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UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

BI Board of Governor Meeting

September 2020

Highlights

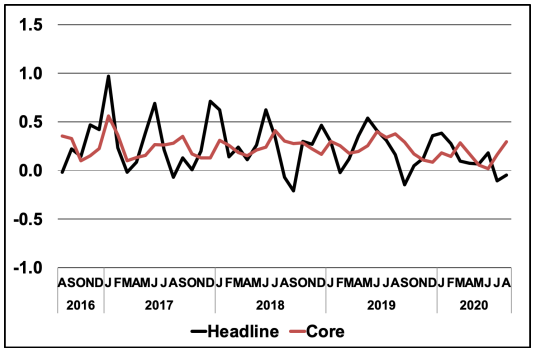
- BI should keep its policy rate at 4.00% this month
- The aggregate demand has not yet recovered as the inflation remains very low
- BI should maintain its macroprudential policy and expand the unconventional monetary policy measurements to prompt the liquidity, thus, promote economic growth

Since March, BI has become more concerned over economic growth risks and shifted its policy stance to one that preemptively supports growth to mitigate the impact of the health crisis while managing the financial market stability. However, the increased risk of the deeper contraction in the global economy, coupled with the prospect of the prolonged spread of the virus in Indonesia, has caused uncertainty in the market at least since early September. As a consequence, Rupiah has weakened to the level of IDR14,900 as of September 14, 2020. It is recorded as the worst-performing currency in emerging Asia. Meanwhile, the accumulation of capital inflows further plunged, thus, picked up the government bonds yields. Despite the very low inflation last month, the credit demand is expected to be halted in the near future following the extension of large-scale social restrictions (PSBB) in the Jakarta area. These conditions provide room for BI to prioritize Rupiah stabilization this month due to the heightened risk of uncertainty in the financial market. Therefore, we view that BI should keep its interest rate at 4.00% this month to maintain financial stability while supporting growth through the macroprudential and unconventional measurements as the channels in prompting liquidity.

Weaker Demand Brought Deflationary Pressures

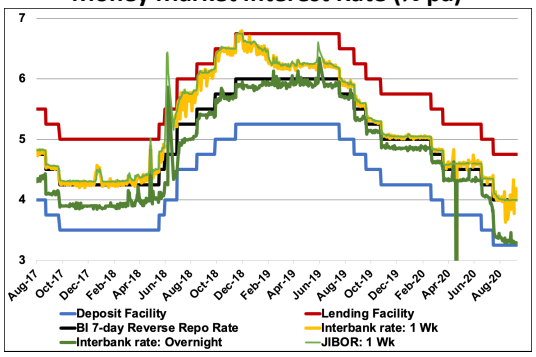
The annual inflation in August continued to fall to its lowest level in two decades to 1.32% (yoy) from 1.54% (yoy) in the preceding month. Even though the government has eased the large-scale social restrictions (PSBB) since June, the inflation remains below the BI's target range for three consecutive months, as consumers remain cautious about going out to shopping center and public place after the daily cases of confirmed infections of Covid-19 has been persistently increasing. Sluggish consumer spending is also captured in the second straight monthly deflation of -0.05% (mtm) and -0.10 (mtm) in August and July, respectively. Moreover, the declining trend of annual and monthly core inflation at 1.99% (yoy) and 0.29% (mtm), compared to 2.07% (yoy) in the previous month and 0.38% (mtm) in the same month last year, indicates that the purchasing power has not yet recovered.

