

Emerging Insight

Asia's policy rate gap – time to mend?

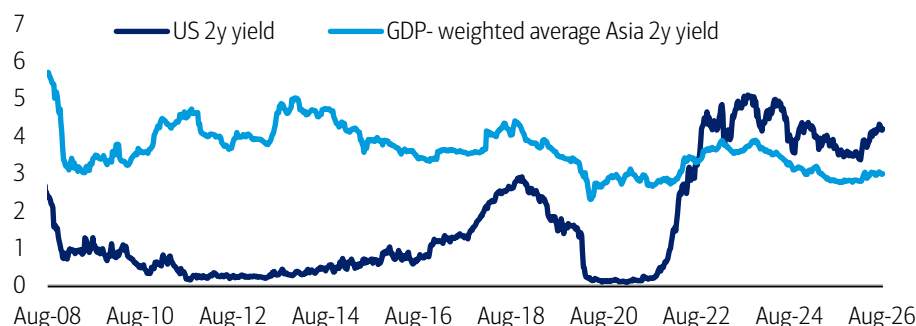
Key takeaways

- US-Asia front-end yield gap has widened, keeping the Fed's rate advantage a headwind for Asia FX appreciation.
- BoT and BoK seen on hold, BSP to hike 25bps; we are non-consensus on BoK versus a market expecting a hike.
- IDR, INR and PHP already lead the Fed; KRW and TWD must catch up while CNY, MYR and THB lag on convergence.

By Claudio Piron

Exhibit 1: The US-Asia front-end yield gap widened recently as the US 2y yield has been on a steep upward trajectory since the onset of the US- Iran conflict

2y yields- GDP-weighted Asia average vs the US



Source: BofA Global Research, Bloomberg, Haver

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Addressing the yield gap - one policy at a time

Asian monetary policy remains is the focus this week as three key central banks are set to announce their policy decisions: BoT on Wednesday, BoK and BSP Thursday. We expect the BoT and BoK to hold, but the BSP to hike 25bps. We are non-consensus on the BoK with the majority of the analysts and the markets expecting a hike.

The slow pace of Asia's monetary convergence with the Fed means the yield gap advantage of the US vs Asia (see chart above) remains a headwind for Asia FX appreciation. We evaluate which Asian central banks will be faster to converge and which will lag. IDR, INR and PHP are ahead of the Fed by virtue of their need to stabilize their currencies amid higher oil prices and current account deficits. KRW and TWD will need to pick up the pace in coming months, while CNY, MYR and THB lag with reason.

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Glossary:

BSP: Bangko Sentral ng Pilipinas

BI: Bank Indonesia

BoT: Bank of Thailand

BoK: Bank of Korea

The policy rate gap – time to mend?

EM Asia maintained a higher (simple) average policy rate than the Fed over the past one and half decades until the Fed hiking cycle of 2022-23 flipped the script (Exhibit 2). At that time, EM Asian central banks expectedly mirrored Fed's hawkish policy decisions as the Fed embarked on the steepest hike since the 1980s, increasing policy rate from 0.25% in Feb 2022 to 5.5% in July 2023.

The Fed's positive yield gap over Asia is being maintained, despite a subsequent easing cycle as US inflation has remained sticky and above target.

