Developments in Regional Financial Conditions

Financial conditions in emerging East Asia slightly weakened from 1 March to 31 May on a delay in the expected rate cut in the United States (US).[1] The widely expected US rate cut in June was delayed due to a slower-than-expected disinflation path and related uncertainty. Higher-for-longer interest rates in the US pushed up bond yields in both advanced economies and emerging East Asia, and contributed to a strengthening US dollar and widening risk premiums in most regional markets during the review period. Association of Southeast Asian Nations (ASEAN) markets recorded bond and equity portfolio outflows during the review period. Risks to regional financial conditions remain tilted to the downside, as lingering geopolitical risks and weather-related shocks add uncertainty to the future inflation path and monetary policy adjustments.

Local currency (LCY) sovereign bond yields rose for both 2-year and 10-year tenors in major advanced economies from 1 March to 31 May, largely driven by persistent inflation and expectations of higher-for-longer interest rates (**Table A**). The timing of policy rate cuts in the US remains uncertain due to sticky inflation that lingers above the 2% target. In the euro area, the central bank proceeded with a widely expected rate cut in June; however, uncertainty persists with regard to future monetary policy direction after that. In the case of Japan, the rise in yields was driven by the Bank of Japan's (BOJ) tightening monetary stance as it ended its quantitative and qualitative easing program in March (with a prospect for further tightening).

During the review period, 2-year and 10-year government bond yields in the US rose on uncertainty in the timing and magnitude of expected rate cuts. The slow decline in inflation and ongoing geopolitical tensions generated uncertainty about the path of inflation. During the review period, the Federal Reserve turned hawkish about possible interest rate cuts. At its 19–20 March Federal Open Market Committee (FOMC) meeting, the

Table A: Changes in Financial Conditions in Major Advanced Economies and Select Emerging East Asian Markets from 1 March to 31 May 2024

	2-Year Government Bond Yield (bps)	10-Year Government Bond Yield (bps)	5-Year Credit Default Swap Spread (bps)	Equity Index (%)	FX Rate (%)
Major Advanced Economies					
Germany	21	25	–	1.8	0.1
Japan	22	35	1	1.7	(4.6)
United States	34	32	–	2.7	–
Select Emerging East Asian Markets					
People's Republic of China	(28)	(6)	(2)	2.0	(0.6)
Hong Kong, China	19	3	–	9.0	0.1
Indonesia	44	28	3	(4.7)	(3.4)
Republic of Korea	(0.2)	10	3	(0.2)	(3.9)
Malaysia	9	4	8	3.8	0.8
Philippines	19	51	6	(7.0)	(4.3)
Singapore	15	25	–	6.4	(0.5)
Thailand	25	25	1	(1.6)	(2.3)
Viet Nam	64	52	(10)	0.3	(3.2)

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.

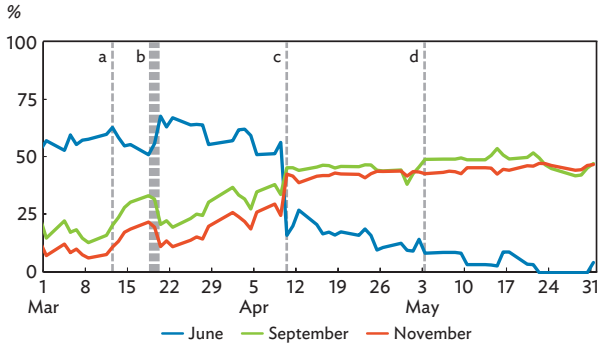
Note: FX rates are presented against the United States dollar. A positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currency against the United States dollar.

Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

[1] Emerging East Asia is defined to include member states of the Association of Southeast Asian Nations (ASEAN) plus the People's Republic of China; Hong Kong, China; and the Republic of Korea.

Federal Reserve held steady the federal funds target rate range at 5.25%–5.50% and announced it still expected three rate cuts in 2024. This supported expectations that the Federal Reserve would make its first rate cut in June, with the CME FedWatch Tool's probability of a June rate cut increasing from 50.8% on 18 March to 67.4% on 20 March. However, the March FOMC meeting minutes, released on 10 April, noted uncertainty over the persistence of high inflation, as data releases did not support the view that inflation was heading sustainably toward its goal. Federal Reserve officials further bolstered their hawkish tone in subsequent pronouncements, reinforcing expectations that the Federal Reserve did not expect to reduce its policy rate until it had greater confidence that inflation was moving toward the 2% target.[2] During the 30 April–1 May FOMC meeting, Chairman Jerome Powell ruled out the possibility of a rate hike at the June FOMC meeting, noting that inflation had not progressed toward its goal. Moreover, on 11 May, Federal Reserve Governor Michelle Bowman said that she saw no reason for the Federal Reserve to cut rates in 2024. As a result, the likelihood of the first rate cut in June, as indicated by the CME FedWatch Tool, plunged from 67.4% on 20 March to 9.3% on 1 May and further to 4.4% on 31 May (**Figure A**). During its 11–12 June FOMC meeting, the Federal Reserve left the policy rate unchanged, as widely expected, and revised the federal funds target rate forecast from three cuts each in 2024, 2025, and 2026 to one cut in 2024 and four cuts each in 2025 and 2026. On 31 May, the market was pricing in the probability of the Federal Reserve's first rate cut of 25 basis points (bps) occurring in September at 47.0%, up from 14.9% on 1 March, and occurring in November at 46.6%, up from 7.3% on 1 March (Figure A).

