BI Board of Governor Meeting

July 2020

Highlights

- BI should cut its policy rate to 4.00% this month.
- For the first time in 2020 inflation fell below BI's target band of 3±1%.
- BI and MoF should implement the *burden-sharing* scheme in an appropriate manner to maintain their credibility.

As the end of the pandemic seems nowhere in the near future, the government has been put in an extremely rough situation as business activity has been in halt for several months and through the large-scale social restrictions (PSBB) has enforced some groups of people to earn less. The condition is costly for the government as it has to provide social benefits and several other stimulus to cushion people by safeguarding their basic needs and to prevent firms from being bankrupted. While the escalation of Covid-19 is getting worse in terms of its spread, the government has tried to reach a middle ground by applying the "new normal" protocol in order to stimulate economic activity without significantly jeopardizing the health and safety aspects of the population. Regardless, the impact of increasing economic activity has not been reflected yet in June's inflation data.

The unconventional monetary policy of debt monetization to share the economic burden between the government and the central bank has taken place. In theory, this act of debt monetization would impose a risk of credibility as it gives some dimension of moral hazard by the less independent central bank. Furthermore, higher money supply due to the burden-sharing scheme would also put pressure on inflation and exchange rate volatility. However, BI and MoF seem well-aware of these risks as they have clarified this burden-sharing scheme would be a "one-off" policy as to assure investors of the central bank's credibility. Following the recent development of a burden-sharing agreement between BI and MoF, a relatively stable external pressure and exchange rate, adequate reserves, and a rather convinced investors toward the steps' authority has taken and will be taking in the future, we view that a policy rate cut of 25bps by BI would be appropriate this month. Policy rate cut aims to enhance aggregate demand and to ease the burden shared in which rate cut could lower the cost of monetary operations using the "burden-sharing" instruments or bonds issued by MoF.

"New Normal" impact is yet to take place

In order to jumpstart the economy, the government has applied a "new normal" protocol to replace the large-scale social restrictions (PSBB), which enable people to get back to their regular activities such as working and opening up business amidst the pandemic. Regardless, the impact of increasing economic activity has not been reflected yet in June's inflation data. Monthly inflation in June is still continuing the pattern of the "*pandemic era*" low level, which stood at 0.18% (mtm), relatively lower than the rate of the same month last year (0.41%, mtm). The same story is told by the headline annual rate, which drops from 2.19% (yoy) in May to 1.96% (yoy) in June, which counts as the fifth consecutive drops since February. This came as no surprise as the number of Covid-19 is still increasing at a worrying rate, and the emerging of several new epicentrum across Indonesia hold back people and business activities to go back to its "business as usual" routine. In addition, annual core inflation also plunged to 2.26% (yoy) in June from 2.65% (yoy) in the previous month. Essentially, the muted headline and core inflation captures the current reality of dismal aggregate demand and the impact of the "new normal" initiative has not yet materialized.

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Key Figures

- BI Repo Rate (7-day, May '20)
  4.25%
- GDP Growth (y.o.y, Q1 '20)
  2.97%
- Inflation (y.o.y, June '20)
  1.96%
- Core Inflation (y.o.y, June '20)
  2.26%
- Inflation (m.t.m, June '20)
  0.18%
- Core Inflation (m.t.m, June '20)
  0.02%
- FX Reserve (May '20)
  USD131.7 billion

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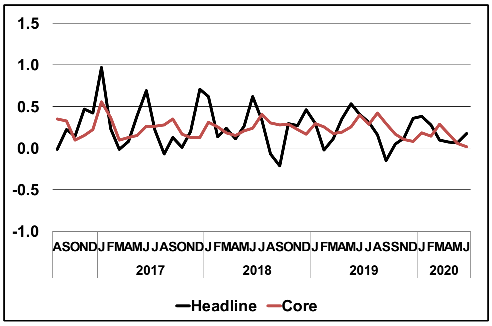
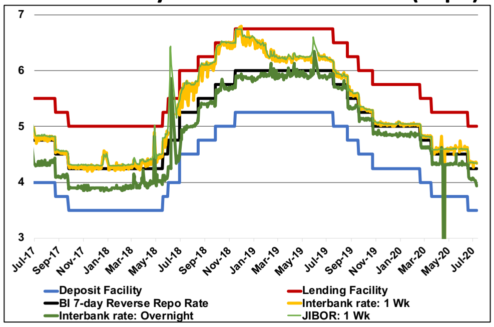
Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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



