

Global and Regional Market Developments

Yields for 2-year local currency (LCY) government bonds declined in most emerging East Asian economies between 31 August and 6 November, while 10-year bond yield movements were mixed due to individual market differences.¹ Global financial conditions improved during the review period as investment sentiment was boosted by the enhanced performance of key advanced economies in the third quarter (Q3) of 2020. However, some caution remained as confirmed coronavirus disease (COVID-19) cases rose in many advanced economies and uncertainty about the global economic recovery lingered.

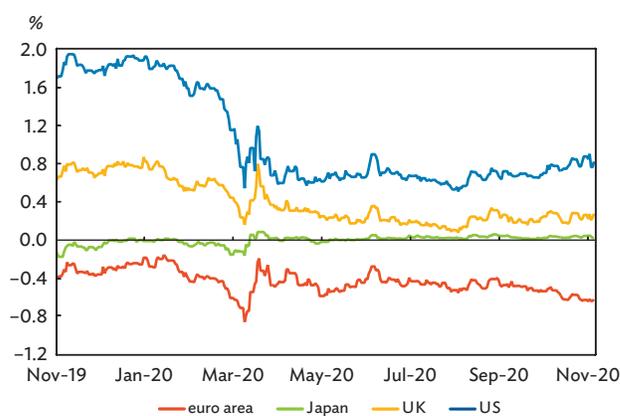
Between 31 August and 6 November, 2-year and 10-year bond yields rose in the United States (US) and declined in other developed economies (**Figure A**). In the US, 2-year and 10-year government bond yields rose by 2 basis points (bps) and 11 bps, respectively. The uptick in yields was largely due to expectations of a new phase of spending on pandemic relief despite uncertainty regarding the timing and size of the stimulus package following the US election.

While the Federal Reserve noted that the US economy showed signs of recovery during Q3 2020 and left monetary policy unchanged at its September meeting, it also acknowledged uncertainty regarding the impact of COVID-19. US economic data have been mixed. Retail sales growth contracted to 0.6% month-on-month in October from 1.6% month-on-month in September, and the unemployment rate fell to 6.9% in October from 7.9% in September. Gains in nonfarm payrolls, however, declined to 672,000 in September and 638,000 in October from 1.5 million in August.

The Federal Reserve also upgraded its 2020 gross domestic product (GDP) growth forecast to -3.7% in September from -6.5% in June, and it revised downward the GDP growth forecasts for 2021 and 2022 from 5.0% and 3.5%, respectively, to 4.0% and 3.0%.

At the press conference following the Federal Reserve meeting, Chairman Jerome Powell indicated that it

Figure A: 10-Year Government Bond Yields in Major Advanced Economies (% per annum)



UK = United Kingdom, US = United States.
Note: Data as of 6 November 2020.
Source: Bloomberg LP.

would take time for the US economy to return to its pre-COVID-19 output level and that additional fiscal support would be required. The Federal Reserve subsequently also left its monetary policy stance unchanged during its 4-5 November meeting.

In line with the Federal Reserve, the European Central Bank (ECB) left its monetary policy unchanged at its monetary policy meeting on 10 September. The ECB also noted some improvement in economic performance in the euro area, but remained cautious over uncertainty associated with COVID-19. The ECB's forecast for 2020 GDP growth was revised upward to -8.0% in September from -8.7% in June, while the 2021 and 2022 GDP forecasts were lowered slightly to 5.0% and 3.2%, respectively, from 5.2% and 3.3%. The euro area's economic recovery remained weak, as industrial production declined 6.8% year-on-year (y-o-y) in September and fell 6.7% y-o-y in August. The recent rise in COVID-19 cases in the euro area also heightened uncertainty over the economic recovery, while expectations of further monetary easing pulled bond yields down in the euro area.

¹ 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.

In line with the ECB's forecasts, the euro area's GDP growth improved in Q3 2020, with GDP expanding 12.6% quarter-on-quarter (q-o-q) in Q3 2020 after declining 11.8% q-o-q in the prior quarter. However, on a y-o-y basis, GDP growth was negative at -4.4% in Q3 2020, which was still an improvement from a decline of -14.8% posted in the second quarter (Q2) of 2020.

During its 29 October monetary policy meeting, the ECB again left its monetary policy unchanged. However, the ECB noted that rising COVID-19 cases were dampening growth and initial data suggested that fourth quarter growth would be weaker. The ECB also hinted that it might ease monetary policy in December when its economic forecasts are updated.

The Bank of Japan (BOJ) also left its monetary policy unchanged at its monetary policy meeting on 17 September. While the BOJ noted some gains in the domestic economy's performance, the recovery is considered to be delicate. Japan's 2-year and 10-year yields marginally fell 1 bp each, despite expectations of expanded stimulus that could increase the debt supply to fund spending. The BOJ again left its monetary policy unchanged on 29 October. Updated economic forecasts from the BOJ showed a downgrade in 2020 GDP growth to -5.8% from -4.7% in July. The GDP forecast for 2021 was adjusted upward to 3.6% from 3.3%. However, the

BOJ noted that the forecasts were highly uncertain given the impact of COVID-19. Japan posted an annualized quarterly GDP growth of 21.4% in Q3 2020 from -28.8% in Q2 2020. However, concerns that the gains may not be sustained led to Prime Minister Yoshihide Suga to call for a third extra budget.

Between 31 August and 6 November, yields on 2-year government bonds fell in most emerging East Asian markets, while 10-year bond yield movements were mixed (**Table A**). The declining short-term bond yields reflected the accommodative monetary policies of most central banks in the region.

All emerging East Asian markets except the People's Republic of China (PRC) and Viet Nam recorded contractions in Q3 2020 GDP. However, while all other emerging East Asian economies recorded GDP contractions in Q3 2020, the pace of decline moderated compared with Q2 2020. The most significant improvement was noted in Malaysia as GDP declined to -2.7% y-o-y in Q3 2020 from -17.1% y-o-y in Q2 2020 buoyed by the easing of quarantine restrictions. In Singapore, advance estimates showed that GDP contraction slowed to -7.0% y-o-y in Q3 2020 from -13.3% y-o-y in Q2 2020, fuelled by the recovery in the manufacturing sector. Other markets with y-o-y GDP contractions in Q3 2020 include Hong Kong, China

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	2	11	-	0.3	-
United Kingdom	2	(4)	(0.05)	(0.9)	(1.6)
Japan	(3)	(3)	(0.6)	2.6	2.5
Germany	(13)	(22)	0.1	(3.6)	(0.5)
Emerging East Asia					
China, People's Rep. of	38	18	(1)	(2.5)	3.6
Hong Kong, China	(13)	(4)	-	2.1	(0.04)
Indonesia	(20)	(57)	(10)	1.9	2.5
Korea, Rep. of	(2)	4	0.8	3.9	6.0
Malaysia	(0.7)	8	(6)	(0.4)	0.8
Philippines	(6)	19	(5)	13.6	0.3
Singapore	2	(23)	-	1.8	0.9
Thailand	3	(11)	5	(3.9)	1.5
Viet Nam	(9)	(32)	(14)	6.4	(0.004)

() = negative, - = not available, bps = basis points, FX = foreign exchange.

Notes:

1. Data reflect changes between 31 August and 6 November 2020.

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.

(-3.5% from -9.0% in Q2 2020), Indonesia (-3.5% from -5.3% in Q2 2020), the Republic of Korea (-1.3% from -2.7% in Q2 2020), the Philippines (-11.5% from -16.9% in Q2 2020), and Thailand (-6.4% from -12.1% in Q2 2020). In contrast, Viet Nam experienced an economic recovery in Q3 2020, with GDP growth rising to 2.6% y-o-y from 0.4% y-o-y in Q2 2020, buoyed by strong exports. The PRC's GDP expanded 3.2% y-o-y in Q2 2020, and accelerated to 4.9% y-o-y in Q3 2020, the fastest growth rate among all regional markets.

