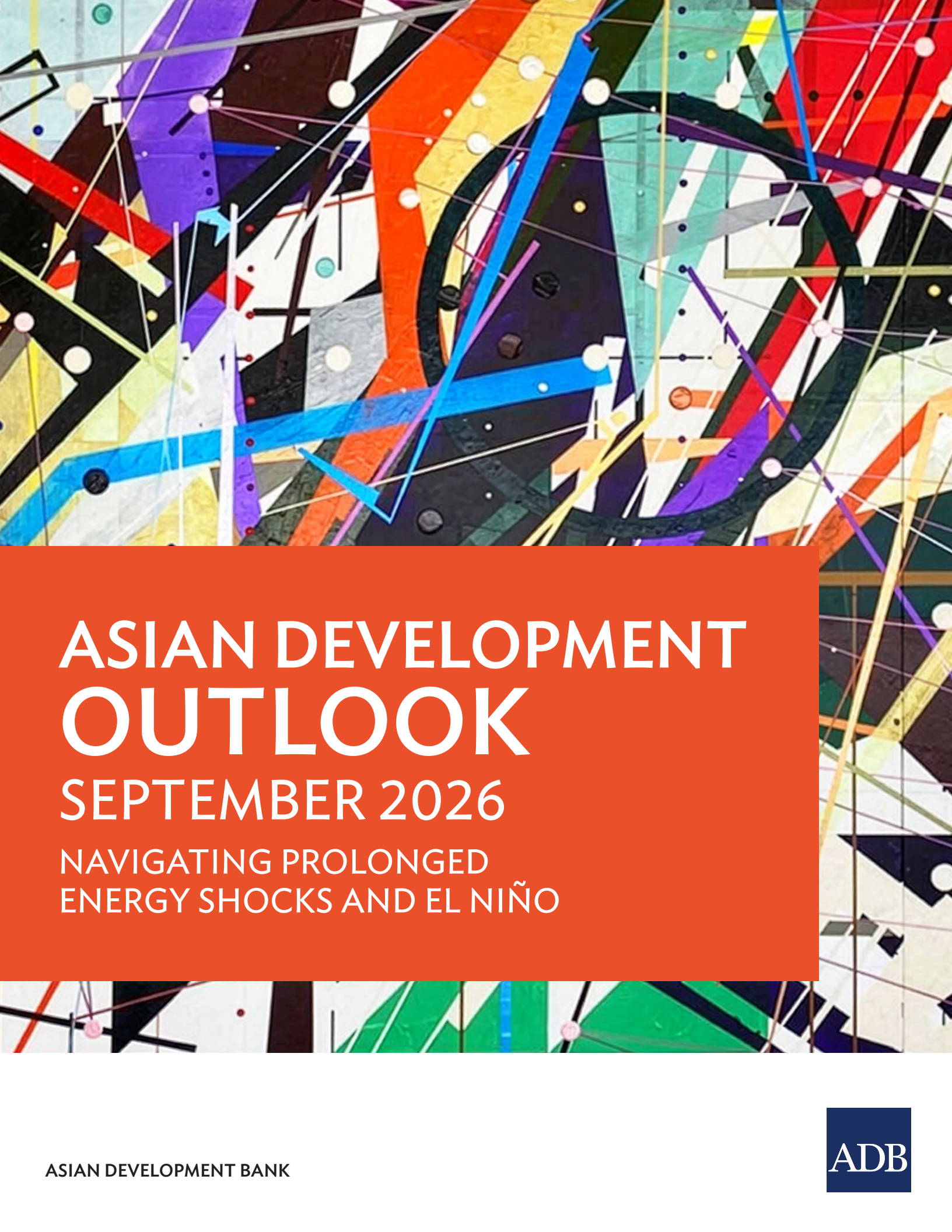




ASIAN DEVELOPMENT OUTLOOK

SEPTEMBER 2026

NAVIGATING PROLONGED
ENERGY SHOCKS AND EL NIÑO

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NAVIGATING PROLONGED
ENERGY SHOCKS AND EL NIÑO



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ISBN 978-92-9277-939-9 (print); ISBN 978-92-9277-940-5 (PDF); ISBN 978-92-9277-941-2 (e-book)
ISSN 0117-0481 (print), 1996-725X (PDF)
Publication Stock No. FLS260387-3
DOI: <http://dx.doi.org/10.22617/FLS260387-3>

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Notes:

In this publication, “\$” refers to United States dollars, “¥” refers to yen, “A\$” refers to Australian dollars, “AF” refers to afghanis, “B” refers to baht, “CNY” refers to yuan, “K” refers to kina, “NZ\$” refers to New Zealand dollars, “RM” refers to ringgit, “SI\$” refers to Solomon Islands dollars, “TJS” refers to somoni, “Tk” refers to taka, and “VND” refers to dong. ADB recognizes “China” as the People’s Republic of China, “Korea” as the Republic of Korea, “USA” as the United States, and “Bombay” as Mumbai.

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FOREWORD

Developing Asia and the Pacific is growing more slowly than last year, but the region's economy remains resilient in increasingly difficult conditions. The *Asian Development Outlook September 2026* finds that uncertainty is high and the risks have shifted further to the downside.

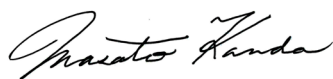
Persistent conflict in the Middle East and the renewed escalation of Russia's war in Ukraine have broadened energy market disruptions beyond crude oil to refined products and shipping routes, raising costs for households and businesses. A very strong El Niño adds to these pressures, threatening harvests and hydropower generation and compounding the delayed effects of higher fertilizer and energy prices. Higher energy and food prices fall hardest on households that spend most of their income on both. Unlike most shocks, this one comes with advance warning of its likely timing. Governments must use it.

Preparation means managing public resources carefully. Support for poor and vulnerable people should be targeted and time-bound, so that governments can still afford to respond to the next shock. Agriculture, water, and power systems need strengthening before severe weather arrives, not after. And central banks should stand ready to act if temporary price increases become persistent, explaining their decisions clearly to maintain confidence in monetary policy.

Regional cooperation makes these efforts more effective. More reliable supply chains, better connectivity, and simpler trade procedures leave economies less exposed when disruption strikes elsewhere. Cooperation on food and energy security is especially urgent given the shocks now facing the region.

These pressures also expose a deeper vulnerability. Many economies in the region remain heavily dependent on imported energy, which means disruptions elsewhere can quickly become price shocks at home. Reducing that exposure is a long-term task: expanding renewable capacity, improving energy efficiency, and building infrastructure that can withstand severe weather. Much of the financing must come from the private sector. That requires predictable policies and financing tools that make projects investable.

The Asian Development Bank will help its developing member countries respond to these pressures and undertake reforms that strengthen their economies and improve people's lives. This report offers the evidence to guide those decisions. Our task is to help turn it into action.



MASATO KANDA

President

Asian Development Bank

ACKNOWLEDGMENTS

Asian Development Outlook (ADO) September 2026 was prepared by staff of the regional departments and resident missions of the Asian Development Bank (ADB) under the guidance of the Economic Research and Development Impact Department (ERDI). Representatives of these departments met regularly as the Regional Economic Outlook Task Force to coordinate and develop consistent forecasts for the region.

Matteo Lanzafame, director of the Macroeconomics Research Division, led the production of this report, assisted by Priscille Villanueva and Melanie Grace Quintos. Emmanuel Alano, Shiela Camingue-Romance, Suzette Dagli, Ma. Lourdes Lacson, Melanie Grace Quintos, Pilipinas Quising, Ed Kieran Reyes, Patrick Jaime Simba, Dennis Sorino, Priscille Villanueva, and Mai Lin Villaruel provided technical and research support. Economic editorial advisors Robert Boumphrey, Eric Clifton, Joshua Greene, and Reza Vaez-Zadeh made substantial contributions to the chapters on individual economies.

The support and guidance of ADB Chief Economist Albert Park and Deputy Chief Economist Abdul Abiad are gratefully acknowledged.

The subregional coordinators were Kiyoshi Taniguchi, Parvina Rakhimova, George Luarsabishvili, Babur Wasim, and Rene Cris Rivera for the Caucasus and Central and West Asia; Thiam Hee Ng and Mia Andrea Soriano for South Asia; James Villafuerte and Dulce Zara for developing Southeast Asia; and Kaukab Naqvi, Cara Tinio, and Kayleen Gene Calicdan for the Pacific.

Peter Fredenburg, Guy Sacerdoti, and Eric Van Zant edited *ADO September 2026*. Principe Nicdao and Glenda Cortez did the typesetting and graphics. Art direction for the cover was by Anthony Victoria, with artwork from Victor D. Base. Breezy Boter designed the landing page for *ADO*. Heili Ann Bravo, Dyann Buenazedacruz, Fermirelyn Cruz, Eugene Creely Ingking, and Charlene Lim provided administrative and logistical support. A team from the Department of Communications and Knowledge Management, led by Terje Langeland, Micheline Millar, Angela Wells, and Jose Angelo Templonuevo, planned and coordinated the dissemination and media engagement for *ADO September 2026*.

DEFINITIONS AND ASSUMPTIONS

The economies discussed in *Asian Development Outlook September 2026* are classified by major analytic or geographic group. For the purposes of this report, the following apply:

- **Asia and the Pacific** includes all the 50 Asian Development Bank (ADB) regional member economies.
- **Developing Asia and the Pacific** comprises the 43 members of the Asian Development Bank listed below by geographic group.
 - **Caucasus and Central and West Asia** comprises Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Türkiye, Turkmenistan, and Uzbekistan.
 - **Developing East Asia** comprises the People's Republic of China and Mongolia.
 - **South Asia** comprises Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
 - **Developing Southeast Asia** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Thailand, Timor-Leste, and Viet Nam.
 - **The Pacific** comprises the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Naoero, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.
- **Advanced Asia and the Pacific** comprises seven regional members of the Asian Development Bank: Australia; Hong Kong, China; Japan; the Republic of Korea; New Zealand, Singapore; and Taipei, China.
- **Association of Southeast Asian Nations (ASEAN)** comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste, and Viet Nam. ASEAN 4 comprises Indonesia, Malaysia, the Philippines, and Thailand.

Unless otherwise specified, the symbol "\$" and the word "dollar" refer to US dollars.

A number of assumptions have been made for the projections in *Asian Development Outlook September 2026*. The policies of domestic authorities are maintained. Real effective exchange rates remain constant at their average from 1 August to 4 September 2026. The average price of oil is \$90/barrel in 2026 and \$78/barrel in 2027.

Asian Development Outlook September 2026 is generally based on data available up to 4 September 2026.

ADB placed its regular assistance to Afghanistan on hold effective 15 August 2021. Effective 1 February 2021, ADB placed a temporary hold on sovereign project disbursements and new contracts in Myanmar.

ABBREVIATIONS

AAP	advanced Asia and the Pacific
ADB	Asian Development Bank
ADO	Asian Development Outlook
ADP	Annual Development Program
AI	artificial intelligence
ASEAN	Association of Southeast Asian Nations
BNM	Bank Negara Malaysia
CBI	central bank independence
CBIE	CBI extended
CCWA	Caucasus and Central and West Asia
COFA	Compact of Free Association
COVID-19	coronavirus disease
CPI	consumer price index
DAP	developing Asia and the Pacific
DEA	developing East Asia
DSEA	developing Southeast Asia
EFF	Extended Fund Facility
EMDEs	emerging markets and developing economies
ENSO	El Niño Southern Oscillation
EU	European Union
EV	electric vehicle
FBR	Federal Board of Revenue
FDI	foreign direct investment
FSM	Federated States of Micronesia
FY	fiscal year
GDP	gross domestic product
H	half
ICT	information and communication technology
IT	information technology
Lao PDR	Lao People's Democratic Republic
LNG	liquefied natural gas
LPG	liquefied petroleum gas
MAS	Monetary Authority of Singapore
NOAA	National Oceanic and Atmospheric Administration
NPL	nonperforming loan
PBOC	People's Bank of China
PMI	purchasing managers' index
PNG	Papua New Guinea
pp	percentage point
PPI	producer price index

PRC	People's Republic of China
Q	quarter
qoq	quarter on quarter
RBI	Reserve Bank of India
ROK	Republic of Korea
RONI	Relative Oceanic Niño Index
RPC	Regional Processing Centre (Naoero)
SBV	State Bank of Viet Nam
US	United States
VAT	value-added tax
WMO	World Meteorological Organization
yoy	year on year

ADO SEPTEMBER 2026

HIGHLIGHTS

Growth in developing Asia and the Pacific is projected at 5.0% in 2026, down from 5.5% in 2025 but a slight upgrade from the July forecast. The 2027 projection is unchanged at 5.1%. Firm domestic demand, government stimulus measures, and continued strength in technology-related industries have supported activity, even as persistent energy market disruption took a toll. El Niño is expected to be very strong, further dragging on growth while raising price pressures. The regional inflation forecast is trimmed to 4.2% in 2026 and revised up slightly to 3.5% for 2027.

Risks remain tilted to the downside. Further escalation of conflicts or worse-than-expected El Niño impacts could dent growth and push inflation higher, with scenarios in this report indicating that most impacts would materialize in 2027. Tighter financial conditions, a sharp repricing of AI equity valuations, and renewed trade policy uncertainty add to downside risks. On the upside, faster normalization of energy markets or a milder El Niño impact than forecast would improve the outlook.

This report's analytical chapter examines how elevated debt shapes monetary policy decisions and transmission. It finds that fiscal pressures can constrain central banks' ability to raise interest rates, particularly where public debt is high. The chapter also shows that elevated public and private debt can weaken the pass-through of policy rates to borrowing costs and economic activity. These effects are more pronounced where central banks have less independence, underscoring the importance of strengthening central bank autonomy alongside credible fiscal frameworks to preserve monetary policy effectiveness and maintain adequate policy space.



Albert F. Park
Chief Economist
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Navigating Prolonged Energy Shocks and El Niño

- **Growth in developing Asia and the Pacific (DAP) is forecast at 5.0% in 2026, 0.1 percentage points above the July projection, but down from the 5.5% recorded in 2025.** A prolonged Middle East conflict and the reescalation of Russia's war in Ukraine have kept energy prices elevated and volatile. A very strong El Niño is also expected to challenge the outlook. Against these headwinds, private investment, government stimulus, and strong technology exports driven by an artificial intelligence (AI) boom will support growth prospects. Across subregions, growth forecast upgrades for developing Southeast Asia and South Asia offset downgrades in the Caucasus and Central and West Asia and the Pacific. For 2027, the growth projection is maintained at 5.1%. Regional inflation is projected to remain above the 3.0% recorded in 2025. The forecast is trimmed by 0.1 percentage points to 4.2% in 2026 on weaker demand in the People's Republic of China (PRC) and, in South Asia, as government price stabilization measures temper the pass-through of higher global energy costs. The 2027 projection is raised to 3.5% as the effects of El Niño are expected to be more pronounced. Persistently high energy prices and El Niño intensification keep the balance of risks tilted to the downside.
- **Geopolitical pressures on global energy markets persist and have broadened beyond crude oil and the Strait of Hormuz.** A decline in oil and gas prices following an agreement in mid-June on a ceasefire framework was reversed in early July after the agreement broke down, heightening market volatility. More significantly, markets for refined products tightened, driving diesel and gasoline refining margins to multiyear highs. Supply constraints emerged as conflict disrupted refining operations in the Middle East, while Ukrainian strikes on Russian refineries reduced Russian exports of diesel and other refined products. Disruption also spread to the Red Sea after the Houthis declared a blockade on Saudi Arabia-linked shipping, threatening the main Saudi alternative export corridor through the Bab el-Mandeb Strait. In response, Gulf producers are exploring ways to bypass Hormuz, including rerouting cargoes and using ship-to-ship transfers, while Iran and Oman discuss commercial transit arrangements. These measures may ease supply constraints, but elevated security risks and high shipping costs are likely to keep energy markets volatile.
- **Asia and the Pacific as a whole has reduced reliance on Middle Eastern crude oil.** Oil imports in DAP excluding the PRC continued to rise as economies replaced lost Gulf volume with imports from Africa, the Americas, and Russia. However, the PRC lowered Middle East crude imports by around two-thirds from the onset of the 2026 conflict to July, and also reduced purchases from other suppliers, cutting total imports by nearly half. In advanced Asia and the Pacific, oil imports recovered in May and June after falling in March and April, but sourcing shifted markedly away from the Middle East toward alternative suppliers, particularly North America. As tensions eased, imports from the Middle East picked up again. Despite these diversification efforts, Asia and the Pacific remains reliant on Gulf crude and vulnerable to disruption along key shipping routes.
- **The conflict's impact on tourism in the region has been more evident than on remittance flows so far.** Tourist arrivals in DAP declined in April and again slightly in May, while arrivals in advanced Asia and the Pacific remained slightly higher than a year earlier. Airspace closures and flight rerouting disrupted travel by increasing flight times and airfares, with higher jet fuel costs and weaker outbound travel from the Gulf adding to the pressure on tourism. The April decline was steepest in South Asia, which depends heavily on Gulf carriers and transit hubs, while destinations accessible without Gulf transit fared better. In contrast, remittance flows to economies dependent on the Middle East have generally remained resilient, although risks could increase if employment opportunities decline or worker repatriation rises.

- **A strengthening El Niño is compounding energy and food price pressures, particularly in economies dependent on imported energy and agricultural commodities.** El Niño conditions are expected to intensify through the end of 2026 and persist into 2027. Energy and weather shocks reinforce each other through several channels. Higher crude oil and refined fuel prices raise transport, production, and fertilizer costs, even as heat and deficient rainfall threaten agricultural output. At the same time, higher temperatures increase electricity demand for cooling, and weaker rainfall reduces hydropower output, adding to demand for fuel and liquefied natural gas.
- **Growth moderated in the second quarter of 2026 as weaker domestic demand more than offset stronger net exports.** Persistent energy market disruptions dented solid pre-conflict activity, with effects spreading to the broader economy in the second quarter. Net exports contributed strongly to growth in the PRC, India, Malaysia, and the Philippines, but subtracted from it elsewhere, as higher prices for energy, shipping, and aviation raised trade costs and slowed global activity. Consumption growth remained subdued as higher energy costs and inflation eroded purchasing power and consumer confidence. In the PRC, fragile sentiment and persistent property market weakness further weighed on consumption, while in India, elevated consumer goods prices dampened household spending. Regional investment eased, as higher costs squeezed operating margins amid heightened geopolitical tensions and weaker business sentiment. Strong AI demand, however, provided a significant boost to investment in India and Thailand. On the supply side, regional industrial activity moderated as weaker manufacturing in the PRC outweighed stronger gains in other technology-producing economies. Services also eased, reflecting subdued consumption and real estate activity in some economies. Construction remained in negative territory in the PRC and contracted in the Philippines for a fourth consecutive quarter.
- **Inflation eased in July as a temporary dip in energy prices more than offset firmer food prices.** Regional inflation fell to 3.7% as global energy and shipping costs eased following progress in ceasefire negotiations, although it remained above pre-conflict levels and stood at 7.5% excluding the PRC. Conflict-related disruption raised import costs, contributing to a marked acceleration in average producer price inflation from 8.7% in February to 16.5% in June. Producer price inflation in the PRC and wholesale price inflation in India intensified, reaching multi-year highs of 4.0% and 10.0%, respectively, in June, before easing in July. In the PRC, surging mining and raw material costs and rising prices of high-technology inputs drove the increase. Regional food inflation increased modestly, with low food price pressures in the PRC countering sharper increases elsewhere driven by higher input and logistics costs and weather-related factors. Food inflation continued to rise in 12 of 19 economies with available data, mainly in South Asia, developing Southeast Asia, and the Caucasus and Central and West Asia.
- **Regional central banks have mostly kept policy rates unchanged in 2026, with future policy paths expected to diverge in response to economy-specific conditions.** About three-quarters of policy rate decisions in the second quarter, and 16 of 20 decisions between July and 4 September, were holds as central banks cautiously balanced inflation against support for growth. Bangladesh cut rates in July to support growth, while Kazakhstan continued to ease as disinflation progressed. The Philippines raised rates for a third consecutive time in August to contain price pressures. Expected monetary policy paths to the end of 2026 are mixed, with consensus forecasts suggesting scope for tightening in some economies and unchanged rates in others. Further modest easing is expected in Kazakhstan, Tajikistan, and Uzbekistan in 2026, with broader easing expected to resume in 2027 as inflationary pressures recede.

- **Regional financial markets remained tight, with regional bond yields elevated on rising global yields and cautious monetary policy.** Investor sentiment recovered as geopolitical risk and market volatility gradually eased to levels close to those at the beginning of the year. Nevertheless, regional 10-year government bond yields remained high, driven by lingering inflationary pressures, a cautious monetary policy stance among regional central banks, and spillovers from rising yields in major advanced markets. Lower market volatility supported a broadly stable performance of other market indicators year to date. Risk premia, as measured by credit default swap spreads, narrowed slightly, and regional currencies remained stable against the US dollar, while equities declined marginally amid volatile AI-related stocks.
- **Debt ratios are broadly stable, but the longer-term outlook has deteriorated.** Public debt in DAP is projected to rise from \$26 trillion in 2025 to nearly \$29 trillion in 2026. Strong nominal GDP growth, increasingly driven by inflation, is expected to keep the average ratio of debt to GDP near 45%, broadly unchanged from 2024–2025 and well below its pandemic peak. However, 14 DAP economies are projected to run primary balances below debt-stabilizing levels in 2026. These economies could face greater fiscal adjustment needs if the Middle East conflict, currency depreciation, and monetary policy tightening raise debt burdens and spending pressures.
- **External conditions are challenging, with heightened geopolitical tensions and a very strong El Niño weighing on the regional outlook.** Brent crude oil price projections are revised up to an average of \$90/barrel in 2026, amid renewed conflict in the Middle East and a reescalation of Russia's war in Ukraine, before declining to \$78 in 2027. Adverse weather associated with El Niño is expected to compound the lagged effects of higher fertilizer prices on food inflation across the region. On the upside, sustained global demand for AI-related products is anticipated to support growth in several economies in Asia and the Pacific.
- **Growth projections for DAP are broadly consistent with ADO July, although prospects vary across subregions.** In the PRC, projections are maintained for this year and next, reflecting robust growth in high-technology manufacturing and exports, AI-related investment, and government support for domestic demand. For South Asia, the 2026 forecast is upgraded on an upward revision for India, supported by strong investment and exports, while the 2027 projection is downgraded, reflecting lower forecasts for Afghanistan, Bangladesh, India, and Nepal amid trade, energy, and weather-related shocks. Forecasts for developing Southeast Asia are revised up following stronger-than-expected economic performance in the first half of 2026. The upgrades reflect robust technology-related exports from Malaysia and Thailand, and stronger activity in Timor-Leste and Viet Nam from fiscal stimulus and increased investment. These upgrades offset a lower projection for the Caucasus and Central and West Asia driven by renewed escalation of Russia's war in Ukraine and weaker external demand, particularly in Türkiye, the subregion's largest economy. Growth forecasts are also lowered for the Pacific following prolonged energy market disruption and in anticipation of adverse effects from El Niño on mining and agriculture.
- **The regional inflation forecast is revised down to 4.2% for 2026 but raised to 3.5% for 2027.** Persistently high global energy prices continue to exert upward pressure on prices across much of the region, although fiscally costly broad subsidies to stabilize prices have tempered the pass-through to consumers. That pass-through is likely to be strongest where food weighs heavily in the consumption basket, such as in South Asia, and inflation is already high. Inflation in the PRC is projected at 0.9% in 2026, 0.3 percentage points lower than forecast in July, because of weaker-than-expected consumer demand, while the 2027 forecast remains unchanged at 0.9%. For South Asia, the 2026 forecast is lowered to 5.5% supported by government measures that have cushioned the impact of higher oil prices in some economies, while the 2027 forecast is retained at 4.8%. By

contrast, the projections for the Caucasus and Central and West Asia are revised upward for both 2026 and 2027, largely due to slower disinflation in Türkiye. Similarly, the forecasts for developing Southeast Asia and the Pacific are raised for both years, reflecting higher global oil prices and the expected impact of El Niño on food prices.

■ **Escalating conflicts and extreme weather shocks pose the largest threats to the outlook.**

Further intensification of conflicts in the Middle East and Ukraine could exacerbate disruption to global supplies of energy and other commodities. A worse-than-anticipated El Niño could further constrain food supply. Renewed tariff hikes and higher trade policy uncertainty could also weigh on the region's economic activity. An abrupt repricing of AI-related equities poses a further downside risk. If expectations of AI-related productivity and profitability weaken, a sharp correction could further tighten financial conditions and weigh on balance sheets, investment, and confidence. On the upside, faster normalization of energy markets and a less severe El Niño could ease supply disruption and inflationary pressure.

Special Topic—"El Niño 2026: Potential Physical and Economic Impacts for Asia and the Pacific"

- **A very strong El Niño is expected to weigh on growth across Asia and the Pacific through 2027, underscoring the need for early and proactive policy action.** El Niño is expected to intensify through late 2026, peaking around November, and is likely to rank among the strongest on record, with sea surface temperature anomalies near 2.9°C. As El Niño effects often persist into the following year, the largest impacts across Asia and the Pacific are likely to be felt in 2027. A Special Topic in this report traces how the event affects economic activity through agriculture, energy, industry, services, and labor markets, as well as the ecosystems and natural capital that underpin them, and how those channels interact with elevated debt, conflict-related supply disruptions, and trade policy uncertainty. Historical evidence shows that Asia and the Pacific is particularly exposed to El Niño-related economic losses, some of which persist for several years. Because the timing and broad pattern of El Niño impacts can be forecast with reasonable confidence, policymakers have a valuable window to act before the effects are felt and limit the resulting economic losses.

Analytical Chapter—"Monetary Policy in High-Debt Environments"

- **High debt has become a structural concern for monetary policy in advanced and emerging economies.** Public and private debt rose worldwide after the global financial crisis of 2008–2009 and again during the COVID-19 pandemic. Excluding the People's Republic of China (PRC), total debt in developing Asia and the Pacific (DAP), including public debt and nonfinancial private debt, rose from about 47% of gross domestic product in 2007 to 89% in 2019, and peaked at 103% during the pandemic before declining to 93% in 2025. Persistently high debt can leave governments, households, firms, and financial systems more exposed to changes in interest rates, potentially complicating the environment in which central banks pursue price and macroeconomic stability.
- **This analytical chapter provides new evidence on monetary policy in high-debt environments.** Analysis draws on more than 3 decades of data on advanced and emerging economies, with particular attention to DAP, and addresses two key empirical questions: first, whether high debt influences how central banks set policy rates and, second, whether it weakens

the transmission of policy rate adjustments to real economic activity and financial conditions. The chapter also examines how these relationships vary with the degree of central bank independence, a key institutional determinant of monetary policy outcomes.

- **High debt may constrain monetary policy decisions.** Under normal conditions, conventional monetary policy operates through the policy rate, which central banks adjust in response to inflation and economic activity. However, high public debt and fiscal imbalances may give rise to fiscal dominance, whereby concerns about government borrowing costs and debt sustainability deter central banks from raising rates to levels that macroeconomic conditions alone would warrant. High private debt may also induce greater caution, as tighter monetary policy can expose balance-sheet vulnerabilities in leveraged households, firms, and financial institutions. Strong central bank independence can help insulate policy decisions from both pressures.
- **High debt may also influence monetary policy transmission.** Policy rate changes affect the economy through balance sheets, asset prices, expectations, and exchange rates. High government borrowing and concerns about fiscal sustainability can raise sovereign and term premia such that long-term yields respond more to fiscal risk than to policy rates, weakening pass-through to longer-term borrowing costs. Further, high public borrowing can crowd out private financing and transmit stress to banks and firms, blunting the credit channel. Highly indebted households and firms may prioritize deleveraging and balance-sheet repair over spending and investment, making aggregate demand and economic activity less responsive to changes in interest rates and reducing traction for monetary policy.
- **The chapter adopts a two-step integrated approach to assess whether and how debt shapes both monetary policy decisions and transmission.** The first step estimates Taylor rules—an approximation to central banks' reaction functions relating policy rates to inflation and economic activity—augmented with fiscal variables to directly test for fiscal dominance. Residuals from these estimations identify the component of policy interest rate changes not explained by macroeconomic conditions and therefore serve as monetary policy shocks. The second step traces the dynamic responses of output and bond yields to these shocks using a smooth-transition local projection framework, which allows responses to vary continuously with debt levels.
- **The findings indicate that fiscal dominance plays a significant role in policy rate decisions globally, most particularly in emerging economies.** Controlling for conventional determinants of monetary policy, a deterioration of 1 percentage point in the expected fiscal balance is associated with a policy rate 16 basis points lower on average, and 22 basis points in emerging economies. The effect is substantially larger when public debt is high—32 basis points, compared with 12 basis points in low-debt environments—suggesting that heavier fiscal burdens constrain central banks' room to raise rates. Notably, this constraint appears less pronounced in DAP. Fiscal dominance effects become statistically insignificant when central bank independence is high, underscoring how important strong institutions are to insulating monetary policy decisions from fiscal pressures.
- **A surprise monetary policy tightening has sizable effects on output and financial conditions.** On average, a surprise increase in the policy rate of 1 percentage point lowers real output by about 0.6% after 2 years. Sovereign bond yields rise by 30 basis points for 2-year bonds and 20 basis points for 10-year bonds in the quarter immediately following the monetary policy tightening. This milder response at longer maturity reflects the influence of other pricing factors, notably inflation expectations, sovereign risk premia, and term premia.

- **High public and private debt weaken the transmission of monetary tightening to financial conditions, as does high private debt on real activity.** Both forms of indebtedness mute the pass-through of surprise monetary tightening to sovereign bond yields. In the full sample, a surprise policy rate increase by 1 percentage point raises the 2-year yield by about 54 basis points in the following quarter where public debt is low, compared with a statistically insignificant 11 points where public debt is high. High private debt also dampens the real output response. Following the same policy rate shock, output falls by about 0.5% after 2 quarters in low-debt environments but shows no response when debt is high. This pattern is consistent with a debt-overhang mechanism. When highly leveraged households and firms face binding balance sheet constraints, their consumption and investment decisions may be driven more by the burden of existing debt payments and the need to repair balance sheets than by marginal changes in interest rates. These findings are broadly consistent across the global sample, in emerging markets and developing economies, and in DAP.
- **Central bank independence shapes how indebtedness affects monetary policy transmission.** Low central bank independence is associated not only with greater fiscal dominance, but also with stronger erosion of transmission at high debt levels. When independence is low, high public and private debt mute responses of both real output and bond yields to monetary policy shocks. When independence is high, by contrast, output responses do not differ significantly between high- and low-debt regimes, but the transmission to bond yields remains weaker where public and private debt is high. This suggests that high debt becomes a binding constraint when central bank independence is weak. While strong institutions can make monetary policy more effective, they do not appear to fully offset the dampening effects of indebtedness.
- **Independent and effective monetary policy requires strong fiscal frameworks, central bank autonomy, and low debt vulnerability.** Credible fiscal institutions can ease the pressure that debt service places on central banks and restore the pass-through of policy rates to sovereign borrowing costs. Deepening domestic financial markets can facilitate debt management, reducing liquidity premia and reliance on external debt. Macroprudential limits on leverage and effective insolvency frameworks can prevent the balance-sheet overhang that blunts how spending and investment respond to interest rates. Central bank independence preserves monetary policy effectiveness and is most valuable where debt is high, but strong institutions alone are not a substitute for addressing underlying debt vulnerability and restoring fiscal credibility.

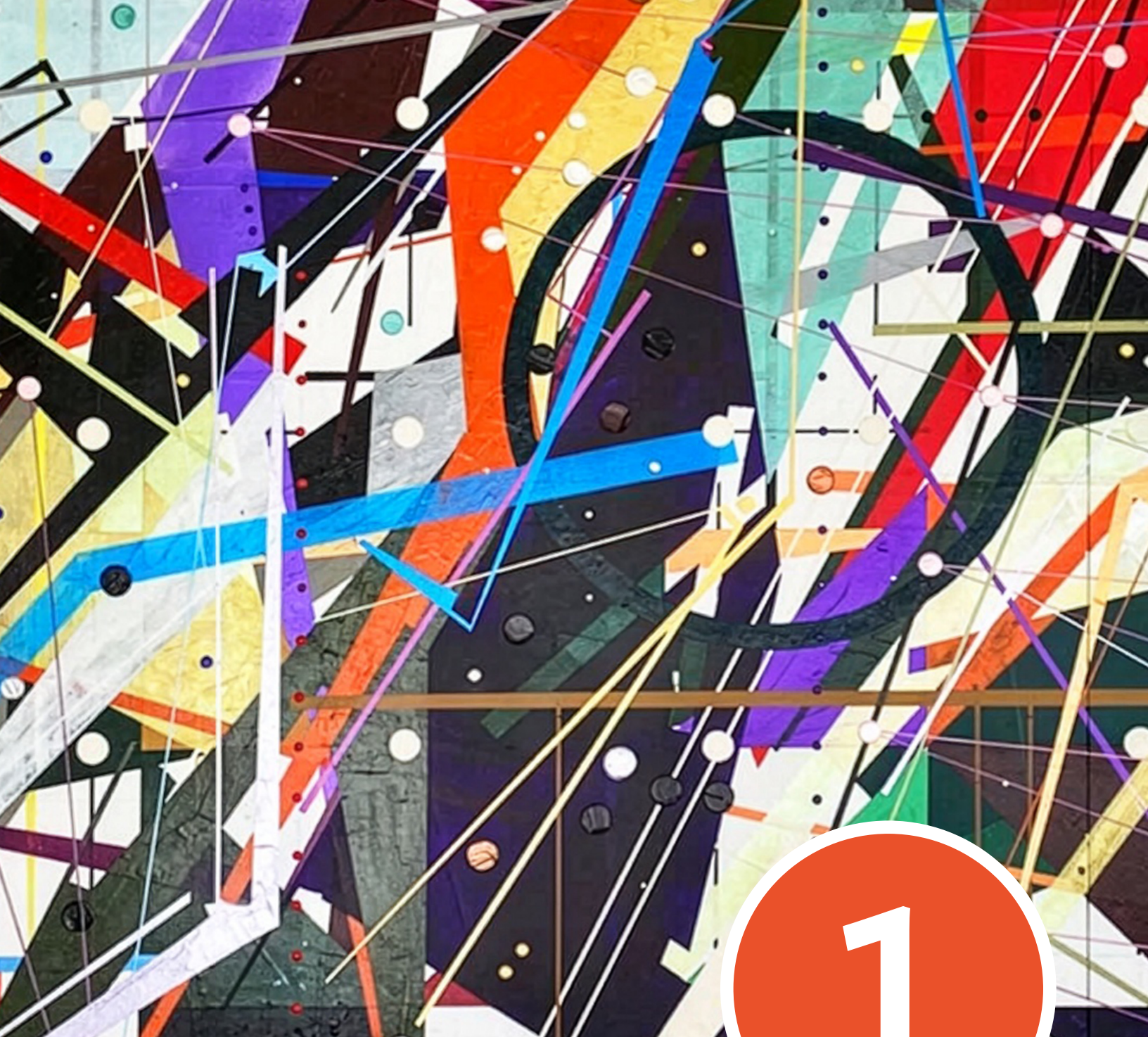
Asian Development Outlook September 2026

Subregion/Economy	GDP Growth					Inflation				
	2025	2026		2027		2025	2026		2027	
		Jul	Sep	Jul	Sep		Jul	Sep	Jul	Sep
Developing Asia and the Pacific (DAP)	5.5	4.9	5.0	5.1	5.1	3.0	4.3	4.2	3.4	3.5
DAP excluding the People's Republic of China	6.0	5.3	5.4	5.7	5.6	6.0	7.5	7.7	5.9	6.2
Caucasus and Central and West Asia	4.6	3.8	3.7	4.2	4.1	25.6	22.0	23.1	16.3	17.6
Armenia	7.1	5.0	5.0	5.5	5.5	3.3	4.2	4.2	3.5	3.5
Azerbaijan	1.4	2.0	1.6	1.8	1.8	5.6	5.7	5.9	4.9	5.0
Georgia	7.5	5.5	6.3	5.2	5.2	3.9	4.9	5.2	3.3	3.3
Kazakhstan	6.5	4.8	4.8	4.5	4.5	11.4	10.4	10.4	9.5	9.5
Kyrgyz Republic	11.1	8.9	8.9	8.4	8.4	8.2	11.2	11.2	8.5	8.5
Tajikistan	8.4	7.3	7.0	6.8	6.8	3.5	4.5	4.5	4.7	4.7
Türkiye	3.7	3.1	2.8	3.8	3.6	35.2	29.7	31.5	21.5	23.5
Turkmenistan	6.3	6.3	6.3	6.2	6.2	5.5	6.0	6.0	6.0	6.0
Uzbekistan	7.7	6.7	7.0	6.8	6.8	7.3	6.5	6.7	5.0	5.0
Developing East Asia	5.0	4.6	4.6	4.5	4.5	0.0	1.2	0.9	0.9	0.9
People's Republic of China	5.0	4.6	4.6	4.5	4.5	0.0	1.2	0.9	0.9	0.9
Mongolia	6.8	5.7	5.7	6.0	6.0	8.6	7.8	10.7	6.8	8.3
South Asia	7.0	6.0	6.4	6.7	6.5	2.9	5.7	5.5	4.8	4.8
Afghanistan	1.9	2.3	1.5	3.0	2.2	-4.2	3.6	3.6	5.5	7.0
Bangladesh	3.5	3.7	3.7	4.5	4.0	10.0	9.0	8.7	8.8	9.0
Bhutan	8.5	6.5	6.5	7.2	7.2	3.5	4.5	6.5	4.0	4.5
India	7.8	6.6	7.0	7.3	7.1	2.1	5.2	5.0	4.0	4.0
Maldives	6.2	1.0	1.0	3.0	3.0	4.0	5.0	2.2	4.0	2.0
Nepal	4.4	3.9	3.9	4.5	4.1	4.1	3.2	3.1	5.0	5.3
Pakistan	3.2	3.7	3.7	3.7	3.7	4.5	7.2	7.1	8.3	8.3
Sri Lanka	5.0	4.0	4.0	4.0	4.0	-0.5	6.0	6.0	5.2	5.2
ASEAN	4.8	4.5	4.7	4.6	4.7	2.0	3.8	3.9	2.9	3.2
Developing Southeast Asia	4.8	4.6	4.7	4.8	4.9	2.1	3.9	4.0	2.9	3.3
Brunei Darussalam	1.0	1.8	1.2	1.9	1.9	-0.3	1.1	1.1	0.5	0.5
Cambodia	5.3	4.1	3.9	4.7	4.7	2.5	4.5	4.7	2.5	2.8
Indonesia	5.1	5.2	5.2	5.2	5.2	1.9	3.0	3.3	2.5	3.0
Lao People's Democratic Republic	4.4	4.0	4.0	4.5	4.5	7.7	9.8	8.0	6.7	6.5
Malaysia	5.2	4.6	4.9	4.5	4.7	1.4	2.0	2.0	1.9	2.0
Myanmar	-2.2	2.4	2.2	2.7	2.7	17.0	24.0	24.0	16.0	16.0
Philippines	4.4	3.8	3.3	5.3	5.1	1.7	5.9	5.9	3.9	4.4
Thailand	2.4	1.8	2.0	2.0	1.9	-0.1	2.9	2.5	1.3	1.3
Timor-Leste	4.5	3.8	4.0	4.1	4.1	0.5	2.2	1.0	2.0	1.8
Viet Nam	8.0	7.2	7.8	7.0	7.6	3.3	4.0	4.3	3.8	4.0
The Pacific	4.5	3.3	3.0	3.2	2.9	2.9	4.2	4.6	3.5	4.1
Cook Islands	4.0	2.7	3.5	3.0	3.5	2.0	3.5	4.5	3.3	4.0
Fiji	2.5	2.6	2.2	2.5	1.9	-1.4	3.6	3.9	1.9	2.5
Kiribati	4.3	3.1	3.1	2.6	2.6	5.9	5.3	4.0	4.2	4.0
Marshall Islands	1.8	3.0	2.2	2.6	2.0	5.6	6.2	5.7	5.3	4.7
Federated States of Micronesia	1.1	0.7	0.5	1.0	0.9	2.8	3.8	3.8	3.5	3.5
Naoero	2.6	2.5	2.5	2.5	2.5	6.1	4.5	4.5	4.0	4.0
Niue	2.0	2.5	1.0	2.5	2.0	2.3	3.4	3.8	2.8	3.8
Palau	6.9	5.8	5.8	3.6	3.6	0.2	2.9	3.0	2.5	2.5
Papua New Guinea	5.2	3.6	3.4	3.4	3.2	4.4	4.6	5.0	4.0	4.6
Samoa	4.2	2.0	0.4	3.0	2.0	1.9	1.2	1.4	4.0	5.0
Solomon Islands	3.6	3.0	1.7	3.4	3.3	2.7	4.5	5.5	2.8	5.0
Tonga	4.4	2.3	2.3	2.3	1.8	2.9	3.8	4.0	2.7	6.0
Tuvalu	-0.8	2.5	1.9	2.4	1.7	2.9	3.5	4.8	1.7	3.1
Vanuatu	3.8	4.7	4.7	3.9	3.9	0.7	2.0	2.0	2.7	2.7

ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product.

Notes: ASEAN comprises Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste, and Viet Nam. Most regional economies report by calendar year; reporting by fiscal year are South Asian countries (except Bhutan, Maldives, and Sri Lanka), the Cook Islands, the Marshall Islands, the Federated States of Micronesia, Myanmar, Naoero, Niue, Palau, Samoa, and Tonga. ADB placed its regular assistance to Afghanistan on hold effective 15 August 2021. Effective 1 February 2021, ADB placed a temporary hold on sovereign project disbursements and new contracts in Myanmar.

Source: Asian Development Outlook database.



NAVIGATING PROLONGED ENERGY SHOCKS AND EL NIÑO



NAVIGATING PROLONGED ENERGY SHOCKS AND EL NIÑO

Prolonged disruptions in global energy markets and a very strong El Niño are shaping the outlook for developing Asia and the Pacific. Renewed conflict and trade disruptions in the Middle East, alongside the reescalation of Russia's war in Ukraine, have kept energy prices elevated. Economies across the region have cushioned some of these pressures by diversifying energy sources and introducing price stabilization measures, but higher energy, logistics, and trade costs are weighing on economic activity. Growth moderated in the second quarter of 2026, reflecting rising production costs, weaker demand, and heightened uncertainty. El Niño is expected to persist into 2027, adding further pressure on food and commodity prices.

The regional growth forecast is revised up slightly to 5.0% for 2026 and maintained at 5.1% for 2027, both below the 5.5% expansion recorded in 2025. The upward revision for 2026 reflects stronger technology exports in Southeast Asia, driven by the artificial intelligence (AI) investment cycle, and robust capital spending and exports in India, which more than offset downgrades for the Pacific and the Caucasus and Central and West Asia. Inflation is expected to remain well above the 3.0% recorded in 2025. The 2026 forecast is trimmed to 4.2%, partly reflecting government price stabilization measures, and weaker-than-expected consumer demand in the People's Republic of China. By contrast, the 2027 inflation projection is raised slightly to 3.5%, as higher global oil prices and the peak pass-through of El Niño-related price increases add to inflationary pressures.

Downside risks dominate. The main risks stem from worsening geopolitical tensions, energy market disruptions, and extreme weather shocks. Tighter financial conditions, a sharp repricing of AI-related equity valuations, and renewed trade policy uncertainty also weigh on the region's prospects.

This section was written by John Beirne (lead), Shiela Camingue-Romance, Suzette Dagli, Roshen Fernando, Jaqueson Galimberti, Henry Ma, Tolga Ozden, Madhavi Pundit (colead), Melanie Grace Quintos, Pilipinas Quising, Ed Kieran Reyes, Patrick Jaime Simba, Shu Tian, Priscille Villanueva, Mai Lin Villaruel, and Ma. Lourdes Lacson (consultant), under the guidance of Matteo Lanzafame of the Economic Research and Development Impact Department.

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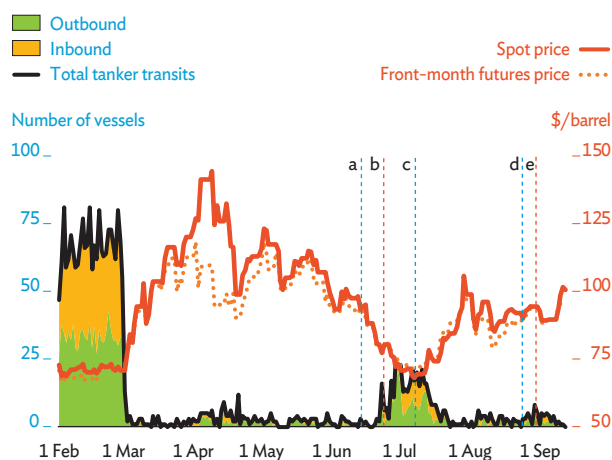
Geopolitical and Weather-Induced Shocks Intensify Pressure on Global Energy Markets

Geopolitical tensions continue to disrupt global energy markets, keeping crude oil prices volatile and shipping through the Strait of Hormuz severely constrained. A United States–Iran framework agreement in mid-June raised expectations of a gradual recovery in shipping, pulling Brent spot prices down from \$85/barrel on 15 June to \$68 on 2 July, well below their April peak of nearly \$145 (Figure 1.1.1). A subsequent breakdown of the framework agreement in early July, attacks on Saudi-linked tankers, and growing threats to Red Sea shipping renewed volatility, briefly pushing crude oil prices above \$100. Diplomatic efforts in August, including discussions on a temporary

maritime corridor coordinated by Iran and Oman, briefly improved market sentiment and pushed Brent crude prices below \$90. However, military action on 30 August again raised the risk premium, pushing Brent above \$100 on 4 September, the data cutoff for this report. Shipping conditions remained far from normal, with daily vessel crossings through the Strait of Hormuz fluctuating well below pre-conflict levels. Heightened security risks continue to keep insurance premiums and freight costs elevated, adding pressure to global energy markets. While the proposed Iran–Oman arrangement could facilitate some traffic, its implementation remains uncertain. Recent developments underscore the fragility of the diplomatic process and the continuing risk of renewed disruption to energy markets and shipping routes. Even if implemented, it would likely provide only partial relief without resolving the wider conflict and associated shipping risks.

Figure 1.1.1 Strait of Hormuz Daily Tanker Transits, 2026

Tanker traffic through Hormuz remains well below normal before the conflict.



Notes: Conflict in the region brings reports of global positioning system jamming, automatic identification system spoofing, and vessels going dark, so data on the number of ships passing through the Strait of Hormuz since March 1 may not be accurate. Data are up to 4 September 2026.

^a 14 Jun—Announcement of framework agreement in the Middle East

^b 25 Jun—Iranian drone struck cargo ship Ever Lovely

^c 8 Jul—Framework agreement declared over

^d 25 Aug—Proposed Iran–Oman Maritime Corridor announced

^e 30 Aug—Military action resumes in the Middle East

Source: Bloomberg.

Disruption has spread beyond Hormuz, increasingly constraining alternative routes for Gulf oil exports.

As disruption at Hormuz intensified, Saudi Arabia routed more crude through the East–West Pipeline to Yanbu, increasing traffic through Bab el-Mandeb, the narrow strait connecting the Red Sea to the Gulf of Aden, in early and mid-July. After a Houthi blockade started to target Saudi-linked shipping and other tankers, crossings fell as some vessels turned back or rerouted. Traffic had only partly recovered by early September. Because shipments from Yanbu to Asia must transit Bab el-Mandeb, simultaneous disruption at both straits is constraining the main Gulf export route and its key alternative, lengthening voyages and raising costs for freight, insurance, and energy. After the 4 September data cutoff, drone attacks on 10 September damaged Saudi Arabia’s East–West Pipeline, prompting its precautionary shutdown and further highlighting the vulnerability of alternative export routes.

Markets for liquefied natural gas (LNG) and other refined products are under pressure, amplifying the energy shock. Disruption to Qatari production and LNG exports, including declaration of *force majeure* on some LNG deliveries, have tightened global availability. The Japan Korea Marker averaged \$22 per million British thermal units in August, more than double its January–February average before the conflict and above the European Title Transfer Facility benchmark, reflecting constrained Qatari supply and competition for available cargoes. Risks around Bab el-Mandeb could further hamper cargo redirection between Europe and Asia, leaving LNG-importing economies vulnerable to renewed price spikes. Refined-product markets have tightened even more sharply than crude oil markets (Figure 1.1.2). The Singapore gasoil–Brent crack spread surged after the conflict began, narrowed following the mid-June framework agreement, and widened again as supply disruption intensified. By 4 September, it was more than three times wider than before the conflict. Consistent with this widening, Singapore spot prices for gasoline, bunker fuel, jet fuel, and diesel all rose more than Brent crude from the onset of the conflict to 4 September, with the largest increases for diesel and jet fuel. This reflects disruption to global seaborne oil-product trade, which has fewer pipeline alternatives than crude, compounded by lower fuel exports from the People’s Republic of China (PRC), Ukrainian strikes on Russian refineries, and Russian restrictions on fuel

exports. As a result, refined-product prices may remain elevated even if crude prices ease, sustaining pressure on transport, industrial, and agricultural costs.

With unusual strength in this cycle, El Niño could intensify the energy shock and broaden it to food and other commodities (Figure 1.1.3). The US National Oceanic and Atmospheric Administration expects El Niño to intensify toward the end of 2026, with a very high probability of persisting to sometime in February–April 2027 (see [Special Topic on El Niño 2026: Potential Physical and Economic Impacts for Asia and the Pacific](#)). Dry conditions have emerged in Indonesia, India’s monsoon deficit initially delayed planting, and Australia expects rainfall across much of its south and east to be below average. Philippine authorities have warned of greater drought risks despite intermittent monsoon rains and heavy rainfall from cyclones. These weather shocks could compound the lagged effects of earlier increases in fuel and fertilizer costs on harvests already exposed to heat and water stress. At the same time, greater cooling need could raise demand for electricity even as hydropower generation weakens, raising demand for refined petroleum fuels and LNG. Low water is curtailing transit through the Panama Canal, adding to rerouting pressures, delivery delays, and freight costs. Together, these shocks could generate broader and more persistent food-price and inflationary pressures.

Figure 1.1.2 Oil Product Crack Spreads

After easing from their March peaks, crack spreads climbed again in July and remained in September more than three times wider than before the conflict.

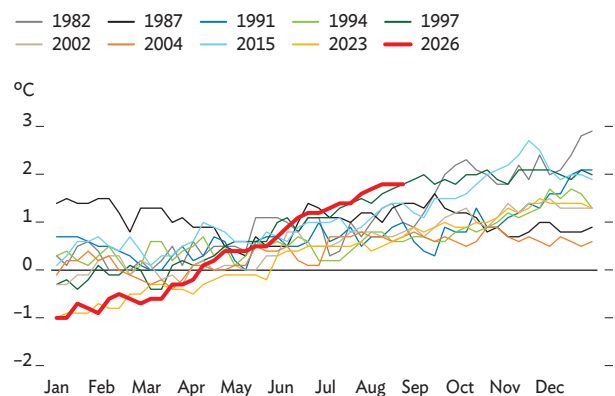


Notes: Data show Singapore jet fuel and gasoil crack spreads relative to Brent crude. A crack spread measures the difference between the prices of a refined petroleum product and crude oil. Data are up to 4 September 2026.

Source: LSEG Workspace.

Figure 1.1.3 Sea-Surface Temperature Anomalies in Selected Years with El Niño

The 2026 El Niño has strengthened faster than comparable episodes in recent decades, with sea-surface temperatures 1.8°C above normal by mid-August.



Notes: Data show weekly sea-surface temperature anomalies in the Niño 3.4 region of the central equatorial Pacific. Data are up to 2 September 2026.

Source: US National Oceanic and Atmospheric Administration’s Climate Prediction Center.

Persistent Energy Disruption Slows Growth and Sustains Inflationary Pressure

Regional growth moderated in the second quarter (Q2) of 2026 from Q1 as weaker domestic demand more than offset stronger net exports (Figure 1.2.1, panel A). Solid pre-conflict economic activity buoyed growth in Q1, but the effects of persistent energy market disruption increasingly spread to the broader economy in Q2. Moderation was broad-based, though the two largest economies diverged. In the People's Republic of China (PRC), growth slowed to 4.3% in Q2, its weakest pace in almost 4 years, while India held steady at 7.8%. In the rest of the region, growth declined to 3.8%, 0.3 percentage points below Q1.

Consumption and investment growth eased across much of the region. Higher energy costs and inflation eroded household purchasing power and dampened consumer sentiment, weighing on consumption growth. In the PRC, weaker consumption also reflected slower household income growth and fading support from a consumer goods trade-in program. In India, household spending was dampened by elevated consumer goods prices. Regional investment also moderated amid heightened geopolitical tensions and weaker business sentiment. The artificial intelligence (AI) boom provided a countervailing force, supporting investment growth in India and significantly boosting it in Thailand. In the PRC, robust investment in computing infrastructure, AI, advanced manufacturing, and high-tech export industries was offset by the continuing drag from the property sector downturn on fixed-asset investment and the government's campaign to promote orderly competition. Investment remained weak in the Philippines, owing to constrained public infrastructure spending, and in Türkiye on tight financing conditions.

Regional net exports strengthened, but gains were narrow. Supply chain diversification and the AI investment boom drove export growth. Global demand for advanced microchips, electronics, and computing infrastructure boosted net exports in India, Malaysia,

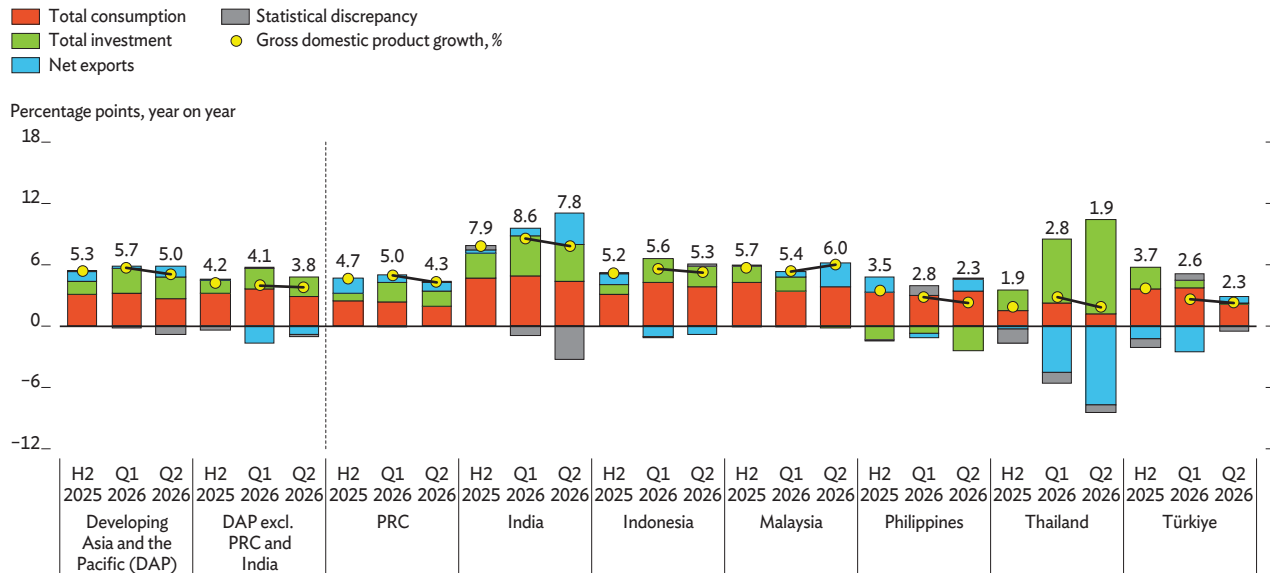
and the Philippines, with India accounting for much of the regional improvement. However, rising imports of materials and capital goods to support investment and manufacturing offset export gains in some economies—particularly Thailand, where the drag from net export was the largest. Excluding the PRC and India, net exports subtracted 0.8 percentage points from overall growth.

On the supply side, regional industrial activity moderated from Q1 to Q2 as weaker manufacturing growth in the PRC outweighed gains in other tech-producing economies (Figure 1.2.1, panel B). Despite robust AI exports, particularly chips and advanced electronics, manufacturing weakened in the PRC, reflecting the impact of the real estate downturn on related upstream industries and the government's efforts to promote quality-based competition. By contrast, Malaysia and the Philippines saw stronger factory activity as firms ramped up production and worked through order backlogs. In India, manufacturing continued to expand, supported by such government measures as production-linked incentives and initiatives to boost semiconductors, electronics, and medium- and high-tech industries. Services growth also eased, weighed down by weaker consumption and real estate in the PRC and the Philippines, while higher commodity prices weighed on retail trade, travel, and hospitality in India. Construction subtracted from growth in the PRC and in the Philippines, where it contracted for a fourth consecutive quarter. Outside of the PRC, strong growth in financial, real estate, and professional services helped offset weaker tourism in Thailand and Türkiye.

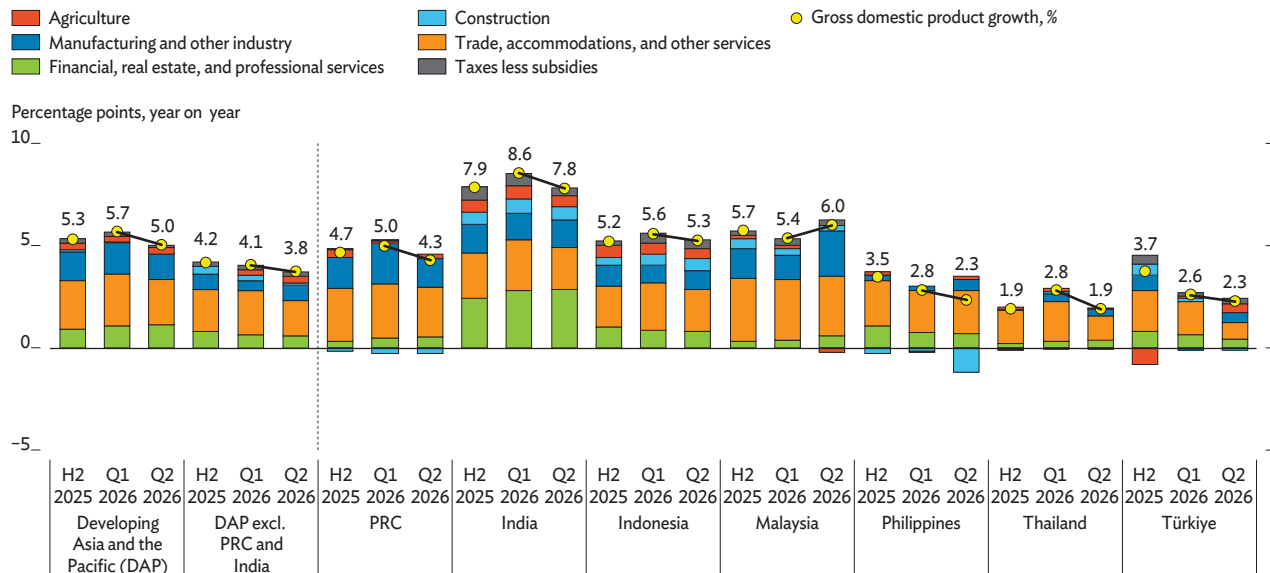
Leading indicators point to continued but uneven gains in manufacturing across developing Asia and the Pacific (DAP) in August. Readings of the S&P purchasing managers' index (PMI) remained above the 50-point threshold in six of the eight economies

Figure 1.2.1 Contributions to GDP Growth
A. Demand-Side

Regional growth slowed in Q2 2026 as weaker consumption and investment outweighed narrowly based net export gains.


B. Supply-Side

Manufacturing activity weakened in Q2 despite strong gains in tech-producing economies.



DAP = developing Asia and the Pacific, GDP = gross domestic product, H = half, PRC = People's Republic of China, Q = quarter.

Notes: DAP economies included are India, Indonesia, Malaysia, the Philippines, the PRC, Thailand, and Türkiye, because they have quarterly GDP figures and supply- and demand-side data. These economies account for 89% of DAP GDP weighted by purchasing power parity. Totals may not sum precisely due to statistical discrepancies and chain-linking in panel A and in product taxes less subsidies in panel B. Data are for calendar years, not seasonally adjusted. For the PRC, the breakdown of supply-side contributions was estimated using sector shares from the 2023 ADB Multiregional Input-Output Table.

Source: Asian Development Bank estimates using data from Haver Analytics, CEIC Data Company, and official sources.

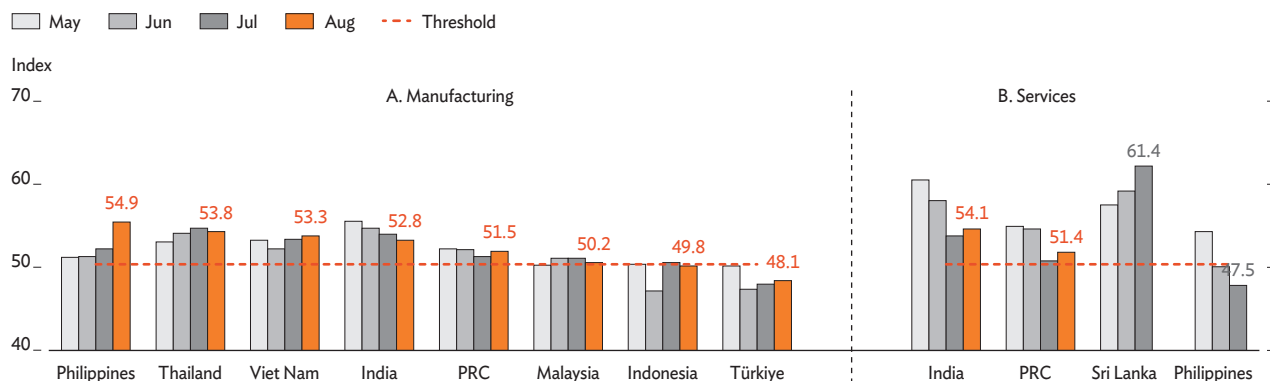
covered (Figure 1.2.2, panel A). The PRC's S&P PMI improved on firmer demand, output, and export orders, diverging from the official manufacturing PMI, which remained below the threshold at 49.8. This suggests stronger conditions for private firms and small- and medium-sized enterprises than for larger domestic and state-owned firms. The Philippines' PMI was the highest in nearly a decade, supported by rising new orders and production, new product launches, and a return to export order growth for the first time in 6 months (Figure 1.2.2, panel B). By contrast, readings declined in India, Malaysia, and Thailand, reflecting

uneven operating conditions that lowered output and demand. Indonesia's PMI fell below 50 after signaling improvement in July, and Türkiye's continued to signal worsening business conditions and subdued demand amid the ongoing Middle East conflict. Supplier delivery times showed little improvement in several economies, such that persistent supply chain bottlenecks could induce firms to resume precautionary inventory building. Services PMIs, available for four economies, broadly signaled continued improvement. In the PRC and India, readings rose in August after weakening to multi-month lows in July. In the Philippines, the July

Figure 1.2.2 S&P Purchasing Managers' Index, Selected Asian Economies

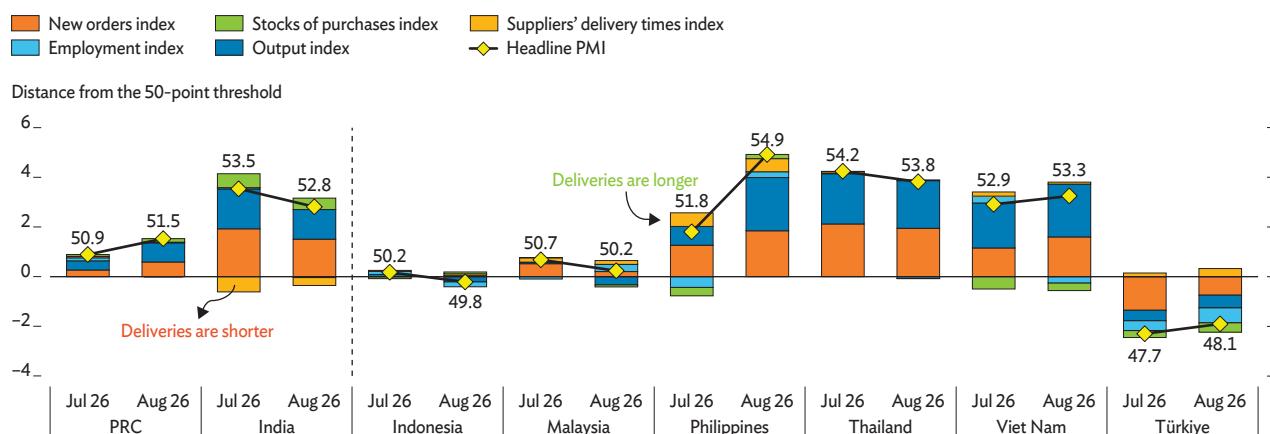
A. Manufacturing and Services PMI

PMIs show manufacturing improving in most economies in August, with services expanding in the PRC and India.



B. Manufacturing PMI, by Component

Demand and output continued to support factory activity, to varying degrees across economies.



PMI = purchasing managers' index, PRC = People's Republic of China.

Notes: Panel A: The manufacturing PMI is a diffusion index based on survey responses from purchasing managers. A reading above 50 indicates expansion in manufacturing activity from the previous month, while a reading below 50 indicates contraction. Panel B: The manufacturing PMI is a weighted composite index of five subindexes: new orders (30%), output (25%), employment (20%), supplier deliveries (15%), and inventories (10%). The contribution of each component to headline PMI is calculated as its weight multiplied by its deviation from the 50-threshold. The 50-threshold is marked as zero; above zero indicates expansion, below contraction.

Source: Haver Analytics.

reading remained below 50 as elevated operating costs, subdued consumer demand, and disruptive weather constrained activities.

Headline inflation in DAP eased to 3.7% in July, as a dip in energy inflation more than offset food inflation that was firmer outside the PRC (Figure 1.2.3, panel A).

Global energy and shipping costs moderated in July following progress in ceasefire negotiations, though geopolitical tensions reemerged later in the month. Inflation in the PRC also eased, as

lower fuel and transportation costs, continued declines in food prices, and moderating domestic demand outweighed persistent price increases in services (Figure 1.2.3, panel B). Excluding the PRC, regional inflation was 7.5% (Figure 1.2.3, panel C), though this largely reflects Türkiye, where inflation reached 31.8%; excluding both economies, regional inflation was 4.5% (Figure 1.2.3, panel D). Inflationary pressures remained elevated in several energy-importing economies still absorbing pass-through from earlier increases in energy, shipping, and import costs.

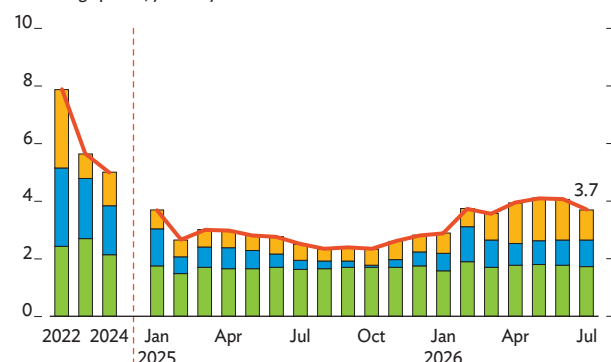
Figure 1.2.3 Contributions to Inflation, 2022 to July 2026

Inflation eased in July, though the regional figure masks wide differences across economies.

Core Energy-related Food Headline, %

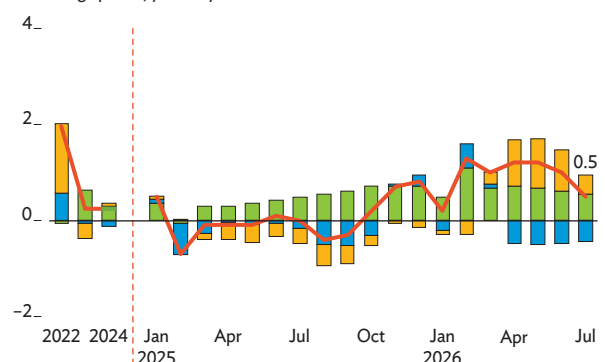
A. Developing Asia and the Pacific

Percentage points, year on year



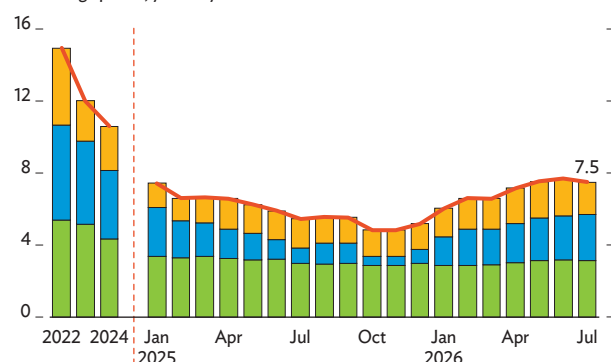
B. People's Republic of China

Percentage points, year on year



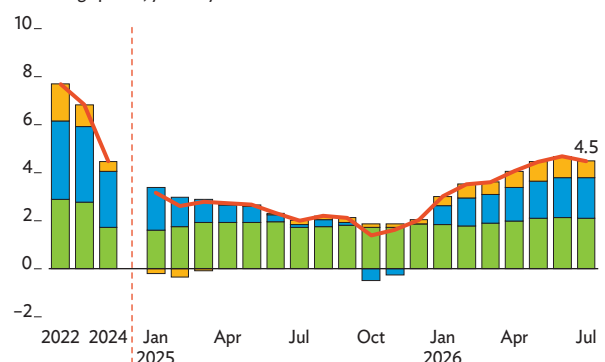
C. Developing Asia and the Pacific Excluding the People's Republic of China

Percentage points, year on year



D. Developing Asia and the Pacific Excluding the People's Republic of China and Türkiye

Percentage points, year on year



Notes: Core inflation excludes food and energy. For some economies, core inflation is estimated as the residual between overall inflation and the sum of food and nonalcoholic beverages and energy-related items. For lack of a more disaggregated breakdown, energy-related consumer prices include in most economies housing, water, and non-fuel transport. For the PRC, energy-related inflation is calculated based on revised weight estimates from Oxford Economics. Subregional averages are calculated using gross domestic product purchasing power parity shares as weights for 19 economies.

Source: Asian Development Bank estimates using data from Haver Analytics and official sources.

Upward price pressures remain, given rising import costs.

Imported input costs are an important upstream channel through which global commodity and import price shocks eventually reach consumers. The impact tends to be more pronounced in economies with high import dependence and large manufacturing industries, where imported intermediate goods and raw materials account for a larger share of production costs. Since February 2026, import costs have risen significantly in the region (Figure 1.2.4), alongside a marked acceleration in average producer price inflation, from 8.7% in February to 10.1% in March and 16.5% in June (Figure 1.2.5). The acceleration was led by South Asia, where wholesale price inflation in India climbed to a 44-month high of 10.0% in June, and by the Caucasus and Central and West Asia, where producer price inflation remained elevated, driven largely by Türkiye. In the PRC, producer price inflation rose to a 47-month high of 4.0% in June before easing to 3.5% in July. This was driven by surging mining and raw material costs and by AI-fueled technology demand, which raised prices

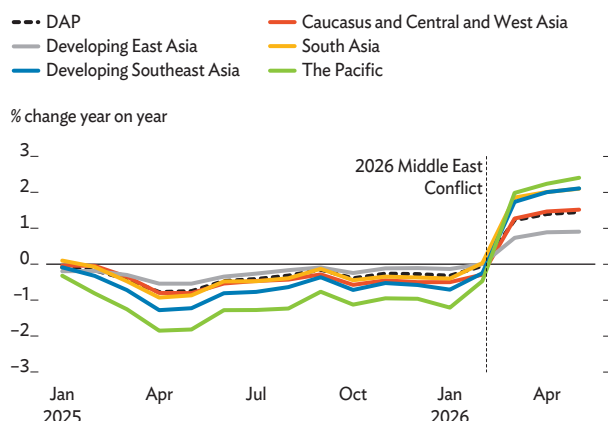
for high-tech component inputs. Empirical evidence for DAP indicates that increases in producer prices are transmitted to consumer prices, though not fully, with the magnitude and speed of pass-through varying across economies (Box 1.2.1).

Elevated input costs continued to feed through to food prices and core inflation, albeit unevenly across economies.

Modest increases in regional food inflation since May largely reflect developments in the PRC, where weaker pork prices and moderating domestic demand limited retailers' ability to raise food prices. Outside of the PRC, average food inflation was higher and rose in 12 of the 19 regional economies with available data from May to July 2026, on weather- and economy-specific factors. Food inflation accelerated most in South Asia and developing Southeast Asia, remaining high in the Caucasus and Central and West Asia, as weather shocks and other supply-side disruptions raised agricultural production costs and increased food imports. Higher input and energy costs also fed into services and non-food prices, keeping core inflation elevated in South Asia and pushing it higher in developing Southeast Asia, before easing in July (Figure 1.2.6).

Figure 1.2.4 Import Price Index, by Subregion

Rising import costs added to producer price pressures.



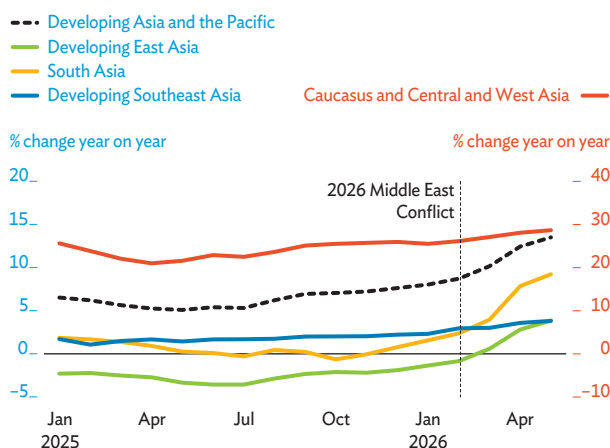
DAP = developing Asia and the Pacific.

Notes: The import price index is weighted by the ratio of imports to gross domestic product. The Caucasus and Central and West Asia includes Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, Türkiye, and Turkmenistan; developing East Asia includes the People's Republic of China; South Asia includes Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka; developing Southeast Asia includes Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Thailand, Timor-Leste, and Viet Nam; and the Pacific includes Fiji, Kiribati, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Developing Asia and the Pacific and subregional averages are aggregated using gross domestic product at purchasing power parity.

Sources: Asian Development Bank estimates using data from the International Monetary Fund. Commodity Terms of Trade Database; CEIC Data Company.

Figure 1.2.5 Producer Price Index, by Subregion

Producer price inflation accelerated gradually from February, driven by South Asia and developing East Asia.



Notes: Regional aggregates are calculated using available data for 19 economies: Armenia, Azerbaijan, Georgia, Kazakhstan, the Kyrgyz Republic, Tajikistan, and Türkiye in the Caucasus and Central and West Asia; the People's Republic of China and Mongolia in developing East Asia; Bangladesh, Bhutan, India, Nepal, and Pakistan in South Asia; and Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam in developing Southeast Asia.

Source: Asian Development Bank estimates using data from Haver Analytics.

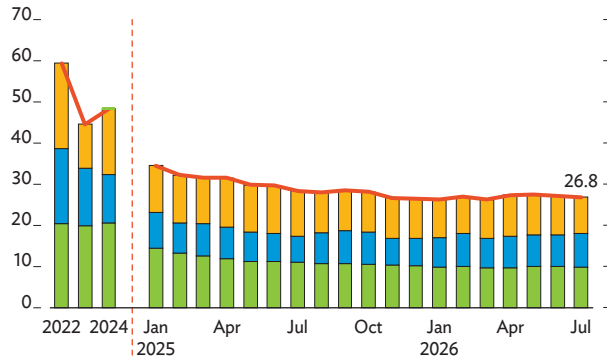
Figure 1.2.6 Contributions to Inflation, by Subregion

Headline inflation moderated across the region, but remained elevated in the Caucasus and Central and West Asia.

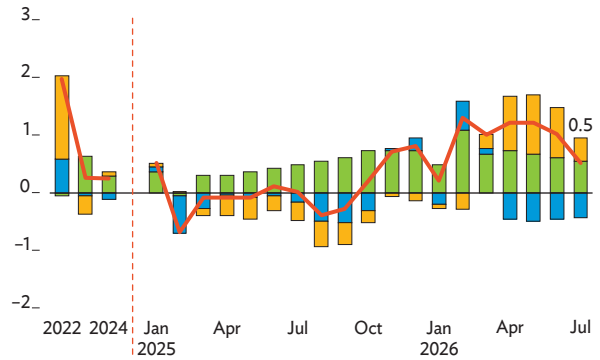
Core Energy-related Food Headline, %

A. Caucasus and Central and West Asia

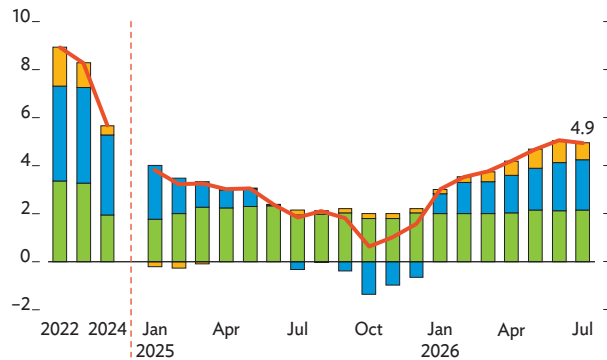
Percentage points, year on year


B. Developing East Asia

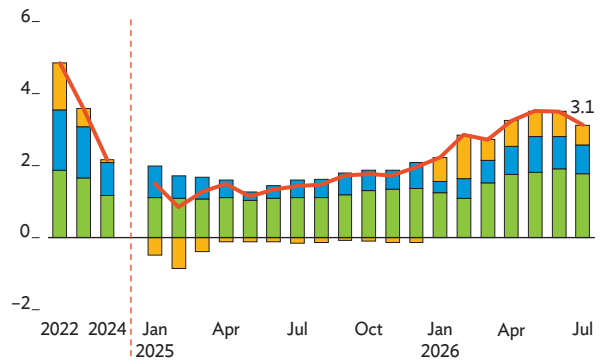
Percentage points, year on year


C. South Asia

Percentage points, year on year


D. Developing Southeast Asia

Percentage points, year on year



Notes: Core inflation excludes food and energy. For some economies, core inflation is estimated as the residual between overall inflation and the sum of food and nonalcoholic beverages and energy-related items. For lack of a more disaggregated breakdown, energy-related consumer prices include in most economies housing, water, and non-fuel transport. For the PRC, energy-related inflation is calculated based on revised weight estimates from Oxford Economics. Subregional averages are calculated using gross domestic product purchasing power parity shares as weights for 19 economies.

Source: Asian Development Bank estimates using data from Haver Analytics and official sources.

Box 1.2.1 Are Producer Prices a Good Leading Indicator of Consumer Price Inflation in Asia and the Pacific?

Renewed cost pressures have revived interest in how strongly and how quickly producer price increases transmit to consumer prices. The link between producer and consumer prices reflects the potential transmission of inflationary pressures along the production and distribution chain. Higher raw material and intermediate input prices raise firms' production costs, which can be passed through to downstream producer prices and, ultimately, to consumer prices. Producer prices may therefore lead consumer prices (Clark 1995), as they capture prices received by domestic producers before the addition of distribution margins, retail markups, and other costs embedded in consumer prices. Box figure 1 shows clear positive co-movement between producer price index (PPI) and consumer price index (CPI) inflation. The relationship is concentrated at short horizons, as co-movement is strongest within the same month and largely disappears within 2 years. Co-movement alone does not indicate the pass-through rate, however, or how much of a given movement in PPI ultimately feeds into CPI. Examining the magnitude and timing of this pass-through is important for understanding how cost pressures propagate through the economy. PPI movements reflect a range of shocks—notably

energy and commodity prices, exchange rates, and supply chain conditions—while CPI inflation captures the prices of imported goods, taxes, distribution costs, and domestic demand conditions. Pass-through may therefore be incomplete, delayed, and potentially bidirectional.

This box uses panel local projections (Jordà 2005) to estimate the response of CPI inflation to changes in PPI inflation in Asia and the Pacific.^a

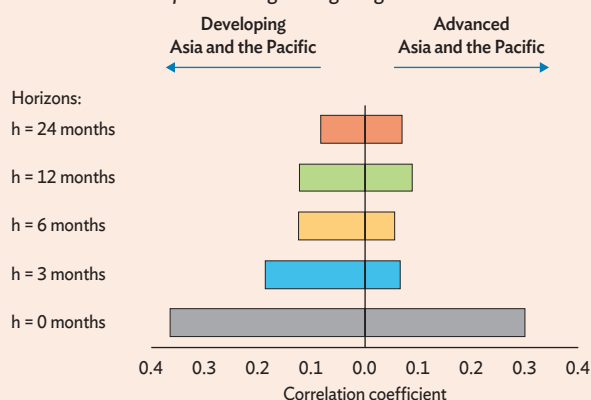
Analysis traces the cumulative response of CPI inflation to a PPI inflation shock of 1 percentage point (pp) to horizons of 3–24 months. The local projection framework identifies the dynamic response to an identified PPI shock but does not distinguish its underlying source. In other words, it answers a simple forecasting question: given a sudden increase in PPI inflation, regardless of its origin, by how much should CPI inflation be expected to rise? The pass-through rate reported in box figure 2 is the cumulative CPI response expressed as a share of the cumulative PPI movement.

Producer price inflation provides a meaningful early signal of subsequent consumer price inflation, though pass-through is partial and gradual (box table). For Asia and the Pacific as a whole, following a 1 percentage-point increase in PPI inflation, cumulative pass-through to CPI inflation reaches 28% after 6 months and 46% after 2 years, with estimates statistically significant at all horizons. Partial pass-through is consistent with the large weight of services and distribution costs in consumption baskets. It also reflects firms absorbing part of higher input costs through lower margins, along with pricing rigidities, contractual arrangements, competitive pressures, and differences in basket composition and index construction (Bureau of Labor Statistics 2023). Government interventions, including price controls, subsidies, and administered prices, can further delay or attenuate transmission (Abiad et al. 2026; Jongwanich, Wongcharoen, and Park 2016). Nonetheless, results show that sustained producer price increases transmit to consumer prices over time.

Transmission differs sharply across subregions, with strongest pass-through in South Asia and weakest in developing East Asia (box figure 2). In South Asia, pass-through rises from 54% at the

1 Co-movement of CPI with earlier PPI, by Horizon in Asia and the Pacific

CPI inflation co-moves most strongly with PPI inflation on impact, with the relationship weakening at longer lags.



CPI = consumer price index, h = horizon, PPI = producer price index.

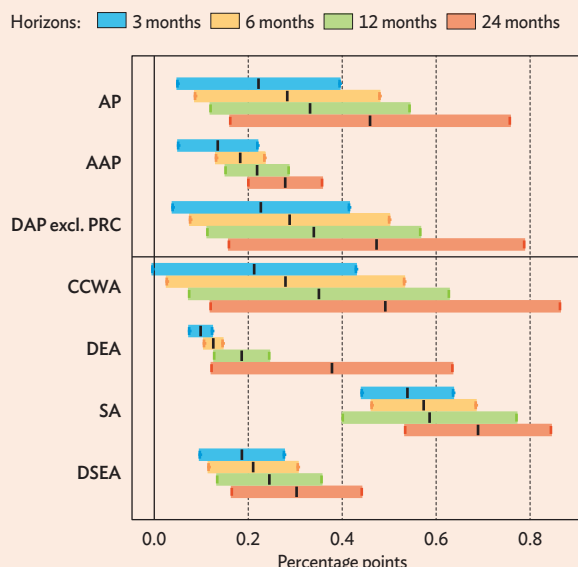
Notes: Calculated based on available data for 20 economies in developing Asia and the Pacific and 7 economies in advanced Asia and the Pacific from 1990 to June 2026.

Source: Asian Development Bank estimates using data from Haver Analytics.

Box 1.2.1 Continued

2 PPI-CPI Pass-Through Rates, Full Panel, by Subregion

Pass-through rises with the horizon in every subregion, but its timing and magnitude differ sharply.



AAP = advanced Asia and the Pacific, AP = Asia and the Pacific, CCWA = Caucasus and Central and West Asia, CPI = consumer price index, DAP = developing Asia and the Pacific, DEA = developing East Asia, DSEA = developing Southeast Asia, PPI = producer price index, PRC = People's Republic of China, SA = South Asia.

Notes: Analysis uses available monthly CPI and PPI data from January 1990 to June 2026. The cumulative impulse responses are reported in boxes with 95% confidence intervals for the full sample and subregional panels at 3-, 6-, 12-, and 24-month horizons. The line marks the point estimate per horizon.

Source: Asian Development Bank estimates.

3-month horizon to 69% at 2 years. Economies in this subregion tend to have relatively large weights for food and energy, together about 50%–60% in their consumer price baskets, and imported cost pressures also transmit more strongly to consumer prices than elsewhere in the region. In developing East Asia, comprising the People's Republic of China (PRC) and Mongolia, pass-through is only 10% after 3 months, but converges toward the full panel average at the 2-year horizon, at 38%. The lowest 2-year estimates are for advanced Asia and the Pacific, at 28%, and developing Southeast Asia, at 30%. Taken on its own, the PRC is close to the average for Asia and the Pacific at 3 months, at 19% against 22%, but substantially lower at 2 years, at 28% against 46%. This pattern is consistent with evidence that consumer prices in the PRC are also driven by domestic demand rather than solely by transmission from upstream costs. PPI and CPI inflation therefore appear to interact through a dynamic feedback loop rather than a one-directional chain (Sun et al. 2023). Excluding the PRC leaves the estimates essentially unchanged, indicating that pooled results are not driven by the region's largest economy.

The relationship between producer and consumer price inflation has remained broadly stable before and after the COVID-19 pandemic (box table).

A potential break is a natural concern: the 2020–2022 period combined exceptionally large supply and demand shocks with elevated inflation, which

PPI-to-CPI Pass-Through, Full Panel, Before and After COVID-19

Pass-through reaches roughly 46% after 2 years, with no significant change after the COVID-19 pandemic.

Sample ↓	Pass-through horizon, PT(h) →			
	3 months	6 months	12 months	24 months
Full sample	0.222**	0.284***	0.332***	0.459***
Pre-COVID-19 (to 2019)	0.239***	0.309***	0.350***	0.454***
COVID-19+ (from 2020)	0.190*	0.241**	0.303***	0.464***
Test of COVID-19 break (p-value)	0.465	0.389	0.483	0.888

* = statistical significance at the 10% level, ** = 5%, *** = 1%. CPI = consumer price index, h = horizon, PPI = producer price index, PT = pass-through.

Notes: PT(h) is the cumulative CPI-inflation response as a share of the cumulative PPI-inflation movement, h months after the shock. Full sample: estimates over the entire sample period without regime distinction. The test of COVID-19 break row reports the p-value for the structural break test of the pre- and COVID-19+ difference. Standard errors clustered by economy.

Source: Asian Development Bank estimates.

continued on next page

Box 1.2.1 Continued

could plausibly have strengthened pass-through. Nonetheless, estimates before and after 2020 are similar at every horizon, with differences statistically insignificant and tests not rejecting the null hypothesis of no structural break at any horizon. For Asia and the Pacific as a whole, the pandemic generated unusually large movements on both price indices without fundamentally altering the relationship between them. For inflation monitoring, the results offer a useful rule of thumb: a sustained 1 pp surprise in PPI inflation signals roughly 0.33 pp of additional cumulative CPI inflation over the following year for the typical economy in the panel, and materially more in South Asia.

The findings reported in this box carry direct implications for inflation monitoring and monetary policy in Asia and the Pacific. Because pass-through operates with a lag, persistent producer price pressures serve as an early signal of future consumer price inflation, strengthening assessments of the inflation outlook and informing monetary policy. The heterogeneity documented across economies, however, cautions against a uniform interpretation. Subsidies and price controls can also dampen transmission, but such buffers are temporary and fiscally costly. PPI-to-CPI pass-through may also be stronger where food has a larger weight in the CPI basket, dependence on food imports is high, producer

costs account for a larger share of retail prices, retail prices adjust more frequently, current inflation is higher, and expectations less firmly anchored. Once withdrawn, accumulated upstream cost pressures can reach consumers more forcefully.

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This box was written by Shiela Camingue-Romance and Tolga Ozden.

^a The analysis covers monthly data for 27 Asia and the Pacific economies from 1990 to June 2026. Data availability and coverage vary across economies. Where PPI data are unavailable, the wholesale price index is used as a proxy. For economies without monthly PPI observations, quarterly data are interpolated to construct monthly series. PPI data for some economies cover all commodities, while others are limited to manufactured goods or domestically produced goods. Series breaks and discontinued series are spliced to ensure continuity.

Solid Export Performance Despite Geopolitical Disruptions

Export growth remained robust in both developing and advanced Asia and the Pacific (DAP and AAP) in the first half of 2026.

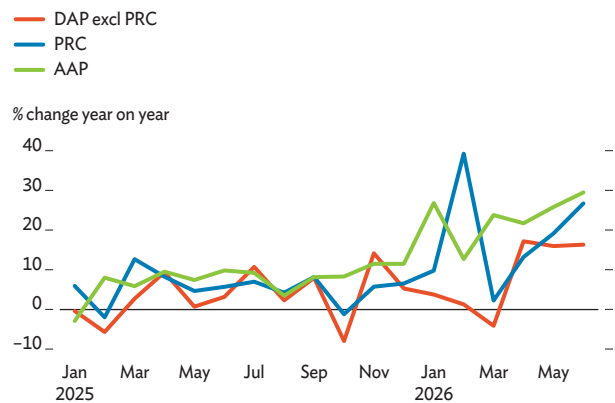
Nominal goods exports continued to expand in AAP, supported by sustained momentum in technology-related exports (Figure 1.2.7). Exports continued to increase strongly in DAP as well, with regional performance driven to a large extent by the People's Republic of China (PRC), alongside contributions from other regional economies. Excluding the PRC, DAP export growth was more volatile, slowing through March and turning negative as India's exports declined to its two largest markets, the US and the United Arab Emirates. Growth rebounded sharply in April as India's exports to the US returned to positive territory, while exports to Bangladesh; Hong Kong, China; Singapore; and Sri Lanka picked up. Stronger Indonesian exports to the PRC and the US provided an additional boost, alongside continued support from Malaysia and Thailand.

Electronics and machinery continued to account for the bulk of export growth in both DAP and AAP (Figure 1.2.8). Their contribution was especially pronounced in AAP, reflecting the different roles economies play in global technology supply chains. Several DAP economies specialize in downstream activities such as assembly, testing, and packaging,

while AAP economies are more heavily involved in semiconductor manufacturing and other higher-value segments. Within DAP, strong growth in electronics and machinery exports was driven largely by the PRC, Malaysia, the Philippines, and Thailand. The March slowdown reflected weaker textile exports from the

Figure 1.2.7 Nominal Goods Export Growth in Asia and the Pacific

AAP export growth continued to strengthen, while DAP growth was driven by the PRC, with the rest of the region recovering only from April.



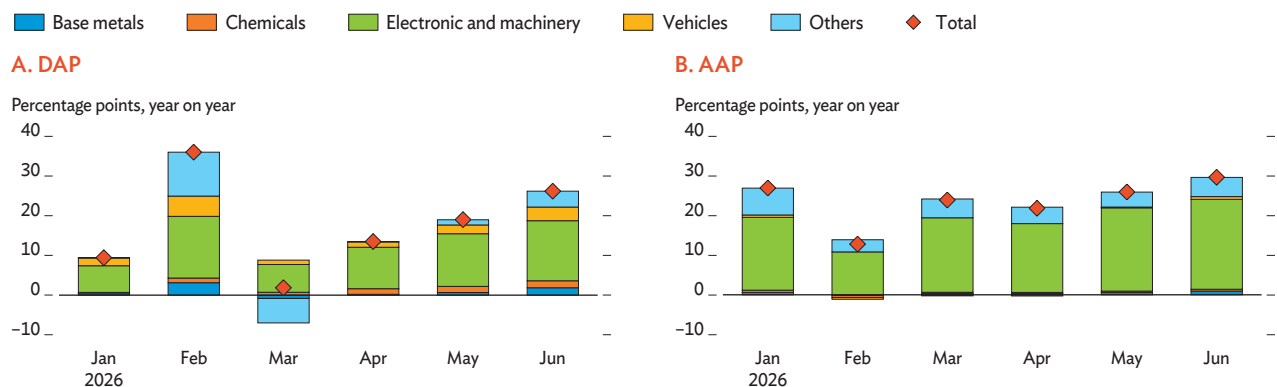
AAP = advanced Asia and the Pacific, DAP = developing Asia and the Pacific, PRC = People's Republic of China.

Notes: DAP includes Cambodia, the PRC, Georgia, India, Indonesia, Malaysia, Mongolia, the Philippines, and Thailand; AAP includes Australia; Hong Kong, China; Japan; the Republic of Korea; New Zealand; and Taipei, China. Regional figures are weighed by GDP purchasing power parity.

Source: Asian Development Bank calculations using data from ITC Trade Map.

Figure 1.2.8 Sectoral Contributions to Nominal Export Growth

Electronics and machinery remained the main driver of export growth in both DAP and AAP.



AAP = advanced Asia and the Pacific, DAP = developing Asia and the Pacific.

Notes: DAP includes Cambodia, the People's Republic of China, Georgia, India, Indonesia, Malaysia, Mongolia, the Philippines, and Thailand; AAP includes Australia; Hong Kong, China; Japan; the Republic of Korea; New Zealand; and Taipei, China. Regional figures are weighed by GDP purchasing power parity.

Sources: Asian Development Bank calculations using data from ITC Trade Map.

PRC, India, and Indonesia, lower food and beverage exports from India and Indonesia; and contraction in India's stone, glass, and ceramics exports.

Resilient exports have been reinforced by an improved trade policy environment in recent months.

Trade policy uncertainty has eased significantly, falling below levels observed through much of 2025 (Figure 1.2.9). This year's trade policy has mostly followed statutory processes with fixed expiration dates and published investigation schedules, which makes the scope and timing of actions more predictable. Additionally, a surge in news coverage of the Middle East conflict may have crowded out reporting on trade since March, so the text-based trade policy uncertainty index may overstate the underlying easing. Nevertheless, trade policy developments have remained active, with several tariff measures implemented or announced in recent months. Section 122 US tariffs expired in July 2026 and were replaced by Section 301 tariffs addressing forced labor concerns. On 23 July, the US announced further Section 301 tariffs of 10%–12.5% on imports from 60 economies and 15% tariffs on strategic products such as polysilicon, solar panels, and components, with further measures on semiconductors, clean energy, and other critical sectors possible under Section 232. The Office of the United States Trade

Representative continues its Section 301 investigation into structural excess capacity in 12 economies in Asia and the Pacific, alongside a separate investigation into intellectual property protection and enforcement in Viet Nam. Recent reports of potential tariffs of up to 7.5% on imports from the PRC under the excess capacity investigation underscore the risk of further trade actions.

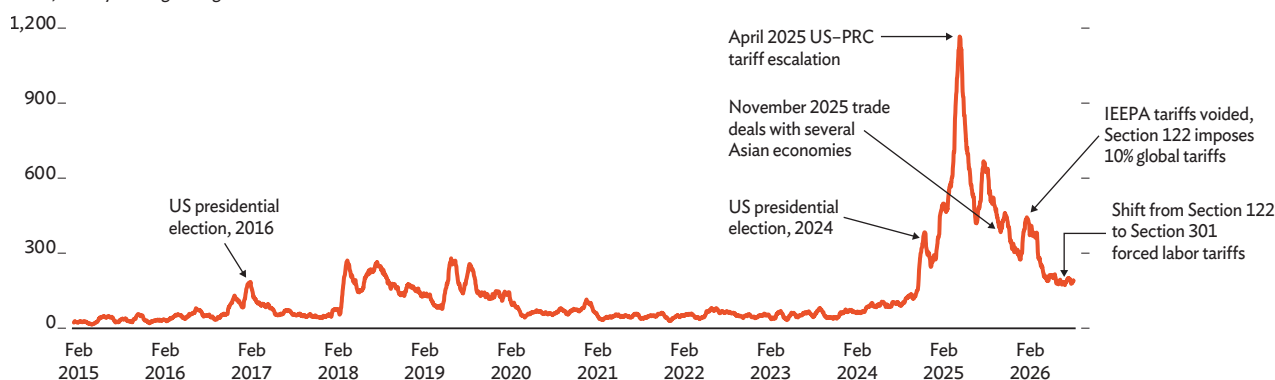
The effects of heightened geopolitical risks are becoming visible in energy trade.

Economies in Asia and the Pacific have been diversifying their crude oil supplies in response to disruption and uncertainty surrounding major shipping routes. In DAP excluding the PRC, overall crude imports continued to increase as imports from alternative sources—notably in Africa, the Americas, and Russia—offset a decline in purchases from the Middle East (Figure 1.2.10, Panel A). Meanwhile, the PRC cut its oil imports from both the Middle East and other sources, nearly halving its total imports (Figure 1.2.10, Panel B). In AAP, oil imports recovered in May after falling through April, but sourcing shifted markedly away from the Middle East toward alternative suppliers, particularly in North America (Figure 1.2.10, Panel C). As tensions eased in subsequent months, Middle East volumes picked up again.

Figure 1.2.9 Trade Policy Uncertainty Index, 30 Jan 2015–24 Aug 2026

Trade policy uncertainty has declined, though risks of additional US trade measures remain.

Index, 30-day moving average



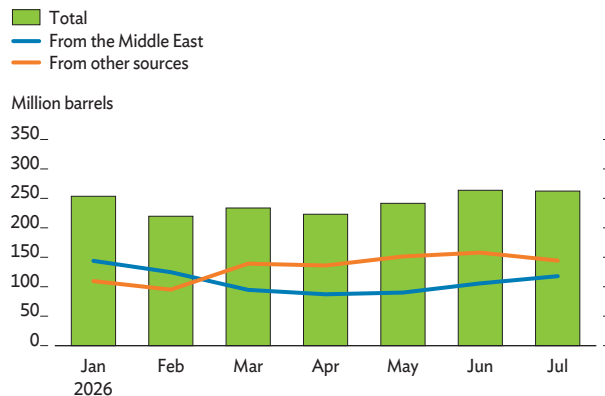
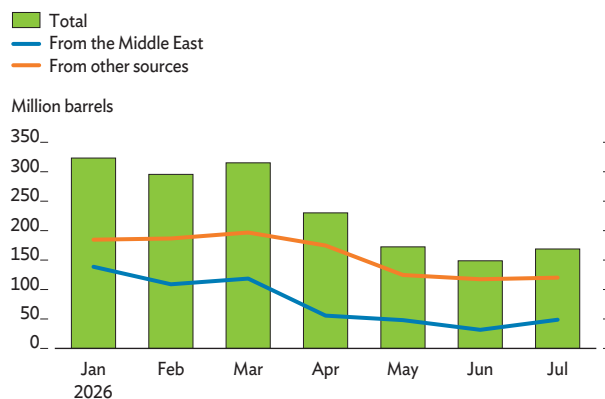
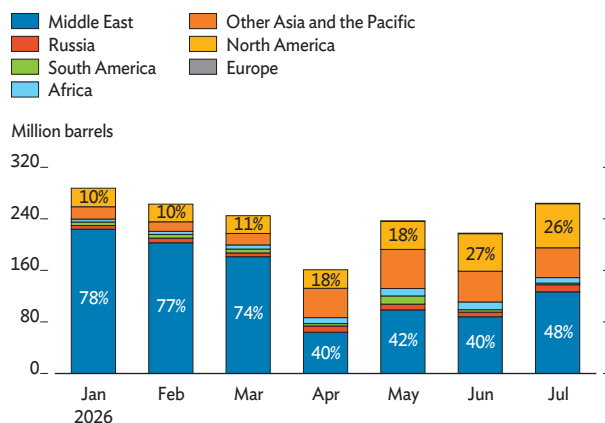
IEEPA = International Emergency Economic Powers Act, PRC = People's Republic of China, US = United States.

Note: The 30-day moving average of the trade policy uncertainty index measures the frequency of articles discussing trade policy uncertainty in seven newspapers: six in the US and one in the United Kingdom.

Source: Caldara D. et al. 2020. *The Economic Effects of Trade Policy Uncertainty*. *Journal of Monetary Economics* 109.

Figure 1.2.10 Volume and Share of Crude Oil Imports

Crude imports fell sharply in the PRC but held up in the rest of the region, where other suppliers replaced Gulf volumes.

A. DAP Excluding the PRC

B. PRC

C. Advanced Asia and the Pacific


DAP = developing Asia and the Pacific, PRC = People's Republic of China.

Source: Asian Development Bank calculations using data from London Stock Exchange Group.

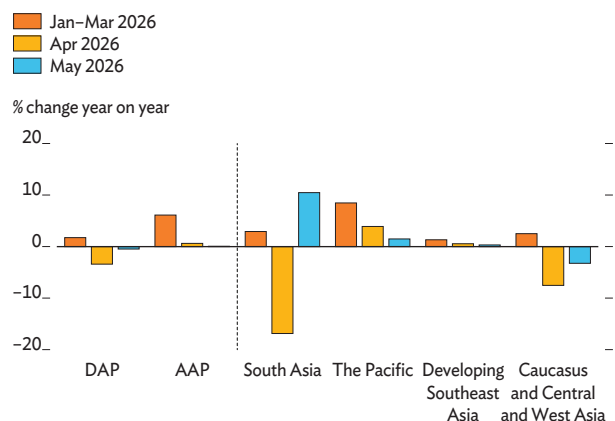
Diversification remains incomplete and costly.

Much of the region's refining capacity is configured to process Middle Eastern sour crude, and sourcing from alternative suppliers, particularly those in the Americas, involves longer voyages and higher freight and insurance costs. Recent changes in sourcing appear partly reactive to developments in the conflict rather than a permanent shift in trade patterns, as refiners in the region returned to the Gulf when flows through the Strait of Hormuz briefly recovered in June, before moving back toward US spot cargoes in July. Houthi threats to Saudi-linked shipping have further complicated the use of the Red Sea corridor, with transits through the Bab el-Mandeb strait already slowing. Despite efforts to diversify supply sources, therefore, the region remains structurally reliant on Gulf crude and vulnerable to renewed disruption along key shipping routes.

The conflict has weighed on tourism across the region. Tourist arrivals in DAP declined in April 2026 and again slightly in May (Figure 1.2.11). Airspace closures and flight rerouting have lengthened travel times and raised airfares, with higher jet fuel costs and weaker outbound travel from the Gulf adding

Figure 1.2.11 International Tourist Arrivals

Tourism growth slowed after February as the conflict disrupted air travel, particularly in South Asia.



AAP = advanced Asia and the Pacific, DAP = developing Asia and the Pacific.

Notes: The Caucasus and Central and West Asia comprises Armenia, Georgia, and Türkiye. The Pacific comprises the Cook Islands, Fiji, Palau, Samoa, and Tonga. South Asia comprises Bhutan, Maldives, Nepal, and Sri Lanka. Developing Southeast Asia comprises Cambodia, Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam; Advanced Asia and the Pacific comprises Australia; Hong Kong, China; Japan; the Republic of Korea; New Zealand; Singapore; and Taipei, China.

Sources: CEIC Data Company; official sources.

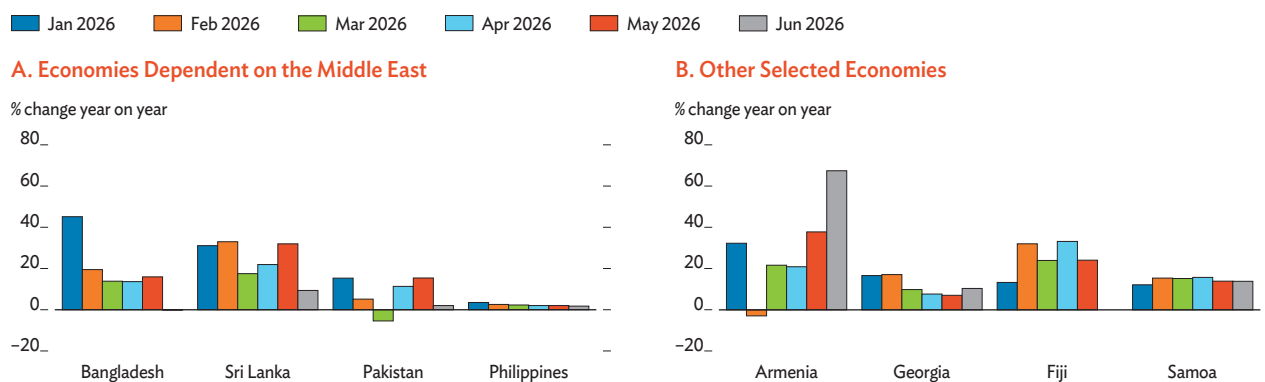
further pressure. The April decline was steepest in South Asia, which relies more heavily on Gulf carriers and transit hubs. Arrivals there rebounded strongly in May as disruption eased, driven largely by record arrivals from India, whose outbound travelers reach neighboring destinations on direct short-haul flights mostly unaffected by Gulf routings. Indian arrivals in Sri Lanka rose by 28% year on year to a record for the month, accounting for over 40% of all arrivals, while Nepal recorded its highest-ever May arrivals from India. With European arrivals in Sri Lanka still declining, the rebound thus rested on short-haul regional demand rather than a full restoration of Gulf-routed connectivity. Growth in developing Southeast Asia moderated, reflecting a mixed picture. The Middle East conflict weighed on visitor arrivals in Malaysia and Thailand, while the Philippines and Viet Nam remained resilient on strong regional demand. Cambodia recorded a decline, as closure of the border with Thailand prompted travel advisories and cancellations, while concerns linked to transnational cyber-scam operations also weighed on visitor sentiment. Statistics from the Thai Ministry of Tourism and Sports showed that the economy, which has become an increasingly

popular destination for Middle Eastern travelers, recorded a 25% decline in arrivals from the Middle East during the January–May period. If the conflict persists, tourism could face additional headwinds, given the growing importance of the Middle East as a source market for several economies in Asia and the Pacific.

Remittance inflows held up well across selected economies in the first half of 2026, though growth was uneven. Among DAP economies that rely on the Middle East as a source of remittances, growth in Bangladesh fell year on year from exceptionally high rates earlier in the year to slightly negative in June, reflecting normalization after elevated transfers ahead of Eid-ul-Adha festivities (Figure 1.2.12, Panel A). In Sri Lanka, remittance growth eased slightly in June, partly reflecting a seasonal slowdown after strong inflows in May. In Pakistan, inflows contracted in March, and growth was only slightly positive in June, coinciding with periods of heightened tensions in the Middle East, where more than half of Pakistan's remittances originate. Economies less dependent on Middle East remittances generally maintained stable growth (Figure 1.2.12, Panel B).

Figure 1.2.12 Remittances to Selected Economies in Developing Asia and the Pacific

Remittance inflows held up in the first half of 2026, though growth slowed in the economies most dependent on Middle East flows.



Notes: Pakistan, Sri Lanka, Bangladesh, and the Philippines are classified as dependent on Middle East remittances. Based on central bank data, the Middle East accounts for about 54% of remittance inflows to Pakistan, 44% to Sri Lanka, and 18% to the Philippines. Based on RemitScope, 4.9 million of Bangladesh's 8.7 million migrants abroad were located in Gulf economies in 2024.

Sources: Official sources; CEIC Data Company; RemitScope (2026).

Monetary Policy Remains Cautious in Asia, with Divergent Paths Ahead

Regional central banks kept policy rates largely unchanged in 2026 as they balanced persistent inflationary pressures against support for growth.

As price pressures escalated, the share of decisions to hike policy rates rose from 3% in the first quarter (Q1) of 2026 to 20% in Q2, before falling back to 5% between July to 4 September as some pressures eased (Figure 1.2.13). Most policy decisions in Q2 left rates on hold, reflecting central banks' cautious approach in an uncertain macroeconomic environment. Of 20 decisions between July and 4 September, 16 were holds, alongside three rate cuts and one hike. Bangladesh Bank lowered its benchmark rate by 50 basis points, its first cut since 2020, to support credit growth, private investment, and economic activity. In Kazakhstan, the central bank lowered its base rate by a total of 75 basis points in response to continued disinflation. Bangko Sentral ng Pilipinas raised its benchmark rate by 25 basis points in August, its third consecutive hike, to contain price pressures.

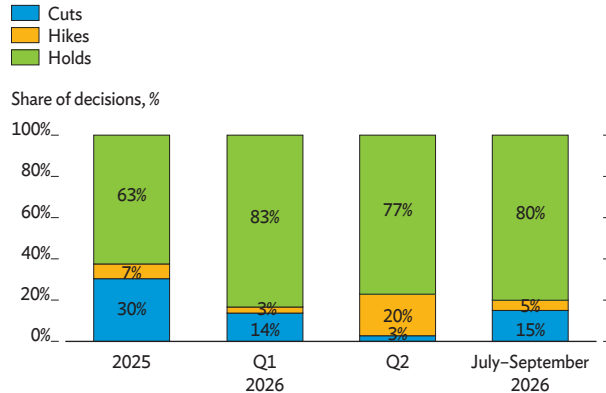
Expected monetary policy paths to the end of 2026 remain mixed across the region. Differences in domestic inflation and demand conditions are expected to drive divergence despite continued global uncertainties. Consensus forecasts, drawing on projections from several hundred global analysts and organizations, suggest that several economies have scope for further monetary tightening this year if inflation persists (Figure 1.2.14): Bangladesh, India, Indonesia, Pakistan, the Philippines, and Viet Nam. Policy rates are projected to remain broadly stable in Armenia, Azerbaijan, Malaysia, the PRC, and Thailand, while modest easing is expected in Kazakhstan, Tajikistan, and Uzbekistan.