Figure A: Probability of the First 25 Basis Points Rate Cut at the June, September, or November 2024 Federal Open Market Committee Meeting



FOMC = Federal Open Market Committee.

Note: Data are as of 31 May 2024.

a Release of higher-than-expected February consumer price inflation.
b March FOMC meeting with the Federal Reserve dotplot indicating three rate cuts still likely in 2024.
c Release of March FOMC minutes with participants indicating the need for greater confidence to bring inflation toward its 2% goal.
d Release of April nonfarm payroll employment, which fell sharply from March level.

Source: CME FedWatch Tool.

A sound economic performance and slow progress toward the Federal Reserve's 2% inflation target in the US supported the delay in rate cuts. Consumer price inflation continued to tick downward, coming in at 3.3% year-on-year (y-o-y) in May versus 3.4% y-o-y in April and 3.5% y-o-y in March. Core inflation, which excludes volatile items such as food and energy, also trended down to 3.4% y-o-y in May from 3.6% y-o-y in April and 3.8% y-o-y in March. However, disinflation progress has been slow amid pending upside risks from geopolitical tensions and adverse weather conditions. The Federal Reserve raised its 2024 and 2025 Personal Consumption Expenditures inflation forecasts in June to 2.6% and 2.3%, respectively, from 2.4% and 2.2% in March. While disinflation progress has been slow, the US economy remains sound. Although annualized gross domestic product (GDP) growth slowed to 1.3% in the first quarter (Q1) of 2024 from 3.4% in the previous quarter, in March the Federal Reserve upgraded its GDP projections for 2024 and 2025 to 2.1% and 2.0%, respectively, from projections of 1.4% and 1.8% made in December. US GDP forecasts were left unchanged at the June FOMC meeting. Meanwhile, the unemployment rate remained low at 3.9% in April and 4.0% in May. On 7 June, the release of nonfarm payroll data showed additions had improved to 272,000 in May from 165,000 in April. The combination of a strong labor market and slow progress in steering inflation toward a sustainable level led the Federal Reserve to extend its hawkish stance.

Government bond yields rose in the euro area during the review period, reflecting uncertainty about the European Central Bank's (ECB) monetary policy path following its rate cut in June. The ECB kept its key interest rates unchanged at its 10–11 April meeting, with the minutes indicating that a rate cut at its June meeting was likely if growth and inflation developments

[2] These include talks in April made by Federal Reserve Governor Michelle Bowman, Federal Reserve Bank of Dallas President Lorie Logan, and Federal Reserve Bank of Kansas City President Jeff Schmid.

were in line with ECB projections and inflation "was converging to target in a sustained manner." On 14 May, Dutch central bank Governor Klaas Knot stated that it would be appropriate to remove some monetary restrictions if growth and policy developments remained on track. On 15 May, Bank of France Governor Francois Villeroy de Galhau said that the initial rate cut would likely take place in June. On 21 May, ECB President Christine Lagarde noted that if incoming data confirm the ECB's view that the 2% inflation target is within reach, then it is highly likely that the ECB would cut rates in June.

