Global and Regional Market Developments

Emerging East Asian bond markets have remained relatively stable in spite of the turmoil impacting other emerging markets around the globe.[3] The United States (US) Federal Reserve's decision in January 2014 to reduce its monthly purchase of securities by US$10 billion—from US$75 billion to US$65 billion—came on the back of a similar cut in December 2013. Under its new Chair, Janet Yellen, the Federal Reserve has confirmed that it will continue the tapering process unless there is a significant change in the economic outlook. This suggests that liquidity in emerging East Asian economies is likely to tighten in the months ahead. Since the tapering began, bond yields in the region have risen, with further increases likely as the tapering continues.

While the announcement by the Federal Reserve in December 2013 elicited little reaction from the region's bond markets, the decision in January 2014 to further reduce the pace of its bond buying program has had an impact on financial markets. This suggests that while tapering might have been the trigger, other country-specific factors could be driving the sell-off. Economies with large current account deficits and low levels of foreign exchange (FX) reserves are seen as being particularly vulnerable. The worst-affected countries were forced into undertaking drastic policy actions. For example, Argentina has devalued its currency and Turkey has raised its overnight lending rate by a massive 425 basis points (bps) to defend the Turkish lira.

Emerging East Asian exchange rates have also been adversely affected by the sell-off, though on a much smaller scale than in other emerging markets. This shows that investors have been distinguishing between stronger and weaker markets based on country-specific economic vulnerabilities and have not been treating all emerging economies as a homogeneous group. The region's robust economic fundamentals, combined with a reliance on mainly local currency (LCY) financing, have allowed it to ride out the worst impacts of the global market turmoil. Policy reforms undertaken by emerging East Asian economies have led to stable monetary policies, more flexible exchange rates, and prudent fiscal management, all of which have helped strengthen the region's economic resilience.

The turmoil in emerging markets in the wake of US tapering has led to calls for greater policy coordination among countries given the strong spillover effects from the actions of the Federal Reserve. However, Federal Reserve decisions are likely to continue to be guided by domestic economic developments. Unless there is a major setback to the US recovery, the region's economies should not expect a reprieve from tightening liquidity.

Despite the tapering, bond yields in the US showed a marginal decline in recent months. This likely reflects the role that US Treasuries play as a safe haven. When concerns arise over the health of emerging economies, investors prefer to park their savings in a safe and liquid asset. The US Treasury market, by virtue of being the world's largest and most liquid market, tends to benefit from this market phenomenon.

Bond markets in the region have been able to avoid the worst effects of the turmoil. Nevertheless, bond yields for most of the region's economies increased between 1 December 2013 and 31 January 2014 **(Table A)**. Among the region's bond markets, Philippine 10-year yields rose the most, gaining 70 bps. Bond yields on 10-year maturities in Thailand and the Republic of Korea were the exception, however, and slightly decreased in December–January. Over the same period, most of the region's currencies depreciated. The Malaysian ringgit and Philippines peso showed the largest declines at –3.7% and –3.6%, respectively. Meanwhile, the Chinese renminbi and Vietnamese dong were able to buck the regional trend and strengthen marginally in December–January.

With emerging markets around the globe experiencing turmoil, investors' risk perception has risen. The region's economies have not been completely immune to the upheaval in global financial markets. For example, credit default swaps (CDSs) in the region have generally increased, particularly in Thailand due mainly to investor concerns over domestic political developments **(Figure A)**. Meanwhile, the market turmoil has left European economies relatively unaffected. CDSs for

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

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	5	(10)	0	(1.3)	–
United Kingdom	4	(6)	0	(2.1)	(0.4)
Japan	(1)	2	2	(3.6)	0.4
Germany	(5)	(3)	2	(1.1)	0.8
Emerging East Asia					
China, People's Rep. of	(34)	8	32	(8.4)	0.5
Hong Kong, China	8	19	4	(7.7)	(0.2)
Indonesia	(20)	37	(8)	3.8	(2.1)
Korea, Rep. of	(6)	(5)	12	(5.1)	(2.2)
Malaysia	12	17	23	(0.5)	(3.7)
Philippines	78	70	21	(2.7)	(3.6)
Singapore	5	6	0	(4.7)	(1.7)
Thailand	(20)	(11)	36	(7.1)	(3.0)
Viet Nam	(60)	0	–	9.6	0.3
Select European Markets					
Greece	(56)	(14)	0	(1.6)	0.8
Ireland	6	(46)	(3)	3.2	0.8
Italy	(15)	(22)	(13)	2.1	0.8
Portugal	(144)	(93)	(48)	2.4	0.8
Spain	(39)	(46)	(18)	0.8	0.8

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 December 2013 and 31 January 2014.
2. For emerging East Asian markets, a positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currency against the US dollar.
3. For European markets, a positive (negative) value for the FX rate indicates the depreciation (appreciation) of the local currency against the US dollar.
Sources: Bloomberg LP, Institute of International Finance (IIF), and Thomson Reuters.

most European economies have generally remained steady **(Figure B)**. On the other hand, emerging market spreads widened in January 2014. At the same time, there has also been a spike in the VIX, which is indicative of increased volatility in equity markets **(Figure C)**.

