OCBC TREASURY RESEARCH

Global Snapshot

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A Not-so-Gentle Reminder

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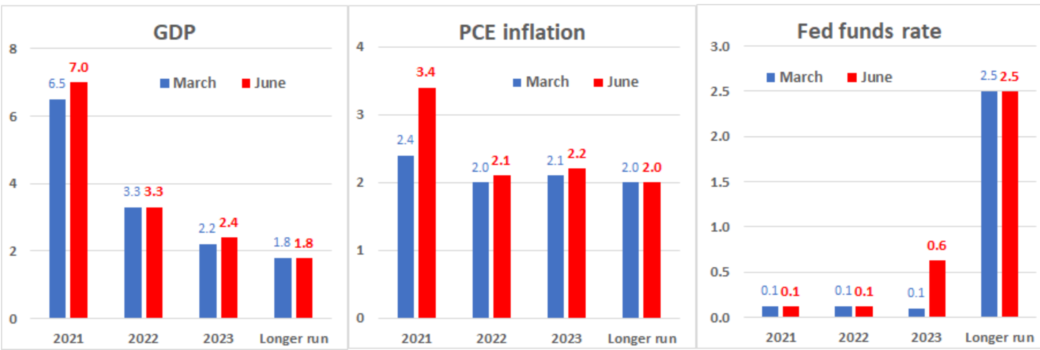
The Fed's hawkish shift presents a warning signal to EMs

- The dot plot has shifted considerably. From expecting no rate hike in 2023, the median FOMC expectation is now signalling as many as two rate hikes. While Chair Powell offered that we should take the move "with a big grain of salt", the aftertaste would be closer to bitterness than anything else for many EM central bankers. Even if nothing is set in stone yet, the spectre of the Fed rates uptick is now firmly on the horizon.
- Before any rate hike would come asset purchase tapering. On that front, even as Powell pledged that QE would go on at the current pace until "substantial further progress" is seen in the economy, he acknowledged that the debate on the timing has already begun. The recent upticks in prices for consumers and producers alike look to have brought forward the timeline.
- For various EM countries, the shadow of 2013 Taper Tantrum would now be looming ever larger. For Indonesia, things are looking to be on steadier grounds now than before. Its foreign reserves are adequate, and its exchange rate does not appear overvalued. Still, to anchor market confidence further, it might have to signal a more conservative stance on both fiscal and monetary fronts – at a tricky time when its economy may be getting hit once again by a pandemic resurgence and requires more help.

Onslaughts of the Dots

How things changed. Before last night's FOMC meeting decisions were made public, it appears that the Fed's months of beating the same drumbeat about how while the US economy is recovering, there is still too much scarring in the labour market to be overly worried about inflationary momentum. While the market was initially sceptical, it has started to buy the Fed's lines. Indeed, last week saw US Treasuries rallying, with the 10yr yield touching below 1.43%, partly as a reflection of a convergence between market views and the Fed's.

FOMC Dot Plots, March 2021 vs. June 2021



Source: OCBC, Federal Reserve.

No sooner has that gap been closed, it was ripped open again, however. This time round, the Fed was responsible for much of the shift, catching the market largely unaware of its newfound appetite for eventual rate hikes. In the quarterly dot plots – where the FOMC members update their projections for growth, inflation and rates trajectories – they made it known that they now think all three dimensions deserve substantial upgrades.

Growth in 2021 is now expected to be 7.0%, compared to 6.5% before. More tellingly, the PCE inflation print is now seen rising by 3.4% - a substantial uptick from 2.4% when the dot plot was last updated in March.

However, the 'star of the show' is none other than the FOMC's expectation for the Fed funds rate. From expecting no rate hike from this year to 2023, the median of the dot plots is now signalling a potential increase in the policy rate by 50bps. The median's uptick has been driven by a crossing-over of 6 members from the "holding camp" back in March to the "hiking bunch", which now counts as many as 13 out of a total of 18 FOMC members.

Getting closer

Moreover, for the forecast horizon of 2022, as many as 7 members see rate hikes by end of the year, compared to just 4 back in March. Arithmetically speaking, it would now take just 2 more crossovers to nudge the median upward, potentially in the next dot plot update in September. Hence, as much as market is now smarting from the prospect of the potential rate hikes in 2023, we could soon have to deal with the spectre of an even more accelerated rate hike timeline of 2022.

