

## Asia economic round-up

Our economists and strategists take a look at some of the key issues and events driving Asian markets this year

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# Asia: The easy bit is over

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## Author

**Robert Carnell**

Regional Head of Research, Asia-Pacific

[robert.carnell@asia.ing.com](mailto:robert.carnell@asia.ing.com)

## CNY: PBOC relinquishes some control

China is changing the way it manages the Renminbi and we think the move is line with PBoC's journey towards liberalising its FX regime



Source: Shutterstock

The Renminbi (CNY) has weakened today on news that the People's Bank of China (PBOC) has told commercial bank counter-parties that it is removing the counter-cyclical factor (CCF) from its daily CNY fixing mechanism. The CCF was an arcane measure introduced last May by the PBOC to exert more influence over the Renminbi – after USD/CNY neared 7.00 and threatened to exacerbate portfolio outflows from China.

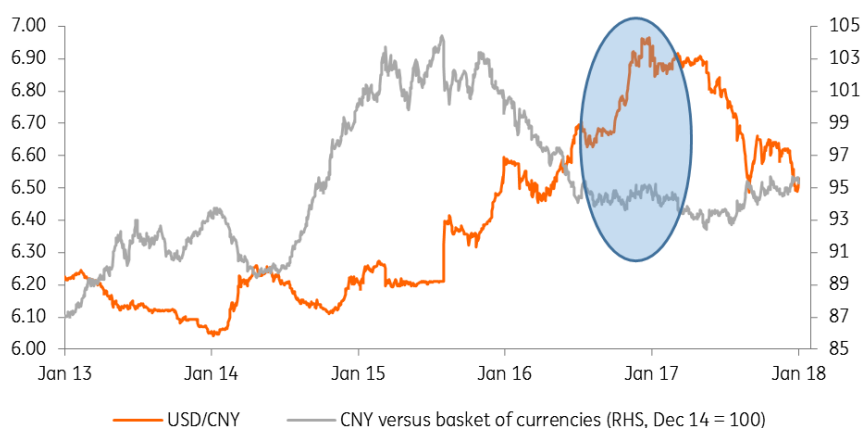
### Why now?

At the time (May 2017) we felt the introduction of the measure was to limit the chances of USD/CNY breaking above 7.00 – triggering further portfolio outflows and likely to send China's FX reserves below the psychological US\$3 trn level.

In a way, the PBOC was unlucky in choosing to liberalise its FX regime at the start of 2016, choosing to keep the Renminbi stable against a basket of currencies rather than the dollar. The PBOC was caught out by the dollar strength from 2016 onwards as the ECB extended QE, and the dollar broadly rallied.

## USD/CNY versus CNY basket

PBOC had struggled with USD/CNY near 7.00 in late 2016 and early 2017



Source: Bloomberg

Indeed the CCF was introduced to try and break the 'herd behaviour' of dollar strength, leading to higher USD/CNY fixings, fuelling expectations of further USD/CNY strength.

Yet the broad dollar trend turned in 2017, and the PBOC will be far less concerned now about CNY weakness. In fact, one could argue that today's move could have been triggered by a desire to prevent excessive CNY strength. Incidentally, the Korean Won weakened yesterday when a government official warned it would take action to avoid one-sided moves in the Won.

### What's the outlook for the Renminbi?

The initial market reaction has seen USD/CNY move higher on the view that the PBOC is down-scaling its support operation for the CNY. We prefer to view the move as one in keeping with the PBOC's journey towards liberalising the FX regime – after a retrograde step last May.

A more flexible (and presumably more volatile) Renminbi should, therefore, be more susceptible to the external FX environment. Given that we look for the DXY dollar index to depreciate around 7% this year, we believe the USD/CNY bear trend will remain in place.

As ING's Economist for Greater China, Iris Pang, [notes](#), we expect PBOC to tolerate modest appreciation pressure in the Renminbi this year and USD/CNY to end 2018 at 6.30.

