Global and Regional Market Developments

Emerging East Asia has witnessed an outflow of funds following the remarks of United States (US) Federal Reserve Chairman Ben Bernanke on 22 May that US monetary policy could soon be tightened.[2] Assuming that economic conditions do not deteriorate, the Federal Reserve could start tapering its quantitative easing program in late 2013 and end its asset purchases by the middle of 2014. These remarks sparked a sell-off in bond markets in the US, with 10-year bond yields rising from 2.1% at the beginning of June to 2.6% on 8 July. Interest rates have since eased a little, settling at around 2.5% on 19 July, after the Federal Reserve clarified that tapering was not imminent and would remain dependent on economic conditions.

Both the US economic recovery and the expected phasing-out of quantitative easing have had the effect of pushing up bond yields. The key question is whether the Federal Reserve may act too soon in tightening policy. With unemployment still high and inflation low, the fear is that the rise in interest rates could stunt the recovery that is just getting underway.

While the initial trigger for capital outflows from the region may have been the Federal Reserve's announcement that the end of quantitative easing could be near, weaker economic prospects are also now contributing as most of the region's economies are reporting slower growth in 2Q13. In addition, interbank interest rates in the People's Republic of China (PRC) spiked in June as the authorities tried to engineer a slowdown in the rapid expansion of credit. This raised worries that the PRC's growth could also slow considerably, which would have repercussions for other economies in the region. The bond market sell-off in the US has subsequently spread to emerging East Asian markets, with the immediate impact being rising bond yields and depreciating currencies (**Table A**). While the sell-off has affected most bond markets in the region, the impact has not been even across all economies.

[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.

The bond markets in economies where economic fundamentals are weaker, particularly those with current account and fiscal deficits, have been more affected. For example, Indonesia experienced a 225 basis points (bps) increase in its 10-year government bond yield between April and July. Rising inflation and widening fiscal and current account deficits likely contributed to increased risk perceptions in the Indonesian government bond market. Meanwhile, the bond markets of Malaysia and the Philippines, where economic fundamentals are stronger, have shown smaller increases in bond yields.

Even Singapore and Hong Kong, China, which exhibit strong economic fundamentals and are traditionally seen as safe havens in the region, saw their 10-year bond yields rise significantly between April and July. However, in both cases, the increase was from a very low level and the rise in yield was likely due to a reassessment of risk by investors. Singapore's 10-year bonds have been yielding about 50 bps less than US 10-year bonds since the beginning of the year, but the differential has since narrowed to less than 20 bps. Meanwhile, bond yields for the PRC and Viet Nam were also relatively unaffected by the selloff.

The withdrawal of foreign investors also resulted in most of the currencies in the region depreciating against the US dollar. Between April and July, the currencies of Thailand, the Philippines, and Indonesia depreciated 6.6%, 6.4%, and 5.3% against the US dollar, respectively. The renminbi, however, bucked the trend and appreciated against the US dollar over the same period.

Reflecting the more pessimistic outlook for the region, credit default swap (CDS) spreads in the region have been rising, particularly in Indonesia, where the CDS spread increased by almost 60 bps from the beginning of April through the end of July (**Figure A**). Over the same period, there have been increases of around 40 bps in CDS spreads in Malaysia and the PRC. While CDS spreads in most

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	7	74	–	7.9	–
United Kingdom	12	59	(10)	3.3	0.1
Japan	6	23	(9)	13.5	(5.0)
Germany	18	38	(10)	6.2	(3.5)
Emerging East Asia					
China, People's Rep. of	47	16	44	(10.8)	1.3
Hong Kong, China	31	115	11	(1.9)	0.1
Indonesia	279	225	57	(6.6)	(5.3)
Korea, Rep. of	32	68	12	(4.1)	(0.8)
Malaysia	27	63	40	6.3	(4.9)
Philippines	0	44	20	(2.9)	(6.4)
Singapore	(1)	93	–	(2.6)	(2.5)
Thailand	0	41	23	(8.2)	(6.6)
Viet Nam	(13)	(10)	–	(2.8)	(1.1)
Select European Markets					
Greece	(136)	(189)	–	1.8	(3.5)
Ireland	(13)	(27)	(39)	3.7	(3.5)
Italy	(33)	(34)	(38)	7.5	(3.5)
Portugal	74	4	10	(1.7)	(3.5)
Spain	(15)	(45)	(44)	6.5	(3.5)

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 April 2013 and 31 July 2013.
2. For emerging East Asia, a positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currrency against the US dollar.
3. For European markets, a positive (negative) value for the FX rate indicates the depreciation (appreciation) of the local currrency against the US dollar.
Source: Bloomberg LP, Institute of International Finance (IIF), and Thomson Reuters.

European economies have trended downward, there has been a rise in Portuguese spreads as ministerial resignations raised concerns about the Portuguese government's ability to implement its bailout program (**Figure B**). In general, emerging market CDS spreads have widened in recent months as investors are showing reduced appetite for emerging markets bonds (**Figure C**).

