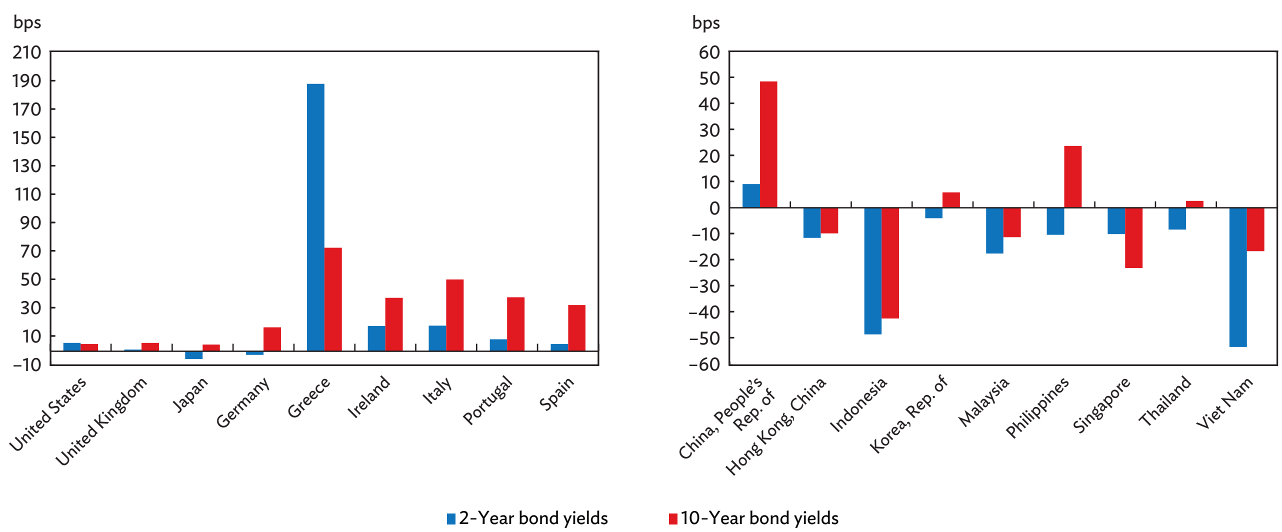
Introduction: Bond Yields Diverge Amid Heightened Global Uncertainty

Yields on global local currency government bonds varied widely between 30 December and 15 February. While yields in advanced economies largely rose during the review period, yields in most emerging East Asian economies trended downward **(Figure A1)**.[4,5] Despite recent economic data pointing to a pickup in the global economy, the divergence in government bond yields reflects heterogeneous economic fundamentals and changes in risk appetite around the world.

In the United States (US), the Federal Reserve has conveyed that it is likely to accelerate the pace of its rate hikes in 2017 if the economy continues to strengthen. Recent data from the US suggest steadily advancing inflation and an unemployment rate that remains low. The Consumer Price Index (CPI) for full-year 2016 rose 1.6% year-on-year (y-o-y), and further climbed 2.5% y-o-y in January 2017 and 2.7% y-o-y in February 2017. While core inflation is approaching the Federal Reserve's target, the labor market is also exhibiting strong momentum. Job gains averaged 190,000 per month in the second half of 2016, rising to 235,000 in February 2017. The unemployment rate stood at 4.7% in February, which is within the estimated range of the economy's long-run natural unemployment rate. In a report to Congress in February, Federal Reserve Chair Janet Yellen indicated that the US economy's performance has moved closer to central bank targets. She stated that if the labor market and inflation continue their current trends, the Federal Reserve is likely to further increase the policy rate. In short, monetary policy is gradually being normalized in the US.

In the eurozone, gross domestic product (GDP) growth remained stable and labor market conditions improved.

Figure A1: Changes in Government Bond Yields in Select Markets between 30 December 2016 and 15 February 2017



bps = basis points.
Sources: Bloomberg LP and *AsianBondsOnline*.

[4] 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.
[5] Bond yields in many emerging East Asian markets have rebounded slightly since the end of the review period (mid-February), largely due to the United States Federal Reserve's policy rate hike on 15 March. Nevertheless, regional bond yields were still mostly down year-to-date as of 15 March.

The seasonally adjusted quarter-on-quarter growth rate was unchanged at 0.4% in the fourth quarter (Q4) of 2016. The unemployment rate remained at 9.6% in January, the lowest reading since May 2009. Inflation rose to 2.0% y-o-y in February 2017 from 1.8% y-o-y in January 2017. Excluding rising energy prices, the eurozone's y-o-y inflation rate was 1.1% and 1.2% in January 2017 and February 2017, respectively, indicating limited underlying inflationary pressures. Given policy uncertainty associated with forthcoming elections in some major European economies later this year, the European Central Bank's President Mario Draghi hinted that monetary policy is likely to remain accommodative to meet inflation targets.

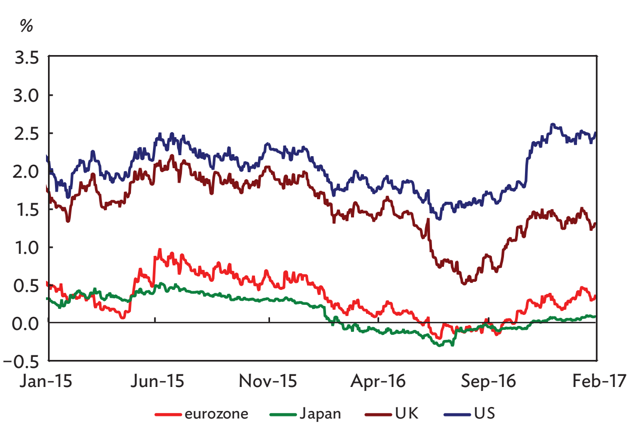
The Bank of Japan (BOJ) recently raised its growth outlook for the domestic economy. Per BOJ, the Japanese economy will grow above its potential in fiscal year 2018. The inflation forecast remained unchanged and inflation is expected to hit the central bank's 2.0% target over the medium-term. Japan's quarter-on-quarter GDP growth was unchanged at 0.3% in Q4 2016. GDP growth in fiscal year 2017 is expected to be higher than in fiscal year 2016.[6] Exports also turned positive in December 2016 and January 2017, reflecting the global economic recovery. To further buoy growth and foster inflation, the BOJ maintained its accommodative monetary policy.

Overall, promising signs of economic recovery in major advanced economies have pushed up long-term government bond yields since Q4 2016 **(Figures A2, A3)**.

Emerging East Asia also saw signs of rising inflation and improving growth, fostering investor confidence. As a result, emerging East Asia may now be more resilient to potential capital outflows in response to the Federal Reserve's monetary policy normalization. Between 30 December and 15 February, yields on 2-year and 10-year local currency bonds fell in most emerging East Asian markets **(Table A)**. One notable exception was the People's Republic of China (PRC), where yields on 2-year and 10-year bonds increased 9 bps and 48 bps, respectively. A rise in the PRC's yields was partly driven by a tightening monetary stance, reflecting the People's Bank of China's growing concerns with credit and asset price risks. To promote deleveraging, the central bank recently raised rates on its repurchase agreements by 10 bps and on its Standing Lending Facility by 35 bps. The other economies that saw an uptick in 10-year bond yields were Thailand (3 bps), the Republic of Korea (6 bps), and the Philippines (23 bps).

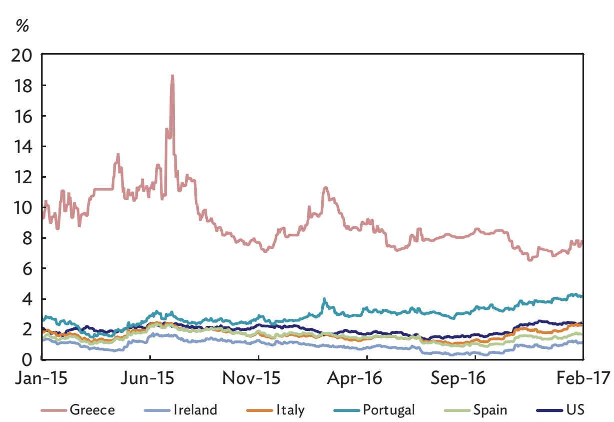
The largest decline in yields occurred in Indonesia, where yields slid 48 bps for the 2-year bond and 42 bps for the 10-year bond, mainly due to improving market sentiments and rising risk appetite as a result of a narrowing current

Figure A2: 10-Year Government Bond Yields



UK = United Kingdom, US = United States.
Source: Bloomberg LP.

