

## Mid-Year Economic Review

# Headwind vs. Windfall

*Can commodity windfall still help Indonesia weather the coming global storm?*

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- The first half of 2022 had been eventful, to say the least. Just as global supply chains and consumer demand began to recover from two years of lockdown, Russia's invasion of Ukraine and the ensuing sanctions threaten to worsen scarcity among key commodities. Then, in response to the inflationary shock, the Federal Reserve (Fed) hikes its policy rate faster than previously expected, destabilizing the market and potentially tipping much of the world into a new recession.
- Amid these worries, the Indonesian authorities stand out for their rather unhurried approach in normalizing policies. The benchmark rate (BI 7-Day Reverse Repo, BI7DRR) remains at its historic low of 3.50%, although the reserve requirement ratio (RRR) is gradually being raised from 3.50% in February to 9.00% in September. Fiscal stimulus, meanwhile, remains in place ahead of the expected fiscal normalization next year. In fact, fiscal policy is getting even more supportive as energy subsidies are expanded to curb higher fuel prices.
- The usual explanation for this lack of haste is commodity windfall. Rising commodity prices bolsters Indonesia's current account (CA), which cushions the Rupiah against capital outflows. These windfall profits can also be tapped to finance private spending and government subsidies, allowing Indonesia to sustain both faster growth and lower inflation amid a sea of stagflation elsewhere. In other words, the commodity boom seemingly allows us to have the cake and eat it too.
- But is this a feasible, or even desirable, course of action? And does it still hold true even if the commodity boom turns out to be short-lived, after the recent fall in prices? Our **Mid-Year Review** presents an overall assessment of the situation. **Part A** estimates the size of the CA windfall, and **Part B** examines whether this windfall is sufficient to preclude substantial monetary adjustment. In **Part C**, we take a detour to observe how the windfall is distributed, using the novel source of **BCA transaction data (big data)**. **Part D** concludes with a discussion about inflation, growth, and policies.

## ***Part A – How cushy is the cushion?***

- Since commodity prices spiked at the onset of the Ukrainian War, most Indonesians have grown bullish regarding CA prospects, thanks to our status as a net exporter of basic commodities ([Exhibit 1](#)). The optimism is such that our CA forecast, which has varied between +0.5% and +1.4% of the GDP earlier this year, is often criticized for being too low. In contrast, other professional forecasters, including those at Bank Indonesia (BI), tend to be more cautious, with the median for those surveyed by Bloomberg at just -0.2% of the GDP. To reconcile these two viewpoints, then, we will have to take a more detailed look at how changing commodity outlook can affect the CA.

***There are good reasons to believe that coal prices would continue to outperform other fossil fuels in the near term***

- First of all, we cannot use the usual composite commodity indices (such as S&P GSCI) to predict the CA, as Indonesia is a net exporter for some commodities but a net importer for others – including, most crucially, oil. Our solution is to construct a **terms-of-trade (ToT) adjusted commodity price index**, in which commodities are weighted according to their respective contributions to Indonesia's exports and imports ([Exhibit 2](#)).
- The resulting index, fortunately, still shows positive ToT shock for Indonesia ([Exhibit 3](#)), even after the prices of such export mainstays as CPO and copper tumbled in the last two months. The biggest remaining positive contributor – by far – is coal, whose price gains have outpaced that of other fossil fuels. And there are several good reasons to believe that coal's outperformance would continue in the near-term, most importantly vis-à-vis oil.

- The most pressing factor is of course the threat of Russia cutting its gas supplies to Europe, forcing European countries to switch to coal. A similar fear of an energy crunch also motivates countries like India to beef up their energy security by stockpiling coal. On the flip side, oil prices are under sustained pressure from the US and its G7 allies, be it via the proposed price cap on Russian oil or the release of the US' strategic petroleum reserves (SPR). Taken together, all these factors tilt the energy ToT squarely in Indonesia's favor.
- But this is far from the end of the story. Going by the ToT index alone, Indonesia should have booked monthly trade surpluses on the order of USD 7 – 8 Bn during H1-22, which is consistent with a massive annual CA surplus of about 4 – 5% of the GDP. Even the recent commodity crash would only erode that potential surplus by about USD 1.5 Bn, thanks to coal's aforementioned staying power. The problem, however, is that actual monthly trade surplus in H1-22 was only USD 4.1 Bn (on average), way lower than what we would expect from the ToT index ([Exhibit 3](#)).
- So is this big miss the result of too little exports, or too much imports? There is evidence for both, but it swings wildly from month to month ([Exhibit 4](#)). During Jan-Feb (coal export ban) and again in May (CPO export ban), exports were the clear culprit. Both times, the government halted exports in a bid to force producers' compliance with domestic market obligation (DMO) regulations – whereby a certain percentage of coal and CPO produced are reserved for domestic use at a specified (low) price, in order to maintain electricity and cooking oil prices. The problem, of course, was that the gap between this price and the global price dis-incentivized compliance and even drove exports outside of the official channels, necessitating the use of such shock tactics.

***DMO for coal and CPO  
implies tradeoff  
between inflation and  
current account  
surplus***

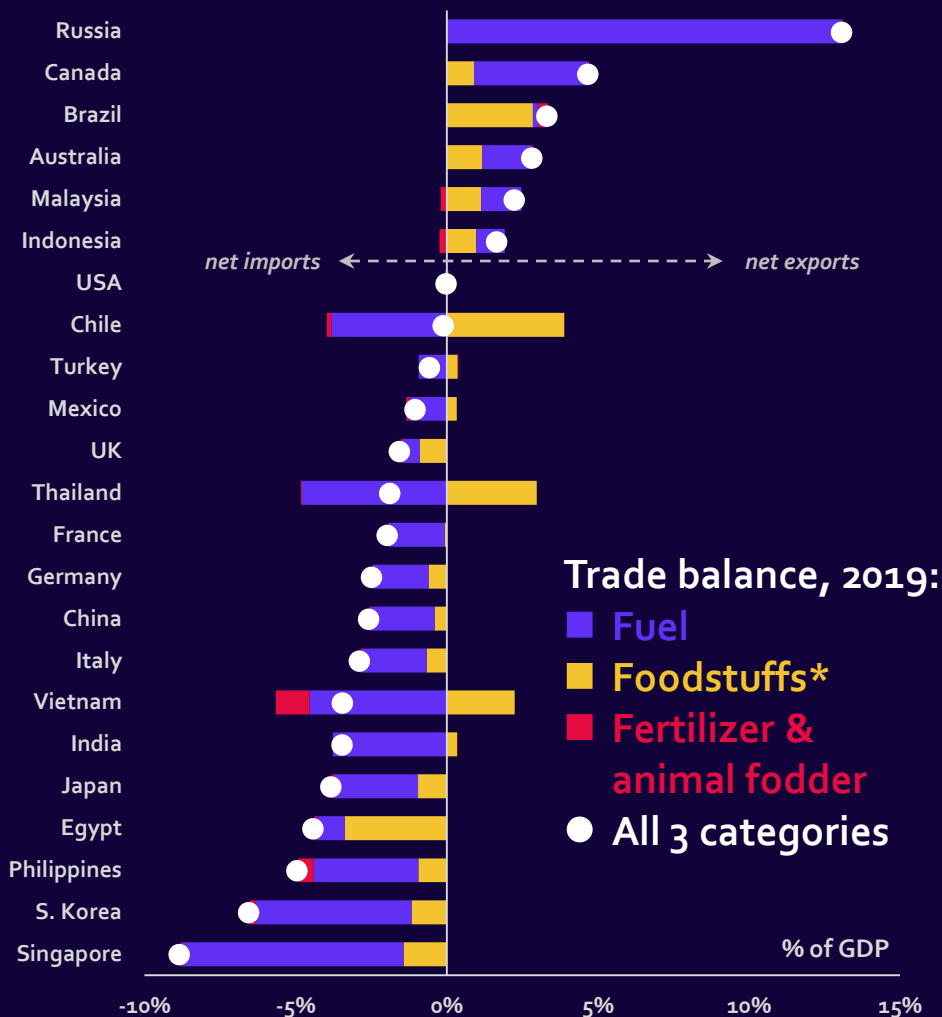
- Recently, the government is beginning to change tack towards promoting exports while cross-subsidizing consumers. This is particularly true for CPO, where the government has temporarily reduced export fees to zero, spurred by fears of falling global prices. This policy zig-zag (DMO in boom times, export promotion in bad times) shows that there is tradeoff between inflation and CA, and it is also why we think the CA may not be as overly sensitive to swings in commodity prices [\(Table 1\)](#). In other words, it may have a rather high floor but also a low ceiling.
- Import over-performance, meanwhile, is partly a function of higher global prices but also of demand recovery – in contrast to its underperformance earlier during the pandemic [\(Exhibit 4\)](#). Here there may also be tradeoff between inflation and CA. Artificially low energy prices, thanks to government subsidies, bolster consumer surplus. In turn, given Indonesia's relatively high marginal propensity to consume, this surplus is liable to be spent on more consumer goods, some of which are imported.

***Low energy prices thanks to subsidies is liable to increase imports***

- Taking all these factors together, we arrive at an estimate for trade and CA surplus that is still positive, but much narrower than what the overblown narratives about a commodity boom might have hinted at [\(Table 1\)](#). Furthermore, it appears that we are heading

for the “reversion” scenario where global demand destruction pushes down on commodity prices, at least non-energy ones. In this scenario, we expect an annual trade surplus of only about USD 35 – 40 Bn, and a corresponding CA surplus of roughly 0.3 – 0.6% of the GDP.

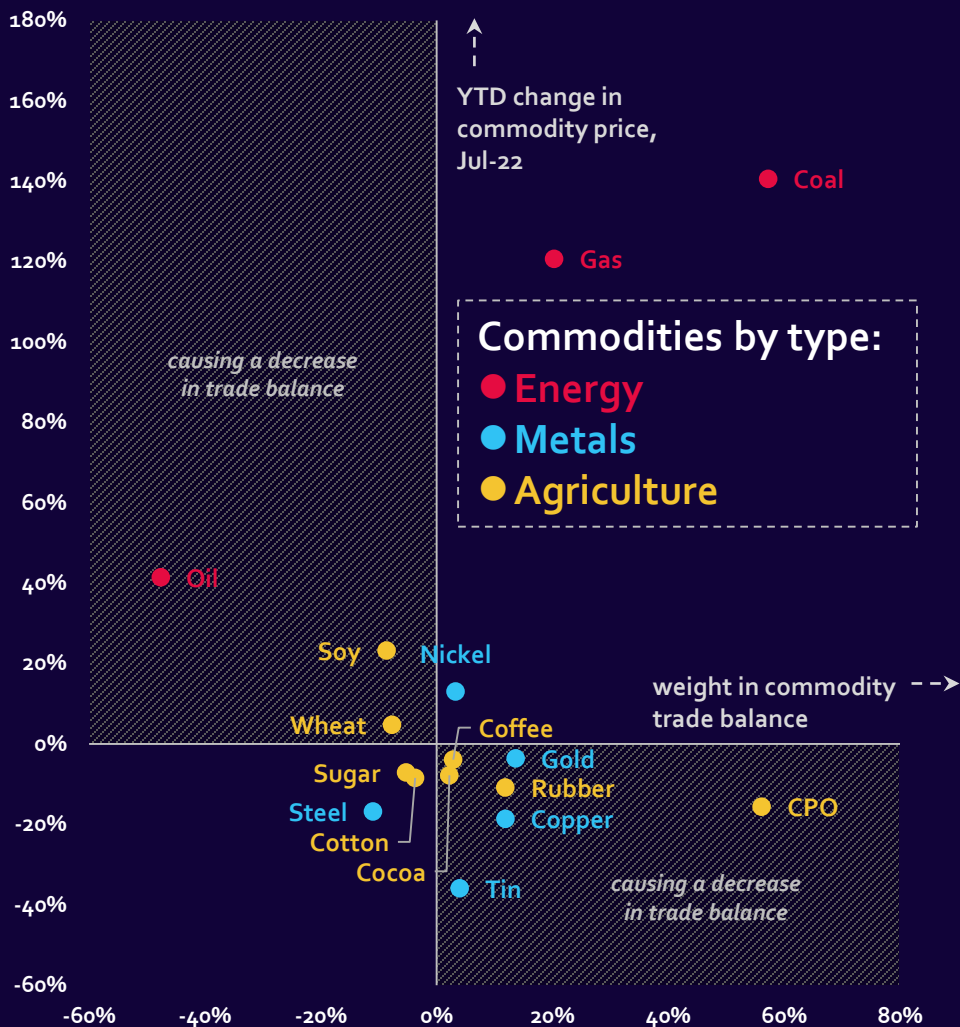
## Indonesia is quite self-sufficient in food and fuel, but does import key agricultural inputs



Source: UN Comtrade, calculations by BCA Economist

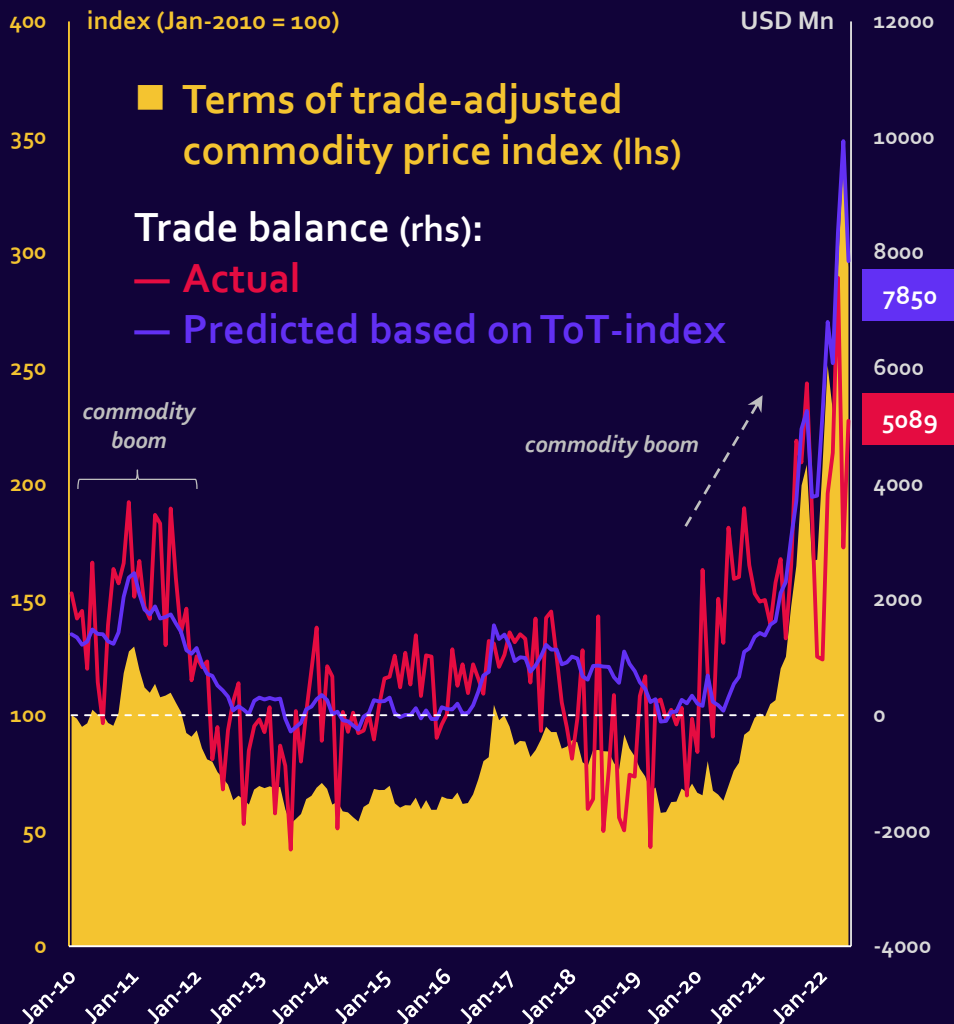
\* Excluding milled cereals and non-essential food products (tea, coffee, snacks, etc.)

