

What's happening in Asia ?

The US-China trade tensions have had a significant impact on Asian countries. But fiscal stimulus in China is helping, Taiwan is hoping that 5G equipment production comes to its rescue soon. Singapore's small and open economy is still hurting from the global tech slump while Japan continues to suffer from the perennial problem of low inflation

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Report | 1 April 2019

Asia in 2019: Macro and markets

In this report, we take a look at some of the underlying regional trends in Asia and if a global recession is really set to hit the region. We also have a bash at comparing different growth rates and finding the perennial underperformers alongside delving into the weird relationship this place has with oil



Source: Shutterstock

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China's stimulus is working but debt and external political pressure is growing

China's ongoing trade war with the US will hurt the jobs market and spending power. While this is being countered by stimulus measures, debt levels will increase. China's tourists have helped lower the current account to almost zero, but that might all change in 2019. China is likely to face more external political pressure as it continues to grow



Source: Shutterstock

Asian young woman in old traditional Chinese dresses in the Temple of Heaven in Beijing, China.

With stimulus in place, Chinese growth is likely to be above 6%

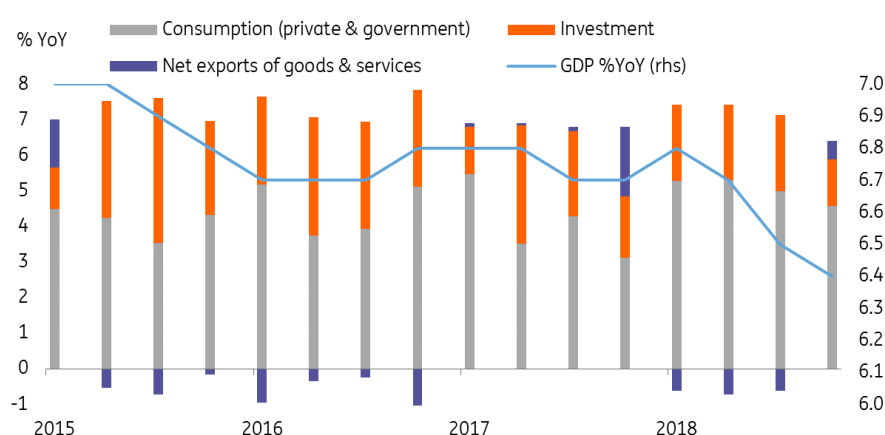
With a sizeable stimulus and monetary easing in place, we expect the Chinese economy to grow above the 6% lower boundary target set by the government.

The 'two sessions' meetings held in early March set a fiscal stimulus package of CNY 4 trillion, of which around half was tax and fee cuts. The other half is coming via local government infrastructure projects, including new metro lines and toll roads. Aside from the stimulus, some local governments have quietly relaxed housing regulations too.

With a sizeable stimulus and monetary easing in place, we expect the Chinese economy to grow above the 6% lower boundary target set by the government

On the monetary side, the central bank has adopted a targeted approach. This directs extra liquidity flows mainly to small private firms, which have been the hardest hit by the ongoing US-China trade war. On top of targeted liquidity for private firms, we expect four required reserve ratio (RRR) cuts in total. We've revised down each cut to 0.5 percentage points from one percentage point after the central bank governor said there is limited room for cuts in 2019.

Quarterly GDP growth



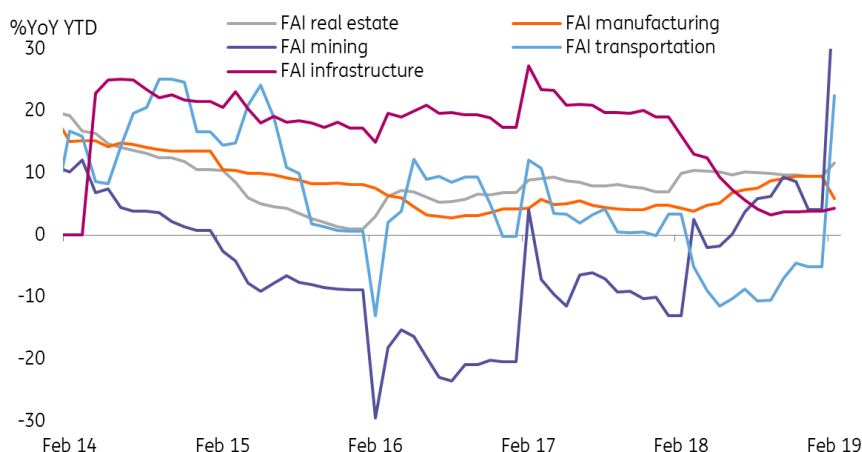
Source: ING, CEIC

PPI is more likely to inflate but CPI will be modest given low wage growth

As government spending continues on new metro lines and toll roads, we expect construction material prices to go up for most of 2019. This will not only prevent producer prices (PPI) from heading towards deflation but also give industrial profits a boost in some sectors.

We believe wage growth will be low in 2019, reflecting the challenges faced by export-related manufacturers and the subdued demand for electronics due to the trade war. This will limit consumer price inflation, but we don't expect CPI to fall into negative territory, as the consumer price basket has a large necessity component.

Stimulus aimed at transportation and mining



Source: ING, Bloomberg

Debt is growing, but it all depends on the progress of trade talks

As stimulus increases, so does debt in various parts of the economy.

Tax and fee cutting directly increase the central government's fiscal deficit, targeted at 2.8% of GDP. In China, the actual deficit is usually one percentage point above the planned deficit.

Infrastructure investment is mostly funded by the issuance of local government special bonds. These bonds are categorised as corporate bonds because the local government has no guarantee on the bonds. We also think local governments are unlikely to take any responsibility if there are defaults on these bonds until the number increases to a level that catches market attention.

The duration of the trade war is a critical factor in evaluating how fast debt levels will grow, as the current debt issuance supports infrastructure investment to stimulate a weakening economy

If there was an outbreak of large-scale onshore bond defaults, the potential remedy would be placing these credits into 'debt-to-equity-swap' schemes, which can isolate bad credits from the good ones, and these bad credits would eventually be disposed of by asset management companies.

This is what happened in 2016 when smaller state-owned enterprises defaulted during the overcapacity cutting reforms. After the clean up of overcapacity companies, the overall debt level of the country fell from a peak of 262% of GDP in February 2017, to 250% in March 2018. But now, debt levels have increased again to 253% of GDP due to the issuance of local government special bonds to tackle the impact of the trade war.

The duration of the trade war is a critical factor in evaluating how fast debt levels will grow, as the current debt issuance supports infrastructure investment to stimulate a weakening economy.

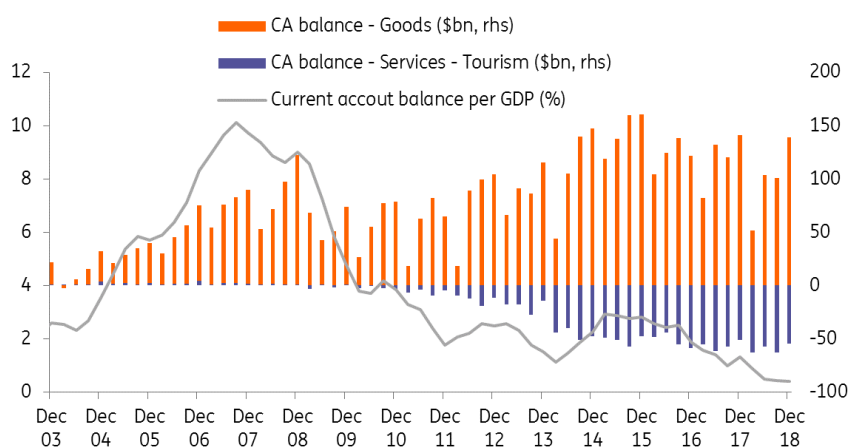
Current account near balance thanks to outbound tourism

The chart below shows that an increase in outbound tourism has been the main factor behind the narrowing current account surplus, which as a percentage of GDP is now close to zero.

As wage growth slows in 2019, there will be fewer Chinese tourists going abroad, so tourism may not be as big a negative factor in China's current account in 2019.

But, if a trade deal between China and the US is sealed this year, then China will import more US products. It's still unclear if China will cut imports from the rest of the world to maintain an overall trade surplus or will allow the balance to move into deficit.

Goods contribute positively to China's current account while services do the opposite



Source: ING, Bloomberg

Massive capital outflows are not really a concern

We have to remember China's capital account isn't completely open, which is why we don't believe there is a high chance of massive capital outflows, because even if there's a demand for fund outflows, there aren't many channels to do this.

On the other hand, we expect the cross border regulator (SAFE) to slowly open up the capital account, only for the easy part of the opening up process. For example, [SAFE has slightly relaxed the regulations of cross border cash pooling](#) to provide convenience for usual transactions made by multinational companies.

In the extreme case of market panic, we believe the central bank is likely to impose a strict policy on outflows.

Central bank is practicing a semi-free floating yuan by following the dollar

Given that we expect the current account to be almost balanced in 2019, and the capital account still isn't fully open, we believe the yuan exchange rate will be what the central bank claims will be "more flexible" according to market movements. This isn't really a new thing, as the USD/CNY

exchange rate has been broadly following the dollar index since mid-2016.

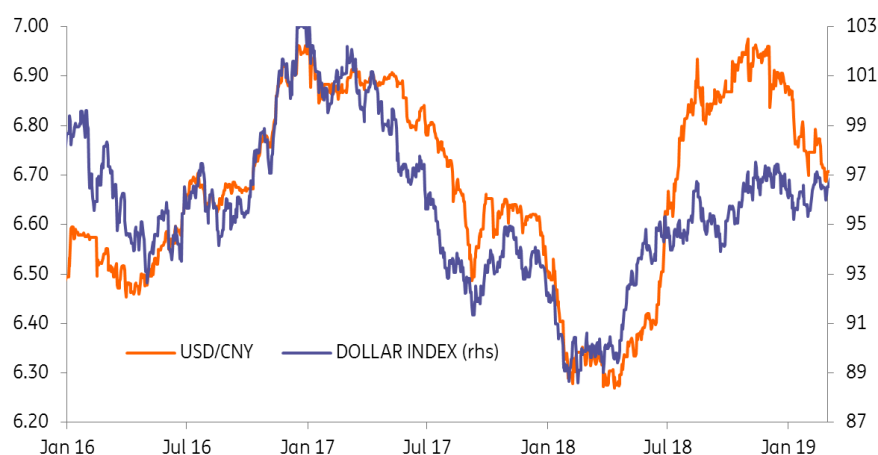
Another step in the preparation of a free-floating currency is to make the daily USD/CNY fixing mechanism more transparent, but this change is unlikely to take place in 2019

To pave the way for a truly free-floating currency, the central bank needs to reform interest rates. [Yi Gang commented that there would be interest rate liberalisation](#). For example, taking China sovereign yields as the risk-free interest rate to facilitate a market-based pricing mechanism for financial products.

Another step in the preparation of a free-floating currency is to make the daily USD/CNY fixing mechanism more transparent, but this change is unlikely to take place in 2019, given it's full of uncertainties, and the central bank won't want more risks in the market.

In case there's a quick turn towards negative market sentiment, we expect the central bank to impose a higher reserve ratio on short yuan positions. The last increase was in 2018 from 0% to 20%.

USD/CNY exchange rate has largely followed the dollar index since 2016



Source: ING, Bloomberg

External political challenges

Aside from the trade war initiated by the US, external pressure from other countries is also growing. China faces an increasingly tough external political climate as it grows in terms of economic ability, international influence, and its technology development ability.

China is trying to build a new set of institutional platforms more suitable for its growth. For example, the Belt and Road Initiatives which are paired with the Asian Infrastructure Investment Bank (AIIB); and the Boao forum, which is seen as the Asian Davos.

These Chinese platforms have caused some international unrest. Will the increasing influence of China weaken the power of existing players in the world? Though simultaneously, the rest of the world wants to tap into the Chinese consumer market because of its sheer population size and the growing middle-class.

These contrasting viewpoints will complicate how countries, especially in the developed world, interact with China.

Headwinds are tackled by stimulus measures

Overall, we believe that despite the trade tension, China can grow by 6.3%.

There will still be lingering uncertainties from the trade negotiation even if there is a deal. But the scale of fiscal stimulus and the central bank's flexible liquidity management should provide enough support for the economy to face the headwinds.

Overall, we believe that despite the trade tension, China can grow by 6.3%

The USD/CNY exchange rate will follow the dollar index. As the Federal Reserve probably isn't hiking in 2019, we may see the yuan appreciate more this year, instead of depreciating.

As such, our forecasts of USD/CNY and USD/CNH at 6.75 by the end of 2019 from 6.88 at the end of 2018 remain intact.

China	2017	2018	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (% YoY)	6.9	6.6	6.2	6.2	6.3	6.3	6.3	6.2
CPI (% YoY)	1.6	2.1	2.0	2.3	2.5	2.5	2.3	2.5
PBOC 7D reverse repo rate (% eop)	2.50	2.55	2.55	2.55	2.55	2.55	2.55	2.55
10Y govt. bond yield (% eop)	3.90	3.30	3.10	3.00	2.90	2.80	2.80	2.80
CNY per USD (eop)	6.507	6.879	6.740	6.850	6.850	6.750	6.750	6.700

Source: ING, Bloomberg

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Japan's central bank: Best intentions, poor outcomes

To add to a long list of things considered cornerstones of Economics, which I suspect are well-meaning but misguided, let me propose central bank policies, as rates approach or pass zero. This is of particular note for the Bank of Japan, but the ECB might also want to pay attention



Source: Shutterstock

An elderly couple celebrating a cherry-blossom viewing

Growing debate in Japan about the central bank's policy

Pensioners committing acts of petty crime to get locked-up and receive food and shelter is a trend that is on the rise in Japan. Who's to blame? Could you perhaps point a finger at the Bank of Japan (BoJ)?

While that claim may sound outrageous, it might not be so crazy after all. But in giving it the benefit of the doubt, it requires you to accept that much of what you may ever have been taught or learned about economics was either wrong or at best, only partly right. That shouldn't be too hard a concept to swallow surely? [A recent article by Jim O'Neill](#) - he of BRIC fame - suggests the same, though without any detailed consideration ([at least that's my view](#)). We try to go one better here.

So how does all this relate to the Bank of Japan?

