Mizuho Insights: Central Bank Policy

Economics & Strategy | Asia ex-Japan

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"Physics is not about how the world is. It is about what we can say about (it)" – **Niels Bohr**

The "Kokomo" Conjecture

In a nutshell: Despite uncertainties from Omicron (and *wider variant risks*) casting a shadow on hopes of unfettered recovery, the ***risks associated with being too slow to "exit" ultra-accommodative policies have intensified***. Especially as the **rapid pick-up in**, and more **rampant proliferation of**, **inflation accentuate policy dilemma**. On one hand, *tightening too much too soon threatens to derail the nascent* (and arguably fragile) *recovery.* Yet on the other, *leaving it till too late could result in inflation expectations becoming unhinged.*

The **optimal solution** to this unenviable predicament is the **"Kokomo" conjecture**. Specifically, "*get there fast and then … take it slow*" approach in initiating calibrated "exit" from unprecedented policy accommodation **not only mitigates inflation risks at a fairly low policy cost**, but **checks risks of having to over-tighten** later to compensate for delayed policy response. In Asia, the *BoK, MAS and RBNZ appear to already be humming "Kokomo"*, with the **Fed now notably primed to belt out "Kokomo"**.

A **"Kokomo Fed"**, so to speak, is **set to hasten "taper" to wind down QE** in late-Q1 or early-Q2 2022 and **hike at least twice starting mid-2022**. And with a "Kokomo" Fed leading the ECB, BoJ and many EM central banks, a ***"Kokomo USD" inclined to strengthen in H1 2022*** (at least until policy divergence starts to fade) looks likely.

Kokomo Conjecture: The What

"Aruba, Jamaica, oh I want to take you to/
Bermuda, Bahama, come on pretty mama/
Key Largo Montego, baby why don't we go/
Oh I want take you down to Kokomo/
We'll get there fast and then we'll take it slow/
That's where we want to go/
Way down in Kokomo"
- **Kokomo, Beach Boys, 1988**

Our so-called **"Kokomo" conjecture about central banks** is inspired by the Beach Boys song of that same title: "Kokomo". Specifically, our allusion to the "Kokomo" conjecture is inspired by arguably the most inspirational line, "*get there fast and then … take it slow*". Admittedly, Beach Boys' genius taken out of context. But oh so deliciously apt.

For clarity, the "Kokomo" conjecture **proposes *two key postulates*** on policy approach.

1. First, "*we get there fast*"; **in reference to initiating calibrated normalization** from exceptionally accommodative setting.

2. Second and crucially, "*and then we take it slow*"; whereby **by virtue of "getting there fast"**, central banks **may able to stop sooner and at lower terminal rates**, exploiting the policy space from earlier calibrations.

Kokomo Conjecture: The Why

Why "Kokomo"? Because "*getting there fast, and then … taking it slow*", despite the initial appearance of aggressive normalization, eventually results in the **highest likelihood of minimizing economic costs** (both from current tightening in the context of future liability to tighten) whilst **insuring against** the dangers of **run-away inflation** and **mitigating policy credibility risks** associated with reluctance to respond to inflation.

Minimizing Policy Costs: The most compelling reason **"Kokomo" presents the most optimal solution** to an unenviable policy predicament is because this minimizes the economic costs from tightening over a longer horizon.

Specifically, by way of;

i) **fairly muted economic cost of earlier calibrations** *from exceptionally accommodative policy settings* (e.g. **initial hikes from record low rates** unlikely to derail economic recovery) and;

ii) **diminished risk of compensatory over-tightening** thanks to **moving** earlier, possibly **"ahead of the curve"**.

Put differently, "Kokomo" **offers "a stitch in time" mitigation of far greater costs later**. In "*getting there fast, and then taking it slow*" not only are *costs associated with initial calibrations likely to be measured (helped by an exceptionally low base)*, but higher chances of a lower terminal rate *check potential economic pain from having to (over-)tighten later to compensate for delayed policy response.*

The Inflation Quagmire: Crucially, **rising inflation that has proliferated more widely poses a quagmire demanding *urgent* policy response despite lingering pandemic risks**. What began as inconvenient but innocuous supply-side cost push, and mostly dismissed as "transitory", is justifiably fuelling worries of enduring, self-reinforcing inflationary risks.

