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By Robert Carnell



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Capital markets are not the same as markets for goods and services

I would go as far as to say that every *reputable economist* would agree that free trade is better at creating wealth than restricted trade and that more trade is better than less trade. NB Emphasis on reputable and economist. Clearly, not everyone agrees.

The same does not hold true for capital markets though. There is, to the best of my knowledge, no similar uncontested and voluminous theoretical support for unfettered movement of capital, nor any suggestion that more capital flows are unambiguously better than less.

That is not to say that it is not so, and in the absence of a strong case against this premise, supra-national bodies like the IMF have simply tended to assume that capital works more or less the same as trade, and so more open markets are better. Usually. Because there is also a long history of countries seeking to liberalize capital markets ending up wrecking their banking systems. Sometimes twice. Even so, that tends to be viewed as an unfortunate consequence of moving to a

better state, an omelette does require the breaking of a few eggs, after all.

Pre-emptive controls?

It is no surprise that the latest suggestion to do more with capital controls comes from Malaysia's central bank governor. After all, under PM Mahathir in the Asian financial crisis, Malaysia aggressively implemented capital controls to protect the Ringgit, and with the massive benefit of hindsight, history seems to have judged that decision reasonably kindly, though not at the time.

What is also interesting about the new suggestion, spearheaded by the Malaysian Central Bank Governor, Nor Shamsiah Mohd Yunus, is that the controls would be implemented "pre-emptively". In other words, they would be imposed before a crisis developed.

This raises all sorts of interesting questions like, when do you opt to implement them? Is the Fed tightening one of the factors that might lead ASEAN central banks to implement such controls? Why not just try to limit hot capital inflows if you are worried about subsequent outflows? And hasn't Malaysia's capital account, which is far from free and open, got enough controls already? None of which I intend to answer here.

All I will say in conclusion is that this initiative is not necessarily and intrinsically harmful to the economic prospects of the countries advocating it. Some version of this proposal might, under some circumstances, have some economic merit. Defining that version and those circumstances is unlikely to be easy, and a one-size-fits-all policy remedy for Malaysia, Indonesia and Thailand is not very likely.

Moreover, while the IMF has softened its dogmatic criticism of capital controls over the decades since the Asia crisis, it's gut instinct is still to support open markets, so I don't expect they will be rushing to support this proposal.

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International theme: Strong earnings soothe frayed nerves, for now

- Risk-on tone helped markets rebound with earnings reports showing strong gains. Traders look to FOMC minutes for further direction.

EM Space: ASEAN central banks talk capital controls

- **General Asia:** Asian markets may rebound after the Dow's strong showing, though with a cautious trading ahead of the FOMC minutes and still unresolved issues in the Middle East.
- **ASEAN:** A Financial Times report cited heads of central banks of Malaysia and Thailand as advocating management (control) of capital flows to stabilize financial markets during times increased volatility. Both Malaysia and Thailand are well-known for their capital controls. We consider markets in Malaysia at greater risk of potential controls than those in Thailand.
- **Malaysia:** As per the FT report, BNM Governor Nor Shamsiah Mohd Yunus viewed capital controls as a "legitimate policy tool that can be deployed in a pre-emptive manner to deal

with potential risk to financial market stability". Upon his return to power in May this year, PM Mahathir downplayed the need of capital controls unless people start "fiddling" with the currency.

- **Thailand:** Thailand's strong external position and its best-performing currency in Asia eliminate the risk of capital controls for now. Tourist arrivals rose 2.1% YoY in September, a modest slowdown from 3% growth in the previous month led by continued declines in Chinese tourist. Arrivals from China were down 15% YoY. Lower tourism inflows and falling trade surplus will be associated with narrower current account surplus this year.
- **Indonesia:** Indonesian government officials expect growth in 2019 to stabilize at 5.12% and the local currency to average at 15,000 as increased energy subsidy contributing to the weakness of the IDR going forward. Indonesia is said to be one of the ASEAN central banks in favor of Malaysia's push for capital controls to pre-empt financial market stress.
- **Philippines:** Government officials revised growth targets lower for 2018 to 6.5-6.9% (from 7-8%) after the disappointing 1H performance and with inflation sapping growth momentum. Meanwhile, a BSP policymaker signalled a dovish bias, indicating that the central bank may pause from hiking rates if month-on-month inflation shows a decelerating trend.

