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ASIA CAPITAL MARKETS MONITOR

MAY 2010

HIGHLIGHTS

Asian Development Bank

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Asia Capital Markets Monitor

MAY 2010

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The *Asia Capital Markets Monitor* (ACMM) reviews recent developments in emerging Asia's stock, bond, and currency markets along with their outlook, risks, and policy implications. This issue features a special section, "Managing Capital Flows: Issues and Challenges for Emerging Asia."

The ACMM covers the capital markets of China, People's Republic of; Hong Kong, China; India; Indonesia; Korea, Republic of; Malaysia; Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

Download the ACMM at:

http://asianbondsonline.adb.org/events/2010/asia_capital_markets_monitor/acmm_2010.pdf

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Highlights

Global and Regional Environment

- Global economic and financial conditions have improved over the past year in part due to the unprecedented policy measures taken in response to the global financial crisis.
- As a result of the improving external environment and swift policy responses of the region's governments, emerging Asia's economic recovery has gained substantial traction.
- Inflation, though rising, remains manageable; while balance of payments across the region remain in surplus as exports rebound and capital inflows surge.
- External funding conditions for emerging Asia have vastly improved as the global credit environment eases and investors' risk appetite returns.
- The Greek debt crisis and fears of contagion effects have weighed on investor sentiment—although the impact on emerging Asia's capital markets has been and is expected to remain limited.
- The timing and pace of exits from fiscal and monetary stimulus will also influence the region's capital markets.

Emerging Asia's Market Performance and Outlook

- The global economic recovery, very low returns on safe assets in developed countries, and attractive valuations drove the post-crisis rebound in emerging Asian equity markets.
- Emerging Asian equities delivered lofty returns in 2009 and market capitalization soared, though still remained below pre-crisis levels.
- Despite favorable cyclical developments, the strong performance of emerging Asian equities in 2009 limits room for further gains this year.
- The region's low interest rate environment, stable financial markets, economic recovery, and improved risk appetite brought a surge in issuance on local currency bond markets.
- Risk premiums for high-yield papers remain elevated, even as credit spreads on high-grade emerging Asian local currency corporate bonds tighten.
- Government bond yield curves are steepening—due to a combination of concerns over supply, the buildup of public debt, and strong recovery in other asset markets.
- Yields on government bonds may rise further amid increasing inflation expectations as monetary authorities raise interest rates.
- Emerging Asia's currencies broadly strengthened against the US dollar in 2009, although the extent of appreciation varied depending on country-specific economic conditions.
- Appreciation pressures on Asian currencies will likely intensify as capital inflows surge on improved economic prospects for the region.

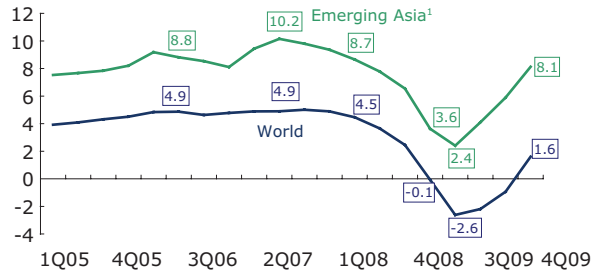
Managing Capital Flows: Issues and Challenges for Emerging Asia

- Improved risk appetite and the region's strong economic recovery have led to a surge in capital flows to emerging Asia.
- This surge has been driven by portfolio equity flows—creating net inflows in 2009—spurred by increased earnings potential in emerging Asian markets.
- While the return of capital flows is welcome, surges in short-term capital inflows could destabilize financial markets and pose a risk to stability.
- Managing capital flows effectively requires an array of policy measures, including (i) sound macroeconomic management, (ii) flexible foreign exchange regimes, (iii) resilient financial systems, and (iv) temporary and targeted capital controls.
- The use of capital controls may be appropriate when capital inflows are transitory, add undue pressure on exchange rates, and pose risks to financial stability; and where the effectiveness of macroeconomic policies is uncertain.