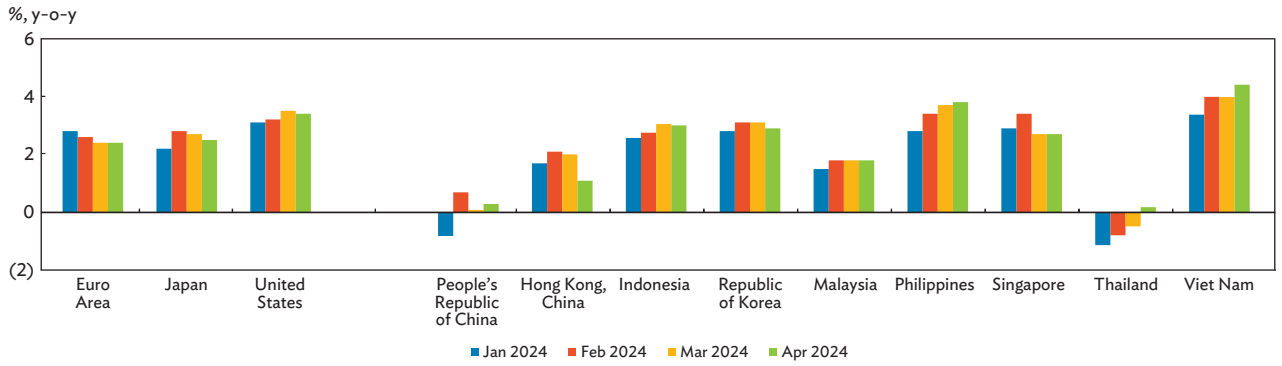
The ECB, as widely expected, reduced by 25 bps its key policy rates in its 6 June meeting but noted the magnitude and timing of subsequent rate cuts remain uncertain amid upside risks to the inflation outlook. Such risks include uncertainty in food prices due to extreme weather events and uncertainty in oil prices due to wider conflict in the Middle East. Annual inflation in the euro area trended down to 2.4% in March and April from 2.6% in February and 2.8% in January. The ECB's revised projection for 2024 indicated that inflation is stickier than previously expected, with 2024 inflation projected at 2.5% in June compared with a 2.3% projection in March. The corresponding inflation forecast for 2025 was also raised to 2.2% from 2.0%. The European Commission's inflation forecasts for the euro area were also revised down to 2.5% and 2.1% for 2024 and 2025, respectively, from 2.7% and 2.2%. Meanwhile, the economic outlook remains robust. GDP growth rose to 0.4% y-o-y in Q1 2024 from 0.2% y-o-y in the previous quarter. In June, the ECB upgraded its 2024 GDP growth forecast to 0.9% from 0.6% in March, largely due to robust wage growth driving household spending. May inflation rose slightly to 2.6% y-o-y, confirming uncertainty over the future monetary policy path.

During the review period, Japan's bond yields rose on the BOJ normalizing its monetary policy. Japan's inflation remains above the BOJ's 2% target, with consumer price inflation trending down from 2.8% y-o-y in February to 2.7% y-o-y in March and 2.5% y-o-y in April. In its April meeting, the BOJ adjusted upward its 2024 and 2025 inflation forecasts to 2.8% and 1.9%, respectively, from January forecasts of 2.4% and 1.8%. At its 18–19 March meeting, the BOJ ended its quantitative and qualitative monetary easing by ceasing yield curve control, the negative interest rate, and the asset purchase program of exchange-traded funds and real estate investment trusts. The central bank announced the shift to using the short-term interest rate (uncollateralized overnight range) as its primary monetary policy tool and decided to increase the range of the uncollateralized overnight call rate to 0.0%–0.1% from a range of –0.1% to 0.0%. The BOJ will gradually reduce and eventually end its purchase of commercial paper and corporate bonds in about a year. In its announcement of the change in its monetary policy framework, the BOJ stated that its large-scale monetary easing program had fulfilled its purpose, judging that the previous inflation target of 2.0% could now be achieved in a stable and sustainable manner.

The BOJ also signaled the possibility of further tightening. On 8 May, BOJ Governor Kazuo Ueda said that it would be appropriate to reduce the Japanese Government Bond purchasing plan as the BOJ normalizes its monetary policy. In the Summary of Opinions at the Monetary Policy Meeting released on 9 May, the BOJ stated that the degree of monetary policy accommodation will be adjusted once "the outlook for economic activity and prices will be realized and underlying inflation will increase." Per the BOJ statement, if the current forecasts are achieved, the expected BOJ policy rate will be higher than what the market is currently pricing in. Further, at its 13-14 June monetary policy meeting, the BOJ left unchanged its policy rate but announced that it would begin to reduce Japanese Government Bond purchases, subject to a finalized plan to be released at its July monetary policy meeting.

LCY government bond yields in emerging East Asia rose for 2-year and 10-year tenors across the region, largely on persistent domestic inflation in a few regional markets in recent months and rising yields in advanced markets. The persistent inflation was related to weather disturbances and geopolitical tensions that added pressure to commodity and food prices (**Figure B**). Persistent inflation coupled with the Federal Reserve's delay in cutting rates to support expectations of possible higher-for-longer interest rates in regional markets (**Table B**). In April, Bank Indonesia raised its policy rate by 25 bps to 6.25% to safeguard its currency. Meanwhile, other regional central banks signaled delays in possible rate cuts. Bank of Korea Governor Rhee Chang-yong noted that, while there were expectations for interest rate cuts in the second half of the year, uncertainty over their timing had risen. The Bank of Thailand maintained the policy rate on 10 April at 2.50% despite the government's pressure for a rate cut, noting that inflation would gradually move toward the target range by the end of 2024. In March and April, regional bond markets witnessed net portfolio

Figure B: Inflation in Major Advanced Economies and Select Emerging East Asian Markets



y-o-y = year-on-year.
Sources: Various local sources.