Bond yields in the advanced countries have generally risen along with expectations that the Federal Reserve will soon tighten its monetary policy (**Figure D**). Furthermore, a string of good economic news from the US since the announcement has strengthened the likelihood of imminent tightening.

Interest rates have increased across emerging East Asia as capital outflows from the region result in tighter liquidity conditions. While the initial increase was rather large, yields have since fallen somewhat (**Figure E**). Foreign holdings of the region's local currency (LCY) government bonds have leveled off as foreign capital left the region following the rise in US interest rates. Foreign holdings of government bonds in Indonesia are the highest in the region at 31.9% (**Figure F**).

One impact of the turmoil in global financial markets is that it has become harder and more expensive for companies to issue bonds. This is especially the case with foreign currency (FCY) bond issuance. After US$81 billion of issuance in the first 5 months of 2013, FCY bond issuance fell substantially to just US$7.5 billion in June and July. One particular corner of the FCY market that has been badly affected is the high-yield market, which is nearly at a standstill. This represents a major change from the situation at the beginning of the year when high-yield bonds in Asia were popular with global investors hunting for yield in a low-interest-rate environment. The change in the Federal Reserve's stance will likely make it more difficult for Asian companies to issue

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

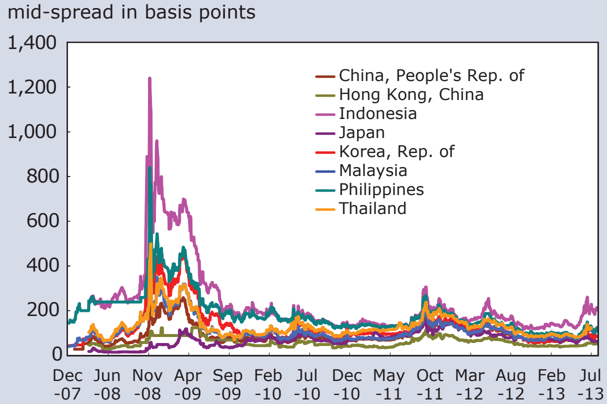


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

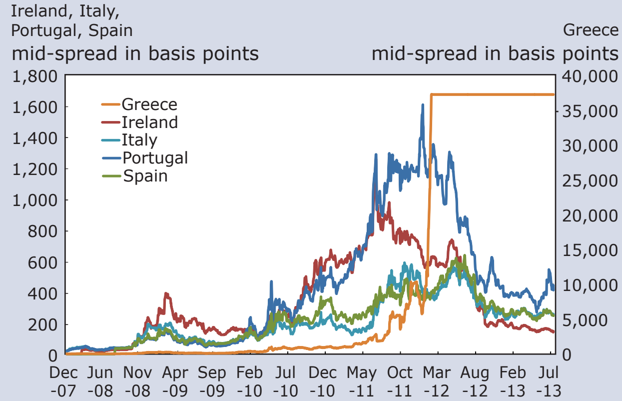


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

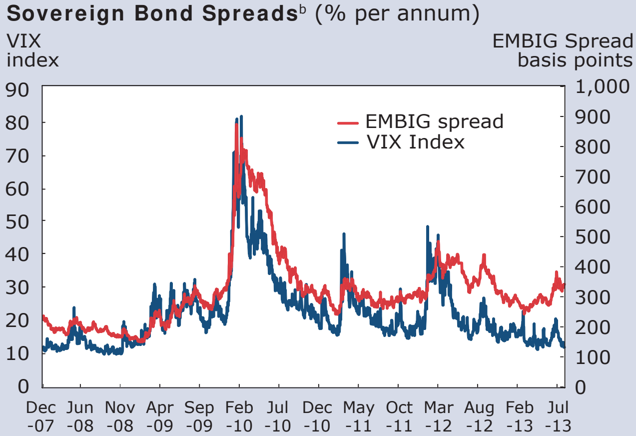


Figure D: 10-Year Government Bond Yields[b] (% per annum)

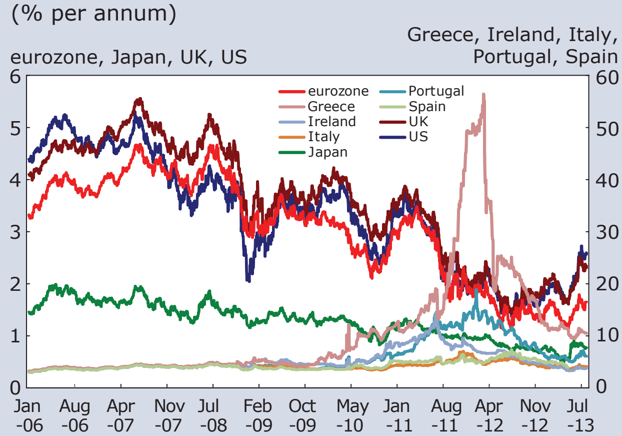


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a,b]