Figure A3: 10-Year Government Bond Yields



[6] Per BOJ's January 2017 Outlook Report, Japan's Real GDP growth in 2016 and 2017 will be 1.4% and 1.5%, respectively, higher than the 1.0% and 1.3% forecasts made in October 2016. For details, see https://www.boj.or.jp/en/mopo/outlook/gor1701b.pdf

Table A: Changes in Global Financial Conditions

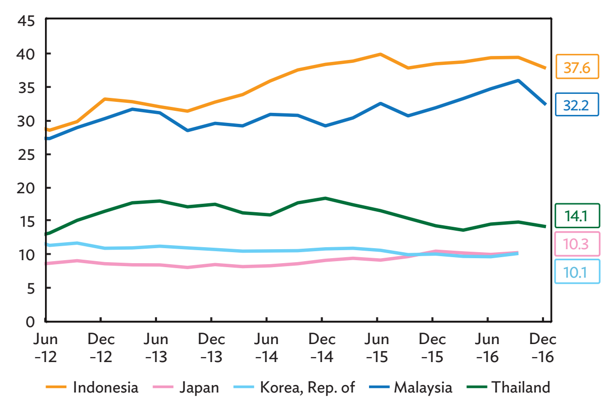
	2-Year Government Bond (bps)	10-Year Government Bond (bps)	5-Year Credit Default Swap Spread (bps)	Equity Index (%)	FX Rate (%)
Major Advanced Economies					
United States	6	5	–	4.9	–
United Kingdom	1	6	(1)	2.2	1.0
Japan	(6)	5	(4)	2.0	2.5
Germany	(3)	17	1	2.7	0.8
Emerging East Asia					
China, People's Rep. of	9	48	(20)	3.5	1.1
Hong Kong, China	(12)	(10)	–	9.1	(0.05)
Indonesia	(48)	(42)	(20)	1.6	1.2
Korea, Rep. of	(4)	6	2	2.8	5.6
Malaysia	(17)	(11)	(21)	4.1	0.8
Philippines	(10)	23	(23)	4.9	(0.6)
Singapore	(10)	(23)	–	7.2	2.0
Thailand	(8)	3	(14)	2.0	2.3
Viet Nam	(53)	(17)	(23)	7.0	0.03
Select European Markets					
Greece	186	72	(3)	(2.7)	0.8
Ireland	18	37	3	0.6	0.8
Italy	18	50	19	(0.9)	0.8
Portugal	8	37	9	(1.1)	0.8
Spain	5	32	(0.9)	2.5	0.8

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 30 December 2016 and 15 February 2017.
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 (IIF).

account deficit in Q4 2016, an upgrade in the sovereign rating outlooks (Fitch Ratings in December 2016 and Moody's Investors Service in February 2017), expanding international reserves, and various policy reforms initiated by the government. Singapore saw a 10-bps decline in the 2-year bond yield and a 23-bps decline in the 10-year bond yield. The drops were partly driven by bolstered investor confidence as GDP growth accelerated to 2.9% y-o-y in Q4 2016 from 1.2% y-o-y in the third quarter of 2016. Malaysia also witnessed a decline in its 2-year and 10-year bond yields, partly due to strong demand from local investors despite a rise in inflation to 3.2% y-o-y and continued (but slowing) capital outflows in January.

The divergence in global growth prospects, risk outlooks, and monetary stances is driving international capital flows in different directions. Recent quarters have witnessed variations in foreign holdings across Asian bond markets **(Figure B)**. At the end of Q4 2016, the share of foreign holdings in regional bond markets fell in Indonesia, Malaysia, and Thailand, following the US dollar's appreciation and consequent depreciation pressures on local currencies. Malaysia's foreign holdings share dropped the most, shedding more than 3 percentage points to 32.2% at the end of December. The share of foreign holdings in Indonesia slipped from 39.2% to 37.6% in the same period. However, neither Malaysia nor Indonesia experienced yield upticks as a result of a foreign sell-off. These markets have become more resilient to capital outflows due to solid economic fundamentals, increased

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



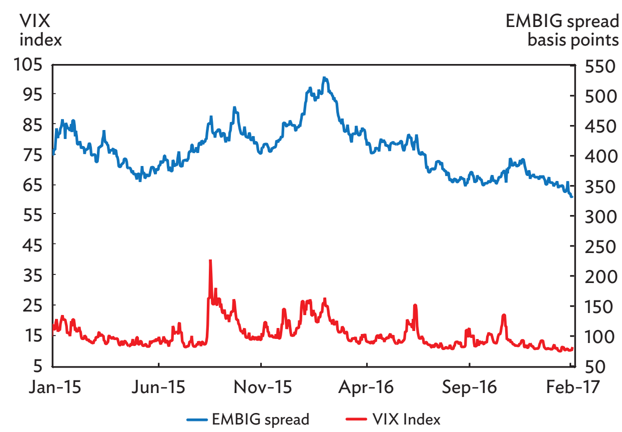
Note: Data as of end-December 2016 except for Japan and the Republic of Korea (end-September 2016).
Source: *AsianBondsOnline*.

demand from domestic market participants, improved investor profiles, and better-developed local currency bond markets following the implementation of the Asian Bond Markets Initiative. Even with the headwind of policy uncertainty in the US and political uncertainty in the eurozone, global capital flows have started to return to emerging East Asia in 2017. Foreign holdings in Indonesia inched up to 37.8% of the total at the end of January. In the Republic of Korea, after 5 consecutive months of foreign bond outflows, January saw the return of foreign inflows. Thailand also reported strong foreign inflows into its bond market in January.

As the monetary policies of major advanced economies have diverged, Asian financial markets have benefited from improved investor confidence and rising risk appetite. Consistent with the region's promising economic prospects, credit default swap spreads declined in all markets between 30 December and 15 February except for the Republic of Korea **(Figure C)**. The largest declines were seen in the Philippines and Viet Nam, with spreads in both markets shedding 23 bps. Malaysia's credit default swap spreads fell 21 bps, while spreads in the PRC and Indonesia shed 20 bps each.

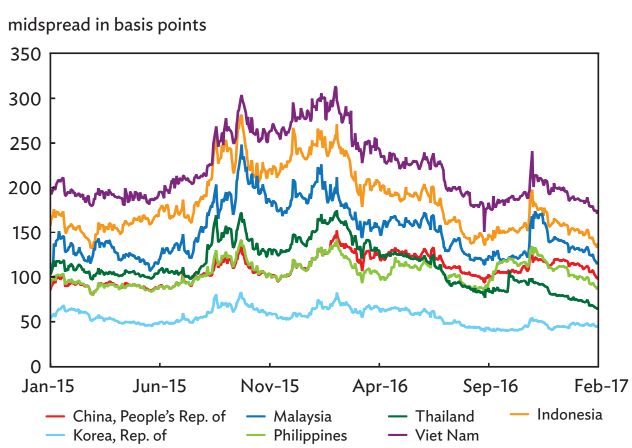
In line with the upturn in the global economy and upbeat investor sentiment, the Volatility Index has been stable and EMBIG spreads and JP Morgan EMBI Sovereign Stripped Spreads both declined between 30 December and 15 February **(Figures D, E)**. Equity markets also recovered across emerging East Asia during the review period, largely driven by healthier economic outlooks across the region. The biggest gains were seen in Hong Kong, China (9.1%); Singapore (7.2%); and Viet Nam (7.0%) **(Figure F)**. In Hong Kong, China, much of the recovery in the stock market was due to strong demand from PRC-based investors. Trade, however, weakened, with exports decreasing 1.2% y-o-y in January

Figure D: United States Equities Volatility and Emerging Market Sovereign Bond Spreads



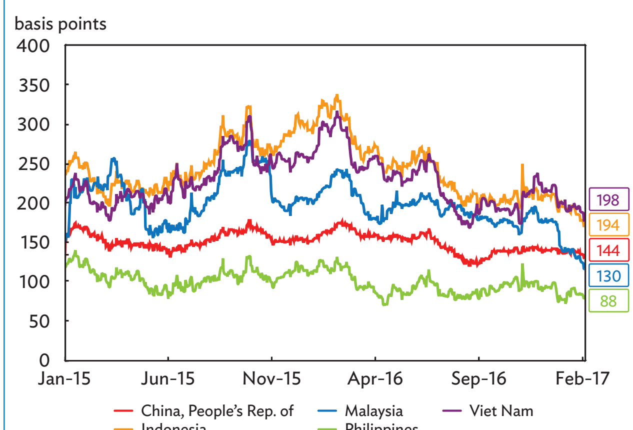
EMBIG = Emerging Markets Bond Index Global, VIX = Chicago Board Options Exchange Volatility Index.
Note: Data as of 15 February 2017.
Source: Bloomberg LP.