Table B: Changes in Monetary Stances in Major Advanced Economies and Select Emerging East Asian Markets

Economy	Policy Rate 1-May-2023 (%)	Rate Change (%)													Policy Rate 31-May-2024 (%)	Change in Policy Rates (basis points)
		May-2023	Jun-2023	Jul-2023	Aug-2023	Sep-2023	Oct-2023	Nov-2023	Dec-2023	Jan-2024	Feb-2024	Mar-2024	Apr-2024	May-2024		
Euro Area	3.00	↑0.25	↑0.25		↑0.25	↑0.25									4.00	↑ 100
Japan	(0.10)											↑0.20			0.10	↑ 20
United Kingdom	4.25	↑0.25	↑0.50		↑0.25										5.25	↑ 100
United States	5.00	↑0.25		↑0.25											5.50	↑ 50
People's Republic of China	2.75		↓0.10		↓0.15										2.50	↓ 25
Indonesia	5.75						↑0.25						↑0.25		6.25	↑ 50
Republic of Korea	3.50														3.50	◆ 0
Malaysia	2.75	↑0.25													3.00	↑ 25
Philippines	6.25						↑0.25								6.50	↑ 25
Singapore	–														–	–
Thailand	1.75	↑0.25			↑0.25	↑0.25									2.50	↑ 75
Viet Nam	5.50	↓0.50	↓0.50												4.50	↓ 100

( ) = negative, ◆ = no change, – = no data.

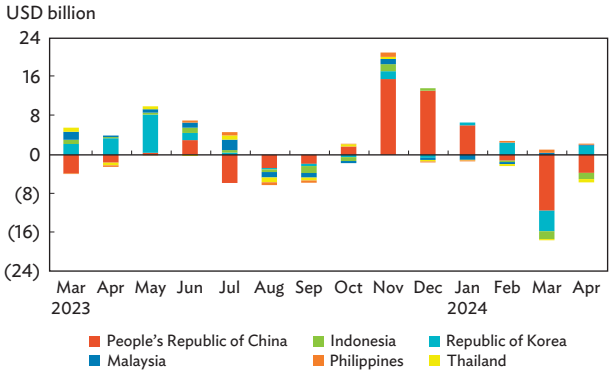
Notes:
1. Data coverage is from 1 May 2023 to 31 May 2024.
2. For the People's Republic of China, the data used in the chart are for the 1-year medium-term lending facility rate. While the 1-year benchmark lending rate is the official policy rate of the People's Bank of China, market players use the 1-year medium-term lending facility rate as a guide for the bank's monetary policy direction.
3. For Japan and the United States, the upper bound of the policy rate target range is reported on the table.
4. The up (down) arrow for Singapore signifies monetary policy tightening (loosening) by its central bank. The Monetary Authority of Singapore utilizes the Singapore dollar nominal effective exchange rate to guide its monetary policy.

Sources: Various central bank websites.

outflows of USD20.0 billion due to a collective rise in bond yields and subdued risk appetite over expected higher-for-longer interest rates (**Figure C**). One exception to this rising yield trend was the People's Republic of China (PRC), where bond yields fell on low inflation and monetary easing to support economic growth and the property market.

Emerging East Asian currencies weakened against the US dollar during the review period, with the dollar strengthening after the Federal Reserve delayed its expected rate cut. Regional currencies weakened by 1.8% (simple average) and 1.1% (GDP-weighted average) from 1 March to 31 May. The currency depreciations mostly happened in March and April, while some strengthening

Figure C: Foreign Capital Flows in Select Emerging East Asian Local Currency Bond Markets

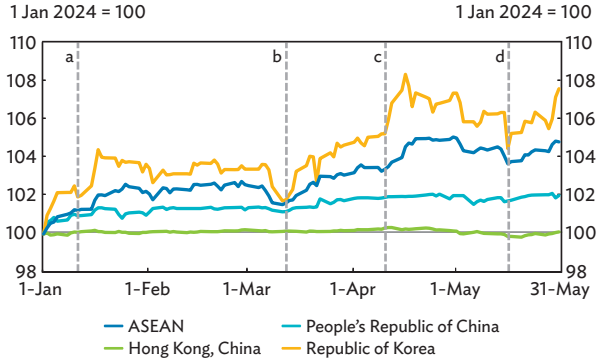


( ) = negative, USD = United States dollar.

Notes:
1. The Republic of Korea and Thailand provided data on bond flows. For the People's Republic of China, Indonesia, Malaysia, and the Philippines, month-on-month changes in foreign holdings of local currency government bonds were used as a proxy for bond flows.
2. Data are as of 30 April 2024.
3. Figures were computed based on 30 April 2024 exchange rates and do not include currency effects.

Sources: People's Republic of China (Bloomberg LP); Indonesia (Directorate General of Budget Financing and Risk Management, Ministry of Finance); Republic of Korea (Financial Supervisory Service); Malaysia (Bank Negara Malaysia); Philippines (Bureau of the Treasury); and Thailand (Thai Bond Market Association).

Figure D: Currency Exchange Rate Movements in Select Emerging East Asian Markets



ASEAN = Association of Southeast Asian Nations.

a Federal Reserve Bank of Cleveland President Loretta Mester says March is probably too early for a rate cut.
b February United States consumer price inflation is reported higher than in the previous month.
c Minutes of 19–20 March Federal Open Market Committee meeting released with participants noting inflation remains persistently high.
d Federal Reserve Bank of Minneapolis President Neel Kashkari says rate cuts should be kept on hold.

