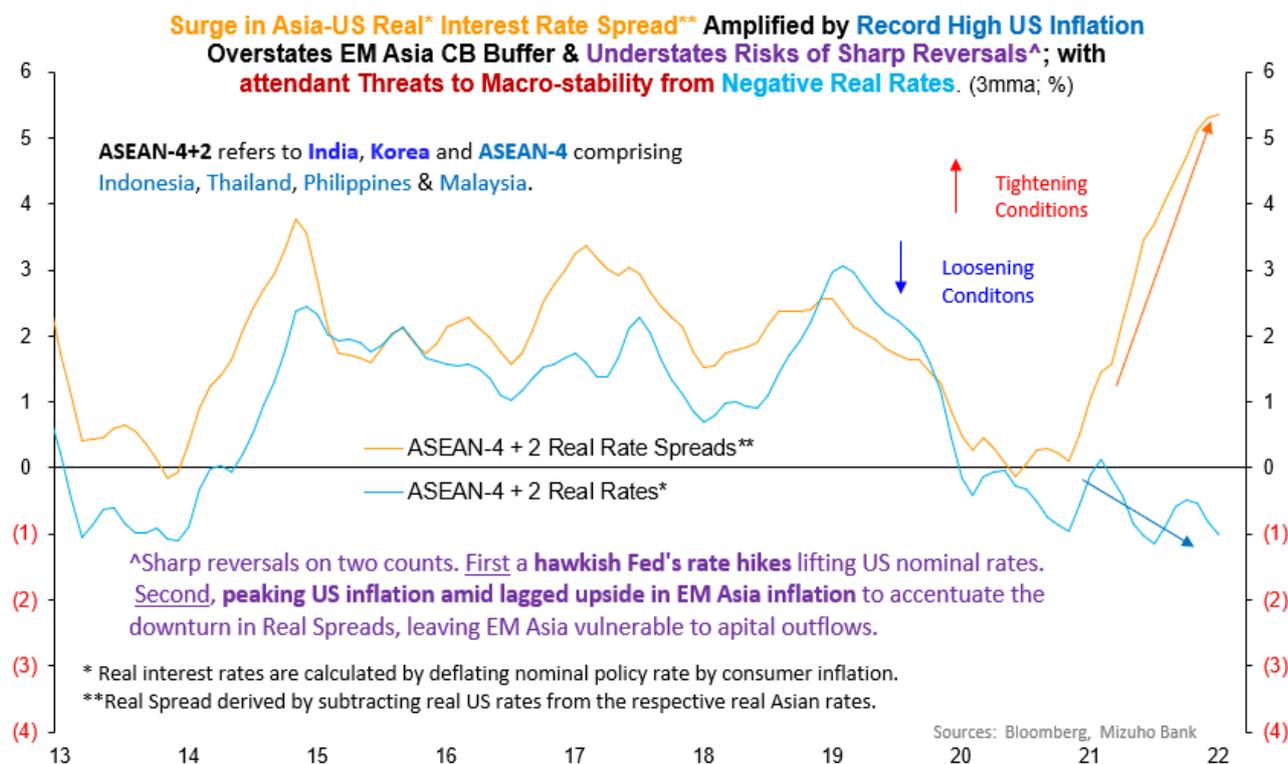


EM Asia Central Banks: Of Dissonance & Delusions



“Great, kid. Don’t get cocky” – Han Solo, Star Wars

In a Nutshell: An **increasingly hawkish** US Federal Reserve (**Fed**) **juxtaposed** against **record high US inflation**, which is unusually far in excess of EM Asia inflation, set the stage for dangerous **policy dissonance between levels and spreads of real policy rates in EM Asia**. The **potential for record high spreads**, gauged as policy cushion, to **breed delusions of insulation from a hawkish Fed** heighten risks of policy miscalculation, and consequent capital outflows leading to asset market and exchange rate pressures for EM Asia. This **underscores the inevitability of tightening by EM Asia central banks in response to the Fed. More so if** currency backstops from **favourable inflation differentials dissipate**.

Extraordinary US-Asia Inflation Dynamics:

Setting the stage is **extraordinary global inflation** dynamics, *whereby inflation in US outruns EM (Asia)*. Resultant **cognitive dissonance**, given EM economies are by definition more vulnerable to higher inflation, is one thing. But manifestation of **dissonance between extremely low** (negative) **EM Asia real policy rates and record high real rate spreads** (vis-à-vis real US rates) is quite another; **entailing grave policy risks**.

Policy Miscalculation Risks:

Specifically, **glaring dissonance between negative real rates** and **record high real rate spreads** **flag up the dangers of policy mis-calculations**. In particular, **exceptionally wide EM Asia real rate spreads** (vs. real US rates) **risks overstating policy flexibility and buffer from the Fed’s pipeline rate hikes**. The **real danger** is limited cushion from **dissonance descending into delusions of enlarged policy insulation**. And **with dire consequences** for policy credibility and wider macro stability.