Figure C: Credit Default Swap Spreads in Emerging East Asia (senior 5-year)



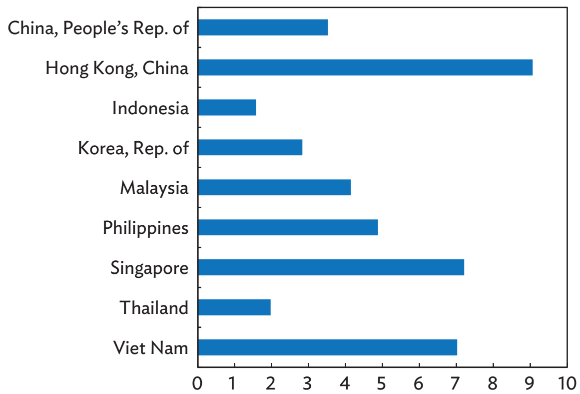
Notes:
1. In United States dollars and based on sovereign bonds.
2. Data as of 15 February 2017.
Source: Bloomberg LP.

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



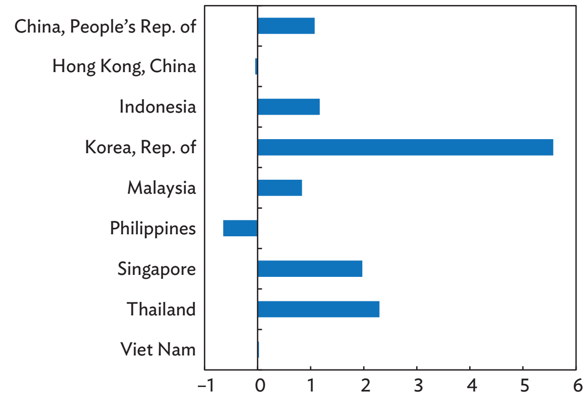
Notes:
1. In United States dollars and based on sovereign bonds.
2. Data as of 15 February 2017.
Source: Bloomberg LP.

Figure F: Change in Equity Market Indexes in Emerging East Asia between 30 December 2016 and 15 February 2017 (%)



Note: The equity indexes used were Shanghai Stock Exchange Composite Index (People's Republic of China); Hang Seng Index (Hong Kong, China); Jakarta Composite Index (Indonesia); Korea Composite Stock Price Index (Republic of Korea); Kuala Lumpur Composite Index (Malaysia); Philippine Stock Exchange Index (Philippines); Straits Times Index (Singapore); Stock Exchange of Thailand (Thailand); and Vietnam Stock Index (Viet Nam).
Source: Bloomberg LP.

Figure G: Change in United States Dollar Value per Unit of Local Currency between 30 December 2016 and 15 February 2017 (%)



Note: 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.

from a 10.1% y-o-y increase in December. In Singapore, the GDP growth rate accelerated to 2.9% y-o-y in Q4 2016 from 1.2% y-o-y in Q3 2016. In Viet Nam, GDP growth nudged up to 6.2% y-o-y in Q4 2016 from 5.9% in the previous quarter.

Underpinned by strengthening economic fundamentals, currencies in emerging East Asian markets have appreciated against the US dollar amid a backdrop of policy uncertainty in the US **(Figure G)**. Among the region's economies, the Korean won gained the most between 30 December and 15 February, appreciating 5.6% during the review period, largely buoyed by positive capital inflows in January. The Thai baht also recovered some of its earlier losses, gaining 2.3% against the US dollar. The two exceptions were the Hong Kong dollar and Philippine peso, which weakened 0.05% and 0.6%, respectively. The recovery in emerging East Asian currencies can be mainly attributed to improvements in economic outlook and investor sentiment. In markets such as Indonesia, the Republic of Korea, and Thailand, positive capital inflows at the start of 2017 also contributed to currency appreciation.

As the global economy starts to pick up, uncertainty will become a key theme for investors in 2017. Different paces of recovery and varying economic outlooks are leading to divergences in monetary policies. **The possible acceleration of rate hikes by the Federal Reserve may pose risks to emerging Asian financial stability (Box 1)**.[7] With unemployment and inflation rates approaching policy targets, the market consensus is that the Federal Reserve will raise the federal funds rate more than once this year. Higher interest rates may cause global capital to flow out of emerging Asian markets and exert depreciation pressure on local currencies. Although many regional economies are adopting a wait-and-see approach and keeping their monetary policy stable, heightened depreciation pressures may push central banks to tighten their domestic monetary stance. Since many emerging Asian economies have rapidly built up foreign and local currency debt positions in the low interest rate environment prevailing after the global financial crisis, the possible tightening of liquidity could challenge their financial stability. Nevertheless, solid economic prospects and sufficient international reserves should cushion such shocks.

Another major source of risk is policy uncertainty in developed economies. **Policy and political risks in the US and eurozone will influence the global economic outlook and become a key risk to emerging Asian financial markets (Box 2)**. Despite a global recovery, the prices of safe-haven assets such as gold remain robust during the review period, which reflects investor concerns

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

about possible policy risks in advanced economies and the sustainability of their economic recoveries.

In the US, policy uncertainty may have not been fully priced into asset prices. Changes in trade policy could trigger tensions with major trade partners, which would not only hurt US exports but also raise US inflation due to higher prices of goods. A fiscal stimulus package based on tax cuts and infrastructure investments is still subject to a great deal of uncertainty and has yet to be spelled out clearly. While stimulus would benefit growth, it might also unleash inflationary pressures, which would in turn influence the Federal Reserve's monetary policy and cause accelerated rate hikes and US dollar appreciation. Asian financial markets may further adjust and price in these risks in the future, which would exacerbate volatility.

The eurozone will see several elections in major economies in 2017. The United Kingdom is aiming to invoke Article 50 of the Lisbon Treaty by the end of March, although the timing and outcome of Brexit negotiations between the United Kingdom and the European Union remains unclear. The series of elections in some European economies and possible changes in economic policies of new governments in the eurozone may threaten the sustainability of Europe's budding recovery. The eurozone still faces major unsolved problems such as Greece's sovereign debt and the Italian banking sector's fragility, which further add to the vulnerability of the eurozone's recovery. Under this cloud of global political and policy uncertainty, Asian financial market might become more volatile and the demand for safe-haven assets such as precious metals and highly rated sovereign bonds could surge.

The Chinese yuan's depreciation also poses potential risks to the economies and financial markets of Asia (Box 3). A weaker yuan might curb the exports of Asia to the PRC, the region's largest trade partner, and intensify competition for exports to the US and other economies. In the unlikely case that the yuan's depreciation accelerates, capital may flow out of the PRC and pull down asset prices, which would weaken the balance sheets of financial institutions and challenge highly leveraged investors in the PRC. Negative investor sentiment could also spill over to other Asian markets, leading to capital outflows from the region.

