

# Introduction: Global and Regional Market Developments

The global outlook facing emerging East Asia has deteriorated significantly in recent months with weaker growth now expected in Europe and an uncertain pace of recovery in the United States (US).<sup>2</sup> This slowdown—exacerbated by ongoing sovereign debt issues in the eurozone—is heightening risk aversion and generating volatility in financial markets (**Table A**).

The real sector in Asia will be impacted through both trade and financial channels, with growth in the region expected to moderate as demand slackens in the developed economies (**Figure A**). Increased volatility in capital flows and exchange

rates, largely driven by the deepening sovereign debt crisis in Europe, could further aggravate the situation (**Figure B**).

The recent bouts of financial market volatility are a timely reminder of the region's continued vulnerability to external shocks. Emerging markets have not been spared as the uncertain economic outlook intensifies volatility and dampens market sentiment in the developed economies (**Figure C**). The end of the third quarter witnessed substantial portfolio outflows from the region as heightened risk aversion spread throughout financial markets. Some economies have already witnessed capital

**Table A: Changes in Global Financial Conditions, July–October 2011**

	2-Year Government Bond (bps)	10-Year Government Bond (bps)	5-Year CDS (bps)	Equity Index (%)	FX Rate (%)
<b>Major Advanced Economies</b>					
United States	(23.37)	(106.90)	–	(6.45)	–
United Kingdom	(34.50)	(103.20)	21.19	(7.44)	0.08
Japan	(1.30)	(9.30)	2.82	(10.64)	(3.29)
Germany	(107.21)	(98.62)	43.39	(17.23)	(4.60)
<b>ASEAN+3</b>					
China, People's Rep. of	22.00	(13.00)	(34.00)	(10.55)	(1.70)
Hong Kong, China	(5.00)	(75.10)	(21.00)	(11.31)	(0.17)
Indonesia	(86.50)	(118.70)	(61.00)	(3.47)	3.58
Korea, Rep. of	(19.00)	(46.00)	(50.00)	(10.19)	0.30
Malaysia	(20.10)	(18.80)	(34.50)	(5.75)	1.88
Philippines	(129.23)	(64.47)	(46.50)	(0.41)	(1.20)
Singapore	(17.00)	(59.00)	3.00	(9.02)	2.27
Thailand	(50.90)	(49.30)	(49.50)	(6.41)	(0.03)
Viet Nam	2.50	2.30	–	(1.05)	2.06
<b>Select European Markets</b>					
Greece	4,428.10	1,220.09	1,864.08	(19.95)	(4.60)
Ireland	(504.77)	(365.47)	(39.35)	(21.93)	(4.60)
Italy	214.84	132.92	264.06	(9.00)	(4.60)
Portugal	604.49	50.37	278.91	(38.20)	(4.60)
Spain	54.19	20.07	78.63	(14.65)	(4.60)

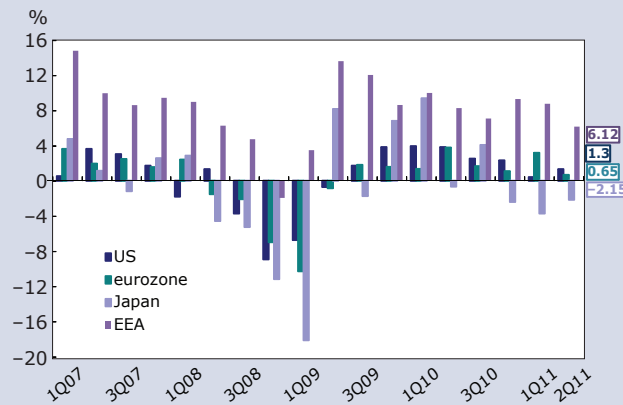
– = not available, ASEAN = Association of Southeast Asian Nations, bps = basis points, CDS = credit default swap, FX = foreign exchange.

Note: Changes from 01 July 2011 to 31 October 2011.

