Macroeconomic Analysis Series

BI Board of Governor Meeting

August, 2023

LPEM FEB UI
Institute for Economic and Social Research

Highlights

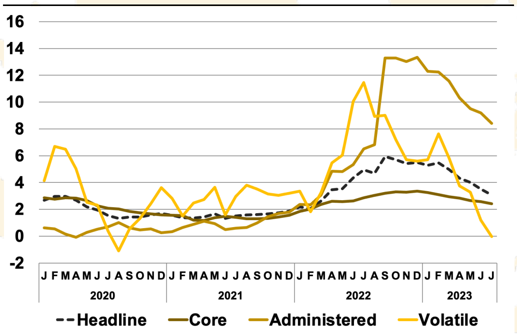
- BI should maintain the policy rate at the current level of 5.75% this month.
- Headline inflation marched to the midpoint of BI's target range.
- Another interest rate hike by the Fed in the latest FOMC has triggered the capital outflow and led to Rupiah depreciation.

Inflation slowed further after the normalization of global prices and the domestic price control program implementation. The economy also grew stronger than expected in the second quarter of this year, thanks to robust domestic demand. External pressures, on the other hand, have intensified as the Fed raised interest rate again at the July FOMC, resulting in capital outflows as well as currency depreciation in EMs. Despite maintaining one of the best performing EMs currencies, Rupiah is weakening as Indonesia's trade surplus shrinks. BI should be able to manage external pressures on Rupiah amid the Fed's potential continuation of another interest rate hike before the end of this year. Therefore, we see that BI should hold its policy rate at the current level of 5.75% while monitoring Rupiah stability and maintaining domestic prices.

Inflation Continued to Slow Further

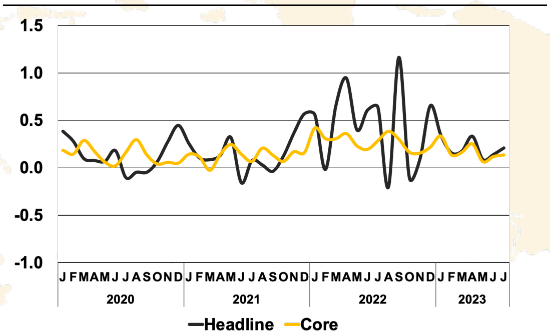
The normalization of global commodity prices, which peaked in June 2022 due to unprecedented geopolitical tension, has subsided Indonesia's inflation in 2023. This trend is evident in the continuance of decreasing inflation to 3.08% (y.o.y) in July 2023 from 3.52% (y.o.y) a month earlier. July headline inflation was the lowest in the last 16 months, reaching the midpoint of BI's target range of 3±1%. Lower inflation was reflected in the moderation of administrated prices, which fell from 9.21% (y.o.y) in June 2023 to 8.42% (y.o.y) in July 2023. At the same time, energy prices inflation fell to 10.49% (y.o.y) from 11.35% (y.o.y) following the lower crude oil and gas prices. A significant portion of this improved performance was also the result of BI's effort to maintain consistent monetary policy and continue to coordinate with GoI to implement various price control programs, including the National Movement for Food Inflation Control (GNPIP) and Low-Priced Food Markets (GPM).

Figure 1: Inflation Rate (y.o.y)



Source: CEIC

Figure 2: Inflation Rate (%, m.t.m)



Source: CEIC

Macroeconomics, Finance & Political Economy Research Group

Jahen F. Rezki, Ph.D.
jahen@lpem-feui.org

Syahda Sabrina
syahda.sabrina@lpem-feui.org

Teuku Riefky
teuku.riefky@lpem-feui.org

Amalia Cesarina
amalia.cesarina@lpem-feui.org

Faradina Alifia Maizar
faradina@lpem-feui.org

Yoshua Caesar Justinus
yoshua@lpem-feui.org

Key Figures

BI Repo Rate (7-day, July '23)
5.75%
GDP Growth (y.o.y, Q2 '23)
5.17%
Inflation (y.o.y, July '23)
3.08%
Core Inflation (y.o.y, July '23)
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Inflation (m.t.m, July '23)
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Even though the yearly inflation has steadily plummeted, cyclical pressure remains, as seen by higher monthly inflation of 0.21% (m.t.m) in July 2023 against 0.14% (m.t.m) in June 2023. This increase was mainly attributable to the seasonal pattern of mid-year holidays and the start of the new school year. The education prices increased to 0.66% (m.t.m) from 0.01% (m.t.m) in the previous month. Transportation prices also inflated by 0.58% (m.t.m) in July 2023 after falling by 0.10% (m.t.m) in June 2023. In addition, clothing and footwear prices jumped to 0.18% (m.t.m) this month from only 0.08% (m.t.m) in the preceding month. However, the inflation in food, beverage, and tobacco eased to 0.22% (m.t.m) in July 2023 from 0.39% (m.t.m) in June 2023 as a result of decreasing onions, cayenne pepper, mustard greens, tomatoes, as well as fresh fish prices due to copious supply of these foods. The manageable prices of food components contributed to lower inflation of volatile prices at 0.17% (m.t.m) in July 2023 from 0.44% in the previous month.