Two-Part "Kokomo" Effect	Drivers
Part 1: "*get there fast*" - Fed to **end QE in Q1-2022** | **At least 2 hikes in 2022** | Starting mid-2022 - BoE to hike ~3 times in 2022	1) **Exceptionally accommodative settings** 2) Inflation **sticker shock** 3) Surge in **Energy Prices** (stagflation worries) 4) **Conspiracy of other cost-push** factors 5) **Sticky Inflation** till mid-/late-2022 6) **Sustained**, if not strong, growth **recovery**
Part 2: "*then … take it slow*" - Fed to not rush QT | pace of hikes to decline by mid-2023 - BoE to slow the pace of hikes by mid-2023	**1) Cost Push factors to subside** into late-2022; albeit unevenly **2) Oil** turns dramatically **dis-inflationary** **3) China** to resume absorbing global inflationary pressures 4) Post-COVID **reversion to services consumption** (even if with a lag) to ease supply-chain/shipping kinks **5) Fiscal fade** from COVID largesse **6) Labour supply catch-up** on lagged re-entry of workers (enhanced by border re-opening)

Especially as the **conspiracy of cost-push and demand-revival factors obfuscate just how persistent and profound inflationary pressures may end up**. Hence, **growing inflation risks amid de-sensitized policy response underscores need to** "*get there fast*". Although, "*then take it slow*" checks over-tightening risks as wage-price spirals are arrested; allowing for cost-push driver o fade off alongside COVID distortions.

Curbing Affronts to Policy Credibility: Consequently, restraint premised on "transitory" cost-push amid nascent recovery must concede to **growing risks of inflation expectations becoming unhinged**. Worryingly, the **real danger may be to the credibility of central banks**.

In turn, this requires some urgency of policy response, even if there is genuine belief of fading price pressures in the longer horizon. Inevitably, **policy makers need to,** "*get there fast*" **in spite of "variant risks"** (currently manifesting as "Omicron") and only "*then take it slow*" **once self-fulfilling inflation spiral risks are snapped**; allowing for cost-push to fade.

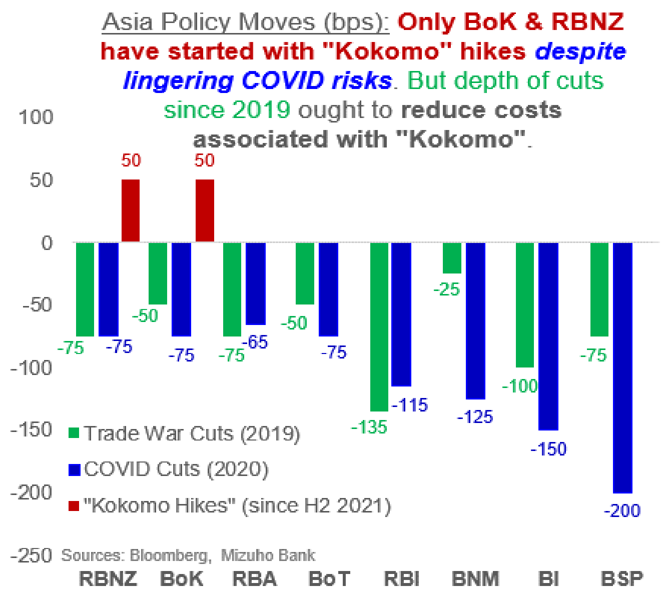
Kokomo Conjecture: The How

To be fair, between tolerating some inflation as a by-product of recovery and repudiating worrying dimensions of inflationary risks, policy makers are caught between a rock and a hard place. Precisely why **"Kokomo", done right, will help engineer a policy transition that both anchors inflation expectations** (with rapid and decisive early "exit") **and insures recovery** (by refraining from pre-ordained, overdone tightening cycles; especially as inflation fades further out, once wage-price spiral risks are snapped).

The idea being, **"Kokomo" helps avert an inadvertent lurch from over-confidence** (about "transitory)" **to over-reactions** (to exaggerated inflation fear-mongering); thereby mitigating policy mistake risks with an optimal, "low-cost" approach of **early policy response to inflation upside surprise**.