## The commodity boom is fading, but high coal prices (vis-à-vis oil) still benefit Indonesia



Source: Bloomberg, UN Comtrade, calculations by BCA Economist

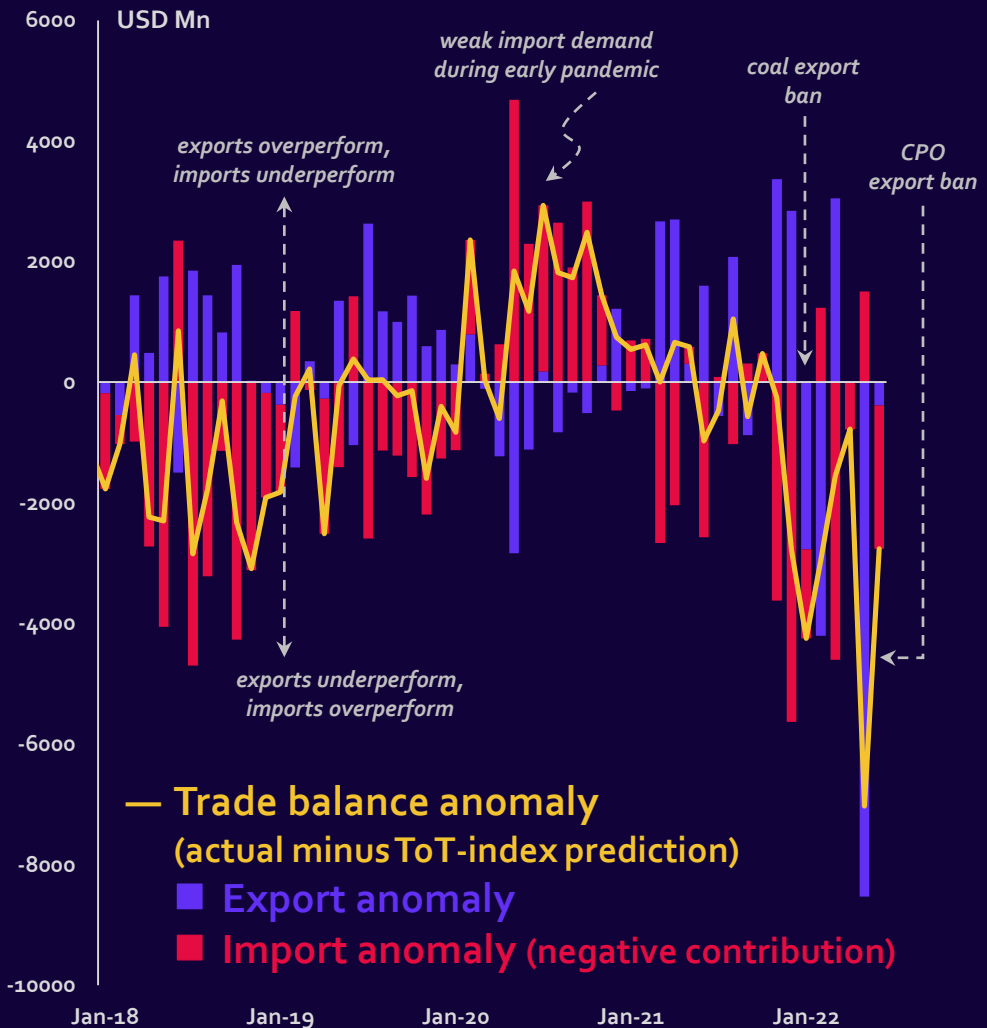
Despite lofty expectations due to commodity boom,  
the actual trade balance has fallen well short ...



Source: Bloomberg, BPS, UN Comtrade, estimates by BCA Economist



... due to a combo of export restrictions and strong demand for imports amid economic recovery ...



Source: Bloomberg, BPS, UN Comtrade, estimates by BCA Economist

... and the current account surplus is likely to be rather narrow as a result

	SCENARIOS		
	"Reversion"	"Baseline"	"Escalation"
Situation	<ul style="list-style-type: none"> <li>Global recession</li> <li>Sanctions are reversed or bypassed</li> </ul>	<ul style="list-style-type: none"> <li>Global demand slows moderately, balancing supply tightness</li> </ul>	<ul style="list-style-type: none"> <li>Renewed shocks in the energy/ commodity markets</li> </ul>
Brent Crude Price (USD/bbl)	83.8	101.0	136.3
TRADE ESTIMATES BASED ON ToT-INDEX (in % of GDP)			
Exports	22.72%	23.60%	25.59%
Imports	16.61%	16.98%	17.81%
Trade Balance	6.11%	6.62%	7.78%
ADJUSTMENTS/DEVIATIONS FROM ToT-INDEX			
Extra Imports due to Cons. Surplus	0.87%	0.94%	1.09%
Extra Imports due to Global Inflation	0.64%	0.74%	0.87%
DMO Loss (Coal)	1.11%	1.21%	1.45%
DMO Loss (CPO)	0.60%	0.63%	0.68%
Adj. Balance	2.89%	3.10%	3.69%
(in USD Bn)	36.9	39.6	47.1
CURRENT ACCOUNT BALANCE			
Service & Income	-2.37%	-2.54%	-2.72%
CA Balance	0.53%	0.56%	0.97%

Source: Estimates by BCA Economist, based on data from Bloomberg, BI, BPS, MoF, Pertamina, PLN

## ***Part B – In one way, out the other***

- The key question, of course, is whether or not this surplus provides sufficient cushion against capital outflows. At a glance, it seems good enough. In the past decade, there has seldom been an instance when the capital account (the totality of FDI, portfolio, and other investments) showed a net outflow ***(Exhibit 5)***. But unfortunately, such outflows has become more frequent since the pandemic, indicating that we are moving to a whole new territory – away from the certainties of low yields and QE – that might entail more volatile capital flows to emerging markets.
- Indeed, it looks as if the CA surplus has hardly made a dent in the face of sustained outflows. Domestic FX liquidity has shrunk, as evident from the declining purchase of BI's FX instruments by banks ***(Exhibit 6)***. This decline coincided with the period when the Fed began to hike their rates, indicating that yield-seeking capital outflows are outweighing any CA surplus thus far.
- Despite this probable balance of payment (BoP) deficit, the Rupiah is holding up quite admirably compared to many other emerging currencies. Part of the reason is, again, the positive sentiment sustained by high coal prices. This stands in contrast to several other commodity currencies, such as the Chilean Peso and Brazilian Real, which have recently declined alongside the prices of their main export commodities – copper in Chile's case, soybean in Brazil's case ***(Exhibit 7)***. A closer comparison for the Rupiah may be the Australian Dollar, which is similarly supported by coal exports, although it has also been helped by the Reserve Bank of Australia (RBA) raising rates by 125 bps year-to-date.
- Overall, though, the Rupiah's relatively flat trajectory compared to these currencies bears witness to BI's active involvement in stabilizing the exchange rate. This is a state of affairs that may not be sustainable in the medium-term.

The ratio of FX reserves to potential outflows (defined as foreign ownership of financial assets plus external debt maturing over the next year) has fallen below its long-term average ([Exhibit 8](#)). This reserve coverage ratio is strongly correlated with the Rupiah's performance over the next year, which points to the fact that reserves are more useful as deterrent rather than an actual buffer to be tapped for the Rupiah's defense. BI's has actually used its reserves more sparingly compared to some other emerging central banks (e.g. India), but we suspect that it can spend no more than 5 – 10% of its remaining reserves before this deterrent effect starts to fade.

***FX reserves are more useful as deterrent rather than an actual buffer to be spent on FX intervention***

- Another one of our favorite leading indicator for the Rupiah is the so-called FX liquidity index ([Exhibit 9](#)). Simply put, it compares the growth of FX supply – the net foreign assets (NFA) component of money supply – with FX demand. We use only FX loans from domestic banks as proxy for demand, as this constitutes

demand for FX that is not met directly by foreign inflows (as in the case of external debt), but instead by ex-nihilo creation of FX liquidity by domestic banks (i.e. Eurodollar). As we can see, the liquidity index is worsening due to both slower NFA growth and faster FX loan growth. The latter seems to be driven by investment needs in select sectors (e.g. smelters), as well as the cash flow needs of state-owned energy companies (Pertamina and PLN) which are involved in stabilizing energy prices.

- Both the reserve coverage ratio and FX liquidity index suggest that we might be at an early stage of a new IDR depreciation cycle, and – unless the Fed pivots its policy sooner – pressure might continue to build in the near-term. In this light, BI's decision to hold the BI7DRR appears to be a significant change from its posture in the recent past (2018-21), when it maintained positive spread relative to current inflation in part as insurance against global uncertainty and potential depreciation ([Exhibit 10](#)).

- Can RRR hike alone, without BI7DRR hike, support the Rupiah? The sharp RRR hike should indirectly raise long-term yields, as it forces banks to reduce their government bond (SBN) holdings. Unfortunately, the rise in long-term rates may not be as helpful for the Rupiah as that of short-term rates, as our regression results indicate [\(Table 2\)](#). In this light, BI's latest move – selling Rp 70 T worth of short-dated SBN – seems to be its way to normalize short-term rates [\(Exhibit 11\)](#) while still avoiding the optics of BI7DRR hike.
- Still, our results point to real overnight rate differentials as one of the key determinants of USD/IDR trajectory, which suggests that BI would eventually have to raise the BI7DRR. Even its current maneuvers to raise RRR and sell off SBN may eventually force it to do so, as the banks' IDR liquidity buffer is starting to thin out as a result [\(Exhibit 12\)](#). If this trend continues, the overnight money market rate would finally lift off from the lower end of BI's policy corridor (i.e. slightly above 2.75%), after staying there for most of the pandemic. Once this starts to veer towards the upper ranges of the corridor, BI would have little choice but to raise its benchmark rate accordingly.
- The fact that long-term rates matter less for the Rupiah than short-term rates may seem counterintuitive, given that foreign investors – who conventionally hold the whip hand on emerging currencies – tend to invest in longer-dated bonds. However, foreign holdings of SBN have fallen precipitously since the start of the pandemic, to the point where foreign private investors now count for just 11% of total [\(Exhibit 13\)](#). So from the perspective of bonds, Indonesia is indeed less vulnerable to sudden shifts in investor sentiment, and is therefore in a better position especially compared to taper tantrum in 2013.

***Evidence from recent years shows that short-term rates are more relevant than long-term rates for IDR exchange rates***

- Instead, the sensitivity to short-term rates hints at a different challenge for Indonesia. A significant portion of the commodity windfall may not end up inside the Indonesian financial system, but either flows out or retained abroad. Some of these outflows might in fact go unrecorded, as there is some correlation between export booms and net errors and omissions (NEO) in the BoP statistics ([Exhibit 14](#)) – NEO being a common proxy for illicit capital flows in academic literature. This “leaky windfall” could be an explanation as to why the supposed windfall has hardly been able to offset the capital outflows ([Exhibit 6](#)).

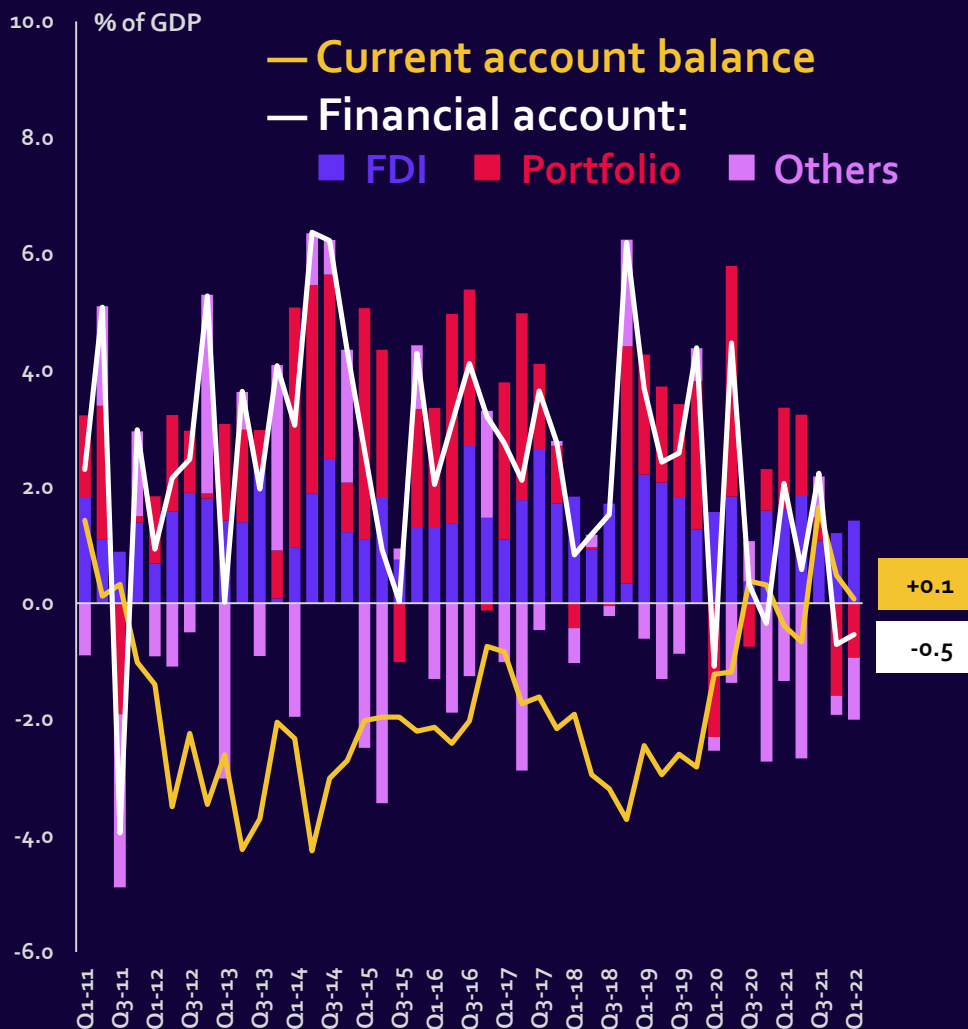
*Some portion of the commodity windfall may either flow out or retained abroad*

- How can the authorities stanch such outflows? This is partly a structural issue, as some mines and plantations are controlled by foreign shareholders who would prefer to park their export

receipts elsewhere. But – as we hinted before – there may also be a cyclical component to it, driven by difference in short-term returns. The current situation, where global USD deposit rates have risen in line with Fed funds’ rate while the corresponding rates in Indonesia has not, has made depositing export receipts in Indonesian banks unattractive. In this situation, it would be necessary for the deposit insurance agency (LPS) to raise its threshold on insured FX deposits from the current 0.25%, which would allow banks to raise their rates accordingly.

