Emerging Insight

Asia FX: The real risk of nominal stability

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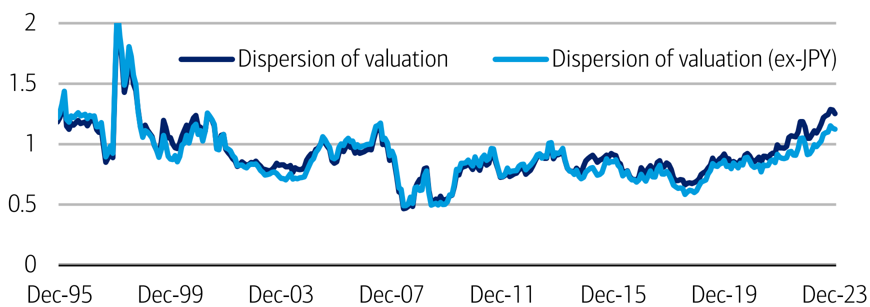
Key takeaways

- Asia policy maker fixation on FX stability could come at the cost of unsustainable diverging FX valuations and misevaluations
- FX stability polices and valuation for INR, IDR, PHP and THB may be less sustainable and prone to depreciation
- Two key tail risks to FX stability policy are Fed not easing in June and accelerated real devaluation in CNY and disinflation

By Claudio Piron

Exhibit of the day The dispersion of Asia FX valuations is historically high due to FX policies
The standard deviation of Asian real exchange rates deviating from their long-term average



Source: BofA Global Research, Bloomberg, BIS

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The dark side of FX stability

FX volatility in Asia has collapsed as policy makers intervene to reduce FX uncertainty, secure investment flows, and shadow the Fed. This is usually viewed as a good thing, with Asia inflation performance beating EM peers and Asian bond market duration less vulnerable with Asia's monetary policy anchored to the Fed.

Nonetheless, this policy can bring with it negative side-effects and unintended consequences. Reducing the ability of the nominal or market exchange rate to adjust to fundamental shocks means that the prices in the underlying economy must adjust, potentially resulting in real distortions and a policy mistake accumulating overtime.

Consequently, Asia FX policy intervention is resulting in a widening divergence in valuations not seen since the Asian financial crisis of 1997 and Global Financial Crisis of 200. Exhibit of the Day shows this dispersion (standard deviation) of current Asian real effective exchange rates from their 30-year average over time.

Glossary:

PBoC: People's Bank of China

CFETS: China Foreign Ecchange Trading System

REER: Real effective exchange rate

BIS: Bank International Settlements

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Nominal fixations belie real consequences.

One of the notable features of the Asia FX complex for the past couple of years is the notable collapse in FX volatility. This is especially so for CNY, INR, IDR, and KRW, where central banks are especially focused on dampening volatility.

Initially, this intervention was motivated by a desire to prevent Asia FX depreciation from aggravating higher inflation through increasing import prices, especially of commodities. More recently, the motivation has shifted to dampening FX volatility to protect already fragile foreign investor sentiment amid US-China tensions and secure foreign direct investment and portfolio inflows.

One of the consequences of this FX policy fixation on the stability of the nominal value of the exchange rate is that economic shocks must be absorbed through an adjustment in the real exchange, rather than the nominal exchange rate. The risk is that this could result in a fundamental misalignment of the currency and its external competitiveness.

For example, an EM country could be running high inflation, raising the cost of its production, but not allowing its currency to depreciate to compensate for this – resulting in FX overvaluation (see India/Philippines). Alternatively, a country could be running weak domestic growth and disinflation, but keeping its currency stable rather than nominally appreciating, resulting in currency depreciation and undervaluation. This in turn creates an overdependency on the export sector to support growth to the detriment of the domestic economy.

Exhibit 1 shows the current real effective exchange rate of Asian countries, subtracting from their 30-year average and divided by their standard deviation. This gives us the valuation of the currency in purchasing power parity terms against its trade-weighted partners. We can see that JPY and MYR look significantly undervalued and INR, PHP and SGD look significantly overvalued.

We can also look at how extreme this divergence in currency valuations shown in Exhibit 1 has evolved over time by taking the standard-deviation of this cross section in currencies over time. This is shown in Exhibit 2 and shows that Asian currencies are the most divergent in over 20 years (with or without the extreme undervaluation of the JPY included). The implication is that Asia's FX policy intervention is potentially becoming problematic in creating diverging over and under-valuations in the region.

