ASEAN Connect
By Global Economics & Markets Research

ASEAN monetary policy: Uneven timing of rate hikes and impact on capital flows

Summary

The US Fed is likely to be on track in lifting its rates to reach the 3.25-3.50% range by the end of the year, resulting into narrower policy rate differential with the ASEAN counterparts.

We expect the ASEAN-4 central banks to continue with their respective hiking cycle, or starting one soon enough for BI and BOT.

Uneven timing and quantum of rate hikes would have impact on the capital flows to these ASEAN countries, although it isn't clear that those who hiked first will see capital inflows while those who resisted may not necessarily be at a greater risk of capital outflows. So far, there are no signs of disruptive capital flow movements in ASEAN, despite aggressive policy tightening by the US Fed. .

Capital flows movement in ASEAN remain benign despite aggressive Fed actions

The Fed is very likely to deliver an aggressive series of hikes, with our forecast of further liftoff to reach an upper end of 3.50% by end 2022 and further to 4.00% by end of 1Q23 (see Central Bank Policy Focus: When The Fed Aggressively Hikes, How High Can The Asian Central Banks Go?).Emerging markets central banks will start to follow suit or risk falling behind in the rate gap with US interest rate.

With uneven timing and quantum of rate hikes by the various ASEAN central banks, there would be impact on the capital flows to these ASEAN countries, although it isn't clear that those who hiked first will receive tremendous amount of capital inflows while those who resisted may not necessarily be at risk of capital outflows. So far, there are no signs of disruptive capital flow movements in ASEAN, despite aggressive policy tightening by the US Fed.

Our country-specific analyses that follow show that Malaysia and Thailand have recorded net portfolio inflows on a year-to-date basis while Indonesia and the Philippines are still recording net outflows. Malaysia's BNM and the Philippines' BSP are expected to deliver further rate hikes while Thailand's BOT is likely to deliver its token rate hike only later this year. Indonesia's BI is likely to hold on to its rates for 1H22 and we expect it to hike next month (Jul).

One major factor for the benign picture of capital flows is that these ASEAN-4 economies have built up relatively sound external sector positions with stronger FX reserves and this is a boon in weathering the possible capital reversal storm amidst the aggressive rate hikes by the US Fed (see: Asian Focus: Whither Regional Portfolio Capital Flows Amidst Fed's Tapering).

Unlike decades ago, current account (CA) positions of these economies are also relatively resilient to cushion the impact of capital outflows risks while having fully flexible exchange rate regimes allow these economies to absorb the externally-driven shocks through synched movements in their respective exchange rates and allow the economy to sustainably grow.

Nevertheless, the major risk in these ASEAN-4 countries are the significant jump in the inflation rates due to higher oil and food prices in light of the ongoing uncertainty in the Russian-Ukrainian conflict and supply chain disruptions, especially in the Chinese ports, which are still expected to persist in due course. Persistently high commodities prices and supply disruptions could put all 4 central banks to eventually be in-sync in terms of their rate-hiking cycle in response not only to counter Fed's aggressive hikes but also to manage the risks of higher and possibly more persistent inflationary pressures.

In short, based on data to date, capital flows in ASEAN remained well behaved especially relative to the periods of early 2020 (COVID-19 pandemic) and the 2013 taper tantrum period, and the probability of disruptive capital outflows is greatly reduced as ASEAN central banks accelerate their own policy tightening cycles in the second half of 2022.

Malaysia

Although BNM does not adopt an inflation targeting framework, headline inflation remains manageable largely due to government subsidies in place. Nevertheless, the rising cost of the government's subsidy bill and supply distortions due to the price controls are pushing the government to reevaluate the subsidy mechanism. Meanwhile improving domestic growth prospects following a full reopening of the economy and country's borders in Apr-May are pushing up underlying demand price pressures.

Core inflation rose for the seventh straight month to 2.1% in Apr, marking the highest level since Jan 2018. It has risen above the long-term average of 1.4%, and edged closer to headline inflation of 2.3%. This trend is likely to continue into 2H22 given persistent global food supply shortages, higher commodity prices, the lapse of favorable base effects (particularly in electricity rates), and currency weakness. Higher demand-driven inflation owing to normalising domestic activity and labour market improvements would continue to fuel upside risks to underlying inflation. A higher minimum wage of MYR1,500 /month (w.e.f. 1 May), labour shortages, and higher demand for skilled labour in new growth areas are helping to narrow Malaysia's pay gap. This coupled with easier financing options and excess funds saved during the pandemic is helping to drive consumer spending and fuel secondary price pressures.

