

CPI:

Time for a gear shift

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Executive Summary

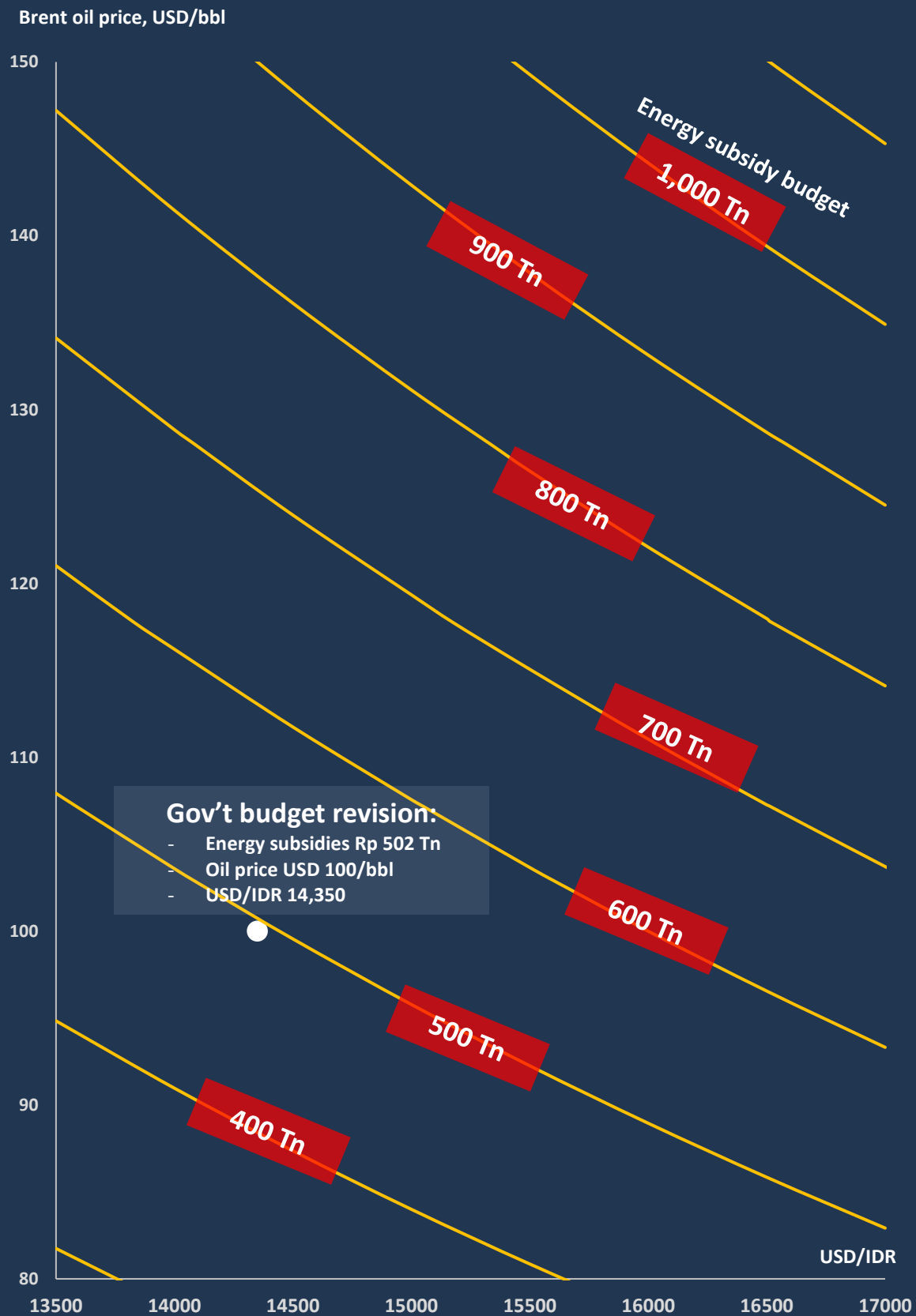
- The consumer price index increased by 4.35% YoY (0.61% MoM) in June 2022, higher than analysts' median expectations of 4.17% YoY.
 - While inflation so far has largely been led by domestic factors, imported inflation would increasingly seep into the domestic market due to: (1) additional global inflationary pressures; (2) pre-existing global inflation which has not translated to domestic inflation; and (3) IDR depreciation.
 - With all these in mind, we expect BI to announce its first hike after this month's meeting (July 21st), and there is even a probability – albeit not the likeliest scenario – of a 50 bps hike to send a clear signal that BI is committed to preventing undue IDR depreciation.
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- Indonesia's consumer price index (CPI) increased by 4.35% YoY (0.61% MoM) in June 2022, higher than analysts' median expectations of 4.17%. Core inflation went lower than expected (2.63% vs. 2.70% YoY), but this is cold comfort given the nature of the June inflation and the challenges that may come in the months ahead.
 - The inflation in June was largely food-driven, with items such as cooking oil, onion, and chili experiencing significant price gains. We should note, however, that all these three commodities are largely home-grown – meaning that the inflation had little to do with global factors. The rise in cooking oil prices also occurred in spite of the government's best efforts to curtail it, be it through price ceilings or export controls.
 - This means we still have to contend with the force of global inflation with six months left on the calendar. The issue here are three-fold: (1) additional global inflationary pressure; (2) pre-existing global inflation which has not translated to domestic inflation; and (3) IDR depreciation. The first issue appears to be a non-factor given falling commodity prices over the past two weeks. However, the decline was largely driven by concerns over recession and the ensuing demand destruction, as well as (potentially) declining liquidity as the Fed swiftly tightens its monetary spigot. What has not eased is supply concerns over certain key commodities that are linked to Russia or Ukraine, e.g. fossil fuels, wheat, and fertilizer.

