BI Board of Governor Meeting

Highlights

- BI should hold its policy rate of 4.5% this month.
- Policymakers should address the potential credit crunch to curb the risk of high inflation due to supply shocks.
- The positive ongoing momentum of stabilization amidst the crisis should be maintained by policymakers.

Macroeconomic & Financial Sector Policy Research

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The pandemic of Covid-19 has shown as a shock we have never experienced at least in the last 100 years. The disturbance brought by Covid-19 is touching all aspects of life globally. Besides risking the life of millions of people, Covid-19 is also bringing an economic turmoil not only at the individual level but also on the national and global scale. The turmoil caused by the outbreak has shocked the financial market due to the increased in volatility and uncertainty, which caused global investors to shift their portfolio from risky assets to safe-haven assets. This behavior of "flight-to-safety" has triggered capital outflows from emerging markets, induced the shortage of liquidity in FX markets and threatening currencies' stability. Furthermore, the disruption of supply chain and credit crunch in the banking sector might pose a risk of goods supply shortage during the Ramadhan and Eid period which could potentially translate into high inflation due to supply shock.

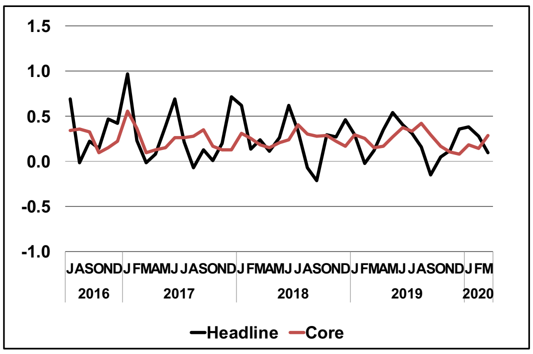
Policymakers in Indonesia has taken decisive steps through massive fiscal stimulus, necessary relaxation and interventions in the financial market to weather the crisis. As a consequence, the recent condition is relatively more stable compared to a few weeks ago. However, Policymakers should be careful in taking any next steps as any injudicious measure would stop the momentum gained and put any right steps taken before into waste. Therefore, given all the ongoing positive trend, we view that holding the policy rate at 4.5% this month by BI should be appropriate.

Weakening Aggregate Demand with the Risk of Supply Shock

Economic turmoil brought by Covid-19 pandemic has been reflected in the inflation data. March headline inflation slightly decreased to 2.96% (yoy) compared to the inflation in previous month at 2.98% (yoy) due to physical distancing measure and stores shutdown which translate into a decline in aggregate demand. On the other hand, the disruption in supply chain has resulted in increasing volatile food inflation to 10.70% (yoy) in March from 6.68% (yoy) in February. The drop of energy prices (-4.75%, yoy) due to the persistent substantial drop in global oil prices since the beginning of 2020 coupled with lower administered prices (0.19%, yoy) have cancelled out the hike in volatile food basket, thus, resulted in the relatively benign headline inflation.

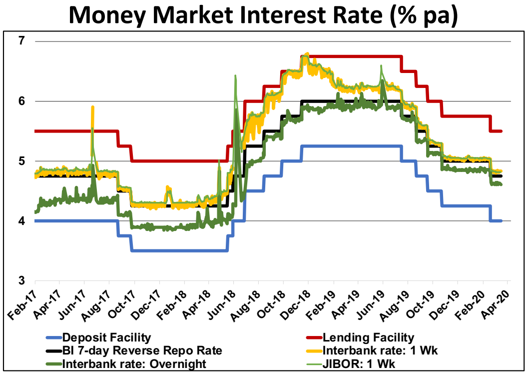
However, another force triggered by the outbreak has put an inflationary pressure caused by the act of rush buying to secure the supplies during the isolation period has drove up core inflation, in addition to the disruption in supply chain. Core inflation recorded an increase from 2.76% (yoy) in February to 2.89% (yoy) in March.

