Developments in Regional Financial Conditions

Improved economic fundamentals in emerging East Asia buoyed investor sentiment in the region.

Financial conditions marginally improved in emerging East Asia from 1 June to 31 August, supported by sound economic fundamentals and regional central banks approaching the end of their respective monetary tightening cycles.[1] As major advanced economies continued with monetary tightening to address inflation, bond yields in advanced economies rose, which pushed up bond yields in most emerging East Asian markets. During the review period from 1 June to 31 August, most regional economies witnessed narrowing risk premiums, gains in the equity markets, and portfolio inflows in the bond markets. Regional currencies slightly depreciated against the United States (US) dollar, as the dollar strengthened on a resilient economic outlook for the US and continued hawkishness by the Federal Reserve. A dimmed economic outlook in the People's Republic of China (PRC) weighed down its domestic financial markets. Looming financial risks remain worth monitoring, as higher interest rates will challenge both public and private sector entities with weak balance sheets and governance. During the review period, debt stress and bond defaults were observed in some regional markets.

Government bond yields in the US rose from 1 June to 31 August, mainly supported by the continued monetary tightening of the Federal Reserve as well as elevated inflation and solid economic conditions (**Table A**). After three consecutive rate hikes in February, March, and May—for a total of 75 basis points (bps)—the Federal Reserve paused hiking rates at its 13–14 June Federal Open Market Committee (FOMC) meeting to reassess economic conditions and the possible effects of banking sector stress on credit availability. Citing elevated inflation and robust job gains, the Federal Reserve resumed with a 25 bps rate hike at the 25–26 July FOMC meeting, as was widely expected, raising the federal funds target rate to 5.25%–5.50%, the highest level since February 2001 (**Figure A**).

Table A: Changes in Financial Conditions in Major Advanced Economies and Select Emerging East Asian Markets from 1 June 2023 to 31 August 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					
Germany	26	22	3	0.6	0.8
Japan	9	23	2	8.9	(4.6)
United States	52	51	–	6.8	–
Select Emerging East Asian Markets					
China, People's Rep. of	(3)	(12)	10	(2.6)	(2.2)
Hong Kong, China	24	29	–	0.9	(0.2)
Indonesia	62	0.9	(5)	4.8	(1.6)
Korea, Rep. of	14	28	(6)	(0.5)	(0.1)
Malaysia	9	13	(12)	5.0	(0.5)
Philippines	33	55	(9)	(4.0)	(0.6)
Singapore	13	25	–	2.1	(0.3)
Thailand	20	27	(5)	2.9	(0.6)
Viet Nam	(80)	(54)	2	13.5	(2.5)

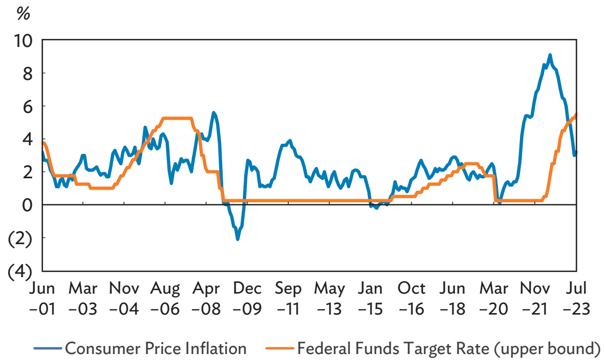
( ) = negative, – = not available, bps = basis points, FX = foreign exchange.

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.

Figure A: Inflation and Federal Funds Target Rate in the United States



( ) = negative.
Note: Data coverage is from June 2001 to July 2023.
Source: Based on Bloomberg LP data.

In the US, bond yields increased during the review period, supported by elevated inflation and a positive economic outlook. The US economy grew an annualized 2.1% per the revised reading for the second quarter (Q2) of 2023, surpassing 2.0% growth in the previous quarter, driven by the rebound in private investment and increases in government expenditure and consumer spending. Consumer Price Index inflation has largely eased, falling from 4.0% year-on-year (y-o-y) in May to 3.0% y-o-y in June and 3.2% y-o-y in July. Core inflation, which excludes food and energy prices, moderated from 5.3% y-o-y in May to 4.8% y-o-y in June and 4.7% y-o-y in July. As inflation stayed well above the 2.0% target, the Federal Reserve remains hawkish. On 15 August, the Federal Reserve minutes showed that while participants noted inflation has trended downward, it is still “unacceptably” high. In line with this, Federal Reserve Chairman Jerome Powell, during the Jackson Hole Symposium on 25 August, said that while inflation has moved down from its peak, it is still too high.

The US labor market slightly softened but remained strong. The unemployment rate rose to 3.8% in August from 3.5% in July and 3.6% in June. Nonfarm payroll additions were lower in June (105,000), July (157,000), and August (187,000) compared to May (281,000). Average hourly earnings growth slowed to 0.2% month-on-month in August from 0.4% month-on-month in July and June. Easing inflation, a slight cooling in the job market, and the recent credit downgrade of 10 mid-sized banks by Moody’s after the FOMC July meeting have led to market expectations of a pause in rate hikes at the upcoming September meeting. The CME FedWatch Tool probability of a 25 bps rate hike at the September FOMC meeting decreased from 22.0% on 27 July, after the July FOMC meeting, to 12.0% on 31 August and 6.0% on 1 September.[2] At the Jackson Hole Symposium, Chairman Powell also indicated that the Federal Reserve would proceed carefully in the next few meetings, suggesting that a pause is likely in the September FOMC meeting.

