10 July 2017

ESSENTIAL ASIA

Positioned to walk the (policy) tight rope

National Australia Bank

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Talking Points

- **Most Asian currencies ended the first half of 2017 stronger vs the USD. Asian currency strength has led to the unintended consequences of tighter monetary conditions and worsening terms of trade.**
- **Market players see the recent CNY movements and intervention as signs that the authorities are no longer against CNY appreciation.**
- **The scope for USD/CNY to climb higher for the rest of 2017 is supported by the slower macro outlook, but admittedly the ongoing soft global USD trend may be a drag to the extent and momentum.**

Recent Reports

- **30 Jun 2017 – China economic update: Opportunity knocks**
- **15 Jun 2017 – India GDP & Monetary Policy – June 2017**
- **14 Jun 2017 – China economy at a glance: Trends stable across the board**

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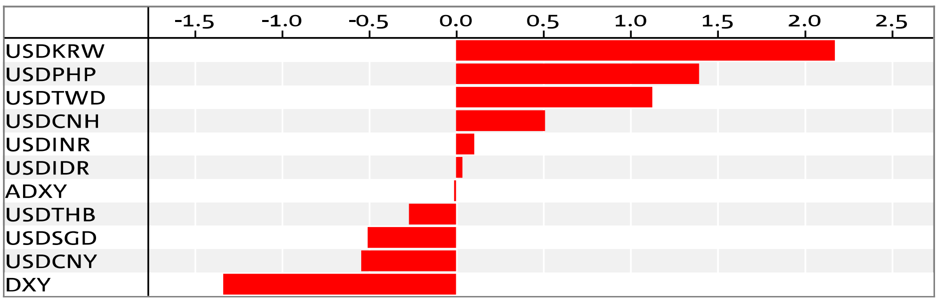
Asia FX in June

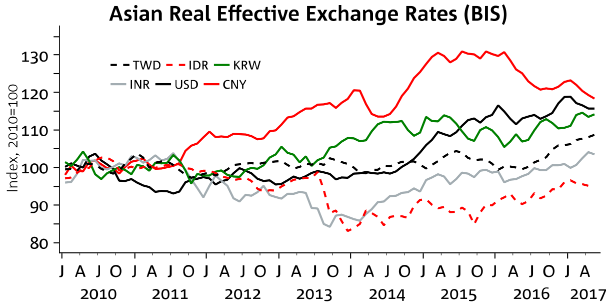
FX changes over the month (% change)



Source: National Australia Bank, Bloomberg, Macrobond

Chart of the month

Asian Real Effective Exchange Rates (BIS)



Source: National Australia Bank, Macrobond

Asia Policy Rates

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Korea	1.50	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Thailand	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
Malaysia	3.25	3.25	3.00	3.00	3.00	3.00	3.00	3.00
India	6.75	6.50	6.50	6.25	6.25	6.25	6.25	6.00
Indonesia	5.50	5.25	5.00	4.75	4.75	4.75	4.75	4.75
China	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35

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WALK THE (POLICY) TIGHT ROPE

- **Most Asian currencies ended the first half of 2017 stronger vs the USD. The biggest winners were TWD and KRW with over 6% appreciation. The small losers were HKD (-0.6%) and PHP (-1.1%).**
- **Asian currencies strength has led to the unintended consequences of tighter monetary conditions and worsening terms of trade.**

We expect Asian central banks to start reducing policy accommodativeness in the second half of 2017, or signal the intention, at the very least. In fact, monetary conditions may have started to tighten in some Asian economies, an unintended consequence of currency strength. Korea, China and potentially Taiwan fall into this camp. Most Asian currencies ended the first half of 2017 stronger vs the USD. The biggest winners were TWD and KRW with over 6% appreciation. The small losers were HKD (-0.6%) and PHP (-1.1%).

Inflation, or the lack thereof, remains a hurdle

The lack of demand-led inflationary pressure remains thematic across Asia. Soft oil prices have also been hampering a meaningful recovery in prices. Nevertheless, amongst the inflation-targeting Asian economies of Korea, Indonesia, Thailand and the Philippines, most are able to meet their inflation targets this year. Korea's latest inflation was at 1.9%, just slightly off its 2% full year target. The Philippines will meet its 2%-4% target with latest CPI growth at 3.1% yoy. Noteworthy though that the BSP just cut its 2017 forecast to 3.1% from 3.4%. Indonesia's growth and inflation profile appears to be in a sweet spot and will meet its 3-5% target (latest CPI 4.3% yoy). Thailand is the clear exception with deflationary pressure resurfacing and will most probably undershoot its 1-4% target (latest CPI -0.04% yoy).

Amongst the non-inflation targeters, Singapore's core and headline inflation are within the MAS' forecast ranges of 1%-2% and 0.5%-1.5% respectively. In Malaysia and India, inflation risks are quite balanced and will be dependent on commodity prices and weather conditions. China's inflation profile has been quite interesting, in that there has been very minimal trickle-down effect from the robust PPI growth to consumer prices. However, wages have been rising steadily and this will eventually feed through to demand for better quality products and services in higher price brackets. A recent report by the South China Morning Post highlighted that the average 2016 remuneration of the highest-paid executives rose 9% to CNY1.02 million (US$146,300) per annum among China's publicly traded companies, citing data accounting firm Deloitte's survey of 3,100 companies on the Shanghai and Shenzhen exchanges. Up to 80% of industries surveyed reported increments for senior management, led by the hospitality and catering industries, with 37% in compound annual raises over three years.

