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Asia Economics | Asia Pacific

The Viewpoint: How fast will Asian central banks tighten?

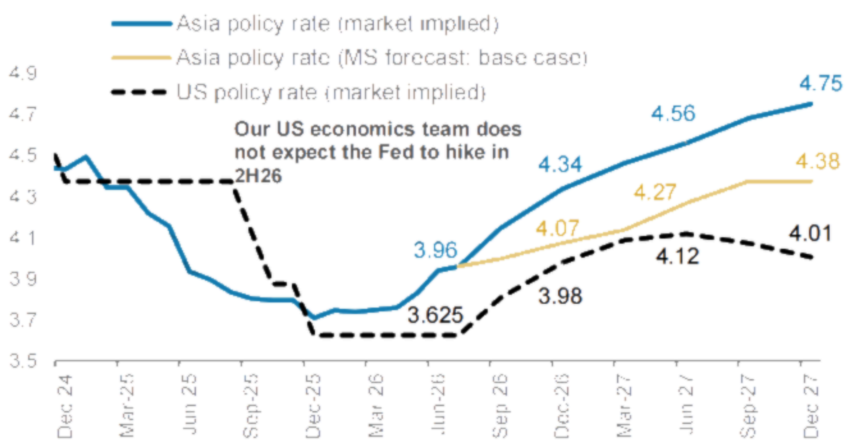
We think Asian central banks will hike rates at a slower pace than markets are pricing in. More importantly, we see these rate hikes as being counter-cyclical – considering that the key factor driving them is stronger growth outcomes.

Key Takeaways

- Markets continue to price in a faster pace and higher terminal rate as compared to our forecasts.
- The main reason is that markets are pricing in Fed rate hikes vs our US team's forecast of no hikes.
- Even without the Fed hiking in our base case, six out of 10 central banks in the region will be hiking.
- Four of the central banks are hiking in response to better growth conditions, or in other words they are tightening counter-cyclically.
- We see potential Fed rate hikes, higher oil prices and stronger than expected demand as key upside risks to our policy rate forecasts.

In this report, we discuss why our expectations for monetary policy differ from what the market is pricing in and what the risks to our forecasts are.

Exhibit 1: We expect policy rates to rise in Asia, but at a slower pace than the market has priced in



Source: [illegible], Morgan Stanley Research forecasts; Asia includes India, Korea, Malaysia, Thailand, Australia, Japan, Taiwan, Indonesia and Philippines. Market consensus is used for Indonesia and Philippines as their market pricing is not available

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Details

In agreement on direction, in disagreement on pace and magnitude: We agree with the market on one thing, which is that policy rates are going up across most Asian economies. Where we differ is on the pace and magnitude of hikes. Markets are pricing in faster and more hikes than our base case forecasts.

Why the difference? The biggest difference between our forecasts and market pricing really boils down to just one factor – the outlook for the Fed. While markets are pricing in 36bps rate hikes by end-2026, our chief US economist Michael Gapen expects the Fed to stay on hold for the rest of 2026. He expects disinflation in the coming months because of the cooling off of the tariff effects, weaker shelter inflation, and a reversal in energy prices. Our core PCE forecasts are around or below 0.2% on a m/m basis, going to 3.0% on a y/y basis by Dec-26.

Why we expect policy rates to rise in Asia: Even without the Fed hiking, our base case is rate hikes for six of the ten central banks. For the central banks which are hiking rates, it will be because they have to respond to either (1) weak trends in FX or supply-side factors or (2) strengthening aggregate demand.

Group #1: Having to address FX weakness or supply-side factors

Central banks in this group – BOJ, BI, BSP

We see three central banks in this group focused on FX and supply-side factors, lending upside to inflation.

BOJ – A more explicit focus on the role of FX in underlying inflation: Our chief Japan economist Takeshi Yamaguchi notes BOJ made important changes, suggesting a more hawkish policy stance in its July outlook report, including specific references to exchange rate developments as one of the factors in considering rate hikes (see July MPM Review: Bringing Forward the Timing of Expected Rate Hikes, July 31, 2026). We also previously highlighted the shift in BoJ's underlying rationale for rate hikes from the wage-price mechanism towards the pass-through from exchange rate depreciation and higher import prices to PPI and to CPI (see The Viewpoint: 10 questions about BoJ policy outlook, July 14, 2026). This is as an analysis from BOJ has shown that not only has the pass-through from exchange rate depreciation and higher import prices to CPI risen in recent years, but currency depreciation also affects inflation through second-round effects via higher wages, stronger services inflation, and rising corporate profit margins.

