Global and Regional Market Developments

Bond markets in emerging East Asia have regained some of their recent losses as global financial markets have stabilized.[4] The United States (US) Federal Reserve's announcement on 18 September that economic conditions did not yet warrant the start of tapering buoyed financial markets and helped drive down bond yields in the US. The region's bond yields also similarly fell in response to the news.

The uncertainties surrounding the raising of the US federal government's debt ceiling shifted focus away from emerging East Asia's economies. While the US Congress passed a last minute budget deal averting the threat of a looming debt default by the federal government, the debt impasse in the US remains unresolved and has merely been postponed until February. Unless a compromise deal is reached before then, which is unlikely given the deep divide between the Democratic and Republican parties, there is likely to be further policy uncertainty in 2014.

The timing of the Federal Reserve's move to taper its quantitative easing program will depend on how much the recent shutdown of the federal government and the threat of a default has hurt the US economy. The direct effect of the shutdown on the US economy is expected to be relatively small as it lasted a short time. Much more difficult to quantify has been the impact on consumer and business confidence. The budget deal that was passed is only temporary and the threat of further brinkmanship over the budget has not been completely lifted, only postponed until January. Given the continued uncertainty, consumers might opt to cut back on their spending and businesses refrain from investment and hiring.

These developments—specifically, their impact on consumer confidence and the delay in the government's publishing of economic data—may contribute to the Federal Reserve pushing plans to taper its quantitative easing operations further into the future. It might opt for caution and postpone any action until 2014. That said, there are also risks from prolonging quantitative easing longer than necessary as these operations may have reached the limits of their benefits to the economy. Additional bond purchases are likely to contribute to risks to the economy while producing smaller corresponding benefits.

All of this has implications for emerging East Asia's economies. The delay in tapering can help ensure that the US economy is on a stronger footing before interest rates rise further. With economic performance weakening in the region, an improving US economy can provide a helpful boost to the region's growth prospects. The delay in tapering also offers more time for the region to prepare for the eventual normalization of US monetary policy. Governments in emerging East Asia should use this window of opportunity to strengthen their economies and focus on further structural reforms. The resilience of the region's financial systems also needs to be improved to better handle the possible turmoil ahead.

Lower bond yields in the US due to the expected delay in tapering have boosted bond markets in emerging East Asia. This is reflected by lower bond yields and appreciating currencies in most of the region's economies in the period between 1 July 2013 and 18 October 2013 **(Table A)**. While government bond yields declined in most economies, the yield on the 10-year bond in the People's Republic of China's (PRC) rose 50 basis points (bps). This was due to moves by the People's Bank of China to tighten liquidity to slow credit growth in the economy. The yield on Indonesia's 10-year bond rose 30 bps, partly reflecting Bank Indonesia's decision to raise its policy rate twice by a total of 75 bps in August and September, following two previous rate increases totaling

[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.

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	(4)	10	–	8.0	–
United Kingdom	9	30	(21)	5.0	(6.2)
Japan	(4)	(27)	(19)	4.6	1.9
Germany	(2)	11	(11)	11.0	(4.8)
Emerging East Asia					
China, People's Rep. of	78	50	(39)	10.0	0.6
Hong Kong, China	(6)	(1)	(8)	12.2	0.03
Indonesia	10	30	(2)	(4.8)	(9.8)
Korea, Rep. of	(17)	(7)	(25)	10.6	6.3
Malaysia	(21)	8	(6)	1.4	0.3
Philippines	(10)	(21)	(25)	1.2	0.1
Singapore	14	(35)	–	1.7	2.0
Thailand	(10)	5	(4)	2.3	(0.4)
Viet Nam	36	(7)	–	4.3	0.3
Select European Markets					
Greece	(87)	(163)	–	36.9	(4.8)
Ireland	(41)	(22)	(42)	9.2	(4.8)
Italy	(53)	(29)	(32)	24.7	(4.8)
Portugal	38	(10)	(6)	13.0	(4.8)
Spain	(69)	(37)	(53)	26.5	(4.8)

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 July 2013 and 18 October 2013.
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.
Source: Bloomberg LP, Institute of International Finance (IIF), and Thomson Reuters.

75 bps in June and July. Meanwhile, both Malaysia and Thailand saw yields on their 10-year bonds increase only marginally.

Most of the region's currencies remained relatively stable against the US dollar in 3Q13. The exceptions were the Korean won, which posted a strong gain of 6.3% against the US dollar, and the Indonesian rupiah, which depreciated 9.8% against the US dollar.

