Asia Bond Monitor Highlights

Bond Market Outlook

The continued improvement in global economic prospects helped drive yields lower in most markets in emerging East Asia amid positive investor sentiment.[1] Between 1 March and 15 May, yields for both 2-year and 10-year government bonds declined in most emerging East Asian markets.

Among all bond markets in emerging East Asia, Indonesia experienced the largest decline in yields during the review period, driven by positive investor sentiment and an expected credit rating upgrade from Standard and Poor's (S&P) Global Ratings.[2]

While there was a slowdown in the United States (US) economic growth in the first quarter (Q1) of 2017, the Federal Reserve expects this to be temporary.

Economic growth is also picking up in other developed economies. The European Central Bank upgraded its 2017 forecasts for growth and inflation. The latest forecasts from the International Monetary Fund and Asian Development Bank both show better global growth prospects.

Financial stability has improved as evidenced by declines in emerging East Asia's credit spreads. Foreign capital flows in emerging East Asia have also recovered.

Despite improved financial stability and receding risks for emerging East Asia's bond markets, a number of risks remain, including tightening global liquidity conditions and the vulnerability of financial markets to cyberattacks.

This issue of the *Asia Bond Monitor* includes two special discussion boxes. Box 1 discusses the risks to emerging Asia's financial stability under tightening global liquidity conditions. Box 2 discusses cybersecurity and financial stability.

Local Currency Bond Market Growth in Emerging East Asia

Emerging East Asia's local currency (LCY) bond market continued to expand in Q1 2017, with outstanding bonds reaching USD10,513 billion at the end of March. A slowdown in the People's Republic of China's (PRC) bond market expansion, however, dragged down the region's overall growth.

In terms of size, the PRC remained the largest LCY bond market in the region, representing a 68.9% share of emerging East Asia's aggregate bond stock. The PRC's bond market growth slowed in Q1 2017 amid rising credit concerns and the government's associated deleveraging efforts.

The LCY bond market in emerging East Asia mainly comprises government bonds, which amounted to USD6,819 billion and represented a 64.9% share of the region's total bond stock at the end of March. The corporate bond segment reached USD3,694 billion and accounted for the remaining 35.1% share.

As a share of gross domestic product (GDP), emerging East Asia's bond market was the equivalent of 68.5% of the region's GDP at the end of March, marginally lower than 68.9% at the end of December. The Republic of Korea remained the market with the largest share of LCY bonds to GDP at 126.5%.

LCY bond issuance in emerging East Asia was lower at USD852 billion in Q1 2017 versus USD946 billion in the prior quarter, due largely to a decline in issuance from the PRC.

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[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.
[2] On 19 May, S&P Global Ratings raised Indonesia's sovereign credit rating to investment grade.

Structural Developments in Local Currency Bond Markets

Offshore holdings of LCY government bonds rose in Q1 2017 for most emerging East Asian markets where data are available. Investor sentiment turned positive amid an improving global economic outlook in most developed markets.

The largest gain was noted in Indonesia where the foreign holdings' share climbed to 38.2% at the end of March amid positive investor sentiment on the back of improved macroeconomic and financial conditions, and an expected upgrade from S&P.

The foreign holdings' share also climbed in Thailand, gaining 0.6 percentage points to reach 14.7% at the end of March. The only exception to this trend was Malaysia as foreign investors shed their holdings of government bonds by 6.6 percentage points during the review period.

In Q1 2017, foreign capital flows were positive in all four markets for which data are available except for Malaysia. In April, however, Malaysia posted an inflow into its bond market after 5 consecutive months of capital outflow.

Local Currency Bond Yields

LCY government bond yields fell between 1 March and 15 May for most tenors in most markets in emerging East Asia on the back of improved investor sentiment. The PRC was notable as it was the only market whose entire yield curve shifted upward due to rising credit concerns and the government's efforts to deleverage to reduce risk. The Philippines had a rise in most yields due to increased concerns about inflation.

The 2-year versus 10-year yield spread fell for all markets except in the Republic of Korea, the Philippines, and Thailand.

Theme Chapter: Do Local Currency Bond Markets Enhance Financial Stability? Some Empirical Evidence

It has long been argued that LCY bond markets enhance financial stability in developing markets. In particular, LCY bond markets that offer bonds of varying maturities can mitigate the double (currency and maturity) mismatch problem that lay at the heart of the 1997/1998 Asian financial crisis.

The theme chapter empirically investigates the role of LCY bond markets in enhancing financial stability in developing markets. This research analyzes and compares the financial vulnerability of developing economies during two episodes of financial stress: the Global Financial Crisis and the so-called "Taper Tantrum."

Empirical evidence shows that economies with a greater expansion in between the two episodes experienced less currency depreciation, which is a measure of financial vulnerability, during the "Taper Tantrum." This evidence indicates the stabilizing role of LCY bond markets. However, there is no evidence of a stabilizing effect for stock market development.

This study provides quantitative evidence to the notion that LCY bond markets protect the financial systems of developing economies by mitigating external shocks.