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Can it be Sustained?

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Definitions and Country Groupings

In this *Regional Economic Outlook: Asia and Pacific*, the following groupings are employed:

- “ASEAN” refers to the members of the Association of Southeast Asian Nations, and includes Brunei Darussalam, Cambodia, Indonesia, Lao People’s Democratic Republic (PDR), Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste, and Vietnam, unless otherwise noted.
- “ASEAN-5” refers to Indonesia, Malaysia, the Philippines, Singapore, and Thailand.
- “Advanced Asia” or “AE Asia” refers to Australia, Hong Kong Special Administrative Region (SAR), Japan, Korea, Macao SAR, New Zealand, Singapore, and Taiwan Province of China, unless otherwise noted.
- “Emerging Asia” or “EM Asia” refers to Brunei Darussalam, China, Fiji, India, Indonesia, Malaysia, Maldives, Marshall Islands, Micronesia, Mongolia, Naoero, Palau, the Philippines, Samoa, Sri Lanka, Thailand, Tonga, Tuvalu, Vanuatu, and Vietnam, unless otherwise noted.
- “Low-Income Developing Countries” or “LIC Asia” refers to Bangladesh, Bhutan, Cambodia, Kiribati, Lao PDR, Myanmar, Nepal, Papua New Guinea, Solomon Islands, and Timor-Leste, unless otherwise noted.
- “Pacific Island Countries” refers to Fiji, Kiribati, Marshall Islands, Micronesia, Naoero, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu, unless otherwise noted.
- “REO-14” represents the major 14 economies in Asia, including Australia, China, Hong Kong SAR, India, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, Taiwan Province of China, and Vietnam.
- The International Organization for Standardization (ISO) country codes for Asia-Pacific are:

Australia	AUS	Bangladesh	BGD	Bhutan	BTN
Brunei Darussalam	BRN	Cambodia	KHM	China	CHN
Fiji	FJI	Hong Kong SAR	HKG	India	IND
Indonesia	IDN	Japan	JPN	Kiribati	KIR
Korea, Republic of	KOR	Lao PDR	LAO	Macao SAR	MAC
Malaysia	MYS	Maldives	MDV	Marshall Islands	MHL
Micronesia	FSM	Mongolia	MNG	Myanmar	MMR
Naoero	NRU	Nepal	NPL	New Zealand	NZL
Palau	PLW	Papua New Guinea	PNG	Philippines	PHL
Samoa	WSM	Singapore	SGP	Sri Lanka	LKA
Solomon Islands	SLB	Taiwan Province of China	TWN	Thailand	THA
Timor-Leste	TLS	Tonga	TON	Tuvalu	TUV
Vanuatu	VUT	Vietnam	VNM		

The following conventions are used:

- In figures and tables, shaded areas show IMF projections.
- “Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).
- “Billion” means a thousand million; “trillion” means a thousand billion.

As used in this report, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Executive Summary

The outlook for Asia and the Pacific is being shaped by three major factors: the energy shock arising from the conflict in the Middle East, the AI-driven technology boom, and continued trade reconfiguration. The region overall has shown resilience so far. However, the effects are uneven across the region, and even within economies, where tech-related sectors are benefiting more than other parts of the economy. Furthermore, buffers are not unlimited and, going forward, the resilience is likely to be tested.

- Large economies have mitigated disruptions from the oil shocks through inventory drawdowns, diversifying energy sources, and substituting toward alternative energy inputs, supplemented by other policy support. By contrast, many low-income, agricultural, and Pacific island economies have been harder hit, by higher fuel, transport, electricity, and fertilizer costs, despite policy support, intensifying cost-of-living pressures and straining public finances.
- The AI-driven technology boom has provided an important offset for economies in East and Southeast Asia, although the evolution of AI investment and its long-term economic effects are uncertain. Strong global demand for semiconductors, AI infrastructure, and related technology products has boosted exports and investment, particularly in economies integrated into technology supply chains.
- Robust intra-Asian trade, supported by expanding trade agreements and growing services exports, has also reinforced the region's resilience, despite elevated tariffs and export restrictions.

As a result, aggregate regional growth in the first half of 2026 has outperformed earlier projections, but has been uneven across economies. Regional growth is expected to moderate from 5 percent in 2025 to 4.8 percent in 2026, up from 4.4 percent in our April forecasts. Growth projections have been revised up sizably for those benefitting from the ongoing technology boom—notably Korea and several ASEAN economies—and also for China, India, and Japan. Downward revisions have been seen in countries facing higher inflationary pressures without gains from the technology boom, particularly low-income and Pacific Island economies.

Risks remain tilted to the downside. A prolonged conflict in the Middle East could sustain high energy prices. A correction in AI-related investment or asset valuations could weigh disproportionately on Asia given its central role in global technology supply chains. Higher global sovereign yields could spill over to regional bond markets and worsen fiscal vulnerabilities. In addition, a severe El Niño episode could disrupt agriculture, fisheries, and hydropower generation, adding to food and energy inflation. Conversely, stronger productivity gains from AI and deeper trade integration could provide upside potential.

Policies should balance near-term stabilization with rebuilding buffers. Monetary policy should remain focused on price stability and respond promptly where inflationary pressures become more persistent. Fiscal policy should prioritize preserving sustainability while protecting vulnerable households. Targeted and time-bound fiscal measures are preferable to broad-based fuel subsidies or price controls, which can be more costly and weaken price signals and incentives to reduce demand. Supervisors should remain vigilant to market and technology-related risks. Over the medium term, labor market reforms, stronger social safety nets, deeper services trade integration, investment in digital infrastructure and skills, and enhanced energy security will be critical to sustaining growth and promoting a more resilient and inclusive growth model.

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1. Outlook for Asia and the Pacific¹

The outlook for the Asia-Pacific region is being shaped by three major factors: the energy shock arising from the conflict in the Middle East, the AI-driven technology boom, and continued trade reconfiguration. The region as a whole is projected to grow faster than previously expected, supported by effective adaptation and strong tech demand. At the same time, these factors have widened differences across economies and sectors, and intensified pressures on inflation and fiscal positions, leaving risks tilted to the downside. Policies should focus on preserving macroeconomic and financial stability, rebuilding policy buffers, and strengthening resilience to future shocks.

Recent Developments: Divergent Paths amid Global Shocks

The Asia-Pacific region has navigated a complex external environment in 2026. The region's economic developments and prospects have been shaped by the interaction of three major global factors: an energy shock emanating from the conflict in the Middle East, a global technology boom driven by AI, and continued reconfiguration of global trade patterns following US tariff measures. Overall, the region has been resilient, but there has been divergence across economies and sectors. Even though aggregate regional growth has surprised on the upside, the benefits and costs of these factors have been distributed unevenly across economies, reflecting differences in their exposures and reactions to these shocks. At the same time, some financial markets have been volatile, with vulnerabilities stemming from elevated technology sector valuations, high investor leverage, market concentration, and rising yields.

Three Major Factors Shaping Economic Activity: Energy, Tech, and Trade

The Energy Shock

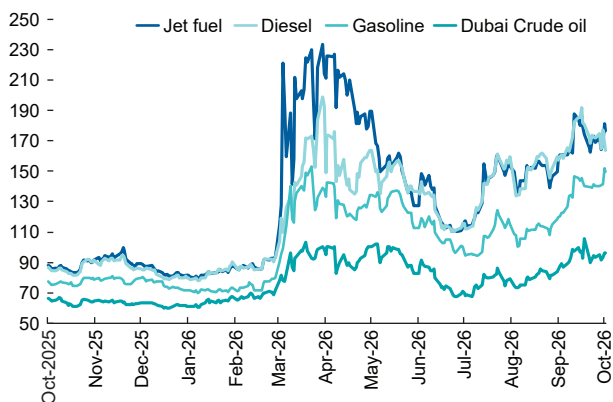
The Asia-Pacific region is highly energy intensive and dependent on oil imports from the Middle East. Crude oil prices have retreated from their peaks in April, but remain elevated and volatile. Price increases for refined products, particularly diesel and jet fuel, and, to a lesser extent, gasoline, have been considerably more pronounced than the rise in crude oil prices, with crack spreads showing a historically large spike after the conflict (Figure 1.1.1). Some economies are particularly vulnerable because of their dependence not only on energy and fuel sources but also industrial inputs such as petroleum products and chemicals (Figure 1.1.2).

Despite this vulnerability, the Asia-Pacific region *overall* has so far weathered the oil shock better than expected when the conflict broke out in February 2026. Some large economies (such as China and Japan) have been able to draw down on oil reserves (Figure 1.1.3). In China, substitution toward other energy sources, including coal and renewables, and weaker demand for oil have helped mitigate supply shortfalls (although part of reduced demand for crude oil in China reflects reduced refinery activity and exports of refined products, such as gasoline, diesel, and jet fuel, to other Asian countries). For other large Asian economies (including India, Japan, and Korea), the resilience in part reflects adaptation by securing oil from alternative sources outside the Middle East (Figure 1.1.4), such that total oil flows to these countries have returned to their pre-conflict rates since June.

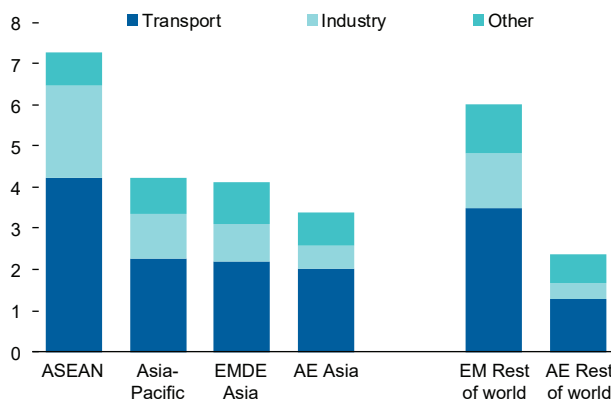
¹ The authors of this chapter are Chikako Baba (lead), Sun Young Park, Narayanan Raman, Masashi Saito, Xiaoxiao Zhang, and Yuanyan Sophia Zhang, with contributions from Fabien Gonguet, Chris Redl, and Ken Teoh, with outstanding research support from Sofia Felici, Assyifa Szami Ilman, and Vyshnavi Thumbala Saikrishnan, and under the guidance of Yan Carrière-Swallow, Andrea Pescatori, and Alasdair Scott.

