LPEM FEB UI
UNIVERSITAS INDONESIA

MACROECONOMIC ANALYSIS SERIES

Inflation Outlook 2022

Key Figures

- Inflation (2021)
  1.87%
- Core Inflation (2021)
  1.56%
- Inflation* (2022)
  2.5 – 2.8%
- Core inflation* (2022)
  2.3 – 2.5%
- Consumption Growth (Q3 '21)
  3.51%
- % Current Account of GDP (Q3 '21)
  1.5%

____
**) Forecast*

Researchers

Chaikal Nuryakin

chaikal.nuryakin@lpem-feui.org

Dearizki Putratama

dearizki.putratama@lpem-feui.org

Yuli Rosdiyanti

yuli.rosdiyanti@lpem-feui.org

Apparent Economic Recovery: Optimism Towards 2022

Summary

Throughout 2021, we observe an overall 'better' inflation landscape, as made apparent by its inflation rate being higher than the 2020 figure. The most important contributor to such a condition is volatile inflation, for which we have observed a less volatile rate throughout 2021 compared to 2020 circumstances. The core inflation rate also contributes to a more stable yet lower rate. On the broader picture, however, the inflation rate recorded along 2021 is still considerably lower than before the pandemic.

First, we view the low yet better inflation phenomenon as a demand-side phenomenon due to post-pandemic recovery that affected consumption growth and the inflation rate. Regarding the inflation rate, the transportation sector, previously the most impacted by the pandemic, can bounce back in 2021. It recorded deflation by December 2020 but turned out to register inflation by December 2021 with a significant difference. The ultimate factor associated with higher inflation is a relaxed social restriction that leads to higher mobility. The other sector that also shows the sign of post-pandemic recovery is the health sector. Supplies can satisfy the market while demand is not as higher (or severe) as the 2020 condition. Although the surge of new and more dangerous strain that happened mid-2021 entirely crashed the economy, rapid vaccination run in mid to end of the year can be a remedy that gets pandemic to subside.

Table 1: Inflation Rate (Forecast LPEM FEB UI)

2021		2022 Forecast	
Headline	Core	Headline	Core
1.87%	1.56%	2.5-2.8%	2.3-2.5%

Second, we see a rebound movement of the exchange rate after it depreciated to its lowest point in March 2020 due to the pressure on the financial market when the government announced the COVID-19 case in Indonesia. The trade surplus in Q3 2021 induces exchange rate dynamics amidst a further recovery in global demand and rising commodity prices. However, the recovery of domestic demand at the end of 2021 contributed to a relatively small trade surplus.

We expect inflation to grow even higher at 2.5% to 2.8% in the upcoming year due to the optimism of economic recovery and pandemics under control. The extra vaccines set to be provided soon and higher people mobility can induce demand back to its normal pre-pandemic level. In the exchange rate context, we expect a modest depreciation of the Rupiah due to the BI's commitment to maintaining their currency and bond stability and widening trade surplus. Lastly, we argue that global crude oil prices will experience a softened price increase in the upcoming year as production looks set to recover and demand growth will slow.

Key Figures

- Inflation (2021)
  1.87%
- Core Inflation (2021)
  1.56%
- Inflation* (2022)
  2.5 – 2.8%
- Core inflation* (2022)
  2.3 – 2.5%
- Consumption Growth (Q3 '21)
  3.51%
- % Current Account of GDP (Q3 '21)
  1.5%

