

In the top left corner, there are six small white dots arranged in a horizontal line, followed by a blue wavy line below them. A large, thin blue arc curves from the left side of the slide towards the center.

2023 Global Macroeconomic Outlook

“Pockets of hope amidst mounting uncertainties”

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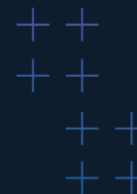


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Executive summary

1

The Fed's tactics to raise rates in order to bring down inflation seems to be working, as weakening demand have driven disinflation for core goods and services. Commodities remain a wildcard given the supply-constrained energy market, but in the short-run strong USD and the spectre of recession is still weighing down on prices. A moderating inflation means that the Fed could end its rate hikes relatively early, but it may not ease policy too rapidly either in our baseline, soft landing, scenario.

2

The probability of a soft landing and rather shallow recession have been bolstered by the end of China's zero-COVID policy recently, which should provide some support for commodity prices and Asian economies in general. However, China is facing difficulties in trying to revive its beleaguered property sector and domestic consumption. The path of least resistance is still for China to export its way out of a slump, which could translate to more disinflation plus anaemic global growth going forward.

3

Despite the reduction in USD liquidity and asset prices in general, the risk of financial instability at the core of the Dollarised financial system (the US) is relatively modest. However, the risk remain significant elsewhere (in energy-importing Europe and risky peripheral markets), implying that the Fed should, eventually, return to more accommodative policies. Increased volatility on the supply side (related to energy and geopolitics) may limit the Fed's ability to dampen the global business cycle, however, which means that there are alternative (worse-case) scenarios where the global economy would either (1) suffer from stagflation, or (2) experience sharp swings between reflation and recession.

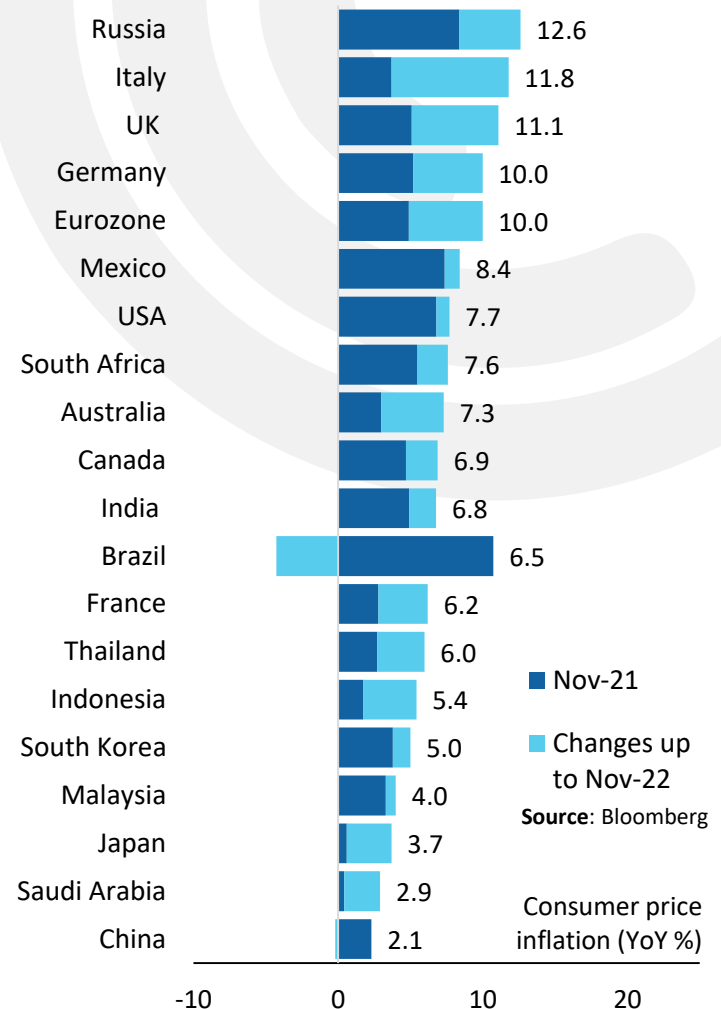
#1: Introduction

Recovery, rudely interrupted

The year 2022 was supposed to be the year of recovery after a two-year pandemic hiatus; inflation was supposed to be a temporary hiccup. Instead, we are teetering on the brink of a new recession. Russia's invasion of Ukraine upended the energy market and revved up inflation to levels unseen in four decades. The Federal Reserve was pushed to tighten its policy, forcing other monetary authorities to follow suit (with a couple of exceptions). The drying pool of global liquidity is now starting to curtail demand, which is the cost that the global economy has to pay to supplicate the gods of inflation.

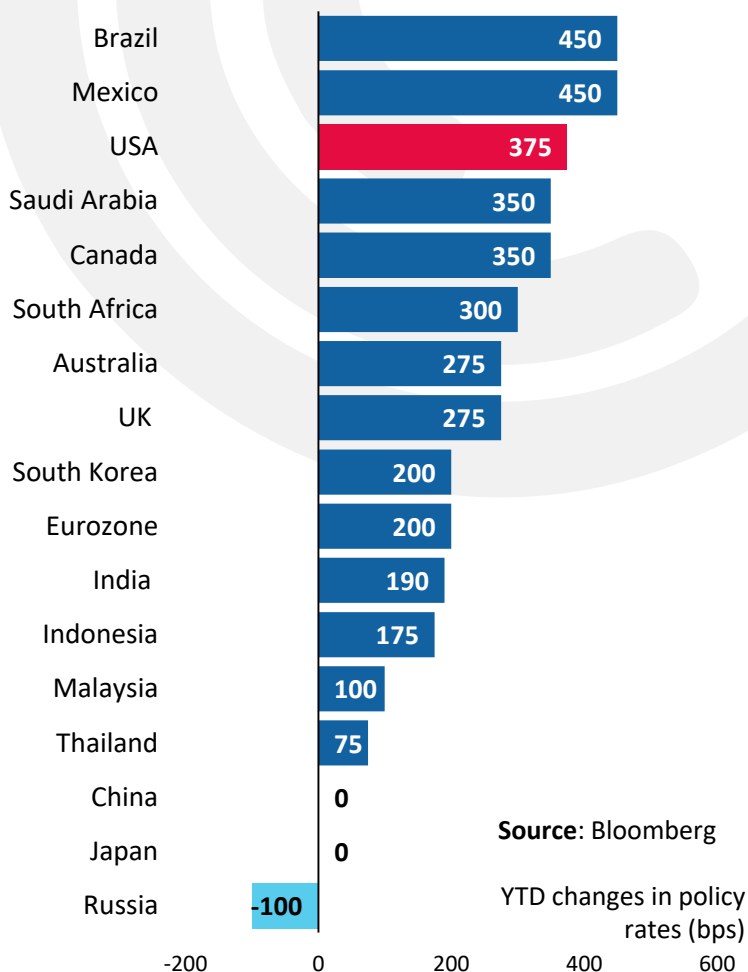
- Inflation is, undoubtedly, *the* central question facing global policymakers today, and the reason why – instead of a long post-pandemic boom, we are now staring at a second recession in four years.
- We should recall, however, that **the current inflationary pressures dated back to 2021, not just 2022**. For example, US inflation was already past 6% in Q3-21. This earlier wave was driven by soaring demand, boosted by fiscal and monetary stimulus, as well as supply chain bottlenecks across the globe. On the other hand, the 2022 wave was more clearly related to the surge in commodity prices after the Russo-Ukrainian War.
- Inflation, then, is not the same experience for every country. A few, like Brazil, were already in the throes of inflation by late 2021 and consequently tightened policy much earlier. On the other hand, Europe's inflationary surge happened mostly in 2022, and the ECB is only starting to grapple with the problem. The same combo of spiking energy prices and stronger USD that wreaks havoc in Europe is also at work in many economies, including Indonesia, which – after holding the line against energy inflation for almost a year – ultimately was forced to hike subsidised fuel prices.

Chart I-1. Global inflation did not start with the Russo-Ukrainian War



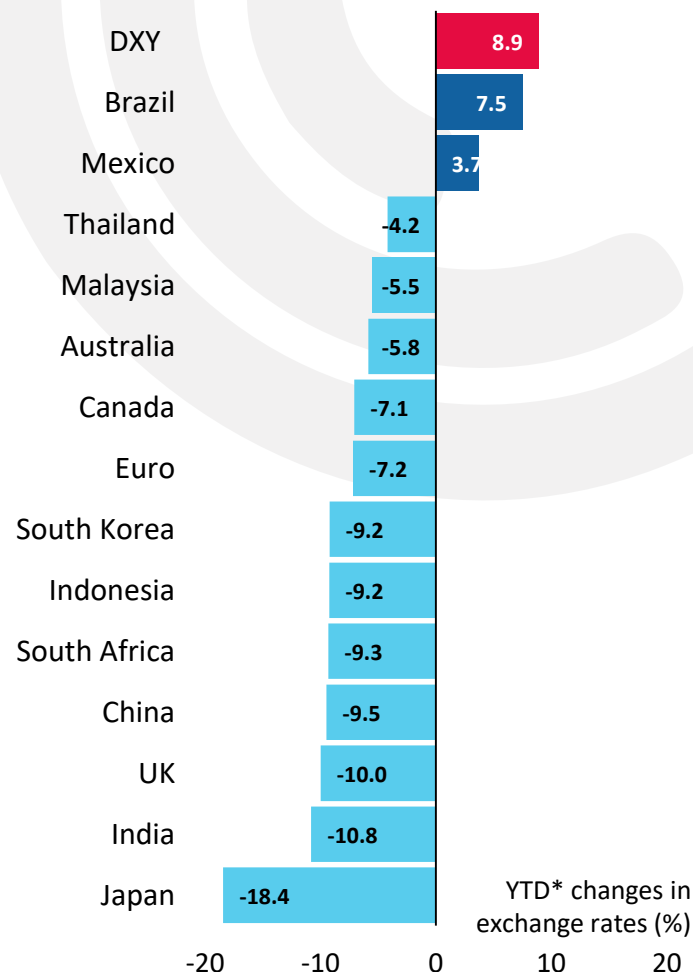
- Jerome Powell's Federal Reserve has done an about-face by withdrawing stimulus and raising rates by 375 bps per November. For the Fed, this tightening is a no-brainer, as the US economy has bounced back quite strongly from the pandemic, and **there are some evidence that too-strong demand has contributed to inflation (although supply-side factors are likely a bigger part of the equation).**
- But not all economies have – or indeed can afford to – hike as aggressively as the Fed. Some are in an earlier stage of recovery, while others (like Europe as a whole) have seen greater supply-side pressure, which may not be quelled by rate hikes alone.
- As such, Fed rate hikes have put other central banks into a quandary. **They can attempt to match the Fed's pace at the expense of growth, or they can let their currency slide vs the USD, which would then prompt more imported inflation.** Indonesia is arguably a rate-hike laggard, which was justified (at least for a while) by commodity-related inflows, but in recent weeks have left the Rupiah exposed as coal prices slipped.

Chart I-2. Not all central banks are willing to hike rates as aggressively as the Fed



- Other economies are laggards for different reasons. For instance, Russia is facing a peculiar mix of huge windfall and inability to import, which strengthen the Ruble to the point where “Dutch disease” is now a real danger. But the most interesting and relevant laggards are China and Japan.
- Both China and Japan are export-oriented economies, with obvious incentives to keep an undervalued currency – but there are more distinct factors at work. **China’s zero-COVID policy, coupled with the implosion of its real estate sector, has put its recovery behind other major economies.** Indeed, the urgency to prop up its economy justifies the PBOC’s (and the CCP’s) defiance in the face of a stronger USD.
- Meanwhile, Japan had faced multiple decades of stagnant growth, rising debt levels, and low inflation. As such, the current bout of inflation offers a unique chance for the BoJ to recalibrate inflation expectations, reset consumer outlook, and ease the debt burden. Japan’s current experiment with yield curve control is not without its threat (more on this later), but in the short term, its impact on the value of the Yen – and the Yuan – are of importance for their influence on other Asian currencies.

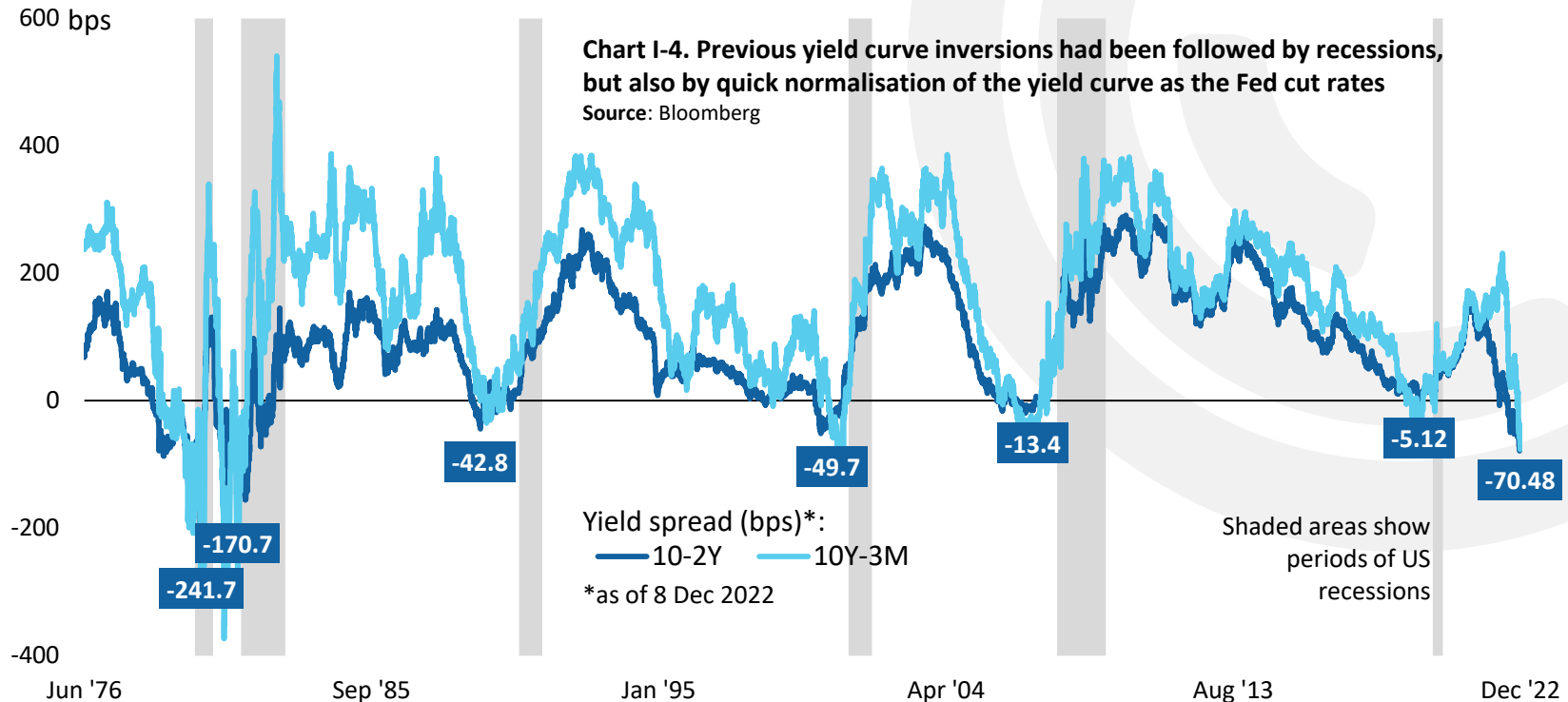
Chart I-3. Radical tightening could be needed to withstand the USD’s pressure



Source: Bloomberg

*As of 9 Dec 2022

The inverted yield curve signals potentially the sharpest global downturn since the early 1980s



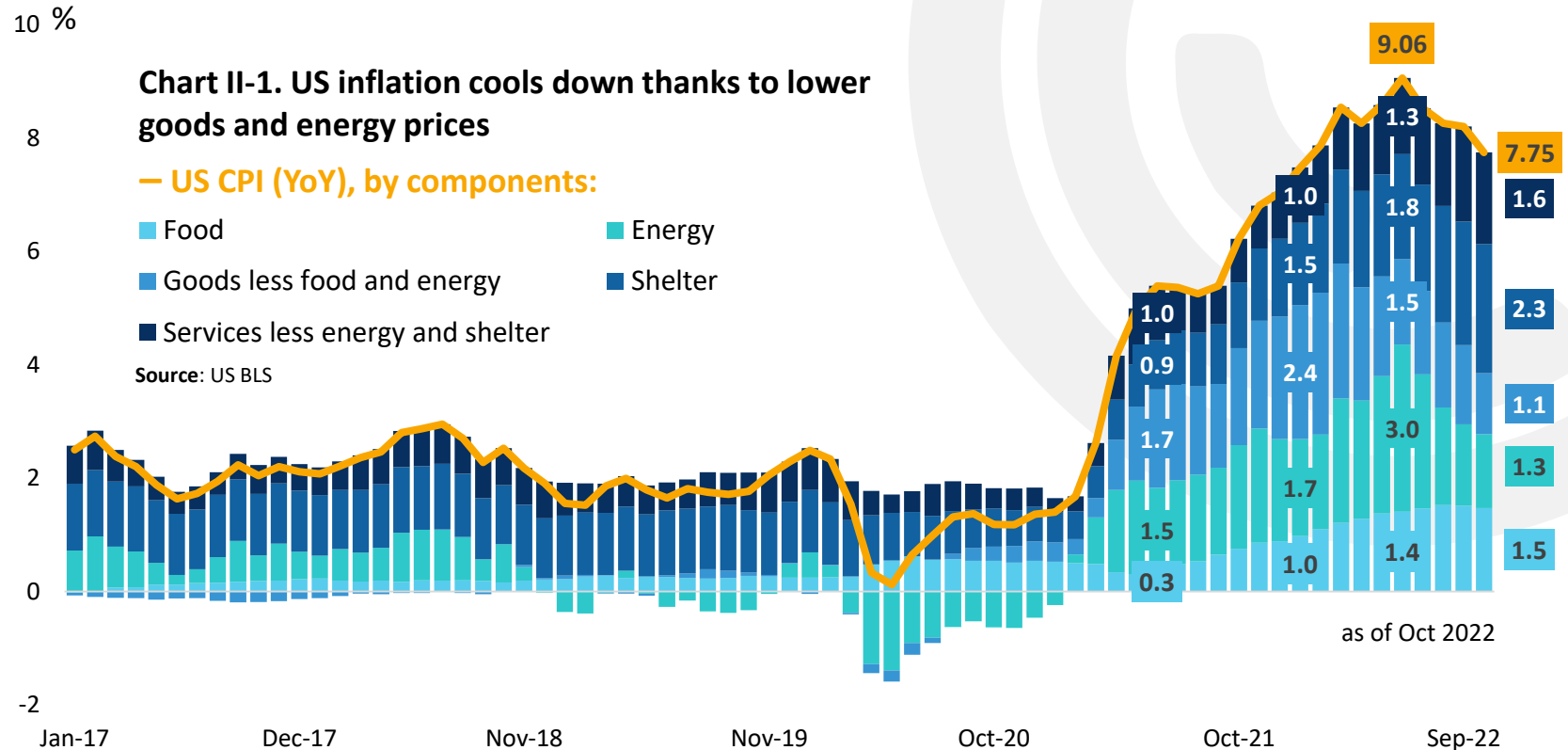
- Finally, there is also the story of downturn, as rate hikes are taking a toll on global demand. Many in the market expects the Fed to continue hiking rates in the short-term, but revert to a lower-rate environment in the longer-run. This is reflected in the yield curve, which (especially for 10-2Y) has reached its most inverted level since 1981. **This is both a bad sign and a good sign; bad as it signals a potentially severe economic contraction, but good if it indicates a quick return to normal for the inflationary outlook.** Our first order of business, then, is to look at the inflationary dynamics in the US as a starting point for a wider global outlook.

