Emerging East Asian Local Currency Bond Markets: A Regional Update

Highlights

Bond Market Outlook

Emerging East Asian local currency (LCY) bond markets have regained their bounce as bond yields have fallen for most markets in recent months, shrugging off the impact of the tapering of asset purchases by the United States (US) Federal Reserve.[1] As economic conditions in the US point to a recovery, tapering is expected to proceed as planned. This may result in tighter liquidity conditions for the region's bond markets in the coming months.

Risks to the region's LCY bond markets have eased as investors' risk appetite returns. The risks to the region's outlook include (i) a potential slowdown in the People's Republic of China's (PRC) economy, (ii) market turmoil generated by Federal Reserve tapering and uncertainty over the timing of its policy rate hike, and (iii) volatile capital flows that might arise should the European Central Bank (ECB) address the potential threat of deflation in the eurozone.

LCY Bond Market Growth in Emerging East Asia

The outstanding size of the emerging East Asian LCY bond market reached US$7.6 trillion at end-March, up 2.1% quarter-on-quarter (q-o-q) and 9.5% year-on-year (y-o-y). The PRC accounted for about two-thirds of the quarterly growth in 1Q14. The PRC's LCY bond market remained the largest in the region, with an outstanding size of US$4.7 trillion at end-March, which is equivalent to 61.5% of the total emerging East Asian LCY bond market. Meanwhile, Viet Nam was the fastest growing LCY bond market in emerging East Asia in 1Q14 on a q-o-q basis at 23.0%. However, its contribution only accounted for 4.3% of the region's quarterly growth.

While growth in the region's LCY bond market remained positive in 1Q14, the pace of growth slowed on both a q-o-q and y-o-y basis. This slowdown may have been due to uncertainties over Federal Reserve tapering, which began in January, and eventual interest rate hikes. While most markets priced in the effects of tapering during the second half of last year, expectations of a subsequent rise in US interest rates have posed a drag on LCY bond market growth in the region.

The region's government bond market expanded 2.2% q-o-q and 8.0% y-o-y in 1Q14 to reach US$4.6 trillion at end-March, while corporate bonds grew 1.9% q-o-q and 11.7% y-o-y to reach US$3.1 trillion. Government bonds continued to dominate the region's LCY bond market, accounting for 60% of total LCY bonds outstanding in 1Q14.

As a percentage of gross domestic product (GDP), the emerging East Asian LCY bond market was relatively stable in size at 58.4% in 1Q14, compared with a share of 58.2% in the previous quarter.

In 1Q14, emerging East Asian LCY bond issuance totaled US$851 billion, up 7.1% q-o-q, but down 8.2% y-o-y. LCY government bond issuance reached US$570 billion, while new LCY corporate debt hit US$281 billion in 1Q14.

Structural Developments in LCY Bond Markets

The share of foreign holdings in emerging East Asian LCY government bond markets recovered in 4Q13 in most markets. Foreign investor interest in Indonesian government bonds continued to rise as the share of foreign holdings climbed to 33.6% at end-March from 32.5% at end-December on positive market sentiments amid improving macroeconomic fundamentals.

The shares of foreign holdings of LCY corporate bonds in Indonesia and the Republic of Korea were both significantly lower compared with government bonds. This may be due to the highly illiquid nature of corporate bonds in Indonesia and the Republic of Korea, where most investors tend to buy and hold until maturity.

Emerging East Asian LCY bond markets were attractive to foreign investors in 1Q14 as investors' risk appetite returned and net foreign bond inflows resumed following the outflows experienced in the second half of 2013.

[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.

LCY Bond Yields

Between end-December 2013 and end-April 2014, most government bond yield curves in the region shifted downward, except in the Philippines were the yield curve rose. The fall in yields for most markets was driven by both domestic and external factors.

The yield spread between 2- and 10-year government bonds fell in most markets, reflecting the possibility that the region's economies were at risk of slowing due to weaker growth in the PRC and deflation in the eurozone.

Box: Bond Market in Kazakhstan—Developments and Challenges

Kazakhstan's LCY bond market has grown at a rapid pace from only US$15.8 billion at end-2006 to US$55.2 billion at end-March 2014. In contrast to emerging East Asia, where government bond markets tend to be bigger, Kazakhstan's corporate sector dominates its bond market, accounting for nearly two-thirds of total LCY bonds at end-March.

In 1Q14, the size of Kazakhstan's LCY bond market rose 4.4% q-o-q and 13.6% y-o-y. Outstanding fixed income securities issued by Kazakhstan's central government and central bank reached US$20 billion, while outstanding corporate bonds stood at US$35 billion.

The current challenges in Kazakhstan's LCY bond market include the high costs of issuing bonds, the lack of a liquid secondary market, and underdeveloped bond market infrastructure. At the same time, there is strong interest among the public and private sectors in further developing the *sukuk* (Islamic bond) market in Kazakhstan and in promoting bonds as an alternative source of funding for companies.