By Global Economics & Markets Research

ASEAN monetary policy: Gradual and lagged rate hikes with limited impact on capital flows

Summary

ASEAN central banks are likely to start lifting-off only nearing the latter part of this year in contrast with some of their other global EMs counterparts elsewhere that have already begun tightening rates.

Given ASEAN's stronger external positions, the risks of capital outflows are mitigated. In fact, allowing them to keep rates lower for longer will support the domestic economic recovery. However, country with twin deficits would be more vulnerable than one(s) that does not, especially in the light of potential external downside risks, e.g. geopolitical risks.

In our view, the Bank Negara Malaysia (BNM) and the Philippine Central Bank (BSP) will hike first, followed by the Bank of Thailand (BOT), and the Bank Indonesia (BI). BI is expected to deliver the most quantum of rate hikes this year, amounting to a cumulative of 100bps in 2H 2022.

It is almost certain for the markets that the Federal Reserve (Fed) is very likely to deliver at least 5 rate hikes this year, possibly more and with other possible surprises (see US: Front Loading Fed Rate Hikes As Jan CPI Inflation Continued To Soar), emerging markets will start to follow suit. Nevertheless, idiosyncratic factors exist amongst them, most notably the strength of each's external sector, and to lesser extent, ramifications to the domestic sector in determining the timing of this first hike.

In this regional note, we take a closer look at 4 key regional interest rate-based central banks of Indonesia, Malaysia, Thailand, and the Philippines and found that all these ASEAN regional central banks are likely to have their first lift-off only in the latter half of this year, lagging behind its Eastern European or Latin American emerging economies who have started their hiking cycle. However, we do not think that such lagged responses to DMs policy normalization would come at their disadvantage as their relatively external positions have been much stronger, allowing their respective central banks more time to support economic recovery by keeping rates lower for longer without jeopardizing significant risks of capital outflows, as evident from recent strong inflows to Thailand and Indonesia. Our analysis concludes that BNM and BSP will hike first in 2Q22 (but closer to the tip end of that quarter), followed by BOT's likely token (one-off) hike of 25bps in 3Q22, then BI for series of hikes starting from 3Q22 consisting 2x25bps in Q3 and 2x25bps in Q4.

Our analysis shows that from the inflation perspective, demand-pull pressures from these economies seem to have gotten back albeit rather gradual. For example, the BNM sees underlying inflation or core inflation rising but to remain modest amid continued slack in the economy and labor market. However, the inflation outlook, is subject to global commodity price movements and prolonged supply-related disruptions. Indonesia, another example, will see higher administrative price hikes in the form of VAT hike later this year, along with an increase in cigarette excise tax. But, as far as the overall demand goes, it remains in a slow pace of return to its usually robust pre-pandemic level, most notably in those non-

essential consumption. In the case of the Philippines and Thailand, elevated global oil prices and continued shortage in selected food supply may put pressure on inflationary pressures to build up further.

Externally, FX reserves have been stronger (as compared to pre-pandemic) and this is a boon for these four economies in weathering the possible capital reversal storm amidst the upcoming rate hikes by the Fed (see: Asian Focus: Whither Regional Portfolio Capital Flows Amidst Fed's Tapering). Current account (CA) positions of these economies are also relatively resilient, with all but the Philippines expected to remain in surplus for year 2021. Specifically, Indonesia is recording a surplus in its CA for the first time in a decade (but likely to be one-off), thanks to a sharp rise in global commodity prices and the demand for these commodities. And finally, from the first two factors, one should expect the exchange rate movement to remain relatively well-measured against the USD movement, though we believe that broad dollar strength will ensue following US monetary policy normalization.

That said, there is more vulnerability of a more sustained capital outflows in the case of country with twin deficits, like Indonesia viz. economies with strong and a more sustained current account surplus like Malaysia or Thailand, for example. Additional possible downside risk scenario is for an economy in this region would be forced to hike by more in the event of a lagged monetary policy tightening. This might happen, for example, when larger than anticipated capital outflows took place and trigger excessive currency volatility during the potential adverse external shocks such as negative geopolitical development.

