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Global Economics & Market Strategy

Indonesia: Expected Downside Risk on Core Inflation in 2H24

- **We keep our 2024 headline and core inflation forecast at 3.3% YoY and 2.2% YoY, respectively.**
- **We expect Bank Indonesia (BI) to maintain the benchmark policy rate unchanged at 6.25% for the rest of the year. In 2025, we anticipate three 25 basis points (bps) cuts in the BI rate, bringing it down to 5.50%.**
- **April headline inflation decelerated to 3.00% YoY vs March print of 3.05% YoY, lower than the Bloomberg consensus estimate at 3.10% YoY.**

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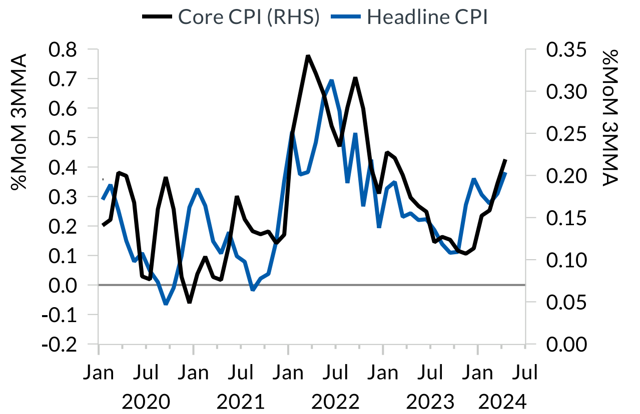
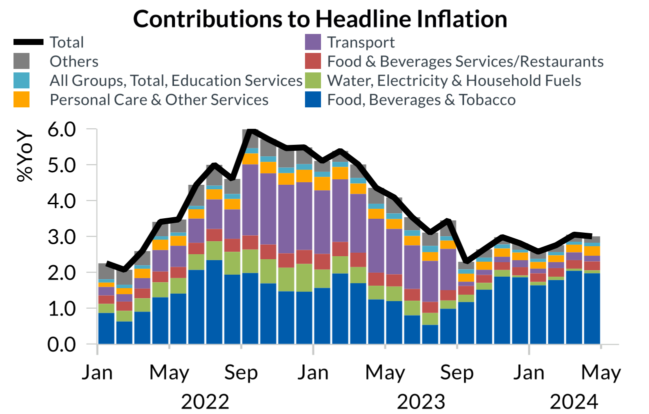
Figure 1: Indonesia headline and core inflation momentum picks up in April…



Source: Macrobond, RHB Economics & Market Strategy

Figure 2: …where the key contributor remains food, beverage and tobacco



Source: Macrobond, RHB Economics & Market Strategy

Inflation Trajectory to Driven by Food Price and ERPT

We keep our 2024 headline and core inflation forecast at 3.3% YoY and 2.2% YoY, respectively. While we believe that the headline inflation will likely align with the official target at the upper bound of the 2.5% ± 1% YoY range, we perceive a downside risk of slower core inflation in the second half of 2024. This risk stems from a combination of weaker retail spending expectations and the unexpected hike in the policy rate by Bank Indonesia in April. **Moving forward, we expect Bank Indonesia to keep the benchmark policy rate unchanged at 6.25% for 2024 and anticipate three 25 bps cuts in 2025, reducing it to 5.50%.** We remain watchful of the inflation momentum and have identified several key determinants of its trajectory. These include (1) the delayed impact of El Niño conditions on food prices, (2) the potential impact from exchange rate pass-through due to the weakening of the IDR, and (3) muted demand-side pressure in 2H24.