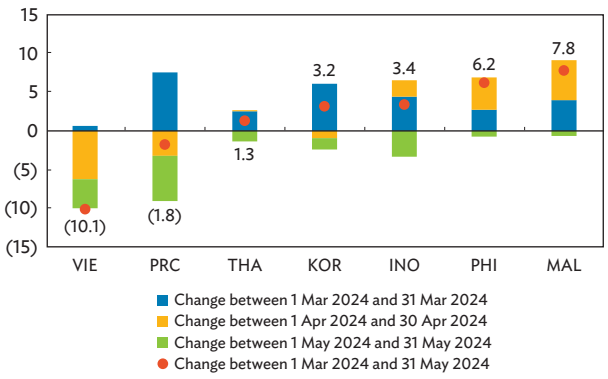
Notes:
1. ASEAN comprises the markets of Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
2. Data are as of 31 May 2024.
3. A higher level indicates currency depreciation against the United States dollar.

Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

was observed in early May following the release of easing US April inflation data compared to March, as well as a large drop in nonfarm payroll additions (**Figure D**). This news raised optimism that the Federal Reserve might consider a rate cut within the year.

Similarly, risk premiums, as measured by credit default swap (CDS) spreads, widened in most markets in the region between 1 March and 31 May. The CDS spread increased by a simple average of 1.4 bps, but narrowed 0.9 bps when GDP-weighted, during the review period. Risk premiums widened across most regional markets in March and April following the announced delay in US rate cuts (**Figure E**). However, CDS spreads narrowed in May as expectations of higher-for-longer interest rates in the US were tempered by data for April nonfarm payroll additions and inflation, both of which were down from March levels. Viet Nam witnessed a large reduction in its risk premium as it was kept on the watchlist in March 2024 for a possible upgrade to secondary emerging market classification by FTSE Russell. The next FTSE Russell review will be in September 2024.

Figure E: Changes in Credit Default Swap Spreads in Select Emerging East Asian Markets (senior 5-year)

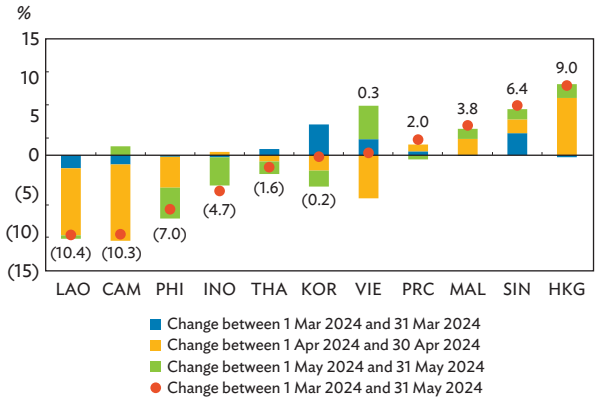


( ) = negative; INO = Indonesia; KOR = Republic of Korea; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; THA = Thailand; VIE = Viet Nam.

Note: The numbers above (below) each bar refer to the change in spreads between 1 March 2024 and 31 May 2024.

Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

Figure F: Changes in Equity Indexes in Select Emerging East Asian Markets

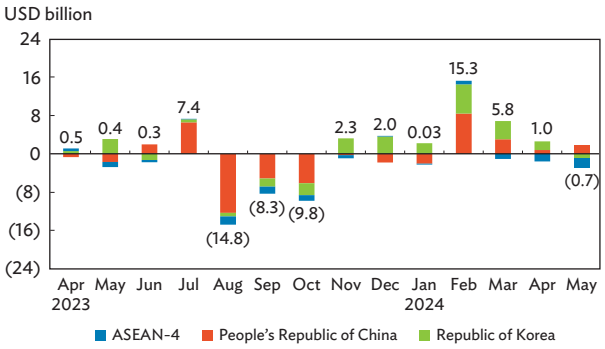


( ) = negative; CAM = Cambodia; HKG = Hong Kong, China; INO = Indonesia; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; THA = Thailand; VIE = Viet Nam.

Note: The numbers above (below) each bar refer to the change between 1 March 2024 and 31 May 2024.

Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

Figure G: Foreign Capital Flows in Select Emerging East Asian Equity Markets



( ) = negative, USD = United States dollar.

Notes:
1. Data coverage is from 1 April 2023 to 31 May 2024.
2. The numbers above (below) each bar refer to net inflows (net outflows) for each month.
3. Emerging East Asia is defined to include member states of the Association of Southeast Asian Nations (ASEAN) plus the People's Republic of China; Hong Kong, China; and the Republic of Korea.
4. ASEAN-4 includes Indonesia, the Philippines, Thailand, and Viet Nam.

Source: Institute of International Finance.