[Read the full article by Jim O'Neill here](#)

Negative rates may be doing more harm than good

It isn't such a big stretch to make the claim that the Bank of Japan's extended relationship over the years with unorthodox monetary policy, qualitative and quantitative easing, zero and negative interest rates and negative bond yield targeting, has failed to achieve what was intended - a consistent increase in price level inflation, and faster nominal GDP growth. At present, the central bank has an inflation target of two percent. Right now, they aren't even close, and few believe it'll ever be achieved.

The subject I will focus on is the non-linearity of the investment-savings decision as rates approach zero or turn negative. Believe me, it isn't as dull as it sounds

So why has it been such a big failure? There are many factors I could list here, but in this note, I will deal with only one of them. The subject that I will focus on here specifically, though acknowledging that there may well be many others, is the non-linearity of the investment-savings decision as rates approach zero or turn negative. Believe me, it isn't as dull as it sounds.

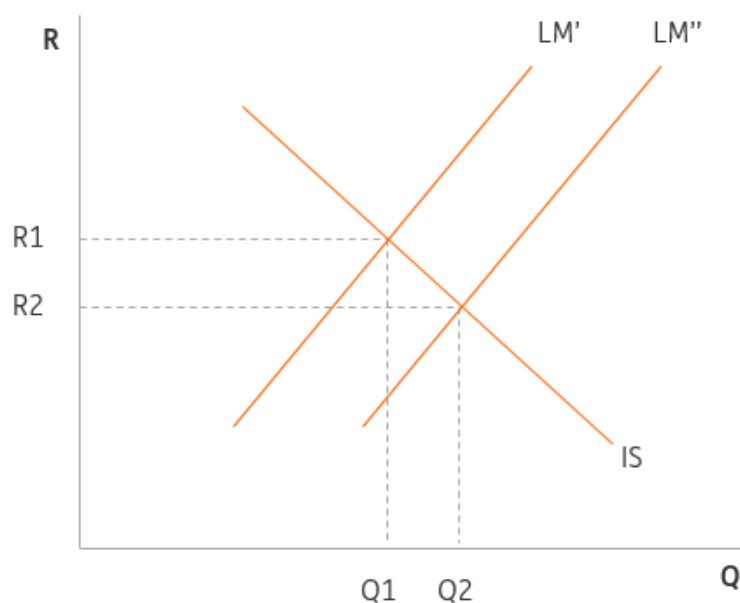
Most text-book economics is a big simplification

When you first get taught Economics, you will come across various versions of what is known as 'IS-LM' analysis. This combines the LM curve, which shows the relationship between the money supply for different interest rates and economic output, and the IS curve, which shows the substitution that occurs between investment and saving at different interest rates.

The basic notion is that at lower interest rates, people substitute investment (by which we mean any spending, which can include business investment) and saving (any part of your income that you don't save). This is called the IS curve, and in almost all textbooks, it is simplified - as is the LM curve - as a straight line. So as rates are lowered or the money supply increases (LM shifts right from LM' to LM'' as you can see in the chart below and output rises from Q1 to Q2.

This essentially is a boiled-down version of the thinking behind all central bank monetary policy - lowering rates or supplying more money with quantitative easing shifts out the LM curve, and (even if only for a short time before inflation or an appreciating currency erodes its influence) results in stronger growth and in the process, higher inflation.

Traditional IS-LM curve analysis



The problem is it doesn't work

The theory and the practice of this type of thinking worked reasonably well through most of the central bank era of inflation targeting, though it's worth reminding ourselves, that this era wasn't really that long, and that for much of the prevailing time, inflation was considerably higher than is typically the case these days.

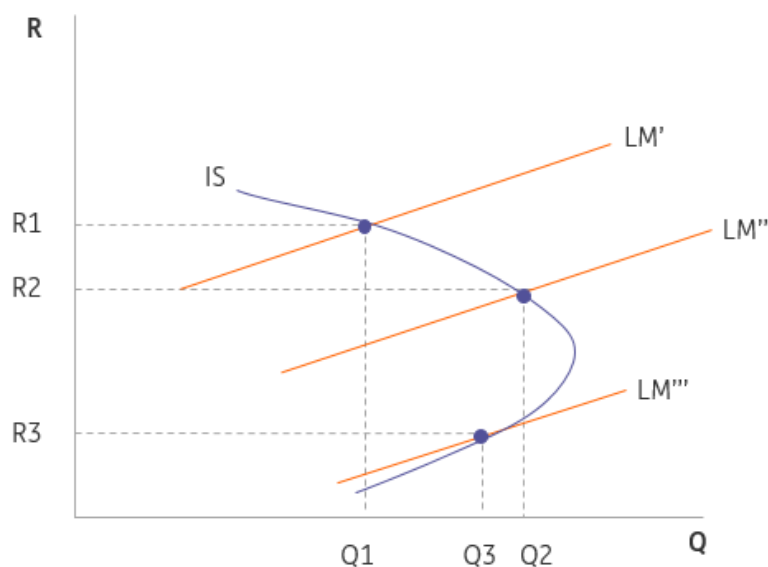
I don't think it's my imagination, but the power of low rates to boost economic activity seems to have diminished

During the successive cyclical upswings and downswings, market bubbles and bursts, central bank interest rates have peaked and troughed at lower and lower levels, as have market bond yields.

I don't think it's my imagination, but the power of low rates to boost economic activity seems to have diminished. Now central banks talk about raising rates to have room to cut them, suggesting the level of rates are no longer the determining factor of output, even in the short term. Instead, only the rate of change seems to be important and even then, not very much.

One explanation for this could be that as rates approach zero, the IS curve becomes non-linear. Indeed, for what I am about to describe, the IS curve becomes 're-curved'. (For the mathematicians reading this, please let me know the proper term for the shape of the curve illustrated below, as a quick search on Wikipedia didn't throw up convincing answers).

IS curve at low or negative rates



The power of the market...

Geometry, like that shown above, can be fiddly. So how about a real-world explanation to describe why we may have a curve this shape and what the implications of this may be.

Consider people from my parent's generation, born in the 1930s. They worked and earned in a world where there was inflation, from the 1950s through 1990s, with positive and significant interest rates. Borrowing was costly, and servicing that debt ate up a lot of disposable income. Cutting rates really did free up a lot of spending power. A bit of inflation also helped deflate away the outstanding pile of debt, so real interest rates were the important measure for how tight monetary policy was.

Consider people from my parent's generation. Higher rates meant they were encouraged to save more to benefit from greater returns. But in the process, they would spend a little less - and this is how monetary policy worked

My parents could save, with even low-risk savings like bank deposits getting a non-trivial interest rate. And, thanks to the power of compounding, this helped grow their savings. Market returns were also higher, though of course, inflation was also a scourge on savers.

At the point of retirement, or of realising the value of a savings project for other purposes, not only would the pot of savings be considerably more than the sum of savings, thanks to non-trivial interest rates, but in the case of a pension, it could be harnessed to pay an income that might even be high enough to fend off starvation. Higher rates meant my parents would be encouraged to save more to benefit from these greater returns. But in the process, they would spend a little less,

and vice versa. This is how monetary policy worked - and, for the most part, it did work.

...not really powerful any longer

Now take today's savers. A peak-earning person of middle-age looking towards a retirement date in the next ten years or so will look at the miserable rate of return on their savings, with bond yields and interest rates close to zero. In Japan's case, this is absolutely true or even generous as rates and bond yields can even be negative. In Europe's case, it is close to the truth, though bond yields still remain positive, they are in many cases very low. For these savers, a lifetime of saving may generate a savings pot of not much more than the sum of their savings.

Sure, inflation is low, but debt levels rose as rates successively fell, and borrowers now get no relief from higher inflation. Indeed, as rates have been cut towards zero, savings haven't always been reduced and substituted for spending. Instead, today's 50 - something will likely save even harder (resulting in Q3 in the chart above, where $Q3 < Q2$).

The market is providing these savers with no boost in terms of compounded growth rates towards their pension goals and the projected income stream from the savings pot at retirement age will also be effectively zero, requiring the pot itself to be spent to support retirement income. The 50-something today may have to save many times as much as the same demographic 30 years earlier, and faces a poorer income in retirement. No wonder they save even harder as rates fall.

What does this all mean?

What this tells you is what most pensioners in Japan would likely tell you, namely, that running ultra low, even negative policy rates and bond yields is in net terms, doing more harm than good, even if there are some beneficiaries in the corporate world - but don't even get me started on zombie companies and productivity.

Keeping rates low to maintain a weak currency may also hurt these individuals. Pensioners spend disproportionately more of their incomes on food than working families - much of which is imported. So their savings incomes are squeezed, and then their cost of living rises as the yen depreciates. Double whammy - which is why a spot of shoplifting, even if apprehended, can seem a [reasonable trade-off to an increasing number on the edge](#) of poverty in old age in Japan.

What this tells you is that running ultra low, even negative policy rates and bond yields is in net terms, doing more harm than good

Were the Bank of Japan (or dare I suggest the ECB) to actually abandon its current, and arguably failed policy efforts, it may find, higher rates aren't met with collapsing consumer spending, but the exact opposite. Yes, I dare say the yen would appreciate a bit and the headline CPI inflation rate would fall even further. But Japan seems to be managing quite well with an inflation rate of practically zero, and I don't believe households would start to panic if their incomes actually stretched further in real terms, even if that did mean a negative growth rate for the headline CPI index.

Why now?

Although this is the precisely the sort of unorthodox thinking that would get me kicked out of the monetary policy setting committee of most central banks, a recent quote from Japan's finance minister, Taro Aso suggests that some members of prime minister Shinzo Abe's government are also having a re-think about Bank of Japan's targets. "*For the general public, there isn't a single person out there saying it's outrageous that we haven't reached 2 percent inflation*". He recently added: "*You have to think about the possibility that things will go wrong if you focus too much on 2 percent*".

It looks as if the Japanese government is coming round to my way of thinking on the non-linearity of the IS curve as rates approach or pass zero, but the central bank might take a little longer. This sort of unconventional thinking is anathema to most central bankers and may take a little time to percolate. They would rather apply unorthodox policy remedies based on orthodox thinking, even if they don't seem to be working.

But in bravely taking the lead on this, Japan's central bank could provide a very useful lead to other central banks around the world who are clinging on to zero or negative interest rate policies, without much sign of any benefit. You know who I'm talking about...

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Australia: Mixed present, decent future

Australia suffers more from a surfeit of unfulfilled optimism than any genuine issues. Sure, there are some areas of economic softness, and some longer-term structural features that will bear watching over the medium term. But the economy remains one of the most robust in the developed world



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Singapore: Safe port in a storm

The trade war and global tech slump are weighing on Singapore's economy, and 2019 will not be a year to remember. But this economy is well poised to bounce back and benefit from any positive trade news and the next wave of tech demand, which could be exceptional



Source: Shutterstock

Singapore's longer term strengths are near term weaknesses

Singapore is a well-run, prosperous economy with ambitions as a tech hub to supplement its other industrial strengths. These are sensible aims, although admittedly difficult to legislate for. But primarily, Singapore is a small and extremely open economy in the middle of a region which is being hit not only by the trade war, and associated spillovers, but also from a global slump in technology demand. Longer term, we have no worries about Singapore's future. Near term, things could require some policy support.

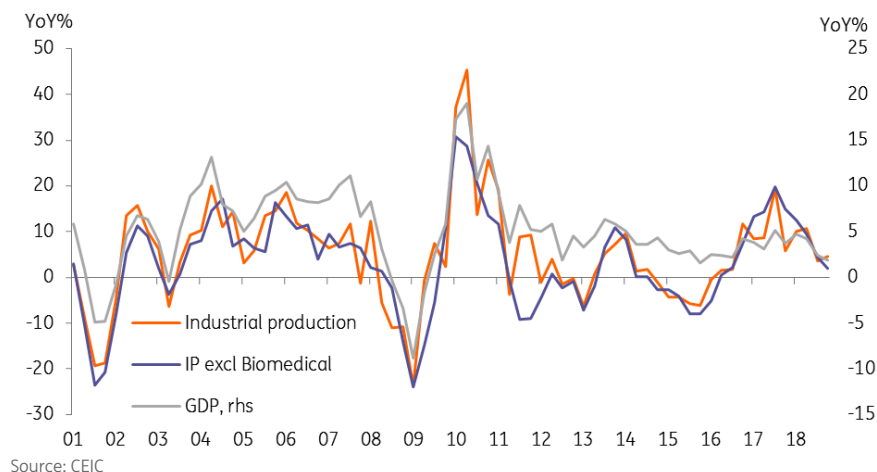
Macroeconomy, the near term view

For a small open economy like Singapore, the external environment is a very important factor in the variance of its economic activity around the trend rate.

The near term outlook for Singapore is marred by disappointing trade flows and weak tech demand

Export growth has slumped in recent months, and production has been dragged down as a result. Fortunately, the services side of the economy has held up better than its historical 0.9% correlation with manufacturing would suggest, and overall GDP has been buffered a little as a result.

GDP and Industrial production

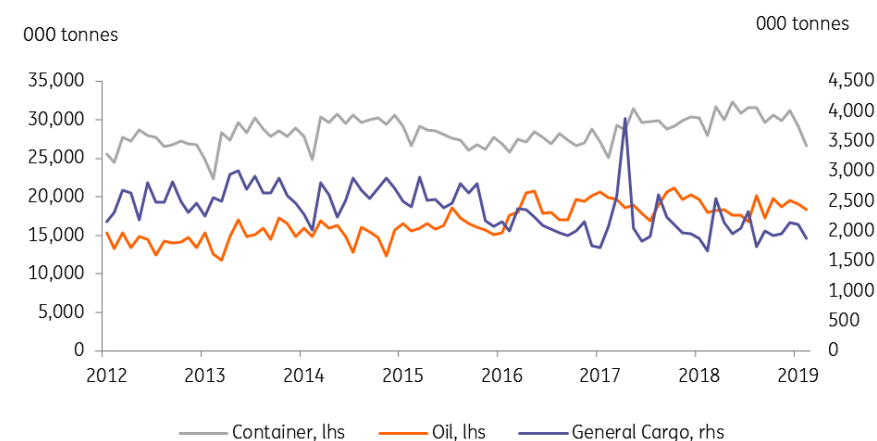


External sector hit by the trade war and the tech slump

Right now, there are two very important considerations for Singapore's export and production strength, both of them negative. These include the trade war and the tech slump.

The trade war is between the US and China, but with Singapore the second busiest port in the world after Shanghai, it would be naive to imagine that this was having no impact on one of the island's main sources of income – namely the direct income from its trade activities.

