Introduction: **Global and Regional Market Developments**

The external environment facing emerging East Asia remains challenging as the eurozone sovereign debt crisis lingers and markets reflect concerns over the sustainability of the economic recovery in the United States (US).[2]

Massive liquidity injections in December and February into the European banking system from the European Central Bank (ECB), through its Long-Term Refinancing Operations (LTRO), helped ease pressure on short-term rollovers. These efforts, along with the resolution of the Greek debt crisis and some signs of US economic recovery, soothed market sentiments in the first quarter of the year. However, the rally in risk assets in 1Q12 **(Table A)**, with US equities and emerging market equities and bonds posting strong performances, appears to be moving into a consolidation phase as markets turn their focus to challenges in Spain, Portugal, and other peripheral economies in the eurozone.

While the second international bailout of Greece in March may have prevented a disorderly default and

Table A: Changes in Global Financial Conditions, 1 January to 15 March 2012

	2-Year Government Bond (bps)	**10-Year Government Bond** (bps)	**5-Year Credit Default Swap Spread** (bps)	**Equity Index** (%)	**FX Rate** (%)
Major Advanced Economies					
United States	12	40	–	11.5	–
United Kingdom	14	14	(33)	6.6	1.1
Japan	(2)	(2)	(34)	21.1	8.7
Germany	14	14	(29)	18.7	0.9
Emerging East Asia					
China, People's Rep. of	12	12	(36)	7.9	0.5
Hong Kong, China	(9)	(2)	(27)	15.8	(0.1)
Indonesia	(39)	(1)	(54)	5.7	1.2
Korea, Rep. of	15	16	(39)	3.2	(2.1)
Malaysia	17	(10)	(45)	15.1	(3.5)
Philippines	68	15	(18)	14.3	(1.8)
Singapore	(10)	12	(52)	11.9	(2.6)
Thailand	9	49	(0.02)	14.2	(2.6)
Viet Nam	(105)	(113)	–	25.7	(1.0)
Select European Markets					
Greece	4,179	(957)	26,799	10.3	0.9
Ireland	(341)	(146)	(110)	14.5	0.9
Italy	(302)	(192)	(123)	12.6	0.9
Portugal	(9)	36	172	1.8	0.9
Spain	(115)	(17)	23	(1.6)	0.9

– = not available, bps = basis points, FX = foreign exchange.
Notes:
1. For emerging East Asia, positive value for FX rate means depreciation of local currency against US dollar.
2. For European markets, positive value for FX rate means appreciation of local currency against US dollar.
Source: Bloomberg LP, CEIC, Institute of International Finance (IIF), and Thomson Reuters.

[2] Emerging East Asia comprises the People's Republic of China (PRC); Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.

reduced the risk of a liquidity crunch in the short-run, sovereign debt problems in other larger economies remain unresolved and will likely contribute to a new round of financial market instability. Thus, market participants have grown more cautious recently as they perceive that the short-term, liquidity-driven market recovery may have run its course, while severe fiscal austerity measures in Spain and Portugal could worsen growth prospects and impinge on debt sustainability.

Credit default swap (CDS) spreads in emerging East Asia **(Figure A)** and most countries in the eurozone **(Figure B)** fell at the start of 2012 as efforts to manage the eurozone debt crisis began showing promise. However, low investor demand for Spanish debt at its April auction renewed concerns and drove CDS spreads higher in the first half of the month.

Yields on government bonds in mature economies in the latter part of 2011 fell to their lowest levels in recent years and have continued to fluctuate in a relatively narrow range in early 2012 **(Figure C)**.

Growth in emerging East Asia is expected to remain robust this year, driven by domestic demand and regional reconstruction activities, as Japan and Thailand recover from last year's natural disasters and supply disruptions. The expansion of government spending in several other emerging East Asian countries should also support domestic growth in the region. The ability of governments to increase expenditures in 2012 has been helped by decreases in local financial market volatility and lower emerging market sovereign bond spreads **(Figure D)**. The JP Morgan Emerging Market Bond Index (EMBI) for stripped spreads has moved downward since the beginning of 2012 **(Figure E)**.

While growth prospects for emerging East Asia remain robust, simmering uncertainties in the eurozone and weak external demand could dampen the investment outlook.

Inflationary pressures have moderated but could spike on the back of rising oil prices and/or volatile commodity prices **(Figure F)**. Monetary authorities in emerging East Asia have largely adopted a neutral stance as uncertainty deepens over global economic prospects and countries brace for the potential fallout from slowing external trade and the transmission of volatility through financial market channels.

The continuation of accommodative monetary policies by the US Federal Reserve and similar postures adopted in other developed markets have sent large volumes of capital into Asian equity and local currency (LCY) bond markets. These policies have also led to strong demand for Asian G3 currency bonds.