To be sure, none other than Chair Powell himself appeared to pour cold water on the predictiveness of such dot plots, saying that it is "not a great forecaster of future rate moves" and it ought to be taken with "a big grain of salt." Still, the degree of the dot plot shift betrays the fact that, for all the talk by various Fed officials about having to maintain an accommodative stance to nurture the economic recovery, there has already been some signals of hawkish – or at least less dovish – tilt from some members recently, and that the dot plot is merely reflecting that shift.

This may be particularly apparent in the discussion surrounding the potential tapering of asset purchase program. Philadelphia Fed's president, Patrick Harker, said earlier this month, for example, that "It may be time to at least think about thinking about tapering." Last night's comments by Powell suggest that the discussion about tapering discussion has indeed begun, noting that "You can think of this meeting that we had as the 'talking about talking about' meeting, if you'd like."

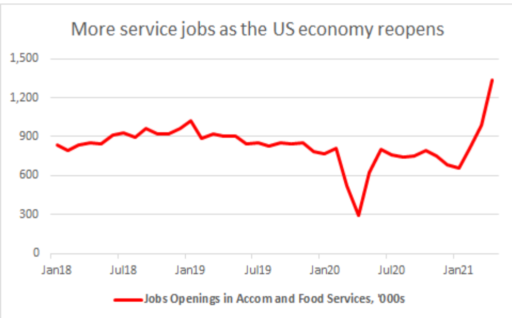
We've warned you

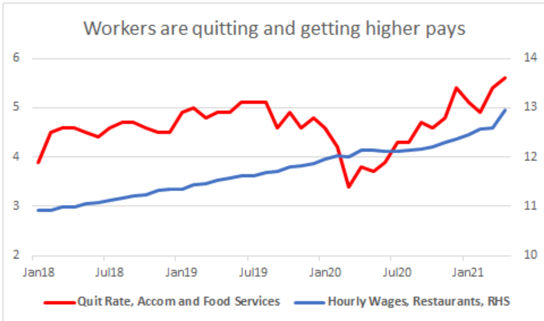
Overall, for all the couched and frustratingly layered language, the FOMC appears to now be actively priming the market for an eventual withdrawal of its massively accommodative policy. Indeed, given the recent upside surprises in the May CPI and PPI prints, both of which beat market expectations handily, one might argue that the writing has already been on the wall for a while.

Even though there might be some truth to the argument that temporary factors might be at play and inflation could well prove to be transient, there is also the tail risk that inflation begets more inflation – a possibility that the FOMC members appear to be positioning for with their dance towards the exit door for their accommodative stance.

Supersized Services

Already, the reopening of the US economy, backed by a rapid rollout of its vaccination program, has prompted more and more Americans to venture out. This would be especially beneficial to the services sector, which contribute 69% of the average American personal consumption. While they could still shop for goods online during lockdown, they could not go out to restaurants, etc. Now that the lockdowns are over, many are eager to spend on such services once again, which could add to the inflationary uptick.





Source: OCBC, Bloomberg.

That shift is starting to show up in some specific prints. The number of job openings in the accommodation and food services sub-sector, for instance, have ballooned to over 1.3mn in April. As a reflection of how hot this segment of the economy has become, workers are also quitting at a record-high clip with 5.6% attrition rate as of the last data in April.

In a bid to retain existing workers and attract new ones, restaurant wages have marched up steadily too to nearly $13/hour, on average. Indeed, following a similar move by other restaurant chains such as Chipotle and Olive Garden, McDonald's said that it will up its employee pays by 10% and boost the entry-level wages for all staff from $11 to $17/hour.

While such wage uptick may be reflecting specific sectors rather than a broad phenomenon for now, the fact that labour cost increase is adding to the price pressures that businesses are already facing due to a crunch in input prices and availability on top of higher distribution costs is pointing towards a potentially bubbly inflationary mix for the US economy.