____
**) Forecast*

Higher Inflation Rate than 2020, a Sign of Economic Recovery

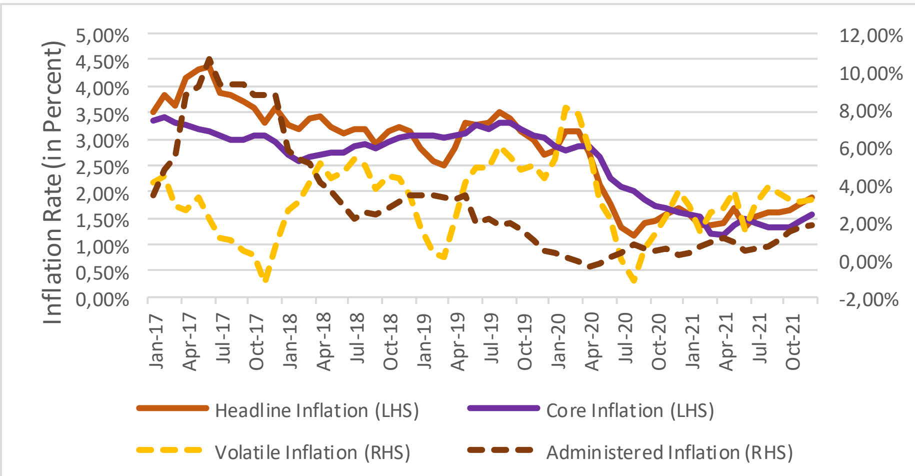
Overall, the year 2021 relatively saw a slight upward trend in the headline inflation rate compared to what happened in 2020. The upward trend tends to crawl towards its mean reversion pattern in 5 years. However, the drop due to the COVID-19 pandemic still pushed the rate below the average. The upward trend has largely been contributed by the less volatile percentage all year long in the volatile inflation rate. The volatile inflation rate was, by August 2021, at its highest peak all year long (at 3.8 percent), while the lowest point was at 1.52 percent in February 2021 (Figure 1). On the contrary, the highest rate in 2020 was 8.06 percent, and the lowest one was -1.16 percent. Thus, the discrepancy in 2021 is far smaller and less volatile.

The core inflation was also relatively stabilized within 2021, although there was a surge of new pandemic waves in the middle of the year. However, the average rate in 2021 is considered the lowest rate in the observed years. The core inflation rate by January 2021 was at 1.56 percent and so was by December 2021 (Figure 1). Meanwhile, administered inflation seemed to experience a gradual increase along the year and peaked in the last two years. As we discuss further later, the increase in the Brent crude oil prices has impacted administered prices especially in the second semester of 2021.

We argue that the actual condition of the inflation rate in 2021 is due to economic recovery amid pandemics and the rapid growth of the vaccination process. Reflecting the core inflation rate, domestic demand for the first three quarters of 2021 was indeed higher than 2020. However, it was still lower than 2019. Weak domestic demand has caused a lot of unused economic capacity, so prices tend to fall. Moreover, the surge of the Delta variant of COVID-19 in mid-2021 hit socioeconomic conditions in Indonesia.

Nonetheless, we can imply that there exists such a progressive post-pandemic recovery -although the pandemic does not last yet-. Besides the demand side, we also see that the supply side did not appear distorted, especially the supply of the essential goods. For example, rice production in 2021 is higher than before the pandemic. Thus, this surplus quite satisfied the market and even prevented imports.

Figure 1: Inflation Rate (Headline, Core, Volatile, Administered Goods), 2017-2021



