

Good MornING Asia - 14 July 2021

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By Robert Carnell



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Shock inflation could spur more change from the Fed.

I've written in recent days about [the Cleveland Fed NowCast for inflation](#). Last night's US June inflation numbers show the limitations for such measures, though I struggle to understand why such measures can't include an accurate measure of used and rental car prices - both things you would imagine you could find out fairly easily if you were minded to look for them. So US June headline inflation not only managed to exceed last year's tough 0.5%MoM hurdle, it smashed it, rising 0.9%MoM taking the annual rate of inflation to 5.4%YoY and a similar monthly rise took core inflation to a whopping 4.5%YoY.

[James Knightley's piece here](#) covers the main details - note especially the pipeline pressures indicated by the NFIB survey, and also the likelihood of housing joining the inflation party over the coming 12 months as rentals catch up with house prices. As JK suggests, this is not consistent with the "transitory" story Jerome Powell has been feeding markets. And with him testifying in front of Congress tomorrow, JK thinks that we may get the first hint of an earlier taper a lot sooner than we had been expecting. Let's see how markets digest that (watch also for tonight's Beige book).

Markets are coming to terms with the higher inflation story, though their reaction is not totally conventional. Firstly, and as I mentioned too a few days ago, markets may also be anticipating an earlier taper, and an earlier first fed rate hike, just like we are. But they aren't necessarily pricing in more tightening in total. Earlier might mean less in total according to this market view, which seems to be the message you get when you look at today's USD OIS curve and compare it with the same curve a month ago. And not much is being priced in for the peak Fed funds in total. The long term peak in the OIS yield is about 1.2%, and that is years in the future, with medium-term yields 2-3 years ahead not much higher than 0.75%. Could this be one explanation for 10Y US Treasury yields in the 1.40 area? It seems reasonable until this view alters.

This backdrop of higher for longer US inflation and a faster hiking Fed and strengthening USD is not a good recipe for emerging Asia. Following the Fitch outlook revision of the Philippines long term foreign currency issuance to negative from stable (affirming the BBB rating), questions might well be drawn over nearby neighbours, Indonesia, but also Malaysia and Thailand, all of which are suffering from new waves of Covid which will weigh on activity, tax revenues and ability to repay foreign debt. We haven't seen too much spillover yet, but it is worth considering with the backdrop turning less supportive, we may have to deal with a broad-based EM souring in both bond and FX space (equities obviously too) as we head into the year-end.

Asia today

Korea has already released June unemployment data, which shows that before the latest Covid restrictions kicked in, Korea was making progress in the labour market. The unemployment rate for June edged down to 3.7% from 3.8%, with gains in most sectors except, interestingly, manufacturing. Total employment gained, and unemployment fell against a modestly increasing labour force, so the decline in the unemployment rate looks legitimate, though comes with caveats about what may happen if the Covid daily increase does not soon start to fall.

And in Singapore, 2Q GDP was just released, Prakash Sakpal writes "Singapore's advance GDP estimate for 2Q21 showed the economy growing by 14.3% from a year ago but contracting by -2.0% from the previous quarter. The outcome was in line with the consensus, so unlikely to have much market impact. Manufacturing remained in the driving seat for headline GDP growth with an 18.5% YoY surge. But the recovery of this sector was set back as we have also seen recently with exports data, and showed a 1.8% QoQ contraction in output. Likewise, construction and services sectors posted year-on-year rebounds but also contracted on a quarterly basis. The gradual reopening of the economy should instil some more life into the domestic economy, but this negative spell is likely to linger for some time to come. That means the recovery will be mainly dependent on exports regaining their recent strength. We see nothing in this data warranting any changes to the current fiscal or monetary policy settings just yet".

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The return of twin deficits will complicate recovery in the Philippines

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Source: Shutterstock

People observe social distancing as they stand on circle shaped yellow markers while waiting for public transport to arrive, Philippines

4.7%

2021 Philippine GDP growth forecast

Lowered from 5%

Recovery status: It's complicated

It's been more than six months since our last Philippines economic outlook, and since then, there have been several developments on the Covid-19 front, but not much has changed in terms of outlook.