#2: Inflation

The name of the game

Weaker demand is starting to deflate consumer prices, although the extent to which disinflation is already underway may remain obscured by multiple factors for the time being. Commodities, energy in particular, are still the biggest inflationary wildcard, but even here stronger USD are pushing down prices in the short-term. The US and many emerging economies could start to breathe a (monetary) sigh of relief, but little succour is to be found for the big energy-importing economies in Europe and Japan.

US inflation remains on a high note, but more disinflation could be on the way



- Despite the looming slowdown and possible recession, inflation figures in the US are still some way above the Fed's customary target of 2%. Weaker demand have helped suppress goods inflation, especially outside of food and energy, but the service component – particularly rental costs – is still pushing the inflation rate northbound. Part of this high inflation may well persist into the next year, but **the still-high headline CPI figure likely conceals the extent of disinflation that is already underway.**

The Fed is still the ultimate joker card

Chart II-2. The Fed is expected to deliver higher rates, but also more aggressive easing afterwards

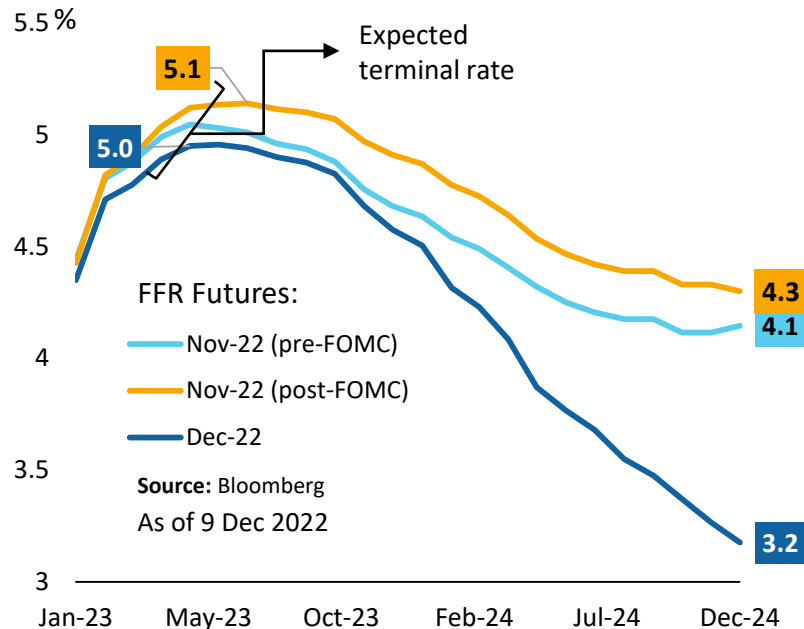
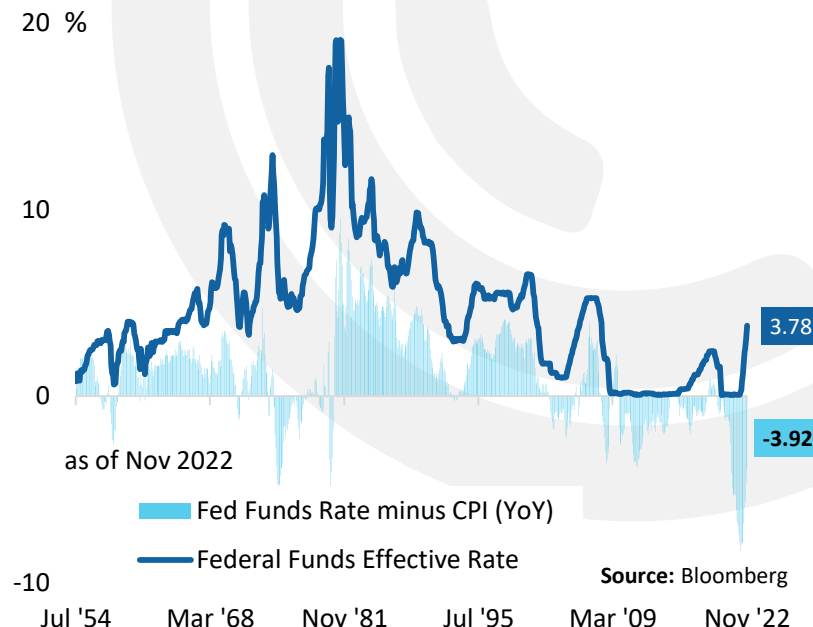


Chart II-3. The Fed's rate hike cycle typically did not end until the contemporary real rate turns back positive



- The receding-but-still-stratospheric headline CPI figure still threatens the Fed's credibility in future fights against inflation. While the Fed has been shifting to a less rigid framework (Flexible Average Inflation Targeting – FAIT), **it also worries that shifting its target from 2% to 3-4% would shift consumers' inflation expectations, which the Fed had worked hard to bring down in previous decades.**
- The historical pattern shows that the Fed's tightening cycle seldom ends when the FFR is still lower than the current inflation rate. If the Fed holds true to form, it still has a lot of ground to hike until it reaches the terminal rate. **Luckily, signs of disinflation are starting to appear, meaning that the Fed may keep rates relatively close to current levels – or even lower – while still maintaining credibility.**

Weakening demand suppress goods inflation

Chart II-4. US consumers are running out of dry powder to support consumption...

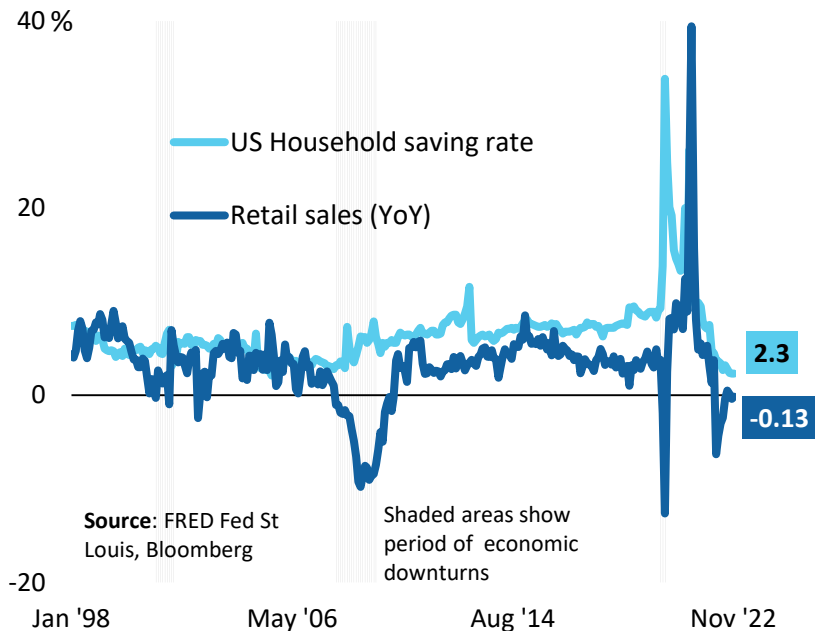


Chart II-5. ...which ease supply chain pressures that further bring goods disinflation



- To be sure, the Fed's tighter monetary policy has hit at one major source of inflation: the exuberant demand.** Looking back, a deluge of stimulus has created considerable build-up in US household savings, which, coupled with the disrupted supply chains and consumption pattern (less services, more goods), caused quite a drastic goods inflation. **Nowadays, those savings has largely been spent, and higher rates would limit consumption, especially for big-ticket items.** Weakening demand has also loosened the supply chain pressures, reducing shipping costs which had been the major inflationary bane in 2021. Of course, the sharp decline in container volumes from China to US is also an indication of a potential global manufacturing recession.

(Slowly) loosening job markets provide further hints of slower inflation

Chart II-6. The wage-price dynamic remains hot but is starting to cool down

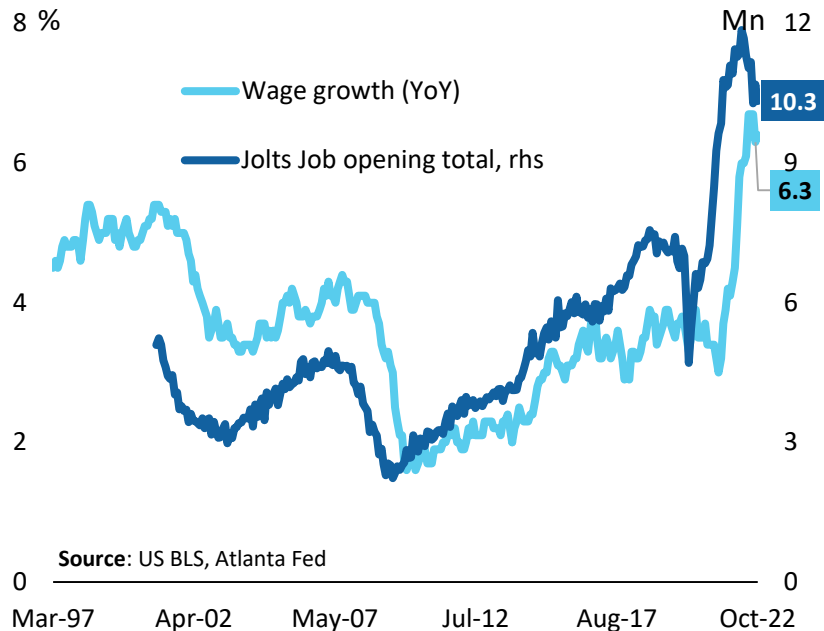
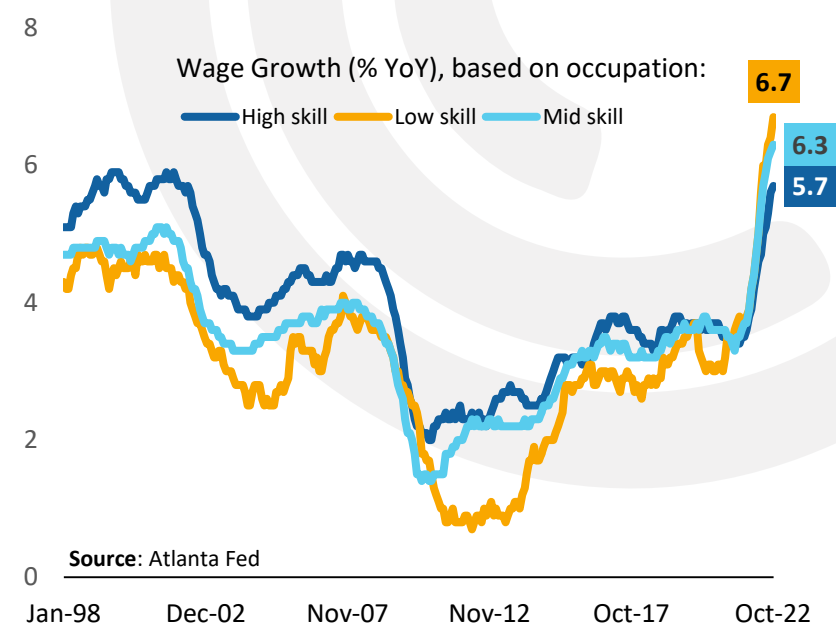


Chart II-7. Much of the wage gains occurred in the lower segments, which might be easier to tamp down as well



- Weakening demand may have deflated goods prices, but **American consumers remain euphoric about the full-scale return of the service sector**. Still-robust demand conditions, especially for services, explain the still-hot labour market (the US economy now employs 804,000 more workers compared to the pre-pandemic peak). However, with interest rates continuing to reach higher, demand for labour finally shows some hint of slowing down (although not slow enough to suppress wages and put the wage-price spiral to bed). Moreover, it seems that labour demand is tilted towards lower-skilled jobs. As this side of the labour market is typically more elastic, **weaker consumption may lower demand for lower-skilled workers more precipitously**, which may soon put a stop to the wage-price spiral.

Housing disinflation is not distributed equally ...

Chart II-8. US property values are trending downward as financing costs soar...

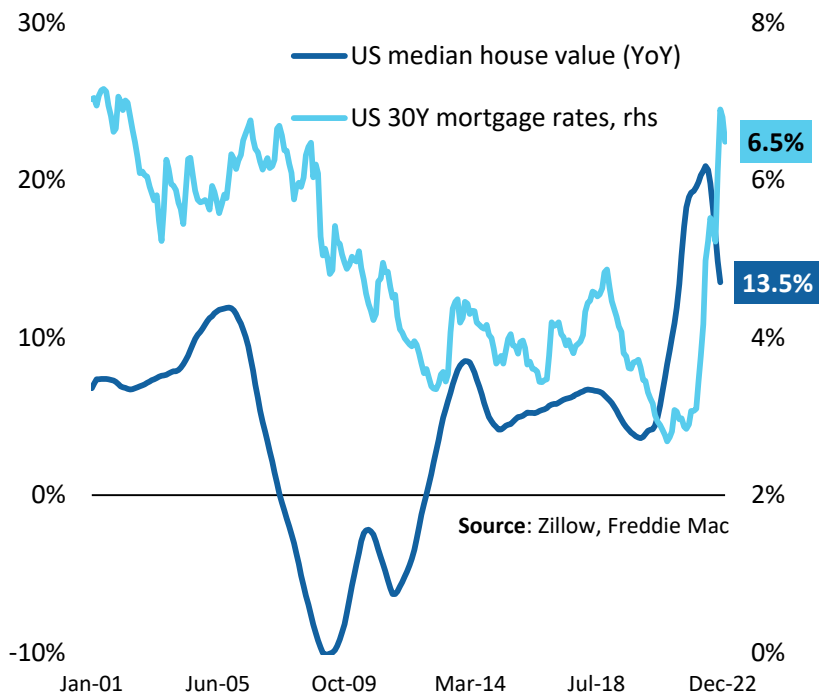
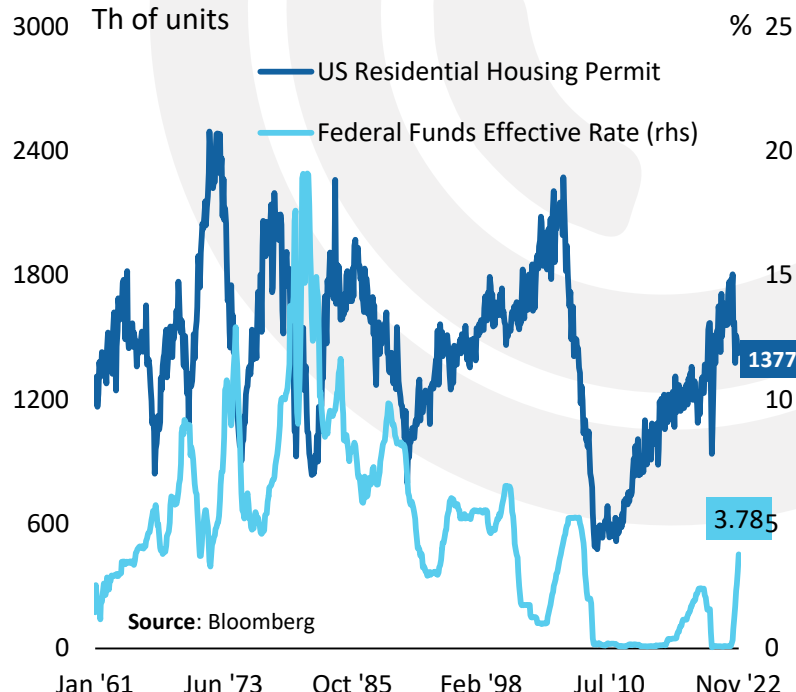


Chart II-9. ...while property development stalled as interest rates surged

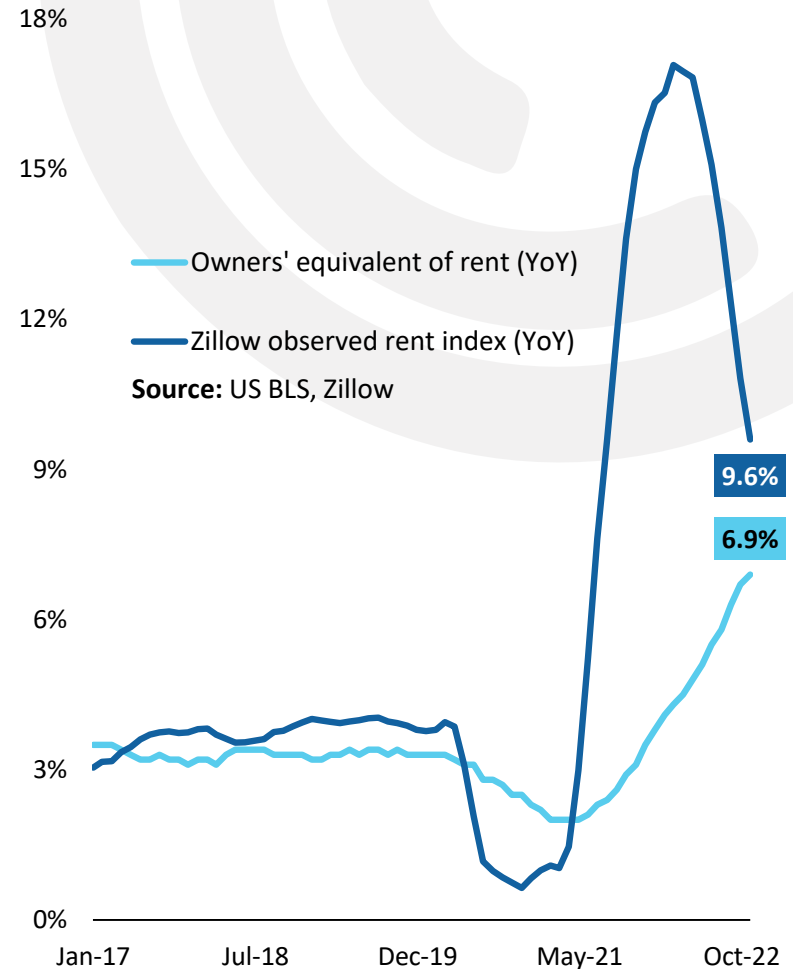


- Unlike demand for most goods and services, **the impact of higher rates may not translate directly when it comes to shelter CPI**. Yes, higher interest rates deflate property prices which had been rallying during the pandemic-era QE. But higher mortgage costs may turn aspirant owners back to the rental market despite declining property prices. At the same time, higher interest rates also stymie property developers sensitive to changes in short-term rates, **which could limit the supply of new residential units, some of which might be available for rental**. As such, rising rates may actually cause *higher* rental inflation in the short-run.

