Economics

DBS Flash

South Korea & Taiwan: lower inflation, stable rates

Group Research

March 5, 2019

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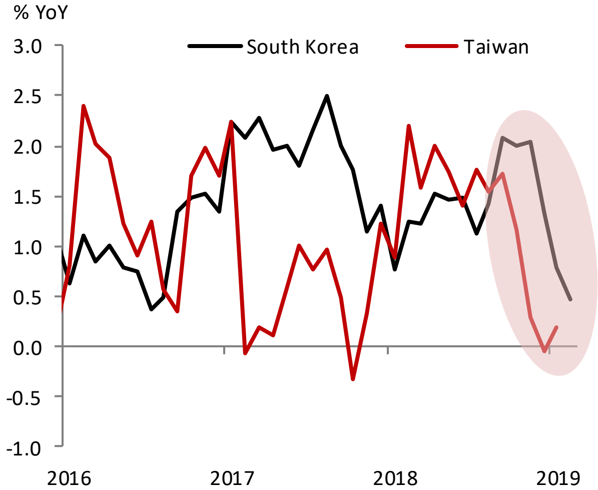
- *Inflation is easing faster than expected in South Korea and Taiwan. Given the strong momentum of disinflation, we have lowered South Korea's CPI forecast to 1.1% for 2019 and 1.5% for 2020. Taiwan's forecast has also been trimmed to 0.7% for 2019.*
- *Our numbers have considered a moderate rebound in oil prices to US$70-75/bbl in 2H19, normalisation in food prices, and hikes in minimum wages.*
- *Despite lower inflation, we maintain the view for the short-term KRW and TWD rates to stay stable in 2019-20.*
- *The BOK just raised rates four months ago to address the side-effects of accommodative monetary policy. A policy U-turn appears unlikely unless economic shocks occur and recession risks increase substantially.*
- *Excess liquidity, narrow interest margin and intense competitions in the banking sector are long-standing problems in Taiwan. The CBC may not rush to cut rates unless recession happens, and stimulus is strongly required.*

Trimming inflation forecasts

Inflation is easing faster than expected in South Korea and Taiwan. Headline CPI in South Korea registered an average of 0.6% YoY in January-February, sharply lower than the 1.8% in 4Q18. In Taiwan, headline CPI also dropped notably to 0.2% in January, down from 0.5% in 4Q18 and 1.7% in 3Q18 (Chart below). **The strong momentum of disinflation necessitates a downward revision in the annual CPI forecasts.** We have revised down South Korea's inflation forecast to 1.1% from 1.7% for 2019, and to 1.5% from 1.6% for 2020. Taiwan's inflation forecast has been trimmed to 0.7% from 1.0% for 2019, while kept unchanged at 1.0% for 2020.

South Korea & Taiwan: CPI inflation easing rapidly



Admittedly, oil prices have started to rebound more recently, thanks to the recovery in global risk appetite, policy stimulus out of China, and optimism about US-China trade negotiations. A further rise appears likely in the coming months, given that OPEC countries have started to cut back oil production and the US's waiver on Iran sanctions will expire by end-April. We currently forecast the Brent crude oil prices (USD/bbl) to average mid-60s in 1H19 and rise towards the USD70-75 range in 2H19. Nonetheless, this implies that **the full-year energy inflation will be about 0% YoY in 2019**.

The underlying core inflation is also likely to be muted this year. **Despite the government's push for minimum wage hikes in South Korea and Taiwan, the passthrough onto consumer prices is expected to be minimal**. This considers the ongoing slowdown in GDP growth, deterioration in output gap and subdued inflation expectations. The corporate sector in South Korea and Taiwan are more likely to absorb the increase in wage costs (e.g., scaling back hiring plans, shifting to part-time workforce) than to raise the selling prices, in our view.