During the review period, regional equity markets recorded mixed performances and posted aggregate portfolio inflows, mainly driven by domestic factors (**Figure F**). Regional equity markets rose an average of 0.9% (simple) and 2.9% (market-weighted), supported by the continued strong economic outlook.[3] The region's equity markets also received USD6.2 billion net inflows during the review period, buoyed by strong inflows in the Republic of Korea and the PRC (**Figure G**). In the Republic of Korea, capital inflows were supported by strong electronic chip demand amid an expected boom in interest in artificial intelligence. In the PRC, investors were encouraged by government efforts to support the stock market such as a plan to eliminate the dividend tax on stocks purchased through Stock Connect as well as the release of a capital reform plan by the State Council, which called for increasing dividend payments, enhancing the security of quantitative funds and strengthening corporate governance. However, ASEAN equity markets in the region recorded outflows of USD4.7 billion during the period over the increased likelihood of higher-for-longer interest rates.

The risks highlighted in the March 2024 edition of the *Asia Bond Monitor* remain relevant, particularly regarding uncertainty surrounding the path of the Federal Reserve's monetary policy adjustment. Regional interest rates may remain elevated, as the Federal Reserve extends its tight monetary policy to address inflationary pressures. Expected higher-for-longer interest rates in the US could heighten risk aversion among investors, contributing to capital outflows and currency depreciations in the region. Higher-for-longer interest rates in the region would also exacerbate the debt burdens of public and private sector borrowers with high leverage.

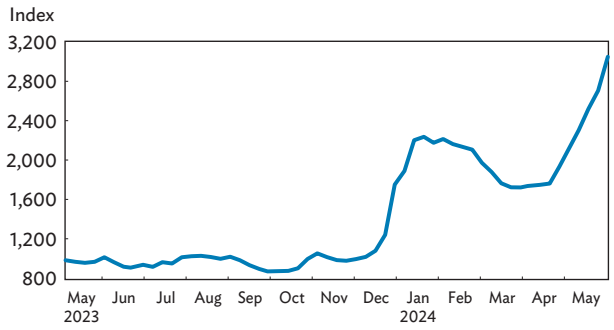
Furthermore, geopolitical risks and extreme weather events have added to the probability of persistent inflation, supporting the likelihood of higher-for-longer interest rates. Ongoing geopolitical and trade tensions have increased freight rates this year. The container freight index, which tracks the cost of shipping containers on major trade lanes from Shanghai, rose 53.8% between 1 March and 31 May—driven by a sharp uptick in May caused by port congestion; container shortages; a surge in electric vehicle shipments to South America ahead of tariffs to be imposed by Brazil and Mexico in July on electric vehicles from the PRC; as well as geopolitical instability, especially from conflict in the Red Sea (**Figure H**). In addition, rising trade tensions between the US and the PRC could hurt domestic and external demand, affecting their respective trading partners.

[3] Asian Development Bank. 2024. *Asian Development Outlook April 2024*. Manila.

Heightened trade and geopolitical tensions could also amplify supply chain disruptions and hinder the progress of disinflation in both advanced economies and emerging East Asia. Adverse weather patterns hold the potential to drive commodity prices higher. The extremely high temperatures and bad weather experienced across ASEAN economies during March–May contributed to the recent increase in food prices. With risks tilted to the downside, it is important to understand how adverse global shocks—including a longer-than-expected tight US monetary policy stance, elevated global financial market uncertainty, and global climate-related risks—could affect the transmission of monetary policy in emerging markets, as discussed in **Box 1**.

In the medium-term, addressing climate change is an important policy matter for the entire region. Financial markets should facilitate the mobilization of substantial climate-aligned investments. Aside from directing funding to green projects in the form of green finance, another important avenue would be to support the low-carbon transition of carbon assets. **Box 2** discusses how transition bonds enable carbon-intensive industries to enhance their environmental sustainability.

Figure H: Shanghai Containerized Freight Index



Notes:
1. Data are as of 31 May 2024.
2. The index reflects the spot rates of the Shanghai export container transport market. It includes both freight rates (indices) of 15 individual shipping routes and a composite index. Shipping routes are the major container trade routes of exports from Shanghai to the following regions: Europe; Mediterranean Sea; United States West Coast; United States East Coast; Persian Gulf; Australia and New Zealand; West Africa; South Africa; South America; West Japan; East Japan; Southeast Asia; Republic of Korea; Taipei,China; and Hong Kong, China.

Source: Based on Bloomberg LP data.