Figure 1.1. Energy Shocks, Exposures, and Adaptation**1. Oil Products Prices: Asia**

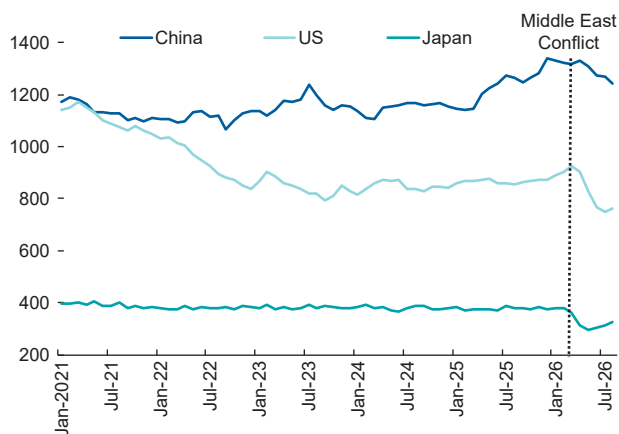
(US dollars per barrel)

**2. Oil and Gas Use**

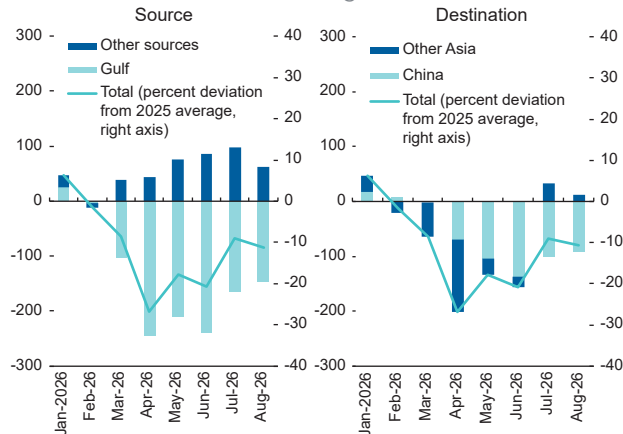
(Percent of GDP)

**3. Crude Oil Inventory**

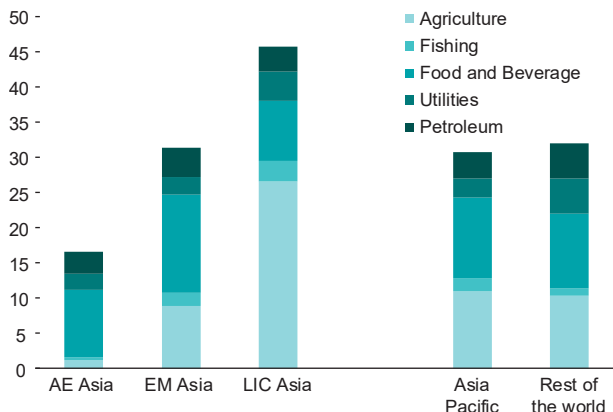
(Million barrels)

**4. Crude Oil Imports by Source and Destination**

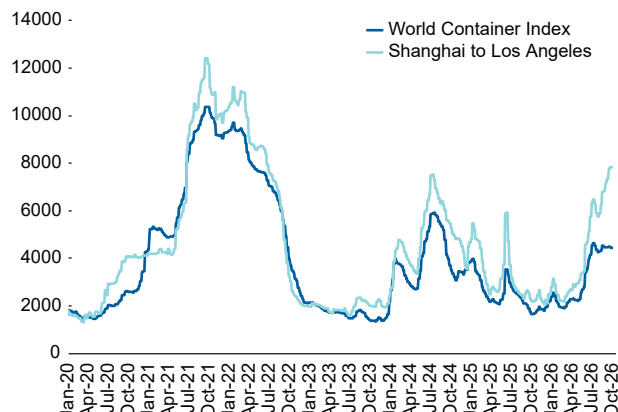
(Difference from 2025 average, million barrels)

**5. Food and Energy in Household Consumption**

(Percent)

**6. Container Costs**

(US dollars per 40-foot container)



Sources: Bloomberg Finance L.P.; Datastream; Energy Institute, International Energy Agency, JODI Oil and Gas World Databases; Eora 2 Common Classification Multi-Regional Input-Output tables, Lenzen and others (2013); Haver Analytics; Kpler; World Economic Outlook; and IMF staff calculations.

Note: For panel 1, oil product prices are based on Asia benchmark prices. For panel 2, data are based on 2024 and 2023. Oil includes crude oil and refined products; natural gas includes pipeline gas and LNG. "Other" includes commercial, residential, and residual categories. Asia-Pacific comprises AUS, BGD, CHN, HKG, IDN, IND, JPN, KOR, LKA, MYS, NPL, NZL, PHL, SGP, THA, and VNM. EM RoW includes ARG, BRA, CHL, COL, EGY, MEX, ZAF. AE RoW includes CAN, CHE, EU27, GBR, ISL, NOR, and USA. Regional values are simple averages over economies. For panel 4, Asia includes REO-14 and BGD and LKA. Gulf countries include ARE, BHR, IRN, IRQ, KWT, OMN, QAT, and SAU. For panel 5, utilities include water supply, gas, and electricity. Regional values are simple average over economies. EM Asia does not include FSM, MHL, NRU, PLW, and TON. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economy; ASEAN = Association of Southeast Asian Nations; EM = emerging market; EMDE = emerging market and developing economy; LIC = low-income country.

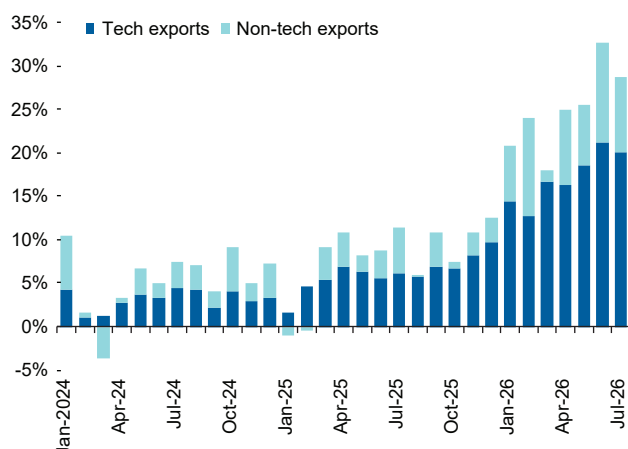
Adaptation has also extended beyond crude oil: efforts have also been made to substitute petrochemicals imported mainly from the Middle East—most notably fertilizer—with those produced elsewhere.

That said, lower-income and agricultural economies—many already facing cost-of-living stresses (see Chapter 2 of the October 2026 *World Economic Outlook*)—have been hit hard by the crisis, reflecting heavy dependence on imported oil products (Figure 1.1.5) and fertilizers, as well as limited ability to adapt. In Pacific Island countries (PICs), higher transportation costs (Figure 1.1.6) have added further pressures to the prices of imported food and other essential goods, while diesel prices have escalated electricity generation and transportation costs. In economies with large agricultural sectors, such as Cambodia, Indonesia, and Nepal, higher energy and fertilizer prices have raised farming costs, weakened agricultural yields, and weighed on agricultural output. Extensive subsidies and policy support have helped cushion impacts in some economies, but at costs to public finances.

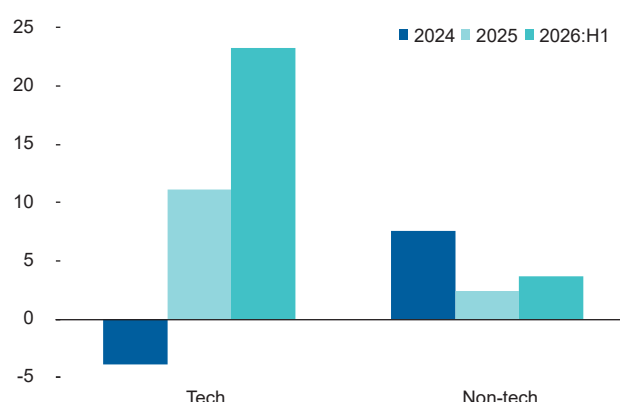
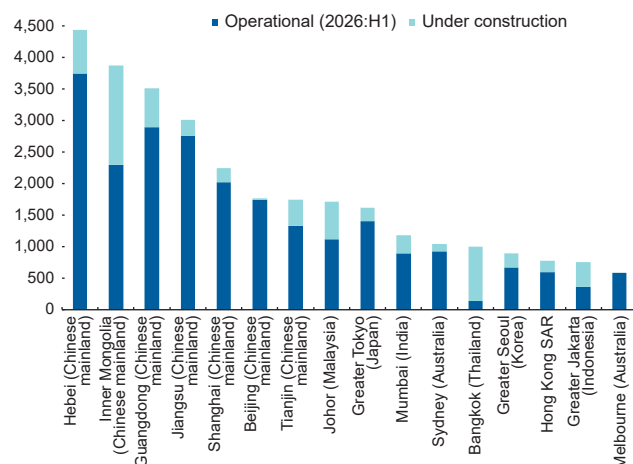
The Technology Boom

Meanwhile, the tech boom has provided a sizable boost to some Asian economies. Amid robust global demand for AI-related and tech products, Asia's tech exports have risen sharply in the first half of 2026 (Figure 1.2.1). Although part of this increase reflects intra-regional trade in intermediate tech products within Asia's supply chains, exports have accelerated to a broad range of destinations. Strong demand for AI infrastructure has driven up demand for semiconductors, with sharp terms of trade gains for producers of advanced logic and memory chips (Korea and Taiwan Province of China) and AI servers and finished products (Taiwan Province of China). Malaysia and Singapore have also increased exports as assemblers and packagers of tech products. Strong investment in building data centers in the region (including China, India, Japan, Indonesia, and Malaysia) has also contributed to growth (Figures 1.2.2 and 1.2.3), and has generated broader demand for intermediate goods from regional suppliers (for example Thailand and Vietnam).

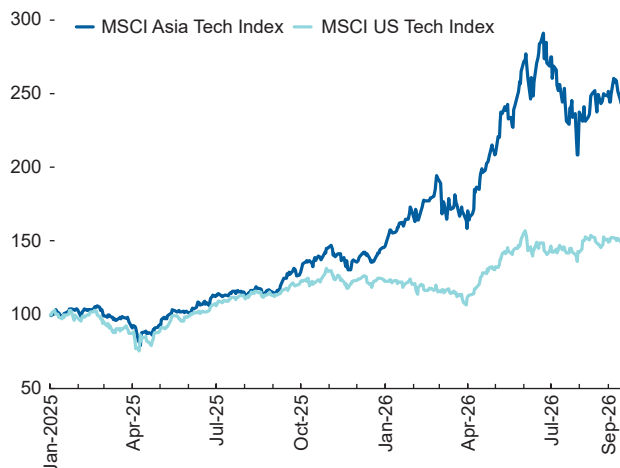
At the same time, the technology boom has fueled both financial market gains and vulnerabilities. Strong earnings among tech firms have driven sharp increases in equity valuations this year in advanced Asian markets, even more so than those of US tech firms (Figure 1.2.4). Globally, rising leverage in AI-related investments has supported the equity rally, while raising the risk of significant market turbulence, as illustrated by recent volatility in Korean equity markets (October 2026 *Global Financial Stability Report*). The sustainability of these valuations depends on continued AI monetization and investment and whether the technology delivers expected productivity gains. Concerns have emerged around technology-firm valuations, the funding of AI-related companies, the costs of AI adoption, and the scope for multiple competitors in the AI market.

Figure 1.2. Technology**1. Technology versus Non-Technology Exports: Asia**
(Percent, contributions to year-over-year growth)**2. Capital Expenditure: Asia Pacific**

(Percent, average quarterly year-over-year growth)

**3. Data Center Capacity: Asia Pacific**
(Megawatt)**4. Tech Stock Market Valuations**

(Index; January 2025 = 100)

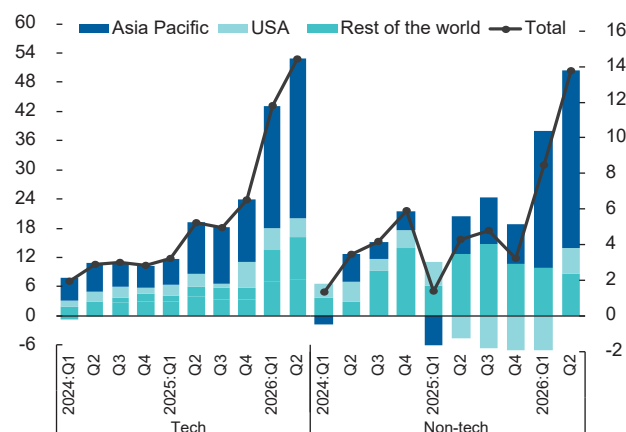
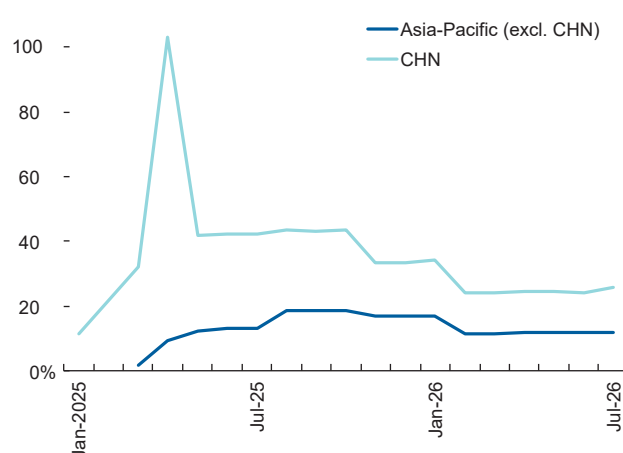


Sources: Bloomberg Finance L.P.; Capital IQ; Cushman and Wakefield "Asia Pacific Data Centre H1 2026 Update"; CBRE "2026 Asia Pacific Data Centre Trends & Outlook"; S&P 451; Trade Data Monitor; and IMF staff calculations.