Monetary policy is expected to shift toward easing in 2027 as inflation gradually recedes.

Kazakhstan and Uzbekistan are projected to continue easing in 2027 following cuts in 2026, resulting in the largest cumulative reductions in the region. Rate cuts are also expected in Georgia, Pakistan, Sri Lanka, and Tajikistan. Pakistan's easing is projected to be among the largest, as energy price pressures from

Figure 1.2.13 Share of Policy Rate Decisions

Most central banks held policy rates unchanged in 2026, while the share of rate hikes fell from 20% in Q2 to 5% between July and 4 September as inflationary pressures eased.



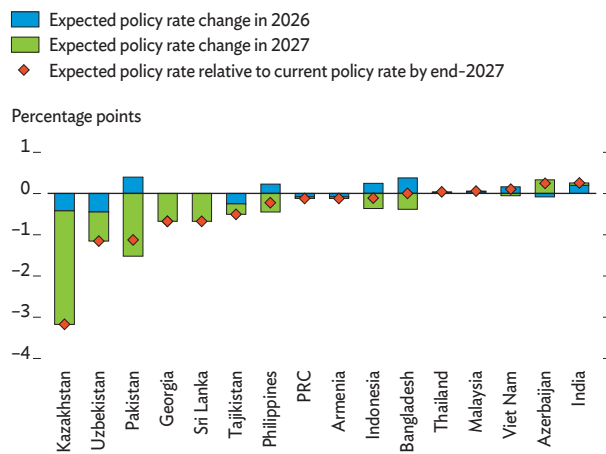
Q = quarter.

Notes: Includes policy decisions in Armenia, Bangladesh, the People's Republic of China, Fiji, Georgia, Indonesia, Kazakhstan, the Kyrgyz Republic, the Lao People's Democratic Republic, Malaysia, Mongolia, Nepal, Pakistan, Papua New Guinea, the Philippines, Samoa, Sri Lanka, Tajikistan, Thailand, Türkiye, Uzbekistan, and Vanuatu. There were 128 policy decisions in 2025, 36 in Q1 2026, 35 in Q2 2026, and 20 between July and 4 September 2026.

Source: Asian Development Bank estimates using data from official sources.

Figure 1.2.14 Expected Change in Policy Rate

Policy rate paths are expected to stay mixed to the end of 2026, before easing becomes more widespread in 2027.



PRC = People's Republic of China.

Notes: The blue bar indicates the expected movement from 4 September 2026 to the end of 2026. The green bar indicates the expected movement of policy rate from the end of 2026 to the end of 2027. The red marker depicts the change between the current policy rate and the rate at the end of 2027. Policy rate expectations are derived from Focus Economics reports published in July 2026 for economies in the Caucasus and Central and West Asia, and August 2026 for the rest. Economies are ordered based on their expected policy rates by the end of 2027 relative to their 4 September 2026 policy rate.

Source: Asian Development Bank estimates using data from CEIC Data Company and Focus Economics.

the Middle East conflict are expected to recede and growth to improve in 2027. In Bangladesh, Indonesia, and the Philippines, expected rate cuts in 2027 would partly or largely reverse the tightening projected for 2026. Rates are forecast to remain little changed in several other economies, while a modest increase is expected in Azerbaijan on favorable foreign exchange conditions and broadly balanced inflation risks. Overall, policy rates are expected to move gradually toward levels observed before the escalation of the Middle East conflict, though the pace and extent of easing will depend on the evolution of inflation, growth, and external risks.

Elevated Global Bond Yields Keep Regional Financial Conditions Tight

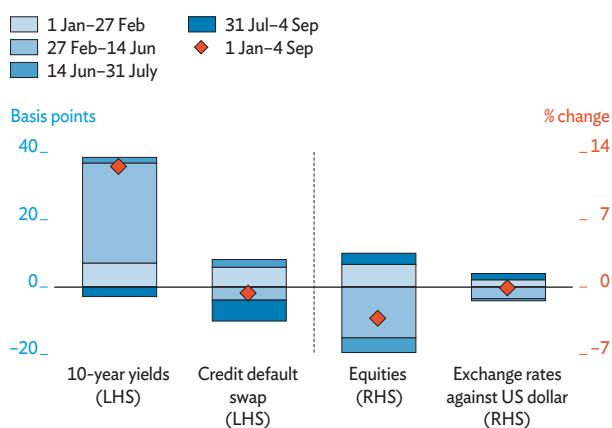
Regional financial conditions remained tight despite improving investor sentiment. As geopolitical risk and market volatility eased, investor sentiment gradually improved, moving close to levels observed at the beginning of the year (Figure 1.2.15). Nevertheless, regional bond yields remained elevated due to ongoing geopolitical uncertainty, lingering inflationary pressures, and cautious monetary stances maintained by regional central banks. Rising bond yields in advanced economies have added to these pressures.

Regional financial markets remained broadly stable in the year to date, strengthening in August.

GDP-weighted average sovereign risk premia, measured by 5-year credit default swap spreads, narrowed by 1.8 basis points in the year to date (Figure 1.2.16).

Figure 1.2.16 Changes in Aggregated Key Financial Indicators in Developing Asia and the Pacific

Improved market sentiment contributed to broadly stable financial market performance, though bond yields remained elevated over multiple factors.



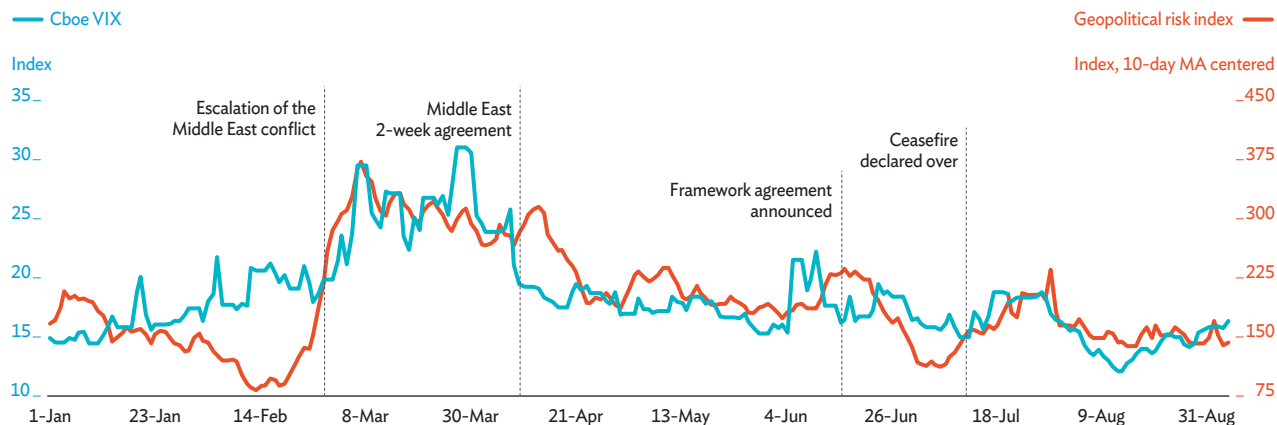
LHS = left hand side, RHS = right hand side, US = United States.

Notes: Average changes in yields, credit default swap spreads, and exchange rates for developing Asia and the Pacific are aggregated using as weights shares of gross domestic product at purchasing power parity in current international dollars. The average change in equities is weighted by market capitalization. For exchange rates, positive values indicate appreciation against the US dollar, negative depreciation.

Source: Bloomberg.

Figure 1.2.15 Geopolitical Risk and Volatility Index

As tensions moderated, geopolitical risk and market volatility returned close to levels seen before the escalation of the Middle East conflict.



Cboe VIX = Chicago Board Options Exchange Volatility Index, MA = moving average.

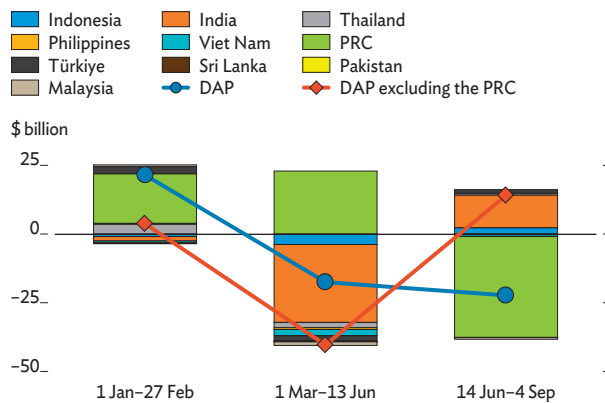
Sources: Bloomberg; Caldara, D. and M. Iacoviello. 2022. Measuring Geopolitical Risk. American Economic Review 112(4) (Data downloaded from <https://www.matteoiacoviello.com/gpr.htm> on 31 August 2026).

Regional equity markets declined by 3.3% over ongoing geopolitical uncertainty and a continued sell-off in AI and semiconductor stocks that began in late June. Regional currencies weakened marginally against the US dollar. Financial markets strengthened in August as geopolitical risk eased, with bond yields falling, risk premia narrowing, equities gaining, and currencies appreciating against the US dollar. Performance varied, however, across regional economies.

Setting aside the PRC, net portfolio inflows followed the announcement of a framework agreement. Other regional economies recorded net inflows of \$14.2 billion, mainly to India, Indonesia, and Thailand. These inflows were underpinned by resilient domestic growth and policy measures to support local currencies and keep domestic assets attractive (Figure 1.2.17). However, substantial outflows from the PRC—amid slower than expected Q2 GDP growth and a global sell-off of AI stocks—more than offset these inflows, leaving the region with a net outflow of \$22.3 billion.

Figure 1.2.17 Portfolio Flows into the Region, 2026 Year to Date

Portfolio flows into regional markets, except in the PRC, recovered following the framework agreement announcement and continued to early September.



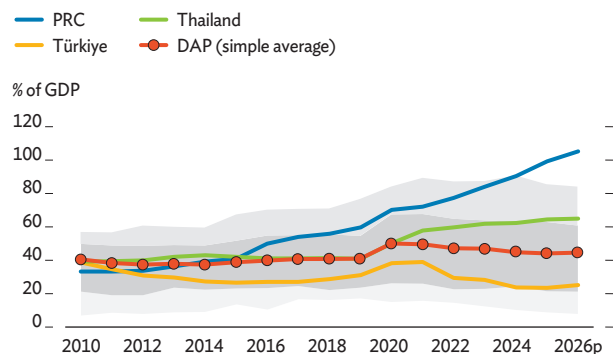
DAP = developing Asia and the Pacific, PRC = People's Republic of China.
Source: Institute of International Finance.

Stable Debt Ratios Mask Rising Debt and Fiscal Pressures

Debt ratios in developing Asia and the Pacific are projected to remain broadly stable in 2026, but debt levels are rising. The simple average ratio of debt-to-GDP is expected to stay at about 45% in 2026, broadly unchanged from 2024–2025 and well below the 2020 pandemic peak. This stability masks a distribution that has grown considerably wider, as the gap between the 25th and 75th percentiles has widened from about 28.6 percentage points in 2010 to a projected 39.7 in 2026 (Figure 1.2.18). Economies have also shifted position within it. The PRC's ratio has risen from the middle of the distribution to above the 90th percentile, and Thailand's has climbed into the upper quartile, while Türkiye has eased from

Figure 1.2.18 Government Debt-to-GDP Ratios

Stable regional debt ratios hide considerable variation across economies.



DAP = developing Asia and the Pacific, p = projected, PRC = People's Republic of China.

Notes: Shaded bands show the distribution of ratios of public debt to GDP across the 43 DAP economies with data for 2010–2026. The lighter band indicates the 10th–90th percentile range, the darker band the 25th–75th. The DAP average is a simple, unweighted average across economies. Economies are shown individually where they are discussed in the text and where their position in the distribution shifted materially over the period. For international comparability, the figure uses the general government gross debt measure used by the World Economic Outlook of the International Monetary Fund. It covers central and local government debt and certain off-budget liabilities, including the debt of some local government financing vehicles. The PRC's statutory measure is narrower: the Ministry of Finance's report to the National People's Congress puts statutory debt equal to about 68.5% of GDP at the end of 2025, or 73.2% including recognized off-balance-sheet local debt. The gap reflects mainly differences in the coverage of local government financing vehicles and other off-budget borrowing, rather than discrepancies in underlying data. Both measures show a rising debt trend for the PRC.

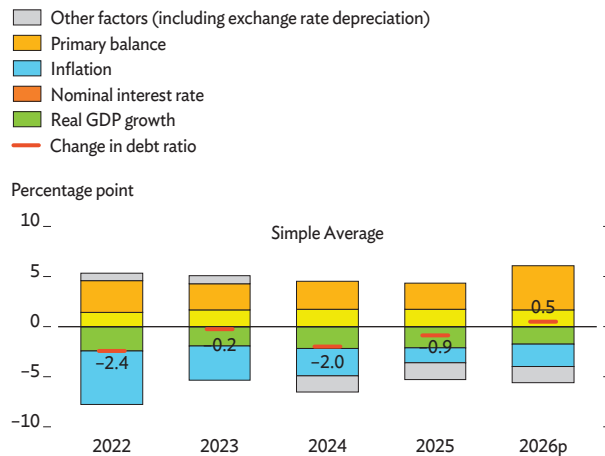
Sources: Asian Development Bank calculations using data from the Asia Sovereign Debt Monitor, *Asian Development Outlook July 2026*, and International Monetary Fund World Economic Outlook (April 2026).

its pandemic peak toward the lower quartile. Total public debt is nevertheless projected to rise to around \$29 trillion in 2026, from \$26 trillion in 2025. The increase is driven by the PRC, primarily through higher local government borrowing, as well as in Türkiye, reflecting earthquake reconstruction, and in Kazakhstan, driven by higher public spending on digital transformation.

Nominal GDP growth continues to contain regional debt ratios, but less than in recent years. With real GDP growth weakening, higher inflation will support nominal GDP growth in 2026 (Figure 1.2.19). Nominal growth will not fully offset primary deficits and interest payments, however, and the average debt ratio is projected to rise by 0.5 percentage points after 4 consecutive years of decline. In 24 DAP economies,

Figure 1.2.19 Regional Debt Dynamics

The debt ratio is projected to rise in 2026, as growth and inflation no longer fully offset primary deficits.



Note: Other factors can include cross exchange rate valuation effects, an intra-period valuation effect, and other accounting issues that affect the value of the stock of debt.

Sources: Asian Development Bank calculations using data from the Asia Sovereign Debt Monitor, *Asian Development Outlook July 2026*, and International Monetary Fund World Economic Outlook (April 2026).

notably Bangladesh, Bhutan, Indonesia, and the Philippines, growth and inflation are still expected to help offset primary deficits. By contrast, in Cambodia, the PRC, Fiji, Maldives, and Thailand, primary deficits and currency depreciation are projected to outweigh support from nominal GDP growth, raising ratios of debt to GDP.

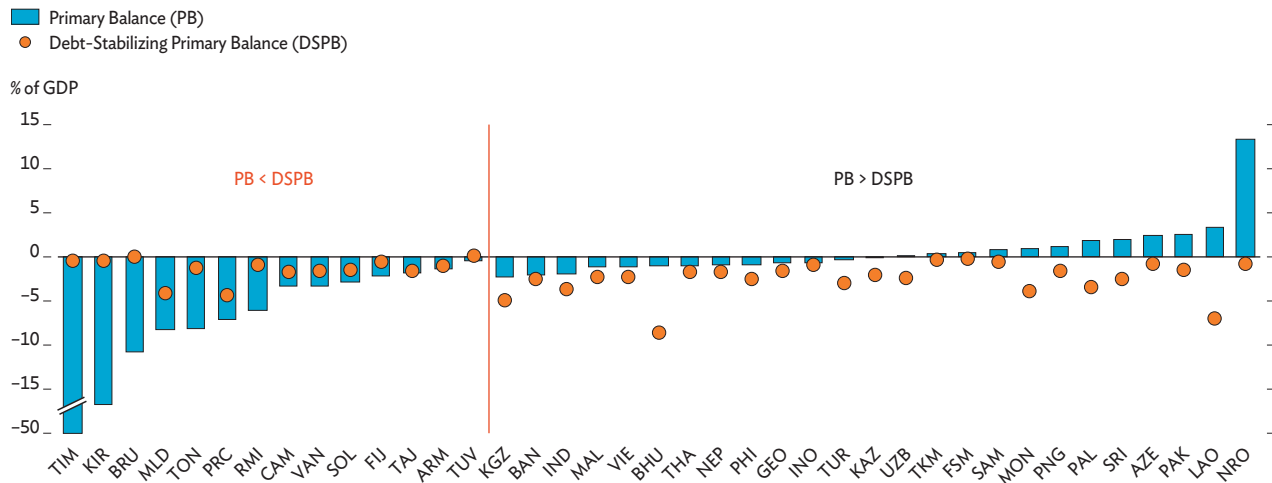
Persistent primary deficits could make debt stabilization more difficult beyond 2026. Primary balances in 14 DAP economies are projected to remain below the levels required to keep debt ratios constant, based on current growth and inflation projections (Figure 1.2.20). In Maldives, a projected primary deficit equal to 8.2% of GDP in 2026 is almost double the 4.2% deficit consistent with debt stabilization. In Cambodia, a projected primary deficit of 3.3% of GDP is well above the 1.8% threshold. Reducing deficits will be challenging, however, under slowing economic growth and sustained pressure on government spending.

Fiscal adjustment is further constrained by rigid public spending. Public spending persistence in DAP has remained broadly stable over the past 2 decades (Figure 1.2.21). Pensions, public investment, and defense show the greatest persistence. In 2022, spending was most persistent in Malaysia, the Philippines, Tajikistan, Türkiye, and Uzbekistan.

The Middle East conflict could intensify fiscal and debt pressures. Debt conditions across the region could worsen under weaker growth, lower revenue, higher spending needs, tighter financing conditions, and currency depreciation that raises the local-currency burden of foreign-currency debt. Debt dynamics could deteriorate further as tighter monetary policy dampens inflation, slowing nominal GDP growth while increasing sovereign borrowing costs. This would hamper fiscal consolidation and raise debt sustainability risks.

Figure 1.2.20 Primary Balance and Debt-Stabilizing Primary Balance, 2026

Primary balances in several economies are below levels required to stabilize debt.



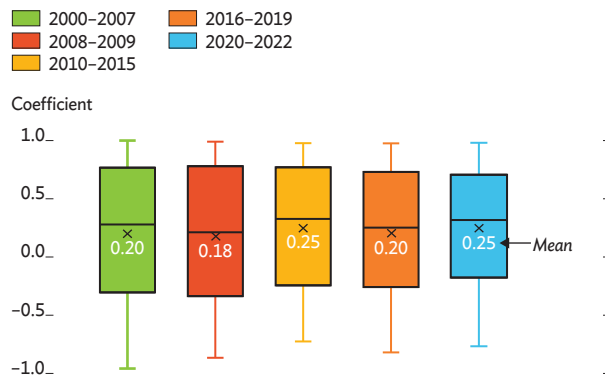
ARM = Armenia, AZE = Azerbaijan, BAN = Bangladesh, BHU = Bhutan, CAM = Cambodia, FIJ = Fiji, FSM = Federated States of Micronesia, GDP = gross domestic product, GEO = Georgia, IND = India, INO = Indonesia, KAZ = Kazakhstan, KGZ = Kyrgyz Republic, KIR = Kiribati, LAO = Lao People's Democratic Republic, MAL = Malaysia, MLD = Maldives, MON = Mongolia, NEP = Nepal, NRO = Naoero, PAK = Pakistan, PAL = Palau, PHI = Philippines, PNG = Papua New Guinea, PRC = People's Republic of China, RMI = Marshall Islands, SAM = Samoa, SOL = Solomon Islands, SRI = Sri Lanka, TAJ = Tajikistan, THA = Thailand, TIM = Timor-Leste, TKM = Turkmenistan, TON = Tonga, TUR = Türkiye, TUV = Tuvalu, UZB = Uzbekistan, VAN = Vanuatu, VIE = Viet Nam.

Note: PB < DSPB indicates that the projected primary balance is insufficient to stabilize debt, while PB > DSPB indicates that it is more than sufficient to stabilize debt.

Sources: Asian Development Bank calculations using data from the Asia Sovereign Debt Monitor, *Asian Development Outlook July 2026*, and International Monetary Fund World Economic Outlook (April 2026).

Figure 1.2.21 Fiscal Spending Rigidity 2000–2022

Spending rigidity has remained broadly stable over the past 2 decades.



Notes: The figure shows the 1-year lag autocorrelation of total public expenditure. The range of values is from -1 to 1. The dataset covers 27 economies in developing Asia and the Pacific.

Source: International Monetary Fund. 2025. Fiscal Monitor October. Rigidity Database.

Growth Outlook Remains Steady Despite Prolonged Geopolitical Headwinds

An Uncertain and Challenging External Environment

External conditions are expected to remain challenging, with heightened geopolitical tensions and a very strong El Niño weighing on the outlook.

Renewed hostilities and disruption in the Middle East, together with the reescalation of Russia's war in Ukraine, have prompted upward revision to the Brent crude oil forecast to an average of \$90/barrel in 2026 and \$78 in 2027, based on assumptions finalized on 4 September (Table 1.3.1; Annex). Oil market conditions are expected to normalize gradually through the forecast period, though geopolitical tensions are likely to remain elevated. El Niño is projected to strengthen over the course of the year and is very highly likely to persist into early 2027. Adverse weather associated with El Niño is expected, together with the lagged effects of higher energy and fertilizer costs, to push up food prices and consumer inflation in a number of economies across the region. On the upside, sustained

global demand for AI-related products is projected to support growth in several economies in Asia and the Pacific.

Growth forecasts are unchanged from July for the United States and the euro area, while inflation is projected to remain above central bank targets.

In the US, growth is expected to remain resilient, underpinned by strong AI investment and stable labor market conditions. Nonetheless, elevated inflation, subdued consumer confidence, and tight financial conditions may temper private consumption. In the euro area, growth forecasts are likewise unchanged. Activity is projected to be subdued in 2026 by external headwinds before gradually strengthening in 2027 on resilient employment and higher defense and infrastructure spending. Inflation in both economies is projected to stay above the 2% targets of the Federal Reserve and the European Central Bank over the forecast horizon, with euro area forecasts slightly upgraded on higher energy prices (Annex).

Table 1.3.1 Baseline Assumptions on the International Economy

Growth projections are unchanged for the United States and the euro area but upgraded for advanced Asia and the Pacific on strong technology exports.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
Gross domestic product growth, %					
United States	2.1	2.1	2.1	2.0	2.0
Euro area	1.4	0.8	0.8	1.2	1.2
Advanced Asia and the Pacific	2.5	2.6	3.1	1.7	2.0
Inflation, %					
United States	2.6	3.4	3.4	2.4	2.4
Euro area	2.1	2.8	3.0	2.3	2.5
Advanced Asia and the Pacific	2.5	2.6	2.4	2.1	2.1
Brent crude spot prices, average, \$/barrel	69	87	90	77	78

Note: The baseline assumptions were finalized on 4 September.

Sources: CEIC Data Company; Haver Analytics; Asian Development Bank estimates.

Stronger-than-expected growth driven by a surge in AI-related exports prompts upward revision to growth forecasts for advanced Asia and the Pacific.

The upgrade reflects higher 2026 growth projections for Hong Kong, China by 1.2 percentage points (pps); the Republic of Korea by 0.6 pps; Singapore by 1.8 pps; and Taipei, China by 1.5 pps (Annex). Sustained demand for AI-related products will continue to support growth in 2027, but the pace of expansion is expected to moderate as the effects of the current export surge ease. Japan's growth forecasts for 2026 and 2027 are maintained. Fiscal support measures, including a supplementary budget and utility subsidies, are anticipated to cushion the impact of higher energy and import costs from the prolonged Middle East conflict. Projections for Australia and New Zealand are likewise maintained, with moderate growth anticipated in 2026 amid weak external demand and ongoing geopolitical tensions. The 2026 inflation forecast for advanced Asia and the Pacific is trimmed by 0.2 pps, largely on slower-than-expected inflation in Japan in the first half of the year, while the 2027 projection is unchanged. Nonetheless, continued disruption to energy supply poses upside risks to the inflation outlook.

Regional Growth Remains Resilient

The growth projection for developing Asia and the Pacific in 2026 is revised up by 0.1 pps to 5.0%—still slower than 5.5% in 2025 (Table 1.3.2).

Across subregions, upward revisions for South Asia and developing Southeast Asia offset downgrades for the Pacific and the Caucasus and Central and West Asia. Economic activity in the region is anticipated to remain resilient, supported by firm domestic demand and government stimulus measures. Amid continued AI investment and data center buildout, strong demand for technology exports is expected to support growth, particularly in the PRC and some economies in developing Southeast Asia. These factors support growth despite moderation from last year's pace. For 2027, the growth projection is maintained at 5.1%. Prolonged disruption to energy markets and El Niño strength weigh on growth prospects.

Growth projections for the PRC remain unchanged at 4.6% in 2026 and 4.5% in 2027.

Economic activity will continue to be underpinned by robust growth in high-technology manufacturing and AI-related investment. Greater fiscal spending, expanded bond issuance, and other consumption-support measures are expected to bolster domestic demand. Nonetheless, subdued consumer sentiment and continued weakness in the property sector are expected to constrain growth.

Growth projections for South Asia are revised up for 2026 but lowered slightly for 2027 amid prolonged trade and energy-related shocks.

The subregion's growth forecast for 2026 is raised by 0.4 pps from July projections to 6.4%, driven mainly by an upward revision in India, while forecasts for most other economies remain unchanged. India's economy is projected to expand by 7.0% in 2026, 0.4 pps higher than previously forecast, supported by strong public investment and firm export growth, particularly in services and electronics. For 2027, the subregional forecast is trimmed by 0.2 pps to 6.5%, reflecting weaker prospects for Afghanistan, Bangladesh, India, and Nepal. In Afghanistan, trade-related shocks are expected to persist longer than previously anticipated, as border crossings with Pakistan remain closed and disruption from the Middle East conflict continues to affect shipping. In Bangladesh, banking sector stress and persistent energy shortages are expected to dampen economic activity, while growth is projected to moderate in India following a strong outturn expected in fiscal year 2026 (FY2026, ending 31 March 2027). Severe flash floods in Nepal that damaged infrastructure and hydropower facilities are expected to weigh on growth in FY2027 (ending 16 July 2027).

Growth forecasts for developing Southeast Asia are upgraded on strong expansion in the first half of 2026, driven by higher public spending, and robust technology exports.

The subregion's forecast for 2026 is raised by 0.1 pps to 4.7%, reflecting upward revisions for Malaysia by 0.3 pps and Thailand by 0.2 pps, both on robust technology exports; for Timor-Leste by 0.2 pps on fiscal stimulus measures; and for Viet Nam by 0.6 pps on increased infrastructure investment. These upgrades are partly offset by downward revisions by 0.6 pps for Brunei Darussalam

Table 1.3.2 Gross Domestic Product Growth Rate and Inflation, %

The 2026 projection for regional growth is revised up slightly on resilient domestic demand and strong technology exports, and for inflation notched down.

Subregion/Economy	GDP Growth					Inflation				
	2025	2026		2027		2025	2026		2027	
		Jul	Sep	Jul	Sep		Jul	Sep	Jul	Sep
Developing Asia and the Pacific (DAP)	5.5	4.9	5.0	5.1	5.1	3.0	4.3	4.2	3.4	3.5
DAP excluding the People's Republic of China	6.0	5.3	5.4	5.7	5.6	6.0	7.5	7.7	5.9	6.2
Caucasus and Central and West Asia	4.6	3.8	3.7	4.2	4.1	25.6	22.0	23.1	16.3	17.6
Armenia	7.1	5.0	5.0	5.5	5.5	3.3	4.2	4.2	3.5	3.5
Azerbaijan	1.4	2.0	1.6	1.8	1.8	5.6	5.7	5.9	4.9	5.0
Georgia	7.5	5.5	6.3	5.2	5.2	3.9	4.9	5.2	3.3	3.3
Kazakhstan	6.5	4.8	4.8	4.5	4.5	11.4	10.4	10.4	9.5	9.5
Kyrgyz Republic	11.1	8.9	8.9	8.4	8.4	8.2	11.2	11.2	8.5	8.5
Tajikistan	8.4	7.3	7.0	6.8	6.8	3.5	4.5	4.5	4.7	4.7
Türkiye	3.7	3.1	2.8	3.8	3.6	35.2	29.7	31.5	21.5	23.5
Turkmenistan	6.3	6.3	6.3	6.2	6.2	5.5	6.0	6.0	6.0	6.0
Uzbekistan	7.7	6.7	7.0	6.8	6.8	7.3	6.5	6.7	5.0	5.0
Developing East Asia	5.0	4.6	4.6	4.5	4.5	0.0	1.2	0.9	0.9	0.9
People's Republic of China	5.0	4.6	4.6	4.5	4.5	0.0	1.2	0.9	0.9	0.9
Mongolia	6.8	5.7	5.7	6.0	6.0	8.6	7.8	10.7	6.8	8.3
South Asia	7.0	6.0	6.4	6.7	6.5	2.9	5.7	5.5	4.8	4.8
Afghanistan	1.9	2.3	1.5	3.0	2.2	-4.2	3.6	3.6	5.5	7.0
Bangladesh	3.5	3.7	3.7	4.5	4.0	10.0	9.0	8.7	8.8	9.0
Bhutan	8.5	6.5	6.5	7.2	7.2	3.5	4.5	6.5	4.0	4.5
India	7.8	6.6	7.0	7.3	7.1	2.1	5.2	5.0	4.0	4.0
Maldives	6.2	1.0	1.0	3.0	3.0	4.0	5.0	2.2	4.0	2.0
Nepal	4.4	3.9	3.9	4.5	4.1	4.1	3.2	3.1	5.0	5.3
Pakistan	3.2	3.7	3.7	3.7	3.7	4.5	7.2	7.1	8.3	8.3
Sri Lanka	5.0	4.0	4.0	4.0	4.0	-0.5	6.0	6.0	5.2	5.2
ASEAN	4.8	4.5	4.7	4.6	4.7	2.0	3.8	3.9	2.9	3.2
Developing Southeast Asia	4.8	4.6	4.7	4.8	4.9	2.1	3.9	4.0	2.9	3.3
Brunei Darussalam	1.0	1.8	1.2	1.9	1.9	-0.3	1.1	1.1	0.5	0.5
Cambodia	5.3	4.1	3.9	4.7	4.7	2.5	4.5	4.7	2.5	2.8
Indonesia	5.1	5.2	5.2	5.2	5.2	1.9	3.0	3.3	2.5	3.0
Lao People's Democratic Republic	4.4	4.0	4.0	4.5	4.5	7.7	9.8	8.0	6.7	6.5
Malaysia	5.2	4.6	4.9	4.5	4.7	1.4	2.0	2.0	1.9	2.0
Myanmar	-2.2	2.4	2.2	2.7	2.7	17.0	24.0	24.0	16.0	16.0
Philippines	4.4	3.8	3.3	5.3	5.1	1.7	5.9	5.9	3.9	4.4
Thailand	2.4	1.8	2.0	2.0	1.9	-0.1	2.9	2.5	1.3	1.3
Timor-Leste	4.5	3.8	4.0	4.1	4.1	0.5	2.2	1.0	2.0	1.8
Viet Nam	8.0	7.2	7.8	7.0	7.6	3.3	4.0	4.3	3.8	4.0
The Pacific	4.5	3.3	3.0	3.2	2.9	2.9	4.2	4.6	3.5	4.1
Cook Islands	4.0	2.7	3.5	3.0	3.5	2.0	3.5	4.5	3.3	4.0
Fiji	2.5	2.6	2.2	2.5	1.9	-1.4	3.6	3.9	1.9	2.5
Kiribati	4.3	3.1	3.1	2.6	2.6	5.9	5.3	4.0	4.2	4.0
Marshall Islands	1.8	3.0	2.2	2.6	2.0	5.6	6.2	5.7	5.3	4.7
Federated States of Micronesia	1.1	0.7	0.5	1.0	0.9	2.8	3.8	3.8	3.5	3.5
Naoero	2.6	2.5	2.5	2.5	2.5	6.1	4.5	4.5	4.0	4.0
Niue	2.0	2.5	1.0	2.5	2.0	2.3	3.4	3.8	2.8	3.8
Palau	6.9	5.8	5.8	3.6	3.6	0.2	2.9	3.0	2.5	2.5
Papua New Guinea	5.2	3.6	3.4	3.4	3.2	4.4	4.6	5.0	4.0	4.6
Samoa	4.2	2.0	0.4	3.0	2.0	1.9	1.2	1.4	4.0	5.0
Solomon Islands	3.6	3.0	1.7	3.4	3.3	2.7	4.5	5.5	2.8	5.0
Tonga	4.4	2.3	2.3	2.3	1.8	2.9	3.8	4.0	2.7	6.0
Tuvalu	-0.8	2.5	1.9	2.4	1.7	2.9	3.5	4.8	1.7	3.1
Vanuatu	3.8	4.7	4.7	3.9	3.9	0.7	2.0	2.0	2.7	2.7
Advanced Asia and the Pacific	2.5	2.6	3.1	1.7	2.0	2.5	2.6	2.4	2.1	2.1
Asia and the Pacific	5.0	4.5	4.7	4.5	4.5	2.9	4.0	3.9	3.2	3.3

ASEAN = Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste, and Viet Nam).

Note: Most regional economies report by calendar year; reporting by fiscal year are South Asian countries (except Bhutan, Maldives, and Sri Lanka), the Cook Islands, the Marshall Islands, the Federated States of Micronesia, Myanmar, Naoero, Niue, Palau, Samoa, and Tonga.

Source: Asian Development Outlook database.

reflecting lower-than-expected oil production this year; 0.5 pps for Philippines on elevated inflation and weak public investment; 0.2 pps for Cambodia with tourism growth slowing, and for Myanmar as domestic demand is subdued and production costs rise. Forecasts for Indonesia and the Lao People's Democratic Republic are unchanged. For 2027, the subregional projection is raised by 0.1 pps to 4.9%, primarily driven by an upward revision for Viet Nam on expectations of stronger investment.

Growth forecasts for Caucasus and Central and West Asia are revised down slightly as weak external demand is expected to weigh on growth in Türkiye, the subregion's largest economy. The subregion's growth forecast is lowered to 3.7% in 2026 and 4.1% in 2027, both 0.1 pps below the July projections. Growth prospects nevertheless vary across economies. For 2026, forecasts are lowered for Azerbaijan by 0.4 pps as a decline in hydrocarbons production is expected to persist to year-end; for Tajikistan by 0.3 pps as reescalation of Russia's war in Ukraine has disrupted fuel imports and constrained domestic supply; and for Türkiye by 0.3 pps because of subdued external demand. By contrast, forecasts are raised for Georgia by 0.8 pps and Uzbekistan by 0.3 pps following performance stronger than expected in the first half of the year, driven by resilient domestic demand. Forecasts for Armenia, Kazakhstan, Kyrgyz Republic, and Turkmenistan are maintained. For 2027, the subregional forecast is lowered slightly with downward revision for Türkiye as weak external demand continues, while projections for all other economies are retained.

Growth projections for the Pacific are downgraded on prolonged energy market disruption and adverse effects from El Niño. Subregional forecasts are lowered to 3.0% in 2026 and 2.9% in 2027, both down by 0.3 pps from July. For 2026, this reflects weak mining and agriculture in Papua New Guinea, where reduced milling operations have affected gold production. In addition, dry conditions caused by El Niño are expected to further disrupt mining operations in the Pacific's largest economy through water shortages and curtail agricultural production, especially in drought-prone areas. Revisions also reflect subdued industrial output in Fiji; power outages in Tuvalu; typhoon impacts in the Federated States of Micronesia; and slower construction and capital

spending in Niue, Samoa, Solomon Islands, and Tonga, where a lack of new major infrastructure projects and delays to ongoing ones weigh on activity. Weaker growth prospects are expected to continue into 2027, reflecting effects from the prolonged Middle East conflict and a forecast that El Niño will be persistent.

Price Pressures Remain Elevated

The inflation forecast for developing Asia and the Pacific is revised down for 2026, while the 2027 projection is raised. The regional forecast is cut by 0.1 pps to 4.2% for 2026, mainly on downward adjustments for the PRC and South Asia. Inflation is nevertheless expected to remain substantially higher than in 2025, underscoring continued price pressures across the region. Persistently high global energy prices continue to spur inflation across much of the region through higher fuel, transport, and commodity costs. In some economies, fiscally costly broad subsidies have tempered pass-through to consumer prices (Box 1.3.1). The inflation forecast for 2027 is raised by 0.1 pps to 3.5%, reflecting slower disinflation in Türkiye and the expected peak in the pass-through of El Niño-related commodity price increases (Box 1.3.2). Pass-through is likely to be strongest where food accounts for a large share of the consumer price basket, as in South Asia, and where inflation is already high (Box 1.2.1).

The PRC inflation forecast for 2026 is lowered on weaker-than-expected consumer demand. Inflation is projected at 0.9% in 2026, down by 0.3 pps from July, while the 2027 projection is maintained at 0.9%. Ongoing deflationary pressures from the property sector and consumer goods, alongside adequate oil reserves, are expected to contain price pressures through the forecast period.

The 2026 inflation forecast for South Asia is revised down on government price stabilization measures, while the 2027 projection remains unchanged. The subregional forecast for 2026 is trimmed by 0.2 pps to 5.5%, driven mainly by downward revisions for India by 0.2 pps and Maldives by 2.8 pps, as government subsidies on fuel and electricity cushioned the impact of higher global oil prices. Mild price pressures in Bangladesh and Pakistan in FY2026 (ended 30 June 2026) also supported downward

revision. These downgrades more than offset an upward revision of 2.0 pps for Bhutan, reflecting larger-than-expected inflationary effects from a new goods and services tax system and excise tax introduced in January 2026, as well as higher fuel and transportation costs from the Middle East conflict. The subregional inflation forecast for 2027 remains unchanged, but the outlook differs across economies. Projections are adjusted up for Afghanistan, Bangladesh, and Bhutan as energy prices are expected to remain high, offset by a 2.0 pp reduction for Maldives on continued fiscal subsidies.

The inflation projections for Caucasus and Central and West Asia are raised for both 2026 and 2027, mainly on slower disinflation in Türkiye, the subregion's largest economy. The subregional projections are raised to 23.1% in 2026 and 17.6% in 2027, up from July by 1.1 pps and 1.3 pps, respectively. Persistent energy price pressures and trade disruptions are slowing disinflation in Türkiye and prompted upward revisions for both years. Forecasts for 2026 are also raised for Azerbaijan, Georgia, and Uzbekistan, reflecting higher fuel prices from disruption linked to Russia's war in Ukraine, which has also increased transportation and food costs. In Uzbekistan, recent utility tariff adjustments are anticipated to buoy prices through the remainder of 2026, particularly in logistics and services.

Similarly, inflation forecasts for developing Southeast Asia are revised up on higher global energy prices and expected impact of El Niño. The subregional projection for 2026 is raised by 0.1 pps from July to 4.0%, reflecting upward revisions for Cambodia and Indonesia in response to higher global oil prices, as well as stronger demand-side pressures in Viet Nam. In Indonesia, the government has allowed the higher global oil prices to pass through to the prices of non-subsidized fuel, while keeping prices of subsidized fuels unchanged. In contrast, forecasts for the Lao People's Democratic Republic, Thailand, and Timor-Leste are lowered, as fuel support measures and other price-stabilization policies are expected to mitigate the pass-through of higher energy costs to consumer prices. For 2027, the subregional forecast is raised from 2.9% in July to 3.3% on higher projected inflation in Cambodia and Viet Nam as elevated energy costs continue to feed into domestic prices, and in Malaysia and Indonesia as El Niño's strength and duration are expected to keep prices elevated.

Inflation projections for the Pacific are also revised up on elevated energy prices and disruption from El Niño. The subregional forecast is raised to 4.6% in 2026 and 4.1% in 2027, up from July by 0.4 pps and 0.6 pps, respectively. Revisions reflect the pass-through of higher global oil prices amid renewed tensions in the Middle East, as well as currency depreciation in some economies. El Niño strengthening is also expected to put upward pressure on food prices as drier conditions affect agriculture.

Box 1.3.1 Strengthening Resilience Through Timely and Targeted Action

Economies across Asia and the Pacific face mounting challenges from geopolitical and weather-induced shocks. Since the Middle East conflict began on 28 February 2026, global energy markets have experienced significant disruption, sharply higher oil and gas prices, and increased volatility. As several economies in the region are net importers of hydrocarbons and rely heavily on supplies from the Middle East (ADB 2026), disruption has translated into higher energy costs and energy security concerns. At the same time, El Niño conditions, which began in June 2026 and are expected to intensify through the remainder of the year, are amplifying food price pressures and affecting agriculture and water resources in the most exposed economies. The combined effects of these shocks have strained households and businesses, prompting governments to implement mitigating measures.

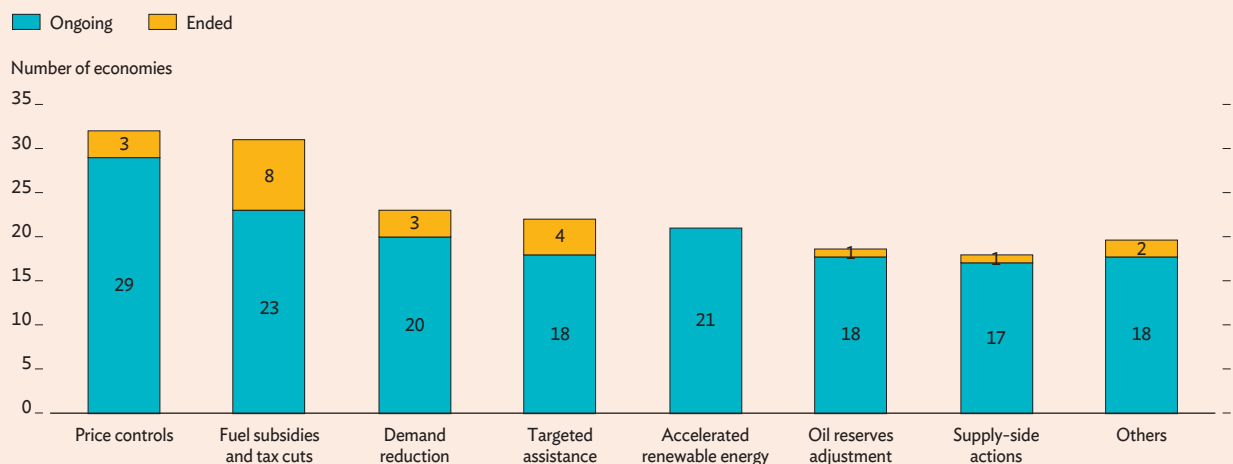
Policy responses have focused largely on mitigating the immediate effects of the energy shock. Although some economies have gradually unwound temporary support measures to ease fiscal pressures, most have maintained them as a prolonged Middle East conflict and renewed escalation of Russia's war in Ukraine continue to rattle energy markets. Price controls are the most widely used measures, adopted by 32 economies and still in place in 29. They are followed by fuel subsidies and tax

cuts, adopted by 31 and ongoing in 23; demand-reduction measures, 23 with 20 ongoing; and targeted assistance, 22 with 18 ongoing. Oil reserve adjustments, supply-side actions, and other measures were also introduced (box figure and box table).

As El Niño intensifies, governments have expanded measures to protect agriculture, water resources, and food security. As of 4 September, 11 economies have implemented measures to enhance preparedness and reduce vulnerability to drought and other weather-induced disruption (box table). In India, the government announced a contingency plan covering 315 districts affected by weak monsoon rains, emphasizing short-duration crops, improved water management, and the stockpiling of seed and fodder reserves. In Cambodia and the Philippines, authorities directed ministries to strengthen climate and weather monitoring, conduct public awareness campaigns, improve drought preparedness and emergency response planning, and ensure adequate food reserves. Thailand introduced a range of preparedness measures, notably optimizing reservoir and irrigation management; securing water supplies for households, agriculture, and industry; cloud seeding to encourage rainfall in drought-prone areas; and strengthening water allocation and contingency planning.

Ongoing and Ended Policy Measures in Response to the Middle East Conflict

Several economies in Asia and the Pacific have implemented measures to mitigate the impact of the Middle East conflict, most of which are still ongoing.



Sources: Asian Development Bank economy desks, a resident mission survey, and news reports as of 4 September 2026; official sources.

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Box 1.3.1 Continued**Summary of Ongoing Policy Measures as of 4 September 2026**

Governments have adopted a range of measures to mitigate the effects of energy and weather-related shocks.

Policy Actions	Examples	List of Economies	Number of Economies
Price controls	Working with oil companies and state-owned enterprises to implement price increases in smaller, scheduled increments rather than all at once to mitigate shock	Brunei Darussalam; Cambodia; People's Republic of China; Cook Islands; Fiji; India; Indonesia; Japan; Kiribati; Republic of Korea; Kyrgyz Republic; Lao PDR; Maldives; Federated States of Micronesia; Naoero; Nepal; Niue; Pakistan; Papua New Guinea; Philippines; Samoa; Solomon Islands; Sri Lanka; Taipei, China; Thailand; Timor-Leste; Tonga; Türkiye; Viet Nam	29
Fuel subsidies and tax cuts	Governments directly subsidizing users such as public transport, or specific fuel types, or reducing excise and value-added taxes on petroleum products to benefit consumers	Bhutan; Brunei Darussalam; Cambodia; Cook Islands; Fiji; India; Indonesia; Japan; Republic of Korea; Kyrgyz Republic; Malaysia; Maldives; Mongolia; Myanmar; Nepal; Papua New Guinea; Philippines; Sri Lanka; Thailand; Timor-Leste; Türkiye; Vanuatu; Viet Nam	23
Accelerated renewable energy	Further development of a pipeline for renewable energy investment	Bangladesh; Brunei Darussalam; Cambodia; Cook Islands; Fiji; India; Indonesia; Republic of Korea; Lao PDR; Maldives; Palau; Philippines; Samoa; Singapore; Solomon Islands; Tajikistan; Thailand; Timor-Leste; Türkiye; Tuvalu; Viet Nam	21
Demand reduction	Addressing fuel consumption through, for example, conservation measures, transportation alternatives, remote work, traffic management, and shorter school days	Bangladesh; Bhutan; Cambodia; Cook Islands; Fiji; India; Indonesia; Japan; Republic of Korea; Lao PDR; Maldives; Marshall Islands; Myanmar; Naoero; Philippines; Singapore; Solomon Islands; Sri Lanka; Thailand; Viet Nam	20
Targeted assistance	Support for the transportation sector, social assistance, and rationing liquefied natural gas	Bangladesh; Brunei Darussalam; Cambodia; Cook Islands; Fiji; India; Indonesia; Japan; Republic of Korea; Malaysia; Marshall Islands; New Zealand; Palau; Philippines; Singapore; Sri Lanka; Vanuatu; Viet Nam	18
Oil reserves adjustment	Bans on refined fuel exports, building and extending fuel storage, export licensing or approval requirements, higher export duties	Australia; Bangladesh; People's Republic of China; India; Indonesia; Japan; Republic of Korea; Mongolia; New Zealand; Philippines; Singapore; Solomon Islands; Thailand; Timor-Leste; Türkiye; Tuvalu; Vanuatu; Viet Nam	18
Supply-side actions	Allowing the temporary and controlled rollout of Euro II fuel, diversification of sources for energy imports	Bangladesh; Cambodia; India; Indonesia; Japan; Republic of Korea; Kyrgyz Republic; Mongolia; Philippines; Singapore; Sri Lanka; Tajikistan; Thailand; Timor-Leste; Tuvalu; Uzbekistan; Viet Nam	17
Others	Price monitoring, setting up emergency crisis committees	Bangladesh; Brunei Darussalam; Cambodia; Hong Kong, China; India; Indonesia; Japan; Republic of Korea; Kyrgyz Republic; Maldives; Mongolia; Philippines; Singapore; Tajikistan; Thailand; Timor-Leste; Uzbekistan; Viet Nam	18
Weather-related policies		Cambodia; Cook Islands; India; Indonesia; Japan; Philippines; Solomon Islands; Sri Lanka; Thailand; Vanuatu; Viet Nam	11

Lao PDR = Lao People's Democratic Republic.

Sources: Asian Development Bank economy desks, a resident mission survey, and news reports as of 4 September 2026; official sources.

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Box 1.3.1 Continued

Beyond immediate crisis response, governments are increasingly adopting structural policies to strengthen energy security and external shock resilience. Measures to accelerate renewable energy investment have been identified in 21 economies, including the development of investment pipelines. Sustained investment in renewable energy generation, power grids, energy storage, and energy efficiency can reduce dependence on imported fossil fuels and exposure to global energy price volatility. Governments are strengthening preparedness and supply security by diversifying energy sources and suppliers, building strategic fuel reserves, and updating contingency plans to better manage future supply disruption. Over time, these measures can reduce economies' structural exposure to energy shocks and lessen reliance on general emergency support.

The policy mix points to scope for greater emphasis on structural measures. Experience across Asia and the Pacific underscores the importance of timely, targeted, and well-coordinated policy action. Near-term measures can cushion households and businesses from sudden shocks, but sustained investment in energy diversification, food security, and resilient infrastructure is needed to address underlying vulnerabilities. Calibrating temporary support as conditions evolve, while strengthening fiscal buffers and crisis management capacity, can help governments respond more effectively to future geopolitical and climate-induced shocks.

Reference:

ADB. 2026. [Asian Development Outlook April 2026: The Middle East Conflict Challenges Resilience in Asia and the Pacific](#). Asian Development Bank.

This box was written by Melanie Grace Quintos and Priscille Villanueva.

Box 1.3.2 Risk Scenarios for El Niño and Energy Market Disruption

Two supply shocks shape risks to the outlook for developing Asia and the Pacific (DAP): El Niño and ongoing energy market disruption. El Niño is now forecast to be very strong and could weigh on economic activity as drought and monsoon failure reduce agricultural production, hydropower generation, and mining output in directly affected economies. By restricting supply, these effects can push up global food and metal prices, while lower hydropower generation increases demand for oil and gas. Energy market disruption could be more persistent than assumed, particularly if ongoing conflicts and geopolitical tensions escalate further. Importantly, the two shocks may compound each other, posing significant challenges to economies in DAP.

The outlook in this report incorporates a very strong El Niño and persistent energy market disruptions, but the magnitude of their effects remains uncertain. The baseline assumes that the combined effects of El Niño and continued energy disruption keep Brent crude spot prices at an average of \$90/barrel in 2026, \$78 in 2027 and about \$75 in 2028. However, empirical evidence on the size and impacts of El Niño effects is mixed (e.g., Cashin, Mohaddes, and Raissi 2017; Callahan and Mankin 2023). The extent and pace of energy market normalization to the forecast horizon are also highly uncertain, depending primarily but not entirely on how the Middle East conflict and Russia's war in Ukraine play out.

The assumed path for El Niño in the baseline captures effects on global commodity prices and direct impacts on exposed economies. Historically, a typical event raises global agricultural and metal prices by about 5.3% at its peak, reflecting harvests lost to drought and disrupted mining across major producers. The baseline assumes effects twice as large, building gradually from the third quarter (Q3) of 2026 to Q3 2027 and fading thereafter. In addition, economy-specific supply shocks are imposed on 21 economies with direct exposure to El Niño, applied as exogenous gross domestic product (GDP) paths. For eight of these economies, shocks are guided by global vector autoregression impulse responses in Cashin, Mohaddes, and Raissi (2017), which capture in full the historical response of GDP to El Niño events. Shocks in the remaining 13 economies, mostly in DAP, are calibrated in line with national studies of recent events.^a

To reflect uncertainty about the baseline, this box sets out four scenarios. Each scenario pairs an energy market path resulting from either renewed escalation or faster normalization with an assumption about El Niño. The two downside scenarios combine renewed escalation with El Niño effects from the baseline or stronger while the two upside cases combine faster energy market normalization with El Niño effects from the baseline or milder. This box assesses the implications for global oil prices and growth and inflation in DAP.

The two downside scenarios add renewed energy market disruption, first on its own and then together with El Niño effects. In downside scenario 1, heightened energy market disruption pushes Brent to nearly \$106/barrel in Q3 2026, with annual averages of \$98 in 2026 and \$90 in 2027 (box table). Downside scenario 2 combines escalation

Brent Crude Spot Prices Assumptions
 (\$/barrel, annual averages)

Each scenario assumes oil price paths based on combined assumptions about the energy market escalation and the impacts of El Niño.

Scenario	2026	2027	2028
Baseline <i>Persistent energy disruption and very strong El Niño</i>	90	78	75
Downside scenario 1 <i>Renewed escalation of energy disruption</i>	98	90	83
Downside scenario 2 <i>Renewed escalation of energy disruption and stronger effects from El Niño</i>	99	92	83
Upside scenario 1 <i>Faster normalization from energy disruption</i>	82	67	60
Upside scenario 2 <i>Faster normalization from energy disruption and El Niño with milder effects</i>	82	65	59

Notes: Each scenario combines an assumed global oil-supply path with the oil demand uplift associated with El Niño. The baseline assumes El Niño effects twice those of a typical historical event, and the supply path is stated net of the additional oil demand implied by El Niño baseline effects, so the two together reproduce the baseline Brent path exactly. Stronger effects from El Niño raise Brent further, while milder effects lower it. In all scenarios, gas prices follow the oil price path, with deviation from the model's no-disruption path set at 1.5 times the corresponding deviation for oil.

Source: Asian Development Bank estimates using the Oxford Economics Global Economic Model.

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Box 1.3.2 Continued

in energy markets with El Niño effects that are three times greater than those of a typical historical event. These raise demand for oil and gas as hydropower generation falls, pushing Brent to \$99/barrel in 2026.

The two upside scenarios assume faster energy market normalization, first on its own and then with El Niño effects that are milder. In upside scenario 1, energy markets normalize more quickly than assumed in the baseline, removing the risk premium on oil prices. Brent averages \$82/barrel in 2026 and \$67 in 2027. Upside scenario 2 combines this faster normalization with El Niño effects in adversely affected economies that are milder, set at those of a typical historical event. These reduce demand for oil and gas further, taking Brent down to \$65/barrel in 2027. Downside and upside scenario 2 differ from their scenario 1 counterparts only in the assumed strength of El Niño effects.

Impacts on the region are modest in 2026 because scenarios start diverging from the baseline only late in the year (box figure). Downside scenarios reduce growth by up to 0.11 percentage points (pps) and raise inflation by up to 0.25 pps, while upside scenario 2 lifts growth by 0.10 pps and lowers

inflation by 0.36 pps. In each direction, the scenario 2 total combines the scenario 1 effect with the additional effect of a stronger or milder assumption about El Niño.

Effects widen considerably in 2027, when commodity price shocks peak. In the downside scenarios, higher energy and food prices raise inflation and squeeze real incomes and demand. In downside scenario 1, growth in 2027 falls 0.32 pps below the baseline and inflation rises 0.69 pps above it. Downside scenario 2 increases these effects to 0.44 pps and 0.91 pps, with El Niño's stronger effects accounting for an additional 0.12 pps reduction in growth and 0.22 pps increase in inflation.

The upside scenarios reverse the channels, easing price pressures and supporting activity. In upside scenario 1, faster energy price normalization adds 0.22 pps to 2027 growth and subtracts 0.76 pps from inflation, both relative to the baseline. The milder effects of El Niño in upside scenario 2 add a further 0.14 pps to growth and reduce inflation by an additional 0.23 pps, leaving 2027 growth 0.36 pps above the baseline and inflation 0.99 pps below it.

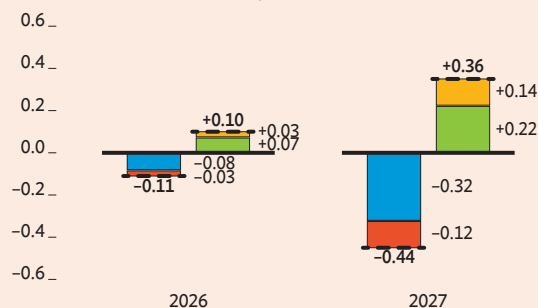
Scenario Impacts on Growth and Inflation in Developing Asia and the Pacific

Impacts occur mostly in 2027, when commodity price shocks peak, and are larger for inflation than for growth.



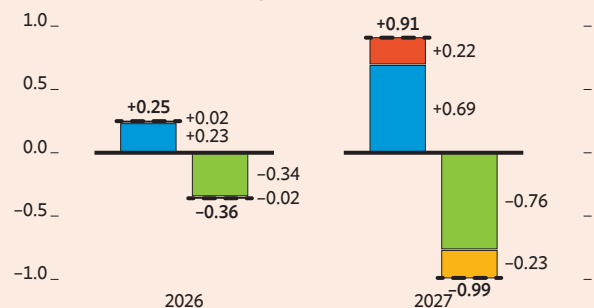
A. Real Gross Domestic Product

Deviation from baseline, percentage points



B. Inflation

Deviation from baseline, percentage points



Notes: Each direction stacks the scenario 1 effect and the additional effect of the stronger or milder assumption about El Niño, so that stacked totals correspond to downside and upside scenario 2. Dashed rules mark those totals.

Source: Asian Development Bank estimates using the Oxford Economics Global Economic Model.

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Box 1.3.2 Continued**Several caveats should be borne in mind when interpreting these estimates.**

First, the shocks enter as an aggregate output loss for each affected economy rather than at the sector level, so agriculture, hydropower, and mining channels are not separately identified, even though the commodity price channels they generate are modeled globally. If these channels have heterogeneous or offsetting effects, the aggregate approach may over- or understate impacts. Second, the analysis does not account for potential nonlinear effects of El Niño shock, whereby large and persistent effects or severe weather may have disproportionately strong impacts on output and inflation. Similarly, shocks are assumed to be transitory, with all paths returning to the baseline by the end of 2028, so any permanent damage from a severe episode is excluded by design. Scenario severity is scaled by a common factor across all affected economies, holding relative

exposure fixed. Third, while monetary policy responds endogenously through the model's reaction functions, discretionary measures that could soften impacts are not incorporated: food subsidies, targeted transfers, price controls, and releases from public food buffer stocks. In addition, United States and euro area policy rates are held on an assumed path in the first half of the scenario period. Fourth, some economies lack sufficient data to be modeled directly and are assumed to co-move with peers.

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This box was written by Tolga Ozden.

^a Four of the eight economies with paths taken from Cashin, Mohaddes, and Raissi (2017) are in Asia and the Pacific—Australia, India, Indonesia, and New Zealand—the others being Argentina, Peru, South Africa, and the United States. Ten of the 13 economies calibrated to national studies are in the region—Bangladesh, Fiji, Malaysia, Papua New Guinea, the Philippines, Solomon Islands, Thailand, Tonga, Vanuatu, Viet Nam—the others being Panama, Zambia, and Zimbabwe.

Geopolitical and Weather-Induced Risks Cloud the Outlook

Worsening geopolitical tensions could perpetuate disruption to global energy markets and supply chains longer than anticipated. Further escalation in the Middle East, together with Russia's war in Ukraine, could disrupt supplies of crude oil, natural gas, fertilizers, chemicals, and agricultural commodities. The 10 September attacks on Saudi Arabia's East-West Pipeline underscore risks to alternative Gulf oil export routes. Heightened security risks in the Red Sea and the Bab el-Mandeb strait have already rerouted shipping around the Cape of Good Hope, raising freight costs and delivery times. Attacks in July and August on ships, ports, and export terminals in the Black Sea and persistent disruption to maritime transport highlight the growing vulnerability of global supply chains. Higher shipping costs and insurance premia could further raise import prices. Given the region's high dependence on imported energy, a sustained increase in energy prices could widen current account deficits, weaken currencies, and amplify inflationary pressures. This could induce tighter monetary conditions, weighing on aggregate demand.

Worse-than-expected El Niño could reduce agricultural output and raise food inflation. Droughts and heat waves could intensify across parts of Asia and the Pacific, reducing crop yields while increasing irrigation and electricity demand. Higher production costs and food supply shortfalls would be compounded by higher fertilizer prices resulting from geopolitical disruption. Because food accounts for a large share of household consumption in many DAP economies, higher food prices would dampen private consumption, in particular for lower-income households, and complicate inflation management. These impacts would be amplified if a worse-than-expected El Niño coincided with an escalation of conflict in the Middle East ([Box 1.3.2](#)). On the upside, a milder El Niño would imply less damage to agricultural production and weaker effects on inflation.

Food and consumer price inflation could prove more persistent than anticipated. The lagged effects of earlier increases in energy and fertilizer

costs are still feeding through to planting decisions, crops, and yields, even as El Niño threatens harvests. Renewed disruption to Ukrainian wheat exports through the Black Sea could further tighten global supply. An additional concern is the pass-through from producer price inflation, which nearly doubled from February to July, as its impact on consumer prices typically continues to build for up to 24 months after the initial increase (see [Box 1.2.1](#)). This suggests that a substantial part of the rise in input costs has yet to be passed through to households.

A sharp repricing in global AI equity valuations could amplify financial market volatility in the near term. Elevated valuations and recent volatility in technology stocks have raised concerns about the underlying profitability of AI firms and the sustainability of their large investments. An abrupt correction in AI-related equity valuations could tighten financial conditions, weaken business confidence, and reduce investment, particularly in economies highly exposed to AI and semiconductors. While near-term risks tilt to the downside, over the medium to longer term, unexpectedly rapid advances in AI capabilities and broader adoption across industries could generate larger productivity gains than currently assumed. This could raise market valuations and support consumption through positive wealth effects.

Rising long-term interest rates could compound risks from a market correction, further tightening financial conditions and worsening debt dynamics. Global 10-year bond yields remain elevated amid heightened fiscal and inflation concerns ([Box 1.4.1](#)). A further rise, driven by higher long-term yields and shifting policy expectations in the major advanced economies, would raise sovereign borrowing costs at a time when several DAP economies continue to run primary balances below debt-stabilizing levels. This would place a heavier adjustment burden on fiscal policy, narrowing the scope for gradual consolidation. These pressures could compound the risk of a repricing

of AI equities, as higher long-term interest rates would reduce the present value of future profits on which AI valuations rest. Additionally, a sharp correction could drive investors toward safe assets, widening spreads for regional sovereign bonds.

Renewed trade policy uncertainty could weaken trade, investment, and supply chain resilience.

Recent US tariff measures and pending Section 301

investigations leave scope for further trade actions. If these developments lead to additional tariff hikes and retaliation, cross-border investment and exports could weaken. Even without further escalation, uncertainty over the implementation and duration of announced trade measures could discourage investment and accelerate supply chain fragmentation, with adverse implications for productivity and growth in the medium term.

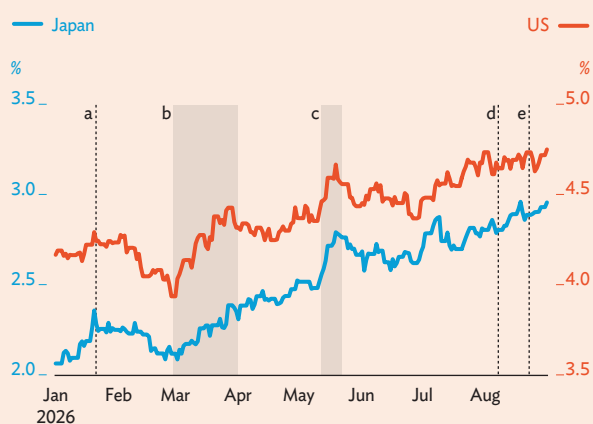
Box 1.4.1 Fiscal Woes and Inflation Concerns Shake Global Bond Markets

Concerns about fiscal sustainability in major advanced economies, compounded by inflation risks, have led to heightened volatility in global bond markets. US government debt exceeded \$40 trillion in August 2026, the highest on record and equal to 123.7% of gross domestic product (GDP). In Japan, government debt stood at over 200% of GDP, with debt servicing costs expected to rise further next year. As concerns about fiscal imbalances rose and ongoing energy market disruption threatened higher inflation, government bond yields climbed to multiyear highs. This prompted policy interventions to prevent further increases in borrowing costs, but these measures also signaled official concern about the sustainability of prevailing yields, contributing to heightened volatility in global bond markets. On 31 July, the US and Japan conducted a coordinated currency intervention to stabilize the yen and contain volatility in the Japanese government bond market (box figure 1). On 19 August, the US Treasury announced an increase in its buyback of 10- to 30-year bonds from \$2 billion to \$4 billion, effective from 9 September to 4 November, which market participants read as an attempt to support market liquidity and prevent a sharp increase in long-term interest rates. Given the central roles of US and Japanese sovereign debt markets in global finance, such developments can have important implications for financial conditions in Asia and the Pacific, posing risks to the outlook.

Term premia account for more than half of the rise in US and Japan 10-year government bond yields this year, the remainder from higher expected policy rates (box figure 2). Model-implied 10-year yields rose by 0.56 percentage

1 US and Japan 10-Year Government Bond Yields, 2026

10-year government bond yields in Japan and the US surged in 2026 on growing fiscal concerns and inflation risks.



- a Japan prime minister calls for snap elections
- b Inflation concerns over prolonged conflict in the Middle East
- c Uncertainty over Middle East talks and Japan's supplementary budget
- d The US and Japan launch a coordinated currency intervention
- e US Treasury announces an increase in its buyback of 10- to 30-year bonds

Source: Bloomberg.

points in the US and 0.78 percentage points in Japan between 1 January and 21 August 2026, with the term premium contributing 53% and 61% of those increases respectively.^a Energy price shocks emanating from the conflict in the Middle East have raised global inflation, lifting expected interest rates and, consequently, nominal bond yields.^b The increase in term premia is harder to attribute. In the Middle East, protracted negotiations and fragile ceasefires have added to geopolitical uncertainty, while concerns over debt sustainability can raise

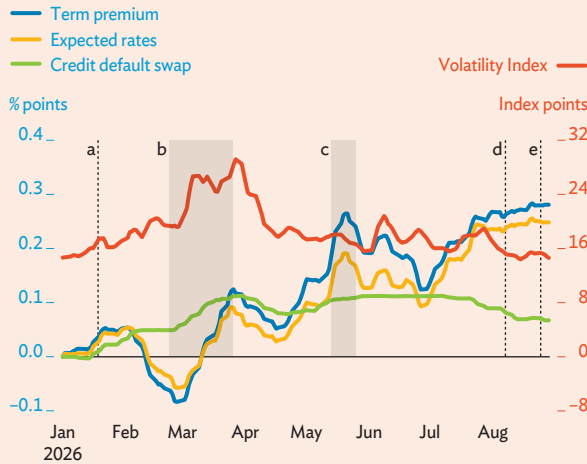
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Box 1.4.1 Continued

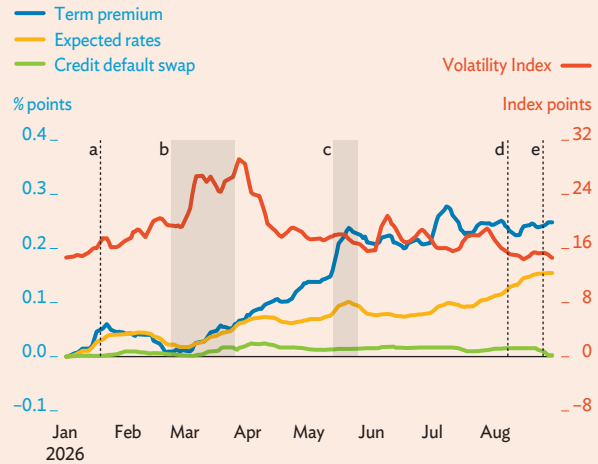
2 Government Bond Yields and Financial Risks in the United States and Japan, 2026

Higher expected rates and term premia drove a recent rise in the US and Japanese bond yields.

A. United States



B. Japan



Notes: All series are presented as 5-day centered moving averages. Expected rates are calculated as the fitted 10-year government bond less the term premium.

^a Japan prime minister calls for snap elections

^b Inflation concerns over prolonged conflict in the Middle East

^c Uncertainty over Middle East talks and Japan's supplementary budget

^d The US and Japan launch a coordinated currency intervention

^e US Treasury announces an increase in its buyback of 10- to 30-year bonds

Sources: Bloomberg; Board of Governors of the Federal Reserve System, 2 September 2026; Ichiiue, H. and Y. Ueno. 2013. *Estimating Term Premia at the Zero Bound: An Analysis of Japanese, US, and UK Yields*. Working Paper Series No. 13-E-8. Bank of Japan.; Investing.com; Kim, D. and J. Wright. 2011. *An Arbitrage-Free Three-Factor Term Structure Model and the Recent Behavior of Long-Term Yields and Distant-Horizon Forward Rates*. Finance and Economics Discussion Series No. 2005-33. Federal Reserve Board; and Nakajima, J. 2025. *Impact of US Monetary Policy Spillovers and Yield Curve Control Policy*. Discussion Paper Series A.760. Institute of Economic Research, Hitotsubashi University.

the compensation investors demand, through both higher perceived default risk and fiscal dominance.^c For the US and Japan, the rise in term premia appears consistent with fiscal dominance concerns and underlying inflationary risks. Credit default swap spreads have risen for both sovereigns, but for safe haven bonds these spreads largely reflect banks' capital requirements on uncollateralized sovereign derivatives rather than any change in default risk (Klingler and Lando 2018). In addition, there is weak evidence that the rise in term premia may have been attenuated by fluctuations in global risk aversion, as captured by the Chicago Board Options Exchange's Volatility Index, which raises demand for safe assets.^d Hence, the rise in US and Japanese sovereign bond yields this year reflects higher expected nominal rates, driven partly by rising inflation, and elevated term premia associated with fiscal, inflation, and geopolitical risks.

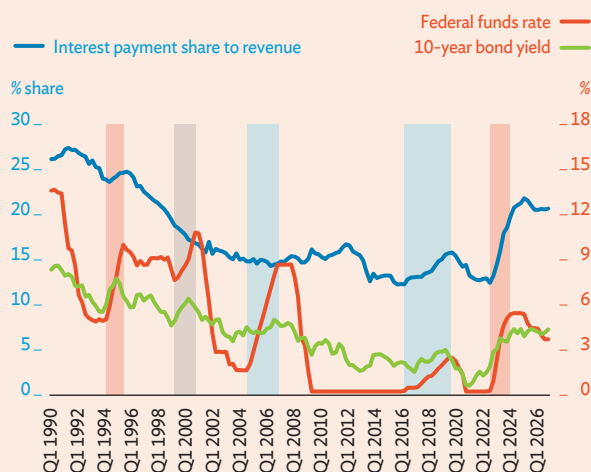
Historically, increases in US sovereign bond yields have been more pronounced when monetary policy tightening has coincided with elevated fiscal pressures.

In 1994, US government bond yields rose sharply after the Federal Reserve began raising interest rates to contain inflation, and a similar increase followed tightening that began in 2022. However, yields did not rise as much in the hiking cycles of 2004–2006 and 2015–2018 (box figure 3, panel A). One key difference between 1994 and 2022, on the one hand, and the other two episodes is the degree of fiscal pressure, as inferred from the share of federal interest payments relative to government revenue. Over the year following the start of hiking cycles under high fiscal pressure, the 10-year US government bond yield rose, on average, by up to 1.7 percentage points, against a decrease of 0.7 percentage points during hiking cycles under low fiscal pressure (box figure 3, panel B).

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Box 1.4.1 Continued**3 US Policy Rates, Debt-Servicing Costs, and Government Bond Market Indicators**

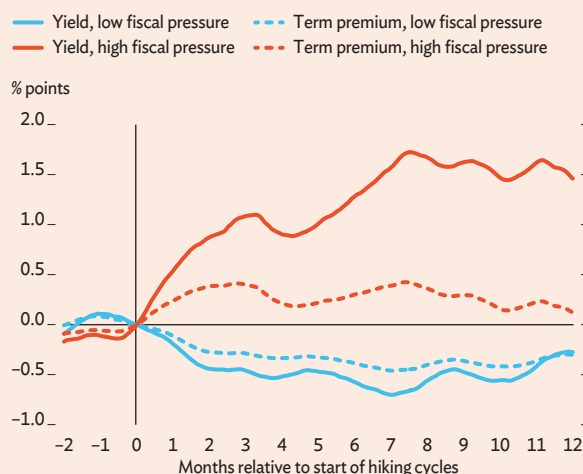
US government bond yields rose more during rate-hiking cycles under high fiscal pressure.

A. US Interest Payment, 10-year Government Bond Yields and Federal Funds rate

Q = quarter, US = United States.

Notes: Shaded areas in panel A indicate tightening cycles in US monetary policy, color-coded according to the degree of fiscal pressure (red = high, blue = low, gray = moderating), identified through the level and direction of change in the share of federal government interest rate payments relative to federal receipts, such that high pressure episodes have a 4-quarter share higher than 15% and not declining during the hiking cycle. The Federal funds rate is spliced using the Federal Funds Effective Rate (Percent, Monthly, Not Seasonally Adjusted) for Q1 1990–Q4 2008. Panel B shows 10-year government bond yields and term premia, averaged across Fed funds rate hiking cycles, with $t = 0$ as the start of the cycle and fiscal pressure regimes identified in panel A. Low fiscal pressure includes cycles starting on 30 June 2004 and 16 December 2015. High fiscal pressure includes cycles starting on 4 February 1994 and 16 March 2022. The hiking cycle beginning on 30 June 1999 is classified as moderating and excluded from panel B because, while elevated, the share of interest rate payments had been declining for about 3 years before the start of the hiking cycle; similar results are obtained when including this episode under the high fiscal pressure.

Sources: Bloomberg; Board of Governors of the Federal Reserve System, 2 September 2026.

B. 10-year Government Bond Yields and Term Premium during US Monetary Policy Tightening Cycles

The decrease in yields was largely driven by a lower term premium, despite rising policy rates. These contrasting responses highlight the relevance of fiscal sustainability concerns for sovereign bond pricing and, consequently, the cost of borrowing ([Analytical Chapter](#)). While higher policy rates should increase borrowing costs, their transmission to long-term yields can be weakened or strengthened by changes in the risk premium. Given the current outlook for US monetary policy, with rising expectations of a new tightening cycle to bring inflation back to target (Annex), elevated fiscal pressures raise the risk of further increases in borrowing costs.^e

Stress in global bond markets can tighten financial conditions in Asia and the Pacific and adversely impact the economic outlook. Cyclical fluctuations in sovereign bond yields in advanced economies are strongly correlated, reflecting the close integration of global financial markets (box

table). In the first quarter of 2026, the United States accounted for 35.7% of global public debt, the euro area 15.0%, and Japan 7.6%. Given a combined 58.3% share of outstanding global public debt, developments in these benchmark sovereign bond markets can have significant spillover effects on global yields and financing conditions.^f Meanwhile, relatively weak correlation between bond yields in advanced economies and the People's Republic of China (PRC) suggests that global fluctuations influence the PRC bond market to a lesser extent. This reflects differences in market structure and investor composition, where government securities in the PRC are predominantly held by domestic investors, particularly commercial banks, while foreign holdings of PRC sovereign debt have declined in recent months (ADB 2026). Meanwhile, over the past decade, PRC holdings of foreign sovereign bonds, particularly US Treasuries, have also declined substantially as it has diversified its foreign reserves away from

continued on next page

Box 1.4.1 Continued

Cyclical Correlations Between 10-year Sovereign Bond Yields Across Markets

Government bond yields across advanced economies exhibit strong positive correlations.

	United States	Euro area	Japan	PRC	Türkiye	DAP excl. PRC and Türkiye	AAP excl. Japan
United States		0.68	0.47	0.24	0.11	0.45	0.87
Euro area	0.68		0.50	0.18	0.19	0.50	0.75
Japan	0.47	0.50		0.22	0.11	0.33	0.48
PRC	0.24	0.18	0.22		0.20	0.26	0.23
Türkiye	0.11	0.19	0.11	0.20		0.23	0.13
DAP excl. PRC and Türkiye	0.45	0.50	0.33	0.26	0.23		0.51
AAP excl. Japan	0.87	0.75	0.48	0.23	0.13	0.51	

AAP = advanced Asia and the Pacific, DAP = developing Asia and the Pacific, PRC = People's Republic of China.

Notes: The sample covers daily data from 1 January 2016 to 21 August 2026, and correlations are calculated using the Pearson correlation coefficient based on bond yield gap series, where gaps are measured as deviations from Hodrick-Prescott filter-estimated trends. Green denotes stronger positive correlation; red weaker correlation. DAP excluding the PRC and Türkiye is represented by the average government bond yields of India, Indonesia, Malaysia, the Philippines, Thailand, and Viet Nam. AAP excluding Japan is represented by the average government bond yields of Australia; Hong Kong, China; the Republic of Korea; New Zealand; Singapore; and Taipei, China. Aggregate yields for DAP and AAP are weighted by gross domestic product at purchasing power parity.

Source: Authors' calculations based on data from Bloomberg and official sources.

US dollar assets (Greene 2024). While bond yields in developing Asia and the Pacific are only moderately correlated with those in advanced economies and the PRC, a tightening of financial conditions in those core markets can nevertheless spill over to emerging markets in the region through capital outflow, exchange rate pressure, higher domestic risk premia, and weakening foreign demand.^g

While bond yields are already elevated, a resumption of US monetary policy tightening could trigger further sharp repricing and tighter global financial conditions. With US inflation persisting above target, the Federal Reserve may need to resume raising policy rates, increasing the pressure on borrowing costs. Fiscal concerns could compound the effect, as debt sustainability worries interact with high energy and food prices. To evaluate the potential economic impacts of such a risk scenario of stress in global bond markets, simulations of a global macroeconomic model are conducted.^h The Fed is assumed to hike interest rates by 75 basis points above the baseline over the course of the fourth quarter of 2026 and start to ease gradually only after mid-2027. US and global bond yields are shocked over the period with magnitudes calibrated in proportion to the average effects observed during

the tightening cycles under high fiscal pressure in box figure 3, panel B. Model simulations then assess two alternative assumptions about monetary policy responses outside the US. First, under a strong global monetary policy reaction, central banks outside the US actively tighten monetary policy in response to higher US interest rates, particularly in emerging economies facing greater currency depreciation pressures. Second, under a weak global monetary policy reaction scenario, central banks react more moderately, placing greater weight on limiting the growth effects of tighter financial conditions and rising borrowing costs.

Bond market stress would weaken GDP growth across most economies, with the drag concentrated in 2027 as financial conditions tighten. The effects operate through lower consumption and investment as borrowing costs rise, and through second-round impacts as global demand slows. Under a strong global monetary policy reaction, cumulative growth in 2026–2027 falls by about 0.11 percentage points in developing Asia and the Pacific relative to the baseline, or by about 0.12 points excluding the PRC (box figure 4, panel A). The declines are smaller under a weak monetary policy reaction, at around 0.03 points.

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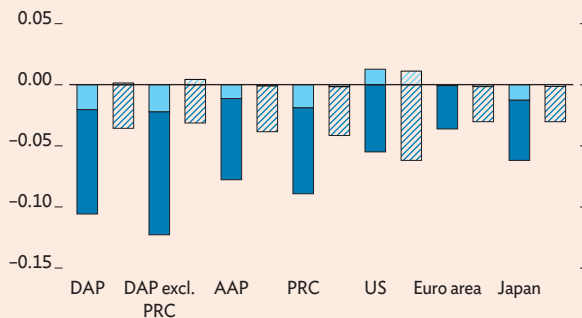
Box 1.4.1 Continued**4 Estimated Impact of a Bond Market Stress Scenario**

Bond market stress weakens growth across the region, and stronger policy tightening reduces inflation but increasing output losses.

A. Gross Domestic Product Growth

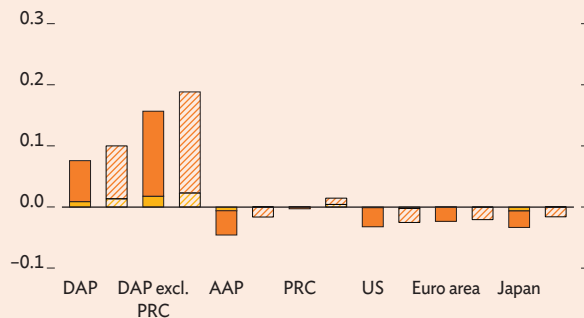
- Strong global monetary policy reaction, 2026
- Strong global monetary policy reaction, 2027
- Weak global monetary policy reaction, 2026
- Weak global monetary policy reaction, 2027

Percentage points relative to the baseline

**B. Inflation**

- Strong global monetary policy reaction, 2026
- Strong global monetary policy reaction, 2027
- Weak global monetary policy reaction, 2026
- Weak global monetary policy reaction, 2027

Percentage points relative to the baseline



AAP = advanced Asia and the Pacific, DAP = developing Asia and the Pacific, PRC = People's Republic of China, US = United States.

Source: Asian Development Bank estimates using the Global Economic Model of Oxford Economics.

The difference reflects additional drag from more synchronized policy rate hikes, over and above the effect of higher bond yields alone. The US is the exception: growth losses there are marginally larger under the weak global reaction. With central banks elsewhere raising rates by less, the gap between US and foreign bond yields stays wider than it otherwise would. That weighs on US equity prices and hence on consumption through wealth effects, as well as keeping the dollar stronger, dampening exports.

Inflation effects are concentrated in developing Asia and the Pacific and differ depending on global monetary policy responses. Under a strong global monetary policy reaction, cumulative inflation in 2026–2027 is about 0.08 percentage points above the baseline in the region, or about 0.16 points excluding the PRC (box figure 4, panel B). Under a weak reaction, the increases are larger, at about 0.10 points, or 0.19 points excluding the PRC. The difference reflects the role played by the exchange rate channel. As international interest rates increase, a weak response by regional central banks widens interest rate differentials and leads to currency depreciation, which then passes through to domestic prices via higher prices for imported goods. In contrast, inflation falls marginally below the baseline in advanced Asia and the Pacific, the United States, the euro area, and Japan, particularly in 2027, while the impact in

the PRC is negligible. The relatively muted inflation rates for these economies can be attributed to both more limited exchange rate pressures and relatively weaker domestic price pressures due to slowing economic activity.

Under this risk scenario of heightened global bond markets stress, central banks in the region would face a policy trade-off. A stronger global monetary response moderates the inflationary impact of bond market stress in developing Asia and the Pacific but imposes a greater cost in terms of growth. While the estimated impacts are relatively small, the model only partly reflects the nonlinear financial market dynamics that could amplify shocks and their macroeconomic effects. As such, the estimates are likely to understate the impact of a disorderly repricing.ⁱ Policymakers in the region should therefore remain vigilant about developments in global bond markets and calibrate policy responses according to potential spillovers into their domestic markets.

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Box 1.4.1 Continued

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This box was written by Jaqueson Galimberti, Melanie Grace Quintos, Dennis Sorino, and Mai Lin Villaruel.

- ^a Yields are model-implied (fitted) rather than observed; contributions are shares of the fitted change over the period. See Box Figure 2 for sources.
- ^b Conceptually, nominal bond yields can be decomposed into expected real interest rates, expected inflation, and a nominal term-risk premium capturing both inflation risk and (real) credit or liquidity risk premia. Expected real interest rates can be associated with equilibrium interest rates, which are generally thought to move only slowly over time (Del Negro et al. 2019), leaving most of yield fluctuation over the short to medium term to changes in expected inflation (or nominal interest rates) and the term premium. Term structure models typically decompose yields into nominal rate expectations and a nominal term premium (Kim and Wright 2011; Ichioe and Ueno 2013; Nakajima 2025).
- ^c Fiscal dominance refers to fears that rising debt burdens could constrain the ability of monetary policy to maintain price stability, notably through pressure to keep borrowing costs low or allow higher inflation to reduce the real value of debt ([Analytical Chapter](#)).
- ^d Pearson correlations between term premium estimates and the Volatility Index in 2026 were -0.371 in the US and -0.431 in Japan.
- ^e Given the high degree of integration between sovereign bond markets, as discussed below, cross-border monetary policy developments can have important spillover effects globally, even where government debt is predominantly held by domestic actors. For example, expectations of higher interest rates in Japan, where sovereign debt is predominantly held domestically, can encourage Japanese investors to repatriate capital, potentially sparking bond sell-offs in other markets and higher yields globally.
- ^f Despite being considered the safest and most liquid market in the world, the global treasuries market has also been subject to episodes of sudden illiquidity, most recently in March 2020, triggered by sudden changes in market expectations under high exposure to carry trade positions (Kahn and Nguyen 2022).
- ^g Among the economies in developing Asia and the Pacific, the correlation between Türkiye's sovereign bond yields and those from non-regional economies is lower than the average across other economies in developing Asia and the Pacific, implying a less direct channel to financial conditions. It is also important to note that Türkiye's sovereign bond yields are substantially more volatile than others'.
- ^h These simulations were carried out using the Oxford Economics Global Economic Model, a macro-econometric model.
- ⁱ The analysis is subject to other caveats: (i) Some economies lack sufficient data to be modeled directly and are assumed to move in line with comparable economies. (ii) The impact of monetary policy responses depends on the model-based assessment of economic slack, which is subject to large measurement uncertainty. (iii) Other policies may mitigate the impact of financial tightening, such as macroprudential and financial market regulation policies, which are not accounted for in the model. (iv) Finally, the bond yield shock is calibrated from the high fiscal pressure episodes in box figure 3, panel B and therefore inherits the potential limitations of that comparison.

El Niño 2026: Potential Physical and Economic Impacts for Asia and the Pacific

Introduction

El Niño is forecast to intensify through the second half of 2026 and may become one of the strongest events on record. As it is expected to peak around November, policymakers have a short but important window to take anticipatory measures before its effects intensify across the region.

This *Special Topic* outlines what policy makers in Asia and the Pacific need to know to prepare for El Niño. It begins with the science of El Niño Southern Oscillation (ENSO) and the current forecast, then examines the physical impacts expected across the region. Its central focus is on the channels through which those physical impacts transmit to economic activity, from agriculture and energy to industry, services, and labor markets, as well as the ecosystems and natural capital that underpin them. It then turns to the vulnerabilities that compound those effects, the historical macroeconomic evidence for the region, and a set of policy priorities organized around key transmission channels.

Basics of El Niño Southern Oscillation

El Niño is the warm phase of ENSO, a naturally occurring climate pattern centered in the tropical Pacific Ocean. ENSO is the largest source of variation year to year in the global climate system. The name reflects two coupled components: El Niño, the warming of the ocean surface, and the Southern Oscillation, the accompanying swing in atmospheric pressure between the western and eastern Pacific. During El Niño, sea surface temperatures rise in the central and eastern tropical Pacific, and the resulting shift in ocean heat

reorganizes atmospheric circulation and rainfall patterns across the Pacific and beyond. These changes have been associated with higher global temperatures, altered rainfall, prolonged drought, reduced freshwater availability, increased wildfire risk, coral bleaching, and shifts in tropical cyclone activity.

ENSO cycles through three phases, each with a distinct regional signature. Under neutral conditions, strong trade winds keep warm water banked up in the western Pacific, near Indonesia and the Philippines, supporting a fairly predictable pattern of rainfall and pressure. El Niño begins when these winds weaken, and warm water drifts east and pools off the coast of South America, pulling rainfall away from the western Pacific and further weakening the winds. This self-reinforcing loop builds over several months. La Niña, which frequently follows El Niño, is the mirror image, bringing stronger trade winds, cooler central and eastern Pacific waters, and largely opposite regional impacts, including wetter conditions in Australia and Indonesia. El Niño events also differ in where the warming concentrates. Canonical, or eastern Pacific, events warm the ocean off South America, while Modoki, or central Pacific, events shift the warming westward and produce a different regional footprint, which is one reason impacts vary between episodes of similar measured strength.

Recurrence is irregular, but the seasonal evolution of an event is more predictable, and that distinction defines the planning window. Trade wind strength, the depth of the thermocline—that is, the boundary between warm surface water and cold deep water—and the state of the prior ENSO cycle vary from year to year. El Niño events recur every 2–7 years or so, but their timing, onset, and intensity become clear only within the same calendar year, as the rapid intensification of the current event illustrates (WMO

2026d). Once an event is underway, its seasonal trajectory is comparatively predictable. Most episodes last 9–12 months, developing in March–June, peaking in November–February, and exerting their strongest influence in the year following onset. For an event peaking around November 2026, the largest economic effects will likely occur in 2027 (Box 1.3.2).

El Niño strength is measured using a small set of standard indexes. The conventional measure is the sea surface temperature anomaly in the Niño 3.4 region of the equatorial Pacific, known as the Oceanic Niño Index. An episode is identified when the 3-month average anomaly reaches at least 0.5 degrees Celsius ($^{\circ}\text{C}$) and persists across 5 consecutive overlapping seasons. The World Meteorological Organization (WMO) classifies events across four categories: weak at 0.5°C – 1.0°C , moderate at 1.0°C – 1.5°C , strong at 1.5°C – 2.0°C , or very strong at 2.0°C or more (World Bank 2026; WMO 2026b). In February 2026, the National Oceanic and Atmospheric Administration (NOAA) adopted as its primary measure the Relative Oceanic Niño Index, which subtracts the tropics-wide

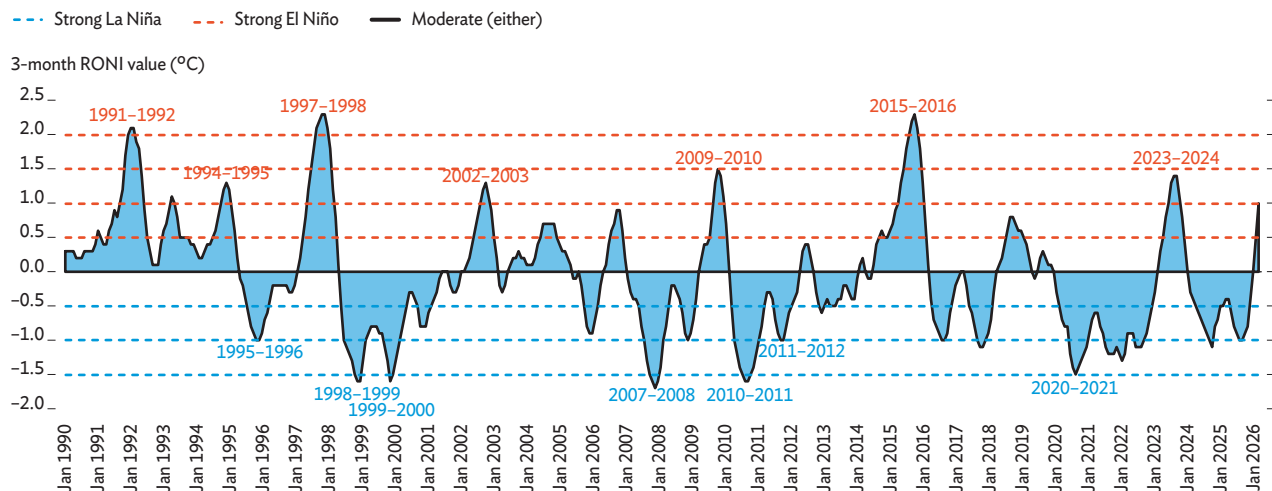
average sea surface temperature anomaly from the Niño 3.4 anomaly (NOAA 2026a). The adjustment matters because tropical oceans are warming overall, and an index measured against a fixed baseline increasingly registers that background warming alongside the ENSO signal. In addition, the Relative Oceanic Niño Index tracks more closely the rainfall anomalies that are the main pathway by which ENSO affects economic activity. Figure 1.5.1 illustrates the strength of El Niño and La Niña episodes since 1990.

El Niño and climate change are distinct phenomena that operate on different timescales but interact.

ENSO redistributes heat already in the climate system, rather than adding new heat, and typically runs its course within a year. Climate change is a long-term phenomenon driven predominantly by greenhouse gas emissions from economic activity, raising the baseline temperature against which every ENSO phase occurs.¹ The current El Niño therefore unfolds on a warmer baseline than an equivalent event would have decades ago. WMO (2026a) noted that the event is developing against the backdrop of unprecedented

Figure 1.5.1 Historical Occurrence and Strength of El Niño and La Niña Events Since 1990

Strength of El Niño and La Niña events varied since 1990, with the strongest El Niño peaks in 1997–1998 and 2015–2016 and the 2026 event already building.



RONI = Relative Oceanic Niño Index.

Source: Golden Gate Weather Services. 2026. [El Niño and La Niña Years and Intensities](#).

¹ The Intergovernmental Panel on Climate Change defines climate change as a change in the state of the climate that can be identified by, for example, using statistical tests that capture changes in the mean and/or the variability of its properties and that persists for an extended period, typically decades or longer. It may be due to natural internal processes or external forcings, such as variations in solar cycles, volcanic eruptions, and persistent anthropogenic changes in atmospheric composition or land use. The United Nations Framework Convention on Climate Change defines climate change as a change in climate that is attributed directly or indirectly to human activity that alters the composition of the global atmosphere, and that is in addition to natural climate variability observed over comparable time periods (IPCC 2018).

ocean heat. Whether climate change is also altering the characteristics of ENSO itself remains an active area of research. Cai et al. (2014) projected that El Niño events could be extreme at roughly double the past frequency due to climate change, from once every 20 years to once every 10, though substantial model uncertainty remains. For planning purposes, the distinction is important: El Niño is a recurring, short-lived, and largely forecastable shock, while climate change is the longer-term trend that shapes the severity of its impacts.

Current Situation and Outlook

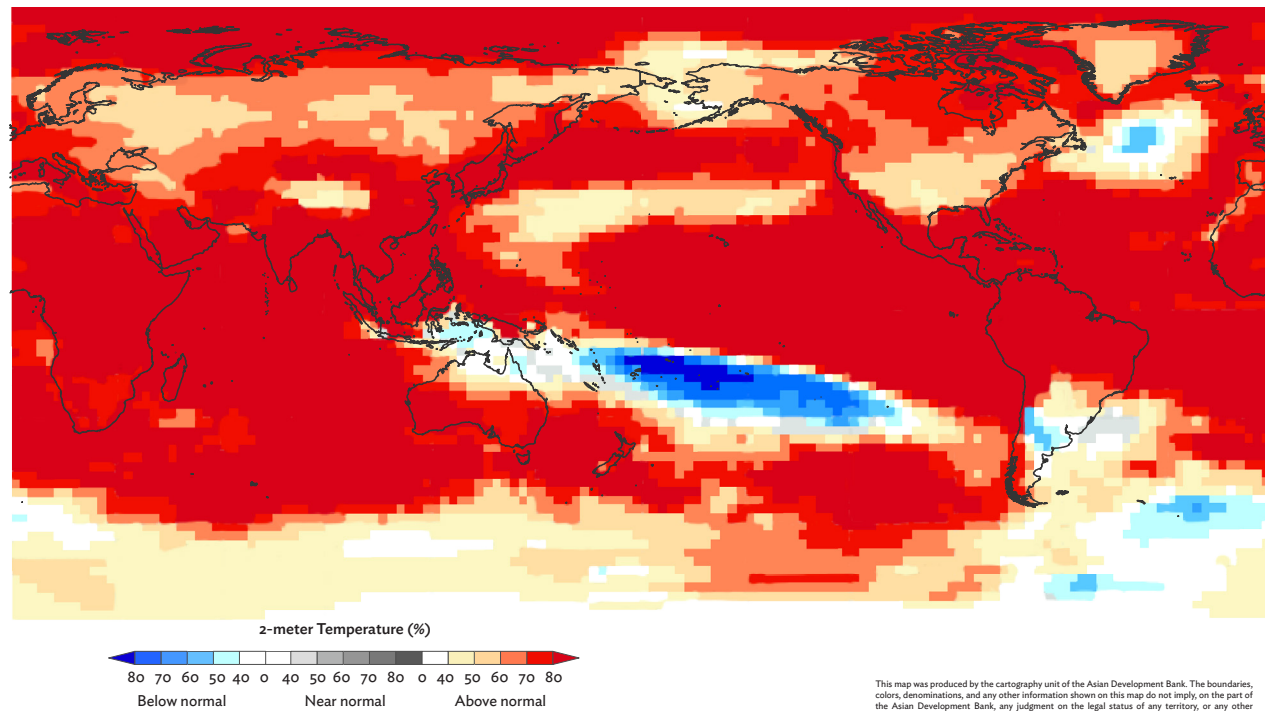
El Niño is under way and strong, and continues to intensify. WMO's Global Seasonal Climate Updates, issued in July and August, report sea surface temperature anomalies exceeding 2°C in the Niño 3.4 region. The event is expected to peak around November before gradually easing toward early 2027 (WMO 2026b, c).

Official forecasts indicate an unusually high probability of an exceptional event. As of August 2026, NOAA (2026b) put the probability of a very strong El Niño at over 90% for September 2026 to February 2027, with a 75% chance of an event during October–December exceeding any since 1950. WMO (2026a) puts the likelihood of El Niño persisting through February 2027 at nearly 100%, with the event expected to reach very strong intensity before peaking toward the end of the year. A positive Indian Ocean Dipole is developing alongside El Niño, marked by a warmer western Indian Ocean and a cooler eastern Indian Ocean. This concurrent pattern can amplify drought, flood, and wildfire risks around the Indian Ocean.

Expected weather conditions over the next 6–12 months follow closely the typical pattern associated with El Niño when it is strong. WMO's recent outlooks point to temperatures above normal across most land areas (Figure 1.5.2), with the strongest signals over Africa, eastern Asia, the Indian

Figure 1.5.2 Multi-Model Ensemble Forecasts for Temperature Variation Possibilities for September–November 2026

Temperatures are forecast to be above normal across most land areas in September–November 2026, with the strongest signals over Africa, eastern Asia and the Indian subcontinent.



Notes: Probabilistic forecasts of surface air temperature for the season September–November 2026. The tercile category with the highest forecast probability is indicated by shaded areas: blue for temperature below normal, red for above normal, and gray for near normal, with white indicating equal chances for all categories. The baseline period is 1993–2009.

Source: WMO. 2026. *Global Seasonal Climate Update for September–October–November 2026*. World Meteorological Organization.

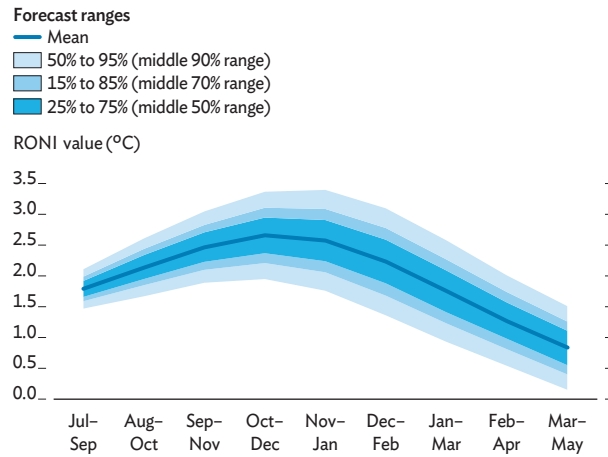
subcontinent, the Arabian Peninsula, southern Europe, Central America, the Caribbean, much of South America, and New Zealand (WMO 2026b, c).

Rainfall anomalies follow a broadly complementary pattern. Conditions wetter than normal are expected across the Greater Horn of Africa, parts of Central Asia, southern Europe, western North America, and southeastern South America (Figure 1.5.3). Drier than normal is more likely over the Indian subcontinent, southern and eastern Australia, northern Europe, southern Central America, parts of the Caribbean, and northwestern South America (WMO 2026b, c).

Remaining uncertainty concerns magnitude, not whether a very strong event will occur. Leading forecast models consistently point to a very strong event persisting to October 2026, though confidence is lower on the peak magnitude, the interaction with the Indian Ocean Dipole, and the pace of decline into 2027 (Figure 1.5.4). As forecasts become more accurate at shorter lead times, projections will sharpen through WMO's monthly updates.

Figure 1.5.4 El Niño Event Forecast and Probabilistic Variation of Its Strength

NOAA forecasts show a very strong El Niño peaking in late 2026, with uncertainty around the size of the peak and how quickly it eases in 2027.



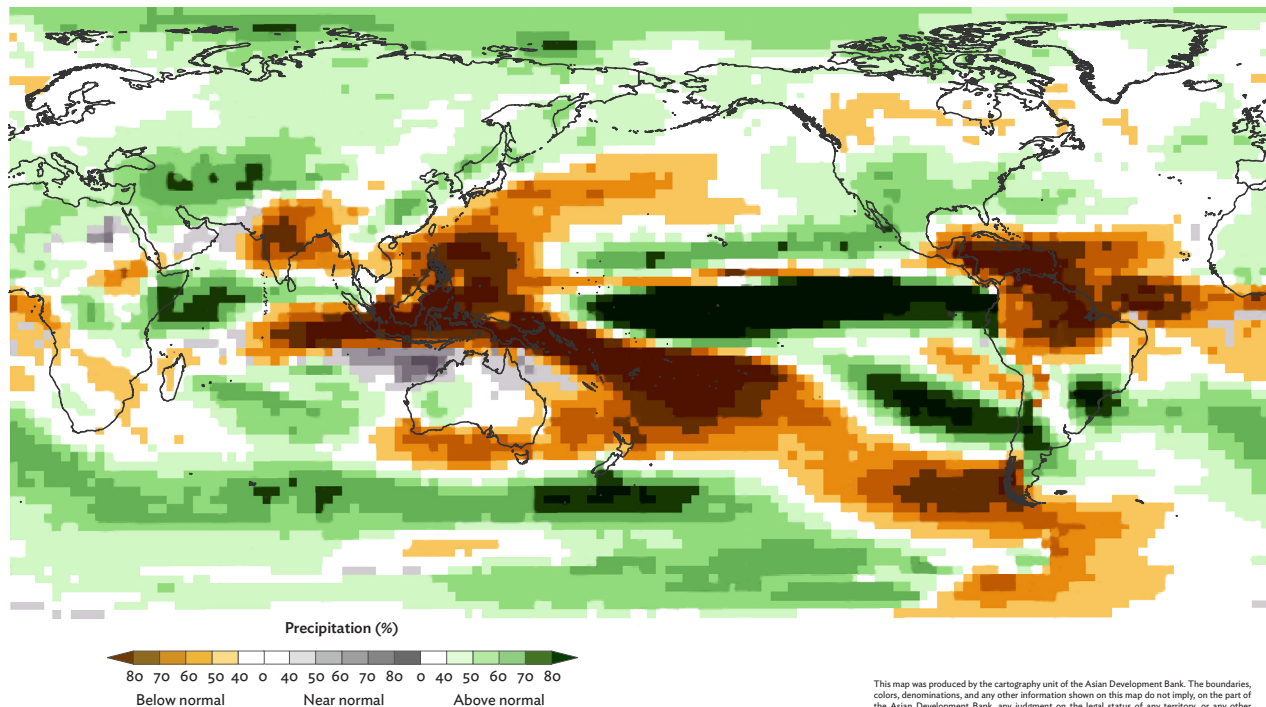
RONI = Relative Oceanic Niño Index.

Note: Seasons are overlapping 3-month averages, with adjacent values sharing 2 months. The Relative Oceanic Niño Index is obtained by subtracting the tropical mean sea surface temperature anomaly from the Niño 3.4 anomaly. Shading shows the middle 50%, 70%, and 90% of the forecast distribution.

Source: NOAA. 2026. [Official NOAA Relative Oceanic Niño Index \(RONI\) Outlook](#).

Figure 1.5.3 Multi-Model Ensemble Forecasts for Rainfall Variation Possibilities for September–November 2026

Rainfall forecasts for September–November 2026 show drier conditions over the Indian subcontinent and southern and eastern Australia.



Notes: Probabilistic forecasts of precipitation for the season September–November 2026. The tercile category with the highest forecast probability is indicated by shaded areas: orange for below normal, green for above normal, and gray for near-normal, with white indicating equal chances for all categories. The baseline period is 1993–2009.

Source: WMO. 2026. [Global Seasonal Climate Update for September–October–November 2026](#). World Meteorological Organization.

Physical Climate Impacts

El Niño shifts both temperature and rainfall from their normal patterns. Global temperatures tend to be higher than average during El Niño years because the warming tropical Pacific releases heat into the atmosphere that would otherwise remain stored in the ocean—now compounding a rising baseline under climate change. Rainfall departures follow the canonical pattern described above, in which drought and flood risk rise simultaneously in different parts of the world rather than in sequence. That simultaneity distinguishes El Niño years from ordinary ones, since distant regions can experience opposite extremes within the same season.

El Niño also alters the occurrence and intensity of extreme weather beyond changes in temperature and rainfall. Stronger wind shear suppresses Atlantic hurricane activity while storm activity rises in the central and eastern Pacific. Typhoon landfall risk increases in parts of East Asia even as cyclone frequency declines elsewhere. Drought and heat together raise wildfire risk, and elevated sea surface temperatures increase the likelihood of coral bleaching. Disaster risk compounds further when El Niño coincides with other climate modes, such as the Indian Ocean Dipole, which can deepen drought and flood extremes alike within the same event.

Southeast Asia lies at the center of El Niño’s western Pacific drying pattern. In the Association of Southeast Asian Nations, the ASEAN Climate Outlook Forum (2026) identified the most immediate rainfall risks for the current event in the southern Philippines, Brunei Darussalam, and Singapore, with rainfall below to near normal also likely over central and southern Thailand, central Cambodia, and southern Viet Nam, alongside temperatures above normal across most of the subregion. The 2015–2016 event illustrated the potential consequences of such conditions. Drought affected 85% of provinces in the Philippines and 2.5 million people in Cambodia, while Viet Nam recorded crop damage across 400,000–600,000 hectares and aquaculture damage across 70,000 hectares (UNESCAP 2017).

South Asia’s exposure is largely due to variation in the summer monsoon. El Niño 2015–2016 coincided with India’s first back-to-back monsoon drought in

3 decades, with rainfall dropping to 760.6 millimeters in 2015 from a normal of 887.5. The resulting drought affected 330 million people through water supply, food security, and health. Sri Lanka experienced both extremes within the same episode. Cyclone Roanu displaced more than 100,000 people in May 2016, while the northeast monsoon later that year delivered rainfall 23% below normal and carried drought into 2017 (UNESCAP 2017).

The Pacific islands display a distinct climate pattern. Wet-season rainfall declines across most Pacific island countries during El Niño, with Kiribati and Naoero the main exceptions, and sea level falls across much of the western Pacific. Cyclone formation shifts northeast, raising storm frequency across the central and southern islands. The 1997–1998 event demonstrated the reach of these effects, producing widespread food insecurity for a million people in Papua New Guinea and coral bleaching across multiple island nations (UNESCAP 2014).

Economic Impact Transmission Channels

El Niño affects economic activity through several interacting channels. Water shortages disrupt supply and sanitation systems, drought reduces both agricultural output and hydropower generation, and extreme heat degrades transport infrastructure and reduces labor productivity. Elevated sea temperatures, ecosystem degradation, and wildfire risk erode biodiversity, tourism, and livelihoods dependent on natural resources. The sections that follow trace each channel in turn while noting where they overlap.

Agriculture, Food Systems, and Food Security

El Niño disrupts food systems through extreme heat, altered rainfall, and drought, but its effects on crop yields vary across regions. A global assessment of maize, rice, wheat, and soybean found that El Niño significantly reduces yields on 22%–24% of the world’s harvested area while significantly increasing them on a larger 30%–36% (Iizumi et al. 2014). Losses are concentrated in maize in East and West Africa, the People’s Republic of China (PRC),

and the southeastern US; rice in the southern PRC and Myanmar; and wheat in the US, Australia, and Mexico. Gains appear in maize in Argentina and Brazil; soybeans in Brazil and the US; and wheat in Argentina, Kazakhstan, and South Africa. On a global mean basis, soybean yields are 2%–5% above normal, while maize, rice, and wheat yields change by a range from –4% to +1%. For import-dependent economies, the problem is the price volatility that redistribution produces.

Rice warrants particular attention in the region, as ENSO influences the Asian monsoon, which is critical to rainfed cultivation. Historical studies find that El Niño-linked dry spells during the wet-season planting window reduce rainfed rice yields in the Philippines (Roberts et al. 2009) and in Viet Nam’s Mekong River Delta (Yen et al. 2019). The size of the effect varies by region and by whether El Niño is a canonical eastern-Pacific or a more localized central-Pacific event. Irrigated systems fare better but are not immune, as reservoir levels depend on rainfall, as does the availability of irrigation water.

Livestock systems face distinct challenges, particularly from heat stress and reduced feed availability. Heat stress reduces feed intake, growth rates, milk yield, and fertility, while drought-driven feed and water scarcity can directly increase mortality (Reeve, Watkins, and Kuleshov 2024; Cheng, McCarl, and Fei 2022). These effects are stronger in intensive poultry and dairy operations for lack of cooling infrastructure—a particular concern given the scale of poultry production across South and Southeast Asia. Further, altered rainfall and temperature shift the range and transmission of livestock parasites and vector-borne animal diseases, with effects that vary by agroecological zone (Henry, Tinsley, and Morgan 2025).

Fisheries and aquaculture are exposed through diminished ocean productivity rather than rainfall. Warm water and a deepened thermocline cut off the upwelling of cold, nutrient-rich water along the Pacific coast of South America, which during the 1982–1983 event devastated anchovy and sardine fisheries from Chile to British Columbia. Catch composition and volumes shift across ocean basins more broadly, affecting eastern Pacific fisheries most directly but also reaching Indian Ocean tuna fisheries relevant to

Asia and the Pacific (FAO 2024). Marine aquaculture of mollusks and crustaceans is especially sensitive to temperature shifts. Inland aquaculture, a large and growing source of protein and livelihoods across South and Southeast Asia, faces distinct pressures from altered rainfall and reservoir levels.