Box 1: Monetary Policy Transmission in Emerging Markets and the Role of Global Factors

There is growing evidence that macroeconomic conditions in emerging market economies (EMEs) have become more synchronized with global factors over the last 2 decades, as EMEs are increasingly integrated into the global economy through real and financial linkages (see, for example, De Leo, Gopinath, and Kalemli-Ozcan 2022; Miranda-Agrippino and Rey 2022).[a] New research by Renzhi and Beirne (2024) at the Asian Development Bank examines the extent to which the effectiveness of monetary policy in EMEs has been affected by global factors, including United States (US) monetary policy, global financial market uncertainty, and the impacts of climate change. Following the panel-local-projections framework proposed by Jordà (2005), Renzhi and Beirne (2024) estimate the impulse responses of key macroeconomic variables to monetary policy shocks in 24 EMEs from 2000 to 2022, conditioning on these global factors.[b]

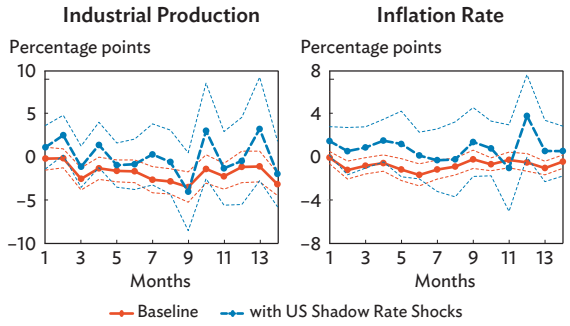
To overcome potential endogeneity concerns, Renzhi and Beirne (2024) estimate a series of identified monetary policy shocks for each of the 24 EMEs. Using a set of structural vector autoregressive models, short-term interest rate changes are orthogonalized against the respective central bank's reactions to the macroeconomic environment, assuming a Taylor-type rule to determine the exogenous component. The estimated residuals can be considered exogenous monetary policy shocks and the source of the impulse response function analysis. The findings revealed that negative global shocks—including tightened US monetary policy, increased uncertainty in global financial markets, and the impacts of climate change—can weaken the transmission channels of monetary policy in EMEs. Specifically, industrial production and inflation are less affected by monetary policy shocks compared to when global factors are isolated. **Figure B1** presents the impacts of contractionary monetary policy shocks on industrial production and inflation, conditioned on the US monetary policy stance.[c]

[a] This box was written by John Beirne (principal economist) of the Asian Development Bank and Nuobu Renzhi (assistant professor) at the School of Economics of Capital University of Economics and Business in Beijing.
[b] The EMEs include Argentina; Brazil; Chile; Colombia; Czechia; Egypt; Hong Kong, China; Hungary; Indonesia; India; Israel; Mexico; Malaysia; the People's Republic of China; Peru; the Philippines; Poland; the Republic of Korea; Romania; the Russian Federation; Singapore; South Africa; Thailand; and Türkiye.
[c] Please refer to Renzhi and Beirne (2024) for the full set of results, including those that condition on global financial market uncertainty and climate change.

continued on next page

Box 1 *continued*

Figure B1: Impulse Responses to a Contractionary Monetary Policy Shock—United States Shadow Policy Rates



US = United States.

Notes: The figure plots the impulse responses of industrial production and inflation to a 100 basis points contractionary monetary policy shock, conditioned on US shadow policy rates. The dashed lines represent the 95% confidence bands. The US monetary policy stance is measured using the shadow policy rate proposed by Wu and Xia (2016), which reasonably reflects both conventional and unconventional monetary policy regimes.

Source: Renzhi, Nuobu, and John Beirne. 2024. Global Shocks and Monetary Policy Transmission in Emerging Markets. ADB Economics Working Paper No. 726; Wu, Jing C., and Fan Dora Xia. 2016. Measuring the Macroeconomic Impact of Monetary Policy at the Zero Lower Bound. *Journal of Money, Credit and Banking* 48 (2–3): 253–91.

The dashed blue lines in Figure B1 represent the estimated impulse responses in percentage points over the following 14 months to a contractionary monetary policy shock interacted with US shadow policy rates. By comparing to the baseline estimates that isolate the impacts of global factors (red solid line), the shocks that control for the US monetary policy stance seem to matter a great deal for monetary policy transmission in EMEs. Conditioned on the US shadow policy rate, unlike the baseline case, the response of industrial production is muted and not significantly different from zero, while the inflation rate exhibits little response. The results remain robust following a series of sensitivity checks that include alternative monetary policy measures.

Economy-specific characteristics across EMEs are also shown to affect monetary policy transmission from global shocks. Specifically, an enhanced degree of financial development can weaken the impacts of global shocks, while more capital account and trade openness can amplify these impacts. Deeper financial development may imply greater shock-absorbing capacity due to greater local market liquidity and financial intermediation efficiency. On the other hand, an economy with a higher degree of global financial integration is more likely to be exposed to external shocks through temporary swings in capital flows, resulting in adverse macroeconomic outcomes.