As financial market conditions stabilize and investor confidence returns to the region, credit default swap (CDS) spreads on government bonds have been falling, particularly in Indonesia, where the CDS spread declined almost 100 bps from its peak in September **(Figure A)**. CDS spreads for most European economies have also moved downward in line with calmer financial conditions **(Figure B)**. Emerging market spreads have narrowed somewhat in recent months as investors regained their interest in emerging markets bonds **(Figure C)**.

Bond yields in the advanced economies have eased a little as it is becoming clear that the Federal Reserve is likely to delay its move to tighten monetary policy **(Figure D)**. Further, the debt ceiling standoff and partial government shutdown are likely to have weakened the US economy and will contribute to the postponement of tapering. Interest rates have eased across emerging East Asia in line with the pullback of global interest rates. In addition, Indonesia and Viet Nam saw large declines in their government bond yields, reflecting reduced risk perceptions in both economies **(Figure E)**.

The share of foreign holdings in the region's local currency (LCY) government bond markets has generally slipped since the beginning of this year. However, this mainly reflects a sharp increase

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

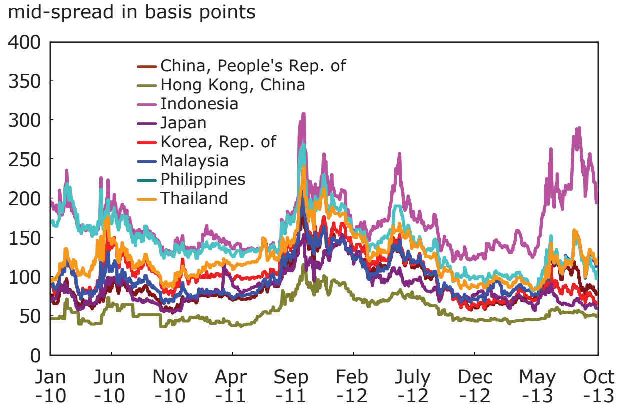


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

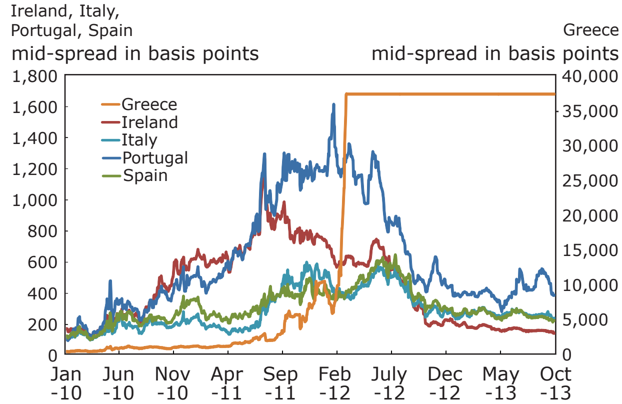


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

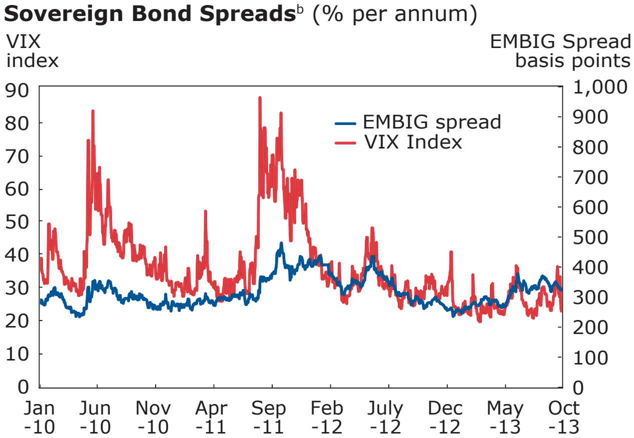


Figure D: 10-Year Government Bond Yields[b] (% per annum)

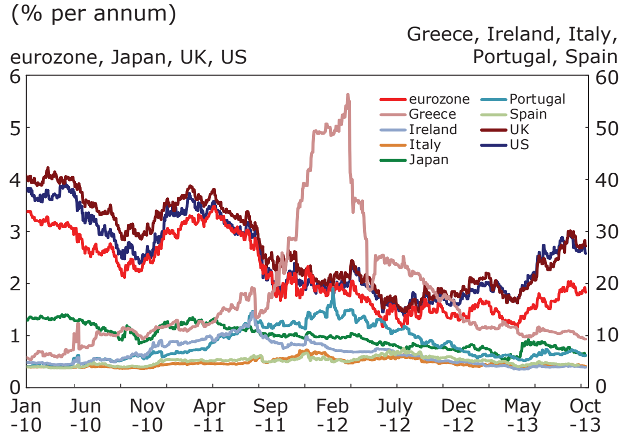


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]