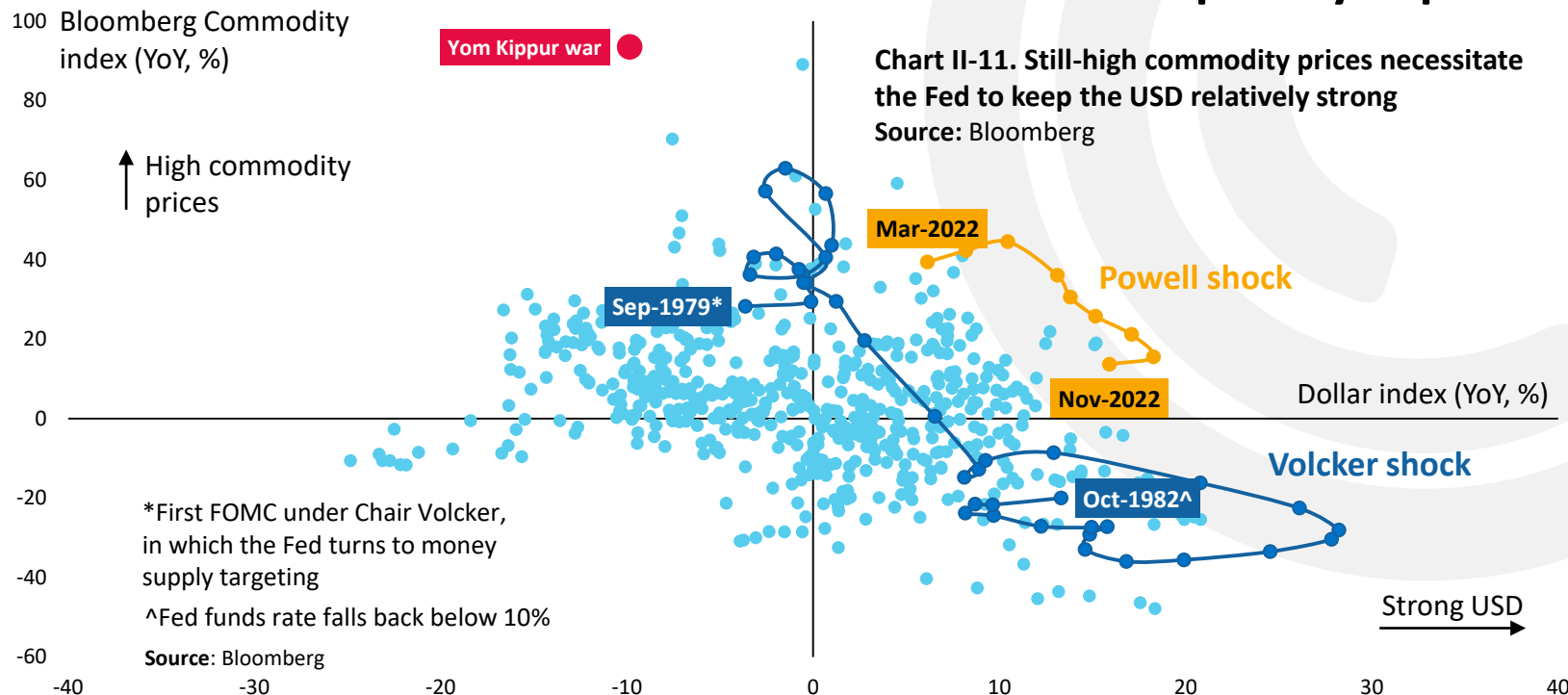
... and may be obscured by a rather peculiar methodology

- The issue is further complicated by the methodology used to estimate shelter inflation. The BLS calculates the so-called owners' equivalent rent (OER), which tracks property owners' expectation of rental income. Higher mortgage payments naturally prompts homeowners to demand higher rentals, adding another positive component to shelter inflation.
- We should also keep in mind that the rental CPI for non-owners includes the utility bills, which have risen as electricity and gas prices soar. Rental surveys also tend to be backward-looking as the prices tend not to adjust on month-to-month basis.
- A potentially fairer – and more timely – benchmark for shelter inflation would be observed rental prices from online marketplaces. Here, indeed, we have seen a sharp slowdown since Q2-22 (pretty much concurrent with Fed rate hikes). **We could thus add shelter to the disinflation column, even though its impact on headline CPI may remain obscured for some time.**

Chart II-10. Rent prices may already fall despite surging OER inflation



Powell's shock therapy is working, but commodities have not completely capitulated



- However, **inflation dynamics in the US (and globally) are still volatile**. The prices of most commodities may have moved southbound as demand recedes and the USD continues to flex its muscle. But, many commodities are still traded above their pre-pandemic level. Indeed, commodity prices (mainly energy and food but also others) remain the elephant in the room for monetary policymakers. **A tight USD environment would be needed to put downward pressure on the commodity market**, considering the USD's central role as the common denominator for many commodities. Moreover, tight Dollar liquidity tend to remove the support for commodity-bullish speculations. **The Fed, then, may not afford to be complacent and declare a win against inflation just yet.**

The global energy (oil) market is held in check by policy interventions ...

Chart II-12. Receding oil prices seem to be the combination of slowing demand...

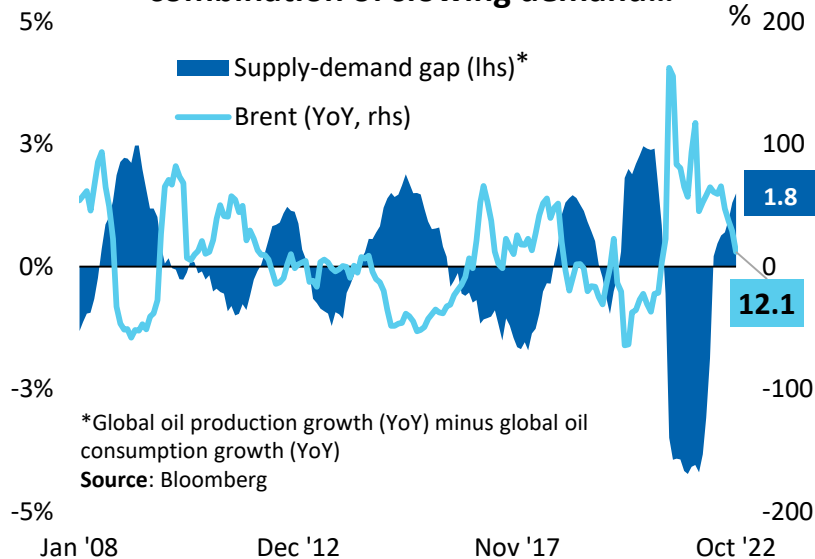
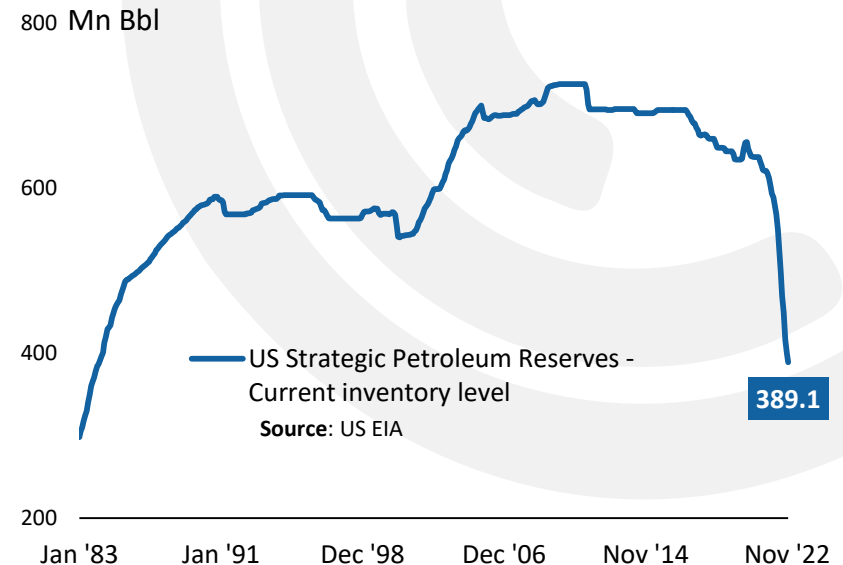


Chart II-13. ...and massive withdrawal of SPR



- Much of the attention regarding commodity prices would eventually narrow down to the price of energy commodities. For now, oil prices seem to be relatively subdued. Indeed, a bleaker economic outlook combined with the significant withdrawal of SPRs had brought down oil prices from the triple-digit level that was common for most of Q1-Q3 2022. Sanctions on Russia's energy exports may also translate to the fire-sale of Russian oil in the short-term, further depressing oil prices as countries snap up Russian oil at discounts.
- **But the global oil market is still fundamentally a seller's market.** Producers including OPEC+ countries have little capacity to increase output, but much willingness and cooperation to cut it. Other swing producers such as the US shale industry could theoretically ramp up production in short-notice, but it is increasingly harder to do so when prices are suppressed and access to cheap credit is being choked by Fed policy.

... but the fundamentals continue to point to a tight market in the long-run

Chart II-14. Restarting activities in China will bring tightness to the oil market...

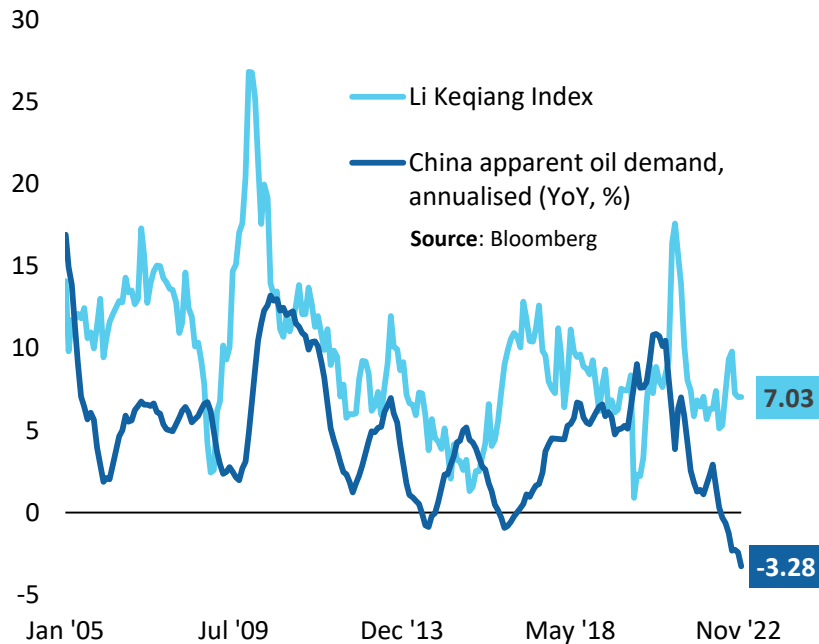
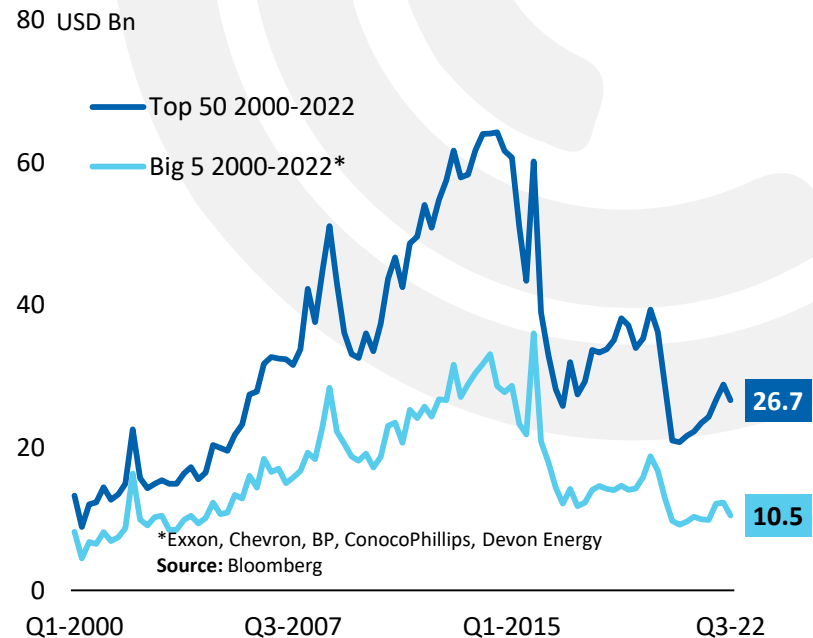


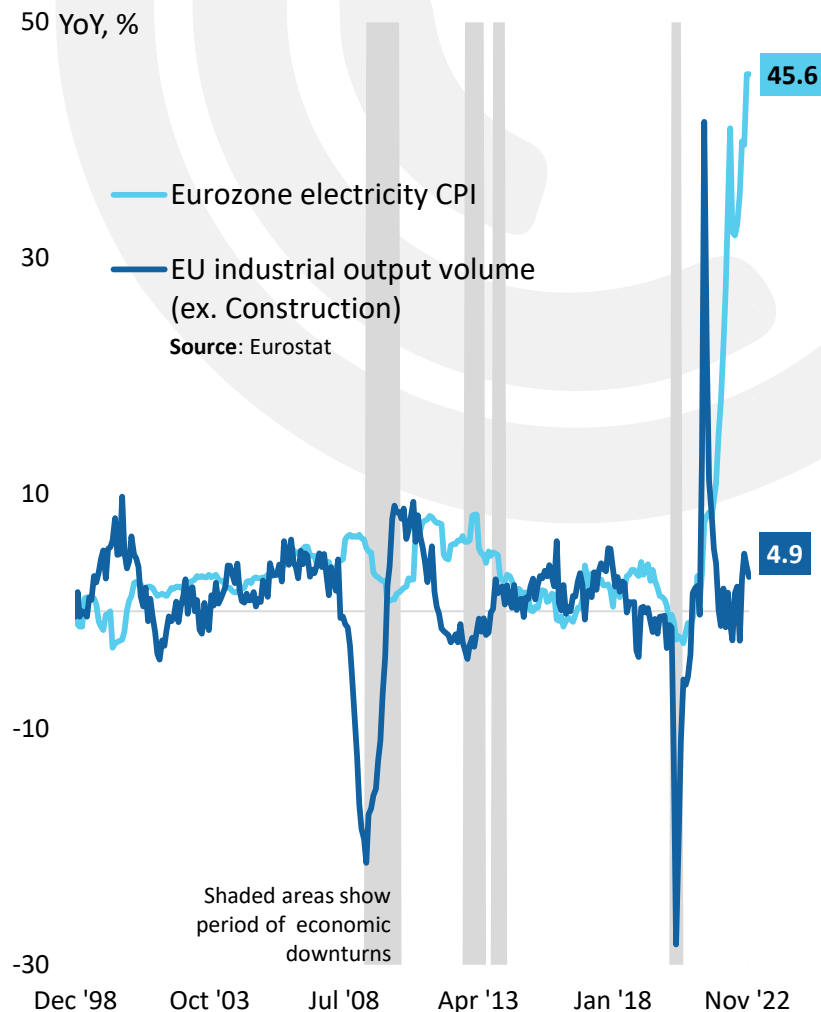
Chart II-15. ...while disrupted CAPEX cycle may limit future production



- **The odds that oil prices will return to the 'goldilocks' level may worsen in the medium term.** First, the full reopening of China's economy is sure to increase demand from the world's second largest oil consumer, driving prices up north. Second, sanctions on Russian energy exports may force Russian producers to downsize their operations, which in turn will tighten supply in the longer-run. Finally, the upward pressure on oil prices would be exacerbated by the presently disrupted CAPEX cycle (a product of tighter financing conditions, especially for “dirty” industries like oil), which may further cap supply in the future.