Box 1: Emerging Asia's Financial Stability amid the Latest Round of Interest Rate Hikes in the United States

The latest round of United States (US) interest rate hikes, which began in December 2015, accelerated in recent months with 25-basis-point hikes in both December 2016 and March 2017. The recent release of US economic data points to a robust economy. Nonfarm payroll growth surpassed expectations and unemployment remains low.[a] The core Consumer Price Index, excluding food and energy, rose 2.2% year-on-year (y-o-y) in February 2017.[b] Solid labor market conditions and improvements in inflation suggest upbeat growth prospects, which may lead to one or two more rate hikes in 2017.[c]

Uncertainty in the International and Domestic Liquidity Environments

A strong US dollar attracts international capital flows. The gradual normalization of monetary policy and robust economic performance in the US provide support to the US dollar. Despite the retreat of the US dollar index in January 2017, the US dollar still enjoys solid economic fundamentals **(Figure B1.1)**.[d] With improving economic prospects, international capital will flow back to US dollar-denominated assets, placing downward pressure on asset prices in emerging Asia.[e] International capital flows are

[a] https://www.bls.gov/news.release/pdf/empsit.pdf
[b] https://www.bls.gov/news.release/cpi.nr0.htm
[c] Details available at http://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html
[d] Real trade-weighted US dollar value and nominal US effective exhange rate.
[e] Emerging Asia comprises the People's Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

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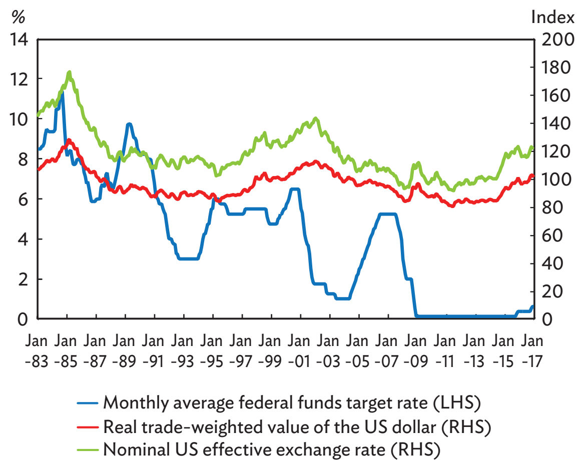
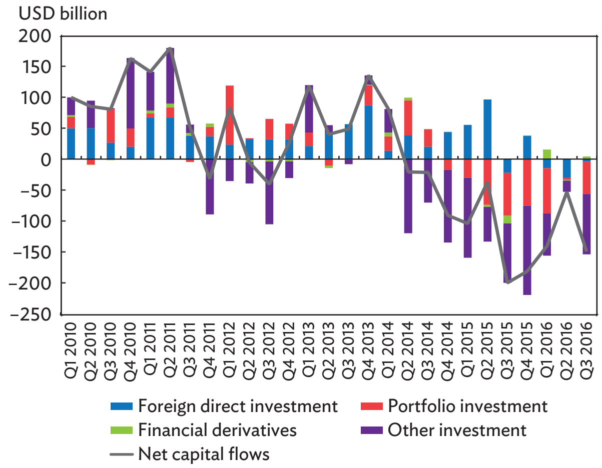
Box 1: Emerging Asia's Financial Stability amid the Latest Round of Interest Rate Hikes in the United States *continued*

Figure B1.1: Federal Funds Target Rate and the Value of the United States Dollar



LHS = left-hand side, RHS = right-hand side, US = United States.
Note: Monthly average federal funds target rate and real trade-weighted value of the US dollar data are as of February 2017; nominal US effective exchange rate data is as of January 2017.
Sources: Haver Analytics and Bank for International Settlements.

Figure B1.2: Capital Flows in Emerging Asia

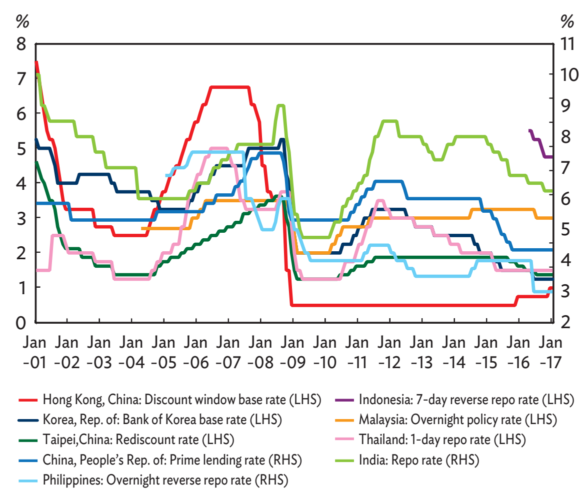


Q1 = first quarter, Q2 = second quarter, Q3 = third quarter, Q4 = fourth quarter, USD = United States dollar.
Note: Emerging Asia comprises the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
Source: Haver Analytics.

sensitive to the US dollar exchange rate. When the US dollar index was low before 2014, emerging Asia experienced net capital inflows; when the US dollar started to rise in the second half of 2014, emerging Asia witnessed net capital outflows **(Figure B1.2)**. More interest rate hikes in the US could further drain foreign investment from emerging Asia.

Emerging Asia also faces uncertainty concerning the domestic monetary stances of many regional economies that have been lowering policy rates over the past 2 years to support investment and growth. A tightening monetary stance in the US might spillover to emerging economies, especially those which have open capital accounts and flexible exchange rates. If currency depreciation pressures gain momentum, central banks may adjust domestic monetary policies in line with the Federal Reserve. Since policy rates in emerging Asia are strongly correlated with one another due to common external shocks and growing regional integration, rising interest rates may adversely affect the region's liquidity environment **(Figure B1.3)**.

Figure B1.3: Policy Rates in Emerging Asia



LHS = left-hand side, repo = repurchase, RHS = right-hand side.
Note: Data as of 31 January 2017.
Source: Haver Analytics.

Increased Leverage in Emerging Asia in a Low Interest Rate Environment

Emerging Asia has witnessed a rapid expansion of leverage in both the public and private sectors in recent years. Rising leverage poses several types of risks. The first risk is a currency mismatch associated with surging foreign currency (FCY) debt. Global monetary easing and a weak US dollar between 2010 and 2014 triggered burgeoning FCY debt in emerging Asia.

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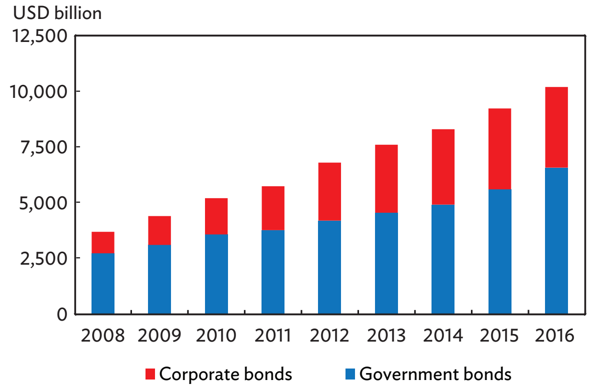
Box 1: Emerging Asia's Financial Stability amid the Latest Round of Interest Rate Hikes in the United States *continued*

During the period 2010–2016, the outstanding amount of FCY debt in emerging Asia doubled, with corporate debt increasing by more than 150% **(Figure B1.4)**. The rapid expansion of FCY debt exacerbates currency mismatches, which arise when domestic corporates generate profits in local currencies but repay principal and interest in foreign currencies. Heightened FCY exposure may pose a risk when the local currency depreciates in the face of US interest rate hikes.

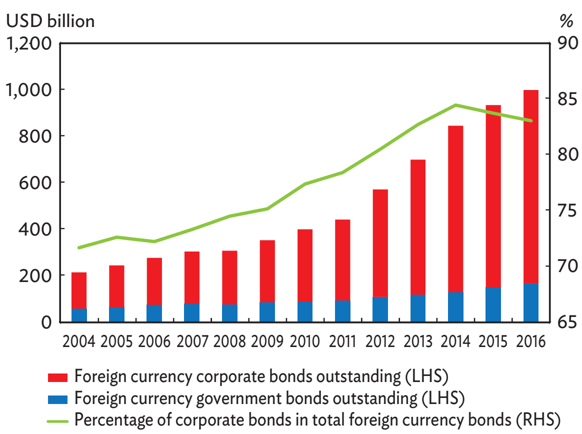
Growing domestic leverage also increases the risk exposure to interest rate hikes. Amid an accommodative monetary environment since 2012, emerging Asia's domestic leverage levels have been increasing, especially in the private sector. In terms of direct financing, the aggregate amount of outstanding corporate bonds in select emerging Asian economies rose 280% from 2008 until 2016, while outstanding government bonds rose 139% over the same period **(Figure B1.5a)**. In terms of indirect financing, bank credit extended to the private nonfinancial sector continued to expand in many emerging Asian economies **(Figure B1.5b)**. Higher interest rates would decrease the value of these debt assets and challenge financial stability.