Despite the marginal easing in staple food prices after the Lebaran festival in April, we maintain our expectation that El Niño conditions will continue to impact food prices. We observe that the prices of several staple foods began to decline after Eid al-Fitr; however, they are still higher compared to last year. For example, according to the National Food Agency's (Bapanas) food prices panel, the national average price of rice fell by 0.36 per cent from IDR 14,450 per kg on 11 April to IDR 13,700 per kg on 21 April, versus the highest level in 2023 at IDR 13,210 per kg. This decline is likely due to the surplus of rice production levels in April. However, we believed the decline to be temporary as the rice production in the form of ground dry grain (GKG) was likely to decrease after the main harvest (as depicted in Figure 5), and the rice supply would remain dependent on imports. Hence, a smaller rice surplus is expected in May, with a potential deficit in the rice supply in June 2024. Additionally, our El Niño model, as shown in Figure 4, suggests that the impact of food inflation is delayed by 12-18 months, indicating that the negative effect on global food production and upside to prices may be more prolonged.

We observed some potential impact from exchange rate pass-through (ERPT) from the weakening of the IDR on Indonesia's inflation. According to the Bank of International Settlements (BIS)[1], the ERPT from the exchange rate fluctuation to the headline CPI is around 0.13%. Hence, a 1% Rupiah depreciation is expected to increase inflation by approximately 0.13%. Other factors to consider when calculating the impact of ERPT include the ability of producers to absorb increased costs during periods of currency fluctuations. The government may provide aid or subsidies to impacted sectors, as evidenced by the oil and gas sector. For example, despite the sharp increase in oil prices and depreciation of the IDR during geopolitical tension, we observed the state-owned enterprise Pertamina announce that retail fuel prices will remain unchanged for May since January 2024. **If the trend of the year-to-date (YTD) depreciation of the IDR, which is around 5%, continues until the end of the year, we may see the impact materialize and increase inflation by a maximum of 0.65%.**

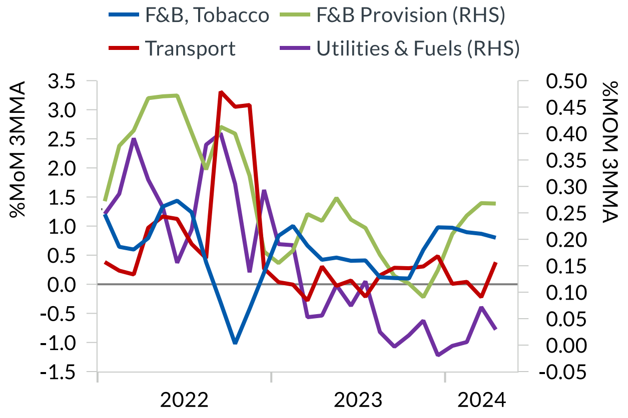
The depreciation of the IDR may continue, which may support inflation pressures should the ERPT effects persist. According to our thematic report on the IDR, we expect USD/IDR to remain elevated above 16,000 throughout 2024, reaching its peak in 2Q24, before stabilising on a flat trajectory towards the year-end. The weakness of IDR against USD is mainly attributed to revised market expectations of fewer FFR cuts in Dec 2024 as US inflation is not in the trajectory toward the 2% target. Despite our projection of a flat trajectory for the IDR in 2H24, the risks toward no FFR cut in 2024 are magnifying, underlying a caveat toward even deeper depreciation to be seen.

In contrast to the drivers of stronger inflation momentum mentioned above, we see downside risk from weaker core inflation in the second half of 2024. As mentioned in our thematic report, retail spending in 2H24 is expected to be slower due to weaker sentiment post-Lebaran, lower purchasing power, and stagnant income growth expectations. The surprise hike in the April Bank Indonesia policy meeting may further exacerbate the decline in consumer demand. The tightening of monetary conditions is expected to slow down the two main drivers of retail sales: loan growth and the stock market performance. Higher interest rates toward the year-end are likely to delay consumer purchases of durable goods, given the higher cost of borrowing and the higher risk premium required by investors, which tends to lower stock market valuations, limiting the consumer wealth effect. Hence, we expect core inflation, as a gauge to demand-pull inflation, to face downside risk in 2H24.

