BI Board of Governor Meeting

January 2021

Highlights

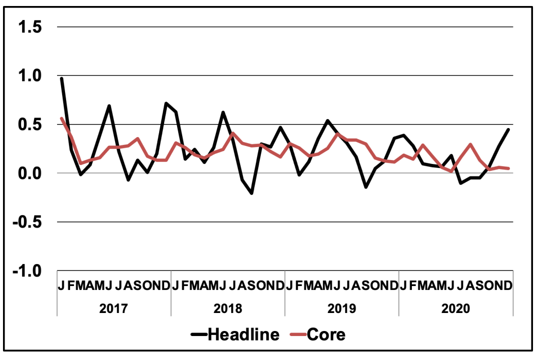
- BI should keep its policy rate at 3.75% this month.
- Recorded at 1.68% (yoy), 2020 annual headline inflation is the lowest in history.
- The current problem of the credit bottleneck is obviously on the demand side as real sector is still on mute as the pandemic prolongs.

Serving as the main theme of 2020, ultra-weak aggregate demand and purchasing power of the population is a rather global phenomenon, as the pandemic of Covid-19 wreaked havoc almost all the countries in the world. However, while some countries are doing relatively well in getting their focus in order and are trying to solve the health issue in a pertinent manner, Indonesia seems to struggle to manage the situation. Marching towards the end of 2020, any substantial signs of recovery has not been emerged over the horizon. Regardless, the occurrence of a recent series of events has materialized in Indonesia's economic condition. By breaking down the component of Indonesia's Balance of Payment (BoP), from the financial account perspective, the results of the US election and vaccines rollout in mid-November triggered a positive sentiment by investors; thus showering emerging markets with liquidity and caused EM currency to appreciate rapidly against USD. From the current account perspective, Indonesia's foreign trade is also showing a rather favorable sign. On the other hand, a bleak development of public health condition continues its occurrence. A higher-than-ever daily recorded cases of Covid-19 left the government with no choice but to reimpose social restriction measure, as a repercussion of the overcapacity of public health facilities. Moving forward, the escalation of financial sector as well as the real sector remains unclear as it is highly dependent on the ongoing pandemic situation. With many things still on the uncertain status, we are on the view that BI should hold its policy rate at 3.75% this month, while also maintaining its macroprudential policy to manage financial sector stability.

Not-So-Surprising Lowest Recorded Level of Inflation in History

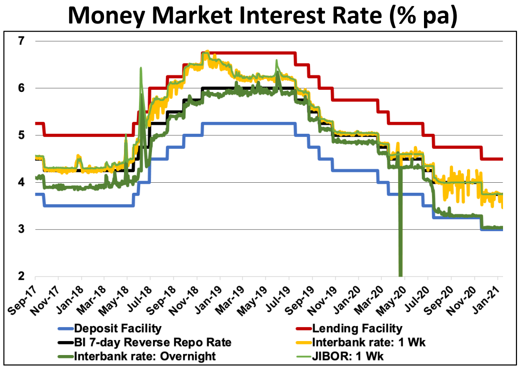
Indonesia recorded the lowest level of inflation in history. The annual figure of 2020 inflation is recorded at 1.68% (y.o.y), which neatly summarizes the downturn economic activity of 2020 as it is decreased significantly from 2.72% (y.o.y) in 2019. Serving as the main theme of 2020, ultra-weak aggregate demand and purchasing power of the population is a rather global phenomenon, as the pandemic of Covid-19 wreaked havoc almost all the countries in the world. However, while some countries are doing relatively well in getting their focus in order and are trying to solve the health issue in a pertinent manner, Indonesia seems still struggling to manage the situation. So far, we have seen Indonesia's authority repeatedly trying to jumpstart the economy by easing the social restriction measures, only to find out after a while the hospital's capacity is running low and at the end forced to tighten the measures once again. Driven by the motivation to keep businesses and economy afloat, neglecting the public health aspect while doing so is surely not the best mean to achieve its end and could be a recipe for disaster if the cycle keeps being repeated in the future.