Energy

Hydropower exposure varies significantly by location, making national aggregates potentially misleading. Ng, Turner, and Galelli (2017) examined some 1,600 dams, representing over half of global installed capacity, and found that about 35% exhibit statistically significant production anomalies during El Niño or La Niña years, yet positive and negative anomalies largely cancel out at the global and even continental scales. Basin-level analysis is therefore essential. The Lancang–Mekong illustrates the point. El Niño-linked dry-season flow reductions constrain generation across the basin’s cascade of dams, with effects extending downstream to Cambodia and Viet Nam’s Mekong Delta, where hydropower, irrigation, and salinity intrusion are closely linked (Gao et al. 2022).

Generation losses coincide with rising demand, increasing pressure on power systems. Drought reduces hydropower output and the amount of cooling water available to thermal plants, and economies that consequently face shortfalls turn to fossil fuels. El Niño raises demand for coal and crude oil as thermal generation replaces lost hydroelectric output, pushing energy prices up (Cashin, Mohaddes, and Raissi 2017). At the same time, higher temperatures raise cooling demand. The squeeze is particularly acute in Southeast Asia, where El Niño-driven heat both raises electricity consumption and reduces system efficiency, with potential for outright power failures.

Solar generation offers a smaller buffer than suggested by its growing share of the energy mix. Feron et al. (2026) found that El Niño systematically reduces surface solar irradiance and photovoltaic output in California, the southern Atacama Desert and Chile, the Chaco Basin in Brazil and Argentina, the Middle East, and the eastern PRC. The most intense events can cut photovoltaic output by up to 15% for months at a time.

Industry and Manufacturing

Industry is affected by El Niño through three channels: input costs, physical supply chain disruption, and reduced construction activity.

Commodity price changes reach producers relatively quickly through input prices. Brunner (2000) found that a shock from El Niño by 1 standard deviation raises real commodity price inflation excluding petroleum by 3.5–4.0 percentage points, accounting for almost 20% of historical variation. Cashin, Mohaddes, and Raissi (2017) put the average rise in non-fuel commodity prices at about 5.5% over the following year, with energy prices climbing as coal and oil substitute for lost hydropower. Two sets of prices matter most for Asian manufacturers. Metal prices rise, as heavy rain disrupts access to Chile’s mountainous mining regions, and coffee, cocoa, and palm oil prices rise following Indonesian and Southeast Asian supply disruption, feeding into costs for food processors and other downstream industries.

Beyond immediate price changes, physical disruption can have more severe and longer-lasting consequences.

Evidence from individual firms shows that flooding, water constraints, and transport bottlenecks alter output and sourcing decisions as they ripple through production networks (Bas and Paunov 2025). Economies with agricultural processing and resource extraction sectors face these disruptions on top of the agricultural and energy shocks described above, compounding their effects. Construction moves in two directions over time: extreme heat and flooding disrupt building activity and damage infrastructure in the near term, then reconstruction generates a rebound, as observed in Japan following past episodes.

Services, Trade, and Transport

Water utilities underpin nearly every other sector, which makes them a critical leverage point in this transmission channel. Prolonged rainfall deficits reduce reservoir levels and deplete groundwater, degrading water quality and disrupting supply and sanitation systems. Severe events have required rationing and emergency supply measures to maintain essential services. As agriculture, energy, health, and industry all depend on water utilities, disruption here propagates across every other channel described in this section.

Tourism is exposed both directly and indirectly through changes in income and demand abroad.

Drought, heat, coral bleaching, and altered cyclone risk make destinations less attractive, while weaker incomes in source markets suppress visitor demand. As there are few quantified, region-specific estimates for Asia and the Pacific, this channel warrants monitoring rather than precise forecasting.

Transport is exposed on both water and land through mechanisms that operate independently.

Rainfall extremes affect port operations and canal transit, and these effects interact with conflict-induced shipping disruptions to raise freight costs and lengthen transit times. Most of developing Asia and the Pacific depends on seaborne trade, so exposure is widespread. Land transport carries a separate set of risks from drought and heat. High temperatures accelerate road surface deterioration by softening, cracking, and rutting asphalt, while prolonged dry conditions cause ground shrinkage and settlement that undermines roads, bridges, railways, and airports. Reduced water availability can constrain construction and maintenance.

Ecosystems and Natural Capital

The ecological impacts of El Niño can persist and accumulate for years after the event has ended.

Elevated sea surface temperatures raise the risk of coral bleaching, while drought stresses forests, wetlands, river systems, and biodiversity. Prolonged dry conditions raise wildfire risk, degrading habitats and ecosystem services that underpin livelihoods, water security, and disaster resilience. These land effects often move in the opposite direction to marine productivity effects, which complicates any single aggregate assessment of ecosystem impact (Holmgren et al. 2001).

Labor, Health, and Livelihoods

Heat stress reduces hours worked and output per hour, with the greatest impact on outdoor and physically demanding jobs.

That concentration puts agriculture, fisheries, construction, and informal urban labor at the forefront of exposure. El Niño-specific estimates are scarce, but studies of warming more generally indicate the scale of the region’s exposure. Dasgupta et al. (2021) combined supply

and productivity effects into a single “effective labor” measure. It found that Asia, particularly India and Southeast Asia, already loses substantial effective labor to current climate conditions, with further annual losses of about 7 percentage points at 1.5°C of warming relative to pre-industrial levels under no additional adaptation, 10 points at 2.0°C, and 19 points at 3.0°C for work indoors, rising to 25 points at 3.0°C for work outdoors.

Health risks increase alongside these labor effects, placing additional strain on the same public systems.

Higher temperatures and prolonged drought raise the risk of heat-related illness, impair water quality, and increase the potential for waterborne and vector-borne outbreaks. During the 2015–2016 event, disease intensity ranged higher by 2.5%–28.0% in ENSO-affected regions than in years without El Niño, spanning plague and hantavirus in the southwestern US; cholera in East Africa; and dengue, Zika, and chikungunya across the Western Hemisphere and parts of Asia (Anyamba et al. 2019). World Health Organization analyses of previous events identified a similar pattern, compounded by increased pressure on health systems from concurrent heat and water scarcity emergencies (WHO 2023).

The distribution of these impacts is uneven. Poor and vulnerable households bear the brunt because they have the least capacity to absorb shocks and depend most on the climate-exposed sectors described above. Women, children, older people, people with disabilities, informal laborers, and remote communities face disproportionate risk of food and water insecurity, income loss, health impacts, and service disruption.

Compounding Vulnerabilities

The 2026 El Niño is unfolding as food, energy, and freight markets are already under strain. The Middle East conflict and the Russia’s war in Ukraine have disrupted these markets independently of any weather shock. The Middle East conflict has kept energy prices elevated and volatile, with disruption spreading from crude to refined products and constraining transit through the Strait of Hormuz. The war in Ukraine removed a substantial share of

global wheat, maize, and sunflower oil exports and disrupted fertilizer supply, passing through to global food prices and to food security in import-dependent regions (Brown and Froggatt 2023; Benton and Froggatt 2022). Attacks on Black Sea ports and export terminals since July 2026 have renewed those pressures. Shipping through the Red Sea and the Bab el-Mandeb strait remains constrained, with the Houthi blockade on Saudi-linked shipping adding to earlier disruption that had already cut Suez Canal trade volume by an estimated 40% and pushed vessels around the Cape of Good Hope, roughly doubling transit times on affected routes. About 14% of globally traded cereals and 20%–30% of European Union, Russian, and Ukrainian wheat exports typically transit through that corridor, with South Asia and Southeast Asia among the most exposed regions for imports (Glauber and Mamun 2024). Where El Niño simultaneously reduces production in exporting regions or raises freight costs, these pressures compound rather than simply add.

High debt constrains the fiscal space available for policy responses. Many economies in developing Asia and the Pacific remain heavily indebted following the pandemic and successive external shocks. Greater climate vulnerability correlates with higher sovereign bond yields (Volz et al. 2020) and weaker sovereign credit ratings (IMF 2021), thereby raising borrowing costs for governments already deep in debt. El Niño shocks to growth, export revenue, or fiscal balances therefore interact with debt vulnerability in a self-reinforcing manner, raising financing needs precisely when financing becomes more expensive. High debt also weakens the transmission of monetary policy, narrowing the room for a monetary response alongside fiscal support ([Analytical Chapter](#)).

Trade policy uncertainty adds a further constraint.

For ASEAN economies, uncertainty that spills over from trading partners is the most damaging form, depressing investment and consumption and reducing output per capita, while domestic protectionist measures worsen trade balances and raise inflation (Hlatshwayo and Trivedi 2026). When El Niño-driven supply disruption coincides with this environment, governments face harder choices on export restrictions and tariff adjustments used to manage domestic food and energy prices.

Macroeconomic Impacts of El Niño: Historical Evidence for Asia and the Pacific

This region faces greater macroeconomic losses from El Niño than any other, reflecting its heavy reliance on rainfed agriculture, hydropower, and climate-sensitive exports. Using a global panel dataset, Cashin, Mohaddes, and Raissi (2017) found that Australia, India, and New Zealand are among the economies that experience the largest short-lived falls in real gross domestic product (GDP), concentrated in the 2–4 quarters after a shock and driven mainly by agricultural and commodity prices. Channels vary across economies. India’s monsoon weakens, hurting agriculture and pushing up food inflation. Australia and New Zealand see hotter, drier conditions that reduce agricultural output, with bushfire risk and depressed wheat exports adding to Australia’s exposure.

More detailed analyses indicate that effects extend well beyond the event itself. Generoso et al. (2020) studied 75 economies, including Cambodia, the Lao People’s Democratic Republic (Lao PDR), Malaysia, New Zealand, the Philippines, Sri Lanka, Thailand, and Viet Nam. It found that El Niño depresses growth in tropical economies that are already dry by persistently reducing total factor productivity growth, rather than delivering a one-off hit to output. Much of developing Asia and the Pacific falls into that category, which suggests the 2026 event could leave lasting scars on regional growth trajectories. Callahan and Mankin (2023) reached a similar conclusion at the global level, finding growth effects that persist for 5–14 years, with the 1997–1998 episode alone estimated to have cost the global economy \$5.7 trillion in income.

Subregional evidence reveals where losses are concentrated and which groups ultimately bear them. World Bank (2019) assessed El Niño and La Niña risk to agriculture in Cambodia, the Lao PDR, Myanmar, the Philippines, and Viet Nam, where agriculture accounts for 13%–30% of GDP and 40%–68% of employment. It found measurable losses in GDP, consumption, and income concentrated in agriculture, falling disproportionately on poor rural households and women, who consume less and face longer-lasting hardship than other groups.

Supply disruption that reduces output pushes up headline inflation through higher food and energy prices. Cashin, Mohaddes, and Raissi (2017) found inflation responses to a typical shock from El Niño ranging from about 0.1 to 1.0 percentage points globally, driven mainly by food and energy prices, with the size of the response tied to the weight of food in the consumer price basket. Countries with significant shares of food in the consumer price index experience the largest increases. How much of the underlying shock reaches headline inflation depends heavily on the anchoring of inflation expectations and on policy responses, including buffer stock releases and import policy changes.

Policy Implications

Governments can limit damage from El Niño by acting early on multiple fronts. Combining diverse interventions limits GDP losses far more effectively than any single measure (World Bank 2019), and acting on forecast information before impacts materialize outperforms a reactive approach. Anticipatory action, or forecast-based financing, releases resources through pre-agreed triggers linked to seasonal forecasts (IFRC 2025). Given high forecast confidence for the 2026 event, the case for acting now rather than waiting is unusually strong.

Agriculture should be addressed first, since planting decisions are already under way. Priorities should include faster access for farmers to drought- and heat-tolerant crop varieties, particularly for rainfed rice given its monsoon sensitivity, and planting and irrigation advisories timed to seasonal forecasts. Livestock heat-management infrastructure, including shade, ventilation, and access to water, should be strengthened alongside veterinary surveillance for climate-sensitive diseases. Fisheries and aquaculture should diversify toward less sensitive species where feasible. Strategic food reserves and social protection instruments, such as cash transfers, should be designed to trigger before anticipated shortfalls rather than after.

Energy policy should prioritize reducing correlated exposure across the generation mix. Diversification away from single-source hydropower dependence is the central priority, with renewable capacity sited to avoid

concentrating ENSO risk. Demand-side management can smooth heat-driven load spikes, and regional grid interconnection allows exposed economies to import power during domestic shortfalls. Fuel-substitution flexibility remains important, though its energy-security and price implications need active management.

For industry, the priority is to shield firms from input shocks beyond their control. Supply-chain diversification and inventory buffering matter most for firms dependent on El Niño-exposed inputs, such as metals, coffee, cocoa, and palm oil. Water-intensive manufacturing requires water-stress contingency planning. Close monitoring of producer price pass-through can inform policy to limit the extent to which commodity costs propagate into broader inflation (Box 1.2.1).

Strengthening water-utility resilience is essential, as water is a critical input to nearly every other sector. Reservoir management, leakage reduction, and alternative supply sources all reduce downstream exposure. Investment in port and logistics resilience and coordination with regional partners help manage the compounding freight-cost and trade-disruption risks described above. Tourism can diversify destinations and source markets.

Ecosystem measures should protect assets that are expensive or difficult to restore. Continued investment in marine protected areas, coral reef monitoring, and restoration should proceed alongside forest and wetland conservation to limit wildfire risk and biodiversity loss. Integrating ecosystem service value into disaster risk planning helps prevent ecosystem degradation from compounding sector impacts.

Measures to support vulnerable workers and strengthen public health capacity should be in place before the seasonal peak. Heat-safety regulation and enforcement for outdoor and informal workers, covering adjusted work hours and hydration and shade requirements, should be paired with expanded social protection and public health preparedness. Preparation includes vector control, water-quality monitoring, health-system surge capacity, and targeted support for groups that bear a disproportionate share of these impacts.

Macro-fiscal measures should be arranged in advance, as financing, communication, and coordination all become harder once the shock arrives. Governments in exposed economies should pursue forecast-based financing and contingent credit lines negotiated ahead of peak impact, alongside sovereign catastrophe risk insurance or regional risk-pooling arrangements that ease debt vulnerability. Monetary policy communication should distinguish El Niño-driven relative price shocks in food and energy from underlying inflation trends. Regional coordination on early warning, financing, and trade policy predictability offers the clearest route to preventing El Niño's shocks from compounding the conflict, debt, and tariff pressures already in play.

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Resilient Growth Despite Persistent Disruption from the Middle East Conflict

Growth forecasts for the United States and the euro area remain unchanged from *Asian Development Outlook July 2026 (ADO July 2026)* (Table A.1).

In the US, economic activity is resilient, but elevated inflation, weaker confidence, and tight financial conditions weigh on domestic consumption. Tensions in the Middle East continue to pose risks to energy prices, while inflation above target is expected to keep the US Federal Reserve's monetary policy restrictive. In the euro area, growth is expected to strengthen in 2027 as the energy shock fades, inflation eases, and higher defense and infrastructure spending supports domestic demand. These factors will be partly offset by competitiveness pressures and US tariffs.

Table A.1 Baseline Assumptions on the International Economy

Growth in the advanced economies is steady, while oil price forecasts edge higher.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
Gross domestic product growth, %					
United States	2.1	2.1	2.1	2.0	2.0
Euro area	1.4	0.8	0.8	1.2	1.2
Inflation, %					
United States	2.6	3.4	3.4	2.4	2.4
Euro area	2.1	2.8	3.0	2.3	2.5
Brent crude spot prices, average, \$/barrel	69	87	90	77	78

Note: Average growth rates are weighted by GDP purchasing power parity.

Sources: Bloomberg; CEIC Data Company; Haver Analytics; Asian Development Bank estimates.

Major Advanced Economies

United States

Gross domestic product (GDP) growth moderated from an annualized 2.1% in the first quarter (Q1) of 2026 to 1.5% in Q2.

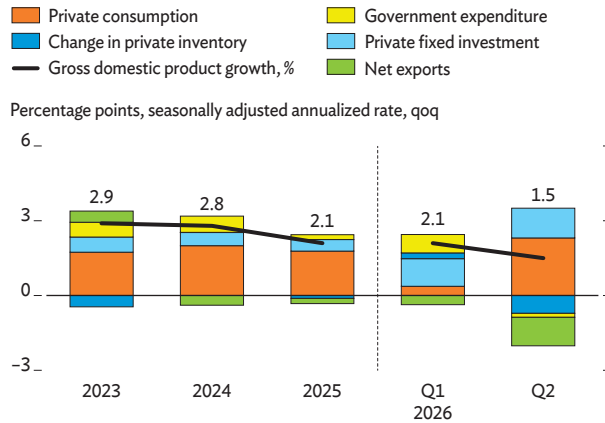
Domestic demand remained resilient as consumer spending rebounded by 3.4%, partly supported by larger tax refunds, while equipment investment rose by 13.6%, buoyed by artificial intelligence (AI) investment. However, growth

was weighed down by inventory drawdowns, a wider trade deficit, and lower government spending, mainly reflecting sales of crude oil from the Strategic Petroleum Reserve (the crude purchases not directly affecting GDP statistics as they are reflected in other GDP components). Although exports continued to expand, stronger imports, driven by a surge in capital goods including semiconductors and telecommunications equipment amid strong AI investment, more than offset this support. As a result, net exports subtracted 1.1 percentage points from growth (Figure A.1).

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Figure A.1 Demand-Side Contributions to Growth, United States

Domestic demand supported Q2 growth, partly offset by inventory drawdowns and weaker net exports.



High-frequency indicators point to solid business activity but weakening household demand.

Manufacturing remained in expansion, with the Institute for Supply Management's manufacturing purchasing managers' index (PMI) easing from 55.6 in July to 54.6 in August (Table A.2). Growth in

new orders moderated, while production remained strong and employment continued to expand. Backlogs also eased, while price pressure remained elevated. Services also remained expansionary, with the services PMI edging up from 54.1 in July to 55.4 in August, reinforcing the composite PMI's signal of continued expansion in private sector activity. Household demand, however, showed some signs of cooling, as retail sales fell by 0.6% month on month in July. Sentiment indicators remained weak as the Conference Board consumer confidence index slipped from 90.2 in July to 89.4 in August, while the University of Michigan consumer sentiment index fell from 55.2 to 51.7. Overall, business activity remained supportive, but consumption growth appears to be weakening in Q3.

Persistent inflation and a resilient labor market leave room for monetary policy tightening. Inflation eased slightly in July as energy price pressures receded and underlying price increases moderated, though still remaining above the inflation target. Headline inflation declined to 3.4% year on year from 3.5% in June, while core inflation edged down to 2.5% from 2.6% (Figure A.2). Labor market conditions remained broadly resilient in August, with nonfarm

Table A.2 Business, Consumer, and Employment Indicators, United States

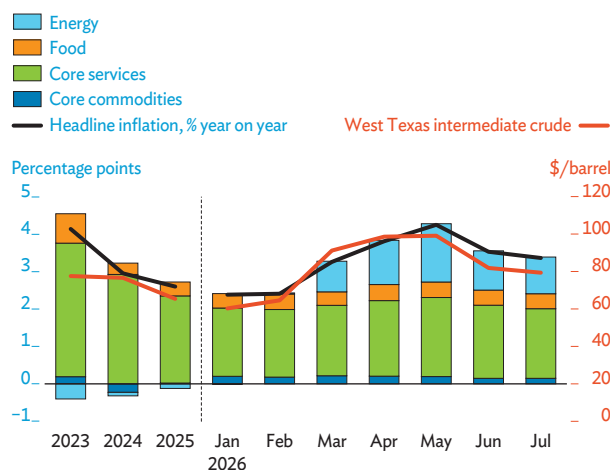
Business activity remained firm, while household demand and labor market conditions showed signs of weakening.

	Annual Average			2026							
	2023	2024	2025	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Business											
Manufacturing PMI, 50 = no change	47.1 ▼	48.2 ▼	48.9 ▼	52.6 ▲	52.4 ▲	52.7 ▲	52.7 ▲	54.0 ▲	53.3 ▲	55.6 ▲	54.6 ▲
Services PMI, 50 = no change	52.7 ▲	52.4 ▲	51.7 ▲	53.8 ▲	56.1 ▲	54.0 ▲	53.6 ▲	54.5 ▲	54.0 ▲	54.1 ▲	55.4 ▲
Composite PMI, 50 = no change	52.0 ▲	52.4 ▲	51.7 ▲	53.7 ▲	55.7 ▲	53.9 ▲	53.5 ▲	54.4 ▲	53.9 ▲	54.3 ▲	55.3 ▲
Industrial production index, 2017 = 100	100.8 ▼	100.1 ▼	101.2 ▲	101.0 ▼	101.9 ▲	101.8 ▼	102.5 ▲	102.5 ⇄	102.8 ▲	103.0 ▲	...
Consumer											
Consumer confidence, 1985 = 100	105.4 ▲	104.5 ▼	96.1 ▼	89.0 ▼	91.0 ▲	92.2 ▲	93.8 ▲	90.6 ▼	92.2 ▲	90.2 ▼	89.4 ▼
Consumer sentiment, Q1 1966 = 100	65.4 ▲	72.5 ▲	57.6 ▼	56.4 ▲	56.6 ▲	53.3 ▼	49.8 ▼	44.8 ▼	49.5 ▲	55.2 ▲	51.7 ▼
Retail sales, \$ billion	590.2 ▲	603.6 ▲	626.1 ▲	634.9 ▲	641.0 ▲	653.8 ▲	657.8 ▲	663.6 ▲	665.1 ▲	660.0 ▼	...
Employment											
Unemployment rate, %	3.6 ▼	4.0 ▲	...	4.3 ▼	4.4 ▲	4.3 ▼	4.3 ⇄	4.3 ⇄	4.2 ▼	4.1 ▼	4.1 ⇄
Nonfarm payrolls, thousand	210 ▲	122 ▼	10 ▼	160 ▲	-156 ▼	214 ▲	148 ▼	63 ▼	31 ▼	21 ▼	162 ▲
Job openings, million	9.3 ▼	7.7 ▼	7.1 ▼	7.2 ▲	6.9 ▼	6.9 ⇄	7.6 ▲	7.5 ▼	7.2 ▼	7.3 ▲	...

... = data not available, PMI = purchasing managers' index, Q = quarter.

Notes: For PMI, ▲ is greater than 50, ▼ is less than 50, and ⇄ equals 50. For other indicators, ▲ is increasing, ▼ is decreasing, and ⇄ remains the same.

Source: Haver Analytics.

Figure A.2 Inflation and West Texas Intermediate Crude, United States*Inflation eased slightly as energy price pressures receded.*

Note: West Texas Intermediate prices are reported as monthly averages.

Source: Haver Analytics.

payroll employment increasing by 162,000 and the unemployment rate holding steady at 4.1%. Meanwhile, job openings remained elevated at 7.3 million in July indicating continued underlying labor demand (Table A.2). Against this backdrop, the Federal Reserve maintained the federal funds target range at 3.50%–3.75%. With persistent inflation pressures and labor market conditions remaining relatively resilient, expectations for monetary policy have shifted toward a more restrictive stance, with markets increasingly expecting a rate hike already in 2027.

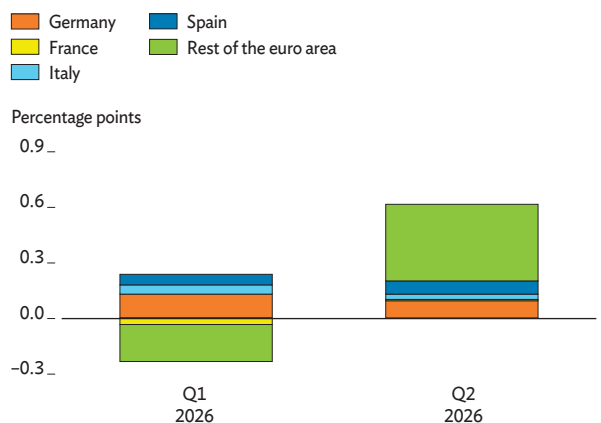
Forecasts for GDP growth and inflation are unchanged from ADO July 2026. Growth is projected at 2.1% in 2026 and 2.0% in 2027, while inflation is forecast at 3.4% and then 2.4%. Recent data broadly align with earlier baseline assumptions. Economic activity remains resilient, supported by strong AI investment, and labor markets that remain broadly stable. However, elevated inflation, weaker consumer confidence, and tight financial conditions are expected to restrain household spending. Renewed tensions in the Middle East pose risks of higher energy prices but have not materially altered the inflation outlook. With inflation remaining above target, the Federal Reserve is expected to maintain a restrictive monetary policy.

Risks to growth skew to the downside, alongside heightened inflation risks. Further escalation in the Middle East, including renewed disruption to shipping

through the Strait of Hormuz, or intensification of Russia's war in Ukraine could push up oil and other commodity prices, sustain inflationary pressures, delay monetary easing, and weigh on consumption and investment. Expanded US tariffs, including additional sector-specific measures and tariffs targeting transshipment or economies purchasing Russian energy, could further raise import costs, disrupt supply chains, and dampen trade and investment. Continued uncertainty over the scope of changes to US trade policy could encourage import front-loading and investment delay, weighing on growth.

Euro area

GDP expanded at an annualized 2.6% in Q2 2026, or 0.6% quarter on quarter following stagnation in Q1. Output increased by 0.3% quarter on quarter in Germany, by 0.2% in Italy, and by 0.7% in Spain and was unchanged in France (Figure A.3). Survey data point to improvement entering Q3. The economic sentiment indicator rose for a fourth consecutive month to 98.4 in August, while the composite PMI reached a 9-month high of 52.1, indicating moderate growth in business activity (Figure A.4). Consumer confidence and employment expectations strengthened markedly, though both remained below their long-term averages. Earlier hard data were mixed, with industrial production unchanged in June and retail sales declining by 0.3% month on month. Labor markets remained resilient, with employment rising by 0.1% in Q2 and

Figure A.3 Contributions to Real GDP Growth, Euro Area*Growth broadened across economies.*

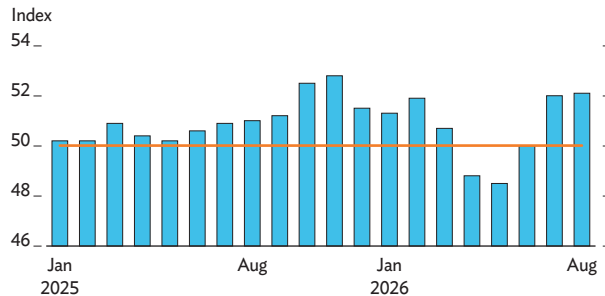
Q = quarter.

Source: Author's calculations using data from Haver Analytics.

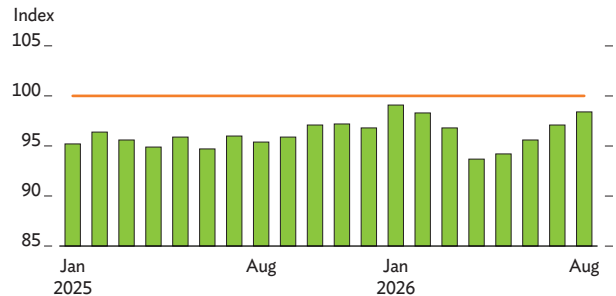
Figure A.4 Purchasing Managers' Index and Economic Sentiment, Euro Area

Leading indicators point to activity improving but still subdued.

A. Composite PMI, January 2025–August 2026



B. Economic Sentiment Indicator, January 2025–August 2026



PMI = purchasing managers' index.

Note: A PMI >50 signals improvement, <50 deterioration. Economic sentiment indicator values >100 indicate economic sentiment above the long-term mean.

Sources: CEIC Data Company; Haver Analytics.

unemployment at 6.4% in July. Headline inflation eased to 2.9% in July before rising to 3.3% in August, remaining above the European Central Bank target. Core inflation stood at 2.4%, the gap between headline and core inflation largely reflecting energy inflation of 14.3% (Figure A.5). After raising its deposit facility rate by 25 basis points to 2.25% in June, the central bank left rates unchanged in July and reiterated that future decisions would remain data-dependent.

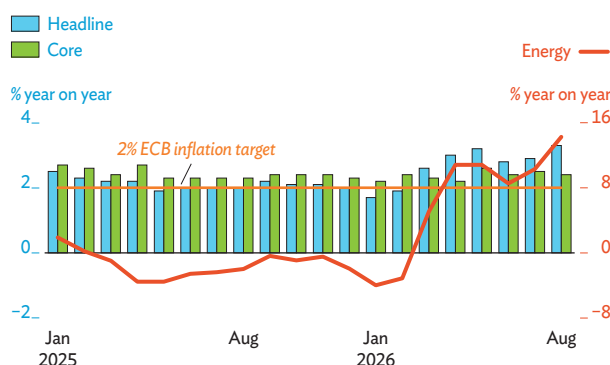
Growth is expected to remain modest in 2026.

The Q2 rebound and improving survey indicators provide a firmer starting point, but various headwinds are likely to limit growth over the remainder of 2026. Higher prices for natural gas and refined petroleum

products resulting from renewed hostilities in the Middle East will erode household purchasing power and raise production and transportation costs. Energy-intensive manufacturers, already facing weak demand and structural competitiveness pressures, may respond to compressed margins by reducing production or delaying investment, while heightened uncertainty could keep household precautionary saving elevated. Tighter financing conditions may reinforce these pressures, as the central bank's June rate increase raises borrowing and refinancing costs and weighs on housing and business investment. Higher US tariffs may weaken external demand for euro area manufactures, while trade diversion from affected economies could intensify domestic competition.

Figure A.5 Monthly Inflation, Euro Area

Energy has driven inflation above target.



ECB = European Central Bank.

Source: Haver Analytics.

Domestic demand should be a bright spot in 2026.

Resilient employment and wage growth will cushion the energy shock and support consumption. Public investment and increased defense expenditure, especially in Germany, should boost demand and crowd in private investment. Accelerated completion of projects funded under the Next Generation EU initiative ahead of the December 2026 deadline will provide additional support this year, particularly in southern member states. This direct impulse will fade after the program ends, though the completion of many projects may extend in 2027.

Growth will strengthen in 2027. As the energy shock fades, lower inflation should restore purchasing power and reduce firms' input costs, allowing resilient employment and wage growth to translate more fully

into consumption. The drag from tighter financing conditions and uncertainty should gradually diminish, while higher defense and infrastructure spending, particularly in Germany, should become more visible as projects move into implementation. US tariffs and persistent structural competitiveness pressures will nevertheless constrain exports, keeping recovery gradual. On balance, growth forecasts are maintained at 0.8% in 2026 and 1.2% in 2027. Inflation forecasts are raised slightly to 3.0% and then 2.5%, reflecting the energy shock and its gradual pass-through to food, goods, and services. Inflation should moderate in 2027, as energy base effects unwind and subdued demand limits second-round pressures, but remain above target as services inflation and wage growth decline only gradually.

Risks remain tilted toward weaker growth and higher inflation. A prolonged or intensified Middle East conflict could keep energy prices elevated or disrupt shipping and energy supplies, undermining real income and confidence more than assumed. Greater pass-through from energy prices to other prices, or stronger wage responses, could make inflation more persistent and require additional monetary tightening. Constraint on exports and investment could arise from further trade restrictions, renewed supply-chain disruption, additional euro appreciation, or weaker global demand. Domestic risks include delays in implementing defense, infrastructure, and Next Generation EU investments, as well as capacity constraints that reduce their growth impact in the near term. Conversely, faster normalization of energy markets, trade deescalation, or a strong response in consumption to recovering real incomes could lift growth while allowing inflation to fall more rapidly than projected.

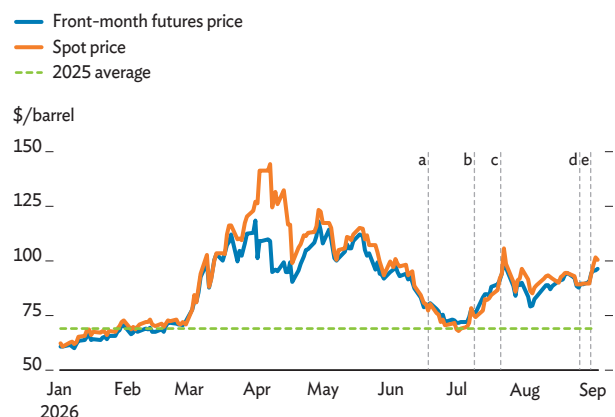
Oil Price

Brent crude spot prices were highly volatile in July and early August as markets reacted to rapidly shifting geopolitical developments. Prices initially fell after a framework agreement signed on 17 June raised expectations of improved flows through the Strait of Hormuz. However, subsequent breakdown of the agreement and renewed hostilities reversed much of the decline. Risks broadened beyond Hormuz, with Houthi threats and attacks on Saudi oil interests disrupting shipping through the Bab el-Mandeb strait,

while intensified Ukrainian strikes on Russian refining and export infrastructure added pressure in markets for refined products that were already tight. Brent spot prices swung by almost \$40/barrel in July, falling to \$68 on 2 July before rising to \$106 on 23 July (Figure A.6). Prices subsequently eased as negotiations raised hopes of safer passage through the Strait of Hormuz, but renewed military action in late August reversed some of the decline, pushing Brent crude spot prices above \$100 in the first week of September. Overall, prices remained volatile as changing security conditions and diplomatic developments repeatedly shifted expectations for regional oil supplies and shipping. Spot prices have generally exceeded front-month futures prices, reflecting a persistent premium on immediately available crude and concerns about near-term supply.

Figure A.6 Brent Crude Oil Prices

Brent spot prices remained highly sensitive to geopolitical developments.



a 17 Jun—Signing of framework agreement in the Middle East

b 8 Jul—Framework agreement declared over

c 20 Jul—Houthi declare naval blockade

d 25 Aug—Iran–Oman proposal for a maritime corridor announced

e 30 Aug—Military action resumes in the Middle East

Source: Bloomberg.

The Brent crude oil price forecast is revised up from ADO July 2026 to average \$90/barrel in 2026 and \$78/barrel in 2027.

Brent spot prices averaged \$90.68/barrel from 1 January to 31 August, broadly consistent with the revised 2026 forecast and implying an average of about \$89/barrel over the remainder of the year. The baseline assumes that geopolitical tensions and shipping disruption will remain elevated in the near term, followed by only gradual normalization to the forecast horizon. Even as crude flows gradually recover, elevated freight and insurance costs, constrained refining capacity, and depleted inventories are expected to

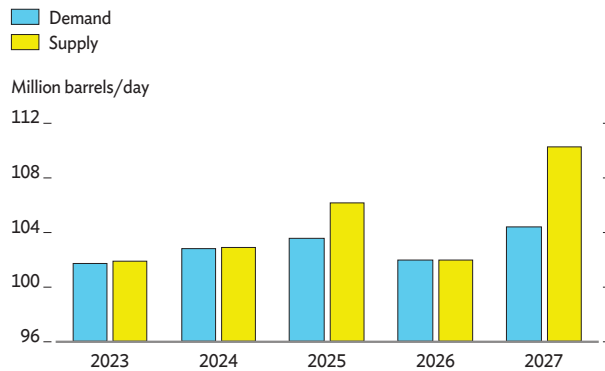
keep prices above pre-conflict levels through much of the forecast period. The International Energy Agency's August 2026 Oil Market Report indicates that global oil demand will decline by 1.6 million barrels per day (mb/d) in 2026—0.5 mb/d more than projected in July—as restricted Hormuz transit, elevated fuel prices, and reduced product availability weigh on consumption (Figure A.7). Contraction is expected to moderate from 4.9 mb/d in Q2 to 2.8 mb/d in Q3 before demand growth resumes in Q4. Demand is forecast to rebound by 2.4 mb/d in 2027.

Supply conditions have deteriorated. Global output rose by 2.4 mb/d to 101.5 mb/d in July but remained 6.3 mb/d below a year earlier, with 8.3 mb/d of Gulf

production still shut in. The International Energy Agency now expects supply to fall by 4.3 mb/d to 102.0 mb/d in 2026, before rebounding by 8.3 mb/d to 110.3 mb/d in 2027. Meanwhile, observed inventories fell by 69 million barrels in July, and by 410 million barrels cumulatively from the end of February, substantially reducing the buffer against further disruption. The global market is now projected to record a deficit of 1.8 mb/d in Q3. Risks to the forecast therefore remain tilted toward higher oil prices, particularly if disruption to Hormuz or Bab el-Mandeb persists, geopolitical tensions intensify, or recovery in Gulf and Russian production and refining activity is slower than assumed.

Figure A.7 Crude Oil Supply and Demand

Oil supply is forecast to rebound strongly in 2027.



Source: IEA Oil Market Report, various issues.

Advanced Asia and the Pacific

Growth in advanced Asia and the Pacific remains resilient on strong global demand for AI but is expected to moderate. Growth forecasts for

2026 are revised up for Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China, reflecting sustained global demand for AI-enabled semiconductors, despite risks from geopolitical tensions, financial volatility, and higher US tariffs (Table A.3). Growth prospects for other economies in advanced Asia and the Pacific remain largely unchanged to the forecast horizon.

Table A.3 Gross Domestic Product Growth and Inflation, %

Subregion/Economy	GDP Growth					Inflation				
	2025	2026		2027		2025	2026		2027	
		Jul	Sep	Jul	Sep		Jul	Sep	Jul	Sep
Advanced Asia and the Pacific	2.5	2.6	3.1	1.7	2.0	2.5	2.6	2.4	2.1	2.1
Australia	2.0	2.0	2.0	1.7	1.7	2.9	4.3	4.3	2.6	2.8
Hong Kong, China	3.6	3.0	4.2	2.5	2.5	1.4	2.0	2.0	1.8	1.9
Japan	1.2	0.7	0.7	0.8	0.8	3.2	2.1	1.9	2.1	2.1
Republic of Korea	1.1	2.6	3.2	2.0	2.3	2.1	2.7	2.7	2.2	2.2
New Zealand	0.2	1.6	1.6	2.5	2.5	2.8	3.8	3.8	2.5	2.5
Singapore	5.0	3.2	5.0	2.4	3.0	0.9	2.2	2.2	1.9	1.9
Taipei, China	8.8	9.5	11.0	4.0	5.0	1.7	2.0	2.0	1.8	1.7

GDP = gross domestic product.

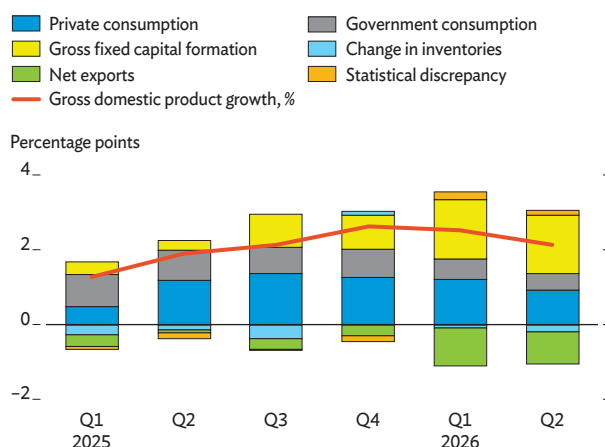
Source: Asian Development Bank estimates.

Australia

Growth moderated in Q2 2026, and leading indicators are mixed. GDP grew by 2.1% year on year in Q2 2026, slowing from 2.5% in Q1. Resilient fixed investment and steady private spending supported expansion, even as external demand weakened (Figure A.8). Household consumption rose by 1.8%, but with subdued spending across most categories. Reduced domestic and international travel dampened consumption as households curtailed spending on fuel and services amid higher costs. Government spending eased as household energy subsidies were reduced. Private investment expanded by 8.4% with increased business spending in data centers and other AI infrastructure. Net exports dragged on growth as rising imports of vehicles and AI equipment offset gains from investment. Leading indicators suggest moderate but sustained momentum into Q3 2026. Purchasing managers' indexes (PMIs) for both manufacturing and services stayed in expansionary territory in August, as the composite PMI marked three consecutive months of private sector growth. The labor market remains resilient, sustaining household incomes with stable wage growth, and the unemployment rate remained below its long-term average throughout the first half of 2026. However, consumer and business sentiment indicators alike are at multiyear lows, underscoring downside risks to private spending and investment.

Figure A.8 Demand-Side Contributions to Growth, Australia

Fixed investment and household spending continue to underpin growth.



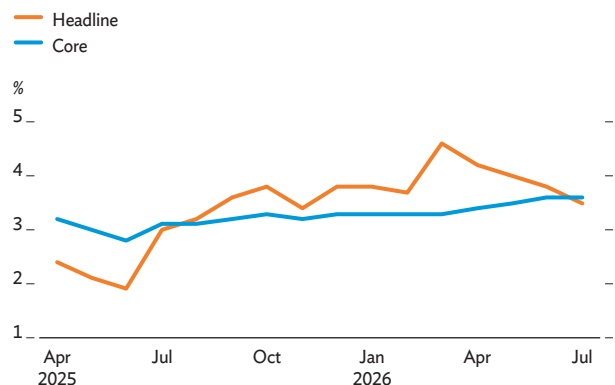
Q = quarter.

Source: CEIC Data Company.

Headline inflation slowed in Q2 2026 but remained above the central bank target. Inflation fell from 4.6% in March to 3.8% in June, and further to 3.5% in July, as fuel excise cuts lowered energy costs (Figure A.9). Core inflation, however, remained elevated at 3.6% in July, highlighting ongoing price pressures in housing, electricity, and services. Inflation remained above the Reserve Bank of Australia's 2.0%–3.0% target band. In response, the central bank raised its policy rate to 4.35% in May, for a third hike this year. At its June and August meetings, hawkish rate holds materialized, keeping rates unchanged while monitoring the impact of earlier tightening.

Figure A.9 Inflation, Australia

Both headline inflation and core inflation remain above target.



Sources: Australian Bureau of Statistics; Haver Analytics.

Growth will be modest at 2.0% in 2026 and 1.7% in 2027, with inflation at 4.3% in 2026 and 2.8% in 2027. The Australian economy is expected to grow moderately this year on steady private consumption and continued investment in AI infrastructure and data centers, though a housing downturn is expected to weigh on broader consumer demand. Inflation is projected to remain above target at 4.3% in 2026, driven by rate pass-through and unstable energy markets, before easing to 2.8% in 2027 as the oil shock unwinds and lagged effects of monetary policy take hold. Additional downside risks include El Niño generating worse weather patterns than expected, hitting agriculture. Weaker global demand, including from the People's Republic of China (PRC), and persistently low commodity prices for iron ore, coal, and liquefied natural gas are expected to constrain exports in the near term. Growth is anticipated to slow further next year as global demand softens and supply

disruption in energy markets persists. The delayed impact of earlier interest rate hikes is expected to weigh increasingly on economic activity, gradually pulling output below potential and putting pressure on the job market.

Hong Kong, China

Strong exports throughout the first half (H1) of 2026 raised GDP growth to 5.1% year on year, offsetting slackening domestic demand in Q2.

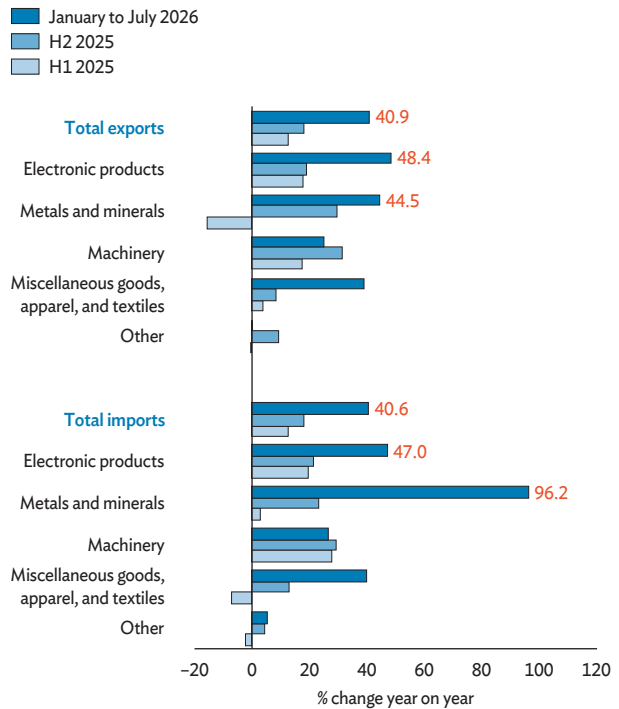
Goods exports grew by 26.0%, the strongest since their post-pandemic rebound. However, private consumption growth slowed to 2.8% in Q2 from 4.9% in Q1 as global uncertainty increased and tax breaks for electric vehicle purchases expired, outweighing the wealth effect from rising housing and stock prices. Fixed investment growth slid to 4.4% in Q2 from 18.3% in Q1, mainly due to a 33.0% Q2 contraction in public building and construction. Consequently, seasonally adjusted real GDP contracted by 0.6% quarter on quarter in Q2, after growing by 2.9% in Q1.

The artificial intelligence (AI) boom boosted technology exports. Electronics exports increased by 48.4% from January to July 2026 (Figure A.10). Merchandise exports to the People's Republic of China (PRC) grew by 44.6% year on year on strong demand for AI-related products, while those to the United States (US) rose by 63.1% partly due to continuing strength as a re-export hub to the US. Spending by nonresidents was subdued likely due to travel disruptions from the Middle East conflict.

GDP is forecast to grow by 4.2% this year, up from the 3.0% projected in ADO July 2026, while the 2027 forecast is unchanged at 2.5% (Figure A.11). The improved outlook for 2026 is based on the AI boom continuing to drive exports through year-end, as global technology firms invest heavily in AI capacity. The role of Hong Kong, China as a super-connector to the PRC should also support the financial sector, with initial public offerings surging and CNY bond futures expanding. After weakening in Q2, domestic demand should stabilize, supported by improving property prices, moderate inflation, and financial sector spillovers. Growth is forecast to moderate in 2027 as the pace of global data center and compute capacity buildout is expected to slow from its 2026 surge,

Figure A.10 Exports and Imports Growth, Hong Kong, China

The artificial intelligence boom drove electronics exports.

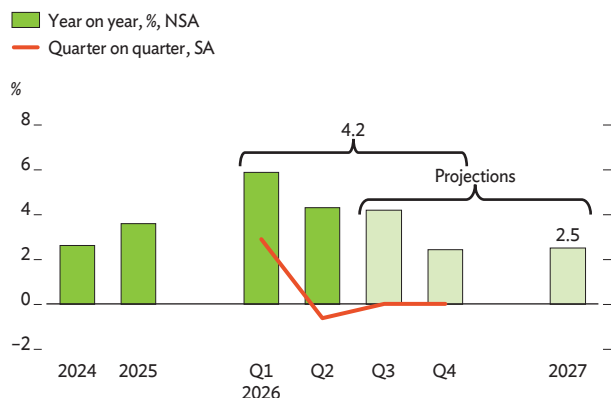


Note: Based on nominal values in US\$.

Source: Haver Analytics.

Figure A.11 Gross Domestic Product Growth, Hong Kong, China

The AI-driven export boom lifts growth in 2026, before moderating in 2027 as global investment in data centers and compute capacity levels off.



AI = artificial intelligence, Q = quarter, NSA = non-seasonally adjusted, SA = seasonally adjusted.

Note: Dark green bars are actual growth, while light green bars are projections.

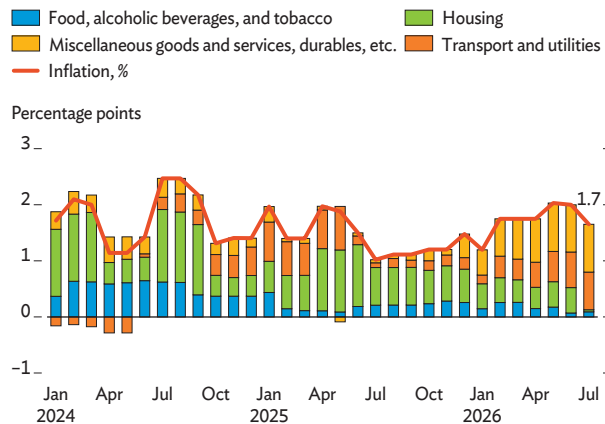
Source: ADB estimates.

and with local interest rates unlikely to ease given the expected upward tilt to the US Federal Reserve policy rate.

Despite healthy growth and higher global prices, inflation should remain modest in 2026 and 2027 (Figure A.12). Headline inflation averaged 1.7% from January to July, with underlying inflation, which excludes government relief measures, at 1.6%. Although the Middle East conflict and El Niño effects should push up key global commodity prices, the economy is largely protected given its access to ample food and fuel stocks in the PRC. Thus, the inflation forecast for 2026 remains at 2%, while the 2027 forecast is raised to 1.9% from the 1.8% projected in ADO July 2026.

Figure A.12 Contributions to Monthly Inflation, Hong Kong, China

Inflation increased through May, driven largely by higher energy prices and miscellaneous services, before easing from July.



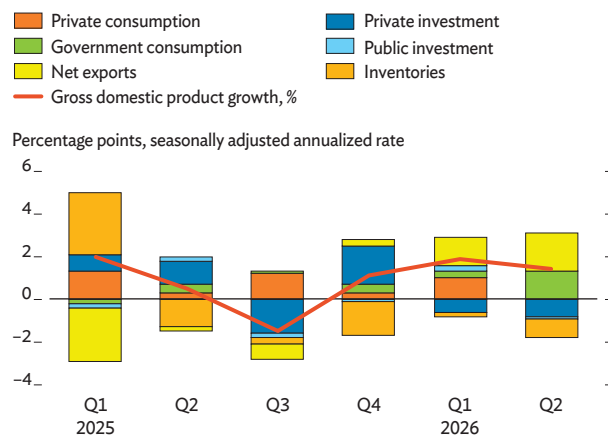
Risks are tilted to the downside. A prolonged or escalating Middle East conflict would fuel inflation and slow domestic demand and tourism. Similarly, El Niño, likely the strongest since 1950, could disrupt supplies and raise agricultural import prices. If the AI boom weakens sharply, the ensuing drop in technology-related investment and stock market sell-off could hurt exports, fixed investment, and financial activity. While exemptions covering most electronic products should limit the impact of the new 12.5% US tariff rate, exports remain vulnerable to trade policy shocks.

Japan

Real GDP in Q2 2026 expanded by an annualized 1.4%, down from 1.9% in Q1 (Figure A.13). Strong exports supported growth, driven by robust US demand for hybrid Japanese vehicles and sustained global demand for semiconductors. Private consumption was flat, partly because government subsidies to lower education costs ran up government consumption. Business investment declined by 0.8%, however, as the Middle East conflict persisted. Nevertheless, the economy recorded a third consecutive quarter of growth.

Figure A.13 Demand-Side Contributions to Growth, Japan

Q2 growth slowed as consumption stalled.

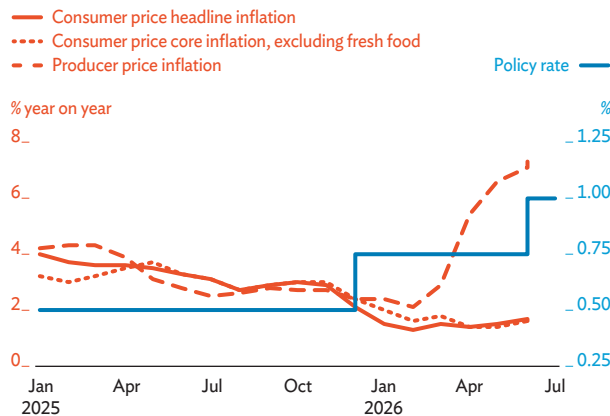


Source: CEIC Data Company.

Headline inflation rose from 1.6% year on year in June to 1.9% in July (Figure A.14). Energy prices increased by 0.6% year on year in July, reversing a 0.4% decline in June, as higher kerosene and propane gas prices more than offset continued declines in electricity and gasoline prices. Producer price inflation remained elevated at 7.2% in July, although it eased slightly from a revised 7.3% in June, as higher energy costs and yen weakness continued to raise firms' input costs. Core inflation, which excludes fresh food, increased from 1.6% to 1.8%, while inflation excluding both fresh food and energy rose from 1.7% to 1.9%, suggesting that price pressures may be broadening. The yen continued to slide in early August despite a coordinated Japan-US foreign exchange intervention to

Figure A.14 Inflation and Policy Rate, Japan

Consumer inflation remains below the central bank's 2% target, but rising producer costs point to renewed risk of higher inflation.



Source: CEIC Data Company.

support it at the end of July, driven down by persistent interest rate differentials relative to the US and concerns over fiscal sustainability.

Growth forecasts remain unchanged from ADO July 2026 at 0.7% in 2026 and 0.8% in 2027.

Prolonged conflict in the Middle East weighs on economic activity through elevated energy and import costs, compounded by yen weakness. However, the government's ¥3.1 trillion supplementary budget, including gasoline and utility subsidies, will lighten the drag on growth. Real wages rose by 2.4% year on year in July, and consumer confidence improved in August, providing some support for household consumption. Manufacturing remained a bright spot, with its PMI at 54.9 in August, buoyed by the strongest growth in new orders in 4.5 years, rising backlogs, and robust AI demand. Services continued to expand, with August PMI rising to a five-month high of 52.5 as growth in new-business establishment accelerated. Growth is expected to improve slightly next year as energy prices normalize, supporting corporate profitability and business investment.

Inflation is forecast at 1.9% in 2026, revised down from 2.1%, while the 2027 forecast is maintained at 2.1%. Inflation averaged 1.5% in the 7 months of 2026, while government subsidies through September should continue to limit the pass-through of elevated energy and producer costs in the near term. Inflation is nevertheless expected to accelerate moderately in the second half, consistent with Tokyo inflation

reaching 1.9% in August and continued pressure from yen weakness and higher input costs. Expected monetary tightening this year could alleviate price pressures and depreciation pressure on the yen. In 2027, the withdrawal of temporary support and lagged impacts of higher input costs are expected to sustain price pressures, though they will be partly offset by tighter monetary policy and easing energy prices. A proposed temporary reduction in the food consumption tax from 8% to 1% from Q2 2027 will lower measured inflation.

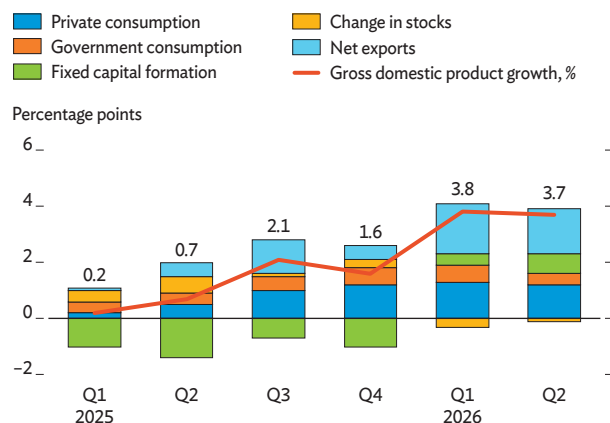
Risks to the outlook skew to the downside. A prolonged or intensified conflict in the Middle East could increase energy, shipping, and import costs, weakening household purchasing power and corporate profitability. Further yen depreciation could amplify these pressures, while additional risks stem from a sharper rise in government bonds yields and a weaker-than-expected recovery in household consumption.

Republic of Korea

The economy grew by a robust 3.8% in the first half of 2026, underpinned by strong export performance (Figure A.15). Merchandise exports rose by 10.8%, led by strong shipments of semiconductors and computer storage devices to meet sustained global demand for AI. Exports recorded strong gains in key markets, increasing by

Figure A.15 Demand-Side Contributions to Growth, Republic of Korea

Growth accelerated in the first half of 2026, driven by robust exports.



Q = quarter.

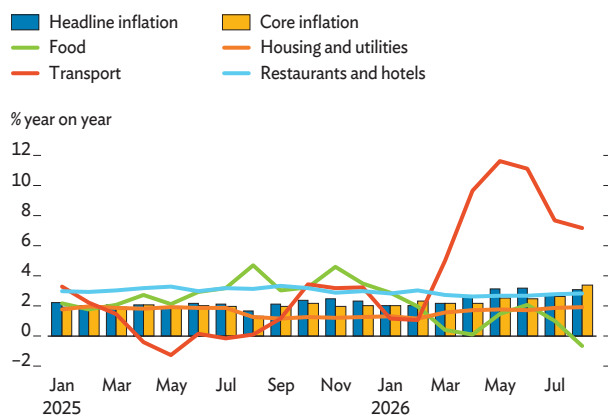
Source: CEIC Data Company.

64.5% to the PRC and 50.4% to the US. Import growth also accelerated in the first half, reflecting resilient domestic demand, with net exports contributing 1.7 percentage points to overall growth. Supported by government stimulus measures, consumption expanded by 2.6%, contributing 1.7 points to growth. Gross capital formation rebounded, growing by 1.4% and contributing 0.4 points to growth, driven by higher investment in facilities, research and development, and software.

Inflation averaged 2.6% year on year in the first 8 months of 2026, driven primarily by higher energy prices. Transport inflation accelerated to 6.8% in the period, up from 0.7% in the same period last year, reflecting higher oil and gas prices (Figure A.16). Pass-through to consumer prices was partly contained by government measures, notably fuel price caps and subsidies. Meanwhile, core inflation, which excludes food and energy, rose to 2.5%, suggesting that price pressures spilled over into other goods and services. With inflation remaining above its 2.0% target, the central bank raised its policy rate by a total of 50 basis points to 3.0% since July 2026.

Figure A.16 Inflation, Republic of Korea

Headline inflation increased on a surge in transport costs caused by high global oil prices.



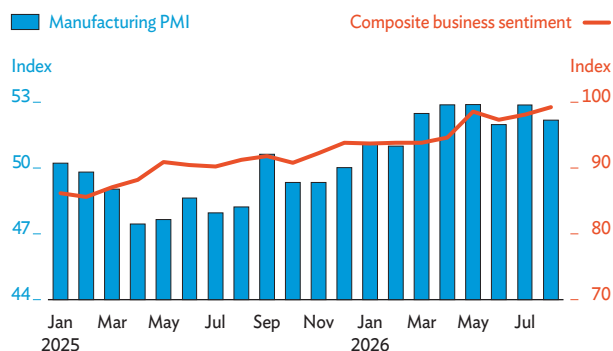
Source: CEIC Data Company.

Growth forecasts are revised up from July projections to 3.2% for 2026 and 2.3% for 2027 on stronger export growth. Continued global demand for semiconductors used in AI is expected to sustain export growth. Recent manufacturing indicators point to continued expansion, as the seasonally adjusted manufacturing PMI stood at

52.3 in August, slightly lower than 53.1 in July, marking 9 consecutive months of expansion driven by increases in output and new orders, particularly in semiconductors (Figure A.17). Business sentiment across industries also improved in August, buoyed by a strong manufacturing outlook. Private consumption is projected to grow moderately supported by fiscal stimulus and strong corporate earnings, though higher energy prices and tighter monetary policy may weigh on household spending. Notable downside risks to the growth outlook stem from renewed geopolitical tensions, global financial market volatility, and further increases in US tariffs, which could weigh on exports and investment.

Figure A.17 Leading and Confidence Indicators, Republic of Korea

The manufacturing PMI signals continued expansion, and business sentiment has strengthened.



PMI = purchasing managers' index.

Notes: A PMI reading >50 signals improvement, <50 deterioration. The composite business sentiment index for all sectors, with a reading >100 indicates positive business expectations compared to the long-term average.

Sources: Bank of Korea; CEIC Data Company.

Inflation projections are unchanged at 2.7% for 2026 and 2.2% for 2027. Inflation will rise in 2026, as higher energy prices and continued strength in domestic demand add to price pressures. The increase will be moderated by government measures to stabilize prices and limit pass-through of higher energy costs. Inflation will moderate in 2027 as energy price pressures ease and monetary policy tightening takes effect. Risks to the inflation outlook would be renewed geopolitical tensions and a more prolonged or severe El Niño than expected, which could raise energy and food prices.

New Zealand

GDP growth remained steady in Q1 2026, with leading indicators mixed.

Economic activity expanded by 1.5% year on year in Q1 2026, matching Q4 2025 and reflecting stability from increased investments, strong agricultural and manufacturing output, and resilient services. Total investment rose by 6.2% year on year on public infrastructure projects and tax-aided machinery and equipment purchases, while household consumption stayed weak under cost-of-living pressures, and private investment was held back by tight financing. Strong export growth was offset by higher imports, leaving the external sector a drag on growth. Agriculture benefited from robust global demand for dairy, meat, and horticulture, while manufacturing rebounded on export demand and investment incentives, especially in advanced industries. Construction and mining contracted, notably in oil and gas. Services, about 70% of GDP, remained the main growth driver, supported by trade, tourism, and business services (Figure A.18). Labor market conditions softened as unemployment rose to 5.6% even as labor participation fell on continued outflow of skilled labor, and despite wages lifted by demand in services and advanced manufacturing. PMI data show renewed growth in Q2 2026 as the manufacturing PMI neared 60 and services were firmly poised to expand. Despite broad growth in Q1, late-March surveys revealed deteriorating

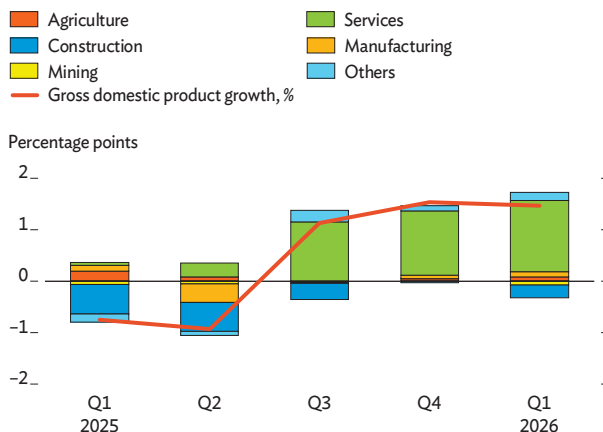
consumer and business sentiment, highlighting risks from global energy market disruption and higher fuel costs.

Inflation rose in Q2 2026, exceeding the central bank target of 1.0%–3.0%. From 3.1% in Q1 2026, headline inflation accelerated to 4.1% in Q2, the highest in 2 years (Figure A.19). This was driven mainly by surging fuel costs in the wake of the Middle East conflict. Gasoline was up by 28%, and other petroleum products, notably diesel, by 71%. Tradable inflation—affecting prices for imported goods and services and their domestic competitors—rose to 4.9%, reflecting imported energy shocks. Non-tradable inflation—affecting mainly domestic services and goods not directly exposed to external competition—eased to 3.4%, reflecting softer domestic price pressures. Inflation above target prompted the Reserve Bank of New Zealand to raise the main policy rate by 25 basis points to 2.75% in September, following its first hike in more than 3 years in July, with more tightening likely if price pressures persist.

GDP growth forecasts are unchanged at 1.6% for 2026 and 2.5% for 2027, as are inflation forecasts at 3.8% this year and 2.5% next year. Growth in 2026 is expected to remain subdued, with household consumption constrained by cost-of-living pressures and investment recovering only gradually. As inflation moderates and monetary policy eventually stabilizes, financing conditions should gradually ease in 2027, allowing business investment to rebound more

Figure A.18 Supply-Side Contributions to Growth, New Zealand

Q1 growth was widespread except in mining and construction, which contracted.

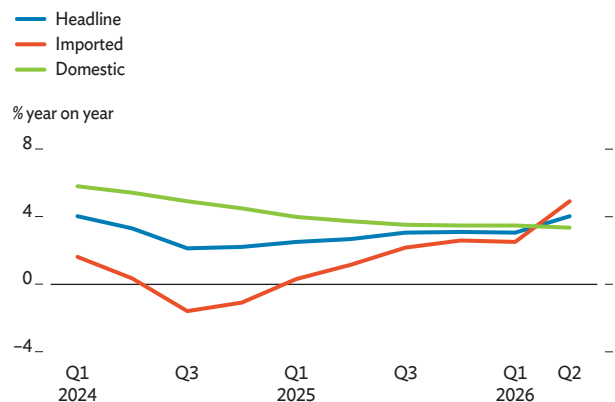


Q = quarter.

Source: CEIC Data Company.

Figure A.19 Inflation, New Zealand

Imported inflation surged while domestic inflation softened in Q2 2026.



Q = quarter.

Source: Statistics New Zealand; Haver Analytics.

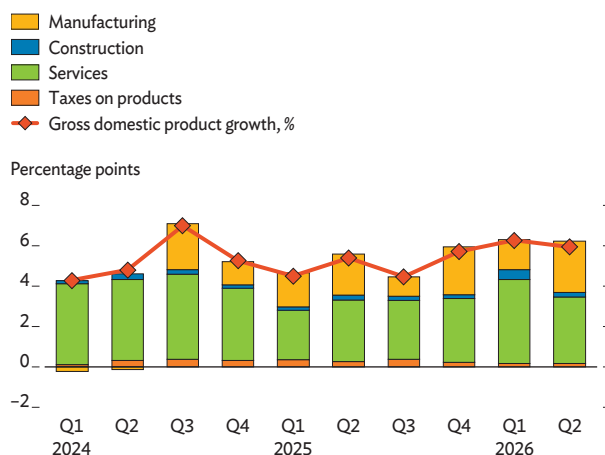
strongly. Persistent disruption to major trade routes from the Middle East conflict is likely to dampen economic activity this year and next. Net exports are expected to drag on growth as stronger domestic demand lifts imports faster than exports, though agricultural exports remain supported by firm dairy and meat prices. Inflation will be driven by imported energy shocks this year before moderating in 2027 as global fuel markets stabilize. Inflation forecasts are unchanged, though risks persist from rising import costs and potential weather-induced disruption from El Niño affecting agriculture. Risks to the outlook are moderation in the PRC growth affecting commodity demand, rising US tariffs, a weak labor market, fiscal sustainability pressures, and exposure to global shocks.

Singapore

Economic expansion was strong in the first half (H1) of 2026, mainly on robust manufacturing and domestic activity. GDP grew by 5.9% year on year in Q2, following 6.3% growth in Q1, for H1 growth of 6.1% (Figure A.20). Manufacturing growth remained the main driver as it accelerated from 7.3% in Q1 to 12.5% in Q2, underpinned by sustained global demand for semiconductors and other AI equipment. Meanwhile, construction growth moderated from 12.9% in Q1 to 5.8%, and services growth eased from 6.0% to 4.7% as related activities normalized.

Figure A.20 Supply-Side Contributions to Growth, Singapore

Strong manufacturing growth drove overall growth in Q2 2026.



Q = quarter.

Source: Ministry of Trade and Industry. Economic Survey Singapore 2026.

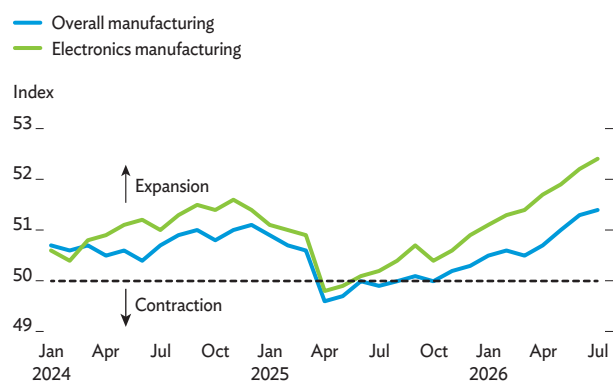
Domestic demand continued to underpin growth, while net exports weighed modestly on it. Consumption grew by 3.4% in Q2, supported by sustained private consumption and a rebound in government spending. Investment growth moderated from 9.5% in Q1 to 8.4% as construction slowed. A net exports surplus moderated marginally as real import growth by 18.1% outpaced export growth at 15.1%.

The growth forecast for 2026 is revised up from 3.2% to 5.0% on H1 performance exceeding expectations and continued global AI investment.

High-frequency indicators point to continued momentum in H2. The manufacturing PMI rose from 51.3 in June to 51.4 in July, and the electronics index from 52.2 to 52.4, indicating sustained expansion in AI-driven manufacturing (Figure A.21). Business sentiment stayed positive across manufacturing and services, supported by continued AI adoption and robust tourism and demand for domestic services. Construction is expected to be firm, buoyed by a pipeline of public and private projects. Despite expected growth moderation in H2 as strong manufacturing-led expansion in H1 normalizes, the expectation of sustained AI investment supports a forecast for 2027 revised up from 2.4% to 3.0%. Downside risks to external demand, production costs, and business investment come from geopolitical tensions and uncertainty regarding additional US trade measures, energy prices, global financial conditions, and AI investment cycles, as well as weather-induced inflation.

Figure A.21 Purchasing Managers' Indexes, Singapore

Manufacturing and electronics indexes remained in expansionary territory in July on robust demand for AI.



AI = artificial intelligence.

Note: A reading >50 signals improvement, <50 deterioration.

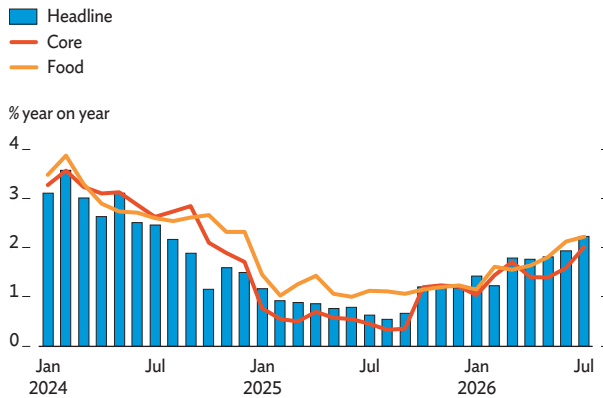
Source: CEIC Data Company.

Inflation remained low despite a pickup in July.

Core inflation increased from 1.6% year on year in June to 2.0% in July and headline inflation edged up from 1.9% to 2.2% on higher costs for food, services, retail goods, and accommodation (Figure A.22). Looking ahead, elevated global energy prices are expected to sustain imported inflationary pressures as higher energy costs gradually pass through global supply chains. To mitigate these pressures, the Monetary Authority of Singapore tightened monetary policy again at its July meeting by increasing the rate by which the Singapore dollar may appreciate in nominal effective terms. The appreciation path is expected to limit the pass-through of imported inflation. However, adverse weather could still raise imported food prices, posing a risk of higher inflation. Overall, moderating domestic cost pressures and tighter monetary policy are expected to keep inflation broadly in line with ADO July 2026 forecasts of 2.2% in 2026 and 1.9% in 2027.

Figure A.22 Inflation, Singapore

Inflation picked up in July, driven by higher food prices, but remained contained.



Source: CEIC Data Company.

Risks to the outlook are broadly balanced.

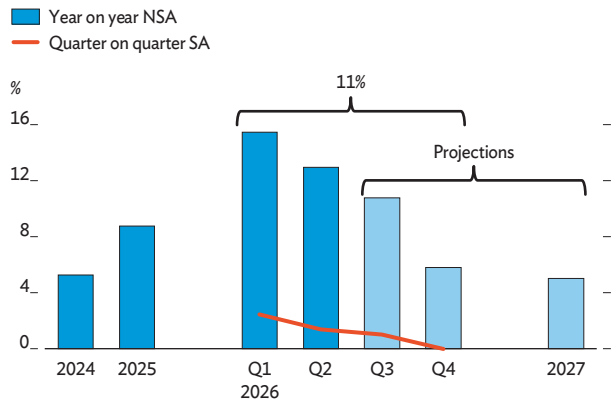
A continued AI investment cycle could further support technology-related manufacturing, exports, and services. Downside risks are geopolitical tensions, unfavorable movements in energy prices and global financial conditions, uncertainty surrounding additional US trade measures, a sharp slowdown in AI investment, and weather-induced inflation.

Taipei, China

The economy countered global shocks by riding the artificial intelligence (AI) boom during the first half (H1) of 2026. Output grew by 14.1%, the fastest pace in 5 decades, with second quarter growth exceptionally strong at 12.9% (Figure A.23). Customs data show technology exports grew by 65% (in US dollars) in H1 2026 (Figure A.24). In real terms, national income data show total exports grew by 28%. Imports also grew by a robust 22%, with the increase mainly channeled to AI-related fixed investment and inventory buildup to meet expected strong demand for technology products.

Figure A.23 Gross Domestic Product Growth, Taipei, China

Strong first half growth in artificial intelligence-related products has lifted the full-year outlook.



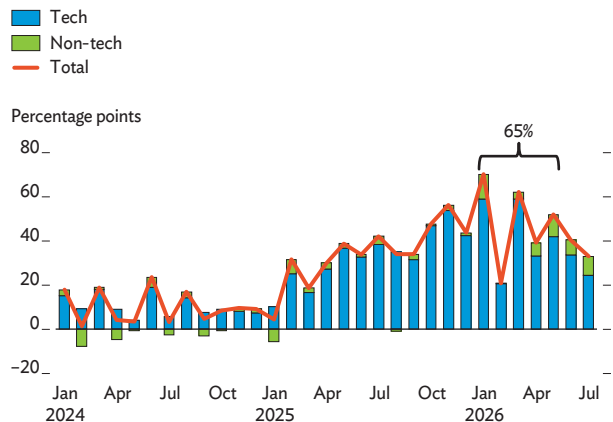
Q = quarter, NSA = non-seasonally adjusted, SA = seasonally adjusted.

Note: Dark blue bars are actual growth, light blue bars are projections.

Sources: Haver Analytics; ADB staff calculations.

Figure A.24 Technology Exports, Taipei, China

Technology exports remained robust in the first half of 2026.



Sources: Haver Analytics; ADB staff calculations.

Domestic demand also firmed up. Confidence improved due to the buoyant outlook for growth, higher stock prices, stable property prices, and some trickle-down wage effects from the technology boom to nontechnology sectors. This spurred private consumption to grow by nearly 6% in H1 from 1.0% in 2025. Businesses remained optimistic and increased fixed investment by almost 10%, with inventories rising by 0.7% of GDP.

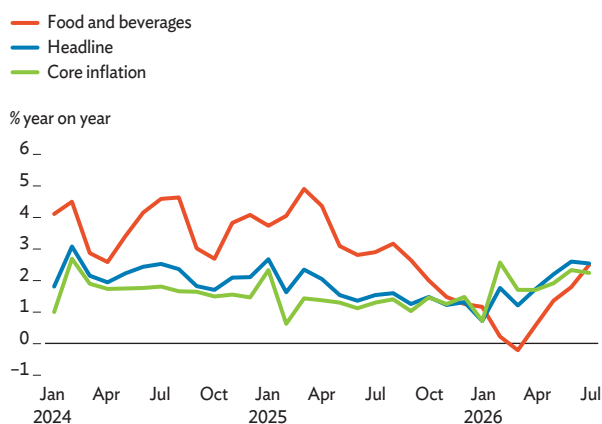
Consequently, the growth forecast is revised up for both years from the ADO July 2026 projections.

Technology exports should continue as the main growth driver as reflected in the economic monitoring indicator remaining positive for a seventh consecutive month in June and continued announcements of large-scale investment in AI infrastructure and data centers. Growth is forecast to moderate in 2027 mainly due to lower AI investment in 2027, as the buildup of data centers and compute capacity meets targets, along with the base effect of exceptionally strong 2026 growth.

Inflation is expected to remain broadly in line with the ADO July 2026 forecast over the next 2 years. After averaging 1.5% in the first 5 months of 2026, inflation jumped to 2.6% in June and 2.5% in July as the Middle East conflict pushed up oil prices and bad weather raised the cost of vegetables (Figure A.25). Inflation should inch upward due to higher global energy prices, higher food costs due to El Niño,

Figure A.25 Inflation, Taipei, China

Inflation rebounded starting in April 2026.

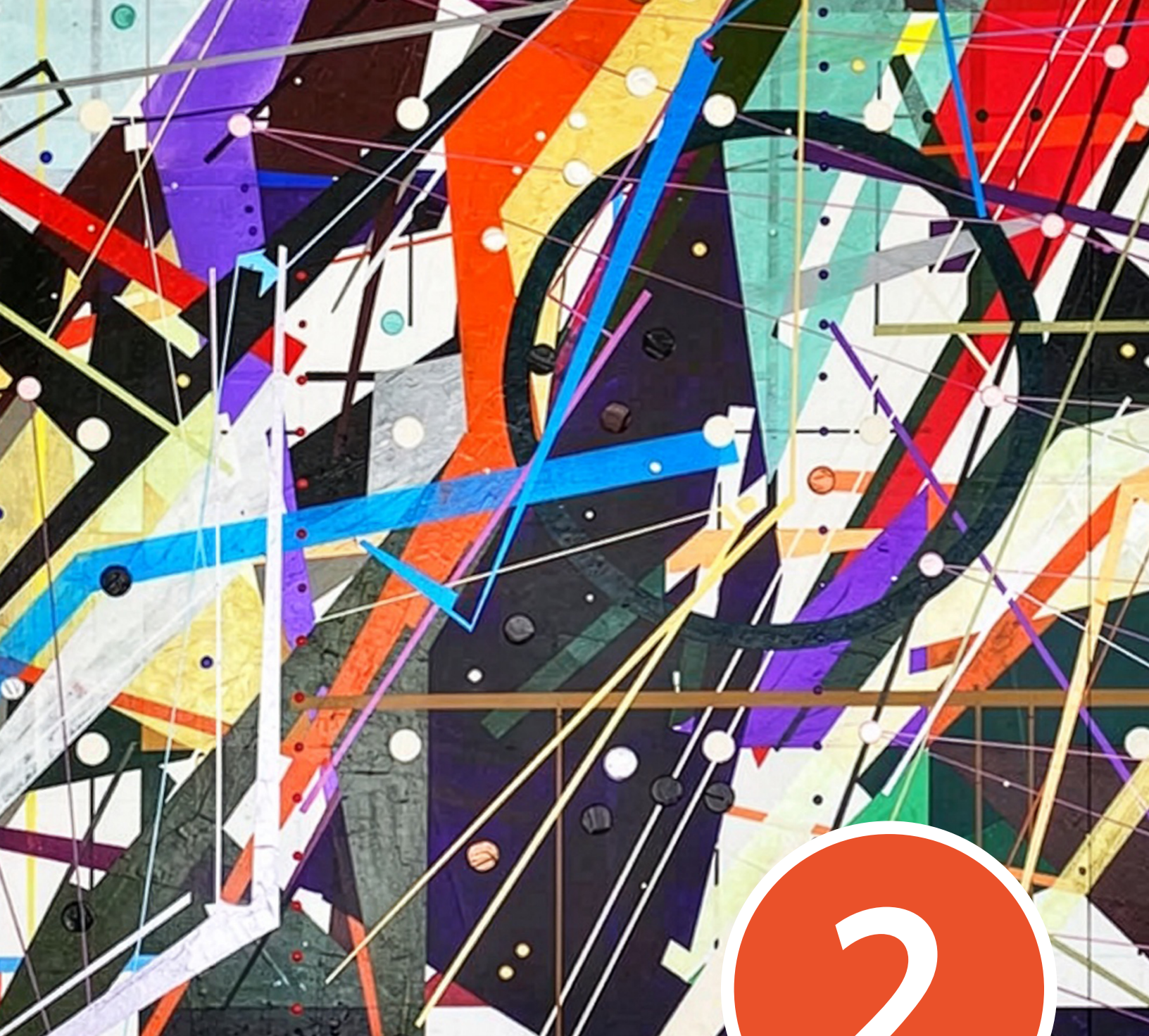


Sources: Haver Analytics; ADB staff calculations.

continued strong domestic demand, and last year's low base effects. Nonetheless, the continued restraint on domestic oil prices by state energy companies should limit any pass-through to overall inflation.

Risks to the outlook persist, but are balanced.

Export prospects depend critically on the AI-driven investment cycle remaining robust, which currently looks likely. However, the prolonged conflict in the Middle East and a worse-than-expected El Niño could hurt global demand by raising energy and food prices, thus weakening AI investments and reducing export demand.



MONETARY POLICY IN HIGH-DEBT ENVIRONMENTS



MONETARY POLICY IN HIGH-DEBT ENVIRONMENTS

High debt has become a structural concern for monetary policy in both advanced and emerging economies. High indebtedness may constrain monetary policy decisions through fiscal dominance and financial stability risks, while associated higher sovereign and term risk premia, debt overhang and deleveraging may affect monetary policy transmission. Using panel data spanning 3 decades and covering 85 advanced and emerging economies, this chapter analyzes how high public and private debt affect both monetary policy decisions and transmission. The findings indicate that, consistent with fiscal dominance, a deterioration in the expected fiscal balance is linked to policy rates lower than would be warranted by macroeconomic conditions. This effect is stronger in emerging economies and in economies with high public debt. Elevated public and private debt weaken the transmission of monetary policy to financial conditions, while high private debt also dampens transmission to real economic activity, consistent with a debt-overhang mechanism. Strong institutions, particularly central bank independence, help preserve monetary policy effectiveness in high-debt environments but cannot fully offset the impact of indebtedness. Thus, an independent and effective monetary policy framework requires strong fiscal frameworks, central bank autonomy, and low debt vulnerability.

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ADB placed its regular assistance to Afghanistan on hold effective 15 August 2021. Effective 1 February 2021, ADB placed a temporary hold on sovereign project disbursements and new contracts in Myanmar.

1 Introduction

Over the past 2 decades, debt has risen rapidly in both advanced economies and emerging market and developing economies (EMDEs). Debt accumulation accelerated especially following major global shocks, such as the global financial crisis of 2007–2008 and the COVID-19 pandemic. While debt levels stabilized and have started declining in recent years amid fiscal consolidation and private-sector deleveraging, they remain historically elevated (Figure 1.1). Excluding the People’s Republic of China (PRC), total debt in developing Asia and the Pacific (DAP)—including public debt and non-financial private debt—rose from about 47% of gross domestic product (GDP) in 2007 to 89% in 2019, then peaked at 103% during the pandemic before declining to 93% in 2025.

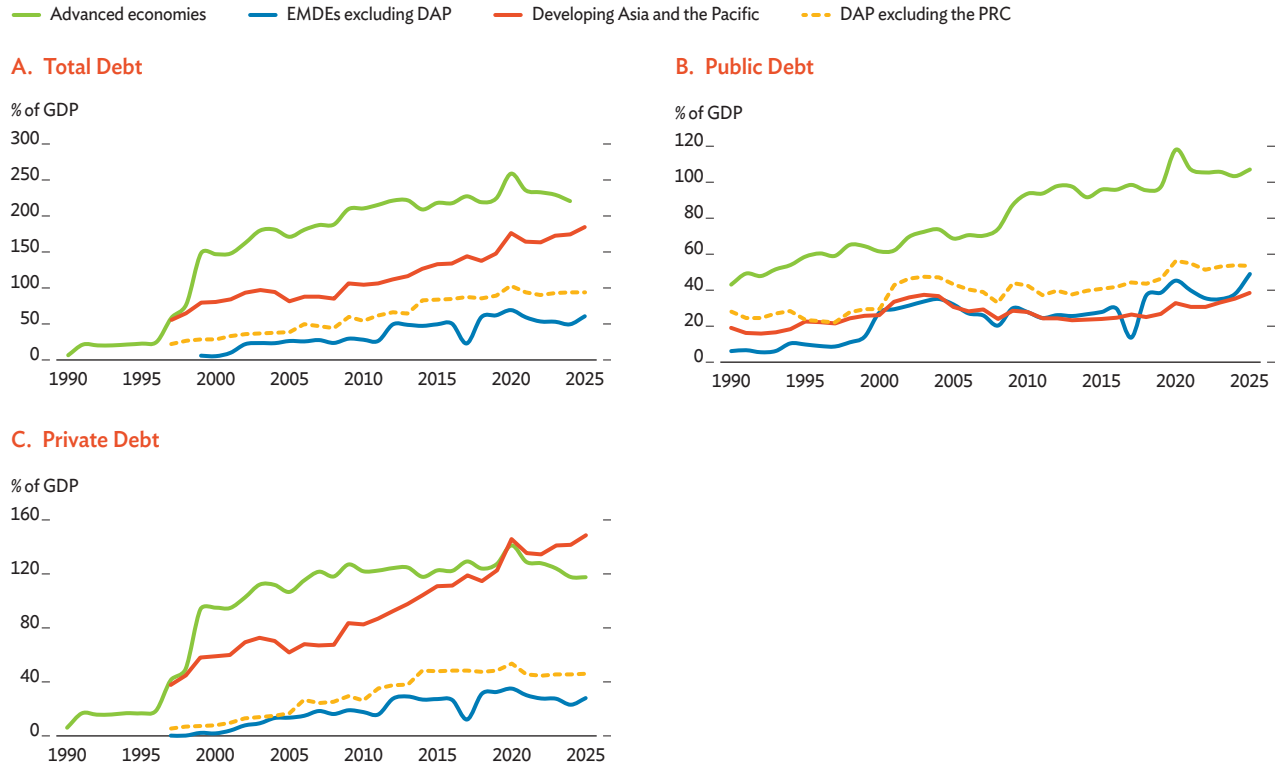
High public debt can complicate the interaction between fiscal and monetary policy. High public debt has several macroeconomic and financial implications. For example, it reduces the fiscal space available for responding to recessions and shocks, pushes up borrowing costs and risk premia due to debt sustainability concerns, and crowds out private investment. Moreover, it can constrain monetary policy through fiscal dominance risks. Effective monetary policy requires central banks to adjust nominal policy rates independently in response to macroeconomic conditions, notably inflation, employment, exchange rates, and output (Clarida, Galí, and Gertler 1999; Woodford 2001). Under fiscal dominance, however, concerns about government borrowing costs and debt sustainability may prompt central banks to keep rates below levels warranted by those conditions (Checherita-Westphal et al. 2024). Fiscal dominance can, therefore, weaken the credibility of monetary policy. This is particularly important in EMDEs where macroeconomic and financial vulnerabilities are more pronounced as fiscal space is often tight, and financial markets tend to be more sensitive to shocks and monetary policy signals.

The economic effects of monetary policy depend not only on the size and timing of policy rate adjustments, but also on how effectively they are transmitted through the economy. In standard frameworks, monetary policy decisions are often represented by a reaction function, such as a Taylor rule, linking the policy rate to economic conditions. Policy rate changes then affect the economy through several channels, including inflation expectations, household and corporate balance sheets, cash flows, asset prices, wealth, and exchange rates. Through these channels, monetary policy decisions ultimately influence borrowing and credit conditions, consumption, investment, savings, inflation, and output.

High indebtedness may affect both monetary policy decisions and their transmission (Figure 1.2). High public debt and fiscal imbalances may generate fiscal dominance pressures that render central banks unwilling or unable to raise interest rates. Bajaro, Galimberti, and Qureshi (2025), for instance, found that central banks tend to keep interest rates lower when fiscal balances are expected to deteriorate. High private debt may also induce greater caution, as interest rate increases may trigger financial instability in leveraged households, firms, and financial institutions. Regarding policy transmission, high public debt can raise sovereign and term risk premia such that long-term yields can be driven more by changes in these premia than by changes in expected short-term rates. This weakens pass-through from policy rates to longer-term borrowing conditions (Corsetti et al. 2013; Gale and Orszag 2003). High private debt can generate debt overhang and deleveraging effects, prompting indebted households and firms to prioritize balance sheet repair, and making consumption and investment less responsive to interest rate changes (Eggertsson and Krugman 2012; Alpanda and Zubairi 2019).

Figure 1.1 Debt in Advanced Economies, Emerging Market and Developing Economies, and Developing Asia and the Pacific

Debt has risen across all regions since the 1990s, but developing Asia and the Pacific's debt—still below advanced economies—has grown faster than other EMDEs and is now more private- than public-debt driven.



DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, GDP = gross domestic product, PRC = People's Republic of China.

Notes:

1. Public debt is government debt, while private debt includes household and non-financial corporate debt. Advanced economies include advanced Asia and the Pacific (Australia; Hong Kong, China; Japan; New Zealand; the Republic of Korea; Singapore; and Taipei, China) and other advanced economies: Austria, Belgium, Canada, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, the United States, and the United Kingdom. EMDEs include Albania, Algeria, Argentina, Bahrain, Belarus, Bolivia, Bosnia and Herzegovina, Botswana, Brazil, Bulgaria, Chile, Colombia, Côte d'Ivoire, Ecuador, Egypt, Ghana, Hungary, Iran, Jordan, Kenya, Kosovo, Kuwait, Lebanon, Malawi, Mauritius, Mexico, Moldova, Montenegro, Morocco, Mozambique, Nigeria, North Macedonia, Oman, Panama, Paraguay, Peru, Qatar, Romania, the Russian Federation, Saudi Arabia, Serbia, South Africa, Sudan, the Syrian Arab Republic, Tunisia, Ukraine, United Arab Emirates, Uruguay, Venezuela, Yemen, and Zambia. DAP includes Armenia, Azerbaijan, Bangladesh, Brunei Darussalam, Cambodia, the PRC, Georgia, India, Indonesia, Kazakhstan, the Kyrgyz Republic, the Lao People's Democratic Republic, Malaysia, Mongolia, Myanmar, Nepal, Pakistan, the Philippines, Sri Lanka, Thailand, Türkiye, Uzbekistan, and Viet Nam. Percentages use GDP at current market prices, in US dollar terms.
2. For the PRC, private and public debt values from 1995 to 2006 were extrapolated using Global Debt Monitor ratios combined with nominal GDP data.

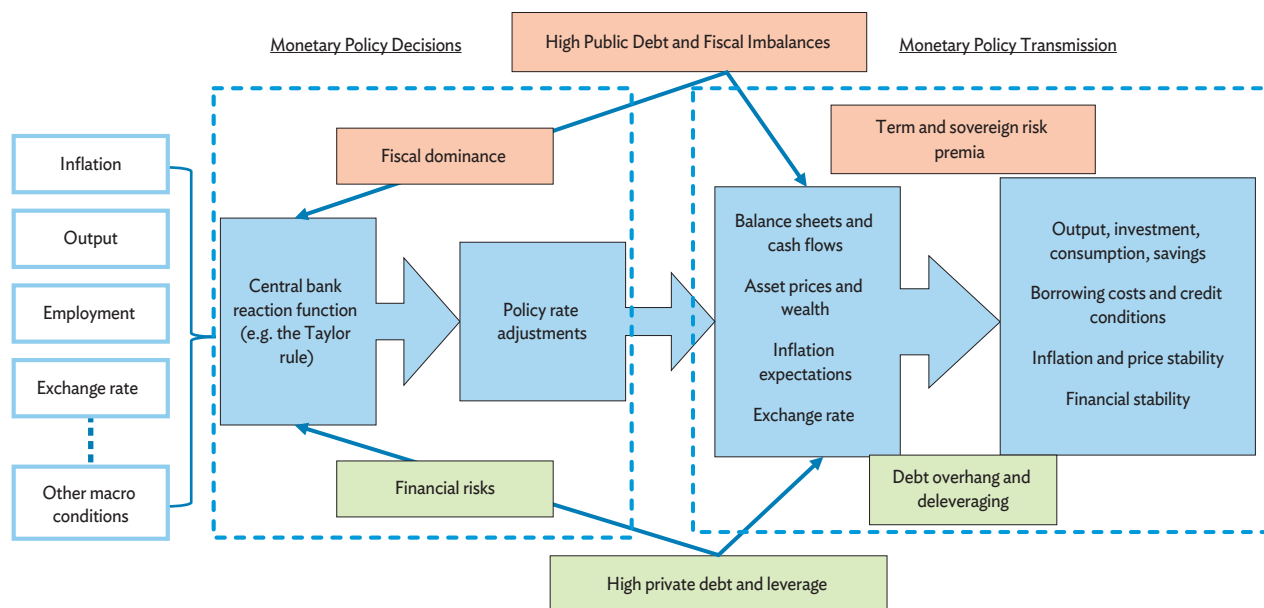
Source: Authors' calculations.

This chapter uses panel data for advanced economies and EMDEs to address two empirical questions about how high indebtedness affects monetary policy. The first question is whether debt levels and fiscal balances influence policy rate decisions. To address this question, the chapter estimates augmented Taylor-rule reaction functions that include fiscal balances and debt alongside

conventional determinants of policy rate decisions, notably inflation, economic growth, exchange rate movements, and interest rate smoothing. The estimated Taylor rules are also used to identify surprise policy rate adjustments, or monetary policy shocks—that is, the components of policy rate changes not explained by prevailing economic conditions. These shocks are used to address a second question,

Figure 1.2 How High Debt Complicates Monetary Policy Decisions and Transmission

Indebtedness can affect monetary policy decisions and transmission through different channels.



Source: Authors' illustration.

namely whether high debt weakens monetary policy transmission to output and financial conditions. More specifically, the monetary policy shocks are incorporated into a smooth-transition local projection framework, building on Jordà (2005), to trace how output and sovereign bond yields dynamically respond to them, and to assess how transmission varies across high- and low-debt regimes. As expectations, macroeconomic conditions, fiscal settings, and institutional arrangements jointly shape both monetary policy decisions and transmission, the chapter also examines whether greater central bank independence (CBI) can mitigate the effects of indebtedness.

The findings indicate that high debt can constrain both monetary policy decisions and policy transmission. Controlling for conventional determinants of monetary policy, a deterioration in the fiscal balance by 1 percentage point is associated with policy rates that are 16 basis points lower on average than warranted by macroeconomic conditions, and 22 basis points lower in EMDEs. Consistent with fiscal dominance pressures, the effect is substantially larger when public debt is high—32 basis points, compared with 12 basis points in low-debt environments. Monetary policy shocks have economically meaningful

effects on output and sovereign bond yields on average, but their transmission weakens in high-debt regimes. High public and private debt reduces the responses of both short- and long-term sovereign bond yields, while high private debt dampens output response as well. These patterns are broadly consistent across the global, EMDEs, and DAP samples.

CBI helps preserve monetary policy autonomy and transmission, but it cannot fully offset the effects of high indebtedness. The association between weaker fiscal balances and lower policy rates is statistically significant only in economies with lower CBI. Lower CBI also amplifies the adverse effects of debt on transmission, weakening the responses of both output and sovereign bond yields to monetary policy shocks in high public and private debt regimes. By contrast, in economies with higher CBI, output responses do not differ significantly between high- and low-debt regimes. However, high public and private debt remain associated with a weaker response of short-term sovereign bond yields. Greater CBI appears, therefore, to support the effective transmission of monetary policy to real activity, though high indebtedness can still impair transmission through financial markets.

The analysis provides new evidence for EMDEs, with particular focus on DAP. While much of the existing evidence on debt and monetary policy pertains to advanced economies or broad cross-economy samples, EMDEs—particularly those in DAP—are especially important given differences in monetary policy frameworks, institutional strength, financial development, and debt structures. These characteristics make them a useful setting for understanding when and why monetary policy may lose traction in high-debt environments, and how these effects may vary according to economy-specific conditions. The findings therefore provide policy-relevant evidence for economies where debt vulnerability and monetary policy constraints may be particularly consequential.

The chapter provides three sets of policy implications for preserving monetary policy credibility and policy space in high-debt environments:

- (i) **Maintaining sustainable fiscal space helps preserve monetary policy autonomy and effectiveness.** Weak fiscal positions may constrain policy rate decisions, while high public and private debt can weaken monetary policy transmission. Debt sustainability and sound private sector balance sheets are therefore important not only for fiscal and financial stability, but also to preserve monetary policy credibility and effectiveness.
- (ii) **Fiscal and monetary authorities should coordinate while safeguarding central bank autonomy.** Credible fiscal policy can reduce sovereign risk premia, anchor inflation expectations, and allow central banks more room to respond to fluctuations in inflation and economic activity without being constrained by government financing needs. Such coordination can enhance macroeconomic stability, but it should not subordinate monetary policy to fiscal objectives, which can give rise to fiscal dominance.
- (iii) **Strong institutions mitigate policy constraints in high-debt environments.** Greater CBI helps counter fiscal dominance pressures and preserve monetary policy transmission. Strong fiscal frameworks reinforce these benefits by supporting debt sustainability and policy credibility. In EMDEs, where fiscal frameworks are often weaker, reforms to strengthen fiscal rules and independent fiscal institutions can improve debt management and transparency. At the same time, safeguarding CBI can make monetary policy more effective in high-debt environments.

2 Literature Review

The literature increasingly recognizes that indebtedness can complicate monetary policy through both the policy rate decision and transmission channels. This section reviews the existing literature on how high debt may influence central banks' policy rate decisions and how effectively policy rate changes are transmitted to output and financial conditions.

2.1 Monetary Policy Decisions in High-Debt Environments

The first stream of literature discusses how indebtedness may influence central banks' decisions. Under normal conditions, policy rate decisions are guided by domestic macroeconomic and financial conditions, such as expected inflation, employment and output, and financial risks and stability (Figure 2.1). In open economies, external conditions such as exchange rates and global economic conditions may play a role in central banks' decisions. When public debt is high, a key factor that may affect such decisions is fiscal dominance. Fiscal

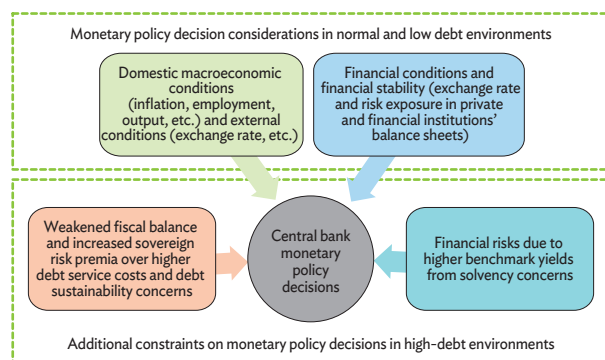
dominance describes how elevated public debt and associated fiscal pressures can constrain monetary policy decisions. As monetary tightening may weaken fiscal balances by raising government debt-servicing costs and increasing sovereign risk premia via debt sustainability concerns, central banks may face additional constraints when setting policy rates.

Fiscal conditions and debt levels have been documented to influence monetary policy decisions. Leeper (1991), for example, showed that, in regimes with active fiscal policy and passive monetary policy, higher interest rates can raise debt-servicing costs and threaten fiscal solvency, eventually requiring monetary policy to accommodate fiscal needs. Bajaro, Galimberti, and Qureshi (2025) documented evidence of fiscal dominance, finding that an expected deterioration in the fiscal balance by 1 percentage point is associated with policy rates 16 basis points lower on average, with effects intensified when CBI and fiscal rules are weak.

When private debt is high, financial stability can become an important consideration in central bank policy rate decisions. Higher interest rates increase the debt-servicing and refinancing costs of households and non-financial corporations, particularly when their liabilities have short maturities and floating interest rates. Further, higher interest rates can expose financial institutions that have maturity mismatches on their balance sheets to greater interest rate risks, as longer-term assets are financed by shorter-maturity liabilities. In such cases, rising interest rates may generate larger valuation losses on long-duration assets than on liabilities, particularly for financial institutions holding long-term bonds, mortgages, and other long-duration assets. Higher interest rates can therefore increase liquidity and refinancing risks, weaken balance sheets and cash-flow positions, and undermine the asset quality of financial institutions as private borrowers experience greater financial stress. These pressures can tighten financial conditions and

Figure 2.1 Monetary Policy Decisions in High-Debt Environments

High debt constrains monetary policy through fiscal pressures, higher sovereign risk, and financial stability concerns.



Source: Authors' illustration.

generate adverse feedback loops between borrowers, financial institutions, and the broader economy (Blanchard 2019; BIS 2023). Thus, when private-sector indebtedness is high, central banks may place more weight on financial stability considerations when setting policy rates, making monetary policy respond more cautiously to macroeconomic conditions than in low-debt environments.

2.2 Monetary Policy Transmission in High-Debt Environments

The literature has documented that debt levels can influence how effectively monetary policy is transmitted through different channels. One key channel of monetary policy transmission is the link between policy rates and long-term interest rates. When transmission is effective, changes in policy rates are reflected in long-term interest rates, which affect in turn credit conditions, broader financial conditions, and aggregate demand. Long-term interest rates can be decomposed into expected future short-term rates and the risk premia investors require for bearing credit, duration, and other risks (Campbell and Shiller 1991; Gürkaynak, Sack, and Swanson 2005; Adrian, Crump, and Moench 2013). As such, how long-term interest rates respond to policy rate adjustments depends not only on the expected path of short-term interest rates but also on factors such as investors' perceptions of sovereign and duration risks (Corsetti et al. 2013; Blanchard 2019).

When public debt is high, the link between policy rates and long-term interest rates may weaken.

Sovereign risk premia may rise as greater fiscal stress heightens risks to debt sustainability. As a result, long-term interest rates may become less responsive to changes in the expected path of short-term interest rates as sovereign risk premia play a greater role in determining long-term rates. Persistent fiscal deficits and high public debt may raise long-term inflation expectations and associated term premia, weakening the response of long-term interest rates to changes in short-term rates. For example, Brandão-Marques et al. (2024) found that public debt persistently raises long-term inflation expectations in emerging market economies when debt levels are high. In addition, higher public debt

can increase demand for loanable funds, crowd out private investment, and push up long-term interest rates (Gale and Orszag 2003), further reducing the influence of short-term policy rates on long-term borrowing costs. Overall, high public debt can weaken monetary policy transmission to long-term interest rates and the broader economy by making long-term borrowing costs less sensitive to policy rate changes and expected short-term interest rate paths because sovereign risk premia, term premia, and government financing needs play greater roles in determining long-term interest rates.

High private debt can weaken the transmission of monetary policy through debt-overhang or deleveraging channels.

Traditionally, interest rate adjustments are expected to influence consumption and investment by altering borrowing costs and financing conditions. When households and corporations are highly leveraged, however, their responses to policy rate adjustments may be constrained by debt-servicing burdens, cash-flow pressures, and the need to repair their balance sheets. Under debt overhang, highly leveraged households and firms may prioritize deleveraging over new consumption and investment, making credit and aggregate demand less responsive to policy rate adjustments (Eggertsson and Krugman 2012). While this mechanism explains a weaker response to rate cuts more naturally, it can also dampen the response to rate hikes. Borrowers that are already constrained from taking on additional debt have less scope to reduce new borrowing and the spending it finances. This can weaken transmission through new lending. Alpanda and Zubairy (2019), for example, found that, in the United States, monetary policy has weaker effects during periods of high household debt, generating smaller responses from GDP, consumption, residential investment, and home prices.

These mechanisms imply that both monetary policy decisions and transmission may depend on debt levels. Taken together, in high-debt environments, monetary policy decisions may be constrained and monetary policy transmission may be weakened as additional factors—fiscal needs, financial stability, sovereign risk and term premia, crowding-out effects, and deleveraging pressures—become more influential alongside the factors outlined in a conventional monetary policy framework (Table 2.1).

Table 2.1 Influence of High Debt on Monetary Policy Decisions and Transmission

Four channels through which high public and private debt limits monetary policy and weakens its transmission.

Channel	Debt Type	Working Mechanism
Fiscal dominance	Public	Decision. High public debt and fiscal pressures may constrain policy rate decisions and increase risk of monetary accommodation (Corsetti et al. 2013; Bajaro, Galimberti, and Qureshi 2025).
Financial stability	Private	Decision. High private debt increases financial stability concerns, which may influence policy rate decisions when highly leveraged household, corporate, and financial-sector balance sheets are vulnerable to interest rate changes.
Sovereign and term risk premia, and crowding out	Public	Transmission. High public debt and fiscal sustainability concerns can raise sovereign and term risk premia and increase government demand for funding, driving up long-term interest rates and making them less responsive to policy rate changes (Corsetti et al. 2013; Gale and Orszag 2003).
Debt overhang and deleveraging	Private	Transmission. Highly leveraged households and firms may prioritize balance-sheet repair and deleveraging over new consumption and investment, making aggregate demand less responsive to policy rate changes (Eggertsson and Krugman 2012).

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Eggertsson, G. B. and P. R. Orszag. 2012. *Debt, Deleveraging, and the Liquidity Trap: A Fisher–Minsky–Koo Approach*. *Quarterly Journal of Economics*. 127(3).

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Source: Authors' compilation.

2.3 Role of Central Bank Independence

CBI is a key determinant of how high indebtedness influences monetary policy decisions and transmission. Strong CBI can strengthen monetary policy credibility by anchoring expectations about the future paths of short-term interest rates and inflation (Alesina and Summers 1993; Dincer and Eichengreen 2014). It can reduce the risk of fiscal dominance by keeping monetary policy decisions focused on macroeconomic stabilization rather than fiscal financing needs. CBI and monetary policy credibility are particularly important for EMDEs, where inflation expectations may be more sensitive to political developments, external shocks, and fiscal stress. Qureshi and Ahmad (2026), for example, examined central bank governor turnover across 48 global economies and found politically motivated dismissal of central bank governors associated with higher inflation and inflation expectations in DAP (Box 2.1).

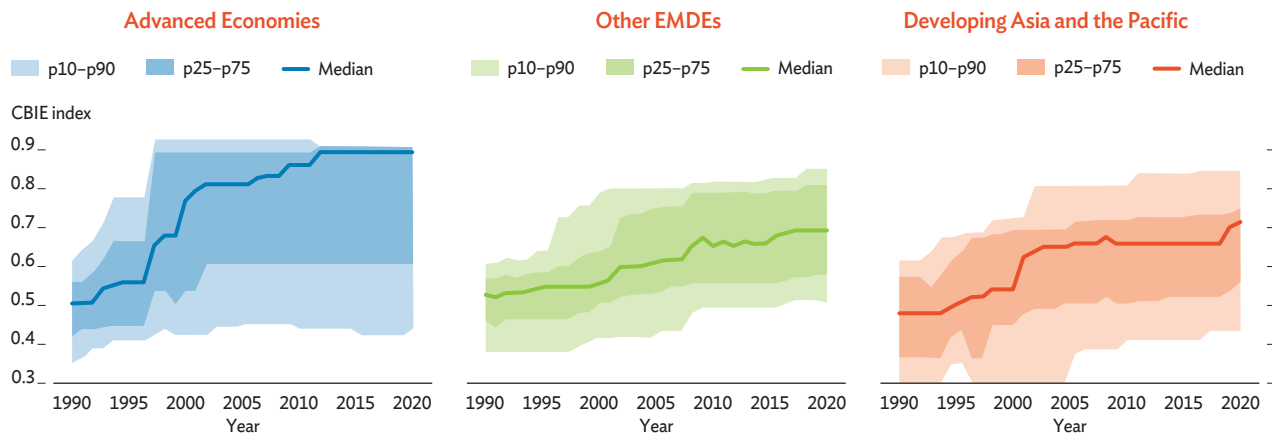
CBI has strengthened over time across economy groups, with levels generally higher in advanced economies than in EMDEs. Using the CBI Extended (CBIE) index of Romelli (2022, 2025) to gauge

CBI, Figure 2.2 summarizes the evolution of CBI since 1990 in advanced economies, EMDEs, and DAP. The CBIE index ranges from zero to one, with higher values indicating more independence. Three patterns stand out. First, CBI has increased across all groups over time. Legal reforms strengthening central bank autonomy spread widely from the early 1990s, in the wake of inflation in preceding decades and accumulating evidence that independent central banks deliver lower and more stable inflation (Alesina and Summers 1993; Cukierman 1992). Second, CBI is highest in advanced economies, where the median index rose from 0.5 in 1990 to 0.9 by the mid-2010s and has been stable since. Third, CBI is broadly similar in DAP and other EMDEs, with the median CBIE index in both groups rising from below 0.5 to 0.7 over the period. Economies across groups experienced a broad rise in the 1990s and 2000s, followed by a plateau. Variation across economies and over time is what this analysis exploits to compare transmission in high- and low-independence environments.

Strong fiscal institutions can reduce the risk of fiscal dominance and mitigate the influence of high indebtedness on monetary policy. Empirical evidence shows that credible fiscal institutions can

Figure 2.2 Distribution of Central Bank Independence in Different Economy Groups

Central bank independence has strengthened across economy groups since 1990, with levels generally higher in advanced economies than in other EMDEs and DAP.



CBIE = central bank independence extended, DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, p = percentile. Note: The CBIE index is a measure of *de jure* independence obtained from the codification of central bank statutes, ranging from zero (no independence) to one (full independence). The distribution of the CBIE index across economies within each group shows the median, interquartile range, and 10–90 percentile range.

Sources: Romelli, D. 2022. *The Political Economy of Reforms in Central Bank Design: Evidence from a New Dataset*. *Economic Policy*. 37(112); Romelli, D. 2025. *Trends in Central Bank Independence: A De-Jure Perspective*. In E. Farvaque and P. Stanek, eds. *Are Central Banks Still Conservative?* Edward Elgar Publishing.

strengthen fiscal discipline, macroeconomic policy credibility, and thus macroeconomic stability (Debrun et al. 2008; Caselli and Reynaud 2020). In high-debt environments, emerging economies with lower CBI and weaker fiscal institutions may face greater risks that fiscal pressures influence monetary policy decisions and transmission (Kydland and Prescott 1977; Barro and Gordon 1983). Credible fiscal institutional frameworks that feature well-designed fiscal rules, independent fiscal councils, and medium-term budget frameworks can improve fiscal discipline, reduce uncertainty about future fiscal adjustment, and lower sovereign risk premia (Debrun et al. 2008; Caselli and Reynaud 2020), thereby supporting monetary policy transmission in environments with high public debt. Bajaro, Galimberti, and Qureshi (2025) show that debt rules are particularly relevant for reducing fiscal dominance. Overall, strong CBI and credible fiscal institutions work to preserve the ability of central banks to respond to macroeconomic conditions and strengthen monetary policy transmission.

Beyond strong fiscal institutions, coordinating fiscal and monetary policy can also improve monetary policy effectiveness and transmission.

Expansionary fiscal policy can offset the effects of monetary tightening by stimulating aggregate demand, while also increasing government borrowing needs, adding to inflationary pressures, and raising sovereign risk premia—especially in environments with high public debt—thereby weakening the effectiveness of higher interest rates in cooling demand and inflation. Conflicting policy signals may thus amplify macroeconomic volatility and undermine policy credibility (Bianchi and Melosi 2019). Monetary policy effectiveness therefore depends partly on the fiscal stance prevailing at the time of monetary policy adjustments. In high-debt environments, effective policy coordination can generate a coherent policy mix that preserves fiscal sustainability while maintaining the ability of monetary policy to respond to macroeconomic conditions.

