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Macroeconomic Analysis Series

BI Board of Governor Meeting

March 2023

Highlights

- BI should maintain its policy rate at 5.75% this month.
- The headline inflation was breaking its downward pattern since September 2022 and stood at 5.47% (y.o.y) this month.
- Indonesia recorded a moderate outflow of USD938 million since mid-February 2023 following the expectation of another interest rate hike by the Fed.
- Indonesia's foreign exchange reserve increased to USD140.31 billion, the highest record since February 2022.

Macroeconomics & Political Economy Policy Research

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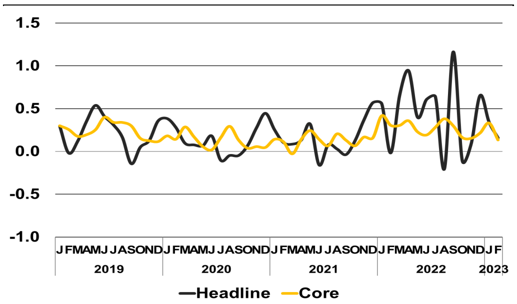
The inflation figure moved in reverse direction as it increased to 5.47% (y.o.y), after a downward pattern since September 2022. This mainly contributed by the combination of supply disruptions due to the occurrence of flood during the harvest season and the low base effect that played a role. From the external side, the expectation of another aggressive rate hike by the US has pushed the fund to leave Indonesia with capital outflow recorded at USD938 million since mid-February 2023. However, the recent tragedy of SVB may force the Fed to be less aggressive in tightening its monetary policy in the near future. The push to delay monetary tightening by the US shall create a momentum of flow of funds to enter the emerging markets, including Indonesia. On the other hand, domestic currency has finally stabilized after a series of depreciation with Rupiah now standing around IDR15,367. Considering those factors, we view that BI should hold its policy rate at 5.75% this month while continuing to apply macroprudential measures to support the growth momentum.

The End of Downward Inflation Trend

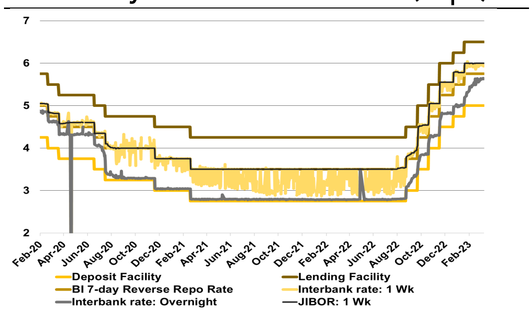
In the second month of 2023, annual headline inflation was recorded at 5.47% (y.o.y), slightly increased from the previous month's inflation of 5.28% (y.o.y), breaking its downward pattern since last September. There are several factors that contribute to higher yearly inflation pattern. Rice was one of the main drivers for the upward inflationary pressure due to the occurrence of floods during harvest season. Another factor that played a role was the ongoing effect of the tobacco excise rate by 10% since the beginning of 2023. As a result, the inflation of overall expenditure group of food, beverage, and tobacco jumped to 7.23% (y.o.y) compared with 5.82% (y.o.y) a month earlier. In addition, the low-base effect also played a role in the increasing level of inflation for food, beverage, and tobacco in February 2023. Conversely, the expenditure group of transportation recorded a cooldown pattern of 13.59% (y.o.y) relative to 13.91% (y.o.y) in January 2023, following the normalization period of airfare after the Christmas and new year holiday season.

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



Source: CEIC

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



Source: CEIC

Key Figures

BI Repo Rate (7-day, February '23)
5.75%
GDP Growth (y.o.y, Q4 '22)
5.01%
Inflation (y.o.y, February '23)
5.47%
Core Inflation (y.o.y, February '23)
3.09%
Inflation (m.t.m, February '23)
0.16%
Core Inflation (m.t.m, February '23)
0.13%
FX Reserve (February '23)
USD140.3 billion

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Despite a slower trend, administered prices still recorded a double-digit growth rate for six consecutive months. In February, administered price inflation moderately decreased to 12.24% (y.o.y) from 12.28% (y.o.y) in January 2023 contributed by the lower airfare and airline fuel price after the holiday season. On the other hand, administered prices on monthly basis experienced a substantial increase to 0.14% (m.t.m) after a significant deflation of 0.55% (m.t.m) in the previous month. The price increase was heavily influenced by kretek and white cigarettes due to the prolonged impact of the rise in tobacco excise.

