Introduction: **Global and Regional Market Developments**

Emerging East Asian economies face a weakened external environment and an increasingly challenging regional outlook.[2] Uncertainty over policy actions to resolve the sovereign debt crisis in Europe and mixed data on the sluggish United States (US) economy have kept investors on edge.

Softening external demand has narrowed current account surpluses and dragged down growth in emerging East Asia. Worries about a larger-than-expected slowdown in the People's Republic of China (PRC) are raising fears of sharply lower growth in the region generally. Authorities across the region are looking at countercyclical measures—such as increasing public spending and monetary easing—to boost domestic demand and investment.

Despite the weakening global outlook, concerns over sustaining regional growth, and risk-on/risk-off market sentiment, investor perceptions of regional capital markets have remained favorable **(Table A)**. Credit default swap (CDS) markets **(Figures A, B)** and tightening emerging market bond spreads **(Figure C)** show market confidence. CDS spreads for emerging East Asia and major European markets have moved in somewhat different directions since the beginning of 2012.

CDS spreads for emerging East Asia have generally moved downward, while CDS spreads in much of Europe have tended to rise.

Table A: Changes in Global Financial Conditions, 1 April to 31 July 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	(12)	(74)	0	(2.1)	–
United Kingdom	(33)	(33)	(6)	(2.3)	(2.1)
Japan	(2)	(2)	(7)	(13.3)	(5.7)
Germany	(30)	(30)	(3)	(2.5)	(7.8)
Emerging East Asia					
China, People's Rep. of	(52)	(23)	0.2	(7.0)	1.0
Hong Kong, China	(4)	(57)	4	(3.7)	(0.1)
Indonesia	40	(23)	6	0.5	3.5
Korea, Rep. of	(68)	(82)	(3)	(6.6)	(0.2)
Malaysia	(7)	(27)	12	2.2	2.1
Philippines	(55)	(39)	(1)	3.9	(2.7)
Singapore	2	(26)	0	0.9	(1.0)
Thailand	(19)	(55)	7	0.2	2.2
Viet Nam	(234)	(111)	–	(6.0)	0.1
Select European Markets					
Greece	(3,788)	(1,298)	0	(17.9)	(7.8)
Ireland	(0.3)	(70)	(57)	(2.6)	(7.8)
Italy	121	96	95	(13.1)	(7.8)
Portugal	(494)	(125)	(349)	(15.6)	(7.8)
Spain	271	136	108	(15.9)	(7.8)

– = 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.

[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.

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

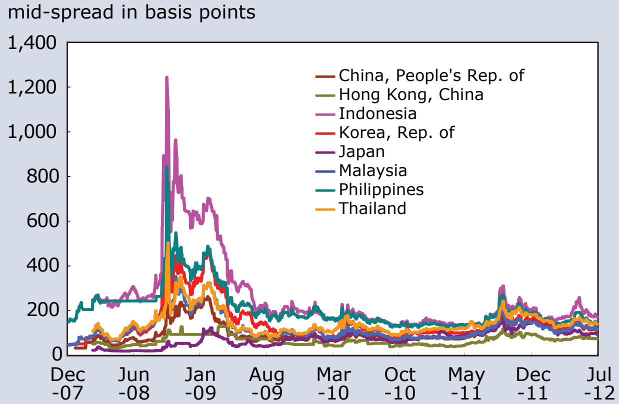


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

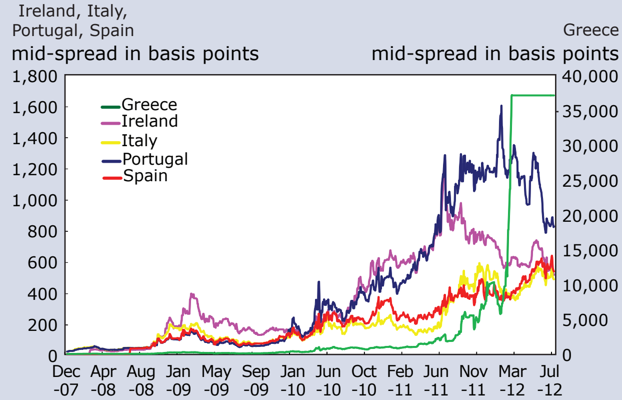


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b]

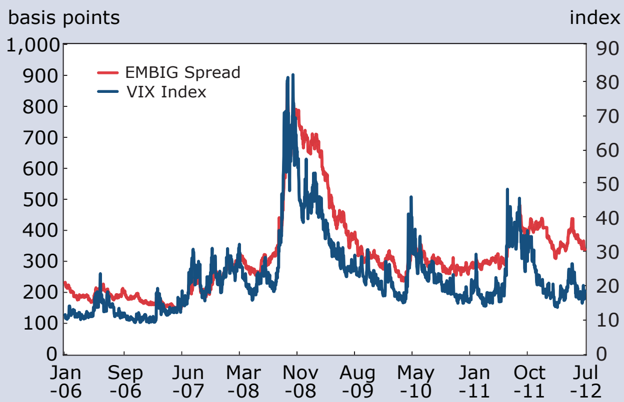


Figure D: 10-Year Government Bond Yields (% per annum)

