Executive Summary

Recent Developments in Financial Conditions in Emerging East Asia

Between 15 June and 27 August, financial conditions in emerging East Asia remained stable amid accommodative policy stances, with some headwinds observed due to looming uncertainty on recovery paths.[1] Some weakening was observed in most regional markets as currencies depreciated versus the United States (US) dollar, equity markets retreated, and foreign portfolio investments intermittently flowed outward. Local currency (LCY) bond yields fell on the back of weakening economic fundamentals.

All emerging East Asian economies posted positive year-on-year (y-o-y) gross domestic product (GDP) growth in the second quarter (Q2) of 2021, with some markets rebounding from contractions in prior quarters. However, rising COVID-19 cases led to the reintroduction of mobility restrictions in some markets in emerging East Asia, casting a shadow over the region's economic growth trajectory.

The risk outlook in emerging East Asia's financial sector is largely tilted to the downside. Uncertainty regarding the region's economic recovery, combined with a strong US economic rebound and possible earlier-than-expected monetary policy normalization in the US, could lead to domestic currencies weakening further and increased capital outflows from the region. Currency depreciations would increase the debt burden on foreign currency borrowings. A continued strong economic recovery in the US could push up US bond yields and have spillover effects, raising financing costs in the region even for LCY borrowing. Lastly, existing high levels of private debt in some regional markets could pose risks to financial stability if financial conditions worsened.

Recent Developments in Local Currency Bond Markets in Emerging East Asia

Regional LCY bond markets continued to expand as governments tapped LCY bonds to support recovery measures and contain the negative impacts of rising COVID-19 cases. Outstanding LCY bonds in emerging East Asia rose to USD21.1 trillion at the end of June, with accelerated growth of 2.9% quarter-on-quarter (q-o-q) in Q2 2021, up from 2.2% q-o-q in the first quarter (Q1) of 2021. LCY bond issuance in Q2 2021 reached USD2.2 trillion on growth of 14.6% q-o-q, reversing a decline of 1.6% in Q1 2021.

The government bond segment led the regional bond market's expansion in Q2 2021. Outstanding government bonds in emerging East Asia reached USD13.1 trillion at the end of June, posting growth of 3.3% q-o-q in Q2 2021 versus 2.1% q-o-q in Q1 2021, while corporate bond market growth moderated to 2.2% q-o-q in Q2 2021 from 2.4% q-o-q in Q1 2021.

LCY bond markets have provided governments in the region with access to long-term financing during the pandemic, particularly in Association of Southeast Asian Nations (ASEAN) markets.[2] By the end of June, 62.5% of LCY government bonds in ASEAN markets had a tenor of more than 5 years. Regional bond markets exhibited reasonable market capacity as bond yields continued to fall amid ongoing market expansions. Domestic financial institutions, particularly banks, supported LCY bond market growth throughout the region in Q2 2021.

ASEAN+3 sustainable bond markets reached a size of USD345.2 billion at the end of Q2 2021, posting continued rapid growth of 13.1% q-o-q and 53.5% y-o-y in Q2 2021.[3] ASEAN+3 sustainable bonds markets comprised 19.0% of the global sustainable bond stock at the end of June. Strong growth momentum in ASEAN sustainable bond markets was also observed, with outstanding bonds of USD23.6 billion at the end of June on growth of 30.4% q-o-q, up from only 0.6% q-o-q in Q1 2021.

[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 the Association of Southeast Asian Nations include the markets of Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
[3] For the discussion on sustainable bonds, ASEAN+3 includes ASEAN members Indonesia, Malaysia, the Philippines, Singapore, and Thailand, 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 September issue of the *Asia Bond Monitor* features five boxes discussing special topics relevant to LCY bond markets in emerging East Asia.

Box 1: Economic Outlook—Strong but Divergent Global Economic Recovery

Despite the progress in global vaccination campaigns, there exists a divide between advanced and developing economies. The regions and economies with the highest income levels are vaccinating their populations more than 20 times faster than those with the lowest income levels. Such a gap is also reflected in economic growth forecasts. The International Monetary Fund's July GDP growth forecasts for advanced economies were upgraded to 5.6% for 2021 and 4.4% for 2022, while those for developing economies were downgraded to 6.3% for 2021 and modestly upgraded to 5.2% for 2022. Within emerging East Asia, such a divergence was also evident in the revised forecasts of the *Asian Development Outlook Supplement* released in July. Relatively richer economies such as the People's Republic of China; the Republic of Korea; and Hong Kong, China are projected to grow a combined 7.5% in 2021 and 5.1% in 2022. Among ASEAN member economies, many of whom have suffered major COVID-19 resurgences in 2021, the aggregate growth forecast was downgraded to 4.0% for 2021 and marginally upgraded to 5.2% for 2022.

Box 2: Market Capacity and Asset Purchase Programs in Emerging East Asian Bond Markets

Since the onset of the COVID-19 pandemic, many regional governments, particularly ASEAN member economies, have tapped the LCY bond markets to finance budget deficits. The region demonstrated robust market capacity with declining bond yields amid rising bond issuances. While foreign capital flows have been volatile, domestic financial institutions have supported regional LCY bond markets during the pandemic. To maintain liquidity in LCY bond markets, some regional central banks implemented modest asset purchase programs for the first time, which helped keep long-term bond yields low and complemented conventional monetary policy. Favorable market conditions in emerging East Asia have contributed to the effectiveness of these programs. Nonetheless, regional authorities should still be aware of the possible risks associated with these unconventional monetary measures.

Box 3: Debt Buildup during the Pandemic in Emerging East Asia

Emerging East Asia experienced a rapid debt buildup in 2020, particularly public debt. The surge in public debt in 2020 reflected the need of governments to fund economic recovery measures and provide basic services during the pandemic. External debt also increased but remained much smaller compared to domestic debt due to the overall development of LCY bond markets. The share of short-term external debt continued to decline across the region in 2020, showing an improving debt maturity profile. Overall, the debt buildup in emerging East Asia is not too concerning but constant monitoring is necessary.

Box 4: Opening the Pandora's Box of Social Risks—Consequences for Investors

COVID-19 exposed how systemic shocks can have catastrophic consequences on unequal and less-resilient societies, bringing social risks to the spotlight. Social risks, defined as all risks arising from social factors that can have material impacts on a company and its stakeholders, are expected to become increasingly important in the post-pandemic world. Thus, investors should start incorporating social risks into their investment value chain. This box discusses a stakeholder-based approach to assess material social risks from an investment perspective. It then outlines how consideration of social risks can be integrated in an investment value chain—from analysis to engagement and voting. Firms with positive social practices are expected to provide attractive investment opportunities in the coming years, as the social pillar in environmental, social, and governance investing becomes even more salient.

Box 5: Social Bond Issues for Developing Asia

The COVID-19 pandemic has created an opportunity for social bonds to address underlying social issues. Given the exponential growth in the issuance of social bonds in 2020 and the first half of 2021, both globally and regionally, the challenge now is for policy makers and issuers to consider how to better utilize social bond markets to solve social issues that are most relevant to Asia. The pandemic has generated a significant shift in social bond issuance to more pandemic-related projects and socioeconomic crisis alleviation. In developing Asia, the social bond market is still at a nascent stage, addressing relatively narrow social areas such as small and medium-sized enterprise financing, transportation, training, and education.[4] More social areas can be supported via projects related to health care, clean water, food security, and gender equity. Clearly defined impact measurement methods and disclosure requirements will help further develop the market and maximize the impact of social bonds.

[4] Developing Asia refers to the 46 developing member economies of the Asian Development Bank.