Developments in Regional Financial Conditions

Financial conditions in emerging East Asian markets weakened from 1 September to 10 November, largely driven by investor expectations that the United States (US) Federal Reserve would keep interest rates higher for longer than earlier anticipated.[1] Inflation in some regional markets also picked up amid elevated food and oil prices during the review period. As a result, emerging East Asian economies experienced a retreat in equity markets, widened risk premiums, currency depreciations against the US dollar, as well as net foreign portfolio outflows. Regional bond yields rose in nearly all markets during the review period, mirroring the upward movement of yields in major advanced economies (**Table A**). Risks to regional financial conditions remained balanced. The downside risk of an extended period of high interest rates posing a threat to financial stability could be offset by factors that support an ending of tight monetary stances, including the expected easing of inflation, headwinds to the economic outlook, and heightened financial risks due to high interest rates.

The rise in long-term bond yields in major advanced economies, especially the US, outpaced the increase in short-term bond yields during the review period, steepening yield curves. Increases in short-term government bond yields in the US and euro area were driven by their respective central banks' decision to hold interest rates higher for longer to address persistent elevated inflation. The rapid rise in long-term bond yields, especially in the US, reflected an increased bond supply and a heavy fiscal burden of rising debt levels and higher interest rates. This was noted by Fitch Ratings when it downgraded the sovereign credit rating of the US from AAA to AA+ on 1 August. In its decision, Fitch Ratings cited an "expected fiscal deterioration in the next [3] years" as well as a high and still growing debt burden as factors for the downgrade. Moody's also revised its US credit rating outlook from stable to negative in November, citing a wider budget deficit. At the end of July, the US Treasury raised its borrowing target in the third quarter to USD1 trillion, which was USD274 billion

Table A: Changes in Financial Conditions in Major Advanced Economies and Select Emerging East Asian Markets from 1 September 2023 to 10 November 2023

	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					
Euro Area	8	17	–	(2.0)	(0.9)
Japan	9	22	10	(0.1)	(3.5)
United States	18	47	–	(2.2)	–
Select Emerging East Asian Markets					
China, People's Rep. of	22	2	0.7	(3.0)	(0.3)
Hong Kong, China	37	25	–	(6.4)	0.5
Indonesia	51	45	5	(2.4)	(2.9)
Korea, Rep. of	17	18	4	(6.0)	0.1
Malaysia	4	5	2	(1.2)	(1.3)
Philippines	30	35	3	(0.3)	1.1
Singapore	(4)	(4)	–	(3.9)	(0.6)
Thailand	25	30	3	(11.0)	(2.5)
Viet Nam	6	5	5	(10.0)	(1.0)

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

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

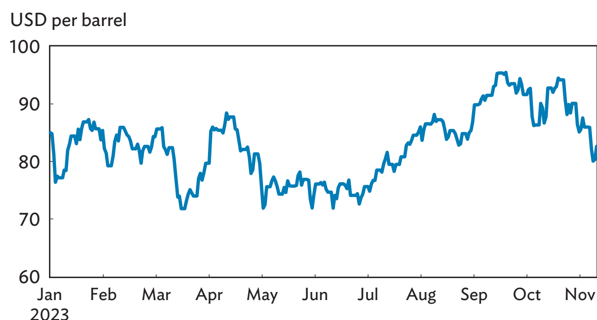
Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

[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.

higher than its initial estimate in May, due to a forecast of lower receipts and higher outlays.[2] The increased supply of US Treasuries needed to finance the deficit pushed up long-term bond yields.

Persistent inflation and a solid job market lent support to the Federal Reserve to maintain higher interest rates for an extended period. The Federal Reserve left the federal funds target rate unchanged at its 19–20 September and 1–2 November Federal Open Market Committee (FOMC) meetings. In its September FOMC meeting, the Federal Reserve raised interest rate forecasts for 2024 and 2025 to 5.1% and 3.9%, respectively, from projections in June of 4.6% and 3.4%. This suggests that the Federal Reserve will keep higher interest rates for longer than previously expected. Subsequently, in its November FOMC statement, the Federal Reserve noted that inflation remains elevated and the labor market has slowed but is still strong. The US inflation rate fell to 3.2% year-on-year (y-o-y) in October over falling energy prices from 3.7% y-o-y in both September and August, but was still above the 2.0% inflation target. Brent crude oil prices had risen to USD95.4 per barrel on 19 September, the highest so far this year, due to supply concerns before falling to USD86.2 per barrel on 5 October as fears of reduced demand from a slowing global economy took hold. The price bounced back to USD94.1 per barrel on 20 October amid the current conflict in the Middle East but had since declined to USD82.6 per barrel by 10 November (**Figure A**). Excluding food and energy, however, core inflation in

Figure A: Brent Crude Spot Price



USD = United States dollar.
Note: Data coverage is from 1 January 2023 to 10 November 2023.
Source: Based on Bloomberg LP data.

the US continued to decline, falling to 4.0% y-o-y in October from 4.1% y-o-y in September and 4.3% y-o-y in August. Nonfarm payrolls declined to 150,000 in October from 297,000 in September. The recent economic performance remained sound in the US, with the annualized quarter-on-quarter gross domestic product (GDP) growth rate climbing to 4.9% in the third quarter (Q3) from 2.1% in the second quarter (Q2) of 2023.