April headline inflation decelerated to 3.00% YoY vs March print of 3.05% YoY, lower than the Bloomberg consensus estimate at 3.10% YoY. At the same time, April's core inflation accelerates to 1.82% YoY, higher than March's reading of 1.77% YoY. In the %MoM term, April's headline inflation printed at 0.25% MoM compared to March's print of 0.52% MoM. Food, Beverages, and Tobacco remain the key contributors toward the headline inflation (7.04% YoY), followed by Personal Care and Other Services (3.56% YoY), and Food and Beverage Serving Services/ Restaurant (2.51% YoY).

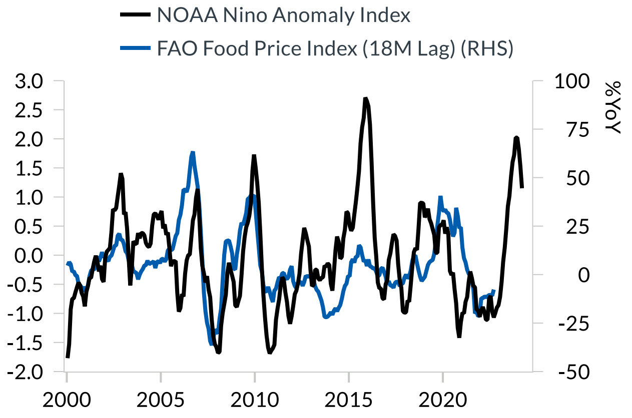
[1] Bank of International Settlements (BIS), Inflation mechanisms, expectations and monetary policy in Indonesia, 2016

Figure 3: F&B inflation remain key concern as its momentum continue to persist…



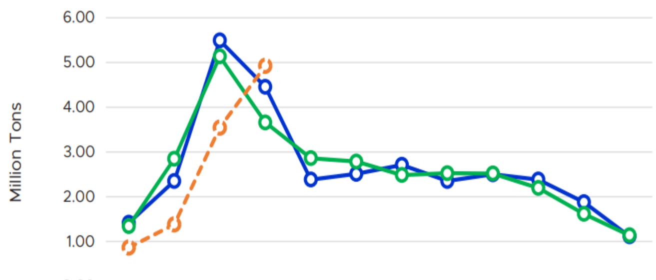
Source: Macrobond, RHB Economics & Market Strategy

Figure 4: …where this is mainly attributed to El Nino conditions…



Source: Macrobond, RHB Economics & Market Strategy

Figure 5: Indonesia rice production in 2024 is projected lower compare to previous period …

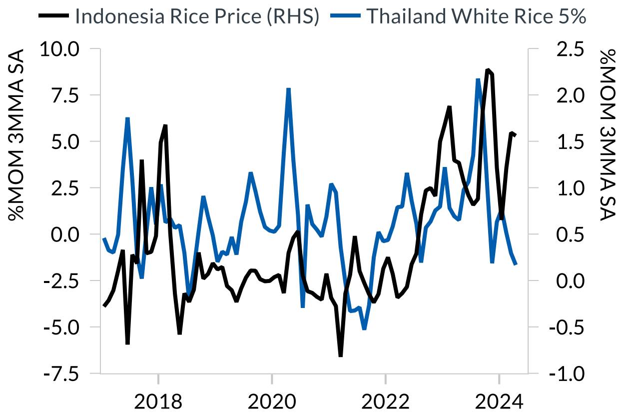


	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2022	1.42	2.35	5.49	4.45	2.38	2.51	2.71	2.35	2.50	2.38	1.88	1.11
2023	1.34	2.85	5.13	3.66	2.86	2.79	2.48	2.52	2.52	2.19	1.62	1.14
2024	0.86	1.38	3.54	4.92								

Note: * Rice production in January-April 2024 are preliminary figures
The difference in decimal numbers is caused by rounding