Malaysia

For Malaysia, the central bank implements monetary policy that aims to maintain a low and predictable pace of inflation taking into consideration the economic outlook and risks of financial imbalances. Malaysia's monetary policy does not have an explicit inflation targeting framework. However, its monetary policy approach has been effective in keeping inflation stable with headline inflation averaging 2.2% between 2001-2010, 1.9% between 2011-2020, and 2.5% in 2021. As such, we assume that a stable and comfortable inflation range to be between 2.0%-3.0%. For 2022, we expect inflation to average on the upper-end of this range at 3.0% (vs MOF est: 2.1%).

Malaysia's headline and core inflation has trended higher above its 12-month rolling average (see figure below). Headline inflation picked up to 3.2% y/y in 4Q21 (3Q21: +2.2%), mainly due to the normalisation in electricity prices following the lapse in the three-month electricity bill discount implemented in Jul 2021. Higher prices for some core and price-volatile items also contributed to the increase amid supply disruptions. The government aims to use administrative price measures to cap higher food prices, and fiscal/energy policies to manage fuel and electricity cost pressures either through fuel subsidies or maintaining the electricity tariff for households. The rising inflation partly reflects improved demand conditions amid an environment of elevated costs. Private sector wages rose 2.5% y/y (3Q21: -0.9%). Wages in the manufacturing sector rose at a faster rate of 4.7% y/y (3Q21: +2.3%). On a q/q basis, private sector wages continued on its improving trend, growing by 4.5% (3Q21: +0.7%).

As part of its rate setting assessment, BNM continues to assess other price determinants including firms' price setting behavior, household inflation expectations that affect spending decisions, and wage pressures. Thus far, BNM sees underlying inflation or core inflation rising but to remain modest amid continued slack in the economy and labour market. However, the inflation outlook, is subject to global commodity price movements and prolonged supply-related disruptions.

In BNM's latest Jan monetary policy statement, it did not mention the need to review the degree of monetary accommodation and continues to judge that the existing monetary policy stance remained appropriate and accommodative. Notwithstanding BNM's patient note on rates, we expect the Overnight Policy Rate (OPR) to rise twice this year, with the first 25bps hike in 2Q22 and the second 25bps hike in 3Q22. This will bring the year-end OPR target to 2.25%. This is premised on:

1. improving growth momentum assuming that the Omicron wave does not become protracted, globally and domestically;
2. domestic inflation pressures building on the supply and demand side as the economy recovers; and
3. possibility that more aggressive Fed monetary policy normalisation including faster US rate hikes and quantitative tightening may lead the BNM to raise rates to stay ahead of the curve. This would help preserve some room between the OPR and US Fed Funds rate, and maintain exchange rate stability.

The risk of portfolio reversal that could weigh on MYR is high given that the coming US monetary normalisation is expected to more aggressive over a shorter period of time (compared to the last Fed tightening cycle) and given the Fed's much larger balance sheet. Malaysia has also been a recipient of foreign portfolio inflows totalling MYR30.4bn in 2021 (2020: -MYR6.3bn). This marks the highest foreign portfolio inflows since 2012. Foreign holdings of government bonds rose to a record MYR238.2bn or 25.5% of total bonds outstanding as at Jan 22.

During the last expisode of US Fed quantitative tightening in 2017-2019, Malaysia recorded net foreign outflows of MYR28.2bn in 4Q16 and MYR31.7bn in 1Q17. Back then, foreign holdings of government bonds fell from 30.6% of total outstanding at end-2016 to 24.7% in Mar 17, or equivalent to MYR34.3bn of net selling that quarter. Flows returned in subsequent quarters once risk sentiment stabilised. As such, a similar trend of selling pressure may recur in coming months before flows return supported by Malaysia's stable growth fundamentals, robust external position with surplus current account and foreign direct investments. Noteworthy is 49% of foreign holders of government bonds are pensions funds and central banks/government while 37.7% are held by asset managers and 10% are held by banks. This provides some confidence that majority are long-term holders and deemed less speculative in nature.

