Macroeconomic Analysis Series

BI Board of Governor Meeting

March 2022

LPEM FEB UI
Universitas Indonesia

Highlights

- BI should hold its policy rate at 3.50%.
- February recorded a monthly deflation as several price components decline due to the materialization of retail price regulation and lower mobility as daily cases spiked.
- Global energy and food commodities increase rapidly as the tension between Russia and Ukraine has escalated into war.
- Capital outflow due to rising global uncertainty has limited impact on Rupiah as trade balance recorded a hefty surplus from commodity export performance.

Macroeconomics & Political Economy Policy Research

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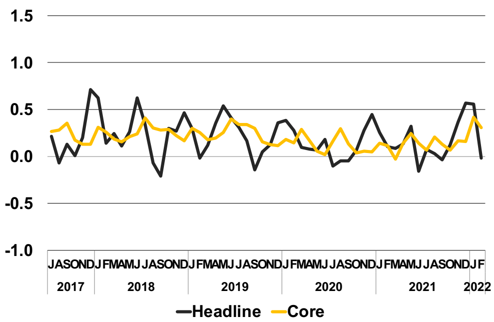
The global economy was not particularly in good condition recently. The uneven domestic demand recovery, continuation of supply chain disruption, and energy shortage in various parts of the world have created an inflation problem that serves as a hiccup to Covid-19 economic recovery. The outbreak of war served as fuel to the flame of current global economic issues, especially inflation, as it triggers the rapid rise in energy and food commodity prices. On a global level, the current economy is facing health and war crisis at the same time. On domestic prospects, fortunately, the impact of recent global development is relatively benign at the moment. However, the risks of future inflation driven by the upcoming Ramadan period, relaxation of social restriction, rising energy and food prices will put policymakers, especially BI, in a tough position ahead. Thus, keeping the policy rate at 3.50% shall be appropriate.

Deflation amidst Demand Recovery Momentum

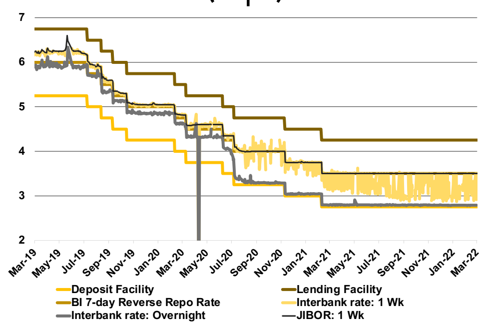
Since late last year, inflation has become a global phenomenon due to its rapid rate of increase in several countries, especially developed ones. The mix of demand-pull aspects from increased mobility and pent-up demand combined with cost-push factors, such as supply chain disruption and energy shortages, create massive inflationary pressures across the globe. However, Indonesia is rather behind the curve on the inflation issue and is still in the early stage of an upward inflationary momentum hike. February's headline inflation in Indonesia is recorded at 2.06% (y.o.y), within BI's target for the second month straight during the pandemic era, although it is still roaming around lower threshold of the target. However, the February inflation rate is lower than the previous month at 2.18% (y.o.y). Monthly rate of headline inflation even recorded a deflation of 0.02% (m.t.m), suggesting the decrease in several prices components due to the materialization of retail price regulations and drop in people's mobility with Covid-19 daily cases peaking driven by the Omicron variant.

Figure 1: Inflation Rate (m.t.m)



Source: CEIC

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



Source: CEIC

Key Figures

BI Repo Rate (7-day, Feb '22)
3.50%
GDP Growth (y.o.y, Q4 '21)
5.02%
Inflation (y.o.y, Feb '22)
2.06%
Core Inflation (y.o.y, Feb '22)
2.03%
Inflation (m.t.m, Feb '22)
-0.02%
Core Inflation (m.t.m, Feb '22)
0.31%
FX Reserve (Feb '22)
USD141.4 billion

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Observing by its components, annual core inflation actually increased as opposed to the pattern of headline inflation. Stood at 2.03% (y.o.y) in February, core inflation indicates a higher purchasing power hike from February last year compared to the hike in January 2022 from January 2021, which recorded only 1.84% (y.o.y). However, on a monthly basis, core inflation decreased to 0.31% (m.t.m) from 0.42% (m.t.m) in January 2022, following the highest rate of Covid-19 daily cases during mid-February as house and car rent price components declined considerably. Lower public mobility in February also materializes in administered price component, which was recorded at 2.34% (y.o.y), slightly lower than 2.37% (y.o.y) in the previous month. The lower inflation rate is more noticeable on the monthly figure, as it declines from 0.38% (m.t.m) in January 2022 to 0.18% (m.t.m) in February 2022. The lower administered price inflation was driven by deflation of air transport prices, although it was somehow offset by the inflation in household fuel price and cigarette products as the impact of LPG price adjustment and hike of tobacco excise started to take place.