Thus, BNM projects underlying inflation or core inflation to average higher at 2.0%-3.0% this year, which is closer to its headline inflation target of 2.2%-3.2% (UOB est: 3.0%). Noteworthy is that current inflation projections have not accounted for potential upward revisions in other price-administered items (i.e. flour, sugar, and cooking oil) or adjustments in electricity and water tariffs as well as fuel subsidies that will further exacerbate upside risks to the baseline inflation forecasts. Should these price revisions materialize, it will further intensify the second-round effects on inflation.

More central banks have done back-to-back rate hikes or larger-than-expected hikes since May. Reasons cited include strong inflation pressures (above targeted levels) and a resilient economy. We think a more persistent inflation outlook has forced the hand of more central banks to front-load the rate hikes in order to tame long-term inflation expectations and shore-up their credibility. However, the aggressive tightening policy guidance, fallout from Ukraine crisis, COVID measures in China, and tighter global financial conditions are fanning global recession fears.

As such, we think BNM would need to weigh how these factors could affect domestic economic conditions while the fast narrowing rate gap with US puts more pressure on capital flows and the Ringgit (MYR). Key takeaway is that doing nothing or acting too slow could sow the seeds of more persistent and elevated inflation in the future, with more negative effects on demand and the economy. Rate hikes would then also need to be sharper and more abrupt in that scenario. There may also be a need to act faster now in order to have sufficient policy buffers in preparation for the next recession (when it happens). A lagged policy response by BNM relative to peers could also risk excessive MYR volatility in 2H22.

Given the ongoing domestic recovery and latest developments, we think there is room for BNM to follow-through with another 25bps rate hike at both the July and Sep meetings. This follows BNM's move to embark on monetary normalisation with an increase in the Overnight Policy Rate (OPR) by 25bps to 2.00% in May. This was the first rate hike since Jan 2018. Though BNM sounded that the removal of monetary accommodation will be "measured and gradual", the pace of recalibration could be adjusted depending on the conditions of the economy and recent events. BNM acknowledged that the negative output gap, a potential indicator of rate adjustments, was closing faster than projected. Meanwhile there is growing consensus that global food and energy prices will continue to stay elevated for longer, whereby potential supply shocks could drive prices and inflation even higher. As we expect Malaysia's growth momentum to remain robust this quarter and next, we think that BNM may consider bringing forward rate hikes to keep a lid on inflation risks while growth remains decent. Our updated OPR projections are 2.50% by end-2022 and 3.00% by end-2023. Even after projected hikes of 75bps for this year, monetary policy would still be accommodative as it only reverses part of the 125bps of rate cuts during the pandemic.

Malaysia has been a recipient of foreign inflows since the start of the pandemic, with net inflows recorded YTD to May. Despite some outflows in Mar-Apr amid the Ukraine war, cumulative net inflows (since Jan 2020) remain positive at MYR32.5bn (US$7.4bn) as at May. Holdings of government bonds by foreigners have edged down albeit still relatively stable at 24.2% of total outstanding (vs peak of 25.5% in Jan 2022). However, the attractiveness of Malaysian government bonds has faded amid the sharp rise in US Treasury yields and weaker MYR. Since mid-Apr, USD/MYR traced the sharp rise in USD/CNY and tested a two-year high of about 4.41 in Jun. With China being Malaysia's top export destination, it is no surprise that the currency or economic woes in the former would also pass through to MYR. The dwindling yield advantage over US Treasuries given the higher rate hike profile of the Fed relative to BNM is expected to weigh further on the MYR.

During the last expisode of US Fed quantitative tightening in 2017-2019, Malaysia recorded net foreign portfolio outflows of MYR28.2bn in 4Q16 and MYR31.7bn in 1Q17. Back then, foreign holdings of government bonds came off from higher levels of 30.6% at end-2016 to 24.7% in Mar 2017, or equivalent to MYR34.3bn of net selling that quarter. Flows returned in subsequent quarters once risk sentiment stabilised. The upsides today are Malaysia's foreign holdings were not that high to begin with, the foreign holders of government bonds are more sticky (i.e. pensions funds and central banks/governments: 48.4%, asset managers: 37.5%, and banks: 11.0% as of end-Mar 2022), economic momentum has picked up, BNM has embarked on rate-hiking cycle, and inflation pressures would be partly tempered by government subsidies. While Malaysia's political uncertainty may be a consideration, we think in the larger scheme of things, Malaysia would remain favourable as global investors reevaluate countries' geopolitical risks and divert funds to "safer" countries that have less complications, stable economic and financial fundamentals, proven resilience, robust external position, and natural resources.