- We could catch a glimpse of this tightness in what is happening in Europe. **The old continent is facing a stagflationary spiral as high energy prices made manufacturing activities uneconomical** – depressing growth and exacerbating inflation at the same time.
- **Continued tightness in energy supplies could lead to greater economic and (upward) price volatility in the future.** Productive activity, especially in more energy-intensive sectors, may oscillate between zones of expansion and contraction as energy prices ebb and flow. **Just as high energy prices in 2022 lead to weaker demand but not necessarily lower prices** (due to the ongoing manu-facturing halt that leads to scarcity), **the lower energy prices next year could stimulate demand which would also push prices north.**
- This scenario, of course, reflects the greater urgency behind the renewable energy revolution, even though higher interest rates would make it more difficult to provide the capital needed to pursue green energy projects. Truly, **the final whistle has been blown to close the period of low inflation that characterised the global economy from 2012 to 2019.**

Chart II-16. Europe can't revive its manufacturing prowess without cheap energy



More on Europe: Inflation may not resolve anytime soon despite falling demand

Chart II-17. Inflation in commodity-importing Europe is yet to recede as in the US

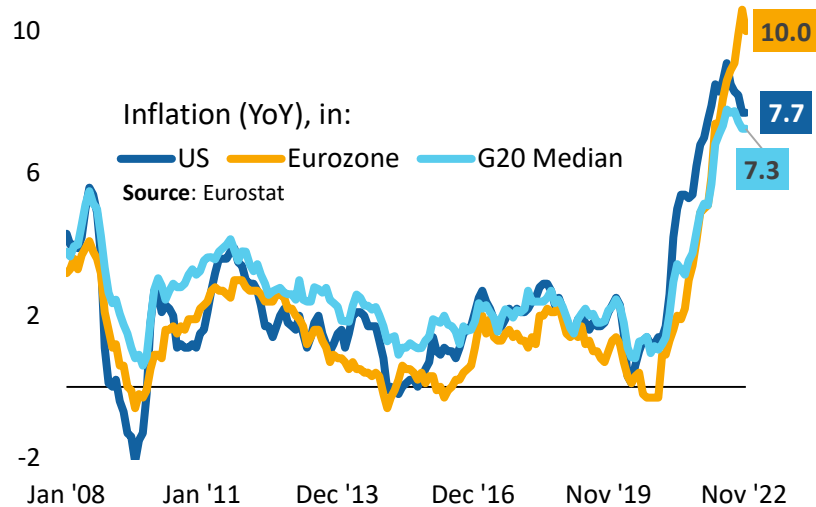
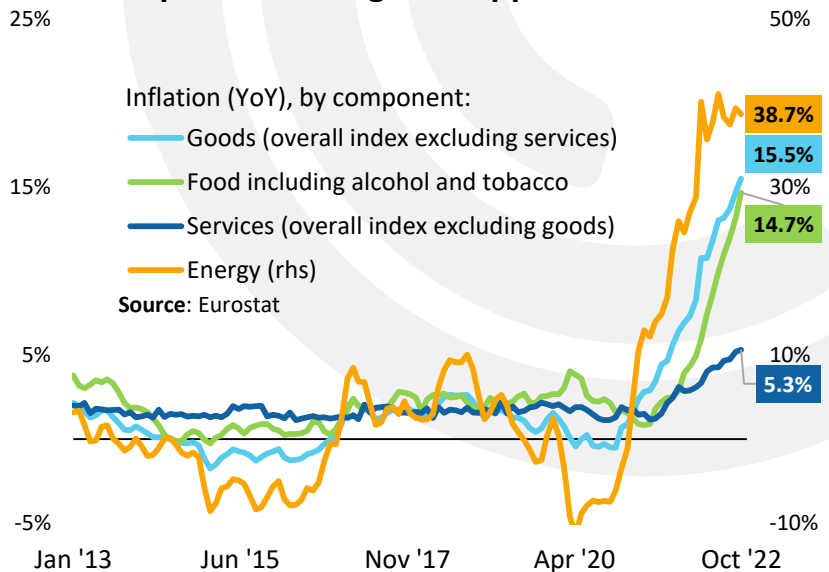
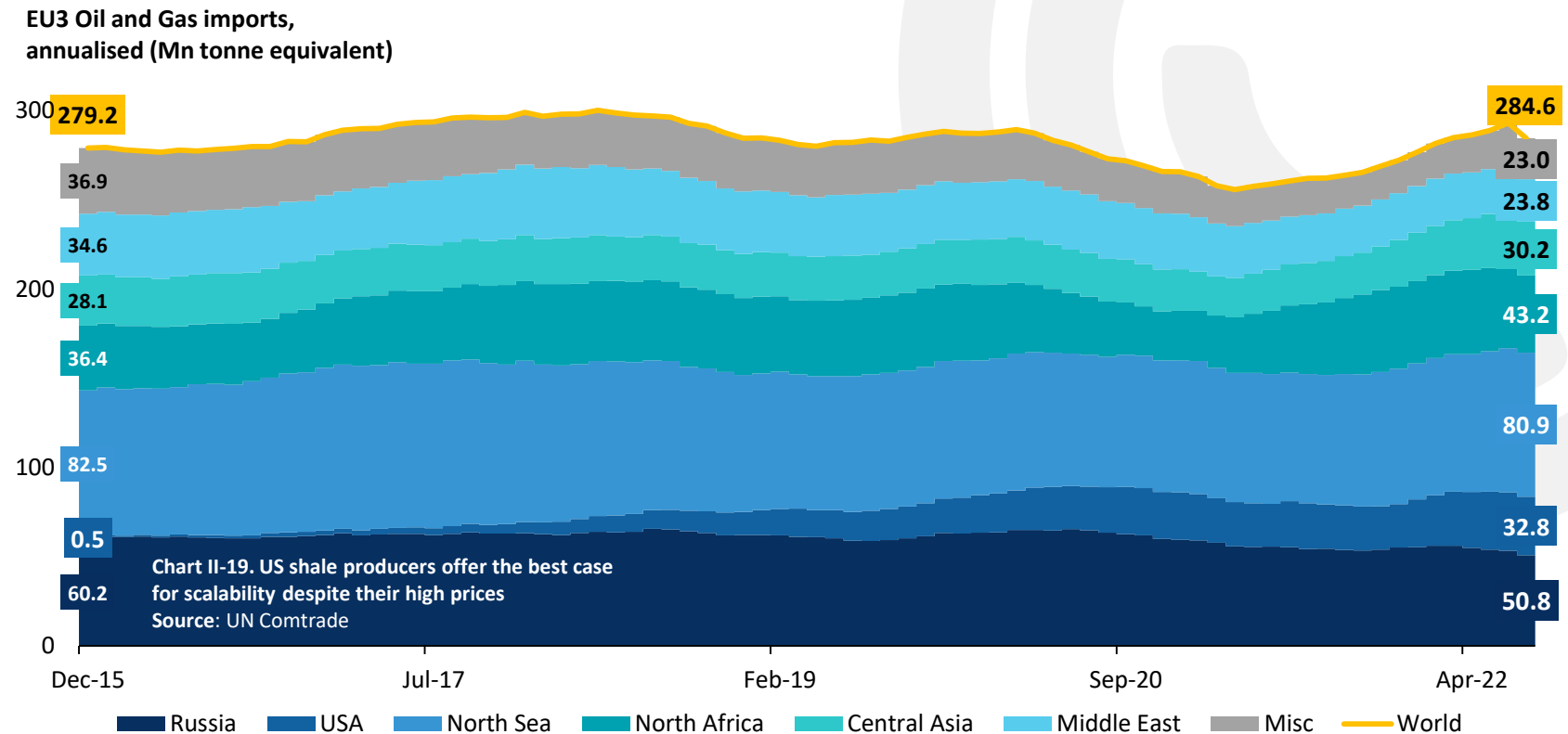


Chart II-18. Goods, energy, and food inflation in Europe remains high as supplies are limited



- All of these inflationary pressures would hit hard on Europe. **The European economy, of course, is a net importer of necessities from food to energy – exposing them to the full extent of volatility in the global market.** Tellingly, it is goods and especially necessities where inflation has hit the hardest in Europe. And while Fed policy has partly succeeded in tamping down commodity prices, it is less effective for Europe as the USD has strengthened at the same time. Furthermore, while Europe's market-based pricing mechanisms for natural gas (in contrast to contract-based mechanisms more common in Asia) helps it secure supplies despite prior pessimism, it comes at a high price and risk further alienating the poorer EU members from the richer ones that could outbid them.

Russia left too big a lurch for US shale producers to fill



- It's important to note that the EU's manufacturing hubs have made a considerable effort to avoid Russian supplies since the invasion of Ukraine. Indeed, Russian oil and gas imports to Europe's manufacturing centre have declined by 13.4% throughout 2022 compared to the previous year. However, other producers simply don't have the scale to meet Europe's increasing demand for natural gas for now, be it US shale or Middle Eastern LNG.

#3: Financial (in)stability

In the shadow of the Dollar

The markets tumble as the Fed tightens, which brings back the spectre of past crises. In truth, the core of the global financial system (the US money market) may be in a robust position as lessons from the past have been applied to build more buffers and liquidity support. But the danger lies on the periphery. Stronger USD tightens financial conditions in the rest of the world, including Europe and Japan which faces bulging fiscal and external deficits. To avoid these troubles feeding back to the US, the Fed might have to extend its support abroad or otherwise change its tune.

Asset values are travelling southward as liquidity tightens

Chart III-1. The US treasury market offered investors a safe place during the 2008 meltdown...

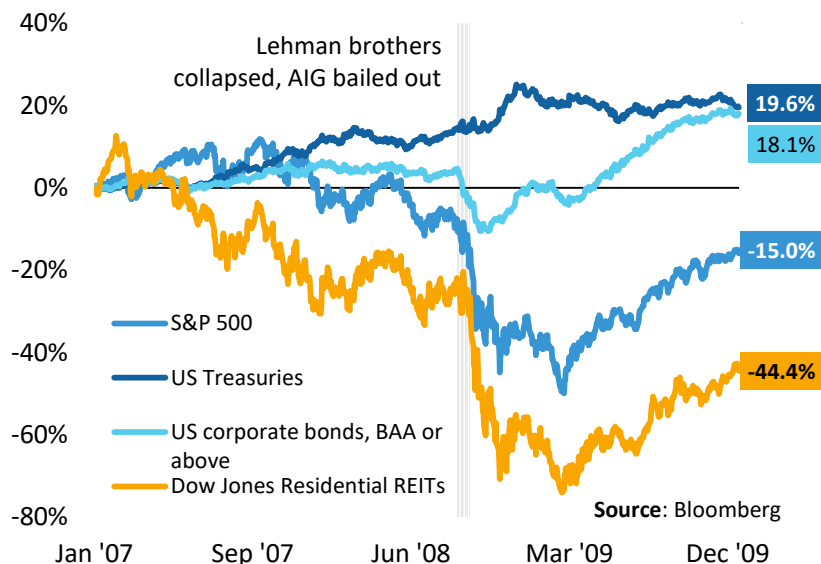
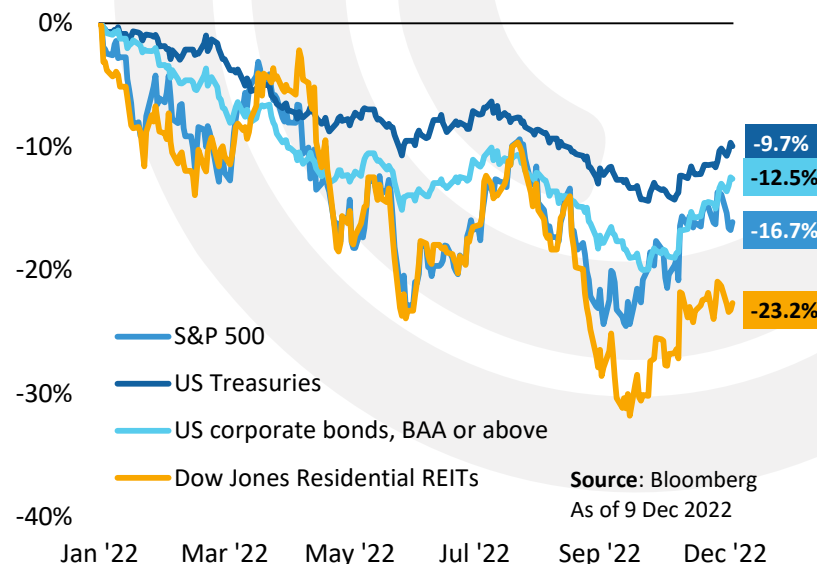


Chart III-2. ...while financial downturns in 2022 offers no place for investors to hide



- Aside from inflation, the Fed's tightening campaign also worked to curb asset prices, which had risen to such exuberance on the back of monetary easing in 2020-21. **Indeed, as 2022 progressed, the market increasingly adopted a "bad news is good news" stance, as worsening macro data induced frenzied speculations that the Fed would pivot and vice versa.**
- And from certain perspectives, there are eerie similarities between 2022 and the historic recession in 2008, in terms of crashing assets and rising volatility in the market (truth be told, the assets downturn in 2022 may be worst than in 2008 as the current market dynamic left no place for investors to seek succour). The issue of mortgages and property prices, in particular, may seem at the surface to be a potential trigger of a wider crisis in the banking system and a sudden drying-up of liquidity in the US (and global) economy. There are, however, several key differences between 2008 and 2022.

The turmoil in the property market is not a particular worry for US banks

Chart III-3. Mortgage delinquency rate in the US remains low thanks to still-ample liquidity

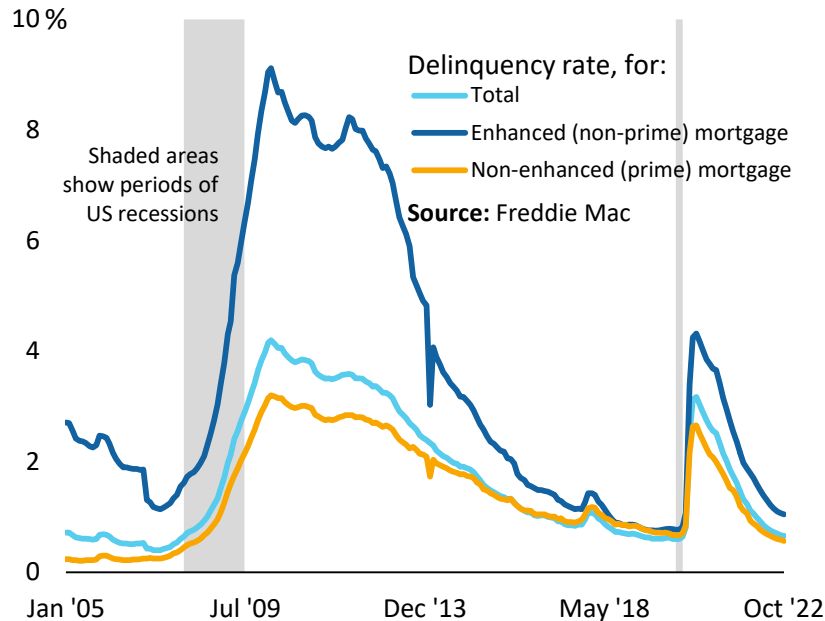
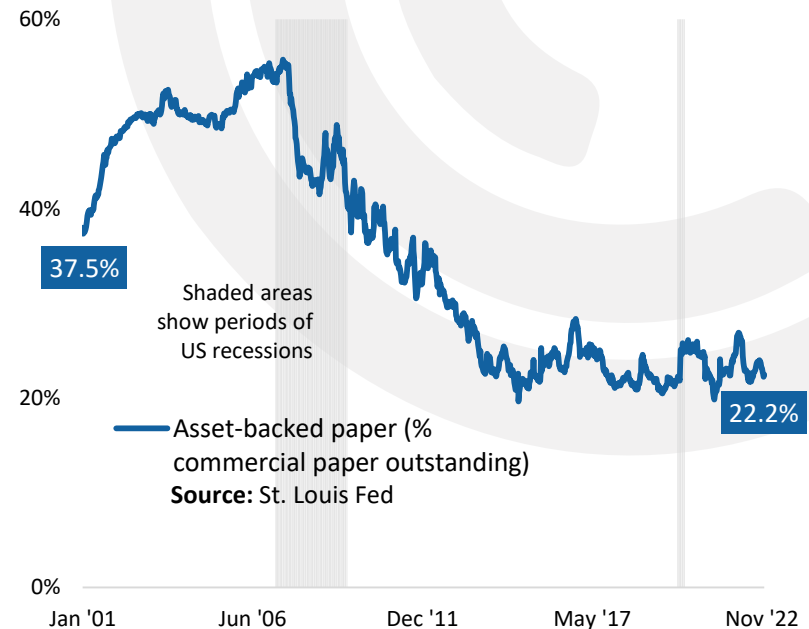


Chart III-4. Lower circulation of ABCP helps banks to avoid downward valuation pressures



- For one, the US banking system has made considerable progress in risk management after the near-death experience of 2008. The improvement comes in two ways. Firstly, banks have eschewed risky instruments like mortgage-backed securities, and focus on higher-quality borrowers compared to the subprime era. This has helped to suppress mortgage delinquency rates (despite the pandemic hiccup, which is quickly resolved). **While delinquencies could rise again due to higher interest rates, the danger that it poses to the financial system as a whole has been greatly dampened.**

The US corporates' financial situation are robust enough to withstand rate hikes

Chart III-5. Weakening consumer confidence would limit private sectors revenue...

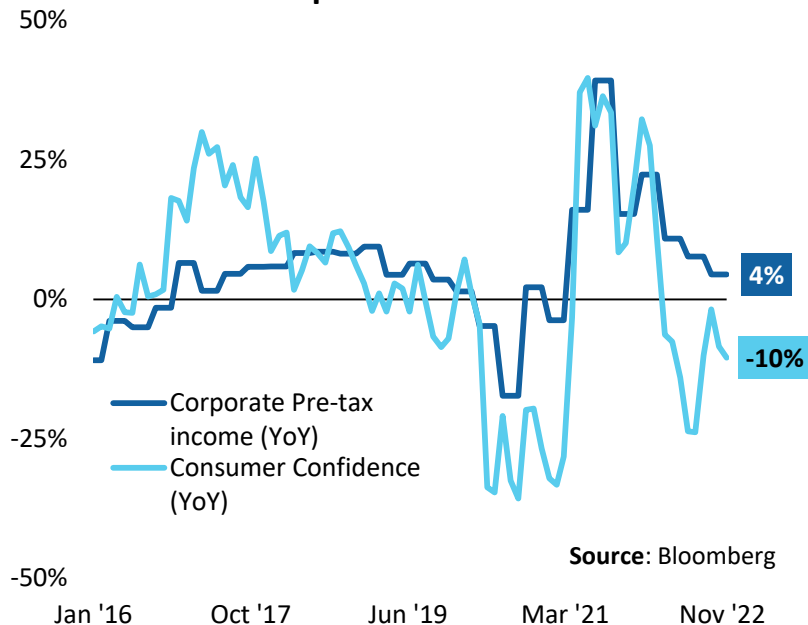
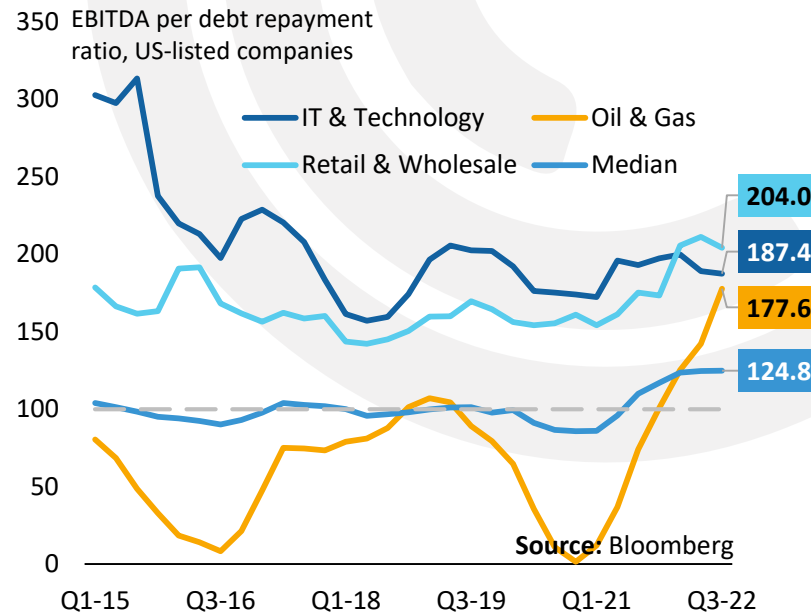


Chart III-6. ...but US companies seem capable of stomaching higher rates



- This also holds true for the corporate lending side. Weakening demand may be putting a brake on US corporate earnings, but they have remained quite resilient thanks to record profit across many industries that stem from supernormal demand throughout Q2-2021 to Q2-2022. **The possibility that the rate hikes could trigger debt deflation and widespread bankruptcies appears remote for now**, and this is especially true if – as we expect – inflation is easing faster than expected and the Fed would start to moderate policies by early or mid-2023.