Box 2.1 Political Dismissals of Central Bank Governors Increase Inflation

Central bank independence (CBI) is key to credible monetary policy, particularly where inflation expectations are sensitive to political and fiscal developments. Independent central banks help reduce inflationary bias, mitigate time-inconsistency problems (Kydland and Prescott 1977; Barro and Gordon 1983; Rogoff 1985), anchor expectations during periods of uncertainty, and insulate policy decisions from short-term political pressures. For developing Asia and the Pacific (DAP), where institutional frameworks are still evolving and macroeconomic volatility is often high, strong CBI plays a crucial role in maintaining price stability and supporting sustainable growth.

Despite formal legal protections, political interference in central banks remains common across emerging market and developing economies (EMDEs). Political pressure can take many forms, including public criticism (Bianchi et al. 2023), informal influence, and direct intervention in leadership appointments and dismissals. These actions can weaken institutional autonomy, de-anchor inflation expectations, and undermine the credibility of monetary policy frameworks (Walsh 2017; Bianchi et al. 2023). Premature dismissals of central bank governors are a particularly visible form of interference, often signaling attempts to influence monetary policy or align central bank decisions with short-term political objectives. Such episodes can trigger inflation, financial market volatility, and currency depreciation—risks that are especially acute in DAP for lack of sufficient policy buffers (Cukierman 1992; Alesina and Summers 1993; Vuletin and Zhu 2011).

A new quarterly dataset of central bank governor turnover across 48 global economies is used to identify political interference systematically.

Qureshi and Ahmad (2026) constructed a quarterly panel database spanning Q4 1991 to Q4 2023 and covering 12 advanced economies, 27 EMDEs, and 9 economies whose income classification changed during the sample. A narrative-based identification strategy examines contemporaneous news articles, official statements, and central bank communications to determine the underlying motive for each exit (Romer and Romer 1989, 2023). This strategy distinguishes politically motivated premature dismissals from other premature dismissals,

such as those driven by performance, economic outcomes, or personal reasons. Political interference turnover is defined as premature dismissal driven by political actors and unrelated to economic crises or performance failures.

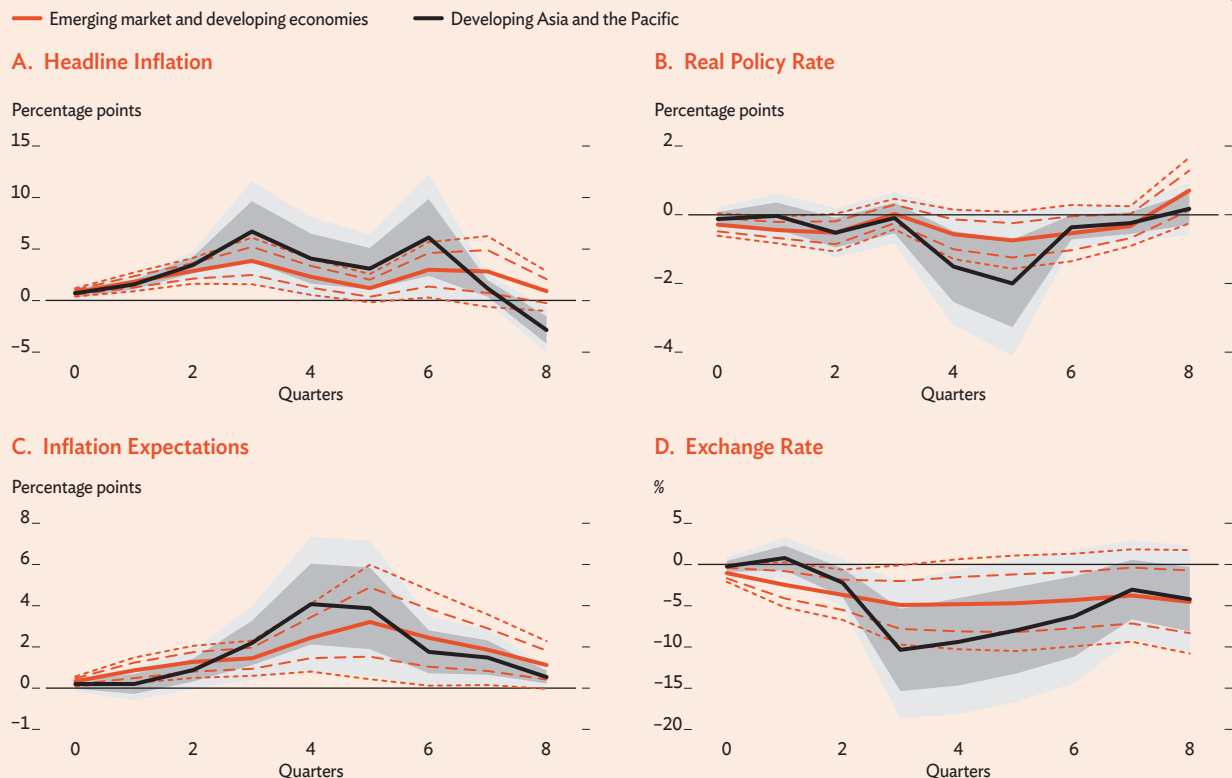
The empirical methodology relies on local projections to estimate the dynamic effects of political interference turnovers. Local projections provide a flexible and transparent way to trace impulse responses without imposing strong parametric restrictions (Jordà 2005). They are particularly well-suited for heterogeneous cross-economy panels, where structural characteristics, policy frameworks, and external vulnerabilities vary widely. The local projection specification for horizon $h = 0, 1, \dots, 8$ is given as follows:

$$y_{i,t+h} = \alpha_{i,h} + \beta_h \text{interference}_{i,t} + \sum_{l=1}^4 [\eta_{h,l} y_{i,t-l} + X_{i,t-l} \theta_{h,l}] + X_{i,t-l} \theta_{h,l} + \lambda_{y,h} + \mu_{q,h} + \varepsilon_{i,t+h} \quad (1)$$

In equation (1), $\text{interference}_{i,t}$ is a binary variable indicating whether a politically motivated turnover occurred in quarter t or not, $\alpha_{i,h}$ and $\lambda_{y,h}$ represent economy and year fixed effects, $\mu_{q,h}$ captures quarterly seasonal fluctuations in macroeconomic variables and institutions, $y_{i,t}$ is the outcome variable of interest, and $X_{i,t}$ is a vector of control variables consisting of policy rate, real exchange rate change, expected GDP growth, and headline inflation year on year. The macroeconomic consequences of political interference turnovers are examined through four key outcome variables: headline inflation, inflation expectations, real policy rates, and exchange rate expressed in local currency to US dollar (box figure). Headline inflation captures the immediate and medium-term price effects of credibility shocks. Inflation expectations reflect how households, firms, and financial markets interpret political interference and adjust their beliefs about future monetary policy. Real policy rates measure monetary stance and help determine whether political interference induces systematic monetary easing. The exchange rate captures external adjustment pressures and the extent to which credibility shocks trigger currency depreciation. The coefficient of interest is β_h , which

Box 2.1 Continued**Variation by Outcome**

Politically motivated dismissals of central bank governors in DAP are associated with higher inflation and inflation expectations.



Notes: Solid red and black lines indicate point estimates of response to a politically motivated turnover. The light (short-dash) and dark (long-dash) shaded regions are 90% and 68% confidence intervals, respectively, around the corresponding point estimates. Four lags are included for all variables in the local projection specification except the turnover. Standard errors are clustered at the economy level.

Source: Authors' calculation.

captures the response to a politically motivated exit at the h -th horizon and is allowed to vary across economies by using interaction terms.

Politically motivated dismissals of central bank governors in DAP are associated with increased inflation and inflation expectations, monetary easing, and currency depreciation. Headline inflation shows an immediate and persistent increase in DAP following politically motivated dismissals, consistent with weakening institutional credibility and greater sensitivity to policy uncertainty. Inflation expectations rise sharply, indicating that political interference de-anchors expectations more quickly in economies where communication frameworks and policy credibility are still developing (Bordo and Siklos 2015). Real policy rates fall more steeply in DAP in the aftermath of politically motivated exits, indicating

systematic monetary easing due to either direct political pressure or expectations of future policy accommodation. Local currencies depreciate more against the US dollar in DAP, amplifying inflation through higher import prices and stronger exchange rate pass-through (Ha, Stocker, and Yilmazkuday 2020). More pronounced responses in DAP than in other EMDEs may arise because central banks face stronger fiscal pressures and have weaker institutional safeguards, which is consistent with fiscal dominance dynamics (Leeper and Leith 2016; Kumhof, Nunes, and Yakadina 2010). The combination of rising inflation and inflation expectations, falling real policy rates, and currency depreciation suggests that political interference pushes DAP economies into a lower-credibility regime in which monetary policy becomes more accommodative despite rising price pressures.

continued on next page

Box 2.1 Continued**Political interference can affect macroeconomic outcomes through three main transmission channels.**

First, politically motivated dismissals weaken *de facto* CBI and reduce policy credibility, causing households, firms, and financial markets to revise their beliefs about future inflation and unanchor inflation expectations. Second, political pressure typically results in monetary easing, with newly appointed governors adopting a more accommodative stance or perceived as more willing to cut interest rates. Third, credibility shocks trigger currency depreciation, particularly in EMDEs with high external vulnerability. Depreciation raises import prices and fuels inflation through exchange rate pass-through.

These dynamics have important policy implications for DAP.

First, strengthening legal and operational CBI can reduce the likelihood and impact of politically motivated turnover. Clear appointment and dismissal procedures, transparent communication, and financial autonomy are essential to insulate central banks from political cycles. Second, credible fiscal frameworks can reduce pressure on central banks to accommodate fiscal needs, lowering the risk of fiscal dominance. Finally, improved communication strategies and anchoring inflation expectations can mitigate the inflationary effects of political interference when it occurs. These measures enhance resilience and macroeconomic stability in the face of political pressures.

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2.4 Role of Foreign Currency Debt

The currency composition of debt matters for monetary policy decisions and transmission.

Foreign currency debt exposes open economies to global financial conditions, making exchange rates and domestic financial conditions more sensitive to external shocks (IMF 2023; Eichengreen et al. 2021). When foreign currency debt is high, currency depreciation increases the local currency value of foreign currency liabilities and debt servicing costs, thereby weakening borrowers' balance sheets. This additional vulnerability can complicate monetary policy decisions, as exchange rate movements affect inflation, balance-sheet soundness, and financial stability. Central banks may therefore be more constrained in setting policy rates, as they need to balance domestic macroeconomic stabilization against exchange rate, capital flows, and

financial stability concerns, especially in economies whose domestic financial markets are open and shallow (Rey 2015; Miranda-Agrippino and Rey 2020; Qureshi and Liaqat 2020).

Foreign currency debt can weaken monetary policy transmission by increasing the influence of external financial conditions on domestic borrowing costs.

This may be particularly important where capital markets and financial intermediation are not sufficiently developed to effectively transmit domestic monetary policy adjustments. Georgiadis (2014) and Deb et al. (2023) found that monetary policy transmission is generally stronger in more financially developed economies. [Box 2.2](#) further illustrates how foreign currency debt can contribute to fiscal dominance risks and influence monetary policy transmission.

Box 2.2 Foreign Currency Debt as a Form of Fiscal Dominance

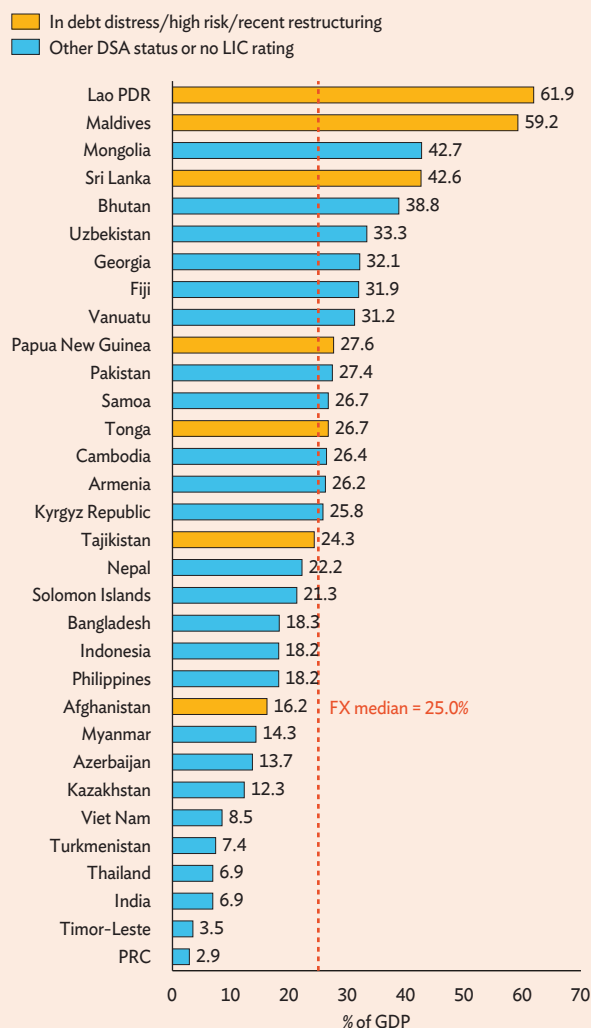
In emerging market and developing economies (EMDEs) with substantial foreign currency debt, fiscal dominance can take a distinctly open-economy form. Fiscal dominance arises when monetary policy is subordinate to the financing needs of the government, rather than to inflation and output stabilization. In economic theory, a classic mechanism has been developed in a closed-economy setting: if fiscal policy does not adjust primary surpluses to stabilize debt, the central bank is eventually forced to accommodate debt dynamics through low interest rates, inflation, or outright monetization (Sargent and Wallace 1981; Leeper 1991; Woodford 1995). Where a substantial share of public debt is external and denominated in foreign currency, the composition of debt may induce a distinct form of fiscal dominance, operating through exchange rate and other channels.^a This is a concern for developing Asia and the Pacific (DAP), where debt has risen and institutional frameworks are still evolving. Box figure 1 maps foreign currency external debt in selected economies across the region. As shown, the unweighted median for the displayed economies is 25% of GDP, but the share of foreign-currency external public debt is significantly higher in many cases, exceeding 40% in Mongolia and Sri Lanka, and about 60% in the Lao People's Democratic Republic and Maldives.^b

Several economies with high or above-median exposure face risks of external debt distress or have restructured debt.

Foreign currency debt constrains policy rate decisions and narrows monetary policy space because exchange rate movements have fiscal implications. Accumulating foreign currency debt creates a currency mismatch on the borrowers' balance sheets (Eichengreen, Hausmann, and Panizza 2007). Domestic inflation cannot erode the value of foreign-currency principal, so depreciation raises the local currency value of debt stock and cost of debt service. Central banks' interest-rate decisions must therefore weigh not only inflation and output but also the consequences of currency depreciation for the sovereign balance sheet, sovereign spreads, and external refinancing conditions. The resulting tension shapes the timing and direction of monetary policy, as raising domestic interest rates supports the currency while also increasing domestic borrowing costs, but not raising them invites depreciation that worsens the burden of foreign currency debt unless offset by growth or larger primary surpluses. Where central bank independence is weak, monetary policy may tend to sacrifice the local currency rather than target domestic stabilization.

Box 2.2 Continued**1 Foreign Currency External Public Debt in Developing Asia and the Pacific as a Percentage of Gross Domestic Product, 2024**

Several highly exposed DAP economies face external debt distress or have undergone debt restructuring.



DAP = developing Asia and the Pacific, DSA = debt-sustainability analysis, GDP = Gross domestic product, FX = foreign exchange, IDS = International Debt Statistics, IMF = International Monetary Fund, Lao PDR = Lao People's Democratic Republic, LIC = low-income country, PRC = People's Republic of China.

Notes: FX-denominated external public debt is proxied using long-term external public and publicly guaranteed debt (World Bank indicator DT.DOD.DPPG.CD) multiplied by the foreign-currency share from World Bank IDS source-6 currency-composition data, plus use of IMF credit (DT.DOD.DIMF.CD), divided by gross domestic product (NY.GDP.MKTP.CD). IMF credit is included in full because it is denominated by special drawing rights. Data are from 2024 for all displayed economies. For Bhutan, the IDS "other currencies" share is treated as Indian-rupee hydropower debt and reclassified as non-FX mismatch given the ngultrum-rupee peg and hydropower risk-sharing arrangements with India. Material "other currencies" buckets for the Lao PDR, Papua New Guinea, Samoa, and Tonga are conservatively treated as FX exposure. The measure excludes short-term external debt, central-bank swap lines, and other public FX liabilities outside long-term external public and publicly guaranteed debt and IMF credit, so it understates exposure in some cases, notably the Lao PDR, where national data put public and publicly guaranteed external debt at about 85.0% of GDP at the end of 2024, versus 61.9% here. Red bars denote economies classified as in debt distress or at high risk of external debt distress in the latest IMF–World Bank LIC DSA list as of 31 March 2026, plus Sri Lanka as a recent debt-restructuring case. Pakistan is a Debt Sustainability Analysis for Market Access Countries/IMF-program economy and has no LIC DSA risk rating. Afghanistan's high-risk classification is the latest published IMF–World Bank LIC DSA rating, but dates to 28 June 2021, before the August 2021 regime change. The dashed line marks the unweighted median of displayed economies.

Sources: World Bank International Debt Statistics and World Development Indicators Application Programming Interface (API), retrieved 8 July 2026; IMF list of LIC DSAs as of 31 March 2026; Bhutan Ministry of Finance Debt Situation Report, December 2024; IMF Bhutan Article IV consultation.

High foreign currency debt distorts monetary policy transmission. An external shock that causes local currency depreciation works through five mutually reinforcing channels:

- (i) Under the *valuation channel*, depreciation means that each unit of existing foreign-currency debt converts into more local currency, so both the recorded debt stock and the budgetary cost of debt service rise even before the government borrows again. The resulting fiscal gap may require higher taxes, lower spending,
- (ii) Under the *sovereign-risk channel*, a larger local-currency debt burden and a weaker fiscal outlook prompt investors to demand a higher risk premium on government debt, and some may decline to roll over maturing claims, further increasing financing needs and default risks (IMF 2006; Alberola et al. 2021).

continued on next page

Box 2.2 Continued

- (iii) Under the *balance-sheet channel*, banks and firms that earn local currency but repay debt in foreign currency see their liabilities and debt payments rise relative to their income and assets. Their net worth and collateral weaken, banks restrict credit, and firms cut investment and employment, so depreciation can reduce rather than stimulate output, consumption, and investment (Céspedes, Chang, and Velasco 2004; Aghion, Bacchetta, and Banerjee 2000; Juselius and Xia 2026).
- (iv) Under the *pass-through channel*, depreciation raises the local-currency price of imported consumer goods, fuel, and inputs, and firms may pass these higher costs to consumers. If high foreign currency debt weakens confidence in the authorities' ability to contain inflation, firms and workers may build higher expected inflation into prices and wages, making the initial price increase larger and more persistent (Carrière-Swallow et al. 2021; Brandão-Marques et al. 2024).
- (v) Under the *external-liquidity channel*, borrowers must obtain foreign currency to service their obligations, which the central bank cannot issue.

Capital outflows, foreign exchange intervention, and repayments can therefore reduce the reserve buffer, which may make lenders less willing to roll over debt, intensifying external liquidity pressure (Committee on the Global Financial System 2007; International Monetary Fund 2011).

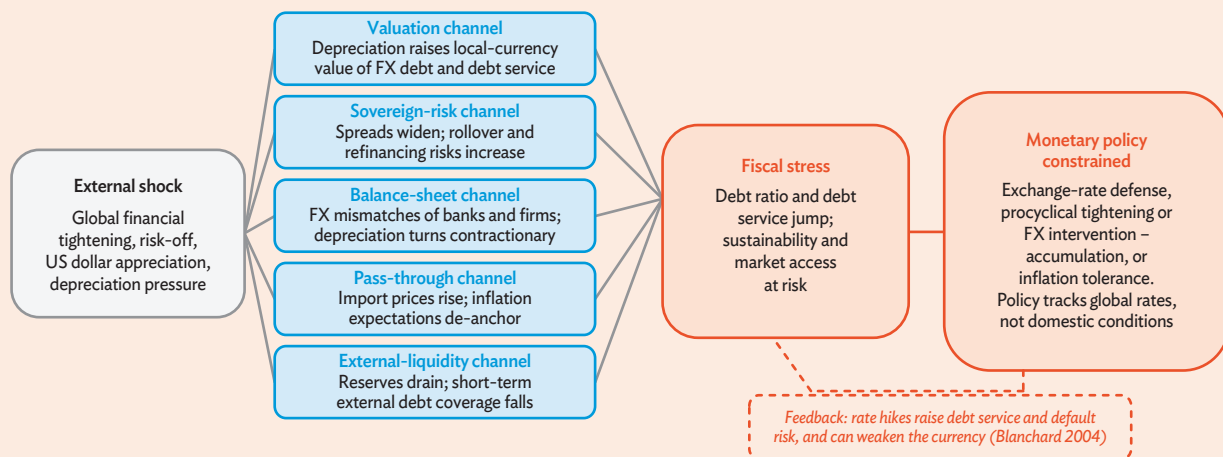
These channels reinforce each other (box figure 2). Currency depreciation that increases the public debt burden also widens sovereign spreads, tightening financial conditions and weakening private balance sheets. As a result, monetary policy transmits not only through standard demand and exchange-rate channels but also through sovereign risk and balance sheets. Thus, higher external debt can weaken the central bank's grip on inflation precisely when the currency is under pressure.

High foreign-currency debt thus exposes monetary policy to the global financial cycle.

When United States interest rates rise or global risk appetite deteriorates, capital outflows, depreciation, and refinancing stress can constrain domestic monetary policy to follow global conditions, even under a floating exchange rate (Rey 2015). Consistent with constrained policy autonomy,

2 How High Foreign-Currency External Debt Constrains Monetary Policy

Currency depreciation increases the burden of foreign-currency debt, limiting the effectiveness of monetary policy.



FX = foreign exchange.

Notes: The figure summarizes the conceptual channels identified in the literature linking foreign-currency debt to fiscal dominance pressures on monetary policy. The dashed feedback arrow captures the mechanism in Blanchard, O. 2004. *Fiscal Dominance and Inflation Targeting: Lessons from Brazil*. NBER Working Paper No. 10389. National Bureau of Economic Research, whereby monetary tightening under fiscal stress can raise default risk and weaken the currency, rather than support it.

Source: Authors' illustration.

Box 2.2 Continued

economies with high foreign currency debt and shallow foreign exchange markets tend to move policy rates in response to United States monetary policy surprises, while exhibiting smaller exchange-rate movements (Juselius and Xia 2026).

High foreign currency debt produces a form of fiscal dominance that pushes in the opposite direction from domestic debt. When domestic debt is high, central banks face pressures to tolerate inflation and keep interest rates low to reduce the real debt burden. When foreign currency debt is high, the pressure runs the other way, as central banks are pushed to prevent currency depreciation by intervening in foreign exchange markets even under a floating exchange rate regime (Calvo and Reinhart 2002) or by keeping interest rates high during downturns and postponing interest rate cuts, making monetary policy procyclical. Both situations are a form of fiscal dominance, whereby monetary policy is subordinate to debt sustainability rather than macroeconomic stabilization.

The policy agenda should aim to restore monetary policy space and credibility. The structural remedy is to reduce the foreign currency share of sovereign borrowing by developing deep and liquid local currency bond markets, which turn depreciation from a fiscal shock into a relative-price adjustment. Credible institutions can also moderate fiscal dominance constraints. Central bank independence and credible inflation targeting are associated with lower exchange-rate pass-through (Carriere-Swallow et al. 2021), while fiscal rules and debt transparency can weaken the link between external debt and policy distortion. Adequate international reserves and cautious use of foreign exchange intervention can restore policy space where mismatches and shallow foreign exchange markets amplify destabilizing exchange-rate movements, though they complement rather than substitute for sound monetary and fiscal frameworks (IMF 2023). Containing this open-economy form of fiscal dominance is a precondition for monetary policy to perform its stabilization role.

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Box 2.2 Continued

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^a A useful distinction exists between external debt and debt denominated in foreign currency. Some debt owed to nonresidents can be in local currency, and some debt issued domestically can be indexed to or denominated in foreign currency. For fiscal-dominance analysis, the key risk is the net unhedged foreign-currency liability position of the public sector and, often, the broader economy.

^b Foreign currency external debt is proxied using a measure of long-term external public and publicly guaranteed debt, adjusted using World Bank International Debt Statistics (IDS) currency-composition data, plus the use of International Monetary Fund credit and SDR allocations. Currency shares are from the World Bank IDS, which breaks down long-term external public and publicly guaranteed debt by currency denomination.

3 Sample Construction and Empirical Strategy

3.1 Data Collection

The empirical framework exploits both cross-economy and time variation in a comprehensive international database. For analysis of monetary policy decisions, the chapter constructs a global economy-month panel covering 52 economies from May 1994 to January 2024, using both forecast and realized data of key macroeconomic variables. Subject to data availability, the augmented Taylor-rule estimation sample comprises 9,523 economy-month observations. For analysis of monetary policy transmission, the chapter constructs an economy-quarter panel covering 85 economies from Q1 1993 to Q4 2025, as the key outcome variable, real GDP, is available only at quarterly frequency. The local projection estimation sample comprises 7,063 economy-quarter observations across global advanced economies and EMDEs. The database draws on multiple sources. Appendix Table A1.1 lists definitions of key variables and the source of the related data. Forecasts are sourced from Consensus Economics and Focus Economics and are converted from annual fixed-event forecasts to fixed-horizon forecasts following Bajaro, Galimberti, and Qureshi (2025).

The expected fiscal balance, a key variable in the monetary policy decision analysis, is the projected difference between government revenue and expenditure as a ratio of GDP. Definitions of fiscal balance forecasts vary across economies, depending on what is commonly reported in the consensus data (see Table A.1 in Bajaro, Galimberti, and Qureshi, 2025). To limit the impact of extreme values, the chapter excludes observations where inflation rates were higher than 40% or policy rates changed by more than 10 percentage points, and it winsorizes bond yields data at the 1st and 99th percentiles.¹ Appendix Table A1.2 presents summary statistics of the key

variables. Box 3.1 discusses the correlation between public and private debt levels and provides additional insights into their potential influence on monetary policy decisions and transmission.

3.2 Determinants of Monetary Policy Decisions: Augmented Taylor Rule

An augmented monetary policy rule framework is adopted to analyze interest rate settings. Standard monetary policy rules, also known as Taylor rules, depict how central banks set interest rates to achieve price stability and sustain economic growth (Taylor 1993). The framework has been further extended to incorporate forward-looking behavior, with forecasts of inflation and GDP growth (Clarida, Galí, and Gertler 2000) and open-economy concerns, such as currency depreciation pressures (Taylor 2001). In this chapter, augmented Taylor rules are estimated in reduced-form panel regression specifications of the following form:

$$\begin{aligned} i_{i,t} &= \rho(L)i_{i,t-1} + \beta_1 \pi_{i,t} + \beta_2 y_{i,t-1} \\ &\quad + \beta_3 X_{i,t} + \beta_4 Z_{i,t} + \alpha_i + u_{i,t}, \\ u_{i,t} &= \varrho(L)u_{i,t-1} + \varepsilon_{i,t}, \end{aligned} \tag{1}$$

where $i_{i,t}$ denotes the nominal interest rate for economy i in month or quarter t ; $\pi_{i,t}$ and $y_{i,t-1}$ denote inflation and real GDP growth, respectively, with their timing and definitions subject to sensitivity analysis; $X_{i,t}$ denotes a vector of variables augmenting the Taylor rule, including the exchange rate depreciation and the US natural rate of interest, which control for the effects of imported inflation and trends in global interest rates, respectively; $Z_{i,t}$ is a vector of fiscal variables used to

¹ Winsorizing limits the influence of outliers by resetting extreme observations to a threshold value rather than dropping them. Here, bond yields below the 1st percentile are reset to the 1st percentile value and those above the 99th percentile to the 99th percentile value, so all observations remain in the sample.

Box 3.1 Correlation Between Public and Private Debt

The correlation between public and private debt may confound the analysis of monetary policy under high-debt environments. To capture the different mechanisms through which different types of debt operate, as shown in Table 2.1, this box decomposes overall indebtedness into public and private debt, both measured as shares of GDP. These debt measures may be influenced by common factors, including long-term borrowing costs, domestic economic cycles, and global conditions such as US monetary policy. As the chapter aims to assess whether public and private debt affect monetary policy differently, it is important to understand the extent to which the two debt measures are correlated within economies. If they are highly correlated, separating public and private debt may yield similar results because the two variables contain overlapping information. If correlation is weak, disaggregation allows public and private debt to capture distinct dimensions of how indebtedness may interact with monetary policy.

Public and private debt are not strongly correlated in the samples: global, emerging market and developing economies (EMDEs), and developing Asia and the Pacific (DAP). Box figure 1 reports the correlations between public and private debt for the global, EMDEs, and DAP samples. Panel A presents the overall association between public and private debt across all economy-time observations. For the global

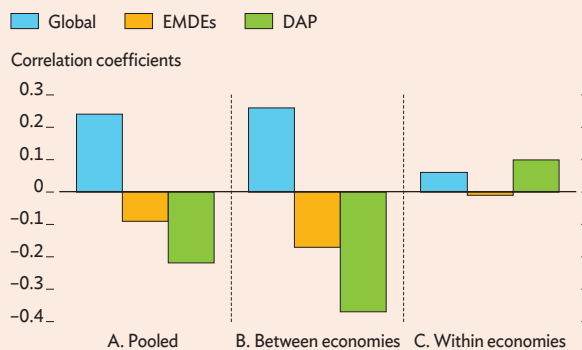
sample, the correlation is about 0.24. This modest positive correlation suggests that higher public debt tends to coexist with higher private debt, which may reflect an accumulation of leverage during periods of low interest rates and abundant liquidity. By contrast, correlations in EMDEs and DAP economies run from modest to negative, suggesting that public and private borrowing do not generally increase together in these economies. This pattern may reflect some substitution between public and private borrowing in emerging economies. For example, rapid increases in government borrowing may coincide with weaker borrowing by households and firms, reflecting perhaps crowding-out effects or different financing cycles across the public and private sectors.

Overall correlations are driven mainly by differences across economies. Panel B reports between-economy correlation, which captures structural co-movement between public and private debt across economies. Similar to panel A, the correlation for the global sample is a low 0.26. A positive correlation indicates that economies with higher public debt also tend to have higher private debt. This may reflect that public and private indebtedness are jointly associated with economy-specific structural factors, such as financial development, income levels, and institutional or macroeconomic characteristics. By contrast, the correlations for EMDEs and DAP economies are negative, though also modest. This indicates that in emerging economies higher public debt tends to coincide with lower private debt, suggesting that borrowing is concentrated in different sectors across economies. For example, economies with less-developed financial systems may have relatively limited private debt and rely more on government borrowing to finance investment.

Public and private debt tend to evolve independently. Panel C reports within-economy correlation between public and private debt, which indicates whether the two move together within an economy over time. A positive correlation indicates synchronized borrowing cycles, which may arise during common borrowing cycles, such as during periods of favorable financial conditions. This positive co-movement may compound financial vulnerabilities when public and private balance sheets weaken simultaneously, reducing policy space to temper adverse shocks. The data show no such pattern. In

1 Public and Private Debt Correlation Across and Within Economies

Public and private debt are weakly correlated, with a positive relationship globally but weakly positive or negative relationships in EMDEs and DAP.



DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies.

Source: Authors' calculations.

Box 3.1 Continued

panel C, correlations are no higher than 0.1 in the global and DAP samples, and marginally negative at -0.01 in EMDEs. These near-zero correlations indicate that public and private debt generally do not move together within economies over time, suggesting that the two types of debt largely follow their own dynamics and may create different constraints on monetary policy.

Indebtedness may interact with monetary policy differently depending on institutional conditions, particularly central bank independence (CBI). It is therefore important to assess whether institutional factors contain information distinct from public and private debt. If they largely capture the same underlying characteristics, examining their interactions with debt would add little to the analysis of debt–monetary policy dynamics. In this chapter, CBI is measured using the index developed in Romelli (2022, 2025).

CBI provides information complementary to public and private debt. To assess the extent to which public debt, private debt, and CBI capture distinct dimensions of economic and institutional conditions, the chapter conducts a principal component analysis. As shown in panel A of box figure 2, the first principal component explains 43% of the total variation across the three indicators, while the first two components together explain 76%. A third component is needed to raise the cumulative explained variation to 100%. This suggests that, although the indicators share some common variation, no single dimension dominates and substantial information remains across multiple dimensions. Panel B provides further evidence of this distinction. The loading vectors for public debt, private debt, and CBI point in different directions in the principal-component space, indicating that they capture different aspects of economic conditions rather than largely overlapping information. These results support examining CBI separately as a potential conditioning factor shaping how debt influences monetary policy.

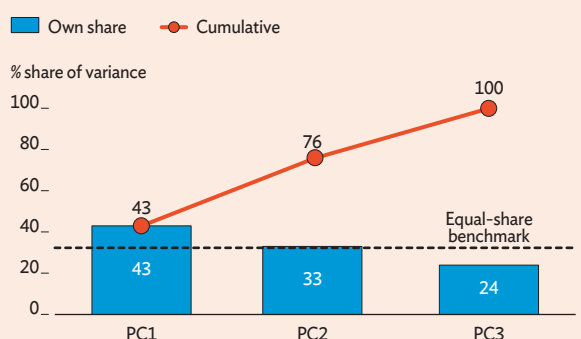
References:

- Romelli, D. 2022. *The Political Economy of Reforms in Central Bank Design: Evidence from a New Dataset*. *Economic Policy*. 37(112).
 Romelli, D. 2025. *Trends in Central Bank Independence: A De-Jure Perspective*. In E. Farvaque and P. Stanek, eds. *Are Central Banks Still Conservative?* Edward Elgar Publishing.

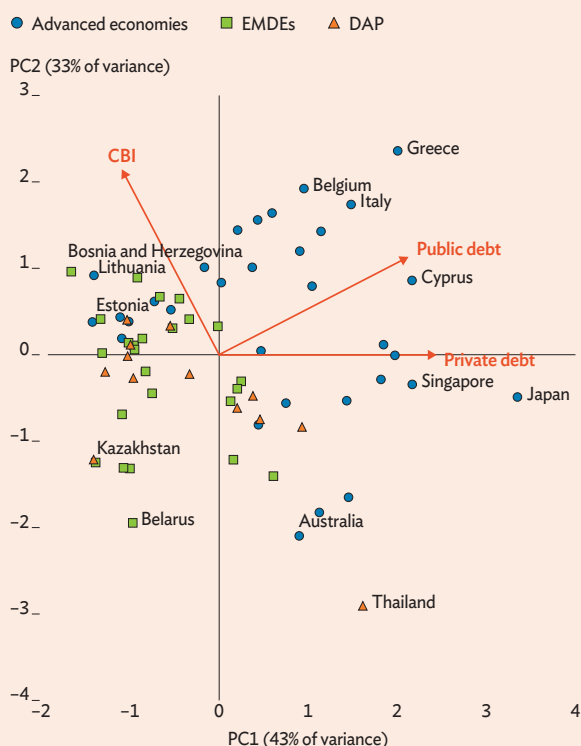
2 Principal Component Analysis of Debt and Central Bank Independence

Principal component analysis shows that CBI provides information distinct from public and private debt.

A. Variance Explained by Principal Components



B. Economies and Variable Loadings in Principal-Component Space



CBI = central bank independence, DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, PC = principal component.

Notes: Standardized economy averages. 71 economies with all three variables observed. Arrows point in the direction of increase; arrows that nearly coincide are variables that rank economies the same way.

Source: Authors' calculations.

assess fiscal dominance effects; α_i is the economy-specific fixed effect, which captures cross-economy differences in natural interest rates, inflation targets, and potential growth; and $u_{i,t}$ is a serially persistent residual determined by the unexpected monetary policy shocks, $\varepsilon_{i,t}$.

The effects of fiscal dominance and financial stability concerns on monetary policy decisions are assessed by augmenting the Taylor rule with fiscal and debt variables.

To examine whether high debt levels and fiscal positions are reflected in actual policy rate decisions, this chapter follows the augmentation strategy of Bajaro, Galimberti, and Qureshi (2025), which augmented the Taylor rule with forecasts of fiscal balances and found evidence consistent with fiscal dominance pressures. This chapter extends that framework by adding realized public and private debt as well as actual fiscal balances. The existence of fiscal dominance and financial stability concerns in monetary policy decisions is evaluated by testing the statistical significance of β_4 in equation (1). Heterogeneity analysis is conducted by interacting the explanatory variables in equation (1) with subgroup dummy variables, covering the distinction across advanced economies, EMDEs, and DAP economies, as well as public and private debt regimes and CBI. The analysis thus assesses not only whether fiscal and private debt conditions systematically affect monetary policy decisions beyond conventional macroeconomic objectives, but also whether the effects differ across economy groups, debt regimes, and levels of CBI.

The augmented Taylor rule incorporates interest rate smoothing and persistent monetary policy shocks.

Interest rate smoothing reflects the empirical observation that central banks generally adjust policy rates only gradually, owing to real-time uncertainties, rather than moving immediately to the desired level (Sack and Wieland 2000). This feature is captured by the lags of nominal interest rates, $\rho(L)i_{i,t-1}$ in equation (1). The specification accounts for persistent monetary policy shocks as an additional source of inertia in interest rates. The rationale is that central banks may at times respond to factors outside the Taylor rule, such as asset prices, liquidity conditions, or market uncertainty, which is reflected as persistence in the policy shocks derived from the estimated monetary policy rule (Coibion and Gorodnichenko 2012). This persistence is captured

by the inclusion of lagged residuals, $\rho(L)u_{i,t-1}$ in equation (1). Both components are allowed to have multiple lags, with optimal lag orders selected by minimizing the Bayesian information criterion, which penalizes the addition of model parameters relative to the model fit to obtain a parsimonious specification.

3.3 Construction of Monetary Policy Shocks

Identifying the effects of monetary policy requires separating exogenous monetary policy shocks from systematic policy responses.

The impacts of debt on monetary policy decisions and transmission are interconnected, as monetary policy actions and their effects are jointly determined within a broader macrofinancial equilibrium. Central banks are expected to adjust interest rates in response to inflation, growth, and other factors relevant to their stability goals, such as exchange rates. Observed interest rate adjustments, therefore, cannot be directly interpreted as monetary policy shocks. Estimating the causal effect of monetary policy requires isolating the unexpected component of policy adjustments—that is, the part not driven by the central bank’s expected response to macroeconomic conditions.

Several empirical strategies have been proposed in the literature to identify monetary policy shocks.

Early approaches used narrative methods, as in Romer and Romer (2004), or structural vector autoregressions. Later approaches use Taylor-rule residuals, interpreting deviations from the systematic policy rule as monetary shocks. For example, Coibion and Gorodnichenko (2012) showed that correctly modeling interest rate smoothing is crucial because policy rates are highly persistent. Recent cross-market studies increasingly use forecast-based and high-frequency identification. Deb et al. (2023) identified monetary policy shocks using forecast errors in short-term interest rates, purged of expected macroeconomic conditions using a Taylor-rule framework. Bolhuis, Das, and Yao (2024) constructed a cross-country database of high-frequency monetary policy shocks using daily changes in interest-rate swap rates around central bank announcements. This approach is designed to capture unexpected policy responses while separating them from information effects. Checo, Grigoli, and Sandri

(2024) provided additional evidence on monetary policy transmission in emerging markets using external instruments based on financial analysts' forecast errors.

In this chapter, monetary policy shocks are derived from panel estimates of the augmented Taylor rule in equation (1). Beyond the expected behavior of central banks embedded in the Taylor rule estimates, the identified shocks account for policy rate inertia from interest rate smoothing and shock persistence. The use of panel estimates imposes discipline on the parameters of the policy reaction function, while fixed effects allow flexibility to capture cross-economy variation. The resulting shocks thus capture unexpected monetary policy responses that are comparable across economies despite differences in monetary policy frameworks. Positive values indicate monetary policy tighter than expected, negative values unexpected easing.

3.4 Transmission of Monetary Policy Shocks: A Local Projection Approach

Assessing the transmission of monetary policy requires an empirical framework that accounts for macroeconomic dynamics. Monetary policy affects the economy gradually as interest rate adjustments pass through to borrowing costs, asset prices, consumer prices, investment, consumption, and output over several quarters. Measuring these dynamic responses requires an empirical framework that can trace the evolution of macroeconomic and financial variables over time after a monetary policy shock. This chapter follows the local projection methodology proposed by Jordà (2005) to examine the responses of economic variables to the monetary policy shocks constructed in Section 3.3.

The local projection method is a standard approach for estimating dynamic policy responses in macroeconomics. Compared with traditional vector autoregressive models, local projections estimate a separate regression at each horizon, which makes them robust to model misspecification and allows

nonlinearities and state-dependent responses to be accommodated simply by interacting the monetary policy shock with alternative conditioning variables. This flexibility makes the framework well suited to comparing monetary policy transmission across heterogeneous economic conditions. For each forecast horizon h , the following baseline model specification is estimated:

$$Y_{i,t+h} - Y_{i,t-1} = \alpha_i + \beta_h MPShock_{i,t} + \Gamma X_{i,t} + \sum_{j=1}^h \delta_j MPShock_{i,t+j} + \varepsilon_{i,t+h}, \quad (2)$$

where $Y_{i,t+h}$ denotes the outcome variable of economy i , h quarters after the shock, measured relative to its level in the quarter before the shock; $MPShock_{i,t}$ is the monetary policy shocks estimated from the augmented Taylor rule panel regression described in Section 3.3; α_i denotes economy fixed effects; $X_{i,t}$ collects four lags of the outcome variable, domestic and US policy rates, consumer price inflation, real GDP growth (omitted when real GDP is itself the outcome), currency depreciation, fiscal balance, and the monetary policy shock itself.²

Local projections provide direct estimates of dynamic responses to monetary policy shocks, while controlling for other determinants of transmission. The coefficient of interest, β_h , tracks the cumulative response of the outcome at horizon h ; the model is estimated for horizons of 0–8 quarters, and the impact-period response is normalized to zero at the base period $t-1$. The specification controls for monetary policy shocks occurring between the shock quarter and the response horizon, $MPShock_{i,t+j}$ for $j=0, \dots, h$, so that β_h measures the response to the time- t shock holding subsequent policy surprises fixed, following Teulings and Zubanov (2014). Standard errors are clustered at the economy level. [Box 3.2](#) provides full details on interpreting the cumulative responses.

Analysis focuses on two sets of outcome variables, capturing the impacts of monetary policy shocks on economic activity and financial markets.

The first is real economic activity, measured as the

² US policy rates are included to capture common trends in international monetary policy, as domestic policy rates often reflect synchronous global financial cycles.

logarithm of real GDP, so that estimated responses read as cumulative percentage changes in the value of real GDP. The second is sovereign bond markets, through 2-year and 10-year government bond yields. Yields enter in levels, so their responses read directly in basis points. To limit the influence of extreme observations, such as yield spikes during crises, yields are winsorized at the 1st and 99th percentiles before estimation.

One further adjustment is applied to the monetary policy shock before estimation. Although Taylor-rule residuals remove the systematic response of policy rates to available macroeconomic information, they may still contain a component that reflects information about the near-term path of the economy, for example when central banks react to news about inflation or currency pressures not yet visible in the data used to estimate policy rules. To address this, the shock is purged by regressing it on current inflation and currency depreciation, as well as their values over the subsequent four quarters, together with economy fixed effects. The residuals from this regression are then used in all local projection estimations. This step removes any anticipated or information-driven component of the measured policy surprises, in the spirit of the central bank information effects documented in the literature (e.g., Nakamura and Steinsson 2018; and Jarociński and Karadi 2020).

Performing the adjustment as a separate step, rather than including future macroeconomic outcomes directly in the Taylor-rule regressions, keeps the estimated policy rules as a description of how central banks respond to both public and private information available at the time of their decisions. It also preserves the interpretation of the reaction-function estimates in Section 4.

To estimate how responses to monetary policy shocks vary by debt level and institutional conditions, baseline local projections are extended in two ways. For debt variables, which are continuous, the monetary policy shock is interacted with smooth logistic transition functions of public debt and private debt. As such, each observation is weighted between a high-debt and a low-debt state rather than being assigned to a regime by an arbitrary threshold. For development and institutional dimensions, which are categorical, transmission is compared across different economy subsamples: economies with high and low CBI, as defined relative to the full-sample median of the CBI index; and economies grouped by inflation-targeting status, exchange-rate regime, and economic development and income group. These dimensions capture differences in fiscal space, balance-sheet vulnerabilities, and institutional credibility that may amplify or attenuate the effects of monetary policy shocks.

Box 3.2 Understanding Cumulative Responses from Local Projections

Local projections report cumulative responses.

For each horizon, the estimated coefficient measures the cumulative change in the outcome variables relative to the quarter immediately preceding the monetary policy shock. For real GDP, which enters in logarithms, responses read as cumulative percentage changes in the level of output; for bond yields, which enter in levels, responses read in basis points. Positive estimated values indicate that the variable is above its pre-shock level, while negative values indicate that it is below its pre-shock level.

Confidence bands convey the uncertainty

around estimated impacts. Each impulse response function is accompanied by 90% confidence bands, constructed using standard errors clustered at the economy level. The confidence bands summarize

estimation uncertainty: responses whose bands exclude zero are statistically significant at the 10% level, larger deviations from zero imply stronger effects of monetary policy, and wider bands indicate greater uncertainty about the magnitude of the estimated effects.

Impulse response functions are presented in the analysis as cumulative responses over an 8-quarter horizon following a surprise monetary policy tightening. The box figure provides a guide to interpreting these functions. As illustrated, the solid line represents the estimated cumulative response of the outcome variable, while the shaded area denotes the corresponding 90% confidence interval. The horizontal dashed line indicates no effect.

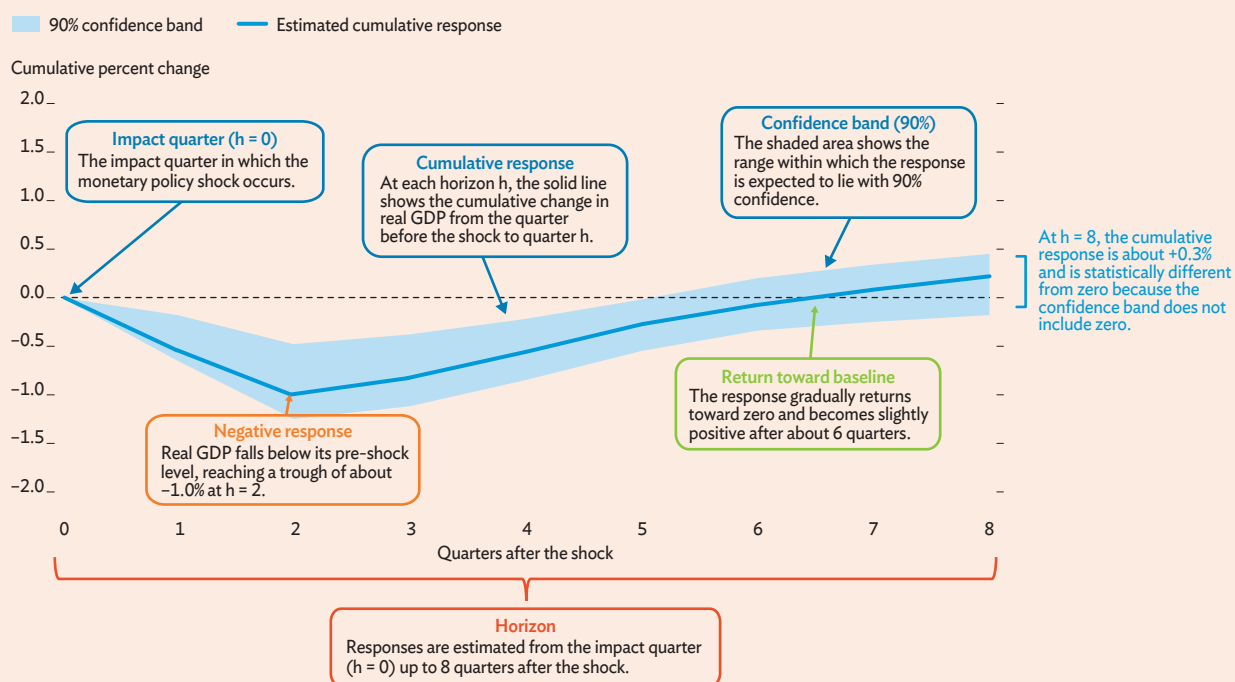
Box 3.2 Continued**State-dependent impulse response estimates allow inferences about how debt levels influence the transmission of monetary policy.**

For state-dependent analysis in Section 5.2, each figure reports two impulse responses: the response in the high state (for example, high debt), shown by the solid blue line, and the response in the low state, shown by the dashed red line. For debt regimes, these states are defined by smooth transition weights, so the two lines trace the responses at the high- and low-debt poles of the distribution rather than the average responses of two fixed groups of economies.

In institutional comparisons in Section 6, the two lines contrast high- and low-debt responses within the relevant subsample. Differences between the two responses indicate how debt levels and institutional characteristics influence the transmission of monetary policy. Because the two responses are estimated from the same regression and are correlated, overlapping confidence bands do not by themselves imply that the difference between them is statistically insignificant. Estimation samples differ modestly across outcome variables and conditioning variables based on data availability.

Interpreting a Cumulative Impulse-Response Function

This figure illustrates cumulative responses of an outcome variable to a surprise monetary policy tightening.



GDP = gross domestic product, h = horizon.

Source: Authors' illustration.

This box was written by Jaqueson K. Galimberti, Tolga Ozden, and Shu Tian of the Economic Research and Development Impact Department, ADB, Manila.

4 Role of Debt and Fiscal Imbalances in Monetary Policy Decisions

4.1 Overall Sample Taylor Rule Estimates

Panel Taylor rule estimates provide a reasonable description of conventional determinants of monetary policy decisions (Table 4.1).

Responses to inflation are consistently positive and statistically significant, indicating that price stability is a key determinant of monetary policy decisions. Specifications with contemporaneous actual inflation (columns 2 and 4–8) are preferred over lagged inflation (column 3), as they yield estimates more consistent with the forward-looking nature of monetary policy (column 1). Responses to GDP growth are smaller and significant only for lagged values (columns 3–8), reflecting the difficulty of assessing growth conditions in real time. Currency depreciation is positively associated with interest rates, in line with open economy concerns that it can lead to imported inflation. Finally, interest rates are strongly associated with the US natural rate, here used as a proxy for trends in global interest rates, indicating an important role for synchronous global monetary policy cycles.

There is some evidence of fiscal dominance effects in the overall sample, driven by fiscal balance concerns. In the Taylor rule estimations, the fiscal balance enters with a positive sign (expected fiscal balance in column 1, and actual fiscal balance in columns 5–8), indicating co-movement with interest rates. As such, a deterioration in the fiscal balance tends to be associated with lower interest rates. This is consistent with fiscal dominance, where concerns about debt servicing pressure central banks to deviate from price stability and growth objectives. The evidence is stronger under the monthly forward-looking specification (column 1), indicating that deterioration by 1 percentage point (pp) in the expected fiscal balance is associated with an interest rate lower by 0.16 pps, on average. The relationship weakens under the

quarterly specification using the actual fiscal balance variable (column 5), indicating the relevance of higher-frequency forward-looking information, though jointly controlling for public and private debt marginally restores statistical significance (column 8). Public and private debt alone show no significant relationship with interest rates after accounting for conventional Taylor rule determinants (columns 6 and 7), which is consistent with debt acting as a conditioning factor rather than a direct determinant of monetary policy decisions (Bajaro, Galimberti, and Qureshi 2025).

4.2 Heterogeneity Analysis of Fiscal Dominance Effects

The stage of development matters, with fiscal dominance stronger in emerging market and developing economies (Figure 4.1). A 1 pp deterioration in the fiscal balance in EMDEs is associated with an interest rate 0.22 pps lower, on average, while in advanced economies that effect falls to 0.07 pps and is only marginally significant. These effects switch sign and turn insignificant in DAP economies, which is consistent with evidence that financial markets perceive little risk of fiscal dominance in the region ([Box 4.1](#)).

Fiscal dominance is stronger in economies with high public debt and weaker where private debt is high. A 1 pp deterioration in the fiscal balance is associated with an average interest rate 0.32 pps lower in economies with high public debt, which is the strongest relationship across the subgroupings. The level of public debt thus appears to be the main conditioning factor for the emergence of fiscal dominance, in line with expectations that concerns about sovereign debt sustainability put pressure on monetary policy. Higher public debt raises debt-servicing costs and makes them more sensitive to interest rates. In contrast, higher

Table 4.1 Taylor Rule Panel Estimation Results

Policy rates respond to conventional determinants of monetary policy decisions, but also to fiscal balances.

	(1) Monthly	(2) Quarterly	(3) Quarterly	(4) Quarterly	(5) Quarterly	(6) Quarterly	(7) Quarterly	(8) Quarterly
Inflation								
Expected	0.889***							
Contemporaneous		0.702***		0.703***	0.687***	0.603***	0.719***	0.650***
Lagged			0.368***					
GDP growth								
Expected	0.134							
Contemporaneous		0.017						
Lagged			0.086***	0.035***	0.033***	0.025*	0.027**	0.027**
Currency depreciation								
Contemporaneous	0.032*	0.045**		0.047**	0.056**	0.033	0.039	0.021
Lagged			0.037					
US natural rate	0.769***	1.196***	1.285***	1.180***	1.227***	1.106***	1.315***	1.111***
Fiscal balance								
Expected	0.160***							
Contemporaneous					0.030			0.094*
Public debt						0.003		0.003
Private debt							-0.002	-0.006
Interest rate smoothing	0.841***	0.925***	0.958***	0.926***	0.929***	0.909***	0.929***	0.923***
Autoregressive policy shocks	0.705***	-0.174	-0.872*	-0.176	-0.146	-0.040	-0.166	-0.109
No. of observations	9,523	8,039	7,989	8,013	7,491	7,150	7,156	6,221
No. of economies	52	89	89	89	89	85	89	85
Lag order	6	6	6	6	6	6	5	5
Autoregressive order	12	6	6	6	6	6	5	5
R-squared (overall)	0.992	0.978	0.977	0.978	0.979	0.981	0.979	0.983
Bayesian info criterion	0.886	2.480	2.548	2.481	2.384	2.229	2.263	1.964
Durbin-Watson stat.	1.833	1.549	1.519	1.531	1.624	1.664	1.507	1.696

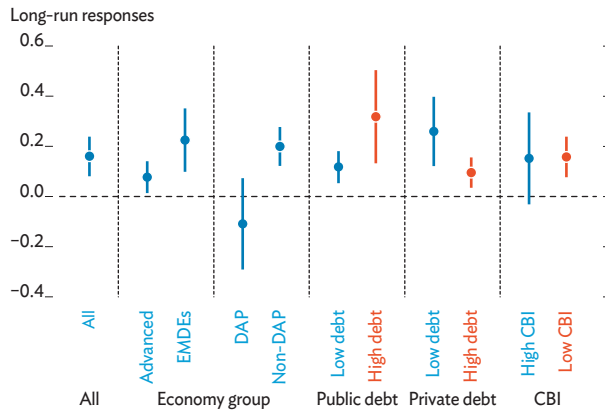
Notes: The table reports estimated coefficients of the augmented Taylor-rule monetary policy decision functions from model specification (1). The dependent variable is the nominal policy interest rate, while explanatory variables are listed in the first column. The estimation sample varies across specifications due to data availability. ***, **, and * denote estimates statistically significant at the 1%, 5%, and 10% level, respectively, calculated based on robust standard errors (period-clustered). Apart from the coefficients on interest rate smoothing and autoregressive policy shocks, coefficient estimates are the implied long-run responses and can be interpreted in percentage-point (pp) terms of the explanatory variable and interest rates. E.g., a 0.889 coefficient on expected inflation indicates that a 1 pp increase in expected inflation is associated with a long-run increase in interest rates of 0.889 pps. Coefficient estimates for interest rate smoothing and autoregressive policy shocks are the sum of corresponding lagged estimates. Lag orders are selected by minimizing the Bayesian information criterion over a grid from 0 to 12 lags for the monthly specification and 0 to 6 lags for quarterly specifications.

private debt is found to weaken fiscal dominance effects. In economies with high private debt, a 1 pp deterioration in the fiscal balance is associated with an interest rate 0.09 pps lower, on average, against 0.26 pps under low private debt. One interpretation is that higher private leverage increases consideration of financial stability in monetary policy decisions, particularly when fiscal conditions are deteriorating and public debt crowds out lending to the private sector.

CBI is an important institutional check on fiscal dominance. While fiscal balance response coefficients across levels of CBI are estimated at magnitudes similar to overall sample estimates, they are statistically significant only under low independence. That is, the evidence suggests that CBI is an important guardrail for monetary policy. Strong independence allows the central bank to focus on its main missions of maintaining price stability and sustainable growth

Figure 4.1 Interest Rate Responses to Expected Fiscal Balance Across Subgroups

Fiscal dominance is stronger in EMDEs, economies with high public debt and with lower CBI.



CBI = central bank independence, DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies.

Notes: Dots depict the long-run responses to expected fiscal balance in each subgroup, with error bars calculated at a 90% confidence level. Each bin corresponds to a single panel regression of the augmented Taylor-rule specification, with the response coefficients interacted with a dummy variable (0/1) defining the economy/regime subgrouping. The baseline specification corresponds to that reported in column 1 of Table 4.1 and is depicted in the first bin in the chart (All). For continuous subgroup-defining variables (debt and CBI), the dummy variable is obtained through threshold regressions, resulting in the following thresholds: 65.7% for public debt/GDP, 60.3% for private debt/GDP, and 0.7 for CBI. Subgroup response estimates for the other variables in the augmented Taylor rule are presented in Appendix 1.

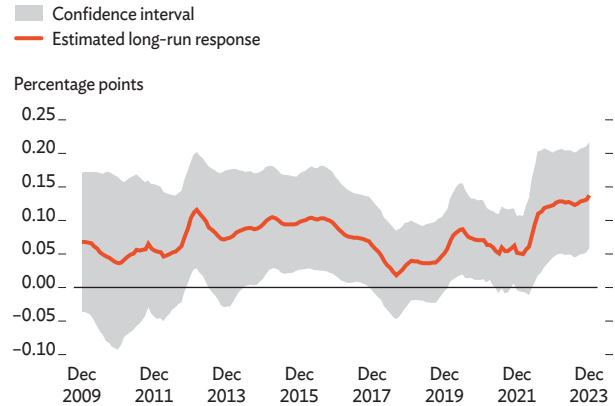
Source: Authors' calculations.

by limiting political interference and fiscal pressure on monetary policy decisions. It also strengthens credibility and the anchoring of inflation expectations, thus making monetary policy more effective.

Fiscal dominance pressures on monetary policy vary over time and increased sharply after the COVID-19 pandemic (Figure 4.2). Monetary policy responses may change over time with turnover of central bank officials, shifting preferences, and structural changes in the economy and policy-making frameworks. Fiscal dominance pressures may likewise be episodic, emerging more prominently at particular times. Time-varying estimates of the augmented

Figure 4.2 Evolution of Interest Rate Responses to Expected Fiscal Balances

Fiscal dominance pressures rose sharply after the pandemic.



Notes: The line depicts rolling regression estimates of the long-run responses to expected fiscal balances in the augmented Taylor rule framework of equation (1). The model specification corresponds to column 1 in Table 4.1, and lag orders are allowed to vary over time and selected using the Bayesian information criterion. The sample of economies included in the rolling regressions also varies over time depending on data availability. The estimation rolling windows cover 10 years ending at the dates indicated on the horizontal axis. The depicted estimates are further smoothed for visualization purposes using a 5-month moving average centered at each period. The shaded areas refer to confidence bands at the 90% confidence level.

Source: Authors' calculations.

Taylor rule indicate substantial fluctuations in interest rate responses to fiscal balances over recent decades. Responses have increased significantly following the COVID-19 pandemic, rising from about 0.06 pps in 2021 to about 0.14 pps by the end of the sample. This period saw public debt and fiscal imbalances grow to fund pandemic support policies and recovery measures. Beyond confirming the role of public debt in the emergence of fiscal dominance, this evidence suggests that fiscal expansion during emergencies may create room for fiscal dominance pressures to build. Institutional frameworks such as CBI thus matter most, and need reinforcement, during crises.

Box 4.1 Limited Market Perception of Fiscal Dominance Risk in Developing Asia and the Pacific

The pandemic and its aftermath generated highly accommodative monetary policy and a sharp increase in sovereign debt in many developing Asia and the Pacific (DAP) economies. Several central banks in the region went further and purchased government securities in primary and secondary markets in explicit coordination with fiscal authorities. Such a policy mix can raise concerns about a future shift toward fiscal dominance, in which central bank actions pursue public debt sustainability over price stability (Sargent and Wallace 1981). If households, firms, and markets anticipate such a shift, deteriorating public finances can raise expectations of long-term inflation and threaten long-run price stability.

How long-term inflation expectations respond to a perceived fiscal burden indicates whether market participants expect monetary dominance or fiscal dominance to prevail. Under fiscal dominance, an increase in the perceived fiscal burden can raise long-term inflation expectations. Under monetary dominance, long-term inflation expectations should be insensitive to fiscal developments or may even decline to the extent that fiscal stress is expected to be resolved.^a Galati et al. (2021) applied this logic to the euro area during the sovereign debt crisis and the pandemic, concluding that markets there did not price in fiscal dominance risks. Perceptions of a rising fiscal burden were not generally associated with higher expectations for long-term inflation, and in some countries greater debt-sustainability concerns were associated with falling expectations for long-term inflation, consistent with anticipated fiscal consolidation.

The analysis combines a market-based measure of perceived fiscal burden with survey measures of long-run inflation expectations. Fiscal perceptions are not directly observable, so, following Galati et al. (2021), the study extracts the first principal component of four sovereign risk indicators for each economy: the 5-year sovereign credit default swap spread; the spread between 10-year and 2-year government bond yields; the spread between the 10-year government bond yield and the policy rate; and the spread between the 10-year government bond yield and the 10-year US Treasury yield. These indicators capture information about default risk, the yield curve, and long-term borrowing costs relative

to domestic policy rates and US yields. The factor summarizes their common variation, with its sign set so that higher values indicate greater perceived fiscal stress. It is estimated at monthly frequency using all available historical data for each economy, resulting in an unbalanced panel. To examine how perceived fiscal stress relates to inflation expectations, the analysis uses professional forecasts from Consensus Economics' long-term forecast surveys, as inflation swap markets lack sufficient depth in most DAP economies. The surveys provide inflation forecasts up to 10 years ahead and the distribution of forecasts across respondents. These data allow the analysis to examine both the level of long-run inflation expectations and disagreement among forecasters, providing complementary evidence on the anchoring of expectations.

Empirical analysis focuses on future 5- and 10-year horizons, at which fiscal dominance concerns should be most visible. The sample comprises 10 economies in DAP for which key indicators and long-horizon inflation expectations are available.^b For each economy c and horizon h , survey-to-survey change in the mean inflation expectation is regressed on the cumulated fiscal burden shock:

$$\Delta\pi_{c,t}^{e,h} = \alpha_c^h + \beta_c^h FB_{\tau}^c + \varepsilon_{c,t}^h, \quad (1)$$

where both the explanatory and dependent variables are standardized within each economy, so that coefficients are directly comparable across economies and can be read as the standard-deviation revision in expectations per one-standard-deviation fiscal burden shock. To study expectation de-anchoring directly, the exercise is repeated with the change in the cross-forecaster standard deviation of the h -year-ahead forecast, σ , as the dependent variable:

$$\Delta\sigma_{c,t}^h = a_c^h + b_c^h FB_{\tau}^c + v_{c,t}^h. \quad (2)$$

Rising disagreement in response to fiscal stress ($b > 0$) indicates that forecasters differ over the prevailing policy regime, which can appear even while the mean expectation is stable.

Results provide little evidence that fiscal dominance risks are priced into long-term inflation expectations in the region. In box table 1,

continued on next page

Box 4.1 Continued**1 Response of Mean Long-Term Inflation Expectations to Fiscal Burden Shocks**

The response of mean expectations to a fiscal burden shock is positive but small, with significance only at the 10% level for the 5-year horizon.

	5-year		10-year	
	(1)	(2)	(3)	(4)
Fiscal burden shock (pooled PC1)	0.083* (0.042)	0.092 (0.062)	0.060 (0.034)	0.103 (0.060)
Economy fixed effects	Yes	Yes	Yes	Yes
Time fixed effects	No	Yes	No	Yes
Observations	586	586	586	586
R-squared (within)	0.016	0.197	0.008	0.223

PC = principal component.

Note: Standard errors in parentheses. The * denotes $p < 0.10$.

Source: Authors' calculations.

the response of mean expectations to a fiscal burden shock is positive but economically small at both horizons. It is statistically significant in only one specification, and only at the 10% level: the 5-year horizon without time fixed effects. Once time fixed effects absorb common global shocks, no coefficient is significant. Box table 2 shows no significant response of forecaster disagreement to fiscal stress at either horizon, indicating that perceived fiscal burdens have not led forecasters to diverge over the prevailing policy regime. Taken together, the evidence suggests that market participants in the region have continued to expect monetary dominance to prevail, and long-horizon inflation expectations have remained broadly insensitive to perceived fiscal stress, even after the expansion of sovereign debt during the pandemic

2 Response of Forecaster Disagreement to Fiscal Burden Shocks

There is no significant response of forecaster disagreement to fiscal stress at either horizon.

	5-year		10-year	
	(1)	(2)	(3)	(4)
Fiscal burden shock (pooled PC1)	-0.008 (0.056)	0.043 (0.073)	0.018 (0.055)	0.108 (0.059)
Economy fixed effects	Yes	Yes	Yes	Yes
Time fixed effects	No	Yes	No	Yes
Observations	577	577	577	577
R-squared (within)	0.000	0.158	0.000	0.121

PC = principal component.

Note: Standard errors in parentheses.

Source: Authors' calculations.

and central bank purchases of government securities. The results are broadly consistent when the sample is restricted to a balanced panel.^c

References:

- Blanchard, O. 2004. [Fiscal Dominance and Inflation Targeting: Lessons from Brazil](#). NBER Working Paper. No. 10389. National Bureau of Economic Research.
- Galati, G. et al. 2021. [Do Markets See Risks of Fiscal Dominance in the Euro Area?](#). Box 17 in Monetary-Fiscal Policy Interactions in the Euro Area. ECB Occasional Paper Series. No. 273. European Central Bank.
- Sargent, T. J. and N. Wallace. 1981. [Some Unpleasant Monetarist Arithmetic](#). Federal Reserve Bank of Minneapolis Quarterly Review. 5(3).

This box was written by Jaqueson K. Galimberti, Tolga Ozden, and Shu Tian of the Economic Research and Development Impact Department, ADB, Manila.

^a Under monetary dominance, the central bank sets policy rates to achieve its inflation objective, and fiscal policy adjusts primary balances to ensure debt sustainability.

^b The People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Thailand; Türkiye; and Viet Nam.

^c Restricting the estimation to a balanced panel reduces the number of observations to 289, covering the period since the end of 2018, over which all four fiscal indicators are jointly available for every economy. Revisions to mean long-term inflation expectations remain insensitive to fiscal burden shocks in all specifications, while forecaster disagreement at the 10-year horizon rises significantly in the specification with time fixed effects, suggesting some uncertainty among forecasters about the prevailing policy regime in the most recent period.

5 Debt as a Structural Constraint on Monetary Policy Transmission

5.1 Transmission of Monetary Policy Shocks to Output and Financial Conditions

Before exploring heterogeneity across debt regimes, it is necessary to establish how monetary policy surprises affect macroeconomic and financial outcomes on average. This section examines average responses of output and sovereign bond yields to the monetary policy shocks constructed in Section 3, using Taylor-rule residuals from the estimates in column 4 of Table 4.1. These residuals are purged of anticipated components as described in Section 3.4. [Box 5.1](#) reports diagnostics confirming that these residuals are reliable measures of unanticipated monetary policy actions.

Real GDP declines after a surprise monetary tightening and remains below its pre-shock level throughout the 8-quarter period (Figure 5.1, panel A). The response to a positive surprise of 1 percentage point (pp) in the policy rate is negative and statistically significant, with the confidence bands remaining below zero over most of the period. The cumulative decline in real GDP reaches approximately 0.2–0.3 pps after 2–4 quarters and deepens to about 0.6 pps by the end of 2 years. On average, therefore, a surprise monetary tightening has a persistent contractionary effect on economic activity. Output responses are consistent with the conventional monetary policy transmission mechanism: higher interest rates raise borrowing costs, dampen private investment and consumption, and reduce aggregate demand and output. The persistence and gradual evolution of responses underscore the lagged nature of transmission, with effects on real economic activity continuing to build over several quarters.

The effects of monetary policy surprises on output may differ depending on the direction of the policy

shocks. Panel B of Figure 5.1 examines separately responses to surprise tightening and surprise easing. Following a surprise tightening, real GDP declines by about 0.3 pps after 2 quarters, with cumulative contraction reaching approximately 0.6 pps by the end of 2 years, which is broadly consistent with the pooled response in panel A. The response to surprise monetary policy easing is, however, more gradual. Output shows no statistically significant response initially, but the expansion becomes significant after about 3 quarters, with real GDP increasing by approximately 0.4 pps after 4 quarters and 0.6 pps by the end of 8 quarters. These results suggest that both surprise tightening and easing transmit to real economic activity in the expected direction, but the expansionary effect of easing shocks emerges with a longer lag.

Monetary policy surprises transmit quickly to sovereign bond markets. Figure 5.2 reports the responses of 2-year and 10-year sovereign bond yields to a surprise monetary policy tightening. On average, a tightening raises 2-year yields by about 30 basis points, and 10-year yields by about 20 basis points, in the quarter immediately following the shock. The increase in the 2-year bond yield remains mostly statistically significant through subsequent horizons, declining to about 15 basis points by the end of the 2-year period. By contrast, the response of the 10-year bond yield dissipates more quickly and becomes statistically insignificant about 3 quarters after the shock.

These dynamics are consistent with the different information embedded in short- and long-term sovereign bond yields. Whereas 2-year bond yields track expectations about the future path of policy rates, 10-year bond yields reflect also longer-term inflation expectations, growth prospects, term premia, and sovereign risk premia. The stronger and more persistent response at the shorter maturity suggests that the identified monetary policy shocks operate mainly through changes in the expected path of short-term

Box 5.1 Validation of the Monetary Policy Shocks

Diagnostics confirm Taylor rule-based estimates as reliable measures of monetary policy shocks.

A useful measure of monetary policy shocks should be centered on zero, unpredictable from past information, and consistent with known monetary policy episodes. Four diagnostic tests indicate that the estimated shocks satisfy these properties. First, the distribution of shocks is centered close to zero and exhibits no systematic bias across economies, which is consistent with their interpretation as unanticipated policy actions (box figure, panel A). Varying dispersion across economies indicates that the fixed-effects panel regression approach is appropriate to capture different degrees of macroeconomic volatility across this global sample. Second, the distribution of shocks over time indicates that the approach captures major

global events, such as the global financial crisis of 2007–2008 and the pandemic, which is characteristic of synchronous monetary policy cycles (panel B). Third, estimated shocks are highly correlated with benchmark international monetary policy shocks in Bajaro, Galimberti, and Qureshi (2025), providing strong external validation while substantially expanding sample coverage (panel C). Finally, shocks display little persistence over time, with only a small, first-order serial correlation, indicating that predictable movements in policy rates have been effectively removed (panel D).

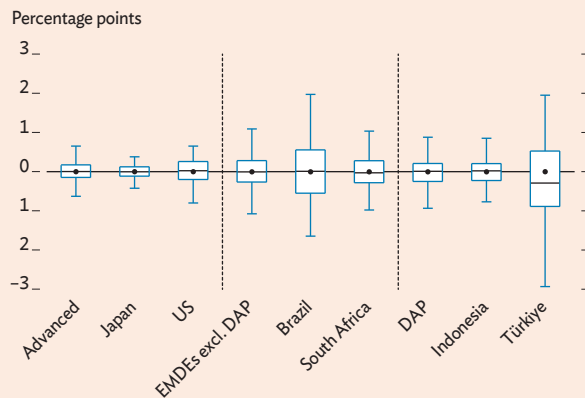
Reference:

Bajaro, D. F. E., J. K. Galimberti, and I. A. Qureshi. 2025. [Monetary Policy Under Fiscal Stress: A Forward-Looking Analysis of Fiscal Dominance](#). *Journal of Macroeconomics*. 86.

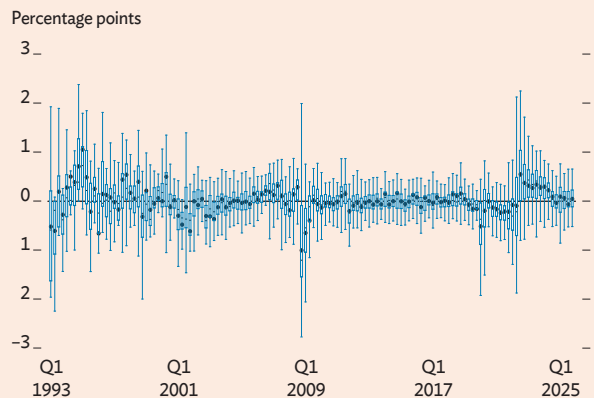
Validation of Monetary Policy Shocks

The Taylor-rule based estimates of monetary policy shocks satisfy the validation criteria.

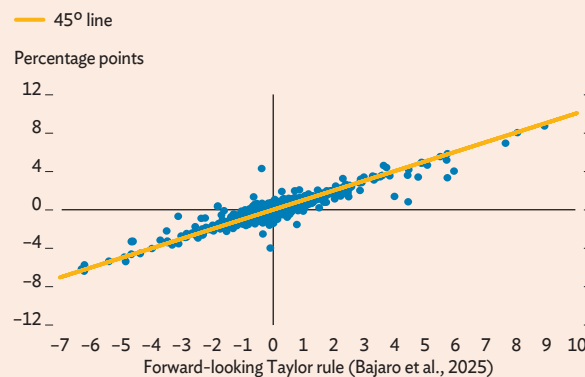
A. Distribution of Shocks Within Economies



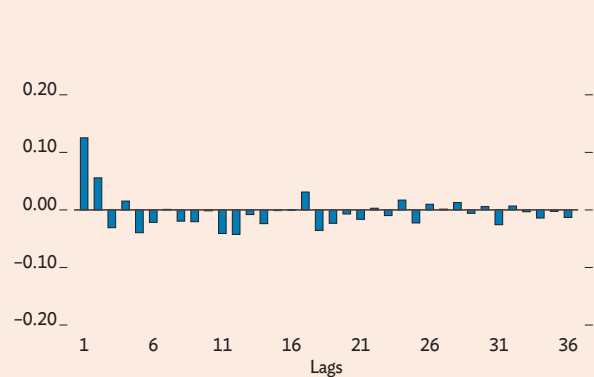
B. Distribution of Shocks Over Time



C. Comparison with Benchmark



D. Shocks Serial Correlations



DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, IQR = interquartile range, q = quarter, US = United States.

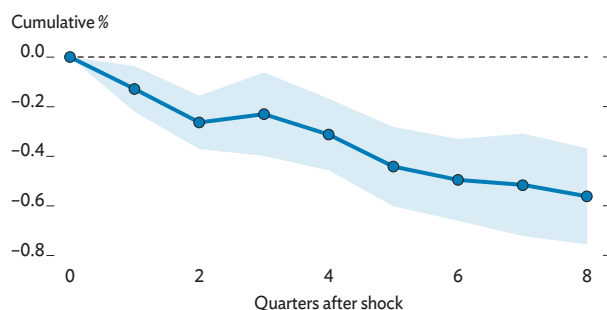
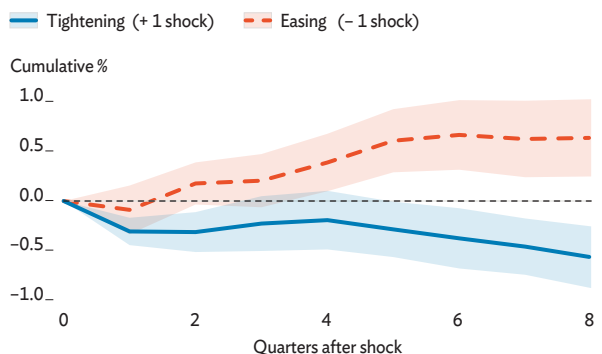
Notes: Boxplots in panels A and B depict distribution medians (horizontal black lines inside boxes), means (filled circles inside boxes), interquartile ranges (IQRs, the height of the boxes), and 1.5 x IQR (whiskers). Outliers are not depicted in the boxplots. Serial correlations in panel D are pooled partial correlations.

Source: Authors' calculations.

This box was written by Jaqueson K. Galimberti, Tolga Ozden, and Shu Tian of the Economic Research and Development Impact Department, ADB, Manila.

Figure 5.1 Cumulative Responses of GDP to Monetary Policy Shocks

Monetary policy surprises affect output in the expected direction, but at different speeds: tightening reduces real GDP more quickly than easing raises it.

A. Surprise Monetary Policy Tightening Under Symmetric Responses**B. Monetary Policy Surprises Under Asymmetric Responses**

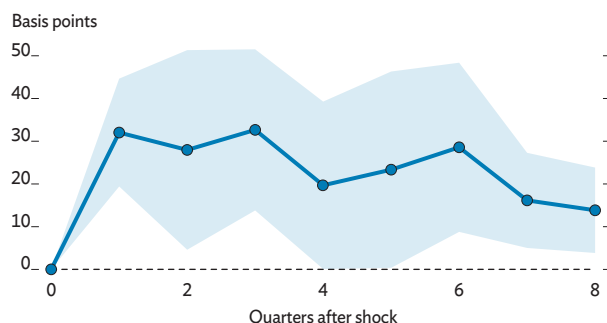
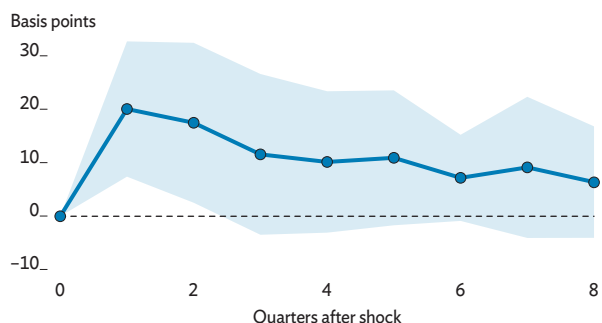
GDP = gross domestic product.

Notes: Impulse responses are estimated using the quarterly local projection framework and the monetary policy shocks constructed as described in Section 3. Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Panel A reports the response to a 1-percentage-point positive surprise in the policy rate based on the pooled monetary shocks, while panel B reports separately the responses to surprise monetary tightening and surprise monetary easing.

Source: Authors' calculations.

Figure 5.2 Responses of Sovereign Bond Yields to Surprise Monetary Policy Tightening

Monetary policy tightening quickly raises sovereign bond yields, with stronger and more persistent effects on 2-year than 10-year yields.

A. 2-Year Bond Yield**B. 10-Year Bond Yield**

Notes: Impulse responses are estimated using the quarterly local projection framework and the monetary policy shocks constructed as described in Section 3. Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

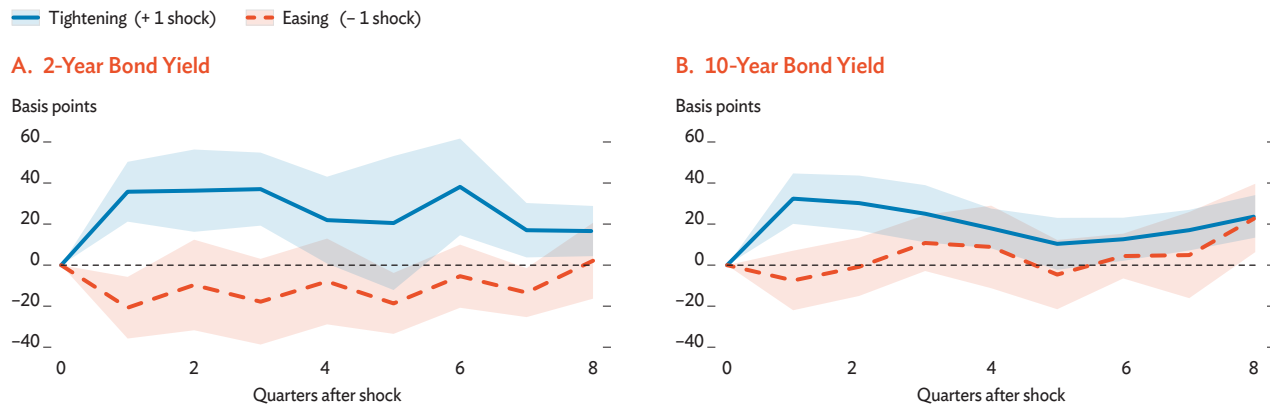
interest rates, while the response of longer-term yields is moderated by a broader set of macroeconomic and risk factors. This is consistent with extensive evidence that monetary policy shocks affect both short- and long-term interest rates, with a stronger influence at the short-term end (e.g., Cook and Hahn 1989; Kuttner 2001; Gürkaynak, Sack, and Swanson 2005; Hanson and Stein 2015).

Asymmetric responses to surprise monetary policy tightening and easing are evident in financial markets. Figure 5.3 reports separately the responses

of short- and long-term sovereign bond yields to surprise monetary tightening and easing. Two-year sovereign bond yields rise by about 35 basis points, and 10-year bonds by about 30 basis points, in the quarter immediately following a surprise monetary tightening. The increases mostly remain statistically significant over the 8-quarter period, with 2-year yields still about 17 basis points above their pre-shock levels, and 10-year yields about 24 basis points higher, by the end of 2 years. In contrast, surprise easing produces less precisely estimated responses. Two-year yields decline by about 20 basis points, on average, in the first

Figure 5.3 Responses of Bond Yields to Surprise Monetary Tightening and Easing

Bond yields respond asymmetrically to monetary policy surprises: tightening raises both short- and long-term yields persistently, while easing produces smaller and less persistent declines, with little evidence of a statistically significant response in 10-year yields.



Notes: Impulse responses are estimated using the quarterly local projection framework and the monetary policy shocks constructed as described in Section 3. Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

quarter following a surprise monetary easing, but the response becomes statistically insignificant thereafter. Ten-year yields do not exhibit a statistically significant response, though their initial response in the first quarter is also negative.

The separate responses to surprise tightening and easing point to meaningful asymmetries in monetary policy transmission. The magnitude and dynamics of GDP and bond-yield responses to tightening closely are similar to responses to pooled shocks, suggesting that the average effects are driven largely by tightening episodes, while easing shocks generate comparatively muted responses. The remainder of the analysis therefore focuses on the pooled shocks, with the discussion framed around a surprise tightening; the separate tightening and easing results serve as a robustness check.

The pattern of monetary policy transmission is broadly similar across EMDEs and DAP, though the output response is larger in DAP. Figure 5.4 compares average responses of real GDP to a surprise monetary policy tightening in the two economy groups. In both EMDEs and DAP, real GDP falls by about 0.3 pps within 2 quarters (panel A). Cumulative contraction reaches about 0.7 pps in EMDEs against nearly 1.1 pps in DAP by the end of 2 years. Appendix Figure A1.5 further shows asymmetric responses to surprise monetary tightening and easing in EMDEs and DAP. Responses to tightening shocks are broadly

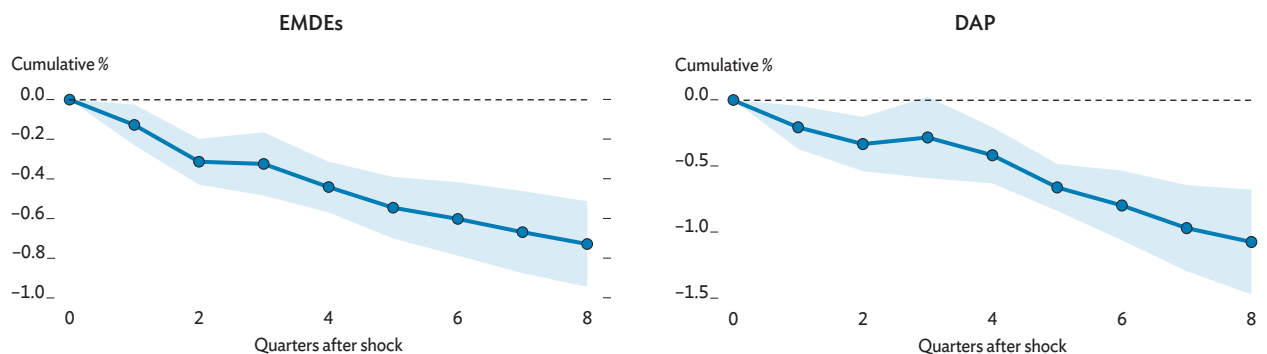
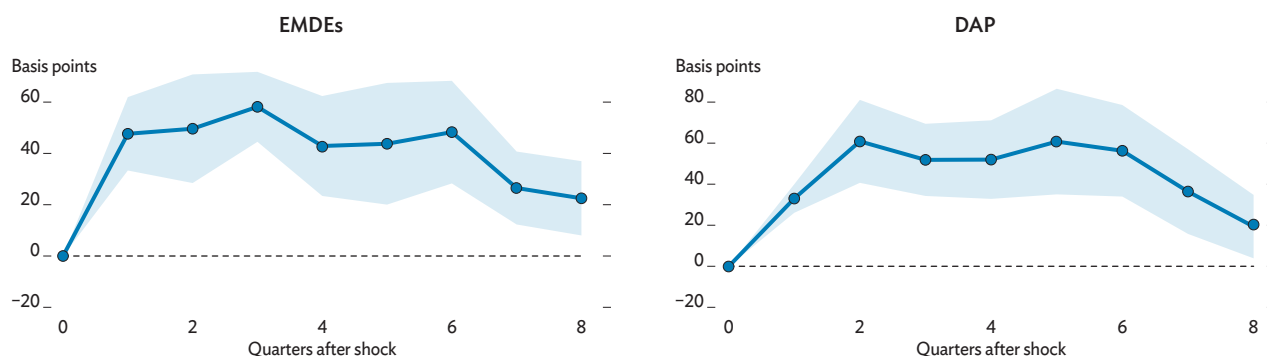
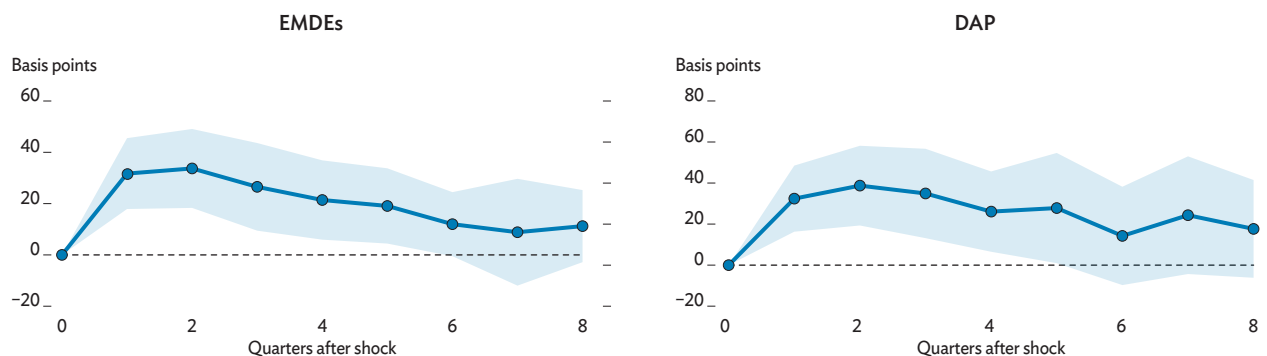
consistent with those estimated using pooled shocks, while responses to easing have longer lags and become significant only after 2–4 quarters.

The responses of sovereign bond yields to surprise monetary policy tightening in EMDEs and DAP resemble those of the global sample. Panels B and C of Figure 5.4 report the responses of 2-year and 10-year sovereign bond yields to the pooled shock. In both subsamples, short- and long-term sovereign bond yields rise following the shock, with the 2-year yield response generally larger and more persistent than 10-year yield response, which is consistent with Figure 5.2.

Baseline estimates in this section show that monetary policy shocks have significant effects on real output and financial conditions, which is consistent with conventional transmission channels. Qualitative transmission patterns in EMDEs and DAP are broadly similar to those observed in the global sample, though some magnitudes differ. As broad geographical or income-group classifications alone may not fully account for heterogeneity in monetary policy transmission, analysis turns to structural characteristics, particularly indebtedness and institutional conditions. While responses to pooled monetary policy shocks broadly resemble those following surprise monetary tightening, the effects of surprise easing tend to emerge more gradually. As isolating shocks by sign significantly reduces the

Figure 5.4 Responses to Monetary Policy Shocks in EMDEs and DAP

Monetary policy transmission is broadly similar across EMDEs and DAP, with larger responses in DAP.

A. GDP Responses**B. Responses of 2-Year Bond Yields****C. Responses of 10-Year Bond Yields**

EMDEs = emerging market and developing economies, DAP = developing Asia and the Pacific, GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

identifying variation available for each coefficient and the precision of estimates, subsequent sections use pooled shocks.

5.2 Monetary Policy Transmission in High- and Low-Debt Regimes

This section examines whether baseline responses of output and bond yields to monetary policy shocks depend on the level of indebtedness.

Baseline results in Section 5.1 show that monetary tightening lowers output and raises sovereign bond yields on average. Following the same specification, this section interacts pooled monetary policy shocks with smooth logistic transition functions of the ratio of debt to GDP to trace responses in high-debt and low-debt states. The analysis considers public debt and then private debt, in each case for the global sample, EMDEs, and DAP.

5.2.1 Role of Public Debt

Public indebtedness does not appear to shape output responses to monetary shocks. Panel A in Figure 5.5 shows the responses of real GDP to monetary tightening under high and low public debt, revealing a consistent pattern. Real GDP declines in both states and across all three samples, but the confidence bands overlap throughout, so the two regimes cannot be distinguished.

High public debt weakens the transmission of surprise monetary tightening to bond yields.

Under low public debt, 2-year and 10-year sovereign bond yields rise significantly following a tightening (Figure 5.5, panels B and C), which is consistent with baseline responses in Section 5.1 and conventional pass-through of policy tightening along the yield curve. Under regimes with high public debt, by contrast, neither 2-year nor 10-year yields respond significantly, as estimated responses are smaller and confidence bands include zero to the 2-year horizon. This pattern holds across the global sample, EMDEs, and DAP.

A muted yield response in high-debt regimes is consistent with the mechanisms outlined in Section 2. When public debt is high, financial

markets may expect the central bank to accommodate fiscal needs, such that policy tightening may not be interpreted as a lasting shift in the expected future path of policy rates, weakening yield movements driven by expectations. Large sovereign financing needs may make yields more heavily influenced by sovereign risk, term premia, and bond-supply considerations than by revisions to expected short-term rates, thereby diluting the signal from the policy surprise in government bond pricing. In either case, results suggest that the policy rate becomes a less-effective instrument for influencing sovereign borrowing costs when public debt is high.

5.2.2 Role of Private Debt

High private debt weakens the output response to surprise monetary tightening. Figure 5.6 repeats the analysis for regimes with high and low private debt, defined as household and corporate debt as a share of GDP. With low private debt, real GDP declines significantly following a surprise monetary tightening, with confidence bands remaining below zero over most of the period (Figure 5.6, panel A). By contrast, with high private debt, the output response is not statistically different from zero. The pattern is consistent across the global sample, EMDEs, and DAP, suggesting that high private debt dampens the transmission of monetary policy to economic activity.

This finding is consistent with the debt overhang and deleveraging channel.

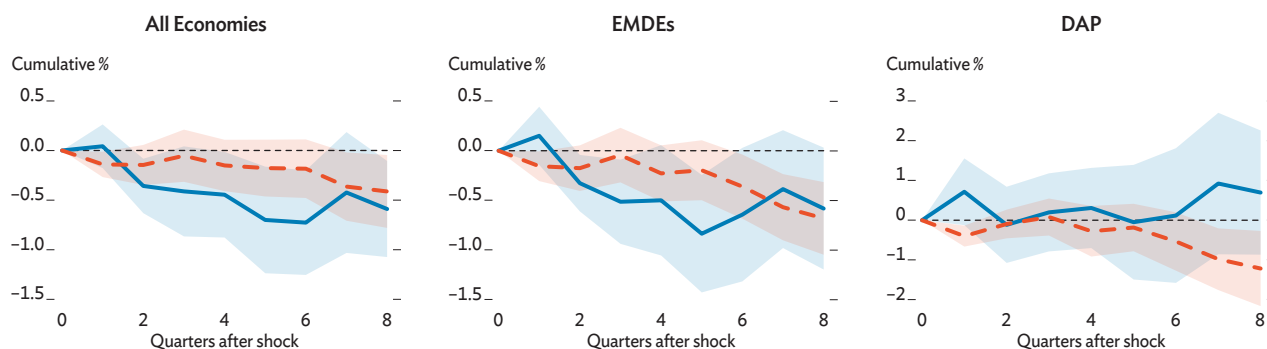
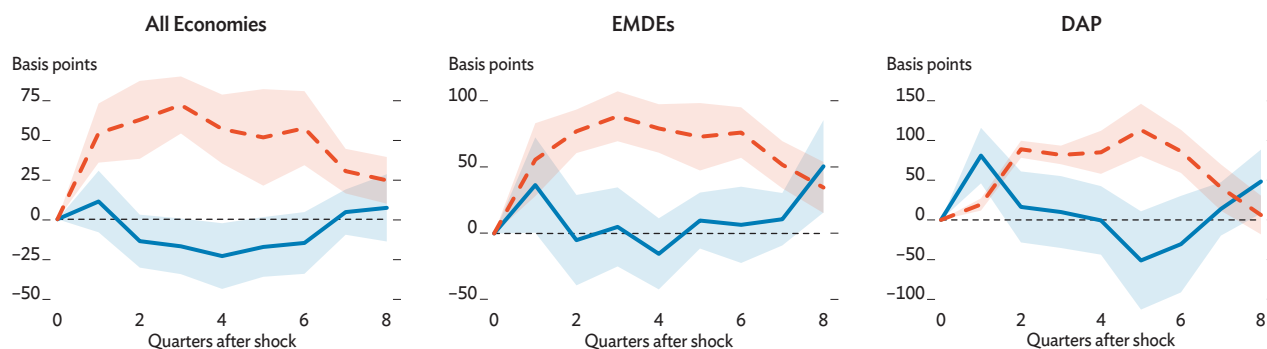
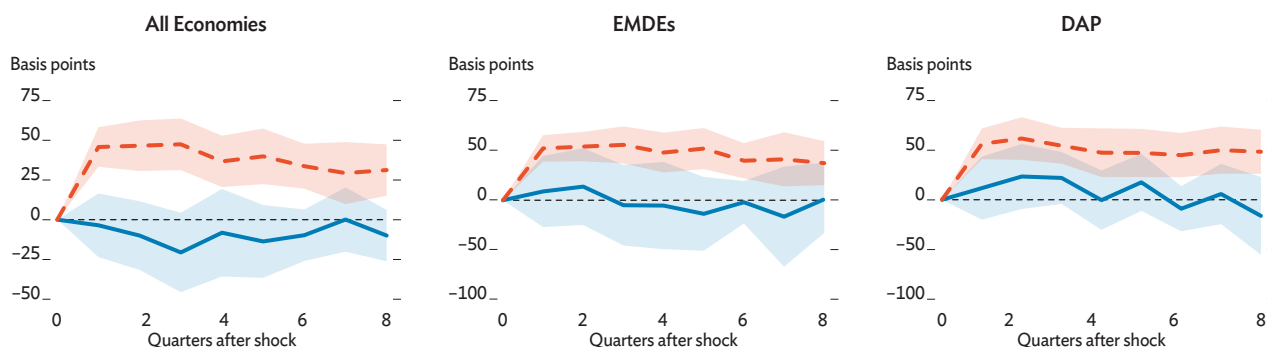
When households and firms are highly leveraged, their spending may be driven less by marginal changes in interest rates than by the need to repair balance sheets. Highly indebted borrowers may face constrained access to credit regardless of the policy rate, so that changes in the policy rate have little effect on their spending. Financial intermediaries in high-debt environments may apply tighter lending standards, reducing the marginal effect of further monetary tightening on credit supply. The result is a weaker link between policy rates and aggregate demand where private leverage is high, which is consistent with the debt overhang mechanism emphasized in the literature (Mian, Sufo, and Verner 2017; Di Maggio et al. 2017).

High private debt weakens bond yield responses to surprise monetary tightening, especially at short maturities. Two-year bond yields respond more significantly when private debt is low across the global

Figure 5.5 Responses to Surprise Monetary Tightening in Regimes with High Versus Low Public Debt

High public debt does not significantly affect output responses but weakens the transmission of surprise monetary tightening to bond yields.

— High public debt - - Low public debt

A. GDP Responses**B. Responses of 2-Year Bond Yields****C. Responses of 10-Year Bond Yields**

DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

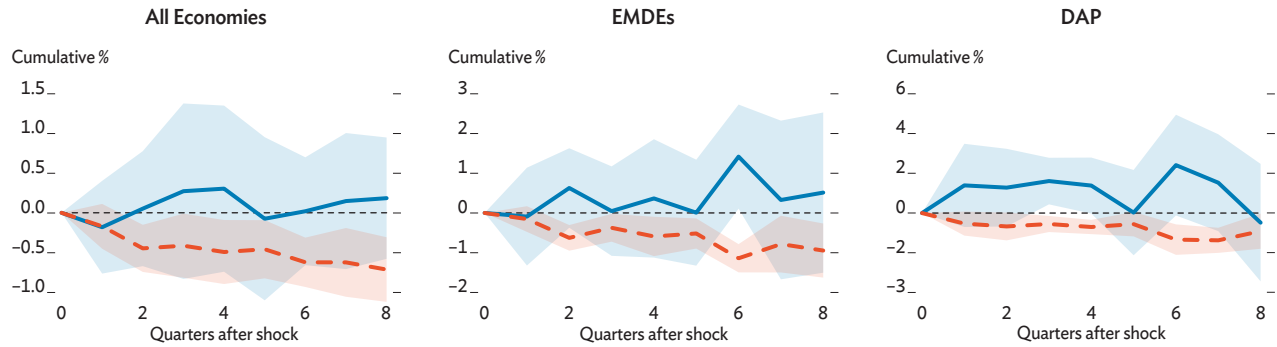
Source: Authors' calculations.

Figure 5.6 Responses to Surprise Monetary Tightening in Regimes with High Versus Low Private Debt

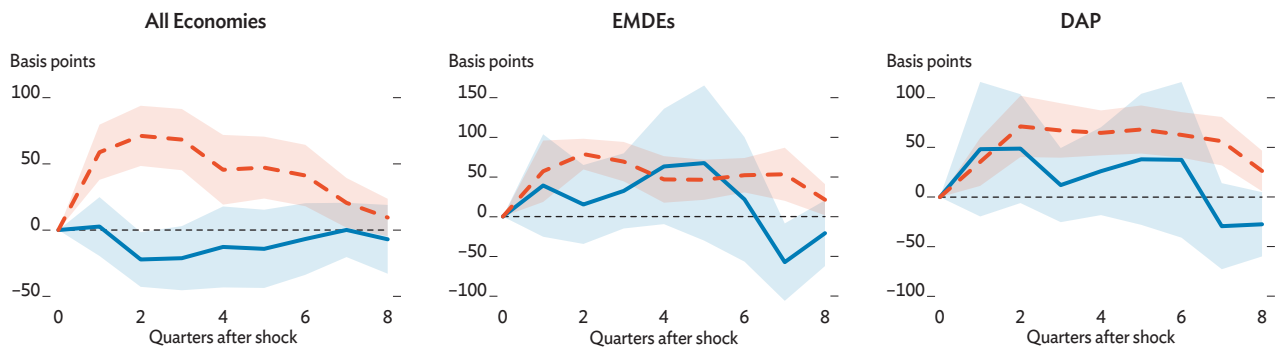
High private debt weakens monetary policy transmission to output and bond yields, particularly at short maturities.

— High private debt - - Low private debt

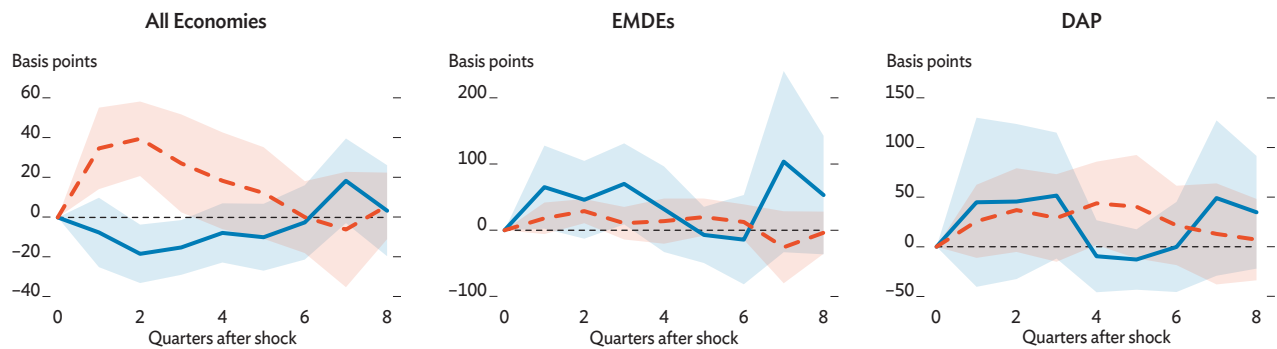
A. GDP Responses



B. Responses of 2-Year Bond Yields



C. Responses of 10-Year Bond Yields



DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

sample, EMDEs, and DAP, while responses in regimes with high private debt are muted in all three samples (Figure 5.6, panel B). Differences are less pronounced for 10-year bond yields. In the global sample, 10-year yields rise significantly under low private debt but not under high. In EMDEs and DAP, 10-year yields become less responsive under both regimes. Overall, low private debt is associated with stronger transmission of surprise monetary tightening to sovereign bond yields, though differences are moderate in EMDEs and DAP, where financial markets are relatively thin.

Taken together, responses to surprise monetary tightening point to distinct roles for the two types of debt.

Public debt matters more for transmission to financial conditions, with high public debt weakening pass-through to bond yields while leaving output

response largely intact. Private debt matters on both fronts. High private debt mutes the responses of output and bond yields alike, which is consistent with the debt overhang effect, whereby highly leveraged private borrowers become less sensitive to interest rate changes when facing binding balance sheet constraints. This distinction underscores that private debt can be more important than public debt as a constraint on monetary policy transmission, as it operates through both the real economy and financial conditions. Appendix 2 reports separately corresponding responses of output and bond yields to tightening and easing shocks. Responses to tightening resemble those to the pooled shock, while high indebtedness plays a lesser role in shaping responses to easing. This pattern is consistent with baseline results in Section 5.1, where responses to easing are smaller and more gradual.

6 Role of Central Bank Independence and Institutional Credibility

This section examines whether the influence of indebtedness on the transmission of monetary policy shocks varies with the degree of CBI.

Institutional quality shapes monetary policy decisions and their transmission, particularly when policy operates under constraints such as high debt. Debt conditions determine the balance-sheet environment in which monetary policy operates, while institutional quality shapes the credibility of policy actions and thereby guides financial intermediation and private sector expectations. Fiscal dominance effects, for example, are found to be more pronounced in emerging economies with low CBI (Bajaro, Galimberti, and Qureshi 2025). CBI is a key indicator of institutional quality, as higher CBI shows that monetary authorities operate in a more stable and credible policy environment, insulated from short-term political and fiscal pressures. This helps to anchor inflation expectations and reduce macroeconomic uncertainty about policy actions.

State-dependent local projections are re-estimated separately for economies with low and high CBI, defined relative to the sample median of the CBIE index (Romelli 2022, 2025). Within each subsample, the monetary policy shock is interacted with the smooth transition functions of public and private debt, so that each figure compares responses under high- and low-debt regimes within a given institutional environment. Figure 6.1 reports results for public debt, with panel A for low CBI environments and panel B for high. Figure 6.2 presents the corresponding results for private debt.

Under low CBI, high public indebtedness weakens monetary policy transmission to both output and bond yields. Output responds significantly and negatively to a surprise monetary policy tightening when public debt is low, while responses become statistically insignificant when public debt is high (Figure 6.1, panel A). This pattern holds for sovereign bond yields, with responses larger and more significant in regimes with low public debt at both maturities.

High CBI does not fully mitigate the influence of high public indebtedness on monetary policy transmission.

In a high CBI environment (Figure 6.1, panel B), output responses are similar across the two debt regimes, so the dampening effect of high public debt on the transmission to economic activity disappears. Sovereign bond yields, however, still respond more strongly when public debt is low, at both 2- and 10-year maturities. High CBI, therefore, partly offsets the role of high public debt in the transmission to output but not the weaker pass-through of policy surprises to sovereign borrowing costs.

The findings for private debt yield the same conclusion (Figure 6.2).

In a low CBI environment (panel A), transmission of monetary tightening to output and bond yields is significant when private debt is low, which is consistent with conventional monetary policy transmission. When private indebtedness is high, output and 10-year bond yield responses become muted, while the transmission to 2-year bond yields becomes smaller and short-lived. Thus, the level of private debt matters for monetary policy transmission when CBI is low. In a high CBI environment (panel B), output responses are similar across the two private debt regimes, while transmission to bond yields remains stronger and more significant when private debt is low. As with public debt, high CBI can offset some of the effect of high private indebtedness on transmission to the real economy but cannot fully remove its influence on borrowing conditions.

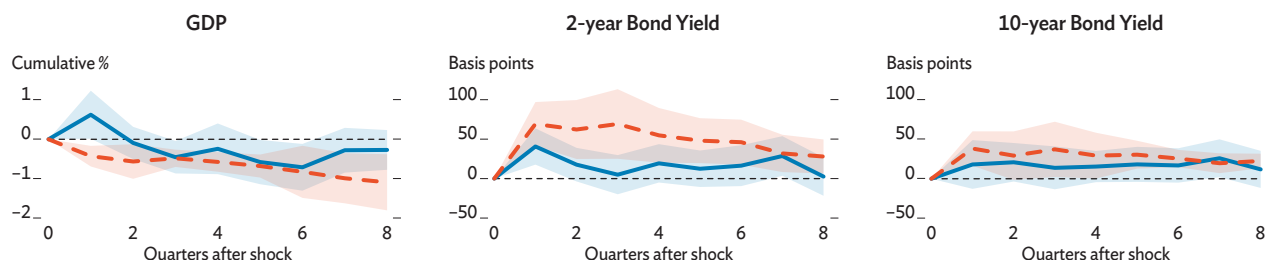
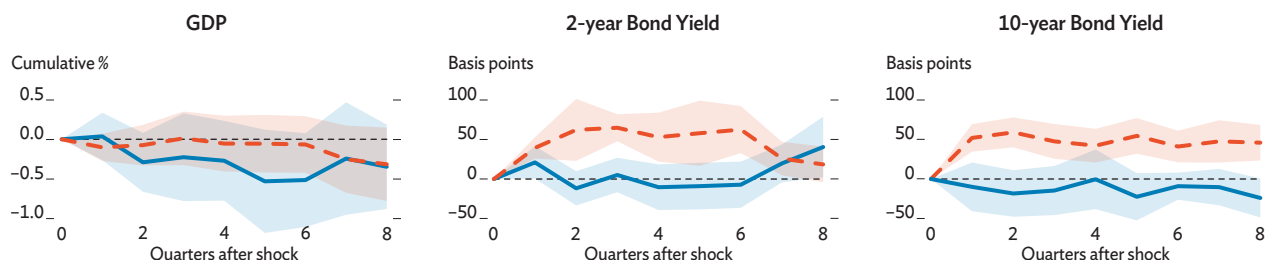
Institutional credibility can partly compensate for balance-sheet vulnerability but cannot substitute for sound fiscal conditions and private balance sheets.

By improving policy credibility, anchoring expectations, and reducing macroeconomic uncertainty, greater CBI contributes to a more predictable and orderly transmission of monetary policy to real economic activity, making the output effects of policy actions less dependent on the balance-sheet

Figure 6.1 Responses in Regimes with High Versus Low Public Debt, by Central Bank Independence

Under low CBI, monetary policy transmission is muted in high-debt regimes. High CBI cannot fully offset the effect of debt.

— High public debt - - Low public debt

A. Low CBI Environments**B. High CBI Environments**

CBI = central bank independence, GDP = gross domestic product.

