Easing cycle underway

An Asian central bank policy outlook

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Key points

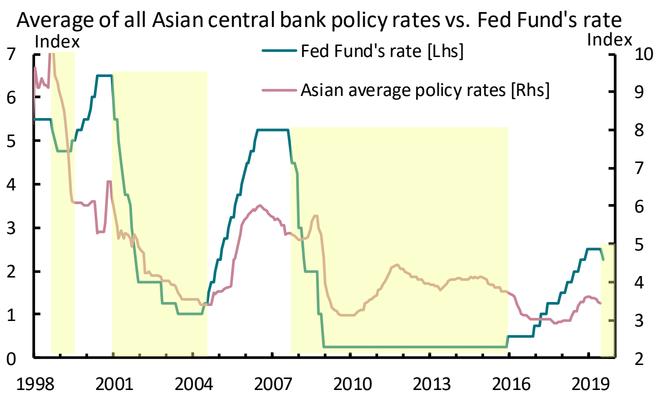
- Historically there has been a general co-movement between Asian central banks and the US Federal Reserve (Fed), albeit that there is heterogeneity between banks' reaction functions.
- Past episodes suggest the magnitude and duration of the easing cycles for Asian central banks are somewhat different to those of the Fed.
- The Philippines and Taiwan tend to be the most aggressive in terms of easing policy, while Thailand seemed to be the least reactive. We consider different reactions to be dependent on associated currency moves.
- Apart from the Fed's trigger, we expect rising growth concerns, declining export growth, low inflationary pressure and stable domestic currencies to play a part in the region's dovish stance.
- Going forward, we expect Asian central banks to continue to cut rates with a few exceptions – Bank Negara Malaysia and State Bank of Vietnam.

Partial co-movement between Fed and Asian central banks

There have been three easing cycles in the past 20 years: 1998-99 during the Asian financial crisis, Russian debt default and the collapse of Long-Term Capital Management (LTCM); 2000-04, in reaction to the bursting of the dot-com bubble and the 9/11 terrorist attacks; and 2007-15, in response to the global financial crisis. We measure the policy cycle for Asia as the average policy rate changes of major central banks, including those of Indonesia, India, Korea, Malaysia, the Philippines, Thailand and Taiwan. China is excluded, as its policy cycle has been relatively independent to the Fed, in part reflecting its closed capital account. We examine monetary easing as conventional policy rate cuts, while those involving balance sheet policies and easing via exchange rates are excluded.

Exhibit 1 shows how policy rates have evolved in the US and Asia over the past two decades.

Exhibit 1: Asia in general move in tandem with the Fed



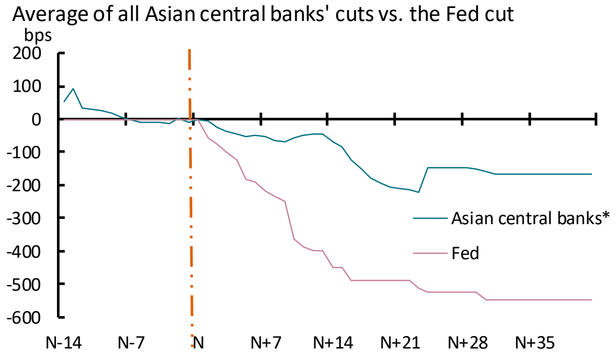
Source: Bloomberg, CEIC and AXA IM Research (August 2019)

First, there is a high degree of policy synchronisation between Asia and the US, with a historic correlation of 0.76. **Second**, the average policy rate in Asia was lowered in all three easing cycles of the Fed, reinforcing the policy co-movements in down cycles. **Third**, the timing and magnitude of policy easing varied in different cycles – Asian banks cut rates earlier and more aggressively than the Fed during the Asian Financial Crisis (AFC), given the local nature of this shock. They did not enact as much easing in the other two episodes, given their less Asia-centric nature.