What to look out for: FOMC minutes and inflation from Europe

- FOMC minutes (18 October)
- Fed Bullard (18 October)
- Fed Kaplan (19 October)

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Source: Shutterstock

Mixed inflation data

September consumer price inflation of 3.8% year-on-year was yet another downside surprise, though it's still an uptick from the 3.7% rate in August. Food prices continued to surprise. But transport has started to accelerate while most other components remained elevated, led by an 8.5% increase in utility prices.

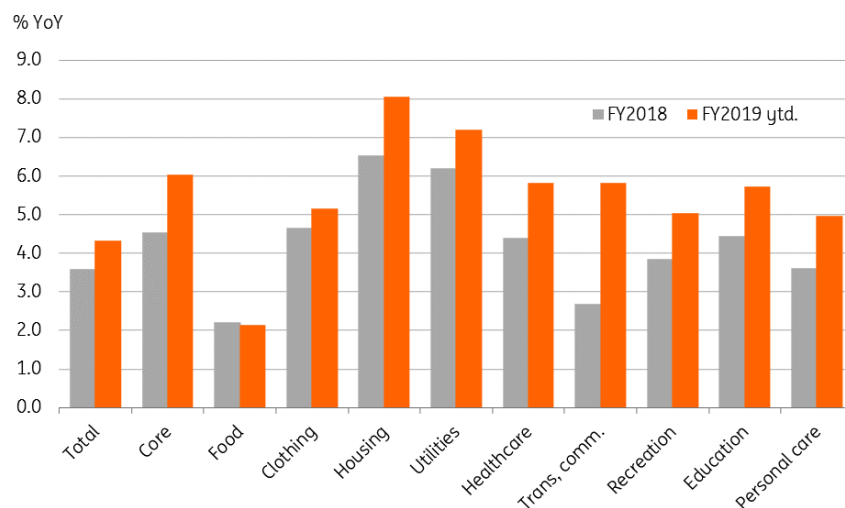
It seems the high base-year effect is outweighing the underlying upward inflationary pressure from higher global crude prices and the weak currency. The base effect will remain in play for the rest of FY2019 (ending in March 2019), and, with the central bank's (RBI) policy driven solely by inflation, this could stave off any pressure to hike rates. However, while food has kept the headline CPI muted, inflation in all other CPI components has been on an upward trend this year (see figure).

And wholesale prices have painted a different picture to consumer prices. A spike in WPI inflation in September to 5.1% year-on-year from 4.5% in the previous month was steeper than expected. As

in the CPI, food inflation continued to be low but utility inflation was in the high double-digits due to rising oil prices, which drove the headline WPI rate higher.

Higher factory gate prices will eventually be passed on to consumers.

Non-food inflation has been up



Source: Bloomberg, CEIC, ING

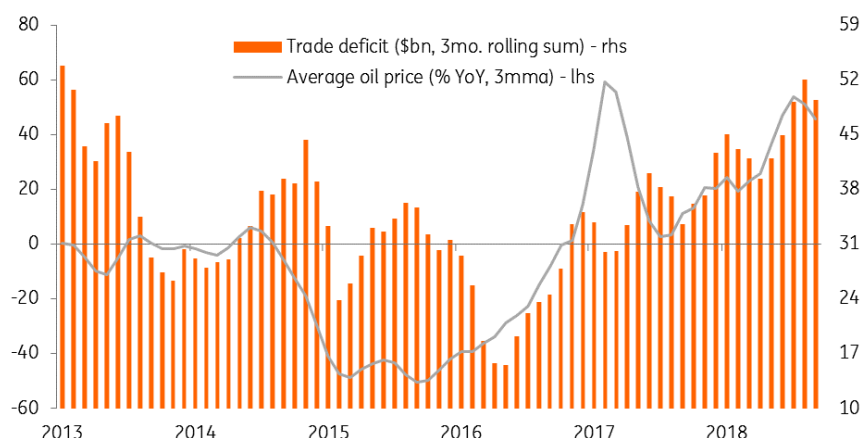
Narrower trade gap

The external trade deficit surprisingly narrowed to \$14.0 billion in September from \$17.4 billion in August. This was despite a sharp slowdown in export growth to -2.1% YoY, the first negative print since March, from 19.2% growth in August. But import growth also slowed to 10.5% from 25.4% on a broad-based slowdown in both oil and non-oil imports.

