LPEM FEB UI
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Macroeconomic Analysis Series

BI Board of Governor Meeting

August 2024

Highlights

- BI should maintain BI Rate at 6.25% this month.
- Headline inflation continued to slow to 2.13% (y.o.y) in July 2024 from 2.51% (y.o.y) in June 2024.
- With the possibility of the Fed cutting its interest rate reaching its highest level since mid-2020, international capital flows have been surging into emerging markets and Rupiah has appreciated by 3.21% (m.t.m) in the past 30 days.
- Indonesia's foreign exchange reserves rose by USD5.2 billion, the highest monthly increase since December 2023.

Macroeconomics, Finance & Political Economy Research Group

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Headline inflation slowed to 2.13% (y.o.y) in July 2024, down from 2.51% in June 2024, driven by declining food prices post-harvest and lower demand after Eid al-Adha. Core inflation edged up slightly to 1.95% (y.o.y) in July 2024, with rising prices in gold jewellery, coffee, and education. Meanwhile, Rupiah appreciated by 3.80% to IDR 15,675/USD between 30 July and 14 August, supported by capital inflows amid expectations of a Fed rate cut. Official reserve asset was USD145.4 billion in July 2024, an increase of USD5.2 billion from USD140.2 billion in the previous month. Despite easing inflation, a premature rate cut might spur Rupiah volatility and potentially weaken Rupiah as it could trigger capital outflows. To preserve the rate differential and stabilize the currency, Bank Indonesia should align any rate cuts with the Fed's monetary easing. Therefore, BI rate should be kept unchanged at 6.25% in August's board of governor meeting.

Slowing Inflation Continues

In July 2024, headline inflation slowed to 2.13% (y.o.y), down from 2.51% (y.o.y) in June 2024, marking the lowest rate since February 2022 but remains within BI's target range of 1.5% to 3.5%. The decline in headline inflation can be attributed primarily to declining food commodity prices following the harvest season. Inflation for food, beverages, and tobacco components weakened to 3.66% (y.o.y) in July 2024 from 4.95% (y.o.y) in June 2024, reaching the lowest level in eleven months. Inflation also eased in other expenditure groups, such as transportation (1.22% (y.o.y) in July 2024 vs 1.61% (y.o.y) in June 2024), health (1.77% (y.o.y) in July 2024 vs 1.89% (y.o.y) in June 2024), and clothing and footwear (0.99% (y.o.y) in July 2024 vs 1.09% (y.o.y) in June 2024). This decrease was driven by lower mobility poset-Eid al-Adha and the absence of long weekends in July 2024. Conversely, the price of personal care and other services accelerated in July 2024, rising to 5.59% (y.o.y) from 5.24% (y.o.y) in June 2024. The inflation rate of personal care and other services has been increasing since the beginning of the year, likely driven by rising gold prices.

On a month-to-month basis, headline inflation recorded its third consecutive deflation in 2024, with a deeper deflation of 0.18% (m.t.m) in July 2024 compared to 0.08% (m.t.m) in June 2024. Similar to the annual price trends, the primary driver of July's monthly deflation was the food, beverage, and tobacco group, which indicated a deflation of 0.97% (m.t.m), contributing 0.28 percentage points to the overall deflation for the month.

Based on its component, the volatile food price component was the primary driver of July's inflation figure. This component recorded an annual inflation of 3.63% (y.o.y) in July 2024, down from 5.96% (y.o.y) in June 2024, marking the lowest level since

