Seri Analisis Makro

LPEM FEB UI
Institute for Economic and Social Research

BI Board of Governor Meeting

June, 2023

Highlights

- BI should maintain its policy rate of 5.75% this month.
- Inflation eased to the upper of BI's target range.
- Demand for Indonesian bonds is still promising as the yield spread between Indonesian government bonds and US Treasury remains attractive.
- The ongoing episodes of inflows bolstered Rupiah to appreciate to around 14,800-14,900

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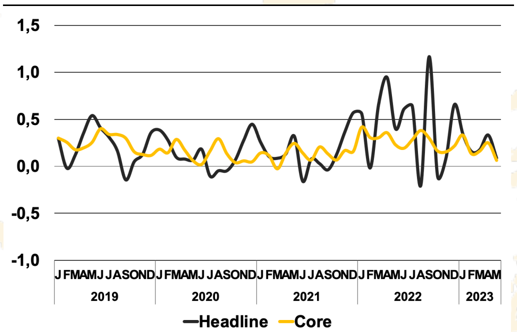
Headline inflation rate eased to the upper range of BI's target with benign core inflation. Amidst declining commodity prices driven by declining global demand, the trade balance still posted a modest surplus with a remarkable performance of imports reflecting the ongoing domestic economic improvements amid the risk of a global slowdown. Externally, the Fed's current pause of rate hikes somehow brings fresh air for Indonesia to enjoy capital inflows and strengthened Rupiah to around IDR14,800-14,900. With the recent developments, we view BI should keep its policy rate at 5.75% this month to maintain price and exchange rate stability while continuing accommodative measures to support economic growth.

Inflation is Heading Back to BI's Target Range

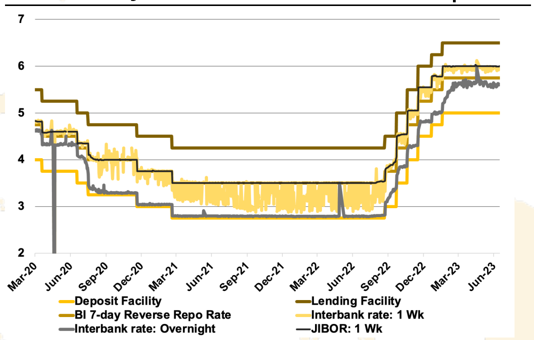
May annual headline inflation rate eased to 4.00% (y.o.y), the upper range of BI's target, earlier than expected. Inflation rate edged down from 4.33% (y.o.y) a month earlier. Since June 2022, the inflation rate has been above BI's target range of 2% to 4% due to pressures from rising global food and energy prices. Low level of inflation was attributable to BI's swift monetary policy response of gradually raising its policy rate by 225bps in total since August 2022, as well as strong coordination between BI and GoI in the form of Central and Regional Inflation Control Teams (TPIP and TPID) through the National Movement for Controlling Food Inflation (GNPIP) Program to control food inflation in various regions. However, the most contributing factor to the slowing inflation in May was the seasonal trends following the end of Eid al-Fitr festivities.

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



Source: CEIC

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



Source: CEIC

On a monthly basis, May inflation rate was recorded at 0.09% (m.t.m), much lower than 0.33% (m.t.m) inflation in April 2023 and 0.40% (m.t.m) inflation in May 2022. Based on expenditure group, the weakened inflation was primarily due to deflation in the clothing and footwear group of 0.46% (m.t.m) and transportation group of

Key Figures

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5.75%
GDP Growth (y.o.y, Q1 '23)
5.03%
Inflation (y.o.y, May '23)
4.00%
Core Inflation (y.o.y, May '23)
2.66%
Inflation (m.t.m, May '23)
0.09%
Core Inflation (m.t.m, May '23)
0.06%
FX Reserve (May '23)
USD139.3 billion

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0.56% (m.t.m). This comes as no surprise that price decreases in those groups may be attributed to the lower demand as seasonal festive effects fade. Meanwhile, looking at inflation per its components, the low headline inflation was primarily supported by lower core inflation component. Core inflation declined to 0.06% (m.t.m) in May, lower than 0.25% (m.t.m) in April 2023. This does not essentially indicate that public demand or purchasing power is starting to decline, as the historical trend of core inflation figures was still affected by seasonal factors such as demand and price normalization after the Eid festive period. The main contributors to the lower core inflation were house rent, bottled water, gold, and household assistant wages.