Note: For panel 1, tech exports include the following HS codes: 8419, 8470-8473, and 85. Asian economies are Regional Economic Outlook-14. For panel 2, capital expenditure is used to define investment. The tech sector is defined as the information technology sector. Sample includes all publicly listed firms from the Asia and Pacific region, excluding real estate. For panel 3, the data for Chinese mainland are from S&P 451 and as of 2026:H1. The data for Melbourne are from CBRE and as of 2026:Q1. For others, the data are from Cushman & Wakefield and as of 2026:H1.

Trade Resilience

Despite a volatile policy environment, Asia's exports have been resilient in the first half of 2026, even excluding tech-related exports (Figure 1.3.1). US tariffs on Asia-Pacific economies are still high (Figure 1.3.2), while export restrictions have become more prominent, with China introducing export licensing requirements for rare earth elements and the United States expanding restrictions on semiconductors and advanced technologies. Nonetheless, intra-Asian exports have been robust, particularly of goods linked to broader tech-related infrastructure. Chinese exports have continued to reorient toward markets to Europe and other regions, while exports to the United States have recently stabilized after a decline in 2025 (see also Box 1.1 of the October 2026 *World Economic Outlook*). Exports to the United States from the rest of the region remain soft, suggesting that widespread trade rerouting has been limited.

Figure 1.3. Non-Technology Trade**1. Export Growth Contribution by Destination**
(Percent, contributions to year-over-year growth)**2. Average US Effective Tariffs on Asia Pacific**
(Percent)

Source: IMF-WTO tariff tracker; Trade Data Monitor; and IMF staff calculations.

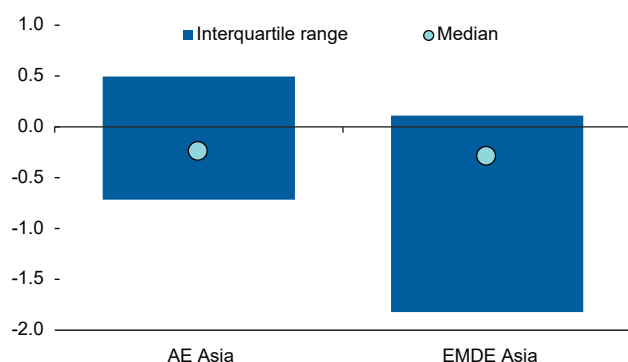
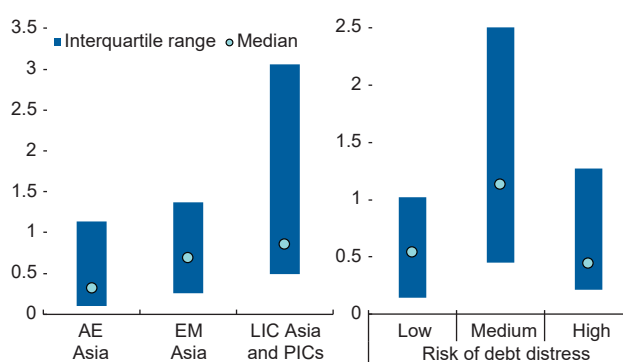
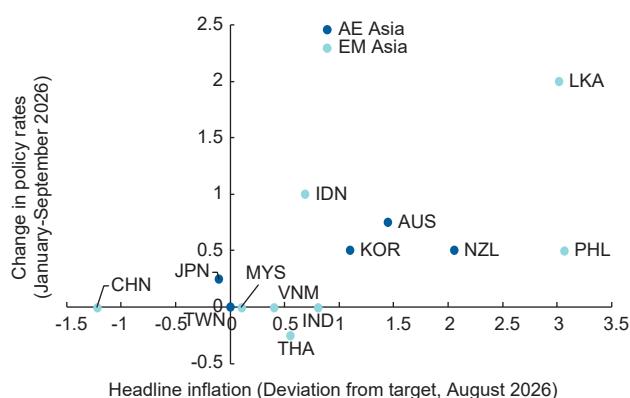
Note: For panel 1, the sample of countries is Regional Economic Outlook-14. Tech exports include the following HS codes: 8419, 8470-8473, and 85. For panel 2, tariff rates are weighted by import value.

Structural factors also support the resilience of trade in the region. Countries have continued deepening trade ties through bilateral and regional trade agreements, both within the region and with European partners. Around 20 bilateral or multilateral trade agreements involving Asia-Pacific economies were agreed or entered into force in 2025 and 2026. Although their full effects are probably still yet to be seen, they may have helped to facilitate trade reallocation and strengthen regional trade and supply-chain linkages. Moreover, services trade now accounts for roughly one-quarter of the region's total exports (see Chapter 4), and digitalization, rising incomes, and the growing role of services as inputs into manufacturing and global value chains are likely to keep shaping the region's trade landscape.

Policy Responses Have Been Diverse

Policy responses have further shaped these outcomes. Fiscal policy has been eased across most economies as the first line of defense against the oil shocks (Figure 1.4.1). A broad range of measures have been used (Box 1.1), ranging from tax cuts on energy products, price controls, subsidies to exposed sectors, to household transfers. These measures have reduced the near-term pass-through of energy price shocks to consumer prices, but at a cost to public finances, weighing more on countries with less fiscal space (Figure 1.4.2). They have been more costly in low-income and Pacific Island countries, reflecting the larger share of energy and food in consumer spending. In several economies, the energy shock has therefore intensified existing fiscal trade-offs, including the need to stabilize debt, finance aging-related spending, and respond to rising development needs.

Monetary policy has pivoted toward tightening in advanced economies and some emerging markets, while others have held policy rates (Figure 1.4.3). Monetary conditions were generally accommodative across the region before the energy shock hit, with many economies close to the end of easing cycles. Advanced economies facing inflationary pressures amid stronger cyclical positions (for example, Australia and Korea) have raised policy rates. Emerging markets have reacted more heterogeneously, reflecting differences in inflation dynamics, exchange rate pressures, and policy credibility. The regional policy environment has also been shaped by changing expectations on the US monetary policy path. Amid currency market volatility, several economies have intervened in foreign exchange markets (including India, Indonesia, Japan, Korea, and Sri Lanka), complementing tighter monetary policy in some cases.

Figure 1.4. Fiscal and Monetary Policy Developments**1. Change in Primary Balance Since WEO****January 2026 Update***(WEO October 2026 versus WEO January 2026)***2. Reported Fiscal Costs of Energy Shock Measures***(Percent of GDP)***3. Change in Monetary Policy Rates versus Inflation***(Percentage point changes between January and September 2026)*

Sources: IMF World Economic Outlook, IMF Global Policy Tracker, Haver Analytics; and IMF staff calculations.

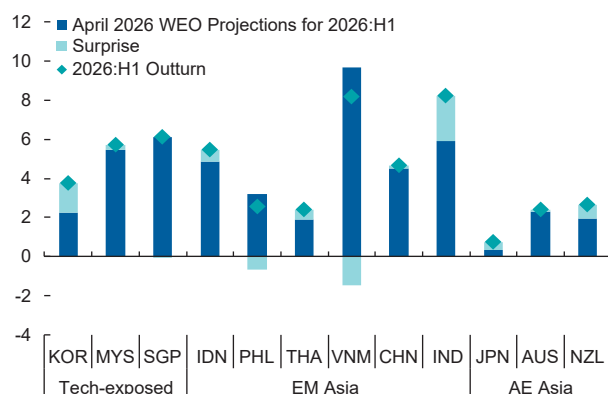
Note: For panel 1, fiscal adjustment is calculated as the change in primary balance between 2025 and 2026. The bars show the distribution of the difference between WEO October 2026 and WEO January 2026 vintage. Primary balance excluding oil and gas was used for BRN. For panel 2, the bars show the interquartile range of the fiscal costs in each category. Low, medium, and high refer to Debt Sustainability Analysis ratings. For panel 3, the inflation target was used for CHN, JPN, KOR, PHL, and VNM. The historical average for 2015-25 was used as the reference benchmark for MYS. For other economies, the midpoint of their target range was used as the central bank target. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economy; EM = emerging market; EMDE = emerging market and developing economy; LIC = low-income country; PICs = Pacific island countries; WEO = World Economic Outlook.

Aggregate Regional Growth Has Held Up, with Divergences across Countries

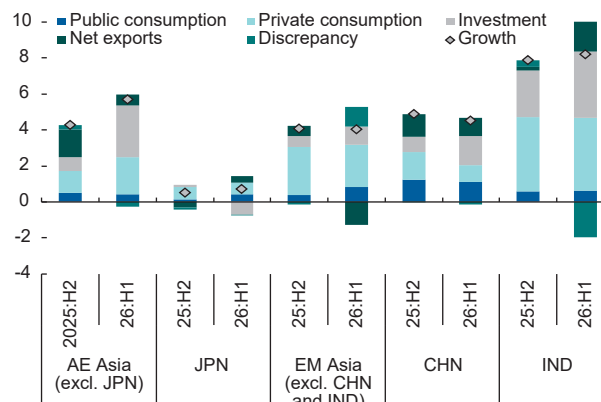
Aggregate growth in Asia-Pacific has been stronger than expected at the start of 2026. GDP growth in the first half of the year has exceeded projections shown in the April 2026 *World Economic Outlook* for most advanced and tech-exposed economies (Figure 1.5.1). However, aggregate resilience masks substantial heterogeneity across countries (Figure 1.5.2) and across sectors, depending on the extent of tailwinds from the tech boom. Advanced economies exposed to the tech boom, especially Korea and Taiwan Province of China, have benefitted from improved terms of trade, leading to strong net exports and larger current account surpluses, despite the energy shocks. But net exports have been a drag on growth in some emerging economies with higher energy import bills and rising costs of tech-related imports for intermediate and capital goods. Domestic demand has remained resilient across many economies, supported, in particular, by robust capital expenditure associated with the AI-driven technology boom. The impact of higher energy prices on private consumption has so far been limited, possibly reflecting fiscal support measures or delays in the transmission of energy costs to consumer prices.