High levels of liquid assets and stable funding highlight US banks' resiliency

Chart III-7. Higher rates suppress banks' liquid assets, but liquidity remains ample

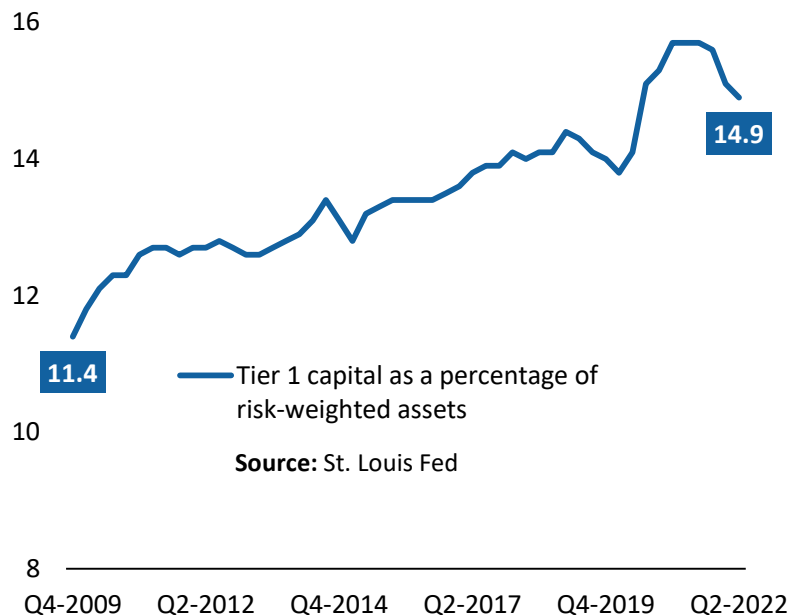
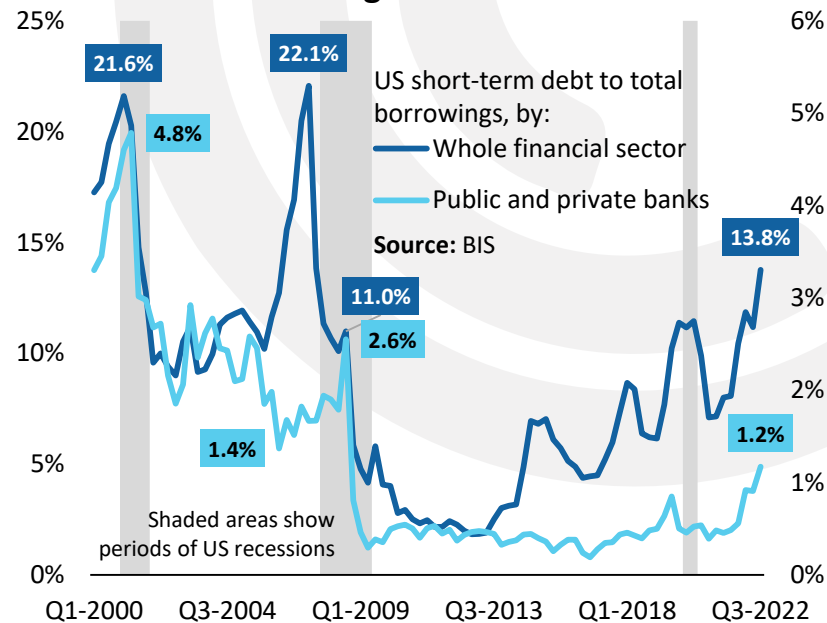
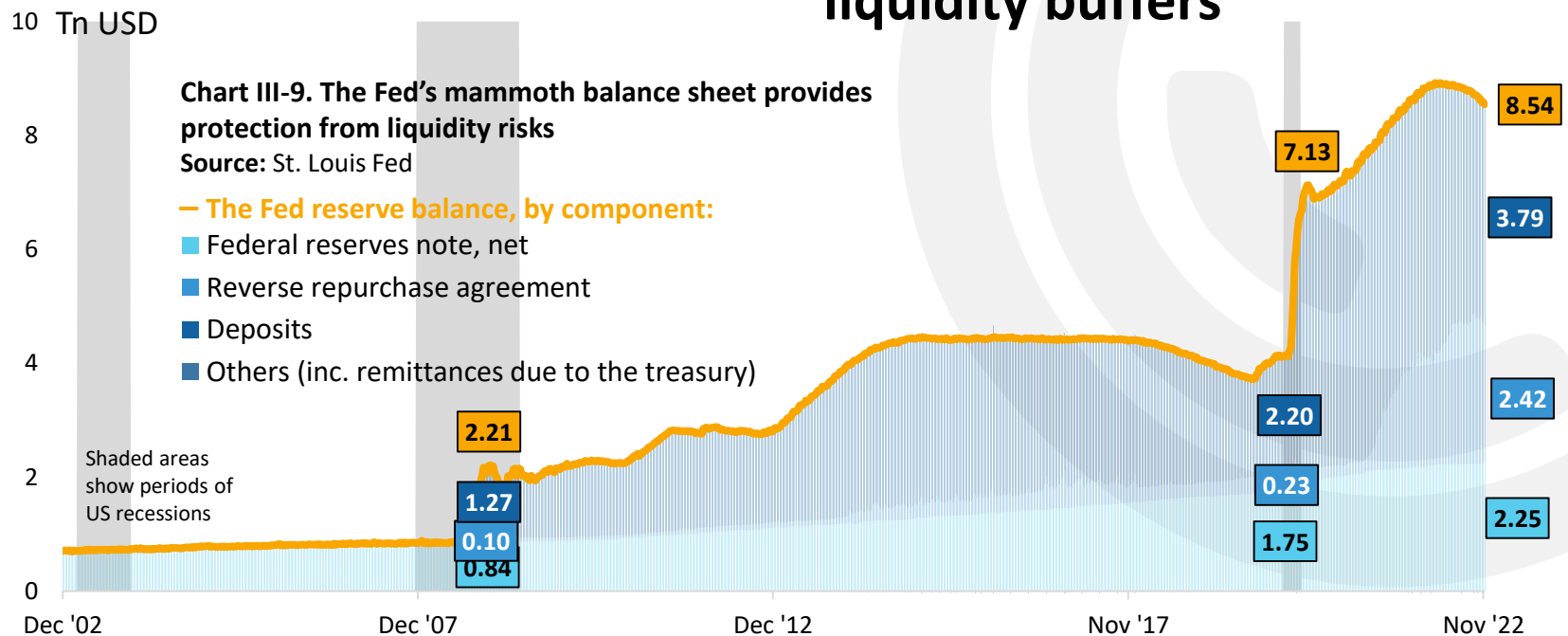


Chart III-8. US banks' reliance on ST wholesale funding remained low



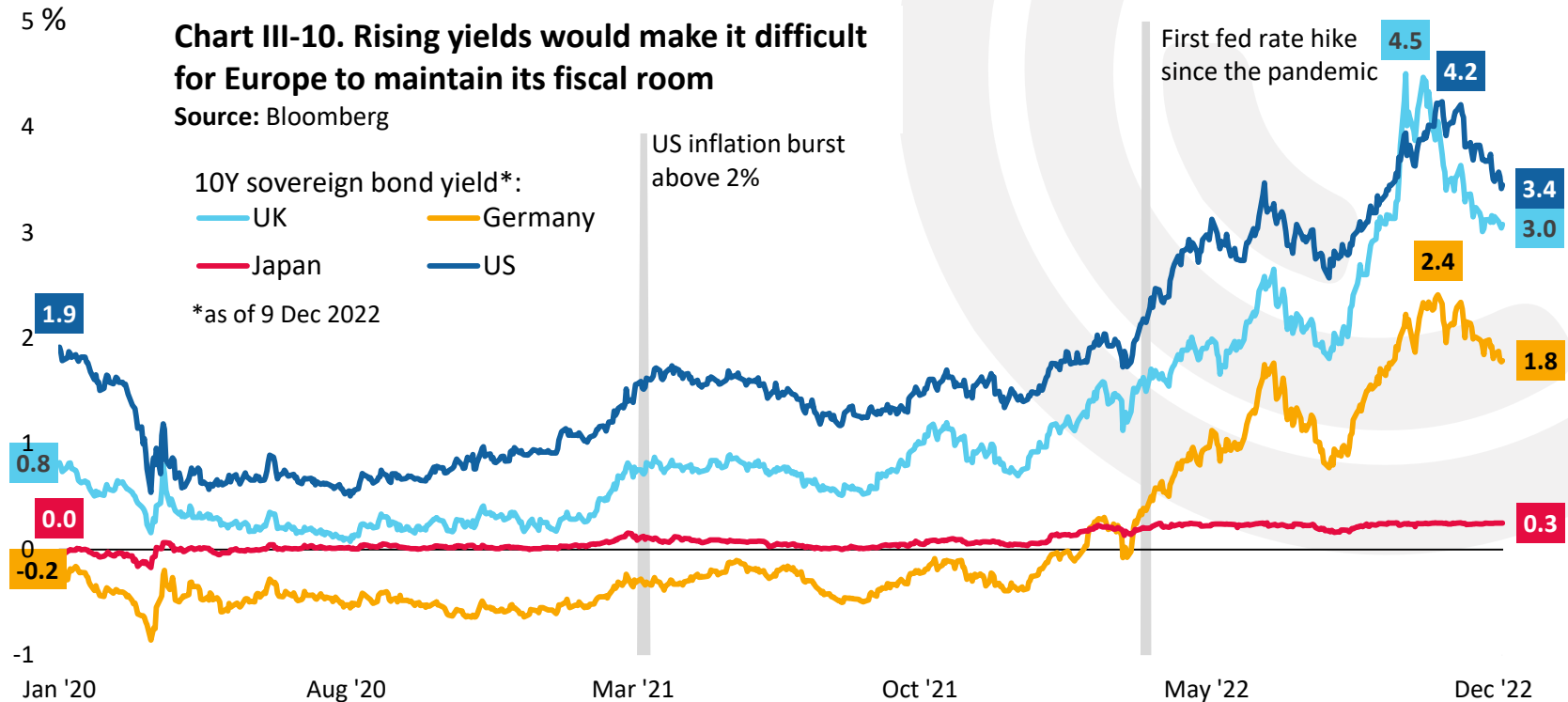
- The second factor is the regulatory-driven changes which have added to the banks' resiliency compared to 2008, in particular the Basel III framework which has forced banks to increase their capital buffers. Basel III also introduced the liquidity coverage ratio (LCR), whereby banks have to cover their short-term liabilities by a certain amount of high-quality liquid assets (HQLA). The general decline in asset prices have reduced the value of the HQLA, but nonetheless **banks have not been forced to turn towards short-term borrowing in the money market – which means they are relatively shielded from the volatility in interest rates.**

QE has given the financial system ample liquidity buffers



- Ultimately, the big reason behind this lack of liquidity risk is the Fed's balance sheet itself, which have swollen with excess bank reserves post-2008. Meanwhile, the Fed's second great round of QE during the pandemic have added another instrument, the overnight reverse repo facility, which functions similarly to the repo market as excess reserves to the banks.
- This is why, while rates have been increased, the pace by which the Fed could pare down its balance sheet is still ultimately limited by the need to preserve financial stability. **The Fed's largesse, then, has underwritten the stability of the US financial system**, except for the more exotic corners like cryptocurrency and – as we shall see – the overseas market which falls outside the Fed's purview but nonetheless might feed back to financial conditions in the US itself.

Higher US yields translate to even higher yields elsewhere



- Indeed, the old maxim of **“the Dollar is our currency, but your problem”** has no more been truer than in recent months. Perhaps the biggest casualty of the stronger Dollar are the European economies, where getting financing for the gaping current account deficit have become harder in a strong Dollar environment. European governments are also having to expand their budget deficit to offset the negative effects of rising energy prices. Thus far, **investors have now shown little appetite for the new batch of European bonds**, and negative real returns may not be the best way to persuade investors to come back anytime soon.

Tight USD liquidity creates havoc in other markets

Chart III-11. Bid-ask spreads for bonds show a growing bifurcation across Europe ...

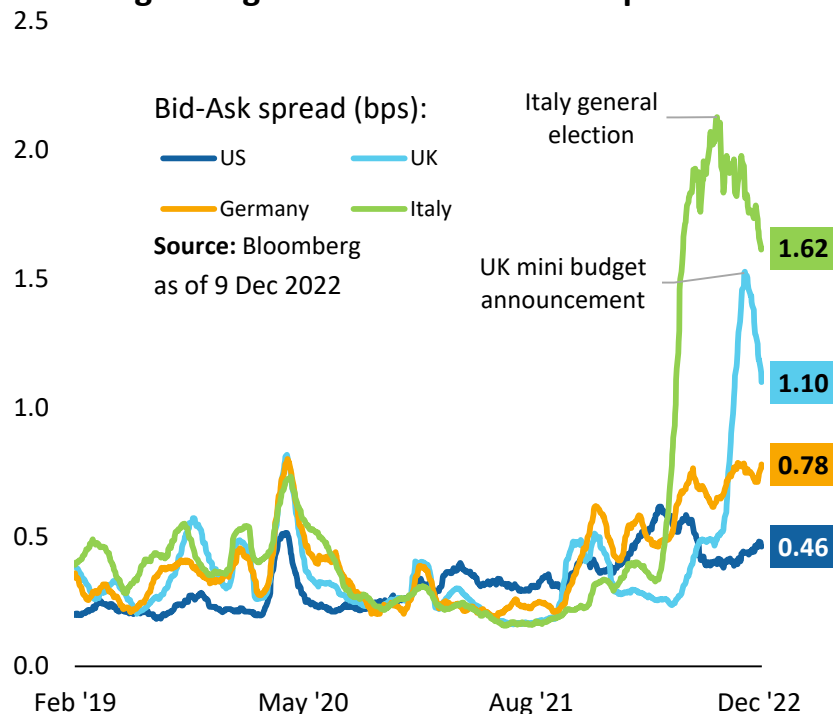
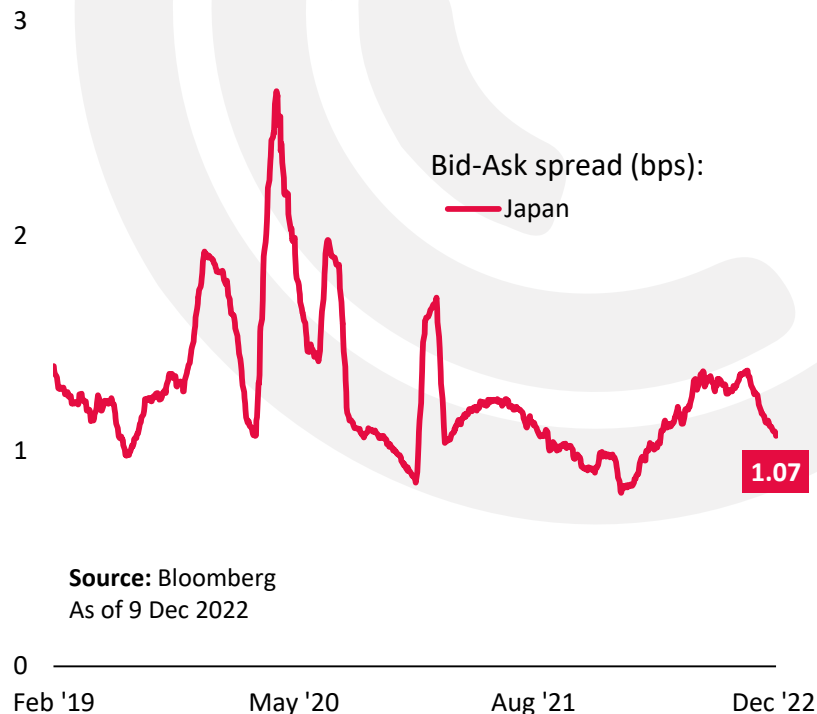


Chart III-12. ... whereas Japan is taming the situation through extensive interventions



- **Negative real rates “could” work in the present situation, so long as it is backed up by the heavy hand of bond and FX market interventions, akin to what the BoJ is doing.** Japan’s peculiar yield-curve control (YCC) is an attempt to keep rates low to maintain growth while potentially reducing debt burdens through financial repression.
- Unfortunately, this is something that is difficult to coordinate in Europe, which is still divided across the North/South polarity. **This has resulted in the predictable pattern where countries like Germany continue to enjoy relative support from investors, while Italy, Spain, and post-Brexit UK are seeing even wider yield spreads.**

An inverted yield curve in the US may threaten financing conditions in Japan

Chart III-13. Negative yields on ST assets incentivise Japanese banks to fund outward...