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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



Source: CEIC

Key Figures

- BI Repo Rate (7-day, Mar '20)
  4.5%
- GDP Growth (y.o.y, Q4 '19)
  4.97%
- Inflation (y.o.y, Mar '20)
  2.96%
- Core Inflation (y.o.y, Mar '20)
  2.89%
- Inflation (m.t.m, Mar '20)
  0.10%
- Core Inflation (m.t.m, Mar '20)
  0.29%
- FX Reserve (Mar '20)
  USD121.0 billion

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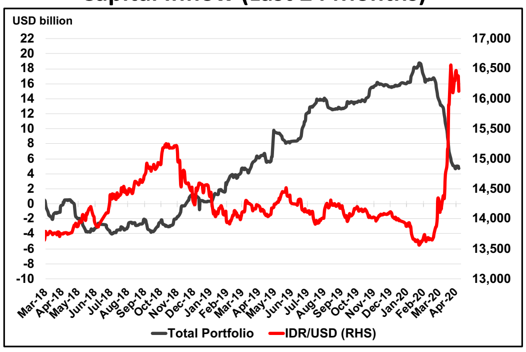
Despite all the calamities, we still see that inflation will remain within BI's target range of 2% to 4% as the potential weakening of purchasing power due to the declining income of people and revenue of the industries during the Covid-19 might weather the pressure for inflation. However, there might be a potential risk of strong inflationary pressures in the following month. Small banks might experience a potential liquidity shortage due to credit relaxation policy by OJK and postponement of loan payments during the pandemic period. As a consequence, the high need of working capital credit from local SMEs in the wholesale and retail trade sector for welcoming the Ramadhan and Eid period in April-May 2020 might not be fulfilled. If this condition left unhindered, combined with the already disrupted supply chain, there would be a risk of food supply shortage which can cause spikes in inflation due to supply shock.

Managing Risks brought by Unprecedented Crisis

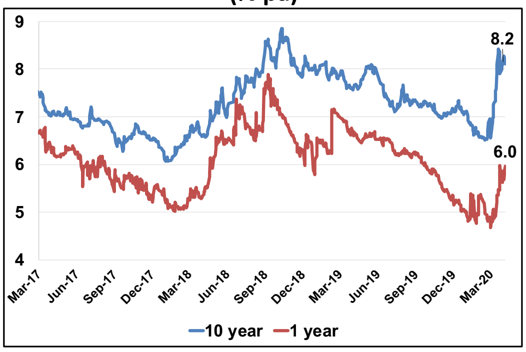
The crisis brought by Covid-19 pandemic is not only affecting the health of the population but also causing disorder in almost of their aspects of life. Besides risking the life of millions of people, Covid-19 is also bringing an economic turmoil not only at the individual level but also on the national and global scale. Furthermore, the economic crisis we are now facing before is like no other crisis we have ever seen before, at least in the last century. Thus, the current condition enforces the government and policymakers to put their best effort to weather the shocks and minimize the damage. Policymakers all around the world have been taking an extraordinary measure to manage the crisis by flooding the world with massive fiscal and monetary stimulus such as fund to the health sector, social safety nets, economic recovery programs, quantitative easing and credit relaxations.

Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 24 Months)



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

Indonesia is no exception. GoI has implemented an extensive stimulus package, both in terms of amount and its beneficiaries, to help the society affected by the pandemic. Fiscal stimulus carried out by GoI is mainly to safeguard the real sector. On the other hand, a wide range of intervention has been taken by BI and OJK to manage the financial sector turmoil. Since the outbreak of Covid-19, we have seen several episodes of capital outflows, highly deteriorating value of our currency, IDR, and the substantial spike in Indonesia's government bond yields, which indicate a soaring perceived risk towards domestic assets.