- Energy prices, in particular, are unlikely to return to normal any time soon. The proposed plan by G7 to introduce a price cap on Russian oil seems unlikely to succeed in the short-term, not due to lack of buy-in by non-Western-aligned countries (although that, too, could be a problem) but simply due to Russia's retaliation by stopping – or at least, significantly reducing – oil and gas flows to Europe. Meanwhile, the high fertilizer prices could lead to lower usage, and therefore lower yields, down the road, exacerbating food inflation in the medium-term.
- Issue #2 is partly about the prices of imported inputs, which is gradually forcing producers to pass on their higher costs onto their customers. But it is also partly about energy subsidies, where we have seen strong commitment from the government to keep inflation low by announcing a large increase (to Rp 502 Tn) in its subsidy budget last May. By spending such large sum on subsidies, however, the government's budget balance are becoming more sensitive both to an increase in oil prices and to IDR depreciation (**Chart 1**). Which brings us to the third problem: unlike previous episodes where imported inflation derived in large parts from depreciation, the present high rate of imported inflation has happened despite relatively limited depreciation (**Chart 2**). As such, the recent weakening of the IDR presents a clear risk to the government's ability to sustain low energy prices.
- There are, to be sure, alternative channels that are being explored to better control energy inflation without such big exposure towards exchange rates. For instance, Pertamina (the state-owned oil/gas corporation) is planning on utilizing digital technologies to track and limit each vehicle owner's consumption of subsidized gasoline (Pertalite). There is also an increase (starting on July) of electricity price for high-consumption households. Both measures are likely to increase inflation, but to a more manageable degree as they mostly affect high-income households – who are also more able to bear the burden of higher prices.
- Finally, in addition to global inflation, we also have to contend with the issue of monetary inflation. Demand for bank loans have remained strong through H1-22, while other drivers of the M2 – net foreign assets (NFA) and net claims on governments (NCG) – are likely to maintain robust growth (**Chart 3**), thanks to exports and fiscal deficit, respectively. The latter two are of course crucial in cushioning the impact of imported inflation, with NFA as buffer against more drastic IDR depreciation and NCG being related to the aforementioned energy subsidies. As such, fighting monetary inflation boils down to taming loan growth, regardless of the potential drag on the GDP.