Figure 1.5. Macroeconomic Developments**1. Growth Surprises in 2026:H1**

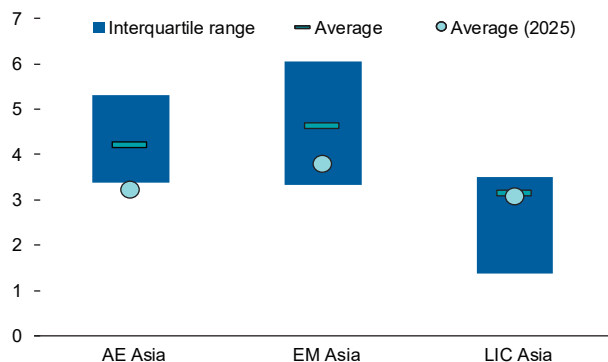
(Percent, year-over-year growth)

**2. Contributions to GDP Growth**

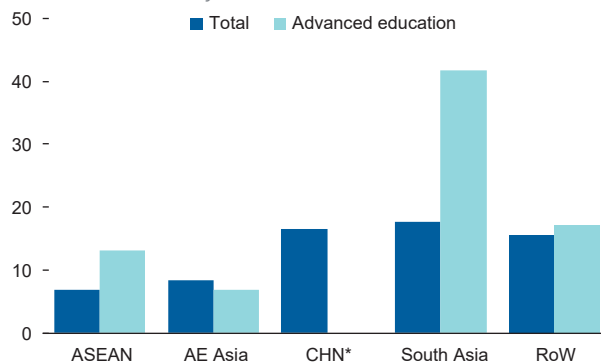
(Percent, year-over-year growth)

**3. Unemployment Rates: Asia-Pacific**

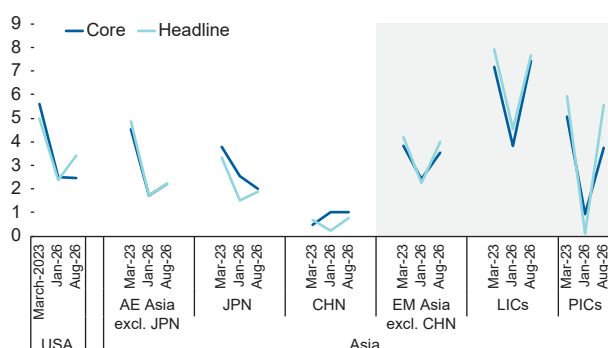
(Percent, 2000-2025)

**4. Youth Unemployment Rates by Education**

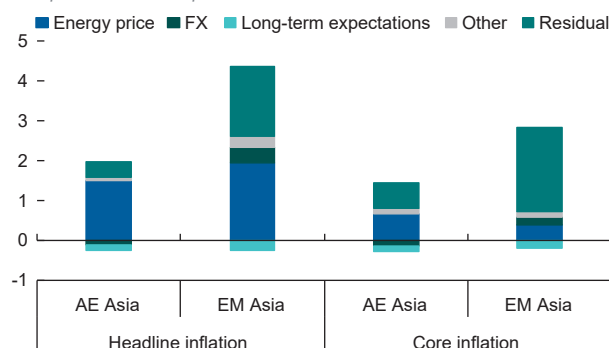
(Percent, latest year available)

**5. Headline and Core Inflation**

(Percent, year-over-year growth)

**6. Decomposition of Inflation Drivers, 2026:Q2**

(Percentage point deviations from targets; quarter-over-quarter annualized)



Sources: Haver Analytics; International Labour Organization; World Economic Outlook; and IMF staff calculations.

Note: For panel 1, the surprise component is calculated as the difference between the 2026:H1 GDP outturn and the April 2026 *World Economic Outlook* projections. Positive (negative) values indicate growth outcomes above (below) the projections. For panel 2, AE Asia: AUS, HKG, KOR, NZL, SGP, TWN; EM Asia: IDN, MYS, PHL, THA. Chinese mainland (CHN) data is seasonally adjusted, and decomposition of consumption is based on IMF staff estimates. For panel 3, unemployment rates use ILO-modeled estimates. EM Asia excludes FSM, MHL, NRU, and PLW. For panel 4, youth is defined as 15-24 years old. The latest data vary by economy but range between 2023 and 2025. AE Asia: AUS, HKG, KOR, SGP. ASEAN: IDN, PHL, SGP, THA, VNM. South Asia: BGD, IND, LKA. Median is used for regional aggregates. (*) Because of data limitations, CHN's youth unemployment is for the urban population of ages 16-24, excluding students. Data are not available for CHN's youth unemployment rate by age and education. For panel 5, core refers to CPI basket excluding food and energy, fuel, and transport. In Japan, core inflation excludes fresh food and energy. Median values were used for group aggregations. AE and EM Asia cover REO-14 economies, excluding MAC and TWN. LICs exclude KHM, KIR, MMR, SLB, and TLS. Pacific island countries include FJI, PNG, and WSM. Due to data limitation, AUS, NZL, and PNG use 2026Q2 data and BTN uses June 2026 data. LAO's core inflation is not available for 2026. Panel 6 shows simple average contribution of each factor across REO-14 economies. Contributions are calculated based on the dynamic simulations of country-by-country Phillips curve regressions. Methodology is as in Baba and others (2025). Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economy; ASEAN = Association of Southeast Asian Nations; EM = emerging market; EMDE = emerging market and developing economy; FX = foreign exchange; ILO = International Labour Organization; LIC = low-income country; PIC = Pacific Island countries.

Labor markets across the region are similarly heterogeneous. In many advanced economies with positive output gaps (for example, Australia, Japan, and Singapore), unemployment rates are near historical lows (Figure 1.5.3). In aging advanced economies, shrinking working-age populations contribute to structural labor shortages. By contrast, across emerging and developing economies, where demographic trends imply a need to generate substantial numbers of new jobs, skill mismatches are often high. Many labor markets have high rates of informality, while underemployment among young skilled workers is particularly high in South Asia (Figure 1.5.4; see also Chapter 2).

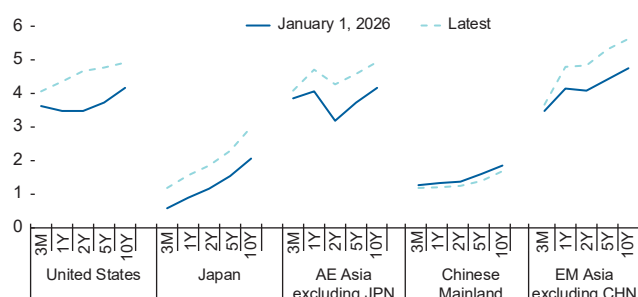
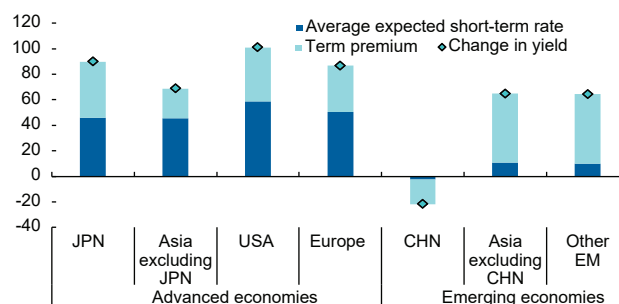
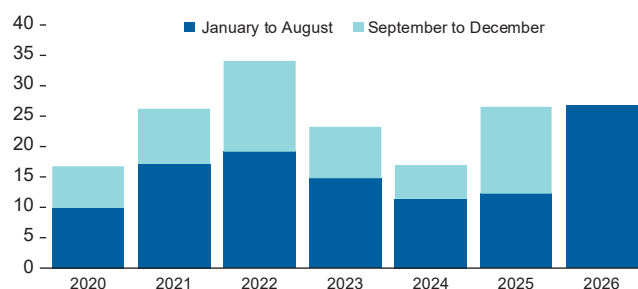
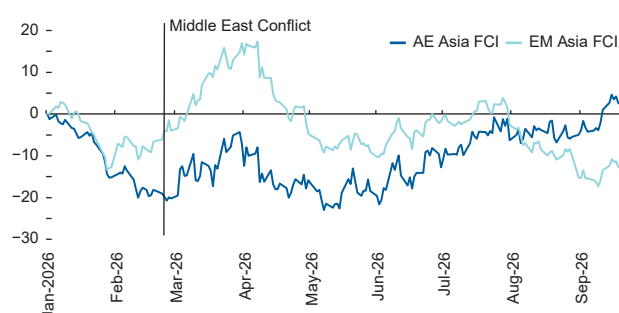
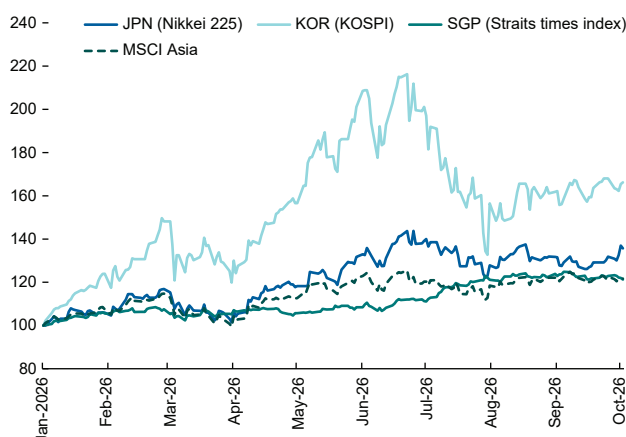
Inflation has risen across many economies after the energy shock, especially among emerging and developing economies, where inflation rates are nearing the peaks experienced after the 2022-23 energy shock (Figure 1.5.5). The impact has varied considerably across countries, reflecting differences in energy exposure and domestic policy responses. A Phillips curve decomposition (Figure 1.5.6) suggests that most of the recent increase in inflation across Asia and the Pacific can be attributed to global energy prices and, in emerging market economies, currency depreciation. However, inflation has risen more quickly than historical relationships would predict in some economies (for example, the Philippines). Headline inflation has risen fastest among Pacific Island countries, low-income countries, and some emerging market economies (for example, Cambodia, Fiji, Mongolia, Nepal, and Sri Lanka), adding to cost-of-living pressures. In many of these economies, core inflation has also picked up significantly after the energy shock, contrasting with more limited increases in core inflation observed globally. By contrast, the pass-through of higher energy prices to both headline and core inflation has remained relatively contained in most advanced and emerging market economies, partly reflecting the reliance on inventories and the widespread use of price-smoothing measures (for example, Korea, Malaysia, and Thailand).

Long-term sovereign yields have risen by 40-60 basis points in 2026 across most Asian economies (Figure 1.6.1), reflecting a mix of global and country-specific factors.² The Federal Reserve and European Central Bank have begun raising policy rates. In advanced Asia, the degree of expected monetary policy tightening has been comparable to that in the United States and Europe, while in emerging market economies risk-free rates have contributed little to rising yields (Figure 1.6.2). The increase in long-term yields has also been driven by a global rise in term premia, associated with a deteriorating fiscal position in most major sovereign issuers (October 2026 *Fiscal Monitor*) and crowding-out from a surge in debt issuance by AI-related firms (October 2026 *Global Financial Stability Report*). These global patterns have been exacerbated by domestic factors in some cases, including market perceptions of higher fiscal risks (Japan) or policy uncertainty (Indonesia). Nonetheless, international bond issuance by Asian emerging market sovereigns has remained robust through 2026 (Figure 1.6.3).

Despite rising sovereign yields, overall financial conditions have on average remained accommodative. In emerging Asia, overall financial conditions tightened immediately after the conflict but have since largely eased, supported by exchange rate adjustments acting as shock absorbers and lower corporate spreads (Figure 1.6.4). In advanced Asia, economies with greater exposure to the technology cycle have benefited from rising stock prices of technology firms (Figure 1.6.5), and narrower corporate bond spreads and exchange rate adjustments have also supported financial conditions.

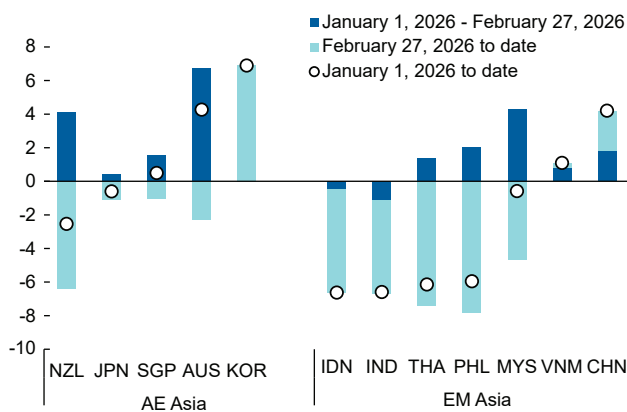
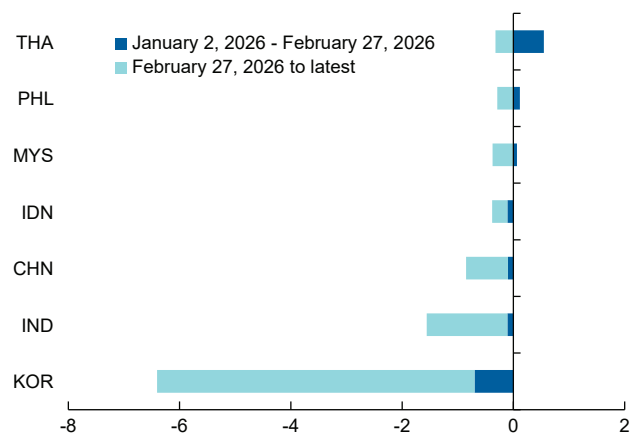
Exchange rates and capital flows have become more volatile since the energy shock this year. Several emerging market economies experienced depreciation pressures, reflecting multiple factors, particularly in Indonesia, India, Thailand, and the Philippines, although pressures have partially eased over the past few months (Figure 1.7.1). These movements have coincided with portfolio outflows—especially equity outflows, including sizable foreign equity outflows from Korea associated with portfolio rebalancing after sharp valuation gains in technology stocks (Box 1.2)—even as debt inflows to the region have generally remained robust and foreign direct investment inflows have stayed strong in some cases (Figure 1.7.2). Uncertainty over the path of U.S. monetary policy, along with shifts in risk premia driven by geopolitical tensions and their perceived impact on Asian oil importers, has sustained volatility in exchange rates and capital flows.