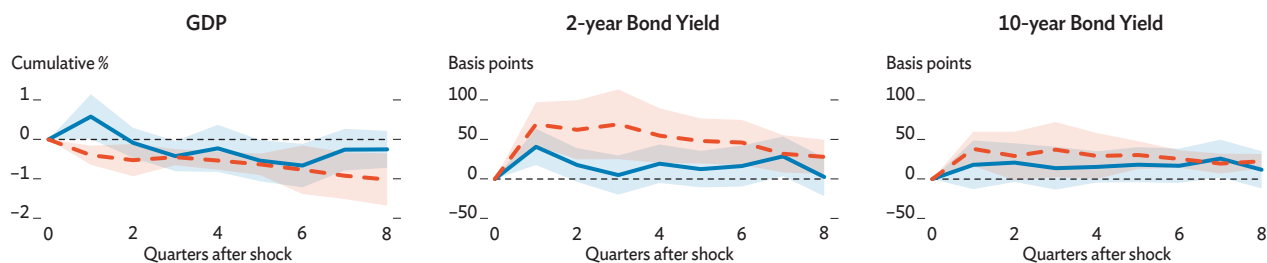
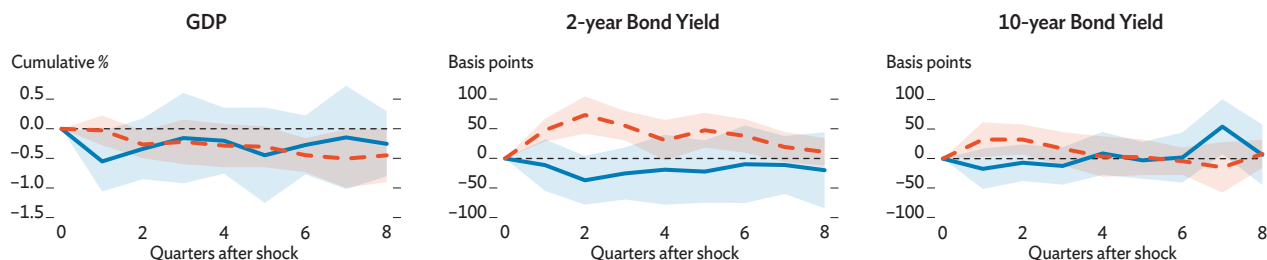
Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

Figure 6.2 Responses in Regimes with High Versus Low Private Debt, by Central Bank Independence

High private debt weakens monetary policy transmission, particularly under low CBI, while high CBI partly mitigates its effects on output but not on borrowing conditions.

— High private debt - - Low private debt

A. Low CBI Environments**B. High CBI Environments**

CBI = central bank independence, GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

position of public and private borrowers. High CBI does not, however, remove the effects of high debt on the transmission to sovereign yields.

Box 6.1 extends the analysis beyond CBI to institutional arrangements such as inflation targeting and floating exchange rates. Additional

evidence points to a similar conclusion: stronger institutional credibility can facilitate transmission to real activity in highly indebted environments, but transmission to financial conditions continues to depend on the level of debt.

Box 6.1 Do Inflation Targeting and Exchange Rate Flexibility Offset the Effects of High Debt?

This box reports additional evidence on whether institutional arrangements beyond central bank independence (CBI) can strengthen monetary policy transmission in high-debt environments.

CBI is one element of the monetary policy framework; the choice of nominal anchor and the exchange rate regime are two others. Inflation targeting is an explicit commitment to price stability that can anchor expectations, while a floating exchange-rate regime gives monetary policy greater room for adjustment and reduces the need to defend a fixed parity. Both may therefore mitigate constraints that high debt places on monetary policy. This box repeats the state-dependent analysis of Section 5.2

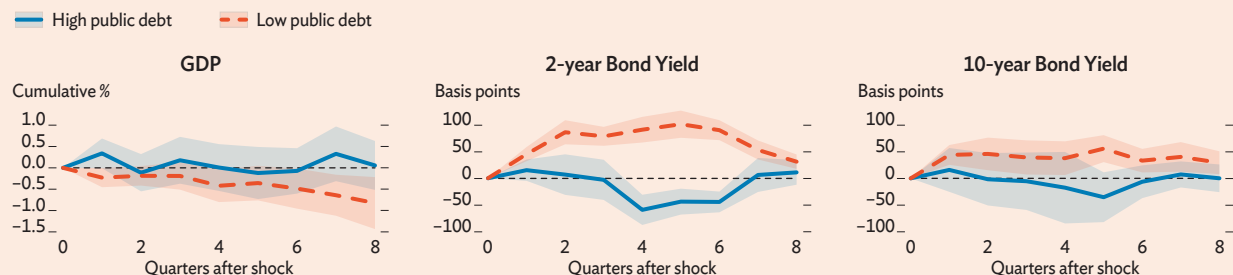
for subsamples of inflation-targeting economies and economies with floating exchange rates. In each case, the monetary policy shock is interacted with the smooth transition functions of public and private debt, so that the figures contrast the responses in high and low debt regimes within a given policy environment. Box figure 1 reports the results for inflation targeters, and box figure 2 reports those for economies with floating exchange rate regimes.

Inflation targeting does not compensate for the weakening of monetary policy transmission in high-debt environments. Within inflation-targeting economies, responses of output and of short-term

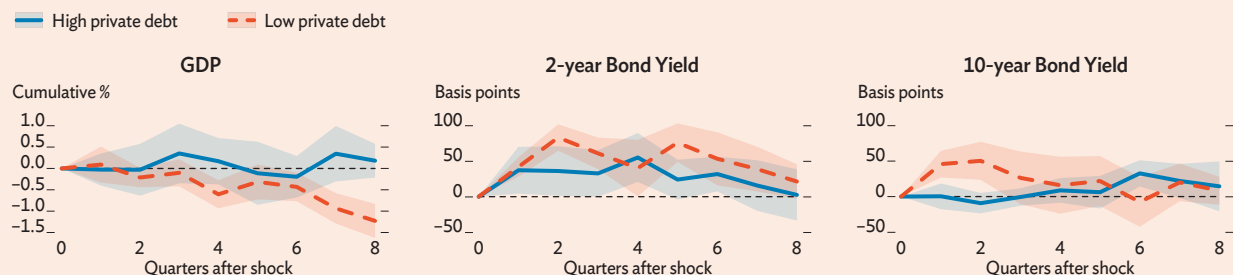
1 Inflation-Targeting Economies: Responses in High- Versus Low-Debt Regimes

Inflation targeting does not offset weaker monetary policy transmission in high-debt regimes, where output and bond yield responses are largely statistically insignificant, unlike those in low-debt regimes.

A. High Versus Low Public Debt



B. High Versus Low Private Debt



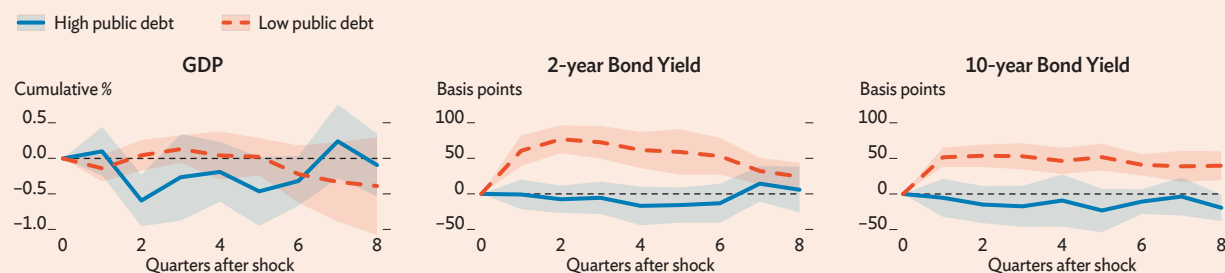
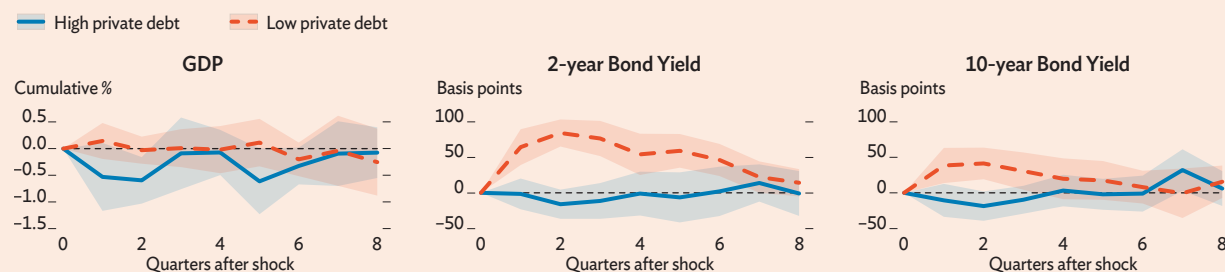
GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

Box 6.1 Continued**2 Floating Exchange Rate Regimes: Responses in High- Versus Low-Debt Regimes**

Exchange rate flexibility does not offset weaker monetary policy transmission in high-debt regimes, with bond yields responding mainly under low debt while output responses remain muted.

A. High Versus Low Public Debt**B. High Versus Low Private Debt**

GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

and long-term bond yields to a surprise monetary tightening are statistically insignificant for the most part in high-debt regimes, be it public or private. By contrast, when public and private debt levels are low, output declines significantly after 4 quarters, and both 2-year and 10-year bond yields rise significantly. These findings are similar to the full sample results in Section 5.2.

Exchange rate flexibility does not fully compensate for the erosion of monetary policy transmission associated with high indebtedness.

Among economies with floating exchange rates (box figure 2), bond yields respond significantly mainly in regimes with low public and private debt, while output responses are broadly muted and not statistically different from zero across all four cases. The different response pattern observed between high- and low-debt regimes in the full sample is absent here, as with CBI. This likely reflects that floating-rate economies overlap heavily with the high-CBI and inflation-targeting groups, so surprises show up in financial conditions rather than in real

activity. Consistent with this, debt levels continue to shape the bond yield response among the floating-rate economies. Yields rise significantly following a tightening in low-debt regimes but not in high-debt ones, and this mirrors the full sample results closely.

Taken together, alternative monetary policy framework designs cannot substantially alter the way in which indebtedness conditions monetary policy transmission. Of the three elements of the monetary policy framework examined in this chapter, inflation targeting does not appear to mitigate the effects of high indebtedness, as high public and private debt continue to weaken the transmission to both output and bond yields. By contrast, greater CBI and exchange rate flexibility appear to partly offset the effects of high indebtedness, but only for transmission to output. None of the three elements of the monetary policy framework appears to offset the weakening effect of high indebtedness on transmission to financial conditions. Sound balance sheets therefore remain a precondition for effective monetary policy transmission across different policy frameworks.

7 Summary and Policy Implications

This chapter examines how indebtedness influences monetary policy decisions and transmission across a global sample of economies, with a focus on EMDEs and DAP. Using international panel data, the chapter provides new empirical evidence and conceptual insights into how monetary policy decisions and the effectiveness of transmission vary with indebtedness. By combining an augmented Taylor-rule framework with local projections incorporating smooth-transition features, the empirical analysis yields five main findings:

- (i) **Lower fiscal balances are significantly associated with policy rates lower than would be warranted by macroeconomic conditions.** This relationship holds in the global sample and in the advanced economy and EMDE subsamples, with larger magnitude in EMDEs. The evidence is consistent with fiscal dominance effects, suggesting that weaker fiscal positions may constrain monetary policy decisions and reduce the scope for central banks to set policy rates independently.
- (ii) **The association between weaker fiscal balances and lower policy rates becomes stronger when public debt is high and CBI is low.** This finding suggests that high public debt can further constrain monetary policy space and increase the sensitivity of policy decisions to fiscal conditions. Similarly, where CBI is weaker, monetary policy decisions appear more susceptible to fiscal pressures, increasing the risk of fiscal dominance.
- (iii) **Monetary policy shocks have economically meaningful and statistically significant effects on output and financial conditions.** Defined as deviations of the actual policy rate from the level predicted by the estimated Taylor rule, these shocks are followed by a contraction in output, higher bond yields, and a flattening of the yield curve. Decomposing them into surprise tightening and easing indicates that the transmission of the

pooled shock broadly resembles that of tightening, while easing exhibits a more gradual and muted transmission. These patterns are broadly consistent across the global, EMDE, and DAP samples.

- (iv) **High indebtedness weakens the transmission of monetary policy shocks.** Higher public and private debt attenuate the responses of sovereign bond yields, while higher private debt also weakens the response of output. These findings are consistent with fiscal-dominance and balance-sheet constraint mechanisms, whereby elevated debt burdens reduce the effectiveness of monetary policy transmission, and they hold across the global, EMDEs, and DAP samples. Moreover, responses to pooled shocks are broadly consistent with those to tightening.
- (v) **CBI strengthens monetary policy transmission but does not fully offset the effects of high indebtedness.** When CBI is low, high public and private debt alike attenuate the responses of output and sovereign bond yields. In economies with high CBI, elevated public and private debt continue to weaken transmission to bond yields, while the output response becomes less dependent on debt conditions. Other institutional arrangements, including inflation targeting and floating exchange rate regimes, likewise do not fully offset the weakening effect of indebtedness on monetary policy transmission, particularly to sovereign bond yields.

Taken together, the evidence suggests that monetary policy decisions and transmission are shaped by indebtedness and the broader fiscal and institutional environment. Strengthening these structural foundations can enhance the effectiveness and credibility of monetary policy and improve macroeconomic stabilization. These findings are particularly relevant for emerging economies with little fiscal space and weak macroeconomic fundamentals, including highly leveraged public, private, and financial sector balance sheets. Key policy implications follow:

- (i) **Maintaining fiscal sustainability helps preserve monetary policy space.** Weak fiscal positions can constrain policy rate decisions, while high indebtedness weakens the effectiveness of monetary policy transmission. Ensuring debt sustainability is therefore an important prerequisite for effective and credible monetary policy.
- (ii) **Institutional strength supports monetary policy in debt-constrained economies but cannot substitute for sound balance sheets.** Strong fiscal frameworks and institutions can support monetary policy implementation and reduce the risk of fiscal dominance. Institutional reforms—notably independent fiscal councils, credible fiscal frameworks and effective enforcement of fiscal rules, sound debt management, and stronger CBI—can enhance the effectiveness and credibility of monetary policy. However, strong institutions cannot fully offset the adverse effects of high indebtedness.
- (iii) **Fiscal and monetary authorities should coordinate without undermining CBI.** Effective coordination between fiscal and monetary authorities is important for macroeconomic stabilization, particularly during periods of heightened fiscal and financial stress. However, coordination should not subordinate monetary policy to fiscal needs, which would increase the risk of fiscal dominance and undermine monetary policy credibility.

Given the empirical nature of this chapter, its conclusions should be taken with caution, as the adopted framework gives rise to several methodological caveats. First, the use of panel estimates may omit important heterogeneity across economies. Second, the identification of monetary policy shocks relies on ex-post revised data, whereas in real time central bank decisions are based on more uncertain information and on expectations prevailing at the time. Third, the evidence on fiscal dominance is reduced-form in nature which cannot rule out omitted common drivers of fiscal and monetary policy conditions. Fourth, the definition of high- and low-debt regimes rests on estimated thresholds, and CBI is measured with a *de jure* index that may not fully capture *de facto* independence.¹ Future research could incorporate the relationships between debt and monetary policy into dynamic general equilibrium and open-economy models to better understand their welfare implications and international spillovers. Despite these limitations, the chapter identifies robust patterns in the role of debt and institutional factors in monetary policy decisions and transmission, and provides a solid foundation for future research.

³ Additionally, data coverage is uneven across economies, particularly for sovereign bond yields in emerging markets. The analysis also centers on a single monetary policy instrument, interest rate setting, which—despite being arguably the most common tool at the disposal of central banks—has increasingly been complemented by macroprudential regulation, balance sheet operations, and forward guidance.

Appendixes

Appendix 1

Table A1.1 Variable Definition and Data Sources

Variable	Description	Source
Policy rate	Central bank rate, % p.a., quarterly (end of period)	BIS, IMF International Financial Statistics, CEIC Data Company
GDP growth	Real GDP, % QoQ, quarterly	CEIC Data Company
	Index	Estimates using data from CEIC Data Company
Inflation	CPI Inflation % QoQ, quarterly	Haver Analytics
	Index	IMF-IFS
Fiscal balance forecast	% of GDP, monthly, fixed-event consensus forecasts	Consensus Economics, Focus Economics
GDP growth forecast	%, monthly, fixed-event consensus forecasts	Consensus Economics
Inflation forecast	%, monthly, fixed-event consensus forecasts	Consensus Economics
Bilateral exchange rate vs. US\$	LCU/US\$, quarterly average	CEIC Data Company
US federal funds rate	Federal funds rate, % p.a., quarterly (end of period)	BIS
2-year sovereign bond yield	2-year government bond yield, % p.a., quarterly (end of period)	Bloomberg
10-year sovereign bond yield	10-year government bond yield, % p.a., quarterly (end of period)	Bloomberg
General government gross debt	Public debt, % of GDP	CEIC Data Company
Private debt	Private debt, % of GDP	Authors' calculation using data on household and corporate debt from CEIC Data Company
Fiscal balance	General government fiscal balance, % of GDP, quarterly	CEIC Data Company, Haver Analytics, IMF-IFS
Central bank independence	Central Bank Independence Index	Romelli (2022, 2025)
Inflation targeting	Inflation-targeting regime dummy	Fratzscher, Grosse-Steffen, and Rieth (2020)
Exchange rate regime	Exchange rate regime classification	IMF

BIS = Bank for International Settlements, CPI = consumer price index, GDP = gross domestic product, IMF = International Monetary Fund, IFS = International Financial Statistics, LCU = local currency unit, p.a. = per annum, QoQ = quarter on quarter.

References:

Fratzscher, M., C. Grosse-Steffen, and M. Rieth. 2020. *Inflation Targeting as a Shock Absorber*. *Journal of International Economics*. 123.

Romelli, D. 2022. *The Political Economy of Reforms in Central Bank Design: Evidence from a New Dataset*. *Economic Policy*. 37(112).

Romelli, D. 2025. *Trends in Central Bank Independence: A De-Jure Perspective*. In E. Farvaque and P. Stanek, eds. *Are Central Banks Still Conservative?* Edward Elgar Publishing.

Source: Authors' compilation.

Table A1.2 Summary Statistics of Key Variables

Variable	N	Mean	Min	Median	Max	SD
Global Sample						
Outcome variables						
Log real GDP	7,014	5.1	4.5	5.1	6.4	0.3
2-year sovereign bond yield, %	3,416	3.3	-0.7	2.7	17.5	3.4
10-year sovereign bond yield, %	3,648	4.6	-0.2	4.0	17.5	3.5
Control variables						
Nominal policy rate, %	6,972	4.8	-0.8	3.8	55.0	5.1
CPI inflation, %	7,063	1.0	-88.9	0.6	65.6	2.5
Real GDP growth, %	7,014	0.7	-55.6	0.7	43.7	2.7
Currency depreciation, %	7,063	0.4	-16.6	0.0	49.1	4.2
Fiscal balance, % of GDP	6,844	-2.6	-37.0	-2.7	27.0	4.6
Public debt, % of GDP	6,562	55.3	1.5	49.9	218.8	34.5
Private debt, % of GDP	5,015	88.4	9.8	80.7	290.9	48.7
Monetary policy shock	7,063	0.0	-9.5	0.0	9.2	0.7
Central Bank Independence Index	6,557	0.7	0.1	0.7	0.9	0.2
Emerging Market and Developing Economies						
Outcome variables						
Log real GDP	3,401	5.2	4.5	5.1	6.1	0.3
2-year sovereign bond yield, %	1,054	5.7	-0.4	5.0	17.5	3.9
10-year sovereign bond yield, %	1,240	7.3	1.2	6.9	17.5	3.8
Control variables						
Nominal policy rate, %	3,450	7.3	0.0	6.0	55.0	5.9
CPI inflation, %	3,450	1.4	-7.0	1.0	65.6	2.6
Real GDP growth, %	3,401	0.9	-35.9	1.0	25.2	2.8
Currency depreciation, %	3,450	0.9	-16.6	0.0	49.1	4.5
Fiscal balance, % of GDP	3,401	-3.3	-20.1	-3.0	19.3	3.9
Public debt, % of GDP	3,132	43.7	1.5	42.6	114.2	22.1
Private debt, % of GDP	2,023	53.6	9.8	47.3	195.7	33.0
Monetary policy shock	3,450	0.0	-9.5	0.0	9.2	1.0
Central Bank Independence Index	3,191	0.7	0.1	0.7	0.9	0.1
Developing Asia and the Pacific economies						
Outcome variables						
Log real GDP	1,039	5.3	4.7	5.3	6.1	0.4
2-year sovereign bond yield, %	569	6.0	0.3	4.9	17.5	4.2
10-year sovereign bond yield, %	578	7.1	1.3	6.3	17.5	4.4
Control variables						
Nominal policy rate, %	1,040	7.3	0.5	6.3	50.0	5.4
CPI inflation, %	1,040	1.3	-3.6	1.0	65.6	2.5
Real GDP growth, %	1,039	1.2	-22.2	1.3	16.7	2.7
Currency depreciation, %	1,040	0.9	-14.4	0.2	36.4	4.0
Fiscal balance, % of GDP	999	-3.2	-15.3	-2.9	9.9	3.2
Public debt, % of GDP	870	43.8	5.4	40.1	114.2	20.4
Private debt, % of GDP	674	68.5	9.8	49.1	195.7	47.9
Monetary policy shock	1,040	0.0	-6.3	0.0	8.5	0.9
Central Bank Independence Index	959	0.6	0.1	0.7	0.8	0.2

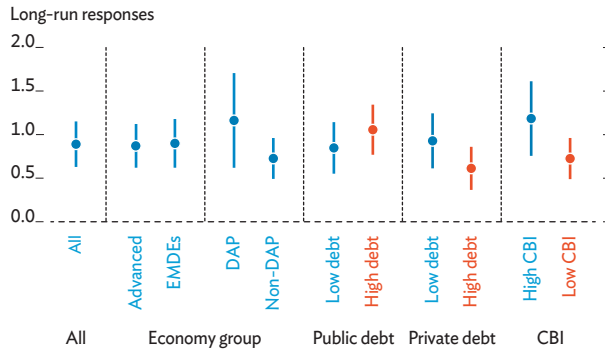
CPI = consumer price index, GDP = gross domestic product, SD = standard deviation.

Notes: Real GDP is measured using real GDP data at 2014 constant prices; where such data are unavailable, the corresponding real output index is used instead. Exchange rates are bilateral nominal exchange rates against the US dollar. Monetary policy shocks are estimated from the Taylor rule in the monetary policy decision analysis.

Source: Authors' computation.

Figure A1.1 Interest Rate Responses to Expected Inflation Across Subgroups

The long-run interest rate responses to expected inflation are stronger in DAP and for economies with high public debt.



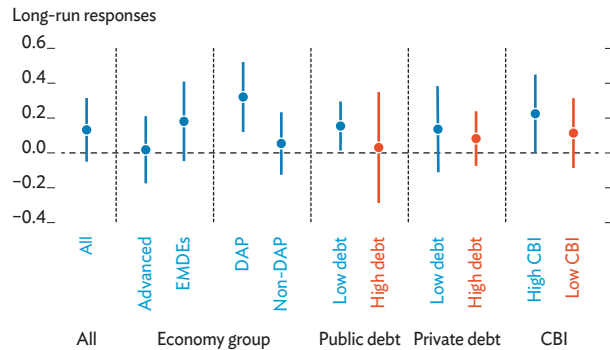
CBI = central bank independence, DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies.

Notes: Filled circles depict long-run responses to expected inflation corresponding to each subgroup, while the error bars are calculated at a 90% confidence level. Each bin corresponds to a single panel regression of the augmented Taylor-rule specification, with the response coefficients interacted with a dummy variable (0/1) defining the economy/regime subgrouping. The baseline specification corresponds to that reported in column 1 of Table 4.1, and is depicted in the first bin in the chart (All). For continuous subgroup-defining variables (debt and CBI), the dummy variable is obtained through threshold regressions, resulting in the following thresholds: 65.7% for public debt/GDP, 60.3% for private debt/GDP, and 0.7 for CBI.

Source: Authors' calculations.

Figure A1.2 Interest Rate Responses to Expected GDP Growth Across Subgroups

The long-run interest rate responses to expected growth are stronger in DAP and for economies with lower public debt.



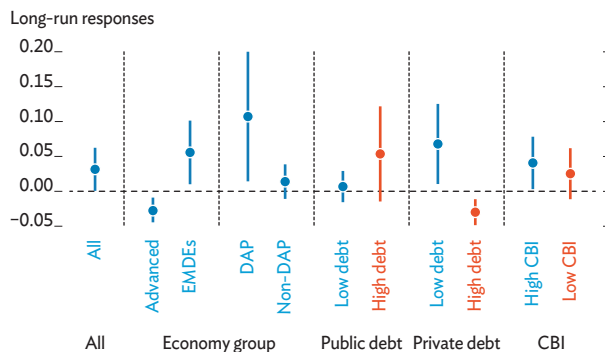
CBI = central bank independence, DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, GDP = gross domestic product.

Notes: Filled circles depict the long-run responses to expected GDP growth corresponding to each subgroup, while the error bars are calculated at a 90% confidence level. Each bin corresponds to a single panel regression of the augmented Taylor rule specification, with the response coefficients interacted with a dummy variable (0/1) defining the economy/regime subgrouping. The baseline specification corresponds to that reported in column 1 of Table 4.1, and is depicted in the first bin in the chart (All). For continuous subgroup-defining variables (debt and CBI), the dummy variable is obtained through threshold regressions, resulting in the following thresholds: 65.7% for public debt/GDP, 60.3% for private debt/GDP, and 0.7 for CBI.

Source: Authors' calculations.

Figure A1.3 Interest Rate Responses to Currency Depreciation across Subgroups

The long-run interest rate responses to currency depreciation are stronger in DAP and for economies with lower private debt.

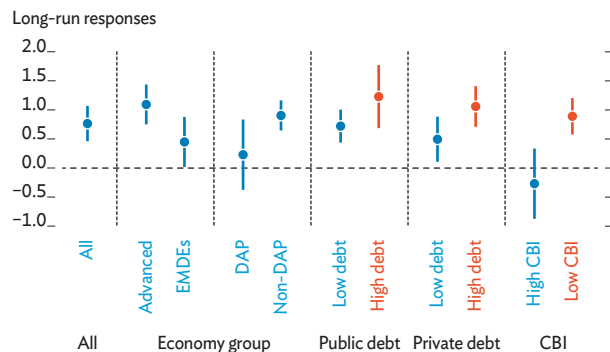


CBI = central bank independence, DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies.

Notes: Filled circles depict the long-run responses to exchange rate depreciation corresponding to each subgroup, while the error bars are calculated at a 90% confidence level. Each bin corresponds to a single panel regression of the augmented Taylor rule specification, with the response coefficients interacted with a dummy variable (0/1) defining the economy/regime subgrouping. The baseline specification corresponds to that reported in column 1 of Table 4.1, and is depicted in the first bin in the chart (All). For continuous subgroup-defining variables (debt and CBI), the dummy variable is obtained through threshold regressions, resulting in the following thresholds: 65.7% for public debt/GDP, and 0.7 for CBI.

Figure A1.4 Interest Rate Responses to US Natural Rate Across Subgroups

The long-run interest rate responses to US natural rates are stronger in advanced economies and high-debt groups.



CBI = central bank independence, DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies.

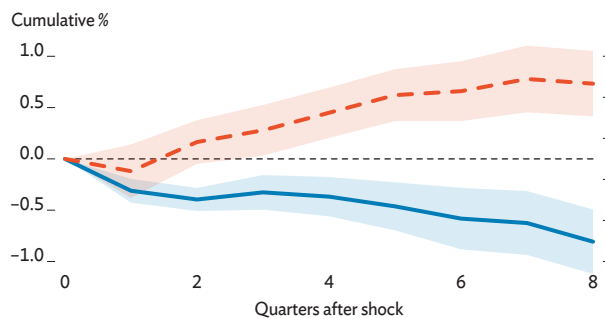
Notes: Filled circles depict the long-run responses to US natural rate corresponding to each subgroup, while the error bars are calculated at a 90% confidence level. Each bin corresponds to a single panel regression of the augmented Taylor rule specification, with the response coefficients interacted with a dummy variable (0/1) defining the economy/regime subgrouping. The baseline specification corresponds to that reported in column 1 of Table 4.1, and is depicted in the first bin in the chart (All). For continuous subgroup-defining variables (debt and CBI), the dummy variable is obtained through threshold regressions, resulting in the following thresholds: 65.7% for public debt/GDP, 60.3% for private debt/GDP, and 0.7 for CBI.

Figure A1.5 Separate Responses of GDP to Surprise Tightening and Easing in EMDEs and DAP

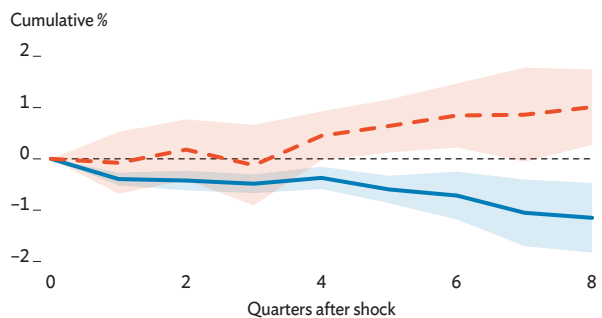
Monetary tightening cuts output and easing raises it in both EMDEs and DAP, with stronger responses in DAP.

— Tightening (+1 shock) - - - Easing (-1 shock)

A. Responses of Output in EMDEs



B. Responses of Output in DAP



DAP = developing Asia and the Pacific, EMDEs = emerging market and developing economies, GDP = gross domestic product.

Notes: The figure reports responses of real GDP to monetary tightening and easing shocks separately in both EMDEs and DAP. Shaded areas denote 90% confidence intervals based on economy-clustered standard errors.

Source: Authors' calculations.

Appendix 2

Asymmetric Responses to Tightening and Easing Shocks Across Debt Regimes

This appendix reports results on how indebtedness affects the asymmetric responses of output and financial conditions to tightening and easing shocks. Highly indebted borrowers may respond differently to a rise in debt-servicing costs than to a decline, while financial markets may also price monetary tightening and easing differently when sovereign or private balance sheets are stretched. Figures A2.1 and Figure A2.2 re-estimate the state-dependent local projections distinguishing between positive and negative monetary policy shocks, to check asymmetric responses for tightening and easing shocks under high- and low-debt regimes. Panels A and B of both figures report responses under high and low public and private debt, respectively. The figures present results for the full global sample. Results for emerging market and developing economies and for developing Asia and the Pacific are broadly consistent and, for brevity, not reported separately.

The responses to tightening shocks confirm that high indebtedness weakens monetary transmission to both output and bond yields. High debt, either public or private, mutes the response of bond yields across both short and long maturities, while the pass-through of monetary tightening works only in regimes with low public and private debt. The responses of output to tightening shocks are not significantly different in both public-debt regimes, but the response is muted in regimes with high private debt.

Output and bond yield responses are mostly insignificant to easing shocks in regimes with either high or low public debt. With high public debt, the output response is initially negative following a surprise monetary easing but gradually rises and becomes statistically significant after about 4–5 quarters. This delayed response may reflect the gradual easing of debt servicing and refinancing pressures when public debt is high, improving fiscal space and supporting aggregate demand over time. By contrast, output response remains statistically insignificant with low public debt, where public financing constraints and debt servicing burdens are less binding. Monetary easing therefore

provides smaller additional support through the public sector balance sheet channel. Meanwhile, 2-year bond yields decline significantly immediately following surprise monetary easing in both public-debt regimes, but the responses become statistically insignificant over time. Ten-year bond yields decline only marginally and are statistically significant following a surprise easing in regimes with low public debt, while with high public debt responses are not statistically distinguishable from zero. Overall, public indebtedness appears to play a limited role in shaping the transmission of easing shocks, with differences across debt regimes generally modest.

Output responses to easing shocks are muted regardless of private indebtedness levels, but the transmission to bond yields appears effective only with low private debt. In regimes with low private debt, output increases after a surprise monetary easing but remains statistically insignificant, while both short- and long-term yields decline significantly. By contrast, in regimes with high private debt, none of these responses are statistically significant. This evidence suggests that high private indebtedness weakens the transmission of surprise monetary easing to financial conditions, consistent with debt-overhang effects. However, there is no visible difference in output responses to a surprise monetary easing.

The results provide consistent evidence that high indebtedness weakens monetary transmission.

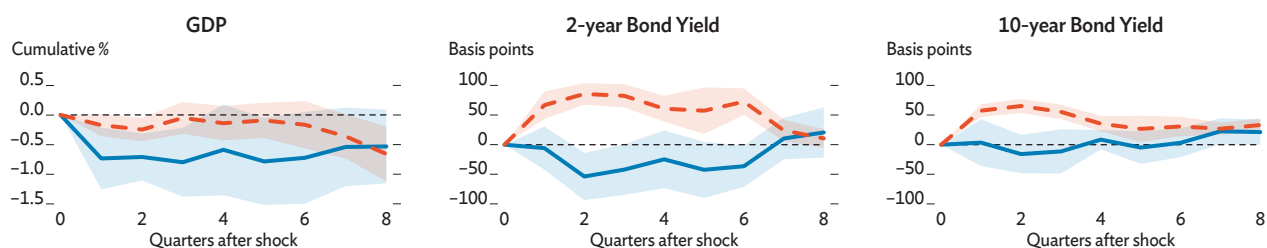
First, private indebtedness remains an important factor shaping monetary policy transmission for both tightening and easing shocks, particularly through financial conditions. Second, the stronger regime dependence observed for tightening than for easing is consistent with asymmetric mechanisms emphasized in the literature (Tenreyro and Thwaites 2016). Higher debt servicing burdens become more binding when interest rates rise, while rate cuts may do less to relax constraints facing borrowers who are already highly leveraged or to stimulate financial markets when other balance-sheet vulnerabilities remain. The insignificance of the easing responses may also reflect that easing surprises are more clustered during downturns and crises, when other factors may dominate the responses of output and yields.

Figure A2.1 Responses to Tightening Shocks in High- and Low-Debt Regimes

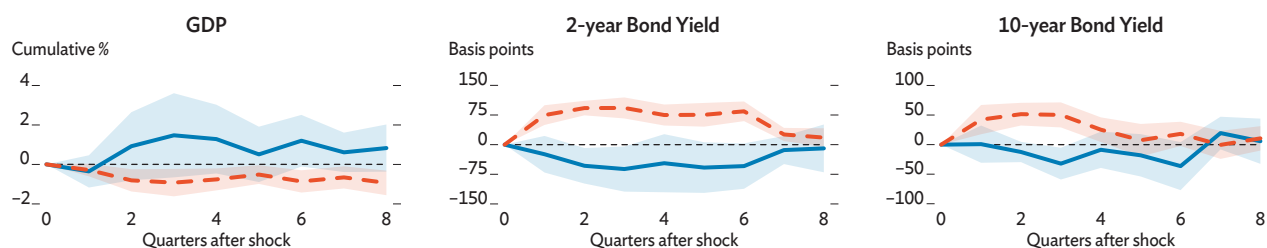
High public and private debt amplify the decline in GDP and the rise in bond yields following monetary tightening.

A. High Versus Low Public Debt

— High public debt - - Low public debt

**B. High Versus Low Private Debt**

— High private debt - - Low private debt



GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

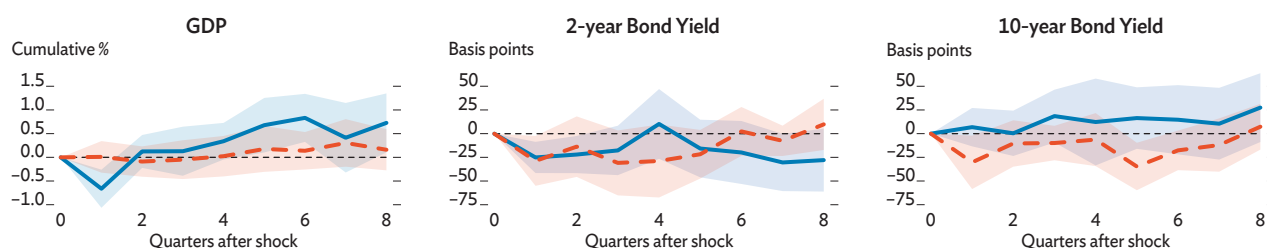
Source: Authors' calculations.

Figure A2.2 Responses to Easing Shocks in High- and Low-Debt Regimes

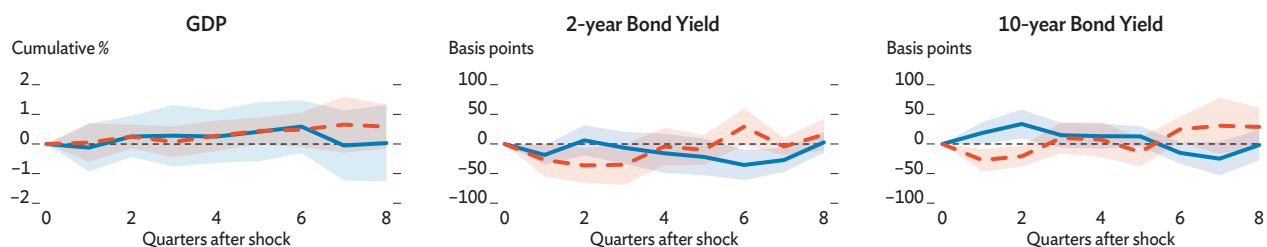
High public and private debt dampen the effects of monetary easing, as GDP gains are smaller and bond yields fall less than in low-debt regimes.

A. High Versus Low Public Debt

— High public debt - - Low public debt

**B. High Versus Low Private Debt**

— High private debt - - Low private debt



GDP = gross domestic product.

Notes: Shaded areas denote 90% confidence intervals based on economy-clustered standard errors. Bond yields are winsorized at the 1st and 99th percentiles to reduce the influence of extreme observations.

Source: Authors' calculations.

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3

ECONOMIC TRENDS AND PROSPECTS



CAUCASUS AND CENTRAL AND WEST ASIA

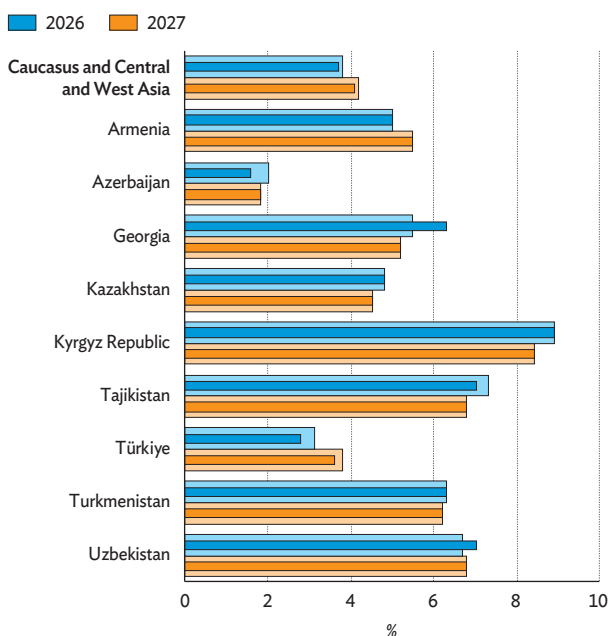
Asian Development Outlook (ADO) September 2026 lowers growth projections for the subregion for both 2026 and 2027. Non-hydrocarbon exporters in Central Asia and most Caucasus countries have continued to expand robustly, supported by public investment, construction, and resilient consumption. However, the region's two large hydrocarbon exporters—Azerbaijan and Kazakhstan—have slowed from 2025 as oil-sector-specific disruptions have weighed on headline growth, even as their non-oil economies held up. Inflation forecasts for 2026 have been revised up for Azerbaijan, Georgia, Türkiye, and Uzbekistan, largely reflecting hydrocarbon price pass-through and administered tariff adjustments but are unchanged for other countries.

Subregional Assessment and Prospects

The Caucasus and Central and West Asia growth outlook is revised down 0.1 percentage points for 2026 and 2027. The *ADO September 2026* now projects growth at 3.7% in 2026, down from 3.8% in July, and at 4.1% in 2027, down from 4.2% (Figure 3.1.1). The revisions reflect lower growth projections for Azerbaijan, Tajikistan, and Türkiye. In Türkiye, disinflation has continued but slowed as regional conflicts have raised energy costs and are expected to weaken external demand. These headwinds are also expected to weigh on the Turkish economy in 2027, lowering growth. The ADO reduces Tajikistan's 2026 growth forecast as Russia's war in Ukraine has escalated, disrupting fuel imports and constraining near-term activity. Contraction in the oil sector has also lowered Azerbaijan's growth projection. In contrast, the 2026 growth forecasts for Georgia and Uzbekistan are upgraded as activity in both economies has expanded faster than previously projected. The stronger momentum is expected to continue in 2027, despite spillovers from price shocks in external oil markets. Growth in other countries has stayed in line with earlier ADO projections.

Figure 3.1.1 Gross Domestic Product Growth in the Caucasus and Central and West Asia

Growth projections for 2026 and 2027 have been reduced, as external headwinds are expected to weigh on activity in several economies across the subregion.



Note: Lighter-colored bars are *Asian Development Outlook July 2026* forecasts.

Source: *Asian Development Outlook* database.

The subregional assessment and prospects were written by George Luarsabishvili and Parvina Rakhimova. The section on Kazakhstan was written by Sanzhar Kaldarov and Genadiy Rau; Türkiye by George Luarsabishvili; and the other economies by Sherzod Akbarov, Maya Grigolia, Grigor Gyurjyan, Jennet Hojanazarova, Khagani Karimov, Gulnur Kerimkulova, and Shuhrat Mirzoev. All authors are in the Central and West Asia Department.

Economies in Central Asia have grown moderately, supported mainly by strong domestic demand, public investment, construction, and expanding services and manufacturing. However, growth prospects are expected to moderate in some economies as external demand weakens, energy costs remain elevated, and regional trade and supply disruptions persist. The Kyrgyz Republic's economy has accelerated as continued public investment, strong private consumption, and broad-based sectoral gains have driven expansion, with a surge in construction supported by continued infrastructure financing and expanded state-backed housing programs. Growth is expected to moderate as trade and domestic demand soften and electricity constraints weigh on industry; forecasts remain unchanged at 8.9% for 2026 and 8.4% for 2027. Tajikistan's growth remained strong at 8.2% in the first half, led by expansion in manufacturing, food processing, and metallurgy, and strong retail-driven services. The *ADO September 2026* reduces the 2026 forecast to 7.0% from 7.3% in July, amid the impact of Russia's war in Ukraine; the 2027 forecast remains at 6.8%. Turkmenistan's reported growth has remained at 6.3%, underpinned by public investment in industrial and social infrastructure and broad-based gains in construction, trade, transport and communications, and agriculture. Uzbekistan's growth accelerated strongly to 8.5% in the first half, exceeding expectations, led by rapid growth in services, industrial expansion, construction, and considerable growth in fixed investment in energy, manufacturing, transport, and housing. The 2026 forecast is raised to 7.0% from 6.7%, although growth is expected to slow in the second half as external demand weakens and energy prices remain high. The 2027 forecast is retained at 6.8%.

Growth among the Caucasus countries diverged in the first half of 2026. Georgia outperformed expectations, supported by strong services, consumption, and exports. With activity exceeding expectations and regional spillovers remaining limited, the 2026 growth forecast is raised to 6.3% from 5.5%; the 2027 forecast remains at 5.2%. Growth in Armenia moderated amid softer demand. Strong construction, supported by public infrastructure and real estate activity, and a rebound in industry partly offset slower services growth and a contraction in agriculture. Forecasts remain unchanged at 5.0% for 2026 and 5.5% for 2027, supported by domestic demand, construction, services, and tourism. Growth was

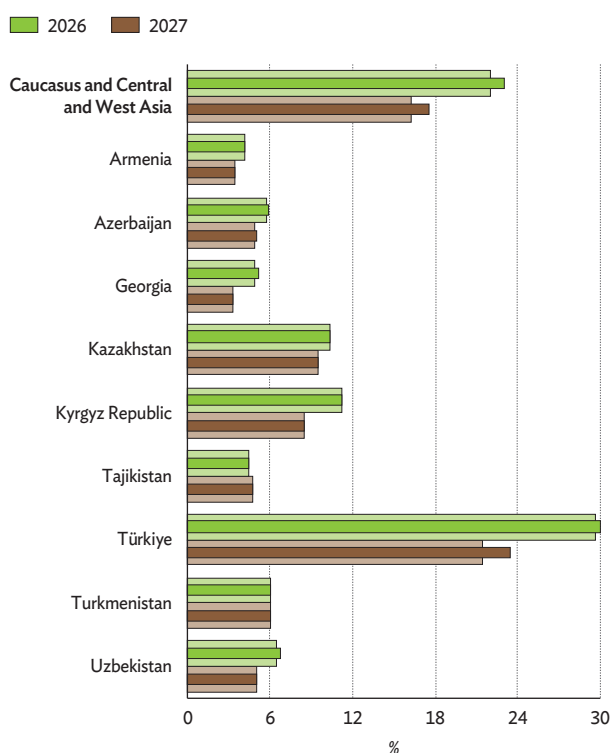
weakest in Azerbaijan as declining hydrocarbon output and construction activity weighed on the economy. The 2026 forecast is reduced to 1.6% from 2.0%, while the 2027 forecast is maintained at 1.8%, reflecting an expected recovery.

Inflation projections for the Caucasus and Central and West Asia region are revised upward despite the diverging dynamics across its economies.

Higher fuel and food prices and energy-related cost pressures have remained the main drivers of inflation. The subregional inflation forecast is raised from 22.0% to 23.1% for 2026 and from 16.3% to 17.6% for 2027 (Figure 3.1.2). Compared to 2025, price pressures have intensified in Armenia, Georgia, the Kyrgyz Republic, Tajikistan, and Turkmenistan, while inflation has moderated in Kazakhstan, Türkiye, and Uzbekistan. Georgia recorded the sharpest acceleration, driven by higher fuel, transport, and food prices, prompting

Figure 3.1.2 Inflation in the Caucasus and Central and West Asia

Higher fuel and food prices and energy-related cost pressures have raised inflation in several economies, prompting a rise in inflation forecasts.



Note: Lighter-colored bars are Asian Development Outlook July 2026 forecasts.

Source: Asian Development Outlook database.

an increase in its policy rate to 8.25% and an upward revision to its 2026 inflation forecast to 5.2%. Inflation in the Kyrgyz Republic rose to 10.6%, reflecting import dependence and electricity-generation shortfalls, while Uzbekistan has faced renewed price pressures from higher electricity and gas tariffs. Inflation in Tajikistan remained within the target range despite higher fuel costs. The ADO keeps Turkmenistan's forecasts at 6.0% for both years, supported by exchange-rate management and administrative controls. In Türkiye, disinflation has continued but inflation remained high at 31.8% in July, reflecting persistent input-cost pressures. Kazakhstan's inflation remained in double digits but is expected to ease gradually, with forecasts unchanged at 10.4% for 2026 and 9.5% for 2027.

Fiscal policy across the region was broadly prudent in the first half of 2026, supported by strong revenue performance and deliberate expenditure restraint. Türkiye recorded its strongest fiscal outturn in years, with the central government deficit narrowing to 2.6% of GDP. Buoyant commodity-linked receipts narrowed Armenia's deficit and helped produce a fiscal surplus in Georgia, while capital-expenditure cuts produced a fiscal surplus in Azerbaijan. In Central Asia, Tajikistan's revenue increased considerably as tax administration strengthened, helping to reduce public debt through Eurobond and other debt repayments. In Kazakhstan, higher tax revenues—supported by increased value-added tax collections—contributed to a declining deficit despite reduced transfers from the sovereign wealth fund. Turkmenistan and Uzbekistan have continued to target balanced budgets or contained deficits under explicit medium-term fiscal frameworks.

External positions have diverged along the same hydrocarbon/non-hydrocarbon fault line as growth. Hydrocarbon exporters have benefited from higher oil and gas prices while several non-hydrocarbon and remittance-dependent economies have seen wider deficits. Kazakhstan's current account shifted to a surplus of 0.7% of GDP in the first half of 2026 as merchandise exports rose sharply, while Azerbaijan's surplus reached 9.5% and its combined official reserves increased to \$85.8 billion. Tajikistan's surplus widened to 21.5% of GDP, as precious-metal exports surged. Armenia's deficit stood at 12.6% of GDP amid trade disruptions, while the Kyrgyz Republic's deficit increased to 24.4% of GDP as exports and remittances

declined. Georgia's deficit narrowed to 3.8% of GDP on stronger merchandise exports, although weaker tourism may temper this improvement. Türkiye's deficit widened to 4.2% of GDP as higher energy import costs outpaced export growth. Uzbekistan's external balance weakened as gold exports declined and imports increased strongly, while Turkmenistan's current account surplus is projected to narrow as import growth exceeds export growth.

Kazakhstan

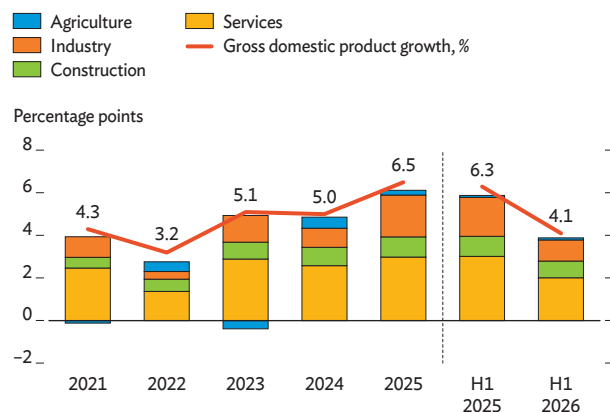
Growth moderated in the first half of 2026, with expansion outside hydrocarbons partly cushioning weaker oil output. Inflation remained in double digits. Public investment and off-budget financing will continue to support growth in 2026 and 2027. Inflation is projected to slow gradually amid utility and fuel price adjustments and external pressures.

Updated Assessment

Growth moderated in the first half of 2026, reflecting disruption in the oil sector. Expansion was 4.1% year on year, down from 6.3% in the same period of 2025, as an 8.4% decline in oil production led to a 4.0% contraction in mining (Figure 3.1.3). The decline reflected an extended outage at the Tengiz oil field in the first quarter and repeated disruptions to the Caspian Pipeline Consortium, which

Figure 3.1.3 Supply-Side Contributions to Growth

Growth moderated in the first half of 2026 amid weaker oil output.



H = half.

Source: Republic of Kazakhstan, Agency for Strategic Planning and Reforms, Bureau of National Statistics.

carries over 80% of Kazakhstan's oil exports. Growth in manufacturing accelerated to 9.8% from 5.6% on expanded government support programs. Construction eased to 15.2% from 18.4% as state infrastructure projects continued. Growth in services slowed to 3.6% from 5.3%, as growth in trade and transport moderated to 5.7% and 7.1%, respectively. Agriculture expanded by 4.4% as crop production increased by 7.7% and livestock by 4.4%.

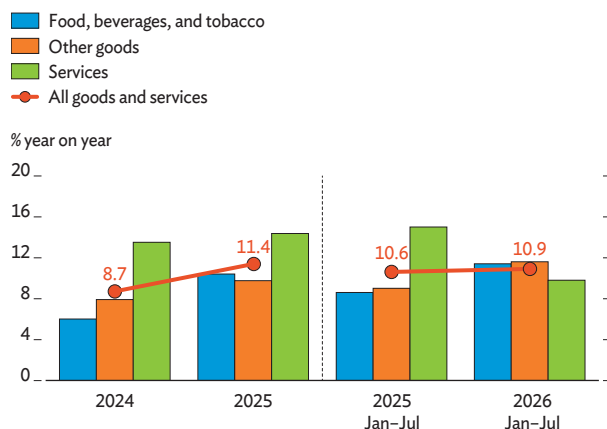
Consumption and investment supported growth while net exports declined.

Demand-side data—available only for the first quarter of 2026—show that consumption growth accelerated to 6.7% year on year from 5.5% in the comparable period of 2025. This reflects increases of 5.7% in private consumption and 12.8% in public consumption. Growth in investment remained healthy but moderated to 7.2% from 9.8%, with gross fixed capital formation rising by 7.9% from 7.4%. Net exports of goods and services declined as exports contracted by 5.9% while imports increased by 3.1%.

Inflation remained in double digits following the end of temporary price controls. Annual average inflation accelerated to 10.9% in the first 7 months of 2026 from 10.6% a year earlier (Figure 3.1.4). Price increases for nonfood items averaged 11.6%, followed by food at 11.4% and services at 9.8%. The temporary freeze on utility and fuel prices through April 2026, weaker consumer lending and business activity amid tax and regulatory changes, and a firmer exchange rate

Figure 3.1.4 Average Inflation

Inflation remained in double digits in the first 7 months of 2026.

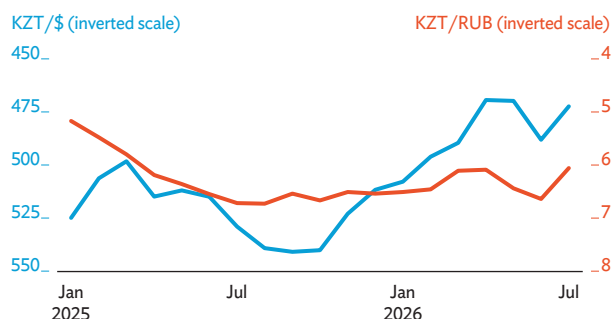


Source: Republic of Kazakhstan, Agency for Strategic Planning and Reforms, Bureau of National Statistics.

all helped ease inflationary pressures. The Kazakhstan tenge appreciated by 5.8% on average against the US dollar in the first 7 months of 2026 but depreciated by 4.8% against the Russian ruble (Figure 3.1.5). The appreciation against the US dollar reflected a high policy interest rate for most of the period, the central bank's gold-mirroring operations, foreign exchange sales by quasi-public entities, and non-resident inflows into government securities.

Figure 3.1.5 Average Nominal Tenge Exchange Rate

The tenge appreciated against the US dollar but depreciated against the Russian ruble in the first 7 months of 2026.



KZT = Kazakhstan tenge, RUB = Russian ruble.

Source: National Bank of the Republic of Kazakhstan.

The policy rate was cut as headline inflation eased.

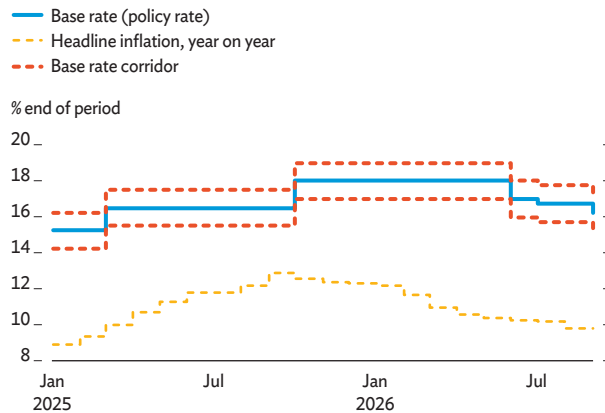
The National Bank of Kazakhstan, the central bank, maintained the key policy rate at 18.00% through May 2026 before cutting it by a cumulative 175 basis points to 16.25% by September. The central bank's actions followed 11 consecutive months of declining headline inflation, which eased to 9.8% in August from 12.2% a year earlier (Figure 3.1.6). Broad money (M3) grew by 4.3% in the first half of 2026, up from 2.7% in the same period of 2025. To absorb excess liquidity, the central bank resumed issuing short-term notes and further raised minimum reserve requirements for banks.

Tax revenue increased amid higher value-added tax and oil export duties.

In the first half of 2026, general government revenue declined to 21.2% of GDP from 23.7% in the same period of 2025. Transfers from the National Fund of the Republic of Kazakhstan, the sovereign wealth fund, fell to 2.6% of GDP from 5.1%, reflecting the absence of targeted transfers. Tax revenue edged up to 17.7% of GDP from 17.5%, driven by nominal increases of 41.9% in value-added tax (VAT) and 7.3% in corporate income tax, while higher

Figure 3.1.6 Monetary Policy and Headline Inflation

The policy rate was lowered following a sustained decline in headline inflation.



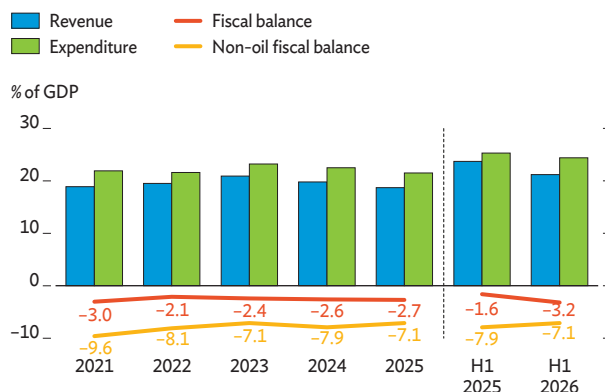
Source: National Bank of the Republic of Kazakhstan.

oil prices boosted crude oil export duties by 23.3%. Nontax revenue decreased to 0.6% of GDP from 1.0%. General government expenditure declined to 24.4% of GDP from 25.3%. The state budget deficit widened to 3.2% of GDP from 1.6%, while the non-oil deficit narrowed to 7.1% of GDP from 7.9% (Figure 3.1.7). Debt service costs rose to 3.0% of GDP from 2.7%.

Higher merchandise exports moved the current account into surplus. Preliminary estimates show a current account surplus of 0.7% of GDP in the first half of 2026, compared with a deficit of 3.0% a year earlier (Figure 3.1.8). The trade surplus expanded to 10.3% of GDP from 6.4%, as merchandise exports

Figure 3.1.7 Fiscal Indicators

The fiscal deficit widened in the first half of 2026 while the non-oil deficit narrowed.

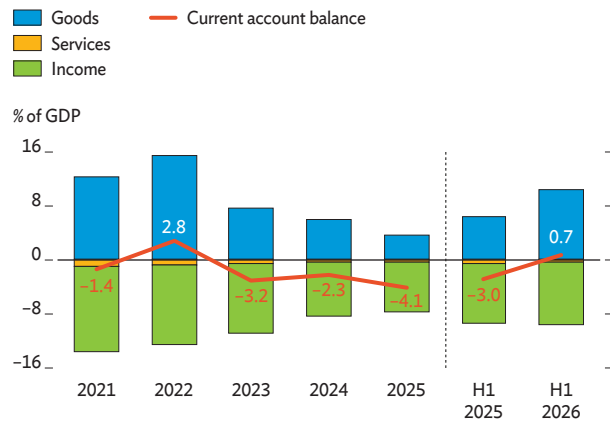


GDP = gross domestic product, H = half.

Source: Ministry of Finance of the Republic of Kazakhstan.

Figure 3.1.8 Current Account Balance

The current account recorded a small surplus in the first half of 2026.



GDP = gross domestic product, H = half.

Note: Preliminary data for the first half of 2026.

Source: National Bank of the Republic of Kazakhstan.

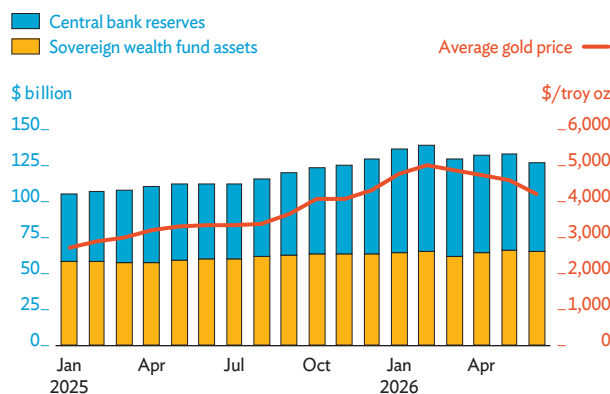
grew by 24.7% year on year due to higher metals and grain exports. Oil export volumes declined by 8.1%, while elevated oil prices cushioned export earnings. Merchandise imports grew by 6.7% amid higher purchases of machinery and equipment. The services deficit narrowed to 0.3% of GDP from 0.6% on stronger exports of transport services. The primary income deficit widened to 9.4% of GDP from 8.8%, reflecting larger net income accruing to foreign direct investors. The secondary income balance shifted from a deficit to a surplus of 0.1% of GDP.

International assets reached \$127.3 billion, with lower gold prices weighing on central bank reserves.

In the first half of 2026, the central bank's foreign exchange reserves decreased by 5.0% to \$62.2 billion, providing 9 months of import cover. Monetary gold, which accounted for 76.5% of central bank reserves, declined by 9.5%, reflecting a downward correction in gold prices from March 2026. Sovereign wealth fund assets increased by 2.0% to \$65.1 billion (Figure 3.1.9). Over the period, the central bank converted \$2.6 billion of the sovereign wealth fund's foreign currency assets into tenge to finance budget transfers, down from \$5.0 billion in the first half of 2025. In the first quarter of 2026, external debt increased to \$182.8 billion, or 58.2% of GDP, with private-sector external debt at \$138.1 billion, or 43.9% of GDP. Public-sector external debt rose to \$44.7 billion, or 14.2% of GDP, in the first quarter (Figure 3.1.10). This was followed by new Eurobond and Panda bond issuances in the

Figure 3.1.9 International Assets and Gold Prices

Central bank reserves declined on lower gold prices, while sovereign wealth fund assets increased.

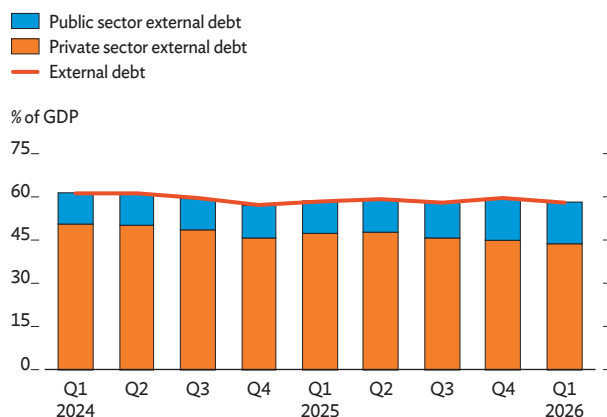


oz = ounce.

Sources: World Bank Commodity Price Data; National Bank of the Republic of Kazakhstan.

Figure 3.1.10 External Debt

External debt increased in nominal terms but declined as a share of GDP in the first quarter of 2026.



GDP = gross domestic product, Q = quarter.

Source: National Bank of the Republic of Kazakhstan.

second quarter. In August 2026, S&P Global Ratings upgraded Kazakhstan's sovereign credit rating to BBB/A-2, with a stable outlook.

Prospects

Non-oil sectors will underpin growth in 2026 and 2027 (Table 3.1.1). In 2026, mining is forecast to contract by 1.0%—a downward revision from ADO July 2026 forecast—as the expected recovery in oil production only partly offsets earlier disruptions. Oil output will also remain constrained by the Organization of the Petroleum Exporting Countries and its partners

Table 3.1.1 Selected Economic Indicators in Kazakhstan, %

Earlier projections for growth and inflation remain unchanged.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	6.5	4.8	4.8	4.5	4.5
Inflation	11.4	10.4	10.4	9.5	9.5

GDP = gross domestic product.

Source: Asian Development Bank estimates.

(OPEC+) compensation requirements and risks to exports through the Caspian Pipeline. Manufacturing growth is projected at 8.0%, above the July baseline, underpinned by government programs supporting manufacturing and investment. Growth in services is projected at 4.3%, slightly below the July baseline, reflecting slower momentum in trade and transport. Construction will remain robust, supported by continuing state infrastructure projects. Agriculture will grow amid expanded concessional financing. In 2027, growth will rely increasingly on non-oil sectors as oil production remains near capacity while planned maintenance and potential disruptions constrain output. Manufacturing and trade are expected to benefit from normalizing domestic demand, while construction will stay robust. Expansion in agriculture will remain sensitive to weather and harvest conditions, and to the scale of state support.

Off-budget fiscal stimulus will support demand-side growth. Consumption growth is projected at 5.0% in 2026, slightly above the July baseline, strengthening further in 2027 due to higher public consumption. Further tightening of consumer lending rules is expected to constrain private consumption. Investment growth is projected at 8.0% in 2026 before moderating in 2027, supported by state infrastructure projects and financing from Baiterek National Investment Holding and Samruk-Kazyna. By mid-2026, Baiterek had provided around \$6.2 billion of its planned annual \$16.4 billion in lending, while Samruk-Kazyna had planned \$10.9 billion in investment expenditure. Net exports of goods and services will decline in both years as imports of intermediate and investment goods continue to grow while exports remain exposed to oil-sector disruptions. New US tariffs will have a limited direct impact, as uranium and other commodities, Kazakhstan's key exports to the United States, are exempt.

Inflation is projected to slow gradually in 2026 and 2027 (Table 3.1.1).

Annual average inflation is forecast at 10.4% in 2026 and 9.5% in 2027, unchanged from the July forecast. In 2026, lagged effects of monetary tightening and prudential measures are expected to contain price pressures. The increase in the VAT rate has had limited impact on inflation, reflecting earlier pass-through to consumer prices. Inflation for food and other goods is expected to decrease as tax and external cost pressures ease. Services inflation is projected to decline more slowly, reflecting utility tariff and fuel price adjustments. In 2027, moderately tight monetary conditions and lower private demand should support disinflation, while further increases in regulated prices and off-budget spending will keep inflation risks elevated.

Higher tax collection will support revenue while expenditure remains rigid.

In 2026, based on government projections, the state budget deficit is expected to widen to 3.0% of GDP from 2.7% in 2025. Higher VAT receipts, improved tax administration, and additional revenue from higher oil prices are expected to help cushion lower sovereign wealth fund transfers. The non-oil deficit is projected to decline to 5.4% of GDP from 7.1%. In 2027, fiscal space will remain limited, although fewer tax exemptions will support revenue. Expenditure will remain rigid, with the government aiming to gradually raise household incomes, including for public-sector workers.

The current account will post a small deficit in 2026 before widening in 2027.

In 2026, a larger trade surplus will support the external balance, with stronger non-hydrocarbon exports. Merchandise imports will also expand as off-budget financing and public investment sustain demand for intermediate and investment goods. In 2027, faster import growth and weaker export momentum will narrow the trade surplus and widen the current account deficit. The services deficit is projected to remain broadly unchanged over the forecast period, while the income deficit is expected to widen.

The outlook is subject to risks, mainly downside.

Repeated disruptions to the Caspian Pipeline, tighter OPEC+ compensation requirements, and extended maintenance could reduce oil output and exports, while higher oil prices would provide a partial offset. Weaker growth in key trading partners and tighter

global financial conditions could also weigh on the outlook. On the upside, larger off-budget financing and public investment could support non-oil sectors and domestic demand. Higher budget and off-budget fiscal stimulus, further utility and fuel price adjustments, renewed exchange rate pressures, and higher global food prices could add to inflation. However, weaker household consumption, slower credit growth, and softer import demand for consumer goods could reinforce disinflation.

Türkiye

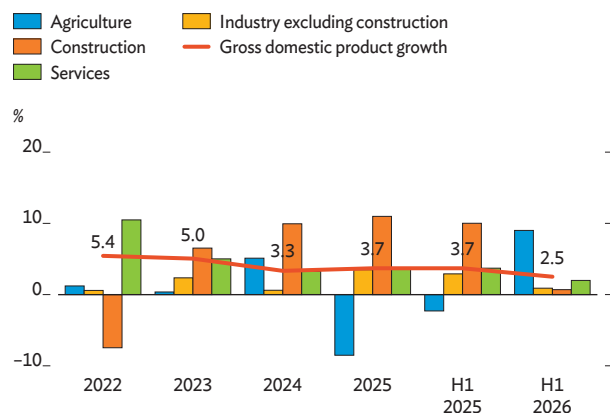
Türkiye's growth slowed but remained underpinned by domestic demand, services, and investment, despite softening activity in industry and persistent external vulnerabilities. The Middle East conflict intensified inflationary pressures by raising energy prices and disrupting trade, slowing disinflation. With a projected growth slowdown and persistent inflationary pressures, the challenge is to sustain disinflation and fiscal discipline while improving external balances and supporting industry.

Updated Assessment

Growth moderated in early 2026 as weak external demand and slow expansion in manufacturing offset higher private consumption. Growth was an estimated 2.5% in the first half of 2026, year on year, down from 3.7% a year earlier (Figure 3.1.11).

Figure 3.1.11 Gross Domestic Product Growth by Sector

Growth softened in the first half of 2026.



H = half.

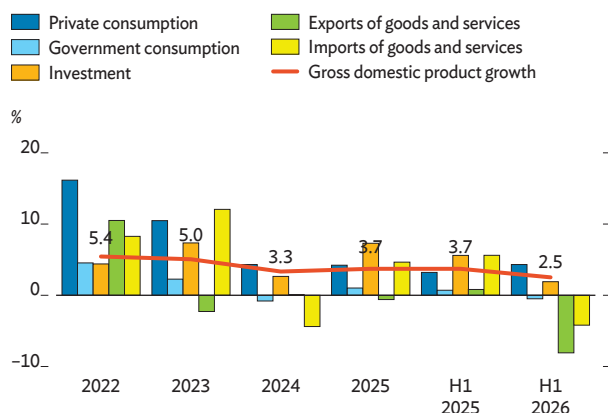
Source: Turkish Statistical Institute.

On the supply side, expansion in industry slowed to 0.9% from 2.9% in the same period of 2025 amid tighter financial conditions. Growth in construction fell to 0.7% from 10.0% a year before as private investment in housing declined (with a quarter of firms in the industry facing financial constraints), while manufacturing grew by 0.6% compared to 2.7% a year earlier amid lower demand for durable consumer goods. Agriculture expanded by 9.0%, reversing a 2.3% contraction a year before, reflecting improved weather and harvest, while growth in services slowed to 2.0% from last year's 3.7%, because of reduced growth in trade, transportation, and accommodation. Within services, the fastest expansion was in information and communication (8.8%), finance and insurance (2.9%), and real estate (2.6%).

On the demand side, private consumption contributed most to growth. It expanded by 4.3% in the first half of 2026, up from 3.2% in the same period of 2025. Government consumption contracted by 0.5% in the same period, as fiscal discipline continued, reversing a 0.7% expansion (Figure 3.1.12). Growth in investment moderated to 1.9% from 5.6%, because of reduced spending on machinery and equipment. Moreover, net exports contracted significantly, reflecting higher imports of energy and gold purchases. The unemployment rate decreased to 7.4% in June 2026 from 8.5% a year before, despite the slowdown in industry.

Figure 3.1.12 Gross Domestic Product Growth by Expenditure

Growth in the first half of 2026 was driven by expansions in private consumption and investment.



H = half.

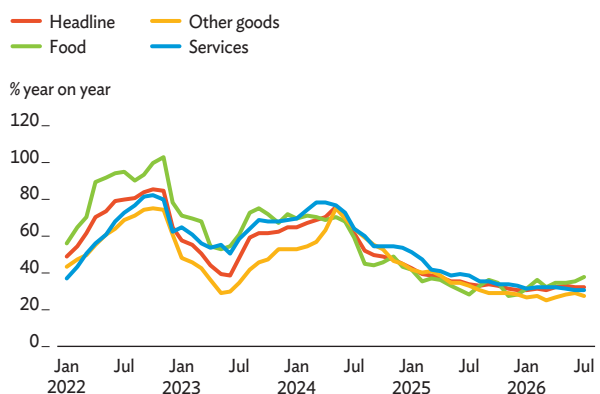
Source: Turkish Statistical Institute.

Headline inflation continued to decrease but remained significant.

Year-on-year inflation decelerated to 31.8% in July 2026 from 33.5% in July 2025 (Figure 3.1.13). Food inflation, at 37.5%, reflecting persistent supply-side pressures, drove headline inflation, while inflation in housing (40.3%) and transportation (30.8%) remained elevated. Inflation in services, at 30.7%, remained higher than that for other goods (27.2%), signaling inertia and relatively slow adjustment in labor-intensive sectors. Producer price inflation increased to 27.8% from 24.2% a year before, indicating persistent input cost pressures. The lira depreciated by 16.9% to the US dollar and 15.9% to the euro from July 2025 to July 2026. However, any gains in competitiveness from currency depreciation were largely offset by weaker external demand as the Middle East conflict disrupted trade.

Figure 3.1.13 Monthly Inflation

Inflation slowed further in 2026.



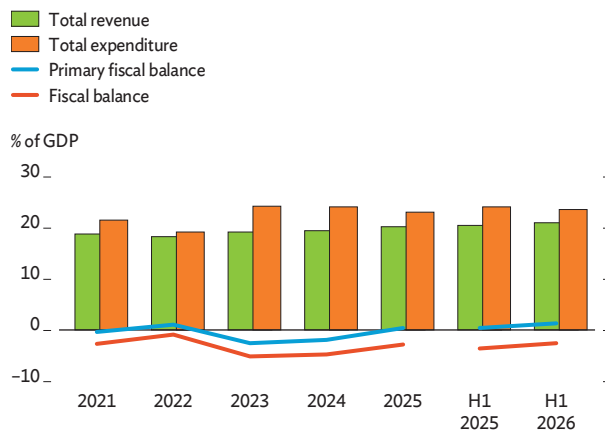
Source: Central Bank of the Republic of Türkiye.

Fiscal performance strengthened in the first half of 2026, supported by strong revenue growth.

The central government budget deficit narrowed to 2.6% of GDP from 3.6% in the same period of 2025 (Figure 3.1.14). Revenue increased to 21.1% of GDP from 20.6% a year earlier, despite a drop in special consumption tax receipts from lower taxes on fuel products aimed at minimizing the pass-through of higher prices to consumers. Expenditure declined to 23.6% of GDP from 24.2% as consolidation curbed government primary spending, despite the challenging external environment and pressures for higher government subsidies to offset the impact of the Middle East conflict. The primary surplus rose to 1.4% of GDP from 0.5% a year earlier, providing

Figure 3.1.14 Fiscal Indicators

Higher revenue and lower expenditure trimmed the fiscal deficit further.



GDP = gross domestic product, H = half.

Sources: Republic of Türkiye Ministry of Treasury and Finance; Turkish Statistical Institute.

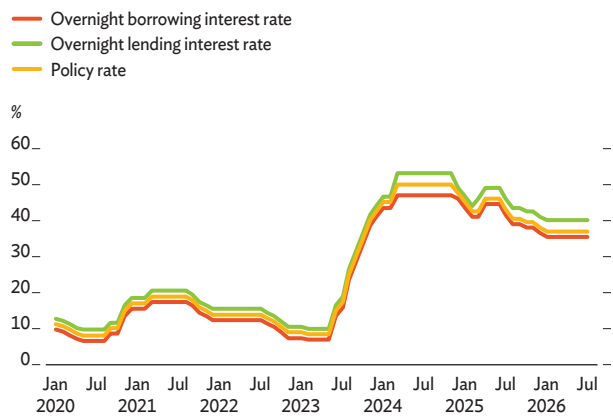
additional room to cushion external shocks. Public debt stayed modest by international standards, at 23.1% of GDP at end-March 2026 compared with 24.1% a year earlier, providing fiscal space despite elevated borrowing requirements and ongoing expenditure pressures.

Monetary policy remained restrictive despite some easing at the beginning of 2026. With lower inflation, the policy rate was reduced to 37.0% in January 2026, from 38.0% at the end of 2025, where it stayed through August. The overnight borrowing rate fell to 35.5% in July from 41.5% a year earlier, and the overnight lending rate declined to 40.0% from 46.0% (Figure 3.1.15). Annual growth in broad money (M3) slowed to 28.6% from 42.9%, indicating that liquidity moderated gradually as monetary policy remained tight. Credit growth also decelerated, to 37.7% in July 2026 year on year from 42.3% in July 2025, but still above the rate of inflation. In June 2026, 37.8% of deposits and 37.0% of banking assets were in foreign currency. Banking soundness indicators remained favorable, with nonperforming loans low at 2.8%, the capital adequacy ratio at 16.6%, and return on equity—while declining—at 12.9%.

The latest data suggest weakening external balances. During the first half of 2026, the current account deficit widened to 4.2% of GDP from 3.6% a year earlier, while the merchandise trade deficit increased to 5.3% of GDP from 5.1% (Figure 3.1.16).

Figure 3.1.15 Overnight Interest Rates and the Policy Rate

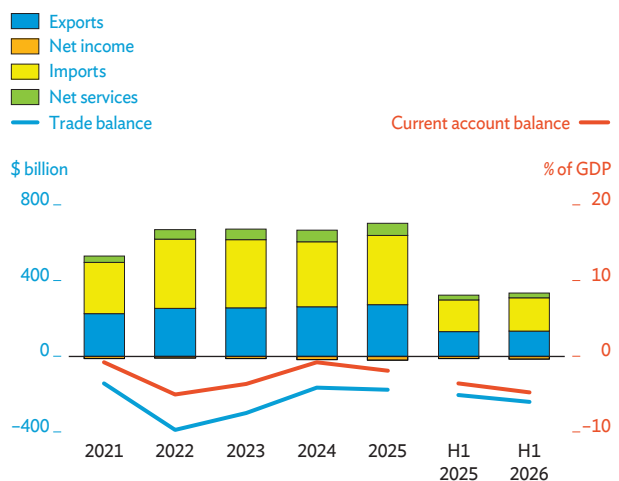
Overnight borrowing and lending rates declined from their peaks.



Source: Central Bank of the Republic of Türkiye.

Figure 3.1.16 Current Account Components

The current account deficit widened in the first half of 2026.



GDP = gross domestic product, H = half.

Source: Central Bank of the Republic of Türkiye.

Merchandise exports rose by only 3.6% in the first half of 2026, year on year, reflecting subdued external demand and the adverse effects of the regional geopolitical tensions on trade. Imports grew by 4.6%, largely from higher prices on imported energy. Excluding energy and gold imports, the current account deficit stood at 0.1% of GDP compared with a 1.0% surplus a year earlier. Crude oil import values increased by 32.9% through June, year on year, while manufacturing remained the key driver of exports, accounting for 93.8% of total exports. Intermediate goods accounted for 71.5% of total imports,

highlighting the economy's reliance on imported inputs. The current account deficit widened more than the merchandise trade deficit, pointing to weaker income receipts, despite continued strength in tourism. Exports of services increased by 1.4% year on year during the first half of 2026, while service imports rose by 1.7%, increasing net services by 1.0%. Foreign exchange reserves declined by 13.8% from the end of 2025 to \$196 billion, cover for 6 months of imports, with gold reserves falling by \$18.1 billion.

Prospects

Growth is expected to moderate in 2026 before strengthening in 2027. From current trends, forecast growth has been reduced from the projections in *ADO July 2026* to 2.8% in 2026 and 3.6% in 2027 (Table 3.1.2 and Figure 3.1.17). Domestic demand is likely to remain the main growth driver, supported by higher real incomes as inflation declines and by continued investment in construction and infrastructure. Services and construction are expected

to outperform industry, while manufacturing should gradually recover as financing conditions improve and external demand picks up. However, persistent weakness in exports suggests that growth will likely remain below recent levels. Manufacturing capacity utilization rose slightly to 74.5% in June 2026 from a year before, with the manufacturing Purchasing Managers' Index, a leading indicator of economic activity, remaining close to 50, suggesting a neutral stance among manufacturers.

On the supply side, services and construction are expected to remain the principal growth drivers, with manufacturing staying relatively weak. Services and construction are projected to expand by 2.5% and 4.5% in 2026, respectively, and by 3.0% and 8.4% in 2027, driven by infrastructure projects and digital services. Manufacturing is also expected to expand, though not as quickly. Agriculture is expected to maintain recent growth momentum, rising to 5.2% in 2026 before moderating slightly to 4.1% in 2027.

On the demand side, private consumption is expected to continue to drive growth. Being the main component of domestic demand, it is projected to grow by less than 4.0% in 2026 as tight monetary conditions restrain credit growth but accelerate in 2027 as conditions become more accommodative. Investment should also remain supportive, expanding by 2.3% in 2026 and 3.1% in 2027, particularly in construction and infrastructure-related activities. Net exports are expected to reduce growth in 2026 before gradually turning positive in 2027 as external demand recovers and import growth moderates.

Table 3.1.2 Selected Economic Indicators in Türkiye, %

Growth is projected to decelerate in both 2026 and 2027 with inflation easing but still elevated.

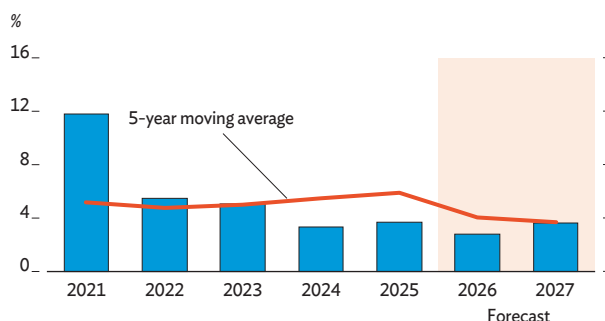
	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	3.7	3.1	2.8	3.8	3.6
Inflation	35.2	29.7	31.5	21.5	23.5

GDP = gross domestic product.

Sources: Turkish Statistical Institute; Asian Development Bank estimates.

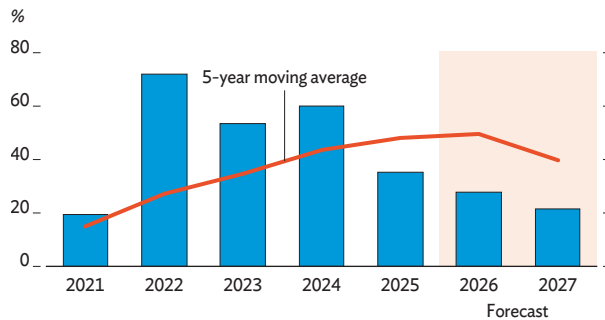
Figure 3.1.17 Gross Domestic Product Growth

Growth will weaken in 2026 before strengthening somewhat.



Sources: Turkish Statistical Institute; Asian Development Bank estimates.

Inflation is projected to continue declining but remain elevated over the forecast horizon. Average inflation is forecast to decrease to 31.5% in 2026 and to 23.5% in 2027—upward revisions from previous projections due to renewed external price pressures (Figure 3.1.18). Slowing money and credit growth should help reduce inflation, while tight monetary policy should help anchor inflationary expectations. Food prices are projected to remain elevated, while service inflation is likely to ease gradually despite some inertia. Although headline inflation is expected to continue declining, pressures from exchange rate movements, higher energy prices, and geopolitical shocks may slow the pace of disinflation.

Figure 3.1.18 Inflation*Inflation will decline further in 2026 and 2027.*

Sources: Central Bank of the Republic of Türkiye; Asian Development Bank estimates.

Fiscal policy is expected to continue consolidation while preserving priority spending.

The strong fiscal outturn in the first half of 2026 suggests that the budget deficit could be limited to 3.5% of GDP in 2026 overall, with solid tax revenue collection. It could then narrow to 3.0% in 2027 as revenues continue to benefit from better tax administration and compliance. Revenue growth could nonetheless diminish as domestic demand slows. The primary surplus is projected at about 0.8% of GDP in 2026 and 0.5% in 2027, supported by stronger fiscal discipline and lower financing costs. A prolonged Middle East conflict, with higher energy costs, could increase pressures for budgetary support to affected sectors. However, the direct fiscal impact is likely to remain manageable, particularly as the fuel tax adjustment mechanism is phased out toward the end of 2026. Public debt is expected to remain broadly stable at around 25% of GDP over the forecast period, preserving fiscal sustainability and providing buffers against external shocks.

The current account deficit is projected to remain elevated in 2026 before improving in 2027.

Merchandise imports are expected to grow faster than merchandise exports during the rest of 2026, although moderating domestic demand should help contain imports. Energy imports should decline if global oil prices are contained. Service exports, including tourism, are expected to remain strong and partly offset the large merchandise goods deficit, while reserve accumulation is likely to remain modest. External financing conditions are projected to remain tight, with foreign direct investment and portfolio

inflows expected to recover gradually, supported by new tax incentives aimed at strengthening Türkiye's investment environment.

Risks to the outlook remain on the downside.

A prolonged Middle East conflict could sustain higher energy prices, weaken trade activity, and increase financial pressures. By contrast, faster-than-expected disinflation, continued policy discipline, and lower borrowing costs could strengthen the fiscal position and improve investor confidence, enhancing macroeconomic stability despite an uncertain external environment. Türkiye's role as a regional transport and logistics hub should help offset some of the adverse effects of external shocks.

Other Economies

Armenia

Growth remained broadly stable despite softer demand, edging up to 6.0% in the first half of 2026 from 5.9% a year earlier. On the supply side, industry and services drove growth, while agriculture contracted. Industry excluding construction grew by 6.6%, reversing a 4.3% decline a year earlier, as mining and quarrying accelerated sharply and manufacturing rebounded from contraction. Construction growth eased marginally to 20.2% from 20.7% a year earlier but remained robust, supported by continued infrastructure investment and residential construction. Growth in services slowed to 6.0% from 7.0% a year earlier. This occurred as moderation in wholesale and retail trade, information and communication, finance and insurance, and professional services more than offset gains in transportation and warehousing, tourism-related activities, and administrative and support services. Agriculture plunged by 11.0%, reversing growth of 5.9% a year earlier, as crop production fell.

On the demand side, overall consumption drove growth.

Slowing domestic demand did cut the expansion of private consumption to 7.1% from 12.1% a year earlier. However, growth in public consumption accelerated to 13.8% from 7.6% a year earlier, reflecting higher allocations for pensions and increased healthcare spending following the

introduction of universal health insurance in January 2026. Total investment growth slowed sharply to 0.4% in the first half of 2026 from 25.2% a year earlier, as growth in fixed capital formation was largely offset by a drawdown of more than 50% of inventories. Import restrictions imposed by Russia and regional trade disruptions from the Middle East conflict will constrain growth. However, domestic demand, expansion in construction and services, rising tourism, and continued fixed investment should support growth over the forecast horizon. Accordingly, growth forecasts for 2026 and 2027 remain unchanged (Table 3.1.3).

Table 3.1.3 Selected Economic Indicators in Armenia, %

Despite growing external uncertainties, growth and inflation forecasts are unchanged.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	7.1	5.0	5.0	5.5	5.5
Inflation	3.3	4.2	4.2	3.5	3.5

GDP = gross domestic product.

Sources: Statistical Committee of the Republic of Armenia, Asian Development Bank estimates.

Inflation accelerated in the first 7 months of 2026, reflecting higher global food and commodity prices and disruptions to regional trade routes. Average inflation rose to 4.5% in January–July 2026 from 3.2% a year earlier, amid a 7.5% increase in food prices. Services prices rose by 2.6% and for other goods by 1.6%. Year on year inflation, at 4.5% in July 2026, was above the Central Bank of Armenia's 2%–4% target range. Despite higher inflation, the central bank kept its refinancing rate at 6.5% during the first 7 months of 2026 to support growth. With inflation developments in those 7 months broadly in line with expectations, inflation forecasts for 2026 and 2027 likewise are unchanged.

Fiscal policy benefited from growth and spending restraint. Budget revenue grew by 14.7% in the first half of 2026 as the economy continued to expand tax collection. Current expenditure rose by 7.0%—driven by rising pension, social benefit, and healthcare spending—partly offsetting a 28.9% decline in capital outlays. Much higher revenues and lower-than-planned capital outlays created a budget surplus of about 1.4%

of GDP in the first half of the year. Accordingly, the 2026 fiscal deficit is now projected to be lower than the originally forecast 4.5% of GDP.

The current account deficit narrowed to 12.6% of GDP in the first quarter of 2026 from 15.0% a year earlier. A more negative income balance more than offset larger surpluses in services and transfers. The merchandise trade deficit in nominal terms remained broadly unchanged at about \$950 million in the quarter, although as a share of GDP it narrowed to 15.5% from 17.5% a year earlier, as exports grew more than imports. Russia's restrictions on imports and disruptions to regional trade from the Middle East conflict will limit export growth for the rest of the year. However, higher exports of services, particularly transportation, information and communication technology, and tourism, will partly offset the widening merchandise trade deficit for the rest of the year.

Azerbaijan

Economic growth slowed in the first half of 2026 as hydrocarbons declined and non-hydrocarbons weakened. It fell to 0.8% in the first 6 months—from 1.5% in the first half of 2025—as the hydrocarbon sector contracted by 0.7% while the rest of the economy expanded by 1.5%. Industry shrank by 1.6% compared to a 0.5% contraction in the first half of 2025, reflecting a 3.1% decline in oil production, a 1.1% rise in natural gas output, and a 13.0% drop in construction. Growth in services moderated to 3.0% from 3.1% a year earlier, reflecting slower expansion in tourism and communications. Growth in agriculture accelerated to 2.2% from 1.4%, driven by stronger expansion in livestock. With slower growth expected to continue through the end of the year, this report lowers the growth forecast for 2026 but maintains the 2027 forecast amid anticipated economic recovery (Table 3.1.4).

Weak demand helped trim cost-push inflation during the first half of 2026. Average annual inflation declined from 5.9% in the first half of 2025 to 5.7% in the first half of 2026, driven by price increases of 6.7% for food, 3.8% for other goods, and 5.7% for services. Although higher hydrocarbon prices in Azerbaijan's trading partners were expected to pass through to the domestic economy, declining demand slowed the

Table 3.1.4 Selected Economic Indicators in Azerbaijan, %

Slower growth through the end of 2026 prompts a downward revision to the 2026 growth forecast, while inflation projections for 2026 and 2027 have been raised.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	1.4	2.0	1.6	1.8	1.8
Inflation	5.6	5.7	5.9	4.9	5.0

GDP = gross domestic product.

Sources: State Statistical Committee of Azerbaijan; Asian Development Bank estimates.

transmission of inflation from import prices. Inflation is expected to rise for the remainder of 2026 as the effects of higher hydrocarbon prices continue to feed into the domestic economy. In response to rising inflation expectations, the central bank paused its monetary easing cycle and raised its inflation forecast. With higher inflation expected in the second half of 2026, ADB has raised its projections for 2026 and 2027.

Measures to optimize the budget led to a fiscal surplus equivalent to 3.7% of GDP. In the first half of 2026, the government continued efforts to reduce reliance on hydrocarbon revenues and improve expenditure efficiency. As part of this policy, it decreased transfers of hydrocarbon revenues from the sovereign wealth fund to the budget, which reduced budget revenue to 29.4% of GDP from 32.0% in the first half of 2025. However, higher tax collections boosted non-hydrocarbon revenue by 6.8%, raising its share of total revenue to 57%. Budget expenditure decreased to 25.7% of GDP from 27.6% in the first half of 2025. Total outlays fell by 1.9%, reflecting a 23.8% cut in capital expenditure that outweighed a 10.1% increase in current spending.

The external position remained strong, supported by higher hydrocarbon prices. In the first quarter of 2026, the current account recorded a surplus of \$1.7 billion, equivalent to 9.5% of GDP, compared to 6.5% of GDP during the same period of 2025. Merchandise trade amounted to \$9.9 billion, with exports totaling \$6.0 billion and imports \$3.9 billion. As in previous years, a surplus in oil and gas trade offset a deficit in other goods, creating an overall trade surplus of \$2.0 billion. Non-hydrocarbon exports increased by 9.5%, while non-hydrocarbon

imports grew by 7.7%. The services balance remained negative, although a larger decline in service imports (7.2%) than in exports (1.7%) cut the deficit to \$0.6 billion from \$0.8 billion in the first quarter of 2025. During the first six months of 2026, combined foreign exchange reserves held by the sovereign wealth fund and the central bank increased by \$0.6 billion to \$85.8 billion, equivalent to 113% of GDP and about 19 times the country's public external debt. Central bank reserves stood at \$13.2 billion, cover for about 10 months of goods imports.

Georgia

The economy remained resilient in the first half of 2026, despite external shocks. Growth was strong at 7.9%, compared with 8.3% in the same period of 2025. On the supply side, first quarter data show services leading the expansion, growing by 13.9%, unchanged from a year earlier. Information and communication technology (ICT) services grew strongly, by 36.0%, while transportation and storage growth more than doubled to 18.0% from 8.4% a year earlier. Industry expanded by 2.0%, up from 0.8% in the first quarter of 2025, while agriculture contracted by 3.3%, less than the 7.5% decline a year earlier. On the demand side, private consumption accelerated by 8.0% from 3.9%, supported by sustained growth in bank lending. Fiscal policy remained prudent, with the budget recording a surplus in the first quarter of 2026, compared with a deficit a year earlier. Government consumption growth slowed sharply to 1.8% from 21.5% a year earlier, while slower public investment execution further restrained domestic demand. Gross fixed capital formation growth moderated to 2.1% from 11.8% a year earlier. External demand strengthened, with exports of goods and services growing by 6.8%, up from 5.2% in 2025, while import growth slowed markedly to 2.3% from 11.8%. Given stronger-than-expected economic activity and as negative spillovers from heightened regional tensions remain limited, the 2026 growth forecast has been raised (Table 3.1.5).

Inflationary pressures intensified in the first half of 2026, largely from external price shocks. Average inflation rose to 5.2% from 3.1% in the same period of 2025, well above the 3% target of the National Bank of Georgia, the central bank. Energy and food were the main drivers. Although Georgia experienced no physical supply disruptions, higher international oil prices due

Table 3.1.5 Selected Economic Indicators in Georgia, %

Stronger-than-expected economic activity in the first half of 2026 prompts a rise in the 2026 growth forecast, while the 2026 inflation projection has increased because of higher import prices.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	7.5	5.5	6.3	5.2	5.2
Inflation	3.9	4.9	5.2	3.3	3.3

GDP = gross domestic product.

Source: National Statistics Office of Georgia; Asian Development Bank estimates.

to the Middle East conflict fed directly into fuel prices and indirectly into transport and production costs, with transport inflation accelerating to 7.7% from –2.2% a year earlier. Food prices rose by 8.0%, up from 6.1% a year earlier, reflecting high food import dependence and increased global price pressures. Core inflation remained contained at 3.2%, supported by slower wage growth and productivity gains, while services inflation rose to 4.1%, increasing the risk of broader second-round effects. The central bank raised the policy rate by 25 basis points to 8.25% and has maintained a tight monetary stance. In view of these developments, the 2026 inflation forecast has been raised.

Georgia's external position remained sound in the first half of 2026 despite weaker tourism. The current account deficit narrowed to 3.8% of GDP in the first quarter from 8.5% a year earlier. Merchandise exports increased by 20.0% in the first half, partly reflecting higher global commodity prices. Imports were broadly unchanged, rising by only 0.7% as lower motor-car imports offset higher energy import costs. Refined petroleum products emerged as the second-largest export category, with exports increasing nearly elevenfold. Precious metal and copper ore exports also rose strongly, by 74.3% and 287.4%, respectively. Motor vehicle re-exports remained the largest category despite declining by 22.9%. While overall spillovers from the Middle East conflict remained limited, disruptions to regional air travel weakened tourism. Tourism revenues declined by 2.0% in the first half of 2026, reversing a 3.8% increase a year earlier. Other services provided a buffer, with total services exports rising by 7.2% in the first quarter, led by a 65.7% surge in ICT services exports. Remittances also increased by 4.0% in the first half of 2026 from 3.5% a year earlier. Strong foreign-currency inflows supported the stability of the

lari and reserve accumulation, with reserves exceeding 118% of the International Monetary Fund's Assessing Reserve Adequacy metric.

Kyrgyz Republic

Growth accelerated to an estimated 11.9% in the first half of 2026 from 11.3% a year earlier.

Continued public investment, strong private consumption, and broad-based sectoral gains drove expansion. Construction sector growth surged by 69.6%, up from 33.1% a year earlier, propelled by continued public infrastructure financing and expanded state-backed housing programs. Industry grew by 12.8%, little changed from 12.5%, as gains in metals processing and construction materials offset a decline in electricity generation. Agriculture accelerated to 4.3% from 1.9% on continued gains in livestock production. Growth in services eased to 6.0% from 9.8%, as wholesale trade and transport slowed amid tighter regional trade controls. On the demand side, with data available for only the first quarter, private consumption remained the principal driver, rising by 20.5% year on year. Real wages and consumer lending have expanded steadily over the past several years, rising by 5.3% and 8.8% in the first quarter, respectively. Net money transfers, including remittances from abroad, by contrast, fell by 6.9% year on year in the first half of 2026, a sharp reversal from growth of 26.2% a year earlier, reflecting tighter migration regulations and weaker labor demand in host countries. This report retains the growth forecasts published in *ADO July 2026*, in view of an expected moderation in trade, domestic demand, and electricity-constrained output in industry over the rest of the year (Table 3.1.6). Downside risks include a

Table 3.1.6 Selected Economic Indicators in the Kyrgyz Republic, %

Robust growth momentum and above-target inflation leave both forecasts unchanged.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	11.1	8.9	8.9	8.4	8.4
Inflation	8.2	11.2	11.2	8.5	8.5

GDP = gross domestic product.

Sources: National Statistics Committee of the Kyrgyz Republic; Asian Development Bank estimates.

weaker recovery in remittances and further tightening of regional trade; upside risks stem from election-related fiscal spending.

Inflation accelerated further above the central bank's target range. Average inflation rose from 7.3% in the first half of 2025 to 10.6% a year later, while year-on-year inflation reached 11.0% in June 2026, well above the 5%–7% target of the National Bank of the Kyrgyz Republic, the central bank. A high import share in the consumption basket, together with domestic electricity generation shortfalls, contributed to recent price pressures, pointing to a need to strengthen domestic supply. Higher services prices added momentum, rising mainly due to changes in service charges in hospitality, alongside scheduled utility tariff increases. Bilateral arrangements for fuel supplies have partly cushioned the impact of higher international fuel prices. The central bank has kept its policy rate unchanged at 12.0% since February 2026, although its effect has been constrained, partly by excess banking system liquidity. The Kyrgyz som remained broadly stable against the US dollar, supported by net foreign exchange sales of \$1.3 billion in the first half of 2026, equivalent to 15.0% of international reserves at the start of 2026, up from \$297 million a year earlier. Given these structural pressures, this report retains its inflation forecasts for both 2026 and 2027, with risks tilted to the upside.

The current account deficit widened to an estimated 24.4% of GDP in the first quarter of 2026, up from 16.9% a year earlier, driven mainly by a deepening trade deficit and smaller surpluses in services and secondary income. The trade deficit widened as exports fell by 13.5%, with both gold and non-gold exports declining, the latter by a more moderate 7.5%. Imports declined by a smaller 1.7%, even as energy imports rose. The secondary income balance softened as remittances declined, while the services surplus narrowed slightly from a year earlier. Reserve coverage increased from 4.2 months of imports at the end of March 2025 to 6.1 months a year later. Disruption to regional e-commerce and logistics channels widely used by small and medium businesses in the country has increased the downside risks to the external and growth outlook.

Tajikistan

Growth remained strong at 8.2% in the first half of 2026, similar to 8.1% a year earlier, despite external shocks. Escalation of Russia's war in Ukraine has disrupted fuel imports, limiting domestic supply, which may constrain growth. The Middle East conflict has had limited impact on growth, despite disrupting trade with some regional partners.

On the supply side, manufacturing and trade remained the main growth drivers. Growth in industry slowed to 14.1% from 24.0% a year earlier. Manufacturing expanded by 26.0%, reflecting gains in garments (15.2%), food processing (23.6%), and metallurgy (9.8%) as new plants, food processing lines, and chemical/fertilizer mixing units opened. However, mining output fell by 6.7% from disruptions at several mines and processing plants and shortages of imported inputs. Growth in services slowed to 10.6% from 12.8% a year earlier. Retail turnover expanded by 31.8%, while wholesale trade contracted by 3.9%, reflecting disruptions in fuel trade and regional markets. Despite floods and mudflows that disrupted mid-summer harvests, agriculture expanded by 7.2%, down from 9.7% in 2025.

On the demand side, strong transfers and public sector pay raises boosted consumption. In the first quarter of 2026, net personal transfers, including remittance inflows, rose 5.3% year on year to \$1.93 billion, equivalent to 50.7% of GDP. Annual increases in public sector salaries (up to 30%), the minimum wage (25%), stipends, and pensions implemented in September 2025 strengthened household purchasing power and demand. These income gains boosted real wages by 14.9% and contributed to a 26.8% year-on-year rise in credit to the private sector in January–May 2026, promoting consumption growth. In view of fuel-related disruptions and heightened external risks, forecast growth for 2026 has been reduced (Table 3.1.7).

Inflation rose to 2.4% in the first half of 2026 from 1.8% in the same period last year but remained within the central bank's 3%–7% target band. Year-on-year inflation was 3.7% at end-June 2026, near the 3.6% in June 2025. Fuel prices were the main inflation driver, rising 22.2%, including increases for liquefied

Table 3.1.7 Selected Economic Indicators in Tajikistan, %

Amid heightened uncertainty and external risks, the 2026 growth forecast has been reduced, while the inflation outlook remains unchanged from the July update.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	8.4	7.3	7.0	6.8	6.8
Inflation	3.5	4.5	4.5	4.7	4.7

GDP = gross domestic product.

Source: Agency on Statistics under the President of the Republic of Tajikistan; Asian Development Bank estimates.

natural gas (34.8%), diesel (20.6%), and gasoline (10.0%). Prices of construction materials rose 5.1%, compared to 1.6% a year earlier, reflecting trade route disruptions and slower cement production. Services prices were also inflated, partly on higher utility tariffs and public service fees. The central bank lowered its policy rate by 50 basis points to 7.0% in February 2026, stimulating credit growth. The local currency, the somoni, depreciated by 0.9% against the US dollar in January–June 2026, compared to last year's appreciation by 17.7%. In view of the developments, inflation forecasts remain unchanged.

Revenues expanded while public debt declined to \$3.4 billion. Revenues increased 14% to \$3.9 billion in the first half of 2026, reflecting strong tax administration, an increase in registered firms and entrepreneurs, and higher non-tax receipts. Revenues and grants equaled 44.9% of GDP, while expenditure reached \$3.2 billion or 37.1% of GDP. Public debt declined by \$100 million, from 19.7% of GDP in December 2025 to 16.0% in June 2026, with repayments of a Eurobond and other debt.

The current account surplus widened in the first quarter of 2026 from 12.6% to 21.5% of GDP, reflecting higher merchandise trade and personal transfers. Data on trade, available for the first 6 months, show merchandise exports rising by 64.5% year on year, with precious metals representing 32.7% of these exports, mineral products 31.7%, and base metals 20.9%. Merchandise imports rose by 38.8%, reflecting currency appreciation relative to early 2025, with vehicles and equipment representing 14.2%, mineral products 14.1%, and base metals 13.0% of these imports. Gross international reserves

decreased slightly from \$6.4 billion at the end of 2025 to \$6.3 billion—equivalent to 8.7 months of import cover—at the end of March 2026.

Turkmenistan

The government reported the economy expanding by 6.3% in the first half of 2026, unchanged from the same period in 2025, with growth reported across all major sectors. Industry excluding construction increased by 2.6%, mainly reflecting higher hydrocarbon production. Stronger gains were recorded in construction (6.7%), agriculture (4.5%), wholesale and retail trade (8.5%), transport and communications (10.3%), and catering and other services (8.4%).

On the demand side, growth was supported by increased public investment in industrial and social infrastructure. Investment from all financing sources rose by 4.7% year on year during the first half of 2026. More than half of total investment went toward social sectors, including housing and urban development, healthcare, education, and social welfare. The remainder was allocated to industrial infrastructure, particularly in oil and gas, petrochemicals, chemicals, textiles, light industry, food processing, consumer goods, and construction materials. Given the strong performance in the first half of the year, consistent with official targets, growth forecasts for 2026 and 2027 remain the same as in *ADO July* (Table 3.1.8).

Table 3.1.8 Selected Economic Indicators in Turkmenistan, %

Growth and inflation forecasts for 2026 and 2027 remain unchanged.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	6.3	6.3	6.3	6.2	6.2
Inflation	5.5	6.0	6.0	6.0	6.0

GDP = gross domestic product.

Source: Asian Development Bank estimates.

Inflationary pressures intensified during the first half of 2026, as prices of both imported and domestically produced goods accelerated. Monetary policy remains focused on containing inflation through the fixed exchange rate regime

and administrative controls on selected basic goods and services. Access to concessional credit and foreign exchange loans continues to be directed primarily toward priority enterprises engaged in import substitution and export-oriented activities. While pressures in the foreign exchange market persist because of foreign currency rationing, overall conditions remain broadly stable. Inflation forecasts are retained for both 2026 and 2027.

The fiscal outlook remains broadly aligned with maintaining macroeconomic stability. The government aims to preserve a balanced state budget in 2026 and 2027, supported by favorable prospects for energy exports and related fiscal revenues. In July 2026, Fitch Ratings affirmed Turkmenistan's long-term foreign-currency issuer default rating at BB- with a stable outlook, citing the country's strong sovereign balance sheet, substantial net foreign assets, and very low public debt. The latter is projected to decline to 2.7% of GDP by end-2027, from an estimated 3.5% currently. Underpinning these strengths are Turkmenistan's significant natural gas reserves. Fitch also noted that further progress in diversification and institutional development could help strengthen economic resilience. In particular, it suggested that the country could do so by reducing the economy's dependence on hydrocarbons, diminishing concentration in export markets, strengthening the exchange rate framework, and enhancing economic data reporting.

Gas exports to the People's Republic of China, Turkmenistan's largest export market, are estimated to have remained broadly stable. However, recently concluded gas export agreements point to stronger regional demand and suggest scope for future export expansion. The People's Republic of China is expected to remain the principal destination for Turkmen gas under existing long-term supply contracts. Prospects for higher production have also improved since the commencement of the fourth development phase of the Galkynysh gas field in April 2026. The large-scale project, financed domestically, is expected to increase annual gas export volumes by 25% over current levels in the medium term.

Looking ahead, imports are projected to rise, reflecting increased demand for construction-related goods and equipment. While hydrocarbon

exports are expected to continue rising, their expansion is likely to be offset by rising imports. As a result, the current account surplus is projected to narrow to about 1.5% of GDP in 2026 and 1.0% of GDP in 2027 from 3.3% in 2025.

Uzbekistan

Growth accelerated strongly during the first half of 2026. According to official estimates, the economy expanded by 8.5% year on year in the first half of the year, up from 7.2% a year earlier and exceeding prior expectations.

Stronger services-led growth on the supply side. Services expanded by 9.2% in the first half of 2026, versus 8.2% in the first half of 2025. Faster growth in information and communication technology services (23.2% versus 21.9%), transportation and storage (15.8% versus 11.3%), trade (15.0% versus 10.9%), and accommodation and food services (10.8% versus 9.5%) supported the acceleration. Industry grew by 8.0%, up from 6.6% a year earlier, as manufacturing expanded by 8.8%. Construction expanded by 13.8%, up from 10.7%, reflecting continuing large infrastructure and housing projects. Agriculture grew by 4.7%, up from 4.0%, reflecting higher crop production.

Demand-side expansion remained broad-based. Fixed capital investment in the first half of 2026 increased by 17.5% year on year, accelerating from 5.5% in the first half of 2025, supported by large-scale projects in energy, manufacturing, transport, and housing. Household consumption remained strong during the same period, reflecting a 23.8% increase in household final consumption in the first quarter of 2026 and strong retail trade growth. Government consumption rose by 30.9% year on year. With a stronger-than-expected first half, the 2026 growth forecast has been raised, despite expected moderation in the second half (Table 3.1.9). The 2027 growth forecast is maintained.

Inflation moderated during the first half of 2026 but remained above the Central Bank of Uzbekistan's 5% target. Consumer prices increased by 3.3% during this period, down from 4.2% a year earlier. Services inflation fell to 4.1% from 10.7%, while food inflation accelerated to 2.4% from 1.7% and other goods inflation to 3.9% from 3.1%. Headline inflation eased

Table 3.1.9 Selected Economic Indicators in Uzbekistan, %

Strong first-half growth warrants an increase to the 2026 growth forecast. Projected 2026 inflation is raised to reflect higher energy prices, including fuel.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	7.7	6.7	7.0	6.8	6.8
Inflation	7.3	6.5	6.7	5.0	5.0

GDP = gross domestic product.

Sources: National Statistics Committee of the Republic of Uzbekistan; Central Bank of the Republic of Uzbekistan; Asian Development Bank estimates.

to 6.4% year on year in June from 8.7% a year earlier. Inflationary pressures strengthened in June following further administered-price adjustments, including average increases of 9.6% in electricity and 10.7% in natural gas. These adjustments are expected to generate additional second-round effects on transport, logistics, and services during the remainder of 2026. Consequently, the inflation forecast for 2026 is raised, while the 2027 forecast is maintained.

Monetary and fiscal policies remain focused on preserving macroeconomic stability. The authorities have continued implementing fiscal reforms aimed at strengthening medium-term sustainability. The Fiscal Strategy 2027–2029 refers to an expected fiscal deficit of 3.0% of GDP in 2026 while maintaining infrastructure and social spending. Consistent

with IMF recommendations, fiscal and monetary policies are expected to remain prudent to contain inflation and moderate domestic demand. The central bank is expected to maintain a tight monetary stance to contain inflationary pressures and anchor inflation expectations.

The trade deficit expanded during the first half of 2026. Merchandise exports declined by 8.8% year on year to \$15.9 billion, largely due to lower gold exports, while imports increased by 21.0% to \$25.1 billion. This widened the trade deficit to \$9.3 billion from \$3.2 billion in the first half of 2025. However, non-gold exports increased by 29.4% to \$6.5 billion, while services exports rose by 34.9% to \$4.6 billion. First quarter data show the current account remaining in deficit, with a shortfall of about \$5.8 billion versus \$5.7 billion a year earlier. Strong growth in services exports and remittance inflows partly offset pressures from the widening trade deficit. International reserves remained substantial, at \$64.35 billion, in July 2026.

Risks remain tilted to the downside. Slower growth among major trading partners, heightened geopolitical tensions, disruptions to trade and logistics networks, commodity-price volatility, and tighter international financing conditions could weigh on external demand, remittances, and investment. Strong domestic demand could also complicate efforts to reduce inflation. On the upside, stronger-than-expected investment and continued strength in exports of services could see growth higher than current projections.

