

In case you missed it: The contagion effect

A slide in the Turkish lira, worries about an escalating trade war between China and the US and signs of slowing global growth piled yet more pressure on emerging markets this week. The question now is, can the sell-off be contained or are things about to get a lot worse?

In this bundle



FX | Turkey

EM portfolio flows: Who's at risk?

Global emerging market assets have come under pressure as investors gauge the next move in Turkey. Should events lead to more indiscriminate selling of EM...

By Chris Turner



FX | Video

Watch: FX markets are on the frontline in Trump's economic war

Watch ING's Head of FX Strategy, Chris Turner, talk about how emerging market FX, notably the Turkish lira, the Russian rouble and the Chinese...

By Chris Turner



China: Cutting our GDP forecast

Aggregate financing shows shadow banking is still shrinking, with sizeable loan write-offs in 1H. Both provide some room for loan growth to support...



China: Central bank closing outflow loopholes for further monetary easing

The People's Bank of China is actively closing possible capital outflow loopholes and this firewall building will allow it to lower interest rates and...



Commodities daily

Crude oil: A story of demand

Growing trade tensions and increasing emerging market risk have weighed on the commodities complex. The Bloomberg Commodities index has fallen by almost...

By Warren Patterson



Indonesia

Indonesia: Central bank raises rates in quest to stabilise currency

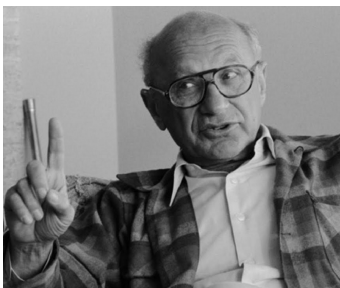
Bank Indonesia (BI) surprised investors with a 25 basis point policy rate hike. BI has resumed tightening to stabilise the rupiah, which had fallen to its...



India

India: No respite for the rupee

As if the global market turmoil isn't enough, domestic economic developments have been turning sour for the Indian rupee. This provides little hope...



eZonomics | Think Forward Initiative

So you think you're an economic hotshot?

Think you're better at predicting successful investment outcomes than your peers? You might indeed be a whizz, or you might have fallen prey to the...

EM portfolio flows: Who's at risk?

Global emerging market assets have come under pressure as investors gauge the next move in Turkey. Should events lead to more indiscriminate selling of EM...

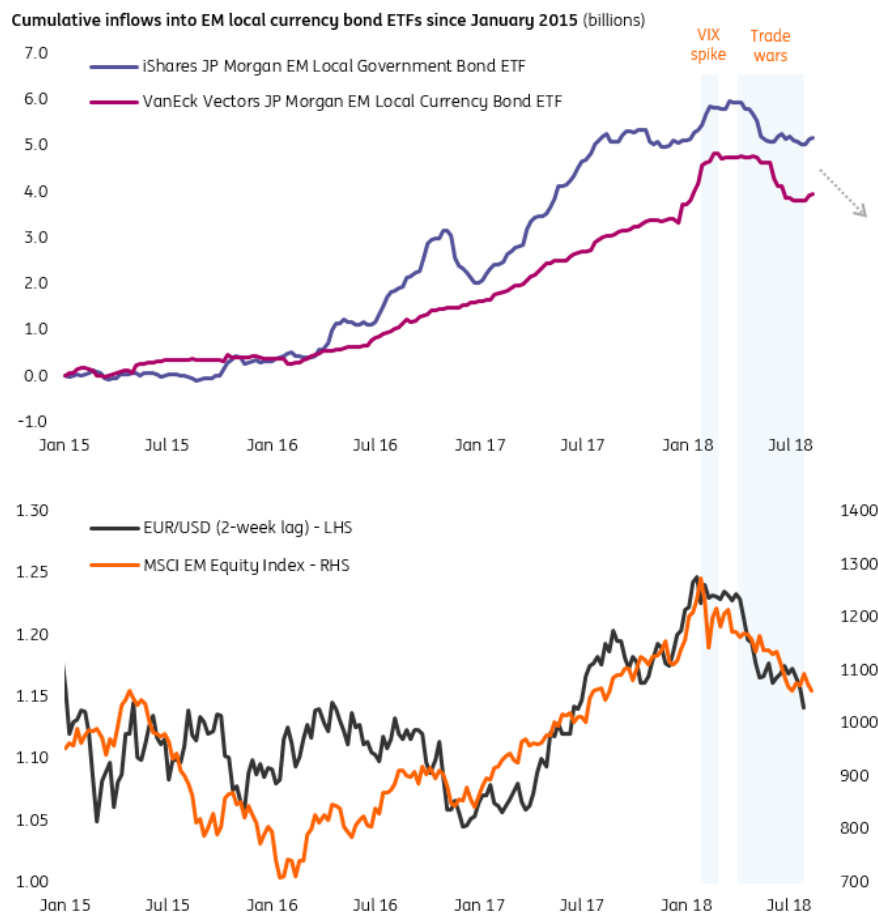


EM investors scale back positions

Global investors have typically been happy to own Emerging Market risk over recent years, although the escalation in trade wars and the dollar rally from early Spring this year has asked some serious questions. That said we are far from seeing a wholesale exodus from emerging markets. Looking at one sub-set of flows – flows in EM local currency debt funds – the retreat has been relatively mild compared to the strong inflows seen through 2016-2017.

An insight into flows into this segment can be gleaned from two popular Exchange Traded Funds (ETFs) that track the JP Morgan EM Local Currency bond index. These ETFs have seen outflows since April this year, but the move looks relatively modest so far. The membership break-down of these ETFs shows Turkey as having one of the smaller EM weightings at 4.0% and 2.4% respectively. This

compares to the 'big beasts' of the EM debt indices such as Brazil, Mexico, Indonesia, Poland and South Africa, which all tend to have weightings closer to 9-10% in these benchmark indices.



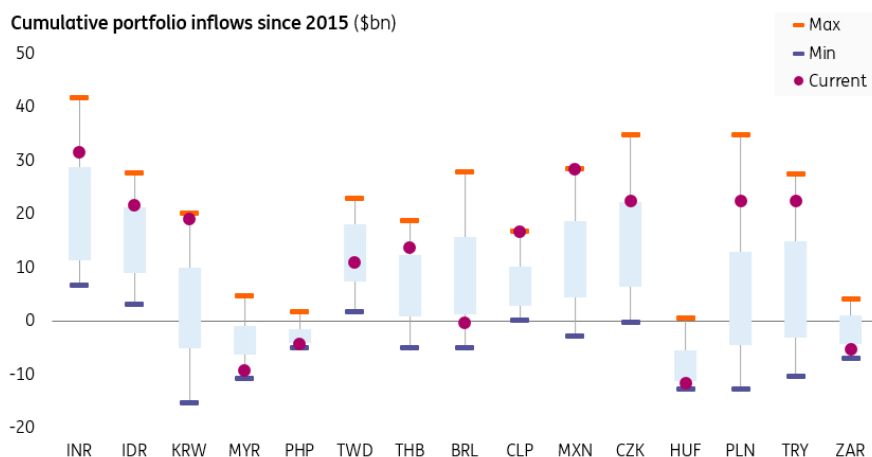
Source: Bloomberg, ING estimates

A broader look at EM portfolio flows

Looking beyond the narrow sector of EM local currency debt, the Institute of International Finance in Washington produces timely data on non-resident equity and debt inflows into particular emerging market countries. Their data proxies the Balance of Payment release in each country, which typically would appear with a large lag.