Monetary policy – neutral, less accommodative

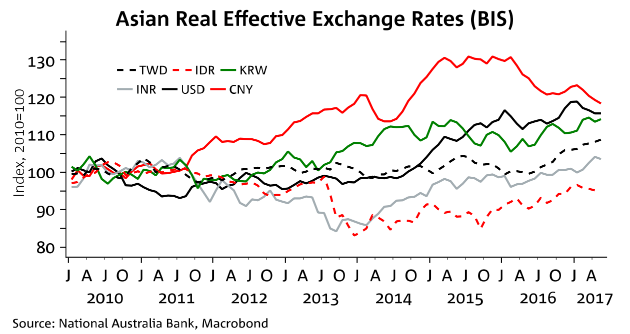
Most Asian central banks are now better positioned to remove some of the monetary loosening. In fact, sustained REER appreciation in TWD, KRW, IDR and INR since late 2015 may have negated some of the loose monetary conditions. This year, the tolerance for more currency appreciation suggests that while Asian central banks may not follow the Fed's rate hike immediately, it is likely that they will do so eventually. Looking at what is implied in the local forward curves, there is not much priced in for rate hikes in the next 3-6 months but the curve steepens visibly beyond 6 months. For India, our economist has pushed back the last rate cut to October from August, and cited balanced risks depending on how inflation behaves during the forthcoming monsoon months.

In China's case, most of the tightening has been done through liquidity tools. As part of the deleveraging efforts, China has been refraining from injecting liquidity since the end of last year and the tightness has persisted since. CNY o/n Shibor has stayed elevated above 2.25% and even broke above 2.5% at some point, compared with around 1.75-2.0% range last year. The tight liquidity was not confined onshore, but also extended offshore with the USD/CNH 3m implied yield reaching double digit earlier this year. The Chinese government yield curve inverted slightly when the CNY started to strengthen vs the USD in May, appreciating from 6.91 to 6.80 currently.

Rate hikes lay as sleeping giants, for now

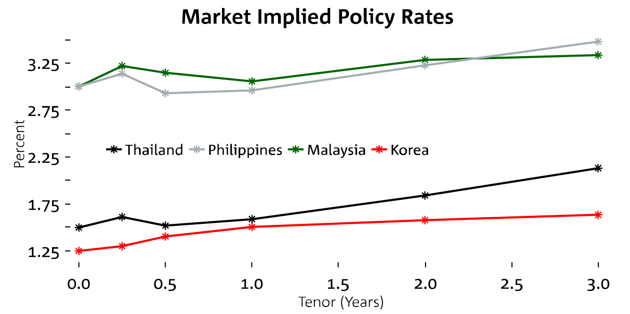
Engineering the removal of monetary policy accommodativeness through real currency appreciation may be the preferred policy strategy in the near term. Lack of clarity of Fed's policy hikes and QE removal will continue to deter Asian central banks to make decisive policy moves around benchmark interest rates. Regionally, inflation pressures have not provided a convincing case for embarking on an explicit tightening cycle as well. Until then, rate hikes will probably lay as sleeping giants.

Chart 1: Less accommodative monetary conditions



Source: National Australia Bank, Macrobond

Chart 2: No sudden moves expected in policy rates



Source: National Australia Bank, Bloomberg, Macrobond

CHINA SPOTLIGHT:

Making intelligent guesses

- **CNY price action in June defies the stability mantra that the Chinese authorities have been repeatedly chanting.**
- **Market players see the recent CNY movements and intervention as signs that the PBoC are no longer against CNY appreciation.**
- **We do not subscribe to the view that China wants a strong CNY policy. The scope for USD/CNY to climb higher for the rest of 2017 is supported by the slower macro outlook, but admittedly the ongoing soft global USD trend may be a drag to the extent and momentum.**
- **We estimate that USD/CNY will trade within 6.75-6.85 range for the rest of 2017.**

Stability mantra disrupted

The PBoC's hand was again visible in June and USD/CNY fell nearly 1%, making it the region's best performer in that month. Market players perceived that the intervention was aimed at squeezing short CNY sellers. The underlying motivations were not precisely known, but could be multi-fold. The leading contender seems to be window dressing during the last week of June ahead of Premier Li in Dalian summer Davos and President Xi visiting HK for the 20th anniversary of HK handover. Some have also suggested that it might have been a backlash from the authorities after they perceived market as going against the "implied guidance" in the fixing. This is debatable though, as USD/CNY fixing has recently edged higher and the spread between spot and fixing hasn't really been that wide. At the peak on Tuesday, USD/CNY was just 0.22% from the fix and USD/CNH just 0.44% from fix. It is possible that perhaps the threshold has been reduced.

Reviewing fundamental support for firmer USD/CNY

Recent macro data has been encouraging, but still within the realm of a slowing economy. Cyclical strength in the first half may start to lose steam in H2 and some of the structural risks may come to the fore. It appears that the fiscal boost has a stronger than expected impact on economic activities as the official NBS PMI and Caixin PMI have surprised on the upside. There has been an increase in optimism, verbalised by ex-PBoC adviser Li Daokui that China will grow 6.7% this year and if there are no unexpected international events that disrupt markets, will grow 6.9% next year. China's fiscal spending is testament though that growth is not robust on its own footing. China's fiscal deficit rose to 4% of GDP in 1Q, exceeding the government's target of 3% of GDP. Ministry of Finance data showed that national fiscal expenditure--central and local governments included--rose 25.4% yoy in March, accelerating from a rise of 17.4% over first two months of the year, the finance ministry said. However, it appeared that the government was frontloading its fiscal spending as the growth fell to below 4% in April. More rampant spending is not likely to persist in view of the fiscal consolidation target as well as the ongoing efforts to reduce leverage within the banking sector. The tight management of interbank liquidity reflects the policy focus along the line of reducing leverage, along the line of reining in property speculation. As mentioned in last month's report, China's worsening terms of trade provides another motivation for not engineering a strong CNY policy.

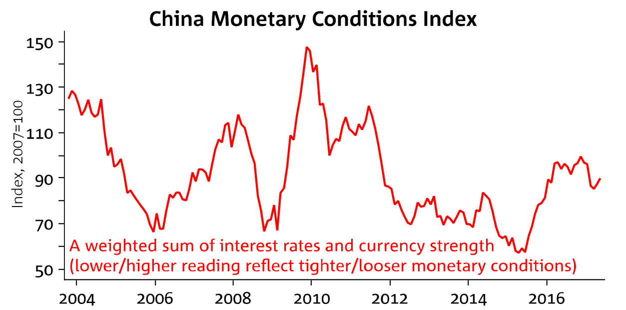
China's monetary conditions have just started to tighten marginally, and that is probably a reflection of real exchange rate appreciation as benchmark interest rates have stayed largely stable. However, there has been some monetary tightening via other policy tools, and the actual monetary conditions may be tighter than as reflected by the indicator.

