ASEAN update

Food price risks?

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Economics - ASEAN

- Food prices are edging higher in the Philippines and Indonesia, but the impact appears manageable…
- …thanks to ongoing improvements in food supply management coupled with subdued demand-side inflation
- We still see room for some additional monetary policy easing in countries with high real rates

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Reflation? Not yet. Positive vaccine developments are spurring chatter about a global reflation story. We think this is some time away, but in ASEAN, it's important to keep an eye on supply-side factors that could drive inflation higher. In particular, food and oil prices. Globally, food prices have moved higher in the last few months due to a mix of budding supply issues and improved demand, but in this report, we take a look at regional issues to monitor in the coming weeks, especially in Indonesia and the Philippines.

Weather disruptions. Global and local authorities have flagged the risk of a "moderate to strong" La Niña meteorological condition lasting until April 2021. This tends to correspond to flooding risks in Southeast Asia, which can disrupt harvests. In the Philippines, a series of typhoons have already pushed food prices higher, resulting in authorities imposing a price freeze on major commodities. Meanwhile, flooding in Central Vietnam appears to have impacted rice harvests (Reuters, 23 October). Note that food prices remain elevated in Vietnam after last year's pork price surge, but prices have since receded, reducing inflationary concerns.

Demand pressures? It is too early to talk about demand-side pressures in ASEAN. COVID-19 related restrictions remain in place across the region, with resident mobility and consumption significantly below the baseline, especially in the Philippines and Indonesia, two countries prone to higher inflation. That said, if conditions quickly return to normal, rural supply chains may see signs of stress. The recent spike in palm oil prices and attendant boost to rural income may explain recent price increases in discretionary food items (i.e. non-staple) in Indonesia. Fortunately, authorities maintain a robust network of food price monitoring, and are addressing pockets of inflation.

Monetary implications. In short, we do not see serious inflation risks over the medium-term thanks to subdued demand. Nevertheless, there is still scope for monetary easing in with high real rates.

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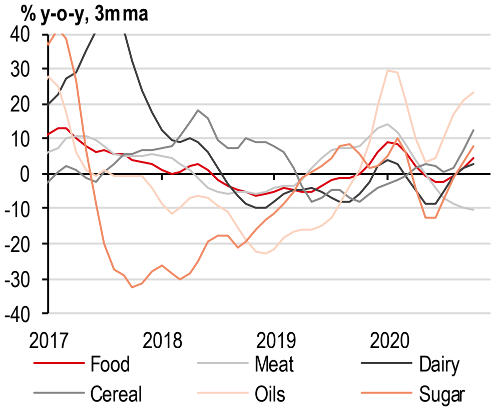
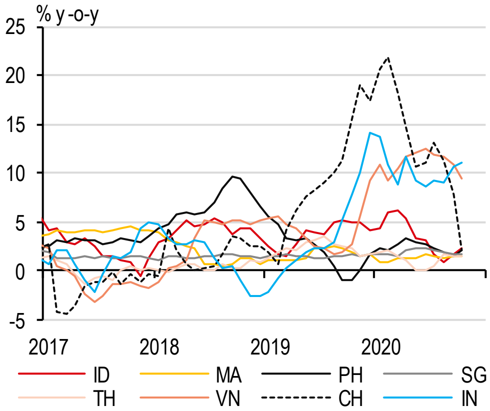
1. Food prices have started to pick up globally after disinflation earlier in the year



Source: FAO, HSBC

2.In Asia, only India and Vietnam are witnessing still-elevated y-o-y food prices



Source: CEIC, HSBC

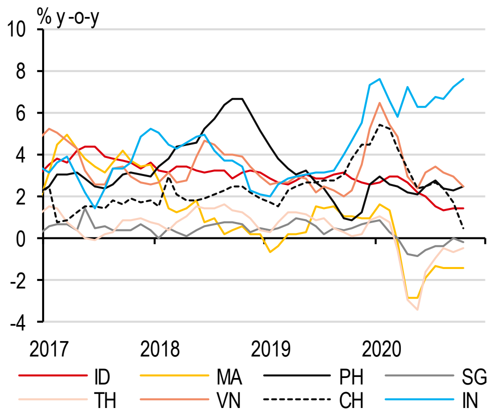
An eye on food prices

We aren't too concerned about inflationary pressures – either globally or regionally. After all, growth will remain significantly below potential across most of Asia, and resilient supply chains have prevented the build-up of supply side price pressures. But in much of Southeast Asia, local factors can offset global trends, especially when it comes to food prices.

First, let's look at the latest global food prices. According to data from the FAO, global prices are increasing across commodities (chart 1) although over a longer horizon, the latest tick-up is rather mild. Food prices across Asia have been rather well behaved, with the exception of India and Vietnam (chart 2). In the case of the latter, this continues to stem from a pork-price surge earlier in the year, which authorities are slowly containing with improved supply. We expect headline inflation in Vietnam to moderate significantly in 2021 as meat prices continue to fall.

