Executive Summary

Recent Developments in Financial Conditions in Emerging East Asia

Financial conditions marginally improved between 1 June and 31 August in emerging East Asia on sound economic fundamentals and regional monetary tightening cycles approaching their end.[1] Most regional central banks kept their interest rate hikes on hold amid easing inflation, while some central banks started to lower rates to boost economic growth.

Most emerging East Asian economies witnessed narrowing risk premiums, gains in equity markets, and net foreign inflows in their bond markets. During the review period between 1 June and 31 August, regional markets excluding the People's Republic of China (PRC), where domestic financial markets weakened on a dimmed economic outlook, posted a market-weighted average gain of 1.4% in equity markets and a gross-domestic-product-weighted decline of 1.2 basis points in risk premiums, as captured by credit default swap spreads. Regional bond markets posted net foreign inflows of USD18.5 billion from April to July, partly supported by weakening inflation across the region. A dimmed economic outlook has softened investment sentiment in the PRC. Weighed down by this, regional equity markets posted net portfolio outflows of USD7.2 billion during the review period, largely driven by USD12.3 billion of net outflows from the PRC in August.

Regional currencies slightly weakened versus the United States (US) dollar amid ongoing monetary tightening and the positive economic outlook in the US. During the review period, regional currencies slightly depreciated against the dollar by 1.5% (simple average) and 1.9% (gross-domestic-product-weighted average).

From 1 June to 31 August, local currency (LCY) government bond yields rose in most emerging East Asian markets, following rising bond yields in major advanced economies. Only yields in the PRC and Viet Nam declined, as their respective central banks cut policy rates to support economic activities and safeguard financial stability.

The risk outlook for regional financial conditions is generally balanced. On the upside, softening inflation in the region has led most regional central banks to move toward the end of their monetary tightening cycles. A faster-than-expected decline in inflation in advanced economies, combined with financial risk considerations, might lead to a less hawkish monetary stance in advanced economies. However, the inflation path remains uncertain. Elevated price pressures together with a robust economic performance and strong job market in the US could support further monetary tightening.

On the downside, higher interest rates could challenge regional public and private borrowers with vulnerable balance sheets and weak governance. The Asian banking sector demonstrated its resilience amid the banking turmoil in the US and Europe earlier this year and the ratings downgrade of 10 mid-sized US banks in August. However, vulnerabilities have been present among both public and private sector borrowers since 2022, due to rising borrowing costs and tightened financial conditions. The Lao People's Democratic Republic has been rated by the International Monetary Fund as being "in debt distress" for both external and public debt, with public debt being deemed "unsustainable." Cambodia recorded a rising share of nonperforming loans in 2022, and some regional economies' corporate bond markets have experienced defaults in recent months. For example, the PRC and Viet Nam witnessed corporate bond defaults, especially in the real estate sector, while in Thailand, weak governance has been noted as a contributing factor in some cases of default. Headwinds to the regional economic outlook can also challenge financial conditions, as high interest rates could dampen consumption and investment, and weakness in the PRC's property sector could affect the broader economy and negatively affect the regional economic outlook.

[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.

Recent Developments in Local Currency Bond Markets in Emerging East Asia

By the end of the second quarter (Q2) of 2023, LCY bonds outstanding in emerging East Asia totaled USD23.1 trillion on growth of 2.0% quarter-on-quarter (q-o-q). Growth in government bonds outstanding eased to 2.3% q-o-q in Q2 2023 from 2.6% q-o-q in the prior quarter as many governments frontloaded bond issuance in the first quarter (Q1) of 2023. Regional corporate bonds outstanding also saw weaker growth of 1.4% q-o-q in Q2 2023, compared with 1.6% q-o-q in Q1 2023, over sizeable amounts of maturities in nearly all markets. Government bonds accounted for 62.0% of the region's total LCY bond stock at the end of June. Association of Southeast Asian Nations (ASEAN) markets comprised a collective share of 9.1% of the regional LCY bond total with aggregate LCY bonds outstanding of USD2.1 trillion at the end of June.

During Q2 2023, emerging East Asia's LCY bond issuance reached USD2.4 trillion—with growth moderating to 4.6% q-o-q from 6.2% q-o-q in Q1 2023. Government bonds issuance, which comprised 41.7% of regional total LCY bond issuance in Q2 2023, posted growth of 2.2% q-o-q, decelerating from 12.4% q-o-q in Q1 2023. The slowing growth was largely driven by some governments tapering their issuance volumes after frontloading financing needs in Q1 2023. On the other hand, corporate bond issuance rebounded during the quarter, surging 12.6% q-o-q in Q2 2023, following a 1.1% q-o-q contraction in Q1 2023, led by the PRC and the Republic of Korea. ASEAN markets' aggregate issuance during the quarter reached USD470.4 billion, accounting for 20.0% of the regional issuance total despite a 6.5% q-o-q contraction.

The region's Treasury bond markets are dominated by medium- to long-term financing. Treasury bonds with a maturity of more than 5 years accounted for 53.2% of regional Treasury bonds outstanding at the end of June and 54.8% of Treasury bond issuance during Q2 2023. The size-weighted average maturities of Treasury bonds outstanding and issued in Q2 2023 were 8.5 years and 6.7 years, respectively. Meanwhile, around 89% of regional LCY Treasury bonds were held by domestic investors at the end of June.

Sustainable bonds outstanding in ASEAN+3 reached USD694.4 billion at the end of June, growing 5.1% q-o-q and 31.5% year-on-year in Q2 2023.[2] The expansion of ASEAN+3 sustainable bonds outstanding was roughly in line with that of the global sustainable bond market (5.5% q-o-q). ASEAN+3 accounted for 19.1% of global sustainable bonds outstanding at the end of June, making it the second-largest regional sustainable bond market in the world following the European Union's (EU-20) 38.5% share. Nevertheless, ASEAN+3's sustainable bond market accounts for only 1.9% of ASEAN+3's overall bond market, which is much smaller than the corresponding share of 6.6% for the EU-20.

During Q2 2023, ASEAN+3 sustainable bond issuance totaled USD69.0 billion, growing 19.7% q-o-q after a contraction of 0.6% q-o-q in Q1 2023. LCY issuance accounted for 78.4% of ASEAN+3 sustainable bond issuance in Q2 2023. Moreover, ASEAN+3 sustainable bond issuance tended to be concentrated in relatively short-term financing, with 59.9% of issuance in Q2 2023 having a maturity of 3 years or less. ASEAN+3's size-weighted average tenor for sustainable bond issuance in Q2 2023 was 4.8 years, or about half of the EU-20's average of 9.1 years over the same period. Around 69.0% of ASEAN+3 sustainable bond issuance was from the private sector in Q2 2023, compared with 44.2% in the EU-20.

[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.