

STONEBENCH

Asia's sovereign debt burden

Asia entered June 2026 with sovereign balance sheets already stretched by the post-pandemic borrowing overhang; it is leaving the month with a materially harder problem. The Iran war that began with US-Israeli strikes on 28 February 2026 closed the Strait of Hormuz for a critical period, drove Brent to triple digits and forced central banks that had been preparing to cut rates into an unwanted tightening cycle. The Bank for International Settlements now warns of a "fiscal–financial stability nexus", with the World Bank forecasting that global growth will be 2.5% for 2026, down from 2.9% in 2025, downgrading two-thirds of economies and warning that Asian energy importers face weaker prospects even as the Gulf takes the biggest direct hit. Meanwhile, Deutsche Bank has told clients to underweight European over US corporate credit specifically because of Iran spillover.

For Asian sovereigns, three developments in June crystallised the shift. First, Bank of Korea policy expectations flipped so decisively that Korean government bonds have become the worst performer this year among 44 sovereign markets tracked by Bloomberg, losing roughly 7.5% in local-currency terms. Second, the yen fell to around 162 on 30 June, its weakest level against the dollar since December 1986, as Japan's exit from ultra-low rates collided with a debt stock most sources place in the 240%–260% of GDP range on a general-government gross basis. Third, the World Bank approved US$1.1 billion in emergency financing for Bangladesh on 26 June and a separate US$450 million banking-sector package on 24 June, against a non-performing loan (NPL) ratio the Bank puts at 32.6% as of end-March 2026.

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The central thesis is that Asia's debt problem is no longer a tail risk to be managed with orthodox fiscal consolidation. Rising global rates, dollar strength versus most Asian currencies and commodity volatility have narrowed the region's refinancing window at the exact moment governments must spend more—on energy subsidies, defence and social protection. The result is a trade-off between fiscal discipline and domestic demand support that is already breaking one way in Pakistan, Bangladesh and Sri Lanka, and another in Japan, Korea and Indonesia.

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Cover image by Pratikxox

For banks, corporates and investors the operating environment is repricing: bond yields are climbing across the region, FX buffers are being consumed, and climate and infrastructure spending is being deferred. This report argues the stress is closer to structural than cyclical, and that the second-order effects—bank asset quality, capex deferral, and geopolitical realignment toward Chinese and multilateral financing—will define Asian investment risk into 2027.

What is the issue?

The specific development is that Asia's post-2020 sovereign debt overhang has, in the space of four months, become a live refinancing and debt-servicing problem rather than a slow-burn concern. Public debt-to-GDP ratios across the region have been elevated since the pandemic, but for most of 2023–2025 that was manageable: global rates were expected to fall, Asian currencies were stable against a softening dollar and commodity prices were benign. All three of those assumptions unravelled after US–Israeli strikes on Iran on 28 February 2026 and the subsequent closure of the Strait of Hormuz—a chokepoint through which roughly a fifth of the world's oil and LNG normally transited before the war.

The World Bank's Global Economic Prospects report, released 11 June, put numbers on the damage. Global growth was cut to 2.5% for 2026 (from 2.9% in 2025), with two-thirds of economies downgraded and Gulf states—notably the UAE and Iraq—absorbing the largest direct cuts. Chief economist at the World Bank, Indermit Gill described the transmission across Asia: "West Asia is being battered by the conflict. South Asia is being affected by higher oil, gas, mineral and fertiliser prices. Southeast Asia, countries like the Philippines, are suffering from higher fuel and mineral prices, and Northeast Asia is also experiencing these effects." The IMF matched the direction of the downgrade shortly after.

The mechanism is straightforward but its scale is not. Persistent higher energy prices—Brent trading in a US$74–US$110 range for much of the quarter—have re-ignited inflation just as Asian central banks were preparing to ease. S&P Global expects persistent inflationary pressures to weigh on emerging markets in Q3, forcing central banks to hold or hike. The Business Times has characterised Asian central banks as "turning hawkish" as bond yields climb across the region. Higher local yields and a stronger dollar together compress the refinancing window for any sovereign carrying meaningful external debt.

The question this report answers is what that means in practice. When a debt burden that looked manageable at 4% policy rates and US$75 Brent must be rolled over at 6% and US$100, three things happen simultaneously: debt-servicing eats a rising share of the budget, discretionary spending on social and physical infrastructure gets crowded out and FX earnings—particularly for energy importers—are diverted from productive investment into paying for imported fuel. Add currency depreciation (the yen at a 40-year low, the rupiah under sustained pressure, the Pakistani rupee absorbing repeated shocks) and the same debt stock now costs more in local-currency terms to service. That is the arithmetic that ran through the June budget presentations in Islamabad and Dhaka, and in March in Manila and it is the arithmetic the BIS spent its Annual Economic Report warning about.

