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UNIVERSITAS INDONESIA

Macroeconomic Analysis Series

BI Board of Governor Meeting

September 2022

Although inflation eased in August 2022, it is still well above BI's target range and expected to accelerate in the remaining months of 2022 following the fuel price hike. From external side, the Fed's aggressive move on interest rate hikes, combined with external pressures, will continue to have an adverse impact on emerging markets, including Indonesia, in terms of capital outflows. As a result, Rupiah depreciated to a level of around IDR15,000 per USD in the last few days. Therefore, we see that BI needs to increase its policy rate by 25 bps to 4.00% in order to maintain inflation expectations and curb future inflationary pressures, given the government's decision of raising subsidized fuel prices earlier this month. In addition, as a pre-emptive measure following the Fed's decision on their policy rates that may induce another round of flight-to-safety moves from risky global assets, we see that it is also the right momentum for BI to start preparing a more comprehensive stabilization strategy for maintaining the exchange rate.

Fuel Price Hike to Push Inflation Above BI's Target Range

Annual headline inflation rate in August was recorded at 4.69% (y.o.y), slightly declined from 4.94% (y.o.y) in the previous month. Based on the expenditure groups, the lower trend of headline inflation was mainly due to a slowdown in several main groups contributing the most to the headline inflation, such as the food, beverage, and tobacco prices and the transportation group which fell from 9.35% (y.o.y) to 7.73% (y.o.y) and 6.65% (y.o.y) to 6.62% (y.o.y), respectively. The inflation level is relatively high compared to the same period last year due to the low base effects as the inflation rate in August 2021 was quite mild. On a monthly basis, headline inflation actually demonstrated deflation of 0.21% (m.t.m), after experiencing inflation of 0.64% (m.t.m) in July 2022. This is mainly due to a decrease in prices for volatile foods and administered prices inflation while core inflation rose slightly.

Observing its component, the monthly volatile food inflation rate in August 2022 experienced a deflation of 2.90% (m.t.m) compared to 1.41% (m.t.m) of inflation in the previous month. The main contributors are an increase in supply of various chilies and shallots from production centers, which causes the price to fall. Rice and broiler eggs, on the other hand, experienced inflation along with the end of the harvest period and increased demand. Meanwhile, the administered prices component in August experienced milder inflationary pressures, owing primarily to lower airfares as aviation fuel prices eased. Core inflation, which reflects people's purchasing power, gradually accelerated to 0.38% (m.t.m) in August 2022 from 0.28% (m.t.m) in the prior month, indicating that consumption and economic activity are gradually returning to normal following PPKM easing. The steady increase in core inflation was

Highlights

- BI needs to increase its policy rate by 25 bps to 4.00% in order to maintain inflation expectations and curb future inflationary pressures, given the government's decision of raising subsidized fuel prices earlier this month.
- Due to capital outflows, Rupiah depreciated to a level of around IDR15,000 per USD in the last few days from around IDR14,800 in August.
- Indonesia's trade balance accumulated a larger trade surplus of USD5.76 billion in August 2022, making the 28th consecutive month of surplus since May 2020.

Macroeconomics & Political Economy Policy Research

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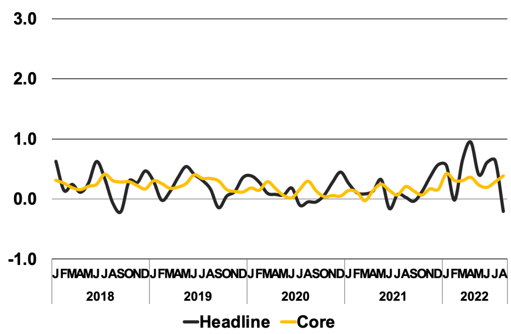
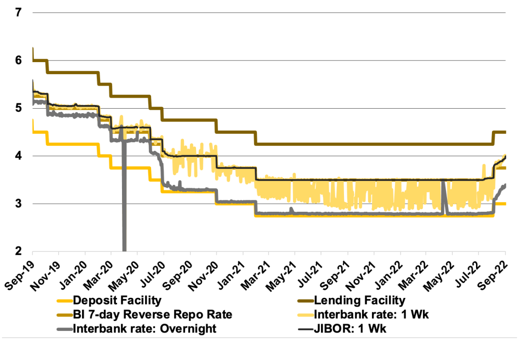
also visible in its annual trend, which stood at 3.04% (y.o.y) in August 2022, up from 2.86% (y.o.y) a month earlier.

