

Highlights

- The external environment facing emerging East Asia is bleak.¹ Market turbulence has prompted safe haven flows into gold, long-dated bonds, and higher quality corporate papers. The unresolved sovereign debt issues in the United States (US) and the ongoing eurozone debt crisis have led investors to re-think definitions of risk-free and risky assets.
- Rising inflationary pressures in the first half of 2011 led to a steady stream of policy rate hikes across the region. However, the monetary policy stance in most markets could become more neutral as authorities in the region move to cushion against any anticipated slowdown in mature markets.
- Capital flows into emerging East Asian bond markets remain strong as investors chase yields. Relatively strong economic fundamentals, interest rate differentials, and the potential appreciation of regional currencies are all key pull factors.
- There has been a bullish flattening of government bond yield curves in most markets. Yields dropped sharply after the recent downgrade by Standard and Poor's (S&P) of its sovereign rating for the United States to AA+ from AAA.
- Total local currency (LCY) bonds in emerging East Asia grew 7.7% on a year-on-year (y-o-y) basis in 2Q11—and 2.4% on a quarter-on-quarter (q-o-q) basis—to US\$5.5 trillion, driven more by the y-o-y growth rate for corporate bonds (19.6%) than for government bonds (2.7%).
- The most rapidly growing bond markets in 2Q11 were Viet Nam, Singapore, and Malaysia, whose LCY bond markets expanded 5.0%, 4.3%, and 3.7% q-o-q, respectively. The People's Republic of China's (PRC) market grew 2.7% q-o-q in 2Q11, reflecting a modest 1.6% increase in its government bond sector, almost the same as for the region-wide government bond market.
- Governments in three emerging East Asian economies—Hong Kong, China; the Republic of Korea; and Thailand—issued inflation-linked bonds in the first half of the year.
- LCY bond issuance dropped sharply in 2Q11 on the back of a decline in issuance of short-term bills by central banks and monetary authorities, which was mostly a result of reduced sterilization activities. Meanwhile, authorities issued more at the long-end of the yield curve, taking advantage of the compression of spreads between 2- and 10-year government bonds.
- Issuance by government sector entities—other than central banks and monetary authorities—rose 7.4% q-o-q and 11.6% y-o-y, while issuance from corporates increased 11.8% q-o-q and 10.7% y-o-y.
- The corporate bond market in emerging East Asia expanded 4.4% q-o-q in 2Q11, led by Indonesia, which grew 8.9%, followed by the PRC, Malaysia, and Singapore.
- The PRC's corporate bond market grew at a rapid rate of 6.3% q-o-q in 2Q11 and is now the region's largest corporate bond market, supplanting the Republic of Korea. The PRC's medium-term note (MTN) sector is still the largest sector of the PRC corporate bond market, comprising 33.5% of the total.
- Movements in corporate bond credit spreads for high yield and high grade bonds differed a great deal across markets in 2Q11. Credit spreads for high grade corporate bonds widened in the PRC, Malaysia, and Thailand, but tightened in the Republic of Korea. Credit spreads for Korean,

¹ Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.

Malaysian, and Thai high yield bonds tightened in 2Q11, while they were largely unchanged in the PRC.

- G3 currency issuance in the region in 2011 reached US\$55.4 billion through the end of July as funding conditions in global markets remained favorable. G3 issuance is on track this year to surpass the US\$87.2 billion of issuance in 2010.
- The risks to the outlook are tilted to the downside. These include (i) a severe slowdown or contraction in mature economies that might impact exports from the region, (ii) destabilizing capital flows, (iii) a lack of timely and appropriate policy interventions in mature markets, and (iv) potential commodity price fluctuations.