² Movements in long-term yields have been small in China in view of a relatively closed capital account.

Figure 1.6. Yields and Financial Conditions**1. Government Bond Yields***(In percent)***2. Changes in Long-term Yield Composition***(Basis points from December 31, 2025 to September 30, 2026.)***3. EM Asia: Total Sovereign Issuance***(USD billions)***4. Financial Conditions Index - Asia***(+: Tighter conditions; -: Looser conditions)***5. Stock Market Index: Asia***(Index; January 1, 2026 = 100)*

Sources: Bloomberg Finance L.P.; and IMF staff calculations.

Note: For panel 1, AE Asia includes AUS, HKG, KOR, NZL, and SGP. EM Asia includes IDN, IND, MYS, PHL, and THA. There is no data for IDN 3-month government bonds. For panel 2, AE Asia includes AUS, KOR, and NZL and EM Asia includes CHN, IDN, IND, MYS, and THA. For panel 4, aggregated series are constructed with individual economy-level cumulative changes in Financial Condition Index (FCI) using stock market capitalization as weights. The latest date is September 18. The FCI captures the cumulative change in financial variables normalized by the standard deviation of daily changes. AE Asia includes HKG, KOR, and SGP; EM Asia includes CHN, IDN, IND, MYS, PHL, and THA. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economy; EM = emerging market; FCI = Financial Condition Index; MSCI = Morgan Stanley Capital International.

Figure 1.7. Exchange Rates and Capital Flows**1. Exchange Rate Movement against USD***(Percent change; positive = appreciation)***2. Net Portfolio Flows to Asia***(Percent of IIP liabilities)*

Sources: Bloomberg Finance L.P., Haver Analytics; International Institute of Finance; and IMF staff calculations.

Note: For panel 2, all countries include equity and debt flows with the exception of KOR and PHL where debt data are unavailable. The latest data cover until October 2, 2026, except CHN for which the debt data are monthly and cover until August 2026. IIP data are as of 2025:Q4. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economy; EM = emerging market; IIP = International Investment Position.

Outlook and Risks: Resilient, but Downside Risks Remain

Improving Prospects

The near-term outlook is underpinned by several key assumptions about global economic conditions: oil supplies return to prewar flows by late 2027, and disruptions to oil exports from the Middle East continue in the meantime. Fuel prices exceed levels assumed in the April 2026 *World Economic Outlook*, nonfuel commodity prices are modestly lower than assumed in the April 2026 *World Economic Outlook*. The AI-driven technology cycle is assumed to moderate, with no exogenous boost to productivity growth, but the demand for AI is assumed to remain robust, with prices settling at higher levels. The U.S. monetary stance is expected to continue to tighten later this year. The combination of monetary policy tightening and fiscal pressures in most major advanced economies is likely to keep upward pressures on yields across Asia and the Pacific. Trade policies remain broadly unchanged through the forecast horizon.

Prospects are better than expected in April 2026 *World Economic Outlook*, reflecting countries' adaptation to external shocks and a stronger-than-expected boost from the technology boom in part of the region. Growth in Asia is forecast to moderate from 5.0 percent in 2025 to 4.8 percent in 2026 and 4.4 percent in 2027—stronger than projected in both the April 2026 and October 2025 *World Economic Outlooks*. The revisions are larger for *advanced Asia*, reflecting greater uplifts from the technology boom. Advanced Asia's growth is projected to rise from 2.5 percent in 2025 to 3.2 percent in 2026 and then moderate to 2.0 percent in 2027. *Emerging Asia* remains the region's main growth engine, but momentum is expected to moderate as higher energy prices weigh on consumption and external positions. Growth projections for emerging Asia show moderation of growth from 5.6 percent in 2025 to 5.1 percent in 2026 and 4.9 percent in 2027, albeit still stronger than those in the April 2026 *World Economic Outlook*. Downward revisions are most pronounced in low-income countries and Pacific Island countries, which face stronger inflationary pressures without benefiting from the tech boom. Growth in 2026 is now projected at 3.7 percent for low-income economies and 2.6 percent for Pacific island countries, compared with 4.4 and 2.8 percent, respectively, in the previous forecast.

Differences across economies reflect differences in position in the global technology value chains, commodity dependence, policy reactions to energy shocks, reliance on remittances, and tourism receipts. Exporters of advanced tech products (such as Korea and Taiwan Province of China) will continue to benefit from strong external demand for semiconductors. Korea's growth is expected to accelerate to 3.3 percent in 2026, from 1.1 percent in 2025. Similarly, growth of most ASEAN economies is revised up slightly, reflecting robust technology-related exports and investments. In economies relatively less exposed to the uplift from technology, expected growth depends on the size of buffers deployed against energy shocks. Growth in Japan is projected at 0.7 percent in 2026, with fiscal support partly cushioning the energy shock. India remains among the fastest-growing major economies, with growth projected at 7.0 percent, supported by broad-based strength in private consumption and services activity.

Growth in China is projected to slow, which has possible spillovers to regional economies. China's 2026 growth is projected to slow to 4.5 percent, as higher global oil prices, together with protracted uncertainty and structural headwinds, are expected to weigh on domestic demand, despite fiscal support. Net exports remain the key driver of growth, reflecting weakness in domestic demand owing to subdued consumer confidence, prolonged property market adjustments, and structural factors (see Chapter 3). The strength of net exports has been associated with falling export prices relative to the rest of the world (Figure 1.8). This has had mixed spillovers to other Asian economies: for those firms competing with Chinese final goods imports, the effect has been to depress profitability and output, whereas other firms have benefited from cheaper Chinese intermediate inputs. So far, the evidence indicates that, on balance, the net effect is broadly neutral in most sectors in most countries (Box 1.3).

Inflation is expected to rise in the near term on account of delayed pass-through of energy price shocks. The path will differ across economies, with the largest pressures likely in countries where imported energy and food account for a larger share of consumption baskets and where policy buffers are weaker. Therefore, cost-of-living pressures are likely to remain a central concern, particularly for low-income households and vulnerable economies.

Downside Risks Dominate

Risks to the outlook remain tilted to the downside. A prolonged stalemate in the conflict in the Middle East could keep commodity prices elevated and volatile for longer, weighing on growth while fueling inflation and cost-of-living pressures. Further drawdowns in oil reserves could push global inventories to stress levels, triggering nonlinear price increases (see the Commodity Special Feature of the October 2026 *World Economic Outlook*). Higher energy prices might lead to worsening fiscal balances. Oil inventory rebuilding and market expectations of a more persistent shock could further raise energy prices.

Another major risk stems from the technology sector, which could surprise on either the upside or downside. With the extent of long-term productivity gains uncertain, a reassessment of profitability of AI-related firms could trigger a sharp correction in investment and financial markets. Such a correction could weigh on global growth through weaker business investment and private consumption, with effects likely to be particularly pronounced

Figure 1.8. Export Prices
(Index, 2019 = 100)



Sources: Haver Analytics; and IMF staff calculations.

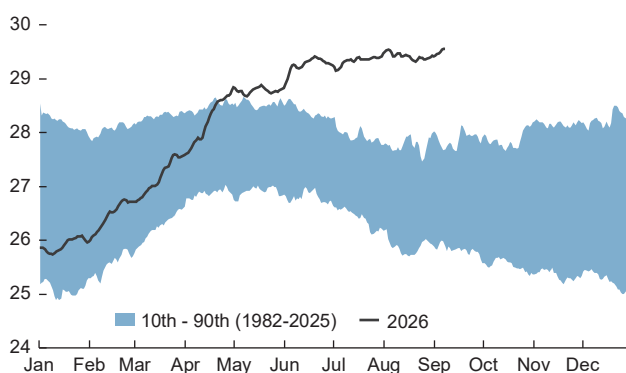
Note: 2026 data are based on the first seven months of the year.

in Asia given the region's extensive exposure to the AI production chain (October 2026 *Global Financial Stability Report*). Further expansion of AI-related infrastructure raises questions about physical resources, including water, electricity, and grid capacity. On the upside, growth could be stronger if the technology cycle keeps strong momentum with continued AI-related investment and supports private consumption, or if faster diffusion of AI technologies generates stronger productivity gains.

With global yields rising, episodes of market stress in major sovereign issuers (the United States, the United Kingdom, euro area, and Japan) could spill over to Asian sovereign bond markets, pushing up yields and exacerbating already-elevated fiscal vulnerabilities³. With public debt and borrowing needs remaining high across much of the region, an abrupt tightening of financial conditions could further strain public finances by raising debt-servicing costs. Such a shock could stem from a repricing of risk in major advanced economies and transmit to emerging market and developing economies, as the recent rise in term premia has illustrated.

The region continues to be vulnerable to natural disasters, as seen most recently in the tragic events in Nepal. Going forward, the prospect of an El Niño “super cycle” heightens risks. Although its full effects are likely to be seen only later in the year, a key indicator—sea surface temperatures in the central-eastern equatorial Pacific—has surged to record highs, on track for the strongest ever El Niño, heightening the risk of economic damages from extreme weather events (Figure 1.9). Volatile rainfall could affect planting seasons and undermine agricultural yields. The higher ocean temperatures could affect fishing—a key source of income—in some Pacific island countries. In addition, lower rainfall could reduce hydroelectricity output across numerous economies in the region. Such shocks could create further inflationary pressures through higher food and energy prices and exacerbate fiscal vulnerabilities in economies with limited policy buffers.

Figure 1.9. Sea Surface Temperature in the Pacific Ocean (Celsius)



Sources: Climate Reanalyzer, National Oceanic and Atmospheric Administration, and IMF staff calculations.

Notes: Average estimated temperatures for the Niño 3.4 area in the central-eastern equatorial Pacific.

Renewed trade tensions could amplify shocks. Protectionist measures to safeguard strategic goods or to respond to shifting trade patterns could dampen growth (see Chapter 3 of the October 2025 *World Economic Outlook*). At the same time, the increasing number of deep trade agreements involving Asia-Pacific economies could help lower trade costs, support supply chain resilience, and improve policy predictability (see Chapter 2 of the October 2025 *Regional Economic Outlook: Asia and Pacific*).

Policies: Preserving Economic Stability and Fostering New Growth Models

Macroeconomic Policies: Balancing Near-Term Stabilization with the Need to Rebuild Buffers

The region's resilience over the past year has resulted, in part, from significant fiscal policy support by governments. This has helped to cushion the effects of the energy shock and sustain growth, despite heightened external uncertainty. However, the policy environment is becoming more challenging. Inflation pressures are persistent in several economies, with signs of second-round effects emerging. Fiscal positions have weakened,

³ The literature has documented extensive evidence of cross-border spillovers from US and euro area interest rates (for a recent example, see Arbatli-Saxegaard and others 2024), and recent IMF work has documented evidence of global spillovers emanating from shocks to Japanese government bond yields (Carrière-Swallow, Kindberg-Hanlon, and Smirnov 2025).