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Why now? The trigger

Four specific June developments turned a slow-moving concern into an urgent one.

The first was the downgrading of growth forecasts by every major multilateral. The World Bank's 11 June cut to 2.5% global growth was followed by a matching IMF revision and, on 28 June, the release of the BIS Annual Economic Report, which formally identified pressure points—Middle East inflation, an unsustainable AI capex boom, financial-market risk appetite and rising public debt levels—that are likely to be manageable individually but risk amplifying one another. BIS deputy general manager Andrea Maechler was measured rather than alarmist, telling reporters that "central banks are already facing a complex situation in a world marked by a great deal of uncertainty"—the framing itself, from an institution that rarely raises its voice, is what markets noticed.

The second was the Asian rates repricing. On 30 June the yen fell to around 162 to the dollar, its lowest level since December 1986, on the back of a widening US–Japan rate gap. Japan reiterated its readiness to intervene, but the underlying arithmetic—a general-government debt stock most sources put in the 240%–260% of GDP range colliding with rising real rates for the first time in a generation—is what CGTN's commentary called an "impossible triangle". On 19 June Forbes reported that Korean government bonds were the world's worst-performing sovereign paper this year among the 44 markets Bloomberg tracks, down about 7.5% in local currency, as the Bank of Korea was pushed toward hiking by the memory-chip cycle and imported energy inflation.

The third was the wave of Asian budget presentations. In Pakistan the picture was starkest: a budget presented on 12 June raised defence spending by 18% and set an aggressive tax target designed to keep the US$7 billion IMF loan programme on track; the State Bank's FY25 review noted debt servicing consumed roughly 70% of tax revenue over the last full fiscal year; by 30 June the Federal Board of Revenue (FBR) had collected about PKR13 trillion—roughly PKR975 billion short of the target the IMF maintained through its May review, though in line with the twice-revised target in Pakistan's own budget



Image by Syed Nouman

documents; and on 7 July central-government debt was reported at PKR82 trillion as of end-May. The Philippines set its 2027 budget deficit target at 5.1% of GDP, still above pre-pandemic norms. India's April–May fiscal deficit ran at 9.6% of full-year estimates—modest by historical two-month standards, though 12 times last year's level, with revenues softening and the headline flattered by a record INR2.87 trillion RBI surplus transfer.

The fourth trigger was the emergency-financing wave. The World Bank approved US$1.1 billion of emergency financing for Bangladesh on 26 June, explicitly citing the Middle East conflict and rising fertiliser, fuel and food prices; a separate US$450 million was approved on 24 June to shore up the banking sector, whose NPL ratio was 32.6% as of end-March 2026, more than four times the South Asian average. Sri Lanka's US$2.9 billion IMF programme moved into its final stretch with the Fund's mission urging deeper reforms and reserve accumulation of US$1.2 billion–US$1.3 billion before programme end. The Paris Club used its June annual report to call for reform of the Common Framework—a call we read as tacit recognition that the current restructuring architecture is not equipped for the coming wave.