Figure 1. Malaysia's core inflation has moved above long-term historical trend

Source: Macrobond, UOB Global Economics & Markets Research

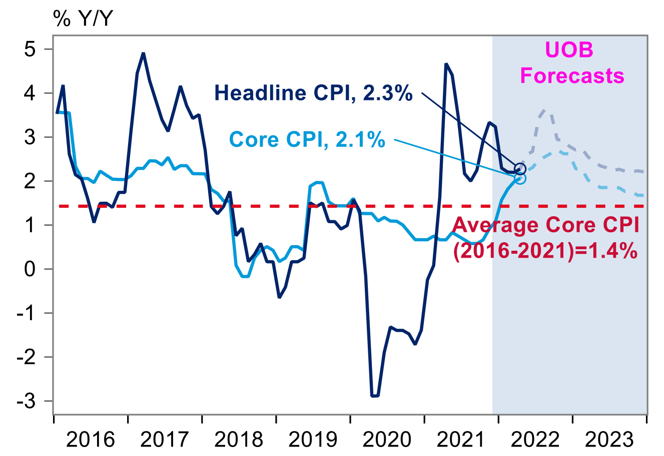


Figure 2. Interest rate gap between OPR and Fate Rate

Source: Macrobond, UOB Global Economics & Markets Research

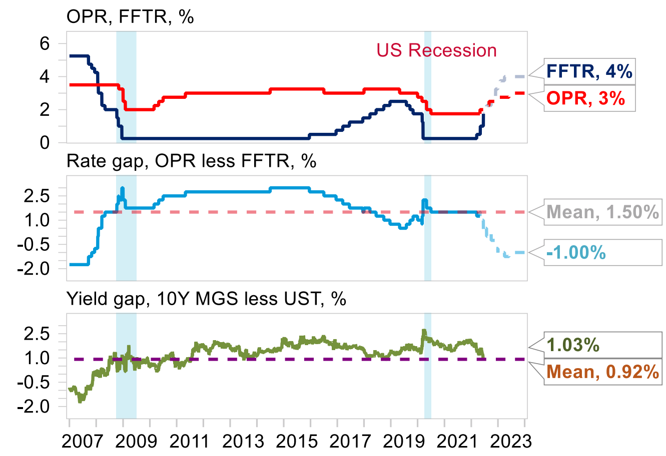


Figure 3. Foreign flows into Malaysia's bonds and equities

Source: Macrobond, UOB Global Economics & Markets Research

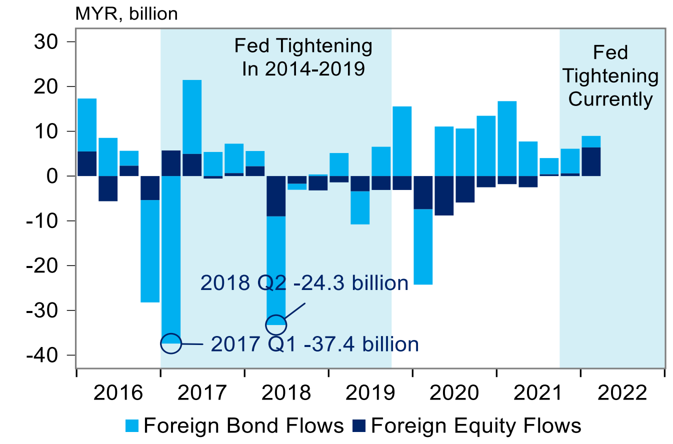
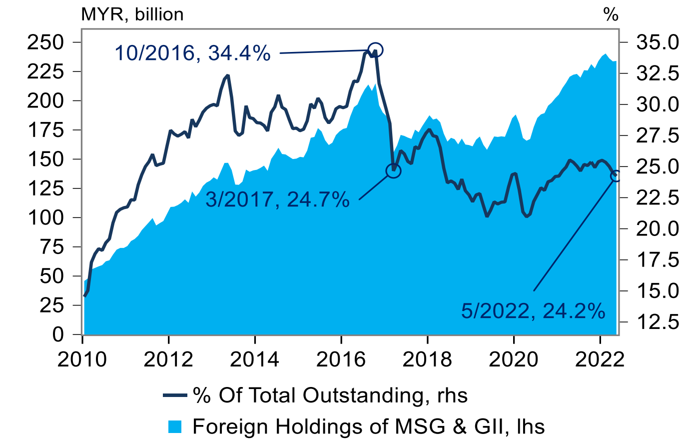


