Executive Summary

Recent Trends in Financial Conditions in Emerging East Asia

Financial conditions in emerging East Asia weakened between 31 August and 5 November on the back of global inflationary concerns and a shift in monetary stance by the United States (US) Federal Reserve.[1] The Federal Reserve announced that it would scale back its bond purchases beginning in November, while rising global inflation is also pressuring central banks in the region to consider tightening monetary policies. This has led to bond yields rising, currencies weakening, and risk premiums edging up in most emerging East Asian economies during the review period. Nevertheless, a positive economic outlook and still-accommodative policy stances have supported financial conditions in the region, as evidenced by positive foreign capital flows into regional bond and equity markets during the third quarter (Q3) of 2021.

Compared with the prior quarter, Q3 2021 witnessed a moderation of gross domestic product growth in most emerging East Asian economies, largely due to a resurgence of coronavirus disease (COVID-19) cases. To support economic recovery, most central banks in the region maintained accommodative monetary stances. A few regional central banks also continued to support local currency (LCY) bond markets through LCY bond purchases, facilitating bond market functioning and government financing.

Recent Developments in Local Currency Bond Markets in Emerging East Asia

Emerging East Asia's LCY bond markets expanded in Q3 2021 to an aggregate USD21.7 trillion at the end of September, posting growth of 3.4% quarter-on-quarter (q-o-q), up from 2.9% q-o-q in the previous quarter. LCY bond issuance rose 6.8% q-o-q to USD2.4 trillion in Q3 2021.

The government bond segment dominates the region's LCY bond markets, accounting for 62.4% of total LCY bonds outstanding. Emerging East Asia's government bond stock reached USD13.6 trillion at the end of September, posting growth of 3.9% q-o-q in Q3 2021. The LCY government bond markets of members of the Association of Southeast Asian Nations (ASEAN) collectively stood at USD1.9 trillion, expanding 3.6% q-o-q and 14.4% year-on-year in Q3 2021. More than 60.0% of the LCY government bonds in ASEAN markets carried maturities of 5 years or more at the end of September. The outstanding amount of LCY corporate bonds in emerging East Asia reached USD8.2 trillion at the end of September, posting growth of 2.8% q-o-q. Domestic investors remain important players in the LCY bond markets of emerging East Asia. Financial institutions—such as banks, insurance companies and pension funds, and mutual funds—held an aggregate 51.0% of the region's government bonds outstanding at the end of September.

Sustainable bond markets in ASEAN+3 continued to expand to reach a size of USD388.7 billion at the end of September.[2] The issuance of sustainable bonds in the first 3 quarters of the year totaled USD165.5 billion. ASEAN+3 is home to the second-largest regional sustainable bond market in the world after Europe, accounting for 19.2% of the global sustainable bond total at the end of September. Green bonds, social bonds, and sustainability bonds accounted for 71.6%, 13.0%, and 15.3% of ASEAN+3 sustainable bonds outstanding, respectively. While the financial sector continued to be a major player in the region's sustainable bond market, a more diversified issuer base is emerging as the market develops.

[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] For the discussion on sustainable bonds, ASEAN+3 includes ASEAN members Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam plus the People's Republic of China; Hong Kong, China; Japan; and the Republic of Korea.

Special Topics on Emerging East Asian Local Currency Bond Markets

The November issue of the *Asia Bond Monitor* presents three boxes discussing relevant topics affecting the region's LCY bond markets. A theme chapter on pricing differentials between labeled and unlabeled bonds is also featured in this issue.

Box 1: Economic Outlook—Slightly Slower and Divergent Recovery

While the regional economic outlook remains positive, uneven vaccination progress and the outbreak of the Delta variant slightly weighed on the economic recovery in Q3 2021. In its *World Economic Outlook* released in October, the International Monetary Fund revised its 2021 growth forecast for emerging markets and developing economies to 6.4%, up marginally from 6.3% in July. The *Asian Development Outlook Update*, released in September 2021, downgraded its 2021 growth forecast for ASEAN, many of whose members suffered a major Delta outbreak during Q3 2021, to 3.1% from a July forecast of 4.4%. However, the growth forecasts for the People's Republic of China; Hong Kong, China; and the Republic of Korea—in all of which the Delta variant was more contained—were either maintained or upgraded.

Box 2: How Big Is the Risk of Another Taper Tantrum?

The Federal Reserve's announcement that it will scale back its asset purchases starting in November raised concerns globally of another taper tantrum. However, several factors indicate that the risk is more limited this time around, particularly in emerging Asia. First, the Federal Reserve has been more transparent in signaling its monetary policy trajectory. In contrast, the taper tantrum of May 2013 came following a surprise announcement. The Federal Reserve also recently stressed that the tapering of asset purchases would not be accompanied by interest rate hikes in the near term. Second, emerging Asian markets have more robust economic fundamentals compared to 2013, as reflected by indicators such as the real effective exchange rate and current account balance. Nonetheless, the risk of a taper tantrum cannot be entirely ruled out. Thus, the region's regulatory authorities should closely monitor potential sources of financial instability.

Box 3: Risks to Outlook—Downside Risks Outweigh Upside Risks

Downside risks continue to outweigh upside risks to the region's economic outlook. Uncertainty related to the pandemic was evident among some ASEAN economies when the Delta variant outbreak triggered the reintroduction of mobility restrictions that dampened economic growth. Slow vaccination rollouts in developing markets could trigger renewed COVID-19 waves. Global supply chain disruptions due to the pandemic pose another major downside risk for economic prospects since such disruptions hamper manufacturing activities. The supply disruptions also give rise to inflationary pressures, which if persistent may spur central banks to tighten monetary policy. On a positive note, rapid vaccination can loosen the link between new outbreaks and economic growth.

Theme Chapter: Price Differences Between Labeled and Unlabeled Green Bonds

The theme chapter analyzes the yield and price differences between labeled and unlabeled green bonds. Recent research empirically investigated the hypothesis that investors would pay more for labeled green bonds than unlabeled green bonds because the former have better information disclosure and lower reputational risk; thus, they are widely viewed as more credible green assets. The results confirm that a green label has a statistically significant negative effect on the yield of green bonds: the yields of labeled green bonds are 24–36 basis points lower than the yields of unlabeled green bonds with similar characteristics. An important policy implication is that widely accepted green bond labels (or certifications) benefit investors with lower information costs and reputational risks, and they benefit issuers with lower financing costs. Moreover, a well-functioning green bond market ecosystem helps issuers better utilize green labels and certifications, enhancing supply and promoting market development.