Furthermore, the core inflation, which reflects people's purchasing power, marked a notable decline from 3.27% (y.o.y) in January to 3.09% (y.o.y) in February 2023. Likewise, the monthly basis of core inflation also weakened from 0.33% (m.t.m) to 0.13% (m.t.m). This is due to the end of housing rent payment period at the beginning of the year. Similarly, volatile food inflation in February decreased to 0.28% (m.t.m) from 1.40% (m.t.m) in the previous month. The lower inflation figure was attributed to several commodities, such as purebred chicken, eggs, and chili. Despite the recent downward trend of inflation since last September, the policymaker should remain vigilant as the reversal of inflation rate direction in the latest data might last due to the upcoming season of Ramadhan and Eid Al-Fitr. If managed well, bringing back inflation to BI's target range of 3±1% should be achievable in the first half of 2023.

Domestic Economy Remains Optimistic

After more than two years of fighting against the pandemic, Indonesia has recently come back to the era of the pre-pandemic situation. This was marked by the GoI's official announcement that annuls the community activities restrictions enforcement (*Pemberlakuan Pembatasan Kegiatan Masyarakat/PPKM*). The official statement has instantly encouraged public confidence toward future economic prospects, including job availability and current income. Although it experienced a slight dip from 123.0 last month to 122.4 this month following the end of holiday period, Indonesian Consumer Confidence Index (CCI) remains upbeat in the optimistic territory as it was marked above 100 for the last 17 months. The latest figure suggested ongoing optimism toward domestic economic condition. Similarly, Purchasing Manager's Index (PMI), serving as a proxy of business and production activity, slightly declined to 51.2 from 51.3 in the previous month but maintain its position on expansive territory. Several supporting factors on the back of Indonesian PMI include less supply chain disturbance due to the drop in global shipping cost and lower input material prices following the re-opening China's economy.

Observing the Indonesia trade performance, trade balance in February was still recorded in surplus territory after 34 consecutive months. The trade balance showed a significant increase to USD5.5 billion, after a series of downward trend since October 2022. Faster decline in imports compared to exports was the main driver of

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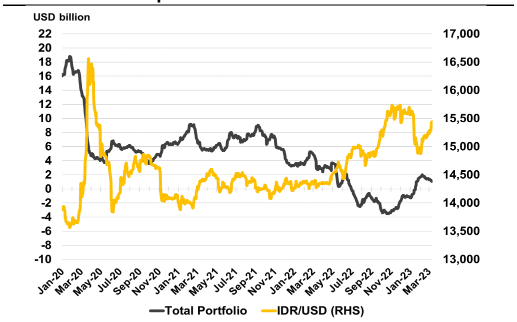
higher trade balance in February 2023. In February 2023, import was down 13.68% (m.t.m) to USD15,9 billion compared to USD18.4 billion in January 2023, while export dipped 4.15% (m.t.m) to USD21.4 billion. The lower import in machinery and electronics were the primary contributor of the lower import. On the other hand, drop in export was due to the decreasing value of several non-oil and gas commodities such as mineral and jewellery, following the lower trend of coal, tin, and gold price. Conversely to the trend in non-oil and gas, export in crude oil was doubled to USD142.9 million in February relative to USD77 million in previous month following the increasing pattern in global oil price that happened in early February to mid-February, which then retained the fall of the overall export.

Unfavorable External Pressure on Domestic Market

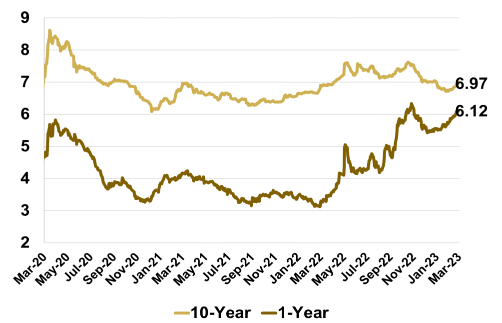
Cooling down the heightened inflation has been the main agenda throughout 2022. It forced the majority of central banks to aggressively increase their interest rate as many viewed it as the only possible way to combat against the price hike. As a result, the interest rate figure is moving in line with the inflation trend. After reaching its peak, several economies have experienced a trending down figure of their price index, thus, pushing by less aggressive steps in monetary policies. In the last FOMC meeting, The Fed took a relatively mild increase of their interest rate by 25 bps to 4.50% - 4.75%, after a series of sky-rocketing rise for around 50-75 bps in 2022. Similarly, after substantial hikes of 75 bps, ECB continued to rise its interest rate on a milder stance of 50 bps. Meanwhile, PBoC left its interest rate unchanged for six consecutive months, in accordance with a low inflation rate which stood at 1.0% (y.o.y) in February 2023.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

