Mizuho Chart Speak: Fed-EM Asia

Economics & Strategy | Asia ex-Japan

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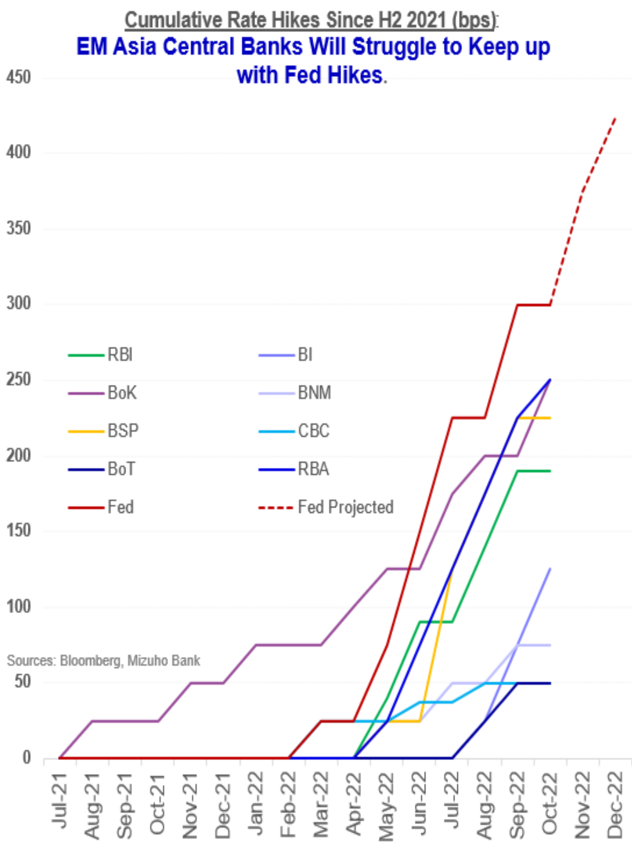
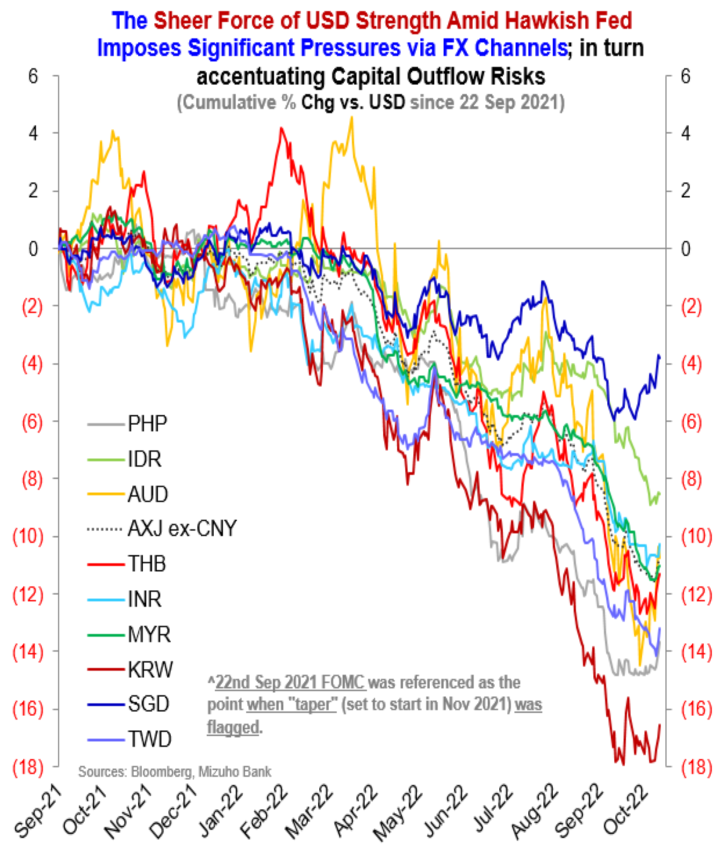
Central Bank Risks: Of Canaries & Collateral Damage





"If no mistake you have made, losing you are. A different game you should play."

