# Mizuho Chart Speak: EM Asia CBs

**Economics & Strategy | Asia ex-Japan**

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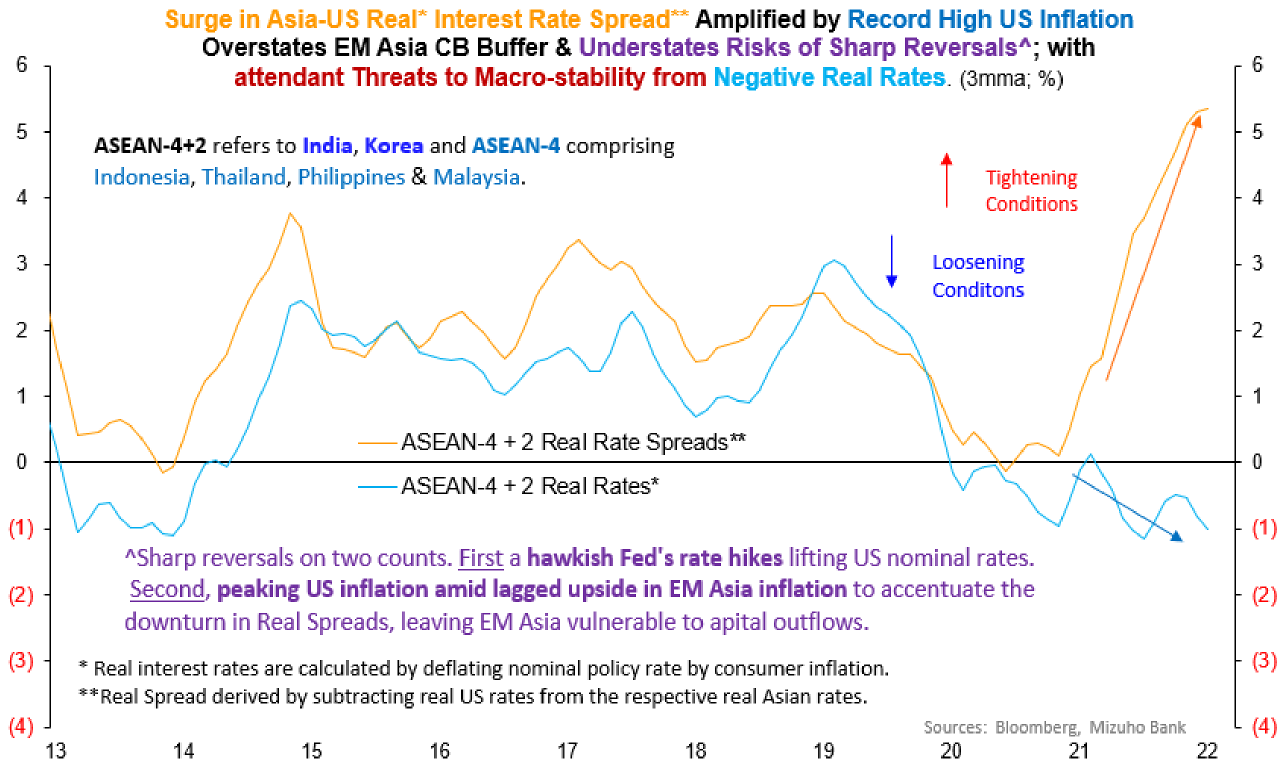
## EM Asia Central Banks: Of Dissonance & Delusions




"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.

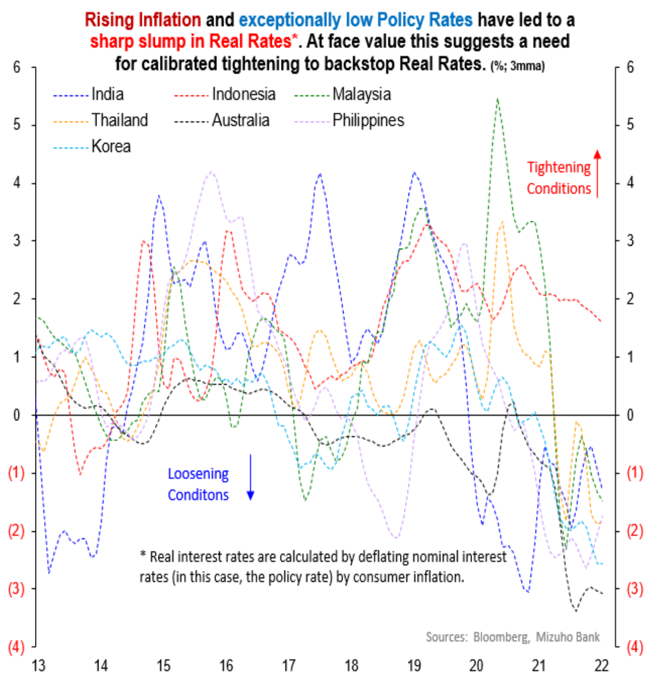
### …Demand Proactive Policy Calibration

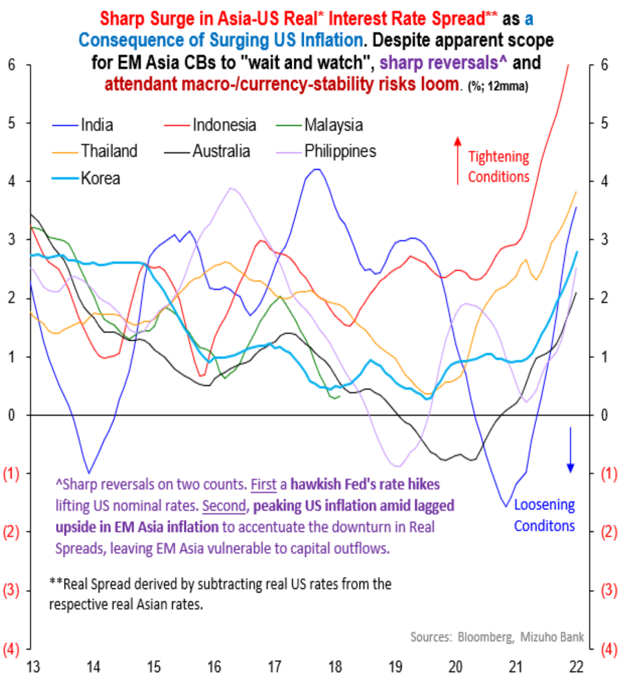
The upshot is that **extraordinarily high US inflation** (which is in excess of EM Asia's inflation) is a *silver lining of measured reprieve, not a silver bullet offering unconditional insulation, from a hawkish Fed.* And so, it follows that **EM Asia central banks will necessarily only enjoy temporary 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^ | 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.
^ 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
^^ 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.