At a Glance

Global economic recovery takes hold, growth in emerging Asia gains traction

GDP Growth—Emerging Asia and World
(year-on-year, %)



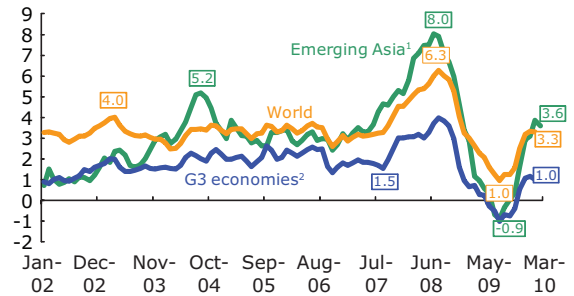
Note: Aggregates are weighted based on gross national income levels (Atlas Method in current USD prices) from *World Development Indicators*, World Bank.

¹Emerging Asia includes China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

Source: National sources accessed through CEIC database and *World Economic Outlook April 2010*, International Monetary Fund.

Inflation edges up as many economies prepare to exit from stimulus packages and tighten monetary policies

Headline Inflation—Emerging Asia, G3 Economies, and World (year-on-year, %)

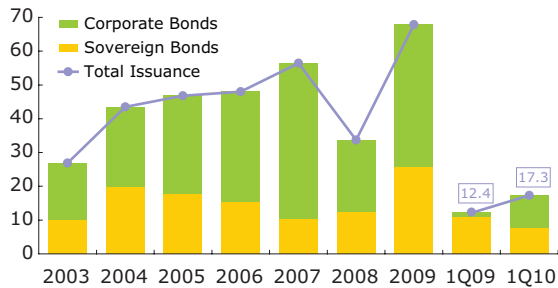


¹Emerging Asia includes China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; Singapore; Taipei, China; Thailand; and Viet Nam. ²G3 economies include eurozone, Japan, and United States.

Source: *World Economic Outlook April 2010*, International Monetary Fund; and national sources accessed through CEIC database.

External funding conditions for emerging Asia turn favorable and sovereign and corporate eurobond issuance jumps

Corporate and Sovereign Eurobond¹ Issuance—Emerging Asia² (USD billion)

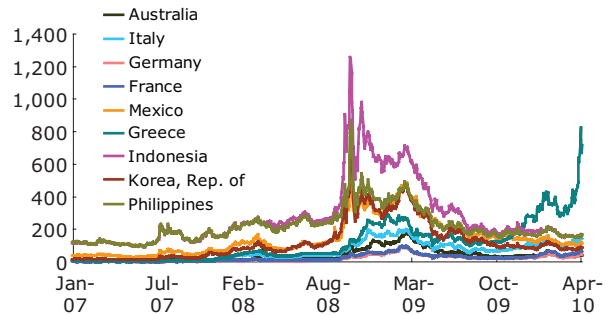


¹Includes US dollar, euro, and Japanese yen bond issuances. Sovereign bonds refer to those issued by national governments and government agencies. Data excludes certificate of deposits. ²Includes China, People's Rep. of; Hong Kong, China; Indonesia; India; Korea, Rep. of; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.

Source: OREI staff calculations using Bloomberg data.

However, Greece's debt crisis and fears of contagion weigh on investor sentiment

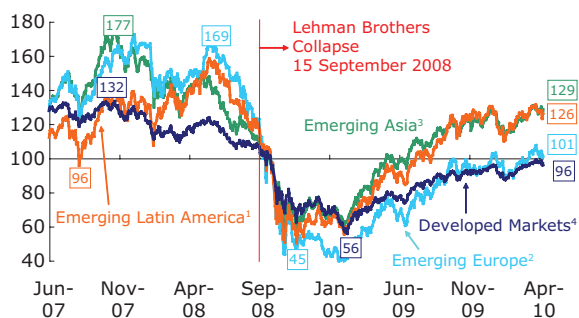
Credit Default Swaps Spreads—Selected OECD and Emerging Asian Economies (basis points)



OECD = Organisation for Economic Cooperation and Development.
Source: Thomson Datastream.