Trade throughput at Singapore's port



Trade has dipped, though this is probably partly seasonal

Neither of the two big contributors to total throughput at Singapore's port, containers or oil, are looking at all positive, though the recent sharp dip in container traffic is most likely to be seasonal,

and some bounce is likely. Even so, trade flows look flat at best, and maybe slightly down.

Singapore is the second busiest port in the world after Shanghai, and so it would be naive to imagine the trade war was having no impact on one of the island's main sources of income – namely the direct income from its trade activities

Suggestions that Singapore may be benefiting from substitution away from China look very hard to substantiate from this data. Though in time, that can't be ruled out.

Transportation and storage GDP figures reflect the scale of Singapore's port logistics activities. At about SGD 8 billion in 4Q18, this makes it about 6.5% of all GDP and about 10% of all service sector GDP. A sharp downturn could cause problems. The good news is, we don't see a sharp downturn. Not yet anyhow.

Singapore GDP by industry

(nominal seasonally adjusted) SGD million

	1Q18	2Q18	3Q18	4Q18
GDP	119,763.7	121,583.7	122,822.5	122,790.8
Goods producing	28,818.8	29,816.2	30,738.2	30,977.5
Manufacturing	23,284.6	24,340.9	25,274.8	25,420.6
Construction	4,110.9	4,021.8	4,031.1	4,114.4
Utilities	1,395.4	1,425.2	1,403.2	1,413.3
Other goods	27.9	28.3	29.1	29.2
Services	80,132.5	80,611.6	81,674.3	81,837.2
Wholesale & Retail	20,599.2	20,905.0	20,985.9	20,453.3
Transportation / storage	7,801.7	7,705.4	8,210.9	8,070.6
Accommodation	2,367.6	2,432.7	2,469.9	2,488.0
Information & Comms	4,597.2	4,743.5	4,782.9	4,918.9
Finance & Insurance	14,784.9	14,741.1	14,764.8	15,077.1
Business services	16,948.8	17,047.1	17,228.8	17,382.0
Other Services	13,033.1	13,036.8	13,231.1	13,447.3
Ownership of dwellings	4,002.9	4,043.3	4,042.8	3,991.1
Gross value added	112,954.2	114,471.1	116,455.3	116,805.8
Taxes on production	6,810	7,113	6,367	5,985

Source: CEIC

The tech slump is more worrying

In terms of the tech slump, the news is less upbeat, though we'll argue that if you were going to have problems with your economy, this is exactly the type of problem you would want to have.

Trade is more than just net exports for Singapore

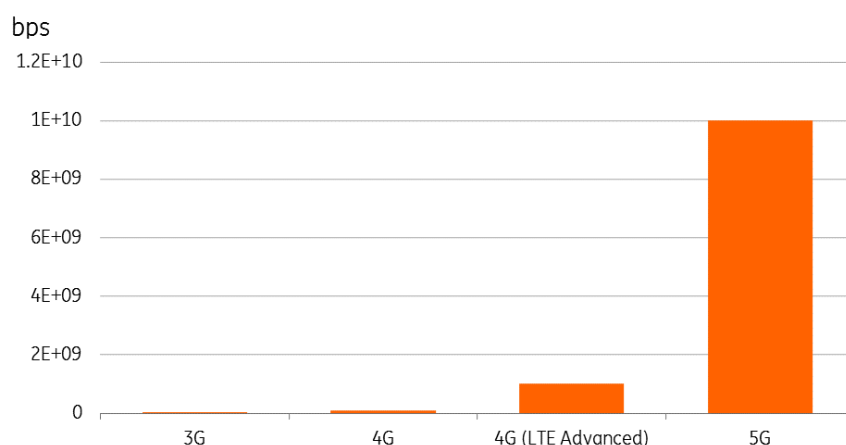
The 'tech slump' has its roots in an unfortunate coincidence in tech manufacturing supply growth, and a global dip in demand for the products (handphones) and their components (semiconductors), and a failure of the more optimistic projections of the tech industry to materialise - think cryptocurrency mining or the internet of things (IOT). Not only is the volume of demand for these goods and their components falling, but so too are their prices. Not so great news indeed for profits.

However, these goods tend to be very capital intensive, which by definition means that too many jobs aren't associated with them, which keeps the unemployment rate from soaring. Singapore's seasonally adjusted unemployment rate is an enviable 2.2%, though this figure may mask some underemployment. But technology/electronics is still an important export earning sector, and so their dismal showing in recent export figures is still an issue.

The 'tech slump' has its roots in an unfortunate coincidence in tech manufacturing supply growth, and a global dip in demand

The 'tech slump' is also a very cyclical problem. And we can already see the signs of deliverance from the weak spell in the roll-out of 5-G. If industry estimates of the quantum leap between 4G and 5G download speeds are correct, then this is going to make the current generation of electronics obsolete very quickly - at least, as soon as content for them catches up. At which point, demand for these goods and their components is going to fly (with the caveat that the associated price jump isn't mismanaged). For Asia, and for Singapore, this is going to be very, very positive. But we have some uncomfortable quarters to weather first.

4G vs 5G download speeds



Source: ING, Various

Exports - falling - some more than others

For now, the current export situation is fairly miserable. Though as well as the 'tech slump' weighing on electronics, there has been an outsize influence from the hugely volatile pharmaceutical industry. As this has moved from very strong to weak and then back to growth again, it has amplified cyclical movements in Singapore's other major export groups.

The hugely volatile pharmaceutical industry has amplified cyclical movements in Singapore's other major export groups

Pharmaceuticals (pharma) volatility simply goes with the territory and makes accurate forecasting of the export performance of the whole industrial complex a highly uncertain business. Activity in the pharmaceutical space need not necessarily result in pills being spat off a production line and exported.

Capacity in Singapore is brought on and offline as global demand fluctuates or as space is needed to be freed up for new runs of products or inventory building. The best guess for this sector from both a production and export perspective is for steady growth, though that view probably only reflects the net annual result and not the actual path this industry will follow.

Exports of petrochemicals can exhibit some of the same volatile characteristics, as batch processes are prone to breakdowns and blockages and require the occasional stoppage. Otherwise, these tend to be run at full capacity and growth requires capacity increases that tend to be lumpy.

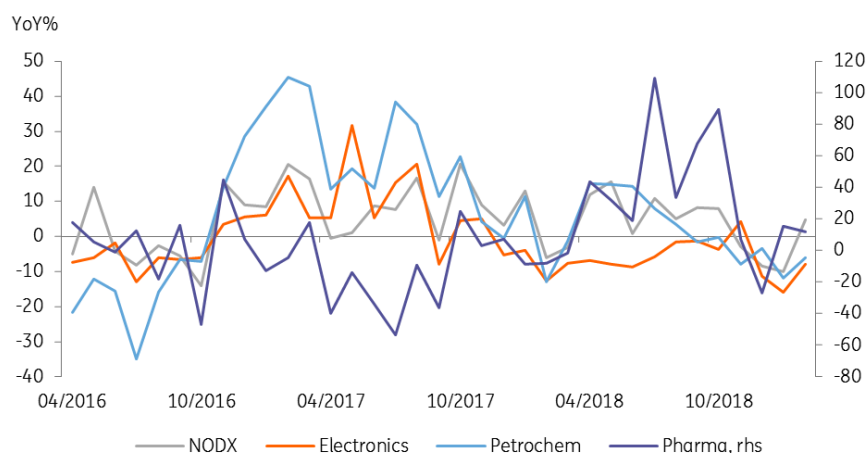
The decline in petrochemicals may be as, if not more worrying, than the semiconductor slump

The somewhat steady decline in petrochemical exports doesn't resemble such volatility but rather a more systematic slowdown. It could reflect a loss of market share to regional competition, or perhaps a broader decline in regional demand for such products, which itself is somewhat worrying, as these products are ubiquitous in all production. A slowdown here can mean, a slowdown in everything else on the way.

The electronics sector is the biggest single component of Singapore's export bundle, and as discussed earlier, has problems right now, though perhaps not for too much longer. Already, some semiconductor firms are hinting at the beginning of the end of the downturn, and the rate of year on year decline seems indeed to have troughed.

It might be a quarter or two before we can talk about year on year growth for this sector, but at least the numbers following the minus sign will likely be smaller.

Non-oil domestic exports breakdown



Source: CEIC

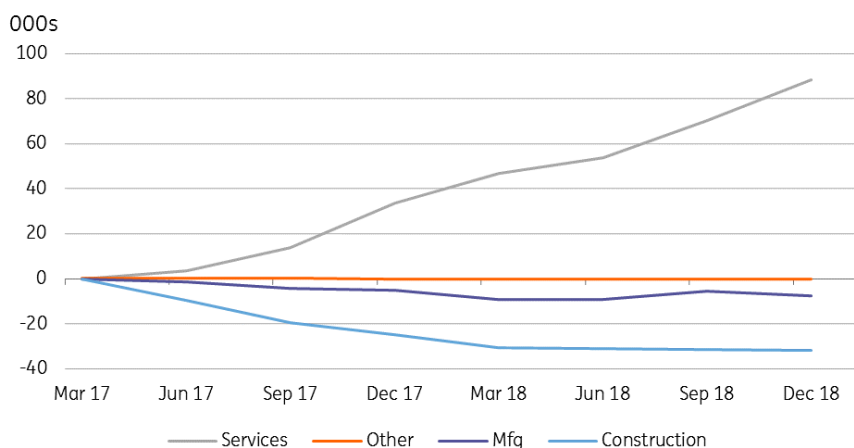
Domestic economy - soggy, but supported

With the fate of the external sector lying largely outside the control of Singaporean authorities, what about the domestic sectors?

We briefly mentioned the low unemployment rate, though it's worth remarking that this is up from its 2016 low of 1.8%. However, wage growth is softening, and the last quarter of data available, in 4Q18, showed the rate of wage growth slowing to 2.8%. This is still delivering a respectable positive real wage growth given the 0.5%YoY inflation rate, but it is perhaps consistent with real consumer spending growth of closer to 2% than 3% without a pickup.

Indeed a closer look at the figures shows that the vast bulk of the cumulative employment growth in Singapore since 1Q17, when the economy began to pull itself out of the 2015/ 2016 soft-patch, has been in the service sector (88 thousand out of a total of only 48,500 cumulative job creation).

Cumulative employment growth (1Q17 = 0) by sector

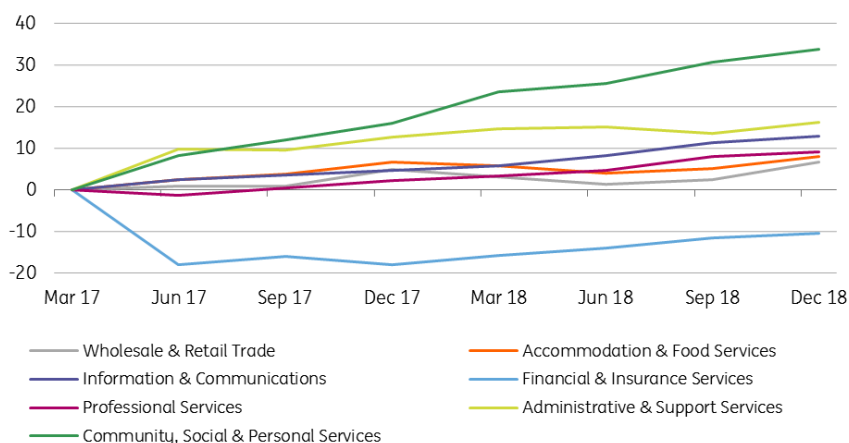


Source: CEIC

Service sector jobs quality questionable

Of this total, most (more than 50,000) have been in administrative sectors, which includes relatively low paid work like security and cleaning, and in public and quasi-public sectors such as community, social and personal services, with health and social services picking up the lion's share.

Cumulative service sector employment, (1Q 2017 = 0)



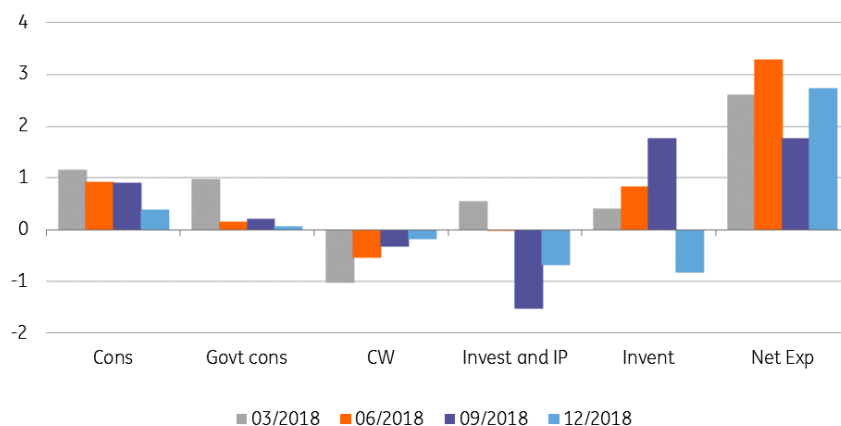
Source: CEIC

Financial employment down - professional services and info/comms up

The relatively well paid financial services sector has seen a net loss of employment since the beginning of 2017 of nearly 10,000 jobs, though this has been offset by a similar increase in both professional services and information and communications jobs, which plays to Singapore's determination to be at the forefront of Industry 4.0.

Perhaps unsurprisingly, this labour shift hasn't entirely prevented some slippage in the contribution to GDP growth from consumer spending. More surprising is the fact that net exports continue to support growth, with the key emphasis being on the term 'net', as import decline has helped offset the slowdown in Singapore's non-oil domestic exports.

Contributions to YoY GDP growth by expenditure (pp)



Source: CEIC, ING

Inflation - there really isn't any

Standard practice with inflation is to compare discrepancies of headline rates with core rates of inflation, though, in Singapore's case, the core rate is something of an oddity, not being an ex-food and energy measure, but the Monetary Authority of Singapore (MAS) measure of headline minus accommodation and private transport costs.