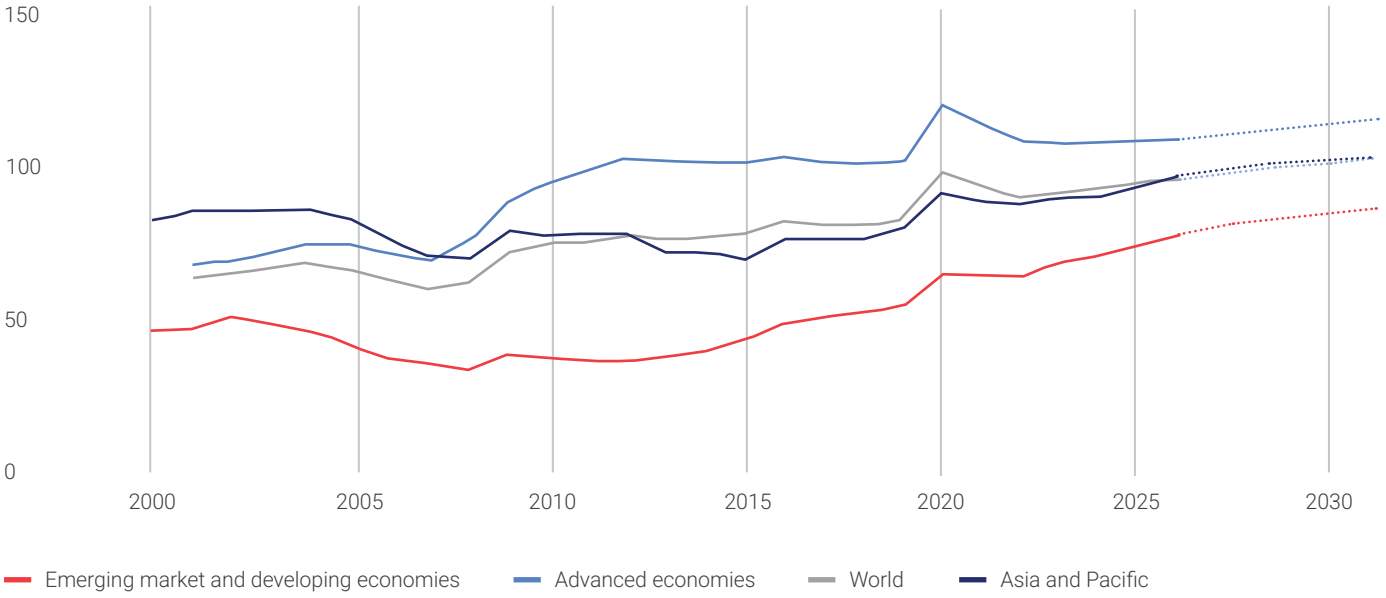
Individually, each is a familiar story. Together, in one month, they mark a point at which the Asian debt question stopped looking purely cyclical.

The landscape

To understand why this matters, it helps to disaggregate Asia into three fiscal cohorts, each facing a different variant of the same squeeze.

IMF DataMapper

General government gross debt (Percent of GDP)



Source: World Economic Outlook (April 2026)

The distressed frontier. Pakistan, Sri Lanka, Bangladesh, Laos and Myanmar sit in genuine debt distress. Pakistan's central-government debt reached PKR82 trillion by end-May 2026; the SBP's own FY25 review shows debt servicing at roughly 70% of tax revenue and 41% of current expenditure. The State Bank of Pakistan repaid US$1.3 billion of external debt during the week ended 19 June—a reminder of the balance-of-payments pressure. The finance ministry is openly signalling more commercial borrowing in 2027 to change the creditor profile without increasing overall external debt—a tacit admission that concessional windows are narrowing. Bangladesh has now taken roughly US$1.5 billion in combined World Bank support in the space of a week while its banking system carries a 32.6% NPL ratio and negative system-wide capital-to-risk-weighted assets. Sri Lanka has stabilised post-restructuring but has yet to build the reserves needed to exit IMF supervision safely. Lazard warned on 11 June that "complex" emerging-market debt—collateralised, growth-linked or export-linked instruments now common in this cohort—could raise borrowing costs and complicate future restructurings.

The pressured middle. Indonesia, the Philippines, Thailand, India and Vietnam retain market access but at rising cost. Indonesia's central bank governor took the unusual step on 10 June of a 90-minute investor call in which he signalled willingness to let bond yields rise and left rate hikes on the table. The rupiah's slide has surfaced what The Jakarta Post called a "possible hidden fiscal bill"—the contingent liabilities from FX-linked support—and forced Bank Indonesia into a rare off-cycle rate hike in early June. Against that backdrop, Danantara, the new sovereign wealth vehicle, tapped the dollar market for US$1.5 billion on 12 June with a peak order book of about US$4.6 billion, pricing its debut just 32bps–34bps over the sovereign curve—investor appetite for high-quality Asian paper is intact even where domestic conditions have tightened. Thailand retained its BBB+ rating but Fitch flagged elevated corporate leverage in late June, and

Bangkok's THB200 billion rail concession buyback is explicitly being funded off-balance-sheet via an infrastructure fund not classified as public debt—a signal of fiscal-space constraint. India's central bank has launched twin USD-INR swap facilities to attract foreign currency inflows and support external financing; a record RBI surplus transfer to the centre is now a material fiscal buffer.

The advanced but constrained. Japan and Korea are not distressed sovereigns but face a policy trilemma that increasingly rhymes with the emerging-market variety. Japan's yen crossed 162 on 30 June with general-government debt-to-GDP ratio between the range of 240% to 260%. Korea has become an unusual case in which the AI boom itself is punishing sovereign paper: the memory-chip cycle is forcing BoK hikes even as it lifts the equity market to record highs. Korean household debt surged again in May—a private-sector counterpart to the public-sector problem.