Source: CEIC

Key Figures

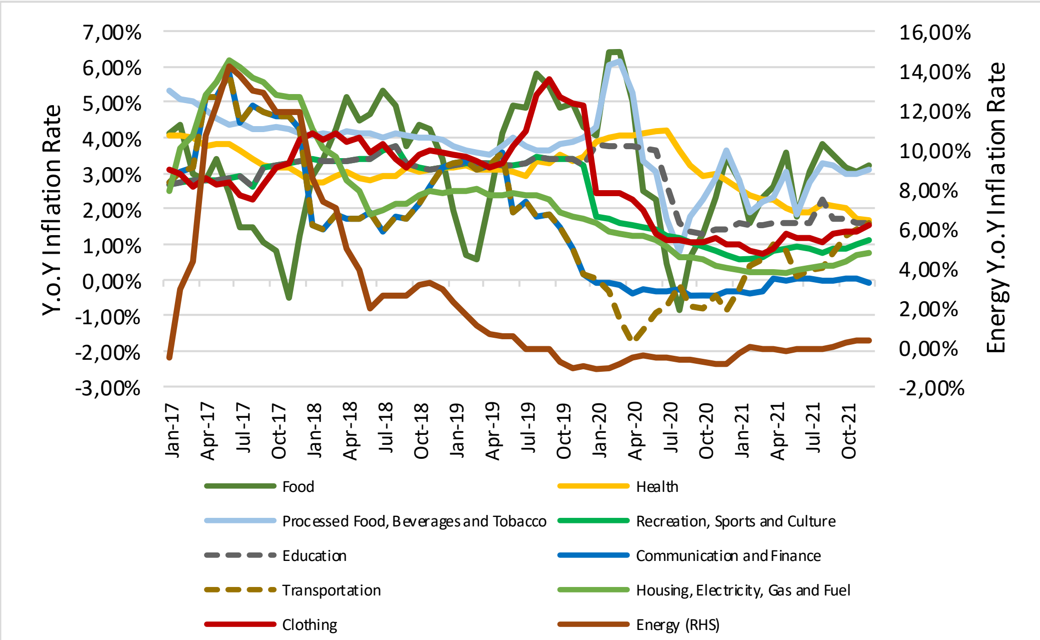
- Inflation (2021)
  1.87%
- Core Inflation (2021)
  1.56%
- Inflation* (2022)
  2.5 – 2.8%
- Core inflation* (2022)
  2.3 – 2.5%
- Consumption Growth (Q3 '21)
  3.51%
- % Current Account of GDP (Q3 '21)
  1.5%

____
**) Forecast*

We then break down the inflation rate by consumption type (Figure 2). We see that throughout 2021, inflation rates have been higher for most goods compared to 2020 conditions yet still relatively low. By December 2021, there is no type of goods recorded at more than a 4% year-on-year inflation rate, but only two goods recorded deflation during 2021. Compared to December 2020, most consumption goods experienced an increase in the inflation rate by December 2021. Only three goods declined: food, health, and processed food. On the other hand, vital sectors such as energy and transportation experienced a turnaround from deflation to inflation and a huge leap between the two-time points.

After analyzing the inflation rate by consumption type, we found that the impact of economic and health recovery is getting apparent throughout 2021. It can be inferred from the fact that some sectors are crawling back to the normal rate. The dynamics in the transportation sector can imply an increase in demand, especially the use of transportation modes. People are getting back to their normal mobility, and in consequence, public transportations are well utilized. The recovery can also be seen through the slower inflation run in the health sector—a massive and structural effort to vaccination yields slower growth of new COVID-19 active cases. Medical supplies are also massively distributed, thus preventing scarcity. These dynamics can be interpreted as a good sign of health recovery amidst pandemics throughout 2021.

Figure 2: Inflation Rate by Consumption Type, 2016-2020 (y.o.y)



Source: CEIC

The exchange rate in 2021 started to rebound after depreciating to its lowest level in March 2020 in the last five years; we also observe the improvement of inflation after its sharp fall in 2020 (Figure 3). Indonesia recorded a trade surplus in Q3 2021 amidst a further recovery in global demand and rising commodity prices. However, 2021 closed with a narrower trade surplus than last year, the smallest trade surplus since March 2020. Depreciation led to increased export competitiveness in Indonesia but was insufficient to prevent a trade balance deficit due to the resurrection of domestic demand. Inflation dynamics in 2021 that

