In case you missed it: Powell to the rescue

Markets liked what they heard from Powell, and it's pretty clear the Fed is preparing for action. But could frustration with the Fed prompt President Trump to take matters in his own hand and weaken the dollar? Possibly. Battered Asian currencies are hoping for some respite, particularly the Korean won. Our Asian FX Talking explains the North-South divide

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Is the South Korean economy headed for a recession?

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In 2Q19, Russia's current account surplus was lower than expected for reasons other than the oil price. This means no respective decline in the...

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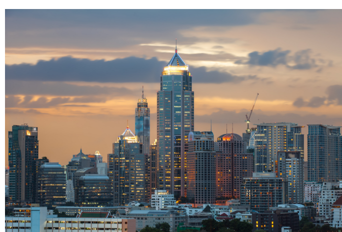

Thailand

Political stalemate hurts Thailand’s economy

Three months after the General Election, politics still remains a key overhang on the Thai economy. With political logjams slowing the emergence of any...

Article | 10 July 2019

US: Powell testimony suggests softly, softly approach

Financial markets have taken Jerome Powell's testimony as a signal that the Federal Reserve is fully on board for rate cuts. However, the statement is more nuanced and hints at a more cautious approach from the Fed than is currently priced

Source: Shutterstock

Fed Chair, Jerome Powell

Markets like what they hear

Today's semi-annual monetary policy testimony by Federal Reserve Chair Jerome Powell offers something for everyone. Headline writers for the newswires have chosen to focus on the line that "uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the US economic outlook". Markets also seem to like this, responding with a bullish steepening of the yield curve (2Y yield down 6 basis points and 10Y down 2bp). Expectations of a July rate cut have also firmed with the market pricing now implying around 30bp of easing on 31 July. The dollar is softer too.

With regards to a potential imminent policy easing, Powell repeated comments that "many FOMC participants saw that the case for a somewhat more accommodative monetary policy had strengthened". He also acknowledged that "business investment seems to have slowed notably", which is attributed to "trade tensions and slower growth in the global economy".

But there were positives...

However, the statement also offered some positives and sounded more balanced than market moves initially suggested. The line "our baseline outlook is for economic growth to remain solid, labour markets to stay strong and inflation to move back up over time" to 2%, suggests to us that any rate cuts will be precautionary and tentative. Moreover, consumer spending is described as "running at a solid pace", thanks to a strong labour market where "job openings remain plentiful". This doesn't suggest that the Fed is seriously contemplating the 100bp of rate cuts that financial markets are currently expecting by the end of 2020. Moreover, there isn't a great deal domestic interest rate cuts can do to mitigate against external threats other than perhaps limit the upside for the US dollar.

Preparing for action

Overall, the tone of the testimony together with Powell's previous commentary, such as his assertion that an "ounce of precaution is worth more than a pound of cure", suggests we should prepare for rate cuts. We agree with the market that the Fed will cut rates 25bp in July and likely follow up with a further 25bp in September. Thereafter, it is down to the big unknown of what happens with trade policy, and that is something that is very firmly in President Trump's hands.

If US-China talks break down and a new round of tariff hikes are implemented this could lead to more economic weakness through disrupting supply chains, putting up costs and hurting profit margins. However, our trade team takes the view that the fear of economic weakness for both sides will lead to China and the US finalising a deal later this year that doesn't necessarily achieve all of President Trump's initial demands. A positive boost to sentiment from this would clearly reduce the need for additional Fed policy easing.

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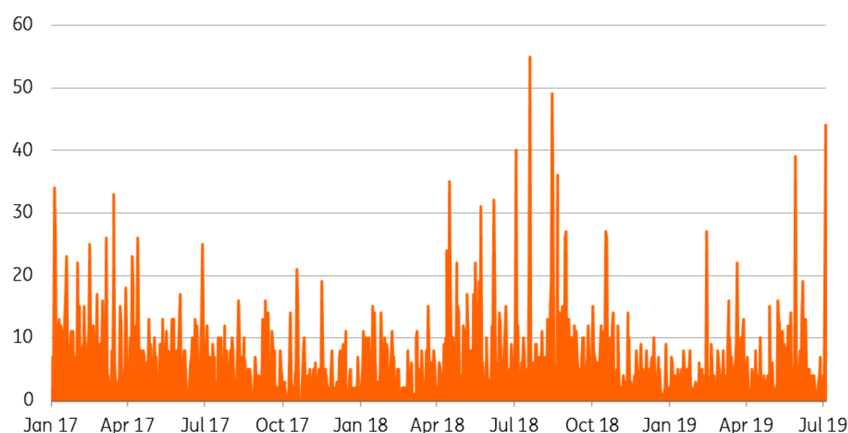
FX intervention: Does President Trump have the means, motive and opportunity?

FX intervention is in the news after President Trump accused China and Europe of playing a 'big currency manipulation game' and suggesting the US should match it. Could frustration with the Fed prompt the President to take matters in his own hands and weaken the dollar?

Source: Shutterstock

US President Donald Trump and Federal Reserve Chairman Jerome Powell

FX intervention is back in the news (Bloomberg story count)



Source: Bloomberg

Beyond pressuring the Fed, how could the President weaken the dollar?

Given the overt pressure on the Federal Reserve to ease policy, it should come as no surprise that President Trump would like a weaker dollar to support the US economy. His problem is that he has few powers over domestic, let alone foreign monetary policy. He may bemoan Europe for keeping its currency weak through prior and perhaps future episodes of quantitative easing, but eurozone core inflation hasn't been near the ECB's 2% target since early 2008 and Washington can do very little to prevent another round of easing from the ECB.

It is possible, Washington may start to look at its own tools to weaken the dollar. There have been no direct suggestions from the White House so far, but tweets regarding the need to match the currency manipulation of other trading partners have the market speculating over whether President Trump would instruct the US Treasury to sell dollars and buy FX in a unilateral intervention.

> *Will the lure of a weaker dollar to support the US economy into 2020 prove to be too great for President Trump?*

The issue of US FX intervention has also gained attention after a post from ex-US Treasury official and respected blogger, Brad Setser, a senior fellow at the Council on Foreign Relations, supporting calls for countervailing currency intervention (CCI) – effectively laying the groundwork for the US Treasury to sell dollars and buy currencies of those countries having been deemed to be manipulating their currencies lower for trade gains.

Given the President's broad use of executive powers – including the obscure IEEPA law to block undocumented Mexican immigration – it is not too much of a jump for the White House to re-familiarise itself with available methods to influence FX rates. Even though, in theory, the US is still signed up, via the March 2018 G20 Communique, to refrain from competitive devaluations, but the

lure of a weaker dollar to support the US economy into 2020 may be too great.

Here we look at whether the White House has the Means, the Motive and the Opportunity to engage in direct intervention to weaken the dollar.

Read Brad Setser's blog post: Three recommended changes to US currency policy

1 The Means: Authority lies with the White House

When it comes to FX intervention, the authority to direct it certainly sits with the President. This derives through the 1934 Gold Act which established the Exchange Stabilisation Fund (ESF). This legislation gave power to the US Treasury and the President to deal in gold and FX 'for the purpose of stabilising the exchange value of the dollar'. There have been several amendments to this law over time, but none to categorically change the position that the President can direct FX intervention.

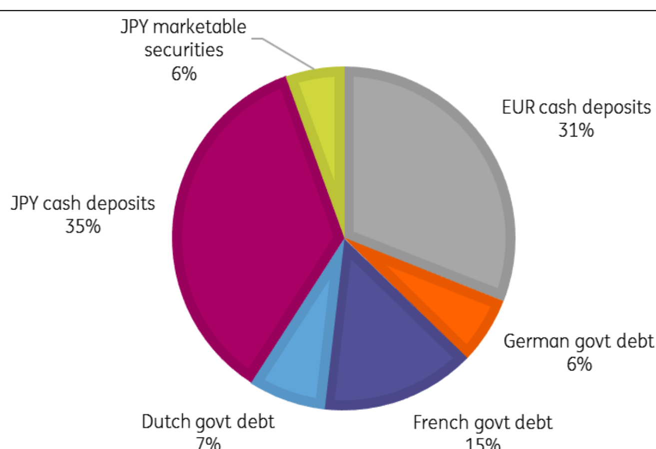
> *It seems pretty clear that the authority for FX intervention sits neither with Congress nor the Fed, but with the President*

Currently, the United States FX reserves are around USD 42bn, held exclusively in EUR and JPY. These are split equally between the Treasury's ESF and the Fed's SOMA account – effectively whenever the US Treasury instructs the Fed to intervene in FX markets, the Fed would undertake the mirror-image activity in both the ESF and SOMA accounts. Currently, FX reserves are roughly split 60:40 for EUR:JPY and 60:40 cash deposits: government securities.

Conceivably, the White House could tell the US Treasury to go out and buy several billion dollars' worth of EUR and JPY to 'stabilise the dollar'. In terms of which dollars get sold for this exercise, we presume the US$23bn worth of US government securities in the ESF may be untouchable. Instead, such activity would involve some money creation from the Fed, given that issuing Treasury debt for FX purposes (as Carter did in 1978) would probably have to go through Congress – something the White House would want to avoid.

However, in short, it seems pretty clear that the authority for FX intervention sits neither with Congress nor the Fed, but with the President.

USD 42bn of US FX reserves are in EUR and JPY



Source: US Treasury

2 The Motive: Trading partners aren't playing fairly

President Trump hasn't minced his words about currency manipulation. Europe and China are certainly in the firing line here and the White House's motives – as Brad Setser rightly points out – are that if the US economy slows and the Fed cuts rates, the US export sector should be able to benefit from a weaker dollar without trading partners preventing an adjustment in their currencies through intervention. Yet the ECB has never intervened to buy FX and the People's Bank of China has probably not done so for five years.

Currently, the US Treasury's foreign currency report is still the vehicle for assessing currency manipulation and the next report is not due until mid-October. Instead, and we're speculating here, perhaps the White House assesses the US needs larger FX reserves to maintain the stability of the dollar.

Enjoying the 'exorbitant privilege' of issuing debt in the world's most popular reserve currency, the US typically doesn't succumb to FX reserve adequacy analysis. However, if President Trump looks for opportunities to artificially dampen the value of the dollar, he may look at some international comparisons.

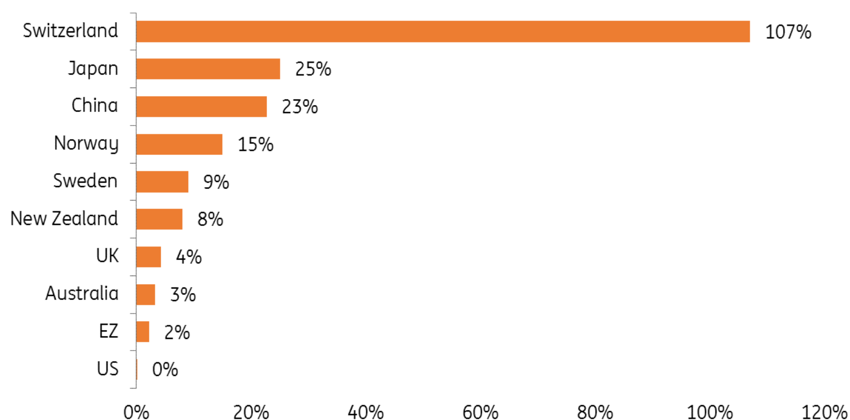
If US FX reserves were to match those of the eurozone in terms of GDP, the US would require an extra USD 400bn worth of foreign currency

In terms of size, the FX reserves-to-GDP ratio for the United States is a miniscule 0.2%. The most commonly used metrics of reserve adequacy, which take into account the short-term debt and the current account deficit, also shows the US with very small FX reserves.

The reason, of course, stems from the fact the US is itself the issuer of the dollar which accounts for most of the FX reserves worldwide. The "infinite" stockpile of USD makes it unnecessary for the US

to hold massive reserves. Nevertheless, the Trump administration might point a finger at the eurozone. Were US FX reserves to match those of the eurozone in terms of GDP, the US would require an extra USD 400bn worth of foreign currency.