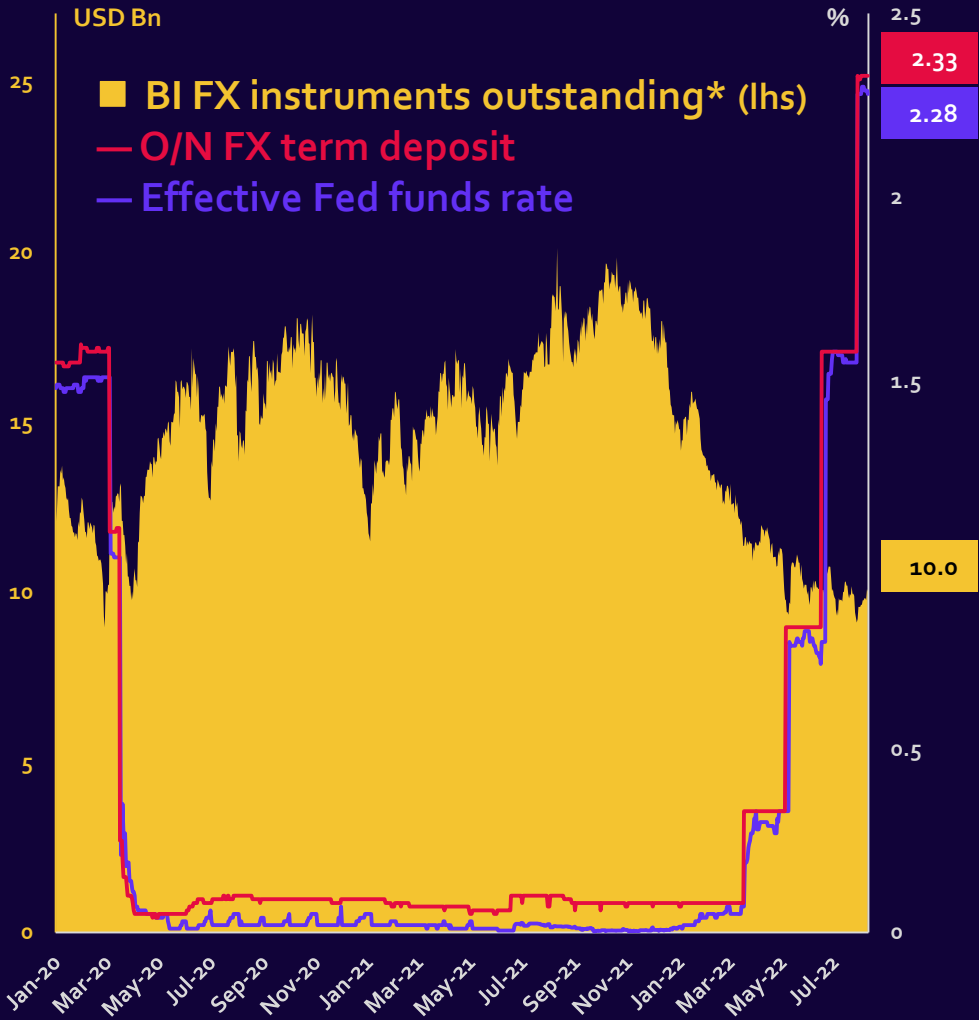
- The bottom line is thus quite clear. CA surplus helps, but the leaky windfall, the strong domestic demand for FX, and the enormity of the global monetary regime change means that monetary tightening – including, ultimately, BI7DRR hike – is likely still needed if BI is to stabilize the Rupiah around its current levels. Unless, of course, BI finds an overly-strong Rupiah undesirable – a possibility that we will return to in [Part D](#).

The improving current account is a fortunate development as capital inflows grow more uncertain



Source: BI, BCA Economist

### Despite the commodity windfall, FX liquidity in the banking system has actually declined

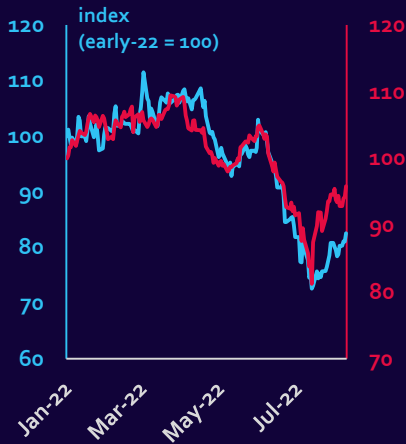
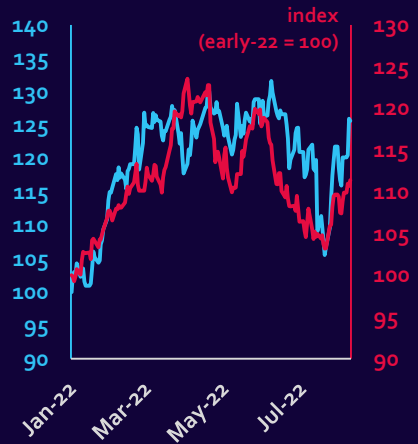
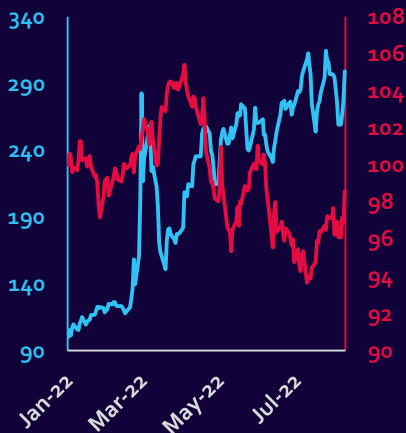
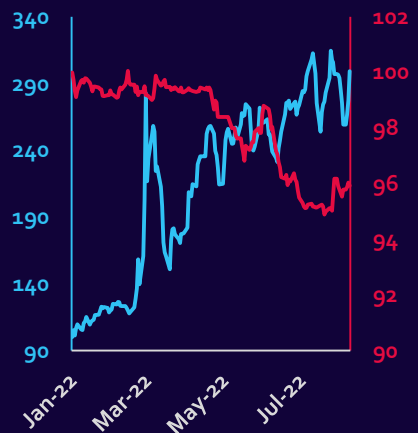


