

## Emerging East Asia's Local Currency Government Bond Yield Curves Steepen

Local currency (LCY) government bond yield curves in emerging East Asia steepened between 29 December 2017 and 15 February 2018.<sup>1</sup> Yields on 10-year LCY bonds in emerging East Asia were largely up, while yields on 2-year LCY bonds declined in most markets. The steeper yield curves reflect the region's positive economic outlook and expectations of rising inflation.

Major advanced economies also saw steeper government bond yield curves, with 10-year yields climbing faster than 2-year yields, signifying positive global economic momentum. The eurozone, Japan, and the United States (US) all raised their economic growth forecasts for 2018.

In the US, economic growth remained firmly on track and the labor market continued to improve. Against this backdrop, the Federal Reserve raised its key policy rate target range by 25 basis points to between 1.25% and 1.50% in its Federal Open Market Committee meeting in December.

The likelihood of global monetary policy normalization has increased. In January, while the European Central Bank maintained its policy rate unchanged in its monetary policy meeting, it began reducing its bond purchases. While the Bank of Japan decided to maintain its monetary policy measures in its most recent monetary policy meeting, a remark by the central bank governor in March signaled the possibility of monetary policy normalization starting in fiscal year 2019.

The continued recovery in the global economy has contributed to a rally in financial markets that lasted through January. Financial risk and volatility indicators—such as the CBOE Volatility Index, credit default swap spreads, and emerging market bond spreads—narrowed in January. However, a price correction in equity markets and an uptick in risk indicators were observed in the first week of February due to uncertainties in US macroeconomic policies and expectations of accelerated

rate hikes by the Federal Reserve. Financial markets and volatility indicators subsequently stabilized, beginning in the middle of February.

This issue of the *Asia Bond Monitor* includes two special discussion boxes. Box 1 discusses the short-term and long-term effects of global monetary policy normalization and the resultant tighter global liquidity in financial markets in the region.

Box 2 discusses the effects of tighter global liquidity on financial stability in the region. It highlights the implications of rising interest rates on the region's private debt that accumulated during the low global interest rate environment, and the impacts on the region's aggregate demand and economic growth.

While the global economic outlook remains positive, risks to the region's economic growth and stability remain. These include (i) faster-than-expected rate hikes in the US, and monetary policy normalization in other advanced economies; and (ii) growing threats of protectionism.

## Local Currency Bond Markets in Emerging East Asia Expand in Q4 2017

Emerging East Asia's markets continued to grow in the fourth quarter (Q4) of 2017, reaching a size of USD12.3 trillion at the end of December. Growth was broad-based across the region, with all markets expanding. However, growth was slower in Q4 2017 than in the previous quarter, moderating to 3.1% quarter-on-quarter (q-o-q) from 4.0% q-o-q, as bond issuance declined. The slowdown was not evident in all markets, with four out of the nine markets showing accelerated growth.

Much of emerging East Asia's bond market gains were dominated by the People's Republic of China (PRC), the largest bond market in the region. The PRC's bond market growth slowed to 4.0% q-o-q in Q4 2017 from 5.3% q-o-q in the previous quarter due to ongoing deleveraging as the government seeks to reduce risks in the market.

<sup>1</sup> 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.

The government bond segment reached a size of USD8.2 trillion at the end of December, comprising 66.6% of total bonds outstanding, roughly the same share as at the end of September. The corporate bond segment accounted for the remainder, with USD4.1 trillion of bonds outstanding at the end of December.

The size of emerging East Asia's bond market relative to the region's gross domestic product inched up to 71.3% at the end of December from 70.1% at the end of September. During the same period, government bonds outstanding as a share of gross domestic product rose to 47.5% from 46.5%, while corporate bonds increased to 23.8% from 23.5%.

Total bond issuance fell to USD1,103 billion in Q4 2017, mostly due to contractions in the amount of bonds issued by the PRC in both its government and corporate bond segments. The PRC accounted for 54.8% of all bond issuance in emerging East Asia in Q4 2017.

## Net Foreign Investment Outflows in October, Inflows in November and December

Despite rising interest rates in the US and in domestic bond markets, foreign investor interest in emerging East Asian bonds remained strong, with foreign investors adding to their holdings in Q4 2017 on the back of improving economic fundamentals. Among the markets for which data are available, Malaysia showed the largest increase in its ratio of foreign investor holdings to total government bonds outstanding in Q4 2017, while gains were also noted in the PRC. Indonesia's foreign investor share remained steady during the quarter.

While bond outflows from the region were noted in October, inflows in November and December led to overall net flows into emerging East Asian bond markets in Q4 2017, with the exception of the Republic of Korea, which recorded net outflows for the quarter.

## Local Currency Bond Yields Rise at the Long-End of the Curve

Government bond yields rose at the long-end of the curve for nearly all emerging East Asian markets between 29 December and 15 February on the back of continued economic expansion and policy normalization in the US. The only exception was Viet Nam, whose yield curve shifted downward during the review period.