FX reserves as a % of GDP (US reserves are small)



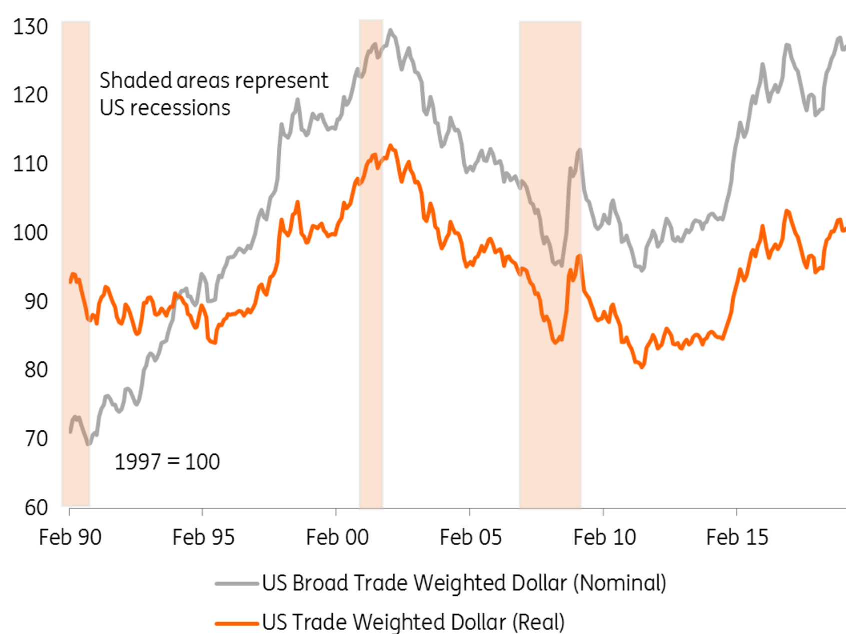
Source: ING, Macrobond

3 The Opportunity: Could ECB action trigger a Washington response?

President Trump's twitter finger has been very sensitive to the ECB policy and the EUR. Were the ECB to cut rates in late July or enact a fresh round of quantitative easing in September – such that EUR/USD comes under fresh pressure – Washington could potentially respond. At this time the trade weighted dollar could well be retesting its all-time high.

Alternatively, the US Treasury could again move the goal-posts in its currency manipulation report – next report due mid October – laying the groundwork for direct FX intervention. Under this approach, however, it is hard to see how the US could penalise Europe unless currency manipulation criteria witness wholesale changes.

US trade weighted dollar near the highs



Source: ING, Bloomberg

Intervention threat to limit the dollar's upside

Dollar strength or least the weak currencies of key trading partners of the US are certainly on Washington's radar. So far the White House has exerted indirect pressure on the dollar via the need for Fed easing. If the dollar doesn't start to fall later in the year, we suspect pressure will grow for the US Treasury to take more direct action on the dollar.

The wild-card of FX intervention is another reason why we prefer the dollar to be topping out this summer and retain year-end forecasts for EUR/USD and USD/JPY at 1.15 and 103 respectively.

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Snap | 11 July 2019

How long can the ECB talk the talk without walking the walk?

Minutes of the June meeting stress the European Central Bank's determination to deliver more

ECB President Mario Draghi delivers a speech at the European Parliament in Strasbourg back in January

The just released-minutes of the June meeting demonstrate the ECB 's willingness to prop up inflation expectations. Interestingly, the June decisions were not unanimous, as illustrated by the phrase that "there was broad agreement, that, in the light of the heightened uncertainty, which was likely to extend further into the future, the Governing Council needed to be ready and prepared to ease the monetary policy stance further by adjusting all of its instrument." Also, there were some disagreements on the different adjustments of forward guidance and the TLTRO (targeted longer-term refinancing operations) pricing at the June meeting.

The tone of the minutes reflects the ECB's concerns about the growth and inflation outlook

In general, the tone of the minutes both reflects the ECB's concerns about the growth and inflation outlook as well as its determination to do more. The latter is clearly shown by the sentence that

"should the environment of too low inflation continue to prevail, considerations of a more strategic nature might be warranted in order to reinforce the credibility of the ECB's monetary policy and support the achievement of a sustained adjustment in inflation to its inflation aim." In this regards, there were some subtle hints at a more symmetric inflation target, allowing for overshooting of inflation expectations and projections in the future. A discussion, which in our view might gain momentum under the new president, Christine Lagarde.

Getting closer to imminent ECB action

For the ECB, at least until Mario Draghi's term ends in October, there are two main factors driving its action: the price stability mandate and showing determination to act. In the eyes of the ECB, there is hardly anything worse than a central bank admitting it has run out of ammunition. Consequently, as long as inflation expectations and the ECB's own inflation projections for the next years remain clearly below 2%, the ECB will fire on all cylinders. No matter whether additional stimulus still reaches the real economy or not.

> *There is hardly anything worse than a central bank admitting it has run out of ammunition*

Looking ahead, Mario Draghi's Sintra speech has made clear that the question regarding the short-term outlook for the ECB is no longer "what negative surprise is needed for the ECB to cut rates" but rather "what positive surprise could actually prevent the ECB from cutting rates". This is how we read Draghi's comments that, absent economic improvements, more stimulus will be needed. Predicting the exact timing is somewhat more complicated though. In fact, traditional ECB watching argues in favour of compiling more data, waiting for the release of Q2 GDP in mid-August and the next ECB staff projections and then take a decision only at the September meeting. Draghi's track record in overdelivering and trying to be ahead of the curve, however, could bring new ECB action at the ECB's July meeting.

Economic data out of the Eurozone as well as the Fed's de facto announcement of a July rate cut have clearly pushed the ECB closer towards July action, rather than waiting until September. After some tentative signs of stabilisation at the end of the first quarter, the Eurozone economy seems to have slipped down once again. What is also worrying is the fact that there are the first signs of the solid domestic part of the economy faltering as well. Here, German data is worrisome in particular, with an increase in short-time work schemes, fading momentum in the labour market and dropping retail sales.

What's on the ECB's menu card for the summer?

The realistic options for the ECB in the coming months are the following:

- **Cut the deposit rate.** Markets have currently priced in a cut by 10bp at the September meeting. However, the risk is increasing that the ECB follows the saying that a bird cannot fly on one wing and cuts the deposit rate by 20bp. A rate cut would very likely be combined with a tiering system for banks and would in our view mainly weaken the euro exchange rate, rather than increasing bank lending.

- **Extend forward guidance.** A very popular tool within the Governing Council up to now, as it comes for "free". Forward guidance has been extended already to mid-2020 but could be extended further and could also be broadened to interest rates will "remain at their present or lower levels…". However, in our view, forward guidance is only a powerful tool when markets start speculating about possible rate hikes, not when interest rates are low and markets are expecting cuts.
- **Restart QE.** To send a powerful message and to show its determination to do "whatever it takes" to bring growth and inflation to higher levels, the ECB would have to start QE again. As discussed before, technical limitations to sovereign bond purchases would push the ECB towards more buying of corporate bonds, potentially even bank bonds, and somewhat more supranationals (EIB, ESM etc). The monetary policy aim of this would be to further bypass the banking transmission channel and provide cheaper market funding for corporates.
- **Buying equity.** Not an option for the time being.

While in the past, we often believed that the ECB would prefer to deliver new stimulus in small steps and in sequences, this view has changed. In Philip Lane's first encompassing speech on monetary policy as ECB chief economist, he clearly pointed to a packaged set of measures rather than a sequencing of smaller individual measures. This means that instead of smaller steps, the ECB seems to shift towards bolder package action.

What does this mean for the July meeting?

In our view, latest disappointing macro data, tentative signs that the resilience of the domestic economy is faltering, a potential rate cut by the Fed and continued dovish communication from ECB officials since Sintra have all pushed the ECB closer to action at the July meeting in two weeks from now. In fact, the ECB and Mario Draghi have let the genie of more action out of the bottle and it will be hard to get it back in.

The ECB can hardly continue talking the talk without walking the walk. The only question is whether words alone, as dovish as they might be, will be enough at the July meeting. We think the only option to once again only talk the talk would be a change in forward guidance, including "or lower", and thereby opening the door for rate cuts. Then, September could see a bigger package than initially anticipated, possibly consisting of a 20bp cut in the deposit rate and a restart of QE. With an increasing risk that this package will already be delivered in two weeks from now. Whether it is July or September, Mario Draghi will definitely leave office with a bang.

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Asia FX Talking: North-South divide

There are essentially two types of currency in Asia right now; those that are being beaten up by trade and tech war fears and would like some respite from a lower Fed funds rates and weaker US dollar, and those that aren't

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Opinion | 11 July 2019

EU top jobs: Restarting the Franco-German motor

In the battle for the European Union's top jobs, France and Germany have come out on top. But there may be a price to pay, writes Luuk van Middelaar

Source: Shutterstock
The German Chancellor and French President, July 2017

An unexpected outcome

After last week's twists and turns in the battle for the EU's top jobs, a clear picture is emerging – even if formal appointments have yet to be made. With the nominations of Ursula von der Leyen and Christine Lagarde at the helm of the European Commission and European Central Bank, respectively, France and Germany have all but cemented their joint leadership of the EU. It was an unexpected outcome after weeks of Franco-German bickering.

Throughout the nomination process, French President Emmanuel Macron made clear he would oppose conservative candidate Manfred Weber - front-man of Angela Merkel's EPP party - as Commission president, attacking the Bavarian's lack of executive experience. At the same time, he was careful to spell out this was not an anti-German move; "if she were a candidate, I would definitely support the Chancellor", he said. Nevertheless, France's obstruction was not taken well in Berlin. Merkel knew she had to stand publicly behind a candidate who had campaigned for the Commission job, if not Weber then the socialist runner-up, Frans Timmermans.

To make matters worse, Paris also quietly backed the Italian and Spanish resistance to German central banker Jens Weidmann as successor to Mario Draghi. In response, Merkel dismissed all French names floated for either the Commission or ECB jobs. In sports terms, both teams focused on preventing the other from scoring and favoured a 0 – 0 match over a 1 – 1 result. So how did we end up with German Commission President Von der Leyen (probably) and French ECB President Lagarde (certainly) in the running?

How it happened

More than ever, both party political and national rivalries entered into the game. The German reaction to the outcome demonstrates this clearly. As EU leaders put forward the first German national for the Commission presidency since 1967, you might have expected big hurrahs in Berlin. Instead, a serious fight arose within Merkel's coalition. The SPD preferred "their" candidate, Dutch socialist Timmermans: rather a party member than a compatriot. French media were stunned at this lukewarm German reaction to a clear national victory.

Leaders who played both cards emerged as the winners. President Macron planted the French flag at the ECB in Frankfurt, but he also secured the job of President of the European Council for a party ally, liberal Belgian Prime Minister Charles Michel. By contrast, Chancellor Merkel misread the mood in her own Conservative party. At the margins of the G20 in Osaka, she agreed to back the socialist claim on the Commission presidency for Timmermans, but underestimated the ensuing revolt of Conservative prime ministers from smaller member states. Resistance against the Dutchman came, not only from the Hungarian and Polish leaders (as expected, in view of Timmermans' actions to uphold the rule of law in their countries) but also from the Conservative leaders of Ireland, Bulgaria, Croatia and Latvia. After Manfred Weber, the other *Spitzenkandidat* was now politically dead, too.

While the papers started writing about the demise of the chancellor's sway over her EPP party, Merkel prepared her next move. Like a tennis player at the end of a long career, she is still capable of brilliant strokes. Following Macron's suggestion (who proved his point that he had nothing against a German candidate in principle), the chancellor secured the candidacy of her party member and Defence Minister Ursula von der Leyen as Commission president. And she did not mind accepting her good friend Christine Lagarde at the ECB, a dual stroke which handed two of the most influential jobs in the EU to women. As predicted, the political campaigns in the wider arena have determined Draghi's successor.

The price to pay

What will be the impact of this Franco-German double victory? On the upside, it may restore trust between Paris and Berlin, which is vital as the EU enters a new political cycle (2019-2024) and as difficult budgetary, economic and geostrategic decisions lie ahead. It also puts two committed Europeans and experienced communicators from the two biggest member states in leadership positions. On the downside, it points to a domination of Western Europe – with the other three top jobs going to a Belgian (summit chair Michel), a Spaniard (foreign policy supremo Josep Borrell) and an Italian (speaker of the Parliament David Sassoli) – and thereby leaves Eastern Europe empty-handed. For lack of a candidate to defend, the four Visegrád countries could only celebrate the blockage of their rule-of-law nemesis Frans Timmermans.

