International Commentary — July 20, 2022

Asian Central Banks Coming Up the Curve

Summary

Over the course of this year, emerging Asian central banks have lagged the overall monetary policy tightening trend. Regional central banks have taken a more gradual approach to lifting interest rates relative to the Fed, but especially as it relates to peer central banks in the developing world. With that said, regional Asian central banks are shifting in a more hawkish direction, and we expect Bank Indonesia and Bank of Thailand to come off the sidelines and initiate tightening cycles in the near future. However, despite a more hawkish stance on monetary policy, we doubt central banks can keep pace with the Fed, and we continue to forecast weaker currencies across emerging Asia through the remainder of this year.

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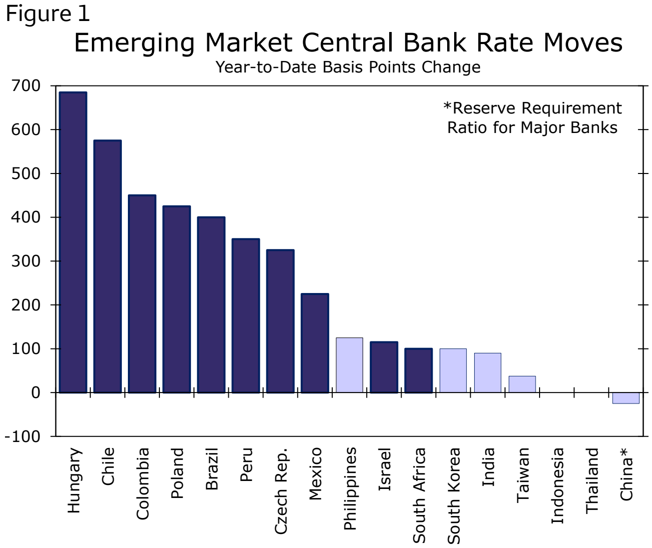
Emerging Asian Central Banks Have Lagged, but Are Turning More Hawkish

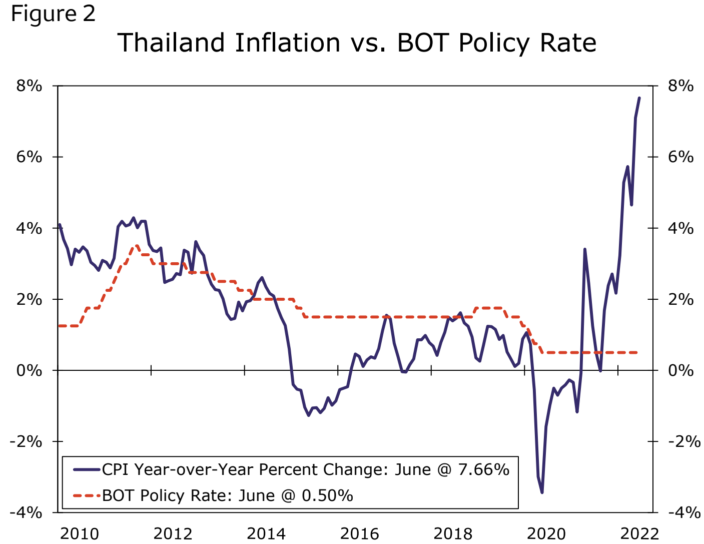
Elevated inflation and central bank tightening have been major themes percolating across global financial markets this year. Above-target inflation has pushed most central banks across the G10 and emerging markets to lift policy rates purely in an effort to contain price pressures. With the exception of the Bank of Japan, and at the time of this publication the European Central Bank, all G10 central banks have raised interest rates, while policy rates across Latin America and EMEA have come up sharply over the past seven months. However, on balance, emerging Asia has been one of the regions that has lagged the overall tightening trend. We say "on balance," as there have been select regional central banks that have responded to high inflation and tightened monetary policy. The Central Bank of the Philippines (BSP) has tightened policy 125 bps, including an emergency 75 bps rate hike this July, while Bank of Korea policymakers have lifted the official bank rate a cumulative 100 bps this year. The Reserve Bank of India (RBI) has lifted the repurchase rate 90 bps through mid-July, and the Central Bank of the Republic of China (Taiwan) has raised policy rates 37.5 bps over the course of 2022. And while it does not adjust monetary policy through interest rates, the Monetary Authority of Singapore (MAS) has tightened policy through strengthening the Singapore dollar real effective exchange rate multiple times. Relative to Latin American central banks, such as Chile, Colombia, Brazil and Mexico, Asian central bank tightening has lagged significantly. The same can be said when comparing tightening in Asia to EMEA institutions in Hungary, Poland, and the Czech Republic (Figure 1).