To support economic recovery, regional central banks are expected to maintain their accommodative monetary stances. During the review period, all regional central banks held their policy rates steady, while the State Bank of Vietnam (SBV) further reduced its refinancing rate by 50 bps to 4.00% on 1 October to support the economy. On 19 November, both Bangko Sentral ng Pilipinas and Bank Indonesia (BI) reduced their respective policy rates by 25 bps each. From January through 20 November, emerging East Asia's central banks lowered policy rates, with a few central banks cumulatively cutting policy rates by 100 bps or more, including Bangko Sentral ng Pilipinas (200 bps), SBV (200 bps), BI (125 bps), and Bank Negara Malaysia (125 bps) (Table B).

The movement of 10-year bond yields depended largely on market-specific factors as well as individual government responses to the COVID-19 pandemic. The weak economic outlook and subdued inflation were reflected in long-term bond yields across the region. In

Indonesia, 10-year government bond yields fell by 57 bps during the review period amid efforts by BI to boost liquidity through macroprudential measures that included lowering banks' reserve requirement ratios and increasing central bank bond purchases, among others. Foreign bond inflows in October also helped push down rates. Viet Nam posted a decline of 32 bps between 31 August and 6 November, as SBV reduced policy rates on 1 October to support the economy. In Singapore and Thailand, 10-year yields fell 23 bps and 11 bps, respectively.

The PRC's bond market continued to buck the regional trend on the back of the domestic economic recovery, with the 2-year government bond yield gaining 38 bps between 31 August and 6 November, and the 10-year yield rising 18 bps. In the Philippines, the 10-year yield rose 19 bps due to an expected higher budget deficit in 2021 as well as increased government borrowing. In Malaysia, the 10-year yield rose 8 bps. A few markets witnessed a marginal change in the 10-year government bond yield, including the Republic of Korea (4 bps) and Hong Kong, China (-4 bps).

Economic Outlook

COVID-19 continues to cast a dark cloud over global economic prospects. The growth of confirmed cases and deaths has been exponential, with the worldwide numbers of cases and deaths surpassing 40 million and 1 million, respectively, as of 20 October 2020. The global nature of the pandemic is evident in the dispersed

Table B: Policy Rate Changes

Economies	Policy Rate 31-Dec- 2019 (%)	Rate Changes (%)											Policy Rate 20-Nov- 2020 (%)	Year-to-Date Change in Policy Rates (basis points)
		Jan- 2020	Feb- 2020	Mar- 2020	Apr- 2020	May- 2020	Jun- 2020	Jul- 2020	Aug- 2020	Sep- 2020	Oct- 2020	Nov- 2020		
United States	1.75			↓ 1.50									0.25	↓ 150
Euro Area	(0.50)												(0.50)	
Japan	(0.10)												(0.10)	
China, People's Rep. of	3.25		↓ 0.10		↓ 0.20								2.95	↓ 30
Indonesia	5.00		↓ 0.25	↓ 0.25			↓ 0.25	↓ 0.25				↓ 0.25	3.75	↓ 125
Korea, Rep. of	1.25			↓ 0.50		↓ 0.25							0.50	↓ 75
Malaysia	3.00	↓ 0.25		↓ 0.25		↓ 0.50		↓ 0.25					1.75	↓ 125
Philippines	4.00		↓ 0.25	↓ 0.50	↓ 0.50		↓ 0.50					↓ 0.25	2.00	↓ 200
Thailand	1.25		↓ 0.25	↓ 0.25		↓ 0.25							0.50	↓ 75
Viet Nam	6.00			↓ 1.00		↓ 0.50						↓ 0.50	4.00	↓ 200

(-) = negative.

Notes:

1. Data as of 20 November 2020.

2. For the People's Republic of China, data used in the chart is the 1-year medium-term lending facility rate. While the 1-year benchmark lending rate is the official policy rate of the People's Bank of China, market players use the 1-year medium-term lending facility rate as a guide for the monetary policy direction of the People's Bank of China.

Sources: Various central bank websites.

locations of the top 10 countries in terms of numbers of infections—the US, India, Brazil, the Russian Federation, Spain, Argentina, Colombia, France, Peru, and Mexico. The US, which also leads the world in the number of deaths, accounts for around 20% of both confirmed cases and deaths despite having only 4% of the global population. While there has been some progress in the development of treatments and vaccines, there is still a lot of uncertainty about when safe and effective treatments, and especially vaccines, will become widely available.

The bottom line is that the world is not out of the woods on the health front, which largely explains why a full-fledged global recovery is nowhere in sight yet. The unprecedented restrictions on the movement of individuals due to lockdowns, community quarantines, stay-at-home orders, and travel bans is crimping economic activity. Even when authorities relax restrictions, plenty of anecdotal evidence—such as Google community mobile data—indicates that individuals are often reluctant to venture outside over concerns that they may become infected. Furthermore, authorities have sometimes been forced to reintroduce stringent restrictions in response to a second wave—that is, a large increase in confirmed cases after a period of stabilization and decline. While the reintroduction is necessary to safeguard public health, it inevitably has a negative impact on economic activity in the short term.

Both the US and Europe have recently begun to experience a second wave of COVID-19. Europe, in particular, is experiencing a spike in new infections despite having tackled the first wave much more effectively than the US. In response, the governments of many European countries, including big economies—such as Germany, France, the United Kingdom, Italy, and Spain—have reintroduced various restrictions. There are growing concerns that Europe may experience a double-dip recession as the restrictions will hinder mobility and economic activity, causing a second recession just when the region had been recovering from the prior one. Europe's economy may contract in the fourth quarter of 2020 instead of growing at a healthy pace, as was widely expected before the second wave. Until a safe and effective COVID-19 vaccine is developed and distributed widely, the viral cloud of fear and uncertainty will limit global mobility and growth.

Despite the gloomy and uncertain economic outlook, the International Monetary Fund (IMF) has slightly

upgraded its short-term global growth forecast. In its *World Economic Outlook*, released in October 2020, the IMF forecast that the world economy would contract by 4.4% in 2020, whereas in June it had forecast a larger contraction of 5.2%. According to projections, the world economy will grow by 5.2% in 2021, slightly down from its June forecast of 5.4%. The improvement in the forecast for the global economy's contraction in 2020 was driven by substantially upgraded growth projections for advanced economies. The IMF is now forecasting a contraction of 5.8% for this group of countries in 2020, compared to a significantly bigger contraction of 8.1% in its June forecast. On the other hand, for emerging markets and developing economies, the IMF's 2020 growth forecast was -3.3% in October versus -3.1% in June. For 2021, the IMF's October growth forecast for advanced economies was 3.9%, down from its 4.8% forecast in June. Its October forecast for growth of 6.0% in 2021 for emerging markets and developing economies was slightly up from the 5.8% forecast in June. It remains to be seen whether the second wave of COVID-19 and the reintroduction of restrictions in advanced economies, especially Europe, will perceptibly affect global growth outcomes in 2020 and 2021.

Developing Asia is not immune to the negative economic impact of COVID-19, but the impact is noticeably smaller than in the rest of the world. Partly, this is due to the fact that the region has done a relatively good job of containing the pandemic. Although some Asian countries, most notably India, have suffered major outbreaks, Asia has mostly weathered the COVID-19 storm better than other regions. This is especially true in East Asia, particularly the PRC, where everyday life is returning to a semblance of normalcy as a result of the remarkable success in containing the disease. In fact, the PRC is the lone bright spot in an otherwise gloomy global economic landscape. Its economy grew by a healthy 4.9% y-o-y in Q3 2020 after an expansion of 3.2% in Q2 2020 and a historic contraction in the first quarter.