Back in late 2020, we viewed the [Philippines as an economy gradually losing momentum](#) with overall activity weighed down by mobility curbs. We expected a modest pickup in growth in 2021

with momentum hampered by high unemployment, poor consumer confidence and a rapid decline in bank lending, all of which pointed to anaemic consumption and constrained capital formation. So what's changed, and what has pretty much stayed the same since the end of 2020?

What's new?

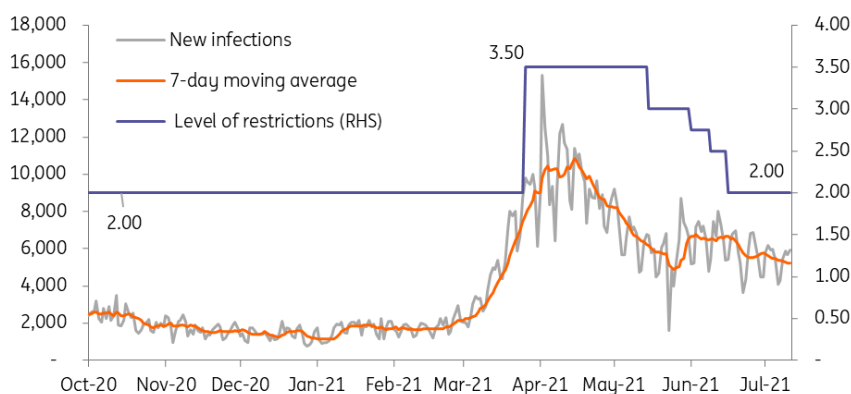
The Philippines began its vaccination program in March 2021, deploying a mix of vaccines, but the program's speed has varied with up to 322,000 jabs administered per day in June, while deployment slowed considerably in July as the country ran out of supply. As of mid-July, the government has fully vaccinated roughly three million citizens (out of 110 million Filipinos), while 9.3 million Filipinos have had at least one dose of the vaccine. Officials target vaccinating 58 million Filipinos in the capital region by the end of November 2021 as new and more infectious variants surface across the globe. Meanwhile, intra-regional movement within the Philippines has resumed as authorities lower restrictions to support the beleaguered tourism industry. But the combination of relaxed international and intraregional movement means that the Philippines remains susceptible to surging infections if new variants enter the country.

What hasn't changed?

Despite the varied developments on the economic and Covid-19 front, we believe the economic trends we highlighted in November last year are still intact.

Firstly, partial mobility restrictions have remained with lockdown measures, even intensifying in April 2021 to fend off an alpha-variant induced spike in cases. Partial lockdowns have been fairly stringent for most of 2021 (vs end-2020) and are back at the same level since our last economic review. Meanwhile, economic indicators have either enjoyed modest improvements like consumer confidence while others have been volatile like unemployment data, and some have even deteriorated like bank lending.

Philippine Covid-19 cases and the simplified scale of mobility restrictions



Source: Johns Hopkins Institute and ING estimates

Downward revision to growth outlook

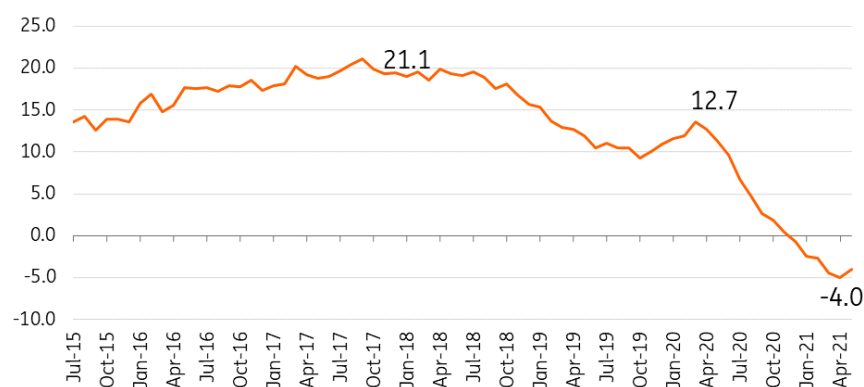
Disappointing first-quarter GDP growth of -4.2%, protracted mobility curbs and a relatively slow vaccination rollout factor into our downward revision to 2021 GDP to 4.7%.