Figure 4. Foreign holdings of Malaysian government bonds

Source: Macrobond, UOB Global Economics & Markets Research



Indonesia

BI seems to remain relatively comfortable to keep its policy rate at current level of 3.50%, which is historical low, and telegraphs to the market that it is not in a hurry to hike rates as inflation (latest print at 4.4% y/y for May 2022) remains within the target range of 2-4%. Key factor for keeping rates unchanged for 15 months in a row now is the lack of evidence thus far that demand has come back strong enough, measured by core inflation trend, such that it warrants BI to embark on rate hiking cycle to anchor inflation expectations. Adding to that, the country's external balance remains strong with 1Q22 current account position recording a surplus position, giving some comfort to BI that risks of capital outflows are likely to be manageable. This has somewhat been reflected to some degree through the relatively stable rupiah exchange rate. Finally, BI seems to take on the route of lowering the amount of excess liquidity in the market first through a more aggressive hike in the reserve requirement, now reaching a terminal point of 9% by the end of 2022 from previous 8% (see Indonesia: BI Holds Interest Rate Unchanged In May).

However, the risk of large capital outflows remains, now that the US Fed rate hike and balance sheet reduction are more aggressive, which could in turn trigger more immediate portfolio capital outflows.

In Indonesia, non-resident holdings of ID bonds have dwindled now to just 16.5% share (Figure 9) from once a high of 40% before the COVID-19 pandemic and continue to head southward comparing to the start of this year. Non-residents portfolio flows have returned to the shore in February but quickly reversed the trend into sharp outflows in Mar to May and is still far from being recouped in Jun (so far, inflows of circa USD675mn is recorded on month-to-date basis). On a year-to-date basis, cumulative net outflows in the bond market stood at slightly above USD4bn.

It is quite a different story for the equity market, which recorded one of its best years as it played catch-up to the earlier global equity rallies (which has lost some steam lately). Almost USD5bn is recorded as net inflows in the equity market on a year-to-date basis, with close to USD3bn of portfolio equity capital inflows in the month of Apr alone. However, there was an outflow of circa USD250mn in May and so far in Jun, some USD130mn has returned.

On the currency front, the rupiah exchange rate so far has been relatively stable amidst triple intervention strategy by BI and its current preferred channel of tightening via raising the reserve requirement ratio for banks. 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 terminal rate this round to 5%. Domestically, as demand-pull inflation will likely to start showing a more persistent sign in the latter half of this year and coupled with our view that the current account balance will also turn into deficit as import demand gradually comes back, in line with stronger domestic economic recovery, BI will start to normalize its monetary policy via interest rate hike.