Figure 1. Malaysia inflation vs. policy rate

Source: Macrobond, UOB Global Economics & Markets Research

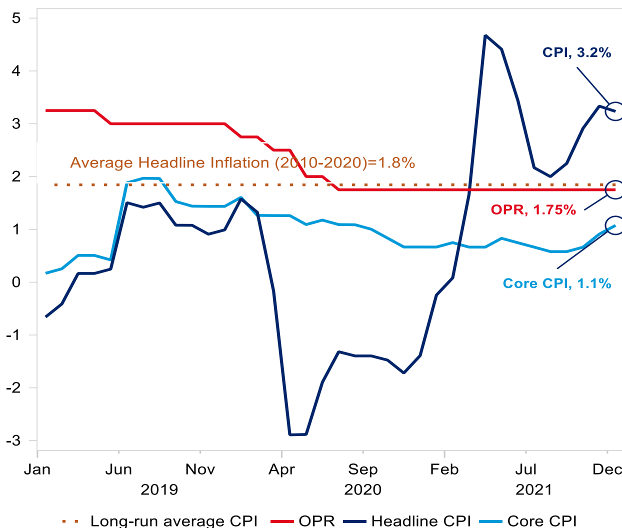


Figure 2. Key inflation contributors

Source: Macrobond, UOB Global Economics & Markets Research

Note:

1. Food prices rose to highest in four years in Dec 21.
2. Utility costs increased from Sep 21 onwards after expiry of electricity bill discounts for households.
3. Domestic fuel prices for RON95 and diesel have been capped at MYR2.05/litre and MYR2.15/litre since Mar 21.

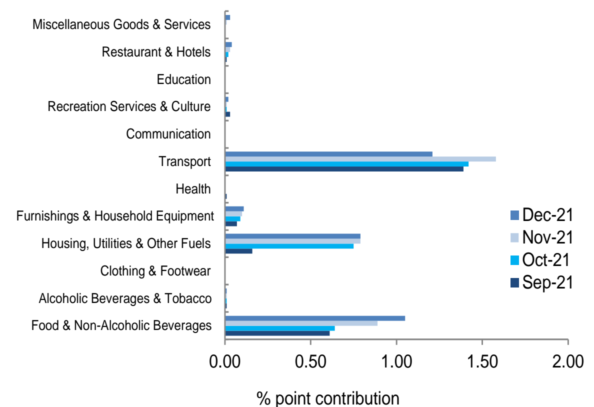


Figure 3. Foreign flows into malaysia's bonds And equities

Source: Macrobond, UOB Global Economics & Markets Research

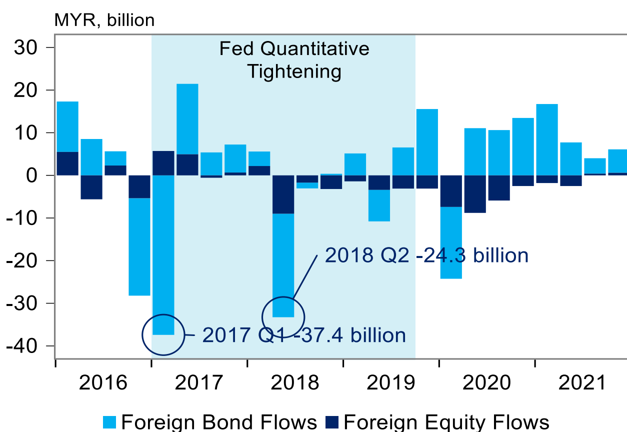
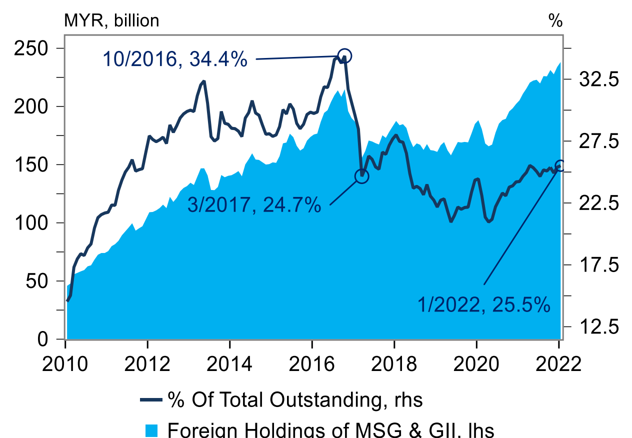