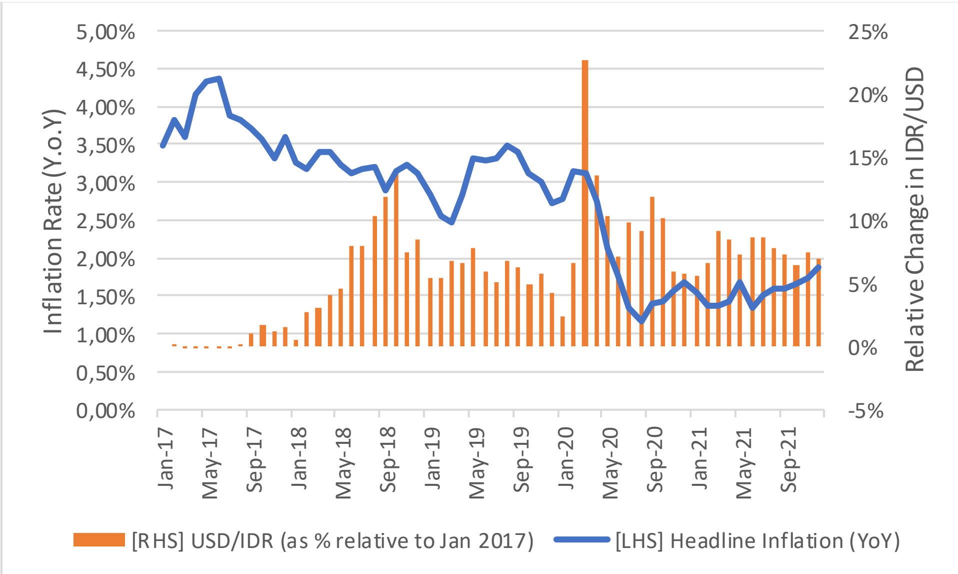
Key Figures

- Inflation (2021)
  1.87%
- Core Inflation (2021)
  1.56%
- Inflation* (2022)
  2.5 – 2.8%
- Core inflation* (2022)
  2.3 – 2.5%
- Consumption Growth (Q3 '21)
  3.51%
- % Current Account of GDP (Q3 '21)
  1.5%

____
**) Forecast*

are maintained in the range of 1.5 to 1.9 percent indicate strengthening consumption, especially during Christmas and the new year, followed by easing social restrictions.

Figure 3: Inflation Rate and Relative Change in USD/IDR, 2017-2021



Source: CEIC

We see fluctuations in Brent crude oil prices followed by movements in inflation, with conditions in 2017 being the exception (Figure 4). While 2020 was marked by a plunge in Brent crude oil prices due to the trade war between Saudi Arabia and Russia, 2021 is characterized by an upward movement in Brent crude oil prices above USD 1,000 per ton as growing global crude oil demand outpaced supply. The oil demand surge occurred in line with the acceleration of vaccination and relaxing pandemic-related restrictions. The increase in demand also occurred due to rising demand from gas-to-oil switching following the high record of European gas prices ahead of winter. Because Brent crude oil is the fuel that drives the economy, the increase in Brent crude oil prices is correlated with the inflation rate, which begins to creep up throughout 2021. The sharp increase in cooking oil also marked the economic turmoil due to Brent crude oil price increases. The government is expected to contain the surge in cooking oil prices, especially before the Fasting Month, because historically, people's consumption always increases during the fasting month. The government can map the cooking oil production areas in the country to deal with production scarcity and future distribution problems.

