Indonesia wounded by deflation: What it means for the economy



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On September 2, 2024, Statistics Indonesia (BPS) released August inflation data, the value of which was calculated at 2.12 % year-on-year (YoY). However, this value is only -0.03 %, when viewed on a month-to-month (MtM) basis. When the inflation value is negative, for example -0.03 %, it signifies entry into what is called *deflation,* or a decline in the price level of goods and/or services during a certain period; it is thus the opposite of inflation.

Deflationary tendencies have been noted since May 2024; this is the same as August's deflation on an MtM basis. This deflation figure increased to 0.08 % MtM in June, and skyrocketed quite significantly to 0.18 % MtM in July. In other words, Indonesia has experienced deflation for four consecutive months (May, June, July and August).

So, what was the cause of deflation in July and August 2024? Referring to the BPS's Official Statistics News on August 1, 2024, the deflation of 0.18 % MtM in July 2024 was driven by inflation in the food, beverage and tobacco expenditure group, with a value of -0.97% MtM, which contributed to inflation of -0.28% MtM. In general, food commodities contributed the largest deflation in July 2024, such as shallots (0.11% MtM), red chilies (0.09% MtM), tomatoes (0.07% MtM) and broiler chickens (0.04% MtM). Meanwhile, although the price level in August 2024 was better than in July, deflation in food commodities, such as shallots (0.08% MtM), chicken meat and tomatoes, each at 0.03 % MtM, and chicken eggs (0.02% MtM) contributed to deflation in August 2024.

In a statement on *rri.co.id*, BPS explained that the deflation occurring in August over the past five years was contributed by a decline in the price of volatile food commodities. A decline in the price level for shallots and tomatoes was the result of excessive supply from the harvest, in production centers. BPS also stated that deflation for shallots and chicken meat has periodically occurred every August from 2022 to 2024, while shallots, chicken meat and chicken eggs have been on a deflationary trend since June 2024. The conclusion of BPS's presentation is that deflation that occurred in Indonesia was caused by oversupply, which drove down prices.

In economic theory, deflation caused by an increase in the supply side, either by increased productivity (such as that which occurs in food commodities) is referred to as "benign" deflation, whereby the decline in the price of goods and/or services is the product of a growing economy, such as those driven by technological advances that reduce production costs or increase input factors, such as an increase in the supply of labor (Szczepanski, 2015).

Benign deflation can be explained by the inflation equation in Acemoglu et al. (2022), which states that inflation is the difference between the growth rate of money supply and the growth rate of real Gross Domestic Product (GDP). In other words, when the growth rate of real output is higher than the growth rate of money supply (where the growth rate of money supply is not as fast as the growth rate of real GDP caused by, for example, contractionary monetary policy), then the Indonesian economy produces more goods and/or services, which leads to a decrease in the price of goods and/or services or "benign deflation".

From the explanation above, at least two questions arise. First, is it true that the deflation that occurred in Indonesia in 2024 is a form of "benign" and not "malign" deflation (deflation that occurs not due to growth in the supply side, but weak aggregate demand)? Second, if what happens is malign deflation, what should the Government do to deal with it?

Answering the first question is no simple feat, because it must be proven scientifically through relevant approaches and data. Meanwhile, the second question can perhaps be explained by assuming that what happens *is* malign deflation, which is deflation that arises due to weak demand. Before discussing recommendations for the Government, if what happens is indeed malign deflation, let us briefly discuss what that is.

Malign deflation is driven by conditions of decreasing demand, which are indications of economic malaise or economic recession. When indications of economic decline emerge, such as when people no longer have money for shopping and other expenses, so that the amount of money in circulation is gradually shrinking, entrepreneurs and business people will lower the prices of goods and/or services to attract public interest to ensure the wheels of the economy keep turning. Even though prices are lower, people are actually holding back from shopping, because they expect the prices to drop even further. Without economic transactions, businesses will suffer losses, because their goods and/or services are not selling even at low prices, causing the economy to enter a "vicious circle", such as increased unemployment due to layoffs to cut company costs. This will eventually result in a decrease in aggregate demand that leads to poor economic growth (Szczepanski, 2015).

Are there any indications of malign deflation in Indonesia? Perhaps it can be decided by a study of the decline in the Indonesian manufacturing Purchasing Manager's Index (PMI) in August 2024, which is 48.9, or down from 49.3 in July 2024 (S&P Global, September 2, 2024). This PMI data can be used to assess economic and business conditions in Indonesia, whether they are contractionary (below 50) or expansionary (above 50). It can be seen that Indonesia's economic and business conditions in August 2024 are in fact contractionary.

S&P Global (September 2, 2024) also states that the sharp decline in new demand and output over these three years has resulted in a decline in the manufacturing sector, with companies responding by laying off employees, although this contraction is believed to be temporary. Therefore, based on the data above, the indications of malign deflation may appear in Indonesia.

So, what can the Government do if the deflation that occurs is in fact *malign* deflation? In order to encourage economic turnover from the demand side, the Government, through Bank Indonesia (BI) and the Ministry of Finance, needs to implement expansionary monetary and fiscal policies to stimulate the money supply. The expansionary monetary policy can be in the form of quantitative easing (QE) or lowering the benchmark interest rate.

On the other hand, expansionary monetary policy can be in the form of a fiscal stimulus that targets government spending to build facilities and infrastructure, such as office infrastructure, manufacturing infrastructure, health infrastructure and education infrastructure, as well as tax cut incentive programs for individuals – or even direct cash assistance (BLT). In principle, the Government must be able to keep deflation rates from being too low and inflation rates from being too high through a combination of monetary and fiscal instruments that require collaboration among various parties.