Figure 4. Foreign holdings of malaysia Government bonds

Source: Macrobond, UOB Global Economics & Markets Research



Indonesia

BI is an inflation-targeting central bank and is not in a hurry to hike rates as inflation (latest print at 2.1% yoy for Jan 2022) still remains within the target range of 2-4%, while there is lack of evidence thus far that demand has come back strong enough to put significant constraint to the supply shocks and yield runaway inflation.

Secondly, the country's external balance is stronger, and risks of capital outflows are likely to be manageable, which implies that the relatively stable rupiah would keep BI providing lower rates environment for longer to meaningfully support the economic recovery process. However, the risk remains on the earlier and faster rate hikes by the US Fed that may trigger immediate portfolio capital outflows. Additionally, non-resident holdings of ID bonds have been waning off and could reaccelerate. But recent data have suggested that many non-residents portfolio flows have returned to the shore sharply in February-to date.

Thirdly, BI-MOF exit strategy and communication about burden sharing will be key to anchor investors' confidence going forward. On balance, we keep our view for BI to start hiking in H2 2022, starting with 2x25bps hike in Q3, followed by another set of 2x25bps hike in Q4, and a final set of 2x25bps in Q1 23, bringing a likely terminal rate hike this round to 5%. Our forecast is intact despite the assumptions of view that the Fed could move more aggressively. Domestic-driven reason would include demand-pull inflation will only start showing in the latter half of this year, and the rate of rupiah's depreciation will remain gradual on the back of its return to a backdrop of its usual self: current account deficit (reversing the anomaly current account surplus of 0.28% of GDP in 2021 – see Indonesia: 2021 Current Account Recorded A Surplus Of 0.28% Of GDP).