The shortage of several food products has shot up the price of volatile food components in early 2022, especially cooking oil. GoI has taken steps to address the problem of scarcity, one of which is by adjusting the "highest retail price" policy for cooking oil and effort to increase the production. As the effects took place, volatile food components recorded a monthly deflation of 1.50% (m.t.m), a substantial decrease from January monthly inflation of 1.30% (m.t.m). The deflation was driven by price decline in several food commodities, including cooking oil, egg, and chicken meat. Looking forward, despite seasonal deflation of various commodities that took place in last February, inflationary pressures are potentially looming ahead of the massive spikes in energy, agriculture, and gold prices due to the Ukraine-Russia conflict and upcoming Ramadhan periods, in addition to the continuation of domestic demand recovery driven by the fall in daily Covid-19 rate and relaxation of social mobility restriction.

Windfall of Rising Energy Prices

February marked a new record of daily Covid-19 cases in Indonesia as the Omicron variant surges. Reaching more than 60,000 daily active cases in mid-February due to the vast spread of the Omicron variant following the end-of-year holiday season, social mobility declined substantially. This is reflected in Consumer's Confidence Index (CCI), which was recorded at 113.13 in February, significantly lower compared to 119.6 in the previous month. Despite still being in an optimist territory (>100), the optimism was mostly driven by the positive expectation of future economic conditions as the CCI for future expectations was at 130.80. Meanwhile, the index suggested that consumers' was holding a pessimistic view towards the present situation in February (the CCI index of present situation was recorded at 95.46, well below 100). Several factors came into play that might explain the phenomenon of

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February consumers' pessimism regarding the economic conditions, including the rapid rise of daily Covid-19 cases, cooking oil shortage, and the escalating geopolitical tension that led to the invasion of Russia to Ukraine.

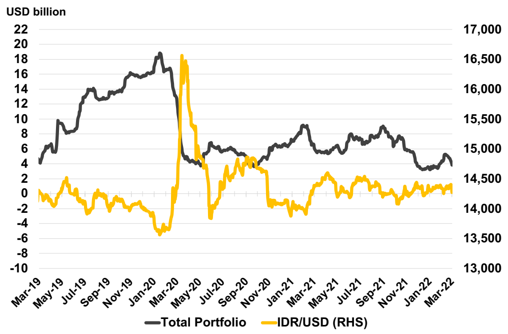
As the global energy prices reached a staggering level in the last few months due to global demand recovery and exacerbated by the start of the Russia-Ukraine war, the windfall is apparent in Indonesia's trade balance figure. Indonesia recorded a trade surplus of USD3.8 billion, a hefty increase compared to January 2021, which only recorded a surplus of USD0.9 billion. The combination of a surge in export and decline in import drove the jump of around USD2.8 billion in trade surplus during last month. The rise in export is mainly contributed by CPO due to high global prices as vegetable and animal fat oil export increased by more than USD1.7 billion in February or around 141% hike compared to the January export value. On the other hand, the February import decline was driven mainly by lower imports for machinery products and iron and steel as economic and production activity declined due to the surge of Omicron cases. Overall, the import balance dropped around USD1.5 billion, from USD18.2 billion in January 2022 to USD16.6 billion in last month.

Worsening of Current Global Challenges due to War

The global economy was not particularly in good condition recently. The uneven domestic demand recovery, continuation of supply chain disruption, and energy shortage in various parts of the world have created an inflation problem that serves as a hiccup to Covid-19 economic recovery. The concern of inflation drove several major central banks, including the Fed, ECB, and Bank of England, to start shifting gears in the monetary tightening process. This serves as bad news for numerous developing countries that are still struggling to recover domestic conditions, including Indonesia, as a more aggressive monetary tightening would risk a surge of capital outflow and put pressure on their currency. At the same time, these countries have no luxury of implementing monetary counter tightening without jeopardizing the progress of domestic recovery.

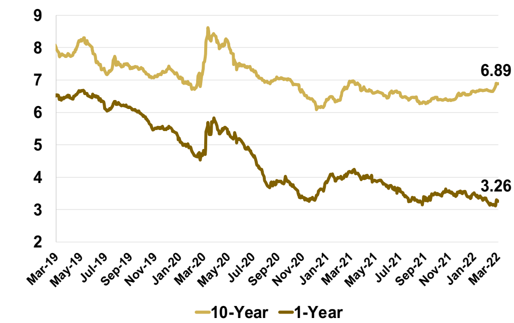
All those problems were prevalent even before the Russian invasion of Ukraine. The outbreak of war served as fuel to the flame of current global economic issues, especially inflation. Russia accounted as the third-largest oil producer with a share of 12% and the second-largest producer of gas, which accounted for 17% of global supply. In addition, Ukraine is the largest wheat producer with a total contribution of 25% global output. The escalating conflict between those countries has jacked up the price for those three commodities. Furthermore, the substitution effects drove up the demand for other energy commodities, such as coal and CPO, and general agriculture commodities, including corn and soybean. While developed countries is expected to struggle even more to fight inflation, the biggest impact will potentially hit developing world. Oil, as a universal intermediary good, influences the costs of commodities and services and transport costs in multiple ways that higher oil price poses a serious challenge for many developing countries that are still behind the recovery curve. In addition, crop production in developing countries could also be hit by fertilizer shortages, considering Russia is also a major fertilizer producer. Combined with massive disruption of the global wheat supply, the upward pressure on global food prices could have dire consequences. Considering the fact that hunger had already increased dramatically during pandemic, particularly in less-developed countries, the food crisis could have the real potential to devastate the lives of hundreds of millions of people.

