

Developments in Regional Financial Conditions

Emerging East Asian financial conditions slightly weakened between 2 September and 31 October as the monetary easing of major central banks was offset by rising uncertainty about the trajectory of the United States (US) monetary policy (**Table A**).¹ Regional financial conditions improved in September with the start of the US Federal Reserve's easing cycle, which was followed by easing of some regional central banks. However, uncertainties around succeeding rate cuts by the Federal Reserve and policy adjustments by the new US administration, as well as rising geopolitical tensions, weighed on regional financial conditions. These risks are clouding the outlook for the region's financial conditions. During the review period, local currency bond yields at the short-end fell in most regional bond markets, tracking rate cuts by regional central banks, while 10-year yields mostly rose following the rise in US bond yields and amid uncertainties related to the Federal Reserve's easing and US elections. Most regional currencies marginally depreciated against the US dollar, and credit default swap (CDS) spreads slightly widened. During the review

period, regional equity and bond markets recorded net portfolio outflows due to large net outflows from major regional markets.

Bond yield movements in advanced economies echoed the uncertainty mentioned above. US yields rose despite the September rate cut, while euro area yields fell and Japanese yields ticked up following their respective central bank policy decisions.

In the US, gradual monetary easing is expected. The Federal Reserve cut the policy rate by 50 basis points (bps) during its 17–18 September Federal Open Market Committee (FOMC) meeting, noting that inflation was on track to sustainably reach the 2.0% target and the labor market had slightly weakened. Most Federal Reserve officials have expressed their preference for a gradual pace of monetary policy easing in the coming meetings this year. For example, Minneapolis Federal Reserve Bank President [Neel Kashkari](#) said on 23 September that he expects smaller rate cuts in the future. Federal Reserve Bank of

Table A: Changes in Financial Conditions in Major Advanced Economies and Select Emerging East Asian Markets from 2 September to 31 October 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					
Euro Area	(14)	5	-	(2.9)	(1.7)
Japan	7	4	0.6	(0.6)	(3.4)
United States	25	38	-	1.0	-
Select Emerging East Asian Markets					
People's Republic of China	(0.8)	0.2	7	16.7	(0.01)
Hong Kong, China	26	20	-	14.8	0.3
Indonesia	(2)	18	2	(1.6)	(1.1)
Republic of Korea	(12)	(3)	2	(4.7)	(2.8)
Malaysia	15	16	4	(4.5)	(0.5)
Philippines	(37)	(20)	3	3.2	(3.0)
Singapore	12	8	-	2.8	(1.0)
Thailand	(11)	(15)	2	8.3	1.4
Viet Nam	(2)	(2)	0.1	(1.5)	(1.6)

() = 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.

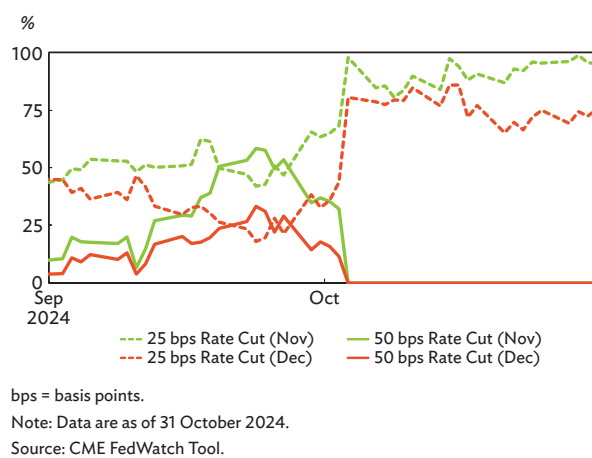
¹ Emerging East Asia is defined to include member states of the Association of Southeast Asian Nations plus the People's Republic of China; Hong Kong, China; and the Republic of Korea.

St. Louis President [Alberto Musalem](#) and Federal Reserve Bank of Dallas President [Lorie Logan](#) also advocated for a slower pace of rate cuts in the future. On 30 September, Federal Reserve Chair [Jerome Powell](#) reiterated that it is unlikely that future rate cuts would be as large as the 50 bps cut in September and, if the economy evolves as expected, to expect two smaller rate cuts by year-end.