The recent rise in Treasury bond yields, especially long-term bond yields, may suggest there will be no further rate hikes this year. The Federal Reserve noted in its November FOMC meeting that financial conditions have tightened for households and businesses. During the FOMC press conference, Federal Reserve Chair Jerome Powell mentioned that the Federal Reserve will be assessing if there is a need for further rate hikes, fueling speculation that the Federal Reserve is done hiking rates. The CME FedWatch Tool reflected this expectation, with its probability of no rate hike at the December FOMC meeting increasing from 68.9% as of 31 October to 95.2% on 3 November and its probability of 25 basis points (bps) rate hike declining from 28.8% to 4.8% during the same period. Nevertheless, uncertainty remained as Federal Reserve Chair Jerome Powell noted that the FOMC is committed to bring inflation down to its target rate during the International Monetary Fund annual research conference on 9 November. Federal Reserve Governor Christopher Waller on 7 November indicated that the recent US GDP figure was a "blowout" and needs observing. Federal Reserve Governor Michelle Bowman, on 7 November in a speech to the Ohio Bankers League, said that the recent US GDP performance suggests the need for a higher federal funds rate. Dallas Federal Reserve President Lorrie Logan also said that US economic performance has been strong and noted that inflation is still elevated. As a result, the probability of a rate hike at the December FOMC meeting rose to 9.1% as of 10 November.

In the euro area, a weakening economic performance and declining inflation increased the possibility of a halt in rate hikes. The euro area also experienced a rise in both long- and short-term bond yields during the review period as the European Central Bank (ECB) persisted in tightening its monetary policy. The ECB raised its three main interest rates by 25 bps each on 14 September and hinted that current interest rates were now sufficient to

[2] US Department of the Treasury. 2023. "Treasury Announces Marketable Borrowing Estimates." Press Release. 31 July.

bring down inflation in the medium-term, suggesting that it will halt its rate hikes. Subsequently, on 26 October, the ECB left policy rates unchanged at their current levels. The ECB observed weakened demand and restrictive financial conditions that could contribute to easing inflationary pressures. Inflation in the euro area eased from 5.2% y-o-y in August to 4.3% y-o-y in September and further to 2.9% y-o-y in October. Recent data confirmed the weakening economic performance in the euro area. GDP growth fell to 0.1% y-o-y in Q3 2023 from 0.5% y-o-y in Q2 2023 and 1.1% y-o-y in the first quarter of 2023. The ECB revised downward its GDP growth forecasts to 0.7% in 2023 and 1.0% for 2024 in September from forecasts of 0.9% and 1.5%, respectively, in June. Meanwhile, amid rising energy prices, the ECB revised upward its inflation projections to 5.6% for 2023 and 3.2% for 2024 in September from June projections of 5.4% and 3.0%, respectively.

During its 31 October monetary policy meeting, the Bank of Japan (BOJ) announced that its previous 1.0% ceiling on the 10-year government bond yield would now be treated more as a reference or guide, and it ceased purchases of 10-year Japan Government Bonds at a fixed yield of 1.0%. The **Box** presents a brief overview of the BOJ's unconventional monetary policy easing measures in the past decade and discusses their impact on the development of domestic bond markets and exchange rates. The BOJ also released updated forecasts in October from its previous ones in June. GDP forecasts were revised to an annualized 2.0% for 2023 and 1.0% for 2024 in October from 1.3% and 1.2%, respectively, in June. Meanwhile, inflation forecasts were adjusted to 2.8% y-o-y in 2023 and 2024, and 1.7% y-o-y in 2025, from June projections of 2.5% y-o-y, 1.9% y-o-y, and 1.6% y-o-y, respectively. In Q3 2023, Japan's GDP shrank an annualized 2.1% after a robust annual growth of 4.5% in Q2 2023. Inflation has been relatively stable in recent months but remained above the BOJ's 2.0% target, with inflation for August at 3.2% y-o-y, September at 3.0% y-o-y, and October at 3.3% y-o-y.

The recent uptick in food and oil prices and expectations of higher interest rate for a longer period in advanced economies increased the possibility of continued tight monetary stances among regional central banks to address inflationary pressure and safeguard financial stability. While a majority of central banks in emerging East Asia kept their monetary policy rates on hold during the review period, Bank Indonesia raised rates unexpectedly by 25 bps on 19 October to support rupiah stability and avert further capital outflows from its financial market (**Table B**). The Bank of Thailand raised its policy rate by 25 bps on 27 September, following an earlier rate hike in August, as a preemptive move to contain inflationary pressure from supply-side factors, particularly the government's proposed economic stimulus measures. Likewise, the Bangko Sentral ng Pilipinas raised its policy rate by 25 bps in an off-cycle move on 26 October. Amid rising food and oil prices, some markets in the region saw an uptick in inflation in September and October (**Figure B**). While some central banks in the region have reacted or are reacting to the rise in inflation, the Bank of Korea has indicated that it may also raise its policy rate but largely to safeguard financial stability. Higher bond yields and expectations of an extended period of higher interest rates in major advanced markets drove up bond yields in most emerging East Asian markets, where both the 2-year and 10-year yields rose between 1 September and 10 November. The rise in yields in the region were capped somewhat toward the end of the review period following the FOMC's 1-2 November meeting over the possibility that the Federal Reserve may no longer raise policy rates. The exception was in Singapore which saw a decline in its 2-year and 10-year yields during the review period, as headline inflation was stable and its core inflation continued to decline.

Due to expectations that the Federal Reserve will maintain higher rates for an extended period, the US dollar slightly strengthened against most emerging East Asian currencies. The average depreciation for all regional currencies was 1.0% (simple) and 0.4% (GDP-weighted) between 1 September and 10 November (**Figure C**). The Laotian kip suffered the largest decline (–5.1%) on high external debt levels and inflation. The Indonesian rupiah fell by 2.9%, driven by capital outflows from its financial market during the review period. The Thai baht also weakened by 2.5% amid slow GDP growth of 1.5% y-o-y in Q3 2023, versus 1.8% y-o-y in the previous quarter, and a rising fiscal deficit. In contrast, the Philippine peso appreciated marginally due to an influx of remittances ahead of the coming holiday celebrations. The Cambodian riel also strengthened (0.9%), buoyed by central bank intervention to support financial stability.