Kokomo Conjecture: The Who

In Asia, the notable **early-adopter "Kokomo" central banks are** the **BoK** (having hiked twice in 25bps increments, first in August then again in November, to 1.00%), the **MAS** (restoring a calibrated appreciation bias for the S$NEER policy October) and the **RBNZ** (hiking twice in 25bps increments in August and November; to 0.75%).



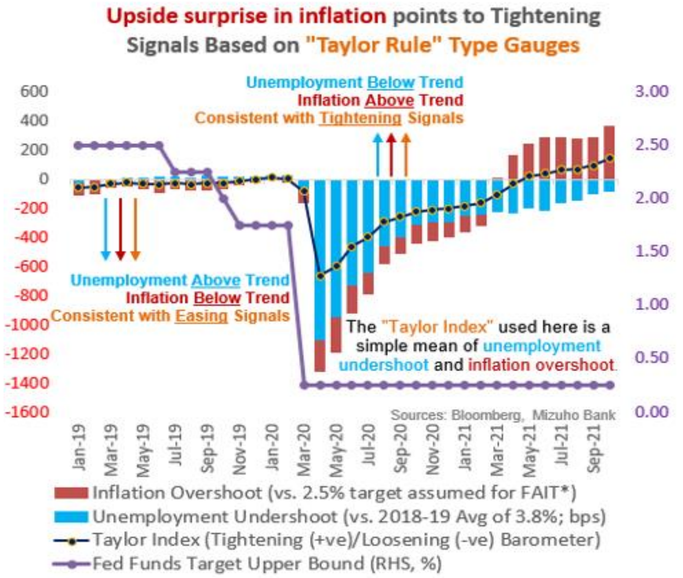
The **common thread** running through is the **caveat that the "calibrations" do not entail hiking cycles**. The BoK is careful *to qualify calibrations to align with economic conditions as is the MAS.* So the **message of** "*and then … take it slow*", especially **contingent on fluid economic risks** is expressly alluded to. As for the RBNZ, despite the aggressive start to "exit" policy accommodation, it has hinted that a cooling property market could be reason to slow the pace of tightening as well.

The upshot being, not only do central banks **have the cushion of exceptionally accommodative setting** (at record low rates) to work up cautiously from, but *may remain highly state-dependent in adopting* the *"Kokomo"* approach. (See Appendix for policy Outlook)

Amongst the G4, the **BoE and Fed are leading the way in getting ready to belt out "Kokomo"**. But not all G4 central banks have signed up for "Kokomo". Interestingly, and in a parallel to the RBA-RBNZ contrast, the ECB has pushed back on urgency near-term policy normalization despite appreciable upside surprise in inflation. In doing so, the ECB points to lingering COVID risks to growth that come unfortunately come bundled with transitory COVID-induced price pressures. So the **ECB will necessarily lag the "Kokomo Fed"**. Regardless, the **title of the most steadfastly dovish central bank** – that for good reasons *cannot appreciate "Kokomo", and hence will not dance to that tune* – **unambiguously belongs to the BoJ**.

The "Kokomo Fed" …

"Kokomo" is a Necessary Reset for the Fed: With the onslaught of upside surprises to US inflation (that hit a 30-year high for October, and still upwardly biased), coupled with broadening price pressures, the **Fed has been caught out overly-dovish** on its pronouncements of "transitory" inflation. This is a threat to, if not **to the detriment of, the Fed's policy credibility**. And adopting the **"Kokomo"** approach is the Fed's **best shot at reclaiming credibility**, ***without snuffing out the recovery***.

