

Highlights

- The economies of emerging East Asia face a weakened external environment and an increasingly uncertain regional outlook.¹ Uncertainty over policy actions and institutional reforms to resolve the sovereign debt crisis in Europe and mixed data signals from the United States (US) have kept investors on edge. Worries about a larger-than-expected slowdown in the People's Republic of China (PRC) have added to the fears of sharply lower growth in the region.
 - These developments, along with softening external demand, have strengthened the case for regional economies to adopt countercyclical measures to boost domestic demand and investment, including increased issuance of government bonds.
 - Hints of further stimulus measures in mature markets if conditions warrant have sparked fears of fresh capital inflows into emerging East Asian capital markets.
 - Despite the heightened risk and volatility in global markets, emerging East Asia's local currency (LCY) bond markets made impressive gains in the first half of 2012. Total bonds outstanding rose 1.9% quarter-on-quarter (q-o-q) and 8.6% year-on-year (y-o-y) to reach US\$5.9 trillion at end-June. The q-o-q growth of corporate bonds at 3.1% outpaced the 1.3% growth in government debt.
 - Most of the region's LCY government bond yield curves shifted downward in the first half of 2012. But yields edged up in July–August for all tenors in the PRC, Indonesia, and Viet Nam, and for most tenors in Malaysia; Singapore; Thailand; and Hong Kong, China
- as uncertainty in financial markets and the real sector deepened.
- Foreign holdings of local government bonds leveled off in Indonesia in the first half of 2012, but increased in Malaysia and Thailand. Meanwhile, foreign fund inflows into government securities in the Republic of Korea have been volatile in recent months.
 - The risks to the region's LCY bond markets include (i) additional stimulus measures leading to increased government bond issuance, (ii) volatile capital flows, and (iii) worsening investor sentiment as the global economic outlook dims.

Impact of Crisis on Local Bond Markets

Our analysis shows that while the growth of individual bond markets in recent years has been impressive, the threat of financial contagion to emerging East Asia's LCY bond markets from shock and volatility spillovers in mature markets is real.

- Although Asian volatilities are more determined by domestic shocks and volatilities, in some countries the spillovers from the US and European crises remain significant. During the Lehman crisis, shock spillovers affected five Asian countries: the PRC, the Republic of Korea, Malaysia, the Philippines, and Thailand. During the eurozone crisis, the spillover affected three countries: the PRC, Indonesia, and Thailand. The strongest shock spillover effects during the eurozone crisis have been experienced by the PRC.
- The volatility spillovers have had a significant effect in Asia during the eurozone crisis, especially among corporate bond markets in the Philippines and Thailand.

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.

- The “own-shock” persistence in Thailand and the Philippines was stronger during the Lehman crisis than the eurozone crisis; in other countries—Indonesia, the Republic of Korea, Malaysia—the effect of eurozone crisis has been stronger.
- All countries in emerging East Asia have shown significant volatility persistence during the two crises, but volatility in the EU high-yield corporate (financial) bond market resulted in significant volatility persistence only in the PRC, Indonesia, the Republic of Korea, and Malaysia.
- Greater regional participation and cooperation in emerging East Asia’s bond markets are needed to counter the volatility from external shocks and to strengthen regional financial safety nets.