Going forward, the bias is tilted toward monetary conditions tightening further, in view of rising prices and wages. While consumer prices have been slow in recovering due to lower food and oil prices, wages have been climbing at a robust rate. Based on a Deloitte survey of 3,100 companies on the Shanghai and Shenzhen exchanges, the average 2016 remuneration of the highest-paid executives rose 9% to CNY1.02 million (US$146,300) per annum. Up to 80% of industries surveyed reported increments for senior management, led by the hospitality and catering industries, with 37% in compound annual raises over three years. In medium run, these consumers are expected to increase demand for better quality and pricier products and services in China.

Return to stability

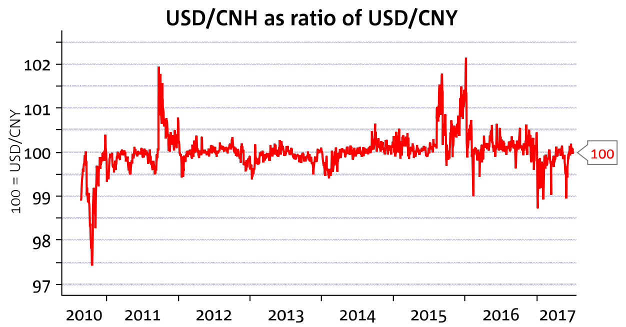
While we do not subscribe to the view that China wants a strong CNY policy, the ongoing soft global USD trend may be a persistent drag to a visibly higher USD/CNY in coming months. We estimate that USD/CNY will trade within 6.75-6.85 range for the rest of 2017 and have revised our end 3Q and end 4Q USD/CNY forecasts to 6.81 and 6.82 from 6.92 and 6.96 respectively.

Chart 1: Slight tightening in monetary conditions



Source: National Australia Bank, Macrobond

Chart 3: USD/CNH discount back to normal range



Source: National Australia Bank, Macrobond

KOREA SPOTLIGHT:

A balanced view

- **The Korean won has shed some of its strength in June but still a strong performer year to date.**
- **While North Korea issues are tail risks, recent provocation may have fatten the tail risks for financial markets.**
- **Near term KRW movements will be dependent on portfolio flows (bond market), North Korea tension and potentially, arbitrage incentive.**

Losing some vigour from position of strength

The won went from top gainer year-to-date to be the worst performer in June, sliding over 2% vs the USD. Admittedly, the won has been a strong beneficiary of portfolio inflows but there have been signs of reduced appetite for the local bonds. The recent recovery in UST yields has triggered a similar move in 10Y KTB yields. Very little has changed fundamentally so the won's reduced vigour could well be a reflection of position unwinding. However, should UST yields continue to move higher, they may sustain the upward bias in KTB yields in coming weeks and keep the USD/KRW supported.

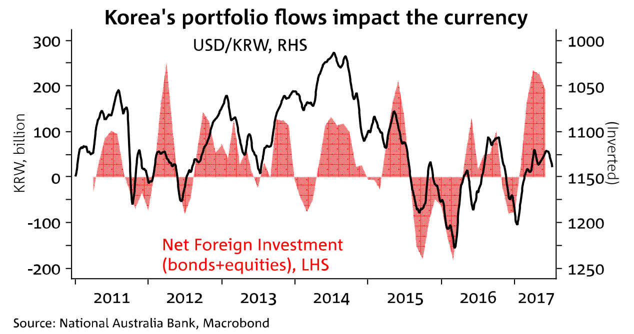
Another risk for the won is in the event that simmering geopolitical tension surrounding North Korea escalates further as North Korea repeatedly adopts a provocative stance with its missile tests that pushes the US, China and Japan even further to commit to a "denuclearized Korean Peninsula".

However, continued jawboning and discussions along the line of bringing North Korea to the negotiation table is likely to end up being the taken course of action; barring full blown military action, significant USD/KRW strength may be averted. Amongst other things, the KRW's strength since the start of 2017 has been motivated, in part, by arbitrage incentives, as evidenced by the spread between the US and Korea 3M yield spread and 3M swap rate. This was observed by the Bank of Korea as the Fed's hike narrowed the yield spread and at the same time swap was continually declining. The arbitrage incentive expanded and spurred strong foreign buying into Korean bonds, by banks and global funds. The arbitrage incentive has reduced since, but still stays rather elevated at around and may trigger some renewed interests for Korean debt and consequently, limit significant upside in USD/KRW.

Macro fundamentals looking balanced

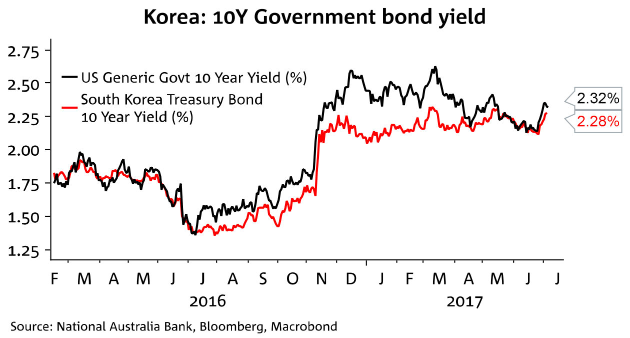
South Korea's macro performance is looking better balanced for monetary policy direction. These will probably be affirmed when the new administration announces its economic policy direction around end of July, along with outlook for 2H. South Korea is also due to also release tax reform plan and a 2018 budget plan in July, and then followed by household debt measures by end-August. Expansionary fiscal policy has been accompanied by an accommodative monetary policy stance and the inflation profile suggests no hurry to hike rates soon. June headline CPI and core CPI came in softer than expected, at 1.9% yoy and 1.4% respectively. Based on Q1 data, most of the inflationary pressure has come from services sector and petroleum products have reversed from deflationary state. Utilities prices are still in contracting, but the magnitude has reduced slightly. In 2Q, petroleum products may be disinflationary in view of soft crude prices globally but underlying price movements are stable. Inflation expectations have increased to 2.7% in Q1 and are expected to maintain in Q2.

