forward a set of proposals for economic reform but implementation of these proposals remains difficult. 2016 will be a testy year for Latin American countries.

Due to economic sanctions imposed by the US and the EU, the Russian ruble has fallen most sharply against the US dollar among all E11 currencies in 2015. The EU announced on December 21, 2015 to extend economic sanctions on Russia by six months to the end of July 2016 and the scope of sanctions covers energy, finance and defense. Soon the US Treasury Department announced expansion of sanctions against Russia, adding 34 Russian companies and individuals from financial, military and energy sectors to the list of sanctions. Because economic sanctions will continue, the Russia ruble is forecast to still perform poorly in the foreign exchange markets.

Some countries with fixed foreign exchange rate regimes were also under pressure of devaluation. Saudi Arabia is the only one among the E11 that adopted a peg to the US dollar. Saudi Arabia has adopted such a fixed foreign exchange rate regime for more than 30 years, which has played a positive role in stabilizing its domestic prices and fiscal revenues. However, as oil prices dropped, the country's trade surplus and fiscal revenues decreased substantially at the same time. Forward contracts on the exchange rate between the Saudi riyal and the US dollar began to climb, putting the country's monetary authorities under huge pressure of devaluation.

Among emerging economies beyond the E11, the case of Venezuela is a lesson for reference. Venezuela is an oil-producing country and oil exports account for 96% of its revenues of foreign exchange. Since March 2013, the country's official foreign exchange rate had been fixed at the level of 6.284 bolivar for 1 US dollar, while supplementary foreign exchange rate (approved by the government) and marginal foreign exchange rate (a freely floating one determined by the market) are also allowed to exist. Because of mounting domestic economic pressures, the cost for Venezuela to defend its official foreign exchange rate has soared rapidly. In February 2016, President Maduro announced that the official foreign exchange rate was adjusted to 10 bolivar for 1 US dollar, a once-off devaluation of 59%.

If the US economy and commodities prices can maintain stable in 2016, the devaluation pressure caused by deteriorating external economic situations may ease for the E11 economies. However, as a result of dim growth prospect, political tensions at home and abroad, domestic inflation, risk aversion and downgraded sovereign ratings, the E11 currencies still face the risk of huge fluctuations in the foreign exchange markets, and even currency crisis is possible.

9.2 Unignorable Risks in the Treasury Bond Markets

This section will analyze the performance of the E11's treasury bond markets. Since 10-year treasury bonds are a kind of treasury bonds with adequate liquidity, the change of their yields can reflect the capital market's risk preference and investors' expectation on economic growth and liquidity. This section will focus on the yields of 10-year treasury bonds and give a brief analysis of the characteristics of the yields.

9.2.1 Divergence of Treasury Bond Yields

Divergence of the E11's 10-year treasury bonds had become obvious in 2015.[1] The first characteristic of such divergence is on the gap in the absolute level of yields. The yields of 10-year treasury bonds issued by the E11 economies can be divided into two categories along the level of 5%. China, Korea and Mexico were three E11 economies that have long kept the yields on their 10-year treasury bonds below 5%. In Brazil, Indonesia, Turkey, South Africa, Russia and India, those yields have continuously stayed above 5%. Among them, Brazil and Turkey had seen the highest yield level as their yields on 10-year treasury bonds stood at 16.49% and 10.47% respectively in December 2015.

The second characteristic of such divergence is the different trends in the movement of yields on the E11's 10-year treasury bonds in 2015. One of the E11 economies (India) had maintained relatively stable treasury bond yields. The yield on India's 10-year treasury bond had moved narrowly around the level of 7.75% in 2015. Three of the E11

1 Because Argentina and Saudi Arabia' 10-year treasury bonds data are not available, this section will analyze the market performance of the 10-year treasury bonds of only 9 economies of the E11.

economies had seen their treasury bond yield declining. China's 10-year treasury bond yield sliced from 3.47% in January 2015 to 2.95% in December while the yield in Korea dropped from 2.41% in January to 2.18% in December and that in Russia went down from 13.22% in January to 9.55% in December. Five of the E11 economies (Turkey, Brazil, South Africa, Indonesia and Mexico) saw a significant rise in the yields on their 10-year treasury bonds. Among them, Turkey had witnessed the steepest rise, followed by Brazil and South Africa. The yield on Turkey's 10-year treasury bond soared from 6.99% in January to 10.47% in December, an increase of 50%. The yields on Brazil and South Africa's 10-year treasury bonds climbed from 11.97% and 7.07% in January to 16.49% and 9.74% in December respectively, up 38% both (See Figure 9.6). Besides, the yield on Mexico's UDIBONOS 10-year treasury bond was 3.27% in December 2015, which, though still low, had increased considerably, up 30% from the beginning of that year.

