Macroeconomic Analysis Series

BI Board of Governor Meeting

May 2023

LPEM FEB UI
UNIVERSITAS INDONESIA

Highlights

- BI should keep its policy rate of 5.75% this month.
- Inflation resumed the lower trend, while economy grew higher than market expectations at 5.03% (y.o.y) in Q1-2023 supported by strong domestic demand.
- Accompanied by less aggressive monetary policy by the Fed and attractive yield difference between Indonesia government bonds and US Treasury, Indonesia is enjoying capital inflows and Rupiah appreciation in recent months.

Macroeconomics & Political Economy Policy Research

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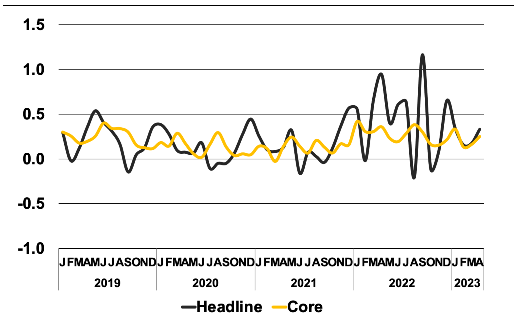
Headline inflation is gradually subsiding with steady core inflation that indicates strong and manageable domestic demand. Externally, the less aggressive monetary tightening from the Fed and attractive yield spread have accommodated capital inflows to Indonesia. As a result, Rupiah is appreciating to the strongest level reaching IDR14,670 in early May supported by the rush upsurge in capital flows following the announcement of higher-than-expected Indonesia's Q1-2023 economic growth of 5.03% (y.o.y). We view BI should hold its policy rate at 5.75% this month while planning to set the accommodative monetary policy to enhance external resilience amid potential global slowdown this year.

Inflation Continues Downward Trend

Headline inflation continued to approach BI's target range of 3±1% despite the seasonal pattern of Ramadhan and Eid-al-Fitr celebration in April 2023. Annual headline inflation was 4.33% (y.o.y) in April 2023, slightly down from 4.97% (y.o.y) in March 2023. The yearly inflation fell in all sectors, except clothing and footwear sector, which accelerated at faster pace due to increased demand for new clothes during the Eid festive season. Aside from GoI and BI's strong efforts to maintain food supply, lower inflation for most components may be attributed to lower imported inflation as commodity prices ease along with price normalization for basic needs because more supply is offered to meet the demand. Moreover, the reduction in inflation may be explained by the high-base effect of Consumer Price Index (CPI) in April 2022, which began to jump from a month earlier.

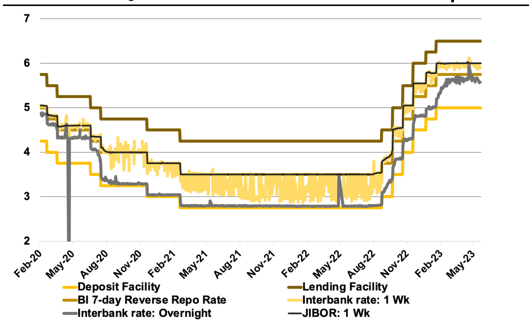
Following the considerations, food ingredients prices fell to 3.77% (y.o.y) in April from 5.72% (y.o.y) in March 2023. Volatile goods inflation also drops to 3.74% (y.o.y) from 5.83% (y.o.y) a month earlier, thanks to decreased chili prices during the recent harvest season. Furthermore, the administered prices component declined to 10.32% (y.o.y) in April from 11.56% (y.o.y) the previous month. Energy components inflation also fell to 12.09% (y.o.y) in April 2023 from 14.43% (y.o.y) in March 2023, partly caused by lower imported oil and gas prices.

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, April '23)
5.75%
GDP Growth (y.o.y, Q1 '23)
5.03%
Inflation (y.o.y, April '23)
4.33%
Core Inflation (y.o.y, April '23)
2.83%
Inflation (m.t.m, April '23)
0.33%
Core Inflation (m.t.m, April '23)
0.25%
FX Reserve (April '23)
USD144.2 billion

On a monthly basis, prices in almost all sectors were higher in April 2023, with the inflation recorded at 0.33% (m.t.m) compared to March 2023, caused by higher demand due to Eid festive and long holiday. The highest monthly inflation was recorded in the administered component at 0.69% (m.t.m) supported by higher transportation demand to accommodate people returning to their hometowns to celebrate Eid-al-Fitr (*Mudik*). The increase was consistent with the high monthly inflation in the transportation sector at 0.84% (m.t.m) in April 2023. At the same time, the inflation in food and footwear sector also escalated by 0.61% (m.t.m). Therefore, even though the monthly inflation experienced an increasing trend, the increase is still under control and considered normal as it is consistent with seasonal patterns. Furthermore, the core inflation component, which reflects the consumer purchasing power, remained steady in April 2023 with a yearly increase of 2.83% (y.o.y) and monthly inflation of 0.25% (m.t.m).

