Good MornING Asia - 5 March 2018

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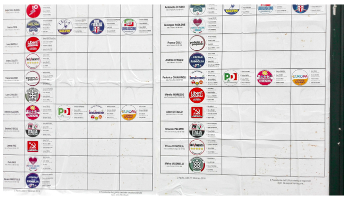
In this bundle



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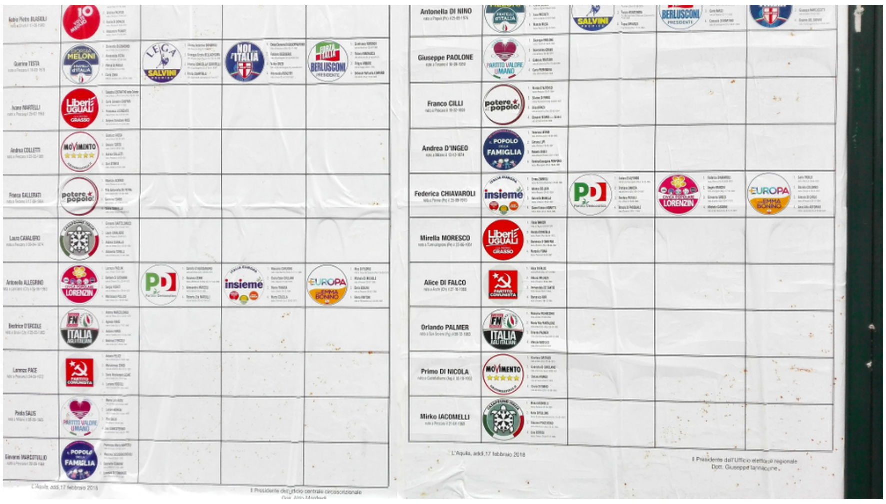


Italian voting slip

Italy's polls provide no answers

According to exit polls, about 50% of Italian votes over the weekend went to Eurosceptic parties, though in terms of seats, it doesn't look as if a centre right bloc, or the far-left 5-star movement will come close to the 316 seats needed for majority in the lower house. What happens next? Well a protracted period of negotiations will now ensue as political leaders try to stitch together a workable coalition government. If that fails, then more elections seem a distinct possiblity. In some ways, a hung parliament, if that is what we are left with, is not a disaster. Though Italy is not a Belgium or Netherlands - recent examples of European countries that have failed to quickly form a government following elections. And as one of the worst performing (and big) European economies, a hung parliament eliminates the possibility of beneficial economic reforms that could help make up the growth shortfall with the rest of Europe.

Donald where's yer troosers?

US President Donald Trump's announcement last week of tariffs on steel and aluminium are still standing this side of the weekend, though we still wait for an official announcement. From what we hear, there will be no exemptions despite big protests from Canada, the EU, UK, Japan and Australia.

According to Trump, Trade Wars are "good", and "easy to win". This is a statement that is hard to back up either empirically or theoretically (editorial policy precludes me from saying anything stronger). We'll see if he still agrees when the EU puts tariffs on his US jeans ("troosers" in case you were wondering), bourbon (shame, but all wars have casualties, this will be mine) and Harley Davidson motorcycles.

Retaliating to the theoretical retaliation, Trump has already suggested adding European cars to the list of tariffed goods. In all seriousness, this is shaping up to get ugly quickly, and trade wars are in my opinion the biggest threat to global growth and financial market strength over the coming 12 months. Moreover, such actions further isolate the US economically and geopolitically. This is an opportunity, if they want it, for Europe to forge greater economic and political ties with Asia, and especially China, as the world seems to be uniting against the belligerent policymaking of the current US administration.

Merkel gets SPD backing

Angela Merkel can begin her fourth term as Chancellor of Germany this week, following the comfortable backing of the SPD membership for a coalition with her CDU party. One of Merkel's most pressing decisions will be the appointment of a finance minister from the SPD ranks. This morning, France's President Macron will be pleased, he wants to pursue bold reforms in Europe, only possible with Germany's (Merkel's) backing. And the UK government should also be breathing a sigh of relief. Merkel is seen as the only politician with enough clout to force a decision on a Brexit deal when the March 2019 deadline approaches.

Week ahead

The week ahead offers more insights into President Xi's vision for China, with the outcomes of the national sessions of parliament, the language on growth targets (or not, which would be equally interesting) and key appointments just some of the things to watch out for. So far, comments from China on the US tariff announcements have been extremely patient and measured, though we may also hear more detail on what China means when they say that they will "not allow its interests to be harmed". There is talk from China of a new trade dialogue with the US. That could be helpful, but we won't hold our breath.

