Global and Regional Market Developments

Bond yields diverge in emerging East Asia amid continued weak risk appetite and a dim economic outlook.

Between 28 February and 29 May, global investment sentiment remained subdued in both developed and emerging markets. The yields on 2-year local currency government bonds fell in the United Kingdom (UK) and the United States (US), as well as in most emerging East Asian markets where policy rates have recently been adjusted.[1] The yields on 10-year government bonds posted a mixed picture, reflecting the respective fundamentals of individual economies. The weak economic outlook and uncertain progress in fighting the coronavirus disease (COVID-19) has cast a shadow on global financial conditions (**Table A**).

In emerging East Asia, the 2-year government bond yield fell in most markets between 28 February and 29 May, while movements in 10-year bond yields diverged. The declines in 2-year bond yields were largely driven by central banks' monetary policy measures, including lowering key policy rates and adjusting reserve requirement ratios (**Table B**). The 2-year bond yield fell the most in the Philippines and Singapore, shedding 133 basis points (bps) and 103 bps, respectively. Both

Table A: Changes in Global Financial Conditions

	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	(75)	(50)	–	3.0	–
United Kingdom	(35)	(26)	10	(7.7)	(3.7)
Japan	10	16	2	3.1	0.1
Germany	11	16	11	(2.6)	0.7
Emerging East Asia					
China, People's Rep. of	(41)	(4)	4	(1.0)	(2.0)
Hong Kong, China	(48)	(38)	–	(12.1)	0.5
Indonesia	83	40	64	(12.8)	(2.0)
Korea, Rep. of	(37)	4	(7)	2.1	(1.8)
Malaysia	(42)	(2)	27	(0.6)	(3.0)
Philippines	(133)	(116)	15	(14.0)	0.7
Singapore	(103)	(56)	–	(16.6)	(1.4)
Thailand	(25)	9	15	0.2	(0.9)
Viet Nam	(40)	28	111	(2.0)	(0.2)
Select European Markets					
Greece	47	26	32	(9.4)	0.7
Ireland	17	28	13	(8.0)	0.7
Italy	37	43	44	(17.2)	0.7
Portugal	(7)	18	35	(9.1)	0.7
Spain	8	22	35	(18.6)	0.7

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 28 February and 29 May 2020.
2. A positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currency against the United States dollar.
Sources: Bloomberg LP and Institute of International Finance.

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

Table B: Policy Rate Changes

Economies	Policy Rate 31-Dec-2019 (%)	Rate Changes (%)					Policy Rate 31-May-2020 (%)	Year-to-Date Change in Policy Rates (basis points)
		Jan-2020	Feb-2020	Mar-2020	Apr-2020	May-2020		
United States	1.75			↓1.50			0.25	↓ 150
Euro Area	(0.50)						(0.50)	
Japan	(0.10)						(0.10)	
China, People's Rep. of	4.35						4.35	
Indonesia	5.00		↓ 0.25	↓0.25			4.50	↓ 50
Korea, Rep. of	1.25			↓0.50		↓0.25	0.50	↓ 75
Malaysia	3.00	↓ 0.25		↓0.25		↓0.50	2.00	↓ 100
Philippines	4.00		↓ 0.25	↓0.50	↓0.50		2.75	↓ 125
Thailand	1.25		↓ 0.25	↓0.25		↓0.25	0.50	↓ 75
Viet Nam	6.00			↓1.00		↓0.50	4.50	↓ 150

( ) = negative.
Note: Data as of 31 May 2020.
Sources: Various central bank websites.

markets also saw declines in their 10-year yields during the review period. The Bangko Sentral ng Pilipinas has been one of the most aggressive central banks in the region in terms of easing monetary policy, reducing policy rates by 125 bps and the reserve requirement ratio by 200 bps year-to-date through 31 May. The People's Republic of China (PRC); Malaysia; and Hong Kong, China also recorded declines in their 2-year and 10-year yields but to a lesser extent. The PRC reduced a number of key interest rates during the review period. On 29 March, the rate on the 7-day repurchase rate was lowered by 20 bps to 2.20%. The rate on the medium-term lending facility was lowered by 20 bps to 2.95% on 15 April, and the rate on the 1-year loan prime rate was cut by 20 bps to 3.85% on 19 April. Malaysia also cut its overnight policy rate by a cumulative 100 bps from 1 January through 31 May.

The Republic of Korea, Thailand, and Viet Nam saw declines in their 2-year yields and increases in their 10-year yields during the review period. Gains in yields at the longer-end of the curve were mostly driven by investor concerns over government finances and an expanded bond supply in the wake of COVID-19. In Thailand, the government passed its largest COVID-19 stimulus package to date on 31 May, which was valued at THB1.9 trillion. Indonesia was the sole exception to the regional trend, with 2-year and 10-year yields increasing by 83 bps and 40 bps, respectively. The uptick in yields in Indonesia was largely driven by a market sell-off as foreign investors dumped government bonds amid heightened global market uncertainties due to the COVID-19 outbreak. Investors had also been expecting additional rate cuts in April and May that did not materialize.