... Accentuated by Sharp Policy Trade-Offs

To be sure, **sharp policy trade-offs** (associated with prematurely yanking support from an incomplete and uneven recovery) entailed in tightening in tandem with the Fed may **tempt**, and to some extent justifiably tilt, **EM Asia central banks to any exploit policy buffer** – real or perceived – to buy time on unavoidable tightening. Inevitably the imprecise judgment in deferment *accentuates odds of policy miscalculations*.

Slim Margin for Errors

And this is rendered **all the more dangerous** as the **margin for error** (corollary of perceived policy buffer from exceptionally large real rate spreads) is **devastatingly slim given that real rate spreads may be set to erode dramatically**; as two dynamics conspire. One is an **aggressive Fed hike cycle**, which *simultaneously lifts US rates and dampens inflation expectations*. The other is **EM Asia inflation poised to catch up with, and then exceed peaking US inflation**, which may abruptly *amplify a downturn in real EM Asia rate*.

Rate Reversals & Capital Outflow Risks ...

In which case, **corresponding plunge in**, and sharp reversal of, **real rate spreads** will inevitably **accentuate the risks of potentially destabilizing capital outflows**. And worse case iteration of this may entail **sharp sell-off in EM Asia assets and currencies**; each feeding off the other.

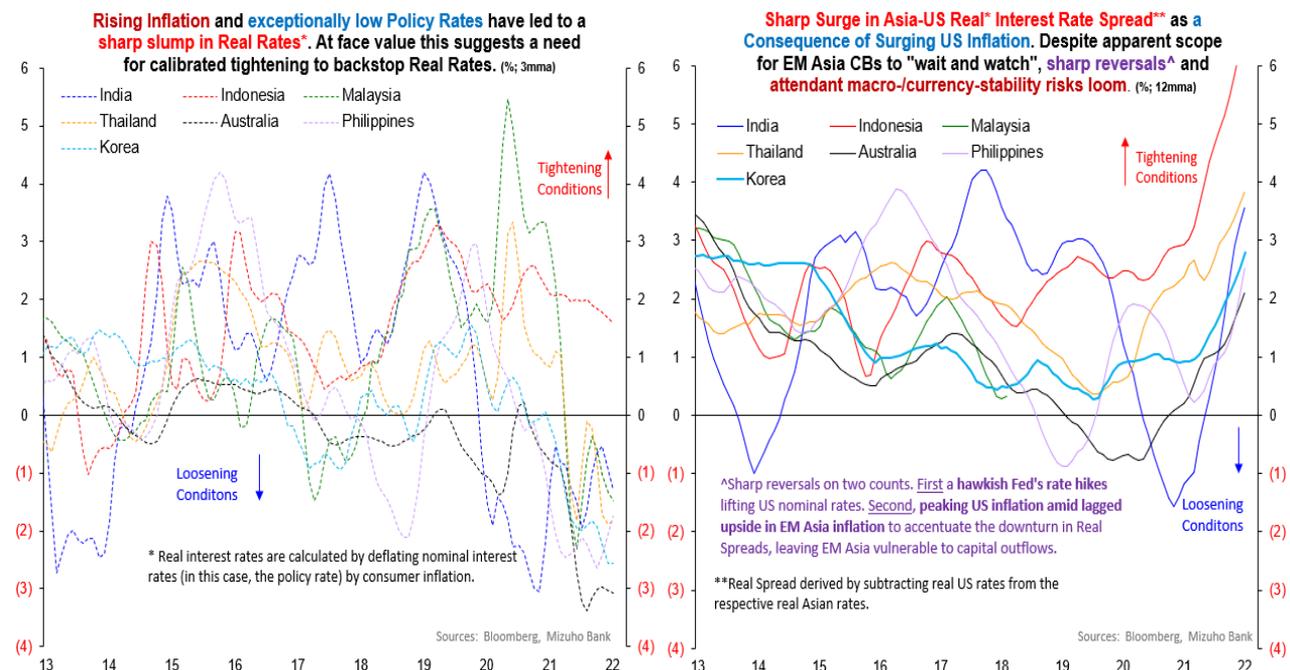
...Demand Proactive Policy Calibration

The upshot is that **extraordinarily high US inflation** (which is in excess of EM Asia’s inflation) is a *silver lining of measured reprieve, not a silver bullet offering unconditional insulation, from a hawkish Fed*. And so, it follows that **EM Asia central banks will necessarily only enjoy temporary shelter but not be spared the pain of policy trade-offs** entirely.