Figure 5. Inflation edging closer to the upper-end range

Source: Macrobond, UOB Global Economics & Markets Research

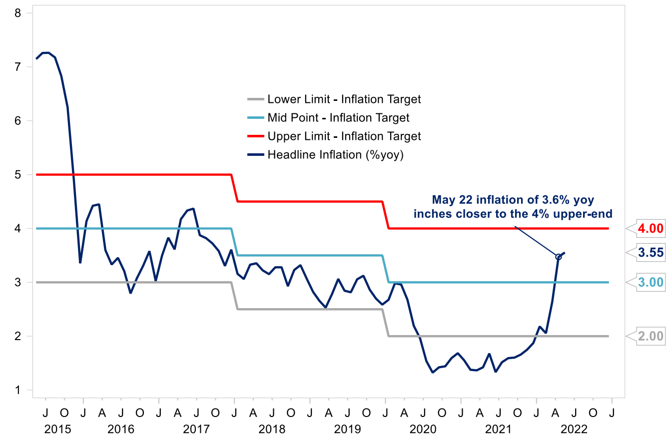


Figure 6. US-ID policy rate differential narrows

Source: Macrobond, UOB Global Economics & Markets Research

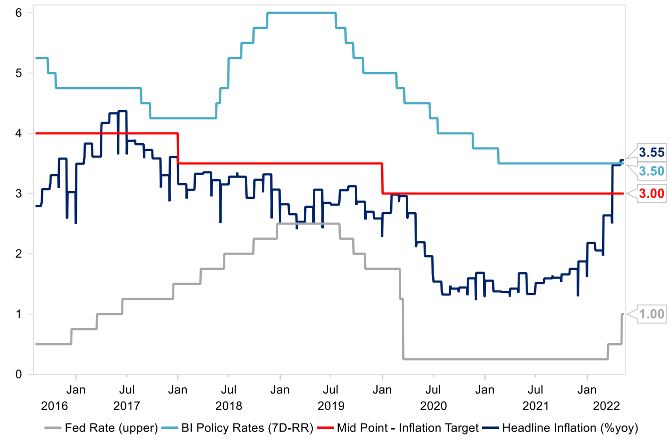


Figure 7. Larger bond outflows in Mar-May 2022

Source: Bloomberg, UOB Global Economics & Markets Research

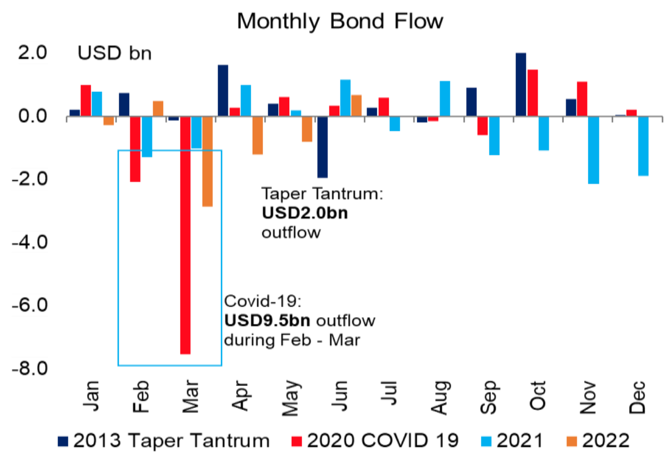


Figure 8. And in May 2022 in the equity markets

Source: Bloomberg, UOB Global Economics & Markets Research

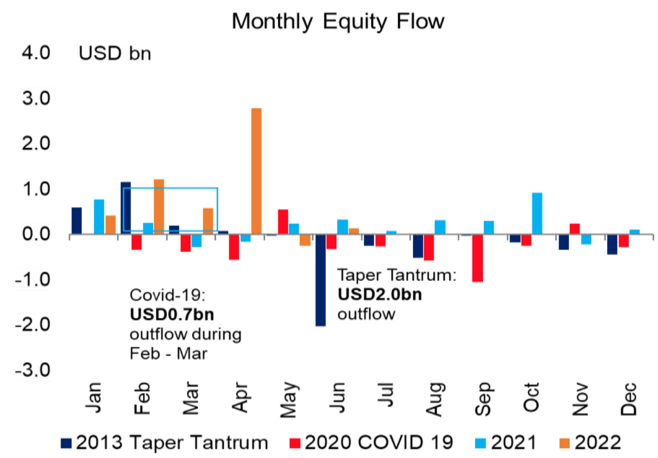


Figure 9. Foreign holdings dwindle to just 16.5%

Institution	Δ (Delta in IDR T)						Ownership							Outstanding 30 May 22 (IDR T) 4,791
	As of 31 Dec 21	As of 31 Jan 22	As of 28 Feb 22	As of 31 Mar 22	As of 30 Apr 22	As of 30 May 22	End of 3Q21	End of 4Q21	As of 31 Jan 22	As of 28 Feb 22	As of 31 Mar 22	As of 30 Apr 22	As of 30 May 22	
Bank (Conventional & Sharia)	3.2	60.6	56.5	(15.1)	(49.2)	(30.9)	▲ 33.7	▲ 35.1	▲ 35.3	▲ 35.8	▲ 35.0	▲ 33.8	▲ 33.6	1,611
Foreign/Non-Resident	(31.5)	(5.0)	7.6	(48.3)	(16.4)	(42.7)	▼ 21.6	▼ 19.8	▼ 19.0	▼ 18.8	▼ 17.6	▼ 17.1	▼ 16.5	789
Bank Indonesia (gross)	58.0	153.7	2.8	(34.8)	52.6	4.7	▲ 22.5	▲ 23.5	▲ 26.0	▲ 25.6	▲ 25.5	▲ 25.5	▲ 25.9	1,243
Gov't securities used in monetary operation with Banks	0.2	(80.0)	(49.0)	93.5	28.8	(2.7)	▼ 7.6	▼ 9.2	▼ 10.7	▼ 11.5	▼ 10.3	▼ 8.7	▼ 8.9	-428
Insurance & Pension Fund	5.5	22.8	27.2	41.0	11.0	10.5	▼ 13.3	14.5	▼14.5	▼14.8	▼15.2	▼15.5	▼16.0	766
Mutual Fund	7.5	(6.0)	(1.9)	4.5	1.2	(8.8)	▲3.3	▲ 3.5	▲ 3.2	▲ 3.1	▲ 3.2	▲ 3.2	▲ 3.1	147
Individual	34.6	(35.8)	27.9	17.3	(9.4)	--	▲ 4.9	▲ 5.8	▲ 4.8	▲ 5.3	▲ 5.6	▲5.4	▲5.5	261
Others	15.5	5.1	16.3	15.4	4.1	(0.1)	▲ 8.3	▲ 8.0	▲ 7.8	▲ 8.0	▲ 8.2	▲ 8.3	▲ 8.4	401

