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Macroeconomic Analysis Series

BI Board of Governor Meeting

October 2022

Highlights

- BI needs to stay ahead of the curve by increasing the policy rate by 50 bps to maintain Rupiah stability amidst the potential capital outflows from another interest rate hike by the Fed.
- Inflationary pressures in September were driven mainly by the fuel price adjustment and demand recovery.
- Trade surplus declines following the global commodity price normalization.
- Despite the external deteriorations, sentiment towards the domestic economy in the long term is still promising.

Macroeconomics & Political Economy Policy Research

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Inflation continues to soar above the BI's target range after the adjustment of subsidized fuels prices in early September 2022. The price level of energy and transportation sectors recorded the highest jump in September 2022 amid the persistently high global energy and food prices. The increase in price level slightly corrected the consumers' confidence despite it is still in optimistic territory. From external side, the trade surplus is declining due to global commodity price normalization. At the same time, risks of global financial turmoil are still lingering with episodes of capital outflows due to aggressive monetary tightening by central banks worldwide. Although BI has raised the policy rate two times, massive capital outflows have weakened Rupiah to IDR15,485 in mid-October. As a pre-emptive measure following the potential episodes of capital outflows caused by further interest rate hikes by the Fed next month, BI needs to raise the policy rate by 50 bps to 4.75% this month. The ahead of the curve stance is expected to cushion the impact of external uncertainty on domestic financial and foreign exchange markets. At the same time, the GoI could perform measures to maintain demand recovery and real sector optimism on economic growth prospects.

Fuel Prices Adjustment and Demand Recovery Escalate the Inflation

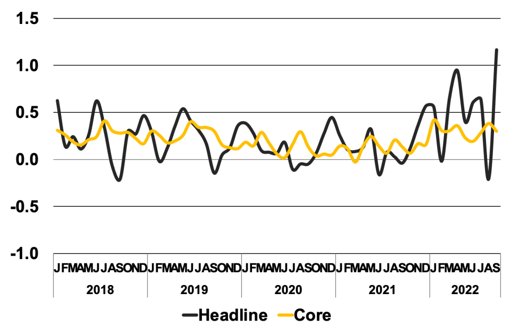
The soaring global commodity prices due to pent-up demand after the Covid-19 pandemic coupled with supply shortage continue to affect global energy and food prices. In Indonesia, headline inflation hit another record high in September 2022 at 5.95% (y.o.y), substantially higher than 4.69% (y.o.y) a month earlier. On monthly basis, the prices went up by 1.17% (m.t.m) from August to September 2022. This month's high inflation was mainly contributed by the adjustment of subsidized fuel prices by GoI as an effort to maintain the energy subsidy amidst the soaring crude oil and gas prices. As a consequence, the domestic prices of energy components jumped with double-digit annual inflation of 16.48% (y.o.y) and monthly inflation of 10.13% (m.t.m). At the same time, administered prices also recorded high annual inflation of 13.28% (y.o.y) and monthly inflation of 6.18% (m.t.m).

Higher subsidized fuel prices since early September also escalated the transportation prices in various regions in Indonesia, with its inflation reaching 16.01% (y.o.y). The transportation prices also increased by 8.88% (m.t.m) compared to a month earlier. On the other hand, inflation of volatile and food ingredients are slightly declining from a month earlier at -0.79% (m.t.m) and -0.68% (m.t.m), respectively. The monthly deflation of volatile and food ingredients in September 2022 can be explained by gradual decrease in global commodity prices as well as the results of GoI and BI efforts in monitoring the food prices.

Key Figures

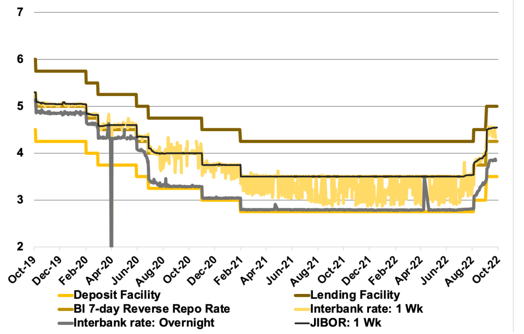
BI Repo Rate (7-day, September '22)
4.25%
GDP Growth (y.o.y, Q2 '22)
5.44%
Inflation (y.o.y, September '22)
5.95%
Core Inflation (y.o.y, September'22)
3.21%
Inflation (m.t.m, September '22)
1.17%
Core Inflation (m.t.m, September'22)
0.30%
FX Reserve (September '22)
USD130.8 billion

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



Source: CEIC

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



Source: CEIC

On the aspect of core inflation, it increased by 3.21% (y.o.y) in September 2022 compared to the same month in the previous year. The annual core inflation figure in September is even higher than in August of 3.02% (y.o.y). The core inflation also increased by 0.30% (m.t.m) from August 2022. The higher core inflation was supported mainly by the prolonged demand recovery from Covid-19. Even though core inflation is still relatively benign, the risks of further surges remain, particularly from expected inflation, as global inflation is expected to soar with the forecast of 8.8% for FY2022. From the domestic-driven factors, core inflation has risk of rising further due to the potential second-round effect of increased energy prices following the adjustment in subsidized fuel prices, which could contribute to higher prices for other goods and services. As a result, both core and headline Inflation is expected to continue rising for the rest of this year.