Figure 5. Inflation is inching higher to BI's mid-point target

Source: Macrobond, UOB Global Economics & Markets Research

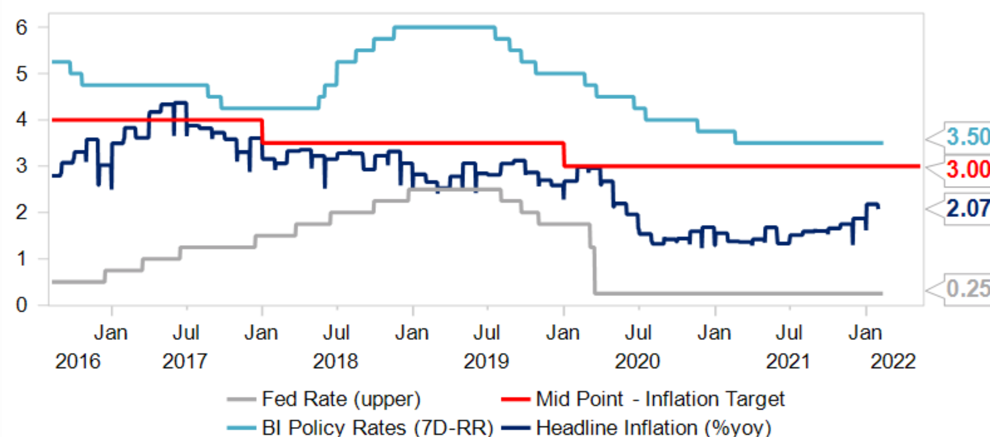


Figure 6. Strong bonds inflows in February 2022

Source: Bloomberg, UOB Global Economics & Markets Research

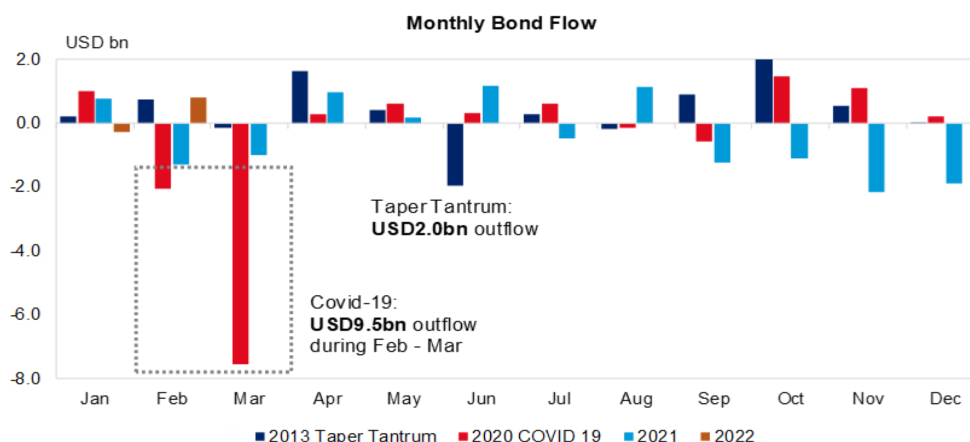
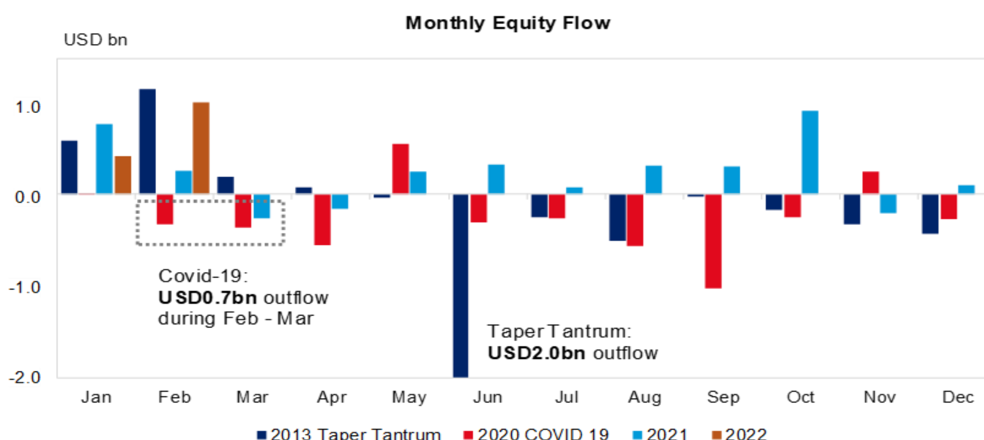


Figure 7. And in the equity markets

Source: Bloomberg, UOB Global Economics & Markets Research



Philippines

As the BSP is also an inflation-targeting central bank, the elevated global oil prices and continued shortage in selected food supply particularly pork and fish have renewed the central bank's concern about near-term inflation in the Philippines. Apart from commodity-related factors, the Fed's abrupt shift in policy since Dec 2021 will further weigh on the Peso and subsequently intensity the Philippines' import price inflation through the year. With these, the nation's headline inflation is expected to hover above the mid-point of the central bank's 2.0%-4.0% target range over the policy horizon (BSP est: +3.7% for 2022 and +3.3% for 2023; UOB est: +3.5% for 2022 and 2023).

Despite increasing upside risks to the country's inflation outlook, the BSP continued to express optimism about domestic growth momentum ahead. It projects the nation's real GDP to return to pre-pandemic levels by 3Q22, in line with our expectations. The central bank also expects the output gap to turn positive by 2H22 amid lingering downside risks from elevated global commodity prices, heightened geopolitical tensions, and softening global growth prospects. One of the key catalysts sustaining the domestic growth momentum is the government's re-opening of its international borders to fully vaccinated tourists from more than 150 countries, without having to undergo facility-based quarantine effective 10 Feb. This alongside improving vaccination rates and better management of the pandemic in the country will help restore real GDP growth to a more solid pace through 2022 (official est: 7.0%-9.0%; UOB est: 5.5%).

