Macroeconomic Analysis Series

BI Board of Governor Meeting

January 2023

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UNIVERSITAS INDONESIA

Highlights

- BI still need to increase its policy rate by 25bps this month to 5.75%.
- The full 2022 headline inflation was recorded at 5.51% (y.o.y), far above the central bank's target corridor.
- Less aggressive stance by most central banks moves capital from advanced economies to emerging economies like Indonesia, which cause Rupiah to slightly appreciate in mid-January 2023.
- Foreign exchange reserves continued to grow to USD137.2 billion driven by tax and service revenue as well as government loan withdrawal.

Macroeconomics & Political Economy Policy Research

Jahen F. Rezki, Ph.D.
jahen@lpem-feui.org

Syahda Sabrina
syahda.sabrina@lpem-feui.org

Nauli A. Desdiani
nauli.desdiani@lpem-feui.org

Teuku Riefky
teuku.riefky@lpem-feui.org

Amalia Cesarina
amalia.cesarina@lpem-feui.org

Meila Husna
meila.husna@lpem-feui.org

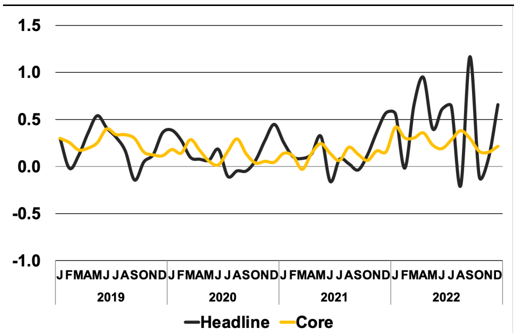
Faradina Alifia Maizar
faradina@lpem-feui.org

Pressured by increasing global energy and food prices combined with seasonal patterns of Christmas and year-end festivity, Indonesia ended 2022 with headline inflation of 5.51% (y.o.y), making the full 2022 headline inflation far above BI's target corridor. Meanwhile, Rupiah experienced slight appreciation in mid-January to around IDR15,100 per US Dollar supported by modest capital inflows due to cooling inflation in most economies and less aggressive stance by most central banks. The Fed is expected to continue its hawkish stance in early 2023. These three combined suggested that BI still need to increase its policy rate this month by 25bps in an effort to maintain Rupiah stability as well as reducing inflationary pressure.

Highest Annual Inflation Figure in the last Seven Years

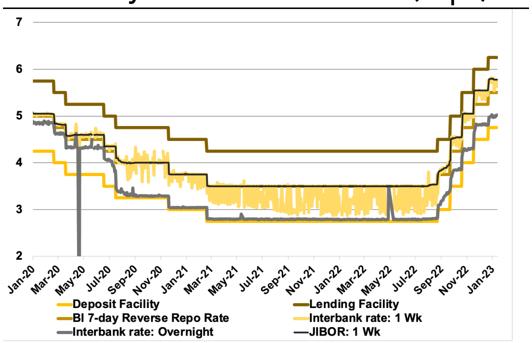
Being above central bank's target corridor of 2% - 4%, the full 2022 headline inflation was recorded at 5.51% (y.o.y), the highest level since 2015. A modest increase from November 2022 figure at 5.42% (y.o.y) is primarily influenced by the domino effect of fuel price adjustment and seasonal year-end trends when people increase their consumption. In general, increase in inflation during 2022 was heavily affected by increase in global energy and food prices, upward adjustment of subsidized fuel prices, and growing domestic demand. Thanks to the concerted effort by BI and GoI at the national and regional level, 2022 ended with lower rate of inflation, which was initially forecasted to reach 6%.

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



Source: CEIC

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



Source: CEIC

The administered price grew by 13.34% (y.o.y) in December 2022, a slight increase from 13.01% (y.o.y) in the previous month. On a monthly basis, the administered price component accelerated by 0.73% (m.t.m) in the last month of 2022, faster than in November 2022 at 0.14% (m.t.m). This is in line with higher water supply tariffs, Key Figures

BI Repo Rate (7-day, December '22)
5.50%
GDP Growth (y.o.y, Q3 '22)
5.72%
Inflation (y.o.y, December '22)
5.51%
Core Inflation (y.o.y, December '22)
3.36%
Inflation (m.t.m, December '22)
0.66%
Core Inflation (m.t.m, December '22)
0.22%
FX Reserve (December '22)
USD137.2 billion

seasonal patterns of increasing demand for air transportation on Christmas and New Year festive period, and filter kretek cigarette inflation. Water supply reported a 3.49% (m.t.m) price increase in December 2022 in comparison to 0.08% (m.t.m) a month earlier. Passenger transportation service basket recorded growing prices of 1.55% (m.t.m) in December 2022, higher than 0.02% (m.t.m) in November 2022. In addition to administered price, volatile food prices also contributed to the increasing headline inflation. After experiencing deflation for four consecutive months, volatile food prices experienced an inflation of 2.24% (m.t.m) in December 2022, in line with seasonal year-end trends when consumption strengthen during the holiday season, contributing to the accelerating headline inflation figures. On an annual basis, volatile food prices recorded an inflation of 5.61% (y.o.y) in December 2022, moderating from 5.70% (y.o.y) in November 2022.