This week also sees inflation data released across a lot of the region, with Korean, Taiwanese, Philippine and Chinese and inflation numbers all due. Consensus forecasts anticipate some moderate increases in headline inflation rates in all of the reporting countries this week. Taiwan, Malaysia, China and the Philippines also release trade data this week. Better than expected Korean trade data last week set a more positive tone for these countries.

The Reserve Bank of Australia (RBA) also meets this week though it seems as far from any hike as ever. Most pundits, when asked, are looking at a combination of good growth (4Q 17 GDP out this week too) but no inflation or wages growth, coupled with high levels of household debt as a reason to forecast no RBA rate hikes until later this year. Whilst this is a kind of lazy forecasting, always pushing action out into the future, we can't say we are any better, and until wages or inflation start to respond more clearly, that seems a sensible holding pattern for RBA rate forecasts.

Author

Olivia Grace
Editor
olivia.grace@ing.com

Julian Geib
Junior Economist, Global Trade
julian.geib@ing.de

Zoltán Homolya
Economic research trainee
zoltan.homolya@ing.com

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@ing.com

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Senior Economist, Healthcare & Technology
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Deputy Global Head of Editorial and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporate Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands
marcel.klok@ing.com

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com

Article | 2 March 2018 China

China: Stability guaranteed

Constitutional changes in China will allow President Xi Jinping to serve as president indefinitely. What does this mean for the economy?

Source: Shutterstock

Xi extends his tenure as the leader of the country

Although Xi's (pictured) tenure will no longer be limited by the constitution, it will end at some point. Let's assume that the arrangement would be similar to a Kingdom. Whether the Monarch eventually abdicates or passes away, the monarchy passes to someone else. The same arrangement is likely to apply to Xi, who is now 64. That means he could be the country's leader for a long time yet.

Overall, this could be positive for the economy because economic policies are likely to be consistent.

> *This is positive for the economy because economic policies are likely to be consistent.*

In contrast, democratic countries' policies often get overturned at elections, and sometimes fail to achieve their goals. China does not have such hindrances. So Xi can set his policies with a long-term vision.

Xi has already initiated several important projects for the economy. These need time for the results to be seen.

- Firstly, the anti-corruption campaign.
- Secondly, the Belt and Road Initiative.
- And finally, to modernise society, that is, to have a society that is wealthy and high-tech.

With Xi likely to be in place for some time, there is a higher probability that these projects will conclude and achieve their results, and in turn, provide economic stability. To maximise the benefit of Xi's longer tenure, he will also need his advisory team to be as stable as possible. That means he will engage people who share his thoughts (Xi's new era thoughts), which will be added to the State Constitution after they have been added to the Party's Charter.

Other countries could feel the heat of a stronger economy and leader

As the economy becomes stronger and more stable, other countries may begin to feel that the rise of China could provide opportunities as well as risks.

Japan and Australia have gestured that they would like to create another project similar to the Belt and Road initiative (BRI). This is perhaps because these two economies are left out of BRI. In the meantime, western countries see China's strength as more of a threat than an opportunity, with the US and some European countries hinting at trade sanctions against China's products.

Could this turn into a trade war? We do not think so because we don't believe that China will react by imposing retaliatory trade sanctions on other countries. This includes the US despite its intention to slap import tariffs on steel and aluminium.

> *Could this turn into a trade war? We do not think so.*

We doubt China will react with tariffs on US food imports. There is a more effective way for China to prevent countries ratcheting up their trade sanctions against them. For one, China could simply stop the companies of hostile countries from operating in Mainland China. Companies of hostile countries would lobby their governments in turn.

Besides running a stronger economy, Xi may build up China's military power faster as mentioned in the 19th Congress. Neighbouring countries and the US will feel the heat. But it is too early to say whether China's military power will worsen geopolitical tension.