Oil imports have been falling on a month-on-month basis since July and the year-on-year growth rate has nearly halved to 34% over the same period despite firmer global crude price inflation of over 40% through September. However, after the recent spike in oil prices above \$80 per barrel and with elevated geopolitical risk in gulf countries (Iran, Saudi Arabia) we anticipate no lasting relief on the trade deficit front.

The cumulative deficit of \$94 billion in the first half of FY2018-19 was still \$20.7 billion wider on the year, supporting our view of a widening of the current account deficit to 2.6% of GDP in the current financial year from 1.9% in the last.

Oil drives trade deficit



Source: Bloomberg, CEIC, ING

No lasting relief for INR

The Indian rupee's oversold position over the last two months provides it with an edge to outperform in a softer US dollar environment. Indeed, the INR stood alongside Asia's best-performing Thai baht (THB) in last week's global equity sell-off. However, the four-day downward USD/INR streak last week was snapped on Monday, a sign that the markets aren't taking much comfort from the better activity data. And we aren't yet ruling out an intensified spillover from the recent high oil price on to the INR, leaving our year-end USD/INR forecast at 76.5 (spot 73.8).

Philippines: August remittance flows slip

August Overseas Filipino Worker (OFW) remittances slip 0.9% but year to date remittances chug along at 2.5%



Source: Shutterstock

2.48% Year-to-date OFW remittance growth
slow and steady structural flow

Remittances continue to provide structural FX flows despite volatile growth

August Overseas Filipino remittances slipped by 0.9% year-on-year with a total of \$2.476 billion sent home in August. All major sources of remittances saw growth save for the Middle East which experienced an inexplicable 28.8% drop in flows. This brings the year-to-date haul to \$19.056 billion, up 2.5% from the same period in 2017 as OFW remittances continue to be a stable source of FX to the Philippines.

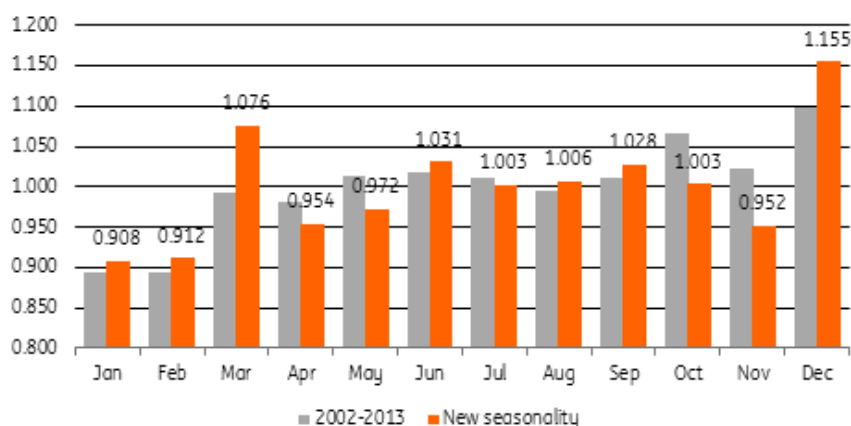
Changing season(al)ity

The contraction in annual terms shows that the seasonality in remittances continues to shift, mainly due to school year changes as well as to possible late payments to workers. A structural

shift occurred in 2014 to yield the new seasonality, with remittances apparently saved for the December holidays (more pronounced now) and in March. Nuances in exchange rates given the divergence in monetary policy may have also caused the discrepancy given yearly growth rates. Going forward, annual and year-to-date growth rates are still seen to average around 3%.

OF Remittance Seasonality 2002-2013 vs New

Seasonality of OF remittance flows



Source: BSP and ING estimates

2002-2013 vs new seasonality of overseas Filipino workers

Slow and steady vs fast and furious

Many sectors have lamented the fact that the trade deficit has zoomed past the traditional structural sources of FX, namely OF remittances and BPO call centre receipts. Given the robust growth in capital goods and raw materials imports, the trade deficit has ballooned to eclipse both remittances and BPO receipts, yielding current account deficits. However, once the investment cycle turns, we could expect remittances and BPO call centre receipts to chug along steadily while capital imports and raw materials peter out to once again yield current account surpluses after the Philippines has built up its infrastructure and productive capability.

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