Figure 1: Inflation Rate (%, mtm)



Source: CEIC

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



Source: CEIC

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Key Figures

- BI Repo Rate (7-day, Dec '20)
  3.75%
- GDP Growth (y.o.y, Q3 '20)
  -3.49%
- Inflation (y.o.y, Dec '20)
  1.68%
- Core Inflation (y.o.y, Dec '20)
  1.60%
- Inflation (m.t.m, Dec '20)
  0.45%
- Core Inflation (m.t.m, Dec '20)
  0.05%
- FX Reserve (Dec '20)
  USD135.9 billion

Observing specifically, although the overall inflation of 2020 is painting a bleak picture, the inflation figure is somewhat showing an upward pressure as it continues to accelerate for the fifth consecutive month to 1.68% (y.o.y) compared to 1.59% (y.o.y) in the previous month. In addition, on a monthly basis, headline inflation of December is recorded at 0.45% (mtm), the highest level in 2020. A stronger inflation figure of December 2020 was driven mainly by increasing food prices which some bolster on inflationary pressure. Food, beverage, and tobacco components recorded an annual inflation of 3.63% (y.o.y), significantly higher than its November level of 2.87% (y.o.y). Similarly, its monthly figure also experienced a substantial increase of 1.49% (mtm), compared to 0.75%(mtm) in the same period of the previous year.

On the other hand, the declining trend of core inflation continues for the ninth consecutive month as the annual rate decelerated to 1.60% (y.o.y) and 0.05% (mtm) compared to 1.67% (y.o.y) in the previous month and 0.12% (mtm) in the same month last year. A conflicting trend of headline and core inflation might suggest that the upward inflationary pressure was not driven by an improvement in purchasing power and rather contributed by other components. Volatile food products fit the story rather nicely as it sheds some light on the driver of headline inflation. The rainy season in the last two months increases the December volatile products prices to 3.62% (y.o.y) from 2.41% (y.o.y) in November and on monthly basis to 2.17% (mtm) compared to December 2019 of 0.98% (mtm). Furthermore, a lower inflation figure or even deflation is also recorded at other price components, such as transportation, ICT, and financial services. All in all, December concludes a year of muted economic activity as overall inflation for FY2020 fell below BI's target range of 3%±1.

End-of-Year Flood of Capital

Marching towards the end of 2020, any substantial signs of recovery has not been emerged over the horizon. Regardless, the occurrence of a recent series of events has materialized in the Indonesia's economic condition. By breaking down the component of Indonesia's Balance of Payment (BoP), from the financial account perspective, the results of the US election and vaccines rollout in mid-November triggered a positive sentiment by investors; thus showering emerging markets with liquidity and caused EM currency to appreciate rapidly against USD. Indonesia is no exception as Rupiah experienced a robust appreciation from around IDR14,600 to IDR14,000 per US dollar. Since then, a flux of capital inflow is still entering Indonesia and appreciate Rupiah to below around IDR13,800 per US Dollar in the first week of 2021.

From the current account perspective, Indonesia's foreign trade is also showing a rather favorable sign. Trade balance soared in the last month of 2020 where monthly exports reached USD16.5 billion (increased 14.6%, y.o.y; 8.4%, mtm), recorded the highest value of export since December 2013. A positive figure of export is contributed by commodity price hikes, such as coal, oil, copper, and palm oil. In addition, demand revival from various countries also plays a role in export improvement as we see the surge of demand for animal and vegetable oils, machinery, and clothing products from US, China, and ASEAN Countries.

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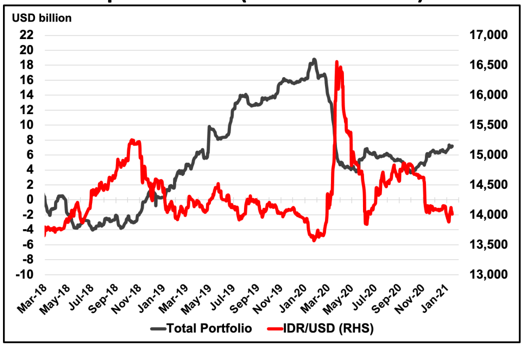
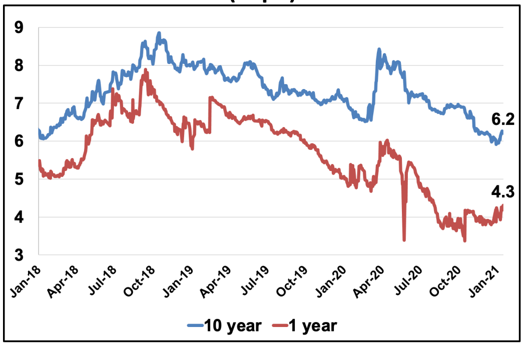
Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 24 Months)