Using data from the IIF, the chart below provides a relative snap-shot of where non-resident portfolio (debt and equity combined) was parked in EM at the end of July. For example, the data suggests that investors had relatively light positions in Malaysia and Hungary, while positions in India, Korea, Mexico and Poland were quite high relative to where they had been over the last three and a half years.

We've removed China from this chart since cumulative inflows of over US\$250bn since 2015 (Chinese asset markets becoming more integrated) eclipse all the other EM flows.



Source: IIF, ING calculations. Note: All flows up to July-18 expect MYR (Jun-18), BRL (Jun-18), CLP (May-18), CZK (May-18), PLN (May-18). Shaded bar shows +/- 1 standard deviation.

Who's at risk?

While the largest inflows have gone to China, we suspect that Chinese policymakers have the tools to prevent large-scale portfolio outflows. Should USD/CNY look to approach 7.00, the PBOC could once again trigger the 'counter-cyclical factor' in the daily fixings – effectively a manual over-ride to keep the fixings steady.

The implications from the above, as [Viraj Patel points out in a recent article](#), is that it could limit a further sell-off in Asia FX.

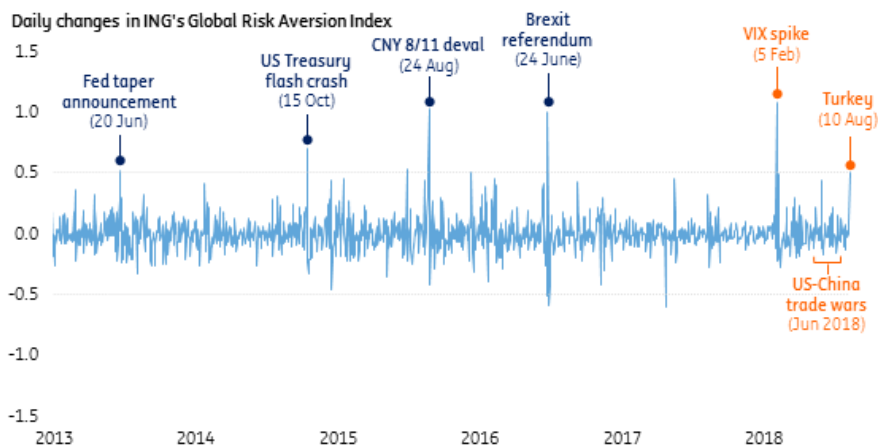
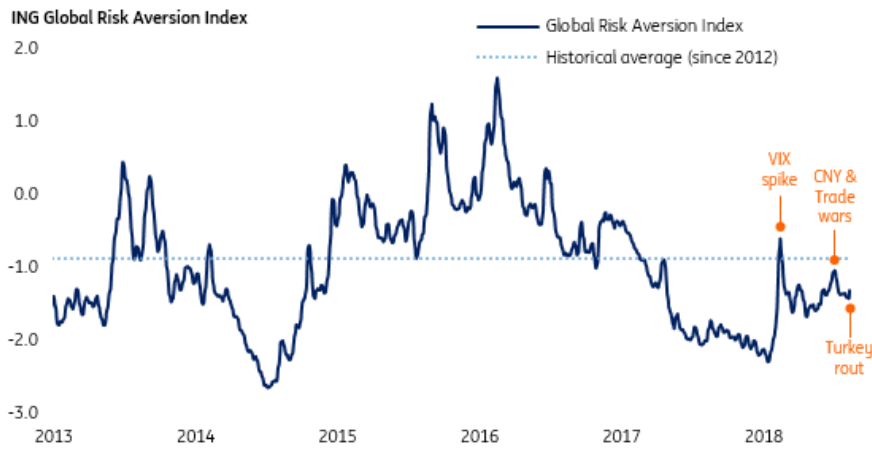
Instead, were the Turkish sell-off to broaden substantially, those countries (and currencies) most exposed to portfolio outflows could be the likes of Poland and the Czech Republic in EMEA – and Mexico and Chile in Latin America.

[Gustavo Rangel has just published a positive piece on Mexico](#) based on the domestic political programme, but our point in this article is to highlight who's at risk should indiscriminate EM selling emerge and even good stories are ignored.

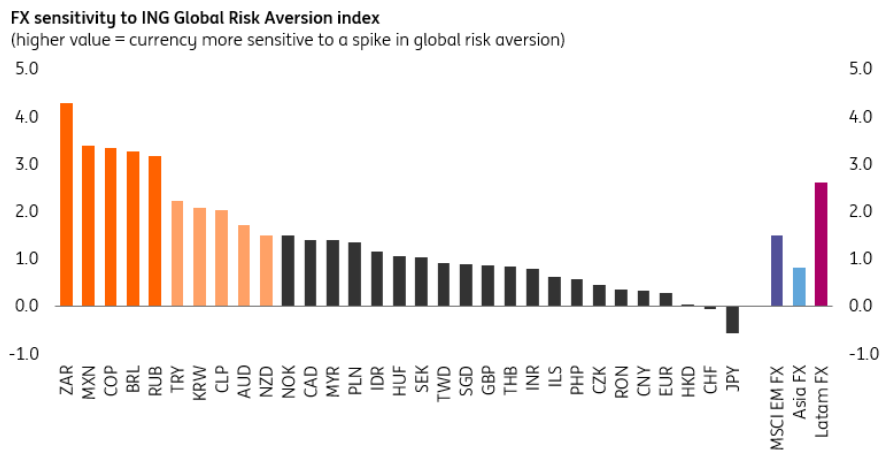
A year of global risk aversion? More like sharp, one-off unsustained spikes

Although the Turkey-related global market sell-off has registered a spike in our Global Risk Aversion index similar to episodes such as the 2013 Fed 'taper tantrum', we note that such sell-off episodes in 2018 have not been sustained (the overall Global Risk Aversion index is still at historically low levels).

Those currencies most sensitive are the usual high-beta suspects like the South African rand (ZAR) and Mexican peso (MXN) - and while these currencies suffer on days when global risk aversion spikes, they also typically rebound quite sharply on any short-term reprieve in global risk sentiment. This is worth bearing in mind given the ever-changing geopolitical backdrop.



Source: ING estimates, Bloomberg, Macrobond. Note: ING's Global Risk Aversion Index calculated using a principal components analysis of a basket of global risk metrics



Source: ING estimates, Bloomberg, Macrobond

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Watch: FX markets are on the frontline in Trump's economic war

Watch ING's Head of FX Strategy, Chris Turner, talk about how emerging market FX, notably the Turkish lira, the Russian rouble and the Chinese...



FX markets are on the front-line in Trump's economic war

ING's Chris Turner on the pressures building in emerging market FX

[Watch video](#)

Author

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Article | 14 August 2018

China: Cutting our GDP forecast

Aggregate financing shows shadow banking is still shrinking, with sizeable loan write-offs in 1H. Both provide some room for loan growth to support...



A race between government stimulus and damages from trade war

China's overall economic performance in terms of GDP depends on whether fiscal stimulus and monetary easing are big enough and happening fast enough to offset the negative impact on exports and related manufacturing activity from the ongoing trade war.

As the Chinese government has put substantial stimulus and easing in place, the Chinese economy should not experience a deep contraction. Nonetheless, we are still revising China's GDP downwards to 6.6% in 2018 from 6.7%. We expect 3Q and 4Q GDP to slow to 6.5% year-on-year and 6.3% YoY respectively from 6.7% in 1H18. This steeper slowdown in 4Q reflects our expectation of 25% tariffs on \$200 billion of exported goods to the US becoming effective.

We retain our end-of-year USDCNY forecast of 7.0.