Exhibit 1: REER values relative to 30-year average - standard deviation
SGD, PHP, INR appears rich, MYR and KRW appear very cheap

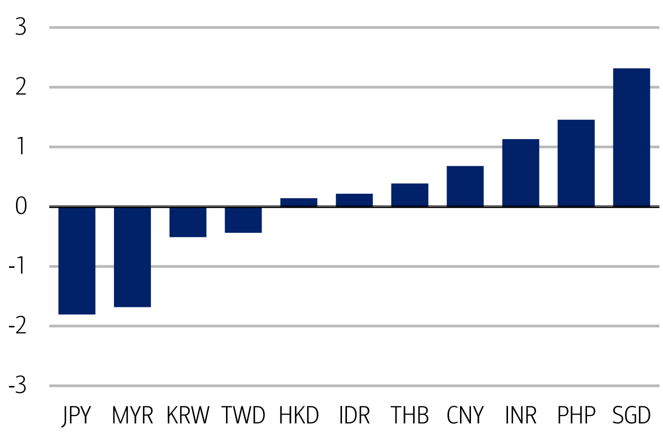

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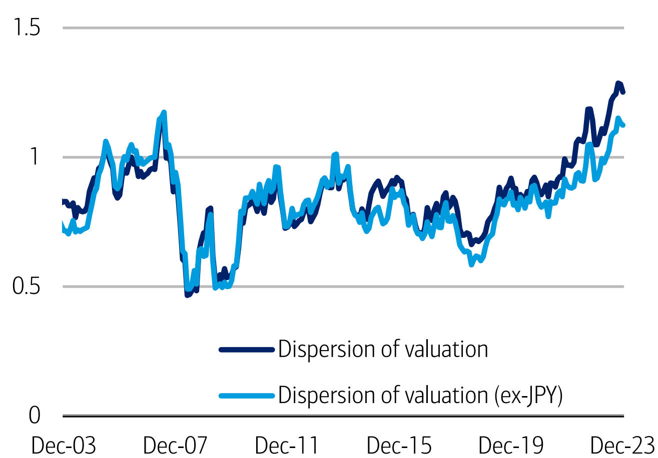
Exhibit 2: The dispersion of Asia FX valuations is historically high
This would suggest relative value opportunities may emerge in long run



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A natural criticism of the above valuation analysis is its pure focus on purchasing power parity. That the same basket of traded goods should be the same price in each country over time after adjusting for the exchange rate. Moreover, in Singapore's case, the monetary authority uses targeted trade-weighted exchange rate appreciation as its monetary policy tool to target inflation. Nonetheless, the overall valuation findings (with the exception of SGD, which appears fairly valued) are consistent with our more sophisticated equilibrium exchange rate model (COMPASS – see World at a Glance: The wait for Fed) that adjusts for the productivity, wealth and the savings equilibrium (current account) of the economy.

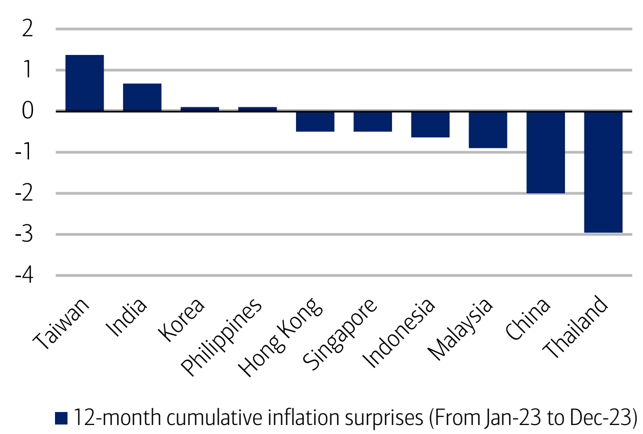
What are the consequences?

There are two key market implications of this pursuit of FX stability. The first is already evidenced by subdued inflation and dampened bond betas to US duration. Exhibit 3 shows the cumulative forecast error over the past year by the market consensus forecasts compiled by Bloomberg. Consumer price inflation was especially weaker than expected for Thailand, China, and Malaysia. Only Taiwan surprised to the upside largely due to adverse weather shocks affecting food prices. Additionally, Exhibit 4 shows that producer prices inflation is generally running below consumer price inflation, an indication that pipeline inflation pressures are running weak.

