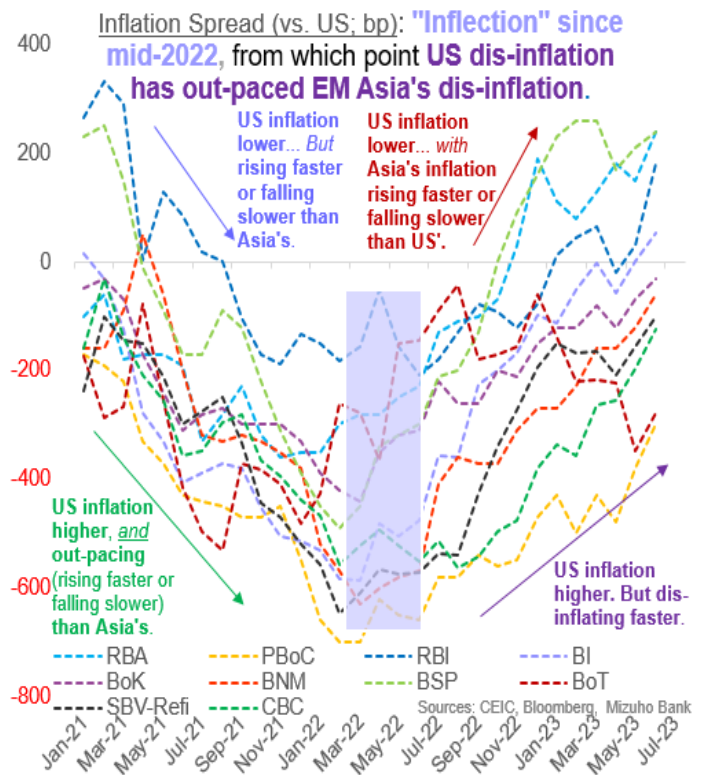
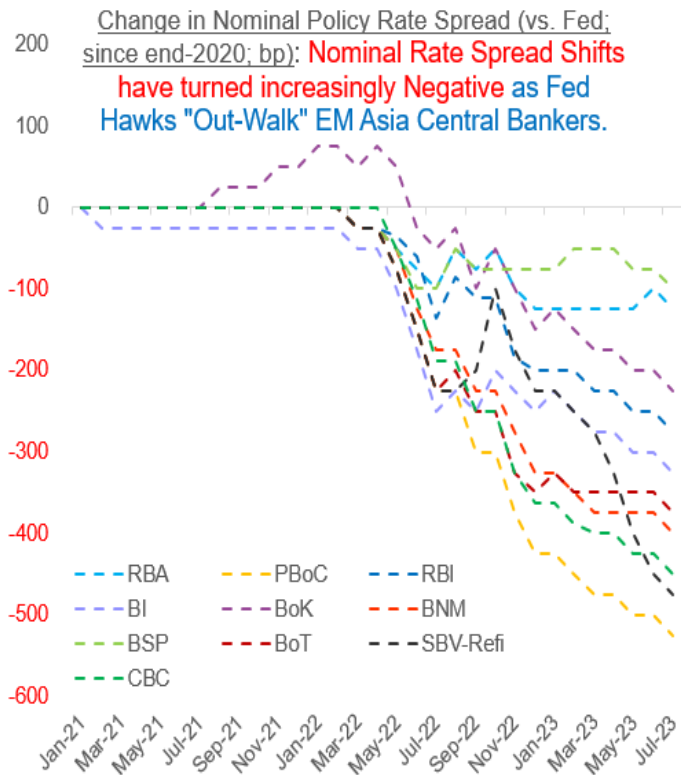
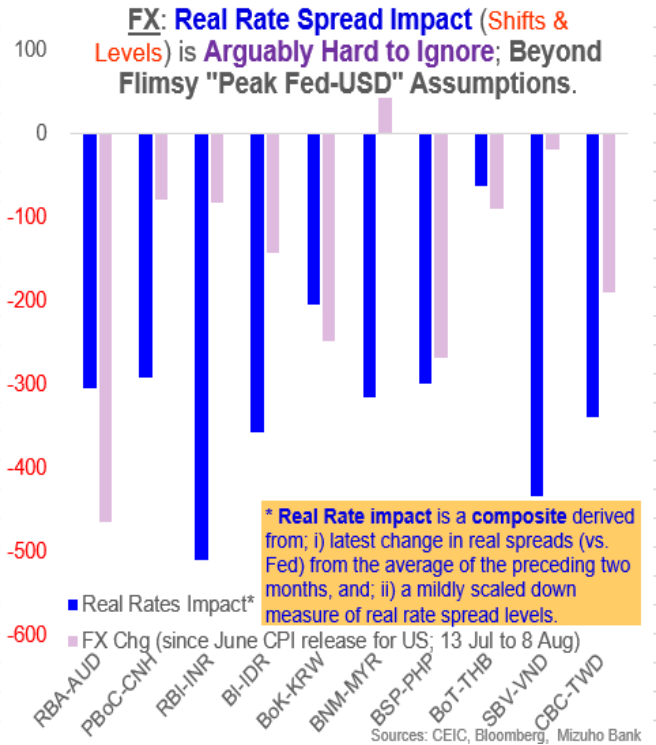
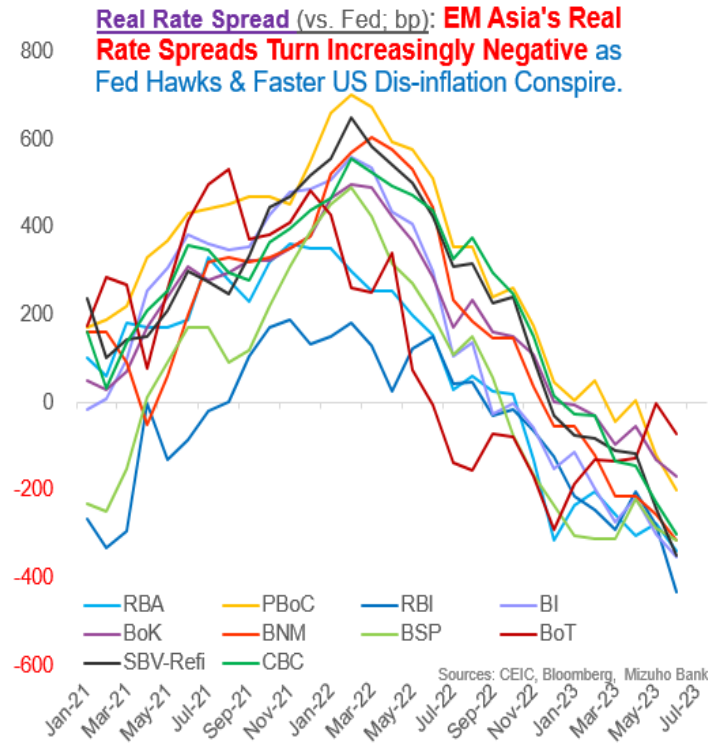