Source: BI, St. Louis Fed, BCA Economist

\* The total of FX term deposit, FX certificate, and FX swaps

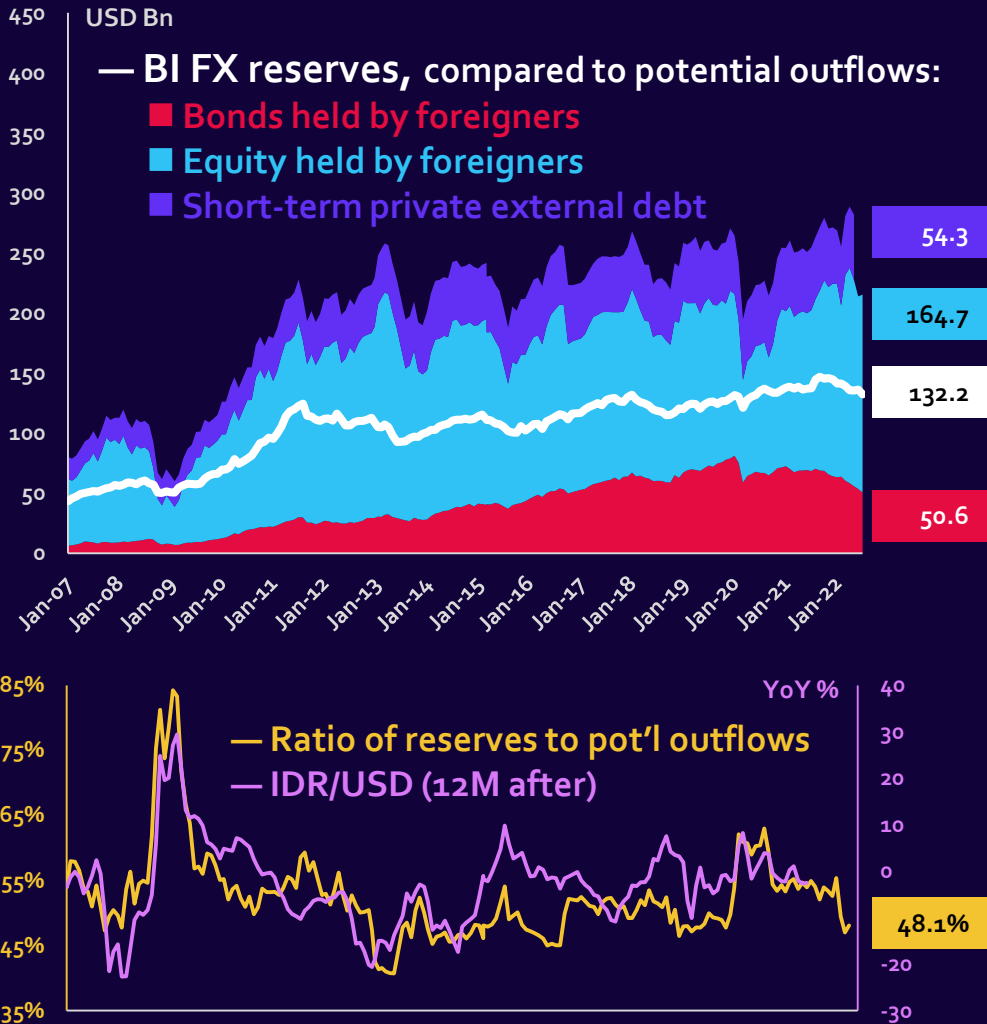


# The Rupiah has been supported by high coal prices, and stabilized by BI interventions

**Copper vs. Chilean Peso**

**Soybean vs. Brazilian Real**

**Coal vs. Australian Dollar**

**Coal vs. Indonesian Rupiah**


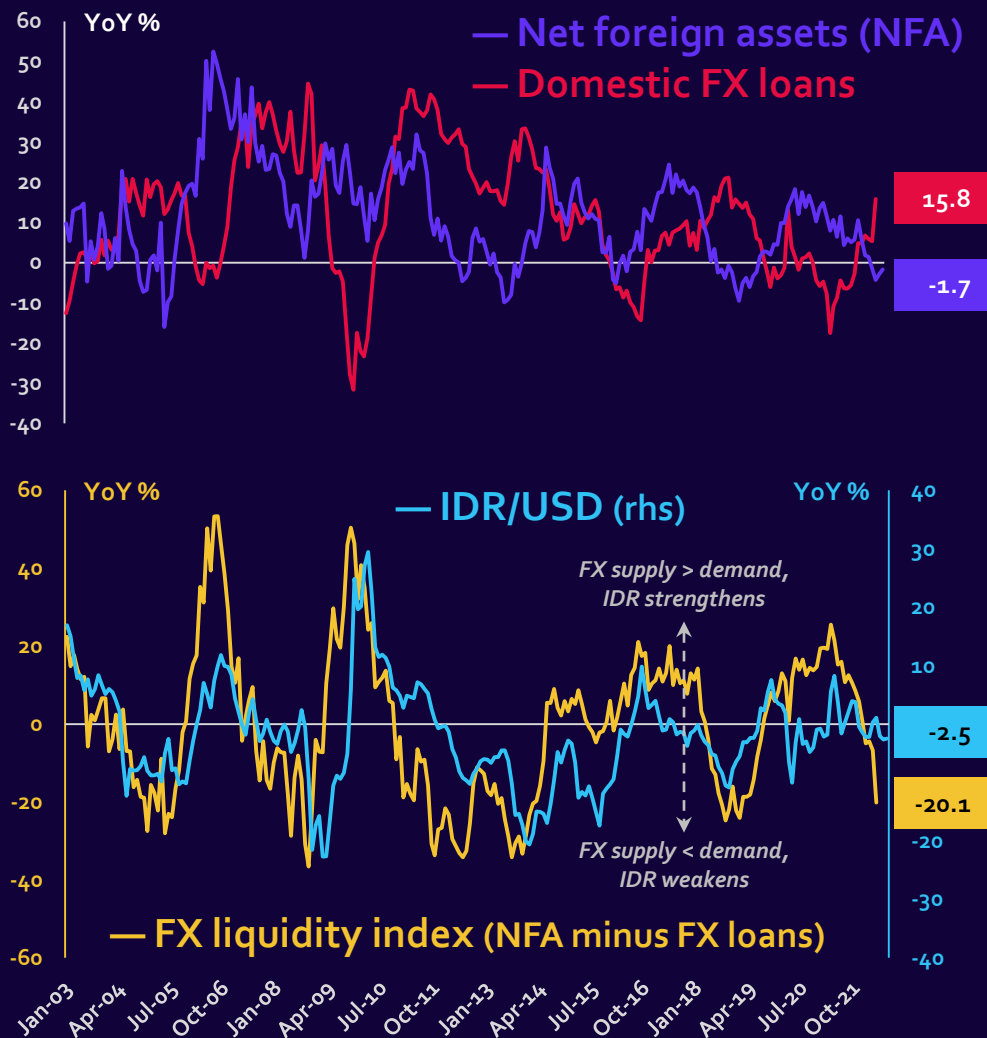
Source: Bloomberg, BCA Economist

## Declining reserves relative to potential outflows may predict more IDR depreciation ahead ...



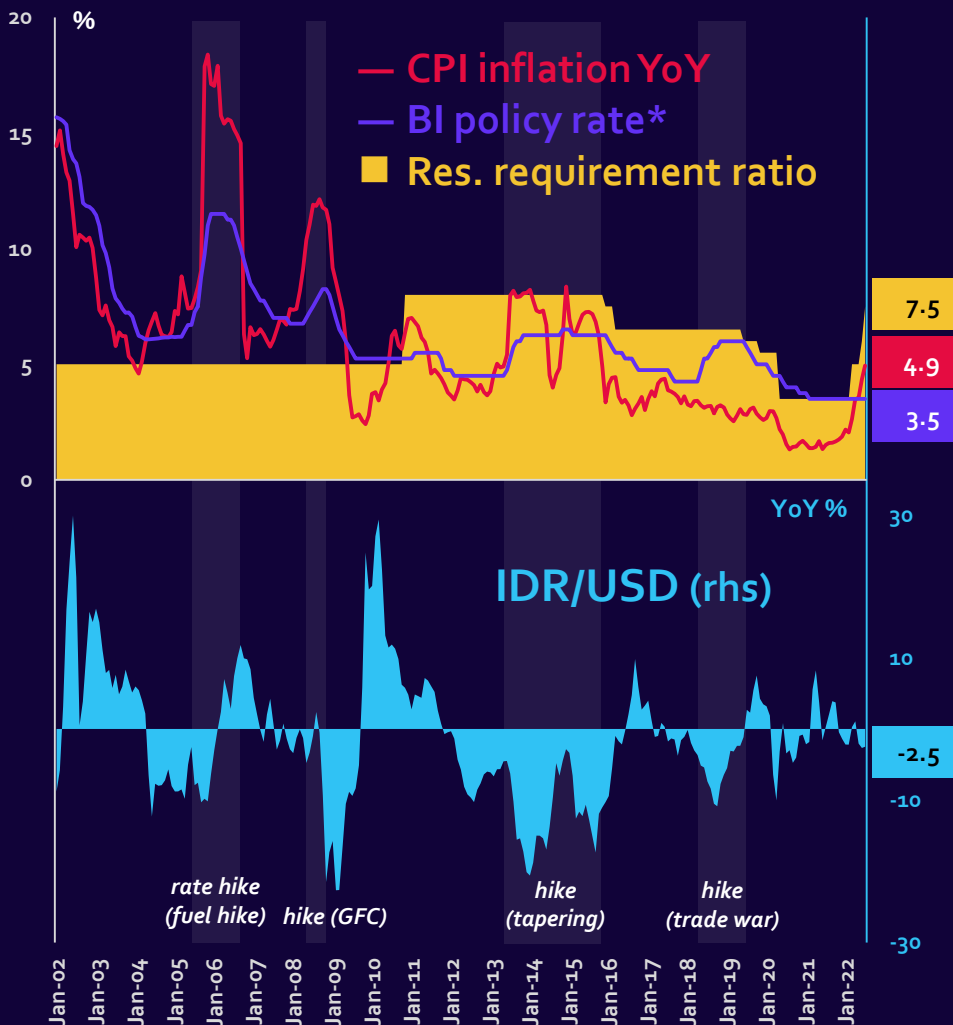
Source: BI, MoF, KSEI, Bloomberg, calculations by BCA Economist

... as does the strong demand for FX loans,  
a sign of limited FX liquidity at home



Source: BI, OJK, Bloomberg, calculations by BCA Economist

BI hikes RRR but eschewed raising the policy rate, a shift from the positive real rate of recent years



Source: BPS, BI, Bloomberg, BCA Economist

\* Merger of three policy regimes: SBI auctions (to Jun-05), BI Rate (to Jul-16), and 7-day Repo Rate

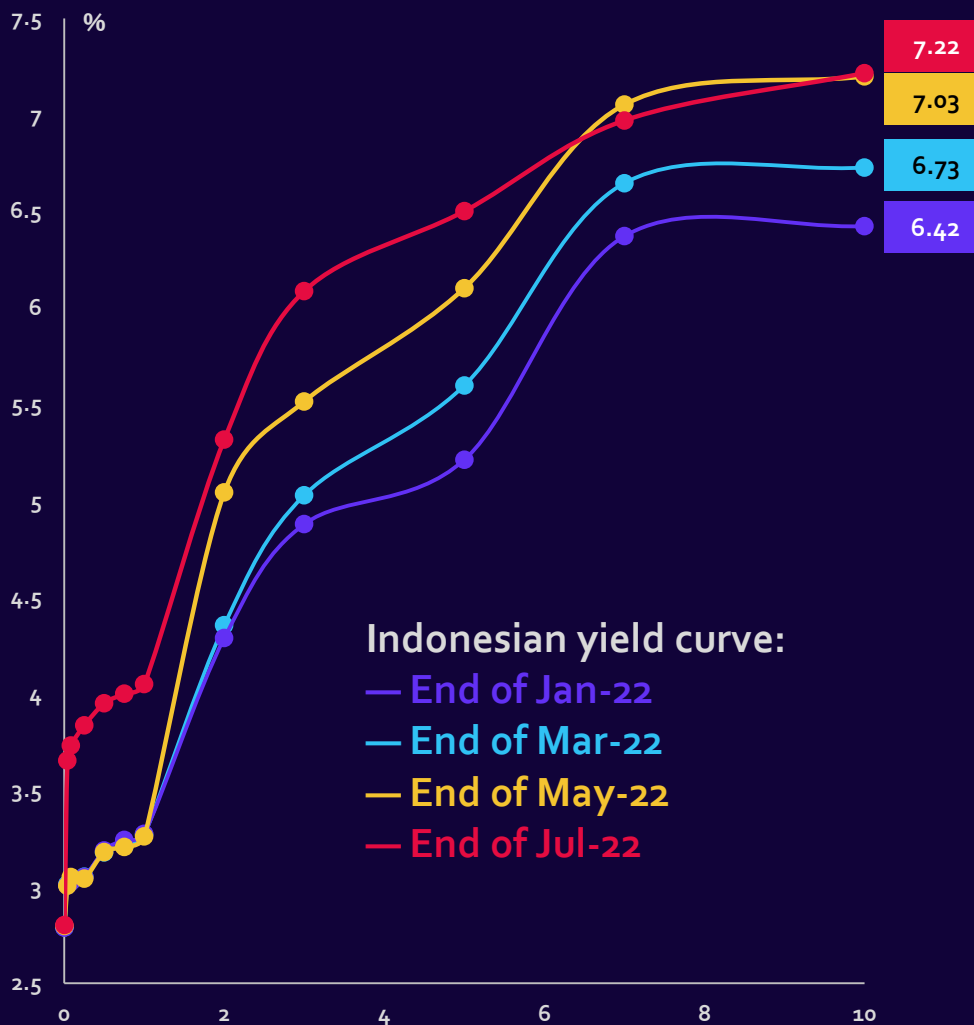
## Real overnight rates are better determinants of exchange rates compared to long-term yields

Interest Rate Differential (Indonesia vs. US)			REGRESSOR FOR IDR/USD (sequential addition of variables)			
			Bivariate	+ Reserve ratio (lag-12M)	+ FX liquidity index	+ CDS 5Y
Nominal	O/N	$\beta$	-0.214	-0.277	-0.016	1.166**
		R <sup>2</sup>	0.1%	48.2%	63.0%	66.3%
	1Y	$\beta$	-0.686	-0.315	-0.524*	0.316
		R <sup>2</sup>	1.4%	48.3%	63.7%	64.9%
	5Y	$\beta$	-1.653**	-0.557	-1.183***	-0.669
		R <sup>2</sup>	3.9%	48.4%	64.7%	65.0%
	10Y	$\beta$	-1.431	-0.168	-1.850***	-1.514**
		R <sup>2</sup>	2.1%	48.0%	65.9%	66.1%
Real (using current inflation rate)	O/N	$\beta$	1.702***	0.766***	0.573***	0.401*
		R <sup>2</sup>	21.3%	51.6%	64.8%	65.5%
	1Y	$\beta$	1.661***	0.766***	0.364	0.179
		R <sup>2</sup>	18.3%	51.4%	63.6%	64.9%
	5Y	$\beta$	1.204***	0.560***	0.242	0.017
		R <sup>2</sup>	12.8%	50.5%	63.4%	64.8%
	10Y	$\beta$	0.969***	0.463***	0.170	-0.064
		R <sup>2</sup>	11.1%	50.4%	63.2%	64.8%

Source: Estimates by BCA Economist, based on data from Bloomberg, BI, OJK, KSEI, MoF

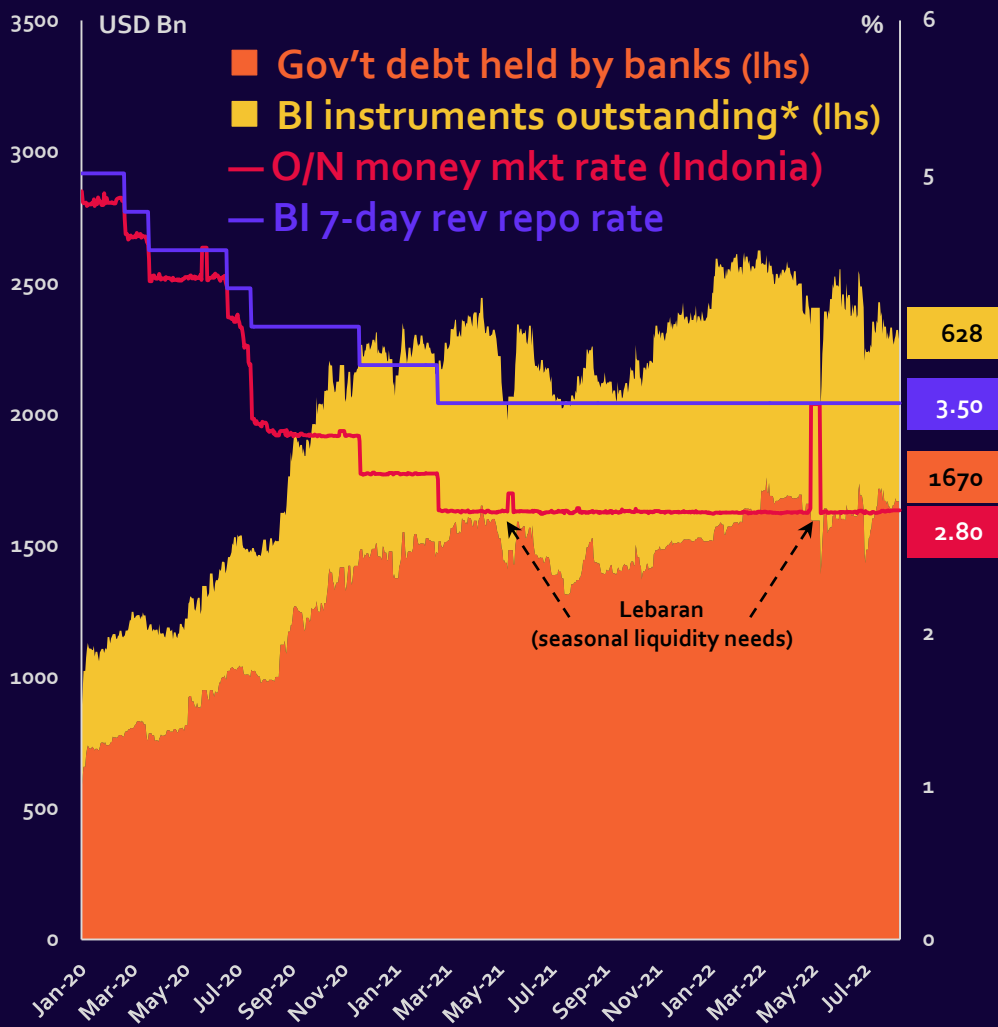
\* Significant at 1% level    \*\* Significant at 5% level    \*\*\* Significant at 10% level

Yields are gradually rising, first in the longer-end and more recently in the shorter-end as BI sold off bonds



Source: BI, Bloomberg, BCA Economist

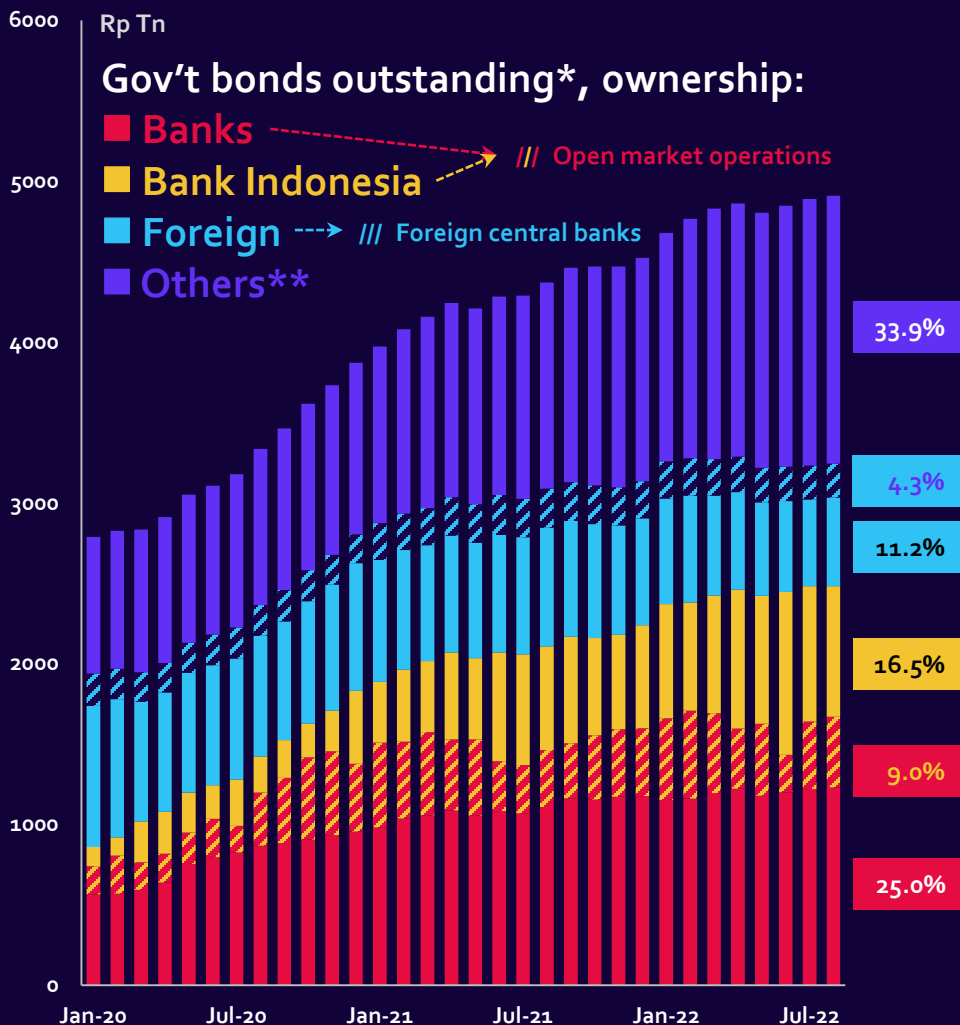
## Money market rates have stayed near the bottom, but excess IDR liquidity is starting to decline



Source: BI, MoF, Bloomberg, BCA Economist

\* Total of term deposit, BI certificate, reverse repo, deposit facility minus repo and lending facility

As foreign bond investors fail to return, the gov't bond market is increasingly reliant on banks and BI