Core inflation, the gauge of real sector demand, has continued to track the path of headline inflation, albeit more sluggish due to the absence of unpredictable prices, such as volatile and administered price components. Yearly core inflation continued to decelerate in July 2023, falling to 2.43% (y.o.y) from 2.58% (y.o.y) in June 2023. July core inflation was even lower than its figure before the pandemic at 3.23% (y.o.y) in July 2019. On a monthly basis, core inflation only increased slightly to 0.13% (m.t.m) in July 2023 from 0.12% (m.tm) in the previous month following the seasonal rise of school fees and property rent. For the remainder of this year, core inflation is expected to be low and manageable. At the same time, headline inflation is projected to be within BI's target.

The Economy Substantially Grew Amid the Lower Exports

Not only inflation, the domestic economy was also on its long-term trend of 5% growth in the second quarter of this year. The 5.17% (y.o.y) growth was mainly driven by robust household consumption, which jumped to 5.23% (y.o.y) from 4.54% (y.o.y) in the previous quarter due to the Ramadhan, Eid-al-Fitr, and Eid-al-Adha festive. Following the seasonal pattern, government consumption also picked up to 10.62% (y.o.y) from only 3.45% (y.o.y) in a quarter earlier given by the disbursement of Eid-al-Fitr Bonus or Tunjangan Hari Raya (THR) and 13th salary. The acceleration in consumption was compensated by higher activity in almost all sectors of the economy. This is reflected by the higher growth of the manufacturing industry, which is the most significant contributor to GDP, to 4.88% (y.o.y) in Q2-2023 from 4.43% (y.o.y) in the previous quarter. The other drivers of the economy, wholesale and retail trade and agriculture, forestry, and fisheries sectors also substantially expanded in Q2-2023.

The economy is expected to grow, albeit slower, in the upcoming quarter, as seen by the slight downward trend of the leading indicators in July. Purchasing Managers

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Index (PMI) increased slightly to 53.3 last month from 52.5 in June 2023. Despite the greater new orders and job opportunities, the workforce expansion of the manufacturing industry was moderate in July. Furthermore, Retail Sales Index growth slowed to 6.27% (y.o.y) in July 2023 from 7.89% (y.o.y) in the previous month. It was influenced by the decline in the growth of all retail sales components, except for motor vehicle parts and accessories and information and communication services. Likewise, Indonesia's Consumer Confidence Index (CCI) decelerated to 123.5 in July 2023 from 127.1 a month earlier due to weakening household sentiment on all fronts, from Indonesia's economic outlook to their income expectations. The weaker performance of these leading indicators in July compared to the previous month is inextricably linked to the seasonal downward pattern in the third quarter of the year compared to the second quarter due to more festive occurrences in the latter. Nevertheless, these indicators remain within the favourable territory and offer optimistic sentiment.

The only expenditure component hampering the upward trend of economic growth was exports. Exports slowed by 2.75% (y.o.y) in Q2-2023, down from the growth of 12.17% (y.o.y) in the previous quarter. Looking to the recent data, export fell by 18.03% (y.o.y) in July 2023 to USD20.9 billion compared to USD25.5 billion during the same period in the previous year. This was driven mainly by the lower non-oil and gas exports, particularly mining products, following the global price normalisation of commodities and several minerals export ban implementations. Exports of non-oil and gas dropped by 18.74% (y.o.y) in July 2023, while oil and gas exports only declined by 4.72% (y.o.y).Similarly, imports declined to USD19.6 billion in July 2023 from USD21.3 billion in the same month the previous year. This deceleration was equivalent to 8.32% (y.o.y) drop, with a decline of 16.67% (y.o.y) in raw and auxiliary imported goods being the main contributor to the lower imports. However, the decline in imports was slower relative to exports. It contributed to the lower trade balance of USD1.3 billion in July 2023 compared to USD3.5 billion in the previous month. The decline in trade balance is projected to continue following the lower-than-expected growth of main Indonesia's trading partner, China.

Another Fed Rate Hike Triggered Capital Outflows in Emerging Markets

After taking a pause in June, the Fed resumed the tightening cycle to fight inflation by raising interest rates by 25 bps to 5.22-5.50% on July 25-26 Federal Open Market Committee (FOMC) meeting. This was predicted to be the last interest rate hike in 2023 as the US inflation has substantially dropped to 3.0% (y.o.y) in June 2023 from its peak of 9.1% in the same period a year earlier. However, market expectations changed swiftly after the new inflation data was released in the first week of August, showing a slight increase in US inflation to 3.2% (y.o.y) in last July. The July inflation

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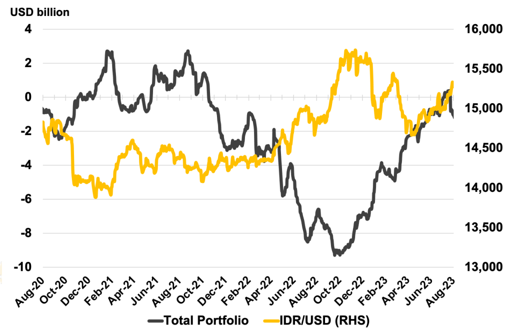
data also showed that the core inflation was still stubbornly high even though the headline inflation was in downward trend relative to the previous year. It has put another interest rate hike by the Fed on the table. If the upward risk remains, the Fed could continue aggressively increasing the interest rate amidst several bank failures, stock market volatility, and the relatively stubborn employment rate. Thus, investors anticipate that the Fed will hike interest rates one more time before the end of this year. At the end of July, the ECB also hiked the benchmark rate to the historically highest level since 1999 at 3.75% in an effort to curb inflation.