Box: The Bank of Japan's Unprecedented Decade-Long Monetary Easing and Recent Challenges Caused by the Ultra-Weak Yen

Haruhiko Kuroda's decade-long governorship at the Bank of Japan (BOJ) from March 2013 to early April 2023 marked an important milestone in Japan's unconventional monetary easing policy, which was initiated in 1999.[a] Over the past 25 years, the BOJ has implemented various unconventional monetary easing policies to overcome mild but long-standing deflation. These include a zero-interest rate policy (1999–2000), quantitative easing (2001–2006), comprehensive monetary easing (2010–2013), and qualitative and quantitative monetary easing (QQE) with yield curve control (YCC) (2013–present). The BOJ has become not only a pioneer in pursuing unconventional monetary policies but also a reference point for other central banks. Kuroda was renowned for being a bold monetary easing practitioner (Kowalewski and Shirai 2023a, 2023b). This box will provide a brief overview of the unconventional monetary policy measures the BOJ has undertaken over the past decade and highlight recent changes under the new governor, Kazuo Ueda. The impact of unconventional monetary easing on developments in domestic bond markets and the associated impact on exchange rates will also be explored.

Unprecedented Scale of Monetary Easing Initiated Under Kuroda's Governorship

In January 2013, the Government of Japan, led by the newly elected liberal democratic party, and the BOJ jointly adopted the 2% price stability target, the first single numerical target adopted in line with global standards. Kuroda assumed the governorship of the BOJ in March 2013 and at his first monetary policy meeting the next month he implemented bold, unprecedented monetary easing known as QQE. The new policy featured the adoption of a monetary base control as the operational target, shifting away from the conventional policy rate (uncollateralized overnight call rate) control. The QQE's key aim was to achieve 2% inflation within about 2 years by emphasizing the size of monetary easing by using a monetary base. An annual increase in the monetary base in the range of JPY60 trillion–JPY70 trillion was set by purchasing Japanese Government Bonds (JGBs) worth about JPY50 trillion up to the maximum 40-year maturity, together with exchange-traded funds and Japanese real estate investment trusts.

Before QQE, Japan faced an overvaluation of the yen for an extended period, reflecting low inflation and the yen's safe-haven currency status similar to the Swiss franc. When economic recessions took place as, first a result of the Lehman shock in 2008 and then the East Japan Earthquake and nuclear power plant accident in 2011, the yen appreciated further, adversely impacting Japanese manufacturers. For most of 2010–2011, the exchange rate remained below JPY80 to USD1. This trend was finally reversed in late 2012 when the liberal democratic party won a landslide victory in the general election. Just before the election, the party had begun to stress the need for both a 2% price stability target and unlimited massive monetary easing to achieve the target. Therefore, the formation of a new government generated speculation among investors that massive monetary easing would be forthcoming under the newly elected BOJ governor in the following year.

The depreciation of the yen, together with higher economic growth in 2013, contributed to turning deflation to inflation and increasing long-term inflationary expectations—such as the inflation swap forward (5Y5Y) shifting from a negative rate in November 2012 to 1.0% by the middle of 2016. However, the increase in long-term inflationary expectations did not last long and began to decline from around mid-2014, partly due to the slowdown in economic growth caused by a consumption tax hike in April 2014 and partly due to a sharp decline in oil prices. The increase in the consumption tax from 5% to 8% boosted Japan's inflation by around 2 percentage points to about 4% and generated a substantial price shock, thus reducing household consumption and weakening economic growth. The combination of these factors led the BOJ to expand QQE in October 2014, while the yen depreciated to about JPY125 to USD1 by the middle of 2015 (**Figure B.1**).

In response to unfavorable economic conditions, the BOJ decided to accelerate the annual pace of expansion in the monetary base from JPY60–70 trillion trillion to about JPY80 trillion. To achieve this monetary base targeting, the amount outstanding of JGB holdings was increased through massive purchases of about JPY80 trillion annually. Purchases of exchange-traded funds and Japanese real estate investment trusts were also increased. This revision of the QQE parameters contributed to the further depreciation of the yen, but this depreciation did not translate into higher long-term inflationary expectations this time. In October 2014, the yield of the Japanese yen inflation swap forward (5Y5Y) was well above 1.0%; by early February 2015, it had

[a] This box was written by Sayuri Shirai, an advisor for sustainable policies at the Asian Development Bank Institute, a professor at the Faculty of Policy Management of Keio University, and a former policy board member of the Bank of Japan.

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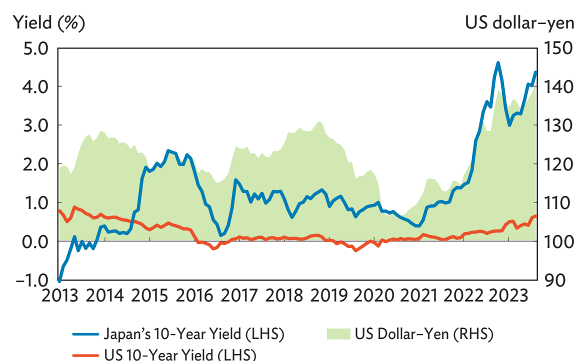
Figure B.1: The Japanese Yen versus the United States Dollar, and the 10-Year Yield in Japan and the United States



LHS = left-hand side, RHS = right-hand side, US = United States.

Source: Federal Reserve Bank of St. Louis. FRED Economic Data (accessed 10 June 2023).

fallen to slightly above 0.6%. In 2016, the BOJ became the fifth major central bank in the world to announce a negative interest rate policy, adding to the policy goals of QQE. The negative rate (–0.1%), however, was applied to only a small portion of the BOJ's current account balance. Adopting a three-tier system with the deposit interest rates of –0.1%, 0%, and 0.1%, the BOJ took every possible effort to minimize the damage of negative interest rates on banks' profitability.