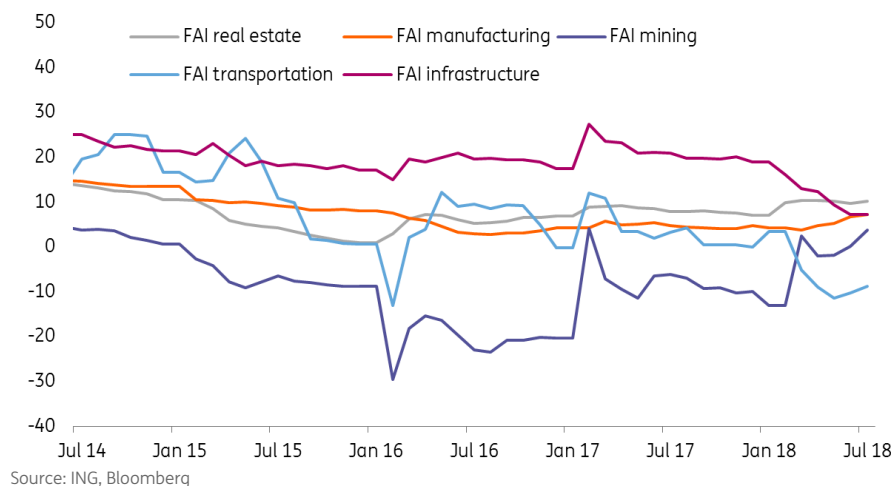
Trade war impact already reflected in July data

Fixed asset investment slowed sharply to 5.5% YoY in July from 6.0% YoY in June; mainly as a result of negative 8.7% YoY growth in transportation, caused by limited local government spending. Real estate could stay strong because in a trade war, the economy still needs investment growth, even if the government previously indicated that tightening measures were needed.

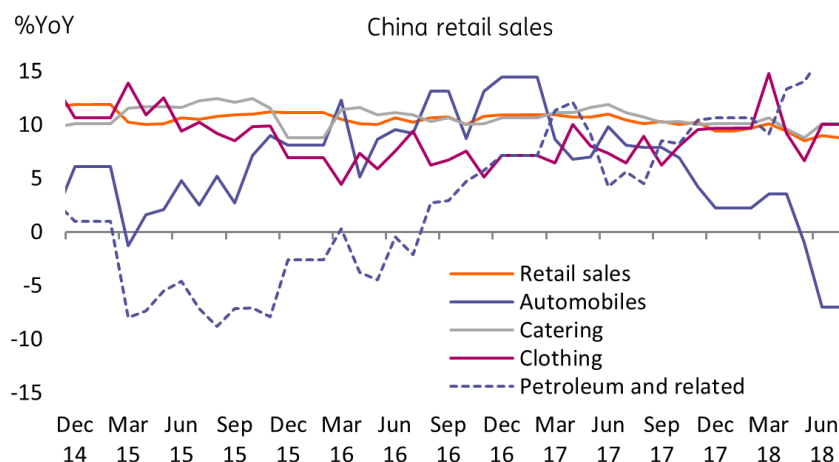
Industrial production growth stayed flat at 6.0% YoY in July, of which industrial robot growth slowed to 6.3% YoY in July. The steep slowdown of robot production growth started in June, where 7.2% YoY was registered, down from May's 35.1% YoY. It seems that the trade war has deferred robot production, as exporters and manufacturers expect lower production order volumes.

Retail sales growth also slowed to 8.8% YoY in July from 9.0% in June due to negative sales growth in automobiles. Tariff cuts on imported automobiles (except for those from the US) may not have yet fed through to existing inventories at retail outlets, and until this clears, a mismatch in price expectations between consumers and sellers may weigh on car sales.

China investment slows previous deleveraging from local government



Retail sales derailed by subsidy cuts on car sales but could revive



Source: ING, Bloomberg

Robot production fall could reflect worry of manufacturers about a trade war



Source: ING, Bloomberg

Faster loan growth coming to support economy

Headline aggregate financing figures show that credit growth shrank in July to CNY1040 billion from CNY1180 billion from the previous month. One interpretation is that the easing of monetary policy has not been effective in boosting the economy. But there is a more positive interpretation.

Reasons why loan growth should improve:

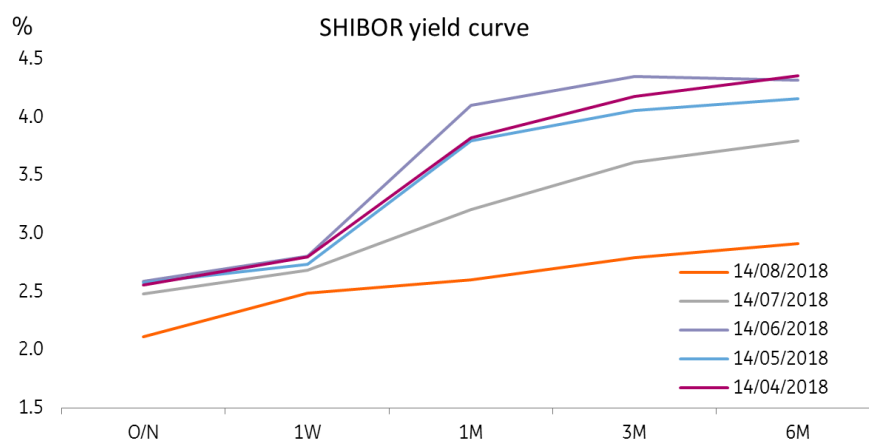
1. Shadow banking activities continued to shrink in July, which could be a result of sustained tight asset management policies despite some relaxation. This should free up some bank capital for on-balance sheet loan growth.
2. Written-off loans, a new statistic in aggregate financing, were also large, in 1H, providing some room for future loan growth.

3. [The bank and insurance regulator reported](#) that infrastructure loans rose by CNY46.9 billion to CNY172.4 billion in July. This indicates that infrastructure activity should rise at a faster speed in coming months given the direction from the State Council.
4. SME loans can be rolled over without repaying any principal.
5. We expect two 50 basis point cuts in the targeted required reserve ratio (RRR) in 2H18 to further ease liquidity for SMEs.

Moreover, interest rates have fallen a lot since the end of June. The current level of interest rates (SHIBOR 7D at 2.4910% and 3M at 2.7910%) is low enough for corporates to rollover debt or make new loans.

Additional loans to boost infrastructure and support SMEs will provide some cushioning against a trade war. Though as we noted earlier, the net effect on growth is still modestly negative.

Interest rates have fallen sharply



Source: ING, Bloomberg

Investment growth and SOEs would be economic engines again, a repeat of 2009?

Fiscal stimulus and monetary easing now is qualitatively, if not quantitatively comparable to the 2009 stimulus:

1. July's State Council meeting has already reinstated infrastructure investments to cushion the economy from the trade war. The slow investment growth in July should not be considered as representative of the rest of 2018.
2. Despite their inefficiency, infrastructure projects could still create overcapacity again in a few years time, similar to the experience following the 2009 stimulus. We believe that the government is going in this direction to keep growth stable. It will not only push forward planned investments but also put up new investment projects to prepare for a long drawn-out trade war.
3. SMEs are vulnerable to tariff barriers; the central bank has already announced that SMEs could have loans rolled-over even without repaying principal amounts.
4. State-owned enterprises with more investment projects and manufacturing activity will show their "social responsibility" by absorbing labour from SMEs. This will stabilise labour markets, but wage growth will likely fall in export-related sectors

unless tax cuts for corporates or tax holidays for exporters are announced.

5. We are uncertain if consumption will slow. Though export sector wage growth may slow, new sector wage growth could offset this. We expect the government will maintain consumption levels if necessary by delivering consumption-friendly policies, e.g. salary tax cuts.