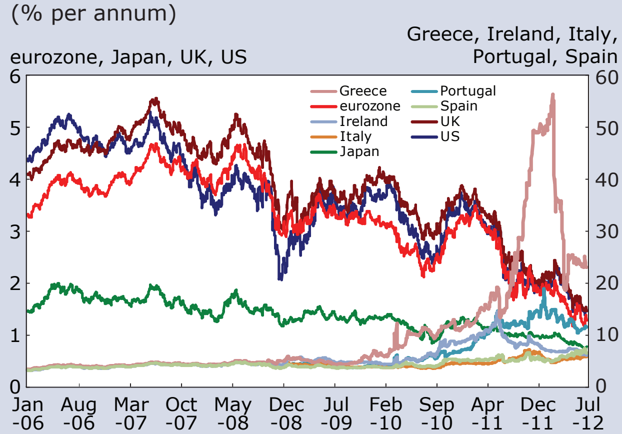


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a,b]

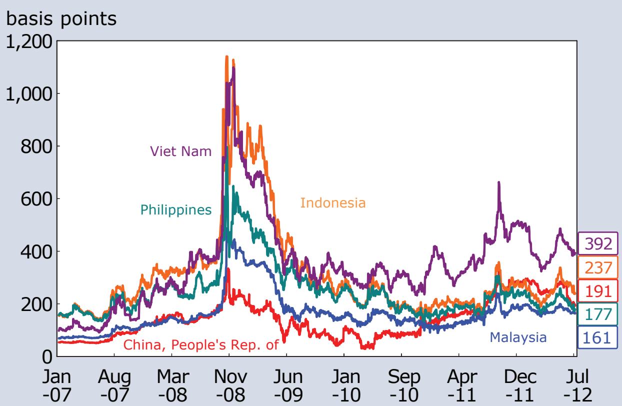
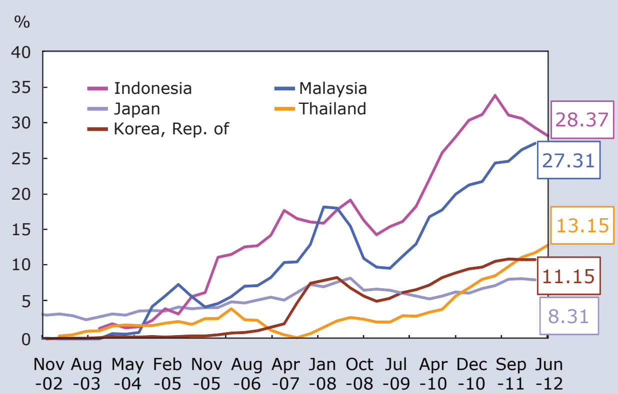


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies (% of total)



EMBI = Emerging Market 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 July 2012.

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

Yields on government bonds in mature markets continue to drop and fluctuate within a narrow range. Yields in mature markets in the first 7 months of 2012 fell to their lowest levels in recent years **(Figure D)**. Yields for government bonds in Spain and Italy have risen modestly, but have been less volatile than the yields for Greek and Portuguese bonds.

This overall trend largely reflects continued investor demand for safe assets,[3] and significantly reduced inflationary pressures since the middle of last year. This has allowed central banks in emerging East Asia to reduce policy interest rates. Yields on the region's local currency (LCY) bonds (and in emerging markets generally) have trended downward since the start of the year. These trends are reflected in narrowing emerging market bond spreads **(Figure E)**.

But yields have edged up in July and August for all tenors in the PRC, Indonesia, and Viet Nam.

Poor or uncertain prospects in Europe and the US, as well as near-zero policy interest rates, have pushed global investors to seek better yields in emerging East Asian debt markets.

Foreign holdings in the region's LCY government debt markets have been mixed, with the share of foreign holdings rising in Thailand and Malaysia, while falling in Indonesia **(Figure F)**. Foreign investors now hold over 27% of Malaysian government bonds and over 13% of Thai government bonds. The share of foreign holdings of Indonesian government debt has dropped to 28.4% in 2Q12 from 30.8% at end-2011.

Foreign holdings of government bonds in the Republic of Korea have been relatively stable at around 11% of total holdings, since late last year, but monthly net investment inflows into the Republic of Korea's bond market have remained volatile in recent months.

Total bonds outstanding in emerging East Asia's LCY bond market rose 1.9% quarter-on-quarter (q-o-q) and 8.6% year-on-year (y-o-y)—totaling US$5.9 trillion at end-June. However, intraregional debt holdings in the region remain low. Cross-border debt investments in the region during 2010 were 7.2% of the regional total of US$3.29 trillion, up slightly from 4.2% in 2001.[4]

Corporate bond growth continues to outpace that of government bonds as lower yields and tighter bank lending ahead of new bank regulations in many markets is encouraging firms to raise funds from local markets.

