Asia Bond Monitor Highlights

ADB

Bond Market Outlook

Emerging East Asia has witnessed an outflow of funds since the 22 May remarks of United States (US) Federal Reserve Chairman Ben Bernanke that US monetary policy could soon be tightened.[1] A slower growth outlook for the region has also contributed to capital flowing out, with the withdrawal of funds leading to rising bond yields and depreciating currencies.

The turmoil in global financial markets has made it harder and more expensive for companies to issue foreign currency (FCY) bonds. However, the issuance of local currency (LCY) bonds has been less affected.

The capital outflows highlight the need to promote more stable sources of funding. Promoting greater intra-Asian holdings of financial assets can help shield the region's financial markets from global financial volatility.

Bond markets in the region are more resilient now than during the 1997/98 Asian financial crisis as the growing use of LCY bonds has reduced currency mismatches.

Yet, risks to the region's bond markets are intensifying. Specifically, (i) the region's interest rates could rise further when the Federal Reserve starts to tighten policy; (ii) weakening growth momentum in the region could accelerate the pace of capital outflows; and (iii) continued outflows could result in vulnerable economies raising interest rates to prop up their currencies, thereby further dampening growth.

LCY Bond Market Growth in Emerging East Asia

The quarter-on-quarter (q-o-q) growth rate for emerging East Asia's local LCY bond market in 2Q13 was 1.7%, down from 2.9% growth in 1Q13, as the region's LCY bond market reached US$6.8 trillion in size. The slight decline in the quarterly growth rate reflected not only a drop in the growth rate for government bonds to 1.1% in 2Q13 from 1.9% in the previous quarter, but an even larger drop in the corporate sector's growth rate to 2.9% from 4.7%.

The region's most rapidly growing markets on a q-o-q basis were Hong Kong, China (4.4%); Thailand (3.0%); Indonesia and the Republic of Korea (2.2% each); and Singapore (2.1%). The growth of Hong Kong, China's market was driven by Exchange Fund Bills (EFBs), while in the Thai bond market growth was driven primarily by a 4.3% expansion in treasury bonds. The most rapidly growing corporate bond markets in 2Q13 continued to be Indonesia and the People's Republic of China (PRC), which expanded 4.5% and 4.2%, respectively.

LCY bond issuance in 2Q13 totaled US$827 billion, a 4.0% increase over 1Q13 that was driven by a 26.8% rise in issuance by central governments and agencies. Issuance by corporates experienced a sharp 20.1% decline, largely due to a dramatic 48.8% dip in corporate issuance in the PRC. The PRC's remaining issuance in 2Q13 was still sufficient to generate a 4.2% q-o-q increase in corporate bonds outstanding.

During periods of interest rate volatility, bond markets can become a source of risk. A rise in interest rates would result in losses for bond holders, with the losses being most severe in markets where there is a large gap between total holdings of both government and corporate bonds, and total corporate bonds outstanding. The larger this gap is, the greater the impact of a reduction to the mark-to-market value of total bond holdings. Hence, monetary policy should also take into account the implications of interest rate changes on corporate balance sheets.

[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.

LCY Bond Market Structural Developments

The maturity profiles of the region's government bond markets generally lengthened in 2Q13, while the region's corporate bond markets remained much more short-dated. On a year-on-year (y-o-y) basis, Indonesia, the Republic of Korea, and Thailand each saw an increase in the proportion of government bonds with maturities of more than 10 years. The PRC, Singapore, and Viet Nam, on the other hand, experienced reductions in the share of bonds with maturities of more than 10 years.

Foreign holdings of government bonds continued to rise in nominal terms in 2012 and the early months of 2013 in most economies, although the share of foreign holdings has begun to stabilize in some markets. In Indonesia, foreign holdings of government bonds continued to rise in nominal terms in 2Q13, but the share of foreign holdings fell slightly to 31.9% of the total at end-June. The share of foreign holdings of Malaysian government bonds continued to increase in 2013, reaching 31.2% at end-March, while the share of foreign holdings of Thai bonds increased to 17.9% at end-June.

Yield Curve Movements

Most government bond yield curves in emerging East Asia have shifted upward since the Federal Reserve suggested on 22 May that the US might exit from its highly accommodative monetary policy sooner than expected. Between end-March and end-July, most yield curves steepened, with very short-dated maturities changing little while yields from the belly to the longer-end of the curve rose substantially. Yields in Viet Nam fell for some shorter-dated maturities, but remained more or less unchanged at the longer-end of the curve. Yields on the Philippine curve tightened for most maturities greater than 2 years between end-May and end-July.

The yield curves for Indonesia and the PRC shifted upward between end-March and end-July. The sharp upward movement of Indonesia's entire yield curve reflected concerns about a widening current account deficit, rising inflation levels, and a weakening currency. Bank Indonesia raised its policy rate by 25 bps in June to 6.0%, 50 bps in July to 6.5%, and 50 bps in August to 7.0%. Yields at the shorter-end of the PRC's curve shifted sharply upward between end-May and end-July, reflecting the impact of the SHIBOR shock event in June.

Special Section: Bond Financing for Infrastructure

The poor state of infrastructure in the region can hamper future growth prospects and poverty reduction efforts. The Asian Development Bank (ADB) has estimated that Asia needs to invest about US$8 trillion in transport, communication, and energy infrastructure between 2010 and 2020.

The region's governments missed an opportunity during the recent period of easy liquidity to ramp up spending on infrastructure. Given recent market turmoil, financing infrastructure needs will now become harder.

Infrastructure financing tends to be carried out by banks using project finance. However, the recent Basel III capital adequacy requirements are reducing the attractiveness for banks of providing long-term infrastructure financing. There has been a notable decline in infrastructure financing from European banks in the aftermath of the global financial crisis.

Developing regional bond markets can help emerging East Asia bridge the financing gap for infrastructure projects. Deeper and more liquid bond markets can draw in non-traditional investors, such as pension funds, into financing infrastructure projects.

Guarantees and the creation of subordinated tranches can help improve the ratings of infrastructure projects to make them attractive to institutional investors that are often mandated to only invest in investment grade bonds. Increasing the transparency and availability of data on infrastructure project costs and performance would also facilitate investment.