Emerging Asian equities rebound, spurred by economic recovery, attractive valuations, and rising investor confidence

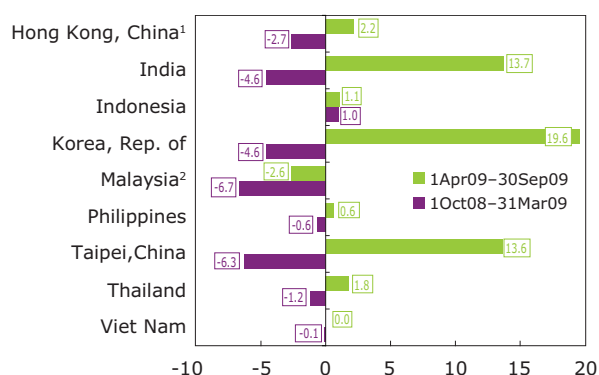
MSCI Equity Market Indexes
(15 September 2008 = 100)



¹Includes Brazil, Chile, Colombia, Mexico, and Peru. ²Includes Czech Republic, Hungary, Poland, Russia, and Turkey. ³Includes China, People's Rep. of; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; Taipei,China; and Thailand. ⁴Includes Canada, France, Germany, Italy, Japan, United Kingdom, and United States.
Source: Morgan Stanley Capital International (MSCI) Barra.

Net foreign investment in Asian equities turns positive as investors regain confidence and global liquidity conditions improve

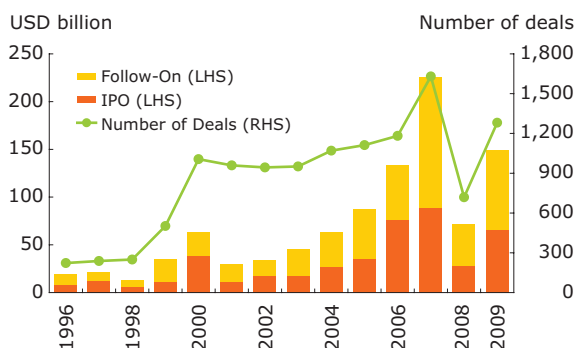
Net Foreign Portfolio Investment in Equities
(USD billion)



¹Data refers to net portfolio investment in equity securities. ²Values refers to net foreign and domestic portfolio investment in shares and corporate securities.
Source: Bloomberg, CEIC database, and Bank Negara Malaysia.

Issuance in emerging Asian equity markets rebounds strongly in 2009 as stability returns and economic prospects brighten

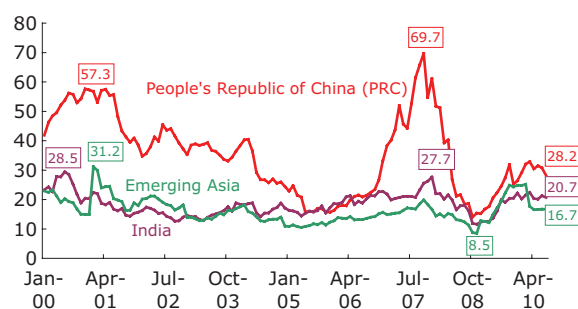
Equity Issuance—Emerging Asia¹



IPO = initial public offering, LHS = left-hand side, RHS = right-hand side.
¹Includes China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
Source: Dealogic.

Despite the favorable cyclical developments, the strong performance of emerging Asian equities in 2009 limits room for further gains

Price-Earnings Ratio—Emerging Asia,¹ PRC, and India



¹Data refers to MSCI All Country Asia (excluding Japan) Index, which includes China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; Singapore; Taipei,China; and Thailand. ²Price-earnings ratio of combined Shanghai and Shenzhen Composite, weighted by their respective market capitalizations.
Source: Bloomberg and CEIC database.

Low interest rates, improved risk appetite, and issuance contribute to robust growth of local currency (LCY) bond markets

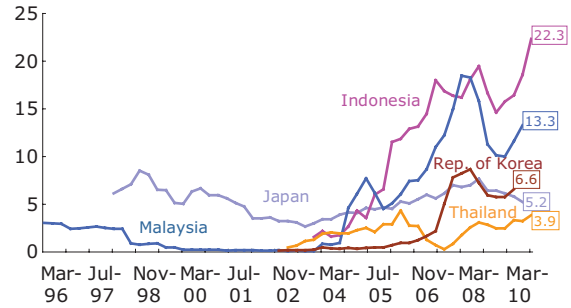
Total Bonds Outstanding—Emerging Asia
(USD billion)



Note: Emerging Asia includes China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.
Source: *AsianBondsOnline* and Bloomberg.