Meanwhile, there are lingering concerns about inflation among some Federal Reserve officials, heightening uncertainty over the monetary policy path. On 18 October, Federal Reserve Bank of Atlanta President [Raphael Bostic](#) indicated that he favors patience to avoid potentially derailing the disinflation process. On 24 October, Federal Reserve Bank of Cleveland President [Beth Hammack](#) mentioned that while progress on inflation has been made, inflation remained above the Federal Reserve's 2.0% goal. During the September FOMC meeting, the median federal funds rate forecast was lowered to 4.4% for 2024 and 3.4% for 2025 from 5.1% and 4.1%, respectively, in June. Thus, the Federal Reserve is projecting two more rate cuts of 25 bps each at its November and December monetary policy meetings. Based on the CME FedWatch Tool, the likelihood of a 50 bps rate cut at the November and December FOMC meetings fell from 50.4% and 23.6%, respectively, on 20 September, to 0% and 0%, respectively, on 31 October, while the probability of a 25 bps rate cut at each meeting rose from 49.6% and 26.3%, respectively, to 94.8% and 75.1% (**Figure A**). Policy adjustments by the new US administration may lead to higher budget deficits and increased inflationary pressure, affecting the pace of monetary easing. As widely expected, the Federal Reserve reduced the federal funds rate by 25 bps at its November meeting. In its decision, the Federal Reserve noted some weakening in the labor market and, while moderating, somewhat still elevated inflation. In addition, uncertainty over a December rate cut increased. As projected by the CME FedWatch Tool on 7 November, the likelihood of a 25 bps rate cut in the December meeting fell to 66.6%, while the likelihood of there being no change rose to 31.0%.

While the US economy remains sound, inflation and the labor market's performance will shape the future path of monetary policy. Annualized gross domestic product (GDP) growth for the third quarter (Q3) of 2024 rose to 2.8% due to strong consumer spending, slightly lower compared with the 3.0% expansion in the previous quarter. The composite Purchasing Managers

Figure A: Probability of a 25 Basis Points versus a 50 Basis Points Rate Cut at the November and December Federal Open Market Committee Meetings



Index (PMI) remained in expansionary territory at 54.1 and 54.0 in October and September, respectively, albeit slightly lower than 54.6 in August. Consumer price inflation was higher in October at 2.6% year-on-year (y-o-y) versus 2.4% y-o-y in September and 2.5% y-o-y in August, raising further uncertainty over the path of monetary policy. Core consumer price inflation remained unchanged at 3.3% y-o-y in October from September, but was higher than August's 3.2% y-o-y. Nonfarm payroll additions significantly fell in October to 12,000 from 223,000 in September and 78,000 in August, partly driven by recent weather disturbances and labor strikes. The unemployment rate remained at 4.1% in September and October, which was slightly lower than August's reading of 4.2%. The Federal Reserve updated its macroeconomic projections in September, revising GDP growth for 2024 slightly down to an annualized 2.0% from a 2.1% estimate in June, while keeping the 2025 growth forecast unchanged at 2.0%. The 2024 and 2025 Personal Consumption Expenditure inflation forecasts were revised downward to 2.3% and 2.1%, respectively, from June estimates of 2.6% and 2.3%. Unemployment rate forecasts, however, were revised upward to 4.4% for both 2024 and 2025 from 4.0% and 4.2%, respectively, in the June forecasts.

Bond yields in the euro area declined during the review period following two consecutive rate cuts by the European Central Bank (ECB) over subdued economic performance and moderating inflation. On 12 September, the ECB reduced its deposit facility rate by 25 bps for the

second time this year, citing that inflation continued to moderate as expected. On 30 September, ECB President [Christine Lagarde](#) hinted of another cut at the ECB's October meeting on growing confidence that inflation would fall toward its target path. Many ECB officials noted this too.² Some ECB officials supported additional rate cuts over concerns of weakening economic performance in the euro area. On 2 October, ECB Executive Board Member [Isabel Schnabel](#) highlighted that headwinds to economic growth could not be ignored, and ECB Vice President [Luis de Guindos](#) mentioned that they were in a low-growth environment and that downside risks were high. As widely expected, the ECB reduced key rates by 25 bps at its 17 October monetary policy meeting, noting that economic activity had been weaker than expected.

The ECB's monetary easing path also faces uncertainty. On 22 October, ECB President [Christine Lagarde](#) noted that the monetary policy direction of the ECB was clear but that the pace had yet to be determined, with some arguing for a 50 bps rate cut and others calling for a 25 bps rate cut or an even slower pace of easing. For example, Bank of Portugal Governor [Mario Centeno](#) and Bank of Latvia Governor [Martins Kazaks](#) both indicated on 23 and 24 October, respectively, that a 50 bps rate cut could be considered at the December ECB meeting. Meanwhile, ECB Chief Economist [Philip Lane](#) said on 23 October that while the disinflation process was on track, they had not noted any signs of dramatic weakening in the economy. Bank of Estonia Chairman [Madis Muller](#) also indicated on 24 October that he was not worried about falling behind the curve.

