Indonesia’s Economic Condition amidst Global Turmoil

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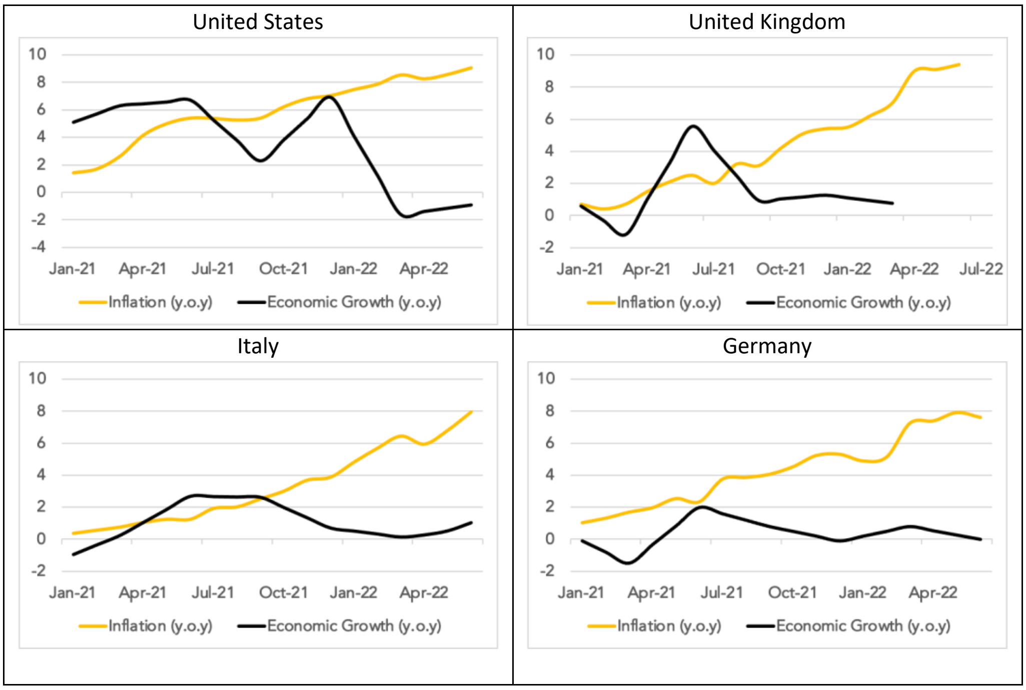
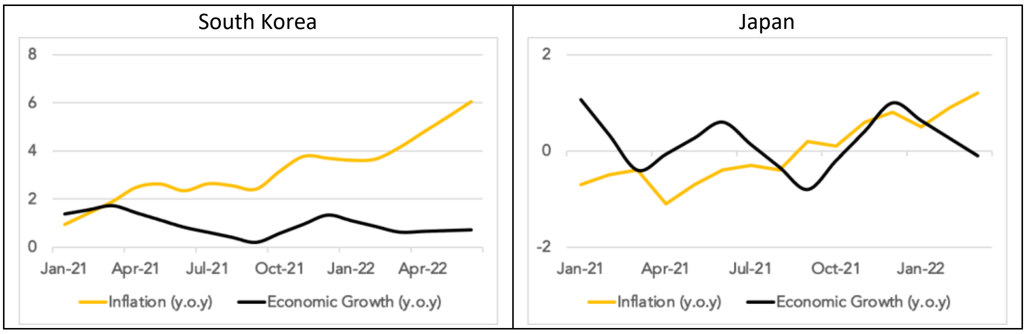
1. Introduction

Global economy is in a difficult position. After two years struggling with the Covid-19 pandemic and has not finished completely, the world enters another crisis in the form of stagflation. Compounding the damage from Covid-19 pandemic, the escalating geopolitical tension in the form of Russian invasion of Ukraine has exacerbated the slowdown in the global economy. In June 2022, the World Bank slashed its global growth forecast to only 2.9% in 2022 from 5.7% in 2021, significantly lower than 4.1% that was anticipated in January 2022. Recently, IMF also cut its global growth forecast to 3.2% in 2022, 0.4 percentage point downwards from the previous forecast in April 2022. Fading pent-up demand, as well as withdrawals of fiscal and monetary stimulus of Covid-19 pandemic, are also expected to contribute to slower global growth.