Although headline inflation will continue the lower trend and is expected to return to its normal pace this year, the GoI should anticipate any shocks of probable severe draughts in Asia caused by the current El Nino heatwave. Some essential factors required to prevent supply shocks stemming from draught are adequate clean water reserves and effective irrigation system for agriculture to assure the food supply. As long as the GoI is capable of tackling and avoiding any unprecedented events, the headline and core inflation will remain stable for the rest of the year.

Faster-than-expected Growth in Q1 Boosts Economic Prospect for FY2023

2023 is expected to be a struggling year for global economy as monetary policy is significantly tighter compared to the previous years in response to inflationary pressures around the world. The unfinished Russia-Ukraine war and the banking sector uncertainty in the US and the EU have further downgraded the global economic prospect. Despite global headwinds, Indonesia's domestic condition remained robust as captured by 5.03% (y.o.y) growth in Q1-2023. The faster-than-expected growth may be attributed to two primary factors, namely the strong domestic consumption and high export demand. Household consumption, which accounts for the majority of GDP, climbed by 4.54% (y.o.y) in the first three months of this year. It was primarily fuelled by the faster acceleration in transportation and communication consumption as people returned to their activities after the GoI officially lifted the social distancing restrictions in January 2023. No more limitation policies for people to gather in meetings, offices, and malls have increased consumer demand for physical activities in the first quarter of this year. The strong consumer demand was reflected in the increasing trend of the Consumer Confidence Index (CCI). The CCI figure kept accelerating to 126.1 in April from only 123.3 in March, owing to more confidence in economic conditions along with the Ramadhan and Eid festive period.

To meet the rising demand, businesses have increased their production which led to positive growth in all sectoral GDP for the first quarter of this year, with manufacturing as well as wholesale and retail trade contributing the most. The situation is in line with the acceleration of Purchasing Manufacturing Index (PMI) figure. According to the most recent figures, the PMI continued to climb to 52.7 in April from 51.9 in March, marking the 20th consecutive month of increase. The recent boost in manufacturing sector confidence was mainly due to a faster surge in new orders from the domestic side coupled with an increase in purchasing power. The persistent increase demonstrates that the manufacturing sector is still expanding, buoyed by optimism about domestic demand despite the global demand slowdown.

Furthermore, Indonesia continued to report high economic growth amid the end of the windfall from commodity prices, thanks to the strong demand from some of Indonesia's main trading partners, which are China, Japan, India, and ASEAN countries. Apart from the low-base effect, higher export demand has countered the reduced commodity prices, resulting in 11.7% (y.o.y) growth in Indonesia's exports in the Q1-2023 GDP figure. The faster acceleration of exports than imports has consistently resulted in trade surpluses since May 2020. Indonesia still enjoys USD3.94 billion trade surplus until April 2023 amid the sharp plunge in exports due to a large drop in commodity prices, which peaked around April last year. While exports declined by 29.4% (y.o.y) from a year earlier, imports plunged by 22.3% (y.o.y), resulting in a trade surplus. Although the ongoing trade surpluses are a positive sign of external balance stability, the recent decline in imports may indicate weaker economic activity in the future. The GoI should look deeper into manufacturing sectors and anticipate any potential challenges that may halt the economy from achieving positive growth this year.

The US Gloomy Outlook Provides Blessings for Emerging Markets

As expected by market, the Fed continued its 10th consecutive interest rate hike with a 25-basis points increase announced in the latest FOMC in May, raising the target rate to 5.00-5.25%. At the same time, the ECB maintained its 25-basis points interest rate hike in response to the prolonged elevated inflation pressures. The continuation of monetary tightening in the US was also driven by the effort to cool down the stubbornly high inflation due to the disrupted supply chain and tight labor market after the Covid-19 pandemic. The aggressive rate increase has successfully lowered the US inflation, in spite of the sluggish pace caused by a persistently tight labor market. Rising interest rates, on the other hand, have partly contributed to the unprecedented shock in the US banking sector, as seen by the recent bank failure of

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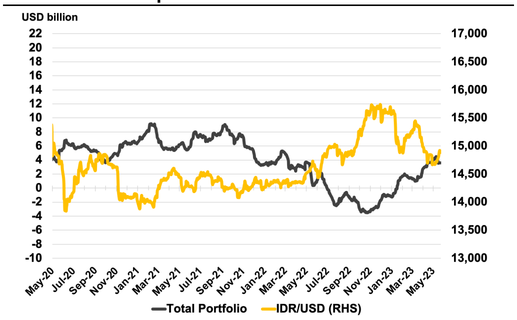
First Republic Bank in early May, which followed the failures of Silicon Valley Bank and Signature Bank in mid-March. These banks have to go down as they failed to maintain asset management during the period of interest rate hikes after benefiting from the low-interest rate era during the pandemic. Despite this banking sector turmoil, the Fed resumed its monetary tightening stance because the inflation is still far above their long-term target. Although the monetary tightening continued, the Fed has reduced the magnitude of the rate hike since early this year and gave signal to pause the hike as they project the interest rate will be at 5.1% at the end of 2023.