Key Figures

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6.25%
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5.05%
Inflation (y.o.y, Jul '24)
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Core Inflation (y.o.y, Jul '24)
1.95%
Inflation (m.t.m, Jul '24)
-0.18%
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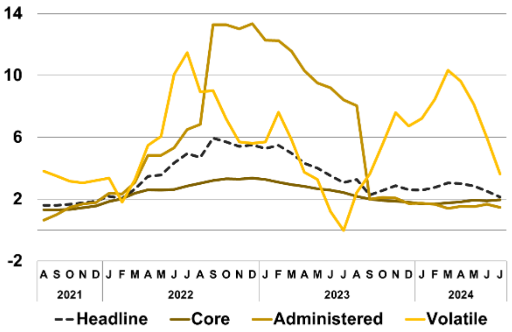
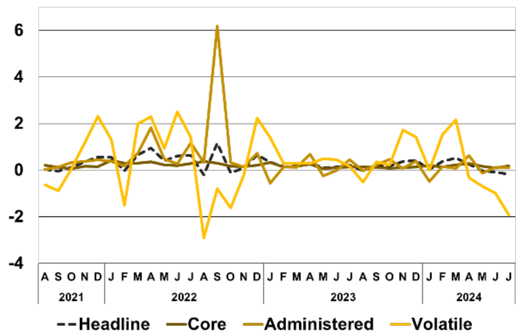
October 2023. On a month-to-month basis, the volatile price component recorded its fourth deflation of the year, reaching 1.92% (m.t.m) in July 2024 from 0.98% (m.t.m) in June 2024. The decline in annual inflation and the deeper monthly deflation were driven by price decreases in shallots, red chilli, and tomatoes. These price decreases resulted from increased supply as ongoing harvest season boosted supply. Meanwhile, the administered price component posted an annual inflation of 1.47% (y.o.y) in July 2024, slightly decreased from 1.68% (y.o.y) in June 2024. On a monthly basis, it recorded an inflation of 0.11% (m.t.m) in July 2024, relatively unchanged compared to last month's rate of 0.12% (m.t.m). The main contributors to the administered price hike were machine-made kretek cigarettes and hand-rolled kretek cigarettes, as producers passed higher excise duties on tobacco products to consumers.

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



Source: CEIC

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



Source: CEIC

Core inflation in July 2024 edged up slightly to 1.95% (y.o.y) from 1.90% (y.o.y) in June 2024. On a monthly basis, core inflation was 0.18% (m.t.m) in July 2024, rose from 0.10% (m.t.m) in June 2024. The key drivers of July's core inflation were gold jewellery, ground coffee, and education expenses. Global gold commodity prices continued to climb due to increasing demand for safe haven assets amid expectations of potential rate cuts by the Fed, geopolitical uncertainties, and gold purchases by most central banks. Ground coffee prices have increased due to a decline in global coffee production.

Moreover, education expenses, including enrolment and tuition fees for primary and secondary schools, contributed to July's core inflation as July coincides with the start of the new academic year, a regular seasonal inflationary driver. Despite this, core inflation remains manageable due to stable inflation expectations during the school holiday and the new academic year. Looking ahead, inflationary pressure in August 2024 is expected to stem from rising rice prices and imported inflation, driven by Rupiah's continued weakening in early August. Since then, Rupiah began to appreciate, which could alleviate some inflationary pressures. BPS projects a 40-50%

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decrease in rice production from June to October 2024 compared to the April-May 2024 harvest period, anticipating the impact of the upcoming La Niña season.

Slower Economic Growth, Shrinking Trade Surplus

In line with expectations, economic growth in Q2-2024 slowed to 5.05% (y.o.y), down from 5.11% (y.o.y) in Q1-2024. This moderation is largely due to the absence of the seasonal boosts from Ramadan and election activities that had propelled growth in the first quarter. On the expenditure side, growth in Q2-2024 was primarily driven by household consumption, investment, and exports. Household consumption rose to 4.93% (y.o.y), slightly above the 4.91% (y.o.y) in Q1-2024, bolstered by Eid-al-Fitr spending, higher civil servant salaries, and performance allowances. Additionally, various social assistance programs, such as Program Keluarga Harapan (PKH) and Bantuan Langsung Tunai (BLT) for food risk mitigation, helped sustain purchasing power. Government spending growth slowed sharply to 1.42% (y.o.y) in Q2-2024, following an extraordinary 19.90% (y.o.y) rise in the previous quarter. This slowdown is due to a high-base effect; in Q2-2023, government spending surged as religious holiday allowances, and the thirteenth salary was disbursed, while in 2024, these were paid out in Q1. Investment also gained strength, growing by 4.43% (y.o.y), up from 3.79% (y.o.y) in Q1-2024, driven by a 5.31% (y.o.y) increase in buildings and structures investment, mainly due to the completion of national strategic projects, including the new capital. Exports surged by 8.28% (y.o.y) in Q2-2024, a sharp rise from 1.37% in Q1-2024, fueled by higher global commodity prices that boosted Indonesia's major export commodities. Imports also rebound strongly, rising by 8.57% (y.o.y) in Q2-2024 from 1.94% in Q1-2024, reflecting strengthening domestic demand.