Figure B1.5a: Outstanding Local Currency Debt in Select Emerging Asian Economies



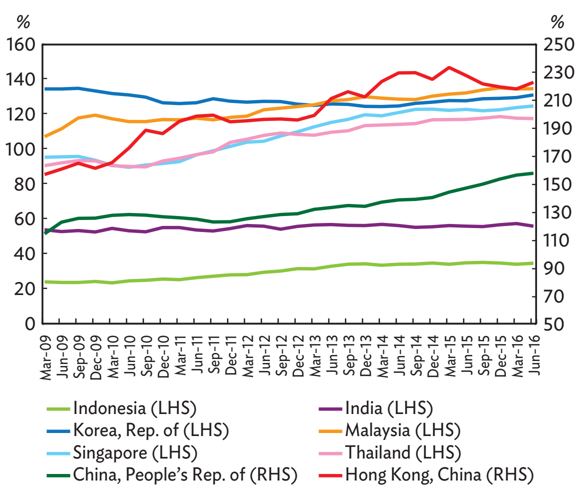
USD = United States dollar.
Notes:
1. Emerging Asia data available for the People's Republic of China; Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.
2. Data are year-end figures.
Source: *AsianBondsOnline*.

Figure B1.4: Outstanding Foreign Currency Debt in Select Emerging Asian Economies



LHS = left-hand side, RHS = right-hand side, USD = United States dollar.
Notes:
1. Emerging Asia data available for the People's Republic of China; Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.
2. Data are year-end figures except for 2016 (end-June).
Source: *AsianBondsOnline*.

Figure B1.5b: Bank Credit Extended to the Private Nonfinancial Sector (share of GDP)



GDP = gross domestic product, LHS = left-hand side, RHS = right-hand side.
Source: Bank for International Settlements.

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Box 1: Emerging Asia's Financial Stability amid the Latest Round of Interest Rate Hikes in the United States *continued*

Moderation in economic growth might also heighten default risks across the region. Nonperforming loan ratios have increased in some emerging Asian economies since 2012, which is ringing alarm bells across the region **(Figure B1.6a)**. Widened credit spreads also reflect concerns of default risk as investors claim higher premiums to cover growing risks **(Figure B1.6b)**.

Risks are Manageable in the Short-Term; Prudent Measures are Needed in the Long-Term

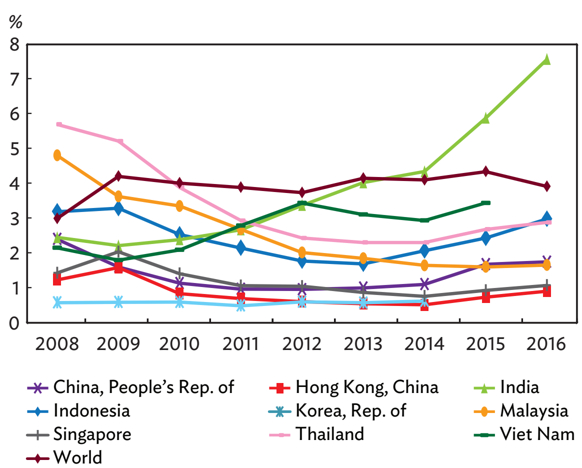
Emerging Asia may be exposed to potential risks in an uncertain liquidity environment, but the risks are still manageable in the short-term.

There is policy uncertainty in the US. Despite a strong economic performance, the US dollar weakened slightly in January 2017, partly due to concerns about policy uncertainty. Fiscal stimulus may face resistance in an environment of rising interest rates. Rapid increases in interest rates would exacerbate the fiscal burden of the US government, especially with tax cuts looming. In addition, an excessively strong US dollar could harm exports and curb economic growth.

Emerging Asian economies may not tighten their monetary stance soon. According to the *Asian Development Outlook Supplement—December 2016*, developing Asia's economic growth is expected to slightly pick up to 5.7% in 2017 from 5.6% in 2016.[f] With economic growth still fragile in light of global uncertainties, Asian central banks may exercise caution before tightening monetary policies. The subdued economic outlook also may not support an uptick in financing costs. Meanwhile, discrepancies in monetary policies among major developed economies indicate that global monetary easing may not end soon.[g] Thus, a combination of domestic and external factors suggest that the region's liquidity environment will remain stable over the short-term.

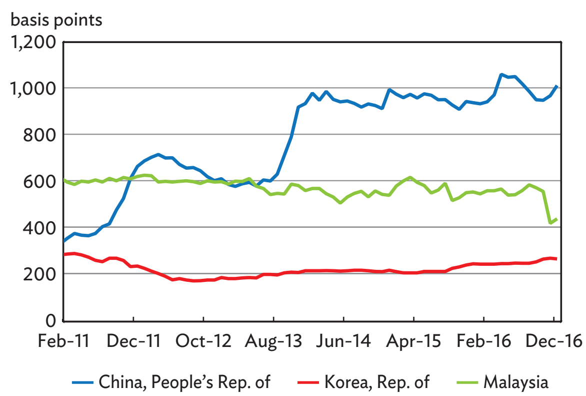
Emerging Asia is maintaining healthy economic growth and enjoying relatively strong macroeconomic fundamentals such as large foreign reserves. Robust growth and fundamentals, aided by relatively sound prudential regulation and (in some cases) macroprudential policies, will protect emerging Asia from external shocks in the short-term. However, in light of the latent danger posed by the region's growing debt, prudential measures that gradually control leverage levels—especially in less-efficient sectors and industries suffering from overcapacity—can facilitate the region's structural transformation and upgrading, and contribute to greater resilience in the long-term.

Figure B1.6a: Bank Nonperforming Loans as a Share of Total Gross Loans



Sources: World Bank's *World Development Indicators* and the International Monetary Fund's *Global Financial Stability Report*.

Figure B1.6b: Credit Spreads between Government Bonds and 3-Year BBB Corporate Bonds



Notes:
1. Credit spreads obtained by subtracting government bonds yields of comparable maturity from corporate indicative yields.
2. Credit spreads obtained using BBB-rated corporate indicative yields for the Republic of Korea and Malaysia. For the People's Republic of China, BBB+ corporate indicative yields are used.

Source: *AsianBondsOnline*.

[f] Developing Asia comprises the 45 regional developing member economies of the Asian Development Bank. https://www.adb.org/sites/default/files/publication/216421/ado-supplement-dec-2016.pdf

[g] At their recent monetary policy meetings, the Bank of Japan and the European Central Bank both indicated that they would keep interest rates steady and maintain existing quantitative easing programs over the short-term. http://www.boj.or.jp/en/announcements/release_2017/k170131a.pdf and https://www.ecb.europa.eu/press/pr/date/2017/html/pr170119.en.html

Box 2: Asian Financial Markets Under a Cloud of Policy Uncertainty

The year kicked off with signs of moderate economic recovery in major developed economies. In the United States (US), the Consumer Price Index (CPI) recorded a 0.6% month-on-month (m-o-m) increase in January, the largest gain since February 2013.[a] Sales for retail and food services rose 0.4% m-o-m in January, while total business sales saw a m-o-m increase of 2.0% in December 2016.[b]

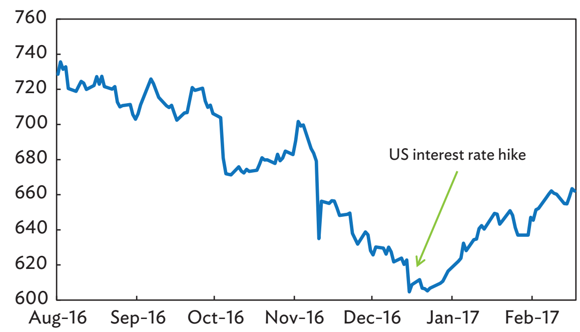
In the eurozone, the All-Items Harmonised Indices of Consumer Prices increased 1.8% y-o-y in January, a 4-year high. The eurozone's unemployment rate of 9.6% in December 2016 and January 2017 were the lowest since May 2009.[c] At the same time, core inflation in the eurozone remained low and the region's 0.4% quarter-on-quarter gross domestic product growth rate for the fourth quarter of 2016 was slightly lower than expectations.[d] The eurozone also saw 1.6% m-o-m and 0.3% m-o-m decreases in industrial production and retail trade volume, respectively, in December 2016.[e]

In Japan, the annual CPI increase in December 2016 was 0.3%. The Bank of Japan expects the CPI to increase at a pace of 1.7% y-o-y by fiscal year 2018, which would be close to the central bank's annual target level of 2.0%. Japan's real gross domestic product growth forecast was raised from 1.0% to 1.4% for fiscal year 2016 and from 1.3% to 1.5% for fiscal year 2017.[f]

A somewhat more robust recovery in the US than in the eurozone and Japan is causing monetary policies to diverge. The US Federal Reserve is expected to hike policy rates two or three times in 2017, while the European Central Bank and the Bank of Japan will retain their respective quantitative easing programs. Notwithstanding heterogeneity in the speed of economic recovery among major developed economies, their overall economic prospects are positive. Yet, looming political and policy uncertainties in developed economies pose potential downside risks. Concerns over these uncertainties are engendering momentum for safe-haven assets such as precious metals. Gold prices, for example, increased following the Federal Reserve's rate hike in December 2016, which was at odds with conventional price patterns **(Figure B2.1)**.

