Highlights

- The external environment facing emerging East Asia remains challenging as the eurozone sovereign debt crisis lingers, while volatility in the financial markets reflects concerns over the sustainability of the economic recovery in the United States (US).[1]

- The rally in US and emerging market equities witnessed in 1Q12 has consolidated somewhat since the beginning of April as markets turn their focus to challenges facing Spain, Portugal, and other peripheral economies in the eurozone.

- Growth in most emerging East Asian economies is expected to remain robust this year, driven by domestic demand and 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.

- The continuation of accommodative monetary policies by the US Federal Reserve and similar postures adopted in other developed economies have sent large volumes of capital into Asian equity and local currency (LCY) bond markets.

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

- Inflation may come under renewed pressure over the next several months on the back of rising energy prices. Monetary policy has remained neutral in most emerging East Asian markets, but authorities are closely monitoring the impact of rising energy prices on their respective inflation indices.

- Most government bond yield curves flattened significantly in 2011, particularly in Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; and Singapore.

- Government bond yield curves in most markets either continued to flatten or shifted downward in 1Q12. However, yield curves in some markets, most notably the People's Republic of China (PRC) and Thailand, have shifted upward since the beginning of the year.

- 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, while the corporate segment of the region's bond market grew at a much more robust rate of 17.1%, following 14.8% growth in 3Q11.

- Contractual savings institutions (CSIs)—pension funds, insurance companies, and social security institutions—have become an increasingly important investor class in the emerging East Asian bond market in recent years. In the PRC, Malaysia, and the Republic of Korea, CSI holdings of corporate bonds have become a key factor supporting corporate bond market growth.

- Foreign investors' interest in the region's LCY government bond market remains strong. The Republic of Korea, Malaysia, and Thailand experienced an increase in the share of foreign holdings of their respective LCY government bonds at end-December 2011 compared with

[1] 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.

end-December 2010. In the case of Indonesia, the share of foreign holdings leveled off at end-2011 after having risen sharply in recent years.

- G3 currency issuance in emerging East Asia fell 14.0% y-o-y in 2011 to US$75 billion, although issuance in G3 currencies rebounded strongly in 1Q12.

- Downside risks to the outlook for emerging East Asia remain, including (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.

- Cross-border portfolio debt holdings in Asia remain low, although they have improved in recent years. Analysis shows a strong home bias among investors. Prior to the global financial crisis (GFC), investors had a clear bias for investing in global markets vis-à-vis regional markets. However, after the GFC they remain indifferent between global and regional markets.

- A survey of 78 investors and analysis of secondary data through gravity models show that bond market conditions—namely return, risks, liquidity, and market infrastructure—are important determinants of cross-border holdings.

- Increasing overall return remains the primary motivation of Asian investors. Cross-border investor holdings of debt assets respond positively to two components of portfolio returns: the return on assets and the return stemming from exchange rate gains.

- The survey's results show support for initiatives that focus on the development of local and regional financial markets, and encourage Asians to invest in each other's markets.