In July 2024, the trade balance recorded its 51st consecutive surplus at USD0.47 billion, though this marked the smallest surplus since June 2023. It represented a 63.44% decline (y.o.y) from the previous year and an 80.29% drop (m.t.m) compared to June 2024. The sharp contraction was driven by faster import growth relative to exports. Exports in July 2024 increased by 6.46% (y.o.y) to USD22.21 billion, maintaining positive growth since April 2024. Oil and gas exports rose by 15.99% (y.o.y), while non-oil and gas exports increased by 5.87% (y.o.y) in July 2024. The rise in oil and gas exports was supported by higher volumes, despite a decline in oil prices (Brent crude fell by 3.70% (y.o.y) and WTI crude by 1.73% (y.o.y)). Among non-oil and gas exports, the strongest growth was seen in precious metals, which surged by 108.46% (y.o.y) to USD788.9 million, followed by ores, slag, and ash, which rose by 100.26% (y.o.y) to USD708.6 million. The jump in precious metals exports was driven by a nearly 30% (y.o.y) increase in gold prices, spurred by heightened demand for safe-haven assets amid escalating military tensions between Iran and Israel. Meanwhile, the growth in ores, slag, and ash exports was fueled by the government's relaxation of copper concentrate export restrictions for several mining companies.

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On the imports front, July 2024 saw an 11.07% (y.o.y) increase to USD21.74 billion, continuing the upward trend since June 2024. The growth in imports was driven by oil and gas, which rose by 13.59% (y.o.y), and non-oil and gas, which increased by 10.60% (y.o.y). Among non-oil and gas imports, the most significant annual growth was in mineral fuels, which surged by 71.52% (y.o.y) to USD555.6 million, followed by precious metals, which grew by 63.36% (y.o.y) to USD420.9 million. By type of goods, the rise in imports in July 2024 was mainly due to a 15.17% (y.o.y) increase in raw materials imports, totalling USD16.03 billion, and a 2.04% (y.o.y) increase in capital goods imports, reaching USD3.64 billion. A notable factor behind the rising import values was the depreciation of the Rupiah, which weakened to IDR16,295 per USD in July 2024. This decline in currency value made imported goods more expensive in local currency terms, contributing to the higher dollar-denominated import figures. Although the increase in raw materials imports could suggest strong demand for production inputs, this might not have been the case in July 2024. The Manufacturing PMI fell to 49.3 in the same month, marking the first contraction in factory activity since August 2021. This contraction indicates that manufacturing demand may have been weaker than the import data suggested.

The Fed Rate Cut is Almost Certain

The US inflation fell to 2.9% (y.o.y) in July 2024 from 3.0% (y.o.y) in June 2024. This figure undercut economists' expectations that inflation would hold steady at 3% and marked the first time headline CPI has fallen below 3% since March 2021. On the other hand, the US unemployment rate rose from 4.1% to 4.3% during the same period. However, the latest data suggested that the initial claims for unemployment benefits dropped by 7,000 to 227,000 at the end of the first week of August. The drop in initial claims for unemployment benefits in the last two weeks has compensated for the rise in late July, suggesting the trend of labor market slowdown remained in place. With the Fed holding its policy rate unchanged on its July FOMC meeting, the latest inflation and labor market data have heightened expectations for a rate cut in the upcoming September meeting. According to the CME FedWatch Tool, an indicator to measure market expectations towards the Fed Funds Rate (FFR), the probability of the Fed leaving policy rate unchanged in the upcoming FOMC meeting has been zero since July 24th. As of August 16th, market expectations suggest a 75% probability of a 25 bps and a 25% chance of a 50 bps rate cut in the next FOMC meeting. The easing of inflationary pressures, combined with signs of labor market cooling provide the Fed with an opportune moment to ease its monetary policy. Timing the rate cut appropriately is vital to avoid being behind the curve and risking any potential slowdown in the real sector.