While recent FX interventions by Japanese and US authorities have led to the outperformance of JPY, our Japan FX strategist Koichi Sugisaki believes USDJPY remains driven by 1) market pricing of the US terminal rate, 2) global risk sentiment; and 3) Japan's terms of trade. The main focus from here remains US economic data and how it changes expectations for Fed policy and global risk sentiment. Unless these underlying drivers change, he expects JPY is likely to grind higher again (see JPY FX Intervention: Key Questions and Market Implications, August 3, 2026). With these considerations in mind, we expect the BoJ to hike in Oct-26 and then again in Mar-27. That said, we still retain our view that BOJ will raise rates to 1.5% by end-2027 only, vs. market pricing of ~1.8%. This is as 1) we are not yet convinced that underlying inflation is as strong as BOJ argues, 2) the effects of higher interest rates on the economy may only gradually become more visible with some lag from next year onwards, and 3) additional board member changes in Jul-27 may raise the hurdle for further rate hikes.

BI – Currency stability is the key factor: BI has already hiked by a cumulative 100bps with a view to restoring currency stability. With the policy rate differential with the US now restored to a four-year high, we believe there may be less scope for further rate hikes at this juncture, especially given subdued growth momentum. Indeed, BI refrained from hiking rates at the recent meeting and instead opted to provide more incentives to attract capital inflows to prevent the effects of even higher rates from transmitting into the real economy. Implicitly we think this signals some concern over growth and highlights how the central bank is having to balance between currency stability and growth considerations. However, we remain watchful of factors that may change this assessment. While the central bank may want to balance growth with currency stability risks, we think that the risks of rate hikes are very high should FX weaken materially.

BSP – Most exposed to supply-side-driven inflationary pressures: At 6.4%Y in June, headline inflation has been above the BSP's target range since Mar-26 and is also the highest in the region. Reflecting this, policymakers have already hiked twice over the past quarter. Looking ahead, we expect another 75bps of rate hikes this year, driven by evidence of rising second-round effects from the pass-through of energy prices as well as renewed currency depreciation leading to further imported inflation. Moreover, we see potential upward pressure on food prices from El Niño in 2H26 (see Asia Economics and Equity Strategy: Strong El Niño, Moderate Effect, July 28, 2026). The Philippines is one of the most exposed economies in the region on account of the high weight of food in its CPI basket. Indeed, BSP also incorporated these factors in its alternative high-inflation scenario published in June, which may lead to a peak of 12%Y in headline inflation in 1Q27. Against this backdrop, we believe that further rate hikes will be needed to anchor inflation expectations. The Governor has also highlighted the potential for a bigger quantum of rate hikes (i.e. 50bps) as a possible response.

Exhibit 2: BOJ increasingly attentive to currency depreciation and higher import prices

Source: Haver, Morgan Stanley Research

Exhibit 3: We see BSP facing further upside inflation risks from oil and El Nino effects given the already high starting point of inflation

	Headline inflation	Core inflation	Headline inflation above central bank inflation target/ midpoint of target range	Core inflation above central bank inflation target/ midpoint of target range
China	1.0%	1.0%	No	No
India*	4.4%	2.5%	Yes	No
Indonesia^	2.9%	2.8%	No	No
Korea	3.2%	2.5%	Yes	Yes
Malaysia	1.9%	1.9%	No	No
Philippines	6.4%	6.0%	Yes	Yes
Singapore	1.9%	1.6%	No	No
Taiwan	2.6%	2.3%	Yes	Yes
Thailand	2.4%	1.2%	Yes	No
Australia	3.9%	3.6%	Yes	Yes
Japan (US-style core)	1.7%	1.1%	No	No

Source: Haver, Morgan Stanley Research. Note: ^We take the 3.5% upper bound of inflation target range for Indonesia given central bank guidance. *India's inflation rate is based on new base period and used core-core inflation

Group #2: Addressing stronger aggregate demand trends

Central banks in this group – BOK, RBI, CBC, BNM

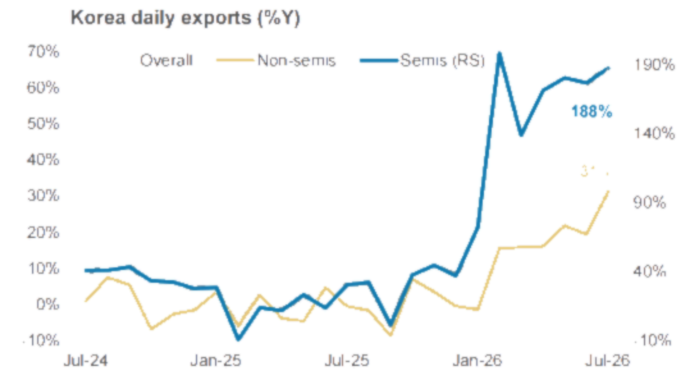
Four central banks in the region fall into this category. Aggregate demand is robust so central banks can tighten in a counter-cyclical manner.