Source: CEIC

Looking deeper, other components of inflation are rather similar. While the increase of the price of chicken and egg put upward pressure on volatile price, chilli and onion recorded a decreasing price, with the net effect of decreasing volatile price from 2.65% (yoy) in May to 2.26% (yoy) in June. Albeit the global oil price has rebounded after a sharp decline and reached its lowest level in late April, the decline in the energy price component continues as the industry demand is still subdued. In June, it recorded a subtle deflation to -0.5% (yoy) from -0.4% (yoy) compared to the previous month. On the other hand, the component of administered price has put an upward pressure of inflation as it recorded an increase both in the monthly rate and annual rate. Administered price rose to 0.5% (yoy) in June from 0.3% (yoy) in May and it also increased to 0.22% (mtm) compared to a deflation of -0.02% (mtm) on the same period of last year. This upward inflationary pressure is contributed by the transportation sector, mainly the increase of the flight ticket prices, as the economic activity started to pick up.

The steady decrease of inflation figure is continuing its trend and for the first time in 2020, it recorded outside BI's target band of 3±1% (1.96%(yoy) headline inflation). However, as the "new normal" protocol takes place, we believe that the restart of economic and business activity would catalyze the current grim purchasing power and aggregate demand. On top of that, the government's plan to safeguard the supply of goods and services and to stimulate the aggregate demand is extensive and we expect that would put back inflation within BI's target band in the near future.

Turbulence Amid the Storm

During the last one month, there have been turmoils as uncertainty increase. The shift from PSBB to "new normal" protocol, debt-monetization issue, and steep increases in Covid-19 daily cases has affected investors' confidence toward Indonesia. Since mid-June, Rupiah has depreciated from IDR14,050 to around IDR14,450 last week and has now strengthened at IDR14,350. Moreover, Indonesia's capital market has experienced a capital outflow of approximately USD0.7 billion in the last 30 days.

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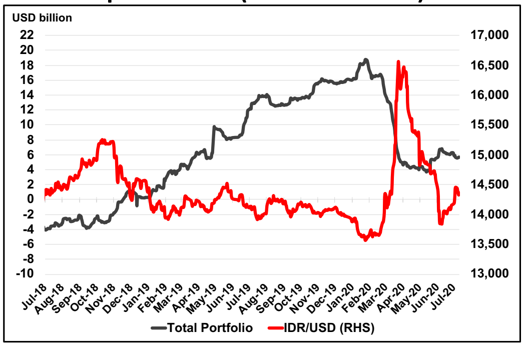
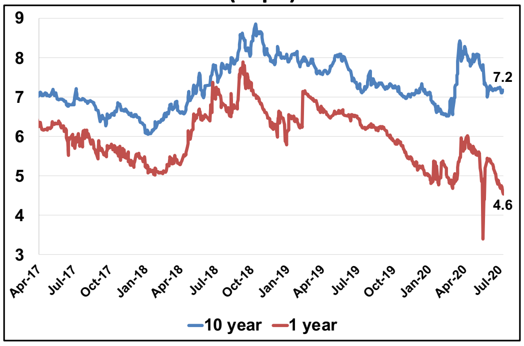
Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 24 Months)



Source: CEIC

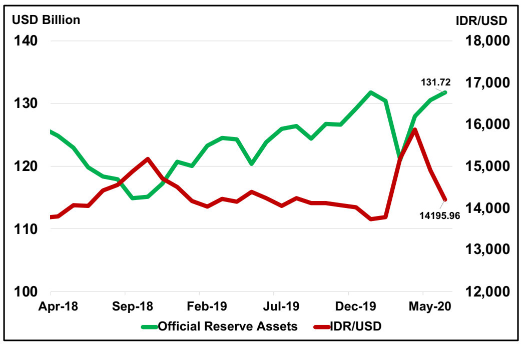
Figure 4: Government Bonds Yield (% pa)



Source: Investing.com

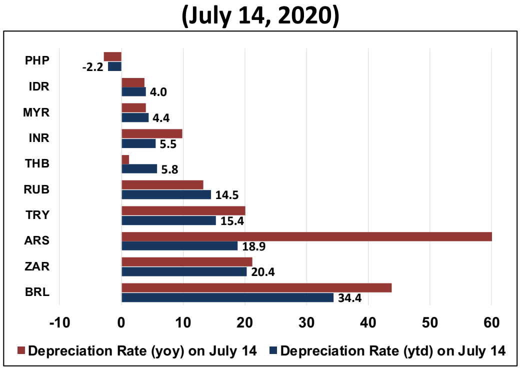
On the other hand, the increase of foreign reserves persists to USD131.72 billion in June from USD130.54 billion in May, continuing its positive trend since March. The rise of BI's foreign reserves is mainly contributed by the issuance of global bonds. Higher foreign reserves also equip BI with more resilience to weather the external volatility and maintain financial stability. In addition, despite the recent turmoil, IDR is relatively among the best performers compared to its peer, as it recorded a low depreciation rate of 4.0% (ytd).