Further contributing to the uptick in 10-year government bond yields in some emerging East Asian markets was a downgrade of the sovereign rating outlook by major rating agencies. In April, S&P Global downgraded Indonesia's sovereign rating outlook to negative from stable and Thailand's from positive to stable. Fitch Ratings revised downward its sovereign rating outlook for Viet Nam from positive to stable in April. As the COVID-19 pandemic halted economic activities globally, all emerging East Asian economies posted much lower growth rates (or contractions) in the first quarter (Q1) of 2020, with the growth outlook expected to further decline in the second and third quarters of the year.

Advanced economies have been among the hardest hit economies globally. Between 28 February and 29 May, all major advanced economies adopted easing monetary stances and introduced fiscal stimulus schemes to mitigate the negative impact of COVID-19 on the economy. In the US, the Federal Reserve deviated from its original course after leaving the policy rate unchanged at its January meeting. As risks from the continued spread of COVID-19 heightened, the Federal Reserve announced an emergency rate cut of 50 bps in the federal funds rate on 3 March, which was well before the regularly scheduled Federal Open Market Committee monetary policy meeting on 17–18 March. Citing the negative impact of COVID-19 containment efforts on consumer sentiment and behavior, as well as the economy, the Federal Reserve reduced the federal funds rate by an additional 100 bps to between 0% and 0.25% on 15 March. In addition to interest rate cuts, the Federal Reserve also implemented measures to ease financial turmoil caused by COVID-19, including purchasing additional assets of at least USD500 billion

and facilitating credit to households and businesses via a reduction in the primary credit rate at its discount window. On 17–18 March, the Federal Reserve established lending facilities for commercial paper, money markets, and primary credit dealers to ease funding demands and improve market liquidity. The Federal Reserve also engaged in coordinated actions with other central banks such as the Bank of Canada, Bank of Japan (BOJ), European Central Bank (ECB), and Swiss National Bank to provide liquidity via US dollar swap lines by reducing the rates charged.

US economic data warranted the Federal Reserve's concern. Gross domestic product (GDP) contracted 5.0% year-on-year (y-o-y), based on a revised estimate, in Q1 2020 after gaining 2.1% y-o-y in the previous quarter. Labor markets were also hit hard, with the unemployment rate soaring to 14.7% in April from 4.4% in March. Nonfarm payrolls showed a reduction of 20.7 million jobs in April, following a decline of only 1.4 million in March and a net gain of 251,000 in February. More recently, the job market rebounded in May with the unemployment rate slipping to 13.3% and nonfarm payrolls showing an increase of 2.5 million jobs. As a result of the supply and (related) demand shock, the Personal Consumption Expenditure inflation rate fell to 0.5% in April from 1.3% in March.

In the euro area, the ECB followed suit. During its 12 March meeting, the ECB left unchanged its policy rates but announced an asset purchase program worth EUR120 billion for the remainder of the year. The ECB enacted these measures on 18 March, establishing a EUR750 billion Pandemic Emergency Purchase Programme that removed prior restrictions limiting the ECB's asset purchases to at most one-third of the outstanding sovereign bonds of a given market. Judging these measures to be sufficient, existing monetary policy measures were left unchanged at the ECB's 30 April meeting. However, worsening economic conditions led the ECB to increase the volume of purchases under the program to EUR1,350 billion on 4 June. The euro area economy was hit hard by COVID-19, with GDP for Q1 2020 falling 3.1% y-o-y after gaining 1.0% in the previous quarter. Inflation also fell to an estimated 0.1% in May from 0.3% in April. In addition, the June economic forecast showed that the euro area's GDP is expected to decline 8.7% y-o-y in 2020 from a previous forecast of 0.8% growth in March.

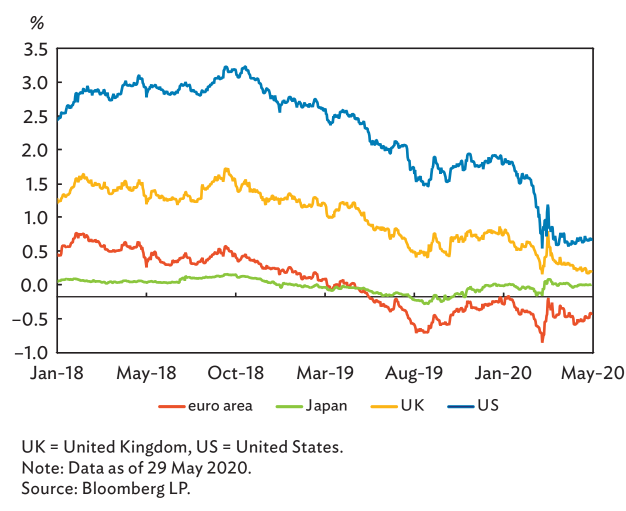
In Japan, the BOJ also enacted easing measures in the form of increased asset purchases. On 16 March, the BOJ left both the monetary policy rate and government bond purchases unchanged but announced an increase of JPY2.0 trillion in asset purchases of commercial paper and corporate bonds and of JPY6.0 trillion and JPY90 billion in purchases of exchange-traded funds and Japanese real estate investment trusts, respectively. On 27 April, acknowledging the worsening economic impact of COVID-19, the BOJ introduced more aggressive measures at its monetary policy meeting. While the interest rate target remained unchanged at 0%, purchases of commercial paper and corporate bonds were more than doubled to JPY20 trillion, and the upper limit on the purchase of 10-year government bonds was lifted. On 22 May, the BOJ announced that it would continue purchasing commercial paper and corporate bonds until March 2021, which is later than the previously announced deadline of September 2020. The GDP growth forecast for fiscal year 2020 was revised downward to between –5.0% and –3.0% from growth of between 0.8% and 1.1%. Japan's GDP in Q1 2020 contracted by 2.2% y-o-y after falling 7.2% y-o-y in the previous quarter.

