Executive Summary

Recent Developments in Emerging East Asian Financial Conditions

Emerging East Asia witnessed the accelerating deterioration of financial conditions and rising bond yields between 31 August and 4 November, largely driven by aggressive monetary tightening in major advanced economies.[1] Nearly all major emerging East Asian central banks continued to pursue monetary tightening to combat persistent domestic inflation and the impact of tightening by the United States (US) Federal Reserve.

During the review period from 31 August to 4 November, regional currencies depreciated against the US dollar by a gross-domestic-product-weighted average of 4.2%, equities declined by a market-weighted-average of 7.5%, and risk premiums, as proxied by credit spreads, widened by a gross-domestic-product-weighted average of 28 basis points. Deteriorating financial conditions were much more pronounced during the review period than during any prior months in 2022. The accelerated deterioration in financial conditions followed the release of higher-than-expected August inflation data in the US, which led to market expectations that the Federal Reserve would persist with its aggressive monetary tightening. The Federal Reserve raised its policy rate by 75 basis points in November, and implied that interest rates may rise higher than previously expected.

Aggressive monetary tightening in the US and negative market sentiment also led to portfolio outflows from the region. Regional equity markets recorded aggregate net outflows of USD5.6 billion during the review period. The largest net outflows were observed in the People's Republic of China (PRC), amounting to USD7.8 billion, amid a negative economic outlook due to uncertainties related to pandemic containment measures. Portfolio outflows were also noted in most regional bond markets in September as accelerated US monetary tightening not only subdued investment sentiment toward risky assets but also made yields on regional bonds relatively less attractive.

The risk outlook for regional financial conditions remained tilted to the downside. In the short-term, the region faces a bleak economic outlook and uncertainties over a larger-than-expected slowdown in the PRC, continued global inflationary pressure, aggressive monetary tightening both globally and domestically, and greater-than-expected fallout from the Russian invasion of Ukraine. Over the medium term, during the transition of some regional economies to net-zero emissions, emerging East Asia's financial sector will be challenged by asset vulnerability, especially in high-emitting sectors that could experience higher cash flow uncertainties, increased financing costs, and stranded asset issues.

Recent Developments in Local Currency Bond Markets in Emerging East Asia

Amid headwinds to the global and regional outlooks, the expansion of emerging East Asia's local currency (LCY) bond market moderated to 2.3% quarter-on-quarter (q-o-q) and 12.5% year-on-year (y-o-y) in the third quarter (Q3) of 2022 from 3.1% q-o-q and 14.0% y-o-y in the second quarter (Q2). The amount of LCY bonds outstanding in emerging East Asia reached USD22.0 trillion at the end of September. Issuance of LCY bonds totaled USD2.2 trillion during Q3 2022, contracting 1.1% q-o-q and rising 5.4% y-o-y, compared with issuance growth of 13.6% q-o-q and 12.1% y-o-y in Q2 2022.

Government bonds continued to dominate emerging East Asia's LCY bond market. At the end of September, outstanding government bonds reached USD14.0 trillion and accounted for 63.6% of the regional bond market's size. During Q3 2022, issuance of government bonds totaled USD1.4 trillion on a contraction of 4.5% q-o-q, as some governments had already fulfilled most of their

[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.

annual financing requirements. Regional corporate bond issuance totaled USD0.8 trillion on growth of 5.7% q-o-q, which was largely driven by Chinese companies (7.2% growth in issuance) taking advantage of monetary easing measures designed to stimulate economic recovery. Corporate bond issuance in member economies of the Association of Southeast Asian Nations (ASEAN) contracted 2.0% q-o-q in Q3 2022 on rising interest rates and a bleak economic outlook.

The dimming economic outlook and monetary tightening in both regional and global markets weighed on ASEAN+3's sustainable bond market in Q3 2022.[2] Sustainable bonds outstanding in ASEAN+3 economies reached USD521.6 billion at the end of September on moderating growth of 1.7% q-o-q versus 5.0% q-o-q in Q2 2022. The region's sustainable bond issuance totaled USD49.8 billion in Q3 2022 on a contraction of 25.3% q-o-q, reversing the 2.6% q-o-q growth posted in Q2 2022. ASEAN+3's sustainable bond market witnessed improved diversification in terms of market profile and bond types. The region's sustainable bond market has significant potential for increased issuance from the public sector, more long-term bonds, and more bonds issued in local currencies.

Special Topics on Financial Markets

The November 2022 issue of the *Asia Bond Monitor* presents two special sections.

Special Section 1: Local Currency Bond Market Development and Exchange Rate Volatility

Recent accelerated monetary tightening in the US has led to currency depreciations and capital outflows in emerging markets, highlighting their vulnerability to global shocks. Several studies have linked LCY bond market development and financial stability by addressing financial market structural issues such as the "double mismatch" problem. The research highlighted in this special section provides empirical evidence that, after controlling for economic fundamentals, emerging economies benefit from lower exchange rate volatility during periods of market turmoil when they have a larger LCY bond market, a greater share of LCY bonds in the overall bond market, and relatively more long-term bonds. Emerging economies should therefore consider designing policies to develop their LCY bond markets to promote financial stability and resiliency in the face of external shocks.

Special Section 2: Does Regional Trade Integration Automatically Foster Regional Financial Integration? The Case of Regional Comprehensive Economic Partnership

The Regional Comprehensive Economic Partnership (RCEP) free trade agreement among 15 economies in Asia and the Pacific came into effect on 1 January 2022. New empirical analysis explores whether growing regional trade integration within the trading bloc, where 50% of all current trade is intra-RCEP, has also led to greater regional financial integration. The evidence clearly shows that the financial markets of RCEP economies have not yet become more closely integrated with each other. This suggests that financial integration requires institutional efforts such as the ASEAN+3 Bond Market Initiative to standardize regional market practices and enhance financial collaboration.

[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.