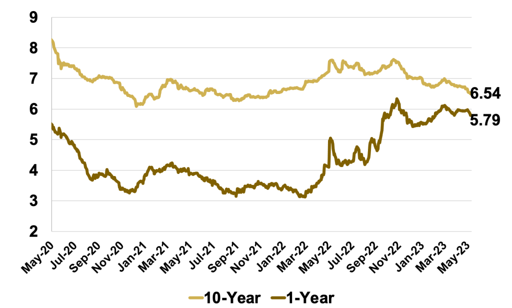
The less aggressive monetary tightening by the Fed along with the banking sector turmoil and potential slowing economic activity in the US have provided such blessings for developing countries as investors' confidence gradually shifted towards emerging markets. As a result, Indonesia continued to report capital inflows with the highest jump in early May recorded at USD4.49 billion. The jump was also supported by the release of robust economic growth data that has reflected the promising outlook of domestic economy. From January to mid-May this year, the cumulative increase of capital inflows has amounted to USD5.7 billion. The robust capital inflows until mid-May are fully reflected in the lower 10-Year government bonds and 1-Year government bond yields from 6.76% and 5.97% a month earlier to 6.54% and 5.79%, respectively.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)



Source: CEIC

Moreover, the capital inflows supported Rupiah with the appreciation against US dollar reached 4.4% (ytd) on May 23rd compared to the beginning of this year, making Rupiah one of the best performers among peers. Some other developing countries' currencies that joined Rupiah in enjoying strong appreciation are Brazilian Real, Thailand Baht, and Philippine Peso. At the same time, the capital inflows have helped Indonesia to manage ample foreign exchange reserves at USD144.2 billion in April, albeit smaller than the previous month. This slight decline is to accommodate the needs of repaying external debt and keeping foreign currency liquidity during the long holiday period at the end of the month. However, the foreign exchange reserves remained robust to weather any potential turbulence in the near future as it is capable to cover 6.3 months of imports and the government's

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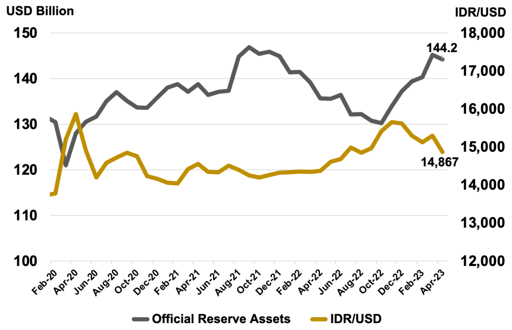
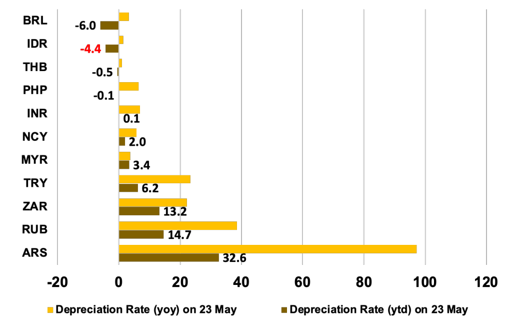
foreign debt. It remained well above the international adequacy standard of around three months of imports.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (23 May 2023)



Source: Investing.com

On monetary policy, BI has held its interest rate at 5.75% for the last three months due to the relatively manageable inflation and strong capital inflows that strengthen and stabilize Rupiah. Looking at the most recent data, inflation is expected to continue on its downward trajectory and return to BI's target range in the near future. Demand for Indonesian bond is also promising as investors expect less aggressive monetary tightening from the Fed for the remainder of the year and the yield spread between Indonesian government bonds and US Treasury remains quite attractive. The impact of banking sector turmoil is also relatively unseen in domestic economy. Moreover, Rupiah performed better than ever since the pandemic and foreign exchange reserves are adequate to cushion any potential short-term shocks. Despite the robust domestic demand, global economic downturn has begun to put risk on Indonesia's external balance as seen by drop in exports to its second largest trade partner, US, in the first three months of this year. At the same time, overall imports declined, which might indicate that economic activity has slightly halted. Following all of the indicators highlighted, BI should continue to hold its interest rate unchanged at 5.75% this month while planning to set the accommodative monetary policy aimed to enhance external resilience and promote domestic price stability amid potential global slowdown this year.