In the euro area, both 2-year and 10-year bond yields increased on continued monetary tightening by the European Central Bank (ECB) and persistent inflationary pressures. In contrast to the Federal Reserve’s pause, the ECB raised its key interest rate consecutively by 25 bps at its 15 June and 27 July meetings. Inflation in the euro area decelerated from 8.6% y-o-y in January to 6.1% y-o-y in May, then fell further to 5.5% y-o-y in June and 5.3% y-o-y in July. The flash estimate for August inflation was unchanged from the previous month at 5.3% y-o-y. The flash estimate for core inflation, however, weakened to 5.3% y-o-y in August from 5.5% y-o-y in July. The ECB has projected inflation in the euro area will remain elevated for some time as price pressures remain strong. Unlike in the US, the euro area’s economic outlook remains weak. The near-term economic outlook for the euro area has deteriorated, owing largely to weaker domestic demand as high inflation and tighter financing conditions dampen spending. GDP growth in the euro area fell to 0.6% y-o-y in Q2 2023 from 1.1% y-o-y in the previous quarter. In June, the ECB revised downward its 2023 GDP forecast to 0.9% from its March forecast of 1.0%, while it revised upward its inflation forecast to 5.4% from 5.3% in the same period. The European Commission’s monthly economic sentiment index fell to 93.3 in August from 94.5 in July, its fourth straight monthly decline. The weakening economic conditions are increasing the chance of a rate-hike pause at the September meeting, according to a poll of economists by Reuters published on 11 August. ECB Executive Board member Isabel Schnabel mentioned at a conference on 31 August that recent data suggested that the economic outlook had worsened compared to forecasts made in June. As a result, the implied probability of a rate hike at the September ECB meeting fell to 23.9% on 31 August from 54.6% the previous day, based on Bloomberg’s World Interest Rate Probability

[2] CME FedWatch Tool.

for the euro area. Nevertheless, the future path of monetary tightening remains uncertain as ECB President Christine Lagarde previously implied in an interview on 28 July that any possible pause in September could still be followed by further rate hikes.

In Japan, despite inflation consistently exceeding the central bank's target and amid signs of economic recovery, the Bank of Japan (BOJ) maintained its accommodative monetary stance during the review period. Japan's inflation slowed from 3.5% y-o-y in April to 3.2% y-o-y in May before rising marginally to 3.3% y-o-y in June and July, remaining above the BOJ's 2.0% target. In its 15–16 June and 27–28 July meetings, the BOJ kept the short-term interest rate at −0.1% but raised its cap on 10-year government bond yields, through which it offers to purchase 10-year government bonds, to 1.0% from 0.5% set at its July meeting. This resulted in a jump in 10-year government bond yields to around 0.57% on 28 July, the highest level in nearly a decade, from 0.45% the previous day. The BOJ lowered Japan's 2023 GDP forecast to 1.3% in July from 1.4% in April and revised the inflation forecast for fiscal year 2023 to 2.5% in July from 1.8% in April. Meanwhile, Japan's GDP grew an annualized 6.0% in Q2 2023, up from 3.7% in the previous quarter, driven by strong export growth.

Most regional central banks paused and held interest rates at a high level during the review period after aggressive tightening in prior quarters (**Table B**). The region witnessed softening inflation during the past several months, which allowed most regional central banks to keep policy rate hikes on hold, with only the Bank of Thailand raising its policy rate by 25 bps on 2 August. The central bank expects the current positive economic trajectory to continue and is aiming to guard against potential inflationary pressures (**Figure B**).

Bond yields in most emerging East Asian markets continued to rise, partly following higher bond yields in major advanced economies (Table A). The Philippines experienced some of the region's largest increases in the 2-year and 10-year yields, with the 2-year tenor rising 33 bps and the 10-year rising 55 bps, driven by elevated inflation. July inflation in the Philippines remained high at 4.7% y-o-y, the highest in the region among markets where data are available. Both Viet Nam and the PRC experienced yield declines from 1 June to 31 August on monetary easing. Viet Nam recorded the region's largest decline in both the 2-year and 10-year bond yield at 80 bps and 54 bps, respectively, as the State Bank of Vietnam further cut its key policy rates by 50 bps in June—after two consecutive rate cuts