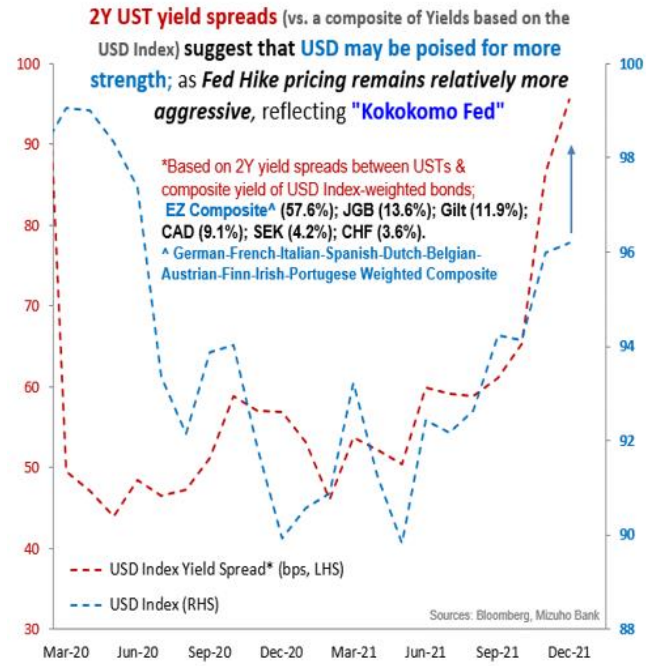


Faster Taper & Rate Hikes for 2022: Accordingly, in deference to inflation dynamics and policy credibility calculus in the US, we have now shifted up our **first Fed rate hike to mid-2022**, with **at least one more hike later in H2**; with a cumulative 100-125bps of hikes by end-2023.

And setting the stage for this will be **hastened "taper" so that QE is wound down by late-Q1/early-Q2 2022**; such that there may be a **distinct break between end of taper and the first hike to de-couple** the latter from the former so as to temper overly-hawkish interpretations.

"First Mover" Effect: The point worth noting though is that while "Kokomo" policy approach may be gaining broad appeal, **a "Kokomo Fed", by virtue of its relative "fist mover"** position that is amplified by its economic/financial heft, **inadvertently ends up being the benchmark for laggards and catch-up** amongst other global central banks. This ***sets the stage for Fed policy divergence to dominate the policy and market narrative***.

… Making Landfall as "Kokomo Dollar"?



Consequently, the **Fed policy divergence theme asserted by** the **"Kokomo Fed"**, via **significant sway on interest rates/yields**, will **result in the "Kokomo USD"** setting the main backdrop for currency markets. To be clear, the "Kokomo USD" is ***not to be mistaken for a bullish USD***.

Instead, the "Kokomo USD" in its true form will evolve roughly in tandem with the two phases of "Kokomo". The earlier "*get there fast*" phase will mostly **correspond to USD strength**. As a corollary, **transition to** "*and then … take it slow*" could result in **a mellower, *albeit not collapsing*, USD**. Moves will be nuanced by Fed policy convergence and other factors leading to policy shocks.

The "*get there fast*" phase: Specifically, in the initial stage (mostly *H1 2022*) of **the "Kokomo Fed"**, where markets are actively pricing in more hawkish outcomes, **UST yields (led by the front-end)** are not only likely to be **upwardly biased**, but set to outpace; resulting in **widening UST spreads**. As a result of which, the **bias may be for a stronger USD supported by interest rate differentials in favour of demand for the Greenback**.

The "*and then … take it slow*" phase: Whereas, transition to the "*take it slow*" phase (*H2 2022*) may align with policy convergence. Which in turn could **at least partly reverse earlier USD strength**; **in tandem with erosion from wider yield spreads** from earlier. And relative equilibrium rates amongst other factors could determine currency catch-up trades against the USD (See Appendix for forecasts).

Borrowing illumination from the famous Quantum Physicist Niels Bohr, it appears that "**Kokomo" is an expression of *what we can say about policy risks***; and **not necessarily how policy risks stack up and will play out in reality**.

Appendix 1. Central Bank Outlook: Accounting or the "Kokomo" Effect

Country	Central Bank	2020 Q1	2020 Q2	2020 Q3	2020 Q4	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2
US	Fed	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.25-0.50%	0.50-0.75%	0.75-1.00%	1.00-1.25%	1.00-1.25%
Australia	RBA	0.25%	0.25%	0.25%	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%	3.85%	3.85%	3.85%	3.85%	3.85%	3.85%	3.85%	3.85%	3.85%
India	RBI	4.40%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	4.25%	4.50%	4.75%	4.75%	4.75%	4.75%
Indonesia	BI^	4.50%	4.00%	4.00%	3.75%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.75%	4.00%	4.25%	4.50%
Malaysia	BNM	2.50%	2.00%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	1.75%	2.00%	2.25%	2.50%	2.50%	2.50%
Philippines	BSP	3.25%	2.50%	2.25%	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		Status Quo		Restore a "Slight" S$NEER Slope (0.5% per annum)		"Slight" Increase S$NEER Slope (1.0% per annum)		Maintain S$NEER Slope (1.0% per annum)		"Slight" Increase S$NEER Slope (1.5% per annum)	
Korea	BoK	0.75%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.50%	1.50%	1.50%	1.50%
Thailand	BoT	0.75%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.00%	1.00%
Vietnam	SBV	5.00%	4.50%	4.50%	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