Other than monetary measures, advanced economies also introduced fiscal stimulus programs to help mitigate the impact of COVID-19. In the US, the Coronavirus Aid, Relief, and Economic Security Act was signed on 27 March, introducing a USD2.0 trillion package that includes direct payments to households. On 27 April, another USD484 billion package aimed at small businesses and hospitals was signed. In the euro area, the European Commission unveiled a proposed EUR750 billion stimulus package on 30 May. In Japan, the government announced a number of support measures on 6 April totaling JPY108 trillion.

The monetary and fiscal policies introduced in response to the COVID-19 pandemic largely shaped bond yield patterns in advanced economies. Between 28 February and 29 May, the 10-year government bond yield declined in the UK and the US, while it rose in Germany and Japan. In March, all advanced economies witnessed a spike in the 10-year government bond yield, driven by deficit concerns in response to the fiscal stimulus measures announced in the US. Markets gradually returned to normal shortly thereafter (**Figure A**). In the case of Germany and Japan, yields ended the review period slightly higher as both the ECB and the BOJ focused largely on asset purchase programs to guide interest rates.

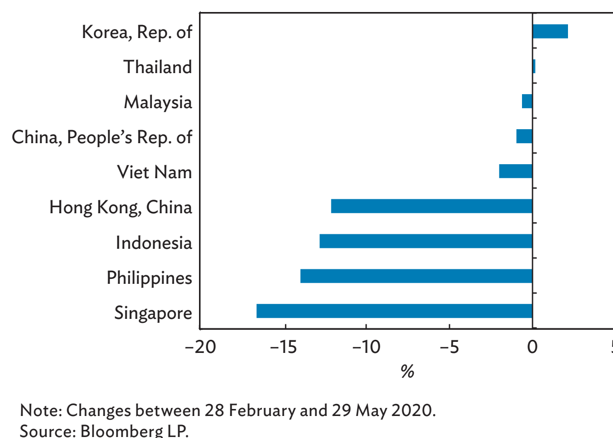
The outbreak of COVID-19 has caused a steep decline in global economic development. The Asian Development Bank (ADB) estimates the global economic impact of COVID-19, excluding the impact of policy measures, at

Figure A: 10-Year Government Bond Yields in Major Advanced Economies (% per annum)



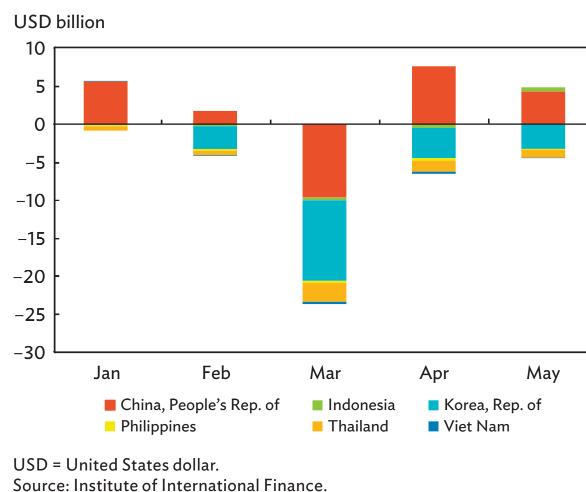
UK = United Kingdom, US = United States.
Note: Data as of 29 May 2020.
Source: Bloomberg LP.

Figure B: Changes in Equity Indexes in Emerging East Asia



Note: Changes between 28 February and 29 May 2020.
Source: Bloomberg LP.

Figure C: Capital Flows into Equity Markets in Emerging East Asia



USD = United States dollar.
Source: Institute of International Finance.

between USD5.8 trillion and USD8.8 trillion (6.4%–9.7% of global GDP).[2] The potential economic impact on Asia and the Pacific is estimated at USD1.7 trillion (6.2% of regional GDP) under a 3-month containment scenario and USD2.5 trillion (9.3% of regional GDP) under a 6-month containment scenario. As discussed, global governments and central banks have launched massive stimulus packages to mitigate the negative impact of COVID-19 on the economy.

The huge economic losses caused by COVID-19 and the continued uncertainty surrounding its containment significantly restricted investment appetite in financial markets. Most equity markets in emerging East Asia posted losses during the review period on heightened risk aversion, with the largest declines recorded in Singapore (–16.6%), the Philippines (–14.0%), and Indonesia (–12.8%) (**Figure B**). Equity markets in the Republic of Korea and Thailand posted slight gains on the back of improved investor sentiment due to effective containment of COVID-19 in the case of the Republic of Korea and a partial lifting of lockdown measures in Thailand on 17 May. March saw the largest outflow across the region's equity markets, with all markets posting outflows (**Figure C**).

