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Global Spotlight

Asian central banks operating on a wing and a prayer?

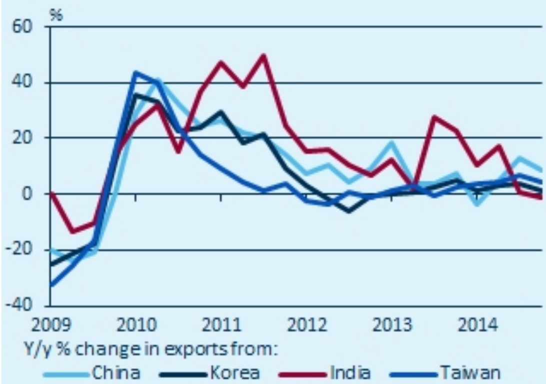
Flocking behaviour among birds has remained a rather puzzling phenomenon for researchers. While relatively common, it remains difficult to explain apparently simultaneous actions without the existence of some synchronising force. This has certainly been the case following the spate of policy easing across much of Asia in recent months. In total, six central banks have eased policy. So is this some form of collective consciousness or is there a more tangible trigger that has sparked the easing bent?

The most obvious common denominator behind central bank thinking is the collapse in oil prices over the last six months. This has resulted in a steep decline in headline inflation pressures in the region. Although most textbooks would suggest that policymakers should ignore such temporary price shocks, as prices are almost certain to rebound in 12 months due to base effects, there is plenty of evidence that oil trends have been influencing decision making. The Bank of Japan linked weaker oil price pressures to a possible delay in the conversion of the deflationary mindset when announcing a further expansion of its QQE programme last October. In India, the Reserve Bank of India cited falling oil prices as providing the headroom for a shift in monetary policy stance as it cut its key policy rate in mid-January. Elsewhere, references to oil have popped up in numerous monetary policy statements from the Monetary Authority of Singapore to the Reserve Bank of Australia (RBA). These announcements were all accompanied by significant policy easing. For seasoned Asian bank watchers this may be no surprise; the reaction function of the region's policymakers indicates a poor record for distinguishing between core and headline inflation pressures. However, it would be wrong to assume the story stops at oil. The decline in oil prices has been atypical in itself in that it has occurred without a significant slowdown in growth or correction in asset prices. So, is there another more pervasive cause that is pushing central banks down the easing path?

An alternative view is that oil explains only part of the recent fall in inflation and that disinflationary pressures may be a result of a more persistent shortage of global aggregate demand. Such an explanation raises a far more complex set of issues. While it would be consistent with the sustained decline in long term borrowing costs witnessed throughout much of 2014, it is far less compatible with global growth trends. The world economy did disappoint at around 3.3% in 2014, but forecasts for 2015 are more optimistic and if anything are being revised upwards due to the impact of cheaper energy costs. This is why it becomes important to try and decipher how the diverging fortunes of different parts of the world economy may play out. In particular, whether the US economy leads the world closer to trend growth or weaker regions keep global growth far lower than historical averages. While the latter scenario has gained momentum primarily due to the high profile woes in the Eurozone, there has been disappointment from other parts of the global economy too. The IMF estimated a drop in emerging market (EM) growth for 2014 to 4.4%, compared to 4.7% in 2013. That was someway short of the 5.1% growth envisaged 12 months earlier, and suggests growth in this region has started to hit some structural barriers. In this environment, the oil-induced fall in prices, although temporary, may serve to reinforce lower inflation expectations, both in the Eurozone and EMs, and reinforce the weakness in aggregate demand growth.

Such an outcome is not our central view but it is one that is gaining traction. Certainly, there are some worrying signs that may be serving as a warning to Asian central bankers. First, trade dynamics point to a far less healthy overseas demand impulse than would typically be consistent with global growth at the current levels – traditionally, global exports have grown at around twice the pace of global industrial production. Weak Asian exports reflect not only a cyclical downturn in the Eurozone and China but also structural issues such as higher wage costs and lower productivity growth in the region (See Chart 1). This is likely to continue to have knock-on effects since corporates' outlook for exports in Asia typically correlates closely with their willingness to invest. Without some impetus from overseas demand then domestic capex and employment trends are likely to remain lacklustre.