Unfortunately, the recent development in the US may create an inflationary momentum that forcing the Fed to recommence its aggressive stance in increasing the interest rate soon. Looking at the US inflation rate, it was recorded at 6% (y.o.y) or still far beyond the Fed target of 2%, with core CPI increased by 0.5% (m.t.m) or higher than the expected rate of 0.4% (m.t.m). Following the expectation of another interest rate hike by the Fed, Indonesia experienced a capital outflow accounted for USD938 million from second week of February to second week in March 2023 as

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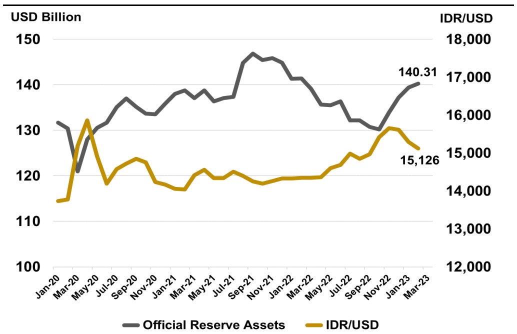
investors are now seeking for higher return. This event has been translated into a substantial hike in the Indonesian government bond yield for 1-year and 10-year tenors. From 1-year tenor, the yield hiked from 5.77% to 6.12%. An increasing yield pattern was also seen in 10-year tenor, which started at 6.75% in mid-February and ended at 6.97% in mid-March 2023. Furthermore, capital outflow also affected the movement of domestic currency negatively, as Rupiah depreciated to IDR15,445 on 10 March 2023 relative to IDR15,130 in the same period last month. The higher domestic risk has then put an additional burden, as reflected by the increasing level of Indonesian 5-year CDS in mid-March which stood at 93.26 bps compared to 84.64 bps at the beginning of March 2023 and yield difference became narrower, which suggests that Indonesia poses a higher risk in short-term assets.

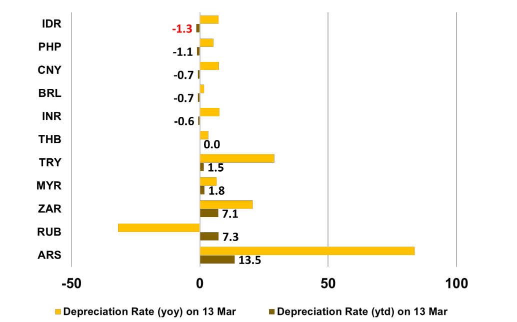
However, the gloomy days, which was recently happened after the down of SVB, may push the Fed to be less aggressive in tightening its monetary policy further due to the current slump in the US financial market. The push to delay monetary tightening by the US may create the momentum of flow of funds to enter emerging markets, including Indonesia. In addition, the launch of Foreign Currency Term Deposit for Foreign Exchange Proceeds of Export (TD Valas DHE) in early March 2023 is expected to secure the supply of foreign exchange in domestic market. Those factors help to stabilize domestic currency as Rupiah is now standing around IDR15,367. On a year-to-date basis, Rupiah marked an appreciation of 1.3% (ytd), making it the best performer among emerging peers together with Philippine Peso and Brazil Lira, while Thailand Baht has remained unchanged.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

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



Source: Investing.com

Despite the capital outflow and depreciation in Rupiah, Indonesia's reserve assets were mounting to USD140.31 billion in February 2023 compared to USD139.4 billion in January 2023, making it the highest record since a similar period last year. The main drivers for the increasing reserve level were tax receipts and the government's foreign loan withdrawal. The position of the current Indonesian reserve was equivalent to finance 6.2 months of imports or 6.0 months of imports and servicing government external debt, and well beyond the adequacy standard of 3 months of imports. As the reserve continues its upward trend, there may be ample support to cushion external shock and maintain macroeconomic and financial system stability.

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8 DECENT WORK AND ECONOMIC GROWTH

The latest condition indicates that Indonesia's economy has improved, with the inflation figure relatively manageable. On the external front, despite the episode of capital outflow in the last few weeks, latest Rupiah movement has been stabilized due to the recent development of market sentiment in the US. In addition, with the increasing trend of reserves, Indonesia may have ample room to cushion the ongoing and upcoming external shocks. Lastly, the yield differential between Indonesian Government Bonds and US Treasury Bonds seems adequate to be left as it is, following the recent case of SVB down that may delay another aggressive hike of interest rate by the Fed. Considering these factors, we view that BI should hold its policy rate at 5.75% this month to maintain price and exchange rate stability while continuing the macroprudential measures to support the growth momentum.