Though the government has not announced the full amount of stimulus planned, the State Council's 23rd July announcement of CNY2628 billion, is still not comparable to [the CNY4 trillion stimulus in 2008-2009](#).

We expect more to come as this is just the start of the trade war and consequently, just the beginning of fiscal stimulus and easing.

Article | 17 August 2018

China: Central bank closing outflow loopholes for further monetary easing

The People's Bank of China is actively closing possible capital outflow loopholes and this firewall building will allow it to lower interest rates and...



Source: Shutterstock

Interest rate stabilises from further downward pressure, for now at least

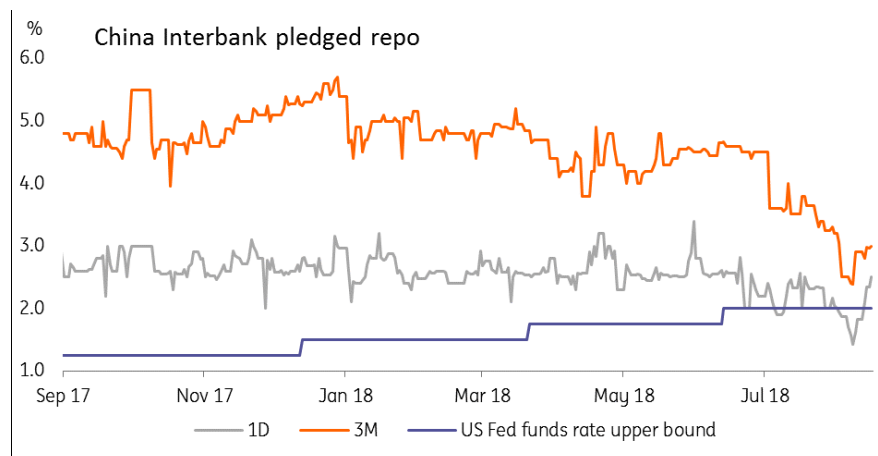
The People's Bank of China would like to lower the interest rate to cushion against potential adverse impacts from the escalating trade war and unwind some harsh damages (e.g. bonds defaults) caused by financial deleveraging reforms in 1H18. However, when the 1D interbank pledged repo and overnight SHIBOR fell below 2% - which is the level of the US's Fed funds rate upper bound - it triggered capital outflow concerns from the inverted China-US interest rate spread.

This could be the reason the central bank has guided the interbank interest rates higher than the 2% level after a sharp fall in the first week of August. The central bank also guided the interest rate on 3M government deposit auction stable at 3.7% in August, the same as July after a sharp fall from 4.73% in June.

As we [expect another rate hike](#) from the Federal Reserve in September, China's interest rate could

be lower than the US again by then. PBoC will have to live with this negative spread because the economy needs lower interest rates to support investments and economic growth in this ongoing trade spat.

Chinese interest rate dipped below the Fed funds rate recently



Source: ING, Bloomberg

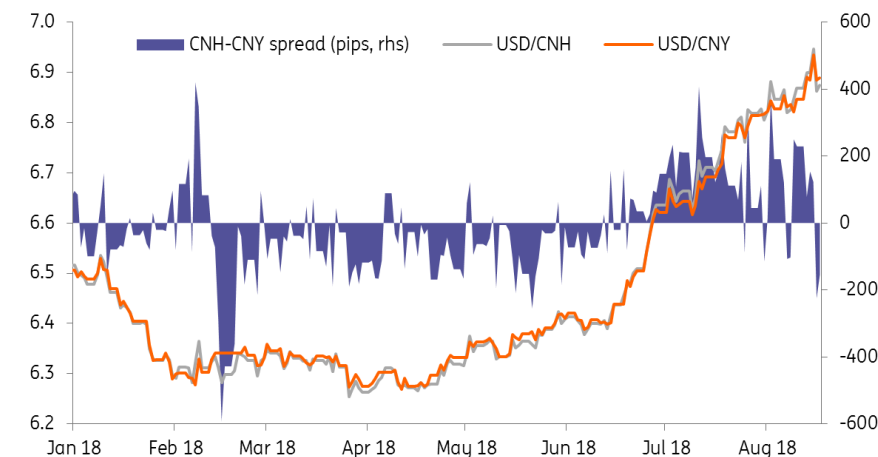
Closing outflows loopholes allows for more monetary easing

The Chinese central bank should have known if it shut down cross-border capital flow channels, then the chance of substantial capital outflows would be small even it guides interest rates lower, and the yuan weakens further due to the strong dollar.

This could be the reason behind the policy to stop capital outflows via interbank accounts set up in the Shanghai Free Trade Zone [as reported by the media](#) on 17th August 2018. We see this as a firewall to prevent capital outflows, give more room for a lower interest rate and a weaker yuan in the coming months when the trade war escalates.

USDCNH may not fully reflect the offshore market reaction of this policy, but USDCNY movements would be more indicative than the USDCNH from here onwards, and we believe the PBoC would allow USDCNY to follow the dollar trend broadly. Once the Fed hikes, the dollar should maintain its strength even after the recent emerging market situation stabilises.

CNH not as indicative as CNY after outflows via free trade zone stop



Source: ING, Bloomberg

We believe the US has invited China to a fresh round of trade negotiations but the low official ranking of representative from both sides signals the chance of a positive result, or of any result, from this negotiation is small.

Given that China isn't going to give way if the US doesn't scale back its tariffs, we think the trade war will escalate, and the yuan would weaken against the backdrop of a strong dollar index. As USDCNY touched 6.9348 on 15th August 2018, passing 7.0 in 2018 looks increasingly likely.

Crude oil: A story of demand

Growing trade tensions and increasing emerging market risk have weighed on the commodities complex. The Bloomberg Commodities index has fallen by almost...



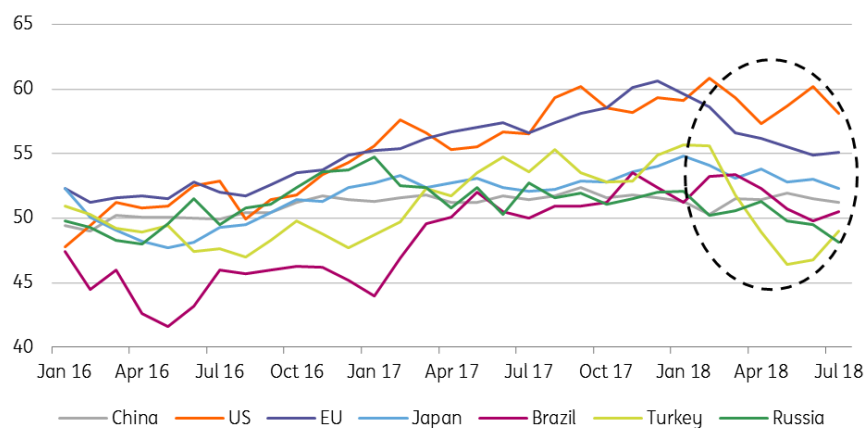
Downside risk to oil demand

It does seem that the synchronised global growth story from earlier this year is losing some momentum. Yes, the US economy is still growing strongly, but with the [US Treasury yield curve moving ever closer to inversion](#), there is concern that this could be a precursor to a slowdown. Meanwhile, trade tensions do not seem as though they will be resolved anytime soon, which will do little to help growth. Already if we look around the globe in recent months, manufacturing PMIs have softened in a number of countries although they still point towards expansion. Adding to this is the potential risk of contagion from the current Turkey crisis. Other emerging markets have already been hit, evident through depreciating currencies, investors demanding higher yields on emerging market debt and a jump in credit default swaps on this debt. However saying all of this, the US Federal Reserve seems unlikely to deviate from its plan for tighter monetary policy, which should remain supportive for the US dollar, whilst growing emerging market risk adds further support to the currency.

