Time for a Hike

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Indonesia's inflation upside chips away at rate hike reticence

- Indonesia is back from a long holiday today, with much awaiting market players and policymakers as they catch up on news. Just out of the gate was the release of GDP data, which showed that the economy grew at a rather middling 5.01% in Q1, with some support from exports and consumption.
- More noteworthy was the upside surprise in April CPI data, with headline inflation at 3.47% yoy, the highest since December 2017. Coinciding with the Ramadan fasting month, the seasonal effect played a role in boosting prices. The uptick in fuel prices did not help too, but the fact that core prices have started to move up markedly to 2.6% yoy should warrant attention.
- Specifically, if Bank Indonesia is inclined to signal its seriousness about tackling the inflation risks head-on in the most prudent and pre-emptive way, it could start to hike its policy rate sooner rather than later. We continue to see a good chance of the first salvo coming in the next meeting on May 24th.

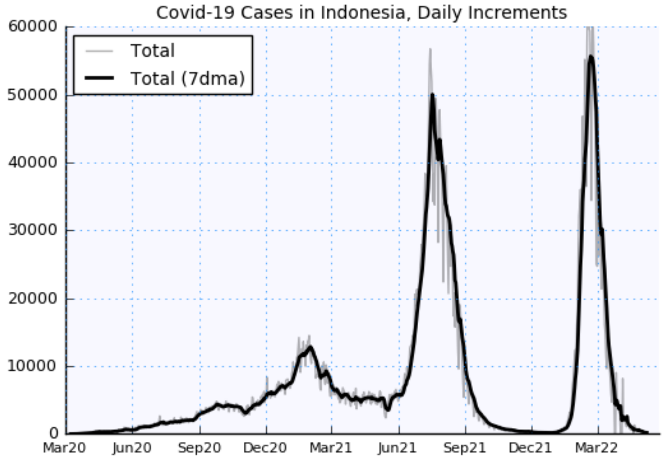
Flatlining at Five

It seems that Indonesia's growth prints can never step too far away from the magnetic pull of the figure of 5. After clocking a growth rate of 5.02% yoy in Q4 last year, the deviation is as minute as it can get with a print of 5.01% yoy this time round for the Q1 2022 Indonesian GDP data. It came a tad above market expectation of 4.95% yoy, but lower than the 6.0% that we had pencilled in with the base effect and the strength of commodities in mind.

Looking at the details, the state of the private consumption signals a still "so-so" pace of recovery thus far. At 4.34% yoy, it did come higher than the 3.55% yoy rate of the previous quarter, but we had thought the pace will be higher given the base effect from the subpar pace of the comparable period last year. While consumer confidence has started to return, the data signals that there are still some ways to go before it can hit the pre-pandemic levels.

Source: OCBC, Bloomberg

Elsewhere, government spending slumped considerably, with a yoy growth rate of -7.74%, compared to 5.25% before, signalling that the government agencies might have retraced back to their standard mode of slow disbursement of spending especially at the start of the year once again. Indeed, on a quarter-on-quarter without seasonal adjustment, the segment slumped by more than 50% compared to end-2021. The issue may be more pertinent in particular for local governments, with Finance Minister Sri Mulyani noting how, in aggregate, their deposits at domestic banks have exceeded IDR200tn in March – sitting idly rather than being deployed to generate their intended multiplier effects for the broader economy.



Source: OCBC, Bloomberg.

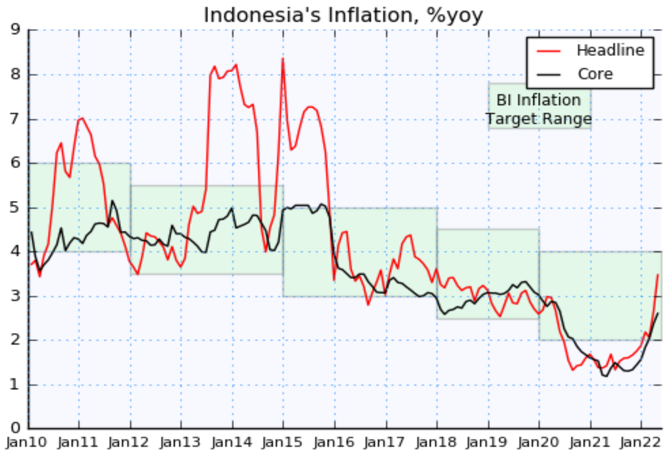
Meanwhile, exports activities remained robust, in line with the strength seen in the monthly customs data over the period. The segment grew by 16.22% yoy, bolstered by commodity-related activities. This can be triangulated with signals from the industry-side GDP data too, with the agriculture segment growing at a good clip of 9.09% yoy.

