Mizuho Insights: EM Asia

Economics & Strategy | Asia ex-Japan

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2022: 5 Themes to Muse for EM Asia

In a nutshell: A risk-based examination of 2022 outlook for EM Asia must inexorably be shaped by hard-to-predict interactions between **pandemic, price, policy and geo-political risks**.

Five themes that occupy prominent space are; i) a **discordant recovery**, *with EM Asia* by and large *still lagging* AEs; ii) **two-way China risks *tilted to downside*** surprises; iii) **persistent**, if not **more profound inflation risks**; iv) **macro-stability risks heightened by "Kokomo USD"**, and; v) EM Asia central banks **coerced into more tightening sooner** as trade-offs sharpen; especially with the Fed's hastened tightening cycle.

Consequently, **EM Asia recovery** is likely *to lag* and *remain uneven;* with *China neither providing emphatic tailwind nor vanquishing downside risks* as stimulus pivot is hampered by pre-existing restraints. *Rising inflation* **conspiring with a *"Kokomo USD"*** will **accentuate troubling policy trade-offs**. And s **macro-stability risks begin to overtake the monopoly of pro-growth policy bias**.

All said, **2022** for EM Asia may be **a year of constrained up-cycle amid sharper trade-offs and fatter tail risks**.

Clash of Risks

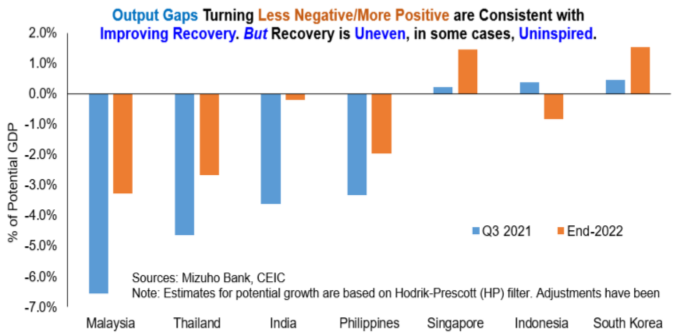
Musing about what 2022 holds is not so much as a question in pursuit of definitive answers as it is an invitation to examine a **chaotic clash of pandemic, price, policy and geo-political risks**. Conveniently, and rather clumsily, **five EM Asia themes for 2022 emerge**. Admittedly, **neither necessarily independent nor comprehensive.** But at least uncovering **some of the more prominent cogs in the complex mechanics involved**.

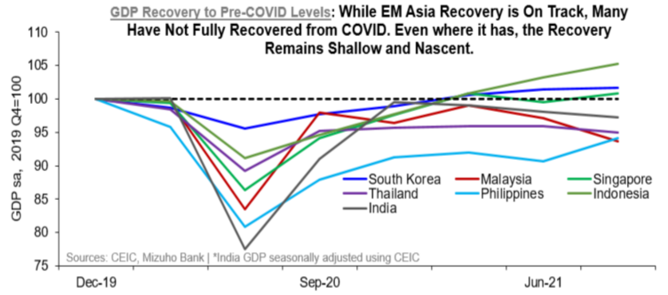
1) Discordant Recovery Stacked Against EM

Arguably, the **overarching theme** is that **despite turning a corner** on COVID, the **global economy is still fraught by**, if not plunged in, a **discordant recovery**; struggling with uneven recoveries stacked against EMs (including Asia) that are disadvantaged by compromised access to healthcare/vaccines and cheap funding.

To be sure, this **does not distract from the big picture of continued improvement** in EM Asia. Especially as adaptation, circumvention and gradual re-opening dampen incremental COVID blows.

Accordingly, most EM Asia economies in 2022 are set to make back ground lost to the pandemic, if not extend recovery to the pre-pandemic growth trajectory.





***But** evolving "variant risks"* and *vaccination lags* vis-à-vis advanced economies (AEs) dictate that **EM Asia's recovery will lag that of AEs**.

Asynchronous recovery aside, **demand rebound is also liable to restraints from**; as resultant *start-stop mobility/activity, "sticky" supply-chain disruptions* and *prolonged border restrictions* **subdue unfettered demand recovery** and **suppress tourism multipliers**.