Chart 1: Portfolio flows tapers a little



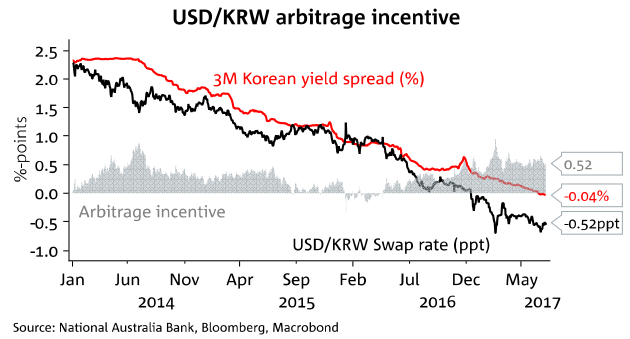
Source: National Australia Bank, Macrobond

Chart 2: KTB "yielding" to the rise in USTs



Source: National Australia Bank, Bloomberg, Macrobond

Chart 3: Arbitrage incentive aided KRW strength in H1



Source: National Australia Bank, Bloomberg, Macrobond

INDIA SPOTLIGHT:

Expectations meet reality

- **With the cyclical growth momentum waning, the structural story will increasingly be more crucial to sustaining the growth of portfolio inflows.**
- **Recent developments though could damage that story in a very serious way, especially in the areas of fiscal discipline and central bank independence.**
- **For now though that will likely remain on the margin given the improvements made over the last few years,**

When it rains it pours

As the waning of India's cyclical growth becomes more evident by the day, the structural story will come to the fore for portfolio investors. Recent developments have been decidedly negative but at the same time will probably remain somewhat marginal for the time being.

The 1st of July saw the introduction of the Goods and Services Tax and market expectations of its implementation is coming under some revision. Compounding that is the growing unease about the government's fiscal discipline, as it extended its agricultural loan waivers to the state of Maharashtra, and having implemented it in Uttar Pradesh.

A third concern is that the Ministry of Finance's attempts to pressure the Reserve Bank of India (RBI) into cutting rates is getting more overt, threatening to undermine the RBI's independence and credibility.

The ebbing tide

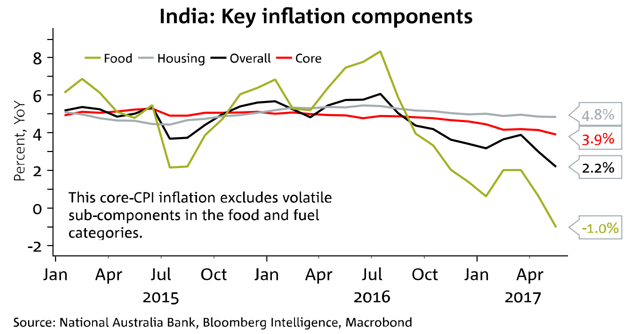
In its June meeting report, RBI flagged that it was surprised at the weakness of inflation. Industrial production of consumer durables and capital goods were both weak in April. Bank credit growth also remained very slow at just 4.9% yoy. Furthermore, inflation remains soft at just 2.2% yoy, albeit mostly due to food inflation at -1.0% yoy. Food inflation though accounts for around 50% of the CPI so second round inflation is a legitimate worry. Add to that the slow Q1 GDP growth and there is justification for a rate cut in the next few months.

The RBI though is right to prioritise core inflation, which has been a lot more robust and is currently at 3.9% yoy. Housing inflation is also high at 4.8% and is another potential red flag. However, this is garnering the ire of the government.

Hopes bound up in GST

The GST was a landmark achievement by the Modi government and could potentially streamline the country's sprawling mess of overlapping tax structures, thereby leading to meaningful productivity gains. The GST could also add more to the state coffers by extending the state's reach to the grey economy. However, there are caveats. One is that taxing the grey economy will of course impose some amount of drag on the economy. The more serious one however, is that the GST structure being introduced is not the simplest one around: it covers effectively 5 tiers, with tax rates ranging from 0% to 28% (5%, 12% and 18% in between). Tiering typically undermines the ability of a GST structure to improve efficiency as it tends to encourage legal wrangling to achieve preferential classification for a firm's products.

Chart 3: Core continues to defy headline inflation



Itching for a fight

While it is natural and quite common for most governments to find their central banks too hawkish for their liking, the Modi government needs to be extra careful to avoid any impression that it steamrolling the new RBI governor. The RBI's credibility is a key bulwark for the INR and for Indian bonds; NAB economics has pushed back its expected rate cut to October from August as the RBI might take more time to watch the inflation trajectory.

While the government's fiscal discipline is not yet under intense scrutiny, India's history of government profligacy means that Modi will need to safeguard the current goodwill that the market has extended to it.