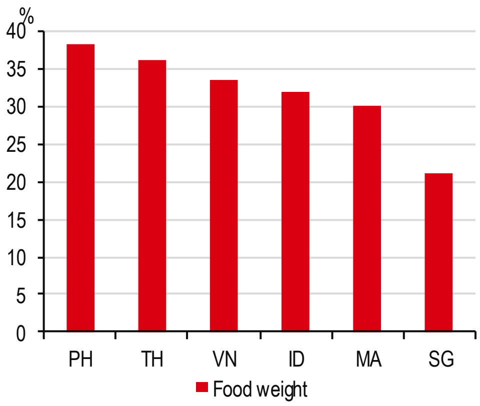
While headline food prices are benign, there are small warning signs starting to emerge, especially in Indonesia and the Philippines. Given the high weighting of food and food services in CPI baskets (chart 4), any sustained increase in related prices can easily drive headline prices higher, which would present complications for central banks across the region, most of which are pursuing extremely accommodative monetary policy (Philippines comes to mind with a negative real interest rate, see chart 5). While most central banks focus on core or underlying prices, the official targets are based on headline inflation, and we have learned from the past

3.Headline inflation remains subdued across the region



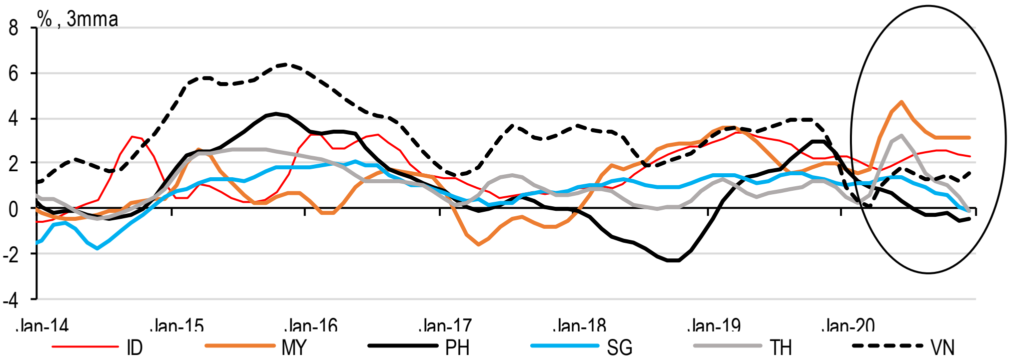
Source: CEIC, HSBC

4. High food and food service weights in ASEAN is a concern



Source: HSBC estimates

5.Real policy rates are relatively high in Malaysia and Indonesia, but are now negative in the Philippines and Thailand



Source: CEIC

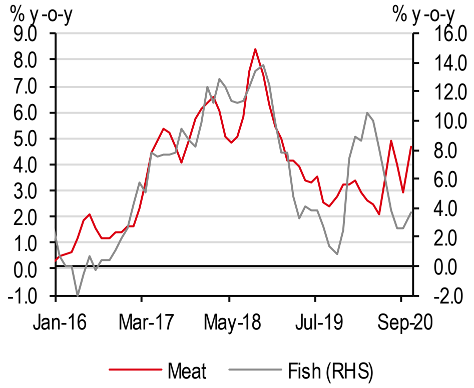
that a supply-side driven price spike can force the hand of a central bank (think back to the Philippines in 2018, when rice and oil prices increased in tandem).

Incipient signs of food price inflation across Indonesia, the Philippines, and Vietnam can likely be attributed to weather effects: numerous typhoons in the case of the Philippines, and floods related to La Niña elsewhere. A "moderate to strong" La Niña event has developed in the tropical Pacific and is likely to continue at least until March 2021. As a rule of thumb, a moderate La Niña can be good for agricultural production given above-average rain, but a strong La Niña typically corresponds to flooding that disrupts harvests. Just in the last two months, there have been signs of flooding in Central Vietnam, in parts of Indonesia (including in Jakarta, where flooding occurred in September), and the Philippines.

Philippines

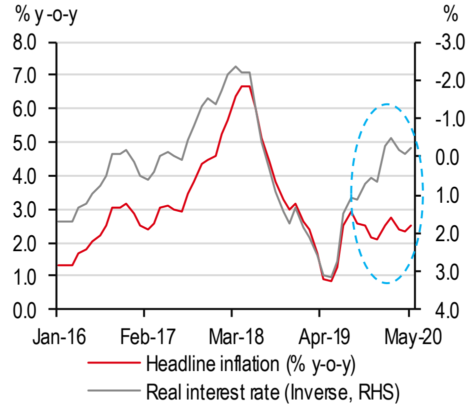
Philippine inflation remains benign as a result of the pandemic, but upside risks loom in the months and quarters ahead. Food inflation is already seeing a marginal acceleration due in part to supply-side constraints and adverse weather. Meat prices, in particular, have been rising due in part to the lingering presence of African swine fever in the country (Chart 6). Rice and vegetable prices, while largely contained for now, could also see some shortages in the future. The Philippine Atmospheric, Geophysical and Astronomical Services Administration (PAGASA) has flagged the possibility of "moderate-to-strong" La Niña persisting up until April next year. Meanwhile, the National Economic Department Agency (NEDA) has warned that "agricultural

6: Meat and fish prices in the Philippines are on a the rise



Source: CEIC, HSBC

7: There is a wide gap between real interest rates and inflation currently



Source: CEIC, HSBC

damage caused by the recent onslaught of typhoons and the occurrence of La Niña may put food supply at risk" beyond 2020.