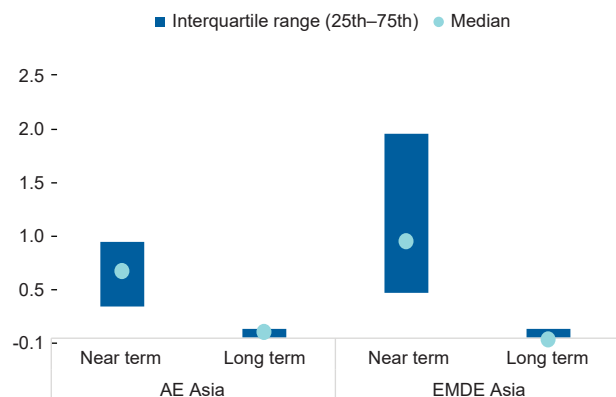
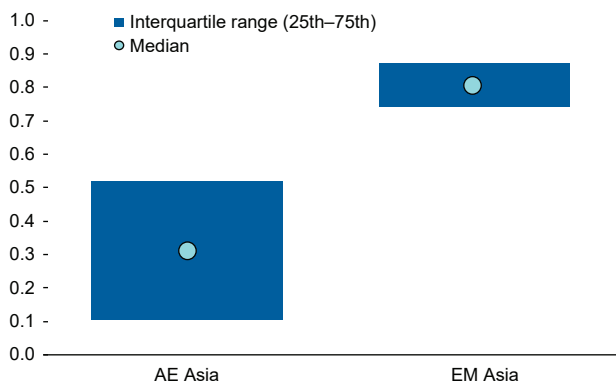
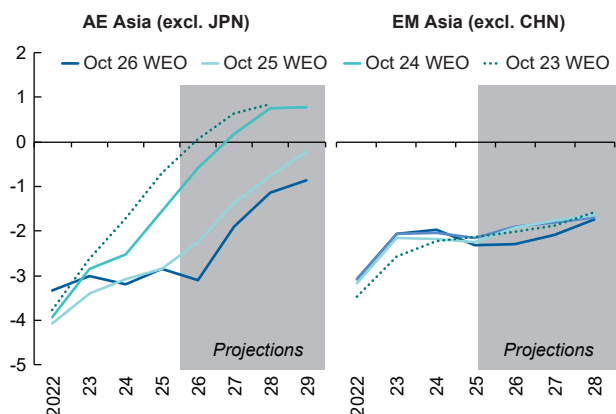
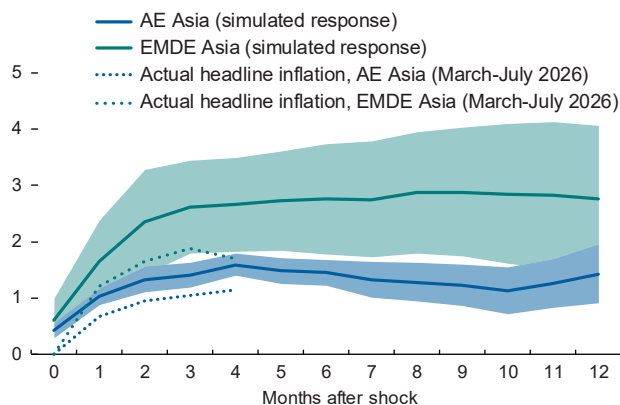
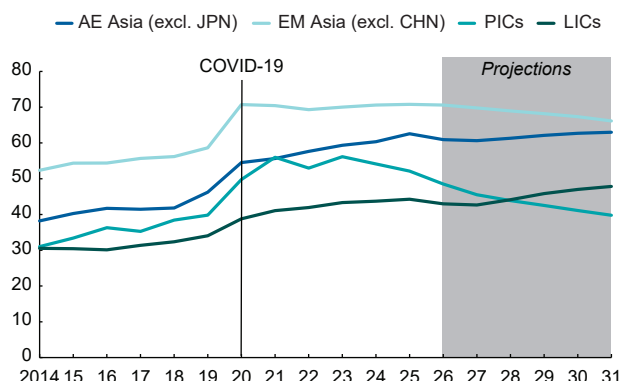
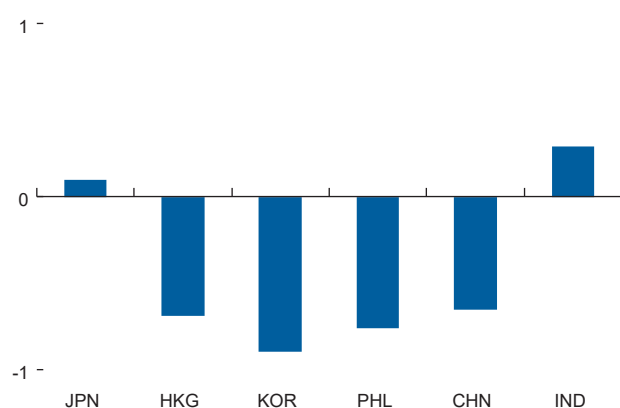
and large fluctuations in financial prices could lead to costly materialization of risk events. Therefore, the policy challenge is to shift from mitigating external shocks toward rebuilding resilience, while laying the foundations for sustainable and inclusive growth.

- *Monetary policy* should continue to focus on preserving price stability. A key question for policymakers is whether they can afford to look through the inflationary effects of adverse oil shocks (Bodenstein, Erceg, and Guerrieri 2008). Near-term inflation expectations have risen, but have fallen since peaks in March and April, while 2-year expectations have mostly remained anchored (Figure 1.10.1). However, there are signs of additional inflationary pressures, including more pass-through of oil supply shocks (Figure 1.10.2).⁴ Hence, policymakers should be ready to tighten monetary conditions, especially where pass-through of oil prices to consumer prices is strong, the demand uplift from the tech boom is significant, inflation expectations are less anchored, monetary frameworks are less credible, and inflation is more persistent. The case is stronger in emerging market economies, where inflation formation appears more backward-looking and hence more persistent (Figure 1.10.3). To keep expectations well anchored in an uncertain global environment, central banks should clearly communicate their policy intentions and the balance of risks, and should be granted strong independence to pursue their mandates.
- *Fiscal policy* should balance the need to preserve fiscal sustainability while protecting the vulnerable. Public debt remains elevated across much of the region following the pandemic and is projected to rise further in advanced Asia (excluding Japan) (Figure 1.10.4), reflecting delays in fiscal consolidation amid mounting structural spending pressures from population aging, higher defense outlays, and rising borrowing costs (Figure 1.10.5). Even where public debt does not appear particularly high—such as in Pacific Island countries—public finances are under stress. Rebuilding fiscal space is becoming more urgent amid elevated debt, rising sovereign yields, and growing spending pressures. Therefore, medium-term fiscal consolidation remains a priority. Where support is warranted to mitigate the impact of higher energy prices, targeted and time-bound fiscal measures are preferable to broad-based fuel subsidies or price controls, which can be more costly and weaken price signals and incentives to reduce demand. Currently, very few measures are time-bound or clearly targeted to low-income households and most vulnerable firms (Box 1.1). Investing in administrative systems—including social registries, beneficiary identification, and delivery mechanisms—would facilitate better targeted support during future shocks.
- *Financial policies* should guard against volatile market conditions. Bank credit to nonfinancial corporations is growing alongside strong investment, especially in advanced economies. Although credit growth remains broadly in line with GDP growth, signs of weakening loan quality are emerging in some countries (Figure 1.10.6). Risks are more pronounced where exposures are concentrated in the tech sector, which relies on elevated equity valuations and leveraged investors (October 2026 *Global Financial Stability Report*). Supervisors should remain vigilant to credit and liquidity risks, including through stress testing of tighter funding, sharp exchange rate movements, and asset price corrections. Macroprudential frameworks should remain attentive to risks in household and corporate balance sheets, including those linked to technology sector exuberance and possible renewed housing pressures. Cyber fraud has rapidly emerged as a significant issue for the region, one that has the potential to reduce trust in financial systems and to set back development in emerging and low-income countries. To that end, the agenda laid out in the “Bangkok Blueprint”, a joint IMF-World Bank-Bank of Thailand high-level framework for tackling cyber-enabled fraud in digital financial services, should be pursued.

Asia-Pacific’s Long-Term Challenges: Toward a More Resilient and Inclusive Growth Model

Asia has been the world’s fastest-growing region in recent years and has accounted for more than half of global growth. Sustaining this performance will require adapting to deep structural shifts. Labor market challenges are increasingly central. Aging economies face shrinking workforces, whereas others continue to grapple

⁴ Anecdotal evidence suggests that manufacturers may be close to exhausting older and cheaper inventories, while the El Niño cycle presents significant risks of food and producer price pressures.

Figure 1.10. Monetary, Fiscal, and Financial Policies**1. Change in Inflation Expectations***(Percentage points)***3. Backward-Lookingness of Core Inflation***(Estimated Phillips Curve coefficients)***5. Cyclically Adjusted Primary Balance***(Percent of GDP)***2. Pass-Through of Energy Supply Shocks***(Cumulative percentage points change in price level in response to oil supply shock)***4. Government Debt***(Percent of GDP, weighted average)***6. Lending Standard from Loan Officer Survey***(Index, Change from 2025:Q2 to 2026:Q2)*

Sources: Consensus Forecast; Haver Analytics; IMF Fiscal Monitor; IMF Global Policy Tracker; IMF, World Economic Outlook; and IMF staff estimates and calculations.

Note: For panel 1, near term refers to current year inflation expectations for 2026, and long term is 2-year inflation expectations. For both series, the change is calculated as the difference between January 2026 and July 2026. EMDE Asia are EM Asia and BGD, LKA, and MMR. Median value was used for regional aggregates. Panel 2 shows cumulative impulse response of headline CPI to a 75 percent increase in the real Brent oil price (corresponding to the increase after the Middle East war between January and April) instrumented with the Känzig (2021) oil supply news shock. The sample covers 2000:M1–2026:M3. Shaded areas denote 90 percent confidence intervals. Panel 3 reports distribution of the coefficient on lagged inflation from country-by-country Phillips curve regression for REO-14. Methodology is as in Baba and others (2025). Panel 4: AE and EM Asia are REO-14 economies. Panel 5: Sample countries are REO-14 excluding SGP, TWN, and VNM. Panel 6 uses the change from 2025:Q2 to 2025:Q4 for CHN. Data labels in the figure use International Organization for Standardization (ISO) country codes. AE = advanced economy; CPI = consumer price index; EM = emerging market; EMDE = emerging market and developing economy; PICs = Pacific island countries; LICs = low-income countries; WEO = World Economic Outlook.

with underemployment and skill mismatches, which could be amplified by AI. These labor market challenges, together with weak social safety nets and income uncertainty, could weigh on consumption and growth. As services become a more important driver of growth, reducing barriers to services trade could raise growth, diversify exports, and enhance resilience to goods-trade disruptions. The current challenging environment offers an opportunity to accelerate reforms to support the region's transformation over the medium term to a more balanced and resilient growth model and support social cohesion as the region navigates aging, informality, and technological change.

Labor market reforms are essential to mitigate the adverse growth effects of demographic changes and adapting to evolving labor demand in the AI era. In aging economies, efforts to increase labor supply by encouraging more participation, training, and better integration of foreign workers should continue. In emerging market economies with young populations, policies should focus on creating productive employment opportunities for large cohorts of young people to harness demographic dividends. Migration policies that effectively balance near-term labor supply losses and medium-term skill gains can complement labor market reforms. A key challenge is that AI is reshaping occupations and the demand for skills for those roles (Chapter 2). Policymakers will need to think how best to foster the creation of high-quality jobs, support workers in acquiring relevant skills, and facilitate labor mobility across sectors and occupations.