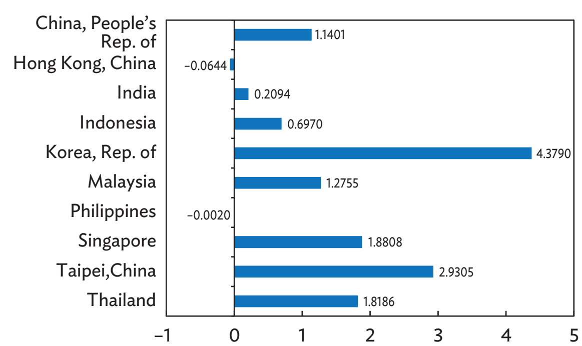
Given the region's healthy economic outlook, emerging Asian financial markets have become more attractive amid global political and policy uncertainty.[g] Since the beginning of 2017, major emerging Asian currencies have appreciated against the US dollar and regional stock markets have risen tangibly **(Figures B2.2a, B2.2b)**. Over the course of 2017,

Figure B2.1: Standard and Poor's Goldman Sachs Commodity Index Gold Total Return Index (close price)



US = United States.
Note: Data as of 17 February 2017.
Source: *Wind Information*.

Figure B2.2a: Change in United States Dollar Value per Unit of Local Currency between 31 December 2016 and 31 January 2017 (in %)



Note: A positive (negative) value means the appreciation (depreciation) of the local currency relative to the United States dollar.
Source: Haver Analytics.

[a] https://www.bls.gov/news.release/cpi.nr0.htm
[b] https://www.commerce.gov/economicindicators, http://www.census.gov/retail/marts/www/marts_current.pdf, http://www.census.gov/mtis/www/data/pdf/mtis_current.pdf
[c] http://ec.europa.eu/eurostat/news/news-releases
[d] In January, y-o-y core inflation (exclusive of energy and unprocessed food) in the eurozone was 0.9%, which was the same as December 2016 and 0.1 percentage point lower than in January 2016. http://ec.europa.eu/eurostat/documents/2995521/7885873/2-22022017-AP-EN.pdf/67b105f6-fd32-4685-ac1d-62e7a394eca1
[e] http://ec.europa.eu/eurostat/documents/2995521/7868348/2-14022017-BP-EN.pdf/da0c1c33-2d80-4cc2-9f34-de2dab92aac5, http://ec.europa.eu/eurostat/documents/2995521/7868318/4-14022017-AP-EN.pdf/d735ee06-3a57-4078-9e2d-e54237b2e374, http://ec.europa.eu/eurostat/documents/2995521/7851535/4-03022017-AP-EN.pdf/0ac0511e-b858-472d-828e-606c58d0ba7a
[f] http://www.stat.go.jp/english/data/cpi/1581.htm, http://www.boj.or.jp/en/mopo/outlook/gor1701b.pdf
[g] Emerging Asia comprises the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

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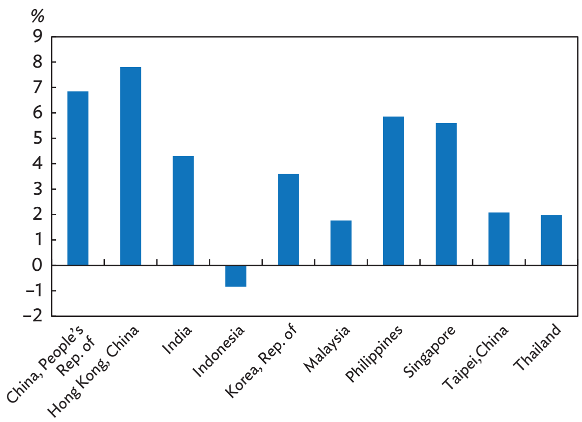
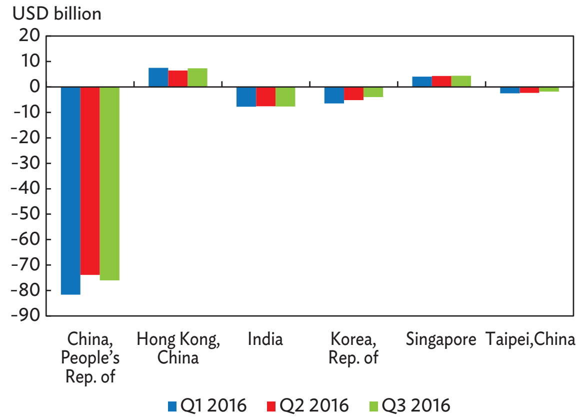
Box 2: Asian Financial Markets Under a Cloud of Policy Uncertainty *continued*

Figure B2.2b: Changes in Morgan Stanley Capital International Stock Market Indexes between 31 December 2016 and 31 January 2017



Note: Price changes are based on local currency values and do not include dividends.
Source: Haver Analytics.

Figure B2.3a: Goods and Services Trade Balance with the United States



Q1 = first quarter, Q2 = second quarter, Q3 = third quarter, USD = United States dollar.
Source: Haver Analytics.

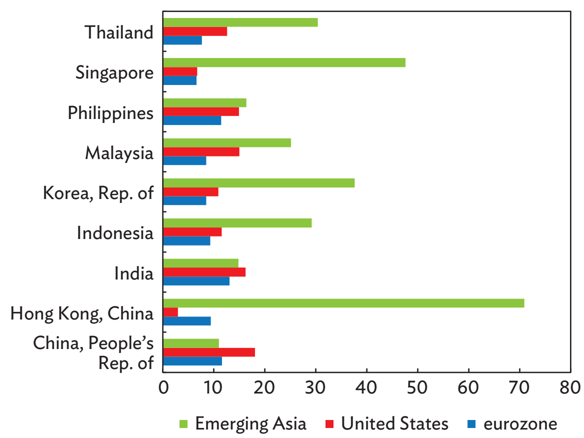
on the other hand, major political and policy events in the US and eurozone may influence emerging Asian financial markets in different ways.

Policy Uncertainty in the United States

The trade policy and fiscal stimulus of the new US administration has generated a great deal of interest and uncertainty. It is not yet clear how the new administration's approaches to trade and spending will evolve. Changes in trade policy would influence emerging Asia's growth, though the shocks could be mitigated. While its fiscal stimulus package lacks clarity at present, its mere airing has improved investment sentiment and risk appetite in the US. Such ebullience might spill over into emerging Asian financial markets.

Changes in trade policy could trigger trade tensions and conflict between the US and its major Asian trade partners. Many emerging Asian economies run trade surpluses with the US and therefore any change in trade policy would affect the region's exports and growth, and hit the earnings of many export-oriented corporations **(Figure B2.3a)**. However, the multilateral World Trade Organization framework makes it difficult for members to unilaterally erect high tariffs and pursue other measures. Emerging Asian economies also have a long history of coping with tariff and nontariff barriers. Futhermore, many emerging Asian economies, especially members of the Association of Southeast Asian Nations, trade increasingly with regional partners **(Figure B2.3b)**. There may also be resistance within the US against trade policy changes, including measures directed at manufactured goods from emerging Asia, which would raise prices and thus reduce the purchasing power of US households. Therefore, the magnitude of a US trade shock on emerging Asia may be more limited than widely feared.

Figure B2.3b: Breakdown of Exports as Shares of Total Exports (%)



Note: Data are as of end-September 2016, except for Singapore (end-August 2016).
Source: Haver Analytics.