According to the Asian Development Bank's *Asian Development Outlook Update*, released in September 2020, the PRC's economy is expected to grow by 1.8% in 2020 and 7.7% in 2021. The corresponding figures for the Association of Southeast Asian Nations (ASEAN) are -3.8% and 5.5%; for the Republic of Korea, the expected growth rates are -1.0% and 3.3%; and for Hong Kong, China, the respective figures are -6.5% and 5.1%. Output in developing Asia as a whole is

projected to shrink by 0.7% in 2020 before expanding by 6.8% in 2021. The PRC's recovery is contributing to the resilience of other ASEAN+3 economies that trade heavily with the PRC, especially since the PRC's growth appears to be increasingly broad-based.² In particular, retail sales, a good bellwether of domestic demand, have risen since August after contracting during the first 7 months of the year.

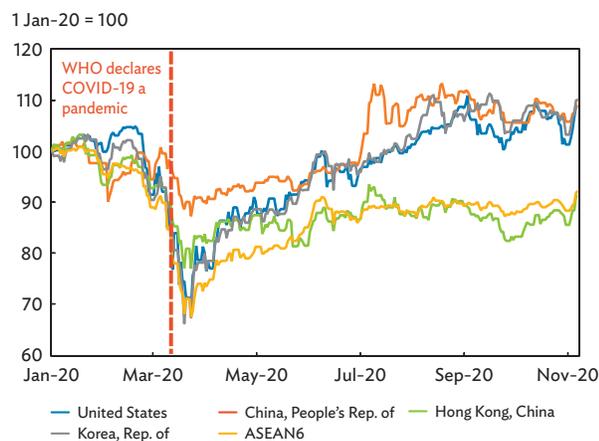
Notwithstanding some positive trends, including the gathering momentum of the PRC's recovery, the overall economic outlook for ASEAN+3 remains subject to a great deal of uncertainty. The fundamental reason is that the global economic outlook will remain uncertain and negative until there is some clarity on when and if COVID-19 will recede. The second wave of new cases, which is forcing European governments to reintroduce restrictions that restrict mobility and hamper economic activity, is a stark reminder that the virus can derail economic recovery at any time until it is firmly brought under control. Until then, economic recovery is more likely to be an intermittent and fitful stop-and-go process rather than a smooth continuous one. Furthermore, many negative effects of the pandemic—such as large-scale unemployment and business closures—are likely

to persist for some time.

As economic performance in major advanced economies strengthened and the results of the US election became more clear, investor sentiment improved on expectations of an additional stimulus package in the US. Most equity markets in emerging East Asia posted gains during the review period (**Figure B.1**). Among regional equity markets, the Philippines gained the most with a 13.6% increase, as the economy showed signs of recovery with the easing of social restrictions. In Viet Nam, the equity market rose 6.4% as the government was successful in gradually lifting restrictions put in place in response to the COVID-19 outbreak. In contrast, declines in equity markets were noted in Thailand (−3.9%), which was driven by rising political concerns, and in the PRC (−2.5%) (**Figure B.2**)

From August through October, investment sentiment was subdued amid rising COVID-19 cases in Europe and uncertainty related to the US election, which led to capital outflows from the region's equities markets. Inflows, however, were noted in early November, buoyed by strong inflows in the markets of the PRC and the Republic of Korea (**Figure C**). The COVID-19 pandemic has significantly shaped global capital flows. **Box 1** examines the effectiveness of COVID-19-related policy

Figure B.1: Equity Indexes in Emerging East Asia



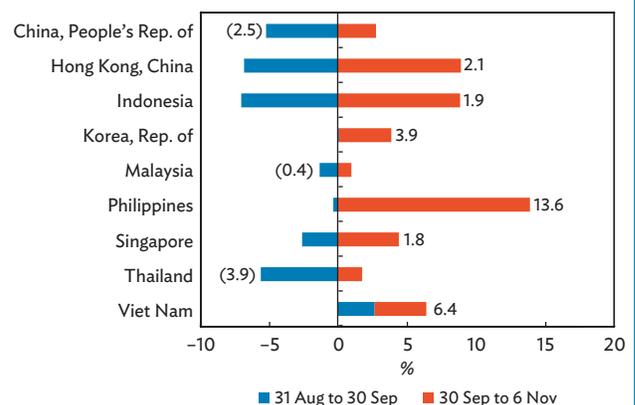
ASEAN = Association of Southeast Asian Nations, COVID-19 = coronavirus disease, WHO = World Health Organization.

Notes:

1. Data as of 6 November 2020.
2. ASEAN6 comprises Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
3. The World Health Organization declared COVID-19 a pandemic on 11 March.

Source: Bloomberg LP.

Figure B.2: Changes in Equity Indexes in Emerging East Asia



() = negative.

Notes:

1. Changes from 31 August to 30 September 2020, and from 30 September to 6 November 2020.

2. Figures on the chart refer to the net change between the two periods.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

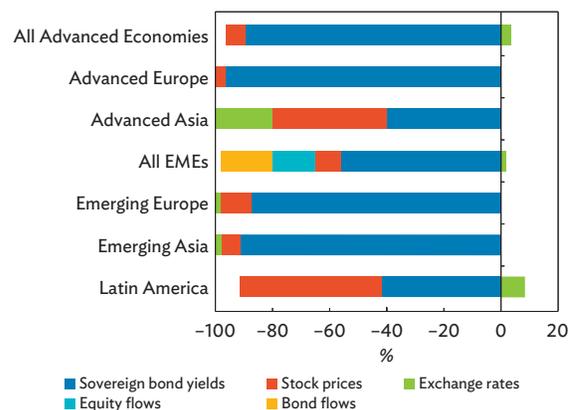
² ASEAN+3 comprises the 10 members of ASEAN plus the PRC, Japan, and the Republic of Korea.

Box 1: Global Financial Markets and Capital Flows: COVID-19 Impacts and Policy Responses

The coronavirus disease (COVID-19) pandemic and the resulting lockdowns have led to an unprecedented economic contraction and turbulence in financial markets, which initially caused the largest ever outflows of portfolio capital from emerging market economies (EMEs).^a Globally, governments have responded to the crisis with substantial fiscal stimulus packages. In addition, central banks around the world have eased monetary policies, with many EME central banks implementing quantitative easing (QE) measures for the first time. Recent Asian Development Bank Institute research examined the impact of COVID-19 on bond yields, stock prices, and exchange rates for a sample of 38 advanced and emerging markets (Beirne et al. 2020). In addition, the effect of the pandemic on EME equity and bond flows across 14 EMEs was assessed. This research also estimated the effectiveness of COVID-19-related policy responses on financial markets and capital flow dynamics.

Figure B1 demonstrates that COVID-19 has had the greatest relative effect on sovereign bond markets across both advanced and emerging economies. In addition, based on an empirical analysis over the period from 4 January 2010 to 30 April 2020, Beirne et al. (2020) show that the magnitude of the effect of COVID-19 on financial markets is notably higher for emerging rather than advanced economies by a factor of around two across bond, stock, and exchange rate markets. In particular, bond yields in European and Asian EMEs are estimated to have declined by 24 basis points (bps) and 14 bps over the sample period, respectively, due to COVID-19. While EME bond yields rose sharply at the onset of COVID-19, coupled with substantial net capital outflows, it is striking that the overall effect on bond yields was negative, which may seem counterintuitive since an increase in COVID-19 cases might be expected to worsen financial market turmoil and increase sovereign bond yields. There are two explanations for why the overall effect on bond yields was negative. First, government bonds were perceived as safer assets than corporate bonds given that the corporate sector, with few exceptions, was very heavily affected by COVID-19 lockdowns. With many businesses fighting for survival, sovereign bonds were seen as the better alternative, even if the crisis also cast questions on the sustainability of public debt. Second, the crisis gave way to extremely accommodative central bank policies in most economies, with slashes in interest rates and new rounds of QE policies in all major advanced economies. Turning to the impact on stock markets, the greatest relative impact of COVID-19 is estimated to have been in advanced Asian economies and Latin America, whose markets plunged sharply.