Nourishing Domestic Optimism Amid the External Deteriorations

The price level, which has risen sharply in recent months, poses risks to economic activity by escalating the cost of living and eroding people's purchasing power. Measures taken by the central bank to contain inflation, such as hiking the interest rate, are also expected to decelerate economic activity in ways that could slow economic growth. Domestic consumption and investment are projected to suffer due to continuing global inflation and aggressive monetary tightening. As a result, global economic prospects are seeing a rather unfavorable circumstances ahead, with slower growth expected in 2023 than this year.

To anticipate a worsening economic condition, GoI has provided cash transfers of IDR12.4 trillion for low-income households affected by the higher subsidized fuel prices. Moreover, around IDR9.6 trillion in wage subsidy assistance for workers is also offered by GoI after adjusting subsidized fuel prices. Social assistance is expected to help preserve people's purchasing power during mounting prices. Consequently, some leading indicators are still showing promising trends in Indonesia's economic conditions. First, Consumer Confidence Index (CCI) is still hovering in the optimistic territory at 117.2 in September 2022, despite slightly declining from 124.7 one month earlier. The persistent positive sentiment of consumers on the domestic economy is mainly driven by future income and job availability expectations.

Second, demand recovery from the pandemic is boosting production in the real sector, as reflected in the higher Purchasing Manufacturing Index (PMI) at 53.7 in September 2022 compared to 51.7 in August 2022. It reflects that business activity remained solid despite inflationary pressures, matching the consumer's high expectations of future income and job availability. The figure of PMI in September has even higher than the PMI in other countries, such as the Philippines (52.9), Vietnam (52.5), and Malaysia (49.1).

From the external side, although the trade surplus is still increasing over the year, indicating that the economy continues to recover, the surplus figure in September 2022 has slightly corrected compared to a month earlier. The surplus fell by 13% (m.t.m) from USD5.76 billion in August to USD4.99 billion in September, with an 11% (m.t.m) decline in exports and imports. The decline in exports can be explained by the downward trend of Indonesia's main export commodities prices, such as vegetable fats and animal oils, as well as iron and steel, since June 2022. Meanwhile, the price of coal, which also has a significant role in exports, is persistently high.

Nevertheless, the correction in September 2022 foreign trade has caused a lower trade surplus in Q3-2022 than in Q2-2022. While the total exports for overall Q3-2022 are persistently higher than in one previous quarter, the value of imports is accelerating faster than exports, mainly due to the depreciation of the Rupiah, which also contributes to high imported inflation. As a result, the narrowed trade surplus could shrink the persistent current account surpluses. The current account balance could turn back into negative territory as the signs of commodity price normalization and demand recovery after the pandemic toughen. Moreover, the gloomy outlook for China's economic growth due to the zero-Covid-19 policy and declining economic activity could reduce its demand for goods and services; consequently impacting Indonesia's trade performance, considering China as its main trading partner.

Further Monetary Tightening to Contain Capital Flights

The financial markets in developing countries are experiencing episodes of capital outflows as global inflation prompts an increase in interest rates from major central banks, especially the Fed, causing trends of weakening emerging markets' currencies against the USD. The Fed raised another 75bps in September 2022, making the benchmark target rate 3.00 – 3.25%. To slow down the inflation, the Fed also aggressively increased the sell-offs of bond portfolios last month. However, apart from the five rate hikes executed by the Fed this year, the inflation rate in the

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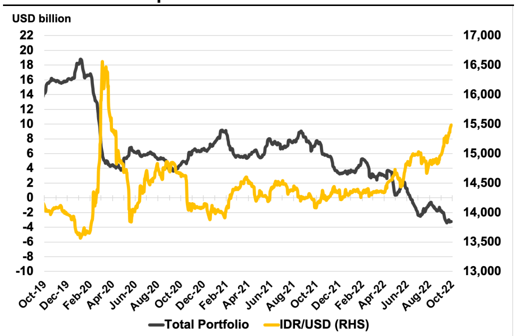
US remained high at 8.20% in September 2022. It indicates a high probability of another rate hike in the two remaining FOMC meetings this year.

Due to the Fed's aggressive monetary tightening, the 10-Year treasury bond yield is persistently going up. It sharply narrowed the yield differential between the US and emerging markets. Even though central banks from developing countries have considerably raised their benchmark rates following the interest rate hike in major developed countries, the massive capital outflows from emerging markets are lingering.