# Mizuho Chart Speak: EM Asia Risks

Economics & Strategy | Asia ex-Japan

8 August, 2023 | Vishnu Varathan | Head, Economics & Strategy

## The Real Risks with EM Asia Policy & FX



"Crime is common. Logic is rare. Therefore it is upon the logic rather than upon the crime that you should dwell." – Sherlock Holmes

- The bottom-line is that **obsession with ‘peak Fed’ dangerously overstates scope for EM Asia central banks to cut rates**; as **critical consideration of *relative rates and inflation* feeding into *real rate spreads*** are overlooked; **at the peril of destabilizing FX- and macro-stability**.
- Point being, received wisdom about “peak USD” derived from (and often front-running) “peak Fed” **unwittingly**, but no less damagingly, **tends to increase vulnerabilities to of being blind-sided by overriding real rate shifts that** in fact **advantage the USD**. And *often abruptly so*.
- Speaking of which, *uncharacteristic late-stage (Fed hike cycle) USD strength* is **evident in the coincidence of sharp pullback of EM Asia’s real rate spreads and attendant drop in Asia FX (vis-à-vis USD)**. Both of which correspond to June’s *sharper-than-expected US dis-inflation*; which has **sharpened Asia-US inflation spreads in favour of USD** (See Charts).
- The *real* (pun intended) **danger** is that **EM Asia central bankers, prematurely encouraged by peak Fed**, may be **more prone to inadvertent**, but potentially costly, **policy miscalculations**.
- As a result of which, *macro- and currency- instability* **inflict greater inadvertent economic pain than the relief that was intended** from (premature) policy easing.
- Moreover, **the Fed’s greater degree of hawkish persistence despite mounting peak Fed bets**, further accentuates pressures on EM Asia FX/assets amid nominal rate spreads skewed to near-term widening; as *central banks in Asia prematurely hint at exhausted tightening, if not desire to ease soon*.
- The upshot is that **insofar as EM Asia’s real rate spread erosion** tends to be **overlooked** by “peak Fed” arguments and/or **understated/obfuscated** by unfamiliar dis-inflation shifts (that advantage the USD), **risk of policy mistakes that imperil stability are heightened**.
- **Averting** such potentially costly **policy pitfalls** will **require acute cognizance of potentially abrupt and unusual shifts in real rate spreads**. **Specifically**, the two key moving parts.
- First, *pressures from nominal rate spreads* as strident Fed hawks apply themselves “higher for longer,
- Second, and concurrently, central bankers in EM (Asia) will also have **to account for, and lean against, faster relative pace of US dis-inflation\*** (vis-à-vis most of EM Asia).
- Arguably, **currency stability rises in prominence as proverbial “canary”** for EM Asia central bankers trying to **divine leeway to calibrate policy** to less restrictive settings.
- But the **dog wagging the currency tail may be underlying (relative) inflation dynamics**. And so, **evolving (relative) inflation dynamics** re-emerges as the barometer of policy risks.
- Accordingly, it is remarkable, and *likely reflected in FX risks*, that *BSP, RBA, RBI and BI appear to be faced with considerably detrimental inflation dynamics* at the margin [bottom, right Chart].

\*Especially as EM Asia is exposed to risks of stickier inflation, slowing dis-inflation (vis-à-vis US); albeit unevenly across EM Asia, dependent on extent of energy price volatility, food price risks from El Nino and lagged services inflation pass-through from tourism resumption.

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