Appendix 2. EM Asia FX Forecasts: A View of the "Kokomo USD"

FX: "Kokomo USD" – Accentuated Strength Near-Term?

FX Forecasts	Dec 21	Mar 22	Jun 22	Sep 22	Dec 22	Mar 23
USD/CNY	6.22 - 6.67 (6.48)	6.35 - 6.80 (6.60)	6.39 - 6.89 (6.55)	6.20 - 6.65 (6.40)	6.13 - 6.58 (6.33)	6.18 - 6.55 (6.38)
USD/INR	73.1 - 78.1 (75.8)	73.3 - 79.0 (76.5)	73.5 - 78.3 (76.0)	71.4 - 77.2 (74.8)	70.9 - 76.6 (74.2)	69.7 - 76.0 (73.0)
USD/KRW	1160 - 1250 (1200)	1170 - 1300 (1250)	1200 - 1310 (1250)	1150 - 1250 (1200)	1100 - 1210 (1150)	1080 - 1170 (1120)
USD/SGD	1.33 - 1.40 (1.37)	1.35 - 1.42 (1.38)	1.33 - 1.44 (1.37)	1.31 - 1.40 (1.35)	1.29 - 1.38 (1.33)	1.29 - 1.37 (1.33)
USD/IDR	13840 - 14920 (14200)	14120 - 15290 (14550)	14310 - 15620 (14750)	13940 - 15140 (14400)	13790 - 14990 (14250)	13650 - 14960 (14100)
USD/MYR	3.96 - 4.40 (4.21)	4.07 - 4.45 (4.23)	3.97 - 4.36 (4.22)	4.00 - 4.33 (4.19)	4.00 - 4.32 (4.17)	3.97 - 4.30 (4.14)
USD/PHP	49.5 - 53.4 (51.2)	49.5 - 53.1 (51.5)	49.4 - 53.2 (51.6)	48.9 - 52.8 (51.2)	48.4 - 52.1 (50.5)	48.0 - 52.2 (50.1)
USD/THB	33.2 - 35.3 (33.9)	32.8 - 35.5 (34.0)	32.0 - 35.0 (33.8)	31.1 - 34.1 (33.0)	31.1 - 33.3 (32.0)	30.7 - 32.9 (31.6)
USD/VND	22500 - 23200 (22800)	22700 - 23200 (23000)	22700 - 23400 (23000)	22600 - 23200 (22700)	22500 - 22900 (22600)	22400 - 23000 (22650)
AUD/USD	0.673 - 0.756 (0.710)	0.667 - 0.757 (0.700)	0.661 - 0.745 (0.713)	0.697 - 0.777 (0.735)	0.727 - 0.801 (0.765)	0.757 - 0.827 (0.788)

USD's "Kokomo" Outcomes

- First, **higher yields** across the curve sooner as taper (lifts the belly) and inflation targeting gets to the 10Y; with the 2Y lifted by rate hike view.

- **Resultant bear flattener in 5-30Y** (from taper) and **2-10Y** from rate hikes underpin a stronger USD. Especially as Fed-ECB divergence in set to widen in early-2022. In turn **a more dominant USD may be expected in H1 2022** at least … building up with rate hike drumbeats.

- But second, **in H2 2022**, as ECB-Fed and RBA-**Fed divergence eases**, **EM Asia FX traction may be aided by USD strength tempered**.

- ***Especially if the CNY gets a boost into Q3 2022*** ahead of the Nov '22 NPC (although CNY NEER at currently rich levels may be consistent with pullback/moderation into Q1/Q2 2022).

- If returning **Chinese tourists helps to broaden and accentuate EM Asia recovery in late-2022** alongside lower inflation (boosting stability), USD may mellow more discernibly in H2.