Similarly, the rising global price on energy commodities since the second half of 2021 has intensified and the trend has also been spreading to agricultural products as the repercussion of the war. For instance, US inflation jumped 9.1% (y.o.y) in June 2022, a fresh four-decade high, breaching all estimates. June’s CPI in the UK also rose by 9.4% (y.o.y), slightly above a consensus forecast, as energy and food prices continue to increase. Besides developed economies, any developing countries, including Brazil, Mexico, Thailand, and India, are seeing a massive rise of inflation. The combination of economic growth decline and rising inflation tension creates a toxic mixture of stagflation. It has been observed in countries across the globe that the development of economic activity and inflation data provides stronger indicatives of upcoming stagflation is getting nearer on the horizon.

Figure 1: Inflation (y.o.y) and GDP Growth (y.o.y) in Selected Countries, 2021 - 2022





Note: GDP growth is calculated using linear interpolation

Source: CEIC

In attempt to soften the blow of rapid price increase on purchasing power, more central banks have been joining the trend of monetary tightening, some even doing it in a rather aggressive manner. However, it is rather unclear whether its consequences would deliver the intended effect, which is decelerating the inflation, or rather overkilling it by bringing the recession altogether. In addition, aggressive monetary tightening stance, especially taken by major developed economies, has triggered massive capital outflow from emerging markets, including Indonesia.

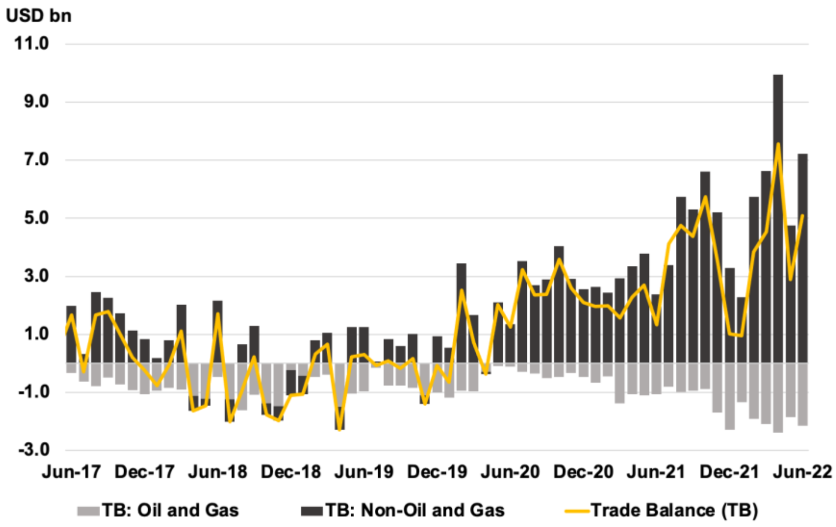
2. The Impact of Global Dynamic towards Indonesia

Marching into 2022, the health and economic indicators has demonstrated a promising progress during the first quarter of this year. On the health front, the daily new cases dropped from its peak of around 64 thousand to less than 3 thousand at the end of March this year. This figure even went reached as low as around 200 new cases per day in last May. The auspicious progress in the domestic public health situation has transpired into a solid GDP growth of 5.01% (y.o.y) in Q1-2022, keeping it rather steady from 5.02% (y.o.y) in the last quarter of 2021. If recession is defined technically as having negative GDP growth for two consecutive period, the latest GDP figure might indicate the opposite as Indonesian economy is already reach its pre-pandemic normal as it was the first time since 2020 that Indonesia's GDP figure reached its baseline growth rate of 5% for two consecutive period.