This is not a positive agenda. Knowing the simmering East-West tensions within the bloc, it might have been wiser to give political responsibility to a leader from the East as well – thereby visibly

binding all to a common future. The last-minute Franco-German compromise does not come without costs.

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Article | 11 July 2019 South Korea

Is the South Korean economy headed for a recession?

Our last report on Korea flagged the difficulties the economy was facing. Since then, things have worsened - the economy may even be in a recession. The central bank looks close to responding with some easing, though they have dragged their feet, which hasn't helped. The government may also have to relegate longer-term restructuring for short term support

Source: Shutterstock

1.75% BoK base rate

Expected 1.25% by year end

In need of some stimulus

Around the region, rates are being cut. Malaysia, Philippines, India, New Zealand and Australia have all cut rates, and more are likely to be on the way now that the US Federal Reserve seems to have shifted to an easing bias.

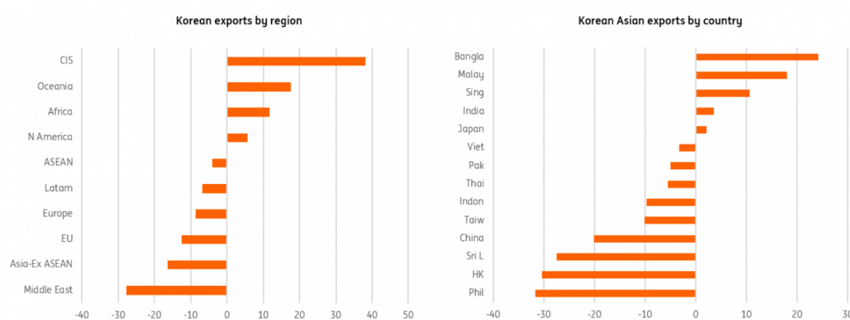
> *The Korean economy may actually be in a recession right now, we're simply waiting for the data to confirm it*

Compared to most of these economies, the argument for some easing from the Bank of Korea is considerably more compelling and is exacerbated by the rate hike in November 2018 which we never felt was justified by the Korean macroeconomic situation. Moreover, since we last wrote about this economy at length, economic conditions have deteriorated further with the escalation of the trade war and the morphing of the global technology slump into a tech war of its own.

The best you can say about the Korean economy right now is that year-on-year comparisons will be less unhelpful in 2019. But this is an economy that may actually be in a recession right now, we're simply waiting for the data to confirm it. Forecasting an imminent upturn is a difficult thought-experiment.

Read our country profile on South Korea from January

Korean exports by region and by Asian country YoY% (May 2019)



Source: CEIC

More than temporary weakness for the external sector

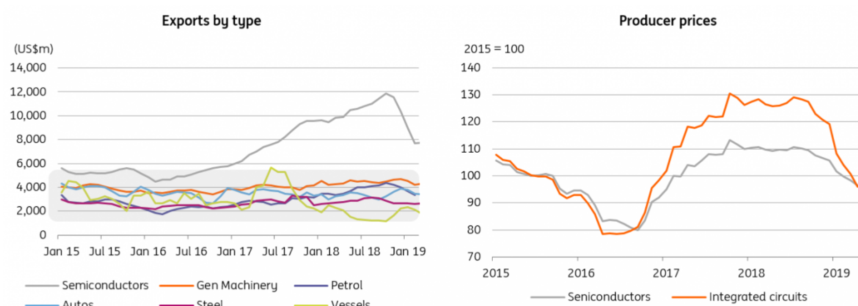
Korea is an export power-house, punching well above its place of the 11th biggest global economy by GDP to rank fifth by export share. But what ought to be a sign of strength is a serious handicap against the backdrop of slowing global trade growth. The World Trade Organisation (WTO) forecast for global trade growth this year is only 2.6%, which is slower than global GDP growth (3.3%), so the headwinds for Korea's external sector are very severe indeed. This is more than a little temporary external weakness (as the BoK initially suggested as a reason not to respond with more accommodative policy).

> *Though the decline in Korea's exports is predominantly a semiconductor phenomenon, it's not as if Korea's other major export sectors are looking like they'll make up for this*

Though the decline in Korea's exports is still, predominantly, a semiconductor phenomenon, it is not as if Korea's other major export sectors are looking like they'll make up for this. Indeed, the more traditional sectors of steel, autos, petrol etc. are also looking a bit subdued, probably reflecting a more general slowdown in global demand.

In the semiconductor industry itself, the Bank of Korea asserts that volume exports are picking up. That may well be the case, but producer price series for semi-conductors still show prices declining at anything between 11%YoY for semiconductors themselves, to 23% YoY for integrated circuits. It will take more than a slight uptick in volumes to offset that.

Korean exports and electronics producer prices



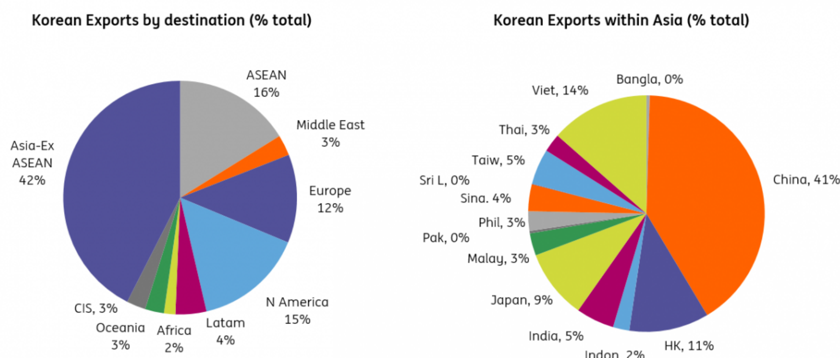
Source: CEIC

Where do Korean exports land?

By destination, more than 50% of Korean exports are destined for other parts of Asia, with North Asia - China (41%), Hong Kong (11%), Japan (10%) and Taiwan (5%) taking the lion's share.

Within South East Asia, Vietnam is the standout recipient at 13.5%, dwarfing the Korean export receipts of most other Southeast Asian economies, even some many times its size. The 2015 Free Trade Agreement has probably helped this, with Vietnam reducing its tariffs by 89% and South Korea reducing its tariffs by 95%. Today, about 40% of Samsung handphones are reportedly made in Vietnam, so electronic imports for assembly and then re-export make up a significant amount of this intra-regional trade.

Korean exports by destination



Source: CEIC

Philippines, another standout

The other standout country in Asia, though for the wrong reasons, is the Philippines. The Philippines is seeing the strongest decline in growth of exports from Korea when compared to any Asian country. A database of trade shows that electronics goods, mainly integrated circuits, make up about a third of all South Korean exports to the Philippines - far more than any other category. While most reports cite exports from the Philippines to Korea being mainly agricultural produce (bananas and pineapples) as well as copper, the Observatory of Economic Complexity (OEC) of MIT shows electrical and electronic goods making up more than half Philippine - Korean exports. There is clearly a strong degree of interlinkage in this sector.

The Philippines is seeing the strongest decline in growth of exports from Korea of any Asian country

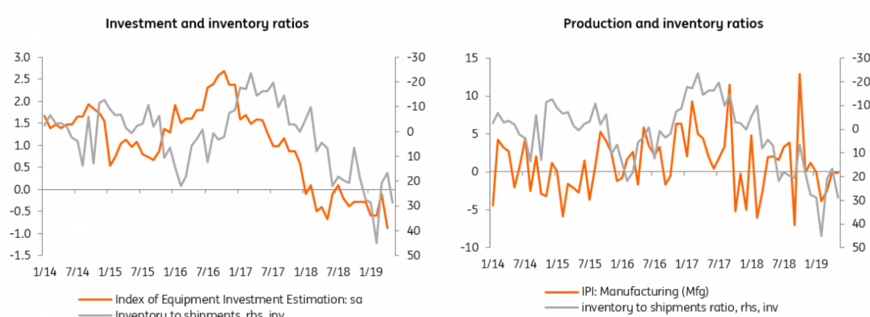
With a free trade deal between Korea and the Philippines due in November, some firms may be holding back exports until after that deal is signed. But the global tech slump may also be playing its role here by weighing on intra-regional exports.

Domestic economy looks (slightly) better

While the external economy is struggling, and the best that can be said of it is that it may be showing signs of reaching a floor, the domestic economy looks slightly better. Inventory to shipments ratios are now falling (see charts below, where inventory ratios are inverted) and together with rising production in the quarters ahead, they also point to rising investment and capacity building.

Retail sales volumes have been slowing on a trend basis, but overall, sales volumes are still holding up reasonably well. And though the unemployment rate has been heading the other direction (higher) it has been doing so at a very gradual pace. However, that hasn't propped up inflation, which at 0.7%, is too far from the Bank of Korea's inflation target for it to be ignored further, and together with weakness elsewhere, make the case for rate cuts almost overwhelming.

Production, investment and inventory cycle troughing (YoY%)



Source: CEIC

Bank of Korea coming round to the idea of some easing

The central bank governor, Lee Ju-yeol admitted at the BoK's semi-annual briefing recently that Korean inflation would likely miss the Bank's 1.1% forecast from April. He also suggested that there was a rising chance that the semiconductor recovery would be delayed. These and other comments seem to be warming the market up for a rate cut, perhaps as early as this month when they next meet (18 July).

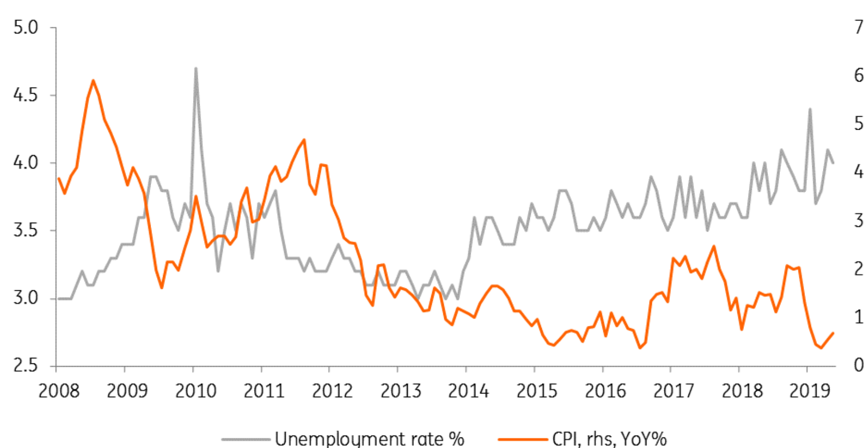
While Governor Lee has indicated that there is not much room for monetary policy easing, we believe there is certainly room for at least two 25bp rate cuts

Downward revisions to both growth and inflation forecasts in the BoK's quarterly Economic outlook for July look highly probable, which should further increase the chances of a rate cut at that meeting. The last BoK meeting already had one dissenter to the no-change policy, and that too could be a precursor to a broader change of mind within the Bank.

While Governor Lee has indicated that there is not much room for monetary policy easing, we believe there is certainly room for at least two 25bp rate cuts. One to reverse last November's unnecessary hike and another to deliver some genuine easing. If we get a July cut, then we may not have to wait too much longer until the next.

Some slight won (KRW) appreciation since May, driven by Federal Reserve rate cut expectations, makes it easier for the BoK to move, though it is difficult to come up with a cogent set of explanations as to why the BoK previously felt that the currency's weakness made it harder for them to act. Nonetheless, to the extent that they felt this was a constraint before, now they should be slightly more relaxed.