Especially as FX Backstops Dissipate:

What’s more, insofar that **relative EM Asia FX resilience** despite increasingly hawkish Fed **partly reflects favourable inflation differentials** (i.e. EM Asia inflation uncharacteristically lower than in the US), the **impending erosion in real rate spreads** may start to **induce more downside volatility in EM Asia currencies**. In turn, this will *amplify macro-stability concerns*, consequently **impelling more pronounced propensity for pre-emptive and defensive tightening** by EM Asia central banks.

Han Solo’s point about not getting carried away, complacent, or worse, over-confident applies to record high EM Asia real rate spreads, and the attendant policy buffer as well as currency backstop.



Appendix 1: Forecast of Central Bank Policy

Central Bank Policy Outlook

Country	Central Bank	2019-20		2021				2022				2023	
		End-2019	End-2020	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US	Fed	1.50-1.75%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.50-0.75%	0.75-1.00%	1.00-1.25%	1.00-1.25%	1.25-1.50%	1.25-1.50%
Australia	RBA	0.75%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.10%	0.25%	0.50%	0.50%
China	PBoC	4.35%											
		4.05%	3.85%	3.85%	3.85%	3.85%	3.80%	3.70%	3.60%	3.60%	3.60%	3.60%	3.60%
India	RBI	5.15%	4.00%	4.00%	4.00%	4.00%	4.00%	4.25%	4.50%	4.75%	4.75%	5.00%	5.00%
Indonesia	BI ^A	5.00%	3.75%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.75%	4.00%	4.25%	4.50%
Malaysia	BNM	3.00%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	2.00%	2.25%	2.50%	2.50%	2.50%
Philippines	BSP	4.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.25%	2.25%	2.50%	2.75%	3.00%	3.00%
Singapore	MAS [*]	Flatten S\$NEER & Re-Centre to Prevailing S\$NEER (~40-70bps lower)		Status Quo		Restore a "Slight" S\$NEER Slope (0.5% per annum)		"Slight" Increase to S\$NEER Slope (1.0% per annum)		Maintain S\$NEER Slope (1.0% per annum)		"Slight" Increase to S\$NEER Slope (1.5% per annum)	
Korea	BoK	1.25%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.50%	1.50%	1.50%	1.50%
Thailand	BoT	1.25%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.00%	1.00%
Vietnam	SBV	6.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.25%	4.50%	4.50%	4.50%

* The MAS conducts monetary policy via FX. Specifically it adopts a trade-weighted SGD appreciation at "modest and gradual" (estimated to be 2% per annum) pace as default.

^A BI shifted to the 7 Day repurchase rate as the benchmark rate in August 2016. This by default constituted 125 bps reduction from the last policy rate

^{AA} PBoC instituted the loan prime rate (LPR), which sets a floor on commercial interest rates. This replaces the 1-yr Lending rate

- **EM Asia Central Banks:** The BoK is pushing calibration further, with the MAS already pre-empting inflation with a "slight" slope to the S\$NEER being restored are "canaries" for more broad-based calibration towards normalization in 2022; but not evenly so. And the PBoC's outright easing bias is a case in point.
- **Australia (RBA):** With YCC dropped amid bond market pressuring 3Y AGBs well above 0.10%, an end of QE as of Feb is on the plate. The real tussle is the RBA's pushback on rate hike expectations for 2022.
- **China (PBoC):** The PBoC's policy review appears to have disposed with the most strident of liquidity/credit tightening; suggesting measured and targeted easing may be a matter of time amid economic slowdown.
- **India (RBI):** Despite having eased, inflation provides little reprieve. In fact, higher oil/energy prices and sticky inflation set to rise has the RBI in an uncomfortable bind. And rate hikes in 2022 is a forgone conclusion.
- **Indonesia (BI):** Contained inflation provides BI the required wiggle room to sit on its hand for now; but not throughout 2022 as Fed's tightening will invoke pressures to normalize via IDR stability channels.
- **Malaysia (BNM):** Fairly anchored inflation will allow for deferring initiation of calibration to early-Q2 of 2022; as evidence of recovery from higher vaccination rates and attendant re-opening solidifies.
- **Philippines (BSP):** Liquidity tightening may buy time, but a rate hold at this point is beginning to be on borrowed time; with early-2022 hike to address high and sticky inflation turning more compelling.
- **Singapore (MAS):** The unexpected, but justifiably pre-emptive restoration of a calibrated S\$NEER slope (~0.5% per annum appreciation) in October 2021 provides some wiggle room. Nevertheless a further, front-loaded increment (~1.0% slope) for April is likely with the pause saved for the October 2022 meeting.
- **South Korea (BOK):** Deeply negative real rates could see further calibrations through H1 2022.
- **Thailand (BOT):** With growth recovery seriously hampered by sluggish tourism recovery, the depth of output gap allows the BoT to maintain a prolonged hold for most of H1 2022; with THB risks watched.
- **Vietnam (SBV):** Relatively low inflation emerging out of COVID to allow a policy hold at least until H1 2022.

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