DEVELOPING EAST ASIA

Developing East Asia growth forecast for this year and next remains unchanged from the ADO July 2026 projections. Inflation forecast for 2026 is lower than the previous projection on weak domestic demand in the People's Republic of China (PRC), but remains unchanged for 2027. Following the reclassification of economies in ADO April 2026, the developing East Asia subregion now comprises only the PRC and Mongolia. Therefore, the forecasts of growth, inflation, and other macroeconomic trends in the subregion closely track those of the PRC and are not discussed separately.

People's Republic of China

High-tech industries and resilient exports were the main drivers of growth in the first half (H1) 2026. Inflation edged up alongside higher global energy prices. Continued policy support and solid external demand for high-tech exports are expected to help offset domestic weaknesses. Accordingly, forecasts remain unchanged from ADO July, with GDP growth projected at 4.6% in 2026 and 4.5% in 2027. The inflation forecast has been lowered to 0.9% in 2026, reflecting the less-than-expected upward pressure on inflation from the Middle East conflict.

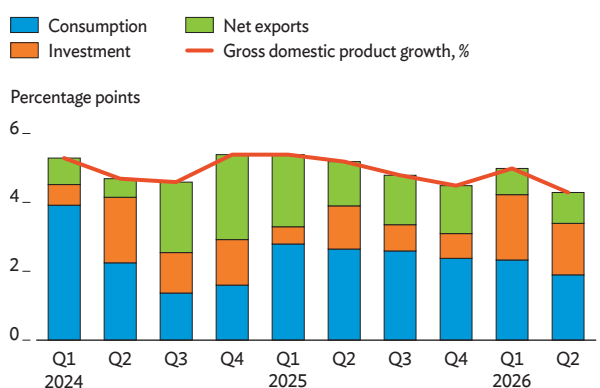
Updated Assessment

GDP growth averaged 4.7% year on year (yoy) in H1 2026. Growth was supported by strong demand for exports and associated activities of high-tech industries. However domestic demand remained weak, slowing growth from 5.0% yoy in the first quarter (Q1) to 4.3% in Q2 (Figure 3.2.1).

Consumption growth slowed and its contribution to GDP growth declined in H1 2026 compared to a year earlier. Slower household income growth weighed on spending, with real per capita disposable income increasing by 4.2% in H1 2026, down from 5.4% a year earlier. Real per capita consumption expenditure growth also slowed, to 2.7% from 5.3%, in the period (Figure 3.2.2). Combined with the fading effects of the consumer goods trade-in program, retail sales of consumer goods grew only 1.3% yoy in H1. In contrast, services expenditure rose a healthy 5.3%, supported by robust tourism and leisure-related spending. To

Figure 3.2.1 Demand-Side Contributions to Growth

The contributions of consumption and investment to growth weakened in Q2 2026 over the previous quarter, while the contribution of net exports increased.

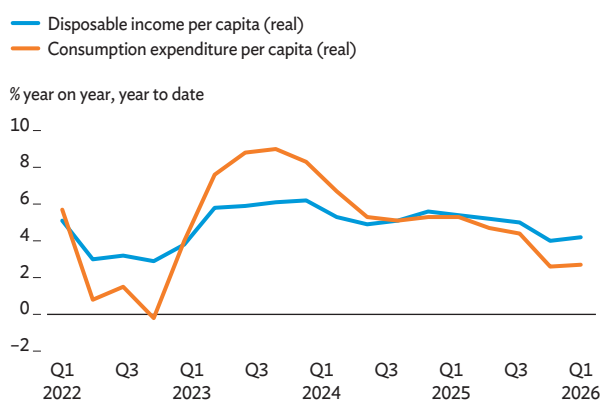


Q = quarter.

Source: CEIC Data Company.

Figure 3.2.2 Real Growth in Income and Consumption Expenditure per Capita

Per capita household consumption growth slowed sharply in H1 2026 over a year earlier, reflecting weaker growth in real household income.



Q = quarter.

Sources: CEIC Data Company; Asian Development Bank estimates.

boost domestic demand, the State Council approved the 15th Five-Year Plan for Expanding Consumption in July 2026, the first standalone five-year blueprint dedicated to consumption. This plan targets total retail sales of CNY60 trillion by 2030, up from CNY50.1 trillion in 2025, through measures to raise household incomes, expand service consumption, and promote inbound tourism. Specific measures to lift incomes include raising pensions and the minimum wage as well as increasing social security coverage. It will support inbound tourism with an expansion of the visa-free policy and lowering of administrative hurdles such as hotel registrations. It will also support service consumption through expansion of tourism and leisure offerings while enforcing paid annual leave policies and piloting spring and autumn holidays in primary and secondary schools.

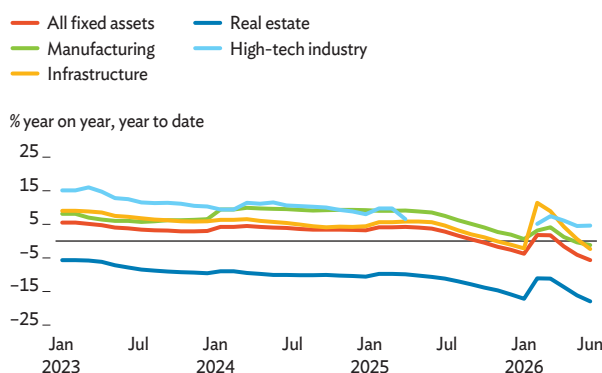
Investment activity weakened broadly, with the real estate sector still under pressure. Despite tentative signs of housing price stabilization in some first-tier cities, real estate investment fell by 18.0% in H1 2026, compared with an 11.2% decline a year earlier, reflecting elevated housing inventories and weak demand in lower-tier cities. Infrastructure investment also weakened, by 2.4%, amid lower fiscal spending and the government's ongoing focus on debt resolution. Manufacturing investment likewise contracted by 1.2%. In contrast, high-tech industries remained the only major investment category to record growth (+4.6%), benefiting from strong policy support and robust external demand for high-tech exports. Overall, fixed-asset investment declined by 5.7% in H1 2026 (Figure 3.2.3).

Net exports contributed less to growth in H1 2026 than a year earlier, even though exports remained resilient, as stronger import growth narrowed the trade surplus. Export freight increased by 6.9% in H1 2026, up from 5.2% a year ago, driven by electric vehicles and semiconductors. Imports freight rose by 2.2%, a notable improvement from a 3.0% contraction a year earlier, largely reflecting increased semiconductor imports to support export-oriented manufacturing.

On the supply side, high-tech industries remained a key driver of industrial growth in H1 2026. In industries with relatively high R&D intensity, which accounted for 17.1% of total industrial production

Figure 3.2.3 Growth in Fixed Asset Investment

Investment activity weakened broadly as the property downturn deepened, while high-tech industries remained a bright spot.



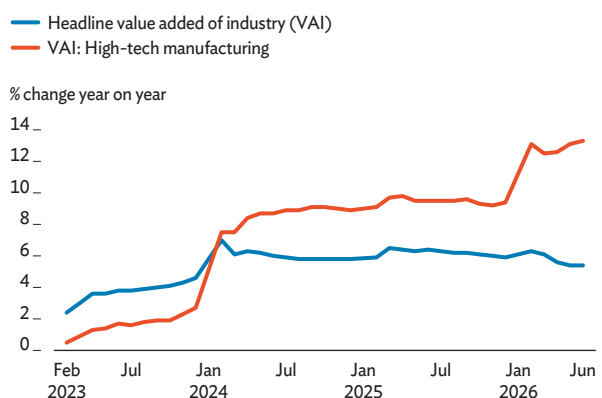
Note: Data on high-tech industry investment are unavailable for March 2025 to December 2025.

Source: CEIC Data Company.

in 2025, production continued to grow faster than overall industrial output (Figure 3.2.4). The added value of high-tech manufacturing increased by 13.3%, driven by integrated circuit manufacturing (+67.3%), electronic materials manufacturing (+31.0%), and aircraft manufacturing (+26.7%). Output of AI-related products also expanded rapidly, including integrated circuits (+23.1%), optical fibers (+19.2%), electronic components (+13.0%), and industrial robots (+28.0%). Strong demand from the global AI investment cycle and domestic policy support boosted production and profitability across the sector. Profits in the electronics industry increased by 96.9% in H1 2026, with the strongest gains in AI-related segments including computer equipment, integrated circuits, electronic

Figure 3.2.4 Growth of Industry Value Added

High-tech industries continued to drive industrial momentum.



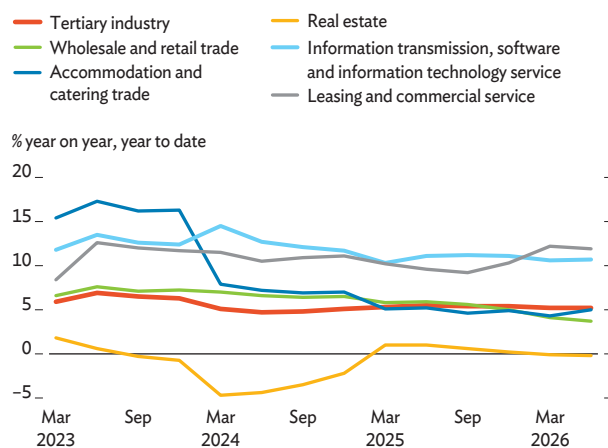
Source: CEIC Data Company.

materials, and electronic circuits. Capacity utilization among manufacturers of computers, communications, and other electronic equipment also reached 77.2% in H1 2026, well above the manufacturing average of 73.7%.

Services growth increasingly reflected a shift toward modern, technology-intensive activities in H1 2026. Value added in the services sector expanded by 5.2% in H1 2026, supported by strong growth in information transmission, software and information technology (IT) services and leasing and business services, which grew by 10.7% and 11.9%, respectively (Figure 3.2.5). Together, these sectors contributed 1.9 percentage points to overall services growth. Benefiting from the ongoing AI-driven technology boom, IT services which include—telecommunications, software development, cloud computing, data processing, integrated circuit design, and digital platform services—became the largest contributor to services growth. In contrast, the real estate sector contracted by 0.2% as the property market adjustment persisted, with construction activity, housing starts, completions, and developer financing all still subdued.

Figure 3.2.5 Growth of Services Value Added

Modern and technology-intensive services outpaced traditional consumer sectors while real estate still weighs on growth.



Source: CEIC Data Company.

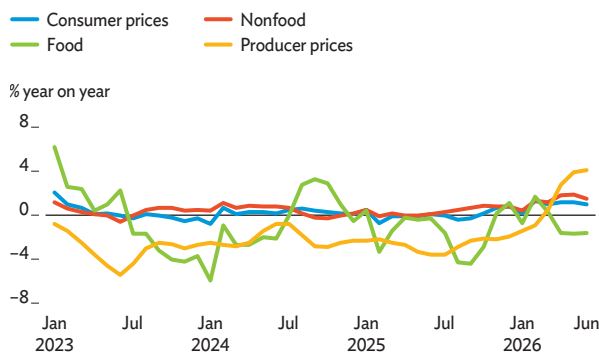
Labor markets remained broadly stable in H1 2026. The surveyed urban unemployment rate was unchanged at 5.2% compared with a year earlier, although youth unemployment increased marginally to 14.9% from 14.5%. New urban employment reached 6.95 million, matching the pace recorded a year earlier

and achieving more than half of the government's annual job creation target of over 12.00 million. Despite stable labor market conditions, per capita disposable income from wages and salaries increased by 5.3% in H1 2026, down from 5.7% a year earlier.

Inflation edged up alongside higher global energy prices but remained modest at 1.0% in H1 2026 amid weak domestic demand (Figure 3.2.6). Food prices declined by 0.6%, largely due to a 13.4% fall in pork prices; domestic energy prices increased by 3.0% following higher international crude oil prices; and gold jewelry prices surged by 54.2%, reflecting higher global gold prices. Service prices also increased by 0.8%, supported by strong travel and healthcare demand. Core inflation (excluding food and energy) rose to 1.2%. The producer price index increased by 1.5% in H1 2026, largely reflecting higher prices in petroleum-related industries amid rising global energy prices.

Figure 3.2.6 Inflation

Weak domestic demand kept CPI inflation relatively moderate and lower than producer price inflation.

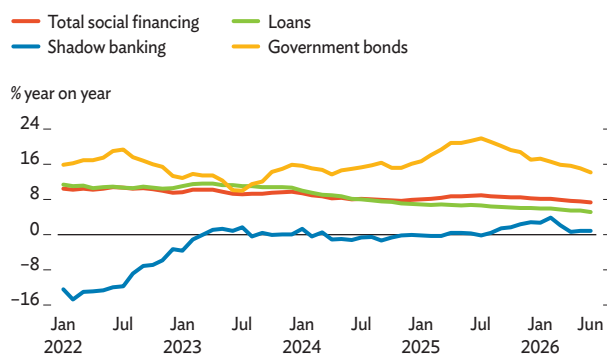


Source: CEIC Data Company.

Monetary policy remained accommodative, but weak credit demand limited its effectiveness in H1 2026. In January 2026, the People's Bank of China cut the one-year rate on central bank lending facilities by 25 basis points and expanded lending quotas to support key sectors, including technology innovation, equipment upgrading, and small and medium-sized enterprises. Despite these measures, credit demand remained weak, with loan growth slowing from 6.8% yoy in H1 2025 to 5.2% by end-June 2026 (Figure 3.2.7). Government borrowing continued to drive growth in total social financing, which includes bank loans, shadow banking, government and corporate bonds,

Figure 3.2.7 Growth in Credit and Government Bonds Outstanding

Government bond financing contributed to growth in social financing.



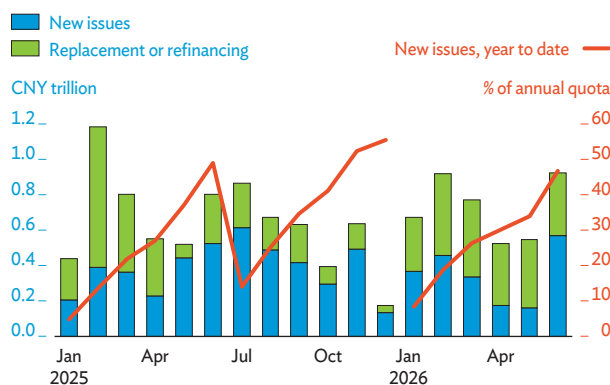
Notes: Shadow banking comprises entrusted loans, trust loans, and banks' acceptance bills. Entrusted loans are loans made on behalf of large companies by banks; trust loans are loans made by trust companies.

Sources: CEIC Data Company; Asian Development Bank estimates.

and equity financing. Outstanding government bond financing increased by 14.2% yoy by end-June, down from 21.3% a year earlier, reflecting a drop in local government special bond issuance to CNY2.1 trillion in the first 6 months of 2026. This is equivalent to only 47.0% of the annual issuance quota, 2.1 percentage points lower than the rate of issuance a year earlier (Figure 3.2.8).

Figure 3.2.8 Local Government Special Bond Issues

Local government special bond issuance moderated in H1 2026, reflecting a slower pace of fiscal expansion than a year earlier.

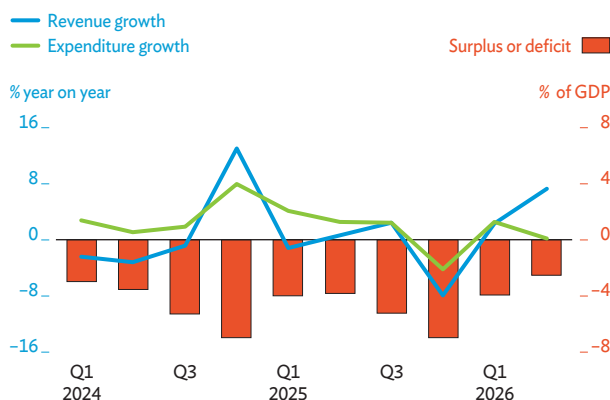


Sources: CEIC Data Company; Asian Development Bank estimates.

The fiscal deficit narrowed to 3.2% of GDP from 3.9% a year earlier as revenue outpaced expenditure growth (Figure 3.2.9). Fiscal revenue increased by 4.7%, recovering from a 0.3% decline in H1 2025, driven by a 5.3% rise in tax collections. Government expenditure grew by 1.5%, slowing

Figure 3.2.9 General Government Fiscal Revenue and Expenditure

The budget deficit narrowed in H1 2026 on slower expenditure growth compared to the same period last year.



GDP = gross domestic product, Q = quarter.

Note: Public finance budget only.

Sources: CEIC Data Company; Asian Development Bank estimates.

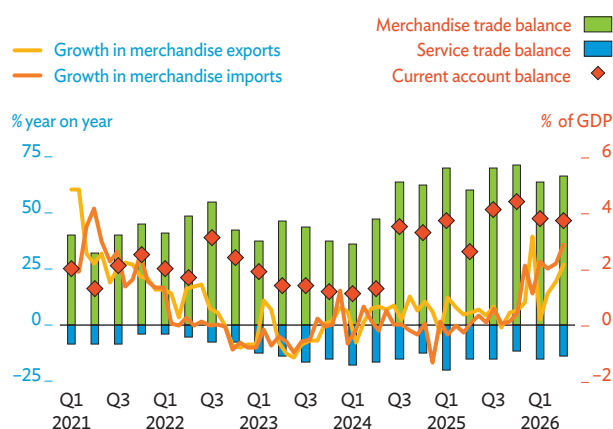
from 3.4% a year earlier, with spending prioritized toward social security and employment (+7.6%), health (+10.8%), education (+0.6%), and science and technology (+1.3%). Despite the improvement in the headline fiscal balance, fiscal pressures on local governments persisted. Local government expenditure increased by only 0.6% in H1 2026, while revenue from land-use rights transfers—an important source of local government financing—fell by 17.0%, reflecting subdued land demand amid the prolonged downturn in the property market. Meanwhile, local governments increasingly prioritized debt resolution over new investment. Bloomberg calculations suggest that local governments had utilized nearly 94% of the CNY6 trillion debt swap quota approved for 2024–2026 by end-June 2026. Against this backdrop, issuance of refinancing bonds—to replace or repay existing debt—increased by 19.0% in H1, while issuance of new bonds, mainly for investment projects, declined by 6.0%, limiting financing for infrastructure investment.

The current account surplus reached 3.8% of GDP in H1 2026 compared with 3.1% in H1 2025.

The merchandise trade surplus was 5.2% of GDP in H1 2026, while the services trade deficit narrowed slightly to 1.1% of GDP (Figure 3.2.10). Merchandise exports rose by 17.6% in US dollar terms in H1 2026, driven by strong growth in high-tech exports (52.2%), particularly semiconductors (96.1%), computing equipment (41.0%), and electric vehicles (around

Figure 3.2.10 Current Account Balance and Merchandise Trade

The merchandise trade surplus narrowed in H1 2026, while the services trade deficit remained relatively stable.



GDP = gross domestic product, Q = quarter.

Note: January and February data are combined to exclude the Lunar New Year effect.

Sources: CEIC Data Company; Asian Development Bank estimates.

75.1%). Exports to the United States recovered, increasing by 0.2%, while shipments to ASEAN grew by 22.9%, to the European Union by 16.8%, and to Japan by 7.1%. Imports surged by 26.6% in dollar terms, largely reflecting higher semiconductor imports to support export-oriented manufacturing.

Official reserve assets reached \$3.8 trillion at the end of June 2026, up by \$159.2 billion from a year earlier supported by the current account surplus.

Net foreign direct investment outflows decreased from 0.5% of GDP in H1 2025 to 0.2% in H1 2026 as foreign direct investment inflows increased. In the first 6 months of 2026, the renminbi appreciated by 3.1% against the US dollar and by 4.6% in real effective terms (weighted by trade shares and adjusted for inflation differentials).

Prospects

The GDP growth forecasts are unchanged from the ADO July projection, at 4.6% in 2026 and 4.5% in 2027 (Table 3.2.1). Recent data show retail sales growth slowing to 0.6% yoy in July 2026, fixed-asset investment declining by 6.7% in January–July, and industrial production growth moderating to 4.5% yoy in July. Household consumption is expected to remain constrained, but stronger policy-supported investment and export momentum are likely to offset

Table 3.2.1 Selected Economic Indicators in the People's Republic of China, %

Growth forecasts remain unchanged from ADO July 2026 while inflation forecast is revised down for 2026 but unchanged for 2027.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	5.0	4.6	4.6	4.5	4.5
Inflation	0.0	1.2	0.9	0.9	0.9

ADO = Asian Development Outlook, GDP = gross domestic product.

Sources: CEIC Data Company; Asian Development Bank estimates.

weakness in household consumption and the property sector investment, helping sustain growth over the forecast period. The growth outlook projects a weaker contribution from consumption and a stronger contribution from investment relative to ADO July.

Household consumption is expected to soften this year and next amid weaker income growth, low consumer confidence, and the prolonged property market downturn. The ongoing shift toward services spending from goods consumption will accelerate as the effects of the consumer goods trade-in program gradually fade, lowering household consumption growth compared with last year. The 15th Five-Year Plan's target of increasing retail sales can help raise consumption, but it should be accompanied by broader improvements in income prospects and household balance sheets. This may also require more stabilization in the property market. Meanwhile, government consumption is expected to remain resilient in the second half of 2026 and in 2027, as boosting domestic demand continues to be a policy priority.

Prioritized government support for high-tech and AI-related sectors and higher government-led investment in H2 2026 is expected to sustain investment growth. Investment in high-tech sectors should continue to outperform, supported by incentives such as the CNY800 billion New Policy-Based Financial Instrument, a special financing mechanism used by the government to support priority investment projects, as well as subsidies and prioritization of high-tech and advanced manufacturing under the 15th Five-Year Plan. Government-led investment is also expected to strengthen following the July 2026 Politburo meeting's call for faster fiscal spending and government bond utilization. By the end

of June, only 65% of the announced CNY1.3 trillion ultra-long government bonds had been issued. In addition, the National Development and Reform Commission finalized the full 2026 project list on 7 July that is to be supported by an additional 15% of budgeted ultra-long bond issuance. With construction activity usually increasing in Q3, this forecast expects implementation to pick up and extend into 2027. With an additional CNY755 billion in government funds allocated and a number of projects prepared by the Commission in H1 2026, investment activity is expected to accelerate substantially in the second half. Further fiscal support remains available. With only 47.0% of the annual special bond quota issued by H1 2026, substantial room remains for stronger fiscal support in H2 2026. Meanwhile, property investment is expected to remain weak as falling house prices, high inventories, and subdued market sentiment continue to weigh on the sector.

Despite strong export growth, the contribution of net exports is expected to moderate this year and next as imports strengthen. Strong external demand for high-tech exports including semiconductors, computing equipment, and other electronics linked to the global AI investment boom, as well as electric vehicles, will support export growth. Recovering trade with the United States and continued strong demand from other emerging markets (such as in ASEAN and Africa) should provide additional support. The 15th Five-Year Plan's emphasis on high-tech manufacturing and industrial upgrading is also expected to sustain the competitiveness of high-tech exports. However, the outlook depends on the durability of the global AI investment cycle. Current demand for semiconductors, computing equipment, and AI-related electronics remains strong. Yet, export growth and high-tech investment could weaken more rapidly than projected under the baseline scenario if global AI investment normalizes faster than expected, inventory corrections intensify along technology supply chains, or trade and technology restrictions are further tightened. At the same time, imports are expected to grow faster than last year, as demand rises for semiconductors and other inputs used in high-tech investment and export-oriented manufacturing.

Supporting employment remains a key government policy priority. While labor market conditions are expected to be supported by continued investment and

production in high-tech and advanced manufacturing sectors, pressures will persist as a record 12.7 million college and university graduates enter the labor market in 2026, up 4.1% from the previous year. To support employment, the government aims to expand social protection for gig workers, re-employ 25 million unemployed urban residents, create jobs for 6.5 million disadvantaged workers, and keep the surveyed urban unemployment rate below 5.5%. It is encouraging private companies to hire graduates through social insurance subsidies and tax benefits for firms hiring them.

The inflation forecast is revised down to 0.9% for 2026 from 1.2% in ADO July, but maintained at 0.9% for 2027. The downward revision reflects the weaker than expected pass-through of higher global energy prices associated with the Middle East conflict to domestic prices. The PRC is relatively insulated from external energy price shocks due to its sizable strategic oil reserves, diversified crude oil import sources, and policy measures that help smooth domestic fuel price fluctuations. Consequently, domestic demand conditions are expected to remain the main driver of inflation, while ongoing weakness in the housing market and excess capacity in some consumer goods industries continue to exert downward pressure on prices.

Fiscal policy should become more supportive in H2 2026 and in 2027. With GDP growth slowing to 4.3% in Q2 2026, the July 2026 Politburo meeting called for faster fiscal expenditure and bond issuance, while reiterating a more proactive fiscal policy and a moderately loose monetary policy. Near-term fiscal easing is expected to rely on faster deployment of existing resources, including policy-bank financing and the remaining local government bond quota. Monetary policy is likely to remain accommodative but play a secondary role, as bank net interest margins reached record lows (1.4% in Q1 2026) and borrowing appetite remains subdued. Instead, policy support is expected to come mainly through targeted credit measures and efforts to boost domestic demand.

Risks remain tilted to the downside. External risks include geopolitical tensions, supply-chain disruptions, higher oil prices, and uncertainty over whether the US–PRC trade truce reached at the Busan, Republic of Korea meeting will be renewed after November

2026. Externally, the baseline also depends on strength in technology-related exports and a stable trade environment; a sharper slowdown than expected in the global AI investment cycle or renewed trade tensions could materially weaken growth. Property-sector deleveraging and constrained fiscal space among local governments could pose a risk to the growth outlook, while stronger pass-through of elevated producer-price inflation, especially in mining and quarrying, could push inflation above the forecast. On the upside, stronger-than-expected policy transmission to household consumption or a faster recovery in private-sector confidence could support domestic demand and improve the growth outlook.

Mongolia

Economic growth remained strong in the first half of 2026, as rapid mining expansion and continued agricultural recovery outweighed weak investment and household consumption. GDP expanded by 7.7% year on year (yoy), with mining growing by 31.5% and accounting for half of overall growth. Mining growth was driven by a 56.3% increase in coal export volumes and the continued ramp-up at the Oyu Tolgoi copper-gold mine. Agriculture expanded by 11.3%, supported by growth in livestock numbers. Mining-related transport and stronger financial intermediation lifted services growth to 3.8%, despite contracting trade. Energy and construction boosted non-mining industrial growth to 4.1%, although manufacturing grew modestly. On the demand side, investment contracted by 14.5% and consumption growth moderated to 1.3% amid sluggish household income.

Inflation accelerated sharply into double digits as severe meat supply constraints were compounded by higher diesel prices and regulated tariff increases. Consumer price inflation averaged 9.1% yoy in the first half of 2026 and reached 12% in June. Meat prices rose by 51.6% in the first half and accounted for one-third of headline inflation, as marketed supply remained constrained despite strong agricultural production. Prices of other domestically produced staples also increased, but more moderately. Diesel prices rose by 34.9% between March and June amid tighter regional supplies and higher global oil prices, while gasoline price adjustments were postponed until July under a

price-stabilization agreement with Russia. Regulated energy and water tariffs increased by 5% and 45%, respectively, in June.

Strong mineral receipts returned the budget to balance and moved the current account into surplus, while international reserves continued to rise. Higher mineral and import-related tax receipts allowed the budget to accommodate increased public-sector wages and capital expenditure, despite early-year deficit pressures. The current account recorded a surplus of 1.2% of GDP, as a 68.2% yoy increase in merchandise export receipts, led by commodity exports, more than offset larger income outflows. International reserves reached \$7.7 billion by June, equivalent to 5.4 months of imports.

Despite stronger-than-expected growth in the first half of 2026, the GDP growth forecasts in ADO July are maintained, as mining growth is expected to moderate after four consecutive quarters of strong expansion, while manufacturing and trade remain weak (Table 3.2.2). Mining and its spillovers to services will nevertheless remain the main drivers of growth. Agriculture is expected to outperform the earlier forecast in 2026, given its higher than projected growth in the first half of the year, before moderating in 2027. Recent liberalization reforms should encourage investment, while cuts in non-mining taxes, alongside pension reforms, will support household consumption in 2027, albeit at the cost of lower fiscal revenues.

Table 3.2.2 Selected Economic Indicators in Mongolia, %

ADO July growth projections are maintained but inflation projections are revised up.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	6.8	5.7	5.7	6.0	6.0
Inflation	8.6	7.8	10.7	6.8	8.3

GDP = gross domestic product.

Sources: National Statistics Office of Mongolia, Asian Development Bank estimates.

Inflation forecasts are raised from the July projections to 10.7% in 2026 and 8.3% in 2027 on persistent increases in meat prices and rising fuel and utility costs. Greater seasonal availability should

moderate meat prices over the coming months, but only partially reverse earlier increases, leaving prices substantially higher than previously expected. Fuel-price assumptions are also revised upwards because disruptions to refining capacity in Russia, together with Middle East conflict-related price pressures, have tightened regional fuel supplies and increased fuel costs.

Risks remain tilted toward weaker growth and higher inflation. Prolonged fuel-supply disruption is the most immediate concern, given its effects on production and prices. Further damage to Russian oil refineries could deepen shortages and disrupt mining,

transport, agriculture, and other economic activity. Inflation could remain in double digits for longer if the expected seasonal easing in meat prices does not materialize and could accelerate further if fuel supply constraints endure. The expansionary 2027 budget submitted to Parliament at the beginning of September could support growth through higher government spending but would also add to demand-side inflationary pressures. Weaker-than-expected mineral revenues could undermine the fiscal position and necessitate expenditure adjustments. On the upside, stronger-than-anticipated mineral exports could sustain growth and further strengthen fiscal and external balances.

SOUTH ASIA

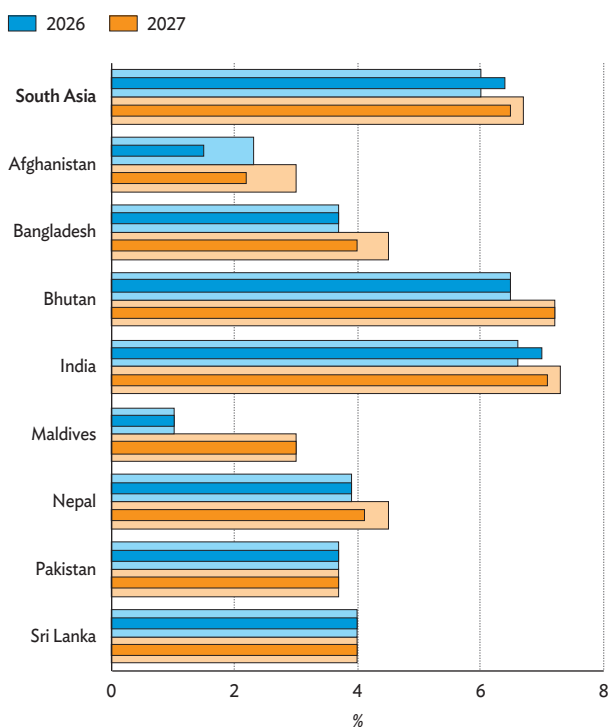
Growth in South Asia is now forecast to be higher in 2026 but lower in 2027 than projected in *ADO July 2026*. A stronger-than-expected outturn in India has lifted the near-term outlook, while a higher growth base and country-specific shocks, including severe flooding in Nepal, are expected to weigh on growth next year. The inflation outlook is broadly similar to the *ADO July 2026* forecast, though price pressures have diverged by source across the subregion. Risks to the outlook are tilted to the downside, centered on the Middle East conflict and climate-related shocks.

Subregional Assessment and Prospects

Aggregate subregional GDP is forecast to grow by 6.4% in 2026, revised up from 6.0% in *ADO July*, and by 6.5% in 2027, revised down from 6.7% (Figure 3.3.1). The September projection holds most economies broadly steady from July, as India's growth continues to accelerate, anchoring the subregional outlook. India's growth is projected at 7.0% in fiscal year (FY) 2026 (ending 31 March 2027), supported by resilient consumption, healthy investment, and strong services exports, which are expected to offset the drag from higher energy costs and a weaker monsoon. In Bangladesh, growth is estimated at 3.7% in FY2026 (ended 30 June 2026), unchanged from the July forecast, as stronger agriculture and services offset a slowdown in industry. In Nepal, growth moderated in FY2026 (ended 16 July 2026), as forecast in the *ADO July 2026*. The growth forecast for 2026 is retained for Bhutan, Maldives, and Sri Lanka. In Bhutan, regional tourism is expected to offset a construction-sector drag from higher fuel costs. In Maldives, resilient construction should offset weaker tourist arrivals and fish exports. And in Sri Lanka, strong, broad-based first-quarter growth is expected to moderate during the rest of the year. In Pakistan, growth strengthened to 3.7% in FY2026 (ended 30 June 2026), supported by improving

Figure 3.3.1 Gross Domestic Product Growth in South Asia

India anchors the subregion's stronger 2026 outlook, while the 2027 forecast eases from July.



Notes: ADB placed on hold its regular assistance in Afghanistan effective 15 August 2021. Lighter-colored bars are *Asian Development Outlook July 2026* forecasts.

Source: *Asian Development Outlook* database.

The subregional assessment and prospects was written by Thiam Hee Ng, Kiyoshi Taniguchi, George Luarsabishvili, and consultant Mia Andrea Soriano. The section on Bangladesh was written by Barun K. Dey and Chandan Sapkota; Bhutan by Sonam Lhendup; India by Abhijit Sen Gupta, Chinmaya Goyal, and, Deeksha Bhardwaj; Maldives by Jules Hugot and consultant Macrina Mallari; Nepal by Manbar Singh Khadka, Neelina Nakarmi, and consultant Himal Acharya; Pakistan by Khadija Ali, Babur W. Arif, and Maleeha Rizwan; and Sri Lanka by Lilia Aleksanyan, Lakshini Fernando, and Dinuk de Silva. ADB placed its regular assistance to Afghanistan on hold effective 15 August 2021.

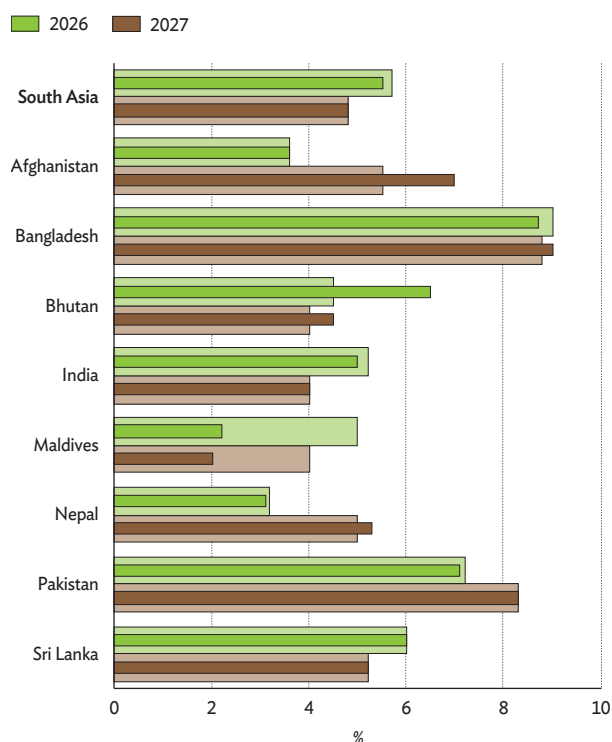
credit conditions and a broad-based recovery. By contrast, in Afghanistan, growth is forecast to moderate to an estimated 1.5% in 2026 as consecutive trade shocks weigh heavily on services, even as industry has stayed comparatively resilient on demand from returnee inflows. The downgrade of the 2027 growth forecast for the subregion reflects higher growth in India in 2026 than previously expected, weaker investment recovery in Bangladesh, and a severe flood-related shock in Nepal.

South Asia's inflation forecast for 2026 is revised down to 5.5%, from 5.7% in July, while the 2027 forecast is maintained at 4.8% (Figure 3.3.2).

Inflation is expected to ease in 2027 as transitory pressures fade, although a more active El Niño cycle risks renewed food-price pressures. India's inflation is expected to firm up in the second half of this fiscal year as the cuts in the Goods and Services Tax (GST) fade from the base and as higher input costs and an unfavorable monsoon weigh on prices. Nevertheless,

Figure 3.3.2 Inflation in South Asia

Inflation is revised down for 2026 and maintained for 2027, though price pressures diverge sharply by source across economies.



Notes: ADB placed on hold its regular assistance in Afghanistan effective 15 August 2021. Lighter-colored bars are Asian Development Outlook July 2026 forecasts.

Source: Asian Development Outlook database.

India's inflation is revised down to 5.0% for FY2026 from 5.2% in July, as tax cuts are expected to limit the pass-through of higher global energy prices to retail prices. The FY2027 inflation forecast for India is maintained at 4.0% as energy prices moderate and agricultural supply normalizes. In Bangladesh, inflation eased in FY2026 on lower food prices, but it is revised up for FY2027 as nonfood and energy pressures persist. Maldives' inflation is also revised down as the pass-through of higher global oil prices was smaller than expected, cushioned by fuel and electricity subsidies. Pakistan's inflation is estimated at 7.1% in FY2026 as higher food and energy costs lifted consumer prices. It is forecast to rise further to 8.3% in FY2027 on continued import-cost pass-through. Nepal's inflation is revised down slightly from the July projection for FY2026, as food prices held steadier than expected. However, it is raised for FY2027, as flood damage to crops, transport links, and distribution networks add to supply pressures, and higher global fuel prices pass through to domestic prices. Bhutan's inflation forecast is revised up for 2026 from the July projection, as GST and excise tax hikes were more inflationary than expected so far this year, and fuel and transport costs rose on the pass-through from the Middle East conflict. The forecast for 2027 is raised moderately as the tax-related effects fade. Elsewhere in the subregion, inflation forecasts largely hold steady from July. Sri Lanka's forecast is retained, although administered utility and fuel price hikes pushed inflation up between March and July. Price pressures are expected to ease in 2027 but linger above the central bank's target amid El Niño-related food cost pressures. Afghanistan's inflation forecast is also maintained from July, as trade and fuel supply disruptions have increased transportation and distribution costs. Price pressures are projected to continue on persistent trade bottlenecks and still-high logistics and import costs.

External positions remain broadly resilient, with remittances a key buffer across the subregion.

India's current account deficit increased marginally in the first quarter of FY2026 as a higher services surplus and remittances tempered a wider merchandise trade deficit, while its foreign exchange reserves strengthened on healthy exports, rising remittances, and policy measures to attract capital. The country's current account deficit is expected to widen moderately this fiscal year before narrowing in FY2027 on lower oil prices and new trade agreements. Nepal's current account surplus widened to 14.0% of GDP in FY2026,

though it is expected to narrow in FY2027 as tourism and electricity exports soften post-flood. Maldives' deficit is now expected to widen more sharply than projected in July, to 13.5% of GDP in 2026, reflecting weaker tourism and fish exports alongside higher construction-related and oil imports, compounding pressure on already-thin reserves. Sri Lanka's current account swung into deficit in the first 7 months of this year, as import growth accelerated and tourism earnings softened. It is expected to weaken further this year and in 2027. In Bangladesh, the current account deficit is estimated to have widened to 0.3% of GDP in FY2026 and is expected to expand further in FY2027. The reserve position has improved, however, on the central bank's purchase of foreign currency. Pakistan's current account position stayed close to balance in FY2026 despite a widening trade deficit, supported by resilient remittances and renewed capital-market access.

Fiscal space is narrowing in several economies even as others continue to consolidate. Pakistan's fiscal deficit continued to narrow on the back of an IMF-anchored consolidation path. Likewise, India's deficit remains on track with its budget target. Fiscal pressure from cuts to its excise duty on fuel and expanded subsidies is likely to be mitigated by a new tax on oil exports and higher duties on precious metals. By contrast, Maldives revised its fiscal deficit higher on rising subsidy costs, and Nepal's deficit is now projected to widen substantially in FY2027 as reconstruction spending increases after the August flash floods. Public debt remains elevated in several smaller economies, including Maldives and Bhutan, adding to external vulnerability.

Risks to the outlook remain on the downside. The Middle East conflict could further raise fuel and freight costs and lower tourism receipts and remittances. These effects could be compounded by climate-related shocks, including El Niño, leading to higher inflation and lower growth.

Bangladesh

GDP growth edged up in fiscal year 2026 (FY2026, ended 30 June 2026) as stronger agriculture and services growth offset weaker industry expansion. Inflation eased but remained elevated, and a rebound in imports moved the current account into a small

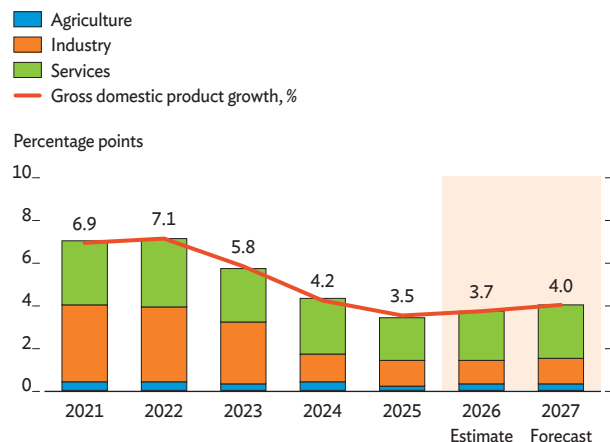
deficit. Growth is forecast to recover only modestly in FY2027 as continued energy shortages, banking sector stress, weak private-sector credit, and an unfavorable external environment constrain industry and investment. Inflation is expected to edge up as supply-side pressures persist, the lagged effects of a stronger El Niño add to food price increases and monetary conditions become gradually less restrictive.

Updated Assessment

GDP growth is estimated at 3.7% in FY2026, up marginally from 3.5% in FY2025, as projected in ADO July 2026 (Figure 3.3.3). Growth slowed from 5.0% year on year in the first quarter of FY2026 (July–September 2025) to 3.0% in the second quarter and 2.2% in the third, mainly on weak manufacturing. Nevertheless, modestly stronger agriculture and services expansion likely raised full-year growth slightly. Agriculture growth is estimated to have risen to 2.6% from 2.4% in FY2025, with continued policy support, as crop production recovered from flood-related losses. Services growth edged up to 4.5% from 4.4%, underpinned by strong remittances and steady activity in trade, transport, and other domestic services. In contrast, industrial growth declined to 2.8% from 3.7% as weak external demand, higher energy and input costs, and structural bottlenecks constrained export-oriented manufacturing.

Figure 3.3.3 Supply-Side Contributions to Growth

Growth is forecast to increase gradually in 2026 and 2027 on steady expansion of services.



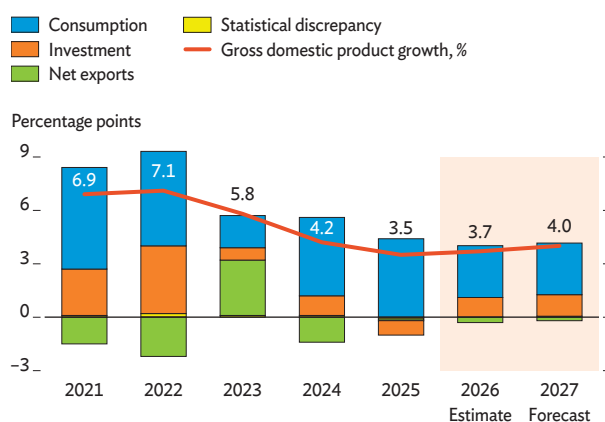
Note: Years are fiscal years ending on 30 June of that year.

Sources: Bangladesh Bureau of Statistics; Asian Development Bank estimates.

On the demand side, consumption growth weakened, investment remained subdued, and net exports made a larger negative contribution (Figure 3.3.4). High inflation constrained real household spending despite strong remittances. Private investment improved marginally from the previous year's low base but remained subdued, and weak Annual Development Program (ADP) execution limited public investment. Net exports weighed more on growth as export volumes weakened and imports recovered, particularly of fuel, intermediate inputs, and selected capital goods.

Figure 3.3.4 Demand-Side Contributions to Growth

Consumption continues to anchor demand through 2027, while weak investment and negative net exports limit the recovery.



Note: Years are fiscal years ending on 30 June of that year.

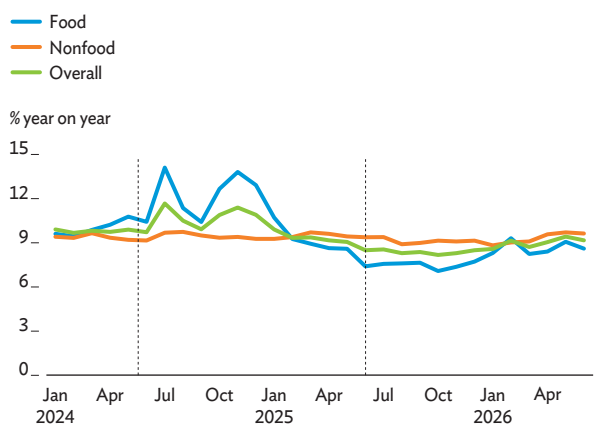
Sources: Bangladesh Bureau of Statistics; Asian Development Bank estimates.

Average inflation declined to 8.7% in FY2026 from 10.0% in FY2025, reflecting lower food inflation and even though nonfood inflation remained high (Figure 3.3.5). Food inflation dropped to 8.1% year on year (yoy) in June 2026 from 10.7% a year earlier, helped by improved domestic supply and tight monetary and fiscal policies. Nonfood inflation slowed to 9.2% yoy from 9.5% as higher energy, import, and administered prices continued to raise domestic costs. Headline inflation declined gradually through most of FY2026 before edging up toward year-end.

Although Bangladesh Bank maintained its policy rate at 10.0% in FY2026, public-sector borrowing and foreign exchange purchases raised domestic liquidity. Private-sector credit growth slowed to 4.5% yoy in June 2026 from 6.5%

Figure 3.3.5 Inflation

Price pressures eased in the first half of FY2026 and accelerated in the second half.



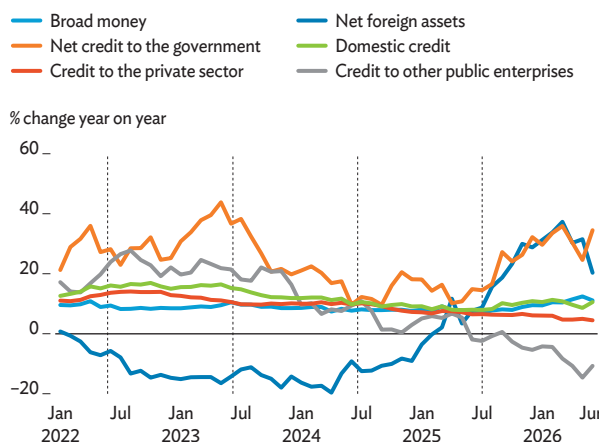
FY = fiscal year.

Source: Bangladesh Bank. 2026. Monthly Economic Trends. July.

a year earlier, constrained by high borrowing costs, subdued investment demand, bank risk aversion, and a preference for government securities. By contrast, credit to the public-sector grew by 30.4% yoy, up from 13.1%, following a revenue shortfall (Figure 3.3.6). This pushed broad money growth to 11.1% from 7.0% in FY2025. Strong remittances improved foreign exchange liquidity, enabling the central bank to purchase foreign currency and increase gross reserves. Monetary transmission nevertheless remained impaired by banking-sector stress, including

Figure 3.3.6 Monetary Indicators

Private credit growth moderated in FY2026 on tight monetary policy, while credit to government increased due to shortfall in revenue.



FY = fiscal year.

Source: Bangladesh Bank. 2026. Major Economic Indicators: Monthly Update. June.

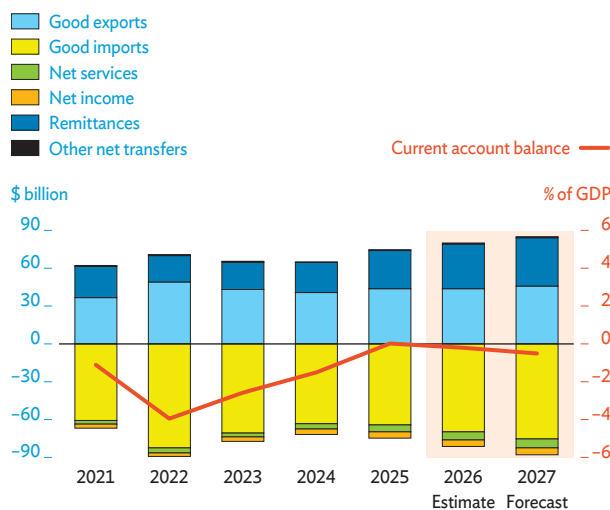
liquidity shortages in some banks, while higher import costs complicated inflation control and external management.

The FY2026 revised budget targeted a deficit of 3.3% of GDP, slightly below 3.5% in FY2025, on higher revenue and lower ADP spending. Revenue was targeted at 9.7% of GDP and spending at 13.0%, with ADP spending lowered to 3.3% of GDP from 3.7% in the planned budget. The outcome is likely to have differed materially from these targets. National Board of Revenue collections grew by 12.0% in FY2026, reaching only 82.6% of the revised target, while ADP implementation rate was only 67.5%. The revenue shortfall was therefore partly offset by expenditure compression. Government domestic borrowing, mainly from banks, rose to 2.3% of GDP from 2.0%, while foreign financing fell to 1.0% of GDP from 1.6%.

The current account deficit is estimated to have widened to 0.3% of GDP in FY2026 from 0.03% in FY2025 as imports increased and exports weakened (Figure 3.3.7). Exports edged down by 0.2%, reversing 7.7% growth in FY2025, while imports

Figure 3.3.7 Current Account Components

The current account deteriorated slightly in 2026 and is projected to record a larger deficit in 2027.



GDP = gross domestic product.

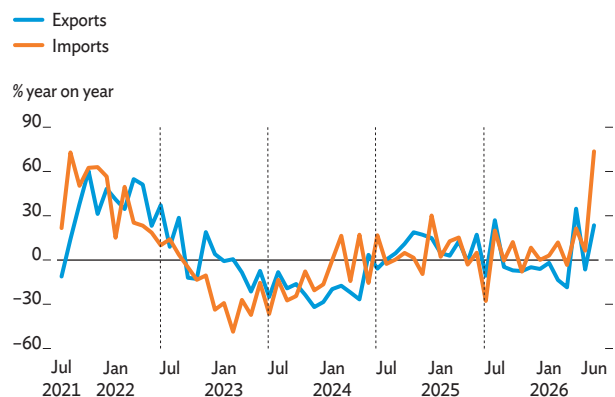
Note: Years are fiscal years ending on 30 June of that year.

Source: Bangladesh Bank.

rose by 10.5%, up from 1.8%, as demand recovered and import costs increased (Figure 3.3.8). Remittances rose by 17.4% to \$35.6 billion after increasing by 26.8% in FY2025. Despite a wider current account deficit, a larger financial account surplus and Bangladesh Bank's purchases of foreign currency pushed up gross foreign exchange reserves to \$32.9 billion from \$26.7 billion. This raised import cover to 4.7 months from 4.2 months in FY2025 (Figure 3.3.9). Supported by these trends, the taka depreciated by only 0.1% against the US dollar, compared with 3.9% in FY2025 (Figure 3.3.10).

Figure 3.3.8 Export and Import Growth

The trade deficit widened in FY2026 on a decline in export growth.

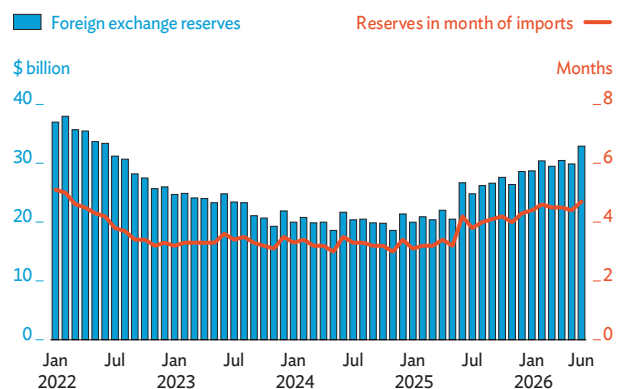


FY = fiscal year.

Source: Bangladesh Bank. 2026. Major Economic Indicators: Monthly Update. July.

Figure 3.3.9 Gross Foreign Exchange Reserves

Foreign exchange reserves continued to rise in FY2026.

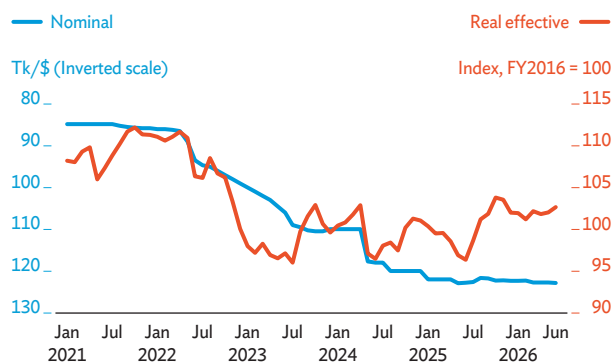


FY = fiscal year.

Source: Bangladesh Bank.

Figure 3.3.10 Exchange Rates

The taka depreciated marginally against the dollar in FY2026.



FY = fiscal year.

Source: Bangladesh Bank.

Prospects

GDP growth is forecast at 4.0% in FY2027, revised down from 4.5% forecast in ADO July 2026

(Table 3.3.1). Growth will remain constrained by banking-sector stress and structural bottlenecks. High nonperforming loans, weak bank balance sheets, bank preference for safer government securities, and high borrowing costs limit private-sector access to credit. At the same time, unreliable energy supply, logistics constraints, and lengthy regulatory and approval procedures limit investment demand and the economy's response to any monetary easing or fiscal impulse. Industrial growth is forecast at 3.3% as continued energy shortages, higher prices and production costs, weak external demand, and persistent uncertainty constrain manufacturing and private investment. However, services growth will be

robust at 4.7%, supported by remittances and a modest improvement in domestic activity. Agricultural output is expected to be affected by limited availability of fertilizers and weather shock.

On the demand side, consumption will remain the main source of growth, while investment stays subdued and net exports continue to weigh on growth. Remittances will continue to support private consumption, although high inflation will limit gains in household purchasing power. Private investment will remain weak as banking sector stress, limited access to and high cost of credit, energy shortages, and uncertainty weigh on business confidence. Public investment may provide modest support, subject to revenue and ADP implementation constraints. Exports are expected to recover only gradually in a difficult external environment, while imports should rise with demand for fuel and production inputs.

Average inflation is forecast to rise to 9.0% in FY2027 from 8.7% in FY2026, revised up from the 8.8% projection in ADO July 2026. The lagged effects of a stronger El Niño event, persistent supply-side price pressures emanating from continued energy shortages, elevated production and transport costs, and possible shipping disruption, together with gradually less restrictive monetary policy and expanded liquidity support will push inflation higher. However, demand-driven inflationary pressures should be tamped down by weak credit growth and subdued economic activity.

Bangladesh Bank has begun to ease its monetary stance while retaining its focus on price stability and greater exchange rate flexibility. The Monetary Policy Committee reduced the repo policy rate from 10.0% to 9.5%, effective 2 August 2026. It also lowered the Standing Lending Facility rate (the upper ceiling of interest rate corridor) from 11.5% to 11.0%, while leaving the Standing Deposit Facility rate (the interest corridor floor) at 7.5%, and expanded refinancing and other liquidity-support measures. These measures point to gradually less restrictive monetary conditions. However, banking sector stress and the weak transmission of monetary policy will limit recovery in private credit and investment, tamping down the inflationary impact of easier liquidity conditions.

Table 3.3.1 Selected Economic Indicators in Bangladesh, %

GDP growth for FY2027 is revised down and inflation revised up from the July projections.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	3.5	3.7	3.7	4.5	4.0
Inflation	10.0	9.0	8.7	8.8	9.0

FY = fiscal year, GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

Sources: Bangladesh Bureau of Statistics; Asian Development Bank estimates.

The FY2027 budget targets a deficit of 3.6% of GDP, above the FY2026 revised-budget target, with higher development spending and stronger revenue mobilization. Spending is projected at 13.7% of GDP, of which ADP outlays account for a third, while revenue is projected at 10.2% of GDP, with tax revenue accounting for 90% of the receipts. Measures include tax-base broadening, stronger compliance, digital filing and payments, modernization of value-added tax and customs administration, risk-based audits, and rationalization of exemptions. The realized fiscal impulse will depend on revenue collection and ADP execution, which remain constrained by the low revenue base and administrative capacity.

The external position is forecast to remain broadly stable in FY2027, although the current account deficit may widen to 0.6% of GDP as imports grow faster than exports and remittances growth moderates. Exports will face weak demand in major markets, trade uncertainty, and domestic production constraints, while imports rise with higher energy costs and demand for production inputs. Remittances will continue to cushion the balance of payments, but reserve accumulation will depend on adequate net financial account inflows. Effective exchange rate flexibility and prudent macroeconomic management will remain important to external stability.

Risks to the FY2027 outlook are tilted to the downside. A prolonged Middle East conflict, higher oil prices, shipping disruption, tighter trade restrictions, or weaker growth in major markets could raise inflation and further dampen exports, remittances, and manufacturing. Persistent exchange-rate pressures, tight external financing, or weaker financial inflows could constrain imports of productive inputs and reserve accumulation. Domestically, a further deterioration in bank balance sheets already burdened with high nonperforming loans, limited effectiveness of credit support measures, delayed fiscal reforms, or continued shortfalls in development spending could weaken growth. Climate-related shocks could disrupt agriculture and food supply, keeping inflation elevated. Strong remittance inflows, improved foreign exchange reserves, and continued external support provide buffers, but these remain limited and need to be reinforced through sustained reforms.

India

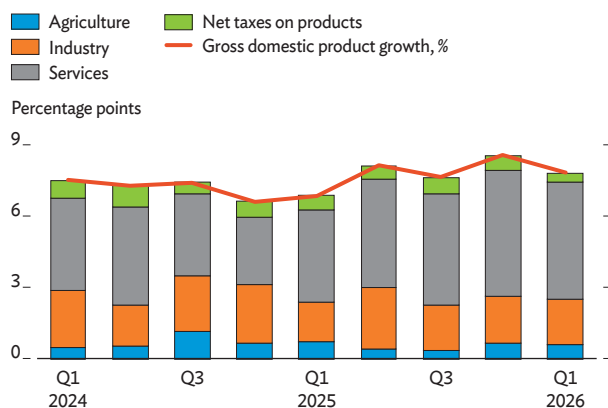
The Indian economy remains resilient despite heightened geopolitical tensions and high commodity prices. It is projected to grow at 7.0% in fiscal year 2026 (FY2026 ending 31 March 2027), faster than expected in ADO July 2026, reflecting strong momentum in investment demand and resilience in services exports. The growth forecast for FY2027 is downgraded to 7.1% from the July projection due to the base effects of faster growth in FY2026. The inflation forecast for FY2026 is lowered to 5.0%, due to the limited pass-through of higher energy prices to consumers, and kept unchanged at 4.0% for FY2027. The country's external position is robust, helped by policy measures to attract capital flows. Geopolitical tensions and the impact of El Niño are the main risks to the outlook.

Updated Assessment

GDP grew by a healthy 7.8% year on year (yoy) in the first quarter (Q1) of FY2026, driven by robust performance in the services and manufacturing sectors (Figure 3.3.11). The services sector emerged as a major driver of growth, expanding by 10.0%. The increase was led by 12.1% growth in financial, real estate, and professional services, aided by strong credit growth and healthy stamp duty collections. Trade, hotels, transport, and communication services growth slowed to 8.5%, likely due to the impact of higher commodity prices on mobility-intensive activities. The manufacturing sector grew by 9.2%, driven by stronger momentum

Figure 3.3.11 Supply-Side Contributions to Growth

The services sector was the main growth driver in Q1 FY2026.



FY = fiscal year, Q = quarter.

Notes: Years are fiscal years ending on 31 March of the next year.

Source: CEIC Data Company.

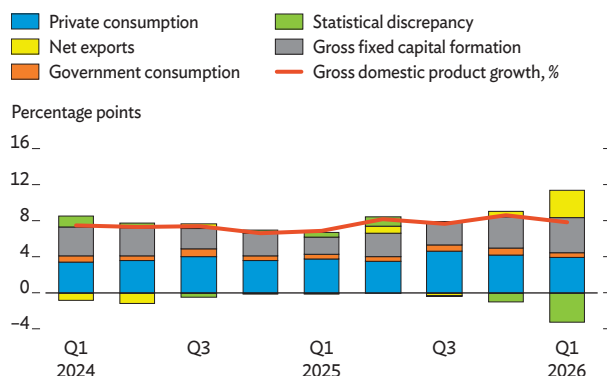
in electronics manufacturing, textiles, and rubber and plastics. Agriculture growth remained robust at 3.6%, despite a below-normal monsoon.

On the demand side, investment and exports emerged as major growth drivers (Figure 3.3.12).

Gross fixed capital formation grew by 11.9% in Q1 FY2026, the fastest pace in 4 years, aided by robust government and private sector investments. Exports of goods and services grew broadly, expanding by 12.0%, aided by a sharp depreciation of the currency and lower tariffs on Indian exports in destination markets. Consumption remained resilient, helped by robust growth in rural and urban demand, which was supported by a reduction in tax rates, higher subsidies, and limited pass-through of input costs to consumer prices. The labor market has held relatively steady. And the unemployment rate declined in both rural and urban areas.

Figure 3.3.12 Demand-Side Contributions to Growth

Domestic demand drove growth in Q1 FY2026.



FY = fiscal year, Q = quarter.

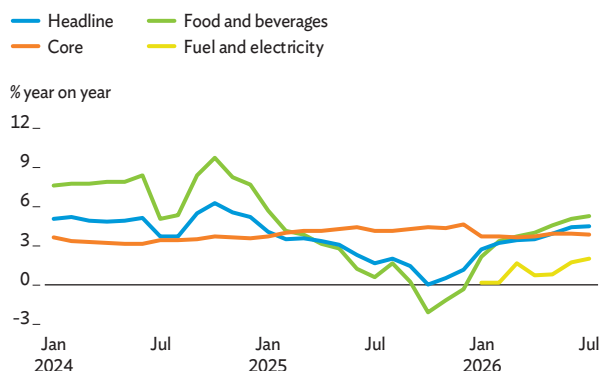
Notes: Years are fiscal years ending on 31 March of the next year.

Source: CEIC Data Company.

Headline inflation rose during April to July 2026, although core inflation remained steady (Figure 3.3.13). Consumer price inflation edged up from 3.5% in April to 4.5% in July, in a broad-based pickup. Food inflation firmed from 4.2% to 5.5% over the same period on higher meat, fish, edible oils, and fruit and vegetable prices (Figure 3.3.14). Energy and transport inflation also rose, reflecting the increase in administered fuel prices in mid-May. Core inflation remained stable, despite a surge in retail prices of gold and silver. The Goods and Services tax rate rationalization in September 2025 (including a reduction in the number of tax rates), lower prices of

Figure 3.3.13 Inflation

Headline inflation rose in the first quarter of FY2026 on rising food and fuel prices.

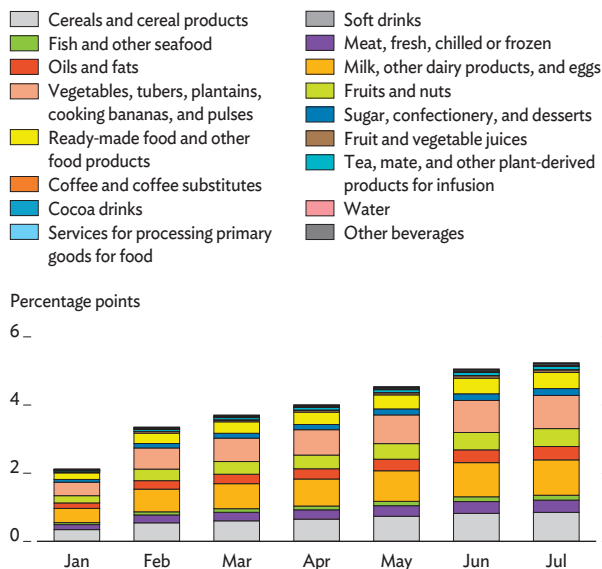


FY = fiscal year.

Source: CEIC Data Company.

Figure 3.3.14 Sources of Food Inflation

Food prices have risen steadily in 2026.



Source: CEIC Data Company.

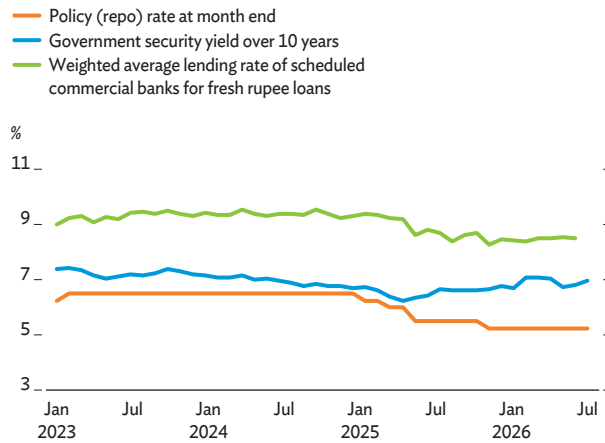
imported goods from the People's Republic of China, and limited pass-through of higher input costs by the private sector contained the increase in core inflation.

Monetary policy remained accommodative in

Q1 FY2026. The Reserve Bank of India (RBI, the central bank) cut the repo rate by 125 basis points between February and December 2025 (Figure 3.3.15). As a result, the weighted average lending rate of scheduled commercial banks dropped by 80 basis points for fresh rupee loans and 91 basis points for outstanding rupee loans from February 2025 to June 2026. The RBI has

Figure 3.3.15 Interest Rates

The central bank's policy rate and banks' interest rates have edged down since February 2025.



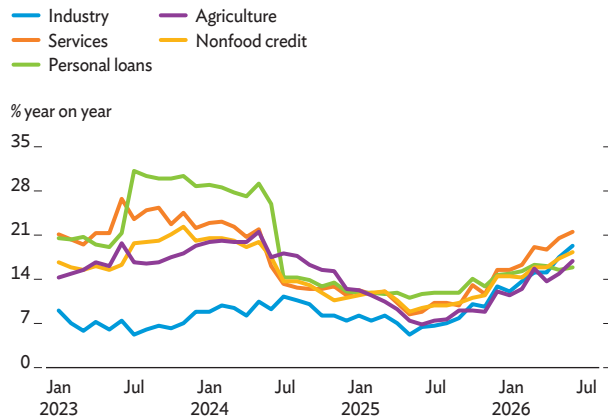
Source: CEIC Data Company.

kept the policy rate unchanged, since December 2025, at 5.25%, as inflation has remained comfortably within its inflation target band of $4\% \pm 2\%$ and 0.3 percentage points below its forecast for Q1 FY2026, despite the recent uptick in inflation driven mainly by supply-side measures. The health of the banking sector continued to improve, with gross nonperforming assets declining from 2.3% of total advances in March 2025 to 1.8% in March 2026 and the capital adequacy ratio improving from 17.4% to 17.7% over the same period. However, banks' liability profiles are shifting from low-cost current deposits to higher-cost term deposits, increasing the marginal cost of funds, with possible adverse effects on profitability. Bank credit growth remained healthy driven by robust borrowings by large and medium firms, and strong lending to NBFCs, real estate and transport operators (Figure 3.3.16).

The FY2026 fiscal deficit remains on track to meet the target. Higher global commodity prices forced the central government to reduce taxes and raise subsidies to limit the pass-through to international prices. However, the government's fiscal deficit during April–July 2026 was contained at 26.8% of its full-year target of 4.3% of GDP, compared to 29.9% of the prior year's target of 4.4% of GDP during the same period. Higher revenue growth and lower tax devolution to states during this period drove the improvement. Gross tax revenue rose by 11.5% during April–July 2026, compared to 8.0% assumed in the budget, as the receipts from personal income and corporate taxes and import duties rose on robust economic activity and an

Figure 3.3.16 Growth in Bank Credit

Bank credit to all major sectors increased in Q1 FY2026.



FY = fiscal year, Q = quarter.

Notes: Excludes public loans to buy crops from farmers and the merger of the Housing Development Finance Corporation (HDFC) nonbank financial corporation, into HDFC Bank, a large bank.

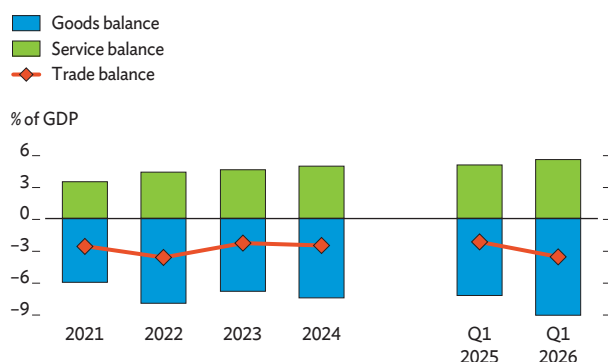
Sources: CEIC Data Company; Reserve Bank of India.

increase in tax rates on imports of gold and jewelry. Receipts from excise taxes contracted due to a cut in the rate on petroleum products, while revenue from the Goods and Services Tax (GST) was also weak, on a reduction of tax rates in September 2025. Non-tax revenue grew by a modest 4.8% from April to July 2026. Overall central government expenditure increased by 12.7% from April to July 2026. Current expenditure rose by 7.8%, mainly because fertilizer subsidies grew by 46.2% amid geopolitical tensions, raising overall subsidies by 37.0%. Interest payments declined by 4.5%, helped by low interest rates, although the share of interest payments in current expenditure remained elevated at 32.5% in the first four months of FY2026. Capital expenditure grew by a healthy 29.9% during this period, against the targeted growth of 11.5%, with expansion led by defense and railway outlays.

The current account deficit marginally increased to 0.5% of GDP in Q1 FY2026, compared to 0.4% of GDP in Q1 FY2025 (Figure 3.3.17). A higher services surplus and remittances tempered a wider merchandise trade deficit. The services surplus rose by 9.0% yoy and remittances by 16.1% yoy. The merchandise trade deficit widened by 22.7% during April–July 2026, as imports outpaced exports. Imports rose by 18.4%, driven by crude oil, electronics, gold, and gems and jewelry. Merchandise exports grew by 17.3%, aided by robust growth in exports of petroleum, electronics, engineering goods, and chemicals. Exports to the People's Republic

Figure 3.3.17 Trade in Goods and Services

The trade balance worsened in the first quarter of FY2026.



GDP = gross domestic product, Q = quarter (by fiscal year).

Notes: Years are fiscal years ending on 31 March of the next year.

Sources: CEIC Data Company; Ministry of Commerce.

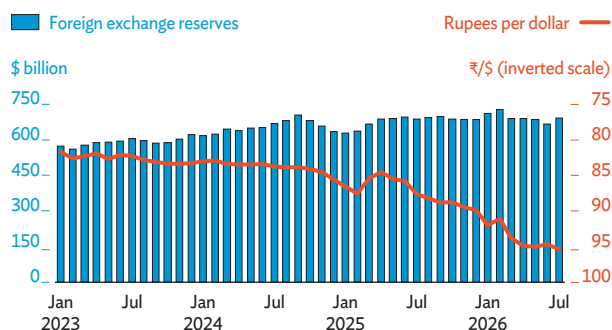
of China, Singapore, South Africa, and the United Kingdom increased strongly, indicating greater market diversification, although the United States remained the largest export destination. Remittances were buoyed by precautionary transfers and rupee depreciation.

Foreign exchange reserves rose by 6.9% to \$740.8 billion in August 2026, bolstered by policy measures to attract foreign capital (Figure 3.3.18).

Net foreign direct investment rose by 23.9% yoy to \$7.8 billion in Q1 FY2026. However, foreign portfolio investment recorded net outflows of \$3.2 billion during April–August 2026, owing to heightened global risk aversion, elevated yields on US financial assets, and volatility in emerging market equities (Figure 3.3.19). The Bombay Stock Exchange Sensex rose by 5.4% from April to August 2026, supported by resilient domestic

Figure 3.3.18 Foreign Exchange Reserves and the Exchange Rate

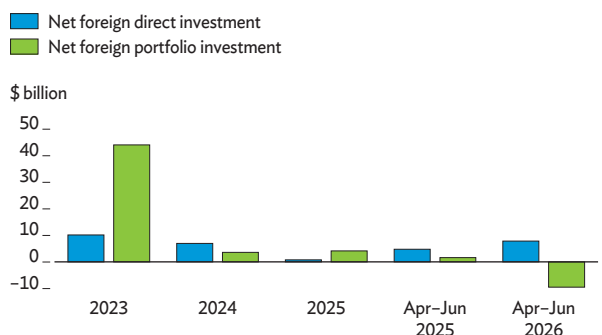
Foreign exchange reserves increased in Q1 FY2026, but the rupee depreciated.



Sources: CEIC Data Company; Reserve Bank of India.

Figure 3.3.19 Net Foreign Direct and Portfolio Investments

Net inflows of capital in Q1 FY2026 remained comparable to the previous year, despite heightened uncertainty.



FY = fiscal year, Q = quarter.

Note: Years are fiscal years ending on 31 March of the next year.

Source: CEIC Data Company.

activity. To attract capital inflows and ease pressure on the rupee, the RBI raised the interest rate ceilings on nonresident deposits, relaxed norms for external commercial borrowing, and widened access for foreign portfolio investors to domestic debt, leading to sizable reserve accretion. The rupee depreciated during April–May 2026 before recovering on RBI measures and lower oil prices.

Prospects

The economic growth forecast is raised from ADO July projection to 7.0% in FY2026, but lowered to 7.1% in FY2027 (Table 3.3.2). The economy is projected to grow faster than expected in FY2026 as the impact of the Middle East conflict is mitigated by lower supply disruptions than expected due to the geographical diversification of energy imports and

Table 3.3.2 Selected Economic Indicators in India, %

Growth will accelerate while inflation will moderate this fiscal year and next.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	7.8	6.6	7.0	7.3	7.1
Inflation	2.1	5.2	5.0	4.0	4.0

GDP = gross domestic product.

Note: Years are fiscal years ending on 31 March of the next year.

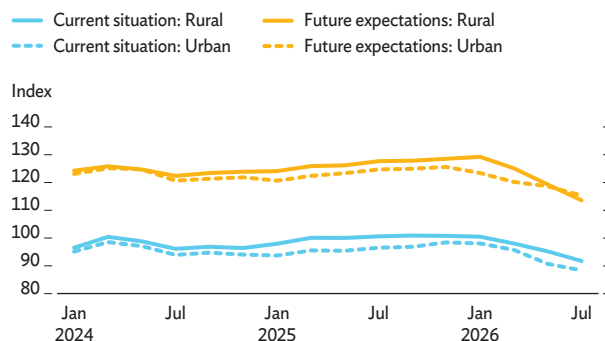
Sources: Ministry of Statistics and Programme Implementation, Government of India; Reserve Bank of India; Asian Development Bank estimates.

consumer protection policies. However, gradually rising consumer prices will weigh on growth in FY2026. Prices are expected to be higher due to the pass-through of higher energy costs, the fading impact of accommodative fiscal and monetary policy measures in the previous fiscal year, and the impact of El Niño. The latter is expected to undermine monsoon rainfall with potentially adverse impacts on agricultural output (as discussed below). However, robust consumption, investment demand, and continued strong services exports are expected to balance the impact of these factors. Continued strong economic growth is forecast in FY2027, helped by domestic demand, but lower than earlier expected due to a stronger base in the previous fiscal year.

Consumption is likely to remain a key driver of growth in both FY2026 and FY2027. Consumption of automobiles and consumer durables will grow robustly this fiscal year, helped by the boost from GST and income tax cuts in FY2025, relatively low interest rates, and a gradual rise in wages and salaries. Nevertheless, consumer confidence has moderated recently in both urban and rural areas due to rising fuel inflation and the waning impact of GST rate cuts, pointing to likely moderation in consumption growth in the second half of FY2026 (Figure 3.3.20). Rural consumption may also be affected in the short run by lower agricultural incomes driven by El Niño. In FY2027, consumption growth is expected to be boosted by an increase in central government employees' salaries following a pay commission award.

Figure 3.3.20 Consumer Confidence Survey

Consumer confidence weakened in the first quarter of FY2026.



FY = fiscal year.

Notes: The consumer confidence index is based on the responses of respondents on the economic situation, income, spending, employment, and prices. A value above 100 indicates optimism, below 100, pessimism.

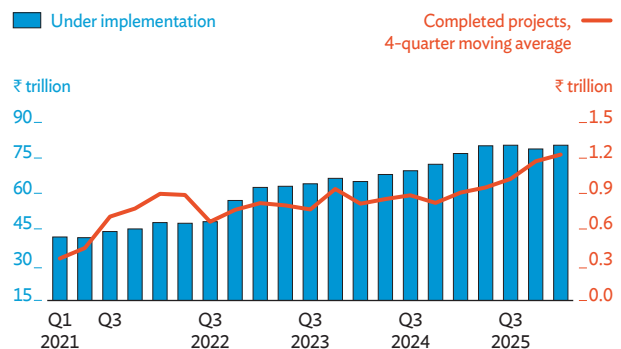
Source: Reserve Bank of India.

Investments will remain resilient, helped by low interest rates and rising public outlays.

Government policy measures to make private investment more attractive will support corporate investment growth, especially through investments in logistics infrastructure, regulatory strengthening, and a strong project pipeline (Figure 3.3.21). Deleveraging and strong cash flows have also enhanced the capacity of the corporate sector to invest. In addition, central government capital expenditure is on track to meet the FY2026 budget target of 11.5% growth. In FY2027, private investment growth may moderate due to global economic uncertainty but is expected to remain strong in select sectors such as data centers and energy, where the investment pipeline is still robust.

Figure 3.3.21 Private Sector Investment Projects

Completion of private sector projects has increased in recent quarters, along with a robust pipeline of ongoing projects.



Q = quarter.

Notes: Note: Years are fiscal years ending on 31 March of the next year.

Source: Centre for Monitoring of Indian Economy.

Net exports will contribute to GDP growth in FY2026 and FY2027.

Global uncertainties and trade disruptions will continue to affect goods exports but certain segments, such as electronics exports, will remain healthy. Goods imports are likely to grow fast due to stronger domestic demand, particularly for capital and intermediate goods. However, services exports are likely to grow strongly and outpace imports, with the short-term impact of AI development leading to higher demand for technology services. In aggregate, net exports will add to GDP growth in FY2026. In FY2027, trade agreements with the United Kingdom and European Union are expected to boost net exports.

On the supply side, deficient monsoons may lower agricultural output and industrial sector growth may falter, but services and construction should remain robust in FY2026 and FY2027.

Monsoon rainfall was 14.7% below normal as of 13 September 2026, with stronger deficits in the central and southern parts of the country. This is expected to impact kharif (summer) crop output, which primarily comprises rice, pulses, and oilseeds. In addition, volatility in rainfall and higher temperatures associated with El Niño could impact supply of perishable commodities such as fruits and vegetables. However, nonfood activities in the agriculture sector, such as livestock, will be less affected, mitigating the impact on growth in the overall sector. Reduced margins from higher input cost pressures will impact industrial sector growth, particularly in the second half of FY2026. The Purchasing Managers' Index for manufacturing dropped from 54.7 in April 2026 to 53.5 in July, reflecting moderating sentiments (Figure 3.3.22). Within the industrial sector, the petroleum refinery segment is likely to be most affected, while electronics, automobiles, and construction goods are likely to see robust demand growth. Strong growth in exports, particularly from mid-sized software companies and global capabilities centers, are likely to drive continued robust growth in the services sector. However, rising input costs could drag on trade and transport services. The construction sector is also projected to continue to do well amid strong demand for housing and government spending on infrastructure. Growth in FY2027 in industry and services will be slower than was anticipated in

ADO July 2026 as a boost from waning oil prices will be lower than expected due to a stronger GDP base in FY2026.

The inflation forecast for FY2026 is lowered from 5.2% in ADO July 2026 to 5.0%, while the FY2027 forecast is maintained at 4.0%. Core inflation will rise in the second half of FY2026 as the impact of GST rate cuts wanes and input cost pressures eventually pass through to retail prices. Food inflation will also rise from a low base of FY2025, as expected earlier, driven by reduced supply, particularly in pulses, oilseeds, fruits, and vegetables due to the unfavorable monsoon, but capped by relatively strong grain buffer stocks. Nevertheless, core inflation is expected to be lower in FY2026 compared to the previous fiscal year due to less-than-expected pass-through of higher global energy prices into retail consumer prices. This in turn is partly due to government measures to absorb some of the effects through tax cuts and other buffers. The inflation forecast for FY2027 is maintained at 4.0% as energy prices are anticipated to moderate and agricultural supply recovers under a normal monsoon assumption.

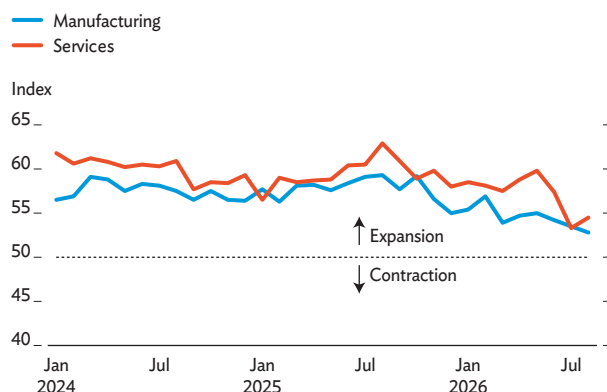
The fiscal deficit in FY2026 is expected to be around 4.3% of GDP as targeted by the budget.

Fiscal pressure from the central government's cut to the excise duty on fuel and expanded subsidies is likely to be partly mitigated by a new tax on oil exports, higher duties on precious metals, and stronger tax revenue growth in other categories due to increased nominal GDP growth. The government is also on track to meet the capital expenditure budget target of 11.5% year-on-year growth in FY2026, but falling global fertilizer prices would limit the increase in subsidy expenditure. In FY2027, the central government is assumed to continue its gradual fiscal consolidation path, with the aim of reducing debt to the target of 50% $\pm$ 1% of GDP by FY2030.

The forecast assumes that the monetary policy stance will remain neutral. However, as consumer inflation remains above the 4% monetary policy target, a modest rate hike later in FY2026 is likely if commodity price inflation spills over into the consumer price index. Nevertheless, growth in bank credit is likely to remain strong due to continued low interest rates relative to inflation and an expected lag in the transmission of interest rates cuts in 2025.

Figure 3.3.22 Purchasing Managers' Indexes

Business sentiments moderated in Q1 FY2026.



Q = quarter.

Source: CEIC Data Company.

The current account deficit is expected to widen as forecast in ADO July, but to contract in FY2027.

Imports will rise in FY2026 relative to the previous year, driven by higher commodity prices and demand for imported electronics goods. This would be partly mitigated by the higher value of petroleum exports, strong export growth in the electronics sector, and continued robust growth in services exports. Remittances are also expected to remain resilient in FY2026. The current account deficit will contract in FY2027, helped by lower global oil prices and robust export growth, supported by India's trade agreements with key trading partners such as the United Kingdom and the European Union.

The external outlook has improved due to policy incentives for capital inflows. Recent measures to attract foreign capital, including a subsidized USD-INR swap facility, will increase aggregate inflows in FY2026, with the current trend in the inflows and outflows of foreign direct investment expected to continue. With financial flows more than covering the current account deficit, foreign exchange reserves should increase and provide a significant buffer to manage external financial market volatility.

Near-term risks are tilted to the downside. Key risks to the outlook come from an exacerbation of geopolitical tensions, particularly in the Middle East, which could affect global energy markets, and greater-than-expected weather volatility resulting from El Niño. The key risks from El Niño include a delayed retreat of the monsoons and a rise in temperatures, which could lead to post-harvest losses of kharif season output or reduced yields in the rabi (winter) cropping season. The risks for rabi crops are particularly likely as water reservoir levels have been lower relative to the previous year. These risks threaten to raise consumer prices and undermine economic growth.

Pakistan

Economic performance continued to improve during fiscal year 2026 (ending 30 June 2026). Growth accelerated, with Pakistan regaining international capital market access. Pakistan's sovereign credit profile strengthened markedly, with international rating agencies upgrading the country's ratings five times in 2025 and 2026, reflecting improved macroeconomic

stability, stronger external buffers, and sustained reform implementation. The Middle East conflict, however, slowed activity in the fourth quarter of FY2026. Inflation rose, prompting a rise in the policy interest rate. Growth is projected to remain modest in FY2027, with inflation rising.

Updated Assessment

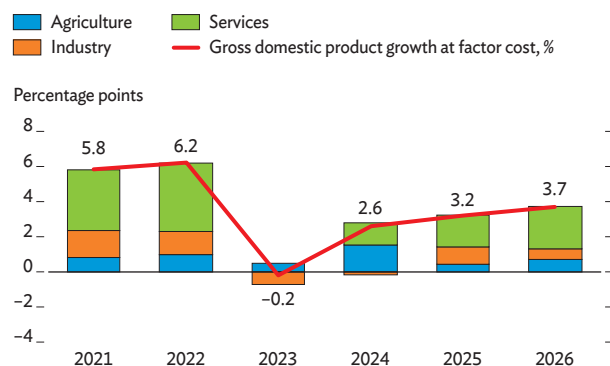
Growth strengthened in fiscal year (FY) 2026 (ended 30 June 2026), although the Middle East conflict curbed activity in the last quarter.

Growth increased to 3.7% from 3.2% in FY2025. Expansion averaged 4.0% during the first 3 quarters, reflecting the lagged effect of monetary easing and improved business confidence. Growth slowed in the last quarter (April–June) as the government's response to the Middle East conflict dampened domestic spending.

Growth was broad-based, driven by resilient services, a rebound in manufacturing, and a recovery in agriculture (Figure 3.3.23). Agriculture grew by 2.9% in FY2026, up from 1.5% in FY2025, though performance varied across sub-sectors. Monsoon floods held major crop output growth at 0.6%, with rice, cotton, and maize most affected, although a record sugarcane harvest partially offset the impact. Livestock, about two-thirds of agricultural value added, expanded by 3.8%, supporting the sector's overall recovery. Industrial output rose by 3.5%, led

Figure 3.3.23 Supply-Side Contributions to Growth

Growth accelerated in 2026 amid strong services activity and a recovery in manufacturing.



Notes: Years are fiscal years ending on 30 June of that year. Gross domestic product at basic prices excludes net indirect taxes.

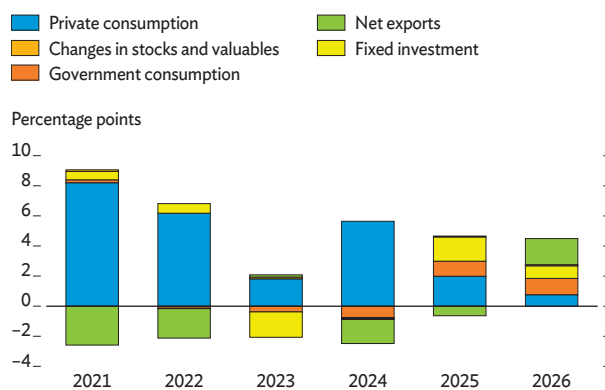
Source: Pakistan Bureau of Statistics. [Updated National Accounts Tables Base FY2016: Table 6 and 7a.](#)

by manufacturing, which grew by 6.6% as large-scale manufacturing reversed its FY2025 contraction to grow by 6.1%. Improved financing conditions and macroeconomic support underpinned the recovery. Sector-specific factors also helped: among them record sugarcane output lifted food processing and new entrants ahead of the expiry of the Auto Industry Development and Export Policy boosted automobile production. In addition, construction incentives alongside strong investment boosted both cement production and construction activity, which grew by 5.7%. A 10.6% decline in electricity generation and gas distribution was the largest drag on industry. Services expanded by 4.1%, up from 3.1%. Wholesale and retail trade, the largest sub-sector, grew by 3.7% from 0.5% in FY2025, reflecting the domestic recovery. Information and communications expanded by 7.5%, reflecting strong service exports.

On the demand side, private investment propelled growth. Household consumption, representing 83% of nominal GDP, grew by only 0.8%, well below 2.1% in FY2025, as higher global energy prices eroded real incomes. Private investment, in contrast, grew by 8.6%, supported by lower borrowing costs and improved business confidence (Figure 3.3.24). Government consumption expanded by 11.2%, though austerity measures moderated public spending toward year-end. Net exports contributed positively to growth, with real exports of goods and services increasing by 5.9% and real imports declining by 6.8%.

Figure 3.3.24 Demand-Side Contributions to Growth

Private investment gained momentum, aided by easing financing conditions and rising business confidence.



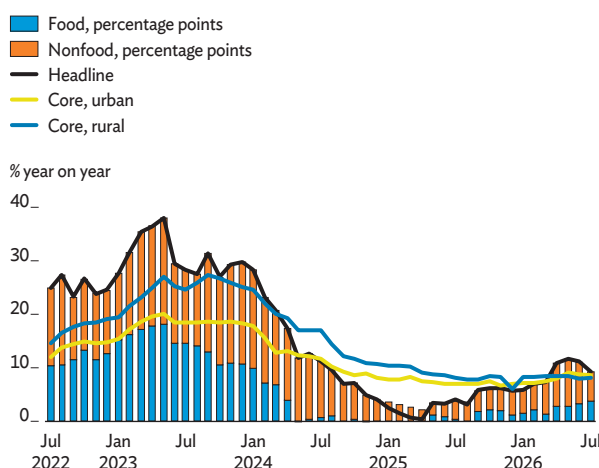
Note: Years are fiscal years ending on 30 June of that year.

Source: Pakistan Bureau of Statistics. [Updated National Accounts Tables Base FY2016: Table 9](#).

The State Bank of Pakistan, the central bank, adopted a cautious, data-driven stance, reverting to tightening as inflation accelerated. Headline inflation averaged 7.1% in FY2026, up from 4.5% a year earlier. The first half of FY2026 was broadly benign: headline inflation rose from a trough of 3.1% in August 2025 but averaged around 5.2% for the half-year, at the lower end of the central bank's 5.0%–7.0% medium-term target range (Figure 3.3.25). Reflecting this environment, the central bank cut the policy rate by 50 basis points to 10.5% in December 2025 (Figure 3.3.26). However,

Figure 3.3.25 Inflation

Inflationary pressures intensified in the second half of fiscal year 2026 as food prices rose and higher oil prices filtered through.

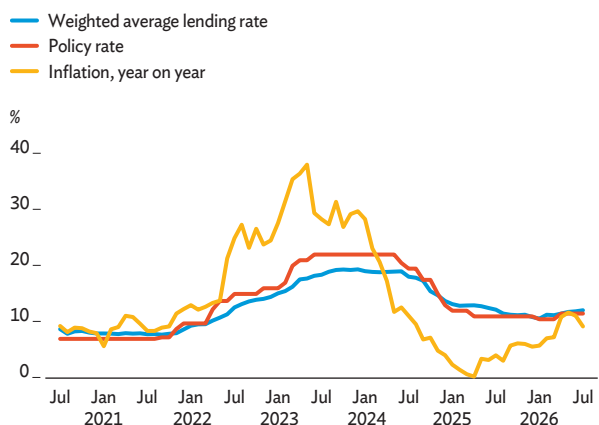


Note: Bars refer to the monthly contributions to inflation.

Source: Pakistan Bureau of Statistics. Price Statistics. [Monthly Review on Price Indices: July 2026](#).

Figure 3.3.26 Interest Rates and Inflation

The central bank tightened monetary policy, raising the policy rate to 11.5% to curb inflationary pressures and anchor expectations.



Source: State Bank of Pakistan. [Economic Data](#) (accessed 20 August 2026).

inflation accelerated in the second half of the year. Rising food prices and gradual pass-through of higher global oil prices raised headline inflation from 5.8% in January 2026 to 7.3% in March 2026, above the target range. The sharpest acceleration came in the fourth quarter as a record fuel price increase in April transmitted rapidly and broadly, lifting headline inflation to a peak of 11.7% in May 2026. Higher fuel costs began feeding into core inflation via transport fares, with urban and rural non-food, non-energy prices edging higher in March and April. The central bank responded with a 100-basis-point rate hike to 11.5% in April 2026 to anchor inflation expectations and contain second-round effects. Headline inflation eased to 11.1% in June and 9.2% in July as global energy pressures moderated. The central bank held the rate unchanged at its July 2026 meeting, assessing the stance as appropriate to return inflation to the target range over the medium term.

Fiscal tightening continued in FY2026. The consolidated budget deficit narrowed to 2.6% of GDP from 5.4% a year earlier, and the primary surplus reached 2.9% of GDP, surpassing the IMF Extended Fund Facility (EFF) program's projection of 2.6% (Figure 3.3.27). The improvement came mainly from interest savings rather than a broadening of the revenue base. Federal Board of Revenue (FBR) collections rose by 10.8% year on year, down from 26.1% in FY2025 and short of the EFF program benchmark by about PRs969 billion. FBR revenue held flat at 10.2% as a share of GDP, indicating that tax base expansion

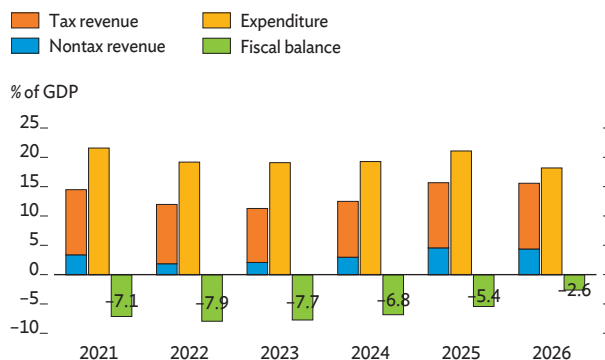
remained limited. Non-tax revenue comprised 4.4% of GDP, supported by a 44.5% increase in Petroleum Development Levy and SBP profit transfers of PRs2,428 billion. Total expenditure decreased to 18.2% of GDP from 21.1% as interest payments declined from 7.7% to 5.5% of GDP on lower interest rates and significant early retirement of domestic debt. Non-interest current expenditure rose in absolute terms, with defense spending up 18.0%. Development spending increased marginally to 2.7% of GDP from 2.6% a year earlier.

The current account remained broadly balanced in FY2026, with renewed pressures from the Middle East conflict in the last quarter.

The current account recorded a small deficit of \$304 million (0.1% of GDP) against a surplus of \$1.8 billion (0.5% of GDP) in FY2025 (Figure 3.3.28). The shift reflected a widening of the merchandise trade deficit from \$26.8 billion (6.6% of GDP) to \$33.7 billion (7.4% of GDP) as exports weakened and imports rose faster than workers' remittances. Merchandise exports declined by 4.7% to \$30.8 billion, driven by a 26.2% fall in rice export volumes following flood-related production losses, while textile exports, about 60% of merchandise exports, grew marginally by 1.7% to \$17.6 billion. Merchandise imports rose by 9.0% to \$64.5 billion, driven by increased raw material and capital goods

Figure 3.3.27 Fiscal Operations

Continued fiscal consolidation narrowed the budget deficit in fiscal year 2026.

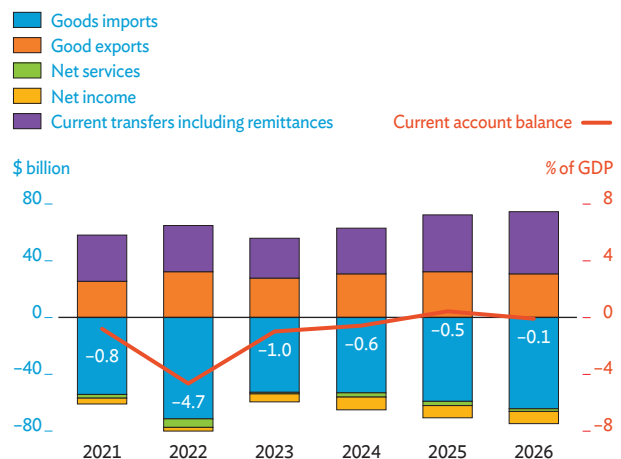


Notes: Years are fiscal years ending on 30 June of that year. Data refers to consolidated federal and provincial governments.

Source: Ministry of Finance. *Pakistan Summary of Consolidated Federal and Provincial Fiscal Operations*.

Figure 3.3.28 Current Account Components

A widening merchandise trade deficit offset remittance gains, resulting in a near-balanced current account in fiscal year 2026.



GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

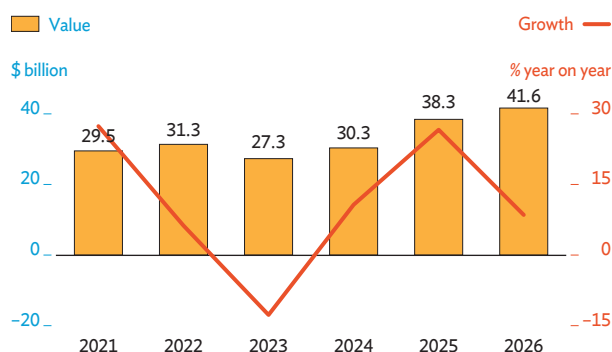
Source: State Bank of Pakistan. Economic Data: External Sector.

Summary Balance of Payments as per BPM6 - July 2026.

imports associated with the manufacturing recovery, and a price-driven surge in energy costs from the Middle East conflict. The services deficit narrowed from \$2.8 billion to \$2.0 billion, as service exports grew 18.6%, led by information technology, business services, and travel receipts. Workers' remittances grew by 8.6% to \$41.6 billion, underpinned by external stability and a market-determined exchange rate (Figure 3.3.29).

Figure 3.3.29 Remittances

Remittances remained resilient, supported by exchange rate flexibility and external stability.



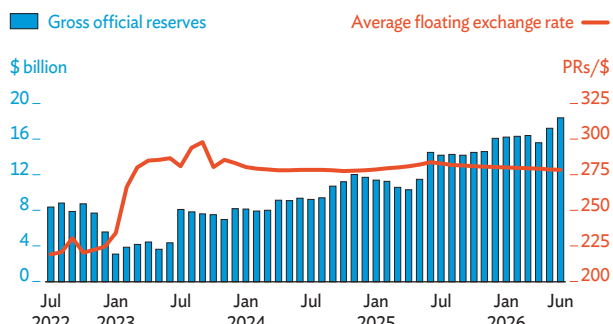
Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan. Economic Data: External Sector. [Worker's Remittances](#).

The financial account reflected Pakistan's improving sovereign standing and renewed access to external financing. The government placed a \$750 million Eurobond and a \$250 million Panda bond in April–May 2026, demonstrating restored market access. Issuance nonetheless did not fully cover large Eurobond repayments of \$500 million in September 2025 and \$1.4 billion in April 2026, leaving net portfolio outflows of \$1.2 billion. The central bank also rolled over many of the bilateral deposits that matured during the year, refinancing much of the maturing stock through fresh placements. Multilateral and bilateral program disbursements, anchored by the IMF's EFF program, remained the primary external financing source. Gross international reserves rose from \$14.5 billion at end-June 2025 to \$18.5 billion at end-June 2026 (Figure 3.3.30). This improved import cover to 2.9 months and underpinned Pakistan's sovereign credit rating upgrades by S&P in July and by Moody's in August.

Figure 3.3.30 Gross Official Reserves and Exchange Rate

International reserves increased in fiscal year 2026, strengthening external resilience and import coverage, while the exchange rate appreciated slightly.



Source: State Bank of Pakistan. [Economic Data](#) (accessed on 30 July 2026).

Prospects

Growth is projected to remain at 3.7% in FY2027 as lingering effects from the Middle East conflict dampen macroeconomic momentum (Table 3.3.3 and Figure 3.3.31). Sustained performance under the IMF's EFF program, re-entry into international capital markets, and the July and August 2026 sovereign credit rating upgrades have collectively improved investor confidence and reduced financing costs from their FY2024 peak. Private investment is expected to be the primary demand driver, building on the 8.6% real expansion in FY2026. Tariff reductions on inputs for industry under the National Tariff Policy 2025–2030 and a lower corporate tax burden following a cut in

Table 3.3.3 Selected Economic Indicators in Pakistan, %

GDP growth is expected to remain unchanged in 2027 while inflation is projected to accelerate in 2027 amid higher global fuel prices.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	3.2	3.7	3.7	3.7	3.7
Inflation	4.5	7.2	7.1	8.3	8.3

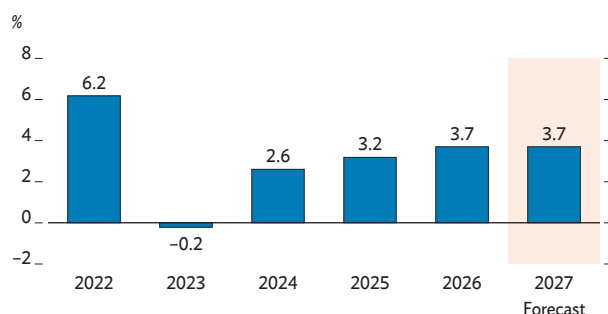
FY = fiscal year, GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

Sources: Pakistan Bureau of Statistics, Updated Annual National Accounts Tables Base 2015–16 (2025–26 Provisional), [Table 6: Real Growth Rates of GDP at constant basic prices of 2015–16](#); Pakistan Bureau of Statistics, Price Statistics, [Monthly Review on Price Indices: July 2026](#); Asian Development Bank estimates.

Figure 3.3.31 Growth Outlook

A stronger macroeconomic outlook supports growth but lingering regional tensions are expected to constrain further acceleration.



Note: Years are fiscal years ending on 30 June of that year.

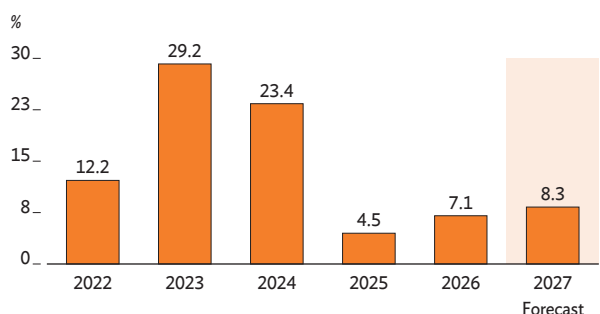
Sources: Pakistan Bureau of Statistics. [Updated National Accounts Tables Base FY2016: Table 6](#); Asian Development Bank estimates.

the super tax should improve the investment climate. Continued fiscal consolidation should reduce the public sector's claim on domestic financing and create space for private credit. Household spending is likely to remain subdued with real incomes compressed by the pass-through of high global energy prices. Services are expected to remain resilient with information technology exports providing a strong basis, while manufacturing faces slower momentum as elevated energy prices raise production costs. Construction is expected to gain from budget incentives, including reduced property transaction taxes and a higher interest subsidy under the Prime Minister's housing scheme.

Inflation is projected to reach 8.3% in FY2027, above the central bank's medium-term target range, complicating monetary policy (Figure 3.3.32). The projection assumes a gradual moderation of inflation from the June 2026 year-on-year rate of 11.1% and a return to the 5%–7% range in the second half of FY2027. Domestic fuel and logistics costs are expected to remain elevated in the first half of FY2027 amid ongoing disruptions to global energy supplies, while higher international fertilizer prices will raise agricultural input costs and food prices. A pickup in economic activity and rising import costs could exert pressure on the exchange rate, raising imported inflation. With the real policy rate having fallen to near zero by end-FY2026, the central bank faces difficult trade-offs between supporting growth and returning inflation durably to the target range. Nevertheless, the central bank has committed to a data-driven, forward-looking approach, anchoring inflation expectations over the medium term.

Figure 3.3.32 Inflation Outlook

Inflation is projected to average 8.3% in FY2027 as elevated energy and food prices sustain price pressures.



Note: Years are fiscal years ending on 30 June of that year.

Sources: Pakistan Bureau of Statistics, Price Statistics: [Monthly Review on Price Indices: July 2026](#); Asian Development Bank estimates.

The FY2027 budget balances support for economic activity with continued fiscal discipline under the IMF program. It targets a consolidated fiscal deficit of 3.6% of GDP and an underlying primary surplus of 2.0% of GDP, consistent with EFF program targets, built on revenue mobilization and selective expenditure containment. FBR collections are targeted to grow by 17.6%, raising FBR taxes from 10.2% of GDP to 10.6%, backed by administrative reforms including a National Faceless Center for automated audit and expanded retail coverage. The budget's growth-supporting measures—revised income tax slabs, a reduced super tax, lower property transaction taxes, and tariff reductions on inputs for industry—aim to improve competitiveness and ease the tax burden on households and firms. However, their revenue cost must be offset through improved compliance and enforcement, making the FBR target ambitious. Pressure on expenditure reflects a 16% increase in defense spending and higher interest payments, the latter reflecting a larger outstanding debt stock and the post-conflict increase in the policy rate. Lower power sector subsidies and smaller provincial development programs partially offset those pressures, but the latter reflect the compression of provincial resources through a reverse transfer to the federal government under Article 164 of the Constitution rather than a shift away from development spending. Execution risks are material: if revenue targets are missed, as in FY2025 and FY2026, in-year expenditure cuts will be required again, limiting already narrow space for growth-enhancing public investment.

The current account deficit is expected to widen amid heightened geopolitical tensions and recovering domestic demand. Stronger import growth, driven by the manufacturing recovery and persistent frictions in global energy markets, including higher freight and insurance premiums, is expected to widen the trade deficit even as petroleum prices ease. On the export side, a rice recovery should partially reverse last year's food export shortfall, while IT-related services are expected to remain resilient, underpinned by a growing freelance and software export base. Workers' remittances are projected to remain broadly stable as labor markets in the Gulf countries stabilize. Post-conflict reconstruction in these countries could boost labor demand, promote migration, and raise remittances over the medium term. External financing conditions and reserve adequacy should remain broadly supportive, supported by multilateral and bilateral official inflows and continued central bank foreign exchange purchases. Gross international reserves are projected at over \$21 billion by end-June 2027 (about 3.3 months of import cover), enough for near-term external stability.

External factors provide downside risks. If the Middle East conflict escalates, it could raise energy import costs, intensify domestic inflationary pressures, and prolong disruptions to the Gulf countries' labor markets, limiting workers' remittances. Pakistan remains particularly exposed because petroleum accounts for a significant share of imports, while remittances from Gulf economies remain the country's largest source of foreign exchange. A sharper-than-expected tightening of global financial conditions would raise external borrowing costs and reduce capital inflows, straining Pakistan's external and fiscal positions. Domestically, falling short of the FBR's revenue target would increase financing needs and crowd out private investment, undermining the expected demand recovery. Weather-related agricultural shocks could reduce crop production, weaken export earnings, and amplify food price pressures. Reform fatigue or implementation delays, particularly in the energy sector and state-owned enterprises, could slow productivity gains, weaken investor confidence, and risk slippage under the EFF program.

Pakistan retains important opportunities to strengthen resilience and support more inclusive medium-term growth. Sustained performance under

the EFF provides a credible macroeconomic anchor, but realizing medium-term potential growth will depend on the consistent implementation of structural reforms. Fiscally, more transparency, improved tax administration, and expenditure efficiency would reinforce credibility and reduce borrowing costs. In the energy sector, cost-reflective tariffs, improved billing and collection efficiency, and private participation in distribution would boost competitiveness in industry. Progress in state-owned enterprise reforms and privatization could help crowd in private investment and improve productivity. Continued implementation of the National Tariff Policy would lower input costs and support export diversification beyond textiles. Pakistan's growing information technology and digital services offer a path for export-led growth less vulnerable to commodity price volatility.

Other Economies

Afghanistan

Growth is estimated to have moderated to 1.5% in fiscal year (FY) 2026 (ended 20 March 2026).

This reflects the impact of two consecutive trade shocks on domestic activity. Closure of Afghanistan–Pakistan border crossings in October 2025 disrupted the country's main southern trade corridor, prompting a costly reorientation of trade toward Iranian and Central Asian routes. The Middle East conflict, beginning in February 2026, then disrupted Iranian transit corridors, affecting routes that carried around 60% of Afghanistan's trade. Together with continued restrictions on women's education and employment, these shocks weighed heavily on services. Industry remained relatively resilient, however, becoming the main contributor to growth. It benefited from momentum in the first half of FY2026 and strong demand from the inflow of returnees, while drought, floods, and diseases constrained agriculture.

Inflation increased notably in the first half of 2026, driven by higher trade and distribution costs.

Headline inflation averaged 7.6%, up from near zero a year earlier, as Pakistan border closures and Middle East-related corridor disruptions increased rerouting costs, delivery delays, and freight charges. Housing, utilities, bread, and cereals represented about two thirds of inflation, placing a heavy burden on households.

Although inflation eased to 7.6% in June from 8.0% in May, underlying pressures remained elevated, with rising inflation in other goods and in healthcare. A real appreciation in the afghani, the currency, helped limit import price pass-through, but a late-June fuel supply disruption and the subsequent fuel and Liquefied Petroleum Gas (LPG) price increases stemming from Russia's war in Ukraine are expected to increase inflationary pressures.

Trade developments during the first 5 months of 2026 indicate a widening external imbalance. The merchandise trade deficit expanded to \$4.8 billion, with exports covering only 9.6% of imports, down from 11.4% a year earlier. Imports rose by 7.3% to \$5.3 billion, driven mainly by fuel and staple foods, while declines in chemicals, transport equipment, and textiles suggest a shift toward importing consumer necessities. Trade diversion was significant. Imports from Pakistan fell by 93.0%, while imports from Central Asia and the Russian Federation rose by 64.9%. Still, Iran remained the largest import source. Exports declined by 9.7% to \$511.4 million, largely reflecting an 81.5% fall in shipments to Pakistan. Exports expanded to other markets, including the People's Republic of China, Iran, and Uzbekistan. Overall, Afghanistan's narrow, agriculture-based export base remains highly vulnerable to corridor disruptions and seasonal shocks.