New central bank governor will not change the course of interest rate and exchange rate reform

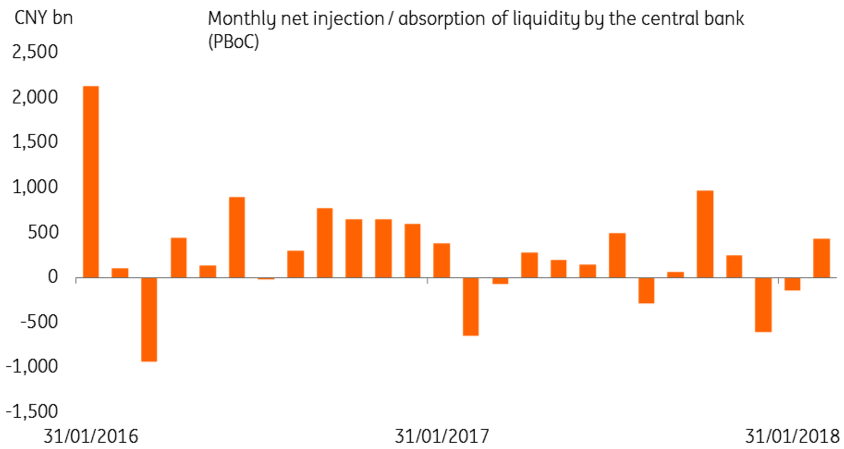
The Two Sessions, Chinese People's Political Consultative Conference (CPPCC) and the National People's Congress (NPC), will be held on 3 and 5 March. We expect by then, Xi's advisory team will be clearer and we should know who will lead the central bank (PBoC) as Zhou retires for another role.

We believe that the new central bank governor will be someone who shares Xi's gradual reform approach on interest rate and exchange rate liberalisation.

We believe the central bank (PBoC) will follow the Fed's four expected rate hikes in 2018.

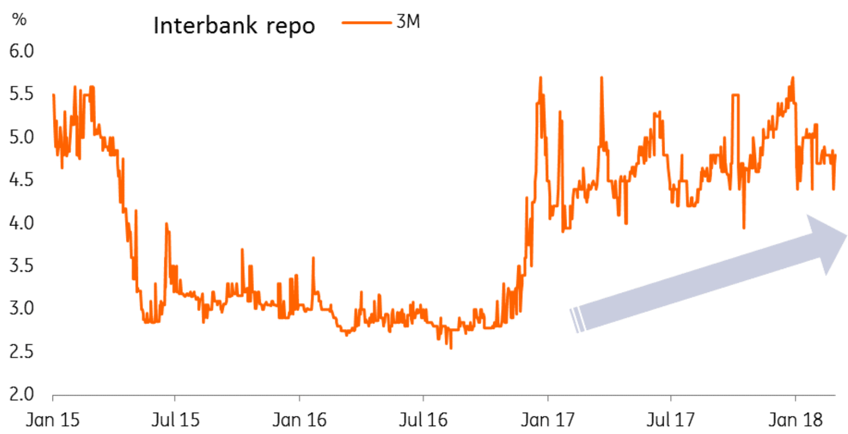
That means the status-quo for monetary policy and exchange rate policy. We believe the central bank (PBoC) will follow the Fed's four expected rate hikes in 2018 to keep interest rate spreads stable, but could only add five basis points each time, as financial deleveraging would push up short-term interest rates further.

Short-term rates should rise with more frequent net liquidity absorption



Source: ING, Bloomberg

PBoC may follow the Fed but at 5bp a time



Source: ING, Bloomberg

The exchange rate mechansim will also remain largely the same. We do not expect any widening of the daily trading band unless the spot rate becomes more volatile during intraday sessions. We maintain our forecast of USD/CNY and USD/CNH of 6.1 by the end of 2018.

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Article | 2 March 2018 China

Keep an eye on reforms in China’s Two Sessions

This year's "Two Sessions" will be different from previous years, as President Xi extends his tenure. Reforms will be under the spotlight. We share our thoughts on what reforms to expect and the risks and opportunities for some sectors

Source: Shutterstock

This time would be different

With President Xi's tenure extended, talking points in the Two Sessions will be different from previous sessions.

As Xi has consolidated power in the Party and also the State, he will demonstrate to the country and also to the world that he is capable of achieving results that previous leaders of China could not fulfil. These include raising the profile of China in international platforms, in terms of economic power and in influencing international opinion. In other words, Xi would like China to play a more prominent role in international politics. At first, this may be imperceptible, but over time, Xi would like China to be a country that is impossible to ignore.

Quantitative vs qualitative targets

To become too big to neglect, the first step is to make the economy even stronger. And the government has realised that quantitative growth targets may not be enough to bring the economy to the top of the world.

We expect that in the coming Two Sesssions, especially on 5 March when Premier Li gives the government report, GDP growth targets could be vague or even absent. Instead, there would be more emphasis on qualitative growth. Last year's "around 6.5% GDP growth target" could become a wide range this year or disappear altogether.