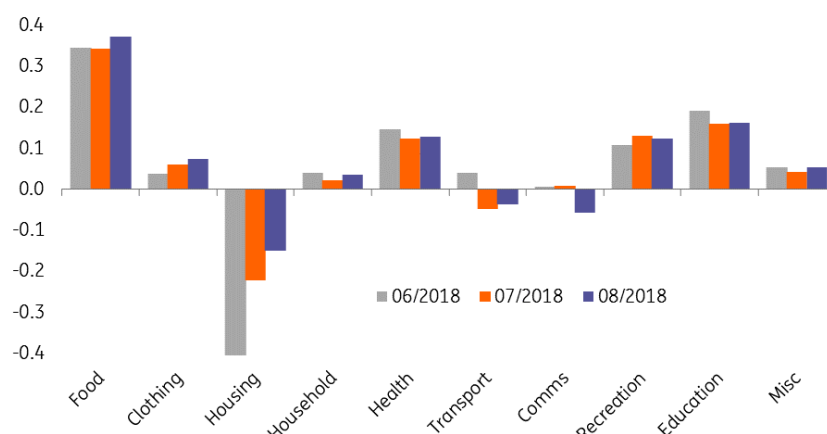
Certainly, for many Singaporean households, those living in housing development blocks (HDBs) and using the excellent public transport facilities, this exclusion makes sense. Though these big ticket items are also excellent measures of fluctuating aggregate demand, and their exclusion does come at some cost in terms of information.

Low inflation isn't necessarily a problem - but it does remove any need for faster nominal effective SGD appreciation

Moreover, it also means the headline indices of inflation aren't commonly adjusted for volatile and externally driven factors such as food prices.

This doesn't necessarily create a problem, but in recent years, the headline CPI inflation rate has consistently undershot the MAS core measure, which suggests that private transportation and accommodation have been consistent drags on the economy – this tells its own story. More recently, the MAS core measure has also lost a little of its lustre, dropping to 1.5% in the last reading for February 2019, and down from its December 2018 1.9% peak.

Contribution to recent headline inflation (pp)



Source: CEIC

Apart from food, no other prices are really rising

What emerges clearly from looking at the breakdown of inflation, is that most broad-based components contribute less than 0.1 percentage point to annual inflation growth, with food and education being the only two that consistently rise above this level. Health is a steady contributor of about 0.1pp, And everything else is either too small to matter or, like transport, housing and communications, a drag.

The declining drag of these last two is why their exclusion is likely causing the MAS inflation measure to fall. Over the coming months, while we may not see the headline inflation rate rise substantially, we might well see some further slight convergence of the headline and MAS core inflation rates.

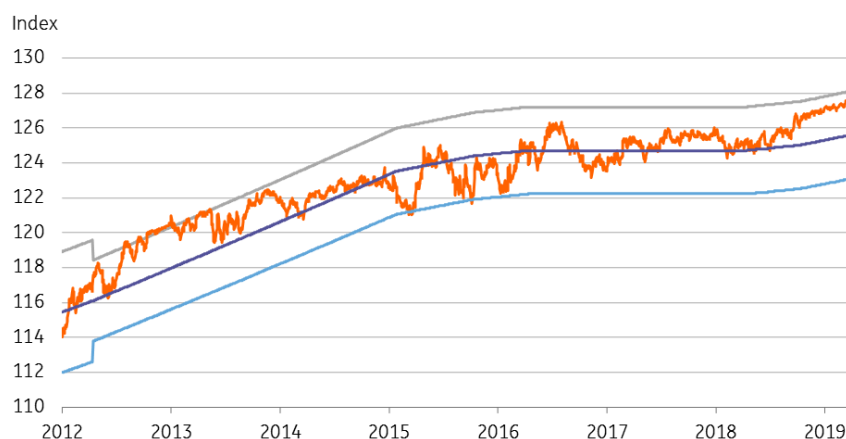
Monetary policy - no need for further tightening

The next central bank meeting to decide interest rate policy will happen later this month. The last meeting in October concluded with a slight increase in the slope of the SGD Nominal Effective Index policy (a NEER tightening). This followed on from a prior slope increase at the April meeting of 2018.

The Monetary Authority of Singapore doesn't have to reverse its earlier tightening, but it certainly doesn't need to tighten any further

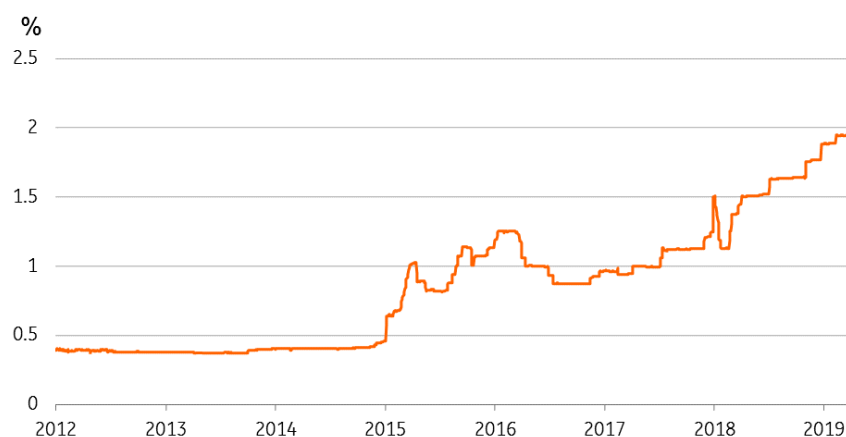
The macro picture we have illustrated is one of both external uncertainties and outright challenges, (the trade war, Chinese economic strength, Fed policy direction) and a domestic economy that is ticking along, thanks in large part to government support. In our view, there is no support for an additional increase in the NEER slope at the next meeting, though saying that, we didn't think there was much reason to argue for one at the October meeting either.

SGD nominal effective exchange rate path



Source: Bloomberg, ING

3-month Sibor



Source: Bloomberg

Rates suggest SGD strength deliberate

Relative to its mid-point, the SGD has remained close to the top of its band in 2019, partly due to Asian competitors weakness. Though we'd also note that this has also coincided with an increase in SIBOR rates, and the SGD's position with respect to the band is beginning to look like a policy decision rather than a market residual.

One policy decision we can't rule out (though not our base case, which is no change) would be a slight upwards shift in the MAS band while leaving the slope and bandwidth intact. Having said that, we think the softening growth outlook and very subdued inflation statistics argue more forcefully for no policy change rather than, what this would be, a slight further tightening.

Fiscal policy

Overall fiscal policy in 2019 relative to 2018 according to the Ministry of Finance figures shows a marked swing from a surplus (SGD 2.12 billion) to a deficit (SGD 3.48 billion) - a swing of about 1% of GDP. But this swing flatters the degree of stimulus being delivered this year.

Operating revenues and expenditures both rise in 2019, but by similar amounts (about SGD1.2bn).

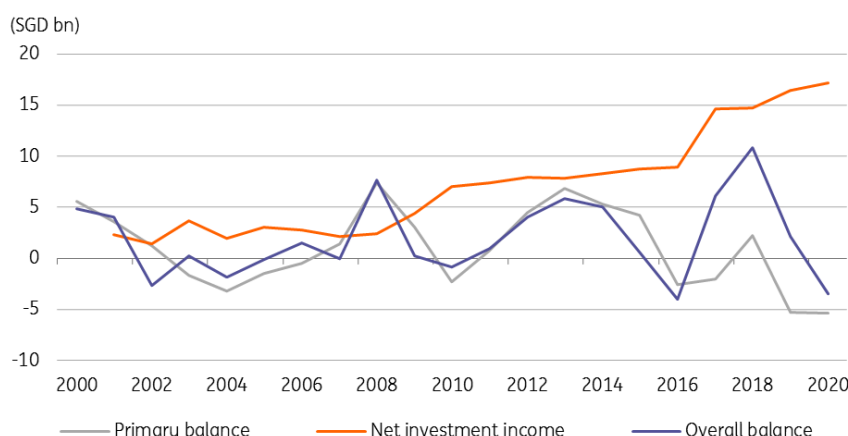
Singapore is a net creditor nation - a real rarity

2019 sees special transfers (mainly to endowment and trust funds) increase from SGD9 billion to 15.3 billion, and this is only partially compensated for with returns from net investments (increase from SGD 16.44 billion to SGD 17.17 billion).

The Singapore government's fiscal position is, however, without any doubt exceptionally strong, with net investment income dwarfing the primary and operating balances in recent years. Singapore's gross national debt is high at about 116% of GDP, but while net debt figures are not readily available, the size of its investment returns suggests that its net debt position is in credit to several times the gross debt position, with no foreign debt at all.

If needs be, the fiscal position could be nudged to be somewhat more accommodative in 2019 with no real detriment to the long term financial position.

Singapore's fiscal balance



Source: CEIC

Hold on, things could get a whole lot better

Singapore's strengths, its competitive logistics hub and hi-tech industry are suffering the double indignity of trade pressures and a global tech slump. The macro numbers will suffer, and the central bank will likely find itself having to sit on the policy sidelines for 2019.

It might look bad now, but this will pass, better times are ahead, maybe much, much better

But this will pass. Until then, Singapore's exceptional public finances will be able to help the economy weather the storm. Jobs will be created, maybe not the well paid hi-tech jobs of

the future, but something that pays a wage nonetheless, supporting consumption, though probably not enough to deliver a meaningful pick up in the property market which remains soft, especially for retail property.

On emerging from the current cyclical downswing, Singapore remains very well placed to benefit from the return of global demand for technology and resumption of world trade flows.

Forecast summary

	2018	1Q 19	2Q19	3Q19	4Q19	2019	2020	2021
GDP (YoY%)	3.2	1.2	1.9	3.0	3.0	2.3	2.9	2.8
CPI (YoY%)	0.4	0.4	0.7	0.5	0.8	0.6	1.0	1.0
Unemployment rate (eop)	2.2	2.2	2.3	2.3	2.2	2.2	2.1	1.9
Private residential real estate YoY%	7.8	3.2	-0.5	-1.2	-0.6	0.1	0.0	1.4
Fiscal balance (overall balance % GDP)	0.5					-1.0	-0.8	-0.5
Gross debt/GDP (%)	120.0					126.0	132.0	137.0
Current a/c balance (USDbn and % GDP)	4.7	11.6	17.5	27.5	26.5	4.8	4.6	4.6
3M SIBOR (eop)	1.8	1.8	1.8	1.8	1.8	1.8	2.0	2.5
10Y yields (eop)	2.0	1.9	1.8	1.7	1.7	2.1	2.3	2.7
USD/SGD (eop)	1,111	1,150	1,140	1,130	1,130	1,130	1,100	1,080

Source: ING

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Taiwan's economy: Still waiting for an export rebound

The US-China trade war has hit Taiwan's manufacturing, exports and the demand for new smartphones, and fiscal and monetary policy can only do so much to help drive the recovery. 5G equipment production could provide some support, but before that happens weaker corporate earnings may lead to capital outflows and a softer currency



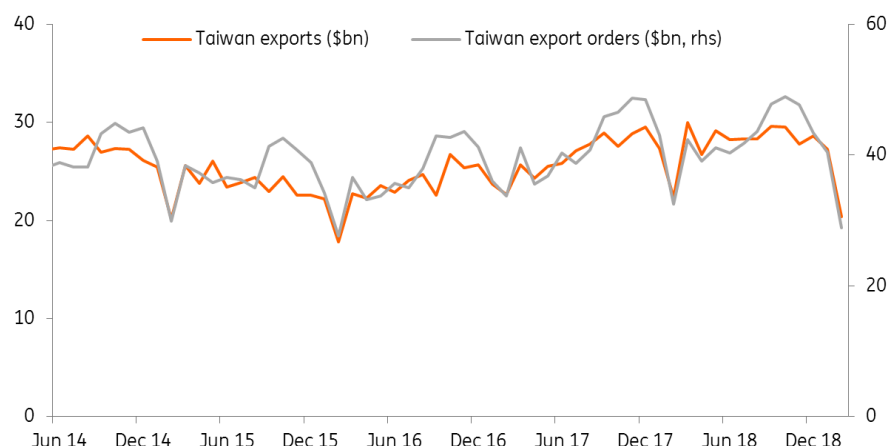
Source: ING, Bloomberg

Taiwan economy is currently under pressure from external factors

Taiwan's economy is a small and open one, which is why the export sector is important to its manufacturing and related service industries such as ports and logistics. But since mid-2018, the external environment has turned negative for Taiwan.

Latest figures show export orders have contracted by 10.94% in February 2019, while exports have contracted by 8.8% since November 2018.

Exports have fallen considerably



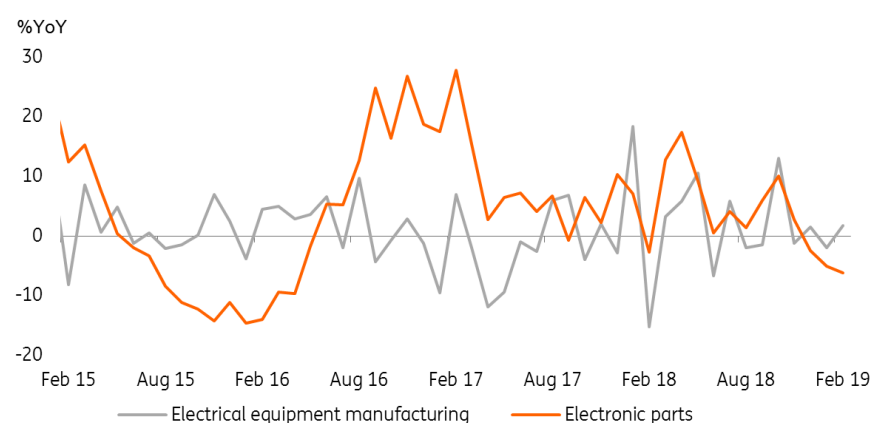
Source: ING, Bloomberg

Taiwan's electronic related sectors have been hit the hardest

This is mostly the result of the trade war between mainland China and the US, which has made businesses defer investment decisions, and therefore orders for electronic equipment have decreased.

Another reason is that the tech giant Apple, who manufactures some parts in Taiwan is experiencing a falling product life cycle for its phones and other smart devices. As a result, exports of integrated circuits have shrunk by 1.1% year-to-date in February, printed circuits have also contracted by 13.2% YoY, and the DRAM market has dwindled by 4.8% YoY.

Historically, electrical equipment manufacturing does not pick up until electronic parts have recovered, so factory expansion may not pick up until there has been a prolonged increase in orders for such items.



