Mizuho Insights: MAS Watch

Economics & Strategy | Asia ex-Japan

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MIZUHO

Doubling Down on "Double-Barrelled"

In a nutshell: Given persistent inflation overshoot, especially amid risks of wage-price spirals and unmoored inflation expectations, the **MAS is not only set to tighten further, but set to do so aggressively**.

Admittedly, growing recession risks diminish threat from inflation; certainly, price shocks. But trouble is, the **bullish 'USD shock' is effectively a proxy price shock**. Specifically, indirect *imported price shocks via brutal USD appreciation* rippling through upstream commodities/energy across supply-chains. Thereby **requiring sufficiently hawkish response** entailing;

i) **emphatic S$NEER slope increment**, dropping "slight" calibration in "steepening the S$NEER" policy slope (*by 1.0-1.5%-pt* to an estimated 2.5-3.0% p.a.*) *aimed at stifling inflation expectations,* and;

ii) **a *record* third "step appreciation"**, re-centring the policy mid-point higher as a means to *enhance efforts to dampen price shocks* (existing or potential).

This **literal doubling down on** (a **second**) "**double-barrelled**" **tightening** stacks up as cumulatively *uncharted hawkishness;* comprising a **third** **"step appreciation"** to supplement a more aggressive, **fourth** (instalment of) **slope steepening**.

Admittedly, *gathering headwinds could argue for tempering* re-centring and/or slope increment in the "double-barrelled" *move*. Moreover, aggressive tightening inevitably *assumes risk of sharp policy reversal in worse-case global recession.*

Regardless, **MAS' aggressive tightening** will **provide immediate S$NEER upside**. *But* **not sustained SGD defiance of exceptional bullish USD trend**. Point being, *"higher for longer" USD* from unrelentingly hawkish Fed will likely *limit SGD gains against USD in sharp contrast to emphatic trade-weighted SGD surge* in response to hawkish policy triggers.

Already Exceptionally Hawkish

For context, the MAS is already exceptionally hawkish. Fact is, the speed and force of tightening thus far (since last October) is simply unprecedented. **Within the span of less than a year** (9 months as of the last off-cycle move in July, to be precise), the **MAS has delivered** a series of;

i) **two "step appreciation" moves** by "*re-centring the S$NEER higher* to prevailing (richly valued) S$NEER levels" (in Apr '22 and Jul '22) and;

ii) **three "slight" increments to the S$NEER slope** (in Oct '21, Jan '22 and Apr '22) to reinstate

MAS Moves & Inflation Outlook

	Policy Action		Inflation Forecast (2022)	
	Slope	Mid-point	Headline	Core
Oct '21	Raise "slightly" (from 0% to ~0.5% p.a.*)	No change (at April 2020 levels**)	1.5-2.5%	1.0-2.0%
Jan '22	Raise "slightly" (to ~1.0% p.a.)	No change (at April 2020 levels**)	2.5%-3.5%	2.0-3.0%
Apr '22	Raise "slightly" (to ~1.5% p.a.)	Re-centre higher to prevailing (Apr '22 S$NEER) levels	4.5-5.5%	2.5-3.5%
Jul '22	No change	Re-centre higher to prevailing (Jul '22 S$NEER) levels	5.0-6.0%	3.0-4.0%

* p.a. refers to per annum appreciation bias

** After the mid-point re-centring lower and slope flattening (to 0% appreciation bias in response to COVID)

Off-cycle Policy Moves

Sources: MAS, Mizuho Bank

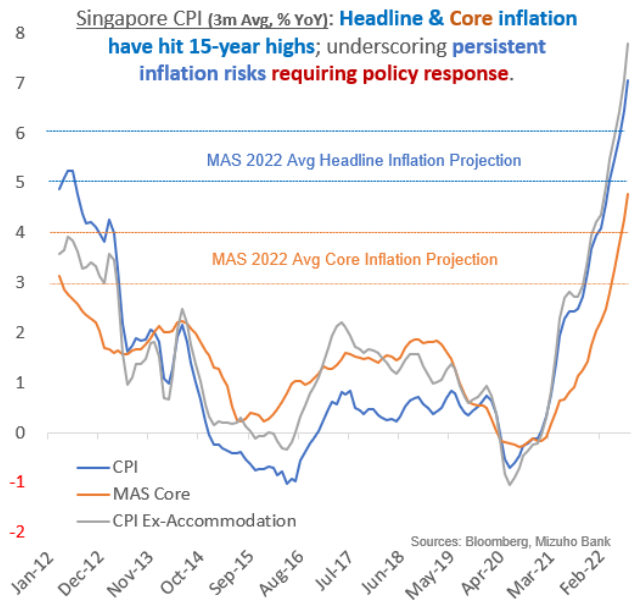
Yet Undeterred into the Uncharted

Yet, evidence and circumstances point to further, potentially **even more aggressive, tightening** at **the next scheduled meeting** (12-14th Oct). In effect, the MAS will be *charging further out into uncharted tightening territory, undeterred.*

But **not just to blindly jump on to the global hawkish doubling down bandwagon.** *Instead, in response to risks of unmoored inflation expectations as well as USD-induced inflation shocks.*

Inflation Forcing Hawkish Hand

For a start, the **unrelenting force of inflation shocks**, which have lifted inflation to 15-year highs, **arguably demand further policy response**.