So what does this all mean for oil? A number of agencies have highlighted the downside risk to current demand growth forecasts. At the moment the IEA estimates that global oil demand will grow by 1.4MMbbls/d over 2018, compared to growth of 1.52MMbbls/d in 2017. For 2019, it estimates demand growth will increase slightly to 1.5MMbbls/d. However, the agency has

stressed that there is potential downside risk as a result of growing trade tensions and the stronger oil price environment; remember ICE Brent is up almost 58% since the lows of June 2017. Given concerns over emerging markets, this risk is likely even more real now. OPEC also downgraded its demand growth forecasts for 2018 and 2019 in its latest monthly report.

Manufacturing PMI edging lower in a number of countries



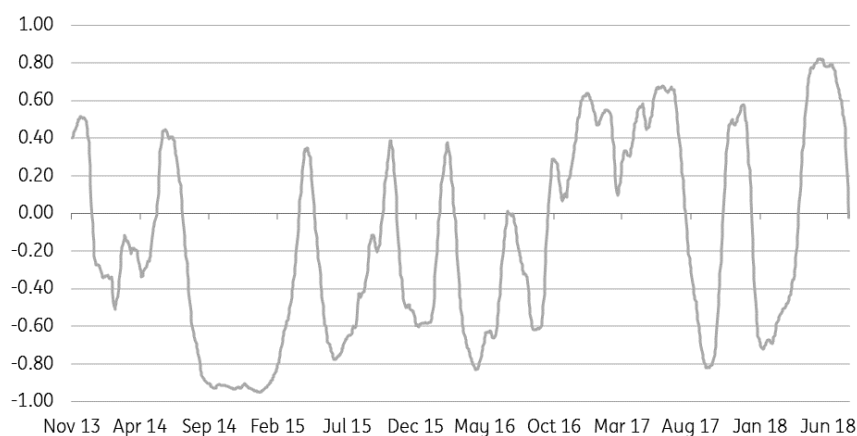
Source: Bloomberg, ING Research

Rising USD and stronger oil prices

Recent developments in Turkey have highlighted a dynamic that has been at play for some time now in the oil market- a strengthening USD along with stronger oil prices. More constructive oil fundamentals had meant that the usual inverse relationship between the two broke down somewhat, calling into question those with more bullish demand growth forecasts. Although more recently, the inverse relationship has started to re-emerge once again.

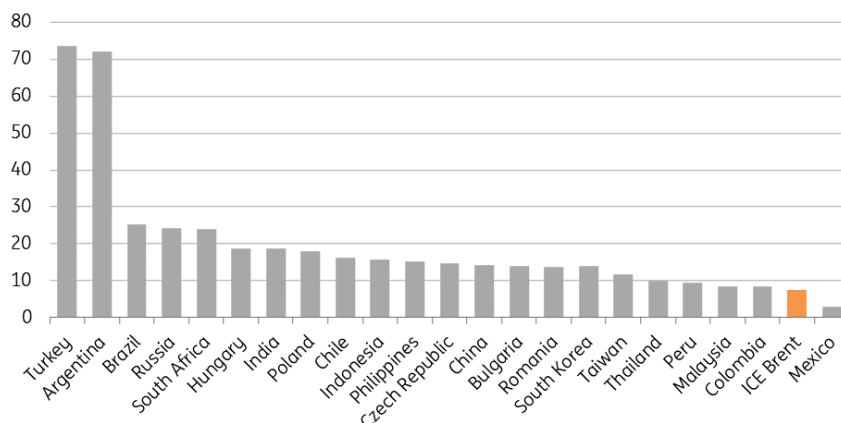
The USD index has appreciated by almost 5% since the start of the year, with the Turkish lira and Argentine peso the worst performers, down over 40% year-to-date against the USD, the Brazilian real is down almost 17%, the South African rand down 12% YTD, whilst the Indian rupee has depreciated by 8.6% over the same time period. This has meant that the 7% YTD rally we have seen in ICE Brent looks far stronger in domestic currency terms. For example, oil prices in Turkish lira have rallied almost 74% so far this year, and 160% since the lows of June 2017.

ICE Brent and USD Index 90 day rolling correlation



Source: Bloomberg, ING Research

ICE Brent YTD oil price movement in local currency (%)



Source: Bloomberg, ING Research

So what does this mean for oil demand?

The impact on oil demand is largely dependent on how governments react. Will higher costs be borne by consumers or will governments try to shield consumers as much as possible from rising fuel prices through subsidies?

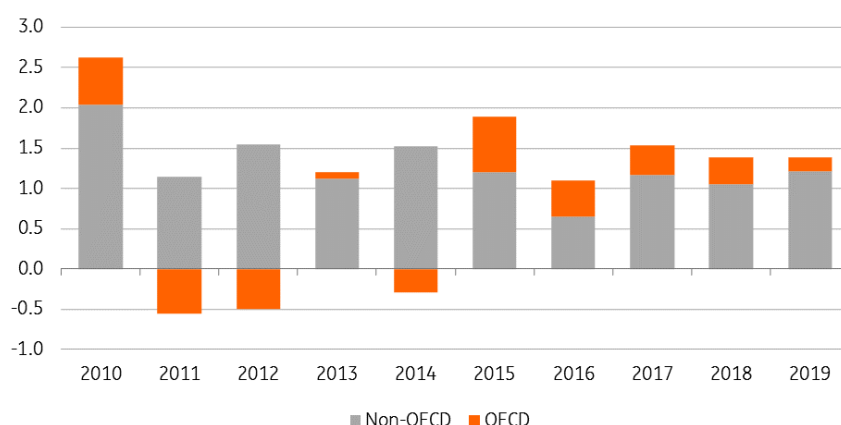
Already we have seen a number of countries reintroduce/increase subsidies. Earlier this year, we saw truck drivers in Brazil go on strike over increasing diesel prices, the strike only came to an end when Petrobras agreed to reduce prices by 10%, and instead of daily price changes, prices will be reviewed every 30 days. Politics were clearly at play here as well, with Brazil set for general elections later this year.

In Malaysia, the government announced that it would fix certain fuel prices through the end of 2018, which would equate to a cost of around \$760 million for the government. While in Indonesia, the government announced energy subsidies totalling \$4.8 billion, in order to keep fuel prices unchanged for the remainder of the year. Subsidising fuel prices obviously creates another issue for a number of emerging markets- it makes it more difficult to hit their fiscal targets.

A good example of a country torn between wanting to keep consumers happy and trying to balance the books is Argentina. The government has tried to liberalise the market, through scrapping fixed domestic crude oil prices and reducing subsidies. This was done in the hope that it would attract investment in the domestic oil industry, whilst also reducing its fiscal deficit. Once lifted, domestic oil prices rallied along with the move in international benchmarks, which also meant consumers were paying higher pump prices. Under pressure, the government intervened earlier this year, fixing domestic crude oil prices for a couple of months, while also coming to an agreement with fuel distributors to limit pump price increases.

Looking at individual cases suggests the potential impact on demand growth is limited, however when looked at in aggregate, the potential impact does start to look more significant. Global oil demand growth is predominantly driven by non-OECD countries, 88% of global oil demand growth in 2019 is expected to come from non-OECD countries, and so the potential impact from an emerging market crisis could be fairly significant for oil demand growth expectations. It is also worth pointing out that a little over 50% of this non-OECD demand growth comes from just China and India. Our current balance is assuming that the global oil market will be largely balanced over 4Q, and so any slowdown in demand will only push the market deeper into surplus. The big assumption around this though, is that supply losses from Iran do not exceed 500Mbbbls/d in 4Q18 as a result of US sanctions, and that Venezuelan output averages 1.2MMbbbls/d over the last quarter.