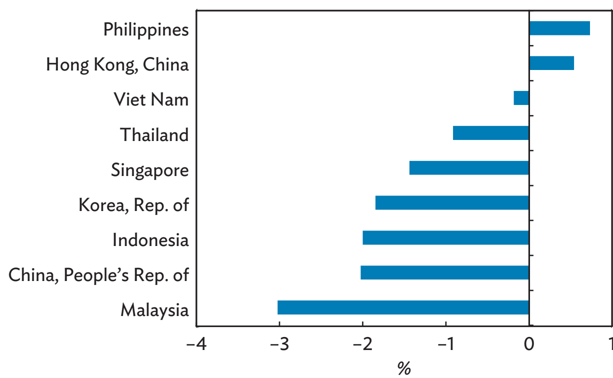
During the review period, nearly all emerging East Asian currencies weakened vis-à-vis the US dollar on the back of subdued investment sentiment (**Figure D**). The Malaysian ringgit saw the largest decline at 3.0% amid capital outflows and a slump in oil prices. The Philippine peso and Hong Kong dollar bucked the regional trend, appreciating 0.7% and 0.5%, respectively, versus the US dollar during the review period. The strengthening of the peso was supported by a stronger balance-of-payments surplus and increased gross international reserves. In 2019, the balance-of-payments surplus in the Philippines reached USD7.8 billion, or the equivalent of 2.2% of GDP, the highest level since 2012. At the end of April 2020, gross international reserves climbed to USD90.9 billion, or the equivalent of 8 months of goods and services. Recently, regional currencies have recovered

[2] Asian Development Bank. 2020. Policy Brief No. 133. https://www.adb.org/sites/default/files/publication/604206/adb-brief-133-updated-economic-impact-covid-19.pdf.

somewhat as investor sentiment slightly improves. This has created challenges for markets such as Thailand, as it seeks a weaker Thai baht to improve exports and attract tourists.

Heightened uncertainty and subdued investment appetite not only led to a climb in the regions' risk premiums but also caused concerns regarding debt refinancing and a rise in financing costs. Credit default swap spreads in emerging East Asia rocketed upward in March and were largely volatile at their higher levels in April before falling slightly in May (**Figure E**). The CBOE Volatility Index and the EMBIG spread also showed similar patterns, with large spikes in March followed by volatility at elevated levels (**Figures F** and **G**). **Box 1** describes the rise of risk premiums in financial markets in more detail.

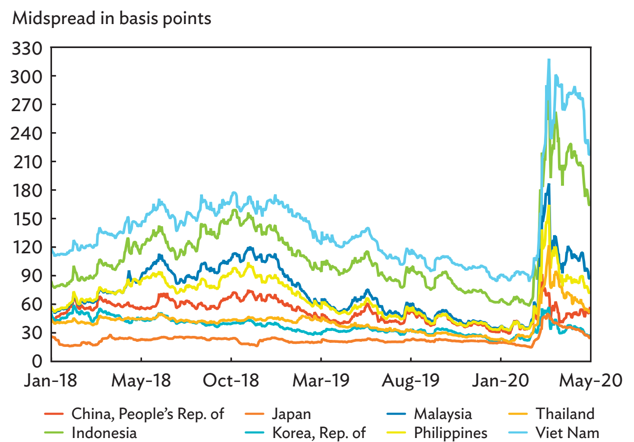
Figure D: Changes in Month-End Spot Exchange Rates vs. the United States Dollar



Notes:
1. Changes between 28 February and 29 May 2020.
2. A positive (negative) value for the foreign exchange rate indicates the appreciation (depreciation) of the local currency against the United States dollar.

Source: Bloomberg LP.

Figure E: Credit Default Swap Spreads in Select Asian Markets (senior 5-year)

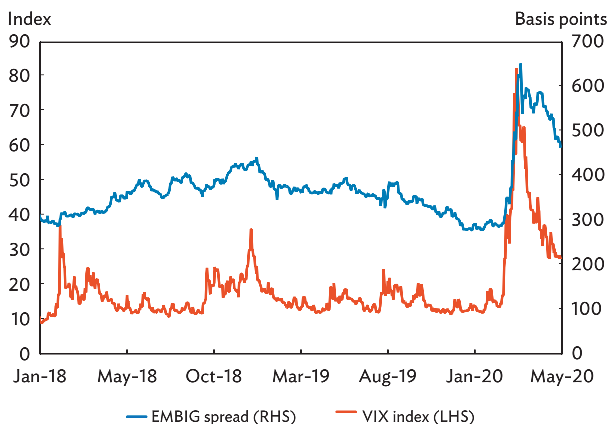


USD = United States dollar.

Notes:
1. Based on USD-denominated sovereign bonds.
2. Data as of 29 May 2020.

Source: Bloomberg LP.

Figure F: United States Equity Volatility and Emerging Market Sovereign Bond Spread

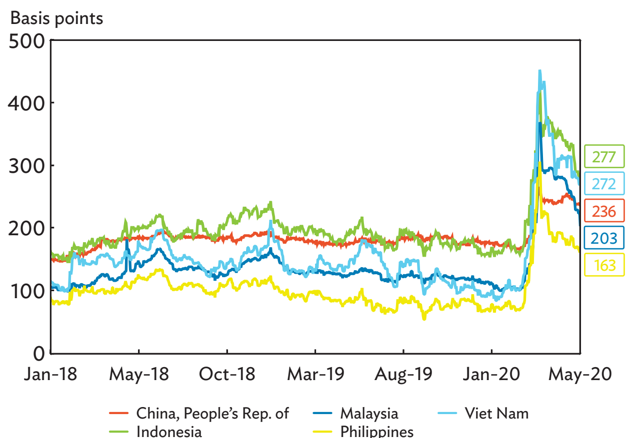


EMBIG = Emerging Markets Bond Index Global, LHS = left-hand side, RHS = right-hand side, VIX = Chicago Board Options Exchange Volatility Index.

