Macroeconomic Analysis Series

BI Board of Governor Meeting

February 2023

Highlights

- BI should maintain its policy rate at 5.75% this month.
- The headline inflation was recorded at 5.28% (y.o.y), consistently declining despite still being above BI's target upper bound.
- Since mid-January, Indonesia experienced a surge in capital inflows, mounting up to USD1.95 billion until the second week of this month.
- Indonesia's foreign exchange reserve increased by USD2.17 billion to USD139.4 billion in January 2023, marking its highest level in the last 11 months.

Macroeconomics & Political Economy Policy Research

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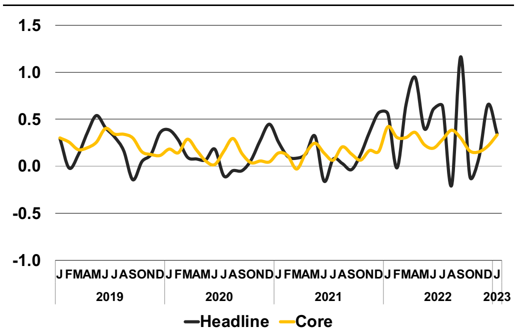
Massive inflationary pressures last year, were met by consistent monetary tightening efforts by Bank Indonesia since last August. As a result, headline inflation continued to decline and stood at 5.28% (y.o.y) in January 2023. The rapid capital inflow since mid-January, has lifted Rupiah to its strongest level of IDR14,875 in early February and currently stabilized at around IDR15,090. Considering these factors, in addition to the current less aggressive stance by the Fed, we view that holding policy rate at 5.75% this month should be adequate to maintain price and exchange rate stability while continuing the macroprudential measures without jeopardizing the current economic growth momentum.

Consistent Inflation Cooldown

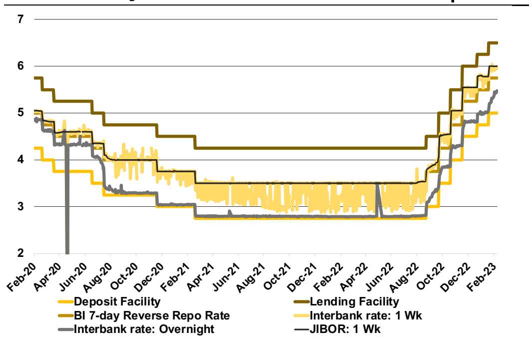
Entering 2023, headline inflation figure was still recorded beyond central bank's upper target of 4% for eight consecutive months. Massive inflationary pressures last year, stemming from high commodity prices, depreciation of Rupiah that heightened cost of import, disrupted global supply chain, and domestic demand upsurge following Covid-19 recovery, were met by consistent monetary tightening efforts by Bank Indonesia since last August. As a result, headline inflation stood at 5.28% (y.o.y) in January 2023, a decline from 5.51% (y.o.y) in the last month of 2022. In addition, additional effort exerted by GoI and Bank Indonesia through National and Regional Inflation Control Team (Tim Pengendalian Inflation Pusat dan Daerah/TPIP and TPID) and National Act Food Inflation Control (Gerakan Nasional Pengendalian Inflasi Pangan/GNPIP) also contributed to the downward trend of inflation rate during the last few months. Beside dedicated effort by policymakers, global trend of energy price normalization and slowing demand post-holiday season also contributed to the decrease in January annual headline inflation. The decline due to seasonal factor of post-holiday period is also shown by its monthly figure. Monthly headline inflation declined from 0.66% (m.t.m) in December 2022 to 0.34% (m.t.m) in January 2023.

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



Source: CEIC

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



Source: CEIC

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Key Figures

BI Repo Rate (7-day, January '23)
5.75%
GDP Growth (y.o.y, Q4 '22)
5.01%
Inflation (y.o.y, January '23)
5.28%
Core Inflation (y.o.y, January '23)
3.27%
Inflation (m.t.m, January '23)
0.34%
Core Inflation (m.t.m, January '23)
0.33%
FX Reserve (January '23)
USD139.4 billion

Administered price is still at its high double-digit growth rate since the announcement of fuel price adjustment last September. Despite its high level, administered price inflation decreased to 12.28% (y.o.y) in January 2023 from 13.34% (y.o.y) in the previous month. On monthly basis, administered price even recorded a deflation of 0.55% (m.t.m) in January 2023. The increase in cigarette price due to the ten percent increase of cigarette excise (effective since January 1st 2023) and higher water supply tariffs has put upward pressure on the administered price. However, the conflicting force of decreasing airfare tariffs and fuel price due to the ending of holiday season, lower airline fuel surcharge, and downward adjustment of nonsubsidized fuel price dominated the overall administered price components; thus decelerated the administered price inflation in the first month of 2023.