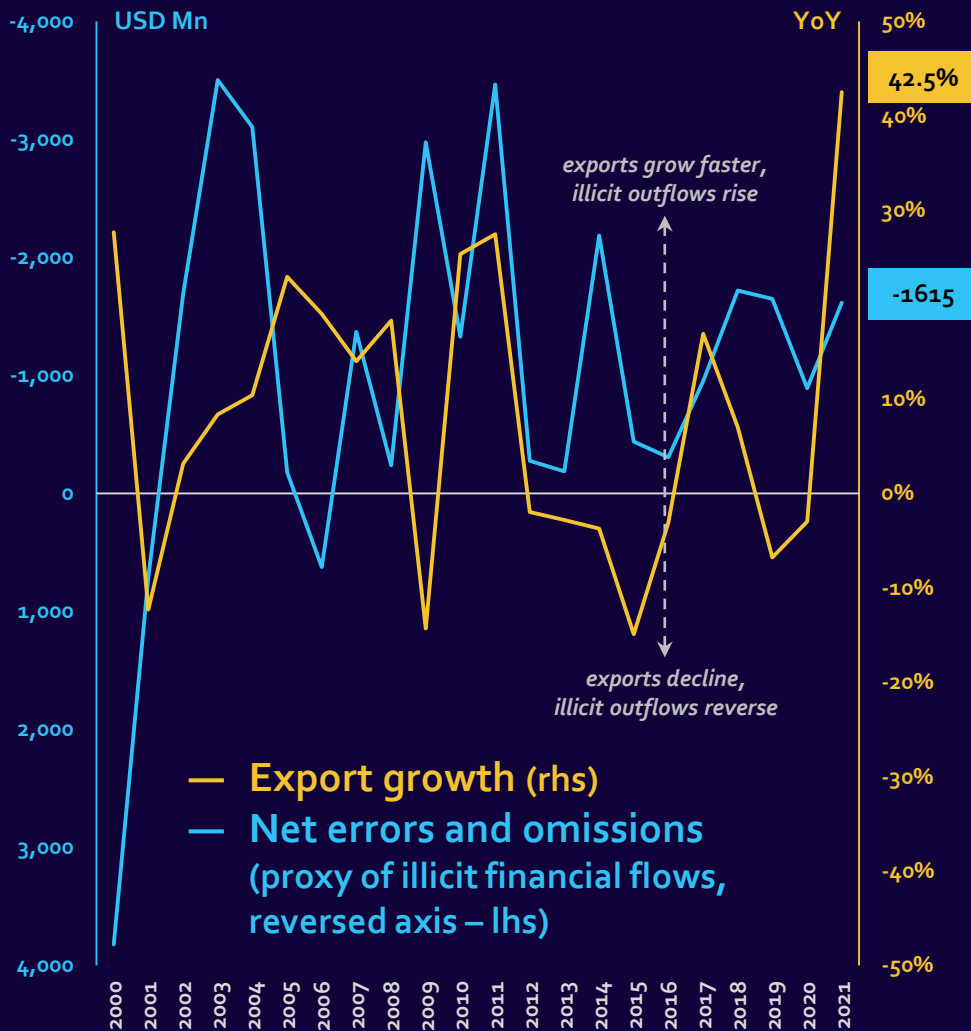


Source: MoF, BCA Economist

\* IDR bonds only



## Indonesia suffers from chronic illicit outflows, which could worsen during commodity booms



Source: BPS, BI, BCA Economist

## **Part C – Surplus sectors, deficit sectors**

- The CA is of course a reflection of the savings-investment (S-I) gap – meaning that Indonesia as a country is probably saving more than it borrows this year. The saving and borrowing, however, are not distributed equally, as we can glean from sectoral loans/bonds and deposits data **(Exhibit 15)**.
- Overall, the data agrees with our view of a narrow and leaky surplus, with the S-I gap moderating despite robust commodity prices in H1-22. We can see that the private corporate sector has been a massive net saver since the start of the pandemic, and continues to do so to this day. Meanwhile, the government has been the biggest net borrower, but it has become a net saver recently as revenue from taxes and commodities improve.
- The two other sectors – households/ small businesses and state-owned enterprises (SOEs) – are showing similar trends: record-high surpluses earlier in the pandemic, followed by a sharp reduction around mid-2021 – but for different reasons. Households' pent-up demand was

***The private corporate sector has been a massive net saver since the start of the pandemic***

unleashed following the end of the Delta wave in Sep-21, and they even flipped to become net borrowers thanks to steady growth in consumer loans. On the other hand, SOE surplus peaked in Q2-21, before oil price began to climb above USD 70/barrel. The decline thus appears to be related to the dwindling cash flows of Pertamina, offset to some extent by increasing revenues from commodity-exporting SOEs such as Antam and Bukit Asam.

- This pattern of commodity-fueled surplus and consumption/subsidy-induced deficit is one that we have seen in [Part A](#). But there are subtler insights that could be found by digging down further. We do this by using BCA's own transaction data (big data), where we can subdivide the business sector by industries and individual customers by their apparent wealth levels.
- The main index that we derive out of these data is the "business revenue index", which is derived by aggregating inflows into business accounts. It is essentially a proxy of nominal output, which as we can see [\(Exhibit 16\)](#) is returning to its pre-pandemic growth trends, notwithstanding the recent fluctuations due to Omicron, Ramadan, and the typical swoon in activity following Lebaran holidays. This does not mean that the economy has recovered fully – that would entail \*real\* growth returning to trend, which is not the case – but it does have important consequences.
- What we call "nominal gap", i.e. the discrepancy between the index and its pre-pandemic trend, is probably reflective of credit risk, particularly on obligations made prior to the pandemic. Presumably, such loans were made with the assumption that revenue would continue to grow in line with prior trends in each respective industry. The fact that the nominal gap is now close to zero means that there is sufficient liquidity within the system to fulfill all those pre-existing obligations. It also points towards an oft-overlooked fact that inflation can help ease debt burdens.
- When we dig down at industry level, however, the heterogeneity becomes clearly apparent. Revenue in tourism, for instance, has remained more than 40% below its pre-pandemic trend [\(Exhibit 17\)](#), whereas the coal and CPO sectors have far exceeded theirs.

***Revenue in some sectors like tourism has remained far below their pre-pandemic trends***

So the recovery is highly uneven, and there are potentially significant amount of non-performing loans – albeit concentrated in certain sectors – once the restructuring period ends at the close of Q1-23. For this reason, plus the great uncertainty that we would face in the next year, we expect the restructuring deadline to be extended further.

- Alongside the nominal gap, we also calculate each industry’s “saving rate” ([Exhibit 18](#)), i.e. how much of the revenue within each sector is left unspent. High saving rates reflect – for lack of a better word – conservatism, as businesses spend smaller portions of their revenue on operations and CAPEX.

The pandemic has made the business sector much more cautious ([Exhibit 20](#)), which mirrored the improving S-I gap and CA balance in 2020-21 ([Exhibit 15](#)). But just like the S-I gap, this trend has reversed in recent quarters, to the point where spending had outstripped income by Q2-22.

***Business spending has begun to rise recently, but very unevenly so loan growth and extension of restructuring deadline remains crucial***

- What explains this decline in saving rates? The decline was relatively broad-based, but what we saw in Q2-22 was concentrated particularly in infrastructure-related and primary sectors ([Exhibit 21](#)). The former was likely related to the resumption of infrastructure projects, after a long postponement in 2020-21. Meanwhile, the latter seems to be caused by a confluence of several factors, notably higher CAPEX (particularly for smelters), Pertamina’s cash flow pressures, as well as DMO and export bans.
- So the decline was indeed associated with faster growth and policies to curb inflation. However, saving rates are also quite variable across different industries. When plotting saving rate against nominal gap ([Exhibit 19](#)), we can see a rough “swoosh-shaped” relationship between the two. Those most affected by the pandemic like tourism and restaurants tend to have high saving rates, which is understandable given their need to operate more efficiently.

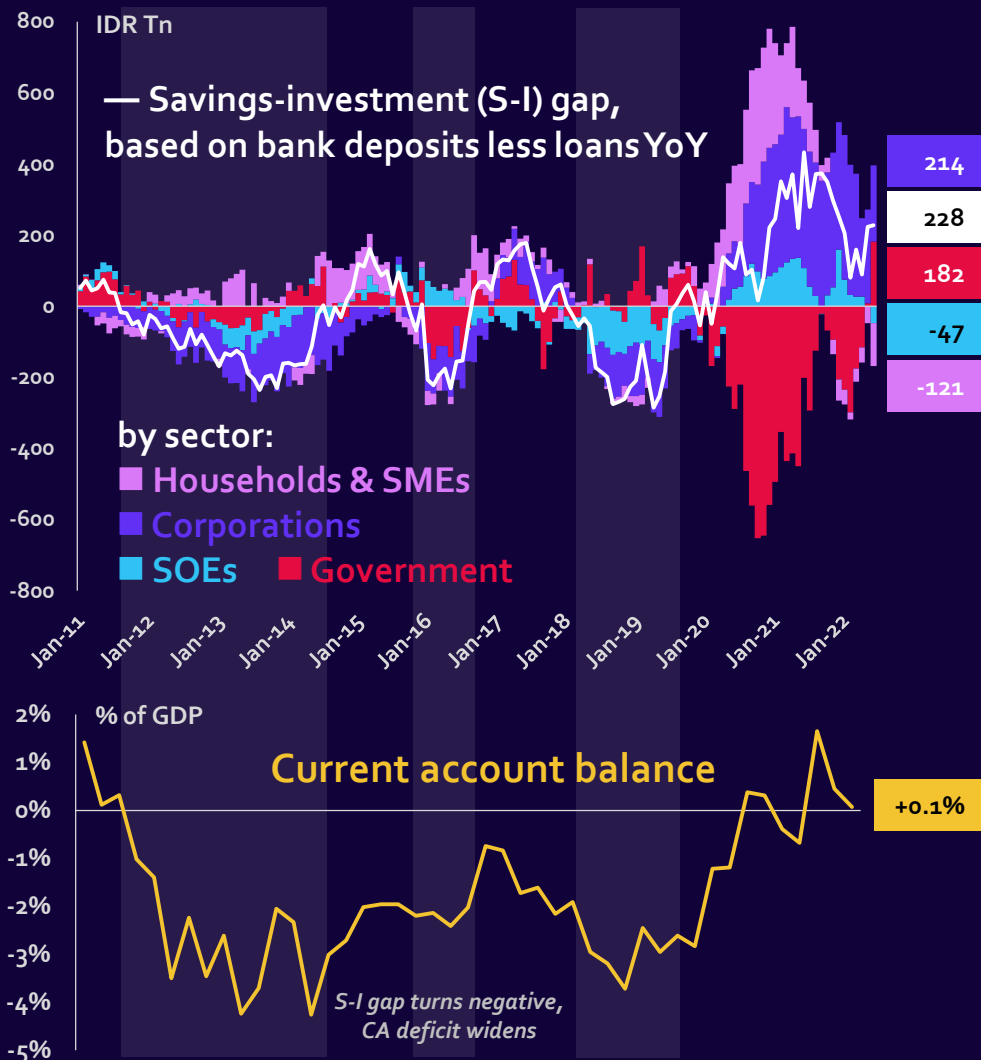
- But sectors with positive nominal gap also tend to show high saving rates, with coal being the highest of all. This indicates that – for all the windfall profit being generated – the coal industry is still disinclined to expand their operations. It is a pattern similar to what we are seeing in fossil fuel industries across the world, where CAPEX is tempered by concerns that the energy boom may not last, and that this might be their last hurrah before transition to renewables would permanently undercut their income.
- Such views are much less prevalent for CPO and metals, which seem to be embarking on a fresh CAPEX cycle (replanting and building smelters, respectively). However, the fact that their prices have recently fallen could eventually limit the amount of new projects in the pipeline. There is thus a paradox: coal, which has the most “ammunition” so to speak, has less to spend on compared to other sectors which enjoy much narrower surplus. Thus, without strong loan growth – or coal business owners diversifying to other industries – the windfall from coal may remain underutilized.

***Evidence from big data also shows that inequality among households may have widened during the pandemic***

- A similar analysis on individuals’ transaction data shows similarly uneven windfall. Our highest segment, corresponding to the top 2% of our individual customers, are now earning a lot more than what would be expected based on their pre-pandemic trend ([Exhibit 22](#)). On the flip side, incomes for the majority of lower- and middle-class

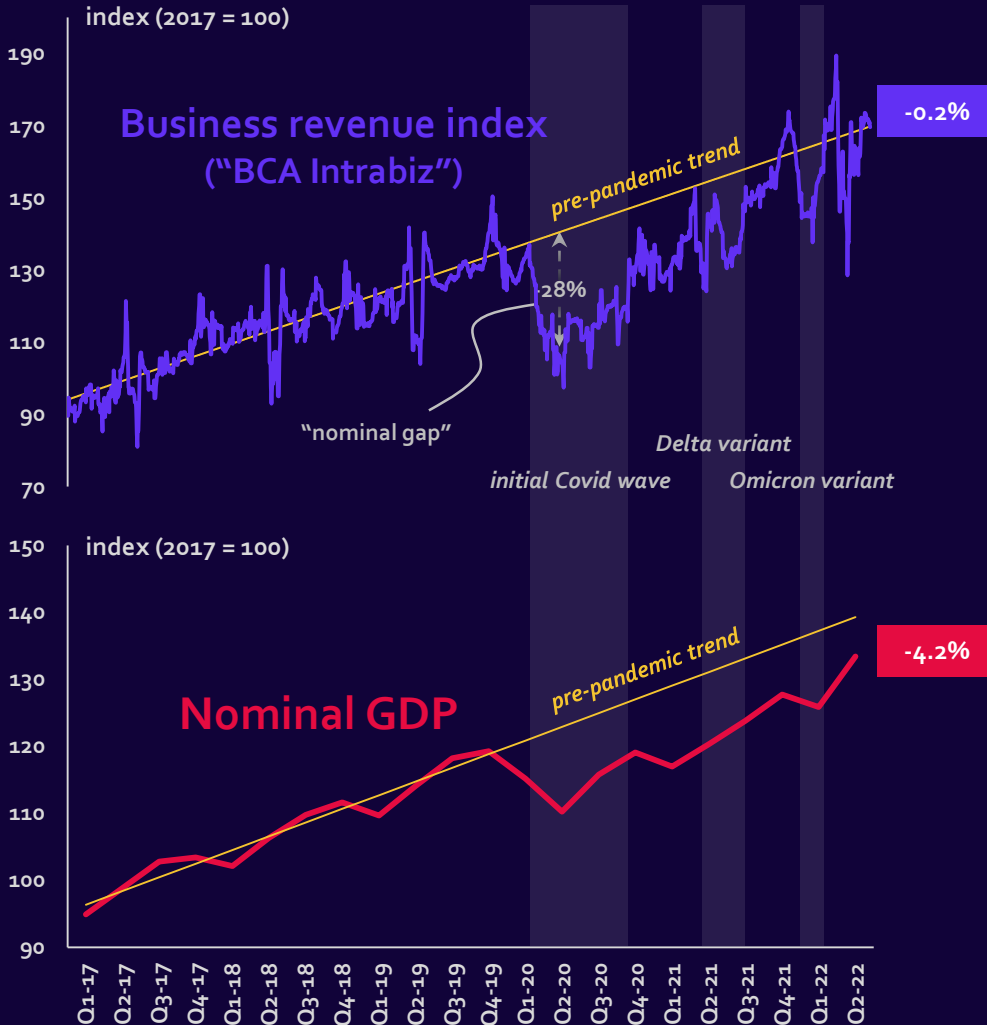
customers have not returned to trend. This suggests that the pandemic has widened inequality, despite the government’s extensive support in the form of social spending and incentives for small businesses for the past three years. Such situation, ahead of a putative global recession and less than two years before the next General Elections, put the government in a rather difficult spot.