This would induce local governments to focus more on how to grow in line with qualitative targets. These could include, making people wealthier (ie, lower unemployment and higher wages), healthier with less pollution, or enjoying more convenient lifestyles with the help of advanced technologies. in terms of corporates, local governments have to make sure that corporates in their locations comply with the State's regulations (eg, not over-invest abroad), and also become more technologically advanced, and push ahead with anti-pollution measures.

We expect local governments will have to work a lot harder under qualitative targets because they are more difficult to measure. The old ways of boosting local GDP by building inefficient projects have passed.

Reforms to achieve qualitative targets

As qualitative growth is increasingly important, the central government will implement more reforms. On the one hand, to clean up issues like overcapacity, and on the other hand, to create better economic growth prospects.

Here are some of the reforms we expect to see in the forthcoming government report, and their potential risks to the economy.

1 Supply-side reforms

It is almost certain that supply-side reforms will continue, but focussed on different sectors, now that production cuts in iron and steel have yielded such good results.

We expect to see more raw material sectors becoming targets of supply-side reform. That means more overcapacity cuts in raw material sectors, including cement and glass. These production cuts would push up prices of materials, and could create better profits for surviving companies in these sectors.

The risk comes from debt defaults from factories facing production cuts, which could in turn affect the quality of the banking sector and the bond market.

We think that some of these risks would be absorbed by other SOEs but some of the losses would be borne by banks and bond investors. Debt-for-equity swaps could play a role in these default cases.

2 Financial reforms

Financial deleveraging will be the key reform in 2018 as the government is determined to clean up shadow banking in the financing sector. It means that the "super financial regulator" will steer reforms to guard against risks coming from online platforms for financial products, including personal loans and wealth management products.

This means tighter liquidity and will result in higher short-term interest rates.

Overly tight liquidity could create tensions for banks and other financial institutions. But we see this risk as quite low as regulators manage liquidity on a daily basis.

There could be some closure of small online financial platforms, possibly creating credit risks among banks and other non-bank financial institutions that have indirectly lent to those platforms through the interbank market, trust companies, etc. To avoid credit risks turning into a domino effect, regulators would act sooner rather than later, and tighten regulations to rein in future risks.

3 Green reforms

Reforms on moving from traditional energy to green energy will also play an important role in the government report. It seems to us that China would like to wash away the stigma of a pollution-generating country, and even reverse that into a clean-energy country.

This would mean big changes in the energy sector in China, and would directly increase infrastructure investments in the utility sector.

Related sectors would also need to adapt to these changes. For example, there would be more production of new energy cars, and that would bring changes to the battery sector.

Green reforms sound a great step forward, but traditional energy companies will find it harder to maintain profit levels and will need to set aside more money to keep pace with ever-tighter environmental regulations.

4 SOE reforms

Reforms on corporate governance and corporate structure of state-owned enterprises (SOEs) will continue.

This reform area is often neglected by the market because of its long term nature. This means that the market will only slowly see the implications for the economy from SOE reforms.

We expect more mergers of SOEs in strategic sectors, eg, energy, raw material sectors. The government's intention is to close down small and loss-making SOEs, and reduce the number of SOEs to a point where they are sufficient merely to serve the strategic needs of the country.

But this does not mean that SOEs will no longer be relevant to economic growth. Quite the opposite. The remaining SOEs will be very important to growth as they will support the economy when needed, and may drive experimental projects for the government.

As some SOEs will close down, there is credit risk to the banks most exposed to the SOEs. Banks will need to be watchful of their capital ratios as write-offs increase.

> The preceding ideas are only likely to be part of the reforms announced from the coming Two Sessions. We would not be surprised if there were other new ideas from President Xi, ideas that would justify his longer tenure.

Author

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Article | 2 March 2018 **Japan**