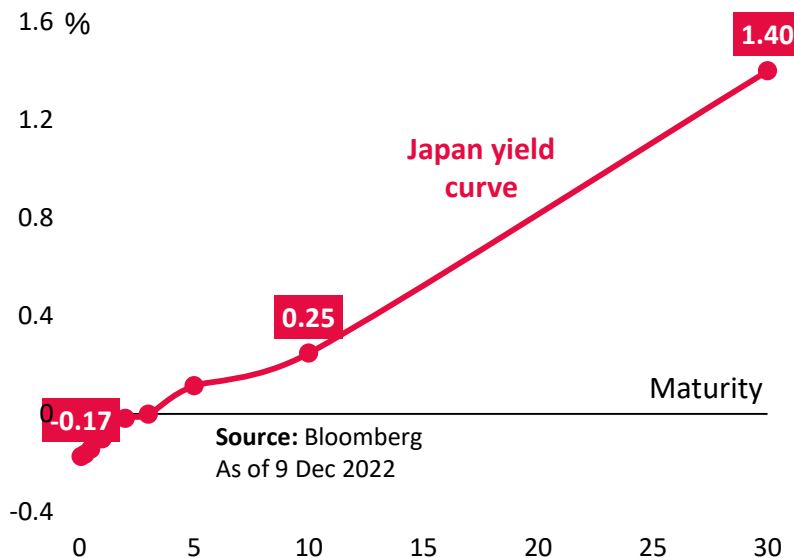
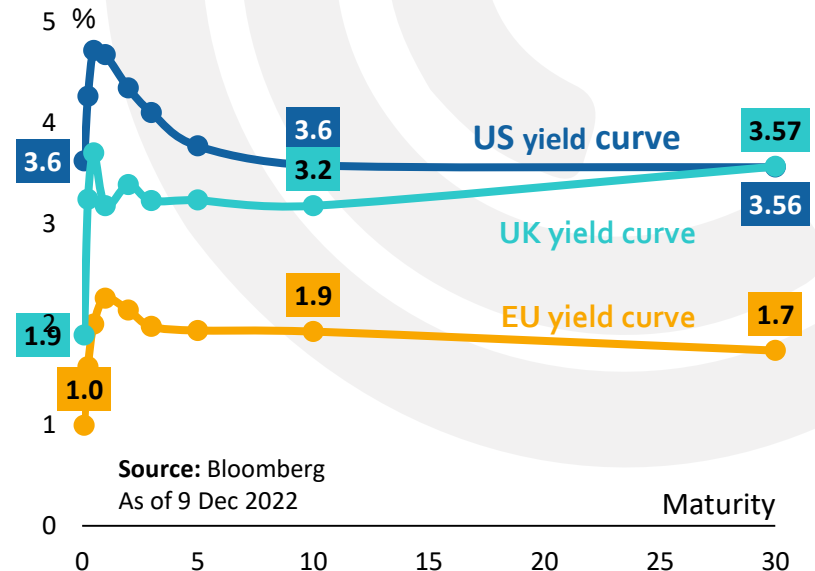


Chart III-14. ...which wouldn't be too profitable now considering an inverted YC in prime markets



- Of course, BoJ-style YCC could be costly in other regards. In addition to the obvious cost in FX reserves, it may in the long run cause a problem for Japanese banks, who have tended to look outwards for profits as domestic lending only yields meagre profits. **Now, an inverted yield curve in the US and European markets would squeeze their already slim margins, while higher commodity prices causes Japan's current account surplus to invert to a deficit – which limits their funding base.**
- Facing threats to its profitability and liquidity, Japan's banks may tighten credit conditions to Japanese firms, which is precisely the outcome the BoJ sought to avoid. **A weaker JPY could improve the current account and the profits from the external lending portfolio, but it would also be fraught for many Japanese corporates or banks with sizable USD liabilities.**

Tighter financing conditions would push many companies to the maw of bankruptcy

Chart III-15. Cross-border funding opportunities would be limited as rates continue to rise

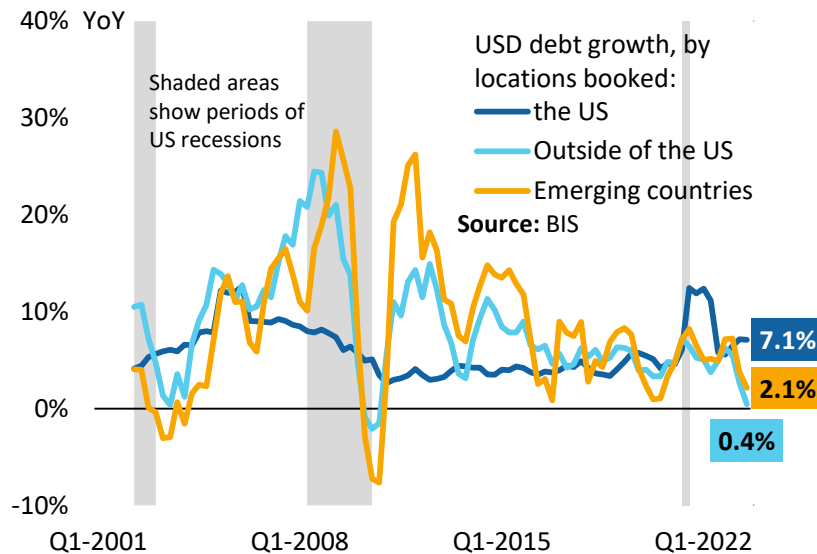
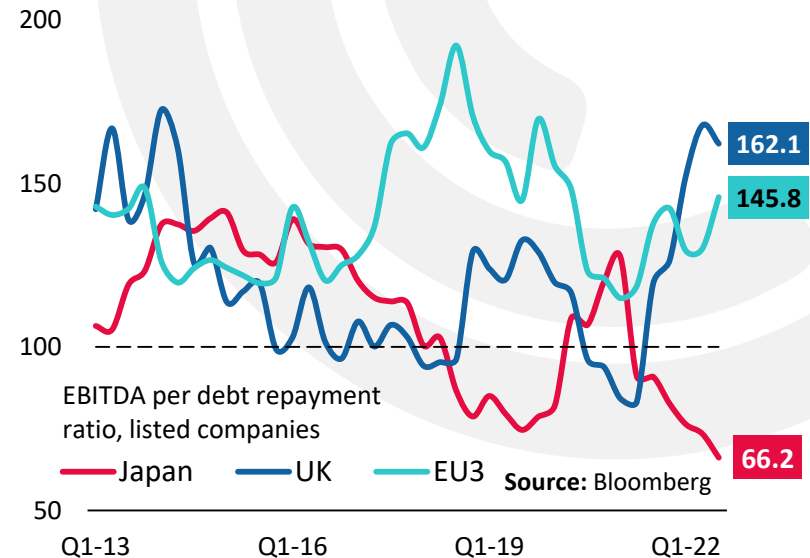
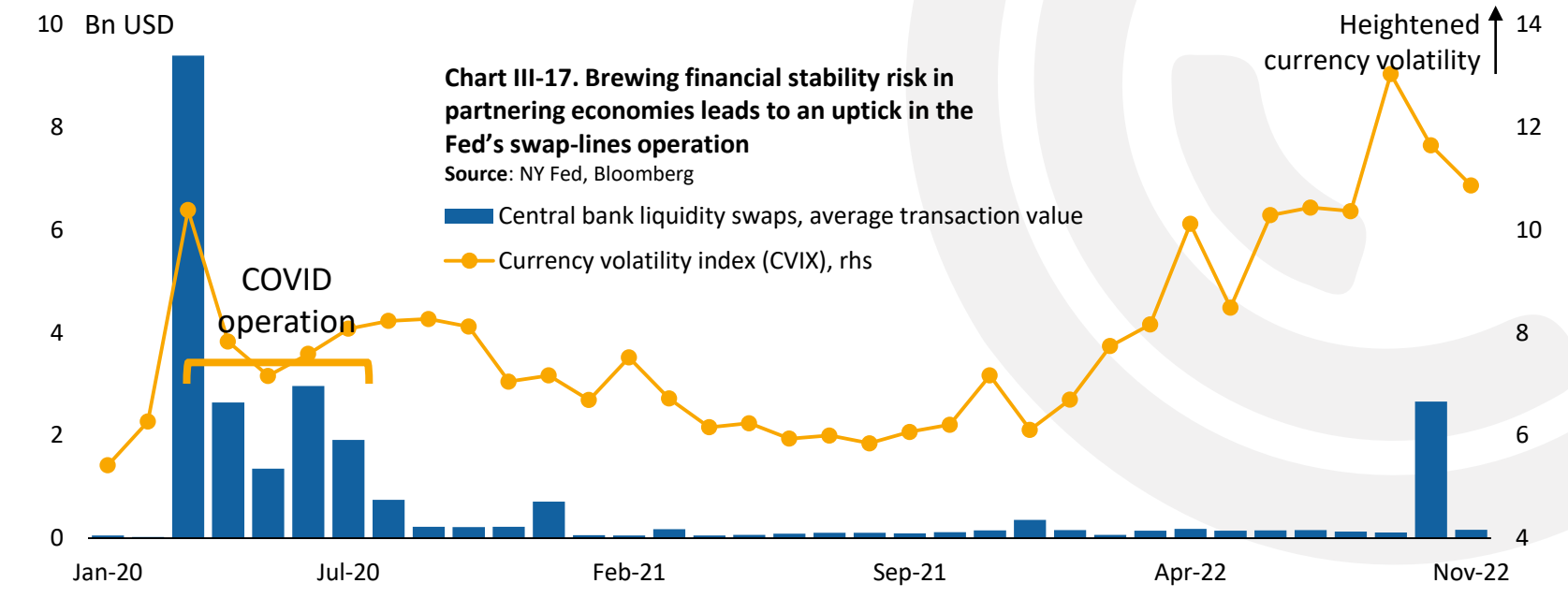


Chart III-16. Some companies may prove unable to stomach higher debt servicing costs



- The situation, then, remains tricky for overleveraged institutions in the “USD extended universe” of Europe and Japan.** On top of the prospects of tighter financing conditions at home, higher rates and stronger USD also limits their ability to obtain financing from abroad. Demand for liquidity from Japanese and European companies is not exactly meagre too. For instance, more than 30% of Japanese corporates’ foreign-denominated bonds would mature within the next 18 months, while more than half of the total outstanding bonds would mature sometime between 2022 and 2025. **Acute liquidity needs coupled with spiking debt-servicing costs are not exactly a great combination, and one that may raise the spectre of bankruptcies and debt-deflation without proper intervention.**

The Fed must not flee from its role as the world's lender of last resort



- **The most straightforward remedy to this lack of global liquidity is the currency swap agreement**, which has existed between the Fed and many of its closest counterparts (including Europe and Japan), and may provide USD liquidity on demand. The Swiss national bank had begun to tap this facility in a limited manner in 2022, and some other central banks may follow suit.
- **The bigger problem, then, is countries that lack access to the swap facility, i.e. those on the outer-rim of the USD-led global financial system.** There is little economic rationale for the Fed to provide such facility, given the relative lack of systemic importance of the emerging/peripheral markets. The same is true for the US' main rival, China, which is mired in its own difficulties (more on this later). As such, absent a geopolitical "Great Game", these countries might be the likelier casualties of the current situation, except for commodity-exporters like Indonesia or big, diversified economies like India.

#4: The China factor

A less-radiant beacon of growth

China took the first step towards recovering its growth momentum after announcing its plan to ease the pandemic prevention measures. The next steps, however, may prove to be harder. China has to revive its troubled real estate sector, spur domestic consumption, and shift to a new, more sustainable growth model. But the path of least resistance still lies in the old strategy of more investment, weaker Yuan, and more exports – which may support demand for commodities but could also export more disinflation to the rest of the world.

China's re-opening provides some certainty in a highly uncertain environment

Chart IV-1. China decided to loosen its pandemic measures as the recent outbreak proved to be less lethal

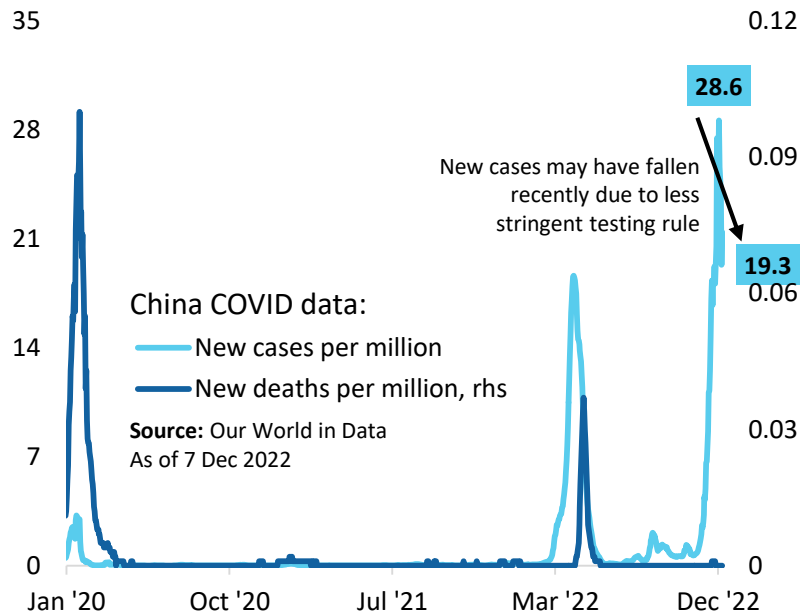
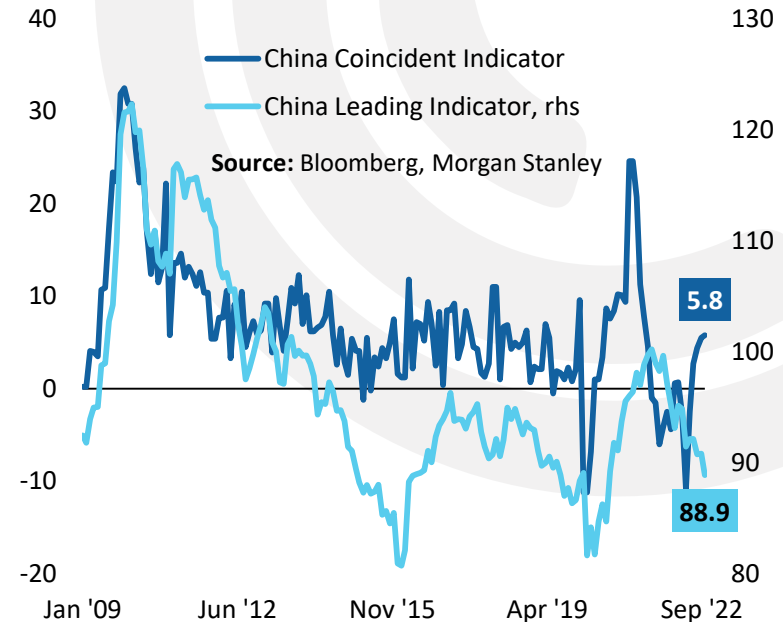
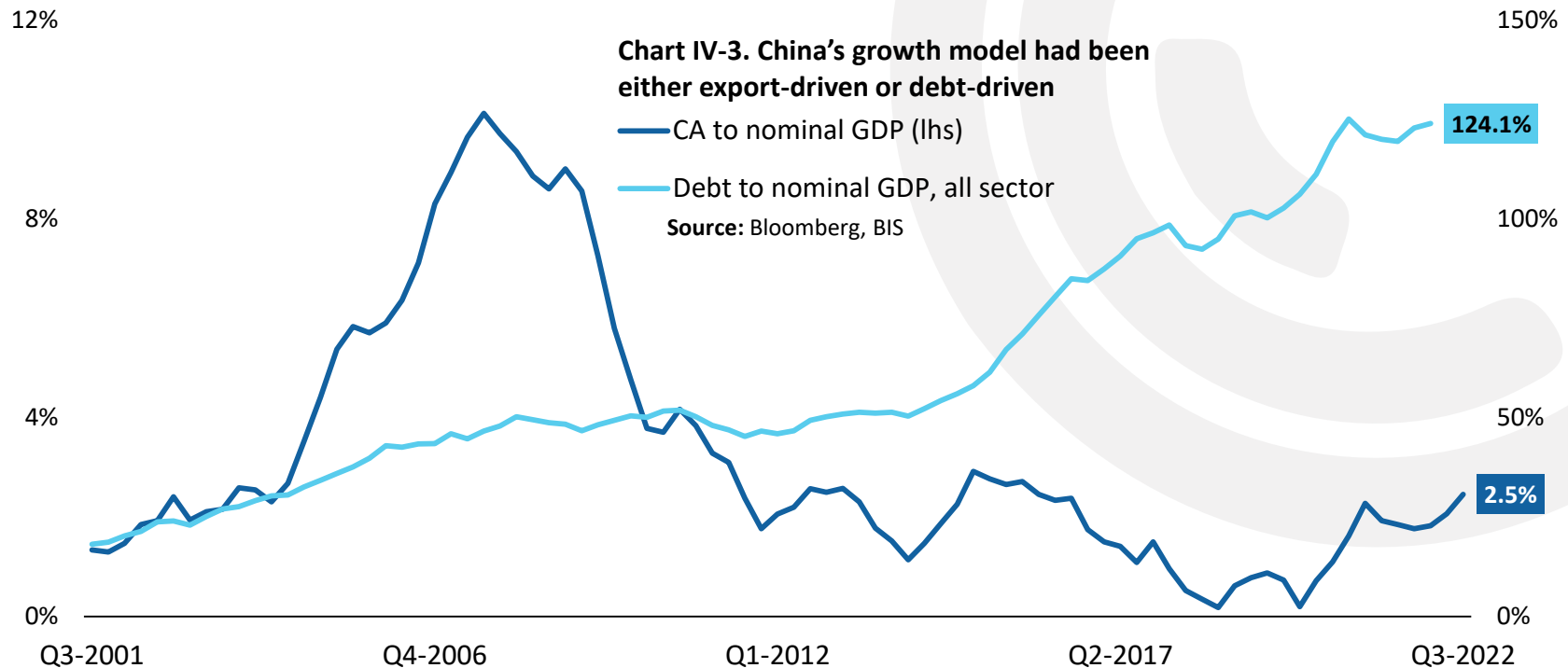


Chart IV-2. Moribund external and property demand doesn't match the present optimism



- The Chinese government has finally decided to relax pandemic measures, signalling some kind of separation from the pandemic policy playbook as the decision to move away from the 'zero-COVID' doctrine comes amid a spike in cases, although the current pandemic situation in Beijing may suggest otherwise. Still, the market seems to react positively to any news regarding the potential easing of the 'zero-COVID' diktats, as evident from the recent upticks in the coincident indicator. However, this optimism may not last too long, as the leading indicator indicates, for the widely uncertain pandemic measures are all but one piece in the jigsaw (while the pandemic measures themselves remain highly uncertain).

China's growth model doesn't work too well in the current global climate

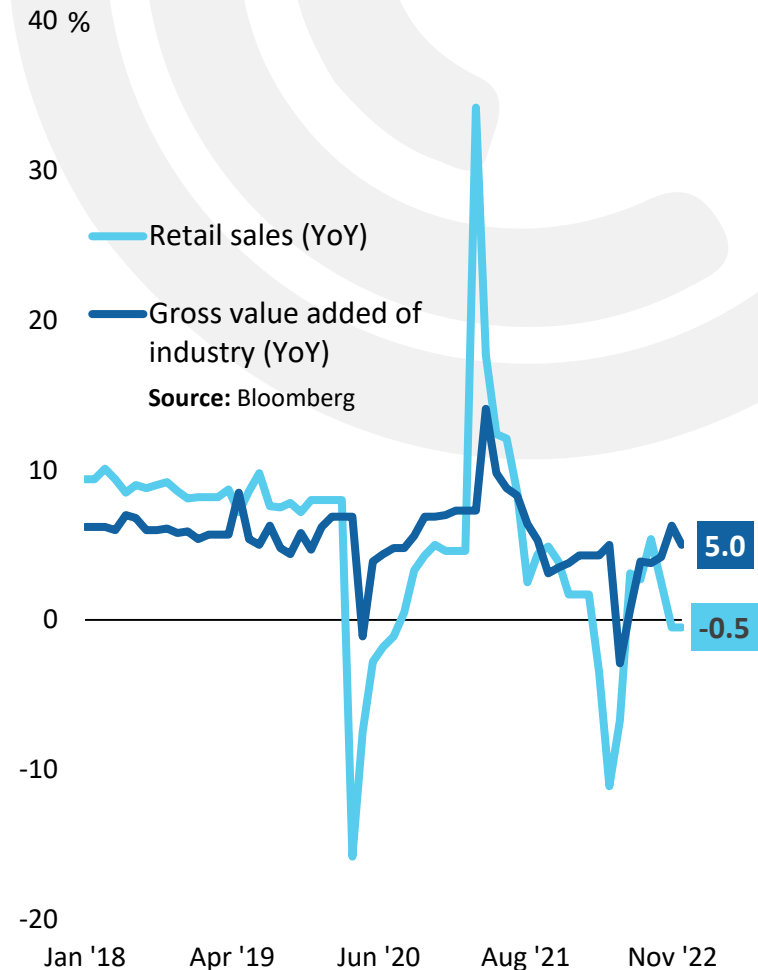


- Zero-COVID may be the main source of uncertainty regarding the Chinese economy in recent months. But there is another, bigger question: which way will the Middle Kingdom now go? Looking back at the historical pattern, **China's growth model had been driven by exports and fixed-asset investment** (which is financed by large amounts of debt).
- The two strategies, however, may not be too compatible with the current global conditions. Higher interest rates push overleveraged economies toward financial fragility, while atrophied global demand complicates the situation for China's mercantilist model. **The onus would then fall to domestic consumers to prop up domestic growth.**

Chinese consumers may not be on a solid footing either...