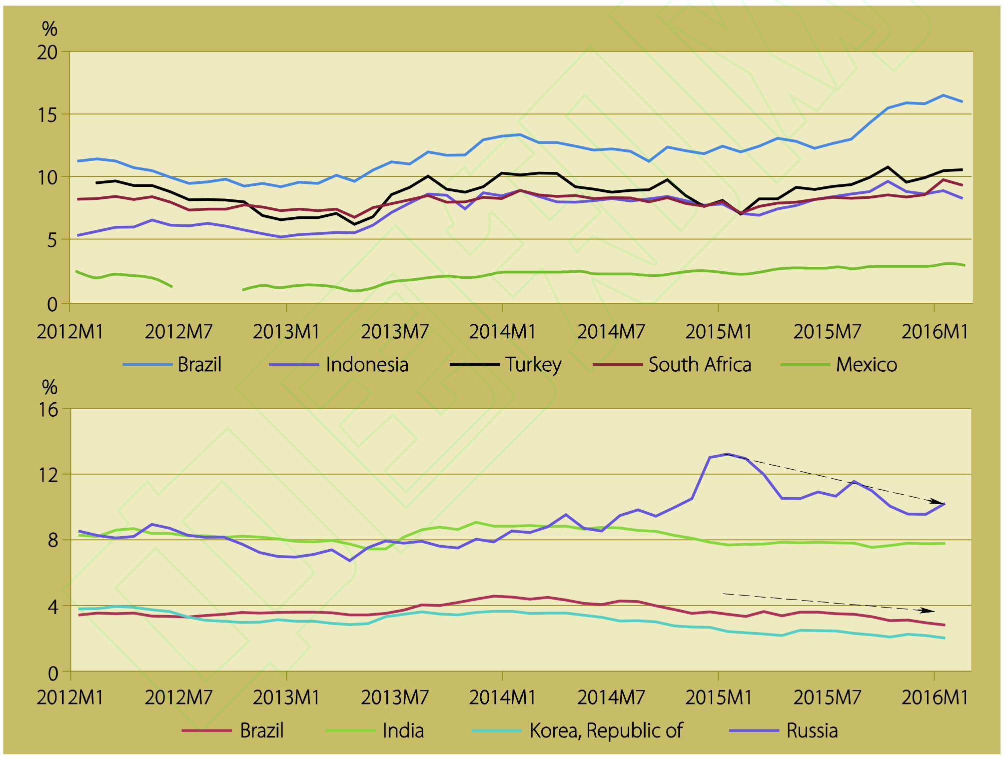

Figure 9.6 The yields on 10-year treasury bonds of the E11 between 2012 and 2015

Note: Argentina and Saudi Arabia's data are not available, so are Turkey's data for Jan. 2012 and Mexico's data between Jul. and Sept. 2012.

Source: CEIC, Wind, Jan. 2016.

The popularity of the G7 treasure bonds in the market had been improved in 2015 and the yields on their 10-year treasury bonds stayed relatively low. Among the G7, the US saw the highest yield on 10-year treasury bonds, followed by the UK, Italy and Canada. In December 2015, the yields on 10-year treasury bonds were 2.24%, 2.01%, 1.58% and 1.39% respectively in the US, the UK, Italy and Canada. The yields on 10-year treasury bonds were all lower than 1% in 2015 in France, Germany and Japan and that in Japan was only 0.27% in December (See Figure 9.7).

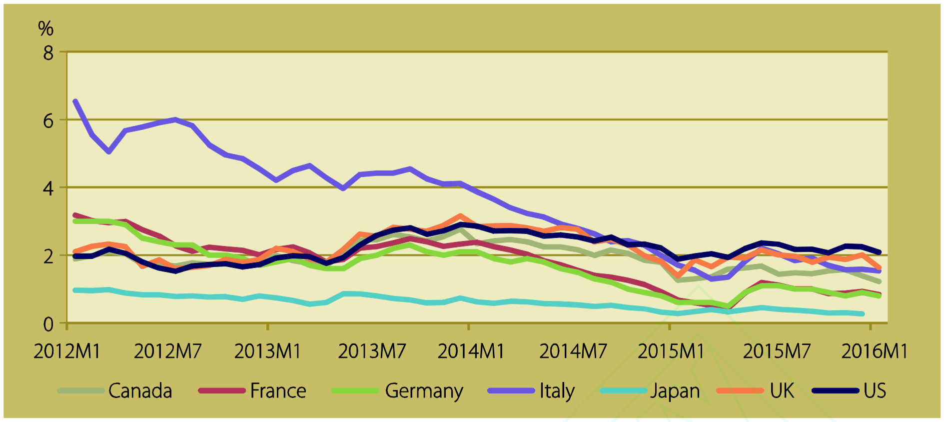

Figure 9.7 The yields on the G7 10-year treasury bonds

Source: CEIC, Jan. 2016.

9.2.2 The Main Factors behind the Change of Yields on Treasury Bonds

1) The effect of economic fundamentals

The market performance of 10-year treasury bonds as a kind of middle and long-term asset reflects investors' basic judgment about economic fundamentals in the future. India's GDP growth exceeded 7% for the first time in 2014 and the country maintained its growth momentum in 2015. Such sound economic growth helped ensure relative stability of the yields on India's treasury bonds. Besides, because the level of inflation and the change of interest rates can directly affect the relative change of the return of investment in treasury bonds, they are often positively correlated to the yields on treasury bonds. Korea, China and Mexico are the three E11 economies that boast lower-than-5% yields on their 10-year treasury bonds. Inflation in these three countries remained relatively low, standing at 0.7%, 1.5% and 2.8% respectively in 2015. Inflation was generally high in those E11 economies that had seen a rise in the yields on their 10-year treasury bonds in 2015, such as Turkey, Brazil, South Africa, Indonesia and Mexico. According to estimates by IMF, inflation in Brazil and Turkey reached 8.9% and 7.4% in 2015.

