

A stack of approximately 25 gold coins, slightly offset to the right, creating a sense of depth. The coins are set against a blue background that has a dark horizontal band across the middle.

ADB

ASIA CAPITAL MARKETS MONITOR

AUGUST 2011

HIGHLIGHTS

Asian Development Bank

The logo of the Asian Development Bank (ADB), consisting of the letters 'ADB' in white serif font centered within a dark blue square.


ADB

Asia Capital Markets Monitor

AUGUST 2011

Asian Development Bank

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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, "Financial Integration and Capital Flow Volatility in Emerging Asia: Issues and Policies."

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

Download the ACMM at
http://www.asianbondsonline.adb.org/publications/adb/2011/acmm_2011.pdf

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Highlights

Global and Regional Environment

- The two-speed global economy—moderating yet robust growth in emerging markets against the painfully slow recovery in advanced economies—continues to chug along, with more modest growth expected in 2011.
- The pattern of anemic growth in advanced economies will likely continue beyond 2011—even as Japan’s reconstruction efforts boost its economy and authorities struggle to deal with Europe’s bailout negotiations and the US debt limit.
- Strong growth in emerging Asia is set to moderate as monetary tightening to fight inflation takes hold.
- Financial volatility has returned to the global marketplace amid renewed uncertainty over the strength of the global economy, spreading social unrest in the Middle East, and deepening fiscal concerns in Europe.
- Government bond yields in major advanced economies have declined due to widespread “flight to safety.”
- The diverging growth and inflation outlooks between emerging markets and advanced economies mean associated monetary and fiscal policies are diverging as well.
- External funding conditions for emerging Asia remain favorable given its relatively strong growth prospects; the low interest rate environment in mature markets continues to push investors to search for yield in emerging market debt.

Emerging Asia’s Market Performance and Outlook

- Strong economic fundamentals support emerging Asia’s equity markets following a wave of market corrections.
- Nonetheless, the outlook for emerging Asian equities has softened as markets factor in higher profit risks amid greater global economic uncertainty; Asia’s equity results remain tightly linked to global financial developments.
- After last year’s recovery-fueled growth bolstered emerging Asia’s share of the global local currency bond market, government issuance eased this year as authorities unwind fiscal stimulus; nonetheless, corporate bond issuance remains strong given the region’s robust outlook.
- Broadening the investor base and improving bond market liquidity remain key policy challenges for deepening emerging Asia’s local currency bond markets.
- The size and pace of capital flows to emerging Asia have moderated since last year’s resurgence, but the region’s strong economic growth and widening interest rate gaps with mature markets continue to attract investors.
- While the return of capital flows to emerging Asia is welcome, today’s dramatic increase in capital inflows, especially driven by short-term flows, may well presage tomorrow’s large outflows.
- Sustained recoveries in trade and investment flows continue to push emerging Asia’s currencies higher on a broad front, although the moderating growth outlook is reducing some appreciation pressures.

- Real effective exchange rates for emerging Asian currencies have stabilized, since late 2010, on slowing nominal appreciation, rising inflation, and divergent currency movements of the region's major trading partners.
- The share of international portfolio assets and liabilities held by emerging Asian investors is increasing over time, with wider geographic diversification and more regional assets held by regional investors.

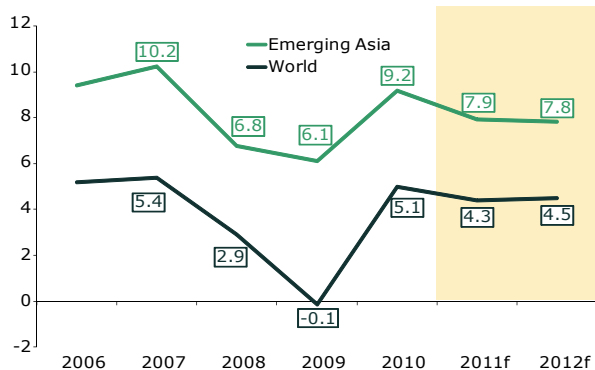
Financial Integration and Capital Flow Volatility in Emerging Asia: Issues and Policies

- Financial integration and contagion are two sides of the same coin: while a virtuous cycle in good times, greater integration reduces defense against negative shocks.
- Emerging Asia's equity markets—particularly those tightly linked to global markets—are vulnerable to abrupt swings in global investor sentiment, potentially increasing capital flow volatility.
- The region's local currency bond markets remain largely fragmented; while protected from external shocks, fragmentation hinders market liquidity.
- Emerging Asia should continue strengthening macroeconomic management and macroprudential supervision to attract stable and long-term capital flows.
- The 1997/98 and 2008/09 crises highlight the region's vulnerability to financial instability arising from rapid financial globalization, large and unfettered short-term capital flows, exchange rate volatility, and the lack of crisis control mechanisms.
- Asia must assume greater responsibility in reforming the global financial architecture by actively participating at all levels of governance.

