Foreign Exchange
Asian Currencies

HSBC Global Research

Asian FX Focus

Policy in motion

- **Policy functions are shifting, resulting in an upgrade to our MYR view**
- **Inflation risk should command greater attention**

The risk issues dominating Asian currencies in recent months are fading – these include sovereign issues in Europe, fears of a double dip in the US and overheating concerns in China. USD-Asia's downmove is therefore returning.

Beyond this there have been important shifts in the Asian monetary policy outlook beyond China. In three particular cases (KRW, MYR and TWD), our economists have shifted views in large part because of a reassessment of policy reaction functions. In our view these have significant implications for currency allocation in the region.

Key is that we have upgraded our view on the MYR, on the view that a higher interest rate structure will be sufficient to offset the structural, broad-based leakage of local savings. For KRW and TWD, in contrast, we do not expect the push back in tightening calls to have any meaningful FX impact. Our key longs in Asia now comprise KRW, IDR, TWD, MYR, and CNY NDFs.

The shifts to delay tightening in Korea and Taiwan do, however, suggest something broader in our view. The bounceback in production in both economies has been remarkable, and in real terms both have negative real interest rates, with only the 2008 commodity price spike being associated with even more negative rates.

Despite this mix, policymakers appear to have taken the view that policy can remain at crisis settings for some while longer. There is clearly some increased inflation risk associated with this judgement. We are reminded that while modest upside inflation surprises can be currency positive to the extent they imply a need for monetary tightening, there is a point at which they can start to become currency negative.

At the very least, we recommend enhanced monitoring of inflation indicators in these markets, as well as across Asia.

10 March 2010

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Policy in motion

- Rate calls are in flux, in some cases because of shifts in the policy reaction function
- We have upgraded our call on MYR as a result
- But inflation risk in Asia could be the cost

A range of external issues has been dominating the price action in Asian currencies in recent months – sovereign issues in Europe, fears of a double dip in the US and overheating concerns in China. Increasingly these issues are either appearing more settled, or the effects are being felt only locally. Certainly the ongoing strength of the Asian data trend, and lack of contagion into credit markets more broadly, is continuing to encourage this localisation. USD-Asia's downmove is therefore returning. Beyond this, however, **there have been some important shifts in the Asian monetary policy outlook** beyond China. In our view these have significant implications for currency allocation in the region. Key is that **we have upgraded our view on the MYR, and now count it among our conviction Asian longs** – KRW, IDR, TWD, and CNY NDFs.

Shifts in policy calls

The following table outlines recent changes in our monetary policy calls across Asia. These shifts follow an extended period of stability in these views. Of the eight markets listed, we have shifted calls in six cases. In two cases (CNY and INR) we have become more hawkish because of upside surprises in the data trend, while the reverse holds for IDR. But in three cases (KRW, MYR and TWD), we have shifted view in large part because of a reassessment of the policy reaction function. It is these latter three cases which are particularly interesting. Moreover, we have written in some detail on CNY, INR and IDR already in recent months.

Table 1. Revisions to Asian monetary policy calls

Currency	Direction of revision	Reason	Start of hikes & 2010 total
CNY	Hawkish	Macro	2Q, 54bp
IDR	Dovish	Macro	3Q, 100bp
INR	Hawkish	Macro	2Q, 125bp
KRW	Dovish	Policy function	3Q, 75bp
MYR	Hawkish	Policy function	1Q, 100bp*
PHP	No change		2Q, +75bp
SGD	No change		Appr'n in April
TWD	Dovish	Policy function	3Q, 50bp

Source: HSBC
* Including the 25bp already delivered

In Malaysia we shifted view shortly before BNM's recent rate hike, and expect a total of 100bp of tightening this year (including the 25bp delivered last week). (See *Malaysia rate rise: 100bps this year?*, published 4 March, for a full write-up.) While the economy has been strong in Malaysia, our economist has been expecting that. Key behind the shift in view were Governor Zeti's more hawkish comments ahead of the meeting.

In Korea and Taiwan conversely, we have scaled back our rate hike expectations. In both cases we have shifted away from a March tightening call, to argue that the first move would only now come in

3Q. In Korea we still expect the same amount of tightening by the end of the year, but argue that because of ongoing concerns from policymakers about whether it is yet appropriate to implement exit strategies, the timing is pushed back (see *OK, not now: Bank of Korea to raise rates in 3Q*, published 25 February). In Taiwan, despite a sharp rebound in the production side of the economy, policymakers appear intent, for now, to control the side effects of very low rates with administrative tools (see *Taiwan Central Bank Watch: Not now, later*, published 9 March).