The results have implications for EME monetary policies and central banks. It is important to build a sufficiently robust and flexible monetary policy operational framework that enables more resilience to external shocks. This can include bolstering the traditional monetary policy toolkit, such as targeted quantitative easing mechanisms. Through an extended toolkit in exceptional circumstances, the mandate of the central bank can be safeguarded while also limiting disruptions to the transmission of traditional monetary policy. Related to this, our findings provide a rationale for policymakers' use of other policy instruments in mitigating the adverse impacts of external shocks. This includes building up ample foreign exchange reserves, thereby enabling the central bank to intervene to mitigate the potential negative effects of global shocks on exchange rates and capital flows. In addition, policies such as macroprudential regulations that involve a broad range of measures aimed at buttressing financial stability could help to dampen the impacts of global financial shocks on economic activity in EMEs. Greater efforts to enhance the coordination of monetary and macroprudential policy, as well as fiscal policy, would also be useful measures.

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Box 2: Promoting Transition Finance

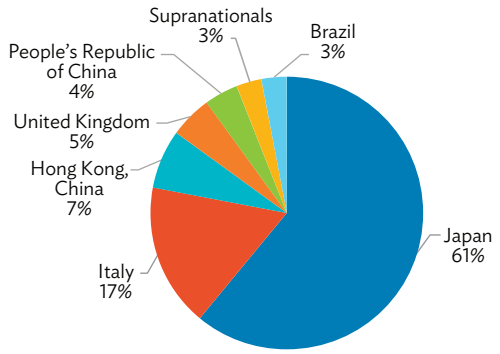
Transition bonds refer to bonds that fund investments that are not necessarily green but result in reduced emissions from high-polluting economic sectors.[a] They currently represent less than 0.5% of the labeled bond market globally—with the most traction to date occurring in the People's Republic of China and Japan, as these two jurisdictions offer specific transition taxonomies. As of 2 April 2024, there were 73 transition bonds outstanding globally placed by 31 different issuers, of which 21 were entities from Japan (**Figure B2**).[b] The Government of Japan is the largest issuer of transition bonds with a 41% global market share.

Transition bonds are currently seen as an Asian-centric instrument and a large part of the growth in this market to date has been driven by official Japanese guidelines for transition bonds that have generated demand among both issuers and investors. Progress has also been made in accelerating the development of transition taxonomies and frameworks in the region via the latest Association of Southeast Asian Nations Taxonomy as well as ongoing efforts by the Hong Kong Monetary Authority. However, similar guidelines are presently lacking in other major economies outside of Asia.

Transition bonds are use-of-proceeds instruments designed to finance specific projects that reduce greenhouse gas emissions and/or support a company's progress toward its decarbonization goals. In contrast, the proceeds raised via sustainability-linked bonds can be used for general corporate purposes, provided it contributes to the bond's embedded long-term sustainability performance targets. In this respect, sustainability-linked bonds are performance-based instruments that allow issuers to commit explicitly to future improvements in sustainability outcomes.

Japan issued the world's first sovereign transition bond in the first quarter of 2024, raising JPY800 billion (USD5.3 billion) via a 10-year tenor. The issuance is part of a JPY20 trillion government program over the next 10 years. The Government of Japan's Climate Transition Bond Framework guided the eligible projects to be funded and received a Climate Bonds Initiative Certification, with second-party opinions provided by the Japan Credit Rating Agency and DNV Business Assurance Japan. The bond's structure was aligned with Japan's Basic Guidelines on Climate Transition Finance and Green Bond Guidelines, as well as the International Capital Market Association's Climate Transition Finance Handbook and Green Bond Principles. The issuance featured an additional layer of credibility as the bond is eligible for inclusion in international green bond funds and indices.

Figure B2: Global Transition Bonds Outstanding by Market *(%)*



Source: Environmental Finance Data (accessed on 2 April 2024).

Despite the very positive approach employed by the government—the deal was 2.9 times oversubscribed, a good but not exceptional result for a Japanese Government Bond auction—the 0.7% coupon was priced at a yield of 0.74%, or 1 basis point (bp) inside where the 10-year Japanese Government Bond was trading. Thus, the "greenium" of 1 bp was smaller than the 2–3 bps greenium usually achieved by Japanese local government issuers of green and social bonds, suggesting that international investor demand for these instruments still has some way to go.

There is anecdotal evidence that the transition bond market is expanding and internationalizing. The Italian utilities provider Snam is now the second-largest transition bond issuer globally, having raised a total of USD4.3 billion from eight issues with tenors of 4–10 years. Snam's green finance framework referenced the International Capital Market Association's Green Bond Principles as supportive standards and is aligned with the European Union's Taxonomy.

Clearly, there is an urgent need for a common global approach to help create a more harmonized transition finance landscape, building on the progress already achieved in Asia. Otherwise, there is a risk of creating a fragmented regulatory landscape for transition bonds reflecting the peculiarities of each jurisdiction. The key to the ongoing success of green and sustainable bond markets is a well-established global standard—be it in use of proceeds or a sustainability-linked format. It is crucial to build the same traction in the transition bond market.

[a] This box was written by Jim Turnbull, deputy director and head of product of the Capital and Financial Markets Development Group at the European Bank for Reconstruction and Development, and Razvan Dumitrescu, head of sustainable finance at Emirates NBD Capital.
[b] Environmental Finance Data (accessed on 2 April 2024).