Source: CEIC

Figure 4: Government Bonds Yield (% pa)

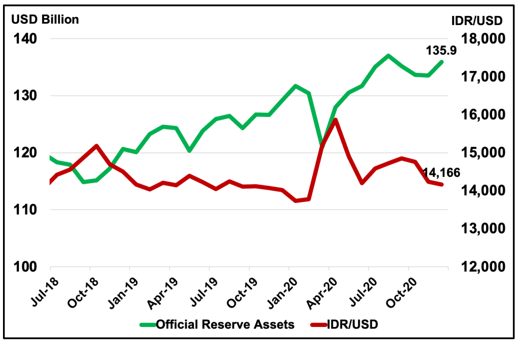


Source: Investing.com

These two factors brought about a surge of US Dollar into domestic market, putting Rupiah in its best performance during 2020. Ending 2020 with excellent performance, Rupiah is setting a robust step in entering 2021. Despite the increasing cases of confirmed Covid-19 patients in Indonesia and more often occurrence of new daily recorded cases, the positive sentiment of foreign investors has put Rupiah among the best performers of emerging market currencies. This positive sentiment has made foreign investors shift their portfolio towards a more risk-taking behavior, as reflected by their increasing appetite of purchasing Indonesia's government bonds. While the government bonds yield, both for long-term and short-term, slowly increasing since the beginning of the year, the yield of 10-Year and 1-Year government bonds has been decreasing to around 5.9% and 4.0% during the last day of 2020, reaching its lowest level since 2013.

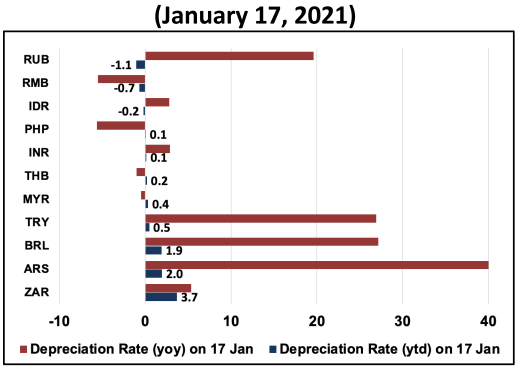
A massive influx of capital flows, driven by foreign investors' confidence and strong trade performance, is translated into a piling foreign exchange reserves of BI. By december 2020, BI's foreign exchange reserves stood at USD135.9 billion, increasing from IDR133.6 billion compared to the previous month. Equivalent to around ten months of import, enormously higher than the international standard of three months of import, the amount of foreign exchange reserves hold by BI suggest an ample amount of liquidity to fulfil its duty in maintaining currency price stability. This might set a good tone in terms of BI's capacity to endure full-year 2021.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (January 17, 2021)



Source: Investing.com

Thus far, contradicting story has taken place surrounding the current domestic economic condition. On the bright side, we have seen several factors relating to external aspects which brought a favorable impact towards the economy. On the other hand, a bleak development of public health condition continues its occurrence. A higher-than-ever daily recorded cases of

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Covid-19 left the government with no choice but to reimpose social restriction measure, as a repercussion of the overcapacity of public health facilities. Moving forward, the escalation of the financial sector as well as the real sector remains unclear as it is highly dependent on the ongoing pandemic situation. Looking at the supply of liquidity, the domestic banking system is having a hard time to channel it towards a more productive use. The current problem of the credit bottleneck is obviously on the demand side as real sector is still on mute as the pandemic prolongs. Considering this factor and all discussions above, while we see there is a room for further policy cut in 2021, we are on the view that BI should hold its policy rate at 3.75% this month, while also maintaining its macroprudential policy to manage financial sector stability.