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



Source: CEIC

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



Source: CEIC

Looking ahead, inflationary pressures are predicted to continue. This is expected to be driven, among other things, by high global energy and food prices coupled with the increase in non-subsidized fuel prices in early September as well as increasing inflationary pressure from the demand side, which also poses the risk of rising core inflation and inflation expectations.

Maintaining Recovery Process amid Rising Uncertainties

Along with Indonesia's economic growth acceleration in the second quarter, the Covid-19 pandemic is getting more manageable domestically. This is evidenced by the fact that the number of daily cases has been declining since the end of July 2022. Data as of September 13 also shows that 74.5% of the population has received at least the first dose of the Covid-19 vaccine and 62.3% has been fully vaccinated.

As a result, several leading indicators, including Consumer Confidence Index (CCI) and the Manufacturing Purchasing Managers Index (PMI), confirmed that the domestic economic recovery process remains intact. A pick-up on CCI from 123.2 in July 2022 to 124.7 in August 2022 indicates consumer optimism in current economic conditions as well as consumer expectations of economic conditions moving forward. The upward trend of CCI has also consistently remained in optimistic territory with an index reading above 100 despite climbing global and domestic inflation. This should be attributed to the lower daily confirmed Covid-19 cases in recent months, which in turn eased social-mobility restrictions, thereby bolstering economic activities and household consumption. Furthermore, the impressive performance of real sector activities was reflected in manufacturing PMI that recorded at 51.7 in August, increased from 51.3 in July and stood well above 50 since September 2021, indicating that the operating conditions across Indonesia's

Key Figures

BI Repo Rate (7-day, August '22)
3.75%
GDP Growth (y.o.y, Q2 '22)
5.44%
Inflation (y.o.y, August '22)
4.69%
Core Inflation (y.o.y, August '22)
3.04%
Inflation (m.t.m, August '22)
-0.21%
Core Inflation (m.t.m, August '22)
0.38%
FX Reserve (August '22)
USD132.2 billion

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manufacturing sector have improved every month in the last 12 months. The current figure has even surpassed the PMI of other ASEAN countries, such as the Philippines (51.2), Malaysia (50.3), and Myanmar (46.5).

From external trade, Indonesia's trade balance accumulated a larger trade surplus of USD5.76 billion in August 2022 compared to USD4.22 billion in the previous month, making the 28th consecutive month of surplus since May 2020. For the period of January-August 2022, the overall trade surplus stood at USD34.92 billion, up significantly from USD20.71 billion in the same period of 2021. Exports value was recorded at USD27.91 billion in August 2022, an increase of 30.15% (y.o.y) compared to August 2021. On a monthly basis, it increased by 9.17% (m.t.m) compared to the previous month. The trade surplus recorded in August 2022 stemmed from a wider non-oil and gas trade surplus, coupled with a narrower oil and gas trade deficit. Such impressive export performance was explained by persistently solid non-oil and gas exports totalling USD26.19 billion in August 2022, up from USD24.20 billion one month earlier, boosted by exports of natural resources, such as crude palm oil (CPO), on the back of government policy to extend the exemption on CPO export levies together with persistently high international commodity prices.

Meanwhile, imports surged by 32.81% (y.o.y) to USD22.15 billion along with accelerating domestic economic recovery. The Central Bureau of Statistics recorded the largest increase in imports of non-oil and gas goods in August 2022 compared to July 2022, namely machinery/mechanical equipment and parts of USD357.2 million or 13.63%. Despite the remarkable trade performance, GoI needs to watch out for the trend of lower commodity prices as global growth is currently slowing, with China's economy faltering dramatically and the U.S. growth appearing to be slower than last year.

Perfect Time to Get Ahead of The Curve

Consensus forecasts for global growth in 2022 and 2023 have been downgraded significantly since the beginning of the year. Although this forecast does not suggest a global recession for this or next year, there are lessons to be learned from previous recessions, such as every global recession since 1970 that was preceded by a significant slowdown in global growth in the previous year, and all previous global recessions have coincided with sharp declines in several major economies. Both have either materialized in recent months or may be ongoing—raising the likelihood of a global recession in the near future.