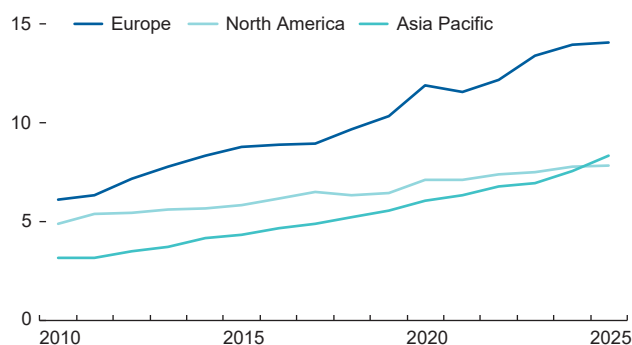
Adequate social assistance can help mitigate income inequality, income uncertainty, and informality, thereby supporting both growth resilience and social cohesion. Chapter 3 finds strong reasons for households to save for retirement and against adverse shocks in emerging Asia—such as inadequate pension systems, high income uncertainty, and widespread informality—weighing on private consumption. Therefore, strengthening social safety nets would support consumption and living standards, especially for vulnerable households. Priorities should be given to pension reforms in aging economies and to income-support programs in younger and more informal economies. These reforms can also gradually encourage workers to emerge from informality to benefit from the coverage of social safety nets, especially if combined with labor market reforms to equip workers with relevant skills, as well as regulatory reforms to reduce barriers for small businesses to formalize. The challenge is to do so while maintaining fiscal sustainability including by undertaking fiscal consolidation where needed, including through revenue mobilization. The analysis in Chapter 3 indicates that well-designed reforms embedded in medium-term fiscal frameworks can achieve these objectives at a manageable fiscal cost.

Deeper services trade integration led by domestic regulatory reforms is key to unlocking the potential of services trade. Chapter 4 finds that services trade integration in Asia-Pacific is lower than that in other regions, reflecting domestic policy barriers. Reducing restrictions on foreign entry, strengthening competition, and improving regulatory transparency could reduce the cost of trading services and generate meaningful welfare gains. As digitalization and AI expand the role of services, complementary policies, including investments in digital infrastructure, regulatory frameworks, and workforce reskilling, will be critical.

Finally, policies to improve energy security should continue over the medium term. The recent energy shock underscores the importance of strengthening energy supply resilience. Key priorities include maintaining adequate inventories to cushion future disruptions, and diversifying both energy sources and import suppliers. Many Asia-Pacific economies have scope to increase the availability of renewable energy (Figure 1.11), which would help reduce reliance on imported fuels while supporting climate objectives.

Figure 1.11. Share of Renewables in Energy Consumption

(Percent of total energy consumption)



Sources: Energy Institute, Statistical Review of World Energy 2026; and IMF staff calculations.

Box 1.1. Policy Responses to the Energy Shock: Objectives and Instruments¹

Asia-Pacific economies responded swiftly with a broad set of policies to cushion the economic and social impacts of the energy shock. Based on the IMF Global Policy Tracker, over 90 percent of economies adopted policy measures, with several—including India, Korea, Lao P.D.R., Sri Lanka, Thailand, and Vietnam—implementing broader packages spanning multiple objectives.

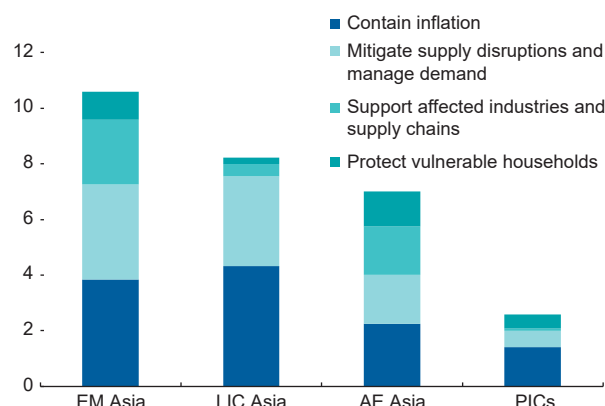
Containing inflation pass-through has been the main policy objective. More than 80 percent of economies adopted measures to dampen the pass-through of higher global energy prices to domestic prices, using two to four instruments on average. These included fuel tax and duty reductions in Cambodia and Lao P.D.R.; subsidy-backed fuel price caps in Japan and Thailand; and fuel or utility price freezes or subsidies in Bangladesh and Malaysia.

Supply- and demand-management measures have been adopted by about 80 percent of economies to address risks of energy shortages and import disruptions. Measures range from petroleum reserve releases and procurement diversification in Japan, Timor-Leste, Thailand, and Vietnam to export restrictions in Thailand. Several economies, including Brunei, Maldives, Myanmar and Sri Lanka, have introduced rationing, quotas, or anti-leakage controls. Demand-side measures—such as work-from-home arrangements, shorter public sector hours, and travel restrictions—have also been deployed in Bangladesh, Bhutan, Fiji, Malaysia, Myanmar, Nepal, the Philippines, and Thailand.

Targeted support has complemented broad-based measures by channeling relief to exposed sectors and households. Production measures have included freight subsidies in Korea, trade-finance support in the Philippines, toll relief in Hong Kong SAR, fertilizer support in Australia and Sri Lanka, and credit guarantees or liquidity facilities in India, Malaysia, and Singapore. Household relief included cash transfers and cost-of-living top-ups in Cambodia, Fiji, Korea, New Zealand, Sri Lanka, Thailand, and Tonga; utility vouchers and food cards in the Philippines and Singapore; and public transport subsidies or fare reductions in Australia, Fiji, and Lao P.D.R. Demand measures to curb energy use, such as shorter working hours, have mostly been targeted to the public sector.

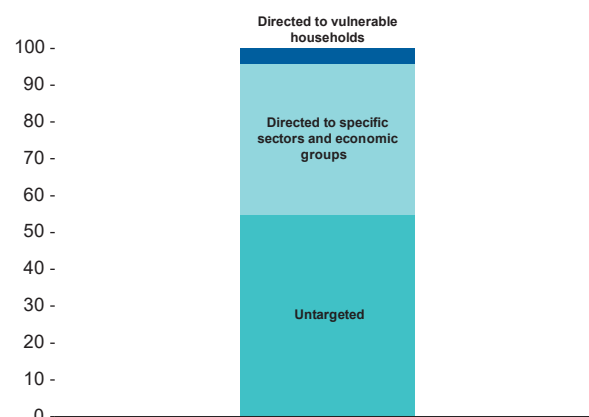
Most fiscal measures are reported to be temporary, yet exit strategies remain unclear in some emerging and developing economies. Most advanced economies have set clear timelines for their interventions, but those for about a third of emerging-market, low-income, and Pacific-Island countries remain open-ended, primarily on price control measures.

Figure 1.1.1. Policy Measures by Objective
(Average number of measures per country)



Source: IMF Global Policy Tracker; and IMF staff calculations.
Note: The tracker is a high-frequency, cross-country database of economic policy measures announced in response to the war in the Middle East since February 2026. The data is compiled using AI-enabled web scanning and IMF country teams inputs.

Figure 1.1.2. Measures based on Target
(Percent of total measures)



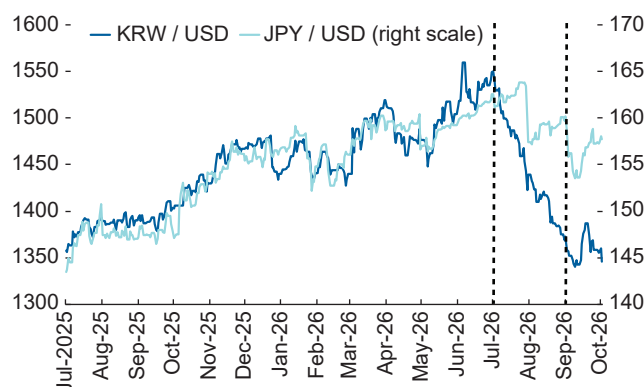
Source: IMF Global Policy Tracker; and IMF staff calculations.
Note: Sector classifications reflect the primary beneficiaries of targeted measures.

^{1/} This box was prepared by Sun Young Park, Vyshnavi Thumbala Saikrishnan, and Yuanyan Sophia Zhang.

Box 1.2. A Tale of Two Currencies: What Is Driving the Yen-Won Divergence?¹

The Korean won and Japanese yen have been among the most highly correlated currencies in global foreign exchange (FX) markets for the past decade. This reflects their shared exposure to global manufacturing and energy cycles, global financial factors, and regional risk sentiment. This pattern continued through the end of June, with the won and yen weakening in tandem against the US dollar (Figure 1.2.1). Yen depreciation has generally moved in line with US-Japan yield differentials, although this relationship has weakened since mid-2025. The won also faced pressures from large capital outflows in 2026H1 (Figure 1.2.2), including from equity portfolio rebalancing by foreign investors amid the rapid rise in equity valuations, despite the current account surplus rising strongly since late 2025 as tech-related exports boomed.

Figure 1.2.1. Exchange Rate: Japanese Yen and Korean Won per US\$

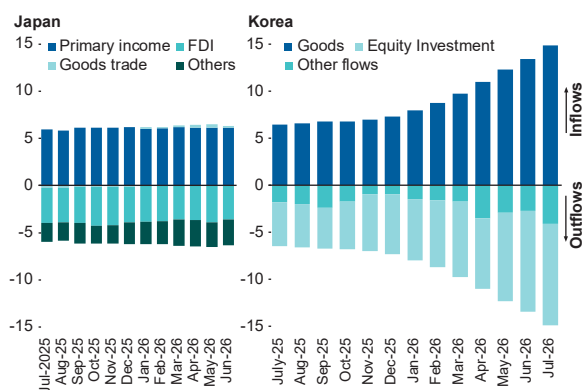


Source: Bloomberg Finance L.P.; and IMF staff calculations

From July 1 to September 3, 2026, the currencies diverged significantly, with the won gaining 11 percent against the yen (Figure 1.2.3). The magnitude of the two-month change was the largest since January 2013 and was in the 99th percentile since 2010. Examining factors behind the divergence may shed light on different roles that country-specific trade and financial flows have played in recent currency movements.

Figure 1.2.2. Japan and Korea: Balance of Payments Flows

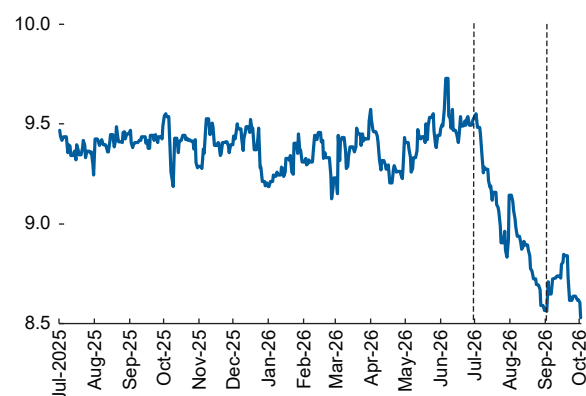
(Percent of GDP, rolling 12-month)



Source: Haver Analytics; and IMF staff calculations.

Note: For Japan, other flows are the sum of the capital account balance, the financial account balance excluding FDI, services, secondary income, and errors and omissions. For Korea, other flows are the sum of the capital account balance, services, incomes, direct investment, reserves, debt flows, net other investment flows and errors and omissions.

Figure 1.2.3. Exchange Rate: Korean Won per Japanese Yen



Source: Bloomberg Finance L.P.; and IMF staff calculations.

¹/ This box was prepared by Yan Carrière-Swallow, Fabien Gouguet, and Ken Teoh.

Box 1.2. (continued)

An important fundamental factor that typically drives currency markets is the interest rate differential between sovereign bonds. Both Japanese and Korean yields have risen in recent months, such that the Japan-Korea yield differentials have not widened significantly. Markets have priced in somewhat higher policy rates in both countries, with 1-year government yields and OIS-implied policy expectations increasing by similar amounts since July 1. Estimated term premia have also increased largely in line with advanced economies elsewhere. As a result, changes in the 10-year differentials between Japanese and Korean government bonds have remained relatively modest. Overall, interest rate developments since July 1 do not appear sufficient, on their own, to explain the magnitude of the exchange rate movement. On the Japan side, IMF staff analysis suggests that a large portion of yen movements since mid-2025 cannot be accounted for by yield differentials or other fundamentals such as global risk aversion or the oil price, while the unexplained component has co-moved with observed positions in the yen futures market (IMF 2026). FX intervention activity reported in recent months is also unlikely to have had a significant incidence on the divergence.