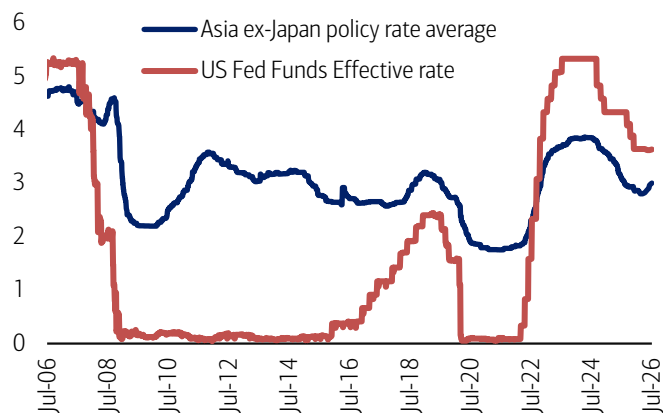
A closer look at the individual rate differentials reveal that the rate gap which was positive at the start of the Fed's monetary policy tightening in March 2022, turned negative for most of the Asian economies by the cycle-end (Exhibit 3), particularly China (kept its rates unchanged at 4.25%) and Taiwan (moderate increase in rates over the period). In contrast, India, Indonesia and Philippines managed to hike their rates enough to stay above Fed's, suppressing capital outflows and depreciation pressure on their currencies.

Notably, only these three countries in our universe, currently enjoy a policy rate advantage over US. On the other hand, Thailand and China have widest negative spreads with the US relative to narrower differentials of Malaysia and Korea.

We further look at the underlying inflationary pressure to ascertain which economies might have the highest urgency to close the gap as the Middle East conflict drags on, risk of second-order price effect looms and the potential of three Fed hikes (BoFA estimates) by year-end persists.

Exhibit 2: US has significantly closed the gap with Asia

Asia ex-Japan policy rate (simple average) vs US Fed funds effective rate (%)

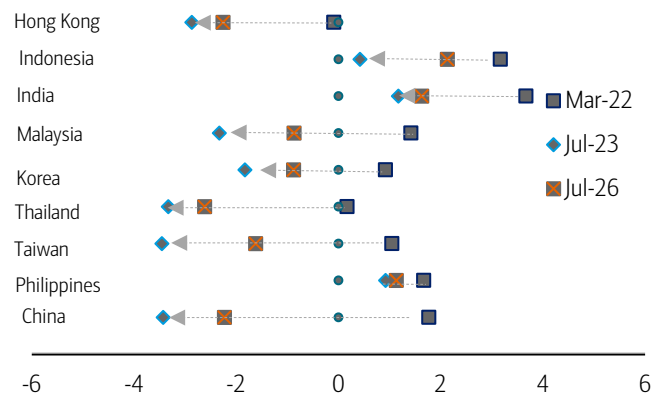


Source: BofA Global Research, Bloomberg. Note: Asia countries included China, Philippines, Taiwan, Thailand, Korea, Malaysia, India, Indonesia, Hong Kong

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Exhibit 3: India, Indonesia and Philippines have positive differentials with US

Policy Rate Differential: Asian ex-Japan economies and US



Source: BofA Global Research, Bloomberg

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Inflationary pressure losing steam on face value

The impact of the Iran conflict was most visible in crude oil prices that skyrocketed to \$118/bbl in March, a 58% year-on-year increase. Being net energy importers, oil price volatility usually flows into the inflation prints of most Asian economies. Exhibit 4 shows Brent crude y/y inflation peaking by April-end (81% y/y rise in oil) followed by the APAC inflation surprise index rising with a lag, to 12.7 by May-end.

As crude prices corrected on y/y basis thereafter, Asia's inflation shock seemingly moderated, providing an apparent signal that the worst of inflationary pressures have been behind us. Exhibit 5 reinforces this as July inflation prints marginally overshot market expectations, only for India and Taiwan in the region while downside surprises

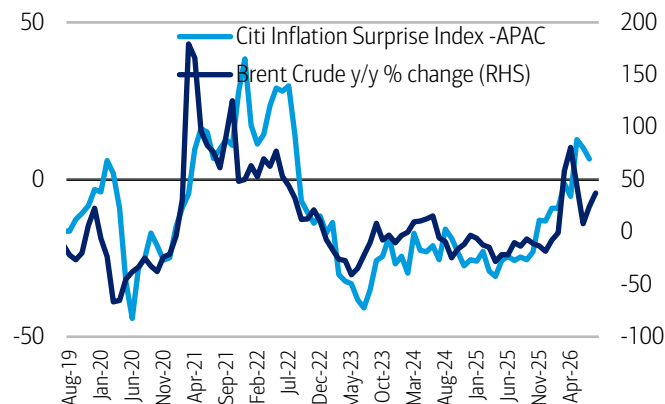


were concentrated in Indonesia, China and Thailand (significantly lower than their 10y historical norms).