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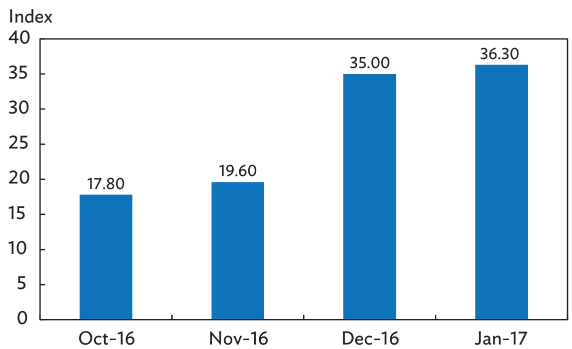
Box 2: Asian Financial Markets Under a Cloud of Policy Uncertainty *continued*

On the fiscal front, the US administration has proposed a stimulus package to boost domestic growth. Plans include individual and corporate tax cuts as well as large-scale infrastructure investments. Once approved by Congress, these tax cuts and infrastructure investments will bolster demand. A possible downside risk is a spike in inflation given the tightening labor market, which could accelerate the interest rate hike cycle and curb investments.

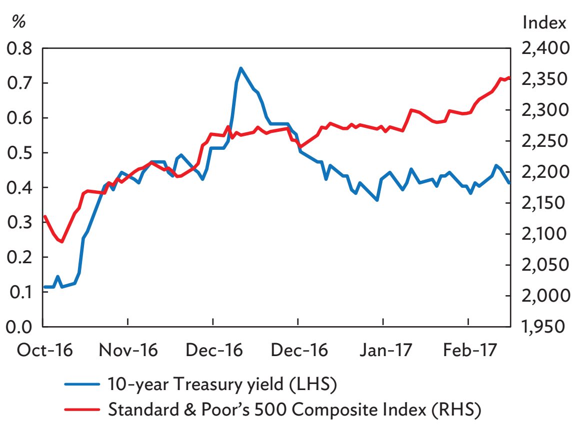
Despite the lack of detail about the magnitude, composition, and implementation of a fiscal stimulus package, the positive economic outlook has improved investor sentiment and risk appetite **(Figures B2.4a, B2.4b)**. The Sentix Investor Confidence Index has surged more than 80% since November 2016 and over the past 3 months the Standard and Poor's 500 Composite Index has gained 7.5%. Yields on 10-year US Treasury bonds initially climbed after November's election result on expectations of a stronger US economy and tightened monetary stance, before sliding due to heightened policy uncertainty. Improved investment sentiment could spill over to emerging Asian financial markets by pushing down bond prices. However, concerns over rising inflation and a tighter liquidity environment might raise bond yields in emerging Asia, leading to a mixed picture. **(Figure B2.5)**.

Figure B2.4a: Sentix Investor Confidence Index



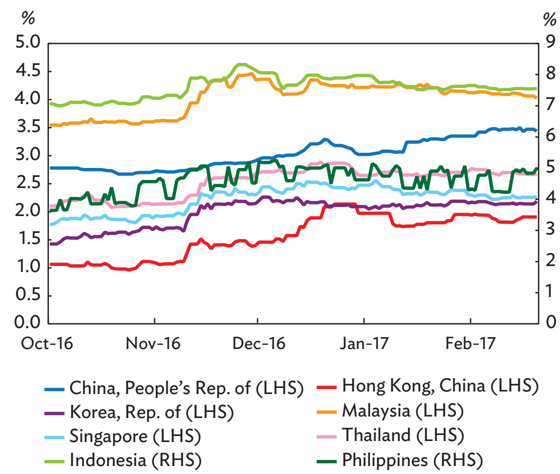
Source: *Wind Information*.

Figure B2.4b: Price Trends in United States Equity and Bond Markets



Note: Data as of 17 February 2017.
Source: *Wind Information*.

Figure B2.5: Yields on 10-Year Government Bonds in Select Emerging Asian Bond Markets



LHS = left-hand side, RHS = right-hand side.
Note: Data as of 20 February 2017.
Source: Bloomberg LP.

Political Risks in the Eurozone

Notwithstanding signs of economic recovery, political uncertainty in the eurozone will be a major investment concern in 2017 as it tends to increase demand for less risky assets. Specific sources of uncertainty include negotiations over the terms of the United Kingdom's exit from the European Union and elections in a number of European economies **(Table B2)**. New administrations of these European economies may shift the current policy agenda and influence the pace of recovery.

Recent opinion polls reveal the weakening of pro-European Union sentiment across the continent, further exacerbating political uncertainty. The possibility of changes in economic policies challenges the sustainability of economic recovery by adversely affecting business confidence, consumer confidence, demand, and growth. Despite some promising

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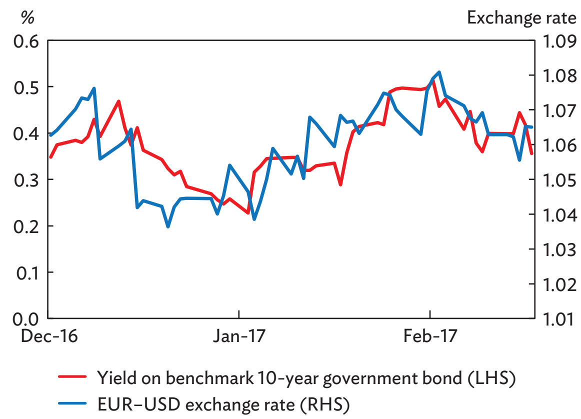
Box 2: Asian Financial Markets Under a Cloud of Policy Uncertainty *continued*

Table B2: Key Political Events in the Eurozone, 2016–2017

Date	Event	Results
Jun 2016	UK referendum on EU membership	The UK voted to leave the EU by 52% to 48%.
Dec 2016	Italian referendum on constitutional reform	Italy voted to reject constitutional reform by 59% to 41%. Prime Minister Matteo Renzi resigned.
Feb–Mar 2017	The UK Parliament voted on a bill to formally start Brexit negotiations by invoking Article 50 of the Lisbon Treaty	The UK Parliament passed the bill to invoke Article 50 of the Lisbon Treaty.
Mar 2017	General election in the Netherlands	Mark Rutte's party won the election.
Apr 2017 May 2017	Presidential election in France	
Oct 2017	General election in Germany	

EU = European Union, UK = United Kingdom.
Source: *AsianBondsOnline* compilation.

Figure B2.6: Exchange Rate and Benchmark 10-Year Government Bond Yields in the Eurozone



Note: Data as of 17 February 2017.
EUR = euro, LHS = left-hand side, RHS = right-hand side, USD = United States dollar.
Source: *Wind Information*.

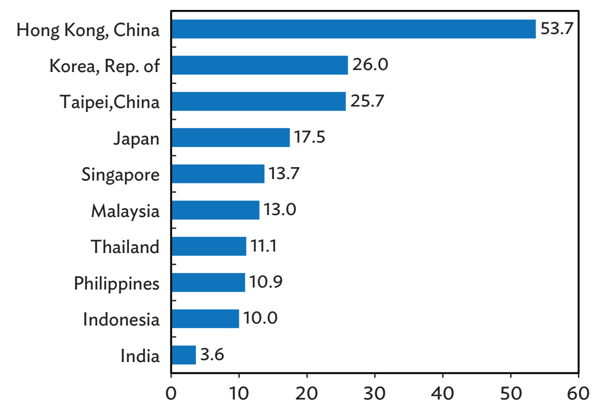
signs of economic recovery in the eurozone, mounting policy risks partly contributed to the European Central Bank's decision to extend its quantitative easing program until December 2017. Both the euro exchange rate and yields on 10-year government bonds fell in February 2017 **(Figure B2.6)**. Further political uncertainty in the eurozone may increase demand for safe-haven assets like precious metals and highly rated sovereign bonds.

Box 3: The Impact of the Chinese Yuan's Depreciation

Over the past 12 months, the Chinese yuan has depreciated against the currencies of all major developed economies as well as many Asian currencies **(Figure B3.1a)**. Given the People's Republic of China's (PRC) economic weight in Asia, the yuan's depreciation poses potential risks to the region's economies and financial markets. The yuan's depreciation also poses a risk to the PRC's financial stability, especially if its depreciation were to gain speed.

The depreciation of the yuan might adversely affect the exports of Asian economies to the PRC, with the impacts most pronounced in East and Southeast Asian economies that trade heavily with the PRC. On the other hand, since the PRC imports a significant amount of parts and components from East and Southeast Asian economies for final assembly and export, these economies would also partially benefit from increased Chinese exports driven by the depreciation of the yuan. The impact on other Asian economies that trade less with the PRC, such as India, would be more subdued **(Figure B3.1b)**.