[Read why we expect 3% appreciation of CNY against the USD](#)

## Author

### Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

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Source: Shutterstock

## Japan: The problem of success

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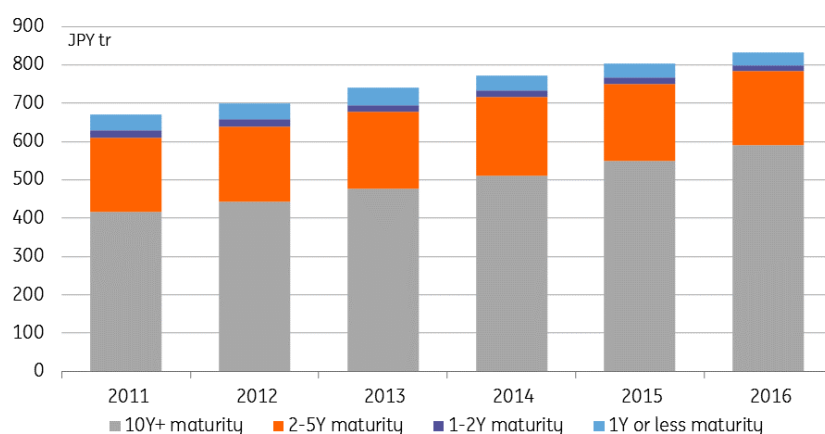
Source: Shutterstock

### 2017 growth set to be strongest since 2010

With only one slight blip in 3Q16, when the economy grew at 0.9% quarter-on-quarter (annualised), Japan has recorded growth of above 1.0% (actually at or above 1.4%) in each of the last seven quarters. The revised 3Q17 GDP growth figures of 2.5% come hard on the heels of a 2.9% growth rate in 2Q17. Full year growth looks likely to come close to 2.0% (ING forecasts 1.8%), which would be the strongest growth performance since 2010, when Japan emerged from the global financial crisis. The extent, and persistence of Japan's growth is leading some to question what this means for Bank of Japan (BoJ) policy. Currently, this targets 10-year Japanese government bonds (10Y JGBs) at about zero percent, and keeps the interest rate on policy-balances held by banks with the BoJ at -0.1%.



## Central government debt outstanding



Source: Macrobond

## 10-year government bond yields are on the rise

Like the yields on other G-3 bonds, Japan's government bonds have not escaped the recent rise in global yields, nosing up to about 0.05% from a recent trough of about 0.01%. That owes partly to overseas influences, the markets' reluctant acceptance that the Fed's 'dot-plot' of interest rate expectations is not so unrealistic and the beginning of the end of quantitative easing in the Eurozone. But is it reasonable to imagine that the BoJ could follow suit in 2018? Shorter maturity Japanese government bond yields remain negative, but they too have been nosing higher, suggesting some expectation of higher rates in the not-too-distant future. Sure, growth data are remarkably strong, and matched by similarly tight labour market data, but the BoJ has so far made little headway in raising inflation towards its 2% target.

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*With a debt stock more than double GDP, won't raising rates create mayhem?*

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If Japan does eventually make some progress on inflation, or the BoJ eventually decides that 2% is simply the wrong inflation target and starts to raise rates, what then? When total government debt is in excess of a quadrillion yen (more than double GDP), shouldn't this cause problems? What happens next depends on a number of moving parts, none of which are clear. Does inflation actually rise, lifting bond yields, but also likely raising nominal GDP. Does real GDP growth remain good, but inflation, and bond yields remain low, even as the BoJ hikes rates? Do we get something in between?

## Rate hike this year is perfectly plausible

With the lion's share of outstanding Japanese government debt of 10 years of longer maturity, even a return to 2% inflation and benchmark bond yields rising to a similar level will take some time to feed through into the government's effective debt financing rate. But in our 'high' scenario, where bond yields and inflation both rise to around 2.0%, this adds a full percentage point of GDP to government debt service costs by 2028. Still, this isn't a catastrophe, and if government

revenues are also rising in line with nominal GDP, this should be quite manageable. In our 'low' scenario, where inflation and bond yields remain low, despite good real GDP growth, then the debt service costs will simply converge on the weighted average of long- and short-term bond yields times the debt stock as a proportion of GDP. There is, therefore, a perfectly plausible scenario in which the BoJ hikes rates this year. We don't think it will, however. We suspect the BoJ will wish to see current real growth rates maintained for longer before relinquishing the comfort blanket of quantitative and qualitative monetary easing. And it will want to see some improvement in inflation. We doubt the latter will be forthcoming, even if the former remains strong. But it is not as silly an idea as it once sounded.

This article comes from our Monthly Economic Update. Download [the full report here](#).

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Regional Head of Research, Asia-Pacific

[robert.carnell@asia.ing.com](mailto:robert.carnell@asia.ing.com)

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[chris.turner@ing.com](mailto:chris.turner@ing.com)

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