Chart 1: Disruption from demonetization in Q1 GDP

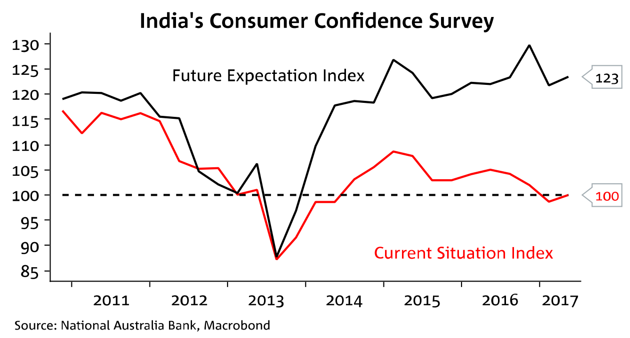
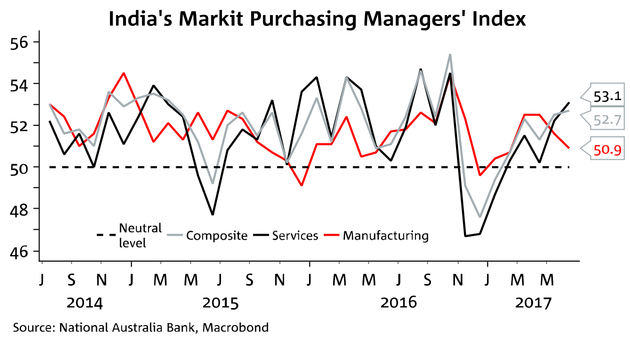


Chart 2: Manufacturers' sentiment might be turning



SINGAPORE SPOTLIGHT:

Stay cool and carry on

- **The market's turbulent reckoning with the trajectory of US interest rates is mirrored in the MAS' concerns that the negative impact on Singapore's property sector could yet intensify.**
- **MAS has declared that property cooling measures are still necessary, partially due to the risk of overseas demand.**
- **The S$NEER is likely to be managed in a tight range around the mid-point with "no-change" in October now highly likely.**

NEER constant

While the Monetary Authority of Singapore (MAS) maintained a fairly calm tone in its annual report, its wariness is hard to miss, even as its latest survey of professional forecasters saw growth projections rise yet again. MAS' main concern is over the domestic property sector, which it sees as being at risk from the twin threats of a spike in still-low mortgage rates, and an influx of foreign demand. This is exacerbated by the fact that local demand continues to remain robust. The MAS' declaration that property cooling measures are still "necessary" was followed up with a warning that commentators should not interpret recalibrations earlier this year as a sign that cooling measures are being unwound. This should also necessitate the avoidance of a depreciating S$NEER to reduce the attractiveness of Singaporean property to foreign investors. Expected softness in the domestic oriented sectors (17%) of the economy will also require containment of imported inflation.

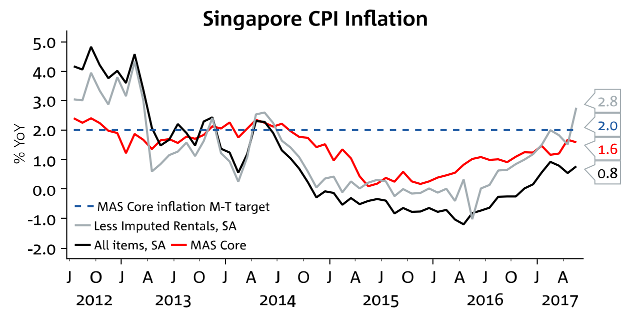
Professional forecasters projected 2017 growth coming in at 2.5%, compared to 2.3% in March, fuelled mainly by manufacturing. MAS partly concurs, projecting that the trade related cluster, which makes up around 43% of the economy and includes manufacturing, transport & storage, and wholesale service sectors, to experience high growth for some. This is broadly underpinned by a fairly rosy view of global growth and suggests a greater tolerance for S$NEER upside going forward.

Comporting these two major themes suggests that in the months ahead, the MAS will very likely opt to stick to its zero appreciation policy, with the main aim being to maintain an air of stability while trying to avoid fomenting the view of the SGD as a safe option for regional investors pursuing reliable returns. Within a flat policy band though, there might be an asymmetric preference for a slightly stronger S$NEER.

Beware the Goldilocks zone

The June survey had 2017 inflation projections easing slightly to 0.9% from 1.0% in March with projections for the MAS Core inflation remaining stable at 1.5%. Manufacturing sector growth projections meanwhile accelerated to 5.0% from 4.5%, even as Non-oil Domestic Exports (NODX) growth decelerated to 5.6% from 6.1% - undoubtedly a worrying hint of cognitive dissonance, given how dependent manufacturing is on exports. Construction sector growth was also projected to slow slightly, which adds to the worries. MAS though has signalled its awareness of risks to growth in its intimation that soft labour demand is likely to keep wage pressures contained.

Chart 3: Core inflation continues to drift towards 2%

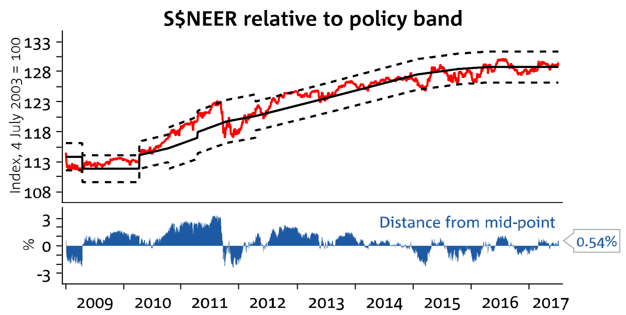


Source: National Australia Bank, Macrobond

The unbearable lightness of property prices

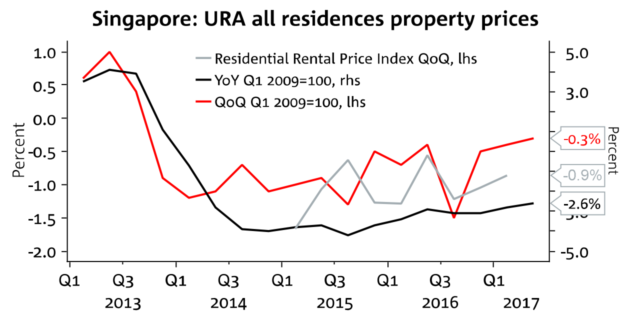
For sure though, MAS' main concern was the property sector, perhaps with one eye on potential contagion on a banking sector already weighed down by rising bad loans from the oil & gas sector. While noting that loan-to-value ratios and total debt servicing ratios have both declined over the last 3 years, recent property launches have seen good take up and Q1 2017 saw a 40% rise in transaction activity relative to the 3 year quarterly average. MAS also mentioned the potential for an increase in foreign interest given the enactment of property tightening measures in China, Hong Kong, South Korea, Australia and New Zealand. If this indeed does come to pass, one cannot rule out further tightening measures here too.