Korean unemployment and inflation



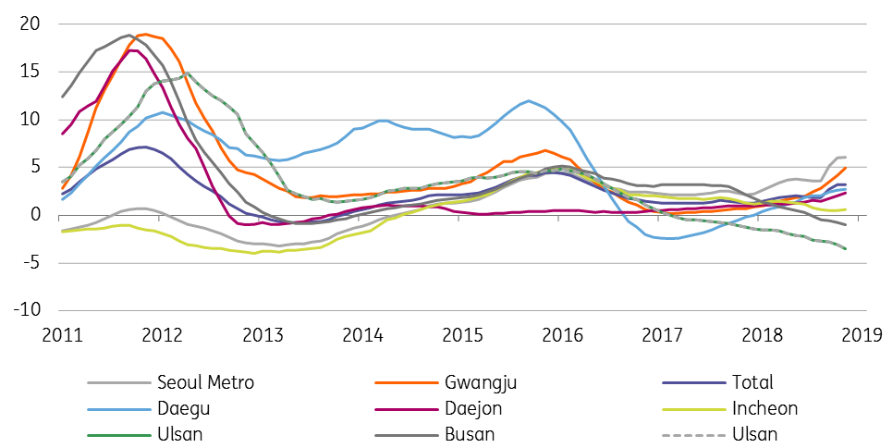
Source: CEIC

Housing - not a bubble, but another reason to ease

One other factor that prompted the rate hike in late 2018 was housing. This was never a convincing story back then, when house price growth was modest, and largely confined to the Seoul Metropolitan area, which still remains one of the strongest regions nationally for house price growth, but even there, house prices are barely keeping pace with wages, and in other parts of the country, is either very weak or falling.

National house price growth is now less than 2%YoY. We expect it to fall further and even register some negative year-on-year comparisons in the quarters ahead. Easier monetary policy would provide some insurance against a harder and more painful decline in house prices, though we don't think there is a bubble on the verge of bursting. House price growth has never been that strong.

Korean residential house prices (YoY%)



Source: CEIC

The Korean won and bond yields

Despite the likelihood of some policy easing from the central bank, the main drivers for the currency are:

1. Global financial market risk appetite, in particular, sentiment about the trade war
2. Korea's trade balance
3. The US dollar

Recent swings in the Korean won are down to almost exclusively non-domestic factors: the growing expectation of Fed easing, ever-declining US Treasury yields, and some sense of relief following the G20 meeting which averted even greater tariff rates on China or retaliation. But looking ahead, we are a bit concerned that Fed easing, and subsequent dollar weakness that has helped the KRW swing from 1180 to break 1150, is overdone and could flip back. To some extent, this has already happened with the KRW already now at 1180. Higher still, is of course possible.

Our forecast of a gradual appreciation of the KRW is centred on an expectation of a gradually improving global outlook as we

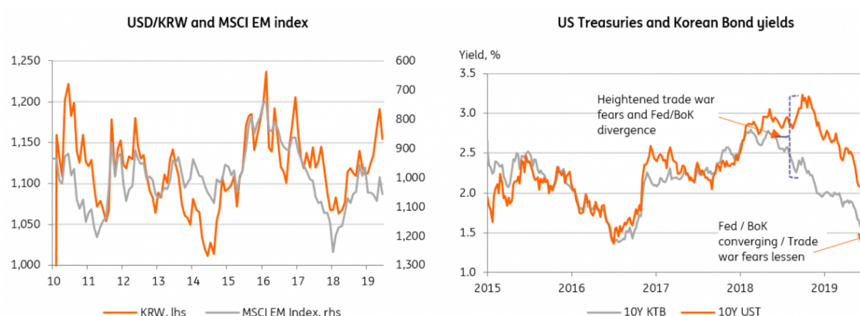
reach the end of the year

A catalyst for this is hard to predict in advance, though could include anything that undermined the easier Fed view – More evidence of strength on the labour market will remain key, but also stronger activity, wages and inflation data. If the US really is slowing now, then this probably won't be a problem, but if recent softer data flows are more a result of inherent noise rather than genuine signal, then it can't be ruled out.

Our forecast of a gradual appreciation of the KRW is centred on an expectation of a gradually improving global outlook as we reach the end of the year and as the commencement of the US Presidential race-proper limits further trade aggression, if only for 2019.

Korea's Treasury bonds rallied on the weak Korean story before they were pushed even lower by the US Treasury story. We have been surprised at just how far US Treasury yields have fallen, and remain suspicious that current levels are sustainable especially if the US is simply showing signs of slowdown, not hurtling into recession, consequently, for both Korean Treasury bonds and the KRW, we have some reversal of recent moves, though the conviction on the timing and extent of this is very low.

Korean Treasury yields and the Won



Source: Bloomberg

Government and fiscal policies

President Moon Jae-in's government continues to focus on measures to provide peace and reconciliation on the Korean peninsula, and in that respect, although there has been no breakthrough on North Korea, the support of US President Trump and recent revitalisation of talks is proof of some progress.

We don't think the government should abandon its reform goals of making the economy less reliant on a few big family-run conglomerates

But on the economy, the approach of tax and spend has been somewhat less successful, though it is hard to draw firm conclusions given the hostile global environment, and the counterfactual of

what might have happened in the absence of a trade war or tech slump would probably have been considerably better. Active industrial policy is not the direction this current government follows, though in April a supplementary budget was crafted, amongst other things, to provide economic support.

The overall size of the budget was KRW 6.7 trillion, about 0.3-0.4% GDP, though arguably on the low side given the scale of the external problem and also the fact that about one-third of that total was related to health and safety, not economic support.

Korea has low rates of public debt to GDP. Consequently, given the uniquely difficult state of the external and domestic environment, one can make a very good argument for further targeted support, especially bearing in mind that the BoK's room for manoeuvre is limited.

We don't, however, think the government should abandon its reform goals of making the economy less reliant on a few big family-run conglomerates, known as chaebol. A more competitive market structure would be positive for Korean growth, even if it meant giving up some of its market share of global exports. In the current environment that doesn't seem like a bad trade-off.

Korean Supplementary budget (April 2019)

Measure	Cost (KRW tr)	Description
Health and safety related	**-2.2**	
Reduce Fine Dust	-0.8	Promote scrapping of old vehicles, support remissions restrictions at industrial sites
Promote environment friendly technologies	-0.4	Promote environment friendly vehicles, installation of solar panels, expand financial support for R&D and new technology
Fine dust monitoring	-0.1	Strengthen fine dust monitoring, work on cooperation with China
Health concerns	-0.2	Hand out dust masks and support purchase of air purifiers, improve subway air quality
Citizen Safety	-0.7	Strengthen mountain fire management, other disaster management, promote corporate investment in workplace safety
Economy boost	**-4.5**	
Export support and ventures	-1.1	Support exporters going into new overseas markets, promote venture startups and support upscaling, develop tourism
Promote new industries	-0.3	Help develop 5G technologies, promote smart factories and fintech services, expand job training programs
Support local economies	-1	Support local economies affected by restructuring, invest in local infrastructure projects, provide emergency funding to small merchants
Increase working class support	-1.5	Expand unemployment benefits, social security benefits, emergency payments and energy vouchers
Support for employment	-0.6	Provide employment support, career change, create public sector jobs
Total	**-6.7**	

Source: Ministry of Finance - Korea

Longer term government plans - service sector the focus

The government seems to see more promise in the services sector, where it feels it lags behind the most developed world economies. Policies to push Korea to a more developed services future include:

- Providing the same level of support to services that has been extended to manufacturing firms
- Invest in basic infrastructure, including national statistics
- Promote convergence between the manufacturing and service sectors
- Build a regulatory foundation
- Relax regulations on promising service sectors, including healthcare and tourism
- Improve the logistics agency

These are of course very long run ambitions, but consistent with a modern developed economy. Though it brings with it a number of problems, including slower economic productivity growth, and in turn slower wages growth across both manufacturing and service sectors. One could argue that

in trying to rid itself of some of its current problems, this policy direction will simply swap them for problems being suffered by most G-7 economies, and for which there seem few obvious remedies.

Korea forecast summary

	1Q 19	2Q19	3Q19	4Q19	2019	2020	2021
GDP (%YoY)	1.7	2.1	0.6	1.1	1.4	2.5	2.3
CPI (%YoY)	0.5	0.7	0.6	1	0.7	1.7	1.9
Unemployment rate (eop)	3.8	4.1	4.2	4.1	4.2	4.2	4
Residential real estate (%YoY)	2.7	1.9	1	-0.3	1.3	0.9	3.4
Fiscal balance (consolidated ex soc sec)					-1.9	-3.9	-3.8
Debt/GDP (%)					38.6	41.3	43.5
Current account balance (US$bn and % GDP)	11.6	17.5	27.5	26.5	3.9	3.8	3.7
7-day repo rate (eop)	1.75	1.75	1.5	1.25	1.25	1	1
10Y yields (eop)	1.83	1.6	1.5	1.45	1.45	1.7	1.9
USD/KRW (eop)	1,135	1,155	1,150	1,180	1,180	1,160	1,140

Source: ING

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Article | 9 July 2019 Brazil

Brazil: A momentous reform

The positive momentum favouring the imminent passage of the Social Security Reform continues, with the goal to conclude the Lower House approval by the weekend. Such an impressive result should trigger a BRL rally, but the rally would be limited by the central bank's willingness to cut rates, by as much as 150bp, which has reduced the currency's appeal

We are nearly there

After years of negotiations, and much political turmoil, it finally appears that we are days away from the approval of the social security reform by the Brazilian Congress. The pro-reform momentum improved sharply last week, with the approval of the reform by a wide margin in the Lower House's Special Committee, and with Speaker Rodrigo Maia standing out for his leadership and savvy command of the House.

In fact, congressional leaders aim to fast-track the debate and have the reform fully approved by the Lower House, which requires a 3/5 majority support in two rounds of the vote, by the weekend. Such an impressive result would consolidate Maia's reputation and would bode well for the ambitious post-reform agenda advocated by the Speaker, which is broadly consistent with the agenda of the Bolsonaro administration, and includes the tax reform and the formal independence of the central bank.

There remains some uncertainty about the timing and the content of the draft that the House should eventually approve. Passage of the proposal already approved by the Special Committee last week would be a favourable outcome.

But the text could be improved with an amendment to, at least, facilitate the extension of the reform to states and municipalities, or it could worsen with, for instance, the easing of the retirement rules for police workers, as advocated by Bolsonaro.

As it stands, the reform could generate savings of about BRL 0.9-1 trillion in 10 years, which is far higher than initial investor expectations and reflects a very mild dilution in the fiscal savings initially proposed by the Bolsonaro administration (BRL 1.1 trillion).

This result would go a long way towards ensuring the long-term sustainability of Brazil's fiscal accounts and should be enough to prompt a reassessment of the near-term credit ratings trajectory for Brazil. But actual upgrades may take a while longer and should depend, in our view, on the evidence of a stronger recovery in economic activity, which is expected to pick up pace in the second half of the year.

Reform approval would green-light the monetary easing process

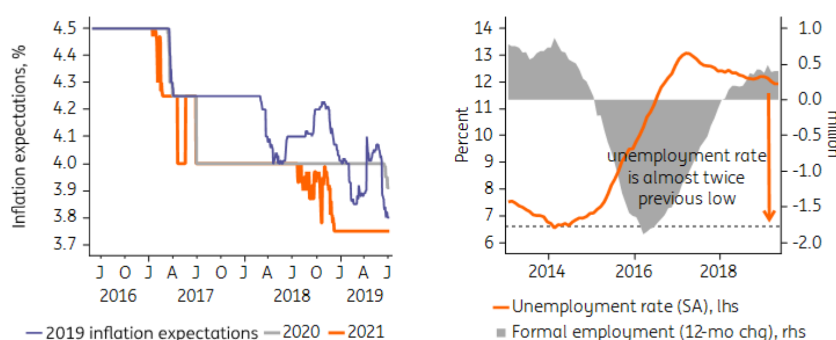
The approval of the reform should have an invigorating impact on the outlook for economic activity, but the reform should also have a benign impact on the inflation outlook. As a result, the reform's approval should not prevent the central bank from adding to the monetary stimulus that is already in place.

In fact, given the (1) ongoing improvement in current inflation trends, as illustrated by falling and fully-anchored inflation expectations, (2) the expected post-reform appreciating bias for the BRL and (3) the dovish shift seen in central banks across the world, we believe the balance of risks favours a larger, more frontloaded and more lasting cycle than currently priced in the local curve.

> *The balance of risks favours a larger, more frontloaded and more lasting rate-cutting cycle than currently priced in the local curve*

Central bank officials have been on the defensive in their effort to justify their reluctance to ease monetary policy, despite the poor economic activity data and high unemployment. Inaction was generally justified by the lingering uncertainties regarding the passage of the social security reform. But with the reform approved and the yearly rate trending considerably below-target, at around 3-3.5% throughout 2H19, the central bank's ability to justify inaction should weaken materially.