Both rising inflationary pressures and improving domestic growth outlook coupled with expectations of a more aggressive Fed tightening have piled pressure on BSP to start normalizing its monetary policy. This is clearly observed in the BSP's monetary policy statement released on 17 Feb, in which the central bank dropped its patient note and added a new line to convey the message of a potential change in its monetary policy stance over the coming months should conditions warrant it and inflation surpasses its target range in the near term. In the previous Fed rate hike cycle in Dec 2015-Dec 2018, BSP began to hike its RRP rate in May 2018 after the Fed had embarked on a series of interest rate increases by a total of 150bps and the Philippine headline inflation breached the 4.0% handle for three months in a row.

Therefore, we have revised our BSP outlook to three rate hikes this year with a 25bps increase in each quarter starting from 2Q22 (vs previous est: two 25bps hike in 2H22), bringing the RRP rate to 2.75% by end-2022 (current: 2.00%). We roll out the possibility of back-to-back interest rate hikes as we believe that the BSP will carefully develop its policy normalization plan in order not to choke off the existing growth momentum particularly when downside risks still linger. The rate hike path beyond 2022 is also anticipated to be gradual given the broadly balance risks to the inflation outlook and more stable economic growth prospects.

We project the number of BSP rate hike to reduce from three times this year to two times in 2023 (+25bps in 1H23 and +25bps in 2H23), and the central bank will end its rate hike cycle with an additional 25bps rise in 2024. This will eventually bring the terminal rate to 3.50% by end-2014, with a 100bps of interest rate differential with Fed Funds Rate (vs. a minimum of 125bps between 2015 and 2021).

An expected gradual monetary policy normalization path embarked by BSP with narrowing interest rate differentials alongside the uncertainty surrounding the presidential election, which will be held on 9 May 2022, will likely result in persistent portfolio outflows from the Philippines this year (9M21: -USD7.2bn; 2020: +USD1.8bn; 2019: +USD2.5bn). In the previous Fed tightening cycle (QE tapering in 2014, interest rate hike in 2015-2018 and balance sheet reduction in 2017-2019), the Philippines witnessed five consecutive years of portfolio outflows between 2014 and 2018, totaling USD13.6bn or an average of USD2.7bn per year.

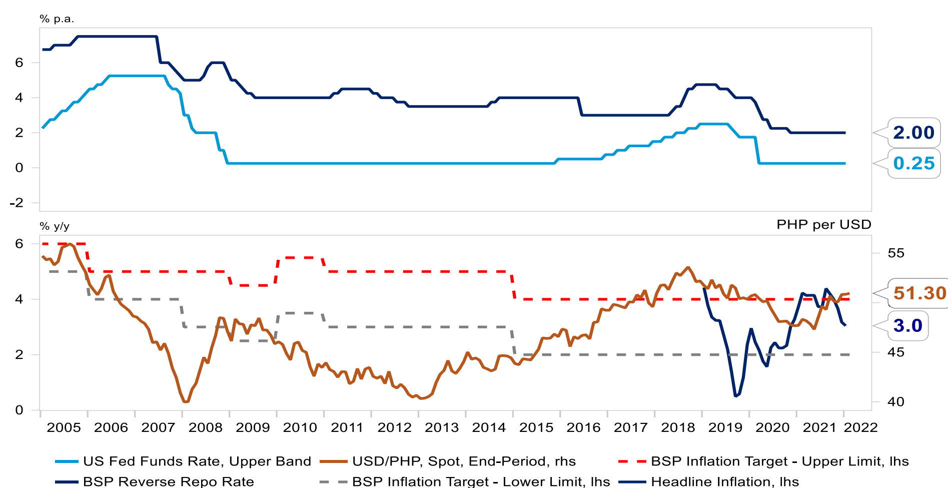
Apart from portfolio outflows, the Philippines is also expected to post a current account deficit (CAD) for the second consecutive year in 2022 due to rising commodity prices particularly crude oil and improving domestic demand for imports. BSP has on 10 Dec 2021 forecasted that the nation's CAD will widen to 2.3% of GDP this year, from an estimated CAD of 1.0% of GDP in 2021 (vs UOB est:-1.0% for 2021 and -2.5% for 2022).