Source: Ministry of Finance, UOB Global Economics & Markets Research

Philippines

The emergence of second-round effects on inflation amid a persistent improvement in domestic economic activities, coupled with much faster tightening of monetary policy around the world have pulled forward BSP's hiking cycles and increased the probability of an acceleration in the hiking speed. The Monetary Board (MB) raised the overnight reverse repurchase (RRP) rate for the first time since Nov 2018 by 25bps to 2.25% on 19 May, which the MB believes that a timely increase in the policy rates will help arrest further second-round effects and temper the build-up in inflation expectations. The nation's headline inflation topped 5.0% for the first time since Dec 2018 at 5.4% y/y in May (Apr: +4.9%), far exceeding the central bank's medium-term target range of 2.0%-4.0%. It is likely to stay above 5.0% for the rest of the year and into 1Q23 as the domestic economy continues to reopen, external supply shocks persist, as well as higher minimum wages and jeepney fares further intensify second-round effects on inflation. This will lead to a higher inflation rate of 5.0% for the entire year of 2022 (BSP est: 4.6%, 2021: 3.9%) and 4.0% for 2023 (BSP est: 3.9%).

With higher inflation expectations surpassing BSP's medium-term target amid continued expansion the domestic economy and a steeper Fed rate trajectory than the beginning of the year, we now see rising odds for BSP to act in every remaining meeting of this year. Our view is further affirmed by recent comments from the incoming Governor Felipe Medalla, who will take over the BSP on 1 Jul, that at least three 25bps hikes this year, including the 25bps in the May meeting, is deemed appropriate for now. He also signaled that the case for more than three rate hikes before 2023 will be depending on inflation and economic growth data as the year progresses. Taken together, we expect BSP to increase its RRP rate by 25bps at subsequent meetings of this year in Jun, Aug, Sep, Nov and Dec. Including the 25bps hike in May, this implies a total of 150bps increases this year (vs cumulative 275bps cuts between 2019 and 2020). This will bring the RRP rate to 3.50% by the end of 2022, leaving a zero interest rate gap with US (vs a minimum of +75bps between 1998 and 2021). For next year, we expect BSP to frontload its rate hike in 1H23 with a 25bps hike each in 1Q23 and 2Q23 (compared to our previous estimate of +25bps in 1H23 and +25bps in 2H23), bringing the terminal rate to 4.00% by mid-2023 (from our earlier projection of 3.50% by end-2014). It will continue to have a zero interest rate differential with US next year. These changes are also reflecting our revised projections for the Fed Funds Target Rate today (16 Jun).

Despite a potential quickening in rate hikes and the removal of uncertainty surrounding the Philippine presidential elections, we continue to expect the country to deal with volatile capital flows and currency weakness in the near term. In 2021, the Philippines faced a net portfolio outflow of USD8.0bn after garnering two consecutive years of net portfolio inflows totaling USD4.2bn in 2019-2020. It was predominantly attributed to a sharp reversal in debt flows (2021: -USD8.0bn vs 2020: +USD5.2bn) amid increasing expectations for Fed normalization and a murky domestic growth outlook during the year. The USD8.0bn net portfolio outflows in the year 2021 alone is deemed large and fast relative to the previous Fed tightening cycle, when the country witnessed five straight years of net portfolio outflows amounting to USD13.6bn between 2014 and 2018.

In addition, the nation's current account balance reverted back to a deficit of USD6.9bn or 1.8% of GDP in 2021 from a record surplus of USD11.6bn or 3.2% of GDP in 2020. This current account deficit is projected to persist and widen this year and next (UOB est: -4.5% of GDP in 2022 and -3.7% of GDP in 2023 vs official est: -3.8% of GDP in 2022 and -3.7% of GDP in 2023) given rising commodity prices and improving domestic demand for imports. It renews attention on the twin deficit hypothesis which, along with mounting external forces, will likely lead to further weakness in the Peso (PHP) into 2023. We project USD/PHP to move higher to at 53.5 in 3Q22, 54.0 in 4Q22, 54.5 in 1Q23, and 55.0 in 2Q23.