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

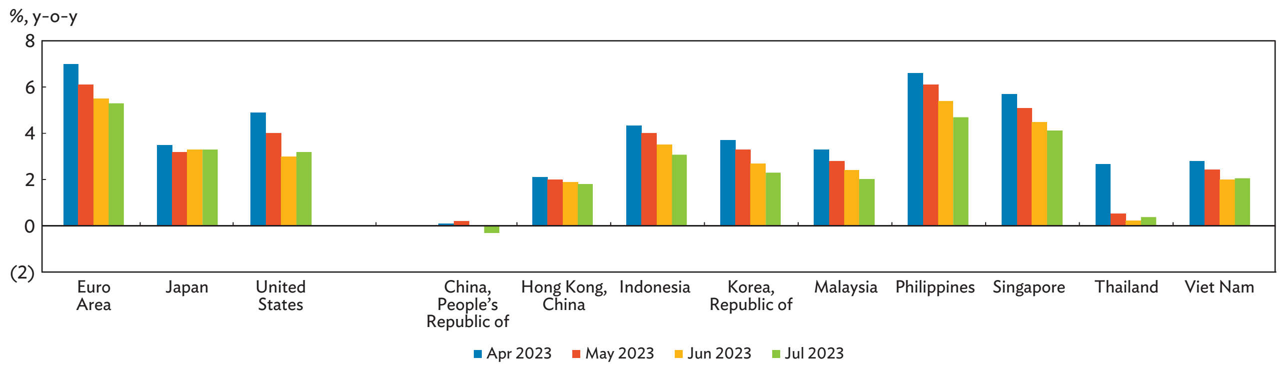
Economy	Policy Rate 1-Aug-2022 (%)	Rate Change (%) Aug-2022	Sep-2022	Oct-2022	Nov-2022	Dec-2022	Jan-2023	Feb-2023	Mar-2023	Apr-2023	May-2023	Jun-2023	Jul-2023	Aug-2023	Policy Rate 31-Aug-2023 (%)	Change in Policy Rates (basis points)
Euro Area	0.00		↑0.75		↑0.75	↑0.50		↑0.50	↑0.50		↑0.25	↑0.25		↑0.25	3.75	↑ 375
Japan	(0.10)														(0.10)	0
United Kingdom	1.25	↑0.50	↑0.50		↑0.75	↑0.50		↑0.50	↑0.25		↑0.25	↑0.50		↑0.25	5.25	↑400
United States	2.50		↑0.75		↑0.75	↑0.50		↑0.25	↑0.25		↑0.25		↑0.25		5.50	↑300
China, People's Rep. of	2.85	↓0.10										↓0.10		↓0.15	2.50	↓ 35
Indonesia	3.50	↑0.25	↑0.50	↑0.50	↑0.50	↑0.25	↑0.25								5.75	↑ 225
Korea, Rep. of	2.25	↑0.25		↑0.50	↑0.25		↑0.25								3.50	↑ 125
Malaysia	2.25		↑0.25		↑0.25						↑0.25				3.00	↑ 75
Philippines	3.25	↑0.50	↑0.50		↑0.75	↑0.50		↑0.50	↑0.25						6.25	↑300
Singapore	–			↑											–	–
Thailand	0.50	↑0.25	↑0.25		↑0.25		↑0.25		↑0.25		↑0.25			↑0.25	2.25	↑ 175
Viet Nam	4.00		↑1.00	↑1.00						↓0.50	↓0.50	↓0.50			4.50	↑ 50

( ) = negative, – = no data.

Notes:
1. Data coverage is from 1 August 2022 to 31 August 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 Advanced and Select Emerging East Asian Economies



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

Notes:

1. Data coverage is from April to July 2023.
2. For the People's Republic of China, inflation for April and June 2023 were 0.1% y-o-y and 0.0% y-o-y, respectively.

Sources: Various local sources.

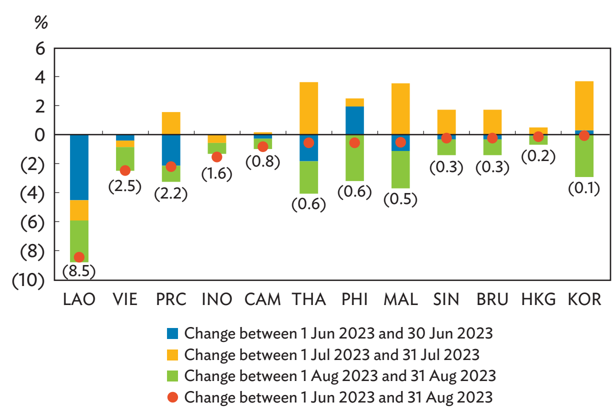
of 50 bps each in April and May—to boost economic growth. Both the 2-year (3 bps) and 10-year (12 bps) yield fell in the PRC during the review period. In June, the People's Bank of China reduced several key interest rates, including the medium-term lending facility and the loan prime rate, by 10 bps each to boost economic activities. In August, the PRC reduced the 1-year medium-term lending facility rate by 15 bps and the 7-day reverse repo and 1-year loan prime rate by 10 bps each.

A hawkish Federal Reserve and the sound economic outlook in the US led to the dollar strengthening against most regional currencies. During the review period, regional currencies posted a slight depreciation of 1.5% (simple average) and 1.9% (GDP-weighted) (**Figure C**). Excluding the Chinese yuan, regional currencies only marginally depreciated versus the US dollar by 1.4% (simple average) and 0.8% (GDP-weighted average). Among regional currencies, the Laotian kip experienced the most significant depreciation of 8.5%, weighed down by negative investor sentiment over debt stress and elevated inflation. The Chinese yuan weakened over heightened concerns regarding the PRC's economic outlook.