## Corporate (and recently gov't) financial surpluses mirror the probable current account surplus



Source: BI, calculations by BCA Economist

### BCA big data point in the direction of recovery, at least in nominal terms ...



Source: BCA Big Data, BPS, calculations by BCA Economist

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## **Part D – A high-pressure economy?**

- In theory, such uneven recovery provides rationale for the authorities to continue running expansive policies, both monetary and fiscal. Credit and fiscal transfers are both means by which liquidity can be redistributed to “deficit sectors” (those with negative saving rates and/or negative nominal gap), especially in situations where the windfall either flows abroad or are often left unspent as we have outlined.
- Unfortunately, this logic does not mesh with the challenging global situation, where we are seeing not just a potential weakening of the Rupiah (**Part B**) but also a dramatic rise in global inflation. Similar to the exchange rate, Indonesia’s inflation is quite modest compared to other emerging countries. However, this comes at considerable cost, and Indonesia has also caught some lucky breaks along the way which might not persist in the future.
- Much of the uptick in inflation during recent months has been caused by the so-called volatile foodstuffs (**Exhibit 23**), such as chili peppers which has been hampered by bad harvests and cooking oil due to high CPO prices. However, these items account for relatively small parts of the consumption basket, while the three most consequential items by far – rice, fuel, and electricity – have stayed mostly stable (**Exhibit 24**). Rice, of course, has been much less affected by the Ukrainian War compared to other staple cereals. Meanwhile, low fuel and electricity prices are sustained by subsidies, and price adjustments thus far have been limited to items that are typically consumed by the relatively few high-income households.

***The three most consequential items to inflation have so far stayed mostly stable***

- Furthermore, we would argue that Indonesian inflation is partly helped by its large amount of manufactured imports from China ([Exhibit 25](#)), which due to its robust supply but weak demand (amid lockdown) has become an inflation “dampener” for its trade partners. But despite this, imported inflation – particularly on raw materials – have been in double-digits in the past year ([Exhibit 23](#)). Local producers and importers had been reluctant to pass on this higher cost to consumers, but this may be changing, as evident from the gradual increase in core inflation. We should emphasize, too, that such high imported inflation has happened despite limited depreciation, so core inflation could rise even further if the Rupiah weakens anew.
- Minimizing inflation, then, would involve pairing expansive fiscal policies with monetary tightening ([Table 3](#)). The latter is crucial not only to stabilize the Rupiah, but also to curtail the expansion in money supply while money velocity continue to rise as the economy recovers ([Exhibit 26](#)). To this end, BI could reduce base money growth by selling its SBN holdings, and also reduce the money multiplier by discouraging bank loan growth. Given the policy changes that we have mentioned, it seems that BI is actually doing both, albeit sans BI7DRR hike.
- Unfortunately, this policy setup could also lead to “Dutch disease” in the long-run, as it maintains a strong Rupiah while subsidizing consumption at the expense of productive investment. Indeed, the Rupiah has been among the stronger commodity currencies in real terms during the past decade ([Exhibit 27](#)), and BI may be open to changing that to restore the competitiveness of Indonesia’s manufacturing sector.

*The Rupiah has been among the stronger commodity currencies in real terms during the past decade*

- The opposite setup – tight fiscally, loose monetarily – is the policy combo that can best prevent Dutch disease, but it would also cause a sharp (but potentially brief) spike in inflation. The case for subsidy reduction is nonetheless quite clear: the budget deficit is expected to return to its usual legal limit at 3% of the GDP in 2023, while interest payment increases due to rising rates. Energy subsidies are very expensive at more than 2.6% of the GDP (Exhibit 28), and as oil prices may remain elevated (i.e. above USD 80/barrel) in the medium-term, expecting an “organic” reduction in outlays without letting fuel prices rise is a dubious prospect.
- Meanwhile on the revenue side, expecting this year’s strong growth to continue into 2023 is also questionable, as the strong nominal GDP growth and highly favorable commodity ToT index might not be replicated next year ([Exhibit 29](#)). Maintaining energy prices at current levels would thus require cuts in other government expenditures, including potentially on infrastructures.

***Maintaining energy prices at current levels through the next fiscal year might require cuts in other expenditures***

- We would argue that such tradeoff – substituting government CAPEX for subsidies – may actually detract from growth, even in the short-run. Except for the pandemic, consumption (basic and discretionary) has been very resilient, consistently contributing about 2.8% to GDP growth even amid a series of fuel price hikes in 2013-14 ([Exhibit 30](#)). Now, with

consumption’s contribution back to pre-pandemic norms (2.92% in Q2-22), keeping subsidies no longer adds much to growth, but would instead limit contribution from government spending and fixed-asset investment.



- So there is no safe and obvious choice going forward. Loose fiscal-tight monetary (LF/TM) is not ideal for the long-run, while the opposite (TF/LM) may impose unacceptably high inflation. “Double tightening” (TF/TM) is certainly the most negative for growth, especially for the deficit sectors as we have discussed.
- Short-term political concerns might eventually lead us towards LF/TM, but for the time being the situation can still be described as LF/LM. Aside from the lack of BI7DRR hike, there are multiple reasons why BI’s posture is still basically accommodative, including relaxation of loan-to-value (LTV) rules for consumer loans (until year-end) and also continued moral suasion for banks to lower their benchmark lending rates.
- But perhaps the policy that is most decidedly accommodative is the requirement (RPIM) for banks to increase lending for small/medium enterprises (SME), where it has to comprise 20% of their portfolio by the end of 2022. As a result, SME loans have grown very rapidly, to the point where they comprise 30% of all loan growth in the past year. Hiking BI7DRR now may thus be akin to stepping one foot on the gas pedal and the other on the brakes at the same time, with the RPIM serving to counteract BI’s effort to control the money multiplier.
- As such, the situation in the next few months might resemble what some have called “high-pressure economy”. This is where the authorities let the economy run slightly hotter than what might be deemed prudent, in the hope that it will bolster employment and improve competitiveness (by weakening the currency). There is no “grand unified theory” for this kind of policy, but some recent leaders – notably Donald Trump and Turkey’s Recep Tayyip Erdoğan – has been claimed as its exponents.

*The situation in the next few months might resemble what some have called “high-pressure economy”.*

- The success of such policy, however, greatly depends on context. If we disregard the sound and fury of his tariff wars, Trump actually succeeded in attaining very low unemployment rates before being derailed by the pandemic. Erdoğan's version, however, led to a spiral of depreciation and inflation which Turkey has not gotten out of. Of course, Erdoğan has two disadvantages relative to Trump, namely that the Lira is not a reserve currency and that Turkey is an energy importer ([Exhibit 1](#)) – meaning that once energy prices started to spike in Q4-21, the Lira's value cratered.

***Global recession and continued QT would lead to a much less benign situation for Indonesia***

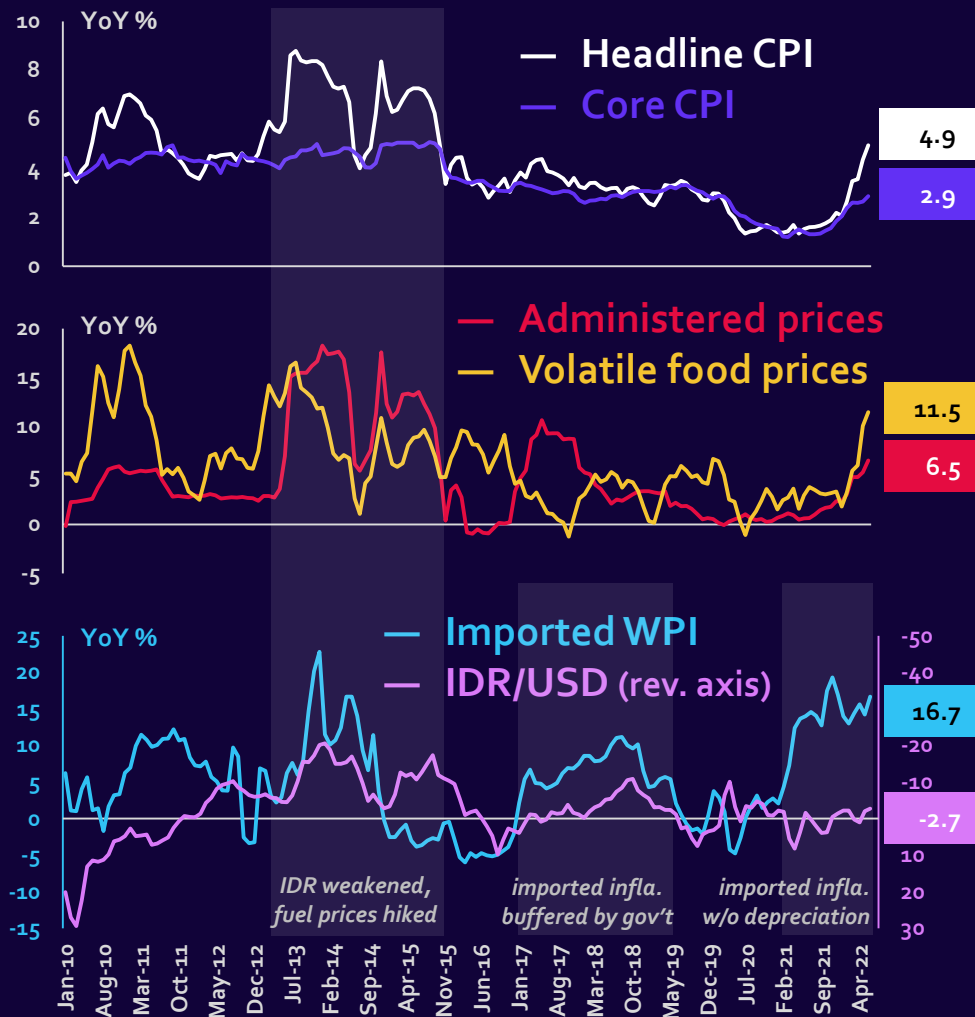
- So what is the context for Indonesia? Unlike Turkey, Indonesia is a commodity exporter, and thanks to BI's reforms in the mid-2010s, it is a less heavily Dollarized economy. Thus, while high commodity prices and strong USD are very disadvantageous for Turkey, it is much less punishing for Indonesia.

However, if the world is plunging into a recession and the Fed does not pivot fast enough – or its quantitative tightening (QT) outweighs a pivot in rates – we might be entering a much less benign situation for Indonesia ([Exhibit 31](#)).

- In a way, we see some parallel between the current “Powell shock” and the old “Volcker shock” of 1980-81. Thanks to higher debt levels and an older US/global demographics, Powell may not need to raise rates up to 20% (like Volcker) to fight inflation and to trigger a recession. The Volcker shock, we should recall, led to the slowest growth rates in the Suharto era prior to the 1998 crisis ([Exhibit 32](#)), as the economy came off the sugar high of the oil/gas boom. The New Order government had to reform the economy in order to attract FDI, which would eventually usher an era of industrialization in the early 1990s.

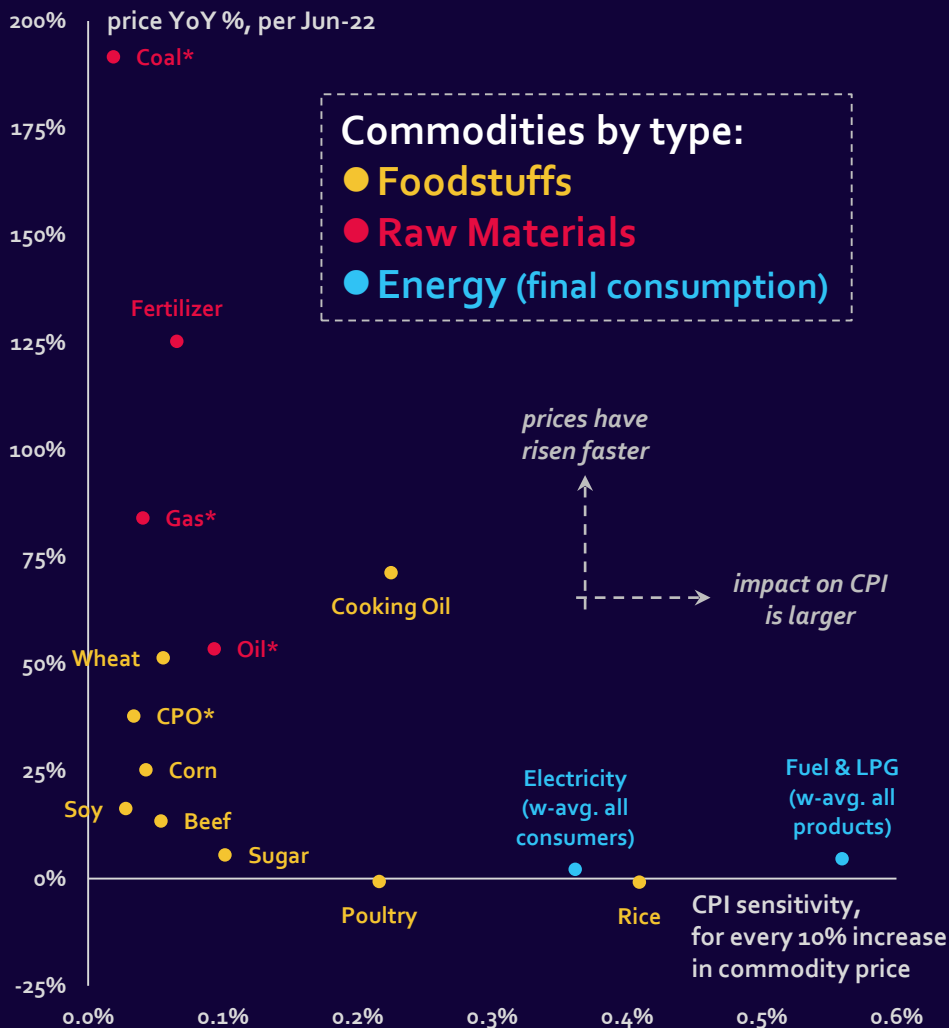
- Indonesia may thus be facing a moment of immense risk and opportunity. If the authorities continue to run a high-pressure economy, it may be forced to reverse policies in the event of a global recession. A rapid double tightening at such a moment would necessarily lead to a painful period of adjustment and a sharp growth slowdown. A more preferable scenario would be for the authorities to begin a gradual adjustment process, while putting finishing touches on Jokowiomics' earlier wins in infrastructure and structural reforms. That way, we may be better placed to weather the short-term uncertainty, while capitalizing on the opportunities of shifting global supply chains in the long-run.