Economic performance in the euro area remained subdued during the review period. GDP growth ticked slightly higher to 0.9% y-o-y in Q3 2024 from 0.6% y-o-y in the previous quarter. The composite PMI inched up to 50.0 in October from 49.6 in September, but was down from 51.0 in August. The manufacturing PMI in the euro area remained below the 50-point threshold in August, September, and October with readings of 45.8, 45.0, and 46.0, respectively. Inflation in the euro area inched up to 2.0% y-o-y in October from 1.7% y-o-y in September, but was down from 2.6% y-o-y in July and 2.2% y-o-y in August. October's reading fell within the ECB's annual 2.0% target for only the second time during the past 3 years. In September, the ECB slightly revised downward its annual GDP growth forecasts for 2024

and 2025 to 0.8% and 1.3%, respectively, from forecasts of 0.9% and 1.4% in June. However, the ECB expects inflation to rise again by the latter part of this year before it trends downward in the second half of 2025. The ECB's annual inflation forecasts were unchanged for 2024 and 2025 at 2.5% and 2.2%, respectively.

In Japan, bond yields rose during the review period over expectations that the Bank of Japan (BOJ) would continue with monetary tightening, despite uncertainties over the timing. The BOJ left policy rates unchanged at its meeting on 20 September but noted that economic growth remained above potential and inflation is expected to rise in 2025. During the press conference for the 20 September BOJ meeting, Governor [Kazuo Ueda](#) mentioned that the BOJ would assess if conditions for further tightening were warranted. On 23 October, BOJ Governor [Kazuo Ueda](#) indicated that the appropriate pace and timing of the rate hikes was still being considered, but emphasized it was important not to wait too long. As expected, the BOJ left its policy rate unchanged on 31 October.

Japan's economy remained sound, with some weakening signs in recent economic indicators supporting a possible delay in the expected rate hike. The seasonally adjusted annualized GDP growth rate moderated to 0.9% in Q3 2024 from 2.2% in the second quarter (Q2) of 2024, amid a decline in investments. The labor market however showed improvement, posting an unemployment rate of 2.4% in September from 2.5% in August and 2.7% in July. Meanwhile, Japan's y-o-y inflation eased in September to 2.5% from 3.0% in August, the lowest level since April. However, the manufacturing PMI remained in contractionary territory, reading 49.2 and 49.7 in October and September, respectively, slightly down from 49.8 in August. Industrial production contracted 2.6% y-o-y and 4.9% y-o-y in September and August, respectively, following 2.9% y-o-y growth in July. The BOJ updated its economic forecasts in October, with the annualized GDP growth forecast for 2024 left unchanged at 0.6% but revised slightly up to 1.1% for 2025 from a July estimate of 1.0%. Similarly, the annual consumer price inflation forecast for 2024 was left unchanged at 2.5% but revised down to 1.9% for 2025 from a July estimate of 2.1%.

Local currency bond yields in emerging East Asia largely declined for 2-year tenors during the review period as inflation remained benign and some regional central

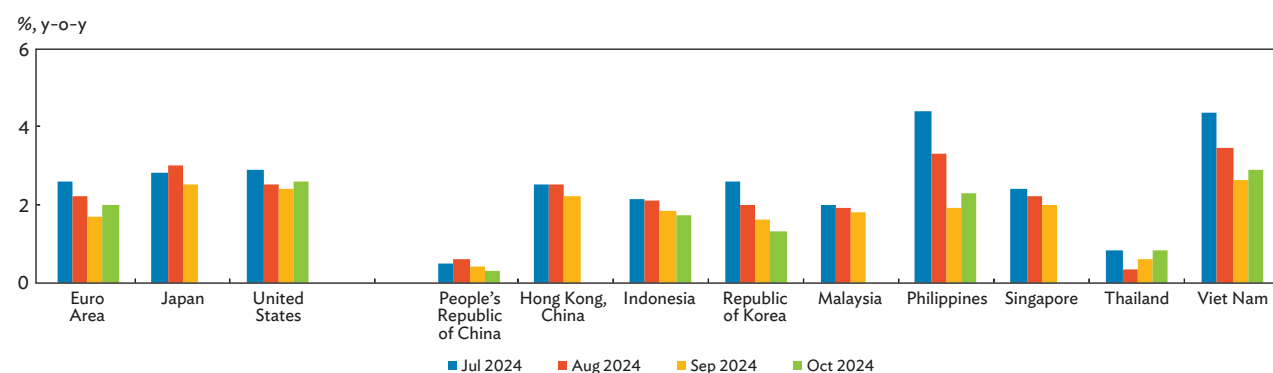
² Several ECB officials noted that a rate cut was forthcoming at the October ECB meeting, including Banque de France Governor [Francois Villeroy de Galhau](#), Bank of Latvia Governor [Martins Kazaks](#), Deutsche Bundesbank President [Joachim Nagel](#), Central Bank of Cyprus Governor [Christodoulos Patsalides](#), and Bank of Greece Governor [Yannis Stournaras](#).