Box 1 discusses how global shocks affect the real economy in emerging East Asia through exchange rates.

Despite the slightly stronger US dollar, softening inflationary pressures and sound economic fundamentals boosted investment sentiment in most regional markets.

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 June 2023 and 31 August 2023.

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

Equity markets gained in a majority of regional economies during the review period. Excluding the PRC, equity markets in the region gained a market-weighted average of 1.4%. However, the regional average was weighed down by equity market losses in the PRC in August, with the region's equity market performance during the review period recording a market-weighted average

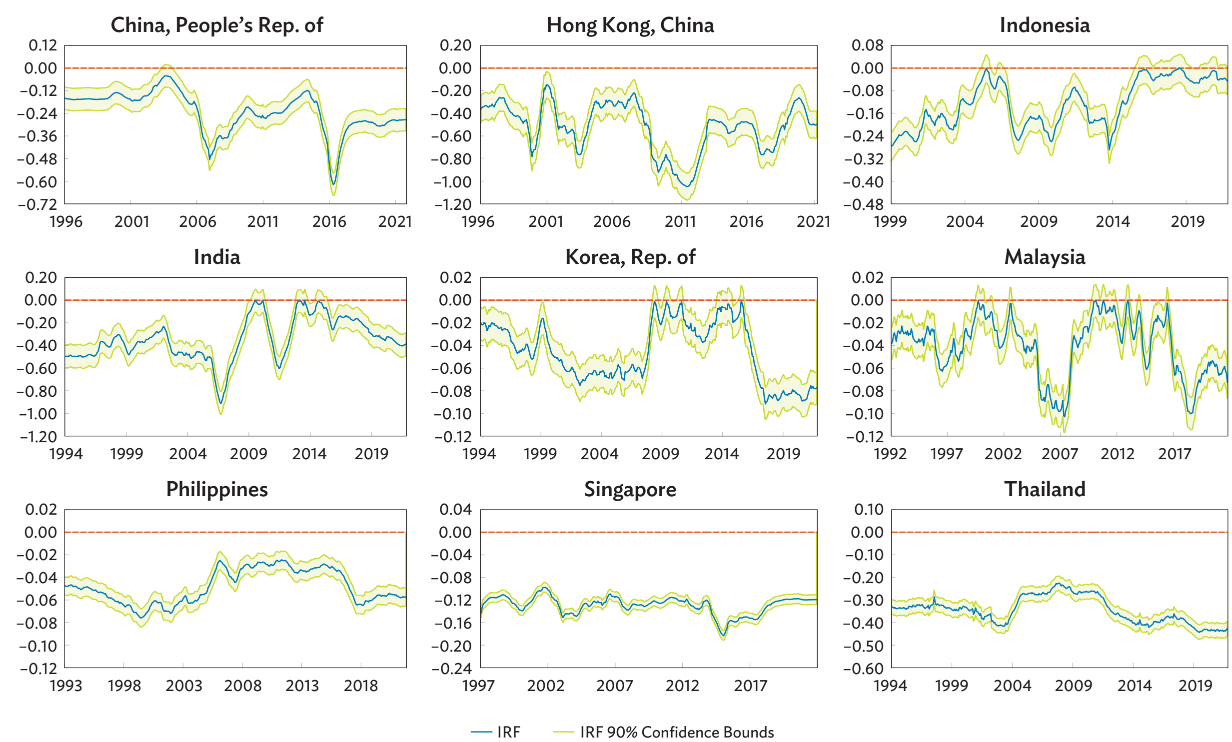
Box 1: Global Shocks and Exchange Rate Pass-Through in Emerging Asia

Over the past 25 years, central banks in emerging Asia have improved their monetary policy frameworks, helping to anchor inflation expectations and support broader macroeconomic stability.[a] While this has also contributed to enhancing the resilience of Asian economies to external shocks, the exchange rate channel remains a key transmission mechanism of disturbances to the real economy and financial markets.

During 2022, aggressive United States (US) monetary policy tightening in the face of soaring inflation triggered exchange-rate-driven inflationary pressures at the global level, with the US dollar appreciating to levels not observed in decades. Given the US dollar pricing of international commodities, net commodity importers during this period experienced sharp currency depreciations and imported inflation. Central banks therefore need to pay close attention to exchange rate developments that might affect their price stability mandates.

Since most developing economies depend on foreign currency for engaging in international trade, their exchange rate pass-through (ERPT) elasticity can be subject to significant variations related to the sectoral composition of the economy and exposure to external economic and financial developments (Burstein and Gopinath 2014; Forbes, Hjortsoe, and Nenova 2018). In addition, given rising levels of global financial integration, emerging market economies (EMEs) are vulnerable to global financial shocks and monetary spillovers, notably via the exchange rate channel (Han and Wei 2018). A new Asian Development Bank Institute paper by Beirne, Renzhi, and Panthi (2023) examines the evolution of ERPT to prices for emerging economies in Asia. Time-varying estimates of ERPT reveal that it has been declining for most Asian EMEs since around 2010, which corresponds to the period after the global financial crisis. **Figure B1.1** shows the estimates relative to consumer prices.