Yield Curve Control as a Turning Point in the Bank of Japan's Monetary Easing

In September 2016, the BOJ introduced YCC, which sought to stabilize the 10-year yield at around 0% in conjunction with the negative interest rate policy. The YCC was a big leap from the QQE since the operation target was changed from the monetary base control to the two short- and long-term interest rates (i.e., –0.1% applied to part of the current account balance and 0% to the 10-year yield). The YCC concept reflected the experience of the United States (US), which set a cap on the yields of 10-year Treasury securities (2.5%) and 3-month Treasury bills (0.375%) during World War II to reduce government deficits driven by increased spending following the US' entry into the war. The BOJ aimed for the YCC to exert strong downward pressure on long-term interest rates and thus stimulate aggregate demand (Amamiya 2017). Meanwhile, market participants widely viewed that the switch to the YCC was undertaken for two reasons. One reason was to correct the tensions created in bond markets due to a substantial concentration of JGB holdings on the BOJ's balance sheet, which accounted for almost 40% of all JGBs outstanding at that time. The resultant scarcity of JGBs reduced liquidity and the functioning of the JGB market. Another was a correction of the 10-year yield, which had fallen into negative territory (–0.25%) and generated negative returns for institutional investors (Figure B.1). The central bank found it increasingly challenging to meet the monetary base target by simply purchasing more JGBs. In addition, the rising scarcity of JGBs reduced liquidity and the functioning of the JGB market. The BOJ thus needed to find a new approach to switch from the quantity-based operational target (Shirai 2018). Under the YCC, the BOJ was able to reduce the amount of JGB purchases steadily and the 10-year yield remained low from 2016 to early 2022.

The COVID-19 Pandemic, Yield Curve Control, and the Yen's Sharp Depreciation

In the face of the coronavirus disease (COVID-19) pandemic, many developed economies took unprecedented monetary and fiscal measures in tandem to mitigate the adverse economic effects caused by lockdowns and mobility controls. While the Federal Reserve and the European Central Bank conducted massive asset purchases, the BOJ's reaction was rather muted in terms of such purchases. Instead, it launched new 1-year lending programs at 0% to foster banks' credit extensions to the private sector while maintaining the YCC. To promote banks' borrowing from the BOJ, the pool of eligible collateral was expanded. The interest rate applied to the BOJ's outstanding current account balances corresponding to the outstanding amounts of these loans was also raised to a range of 0.1%–0.2% to mitigate the adverse impacts of the negative interest rate policy and promote bank lending. This facility was terminated in March 2023.

Under the YCC, the yen–dollar exchange rate remained relatively stable and more or less fair-valued in a range of JPY105–JPY115 to USD1 for more than 5 years. This exchange rate development changed suddenly in 2022, when almost all central banks worldwide started to raise their policy rates to cope with rising inflation. By not raising its rates, the BOJ was the only exception among all developed economies. This interest rate divergence, supported by the YCC, was strong enough to generate substantial yen depreciation. The exchange rate exceeded JPY150 to USD1 briefly in October 2022 and has since reversed to around JPY130–JPY140 to USD1 with substantial fluctuations, mainly reflecting the decline in the 10-year yield in the US, Japan's Ministry of Finance's intervention in the foreign exchange market in September–October 2022, as well as the BOJ's

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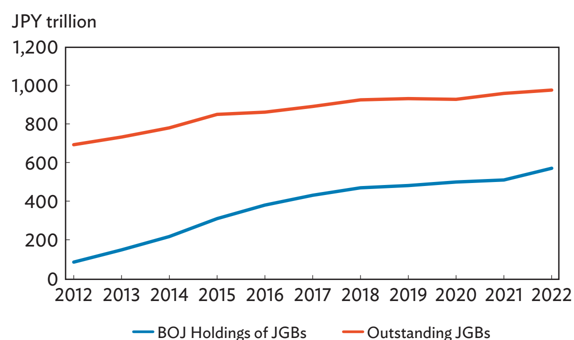
monetary policy adjustment pointed out below. The yen's undervaluation contributed to import inflation and sluggish consumption growth.

In late 2022, the BOJ expanded its tolerance band around the 10-year yield target from ±25 basis points (bps) to ±50 bps. This surprise move created substantial volatility in the JGB bond market, mainly because of the previous rejection of such a policy by the BOJ in September 2022. The decision was made for several reasons—primarily, to correct distortions and improve the functioning of the bond market. This policy adjustment contributed to a reversal of the depreciation of the yen and thus the yen appreciated to around JPY130 per USD1 by early 2023. The first 4 months of 2023 before the end of Kuroda's governorship confirm that this was a step in the right direction since the bond market's functioning improved moderately. Meanwhile, many market participants believe that the BOJ's surprise action was taken to cope with the yen's undervaluation.

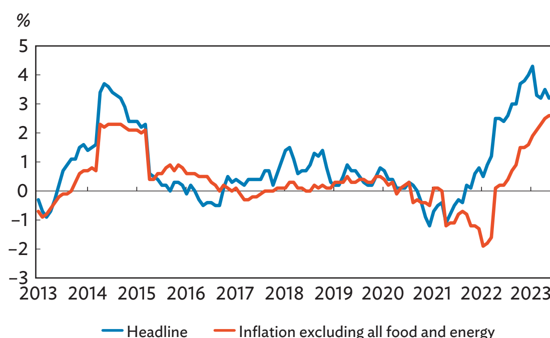
The Japanese bond market has stabilized somewhat since February this year and issues observed in the world banking system caused by the collapse of Silicon Valley Bank and the Credit Suisse scandals did not cause particular tensions from the point of view of preserving the YCC framework. At the same time, the decade-long unconventional monetary experiments ended up expanding the BOJ's balance sheet significantly to JPY735 trillion at end-March 2023 from JPY166 trillion at end-March 2013 and JGB holdings to JPY576 trillion from JPY 91 trillion during the same period, accounting for 53% of outstanding JGBs (**Figure B.2**).