We believe this is all indicative of overall policy conditions being too tight because of currencies being prevented from depreciating fully and interest rates being kept high as Asian central banks hold their breath for the Fed to cut interest rates.

We showed in Global Emerging Markets Weekly: Duration squeezes, Low vol pleases (page 2 & 3) that this FX smoothing policy is resulting in low FX implied volatility in Asia relative to other EM peers and that Asia's duration sensitivity to the US rates sell-off is also less relative to its EM peers. Indeed, Asia's inflation surprises have been consistently below EM inflation surprises over the past 5-years. Asia's 10yr yield beta's to the US have also been below one and lower relative to their EM peers with local factors and policy still playing an important role in stabilizing the long end – see Global Emerging Markets Weekly: Carry Conundrum: Risk, Reflation & China (page 3).

Exhibit 3: Most Asian inflation CPI prints surprise to downside.
Chart represents the cumulative forecast errors over past 12months



Source: BofA Global Research, Bloomberg

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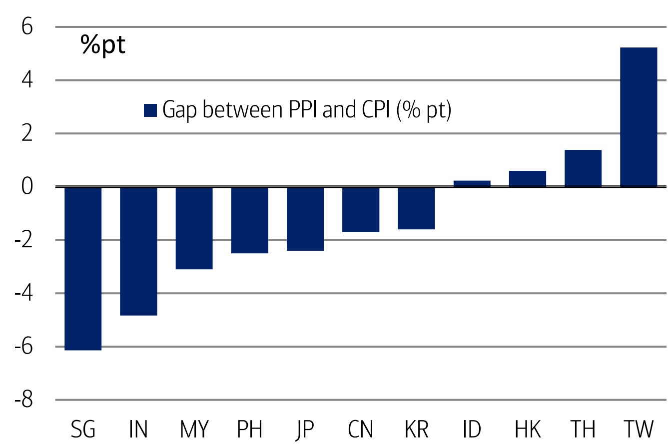
Exhibit 4: Producer price pass through into Asia looks disinflationary.
Producer prices are also falling at faster pace than consumer prices



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The second implication is yet to be determined. One risk is that deflationary pressure in countries could continue to build, ultimately pressuring capitulation and a competitive devaluation in the longer run. This could happen either by central banks stepping back from FX policy smoothing, cutting interest rates or portfolio outflows building. The second is that the disinflationary, undervalued currencies, could switch to reflationary policies, especially if the Fed were to cut interest rates and China were to engage in more forceful fiscal stimulus. This makes the expectations for a June cut by the Fed especially critical.

A final look at the big picture

The above analysis focuses on the trade-weighted inflation adjusted exchange rates. Here, we put it together with the real short term interest rate (3-month), weighted by the trade-exposure of the economy (capped at 75%) and then by GDP weights to get an overall measure of monetary conditions in Asia and Asia ex-China – see Exhibit 5. This shows that monetary conditions in combined real FX and interest rate terms have tightened rapidly since end 2021 and the peak of COVID and the initiation of the Fed tightening cycle in 2022.

Indeed, looking at the changes of individual country monetary condition indices since end-2021, shows there has been a significant tightening in the Philippines, Indonesia, and Thailand, due to rising real interest rates. Indeed, PHP, IDR and THB may become vulnerable to depreciation pressure if they are unable to ease monetary policy in H2 amid disappointing growth dynamics and a further depreciation of the CNY real effective exchange rate.

Only in the case of HK, has the real adjustment in the exchange rate due to weaker inflation and a high trade weight in the monetary conditions index, been able to offset a rise in real interest rates.

Exhibit 5: Asia's monetary conditions are tightening, not easing.
Nominal FX stability is putting is putting downward pressure on prices