Japan: Something fishy

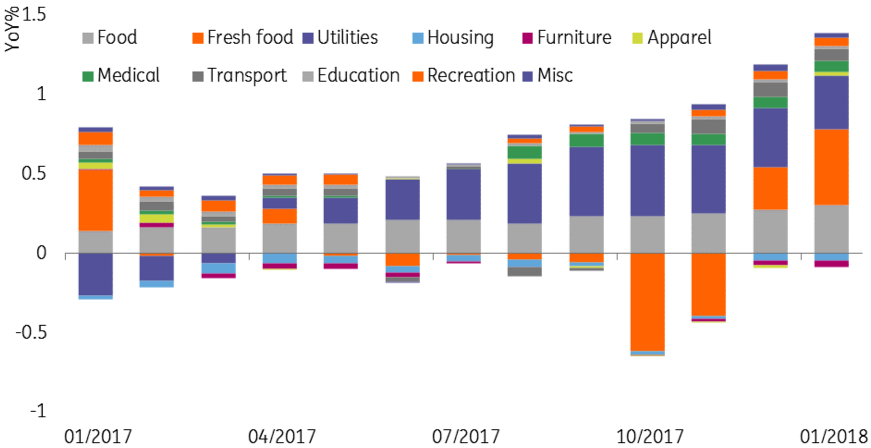
Rising prices for salted fish-guts (among other things) could force the Bank of Japan to trim its qualitative and quantitative easing programme

Source: Shutterstock

Japan's inflation emerged from negative rates in September 2016, and is now comfortably above 1% (1.4% headline). With a 2ppt consumption tax due in April 2019, the next 18-months to two years offers to be one of unexpectedly robust inflation for Japan. So is it time for the Bank of Japan (BOJ) to ditch their Qualitative and Quantitative easing (QQE)?

The answer to this partly depends on why inflation is rising and what else is happening in the economy.

Contributions to Japanese CPI



Source: CEIC

Food is part of the answer to the inflation question

On the former, there are two main factors to consider. The first is food. Normally we would exclude this, as volatile fresh food prices can dominate the headline index. But non-fresh food has also risen, and that is harder to just write off.

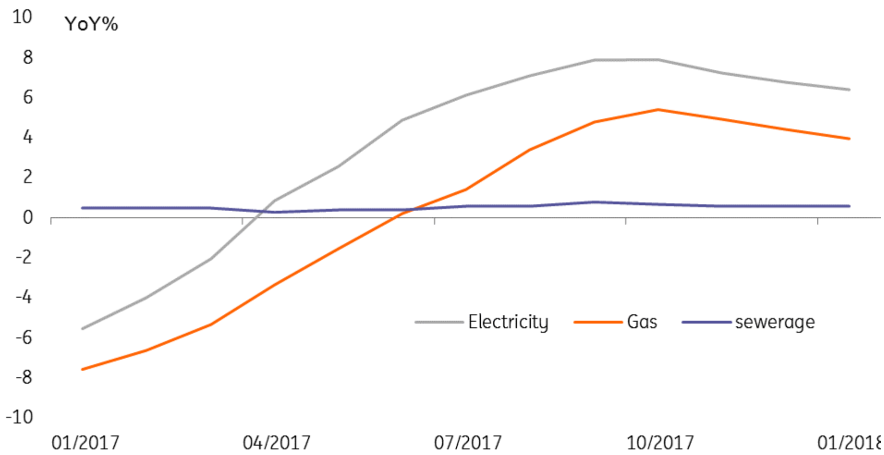
What appears to be going on is a combination of fish, and gas. The Seafood component of Japan's CPI is large and highly diverse. But within this, there have been some substantial price spikes for fish such as tuna, bonito and saury, A spillover of the rise in the prices of fresh fish is that products such as dried fish, squid or salted fish-guts (yes, there is a category for this) have pushed substantially higher. And as the key ingredient for sushi and sashimi, prices of Japan's iconic prepared dishes have been soaring.

The root cause of these price spikes is essentially supply. Fish catches have been very disappointing. For some fish, catches are less than half of last year's, which were also historically low. This looks like an overfishing issue, with fish stocks collapsing. Consequently, the collapse in supply is unlikely to reverse quickly and may require years of fishing restraint to help rebuild stocks. This too will keep prices high, or perhaps lead to further rises.

Inflation is also responding to rising wholesale gas prices

The other main cause of inflation is gas. After the Fukushima earthquake and destruction of Japan's nuclear power generation, Japan became heavily reliant on LNG imports. Wholesale gas prices for purchase in Japan are not particularly high, but they have bounced off their lows of 2016/17 as LNG is also a popular fuel for other countries these days, as cleaner sources of power are sought against a backdrop of relatively inelastic supply. This is pushing up prices of retail gas, but other fuels such as electricity.

Utility inflation rates



Source: CEIC

Normally the BoJ wouldn't respond to such supply shocks But there are other reasons, principally growth, why they might want to trim QQE

Both of these issues are essentially "supply shocks", arising from (1) a lack of fish and (2) a lack of global LNG relative to demand, and not necessarily something the BoJ would respond to.