Compared to the foreign exchange market and the stock market, 10-year treasury bonds are usually deemed as a typical kind of safe asset. When there are fierce fluctuations in other financial makers or the prices of other financial products, the demand for treasury bonds will soar to push up prices for treasury bonds or bring down the yields on treasury bonds. For instance, the roller coaster of China's stock market has pushed more funds into the treasury bond market, leading to a rise in the price of China's 10-year treasury bonds. However, compared to open economies, those economies who are not fully open would have been less influenced.

2) The impact of sovereign rating

The adjustment of sovereign rating can cause over-reaction in the bond market. Because sovereign rating demonstrates one country's payment ability and fiscal burden, it is often used by international investors as a basic guidance for their investment. The performance of the E11's treasury bond markets in 2015 showed that international rating agencies' sovereign ratings had exerted huge influence on the market prices of 10-year treasury bonds and sometimes even caused over-reaction in the markets.

The sovereign ratings of Brazil, Russia and Turkey were degraded by Standard & Poor's in 2015. Brazil's sovereign rating had been lowered twice in July and September of 2015. Standard & Poor's degraded Brazil's sovereign rating to junk rating BB+ and gave a negative rating outlook (See Table 9.1). This change triggered an accelerated flight of international funds and immediately brought down the prices of Brazil's bonds. Similar case also happened in Russia. When Russia's sovereign rating was lowered to BBB in December 2014, the yields on its treasury bonds had climbed up rapidly since the end of 2014, rising from 9.96% in October 2014 to 13.22% in January 2015. Such a change had led to further deterioration of Russia's economic fundamentals to propel Standard & Poor's to degrade its sovereign rating again to BBB- on

January 26, 2015. As panic among investors has been eased, the yield on Russia's 10-year treasury bonds in 2015 gradually returned to the level in the third quarter of 2014.

Table 9.1 The latest change of sovereign ratings of the E11 and the G7 economies

Country	Latest Rating	Latest Rating Date	Change Direction	Last Rating	Last Rating Date
E11					
Argentina	CCC+	2013/9/10	down	B-	2012/11/5
Brazil	BB+	2015/9/9	down	BBB-	2015/7/28
China, People's Republic of	AA-	2010/12/16	up	A+	2008/7/31
India	BBB-	2012/4/25	unchanged	BBB-	2010/3/18
Indonesia	BB+	2015/5/21	unchanged	BB+	2013/5/2
Korea, Republic of	AA-	2012/9/13	up	A+	2001/11/13
Mexico	A	2013/12/19	up	A-	2013/3/12
Russia	BBB-	2015/1/26	down	BBB	2014/12/23
Saudi Arabia	A+	2015/10/30	down	AA-	2015/2/9
South Africa	BBB+	2015/12/4	unchanged	BBB+	2014/6/13
Turkey	BBB-	2015/5/8	down	BBB	2014/2/7
G7					
Canada	AAA	1992/10/14			
France	AA	2013/11/8	down	AA+	2012/1/13
Germany	AAA	2012/1/13	unchanged	AAA	2011/12/5
Japan	A+	2015/9/16	down	AA-	2011/4/26
Italy	BBB-	2014/12/5	down	BBB	2013/7/9
UK	AAA	2015/6/12	unchanged	AAA	2014/6/13
US	AA+	2013/6/10	unchanged	AA+	2011/8/5

Note: The figure showed the ratings on default by issuers of long-term bonds denominated in local currency.

Source: Standard & Poor's, Jan. 2016.

9.2.3 Review and Forecast

The E11 economies performed differently in the treasury bond markets in 2015. Due to the shock of falling oil prices, some oil-exporting countries faced both economic stagnation and inflation. Such changes had added to the pessimism of investors. The performance of those oil-exporting countries among the E11 in the treasury bond markets was worrying: the yields on their 10-year treasury bonds were either quite high or rising rapidly.

The E11's treasury bond markets might continue to fluctuate in 2016. Though the yields on some E11 economies' 10-year treasury bonds are already relatively high, issuing bonds will still be an important way for their governments to raise funds to overcome economic difficulties when economic growth is disappointing and financial resources are limited. But it is indeed possible that such an activity will make the performance of their treasury bonds in the market even worse. The double whammy of plunging oil prices and economic sanctions imposed by the US and the EU had seriously limited Russia's channel of financing. The Russian authorities had responded by issuing bonds not denominated in the US dollar. In November 2015, the Russian central bank announced that Moscow Exchange will issue the first Russian treasury bond denominated in Chinese yuan in the middle of 2016, and the total will be about 6.4 billion yuan (64.8 billion ruble) and preferred subscribers are large investors from the China. In addition, China and Korea also reached a consensus on Korea issuing yuan-denominated