The most obvious way to think about these shifts in policy function is to argue that higher rates make one more bullish the ringgit, and lower rates suggest a bearish stance towards the won and Taiwan dollar. This is fine as far as it goes. It does not, however, incorporate two important nuances. The first is whether rates actually have a significant influence on the currency. The second is whether any shift in rates is augmenting or detracting from the existing balance of fundamentals.

MYR – some cyclical strength at last

We have attached a 'regional underperform' tag to the ringgit for quite some time. We have viewed Malaysia as facing a broad-based outflow of domestic savings, driven by a range of structural factors. Against this backdrop, the recent 25bp hike by BNM was somewhat unexpected in the scheme of things, although our economist had shifted view before the meeting.

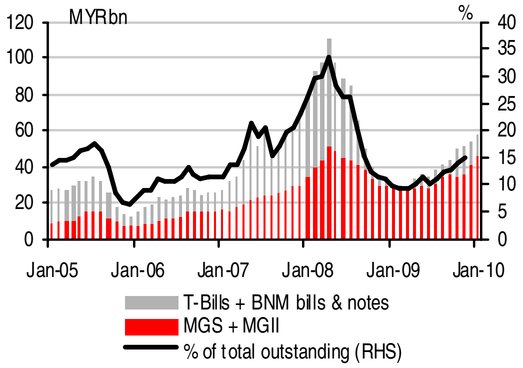
As well as mentioning the improvement in the economy and the strength of regional conditions, in its statement BNM also cited raising rates to "prevent financial imbalances", a factor that has not been cited in central bank policy rhetoric elsewhere recently. There is almost nothing to suggest that BNM is referring to domestic imbalances. In fact, onshore discussion has focussed on the sustained outflow of domestic savings as the key financial imbalance in the economy (refer to *Asian FX and FI Strategy: MYR to lag Asia, but bonds offer value*, published 10 February).

So, **it appears that the outflow of capital that we have long used as justification for our 'underperform' tag on MYR, has now become a target of policy**. If we are correct in our interpretation, this hike is a signal that the authorities are serious about stemming the outflow of savings in Malaysia – and comes on the back of other moves, such as a recent crackdown on moneychangers and the introduction of a new currency declaration requirement at the border. As such, we expect the drag on the currency from the savings outflow to ease going forward. As with other markets that have enacted policies targeted at currency-related issues, **it's not just what policy steps have been taken, but also what those steps suggest about policy intent, and hence potential future moves**. In Malaysia the intent, for now, is clear.

BNM is unlikely to continue tightening to achieve an external objective, if that is inconsistent with internal objectives. With the economy having bounced back well, however, that is unlikely to be an issue for a while. Our economist now expects a further 75bp in tightening from BNM this year, probably placing Malaysia among the most aggressive hikers in the region (second only to India and Indonesia). Malaysia will never be a high yielder, but a cash rate of 3.0% by the end of the year doesn't make MYR a particularly low yielder either. Being a member of global bond indices, Malaysia also can be a destination for global capital when conditions justify. Certainly foreign bond holdings in Malaysia, at around MYR58bn (or less than 20% of the total market), are well below 2008's peak of around MYR100bn

(or one-third of the market). (See Chart 1.) Rate spreads are wider now than they were then.

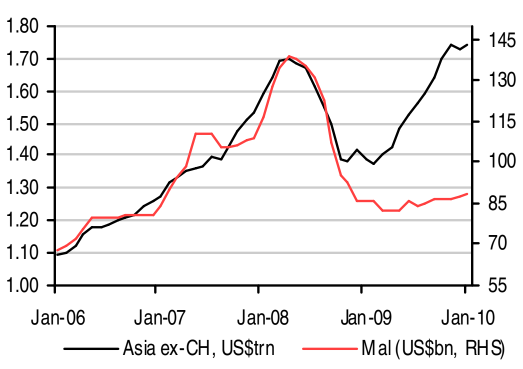
Chart 1. Upside in Malaysia bond ownership



Source: HSBC, CEIC

Our key investment conclusion is that we no longer see the MYR underperforming the rest of Asia, and expect it to show more robust price action going forward. This policy shift is also likely to see Malaysia begin to accumulate reserves again, after lagging much of Asia since the crisis began (Chart 2). We are adding Malaysia to our conviction list of Asian currency longs – TWD, IDR, KRW and CNY NDFs.