Note: Data as of 29 May 2020.

Source: Bloomberg LP.

Figure G: JP Morgan Emerging Markets Bond Index Sovereign Stripped Spreads



USD = United States dollar.

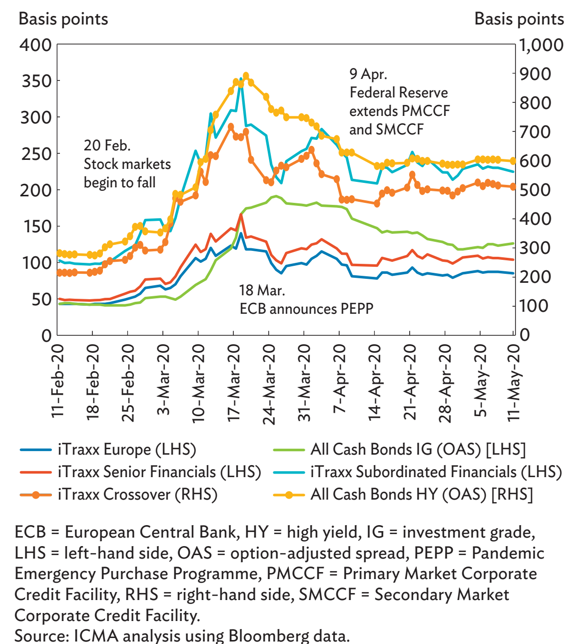
Notes:
1. Based on USD-denominated sovereign bonds.
2. Data as of 29 May 2020.

Source: Bloomberg LP.

Box 1: COVID-19—Impact on Capital Markets

From a market perspective, the coronavirus disease (COVID-19) has caused enormous volatility and provided the ultimate test of the resilience of primary, secondary, and repurchase agreement (repo) markets.[a] In early March, there were days when the normally robust primary markets were simply shut for business and when secondary bond market liquidity evaporated in both the credit and rates segments. On those days, for anything but the most liquid bonds, dealer bids were scarce and offers were in short supply unless the dealer already owned inventory. The situation was exacerbated by many regulated entities adjusting to operating from split locations as they moved part of their critical teams to disaster recovery sites to ensure business continuity. Coincidentally, this scenario occurred shortly after the publication of the International Capital Market Association's (ICMA) latest study on secondary markets, *Time to Act*, which highlighted the fact that, despite the changes in market structure and the move toward electronic trading, secondary markets remain dealer-centric and moves to further limit the ability of dealers to assume risk positions only contribute to the fragility of liquidity in stressed markets (**Figure B1**).

Figure B1: Euro-Denominated Corporate Credit Spreads



ECB = European Central Bank, HY = high yield, IG = investment grade, LHS = left-hand side, OAS = option-adjusted spread, PEPP = Pandemic Emergency Purchase Programme, PMCCF = Primary Market Corporate Credit Facility, RHS = right-hand side, SMCCF = Secondary Market Corporate Credit Facility.
Source: ICMA analysis using Bloomberg data.

The progressive and substantial actions of central banks in the middle of March, particularly the reintroduction and expansion of quantitative easing measures with substantial bond purchase programs, were the catalyst to restarting primary markets, allowing confidence to return and the markets to reopen. From the middle of March onward, issuance volumes picked up, starting with the highest-grade issuers (e.g., sovereigns, supranationals, and agencies) and followed by corporates, both financial and nonfinancial. Strong institutional investor demand led to record volumes of new issuance shortly before the middle of April. These central bank interventions also provided support to secondary markets, easing liquidity concerns. However, liquidity remains a challenge, particularly for lower-grade structurally illiquid bonds.

The repo market is a critical funding tool, particularly in times of stress, and has been arguably the most robust element of the financial market, remaining operational throughout and generally performing well in the face of high trading volumes. Nevertheless, dealer capacity to take on new clients was constrained, with the result being that certain categories of buy-side firms found it problematic to access the repo market. Supply constraints were also evident as counterparties withdrew from lending securities unless it was part of their core business, as explained in more detail in ICMA's recent study on this topic.

The mixture of central bank monetary policy responses and fiscal measures from governments has been designed to ensure that there is sufficient liquidity available in the real economy, particularly for small and medium-sized enterprises, to bridge the temporary cash flow constraints of otherwise healthy companies, minimize unemployment with furloughs and other schemes, and support individuals. As the crisis became deeper and more prolonged, the clamor for government help from large companies in hard-hit sectors intensified; support has often been forthcoming in response.

One problem is that there has not been a globally coordinated response to the crisis, and the piecemeal policy responses have increased market participant nervousness and likely contributed to volatility. Unsurprisingly, the current environment generates enormous challenges and uncertainties for ICMA's buy- and sell-side members, who play a critical role in ensuring liquidity reaches those most in need. However, it has been very positive that the remote working arrangements implemented by many of our members have allowed them to work effectively during the crisis.