banks began easing monetary policy. In contrast, 10-year yields largely rose, tracking US bond yields, on uncertainties regarding the Federal Reserve's monetary path and US elections. Inflation largely either declined or remained stable across the region. The exception to this trend was the Philippines, where inflation rose to 2.3% y-o-y in October (within the central bank's forecast range of 2.0% to 2.8%) from 1.9% y-o-y in September. Marginal increases were seen in Viet Nam, where inflation rose to 2.9% y-o-y in October from 2.6% y-o-y

in September; and in Thailand, where the inflation rate slightly rose to 0.8% y-o-y in October from 0.6% y-o-y in September. The upticks were largely driven by faster increases in food prices in all three markets (**Figure B**).

Among regional central banks, the People's Bank of China (PBOC) and the Bangko Sentral ng Pilipinas (BSP) conducted the most aggressive monetary easing during the review period (**Table B**). On 23 September, the PBOC announced a slew of monetary easing measures,

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-Oct-2023 (%)	Rate Change (%)												Policy Rate 31-Oct-2024 (%)	Change in Policy Rates (basis points)		
		Oct- 2023	Nov- 2023	Dec- 2023	Jan- 2024	Feb- 2024	Mar- 2024	Apr- 2024	May- 2024	Jun- 2024	Jul- 2024	Aug- 2024	Sep- 2024			Oct- 2024	
Euro Area	4.00										↓0.25			↓0.25	↓0.25	3.25	↓ 75
Japan	(0.10)					↑0.20						↑0.15				0.25	↑ 35
United Kingdom	5.25											↓0.25				5.00	↓ 25
United States	5.50													↓0.50		5.00	↓ 50
People's Republic of China	2.50										↓0.20			↓0.30		2.00	↓ 50
Indonesia	5.75	↑0.25						↑0.25						↓0.25		6.00	↑ 25
Republic of Korea	3.50													↓0.25		3.25	↓ 25
Malaysia	3.00															3.00	◆ 0
Philippines	6.25	↑0.25												↓0.25	↓0.25	6.00	↓ 25
Singapore	-															-	◆ -
Thailand	2.50													↓0.25		2.25	↓ 25
Viet Nam	4.50															4.50	◆ 0

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

Notes:

1. Data coverage is from 1 October 2023 to 31 October 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.

3. For 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.

including a 50 bps cut in the reserve requirement ratio and a 20 bps cut in the 7-day reverse repo rate, both of which took effect on 27 September, as well as a 30 bps rate cut in the 1-year medium-term lending facility rate, which took effect on 25 September.³ Easing price pressures led the BSP to reduce rates by 25 bps each at its August and October meetings. The BSP also announced in September a 250 bps cut in the reserve requirement ratio of universal and commercial banks that took effect on 25 October. Other regional central banks also eased their monetary stances during the review period. Bank Indonesia cut the policy rate by 25 bps on 18 September over moderating inflation. The Bank of Korea cut the policy rate by 25 bps on 11 October amid stable inflation, a weak recovery in domestic demand, and slower GDP growth of 1.5% y-o-y in Q3 2024 versus 2.3% y-o-y in Q2 2024. The Bank of Thailand also reduced the policy rate by 25 bps on 16 October to alleviate the debt servicing burden for borrowers. The State Bank of Vietnam reduced its open market operations interest rate by 25 bps each in August and September to encourage economic activities.

Economic performance in the region slightly weakened, with GDP growth in Q3 2024 moderating in many regional economies. According to the September edition of the *Asian Development Outlook*, the 2024 GDP growth forecast for Southeast Asia was slightly lowered to 4.5% in September from 4.6% in July. This is also in line with the monetary easing stances by many regional central banks. Stronger GDP growth was recorded in Q3 2024 in Singapore due to robust growth in manufacturing and in Viet Nam due to strong consumption (**Table C**). GDP growth in the PRC slightly fell to 4.6% y-o-y in Q3 2024 from 4.7% y-o-y in Q2 2024 over weak domestic demand and slower export growth. GDP growth in both Hong Kong, China and the Republic of Korea declined in Q3 2024 from Q2 2024 due to a weak export performance.