Overall, we would characterize the GDP print as one that remains supportive of the broader recovery narrative – with some caveats. For one, the good-but-not-great consumption uptick indicates that Indonesian consumers have not recovered their pre-pandemic strides fully just yet. This may be a function of the omicron wave that the country went through at the start of the year. Even as it ultimately proved to be relatively mild, the scare from the delta episode of last year was enough to keep some people home and their wallets tightly closed.

On the commodities front, even as the broader price uplift should still provide boosts to the economy in the coming quarters, it will likely come replete with a caution on price volatility especially if global growth starts to falter more markedly. On top of that, as evidenced by the CPO exports ban flip-flop, the policy risks can present a sudden and significant headwind too.

Another considerable risk factor is inflation. The April headline inflation came in at 3.47% yoy, a chunky 15bps higher than the market expected and the highest print since December 2017. That does not leave much room for the central bank to keep it within the 2-4% of its inflation target range.

In sequential terms, the headline inflation came in at 0.95%, higher than the 0.66% of March. While the onset of the Ramadan fasting month over the period explains some of the uptick, it is unlikely to be that factor alone. Indeed, as we pointed out in our April 4th report "*Faster after Fasting Month*?", Ramadan tends to contribute about 0.87ppt historically from 2010-2019 but the effect has become more muted in recent years.



Source: OCBC, Bloomberg.

Indeed, even though other factors such as the price increase of the Pertamax fuel grade at the start of the month contributed as well, with the transportation category seeing a big 2.42% mom inflation for instance, there are signals that inflation has broadened in nature beyond just the food and fuel category. For one, core inflation came in at 2.60% yoy, the highest since early 2020.

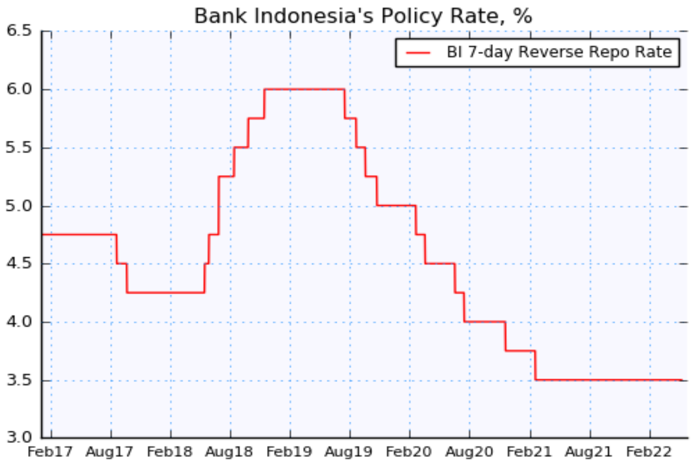
The central bank has signalled that it is not keen to tinker with its policy rate for a while more unless core inflation starts to show sizable upticks. At the same time, it has also indicated that it would like to be pre-emptive and prudent in its fight against any inflationary uptick. To us, the best way to reconcile the two narratives would be to undertake policy rate hike before, rather than after, the core inflation picks up pace even more.

This is even before we start to weigh in on the spectre of further Fed funds rate hikes and the ongoing readjustment by the market players in their thinking of how emerging market currencies including the Rupiah should be trading versus the US dollar. Even as the commodity uplift should curb the level of current account shortfall for Indonesia, it will remain in deficit territory that leaves the economy relatively more exposed to such external factors and more sensitive to widening interest rate differentials.

Putting it altogether, even as the economy is not recovering at full speed, it is doing okay enough. Indeed, the incipient inflation risk should be tackled earlier rather than later to minimize the threat to consumer confidence and broader growth.

Source: OCBC, Bloomberg.

To do that, a pre-emptive first step in hiking rate looks to us to be the most concrete and visible step that Bank Indonesia can undertake now to signal its seriousness about tackling inflation. Hence, our baseline is that the central bank will not wait until H2, as the broader market has it, to start the cycle. We see the first salvo in the next MPC meeting on May 24th, for a total of 100bps hikes this year.



Source: OCBC, Bloomberg.

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