

Bond Market Outlook

Emerging East Asian local currency (LCY) bond markets continued to perform well as global financial conditions have remained relatively benign thus far in 2014.¹ The region, however, should prepare for possibly tighter liquidity as United States (US) quantitative easing is expected to end in October. More expansionary monetary actions from the eurozone and Japan could offset some of the impact on liquidity conditions caused by the end of US quantitative easing.

While the region's LCY bond markets have been calm in 2014, the risks are rising, including (i) earlier-than-expected interest rate hikes by the US Federal Reserve (ii) geopolitical tensions that push up oil prices; and (iii) a slowdown in the People's Republic of China's (PRC) property market.

LCY Bond Market Growth in Emerging East Asia

LCY bonds outstanding in emerging East Asia climbed 2.5% quarter-on-quarter (q-o-q) and 9.3% year-on-year (y-o-y) in 2Q14 to reach US\$7.9 trillion at end-June. The PRC bond market continued to dominate the region's bond market with outstanding bonds totaling US\$4.9 trillion. Viet Nam remained the fastest-growing emerging East Asian bond market in 2Q14, recording growth of 5.9% q-o-q and 36.4% y-o-y.

At end-June, the size of the emerging East Asian LCY government bond market was US\$4.8 trillion, or 60% of the size of the region's overall bond market. In 2Q14, the government bond market expanded 3.0% q-o-q—eclipsing the region's LCY corporate bond market's growth rate of 1.9% q-o-q, while the government bond market's y-o-y growth rate of 9.2% was almost at par with the corporate bond market at 9.4% y-o-y.

LCY bonds outstanding as a share of the region's gross domestic product (GDP) stood at 59.3% at the end of 2Q14, up 1.2 percentage points from the end of 1Q14 and

2.1 percentage points from the end of 2Q13. The Republic of Korea and Malaysia had the largest shares of bonds to GDP in the region.

Emerging East Asian LCY bond issuance stood at US\$1.1 trillion in 2Q14, compared with US\$852 billion in 1Q14 and US\$974 billion in 2Q13. The region's LCY government bond issuance accounted for 72.7% of total issuance in 2Q14, led by central banks and monetary authorities' LCY bond sales of US\$475 billion, and central governments and other government units' combined LCY bond issuance of US\$315 billion.

Structural Developments in LCY Bond Markets

Foreign investor holdings of LCY government bonds in emerging East Asia were generally stable. The only exceptions were in Indonesia, where the share of foreign holdings rose to 35.7% at end-June, and in Thailand, where the share of foreign holdings declined to 15.8% at end-June.

The share of foreign investor holdings in LCY corporate bonds in Indonesia climbed to 7.6% at end-June from 6.6% at end-March, while it remained steady from the previous quarter in the Republic of Korea at 0.4% at end-March.

Emerging East Asia's LCY bond market continued to attract foreign interest, buoyed by improving investor sentiments, as foreign bond inflows recovered strongly in Indonesia, the Republic of Korea, and Thailand in July.

The maturity structures of emerging East Asian LCY government and corporate bond markets were mostly concentrated toward the shorter-end of yield curves (tenors of more than 1 year to 3 years).

LCY Bond Yields

LCY government bond yields generally fell for most emerging East Asian markets between end-March and end-August, supported by ample global liquidity. Government bond yield curves shifted downward in

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.

the Republic of Korea amid moderating growth while Hong Kong, China interest rates fell, tracking US interest rate movements. In contrast, Indonesian government bond yields rose during this period over concerns of a widening current account deficit.

The yield spread between 2- and 10-year government bonds narrowed in all emerging East Asian markets between end-March and end-August amid lower growth expectations.

Special Section: Renminbi Internationalization: Progress and Challenges Ahead

The PRC's economy has grown rapidly to become the second-largest economy in the world. However, the international role of the renminbi is still relatively limited, even though there have been efforts, particularly since the 2008/09 global financial crisis, to promote the internationalization of the renminbi.

On the other hand, the international use of the renminbi is growing. The implementation of a cross-border settlement program has resulted in renminbi trade settlement rising from CNY534.8 billion in 2010 to CNY3.3 trillion in the first half of 2014. Cross-border settlement in other markets is expected to grow with the establishment of clearing banks in Singapore, the United Kingdom, Germany, and the Republic of Korea.

The market share of the renminbi in world payment values has increased substantially from 0.3% in January 2012 to 1.6% in June 2014, ranking the renminbi as the seventh-most used currency in the world.

The offshore renminbi bond market has grown significantly from CNY10 billion worth of bonds issued in 2007 to CNY369 billion in 2013. Majority of offshore renminbi bonds were issued by PRC companies.

The push toward internationalizing the renminbi has made progress so far, but the pace of liberalization is still very much under the control of the authorities. The careful and measured pace of liberalization reflects an understanding that full liberalization could lead to large and destabilizing capital flows.

Meanwhile, there are challenges that hamper the further development of the offshore renminbi bond market that will have to be addressed, including expanding the diversity of issuers, increasing the issuance of higher-rated renminbi bonds, and strengthening the domestic capital market prior to additional liberalization.

The internationalization of the renminbi also has implications for the region's economy. Closer trade and financial ties will likely lead to a greater push for regional cooperation in the region.