OECD and non-OECD oil demand growth (MMbbbls/d)



Source: IEA, ING Research

Brazil is already seeing demand destruction

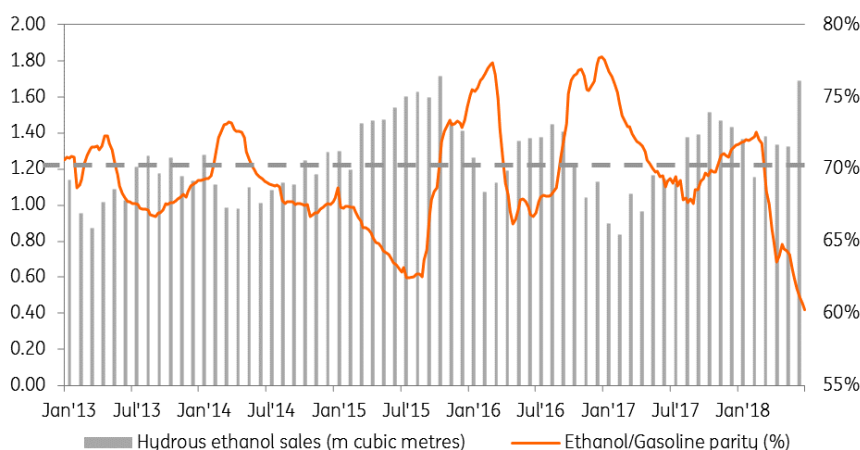
It is interesting to have a look at the impact higher oil prices are having on gasoline demand in Brazil. The reason being that the bulk of motorists have an alternative fuel option. More than 50% of the light vehicle fleet in Brazil is made up of flex fuel vehicles- those that can be run on gasoline or 100% ethanol. Motorists generally act in a rational manner, and should start switching to ethanol when it becomes cheaper than gasoline. The rule of thumb is that energy parity between gasoline and ethanol is 70%, and so when ethanol prices are less than 70% of gasoline prices we should start seeing the switch over.

The average parity across the country stands at 60%, and so there is every incentive for motorists to switch over, and this is exactly what we are seeing. Monthly gasoline sales in the country have

generally trended lower since the start of 2017, whilst over the same period ethanol sales have trended higher. YTD gasoline sales in Brazil through until the end of June have averaged 684Mbbbls/d, down around 93Mbbbls/d from the same period in the previous year, whilst ethanol sales averaged 275Mbbbls/d, up 75Mbbbls/d from the same period last year. This alternative option for motorists in Brazil has meant that we are actually seeing oil demand destruction in the country.

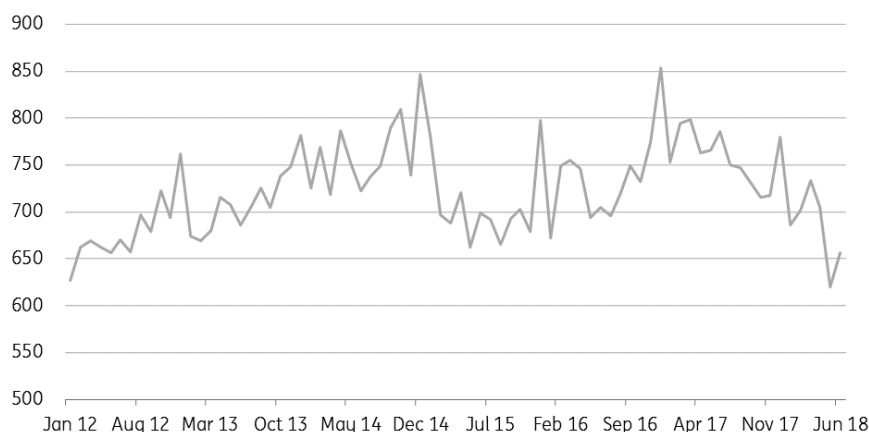
The feedstock for ethanol in Brazil is sugarcane, and given the significant global sugar surplus this season, and the expectation for another large surplus next season, sugar prices are likely to remain under pressure, pushing mills to maximise ethanol output.

Brazil domestic ethanol sales pick up



Source: ANP, ING Research

Brazil gasoline sales (Mbbbls/d)



Source: ANP, ING Research

Author

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

Indonesia: Central bank raises rates in quest to stabilise currency

Bank Indonesia (BI) surprised investors with a 25 basis point policy rate hike. BI has resumed tightening to stabilise the rupiah, which had fallen to its...



Source: istock

5.5%

Higher than expected

BI 7-day reverse repurchase rate

25bps hike today

BI seeks to stabilise IDR

The Indonesian rupiah (IDR) traded as weak as IDR14680 earlier this week from Friday's IDR14400. The weakness came amid a worsening in the current account deficit, which was announced last Friday to have widened to -\$8 billion or to -3% of GDP in 2Q from -\$5.5 billion or -2.2% of GDP in 1Q, and from -\$4.8 billion or -1.9% of GDP in 2Q 2017. The currency was also hit by expectations of a steady policy rate decision at today's meeting as well as the contagion effect of the slide in the Turkish Lira (TRY). Today's July trade deficit of \$2 billion, the highest in five years, indicated that the current account in 3Q could widen further as imports accelerated to satisfy strong domestic

demand.

All of this argued for BI's resumption of its tightening cycle and today's surprise 25 basis point rate hike after a pause in July. This brings BI's tightening to 125 basis points so far this year. We believe that BI could continue with its tightening cycle until some stability is achieved. Higher interest rates will eventually moderate domestic demand and imports. Import substitution efforts by the government such as using a higher palm oil-diesel blend and redirecting oil exports to the local market, and keeping the fiscal deficit at around -2% of GDP may help moderate growth and stabilise the IDR.

This combination of monetary tightening and government measures could eventually address a couple of the drivers of IDR weakness – the weak external payments condition and strong domestic demand. But these measures will take time to work through the economy, which brings the burden of short-term stabilisation onto the central bank.

India: No respite for the rupee

As if the global market turmoil isn't enough, domestic economic developments have been turning sour for the Indian rupee. This provides little hope...



Source: Shutterstock

The Indian rupee (INR) exchange rate per US dollar surged to a record high of 70 when the Turkish financial crisis hit emerging market currencies hard earlier this week. As if the external drags on the INR aren't enough, the domestic economic data -- a multi-year high trade deficit, elevated inflation, and signs of slowing GDP growth -- haven't been any friendlier.

With an apparently shallow central bank (RBI) tightening cycle ahead, the current INR depreciation trend looks to be a prolonged one. The next challenge will be a string of state elections in the remainder of this year and general elections in 2019, which should see investors starting to add a political risk premium into local financial assets. As such, we don't rule out an aggressive central bank (RBI) policy tightening at the October meeting. Yet we see no threat to our 71.5 forecast for the USD/INR by end-2018.