Figure B.2: Japanese Government Bonds Outstanding and the Holdings of the Bank of Japan



BOJ = Bank of Japan, JGB = Japanese Government Bond, JPY = Japanese yen.
Source: Prepared by the author based on Bank of Japan Flow of Funds (accessed 5 September 2023).

Figure B.3: Inflation in Japan



Note: The consumption tax hike from 5% to 8% in April 2014 led to an increase in the headline inflation rate of around 2 percentage points.
Source: Official Statistics of Japan (accessed 7 October 2023).

Over the past decade, Japan gradually moved away from deflation to moderate inflation, and inflation has been above the 2% price stability target since April 2022 (**Figure B.3**). The BOJ's monetary easing, in spite of the scale and various tools adopted, could not achieve the 2% inflation target except when the consumption tax hike in April 2014 briefly resulted in the rate of inflation exceeding 2%. Then, due to commodity price hikes and the depreciation of the yen, the rate of inflation again exceeded 2% in April 2022 and has remained above 3% since August 2022. However, this is mostly cost-push inflation. Currently, about 70% of inflation is due to food price hikes as government subsidies maintain low energy-related inflation. Another nearly 10% of inflation is due to an increase in hotel fees driven by a growing number of inbound tourists, which is partly a result of the sharp depreciation of the yen.

The BOJ has not declared victory, even though inflation has exceeded the 2% target for more than 1 year, since the contributing factors—such as commodity prices and the depreciation of the yen—are external in nature and likely to dissipate. The BOJ therefore maintains monetary easing because inflation is projected to decline toward the end of 2023 and may fall below 2% again in the foreseeable future. However, the likelihood of inflation returning to negative territory is low because of various supply-side factors such as labor shortages, rising production costs in the People's Republic of China (and the relocation of production to Japan and other countries as part of the de-risking process), climate change, and the Russian invasion of Ukraine.

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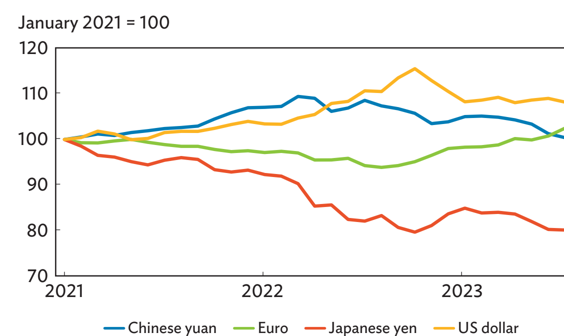
It is yet to be seen how the policies pursued by the BOJ in the last decade will be evaluated in the future. Kuroda's legacy at the BOJ depends on how the BOJ's new governor, Kazuo Ueda, will treat his predecessor's policy. On this front, it is important to conduct a broad-perspective review of monetary policy covering a period of 25 years, which the new BOJ policy board promised to do within 1.0–1.5 years at its first monetary policy meeting in April 2023.

New Challenges for the New Governor

From the beginning, the new BOJ governor stressed the importance of achieving stable 2% inflation based on a virtuous demand-driven, wage-price cycle and the need to maintain monetary easing to do so. At the same time, the governor also pointed out the side effects arising from the YCC—such as distortions in the JGB market—and indicated that such side effect should be dealt with to sustain monetary easing if the BOJ finds that monetary easing will have to be maintained longer than it expects. While market participants expected the BOJ's actions toward normalization, the YCC was maintained at the April and June monetary policy meetings. However, the BOJ increased its flexibility in July by expanding the 10-year ceiling from 50 bps to 100 bps and by keeping 50 bps as the reference.

Since the yen has depreciated against the dollar by about 13% year-to-date in 2023, market participants widely view the BOJ's action as a response to mitigate the yen's excessive undervaluation and the subsequent cost-push inflation, which are hurting consumers and importers. There are no currencies among Japan's major trading partners that have depreciated since 2021 to the same extent as the yen (**Figure B.4**). The resurgence of yen depreciation since late May this year can be attributed to the BOJ signaling that it favors the current pace of monetary easing to achieve stable 2% inflation. The unexpectedly robust US economy, coupled with a services inflation rate (excluding energy) in the 5% range, driven by strong domestic demand and a tight labor market, suggests that there is little likelihood of an interest rate cut in the near term. The Federal Reserve may either raise interest rates once more this year or maintain the current rate until around the middle of 2024. Given this scenario, the BOJ's insistence on maintaining the status quo could benefit yen carry trades due to the stable interest rate differential. Hence, market participants view that the policy adjustment in July 2023 may have been deemed necessary to correct excessive yen depreciation.

Figure B.4: Nominal Effective Exchange Rates of Major Currencies



US = United States.
Source: Bank for International Settlements database (accessed 7 October 2023).

The yen depreciated even further after this policy response because of the expectation that the interest rate differential between Japan and the US would remain large for an extended period. Meanwhile, market participants are increasingly expecting the BOJ to take more steps to normalize monetary policy by the end of next year, including the abolishment of negative interest rates and/or the removal of the 10-year yield target set at around 0% and the abolishment of the 10-year yield control. It is noticeable that the governor recently started mentioning the possibility of ending negative interest rates if the BOJ gains confidence that persistent inflation will be accompanied by wage growth. The market interpreted this as BOJ's efforts to correct excessive yen depreciation by hinting at the possibility of further policy adjustments toward normalization. Thus, the market is likely to continue exerting upward pressure on 10-year interest rates, testing the BOJ's resolve.