Figure 3: IDR/USD and Accumulated Portfolio Capital Inflow (Last 36 Months)



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

Besides the cataclysmic impact of war transmitted by commodity channels, another repercussion of such a horrible event could be observed from the global financial channel. As the war broke out, the global uncertainty rose rapidly and pushed the capital out of emerging markets, including Indonesia. Since the day Russia invaded Ukraine on February 24th, Indonesia experienced a massive capital outflow till mid-March. Indonesia recorded a capital outflow of USD1.29 billion, a drop from USD5.15 billion to USD3.86 billion in the span of less than three weeks. The rising uncertainty and flight-to-safety action taken by foreign investors is also reflected by the widening spread of 10-year and 1-year government bond yield spread in March compared to the previous month. Regardless, the decrease in foreign ownership of domestic assets during pandemic era and robust trade performance has cushioned the impact of capital outflow towards Rupiah. Thanks to the windfall from high energy prices, the exceptional trade performance has outdone the pressure of capital outflow on Rupiah, which appreciated from around IDR14,380 in late February to around IDR14,320 per USD in mid-March.

Despite the recent turmoil in the global financial market, Rupiah has a rather stable movement and is among the top performers compared to its peers. With the depreciation rate of 0.58% (ytd) since the beginning of 2022 and an annual depreciation rate of -0.43% (y.o.y), Rupiah demonstrated a rather stable fluctuations amidst the current economic and geopolitical shock. On the other hand, there is almost no significant change in BI's forex reserves in February 2022. Recorded at

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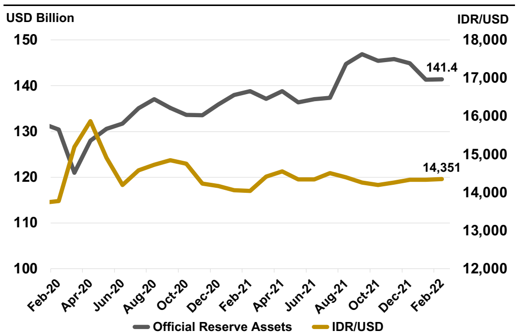
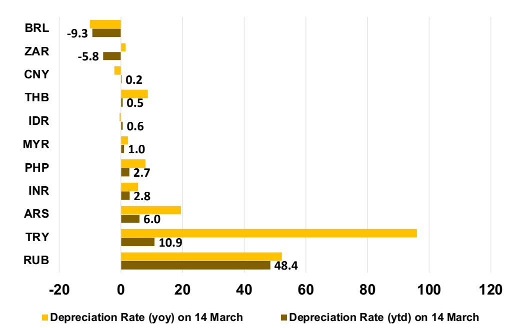
USD141.4 billion, forex reserves had a slight increase of less than USD1 billion from USD 141.3 in January 2022. Nevertheless, the current level of forex reserves is still deemed as ample as it is equivalent to finance 7.5 of imports or 7.3 months of import and public debt repayment, substantially higher than the international standards of adequacy (3 months import equivalence).

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (March 14, 2022)



Source: Investing.com

During the early days of the Covid-19 pandemic, policymakers around the world considered what we were facing was a condition deemed as *unprecedented*, which never before modern economic problem was caused by the health condition. The circumstances have forced global economy to take extraordinary measures to save life and welfare of population. Uncertainty was considered at a record-high back then. As the global economy progress towards the *new normal*, transition from pandemic era to endemic phase seems reasonably over-the-horizon. And then in early 2022, the war broke out as Russia started to invade Ukraine and instantly defined "global uncertainty" to a whole new level. On a global level, the current economy is facing health and war crisis at the same time. On domestic prospects, fortunately, the impact of recent global development is relatively benign at the moment. However, the risks of future inflation driven by the upcoming Ramadan period, relaxation of social restriction, rising energy and food prices will put policymakers, especially BI, in a tough position. Considering the current condition, we are in the view of BI should hold its policy rate at 3.50% this month, as the domestic recovery is still taking its course to fully materialize, and the stability of the price creates no urgency to tighten the policy rate at this time, as any unnecessary monetary tightening would put the progress of economic recovery in jeopardy.