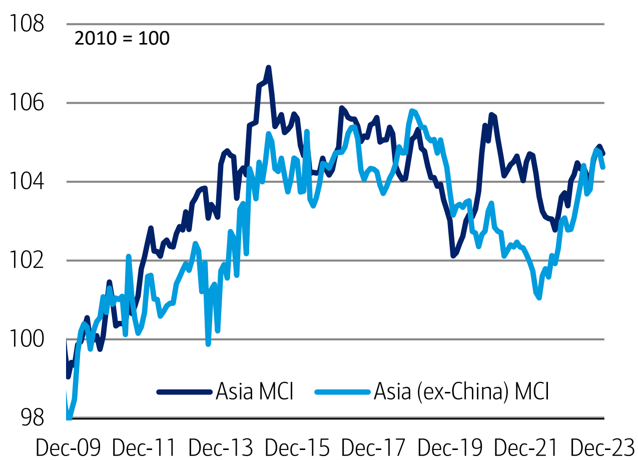

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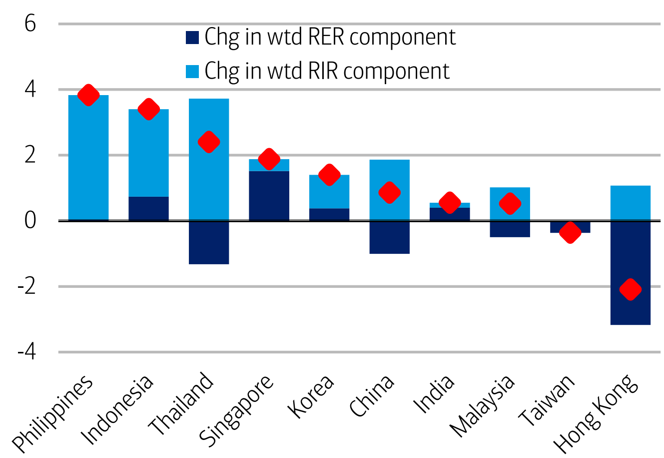
Exhibit 6: Monetary conditions appear tightest in PHP, IDR and THB
Only HK is seeing easing in monetary conditions through real depreciation



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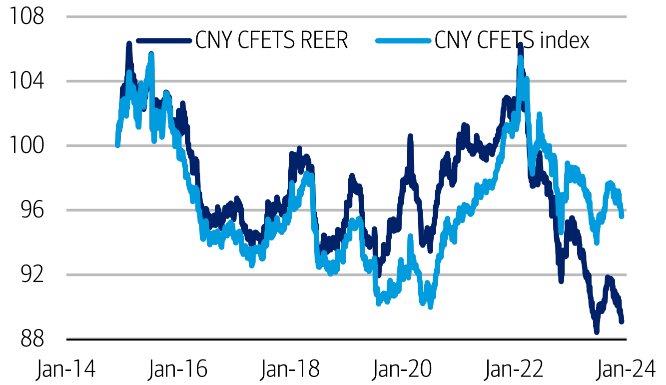
Final piece of the puzzle - RMB

Overall, Exhibit 1 shows that the current CNY real valuation is in line with its 30-year average and there are no overt signs of pressure. However, it is worth noting the recent rate of change of real depreciation, especially against the PBoC's CFETS 24-currency basket, is more significant than the nominal depreciation.

Since the March 2022 peak, the CNY has depreciated 7% in nominal CFETS terms, but in real inflation adjusted terms the depreciation is 15%. Exhibit 8 shows show the relative disinflation in China CPI relative to its trade partners have overwhelmed the nominal market moves to depreciate the trade-weighted exchange rate further. If this pace of depreciation continues into H2, it could spill over into depreciation pressure in other Asian currencies, especially if the Fed fails to ease interest rates in June.

Exhibit 7: China RMB CFETS index also adjusted for inflation.
China's disinflation is having a material impact on real FX valuation



Source: BofA Global Research estimates, Bloomberg, CFETS

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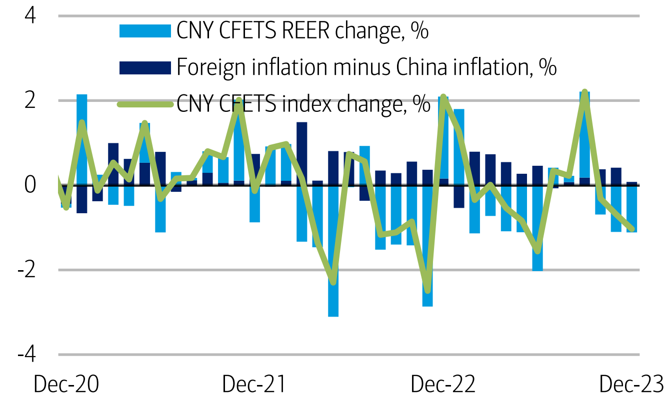
Exhibit 8: China real CFETS decomposed by inflation vs nominal index
China's disinflation is diverging from inflation amongst its peers



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