\$18bn Trade deficit in July

Five-year high

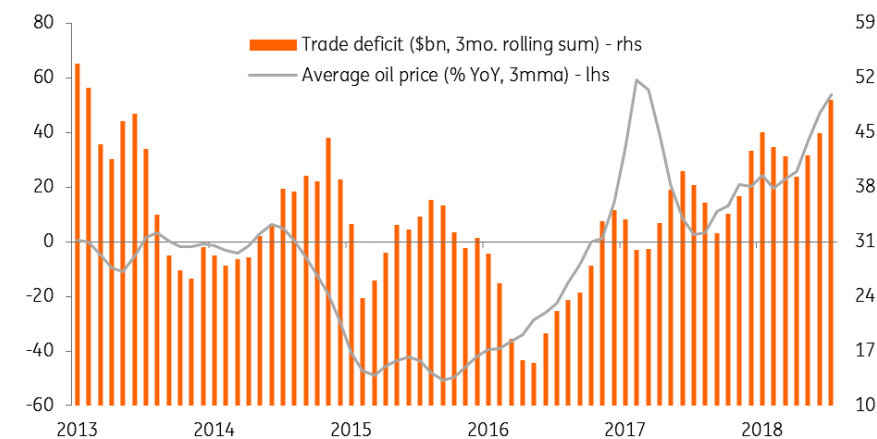
Trade deficit at five-year high in July

India's external trade deficit jumped to the highest level in five years, to \$18 billion in July from \$15.6 billion in the previous month. This was far above our forecast of a \$15.9 billion deficit, while the consensus was centred on an even lower figure of \$15.7 billion. The high trade deficit was due to import growth outweighing export growth for the second consecutive month. Imports grew by 29% year-on-year in July, beating our 26% forecast, while export growth of 14% YoY was in line with expectations.

Oil imports, with a 58% YoY surge in July, remained the main driver of total imports. Even as global oil prices stabilised around \$75/barrel in the three months through July, year-over-year oil price inflation remained on an upward trend, 52% YoY in July, causing the oil import bill to balloon. Therefore, oil has been mainly responsible for the higher trade deficit as is clear from the chart below.

The cumulative deficit in the first four months of FY2018-19 (starting April) was \$63 billion, up from \$51.5 billion a year ago. Nearly all of the widening over the year was due to oil trade. The trade balance drives the current account balance. We expect the current deficit to rise to 2.6% of GDP in the current financial year from 1.9% in the last year.

High oil price inflation is fuelling trade deficit



6.3% Core CPI inflation in July

A four-year high

Rising core inflation, slower GDP growth

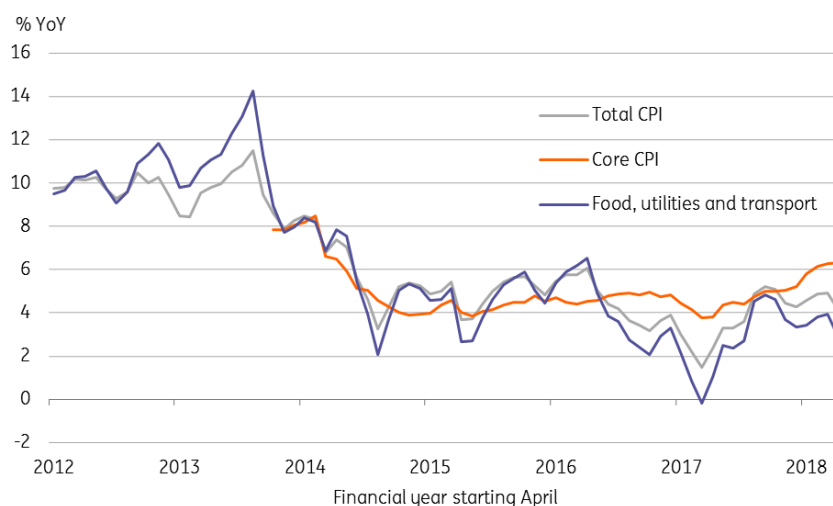
Consumer price inflation surprised on the downside in July, coming in at 4.2% YoY, while June's figure was revised down to 4.9% from 5.0%. But the headline overshadowed a steady increase in the core measure to a four-year high of 6.3%. While central bank (RBI) policymakers aren't letting their guard down against inflation, which will remain elevated due to several administrative factors apart from the high oil price, the ongoing currency weakness and higher trade tariffs will pressure inflation going forward.

And surprisingly strong industrial production data for June, with 7% YoY growth (although this is back-dated data), provides little solace. The average April-June IP growth is still slower at 5.2% from the 6.5% average in the previous three months. This foreshadows a slowdown in GDP growth in 1Q FY2018-19, not a good start to the year, the rest of which will remain exposed to greater global economic uncertainty and rising domestic political risk.

In the 2018 Article IV Consultation released last week, the IMF warned about sustained upward inflation requiring gradual monetary tightening. The Fund also warned about slower growth ahead resulting from adverse terms of trade and loss of real income to households and firms, while tighter monetary policy will hinder the recovery of credit growth and investments.

A month ago, we downgraded our GDP growth forecast for FY2018-19 from 7.2% to 6.7% ([see 'India: Downgrade of growth forecast'](#)). We now increase our inflation forecast for the year from 4.7% to 5.0%.

Rising core inflation



Source: Bloomberg, CEIC, ING

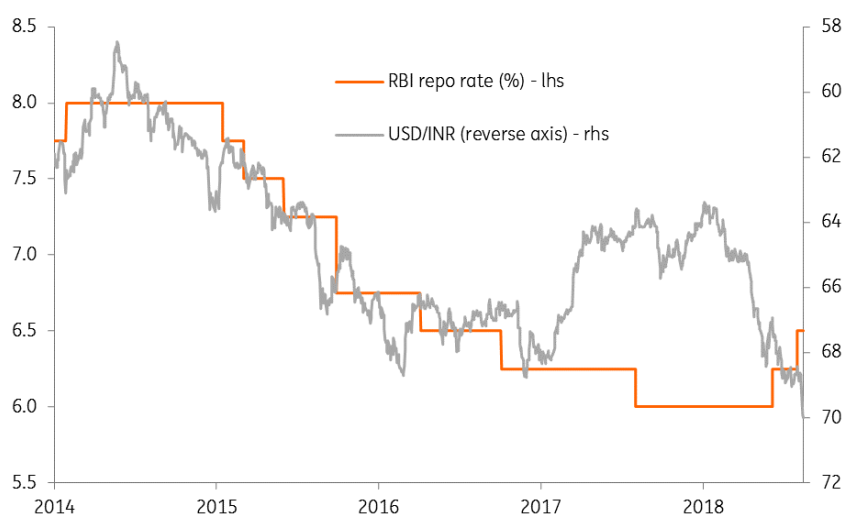
Authorities accommodating INR weakness

The INR's 8.6% year-to-date depreciation is the steepest among Asian currencies, of which 7% has occurred since April. A \$20 billion fall in foreign exchange reserves in the last four months to \$404 billion through July is a testament to the RBI's presence in the market to support the currency. This is still a sufficiently large stock of reserves, though the authorities concede that any intervention will not do much to stabilise the currency when it's due to global factors.

Even if the rupee falls to 80, it will not be a concern provided all other currencies depreciate. – Subhash Chandra Garg, secretary of India's Economic Affairs Department

And with local factors also kicking in now, it might take a more aggressive policy response to rein in INR weakness. Just as in other Asian countries (Indonesia and Philippines), a weak currency was the principal force behind two 25 basis point RBI policy rate hikes in June and August. Will the RBI follow central banks in Indonesia and the Philippines in pursuing aggressive policy tightening? Or, on the contrary, will the central bank take the currency weakness in stride as a factor required to curb imports and the trade deficit, even though this would also be inflationary. This poses a significant policy challenge for the RBI going forward.

Prepare for an entrenched RBI tightening cycle



Source: Bloomberg, ING

Likelihood of more aggressive RBI policy tightening

An apparently shallow RBI tightening cycle based on current domestic economic conditions could become entrenched in the event that global currency turbulence intensifies, which remains a risk if the US delivers on its planned \$200 billion worth of tariffs on China.