Emerging East Asian currencies were mostly stable, posting a marginal depreciation of 0.3% (GDP-weighted average) and 0.7% (simple average) against the US dollar during the review period. In September, the rate cut by the Federal Reserve led to the collective strengthening of regional currencies by a simple average of 2.0% and

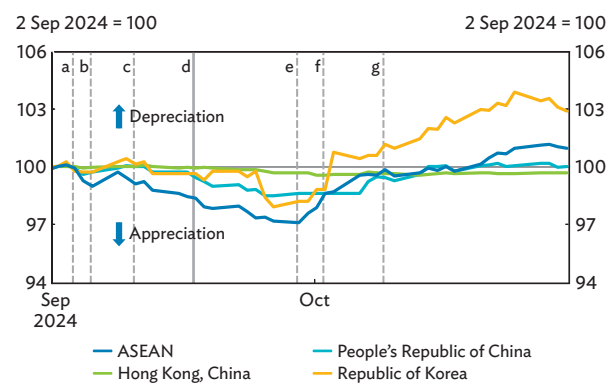
Table C: Gross Domestic Product Growth in Select Emerging East Asian Economies (y-o-y, %)

Economy	2024			Forecast for 2024
	Q1	Q2	Q3	
People's Republic of China	5.30	4.70	4.60	4.80
Hong Kong, China	2.80	3.20	1.80	2.80
Indonesia	5.11	5.05	4.95	5.00
Republic of Korea	3.30	2.30	1.50	2.50
Malaysia	4.20	5.90	5.30	4.50
Philippines	5.80	6.40	5.20	6.00
Singapore	3.00	2.90	4.10	2.60
Thailand	1.60	2.20	3.00	2.30
Viet Nam	5.66	6.93	7.40	6.00

Q1 = first quarter, Q2 = second quarter, Q3 = third quarter, y-o-y = year-on-year.
Notes:

1. Forecasts for 2024 are based on the September 2024 edition of the *Asian Development Outlook*.
 2. Q3 2024 data for the Republic of Korea and Singapore are advanced estimates.
- Sources: Various local sources.

Figure C: Currency Exchange Rate Against the United States Dollar in Select Emerging East Asian Markets



ASEAN = Association of Southeast Asian Nations, US = United States.

- a Federal Reserve's *beige book* shows sluggish and declining economic activity and an uncertain economic outlook.
- b Federal Reserve officials Susan Collins and Christopher Waller advocate for more caution in Federal Reserve easing.
- c US August inflation falls to 2.5% year on year (y-o-y) from 3.0% y-o-y in July.
- d The Federal Reserve reduces its interest rates by 50 basis points to a range of 4.75%–5.00%.
- e Federal Reserve Chair Jerome Powell hints at a slower pace of rate cuts in the future.
- f Stronger-than-expected US labor market data casts uncertainty on the pace of future rate cuts.
- g US September inflation exceeds the forecast of 2.3% y-o-y, stalling disinflation progress.

Notes:

1. ASEAN comprises the markets of Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
2. Data are as of 31 October 2024.
3. A value higher (lower) than 100 indicates currency depreciation (appreciation) against the US dollar.

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

³ In the PRC, the PBOC also said that it would guide loan prime rates and deposit rates lower but has yet to set a date. The PBOC also announced that it will reduce rates on existing home loans and standardize the minimum down payment ratio for home loans. Further measures were announced on 12 October and 18 October, including an additional CNY2.3 trillion special bond quota for local governments, a one-time raise in local governments' debt ceiling, issuance of special sovereign bonds to strengthen the regulatory capital of state-owned banks, a share buy-back facility, and an equity swap facility, among others.

a GDP-weighted average of 1.6%. However, regional currencies weakened following the release of strong US labor market data for September on 3 October (**Figure C**). Heightened uncertainties over the future monetary easing path of the Federal Reserve and US elections led to the depreciation of regional currencies versus the US dollar in October by 2.3% (simple average) and 1.9% (GDP-weighted average). During the review period, the Thai baht posted the largest appreciation, gaining 1.4% over improving investor sentiment following the establishment of the new Thai government. In contrast, the Philippine peso weakened by 3.0% as the BSP was among the most aggressive in monetary easing in the region. Following its second rate cut of the year on 16 October, BSP Governor [Eli Remolona](#) said there was still room for a third 25 bps rate cut at the central bank's Monetary Board meeting in December. The Korean won weakened by 2.8% partly due to capital outflows from the Republic of Korea's equity market.

Uncertainty in the US monetary easing path marginally pushed up risk premiums in emerging East Asian markets from 2 September to 31 October (**Figure D**). Excluding the PRC, the region's CDS spreads—both the simple average and GDP-weighted average—marginally widened by 2.1 bps during the review period. Meanwhile, the CDS spread in the PRC rose by 7.0 bps on a weak economic performance, widening the regional CDS spread by 2.8 bps (simple average) and 6.1 bps (GDP-weighted average).

CDS spreads rose in all regional economies in October, with the exception of Indonesia, due to heightened uncertainty over the Federal Reserve's monetary policy path and US elections. Indonesia's CDS spread narrowed by 0.3 bps in October as investor concerns about the fiscal policy of the new administration abated. This partly reversed a widening of the risk premium in Indonesia in September over concerns that the new administration would increase borrowing to support fiscal spending. In the PRC, risk premiums rose in both September and October on a weak economic outlook.