At end-December 2011, emerging East Asia's share of the global bond market was 8.4% **(Table B)**, up from 8.1% at end-September 2011. The PRC and the Republic of Korea remained the two largest bond markets in the region outside of Japan, with global shares of 5.0% and 1.8%, respectively. Comparisons of LCY government bonds outstanding (excluding central banks and monetary authorities) in emerging East Asia with the more prominent emerging markets of Latin America, Eastern Europe, and Africa are shown in **Figure G**. Considering only government bonds, Brazil and India are the second and third largest markets, respectively. They follow the PRC and precede the Republic of Korea, which is followed by Mexico as the fifth largest emerging market globally. The other more prominent emerging markets—such as Poland, South Africa, Turkey, and Russia—have government bonds outstanding that are broadly comparable with those in Southeast Asia.

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

(i) **Prospects for more stimulus policies.** The weakening external environment and softened demand for regional exports has led to a discernible decline in current account surpluses in some economies, thus dragging down growth. This has strengthened the case for countercyclical policies to boost domestic demand and investment to reinvigorate growth, including increased issuance of government bonds.

[3] Market perception of "safe assets" has evolved since the 2008/09 global financial crisis—particularly since Europe's sovereign debt crisis. A dearth of safe assets and the increased attractiveness of Asian government debt is pushing institutional and official investors away from mature markets and into government securities in markets such as the Republic of Korea, Malaysia, and Thailand.

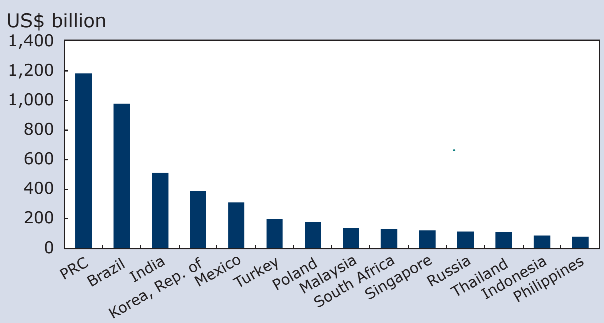
[4] Iwan J. Azis and S. Mitra. 2012. Why Do Intraregional Debt Investments Remain Low in Asia? *Office of Regional Economic Integration Policy Brief*. No. 1. June. Manila: Asian Development Bank.

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

Economy	2011		1996	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	26,333	38.8	10,926	42.9
Japan	12,715	18.7	4,456	17.5
France	3,308	4.9	1,261	4.9
Germany	2,534	3.7	1,888	7.4
United Kingdom	1,744	2.6	678	2.7
Emerging East Asia	5,671	8.4	528	2.1
of which: PRC	3,392	5.0	62	0.2
Emerging East Asia excl. PRC	2,279	3.4	466	1.8
of which: Korea, Rep. of	1,229	1.8	283	1.1
of which: ASEAN-6	883	1.3	149	0.6
Indonesia	110	0.2	7	0.0
Malaysia	263	0.4	71	0.3
Philippines	77	0.1	28	0.1
Singapore	189	0.3	25	0.1
Thailand	225	0.3	18	0.1
Viet Nam	17	0.02	–	–
Memo Items:				
Australia	1,023	1.5	248	1.0
Brazil	1,489	2.2	299	1.2
PRC (excl. policy bank bonds)	2,363	3.5	–	–
India	596	0.9	81	0.3
Russian Federation	87	0.1	43	0.2
South Africa	196	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.

Figure G: Government Bonds Outstanding in Key Emerging Markets, March 2012



PRC = People's Republic of China.
Notes:
1. Data exclude central bank bonds. For the People's Republic of China, data include treasury and other government bonds. For India, data include treasury bills and government bonds.
2. Data for India, Russia, South Africa, and Turkey as of end-2011.
Source: Brazil (Banco Central do Brasil); People's Republic of China (*ChinaBond*); India (Bloomberg LP); Indonesia (Indonesia Stock Exchange); Republic of Korea (The Bank of Korea); Malaysia (Bank Negara Malaysia); Mexico (Banco de Mexico); Philippines (Bureau of the Treasury); Poland (Ministry of Finance); Russia (Ministry of Finance); Singapore (Monetary Authority of Singapore and Singapore Government Securities); South Africa (South Africa Reserve Bank); Thailand (Bank of Thailand); and Turkey (The Central Bank of the Republic of Turkey).

(ii) **A continuation of volatile capital flows.** Near-zero policy rates in mature markets and continuing hints from the US Federal Reserve over the possibility of more stimulus should conditions warrant have sparked fears in emerging markets of a surge in capital inflows. These inflows can cause large exchange rate fluctuations, affect trade, and ratchet credit growth—leading to asset price bubbles.

(iii) **Worsening investor sentiment amid weakening global growth.** Downside risks to global growth have increased as it remains uncertain whether policies and reforms can break Europe's seemingly vicious cycle of sovereign debt and bank stress. Bleak job prospects and mixed US economic data contribute to doubts over its economic recovery. The fear of a deeper growth slowdown in the PRC has added to dampened investor sentiment.