- Master Yoda, Star Wars

In a Nutshell: **With gathering global headwinds** in the horizon, the **job of tackling inflation risks becomes a more precarious endeavour** with each passing day; especially considering policy lags. The **delicate policy balance is alluded to by the MAS** alluding to downturn risks heightened by "persistently high inflation" and "tighter financial conditions" from synchronized global policy tightening in response to inflation.

But a **gradual glide path to neutral policy stance for EM Asia central banks is challenged by growing macro-stability risks posed by brutal Fed rate hikes and unrelenting, record USD strength**; which conspire to accentuate the policy conundrum faced by EM Asia central banks.

The dire assessment is that **inescapable collateral damage from uncompromising Fed hawks and unremitting USD strength** Further rate hikes may be all but non-negotiable. Nonetheless, rather than pursuing the futility (if not fatality) of rate hikes to match the Fed and/or draw a line under currency depreciation, EM Asia central banks ought to employ a combination of tools.

Augmenting rate hikes with liquidity measures, judiciously *leaning against excessive currency weakness* and leaving open the *option of light-touch, temporary capital outflow containment* may be **necessary to mitigate the worst of fallout from Fed hawks.** As Master Yoda counsels, *changing the game (or at least playing it* *differently)* may be a necessity *to salvage a dire situation imposed by Fed and USD externalities.*

MAS Caution a Canary?

The **surprise with the MAS was not overtly aggressive tightening** (step appreciation), **but accompanying underlying restraint** (absence of simultaneous S$NEER slope steepening). **Especially given allusions to persistent, upside inflation risks**; involving "*elevated*" core inflation, "*significant*" imported inflation, and "*upside risks … from fresh (price) shocks … and second-round effects*". Question is, **whether MAS' cautious restraint is the canary in the (EM Asia central bank) coal mine**.

Amid Growing Concerns of Global Recession Fears

Likely so. At least insofar that **restraint concedes coincident and conflicting recession risks amid gathering global headwinds**; as "*persistently high inflation and tighter financial conditions … from globally synchronized (monetary policy) tightening … intensify … drag*". That's to say, **global recession risks not just *despite*, but *because, of* inflation**. Moreover, **stagflation-type risk feature** should "*further (geo-political) shocks … drive inflation higher and cause … recessions in some key economies*".

Sharpening Trade-Off Amid Uncertainty …

The upshot is that **MAS restraint merely reflects the reality of sharpening growth-inflation trade-offs amongst EM Asia central banks for monetary policy**. **But** the **ability to achieve the right policy balance is fraught by significant uncertainty**; around both unrelenting inflation and gathering global headwinds. And policy lags involved lay bare the risks of policy mis-step coming home to roost.

… & an Impossibly Narrow Path to a Soft Landing

Consequently, the ability to achieve a soft landing is challenged by **turbulence from gathering global growth headwinds coinciding with global price shocks**. All of which **leave EM Asia central banks faced with an impossibly narrow path to avoid lurching one way or another**; into an **inflation spiral inflation** from insufficient tightening on one hand **and over-tightening into a hard-landing** on the other.

Aggravated by Fed-Induced Macro Stability Risks

Most worryingly, **macro-stability risks associated with under-tightening vis-à-vis a hawkish,** *"higher for longer"*, **Fed aggravate the dangers of policy mistakes**. To be sure, despite being on the cusp of slowing the pace of hikes, the Fed's pace and extent of hikes outrun most, if not all, EM Asia central banks. Consequently, **EM Asia rate hike** (relative) **laggards are confronted by *potentially de-stabilizing adverse feedback loops*** between *sharp currency depreciation*, amplified *imported inflation*, and *capital outflows*.

Inescapable Collateral Damage …

The upshot is **aggravated risks of de-stabilizing capital outflows/macro-stability risks** on one side and **hard-landing risks from self-inflicted policy tightening** on the other are **inescapable collateral damage from unprecedented speed and brutality of Fed tightening**.

… & Inconvenient USD (Bull)

And unfortunately, an aggressively **bullish USD intensifies inconvenient policy dilemma** for EM Asia central banks; as **sweeping USD strength** of *unprecedented speed* and *magnitude** inevitably **exacerbate Fed policy-induced macro-stability risk** and **amplify ripples from constriction in global financial conditions** inflicted by the Fed's brutal tightening.