Following that, administrative prices posted a deflation of 0.25% (m.t.m) in May after enjoying relatively high inflation of 0.69% (m.t.m) in April 2023. Lower air and city transportation fares mainly drove the drop in government-regulated prices. Aside from lower demand, the adjustment of fuel prices by GoI in May 2023, including the reductions in the prices of Dexlite and Pertamina Dex, which fell by IDR550-650/liter and IDR800/liter, respectively, contributed to lower administered prices. However, higher prices of filtered clove cigarettes in response to a higher tobacco excise tax prevented further deflation.

On the other hand, the volatile prices component climbed to 0.49% (m.t.m) from 0.29% (m.t.m) in the preceding month. The increasing trend of monthly volatile prices was primarily due to rising prices for shallots, purebred chicken meat, purebred chicken eggs, and garlic. Further increases were offset, however, by price corrections affecting various chili varieties. All in all, the current inflationary developments provide room for BI to maintain the policy rate at 5.75% while strengthening coordination with central and regional governments to deal with the potential impact of El Nino that may affect domestic food prices and further suppress inflation.

Narrow Trade Surplus as Imports Surged

Indonesia's Consumer Confidence Index (CCI) increased to 128.3 in May 2023 from 126.1 in the preceding month, reaching its highest level since May last year. The rising figure of CCI was supported by strengthening the current economic conditions and consumer expectations. The current economic condition was recorded at 118.9, climbed from 116.6 in April while households' assessment regarding economic outlook also increased to 137.8 from 135.5 in the previous month. The overall development of CCI in May suggests there is growing consumer optimism in domestic economic conditions.

Meanwhile, Indonesia's Manufacturing Purchasing Managers Index (PMI) in May 2023 stood at the level of 50.3, lower than the previous month at 52.7. Despite the

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decline, Indonesia's PMI remains in expansionary territory. However, the slowdown of PMI reflects slowing manufacturing expansion. This may be partly due to domestic demand adjustment following Eid Festivities, as well as slowing global demand in major markets, such as China and the European Union. The slower-than-expected economic recovery in several countries and the possibility of global economic weakening cannot be avoided. This would have an impact on domestic manufacturing performance, particularly for products that are export-oriented and rely on imported raw materials for production.

Observing the latest foreign trade balance data, Indonesia still recorded a surplus of USD0.44 billion in May 2023. However, it plummeted to the lowest level since April 2020. After two consecutive months of negative growth, export grew by 0.96% (y.o.y) and reached USD21.72 billion in May 2023. This rebound was driven entirely by non-oil and gas exports, which increased by 1.94% (y.o.y). Oil and gas export meanwhile declined by 12.10% (y.o.y). This expansion was also related to the low-base effect since the end of the Eid holiday last year occurred in May 2022. On the other hand, imports reversed to record the highest growth since the beginning of this year, reached USD21.28 billion or grew by 14.35% (y.o.y). Surged in imports was supported by imports of capital goods which experienced the highest growth. The remarkable performance of imports reflects the ongoing domestic economic improvements amid the risk of a global slowdown. Going forward, amidst declining commodity prices driven by declining global demand, the trade surplus is expected to narrow, potentially leading to a trade deficit sooner than previously anticipated.

A 'Hawkish Pause' by the Fed

On the external front, the Fed leaves its benchmark rate unchanged at 5.00-5.25% in the latest FOMC meeting. The first rate pause during the monetary tightening era seems appropriate given the Fed is getting closer to its inflation target, while waiting for the full effect of previous hikes to be realized on inflation. Though it may be uncertain to predict how far the monetary policy affects the economy, the decision to maintain the FFR also considers the potential headwinds from credit tightening, as seen by several bank failures in the US. Notwithstanding, the Fed might have some room to raise the rate further shall inflation do not slow down. The recent data on US inflation shows that inflation fell sharply to two-year lows in May, stood at 4% (y.o.y) and stayed well above the desired target of 2%. The easing US inflation rate was primarily driven by a decline in energy prices and a slowdown in food inflation.