Projected growth in FY2027 has been reduced to 2.2% from 3.0%, with trade shocks persisting longer than previously expected (Table 3.3.4). The July forecast assumed normalized trade corridors through Pakistan and Iran, but disruptions persist on both routes. Agriculture is expected to remain the main

growth driver, supported by favorable rainfall, improved crop conditions, expanded planting, and higher cereal and livestock output. Industry and services are likely to remain subdued as longer rerouting raises logistics and input costs, delays critical supplies, compresses margins, and weighs on private investment and trade. Risks remain tilted to the downside, particularly from the late-June fuel supply disruptions and continued returnee inflows, which could further weaken per capita income.

Inflation is projected to rise to 7.0% in FY2027, up from the earlier forecast of 5.5%, reflecting longer trade disruptions and fuel supply pressures.

Continued closure of Pakistan border crossings and Middle East-related disruptions along Iranian transit corridors are expected to keep freight premiums elevated. The late-June fuel supply shock is likely to add further pressure, with oil and LPG prices remaining high amid extended Russian export restrictions and limited near-term recovery in refining capacity. Pass-through is expected to be broad-based, particularly through housing, utilities, and transport, while the widespread use of LPG for cooking and heating could amplify household price pressures.

Bhutan

The growth forecast is unchanged from ADO July 2026 projections for 2026 and 2027 (Table 3.3.5).

The forecast incorporates softer first quarter (Q1) 2026 growth of 5.8% year on year, 2 percentage points lower than a year earlier. Tourism remained robust in the first half (H1) of 2026, with arrivals from regional markets exceeding the previous year's levels in every month. Arrivals from outside the region have been comparatively subdued. Because regional tourists on average have been spending less per visitor, the impact

Table 3.3.4 Selected Economic Indicators in Afghanistan, %

Growth forecasts for FY2026 and FY2027 have been reduced, with higher projected inflation in FY2027.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	1.9	2.3	1.5	3.0	2.2
Inflation	-4.2	3.6	3.6	5.5	7.0

FY = fiscal year, GDP = gross domestic product.

Notes: Years refer to fiscal years ending in March of that year.

ADB placed on hold its regular assistance to Afghanistan effective 15 August 2021.

Source: Asian Development Bank estimates.

Table 3.3.5 Selected Economic Indicators in Bhutan, %

The growth forecast is maintained for 2026 and 2027, while the inflation forecast is raised for both years.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	8.5	6.5	6.5	7.2	7.2
Inflation	3.5	4.5	6.5	4.0	4.5

GDP = gross domestic product.

Sources: National Statistics Bureau; Ministry of Finance; Royal Monetary Authority of Bhutan; Asian Development Bank estimates.

of tourism receipts has been weaker than headline arrivals imply. The electricity subsector grew by 6% year on year in H1 2026, in line with expectations. Other principal factors affecting growth are broadly aligned with the expectations in the *ADO Update July 2026*. Higher diesel costs have raised construction and freight charges, including for hydropower and government projects, and eroded household purchasing power. Elevated haulage and material costs have seen private investors postponing project starts pending greater clarity on input costs. Public capital works face the same pressure, raising the risk of slower budget execution. At this update, the hydropower scenario remains unchanged. Approval of the design and the agreement for resuming dam construction at the Punatsangchhu-I project have been delayed, tempering the pace of works. However, other projects, including Khorlochhu and Dorjilung, have advanced as planned.

The inflation forecast is revised up from ADO July projections to 6.5% in 2026 and 4.5% in 2027. The revisions reflect the rise in average inflation to 6.4% over the first half of 2026 and higher-than-expected price pressures from the Goods and Services Tax and excise tax introduced in January 2026. They also reflect a surge in fuel and transport costs stemming from the Middle East, transmitted to Bhutan's economy through India. Food inflation averaged 6.6% in H1 2026 as the prices of alcoholic beverages and betel nuts jumped 24.1% in Q1 and by another 22.4% in Q2. Fuel prices have remained broadly stable at an elevated level since July amid ongoing government subsidies, pushing the transport inflation to 15% by mid-year from a low of near zero in January. Inflation is projected to moderate in 2027 as one-off tax effects fall out of the annual comparison and assuming external price pressures subside as fuel prices stabilize and food inflation eases.

Risks to the outlook arise mainly from external sources and remain tilted to the downside. A protracted conflict in the Middle East is the dominant risk as it will raise fuel prices and intensify inflationary pressure, eroding real household purchasing power. The pass-through of higher fuel prices is currently contained, but through a subsidy that raises an already large fiscal deficit and high public debt. A prolonged shock would therefore narrow fiscal space and add to debt pressures. The Middle East conflict will also erode Bhutan's fragile international reserves position and necessitate stringent import restrictions, further

constraining economic activity and reducing resources for development. On the upside, a cessation of the Middle East conflict could bring fuel prices down quickly, easing inflation, restoring confidence, and lifting growth above baseline.

Maldives

GDP growth is projected at 1.0% in 2026 and 3.0% in 2027, unchanged from ADO July (Table 3.3.6).

The Middle East conflict has disrupted tourism, with arrivals in the first half (H1) of 2026 declining 5.7% from in H1 2025. Yet, travel earnings still grew 1.9% year on year (yoy) in January–May 2026, as strong gains in the first 2 months of the year and higher spending per tourist offset the contraction in arrivals during March and April. Construction grew on sustained investment in resorts and a 12.9% rise in government capital spending, after a sharp drop in 2025. In contrast, fish exports fell 49.7% yoy, hit by a lower fish catch and possibly influenced by changing seasonal patterns, higher freight costs, operational delays, and muted demand. The decline occurred even though fuel subsidies to fishers helped ease operating costs. Promotional campaigns and increased flight connectivity should lift tourism during the fourth-quarter peak season, while construction momentum is likely to continue. But the rebound will be limited, as fisheries are not expected to recover for the remainder of the year, contrary to earlier expectations. Likewise, tourism receipts are expected to grow less in 2026 than in 2025 given the H1 slump. These trends are seen carrying into 2027. These developments suggest the economy is broadly tracking the July forecast, although the impacts of the Middle East conflict may temper the upside.

Table 3.3.6 Selected Economic Indicators in Maldives, %

The growth forecast for 2026 and 2027 is unchanged from the July projection, while prices are expected to rise by less than forecast in July.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	6.2	1.0	1.0	3.0	3.0
Inflation	4.0	5.0	2.2	4.0	2.0

GDP = gross domestic product.

Sources: Maldives Monetary Authority. *Monthly Statistics, July 2026*; Asian Development Bank estimates.

Inflation is projected at 2.2% in 2026 and 2.0% in 2027, both lower than forecasts in July, reflecting the smaller-than-expected impact of higher global oil prices. Although electricity and transport costs rose slightly in the second quarter of 2026—reflecting the impact of the Middle East conflict—overall pressures remained contained in H1 2026, with inflation averaging 0.9%, compared with 5.2% a year earlier. The lower inflation forecast for 2027 reflects easing prices across imported commodities and services—including transport—as extensive subsidies, particularly for fuel and electricity, will continue limiting the pass-through of higher oil prices.

The fiscal deficit is forecast to be higher than July projections, at 6.0% in 2026 and 4.5% in 2027.

The upward revision reflects higher subsidy spending this year, which by July had jumped by 77.0% yoy. Government expenditure grew 20.7% yoy in January–July 2026, outpacing 9.0% revenue growth and resulting in a deficit of 1.0% of GDP, after a slight surplus last year, financed largely by domestic borrowing. The fiscal deficit is likely to narrow in 2027, supported by higher tourism-related receipts. Meanwhile, debt service is projected to decline to \$666 million in 2027 from over \$1.0 billion in 2026. Public debt fell to 122.7% of GDP at the end of June 2026, and Fitch Ratings upgraded Maldives’ rating to “substantial credit risk” (CCC) in June, citing reduced default risk.

The current account deficit is expected to widen more sharply than projected in July, reaching 13.5% of GDP in 2026 before easing to 12.5% in 2027. Recent external liquidity indicators point to persistent foreign exchange pressures and heightened vulnerability. Usable foreign reserves fell from 3.3 weeks of imports to 2.8 weeks between end-April and end-July, and the rufiyaa market exchange rate depreciated further since July. In response, the government amended the Foreign Exchange Act in August to increase mandatory conversion of foreign-currency earnings into rufiyaa. The deterioration in 2026 stems from a weaker trade position, as tourism receipt growth eases and fish exports fall, while imports rise due to higher construction-related demand from the government’s investment drive and higher oil prices. The outlook for 2027 improves modestly as tourism is expected to rebound, strengthening the services balance. Nonetheless, sizable debt repayments coinciding with rising import requirements will maintain pressures on the balance of payments.

The risks to the outlook are tilted to the downside.

Construction resilience and a modest recovery in tourism provide near-term support, but vulnerability to external shocks, the debt overhang, and weakening fish exports cloud the outlook. Continued instability in the Middle East threatens to disrupt tourist flows during the late 2026–early 2027 peak season, and delays in reforming loss-making state-owned enterprises and the universal subsidy schemes could intensify fiscal strain.

Nepal

GDP growth moderated in fiscal year (FY) 2026 (which ended 16 July 2026), as forecast in the ADO July 2026 (Table 3.3.7). Agriculture expanded by only 1.6%, as delayed monsoon rains and October 2025 floods reduced paddy production, while industry growth accelerated to 5.7%, driven primarily by additions to hydroelectric generation capacity. Services growth remained resilient at 4.2%, despite disruptions at key Middle East transit hubs during the peak spring climbing season and lingering uncertainty arising from the conflict in that region.

Table 3.3.7 Selected Economic Indicators in Nepal, %

Flood impacts temper growth momentum while pushing up inflation in FY2027.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.4	3.9	3.9	4.5	4.1
Inflation	4.1	3.2	3.1	5.0	5.3

FY = fiscal year, GDP = gross domestic product.

Note: Years are fiscal years ending in mid-July of that year.

Source: Asian Development Bank estimates.

Both external and domestic demand strengthened in FY2026 as political stability improved following civil unrest in September 2025. Private consumption remained the largest component of aggregate demand, growing by 3.2%, from 2.3% a year earlier. Strong remittance inflows and lower interest rates supported consumption. Private investment also rebounded strongly, increasing by 39.6% following an 8.1% contraction in FY2025, while weak capital-budget execution continued to constrain the contribution of public investment. On the external side, goods imports increased by 7.2% in the first 11 months of FY2026, goods exports rose by 7.9%, and workers’

remittances increased by 29.6%, substantially exceeding the pace anticipated earlier in the year, despite the Middle East uncertainties.

Growth is expected to moderate in FY2027 relative to the ADO July projections, reflecting economic disruptions caused by the severe August flash floods.

Damage to transport infrastructure, hydropower facilities, and other productive assets—together with disruptions to trade, tourism, agriculture, and local economic activity—is expected to weigh on industrial and services growth for the first quarter. Reconstruction and rehabilitation spending, including hydropower expansion, will partly offset these impacts by supporting demand and restoring critical infrastructure, although post-disaster spending may place additional pressure on public finances.

Inflation was marginally lower in FY2026 than the ADO July forecast, but is projected to be higher in FY2027 than the previous forecast.

Inflation averaged 3.1% in FY2026, with food inflation at 1.1%, while nonfood inflation averaged 4.2%, driven mainly by transportation and restaurant and accommodation services. Inflation is expected to rise in FY2027 as the impact of the flash floods constrains supplies of food and other essential goods and increases logistics costs. At the same time, reconstruction and rehabilitation are likely to boost demand for construction materials, transport, and labor, supported by expansionary fiscal policy and ample liquidity. Higher global fuel prices resulting from the Middle East conflict are expected to add cost pressures. The FY2027 inflation forecast is therefore revised upward to 5.3%.

The fiscal deficit is estimated at 3.0% of GDP in FY2026 and is projected to widen in FY2027, reflecting increased spending on post-flood reconstruction and rehabilitation.

The deficit is forecast at 4.7% of GDP in FY2027, up from the pre-disaster projection of 3.4%, as the government expands recurrent and capital spending to support recovery efforts. Public debt rose to an estimated 44.9% of GDP in FY2026 from 43.7% in FY2025, while debt-servicing costs eased to 5.9% of GDP from 6.3%. Public debt is expected to increase further in FY2027 as additional resources are mobilized for reconstruction and recovery. Despite higher financing needs, Nepal remains at low risk of debt distress.

The external position strengthened considerably in FY2026, supported by robust remittance inflows and higher exports.

Strong remittance inflows more than offset the trade deficit, leading to a current account surplus of 14.0% of GDP and an overall balance-of-payments surplus of 15.6% of GDP in FY2026. Foreign exchange reserves reached record levels of more than 19 months of imports. Remittance inflows are expected to remain strong in FY2027, although tourism receipts could weaken temporarily as the floods disrupt arrivals. Electricity exports are also unlikely to contribute to export growth in FY2027, given disruptions to hydropower infrastructure. At the same time, stronger domestic demand and reconstruction-related activity are expected to increase imports, narrowing the current account surplus, although the external position should remain comfortable.

The outlook remains subject to significant downside risks.

The recovery from the disruptions to infrastructure, agriculture, tourism, and trade could be long and weaken growth. Reconstruction needs could be higher than expected, placing additional pressure on public finances and pushing up inflation. Global geopolitical tensions, particularly a prolonged conflict in the Middle East, could raise oil and other commodity prices and affect remittance inflows and tourism receipts. Weather-related shocks could further disrupt agricultural production and food supplies. Financial-sector vulnerabilities, including rising nonperforming loans, also remain a concern. On the upside, faster reconstruction, stronger public investment execution, and continued expansion of digital and information technology services could support economic activity and accelerate the recovery.

Sri Lanka

Growth forecasts remain unchanged from the July revision (Table 3.3.8).

GDP expanded by 5.1% year on year in the first quarter of 2026, driven by broad-based growth in industry (7.2%), services (3.4%), and agriculture (1.1%). On the demand side, private consumption grew by 7.1% and gross capital formation by 16.5%, supported by reconstruction activity and resilient domestic demand. Momentum has since softened, as the index of industrial production fell from 4.3% year on year in January to 0.8% in June.

Table 3.3.8 Selected Economic Indicators in Sri Lanka, %

Growth will slow in 2026 and stabilize in 2027, but inflation will rise in 2026 and moderate in 2027.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	5.0	4.0	4.0	4.0	4.0
Inflation	-0.5	6.0	6.0	5.2	5.2

GDP = gross domestic product.

Sources: Department of Census and Statistics; Asian Development Bank estimates.

Domestic financial conditions have eased since July, with Treasury bill yields declining steadily and partly unwinding the market's initial overreaction to the May policy rate increase. Private sector credit growth remained robust, driven mainly by working capital needs and vehicle imports, but is expected to slow through 2027. Industry is expected to be a key growth driver in 2027, led by construction and supported by planned transport and digital investments, alongside reforms to promote export diversification and foreign direct investment.

Inflation forecasts for 2026 and 2027 remain unchanged from the July projections. Headline inflation measured by the Colombo consumer price index rose from 2.2% year on year in March to 8.0% in August, driven by faster food inflation and transport and utility-related price increases. The July projection already incorporated the energy price shock, while subdued inflation earlier in the year offset the subsequent acceleration. Administered prices will add no further impulse in the third quarter, as electricity tariffs remain unchanged. Inflation is projected to moderate in 2027 as base effects from 2026 increases fade and tighter monetary conditions contain demand. However, it will remain above the central bank's target, partly reflecting higher food prices from El Niño.

Statutory review of the inflation target, due later this year, could affect medium-term policy calibration but not the near-term outlook.

The current account weakened sharply in the first seven months of 2026. It recorded a deficit of \$387 million, against a surplus of \$1.7 billion a year earlier, as the merchandise trade deficit widened 69.0% to \$6.5 billion on 25.8% import growth and 4.4% export growth. Total goods and services exports rose 2.2% to \$12.3 billion but were outweighed by the import surge and a narrower services surplus. Remittances remained the main buffer, up 21.4% year on year in the first 7 months. Tourism weakened, with arrivals down 1.8% in the same period and earnings down 11.5% on lower spending per visitor. With only 1.5 million arrivals by end-August, the 3 million target for 2026 appears distant. Gross official reserves fell from \$6.8 billion at end-December to \$6.6 billion by end-July amounting to 3.2 months of imports. In addition, the rupee depreciated 7.8% against the US dollar by end-July before recovering in late August, narrowing year-to-date depreciation to 5.5%. US trade policy risks eased, as the US tariff over forced-labor concerns was set at 10% rather than 12.5%. The current account is forecast to weaken this year and in 2027. Meanwhile, rebuilding reserves and sustaining investor confidence remain priorities, as public debt remains high despite declining in dollar terms by end-June.

Risks to the outlook remain tilted to the downside. Escalation of the Middle East conflict could raise fuel, freight, fertilizer, food, and subsidy costs, and weigh on exports, remittances, tourism, and reserves. A very strong El Niño is already materializing, damaging crops and threatening hydropower supply. Domestically, rapid credit growth warrants monitoring, skilled labor shortages could constrain reconstruction, and slack in expenditure control or a revenue shortfall could undermine the 2027 fiscal position.

DEVELOPING SOUTHEAST ASIA

Growth in developing Southeast Asia for 2026 and 2027 is now forecast slightly higher than in *ADO July 2026*. However, there are considerable variations across countries. Domestic factors boosted growth in many economies, but in others headwinds dampened activity. The inflation outlook for 2026 and 2027 is revised up from previous projections as governments react differently to the Middle East conflict and a strengthening El Niño.

Subregional Assessment and Prospects

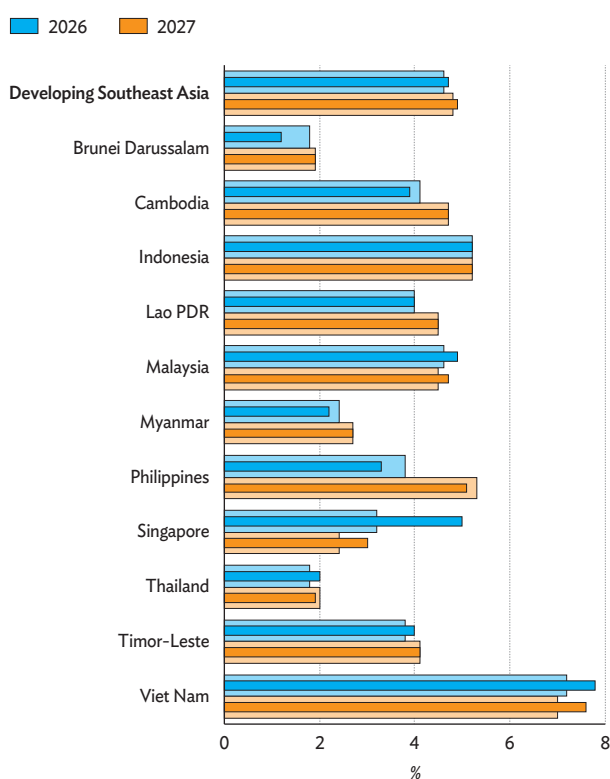
Subregional growth forecasts have improved modestly, but remain uneven across economies (Figure 3.4.1). GDP growth is revised up from 4.6% to 4.7% in 2026 and from 4.8% to 4.9% in 2027. Viet Nam records the largest upgrade, followed by Malaysia and Thailand, while Indonesia's outlook is unchanged. Forecasts are lowered for the Philippines, Cambodia, Myanmar, and Brunei Darussalam, and the divergence will likely persist in 2027.

Recent economic performance has been broadly resilient, but growth drivers are becoming more differentiated. In the first half of 2026, manufacturing and services sustained activity across much of the subregion, supported in some economies by resilient consumption and public spending. Elsewhere, high food and energy costs, an incomplete tourism recovery, delayed project implementation, and domestic uncertainty constrained demand and investment.

Three broad factors explain the subregion's diverging growth and prospects. Variations include the relative importance of technology-linked external demand, public investment and policy support, and domestic demand conditions.

Figure 3.4.1 Gross Domestic Product Growth in Developing Southeast Asia

Forecast revisions vary significantly by country.



Lao PDR = Lao People's Democratic Republic.

Notes: Effective 1 February 2021, ADB placed a temporary hold on sovereign project disbursements and new contracts in Myanmar. Lighter colored bars are *Asian Development Outlook July 2026* forecasts.

Source: *Asian Development Outlook* database.

The subregional assessment and prospects was written by James Villafuerte and Dulce Zara. The section on Indonesia was written by Priasto Aji and Reza Anglingkusumo; Malaysia by Mae Hyacinth Kiocho, consultant, and James Villafuerte; the Philippines by Katelyn Yoo and Teresa Mendoza; Thailand by Chitchanok Annonjarn; Viet Nam by Nguyen Luu Thuc Phuong, Chu Hong Minh, and Bui Minh Giap. The other economies by Poullang Doung, Roshen Fernando, Kavita Iyengar, Soulinthone Leuangkhamsing, Eve Cherry Lynn, Ahmad Miraj, David Richard Fay, Bold Sandagdorj, Patrick Jaime Simba, and Milan Thomas. The authors are in the Southeast Asia and Economic Research and Development Impact departments, ADB. Effective 1 February 2021, ADB placed a temporary hold on sovereign project disbursements and new contracts in Myanmar.

First, the global technology and artificial intelligence investment cycle helps economies better integrated into electronics and digital supply chains.

Viet Nam's growth is revised up from 7.2% to 7.8% in 2026 and from 7.0% to 7.6% in 2027, supported by rapid manufacturing expansion, robust foreign direct investment, and resilient services. Malaysia's forecast rises from 4.6% to 4.9% in 2026 and from 4.5% to 4.7% in 2027 as the semiconductor upcycle and data center investment reinforce consumption and construction. Thailand's 2026 forecast increases from 1.8% to 2.0%, as electronics exports and technology investment partly offset weaker tourism and higher energy costs, before easing to 1.9% in 2027 as export momentum normalizes. Continued strength in electronics exports should drive Philippine growth in 2026 and 2027.

Second, differences in public investment and policy support are widening growth outcomes.

Accelerated infrastructure spending and accommodative policies are strengthening investment-led growth in Viet Nam, while public infrastructure programs provide additional support in Malaysia. Timor-Leste's forecast rises from 3.8% to 4.0% in 2026 and remains at 4.1% in 2027 on stronger government spending, credit growth, and improved investor confidence following its ASEAN accession. In the Philippines, weak public investment contributed to the 2026 downgrade from 3.8% to 3.3%, although a rebound is expected to support growth of 5.1% in 2027.

Third, differing domestic demand, tourism, supply conditions, and economic structure are increasingly behind the uneven results.

Indonesia's outlook remains unchanged at 5.2% in both 2026 and 2027, underpinned by consumption, services, and supportive fiscal and credit conditions. In Thailand, government support has helped household spending remain resilient, although high household debt continues to constrain consumption. In the Philippines, higher food and fuel prices, and soft labor market conditions, weigh on domestic consumption. Cambodia's 2026 forecast falls from 4.1% to 3.9% as tourism remains below pre-pandemic levels and border disruptions persist, despite resilient manufacturing and more diversified exports, which should help growth recover to 4.7% in 2027. Myanmar's forecast declines from 2.4% to 2.2% in 2026 and remains at 2.7% in 2027 as instability, supply constraints, import restrictions, and weak investment limit activity. The Brunei

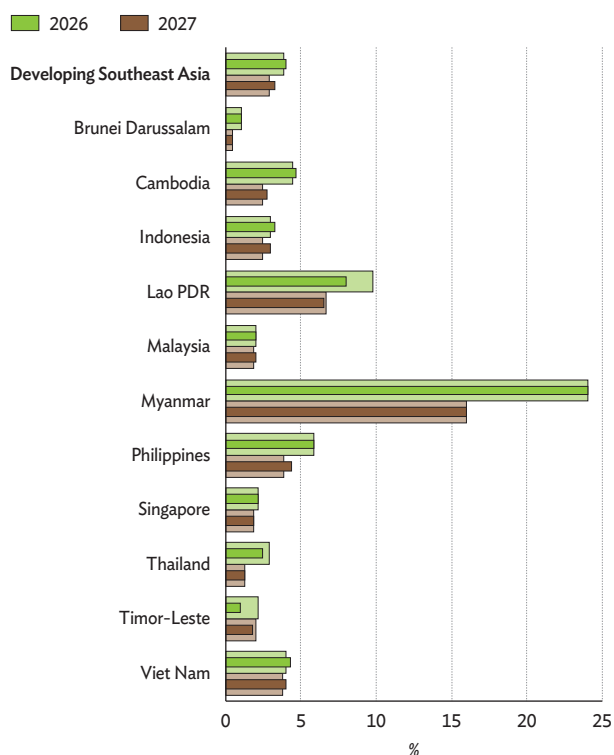
Darussalam forecast is reduced from 1.8% to 1.2% in 2026 and maintained at 1.9% in 2027 as stronger hydrocarbon production does not fully offset weakness in the non-oil economy. The Lao PDR outlook remains unchanged.

The subregional inflation outlook has been revised up, with substantial variations across economies

(Figure 3.4.2). The overall forecast rises from 3.9% to 4.0% in 2026 and from 2.9% to 3.3% in 2027. Cambodia, Malaysia, Myanmar, the Philippines, and Viet Nam face stronger price pressures as higher global energy costs related to the Middle East conflict and climate-related disruptions raise food and transport prices. Indonesia has allowed higher international energy price to pass through into domestic non-subsidized fuel price. However, inflation should be relatively contained in most large subregional economies while remaining particularly high in Myanmar and the Lao PDR.

Figure 3.4.2 Inflation in Developing Southeast Asia

For most countries, inflation is expected to remain elevated in 2026 and 2027.



Lao PDR = Lao People's Democratic Republic.

Notes: Effective 1 February 2021, ADB placed a temporary hold on sovereign project disbursements and new contracts in Myanmar. Lighter colored bars are Asian Development Outlook July 2026 forecasts.

Source: Asian Development Outlook database.

Policy support has lowered projected inflation in the Lao PDR, Thailand, and Timor-Leste relative to the July forecasts.

Monetary policy responses reflect differing balances between supporting growth and containing inflation and exchange-rate pressures.

Viet Nam maintained an accommodative stance, supporting liquidity and directing credit toward priority sectors; however, rising inflation, currency pressure, rapid credit growth, and asset-quality risks limit the scope for further easing. Malaysia kept its policy rate at 2.75% as growth remains firm and inflation manageable. Indonesia adopted a more stability-oriented mix, using monetary instruments to manage capital flows, the exchange rate, and imported inflation, while macroprudential measures continue to support credit. The Philippines raised its policy rate by a cumulative 75 basis points between April and August to ease inflationary pressures. Across the subregion, monetary authorities will likely remain cautious and data dependent.

Inflation prospects reflect external cost pressures, policy responses, and climate risks. Higher international energy and input costs, including fertilizer, remain the main near-term pressure. Policy responses are producing different results: Indonesia, Thailand, and Timor-Leste have contained inflation using subsidies, price controls, and food supply management, while Cambodia, Malaysia, and the Philippines have relied more on targeted support that cushions price increases. Looking ahead, a strengthening El Niño is the principal inflation risk for 2027, as drought and heat-related disruptions could constrain food production, water availability, and energy generation, thereby increasing food and utility prices.

Countries are combining supply-side preparedness and consumer support to mitigate El Niño's effects on growth and inflation. Thailand is advancing irrigation and water-management projects, supporting farmers facing higher fertilizer costs, and applying lower household electricity tariffs, fuel support, and essential-goods price controls. The Philippines is rehabilitating and expanding irrigation facilities, raising investments in water resource management, supporting farmers amid high fertilizer and input costs, and distributing drought-resistant seeds and inputs. Indonesia is strengthening food and energy security

through food-supply management and related price-stabilization measures. Timor-Leste is also using subsidies and price controls to contain essential price increases, while Cambodia and Malaysia rely more on targeted support to cushion vulnerable households from higher food and energy costs. However, these can only partly offset the risk that a stronger and more persistent El Niño reduces crop yields and farm incomes, raises food and utility prices, and weakens rural consumption in 2027.

Risks in the subregion are generally tilted to the upside. The uncertain outlook for the Middle East conflict continues to impact the outlook. Further increases in international oil prices would adversely hit most countries. El Niño could strengthen beyond current forecasts with even more climatic damage.

Indonesia

GDP is forecast to grow by 5.2% in both 2026 and 2027, unchanged from ADO July 2026, driven by domestic demand and fiscal support, despite limited net exports. Average inflation should reach 3.3% in 2026 before easing to 3.0% in 2027, revised up from July, but within the official target range. Lower energy prices and gradually strengthening private investment should support the 2027 outlook, while a stronger or prolonged El Niño, renewed oil price pressures, and elevated global interest rates pose important risks.

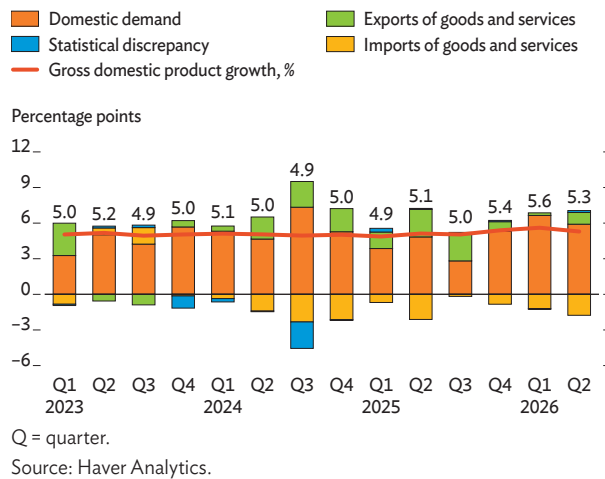
Updated Assessment

Economic growth remained strong in the first half (H1) of 2026 despite some slowdown in the second quarter (Q2). GDP expanded by 5.6% year on year in Q1 and 5.3% in Q2 2026, bringing H1 growth to 5.4%. The moderation in Q2 followed exceptionally strong growth at the start of the year, when holiday demand and accelerated government spending provided a substantial boost. Domestic demand continued to drive Q2 growth, supported by investment and government consumption, while net exports deducted from growth as imports expanded faster than exports (Figure 3.4.3).

Growth remained broad-based across regions, although the pace varied. Regional economic growth in Java, which accounts for more than half the total

Figure 3.4.3 Demand-Side Contributions to Growth

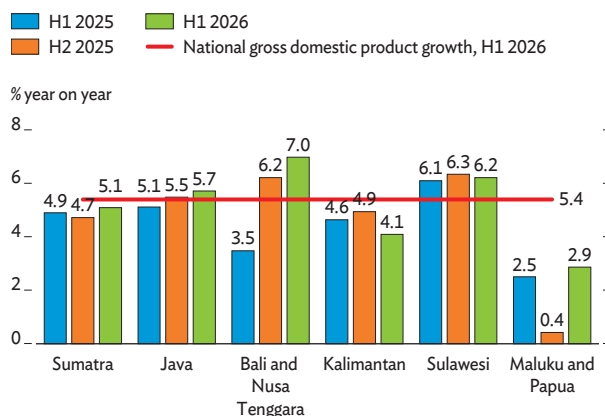
Domestic demand continued to underpin strong growth in the first half of 2026.



economy, strengthened to an average 5.7% in H1 2026 from 5.1% in H1 2025, while Bali and Nusa Tenggara accelerated sharply to 7.0% and Sulawesi remained strong with an average of about 6%. Kalimantan slowed to 4.1%, while growth in Maluku and Papua remained subdued at 2.9%, largely due to a mining-led contraction in Papua Tengah (Figure 3.4.4).

Figure 3.4.4 Regional Economic Growth

Growth remained geographically broad-based in the first half of 2026.



Domestic consumption remained resilient. Private consumption grew by 5.1% in Q2, down from 5.5% in Q1 as spending normalized following Ramadan and the Eid al-Fitr holiday. Spending on restaurants and hotels

remained relatively strong. Government consumption expanded by 16.0% in Q2 after growing by 21.8% in Q1, remaining the fastest-growing expenditure component. Fiscal stimulus boosted spending along with higher personnel costs and purchases of goods and services. The continued implementation of priority programs also contributed.

Investment strengthened further, becoming an important source of Q2 growth. Gross fixed capital formation accelerated from 6.0% in Q1 to 6.9% in Q2, led by stronger construction and continued implementation of infrastructure and other government-related projects. Vehicle investment also strengthened on firmer commercial vehicle demand, while machinery and equipment moderated.

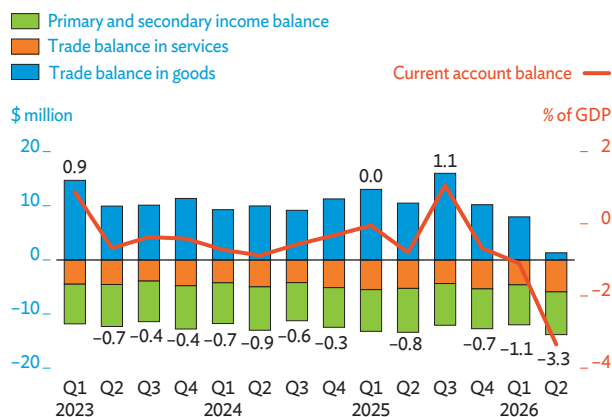
Exports recovered in Q2, but stronger imports left net external trade negative. Real exports increased by 4.1% in Q2 after growing by only 0.9% in Q1. Imports accelerated more strongly to 8.8%, from 6.4% in Q1, reflecting firmer demand for capital and intermediate goods alongside robust investment and domestic activity. Consequently, net exports detracted from growth, partly offsetting the strength in domestic demand.

Manufacturing growth moderated. Manufacturing growth eased to 4.5% in Q2 from 5.0% in Q1, while construction accelerated to 6.7% with services still robust. Mining remained in contraction, while electricity and gas rebounded strongly.

The current account deficit widened in Q2 2026, reflecting a narrower goods surplus and higher seasonal outflows for services and income. The deficit rose from \$3.6 billion, or 1.0% of GDP, in Q1 to \$12.5 billion, or 3.3% of GDP, in Q2 (Figure 3.4.5). The goods surplus fell from \$8.2 billion to \$1.3 billion as imports rose considerably faster than exports. The oil and gas deficit doubled to \$10.2 billion as higher global oil prices lifted the oil import bill, while strong domestic activity also raised non-oil imports. Non-oil and gas exports nevertheless continued to expand, although performance remained uneven across major destinations (Figure 3.4.6). The services deficit widened to \$5.9 billion amid higher freight payments and seasonal outbound travel, while the primary income deficit edged up to \$9.7 billion on seasonal payments. The unusually large deterioration

Figure 3.4.5 Current Account Components

Higher energy imports and stronger non-oil import demand narrowed the goods surplus, while services and primary income also weighed on the current account.

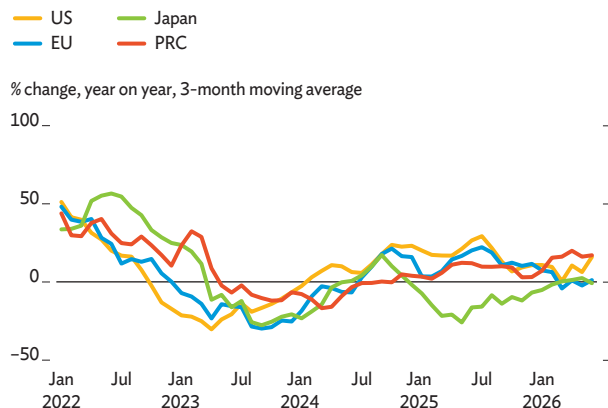


GDP = gross domestic product, Q = quarter.

Source: Haver Analytics.

Figure 3.4.6 Merchandise Exports by Destination

Exports remained uneven across major markets, with stronger shipments to the United States and the People's Republic of China offset by weaker exports to the European Union and Japan.



EU = European Union, PRC = People's Republic of China, US = United States.

Source: Haver Analytics.

thus reflected the convergence of higher energy import costs, strong domestic import demand, and seasonal services and income outflows.

Financial inflows rebounded, largely covering the wider current account deficit. The capital and financial account recorded a \$12.0 billion surplus in Q2, reversing a \$4.8 billion deficit in Q1. Net direct investment rose to \$2.8 billion from \$2.3 billion, supported by higher foreign investment

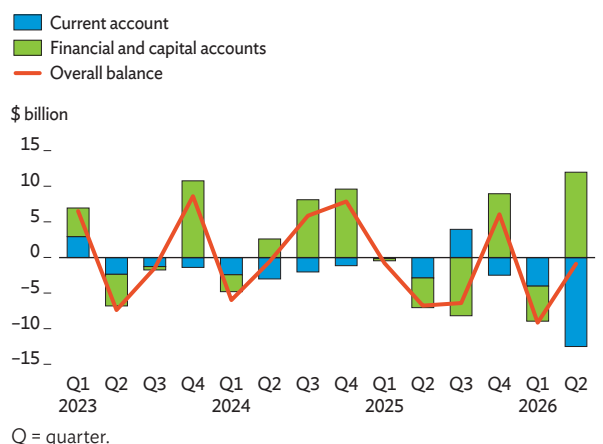
in manufacturing, trade, and construction. Portfolio investment accounted for most of the increase with a \$10.0 billion surplus. Of this, net foreign portfolio inflows into public-sector instruments reached \$13.0 billion, while the private sector recorded \$3.1 billion in net foreign portfolio outflows, largely reflecting continued foreign equity selling.

The overall balance of payments deficit narrowed, while external buffers remained adequate despite exchange rate pressures. The overall deficit declined to \$0.9 billion in Q2 from \$9.1 billion in Q1, as the recovery in financial inflows largely offset the wider current account deficit (Figure 3.4.7). Foreign exchange reserves rose from \$145.6 billion at end-June to \$146.5 billion at end-August, equivalent to 5.3 months of imports and government external debt service (Figure 3.4.8). Pressures on the rupiah persisted amid high global financial volatility and foreign exchange demand, with the currency depreciating for much of 2026 despite some strengthening in August as portfolio inflows resumed.

Inflationary pressures were contained. Headline inflation averaged 3.4% year on year during January–August 2026, near the upper end of the official 2.5% $\pm$ 1% target range (Figure 3.4.9). The pickup partially reflected the pass-through from high international energy and imported input prices. Adequate government rice reserves and a favorable harvest helped contain volatile-food price pressures. Core

Figure 3.4.7 Balance of Payments

Strong financial inflows largely offset the widening current account deficit in the second quarter of 2026.

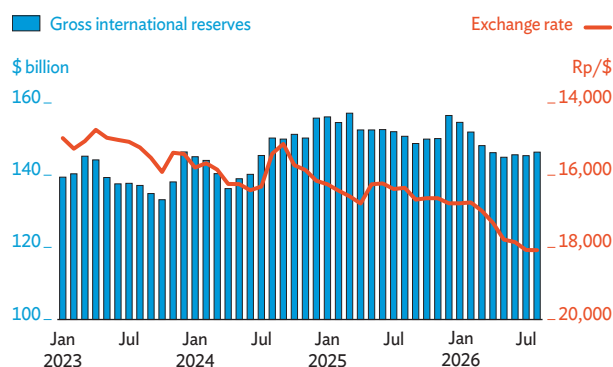


Q = quarter.

Source: Haver Analytics.

Figure 3.4.8 Foreign Exchange Reserves and Exchange Rate

Foreign exchange reserves remained adequate amid intensified external pressures, with the rupiah stabilizing in August.

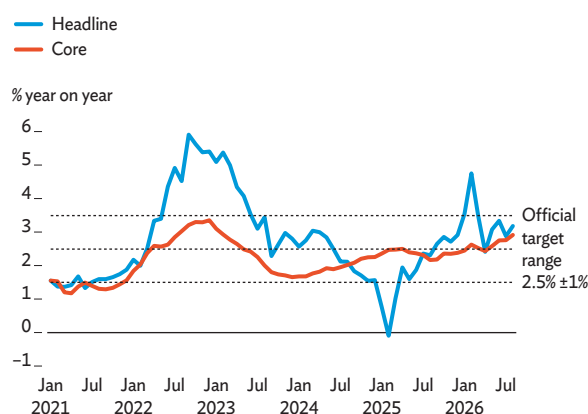


Rp = rupiah.

Source: Haver Analytics.

Figure 3.4.9 Headline and Core Inflation

Headline inflation returned to the high-end of the target range, while core inflation remained contained.



Source: Haver Analytics.

inflation averaged 2.6% during the period, indicating limited broad-based price pressures and well-anchored inflation expectations.

Monetary policy shifted to a more stability-focused stance as global financial uncertainty intensified. The central bank, Bank Indonesia, raised the policy rate by a cumulative 100 basis points during May–June to 5.75%, primarily to support the rupiah and contain imported inflation from higher energy prices and tighter global financial conditions. Bank Indonesia also strengthened its foreign exchange intervention and maintained supportive liquidity and macroprudential measures. This allowed the broader

policy mix to support domestic activity with the policy rate remaining focused on price and exchange rate stability.

Fiscal policy remained supportive in H1 2026 while preserving fiscal prudence. Revenue rose by 21.4% year on year, supported by a 24.6% increase in tax collection and stronger non-tax receipts. Expenditure increased by 17.8%, with central government spending rising by 29.4% as implementation of priority programs accelerated. Ministry and agency spending increased by 40.0%, reflecting outlays for priority programs, personnel, social assistance, and infrastructure, while capital spending also rose. Despite faster spending, the fiscal deficit remained at 0.76% of GDP with the primary balance in surplus. Energy-related fiscal pressures remained elevated, however, with subsidy and compensation spending up by 44.4% year on year, leaving the budget sensitive to oil-price developments.

Prospects

GDP is forecast to grow by 5.2% in both 2026 and 2027, unchanged from ADO July 2026, while inflation is revised up from 3.0% to 3.3% in 2026 and from 2.5% to 3.0% in 2027 (Table 3.4.1). Although better-than-expected H1 2026 growth offers a firm base, activity will likely moderate in H2 as fiscal and consumer spending normalizes and external demand remains subdued. Recent manufacturing indicators provide mixed signals, signaling softer momentum in Q3. While Bank Indonesia's real activity indicators suggest continued manufacturing and broader business resilience, the S&P global purchasing managers' index hovered close to the expansion threshold through August (Figure 3.4.10). Inflation will likely rise in

Table 3.4.1 Selected Economic Indicators in Indonesia, %

Growth is forecast to remain resilient in 2026 and 2027, while inflation rises in 2026 before easing in 2027.

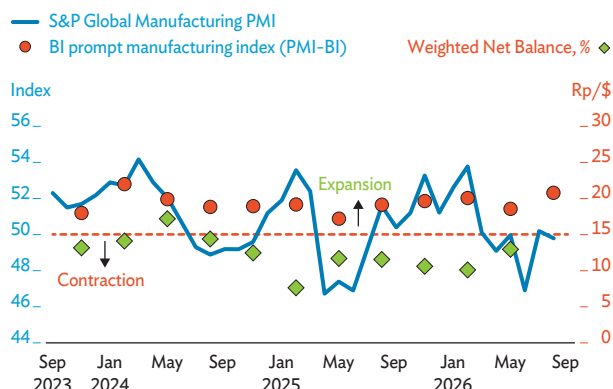
	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	5.1	5.2	5.2	5.2	5.2
Inflation	1.9	3.0	3.3	2.5	3.0

GDP = gross domestic product.

Sources: Central Bureau of Statistics; Asian Development Bank estimates.

Figure 3.4.10 Manufacturing and Business Activity Indicators

The S&P Global PMI points to softer manufacturing, while central bank indicators continue to signal expansion in manufacturing and broader business activity.



Note: Q3 2026 PMI-BI is a Bank Indonesia projection.

Source: CEIC Data Company.

2026, reflecting the partial pass-through from external pressures, including international energy prices and imported inflation. It should gradually ease in 2027 as headline inflation returns closer to the midpoint of the target range. Food price inflation is expected to remain relatively moderate, although weather-related risks warrant continued monitoring. Adequate rice reserves and policy measures supporting agricultural production could help alleviate supply-side pressures. At the same time, continued coordination between the government and central bank should calm inflation expectations, while ongoing measures on irrigation, food reserves, and social assistance should mitigate some of the El Niño impact on food prices and vulnerable households.

The growth forecast remains supported by domestic demand and strengthening private investment, while several risks warrant close monitoring.

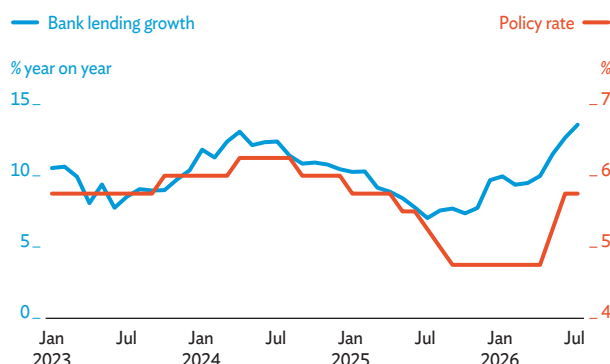
A stronger or prolonged El Niño could weigh on agriculture and other climate-sensitive sectors, particularly in early 2027, while subdued external demand and persistently high global interest rates could dampen capital inflows and private investment. The impact of dry weather conditions on staple food production has thus far been limited. Agricultural output has generally remained resilient, although weather-related risks continue to warrant close monitoring. Continued policy support for agriculture and safeguarding food supplies should help

mitigate potential output and food price disruptions. Forest and peatland fires along with other natural hazards pose additional downside risks if they significantly disrupt production and economic activity.

Fiscal policy should support domestic demand through the remainder of 2026. Exceptionally strong government consumption in H1 2026 should moderate. Household consumption should continue to benefit from social protection, food and energy price stabilization, and priority programs that help preserve purchasing power. Also, H2 2026 budget execution should support infrastructure investment, capital spending, and strategic project implementation. The full-year fiscal deficit should remain below fiscal deficit ceiling of 3% of GDP.

Fiscal support in 2027 will likely be more investment-oriented while continuing to support household consumption. The draft budget maintains spending on social protection and basic public services, thus helping household purchasing power, while placing greater emphasis on food and energy security, infrastructure and housing, downstreaming and industrialization, health, and education. Public investment will be complemented by efforts to optimize state-owned assets and promote stronger private investment. Although total expenditure will rise, stronger revenue mobilization, supported by administrative and governance reforms, should create enough space to continue supporting development priorities alongside moderate fiscal consolidation.

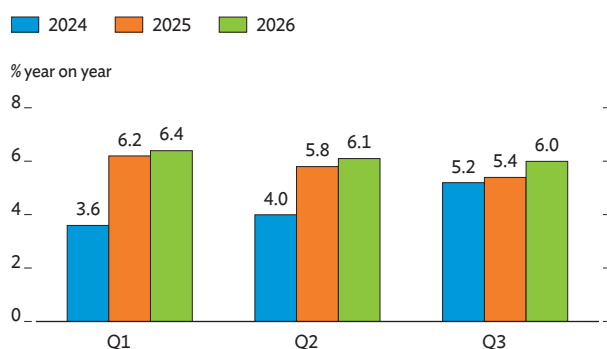
Monetary policy will remain cautious. The policy rate will continue to focus on maintaining price and exchange rate stability while liquidity and macroprudential measures support domestic activity. Bank Indonesia will likely maintain a prudent interest rate stance through the rest of 2026 amid tight global financial conditions and a rupiah sensitive to capital flow volatility. Nonetheless, liquidity conditions and financial intermediation remain supportive, with bank lending growth accelerating in July (Figure 3.4.11). Ample liquidity and macroprudential incentives should help sustain credit, particularly for investment and priority sectors. In 2027, easing global inflation and lower energy prices should reduce pressure from imported inflation, while continued financial intermediation would provide additional support to investment and domestic demand.

Figure 3.4.11 Monetary and Credit Conditions*Bank lending accelerated while monetary policy remained cautious.*

Source: Haver Analytics.

Household consumption should remain resilient, while investment becomes an increasingly important driver of growth through 2027.

Consumption growth will likely moderate from a strong H1 as post-holiday spending normalizes, with recent indicators showing easing momentum but higher than year-earlier levels (Figure 3.4.12). Consumption should still benefit from government initiatives that improve labor market conditions and social protection along with other fiscal measures that preserve purchasing power. Lower inflationary pressures and energy prices provide additional support in 2027. Investment should remain comparatively strong, underpinned by continued infrastructure and priority-program spending, supportive credit conditions, and efforts to boost private investment through expedited reforms to

Figure 3.4.12 Mandiri Spending Index Growth*Household spending growth moderated from a strong first quarter 2026 but remained above year-earlier levels.*

Q = quarter.

Note: Q3 2026 refers to the average through 23 August.

Source: Bank Mandiri.

improve the investment and business climate. Resilient consumption and stronger investment will offset a more limited contribution from external demand and help sustain growth in 2027.

The external position should gradually improve after deteriorating sharply in Q2 2026, although strong domestic demand will keep import growth relatively firm.

Commodities and manufactured goods will continue to drive export growth, while an expected decline in global oil prices should reduce the energy import bill and help the trade balance recover, particularly in 2027. As a result, the current account deficit will likely narrow from its Q2 peak and remain manageable over the forecast horizon. Capital and financial inflows should continue to provide financing, supported by relatively attractive domestic yields and continued foreign direct investment. Favorable investor sentiment, reinforced by Indonesia's continued investment-grade sovereign rating and inclusion in Morgan Stanley Capital International (MSCI)'s emerging-market index, should help maintain the flow of foreign financing. Sustained capital inflows alongside a smaller current account deficit should support an overall resilient balance of payments and preserve adequate foreign exchange reserves.

Risks to the growth outlook are broadly balanced.

On the downside, a stronger or more prolonged El Niño could temporarily disrupt agricultural output and other climate-sensitive sectors, potentially adding to food-price pressures and weakening household purchasing power. Other natural hazards could also temporarily disrupt transport, logistics, tourism, and local economic activity. Elevated global borrowing costs and tighter financial conditions could raise financing costs, constrain capital inflows, and weaken private investment. Higher subsidies and compensation costs could narrow fiscal space if energy-price pressures persist, while slower implementation of priority programs, infrastructure projects, investment-climate reforms, or efforts to mobilize private investment could weaken domestic demand. External downside risks stem from renewed geopolitical tensions, persistently high global interest rates, renewed trade tensions, and weaker growth among major trading partners. These could raise energy prices and imported inflation, add currency pressure, hurt the trade balance, constrain capital inflows, and weigh on exports. Any adverse reassessment of Indonesia's sovereign credit standing

or its position in major global equity indices could further weaken investor sentiment and amplify portfolio outflows.

Upside risks emanate from stronger private investment following newly implemented reforms and a more favorable external environment.

Faster execution of priority infrastructure and strategic projects, as well as stronger private investment on the back of expedited investment and business climate reforms, could lift domestic investment above baseline estimates. Faster-than-expected investment associated with the energy transition, particularly in renewable energy and related infrastructure, and downstream industries, could provide an additional boost to investment and growth. Stronger revenue mobilization and expenditure efficiency could preserve fiscal space, while effective food-supply management could support household purchasing power. Externally, quicker energy market normalization, easing global financial conditions, and stronger demand from major trading partners would support exports, capital inflows, and the balance of payments. Continued investment-grade sovereign ratings and MSCI emerging-market inclusion also help sustain investor confidence.

Malaysia

GDP growth exceeded first half (H1) 2026 forecasts and should be higher than projected in ADO July 2026 for this year and next. Nonetheless, it will be lower than in 2025 given heightened external uncertainties, rising global prices and a strong, worse than previously expected El Niño. Inflation in H1 rose in tandem with higher global commodity prices and will likely increase in 2026 and remain elevated in 2027.

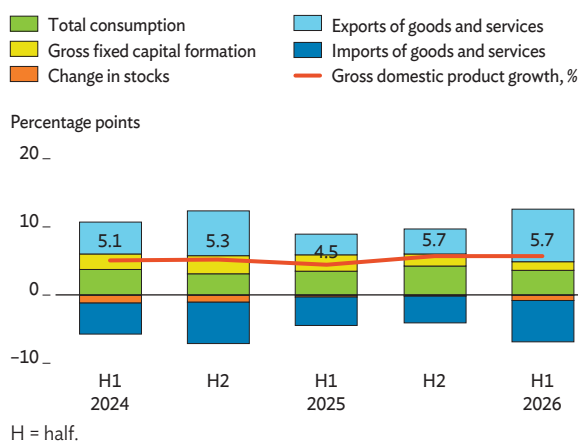
Updated Assessment

The economy performed steadily despite global headwinds, with solid growth in H1 2026. GDP grew by 5.7%, up from 4.5% in H1 2025, underpinned by firm domestic demand, robust external trade and continued expansion across most sectors (Figure 3.4.13).

Consumption grew steadily, rising by 4.9% in H1 2026 from 4.8% in H1 2025, largely supported by higher government spending. Private consumption expanded by 4.7%, down moderately

Figure 3.4.13 Demand-Side Contributions to Growth

Growth accelerated on the back of stronger exports while domestic spending and investment remained resilient.



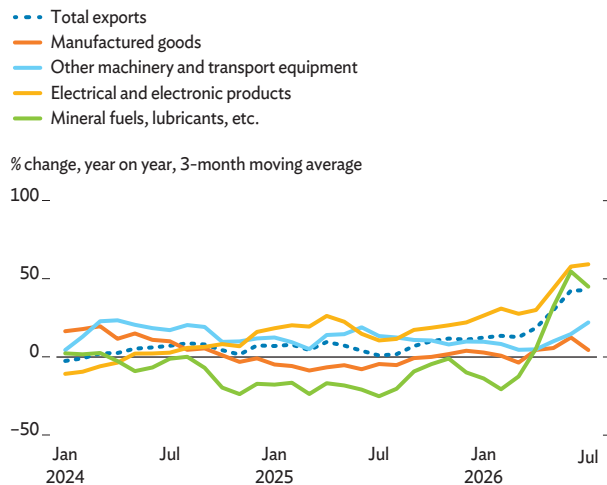
from 5.0% last year. Household demand remained underpinned by positive labor market conditions, steady income growth, and continued government support. Government expenditure accelerated by 5.9% in H1 2026 from 4.2% in H1 2025 as policy measures countered the higher prices associated with the Middle East conflict. Subsidies surged by 33.7% in the first quarter (Q1) of 2026 alongside increased spending on emoluments, pensions and gratuities, and higher debt repayments.

Investment expanded by 5.9% in H1 2026, down from 10.9% in H1 2025. Private investment grew by 6.0% with public investment rising 5.8%, both down significantly from last year's double-digit gains. Net inflows of foreign direct investment remained positive, increasing by 6.8% in Q2 2026, largely driven by services, particularly information and communications, which almost doubled. Government investment moderated with reduced fixed-asset spending and slower outlays for major infrastructure projects as the East Coast Rail Link and Pan Borneo Highway Sarawak near completion.

External trade remained strong despite elevated uncertainties. Exports grew by 11.2% in H1 2026 as the technology upcycle drove electrical and electronics products up by 43.9%, nearly half of total exports (Figure 3.4.14). Also, demand from major trading partners rose by double-digits from January to July 2026, with goods exports to the United States up by 58.3%, the European Union 29.8%, the People's

Figure 3.4.14 Merchandise Exports

Robust exports, particularly electrical and electronics goods, were boosted by the technology upcycle.

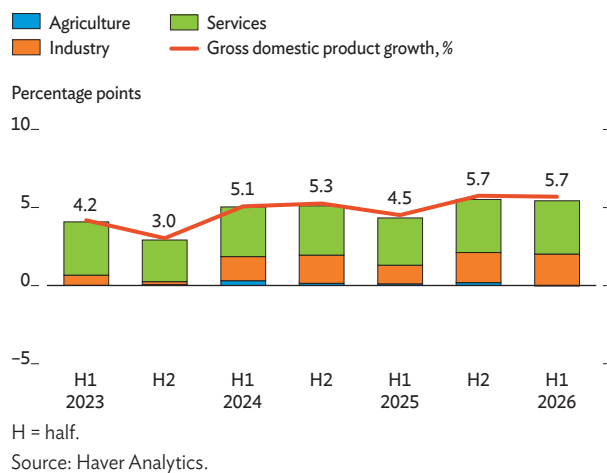


Republic of China 24.3%, and Singapore 13.6%. Imports increased by 9.4% in H1 2026 on higher imports of consumption and intermediate goods. With exports outpacing imports, the trade balance rose by 51.7% to RM36.1 billion.

Broad-based supply-side improvements supported overall growth (Figure 3.4.15). Manufacturing accelerated, while services and construction remained steady. Mining and quarrying rebounded after contracting in H1 2025, while agriculture declined slightly due to weaker production.

Figure 3.4.15 Supply-Side Contributions to Growth

Stronger manufacturing, together with steady growth in services and construction, supported economic expansion.

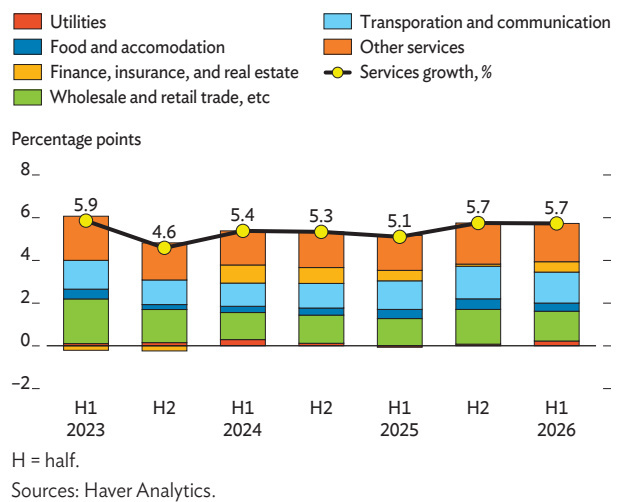


Services continued steady growth with broad-based expansion across subsectors (Figure 3.4.16).

Services expanded by 5.7% in H1 2026, slightly above the 5.1% in H1 2025. Steady household spending and tourist arrivals lifted consumer- and tourism-related activity. Newly operationalized data centers further boosted the expansion, while real estate, business, and government services also posted strong growth.

Figure 3.4.16 Contributions to Services Growth

Resilient services growth was driven by continuing improvement in consumer- and business-related services.



The technology upcycle bolstered manufacturing.

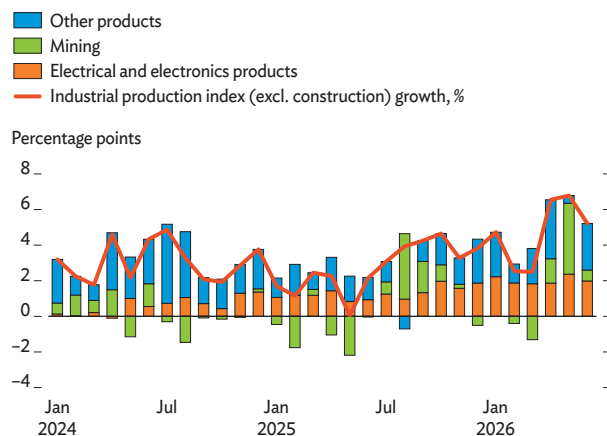
Growth accelerated, rising by 6.6% in H1 2026 from 3.9% in H1 2025. Production rose across all segments with significant momentum coming from electrical and electronics products (Figure 3.4.17). Malaysia benefited from the technology upcycle given its position in the value chain.

Data centers and public projects continued to drive construction. Construction expanded by 7.1% in H1 2026, slower than the 13.1% growth in H1 2025. Private sector projects, which accounted for 65.7% of total construction work, increased by 12.3%, while public sector activity rose by a far more modest 2.3%. Construction remained concentrated in key regions including Selangor, Johor, Wilayah Persekutuan, Sarawak, and Sabah.

Mining and quarrying recovered in H1 2026 while agriculture posted minimal growth. Higher production in natural gas led mining up by 3.2%,

Figure 3.4.17 Contributions to Industrial Production Growth

Manufacturing growth accelerated from higher electrical and electronics production amid the technology upcycle.



Sources: Haver Analytics; Department of Statistics Malaysia.

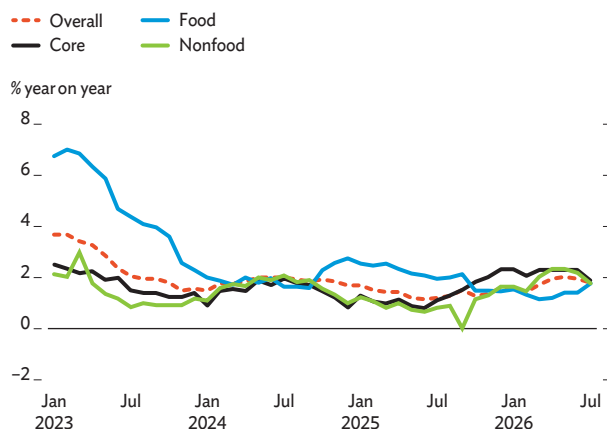
reversing the 3.8% contraction in H1 2025. Meanwhile, weaker rubber, palm oil and fishing production drove agricultural output down by 0.7%.

Inflation increased in line with rising global prices.

Inflation was 1.8% in the first 7 months of 2026, higher than 1.4% for the same period last year (Figure 3.4.18). Core inflation climbed to 2.0% from 1.8%. Prices rose sharply among nonfood items, especially for personal care products. From January to July 2026, nonfood inflation reached 2.0% while food inflation remained stable at 1.4%.

Figure 3.4.18 Inflation

Alongside rising global prices, inflation accelerated largely from nonfood items.

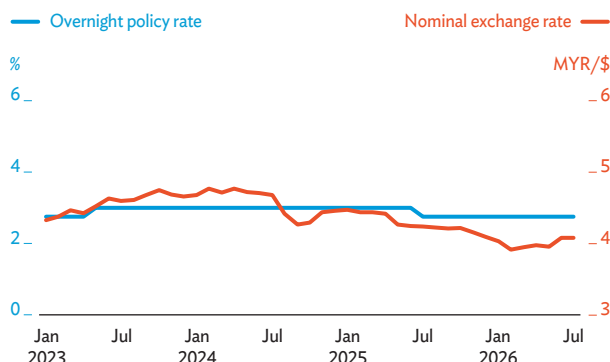


Source: Haver Analytics.

The central bank, Bank Negara Malaysia, has held the monetary policy rate at 2.75% since mid-2025 (Figure 3.4.19). With the strong H1 2026 expansion sustained by resilient demand and faster export growth, the policy rate was deemed still appropriate to both support the economy and to manage inflation. The ringgit weakened slightly against the US dollar, reaching RM4.09 = \$1 by end-July 2026 from below RM4.00 at the start of the year. This reflected heightened uncertainty and investor preference for safer US dollar assets.

Figure 3.4.19 Monetary Policy

With GDP growth remaining strong and inflation contained, the monetary policy rate was left unchanged.



MYR = Malaysian ringgit.

Source: Haver Analytics.

The fiscal deficit was below the 2026 target of 3.5% of GDP. In Q1 2026, the fiscal deficit was 3.3% of GDP. Revenue increased by 11.7%, outpacing current expenditure which rose by 8.8%. Net development expenditures declined by 17.7%.

External debt expanded by 7.5% in Q2 2026 compared to Q2 2025.

External debt reached RM1.5 trillion or 71.6% of GDP at end-June 2026. The increase came from a rise in interbank borrowings, intercompany loans, loans, nonresident holdings of ringgit-denominated debt securities and nonresident deposits.

International reserves rose to \$132.1 billion at end-July 2026, up by 8.9% from July 2025.

Import cover was 4.7 months, below the 4.9 average in 2025.

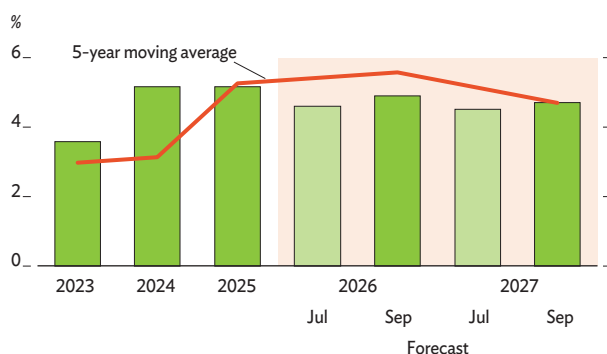
Prospects

Growth is expected to moderate slightly in H2 2026 and in 2027 (Figure 3.4.20).

The Middle East conflict disrupted supply chains and elevated international prices, which can impact domestic costs, thus constraining household consumption and business activity. The uncertain external environment will continue to weigh on growth. Growth in 2027 will likely slow further from El Niño-related disruptions to local output and continued pressures on food and energy costs. Given the robust growth momentum in H1 2026, which outperformed expectations, GDP is projected to grow by 4.9% in 2026 and 4.7% in 2027, higher than the 4.6% and 4.5% forecast in ADO July 2026 (Table 3.4.2).

Figure 3.4.20 Gross Domestic Product Growth

GDP growth should moderate somewhat amid external uncertainties and elevated prices.



Source: Asian Development Outlook database.

Table 3.4.2 Selected Economic Indicators in Malaysia, %

Growth forecasts for 2026 and 2027 are revised up slightly while inflation for 2027 is adjusted higher.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	5.2	4.6	4.9	4.5	4.7
Inflation	1.4	2.0	2.0	1.9	2.0

GDP = gross domestic product.

Sources: Department of Statistics Malaysia; Asian Development Bank estimates.

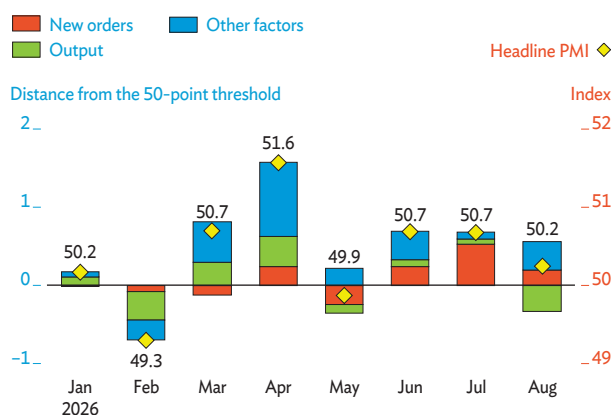
Domestic spending will likely remain resilient, but heightened downside pressures may limit labor and consumption growth. Consumer confidence has slowly recovered after the dive following the start of

the Middle East conflict in late February. Labor market conditions continue to be favorable with a steady rise in wages. Unemployment has stabilized at 3.0% after rising slightly from 2.9% in Q1 2026. Labor market demand remains stable with jobs totaling 9.3 million in Q2 2026, barely up from last year's 9.2 million. Services continues to dominate, accounting for the majority of both existing (52.5%) and newly created jobs (45.7%). Labor market prospects should be bolstered by tourism in H2 2026, alongside Visit Malaysia 2026 initiatives and the upcoming Formula One event in Sepang. Continuing fuel subsidies and cash transfers to low-income households will support household spending. However, persistently high prices could limit household spending and restrain consumption growth.

Firms are expected to remain cautious. The manufacturing purchasing managers' index returned to expansionary territory since June after showing contraction in May, indicating growing business activity (Figure 3.4.21). Despite improving, firms continue to be cautious with orders and hiring subdued. Firms are waiting for stronger demand while restoring margins that were compressed earlier in the year.

Figure 3.4.21 Manufacturing Purchasing Managers' Index

Manufacturing continued to expand in August, albeit at a slower pace.



PMI = Purchasing Managers' Index.

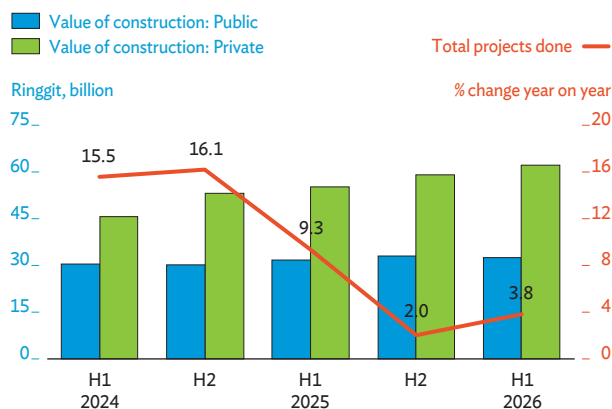
Note: A purchasing managers' index reading of <50 signals deterioration and >50 improvement.

Source: Haver Analytics.

Construction and investment should remain robust, though expanding slower than in previous years (Figure 3.4.22). A second data center boom is expected in H2 2026 as hyperscalers begin

Figure 3.4.22 Construction Indicators

New data centers and public works rollouts will likely spur a construction rebound in the latter half of 2026.



H = half.

Sources: Haver Analytics; Department of Statistics Malaysia.

megacampus developments in Springhill, Serendah, and Johor. In addition, major public infrastructure projects such as the Penang light rail transit and Kerian water project in Perak roll out in the coming months. However, compared to previous years, activity may be subdued given tighter investment approvals due to strains on water and electricity supply.

Manufacturing and external trade will likely be bolstered by further developments and use of artificial intelligence. Rising demand from the global technology upcycle has boosted production and trade, with the industrial production index rising by 13.9% and exports of electrical and electronics products up 43.9%. Growth will likely remain strong, with global semiconductor sales projected to climb to \$1.5 trillion in 2026, up from \$795.6 billion in 2025.

Agricultural production and the domestic water supply face heightened risks from a strong El Niño. The Malaysia Meteorological Department projects El Niño effects to peak between March and May 2027, with Sabah and Sarawak, the largest palm oil producing states, along with northern areas of the Malay peninsula, expected to be most affected by reduced rainfall and higher temperatures. Key commodities such as palm oil and rice are particularly vulnerable, with yield losses estimated at around 10.0% to 18.0%. The Department of Irrigation and Drainage is prioritizing close monitoring of water levels, risk identification, and equipment readiness where needed.

Inflation will likely remain at 2.0% through the rest of 2026 and in 2027. Higher energy prices and associated second round effects will continue to keep prices elevated. External cost pressures from tighter supply conditions, which raise transport and logistic costs, may feed into domestic prices. The local producer price index has been trending upward, recording its highest increase, 9.7% year on year, in July 2026. The very strong El Niño should increase price pressures, driving up food costs through supply chain disruptions and higher energy rates as households increase their reliance on cooling equipment. Inflation is projected to reach 2.0% in 2026, unchanged from ADO July 2026. For 2027, the forecast has been revised up to 2.0% from the earlier 1.9% estimate.

The central bank is expected to maintain its policy rate. While higher global prices pose upside risks, the impact on inflation should remain manageable. The current monetary stance is considered consistent with supporting growth while containing inflationary pressures. The ringgit should remain resilient against the US dollar, underpinned by strong domestic fundamentals. In addition, a boost from investment inflows, reinforced by the country's position as net energy exporter and its role in the artificial intelligence value chain, provides additional currency support.

The effects of increased external shocks require additional government support and create significant challenges to meeting the fiscal deficit target. Should high fuel prices continue, subsidies may more than double the RM15 billion allocated in the 2026 budget. The fiscal deficit could widen beyond last year's 3.7% of GDP, well above this year's 3.5% target.

There are notable upside and downside risks to the outlook. Recent developments suggest the economy could expand toward the upper end of the government's forecast range of 4.0% to 5.0% growth. Upside factors include stronger demand in technology, faster government implementation of planned initiatives and increased tourist arrivals in H2 2026. Downside risks are mostly external. Heightened tensions in the Middle East could trigger deeper trade disruptions and sharp increases in global prices, weighing heavily on growth. Others include higher inflation, reduced domestic output due to

El Niño and other weather-related disturbances, and an unanticipated pause in technology's demand momentum.

Economic prospects remain stable. In July 2026, Moody's Ratings confirmed Malaysia's A3 long-term local and foreign currency issuer rating with a stable outlook. The economy could outpace its A-rated peers in 2026, backed by its competitive and diversified structure, strong growth prospects, abundant natural resources and substantial domestic savings. Also, the large investor base continues to underpin the government's financing needs, mitigating risk and helping maintain borrowing costs at moderate levels. Moody's also highlights ongoing government reforms aimed at broadening the tax revenue base, strengthening fiscal consolidation, and managing fiscal balance risks.

Philippines

The GDP growth forecast has been revised down from ADO July 2026 amid global and domestic headwinds. Elevated inflation and the prolonged Middle East conflict have weighed on consumption and investment. An expected recovery in public investment should help lift growth next year, while the inflation projection for 2027 has been raised. Greater global uncertainties and severe climate-related shocks pose downside risks.

Updated Assessment

Growth slowed in the first half (H1) of 2026 as consumption softened and investment eased.

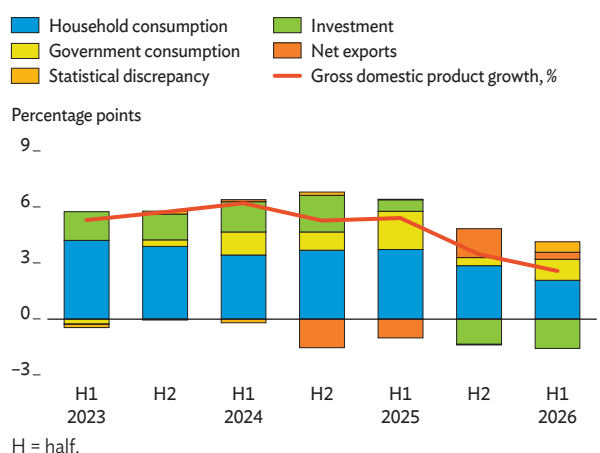
GDP growth decelerated to 2.3% in the second quarter (Q2) of 2026 from 2.8% in Q1 2026, bringing first-half growth to 2.6%, the slowest since the coronavirus pandemic. The shock from the Middle East conflict quickly affected the economy given its heavy reliance on imported fuel from the region along with other inputs, including fertilizer. Sharply higher global commodity prices fed rapidly into domestic prices, weakening economic activity. Public infrastructure spending continued to decline as tighter budget controls amid alleged anomalies on publicly funded projects led to temporary delays in implementation.

Household consumption was subdued amid high inflation and weak consumer confidence. Even as it remained the largest contributor to growth,

household spending rose by 2.9% in H1 2026, down from 5.2% a year earlier, as rising food and oil prices reduced real income (Figure 3.4.23). Investment fell by 6.5% on lower construction activity and reduced outlays on durable equipment (Figure 3.4.24). Public infrastructure spending continued to decline, falling 32.2% year on year in H1 2026. Private investment softened and employment weakened, with the unemployment rate up to 5.1% in H1 2026 from 4.0% a year earlier. The trade account, in real terms, supported growth as robust merchandise exports, primarily electronic products benefiting from strong global demand, outpaced import growth. Services exports also rose, largely from business process outsourcing and computer and information services.

Figure 3.4.23 Demand-Side Contributions to Growth

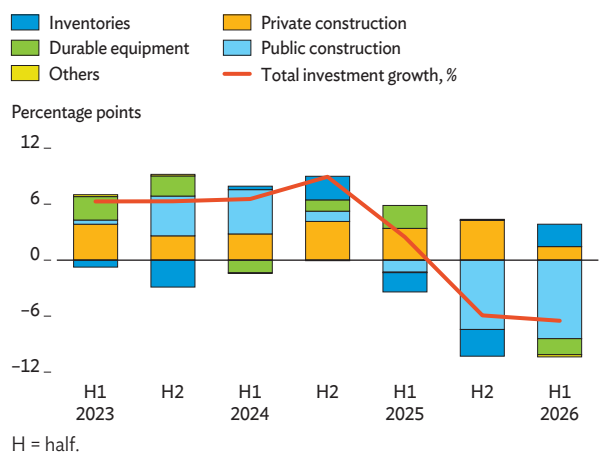
Growth slowed as household consumption eased and investment fell.



Sources: Philippine Statistics Authority; CEIC Data Company.

Figure 3.4.24 Contributions to Investment Growth

Tighter budget controls led to delays in public investment.

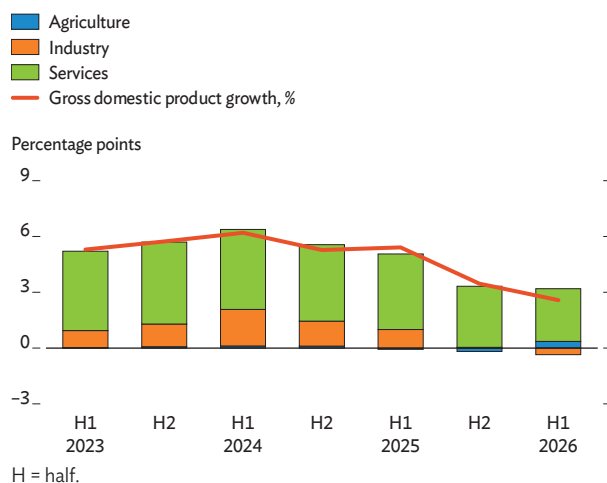


Sources: Philippine Statistics Authority; CEIC Data Company.

Services growth mitigated the contraction in industrial output. Services expanded by 4.5% in H1 2026, down from 6.5% in H1 2025 (Figure 3.4.25). Subdued household consumption moderated retail trade, accommodation, and food services. Financial, professional, and business services grew, though more slowly. Industry fell by 1.2%, reversing the 3.3% growth in H1 2025, on sharply curtailed construction and slower manufacturing. Agriculture grew by 1.2%, down from 4.5%, as lower crop production and fisheries output reflected poor weather conditions and higher fuel costs.

Figure 3.4.25 Supply-Side Contributions to Growth

Services underpinned growth, offsetting industry's construction-led contraction.



Sources: Philippine Statistics Authority; CEIC Data Company.

Inflation has been up sharply in 2026, driven largely by food and transport costs. After averaging 1.7% in 2025, inflation peaked at a 3-year high of 7.2% in April 2026 before easing to 6.1% in August. Food inflation was a key contributor, led by rice prices, along with higher transport costs (Figure 3.4.26). Lower-income households were disproportionately affected, reflecting the larger share of food in their consumption basket. Food inflation was 4.6% in August, although it reached 8.3% for households in the bottom 30% of income distribution. Inflation averaged 5.2% in the first 8 months of 2026, exceeding the government's 4% high-end target range. The central bank raised its policy rate by a cumulative 75 basis points between April and August. Core inflation eased slightly to 4.1% in August from a 4.4% high in June. It averaged 3.7% over the first 8 months of the year (Figure 3.4.27).

Figure 3.4.26 Contributions to Inflation

Inflation surged on higher food, fuel, and transport prices.

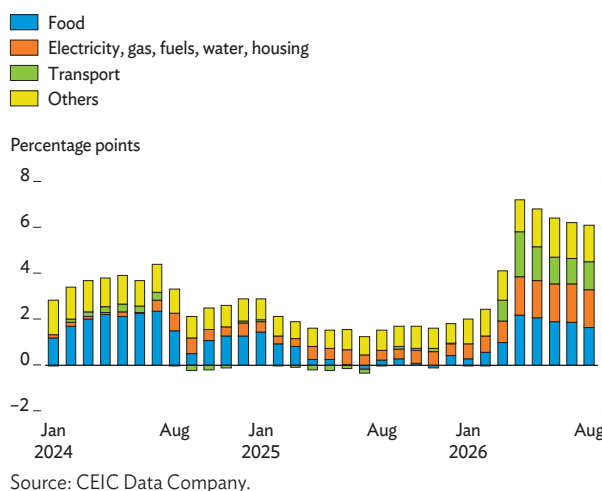
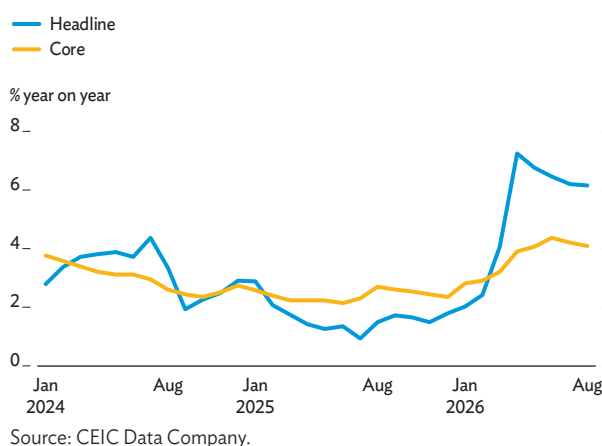


Figure 3.4.27 Headline and Core Inflation

Core inflation has trended upward, slightly easing in August.



The fiscal deficit widened as expenditure growth outpaced revenue gains.

The fiscal deficit widened by 13.9% year on year to ₱893.1 billion in the first 7 months of 2026, reflecting higher spending to mitigate the impact of the Middle East conflict. Expenditures rose by 7.0%, exceeding the 5.1% growth in revenues. Excluding interest payments, primary spending rose by 17.2% driven primarily by targeted social assistance and support under the Unified Package for Livelihood, Industry, Food, and Transport (UPLIFT) program and outlays for rail transport projects.

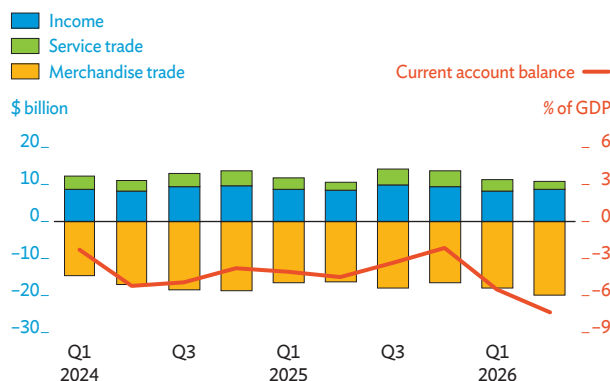
The current account deficit widened primarily due to a larger gap in traded goods.

The current account deficit rose to 6.4% of GDP in H1 2026

from 4.3% in H1 2025 reflecting the surge in import costs (Figure 3.4.28). Merchandise exports rose by 9.2% year on year from strong shipments of electronic products, machinery and transport equipment. Imports, however, rose by a faster 12.4% with a spike in oil and other global commodity prices. Higher services exports and remittances partly mitigated the larger merchandise trade deficit. In the financial account, higher inflows were partly driven by increased foreign loan availments by domestic banks and other sectors. Direct investment posted net inflows, although lower. Stronger equity investments and repayments of intercompany loans by foreign affiliates were partly offset by the moderation in foreign direct investment (FDI). Net FDI declined by 17.8% amid heightened global uncertainties, while the portfolio investment account reversed from net inflows to net outflows. Overall, the balance of payments deficit narrowed to 1.6% of GDP in H1 2026 from 2.4% in H1 2025. Gross international reserves fell to \$104.8 billion at end-August 2026, equivalent to 6.8 months of imports, 5.4% lower than end-December 2025. The peso hit a record low in September 2026, depreciating by 6.4% against the US dollar since the start of the year. External debt rose to 31.6% of GDP at end-June 2026 from 30.3% at end-December 2025.

Figure 3.4.28 Current Account Components

Higher import costs widened the current account deficit despite strong export growth.



GDP = gross domestic product.

Source: CEIC Data Company.

Prospects

Growth forecasts are revised down from ADO July 2026 amid persistent external and domestic headwinds.

GDP is forecast to grow by 3.3% in 2026 and 5.1% in 2027, down from 3.8% and 5.3% respectively in July (Table 3.4.3 and Figure 3.4.29). The prolonged Middle East conflict dampened economic activity more than expected through persistent inflation and tighter financial conditions. Higher inflation has squeezed real household income, and heightened uncertainties continue to loom over consumption and investment. A gradual recovery in public investment is expected from Q4 2026 in line with the government's move to accelerate ongoing flagship projects under the proposed 2027 budget. A very strong El Niño in late 2026 through early 2027 could adversely impact agriculture, water resources, and public health, among others.

Government programs are helping mitigate the impacts from the Middle East conflict and projected El Niño effects beginning Q4 2026.

Table 3.4.3 Selected Economic Indicators in the Philippines, %

Growth forecasts are lowered, inflation remains elevated.

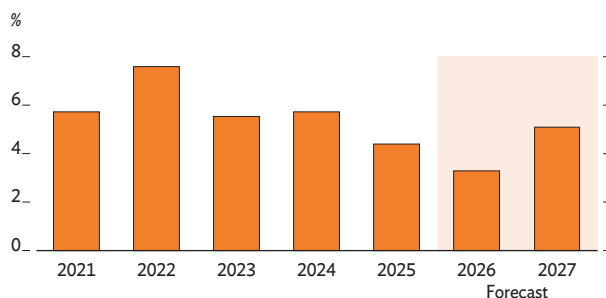
	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.4	3.8	3.3	5.3	5.1
Inflation	1.7	5.9	5.9	3.9	4.4

GDP = gross domestic product.

Source: Asian Development Bank estimates.

Figure 3.4.29 Gross Domestic Product Growth

Growth is expected to pick up in 2027 as public infrastructure spending rebounds.



Sources: Philippine Statistics Authority; Asian Development Bank estimates.

has introduced a range of measures to protect agriculture, water resources, and rural livelihoods. These include irrigation and water management projects and support to farmers facing elevated fertilizer and production costs. The government declared a state of national energy emergency in March 2026 in response to the Middle East conflict and implemented the UPLIFT program. The program includes targeted and time-bound support to cushion the impact of higher prices while containing fiscal costs. These include cash assistance to the poor and other vulnerable groups including affected overseas Filipino workers, emergency livelihood support, fuel subsidies, public transport fare discounts, and support to small businesses and heavily affected sectors, including transport and agriculture. Excise taxes on liquid petroleum gas and kerosene used for cooking were suspended for 3 months from mid-April to cushion the impact of the surge in fuel prices.

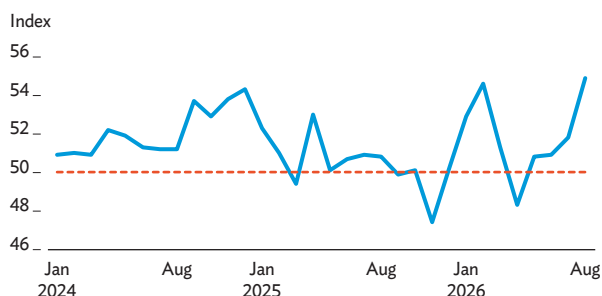
Household consumption will likely remain subdued amid high inflation and soft labor market conditions.

The unemployment rate rose to 6.0% in July 2026 from 5.3% a year earlier as the labor force expansion outpaced an increase in employment. Youth unemployment remained high at 18.6% in July 2026. Remittances, which help fuel household spending, continued to expand by 2.3% in the first seven months from 3.1% growth a year earlier. They remain vulnerable, however, with inflows from the Middle East comprising 18% of the total. Overseas worker deployment fell by 34% year on year in the first 7 months, signaling a possible further moderation in remittance growth.

Business indicators point to improved economic activity, although sentiment remains cautious. The manufacturing purchasing managers' index rose to 54.9 in August, a 6-month high, with buoyant increases in new orders and output, even as supply chain constraints and cost pressures remain (Figure 3.4.30). Manufacturing capacity utilization was a firm 78.8% in July from 77.6% a year earlier. Food processing (half of total manufacturing output) expanded along with the production of transport equipment, machinery, computers, and electronic products. Imports of capital goods were 16.0% higher year on year in the 7 months to July, while those for raw materials and intermediate goods rose by 26.4% with a strong increase for the manufacture of electronic equipment. The business

Figure 3.4.30 Manufacturing Purchasing Managers' Index

The index has been trending upward, with substantial increases in output and new orders.



Note: A purchasing managers' index reading of <50 signals deterioration and >50 improvement.

Sources: CEIC Data Company, S&P Global.

outlook based on the central bank's latest survey remains optimistic for the next 12 months, though less than previously given inflation concerns. Nevertheless, industrial firms are maintaining their expansion plans for next year.

Services will remain a key growth driver. Services account for around 60% of GDP and employment. Trade, communications and transportation, information technology, finance, and business services will remain key components. International visitor arrivals rose by 5.4% year on year to 3.2 million in H1 2026, supporting tourism-related industries. Tourism contributed 8.1% of GDP and 15.7% of employment in 2025, still below pre-pandemic levels.

The government's proposed 2027 budget supports higher investment in social sectors, infrastructure, and climate and disaster resilience. The proposed budget is 6% more than in 2026, with social services comprising one-third of expenditure, including universal healthcare, programs on nutrition, education assistance and early childhood development, upskilling, conditional cash transfers, and food vouchers for poor families. The government plans to further reduce poverty, which fell to 9.7% of the population in 2025 from 15.5% in 2023, by protecting vulnerable groups from shocks such as the Middle East conflict. The government's multidimensional poverty index data, show that about 12.8% of the population in 2024 suffer deprivation in different aspects such as in education, health, housing, water and sanitation, and employment.

Infrastructure spending is budgeted at 4.4% of GDP in 2026, focusing on accelerating flagship project implementation. Under the government's flagship program, 85 projects valued at approximately \$75 billion are underway, including transport networks, ports, bridges, and investments in health, education, and agricultural infrastructure. The proposed budget for the rail transport program was raised to ₱197.3 billion (about \$3.2 billion), more than triple the 2026 budget for large projects such as the North–South Commuter Railway and Metro Manila Subway. Public–private partnerships support investment under a strengthened regulatory environment, with 303 projects currently being implemented as of August.

Reforms boosting the investment climate underpin medium-term growth. Renewable energy, telecommunications, and major transport infrastructure—including airports, railways, and expressways—are now open to full foreign ownership. The Corporate Recovery and Tax Incentives for Enterprises to Maximize Opportunities for Reinvigorating the Economy (CREATE MORE) Act lowers the corporate income tax rate from 25% to 20% for eligible registered business enterprises, enhances fiscal incentives, and streamlines business processes. Greater investment openness, together with rising public investment, should boost productivity and strengthen growth as the country builds on its attainment of upper-middle-income status, with gross national income per capita reaching \$4,850 in 2025, above the \$4,636 threshold.

The government has adopted gradual fiscal consolidation. Slower economic growth and higher spending to protect the poor and vulnerable households and sectors from the impact of the Middle East conflict prompted an increase in fiscal deficit targets. From 5.6% of GDP in 2025, the deficit target was set to 5.4% of GDP in 2026, raised from 5.3% pre-conflict and 5.1% in 2027 from 4.8%. Under the medium-term fiscal framework, the deficit should narrow steadily to 3.5% of GDP by 2030. In line with this, government debt will gradually decline over the medium term. It rose to 66% of GDP as of end-June 2026 from 63.2% at end-December 2025. Debt service has increased, with interest payments equal to 20.3% of revenues in H1 2026 from 19.4% in full year 2025. Debt remains largely domestic, about two-thirds of the total and about 90% long-term, and mostly fixed rates. The country's investment-grade credit ratings were affirmed in August 2026 with a stable outlook.

Fiscal consolidation is supported by reforms that improve spending efficiency and strengthen domestic revenue mobilization. The proposed Philippine Budgeting Code streamlines budget preparation, execution, and monitoring, building on broader public financial management reforms. These include the New Government Procurement Act, which enhances competition, transparency, and digitalization in public procurement, and the Government Optimization Program, which aims to rationalize government structures and processes. Tax revenues remained broadly stable at 14.9% of GDP in H1 2026, compared with 15.0% in H1 2025, supported by tax measures and improved revenue administration. Reforms, including the value-added tax on nonresident digital service providers, are contributing to stronger collections. Enhancing value-added tax system efficiency could further broaden the revenue base. Additional reforms under the proposed Promoting Growth, Revenue, and Equity towards Socio-Economic Sustainability Bill would combine tax relief for workers and small businesses, with offsetting revenue measures. These include proposed higher excise taxes on sweetened beverages, e-cigarettes, and luxury vehicles, excise taxes on single-use plastics, and updated alcohol excise taxes and motor vehicle road user charges. A 15% global minimum tax on large multinational enterprises is also being proposed.

Inflation remains elevated despite its recent moderation. Inflation is projected to reach 5.9% in 2026 (unchanged from ADO July 2026) and 4.4% in 2027 (up from 3.9% in July). Inflation eased for the fourth straight month to 6.1% in August, averaging 5.2% in the first 8 months, well above the 4% upper end of the central bank's target. Price pressures persist. Transport inflation rose to 13.5% in August after slightly easing in June and July. High fertilizer costs are impacting crop production. Rice inflation rose to 19.4% in August, disproportionately affecting lower-income households (22.5% for the bottom 30% of households). El Niño effects will likely sustain food price pressures, while transport fare hikes and pending wage adjustments may contribute to second-round inflation effects. Currency depreciation adds to imported inflation.

Domestic liquidity (M3) grew by 10.3% year on year in July 2026 from 10.7% in June, driven by private and public sector borrowings. Lending to businesses rose by 9.8% year on year in July (from

9.2% in June) with higher lending to sectors such as wholesale and retail trade, real estate, manufacturing, information and communication. Consumer loans expanded by 17.1% from 17.8% in June. The government's issuance of debt securities also supported liquidity growth. The banking sector remained sound, with a capital adequacy ratio of 15.2% as of June 2026, above the 10% regulatory minimum, and a nonperforming loan ratio of 3.4% in July from 3.3% in June.

The current account deficit will widen in 2026 on higher import costs before gradually narrowing next year as global commodity prices moderate.

Higher commodity import bills will likely offset increased exports from strong global demand for electronic products. Easing energy prices projected for 2027, continued strength in electronics (about half of total exports), and resilient services exports should support a gradual narrowing of the current account deficit.

Downside risks weigh on the outlook. A more prolonged and severe Middle East conflict could further intensify inflationary pressures and lead to tighter monetary policy. Persistent delays in public infrastructure investment could weaken growth, while extreme climate events, including severe El Niño effects, could amplify inflationary pressures.

Thailand

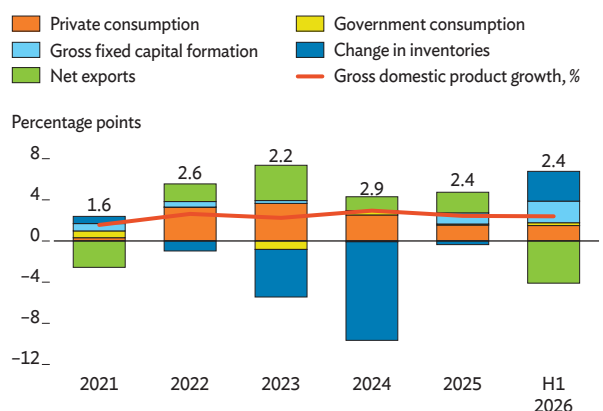
The economic growth forecast for 2026 is revised up to 2.0% from the 1.8% projection in *ADO July 2026*, but down slightly for 2027. Inflation drops to 2.5% in 2026 from 2.9% in July as government measures will likely mitigate some of the impact from the Middle East conflict. Inflation should ease to 1.3% in 2027 as energy prices decline. Downside risks to the outlook include geopolitical and trade tensions, narrowing fiscal space, and potentially adverse weather.

Updated Assessment

Economic growth moderated in the first half (H1) of 2026 compared with H1 2025. Real GDP expanded by 2.4% in H1 2026 compared with 3.0% in H1 2025 (Figure 3.4.31). Strong merchandise exports, private investment (particularly technology-related),

Figure 3.4.31 Demand-Side Contributions to Growth

Growth in the first half of 2026 was driven mainly by robust merchandise exports and private investment.



H = half.

Source: Haver Analytics.

and government stimulus supported economic activity, partly offsetting the impact of higher energy and transportation costs following the escalating Middle East conflict and weaker international tourism.

Merchandise exports remained strong, following the global electronics and artificial intelligence cycle. Merchandise exports increased by 14.8% year on year in H1 2026 compared with 14.2% in H1 2025. Growth was led by computers, electronic components, telecommunications equipment, and machinery, reflecting robust global demand for technology-related products. In contrast, agricultural and agro-industrial exports contracted, while exports of some traditional manufacturing products remained subdued, leaving overall export growth increasingly dependent on technology-related products. Shipments to the United States (US) increased markedly.

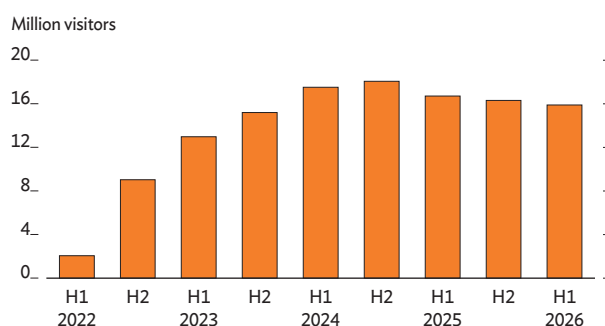
Merchandise imports also rose, up by a sharp 26.3% in H1 2026 compared with 8.7% in H1 2025.

Higher imports of electronic components and other intermediate goods, machinery and equipment, and crude oil were major contributors. Strong capital and intermediate goods imports reflected expanding technology-related production and investment, while the increased value of crude oil imports partly reflected higher global energy prices.

International tourism remained weak. There were 15.9 million international tourist arrivals in H1 2026, down by 4.9% from H1 2025 (Figure 3.4.32). Arrivals

Figure 3.4.32 International Tourist Arrivals

The Middle East conflict disrupted flights and raised airfares, reducing international tourist arrivals.



H = half.

Source: Haver Analytics.

from the Middle East fell by 25.4%, partly reflecting flight disruptions and higher aviation costs following the escalation of the Middle East conflict. Arrivals from Southeast Asia declined substantially, partly due to disruptions in cross-border travel. Fewer visitors reduce receipts from tourism and related services.

Private consumption grew by 2.6% in H1 2026 compared with 2.4% in H1 2025. Household spending was supported by government stimulus, including a copayment scheme providing eligible consumers monthly spending support and additional assistance to welfare cardholders, which helped cushion the impact of higher energy and living costs on purchasing power. Nonetheless, high household debt and tight financial conditions continued to constrain consumption. Consumer lending contracted amid high credit risk, while banks continued to provide debt restructuring to vulnerable borrowers. Spending on durable goods was supported by higher electric vehicle sales, while services consumption remained subdued alongside weaker tourism.

Private investment expanded by 11.6% in H1 2026 compared with 1.3% in H1 2025. Growth was supported by machinery and equipment, particularly computers, software, and industrial machinery, alongside expanding technology-related investment. The investment pipeline also remained strong, with investment promotion applications rising by 37% year on year to B1.5 trillion in H1 2026, led by digital activities, electronics, and electrical appliances. Foreign direct investment applications increased by 80% to B1.4 trillion.

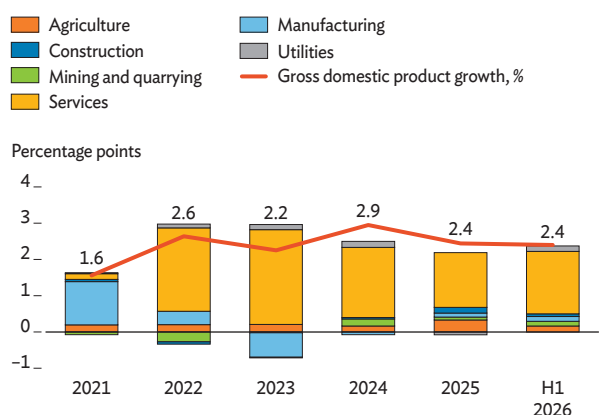
Government spending continued to support economic activity.

Government consumption grew by 1.8% in H1 2026 compared with 2.9% in H1 2025, while public investment expanded by 3.8% compared with 17.3%. Capital spending was buttressed by transport and water-management infrastructure, including highway and bridge maintenance and construction, irrigation improvements, and expansion of water-resource infrastructure. Public investment lost momentum in the second quarter as state-owned enterprise (SOE) investment declined, although government investment continued to expand. Public debt rose to 66.9% of GDP at the end of June 2026 from 64.7% at end of fiscal year 2025 (ending September 2025), still below the 70% ceiling.

On the supply side, manufacturing of technology-related goods grew, while tourism-related services weakened (Figure 3.4.33). Agricultural output grew by 1.7% in H1 2026 compared with 6.3% in H1 2025. Fruit, sugarcane, rubber, and livestock production increased, while paddy, oil palm, and fisheries declined. Industry expanded by 2.5% compared with 2.7% in H1 2025. Growth in the production of computers, electronic components, and related products expanded, while some traditional manufacturing, including conventional automobiles and petroleum-related products, remained subdued. Services expanded by 3.0%, down from 3.6% in H1 2025, as weaker international tourism weighed on accommodation, food services, and passenger transportation.

Figure 3.4.33 Supply-Side Contributions to Growth

Growth moderated across agriculture, industry, and services in the first half of 2026.



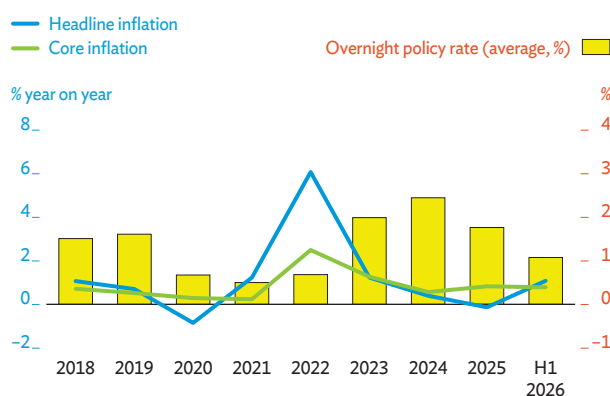
H = half.

Source: Haver Analytics.

Headline inflation averaged 1.1% in H1 2026, up from 0.4% in H1 2025. Inflationary pressures increased following the escalating Middle East conflict as higher global energy prices raised domestic fuel and transportation costs. Core inflation also increased as higher input costs passed through to prepared food and other consumer prices. Government measures, including fuel price support and those to contain prices of essential goods, helped keep inflation down and cushion the impact on consumers. The central bank maintained the policy rate at 1.00% in June and August 2026 after easing the rate from 1.25% in February 2026 (Figure 3.4.34).

Figure 3.4.34 Inflation and Policy Interest Rate

Inflationary pressures increased, while monetary policy remained accommodative.



H = half.

Source: Haver Analytics.

Prospects

The growth forecast is revised up to 2.0% for 2026 from 1.8% in ADO July 2026, and down to 1.9% for 2027 from 2.0% (Table 3.4.4). Stronger merchandise exports (particularly technology-related products), robust private investment, and government support back the upward revision for 2026, partly offsetting weaker tourism and the effects of higher energy costs. Growth is projected to moderate slightly in 2027 as technology-related export growth normalizes and temporary government support fades. Lower energy prices, recovering tourism, and continued implementation of promoted investment projects should help next year (Figure 3.4.35).

Table 3.4.4 Selected Economic Indicators in Thailand, %

Growth prospects have improved for 2026, while the inflation outlook has eased.

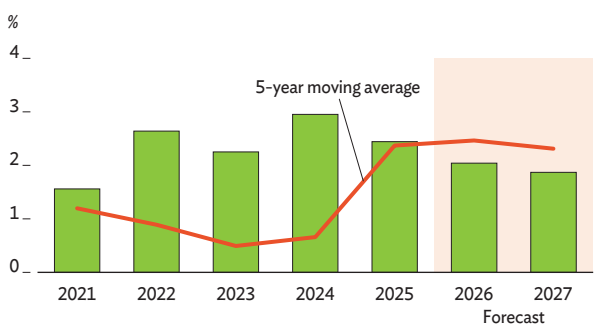
	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	2.4	1.8	2.0	2.0	1.9
Inflation	-0.1	2.9	2.5	1.3	1.3

GDP = gross domestic product.

Sources: Office of the National Economic and Social Development Council; Asian Development Bank estimates.

Figure 3.4.35 Gross Domestic Product Growth

Growth is expected to improve modestly in 2026 before moderating slightly in 2027.



GDP = gross domestic product.

Source: Haver Analytics.

Exports of goods and services are projected to grow by 10.2% in 2026, substantially faster than the 3.0% forecast in July. Strong global demand for computers, electronic components, telecommunications equipment, and other technology-related products should sustain merchandise exports during H2 2026, although weaker international tourism will constrain services exports. The impact of the new 12.5% US tariff should be relatively limited in 2026 given its late July implementation and exemptions covering more than 2,100 Thai product lines, which include key products such as integrated circuits. Export growth should moderate in 2027 as the technology-related export cycle normalizes and the new US tariff covers a full year. Higher tariffs on non-exempt products and continued trade-policy uncertainty could bring additional headwinds to merchandise export momentum in 2027.

The tourism outlook remains as in ADO July 2026.

International tourist arrivals will likely drop to around 33 million in 2026 on weaker arrivals from regional markets and disruptions to Middle East travel and aviation. Arrivals are projected to recover to 35 million in 2027, unchanged from the July forecast, as geopolitical and aviation disruptions ease, flight connectivity improves, and lower energy prices reduce travel costs. The rebound in tourism and related services should partly offset the moderation in merchandise export growth in 2027.

Imports of goods and services should strengthen in 2026 in line with robust merchandise exports and improving private investment. Demand for intermediate and capital goods should remain firm, reflecting strong technology-related production and continued implementation of investment projects. Import growth will likely moderate in 2027 alongside slower merchandise export growth, while continued investment sustains demand for capital goods.

Private consumption is projected to grow by 2.4% in 2026 compared with the 1.8% July forecast.

Government support should cushion household purchasing power against higher energy and living costs through the remainder of the year. High household debt and tight credit conditions will continue to constrain spending, although pressures are gradually easing as consumer lending continues to decline and ongoing debt restructuring and other assistance help vulnerable borrowers. In 2027, private consumption will likely slow as temporary fiscal support fades, while lower inflation, declining energy costs, and gradually improving household balance sheets help consumption.

Government spending should continue to support domestic demand. Public consumption and investment growth projections are unchanged from the ADO July 2026 forecast. Government and SOE infrastructure project implementation should continue to support public investment. However, narrowing fiscal space warrants close monitoring as a further increase in public debt could constrain new government borrowing along with public investment and SOE project implementation.

Private investment should remain strong, supported by the large pipeline of promoted investment in data centers, electronics and other

technology-intensive industries. Rising imports of machinery and equipment and continued project implementation point to sustained investment momentum. This will remain an important growth driver in 2027 as approved projects are implemented, even as growth normalizes from the strong 2026 pace. Tighter screening of new data-center projects, including requirements related to power and water availability along with project readiness, could moderate the pace of new investment approvals.

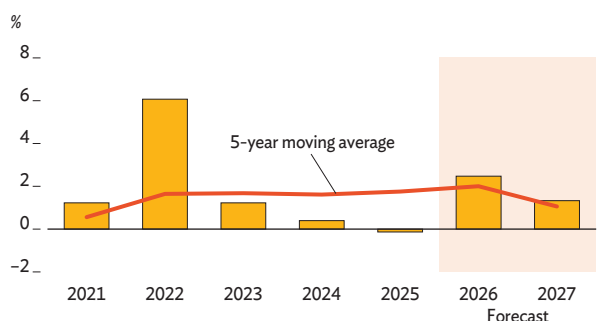
From the supply side, manufacturing should remain supportive in 2026 before moderating in 2027.

Services should expand in 2027 as tourism conditions improve. Agriculture faces a more challenging outlook from higher production costs and a very strong El Niño which could bring drier conditions. Government measures to ease fertilizer costs should provide some relief to farmers. Nonetheless, the dry weather could constrain crop yields, including rice, cassava, maize, and sugarcane, along with farm incomes, as the impact becomes more pronounced in 2027.

Headline inflation rises on higher energy costs but remains within the central bank target. Headline inflation should be 2.5% in 2026, revised down from 2.9% in ADO July 2026, before moderating to 1.3% in 2027 (Figure 3.4.36). The downward revision this year mainly reflects government measures including lower electricity tariffs for households, fuel price support, and continued price controls on essential goods. These should continue to limit the pass-through of higher input costs to consumer prices for the rest of 2026. Inflation will likely ease in 2027 as energy prices decline and supply-side pressures dissipate.

Figure 3.4.36 Inflation

Higher energy costs drive inflation up in 2026 before supply pressures ease in 2027.



Source: Haver Analytics.

Risks to the outlook remain tilted to the downside.

Further escalating geopolitical tensions could prolong high energy and transportation costs, weaken household purchasing power, and disrupt trade and tourism. Greater impact from higher US tariffs or sharper normalization in the global technology cycle could weigh on exports and investment, particularly in 2027. Domestically, high household debt and tight credit conditions could constrain consumption, while narrowing fiscal space could limit government and SOE investment. Stronger El Niño effects could reduce agricultural output and farm income.

Upward inflationary pressures could also be stronger than expected. Headline inflation could exceed forecasts if geopolitical tensions intensify, cost pass-through intensifies, or a more severe El Niño raises food prices beyond expectations.

Viet Nam

The economy's strong first half (H1) 2026 momentum has boosted growth and inflation projections from ADO July 2026. The economy is now projected to grow by 7.8% in 2026, before moderating slightly to 7.6% in 2027. However, increasing reliance on bank credit to finance investment is adding to domestic macroeconomic and financial pressures, while external headwinds are strengthening. The challenge is to ensure sustainable growth while safeguarding macroeconomic and financial stability.

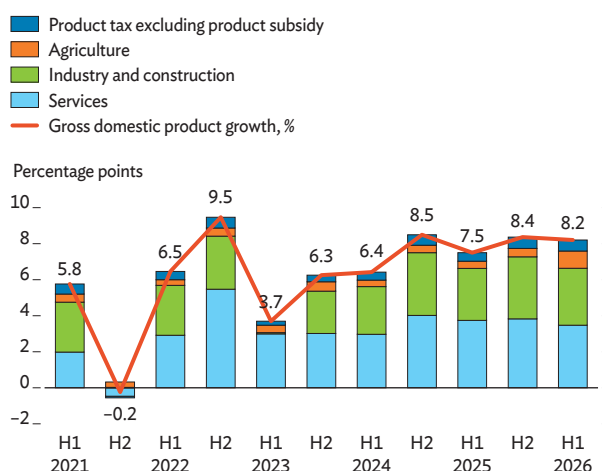
Updated Assessment

Robust economic growth momentum continued in H1 2026. GDP growth accelerated to 8.2% from 7.5% in H1 2025 on strong broad-based performance.