Despite considered as being 'behind-the-curve' on the economic recovery timeline, Indonesia was rather in an advantageous position to face the latest global economic turmoil, stemming from escalating geopolitical tension, global monetary tightening, and rising commodity prices. Thanks to the combination of good policy and good luck, Indonesia in the first half of 2022 was well-positioned to encounter global turmoil. Having a robust domestic recovery due to the momentum buildup of economic activity and the cyclical aspect of Ramadhan and Eid Al-Fitr, a net exporter of major energy commodities, the lift-up of mobility restriction, current account surplus and lower foreign ownership of financial assets has blessed Indonesia with adequate capacity to absorb global shock relative to other countries thus far, especially in terms of inflation and currency volatility.

Rising global commodity prices has benefitted Indonesia. Being a net exporter of main energy commodities (i.e., coal and CPO), Indonesia has experienced a rather outstanding performance of trade balance during the first half of 2022. The soaring commodity prices brought fruitful momentum to overall trade balance in Q2-2022, which recorded another increase in surplus to USD15.6 billion from USD9.33 billion in Q1-2022. The surplus amounts also jumped 39% (y.o.y) compared to the same period in the previous year. In addition, high commodity prices also contributed positively to the fiscal posture, as government revenue recorded an annual increase of 57.7% during the first half of 2022.

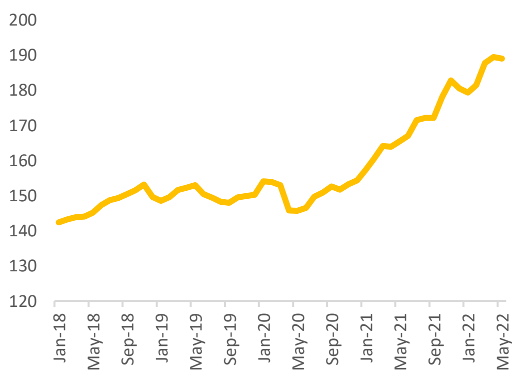
Figure 2: Monthly Trade Balance (Nominal)



Source: Statistics Indonesia, 2022

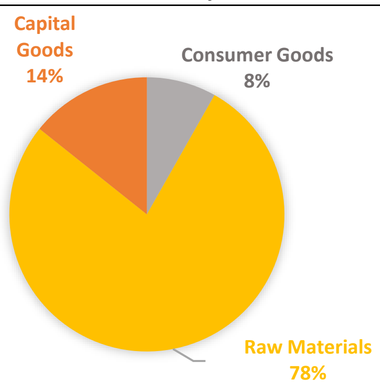
Good news aside, Indonesia is facing an emerging risk of domestic inflation. Indonesia's import price index has reached 188.97 in last June, a substantial increase from around 150 during the Covid-19 era. On the other hand, Indonesia's import profile suggested that more than 90% of import to Indonesia is contributed by capital goods and raw materials, meaning any increase in the price of imported goods will affect the cost of domestic production. The pressure from external channel has been exacerbated by the depreciation of Rupiah, which depreciated over US dollar by 5.39% (ytd). This is confirmed by a striking figure of producers' price index. Despite having relatively benign inflation on the consumer level of 4.94% (y.o.y), the inflation on the producers' level has reached 11.77% (y.o.y).