While we maintain our forecast of one more 25 basis point RBI policy rate hike at the next meeting on 3-5 October, we don't rule out the RBI doubling it up. Not only that, we now add to our policy forecast a further 50 basis points of rate hikes in 2019.

Will this stem the INR weakness? Besides external and domestic economic factors, politics will be an added overhang on the currency as a string of state elections in the remainder of the year culminates in general elections by mid-2019. With investors starting to add a political risk premium into local financial assets, any relief to the currency from higher interest rates will be transitory. This should keep the USD/INR rate on the path towards our 71.5 forecast for the end of 2018.

Economic Forecast Summary

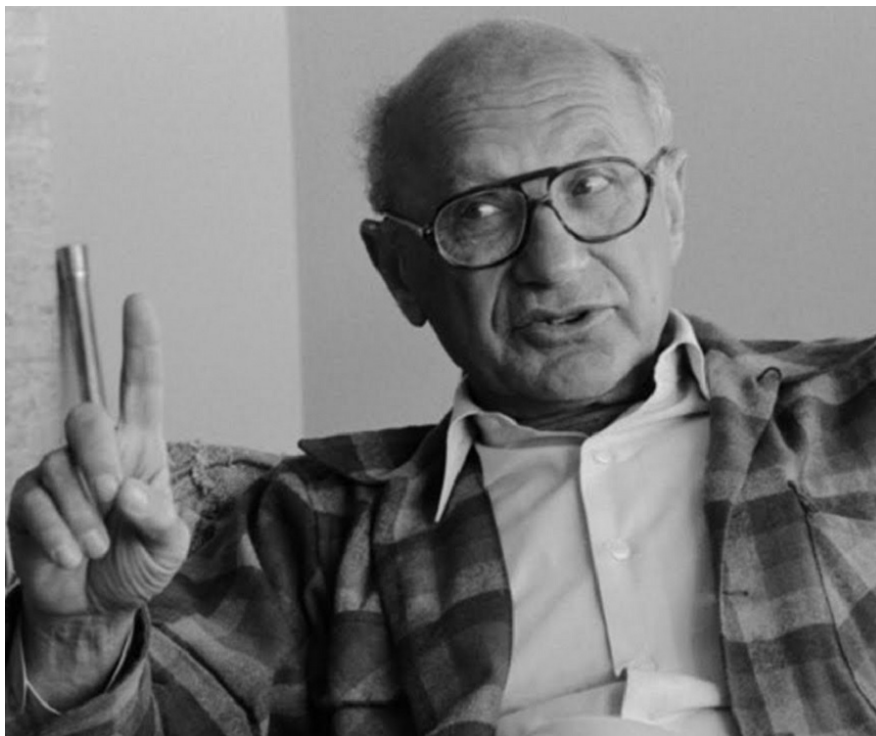
India (FY April-March)	2017	1Q18F	2Q18F	3Q18F	4Q18F	2018F	2019F
Real GDP (% YoY)	6.7	7.7	7.0	6.7	6.5	6.7	7.2
CPI (% YoY)	3.6	4.6	4.8	5.0	4.8	5.0	4.8
RBI repo rate (% eop)	6.00	6.00	6.25	6.50	6.75	6.75	7.25
3M T-bill rate (% eop)	6.15	6.09	6.46	6.80	7.05	7.05	7.50
10Y govt. bond yield (% eop)	7.23	7.40	7.90	8.10	8.30	8.30	8.60
INR per USD (eop)	63.87	65.18	68.47	70.10	71.50	71.50	69.80

Note: Annual growth and inflation forecast on financial year basis, rest on calendar year basis.

Source: Bloomberg, CEIC, ING

So you think you're an economic hotshot?

Think you're better at predicting successful investment outcomes than your peers? You might indeed be a whizz, or you might have fallen prey to the...



Source: Wikipedia

The renowned economist and Nobel Prize Winner, Milton Friedman

Will gold go up, when will the dollar fall? If you're an investor, you could well be making decisions you think will make you richer. But what are you basing your actions on? Are you a highly experienced trader? Do you have the insight of such economic luminaries as Milton Friedman (pictured) or Paul Krugman? Or, do you feel you've just got that extra bit of knowledge and skill that sets you apart from your peers? While the idea that we naturally tend to favour our own personal abilities won't be news to many, that feeling could just be an illusion.

Ample confidence

[Research](#) has shown that people of lower abilities, indicated by scoring in the bottom quartile on tests of humour, grammar and logic, are more likely to feel they're highly competent at a task. This is called the Dunning-Kruger effect after the two psychologists who carried out the studies. The effect happens, say these doctors of psychology, because without a higher level of skill or

knowledge, people can't accurately assess their own level of ignorance or even realise they don't have all the skills they think they do. As David Dunning puts it himself in the [Pacific Standard](#): *'In many cases, incompetence does not leave people disoriented, perplexed, or cautious....Instead, the incompetent are often blessed with an inappropriate confidence, buoyed by something that feels to them like knowledge.'* And he goes on to suggest that this is particularly true of people managing their finances.

Is ignorance bliss?

Much work has been done on this, not least the 2012 US National Financial Capability study which asked around 25,000 people to rate their own financial knowledge. Interestingly 800 of these respondents had filed for bankruptcy and their actual financial literacy was tested. They didn't do well on the latter, coming in the 37th percentile, on average. But despite this, they rated their overall financial knowledge more positively than others. As Dunning says in his article for the [Pacific Standard](#): *"An ignorant mind is precisely not a spotless, empty vessel, but one that's filled with the clutter of irrelevant or misleading life experiences, theories, facts, intuitions, strategies, algorithms, heuristics, metaphors, and hunches that regrettably have the look and feel of useful and accurate knowledge."*

Similarly, [2015's](#) National Financial Capability study asked people how good they were at day-to-day financial matters, 42% gave themselves a perfect score – yet 29% of these respondents engaged in costly credit card behaviours, such as paying late fees, and 12% had a current account that was overdrawn.

This was also seen in people who were provided with 15 financial terms, while some of which were completely made up. Dunning and his colleagues discovered that those who believed they understood money matters also claimed to be aware of some of those fictitious phrases, such as 'pre-rated stocks', 'fixed-rate deduction' and 'annualised credit'. In fact, some 93% of participants claimed they knew at least one of those fake concepts. It doesn't mean they're liars, says Dunning, suggesting such 'over-claiming' is an honestly held belief.

Expert touch

Of course, actually being an expert doesn't automatically translate into great returns. In addition to the Dunning-Kruger effect, similar tendencies are seen in areas of finance that haven't been predominantly only found in those of lower social or intellectual skill. [An interesting study](#) shows how gut feelings can prove to be more useful than expertise despite our expectations or assumptions. In this study, both stock market professionals and laypeople were asked to provide thirty-day forecasts for twenty stocks. All predicted that laypeople would be correct in their predictions half as many times as experts.

The results were interesting though. Possibly unsurprisingly laypeople provided correct predictions 50% of the time or were, by chance, right half the time and wrong the other half. Experts however were only right 40% of the time. As the German psychologist, [Gerd Gigerenzer](#), explains in his book, experts based their predictions on complex information and faced heavy competition amongst themselves causing them to select stock picks that varied widely. Not everyone could be right so, by chance, more of them were wrong. Laypeople relied more on gut instinct which paid off in this case.

Making sense

These tendencies or expectations aren't failures. In many cases, they can explain why sometimes unexpected or non-rational actions can make a lot of sense. It's logical to back ourselves or to expect more from experts. But the Dunning-Kruger effect also has some pretty blunt truths for many, the upshot being that knowing a little could be worse than knowing nothing at all.

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.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.