Fact is, core (headline) inflation at 5.1% (7.5%) for August is not only **uncomfortably elevated** at 15-year highs, but is **perilously close to breaching** the MAS' **already upwardly revised projection of 3.0-4.0%** (5.0-6.0%) average for 2022.

Even in the unlikely event of price levels plateauing at August levels (based on overly benign assumption of sequential price pressures fizzling) average core and headline inflation will hit 3.8% and 5.9% respectively.

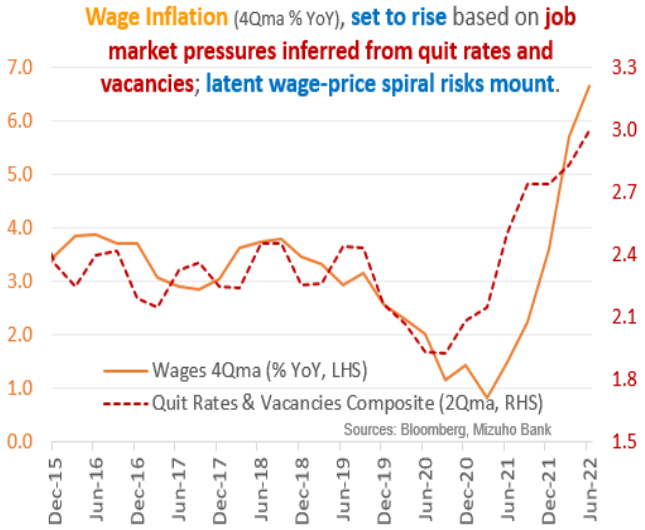
Whereas **if price pressures continue to build**, as they are more likely to, **inflation is set to overshoot**; *underscoring inflation risks.*

Consequently, even at first glance, there appears to be a case for the **MAS to pair further upward revisions to inflation** forecasts **with policy tightening**.

Amid Wage-Price Spiral Risks …

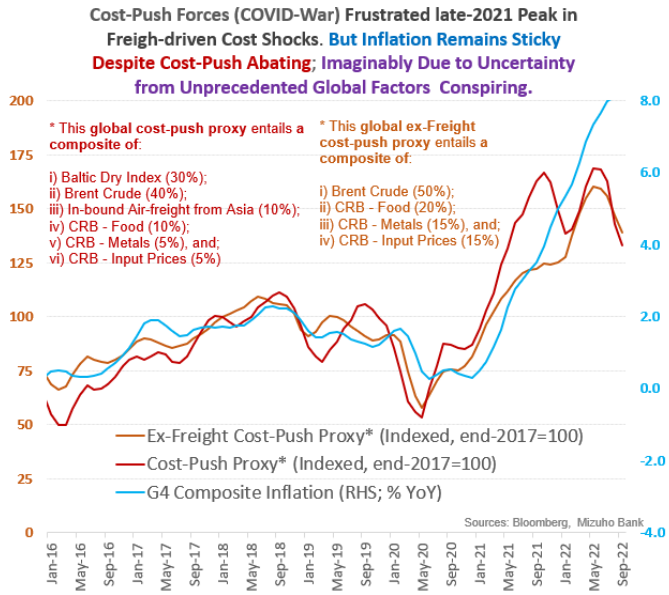
And the build-up in **wage-price spiral threats** revealed by inflation dynamics unpacked from the hot headline **only reinforces the case for tightening**.

So, **despite soft spots in the recovery** and glimpses of **global headwinds in the horizon**, **tight labour market conditions** – highlighted in elevated quit rates and vacancies – **underscore inconveniently high and sticky wage pressures**. Precisely the conditions that **invoke wage-price spiral risks**.



… & Heightened Inflation Uncertainty

Admittedly, *economic theory supports looking past near-term inflation volatility from temporary supply-shocks and one-off price impact* (e.g. GST hikes). In which case, the record, front-loaded tightening by the MAS thus far is arguably sufficient.



But the **lived reality of exceptional, one-in a-lifetime cost shocks** from COVID (constraints and re-opening) war and US-China conflict (compromising China's ability to export dis-inflation to the world) **conspiring in a hard-to-predict manner** cast far **greater uncertainty over how persistent and profound** the **resultant inflation shocks** may be.

