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Macroeconomic Analysis Series

BI Board of Governor Meeting

August 2022

Highlights

- BI still have some room to hold its policy rate at 3.50% this month.
- Due to capital inflows driven by positive sentiment toward the domestic economy, the Rupiah strengthened in mid-August to around IDR14,800 from around IDR15,000 in July.
- Indonesia's trade balance in July 2022 recorded a surplus of USD4.23 billion, making it the 27th consecutive month of surplus since May 2020.

Macroeconomics & Political Economy Policy Research

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Amidst a bleak outlook for global growth and elevated inflation level everywhere, Indonesia's economy has shown a more optimistic attitude in the remainder of the year. The economy grew by 5.44% (y.o.y) in Q2-2022, better-than-expected and well above many consensus. Core inflation remained relatively benign compared to headline inflation, although we projected the trend will be going upward. From external side, the aggressive move by the Fed provoked a wider rate differential, resulting in the capital outflow from emerging markets. Fortunately, it did not appear in Indonesia this month due to the positive market sentiment toward domestic fundamentals, particularly after the published growth of the second quarter has amplified the capital inflows into domestic financial market. As a result, Rupiah strengthened in mid-August to a level of around IDR14,800. Therefore, we see that BI still have some room to hold its policy rate at 3.50% this month to support external resilience while maintaining macroeconomic and financial system stability.

Mounting Pressure on Headline Inflation

Annual headline inflation rate rose sharply in July on the back of persistent soaring energy and food prices, as well as strengthened by the low base effect as inflation was quite mild in the same period last year. July headline inflation was recorded at 4.94% (y.o.y), substantially higher than 4.35% (y.o.y) in June 2022 and being the highest level since October 2015. On a monthly basis, headline inflation picked up slightly to 0.64% (m.t.m) in July, from 0.61% (m.t.m) one month earlier. There are at least three main expenditure groups contributing the most to the headline inflation. First, the food, beverage, and tobacco prices that accelerated to 9.35% (y.o.y) in July from 8.26% (y.o.y) due to a hike in several food prices particularly in shallot, red chili, and bird's eye chili. Second, the transportation group with a continuous surge to 6.65% (y.o.y), significantly higher than the June figure of 5.45% (y.o.y). It was mainly driven by an increase in non-subsidized fuel prices (Pertamax Turbo, Dexlite, and Pertamina Dex). Third, the housing, water, and electricity group gradually hike to 2.57% (y.o.y) from 2.14% (y.o.y) due to adjustments on electricity tariffs for household customers above 3,500 VA.

Observing its component, the monthly volatile food inflation rate in July experienced a slower pace of 1.41% (m.t.m) in July 2022 compared to 2.51% (m.t.m) in the previous month. The main contributors to milder inflationary pressures on volatile food were lower cooking oil, purebred chicken eggs, garlic and vegetables prices. Meanwhile, the administered prices in July increased to 1.17% (m.t.m) from 0.27% (m.t.m) in June, owing to a rise in aviation fuel prices and increased air mobility due to relaxed PPKM restrictions. Core inflation, which reflects people's purchasing power, gradually accelerated to 0.28% (m.t.m) from 0.19% (m.t.m), indicating that

Key Figures

BI Repo Rate (7-day, July '22)
3.50%
GDP Growth (y.o.y, Q2 '22)
5.44%
Inflation (y.o.y, July '22)
4.94%
Core Inflation (y.o.y, July '22)
2.86%
Inflation (m.t.m, July '22)
0.64%
Core Inflation (m.t.m, July '22)
0.28%
FX Reserve (July '22)
USD132.2 billion

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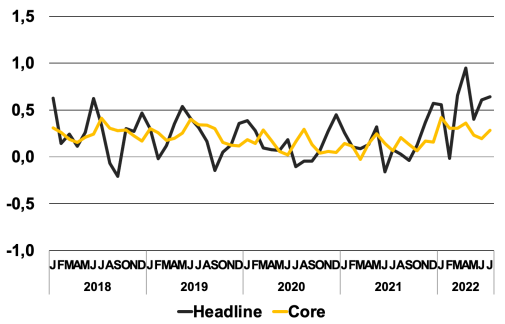
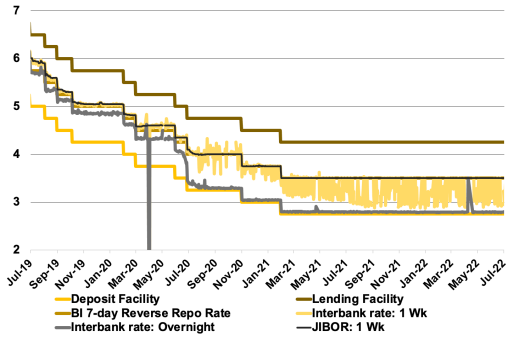
consumption and economic activity are gradually returning to normal following PPKM easing. The steady increase in core inflation was also seen in the annual trend, which stood at 2.86% (y.o.y), up from 2.63% (y.o.y) a month prior.

