Introduction: **Global and Regional Market Developments**

The global economy that emerging East Asia faces remains weak, with growth in the United States (US) struggling to gain momentum and the eurozone economies slipping back into recession.[2] At the same time, the outlook for the region's economies has also worsened as growth in the People's Republic of China's (PRC) is expected to fall to its slowest since the 2008/09 global financial crisis. The looming fiscal cliff in the US and the unresolved debt crisis in Europe are the key risks facing investors.

The eurozone debt crisis remains unresolved. The European Central Bank's (ECB) commitment to do what is needed to preserve the euro has boosted investor confidence in the currency. While the threat of a eurozone breakup has receded, Europe is still struggling with dismal economic conditions. There is growing discontent over the hardship brought about by austerity measures. Greece is struggling to make its debt payments even after restructuring; Spain is likely to seek further assistance as it finds it difficult to reduce its fiscal deficit. Any worsening of the eurozone debt crisis will likely cause an increase in investors' risk perception and prompt an outflow from the region's bond markets.

Export growth across the region was down sharply in most of 3Q12 due to weaker external demand. Slower growth in the PRC has also been a factor. The newly industrialized economies with close trading and financial ties with the PRC—such as Singapore; the Republic of Korea; and Hong Kong, China—have seen their growth moderate significantly as well. To address the slowdown, the PRC has rolled out new stimulus measures and eased its monetary policies. Several other economies have also cut their policy rates to boost spending.

Even with the uncertain economic outlook and signs of slower regional growth, investor perceptions of risk in the region's capital markets remain favorable, with bond yields falling, stock markets rising, and currencies appreciating **(Table A)**. Markets for credit default swap (CDS) spreads remain calm **(Figures A and B)**, and emerging bond market spreads have been narrowing, reflecting investor confidence **(Figure C)**. The announcement that the ECB is committed to preserving the euro has helped allay some fears of a eurozone break-up for the time being. This has resulted in sharply lower CDS spreads for select European bonds.

Yields on government bonds in mature markets remained broadly stable in 3Q12, with a slight downward bias **(Figure D)**. This reflected continued market demand for safe assets and a supply that is dwindling. Low inflation expectations have also contributed to lower yields. The commitment by the ECB to buy unlimited amounts of government bonds has helped drive down bond yields in Europe, particularly in Ireland and Portugal. The threat of a breakup in the eurozone has faded and market confidence in the euro has distinctly improved, as reflected by the strengthening of the euro.

Most emerging East Asian LCY bond yields have been declining since end-July. Concerns over weak growth in the first half of the year and continued low inflation have prompted the Republic of Korea, the Philippines, and Thailand to cut their policy rates. In addition, low interest rates in advanced economies and a new round of quantitative easing by the US Federal Reserve will help push more funds into the region in search of higher yields. Both Korean and Philippine sovereign bond ratings have recently been upgraded one notch. (Meanwhile, Viet Nam was recently downgraded over concerns about the health of its banking sector.) As a result, the spreads for emerging market bonds have tightened **(Figure E)**.

Foreign holdings in the region's LCY government bond markets have mostly risen **(Figure F)**. At end-September, foreign investors held nearly

[2] 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 A: Changes in Global Financial Conditions, 31 July–31 October 2012

	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	(2)	5	0	3.7	–
United Kingdom	(2)	(2)	(40)	3.8	2.7
Japan	(1)	(1)	(19)	(3.5)	(0.03)
Germany	(9)	(9)	(73)	13.2	2.3
Emerging East Asia					
China, People's Rep. of	63	24	(52)	(7.0)	(1.8)
Hong Kong, China	1	(29)	(28)	11.3	(0.1)
Indonesia	6	(44)	(63)	10.0	2.0
Korea, Rep. of	(52)	(66)	(55)	3.1	(4.8)
Malaysia	2	(5)	(50)	4.6	(4.1)
Philippines	(31)	(58)	(55)	3.4	(2.3)
Singapore	9	(27)	0	5.6	(3.6)
Thailand	(36)	(18)	(57)	10.8	(2.7)
Viet Nam	15	40	–	(8.0)	(0.3)
Select European Markets					
Greece	(109)	(635)	0	31.1	2.3
Ireland	(220)	(134)	(382)	3.2	2.3
Italy	(121)	(83)	(215)	8.9	2.3
Portugal	(392)	(264)	(356)	14.0	2.3
Spain	(122)	(67)	(231)	10.4	2.3

– = not available, ( ) = negative, bps = basis points, FX = foreign exchange.
Notes:
1. For emerging East Asia, positive value for FX rate means depreciation of local currency against US dollar.
2. For European markets, positive value for FX rate means appreciation of local currency against US dollar.
Source: Bloomberg LP, Institute of International Finance (IIF), and Thomson Reuters.

