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UNIVERSITAS INDONESIA

Macroeconomic Analysis Series

BI Board of Governor Meeting

December 2022

November inflation stood at 5.42% (y.o.y), continuing its deceleration pattern in the last three months. A combination of seasonal events as well as impact of inflation controlling efforts by the government and central bank has resulted in a sooner-than-expected inflation peak and more benign inflation rate towards the end of 2022. On the other hand, anticipated rate hike ease by major central banks has triggered surge of capital flows into emerging markets, including Indonesia. Since mid-November, net capital inflow to Indonesia has amounted to around USD2.12 billion, strengthening Rupiah to around IDR15,500 and driving down yields for both 10-year and 1-year Indonesian government bonds to 7.02% and 5.49%, respectively. Thus, we see that BI should ease its hawkish stance and hike policy rate by 25bps this month to 5.50%.

Has Inflation Passed Its Peak?

Inflation in November came as a relief amidst the worry of price hike pressure following the global trend and the ongoing impact of recent fuel price hike. Headline inflation continued a deceleration pattern in the last two months as it was recorded at 5.42% (y.o.y) in November 2022, down from 5.71% (y.o.y) in the previous month. Several components have contributed to the slowing of inflation figures, especially food products, as it weights of around 20% of all inflation components. On an annual basis, volatile food price components grew slower from 7.19% (y.o.y) in October 2022 to 5.70% (y.o.y) in November 2022. At the same time, it experienced a deflation of 0.22% (m.t.m) on a monthly basis last month, prolonging the deflation trend of monthly volatile food price in the last four months. This is attributable to its seasonality trend and a rather successful effort by the government in managing the availability of food stocks in the market, especially for chilies, through its National and Regional Inflation Control Team (TPIP and TPID). However, the increasing price of egg and tomato due to rising demand and rejected products as well as hiking price of rice commodity due to decreasing production volume and the impact of fuel price adjustment, have moderated the slowdown of volatile food price components.

In addition, the impact of increase in fuel prices was relatively lower than what has been initially forecasted and may have reached its peak. On a monthly basis, the energy price component shown a deflation of -0.02% (m.t.m) in November 2022 and transportation energy price increase decelerated slightly to 0.01% (m.t.m) this month from 0.35% (m.t.m) a month earlier. On the other hand, annual inflation of energy and transportation components in November are still on a high level due to low-base effect, though slightly declining. Energy prices in November increased by 16.85% (y.o.y), down from 16.88% (y.o.y) in last month, while transportation prices declined to 15.45% (y.o.y) from 16.03% (y.o.y) during the same period. The high-yet-decreasing annual figure and rather muted monthly figure of energy and

Highlights

- BI should ease its hawkish stance and hike policy rate by 25bps this month to 5.50%.
- Recorded at 5.42% (y.o.y), inflation continued its deceleration pattern and might indicate that inflation has passed its peak.
- Expected rate hike ease by major central banks has triggered capital flows to Indonesia, consequently appreciating Rupiah and driving down Indonesian government bond yield.
- Foreign exchange reserves surprisingly increased by USD3.8 billion to USD134 billion, thanks to services and tax revenue, as well as oil and gas revenue

Macroeconomics & Political Economy Policy Research

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Key Figures

BI Repo Rate (7-day, November '22)
5.25%
GDP Growth (y.o.y, Q3 '22)
5.72%
Inflation (y.o.y, November '22)
5.42%
Core Inflation (y.o.y, November '22)
3.30%
Inflation (m.t.m, November '22)
0.09%
Core Inflation (m.t.m, November '22)
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FX Reserve (November '22)
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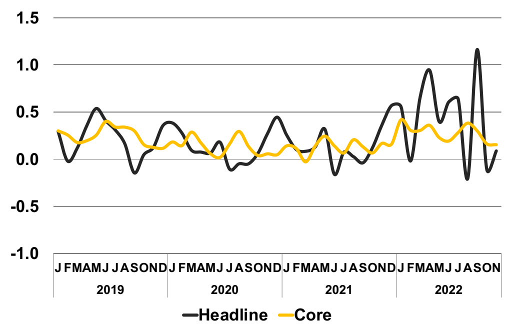
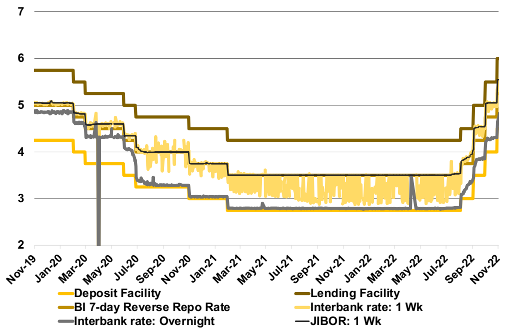
transportation component suggest that while the impact of fuel subsidy removal is relatively massive, it might have reached its peak and has been moderated.