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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



Source: CEIC

August's low inflation figure was driven by a decline in all food, energy, and volatile prices, while the administered prices were picking up to 1.03% (yoy) from 0.70% (yoy) in the previous month due to a persistent trend of higher cigarettes prices. At the same time, the loosen national travel restriction has slightly increased the prices in the transportation sector to deflation of -0.13% (yoy) from -0.71% (yoy) last month. On the other hand, the muted consumer demand was attributable to the steepest deflation in food and beverage prices in August, reflected by the

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Key Figures

- BI Repo Rate (7-day, Aug '20)
  4.00%
- GDP Growth (y.o.y, Q2 '20)
  -5.32%
- Inflation (y.o.y, Aug '20)
  1.32%
- Core Inflation (y.o.y, Aug '20)
  1.99%
- Inflation (m.t.m, Aug '20)
  -0.05%
- Core Inflation (m.t.m, Aug '20)
  0.29%
- FX Reserve (Aug '20)
  USD137.0 billion

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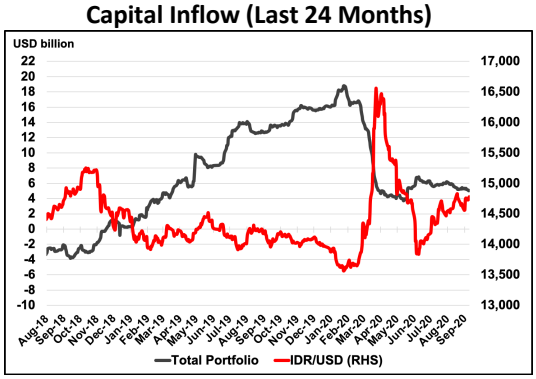
annual and monthly deflation of food ingredients prices at -0.85% (yoy) and -1.29% (mtm), much lower than the inflation of 0.46% (yoy) in the previous month and 0.01% (mtm) in the same month last year. Volatile food also experienced both yearly and monthly deflation of -1.09% (yoy) and -1.44% (mtm) in August due to the harvest season. Moreover, almost all prices on each goods sectors have deflationary forces in August, with the exception of personal care and other services prices, which are resisted from demand disruptions during the health crisis.

As the pandemic would not disappear entirely at any time soon, the sluggish aggregate demand will continue to halt the inflation figure in the upcoming months. The extension of large social distancing in the Jakarta area will also put additional pressure on economic activity, resulting in lower aggregate demand and inflation. Meanwhile, the higher money in circulation due to central bank and GoI expansion steps is expected to have a limited effect on inflation. The estimated low inflation level for the rest of the year might provide BI with enough momentum to further ease its monetary stance.

Maintaining Market's Perception Amidst Heightened Uncertainty

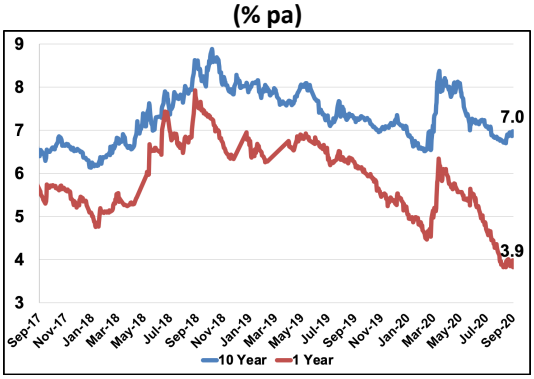
Despite the gradual loosening of travel and social distancing restrictions, uncertainty in the global market remains high as the economy progresses to the end of Q3 2020. The fear of further heightened uncertainties and deeper economic contraction in major countries due to the continuation of Covid-19 escalation caused global financial market turmoil and pushed investors to shift their portfolio into safe-haven assets. On the domestic side, the government's decision to tighten virus containment in mid-September has put additional pressure on the market's perception of Indonesia's assets. As a result, the total accumulated portfolio inflows in Indonesia plunged to USD4.60 billion as of September 11, 2020, decelerated from the previous month's portfolio inflows accumulation of USD5.68 billion. At the same time, Rupiah slumped around 7.8% (ytd) against the US dollar or weakened to the level of IDR14,900. The capital outflow has prompted an increase in the yields of 10-Year and 1-Year government bonds to 7.0% and 3.9%, respectively.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: Bloomberg

