

Executive Summary

Recent Developments in Financial Conditions in Emerging East Asia

Financial conditions in emerging East Asia have remained stable amid uncertainty over the future monetary stance of the United States (US) Federal Reserve.¹ Between 1 March and 2 June, regional equity markets and currencies slightly weakened, while risk premiums narrowed overall. Local currency (LCY) bond yields declined as inflationary pressure eased and regional central banks moderated their monetary tightening pace. The banking sector turmoil in the US and Europe has had limited impact on regional financial markets thus far.

Concerns over financial stability and elevated inflation generated uncertainty over the Federal Reserve's future monetary stance. While markets expected a pause in rate hikes at the June Federal Open Market Committee meeting, uncertainties persist over future monetary policy actions. In addition, the US debt ceiling negotiations in May raised some market concerns but had minimal impact on regional financial conditions. Amid these uncertainties, equity markets in the region posted a 1.7% (simple average) and 3.0% (market-weighted average) decline during the review period. Currencies slightly weakened by 0.7% (simple average) and 2.4% (gross-domestic-product-weighted average) against the US dollar, while risk premiums, as proxied by credit default swap spreads, slightly narrowed by 4.1 basis points (bps) (simple average) and 7.3 bps (gross-domestic-product-weighted average).

Emerging East Asian LCY government bond yields fell in nearly all markets as inflation trended downward and regional central banks slowed their monetary tightening. Most central banks in the region have moderated the pace of rate hikes, posting a total increase of 225 bps from eight rate hikes across the region between 1 January and 2 June. This contrasts with a total increase of 850 bps from 19 rate hikes between 1 August and 31 December 2022. The State Bank of Vietnam was the

first regional central bank that reversed its monetary policy in 2023 by lowering the key policy rate by 50 bps in April, May, and June. Between 1 March and 2 June, 2-year and 10-year bond yields across emerging East Asia fell by an average of 36 bps and 44 bps, respectively.

Between 1 March and 2 June, the equity markets of members of the Association of Southeast Asian Nations (ASEAN) recorded net capital outflows of USD1.7 billion. However, equity markets across the entire region recorded net capital inflows of USD5.5 billion, driven by USD3.8 billion of net inflows in the People's Republic of China (PRC) owing to its economic rebound and USD3.4 billion of net inflows in the Republic of Korea on easing foreign investor restrictions. Regional LCY bond markets posted net foreign inflows of USD3.2 billion in March–April, buoyed by net inflows in the Republic of Korea and ASEAN economies, while the PRC recorded net outflows of USD5.7 billion on less attractive yields resulting from its accommodative monetary stance.

Regional financial conditions may continue to be affected by heightened uncertainty over the future path of US monetary policy. Other uncertainties over the short term include various headwinds to the global economic outlook, inflation and monetary policies at the domestic level, heavier debt burdens, and decrease in asset values due to higher interest rates. Emerging East Asian markets need to monitor debt sustainability and financial stability in an era of higher interest rates. Climate-related risks will further affect pricing and valuations in the financial sector over the medium term.

Recent Developments in Local Currency Bond Markets in Emerging East Asia

Emerging East Asian LCY bond market reached a size of USD23.8 trillion at the end of March, on growth of 2.2% quarter-on-quarter (q-o-q) in the first quarter (Q1)

¹ Emerging East Asia is defined to include member states of the Association of Southeast Asian Nations (ASEAN) plus the People's Republic of China; Hong Kong, China; and the Republic of Korea.

of 2023, up from 1.2% q-o-q in the fourth quarter (Q4) of 2022. Growth was largely driven by increased issuance from the public sector. Government bonds accounted for 61.9% of the region's outstanding LCY bonds at the end of March. The growth of government bonds inched up to 2.6% q-o-q in Q1 2023 from 2.0% q-o-q in Q4 2022. Corporate bonds, which accounted for 35.8% of regional LCY bonds outstanding at the end of March, posted modest growth of 1.6% q-o-q in Q1 2023 following a contraction of 0.1% q-o-q in Q4 2022. At the end of March, aggregate outstanding LCY bonds in ASEAN stood at USD2.1 trillion, accounting for 9.0% of emerging East Asian LCY bonds outstanding.