Chart 1: Export impulse weak



Source: Datastream, National sources (as of Q4 2014)

This leads us to the second part of the puzzle for Asian central bankers. Domestic demand trends have proven weaker than expected, with central banks such as the People's Bank of China and RBA appearing to misjudge the strength of the domestic economy. This is partly a result of a failure of rebalancing efforts. In Australia, an uptick in private consumption has failed to compensate for weakness elsewhere, with fixed capital formation from the non-mining sector still insufficient to offset the collapse in investment in the resources sector. In China, the much-vaunted shift away from investment-led growth continues to underwhelm, with the services sector displaying increasingly similar symptoms to the nation's beleaguered manufacturers. But there are other problems too. Many key Asian economies suffer from excessive leverage, with China, Korea, Hong Kong and Singapore all witnessing spiralling debt servicing costs. These problems are likely to be exacerbated by a rise in real interest rates as weaker price pressures bite (See Chart 2).

Chart 2: Real rates on the rise

Source: Datastream, National Sources (as of 31 December 2014)

Given these numerous constraints, it may seem intuitive that central banks are aiming to stimulate growth through lower interest rates. However, this path is not without its perils. The Federal Reserve has been far less convinced by the threat posed by a temporary, oil-induced slowdown in inflationary pressures or by a wider problem of excess global capacity. It continues to talk up the prospect of a rate hike later this year, and possibly as early as June, as it seeks to return policy rates to a more ‘normalised’ state. Based on historical evidence, such a move is likely to result in a reversal of the recent policy easing efforts as it draws capital out emerging markets, puts currencies under pressure against the US dollar, and invariably causes debt servicing capacity to be stretched.

So why are central banks not taking a more cautionary approach? The most obvious reason may be that they are rather more sanguine about the US rate cycle, either because any lift-off in rates is likely to be delayed or that the pace of tightening will be extremely moderate. Given the rapid improvement in the US labour market, such an outcome would have to be premised on the assumption that the Fed eventually buys in to the idea that the problems elsewhere in the global economy are severe enough to present a risk to the medium term fortunes of the US economy, i.e. the US gets reeled back in by sub-trend growth elsewhere. There is certainly evidence that excess capacity extends far beyond the resources sector, while poor wage growth and high debt are certain to continue to weigh on growth. However, there is also much to lose from a further Fed delay, with chairwoman Janet Yellen keen to ensure that her own policy firepower is not reduced to unconventional policies in the event of another downturn.

Another popular explanation for the timing of the rate moves is that the region’s economies are responding to a currency-induced loss of competitiveness due the policy actions of G3 nations. The improving growth dynamics in the US has pushed the dollar higher and this is feeding though to stronger currencies in the region, either as a result of formal pegs or otherwise. At the same time, the aggressive bond buying by the BOJ and ECB has resulted in a significant weakening of the yen and euro. Not surprisingly, the renminbi’s real effective exchange rate has appreciated almost 10% since mid-2014, while Indonesia Thailand and the Philippines have also seen strong appreciation. However, we are sceptical that the recent round of policy cutting is purely designed to devalue currencies. Such action always leaves oneself open to retaliatory action; forcing us to repeat once more that competitiveness gains are best achieved through structural changes capable of restoring unit labour cost advantages.

One final factor that may be supporting central banks’ policy choices is an increasingly confidence that financial stability risks can be controlled by non interest rate policy tools such as macro-prudential mechanisms. Certainly, we think there is every reason to be concerned that credit risks remain elevated in a number of Asian economies, most noticeably China, with excessive credit growth and capital misallocation yet to be recognised fully by markets. We would be sceptical that these relatively untested macro-prudential tools could diffuse the credit excessives of recent years without a more painful market correction.

While we see the short term attractiveness of recent rate cuts in boosting domestic demand in the absence of a more sustained rebound in global growth, we continue to believe that the downward pressure on headline inflation rates is primarily oil-related, although we accept that excess capacity may be playing a larger part in driving disinflationary forces in some economies. Ultimately, the appropriateness of a policy loosening bias among the region's economies still depends on domestic demand trends, with those nations witnessing a deterioration of economic fundamentals, such as China, justified in cutting rates. In the same way, those with improving dynamics, such as the US, are justified in raising them. Looking ahead, it will be necessary to closely monitor the US economy for signs of spill-over effects from weak demand trends elsewhere, at the same time we will also be paying close attention to whether Asian exports start to recover to levels more consistent with their historical relationship with global output. While we think it unwise to fully rule out the possibility of a deflationary shock and a period of economic stagnation, we think policy actions in those regions suffering demand weakness combined with signs of a cyclical upturn can push the global economy forward in 2015.

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