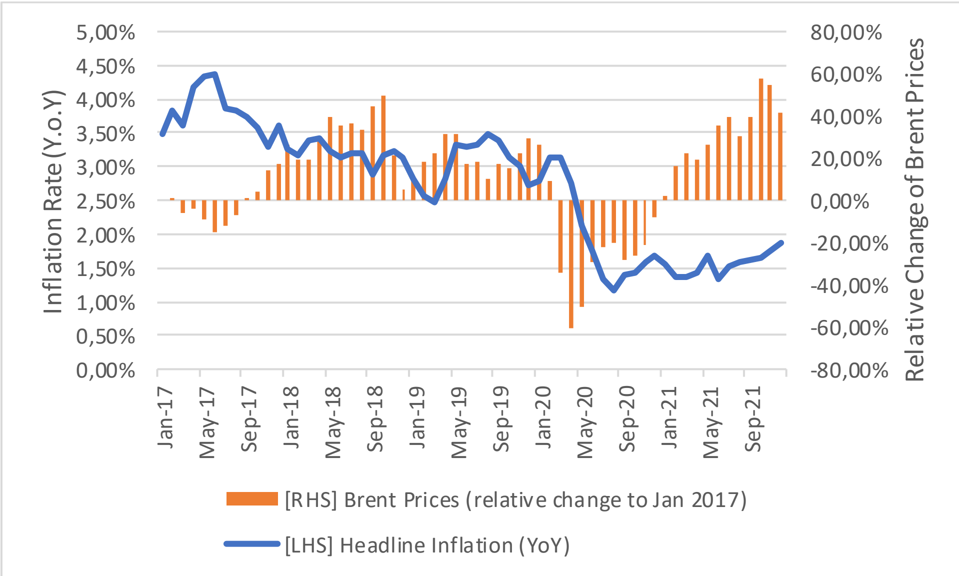
Key Figures

- Inflation (2021)
  1.87%
- Core Inflation (2021)
  1.56%
- Inflation* (2022)
  2.5 – 2.8%
- Core inflation* (2022)
  2.3 – 2.5%
- Consumption Growth (Q3 '21)
  3.51%
- % Current Account of GDP (Q3 '21)
  1.5%

____

**) Forecast*

Figure 4: Inflation Rate and Relative Change in Oil Price (Brent), 2017-2021



Source: CEIC

Figure 5 exhibits a stable movement in consumption growth during 2017 and early 2020, yet it begins to fluctuate in 2020 and 2021. Indonesia's economy experienced a chaotic slump in 2020 as the pandemic weakened consumer demand until it returned with the most robust growth in the second quarter of 2021 (7.07% YoY). This growth results from higher mobility in response to relaxed social restrictions and picked up vaccination pace, luxury tax holiday stimuli, macroprudential policy, and seasonal boost during religious holiday momentum. However, Q3 2021 experienced a downward movement again (3.51% YoY) as Indonesia remains vulnerable to a new wave amidst the discovery of more transmissible strains in other countries. The fluctuation in the core inflation rate goes in the same pattern with the consumption growth, yet it is still laborious to reach pre-pandemic levels. Such inflation movement indicates a stretch of purchasing power but is still being held back by economic uncertainty amid the prolonged COVID-19 pandemic.

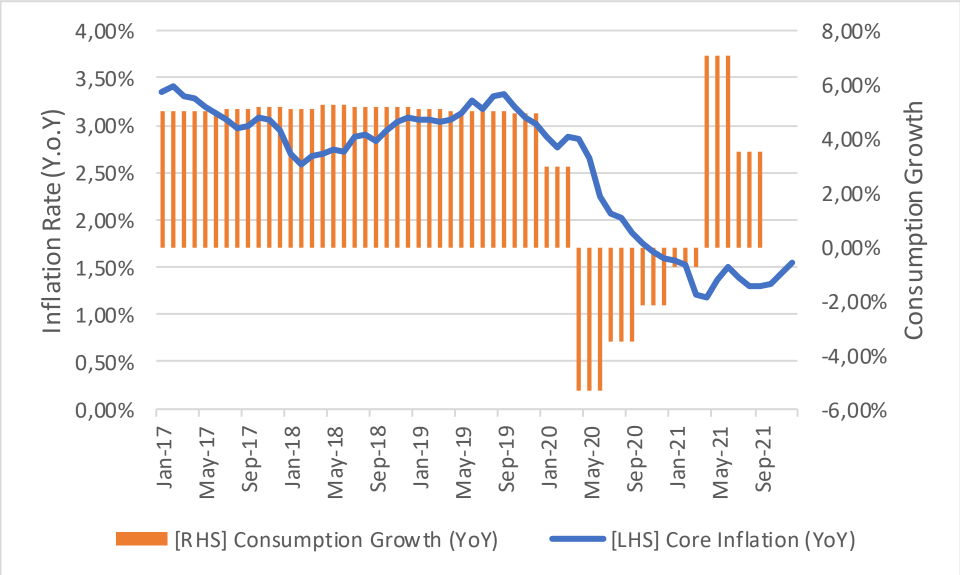
Key Figures

- Inflation (2021)
  1.87%
- Core Inflation (2021)
  1.56%
- Inflation* (2022)
  2.5 – 2.8%
- Core inflation* (2022)
  2.3 – 2.5%
- Consumption Growth (Q3 '21)
  3.51%
- % Current Account of GDP (Q3 '21)
  1.5%