Tightening was to be more counter-cyclical in nature: In our base case, we had been expecting that central banks in Asia would be lifting interest rates over the forecast horizon. But the nature of the tightening was meant to be counter-cyclical or in other words central banks are having to tighten monetary policy mostly to lean against stronger aggregate demand pressures.

BOK – Hiking on the back of materially stronger growth momentum: The BOK started its rate hike cycle in July, while delivering hawkish messaging regarding growth momentum. Our Chief Korea Economist Kathleen Oh notes that Governor Shin 1) indicated the timing of the output gap turning positive is likely to be brought forward from early next year, and 2) signaled a possible upgrade to BOK's GDP growth forecasts at the next meeting by indicating that the growth forecasts are "looking too low" (see BoK Review: Hike Cycle Kicks Off, July 16, 2026). Since the meeting, Korea's 2Q26 GDP growth of 3.7%Y has surprised us and consensus to the upside, and implies full-year growth at the mid-3% level. Coupled with Governor Shin's comments that "the next several policy meetings are all live", Kathleen expects the next rate hike to be in August. She sees two additional rate hikes per quarter after that, taking the terminal rate back to the 2023-24 peak level of 3.5% by 1Q27. In contrast, markets have priced in a higher terminal rate of almost 4% – a level not seen since 2008.

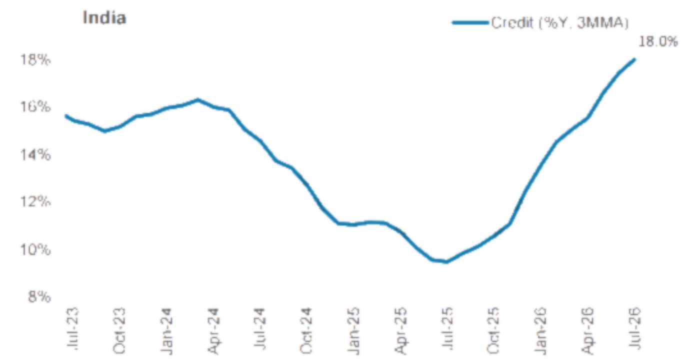
RBI – Risk of earlier hikes from stronger demand conditions: Incoming growth continues to track at a robust clip across high frequency indicators for capex, consumption and exports. Easy financial conditions have lifted bank credit growth to a 14-year high of 18%Y in Jul-26 on a 3mma basis. Our Chief India Economist Upasana Chachra is tracking 2Q GDP growth at 7%Y and sees modest upside risk to her F27 GDP growth forecast of 6.7%Y. In the near term, Upasana still sees a higher bar for tightening as RBI seeks evidence that inflationary pressures are becoming more broad-based (see India Economics: RBI Policy Preview: Data Dependent, July 30, 2026). Core CPI (excluding gold and silver) has been below 4% now for 32 consecutive months. Hence, in her base case, she expects rates to be hiked in Apr-27, vs. current market pricing of a first hike in October and one and a half hikes by the end of the year. However, if demand conditions remain strong and lead to a firming of underlying inflation momentum, then we see the risks skewed towards an earlier start in December. We also see upside risks to headline inflation from trailing FX depreciation, higher oil and food prices.

Exhibit 4: Korea daily exports growth continues to accelerate in July



Source: Haver, Morgan Stanley Research

Exhibit 5: In India, credit growth has reached a 14-year high of 18% on a 3MMA basis



Source: RBI, Morgan Stanley Research

CBC – Firming growth and price dynamics to drive modest hiking cycle: 2Q26 GDP growth continued to maintain double-digit %Y growth, as strong AI-related demand supported exports and investment. The recovery is also now visibly broadening out to consumption, and Kathleen expects full-year growth to be close to 11-12%Y. At the June meeting, Governor Yang noted that it was key to watch for a buildup of inflationary pressures going forward and that uncertainty in inflation trajectory remains high in 2H26. Since then, incoming headline and core inflation data have both accelerated to above 2%. Looking ahead, Kathleen expects growth and inflation dynamics to drive a modest hiking cycle with two 12.5 hikes each in 1Q27 and 3Q27, while markets have priced in a earlier first hike by 4Q26.