However, the country's current external liquidity buffers are deemed sufficient with gross international reserves still staying high and above the USD100bn level at USD108.5bn as at end-Jan 2022 (versus an average of USD81.6bn in 2014-2019). The latest foreign reserves position is sufficient to finance 10.3 months of imports, which is higher than the average of 8.5 months recorded during Fed policy normalization in 2014-2019 and is 8.6 times short-term external debt based on original maturity (vs average 5.3 times in 2014-2019).

Taking all the above factors into consideration, we expect the Philippines to face manageable risks of capital flow reversals and falling currency brought by Fed's rate hikes and quantitative tightening in the near term. The government's management of the pandemic, policies and reforms of the next President and administration, commodity price movement, and global growth prospects are wildcards for the Philippines' growth outlook, monetary policy direction, capital flows, and currency movement ahead.

Figure 8. A still comfortable gap in policy yield

Source: Macrobond, UOB Global Economics & Markets Research



Thailand

The Bank of Thailand's (BOT) key role is to set a target for the country's monetary policy, accounting for the economic and financial condition and government policies. The monetary policy approach has been an effective tool to keep inflation stable, keeping in mind the impact policy maneuvers may have on the THB. With stable inflation pressures at an average of 1.2% in 2021, the BOT expects inflation to range between 1% and 3% for 2022, as compared to the Commerce Ministry's outlook of between 0.7% and 2.4%. Given the higher oil prices of late and brewing global supply disruptions, we see upside risks to our full-year inflation outlook of 1.2% for the year ahead, although any rise in price pressures are likely transitory and should dissipate in 2H22.

Thailand remains to be more of the more vulnerable economies should COVID-19 risks exacerbates in 2022. COVID-19 infections have been rising in Thailand, especially due to the more infectious Omicron variant. Tourism demand remains to be a key driver for growth in 2022, where authorities have made huge strides in establishing quarantine-free visas and negotiating with global leaders on bubble travel lanes. We remain cautiously optimistic for Thailand to expand by 3.5% in 2022, barring further social restrictions measures.

Foreign reserves rose to US$243.3bn for the week ended 4 Feb 2022, from US$242.1bn the week before. As such, the import cover was at 9.7 months at latest reading, from the peak of 17.4 months in May 2020. Still, reserves are at healthy levels, with the amount enough to cover 3.4 times short-term foreign debt.

Global investors continue to flock to Thailand in 2021 despite the COVID-19 risks, suggesting that Thailand remains to be one of Asia's popular investment destination. Fund flows (equities and bonds) saw a net inflow of US$4.9bn in 2021, bucking three straight years of net outflows (2018: -US$0.1bn, 2019: -US$2.0bn, 2020: -US$9.3bn). Moreover, global funds have poured in US$2.9bn in January, the highest monthly inflow since June 2019, suggesting that global investors are unfazed over Thailand's accommodative rate stance.

Notwithstanding the recovery of investors' confidence in early 2022, Thailand remains vulnerable to fund outflows as seen in past episodes of higher global rates. In the period between 2015 – 2018 during which the US Federal Reserve embarked on its tightening cycle, investors pulled out $5.0bn of equity and bond funds in 2015 alone, marking the largest outflow since available data as of 2009. Even though fund flows returned in 2016, inflows amounted to merely US$11.7bn and were materially smaller compared to the peak at US$31.8bn inflows in 2012, while equities resumed its outflow momentum in 2017 (-US$795.5mn) and 2018 (-US$8.9bn). We think that BOT may likely stay accommodative despite higher global interest rates. Economic downside risks remain tangible given the subdued tourism recovery and weak domestic investor demand. Meanwhile, the Omicron variant poses a material risk to GDP as well as Thailand's tourism-reliant sectors. However, we lean towards a token rate hike of 25bps to bring its benchmark rate to 0.75% in 2022, possibly as early as 3Q22, in response to the faster-than-anticipated FOMC rate hike for the year ahead.

