Asia Bond Monitor Highlights

ADB

Bond Market Outlook

Emerging East Asian bond markets remained relatively stable in 4Q13 amid the financial turmoil swirling in emerging markets.[1] However, global liquidity is likely to tighten as the United States (US) Federal Reserve is expected to continue tapering its monthly asset purchases. Bond yields in the region have risen since the tapering began in December 2013, and could rise further in the months ahead.

Emerging East Asian exchange rates have been adversely affected by the sell-off, but on a much smaller scale than in other emerging markets due to strong economic fundamentals and stable domestic financial systems.

Risks to the region's local currency (LCY) bond markets have increased. Specifically, the risks are (i) potential vulnerability to contagion effects, (ii) tighter liquidity conditions and rising inflation putting upward pressure on bond yields, and (iii) economies with high levels of foreign currency (FCY)-denominated debt being vulnerable to the impacts of currency depreciation.

LCY Bond Market Growth in Emerging East Asia

The LCY bond market in emerging East Asia ended 2013 with outstanding bonds totaling US$7.4 trillion, up 2.4% from the previous quarter and 11.7% from a year earlier. As a share of the region's gross domestic product (GDP), the bond market stood at 56.5% in 4Q13, up from 56.2% in the previous quarter. In terms of bond market growth, Viet Nam recorded the most rapid quarter-on-quarter (q-o-q) expansion in 4Q13 at 14.8%, while Indonesia posted the highest year-on-year (y-o-y) growth rate at 20.1%. The amount of LCY bonds outstanding in the People's Republic of China (PRC) remained the largest in emerging East Asia, accounting for 61% of the region's total at the end of the year.

[1] Emerging East Asia refers to the People's Republic of China; Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.

The region's corporate bond market recorded growth rates of 3.0% q-o-q and 19.7% y-o-y in 4Q13, surpassing growth rates in the government bond market of 2.0% q-o-q and 7.2% y-o-y. The fastest-growing corporate market in the region on a q-o-q basis was the Philippines at 8.7%, while on a y-o-y basis the PRC led all corporate bond markets with growth of 31.3%. For government bonds, the highest q-o-q growth rate was recorded in Viet Nam at 15.4%, and the highest y-o-y growth rate was in Indonesia at 20.9%.

In 4Q13, LCY bond issuance in emerging East Asia amounted to US$733 billion, down 13.5% from 3Q13 and 6.9% from 4Q12, due mainly to lower government bond sales. National governments and central banks and monetary authorities raised US$518 billion from LCY bond sales, down 23.4% from the previous quarter and 6.0% from a year earlier. Meanwhile, emerging East Asian LCY corporate bond issuance had a mixed performance in 4Q13, rising 25.3% q-o-q but falling 8.9% y-o-y to level off at US$216 billion.

Structural Developments in LCY Bond Markets

Government bonds are concentrated in medium- to long-term tenors in most emerging East Asian markets, particularly in the PRC, Indonesia, Malaysia, the Philippines, and Singapore. In contrast, short-term government bonds (maturities of 1 year to 3 years) are relatively popular in Hong Kong, China; the Republic of Korea; Thailand; and Viet Nam; where they comprise at least 40% of total government bonds outstanding.

For corporate bonds, 5- to 10-year tenors are dominant in most emerging East Asian markets, including the PRC, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.

Foreign holdings of the region's LCY government bonds remained relatively stable in 4Q13. The share of foreign holdings of total government bonds outstanding in Indonesia remained the highest in the region at 32.5% at end-December 2013, followed by Malaysia at 29.4%. However, in 3Q13, the share of foreign holdings of government bonds in Japan, the Republic of Korea, and Thailand declined slightly.

LCY Bond Yields

Government bond yields rose for most tenors in most emerging East Asian markets between end-June 2013 and end-December 2013 due in part to expectations of tapering by the Federal Reserve of its asset purchase program. Yield hikes during this period were most pronounced in the PRC, Indonesia, and Malaysia. Domestic conditions contributed to much of the increase in yields in the PRC and Indonesia.

In January 2014, government bond yields rose further in most markets except the PRC and Viet Nam where yields fell for all tenors. Yields rose the most in Indonesia and the Philippines.

Yield spreads between 2- and 10-year government bonds widened in most emerging East Asian economies between end-June 2013 and end-January 2014, as yields rose more at the longer-end of the curve.

Special Section: *Sukuk* in Emerging East Asia

The global *sukuk* market continued to post robust growth in 2013, having risen from only US$14.8 billion in 2001 to US$281.3 billion at the end of 2013. Malaysia is the largest *sukuk* market in emerging East Asia, accounting for nearly 60% of outstanding global *sukuk*.[2]

Sukuk issuance remained strong in the region in 2013, with total issuance reaching US$91.7 billion for the year. Malaysia was the most active issuer with US$83.7 billion in new *sukuk* issuance, as Malaysia is seeking to develop itself as an offshore *sukuk* center for other countries. There has been interest from foreign issuers to issue MYR- and CNH-denominated *sukuk* in Malaysia.

Emerging East Asia (excluding Malaysia) accounts for only 6.0% of the world's outstanding *sukuk*. Indonesia, Singapore, and Brunei Darussalam have established *sukuk* markets, but these markets lack the size and depth of the Malaysian market. Other markets like Hong Kong, China and Thailand have introduced regulations to develop Islamic finance.

Sukuk have great potential as a source of financing for infrastructure projects since the financing for such projects can easily be adapted to accommodate *sukuk*. Malaysia has already used *sukuk* to finance several large infrastructure projects, although the practice has yet to gain popularity outside Malaysia.

Governments face challenges in enacting the needed regulatory framework to make *sukuk* a viable alternative to conventional bonds. These challenges include standardizing *sukuk* structures, promoting price transparency, and harmonizing tax treatment for conventional bonds and *sukuk*.

[2] In the special section: Sukuk, data for emerging East Asia also include Brunei Darussalam.