Foreign holdings of LCY government bonds rise as investors hunt for yields and regional currencies appreciate

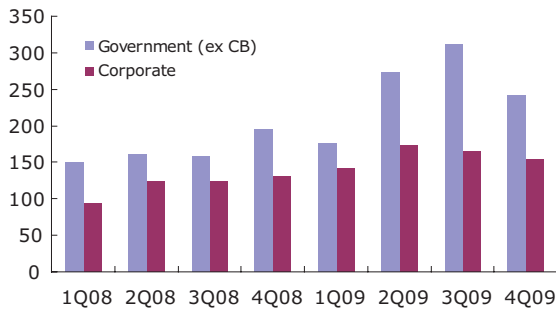
Foreign Holdings of Local Currency Government Bonds (March 2010)



Note: Data for the Republic of Korea is as of September 2009. Data for Malaysia and Japan are as of December 2009.
Source: *AsianBondsOnline*.

LCY issuance rises as governments finance increased deficits and firms raise fresh funds

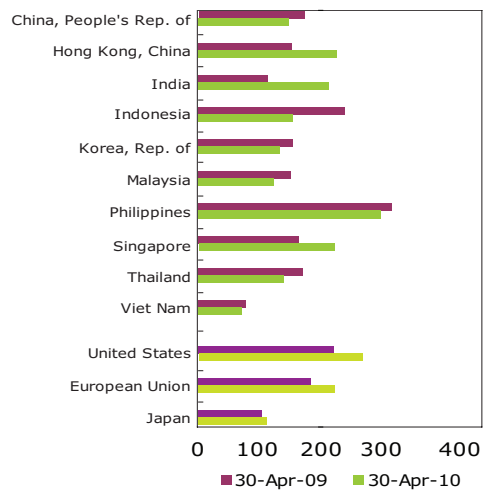
Government (excluding Central Bank) and Corporate Bond Issuance—Emerging Asia
(USD billion)



CB = Central Bank.
Notes:
1. These data include both bonds and bills issued by governments and central banks as well as commercial paper issued by corporate entities.
2. Includes local currency (LCY) bond issuance of China, People's Rep. of; Hong Kong, China; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.
Source: China, People's Rep. of (*ChinaBond*); Hong Kong, China (Hong Kong Monetary Authority); India (Bloomberg); Indonesia (Bloomberg); Korea, Rep. of (Bank of Korea); Malaysia (Bank Negara Malaysia); Philippines (Bloomberg); Singapore (Singapore Government Securities and Bloomberg); Thailand (Bank of Thailand); and Viet Nam (Bloomberg).

Yield curves steepen amid rising inflationary expectations

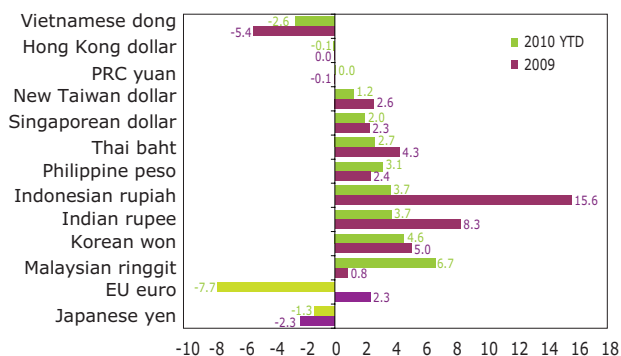
Yield Spreads Between 2- and 10-Year Government Bonds (basis points)



Source: Based on data from Bloomberg.

Emerging Asian currencies broadly appreciate as recovery gathers pace and interest rate differentials widen

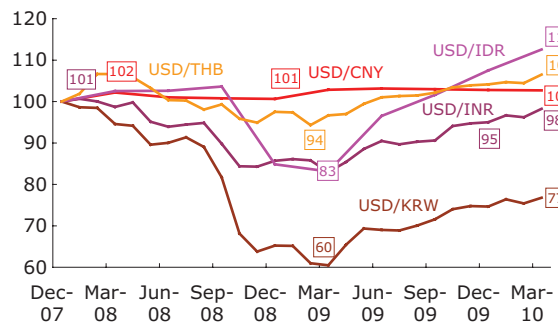
Change in Exchange Rate versus the US Dollar¹
(%)



EU = European Union, PRC = People's Republic of China.
¹Year-to-date (YTD) figures for 2010 from 4 January to 30 April. Negative figures indicate depreciation of local currency; positive values indicate appreciation of the local currency.
 Source: OREI staff calculations based on Reuters data.

