t.q). The investment realization consists of foreign direct investment (FDI), which was recorded at IDR163.2 trillion or grew by 30.8% (y.o.y), and domestic direct investment (DDI) which was recorded at IDR139.0 trillion or grew by 35% (y.o.y) compared to Q2-2021. The basic metal, metal goods, non-machinery, and equipment industrial sectors are the main supporting sectors for the investment realization with an investment value of IDR48.2 trillion. Followed by the mining sector with IDR22.0 trillion, housing, industrial, and office areas with IDR26.7 trillion, transportation, warehouse, and telecommunications with IDR25.6 trillion and the food industry with IDR22.4 trillion.

"The investment realization in Q2-2022 recorded an all-time high in a decade, with IDR302.2 trillion or grew by 35.5% (y.o.y) compared to Q2-2021."

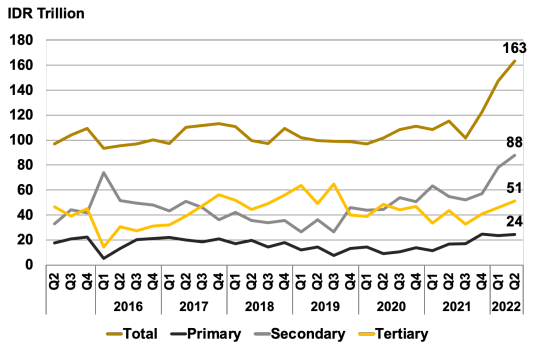
Based on the location, the first position of the total investment realization in Q2-2022 was occupied by West Java amounting to IDR44.0 trillion. In the previous quarter, West Java was in second place with an investment realization of IDR39.5 trillion. The second position is occupied by DKI Jakarta with an investment value of IDR40.1 trillion, followed by Central Sulawesi with IDR32.1 trillion, East Java with IDR29.9 trillion, and Riau with IDR20.7 trillion. Based on the FDI distribution, the first position is still occupied by Central Sulawesi with an investment realization of USD2.2 billion. Meanwhile, DKI Jakarta ranks first in the realization of DDI in the Q2-2022 with a realization of IDR27.5 trillion.

Figure 11: FDI and Domestic Investment (Nominal)



Source: CEIC

Figure 12: FDI Realization by Sectors (Nominal)



Source: CEIC

Based on the business sector, all three sectors of foreign investment experienced an increase. The main contributor to the increase in the FDI realization itself came from the secondary sector, with an increase of almost 13% compared to the previous quarter. This shows that despite being in the midst of global economic turmoil and the impact of the Covid-19 pandemic, investors' confidence, especially from the industrial sector, is still very high.

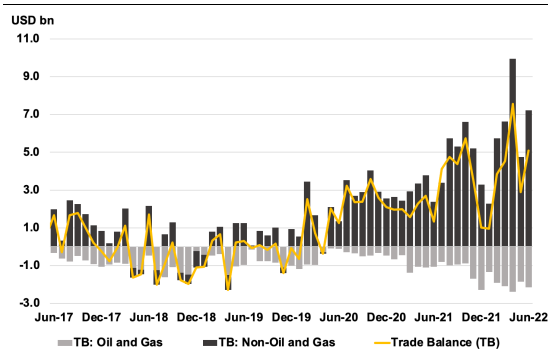
Persistent Trade Surpluses Cushion External Resilience

Indonesia continued enjoying trade balance surplus despite the pressures from commodity prices and geopolitical tension between Russia and Ukraine. The surplus resulted from higher export growth than imports, mainly driven by the high commodity prices, particularly coal and palm oil. The commodity prices windfall bolstered export performance as the figure of Indonesia's exports remains largely contributed by raw materials and commodities. Around 35% of the total exports were mineral resources, vegetable and animal fat, pearl, diamond, and precious metals. The soaring commodity prices brought fruitful momentum to overall trade balance in Q2-2022, which recorded another increase in surplus to USD15.6 billion from USD9.33 billion in Q1-2022. The surplus amounts also jumped 39% (y.o.y) compared to the same period in the previous year. Aside from soaring commodity prices, the notable export performance was partly contributed by increased coal exports to EU countries and the lifting of three-week ban on palm oil exports. Indonesia recorded additional coal exports to Italy, Poland, and the Netherlands, which were experiencing disrupted supply due to several trade bans and sanctions imposed by the EU on Russia. The palm oil export ban lifting since mid-May has also significantly maintained the overall sound exports in Q2-2022.

"Aside from soaring commodity prices, the notable export performance was partly contributed by increased coal exports to EU countries and the lifting of three-week ban on palm oil exports."

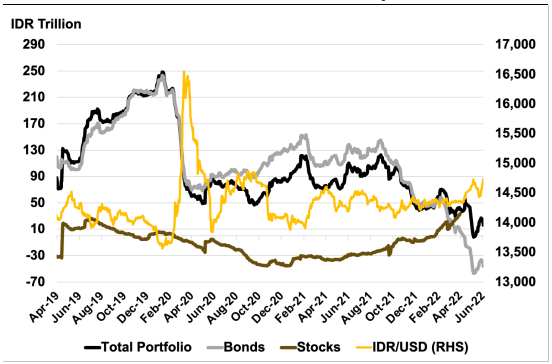
On the other hand, imports grew by 15% (y.o.y) from the figure in the same period in 2021. Both imports of oil and gas as well as non-oil and gas increased in Q2-2022 compared to the same period last year due to higher demand from economic recovery after the Covid-19 pandemic. While the 70% (y.o.y) higher imports in oil and gas were also impacted by high global energy prices, the 18% increased imports in non-oil and gas imports were the notable result of picked up demand for raw materials and capital goods needs for business activities. Nevertheless, Indonesia's imports acceleration was still lower than exports, resulting in a trade surplus.