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



Source: CEIC

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



Source: CEIC

The increase in fuel price is also transmitted into a rather manageable figure of core inflation in November. Both annual and monthly core inflation in November is relatively unchanged compared to the previous month (3.30% (November 2022, y.o.y) vs. 3.31% (October 2022, y.o.y) and 0.15% (November 2022, m.t.m) vs. 0.16% (October 2022, m.t.m)). The relatively unchanged figure of core inflation also suggests that the purchasing power of household remain stable. On the other hand, administered price component was reported at 13.01% (y.o.y) in November, decreased from 13.28% (y.o.y) in the previous month. This is mainly driven by lower tariff of air transport following the relaxation policy on airplane landing and storage services set by Ministry of Transportation. However, the conflicting inflationary force of administered prices came from the prolonged transmission of tobacco and cigarette excise. On a monthly basis, administered prices also reflected the same decelerating pattern of inflation of 0.14% (m.t.m) in November from 0.33% (m.t.m) in the previous month.

Again, we might be seeing the favourable mix of good policy and good luck taking its course on domestic inflation figure. A combination of seasonal events as well as impact of inflation controlling efforts by the government and central bank has resulted in a sooner-than-expected inflation peak and more benign inflation rate towards the end of 2022. However, the potential upward inflationary pressure might come as the end-of-year holiday season is on the horizon. While the current and projected 2022 overall inflation rate is likely to be well above BI's target upper bound of 4%, domestic inflation may fall short of 6% as initially projected.

Promising Signs from Real Sector

Having a good momentum of excellent economic growth throughout 2022, the main threat to the Indonesian economy comes in the form of inflation. If not managed

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properly, inflation has the potential to harm the supply side by increasing production cost and demand side by eroding household's purchasing power. Moreover, failure to convince society that inflation will be well-managed could trigger a spiraling inflation expectation, leading to excessive saving and lower consumption, both of which have serious implications for future growth.

Facing this challenge, within its capacity, GoI and Bank Indonesia have signaled their commitment to maintain domestic economic growth while promoting stability amidst global inflationary pressures and economic volatility. Various measures have been taken to demonstrate this commitment. In response to increasing fuel prices, the GoI has strengthened its social protection program by providing IDR12.4 trillion in cash transfers to low-income households and IDR9.6 trillion in wage subsidy assistance. On the other hand, BI has raised its policy rate in total by 125 bps in 2022 and implemented other monetary measures in order to stay ahead of the curve and manage its forward guidance transmission in promoting price stability. Thus far, these policy mix have been working quite well. In November, Consumer Confidence Index (CCI) was still on optimist territory as it is recorded at 119.06, though slightly declining from 120.30 in the previous month. Similarly, manufacturing Purchasing Managers' Index (PMI), a proxy of production activity, is also still in the expansion zone with the level of 50.30 in November 2022.

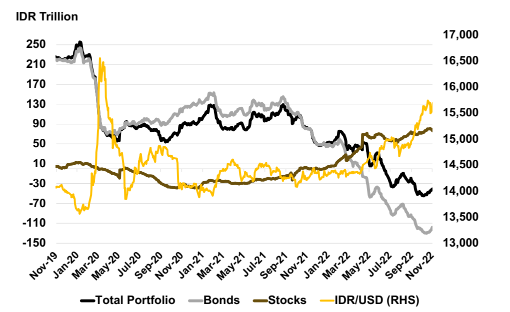
From the external side, trade balance in November has prolonged Indonesia's notable performance as it recorded trade surplus for 31 consecutive months. Nevertheless, the surplus of USD5.16 billion in November is lower than USD5.59 billion in the previous month as export declined by 2.46% (m.t.m) while import decreased less by only 0.91% (m.t.m). The decline in both export and import component could be explained by the moderation of commodity prices, as the decline for export is attributable to lower export value of CPO and oil products, while import drop was driven by oil and gas products.

Emergence of Easing Rate Hike Era

Approaching the end of 2022, we have seen inflation figures across the world reaching their highest levels in decades, thus triggering a cycle of interest rate hikes that was far beyond normalcy, even unprecedented in several countries. This trend is expected to continue in the short term, as the interest rates are considered currently have not reached a sufficient level to ensure a timely return of inflation. However, inflation in several countries has reached its peak and bring a new phase of monetary tightening. In the US, inflation rate declined for five consecutive months as it eased to 7.1% in November 2022. Retrospectively, the Fed raised its benchmark rate by half-point to a range of 4.25 – 4.50% in December Federal Open Market Committee (FOMC) meeting. While the Fed has signalled to continue raising its policy rate in 2023, last FOMC meeting marked a new phase of relatively less-aggressive monetary tightening as the last hike of 50bps was a step down from