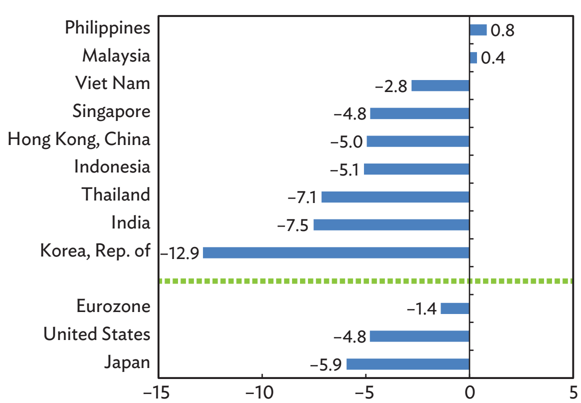
Figure B3.1b: Exports to the People's Republic of China as Share of Total Exports, 2015 (%)



Sources: International Monetary Fund *Direction of Trade Statistics* and CEIC.

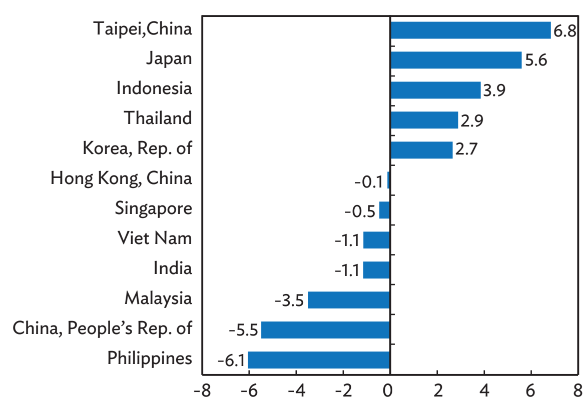
Asian exporters that compete with the PRC's exporters in markets such as the United States (US) would lose a degree of competitiveness due to a weaker Chinese yuan. The magnitude of the loss would depend on the relative depreciation of the exporter's currency vis-à-vis the yuan **(Figure B3.2)**. For example, the extent to which manufacturing exporters in the Republic of Korea would be impacted would depend on the relative depreciation of the won–dollar versus the yuan–dollar exchange rate. The competitiveness effects would be felt most strongly in East and Southeast Asian economies with significant exports of manufactured goods to the US and other markets in common with PRC exporters. In principle, this could raise the specter of competitive devaluation among regional currencies.

Figure B3.1a: Chinese Yuan versus Selected Currencies between 28 February 2016 and 27 February 2017 (%)



Note: A positive (negative) value means the appreciation (depreciation) of the Chinese yuan relative to other currencies.
Source: Bloomberg LP.

Figure B3.2: Change in United States Dollar Value per Unit of Local Currency between 1 January 2016 and 15 February 2017 (%)



Note: A positive (negative) value means the appreciation (depreciation) of the local currency relative to the United States dollar.
Source: Bloomberg LP.

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Box 3: The Impact of the Chinese Yuan's Depreciation *continued*

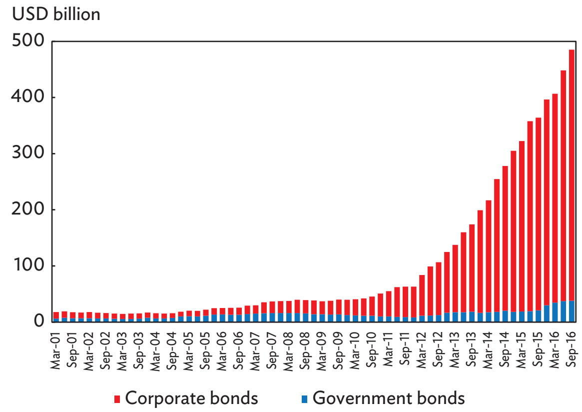
There is a risk that the depreciation of the yuan against the US dollar will further widen the US's bilateral trade deficit with the PRC, which could lead to a change in trade policy in the US. This would be a very negative development for Asia, which depends on trade and openness for its prosperity.

A weaker yuan would also reduce tourism demand across Asia. The large and growing number of tourists from the PRC is a major source of demand for many economies in the region. Reduced tourist traffic from the PRC resulting from a weaker yuan would be felt in the tourism sectors of many regional economies.

It is unlikely that the depreciation of the yuan would have a major effect on either foreign direct investment inflows or outflows in the absence of an extended and sharp depreciation since foreign direct investment is mainly driven by long-term fundamentals. However, since depreciation lowers the return on short-term portfolio investments, the PRC might experience short-term capital outflows, especially when the Federal Reserve accelerates the pace of its interest rate increases in 2017. Short-term capital outflows would further contribute to expectations of currency depreciation and may lead to more capital flight from the PRC. If such a negative feedback loop were to form, investor sentiment on the PRC would sour. Given the strong economic linkages between the PRC and many East and Southeast Asian economies, the expectations of further yuan depreciation would also lead to negative investor sentiment in the region and short-term capital outflows from Asia, including outflows from the region's bond markets. As an example of the impact of weakening investor sentiment in the region, in the third quarter of 2016, portfolio investment in Asian markets fell almost USD50 billion from the previous quarter.[a]

In an unlikely case, an extended and sharp depreciation of the yuan also poses significant risk to the PRC's financial stability. The low interest rate environment globally during the past several years led to a build-up of foreign currency debt in the PRC, especially in the private sector **(Figure B3.3)**. The yuan's rapid depreciation would increase the risk of currency mismatch in instances where US dollar loans were used to finance investments that generate revenues in yuan. This would also lead to the erosion of corporate profits. In addition, exacerbated capital outflows based on market expectations of further depreciation could trigger declines in asset prices, such as real estate, which would not only weaken the balance sheets of financial institutions but also heighten default risks for investors with significant leverage.

Figure B3.3: Foreign-Currency–Denominated Bonds Outstanding in the People's Republic of China



USD = United States dollar.
Source: *AsianBondsOnline*.

Despite the potential risks mentioned above, several factors are likely to mitigate the negative effects of a weaker yuan on Asia. First, the dominant driver of global currency markets at present is the prospect of a strong US dollar. The likely policy mix of the new US administration—fiscal stimulus and trade policy combined with monetary tightening—suggests that a strong US dollar will persist for some time. Given the dominance of the dollar in exchange rate movements, other Asian currencies are also likely to remain weak and the scope for their depreciation vis-à-vis the yuan will be limited.

Second, there are indications that PRC authorities view the yuan's rapid fall negatively given the risk it poses to financial stability. Throughout 2016, the People's Bank of China intervened in foreign exchange markets to prevent the rapid depreciation of the yuan by utilizing its foreign exchange reserves **(Figure B3.4)**. Authorities may undertake an array of measures to arrest the yuan's slide, including tightening restrictions on capital outflows. While the yuan cannot be

[a] This figure was generated using data from Haver Analytics on 11 Asian economies: the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.

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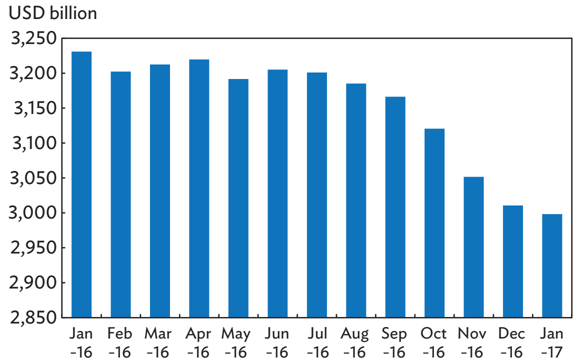
Box 3: The Impact of the Chinese Yuan's Depreciation *continued*

Figure B3.4: Foreign Currency Reserves of the People's Republic of China



USD = United States dollar.
Source: Haver Analytics.

exchanged freely, every citizen of the PRC has an annual currency conversion quota of up to USD50,000. In practice, authorities may conduct tighter scrutiny of this conversion allowance by more closely examining the purpose of currency exchanges. Greater inspection of capital account trades, such as international foreign exchange transfers, could also be used to manage the pace of capital outflows. These potential measures imply that the central bank could put a hard floor on the yuan's decline.