Figure 9. THB bond assets a regional safe haven?

Source: Bloomberg, UOB Global Economics & Markets Research

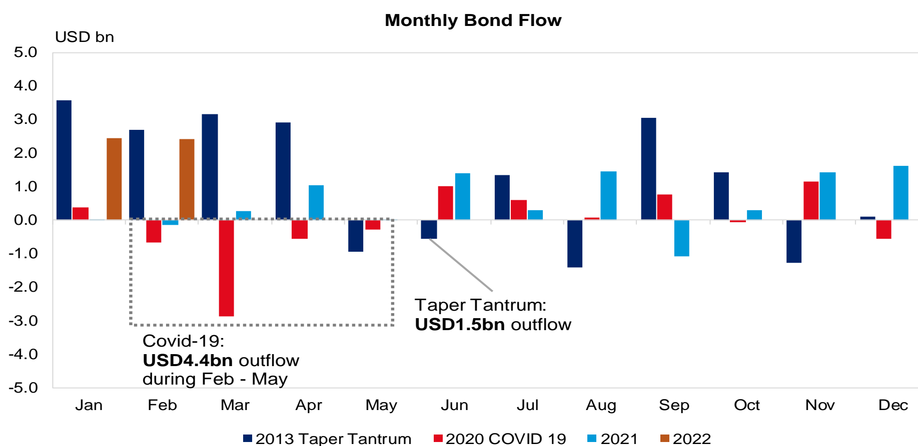
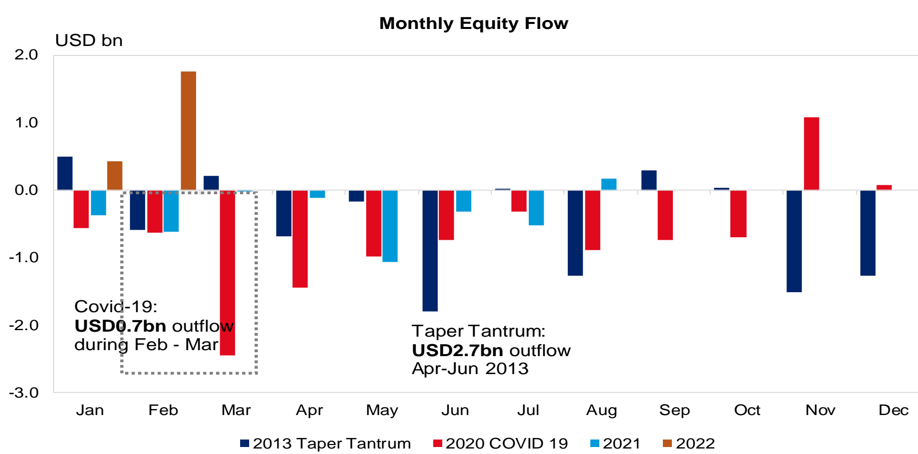


Figure 10. And in equity?

Source: Bloomberg, UOB Global Economics & Markets Research



UOB

Enrico Tanuwidjaja
Economist
Enrico.Tanuwidjaja@UOBgroup.com

Julia Goh
Senior Economist
Julia.Gohml@uob.com.my

Jasrine Loke
Economist
Jasrine.Lokest@uob.com.my

Barnabas Gan
Economist
Barnabas.Gan@uobgroup.com

Research insights

www.uob.com.sg/research

Contact us

Email: GlobalEcoMktResearch@UOBgroup.com
Bloomberg: NH UOB <GO>

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