Figure B1: Relative Impact of COVID-19 on Financial Markets and Capital Flows



COVID-19 = coronavirus disease, EMEs = emerging market economies. Note: The estimation period runs from 4 January 2010 to 30 April 2020, with COVID-19 defined as the number of daily new confirmed COVID-19 cases per one million population. The statistically significant coefficients for the COVID-19 variable are reported via a panel regression that uses each of the asset markets and capital flows as dependent variables, expressed as a percentage relative to the total. These results are consistent with an updated estimation by the authors over the period from 4 January 2010 to 31 August 2020.

Source: J. Beirne, N. Renzhi, E. Sugandi, and U. Volz. 2020. Financial Market and Capital Flow Dynamics During the COVID-19 Pandemic. *Asian Development Bank Institute Working Paper*. No. 1158. Tokyo: Asian Development Bank Institute.

On exchange rates, advanced Asian economies were most affected in relative terms, experiencing currency depreciations due to COVID-19, although the magnitude of these effects was not as large overall when compared to the effects on stock and bond markets. With regard to EME capital flows, COVID-19 has led to significant outflows of both equities and bonds, reflecting investors' flight to safety.

While there has been substantial heterogeneity across regions in the magnitude of the effects of COVID-19 on markets, the results in Beirne et al. (2020) show that this has also been the case in relation to the effectiveness of policy responses. Compared to EMEs, fiscal stimulus packages in advanced economies have had around twice the impact in terms of compressing sovereign bond yields. On monetary policy, while interest rate reductions passed through along the yield curve with similar magnitudes in both advanced and emerging economies, the impact on bond yields due to QE was statistically significant for advanced economies only. However, the advanced economy QE measures spilled over to EMEs, reducing EME bond yields by around 27 bps.

^a This box was written by John Beirne (Research Fellow) of the Asian Development Bank Institute and Ulrich Volz (Director of the SOAS Centre for Sustainable Finance) of the SOAS University of London.

Box 1: Global Financial Markets and Capital Flows: COVID-19 Impacts and Policy Responses

continued

As regards stock markets, interest rate reductions were more effective in advanced compared to emerging economies by a factor of around two. In addition, QE measures in advanced economies, as well as spillovers to EMEs, helped to boost domestic stock prices by around 12% and 16%, respectively. Moreover, QE by central banks in emerging Asia helped to increase stock prices by around 6%. The impact of fiscal policy on stock markets was confined to European advanced economies and EMEs overall, increasing stock prices by an average of around 8%. At the global level, while the magnitude of the effect of policy responses on exchange rates was much lower than in other markets, QE measures in EMEs led to a rise in net capital inflows by around 14% in the case of equities and around 16% in the case of bonds. Moreover, fiscal stimulus packages in EMEs increased net equity inflows by around 9%.

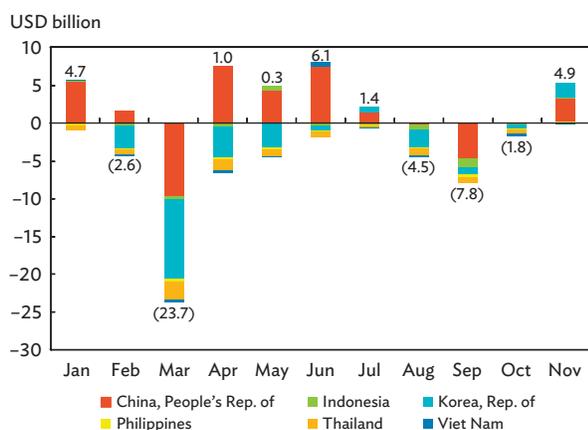
Overall, although heightened uncertainty due to the COVID-19 pandemic has affected the financial markets of EMEs more detrimentally than advanced economies, it appears that most EMEs have performed well in their policy responses to the pandemic. Whereas fiscal stimulus packages have contributed to restoring confidence in domestic financial markets, QE policy measures and interest rate reductions have also been effective in Asian economies by supporting stock prices. Notably, these measures also

helped to stabilize capital flows. The scale of bond and equity capital outflows from EMEs highlights the importance of strengthening the domestic investor base to be less reliant on international portfolio investment. The COVID-19 crisis has illustrated the need for concerted efforts at bolstering domestic financial resource mobilization in EMEs and for reducing exposure to international portfolio capital and financial contagion. The extent of capital outflows also strengthens the case for reviving discussions around the management of capital flows and the development of a global financial safety net. It is important for EMEs to develop further their overall policy toolkits to respond to spikes in financial market volatility and crisis episodes, notably with the use of QE measures. With conventional monetary policy having easing limits and fiscal policy space constrained by excessive public debt, using QE policies can be a potent stimulator in domestic markets, particularly where inflation expectations are contained and exchange rates are flexible.

References

J. Beirne, N. Renzhi, E. Sugandi, and U. Volz. 2020. Financial Market and Capital Flow Dynamics During the COVID-19 Pandemic. *Asian Development Bank Institute Working Paper*. No. 1158. Tokyo: Asian Development Bank Institute.

Figure C: Capital Flows into Equity Markets in Emerging East Asia



() = outflows, USD = United States dollar.

Notes:

1. Data as of 6 November 2020.

2. Figures refer to net inflows (net outflows) for each month.

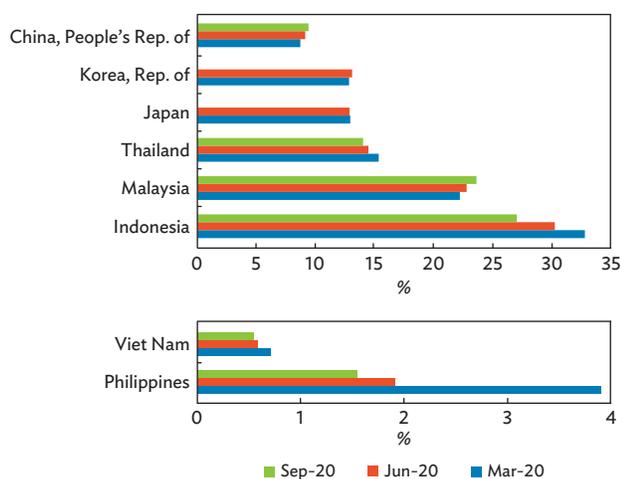
Source: Institute of International Finance.

responses with regard to financial markets and capital flow dynamics.

Foreign holdings of LCY government bonds showed mixed patterns in Q3 2020 (**Figure D.1**). The foreign holdings share declined in Indonesia, the Philippines, and Thailand between the end of June and the end of September. In Indonesia, the foreign holdings share fell from 30.2% to 27.0% during the review period. Foreign investors dumped Indonesian bonds on concerns over debt monetization and a wide budget deficit in the 2021 state budget. The foreign holding shares in the Philippines and Thailand declined from 1.9% and 14.4% at the end of June, respectively, to 1.5% and 14.0% at the end of September.

The PRC and Malaysia witnessed slight increases in their respective shares of foreign holdings in the LCY government bond market. In Malaysia, the foreign holdings share climbed to 23.6% at the end of September from 22.7% at the end of June on expectations that

Figure D.1: Foreign Holdings of Local Currency Government Bonds in Select Asian Markets (% of total)



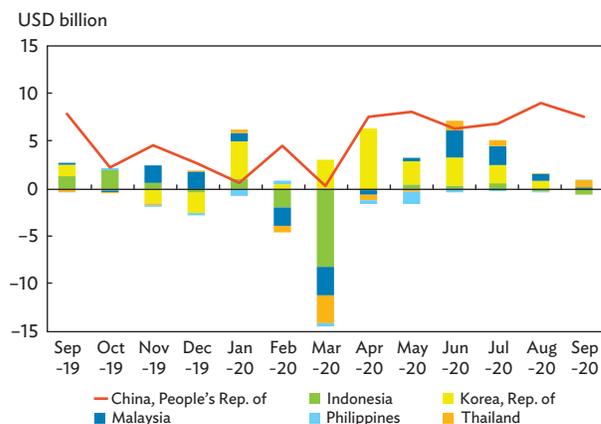
Note: Data for Japan and the Republic of Korea as of 30 June 2020.
Source: *AsianBondsOnline*.