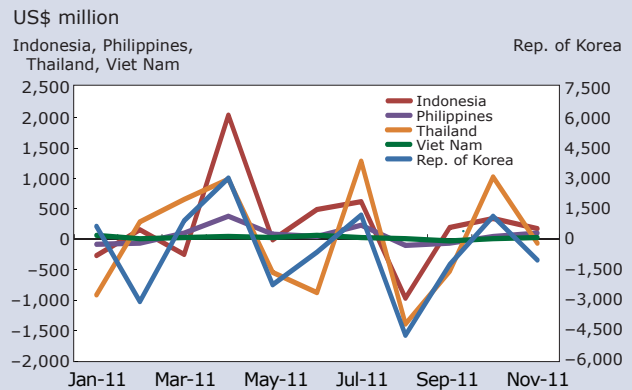
Source: Bloomberg LP, CEIC, and Institute of International Finance (IIF).

<sup>2</sup> 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.

**Figure A: GDP Growth Rates** (seasonally adjusted, annualized, q-o-q, % change)

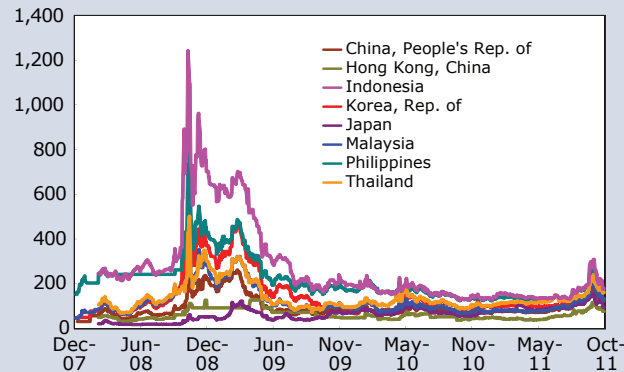


**Figure D: Net Foreign Portfolio Investments in Equities<sup>b</sup>**

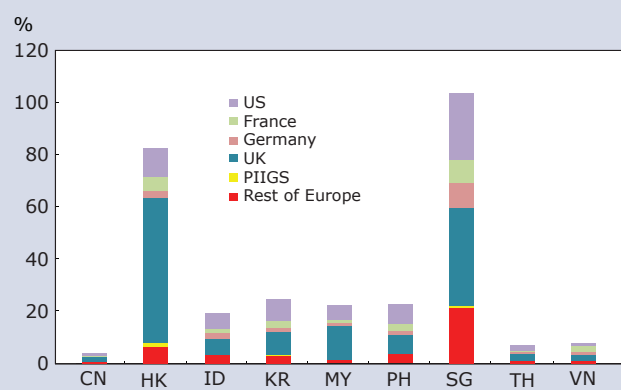


**Figure B: Credit Default Swap Spreads<sup>a</sup>** (senior 5-year)

mid-spread in basis points

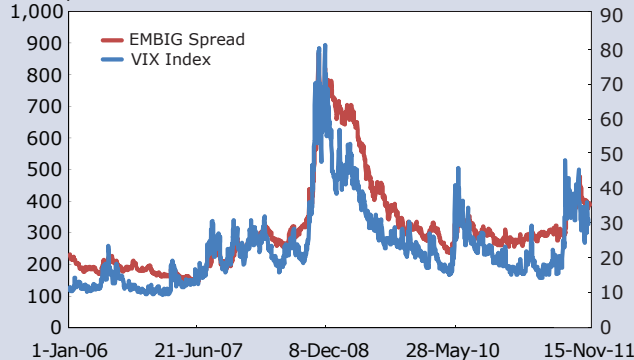


**Figure E: Exposure to US and European Banks** (% of domestic credit as of June 2011)<sup>c</sup>



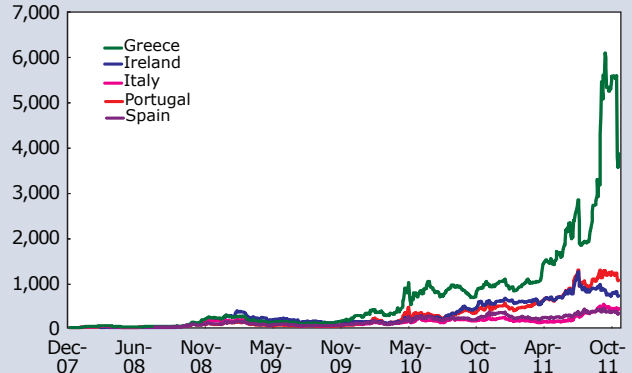
**Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads**

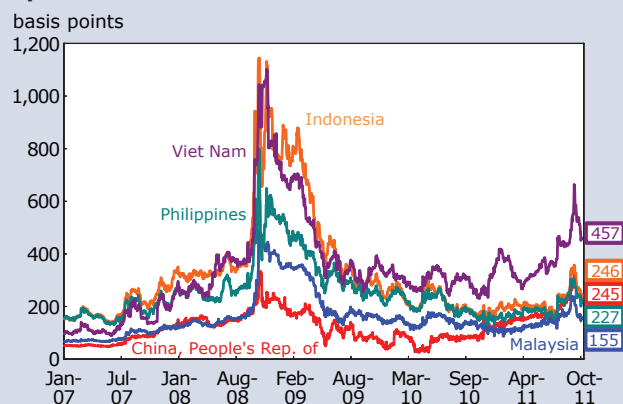
basis points



**Figure F: Credit Default Swap Spreads for Select European Markets<sup>a</sup>** (senior 5-year)

mid-spread in basis points



**Figure G: JPMorgan EMBI Sovereign Stripped Spreads**

CN = People's Republic of China; EMBI = Emerging Market Bond Index; EMBIG = Emerging Markets Bond Index Global; HK = Hong Kong, China; ID = Indonesia; KR = Republic of Korea; MY = Malaysia; PH = Philippines; PIIGS = Portugal, Italy, Ireland, Greece, Spain; SG = Singapore; TH = Thailand; UK = United Kingdom; US = United States; VIX = Chicago Board Options Exchange Volatility Index; VN = Viet Nam.

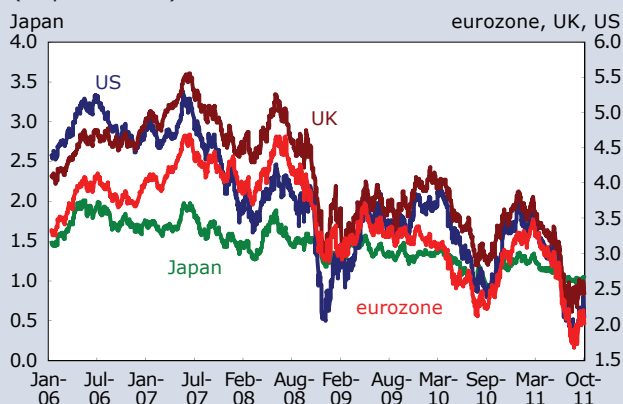
## Notes:

a. US\$ spread based on sovereign bonds.

b. Data as of 15 November 2011.

c. Domestic credit as of March 2011 used for the Philippines and Viet Nam.

Source: Thomson Reuters and Bloomberg LP.

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

outflows as leveraged investors and European banks pull back funds from emerging markets, including Asia, to shore up liquidity in domestic markets. However, this trend has reversed itself somewhat in recent weeks and the region's bond markets are again attracting capital inflows (**Figure D**).

Markets remain focused on the possible outcomes of the European debt crisis and the potential impact on global financial conditions and slowing economic growth. While Asian economies are not home to significant holdings of European sovereign debt, a squeeze in global liquidity and tightening external credit conditions could impact the region, particularly economies and firms that are dependent on external borrowing (**Figures E and F**).