Exhibit 2 illustrates the average easing cycles of the Fed and Asian central banks. Despite having eased more aggressively during the crisis, the average rate reduction for Asia of all three episodes was less than half that of the Fed, at 222 basis points (bps) vrsus 550bps. Considering that the Fed has also engaged in quantitative easing since 2009, the differences in the scale of policy easing have historically been higher in the US.

Exhibit 2: Asian central banks cut less than the Fed

Average of all Asian central banks' cuts vs. the Fed cut

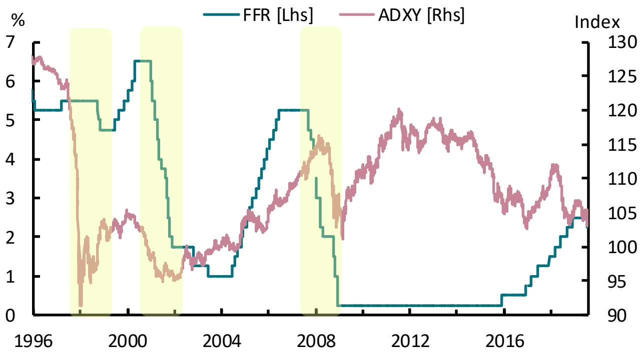


*Note: *average of IN, MA, PH, KR, TW, TH, ID over three episodes (98, 01 and 07)*
Source: Bloomberg, CEIC and AXA IM Research (August 2019)

One of the reasons for Asia's more conservative behaviour is associated with movements in the currency. Exhibit 3 shows that Asian currencies depreciated against the dollar during the US easing cycles. This somewhat counterintuitive performance likely reflects the significant risk aversion associated with each episode, which tends to benefit the US dollar as a safe-haven currency.

Exhibit 3: FX tend to depreciate during easing cycles

Fed Fund's Rate and Asian dollar index



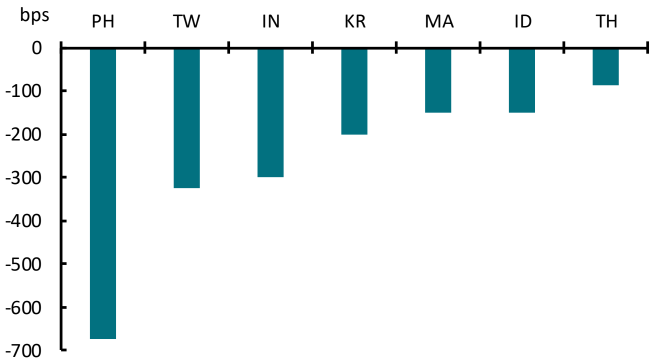
Source: Bloomberg, CEIC and AXA IM Research (August 2019)

In such an environment, monetary policy in emerging markets tends to be constrained by fears of large currency (FX) depreciation – causing external debt financing pressure and capital flight, resulting in liquidity crunches and collapse of markets. The need to maintain financial stability often requires Asian and other emerging market central banks to keep an interest rate buffer vis-à-vis the US, and hence, tempers the central banks' monetary policy responses.

Exhibit 4 illustrates the relative sensitivity of individual Asian central banks to the Fed. On average, the Philippines was the most reactive to the Fed particularly after 1997 and 2001, cutting rates by almost 700bps. Taiwan and India eased by around 300bps, with the former moving in almost lockstep with the US. Korea also follows the Fed closely in easing cycles, reflecting its more open economy and sensitivity to global trade. Thailand's average number was dragged down by the Bank of Thailand's policy tightening post 9/11 to prevent currency declines and capital flights.