But the growth data is also good, and the arguments for keeping QQE unchanged are looking thinly stretched. This week, the BoJ cut the amounts of super-long dated bonds it usually buys, and we are beginning to wonder if, in the global backdrop of rising rates and bond yields, the BoJ is wondering how it can create an exit strategy that will not result in a USDJPY rate smashing through 100.

The days when you could just forecast zero for everything forever in Japan seem to have passed.

We haven't raised our forecast for JGB yields, though we have trimmed our "actual" asset purchasing by the BoJ from JPY45tr in 2018 to JPY30tr (official target is still JPY80tr annually). Nevertheless, this is something we shall be thinking hard about over the coming months. The days when you could just forecast zero for everything forever in Japan seem to have passed.

Author

Olivia Grace
Editor
olivia.grace@ing.com

Julian Geib

Junior Economist, Global Trade
julian.geib@ing.de

Zoltán Homolya
Economic research trainee
zoltan.homolya@ing.com

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@ing.com

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Senior Economist, Healthcare & Technology
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Deputy Global Head of Editorial and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporate Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com

Thailand: Just keeping afloat

The latest price data dashes the central bank's hopes of inflation hitting the 1-4% policy target in the coming months

A downside inflation surprise

Thailand's consumer price inflation surprisingly slowed to 0.4% year-on-year in February from 0.7% in January. The consensus forecast was no change from January's level. Food and transport prices were the main drags. Core CPI measure at 0.6% was unchanged from January.

0.4%

CPI inflation in February

Year-on-year

Lower than expected

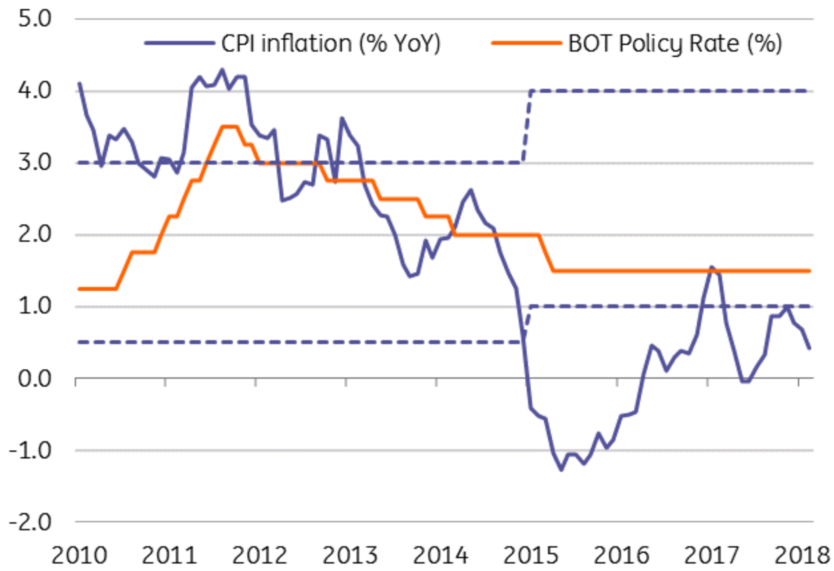
The central bank's inflation optimism

Data dashes the Bank of Thailand's, the central bank, hopes of inflation rising up to the 1-4% medium-term monetary policy target in the coming months. It may get there on a technical ground, the shift to low base in March 2017, rather than an underlying price recovery. The target was raised from 0.5-3% in early 2015, an odd timing when the economy plunged into deflation, and has been hardly achieved since (see chart). Inflation averaged at -0.9% in 2015 followed by a modest recovery to 0.2% in 2016 and then to 0.7% in the last year.

We think it's now time for the BoT to lower policy inflation target.

A sustained weak domestic spending will keep demand-pull inflation low, while strong Thai baht (THB) mitigates spill over of rising global commodity price. Another year of below-target inflation is the baseline. We are reviewing our 1.1% forecast for 2018 for downward revision. We reiterate our forecast of no change to the BoT rate policy all year.

Inflation and the Bank of Thailand policy



Dotted lines are BoT's target for CPI inflation, currently 1-4%.

Source: Bloomberg, ING

Author

Olivia Grace
Editor
olivia.grace@ing.com

Julian Geib
Junior Economist, Global Trade
julian.geib@ing.de

Zoltán Homolya
Economic research trainee
zoltan.homolya@ing.com

Amrita Naik Nimbalkar

Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@ing.com

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Senior Economist, Healthcare & Technology
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Deputy Global Head of Editorial and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland

leszek.kasek@ing.pl

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporate Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

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