Chart 2. Malaysian reserve accumulation



Source: HSBC, CEIC

North Asia – still bullish despite the rate delay

In contrast to Malaysia, we have been cyclical bulls on Korea and Taiwan for some time. The issue then needs to be framed slightly differently. Both currencies remain under significant appreciation pressure, with ongoing reserve accumulation a key hurdle to even more significant gains (see our monthly *Asian Intervention Dashboard*). The shift in rate calls does not change our directional view on either currency, although in the case of Taiwan it does suggest that some more patience may be needed if looking for very significant gains.

Despite the shift in rate calls, in both markets we continue to expect tightening this year, albeit of course with altered timing now. In a zero-Fed-rate world, any tightening is likely to stand out. In addition, the changes in monetary policy profile will only have a modest impact in reducing what is already an excess of flow in favour of appreciation, in our view, as evidenced by ongoing strong reserve accumulation. Moreover, both currencies are seeing a strong cycle of repatriation of offshore assets from local residents. It does not strike us that this flow is particularly interest rate sensitive.

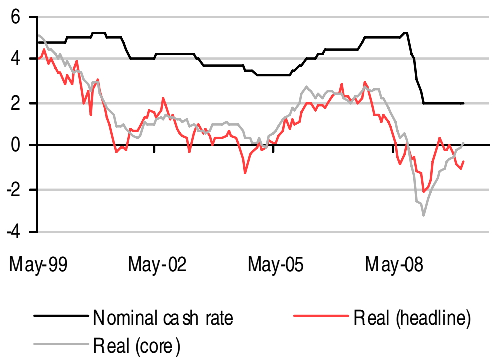
Risk assessments

Beyond our central call on what these policy changes mean for individual currencies, the shifts to delay tightening in Korea and Taiwan also suggest something broader in our view. The bounceback in production in both economies has been remarkable – IP in both markets is now back at pre-crisis peaks in level terms. At the same time, interest rates are at highly stimulatory settings (Charts 3 and 4). In real terms in both markets real interest rates are negative, with only the 2008 commodity price spike being associated with even more negative rates.

Despite this mix, policymakers appear to have taken the view that policy can remain at crisis settings for some while longer. There is clearly some increased inflation risk associated with this judgement. **At the very least, we recommend enhanced monitoring of inflation indicators in**

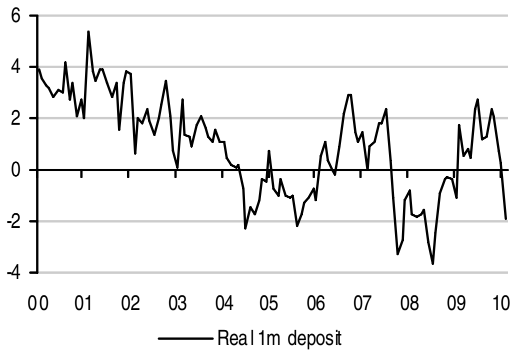
these markets, if not across Asia. We are reminded that while modest upside inflation surprises can be currency positive to the extent that they imply a need for monetary tightening, there is a point at which they can start to become currency negative.

Chart 3. Korea: real interest rates



Source: HBSBC, CEIC

Chart 4. Taiwan: real interest rates



Source: HSBC, Bloomberg

If policy falls too far behind the curve, then credibility starts to be questioned as inflation expectations build. In this environment currencies and data surprises become negatively correlated – i.e. strong data begets currency depreciation as markets begin to fear overheating. At this stage we don't forecast any such dynamics in the region's main currencies, but to the extent some central banks are proving to be even more dovish despite ongoing positive data surprises, it's a risk that we would be on top of.

Conclusion

Our economists have shifted a number of rate calls in Asia recently. The adjustments in Malaysia, Taiwan and Korea are most interesting, not least because they at least partly reflect a change in assessed policy reaction function. We are upgrading our view of the MYR as a result of a more hawkish tightening profile in Malaysia. Despite the reduction in near-term interest rate profiles, however, we remain bullish KRW and TWD. In addition, we suggest giving indicators of inflation greater importance given the shift in policy reaction functions.

Disclosure appendix

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