Economics

Indonesia Inflation Eases On Softer Gold Prices, But More Pressure Looms

Highlights

- **Headline inflation eased slightly to 3.23% yoy in Oct 26** (from 3.28%), in line with expectations, as lower core inflation (2.56%, down from 2.84%) on weak domestic demand and softer gold prices offset a sharp rise in volatile food inflation (5.81%, up from 5.03%) driven by El Niño-related supply constraints.
- **Markets shrugged off the modest CPI print, with the rupiah weakening to Rp18,158/USD and 10-year bond yields rising to 7.73%,** reflecting worsening risk perception amid high oil prices and uncertainty ahead of the US midterm elections.
- **Inflationary pressures are expected to build, breaching the 3.5% target by end-26** and into 2Q27 on intensifying El Niño effects and rupiah-driven imported inflation. This is likely to force Bank Indonesia to raise its policy rate by 25-50bp to 6.00-6.25% by the end of 2026, compounded by a potentially hawkish Fed hike in Dec 26.

Analysis

- **Headline inflation edged down to 3.23% yoy in Oct 26 from 3.28% the previous month,** broadly in line with the market consensus of 3.30%. The marginal decline was driven by lower core inflation, reflecting weak domestic demand and softer gold prices.
- **Core inflation fell from 2.84% to 2.56%, weighed by declining global gold prices and subdued domestic demand**. Administered-price inflation also eased slightly, from 3.25% to 3.24% yoy, on the back of lower airfare. By contrast, volatile food inflation rose sharply from 5.03% to 5.81%, driven by higher prices for red chillies, rice, chicken meat, tomatoes and beef amid lower agricultural output caused by a worsening El Niño.
- **On a monthly basis, inflation slowed to 0.22% mom from 0.30% in Sep 26,** as food-price inflation moderated. Monthly core inflation was steady, while administered-price inflation picked up on higher airfares.
- **Despite the relatively modest CPI print, a robust trade surplus and expansive PMI readings, financial markets reacted only lukewarmly.** The rupiah continued to weaken, reaching Rp 18,158 per US dollar, while 10-year government bond yields rose to 7.73%. This partly reflects market concerns over a repricing of Indonesian assets as risk perception deteriorates amid a looming MSCI downgrade, high oil prices and anticipation of the US midterm elections on 3 November.

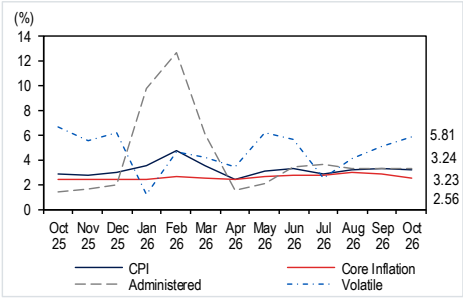
Outlook

- **As anticipated, Oct 26 inflation came in at our forecast of 3.25% yoy (0.25% mom) on lower gold prices**. The relatively moderate inflation numbers reflect significant government efforts to contain price pressures, including food-aid programmes and the maintenance of subsidised fuel prices, despite the policy having caused fuel shortages in some parts of the country. They also reflect private-sector efforts to hold prices down in order to preserve revenue despite rising production costs, as shown by higher wholesale-price inflation.
- **Looking ahead, we expect inflationary pressures to build, breaching the 3.5% target by end-26 and persisting into 1Q27**. The intensifying El Niño effect has sharply reduced the production of key foodstuffs ie red chillies and red onions, which are staples across the archipelago. This could be compounded by imported inflation from a weaker rupiah, which may

Analyst(s)

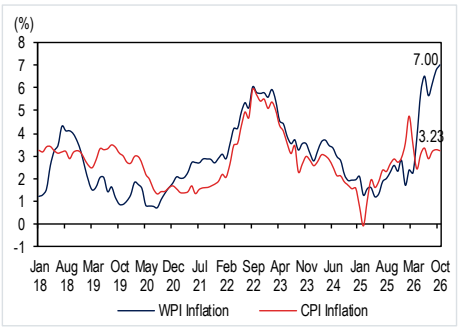
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Indonesia Yearly Headline Inflation



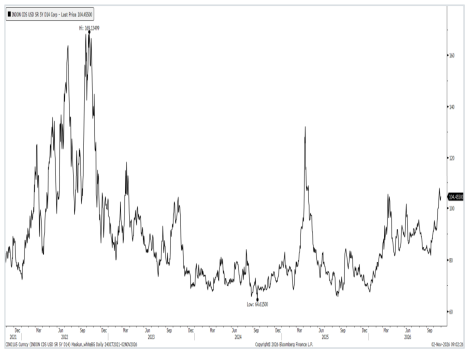
Source: BPS

Indonesia Wholesale Price Index And Consumer Price Index Inflation



Source: BPS

Indonesia CDS



Source: Bloomberg

eventually spill over into CPI inflation, probably at the start of the new year or around the Lebaran festivities in 1Q27.

- **On the monetary policy front, adequate foreign appetite for Indonesian bonds** (government bonds and SRBI) and a significant discount on hedging swaps have allowed Bank Indonesia to avoid raising interest rates at October's Board of Governors meeting. This may not last, however, if Indonesia's risk perception continues to worsen, as signalled by rising CDS spreads, which could trigger a vicious cycle of higher yields and wider premium spreads. This would result in further capital outflows and cause the rupiah to depreciate even further. Ultimately, we think this will prompt the central bank to raise its BI rate by 25bp to 6.00%, or even by two 25bp hikes to 6.25%, by the end of this year. Adding to the pressure is an increasingly hawkish Fed, which may deliver a 25bp rate hike in Dec 26.

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