Fully anchored inflation expectations and ample spare capacity



Source: Macrobond

The BRL could lag other local assets

With the reform approved, political uncertainties related to the sustainability of fiscal accounts should ease materially and prompt an improvement in the outlook for economic activity and for local assets in general.

The Brazilian Real should also rally, but the extent of that rally should be limited by the central bank's willingness to cut rates (by as much as 150bp), which should reduce the currency's appeal. Lower rates should also incentivize the use of the USDBRL as a (relatively cheap) hedge to external risks, such as trade wars, as other local assets such as equities and rates are seen as more appealing.

In addition, as indicated by central bank officials recently, the lower cost of financing in BRLs has also reduced the inflow of USDs in Brazil this year. And this shift could intensify post-reform, as the SELIC policy rate is further reduced and the local debt capital markets deepen further. As a result, we now believe that the post-reform trajectory for the USDBRL may bottom at a higher level, closer to 3.6 than 3.4.

The USDBRL may bottom at a higher level, closer to 3.6 than 3.4

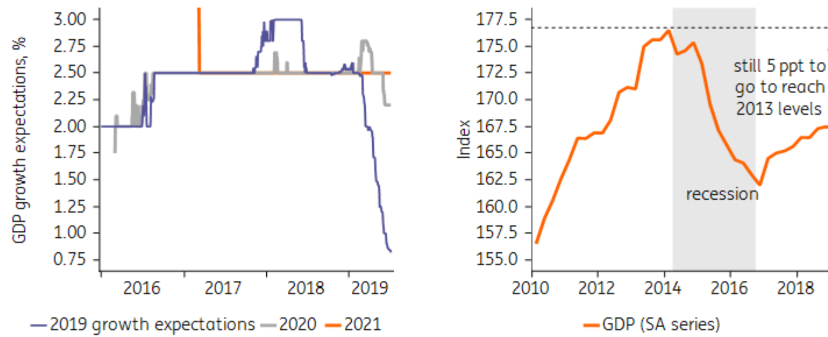
In any case, with the reform approved this week or next, we would expect the Brazilian central bank to be able to launch the easing cycle in its 31 July meeting, possibly with a 50bp cut. This would bring the SELIC rate to a fresh record-low of 6.0%, from 6.5% now. Consecutive 50bp cuts would bring the SELIC rate to 5.0% by the end of October, but a shallower or less-frontloaded cycle should not be ruled out.

Consecutive 50bp cuts would bring the SELIC rate to 5.0% by the end of October, from 6.5% now

A more frontloaded cycle would be amply justified as a catch-up measure needed to help address

the paralysis in economic activity seen in recent quarters. The central bank's own projection for 2019 GDP growth collapsed recently, moving from 2.0% as of the end of 1Q19 to just 0.8% as of the end of 2Q. And, as the chart below illustrates, Brazil's GDP remains 5.5ppts below the peak seen in 2013.

Disappointing economic activity and a long way to go to full recovery



Source: Macrobond

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Article | 9 July 2019

Switzerland | United Kingdom | Video

Watch: Switzerland's Brexit warning

The European Union took a tough line against Switzerland earlier this month, ending the stock exchange 'equivalence' which enabled Swiss shares to be traded within the EU. And that could have big implications for the UK and Brexit, says ING's Charlotte de Montpellier

Watch: Switzerland's possible Brexit warning

Switzerland and the European Union no longer have stock exchange 'equivalence'. And as ING's Charlotte de Montpellier explains, there could well be lessons here for the United Kingdom as it prepares to leave the EU.

Watch video

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Report | 11 July 2019 | The Netherlands

The Dutch Economy Chart Book: Stable profitability for the third year running

Our Dutch Economy Chart Book provides an overview of the many important developments and structural characteristics of the Dutch economy in more than a hundred charts

Dutch domestically produced exports have fallen considerably, despite stability in price the competitiveness of the Netherlands. Domestic profitability relative to value-added of non-financial businesses stabilised on a moderate level for the third year in a row, while GDP-growth is still steady. Below, you'll find a summary of the main points. And you can download the full chartbook above.

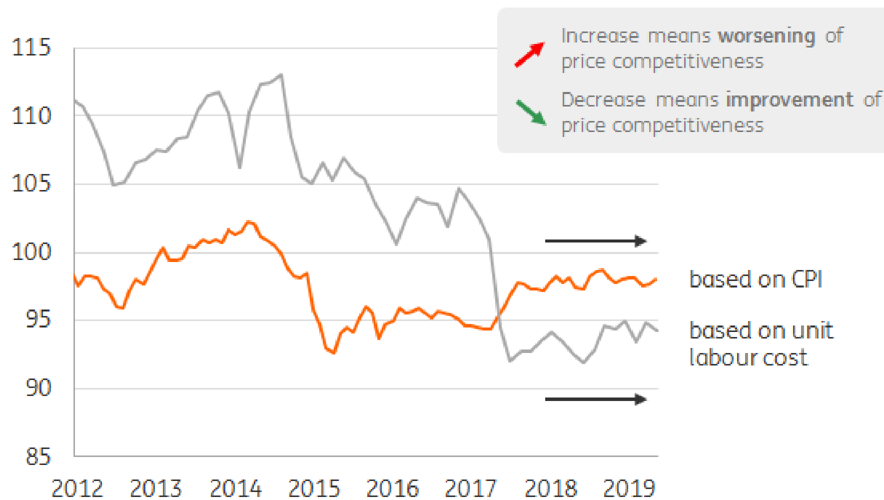
Domestically produced goods exports fell considerably recently

Dutch export volumes of domestically produced goods fell considerably in the last quarter of 2018 and the first of 2019. This happened despite the fact that the price competitiveness of the Netherlands was roughly stable in the past six months. The slowdown in growth (prospects) of the eurozone, which contains The Netherlands' most important European trading partners, may be at the root of this. Re-exports performed better than domestically produced exports in the last two quarters.

See here for our initial assessment of the GDP-figures of 1Q 2019

Dutch price competitiveness stable

Real ECB Harmonised Competitiveness Index* for the Netherlands (1999 Q1 = 100)

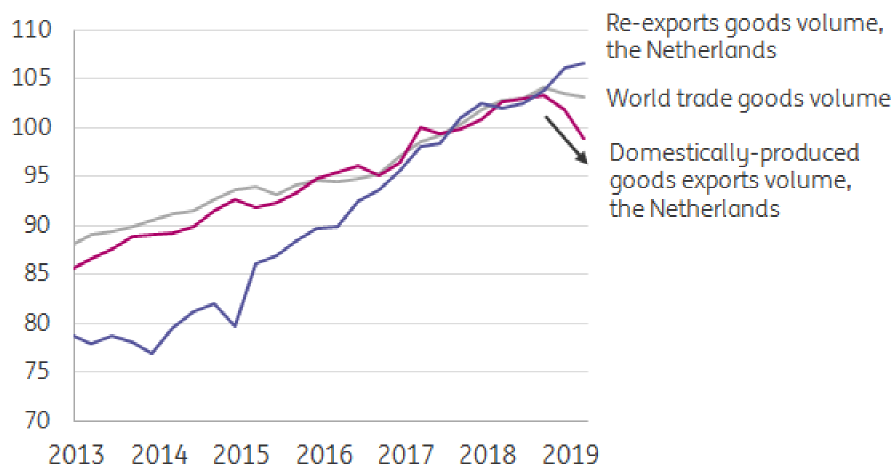


*The indicators use a similar methodology as the BIS nominal trade weighted index but add deflating by either the CPI or unit labour cost, in order to reflect a real competitiveness

Source: ECB via Macrobond

Domestically produced goods exports fell strongly

Index, 2017 = 100, seasonally-adjusted



Source: CPB World Trade Monitor and Statistics Netherlands via Macrobond

Domestically produced exports four times as important as re-exports

Despite the fact that the contribution of re-exports (3.8%) to GDP has nearly doubled in twenty years, the contribution of domestically produced goods (16.6%) is still four times as large. If this recently disappointing development of domestically produced goods' exports continues, GDP-growth may slow down considerably in the period ahead.

World trade outlook bleakest since 2009

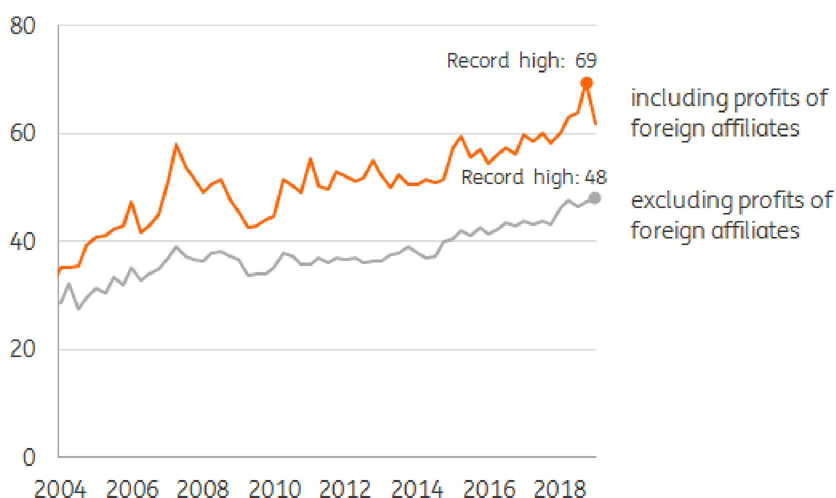
So far, Dutch exporters are still rather neutral about their export outlook. However, our projections for world trade for 2019 haven't been this bleak since the financial crisis. In addition, labour costs are projected to rise faster because of further tightening in the labour market. This may worsen price competitiveness of Dutch exporters. Accordingly, we project total exports to expand by a meagre 1.4% in 2019. To compare: between 1996-2018 export growth was 4.7% on average.

Profitability of non-financial businesses stable at moderate level

Profitability of non-financial businesses has been stable since 2016. And this is happening while overall profitability is already substantially lower than during the previous boom (2006-2008) for quite a while. Nominal pre-tax profits of non-financial businesses are high. In fact, domestic nominal profits were a record high in the first quarter of 2019. However, once we relate profits to the size of the economy – gross operating surplus as a ratio of value-added both of non-financial firms – that profitability appears to be stagnating and even fell in the first quarter of 2019. Now that labour market strains are increasing, further labour cost will continue to increase, leading to our expectation that profitability is more likely to decline rather than increase in the near future.

While total nominal profits fell back from record level, domestic profits are currently at all time high

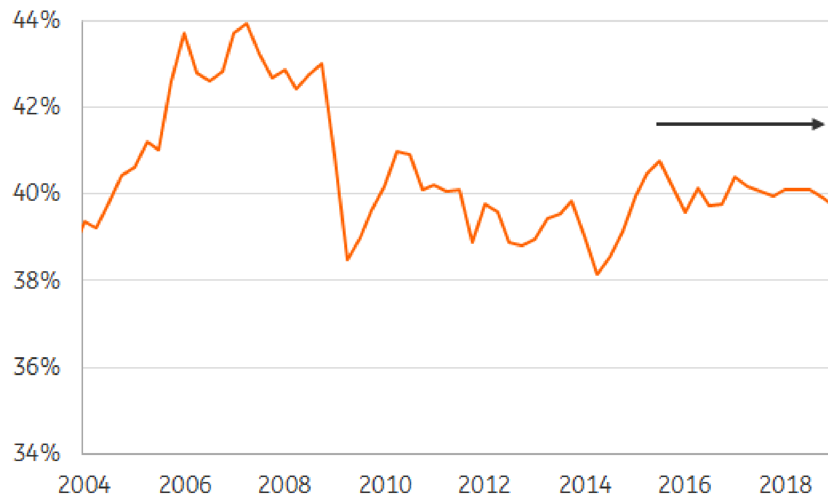
Nominal Pre-tax profits of Dutch non-financial companies, in billion euros, seasonally adjusted



Source: Statistics Netherlands

Profit ratio remains moderate

Gross operating surplus as percentage of gross value added at basic prices*, seasonally adjusted



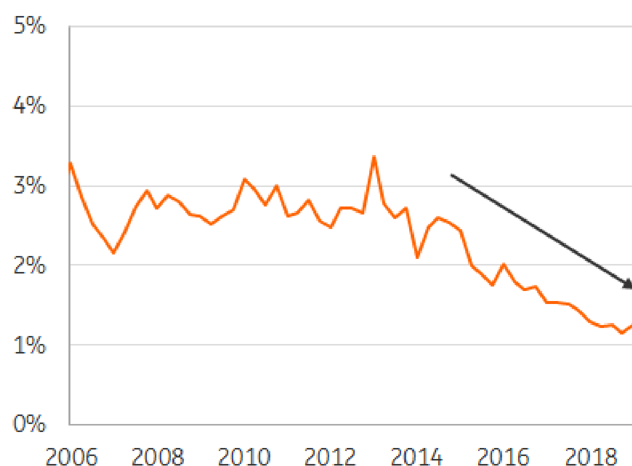
*Macro profitability indicator, non-financial corporations (excluding small unincorporated businesses)

Source: Statistics Netherlands

Share of the oil and gas industry halved since 2012

The share of the oil and gas industry has halved since 2012. For many years, this industry represented almost 3% of the Dutch economy (similar to the current share of temporary job agencies). With the gradual reduction of gas production in the Northern Province of Groningen, the share of oil and gas in total value added fell to 1.3% in 2018. This means that this industry now has a similar share in value added as the automotive sector.