Figure 3: Indonesia's International Trade Price Index: Import



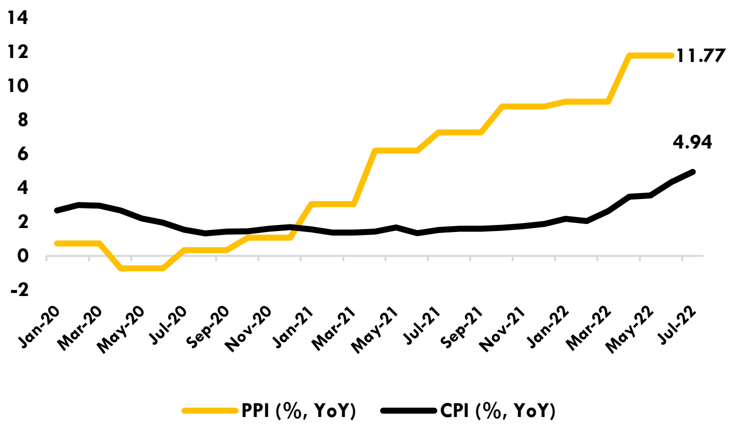
Source: CEIC

Figure 4: Profile of Indonesian Imports by Goods Classification, January-June 2022



Source: Statistics Indonesia

Figure 5: Indonesia's Producer and Consumer Price Index (%, YoY)



Source: Statistics Indonesia, 2022

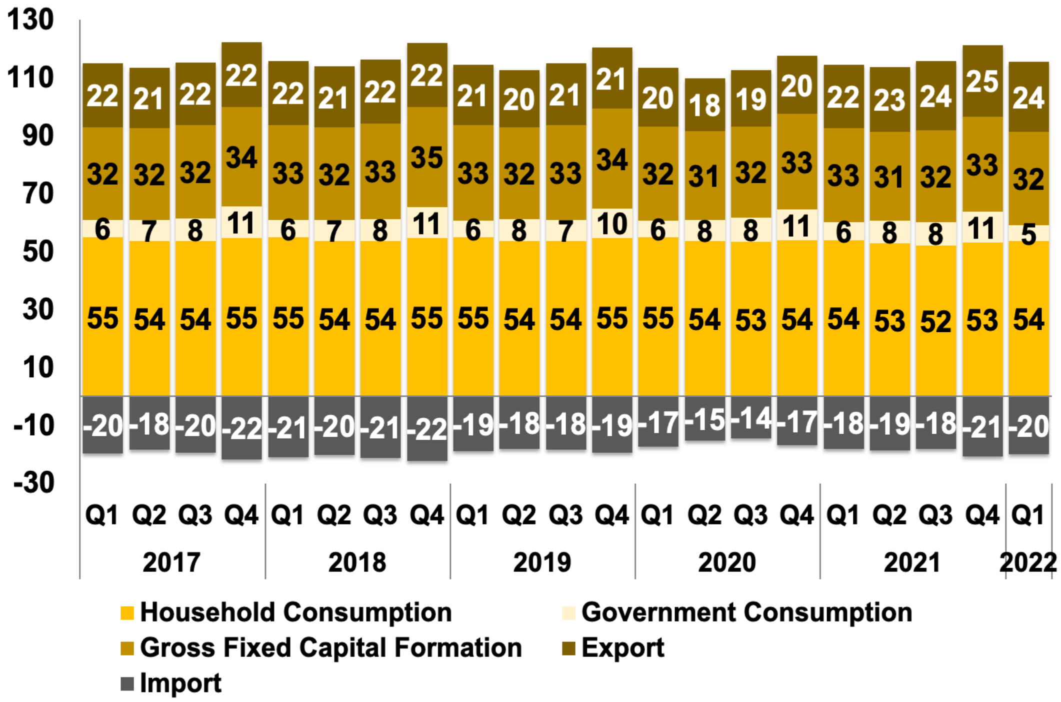
The wide gap between producers' and consumers' price index suggest that the heightened production costs has not been passed through by the producers to the consumer; thus, eroding their profit margin. This situation would certainly not last forever. Sooner or later, the burden of rising cost of production will be passed through to the consumer and once it happens, we might see a surge of domestic inflation in Indonesia. If not manage carefully, spiraling inflation could bring a substantial decline in purchasing power and reversing the progress on various socioeconomic aspects, such as poverty and unemployment. However, weathering the risk of domestic inflation overheat might face some serious challenges down the road.