The relative impact of the AI boom on current and capital accounts offers a more likely explanation for the divergence, especially through shorter-term financial and corporate FX flows in Korea. Although Japan and Korea are both benefiting from the AI boom, the latter has seen a much larger boost to its export receipts, as it plays a dominant role in global memory chip production. Higher global demand for semiconductors has caused a steep increase in prices (+173 percent year-over-year as of July 2026), contributing to a record-high current account surplus (19 percent of GDP forecast for 2026). By contrast, Japan's current account surplus has been smaller (~4 percent of GDP) and more stable, and primarily reflects strong income flows from overseas investments, which are generally reinvested abroad instead of repatriated, rather than tech-related exports. Recent developments among major Korean tech firms, including onshore conversion of rapidly growing export earnings and SK Hynix's repatriation of proceeds from the early July issuance of an American Depositary Receipt in the United States have contributed to an appreciation of the won. Appreciation pressures may also have been reinforced by the easing of equity portfolio rebalancing outflows after the July stock market correction and moderation in hedging-related FX flows.

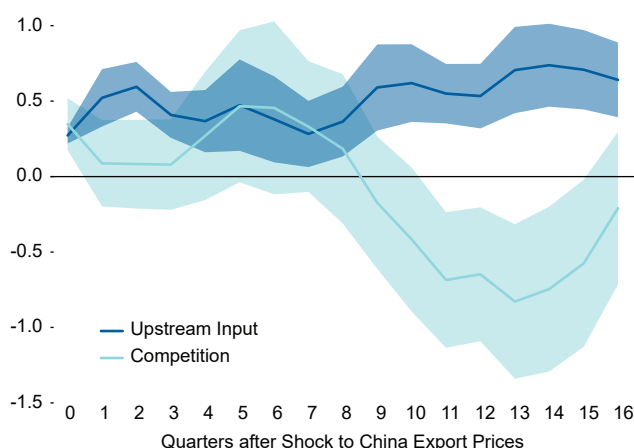
Box 1.3. Spillovers from Chinese Exports to the Rest of Asia¹

The first step in understanding the spillovers from the strength in Chinese exports is to understand what China exports to which sector in which country. Chinese imports are particularly high in electrical equipment and electronics, textiles, and machinery. They are generally higher in lower-income economies. Imports can be of *final* and *intermediate* goods—shares of the latter are overall much higher (not shown), particularly in metals and minerals, wood, rubber, and plastics, and chemicals.

The second step is to identify what is exogenous about Chinese export growth, which is affected by both industry-specific and global demand shifts unrelated to domestic developments in China. The analysis used for this box separates aggregate from idiosyncratic shocks to Chinese exports, using the latter to estimate spillovers.³ The estimates indicate that, on average, a rise in exports to Asia comparable to that which took place after the COVID-19 pandemic has reduced industrial production in trading partners by around 0.8 percent after 3 years. This reflects losses in market share in domestic final goods markets, whereas the benefits from increased availability of intermediate inputs have raised industrial production by around 0.8 percent after 4 years (Figure 1.3.1).

The strength of these two channels varies across economies according to their position in regional value chains (Figure 1.3.2). The estimates indicate that the net effects for economies as a whole are typically small, as Asian economies tend to have large exposure to China along both dimensions. Beltran, Franz, and Presbitero (forthcoming), who identify idiosyncratic shocks from Chinese exports using firm-level data, find a very similar size impact for these channels, but with some differences in the timing of the peak effect. Vietnam is the only economy where the net output effect is statistically significant: There, gains from Chinese intermediate inputs outweigh stronger final-goods competition, which is consistent with Vietnam's specialization in downstream assembly and its deep integration into electronics supply chains.

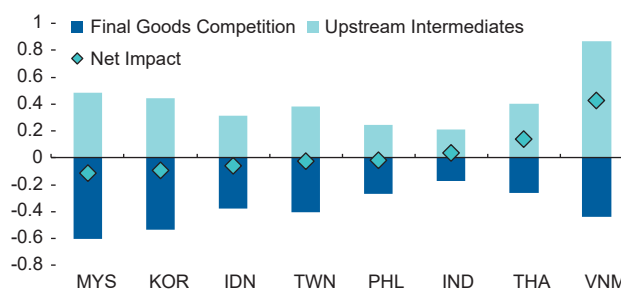
Figure 1.3.1. Response of Industrial Production to a China Export Shock
(Percent)



Sources: UN Comtrade; Haver Analytics; Asian Development Bank Multi-Regional Input-Output tables; and IMF staff calculations.

Note: Impulse responses from panel instrumental-variable local projection estimates with economy and quarter and industry fixed effects. Standard errors are clustered by industry.

Figure 1.3.2. Contribution to Production by Country
(Percentage points of total industrial production)



Sources: United Nations Comtrade; Haver Analytics; Asian Development Bank Multi-Regional Input-Output tables; and IMF staff calculations.

Note: Response to one standard deviation shock in Chinese exports. Data labels in the figure use International Organization for Standardization (ISO) country codes.

^{1/} This box was prepared by Chikako Baba, Chris Redl, and Xiaoxiao Zhang.

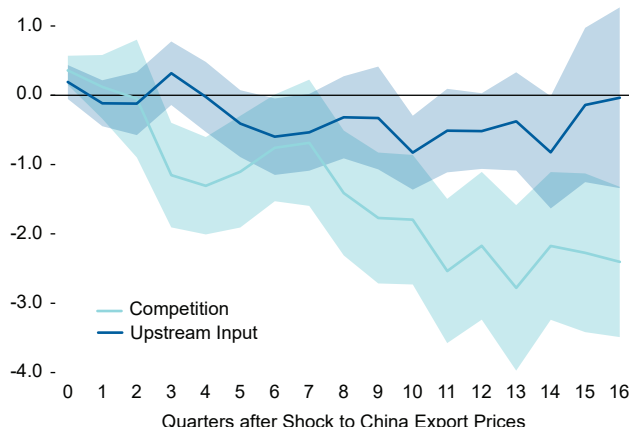
Box 1.3. (continued)

At the sectoral level across countries, the net effect is also typically small, but conceals large offsetting adjustments. For example, computers and electronics show the largest gross responses on both channels. China exports necessary components to regional producers for assembly and competes with the final goods they sell. Thus, the input gain and the competition drag land in the same industry and largely cancel. However, these two do not arrive together— the input gain is immediate and persistent, whereas the competition drag builds over 2–3 years – and so, the netting out is a feature of the horizon, not of any single quarter. Machinery and basic metals display the same configuration on a smaller scale.

Looking at the effects on exporters, the analysis finds that the same shocks lower imports from non-China sources in Asian destinations, especially in final goods markets (Figure 1.3.3). Although evidence of trade displacement is limited for shocks to intermediate goods, export shocks affecting final goods lead to sizable and persistent losses in market share for other suppliers, with imports from non-China sources falling by about 3 percent after four years. These results underscore the importance of distinguishing between final and intermediate goods. The consequences of China's export growth depend not only on the scale of exposure, but also on whether imports displace domestic final production or lower input costs and support downstream activity.

Nevertheless, net sectoral effects may conceal important distributional consequences. Competing and input-using firms can experience different outcomes within the same sector. Moreover, output losses may have larger employment implications in labor-intensive industries such as textiles and apparel, even when their contribution to aggregate output is limited.

Figure 1.3.3. Response of Non-China Imports to a China Export Shock
(Percent)



Sources: UN Comtrade; Haver Analytics; Asian Development Bank Multi-Regional Input-Output tables; and IMF staff calculations.
Note: Impulse responses from panel instrumental-variable local projections with economy $\times$ quarter and industry fixed effects; standard errors clustered by industry. This chart re-estimates the system with the log of imports from non-China sources as the outcome

^{2/} Shares are here defined as overall Chinese value added absorbed domestically out of total domestic absorption.

^{3/} Using the granular instrumental variable approach of Gabaix and Koijen (2024).

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Annex Table 1.1. Asia: Real GDP*(Percent; year-over-year change)*

	Actuals and Latest Projections			Difference from April 2026 WEO	
	2025	2026	2027	2026	2027
Asia	5.0	4.8	4.4	0.4	0.1
Advanced Economies (AEs)	2.5	3.2	2.0	1.2	0.4
Australia	2.0	1.9	1.6	−0.1	−0.1
Hong Kong SAR	3.6	3.8	2.8	1.4	0.5
Japan	1.2	0.7	0.7	0.0	0.1
Korea	1.1	3.3	2.8	1.4	0.7
Macao SAR	4.7	3.3	3.1	0.3	0.0
New Zealand	0.3	2.0	2.6	−0.1	0.2
Singapore	5.0	5.0	3.0	1.5	0.4
Taiwan Province of China ¹	8.8	10.7	4.3	5.5	1.3
Emerging Markets and Developing Economies (EMDEs)	5.6	5.1	4.9	0.2	0.1
Bangladesh	3.5	3.6	3.2	−1.1	−1.1
Brunei Darussalam	1.0	1.9	1.3	−0.7	−1.3
Cambodia	5.3	3.0	4.0	−1.0	−0.7
China	5.0	4.5	4.0	0.1	0.0
India ²	7.8	7.0	7.0	0.5	0.5
Indonesia	5.1	5.1	5.1	0.2	0.0
Lao P.D.R.	4.8	4.5	4.5	0.5	0.6
Malaysia	5.2	5.2	4.6	0.5	0.3
Myanmar	−2.0	2.0	2.0	−0.9	−1.0
Mongolia	6.8	6.2	5.9	0.9	0.6
Nepal	4.4	3.6	3.7	0.6	−0.8
Philippines	4.4	3.4	5.1	−0.7	−0.7
Sri Lanka	−	−	−	−	−
Thailand	2.4	2.1	2.1	0.6	0.0
Vietnam	8.0	8.4	7.5	1.3	0.8
Pacific Island Countries³	3.8	2.6	2.5	−0.2	0.0
Fiji	2.5	1.9	2.3	−0.5	−0.5
Kiribati	4.3	3.0	2.5	−0.1	0.0
Marshall Islands	1.8	3.0	2.2	−0.7	0.2
Micronesia	2.1	1.4	1.7	0.7	0.6
Naoero	2.2	2.1	2.0	0.0	0.0
Palau	6.0	4.3	2.7	1.0	−0.1
Papua New Guinea	6.2	3.1	4.0	−0.7	0.2

	Actuals and Latest Projections			Difference from April 2026 WEO	
	2025	2026	2027	2026	2027
Samoa	4.2	0.4	1.7	−2.8	−1.2
Solomon Islands	3.6	2.7	2.8	0.0	0.0
Tonga ⁴	4.4	1.8	1.9	−0.5	0.6
Tuvalu	5.2	3.4	2.8	0.9	0.4
Vanuatu	3.7	3.5	3.2	0.0	0.0
ASEAN⁵	4.9	4.9	4.7	0.4	0.1
ASEAN-5⁶	4.5	4.4	4.3	0.3	0.0
EMDEs excluding China and India	4.7	4.7	4.6	0.1	−0.1

Sources: IMF, World Economic Outlook database; and IMF staff estimates and projections.

Note: AE = advanced economy; ASEAN = Association of Southeast Asian Nations; EMDE = emerging market and developing economy.

^{1/} Taiwan Province of China forecast data source is Consensus Forecast.

^{2/} India's data are reported on a fiscal year basis. Its fiscal year starts from April 1 and ends on March 31.

^{3/} Pacific island countries aggregate is calculated using simple average; all other aggregates are calculated using weighted average.

^{4/} Tonga's data are reported on a fiscal year basis. Its fiscal year starts from July 1 and ends June 30.

^{5/} ASEAN comprises Brunei Darussalam, Cambodia, Indonesia, Lao P.D.R., Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste, and Vietnam.

^{6/} ASEAN-5 comprises Indonesia, Malaysia, the Philippines, Singapore, and Thailand.