Crucially, **adverse feedback loops involving** *mounting fiscal strains, rising import costs* as a corollary of *more problematic inflation* and a ***hawkish Fed*** – invariably lifting financing costs, and potentially destabilizing capital (out)flows – **fatten downside "tail risks"**.

And adverse balance sheet impact from asset and exchange rate pressures threaten to amplify downside risks. All of which **warn of *stifled and stuttered growth for EM Asia*, underpinning a bumpy recovery**.

2) Conflicted & Asymmetric China Risks

Moreover, **conflicted and asymmetric China risks** may accentuate turbulence.

Asymmetric because China's sway is likely to be *tipped to accentuate downside risks*.

Fact is, **downside risks from financial shocks and supply-chain ripples tend to amplify** amid a tightening Fed. In contrast, **tailwinds** may be **curtailed** by domestically targeted stimulus. Moreover, **China's demand revival may inconveniently amplify pre-existing cost-push**, to the detriment of growth rebound.

And **Beijing's conflicted* impulses** are **crystallized in the dissonance between** its;

i. ***"hand-brake" turn on policy to unambiguous stimulus*** and;

ii. ***lingering headwinds from* the** *property sector crackdown* alongside *regulatory tightening* **aimed at anti-monopolistic measures** (motivated by "common prosperity").

Main Take-Away of CEWC is a Shift to Stimulus

Headwinds to Growth	"Regularity"	Implication
Demand Contraction	Last mentioned in 2015 before the "China crisis". Suggests some severity of downturn.	Policy stimulus to ensure that negative property multipliers are countered via liquidity and offsetting fiscal stimulus to bolster activity and jobs.
Supply Constraints	Not unexpected amid current global supply kinks.	Resolution underway (for the case of the power crunch). On-going efforts to ensure supply-side shocks are buffered.
Confidence Deficit	Never before cited. Likely signals acute policy cognisance of adverse feedback loops (demand-confidence).	Urgent policy stimulus to buttress household and wider corporate balance sheets critical for absorbing potential property sector triggered financial shocks alongside and employment support are par for the course.
Prioritizing "stabilization" in this context suggests ***unequivocal policy inflection to front-loaded stimulus***; but measured in a way not to completely unravel structural reforms.		

Sources: Bloomberg, Mizuho Bank

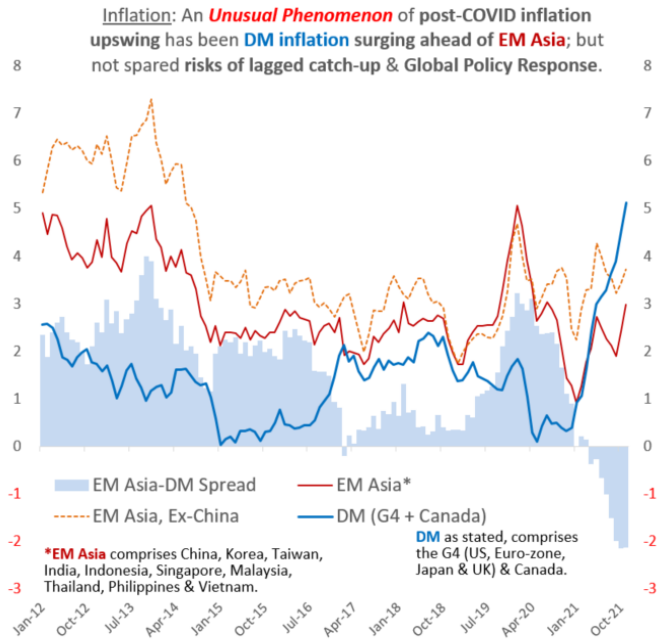
Whether China, in totality, inspires tailwinds, or **churns up headwinds** is as **unclear as it is uneven**; ***across time and countries***

For clarity, "conflicted", **includes, but is not limited to the geo-political threat of US-China conflict. Instead, "conflicted" reflects the tensions between growth, financial stability and redistribution (inequality reduction) objectives. For 2022, these are reduced to the conflicts of both wanting to buoy growth ahead of the 20th National Party Congress in Oct/Nov this year whilst reining in excesses and reducing inequality; both of which require near-term growth trade-off.*

