Bank Indonesia's short note for the BIS Annual Meeting of Emerging Market Deputy Governors

Inflation and labour markets in the wake of the pandemic

November 2022

Inflation in Indonesia showed an increase, although below the initial estimate. The increase was mainly driven by higher fuel prices amid the gradual improvement in domestic demand**.** The labour market is recovering in the wake of the pandemic, with no signs of tightening. Thus, additional inflationary pressure originating from a wage-price spiral is not likely to happen in the near future. Labour market structural reform, especially concerning the minimum wage setting, also contributed positively to more controlled inflation, particularly wage-induced inflation. Labour market developments and their potential impact on inflation is one of the considerations in the formulation of Bank Indonesia's monetary policy.

Inflation in the wake of the pandemic

Soaring global food and energy prices, coupled with higher fuel prices at home, continue to be the main drivers of inflation, amid the gradual improvement in domestic demand. Global inflationary pressures continue to intensify in response to high commodity prices caused by supply chain disruptions given the ongoing geopolitical tensions between Russia and Ukraine, coupled with the proliferation of inward-looking policies. These persistently high global prices have become the source of cost-push inflation, especially through imported inflation. Such increases will affect consumer price index (CPI) inflation through its components: volatile food (VF) and administered prices, and will have second-round impacts on core inflation and inflation expectations.

However, for Indonesia, inflation is lower than initially projected. The CPI in October 2022 stood at 5.71% (yoy), a decrease from 5.95% (yoy) the month earlier. Inflation in October 2022 was lower than previously projected because the impact of fuel price hikes on volatile food and administered prices was weaker than initially forecasted. Volatile food inflation decreased to 7.19% (yoy), in line with close policy coordination and synergy between Bank Indonesia and the Government through the Central Inflation Control Teams (TPIP) and Regional Inflation Control Teams (TPID), as well as National Movement for Food Inflation Control (GNPIP), which aim to safeguard supply availability, seamless distribution, price stability and effective communication. The administered prices inflation was also lower than previously expected, namely 13.28% (yoy). Meanwhile, low core inflation was maintained at 3.31% (yoy), given the weaker second-round effect of fuel price adjustments, coupled with mild inflationary pressures from the demand side and stabilization policies implemented by Bank Indonesia. Bank Indonesia expects lower inflation in 2022 than previously projected, despite still exceeding the upper limit of the 3.0%± 1% target. Policy synergy between the central/regional government and Bank Indonesia will be strengthened to restore inflation to the target corridor.

On labour markets

In Indonesia, the labour market is recovering with no sign of tightening. The recovery is reflected in the decrease of the unemployment rate to 5.83% in February 2022 from the spike to 7.07% in August 2020, although it was still higher than the pre-pandemic level of 4.94% in February 2020. The support provided by fiscal and monetary stimulus as well as well-coordinated national policies through the Financial System Stability Committee (KSSK) is aimed at accelerating the domestic economic recovery, export performance, and improve economic activity and public mobility. The recovery is also supported by a better structure of the labour market as shown by an increase in the share of formal workers from 39.53% in August 2020 to 40.00% in February 2022, although still lower than the pre-pandemic figure of 43.36%. Nonetheless, as the supply of Labour is still high, there is no sign of tightening in the labour market.

In line with the recovery, wage growth is gradually increasing. However, increases in wages are not as rapid as the increase in inflation, as inflation rate pressure is intensifying in response to high and volatile commodity prices. Relatively faster recovery of the labour supply side compared with the recovery of the labour demand side also contributes to the slower pace of wage increases. Furthermore, wage increases are still uneven. The services sector had the largest wage increases as mobility improved, while wage increases in the manufacturing sector remained restrained. The wage increases in primary sectors (agriculture and mining) also increased slightly, although these were still lower than in the services sector.

Considering recent developments in Indonesia's labour market, Bank Indonesia believes that a risk of a wage-price spiral in Indonesia in the near future is still low. Historically, wage growth and inflation are moderately correlated, and workers have collective bargaining power, as reflected by relatively high trade union density. However, Bank Indonesia is of the view that the risk of a wage-price spiral in Indonesia is still relatively low for a number of reasons: (i) relatively loose labour market conditions due to the dominance of informal workers; (ii) weak individual bargaining power; and (iii) continued low firm pricing power due to the ongoing recovery.

Inflation and labour markets: structural aspects

On the structural aspects of inflation

Bank Indonesia is of the view that several structural improvements have had a positive impact in supporting inflation control efforts amid increasing domestic inflationary pressures due to rising global commodity prices. These include:

- The stronger role of inflation expectations in inflation formation in Indonesia. In addition, the inflation expectation remained anchored to the inflation target. This reflects an increase in Bank Indonesia’s credibility given its track record of keeping inflation within the target.

- A relatively manageable exchange rate movement with a lower exchange rate pass-through to inflation. Lower exchange rate pass-through is also the result of central bank policy to maintain exchange rate stability in line with the currency’s fundamental value. Consequently, both developments have made it unnecessary for producers to adjust the prices of final products frequently and abruptly due to exchange rate movements. Competitive rivalry among producers also leads to more competitive pricing policy especially in the digital era. Therefore, the impact of cost-push inflation due to pricing dynamics is limited, as producers absorb some of the price increases by increasing efficiency or reducing profit margin, among others.
- Consistent government policies in improving Indonesia’s infrastructure, including providing better connectivity infrastructure to support more efficient distribution of goods and services. This policy helps to create more efficient distribution/logistics services that supports the availability of goods, particularly staple foods.