Appropriate Steps for Normalization

Finally, let us assume that the BOJ has decided to steer toward normalization, temporarily setting aside the agenda of achieving 2% price stability. In this case, the following sequence for normalization can be envisaged:

First, abolishing the 0.5% reference on 10-year interest rates and establishing a clear range with a 1 percentage point fluctuation margin could be pursued to enhance transparency. Next, eliminating the targeted 0% yield for the 10-year JGB could be examined since the 0% target is no longer binding and the reference rate currently has a more significant impact

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on the prevailing 10-year yield. However, some market participants may interpret this action as another step toward normalization, potentially generating further upward pressure on the 10-year yield. Once the 10-year target is abolished, the next step could be the elimination of negative interest rates applied to part of the excess current account balance, while transitioning to 0%. As having both the 10-year interest rate and short-term interest rates at 0% does not seem desirable from a yield curve perspective, this sequencing is important.

As these steps are taken, it is likely that the volatility of the 10-year interest rate will increase. Furthermore, in the longer term, considering the future natural interest rate and price trends, the 10-year yield might rise above 1%. This reflects that the natural interest rate is expected to rise due to factors such as corporate green and digital investments, the drawdown of savings associated with the retirement of the baby boomer generation, and fiscal factors. In terms of prices, several factors—such as the increasing need for diversifying sources of production and procurement due to geopolitical risks, climate change, and wage increases due to labor shortages—will contribute to the likelihood of higher inflation compared to the period before the COVID-19 crisis.

Therefore, it is necessary for the government and businesses to prepare for a prolonged increase in long-term interest rates. Considering this, it might be appropriate to postpone the abolition of the 10-year interest rate fluctuation range until the public and investor understanding about the direction of monetary policy is strengthened through improved central bank communication.

Lastly, large Japanese companies increased regular wages by around 4% during this year's spring wage negotiations with labor unions, partly in response to the government's call for higher wages and the need to compensate for the rising cost of living. However, Japan's average nominal wage growth from April to August this year, including small and medium-sized companies, was only 1.6%. Average real wage growth remained negative at −2.2%. The BOJ hopes that wage growth may lead to the virtuous demand-driven, wage-price spiral. Currently, however, domestic demand remains weak partly because of negative wage growth. Inflation driven by strong consumer demand seems quite challenging at this stage, given the 2-decades-long period of wage stagnation, an increasing share of the elderly population relying solely on pensions, and expectations of tax hikes considering Japan's public debt. It is thus uncertain whether firms can achieve higher profits by raising productivity and offering higher wages to achieve positive real wage growth on a sustainable basis.

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

Economy	Policy Rate 1-Nov-2022 (%)	Rate Change (%) Nov-2022	Dec-2022	Jan-2023	Feb-2023	Mar-2023	Apr-2023	May-2023	Jun-2023	Jul-2023	Aug-2023	Sep-2023	Oct-2023	Nov-2023	Policy Rate 10-Nov-2023 (%)	Change in Policy Rates (basis points)
Euro Area	0.75	↑0.75	↑0.50		↑0.50	↑0.50		↑0.25	↑0.25		↑0.25	↑0.25			4.00	↑ 325
Japan	(0.10)														(0.10)	◆ 0
United Kingdom	2.25	↑0.75	↑0.50		↑0.50	↑0.25		↑0.25	↑0.50		↑0.25				5.25	↑ 300
United States	3.25	↑0.75	↑0.50		↑0.25	↑0.25		↑0.25		↑0.25					5.50	↑ 225
China, People's Rep. of	2.75								↓0.10		↓0.15				2.50	↓ 25
Indonesia	4.75	↑0.50	↑0.25	↑0.25									↑0.25		6.00	↑ 125
Korea, Rep. of	3.00	↑0.25		↑0.25											3.50	↑ 50
Malaysia	2.50	↑0.25						↑0.25							3.00	↑ 50
Philippines	4.25	↑0.75	↑0.50		↑0.50	↑0.25							↑0.25		6.50	↑ 225
Singapore	–														–	–
Thailand	1.00	↑0.25		↑0.25		↑0.25		↑0.25			↑0.25	↑0.25			2.50	↑ 150
Viet Nam	6.00						↓0.50	↓0.50	↓0.50						4.50	↓ 150

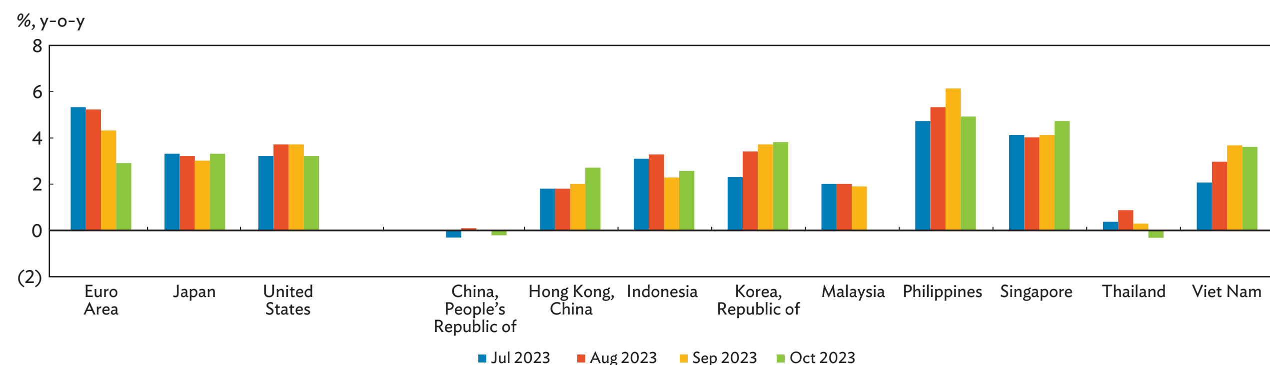
( ) = negative, ◆ = no change, – = no data.

Notes:

1. Data coverage is from 1 November 2022 to 10 November 2023.
2. For the People's Republic of China, 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 monetary policy direction of the People's Bank of China.
3. 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.

