

## Interest rates seem poised to rise, unless inflation begins to moderate soon

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Inflation across Southeast Asia has accelerated more sharply than expected in recent months. For countries such as Indonesia, Malaysia, the Philippines and Thailand, these levels were last seen in 2005-2006 when adjustments were made to fuel subsidies. In the case of Singapore and Vietnam, inflation is at multi-decade highs, with little sign of abating in the short term. Surging food and fuel costs have been the main culprits. With food, in particular, accounting for a much higher weighting in the CPI basket than for the G7 countries, rising food prices have had a more significant influence on headline inflation.

For countries that use interest rates to manage inflation expectations, current inflation rates have now exceeded forecast target ranges, leaving little room for central banks to ease interest rates to cushion the impact of the downturn in global growth. While our initial forecasts were for interest rates to remain on hold over 2008, the significantly higher inflation profile has now raised the risk of interest rates heading up instead.

A complicating factor is that inflation in SE Asia is being driven by food and fuel – two volatile items that are generally excluded from “core” inflation. As such, central banks could choose to look through the recent price rises. However, most central banks in Asia still target headline, rather than core inflation. Their decision as to whether to raise interest rates or otherwise tighten monetary conditions at this stage will depend upon their view as to whether higher energy and food prices are spreading to other categories of goods, thereby threatening an outbreak of broader price pressures. The longer higher oil and food prices persist, the more grave this threat becomes.

### Inflation and Interest rate outlook

	Official inflation forecast for 2008	Latest month (% YOY)	2008 Inflation forecast (annual avg)	Current policy interest rate	End-2008 int. rate forecast
Indonesia	6-6.5%	9%	9.8%	8.25%	8.75%
Malaysia	2.5-3%	2.8%	2.8%	3.5%	3.5%
Philippines	5.5-6.5%	6.4%	6.1%	5.0%	5.25%
Singapore	-	6.7%	5.7%	-	-
Thailand	4-5%	6.2%	6.2%	3.25%	3.75%
Vietnam	<7.0%*	21.4%	22%	-	-

\* An inflation target of below annual real GDP growth is generally pursued.

Source: ANZ Economics & Markets Research

- Indonesia** – Bank Indonesia lifted its benchmark policy rate on 6 May by 25 bps to 8.25% as inflation edged up to 9% over the year to April. The government has indicated that it will lift fuel prices at the end of May 2008 to alleviate pressure on the fiscal balance from escalating subsidy costs, sparking a sharper surge in inflation in the months ahead and the expectation of further interest rate increases. We now expect **Bank Indonesia to lift rates by another 50 bps, in two stages, to 8.75% by year-end.**
- Malaysia** – Bank Negara has maintained its key policy rate at 3.5% since May 2006. Despite inflation accelerating to a 13-month high of 2.8% in March from a trough of 1.4% in June 2007, the central bank does not believe that raising rates will alleviate price pressures “in an environment spurred by supply shortfalls”. However, the government has moved to ease import and export restrictions on certain products such as steel bars and

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billets, while extending rice subsidies (and maintaining subsidies for staple food items as well as fuel) in an attempt to rein in prices. **We forecast interest rates to remain on hold at 3.5% for the foreseeable future.** The appreciating ringgit has also assisted in reining in imported inflation. Nevertheless, scope for a faster appreciation is limited by the need maintain export competitiveness especially against a climate of softening external demand. Moreover, Malaysian inflation remains relatively low by Southeast Asian standards, and is well within the central bank's forecast of 2.5-3% for 2008 (and is set to remain within this band over the year on average).