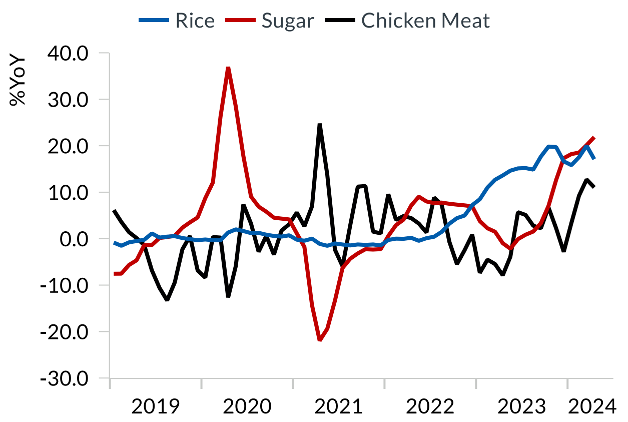
Source: Macrobond, RHB Economics & Market Strategy

Figure 6: …and the tightened supply of rice, both domestically and externally, continue to exert pressure on rice price…



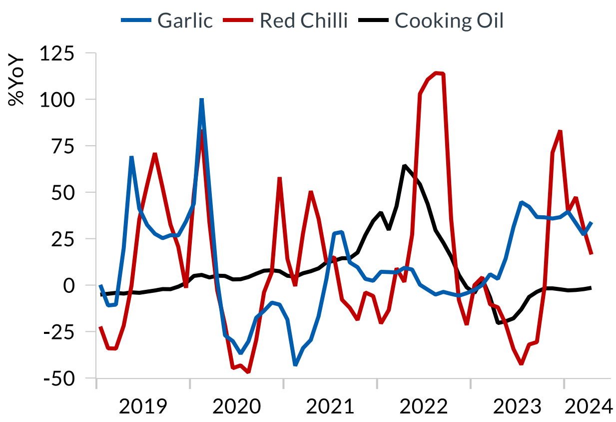
Source: Macrobond, RHB Economics & Market Strategy

Figure 7: …as well as other staple food products…



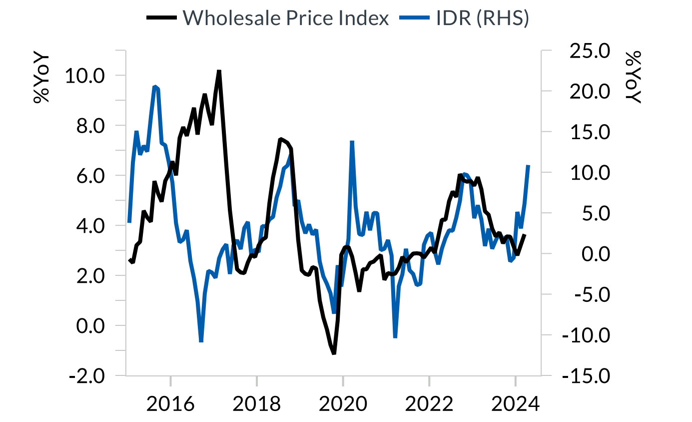
Source: Macrobond, RHB Economics & Market Strategy

Figure 8: … including Red Chili and Garlic…



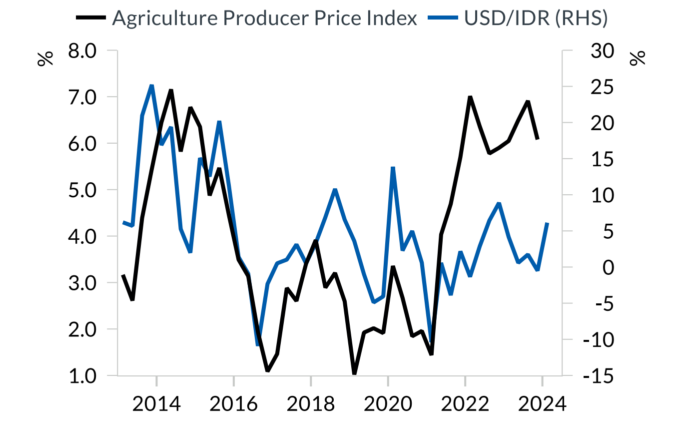
Source: Macrobond, RHB Economics & Market Strategy

Figure 9: We expect IDR depreciation to have some pass-through on inflation...