At a Glance

Global economic growth slows—emerging Asia’s strong growth moderates on monetary tightening while advanced economies continue to struggle with debt

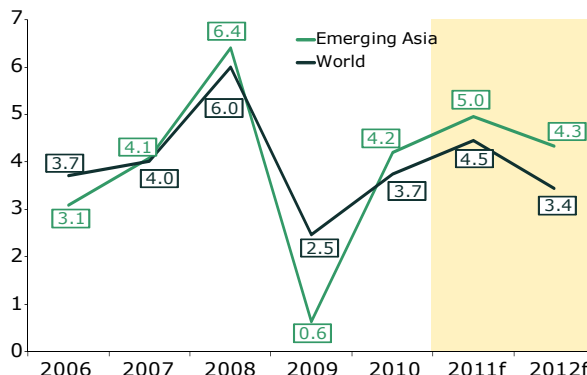
GDP Growth—Emerging Asia and World (year-on-year, %)



f = forecast, GDP = gross domestic product.
 Notes: Emerging Asia includes People’s Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam. 2011 and 2012 figures are estimates.
 Source: ADB Office of Regional Economic Integration using data from *Asia Economic Monitor July 2011*, ADB; *World Economic Outlook Database April 2011* and *World Economic Outlook Update June 2011*, International Monetary Fund.

Inflation continues to rise on broadening global recovery; core inflation accelerates in emerging Asia on closing output gaps

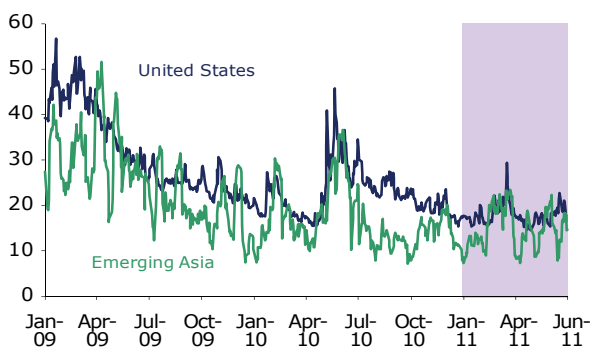
Inflation—Emerging Asia and World (year-on-year, %)



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 Source: ADB Office of Regional Economic Integration using data from *Asia Economic Monitor July 2011*, ADB; *World Economic Outlook Database April 2011* and *World Economic Outlook Update June 2011*, International Monetary Fund.

Financial volatility returns to global markets amid uncertainty over the global economic recovery, social unrest in the Middle East, and fiscal concerns in Europe

Equity Price Volatility



MSCI = Morgan Stanley Capital International.
 Notes: The United States data refer to the implied volatility for options on the Standard and Poors (S&P) 500 Index. Emerging Asia data refer to 10-day price volatility based on MSCI All Country Asia ex-Japan Index, a free-float weighted equity market.
 Source: Bloomberg.

External funding conditions for emerging Asia remain favorable given relatively strong growth prospects and the global search for yield

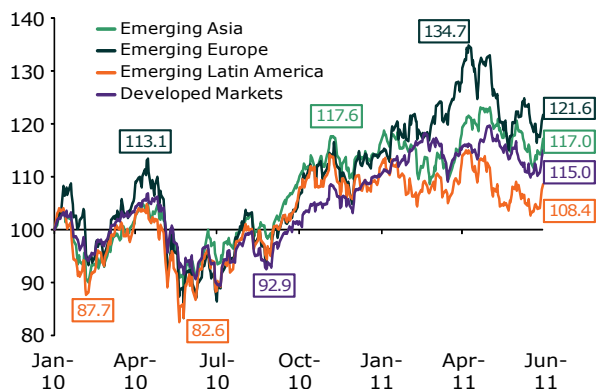
Bond Spreads—Emerging Asia (basis points)



US = United States.
 Note: Data refer to JP Morgan EMBI (Emerging Market Bond Index) corporate and sovereign stripped spreads (over corresponding US zero-coupon rate).
 Source: Bloomberg.