Figure B1.1: Time-Varying Exchange Rate Pass-Through to Consumer Prices



IRF = impulse response function.

Notes: The figure plots yearly time-varying impulse responses of consumer prices to a 1 percentage point appreciation shock of the exchange rate, with 90% confidence intervals. The vertical axis unit is percentage points, and the unit of the horizontal axis refers to months.

Source: Beirne, Renzhi, and Panthi (2023).

[a] This box was written by John Beirne (vice-chair of research and senior research fellow) of the Asian Development Bank Institute in Tokyo; Nuobu Renzhi (assistant professor) at the School of Economics of Capital University of Economics and Business in Beijing; and Pradeep Panthi (research associate) of the Asian Development Bank Institute in Tokyo.

continued on next page

Box 1 *continued*

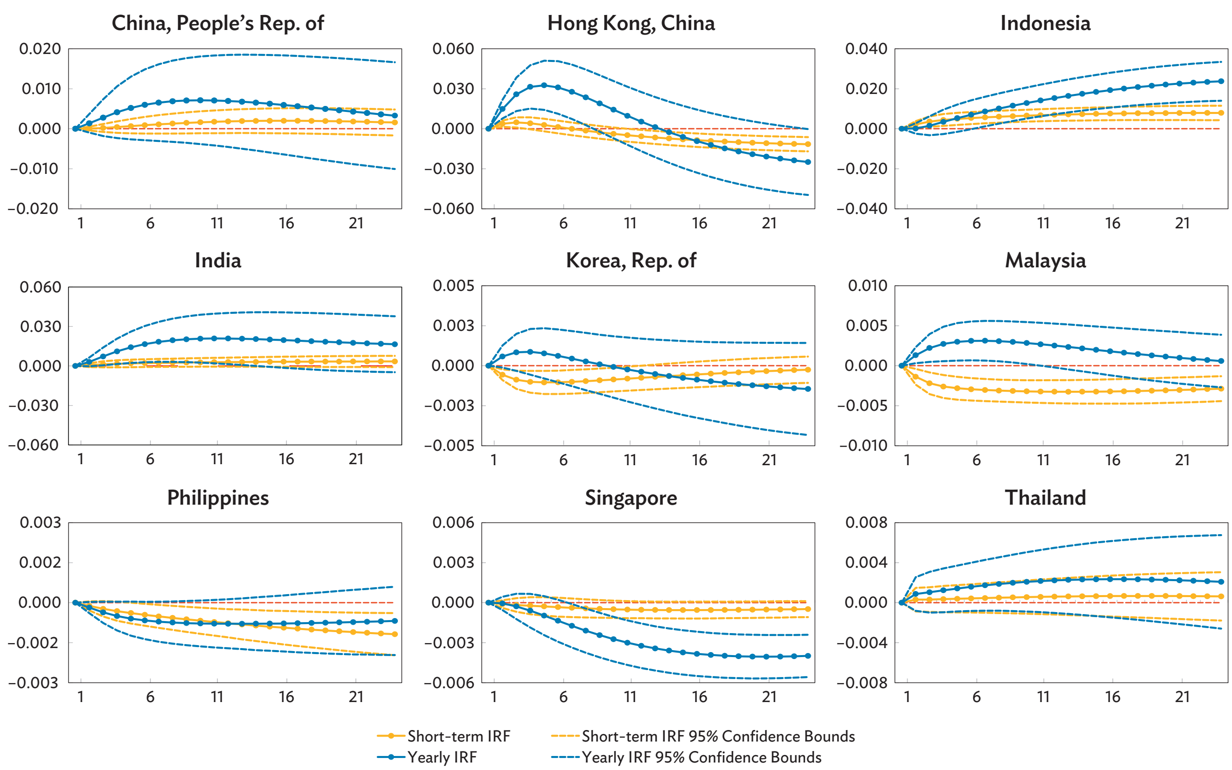
During the post-global-financial-crisis period, Asian economies significantly enhanced their overall macrofinancial resilience capacities, supported by improved central bank credibility. Nonetheless, Asian EMEs continue to remain vulnerable to external real and financial shocks, albeit to differing degrees depending on the nature of the shock. Beirne, Renzhi, and Panthi (2023) also show that ERPT is incomplete and mostly higher for producer than consumer prices and mostly greater in magnitude over a longer horizon of 12 months.

Regarding the significance of global shocks, the authors find that oil price and global output shocks mostly affect longer-term producer price ERPT in emerging Asia, while US monetary policy and global financial market volatility shocks mostly affect longer-term consumer price ERPT in emerging Asia. The response of ERPT to consumer prices due to US monetary policy tightening shocks is shown in **Figure B1.2**. While some heterogeneity is found in the magnitude and duration of statistical significance, US monetary policy tightening shocks amplify ERPT to consumer prices in emerging Asia in most cases, with the results most pronounced over the longer-term horizon.