Regional equity markets posted gains during the review period. Gains were seen mostly in September while markets posted losses in October following the release of stronger-than-expected labor market data in the US in October as well as regional net portfolio outflows in October. Excluding the PRC, regional equity markets gained 2.1% (simple average) and 6.2% (market-weighted average), supported by monetary easing in both advanced economies and domestic markets. The largest gains were seen in the PRC (16.7%) and Hong Kong, China (14.8%) following easing measures enacted by the PBOC and announcements of stimulus measures in the PRC in September and October (**Figure E**). Thailand saw the region's next largest equity market gains during the review period at 8.3% as investor sentiment improved with the establishment of a new government, release of cash handouts, and launch of a state investment fund.

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

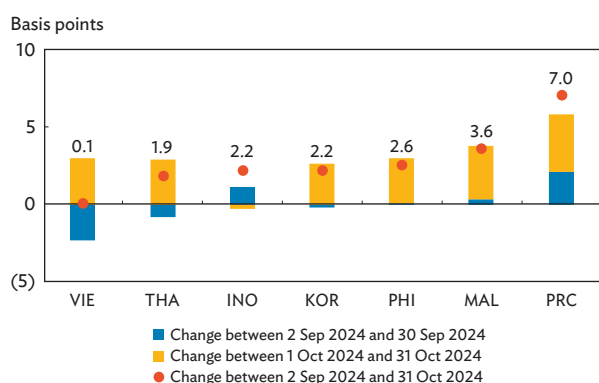


Figure E: Changes in Equity Indexes in Select Emerging East Asian Markets

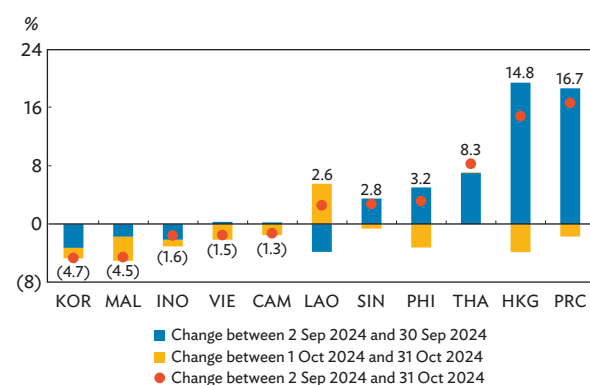
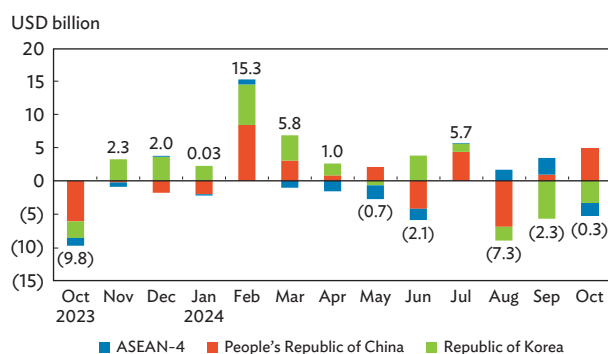


Figure F: Foreign Capital Flows in Select Emerging East Asian Equity Markets


() = outflows, USD = United States dollar.

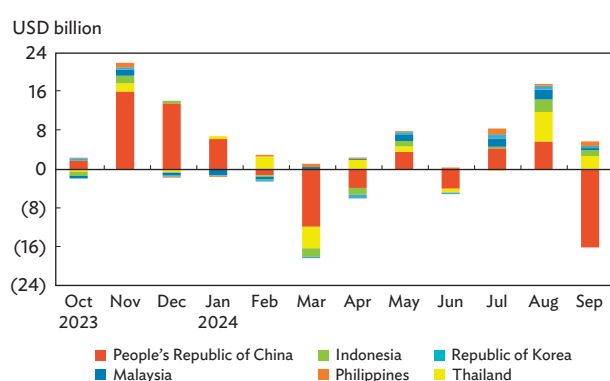
Notes:

1. Data coverage is from 1 October 2023 to 31 October 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.

Regional equity markets recorded net outflows during the review period, driven largely by outflows from the Republic of Korea. In September, net inflows were recorded in the equity markets of ASEAN (USD2.5 billion) and the PRC (USD0.9 billion) amid monetary easing in advanced economies and some regional markets. In October, ASEAN markets posted net portfolio outflows (USD1.9 billion) due to heightened uncertainties over the Federal Reserve's monetary policy path and US elections while the PRC recorded net portfolio inflows (USD5.0 billion) on investor optimism over its stimulus measures. Meanwhile, the Republic of Korea was adversely affected by negative sentiments surrounding the AI industry and lower-than-expected GDP growth, leading to net outflows in both September (USD5.7 billion) and October (USD3.4 billion) (**Figure F**).