3. Challenges ahead

Despite currently experiencing a relatively manageable inflation rate and robust domestic growth – making it rather immune to the threat of stagflation – Indonesia is by no means in a safe path going down the road. Going forward, Indonesia is facing potential pressures on their engine of growth. Indonesia's notable growth rate of beyond 5% during the first half of 2022 is mainly contributed by two growth sources, namely household consumption and net export.

The gradual hike of current inflation rate slowly eroding purchasing power of the household. Observing by its contributions, the main driver of domestic inflation is the rising price of food, beverages, tobaccos and transportation costs. This is mainly driven by rising global commodity prices, especially on agriculture and energy components, suggesting the inflation is mostly pushed by cost, not an increase in the pull of demand. It is worth to note that more than 50% of Indonesia's economic structure is contributed by household consumption. Any decline in household purchasing power would have a substantial impact on the economic activity. Observing the current trajectory of inflation movement, household consumption as one engine of domestic growth might be in jeopardy.

Figure 6: Shares of Indonesia's GDP Components, 2017Q1-2022Q1 (%)



Source: CEIC

Furthermore, US has experienced two consecutive quarter of economic contraction throughout 2022. Technically, this is a recession. Considering its size, slowdown in the US economic activity would be manifested in the decline of its export demand, including from Europe, China, and also Indonesia. Specifically, lower export of China could have a rather significant impact on Indonesia. Besides being as the main trading partner of Indonesia, China's demand for energy commodities is hefty and the decline in China's economic activity would hit severely the export performance of Indonesia. Currently, despite still levelling quite high, the price of energy commodities slowly decreasing and as a country that relies heavily on commodities, net export as another engine of Indonesia's economic growth might also weaken in the future.

The current trend of inflation curbing by monetary tightening is happening across the globe and likely be followed by domestic monetary authority. As of July 2022, the headline inflation of Indonesia is steadily rising, going further beyond the central banks' target of maximum 4%. With no sign of decelerating inflation in sight, it is likely that Bank Indonesia will soon tighten its policy rate. With global and domestic policy rate hike, basic economic theory suggest that it will be translated into higher saving and lower investment rate. If this scenario escalates, lower domestic investment means that another source of growth in the Indonesian economy will be negatively affected.

During the crisis, the most recent one demonstrated by the Covid-19 crisis, government expenditure serves as the only economic buffer for growth. The contraction brought by muted consumption, investment, and export is to a certain extent counterbalanced by the expansion of government expenditure through fiscal stimuli. However, as mandated by the law no.2/2020 (Undang-Undang no.2 tahun 2020), Government of Indonesia is only allowed to widen its deficit beyond 3% of GDP threshold until 2023 as a response to the Covid-19 pandemic, allowing the Government to provide necessary fiscal stimuli serving its purpose as shock absorber. Marching towards the end of 2022 and 2023, the role of fiscal policy to serve as shock absorber once again during the current economic turmoil is heavily restricted exactly due to this mandate of bringing back deficit below 3% of GDP. The implication being is that we might see the reduction in government expenditure in the near future to fulfil this mandate. This also means that another source of growth could have a limited contribution in supporting the domestic economy.

Observing all the components of GDP by expenditure, namely consumption, investment, government expenditure, and net export, are all in a serious risk of slowing down in the short run due to various factors at play. In addition, the tools in the policy arsenal are going short. The windfall revenue might soon decrease as the commodity prices starts to normalize. From the monetary perspective, the central bank of Indonesia soon will find itself in a position to increase the policy rate. Without pertinent policy mix, Indonesia's economic growth and stability could be in jeopardy. Any complacency by policymakers could be costly. Going forward, it is imperative for Ministry of Finance and Bank Indonesia to work hand-in-hand to ensure the rise of inflation is gradual and manageable as the failure to do so could cost a substantial decline in purchasing power and risking the recession. In addition, managing the stability of currency is equally important as managing the domestic price stability.

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