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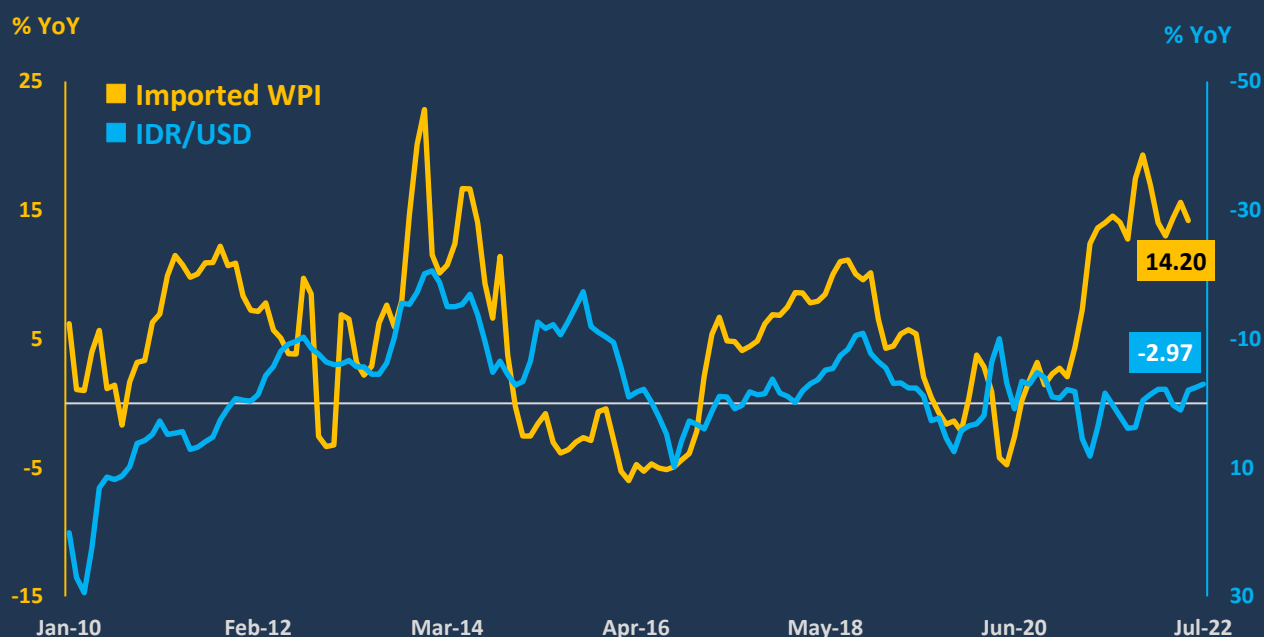
- This is where the sharp increase in reserve requirement ratio (RRR) came in; by reducing the amount of loanable funds, it forced banks to choose between loan and government securities (SBN). This reduces credit volumes, and also raises yields on the longer-end – supposedly obviating the need for an increase in short-end rates (i.e. policy rates). However, we have good evidence (upcoming report) that the IDR is more sensitive to rate differentials on the shorter rather than longer end. Policy rate hikes are thus still needed to fight imported inflation, and to ensure the sustainability of energy subsidies.
- With all these in mind, we find it necessary to revise some of our projections to better reflect the shifting reality. Our inflation forecast, which has always tilted higher compared to other forecasters, is revised from 4.1 – 4.6% YoY to 4.5 – 5.0%. The median expected exchange rate for USD/IDR is revised down from 14,660 to 15,070, as we think that some depreciation is necessary in order to bring down consumer demand for imported goods, as well as businesses' FX demand for investment.
- Finally, our projection for BI7DRR hike in H2-22 is nudged slightly upwards from 50 – 150 bps to 75 – 175 bps. We expect BI to announce its first hike after this month's meeting (July 21st), and there is even a probability – albeit not the likeliest scenario – of a 50 bps hike to send a clear signal that BI is committed to preventing undue IDR depreciation. Ultimately, our "game of two halves" analogy in last month's report is increasingly palpable, and the first half of offense and recovery is turning into a second half of defense and consolidation of that recovery.