Malaysia would be kept in FTSE Russell's World Global Bond Index (WGBI). (On 24 September, FTSE Russell kept Malaysia's sovereign bonds in the WGBI; however, Malaysia remains on the negative watch list.) In the PRC, the foreign holdings share inched up to 9.4% at the end of September from 9.1% at the end of June as it continued to liberalize its bond markets. On 26 September, the PRC announced that it would streamline regulations for its Renminbi Qualified Foreign Institutional Investor and Qualified Foreign Institutional Investor programs into a single set of rules. Also, on 24 September, the FTSE Russell announced the inclusion of PRC government bonds in its WGBI starting in October 2021.

Foreign bond inflows into the region's LCY bond markets totaled USD29.8 billion in Q3 2020, slightly down from inflows of USD35.1 billion in the previous quarter (Figure D.2). All markets for which data are available posted positive quarterly inflows except for Indonesia and the Philippines. The PRC and the Republic of Korea are the only bond markets in emerging East Asia that have consistently posted positive quarterly foreign flows in 2020.

Most regional currencies gained vis-à-vis the US dollar between 31 August and 6 November (Figure E.1). The Korean won appreciated the most of all currencies in the region, gaining 6.0% on capital inflows into its financial market and improved economic conditions. The Chinese yuan also strengthened, rising 3.6% as its economic

Figure D.2: Foreign Bond Flows in Select Emerging East Asian Economies



USD = United States dollar.

Notes:

1. The Republic of Korea and Thailand provided data on bond flows. For the People's Republic of China, Indonesia, Malaysia, and the Philippines, month-on-month changes in foreign holdings of local currency government bonds were used as a proxy for bond flows.
2. Data as of 30 September 2020.
3. Figures were computed based on 30 September 2020 exchange rates to avoid currency effects.

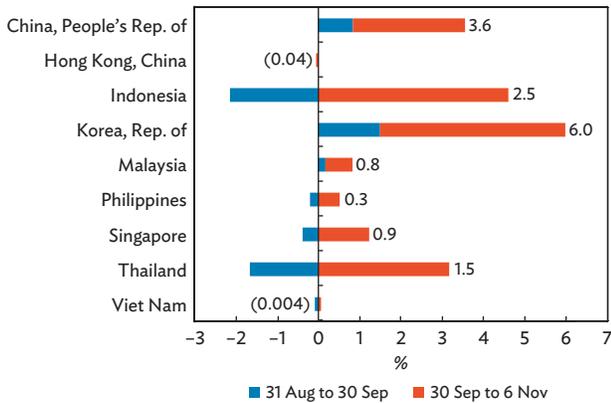
Sources: People's Republic of China (*Wind Information*); Indonesia (Directorate General of Budget Financing and Risk Management, Ministry of Finance); Republic of Korea (Financial Supervisory Service); Malaysia (Bank Negara Malaysia); Philippines (Bureau of the Treasury); and Thailand (Thai Bond Market Association).

growth continued to gain traction. The Indonesian rupiah gained 2.5% and the Thai baht gained 1.5% (Figure E.2).

Improved investment sentiment also led to a decline in credit default swap spreads in most emerging East Asian markets between 31 August and 6 November. During the review period, a spike was noted from the middle of September through early October when the Federal Reserve indicated that more fiscal support would be needed to support the economy and the US President tested positive for COVID-19, heightening risk uncertainty. Credit default swap spreads trended downward during the first half of October before rising toward the end of the month on the back of uncertainty over US stimulus negotiations, increased COVID-19 cases in European economies and the subsequent return of lockdown measures, and the US election. Credit default swap spreads subsequently declined again in the first week of November (Figure F). The sovereign stripped spreads showed a similar trend (Figure G).

While financial conditions improved during the review period, uncertainty over COVID-19 and its impact on economic recovery weighed on global investment sentiment despite accommodative monetary stances

Figure E.1: Changes in Spot Exchange Rates vs. the United States Dollar



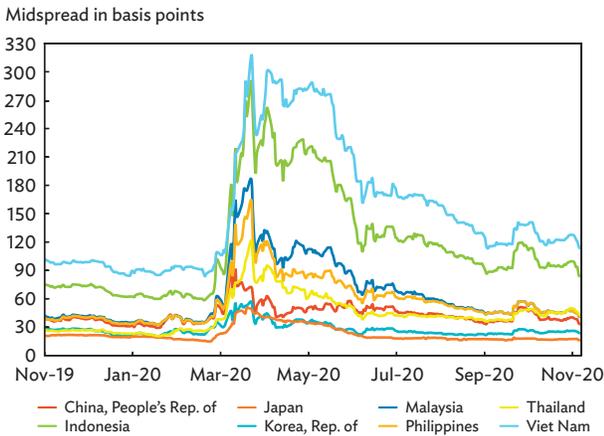
Notes:
 1. Changes from 31 August to 30 September 2020, and from 30 September to 6 November 2020.
 2. Numbers on the chart refer to the net change between the two periods.
 3. A positive (negative) value for the foreign exchange rate indicates the appreciation (depreciation) of the local currency against the United States dollar.
 Source: Bloomberg LP.

Figure E.2: Currency Indexes in Emerging East Asia



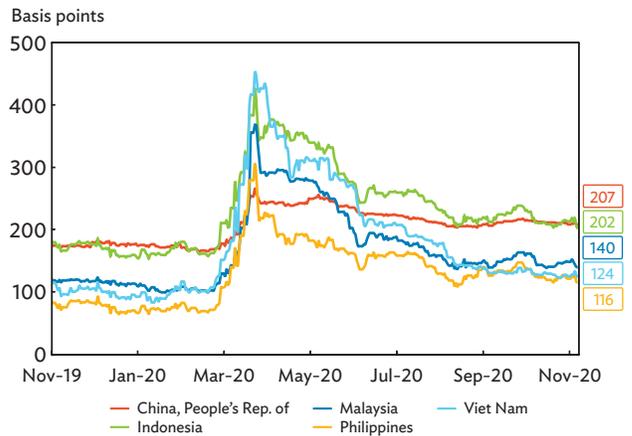
ASEAN = Association of Southeast Asian Nations, USD = United States dollar.
 Notes:
 1. Data as of 6 November 2020.
 2. ASEAN6 comprises Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
 Source: AsianBondsOnline computations based on Bloomberg LP data.

Figure F: Credit Default Swap Spreads in Select Asian Markets (senior 5-year)



USD = United States dollar.
 Notes:
 1. Based on USD-denominated sovereign bonds.
 2. Data as of 6 November 2020.
 Source: Bloomberg LP.

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



USD = United States dollar.
 Notes:
 1. Based on USD-denominated sovereign bonds.
 2. Data as of 6 November 2020.
 Source: Bloomberg LP.

and fiscal stimulus. Fragile investment sentiment and an uncertain economic outlook will challenge financial stability across the region. **Box 2** discusses the effect of COVID-19 on financial stability in ASEAN markets. During periods when exchange rates witness increased volatility, public and private sector borrowers tend to tap LCY bond markets to reduce their exposure to

currency risks (**Box 3**), underscoring the importance of the bond market as a channel to mobilize LCY funding resources for development. Currently, the largest risk to global economies remains the course and duration of the COVID-19 pandemic. **Box 4** examines previous COVID-19-like shocks to determine the average duration of recovery from such events.