- Domestic demand, then, will determine how much China's reopening would help the global economy. The Chinese authorities have had a long track record of trying – and not exactly succeeding – in boosting consumption, which is understandable given the structural issues involved: financial repression, one-child policy, the *hukou* system, undervalued Yuan, and so on.
- This imbalance was worsened by the pandemic, as domestic consumption was disrupted by lockdowns but industrial production much less so. **Industrial output have grown faster than retail sales, barring a brief period in mid-2021, and this translates to China's widening current account surplus versus the rest of the world.**
- Increasing mobility would provide some boost to consumption, but it may still be limited by income growth. Here the picture isn't excellent either. Excess supply coupled with anaemic demand would force many enterprises to operate at a thin margin, which would probably translate to little wage growth. To be sure, China is still enjoying low inflation which keeps purchasing power strong, but **without substantial increase in big-ticket items spending, it is unlikely that demand could soon catch up with the output.**

Chart IV-4. Feeble domestic demand would exacerbate China's oversupply problem



... being hit by the double-whammy of zero-Covid and imploding property sector

Chart IV-5. Spiraling property prices depress demand for property in China...

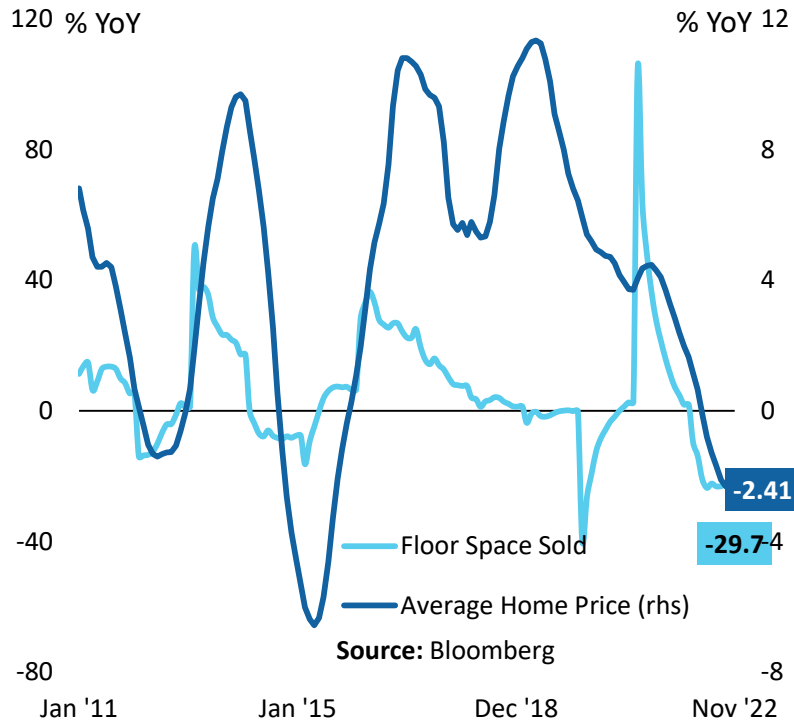
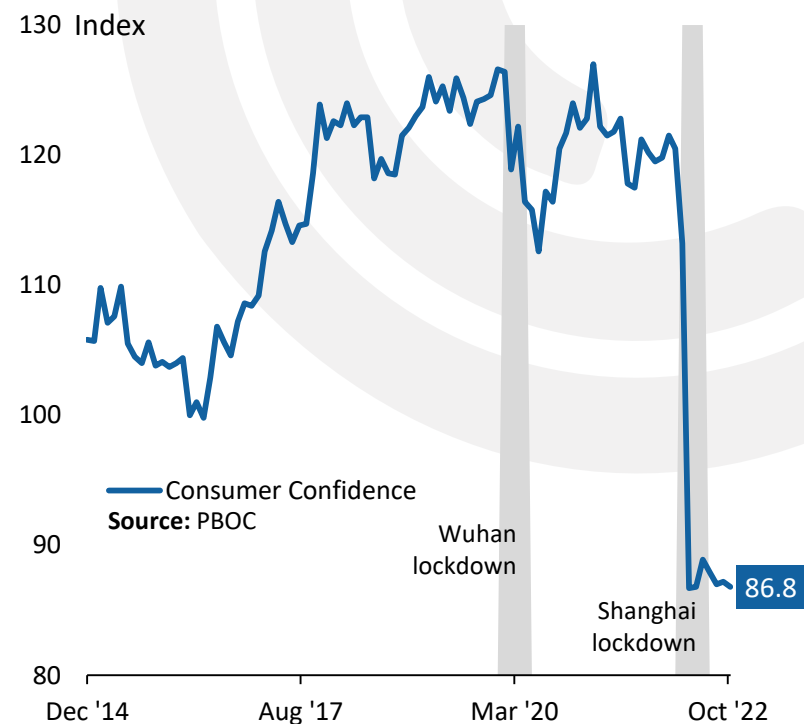
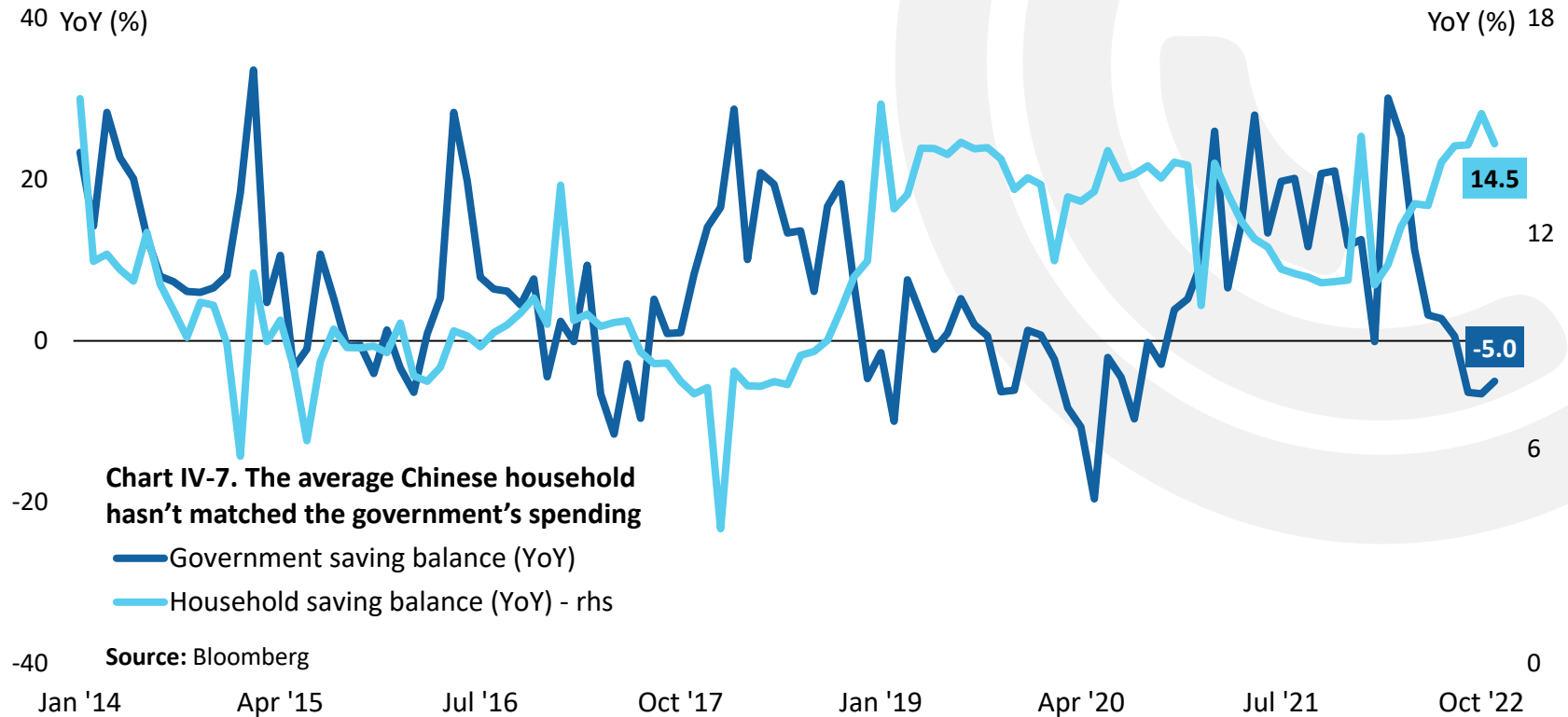


Chart IV-6. ...which in combination with Lockdowns have hit customer confidence hard



Perhaps the biggest headache with China's consumption outlook is the **imploding property sector, which inflicts a lingering pain for many households as plummeting property values (which account for a large proportion of an average household's wealth) left them under the water (their property is now valued less than the principal)**. This situation creates a negative wealth effect that, together with rolling lockdowns, has wreaked havoc on consumer confidence.

The Chinese government continue to pull while households sit and wait



- Recovering confidence without first reviving the property sector may be a futile endeavour. Understandably, the government is focusing on it, among them the '16-point' plan had primarily been directed to restore liquidity in the property sector, to facilitate the completion of real estate projects. Some further stimulus would be needed before the property sector could stand on its feet (despite probably on a shrinking base). **Ultimately, the government has to spend big to boost households' purchasing power, and also to revive property values in order to nudge Chinese consumers to spend again.**

The stimulus may necessitate a weaker Yuan

Chart IV-8. Shrinking land sales means the Chinese government has to create new debt

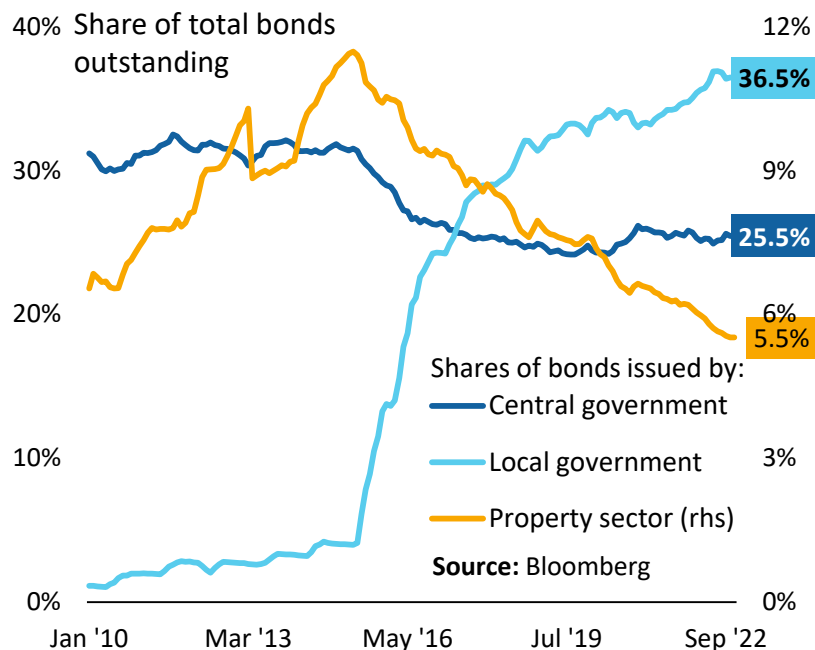
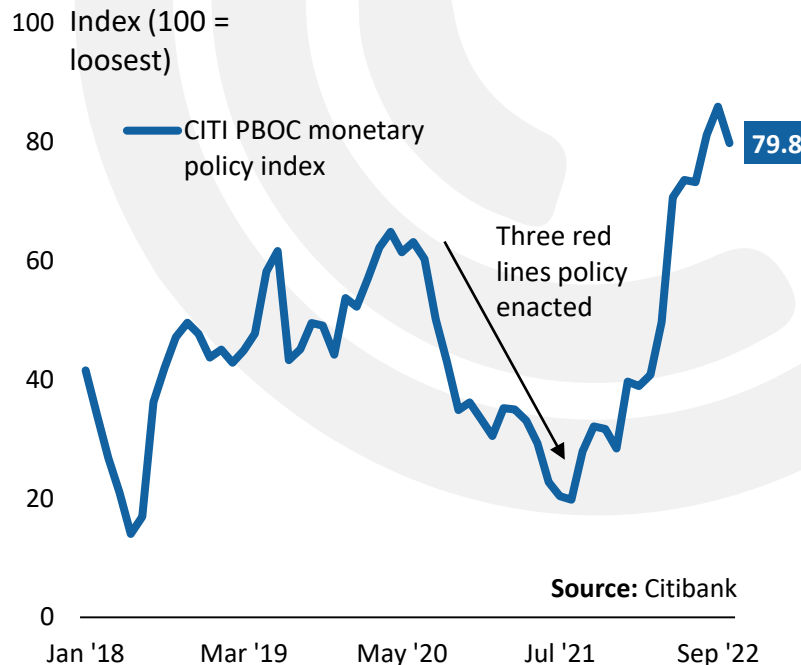


Chart IV-9. The PBoC have changed its tune to its most accommodative in recent years



- Rescue packages would be crucial to reviving the moribund property market. But the imploding property sector also wounds the government finances, especially for regional governments, which have relied on land sales to meet their funding shortfall. **Naturally, monetary policy must also be enlisted in support of the stimulus – to ease financing conditions for the regional governments and the property developers.**
- **This is essentially a rapid reversal of the PBoC's stance in 2020-21, as policies are becoming basically more accommodative than at any point in the previous five years.** As a result, the pressure on the CNY grows stronger, even more given what has happened on other fronts this year.

China's capital account deficit may force its current account to remain outsized

Chart IV-10. Persistent outflows are driving the CNY weaker...

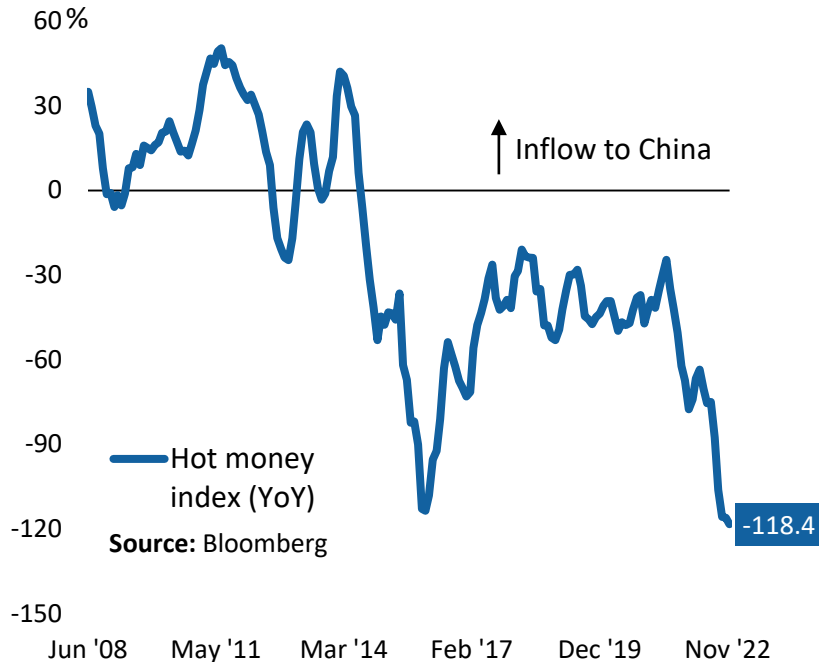
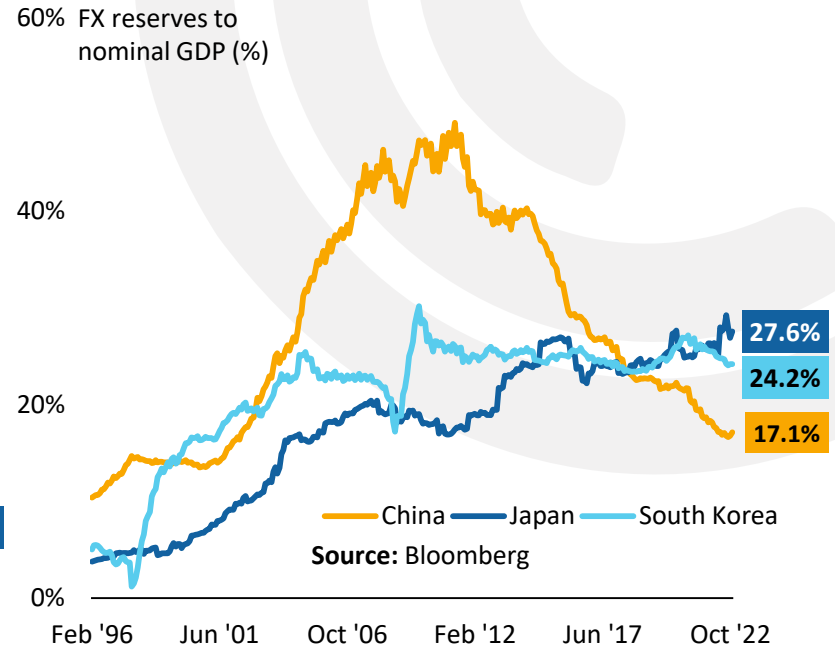


Chart IV-11. ... and it may not have the will to defend it using FX reserves

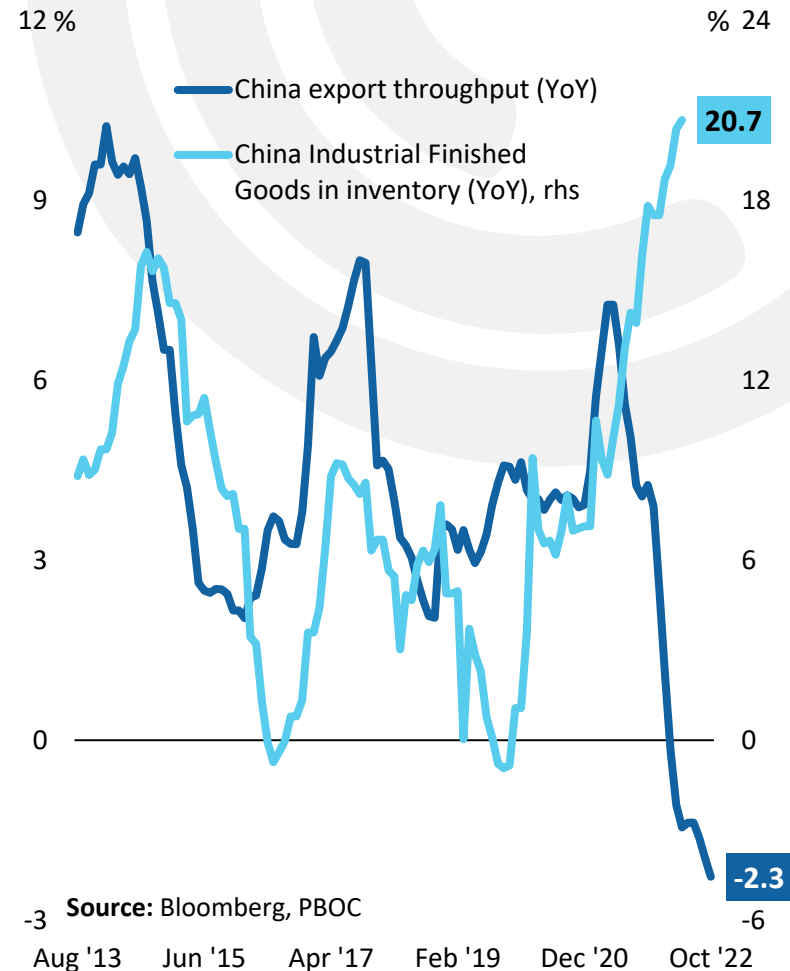


- Rescue packages would be crucial to reviving the moribund property market. But **the imploding property sector also wounds the government finances, especially for regional governments, which have relied on land sales to meet their funding shortfall.** The Chinese government, then, may look for debt to fund this deficit. Unfortunately, this would bring the Chinese government back to square one, considering that it may not be wise to count on debt in a tight Dollar climate. Indeed, a depreciating CNY would make debt servicing more expensive, while a high percentage of short-term debt in China's external debt portfolio further highlights the risk.