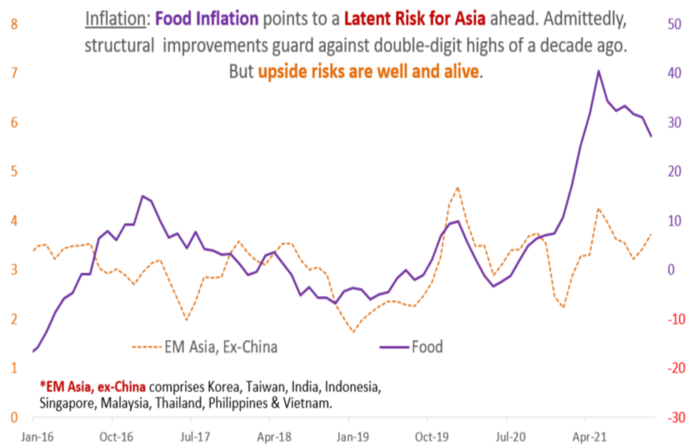
Across time, **ripples from Chinese developers' default cast a pall in early-2022** whereas **lagged stimulus boost** promise **positive spillover later in 2022**.

Across countries, **Beijing's Zero COVID restrictions**, dampen and defer regional tourism recovery, while China's **conflicting swings between anti-speculative clamp-down** and **strategic reserve-building** (in accordance with "dual circulation" intentions), *impose volatility on commodity producers*. All said, **China will inadvertently accentuate a bumpy and uneven EM Asia recovery**.

3) Inflation Insurgence



Speaking of which, **persistent cost-push** factors **amplified by food and energy price pressures** means that **inflation risks will not only manifest and persist 2022, *but* evolve to become more profound**; amid higher food and energy consumption in EM Asia (*in absolute terms and relative to AEs).*

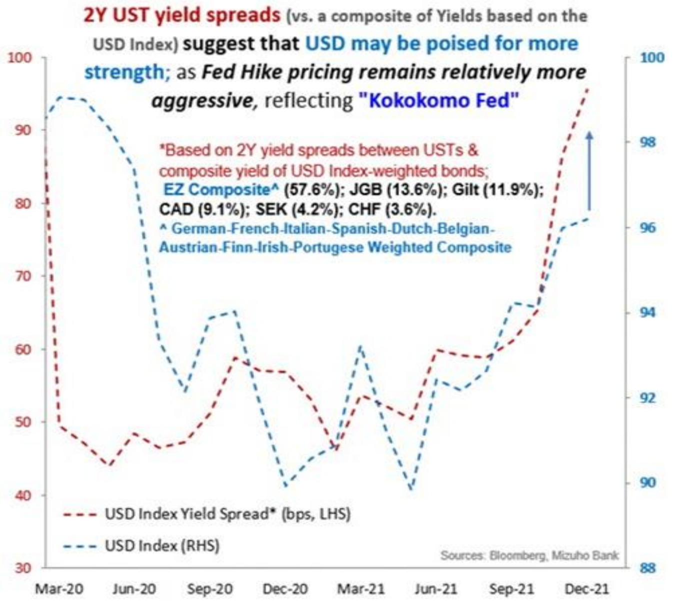


This is **not just an unwelcome accentuation of policy dilemma** in trying to strike a delicate balance between supporting a more complete recovery and checking potentially de-stabilizing inflation risks.

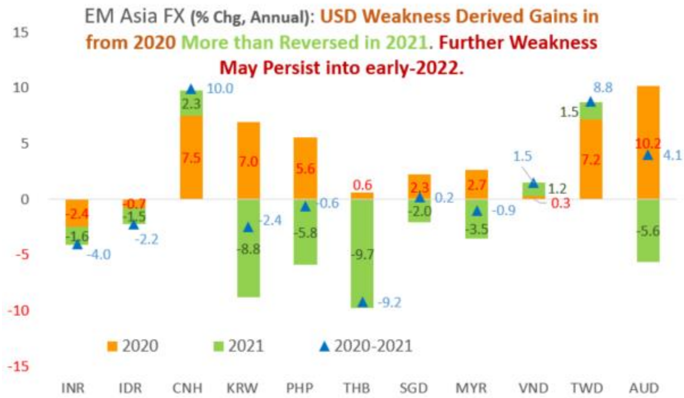
Crucially, **persistent food and/or energy *cost-push***, in *conspiring with strained fiscal position* (hampering stronger fiscal offset for higher prices), and a *hawkish Fed* (that may erode EM Asia FX via capital outflows), **threaten a spiral from inflation to wider macro-stability risks**.