Bond yields in the advanced economies have remained relatively stable with a downward bias, appearing to be unaffected by the Federal Reserve's tapering actions **(Figure D)**. With inflation remaining below target in Europe, the European Central Bank is expected to maintain its expansionary monetary stance. Japanese bond yields are also trending lower on expectations that the Bank of Japan will continue its asset purchase program. Interest rates in emerging East Asia have moved upward, reflecting increased risk perception toward emerging markets in general **(Figure E)**. Foreign holdings of the region's LCY government bonds have remained relatively stable. While no longer rising as fast as before, there are no signs yet of any large scale sell-off. The share of foreign holdings of total government bonds outstanding in Indonesia remained the highest in the region at 32.5% at end-December 2013, followed by Malaysia at 29.4% **(Figure F)**. However, shares of foreign holdings of government bonds in Japan, the Republic of Korea, and Thailand showed slight annual declines at end-September.

The risks to the region's LCY bond markets have picked up as the Federal Reserve's tighter monetary policy stance has resulted in increased volatility in global financial flows. Specific risks are detailed below.

The region's bond markets could be vulnerable to contagion effects. While emerging East Asian bond markets have so far been relatively unaffected by emerging market turmoil elsewhere, there is the potential for contagion effects from other more vulnerable economies impacting the region if the situation in financial markets were to worsen. Thus far, investors have kept their faith in the region's bond markets. However, the region could be vulnerable to a shift in global risk sentiments against all emerging markets if there were a severe crisis in one or two

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

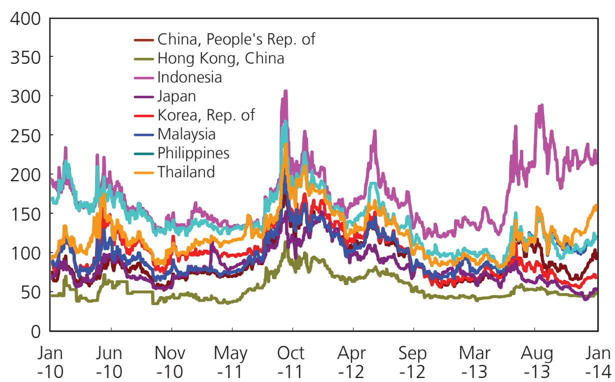


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

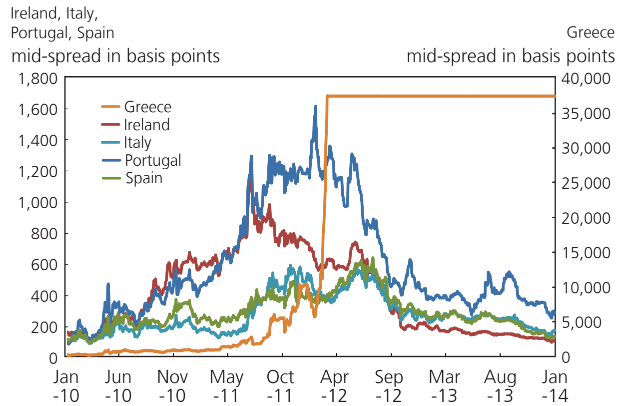


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

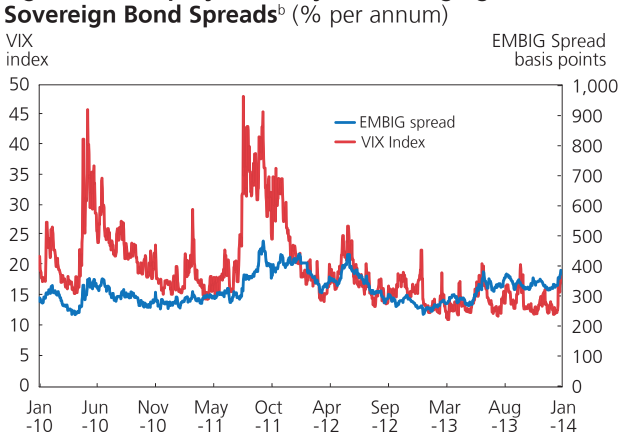


Figure D: 10-Year Government Bond Yields (% per annum)