Emerging Asian equities consolidate strong gains since early 2011 following another year of stellar performance

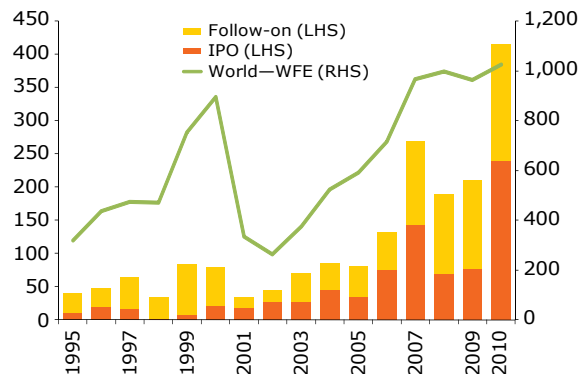
MSCI Equity Market Indexes (1 January 2010 = 100)



MSCI = Morgan Stanley Capital International.
 Notes: Emerging Asia includes People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand. Emerging Europe includes Czech Republic, Hungary, Poland, Russian Federation, and Turkey. Emerging Latin America includes Brazil, Chile, Colombia, Mexico, and Peru. Developed markets includes Canada, France, Germany, Italy, Japan, United Kingdom, and United States.
 Source: Bloomberg.

Equity issuance on emerging Asian markets surges; leading in global initial public offerings on healthy regional corporate earnings and growth prospects

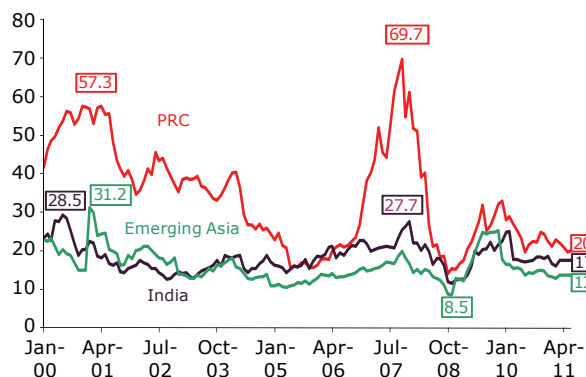
Equity Issuance—Emerging Asia (US\$ billion)



IPO = initial public offering, LHS = left-hand scale, RHS = right-hand scale, WFE = World Federation of Exchanges.
 Note: Emerging Asia includes People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.
 Sources: World Federation of Exchanges, Bank of Korea, Monetary Authority of Singapore, Reserve Bank of India, and International Financing Review Asia.

Following early-year market corrections, valuations appear to match corporate fundamentals—earnings, cash flows, and growth

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



PRC = People's Republic of China, MSCI = Morgan Stanley Capital International.
 Notes: Data for emerging Asia refer to MSCI All Country Asia ex-Japan Index, which includes People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand. PRC data refer to combined Shanghai and Shenzhen composite, weighted by their respective market capitalization.
 Source: Bloomberg.

Net foreign investment in emerging Asian equities has moderated since its rapid return toward the end of 2009

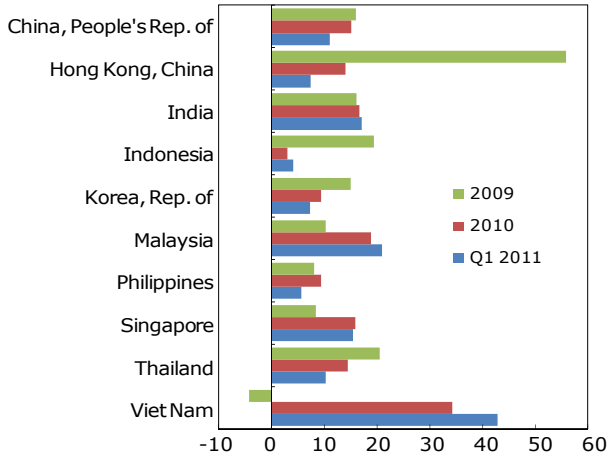
Net Foreign Portfolio Investment in Equities—Emerging Asia, excluding Hong Kong, China (US\$ billion)



H1 = first half.
 Notes: Emerging Asia includes India; Indonesia; Republic of Korea; Malaysia; Philippines; Taipei, China; Thailand; and Viet Nam. Data unavailable for the People's Republic of China and Singapore.
 Sources: Bloomberg and Bank Negara Malaysia.