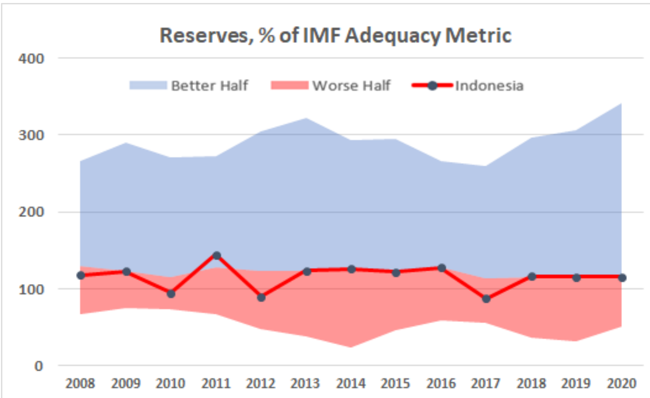
Their hike, our problem

From the EM perspective, the fact that the Fed has fired some warning shots with its upward shift in its dot plots – and that the underlying strengthening of the US economy could be pointing towards further shifts towards less accommodative policies – signals an uneasy road ahead. This is especially so because their own domestic economies remain beset by Covid-19 resurgence and held ransom by the lack of vaccine supplies.

To illustrate what we mean, let's zoom in on Indonesia next.

Unfortunately labelled as being among the "Fragile Five" economies back in the 2013 Taper Tantrum episode, the fact that the Fed is now inching closer towards another tapering and then rate hikes might increasingly be a concern. Even in normal circumstances, any sudden pullback of global liquidity is problematic due to Indonesia's dependence on foreign fund flows to finance its current account deficit. At the current juncture whereby Indonesia may have started to see another considerable wave of Covid-19 resurgence – it recorded nearly 10000 cases on June 16, the highest since February – it can only add salt to the wound.

That is the not-so-good news. On the brighter side of things, however, years of prudent policymaking have given Indonesia some buffer that can help it tide things over. It has been earnestly building up foreign reserves, for instance, which would offer the authorities a good stock of ammunition in curbing any foreign exchange outflow risk that rises as and when the Fed pulls the trigger.

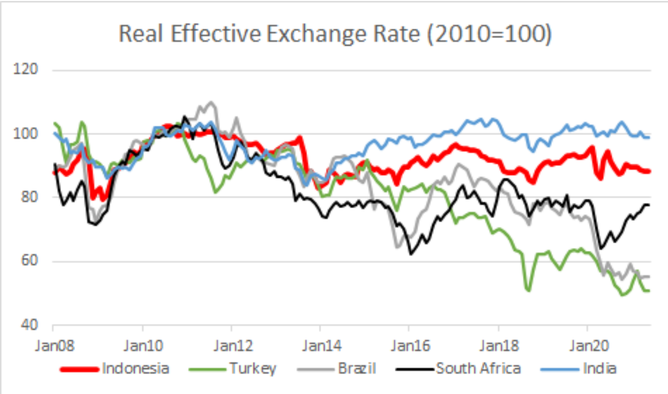


Source: OCBC, Bloomberg, International Monetary Fund. Note: Better and worse halves refer to the median-based distribution profile of the metric for 23 emerging markets.

At the end of 2012, just before the Taper Tantrum took hold months after, the IMF calculated that Indonesia had a 10% shortfall in its reserves adequacy. By our calculation, that also put it in the worse half of the 23 emerging economies at that point. Fast forward to end-2020, the last available data point, Indonesia is right at the median of its peers.

While its latest foreign reserves print did show a drop from the record-high print of USD136.4bn, it was largely due to the payment of government's external debt. By and large, it remains well within the adequate zone, as defined by a set of IMF metrics that consider the country's import bills and short-term debt coverage.

In terms of real effective exchange rate, which can be a proxy for whether a currency is overvalued or not, Indonesia is also at a relatively better place compared to the Taper Tantrum episode.



Source: OCBC, Bloomberg, Bank for International Settlements.

Going by the estimates by the Bank for International Settlements (BIS), which indexes the reading to 100 at the respective 2010 levels, Indonesia's REER now stands at around 88.2 level, compared to 97.6 at the start of 2013, signalling it has gotten more undervalued compared to historical norms.