- **Philippines** – Headline CPI reached 6.4% YOY in March, clearly breaching its earlier 3-5% target. Higher inflation expectations prompted the central bank, in May, to raise its forecast for 2008 to 5.5-6.5%. While we now expect a tighter monetary policy bias, the extent is likely to be tempered by concerns over economic growth, especially as the US is a major trading partner and source of remittance inflows. **We have brought forward a 25 bps hike in the Philippines' central bank policy rate to peak at 5.25% by June 2008.**
- **Thailand** – Thailand's inflation accelerated to 6.2% over the year to April 2008, the highest rate since May 2006. Domestic demand is expected to gain momentum following the return to democratic rule, with expansionary fiscal policies and pent-up demand fuelling inflation expectations. The Bank of Thailand has kept its policy rate unchanged at 3.25% since July 2007 after lowering it by a cumulative 150 bps between February and July 2007. **We have factored in a cumulative 50 bps hike in the key policy rate by the end of the year.**
- **Vietnam** – Prices in Vietnam have grown by 21.4% over the year to April, with food, fuel and construction costs as the main drivers. The State Bank of Vietnam has initiated a number of policies in an attempt to rein in inflation: **three main policy rates have been raised, as have reserve requirements for banks.** Most pertinently, from November 2007, the Bank pursued an appreciation of the currency as its key monetary policy tool, while widening the US dollar-dong daily trading band. However, since mid-April this policy has been reversed, likely prompted by concerns regarding the country's worsening trade deficit, with dong depreciation now being pursued in order to support exports.
- **Singapore** – The Monetary Authority of Singapore (MAS) uses the **exchange rate as its key monetary policy tool.** With inflation at a 26-year high, the MAS moved, in April 2008, to re-centre the exchange rate policy band at the prevailing level of the S\$ nominal effective exchange rate (NEER) with no change to the slope or width of the band. This effectively allows for a stronger appreciation of the Singapore dollar. Our forecast is for the Singapore dollar to peak at 1.33 against the US dollar by June 2008 before retreating slightly to 1.36 by end-2008. This represents an appreciation of close to 6% against the US dollar since end-2007.

Overall, as commodity prices respond to the slowdown in global demand, we expect inflation to moderate over the second half of this year and into 2009 (except for Indonesia if subsidies are reduced). Nevertheless, given that Asia is likely to weather the slowdown in developed economies supported by relatively healthy domestic demand, expectations are that inflation in 2008 will remain above levels recorded at the start of the decade, when ASEAN-5 inflation averaged 2.3% YOY.

### Exchange rate outlook

The exchange rate outlook for these countries over the next twelve months remains unchanged – that is, a forecast for a slight easing against the US dollar over the second half of this year and into 2009. While wider interest rate differentials against the US should support Asian currencies, the likelihood that some countries will continue to record negative real interest rates, until inflation

abates, is likely to weigh on the outlook. In addition, the US dollar is expected to record a more sustained recovery backed by expectations that expansionary fiscal and monetary policies in the US will help to shore up the economy. Asian currencies are expected to appreciate against the Euro, however, as the euro weakens from its current level of EUR/USD1.54 to EUR/USD1.47 by end-2008 and EUR/USD1.27 by end-2009.

#### Exchange Rate forecasts

End-period	Current	Jun 08	Sep 08	Dec 08	Jun 09	Dec 09
<b>Indonesia</b>						
USD/IDR	9,320	9,100	9,250	9,350	9,400	9,200
EUR/IDR	14,368	14,014	13,968	13,745	12,972	11,684
<b>Malaysia</b>						
USD/MYR	3.246	3.19	3.24	3.28	3.36	3.41
EUR/MYR	5.02	4.91	4.89	4.82	4.64	4.33
<b>Philippines</b>						
USD/PHP	42.66	41.5	42	42.3	42.8	43.5
EUR/PHP	65.95	63.91	63.42	62.18	59.06	55.25
<b>Singapore</b>						
USD/SGD	1.37	1.33	1.34	1.36	1.38	1.395
EUR/SGD	2.12	2.05	2.02	2.00	1.90	1.77
<b>Thailand</b>						
USD/THB <sup>*</sup>	32.4	30.8	31.0	31.3	32.0	31.9
EUR/THB <sup>*</sup>	50.1	47.43	46.81	46.01	44.16	40.51
<b>Vietnam</b>						
USD/VND	16,158	16,167	16,233	16,300	16,450	16,370
EUR/VND	24,982	24,896	24,512	23,961	22,701	20,790

\*: onshore rate

Source: ANZ Economics & Markets Research

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