Source: ING, Bloomberg

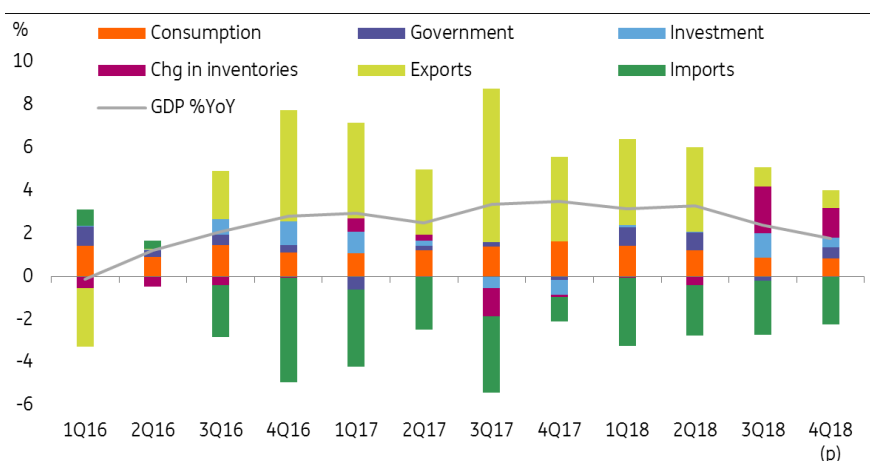
There is only so much fiscal stimulus can do to help

The government has taken up the main role in supporting the economy and will probably increase spending by 2.8% to TWD 2.022 trillion in 2019, which will be around 11% of nominal GDP.

This includes raising infrastructure spending and giving rebates to consumers on energy-saving automobiles.

As you can see in the chart below, historically, fiscal spending can only support the economy for so long. For example, government spending in 1Q16 couldn't prevent GDP growth from falling below zero in annual terms, and it wasn't until export growth rebounded in 3Q16, the economy picked up momentum. So in light of that, we believe, the economy still needs to see a bounce back in exports to see faster economic growth.

GDP growth falls as export sector contributes less to the economy



Source: ING, Statistics Taiwan

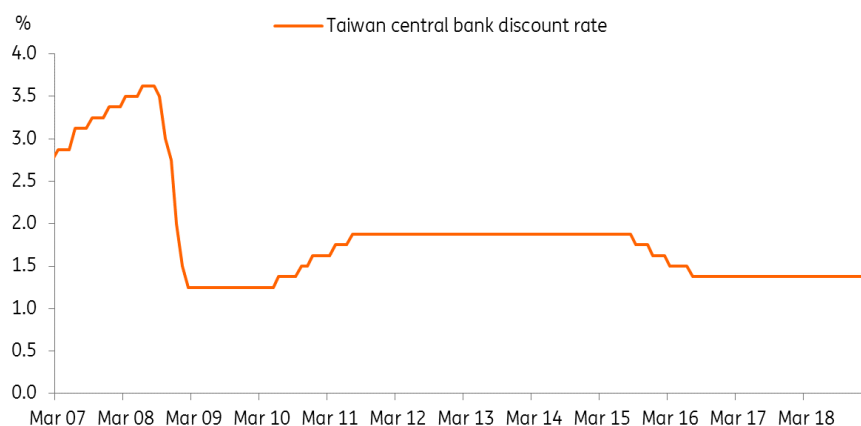
Monetary easing would be the last resort

Monetary easing in 2009 brought Taiwan into the low-interest-rate economy territory, and for the last 32 months, the policy rate has been on-hold at 1.375%. Like other economies suffering from the indirect effects of the trade war, inflation at 0.23% year on year isn't really a concern for a future rate cut, but external headwinds are a challenge for the central bank.

The central bank's recent history of cutting rates by only 0.125 percentage points per move would be too small to have a meaningful impact, and would likely require multiple cuts over successive meetings to provide any noticeable stimulus. Even then, with rates as low as they already are, cutting rates further isn't really going to have a significant impact on the availability of credit, and as we have seen elsewhere (e.g. Japan), as rates approach zero, further easing can deliver the opposite response to that intended.

Therefore, we believe the central bank is saving the bullet until economic growth turns close to negative. But even that doesn't guarantee a rate cut will be an effective tool to rescue the economy.

A rate cut maybe the only trump card the central bank has



Source: ING, Bloomberg

5G to the rescue?

5G could be the opportunity Taiwan needs. As 5G mobile networks begin to develop around the world, there is a demand for 5G equipment from upstream to downstream, and Taiwan has the labour force to produce it all.

But as most of the production demand will arrive when 5G infrastructure coverage worldwide is ready for commercial use, the demand for 5G downstream equipment will come in around late 2020. So 5G may not be able to provide timely support to the open economy, but it should still be a positive in a couple of years.

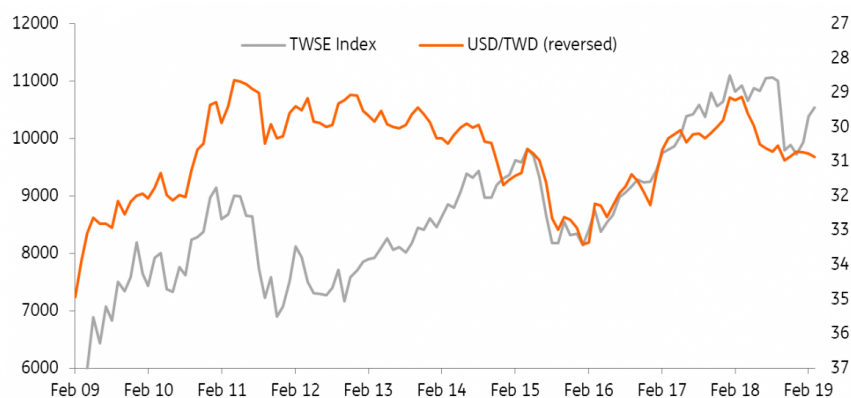
Domestic politics intertwined with external force

The issue that is likely to dominate the presidential elections in January 2020 is whether the new Taiwanese government would like to be more pro-mainland China to be able to get some economic support. But before we see the election results, this debate is likely to create confrontations between the two main political parties - the Kuomintang (KMT), and the Democratic Progressive party (DPP).

The currency will be sensitive to corporate earnings

Taiwan's stock market movements impact the country's exchange rate a great deal because of foreign investments in the stock market.

[Why we're revising our call on the Taiwan dollar](#)



Source: ING, Bloomberg

We are concerned that there could be downward surprises in corporate earnings because of the weak sales of smart devices and this will put downward pressure on the Taiwan dollar against the USD.

As such we've [revised our TWD forecast from 30.40 to 30.95 by the end of 2019.](#)

Taiwan	2017	2018	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F
Real GDP (% YoY)	2.9	2.6	1.4	1.4	2.0	2.2	1.8	2.0
CPI (% YoY)	0.6	1.5	0.2	0.3	0.3	1.5	1.0	1.0
CBC discount rate (% eop)	1.38	1.38	1.38	1.38	1.38	1.38	1.38	1.38
3M CP rate (% eop)	0.65	0.72	0.66	0.66	0.66	0.66	0.66	0.66
10Y govt. bond yield (% eop)	0.95	0.86	0.82	0.81	0.80	0.80	0.80	0.78
TWD per USD (eop)	29.73	30.55	30.80	30.85	30.90	30.95	30.95	31.15

Source: ING, Bloomberg

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Indonesia: Reforms needed for lift-off

Indonesia has seen growth plateau at the 5% range since 2016. After targeting 7% since taking office in 2014, President Jokowi looks to secure a fresh term with the current administration forecasting the fastest pace of growth in the next two years



Source: Shutterstock

Recent Growth and outlook: On cruise control with elections ahead

Growth in Indonesia has hovered about the 5% level in recent quarters and given the nation's solid fundamentals will likely keep to this range in the near term. The administration however is now forecasting economic growth to average 5.3% in 2019 and at 5.3-5.5% in 2020 against a backdrop of benign inflation. The elections in April are expected to boost economic growth on the consumption side but more investment and reforms will be needed to achieve lift-off and break free from the 5% level.

Inevitably the growth trajectory will depend largely on the elections, with incumbent Joko Widodo (Jokowi) vowing to continue his infrastructure and investment push while challenger Prabowo Subianto (Prabowo) has pledged to ban imports of agricultural products, lower the reliance on imported oil and reinstate fuel subsidies cut by Jokowi.

Indonesia GDP growth (2010 base year) actual and forecast values



2010 base year

Inflation and outlook: well-behaved and on course to stay within target

Price pressures have been subdued with the basic food component pushing headline inflation closer to the lower-end of the 2.5-4.5% inflation target. Meanwhile, prepared food, beverages, tobacco and utilities were the main contributors to the latest 2.57% inflation reading for February. Meanwhile, core inflation, which strips out some food items as well as government influenced transport and utilities was also well-behaved, settling at 3.06% for the month of February.

One factor that has helped inflation settle at the lower-end of the 2.5-4.5% target has been the ability of Indonesia to import important grains which has ensured adequate supply domestically, something that Prabowo has vowed to cancel should he take power.

On the other hand, Prabowo has also campaigned on a promise to reinstate fuel subsidies and lowering reliance on imported fuel via higher biofuel content, something that would also affect the inflation dynamic should he wrest the presidency from Jokowi. For the time being, inflation is forecast to remain within the lower end of the inflation target with Bank Indonesia (BI) shifting focus to financial market stability over price stability.

Indonesia inflation (in %) actual and forecast values



Source: Bloomberg and ING

Monetary policy and interest rates: BI on hold for now but rate cut now on table

In 2018, Bank Indonesia (BI) unleashed a flurry of rate hikes at the height of the emerging market currency rout, citing the need to establish financial market stability as they looked to steady the Indonesian Rupiah's fall. Governor Warjiyo hiked a total of 6 times in 2018, beginning in May, to bring BI's 7-day reverse repurchase rate to 6.0% by November with the last rate hike catching some market players by surprise. BI had maintained that raising rates aggressively and acting in a "pre-emptive" manner was done in order to maintain the stability of the economy and financial system by keeping financial assets attractive to foreign funds. The ability to keep the IDR stable is in line with the overall government move to keep the current account from ballooning.

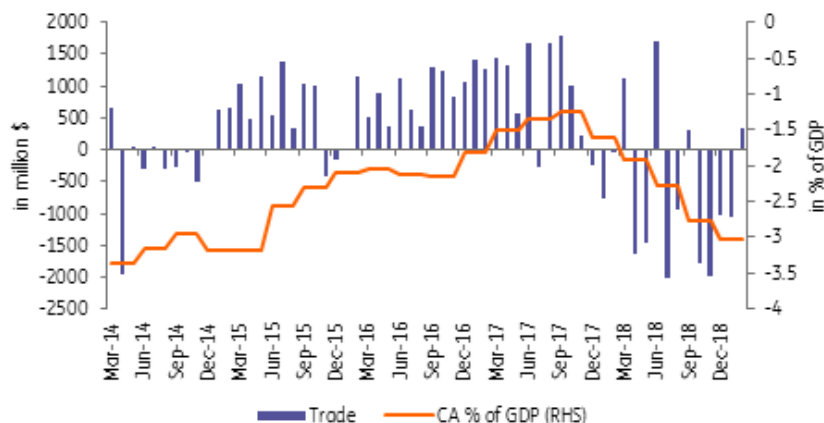
The widening of the trade and current account deficits had been flagged as a major concern for foreign investors and one of the main reasons cited for the flight of capital at the height of the EM rout in 2018. In the coming months, the central bank will remain vigilant to ensure IDR stability, although the Fed's recent reversal in outlook coupled with Governor Warjiyo's comments indicating that he felt rates may be "close to peak" hint at the possibility for a policy reversal in the coming months. Should the IDR remain stable, with an appreciation bias and global market conditions remaining favourable to emerging markets, we believe Warjiyo will be afforded a window to dial back 2018's rate hike salvo to help boost economic growth in an environment of slowing global growth.

Country specific highlight: Narrowing the current account

The twin threats of 2018 - a trade war between the United States and China moving in tandem with a hawkish Federal Reserve - buffeted currencies across emerging markets. The three currencies that had been hit the most were those whose economies ran substantial current account deficits, with the IDR joining the INR and PHP at the back of the line. For the year, Indonesia recorded a current account deficit of 2.98% of GDP, the widest since 2014 as the deficit swelled to \$31.1bn. With the trade gap ballooning to \$8.496bn, Indonesia rolled out several reforms to help boost exports, with incentives and tax perks doled out to exporters while some infrastructure projects requiring substantial imports were postponed in order to achieve import compression.

Indonesia is now targeting a current account deficit of 2.5% of GDP which should alleviate some pressure on the IDR, especially with the turn in risk sentiment in the first quarter of the year. In 2019, market players will continue to monitor whether Indonesia can continue to whittle down the current account deficit, with early 2019 trade data showing a surplus recorded, but at the expense of a large contraction in imports.

Indonesia trade balance and current account % to GDP

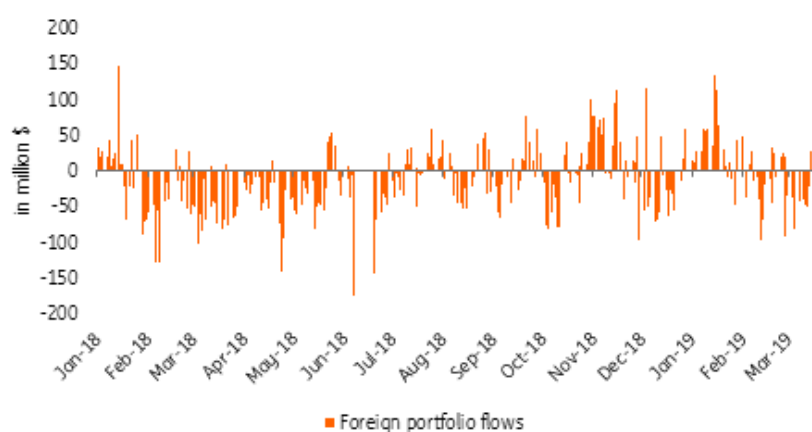


Source: Bloomberg

Currency movement: IDR depreciates then steadies as foreign flows return

The IDR was one of the worst performing currencies in 2018 with stark risk-on sentiment forcing foreign investors to head for the exits, noting the outlook for the Fed and the US-China trade war. At the height of the emerging market currency rout, the Rupiah had lost 12.72% from its level at the start of the year on renewed concerns about Indonesia’s current account position. Bank Indonesia was called into action, actively participating in the foreign exchange market, setting up a domestic non-deliverable forward market and revising rules on export revenue repatriation to limit outflows. 2019 brings a more favourable environment with the Fed taking a more dovish tack while US and China appear amenable to some form of agreement, hopefully in the near term. The IDR has managed to appreciate for the most part in 2019 as portfolio flows have returned as a result of the improved sentiment. With the currency stable and growth expected to receive a boost from the elections, Bank Indonesia has held off on adjusting monetary policy while vowing to help boost liquidity to offset the ill effects of its recent aggressive tightening cycle. If risk sentiment continues to favour emerging markets, we could see the IDR appreciating further as Governor Warjiyo still views the currency as “undervalued” with the possibility of a policy reversal from the central bank now gaining some steam.