Share of gas and oil industry in the economy halved
Share of mining* industry in value added (at basic prices, seasonally adjusted volumes)



*Mining includes production of oil and gas and the provision of related services. Quantitatively it mainly concerns gas production.

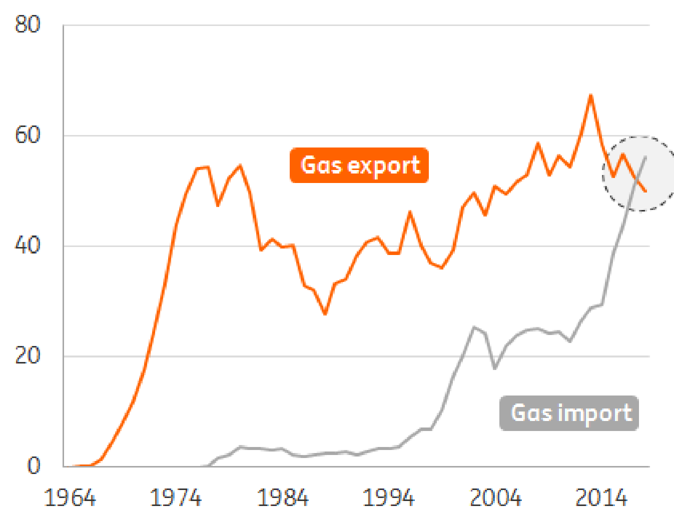
Source: Statistics Netherlands via Macrobond

Net gas importer for the first time

Last year the Netherlands, for the first time, imported more natural gas than it exported. This meant an end to a long history of being a net gas exporter. When Dutch gas production is limited further in the years to come, the share of the oil and gas industry will yet again be halved.

Read our latest forecast for the Netherlands in the Eurozone Quarterly here

After years of being a net exporter of gas, the Netherlands has become a net gas importer in 2018
Gas trade in billion m3 (both natural gas and lng)



Source: Statistics Netherlands

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Philippines: Central bank governor maps out policy sequence

Bankgo Sentral ng Pilipinas (BSP) Governor Benjamin Diokno laid out the possible sequence for his next moves, hinting that policy rate cuts would be followed by RRR reductions

BSP credibility key to efficacy

BSP Governor Diokno stressed the importance of credibility in crafting monetary policy, indicating that "without credibility, central banks resort to traditional aggressive tools to achieve the same result". Oftentimes, the ability of the BSP to communicate its policy stance and direction effectively to the market is enough to manage not just inflation but inflation expectations as well. Managing expectations in many instances may be just as integral to inflation targeting if the BSP has an effective "hold" on the markets through its credibility.

Diokno signals policy rate cut

With inflation down again in June, the BSP governor hinted at potential policy rate (RRP) cuts in the near term, even indicating that a rate cut will likely come before further reductions in reserve requirements (RRR). With the last instalment of the RRR reduction scheduled for the end of July, we expect the BSP to gauge the effect of this additional liquidity on the financial system before making more adjustments on this front. Previously, Diokno had said he was open to reducing reserve requirements further should the funds be put to “good use”. Today's term deposit facility (TDF) auction showed that the already doubled PHP 60 billion worth of offering was fully awarded and oversubscribed, which could indicate that the influx of liquidity has yet to find its way to the real sector.

As such, we can expect the BSP to slash borrowing costs further as inflation grinds lower. We have pencilled in a 25bp RRP cut as early as the August meeting with 2Q GDP likely to have fallen below potential. Meanwhile, we can expect reductions to the RRR to be carried out at a non-monetary policy meeting, perhaps after the 26 September policy meeting via a phased 50bp reduction at the end of October and another 50bp by year-end.

Timing is everything

Diokno's predecessors Amando Tetangco and Néstor Espenilla helped to lay the groundwork for a successful and almost seamless exit from an era of high RRR. Governor Tetangco’s constant clamour for amendments to the BSP charter, such as the ability to issue BSP bonds, was fulfilled during his successor Espenilla’s term with implementation of the interest rate corridor laying the foundation for the eventual first RRR reduction.

Diokno espouses the belief that central bank credibility is integral to monetary management, and his version of RRR cuts are viewed to be gradual and well-telegraphed. Although seemingly unorthodox, the pre-announced schedule of phased reductions for RRR (100bp in May, 50bp in June and 50bp in July) was welcomed by the market. Timing his resumption of RRR cuts when inflation was decelerating was well-received by the market and consistent messaging helped keep market panic to a minimum.

For the rest of the year, we expect BSP to continue to normalise policy rates after its aggressive rate hike in 2018 while at the same time signal effectively to market players that reductions in the RRR will follow in a scheduled and phased manner.

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Article | 9 July 2019 **Russia**

Russia Balance of Payments: Portfolio flows remain key

In 2Q19, Russia's current account surplus was lower than expected for reasons other than the oil price. This means no respective decline in the mandatory FX purchases and therefore leads to the ruble's higher dependence on portfolio inflows to OFZ, which seems to have narrowed in June from April and May despite the global risk-on

Source: iStock

$12.1 bn

Lower than expected

2Q19 current account surplus

$45.8 bn for 1H19

2Q19 current account weak on non-oil&gas side...

The 2Q19 current account surplus of US$12.1 billion was significantly below the US$19.1 billion consensus and our forecast of US$17.0 billion. All the reasons for the underperformance were on the non-oil&gas side, which we believe to be a reflection of weakness in the local industrial output amid budget policy seasonality and strengthening of RUB by 10% to USD since the beginning of

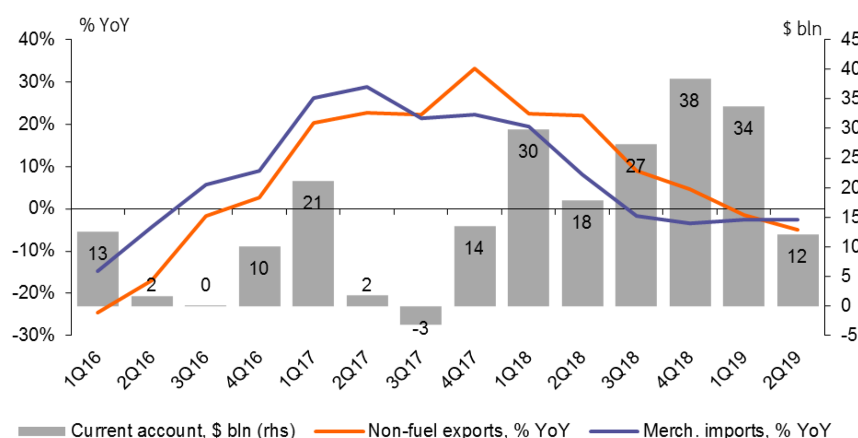
the year:

All the reasons for the current account weakness were on the non-oil&gas side, which we believe to be a reflection of weakness in the local industrial output amid budget policy seasonality and strengthening of RUB by 10% to USD since the beginning of the year.

- The drop in the non-oil&gas merchandise exports deepened from -2% year on year in 1Q19 to -5% YoY in 2Q19
- Persistent 3% YoY drop in merchandise imports (instead of a deeper drop)
- Stagnating balance of services
- Some increase in the dividend payments in favour of non-residents (the main bulk of those transactions is normally accounted for in June, however, the actual payments may take place later - in July-August)

While the weak trends in the non-oil current account are unlikely to prevent its seasonal widening to US$15-20 billion in 3Q19, our full-year US$100 billion expectations will now require some effort to be met.

Key current account parameters



Source: Bank of Russia, ING

...and fully sterilized by FX purchases

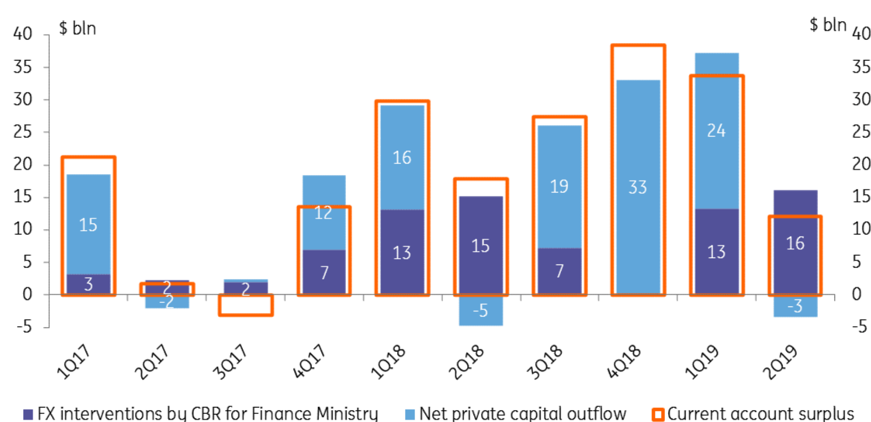
It is important for the FX market that the current account weakness is on the non-oil&gas side, because it means that it does not lead to any reduction in the mandatory FX purchases by the Central Bank of Russia (CBR) to fulfil the budget rule (the latter depends only on the expected extra oil&gas revenues of the budget). In fact, in 2Q19 the FX purchases of US$16 billion exceeded the current account surplus for the first time in 2 years. Only the small (and seasonal) net private capital inflow of US$3 billion allowed to balance those flows.

Given the current oil price trend, we expect FX purchases to sterilize 75-100% of the 3Q19 current account surplus. Meanwhile, the net private capital outflow should return, mainly reflecting the accumulation of international assets by corporates and households.

Overall, the current framework of the Russian balance of payments assumes that the current account surplus is used to finance the accumulation of foreign assets by the government and the private sector. Unless there are changes in the budget rule mechanism and/or recovery in the local CAPEX activity by the private sector, there is little grounds to expect the current framework to change anytime soon.

The current account surplus is used to finance accumulation of the foreign assets by the govenment and the private sector.

Current account: where do you go? (i wanna know)



Source: Bank of Russia, ING

OFZ flows remains the key variable for RUB, inflow slowed in June

So, if the large trade and capital flows balance each other out, why was the ruble so strong in 2Q19, appreciating to USD by almost 4%?