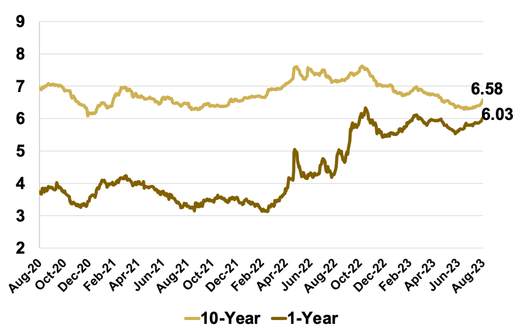
The higher interest rate in developed countries boosts the attractiveness of their assets compared to emerging countries. This has triggered selloff in emerging market assets, notably in Asia. The Asian market volatility has been exacerbated by the disappointing growth of China's economy this year, which lowered investors' appetite for Asia's assets. Consequently, the capital outflow in Indonesia financial market was recorded at USD1.04 billion throughout mid-July until mid-August. The decline in the total portfolio was contributed by the selloff in both stocks and bonds assets. It was priced in by the increases in Indonesia's 10-year and 1-year government bond yields to 6.58% and 6.03% in mid-August from 6.32% and 5.80% in mid-July, respectively.

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



Source: CEIC

Figure 4: Government Bonds Yield (% pa)

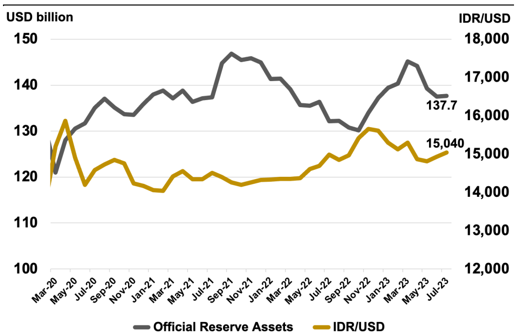


Source: CEIC

Recent financial market shock has pushed the Rupiah down to IDR15,335 in mid-August. Even though Rupiah and Brazilian Lira continued to be the best currency performer relative to other emerging markets, the year-to-date appreciation rate of Rupiah was slashed to only 1.54% (ytd) from its peak of 5.03% (ytd) in mid-April. The lower performance of the Rupiah this month was attributable to the deterioration of the trade surplus since April as we have mentioned above. The shrinking of the trade surplus could further undermine the performance of Rupiah in the coming months as it indicates less foreign exchange in the market.

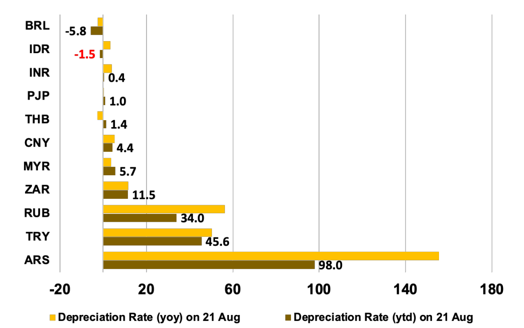
To cushion the volatility of Rupiah coming from the uncertainty of aggressive monetary tightening by the Fed, BI has recently strengthened its export proceeds reserves (DHE) policy. Since August 2023, natural resource exporters having a total export value of USD250,000 or its equivalents are required to keep their foreign exchange proceeds in the domestic financial system. This policy is expected to support BI in maintaining the depreciation of Rupiah by providing more foreign exchange reserves. Therefore, the foreign exchange reserves of USD137.7 billion at the end of July is projected to move higher in the coming months. Nevertheless, the current level of reserves is adequate to support external sector resilience as it is capable of covering 6.0 months of imports while also servicing the government's foreign debt.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (21 August 2023)



Source: Investing.com

Despite the asset selloff, we see that capital outflows from Indonesia's financial market could have fared even worse than it has been if BI had not implemented consistent monetary policy and direct intervention instruments. From domestic side, the robust economic growth has amplified investors' confidence in Indonesia compared to other emerging markets. The remaining low and manageable inflation has also put BI with no urge to adjust the policy rate amid the increased pressures from the Fed's uncertain end of its monetary tightening. BI should be able to manage the external pressures on Rupiah amid the Fed's potential continuation of another interest rate hike before the end of this year. Therefore, we see that BI need to hold its policy rate at the current level of 5.75% while monitoring the Rupiah stability and maintaining the domestic prices.

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