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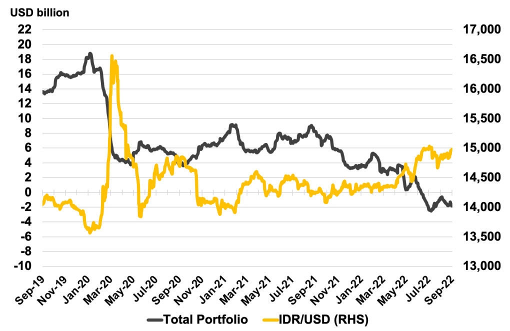
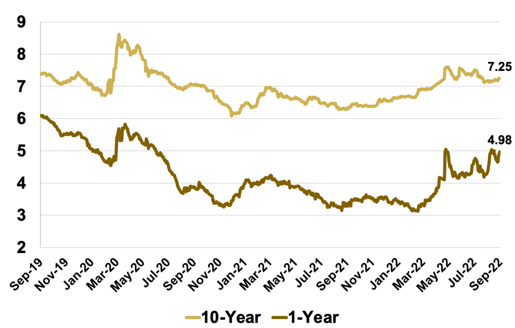
The Fed has raised interest rates by 225 bps so far in 2022, and given the persistently higher US August inflation figures, it is widely expected that the rate hike at the next FOMC meeting in September could reach 75 bps or even 100 bps. The aggressive move by the Fed and other developed countries in tightening liquidity and interest rates, combined with other external pressures, will continue to have an adverse impact on emerging markets, including Indonesia, which has already experienced net outflows of around USD1.09 billion since late August. The Fed's decision on interest rates this month may appear as one of the determinants that weaken the positive sentiment from the market, which should be gained from the outstanding trade balance's performance. A further increase in FFR has also the potential to widen the yield spread, resulting in capital outflows and further Rupiah depreciation. The recent trend of capital outflow contributes to widening 10Y and 1Y government bond yield spread from 7.2% and 4.3% in mid-August to 7.2% and 4.9% in mid-September, suggesting a pessimism of investors' sentiment toward Indonesia's short-term economic situation.

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



Source: CEIC

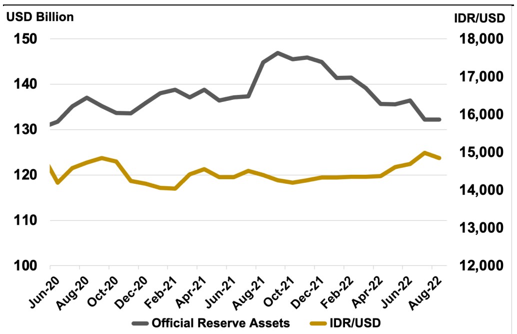
Figure 4: Government Bonds Yield (% pa)



Source: CEIC

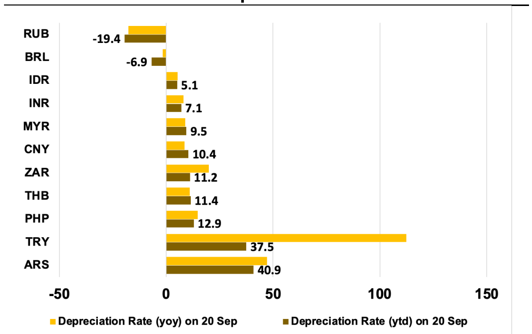
As a result of capital outflows, Rupiah depreciated to a level of around IDR15,000 per USD in the last few days from around IDR14,800 in August. However, Rupiah performed better with depreciation rate of 5.1% (ytd), compared to other emerging peers, such as Malaysian Ringgit (9.5%), Thailand Baht (11.4%), and Philippines Peso (12.9%). Aside for the payment of foreign government debt, BI's effort to stabilize Rupiah over the last month has been translated into a stable foreign exchange reserves, with 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 6.1 months of imports or 6.0 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 (Sep 20, 2022)



Source: Investing.com

Considering both domestic and external circumstances, we see that BI needs to prolong its tightening stance and increase its policy rate by 25 bps to 4.00% for the second time this year. Given the government's decision to raise subsidized fuel prices earlier this month, a forward-looking stance is required to maintain inflation expectations and curb future inflationary pressures. Furthermore, a rather rapid depreciation of Rupiah in the last few days also transpire into the need of BI to continue increasing policy rate in order to maintain currency stability. As a pre-emptive measure following the Fed's decision on their policy rates that may induce another round of flight-to-safety moves from risky global assets, we see that it is also the right momentum for BI to start preparing a more comprehensive strategy for maintaining the exchange rate stability. Given the current state of a prolonged solid economic recovery, fuelled one of which by strong credit demand and a robust trade surplus, BI's decision to be ahead of the curve this time is unquestionably necessary.

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