FEB 02.05.2016

ECONOMICS: ASIAN PERSPECTIVES

MODEST REACTION SEEN IN ASIA AFTER BOJ'S NEGATIVE RATE MOVE

+ Anthony Chan, Asian Sovereign Strategist—Global Economic Research, anthony.chan@abglobal.com

Asian central banks are unlikely to emulate the Bank of Japan's negative rate policy, at least for now. But they may ease sooner than previously thought, given that real interest rates have been too high to start with. Likewise, their currencies may track the yen, given the upward pressure on the US dollar resulting from the BoJ action.

Ripple Effect

The Bank of Japan's (BoJ) announcement of a negative-interest-rate policy stunned Asian capital markets and raised a number of questions. Will it set off more easing and currency weakness in the region? Will more Asian central banks move to negative rates? Is there portfolio action we should be taking?

We think the likelihood of other Asian central banks following suite remains remote, since nominal rates across the region are still well above zero.

Still, as the BoJ's policy move pushed the yen and Japanese government bond (JGB) yields lower, the pressure on central banks across Asia to cut interest rates has increased, as has the pressure on their currencies.

After all, as we have been arguing for some time, real interest rates—nominal rates minus the inflation rate—in most Asian countries are too high, given the current economic slowdown (*Display 1*).

We have been forecasting lower bond yields and weaker currencies across the region on a six-month horizon, and the BoJ's action has only increased the risk that these will happen sooner than later, particularly as gradual US Federal Reserve rate hikes have already been priced in.

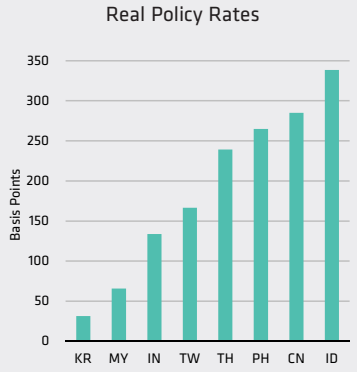
Ripe for Rate Cuts

The most appealing market is Indonesia's local-currency bonds, given their high nominal and real yields. India is next, but we expect the Reserve Bank of India to hold steady in our base-case scenario because of the need to maintain reasonably tight real rates to ensure the credibility of its inflation-targeting policy.

China, too, has some room to cut the one-year benchmark lending rate. But a recently leaked document suggests that the People's Bank of China (PBOC) is worried about cutting the reserve requirement ratio and interest rates too aggressively, as that may accelerate capital outflows and exacerbate the downward pressure on the renminbi (RMB). Therefore, the central bank may prefer using open market operations and high-frequency liquidity adjustments to directly control the quantity of money.

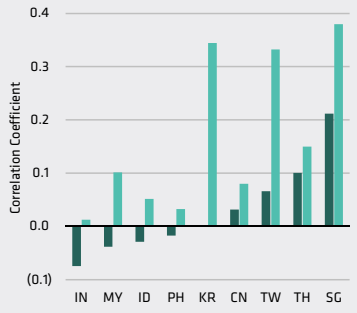
The country which has a lot of similarity with Japan is South Korea—an aging population, slowing structural growth, low

Display 1
Real Rates Remain High in Most of Asia



As of February 1, 2016
KR = South Korea, TH = Thailand, TW = Taiwan, MY = Malaysia, PH = Philippines, CN = China, IN = India, ID = Indonesia
Source: CEIC Data and AB

Display 2
Asian Yields, Currencies Poorly Correlated with Japan's



As of February 1, 2016
Source: CEIC Data and AB

nominal and real rates and a large current account surplus. But we don't think the Bank of Korea's (BOK) inherently reactive stance on monetary easing will change. Even so, we expect the pressure from the BoJ's actions to increase the odds for an earlier-than-expected BOK rate cut.

Taiwan is moving in the same direction as South Korea and Japan, but on a less pronounced scale. The central bank has always been conservative, and changes have come gradually.

US Dollar Strength

Currencywise, the yen's renewed weakness against the US dollar, which also prompted the euro's depreciation against the greenback, will likely keep an upward pressure on the US currency against its trade-weighted basket. This likely means more downward pressure on Asian currencies, particularly the RMB.

There are many questions on what China might do with its currency after the BoJ's negative rate move. Many investors fear that this could increase the odds of a major RMB devaluation and an economic disaster. They believe China may be the next "credit event" in the world market.

While this argument cannot be entirely thrown out of the window, we think that a more likely outcome is that China closes its capital account further to defend currency stability. There is already some evidence of this in various capital-flow and investment channels over the past weeks.

Many leading policymakers around the world, including the head of the International Monetary Fund, have warned against China's intervention to prop up the RMB, saying it was wasting its reserves. But they have been conspicuously quiet about Beijing's move to gradually close the capital outflow channels. There has been no criticism that such a move would jeopardize the RMB's reserves currency status.

Risk/Reward Propositions

The risk/reward for shorting the RMB does not look attractive to us. On the other hand, those for receiving local rates in Indonesia and South Korea are the most attractive, even with the currency exposure hedged.

Historically, Asian yields and JGB yields have shown low correlation, as have Asian currencies and the yen (*Display 2*). Interestingly, however, South Korean bond yields have been fairly highly correlated with Japan's lately—more so than the won has been with the yen. This may sound counterintuitive, given the close export competition between the two countries, but the won has appreciated significantly against the yen over the past few years, depressing the correlation.

Elsewhere, shorting the Singaporean dollar and the Taiwanese dollar as funding currencies for US dollar portfolios continues to look reasonable. India will remain a stand-alone market in both the interest rate and currency markets, owing to its low correction with Japan.

In China, the PBOC has been maintaining a strong RMB fixings in recent weeks, and the CFETS basket index has remained generally quite stable. We still expect no RMB devaluation, but we anticipate that a continued modest easing in local yields in the next six months.

We have been waiting for Japanese money to flow into Asian markets in search of higher yields, ever since the second round of the BoJ's bazooka easing in October 2014. But the flow has mainly gone to the US and, to a less extent, Europe. Japanese gross portfolio flows into Asia have totaled only US$16 billion since Oct 2014, substantially smaller than US-bound funds, at US$123 billion. We don't think the negative-rate policy will make a marked change to this trend. ■