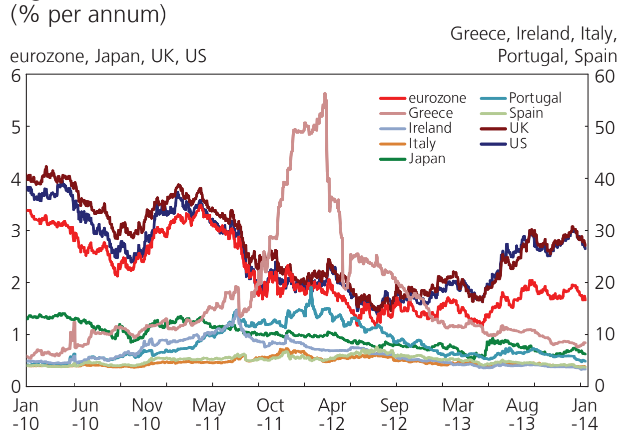


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]

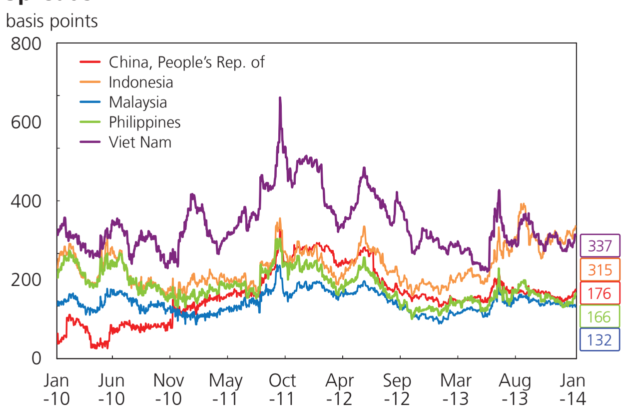
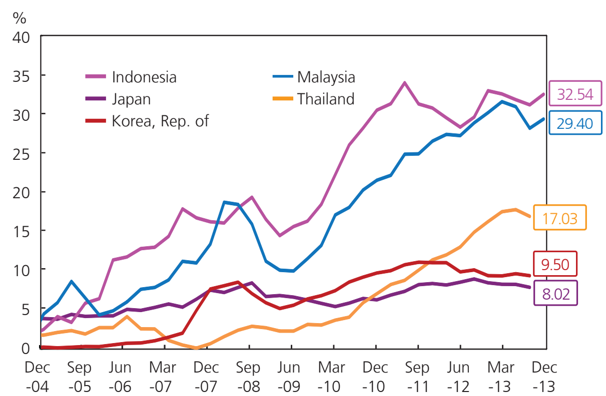


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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

Notes:

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

[b] Data as of 31 January 2014.

[c] Data as of end-September 2013, except for Indonesia and Malaysia as of end-December 2013.

Sources: *AsianBondsOnline*, Bloomberg LP, and Thomson Reuters.

vulnerable economies. Further reforms may be needed in some of the region's economies to improve their resilience in the face of possible contagion effects.

Tighter liquidity conditions and rising inflation could result in higher bond yields. Inflationary pressures have started picking up in several countries in the region. Some of the increases have been driven by the removal of subsidies, as in Malaysia, or supply shocks, as in the Philippines and Indonesia. At the same time, generally tighter global liquidity conditions will also push up interest rates. Further, if some emerging market currencies were to come under selling pressure, they might be forced to raise interest rates to stave off an attack.

Economies with high levels of foreign-currency-denominated debt are vulnerable to currency depreciation. While the region's sovereigns have mostly focused on issuing LCY bonds in recent years, corporates in some markets have taken advantage of plentiful liquidity in the US dollar market to issue more foreign currency (FCY) bonds. In 2013, for example, real estate companies in the People's Republic of China (PRC) were major issuers of FCY bonds, partly because it is becoming more difficult for them to borrow from banks domestically due to tightening regulatory restrictions. Overall, the region's G3 currency bond issuance in 2013 reached US$141.5 billion, of which US$128.4 billion originated in the corporate sector. Furthermore, G3 currency bond issuance by corporates represented 14.4% of total corporate bond issuance in emerging East Asia in 2013. If the region's exchange rates were to fall, many corporates would face higher debt servicing costs at a time when domestic economic conditions would also likely be weakening.