In September, regional bond markets recorded net outflows, largely due to outflows from the PRC. Easing monetary policies and moderating inflation generated capital inflows in the rest of the region's bond markets in September (**Figure G**). All regional bond markets, excluding the PRC, posted net portfolio inflows in September amounting to USD5.8 billion on improved investor sentiment over declining inflation across the region and monetary easing in advanced economies. In contrast, the PRC reported net outflows of USD16.1 billion as low yields and economic stimulus prompted investors to shift to equity markets.

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


() = outflows, 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 2024.
3. Figures were computed based on 30 September 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).

Risks to the region's financial conditions outlook remain balanced. On the upside, anticipated easing by central banks throughout the region and in advanced economies is expected to lower borrowing costs and improve financial conditions. This, in turn, will help boost investor confidence and promote economic activities. The regional economy remains robust, and inflation is continuing to moderate. Additionally, a La Niña climate event beginning later this year could create favorable growing conditions for crops, potentially lowering global food prices. These factors are contributing to expectations of continued monetary easing in the region.

There are also several downside risks to the region's financial conditions. In the US, there is uncertainty regarding the pace of the Federal Reserve's monetary easing. The recent strong US labor market data contributed to a less dovish view of future Federal Reserve decisions. A more gradual easing cycle in the US could contribute to monetary policy divergence between the Federal Reserve and regional central banks, heightening uncertainty over exchange rates, capital flows, and asset prices. There is also uncertainty surrounding the policies of the new US administration. The new administration may run higher budget deficits

and escalate trade tensions with major regional economies, which may affect the economic outlook and the future inflation path.

Within the region, uncertainty centers around a possible weaker-than-expected economic performance in the PRC. Given close trade ties, this might deter foreign investment and weaken trade performance in other regional markets, possibly dampening consumer and investor sentiment.

Geopolitical tensions in the Middle East are also casting uncertainty on global financial conditions. Inflationary pressures could rise with the possible further disruption to shipping routes and subsequent rise in oil and commodity prices. Moreover, extreme weather from a La Niña event would increase the risk of flooding and landslides, threatening agriculture and livelihoods, which could potentially push up food prices and slow monetary easing in the region. Climate risks also threaten the fiscal space of the economy, as discussed in the **Box**.

Box: Mitigating the Sovereign Credit Risk Impact of Climate Vulnerability

Climate risks, which refer to the potential adverse socioeconomic impacts of climate change, entail substantial fiscal risks, especially through their adverse effects on fiscal space. For instance, a major disaster due to climate change is likely to necessitate large fiscal outlays for relief and recovery efforts; or, extreme heat resulting from global warming may cause extensive agricultural damage, forcing governments to provide subsidies to hard-hit farmers. At a broader level, public spending on climate change adaptation and mitigation looms as one of the biggest sources of fiscal demands around the world. In combination with other large looming fiscal demands, such as those related to population aging, climate-change-related fiscal expenditures pose a major threat to fiscal space and fiscal sustainability in the future.

Beirne, Park, Saadaoui, and Uddin (2024) examine the impact of climate risks on fiscal space across a sample of 199 economies over the period 1990 to 2022. To measure fiscal space, the paper uses both sovereign bond yields and ratings on foreign-currency, long-term sovereign debt. Higher sovereign bond yields and lower sovereign debt ratings imply higher borrowing costs and default risks, and shrinking fiscal space.

The paper also examines the role of political stability and financial development in mitigating such climate-related fiscal risks. That is, it investigates whether politically more stable and financially more developed economies are less vulnerable to climate-related fiscal risks. Political stability is likely to mitigate these risks since it increases the likelihood of more sustainable fiscal policy—for example, in the form of a more

robust medium-term fiscal framework. As a result, a more stable political environment is likely to reduce the impact of climate shocks and other shocks on fiscal sustainability.