Fickle domestic demand means China can't afford to lose its exports

- The stimulus, then, may end up further entrenching China's export-driven growth model rather than establishing a new, more consumption-driven model. **Globally, this implies that China's strong growth next year may not necessarily help growth in the rest of the world, but might in fact subtract from it.**
- **One striking data point here is the piling inventories in China's warehouses, as domestic consumption is hindered by zero-COVID while global demand is rapidly cooling.** Chinese manufacturers, as such, are faced with difficulties, hoping either that domestic consumption recovers to absorb these goods or they would have to dump their output abroad at the slimmest of margins – or probably at a loss. Indeed, some of these manufacturers are now relying on government stimulus to continue operating at such borderline uneconomical level.
- **In essence, then, China's likeliest path out of its slump would be the same one it has trodden in the past decades – exporting manufactured goods (and disinflation) and importing raw materials.**

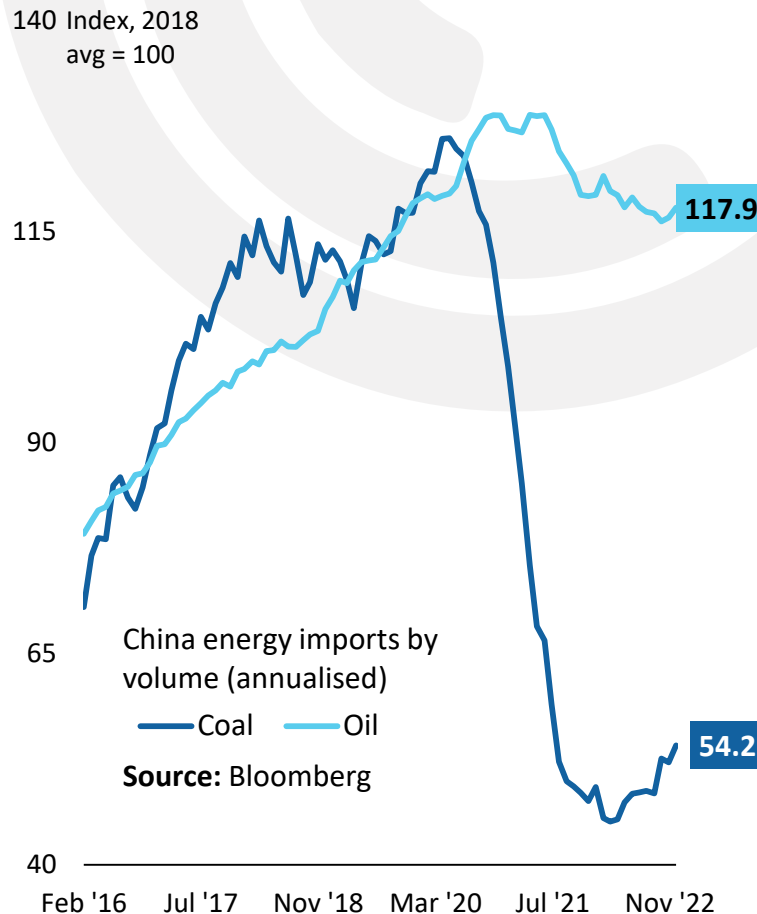
Chart IV-12. Piling inventory would encourage China to keep on exporting



China's reopening may not necessarily help coal producers (read: Indonesia)

- The re-opening of China's economy will thus bring even more disinflation in the price of goods. This strengthens our earlier argument that inflation may be easing across the world, and the Fed is likely to stop raising rates quite a bit earlier than expected. **Chinese demand may not be the saviour of the global economy, but Chinese supply could, indirectly, return some semblance of the old monetary "normalcy".**
- The flip side of the Chinese growth model, importing raw materials, may seem to be the one factor that would help commodity exporters like Indonesia. **This is especially true for oil and coal, both of which had seen weaker Chinese demand during the pandemic and subsequent lockdown.**
- But there are some caveats. **China has been speeding up its bid for energy security, by for example ramping up its domestic coal production and securing a long-term LNG contract from Qatar.** It has also restored trade relations with Australia, which was halted due a diplomatic spat in 2020. Meanwhile, if China's real estate sector does not return to its old growth baseline, it may lower demand for steel, and therefore coking coal.

Chart IV-13. Higher domestic production means China won't need to import as much coal as it previously was



Further sanctions may push Russia closer to China's energy sphere

Chart IV-14. Russia already dominates China's coal market...

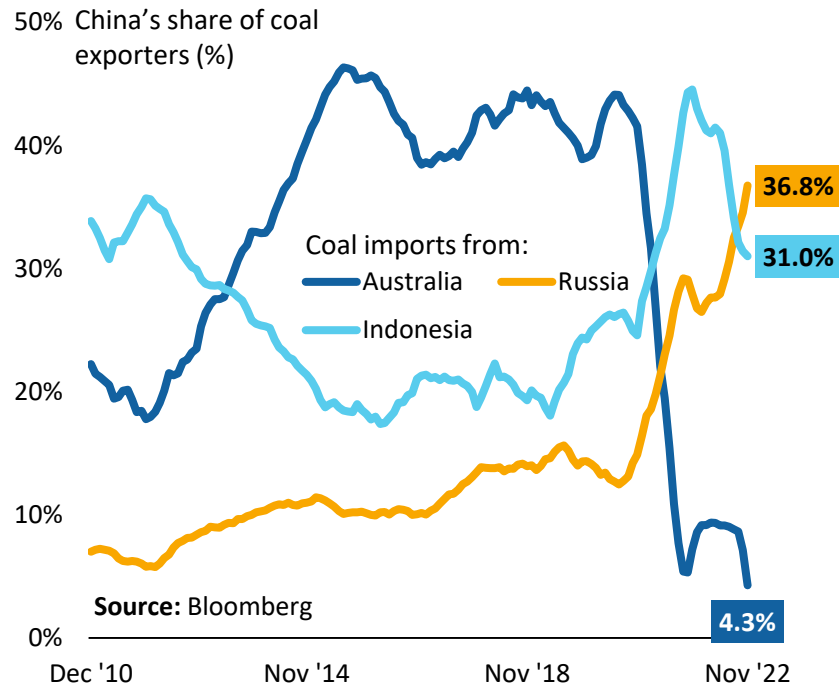
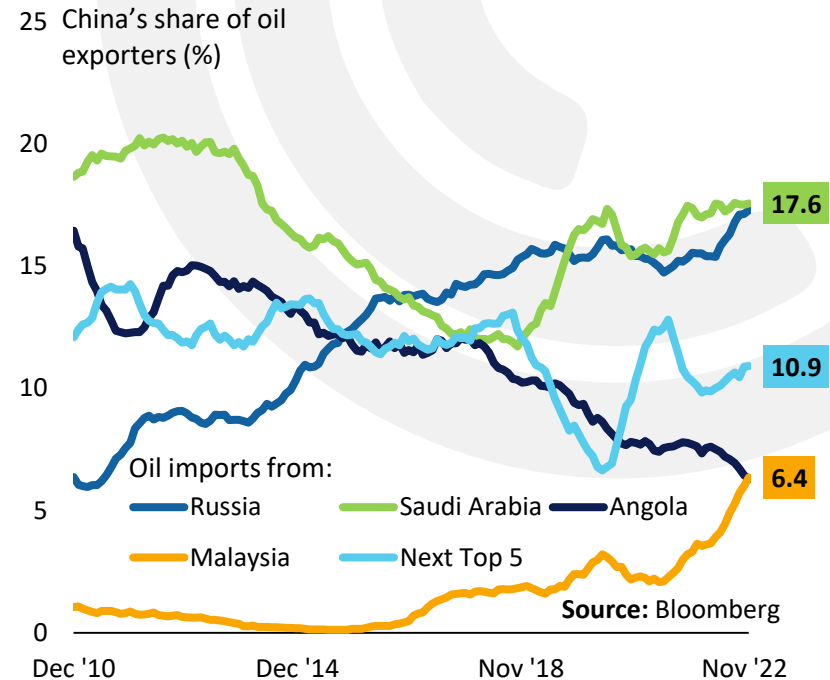


Chart IV-15. ...while also competing for the top spot in the oil market



- **Even more importantly, Indonesia's role as China's energy supplier is facing direct competition from Russia.** Banished from the European market, the Russians may need to direct all their attention to the Chinese market, at least in the short-term. Insurance bans on Russia's energy exports would add a layer of complexity for those who insofar managed to do business with Russian energy producers. But given the relative geographical proximity (which would allow safe travel of Russian oil to China), increasing domestic demand, and heavily discounted prices, it may be hard for China to say no to their Russian suppliers.

#5: Towards 2023

Mapping out the new year

Where we stand, where might we go?

Baseline scenario:

Disinflation and China reopening brings the global economy to a rather soft landing and some easing in the rate outlook

Alternative #1: Commodity price pressures more stubborn than expected

Alternative #2: Something breaks first in the global financial system

Alternative #3: Sharper swings between reflation and recession pointing to a hard landing

-
- Now that we have laid out the three big themes: disinflation, financial stability, and China's reopening and recovery, we can put them together to see the bigger macro picture for 2023. **There is the main (baseline) scenario, which we think is the likeliest – it involves continued disinflation and China's reopening, which when combined, paint a picture of a rather soft landing for the global economy.**
 - There are, however, other eventualities that should be considered. The first is the possibility that we are wrong about disinflation – that geopolitics would trump the present trend and dictate that commodity prices would rebound from its temporary lull. The second is the possibility of financial instability, which – as we mentioned – exists, but thus far is confined mostly on the fringes of the US Dollar system. Finally, there is the third possibility, where China's (and the world's) demand-side problems are worse than we thought. In this scenario, the global economy would seem as if on the down side of the big bullwhip that had started since the pandemic, with even deeper recession and even deeper disinflation.

Baseline scenario: A soft-ish landing

Probability:

50%

Why 50%: Despite the still-strong service inflation, we think that **the disinflationary dynamic in the US has started to take shape and will continue to play out**. Adding to this is China's reopening, which in the short-term would spur the offloading of excess inventory but should restore some balance to China's supply-demand dynamics in the longer-term.

Commodities remain a wild card, but for now the playing fields look moderately tilted to the biggest buyers (i.e. Western economies), thanks to the combination of rate hikes, price caps, SPR release, and diplomatic cajoling. Moderate commodity prices – e.g. oil at about USD 70-80 could give succor for demand while simultaneously provide enough stimulus for suppliers.

- **Growth outlook:** A recession in the US has largely been called for in 2023 (while it already struck in Europe), but there's hope that the incoming US recession would be a short and shallow one – with unemployment rising only to 5% or less (higher than the projected non-cyclical rate of unemployment at 4.4%, but still below its post-GFC average). China's growth, meanwhile, would likely improve relative to 2022, inching closer to the authorities' target of 5.25%. Emerging markets' growth outlooks are mixed, but Indonesia and its regional peers (SE Asia, India) are set to be relative stars in the current climate – thanks to both commodity exports and manufacturing relocation.
- **Interest rates:** Disinflation and slowing growth means the Fed will end its tightening campaign early, perhaps as early as Q1-23. The Fed's highest (terminal) rate would probably reach around 5.25%, which could be enough to ensure positive real rate at least in the short-term. The Fed may not be in a hurry to normalise rates as yet, but a tentative move towards monetary easing might be on the cards by H2-22.
- **Asset classes:** The end of monetary tightening implies a moderate reversion in exchange rates (weaker USD, stronger EM currencies), although the currencies of Europe and Japan are likely to remain laggards given the extent of their energy/CA crises. This is also rather good news for risk assets in general (equities and emerging market assets), while fixed income could benefit in the short-term when rate outlook reverses.

Variation #1: Persistently high inflation

Probability:

25%

Why 25%: Geopolitical tensions may have outwardly cooled towards the end of 2022, but the underlying rivalry remains that may cause another supply crunch down the road. The consumers' current advantage in the commodity bargaining table at the moment is a fragile one and relies on delicate diplomatic dealings and short-term advantages (e.g. SPR) that may evaporate. Meanwhile, the oil market is fundamentally much tighter than it had been in previous year, while the transition to renewable energy adds another impetus for commodity-driven inflation.

In this scenario, the Fed can no longer stick to its stated plan of bringing down inflation to 2% nor its typical pattern of attaining positive real rates, as the cost of doing so is unacceptably high unemployment. As such, the situation looks eerily similar to the 1970s, when Arthur Burns' Fed presided over persistent stagflation as geopolitical hotspots flared in instability.

- **Growth outlook:** Much will be determined by whether the Fed continue in its inflation-fighting crusade or capitulate to the unpleasant supply-side reality. But even if it chooses the latter, the high energy cost would ensure unacceptably high levels of “misery” (inflation plus unemployment) across the world, except perhaps in countries like Indonesia that are net exporters of basic commodities.
- **Interest rates:** Renewed commodity inflation would behave the Fed to act at first, but at some point (terminal rate of 6% or slightly higher) the trade-off may become too unpleasant. This situation also translates to further rate hikes by other central banks as the Dollar's current strength persists.
- **Asset classes:** A prolonged strong-commodities/strong-USD environment was historically rare except in the 1970s, so it is hard to see a pattern in asset movements. However, some continuation of the trends in 2022, when almost all assets but the “safest” ones – USD, US Treasury/TIPS – come under pressure is possible.

Variation #2: Trouble in the plumbing system

Probability:

10%

Why 10%: The bevy of regulations and Fed support had, as we saw, made the US financial system much safer and push risk-taking towards stranger and more exotic lands like cryptocurrency. **But there are still certain intermediaries within the plumbing of the global Dollar system which may be exposed to undue stress by the current strong USD environment.**

There are also institutions like insurance and pension funds whose balance sheet are sensitive to higher rates, as we saw in the example of the UK during Liz Truss's brief government. Finally, we have seen much volatility in both the currency and Treasury markets that could grow into a more systemic issue as we saw in late 2019 (the spike in US repo rates) and very early in the pandemic. **The solution to these problems, as ever, is a rapid Fed pivot towards lower rates accompanied by quantitative easing.**

- **Growth outlook:** Financial shocks can amplify business cycles as we saw during the GFC, and consequently it is likely to drive much lower global growth than typically predicted for 2023 (probably towards 2% or lower). However, the drastic monetary actions could at the same time drive relative optimism, and more importantly ease the situation in China amidst its real estate crisis.
- **Interest rates:** A return to ZIRP (zero interest rate policy) or at least QE (quantitative easing) is likely, as commodity would probably be pushed down by the liquidity crunch. This should help the rest of the world to return to easier monetary stance, at least in the short-term.
- **Asset classes:** The rapid volte-face in monetary policy implies a rapid reversal in asset returns, with bonds and emerging currencies likely the main beneficiary of the new stance. Risk assets could benefit as well, but this would be tempered by the anaemic growth for the time being.

Variation #3: The downside of a bullwhip

Probability:

15%

Why 15%: This scenario can be thought of as a more extreme, volatile version of the baseline. The main ingredients (disinflation, demand slowdown) are there, but the main positive catalyst – China’s reopening – may not give sufficient jolt given the fundamental weakness in global demand.

Commodity producers may be scrambling to defend prices amid this weakness, and a falling-out among top producers (akin to Saudi vs. Russia early in the pandemic, which briefly led to negative oil price) cannot be ruled out. **However, the sharp decline in energy prices itself led to reduced output and rather robust demand recovery, which start a new round of inflation.**

In a way, such business cycle volatility could be seen as part of a “bullwhip” that have begun since the pandemic. **It would also imply that the Fed’s role as a stabiliser of global business cycles has been undermined by geopolitical/supply chain disruptions and energy market tightness.**

- **Growth outlook:** Bullwhips are tough to navigate, given the extreme swings from strong demand/supply crunch and weak demand/oversupply, and will probably weaken businesses’ appetite to expand given the uncertainty (barring perhaps policy-driven strategic investments). As such, not only the outlook in 2023 tougher (the landing “harder”), but the longer-run growth outlook may be more challenging as well.
- **Interest rates:** The drastic recession and disinflation may prompt the Fed to begin cutting rates more proactively compared to the baseline, which should – on the surface – drive other central banks to do so at well. But monetary policy also acts with a lag, which means it may in fact add on to the volatility rather than dampen it in this kind of scenario.
- **Asset classes:** The rapid mood swings from reflation to recession and back may have a familiar ring as we saw this during the past three pandemic-ridden years. In this situation, the correct macro call is crucial in allocating between risk assets and safer ones.

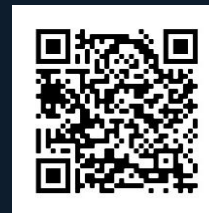
Projections of macroeconomic indicators

	2018	2019	2020	2021	2022E	2023E
GDP growth (% YoY)	5.17	5.02	-2.07	3.69	5.23	4.57
GDP per capita (USD)	3927	4175	3912	4350	4646	4525
CPI inflation (% YoY)	3.13	2.59	1.68	1.87	5.60	4.43
BI 7-day Repo Rate (%)	6.00	5.00	3.75	3.50	5.50	6.00
10Y government debt yield (%)	7.98	7.04	5.86	6.36	7.45	6.79
USD/IDR exchange rate	14,390	13,866	14,050	14,262	15,576	16,292
Trade balance (USD Billion)	-8.5	-3.2	+21.7	+35.3	+52.8	+43.2
Current account balance (% of GDP)	-2.94	-2.71	-0.42	+0.28	+0.90	-0.19

Source : BPS, Bloomberg, BCA Economist calculations

Notes:

- BI 7-day Repo Rate, 10Y yield, and USD/IDR exchange rate all refers to end of year position
- 10Y yield and USD/IDR exchange rate projections refer to fundamental values; actual market values may vary depending on sentiment and technical factors



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