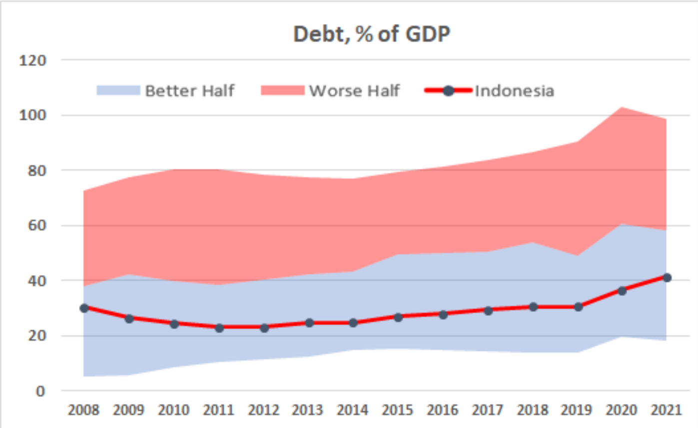
Defensive Plays

Still, even though Indonesia's currency does not appear to be overvalued – thus, with less room for a big and sustained lurch downward as well, even if the global situation turns less favourable – and that the country has more than enough reserves to smooth out volatility if needed, there are some areas that the authorities will be keen to improve on to buttress its defences further.

For one, transitioning Indonesia's fiscal stance back to normalcy – i.e. back to the 3% of GDP deficit pre-Covid threshold – by 2023 may be increasingly important given the potential Fed rate hike cycle at around the same time.

Compared to the deficit-to-GDP ratio of 5.7% expected this year, Minister of Finance Sri Mulyani said that the government remains committed to bring it down to 2.71-2.97% by 2023, with 4.5-4.9% in between in 2022. As the minister acknowledged herself in an end-May parliamentary hearing, "It is not easy to combine fiscal consolidation and economic recovery. But that is our commitment."

The challenge of balancing fiscal consolidation while supporting growth can be made even more acute, should there be a downtick in economic momentum due to virus resurgence. Not only would it affect growth – and hence cause an unfavourable denominator effect – it may also increase the need for stimulus spending by the government. Already, the government appears to be earnestly searching for new revenue sources, including floating the potential for yet another round of tax amnesty, a new income tax bracket for those earning IDR5bn and more, as well as an imposition of value-added tax on daily consumption goods.



Source: OCBC, Bloomberg, International Monetary Fund. Note: Better and worse halves refer to the median-based distribution profile of the metric for 23 emerging markets.

By and large, the need to find new revenues to help nudge Indonesia's fiscal deficit back to the Maastricht Treaty-inspired 3% threshold is crucial not necessarily because its stock of debt is high. Indeed, even though Indonesia's debt-to-GDP ratio is likely to creep up to 41.4% by end of this year according to the IMF, compared to 23.0% in 2012, it has come at a time when the indebtedness of EMs has also gone up and that Indonesia remains squarely within the "better half" of its peers.

Still, the need to posture towards fiscal consolidation would go a long way in terms of building market confidence at a time when it may become shaken by global circumstances. After all, returning the deficit to lower levels may have been part-and-parcel of the tacit agreement that Indonesia had struck with market players for accepting some of the more controversial measures, including direct debt monetization by the central bank, during the height of the global pandemic last year. Given that the arrangement which allows Bank Indonesia to purchase sovereign bonds in the primary market is supposed to lapse at the end of this year, the government would become relatively more dependent on foreign investors to fund its budget shortfall as well next year onwards.

From the monetary policy perspective, to anchor market confidence in the face of less-supportive Fed policies, BI may have to start signalling a less dovish stance too. Even though in its post-MPC press conference today, Governor Perry Warjiyo said that BI sees the Fed beginning to taper only in early 2022 and to hike rate only in 2023, BI may have to start contemplating the scenario of an earlier tightening by the Fed more concretely.

Doing so will make things complicated, to be sure. While we had thought that there is an outside chance of a BI rate cut in the coming months, if the Covid-19 resurgence worsens in Indonesia, the probability has been slimmed down further by the shift in the FOMC dot plots considerably.

It looks to us now that BI would have to reach deeper into its macroprudential toolkit to be seen helping the economy along. It eased the down-payment requirement for mortgages and car loans earlier this year, and announced a lower cap on credit card interest rates last month – and more such piecemeal and targeted actions might come forth.

All in all, even though BI might not need to hike rate this year if the market conditions continue to be favourable, the odds of the central bank easing has come down because of the need to anchor FX market stability.

As noted earlier, compared to the initial conditions before the Taper Tantrum struck in May 2013, Indonesia has broadly improved its odds of navigating through any upcoming storm on the macroeconomic front. Still, given so many moving parts – including the developing domestic Covid-19 situation – caution will be in the air for a while and the authorities are more likely to posture towards consolidation on the fiscal and monetary fronts, rather than pursuing more accommodative policies.

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