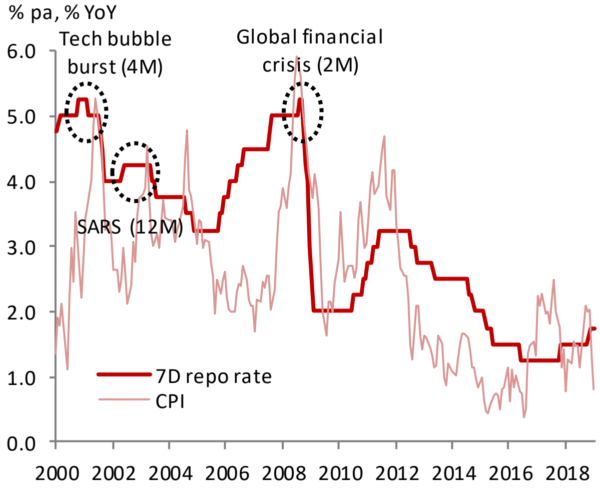
Uncertainties will mainly come from the volatile food components in the CPI basket. Food prices in South Korea surged as much as 7-8% in 2010-11, due to the serious outbreak of foot-and-mouth disease and the resultant shortage of meat/dairy supply. This year, the country temporarily raised alert on FMD in January. In Taiwan, food prices tend to be boosted by the summer typhoons due to the disruption on vegetable and fruit supply (e.g., 4-5% rise in food prices in 2012 and 2016). Under our baseline scenario, we expect food inflation to stay at the long-term normal levels this year, at a circa 4% in South Korea and 2% in Taiwan. This implies a moderate pickup from last year's 2.9% and 1.0%, respectively.

Rate cuts remain unlikely

On surface, CPI inflation has fallen well below the benchmark interest rate in South Korea and Taiwan, opening the door for potential rate cuts. But we doubt that the two central banks will pursue such moves anytime soon. Our forecast remains for the Bank of Korea (BOK) to keep the 7-day repo rate unchanged at 1.75% through 2019-20, and for Taiwan's central bank (CBC) to hold the discount rate at 1.375% in 2019-20.

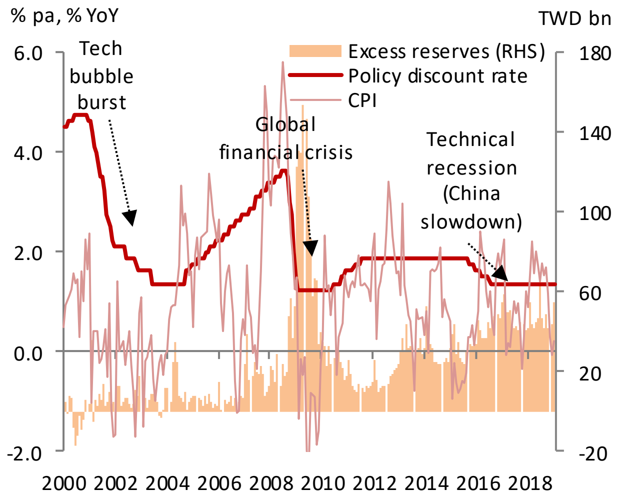
The BOK has said explicitly at the latest policy meeting in February that it is not considering a rate cut for the time being. In fact, the BOK just raised rates by 25bps four months ago in Nov18 to address the side-effects of the persistently accommodative monetary policy, such as the rise in property prices, expansion in household debt and deterioration in financial imbalance. **Historically, the BOK shifted from rate hikes to rate cuts within 12 months only when economic shocks occurred and recession risks increased substantially**. These include the periods during the global tech bubble burst in 2001, SARS outbreak in 2003, and global financial crisis in 2008 (Chart below). Back then, GDP growth contracted on the QoQ basis for one quarter (-3.0% in 4Q00, -2.7% in 1Q03, -12.7% in 4Q08). The current macro environment does not justify such a drastic policy U-turn, in our view.

South Korea: Monetary policy U-turns (2000-18)



The CBC has also maintained a neutral policy as of the latest meeting in Dec18. Excess liquidity, narrow interest margin and intense competition among the banking sector are long-standing problems in Taiwan. The amount of excess reserves held by financial institutions, for instance, has risen steadily after the 2008 GFC and is now equivalent to two times of the long-term average (Chart below). Prior to the recent economic slowdown, the bias was for the CBC to normalise interest rates and mop up liquidity. In fact, **during the past two decades, the CBC moved to cut rates only when recession happened and monetary stimulus was strongly required.** These include the 2001 tech bubble burst, 2008 GFC, and 2015 technical recession, when GDP growth went negative on the QoQ basis for at least two quarters. Barring a recession this year, the CBC may not rush to slash rates, in our view.

Taiwan: rate cut cycles (2000-18)



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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).