Similarly, volatile food prices inflation dipped to 1.40% (m.t.m) in January 2023 from 2.24% (m.t.m) at the end of 2022. The deflation of egg and tomato prices dominated the overall volatile food basket despite the inflationary pressure in other food components, such as rice, chili, and fresh fish, which prices increased due to rising demand in the beginning of the year and a decrease in stock due to bad weather. On the other hand, core inflation rose to 0.33% (m.t.m) from 0.22% (m.t.m) over the same period. The price hike of the core component was driven by seasonal housing rent inflation. Overall, 2023 kicked in with a promising inflation figure. The continuous trend of approaching back to BI's inflation target range suggests that inflation management effort has on its trajectory to come to fruition. Regardless, BI needs to remain vigilant as upcoming inflationary pressures might be on the horizon following the seasonal event of Ramadan period is only a few weeks away.

A Good Start for 2023

In comparison to the global economic situation, Indonesia performed notably well throughout 2022. For four consecutive quarters, Indonesian economy consistently grew beyond expectations. Indonesia's GDP grew by 5.01% (y.o.y) in the last quarter of 2022, making the overall economy grew by 5.31% (y.o.y) in 2022. The GDP growth in 2022 marked its highest since 2013. Despite still reached the long-term growth trend of 5%, in the last quarter of 2022, GDP grew slower from 5.72% (y.o.y) in the previous quarter as the windfall profit moderated due to normalization of commodity prices and no more low-base effect. Despite decelerating, exports still recorded double-digit growth of 14.93% (y.o.y) in Q4-2022. A sharper decline was observed in the import component as its growth decreased substantially from 25.37% (y.o.y) in Q3-2022 to only 6.25% (y.o.y) in the last quarter due to slower global demand as China implemented zero Covid-19 policy and worldwide monetary tightening affected the demand for consumption and investment. Consequently, Indonesia's net export of goods and services grew by 86.25% (y.o.y) in Q4-2022, skyrocketing from -4.93% (y.o.y) in Q3-2022.

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Ending 2022 with remarkable economic performance amidst looming global uncertainty provides confidence for consumers toward domestic economy in 2023. This is reflected by the Consumer Confidence Index (CCI), which increased to 123.0 in January 2023 from 119.9 in the last month of 2022. The CCI figure continued its upward trend in the last three months and prolonged in the optimistic territory for 16 straight months. Besides the notable domestic situation in the last year, other factors that contributed to the rising optimism of consumers are the downward inflation trend and the announcement by GoI to officially revoke the community activities restrictions enforcement (*Pemberlakuan Pembatasan Kegiatan Masyarakat/PPKM)*, effective in 2023. The official statement of lifting social restrictions has boosted public confidence toward future economic prospects, as shown by CCI for expectations which spiked from 127.3 last December to 133.9 in January 2023. The sign of increased optimism is also visible in the expectations for future income, business conditions, and employment, as suggested by the same survey. The growing confidence from the consumer side is mirrored by the production activity. Manufacturing Purchasing Manager's Index (PMI), serving as a proxy of business and production activity, substantially hiked to 53.1 in January 2023 from 50.9 in the previous month. Increasing and staying above the expansion threshold suggests an optimistic view of the current aggregate demand and purchasing power driven by a more stable exchange rate, manageable inflation figure, post-Covid-19 economic activities, and robust economic growth; thanks to consistent effort by the GoI and BI.

Amidst the drop of global energy prices, Indonesia's windfall effect on the net export performance has been gradually tapered off. Trade balance in January 2023 was recorded at USD3.87 billion, a slight decline from USD3.96 in the previous month. Export in January 2023 was down by 6.36% (m.t.m) from a month earlier to USD22.31 billion while import decreased by 7.15% (m.t.m) to USD18.44 billion during the same period. Decline in export value was driven by the decreasing coal price due to increased coal production in India and a lifting of China's ban on Australian coal, and lower export value for palm oil and metal products. On the other hand, the main contributor of import decline was the lower import of machinery products. Overall, current trade surplus has formed a downward trend since last October, although it manages to continue being on the surplus territory for 33 consecutive months.

Emerging Divergence in Monetary Tightening Stance

The uniformity of central banks' movement towards a tightening monetary stance has been the main theme of global policy agenda during the second half of 2022. Entering 2023, however, the uniformity of monetary policy stance might come to an end soon and will be followed by the divergence of paces in the interest rate hike by various major central banks. While the latest move has shown that central banks are still increasing their policy rate, some are being less aggressive and increasing