Figure 13: Monthly Trade Balance (Nominal)



Source: CEIC

Figure 14: Exchange Rate and Accumulated Short-Term Capital Inflow



Source: CEIC

Furthermore, the significant trade surplus in goods contributed to a persistent current account surplus in Q1-2022, albeit smaller. The current account surplus was slightly lower than the surplus in the previous quarter of USD1.5 billion (0.5% of GDP) to only USD0.2 billion (0.1% of GDP). The decline was mainly affected by a higher trade deficit in services due to the soaring outbound visitors in the recovery period. Even though the current account surplus persisted, the balance of payments (BoP)

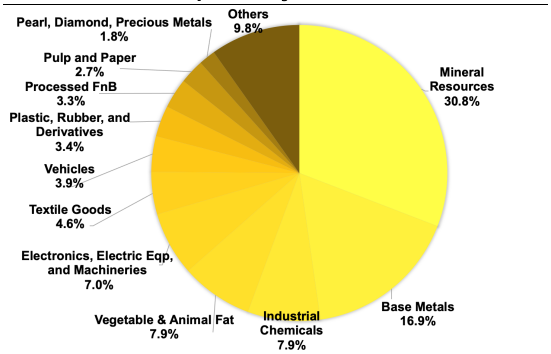
recorded a deficit of USD1.8 billion due to the capital and financial deficit. The monetary tightening, knowingly marked by the interest rate hike by the Fed since mid-March, has caused deterioration in the global capital market. The wider rate differential made the capital outflow from emerging markets, including Indonesia, unavoidable.

Indonesia's capital outflow reached USD5.12 billion at the end of July compared to early March, with a massive net sell-off in bonds assets while the stock market continued to record net buy. However, the capital outflow is rather manageable than the previous Fed's monetary tightening in 2018, with capital outflow of USD3.5 billion in October 2018, a month after the third-rate hike in September 2018. The lower outflow in current tightening was mainly supported by the persistent trade surpluses in goods, nullifying another episode of twin deficit. Furthermore, the share of foreign ownership in domestic bonds has sharply declined to 41% in Q2-2022 from 62% in Q2-2010. The less reliance on foreign portfolios has also contributed to relatively manageable capital outflow this time around.

"The sound trade surpluses have cushioned the effect of monetary tightening on depreciation as higher exports than imports indicate more foreign exchange liquidity in the market"

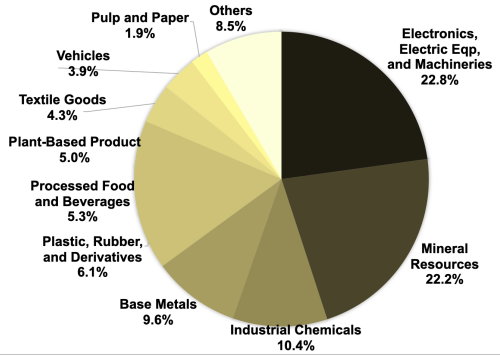
Another consequence of global monetary tightening is depreciation. Many currencies are losing value against the US dollar due to their countries' tremendous asset sell-off. Indonesian Rupiah depreciated over US dollar by 5.39% (ytd) to IDR15,030 in late July. Even though it depreciates, Rupiah is still the best performing currency among other developing countries in Southeast Asia, with the depreciation of Thailand Bath at 10.2%, the Philippines Peso at 9.96%, Malaysian Ringgit at 6.92% in the same period. Rupiah depreciation is even better than the last Fed's rate hike in 2018, where Rupiah depreciated by 12% (ytd). The sound trade surpluses have cushioned the effect of monetary tightening on depreciation as higher exports than imports indicate more foreign exchange liquidity in the market. BI also managed to maintain adequate foreign exchange reserves, with a slight contraction of USD8.5 billion from its figure in December 2021 to USD136.4 billion in June 2022. BI believes that current foreign reserves can support external sector resilience while maintaining macroeconomic and financial system stability.

Figure 15: Indonesia Export Profile (April-May 2022)



Source: CEIC

Figure 16: Indonesia Import Profile (April-May 2022)



Source: CEIC

"The favorable performance of exports coupled with modest core inflation, robust economic outlook, and promising fiscal consolidation has prompted BI to keep its benchmark rate unchanged at 3.5%."

The high commodity prices maintained persistent Indonesia's trade balance surpluses in the first half of 2022, which indicatively provides relatively ample monetary capacity for BI. The favorable performance of exports coupled with modest core inflation, robust economic outlook, and promising fiscal consolidation has prompted BI to keep its benchmark rate unchanged at 3.5%. Moreover, BI remains to stay behind the curve to prevent potential lower demand and slower economic growth from increased interest rates in 1H-2022. Going forward, BI will likely increase the interest rate once the US-Indonesia rate differential has widened due to the Fed's aggressive monetary tightening. In addition, the room for BI to hold the rate in 2H-2022 will be narrower because the current account might turn back into its negative territory as the signs of full recovering demand toughens. The probability of palm oil normalization is also high in the near future as global CPO prices in July have corrected by 31.5% (ytd). On the other hand, GoI needs to prepare the most effective policy to support growth amidst higher interest rate and inflation. Nevertheless, the effect of monetary tightening on fiscal figures will likely be limited as GoI has put efforts in maintaining the fiscal consolidation.