## Inflation has mostly been driven by some food items, but core and depreciation remain as future threats



Source: BPS, BI, Bloomberg, BCA Economist

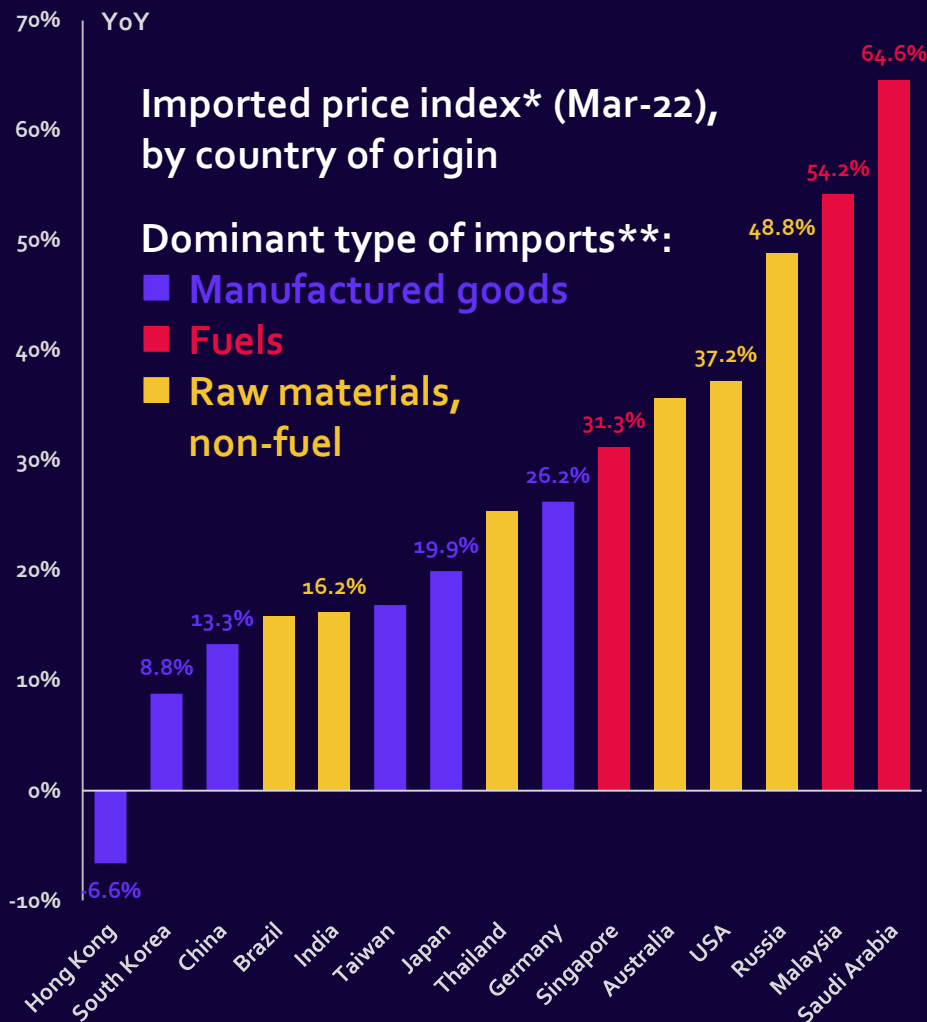
## The key to Indonesia's modest inflation is gov't control over three critical items: rice, fuel, electricity



Source: BPS, PIHPS, Bloomberg, PLN, Pertamina, estimates by BCA Economist

\* Not including impact on the final goods included here – cooking oil, electricity, and fuel/LPG

## China has played the role of inflation dampener for its trade partners, including Indonesia



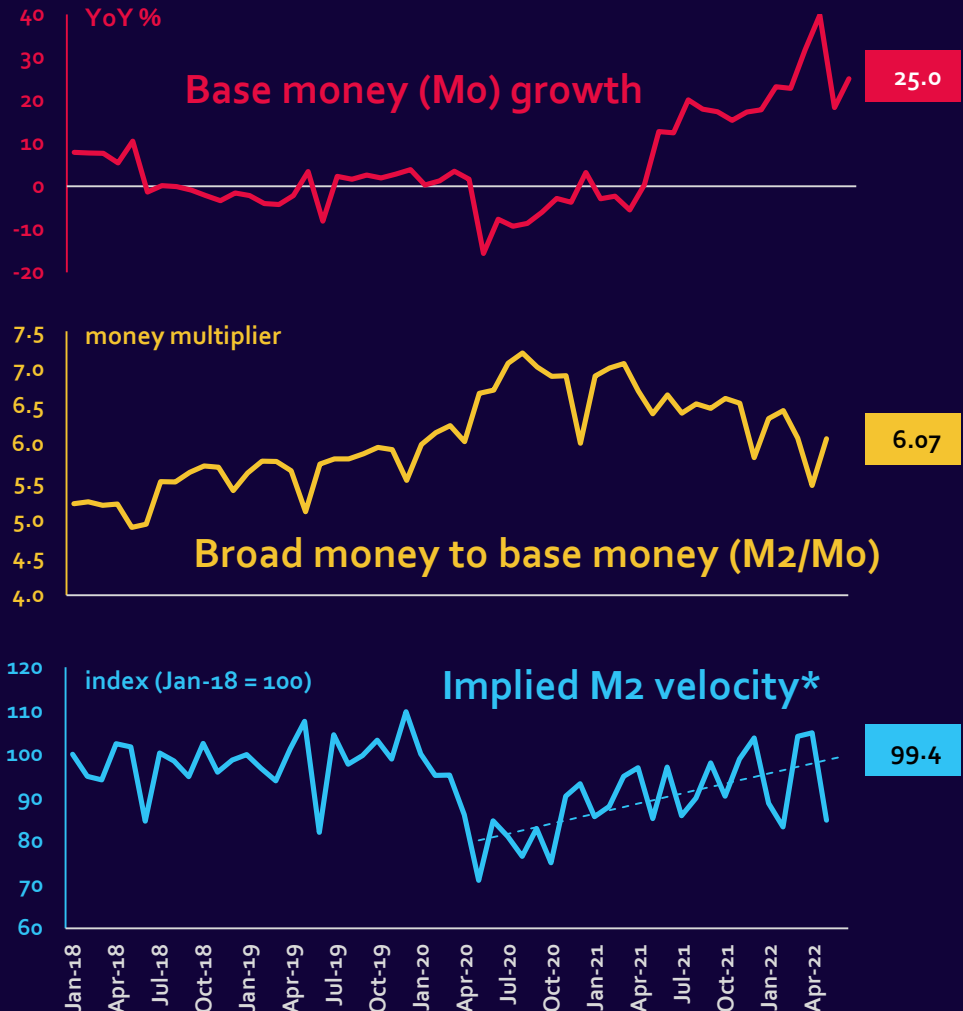
Source: BPS, calculations by BCA Economist

\* Last 12-month cumulative \*\* Based on top 5 imported items

## There is a clear tradeoff between short-term growth and stability with long-term competitiveness

		FISCAL POLICY	
		Accommodative	Constrictive
M O N E T A R Y  P O L I C Y	Accommodative	<ul style="list-style-type: none"> <li>• Best for short-term growth</li> <li>• Weaker IDR:               <ul style="list-style-type: none"> <li>- Higher burden for subsidies and SOE debt service</li> <li>- Higher imported inflation</li> </ul> </li> <li>• High producer price inflation, moderate consumer inflation tempered by subsidies</li> <li>• <b>Policy combo in H1-22</b></li> </ul>	<ul style="list-style-type: none"> <li>• Higher inflation due to weaker IDR, less subsidies</li> <li>• Less fiscal support means weaker purchasing power</li> <li>• Windfall is reallocated by the market (credit)</li> <li>• IDR is weakest in real term, most optimal for export competitiveness (no Dutch disease)</li> <li>• <b>Potential scenario in 2023?</b></li> </ul>
	Constrictive	<ul style="list-style-type: none"> <li>• Moderate short-term growth, tempered by loan slowdown</li> <li>• Limited inflation, limited IDR depreciation</li> <li>• Government reallocates commodity windfall:               <ul style="list-style-type: none"> <li>- Maintaining purchasing power via subsidies, social spending</li> </ul> </li> <li>• Greater risk of Dutch disease</li> <li>• <b>Potential combo in H2-22</b></li> </ul>	<ul style="list-style-type: none"> <li>• Slowest short-term growth</li> <li>• Windfall does not translate to economic growth due to limited credit growth plus lack of fiscal transfers</li> <li>• <b>Potential scenario in 2023?</b></li> </ul>