The re-pricing of liquidity in global markets is raising the cost of credit for Asian companies (**Figure G**). Market uncertainty and lingering concerns over the health of the banking sector and tighter regulatory capital provisions are squeezing liquidity in credit markets. These developments are making foreign borrowing more expensive, even for the region's higher-rated companies.

Some economies in the region are still dependent on loans from abroad and therefore have significant exposure to the spillover effects of the European sovereign debt crisis. If the crisis worsens affected foreign banks might sell off assets, refuse to roll over maturing loans, or cut credit lines to Asia, especially if they face large losses at home. On the other hand, Asian banks remain well capitalized and can provide ample credit to domestic borrowers if global liquidity dries up. Furthermore, central bank reserves should alleviate any short-term foreign liquidity constraints.

A slowdown in growth and an easing of inflationary pressure in 3Q11 have moved the policy focus in emerging East Asia toward supporting growth. Authorities in the region had begun tightening liquidity in their respective financial systems in late 2010, but in most cases they have since suspended these efforts and are now leaving policy rates unchanged. The policy rate in Indonesia was even reduced recently. Meanwhile, growth prospects for emerging East Asian economies remain relatively robust despite increasing downside risks.

The eurozone debt crisis and volatility in equity markets in recent weeks have increased demand

for US treasuries as a safe-haven bid (**Figure H**). While the US' 3Q11 growth data surprised markets on the upside, there are widespread expectations that the US Federal Reserve will keep rates low to support growth as Europe struggles to contain the debt crisis that is threatening to drag down the global economy.

Total bonds outstanding in emerging East Asia's LCY market expanded 5.5% year-on-year (y-o-y) in 3Q11 to reach US\$5.5 trillion, driven by strong growth in the region's corporate bond market. Growth in the region's government bond market slowed to 1.3% y-o-y after posting 2.7% growth in the previous quarter.

Corporate bond market growth remained robust in 3Q11 with 15.4% y-o-y growth, although this was down from 19.7% in 2Q11. On a quarter-on-

quarter basis (q-o-q), the region's LCY corporate bond market growth in 3Q11 was 2.0%, led by the Republic of Korea and Malaysia.

At end-March emerging East Asia's share of the global bond market stood at 8.0%, compared with only 2.1% before the onset of the 1997/98 Asian financial crisis (**Table B**). The two largest markets in the region at the end of 1Q11 were the PRC (4.6% of the global bond market) and the Republic of Korea (1.8%).

The risks to the region's outlook are significantly tilted to the downside. These risks include (i) potential spillover from Europe that impairs demand and investment, (ii) growing volatility in global markets and a flight to low-risk investments, (iii) a reduced growth outlook for Asia in 2012, and (iv) moderately high inflation in some markets.

**Table B: Bonds Outstanding in Major Markets** (US\$ billion)

Economy	March 2011		1996	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	25,475	38.1	10,926	42.9
Japan	11,504	17.2	4,456	17.5
France	3,421	5.1	1,261	4.9
Germany	2,815	4.2	1,888	7.4
United Kingdom	1,727	2.6	678	2.7
Emerging East Asia	5,321	8.0	531	2.1
of which: PRC	3,066	4.6	62	0.2
Emerging East Asia excl. PRC	2,255	3.4	469	1.8
of which: Korea, Rep. of	1,211	1.8	283	1.1
of which: ASEAN-6	878	1.3	149	0.6
Indonesia	118	0.2	7	0.0
Malaysia	259	0.4	71	0.3
Philippines	73	0.1	28	0.1
Singapore	187	0.3	25	0.1
Thailand	225	0.3	19	0.1
Viet Nam	16	0.0	–	–
Memo Items:				
Brazil	1,528	2.3	299	1.2
PRC (excl. policy bank bonds)	2,200	3.3	–	–
India	711	1.1	81	0.3
Russian Federation	81	0.1	43	0.2

– = not available, ASEAN = Association of Southeast Asian Nations, LCY = local currency, PRC = People's Republic of China.

Source: Bank for International Settlements and *AsianBondsOnline*.