Policy Implications for Central Banks in Emerging Asia

While ERPT has in general trended downward and varies somewhat across economies in terms of its elasticity, it has a material and statistically significant effect on inflation, with evidence of persistence. This implies that exchange rate developments are important considerations for central banks in the sense that they can affect their core mandates for price stability. While recognizing the shock-absorbing capacity of exchange rates in flexible exchange rate regime settings, a persistently high rate of ERPT could trigger an assessment of the appropriateness of the monetary policy framework.

Figure B1.2: United States Monetary Policy Shocks and the Response of Exchange Rate Pass-Through to Consumer Prices



IRF = impulse response function.

Notes: Impulse responses with 95% confidence bands are reported. Yellow lines refer to the short-term exchange rate pass-through and blue lines refer to the yearly exchange rate pass-through. The vertical axis unit is percentage points, and the unit of the horizontal axis refers to months.

Source: Beirne, Renzhi, and Panthi (2023).

continued on next page

Box 1 *continued*

The findings from the paper also have implications for policy makers and central banks in shielding their economies from the ERPT effects of global economic and financial shocks. For example, amplified ERPT to producer prices from oil price shocks could trigger an acceleration of efforts aimed at reducing concentration risks through the diversification of energy supply networks. For central banks, the dominant role of US monetary policy in driving the global financial cycle makes it a difficult proposition for emerging Asian economies to have buffers in place against US monetary policy shocks. However, strong macroeconomic fundamentals are an important consideration in this regard, including adequate foreign exchange reserve accumulation.

Finally, these results can also help central banks to improve forecasts of inflation that derive from exchange rate movements. While fraught with difficulty and notoriously bound by wide margins of error, the lags in monetary policy in affecting inflation mean that accuracy in inflation forecasting is central to effective monetary policy. The incorporation of time-varying ERPT estimates into inflation forecasting models may be an area worth further examination.

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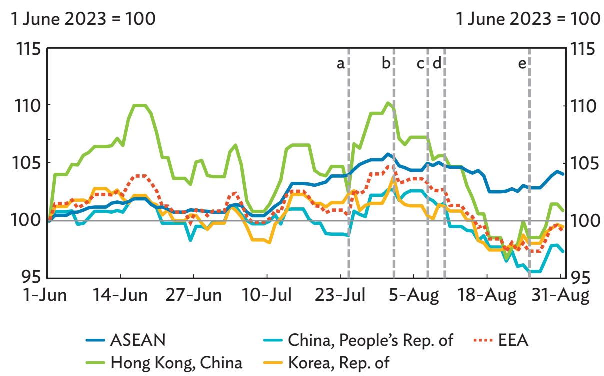
decline of 0.9%. Investment sentiment in regional equity markets was significantly boosted in July when the PRC announced additional policy support to stimulate its economy, but it weakened following a series of negative economic news in August (**Figure D**). Investor risk aversion rose following Fitch's downgrade of the sovereign credit rating of the US on 1 August and Moody's downgrade of the credit ratings of 10 mid-sized US banks on 7 August. Risk aversion was further exacerbated when the PRC reported negative export growth for July on 8 August and a decline in July consumer prices on 9 August. On 10 August, the US announced that it would restrict investments by US venture capital firms, private equity firms, and joint ventures in PRC companies involved in artificial intelligence, quantum computing, and semiconductors.

Similarly, improved risk sentiment during the review period pushed down risk premiums, which are typically reflected in the credit default swap spread, in most regional markets. During the review period, credit default swap spreads in the region excluding the PRC declined by 6.0 bps (simple average) and 1.2 bps

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



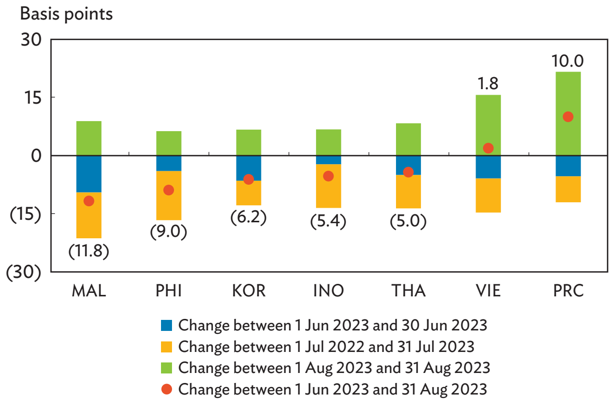
ASEAN = Association of Southeast Asian Nations, EEA = emerging East Asia, PRC = People's Republic of China, US = United States.

a The Government of the PRC promises additional economic support.
b Fitch downgrades US' credit rating.
c Moody's downgrades the credit ratings of 10 US banks.
d US passes laws limiting PRC investments by US venture capital firms, private equity firms, and joint ventures.
e US Fed chair Powell speaks at Jackson Hole.

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 31 August 2023.