## As recovery raise money velocity, BI needs to control the money multiplier and base money growth

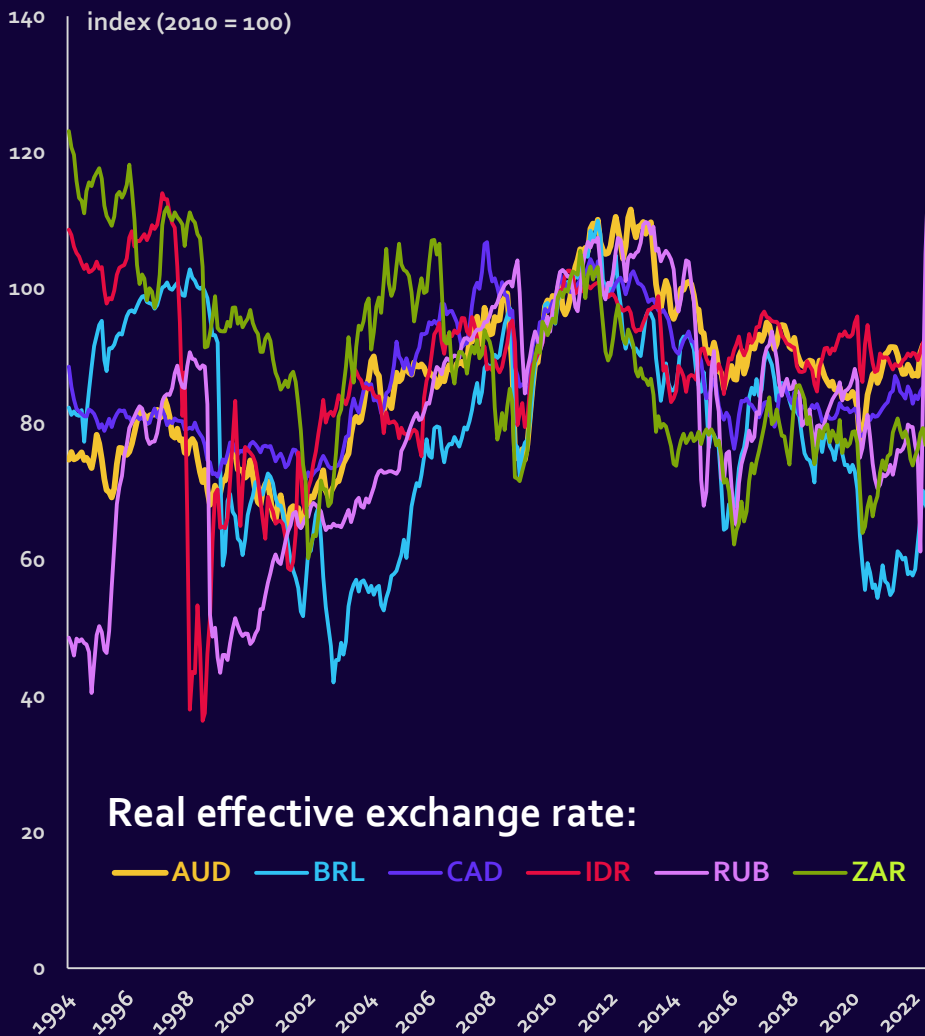


Source: BI, BCA Big Data, calculations by BCA Economist

\* Using total nationwide business transactions as proxy for nominal output

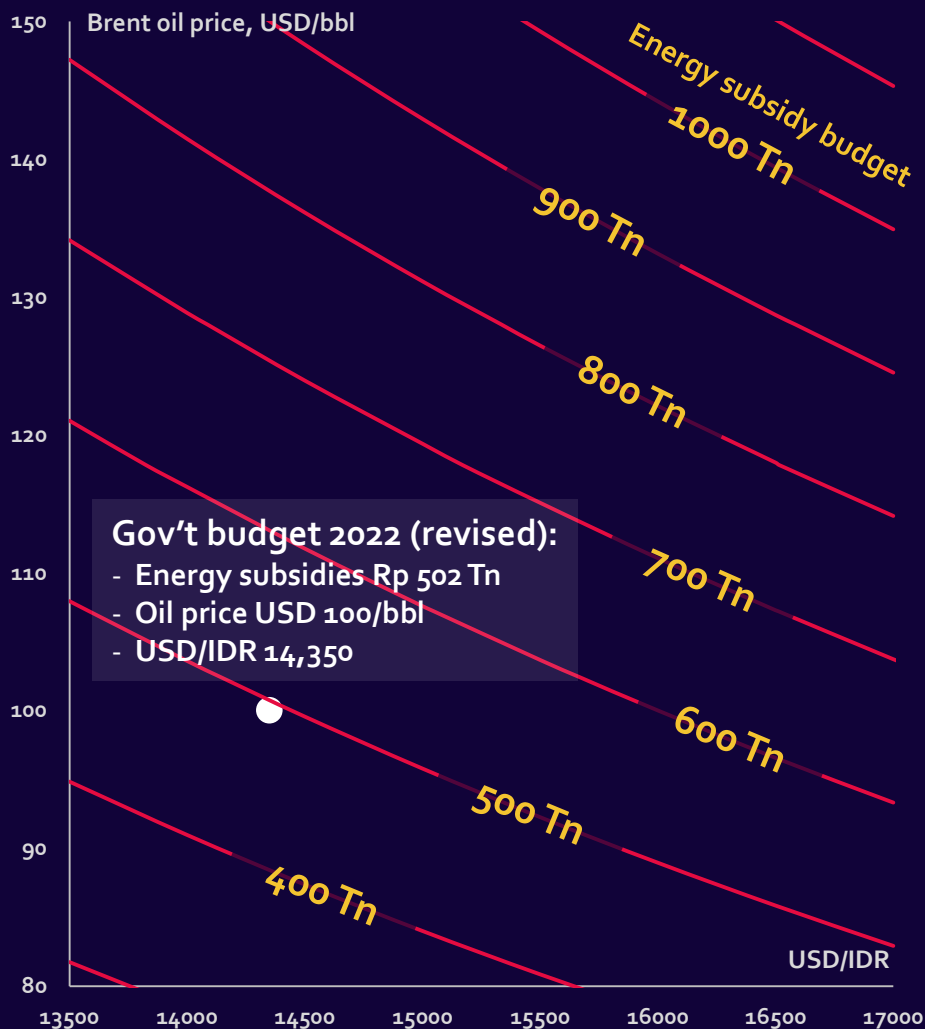


**In recent years, the Rupiah may have been overvalued against other commodity currencies**



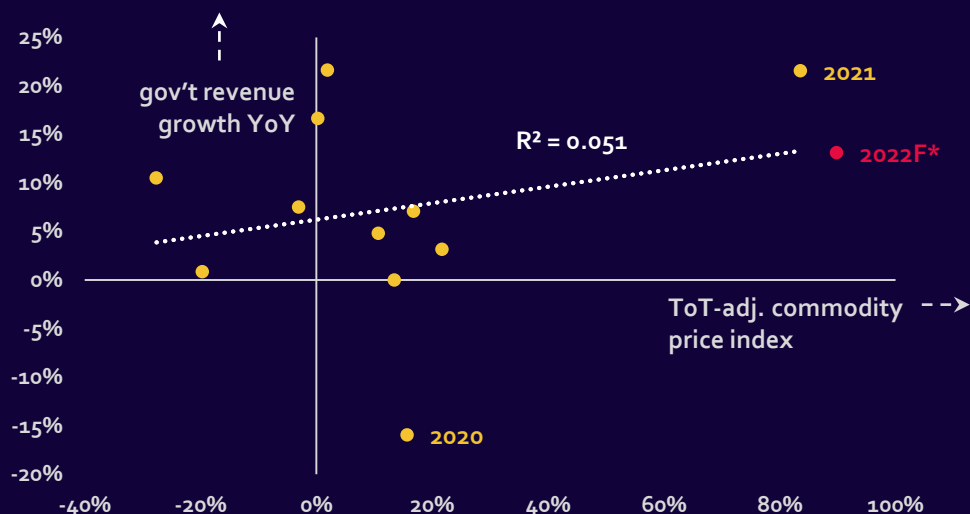
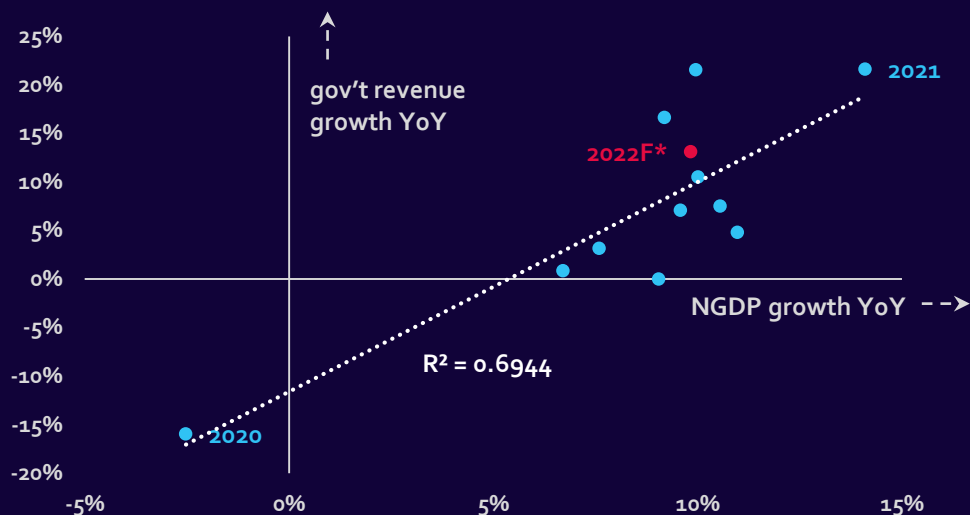
Source: BIS, BCA Economist

## Energy subsidies are unlikely to decline significantly by itself, amid tight energy market and strong USD



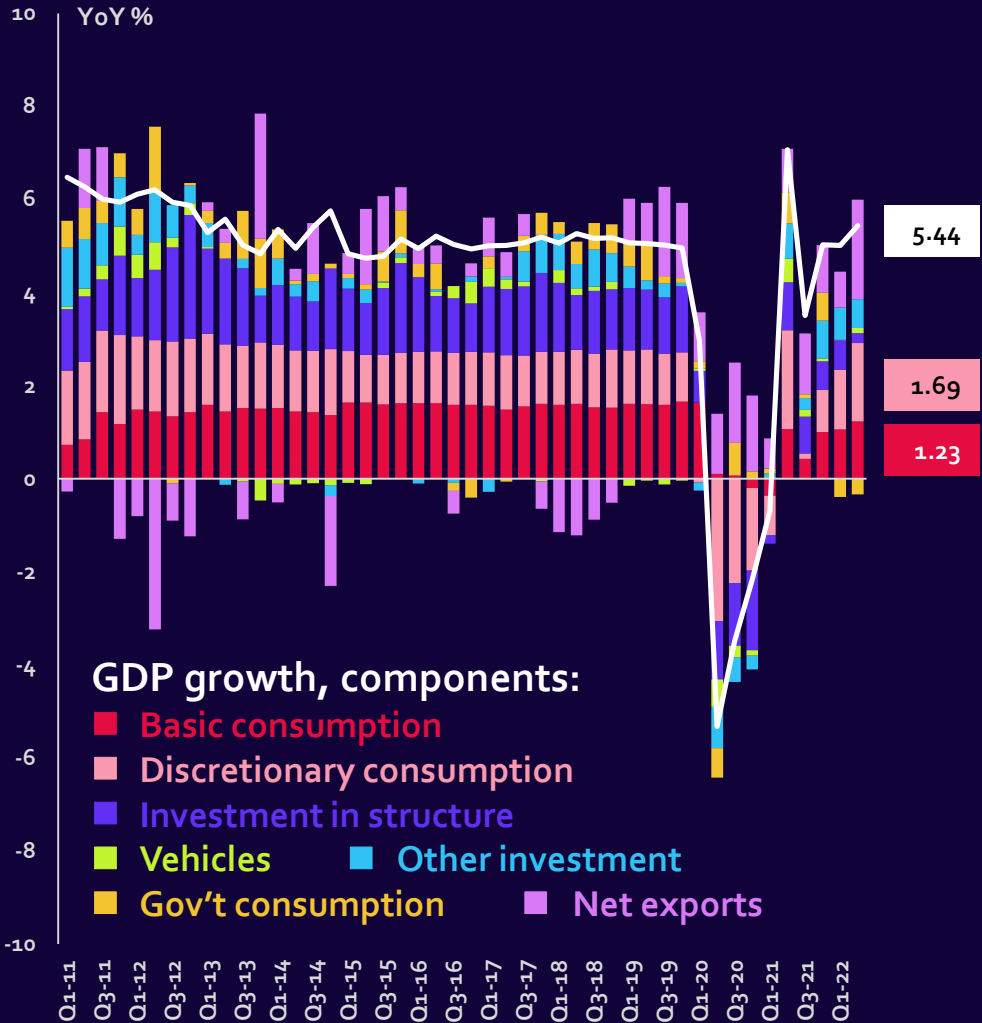
Source: Estimates by BCA Economist, based on data from Bloomberg, MoF, Pertamina, PLN

**Gov't revenue has been boosted by NGDP growth and commodity boom, which might not be repeated in 2023**

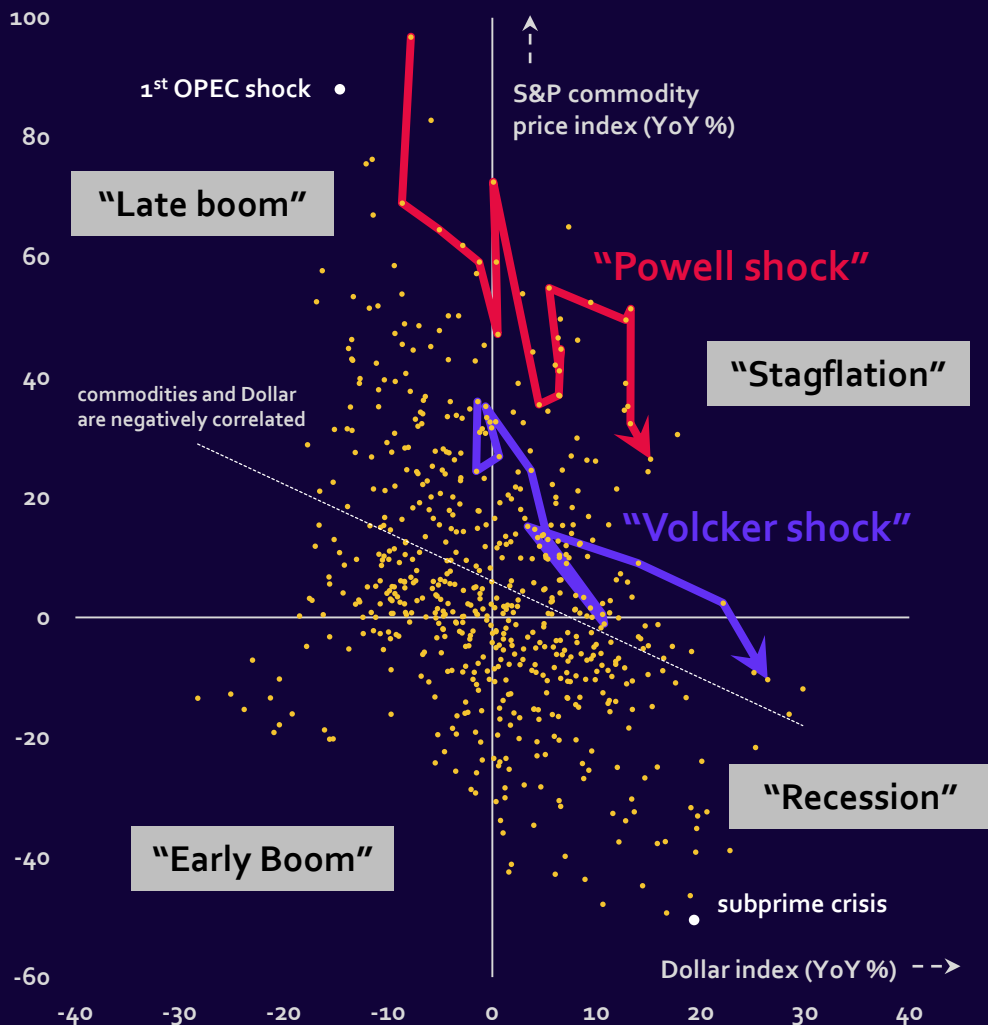


Source: MoF, BPS, Bloomberg, calculations by BCA Economist

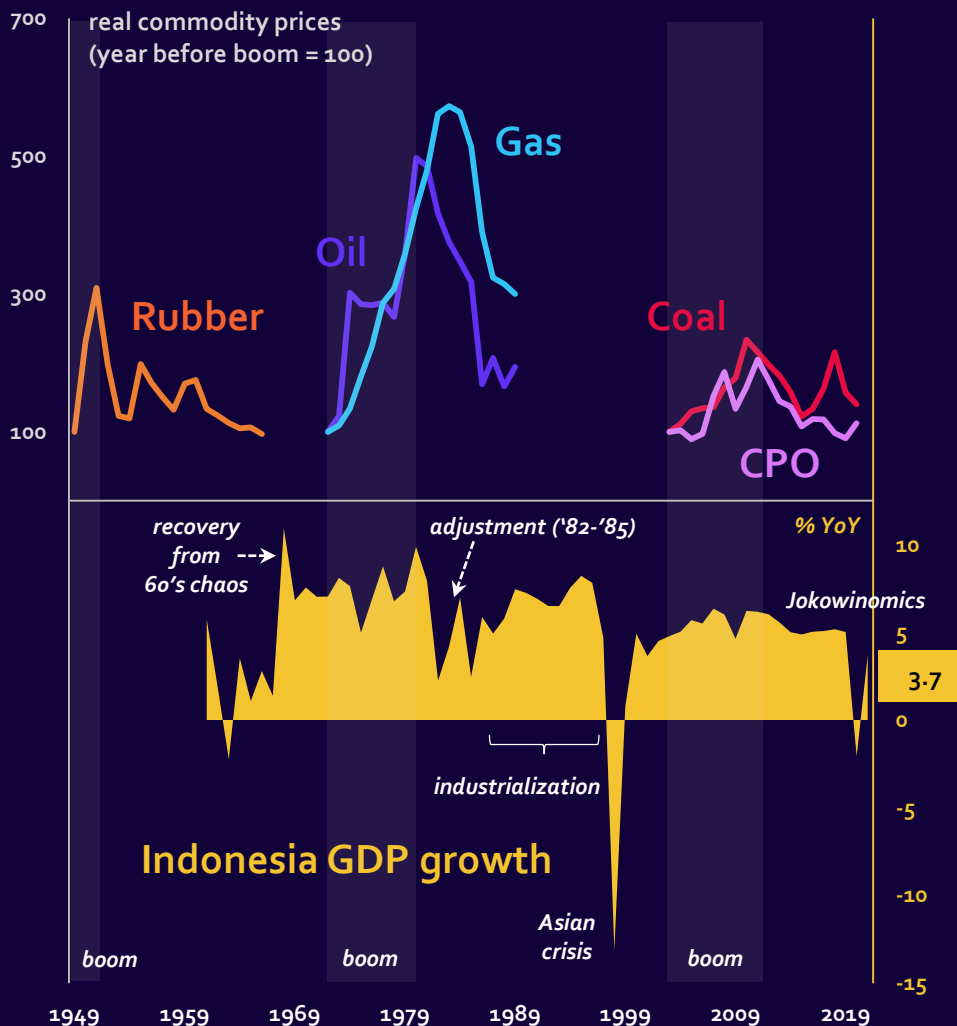
GDP growth, especially its consumption component, has recovered although investment is still subpar



Despite differing circumstances, the current global trajectory looks similar to “Powell shock” in 1980-81 ...



... which might be a harbinger of growth slowdown in Indonesia, if the commodity boom tails off



## Macroeconomic Indicator Projections

	2017	2018	2019	2020	2021	2022E
<b>GDP growth</b> (% YoY)	5.07	5.17	5.02	-2.07	3.69	5.07
<b>Per capita GDP</b> (USD)	3877	3927	4175	3912	4350	4564
<b>Consumer price inflation</b> (% YoY)	3.61	3.13	2.59	1.68	1.87	5.20
<b>BI 7-day Repo Rate</b> (%)	4.25	6.00	5.00	3.75	3.50	4.50
<b>10Y gov't bond yield</b> (%)	6.29	7.98	7.04	5.86	6.36	7.45
<b>USD/IDR rate</b>	13,433	14,390	13,866	14,050	14,262	15,070
<b>Trade balance</b> (USD Bn)	+11.8	-8.5	-3.2	+21.7	+35.3	+36.9
<b>Current account</b> (% of GDP)	-1.60	-2.94	-2.71	-0.42	+0.28	+0.50

Sumber: BPS, Bloomberg, BCA Economist calculations

Notes:

- Numbers marked with asterisk (\*) for 2021 are provisional
- BI 7-day Repo Rate, 10Y yield, and USD/IDR exchange rate all refers to end of year position
- 10Y yield and USD/IDR exchange rate projections refer to fundamental values; actual market values may vary depending on sentiment and technical factors

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