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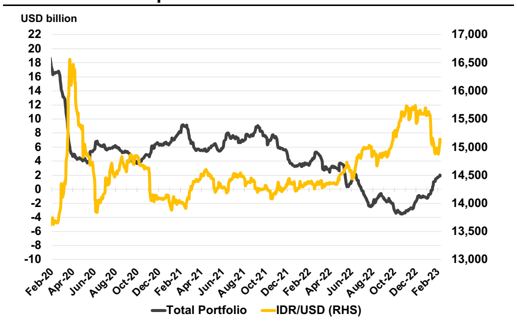
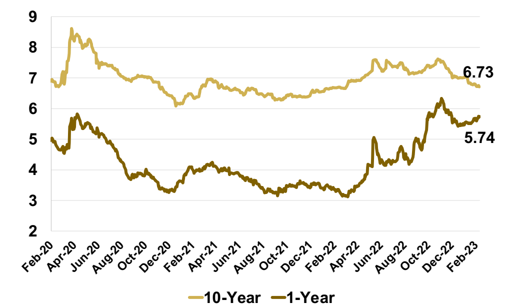
their rate at a slower pace. Earlier this month, the Fed dialled down another notch on its policy rate as it increased Fed Funds Rate (FFR) by 'only' 25bps to 4.50% - 4.75% in the last January FOMC meeting, after four episodes of 75bps rate increase and one 50bps rate increase since mid-2022. While it is expected that the Fed rate hike to continue for foreseeable future as the labor market is currently still quite tight, the US inflation has consistently cooled down due to significant drop in energy prices. With a less rapid deceleration, European Central Bank (ECB) raised its interest rate by half a percentage point for a second time to 2.5%, in a sign of its concern that inflation will remain high despite the recent fall in energy prices, after previously taken two episodes of 75bps rate hike. On the other hand, Bank of England (BoE) policy rate increased by 50bps in February to 4%, still maintaining the same level of monetary tightening aggressivity and bringing the rate to its highest level since 2008.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)

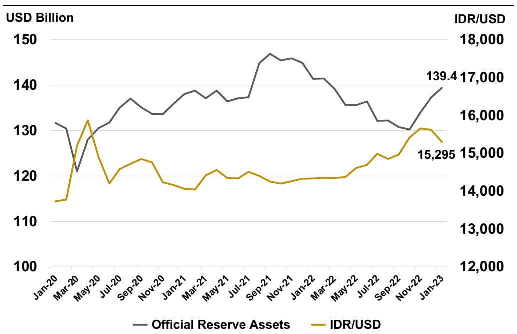


Source: CEIC

Since mid-January, Indonesia experienced a surge in capital inflows, mounting up to USD1.95 billion until the second week of this month. Several factors have driven the flow of capital toward Indonesia. From the external side, the slower pace of global monetary tightening, especially the less aggressive move taken by the Fed, has limited the potential return expected by investors. Consequently, investors shifted their portfolios toward riskier assets, such as instruments in emerging markets, including Indonesia. From the domestic side, better prospect of current and future Indonesian economic conditions following the announcement of Indonesia's GDP data which realized beyond consensus has become a pull factor for capital flows into domestic financial market. As a result, 10-year government bond yield decreased from 6.91% in mid-January to 6.73% in mid-February. On the other hand, 1-year government bond yield hiked from 5.55% to 5.74% during the same period; thus, flattening the yield curve, which suggested that investors perceived that Indonesia's current economic state may already have reached its full recovery.

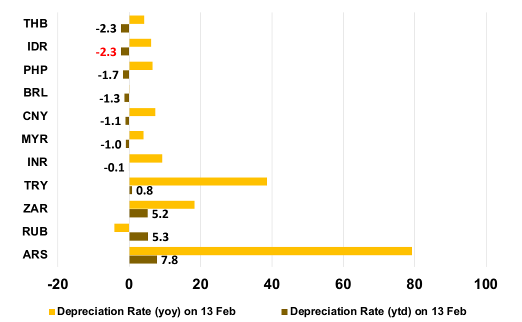
The rapid capital inflow since mid-January, where Rupiah was around IDR15,500, has lifted Rupiah to its strongest level of IDR14,875 in early February. However, the appreciating effect brought by the capital inflows has been met by conflicting forces of depreciation that stem from substantial decline in net export performance due to a significant drop in energy prices. The net result has put Rupiah in a slight depreciation to IDR15,090 in mid-February, compared to its level a month earlier. Regardless of its recent depreciation pressure, Rupiah has recorded a notable performance throughout 2023. On a year-to-date basis, Indonesia has appreciated by 2.3% (ytd), making it the best performer among emerging market peers' currencies, along with Thailand Baht. Furthermore, Indonesia's official foreign exchange reserve asset was recorded at USD139.4 billion in January 2023, increased around USD2.17 billion from USD137.23 in the previous month and marking its highest level in the last 11 months. The spike on foreign exchange reserve is contributed by the issuance of global bonds by the GoI and tax and services revenues. The current level of foreign exchange reserve is equivalent to 6.1 months of imports or 6 months of imports plus government's foreign debt payment, way beyond the international adequacy standards of three months of imports. The mounting amount of foreign exchange reserves should serve as an arsenal by BI to weather the potential future pressure on Rupiah stability.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (13 February 2023)



Source: Investing.com

The latest development indicates that Indonesia's financial and monetary situations are in a better place compared to a few months back. On the inflation front, while it is still above BI's target range, it has reached its peak and consistently declining towards 4% and below. On the external front, Rupiah has been appreciating rapidly during last month and currently are stabilizing around IDR15,000. In addition, the Fed has taken another notch down on reducing its aggressiveness on the monetary tightening. Lastly, the yield differential between Indonesian Government Bonds and US Treasury Bonds seems adequate and attractive enough to pull capital flows toward Indonesia's financial market. Considering these factors, we view that holding policy rate at 5.75% this month should be adequate to maintain price and exchange rate stability while continuing the macroprudential measures without jeopardizing the current economic growth momentum.

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