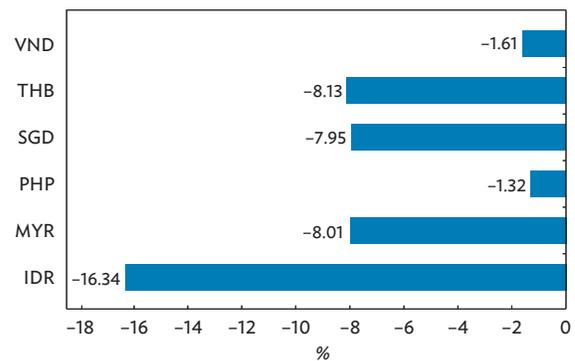
Box 2: The Effect of COVID-19 on Financial Stability in ASEAN

The coronavirus disease (COVID-19) pandemic is a once-in-a-century global public health and economic crisis.^a Member countries of the Association of Southeast Asian Nations (ASEAN) have been profoundly affected by COVID-19's impact.^b Like the rest of the world, ASEAN has seen a significant number of confirmed cases and fatalities. Although the region has been spared huge outbreaks such as those in the United States, India, the Russian Federation, and Brazil, the numbers are far from trivial. As of 7 October, ASEAN as a whole had suffered over 500,000 confirmed cases and over 10,000 deaths. To contain the pandemic, the region's governments imposed various restrictions—lockdowns, community quarantines, and travel bans—which limited the mobility of people within and across countries. As a result, the region was hit hard economically. According to the forecast of the *Asian Development Outlook 2020 Update*, which was released in September 2020, the 10 economies of ASEAN will collectively shrink by 3.8% in 2020, although they will bounce back into positive territory with growth of 5.5% in 2021. In addition to the COVID-19-related restrictions, the dire global outlook is another major factor in the region's severe economic downturn.

ASEAN's relatively high level of economic globalization, in terms of both trade and capital flows, suggests that COVID-19 may adversely affect not only the region's economic growth but also its financial stability. The region suffered a devastating blow during the 1997/98 Asian financial crisis as a result of a sudden and sharp reversal of capital flows. Since then, ASEAN economies have strengthened fundamentals to protect themselves from another financial crisis. These robust fundamentals served ASEAN well during the 2007–2009 global financial crisis, which had only a limited impact on the region's financial stability. Nevertheless, the unprecedented scale and global nature of the COVID-19 shock, in conjunction with the region's relative financial openness, poses a clear and present danger to financial stability. The global financial market turmoil of March 2020 also affected ASEAN economies, as evident in the tangible depreciation of their currencies (**Figure B2.1**). Financial conditions have subsequently turned more benign in ASEAN and the rest of the world. Nevertheless, if the pandemic persists, instability may return to financial markets.

A major contribution to the restoration of financial stability in ASEAN in 2020 has been the concerted implementation

Figure B2.1: Depreciation of Select ASEAN Currencies vs. the United States Dollar, 1 January–23 March 2020 (%)



ASEAN = Association of Southeast Asian Nations, IDR = Indonesian rupiah, MYR = Malaysian ringgit, PHP = Philippine peso, SGD = Singapore dollar, THB = Thai baht, VND = Vietnamese dong.
Source: Bloomberg LP.

of expansionary monetary policy. Like their counterparts elsewhere, the central banks of ASEAN have cut benchmark interest rates decisively (**Figure B2.2**). They have also taken other measures to inject additional liquidity into their financial systems. These include reducing reserve requirement ratios, creating funds for lending to firms, implementing temporary suspensions of interest repayments, and relaxing payment conditions for loans related to COVID-19. In addition, ASEAN governments have launched fiscal stimulus packages to support growth and protect vulnerable groups. Such fiscal stimulus indirectly supports financial stability by boosting growth and thus preventing a rise in business closures and nonperforming loans. At the same time, stimulus expands fiscal deficits and public debt, which can eventually pose a risk to financial stability. While these strong domestic policy measures are the primary defense against financial turbulence, regional financial safety nets can also make a significant contribution.

Regional financial safety nets matter because there can be significant spillovers across the region from major shocks. This was painfully evident during the 1997/98 Asian financial crisis. In response to that crisis, ASEAN created the ASEAN+3 financial cooperation initiative.^c The Chiang Mai Initiative Multilateralization (CMIM) process emerged in

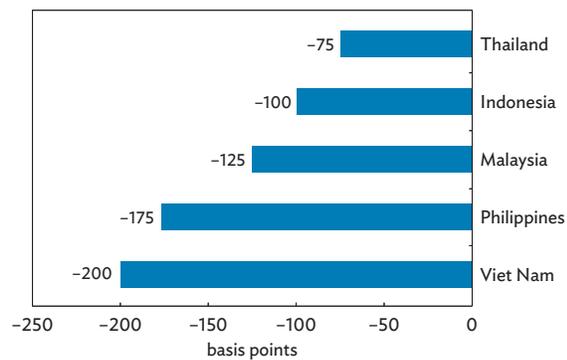
^a This box was written by Donghyun Park (Principal Economist) of the Asian Development Bank (ADB), Pitchaya Sirivunnabood (Capacity Building and Training Economist) of the ADB Institute, and Santi Setiawati (Intern) of the ADB Institute.

^b Unless otherwise stated, data for ASEAN in this box include the markets of Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.

^c ASEAN+3 refers to the 10 members of ASEAN plus the People's Republic of China, Japan, and the Republic of Korea.

Box 2: The Effect of COVID-19 on Financial Stability in ASEAN *continued*

Figure B2.2: Policy Rate Changes in Select ASEAN Economies, 31 December 2019–7 October 2020 (bps)



ASEAN = Association of Southeast Asian Nations, bps = basis points.
 Note: Negative value denotes reduction of policy rate.
 Source: Various central bank websites.

March 2010 under the ASEAN+3 initiative as a network of bilateral swap arrangements amounting to USD120 billion. CMIM's implementation and surveillance processes are being strengthened to improve its effectiveness and speed in tackling financial crisis.

Separately, the ASEAN Disaster Risk Financing and Insurance (ADRFI) scheme is being developed to strengthen regional financial resilience in the context of climate change and natural hazards. The comprehensive framework is designed to equip ASEAN member countries with risk management and risk transfer capabilities. ADRFI will enable them to overcome the financial burden caused by extreme events through both ex-ante and ex-post arrangements.

ASEAN has yet to develop a regional mechanism for the COVID-19 pandemic crisis or similar shocks. The policy gap

in both the CMIM and ADRFI initiatives for dealing with transnational disease outbreaks includes the lack of technical and financial capacity building and public health sector cooperation among ASEAN countries. This includes funding hospitals and medical clinics; health care training for lower-income countries; and the stockpiling of medicines, alcohol, surgical masks, vaccines, and other emergency equipment to quickly tackle the spread of a transnational disease. At the global and regional levels, international financial institutions have also supported countries affected by the COVID-19 outbreak. The International Monetary Fund uses the Catastrophe Containment and Relief Trust to support its member countries, while multilateral development banks like the Asian Development Bank are supporting countries—including Thailand, the Philippines, and Indonesia—through grants and loans. Although this financial support is helpful, it is nowhere near enough to respond to a systemic financial crisis.

Appropriate and timely policies supported by regional cooperation can reduce the negative economic impacts of the pandemic. We propose three policy recommendations. First, the establishment of an ASEAN task force on pandemics would facilitate the coordination and alignment of policy responses among member countries. A regional framework for policy responses can create public trust and promote transparency. Second, the building-up of an ASEAN pandemic network—consisting of hospitals, healthcare workers, pharmaceutical companies, and research institutions—is needed to share information and knowledge on healthcare resources for mitigating pandemic-related shocks and preparing financing schemes. Third, regional financial safety nets must be strengthened, including their role in mitigating the impact of COVID-19 and other similar shocks to financial stability.