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



Source: CEIC

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



Source: CEIC

Overall, July inflation rate was still dominated by inflation from the supply side due to soaring food and energy prices and it is expected to consistently increase in the near future. On the other hand, the windfall profit from commodity prices, enables GoI to triple its energy subsidy to IDR502.4 trillion, is enough to keep prices of Pertalite, 3kg canister LPG, and electricity tariffs unchanged. The large subsidy along with the continuous social aid has helped to maintain household consumption and suppress domestic inflation not to skyrocket so far, providing adequate room for BI to prolong its current policy stance.

Higher-than-Expected Growth Keeping Recovery Momentum On-Track

Amidst a bleak outlook for global growth and elevated inflation level everywhere, Indonesia's economy has shown a more optimistic attitude in the remainder of the year. The economy grew by 5.44% (y.o.y) in the second quarter, better-than-expected and well above many consensus. The improvement was primarily driven by household spending and external sector. Solid growth of household consumption occurred due to the easing of PPKM, increased vaccination rate, and momentum Ramadan and Eid-ul-Fitr period, which accelerated public mobility and spending activities. Meanwhile, export performance has been very impressive, thanks to high commodity prices. Although palm oil exports experienced a hiccup by a temporary government palm oil export ban, imports rose at a much slower pace, allowing a continuous trade surplus.

Several leading indicators, including Consumer Confidence Index (CCI) and the Manufacturing Purchasing Managers Index (PMI), confirmed that the domestic economic recovery process remains intact. CCI experienced a pick-up during the second quarter of 2022 with an average of 123.4, rising from its average of 114.6 in the previous quarter. The upward trend of CCI indicates that household confidence has kept rising despite climbing global and domestic inflation. This should be

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attributed to the lower daily confirmed Covid-19 cases in the second quarter, which in turn eased social-mobility restrictions, thereby bolstering economic activities and household consumption, especially during Ramadan and Eid-al-Fitr. However, on a monthly basis, CCI slightly dropped to 123.2 in July compared to 128.2 in June 2022, but still in the optimistic territory. Furthermore, the impressive performance of real sector activities was reflected in manufacturing PMI that recorded at 51.3 in July, increased from 50.2 in June and stood well above 50, indicating an expansion in the manufacturing sector. The current figure has even surpassed the PMI of other ASEAN countries, such as Vietnam (51.2), the Philippines (50.8), Malaysia (50.6), and Myanmar (46.5).

From external trade, Indonesia's trade balance in July 2022 recorded a surplus of USD4.23 billion, making it the 27th consecutive month of surplus since May 2020. However, the surplus has shrunk from last month's figure, which stood at USD5.09 billion. Exports grew by 32.03% (y.o.y) to USD25.57 billion but on a monthly basis dropped by 2.20% (m.t.m) compared to the value in June. Such impressive export performance was still mainly driven by persistently strong export demand amid high global commodity prices. Yet, the windfall from exports may start dwindling as several key commodity prices have started to ease amid fears of global recession. Such a condition was reflected by the stagnant volume of commodity exports, including CPO, coal, and nickel, and this could lead to weakening export performance in the near future.

Meanwhile, imports surged by 39.86% (y.o.y) to USD21.35 billion along with accelerating domestic economic recovery. With intensifying external pressures that might affect Rupiah's stabilization, any potential rise in import prices might viciously impact domestic prices through the channel of rising producers' prices since input materials still dominate imports. Furthermore, the significant trade surpluses during the second quarter, particularly in April and June, contributed to an increase in the current account surplus in Q2-2022. The current account posted a USD3.9 billion surplus (1.1% of GDP), substantially higher than the USD0.4 billion surplus (0.1% of GDP) in Q1-2022. Despite the remarkable trade performance, GoI needs to watch out for the trend of lower commodity prices and be aware of the growing China-Taiwan tension that could potentially bring undesirable impact on the trade balance.

Maintaining External Resilience

Global economic slowdown intensifies as downside risks have started to materialize and brought a gloomy and more uncertain outlook of both advanced economies and emerging markets. IMF, in its latest report, downgrades global growth by 0.4 ppt to 3.2% this year and 0.7 ppt to 2.9% next year. At this juncture, global inflationary pressure is also unavoidable and is going to skyrocket in response to high commodity prices caused by supply chain disruptions given the ongoing geopolitical