Figure 10. Inflation surpassed BSP's medium-term target

Source: Macrobond, UOB Global Economics & Markets Research
Note: BSP has stopped publishing core inflation data since Jan 2022

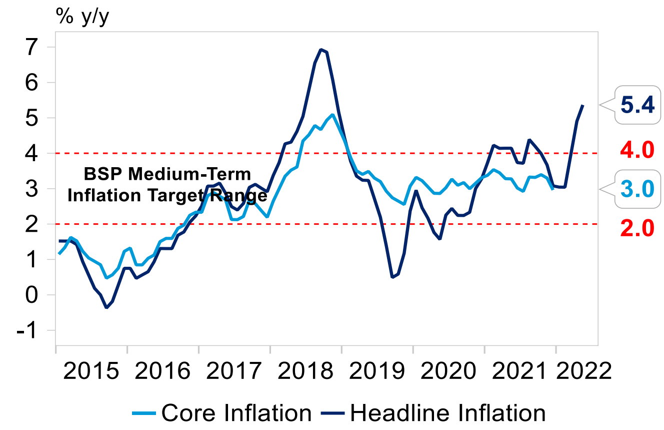


Figure 11. Projected trajectory for BSP and US Fed rate

Source: Macrobond, UOB Global Economics & Markets Research

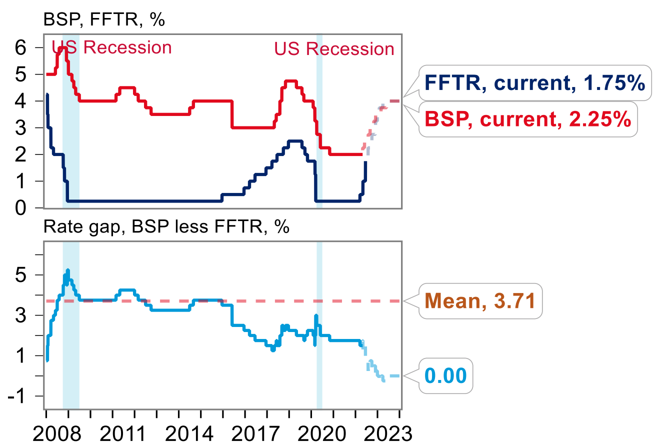


Figure 12. Large net portfolio outflows reported in 2021

Source: CEIC, UOB Global Economics & Markets Research

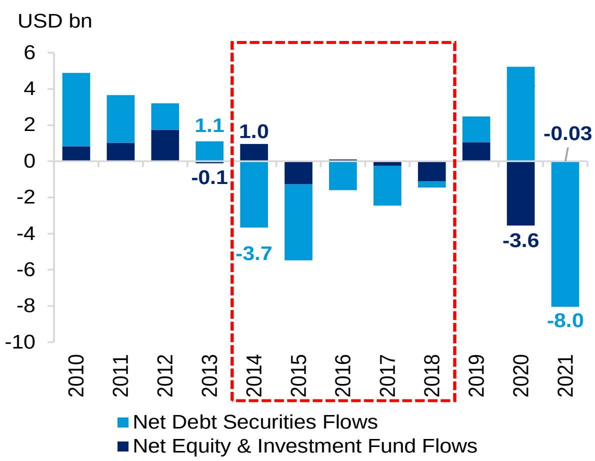
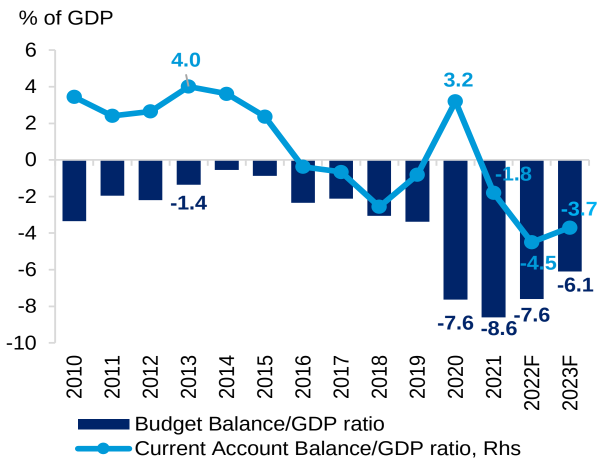


Figure 13. The return of twin deficits

Source: CEIC, UOB Global Economics & Markets Research



Thailand

The BOT continued to keep its 1-day repo benchmark rate unchanged for 16 months in a row now at a record low level of 0.50% in a clear move to lend support towards the Thai economic recovery. Given surging inflation of more than 7% recorded in May and yet the most recent MPC decided to keep rates unchanged that implies negative real rates will continue to remain as long as necessary for economic recovery to gain traction, BOT's monetary policy approach seems to continue leaning on pro-growth stance. This has undoubtedly put pressures on the THB to depreciate against the USD, further underpinned by the aggressive US Fed. However, with price pressures are expected to rise further and remain persistently high, the room to keep interest rates low is closing in and making interest rate hike is imminent. Our forecast is currently for BOT to hike 25bps in Nov MPC, but with increasingly higher probability of it delivering an earlier hike (still at a 25bps quantum) either in Aug or Sep MPC.