Bank lending has since slipped into negative territory, indicating depressed demand for investment

outlays. Consumer confidence improved but remains negative, suggesting a modest recovery in consumption in the near term while unemployment bounces between 7% to 8% depending on the level of mobility restrictions in place.

The little improvement in economic indicators coupled with the threat of the Delta variant-induced spike point to growth losing even more momentum in 2021. The economic recovery remains challenging and could be further complicated by the return of twin deficits as we move into the second half of the year.

Philippine bank lending shows no appetite for investments just yet



Source: Bangko Sentral ng Pilipinas

Reopening could bring back an old nemesis: The current account deficit

In a curious case of “be careful what you wish for”, the spirited push by authorities to reopen the economy may usher in an old nemesis - the current account deficit.

The Philippine economy contracted by 9.6% in 2020, and as a direct result of the slowdown, imports fell by 19.5%, narrowing the trade deficit by 39.5%. Corporate dollar demand evaporated for most of 2020 due to import implosion resulting in a current account surplus and an appreciating bias for the currency.

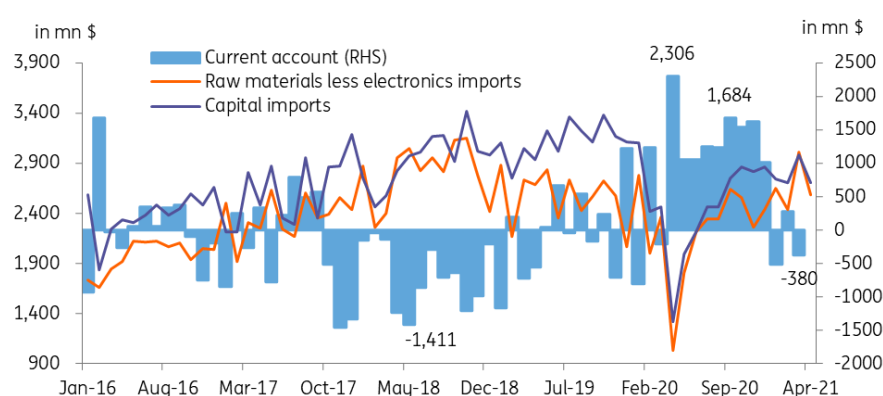
Noticeably absent from the 2020 import bill were capital goods and raw materials, which together comprise 73% of total imports. The stark drop in capital and raw materials mirrored the steep decline of capital information in 2020, which likewise weighed heavily on overall GDP last year. Not too long ago, the government’s infrastructure push in 2017-19 saw a substantial surge for capital and raw materials imports, which bloated the country’s trade deficit and sent the current account balance deep into deficit territory.

The widening of the current account deficit in 2019 left the Philippine external position vulnerable, resulting in a general depreciation trend for the peso. But sustained currency weakness ultimately forced the central bank to hike policy rates by 175 basis points as inflation surged past target. The central bank rate hikes quickly extinguished investment momentum from the economy and slowed growth to a four-year low of 6%.

The reopening of the economy and the pickup in import demand may have already begun to exert pressure on the peso, with the currency reeling by 1.98% in July. A combination of corporate demand and financial outflows triggered by the recent ruling by the global money-laundering watchdog Financial Action Task Force's (FATF) has sparked the recent PHP swoon, and a sustained pickup in import demand in the coming months will translate to a wider current account deficit and further pressure on PHP.