4) 'Kokomo USD' & Macro-stability Risks

Moreover, a **"Kokomo USD"**, which is a derivative feature of a **"Kokomo Fed" –** the US Federal Reserve (Fed) **poised to** "*get there fast, and then ... take it slow" (i.e front-loading tightening)* – **may amplify macro-stability risks**.



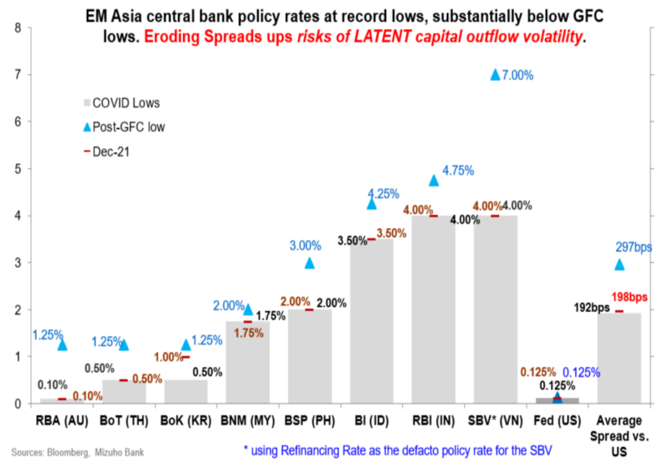
Specifically, **EM Asia FX predisposed to depreciation as a corollary to a "Kokomo USD"** (front-loaded USD strength consistent with policy differentials involved in the transition from "taper" to rate hikes) may tip over as *tail risk of self-reinforcing sell-off in EM Asia FX and asset markets.* Especially if resurgent inflation, elevated debt, and capital outflows conspire to set off adverse feedback loops.



Admittedly, measured EM Asia FX softening may confer **advantages to exports recovery**. But these are not only washed out by supply-chain limitations and cost-push vulnerabilities, but crucially, **overwhelmed by the threat of "tipping risks" undermining macro-stability**.

5) Coerced Normalization & Sharper Trade-Offs

Given **tail risks to macro-stability** are disproportionally damaging, a **hawkish Fed may require that EM Asia central banks' tightening path start sooner and go further** than underlying growth conditions would otherwise have inspired.



Moreover, **AEs weaning off drastic fiscal impulse will not flatter, potentially compromise, EM Asia's fiscal deficits and debt**. So, **policy trade-offs** between **inflation-growth balance** and **macro stability risks are sharpened**.

And policy normalization, if not compelled by fundamentals, may be coerced by threats to stability; considering that r**elative inflation overshoot and/or policy lags will differentiate relative FX and asset market outcomes**

Constrained Up-Cycle?

All considered, the macro themes suggest a **half-full rendition of economic outcomes in 2022 for EM Asia**. The **recovery will extend**, ***but*** amid prolonged pandemic "variant risks" **suffer on-going struggles with bumps and dampeners**. China, becomes a bigger wild card, with risks tilted to the downside, despite stimulus buoyancy.

Inflation will be increasingly inconvenient, demanding policy calibration against a tightening Fed; and at pain of capital outflows. Consequently, **EM Asia central banks must endure sharper trade-offs**, guarding more against inflation and macro-instability rather than insuring growth.

And **weaker EM Asia currencies** as a corollary to a "Kokomo USD", while possessing some allure for exports boost, will be washed out by imported inflation vulnerabilities and "fat tail", stability risks. A **constrained up-cycle is an optimistic characterization of the road ahead in 2022**. But as ***Richard Feynman*** said in all his learned wisdom, "*I have approximate answers, and possible beliefs, and different degrees of certainty about different things, but I'm not absolutely sure of anything*".

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