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Macroeconomic Analysis Series

BI Board of Governor Meeting

November 2022

Highlights

- BI should continue its tightening stance by raising the BI rate by 50bps during the November meeting to lower inflationary pressures and stabilize Rupiah.
- Still above target, inflation slowed in October 2022 as lower food prices offset fuel price increase.
- Trade surplus widened in October 2022 supported by higher exports while imports fell.

Macroeconomics & Political Economy Policy Research

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Although easing due to lower food prices, inflation is still far above BI's target range at 5.95% (y.o.y) in October 2022, following the increase in subsidized fuel prices in early September 2022. On top of that, Rupiah continued to depreciate to IDR15,487 per US Dollar in mid-November. Globally, the Fed is expected to continue its rate hike rally in December, although at a slower pace. These three combined suggested that BI still need to increase its policy rate by 50bps this month to 5.25% in an effort to manage inflation expectation and to keep Rupiah stable. Robust economic growth in Q3-2022, supported by intact household consumption growth, provides justification for BI to continue its monetary tightening cycle.

Inflation Starts to Ease but Still Above Central Bank's Target

After hitting a seven-year peak at 5.95% (y.o.y) in September 2022, headline inflation eased to 5.71% (y.o.y) in October 2022 despite being far above the central bank target range of 2% to 4% for a fifth straight month. Although it remained high, headline inflation in October 2022 was lower-than-expected because the impact of a hike in subsidized fuel prices in early September 2022 on volatile prices and administered prices inflation was not as high as initially forecasted. While the increase in fuel prices is still keeping inflation high, food prices in October 2022 remain manageable thanks to harvest season for horticulture products and efforts by GoI, both national and regional, Bank Indonesia, and Regional Inflation Control Team (*Tim Pengendalian Inflasi Daerah* (TPID)) in managing stocks of strategic food commodities, such as chilies, eggs, and purebred chickens. As food prices offset fuel price hikes, headline inflation slowed in October 2022.

On a monthly basis, deflation of 0.11% (m.t.m) was reported in October 2022, lower than inflation of 1.17% (m.t.m) in September 2022. Again, the lower-than-expected monthly inflation was driven by the success of GoI in maintaining the availability of food stocks in the market, which was demonstrated by monthly deflation of 1.62% (m.t.m) or annual inflation of 7.19% (y.o.y) in volatile prices. The annual inflation was down from 9.02% (y.o.y) in September 2022. The administered price, the main contributor to this month's inflation, increases by 13.28% (y.o.y) or 0.33% (m.t.m). Monthly inflation of administered prices was significantly lower compared to a month earlier at 6.18% (m.t.m) due to the normalization of the first round effect of fuel price hike and decrease in airline tickets as a result of the lower price of aviation fuel. However, further decline in administered prices inflation was restrained due to price adjustments in urban transportation and household fuel at retail level. As a result, annual inflation of administered price was reported to be stable at 13.28% (y.o.y) in October 2022, the same level as in the previous month. Looking at inflation by

Key Figures

BI Repo Rate (7-day, October '22)
4.75%
GDP Growth (y.o.y, Q3 '22)
5.72%
Inflation (y.o.y, October '22)
5.71%
Core Inflation (y.o.y, October'22)
3.31%
Inflation (m.t.m, October '22)
-0.11%
Core Inflation (m.t.m, October'22)
0.16%
FX Reserve (October '22)
USD130.2 billion

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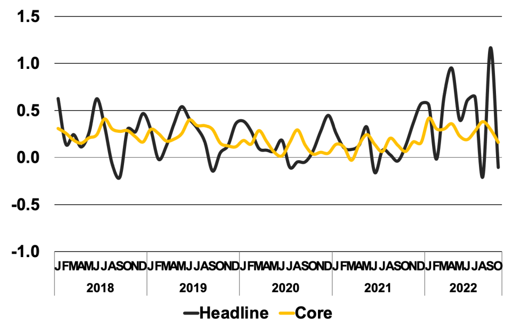
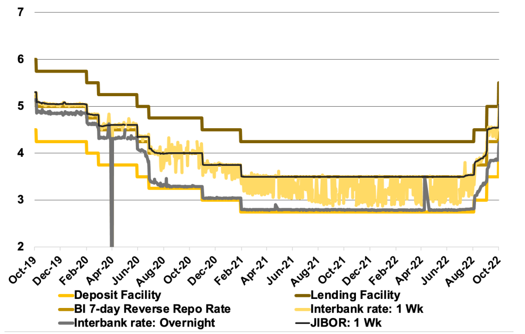
expenditure group, the transport group indicated the highest annual inflation at 16.03% (y.o.y) or 0.35% (m.t.m), in line with the increase in fuel price.