Emerging Asia’s local currency bond markets continue to expand, accounting for a rapidly rising share of the global local currency bond market total

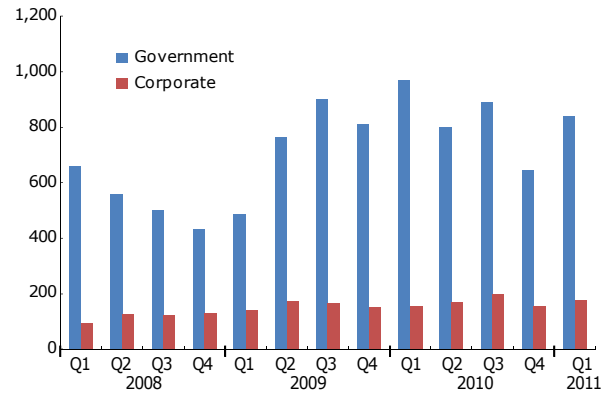
Growth of Local Currency Bond Markets in 2009, 2010, and Q1 2011 (year-on-year, %)



Q = quarter.
Sources: ADB *AsianBondsOnline* and Bloomberg.

Asian local currency bond issuance decline on lower fiscal spending; corporate bond issuance continue to grow rapidly

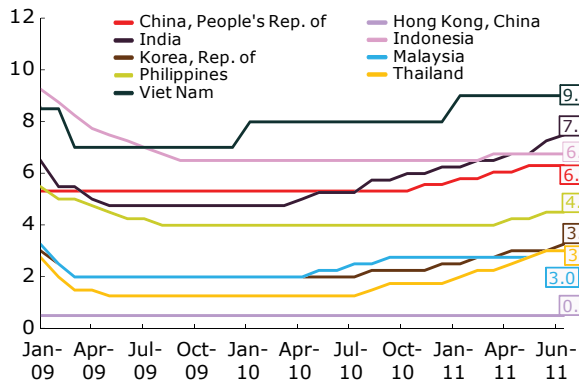
Government and Corporate Bond Issuance—Emerging Asia (US\$ billion)



Note: Includes local currency bond issuance of People’s Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.
Sources: ADB *AsianBondsOnline* and Bloomberg.

Emerging Asia’s monetary authorities step up fight against inflation

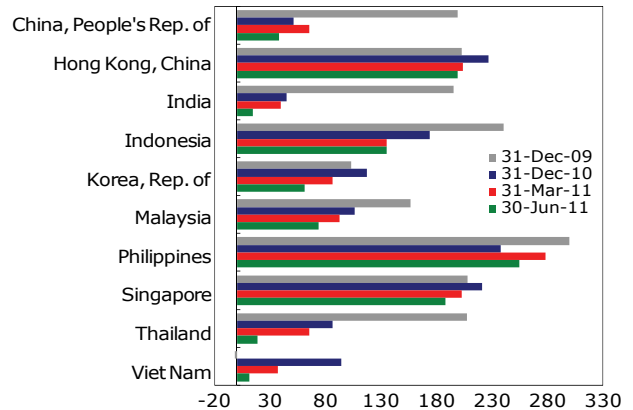
Policy Rates—Emerging Asia (% per annum)



Source: Bloomberg except for Viet Nam (State Bank of Viet Nam).

Yield curves flatten across the region, driven mainly by increases in policy rates in response to rising inflationary pressures

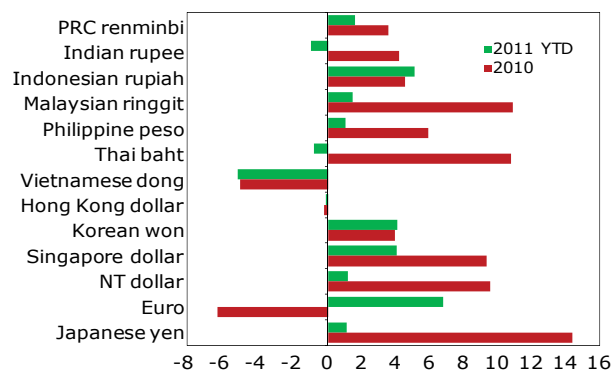
10-Year and 2-Year Government Bond Yield Spreads—Emerging Asia (basis points)



Source: Bloomberg.