Since March, BI has become more concerned over economic growth risks and shifted its policy stance to one that preemptively supports growth to mitigate the impact of the health crisis while managing the financial market stability. Besides the four policy rates cuts so far this year, two of which have occurred during the pandemic period, BI has also performed the unconventional monetary tools of quantitative easing measurements to support the inevitable deeper fiscal

Key Figures

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  4.00%
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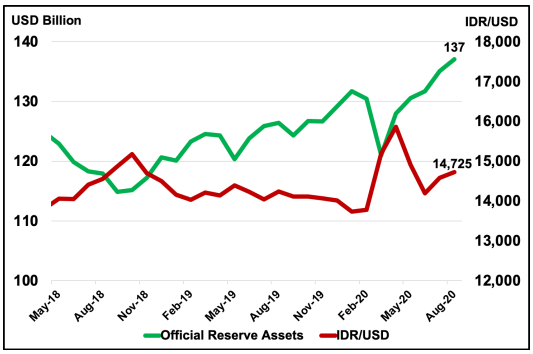
deficit during the pandemic by purchasing government bonds through the burden-sharing scheme. Under this scheme, BI has bought around USD6.79 billion worth of government bonds over the last month. However, the rising amount of Rupiah-denominated debt in the market might hold investors back to put their assets due to the risk of currency depreciation. But thus far, the investment risk in Indonesia is relatively manageable during the burden-sharing transactions, as seen by the lower 5-Year CDS premium to 88.9 bps on August 31, 2020, from its level of 119.2 bps on August 3, 2002. Nevertheless, BI and GoI still need to maintain investors' perception towards the financial market as the CDS premium rose back to 91.5 bps as of September 14, 2020, following the announcement of the re-implementation of PSBB measures in Jakarta. Accordingly, Rupiah depreciated to IDR14,900 and was recorded as the worst-performing currency among emerging Asian countries.

The lower-than-expected trade balance surplus of USD2.3 billion in August is expected to put additional pressures on market sentiment towards the fundamentals of the domestic economy, thus, increasing the risk of capital outflow. On the other hand, BI has managed to accumulate more foreign exchange reserves last month, amounting to USD137 billion, reaching the highest level in history. The increase was influenced by the government's foreign loan withdrawal as well as tax revenues, and oil and gas export proceeds. This increased amount of reserves might be needed to support BI in struggling the future potential shocks.

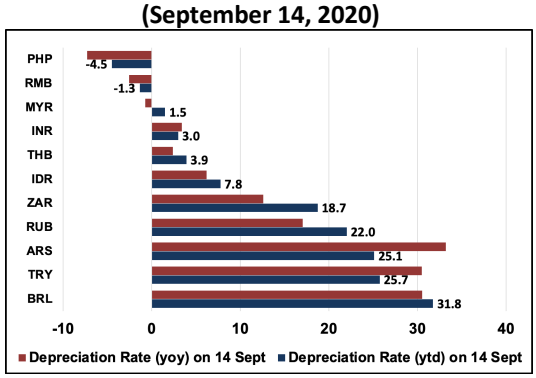
The risk of the deeper economic contraction in the near future, coupled with the prospect of the prolonged spread of the virus in Indonesia, has driven the market to be more volatile than before. The looming fears from investors may continue to jeopardize the future stability of the Rupiah, thereby increasing the costs of business activities related to international transactions. Although rising deflationary pressures provide BI with enough momentum to further ease its monetary stance, Rupiah's stability is very crucial right now. Nevertheless, the demand for credit is expected to remain low as the extension of the large-scale social restriction in the Jakarta area has started. In the meantime, BI should maintain its macroprudential policy and expand the unconventional monetary policy measurements to prompt the liquidity, thus, promote economic growth. For now, we view that the current rate differential remains relatively attractive to maintain capital inflows and exchange rate stability. Given the heightened risk of uncertainty in the financial market, BI should keep its policy rate at 4.00% this month.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

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



Source: CEIC