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



Source: CEIC

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



Source: CEIC

Moving on to core inflation, it remained low at 3.31% (y.o.y), although slightly higher than 3.21% (y.o.y) in September 2022. On a month-to-month basis, core inflation was reported at 0.16% (m.t.m) in October 2022, down from 0.30% (m.t.m) a month earlier. The decline in monthly core inflation was in line with the subdued effect of fuel price hikes and low demand-side inflationary pressure. Looking ahead, core inflation is expected to remain manageable as inflationary pressure from subsidized fuel price hikes normalizes as well as efforts to keep inflation benign. On the other hand, the ongoing depreciation will continue to strain headline inflation to stay above the upper band of 4% BI's inflation target in the near future. To keep inflation at a manageable level, Bank Indonesia intends to take front-loaded, pre-emptive, and forward-looking steps to manage inflation expectations, which currently are too high.

In A Much Better Place to Face The Current Storm

In the middle of a rather tricky global economic condition, including aggressive monetary tightening worldwide, increased risk of stagflation, the Russian-Ukraine war, and weak growth in China, Indonesia's economic growth was recorded impressively at 5.72% (y.o.y) in Q3-2022. The current level of growth is better compared to the previous quarter's growth at 5.44% (y.o.y), as Indonesia enjoyed a peak in consumption during the month of Ramadan and the celebration of Eid al Fitr. Robust growth in the third quarter of 2022 happened as household consumption and export posted solid growth of 5.39% (y.o.y) and 21.64% (y.o.y), respectively, as Indonesia still enjoyed windfalls from high global commodity prices. Household consumption growth was driven by rising spending among households in the middle

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to upper classes, indicating that the economic recovery is continuing and strengthening despite global challenges.

Following the release of the GDP growth figure, Consumer Confidence Index (CCI) also demonstrated a lift to 120.3 in October 2022 after hitting the lowest level in five months at 117.2 in September 2022. After being negatively impacted by the increase in subsidized fuel prices in early September, consumers began to have growing confidence in current economic conditions and expectations of economic conditions moving forward, which was reflected in a higher index across all spending, age, and education brackets. The Current Economic Condition Index (CECI) increased in terms of all components, led by the Purchase of Durable Goods Index, while the Consumer Expectation Index (CEI) was primarily driven by consumer expectations of business activity moving forward.

While consumers indicated growing confidence, a slightly different story was reflected in the real sector. Purchasing Managers Index (PMI) was reported at 51.8 in October 2022, down from 53.7 in September 2022. The decrease in PMI was due to manufacturing companies reducing their recruiting and purchasing activities due to global demand growth slowdown. Additionally, supply constraints and cost pressures for the Indonesian manufacturing sector are still present, where lead times for orders continue to be extended, causing a decrease in inventories. Although the PMI decreased in October 2022, it was still above 50, indicating an expansion compared to the previous month. Neighboring countries like the Philippines, Thailand, and Vietnam also experienced a slip in PMI in October 2022 due to slowing foreign demand following high inflation. Comparing the level of PMI in October 2022, Indonesia's figure was higher than Vietnam and Thailand at 50.6 and 51.6, respectively, but lower than the Philippines at 52.6.

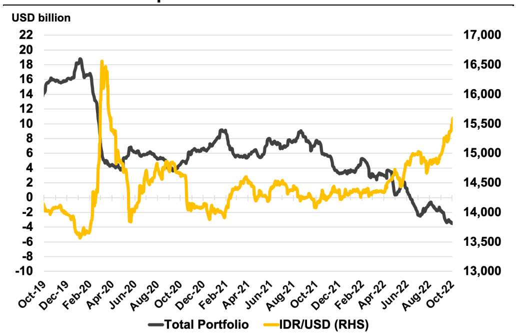
Still enjoying an export boom thanks to high commodity prices, the trade balance was still reported in the surplus territory in October 2022. The surplus in October 2022 was seen at USD5.67 billion, up by 14.18% (m.t.m) from September 2022 figure of USD4.97 billion. Breaking down its component, exports increased by 0.13% (m.t.m), while imports fell by 3.4% (m.t.m) in October 2022. Exports increased moderately as commodity prices starts to normalize, especially in coal, palm oil, nickel, and tin, which were Indonesia's primary export commodities. On the other hand, imports were down this month as manufacturing pauses its purchasing of machinery, fuel, and gold due to slowing global demand and depreciating Rupiah, which implies higher cost of production.