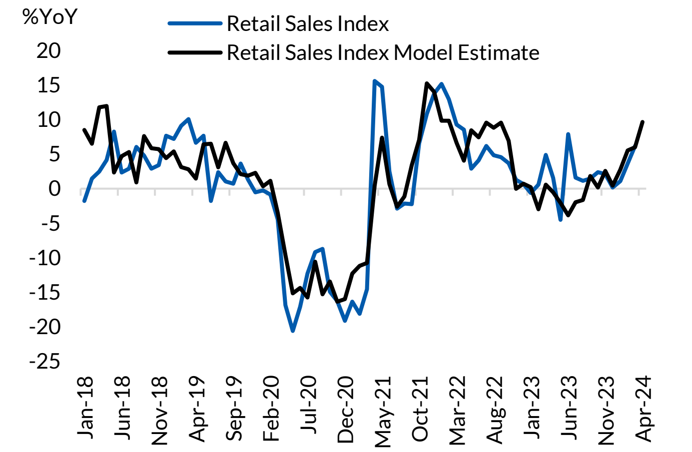
Source: Macrobond, RHB Economics & Market Strategy.

Figure 10: ...especially on import dependent sector such as food and agriculture



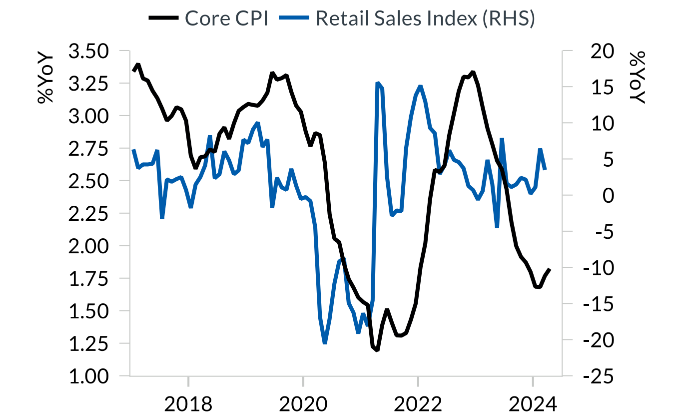
Source: Macrobond, RHB Economics & Market Strategy.

Figure 11: Retail spending is expected to decline in 2H24...



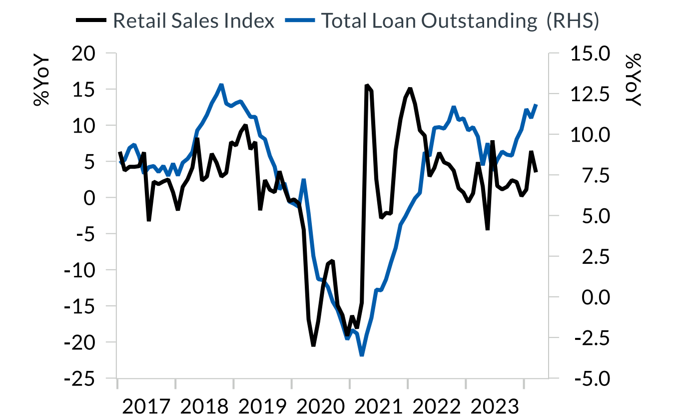
Source: RHB Economics & Market Strategy.

Figure 12: ...which may translate to lower demand-pull inflation as...



Source: Macrobond, RHB Economics & Market Strategy.

Figure 13: weaker sentiment post-Lebaran and the drivers of retail sales are slowing down due to...



Source: Macrobond, RHB Economics & Market Strategy.

Figure 14: ... interest rate hike by Bank Indonesia

Source: Macrobond, RHB Economics & Market Strategy.

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