Core inflation edged up to 0.22% (m.t.m) at the end of 2022, a slight increase from 0.15% (m.t.m) in November 2022. This could be explained by housing rent inflation of 0.54% (m.t.m), higher compared to November figure at 0.07% (m.t.m). On an annual basis, core inflation recorded a moderate increase from 3.30% (y.o.y) in November 2022 to 3.36% (y.o.y) in December 2022, marking the highest level in 2022. The moderate level of core inflation suggested a mild ripple effect of fuel price adjustments and a modest inflationary pressures from the demand side. Moving forward, inflation rate in 2023 is expected to ease back into central bank's target corridor between 2% - 4%. This is in accordance with declining global inflation although there is plenty of uncertainty coming from Russia-Ukraina war, risks of global recession, and how China handle the unwinding of zero-Covid.

Domestic Optimism Continues

With pressure on inflation, particularly coming from the fuel price adjustment, eased at the end of 2022 coupled with seasonal factor of holiday season, Consumer Confidence Index (CCI) reported a slight bump to 119.9 in December 2022 from 119.1 in November 2022. The CCI figure remains in the optimistic territory. In addition to the aforementioned factors, considering the under control COVID-19 pandemic, indicated by daily cases of only 1.7 cases per one million population, weekly positivity rate of 3.35%, bed occupancy rate (BOR) at 4.79%, and mortality rate of 2.39% as of 27 December 2022, the GoI has officially revoked the community activities restrictions enforcement (*Pemberlakuan Pembatasan Kegiatan Masyarakat* (PPKM)) on 30 December 2022. While not indicating the pandemic is over, the revocation of PPKM sent a strong signal to the public that the COVID-19 condition is under control, boosting public confidence in carrying out economic activities, such as mobility and consumption. In parallel, Purchasing Manager's Index (PMI), measuring manufacturing activity, also displayed a slight increase to 50.9 in December 2022 from a five-month low of 50.3 a month earlier. The PMI has been

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consistently above 50 for 16 consecutive months, indicating expansion is still in place. While storms clouds foreign demand, output and new orders still expands, thanks to robust domestic demand. To maintain consumer confidence, Bank Indonesia and GoI should maintain domestic inflation, which in turn will keep consumer confidence optimistic. Additionally, policies to support economic growth as well as employment are needed to keep consumer confidence intact.

Following the impressive performance starting in mid-2020, trade balance may now show signs of weakening performance. While still being in the surplus territory for 32 consecutive months, trade balance was recorded at USD3.89 billion in December 2022, the lowest surplus level since May 2022. The latest trade surplus edged down from November 2022 level at USD5.13 billion and has been on a downward trend since October 2022. The decline in trade surplus was due to higher imports that grew by 5.15% (m.t.m) while exports declined by 1.09% (m.t.m). Breaking down its component, trade surplus in the last month of 2022 was mainly caused by surplus of non-oil and gas of USD5.61 billion while trade of oil and gas recorded a deficit of USD1.72 billion. Decline in commodity prices, particularly CPO, coal, and oil products as well as slowing demand in Indonesia's main trading partners, such as China and the US, contributed to decline in export value. On the other hand, higher imports in December 2022 were mainly driven by import demand of oil and gas that rose by 14.15% (m.t.m). Trade deficit is expected to happen in the second half of 2023 as commodity prices continue to drop and global growth is stalling.

Near The End of Global Rate-Hike Cycle

During 2022, central banks of both advanced and emerging market economies took unprecedented measures by hiking their interest rates at the fastest rate and largest scale in an effort to rein soaring inflation, making it a historic rate hike blast. Most major central banks, except the Bank of Japan (BoJ) and People's Bank of China (PBoC), raised their interest rate this year. While the BoJ maintain their accommodative stance throughout this year, the PBoC has slightly reduced rates during 2022 to counteract slowing economic growth brought on the aggressive zero-COVID-19 measures. Reuters calculation suggested that 10 central banks with most traded currencies delivered interest rate hikes of 2,700 basis points (bps) in 54 rate hikes over 2022. At the end of 2022 and at the beginning of 2023, it may be the case that the tightening cycle is close to its end as inflation finally starts to cool down. In the US, inflation have fallen slightly in December 2022 to 6.50% (y.o.y) due to significant drop in energy prices. The latest US inflation figure is the lowest figure since October 2021 and has been slowing down since it reached its peak in June 2022, leading the market to expect that the Fed will only raise its interest rate by a quarter point during January Federal Open Market Committee (FOMC) meeting.