Entangled in The Fed's Slipstream

As most of the world is currently battling spiking inflation, the monetary tightening cycle that was pioneered by the Fed is happening across the globe. Series of interest rate hikes caused episodes of capital outflows from most other parts of the world, particularly emerging market economies. Focusing on the US data, the annual US inflation eased to 7.7% in October 2022, down from 8.2% a month earlier, but still way beyond the US long-term inflation target of 2%. Due to the inflation still being elevated, as previously expected, the Fed announced another 75bps in early November, making its current target range stand at 3.75% to 4%. This was the fourth consecutive interest rate hike by the Fed. After the conclusion of the FOMC meeting on 2 November, the market absorbed the Fed's decision indicated by an increase in the yield on the 2-year US Treasury by 10bps, reaching a 15-year high at 4.71%. At the same time, the 10-year US Treasury yield went up by 7bps to 4.14%. A rising yield indicated a falling demand for Treasury bonds as the hope that interest rate increases in the future will not be as large and the Fed will soon slow its interest rate hikes is increasing. This is also justified by decrease in inflation, which led investors to believe that inflation in the US may now past its peak.. This expectation led investors to take more risks and shift their portfolios towards assets in the emerging economies. Albeit, the market is currently predicting that the Fed will not pause but may slow its rate hikes in December.

Considering the uncertainty in the global market, while some investors start to tap into riskier assets, others still move their assets from an emerging market, resulting in net capital outflows of USD100 million from mid-October 2022 to mid-November 2022. This was translated into an increase in yield of 1-year Indonesian government bond from 5.83% mid-October 2022 to 6.21% mid-November 2022. An increase in yield was also seen in the 10-year Indonesian government bond, which went up from 7.37% in mid-October 2022 to 7.54% in mid-November 2022. The falling yield spread indicated that investors sell more of their short-term bonds compared to the longer-tenor bonds, suggesting that investors may see worsening economic conditions may be coming.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)

Source: CEIC

With modest amount of net capital outflows between mid-October and mid-November 2022, Rupiah was reported at IDR15,487 per US dollar on 11 November

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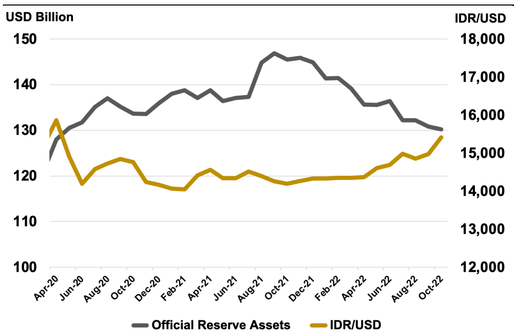
8 DECENT WORK AND ECONOMIC GROWTH

2022, slightly depreciated from IDR15,348 a month earlier and continuing the depreciation trend as the narrowing rate differential prolongs. On a year-to-date basis, Rupiah depreciated by 8.74% (ytd). While being pressured by the continuing rally in the US dollar, Rupiah performed better than most emerging economies currencies like Argentine Peso, Türkiye Lira, Philippine Peso, and Malaysian Ringgit, which experienced more than 10% year-to-date depreciation at 58.52%, 39.52%, 12.20%, 11.13%, respectively. Bank Indonesia is said to continue its triple intervention strategies to keep the Rupiah stable: intervening in the spot market, domestic non-deliverable forward (DNDF), and purchase of SBN.

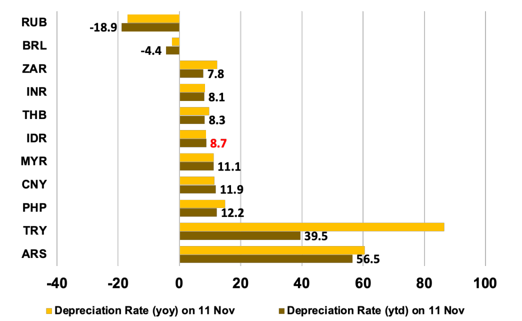
To keep the Rupiah stable, foreign exchange reserves marginally decreased to USD130.2 billion in October 2022 compared to USD130.8 billion in September 2022. Aside from the need for Rupiah stabilization, a slight decrease in foreign exchange reserve was due to the payment of the government's external debt. Another factor that might be contributing to the forex reserves deterioration is domestic banks' USD deposit rate is relatively unattractive compared to other countries, such as Singapore. Despite its slight decrease, the current position of foreign exchange reserve is equivalent to finance 5.8 months of imports or 5.6 months of imports and servicing government's external debt, well above the international adequacy standards of three months imports.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (11 November 2022)



Source: Investing.com

Considering the current level of inflation, which has been above the central bank's target range for five months, BI should increase its policy rate by 50bps to 5.25% this month in order to maintain Rupiah stability in an era of increasing global financial market uncertainty and US dollar appreciation, as well as to safeguard an attractive spread with US rates. Additionally, despite price hike pressures and increasing borrowing rates, Indonesia's economy grew faster than expected in the third quarter, which allows Bank Indonesia to have the flexibility to continue tightening policy even further. Increasing policy rates will help limiting the amount of capital outflows, preventing Rupiah from further depreciation, and curbing inflationary pressures from imported goods.