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



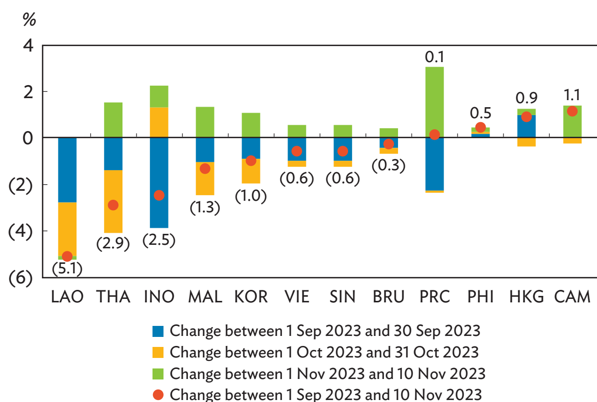
y-o-y = year-on-year.

Notes:

1. Data coverage is from July to October 2023 except for Malaysia (September 2023).
2. For the People's Republic of China, inflation for August and September 2023 was 0.1% y-o-y and 0.0% y-o-y, respectively.

Sources: Various local sources.

Figure C: Changes in Select Emerging East Asian Currencies versus the United States Dollar



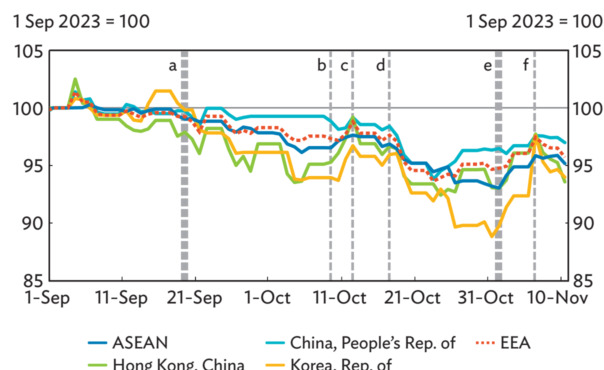
( ) = negative; BRU = Brunei Darussalam; CAM = Cambodia; HKG = Hong Kong, China; INO = Indonesia; KOR = Republic of Korea; LAO = Lao People's Democratic Republic; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; THA = Thailand; VIE = Viet Nam.

Notes:

1. A positive (negative) value for the foreign exchange rate indicates the appreciation (depreciation) of the local currency against the United States dollar.
2. The numbers above (below) each bar refer to the change between 1 September 2023 and 10 November 2023.

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

Figure D: Movements in Equity Indexes in Select Emerging East Asian Markets



ASEAN = Association of Southeast Asian Nations, EEA = emerging East Asia, FOMC = Federal Open Market Committee, PRC = People's Republic of China, US = United States.

a Federal Reserve leaves rates unchanged and signals that it would keep interest rates elevated for a longer period.
b Dovish speeches from Federal Reserve officials.
c September FOMC minutes confirming higher interest rate for a longer period.
d Rising concerns over the current conflict in the Middle East.
e Federal Reserve leaves rates unchanged; notes that financial conditions have tightened.
f Hawkish speeches from Federal Reserve officials.

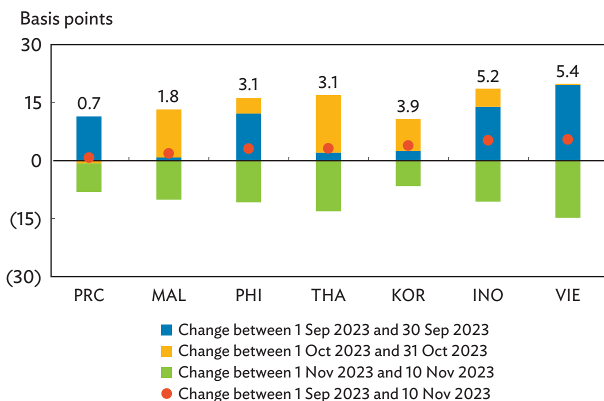
Notes:

1. ASEAN comprises the markets of Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
2. Data are as of 10 November 2023.

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

Gloomy economic outlooks in the region and globally, combined with negative investor sentiments amid expectations of higher-for-longer US interest rates, drove a retreat in most emerging East Asian equity markets and the widening of risk premiums across the region. The region's equity market dropped by an average of 4.9% (simple) and 4.3% (market-weighted) during the review period (**Figure D**). The largest equity losses were recorded in Thailand (–11.0%) and Viet Nam (–10.0%) over doubts about their respective economic prospects. Equity markets in the region posted further losses after the September FOMC minutes were released on 12 October, which indicated an extended period of elevated rates, and subsequently on 17 October over rising concerns about the current conflict in the Middle East. Regional equity markets, however, rebounded after the Federal Reserve left rates unchanged in its November FOMC meeting but the recovery was short-lived as hawkish speeches by some Federal Reserve officials on subsequent days dragged down sentiments in the region's equity markets. Risk premiums, as measured by credit default swap spreads, widened by 3.3 bps (simple average) and 1.4 bps (GDP-weighted average) during the review period (**Figure E**). In some markets, the risk premiums reflect market-specific uncertainties, including a weakened economic outlook. Credit default

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



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 each bar refer to the change in spreads between 1 September 2023 and 10 November 2023.