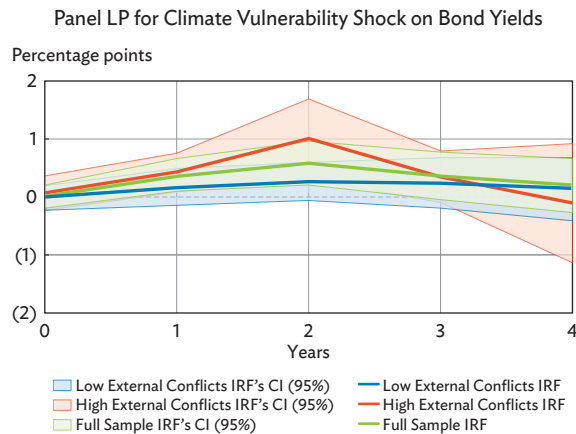
In addition, political stability is conducive to more careful, rational, and cost-effective government planning in response to potential climate shocks, which will help to preserve fiscal space. Financial development is also expected to mitigate climate-related fiscal risks. In particular, in a financially well-developed economy, firms and households will have access to insurance and other financial instruments that protect them from the negative effects of climate shocks. This, in turn, reduces the need for large fiscal outlays and thus mitigates the negative effect on fiscal space. Furthermore, financial development increases the amount of credit available to firms and households to help them cushion the impact of potential climate shocks.

Using panel local projections to estimate the response of sovereign bond yields to climate vulnerability, conditioning on political stability and financial development, the paper finds a significant mitigating role for economies that are more politically stable and have higher levels of financial development. As shown in **Figure B.1**, a one-unit rise in climate vulnerability leads to a statistically significant 1 percentage point rise in bond yields where political stability risks are elevated, with the peak effect at 2 years after the shock. On the other hand, the response of bond yields has no statistically significant impact where political stability risks are more muted. In the case of financial development, as shown in **Figure B.2**, economies with low levels of financial

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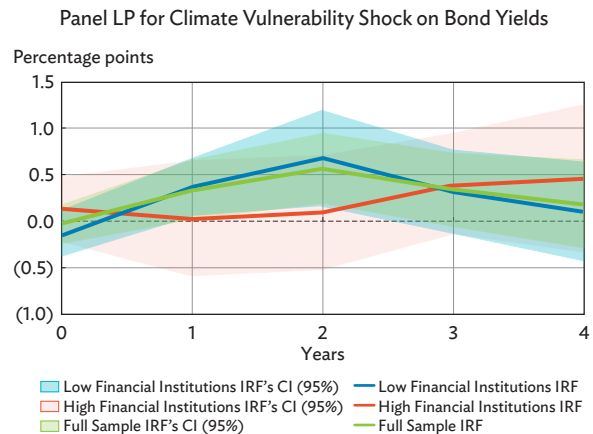
Box continued

Figure B.1: Impact of Climate Risk on Sovereign Bond Yields Conditioned on Political Stability


(-) = negative, CI = confidence interval, IRF = impulse response function, LP = local projection.

Notes: A one-unit shock is imposed on the climate vulnerability variable. The vertical axis denotes the response of sovereign bond yields in percentage points. The horizontal axis denotes the time horizon in years. Low and high levels of external conflict and financial development refer to the lower and upper quartiles within the economy sample.

Source: Beirne, Park, Saadaoui, and Uddin (2024).

Figure B.2: Impact of Climate Risk on Sovereign Bond Yields Conditioned on Financial Development


(-) = negative, CI = confidence interval, IRF = impulse response function, LP = local projection.

Notes: A one-unit shock is imposed on the climate vulnerability variable. The vertical axis denotes the response of sovereign bond yields in percentage points. The horizontal axis denotes the time horizon in years. Low and high levels of external conflict and financial development refer to the lower and upper quartiles within the economy sample.

Source: Beirne, Park, Saadaoui, and Uddin (2024).

development have greater susceptibility to climate-related sovereign risks. Bond yields rise by around 0.6 percentage points for these economies, with a peak effect at 2 years after the shock. Meanwhile, where financial development is high, no significant effect is found.

Overall, the empirical analysis indicates that climate vulnerability adversely affects fiscal space and that the effects are most pronounced in economies that are most vulnerable to climate change, as well as where fiscal space is most constrained. Moreover, it is found that these effects are alleviated in economies with more stable political environments and better developed financial markets.

More precisely, the evidence indicates that climate risks are associated with lower bond risk premiums, as well as higher sovereign ratings, in economies that suffer less from both external and internal conflict. In addition, better financial development weakens the link between climate risks and fiscal space. Financially more developed economies do

not experience a climate-related bond risk premium or a persistent deterioration of sovereign ratings due to climate vulnerability.

While fiscal consolidation is the key to mitigate the adverse effect of climate risks on fiscal space, both political stability and financial development can contribute as well. Political stability is desirable in and of itself, but it can also yield a significant additional benefit in the form of shielding fiscal space from climate risk. Similarly, the results strengthen the case for governments to further promote financial development.

Reference

- J. Beirne, D. Park, J. Saadaoui, and G. Salah Uddin. 2024. Impact of Climate Risk on Fiscal Space: Do Political Stability and Financial Development Matter? *ADB Economics Working Paper*. No. 748. Asian Development Bank.