Box 3: Local Currency Bond Markets and Exchange Rate Risks

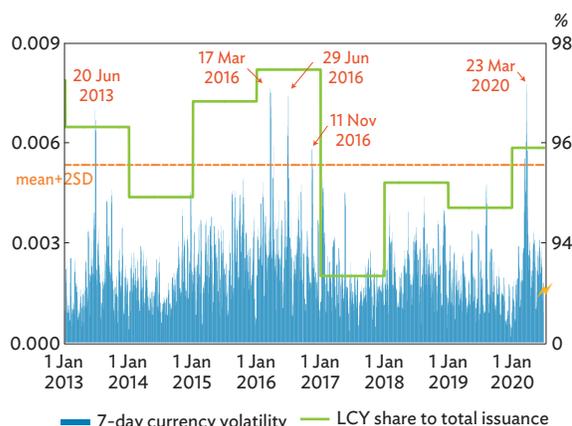
The 1997/98 Asian financial crisis underlined the importance of developing local currency (LCY) bond markets to boost financial resilience.^a LCY bond markets mobilize private sector savings into long-term investments, while also mitigating currency and maturity mismatches in the balance sheets of public and private institutions. LCY bond markets absorb capital inflows, thereby contributing to financial stability.^b Park, Shin, and Tian (2018) showed that LCY bond markets also play a significant role in stabilizing currencies against external shocks.^c

In recent decades, LCY bond markets in emerging Asian economies have expanded rapidly, catching up to European LCY markets in size. Since the Asian Bond Markets Initiative was launched in 2002 by the Association of Southeast Asian Nations (ASEAN) and the People's Republic of China, Japan, and the Republic of Korea—a grouping collectively known as ASEAN+3—regional LCY bond markets have experienced rapid growth. As of June 2020, LCY bonds outstanding in emerging East Asia had reached USD17.2 trillion, a more than 14-fold increase since 2002. Furthermore, LCY bonds outstanding as a share of the region's gross domestic product reached 91.6% in 2020. The rapid development of regional LCY bond markets has reduced financial vulnerability to sudden capital flow reversals, as evidenced by the resilience of the region's financial systems and economies during the 2007–2009 global financial crisis and the “taper tantrum” in 2013.

Well-developed LCY bond markets allow domestic borrowers to tap LCY funding when exchange rates are volatile, thus mitigating currency risk in investments and project implementation. **Figure B3.1** confirms that demand for LCY financing in Asia rose in recent years when exchange rates were more volatile.

Currency depreciation adversely affects balance sheets in both the public and private sectors, especially when exposure to foreign currency financing is large. When a domestic currency weakens, it becomes more costly to repay foreign currency debt. LCY bonds thus offer a financing solution that is cheaper and free of exchange-rate risk for LCY investment and spending. **Figure B3.2** reveals that when emerging market currencies depreciate, the demand for LCY financing tends to increase, as evidenced by greater LCY bond issuance in

Figure B3.1: Currency Volatility and Local Currency Bond Issuance



LCY = local currency, SD = standard deviation.

Notes:

- Volatility is defined as the 7-day rolling standard deviation of the log difference of the MSCI Emerging Market Currency Index in United States dollars, which measures the total return of 25 emerging market currencies relative to the dollar where the weight of each currency is equal to its country weight in the MSCI Emerging Markets Index.
- The share of LCY bonds as a percentage of total bond issuances in Armenia, Georgia, the People's Republic of China, India, Indonesia, Malaysia, Pakistan, the Philippines, the Republic of Korea, Singapore, Thailand, and Viet Nam.

Source: Authors' calculation based on Bloomberg LP data.

emerging Asia. This implies that better developed LCY bond markets serve as an important alternative funding source for local borrowers when the domestic currency weakens.

The outbreak of the coronavirus disease (COVID-19) soured global investment sentiment and caused turmoil in global financial markets in March and April 2020, putting emerging market currencies under pressure. A huge amount of financing will be needed to tackle COVID-19 and its economic effects. As evidenced by Figures B3.1 and B3.2, LCY bond issuance is an important funding mechanism for public and private sector borrowers in emerging markets, especially those facing significant uncertainty.

Larger LCY bond markets also offer central banks an additional tool for monitoring liquidity in the financial system. During market turmoil, major central banks trade LCY bonds to smooth liquidity conditions in the financial sector and

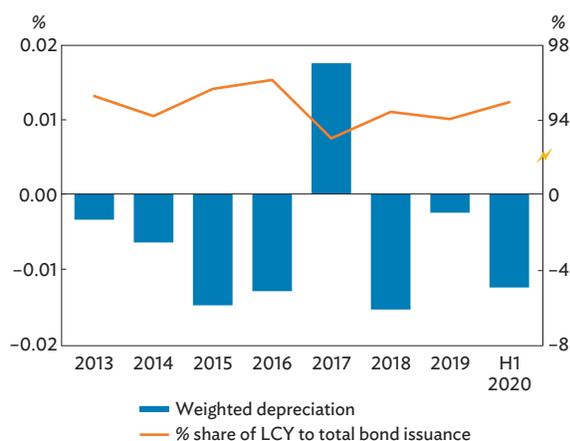
^a This box was written by Donghyun Park (Principal Economist), Shu Tian (Economist), and Mai Lin Villaruel (Economics Officer) in the Economic Research and Regional Cooperation Department of the Asian Development Bank (ADB).

^b ADB. 2019. *Good Practices for Developing A Local Currency Bond Market: Lessons from the ASEAN+3 Asian Bond Markets Initiative*. Manila.

^c D. Park, K. Shin, and S. Tian. 2018. Do Local Currency Bond Markets Enhance Financial Stability? *ADB Economics Working Paper Series*. No. 563. Manila: ADB.

Box 3: Local Currency Bond Markets and Exchange Rate Risks *continued*

Figure B3.2: Exchange Rate Performance and Issuance of Local Currency-Denominated Bonds in Select Asian Economies



Notes:

1. Weighted depreciation of the nominal exchange rate (%) is measured as annual mean depreciation (previous over current) of the daily nominal exchange rate of selected Asian economies (Armenia, Georgia, the People's Republic of China, India, Indonesia, Malaysia, Pakistan, the Philippines, the Republic of Korea, Singapore, Thailand, and Viet Nam) weighted using gross domestic product at current prices in United States dollars.
 2. Share of LCY to total bond issuance of Armenia, Georgia, the People's Republic of China, India, Indonesia, Malaysia, Pakistan, the Philippines, the Republic of Korea, Singapore, Thailand, and Viet Nam
- Source: Authors' calculation based on Bloomberg LP data.

support financial stability. Recent analysis shows that LCY bond yields fell significantly after central banks announced asset purchase programs in response to the COVID-19 pandemic, but exchange rates were largely unaffected.^d Others argue that credible emerging market central banks could consider purchasing LCY government bonds to support COVID-19-related health and welfare expenditures, and fiscal stimulus.^e

Overall, LCY bond markets serve as useful financing instruments for emerging markets during periods of volatility and weakening exchange rates. They not only mitigate the double mismatch problem but also offer a tool to smooth liquidity in the domestic financial system. The impact of COVID-19 has demonstrated the importance of developing deep and balanced LCY bond markets to boost financial sector resilience.

^d Y. Arslan, M. Drehmann, and Boris Hofmann. 2020. Central Bank Bond Purchases in Emerging Market Economies. *BIS Bulletin*. No. 20. Basel: Bank for International Settlements.

^e B. Gianluca, J. Hartley, A. García-Herrero, A. Rebucci, and E. Ribakova. 2020. Credible Emerging Market Central Banks Could Embrace Quantitative Easing to Fight COVID-19. *CEPR Policy Portal*. Washington, DC.

Box 4: The Duration of Recoveries from Economic Shocks Like COVID-19

Introduction

Attention is beginning to turn from the magnitude of the economic impact of the outbreak of the coronavirus disease (COVID-19) to the likely trajectory of recovery.^a In this connection, Eichengreen, Park, and Shin (2020) seek to make headway on the question of what recovery from a COVID-19 recession may look like, focusing on the duration of the recovery; that is, how long will it take to re-attain the levels of output and employment reached at the prior business cycle peak?

We start by categorizing all post-1950 recessions in advanced economies and emerging markets into those that were induced by a supply shock, a demand shock, or both shocks. We measure recovery duration as the number of years required to re-attain prerecession levels of output and employment. We then rely on existing literature on business cycle dynamics to identify candidate variables that can help account for variations in recovery duration following different kinds of shocks. By asking which of these variables are operative in the COVID-19 recession, we can then draw inferences about the duration of the recovery under different scenarios.