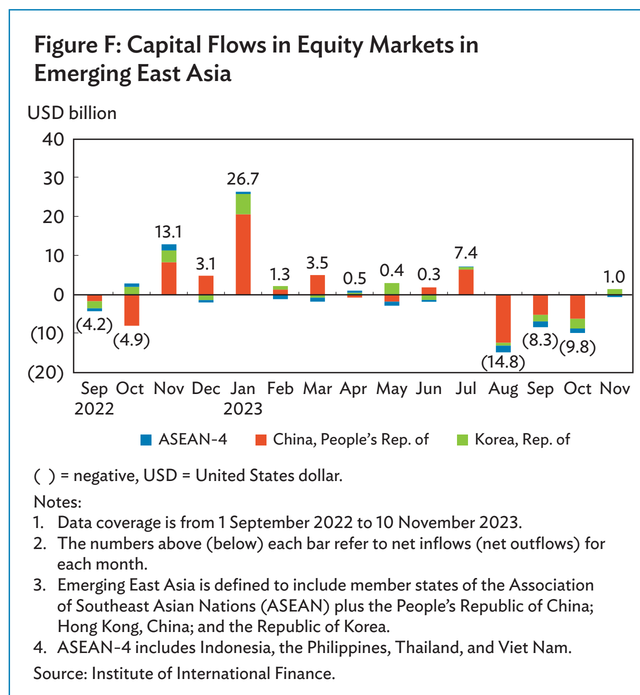
Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

swap spreads in Viet Nam and Indonesia widened the most in the region due to some weakness in their respective export sectors. Viet Nam also faces the risk of missing its 6.5% economic growth target for the year.

The Federal Reserve's signal of keeping interest rates elevated for an extended period dampened investor confidence in emerging East Asian capital markets, driving capital outflows. Regional equity markets experienced net foreign portfolio outflows of USD17.1 billion from 1 September to 10 November (**Figure F**). All markets in the region experienced outflows, with the People's Republic of China (PRC) accounting for the largest share, equivalent to USD11.3 billion, amid moderation in economic performances. The Republic of Korea also saw significant outflows of USD2.6 billion, reflecting the weak performance of the semiconductor industry, which faced a 32.6% decline in exports in the first 9 months of 2023 compared to the same period last year. Among Association of Southeast Asian Nations economies, aggregate net portfolio outflows amounted to USD3.1 billion, with Thailand registering the largest outflows at USD1.3 billion due to policy uncertainties under the new government. Meanwhile, the region's bond markets experienced foreign outflows of USD5.9 billion in September (**Figure G**). The PRC recorded the largest foreign bond outflows at USD1.8 billion in September, driven by economic outlook concerns. In Indonesia, foreign bond outflows of USD1.5 billion were recorded in September when its reported Q2 2023 current account deficit added pressure to the rupiah.

Risks to the region's financial conditions remained balanced. On the downside, the Federal Reserve signaled it would keep interest rates higher for an extended period, which will lead to a longer period of elevated borrowing costs in most regional markets. Higher interest rates pose risks to borrowers with high leverage and liquidity needs to refinance their debts. For example, several high-profile property companies in the PRC have already experienced debt repayment difficulties. In economies where the banking sector has large exposure to these high-leveraged borrowers, the soundness of the banking sector and even the financial sector will be challenged. Similar liquidity stress is also present in the Lao People's Democratic Republic where the government needs to refinance its debt, a sizeable share of which is denominated in foreign currency. To safeguard financial stability, close monitoring of debt sustainability and liquidity conditions will be needed. Meanwhile, high interest rates will generally add to fiscal burdens, which may weaken fiscal conditions in some regional markets

Figure F: Capital Flows in Equity Markets in Emerging East Asia

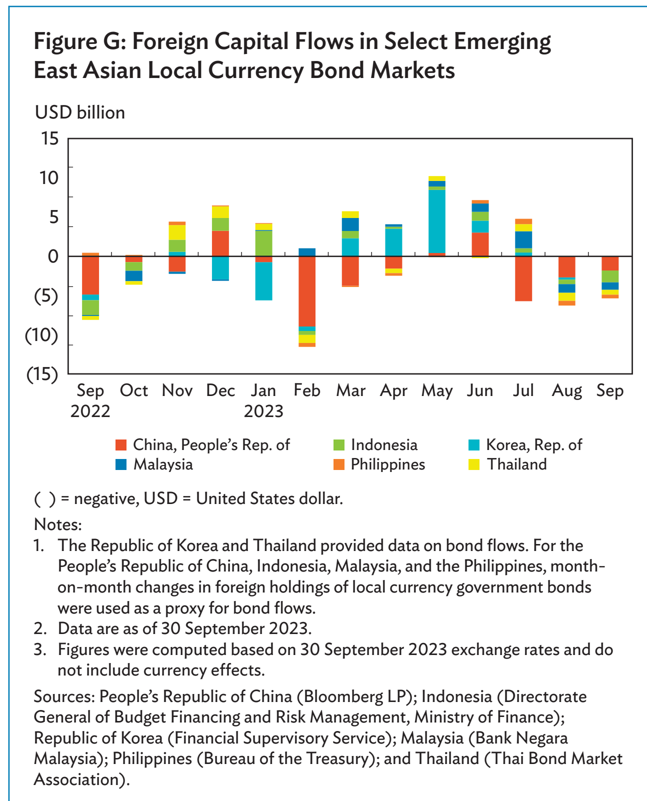


( ) = negative, USD = United States dollar.

Notes:
1. Data coverage is from 1 September 2022 to 10 November 2023.
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.

Figure G: 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 September 2023.
3. Figures were computed based on 30 September 2023 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).

even with sound fundamentals. For example, to support the economy, Thailand has introduced stimulus measures, while Indonesia increased its borrowing plans in the fourth quarter of the year. With higher interest rates, these measures become more costly, weakening the fiscal balance and possibly the local currency too.

On the positive side, inflation rates are largely expected to moderate next year, which, combined with headwinds to the regional economic outlook and heightened financial risks, could possibly ease the pressure of persistently high interest rates. While food and oil prices have risen and pushed up inflation recently, this is likely to be transient and inflation should decelerate next year, based on estimates in the recent *Asian Development Outlook*, and over the medium-term, according to Capital Economics Global Inflation Watch. Previous monetary tightening measures by regional central banks have yet to fully pass through and could also ease inflationary pressures. Moreover, various headwinds weighing on the regional economic outlook, including subdued global demand and a strained property market and weakened domestic demand in the PRC, together with looming financial risks from higher interest rates, may encourage central banks to consider ending their tightening stances to support economic growth.