Chart 1: S$NEER hovering in upper half of policy band



Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: Property market continues to consolidate



Source: National Australia Bank, Macrobond

MALAYSIA SPOTLIGHT:

Beware the inflows

- **The MYR has been one of the top performers in Q2 on the back of portfolio inflows but this is a double-edged sword.**
- **FX reserves have also increased but these have not kept pace with the increase in inflows so BNM's ability to intervene remains constrained if and when USD strength returns.**
- **S&P has cited the current account surplus as a key bulwark for the sovereign ratings outlook but this makes the oil price a key concern.**

Walking on thin ice

Malaysian financial assets have been a key beneficiary of the global risk appetite in Q2 2017, with at least USD 4.5bn pouring into the nation's equity and bond markets. Bank Negara Malaysia (BNM) however has boosted FX reserves by just USD 3.3bn in the quarter till mid-June. The resulting outperformance of the MYR relative to regional peers might thus be somewhat illusory if and when USD strength returns.

In the near term, Malaysia's sovereign rating continues to enjoy a charmed existence as S&P maintains its stable outlook. However, the ratings agency did also note the deteriorating FX reserves situation and suggested that the outlook was conditional on the authorities continuing to implement "prudent budgetary and economic policies". As Q1's obvious effects of fiscal stimulus start to wane, it will be interesting to see if the government will be able to stick to its commitment to fiscal prudence.

MYR as Icarus

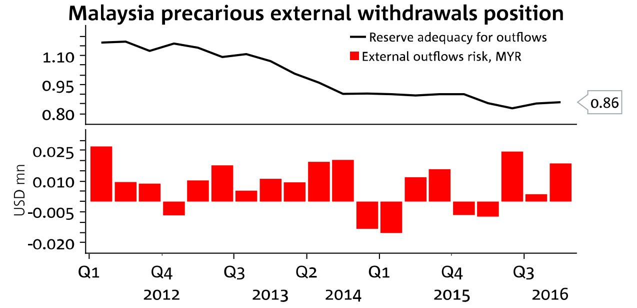
The MYR has been the best performer in the Asian FX space in Q2, rising 3.1%, compared to the second best CNY at 1.5%. That this has been on the back of strong portfolio inflows though is somewhat worrying given that risk appetite could turn quite quickly, and Malaysia's growth fundamentals are hardly one of the strongest in the region. Add to that the potential for political uncertainty in the months ahead, little headroom for fiscal stimulus, and a fairly weak FX reserves position, and the likelihood of a sharp reversal is hardly beyond the pale.

Undoubtedly, part of the attraction of Malaysian equities stems from the strong 5.6% growth in Q1 2017. However, as we had noted in June's Essential Asia, this was clearly the result of many generous fiscal hand-outs kicking in in January – domestic demand surged and caused a sharp reversal in net exports. This is probably not sustainable, and if it does extend into Q2, the current account should show worrying signs of deterioration.

Against this backdrop, the fact that BNM has not elected to boost reserves by more than the amount of portfolio inflows in Q2 means that ratio of FX reserves to short-term withdrawals has likely fallen from an already low 0.85. S&P also noted that reserve coverage of current account payments seems to have fallen from 5.4 months in 2016 to just 4.4 months at the latest.

If so, this will leave BNM with even less ability to support the MYR if and when USD strength returns. Given the prospect of further rate hikes in the US and balance sheet reduction by the Federal Reserve, the prospect of a broadly stronger USD is quite real.

Chart 3: Reserve adequacy hovering at a lower level

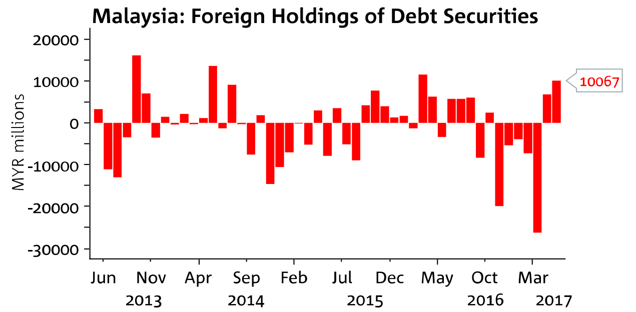


Source: National Australia Bank, Macrobond

Fiscal temptations

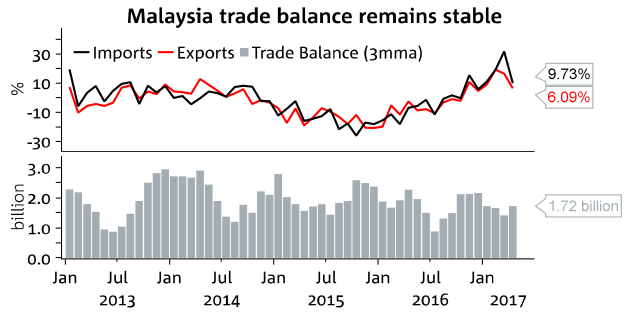
At a recent consultation session for 2018 budget, Prime Minister Najib Razak lauded his administration's fiscal restraint despite the prospects of elections in the near term. Najib also suggested that growth could exceed 5% in 2017 and that the government's fiscal deficit would fall to 3%. Officially, the growth projection is 4.3%-4.8%, with S&P projecting "above 4%" between now and 2020. With investor sentiment appearing somewhat soft, and likely to stay that way ahead of the elections, it remains highly questionable whether growth can beat expectations this year even with a strong global economy. Additionally, the oil price remains a key concern for both the net exports and the current account balance.