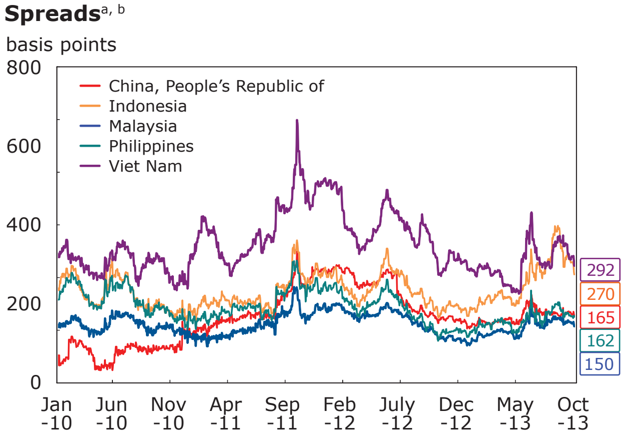
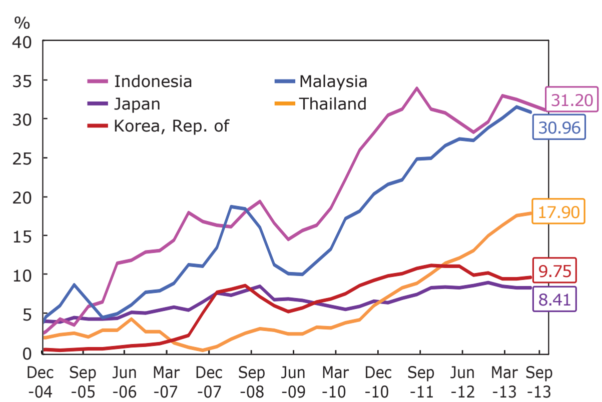


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 18 October 2013.

[c] Data as of end-June 2013 except for Indonesia as of end-September 2013.

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

in LCY government bond holdings by domestic investors that have outstripped purchases by foreigners. Foreign holdings of LCY government bonds have continued to rise in nominal terms this year in most markets. (However, foreign holdings of Korean government bonds at end-June were just slightly below levels at end-March 2012.) The nominal value of foreign holdings of Malaysian and Thai bonds continued to rise through end-June and, in the case of Indonesia, through end-September. Indonesia continues to have the largest proportion of its government bonds held by foreigners at 31.2% **(Figure F)**.

The risks to the region's LCY bond markets have receded slightly as the prospect of the Federal Reserve tapering its quantitative easing operations this year becomes increasingly unlikely. Specifically, risks include the following:

The region's bond markets remain susceptible to sudden shifts in global investor sentiment. While global financial conditions have stabilized in recent months, they remain somewhat volatile and susceptible to sudden shifts in investors' risk perceptions toward the region. While US interest rates have been moving down recently, they could suddenly rise again if the Federal Reserve decided to change tack and tighten ahead of market expectations. The funds that have recently flowed back into emerging East Asia could reverse direction, driving up bond yields in the region.

Tighter liquidity conditions could impact financial stability in the region's economies. The region's economies face the prospect of tighter liquidity conditions as the global financial situation remains uncertain. Capital inflows are likely to be lower in the future, suggesting that the liquidity situation may tighten in the region. During the period of easy liquidity following the global financial crisis, asset prices in the region increased, especially in the property sector. Tighter liquidity conditions could result in a correction in asset prices that could affect the health of financial institutions with large exposures.

Volatile capital flows makes policymaker efforts to stabilize the economy more difficult. Most Asian markets have been affected by the recent outflow of funds. The sudden outflows have complicated authorities' efforts to manage their respective economies. They face the difficult choice of either allowing their currencies to sharply depreciate or intervening to smooth out the fluctuations. In many economies in the region, policymakers have allowed their currencies to find a new equilibrium without much intervention. The benefit of this approach is that it has allowed authorities to preserve their foreign exchange reserves. Some countries have raised their policy rates to try to stave off further capital outflows. While higher interest rates may help increase returns to investors and encourage inflows, they are likely to worsen growth prospects, which could hurt investor confidence.