The renewal of portfolio inflows in 1Q12 reversed the trend of capital outflows, particularly from the region's equity markets, that emerged in late 2011 **(Figure G)**. The most dramatic recoveries in equity flows have occurred in the Republic of Korea and Thailand. Indonesia was also a recipient of increased volumes of foreign portfolio investment prior to the anticipated upgrade of its sovereign credit rating to investment grade by Fitch Ratings (December) and Moody's Investors Service (January).

The inflows to emerging East Asia's LCY bond market—spurred by interest rate differentials and easy monetary conditions in mature markets—are expected to continue exerting downward pressure on domestic yields. This trend could accelerate in 2012 in anticipation of the appreciation of domestic currencies.

Total bonds outstanding in emerging East Asia's LCY bond market grew 7.0% year-on-year (y-o-y) in 4Q11, up from 5.7% growth in 3Q11. The government bond market grew a modest 2.5% y-o-y in 4Q11. Meanwhile, the corporate segment of the region's bond market grew a much more robust 17.1% y-o-y, led by Indonesia (28.0%), the PRC (26.0%), the Philippines (13.4%), and the Republic of Korea (12.1%).

At end-September 2011, emerging East Asia's share of the global LCY bond market stood at 8.1%,

Figure A: Credit Default Swap Spreads[a, b] (senior 5-year)

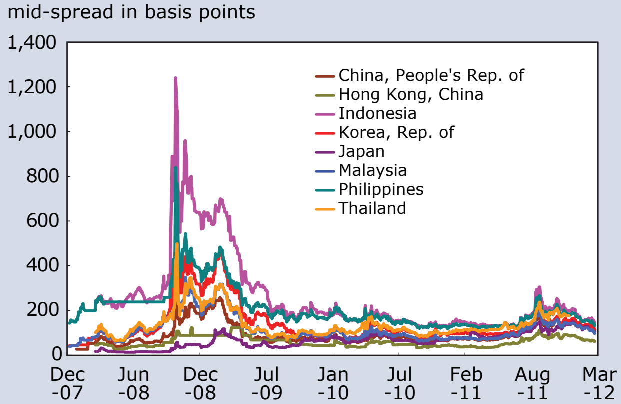


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

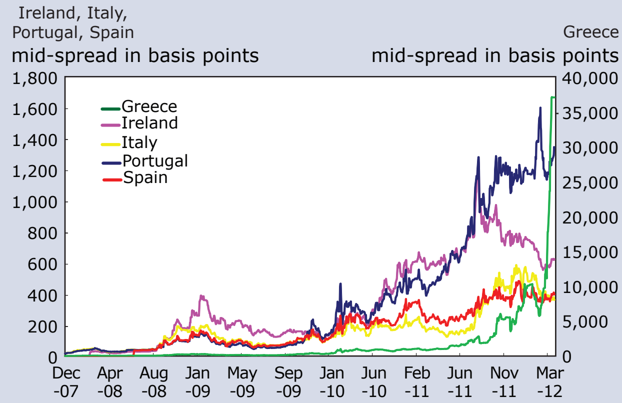


Figure C: 10-Year Government Bond Yields (% per annum)

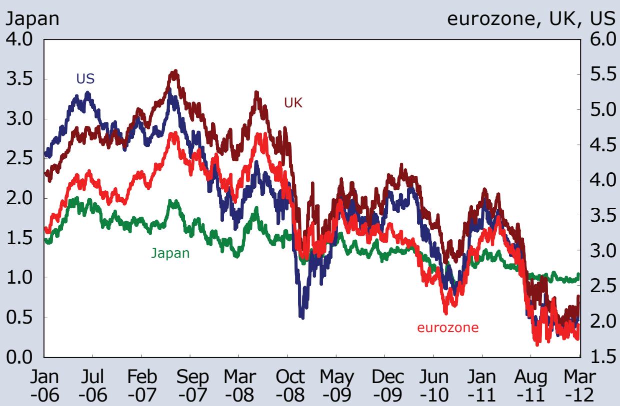


Figure D: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b]