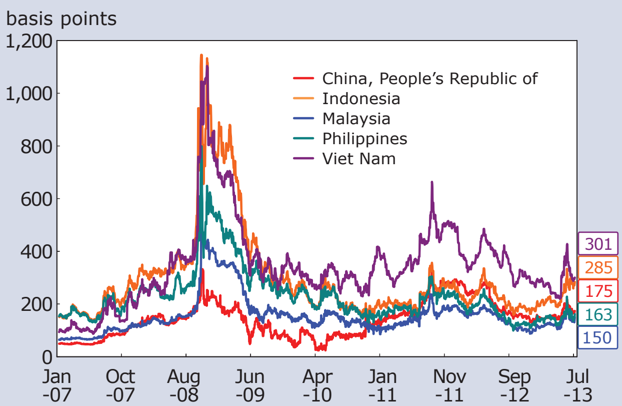
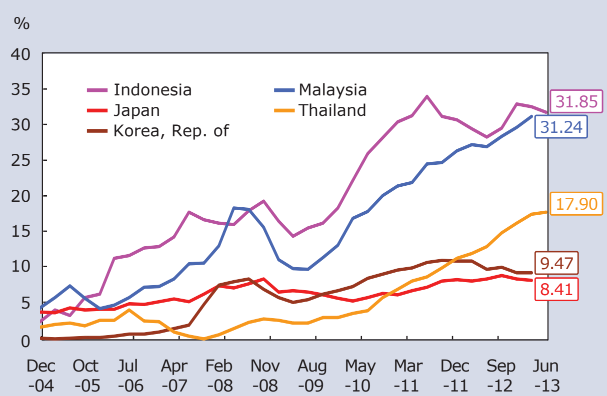


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 end-July 2013.

[c] Data as of end-March 2013 except for Indonesia and Thailand as of end-June 2013.

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

non-investment grade bonds to fund their financing needs. The end of quantitative easing in the US may have less of an impact on the issuance of investment grade bonds and LCY bonds. The yields will be higher, but funding is still likely to be available.

The outflow of funds from the region also highlights the need for authorities to continue to promote more stable sources of funding. Promoting greater intra-Asian holdings of financial assets can help shield the region's financial markets from global financial volatility. However, underdeveloped financial markets combined with differing rules and regulations across economies have made it unduly difficult for the region's investors to make intra-regional investments. Instead, they prefer to park their funds in more liquid and developed financial markets. Collective efforts by the region's governments—such as the Asian Bond Markets Initiative (ABMI) and ASEAN+3 Bond Market Forum (ABMF)—can be further strengthened to facilitate greater intra-regional bond investment in emerging East Asia.

The recent sell-off in regional bond markets brings back memories of previous crises in emerging East Asia. However, financial systems in the region are more resilient this time around. One key difference is that the growing use of LCY bonds means that Asian financial markets are no longer plagued by the problem of currency mismatches. During the 1997/98 Asia financial crisis, currency depreciations meant that government and corporate financial conditions worsened as FCY-denominated liabilities grew. Today, with the vast proportion of debt denominated in LCY, there is less prevalence of currency mismatches. For most economies, LCY bonds account for more than 90% of total bonds. However, in Indonesia and the Philippines, FCY-denominated bonds account for more than 30% of total bonds outstanding.

In spite of the reduced risk from currency mismatches, other risks to the region's LCY bond markets have increased:

The region's interest rates could rise further once the Federal Reserve starts to tighten policy. So far, the rise in US interest rates has been driven by anticipation of the end of quantitative easing operations. When the Federal Reserve actually starts reducing its purchase of securities, US interest rates, which remain at historically low levels, could rise further and lead to another round of increases in bond yields for the region's markets.

Growth momentum in the region has been weakening. Most of the region's economies have reported slower growth in 2Q13. The PRC's growth has been revised downward as it seeks to slow the rapid pace of credit expansion, especially in the shadow banking sector. This has dampened imports from other regional economies for which the PRC is a large and important export market. Other economies in the region are also facing tighter liquidity conditions and higher interest rates as foreign inflows have dried up. Growth in the region had been fueled by the easy availability of credit, which will now become more restricted. Rising levels of corporate indebtedness also suggest that the impact of higher interest rates on the economy may be intensifying.

Continued outflows of funds could result in vulnerable economies raising interest rates to prop up currencies. The Asian markets most affected by the recent sell-off have been India and Indonesia. Foreign investors are concerned about rising current account deficits and weak fiscal conditions in both economies. Other economies facing deteriorating external and fiscal conditions could also face a withdrawal of funds by foreign investors. So far, most policymakers have been allowing their currencies to slide without much intervention, which has helped them to preserve their foreign exchange reserves. Authorities should be cautious about raising interest rates to defend their currencies. It may not have the impact of restoring investor confidence and encouraging inflows, and would likely worsen growth prospects.