Introduction: **Global and Regional Market Developments**

As the global economic recovery strengthens and financial markets stabilize, the external environment facing emerging East Asian[1] economies has turned more favorable. The after-effects of the global economic and financial crisis may linger—with the Greek debt crisis providing a quick reminder of the vulnerabilities remaining. Nonetheless, the global economic recovery appears to be broad-based (led by a strong rebound in Asia), with financial markets staging a turnaround. These trends are evident in 10-year government bond yields **(Figure A)**; declining corporate bond spreads **(Figure B)**; and the rapid rise of MSCI indexes, especially those for Asia **(Figure C)**. Within the region, these trends were especially evident in the sharp decline last year of both JP Morgan EMBI sovereign stripped spreads **(Figure D)**, sovereign credit default spreads **(Figure E)** and credit default spreads for selected Organization for Economic Co-operation and Development (OECD) and Asian economies **(Figure F)**.

The improvement in the external environment combined with ongoing fiscal stimulus and continuing accommodative monetary policies helped the region's growth regain traction in 2009. The People's Republic of China (PRC) posted robust 8.7% gross domestic product (GDP) growth in 2009, followed by Viet Nam at 5.3% and Indonesia at 4.6%.

The economic recovery and return to export growth has led to a sudden reversal of portfolio investment inflows back to East Asian asset markets. The recovery in portfolio equity inflows has been significant, while foreign investors are also raising their exposure to local currency (LCY) denominated debt.

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

Inflation has picked up from low levels, spurred by a rise in food and energy prices, but remains manageable as the recovery gathers steam. Some central banks in the region have hiked reserve requirements, while others have raised policy rates from historically low levels.

Risks to the market outlook in the region are balanced, but remain subject to uncertainty. These include (i) a reversal in recovery in developed economies, (ii) a premature tightening of monetary policies and hasty exit from fiscal stimulus packages, and (iii) potentially destabilizing capital inflows.

Emerging East Asia's LCY bond market recorded another year of substantial growth in 2009, rising 16.5% year-on-year (y-o-y). Growth in the government bond market was more balanced, as the PRC's government sector showed steady growth along with government debt markets in Thailand, Indonesia, Singapore, Republic of Korea (Korea), and Malaysia. All of these markets registered double-digit growth in 2009. In addition, the corporate bond market, led by the PRC and the Philippines, is growing rapidly. G3 currency bond issuance from the region was impressive, with issuance rising to USD63.2 billion in 2009.

At end-September 2009 (the most recent data available), emerging East Asia's share of the global bond market rose to 6.7%, compared with a mere 2.1% before the onset of the 1997/98 Asian financial crisis **(Table A)**. LCY-denominated Asian bonds are emerging as an asset class and are attracting both domestic and foreign investors searching for yield and diversified portfolios.

In 2010, growth momentum in government bond markets is expected to continue as economic recovery gains traction. The LCY corporate bond market is also expected to show steady growth as an additional funding source for domestic companies and an attractive investment alternative for investors.

Figure A: 10-year Government Bond Yields (% per annum)

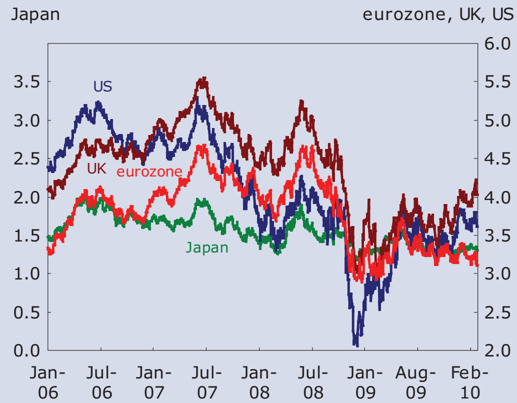


Figure D: JPMorgan EMBI Sovereign Stripped Spreads[3]

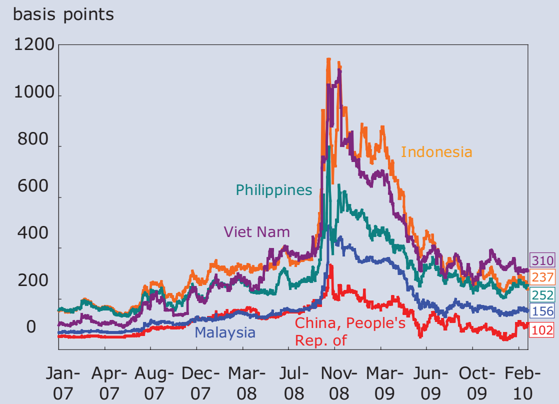


Figure B: Corporate Bond Spreads[1]