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

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

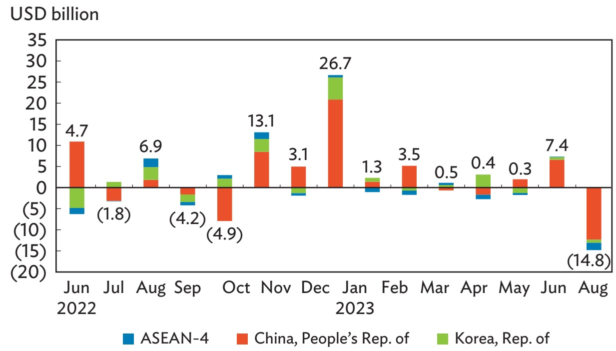


( ) = negative; INO = Indonesia; KOR = Republic of Korea; MAL = Malaysia; PHI = Philippines; PRC = People's Republic of China; THA = Thailand; VIE = Viet Nam.

Note: The numbers above (below) each bar refer to the change in spreads between 1 June 2023 and 31 August 2023.

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

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



( ) = outflows, USD = United States dollar.

Notes:
1. Data coverage is from 1 June 2022 to 31 August 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.

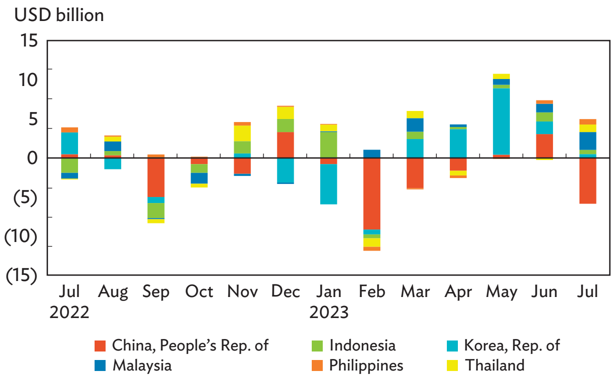
Source: Institute of International Finance.

(GDP-weighted average). However, regional risk premiums widened by 6.8 bps (GDP-weighted average) if the PRC is included—due to its dimmed economic outlook (**Figure E**). The updated regional economic outlook can be found in the forthcoming September 2023 *Asian Development Outlook* report.

Between 1 June and 31 August, the region's equity markets posted combined net portfolio outflows of USD7.2 billion, driven largely by outflows of USD14.8 billion in August (**Figure F**). In June, regional equity markets posted minimal net foreign inflows, as the USD2.0 billion of net inflows to the PRC were offset by outflows from the Republic of Korea and member economies of the Association of Southeast Asian Nations (ASEAN). The Republic of Korea recorded net foreign capital outflows of USD1.3 billion in June following its failed bid to be included in MSCI's developed markets index despite a series of financial market reforms. ASEAN economies recorded net foreign outflows of USD0.5 billion in June on outflows from Indonesia (USD0.3 billion), Thailand (USD0.3 billion), and Viet Nam (USD0.02 billion). In both Indonesia and Viet Nam, the outflows were driven by a weakening export performance, while in Thailand the outflows were due to uncertainties in the political outlook. In July, regional markets recorded USD7.4 billion of net foreign inflows on improved sentiment over a possible pause in US rate hikes in September and the stimulus measures introduced in the PRC. However, a series of negative news in August, especially the PRC's weak economic outlook, heightened risk aversion and drove portfolio outflows across the region. Emerging East Asian markets posted net outflows of USD14.8 billion in August, with the PRC recording the largest net foreign portfolio outflows of USD12.3 billion.

Elevated inflation in advanced economies led to net portfolio inflows of USD18.5 billion in the region's bond markets from April to July 2023. Net inflows of USD7.1 billion were recorded in June, following consecutive net inflows recorded in April (USD1.7 billion) and May (USD10.6 billion) (**Figure G**). Softening inflation in most emerging East Asian markets relative to the persistent elevated inflation in advanced economies partly contributed to the net inflows. The inflows were also influenced by a pause in tightening by the Federal Reserve in June. The Republic of Korea recorded the largest net bond inflows in the region in Q2 2023 at USD13.8 billion, followed by Malaysia (USD2.2 billion). ASEAN markets posted aggregate net inflows of USD2.4 billion in June, following net inflows of USD1.7 billion in May and net outflows of USD0.4 billion in April. Among ASEAN markets, Indonesia (USD1.9 billion) and Malaysia recorded net inflows in Q2 2023 due to relatively attractive yields compared with US Treasuries and easing inflation in both markets. In contrast, Thailand, recorded net outflows of USD0.2 billion due to political uncertainties following the general election in May.

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 31 July 2023.
3. Figures were computed based on 31 July 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).

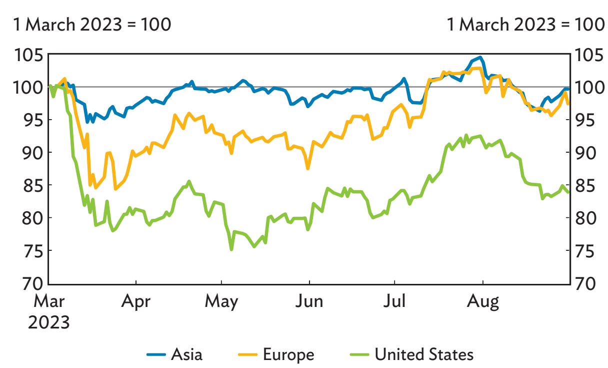
The Philippines also posted net marginal outflows of USD0.04 billion on relatively elevated inflation compared with other ASEAN economies. In July, however, weighed down by the PRC's weak economic outlook and lower interest rates, net foreign portfolio outflows of USD0.9 billion were observed in regional bond markets with USD5.9 billion of outflows from the PRC's bond market. All other regional bond markets recorded net inflows in July.

