Executive Summary

Local Currency Government Bond Yields Decline in Emerging East Asia

Between 28 December 2018 and 15 February 2019, local currency (LCY) government bond yields trended downward in most emerging East Asian markets, partly driven by the dovish outlook of the United States (US) Federal Reserve and expectations of a slowdown in global economic growth.[1]

While the Federal Reserve hiked its policy rate target as expected at the 18–19 December meeting of the Federal Market Open Committee, economic projections and notes from the more recent 29–30 January meeting led to market expectations of a more dovish stance from the Federal Reserve. Similarly, the European Central Bank ended its asset purchase program in December, but also noted that incoming economic data pointed toward slower growth.

The Federal Reserve's shifting stance is providing greater stability to financial markets in emerging economies. However, global trade tensions continue to pose a threat to the region's economic growth and financial stability. Trade tensions can also lead to heightened investor risk aversion. Uncertainties regarding the Brexit process, particularly should it become disorderly, could also impact investors.

The March issue of the *Asia Bond Monitor* includes three special discussion boxes. Box 1 explains how emerging market currencies remain vulnerable to external shocks. Box 2 provides background on green bonds in emerging markets. Box 3 examines climate risk and the rising cost of debt in climate-vulnerable economies.

Local Currency Bonds Outstanding in Emerging East Asia Surpass USD13 Trillion in Q4 2018

Emerging East Asia's LCY bonds outstanding climbed to USD13.1 trillion at the end of December, with growth in the fourth quarter (Q4) of 2018 moderating to 2.4% quarter-on-quarter (q-o-q) and 11.9% year-on-year (y-o-y) from 4.3% q-o-q and 12.6% y-o-y in the third quarter (Q3) of 2018. The People's Republic of China (PRC) continued to lead the region in terms of bond market size, accounting for a 72.2% share of the regional total at the end of December, despite a slowdown in its bond market's growth in Q4 2018.

The government bond segment dominated the region's LCY bond market, with government bonds reaching USD8.8 trillion at the end of December and accounting for 66.8% of emerging East Asia's total bond stock. LCY corporate bonds outstanding totaled USD4.3 trillion at the end of December. Growth trends in the two segments of the bond market diverged, with government bonds posting slower growth in Q4 of 2018 compared with Q3 2018, while growth in corporate bonds rose at a much faster pace in Q4 2018.

The aggregate amount of outstanding LCY bonds among member economies of the Association of Southeast Asian Nations (ASEAN) reached USD1.4 trillion at the end of December, up from USD1.3 trillion at the end of September.[2] Thailand has the largest LCY bond market among ASEAN member economies, while Malaysia is home to the largest *sukuk* (Islamic bond) market not just in ASEAN but in all of emerging East Asia.

[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] LCY bond statistics for ASEAN include the markets of Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.

As a share of regional gross domestic product, emerging East Asia's LCY bond market was barely changed in Q4 2018 at 73.3% versus 73.2% in Q3 2018. The Republic of Korea led the region in terms of its share of bonds to gross domestic product at 125.5% at the end of December.

Gross issuance of LCY bonds in Q4 2018 amounted to USD1.1 trillion, reflecting a decline of 18.7% q-o-q and an increase of 7.1% y-o-y. The q-o-q decline stemmed from lower bond sales from governments that more than offset rising corporate issuance.

Foreign Investor Sentiment Turned Positive in Q4 2018, Resulting in Net Bond Market Inflows

Expectations that the Federal Reserve would slow the pace of its monetary tightening in 2019 led to improved investor sentiment in emerging East Asian LCY bond markets toward the end of Q4 2018. Foreign investor holdings of LCY government bonds rose in all markets in emerging East Asia in Q4 2018 for which data are available, except the PRC and Malaysia.

The foreign holdings share in the Philippines rose the most in the region, rising to 7.5% in Q4 2018 from 4.4% in the previous quarter, as lower inflation expectations and a likely pause in the Bangko Sentral ng Pilipinas' monetary tightening helped boost demand for government bonds. The foreign holdings share in Thailand also climbed to 18.5% from 17.3% in Q4 2018 from Q3 2018, buoyed by strong economic fundamentals. Indonesia's share of foreign holdings rose to 37.7% from 36.9% during the same period.

The region continued to attract foreign funds in Q4 2018, albeit less so than in Q3 2018. Foreign fund inflows were recorded in all markets in Q4 2018, except for the PRC and Malaysia.

Box 1: Are Emerging Market Currencies Out of the Woods?

This box reviews the impacts of monetary policy normalization in the US on global financial markets, particularly its effects on emerging markets and developing Asia. The box explains how tightening global liquidity led to the depreciation of most emerging market currencies in 2018. While risks somewhat abated in Q4 2018, emerging market currencies in 2019 will remain vulnerable to a slowdown in the global economy and uncertainties relating to PRC–US trade tensions.

Box 2: Spotlight on Emerging Market Green Bonds

This box discusses the huge potential of green bonds as an alternative funding source for issuers in emerging markets that will require large-scale investment in infrastructure, and how green bonds can help attract new international investors to finance such projects. It also details the development of green bond markets in emerging economies in 2016–2018, citing the PRC, India, and Mexico as the most prolific issuers.

Box 3: Climate-Vulnerable Developing Economies Face Rising Debt Costs

This box examines the impact of climate vulnerability on the cost of debt, noting that debt tends to be more expensive in markets with greater climate vulnerability. Rising debt costs also increased the cost of projects that climate-vulnerable economies need in order to mitigate the physical impacts of climate change. While investing in climate preparedness can help mitigate these costs, international cooperation is also needed.