Indonesia foreign portfolio equity flows



Source: Bloomberg

Summary: on cruise control but reforms needed for lift-off

Growth prospects for Indonesia remain favourable, given still robust domestic consumption which will be aided further by benign inflation dynamics. Elevated borrowing costs, raised last year to ensure IDR stability, however may limit capital formation to some extent but government spending is expected to continue to provide a lift. Reforms and investment may be needed in order for the economy to break out of the 5% trend, something that incumbent Jokowi has pledged to do with improvements in infrastructure seen as a priority. Meanwhile, Indonesia will need to secure other more stable sources of foreign currency, given the economy's susceptibility to foreign outflows and its reliance on low value added exports for foreign currency. A shift to higher value added export products would help address two concerns at once by securing a stable source of foreign flows and at the same time offering an alternative outlet for the young labour force in the manufacturing sector. Regardless of the outcome of the election, Indonesia's growth trajectory will lean heavily on the next president's ability to boost investment in order to improve productivity and increase efficiencies. Growth of 5% is highly achievable but reforms to push a shift to higher value added production will be key to not only secure Indonesia's external position but also provide another stable source of growth via higher value added manufacturing.

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Thailand: Steady economy amid political risks

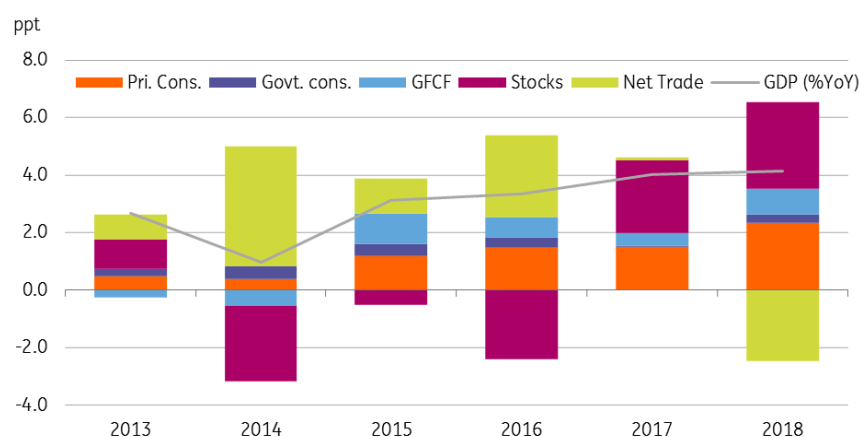
Prime Minister Prayut Chan-o-cha is likely to remain in power at the general elections next month, though the transition to the new government under him may not be smooth. Absent a significant political shock, the economy will be on a steady 3-4% growth path and the currency will continue to be an Asian outperformer in the medium-term



2018 wasn't all that bad with firmer growth

Thailand's economy grew by 4.1% in 2018, the best performance in the last six years. However, it was not much of an improvement from the 4% growth rate recorded in the previous year and underlying drivers of growth weren't very impressive either. As in 2017, a large contribution to growth came from inventory re-stocking, which isn't a healthy sign as the potential inventory overhang is likely to keep future output growth subdued. There was some improvement in domestic demand but the all-important investment demand continued to be anaemic and lacked a material boost from public investment. Meanwhile, narrowing external trade surpluses held headline GDP growth down.

Sources of GDP growth



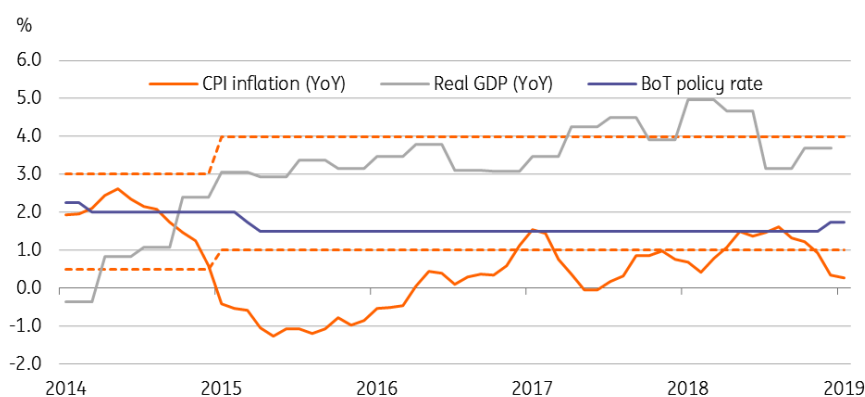
Source: CEIC, ING

The strong currency and lack of demand-side pressure have kept consumer prices subdued. The Bank of Thailand's (BoT) 1-4% policy inflation target has barely been achieved on a sustained basis in recent years. Last year was no different. Even though average CPI inflation of 1.1% in 2018 was the most in four years, after a brief return to the target level, inflation slid closer to zero toward the year-end. Apart from the pass-through of higher global oil prices to domestic fuel prices, which kept the CPI transport component elevated, and higher "sin taxes" on alcohol and tobacco products, there was no inflation in most other CPI components, not even in food prices, which have been the main driver historically, due to their 36% CPI weight.

On the external side, the current account surplus equivalent to 7.5% of GDP in 2018 represented a sharp narrowing from 11% recorded in the previous two years. Yet this remained the main source of currency (THB) strength. The Thai baht was unscathed and retained its top spot among Asian currencies during bouts of emerging market volatility owing to the trade war and contagion from the crisis in Argentina and Turkey.

Indeed, persistently low inflation was an argument against the Bank of Thailand following the US Federal Reserve in tightening. Even so, the BoT stepped up its hawkish rhetoric and moved policy with a 25 basis point interest rate hike in December. The first BoT rate hike in seven years was aimed at gaining policy space for the future. Meanwhile, fiscal policy remained expansionary with close to a 3% of GDP budget deficit.

Growth, inflation, and central bank policy



Note: Dotted lines are BoT's inflation target, currently 1 to 4%.

Source: Bloomberg, CEIC, ING

Could 2019 be ugly as politics overtakes the economy?

After frequent rescheduling, general elections are (hopefully finally) set to take place on 24 March 2019. Hopes rest on this ending the long-standing political uncertainty about establishing a civilian government after the military grabbed power in May 2014. That coup overthrew the last elected government of Yingluck Shinawatra (2011-14), the sister of the former Prime Minister Thaksin Shinawatra (2001-06). General Prayut Chan-o-cha initially promised elections within a year of the coup but has pushed out the timing until this latest rescheduling.

Will the transition from military to publicly-elected government be smooth, without any political turmoil? Maybe not, judging by Thailand's political history which has been marred by frequent unrest, military interventions, and short-lived governments. A glimpse of this came earlier this month when a Thaksin-linked Thai Raksha Chart Party announced Princess Ubolratana Rajakanya, the elder sister of King Maha Vajiralongkorn, as its prime ministerial candidate for upcoming elections. A spike in political risk ensued with a public outcry against the move deemed unconstitutional and disrespectful to the royal family. The sell-off in local financial markets was associated with the steepest single-day depreciation of the THB since last October.

The King denounced the Thai Raksha Chart's move as unconstitutional, and the party now faces dissolution by the constitutional court on the grounds of violating election laws. This nipped in the bud Thaksin's bid to reacquire his grip on Thai politics via a royal family member and also bolstered the odds of Prayut holding on to power.

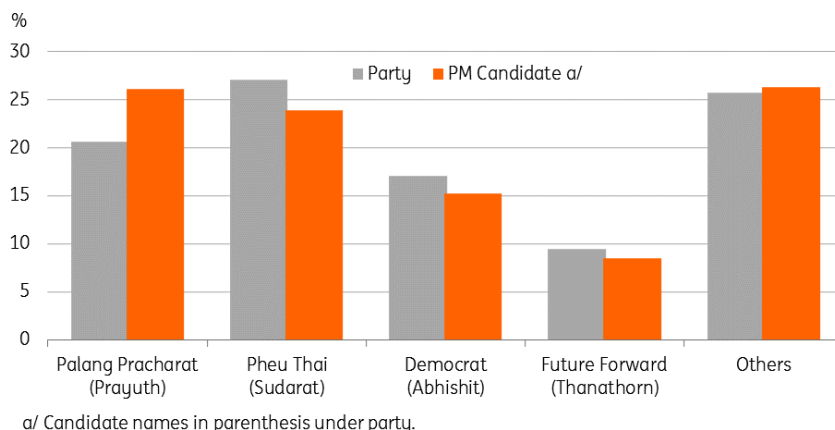
There are 68 prime ministerial candidates in the ring, including Prayut contesting from the military-backed Phalang Pracharat Party and former Prime Minister Abhisit Vejjajiva (2008-11) from the Democrat Party. Thaksin's Pheu Thai Party is also fielding three prime ministerial candidates, while the fourth major party in the fray is the newly-formed Future Forward Party led by Thanathorn Juangroongruangkit.

Moreover, the new constitution adopted in 2017 allows the military to retain its decisive role in future governments. The upcoming elections will be for the 500-seat lower house of parliament, but the 250-seat upper house, or Senate, is the non-partisan body of appointees from the Royal Thai Military. As such, the balance of power remains tilted toward Prayut. Yet, the passage to the

new government may not be without any political gridlock or public unrest.

What pre-election opinion polls point to?

Average results of various opinion polls held since December 2018.



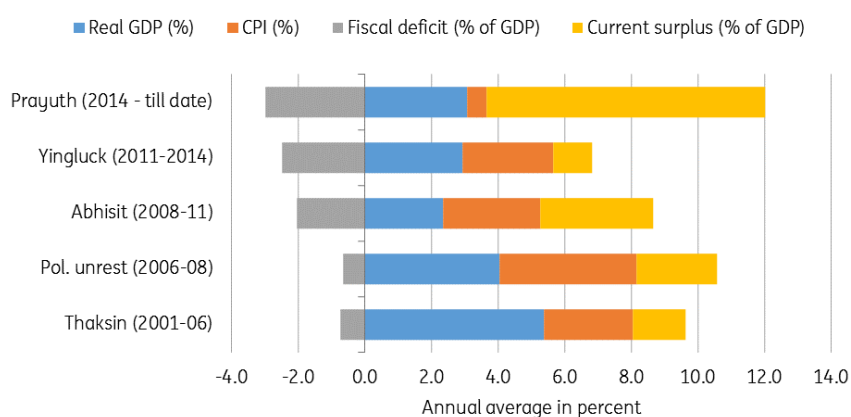
Source: Wikipedia, ING

Economic case for Prayut's re-election

Let's take a look at Thailand's economic performance under the current and previous regimes to assess Prayut's chances of continuing as prime minister.

Growth improved from a low of 1% in 2014 (the year of the military coup) to about 4% in the last two years, though the 3% average over these years was hardly an improvement over previous administrations. The economy enjoyed lower inflation under Prayut than previous regimes though this is more a result of weak demand and lower commodity prices.

How did the economy fared under recent governments?



Source: Bloomberg, CEIC, ING

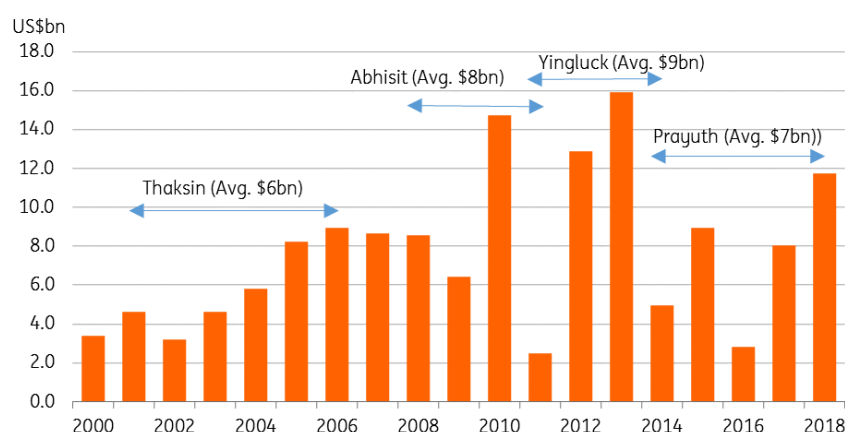
External situation - great, but thanks to weak demand

Of course, the external payments position had never been as strong as it was under Prayut, supported by a lumpy current account surplus and swelling foreign exchange reserves. However, a

large current account surplus also reflects a gross economic imbalance, which has failed to correct despite expansionary macroeconomic policies. Having slashed policy rates by 200 basis points to 1.5% from late 2011 to early 2015, the BoT held policy stable until the latest hike in December 2018. The fiscal deficit averaged about 3% of GDP in the years from 2014, more than the previous administrations.

Foreigners have been pouring funds into local stocks and bond markets in recent years, thanks to the comfort of healthy external payments boosting the currency. And direct investment inflows also gained traction in the last two years. But real investment growth continued to be depressed under military rule (there is also a structural aspect to this as discussed in the next section).

Net foreign direct investment inflows



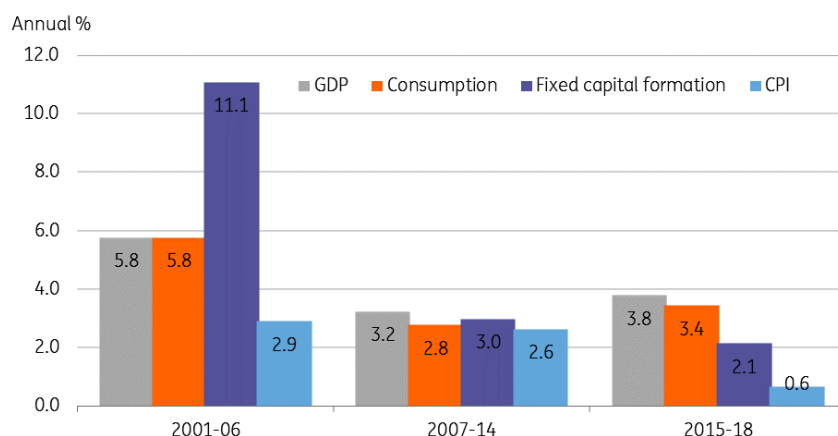
Source: CEIC, ING

Structural trends – plenty of slack in the economy

The post-Thaksin era was marked by a significant surge in political uncertainty taking a toll on the economy. This is evident from the almost permanent shock to growth via weak investment demand. Once an Asian tiger, Thailand's economy has struggled to grow in recent years with a steady slowdown from an annual average rate of 5.8% in 2000-06 (Thaksin era) to 3.2% in 2007-14 (years of heightened political turmoil). A slight improvement in recent years (military government) can be characterised as lopsided – persistent weak domestic demand – without stoking any inflation.