In addition to rising food costs, global oil prices may also see a continued increase as a result of supply constraints. Despite a price freeze imposed on most major commodities as a result of recent typhoons (i.e. food, kerosene, liquefied petroleum gas), oil companies domestically have recently implemented price increases to reflect rising global oil prices (*Philstar*, 17 November 2020). Meanwhile, HSBC's oil and gas analysts expect OPEC+ to extend its "phase 2" cuts to at least end-Q1 2021 when it meets on 30 November-1 December. In addition, HSBC expects OPEC+ to remain extremely cautious about unwinding its production cuts by too much, even if global demand for oil improves in 2021. These pose a "risk scenario" for Philippine inflation as a country that is heavily reliant on oil imports.

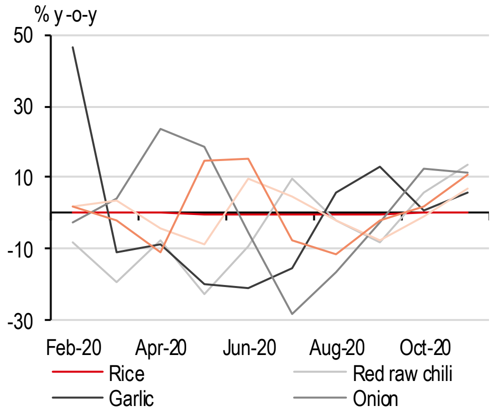
Beyond supply-side risks, however, demand-side risks to inflation also loom. Real interest rates in the Philippines are currently at their lowest levels in two years as a result of the Bangko Sentral ng Pilipinas' (BSP) recent policy rate cuts. The BSP has reduced interest rates by 200bp this year, in addition to injecting additional liquidity to the market through reserve requirement ratio cuts (RRR) and increased purchases of government securities. Demand-side inflation has remained relatively benign for now, causing the gap between headline inflation (% y-o-y) and real interest rates to widen (Chart 7). However, underlying price pressures may build in the coming months as the economy emerges out of lockdown and economic activity normalizes. We expect full-year headline inflation to average 2.9% in 2021, with notable upside risks if the pace of the economic recovery quickens. We believe the BSP will keep the policy rate on hold in 2021, but expect the central bank to resume RRR cuts in the second half of the year.

Indonesia

Indonesia's inflation has been remarkably well behaved in recent years. While subdued growth and energy price controls explain a large part of this, we must remember that food price management in Indonesia has improved drastically. The government was able to boost rice yields through improving farmer education, resulting in a reduction of domestic crop prices, while simultaneously liberalizing food imports and improving rural food supply management.

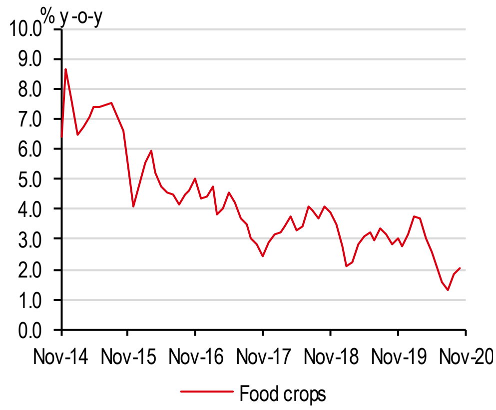
Headline and core inflation fell substantially over the course of 2020. Lower incomes reduced demand for discretionary items, while sufficient domestic rice supply kept prices at bay. Recently, however, food prices are increasing. Based on daily food price data, prices of chicken, red chili, onion, eggs, and cooking oil have started to increase, just to name a few (chart 8). As of now, the price increase is moderate, and for some of the more discretionary food

8. Food prices are starting to pick-up in Indonesia, in a broad-based manner



Source: Indonesian Statistics Authority

9. Fortunately, food inflation will likely continue the long-run downward trend



Source: CEIC, HSBC

items, a sharp improvement in palm oil prices and rural incomes may help explain the increase. The momentum in rural income growth is unlikely to be sustained. Crucially, rice prices have remained flat all year, thanks to sufficient stockpiles and a strong harvest (see chart 9).

We think that Bank Indonesia continues to pursue accommodative monetary policy in the short-term, with 50bp of further cuts by the end of 1Q21 (25bp in the December meeting and 25bp in 1Q21). Previously, we only expected one more 25bp cut. Conditions are expected to remain ideal for cutting rates in the short-term: a massive trade balance (by historical standards), low inflation and a high real policy rate, subdued growth, and improving global risk sentiment. This may not remain the case for too much longer, meaning that there is a risk that BI may seek to front-load the last rate cut in the December meeting. We believe monetary authorities will start to turn more cautious in the second half of 2021 as the current account deficit starts to widen, but we only expect a tightening cycle to begin in 2H22.

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