[a] This box was written by Martin Scheck, Chief Executive of the International Capital Market Association.

continued on next page

Box 1: COVID-19—Impact on Capital Markets *continued*

The economic impacts of the pandemic are beginning to become evident. The main questions being just how severely growth will be damaged, what is the long-term outlook for unemployment, what will be the related social impacts—and, of course, who ultimately will "pay the bill." One can certainly expect rates to remain lower for even longer and, while it is evident that economic activity has declined significantly during the government-imposed lockdowns, it is not at all clear to what extent, and how quickly, economic activity will pick up as many economies start to ease their current restrictions.

The impact of COVID-19 on capital markets has been the overarching concern for ICMA, and we have responded with a range of activities designed to keep markets open and operating efficiently, while assisting our members on a day-to-day basis. An important initiative has been to review the timetables of consultation papers and regulatory implementation that were already in progress and to work with our members and the appropriate authorities to have these measures postponed where needed. This was particularly important for the European Union Securities Financing Transaction Regulation implementation deadline, which is set to introduce an extensive reporting regime for repo and other securities financing instruments. Following ICMA's intervention, the European Securities and Markets Authority provided a 3-month forbearance on the implementation date. Similarly, the consultations for the European Securities and Markets Authority's Markets in Financial Instruments Directive and Associated Regulation have been postponed, as have the deadlines of many other regulatory bodies. Given that it is not clear how quickly the crisis will abate, discussions are ongoing with respect to all appropriate timelines for these and other consultations and implementations.

In the market for EUR-denominated commercial paper, where ICMA has provided its members with standard form documentation for many years, following confirmation from the Bank of England that it would accept commercial paper with documentation based on ICMA's Euro Commercial Paper standard, for the period of the crisis we have chosen to make this documentation available to all participants whether or not they are ICMA members. We have also recommended to the European Central Bank that it include asset-backed commercial paper in its asset purchase program.

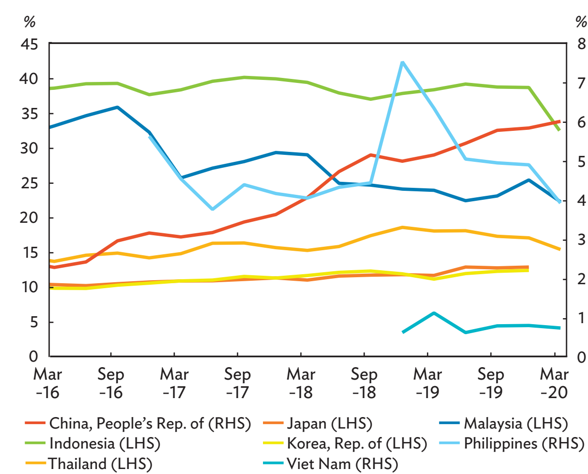
Sustainability remains an intense focus for the market and for ICMA. There has been an increase in the issuance of social bonds that reference the Social Bond Principles, which ICMA manages, to raise funds to respond to the social and economic impacts of the COVID-19 pandemic; we expect this market segment to grow. We also foresee that as future environmental, social, and governance reporting becomes more complex and far-reaching under a range of different regulations, it will impact most of our member categories as a topic of increased focus during 2020 and beyond.

In conclusion, the COVID-19 pandemic has presented enormous challenges and reminded us of the fragility of markets in times of great stress. The capital markets have a vital role to play in facilitating the flow of liquidity during these trying times. It is important that they remain open for business.

Foreign holdings of local currency government bonds declined in most emerging East Asian markets during the review period, as global investors shifted to safe-haven assets (**Figure H**). The largest decline in foreign holdings was seen in Indonesia, where the foreign holdings' share dropped from 38.6% at the end of December to 32.7% at the end of March. Indonesia's financial market was routed by a sell-off, leading to record-high capital outflows from the bond market in March on heightened risk aversion. A similar market sell-off was observed in Malaysia with the foreign holdings' share falling from 25.3% at the end of December to 22.2% at the end of March. The foreign holdings' share in the PRC remained stable during Q1 2020. More recently, investor sentiment has improved over optimism that economic growth will recover as markets began unwinding quarantine measures.

Overall, risk to the region remains titled toward the downside. The regional outlook has been weakened by ongoing uncertainty regarding the containment of COVID-19, a risk that also hovers over the global economy and financial markets. In addition to COVID-19, trade tensions between the PRC and the US have escalated again, casting further uncertainty on the global economic outlook. Global oil prices also contribute to the uncertainty given ongoing geopolitical risks and tensions in the Middle East.

Figure H: Foreign Holdings of Local Currency Government Bonds in Select Asian Markets (% of total)



LHS = left-hand side, RHS = right-hand side.
Note: Data as of 31 March 2020 except for Japan and the Republic of Korea (31 December 2019).
Source: *AsianBondsOnline*.

Economic Outlook

The world is facing an unprecedented public health crisis caused by COVID-19. Although the outbreak initially only affected the PRC and other Asian economies in December 2019 and January 2020, it soon spread to all corners of the world in a matter of weeks. Although some regions and economies were hit harder by the virus than others, no region or economy has been immune from its devastating impact on public health. As the global public health situation went from bad to worse, the World Health Organization declared COVID-19 a global pandemic on 11 March. As of 25 May, the number of confirmed cases and deaths had reached 5,304,772 and 342,029, respectively.[3] The US, the world's largest economy, emerged as the biggest hot spot, with almost one-third of global cases and 30% of global deaths. Other hard-hit countries include Brazil, the Russian Federation, several major Western European countries, Turkey, and India. COVID-19 has inflicted untold human misery, pain, and suffering around the world.