Emerging Asian currencies as an asset class post strong gains, spurred by surges in capital flows

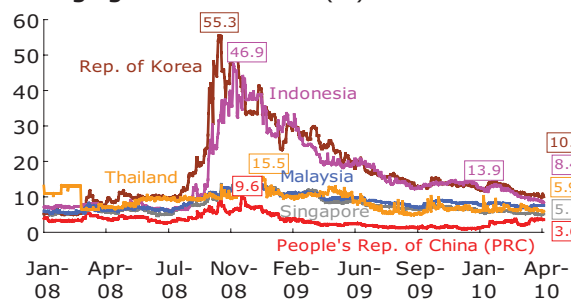
Currency Returns—Selected Asian Emerging Economies (December 2007 = 100)



Source: OREI staff calculations based on Reuters data.

Exchange rate volatility subsides steadily across emerging Asia as financial markets stabilize

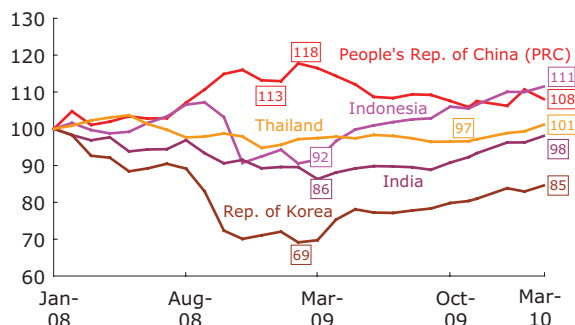
Implied Volatility of Exchange Rates¹—Selected Emerging Asian Economies (%)



¹Data refers to 3 months implied volatility at-the-money (ATM) strike.
 Source: Bloomberg.

Real effective exchange rates for many emerging Asian currencies make gradual upward movements, with the notable exception of the yuan

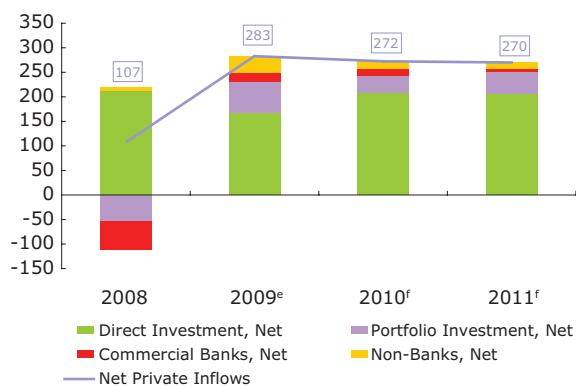
Real Effective Exchange Rates¹— Selected Emerging Asian Economies (January 2008 = 100)



¹Adjusted by relative consumer prices.
 Source: OREI staff calculations using data from the Bank for International Settlements.

Capital inflows return to emerging Asia, led by more volatile short-term portfolio investment

Net Private Capital Flows—Emerging Asia¹
(USD billion)



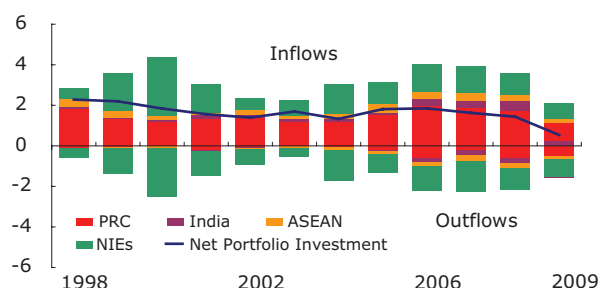
e = estimate, f = forecast.

¹Emerging Asia includes China, People's Rep. of; India; Indonesia; Korea, Rep. of; Malaysia; Philippines; and Thailand.

Source: *Capital Flows to Emerging Market Economies (April 2010)*, Institute for International Finance.