Emerging Asian currencies appreciate on steady recovery in trade and investment flows, lured by growth and interest rate differentials

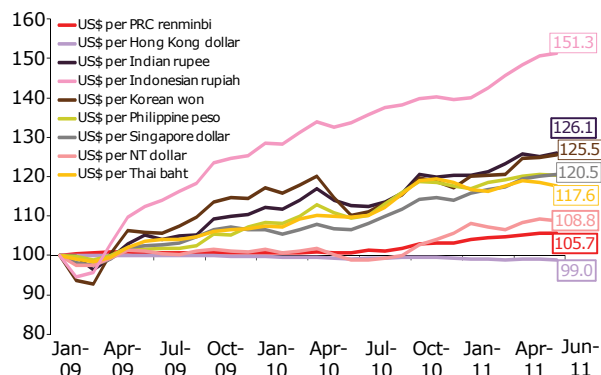
Change in Exchange Rate versus US dollar (%)



PRC = People's Republic of China, US = United States, YTD = year-to-date.
 Note: Year-to-date figures for 2011 are from 3 January to 30 June. Negative figures indicate depreciation of the local currency versus the US dollar; positive values indicate appreciation of the local currency. NT dollar is the currency of Taipei, China.
 Source: ADB Office of Regional Economic Integration using data from Thomson Reuters accessed through Datastream.

Emerging Asian currencies continue to offer favorable risk-adjusted returns, providing attractive investment opportunities

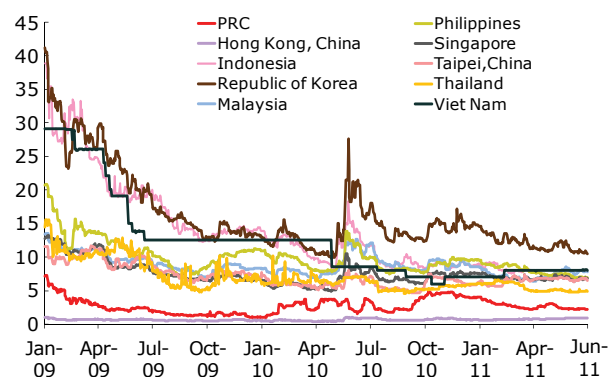
Currency Returns (January 2009 = 100)



PRC = People's Republic of China, US = United States.
 Note: NT dollar is the currency of Taipei, China.
 Source: ADB Office of Regional Economic Integration using data from Thomson Reuters accessed through Datastream.

Exchange rate volatility subsides to pre-crisis levels

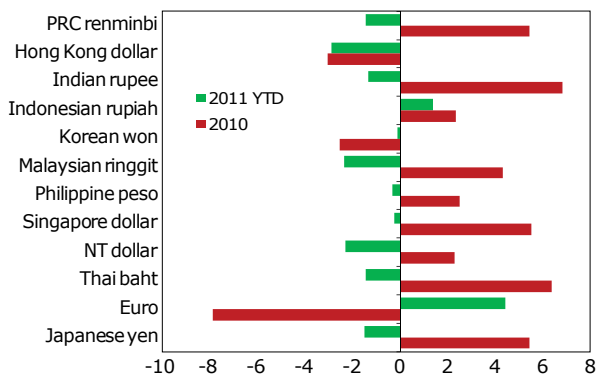
Implied Volatility of Exchange Rates—Emerging Asia (%)



PRC = People's Republic of China.
 Note: Data refer to the implied volatility from 3-month at-the-money options on exchange rates.
 Source: Bloomberg.

Real effective exchange rates stabilize for many emerging Asian currencies; some depreciation evident year-to-date

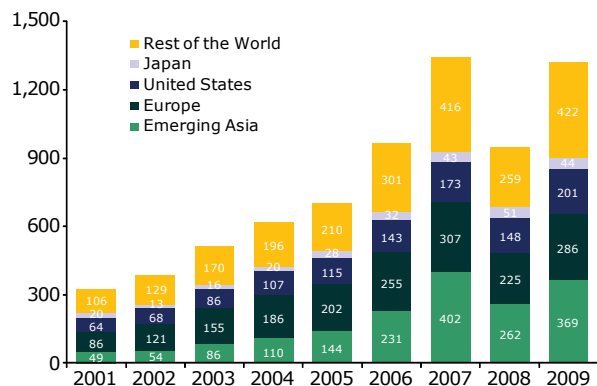
Change in Real Effective Exchange Rates (%)



PRC = People's Republic of China, YTD = year-to-date.
 Note: NT dollar is the currency of Taipei, China.
 Source: Bloomberg.