Figure 1



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Bank Indonesia and Bank of Thailand Headed Toward Rate Hikes

While emerging Asian central banks have been more gradual in their approach to tightening monetary policy, just within Asia there have been multiple central banks that have pushed back on the tightening trend. In that sense, Bank Indonesia (BI) and Bank of Thailand (BOT) have opted to not raise policy interest rates this year, or make any significant adjustments to monetary policy settings. In the case of Indonesia, inflation has remained relatively subdued despite significant upward price pressures globally. The June CPI rose 4.35% year-over-year, only slightly above Bank Indonesia's upper bound of its target inflation range of 3% +/- 1%, while the core CPI rose only 2.63%. We can attribute the subdued rise in local inflation to government subsidies designed to keep price growth in check. Those subsidies appear to be working to keep inflationary pressures contained; however, we would note government-led subsidies are not a sustainable inflation solution, especially when considering the fiscal and debt implications. With inflation contained for the time being and the rupiah experiencing only modest downside this year, **we believe BI has rationale to keep policy rates on hold at 3.50% at its upcoming July meeting**. With that said, we believe BI policymakers will make a hawkish shift in their monetary policy stance at the July meeting. In June, policymakers exhibited modest caution on rising inflation expectations, and with CPI now above the upper bound of the central bank's target range, those inflation concerns could intensify. Also, BI recently started selling debt off its balance sheet to reduce excess liquidity in Indonesia's financial system. While shrinking BI's balance sheet has been gradual to this point, we believe selling bonds is a precursor to BI lifting policy rates in the near future. The combination of above-target CPI and balance sheet reduction leads us to believe that **BI will initiate its tightening cycle in August with a 25 bps hike to its seven-day repurchase rate**. Further out, we expect BI to continue raising interest rates. However, with local inflation still relatively subdued and growth prospects potentially slowing, we expect BI's tightening cycle to be slow and short-lived.

As far as the Bank of Thailand, BOT policymakers have opted to prioritize support for the local economy rather than focus on containing inflation; however, we believe BOT policymakers will indeed shift toward inflation control at its upcoming meeting in early August. As of June, CPI inflation hit 7.7% year-over-year, one of the highest rates of inflation since the Global Financial Crisis and the Asian Financial Crisis of the late 1990s. Elevated inflation has pushed real interest rates in Thailand deep into negative territory (Figure 2). These negative real interest rates have weighed on the Thai baht recently, with the currency underperforming relative to peer emerging Asian currencies and recently weakening to levels last seen in 2015. Also, while Thailand maintains a current account surplus, that surplus has narrowed as oil and other commodity prices remain elevated. A less positive current account surplus, combined with negative real interest rates, should act as a stronger source of potential baht depreciation than the currency has historically been exposed to. With underlying fundamentals in Thailand arguably not as strong as they have typically been, the risk of a sharp depreciation in the Thai baht is building unless BOT policymakers take action in the near future. In that sense, **we believe BOT policymakers will take a more prudent stance on interest rates and avoid an outsized baht depreciation by lifting the benchmark interest rate 50 bps to 1.00% at their August meeting**. In the August statement, we believe the BOT will communicate policymakers are now focused on inflation and the tightening cycle will continue going forward. In that sense, we look for a steady series of 50 bps increases, eventually taking Thai policy rates up to 2.00% by the end of 2022.

In addition to BI and BOT, we expect most central banks in Asia to keep raising policy rates as inflation remains elevated. As far as other institutions, we believe the RBI will lift policy rates a cumulative 150 additional basis points over the remainder of this year, eventually taking the repurchase rate to 6.40% by the end of this year. In addition, policymakers in the Philippines and Korea should continue to tighten monetary policy. And in China, while we do not expect the People's Bank of China (PBoC) to lift interest rates, we believe the need for easier monetary policy is no longer present, and we believe PBoC officials will keep Reserve Requirement Ratios and lending rates steady for the next few quarters. Even though we expect emerging Asian central banks to tighten monetary policy more aggressively, or in China's case stop easing policy, we believe regional central banks will not be able to keep pace with the Federal Reserve. As the Fed lifts interest rates sharply through the end of 2022 and keeps shrinking its balance sheet, we believe the U.S. dollar will be broadly supported. Emerging Asian currencies could continue to trend weaker through the end of this year, with select currencies such as the Indian rupee likely to keep reaching all-time lows against the dollar. However, currencies with stronger fundamentals and sound politics should be more supported. In that sense, we believe the Chinese renminbi and Taiwan dollar should experience the slowest pace of depreciation over the next six months, as each economy maintains a current account surplus, strong policymaking frameworks and adequate FX intervention resources to stabilize their respective currencies if need be.

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