BNM – Reversing the insurance cut: With BNM's 25bps rate cut last year essentially an insurance move to guard against a growth drag from tariff uncertainties, we expect it to be reversed given the economy's strong growth momentum so far. With trailing inflation staying around 2%, policymakers are also unlikely to be in any rush to carry out this normalization move.

Group #3: No hikes

Central banks in this group – PBOC, RBA and BOT

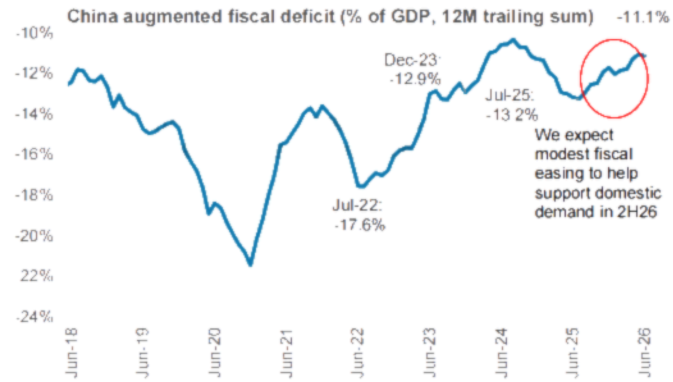
For this group of central banks, weak demand trends at the starting point mean policymakers are keeping policy rates on hold.

PBOC – Opting for other policy tools vs. policy rate moves: Our China economics team notes that policy rate hikes are unlikely given the weak starting point of domestic demand and the need to manage the pace of appreciation in RMB vs. USD. On the flip side, an additional policy rate cut is also unlikely given concerns over banks' already-depressed net interest margin. Instead, PBOC is likely to use targeted credit tools to support growth, and liquidity operations to facilitate the fiscal rollout. More importantly, overtightening in fiscal policy has been a key driver for the slowdown. We are now expecting faster fiscal rollout to help offset a large part of the fiscal tightening that had been underway since July 2025. The augmented fiscal deficit has started to widen modestly again in June this year, after having been narrowing for some time.

RBA – Housing-led slowdown to keep policy rate on hold: After three consecutive rate hikes, RBA paused in June to assess the effects of tighter monetary policy. While policymakers remain clearly focused on the upside risks to inflation, our Australia Economist Chris Read also highlighted that RBA began acknowledging the slowdown in domestic demand conditions (see Australia Macro+: RBA Review: Welcoming The Slowdown, Jun 16, 2026). In contrast, markets were pricing in close to one and a half additional rate hikes a little over one week ago. Since then, 2Q inflation has surprised to the downside and likely removes the likelihood of further RBA rate hikes. Markets have also moved closer to our forecasts but still expects close to one hike by 1Q27. In contrast, Chris continues to believe a broadening slowdown in domestic demand drives RBA to cut in 2027. In particular, a combination of rate hikes and tax changes is already driving a correction in the housing market, with fall in housing price growth becoming broad-based across cities in July data. Chris expects a 5-10% decline in national house prices with consequences for turnover, construction and credit (Australia Macro+: The Game Has Changed for Housing, May 20, 2026).

BOT – A supply shock may not be enough to drive rate hikes: BOT expects 2H26 inflation to exceed its target range, driven by higher energy and production costs and the effects of El Niño on raw food prices. However, policymakers also noted there was no evidence of broad-based and persistent increases in goods and services prices at the moment, and that inflation expectations remain anchored. Earlier in the year, policy makers also noted that a rate hike would not address the inflationary pressures from the supply shock and that "the economic expansion is projected to remain low and uneven". As such, we expect policy rates to be kept on hold through 2027, as we believe policymakers will keep a policy stance supportive of growth. From a broader perspective, Thailand is in a very early stage of reflation, after having had its inflation average just 0.1% for 35 months before the onset of Middle East tensions. Against this backdrop, we believe that BoT will keep nominal rates stable in order to bring about lower real rates to help support the reflation run, rather than prematurely tightening which may bring about the risk of a double dip.