Of Tightening & Tools

The **logical policy conclusion** then is that **emphatic tightening** is **virtually unavoidable** *if persistent and profound price pressures are to be tackled;* especially as inflation gets worked into wage expectations.

The critical question though is **how the MAS' policy tools may be optimally deployed**.

And the upshot is that **insofar that the MAS needs to tackle both inflation expectations** and existing/potential **price shocks**, the optimal policy mix may be achieved by the so-called **"double-barrelled"** tightening move comprising;

i. **more pronounced S$NEER slope increment**, dropping "slight" calibration in "steepening the S$NEER" policy slope (*by 1.0-1.5%-pt* to an estimated 2.5-3.0% p.a.*) *aimed at stifling inflation expectations*, and;

ii. **a *record* third "step appreciation"**, re-centring the policy mid-point higher as a means to *enhance efforts to dampen price shocks* (existing or potential).

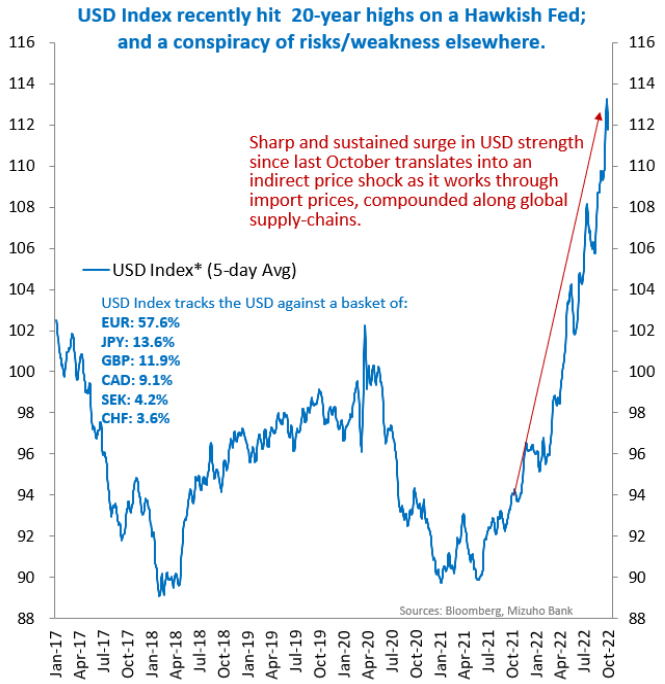
(i) Great Expectations & Gradients

Fact is, **exceptional circumstances** have ***amplified risks of inflation expectations becoming unmoored***; regardless of the technicalities behind inflation drivers. Which in turn **requires appropriately emphatic policy response**.

To that end, a **distinctly steeper S$NEER slope** is arguably **best suited to rein in and anchor inflation expectations**; as expectations of future price increases are dynamically pre-empted or at least mitigated. In this case, given rising concerns about inflation expectations, we think there is a good chance the "slightly" calibration will be dropped in favour of a **more pronounced (1.0-1.5%-pt) increase in the S$NEER gradient as stated above**.

(ii) USD-Price Shocks & S$NEER Shifts

Admittedly, **scope for incremental price shocks have diminished** as "living with COVID" gains traction, and Russia-Ukraine energy (along with wider commodity) shocks are mostly priced in. *Nonetheless*, **unexpected price shocks cannot be dismissed** given unpredictable geo-politics.



Crucially, **acute and sweeping USD strength** (up 18-19% since last October, up 16% YTD and up nearly 3% since the last off-cycle re-centring higher in mid-July**) inevitably imposes an indirect price shock** (via upstream USD-denominated energy and commodity costs); **especially *as price pressures pass-through from the strong USD* impact on *is amplified* across global supply-chains.**

Hence, the **justifiable case for "step appreciation"** (re-centring S$NEER higher) as an *upfront shift higher in the S$NEER* will help *dampen existing and potential price shocks;* thereby *mitigating second-round effects* in an already "hot" inflationary eco-system.

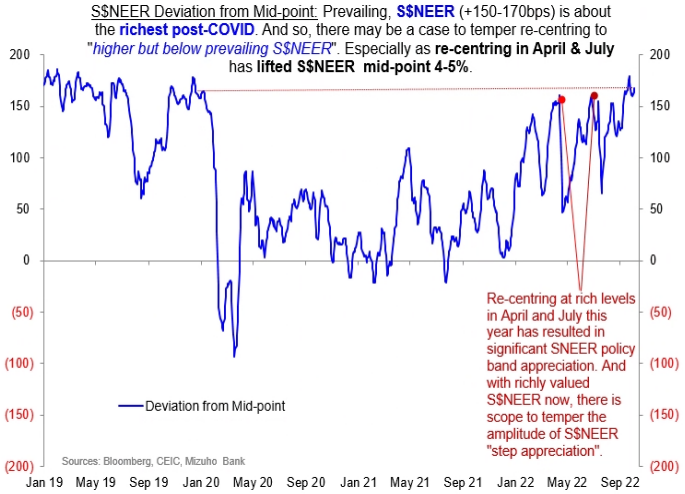
Possible Restraints …

Whilst inflation risks have rightly dominated the monetary policy agenda, **sharpening trade-offs** accompanying exceptionally aggressive tightening simply **cannot be ignored**.