Compromised Containment

Admittedly, **policy options are constrained**; and in any case **compromised**. *But* EM Asia central banks are **not entirely at the mercy of global/Fed policy impact either**. Instead, proactive and nimble use of a combination of policy tools **may** help **contain collateral damage**. While not exhaustive, there are three main channels through which EM Asia central banks can actively manage Fed risks. This is by;

1) Augmenting *the almost non-negotiable need for further rate hike with liquidity measures* rather than needlessly trying to match the Fed in terms of the total quantum of hikes (although inflation will determine how high policy rates will have to go for specific economies);

2) Judiciously *defending against excessively rapid currency depreciation/speculative bets*, but without succumbing to self-defeating reflex of burning reserves to blindly defend exchange rate levels;

3) Retaining the option of *limited iterations of capital controls* with narrow applications/windows.

Compromised Containment

The big picture is that **a combination of liquidity, rates and exchange rate tools** with the *option of light-touch measures to lean against capital flight risks* **underpinned by overall policy credibility** are the best response to brutal Fed policy tightening amid unrelenting, record USD strength. A **dial-back in Fed policy rate is an externality that will also be greatly welcome**. But until then, EM Asia central banks will have to best manage in exceptionally challenging macroeconomic conditions.

Compromised Containment

The upshot is that while the Fed's policy and USD strength may not be the fault (mistakes) of EM Asia central banks, they are inherited policy challenges that cannot be skirted. **Recognizing that most EM Asia central banks cannot beat the Fed at its game is a start.** But to extend *Master Yoda's wisdom on changing an invariably disadvantageous game,* **EM Asia central banks must at the very least change how the game is played given the losing proposition imposed by "higher for longer" Fed and USD**.

*Please see Mizuho Chart Speak - Exceptional USD Strength & Endogenous Risks, 20th Oct 2022

Central Bank Policy Outlook

Country	Central Bank	2021				2022				2023			
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US	Fed	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.25-0.50%	1.50-1.75%	3.00-3.25%	4.25-4.50%	4.50-4.75%	4.75-5.00%	4.75-5.00%	4.50-4.75%
Australia	RBA	0.10%	0.10%	0.10%	0.10%	0.10%	0.85%	2.35%	3.10%	3.35%	3.35%	3.35%	3.35%
China	PBoC	3.85%	3.85%	3.85%	3.80%	3.70%	3.70%	3.65%	3.50%	3.50%	3.50%	3.50%	3.50%
India	RBI	4.00%	4.00%	4.00%	4.00%	4.00%	4.90%	5.90%	6.25%	6.50%	6.50%	6.50%	6.50%
Indonesia	BI^	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	4.25%	5.00%	5.25%	5.25%	5.25%	5.25%
Malaysia	BNM	1.75%	1.75%	1.75%	1.75%	1.75%	2.00%	2.50%	3.00%	3.00%	3.00%	3.00%	3.00%
Philippines	BSP	2.00%	2.00%	2.00%	2.00%	2.00%	2.50%	4.25%	5.00%	5.25%	5.25%	5.25%	5.25%
Singapore	MAS*	Status Quo		Restore a "Slight" S$NEER Slope (0.5% per annum)		Unscheduled "Steeper" Slope to 1.25% p.a.	Re-center Mid-Pt Higher & "Slightly" Increase S$NEER Slope (2.0% p.a.)	Off-Cycle Re-centring Higher to Prevailing S$NEER	Re-centring Higher to Prevailing S$NEER (Maintain Slope 2.0% p.a.)	Maintain S$NEER Slope (~2.0% per annum)		Maintain S$NEER Slope (~2.0% per annum)	
Korea	BoK	0.50%	0.50%	0.75%	1.00%	1.25%	1.75%	2.50%	3.25%	3.25%	3.25%	3.25%	3.25%
Thailand	BoT	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	1.00%	1.25%	1.75%	1.75%	1.75%	1.75%
Vietnam	SBV	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%	5.00%	6.50%	6.50%	6.50%	6.00%	5.00%

* 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