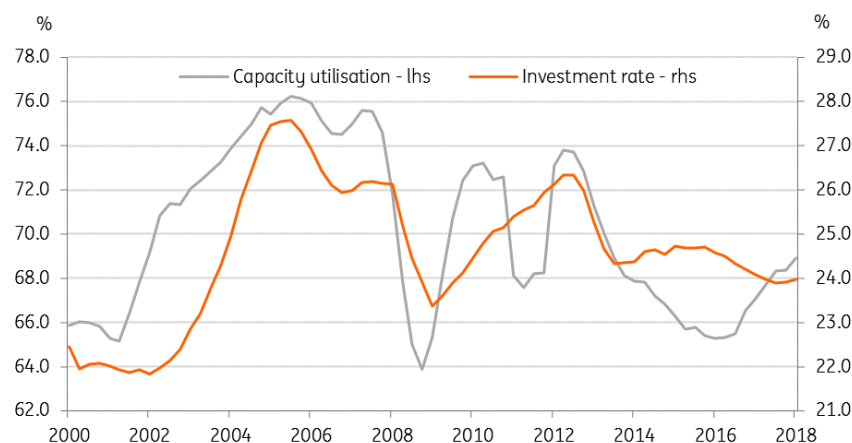
There is plenty of slack in the Thai economy as underscored by factories running at about two-thirds of their capacity. The elevated manufacturing inventory-to-shipment ratio points to the same feature. And this has dampened the investment rate (ratio of fixed capital formation to GDP), which has failed to reach the Thaksin-era highs, while politics has been a constant overhang on investor sentiment.

Years of political uncertainty has shocked growth lower



Source: CEIC, ING

Unused capacity weighs down investment



Source: CEIC, ING

Steady as it goes into the medium term ...

We expect the broad economic trends described above to remain in place in the medium term. Absent significant political risk, we see no reason for Thailand’s GDP growth to break out of the 3-4% range that it’s seen in recent years. The National Economic and Social Development Council (NESDC) projects 3.5-4.5% growth in 2019, as election spending is likely to provide upside to consumer spending. But with the prevailing external risks from the global trade war, GDP growth will likely be closer to the low end of the NESDC’s forecast range.

Investment will persist as a weak spot. Hope rests on the continuation of the Eastern Economic Corridor Plan undertaken by the current administration under the new government. This is a long-term plan to develop three coastal regions into a special economic zone with airports, deep sea ports, and high-speed rail, and spanning a multitude of industries. Thailand is also seen among the destinations for potential supply chain relocation resulting from the US-China trade dispute, but is still not as attractive a destination as Cambodia, Vietnam, Myanmar or Laos – all up-and-coming countries with relatively cheap labour.

We see external trade imbalances narrowing gradually. A significant negative swing in the trade balance in January to a deficit of \$4 billion from a surplus of \$1.1 billion in the previous month heralds this trend. We forecast that the current surplus will shrink further to 4.5% in 2019, providing continued strong support for the currency's appreciation.

Key economic indicators and ING's forecasts

Thailand	2015	2016	2017	2018	FY2019 f	FY2020 f
Real GDP (% YoY)	3.1	3.4	4.0	4.1	3.8	4.0
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	-3.2	-2.9
Public debt (% of GDP)	42.1	41.1	41.2	42.4	43.7	46.9
Current account (% of GDP)	8.0	11.7	11.0	7.5	4.5	3.4
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	1.75	1.75
3M interbank rate (% eop)	1.63	1.59	1.57	1.86	1.85	1.85
10Y govt. bond yield (% eop)	2.50	2.65	2.32	2.48	2.60	2.80
THB per USD (eop)	36.08	35.84	32.58	32.33	31.80	31.50

Source: Bloomberg, CEIC, ING

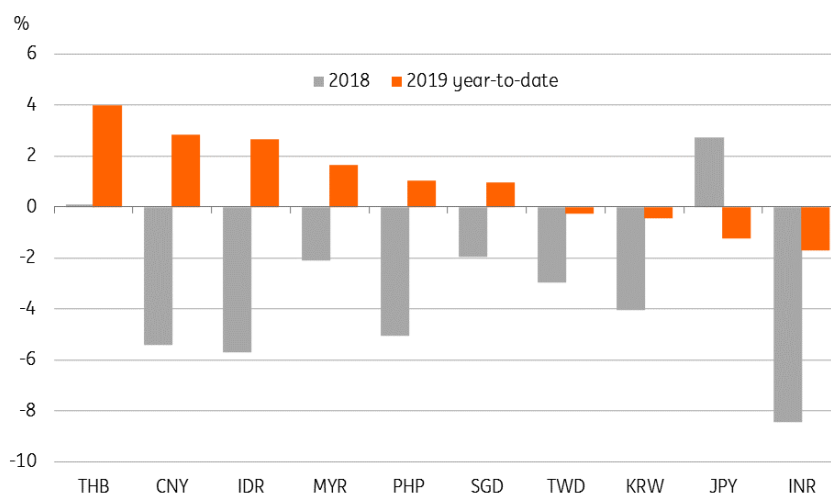
... thanks to continued policy accommodation

We aren't anticipating a near-term departure of monetary or fiscal policy from the current accommodative stances. Despite the sustained hawkish tone, the BoT has flagged policy to be data-dependent and yet likely maintaining an 'accommodative' bias for this year. We don't see anything significant in the data to cause another rate hike this year, nor do we expect any easing. This view of policy status quo hinges on our forecasts of growth slipping below 4% and inflation hovering around 1% in the current year.

Fiscal policy will remain accommodative, too. The state budget for the current financial year ending September 2019 is set to produce a deficit equivalent to about 2.6% of GDP, a consolidation from 3% in FY2018. But slower GDP growth will likely depress revenue, and together with the surge in election spending, this will see a wider budget gap than projected. However, we don't see anything here threatening the country's investment-grade sovereign credit rating underpinned by still sound external payments.

Still, there are more reasons for the authorities to be worried about the ongoing currency strength, which is detrimental to exports in the current environment of rising global trade protectionism. The BoT views recent THB appreciation as consistent with broader emerging currency trends supported by a dovish turn in US Fed policy and softer US dollar. Moreover, we think the reason for the currency's 4% year-to-date appreciation probably lies in investor confidence about the military Junta maintaining its grip on the government, and thus ensuring political as well as economic stability. Although we aren't ruling out some weakness in the run-up to March elections, the THB will remain investors' darling for the rest of the year.

THB remains top-performing Asian currency



Note: In descending order of 2019 performance.

Source: Bloomberg, ING

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Malaysia's new normal

A decent growth rate among Asian countries, 4-5% will be the new normal for Malaysia, and that is where we see it staying in the medium term. Stretched public finances will limit the scope for fiscal stimulus but low inflation has opened doors for monetary easing



Source: Pexels

New government policy shift suppressed both growth and inflation

Malaysia's economy expanded by 4.7% in 2018, but the slowdown in growth from 5.9% in 2017 was the result of domestic and external drags. Domestically, there was an overhaul of economic policy after a surprise change of government in May 2018. And soon after taking office, the new government scrapped the goods and services tax - the key revenue source for the previous government and also suspended infrastructure investments.

While such a policy shift was positive for the economy to an extent, (via a boost in private consumption), it hit investment spending hard. Overall domestic demand shaved off 2.4 percentage points from annual growth in 2018 and was dragged down further by inventory de-stocking among other things.

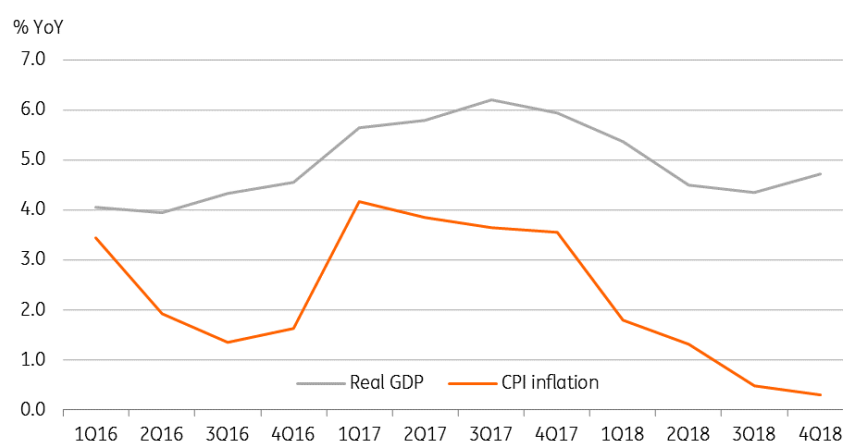
Despite these headwinds, 14% annual export growth was

outstanding performance among Asian economies

Externally, firmer commodity prices supported exports in early 2018, but export prospects deteriorated with increased US-China trade tensions and the renewed oil price slump in the second half of the year. The silver lining in all of this was electronics exports managed to ride out the 'tech slump' observed elsewhere. Despite these headwinds, 14% annual export growth was outstanding performance among Asian economies.

The removal of the goods and services tax in June 2018 was a godsend for consumers as it brought inflation below 1%. The re-introduction of a more benign sales and services tax didn't do much to lift prices either. The average annual inflation of 1% last year was a sharp dip from nearly a decade-high of 3.8% in 2017.

Growth and inflation - both heading downwards



Source: CEIC, ING

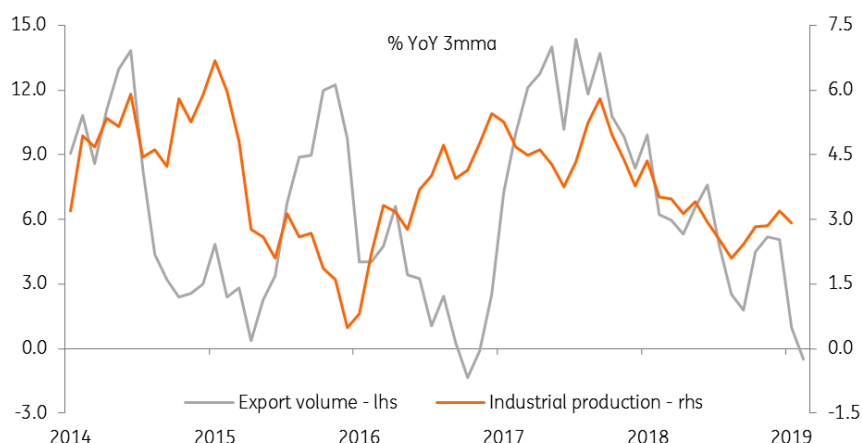
Macro policy has been relatively tight

Malaysia's central bank's efforts to normalise policy after a prolonged accommodative spell was short-lived. In a one-off move, they hiked the policy rate by 25 basis point to 3.25% in January 2018, before low inflation and intensified growth risks stalled the normalisation.

In our view, the new government's initial fiscal policy response to the economy lacked clear direction. The elimination of GST was stimulatory via a boost to consumption but suspending public investments was restrictive. Moreover, a significant spike in the fiscal deficit to 3.7% of GDP in 2018 erased the consolidation of the last four years and ruled out the scope of a stimulus to the economy from this side.

Surprisingly, international rating agencies overlooked this significant fiscal slippage because of the country's sound external payments position with a sustained 2-3% of GDP current account surplus. Despite the political jitters, the Malaysian ringgit came out among Asia's outperforming currencies in 2018 and 2019 too.

Exports and manufacturing, both seem to be slowing



Source: CEIC, ING

Balance of risks tipped towards growth, not inflation

2019 kicked off on the softer side led by a continued slowdown in exports and manufacturing keeping GDP growth on a slowdown path. We expect GDP to grow by 4.2% year-on-year in the first quarter of 2019 - the slowest rate in almost three years and down from 4.7% in 4Q18. We also expect this to be the trough in the current cycle, at least the low base effect should push growth higher for the rest of the year.

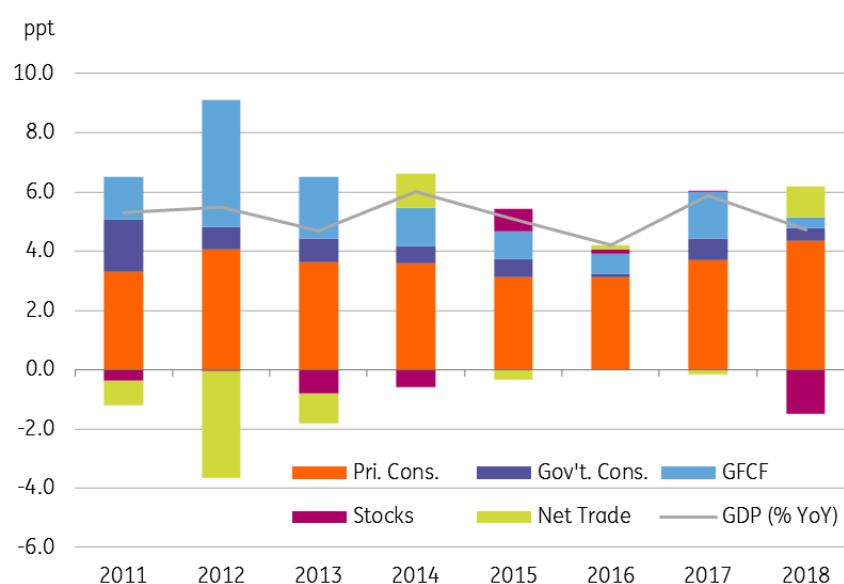
Our full-year GDP growth forecast of 4.6% for 2019 is within the central bank's forecast range of 4.3 - 4.8% for the year, which they recently downgraded from 4.9%. The good news is that domestic demand will remain the principal growth driver this year, softening the impact of external uncertainties including the trade war, commodity price volatility, and the tech slump.

4.6%

ING GDP forecast

For FY19

Domestic demand - principal driver of growth



Source: CEIC, ING

Don't fret about negative inflation

Low inflation should help private consumption remain in the top spot of GDP growth drivers. The administrative curbs in fuel prices produced negative inflation in the first two months of 2019 for the first time in nearly a decade, which prompted us to cut our annual inflation forecast to 1.0% from 1.4%.