Empirical findings

The main findings of the empirical analysis are as follows. For gross domestic product (GDP) per capita, both the amplitude of the recession and the presence of a double-dip increase recovery duration, as expected; that is, severe recessions and double-dip recessions lengthen the time it takes an economy to recover. Similarly, both global recessions and the presence of a financial crisis lengthen recovery durations. There is also some indication that experiencing both supply and demand shocks—as is during the current COVID-19 recession—lengthens recovery time. Recession amplitude, double-dip, financial crisis, and both shock variables remain significant when included simultaneously.

Additional analysis indicates that the results for the duration of employment recoveries are broadly similar with the results for GDP per capita recoveries. In addition, we find that economies with floating exchange rate regimes did better in general, albeit not in response to global recessions. This is likely because flexible exchange rates are not very useful if all economies are in trouble simultaneously. Also, there is evidence that trade openness is associated with faster recoveries. This is consistent with the idea that recovery

Data and Empirical Methodology

Our primary data are real gross domestic product (GDP) per capita in national accounts and employment. These were collected from the Penn World Table 9.1. Dates of financial crises were obtained from Reinhart and Rogoff (2009) and Laeven and Valencia (2018). De facto exchange rate regimes were taken from Ilzetzki, Reinhart, and Rogoff (2019). We considered 23 advanced economies and 21 major emerging markets. The sample period of GDP and employment for advanced economies is from 1950 to 2017. The sample period of GDP and employment for emerging markets varies. For some, it is also from 1950 to 2017, but for others the sample starts as late as 1990. The frequency is annual in all cases. The recovery duration of per capita GDP and employment is defined as how many years it takes for the two variables to recover to their levels at the preceding business cycle peak. For the entire sample, we find that it takes real GDP per capita and employment around 4 years and 3 years, respectively, to recover to their previous peak.

The business cycle chronology is calculated by applying the Bry and Boschan (1971) algorithm as coded by Jorda, Schularick, and Taylor (2013) for both advanced economies and emerging markets. Then we calculate the duration of recoveries, which is defined as number of years for GDP per capita from peak to recovery of prior peak. Then we investigate the determinants of the duration by employing a parametric survival model with a Weibull distribution. We estimate both pooled regressions and panel regressions with random effects. The coefficients estimated determine the hazard rate so that a positive sign on a coefficient means that it shortens the duration of the recovery.

The dependent variable is the duration of the GDP recovery, defined as number of years for GDP per capita from previous peak to recovery of prior peak. We estimate coefficients based on the panel survival model with a Weibull distribution. A negative sign on a coefficient means that it lengthens the time to recovery (i.e., it reduces the likelihood of the ongoing recovery spell ending in the current period).

^a This box was written by Barry Eichengreen (Professor of Economics and Political Science) in the University of California at Berkeley, Donghyun Park (Principal Economist) in the Economic Research and Regional Cooperation Department of the Asian Development Bank, and Kwanho Shin (Professor of Economics) in Korea University.

Box 4: The Duration of Recoveries from Economic Shocks Like COVID-19 *continued*

is aided by the ability to substitute exports for domestic demand.

Some implications for developing Asia's post-COVID-19 recovery prospects

What are the implications of these findings for recovery from the COVID-19 recession in general and in developing Asian economies in particular? A number of our empirical results point in the direction of lengthy recoveries. The COVID-19 recession is unusually severe, which will make for extended recoveries if history is any guide. The fact that the COVID-19 recession is global points in the same direction. It means that economies, including a growing number of emerging markets in Asia and globally, that had been moving in the direction of more freely floating exchange rates will not be able to exploit that policy flexibility by depreciating their currencies and crowding-in exports since their export markets are also likely to slowly recover. It means that the tendency for economies

that are more open to trade to recover more quickly, something that normally works in developing Asia's favor, will be less potent this time.

Another troubling omen is that the COVID-19 recession involves both aggregate supply and aggregate demand shocks, as first supply was disrupted by lockdowns and then households and firms reduced their spending owing to the loss in incomes. Our results strongly suggest that these are the recessions from which recovery is slowest. The negative supply shock is unavoidable under the circumstances, but the negative demand shock can be mitigated by policy. Emerging markets, including those in Asia, have responded more aggressively than to previous recessions. Some of those with greater fiscal space than in previous recessions have used this advantage more aggressively. In addition, the rapid responses of multilaterals such as the International Monetary Fund and the Asian Development Bank have provided low-income economies with additional fiscal space.

Risks to Economic Outlook and Financial Stability

Downside risks continue to dominate upside risks to the global and regional economic outlook and to financial stability. The overriding downside risk remains the uncertain trajectory of the COVID-19 pandemic. Europe's recent experience suggests that economic performance will be inextricably linked to success in containing outbreaks. In February, the European Union (EU) suffered a major outbreak that began in Italy and soon spread to the rest of the continent. EU governments imposed lockdowns and other stringent restrictions that helped contain the disease but also took a heavy toll on the economy. Reduced mobility and economic activity sharply lowered the EU's GDP in Q2 2020 by more than 10.0% q-o-q. However, the restrictions helped to bring the pandemic under control, as evident in a sharp decline in cases and deaths. This allowed governments to ease restrictions, which immediately boosted demand and growth. Third quarter gross domestic growth reached almost 10.0% q-o-q, and there was growing optimism about a sustained recovery. However, a virulent second wave of COVID-19 cases struck Europe in October, and optimism quickly turned to pessimism. In response, governments across the continent have imposed a new round of restrictions. In

September, the ECB forecast that the euro area would grow at a healthy pace of more than 3% in the fourth quarter of 2020. However, some economists are now predicting an outright contraction.

Emerging East Asian economies have fared relatively well in terms of containing COVID-19. In particular, the PRC, which is a major engine of growth for the region, has seen normality return to everyday life after successfully containing COVID-19. As a result, its economic recovery is gathering momentum and becoming more broad-based. Most promisingly, whereas the recovery in Q2 2020 was driven by public infrastructure investment and exports, consumption began to show signs of life in the third quarter as the PRC's retail sales rose by 3.3% y-o-y in September.

The key takeaway for Asia from Europe's second wave is that economic performance is intimately linked to the state of public health. Furthermore, the European experience suggests that even an apparently robust recovery is powerless in the face of sudden and unexpected worsening of the COVID-19 situation. Therefore, if the PRC and other emerging East Asian economies suffer a sharp spike in cases and deaths that tests their public health capacity, it is likely that economic growth and financial stability will also be tested.

The main upside risk is the rapid development of a safe and effective COVID-19 vaccine. The mere news of a breakthrough vaccine would sharply lift business and consumer confidence. Overall, there is cause for optimism as several candidates have already reached Phase 3 clinical trials, which typically involve thousands of participants to confirm and evaluate the overall risks and benefits of a vaccine. At the same time, the temporary suspension of clinical trials by AstraZeneca and Johnson & Johnson due to sick participants suggests that there is still some work left.

While COVID-19 dominates all other risks, there are nevertheless some significant risks besides the pandemic. The conflict between the PRC and the US, which seems to be rooted in structural differences, shows no signs of abating. On a positive note, tensions between the two have not become noticeably worse in recent months. Emerging East Asian economies

depend on close economic links with both the PRC and the US. As such, persistent conflict between the two economic giants represents a significant source of risk and uncertainty. Political and social instability due to various factors is another source of risk and uncertainty. In many countries, central governments are grappling with growing opposition from the general population and regional governments to lockdowns and other COVID-19 restrictions. In the US, there are widespread concerns about whether the government transition following the presidential election on 3 November can be completed smoothly and without major disruption. Any prolonged legal disputes over the election outcome could harm US and global financial stability. Other countries, such as Thailand, are experiencing political instability due to country-specific factors. Finally, as always, a number of geopolitical risks, including geopolitical tensions in the Middle East, loom on the horizon.