Growth was solid across major sectors. Industry and construction expanded by 9.8% from 8.3% a year earlier, driven by continued manufacturing and faster infrastructure investment. Manufacturing grew by 10.2% with strong production across key industries, while construction expanded by 9.5% amid higher public investment spending. Services grew by 8.1%, supported by resilient consumption and continued expansion in trade, transport, and tourism. Agriculture, forestry, and fisheries grew by a steady 3.9% on firm domestic demand and expanding export markets (Figure 3.4.37).

Figure 3.4.37 Supply-Side Contributions to Growth

All major sectors posted strong growth in the first half of 2026.



H = half.

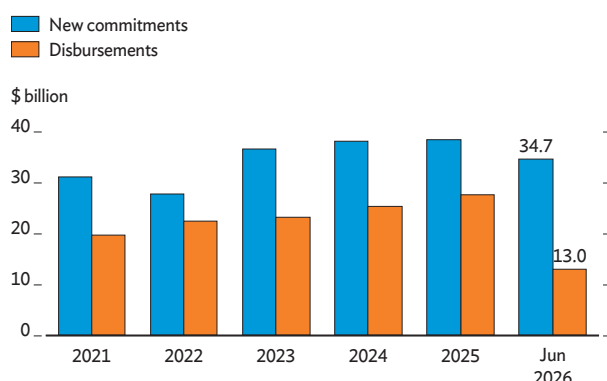
Source: National Statistics Office, Ministry of Finance.

On the demand side, domestic consumption and investment were more prominent in supporting growth. Final consumption rose by 8.2% year on year, supported by resilient household spending, while gross capital formation surged by 15.2%, reflecting stronger investment activity and accelerated public investment. External trade also expanded rapidly. Merchandise exports rose by 21.0% to \$266.5 billion, while imports increased by 33.4% to \$283.2 billion, resulting in a merchandise trade deficit of \$16.7 billion for H1 2026.

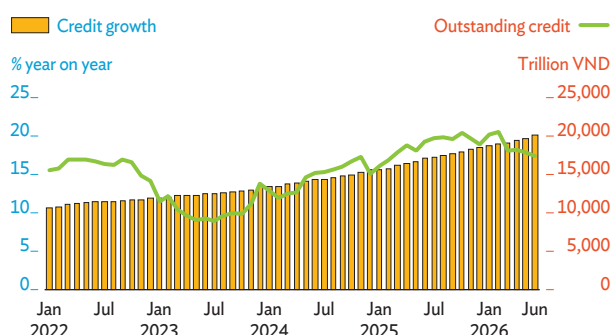
Foreign direct investment (FDI) remained strong in H1 2026 on continued investor confidence.

Total registered FDI rose by 61% to \$34.7 billion with disbursements increasing by 11.2% to \$13 billion, the highest in 5 years (Figure 3.4.38). Manufacturing and processing accounted for 63.0% of new and additional capital and 82.6% of realized FDI. Singapore was the largest source of newly registered investment, followed by the Republic of Korea, Japan, and the People's Republic of China.

Inflationary pressures intensified. Average headline inflation rose to 4.4% in H1 2026 from 3.3% a year earlier, driven mainly by higher housing and utility costs, food prices, and transportation (Figure 3.4.39). Core inflation also accelerated to 4.1% from 3.2%, indicating broader underlying price pressures. Inflation eased marginally in July with the consumer price index falling by 0.1% from the previous month as domestic fuel prices fell, but remained up 4.5% year on year.

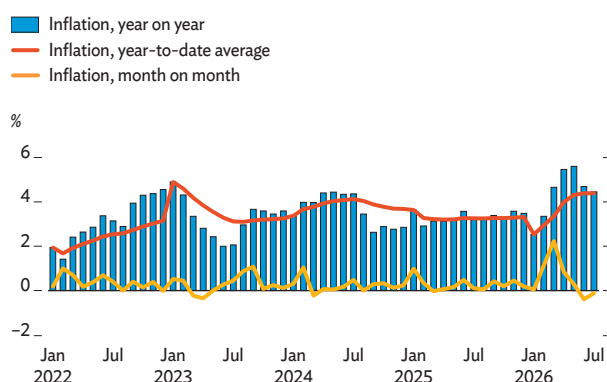
Figure 3.4.38 Foreign Direct Investment*Foreign direct investment remains strong.*

Source: National Statistics Office, Ministry of Finance.

Figure 3.4.40 Credit Growth*The central bank maintained pro-growth monetary policy in the first half of the year.*

VND = Viet Nam dong.

Sources: State Bank of Viet Nam; Asian Development Bank estimates.

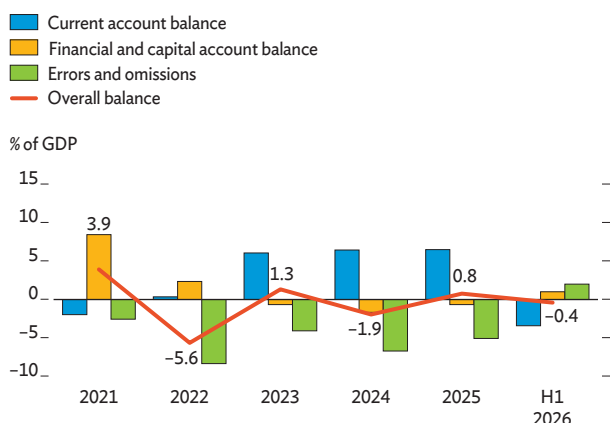
Figure 3.4.39 Inflation*Inflation remained elevated in the first 7 months of 2026.*

Sources: National Statistics Office; Ministry of Finance.

Accommodative monetary conditions continued to support economic growth amid increasing inflation and concerns over asset quality. In H1 2026, the State Bank of Viet Nam kept the refinancing rate at 4.5% and the annual credit growth target at about 15%. It directed lending toward productive and priority sectors and tightened controls over loans to those potentially risky. Open market operations supported liquidity, while the exchange rate was managed flexibly to absorb external shocks. By late June, credit had expanded by an estimated 8.0% from end-2025, with outstanding credit reaching around VND20,000 trillion (Figure 3.4.40). However, strong demand for funds, rising interest-rate pressures, and renewed pressure on the currency limited space for further monetary easing. Rapid credit growth and elevated real estate exposure also warrant close asset quality monitoring.

The current account weakened in H1 2026. Strong import growth, driven by demand for production inputs and capital goods, outpaced exports and weakened the merchandise trade balance. Together with lower remittance inflows, the current account is estimated to have shifted from a surplus of 5.3% of GDP in H1 2025 to an estimated deficit of 3.4% in H1 2026.

Capital and financial inflows continued to provide some support. The financial and capital account is estimated to have recorded a surplus of 1.0% of GDP, but it was unable to offset the weaker current account, resulting in an overall balance-of-payments deficit estimated at 0.4% of GDP (Figure 3.4.41). Reflecting

Figure 3.4.41 Balance of Payments*The current account balance weakened in the first half of 2026.*

GDP = gross domestic product, H = half.

Sources: State Bank of Viet Nam; Asian Development Bank estimates.

rapid import growth, foreign exchange reserves were estimated to cover 2.1 months of imports, down from 2.4 months at end-2025.

Fiscal conditions remain favorable, allowing for continued growth support. Despite continued tax and fee relief, national budget revenue reached VND1,568.2 trillion in H1 2026, up 17.7% year on year and 62% of the annual target. Total expenditure was broadly unchanged at VND1,149.1 trillion, with spending shifting toward development investment. Public investment disbursements reached just 35.5% of planned spending, leaving substantial room for accelerating outlays in the second half. Therefore, strong revenues and contained recurrent spending provide the fiscal space needed to support investment and domestic demand throughout the remainder of 2026.

Prospects

The economic outlook has strengthened, but policy trade-offs associated with sustaining rapid growth have become more pronounced. Stronger-than-expected H1 results, supported by robust manufacturing, strong domestic demand, accelerated public investment, and sustained FDI, warrants an upward revision to the growth forecast. GDP is now projected to grow by 7.8% in 2026, up from 7.2% in ADO July 2026, and by 7.6% in 2027, up from 7.0% (Table 3.4.6). However, rapid investment and associated credit growth could amplify financial vulnerabilities and narrow policy space. A weakening external position, together with global trade uncertainty, geopolitical tensions, and higher energy costs, poses additional risks to exports, investment, and inflation.

Table 3.4.6 Selected Economic Indicators in Viet Nam, %

Growth and inflation forecasts are revised up from ADO July 2026 projections.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	8.0	7.2	7.8	7.0	7.6
Inflation	3.3	4.0	4.3	3.8	4.0

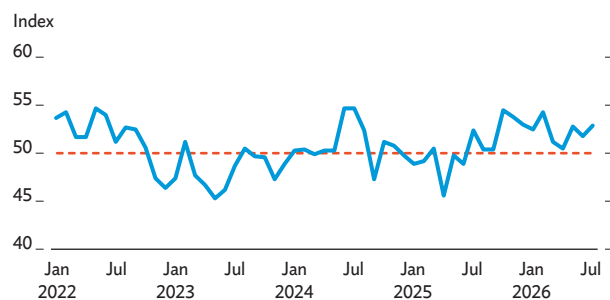
GDP = gross domestic product.

Sources: General Statistics Office; Asian Development Bank estimates.

Industry should remain a major driver of economic growth despite mounting pressure on domestic firms. Industry will likely expand by 9% in 2026, following the strong H1 momentum. The manufacturing purchasing managers' index increased from 51.8 in June to 52.9 in July, indicating continued expansion in output and new orders leading to sustained production activity (Figure 3.4.42). Manufacturing should also benefit from continued FDI inflows, with the sector accounting for 57.0% of total newly registered and adjusted capital in the first 7 months 2026. Stronger industry should generate positive spillovers to trade, transport, logistics, and other business services.

Figure 3.4.42 Purchasing Managers' Index

The indicator has been above 50 for 13 consecutive months, signaling steady expansion.



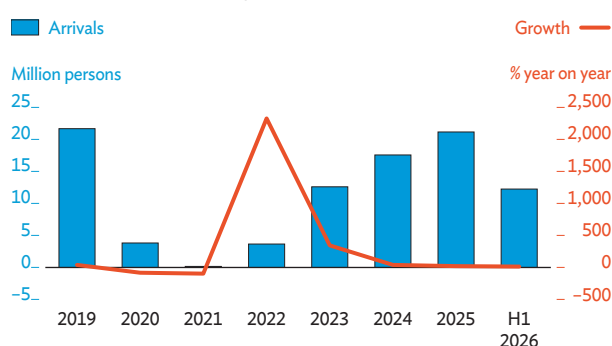
Note: A purchasing managers' index <50 signals deterioration, >50 improvement.

Source: IHS Markit.

Construction should benefit from the large public investment program. Nearly VND357 trillion was disbursed in H1 2026, about VND38 trillion higher than a year earlier. Key national transport projects accounted for about VND59 trillion of disbursements. With a substantial share of the annual investment program still to be implemented, faster execution in the second half should provide further impetus to construction and domestic demand.

Services will likely continue its solid expansion, supported by resilient domestic demand, expanding tourism, and strong transport and trade.

International arrivals in H1 reached 12.3 million, up 14.9% year on year (Figure 3.4.43). Continued growth in tourism, logistics, financial services, and digital activities should sustain momentum in H2. Overall, services should grow by 8.0% in 2026, although weaker global growth and trade uncertainty remain downside risks to tourism and trade-related activities.

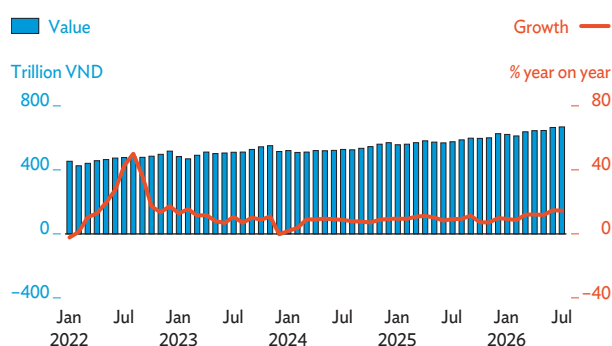
Figure 3.4.43 International Tourism*Increased tourism supports growth in services.*

H = half.

Sources: National Statistics Office; Ministry of Finance.

Agriculture should expand by 3.9% in 2026, supported by steady production and continued export demand. Agro-forestry-fishery exports rose by 6.0% year on year to \$35.9 billion in H1 2026, with particularly strong growth in aquatic and livestock products. Market diversification and greater use of trade agreements should continue to support exports. However, intensifying El Niño conditions could increase drought, heat, and salinity risks, particularly in the Mekong Delta, while higher input costs, trade policy uncertainty, and increasingly stringent sustainability and traceability requirements in major markets remain key downside risks.

Domestic demand should continue to support growth, although consumption has not accelerated significantly. Retail sales of goods and consumer services rose by 13.1% year on year in nominal terms in the first 7 months of 2026. It grew by 7.5% in real terms, little changed from 7.4% a year earlier (Figure 3.4.44). Despite rapid credit

Figure 3.4.44 Retail Sales*Retail sales were strong in the first 7 months 2026.*

Sources: National Statistics Office; Ministry of Finance.

expansion and strong headline growth, consumption has expanded less than investment, suggesting that recent growth has been more investment-led. Looking ahead, household spending should benefit from higher minimum and public wages, while fiscal support, including a 2-percentage-point drop in value-added tax through end-2026, should also help sustain consumption.

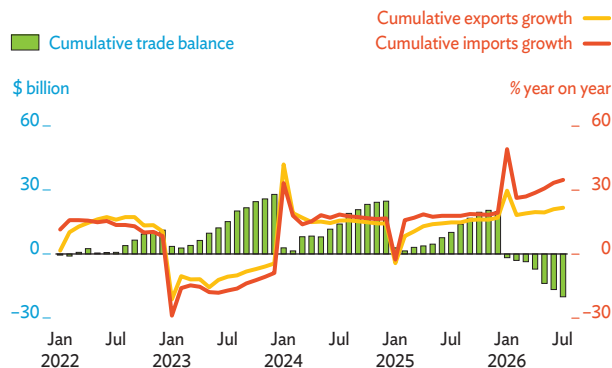
Investment will likely continue as a major driver of growth in H2 2026, supported by public investment, FDI, and increased private investment in major infrastructure projects. Public investment disbursement reached VND425.3 trillion (\$16.3 billion) by end-July, or 41.9% of the annual plan, with realized FDI reaching \$15.2 billion. Large domestic corporations are also playing a larger role in infrastructure and urban development, with banks expected to provide substantial financing for these projects. This could provide a strong near-term boost to construction and growth. However, greater reliance on bank financing may increase liquidity, maturity, and credit concentration risks. Sustaining investment-led growth will therefore depend on whether these projects generate sufficient productivity gains and cash flow to service the associated debt.

The financial system remains predominantly bank-based, with bank credit outstanding equivalent to 145% of GDP at end-2025 and the corporate bond market relatively small at 10% of GDP. Credit growth has also outpaced deposits, bringing loan-to-deposit ratios closer to or exceeding the regulatory limit in many instances. However, relatively thin capital buffers and persistent maturity mismatches limit space for sustained rapid credit expansion, particularly for large infrastructure projects requiring long-term financing. Further reliance on bank financing could thus increase financial vulnerabilities and ultimately constrain investment-led growth.

Trade should remain resilient in H2 2026, although the widening trade deficit weighs on the external position. Exports rose by 21.7% year on year in the first 7 months of 2026, supported by strong manufacturing and electronics shipments. Imports, however, surged by 34.8%, widening the merchandise trade deficit to \$20.5 billion (Figure 3.4.45). While strong imports partly reflect higher demand for production inputs and capital goods, a deficit would

Figure 3.4.45 Trade Indicators

The widening trade deficit could weigh on the external position.



Sources: National Statistics Office; Ministry of Finance.

reduce net exports' contribution to growth, weaken the current account, and add to exchange-rate pressures. Export prospects also face slower growth in major markets, US trade-policy uncertainty, and potential supply-chain disruptions.

The business environment remains challenging, but policy support should help sustain private sector activity. About 155,300 enterprises withdrew from the market in the first 7 months of 2026, although around 187,200 new and reactivated enterprises were also recorded over the same period. The high number of business exits underscores the persistent pressures facing firms despite continued market entry. The National Assembly approved a 30% income tax reduction for businesses with annual revenue of up to VND10 billion (\$382,000). Following State Bank of Viet Nam's guidelines, in August 2026, twelve commercial banks announced preferential credit programs totaling about VND408 trillion (\$15.5 billion) to support small and medium-sized enterprises and priority sectors. However, cheaper credit alone may be insufficient when firms lack collateral or creditworthiness, underscoring the need for stronger credit-guarantee and risk-sharing schemes.

Fiscal policy should remain expansionary through the rest of 2026. Strong revenues provide room for higher spending, while accelerated public investment, the 2-percentage-point value added tax reduction through end-2026, and other tax relief measures will continue to support domestic demand. As capital spending accelerates, the fiscal balance should move toward the approved full-year deficit of 4.2% of GDP. However, slow public investment execution remains a

key constraint. Fiscal policy should therefore prioritize faster and more efficient disbursement to translate available fiscal space into effective growth support.

Inflation is projected at 4.3% in 2026, revised up from 4.0% in ADO July 2026. Average inflation was 4.4% in the first 7 months of 2026, while headline inflation eased to 4.5% year on year in July from 4.7% in June; core inflation edged up to 4.2%. Strong domestic demand, accelerated public investment, and credit growth will likely sustain demand-side pressures, while higher energy and import costs may add to production and transport costs. Inflation is projected to ease to 4.0% in 2027 as commodity and energy prices moderate and domestic price pressures gradually subside.

Near-term growth prospects remain strong, but risks are tilted to the downside. Weaker global demand and trade policy uncertainty could weigh on exports and investment, while geopolitical tensions and higher energy prices could add to inflation and exchange-rate pressures. Domestically, rapid credit expansion associated with investment-led growth could amplify financial vulnerabilities. Smaller firms continue to face financing constraints.

Sustaining high-quality growth will require continued macroeconomic stability and deeper structural reforms. Containing inflation, managing exchange-rate pressures, safeguarding credit quality, and better public investment execution remain priorities. Financial reforms should strengthen bank resilience while deepening capital markets, particularly the corporate bond market, to mobilize long-term financing and reduce excessive reliance on bank credit. Broader institutional reforms that raise productivity, strengthen private sector development, and improve resource allocation will also be essential to sustain growth and support the country's transition toward high-income status.

Other Economies

Brunei Darussalam

Economic growth slowed in the first quarter (Q1) of 2026 as hydrocarbon production growth moderated and the non-oil and gas economy contracted. GDP expanded by 0.3% year on year in Q1 2026, down from

4.8% in Q4 2025. Growth in oil and gas eased to 4.1% in Q1 2026 from 10.1% in Q4 2025 as production increases in crude oil, natural gas, and liquefied natural gas (LNG) moderated. Nevertheless, the sector remained the main source of growth, expanding by 2.8%. By contrast, the non-oil and gas sector contracted by 3.0%. Services declined by 3.1% amid weakness in transportation, government, business, and financial services. Downstream petroleum and chemical activities, however, continued to expand, partly offsetting other non-oil weakness. On the expenditure side, stronger household consumption, exports, and fixed investment partly offset a sharp decline in government consumption.

The growth forecast for 2026 is downgraded to 1.2% as the weakness in non-oil activity persisted beyond the start of the year and was not offset by the expansion in hydrocarbon output (Table 3.4.7).

Higher oil and LNG production, in response to demand driven by renewed oil market disruptions, should support output for the remainder of 2026, while favorable hydrocarbon prices bolster export earnings and government revenue. The gains, however, are likely to be limited, as the earlier disruptions this year delivered less of a boost than anticipated. Downstream industries and initial project implementation under the Twelfth National Development Plan should provide additional support. However, public investment's contribution will depend on the pace of project implementation and execution.

Table 3.4.7 Selected Economic Indicators in Brunei Darussalam, %

Growth forecast for 2026 is revised down while other projections remain unchanged.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	1.0	1.8	1.2	1.9	1.9
Inflation	-0.3	1.1	1.1	0.5	0.5

GDP = gross domestic product.

Sources: CEIC Data Company; Asian Development Bank estimates.

Growth is still forecast to edge up to 1.9% in 2027 from increased hydrocarbon-related activity and stronger domestic investment. Continued implementation of development projects in education, industrial and digital development, and public services should support construction and demand

for private services, gradually expanding productive capacity. However, the benefits will likely emerge gradually, with growth remaining constrained by the continued dependence on oil and gas along with gradual diversification.

Consumer prices remained broadly stable in the first 7 months of 2026, though inflation turned slightly positive as food price pressures strengthened.

The consumer price index declined by 0.02% year on year during January–July, following 0.3% deflation in 2025 and 0.4% in 2024. Services prices fell by 0.6%, led by lower prices for communication and recreation and culture, while goods prices increased by 0.4%. Food and non-alcoholic beverage prices rose by 0.9% on higher prices for fish and seafood, meat, and fruit. In July, consumer prices increased by 0.02% year on year, after a 0.3% increase in June, as a 1.2% rise in food prices outweighed the 0.3% decline in non-food prices.

The inflation forecast remains at 1.1% for 2026, easing to 0.5% in 2027. Price pressures will likely remain strong for the remainder of 2026 as higher import costs follow global shipping route disruptions and costs. Energy and food price pressures derive from the Middle East conflict and active El Niño. Inflation should moderate in 2027 as energy prices and transport costs ease. Government subsidies, administered prices, and the Brunei dollar's parity with the Singapore dollar continue to limit the pass-through of external cost pressures.

Risks to the outlook remain tilted down, reflecting the economy's continued dependence on hydrocarbons and external demand. Unplanned outages or maintenance caused by aging infrastructure could constrain oil and gas production, while weaker demand from major markets such as Australia or the People's Republic of China weighs on hydrocarbon and petrochemical exports. Prolonged Middle East conflicts could increase energy prices and government revenue, disrupt trade, raise shipping and import costs, and weaken global growth. Persistent shipping disruptions or a stronger El Niño would add inflation risk, while subdued non-oil activity or slower government investments would limit growth. On the upside, stronger hydrocarbon production, sustained LNG demand, and faster expansion in downstream industries could lift growth above forecasts.

Cambodia

The growth projection for 2026 is revised down from ADO July 2026 after weak tourism weighed on services. Growth is still expected to recover in 2027, as forecast in July. Inflation forecasts are revised up for both years, reflecting higher global oil prices and other pressure from imports, but inflation is still expected to slow in 2027 (Table 3.4.8).

Table 3.4.8 Selected Economic Indicators in Cambodia, %

Growth projections are revised down for 2026, while inflation projections are revised up.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	5.3	4.1	3.9	4.7	4.7
Inflation	2.5	4.5	4.7	2.5	2.8

GDP = gross domestic product.

Sources: Ministry of Economy and Finance; National Institute of Statistics; Asian Development Bank estimates.

Industry remains the main engine of growth, driven by robust export expansion in the first half outside of the large garment industry. Garment exports increased by a relatively moderate 6.3% year on year to \$8.0 billion, while exports of other manufactures rose by 38.4% to \$6.7 billion as diversification continued into products with higher value added, notably wooden goods, electrical components, vehicle parts, and tires. The United States and Europe continued to take the largest shares of exports. Construction and real estate were subdued.

Weak tourism is expected to hold growth in services below earlier projections. International visitor arrivals declined by 47.9% year on year to 1.8 million in the first half of 2026, or 52.5% of the pre-pandemic level, held down by the conflict in the Middle East, the closure of the Cambodia–Thailand land border, and concerns related to the transnational scam industry. Low arrivals weighed on tourism demand and related services, including trade, transport, hospitality, and retail.

Agriculture is expected to remain a modest contributor to growth, supported by export demand. Despite higher input costs from the conflict in the Middle East, agricultural export value grew by

23.6% year on year in the first half of 2026, driven by cashews, cassava, and milled rice. Parts of the government's Comprehensive Intervention Program, approved in July 2026, will support rural households. Weather warrants continued monitoring given a forecast of a very strong El Niño and associated extreme weather.

Inflation forecasts are revised up on the pass-through of higher global oil prices and other imported input costs. Inflation remained elevated in the first 4 months following the onset of the fuel price shock. It surged from 2.6% year on year in February to 5.6% in March, reflecting dependence on imported inputs. Inflation accelerated to 5.8% in April and 7.2% in May before easing to 6.8% in June and 5.5% in July. Price pressures have been mitigated by fuel tax relief measures, and a broadly stable Cambodian riel helped hold down inflation expectations and stabilize the economy.

Fiscal policy is expected to remain supportive of economic activity. After narrowing to an estimated 1.0% of GDP in 2025, the fiscal deficit is expected to widen to 4.9% in 2026, driven by higher infrastructure and social spending under the Comprehensive Intervention Program, in particular tax relief for fuel. Public debt remains manageable, and Cambodia remains at low risk of debt distress. The authorities are committed to balancing growth support with fiscal sustainability over the medium term.

The current account deficit is projected to widen more in 2026 than previously anticipated. Rising import costs, together with weakened tourism receipts and secondary income inflows are expected to widen the current account deficit to 11.5% of GDP in 2026 before easing in 2027. With buoyant foreign direct investment inflow sustaining international reserves at about 7 months of import cover, Cambodia maintains a cushion against external vulnerabilities and global economic uncertainty.

Risks remain tilted to the downside. Weaker growth among major trading partners, prolonged geopolitical tensions, higher commodity prices, and continued weakness in tourism could dampen growth and increase inflation. Domestically, rising nonperforming loans could further constrain credit growth and weaken economic activity. Uneven rainfall, including potential

El Niño-related weather disruptions, could disrupt rice production, livestock and fisheries, and rural livelihoods, particularly among smallholder farmers.

Lao People's Democratic Republic

Despite a more stable macroeconomy, the recovery remains fragile amid heightened exposure to external shocks and climate-related risk. After growing by 4.4% in 2025, GDP is forecast to grow by 4.0% in 2026 and 4.5% in 2027, unchanged from ADO July 2026 projections (Table 3.4.9). The slower 2026 growth reflects weaker external demand, higher import costs, tight fiscal space, and climate-related risks to hydropower generation. Lower inflation and exchange rate stability have improved confidence. But high public debt service, fuel dependence, and reliance on electricity exports constrain policy space.

Table 3.4.9 Selected Economic Indicators in the Lao People's Democratic Republic, %

GDP growth will moderate in 2026 before improving in 2027, while inflation will likely rise in 2026 and ease in 2027.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.4	4.0	4.0	4.5	4.5
Inflation	7.7	9.8	8.0	6.7	6.5

GDP = gross domestic product.

Sources: Lao Statistics Bureau; Asian Development Bank estimates.

Services sector continues to support growth; but uneven tourism suggests the recovery is not broad-based. International arrivals reached 2.6 million in January–June 2026, up 9.9% year on year. ASEAN remained the largest source market, led by Thailand, accounting for 32.1% of arrivals, an increase of 14% year on year. Arrivals from the People's Republic of China rose by 12.2% with those from Europe up 37.9%. These gains supported transport, hospitality, retail trade, and logistics. However, a 33% decline from the Republic of Korea and other ASEAN markets, together with softer domestic tourism receipts, suggest services growth may be less robust than headline arrivals imply.

Looking forward, industry and agriculture will support growth, although both are increasingly exposed to climate-related risk. The key drivers of

industrial growth continue to be construction, mining, renewable energy investment, and electricity exports. However, hydropower depends on rainfall, river flows, and reservoir levels. Higher temperatures, uneven rainfall, and lower reservoir storage reduce generation, weaken electricity exports, lower power-sector revenues, and add pressure on reserves. Agriculture will likely contribute modestly through rice, livestock, fisheries, and commercial crop production. But high input costs, labor constraints, localized flooding and drought, and weaker yields could limit gains and add to food price volatility.

Inflation is easing but remains above target.

Headline inflation rose from 5.1% in January 2026 to 10.2% in April, before easing to 7.6% in July as fuel and food pressures moderated. Inflation is forecast to average 8.0% in 2026, slightly above the government's 7.0% ceiling, before easing to 6.5% in 2027. The expected drop remains vulnerable to fuel prices, exchange rate movements, imported food costs, and second-round effects on transport and administered prices. Sustained fiscal discipline, together with appropriate central bank liquidity and foreign exchange management, will be essential to anchor inflation expectations.

The external position remains in surplus but has weakened markedly.

The current account surplus narrowed to \$594 million in the first half of 2026 from about \$1.28 billion a year earlier due to the smaller goods trade surplus, weaker services balance, and wider primary income deficit. The goods trade surplus fell to \$734.6 million from about \$1.34 billion as imports rose rapidly and exports remained subdued. Higher imports may provide a temporary boost to customs, excise, and value-added tax collections, but they also increase demand for foreign exchange and raise spending on imported fuel, consumer goods, capital goods, and production inputs. In addition, weaker export momentum limits foreign exchange earnings and fiscal receipts from electricity, mining, agriculture, and tourism-related services. The services balance also deteriorated despite higher tourist arrivals, suggesting that tourism and transport receipts do not yet fully impact net service earnings. This underscores the need to improve tourism yields, strengthen export competitiveness, enhance trade logistics, and increase foreign exchange retention.

Risks to growth are tilted to the downside. External risks include higher fuel and food prices, softer tourism receipts, weaker external demand, and continued debt-servicing pressure. Climate-related shocks could weaken hydropower generation, agricultural output, and related exports. Erratic rainfall, floods, drought, and high input costs could reduce rice, livestock, fisheries, and commercial crop production. This would weigh on rural incomes, food prices, export earnings, and foreign exchange receipts. Policy should remain focused on preserving macroeconomic stability, rebuilding fiscal and reserve buffers, strengthening foreign exchange reserves, improving trade facilitation, diversifying exports, accelerating power sector and state-owned enterprise reform, and integrating climate risk into energy, agriculture, and public investment planning.

Myanmar

Growth will remain stifled due to persistent domestic and global uncertainty alongside prolonged supply chain disruptions. The economy was expected to recover gradually before the Middle East conflict broke out, supported by post-earthquake rehabilitation and easing supply constraints. However, as the conflict triggered fuel shocks, renewed supply disruptions, and intensified external headwinds, the fragile recovery eased. Economic uncertainty increased, compounding the prolonged disruptions from domestic instability and recurring natural hazards. The growth forecast for fiscal year 2026 (FY2026, ending 31 March 2027) is thus revised down slightly to 2.2% from the 2.4% July projection, while the FY2027 forecast remains at 2.7% (Table 3.4.10).

Table 3.4.10 Selected Economic Indicators in Myanmar, %

The 2026 growth forecast has been revised down to reflect persistent downside shocks, while the forecast for 2027 is retained.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	-2.2	2.4	2.2	2.7	2.7
Inflation	17.0	24.0	24.0	16.0	16.0

GDP = gross domestic product.

Note: Years are fiscal years ending 31 March of the following year.

Sources: [Central Bank of Myanmar](#); Asian Development Bank estimates.

The downgrade mainly reflects weaker industrial activity, particularly manufacturing, amid subdued demand, input shortages, and higher production costs.

Domestically, manufacturing remains weak, with the purchasing managers' index showing contraction since May 2026. Import restrictions, disrupted supply chains, and high energy and transport costs continue to constrain access to imported inputs and limit productive capacity, particularly in import-dependent industries. Any renewed escalation of Middle East tensions could keep energy prices elevated, raise import costs, and further slow domestic production. Agriculture remains broadly stable, supported by adequate rainfall and vegetation conditions close to or above historical averages for most crops. Policy measures, including rice export zones, could provide some support, although productivity gains will likely remain limited by high input costs and risks from conflict and weather disruptions. In services, resilient growth in major migrant destination economies and a gradual easing of external disruptions could help sustain remittance inflows and support domestic demand. However, high services inflation continues to constrain performance, particularly in travel and tourism.

External trade has been resilient, though conditions remain fragile. Merchandise exports rose by 6.4% in nominal US dollar terms in the first 4 months of 2026, supported by robust foreign demand, while imports increased by 8.9%, driven by earthquake reconstruction and higher global oil and commodity prices. Sustaining this momentum will be challenging. Persistent trade disruptions related to the Middle East conflict could weaken external demand, while uncertain energy markets, trade friction, and currency depreciation could raise import costs and further impact the external position. Consequently, the current account deficit should remain broadly in line with the ADO July 2026 projection. Given the prolonged unfavorable business climate, foreign direct investment commitments remained at just \$47.6 million as of May 2026, significantly below precrisis levels.

The inflation surge continues. Given persistent supply shortages and high logistics costs, the FY2026 inflation forecast remains at 24.0%. As of mid-August 2026, the pace of fuel price increases slowed to

54.3%, down from the 123% peak in April 2026. While this slowdown and a favorable agricultural outlook should ease some cost pressures, persistent supply constraints, import restrictions, exchange rate pressures, and any renewed domestic or external instability will likely keep inflation high. In the first quarter of FY2026, headline inflation averaged 23.0%, with 17.6% food inflation. The 27.1% non-food inflation was driven mainly by services, particularly transport, health, education, recreation and culture, along with restaurants and hotels.

Risks tilt to the downside, reflecting both domestic constraints and external pressures. Recent global uncertainty, including the Middle East conflict, have heightened risks to global trade and commodity markets, adding volatility to the macroeconomic outlook. Given Myanmar's dependence on imported energy, any further deterioration in foreign exchange availability could bring tighter import restrictions, further economic constraints and limited development resources. Persistent political uncertainty continues to undermine business sentiment, investment, and growth prospects.

Timor-Leste

Economic growth in 2026 is forecast slightly higher than in ADO July 2026, supported by increased government spending and robust domestic demand in a low inflation environment. Public expenditure and private credit continue to underpin consumption and investment. To mitigate the adverse impact of the Middle East conflict, the legislature approved a supplementary budget, raising total expenditure by 4.4% above the original allocation. This additional public spending amounts to 13% of estimated non-petroleum GDP. It aims to keep inflation low, bolster strategic fuel and rice reserves, and provide targeted support to vulnerable groups and specific government institutions. This includes recruiting new personnel for the National Police, establishing a new administrative structure in Oecussi municipality, and procuring equipment for notary services. Together, it should slightly increase the contribution of government consumption to growth.

Following the country's ASEAN accession in October 2025, investment sentiment has remained positive, attracting new investors, tourists, and

increasing visitor mobility. This has supported private consumption alongside consumer credit, remittances, government spending on salaries and wages, and public transfers. Higher credit growth, supported by an improved legal environment and stronger financial infrastructure, should enhance the contribution of investment to growth. With demand higher than the July forecast, the economy is now projected to expand by 4.0% in 2026 before accelerating slightly to 4.1% in 2027 (Table 3.4.11).

Table 3.4.11 Selected Economic Indicators in Timor-Leste, %

Growth will remain solid with inflation expected to be lower than forecast in July.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.5	3.8	4.0	4.1	4.1
Inflation	0.5	2.2	1.0	2.0	1.8

GDP = gross domestic product.

Note: 2025 GDP growth is preliminary.

Sources: National Institute of Statistics of Timor-Leste; Asian Development Bank estimates.

The 2027 government budget focuses on medium term fiscal planning, prioritizing spending efficiency, reducing pressure on the Petroleum Fund, and diversifying financing. The budget process is shifting from a yearly focus to a policy based medium term framework covering 2027–2030. The preliminary budget stresses improved productivity in key sectors, including agriculture and fisheries, tourism, services and trade, and extractive industries. Public capital investment will go to enhancing connectivity, basic services, and rural infrastructure, while also preparing for the ASEAN Chairship, increasing investment's contribution to growth. The government is simultaneously prioritizing public investment in education and health to promote human capital development. The policy shift from 2025 toward long term, low cost concessional financing will continue to help fund strategic development projects for both infrastructure and social development.

Inflation should drop below ADO July 2026 projections. To shield the energy sector and broader economy from the impact of the Middle East

conflict, the government continues to provide budget subsidies aligned with temporary price caps to ensure uninterrupted fuel and rice supply. Measures include increasing domestic fuel reserves when appropriate, close coordination between public agencies and importers, enhanced oversight and monitoring, and strict penalties for violations, particularly illegally diverting fuel. These have helped maintain price stability, keeping inflation below forecasts. Despite a gradual rise in tradable and non-tradable inflation, average inflation was 0.7% with food inflation 1.5% as of July 2026, only 0.2 and 0.3 percentage points

higher than December 2025, respectively. Given the continued low inflation trend along with government support against any geopolitical impact, inflation forecasts have been revised down from *ADO July 2026* to 1.0% for 2026 and 1.8% for 2027.

Several factors pose downside risks to the outlook.

These include potential fuel supply disruptions and higher import prices from a prolonged or intensified Middle East conflict, broader geopolitical risks, a deeper El Niño impact on agriculture, potential natural hazards, and delays in public investment.

THE PACIFIC

The growth forecasts in the Pacific for both 2026 and 2027 have been revised down, and the inflation forecasts for both years revised up, from *ADO July 2026*. Cost pressures from the prolonged Middle East conflict and the impact of a strengthening El Niño weigh on critical sectors across the subregion, including agriculture, fisheries, construction, and tourism, and also exert substantial price pressures. Major downside risks to subregional growth and inflation projections include continued geopolitical tensions and heightened climate and disaster risks.

Subregional Assessment and Prospects

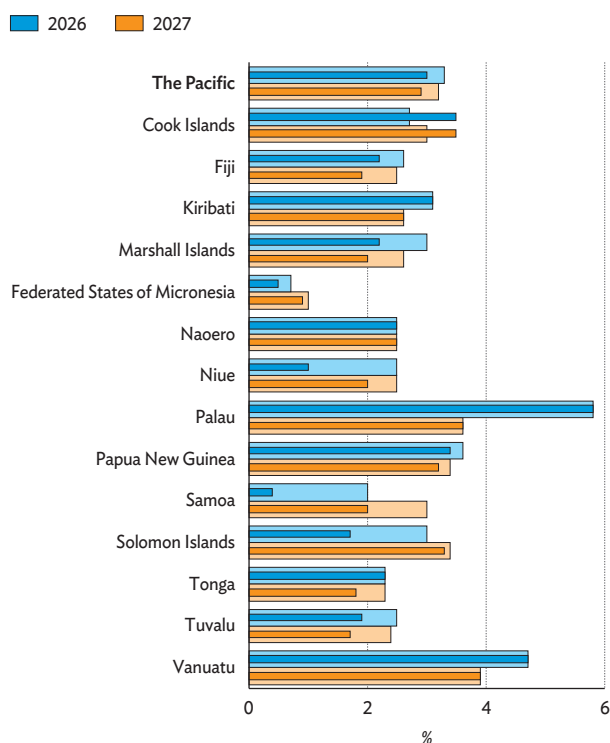
Growth in the Pacific has been revised down to 3.0% in 2026 from 3.3% in *ADO July 2026*

(Figure 3.5.1). Forecasts have fallen across most of the subregion, including the two largest economies, Papua New Guinea (PNG) and Fiji. The El Niño is now expected to be more intense and its impact on agricultural production more severe. Mining output in PNG has been below expectations, and industrial output in Fiji subdued, offsetting continued growth in visitor arrivals. Weaker output in critical commodities and slower capital spending have also prompted a downward revision to the 2026 growth projection for Solomon Islands. Along with El Niño effects, cost pressures arising from the continuing Middle East conflict are dampening the growth outlook for the Marshall Islands and post-typhoon recovery in the Federated States of Micronesia (FSM), while Tuvalu's recent electricity crisis continues to weigh on the economy despite stimulus from targeted crisis response measures and public spending.

Delays in implementing public projects also contributed to lower growth estimates in most South Pacific economies. Growth estimates for fiscal year (FY) 2026 (ended 30 June 2026 for the Cook

Figure 3.5.1 Gross Domestic Product Growth in the Pacific

Weaker growth will likely continue into 2027 as the effects of the Middle East conflict and a very strong El Niño persist.



Note: Lighter colored bars are *Asian Development Outlook July 2026* forecasts.

Source: *Asian Development Outlook* database.

Islands, Niue, and Samoa) are down from July for Niue, where growth was hampered by project delays and moderating tourism. In Samoa, growth was minimal as temporary project delays, weaker investment, and limited agriculture and fisheries output offset strong visitor arrivals, which continued after the onset of the Middle East conflict as tourists from the main Australia and New Zealand source markets preferred to spend their holidays closer to home. In contrast, the Cook Islands showed higher FY2026 growth, driven by more robust tourism and construction activity.

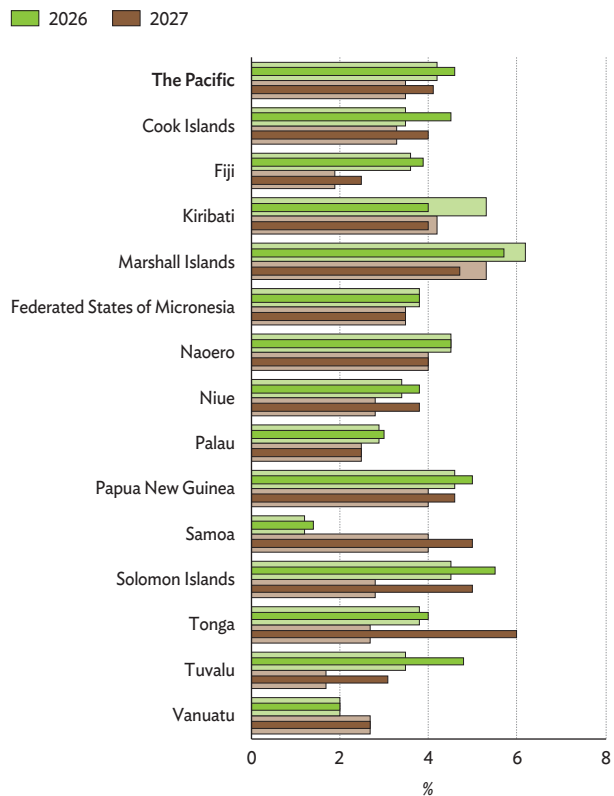
Weaker growth will likely continue into 2027. The subregional forecast is revised down to 2.9% from 3.2% in *ADO July 2026*. The effects of the Middle East conflict and very strong El Niño should persist, constraining agriculture, fisheries, construction, and tourism. A weaker mining outlook for 2027 also leads to a marginally lower forecast for Solomon Islands. However, the forecast for the Cook Islands is revised up, supported by expectations of sustained growth in tourism and improved access to private financing.

Subregional inflation is projected to reach 4.6% in 2026, up from 4.2% in July (Figure 3.5.2). Inflation in PNG may accelerate despite government efforts to mitigate the impact of rising fuel costs, due to food price pressures caused by El Niño. In Fiji, inflation will also likely be higher than projected in *ADO July 2026*, driven by higher import prices and electricity tariffs. Although the effects were first felt toward the end of FY2026 in the South Pacific, the impacts from the Middle East conflict have pushed up food, fuel, utility, and transport prices, resulting in higher inflation in the Cook Islands, Niue, Samoa, and Tonga. Despite lower inflation in Palau during the first half of FY2026 (ending 30 September 2026), higher fuel prices during the second half have likely boosted overall inflation. Meanwhile, inflation has been revised down in Kiribati, as regulated fuel and electricity prices continue and new renewable energy sources come on stream this year. Recent price developments also point toward lower inflation in the Marshall Islands.

As fuel prices increased, Pacific economies used a variety of measures to mitigate their impact on domestic prices. The Marshall Islands and Tuvalu declared states of emergency to more easily respond to energy supply and price shocks, while phased fuel price adjustments helped ease the pass-through of higher

Figure 3.5.2 Inflation in the Pacific

Inflation forecasts have been revised up even as Pacific economies work to mitigate the impacts of higher fuel prices.



Note: Lighter-colored bars are forecasts in *Asian Development Outlook July 2026*.

Source: *Asian Development Outlook* database.

fuel costs in the Cook Islands, Fiji, Niue, Samoa, and Tonga. The FSM and Kiribati managed domestic fuel prices to forestall the fuel price impact, while Fiji, PNG, and Vanuatu provided social transfers and subsidies to contain inflation. Other economies launched campaigns to curb energy demand and expanded access to public transportation. Looking ahead, some economies are accelerating the transition to renewable energy in anticipation of a prolonged conflict in the Middle East.

Price pressures are seen to continue into next year, leading to an upward revision of the inflation projection for 2027. Inflation in the Pacific is now forecast at 4.1% next year, up from 3.5% in *ADO July 2026*. Although international commodity prices will likely moderate, the impact from higher fuel costs will linger in Samoa as public transportation tariffs increase, while a planned increase in electricity tariffs in Tonga will push prices significantly higher than previously projected.

Further geopolitical, climate-, and disaster-related shocks pose the greatest risks to both growth and inflation across the Pacific. Price spikes or supply chain disruptions from geopolitical tensions could destabilize access to fuel and other essential production inputs, adding pressure on industry, construction, and tourism. More severe El Niño effects, together with any disaster damage or loss, could have significant adverse impacts on agriculture and fisheries throughout the subregion, and affect tourism as well. Election-related uncertainty is an additional risk in some economies, as it could delay government spending or reduce investor and consumer confidence.

However, there are also upside risks to the outlook. Higher international prices may also benefit key commodity exports from PNG, Fiji, and Solomon Islands. In addition, a final investment decision leading to the start of a multibillion-dollar liquefied natural gas project in PNG would provide a substantial boost to the economy.

Fiji

The GDP growth forecast is revised down (Table 3.5.1). GDP is projected to grow by 2.2% in 2026 and 1.9% in 2027, lower than in ADO July 2026. Trade strengthened in the first half (H1) of 2026, with growth in containerized and dry bulk cargo volumes indicating continued domestic demand and investment. Tourism should remain resilient, while proactive government measures to mitigate higher fuel costs and supportive fiscal policies help cushion external shocks and support the economy. Nonetheless, external headwinds will likely dampen economic activity, leading to the lower growth outlook.

Table 3.5.1 Selected Economic Indicators in Fiji, %

External pressures temper an otherwise resilient outlook.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	2.5	2.6	2.2	2.5	1.9
Inflation	-1.4	3.6	3.9	1.9	2.5

GDP = gross domestic product.

Source: Asian Development Bank estimates.

Tourism remains resilient despite higher airfares and global uncertainty. Monthly arrivals declined by 0.8% in April and 1.4% in May compared with 2025 before rebounding by 6.3% in June and 6.5% in July, driven by strong growth in arrivals from the Australian and United States markets. As a result, visitor arrivals from January to July 2026 grew by 4.3%. However, tourism earnings fell by 4.9% year on year in the second quarter (Q2) of 2026 and by 1.7% in H1 on shorter visitor stays and weaker visitor spending. Nonetheless, near-term prospects remain favorable, with forward bookings for the next 3 months at 72% of available room nights, up from 70% a year earlier. Resilient international air connectivity—including Fiji Airways services to Cairns and the Gold Coast—should support tourism through the rest of 2026.

Industrial output was mixed in H1 2026.

Improvements in some resource-based industries were offset by continued forestry weakness. Gold output grew by 6.2% in the year to July as stronger gold concentrate production more than offset a sharp decline in gold doré output. Mineral water production showed signs of recovery, expanding in May and June after contracting in the previous 10 months. Forestry production, however, remained weak, with mahogany (-27.4%), sawn timber (-54.7%), pinewood (-5.1%) and woodchips (-15.1%) all contracting in the year to June.

El Niño effects could lower hydropower and agricultural output. Electricity generation remained resilient, increasing by 5.3%. However, strengthening El Niño conditions could lower hydropower output for the remainder of the year. Sugar production remains constrained by cane shortages, harvesting delays, and mill inefficiencies, although output increased by 2.9% in the year to July. Global sugar prices have softened amid strong world supply, although potential weather-related disruptions and export restrictions could provide some price support later in 2026. While favorable weather supported agriculture during H1 2026, the recent decline in rainfall since June and likely very strong El Niño effects pose serious risks to crop and fisheries production.

Consumption softened amid rising cost pressures.

Spending likely moderated in early 2026 amid rising living costs and softer household demand. New consumption lending remains subdued, growing by 1.2% in the year to July after contracting earlier in

2026. Household spending suffers from higher fuel prices, increased electricity tariffs, and inflation, which weigh on disposable incomes along with consumer and business confidence. Nevertheless, government transfers to cushion rising fuel costs should support consumer spending over the remainder of the year. Several indicators remain strong, with inward remittances up by 26.3% in June and vehicle registrations rising 10.4%.

Investment remains robust. Construction and investment remained a bright spot in H1 2026, supported by strong credit growth and multi-year project implementation. New investment lending increased by 54.5% in the year to June, driven by higher borrowing for real estate (up by 63.8%) and building and construction (67.1%). Construction indicators also strengthened through May, as domestic cement sales rose by 41.6% and construction-related imports by 20.6%. The value of construction completed increased by 11.3% in Q1 2026. International Monetary Fund PortWatch data also point to strong import activity in H1 2026, with increased container, dry bulk, and tanker shipments showing strong import demand for construction materials, consumer goods, and fuel. Forward indicators remain positive, with building permits up by 12.1% and completion certificates 30.4% in Q1 2026. Major tourism-related developments in the western division should support activity for the rest of the year, although high fuel and input costs may delay some smaller projects.

Fiscal discipline needs to be in balance with development priorities. Revenue is targeted at F\$3.8 billion (25.8% of GDP), compared with F\$3.9 billion (27.7% of GDP) in FY2026, reflecting the slower economy and temporary fuel-price mitigation measures. Expenditure is budgeted at F\$4.9 billion (32.8% of GDP), broadly the same in nominal terms despite reprioritized spending toward critical bridge replacements, wastewater treatment expansion, a radiotherapy facility, additional bed capacity at the Colonial War Memorial Hospital, primary healthcare upgrades, and funding for general elections and the national census. The budget also promotes public-private investment initiatives, including a planned F\$200 million guarantee for Fiji Airways and renewable energy investments involving Energy Fiji Limited, the Fiji National Provident Fund, and development partners. Consequently, the fiscal deficit should widen

from F\$776 million (5.5% of GDP) in FY2026 to F\$1.1 billion (7.0% of GDP) in FY2027. Public debt will likely increase from F\$11.5 billion (82.1% of GDP) to F\$12.6 billion (84.8% of GDP) by end-July 2027.

Higher fuel, electricity, and food costs raise the inflation outlook. Headline inflation was 7.6% in August 2026, driven by higher fuel, transport, food, and housing (which includes electricity and gas) prices. Pressures will likely persist through the remainder of 2026, reflecting electricity fuel surcharges, high energy costs, and lagged pass-through effects from import prices. Emerging El Niño conditions could further increase prices by disrupting agriculture and reducing food supply. The continuing Middle East conflict should keep domestic fuel and electricity prices elevated in the near term. Inflation is thus revised up to 3.9% in 2026, before dropping to 2.5% in 2027 as fuel-related pressures gradually ease.

Risks to the outlook remain tilted to the downside. These include elevated global fuel prices, geopolitical tensions, and tighter external conditions. Domestic pressures, including rising living costs, skills shortages, and election-related uncertainty, may constrain activity. A very strong El Niño could disrupt agriculture, fisheries, and hydropower generation, further weighing on growth.

Papua New Guinea

Economic growth in 2026 is revised down to 3.4% and inflation up to 5.0% compared to ADO July 2026 (Table 3.5.2). Weaker mining and agricultural output will likely dampen growth. While the government's fuel price subsidy is expected to have partly cushioned the impact of the Middle East conflict on household prices, imported inflation and the effects of a very strong El Niño will likely exert greater upward pressure on inflation than previously anticipated. With El Niño expected to peak around November and gradually ease in early 2027, its impact will likely lead to weaker growth and higher inflation in 2027.

Resource output weakened. Gold production at Porgera declined by 2.7% year on year in the first half of 2026 as processing volumes declined, while output at Lihir fell by 16.7% due to reduced milling operations

Table 3.5.2 Selected Economic Indicators in Papua New Guinea, %*Growth is revised down and inflation up from ADO July 2026.*

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	5.2	3.6	3.4	3.4	3.2
Inflation	4.4	4.6	5.0	4.0	4.6

GDP = gross domestic product.

Sources: National Statistical Office of Papua New Guinea; Asian Development Bank estimates.

and lower ore grades. El Niño-related dry conditions also likely played a role with the temporary suspension of processing at Porgera in August 2026 due to water shortages. Additionally, logistical challenges are emerging for mining companies that rely on river transport, such as Ok Tedi, as low river water levels are disrupting the movement of minerals. Despite favorable commodity prices, increased production at the K92 mine, along with broadly stable liquefied natural gas (LNG) output (supported by supply from the Angore project), output gains are not expected to fully offset production declines at larger mining operations, particularly Porgera and Lihir, leaving sector performance below earlier forecasts.

Agricultural output has started to be affected by El Niño-related dry conditions. Several parts of the country have been affected by dry conditions in the first half of the year. Below-average rainfall is already affecting crop production particularly in the drought-prone Highlands. While favorable international prices for key agricultural exports, including palm oil and coffee, continue to support export earnings and household income, overall agricultural output is projected to be below earlier 2026 forecasts.

Other sectors continue to perform well. A recent business survey indicated more private sector confidence in 2026, with 72% of chief executives surveyed expecting investment to increase, with 52% anticipating a substantial increase. Foreign exchange availability, often cited as a major business constraint, continues to improve, with foreign exchange shortages falling from first to 12th when ranking business impediments. Strong 9.6% year on year private credit growth in the first 4 months of 2026 also signals higher confidence.

Fiscal consolidation is expected to continue over the forecast period. Increased government revenue, particularly mining and petroleum taxes and dividends from higher LNG and other commodity prices, will likely offset increased expenditure. The government's fuel price relief program, introduced in April 2026 and originally budgeted at \$227 million (K1 billion) for 2026, is now estimated to be about \$272 million. The government presented a supplementary budget on 1 September 2026 to incorporate higher government expenditure, including support for fuel subsidies and relief measures to mitigate the El Niño impact on households. Higher revenue from resource output, along with expenditure cuts on non-essential goods and services, and expenditure reallocations, should offset these spending pressures, allowing the fiscal deficit to narrow to 1.1% of GDP in 2026.

Higher imported inflation and El Niño effects raise the inflation forecast. Headline inflation accelerated in the first half of 2026, rising from 3.6% in the first quarter to 4.1% in the second. Food, fruit, and vegetable prices increased as drought affected crop production. While inflationary pressures will be partly moderated by the government's fuel price relief program and continued zero goods and services tax on selected items, inflation is projected to rise to 5.0% in 2026. The increase will be driven by the continued pass-through of exchange rate depreciation to domestic prices and inflationary pressures through cascading increases in the cost of imported food, fertilizer, and other goods. Additionally, El Niño-related disruptions to agricultural production are expected to add to these price pressures. Inflation is forecast to remain high in 2027, as El Niño effects persist along with the inflationary pressure from the impact of next year's election spending.

The outlook faces both downside and upside risks. The Middle East conflict continues as a significant downside risk, given the country's heavy reliance on imported petroleum products for electricity generation and transport. Stronger El Niño conditions could further add to these risks with more severe disruptions to agriculture, electricity, mining, and logistics. On the upside, a final investment decision on Papua LNG and the start of this multibillion-dollar project could provide a substantial boost to economic activity.

Solomon Islands

Economic growth in 2026 will likely be weaker with inflation higher than projected in ADO July 2026 (Table 3.5.3). Output from mining, logging, fisheries, and agriculture in the first half of 2026 was below July expectations. In addition, higher international fuel prices from the Middle East conflict had a stronger impact on inflation than earlier estimated.

Table 3.5.3 Selected Economic Indicators in Solomon Islands, %

GDP growth forecasts were lowered and inflation projections increased.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	3.6	3.0	1.7	3.4	3.3
Inflation	2.7	4.5	5.5	2.8	5.0

GDP = gross domestic product.

Sources: Solomon Islands National Statistics Office; Asian Development Bank estimates.

Mining production fell sharply. Gold production declined by 21.2% in the first half of 2026 as regulatory and operational disruptions weighed on output. The government reduced the number of gold dealer licenses from 40 to 10 following a compliance review with licensing requirements and continued work on revisions to the Mining Act to strengthen transparency and accountability. Adverse weather, which led to a landslide in July, also disrupted mining, contributing to the weaker outlook for 2026 as a whole.

Primary industries also weakened. Continued structural declines in logging and lower commodity prices for cocoa and copra weighed on the primary sector. In the first half of 2026, the fish catch fell by 11.6%, copra production by 44.8%, cocoa by 38.4%, and log production by 26.3%. The declines in log and crop production and fish catch were larger than previously anticipated.

Government budget execution was slower than planned. Capital expenditure was 51% below budget in the first quarter of 2026 following delays in project implementation. Revenue collections increased by 9% from a year earlier but remained 32% below the budget

target. Recurrent expenditure increased by 28% year on year, driven by higher wages and transfers. These developments should widen the fiscal deficit to 4.1% of GDP in 2026 from 3.9% in 2025. The deficit is expected to narrow in 2027 as revenue strengthens and expenditure moderates.

A broad-based recovery, led by mining, is expected to lift growth to 3.3% in 2027. The forecast is marginally below the July forecast, reflecting the weaker outlook for mining. Industry should nonetheless strengthen as gold production recovers from this year's disruptions and infrastructure investment boosts construction-related activity. The primary sector should recover more moderately as agriculture and fisheries rebound from a weak 2026, partly offset by the continuing structural decline in logging, although a very strong El Niño poses a downside risk to the recovery. Services will likely expand alongside stronger domestic activity, including trade, transport, and tourism.

Public debt continues to rise. Total public debt reached 29.6% of GDP at the end of June 2026, reflecting concessional borrowing for development projects. Public debt is expected to increase further in 2027, although the debt portfolio remains predominantly concessional and the risk of external debt distress remains low.

Higher international fuel prices raise the inflation outlook. Inflation is now estimated at 5.5% in 2026, as the Middle East conflict has driven international fuel prices above levels assumed in the July forecast. Consumer price inflation averaged 4.4% in the first half, reflecting the pass-through of higher fuel costs to domestic prices. Fuel price smoothing and temporary reductions in import duties and sales tax in April and May have cushioned the impact on households and businesses.

Inflation will likely ease to 5.0% in 2027 as international fuel prices decline and external price pressures moderate. However, higher transport and electricity rates stemming from earlier fuel price increases will continue feeding into other goods and services, keeping inflation well above the level forecast in July. Any renewed increase in international fuel prices is a risk to the inflation forecast.

Vanuatu

The ADO July 2026 GDP growth and inflation forecasts remain unchanged (Table 3.5.4).

The economy continues to recover following the December 2024 earthquake. Recent developments have been broadly in line with expectations, as tourism, reconstruction, and public investment continue to support growth despite higher global fuel prices. El Niño conditions remain a downside risk, particularly to agricultural production.

Table 3.5.4 Selected Economic Indicators in Vanuatu, %

Growth and inflation forecasts remain unchanged.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	3.8	4.7	4.7	3.9	3.9
Inflation	0.7	2.0	2.0	2.7	2.7

GDP = gross domestic product.

Sources: Vanuatu Bureau of Statistics; Asian Development Bank estimates.

Tourism gained momentum. Visitor arrivals increased by 60% year on year in the first quarter of 2026, driven by a 34% increase in arrivals by air and 69% by cruise ship. Air arrivals increased across the major tourism source markets, led by Australia. The continued recovery is supporting accommodation, transport, retail trade, and other tourism-related services, while restored port infrastructure is helping drive the recovery in cruise ship tourism.

Reconstruction remained strong. Ongoing repairs and the rebuilding of public infrastructure and private assets have sustained activity in construction and related industries. Government infrastructure projects and private rebuilding continued to grow, with government and donor-financed capital investment rising by 61.5% year on year during the first half of 2026. Record cement imports in the first quarter also point to continued strength in construction.

Agriculture remained resilient. Increased exports of copra and kava in the first quarter of 2026 show continued strength in agricultural

production, with export earnings up by 80.2% during January–April 2026 compared with the same period in 2025.

Domestic demand continued to strengthen. Private lending increased by 12.4% over the year to May 2026, reflecting stronger business and household activity. Labor demand also strengthened, with the number of job vacancies more than doubling year on year in May 2026, reflecting broad-based increases across agriculture, industry, and services.

Growth should moderate to 3.9% in 2027 as the impetus from post-earthquake reconstruction gradually wanes. Reconstruction will continue to support growth, but its contribution will likely diminish as the recovery progresses, while tourism should continue to support services.

Downside risks remain. Higher global fuel prices, weaker global growth, and exposure to natural hazards continue to pose risks to the growth outlook. El Niño conditions could also reduce agricultural production.

The fiscal position strengthened. In the first half of 2026, the government recorded a fiscal surplus of 3.3% of GDP. Revenue declined slightly from a year earlier as lower grant inflows offset higher value-added tax and citizenship receipts. The composition of government expenditure shifted toward capital investment, reflecting continued infrastructure spending and post-earthquake reconstruction, while current expenditure declined slightly.

Public debt remained moderate. At the end of June 2026, public debt stood at 36.6% of GDP. External debt, mostly concessional, was equivalent to 25.3% of GDP. No new domestic debt securities were issued during the first half of 2026, reflecting the government's stronger fiscal position.

Inflationary pressures will likely increase during the remainder of 2026. Inflation was 1.0% in the year to March 2026, broadly consistent with expectations but is expected to increase as higher international fuel prices from the Middle East conflict feed into transport and other costs. Inflation is forecast to rise further to 2.7% in 2027 as earlier increases in import costs continue to pass through to domestic prices.

Central Pacific Economies

Growth estimates for Kiribati and Naoero are retained while they are adjusted down from ADO July 2026 for Tuvalu. Weaker growth prospects in Tuvalu are mainly due to power disruptions and rising fuel costs. Infrastructure investment and construction continue to support growth in Kiribati and Naoero. Inflation forecasts diverged: higher for Tuvalu, retained for Naoero, and lower for Kiribati. Rising fuel and transport costs linked to the Middle East conflict led to higher inflation forecasts for Tuvalu. In Kiribati, as fuel supply conditions remain stable given the adequate domestic fuel stock, inflation forecast is lowered.

Kiribati

The ADO July 2026 GDP growth forecasts of 3.1% for 2026 and 2.6% for 2027 remain unchanged (Table 3.5.5). Agriculture growth in the first half of 2026 continued to be subdued, given lower than average rainfall from January to June and heavy rain and strong winds in July and August. Fisheries likely remained broadly stable. Industry grew from ongoing infrastructure projects, including investments in renewable energy, water supply and sanitation, along with coastal protection infrastructure, as several large projects moved toward completion. Trade and logistics, as well as household consumption, supported services. Household spending continued to benefit from targeted social transfers and administered fuel prices, although these add pressure on public finances.

Table 3.5.5 Selected Economic Indicators in Kiribati, %

Growth moderates as projected in ADO July, while unchanged administered prices ease inflation pressures.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.3	3.1	3.1	2.6	2.6
Inflation	5.9	5.3	4.0	4.2	4.0

GDP = gross domestic product.

Source: Asian Development Bank estimates.

Industry and services will remain the main growth drivers. Strong imports of capital goods and construction-related materials in the first half of 2026 point to steady infrastructure investment and

construction. Continued imports of food and other household consumer goods indicate that household consumption should remain resilient. Very strong El Niño conditions and resulting warmer ocean temperatures may support fisheries within the country's exclusive economic zone, boosting catches and government revenue.

Inflationary pressures ease with stable administered prices. In the first 3 months of 2026 inflation averaged 0.8%. Although higher costs for imported food, construction materials, and freight services associated with rising global oil prices place upward pressure on inflation, unchanged administered fuel prices will moderate any increase. The commissioning of the first phase of a renewable energy investment in 2026 will help contain electricity rates by reducing dependence on diesel-based generation. Fuel supply conditions should remain stable given the adequate domestic fuel stock. As a result, inflation projections are revised down to 4.0% in both 2026 and 2027.

Downside risks remain. Fisheries revenues remain subject to uncertainty related to changing ocean conditions and El Niño developments. Prolonged high global oil prices could further exacerbate fiscal pressures if administered fuel prices remain unchanged. In addition, the fiscal deficit will likely be 15% of GDP in 2026, financed primarily from withdrawals from the Revenue Equalization Reserve Fund. The sustained deficits pose risks to long-term fiscal sustainability, particularly if fisheries revenues or reserve fund returns weaken.

Naoero

Government spending and externally financed activity continued to support growth in fiscal year (FY) 2026 (ended 30 June 2026). The economy grew by 2.5% in FY2026, supported by Regional Processing Centre (RPC) and Third Country Reception Arrangement (TCRA) activity, along with development partner-financed infrastructure investment (Table 3.5.6).

Similar drivers should sustain 2.5% growth through FY2027. The RPC and TCRA will continue to drive economic activity, while government and development partner-financed investment should support construction and related services. Airport runway upgrades and construction on TCRA housing, urban

Table 3.5.6 Selected Economic Indicators in Naoero, %*Growth and inflation estimates remain unchanged.*

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	2.6	2.5	2.5	2.5	2.5
Inflation	6.1	4.5	4.5	4.0	4.0

GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

Sources: Naoero Bureau of Statistics; Asian Development Bank estimates.

infrastructure, and the 2028 Micronesian Games will continue into 2027. Limited capacity, however, could slow public investment.

High fuel costs kept FY2026 inflation at 4.5%. Heavy import dependence amplifies the pass-through from high international fuel prices to electricity, transport, imported goods, and business costs. Measures that reduce fuel consumption and mitigate higher energy costs are helping contain inflationary pressure.

Import price pressures will likely ease, lowering inflation to 4.0% in FY2027. This reflects an expected slowdown in external inflation, which is transmitted relatively quickly to Naoero because of its heavy dependence on imports and use of the Australian dollar. Volatile international fuel and commodity prices remain a risk, however.

Tuvalu

GDP growth is now forecast lower than in ADO July 2026 (Table 3.5.7). Aside from rising fuel and transport costs linked to the Middle East conflict, the economy was disrupted by a State of Public Emergency declared in April 2026 following rolling power outages caused by the failure of Funafuti's electricity generation and distribution systems. Although power supply stabilized after backup generation capacity arrived in June, the crisis exposed significant infrastructure and fiscal vulnerabilities. These continue to weigh on economic activity, tourism, and growth prospects.

GDP growth is revised down to 1.9% in 2026 and 1.7% in 2027. Aside from the power disruption, the revision also reflects emerging external constraints and a

Table 3.5.7 Selected Economic Indicators in Tuvalu, %*Infrastructure vulnerabilities and external shocks weigh on growth.*

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	-0.8	2.5	1.9	2.4	1.7
Inflation	2.9	3.5	4.8	1.7	3.1

GDP = gross domestic product.

Sources: Tuvalu Central Statistics Division; Tuvalu Ministry of Finance and Economic Development; Asian Development Bank estimates.

weaker base, as official GDP estimates now show a 0.8% contraction in 2025 compared with the 2.7% growth estimate in *ADO July 2026*. This is derived from weaker results in fishing, trade, and public administration. Medium-term growth will likely come from continued public expenditure, infrastructure investment, and development partner-financed projects, which include climate adaptation and disaster resilience, maritime and land transport, renewable energy, and water and sanitation initiatives. Higher government revenue from fishing licenses may add some fiscal support, with climate and fishery outlooks suggesting that shifts in the Fisheries Convergence Zone could support greater output within Tuvalu's exclusive economic zone this year.

Countercyclical policy targets economic resilience.

The fiscal position should remain stable in fiscal year (FY) 2027 (ending 30 June 2027), despite a planned deficit. Nonetheless, public finances remain vulnerable to climate-related shocks and volatile fishing license and internet domain revenues. The FY2027 budget adopts a countercyclical policy, drawing on fiscal buffers from a stronger FY2026 to support the economy amid the fuel crisis. Revenue is projected at A\$143.9 million with expenditure A\$155.8 million, resulting in a A\$11.9 million deficit equivalent to 9.5% of GDP. This compares to the A\$13.2 million surplus in FY2026, or 12.8% of GDP. Higher expenditure supports the fuel-crisis response and energy security investments, housing assistance, infrastructure development, education investments, transport connectivity, and social protection. The budget also includes costs related to Tuvalu's hosting of the pre-COP31 Leaders' Meeting in October 2026, which should boost visitor arrivals and related services. Revenue will be supported by a A\$21.1 million Tuvalu Trust Fund distribution, development partner assistance, and strong fishing license receipts.

Price pressures remain elevated. Inflation is projected at 4.8% in 2026 before moderating to 3.1% in 2027. The higher average annual 3.1% inflation in the first quarter of 2026 was driven by housing and imported food prices, which more than offset a decline in transport and alcohol and tobacco prices. Domestic price pressures remain as outmigration contributes to labor shortages and associated wage hikes, along with persistently high food and housing costs. Inflation risks are on the upside, as second quarter prices more fully reflect the pass-through of higher fuel, freight, and imported goods prices.

The outlook is subject to several risks. Downside risks include a prolonged Middle East conflict, climate-related supply chain disruptions, limited fiscal space, and continued high outmigration, which drives skills shortages across the economy. In addition, the recent electricity crisis could divert resources toward unplanned repairs and upgrades. Skill shortages linked with outmigration could also slow new infrastructure. On the upside, Tuvalu's role in international climate negotiations could unlock additional climate finance and technical assistance, supporting medium-term investment in climate resilience, water security, renewable energy and infrastructure.

North Pacific Economies

Growth projections for Palau remain as in ADO July 2026 despite the continued economic impact of the Middle East conflict, while external shocks weigh on the outlook for the Marshall Islands and the Federated States of Micronesia (FSM).

Continued disruptions related to the Middle East conflict along with the strengthening El Niño are constraining economic activity in the Marshall Islands and the FSM. They are also applying price pressures in the Marshall Islands and Palau. Domestic factors are limiting price increases in the FSM, but sustainability is a concern. Further adverse conflict-related effects along with continued climate and disaster risk could impact the economic outlook.

Marshall Islands

Growth projections have been lowered from July (Table 3.5.8). Economic activity should pick up in fiscal year 2026 (FY2026, ends 30 September 2026 for all three North Pacific economies) from the lower growth now estimated for FY2025. Nonetheless, the commodity price and supply chain impacts of the Middle East conflict are likely limiting expansion. Construction (largely public infrastructure projects funded by development partners), manufacturing, utilities, and trade are being constrained by higher prices and reduced shipping activity in the second half of FY2026. Growth should moderate in FY2027, with the impact of election-related spending and continued implementation of public infrastructure projects being offset by lingering conflict-driven effects. Agriculture and fisheries also continue to face headwinds over the forecast period, with the strengthening El Niño affecting crop conditions and aggravating ocean warming.

Table 3.5.8 Selected Economic Indicators in the Marshall Islands, %

The impacts of the Middle East conflict continue to weigh on growth and inflation prospects.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	1.8	3.0	2.2	2.6	2.0
Inflation	5.6	6.2	5.7	5.3	4.7

GDP = gross domestic product.

Note: Years are fiscal year ending on 30 September of that year.

Sources: Graduate School USA Economic Monitoring and Analysis Program; Republic of the Marshall Islands Economic Policy, Planning and Statistics Office; Asian Development Bank estimates.

Inflation projections are adjusted down. In FY2026, international price volatility and supply chain disruptions from the Middle East conflict are affecting imports and keeping inflation near its high FY2025 level, yet below the ADO July 2026 forecast. In addition, the ongoing rehabilitation of the Marshalls Energy Company's tank farm is limiting fuel storage capacity that could mitigate the impact of higher prices. Even with government support at the start of the conflict, the company needed to increase tariffs substantially to offset rising fuel costs. Although inflation should still moderate in FY2027,

following projected international fuel price trends, the tank farm rehabilitation will likely continue to limit storage capacity.

Prolonged international price volatility and supply chain disruptions remain key risks to the economic outlook.

Although the state of economic emergency declared in March 2026 was not extended when it expired in June, the Middle East conflict continues as a significant risk to growth and inflation. Any escalation or protracted conflict could bring about a spike in international oil prices or extend supply shocks, affecting overall activity in heavily import-dependent economies like the Marshall Islands.

Fiscal surpluses are likely over the forecast period.

Despite substantial expenditure pressures, especially from higher import costs, development partner grants should offset higher spending and keep the fiscal position positive.

Federated States of Micronesia

Growth projections are adjusted down due to stronger climate and disaster effects (Table 3.5.9).

Typhoon Sinlaku in April 2026 affected 34,000 people, mostly in the state of Chuuk, causing an estimated \$60 million in damage, equivalent to 12.1% of FY2025 GDP. Rising import prices driven by the Middle East conflict will likely increase reconstruction costs, slowing post-disaster recovery and affecting economic activity more broadly. The intensifying El Niño is also constraining agriculture and fisheries output more than initially expected. Nevertheless, growth should still pick up in FY2027 as economic activity normalizes

Table 3.5.9 Selected Economic Indicators in the Federated States of Micronesia, %

Domestic factors are mitigating inflationary pressures from international oil price movements.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	1.1	0.7	0.5	1.0	0.9
Inflation	2.8	3.8	3.8	3.5	3.5

GDP = gross domestic product.

Note: Years are fiscal years ending 30 September.

Sources: Graduate School USA Economic Monitoring and Analysis Program; Federated States of Micronesia Department of Resource and Development, Division of Statistics; Asian Development Bank estimates.

with easing global commodity prices, post-typhoon reconstruction and rehabilitation, and a gradually dissipating El Niño impact. Spending on Yap state elections in November 2026 and national general elections in March 2027 should provide additional stimulus. Any escalation of the Middle East conflict could further raise commodity prices and disrupt supply chains, posing significant downside risks to growth by constraining the level and pace of public spending. Prospects are also vulnerable to the country's continued exposure to severe climate-related and disaster events.

Inflation projections are retained as domestic factors contain the pass-through of higher international oil prices.

The state-owned FSM Petroleum Corporation used its financial reserves to absorb the brunt of the global oil price increase, but raised wholesale fuel prices in May by 30% of the increase in landed costs. This led to higher retail fuel prices, electricity tariffs, and domestic shipping costs across the FSM. There is anecdotal evidence of higher shipping rates and surcharges, and fewer air and sea freight shipments, which also exert retail price pressures. However, inflation should still moderate in FY2027 in line with expected fuel price trends. Thus far, there have been no further fuel price increases, but the financial sustainability of stabilization efforts will significantly affect the FSM's inflation outlook.

Higher costs for goods and services should deepen fiscal deficits during the forecast period.

The projected higher fuel, transport, and construction costs will increase pressure on public spending. Coupled with a decline in government revenue due to subdued economic activity and lower fishing license fee collections, a fiscal deficit equivalent to 1.1% of GDP is projected for FY2026. This will likely widen to 3.2% of GDP in FY2027 as expenditure grows faster than revenue. Given the prominence of state-owned enterprises in fishing, utilities, and maritime transport, the Middle East conflict could also have significant fiscal repercussions if there are no substantial price increases.

Palau

The ADO July 2026 growth projections are unchanged (Table 3.5.10).

Growth has been supported by expanding tourism along with public spending on continuing public infrastructure projects and major national and regional events, including the Belau Games and the 55th Pacific Islands Forum

Table 3.5.10 Selected Economic Indicators in Palau, %

Growth projections are unchanged while the inflation forecast inches up for FY2026.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	6.9	5.8	5.8	3.6	3.6
Inflation	0.2	2.9	3.0	2.5	2.5

FY = fiscal year, GDP = gross domestic product.

Note: Years are fiscal years ending 30 September.

Sources: Republic of Palau Ministry of Finance; Asian Development Bank estimates.

Leaders Meeting. International tourist arrivals in the first three quarters of FY2026 reached 96.7% of FY2019 levels. However, tourism and growth generally should moderate in FY2027 as the economy shifts from recovery back into its long-term trend, affected by heightened global uncertainty, rising energy prices, and higher airfares. Downside risks include increased competition from other tourist destinations, exchange rate depreciation in key source markets, and higher-than-expected travel costs from elevated fuel prices linked to the Middle East conflict.

International tourist arrivals rose by 32.6% as of June 2026.

The recovery of the Japanese market gained momentum with the return of direct flights from Tokyo at end-October 2025, with arrivals surging by 76.5% according to latest available data. The People's Republic of China remains the largest source market (34.2%) with arrivals jumping by 50.7% from FY2025. Visitor arrivals from Australia rose by 89.0% as direct flights continued.

The inflation forecast inches up for FY2026 and remains unchanged for FY2027.

The upward revision reflects higher global oil prices and freight costs since ADO July 2026, as increased import and transportation costs affected by the Middle East conflict pass through to domestic prices. According to a rebased consumer price index report, consumer prices increased by 3.0% year on year in the third quarter of FY2026, led by transport (19.5%), food and non-alcoholic beverages (2.2%), and miscellaneous goods and services (3.8%) (see Box). These increases outweighed the 28.1% decline in communication costs. In response, the government expanded its national public transportation program to help cushion the impact of higher fuel costs on consumers.

Box Palau's Rebased Consumer Price Index

The consumer price index (CPI) released with provisional first quarter 2026 data in April has been rebased to the fourth quarter of 2025. The new basket includes weights based on the Household Income and Expenditure Survey 2023/2024. Food and non-alcoholic beverages still bear the largest weight (26.0%). Restaurants and hotels (12.2%) as well as miscellaneous goods and services (11.8%) notably saw weight increases. Alcoholic beverages, tobacco, and narcotics now comprise only 7.1% of the basket, down from 17.2%.

The revised CPI basket introduces a "Goods and Services" classification, replacing the previous "Domestic and Imported Goods and Services" classification used earlier. An expanded selection of goods and services and larger sample from the 2023/24 survey along with wider price collection coverage allowed for the classification change. The "Goods index" includes food, fuel, furniture and furnishings, and beauty products, and is largely

a reflection of prices of imported goods. The "Service index" is affected mainly by labor costs and comprises laundry services, rent, car maintenance, education, restaurant services, and personal services. Goods make up 72% of the CPI basket with the rest composed of services.

CPI reports will continue to report indices of 12 groups according to the Classification of Individual Consumption According to Purpose (1999).

The revised index has been linked to the previous CPI series (third quarter 2016 = 100). Price surveys are conducted quarterly during the middle month of each quarter from a representative range of retail outlets. After consultations with the International Monetary Fund, revisions were made to first quarter 2026 provisional data and were released in the second quarter report.

Source: Republic of Palau Ministry of Finance.

A fiscal surplus of 2.7% of GDP is projected for FY2026, supported by continued economic growth and development partner funding.

In the FY2026 supplemental budget approved in July, \$17.2 million was appropriated for projects supported by the Infrastructure Maintenance Fund established by the 2023 Compact Review Agreement with the United States. Around \$21.1 million, with 65.4% sourced from the agreement's Debt Consolidation Fund, was appropriated for debt servicing. Other development partners also provide grants for public service and infrastructure projects, including those for renewable energy and sanitation.

South Pacific Economies

Growth prospects across most of the South Pacific have softened.

Tourism remained a key driver in the Cook Islands and Samoa. It moderated in Niue, however, and contracted in Tonga. Strong construction supported the Cook Islands and Niue economies, but delays in public investment projects and slower credit growth constrained activity in Samoa and Tonga. Drier conditions across the South Pacific due to strengthening El Niño limited agricultural output. Growth forecasts have been revised down in Niue, Samoa, and Tonga and inflation revised up in all South Pacific economies as external headwinds intensify. Risks to the outlook remain tilted to the downside, led by the continued unfavorable external environment.

Cook Islands

Growth exceeded forecasts in fiscal year (FY) 2026 (ended 30 June 2026 for all four South Pacific economies), as tourism expanded faster than expected (Table 3.5.11).

Visitor arrivals increased by 8.1% in the first 11 months of FY2026 (July 2025 to May 2026), exceeding projections in ADO July 2026. Arrivals grew by an average 9.7% year on year in April and May 2026, despite uncertainty arising from the Middle East conflict. Construction was robust in the first half of FY2026, with residential building approvals increasing by 29.2%. Merchandise imports also increased by 5.1% year on year in March and April 2026, broadly in line with ADO July 2026 projections and consistent with tourism activity and domestic demand. Fuel imports were steady, indicating that potential risks to fuel supply and import costs did not materialize.

Table 3.5.11 Selected Economic Indicators in the Cook Islands, %

Growth is revised up due to higher tourism, but uncertainty from the ongoing Middle East conflict is a risk to the outlook.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.0	2.7	3.5	3.0	3.5
Inflation	2.0	3.5	4.5	3.3	4.0

GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

Sources: Cook Islands Statistics Office; Asian Development Bank estimates.

Tourism, along with greater access to finance, is projected to drive GDP up by 3.5% in FY2026 and FY2027.

The introduction of routes to Christchurch, New Zealand and flights from Brisbane, Australia in May 2026 will support robust tourism growth. The economic outlook was also buoyed by investor confidence after the August 2026 general election showed political stability. In addition, improved access to private financing, including foreign investment in the fashion industry and enhanced central bank trade finance facilities, should stimulate growth.

Inflation estimates are higher than forecast in ADO July 2026.

Inflation was 4.5% in FY2026, driven by imported food prices and tariff adjustments that included an increase in the tobacco excise tax partially offset by selected duty exemptions on personal imports. The FY2027 inflation forecast is revised up to 4.0%, from 3.3%, reflecting the economy's reliance on imports and exposure to external price shocks.

Contrary to a planned deficit, the fiscal position was likely in surplus in FY2026.

Preliminary estimates put the fiscal surplus in FY2026 at 4.2% of GDP, compared with a 5.0% surplus in FY2025 and the 3.1% deficit estimated at the time of the FY2026 budget. The stronger outcome reflects an operating surplus supported by higher tax and nontax revenue and lower expenditure. Staffing vacancies restrained operating expenditure, while delays in implementing capital projects led to a larger shortfall in capital spending. The fiscal deficit for FY2027 was revised slightly down to 1.8% of GDP in the July 2026 pre-election update from the previous 1.9% target, providing space for continued capital investment while complying with the

–2.0% of GDP fiscal rule. Debt is projected to decline gradually in line with the government’s prudent fiscal position and debt management policy. In addition, the passage of the Cook Islands Sovereign Wealth Fund Act 2026 strengthens the framework for fiscal resilience by managing national savings and potential minerals revenue.

Risks to the outlook are balanced. Downside risks stem from continued uncertainty in the global economic environment, including the Middle East conflict, which could further raise fuel and transport costs while weakening visitor demand. On the upside, ongoing structural reforms, continued investment in sustainable tourism infrastructure, and preparations for the Pacific Mini Games 2029 should support economic activity. Green Climate Fund financing equivalent to 10.5% of GDP for community and business development approved in late 2025, along with planned investments in water and energy security on top of continued critical mineral exploration will support medium-term growth. However, this depends on improved project delivery, effective management of environmental concerns, and the capture of future resource revenue to build the sovereign wealth fund.

Niue

Growth forecasts are revised down for the near term (Table 3.5.12). Economic growth likely slowed to 1.0% in FY2026, as visitor arrivals during July 2025 to April 2026 were lower than a year earlier, contrary to expectations of a modest expansion. A prolonged Middle East conflict could further slow tourism, the country’s most important industry. This contributed to the downward revision to FY2027 growth projections. Tourism, public investment, and externally financed infrastructure projects will continue to be the main

drivers of growth. Construction remains underpinned by the near completion of the NZ\$20.5 million Hikufenoga solar farm and battery storage project, equivalent to about 38% of GDP. It will reduce reliance on imported diesel while supporting the government’s target of generating 80% of electricity from renewables by end-2026.

Economic activity will moderate as projects are completed. Growth could soften as the solar energy project nears completion and tourism demand moderates amid higher travel costs and global uncertainty. Tourism will continue to benefit from Air New Zealand’s twice-weekly Auckland services. Ongoing work toward redeveloping Sir Robert’s Wharf will bolster construction. In addition, Niue recently secured \$9 million in funding from the Global Environment Facility, United Nations Development Programme, and Conservation International for climate and ocean resilience for supporting infrastructure protection, climate adaptation, and community resilience. The re-election of the incumbent government in May 2026 allows for policy continuity and implementation of planned infrastructure and resilience initiatives.

Inflation is expected to remain driven largely by imported costs. Dependence on imported goods, fuel, and construction materials leaves domestic costs highly exposed to movements in global commodity and freight market prices. The government held fuel prices steady until June 2026, absorbing costs to protect households and businesses. On 1 June 2026, petrol rose to NZ\$4.00 per liter from NZ\$3.80 and diesel to NZ\$4.20 per liter from NZ\$4.00. Coupled with high inflation in the March 2026 quarter, projections are revised up to 3.8% in FY2026 and FY2027, higher than ADO July 2026, due to increased transportation and operating costs, with some pass-through to consumer prices in the near term.

The fiscal outlook remains expansionary.

The FY2027 budget projects NZ\$83.4 million in expenditure and NZ\$65.8 million in revenue, resulting in a NZ\$17.6 million deficit. This reflects continued investment in climate-resilient infrastructure, renewable energy, and public services. Consistent with Niue’s no-borrowing policy, fiscal outcomes will depend on the government’s ability to align expenditure with available revenue and external

Table 3.5.12 Selected Economic Indicators in Niue, %

Growth forecasts are revised down with inflation raised.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	2.0	2.5	1.0	2.5	2.0
Inflation	2.3	3.4	3.8	2.8	3.8

GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

Sources: Niue Statistics Office; Asian Development Bank estimates.

grants. Development partner support will remain critical to financing capital investment, while the transition to renewable energy reduces exposure to fuel price volatility and lower energy-related costs over time. Nonetheless, the narrow domestic revenue base and rising expenditure needs will continue to weigh on fiscal sustainability.

Downside risks to the outlook persist. Weaker tourism demand, higher global energy and transport costs, and delays in project implementation could dampen growth. The economy remains vulnerable to external shocks and climate-related disasters, and dependent on development assistance. Structural constraints, particularly labor shortages and accommodation constraints, will continue to limit the expansion of tourism and other sectors.

Samoa

Weaker investment dampens FY2026 growth (Table 3.5.13). Reports indicate the economy contracted during the first 9 months of FY2026 (July 2025 to March 2026). Temporary delays in government spending under the FY2026 budget, particularly public infrastructure projects, arising from the 2025 snap elections and delayed budget enactment contributed to a drop in construction and transport services. Commerce shrank on weaker demand largely due to public investment project delays, contributing to lower imports of machinery and transport equipment and slower growth in commercial bank credit. Agriculture was hit by below average rainfall. Fisheries also contracted due to fewer large longline fishing vessels operating given the low market prices relative to operating costs. In contrast, tourist arrivals

increased by 5.6% in FY2026 and supported growth in accommodation and restaurants, communications, finance, and business services. A 5.5% growth in remittance inflows in FY2026 further supported household spending.

El Niño-related disruptions and spillover effects from the Middle East conflict dampen the FY2027 outlook. The FY2027 growth forecast is revised down to 2.0% from 3.0% in ADO July 2026, reflecting El Niño-related weather disruptions and volatility in global commodity prices. El Niño conditions are expected to reduce agricultural output in FY2027, while vessel operating costs continue to dampen commercial fishing activity. Growth in tourism-related services, such as transport and accommodation, will likely moderate as higher jet fuel prices in the second half of 2026 push up international airfares and government-approved increases in taxi and bus fares raise domestic travel costs. Meanwhile, new energy investments and accelerated construction activities should support industrial output and related trade.

The fiscal deficit comes from higher spending on energy security. The FY2027 budget remains expansionary, with the fiscal deficit targeted at 3.1% of GDP. As the country relies heavily on imported fuel for transport and electricity generation, the budget provides added support for energy security, including 7% of spending on liquidity support for energy and water utilities as well as three new solar farms.

Higher fuel and transport costs could drive up inflation. Inflationary pressures remained moderate through most of FY2026, with full year average inflation 1.4% in FY2026, slightly more than the 1.2% ADO July 2026 estimate. However, inflation accelerated toward the end of the fiscal-year, with inflation year on year reaching 5.8% in June 2026 on higher transport, fuel, food, and housing costs including electricity, gas, and other fuels. Inflation is projected to rise to 5.0% in 2027, higher than the previous projection of 4.0%, reflecting continued high global fuel prices and the 30% increase in taxi and bus fares effective July 2026.

Downside risks stem from both domestic and external factors. External risks include further disruptions to global energy markets and shipping routes, which increase prices for fuel and imported

Table 3.5.13 Selected Economic Indicators in Samoa, %

Growth forecasts are revised down for both years, as investment delays along with weather events weigh on domestic demand; inflation projections are revised up on higher fuel and transport costs.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.2	2.0	0.4	3.0	2.0
Inflation	1.9	1.2	1.4	4.0	5.0

GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

Sources: Samoa Bureau of Statistics; Asian Development Bank estimates.

goods, thus increasing business costs and reducing household purchasing power. Domestic factors include delays in budget implementation and continued weak credit growth that could slow investment growth.

Tonga

After a 4.4% expansion in FY2025, growth is estimated to have slowed to 2.3% in FY2026 as delays occur in implementing new projects and external headwinds intensify (Table 3.5.14).

Private investment remained subdued, with container registrations down by 4.8% to 11,944 and annual average private credit growth slowing to 2.0% on weak import-related and business activity. Total visitor arrivals contracted by 1.3% in FY2026 as a decline in cruise ship visitors more than offset a 12.9% increase in air arrivals. In contrast, remittance inflows expanded by 13.2% to T\$612.2 million, supporting household consumption and cushioning economic activity.

Government response measures will offer economic support in FY2027. Tourism is expected to soften further as higher travel costs reduce visitor demand from key source markets. High inflationary pressures will likely further weaken household purchasing power and raise business operating costs. However, countercyclical measures introduced in the current national budget should partially offset the adverse economic impact from the Middle East conflict. Despite this fiscal support, El Niño-related weather conditions could disrupt agricultural output and heighten exposure to climate-related shocks, posing downside risks to growth and fiscal results.

Inflation will likely remain elevated, driven by imported cost pressures. Annual average prices increased by 4.0% in FY2026, slightly higher than estimated in ADO July 2026. Higher fuel prices, increased freight charges, and a 35.8% rise in electricity

Table 3.5.14 Selected Economic Indicators in Tonga, %

The growth forecast for next year has been downgraded, with inflation up due to the ongoing Middle East conflict and potentially adverse El Niño weather.

	2025	2026		2027	
		Jul	Sep	Jul	Sep
GDP growth	4.4	2.3	2.3	2.3	1.8
Inflation	2.9	3.8	4.0	2.7	6.0

GDP = gross domestic product.

Note: Years are fiscal years ending on 30 June of that year.

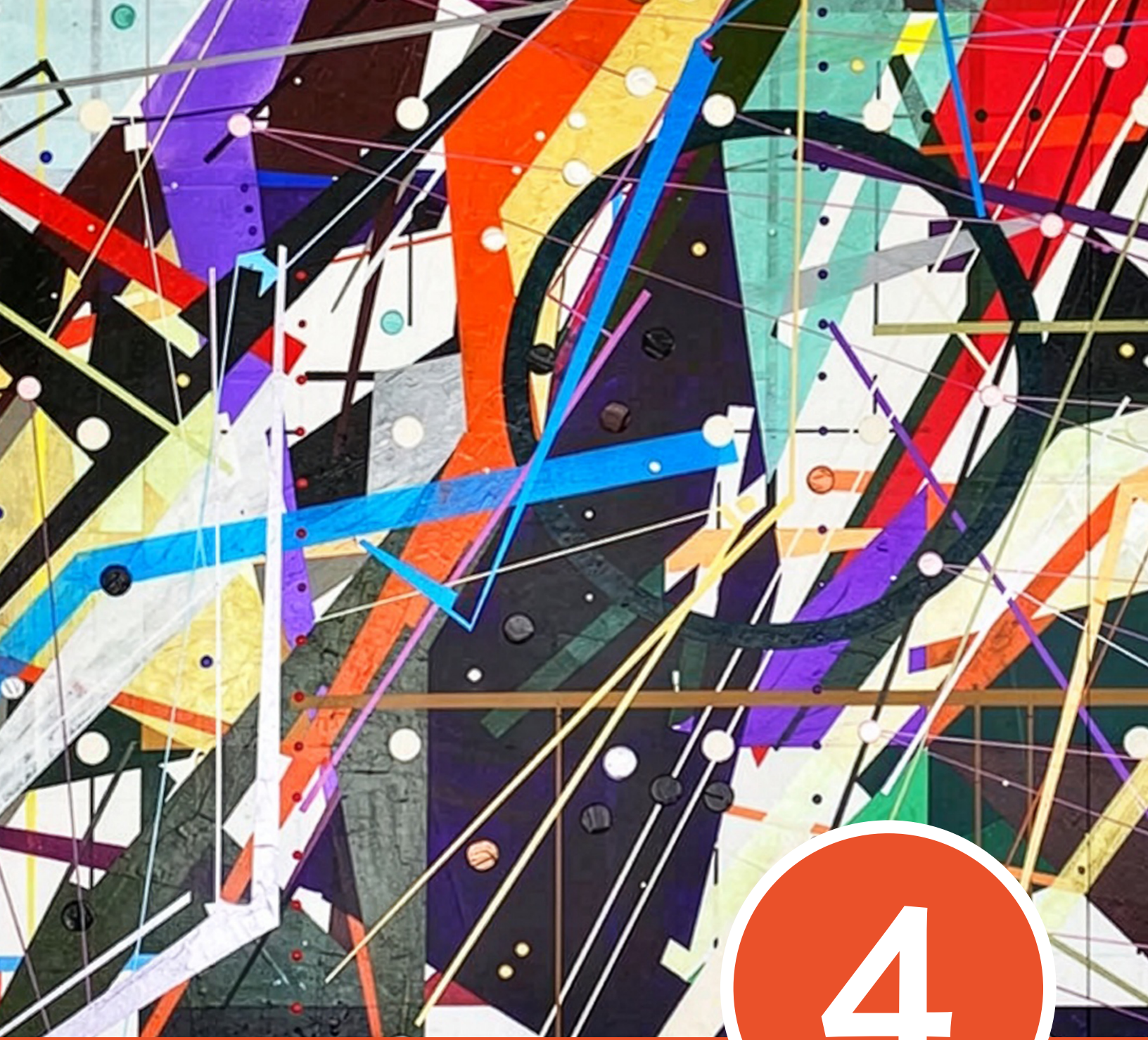
Sources: Tonga Statistics Department; Asian Development Bank estimates.

tariffs will pass through to a broad range of consumer goods and services, with the FY2027 forecast revised up to 6.0%.

Fiscal and external balances will suffer from higher import costs should the Middle East conflict continue. The FY2027 budget projects a deficit of T\$38.1 million, equivalent to 2.1% of GDP, driven by higher expenditure on electricity subsidies, transportation support, welfare assistance, and cost-of-living measures in response to the Middle East conflict. Simultaneously, higher fuel and freight costs will increase the import bill and widen the trade deficit further, placing pressure on foreign reserves.

Risks to the outlook remain tilted to the downside.

The economy remains heavily dependent on imports, grants, tourism, and remittance inflows, with remittances equivalent to about 40% of GDP. The emerging, potentially very strong El Niño conditions continue to pose significant risks to agriculture, infrastructure, and domestic food prices. Comfortably high foreign reserves, currently equivalent to about 11.5 months of import cover, could come under pressure with possible reductions in tourism receipts and remittances.



4

STATISTICAL APPENDIX



STATISTICAL NOTES AND TABLES

The statistical appendix presents economic indicators for the 50 Asian Development Bank (ADB) member economies in two tables: gross domestic product (GDP) growth and inflation. Regional ADB member economies are split into two groups: advanced Asia and the Pacific (AAP) and developing Asia and the Pacific (DAP). AAP comprises Australia; Hong Kong, China; Japan; the Republic of Korea; New Zealand; Singapore; and Taipei, China. DAP includes all remaining regional members from the Caucasus and Central and West Asia, developing East Asia, South Asia, developing Southeast Asia, and the Pacific. The tables contain forecasts for 2026–2027 and historical data for GDP and inflation from 2023.

The data are standardized to the degree possible to allow comparability over time and across economies, but differences in statistical methodology, definitions, coverage, and practices make full comparability impossible. National income accounts are based on the United Nations System of National Accounts. Historical data are obtained from official sources, statistical publications, and databases, as well as documents from ADB, the International Monetary Fund, and the World Bank. For some economies, 2025 data are estimated from the latest available information. Projections for 2026 and 2027 are generally ADB estimates based on available quarterly or monthly data.

Most economies report by calendar year. The following record government finance data by fiscal year: Bhutan; Brunei Darussalam; Fiji; Hong Kong, China; Singapore; Tajikistan; Thailand; and Tuvalu (starting 2025). Reporting all variables by fiscal year are South Asian countries (except Bhutan, Maldives, and Sri Lanka), the Cook Islands, the Federated States of Micronesia, Myanmar, the Marshall Islands, Naoero, Niue, Palau, Samoa, and Tonga.

Regional and subregional averages are provided in the two tables. Averages are weighted by purchasing power parity GDP in current international dollars. Purchasing power parity GDP data for 2021–2024 are obtained from the IMF World Economic Outlook Database, October 2025 edition. Weights for 2024 are carried over to 2027.

The following paragraphs discuss the two tables in greater detail.

Table A1: Gross Domestic Product Growth Rate, % per year. The table shows annual growth rates of GDP valued at constant market prices, factor costs, or basic prices. GDP at market prices is the aggregate value added by all resident producers at producers' prices including taxes less subsidies on imports plus all nondeductible value added or similar taxes. Most economies use constant market price valuation. Pakistan uses constant factor costs.

Table A2: Inflation, % per year. Data on inflation rates are period averages. Inflation rates are based on consumer price indexes. The consumer price indexes of the following economies are for a given city only: Cambodia is for Phnom Penh, the Marshall Islands for Majuro, and Sri Lanka for Colombo.

Table A1 Gross Domestic Product Growth Rate, % per Year

	2023	2024	2025	2026		2027	
				Jul	Sep	Jul	Sep
Developing Asia and the Pacific (DAP)	5.4	5.3	5.5	4.9	5.0	5.1	5.1
DAP excluding the People's Republic of China	5.5	5.7	6.0	5.3	5.4	5.7	5.6
Caucasus and Central and West Asia	5.2	4.4	4.6	3.8	3.7	4.2	4.1
Armenia	8.3	5.9	7.1	5.0	5.0	5.5	5.5
Azerbaijan	1.4	4.2	1.4	2.0	1.6	1.8	1.8
Georgia	7.8	9.7	7.5	5.5	6.3	5.2	5.2
Kazakhstan	5.1	5.0	6.5	4.8	4.8	4.5	4.5
Kyrgyz Republic	9.0	11.5	11.1	8.9	8.9	8.4	8.4
Tajikistan	8.3	8.4	8.4	7.3	7.0	6.8	6.8
Türkiye	5.0	3.5	3.7	3.1	2.8	3.8	3.6
Turkmenistan	6.3	6.3	6.3	6.3	6.3	6.2	6.2
Uzbekistan	6.3	6.7	7.7	6.7	7.0	6.8	6.8
Developing East Asia	5.4	5.0	5.0	4.6	4.6	4.5	4.5
People's Republic of China	5.4	5.0	5.0	4.6	4.6	4.5	4.5
Mongolia	7.4	5.1	6.8	5.7	5.7	6.0	6.0
South Asia	6.2	6.4	7.0	6.0	6.4	6.7	6.5
Afghanistan	-6.2	2.3	1.9	2.3	1.5	3.0	2.2
Bangladesh	5.8	4.2	3.5	3.7	3.7	4.5	4.0
Bhutan	4.9	7.5	8.5	6.5	6.5	7.2	7.2
India	7.2	7.1	7.8	6.6	7.0	7.3	7.1
Maldives	4.9	3.5	6.2	1.0	1.0	3.0	3.0
Nepal	2.0	3.7	4.4	3.9	3.9	4.5	4.1
Pakistan	-0.2	2.6	3.2	3.7	3.7	3.7	3.7
Sri Lanka	-2.0	5.0	5.0	4.0	4.0	4.0	4.0
ASEAN	4.1	5.0	4.8	4.5	4.7	4.6	4.7
Developing Southeast Asia	4.4	5.0	4.8	4.6	4.7	4.8	4.9
Brunei Darussalam	1.1	4.1	1.0	1.8	1.2	1.9	1.9
Cambodia	5.0	6.0	5.3	4.1	3.9	4.7	4.7
Indonesia	5.0	5.0	5.1	5.2	5.2	5.2	5.2
Lao People's Democratic Republic	3.7	4.0	4.4	4.0	4.0	4.5	4.5
Malaysia	3.6	5.2	5.2	4.6	4.9	4.5	4.7
Myanmar	0.8	-0.7	-2.2	2.4	2.2	2.7	2.7
Philippines	5.5	5.7	4.4	3.8	3.3	5.3	5.1
Thailand	2.2	2.9	2.4	1.8	2.0	2.0	1.9
Timor-Leste	2.4	4.3	4.5	3.8	4.0	4.1	4.1
Viet Nam	5.1	7.1	8.0	7.2	7.8	7.0	7.6
The Pacific	5.3	3.9	4.5	3.3	3.0	3.2	2.9
Cook Islands	14.0	15.1	4.0	2.7	3.5	3.0	3.5
Fiji	9.8	3.6	2.5	2.6	2.2	2.5	1.9
Kiribati	3.3	4.6	4.3	3.1	3.1	2.6	2.6
Marshall Islands	-5.0	2.5	1.8	3.0	2.2	2.6	2.0
Federated States of Micronesia	1.1	2.3	1.1	0.7	0.5	1.0	0.9
Naoero	-7.1	0.8	2.6	2.5	2.5	2.5	2.5
Niue	7.9	7.0	2.0	2.5	1.0	2.5	2.0
Palau	1.2	12.0	6.9	5.8	5.8	3.6	3.6
Papua New Guinea	3.8	3.9	5.2	3.6	3.4	3.4	3.2
Samoa	15.2	4.8	4.2	2.0	0.4	3.0	2.0
Solomon Islands	2.8	3.0	3.6	3.0	1.7	3.4	3.3
Tonga	3.4	1.4	4.4	2.3	2.3	2.3	1.8
Tuvalu	-0.9	6.4	-0.8	2.5	1.9	2.4	1.7
Vanuatu	5.8	3.8	3.8	4.7	4.7	3.9	3.9
Advanced Asia and the Pacific	1.3	1.6	2.5	2.6	3.1	1.7	2.0
Australia	2.1	1.1	2.0	2.0	2.0	1.7	1.7
Hong Kong, China	3.2	2.6	3.6	3.0	4.2	2.5	2.5
Japan	0.7	-0.2	1.2	0.7	0.7	0.8	0.8
Republic of Korea	1.5	2.2	1.1	2.6	3.2	2.0	2.3
New Zealand	2.2	-0.3	0.2	1.6	1.6	2.5	2.5
Singapore	1.5	5.3	5.0	3.2	5.0	2.4	3.0
Taipei, China	1.1	5.3	8.8	9.5	11.0	4.0	5.0
Asia and the Pacific	4.7	4.7	5.0	4.5	4.7	4.5	4.5

ASEAN = Association of Southeast Asian Nations.

Source: Asian Development Outlook database.

Table A2 Inflation, % per Year

	2023	2024	2025	2026		2027	
				Jul	Sep	Jul	Sep
Developing Asia and the Pacific (DAP)	5.7	5.3	3.0	4.3	4.2	3.4	3.5
DAP excluding the People's Republic of China	11.3	10.5	6.0	7.5	7.7	5.9	6.2
Caucasus and Central and West Asia	38.3	41.1	25.6	22.0	23.1	16.3	17.6
Armenia	2.0	0.3	3.3	4.2	4.2	3.5	3.5
Azerbaijan	8.8	2.2	5.6	5.7	5.9	4.9	5.0
Georgia	2.5	1.1	3.9	4.9	5.2	3.3	3.3
Kazakhstan	14.5	8.7	11.4	10.4	10.4	9.5	9.5
Kyrgyz Republic	10.8	5.0	8.2	11.2	11.2	8.5	8.5
Tajikistan	3.8	3.6	3.5	4.5	4.5	4.7	4.7
Türkiye	53.4	60.0	35.2	29.7	31.5	21.5	23.5
Turkmenistan	1.4	5.5	5.5	6.0	6.0	6.0	6.0
Uzbekistan	10.0	9.4	7.3	6.5	6.7	5.0	5.0
Developing East Asia	0.2	0.2	0.0	1.2	0.9	0.9	0.9
People's Republic of China	0.2	0.2	0.0	1.2	0.9	0.9	0.9
Mongolia	10.4	6.2	8.6	7.8	10.7	6.8	8.3
South Asia	7.9	6.4	2.9	5.7	5.5	4.8	4.8
Afghanistan	10.6	-7.7	-4.2	3.6	3.6	5.5	7.0
Bangladesh	9.0	9.7	10.0	9.0	8.7	8.8	9.0
Bhutan	4.2	2.8	3.5	4.5	6.5	4.0	4.5
India	5.4	4.6	2.1	5.2	5.0	4.0	4.0
Maldives	2.9	1.4	4.0	5.0	2.2	4.0	2.0
Nepal	7.7	5.4	4.1	3.2	3.1	5.0	5.3
Pakistan	29.2	23.4	4.5	7.2	7.1	8.3	8.3
Sri Lanka	17.4	1.2	-0.5	6.0	6.0	5.2	5.2
ASEAN	4.2	3.0	2.0	3.8	3.9	2.9	3.2
Developing Southeast Asia	4.1	3.0	2.1	3.9	4.0	2.9	3.3
Brunei Darussalam	0.4	-0.4	-0.3	1.1	1.1	0.5	0.5
Cambodia	2.1	0.8	2.5	4.5	4.7	2.5	2.8
Indonesia	3.7	2.3	1.9	3.0	3.3	2.5	3.0
Lao People's Democratic Republic	31.2	23.1	7.7	9.8	8.0	6.7	6.5
Malaysia	2.5	1.8	1.4	2.0	2.0	1.9	2.0
Myanmar	27.5	29.6	17.0	24.0	24.0	16.0	16.0
Philippines	6.0	3.2	1.7	5.9	5.9	3.9	4.4
Thailand	1.2	0.4	-0.1	2.9	2.5	1.3	1.3
Timor-Leste	8.4	2.1	0.5	2.2	1.0	2.0	1.8
Viet Nam	3.3	3.6	3.3	4.0	4.3	3.8	4.0
The Pacific	3.2	1.7	2.9	4.2	4.6	3.5	4.1
Cook Islands	13.2	4.5	2.0	3.5	4.5	3.3	4.0
Fiji	3.0	3.9	-1.4	3.6	3.9	1.9	2.5
Kiribati	9.3	2.6	5.9	5.3	4.0	4.2	4.0
Marshall Islands	7.4	5.7	5.6	6.2	5.7	5.3	4.7
Federated States of Micronesia	6.2	5.4	2.8	3.8	3.8	3.5	3.5
Naoero	4.8	9.3	6.1	4.5	4.5	4.0	4.0
Niue	5.1	5.4	2.3	3.4	3.8	2.8	3.8
Palau	12.4	3.7	0.2	2.9	3.0	2.5	2.5
Papua New Guinea	2.3	0.6	4.4	4.6	5.0	4.0	4.6
Samoa	12.0	3.6	1.9	1.2	1.4	4.0	5.0
Solomon Islands	5.1	4.2	2.7	4.5	5.5	2.8	5.0
Tonga	12.6	8.0	2.9	3.8	4.0	2.7	6.0
Tuvalu	7.0	0.4	2.9	3.5	4.8	1.7	3.1
Vanuatu	11.2	1.1	0.7	2.0	2.0	2.7	2.7
Advanced Asia and the Pacific	3.6	2.6	2.5	2.6	2.4	2.1	2.1
Australia	5.6	3.2	2.9	4.3	4.3	2.6	2.8
Hong Kong, China	2.1	1.7	1.4	2.0	2.0	1.8	1.9
Japan	3.3	2.7	3.2	2.1	1.9	2.1	2.1
Republic of Korea	3.6	2.3	2.1	2.7	2.7	2.2	2.2
New Zealand	5.7	2.9	2.8	3.8	3.8	2.5	2.5
Singapore	4.8	2.4	0.9	2.2	2.2	1.9	1.9
Taipei, China	2.5	2.2	1.7	2.0	2.0	1.8	1.7
Asia and the Pacific	5.3	4.8	2.9	4.0	3.9	3.2	3.3

ASEAN = Association of Southeast Asian Nations.

Source: Asian Development Outlook database.

Asian Development Outlook September 2026

Navigating Prolonged Energy Shocks and El Niño

Growth in developing Asia and the Pacific is projected to moderate from 5.5% in 2025 to 5.0% in 2026 and 5.1% in 2027, as prolonged energy market disruptions weigh on economic activity. Firm domestic demand, government stimulus, and strong technology exports driven by the artificial intelligence boom will support activity, helping offset a substantial drag from higher trade and energy costs. The inflation forecast is trimmed to 4.2% in 2026, as broad and fiscally costly subsidies cushion higher energy prices, before easing to 3.5% in 2027. Downside risks remain elevated, including further geopolitical escalation, a worse-than-expected El Niño, tighter financial conditions, and renewed trade policy uncertainty. This report includes an analytical chapter examining how elevated public and private debt may constrain monetary policy, and a special topic on what a very strong El Niño means for economies in Asia and the Pacific.

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