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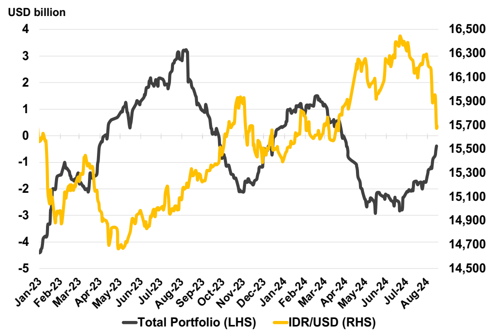
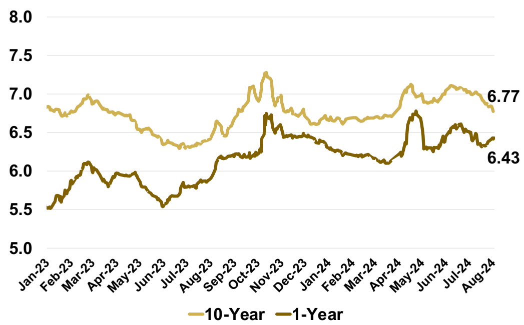
During the last 30 days, Rupiah has reached its lowest point of IDR16,295/USD at the end of last month. This was due to episodes of capital outflow driven by the *wait-and-see* sentiment of investors following the July FOMC meeting, expectations of potential Bank of Japan's rate increase, and elevated US political tension. Fortunately, the trend has been reversed, and Indonesia experienced a surge of capital inflow due to the elevating sentiment that the Fed will cut the rate soon. Between July 30th and August 14th, capital flows into Indonesia amounted to USD1.15 billion and appreciated Rupiah by 3.80% to IDR15,675/USD. Foreign capital flows into the domestic financial market have driven down Indonesia's government bond yield. 10-year government bond yield declined from 7.03% on July 24th to 6.77% on August 16th. Although it had a smaller magnitude, the 1-year government bond yield also declined to 6.43% from 6.49% during the same period. The higher decrease in long-term government bond yield might suggest that foreign investors are more confident in Indonesia's long-term economic prospects compared to its short-term prospects. The relative difference in investors' confidence over Indonesia's economic condition could be caused by the ongoing uncertainty of short-term economic conditions amidst the administration transition period.

Figure 3: IDR/USDand Accumulated Portfolio Capital Inflow (since Jan-23)



Source: CEIC

Figure 4: Government Bonds Yield (% p.a.)



Source: Investing.com

With the possibility of the Fed cutting its interest rate reaching its highest level since mid-2020, international capital flows have been surging into emerging markets and driving down the US Dollar Index (DXY) to 102.4, reaching its lowest point since January 2024. As a consequence, Rupiah has appreciated by 3.21% (m.t.m) in the past 30 days. Similarly, Malaysia, South Africa, Thailand, China, and Philippines also experienced stronger currencies against USD during the last one month. On a year-to-date basis, Rupiah has performed relatively better in comparison to several of its peers' currencies, such as Brazilian Lira and Philippines Peso. Since the beginning of 2024, Rupiah has depreciated by 1.85% (y.t.d). In addition, Indonesia encountered the highest monthly increase in official reserve asset since December 2023. In July 2024, official reserve asset was USD145.4 billion, an increase of USD5.2 billion from USD140.2 billion in the previous month. The rise of official reserve asset was mainly

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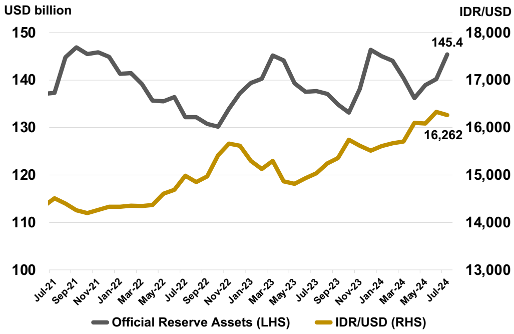
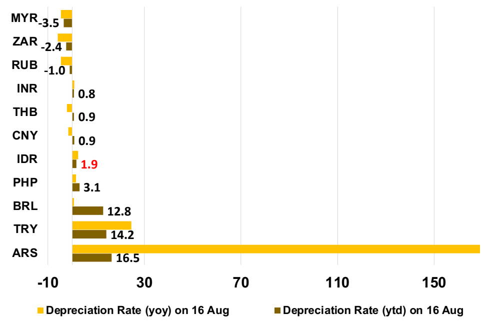
driven by the issuance of GoI's global sukuk and increased tax and services receipts. Indonesia's reserve asset is currently equivalent to 6.5 months of import or 6.3 months of import and servicing GoI's external debt, well above the international reserve adequacy standard of around three months of import value.

Figure 5: IDR/USD and Official Reserve Assets



Source: CEIC

Figure 6: Depreciation Rates of Selected EMs (16 August 2024)



Source: Investing.com

Indonesia is currently in a favourable situation on the currency front. Episodes of capital inflows in the past few weeks have strengthened the Rupiah and, to some extent, reduced external pressure. On the other hand, inflation has reached its lowest point in the past 30 months and monthly deflation has been occurring in the past three months, suggesting a potential of ongoing decline in purchasing power. The development of inflation rate might suggest a need to cut the policy rate to boost aggregate demand. However, a premature rate cut might spur Rupiah volatility and weaken Rupiah as it could trigger capital outflows. Thus, BI's rate cut should be in accordance with the Fed's movement of easing monetary policy to maintain rate differential. Therefore, the BI rate should be kept at 6.25% in August's board of governor meeting.

8 DECENT WORK AND ECONOMIC GROWTH