Chart 1: Rebound in foreign buying in Q2



Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: Trade balance trending lower



Source: National Australia Bank, Bloomberg, Macrobond

INDONESIA SPOTLIGHT:

Stuck in the middle with you

- **One key pillar of attraction for IDR assets will be the prospect of further ratings upgrades.**
- **A major impediment to that remains lackluster growth, but this is in tension with the other key goal of fiscal discipline.**
- **BI will likely come under pressure to ease rates further but it too has to keep one eye on inflation.**

Pining for an upgrade

While the IDR's robust carry buffer and Bank Indonesia's (BI) appetite for market intervention should help the currency to hold up well against a broad USD strength, what will be needed for a strong bout of appreciation is probably cause for another upgrade. Fitch, which already has a positive outlook, declared that the next upgrade would hinge on the growth rate exceeding that of similarly rated peers. While Indonesia's expected 5+% growth rate beats non-Asian peers, it lags its regional peers.

Infrastructure bottlenecks are the main impediment to faster growth, but the Jokowi government is still trying to corral support for increased infrastructure spending while trying to keep the fiscal deficit reined in. In the near term, monetary stimulus and foreign direct investment (FDI) might help boost activity but higher US interest rates domestic inflation could complicate matters.

Consumption losing steam

Consumption had been strong but seems to be losing momentum somewhat. Retail sales growth has been slowing and has been mired below 5% yoy for the last few months. Worse still, expectations appear to be flagging as well. Expectations for the next 3 months remain high but fell in April. 6 month expectations have been even softer, having been declining since February and is now lower than the 3 month expectations. This perhaps reflects the interplay between various factors: higher fuel prices, a flat growth rate, the reduced prospects of rate cuts, and rather robust consumer price inflation.

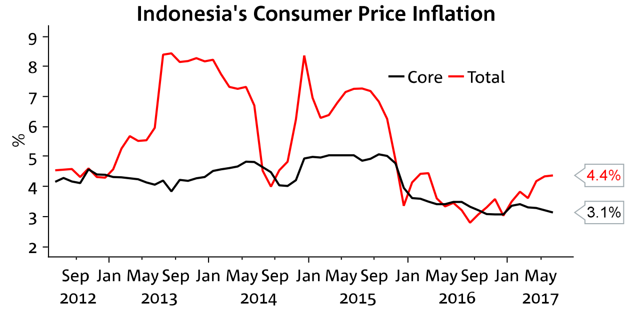
Business is perking up

On the flipside, business activity is showing some signs of life as the government gets some infrastructure spending going. The growth rates in truck production, cement sales and construction credits points to increased capital expenditures. Accelerating growth in rail freight also points to increased demand in domestic trade, potentially across both the consumption and investment space. The belated ratings upgrade from S&P would undoubtedly have also buoyed sentiment but this will probably peter out before long if there are no fresh sources of momentum.

Monetary policy will be key

With the government grudgingly announcing a slight widening of the 2017 budget deficit to 2.7% from the initial 2.4%, it does not appear that fiscal policy will be much help in the near term. A more ambitious 2018 budget is possible but that will not be done till later in the year. This leaves the main source of impetus in the near term as a relaxation of BI's relatively hawkish stance. Although core inflation remains fairly benign at 3.1% yoy, BI has to keep an eye on headline inflation given the high food content in the CPI; this has been climbing sharply and is now at 4.4% yoy.

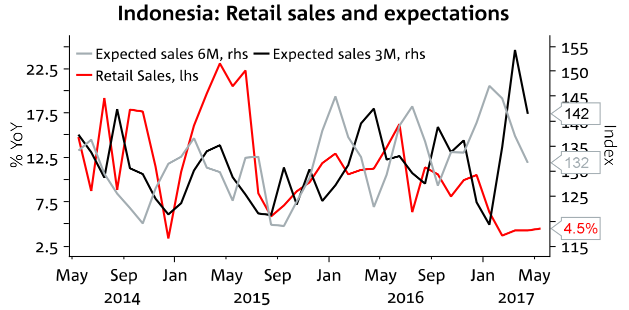
Chart 3: Headline diverges from core inflation



Source: National Australia Bank, Bloomberg, Macrobond

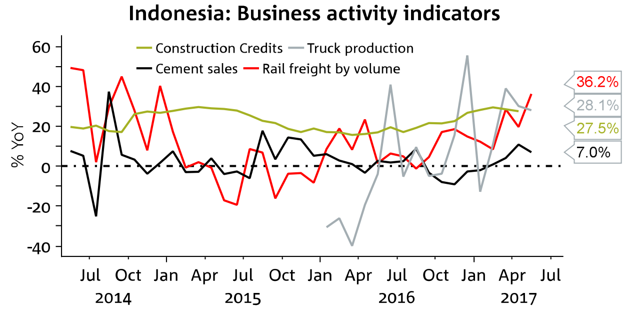
BI has said that it will maintain its neutral monetary policy stance as long as there is no sign of an impact on inflation, especially core inflation. The key data point though will be the post-Ramadan July inflation number; if that falls too then BI will have room to possibly ease. BI's official target is 3%-5% on headline CPI so it is not likely to be officially under pressure to change its policy rates.