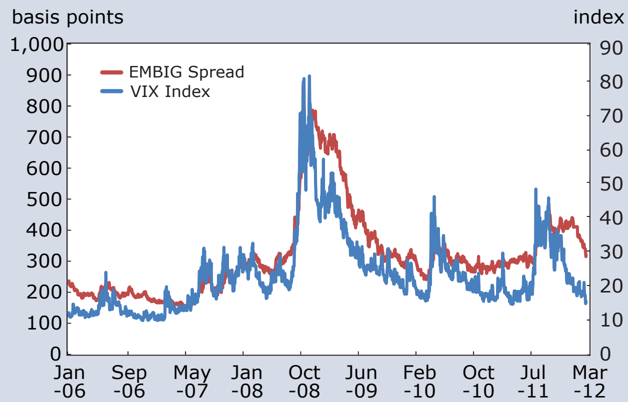


Figure E: JPMorgan EMBI Sovereign Stripped Spreads

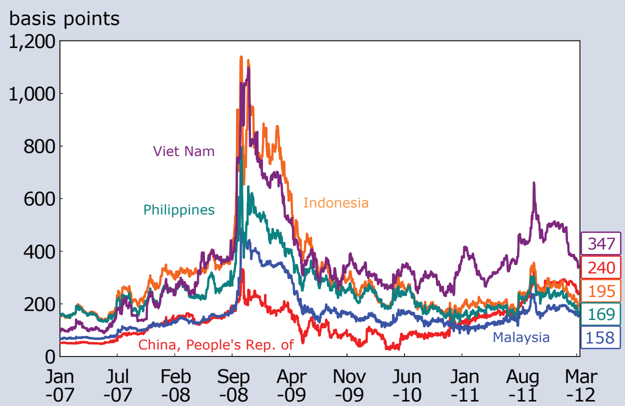
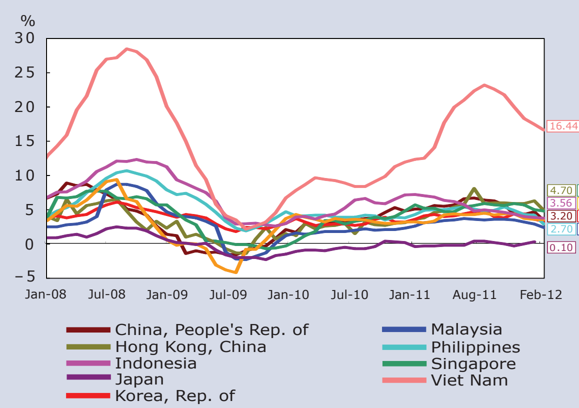


Figure F: Headline Inflation Rates[c]



EMBI = Emerging Market Bond Index, EMBIG = Emerging Markets Bond Index Global, UK = United Kingdom, US = United States, VIX = Chicago Board Options Exchange Volatility Index.

Notes:

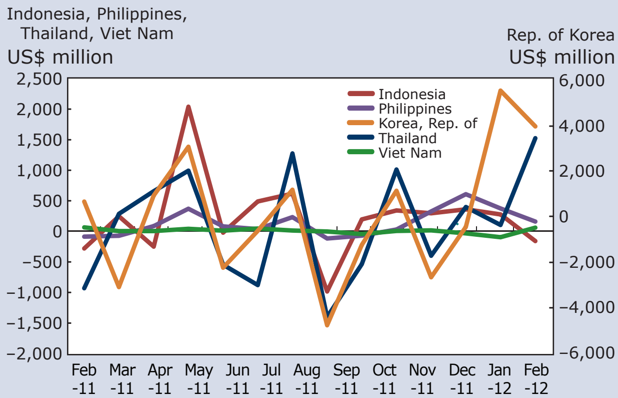
[a] In US$ currency and based on sovereign bonds.

[b] Data as of 15 March 2012.

[c] Data as of February 2012; Japan as of January 2012.

Source: Bloomberg LP and Thomson Reuters.

Figure G: Net Foreign Portfolio Investments in Equities



Note: Data as of 29 February 2012.
Source: Bloomberg LP.

up slightly from 8.0% at end-June and well above its 2.1% share at end-December 1996 **(Table B)**. The PRC and the Republic of Korea remained the two largest bond markets in the region, accounting for global shares of 4.8% and 1.7%, respectively. Meanwhile, the share of the global bond market of ASEAN-6 countries at end-September stood at 1.3%.[3]

The risks to the region's LCY bond markets in 2012 include (i) a worsening external environment if the eurozone economies sink into a deeper recession, (ii) tighter monetary policies on the back of rising inflationary pressures, and (iii) volatile capital flows.

Table B: Bonds Outstanding in Major Markets (US$ billion)

Economy	September 2011		1996	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	26,176	38.7	10,926	42.9
Japan	12,626	18.7	4,456	17.5
France	3,384	5.0	1,261	4.9
Germany	2,648	3.9	1,888	7.4
United Kingdom	1,745	2.6	678	2.7
Emerging East Asia	5,479	8.1	528	2.1
of which: PRC	3,247	4.8	62	0.2
Emerging East Asia excl. PRC	2,232	3.3	466	1.8
of which: Korea, Rep. of	1,179	1.7	283	1.1
of which: ASEAN-6	883	1.3	149	0.6
Indonesia	111	0.2	7	0.03
Malaysia	263	0.4	71	0.3
Philippines	75	0.1	28	0.1
Singapore	188	0.3	25	0.1
Thailand	229	0.3	18	0.1
Viet Nam	17	0.03	–	–
Memo Items:				
Australia	1,012	1.5	248	1.0
Brazil	1,368	2.0	299	1.2
PRC (excl. policy bank bonds)	2,216	3.3	–	–
India	649	1.0	81	0.3
Russian Federation	88	0.1	43	0.2
South Africa	179	0.3	82	0.3

– = not available, ASEAN = Association of Southeast Asian Nations, LCY = local currency, PRC = People's Republic of China.
Source: Bank for International Settlements and *AsianBondsOnline*.

[3] ASEAN-6 refers to the six largest economies of the Association of Southeast Asian Nations (ASEAN): Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.