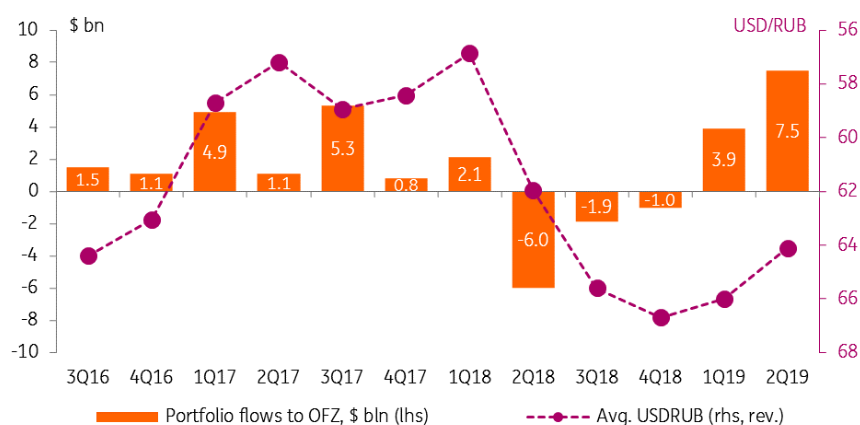
The answer is simple - portfolio inflows to the local state debt market (OFZ). In fact, the government accumulated US$10.0 billion of external liabilities in 2Q19, out of which US$2.5 billion was the June Eurobond placement (irrelevant for the FX market, as the currency went into the Minfin's accounts with the CBR) and the remaining US$7.5 billion reflected inflows of foreign portfolio investments into OFZ. There are several important observations to be made here:

- Portfolio flows remain the main variable and the tipping scale for RUB exchange rate
- 2Q19 was an extremely successful quarter, as the US$7.5 billion inflow to OFZ is the highest since the US$8.6 billion in 4Q12
- The monthly inflow, however, slowed from US$3.0-3.5 billion in April and May to just US$1.0 billion in June - despite the strong global risk-on rally since mid-June

While we continue to see Russia as an attractive macro stability play for global bond investors, there are a number of challenges to continue the strong portfolio inflows, including

- Foreign holders have restored their OFZ holdings close to a historical high of US$41 billion
- Minfin has fulfilled around two-thirds of the annual placement plan in 1H19 and is planning to reduce primary supply to around US$1.5-2.0 billion per month (previously non-residents bought up to two-thirds of the total placement)
- The prospects of further global rally after the recent strong US labor data are under question

Quarterly inflows to / outflows from local state bond market (OFZ) and USDRUB exchange rate



Source: Bank of Russia, Bloomberg, ING

We remain cautious on the 3Q19 ruble trend

Overall, the balance of payments update supports our cautious call on RUB, which after the global rally should depend more on local factors and fluctuate in the RUB63-65/$ range. The longer-term view also remains cautious, subject to the progress in the government's efforts to re-ignite the private CAPEX growth, and depending on how goes the discussion on investing part of the state savings (NWF) locally.

For more details on our RUB view please see our 3 July note "After the rally: Domestic factors to play a greater role in RUB pricing"

https://think.ing.com/articles/after-the-rally-domestic-factors-to-now-play-a-greater-role-in-rub-pricing/

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Article | 8 July 2019 Thailand

Political stalemate hurts Thailand's economy

Three months after the General Election, politics still remains a key overhang on the Thai economy. With political logjams slowing the emergence of any fiscal stimulus, monetary policy will have to do all the heavy lifting to prop up growth. We now anticipate two central bank policy rate cuts before year-end

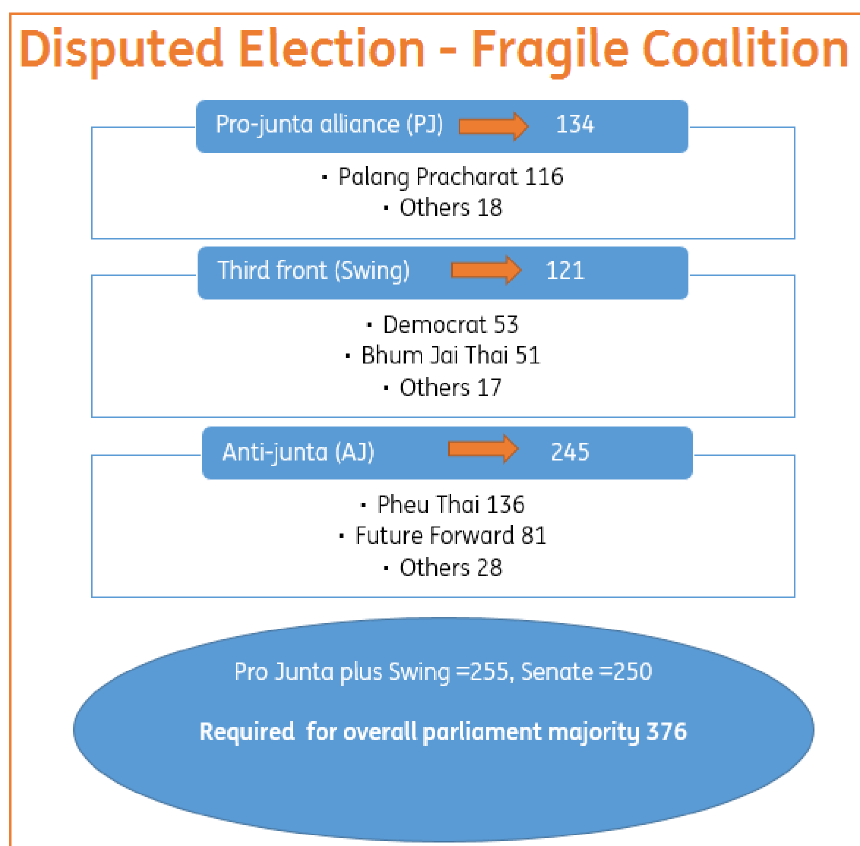
Source: Shutterstock

The political scene continues to be confused

The results of the General Election held on 24 March were widely disputed. And more than three months later, there is still no government in place.

The new parliament is comprised of the 250-seat Senate, entirely held by the military appointees, and the 500-seat lower house. Here, the pro-junta Palang Pracharath Party has managed to form a 19-party coalition holding a very slim majority of only four seats. This Parliament formally elected Prayuth Chan-Ocha as prime minister – the former military general's second term in that office. We thought this had almost ended the long-standing political uncertainty since the 2014 coup. But we were wrong.

Disputed elections - fragile coalition



Source: ING

As the wrangling for cabinet positions and tumult with his own political circle continues to delay formation of the government, PM Prayuth has hinted at a mid-July timeline for instituting his new Cabinet. However, it doesn't look to be going well, given recent reports of a rift within Prayuth's Palang Pracharath Party, as well as the Constitutional Court's order for investigation of 32 lawmakers from the ruling coalition for violating the constitutional prohibition of shareholdings in media companies.

The Court has allowed all 32 embattled lawmakers to keep their seats until the final ruling, an implied leaning towards the junta which faced criticism from the opposition, given the Court's earlier suspension of a main opposition party leader for the same allegations. Thanathorn Juangroongruangkit, the leader of the Future Forward Party, is currently being investigated by the court for his media holdings.

> *I hope that everything will move forward to respond to peoples' needs as the government of all Thais. This will be a beginning for a political reform by the government and its coalition so that politics will not get back to its old problem that might require the old, unwanted solutions – PM Prayuth Chan-Ocha*

These recent developments could potentially destabilise the coalition, reducing it to a minority and thus paving the way for more uncertainty ahead. The additional risk stems from factions within the military, the imminent shift of power away from the Queen's Guards, from which PM Prayuth hails, to the King's Guards led by military commander-in-chief Apirat Kongsompong. The latest story by Nikkei Asian Review will be a good read on this (may require subscription).

So, where do we go with all this? Prayuth's mid-July timeline for having the government in place may seem a bit optimistic. We aren't judging the hopes of a return to the civilian regime as being in vain. but even if it gets there, Prayuth will still be leading a very weak coalition government that would face tests during the passage of key legislation in parliament, e.g. the imminent 2020 budget. After all, with such a fragile coalition, doubts about the new government surviving its entire term will flourish.

On the other hand, if the process is dragged out beyond July, we could be in for quite an unpredictable political future, which would come as a significant dent to investor confidence in the new political machinery. We don't rule out a further spike in political risk.

Against such a backdrop, the strong rally in local financial assets – government bonds, equities and the Thai baht alike – underway since June, remains at risk of being unwound.

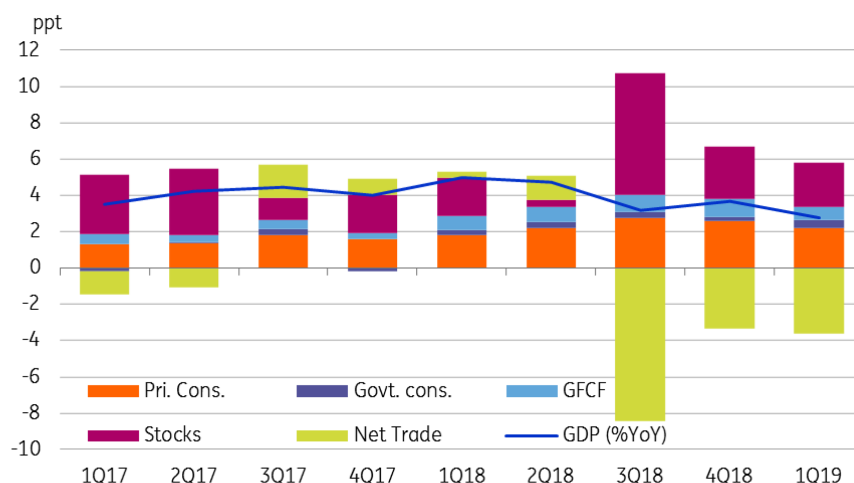
The economy isn't doing any good either

Following on the heels of an exceptionally weak first quarter this year, the economic data continues to unfold on the weaker side. GDP growth slumped to a four-year low of 2.8% in 1Q19. The political jitters during the general elections weighted on domestic demand, while global trade and the technology war continued to depress exports. Indeed, net trade remained a key drag on growth. If it weren't for a sustained inventory re-stocking, GDP growth would have been even worse.

We read the high-frequency activity data as signalling continued economic weakness in the current quarter, while the forward-looking confidence indicators show no respite from this trend over the rest of the year.

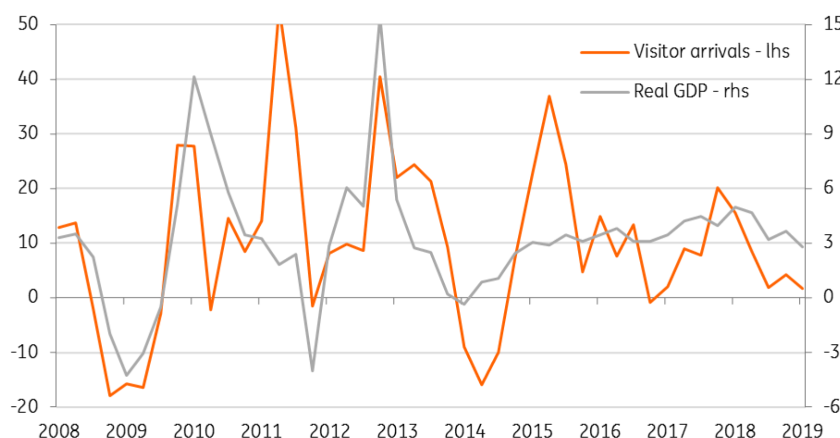
Besides weak exports, a further hit to growth comes from the fallout of the trade war on the tourism sector - the backbone of the Thai economy. This is already evident from the slowdown in Chinese visitors underway since last year. Domestic political jitters also deter tourists and GDP growth.

Sources of GDP growth



Source: CEIC, ING

Slowing tourism, slowing GDP growth (% year-on-year)



Source: Bloomberg, CEIC, ING

Cloudy prospects ahead

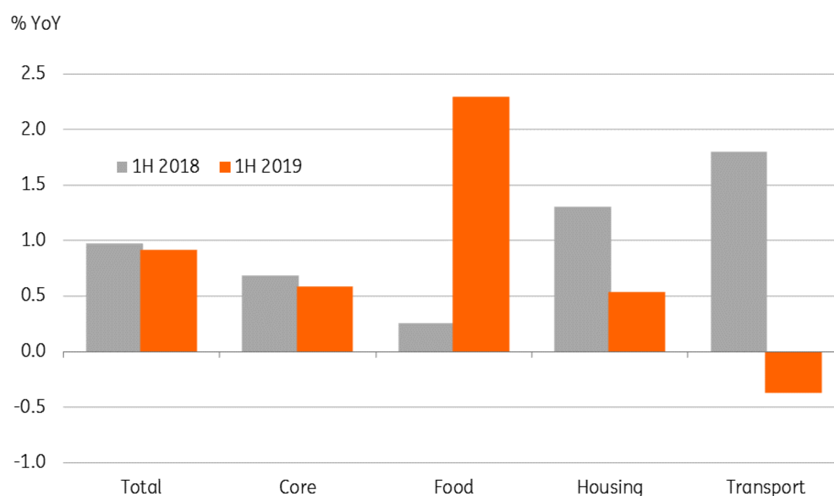
We recently revised our GDP growth forecast for 2019 to 3.1% from 3.8%, putting it below the official 3.3% forecast by both government and the central bank (the Bank of Thailand) which were scaled back from 3.8%.