30% of Indonesian and Malaysian government bonds, and about 15% of Thai government bonds. Only the Republic of Korea experienced declining foreign participation, resulting in a drop of the share of foreign holdings to 10.0% at end-June from 11.1% at end-December 2011.

Total bonds outstanding in emerging East Asia's LCY bond market rose 3.5% quarter-on-quarter (q-o-q) and 11.0% year-on-year (y-o-y) to reach US$6.2 trillion at end-September. Corporate bonds outstanding grew 4.2% q-o-q in 3Q12, compared with a lower growth rate of 3.1% for government bonds. Given rapid corporate bond market growth over the last several years, the size of the region's corporate bond market reached US$2.2 trillion at the end of 3Q12, or slightly more than half of the government bond market's size of US$4.1 trillion.

At end-March, emerging East Asia's share of the global bond market had grown to 8.6% from 8.4% at end-December 2011 **(Table B)**. The PRC and the Republic of Korea continued to be the largest bond markets in the region apart from Japan, accounting for 5.1% and 1.9%, respectively, of the global total.

Risks to the region's LCY bond markets have tilted to the downside:

(i) **Fiscal cliff threatens US recovery.** The looming fiscal cliff threatens to considerably tighten the fiscal stance in the US at a time when the recovery is still fragile. A divided US Congress will have to find a way to craft a consensus to avert the forthcoming expiration of tax cuts and reductions in government spending. Without an agreement, the fiscal cliff scenario has the potential to push the US economy into a recession in 1Q13. The likely impact on bond yields is uncertain and depends on the outcome of the budget negotiations. An agreement that averts the

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

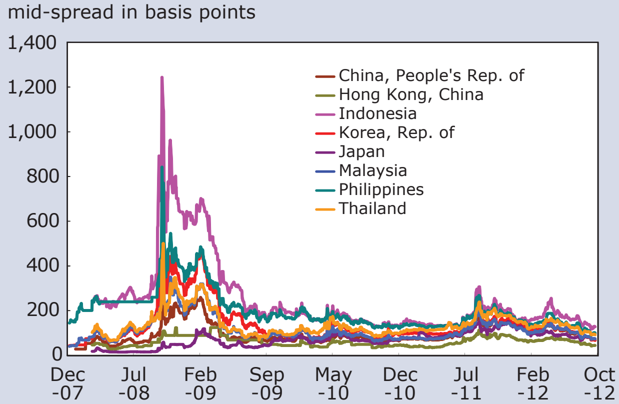


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

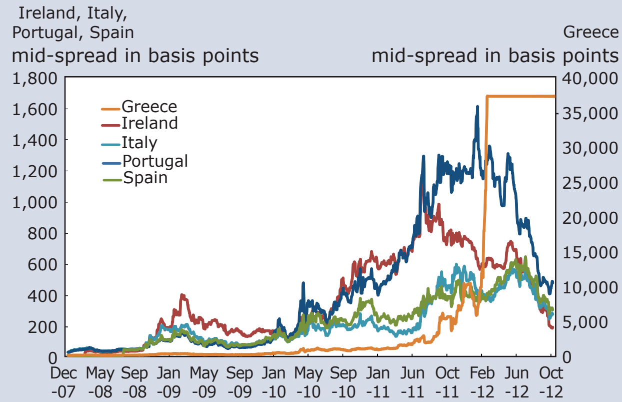


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b]

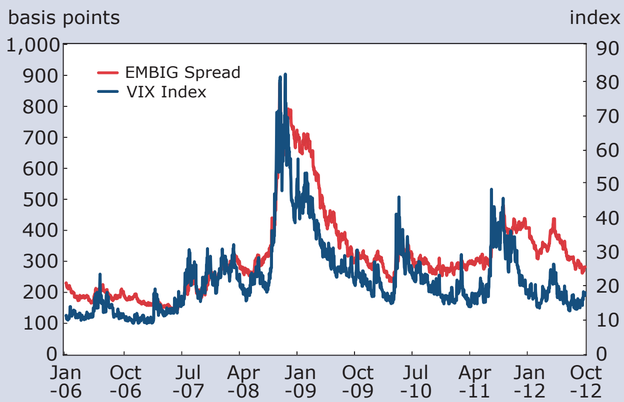


Figure D: 10-Year Government Bond Yields
(% per annum)