Indonesia's capital market has experienced a massive capital outflow of USD12 billion in only around five weeks (from USD16.7 billion at the end of February to USD4.7 billion in early April). This enormous amount of capital reversal is driven by "flight-to-safety" behaviour by global investors, in which they are shifting their portfolio from risky emerging markets' assets toward safe-haven assets. The capital reversal has put high pressure on the exchange rate, which at its

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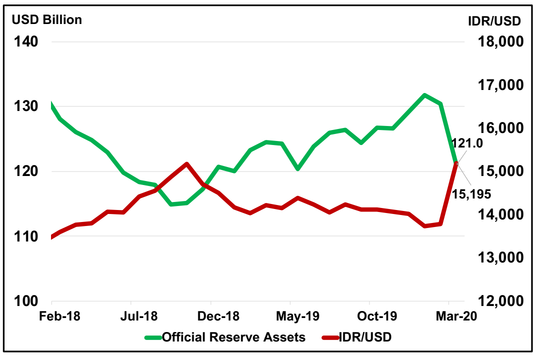
highest point reached a near 20% depreciation rate to around IDR 16,500 in the last week. The similar story of decreasing global investors' appetite towards domestic assets is also given by the condition of government bonds' yield. For 10-year government bonds, the yield once has increased more than 28% to its highest level at the end of March to around 8.4% from around 6.5% in the period of one month, similar with 1-year government bond. Furthermore, while investors' are shifting their assets away from risky assets, the shortage of USD liquidity emerges. This condition, in addition to a high pressure on IDR, pushed BI to allow its forex reserves deteriorates. In March, forex reserves dropped substantially by USD9.1 billion to USD121 billion. In general, the figures on March characterize an upheaval of the domestic financial market.

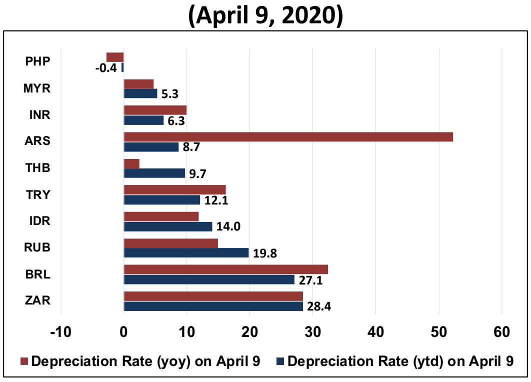
Entering April, the condition is slightly weathered as policymakers (BI and OJK) has put immense effort through interventions and relaxations in the financial market. As of April 10, the depreciation rate is relatively benign, dropped to 14% (ytd) put the exchange rate below IDR16,000 (around IDR15,800) driven by steady capital inflow since the beginning of the month. Furthermore, government bonds' yield started to decrease, although rather slowly to 8.2% from 8.37% for 10-year bond.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (April 9, 2020)



Source: Investing.com

Looking at the big picture, we are still in the middle of the storm as the end of the Covid-19 pandemic seems nowhere in the near future. However, focusing more on the latest development, domestic financial market is in a better situation compared to the last few weeks, thanks to swift reactions by the policymakers. In their last press conference, BI assured the market that they have the "necessary" equipment to carry out its duty of maintaining a stable value of IDR and inflation. The Repo Line agreement between BI and US Fed has given BI the right tool to tackle the USD liquidity shortage. Once depreciation of IDR is considered "too high", BI could stabilize IDR by acquiring the USD which is in shortage by using Repo Line facility. Furthermore, the issuance of USD-denominated global bonds by GoI, which responded relatively well by the market, would also be expected to increase BI's forex reserves up to USD4.3 billion. In the future, if needed, mandated by government regulation in-lieu-of Law No.1/2020, BI could act as "the last resort" to absorb government bonds by buying the bonds in primary market.

All in all, effort put by policymakers has built the momentum of a more stable condition amidst the ongoing crisis. Looking forward, policymakers should be careful in taking any next steps as any injudicious measure would stop the momentum gained and put any right steps taken before into waste. Therefore, given all the ongoing positive trends, we view that BI should hold its policy rate at 4.5% this month.