Exhibit 6: In China, fiscal easing matters more vs. monetary easing



Source: CEIC, WIND, Morgan Stanley Research estimates. Note: For net land sales proceeds we discount gross land sales proceeds by [illegible] as per IMF to account for cost of acquisition, compensation to farmers, and land development costs

Exhibit 7: Housing-led slowdown to keep RBA on hold in 2026

Source: Cotality, Morgan Stanley Research

Risk scenario

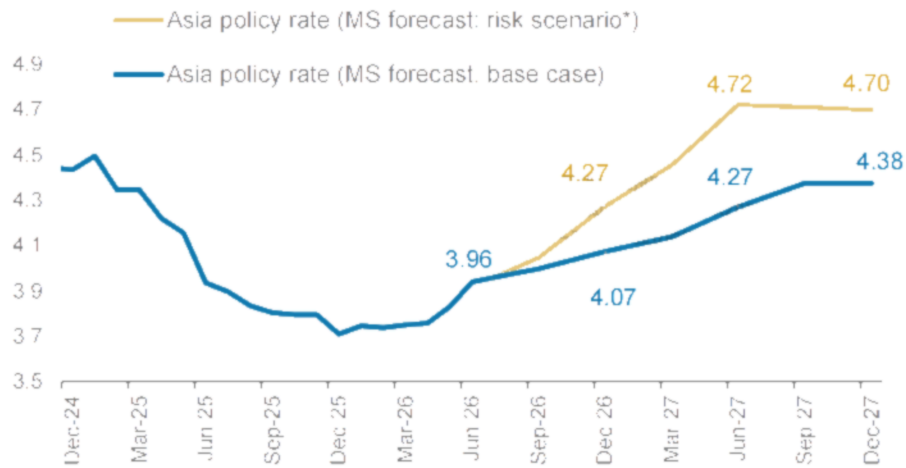
Risks to monetary policy outlook skew towards more rate hikes: We'd highlight three key risk factors to our forecasts – the Fed, oil prices and stronger than expected demand patterns. If central banks are responding to higher oil prices, it would be a pro-cyclical tightening. If central banks are responding to the Fed's action and in turn the Fed is responding to stronger demand, that would be less disruptive. Finally, responding to stronger demand would be the best outcome on a relative basis as that would be counter-cyclical tightening.

1) What if the Fed hikes? Our US economics team acknowledges that risks to our policy rate forecasts are to the upside. They cite the risks as a more hawkish Fed reaction function, persistently higher oil prices or AI-related capital spending boosting neutral rates of interest. The transmission from the rate hikes in the US would be through weaker Asian currencies, which then central banks may have to respond to. An important caveat to note is that it would be less disruptive for Asia if the Fed hikes were driven stronger AI spending than if the Fed hikes due to higher oil prices, given Asia would receive offset from stronger external demand conditions in the former case.

2) What if oil prices rise to US$100 or above in a sustained manner? Oil prices sustained at $100/bbl would pose a modest drag on Asia's growth. A key way for us to assess the extent of the growth drag has been to look at Asia's oil and gas burden (ratio of oil and gas consumption to GDP). We note that Brent prices at $100/bbl and Asian benchmark Japan/Korea marker gas prices at $20/mmBtu, if sustained, would bring Asia's oil and gas burden to just 5.0% of GDP, slightly above the long-term historical average of 4.7%. In this backdrop, we anticipate that there will be first a pass through to domestic fuel prices, which lead to more intense inflationary pressures which the central banks will have to respond to. We would need oil prices sustained at $120/bbl and gas at $25/mmBtu for Asia's oil and gas burden to rise to 6.1% of GDP and become a serious growth drag (close to the peak of 6.5% seen in 2022 given the Russia-Ukraine conflict). Against this backdrop, central banks will have to balance growth downside risks with inflation upside risks, which may lead to lesser rate hikes than in the oil at US$100/bbl scenario.

3) What if demand conditions are stronger than we expect? One way this could materialize is if the transmission from exports to capex to better labour market conditions and ultimately to consumption happens at a faster pace than we expect. Another way would be if export growth, especially ex-semiconductors, turned out to be stronger than we expect. Against this backdrop, central banks may have to lean in more against the wind.

Exhibit 8: In a risk scenario where oil stays elevated at US$100 and the Fed hikes twice, central banks may need to tighten further relative to our base case



Source: WITF, Morgan Stanley Research forecasts; Note: *Assuming oil stays elevated at $100 until year-end and Fed hikes twice by Jan 2027. Asia includes India, Korea, Malaysia, Thailand, Australia, Japan, Taiwan, Indonesia and Philippines. Market consensus is used for Indonesia and Philippines as their market pricing is not available.