Emerging Asia’s financial integration continues with improved geographic diversification in cross-border asset holdings

Cross-Border Portfolio Asset Holdings—Emerging Asia (US\$ billion)

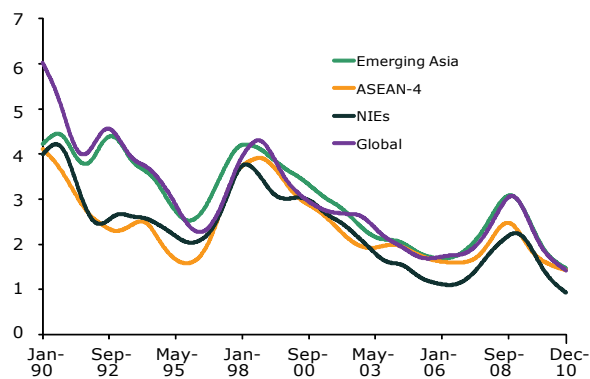


Notes: Emerging Asia includes Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; and Thailand. Europe includes Austria, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and United Kingdom.

Source: Coordinated Portfolio Investment Survey, International Monetary Fund.

Emerging Asian equity markets are increasingly correlated with both regional and global markets

Cross-Market Convergence of Weekly Equity Returns (%)



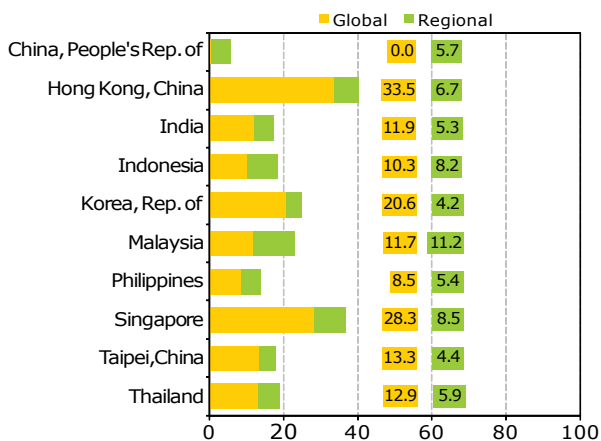
ASEAN = Association of Southeast Asian Nations, NIE = newly industrialized economy.

Notes: Values were smoothed using Hodrick-Prescott filter method. Stock price index for each country is in local currency units. Emerging Asia includes People’s Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand. ASEAN-4 consists of Indonesia, Malaysia, Philippines, and Thailand. NIEs consists of Hong Kong, China; Republic of Korea; Singapore; and Taipei, China. Global includes 25 advanced and emerging economies, including those from Asia.

Source: ADB Office of Regional Economic Integration using data from Bloomberg. Accessed January 2011.

Greater financial integration also means greater contagion from external shocks; global factors explain a large part of emerging Asian equity market volatility

Share of Variance in Local Equity Returns Explained by Global and Regional Shocks, 1994–2010 (%)

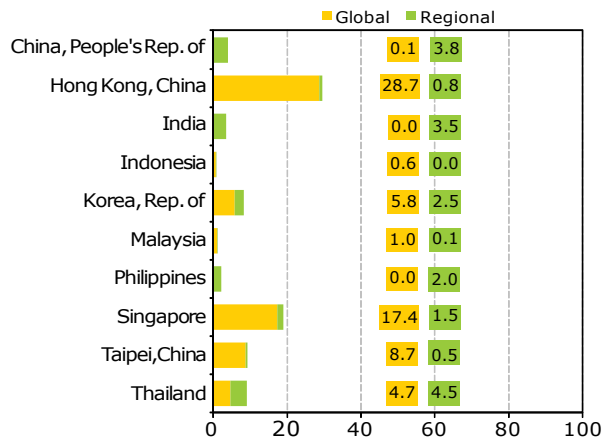


Note: Variance share shows the proportion of total domestic equity return volatility caused by either regional or global shocks.

Source: ADB Office of Regional Economic Integration.

The degree and pace of integration in Asian local currency bond markets lag far behind that of stock market integration; fragmentation can protect from external shocks, but hinders market liquidity

Share of Variance in Local Bond Returns Explained by Global and Regional Shocks, 2001–2010 (%)



Note: Variance share shows the proportion of total domestic bond return volatility caused by either regional or global shocks.

Source: ADB Office of Regional Economic Integration.

Asia Capital Markets Monitor, August 2011

The two-speed global economy continues to favor emerging Asian markets. After an early year correction, the region's markets are poised to gain on sound fundamentals. The *Asia Capital Markets Monitor* reviews emerging Asia's stock, bond, and currency markets and assesses their outlook, risks, and policy implications. This issue includes a special section on financial integration and capital flow volatility in emerging Asia: issues and policies.

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 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.

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