Meanwhile, inflation has remained subdued, making the last rate hike seem even more unnecessary. Weak growth will sustain the low inflation trend for the foreseeable future. At an average rate of 0.9% in the first half of 2019, consumer price inflation was slightly below the 1% average in the same period last year. A sharp spike in food inflation was more than offset by a slump in housing and transport inflation, while inflation in other consumer products (core inflation) continued to be negligible, about 0.5%.

We expect the inflation outturn for the rest of the year to remain benign, especially with strong

currency appreciation this year keeping imported inflation at bay and anaemic domestic demand limiting any upside at home. The Commerce Ministry recently cut its 2019 inflation forecast to 1.0% from 1.2%, putting it on a par with the central bank's forecast. Our 1% annual inflation forecast maintained since the last revision from 1.3% in January this year, remains on track, though with the risks tilted more to the downside than to the upside.

Subdued inflation



Source: Bloomberg, CEIC, ING

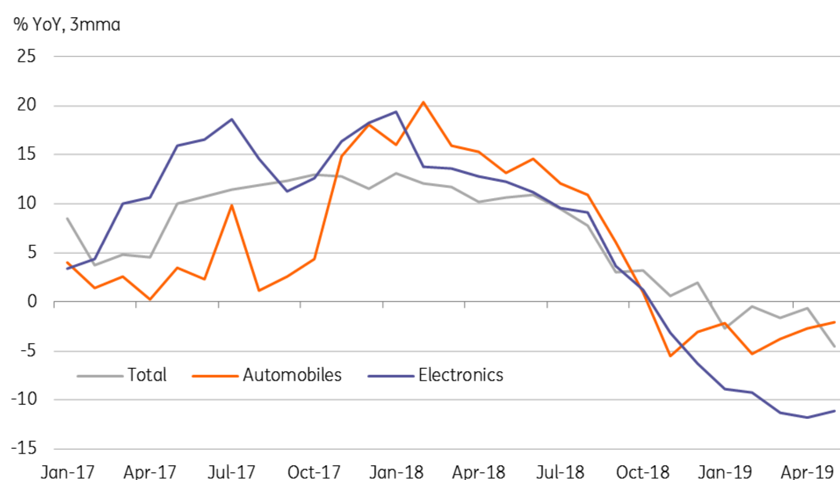
Still, healthy external payments

Thailand isn't spared from the US-China trade and technology war or the global tech slump hanging over the entire region. Exports of automobiles and electronics, together accounting for 30% of total exports, have been on a steady downward grind.

A 2.7% YoY contraction of total exports in the year through May is a significant negative swing from 12% growth a year ago. The swing is much worst for imports, - 1.0% YTD from +16%, which underscores domestic economic weakness. This is associated with a (just slightly) narrower trade and current account surplus than a year ago.

The potential negative impact on the "tourism dollar" could mean that the surplus narrows even further. We foresee the annual current surplus in 2019 to be equivalent to 4.8% of GDP, down from 6.4% in 2018. This is still large relative to most Asian countries and remains a significant support to the currency (Thai baht, or THB).

Slumping automobile and electronics exports



Source: Bloomberg, CEIC, ING

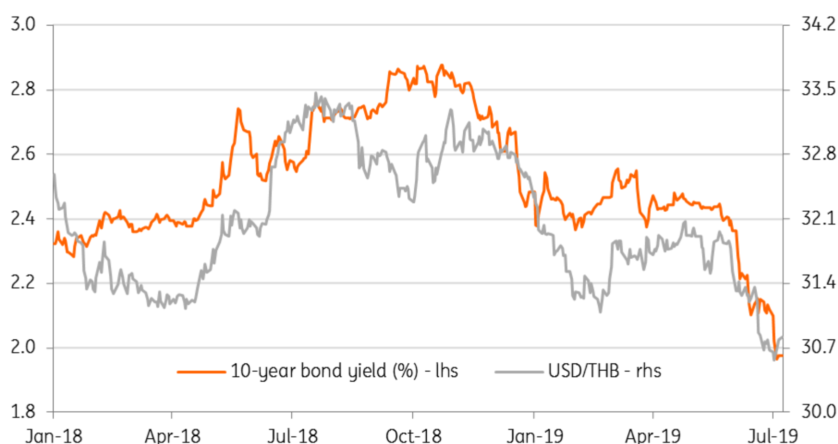
Excessive baht strength hurts more

The THB continues to be among the best performing emerging market currencies so far this year, with a more than 6% appreciation against the US dollar, taking the exchange rate to a six-year high of 30.57, even in the face of heightened global economic and geopolitical uncertainty. Clearly, the THB performance is out of sync with the underlying weak economic trends despite the fact that the currency enjoys a relatively strong backing from the large current surplus, which itself is a by-product of a significant economic imbalance – perennially weak domestic demand.

The BoT attributes recent (fast-paced) appreciation of the THB to a weakening US dollar, short-term capital inflows, and domestic factors. But the central bank also admits to it being inconsistent with economic fundamentals. It's not just inconsistent with prevailing economic fundamentals, the strong currency further dampens the prospects for exports and tourism by making them more expensive for foreigners. Thailand's status as a cheap tourist destination in Asia and perhaps the world is under threat from rapid currency strength.

Indeed, the authorities are worried about this runaway currency appreciation but there is little action to arrest it just yet, even as Thailand has now moved out of the US Treasury's radar for currency manipulators. The BoT is only 'closely' monitoring the foreign exchange market for speculative interests. We believe a policy rate cut might help in the process while the argument for easing is getting stronger and stronger with every piece of additional data.

Surging portfolio inflows



Source: Bloomberg, ING

Lack of fiscal support

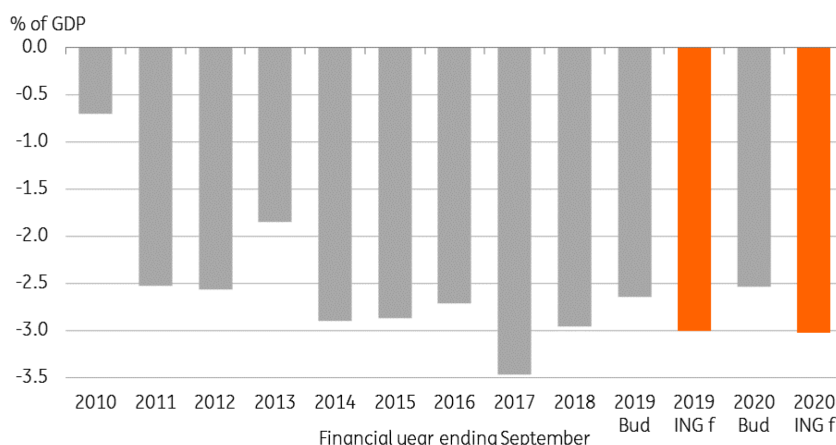
The persistent political uncertainty reduces hopes for any fiscal stimulus to revive the economy going forward, while the delayed government formation itself has been hurting routine government spending.

That said, the 4.4% year-on-year revenue growth in the first eight months of fiscal 2019 through May (fiscal year runs from October to September) was moderate but a bit slower than 4.6% in the same period of the previous year while expenditure growth of 5.6% accelerated from 0.1% a year ago.

Such trends will be associated with a significant overshoot of the fiscal deficit in the current financial year, above the government's target of THB 450 billion, or about 2.6% of GDP target. We see the deficit this year as unchanged from the 3% of GDP level it was in the last financial year.

Without a properly functioning government the fate of big infrastructure projects, like the Eastern Economic Corridor (EEC)- a $45 billion public-private partnership, hangs in the balance.

Fiscal deficit



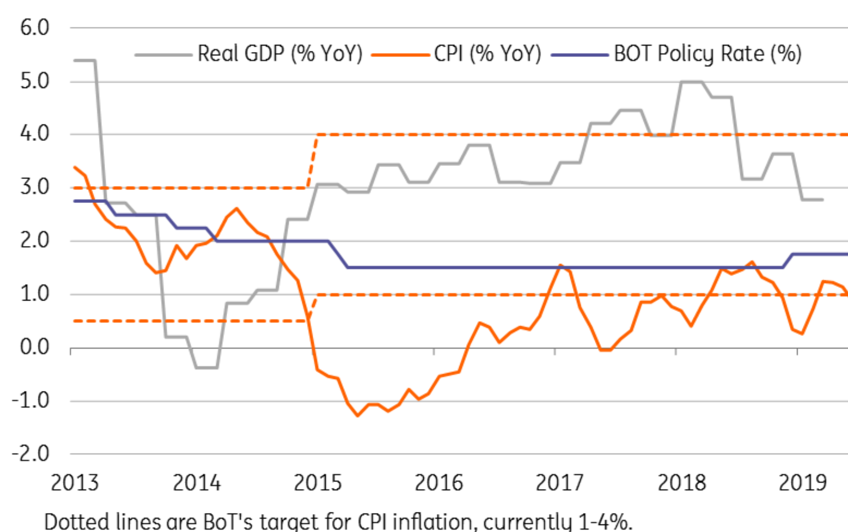
Source: CEIC, ING

Heavy-lifting for monetary policy

The BoT's last policy change was a 25 basis point increase in the one-day repurchase rate, the policy rate, to 1.75% in December 2018. We thought that policy tightening wasn't required in the first place when the external economic headwinds were already getting stronger, GDP growth was petering out, and inflation was running under the BoT's 1-4% target. Indeed, Thailand's economic environment hasn't got any better since the last policy move. Rather, it has deteriorated.

The lack of fiscal policy support means that monetary policy will have to do all the heavy lifting. Slowly but surely, the authorities are coming to terms with the need for easier monetary policy.

Growth, inflation and policy rate



Source: Bloomberg, CEIC, ING

Just recently the government added its voice to calls for monetary easing, with Deputy Prime Minister Somkid Jatusripitak saying that "It can't go against the trend if the economic situation continues to be like this". And a BoT policymaker, Somchai Jitsuchon, signalled that monetary policy would be data-dependent, with the fallout from the US-China trade war on the local economy leaving the bank "open to all possibilities". This being the case, it's hard to imagine the BoT ignoring the latest activity data, which offers no hope of recovery in economic growth in the period ahead.

The BoT's statement after the last meeting was largely dovish and it was also accompanied by a downgrade of the central bank's growth forecast for 2019 to 3.3% from 3.8%. We take this as a signal that a policy rate cut is just around the corner. We continue to expect a 25bp rate cut in the current quarter, more likely at the next meeting on 7 August rather than the 25 September meeting. However, that would still only be a reversal of the hike in late 2019, and not provide much stimulus to a sagging economy. We are adding one more 25bp rate cut to our policy forecast in the fourth quarter, taking the policy rate to 1.25% by end-2019.

Thailand: Key economic indicators and ING forecasts

Thailand	2015	2016	2017	2018	2019 f	2020 f
Real GDP (% YoY)	3.1	3.4	4.0	4.1	3.1	3.5
CPI (% YoY)	-0.9	0.2	0.7	1.1	1.0	1.4
Unemployment rate (%)	0.9	1.0	1.2	1.1	1.2	1.1
Fiscal balance (% of GDP)	-2.9	-2.7	-3.5	-3.0	-3.0	-3.0
Public debt (% of GDP)	42.1	41.1	41.2	41.6	42.9	47.4
Current account (% of GDP)	6.9	10.5	9.7	6.4	4.8	3.1
FX reserves (US$bn)	156.5	171.9	202.6	205.6	220.0	230.0
External debt (% of GDP)	32.7	32.0	34.1	31.3	32.0	33.0
Central bank policy rate	1.50	1.50	1.50	1.75	1.25	1.25
3M interbank rate (%, eop)	1.63	1.59	1.57	1.86	1.50	1.65
10Y govt. bond yield (%, eop)	2.50	2.65	2.32	2.48	2.00	2.25
THB per USD (eop)	36.08	35.84	32.58	32.33	31.00	30.50

Sources: Bloomberg, CEIC, ING forecasts

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