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Thomas LAM
Singapore Management University, thomaslam@smu.edu.sg

David FERNANDEZ
Singapore Management University, dfernandez@smu.edu.sg

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Sandwiched between a rock and a hard place?

The policy gap between US and China is likely to be widening further, potentially raising and unevenly distributing the risks of negative spillovers for Asia and the rest of the world.

By Thomas Lam and David Fernandez

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As economies globally continue to grapple with supply and demand distortions, financial markets have ratcheted up their focus on central bank policy. This is partly because of the divergence between the Federal Reserve, which is poised to commence lift-off at the upcoming meeting in March, and the People's Bank of China (PBOC), which has continued to deliver easier monetary policy at the outset of 2022.

More broadly, the breadth of policy instruments being deployed by the PBOC has increased, intensifying its easing efforts. In addition, we think that China's leaders are unlikely to accept gross domestic product (GDP) growth dipping noticeably below 5 per cent this year, and that another reserve requirement ratio reduction may be imminent.

The tone of the January Fed communique on the likelihood of lifting off and tapering, though a step-up from the prior meeting, was largely in line with the message from the December minutes. But Fed Chair Jerome Powell's comments during the Q&A session were clearly eye-catching on 3 fronts.

First, he noted numerous times that the current economic environment is "much stronger" than the previous normalisation phase and that labour market conditions are presently consistent with "maximum employment". Second, he suggested that stronger economic conditions are "likely to be reflected in the policy" decisions and that there are important implications on the "appropriate pace of policy adjustments", which imply that the frequency and magnitude of rate hikes can differ from the measured pace previously. Third, he neither doused the prospect of raising rates successively nor an outsized 50 basis points move.

For the rest of the region, the historical tendency to lean with the Fed is already apparent. The Monetary Authority of Singapore began normalising in October, and surprised in January by continuing to "raise slightly the rate of appreciation" of the Singapore dollar nominal effective exchange rate policy band. Also, we believe that additional adjustments look likely at the upcoming meeting in April. Similarly, the Reserve Bank of New Zealand lifted off last October and the Bank of Korea moved last August.

It is important to recognise, however, that Fed monetary policy cycles - that are easing and firming episodes - vis-a-vis other central banks might not be congruous. For this exercise, we harness a reasonably comprehensive sample of central banks, including the Fed and PBOC, comprising over 80 per cent of world GDP (in purchasing power parity-terms). Generally, we find that the proportion of central banks globally is more likely to lean with Fed easing periods than Fed hiking phases on average, with the former exceeding the latter by roughly 1.5 times.

Also, we discover that the number of central banks in emerging and developed countries that broadly shift with tighter Fed policy, while typically lower during the early phase of each cycle, tends to build over time. During the 2015 to 2018 episode, the fraction of central banks that normalised along with the Fed was around 20 per cent to 25 per cent at the outset, but moved up to slightly beyond 50 per cent over time. Similarly, during the 2004 to 2006 cycle, the share of central banks that pursued firmer policy rose to about 75 per cent from less than 50 per cent initially.

The somewhat more awkward cycle (in the middle of the Asian financial crisis) during the latter part of 1990s through 2000 also witnessed an increase in the proportion of central banks that co-move with the Fed tightening cycle from under 30 per cent to around 60 per cent of the sample in due course. Therefore, the share of central banks globally that move along with the Fed is likely to rise incrementally, perhaps covering at least half of our sample, particularly if the current rate hike cycle lengthens.

Broadly, spillovers from monetary policy, both from trade and financial channels, can be notable especially for highly open economies. The impact from the financial channel - via capital flows, exchange rates, et cetera - is more immediate, usually pronounced and highly intricate. For example, an abrupt and significant appreciation of the US dollar can amplify dollar liabilities, worsen short-term foreign currency debt dynamics, tighten financial conditions and potentially spark contagion effects.

The level of non-financial US dollar borrowing by foreigners has risen to more than US$13 trillion in 2021, of which greater than US$4 trillion (or around 13 per cent of GDP) is held by developing countries, with developing Asia outpacing the rest. Also, our calculations suggest that China's demand for US dollar credit (as a share of GDP) has moderated by more than the rest of Asia, implying an uneven distribution of risk across the region.

To be sure, the likely implications of the policy divergence between the Fed and PBOC, especially for the rest of Asia and emerging markets, are complex and non-linear. Recent comments by PBOC Deputy Governor Liu Guoqiang emphasised that front-loaded policy action is crucial to improve market expectations.

Although expectations of Fed policy remain decidedly fluid, policymakers also seem to be less inclined to downplay the prospect of hawkish surprises. This implies that the policy gap between US and China is likely to be widening further, potentially raising and unevenly distributing the risks of negative spillovers, sandwiching Asia and the rest of the world between a rock and a hard place.

The writers are from the Sim Kee Boon Institute for Financial Economics, Singapore Management University. Thomas Lam is principal researcher, and David Fernandez, director.