China is in its own category. Fitch reaffirmed the "A" sovereign rating with a stable outlook on 15 June, and Greater China was one of the few regions Fitch did not downgrade in its 8 June sector-outlook cut. But the People's Bank set a weaker yuan midpoint for three straight days later that month, and the Huaan Yifu Gold ETF became China's largest exchange-trade fund (ETF) of any kind in early July, displacing the CSI 300 flagship—a crossover driven partly by the state-backed "national team" unwinding its equity-ETF stakes, but underpinned by record household gold-ETF inflows of about US$8.5 billion in Q1 2026. Retail demand for insulation on that scale has implications for local-government financing vehicles and the capacity of Chinese savings to absorb sovereign paper, though the effect is one input among several.

For governments, this landscape means that every rupee, rupiah or peso spent on debt service is one not spent on the energy subsidies, food-security programmes and climate-adaptation infrastructure that populations increasingly demand. For businesses, it means the operating environment is being repriced sector by sector, most visibly in banks and rate-sensitive corporates.

Implications

The implications fan out along five channels, each of which is now visible in the data.

Fiscal space and the discipline–support trade-off. The single most important implication is that Asian finance ministers can no longer defer the choice between fiscal consolidation and demand support. In Pakistan, the choice has been largely made for them: debt service consumes the majority of tax revenue on SBP's own figures, the FY25/26 revenue effort has fallen short of the IMF's maintained target and the Khyber-Pakhtunkhwa (K-P) provincial budget for FY2026/27 is dominated by security spending. In Indonesia, the choice has been made for support: Danantara has been given broad protections to attract Patriot Bond buyers, drawing an FATF review request from civil-society groups worried about anti-money-laundering compliance. In the Philippines the 2027 deficit narrows only marginally to 5.1%. The IMF has explicitly warned other high-debt jurisdictions against further fiscal loosening in response to the energy shock. Where governments have chosen support over discipline, spreads have widened and governance concerns have followed—Indonesia's Patriot Bond protections have drawn an FATF review request, and students have mobilised against what commentators call "fiscal populism". Where they have chosen discipline, the strain is social: Sri Lanka's cost-recovery fuel pricing has been raised five times between February to May 2026, and Pakistan's tax measures have already fuelled provincial pushback on the federal budget.

Bank balance sheets and credit supply. The banking-system channel is where the sovereign story translates most directly into corporate exposure. Bangladesh's 32.6% NPL ratio and negative capital-to-risk-weighted assets ratio are extreme, but they sit on a distribution that includes elevated Thai corporate leverage, rising Korean household defaults and Japanese megabanks paying record dividends off net interest margins that widen with each incremental hike. The BIS has warned about the non-bank channel specifically—hedge-fund and asset-manager exposures to sovereign paper, and the

interaction with a possible AI-driven equity correction. For Asian banks specifically, three tensions matter: local-currency deposit bases must fund increasingly expensive dollar liabilities; sovereign bond portfolios are under water at current yields; and corporate loan books face rising provisioning as SMEs absorb higher input costs. The World Bank's Bangladesh package is a template for how multilaterals now see banking-sector reform as inseparable from sovereign stabilisation.

Corporate capex and refinancing. Broader Asian corporate behaviour reflects the same defensive posture: capital that would normally rotate into productive investment is being redirected. Mitsubishi Corp's record debt financing move in Japan is unusual for a Japanese trading house and speaks to a strategic decision to lock in balance-sheet capacity before conditions worsen. Tencent's dual-currency bond drew more than US$17 billion in orders on a final US$4.66 billion raised, showing that the highest-quality Asian issuers still command demand—but pricing has widened for weaker names. At the lower end, Korea's JoongAng Ilbo has applied for a creditor-led debt workout; Deutsche Bank's underweight recommendation on European corporates on Iran spillover captures the wider spread-widening cycle now underway.

FX earnings, energy security and the climate agenda. For most of Asia, the arithmetic is that a US$10 rise in Brent costs roughly 0.2%–0.5% of GDP in additional import bills. When those bills are paid in dollars against depreciating local currencies, the effective cost is materially higher. That is a direct hit to reserves and to the FX earnings otherwise available for climate-transition capex. Asia's energy transition—the central theme of Summer Davos in Dalian—is being visibly deferred as governments prioritise short-term energy security. Firms and governments across Asia are already "reassessing their reliance on the Middle East for oil and energy supplies". India's central bank has said 7% growth is achievable only if oil returns to around US$70. Until then, both fiscal space and the renewables ramp-up are constrained. This is the mechanism by which a Middle East war becomes an Asian climate story.