The risk outlook to regional financial conditions remains balanced. On the upside, softened inflation across the region led to a pause in monetary tightening by most regional central banks. Faster-than-expected declines in inflation in advanced economies, combined with financial risk and economic growth concerns, could lead to less hawkish monetary stances by major central banks such as the Federal Reserve and the ECB, further improving financial conditions in the region. However, different possible paces of disinflation have left uncertainty over the monetary policy directions of advanced economies. For example, sound economic growth and a strong labor market in the US combined with still-elevated inflation might support further tightening: On 15 August, Minneapolis Federal Reserve President Neil Kashkari said he is still not ready to say that the Federal Reserve is done hiking rates. On 25 August, Federal Reserve Bank of Cleveland President Loretta Mester said that it was likely that the Federal Reserve would raise rates again and that work still needs to be done to bring inflation down.

Meanwhile, higher interest rates in both domestic and international markets have raised borrowing costs, challenging regional public and private borrowers with vulnerable balance sheets and weak governance. While Asian banks in general demonstrated resilience to negative banking sector news in advanced economies, such as turmoil in the US and European banking sectors earlier this year and the downgrade of 10 mid-sized US bank in August, regional public and private sector borrowers face similar higher debt burdens and interest risks (**Figure H**).

On the sovereign side, the Lao People's Democratic Republic (Lao PDR) has been assessed to be in "external and overall debt distress" by the International Monetary Fund's 2023 Article IV Consultation released in May 2023. Rating agencies have also been pessimistic dating back to last year. Moody's downgraded the Lao PDR's sovereign rating to Caa3 from Caa2 on 15 June 2022, and Fitch Ratings downgraded the Lao PDR's sovereign rating to CCC– from CCC on 4 August 2022 on rising external liquidity risks before subsequently withdrawing its ratings coverage on 10 October 2022.

Figure H: S&P Broad Market Indexes for Banking Stocks in Asia, Europe, and the United States



Notes:

1. Data are as of 31 August 2023.
2. S&P Global's Broad Market Indexes for banks are comprehensive benchmarks of bank stocks in Asia and the Pacific, Europe, and the United States, and are subindexes of the S&P Global BMI for Banks.

Source: S&P Global.

In the region's private sector, signs of vulnerability have appeared in the banking sector and in bond markets. In Cambodia, the banking sector witnessed an uptick in nonperforming loans in 2022. The ratio of nonperforming loans as a percentage of total loans in Cambodia's overall banking sector rose to 3.1% in 2022 from 2.0% in 2021, according to the National Bank of Cambodia's Annual Supervision Report 2022. In recent months, bond defaults have been observed in some regional bond corporate bond markets.

In the PRC, an S&P Global Ratings report in April 2023 estimated that the value of offshore defaults rose to USD54.0 billion in 2022 from USD10.0 billion in 2021, with the increase mostly coming from real estate companies. In 2023, a number of real estate companies reported payment difficulties. For example, Sino-Ocean, a property company, announced on 2 August that it would delay the principal repayments of a bond by 30 days. On 22 August, Sino-Ocean announced that it had reached an agreement with bond holders to delay repayment until August 2024. Country Garden Holdings, another property company, missed a coupon payment on one of its US dollar bonds on 7 August and later announced that it would be discussing repayment plans with its creditors on 14 August. However, as of 31 August, Country Garden had yet to reach an agreement and had delayed the vote on its bond repayment terms twice. On 18 August, Evergrande Group filed for bankruptcy protection in the US. Negotiations for its offshore debt-restructuring plan are still ongoing.

Corporate bond defaults have been rising in Viet Nam, especially in the real estate sector. In February 2023, No Va Land Investment Group, Viet Nam's second-largest property company, announced that it would delay payment of a VND1.0 trillion note due on 12 February. In May 2023, FiinRatings said that 98 firms had missed payments from 17 April to 4 May amounting to VND128.5 trillion. A June FiinRatings report estimated that as of June 2023, the total value of bond defaults was 26.9% of total nonbank corporate bonds outstanding.

In Thailand, three companies reported bond defaults in the first half of 2023 according to the Bank of Thailand. While the defaults only comprised about 0.3% of total Thai corporate bonds outstanding, the Bank of Thailand is undertaking increased surveillance and monitoring of corporates' refinancing activities. In addition, accounting irregularities discovered in a special audit of Stark Corporation Public Company, which defaulted on two bonds on 2 June, have called attention to the need for strengthening corporate governance and transparency in Thailand.

Headwinds to the regional economic outlook are also challenging financial conditions. With most regional central banks holding interest rates steady, higher borrowing costs could negatively affect investment and consumption. Concerns over the PRC's recent economic data and a subdued real estate sector could also negatively affect the growth outlook in other regional economies.