Chart 1. IDR depreciation could enlarge cost of subsidies, expansive fiscal policy requires tight monetary policy



Source: Bloomberg, Pertamina, PLN, MoF, estimates by BCA Economist

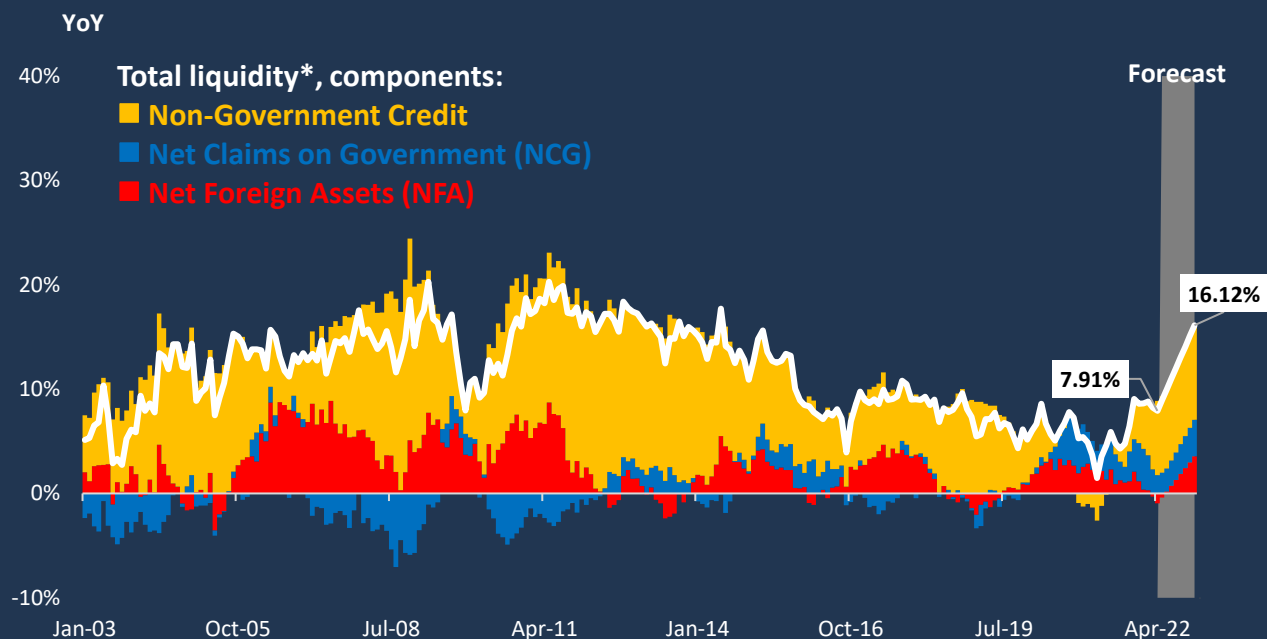
Chart 2. Substantial Rupiah depreciation could further increase imported WPI



Source: BI, Bloomberg

Last Update: May 2022 (Imported WPI), 1 July 2022 (IDR/USD)

Chart 3. While NFA and NCG increases total liquidity, they help shield against imported inflation