Capital flows and the geopolitical dimension. The BIS pressure-point framework treats these as separate risks, but they are converging. Chinese households are rotating into gold at record domestic scale; central banks in emerging economies are diversifying reserves away from dollars, with 74% expecting lower dollar shares over five years in the World Gold Council (WGC) survey; Indonesia's Danantara is pursuing a Panda bond alongside its dollar issuance to diversify currency exposure and Pakistan is signalling more commercial borrowing to change its creditor mix. Taken together this looks like a slow-motion realignment in which Asian sovereigns increasingly finance themselves in a mix of dollars, renminbi and gold-backed reserves rather than exclusively in dollar-denominated multilateral paper. Whether that reduces vulnerability or simply substitutes one dependency for another is an open question, and one the Paris Club's June call for reform of the Common Framework implicitly poses.

Is this structural? All five channels point in a similar direction, though the case is not airtight. What began as a cyclical shock—an unexpected war, a temporary chokepoint closure—is being converted into a more durable repricing by three factors that will not fully reverse in the short term. First, the June memorandum of understanding briefly eased near-term energy risk, but it is already under severe strain: tanker attacks in the strait on 6–7 July drew renewed US strikes on Iran and a US move to revoke the oil-sanctions waiver, and supply routes and shipping insurance premiums remain far from normal. Second, Asian public-debt stocks are now large enough that even normalisation of rates carries a permanent higher debt-service burden. Third, the fiscal-financial stability nexus BIS identifies is a two-way street: constrained fiscal space itself limits central-bank room to fight inflation without triggering debt-service stress. The counter-argument—that a durable ceasefire, a Fed pivot and normalised oil could restore the pre-2026 pattern within 12 months—is not impossible; the report's judgment is only that the balance of evidence favours the structural reading.

Conclusion / what to watch

The most likely trajectory over the next 6–12 months is bifurcation. The distressed cohort—Pakistan, Bangladesh, Laos, Sri Lanka and Myanmar—is likely to move deeper into multilateral-supervised territory, with more emergency financing packages, more IMF programme extensions and a rising probability of at least one further sovereign restructuring in South Asia. The pressured middle—Indonesia, Philippines, Thailand and India—should retain market access but at wider spreads. This means this cohort is likely to lean harder on domestic financing (Indonesia's Patriot Bond template will be studied by others) and will quietly defer some climate and infrastructure ambitions. The advanced constrained—Japan and Korea—can probably manage through with FX intervention and unorthodox monetary tactics, but Japanese sovereign paper has become one of the region's most closely watched systemic risks. China occupies its own quadrant, with policy support offsetting private-sector risk aversion but yuan management becoming harder to reconcile with capital-account pressures.

The key uncertainties are: whether the fragile June MoU holds after the 6–7 July flare-up and energy prices normalise back toward the World Bank's US$94 baseline; whether the AI capex cycle sustains Korean and Chinese growth or corrects sharply; whether the Fed cuts by year-end, easing dollar pressure across the region; and whether a further Asian sovereign—most plausibly in South Asia—is forced into restructuring, which would reprice the entire regional spread curve.

Signposts to monitor:

Brent crude sustained above US$95 or below US$80. Anything above US$95 by August tightens the fiscal squeeze, while anything below US$80 gives Asian finance ministries meaningful breathing room. Sri Lanka's cost-recovery fuel pricing—raised five times between February to May—illustrates how directly and quickly pump prices now move with the crude curve.

The IMF Article IV cycle for Pakistan (autumn), Bangladesh (Q4) and Sri Lanka (post-programme). These reviews will set the tone for whether the distressed cohort stabilises or requires renewed restructuring conversations under the Common Framework.

Japanese intervention thresholds and BoJ balance-sheet actions. Yen moves past 165 or renewed unsterilised intervention would materially change global fixed-income conditions and Asian sovereign spreads.

Chinese local-government financing vehicle refinancing rounds and Panda bond issuance from foreign sovereigns. Increased local government financing vehicles (LGFV) stress or a wave of Panda bonds from Asian sovereigns would strengthen the currency-substitution thesis.

Central-bank gold accumulation and reserve currency composition data. The next WGC survey and IMF Currency Composition of Official Foreign Exchange Reserves (IMF COFER) data will show whether the June signals were a spike or a trend.



Image by Gowtham AGM



Image by Zhou Shen

The single most useful frame for readers is this: Asia's debt question in 2026 is no longer about whether the region can afford its current stock of borrowing. It is about whether, in a world of higher energy prices, higher rates and higher geopolitical risk premiums, Asian governments can simultaneously fund debt service, energy security, social support and climate transition without breaking one of those constraints. As of June 2026, the balance of evidence suggests they cannot fund all four at once. The interesting question is which constraint each government chooses to break first.

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ABOUT STONEBENCH

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