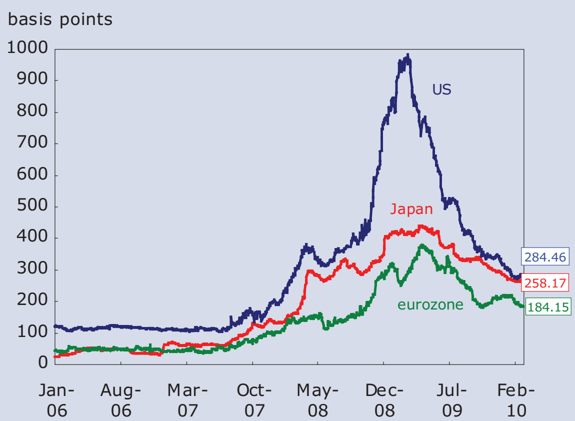


Figure E: Credit Default Swap Spreads (senior 5-year)[3]

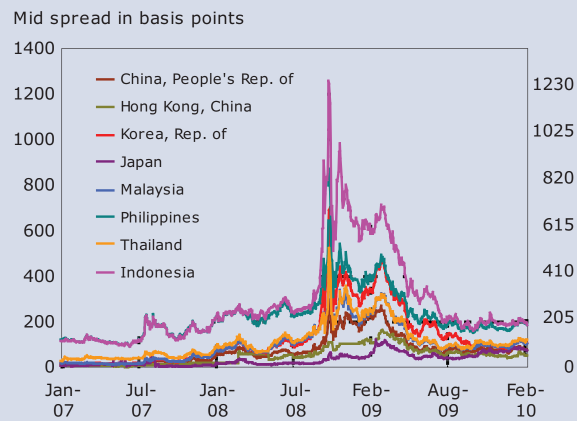


Figure C: MSCI Indexes (January 2007 = 100)[2]

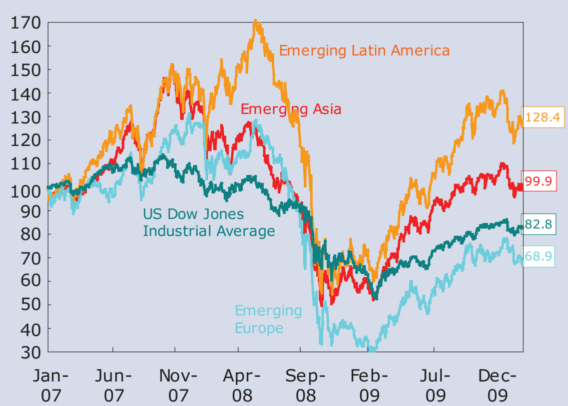
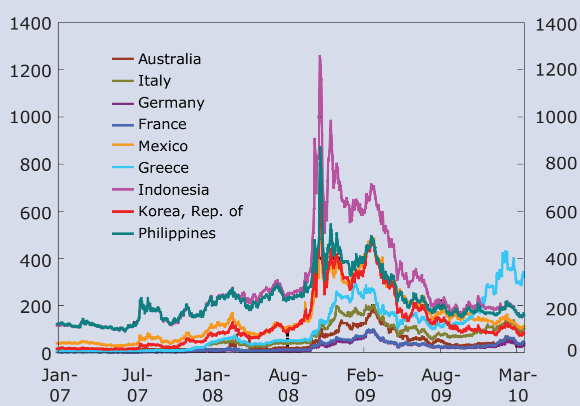


Figure F: Credit Default Swap Spreads for Select OECD and Asian economies



EMBI = Emerging Market Bond Index, OECD = Organization for Economic Co-operation and Development, UK = United Kingdom, US = United States.
[1]Bond spread refers to the difference between yields of 5-year bonds issued by BBB-rated finance companies and yields of sovereign benchmark bonds of the same tenor. [2]Includes People's Republic of China; India; Indonesia; the Republic of Korea; Malaysia; Pakistan; Philippines; Taipei,China; and Thailand. [3]USD based on sovereign bonds.
Source:
Morgan Stanley Capital International (MSCI) Barra, Thomson DataStream, and Bloomberg LP.

Table A: Bonds Outstanding in Major Markets (USD billion)

	3Q09		4Q96	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	25,105	40.0	10,926	42.8
Japan	9,831	15.7	4,456	17.4
France	3,188	5.1	1,303	5.1
Germany	2,927	4.7	1,888	7.4
UK	1,566	2.5	678	2.7
Emerging East Asia	4,209	6.7	537	2.1
of which: PRC	2,415	3.9	62	0.2
Emerging East Asia excl. PRC	1,794	2.9	475	1.9
of which: Korea, Rep. of	1,001	1.6	283	1.1
of which: ASEAN-6	665	1.1	158	0.6
Indonesia	90	0.1	7	0.0
Malaysia	181	0.3	81	0.3
Philippines	59	0.1	28	0.1
Singapore	150	0.2	25	0.1
Thailand	172	0.3	18	0.1
Viet Nam	13	0.0	—	—
Memo Items:				
Brazil	1,227	2.0	299	1.2
India	554	0.9	81	0.3
Russia	43	0.1	43	0.2

— = data not available.
LCY = local currency, PRC = People's Republic of China.
Note:
Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.
Source: Bank for International Settlements and *AsianBondsOnline*.