Chart 1: Sales expectations shows some softness



Source: National Australia Bank, Bloomberg, Macrobond

Chart 2: Business activity shows some signs of life



Source: National Australia Bank, Bloomberg, Macrobond

SELECTED INDICATORS

Table 1: NAB Asian FX Forecasts

		Sep 17	Dec 17	Mar 18	Jun 18	Sep 18	Dec 18	Mar 19	Jun 19		Sep 17	Dec 17	Mar 18	Jun 18	Sep 18	Dec 18	Mar 19	Jun 19
New	**USD/CNY**	6.81	6.82	6.81	6.81	6.80	6.79	6.74	6.73	**AUD/CNY**	4.97	4.77	4.77	4.77	4.76	4.75	4.72	4.78
Old		6.96	6.97	7.00	7.05	7.07	7.07	7.05	7.02		5.08	4.88	4.83	4.79	4.81	4.88	4.94	4.98
New	**USD/IDR**	13450	13500	13500	13480	13460	13400	13360	13350	**AUD/IDR**	9819	9450	9450	9436	9422	9380	9352	9479
Old		13400	13450	13450	13550	13600	13600	13550	13500		9782	9415	9281	9214	9248	9384	9485	9585
New	**USD/INR**	65.0	65.3	65.5	65.8	65.6	65.4	65.2	65.0	**AUD/INR**	47.5	45.7	45.9	46.1	45.9	45.8	45.6	46.2
Old		64.5	64.6	64.8	65.0	65.0	65.2	65.4	65.5		47.1	45.2	44.7	44.2	44.2	45.0	45.8	46.5
New	**USD/KRW**	1160	1200	1200	1180	1160	1160	1150	1150	**AUD/KRW**	847	840	840	826	812	812	805	817
Old		1160	1200	1200	1180	1160	1160	1150	1150		847	840	828	802	789	800	805	817
New	**USD/MYR**	4.25	4.40	4.35	4.35	4.35	4.30	4.25	4.20	**AUD/MYR**	3.10	3.08	3.05	3.05	3.05	3.01	2.98	2.98
Old		4.48	4.50	4.55	4.55	4.55	4.55	4.50	4.45		3.27	3.15	3.14	3.09	3.09	3.14	3.15	3.16
New	**USD/PHP**	50.3	50.5	50.0	49.5	49.2	49.0	48.6	48.5	**AUD/PHP**	36.7	35.4	35.0	34.7	34.4	34.3	34.0	34.4
Old		50.3	50.5	50.6	50.7	50.8	50.8	50.5	50.0		36.7	35.4	34.9	34.5	34.5	35.1	35.4	35.5
New	**USD/SGD**	1.385	1.405	1.400	1.400	1.398	1.395	1.385	1.380	**AUD/SGD**	1.01	0.98	0.98	0.98	0.98	0.98	0.97	0.98
Old		1.430	1.435	1.440	1.440	1.450	1.450	1.440	1.420		1.04	1.00	0.99	0.98	0.99	1.00	1.01	1.01
New	**USD/THB**	34.1	34.5	35.0	34.6	34.5	34.5	34.4	34.3	**AUD/THB**	24.9	24.2	24.5	24.2	24.2	24.2	24.1	24.4
Old		34.8	35.0	35.3	35.6	35.5	35.5	35.3	35.3		25.4	24.5	24.4	24.2	24.1	24.5	24.7	25.1
New	**USD/TWD**	30.2	30.2	30.4	30.5	30.6	30.5	30.3	30.2	**AUD/TWD**	22.0	21.1	21.3	21.4	21.4	21.4	21.2	21.4
Old		30.2	30.2	30.4	30.5	30.6	30.5	30.3	30.2		22.0	21.1	21.0	20.7	20.8	21.0	21.2	21.4

Table 2: NAB Key FX Forecasts

		Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Australian Dollar	AUD/USD	0.73	0.70	0.70	0.70	0.70	0.70	0.70	0.71
New Zealand Dollar	NZD/USD	0.71	0.68	0.68	0.68	0.69	0.69	0.71	0.71
Japanese yen	USD/JPY	114	118	120	120	122	122	120	118
Euro	EUR/USD	1.17	1.15	1.17	1.18	1.20	1.23	1.23	1.25
British Pound	GBP/USD	1.28	1.27	1.28	1.28	1.26	1.25	1.28	1.30
Swiss Franc	USD/CHF	0.96	0.96	0.96	0.97	0.99	0.97	0.97	0.98
Canadian Dollar	USD/CAD	1.33	1.37	1.35	1.34	1.33	1.34	1.35	1.34
Chinese New Yuan	USD/CNY	6.81	6.82	6.81	6.81	6.80	6.79	6.74	6.73

Table 3: NAB Asia Macro Forecasts

	2013	2014	2015	2016	2017	2018
Hong Kong	3.1	2.7	2.4	1.6	1.6	1.6
Indonesia	5.6	5.0	4.9	5.0	5.0	5.0
Singapore	4.6	3.3	2.0	1.5	1.5	1.5
Taiwan	2.2	3.9	0.7	1.3	1.3	1.3
Thailand	2.7	0.8	5.0	4.2	4.2	4.2
Malaysia	4.7	6.0	2.6	2.7	2.7	2.7
S Korea	2.9	3.3	2.8	3.3	3.3	3.3
Philippines	7.1	6.2	5.9	6.8	6.8	6.8
Total	**4.2**	**4.1**	**3.6**	**3.8**	**3.8**	**3.8**
China	7.7	7.3	6.9	6.7	6.5	6.5
India	6.3	7.0	7.2	7.1	7.2	7.2

Table 4: NAB Key Macro Forecasts

Country/region	2013	2014	2015	2016	2017	2018
United States	1.7	2.4	2.6	1.6	2.1	2.3
Japan	2.0	0.3	1.2	1.0	0.8	0.6
Euro-zone	-0.3	1.1	1.9	1.7	1.9	1.8
United Kingdom	1.9	3.1	2.2	2.0	1.8	1.7
Emerging Asia	4.2	4.1	3.5	3.7	3.7	3.6
Latin America	2.5	0.9	-0.2	-1.2	0.1	1.9
China	7.7	7.3	6.9	6.7	6.5	6.3
Canada	2.5	2.6	0.9	1.2	1.7	2.0
Australia	2.1	2.8	2.4	2.4	2.3	2.4
New Zealand	2.2	3.4	2.5	3.2	2.9	2.5
India	6.3	7.0	7.2	7.1	7.2	7.2
Africa	5.2	5.1	3.4	1.6	2.8	3.7
Eastern Europe	2.8	2.8	3.7	2.9	3.1	3.1
Middle East	2.4	2.2	2.5	3.8	3.1	3.5
Other advanced	2.2	2.8	2.0	2.0	2.0	2.0
World	**3.36**	**3.39**	**3.10**	**2.94**	**3.18**	**3.35**

Source all tables: National Australia Bank

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