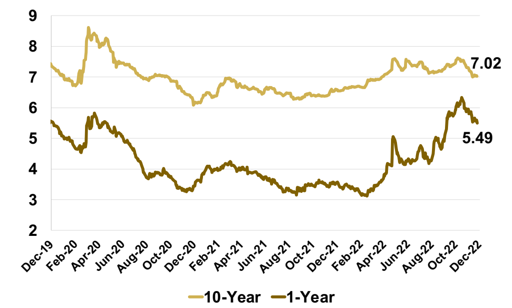
75bps pace in the previous four FOMC meetings. Similarly, European Central Bank (ECB) and Bank of England also chose to ease their strategy from a recent pattern of interest rate rises of 0.75 percentage points down to a half point. Switzerland, Norway, Mexico, and the Philippines also slowed the pace of interest rate rises.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

While the December FOMC meeting started an official pivot stance by the Fed towards less aggressive tightening, the expectation of past-peak inflation build-up in the US and less-aggressive hike has taken place in the last few weeks. In turn, investor has been shifting their portfolio into riskier assets and triggering a wave of capital inflow towards emerging markets, including Indonesia. Since mid-November, net capital inflow to Indonesia has amounted to around USD2.12 billion, strengthening Rupiah to around IDR15,500 in the second week of December from IDR15,700 in the last week of November. The surge of capital inflows has driven down yields for both 10-year and 1-year Indonesian government bonds, from 7.17% during last week of November to 7.02% in mid-December and from 5.87% to 5.49% during the same period. Furthermore, a higher yield decrease in short-term Indonesian government bonds compared to its long-term counterpart resulted in a wider yield spread which suggests growing confidence of investors toward current Indonesian economic prospects.

The slower pace of tightening in the major central banks' monetary policies has pushed the capital flows toward emerging markets. However, despite the stabilizing and slightly appreciated Rupiah in the past few weeks, other emerging markets have attracted more flows of capital from developed economies, thus driving appreciation towards its respective currency. As a consequence, Rupiah performed slightly worse compared to its few peers relative to last month's condition. Recently recorded at IDR15,597 per USD, Rupiah has depreciated by 9.4% (ytd) on a year-to-date basis, only outperforming Argentine Peso, Turkish Lira, Indian Rupee, and Chinese Yuan, which experienced year-to-date depreciation of 67.9%, 40.1%, 11.2%, and 9.7%. In addition, foreign exchange reserves surprisingly increased by USD3.8 billion to USD134 billion in November from USD130.2 billion in October 2022. November

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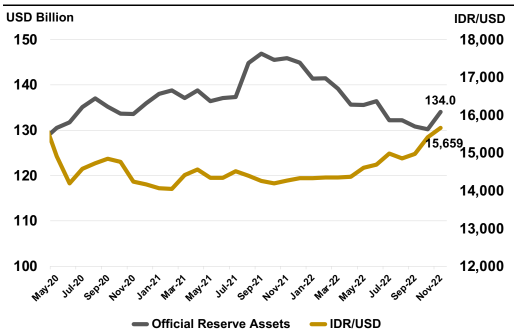
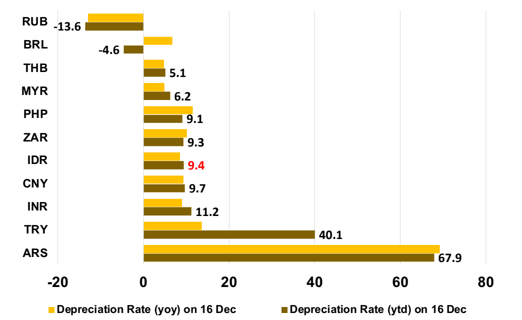
or go to http://bit.ly/LPEMCommentarySubscription foreign exchange reserves hit its first rise in the last six months, thanks to services and tax revenue, as well as oil and gas revenue. The current position of foreign exchange reserve is equivalent to finance 5.9 months of imports or 5.8 months of imports and servicing government's external debt, which is well above the international adequacy standards of three months imports.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (16 December 2022)



Source: Investing.com

Considering the latest circumstances that inflation is still hovering well beyond BI's target and Rupiah is on its depreciation trend with relatively high volatility due to narrowing rate differential that triggers episodes of capital outflow, domestic monetary tightening is still needed. However, several factors has shifting its course and need to be taken into account in monetary policy decision. First, there are strong indications that inflationary pressure has reached its peak and heading towards downward trajectory. Second, several occurrences of capital inflows in the past few weeks as the major central banks shift towards a less-aggressive tightening has eased the pressure on Rupiah. Third, any excessive monetary tightening beyond what is needed to bring down inflation and stabilize Rupiah will unnecessarily hurt economic growth. Thus, we see that BI should ease its hawkish stance and hike policy rate by 25bps this month to 5.50%.

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