The People's Republic of China (PRC) continues to dominate foreign direct investment (FDI) flows to emerging Asia

Foreign Direct Investment Flows—Emerging Asia (% of GDP)

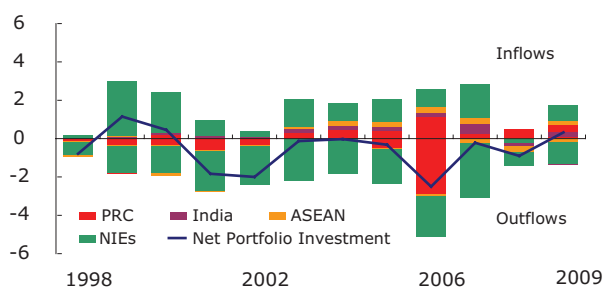


ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product, NIEs = newly industrialized economies, PRC = People's Rep. of China. Note: Emerging Asia includes China, People's Rep. of; Hong Kong, China; Indonesia; India; Korea, Rep. of; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.

Source: *International Financial Statistics and World Economic Outlook Database*, International Monetary Fund; and CEIC database.

Financial deregulation and liberalization has led to foreign portfolio investment flow increases in both directions since the 1997/98 crisis

Foreign Portfolio Investment Flows—Emerging Asia
(% of GDP)

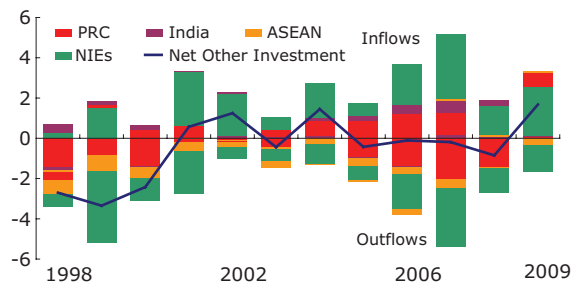


ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product, NIEs = newly industrialized economies, PRC = People's Rep. of China. Note: Emerging Asia includes China, People's Rep. of; Hong Kong, China; Indonesia; India; Korea, Rep. of; Malaysia; Philippines; Singapore; Taipei, China; and Thailand. Inflows refer to foreign portfolio liabilities; outflows refer to foreign portfolio assets.

Source: *International Financial Statistics and World Economic Outlook Database*, International Monetary Fund; and CEIC database.

Other investment flows prove more volatile and vulnerable to external shocks and currency instability

Other Investment Flows—Emerging Asia
(% of GDP)



ASEAN = Association of Southeast Asian Nations, GDP = gross domestic product, NIEs = newly industrialized economies, PRC = People's Rep. of China.

Note: Emerging Asia includes China, People's Rep. of; Hong Kong, China; Indonesia; India; Korea, Rep. of; Malaysia; Philippines; Singapore; Taipei, China; and Thailand. Inflows refer to other investment liabilities; outflows refer to other investment assets. Values include financial derivatives.

Source: *International Financial Statistics and World Economic Outlook Database*, International Monetary Fund; and CEIC database.

Asia Capital Markets Monitor, May 2010

Asian capital markets have delivered spectacular gains as the prospect of strong growth combined with the return of appetite for emerging-market assets brought a surge in capital inflows to the developing economies of Asia once again, says the 2010 issue of ADB's Asia Capital Markets Monitor. This issue reviews the recent performance in emerging Asia's stock, bond, and currency markets along with the outlook, risks, and policy implications of that performance. A special theme chapter on "Managing Capital Flows: Issues and Policy Challenges for Emerging Asia" is also presented.

The Asia Capital Markets Monitor was prepared by a team of economists from the Office of Regional Economic Integration (OREI) of the Asian Development Bank. Primary contributors include Cyn-Young Park and Sabyasachi Mitra, while OREI consultants, Chee Sung Lee and Mike Kennedy, also contributed to the report. The authors thank John Stuermer and the members of AsianBondsOnline, the Asia Regional Integration Center, and Rogelio Mercado for valuable inputs and research assistance.

The Asia Capital Markets Monitor has been reviewed and approved by Srinivasa Madhur, Senior Director and Officer-in-Charge of OREI.

About the Asian Development Bank

ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

Photo Credit: Ko Fujimura

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