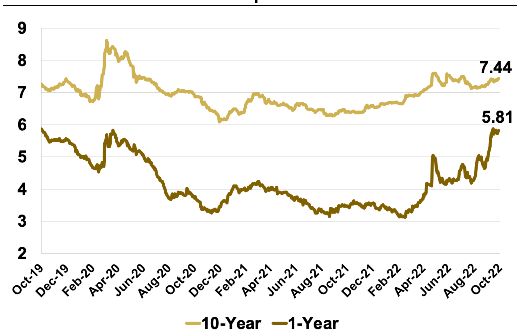
After BI raised the benchmark rate for two consecutive months in an attempt to stay ahead-the-curve, Indonesia still recorded around USD1.66 billion capital outflow from mid-September to mid-October, making the total amount of capital flights reach USD8.13 billion since the first Fed rate hike in March. The capital flights from the bonds market are fully priced in the higher 10-Year and 1-Year tenor government bonds yields of 7.44% and 5.81%, respectively, in mid-October, up from 7.24% and 4.86% a month earlier. The continuing trend of narrowed spread yield between the long and short-term tenor reflects that the investor's sight of Indonesia's economic prospect in the short run is deteriorating.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

Massive capital inflows to the US during the aggressive monetary tightening has strengthened the dollar. As a result, the exchange rate of developing countries depreciated against the dollar, including Rupiah. The performance of the Rupiah is worsening the depreciation rate reaching 8.7% (ytd). Rupiah depreciated to IDR15,485 on October 17th, 2022, from around IDR14,950 last month. However, the depreciation rate of the Rupiah is still relatively manageable than other developing countries which have experienced double-digit rates, such as the Malaysian Ringgit (13.4%), Thailand's Baht (14.7%), and the Philippines Peso (15.7%). This achievement was supported by BI's efforts to maintain Rupiah stability, which is continuing to intervene in the foreign exchange market through spot transactions, DNDF, and the purchase of SBN in the secondary market.

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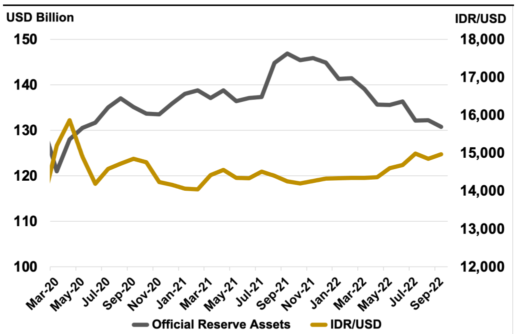
8 DECENT WORK AND ECONOMIC GROWTH

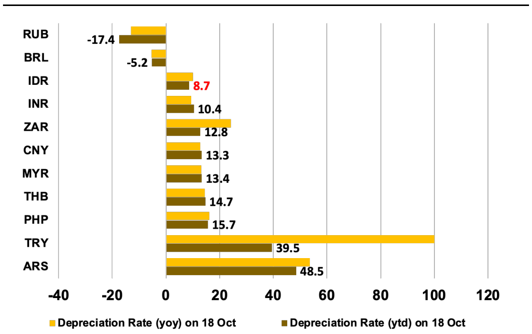
The intervention carried out by BI was reflected in a decline in foreign exchange reserves by around USD2 billion to USD130.8 billion in September 2022 from USD132.2 billion in one month earlier. Despite slightly declining, the amount of foreign exchange reserves is still equivalent to financing 5.9 months of imports or 5.7 months of imports and servicing the government's external debt, which means it is still sufficient to cushion any turbulence in the near future. The figure is also still above the international adequacy standard of about three months of imports.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (Oct 18, 2022)



Source: Investing.com

Apart from looming financial market turmoil, Indonesia is outperforming other developing countries, as seen by the relatively stronger Rupiah, thanks to the efforts made by BI to maintain domestic stability through a variety of measures, including the forward-looking interest rate hikes, spot and DNDF transactions, as well as operation twist through the buying/selling of SBN in the secondary market. Given that aggressive global monetary tightening persists, domestic inflation remains high, and the trade surplus shrinks, the previous milestone can be considered as a reference for BI to stay ahead of the curve until the end of this year. As a pre-emptive measure in anticipation of potential episodes of capital outflows caused by further interest rate hikes by the Fed next month, BI needs to raise the policy rate by 50 bps to 4.75% this month. The resulting widening of the rate differential is expected to cushion the impact of external uncertainty on domestic financial and foreign exchange markets. Raising the policy rate by 50 bps will help BI to decelerate capital outflow and reducing the rate of depreciation, which helps reducing inflationary pressures from imported goods. At the same time, the GoI could perform various complementary measures, such as expanding considerable social assistance, to maintain demand recovery and real sector optimism on economic growth prospects.