Exhibit 4: Some central banks are more responsive

Average of total Asian central bank cuts during past 3 episodes



Source: Bloomberg, CEIC and AXA IM Research (August 2019)

This confirms a high degree of policy synchronisation between Asia and the US – a well-documented relationship that is driven by economic (trade and investment) and financial (currency and capital flow) linkages. With the Fed embarking on a new round of policy easing, the door is open for Asian central banks to ramp up monetary support for their struggling economies. In addition to the Fed influence, we see four local factors propelling further monetary easing in Asia:

– **First, there are rising growth concerns**, with second quarter GDP surprising mostly to the downside and the Purchasing Managers' Indices showing no imminent recovery in sight.
– **Second, further escalation of the Sino-US trade war will weigh on Asia**. Our recent research shows that most Asian economies (apart from Vietnam) have suffered from the negative spill-over effect of the trade conflict. Moreover, our in-house model[1] suggests that the outlook for Asia's exports remains gloomy amid weak global demand. With Asia likely to be the most impacted by the fall-out of the

[1] Shen, S. and Yao, A., "Tracking Asian exports" AXA IM Research, 17 April 2019

Sino-US trade war, the Asian financial crisis might prove the better historical benchmark for future policy action.

- **Third, inflation pressure has fallen below central bank targets,** despite a recent uptick in food prices, which we don't expect to last.
- **Finally, Asian currencies have been relatively steady this year**, posing little concern for local central banks to follow the Fed to cut rates. In turn, this reflects the absence of a significant period of risk aversion in the current episode.

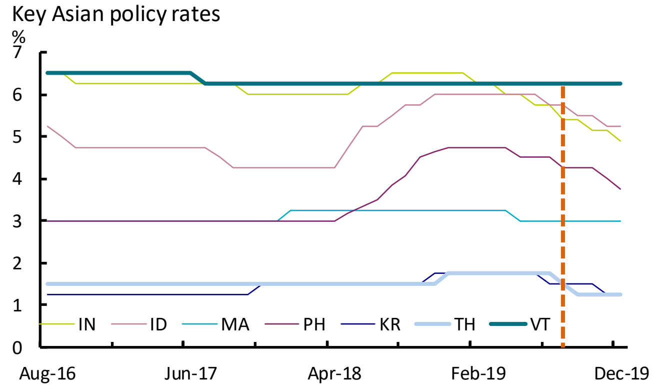
Asian central bank outlook

For India, in particular, weakening growth is taking precedence in the Reserve Bank of India's policy calls as the Consumer Price Index remains within the lower range of the target. In fact, the interim budget clearly hinted at the burning growth issue as the proposed measures specifically target long-term development. These include increased infrastructure spending, opening up of foreign direct investment, and higher tax for the wealthy while tax is being lowered for corporates. Although these measures aim to counter the growth slowdown over the medium and long term, they are unlikely to provide a short-term boost. Going forward, we expect another 50bps of rate cuts by the Reserve Bank of India for the rest of the year.

Elsewhere, Bank Indonesia and the Bangko Sentral ng Pilipinas see room for further monetary easing owing to low inflation and growth headwinds. We pencil in another 50bps of cuts over the next five months. In addition, for the export-dependent economies such as Singapore, South Korea and Thailand, a rapid downturn in trade has caught these economies off-guard. With the central banks already lowering growth targets for 2019, we look for another 25bps cut each by Bank of Korea and Bank of Thailand. Likewise, the Monetary Authority of Singapore will most likely unwind last year's hike back to a neutral stance in its October policy meeting.

Malaysia and Vietnam have been suffering from ultra-low inflation over the past year which has pushed up real interest rates. Therefore, instead of demand pressures, which will most likely remain muted amid a challenging growth backdrop, inflation is likely to rise due to low base effects. For now, we forecast no actions from Bank Negara Malaysia or State Bank of Vietnam in the second half of 2019. However, given the global economic downturn and unsolved trade issues, further deterioration may become likely and would thus elicit a monetary policy response.

Exhibit 5: Asian central banks to remain dovish



Source: Bloomberg, CEIC and AXA IM R&IS calculations

Country codes used in the text: ID: Indonesia; IN: India; KR: South Korea; MA: Malaysia; PH: Philippines; TH: Thailand; TW: Taiwan; VT: Vietnam;

Our Research is available on line:

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