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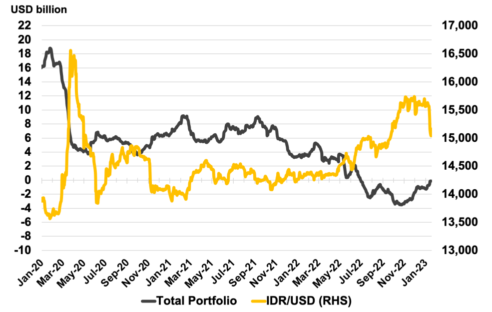
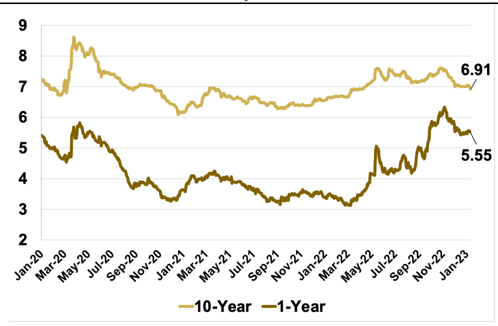
Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 36 Months)



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

Continuing the trend from last month, investors are still moving their assets from safe haven to emerging economies following the downward trend of US inflation and less aggressive move by most central banks. In addition, government's plan to expand the government regulation on export earnings brings positive sentiment to Rupiah. Net capital inflow of USD1.07 billion entered the Indonesian financial market since mid-December 2022, which then translates into a decrease 1-year government bond yield to 5.54% in mid-January 2023 from 5.60% in mid-December 2022, respectively. Decrease in yield was also seen in the 10-year Indonesian government bond, which went down to 6.91% in mid-January 2023 from 7.04% in mid-December 2022. The falling yield spread indicated that investors buy more of longer-term bonds compared to the short-term bonds, suggesting investors see deteriorating economic conditions in the short-term. Net capital inflows combined with positive sentiment caused Rupiah to experience appreciation to IDR15,040 per US dollar on 16 January 2023 compared to IDR15,595 per US dollar on 16 December 2022.. On a year-to-date basis, Rupiah appreciated by 2.68% (ytd) to IDR15,145 per US dollar on 17 January 2023, performing better compared to most emerging economy peers except Thailand Baht that experiences an appreciation against US dollar at 4.52% (ytd).

Supported by tax and service revenue as well as government loan withdrawal, official reserve assets was reported at the highest level of 9 months at USD137.2 billion in December 2022, an increase of USD3.2 billion compared to November 2022 level at USD134.0 billion. The current amount of foreign exchange reserve is said to be equivalent to 6 months of imports or 5.9 months of imports plus government's foreign debt payment, very well above the international adequacy standards of three months imports. To strengthen foreign exchange reserve, the GoI is currently considering to extend the government regulation on export earnings to exporters of manufactured goods. Since 2019, exporters of natural resources are required to keep

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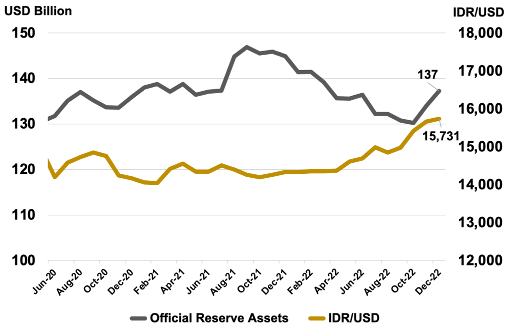
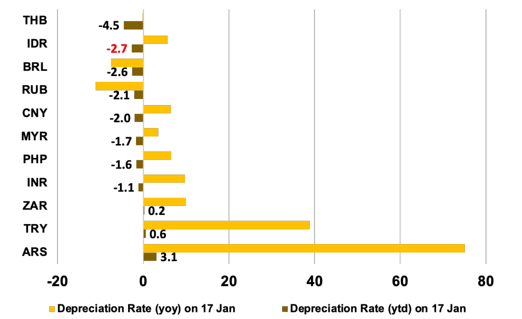
export earnings in a special account at domestic banks in an effort to maintain a stable Rupiah.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (17 January 2023)



Source: Investing.com

Taking into account the possibility of another rate hike by the Fed during January FOMC meeting, maintaining Rupiah stability amid volatile capital flows, and current inflation that stood well above BI's target rage, BI still need to continue its monetary tightening cycle by increasing its policy rate by 25bps to 5.75% this month. Despite the slowing pace of rate hike by the Fed, the yield differential between Indonesian Government Bonds and Treasury Bonds is still quite narrow. Thus, further rate hike is required to maintain rate differential. Raising the policy rate will help in reducing the amount of capital outflows, stabilizing the movement of Rupiah, and reducing inflationary pressures brought on by imported goods.