The price decline is not pervasive. This is different from a severe drop in spending such that firms generally have to cut prices to attract consumers. – BNM Governor Shamsiah Yunus

We see the current negative inflation as a transitory spell as global oil prices are creeping up and will eventually filter through to domestic fuel prices. Neither do we see any big build-up of price pressures anytime soon, at least not until the impact of GST removal moves out of the base by mid-2019.

Even then, the annual average inflation rate won't be far from 1% seen in 2018, or close to the low end of the central bank's 0.7-1.7% forecast range for this year. It will take significant policy thrust to consumer spending, or large supply shocks, for inflation to hit the central bank's medium-term policy target of 2-3%, but we don't see that happening anytime soon.

Low inflation opens doors for monetary stimulus...

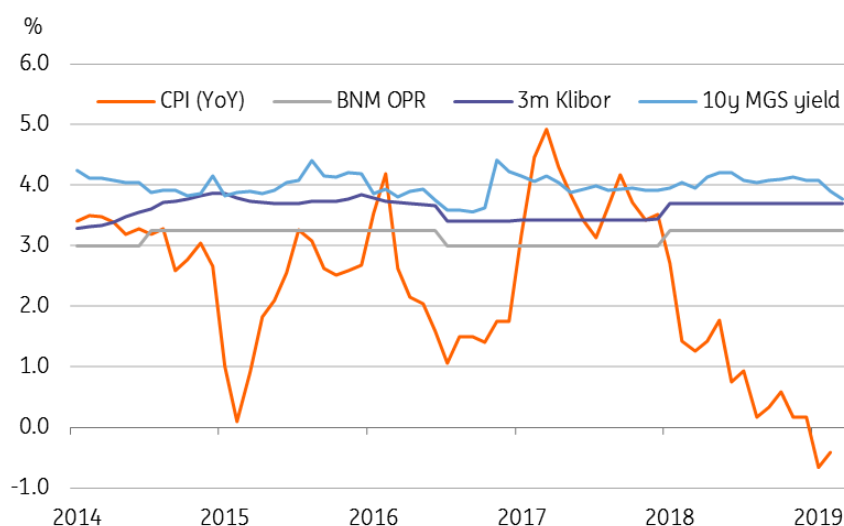
Negative inflation also prompted us to revise our view on the central bank policy from no change this year to one 25bp rate cut in the current quarter, possibly at the next policy meeting scheduled for 7 May.

Recognizing the downside risks to domestic growth, the thrust of monetary policy in 2019 is to remain accommodative to ensure supportive conditions for sustainable economic growth amid the subdued inflation outlook. - BNM Governor Shamsiah Yunus

There are no forceful arguments for easing just yet, but pre-emptive easing to support future growth won't hurt when there is room. Besides growth and inflation influence policy and the following factors substantiate our rate cut view:

- **High real interest rates:** The recent falling inflation trend has pushed real interest rates higher. As noted earlier, investment spending has been a weak spot in GDP growth, and high real interest rates are a further deterrent to investor sentiment.
- **Better now than later:** Being ahead of the curve should allow sufficient time for the impact of monetary easing to trickle down to the real economy, thus preparing the economy to ride the slowdown trend. It won't hurt given there is scope for easing now.
- **Mature tightening cycle:** Based on recent BNM policy history the current tightening cycle appears to have matured. Previous BNM tightening cycles have sometimes been short-lived, and we think this could be another short one, particularly given current growth-inflation dynamics.
- **Market re-pricing for easing:** We infer from the 30 basis point drop in the 10-year local government bond yield so far this year to 3.77%, the market has been re-pricing for a rate cut. Meanwhile, a sound external payment position is keeping the currency among Asia's outperformers this year. In a soft USD environment, this supports BNM easing now, rather than waiting to cut later.

Falling inflation leads to higher real interest rates



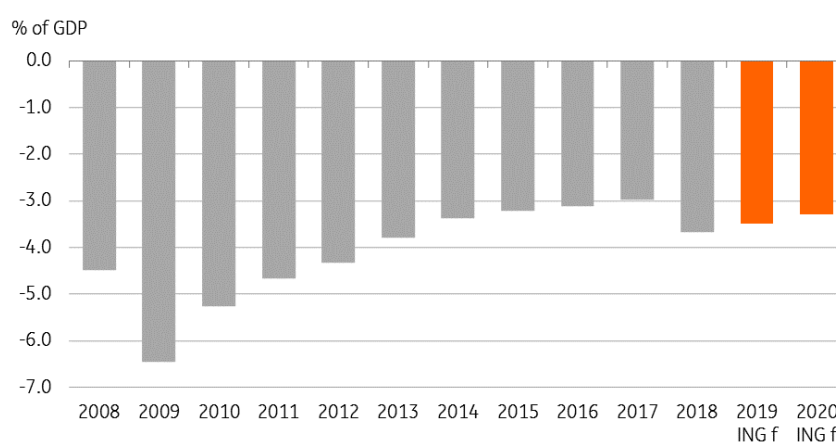
Source: Bloomberg, ING

... as the fiscal restraints prevail

Just as 2018 was a turning point for Malaysian politics, marking an end to the 60-year old Barisan Nasional coalition regime, it also was a turnaround year for the country's public finances. Sweeping policy changes under the new government of prime minister Mahathir were associated with a sharp spike in the fiscal deficit up to 3.7% of GDP - a significant slip above the initial target of 2.8%.

The highest fiscal deficit ended the steady fiscal consolidation the public finances had followed since 2009. With slower growth ahead, curbing the deficit to something below the 3% comfort level will be a challenge for the government in the medium term. The official projection has the shortfall easing to 3.4% in 2019 and then a gradual reduction to 2.8% by 2021, keeping with the medium-term Malaysia Plan review of (above) 3% deficit over the remaining plan years, 2018-2020.

Fiscal deficit - a decade-long consolidation comes to an end



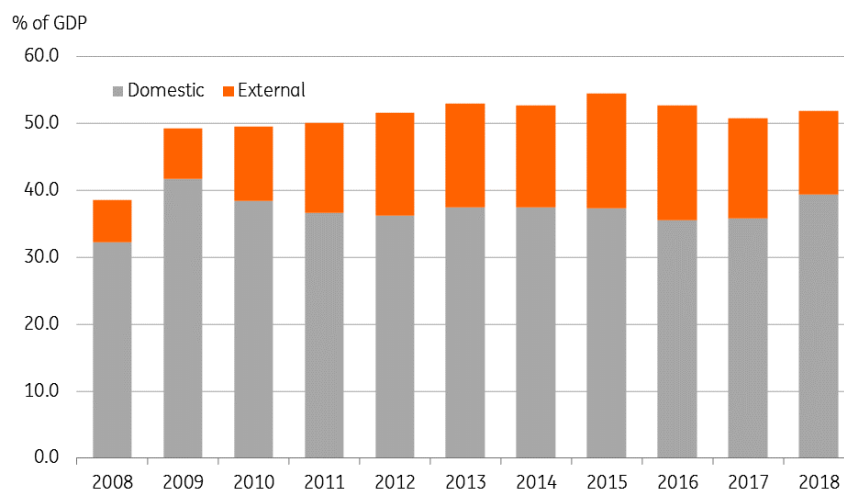
Source: CEIC, ING

Oil price and public finances

Two key factors likely to determine the course of public finances in the coming years will be oil price trends and progress on reducing the public debt.

- Rising oil prices are positive for the economy and public finances. They won't only soften the impact of the global trade war on Malaysian exports but also will increase the petroleum revenue for the government. But high oil prices also mean higher government spending on fuel subsidies for the public.
- We believe the 2014 crash was a permanent shock to the global commodity prices. Global oil prices are creeping up this year, though the potential slowdown in global demand could stall the recovery, but it's unlikely we're going to see \$100/barrel.
- High level of public debt, estimated over MYR 1 trillion (80% of GDP), will keep the operating expenses on interest payments elevated, while the plan to significantly cut down on debt over this and next year faces headwinds from slower revenue growth. The cancellation costs of some of the infrastructure projects undertaken with other countries might as well blunt the debt reduction efforts.

High public debt



Source: CEIC, ING

Note: Excluding debt of Sovereign Fund 1MDB

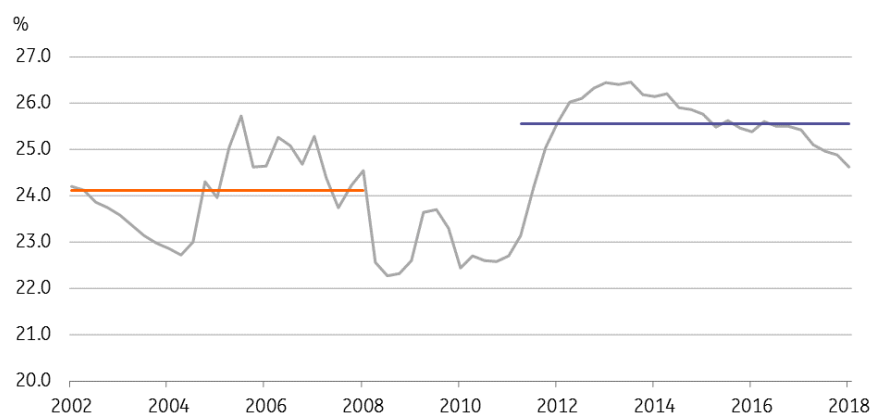
Structural investment weakness

We consider Malaysia more of 4-5% growth economy than 5-6% - the range that prevailed before the 2008-09 global financial crisis. Like most Asian economies, the crisis permanently stunted growth lower and the 2014 global commodity price collapse caused further damage to the net oil exporter.

Going forward, the downside GDP growth risk also stems from weak investment demand. Aside from the ongoing suspension of public projects continuing to depress investment into the medium-term, we observe a structural downward shift in both the investment rate as well as efficiency. Having peaked above 26% just before the 2014 global commodity price crash, the share of gross fixed capital formation in GDP - the investment rate - dipped below 25% last year.

Although the 25.5% average investment rate in recent years (2012-18) was an improvement over 24.2% average a decade ago (2002-08), average GDP growth slowed to 5.1% from 5.8% over the same period, with an even steeper slowdown in domestic demand growth to 5.5% from 6.8%. The contrast of firmer investment rates and yet slower GDP growth may be explained by falling investment efficiency evident from more capital required to produce one unit of GDP (incremental capital-output ratio, or ICOR).

Falling investment rate (fixed capital formation as share of GDP)



Note: Flat lines are period averages for 2002-08 and 2012-18, 24.2% and 25.5% respectively..

Source: CEIC, ING

Falling investment efficiency

Period average	2002-08	2012-18
GDP growth	5.8%	5.1%
Domestic demand growth	6.8%	5.5%
Net export growth	2.2%	1.7%
Current account/GDP	12.4%	3.9%
Investment rate	24.2%	25.5%
ICOR (units of capital per unit of GDP)	4.2	5.0
Average investment efficiency (1/ICOR)	0.24	0.20

Note: Geometric averages for GDP, domestic demand and net exports; simple averages for current account and investment rate

Source: CEIC, ING

Narrowing external surplus, yet resilient ringgit

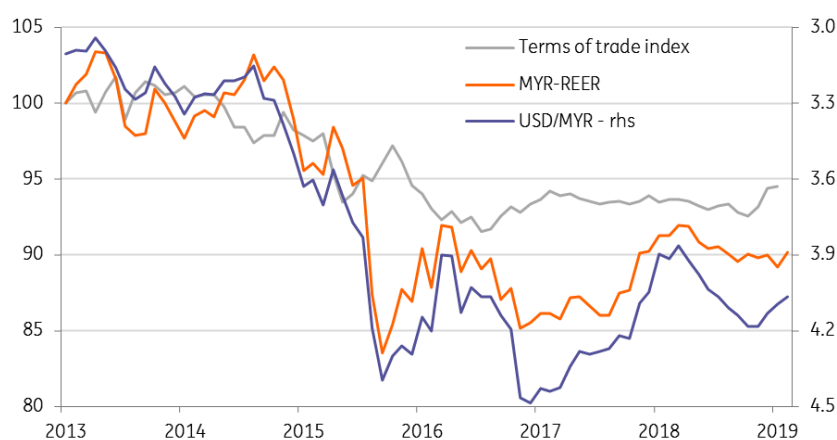
Weak global demand combined with subdued commodity prices suggest the recent trend of narrowing trade and current account surplus will continue to be a drag on GDP growth in the coming years. On our forecast, the current surplus falls to 2% of GDP in the current year and further below 2% next year, from 2.3% recorded in 2018.

Despite a narrowing current account surplus, the external payments position remains sound enough for the currency's performance going forward. Maintaining its position as an outperforming Asian currency in the last two years, the MYR has gained 1.3% against the USD so far this year. Despite this, the MYR real effective exchange rate continues to indicate some undervaluation, which is positive for the competitiveness of Malaysia's exports even as Malaysia's terms of trade appear to stagnate.

Moreover, potential USD weakness from easier Fed policy should continue to sustain the emerging currency strength in the period ahead. Barring any adverse domestic economic factors, we don't think the MYR will be an exception to the broader emerging market currency appreciation trend.

We are revising our end-2019 USD/MYR forecast to 4.05 from 4.10 (spot 4.08).

Stagnated terms of trade, undervalued currency



Source: Bloomberg, ING

Key economic indicators and ING forecasts

Malaysia	2015	2016	2017	2018	FY2019 f	FY2020 f
Real GDP (% YoY)	5.1	4.2	5.9	4.7	4.6	5.0
CPI (% YoY)	2.1	2.1	3.8	1.0	1.0	1.8
Unemployment rate (%)	3.2	3.5	3.4	3.3	3.4	3.3
Fiscal balance (% of GDP)	-3.2	-3.1	-3.0	-3.7	-3.5	-3.3
Public debt (% of GDP)	54.4	52.7	50.7	51.8	45.8	46.0
Current account (% of GDP)	3.0	2.4	3.0	2.3	2.0	1.6
FX reserves (US\$bn)	95.3	94.5	102.4	101.4	108.0	116.0
External debt (% of GDP)	65.4	68.6	69.2	64.9	65.2	66.2
Central bank policy rate	3.25	3.00	3.00	3.25	3.00	3.00
3M interbank rate (% eop)	3.84	3.41	3.44	3.69	3.45	3.45
10Y govt. bond yield (% eop)	4.19	4.23	3.91	4.08	3.70	3.80
MYR per USD (eop)	4.29	4.49	4.05	4.13	4.05	4.00

Source: Bloomberg, CEIC, ING

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