Source: BI, BCA Economist calculations

Last Update: April 2022, forecast until December 2022

Selected Macroeconomic Indicator

Key Policy Rates	Rate (%)	Last Change	Real Rate (%)	Trade & Commodities	30-Jun	-1 mth	Chg (%)
US	1.75	Jun-22	-6.85	Baltic Dry Index	2,240.0	2,571.0	-12.9
UK	1.25	Jun-22	-7.85	S&P GSCI Index	709.2	792.7	-10.5
EU	0.00	Mar-16	-8.10	Oil (Brent, \$/bbl)	114.8	121.7	-5.6
Japan	-0.10	Jan-16	-2.60	Coal (\$/MT)	356.0	346.7	2.7
China (lending)	4.35	Oct-15	2.25	Gas (\$/MMBtu)	6.50	8.25	-21.2
Korea	1.75	May-22	-3.65	Gold (\$/oz.)	1,807.3	1,855.2	-2.6
India	4.90	Jun-22	-2.14	Copper (\$/MT)	8,254.3	9,537.5	-13.5
Indonesia	3.50	Feb-21	-0.85	Nickel (\$/MT)	22,643.0	29,231.0	-22.5
Money Mkt Rates	30-Jun	-1 mth	Chg (bps)	CPO (\$/MT)	1,153.3	1,554.3	-25.8
				Rubber (\$/kg)	1.62	1.63	-0.6
SPN (1M)	1.90	0.97	93.0	External Sector	May	Apr	Chg (%)
SUN (10Y)	7.20	7.01	18.5	Export (\$ bn)	21.51	27.32	-21.3
INDONIA (O/N, Rp)	2.80	2.79	1.0	Import (\$ bn)	18.61	19.76	-5.8
JIBOR 1M (Rp)	3.54	3.54	0.1	Trade bal. (\$ bn)	2.90	7.56	
Bank Rates (Rp)	Feb	Jan	Chg (bps)	Central bank reserves (\$ bn)*	135.6	135.7	-0.04
Lending (WC)	8.62	8.66	-3.55	Prompt Indicators	May	Apr	Mar
Deposit 1M	2.85	2.88	-3.49	Consumer confidence index (CCI)	128.9	113.1	111.0
Savings	0.63	0.69	-6.27	Car sales (%YoY)	-9.8	5.0	16.0
Currency/USD	30-Jun	-1 mth	Chg (%)	Motorcycle sales (%YoY)	-2.5	-7.1	-13.6
UK Pound	0.821	0.790	-3.75	Cement sales (%YoY)	7.6	-10.0	23.2
Euro	0.954	0.928	-2.74	Capital Mkt	30-Jun	-1 mth	Chg (%)
Japanese Yen	135.7	127.6	-5.99	JCI	6,911.6	7,037.6	-1.79
Chinese RMB	6.699	6.661	-0.57	DJIA	30,775.4	33,213.0	-7.34
Indonesia Rupiah	14,898	14,558	-2.28	FTSE	7,169.3	7,600.1	-5.67
Capital Mkt	30-Jun	-1 mth	Chg (%)	Nikkei 225	26,393.0	27,369.4	-3.57
JCI	6,911.6	7,037.6	-1.79	Hang Seng	21,859.8	21,123.9	3.48
DJIA	30,775.4	33,213.0	-7.34	Manufacturing PMI	Jun	May	Chg (bps)
FTSE	7,169.3	7,600.1	-5.67	USA	N/A	56.1	0
Nikkei 225	26,393.0	27,369.4	-3.57	Eurozone	52.0	54.6	-260
Hang Seng	21,859.8	21,123.9	3.48	Japan	52.7	53.3	-60
Foreign portfolio ownership (Rp Tn)	Jun	May	Chg (Rp Tn)	China	51.7	48.1	360
Stock	2,388.2	2,503.9	-115.73	Korea	51.3	51.8	-50
Govt. Bond	780.6	795.7	-15.17	Indonesia	50.2	50.8	-60
Corp. Bond	17.9	18.1	-0.16				

Source: Bloomberg, BI, BPS

Notes:

^Data for January 2022

*Data from earlier period

For changes in currency: **Black indicates appreciation against USD, **Red** otherwise

***For PMI, **>50** indicates economic expansion, **<50** otherwise

Indonesia – Economic Indicators Projection

	2017	2018	2019	2020	2021	2022E
Gross Domestic Product (% YoY)	5.1	5.2	5.0	-2.1	3.7	4.8
GDP per Capita (US\$)	3877	3927	4175	3912	4350	4615
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	4.7
BI 7 day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.50
USD/IDR Exchange Rate (end of year)**	13,433	14,390	13,866	14,050	14,262	15,070
Trade Balance (US\$ billion)	11.8	-8.5	-3.2	21.7	35.3	48.5
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	1.4

* Provisional numbers for 2021

** Estimation of Rupiah's fundamental exchange rate

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