A protracted weakening bias for the currency could force the central bank to reverse its ultra-accommodative stance and hike rates from the historical 2.0% level. A mild tightening of policy stance may arrest the peso's woes momentarily but could also work to undermine the fragile growth prospects with bank lending contracting for six months and counting.

Will the reopening bring the current account deficit back?



Source: Philippine Statistics Authority and Bangko Sentral ng Pilipinas

Will swelling debt raise alarm bells?

The pandemic forced fiscal authorities worldwide to counter stalling economies via huge fiscal stimulus packages at a time of soft revenue collection, resulting in wide fiscal deficits. The Philippines was running fiscal deficits even before 2020, with the pandemic simply pushing the deficit deeper into the red to 7.5% of GDP in 2020. For 2021, the government expects the deficit to GDP ratio to deteriorate further to 9.4% as revenue collections remain meagre when the government has also slashed corporate taxes.

Wider monthly budget deficits pushed the overall debt to GDP ratio to 62% as of May 2021, with authorities banking on a pickup in economic activity to help bring down this metric under 60% by year-end. With the fiscal position challenged, it's no surprise that authorities have been actively curtailing expenditures to limit the impact on the 2021 budget deficit to lower the debt to GDP ratio ultimately.

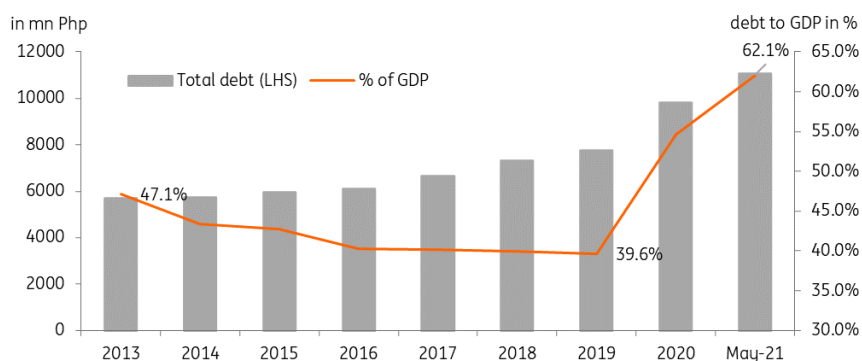
One example of this spartan strategy was the modest 9.5% increase in the 2021 national budget with finance officials preaching the importance of prudence to ensure long-term fiscal viability. Secondly, the budget allocated for the two 2020 stimulus packages was not fully utilised, with unspent funds returning to government coffers to augment the current budget deficit of 9% of GDP recorded last March. Lastly, officials have not supported numerous legislative bills filed by congress for a third stimulus package, citing a lack of funding sources. Overall, government spending is up by a modest 8.8% for the year (as of May), with authorities indicating spending will likely decelerate in the second half of the year.

As of May, total debt to GDP stands at 62.1% of GDP, with domestic and foreign debt totalling Php11.07 trillion. Given the official GDP projection of 6-7%, the 2021 deficit will need to stay below Php445 bn come December - a tall order considering that budget deficit breached this level by May (Php566 bn).

Authorities have been quick to downplay the current elevated levels of both the country's deficit and total debt. At the same time, finance secretary Dominguez remains confident that fiscal metrics will improve in the near term as soon as revenue streams normalise and the economy begins to recover.

However, since we forecast growth and revenue collections to stay modest in the near term, we expect both the deficit and overall debt levels to remain at dangerously elevated levels. Lacklustre growth and a widening deficit could result in the overall debt to GDP ratio staying above 60% by end-2021 - a development that has undoubtedly caught the attention of at least one major rating agency, with Fitch downgrading the Philippines outlook to negative. A possible credit outlook revision or an outright downgrade will be detrimental to the country's recovery fortunes with borrowing costs for the already cash-strapped economy move higher.

Will Philippines debt pile be enough to catch the attention of debt watchers?