Recovery in incoming tourist numbers will certainly help to improve its external position, which is a boon for THB and will likely attract more capital inflows, even without too aggressive of a rate hike cycle in the Thai economy. At the same time, with narrower rate differential between Thai and its US as well as regional counterparts, the potential for THB appreciation is likely to remain limited, which give boosts to its external sector and further aid the economic recovery through its exports, especially from services exports.

Global investors continue to pour their portfolio capital into Thailand's bond and equity markets. On a year-to-date basis, cumulative net bond inflows stood at around USD3.5bn despite a major outflows of USD2bn was seen in Mar while its equity market continue to attract net year-to-date inflows of more than USD4bn thus far. However, on a half-yearly comparison of bond flows, the current inflows still fall short of pre-COVID quantum, save for 2018's Trump-led trade war that was hurting portfolio inflows to Thailand. The reverse is seen, however, for the Thai equity market that has thus far recorded one of the strongest inflows given the expected recovery in its tourism industry as the global and especially regional economies opening up their borders and boosting up the so-called "revenge tourism travels." Such recovery in one of the most important engines of the Thai economy is believed to benefit many other domestic-related sectors, further boosting the country's stock market attractiveness.

Notwithstanding the ongoing return of investors' confidence year-to-date for 2022, Thailand could still be 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 a total of USD5.0bn of equity and bond portfolios in 2015 alone, marking the largest outflow since available data as of 2009. Fund inflows returned in 2016 although at USD11.7bn, it was relatively smaller compared to the peak at USD31.8bn inflows in 2012, while equities resumed its outflow momentum in 2017 (-USD795.5mn) and 2018 (-USD8.9bn). We continue to foresee BOT's hiking cycle to be less aggressive compared to the global and regional trends as BOT is likely to prefer to remain accommodative in support of the Thai economic recovery momentum despite higher global interest rates. This would then imply that less attractive yield differentials will limit further upside to the ongoing portfolio capital inflows into the bond market while that to the equity will largely hinge on the extent and durability of the reopening efforts in the regional economies.

Figure 14. THB bond assets continue to attract inflows

Source: Bloomberg, UOB Global Economics & Markets Research

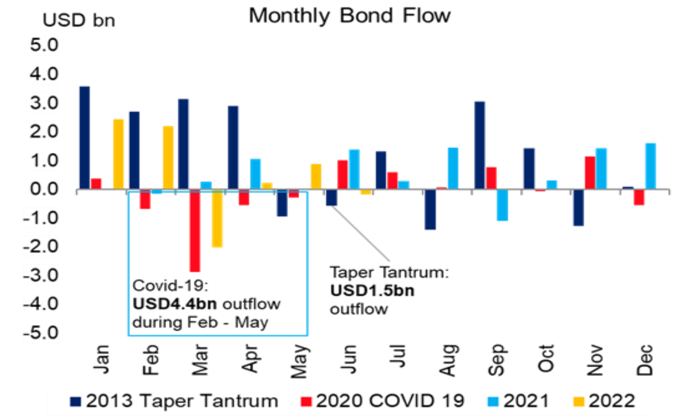
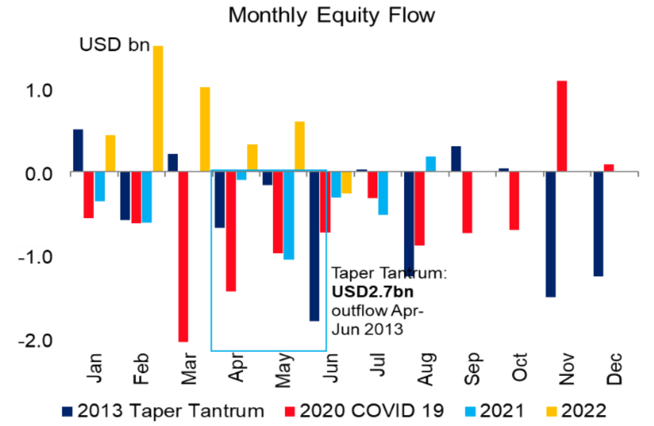


Figure 15. With best year-to-date flows into equity

Source: Bloomberg, UOB Global Economics & Markets Research



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