____

) Forecast

Figure 5: Core Inflation Rate and Consumption Growth, 2017-2021



Source: CEIC

2022 Inflation Forecast: Surging Moderately, But Significant Risk Remain

We estimate the 2022 inflation will settle at a level above the average inflation in the previous year, which stands for 2.5% to 2.8%, with core inflation expected to grow around 2.3% to 2.5%. These underlying estimates come from the combination of demand strengthening this year, followed by the escalation in global commodity prices. Indonesia's economy is entering a recovery zone as economic activity continues to rise and people's mobility is getting liven up amidst loosening pandemic curbs and accelerating vaccination, given that 29% of the population is fully vaccinated. End-year headline inflation, which inched up to 1,87%, the highest since the COVID-19 pandemic, signals upcoming economic recovery. The pressure comes from the supply side, where the upward trend in *imported inflation* due to global price pressures from supply chains and commodity prices; and inflationary pressure from Indonesia's trading partner countries continue to bleed Indonesia's economy. However, significant risks of the third wave of COVID-19 cases remain after discovering the increasingly contagious strain of the Omicron virus. The government may impose a stricter social restriction policy, usually against the economic activity. Hence, 2022 inflation is barely predicted amidst the uncertainty.

Despite a relatively stable exchange rate throughout 2021, we expect a modest depreciation of Indonesia's currency to be around Rp 14.350 – 15.000 per USD, in line with government prediction when drafting the 2022 state budget. Exchange rate movements are inseparable from the normalization of monetary policy by central banks rich countries, including the U.S. Federal Reserve interest rate that potentially lift off this year. Nevertheless, Indonesian central banks' commitment to maintaining their currency and bond stability and widened trade surplus will endure deep depreciation thanks to robust exports. The government's exchange rate prediction indicates their confidence to achieve economic growth target. Such confidence can build investor confidence and attract investment to pick up.

LPEM FEB UI
UNIVERSITAS INDONESIA

Key Figures

- Inflation (2021)
  1.87%
- Core Inflation (2021)
  1.56%
- Inflation* (2022)
  2.5 – 2.8%
- Core inflation* (2022)
  2.3 – 2.5%
- Consumption Growth (Q3 '21)
  3.51%
- % Current Account of GDP (Q3 '21)
  1.5%

____
**) Forecast*

Moving forward, despite the highest climb of Brent crude oil prices in 2021 since the pandemic hit the global economy, we forecast a soften Brent crude oil prices in the upcoming year as production looks set to recover and demand growth would slow. OPEC group would gradually retreat from the production cut that was implemented last year. They expect a substantial increase in global oil demand in 2022 despite the mutated Omicron variant of the COVID-19 virus. However, the optimism regarding global oil demand growth is not without risks. Some big oil user countries like China and the U.S. have shown weakening fuel demand amid rising concern for more transmissible viruses. Considering the vaccination progress and people's habituation to live side-by-side with the virus, but with the risk of tightening social curbs, we estimate a positive undertone of domestic demand for crude oil, but with a slight enhancement.

2022 consumption growth is expected to recover stronger into pre-pandemic level in the 4.7-5.2% range, driven by the ongoing improvement of consumption and investments as the mobility restrictions have been relaxed since COVID-19 daily infections steadied to below 1,000 over the past two months. Such recovery is also supported by a faster vaccination rate, the return of economic activity, and policy stimuli. Nevertheless, Indonesia is not immune from covid conditions, which risk economic growth downside. The consumption recovery mainly comes from the upper-middle consumer segment; the lower-middle consumer, on the other hand, would still prioritize savings after mobility curbs hit their economic condition. The government's policy to maintain basic needs, social assistance for those who hurt the most, and faster deepening of financial markets supported by digital-based technology are essential to cushion the economy.