In particular, the *threat of (Fed-led) policy-induced global recession, while not impending, is nevertheless imposing*. And **doubling down on an aggressive iteration of "double-barelled" tightening** (*that builds on two "step appreciation" and three instalments of S$NEER slope increment since last October*) **heading into gathering global headwinds** is **admittedly risky business**.

And so, **nuanced hawkish restraint is a distinct possibility**, *even if not the base case.* Specifically:

Tempered Re-centring (40% probability): Given the **two prior re-centring** (in April and July) **to richly valued S$NEER**, resulting in *S$NEER mid-point* being *lifted 4-5% since October 2021,* there is a case to be made about **tempering the current re-centring** to "***higher, but below prevailing S$NEER levels***". Especially **given exceptionally rich levels of the prevailing S$NEER** vis-à-vis the policy band.



Slope Restraint (25% probability): Similarly worries about global downturn may induce the MAS to exercise more restraint in raising the S$NEER slope, retaining the "slightly" calibration (estimated to be ~0.5%-pt increment). But this is a lower probability (non-base) case; given our assumption of greater emphasis on anchoring inflation.

… & Potential Pivots

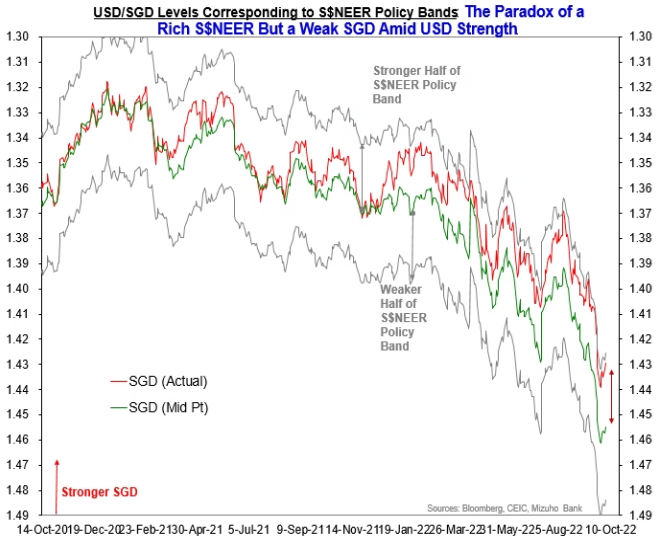
Finally, the base case of a **more aggressive iteration of "double-barelled" tightening** (with more emphatic slope increment) is **inevitably accompanied by risks of an abrupt dovish pivot** down the road; should worse-case scenarios of a global recession and/or hard-landing in assert markets play out.

But this is par for the course given exceptional tensions in global risks and the imminent threats of inflation expectations becoming unmoored. Simply put, **inaction is a greater policy sin** (of neglect) than is policy reversal a sign of mis-step.

SGD: NEER Dominance, But USD Deference

Regardless, given that "step appreciation" cannot be fully front-run by markets (due to prevailing policy band constraints), **it is fair to predict a bullish SGD reflex**; although perhaps ***not sustained bullish trend***.

Despite unprecedented tightening, and *resultant 5-6% jump in S$NEER (trade-weighted SGD),* the **policy-implied USD/SGD range correspond to far weaker SGD** (vs. USD) compared to before MAS started tightening in 2021.



Point being, even with this round of more aggressive tightening, what's given is emphatic relative **SGD out-performance** (vs. trade-basket peers); **not sustained strength against the USD**. *Especially if a "higher for longer" USD continues to impose.*

To be sure, **a knee-jerk, post-MAS jump in SGD of up to 1.0-1.5% is consistent** with assumption of **"re-centring" that retains a rich S$NEER**.

But *beyond the instant gratification of "step appreciation" fillip* and despite scope for more pronounced S$NEER appreciation bias, the *wider USD trend will dictate USD/SGD outcomes.* And until otherwise notified by discernible shifts in relative global policies, a **dominant S$NEER is not absolved of SGD's deference to (King) USD**.

On the rates end, **if indeed the MAS surprises with a more emphatic slope increment** (as we predict), there may be *resultant shift in USD/SGD forward points to the left* (signalling greater future SGD appreciation expectations). In turn, and as per covered interest rate parity, this may be consistent with *expectations for SGD rates to remain below US rates;* even as it follows the direction of travel in rising US rates.