While the immediate impact of COVID-19 is on global public health, it has dealt an equally severe blow to the world economy. There is firm consensus that the current global economic downturn caused by the pandemic will be much worse than the Great Recession that followed the global financial crisis of 2008–2009. That recession reduced global output by around 1%, which marked the first and only contraction of the world economy in the postwar period. The current downturn is likely to be the biggest negative global economic shock since the Great Depression of the late 1920s and 1930s. Like the public health crisis, the economic crisis is widely viewed as a once-in-a-century crisis.

The bulk of the economic costs of COVID-19 do not stem directly from those who are infected by the disease or succumbed to it. Rather, they are the consequences of the travel restrictions, lockdowns, widespread closures, isolation, and other social distancing measures put in place by governments to contain the disease. Precautionary personal behavior, such as staying at home to minimize the risk of infection, is adding to the gloom. Above all, public health restrictions have severely disrupted the production of goods and services, and their transportation. The result has been a massive supply-side shock that is forcing firms and industries to produce far below their capacity.

Global growth forecasts are being sharply downgraded. According to the International Monetary Fund's (IMF) *World Economic Outlook April 2020*, the world economy grew by an estimated 2.9% in 2019 and is projected to contract by 3.0% in 2020 before rebounding to expand 5.8% in 2021. As late as January 2020, the IMF had forecast global growth in 2020 of 3.3%. The downward revision of 6.3 percentage points in just 3 months reflects the scale and speed of the deterioration of the global economic outlook due to the rapid spread of COVID-19 and the concomitant social distancing restrictions. The IMF's forecast of 5.8% growth in 2021 reflects an optimistic underlying assumption of a V-shaped recovery, which is predicated on a sharp yet short downturn. While there is no cause for undue pessimism, the highly uncertain and unpredictable nature of this pandemic implies that the world may be heading instead for a U-shaped, or even an L-shaped, recovery.

According to the IMF's World Economic Outlook April 2020, the output of advanced economies, which grew by 1.7% in 2019, will shrink by 6.1% in

[3] World Health Organization. COVID-19 Situation Report—126. 2020. https://www.who.int/docs/default-source/coronaviruse/situation-reports/20200525-covid-19-sitrep-126.pdf?sfvrsn=887dbd66_2.

2020 before bouncing back to expand 4.5% in 2021. The corresponding figures for emerging markets and developing countries are 3.7%, –1.0%, and 6.6%, respectively. The IMF is downgrading growth forecasts for all the major economies that it tracks, underscoring the global nature of the downturn. Global trade, which was already slowing before the COVID-19 outbreak due to trade tensions, is projected to contract by 11.0% in 2020 after growing by 0.9% in 2019. Next year, in line with the expected global economic recovery, global trade is forecast to expand by 8.4%.

Developing Asia is feeling the economic pain too.[4] ADB's *Asian Development Outlook 2020* released in April 2020 forecast the region's economy to grow by 2.2% in 2020 and 6.2% in 2021, after expanding by 5.2% in 2019. By comparison, ADB's *Asian Development Outlook 2019 Supplement* released in December 2019 had forecast a 2020 growth rate of 5.2%, representing a full 3-percentage-point decline in the April 2020 forecast. The PRC, which grew by 6.1% in 2019, is projected to expand by only 2.3% in 2020, before rebounding to growth of 7.3% in 2021. The 2019 growth estimate and 2020 and 2021 growth forecasts for the 10 members of the Association of Southeast Asian Nations are 4.4%, 1.0%, and 4.7%, respectively. The Republic of Korea is projected to grow by 1.3% in 2020 and 2.3% in 2021, after growing by 2.0% in 2019. The growth figures for Hong Kong, China are –1.2% in 2019 and a projected –3.3% in 2020 and 3.5% in 2021. There is a fairly good chance that developing Asia's growth, likely to be the slowest since 1998, will be even lower than ADB's April forecasts. This is primarily because the global outlook has further deteriorated since the publication of the *Asian Development Outlook 2020* due to the global spread of the pandemic and the resultant severe downturns in Europe and the US.

COVID-19 remains the overarching source of uncertainty in the global and regional economic picture. The trajectory of the economic outlook over the next 2 years will be determined to a large extent by the trajectory of the pandemic. In particular, as economies in Asia and elsewhere gradually reopen, there are widespread concerns about a second wave of COVID-19 that could trigger the reintroduction of travel bans, lockdowns, and other social distancing restrictions. A virulent second wave could stop reopening in its tracks and take the world back to square one. If, on the other hand, COVID-19 recedes on its own, or a safe and effective vaccine is developed and made widely available in record time, it is likely that life would return rapidly to the "pre-COVID-19 normal" and the global economy would experience a robust V-shaped recovery. To sum up, the evolution of the COVID-19 pandemic, which is the huge cloud of uncertainty hanging over the world economy, will have a big say in how the economies of Asia and the world actually perform in 2020 and 2021.

