Highlights

Economic Outlook

- Recent indicators in the United States (US) for employment and housing have been modestly hopeful. The rally of the US stock market since the beginning of the year has been another positive development, although its sustainability is unclear given the unresolved budget deadlock. Financial conditions in Europe have improved and in recent months the euro has rallied against the US dollar. Nevertheless, financial conditions in Europe remain fragile amid political uncertainty in Italy.

- In contrast, emerging East Asia's outlook is brightening with the People's Republic of China's (PRC) growth picking up toward the end of last year.[1] Meanwhile, the Southeast Asian economies continue to sustain robust growth supported by strong domestic demand.

LCY Bond Market Growth in Emerging East Asia

- The quarter-on-quarter (q-o-q) growth rate for emerging East Asia's local currency (LCY) bond market in 4Q12 was 3.0%, down slightly from 3.7% in 3Q12, as the region's LCY bond market reached US$6.5 trillion in size. The slight decline in the growth rate reflected a drop in the quarterly growth of government bonds from 3.5% in 3Q12 to 1.4% in 4Q12. However, much of the downturn in the government sector was offset by an increase in the corporate sector's growth rate from 4.2% in 3Q12 to 6.2% in 4Q12.

- The region's two most rapidly growing corporate bond markets in 4Q12 were those of Indonesia and the PRC, which grew 9.4% and 9.3%, respectively. The next three most rapidly growing corporate bond markets on a q-o-q basis were those of Thailand (6.7%), the Republic of Korea (4.1%), and Malaysia (3.9%).

- The slowdown of the region's growth rate in 4Q12 reflected mainly sluggish growth of only 0.9% in the PRC's government bond market, which accounted for 66% of the region's total government bond market at end-December, as well as slower growth in the government bond markets of Singapore (1.2%); the Republic of Korea (0.9%); and Hong Kong, China (0.5%).

- One factor responsible for the slow growth of the government bond sector in the PRC and several other markets has been a moderation of central bank bill issuance in recent quarters as sterilization activities have been reduced. Monetary Authority of Singapore (MAS) bills rose 12.6% q-o-q in 4Q12, however, as MAS has rapidly increased its bill issuance over the last year to expand the range of monetary policy tools at its disposal.

LCY Bond Market Structural Developments in Emerging East Asia

- The maturity profiles of the region's government bond markets generally lengthened in 2012, as evidenced by a modest expansion of maturities of 10 years or more, while the maturity profiles of corporate bond markets remained much more short-dated. In the Philippines and Indonesia, for example, around 45% of government bonds outstanding had remaining maturities of more than 10 years.

[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.

- Foreign holdings of emerging East Asian LCY government bonds continued to rise in 2012 in most markets. In Indonesia, the share of foreign holdings as a portion of total government bonds outstanding recovered from its downturn in mid-2012 to finish the year at 33%.

- Most government bond yield curves have shifted downward since the end of 3Q12 on the back of moderating inflation and reduced central bank policy rates. The PRC's curve, however, has continued to shift upward since the end of 3Q12, due to the lack of any monetary policy easing measures, while the performance of the economy has remained robust.

Risks to the Outlook

- Risks to the region's LCY bond markets are biased toward the downside, including (i) the budget deadlock threatening the US recovery, (ii) stronger growth potentially leading to higher interest rates and inflation, and (iii) a surge of destabilizing capital inflows into the region.

LCY Bond Market Developments in India

- India's LCY bond market expanded 24.3% in 2012, on the back of buoyant growth in both the government securities and corporate bond markets, to reach the equivalent of US$1 trillion.

- India's infrastructure needs are huge and they will be financed through both public–private partnership (PPP) projects and the LCY bond market.

Special Section: Managing Capital Flows in LCY Bond Markets

- Growth in the use of LCY bonds has helped facilitate management of the region's domestic economies and increased financial stability. It has also helped reduce yields and improve liquidity and efficiency in bond markets.

- Higher yields, appreciating currencies, improved credit ratings, and lower exchange rate volatility are all contributing to increased foreign participation in emerging East Asia's LCY bond markets. Lower global risk perceptions and more developed domestic financial markets are also contributing positively.

- Large inflows of foreign funds into the region's domestic economies can complicate policy management and may require balancing the needs of different policy objectives. In response, authorities in the region have implemented measures to manage the inflows of funds, including capital control measures to limit potentially destabilizing inflows.