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (July 14, 2020)



Source: Investing.com

Extra Shoulder to Carry the Hefty Burden

As the end of the pandemic seems nowhere in the near future, the government has been put in an extremely rough situation as the business activity has been in halt for several months and through the large-scale social restrictions (PSBB) has enforced some groups of people to earn less. The condition is costly for the government as it has to provide social benefits and several other stimulus to cushion people by safeguarding their basic needs and to keep firms from being bankrupted. While the escalation of covid-19 is getting worse in terms of its spread, the government has tried to reach a middle ground by applying the "new normal" protocol in order to stimulate economic activity without significantly jeopardizing the health and safety aspect of the population.

Nevertheless, the burden borne by the government is by no means easy. Thus far, as stated in Presidential Decree No.72, the fiscal deficit has been widened to -6.34% of GDP (IDR1,039 trillion) from -5.07% (IDR853 trillion), partly due to a larger revenue shortfall of IDR533 trillion (compared

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to the previous budget at IDR472 trillion). Furthermore, the new government budget also estimated the burden of interest payment would jump up to around 17% from 12% of state budget spending (pre-pandemic). This burden, while heavy and expensive, is necessary to fight the pandemic and recover the economy. However, this non-negotiable burden imposes several risks on the macroeconomic condition, especially in the medium to long term. The government still needs to finance a spending worth of IDR397.6 trillion for public goods in which it covers health sector spending, social benefits, and support for ministries, central institutions and regional government. The government also needs to finance a spending worth of 505.6tn IDR for SMEs and corporations (defined as non-public goods). If borne only by the government, i.e., Ministry of Finance (MoF), it is estimated to spike the interest payment in state budget up to 20% of total government spending. This imposes massive risks over Indonesia's debt sustainability over the medium and long term, which in consequence would put more pressure on Indonesia's sovereign credit rating. Prompted by all the risks involved and the massive burden on the government's shoulder, BI and MoF have reached an agreement to share this burden.

The burden-sharing mechanism between BI and MoF on fiscal financing will pass-through a portion of interest payment burden to BI as BI directly purchases government bonds. In details, BI would bear all the coupon rate for public goods (equivalent to 7DRR). For non-public goods, the coupon rate will follow the market rate and MoF would pay the cost of debt equivalent to a 3-months reverse repo rate minus 1 percent, and the rest will be covered by BI. In theory, this act of debt monetization would impose a risk of credibility as it gives some dimension of moral hazard by the less independent central bank. The risk of credibility could translate into a higher perceived risk as it could lower the country's rating and, in consequence, might drive up government bond yield. Furthermore, a higher money supply due to the burden-sharing scheme would also put pressure on inflation and exchange rate volatility. However, BI and MoF seem well-aware of these risks as they have clarified this burden-sharing scheme would be a "one-off" policy to assure investors of the central bank's credibility. Further, as the aggregate demand is in an ultra-low state (the last data shows it is even below BI's target range), the upward pressure of printing money would put inflation in its right place (well within BI's target range).

This unconventional monetary policy, coupled with an ample amount of communication by the MoF and BI to the public, has set a precedent regarding future debt monetization for now. Given the circumstances and with other central banks' around the world also employing unconventional monetary policies, investors' confidence might not deteriorate substantially and the market will be likely to give BI and MoF the benefit of the doubt for now. However, the "exit strategy" for the burden-sharing that BI will implement in the future is crucial in maintaining its credibility and market sentiments toward Indonesia.

All in all, with the highly escalating number of Covid-19 cases in Indonesia, government and financial authority are behaving in the manner of "whatever it takes" to weather the ongoing crisis, both in health aspects and economic aspects. Looking forward, policymakers should maintain their agility and focus on fighting this crisis until the end. Following the recent development of burden-sharing agreement between BI and MoF, a relatively stable external pressure and exchange rate, adequate reserves, and rather convinced investors toward the steps' authority has taken and will be taking in the future, we view that a policy rate cut of 25bps to 4.00% by BI would be appropriate this month. Policy rate cut aims to enhance aggregate demand and to ease the burden shared in which rate cut could lower the cost of monetary operations using the "burden-sharing" instruments or bonds issued by MoF.