Risks to Economic Outlook and Financial Stability

By far the biggest source of risks to the global and regional economic outlook, which are heavily tilted to the downside, is COVID-19. Until the pandemic is brought under control, it will hover like a dark cloud over the global economic outlook. The IMF's sharp downgrade of the 2020 global growth forecast and the ADB's sharp downgrade of developing Asia's 2020 growth forecast already factor in the pronounced effect of the negative supply shocks on economic activity. However, there is a fairly good chance that global output may shrink by more than 3.0% in 2020 and developing Asia's output may expand by less than 2.2% due to COVID-19. That is, the pandemic may yet inflict more damage on the economy than expected for a number of reasons. Given the uncertain and unpredictable nature of the outbreak, along with COVID-19's high degree of contagiousness, economists may be underestimating the risk it poses to the economy and society. After all, the pandemic has engulfed the entire world in a few months and shows little sign of receding any time soon.

Above all, the risk is that the COVID-19 pandemic could turn out to be more persistent than expected, and it may not stabilize or recede even with the advent of summer in the Northern Hemisphere. We cannot rule out the possibility that the effect of the public health crisis on the world economy and global financial markets is more potent and persistent than is currently being assumed. For example, the pandemic may leave a powerful imprint on consumer behavior for a long time to come. Individuals typically save more during times of uncertainty, and the current COVID-19 environment is about as uncertain as it gets. Therefore, even as

[4] Developing Asia refers to the 46 developing member economies of the Asian Development Bank.

economies around the world reopen, consumers may be reluctant to open their wallets, weakening aggregate demand and dampening the momentum of economic recovery. And, if reopening leads to second waves of new infections and deaths, the reimposition of lockdowns may be inevitable. Even under more benign scenarios, which assume that the pandemic will be contained in the foreseeable future, negative long-term consequences are entirely possible. For example, supply chains may have been significantly disrupted due to widespread business closures. Equally serious, given the sheer magnitude of the COVID-19 shock, it will take some time for consumer and business confidence to recover. Yet, improved confidence is vital for kickstarting consumption, investment, and overall economic activity.

While the pandemic is the paramount source of downside risks, a wide range of second-tier risks remain, from natural hazards to geopolitical events. The biggest second-tier risk is global trade tensions, in particular the trade conflict between the PRC and the US. The PRC–US trade conflict appeared to ease at the beginning of the year when the two sides reached a Phase 1 trade deal on 15 January 2020. In exchange for the US cutting tariffs on some Chinese imports, the PRC pledged to buy more American agricultural, manufacturing, and energy products and services, in addition to addressing some US complaints about intellectual property practices. The US pledged to cut by 50% the tariffs it had imposed on 1 September 2019 on USD120 billion worth of goods imported from the PRC. The PRC's commitment to buying more US exports was sizable. For example, the PRC committed itself to buying an additional USD77.7 billion more in US manufacturing products over a 2-year period (2020–2021). However, it is unclear whether the PRC will be able to purchase so many goods and services from the US in these difficult economic times, although in recent days officials have repeatedly reaffirmed the PRC's commitment to meet these targets. More ominously, COVID-19 itself has seriously strained PRC–US relations with the two sides becoming increasingly more aggressive in their rhetoric. Furthermore, the growing hostility is threatening to escalate the trade conflict into a broader economic and technological conflict. For example, the US has imposed restrictions on exports of vital components to the PRC tech giant Huawei. In addition, the main US federal government pension fund has halted plans to invest in PRC equities.

In addition to the tangible deterioration of the global trade environment, which will adversely affect the economic prospects of ASEAN+3 countries, severe financial turmoil and financial crises also cannot be discounted. Global financial conditions have tightened significantly since February, increasing demand for safe-haven assets, which has been especially painful for emerging markets and developing economies, many of which are also dealing with the widening spread of COVID-19. Some emerging economies with weak fundamentals are already in financial distress. For instance, Argentina defaulted on its debt on 22 May, although it was continuing to negotiate with its creditors.

Movements in global equity markets, exchange rates, bond spreads, and volatility indexes have been pronounced, while emerging Asian markets experienced a surge in capital outflows in March. Heightened financial volatility and a sudden halt in capital flows into the region cannot be ruled out. The decade-long rise in regional debt, primarily private but some of it public, exacerbates the risk from volatile capital flows. Small and medium-sized firms may be susceptible to tightening financial conditions and a worsening economic environment.

Finally, COVID-19 is likely to leave long-lasting, or even permanent, scars on the world economy. Above all, the pandemic will give impetus to anti-globalization forces that were already gathering momentum before the outbreak, as evident in growing trade protectionism and rising trade tensions. Globalization, in particular the dramatic expansion of international trade made possible by technological progress and trade liberalization, has been perhaps the single most powerful driver of economic growth in the postwar period. However, COVID-19 dramatically highlights the fact that globalization is at best a mixed blessing. After all, close and growing transport linkages among the global community of countries helped to spread the pandemic like a wildfire across the world. More concretely, the pandemic has underscored the vulnerability of global supply chains to trade and transport disruptions. In the current environment of weak confidence and heightened uncertainty, upside risks to the global outlook are few and far between. In particular, the widespread availability of a safe and effective vaccine would fast-forward economic recovery and our return to normality.