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Asian policy tightening ahead as FX and inflation risks build

Growth across Asia is easing gradually, while inflation is only inching higher. The most immediate adjustment so far has been in FX, where moves have been sharper and faster than in real activity or prices. This divergence is increasingly driving policy decisions, and we expect most Asian central banks to raise rates in the third quarter



Growth is softening gradually, while inflation pressures are building

Two main themes are emerging across Asia.

First, growth momentum is beginning to soften at the margin following a strong start to the year. Activity indicators for the second quarter show early signs of losing traction. In China, recent data points to a moderation from a robust first-quarter performance. South Korean industrial production fell more sharply than expected in April. Retail sales have fallen notably in Korea, Singapore, Malaysia, and Indonesia.

At the same time, inflation pressures are building, albeit gradually. Even in economies such as Japan and Korea – where policymakers have sought to cap domestic fuel prices – second-round effects are becoming more visible. Higher energy costs are increasingly feeding into food prices and core inflation, pointing to broader and more persistent pressures. Across Asia,

average food and core inflation rose by around 30bp and 15bp, respectively, in April compared with the first quarter. Inflation is still manageable, but the risks are clearly shifting upward. Persistently high oil prices are poised to pass through more fully to consumers and producers.

In short, growth is softening gradually, and inflation is only picking up slowly. The largest and most immediate adjustment has been in FX. This widening divergence is increasingly shaping the policy response.

A second key theme is that sustained US dollar strength has driven broad-based weakness across Asian currencies, constraining policy flexibility. Currencies such as the Korean won, Indian rupee, and Malaysian ringgit have come under notable pressure over the past month, despite relatively resilient growth backdrops.

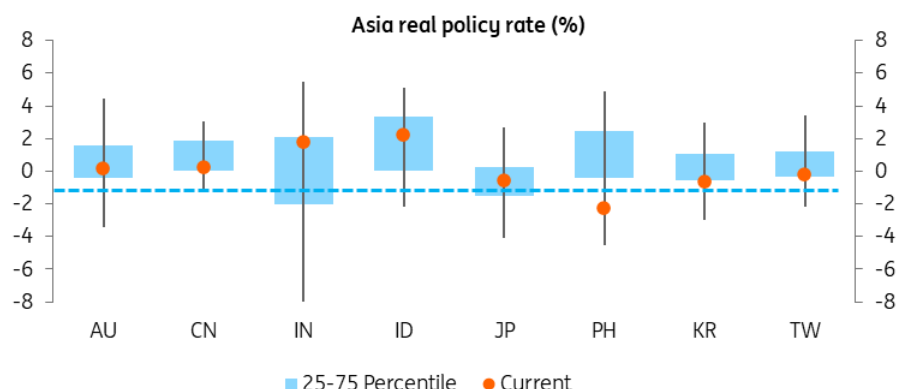
Malaysia's position as a net energy exporter offers some insulation. However, rising freight costs, domestic political risks, and delayed pass-through from higher oil prices continue to weigh on sentiment. With inflation still broadly manageable but FX pressures intensifying, central banks increasingly face a binary choice, skewing policy toward further tightening.

This dynamic reinforces the case for additional rate hikes in both Japan and Korea. We're also incorporating further policy rate tightening into our outlook for India.

Across South and Southeast Asia, policy responses have become increasingly divergent. Some central banks – notably Bank Indonesia – are adopting more front-loaded rate hikes to support their currencies. Others, such as the Reserve Bank of India, where inflation remains relatively contained, are pairing gradual tightening with targeted measures to attract capital inflows. The RBI recently announced a series of forex measures, including offering concessional swaps to encourage external commercial borrowing by state-owned firms and foreign currency non-resident deposits. This could result in a \$30-40bn inflow, helping stabilise the local currency.

Looking ahead, the interplay between moderating growth, gradually rising inflation, and persistent currency pressures will shape the policy outlook. Central banks are likely to prioritise anchoring inflation expectations and stabilising exchange rates, even as growth risks mount. As elevated oil prices continue to tilt inflation risks upwards, we expect most Asian central banks to raise rates in the third quarter. But a gradual US dollar pullback and continued capital inflows should help stabilise regional currencies in the second half.

Real policy rates have fallen with a pick-up in inflation



Source: CEIC

Author

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

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