LCY bond issuance in emerging East Asia tallied USD2.3 trillion in Q1 2023, with growth rebounding to 6.2% q-o-q from a contraction of 6.1% q-o-q in Q4 2022. Government bonds, which accounted for 43.0% of the regional issuance total, climbed by 12.4% q-o-q in Q1 2023, reversing a decline of 9.4% q-o-q in Q4 2022, as a number of governments frontloaded issuance during the quarter. In contrast, corporate bond issuance continued to contract, but at a moderated pace of 1.2% q-o-q in Q1 2023 compared with 4.1% q-o-q in Q4 2022, partly driven by higher interest rates. Aggregate issuance in ASEAN economies reached USD511.9 billion, representing 21.9% of the region's issuance during the quarter.

Emerging East Asian government bonds outstanding and issuance remained concentrated in medium- to long-term tenors in Q1 2023. Treasuries with maturities of over 5 years accounted for 53.4% of regional LCY government bonds outstanding at the end of March, while the size-weighted average maturity of all LCY government bonds in emerging East Asia was 9.0 years. In terms of issuance, 57.7% of LCY Treasury bonds issued in Q1 2023 carried maturities of over 5 years, while the size-weighted average maturity of LCY government bonds issued in Q1 2023 was 6.9 years. Banks, insurance companies, and pension funds remained the largest investors of LCY government bonds in the region.

The sustainable bond market in ASEAN+3 reached a size of USD633.9 billion at the end of March.² As a region, ASEAN+3 accounted for 17.7% of global sustainable bonds outstanding, following only the European Union,

which accounted for 38.6% of the global total. However, sustainable bonds outstanding only comprised 1.8% of total bonds outstanding in ASEAN+3 economies at the end of March. The PRC, the Republic of Korea, and ASEAN markets accounted for 46.0%, 21.6%, and 7.8%, respectively, of ASEAN+3's sustainable bond market. ASEAN+3's aggregate sustainable bond issuance in Q1 2023 reached USD47.7 billion, contracting 13.8% q-o-q after posting 2.7% q-o-q growth in Q4 2022. Green bonds (75.4%), LCY financing (61.7%), and private sector issuance (67.9%) dominated regional sustainable bond issuance. During the quarter, 50.8% and 24.2% of ASEAN+3 sustainable bond issuance carried maturities of over 1 year to 3 years and over 3 years to 5 years, respectively. Sustainable bond issuance had a size-weighted average tenor of 5.8 years in Q1 2023.

Special Section: Climate Risk Awareness and Fund Trading of Individual Investors

This edition of the *Asia Bond Monitor* presents a special section on how increased climate risk awareness can influence investors' trading decisions. The literature has found that institutional investors incorporate climate-related risks into their investment decisions due to both financial and nonfinancial motives. This study adds new evidence to the literature by understanding how individual investment decisions are shaped by awareness of climate risks. Current knowledge shows that governments' environmental commitments are likely to raise investors' climate risk awareness. This study thus uses the PRC's announcement of dual carbon targets as an exogenous shock that is expected to boost investors' climate risk awareness. Using individual investors' account-level trading data, the study finds that after the announcement of dual carbon targets, individual investors in the PRC significantly increased their purchase of environmental, social, and governance (ESG) mutual funds relative to non-ESG mutual funds. This study indicates that governments' climate commitments and policies can drive resource allocation, not only via incentives and regulation but also by shaping investors' risk appetite and investment behavior. Policies that effectively guide investment decisions can help to cost-efficiently mobilize capital toward ESG investments.

² ASEAN+3 is defined to include member states of the Association of Southeast Asian Nations (ASEAN) plus the People's Republic of China; Hong Kong, China; Japan; and the Republic of Korea.