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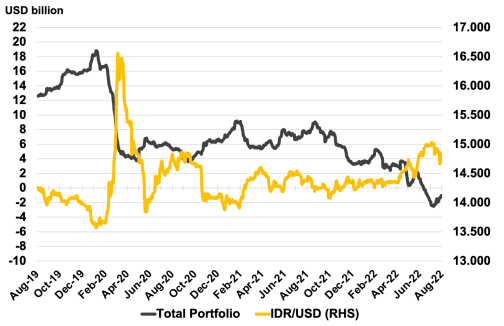
tensions between Russia and Ukraine, coupled with the protectionism practices toward several key food and energy commodities. The higher-than-anticipated inflation triggering central banks worldwide to be more hawkish and faster in raising policy rates, thus impeding the economic recovery and exacerbating the risk of stagflation. As expected, the Fed continued to increase its FFR for the fourth consecutive time by 75bps from 1.50% - 1.75% to 2.25% - 2.50% in July FOMC meeting to signal its determination to tame inflationary pressure. At the same time, as the energy price hike is easing, the US annual inflation rate slightly falls from 9.10% in June to 8.5% in July, raising hopes that inflation has reached its peak.

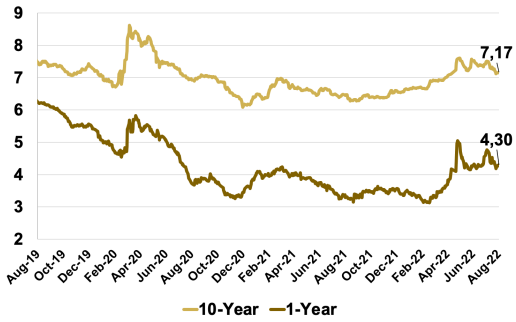
The aggressive move by the Fed provoked a narrower rate differential, resulting in the capital outflow from emerging markets. Fortunately, it did not appear in Indonesia this month as the positive market sentiment towards domestic fundamental, particularly after the published growth of the second quarter has amplified the capital inflows into domestic financial market at approximately USD1.12 billion from the beginning until mid-August. The capital inflows, which is dominated by government bonds, has also brought the lower yields of 10-Year and 1-Year government bond yield to 7.2% and 4.3% in mid-August from 7.5% and 4.7% in the same period last month, respectively. This also led to wider yield gap between 10 and 1-year bonds, indicating a soundness sentiment from investors towards long-term investment.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)

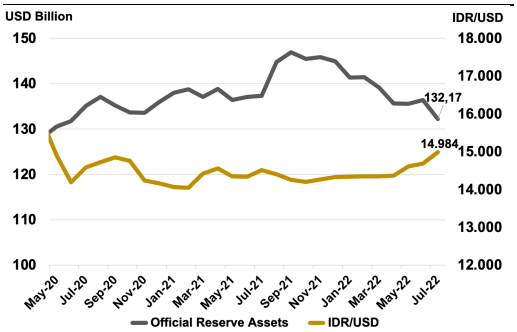


Source: CEIC

As a result of capital inflows, Rupiah strengthened in mid-August to a level of around IDR14,800 from around IDR15,000 in July. Rupiah performed better with depreciation rate of 4.1% (ytd), compared to other emerging peers, such as Malaysian Ringgit (7.5%), Thailand Baht (7.6%), and Philippines Peso (9.7%). Aside for the payment of foreign government debt, BI's effort to stabilize Rupiah over the last month has been translated into lower foreign exchange reserves, with a contraction from USD136.4 billion in July to USD132.2 billion in August 2022. The latest figure of foreign exchange reserves, however, is still adequate to cushion any

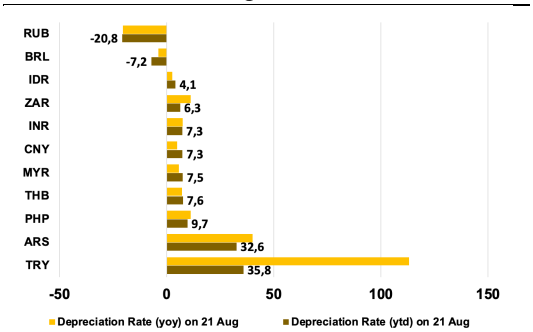
turbulence as the reserves are equivalent to 6.2 months of imports or 6.1 months of imports and government external debt services.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (Aug 21, 2022)



Source: Investing.com

Considering both domestic and external circumstances, BI still has room to leave its policy rate unchanged this month. Externally, amidst the global headwinds and the risk of stagflation, Indonesia is currently in a relatively favourable position compared to most countries. Foreign exchange reserves remained strong, potentially acting as a buffer to help stabilize Rupiah. With maintained external resilience, Rupiah has been strengthened since the end of July. Domestically, robust demand and supply recovery, driven by significant drop in daily Covid-19 cases, is reflected in the solid growth in Q2-2022. This is also confirmed by various leading indicators suggesting investors remain confident toward domestic macroeconomic fundamental. Furthermore, the windfall from high commodity prices maintained trade balance surpluses in the first half of 2022 and successfully increased the current account surplus in Q2-2022. All in all, we see that BI still have some room to hold its policy rate at 3.50% this month to support external resilience while maintaining macroeconomic and financial system stability.

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