The rate pause taken by the Fed halts the narrowing yield spread between US policy rates and EMs', which consequently makes EMs' assets relatively more attractive to investors. This provided such blessings for EMs, as investors move their assets towards emerging markets, including Indonesia. As a result, Indonesia continuing

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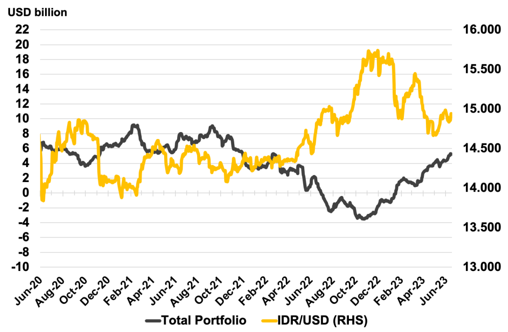
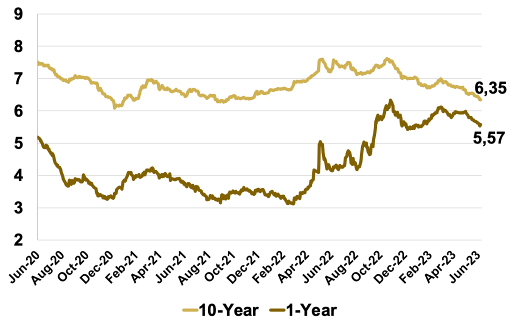
recorded capital inflows of USD1.67 billion to a total of USD5.23 billion from mid-May to mid-June. It has been translated into substantial declines in the 10-Year and 1-Year government bonds from 6.54% and 5.86% in the preceding month to 6.35% and 5.57%, respectively.

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



Source: CEIC

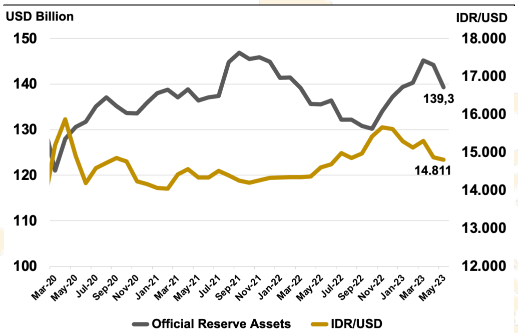
Figure 4: Government Bonds Yield (% pa)



Source: CEIC

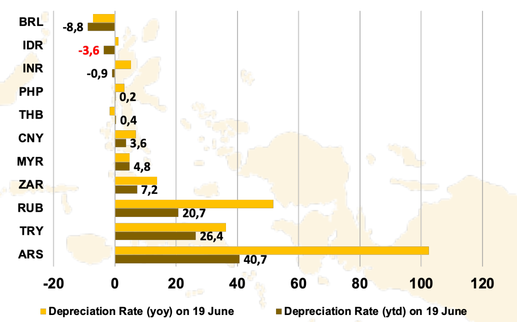
Moreover, the ongoing capital inflows strengthened Rupiah to around IDR14,800 with the appreciation rate against US Dollar reaching 3.6% on June 19th compared to the beginning of this year. Rupiah has performed better compared to its peers and has been outperformed only to Brazilian Lira. On the other hand, the stable financial market is reflected in the sufficient amount of reserves at USD139.3 billion. Although dropped to a five-month low, the decline was linked to payment of the government's external debt and in anticipation of demand for foreign currency liquidity in the banking industry as economic activity continued to accelerate. The current level of reserves is still adequate to support external sector resilience as it is capable to cover 6.0 months of imports and servicing government's foreign debt.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (19 June 2023)



Source: Investing.com

Observing the latest development, the inflation figure is expected to ease further and move within BI's target range, with core inflation remains manageable. Despite narrowing, Indonesia's trade balance remains surplus. In addition, domestic

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economic conditions are still robust with higher demand showing signs of improvement. On the external side, the Fed's current pause of rate hikes somehow brings fresh air for Indonesia to enjoy capital inflows. Demand for Indonesian bonds is still promising as the yield spread between Indonesian government bonds and US Treasury remains attractive. The ongoing episodes of inflows bolstered Rupiah to appreciate to around 14,800-14,900. in addition, the current level of forex reserves is sufficient to support external resiliency. Regardless, BI should keep a close eye on the Fed's move in the next month’s FOMC meeting. Once the Fed raises its benchmark rate, it may affect the yield spread and trigger capital outflows. However, we see that BI should continue to hold its policy rate at 5.75%, for now, to maintain price and exchange rate stability while continuing macroprudential measures to remain accommodative to support economic growth.

8 DECENT WORK AND ECONOMIC GROWTH