On the structural aspects of labour markets

In Indonesia, the setting of the minimum wage is indexed to inflation and economic growth while also taking other factors into account, including labour conditions. These changes are in line with the wage reforms carried out by the government since 2015. The provincial minimum wage (UMP)) has become the main benchmark for wages for businesses. The minimum wage is determined by the provincial governor, following recommendations from the provincial and/or district wage councils. In addition, the governor of the province may also impose a city or regency minimum wage if that regency or city’s economic growth has been higher, for the past three years, than that of the province in which it is located. The minimum wage applies to all workers who have been working in a company for less than one year. After one year, an employee is eligible to be paid in accordance with the pay scale of a particular company. Nevertheless, setting wages for these employees no longer refers to the government's minimum wage. In this regard, wage setting is more of a bilateral agreement between employers and workers.

The minimum wage setting reform, first implemented in 2015, has had a positive impact on controlling inflation, particularly wage-induced inflation. Prior to these reforms, the determination of minimum wages was more irregular, as they did not follow a standard formulation or process. Such conditions, in turn, could drive second-round pressures on wage inflation that were not regulated by the government. With increased certainty in the formulation after the reform, inflation from the wage side becomes more predictable so that its impact on inflation, mainly through the demand side, can be controlled.

On post-pandemic effects on the labour market

The Covid-19 pandemic has the potential to cause scarring to the economy. Economic capacity and employment declined from their normal paths. The potential for scarring exists, although it differs between sectors. Differential impacts across sectors may depend on whether a sector is a high or low contact in nature, the degree to which it was affected by the pandemic, and whether or not it is an essential sector. Sectors that were hurt during the pandemic face different paths of recovery and the potential scarring in each sector is different. Scarring depends on the recovery and also impacts the recovery. AEs with limited scarring may be able to recover faster, while EMs and LICs with larger scarring will recover more slowly.

For Indonesia, the potential for scarring during the current pandemic period is significantly lower than that of during the Asian financial crisis. This is in line with the relatively faster economic recovery, which has boosted improvements in labour demand, and national policy packages implemented to mitigate the impact of Covid-19 pandemic on Indonesia's economy. The recovery is reflected in the decrease of the unemployment rate to 5.83% in February 2022, down from the spike to 7.07% in August 2020. The recovery is also reflected in sectoral labour absorption in line with the reopening of the economy.

To mitigate the risk of scarring and promote economic recovery, Bank Indonesia and the government are strengthening national economic policy synergies. This is to maintain the stability of macroeconomic and financial systems, and revive lending to businesses in priority sectors to stimulate economic growth and exports. Increasing economic and financial inclusion is also a goal. There are several structural avenues to mitigate the risk of scarring. These include labour reallocation to eliminate persistent unemployment and create new capabilities. Additionally, capital reallocation to modernise production and operational functions will boost investment to increase productivity. In turn, these structural changes will create an innovative environment and increase digital inclusion.

Use of labour market indicators in the policy process

Bank Indonesia makes use of labour market indicators and monitors employment dynamics in economic assessments. Labour market indicators are one of the main economic variables that determine the level of prosperity, the standard of living and the poverty level of an economy. At the same time, increasing prosperity and living standards, and minimising poverty, is one of the main goals and is included in the economic policy framework. As the monetary authority, Bank Indonesia analyses the labour market thoroughly and granularly, as well as consider the impact of labour market developments on economic growth and inflation, to determine the necessary policies to maintain stability and the momentum of the recovery.

Bank Indonesia utilizes and monitors various indicators of labour market conditions. Monitoring multiple indicators of the labour market is important to assess economic developments accurately. These include the extent to which a shift in the unemployment rate reflects labour market slack caused by the Covid-19 pandemic, the scarring effect on labour in particular sectors and industries, and differences in labour conditions that impact production. The primary source of employment data in Indonesia is the National Labour Force Survey (Sakernas), which is designed specifically to collect labour force statistics. Sakernas is also one of the statistics used and monitored in conducting assessments on the labour market, including the labour market participation rate; job availability and creation; part-time working numbers; economic inactivity; employment shifts across sectors and between formal/informal sectors; rates of commuting among workers; and unemployment rates by education, real wages, and total working hours. Sakernas surveys are published periodically in February and August. For this reason, Bank Indonesia also utilises higher frequency data/indicators and big data processing, such as job vacancies and consumer surveys. Based on these indicators, Bank Indonesia generates assessments of the latest labour market conditions as part of the analysis of the domestic economy. These are presented to the Board of Governors at their monthly meeting, in which policies are formulated.

The formulation of monetary policy takes into account the impact of labour market developments on economic growth and inflation. Bank Indonesia continues to strengthen monetary policy by raising the policy rate. The decision to raise the policy rate was taken as a front-loaded, pre-emptive, and forward-looking measure to lower overshooting inflation expectations, make sure core inflation remains within the level of 3.0%±1%, and return CPI inflation to the target corridor of 3.0±1% in the second half semester of 2023. It was also taken to strengthen the exchange rate stabilisation policy in line with the rupiah's fundamental value in response to broad-based US dollar appreciation and elevated global financial market uncertainty to minimise imported inflation.