However, the input-output price spreads in Exhibit 6 show that the underlying cost pressures are still quite firm. All economies except Thailand recorded higher input prices as compared to their July output prices while the highest upstream price pressure was felt in Indonesia and Taiwan.

Exhibit 4: Inflation surprises appear to have moderated after peaking in May while oil prices eased on y/y basis

APAC Inflation Surprise Index vs Oil price y/y % change

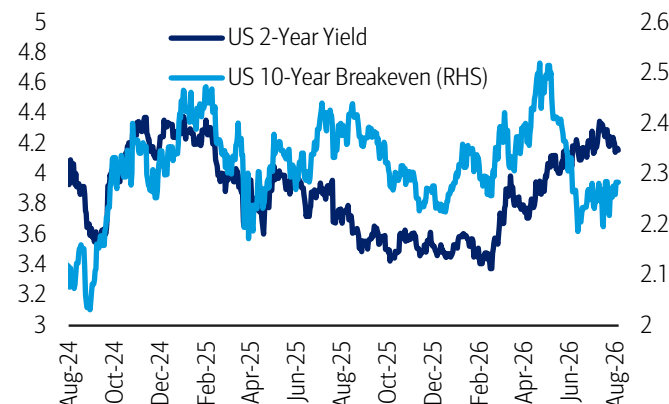


Source: BofA Global Research, Bloomberg

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Exhibit 5: Rise in front-end Treasury yields has been much stronger than the move in inflation expectations

US 2y Treasury yield vs US 10y breakeven (%)

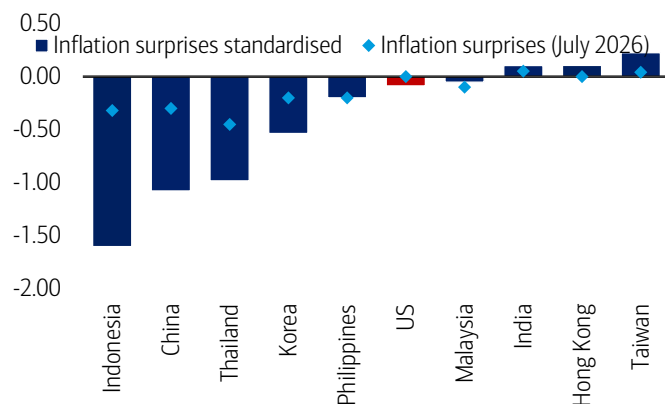


Source: BofA Global Research, Bloomberg

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Exhibit 6: Inflation surprised to the downside for all except India and Taiwan

CPI Inflation surprises (July 2026)

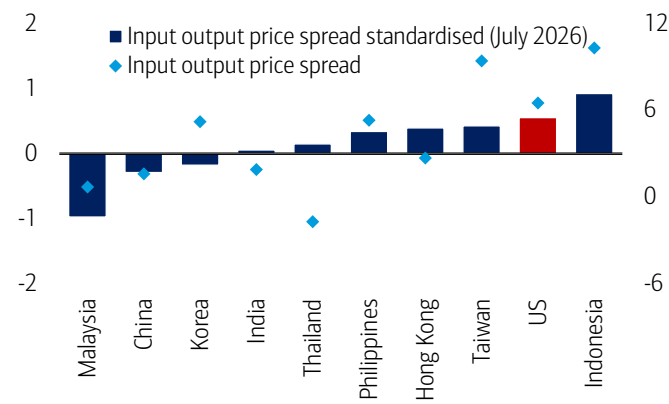


Source: BofA Global Research, Bloomberg

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Exhibit 7: But, there are signs of underlying cost pressure building-up as input prices exceed output prices