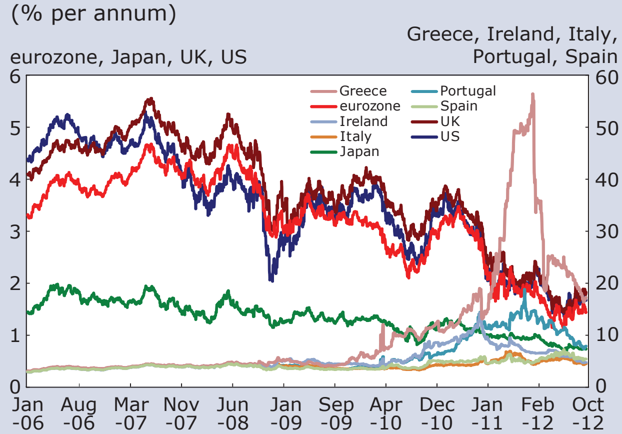


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a,b]

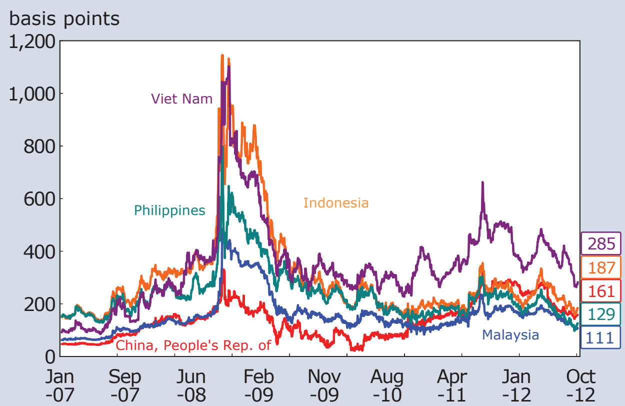
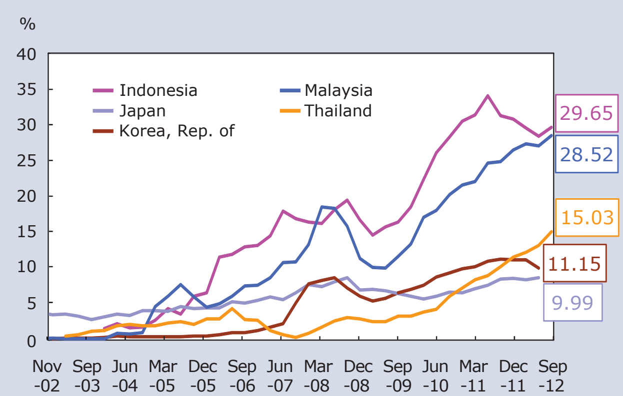


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



EMBI = Emerging Markets Bond Index, EMBIG = Emerging Markets Bond Index Global, 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 October 2012.

[c] Data as of end-September 2012 except for the Republic of Korea and Japan as of end-June 2012.

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

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

Economy	March 2012		1996	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	26,391	38.7	10,926	42.9
Japan	11,897	17.4	4,456	17.5
France	3,574	5.2	1,261	4.9
Germany	2,621	3.8	1,888	7.4
United Kingdom	1,823	2.7	678	2.7
Emerging East Asia	5,886	8.6	528	2.1
of which: PRC	3,448	5.1	62	0.2
Emerging East Asia excl. PRC	2,438	3.6	466	1.8
of which: Korea, Rep. of	1,290	1.9	283	1.1
of which: ASEAN-6	977	1.4	149	0.6
Indonesia	111	0.2	7	0.0
Malaysia	298	0.4	71	0.3
Philippines	87	0.1	28	0.1
Singapore	211	0.3	25	0.1
Thailand	250	0.4	18	0.1
Viet Nam	20	0.03	–	–
Memo Items:				
Australia	1,135	1.7	248	1.0
Brazil	1,568	2.3	299	1.2
PRC (excl. policy bank bonds)	2,359	3.5	–	–
India	621	0.9	81	0.3
Russian Federation	99	0.1	43	0.2
South Africa	218	0.3	82	0.3

– = not available, ASEAN = Association of Southeast Asian Nations, LCY = local currency, PRC = People's Republic of China.
Source: *AsianBondsOnline* and Bank for International Settlements.

fiscal cliff scenario without addressing the long-run sustainability of US deficits may not be welcomed by the market.

(ii) **Surge of capital inflows into the region.** The latest round of quantitative easing by the US Federal Reserve and the expansion of the asset purchase program by the Bank of Japan will lead to continued low interest rates in advanced economies. This has raised concerns that emerging East Asia could be subject to a surge in capital inflows, potentially causing exchange rates to rise and making exports less competitive. The excess global liquidity could also lead to higher credit growth that fuels asset price bubbles in the region.

(iii) **Higher inflation on supply-side shocks.** Inflationary conditions have been benign in the region, which has helped to underpin the decline in yields. However, the region faces the potential of upward inflationary pressures from high food prices as the summer drought in the US reduced its harvest of corn and soybeans. With food accounting for a relatively large share of the region's consumption basket, any spike in food prices could result in higher inflation.