Source: Bureau of the Treasury Philippines

A complicated recovery, compounded by return of the twin deficits

The Philippines has made some strides in the last six months since our last report with the vaccine program getting off the ground and with some cross border and regional travel restrictions relaxed. However, many concerning economic trends, such as relatively high unemployment, negative bank lending and weak consumer confidence, remain, suggesting that overall economic growth will stay modest in 2021, largely driven by base effects.

We have lowered our 2021 growth forecast to 4.7% from 5% with possible downward revisions should the twin deficits widen further

Meanwhile, we note further complications to the growth narrative with the return of the so-called “twin deficits”. Authorities have moved to reopen the economy to jumpstart growth quickly, but that has also ushered in the return of the current account deficit and the depreciation of the peso that tends to accompany it. The weak currency, in turn, may magnify price pressures making it extra vulnerable given the resurgence of the dollar. At the same time, the confluence of strained revenue streams and lacklustre growth has resulted in successive months of wider fiscal deficits, resulting in the overall debt-to-GDP ratio crossing the 60% level.

Given these developments, we have lowered our 2021 growth forecast to 4.7% from 5%, with possible downward revisions should the twin deficits widen further.

Philippines: May remittances up 13.1% on favourable base

Overseas Filipino (OF) remittances rose 13.1% in May largely due to base effects



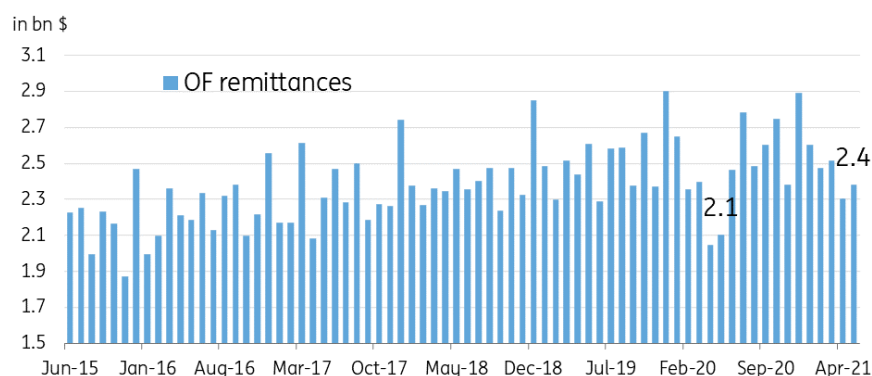
Source: Jun Acullador

\$2.38bn May remittance total

Base effects inflate remittance growth

Overseas Filipinos (OF) sent home \$2.38bn worth of funds in May, bringing the year-to-date haul to \$12.28bn. Remittances grew 13.1%, aided by a favourable base as May 2020 saw remittances plunge by almost 20% amid the global economic shutdown at the start of the pandemic. With world economies gradually reopening in 2021, we've noted a decent pickup in remittance flows, however actual remittance levels have yet to return to pre-Covid 19 levels. For the year, remittances are up 6.3% and we can expect the pace of expansion to continue, albeit with a slight deceleration as base effects fade before year end. The inflow of remittances will help augment domestic incomes strained by the pandemic with purchasing power likely to get an added boost from the now depreciating currency.

Philippine remittance flows just not what they used to be



Source: Bangko Sentral ng Pilipinas

Remittances to offset PHP weakness but not likely to reverse the trend

The steady stream of foreign currency sent home by migrant Filipino workers will help offset some weakness in the peso, however remittances alone are not likely to reverse the currency's recent swoon. With the trade gap swelling past remittance levels and with financial outflows accelerating due to the general risk-off tone, we do expect PHP to remain pressured in the near term. The recent downward revision to the Philippine outlook by Fitch will only work to accelerate the pace of foreign investor outflows until sentiment finally turns. With Bangko Sentral ng Pilipinas (BSP) downplaying possible policy adjustments, the PHP could be on the backfoot until the Bureau of the Treasury opts to offload the proceeds from its recent dollar bond issuance.

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