Input-Output price spread (July 2026)



Source: BofA Global Research, Bloomberg

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EM Asia's divergent monetary stance

Markets are pricing higher for longer Fed policy path or high real rates rather than a major resurgence in long-term inflation in the US (Exhibit 5). This demands Asian central banks to be selective in hiking or be in a wait-and-watch mode as they continue to be exposed to risks from oil price swings, El-Nino related shocks, hawkish Fed and a likely broad-based USD strength. The divergence within Asia can be summed up into following five buckets.

China, Malaysia and Thailand- justified to stay behind

Benign inflationary environment justify select central banks in EM Asia to stay behind the curve for now. China's CPI and PPI inflation moderated in July with expectations of

staying weak in near-term on weak demand and fading gold price [base effect](#) (see report). Moreover, in Malaysia, the inflation outlook appears manageable and thus, there are no strong signals of near-term [Overnight Policy Rate hike](#) (see report). Despite the near-term rise in headline inflation in Thailand, our economists believe the BoT is likely to keep the policy rate unchanged in 2026, given subdued growth and limited evidence of broad-based, demand-driven [price pressures](#) (see report).

These expectations are broadly consistent with the market pricing which implies less than 10 bp of cumulative hikes over next six months for Malaysia and Thailand while China stands out in the region with the market discounting a modest 3bp of easing.

Indonesia and Philippines- contingent on oil and dollar moves

Though Indonesia's and Philippines' inflation surprised to the downside (substantially lower than 10y historical norm) the underlying cost pressures remain elevated (input output price spread z score +0.92 and +0.34, respectively). Given their relatively higher betas with oil and dollar, their tightening decision would likely be contingent upon oil and USD swings in the near-term.

Indonesia maintains a wide positive policy rate differential with the US (cumulative 100 bps hike since May this year), but BI may remain under pressure to align monetary policy towards government's growth priorities resulting in a dovish tilt (rates kept unchanged in the August meeting).

In case of Philippines, our economists are expecting BSP to hike by 25 bps to 5.00% this month, probably its last hike in the hiking cycle while its GDP [growth slowed in 2Q](#) (see report). However, the market's pricing in 50bp of cumulative hike over 6 months suggest market-implied expectation of an extension of hiking cycle beyond upcoming meeting.

India – dovish hold but must stay cautious

The MPC in its August meeting kept the repo rate unchanged at 5.25% under a dovish tone on the back of improving growth-inflation dynamics (lowered FY27 inflation forecast and raised GDP growth forecast by 10bp each). However, given the revised MPC's inflation projections expectedly turning real rate negative in Q3FY27 and growth outlook being robust, our economists [forecast a 50bps of rate hike starting December 2026](#) (25bps in Dec and 25bps in Feb-2027) – see report. This is fairly in line with the market as it is pricing in a solid 44% chance of an extra third hike within 6 months.

Taiwan - needs to catch-up

Taiwan's inflationary pressure is quite evident on both fronts. Consumer inflation modestly surprised higher along with input-output price pressure being above normal. This combined with a positive output gap suggests CBC will need to tighten policy. Our economists are forecasting a 12.5 bp rate hike at its [September policy meeting](#) (see report). Additionally, we believe there is a risk of a more aggressive 25bp tightening next month as consumer price inflation rising beyond 2% y/y pushed the real policy rate into the negative territory since May.

Korea- right on-time

Korea has been on-top of its monetary policy as BoK already began its hiking cycle last month on the back of robust growth, above-target inflation, and elevated financial stability risk. Our economists [expect a hawkish pause by BoK at the upcoming Aug 27th meeting](#) (particularly due to the departure of the hawkish Senior Deputy Governor), followed by two 25bps hikes in October and [January](#) (See report). Furthermore, market is also pricing in a 20% chance of a third hike in 6 months.



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