

The *Asia Bond Monitor* (ABM) reviews the development of East Asian local currency bond markets. It examines market size and composition, market liquidity, and yields and returns. Recent policy reforms are also highlighted. The ABM covers the 10 Association of Southeast Asian Nations member countries plus the People's Republic of China and the Republic of Korea.

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Development of East Asian Local Currency Bond Markets: A Regional Update

Highlights

Market Performance in 2005

- Emerging East Asian local currency government bond markets grew more modestly in the first half of 2005 than in previous years, due to a rise in interest rates and fiscal consolidation.
 - Thailand and Viet Nam registered the strongest growth, followed by PRC, Korea, Malaysia, Singapore, and Philippines, with Indonesia declining slightly.
 - In USD terms, outstanding local currency government bonds grew 6.9% for East Asia as a whole, compared with 32% in 2004 and a 27% average annual growth from 1997 to 2003.
- Corporate bond market growth again lagged behind, with outstanding local currency corporate bonds increasing 5.9% in USD terms during the first half of 2005 in markets where data are available, compared with 10% for 2004 and an 18% average annual growth from 1997 to 2003.
- Turnover was high in the first half for most government bond markets covered, with average daily trading volume up significantly over 2004 levels. Trading was mixed in the corporate sector.
- Except in PRC, Malaysia, and Philippines, local currency government bond yields have risen in most emerging East Asian markets across all maturities since the beginning of the year, due to increases in funding rates in response to US Fed rate hikes and inflationary expectations as a result of high growth and high oil prices. In almost all markets, yield curves have flattened with 2–10 year bond spreads declining.
- Because of rising yields, bond returns are down on average from 2004. The USD return on the iBoxx ABF Pan-Asian Index was 0.26% as of end-October, well below the 11.8% in 2004 calculated from a composite East Asian local currency bond index.
- In 2005, East Asian governments continue to implement institutional and regulatory reforms that will speed development of local currency bond markets. These include improving market infrastructure; introducing new products; promoting retail investment and attracting offshore investors; opening local currency bond markets to supnationals and foreign financial institutions; and pursuing regional cooperation.

Continued overleaf

Acronyms and Abbreviations

ABF	Asian Bond Fund
ABM	Asia Bond Monitor
ABMI	Asian Bond Markets Initiative
ADB	Asian Development Bank
APEC	Asia-Pacific Economic Cooperation
ARIC	Asia Regional Information Center
ASEAN	Association of Southeast Asian Nations
BEX	Bond Electronic Exchange
BIS	Bank for International Settlements
BOT	Bank of Thailand
CAGAMAS	National Mortgage Corporation
CBRC	China Banking Regulatory Commission
CIRC	China Insurance Regulatory Commission
CMBS	commercial mortgage-backed securities
CSRC	China Securities Regulatory Commission
DVP	delivery versus payment
EMEAP	Executives' Meeting of East Asia-Pacific Central Banks
ETF	exchange-traded funds
EU	European Union
Fed	United States Federal Reserve
FIE	Fixed Income Exchange
GDP	gross domestic product
HSTC	Ho Chi Minh Securities Trading Center
IFC	International Finance Corporation
IMF	International Monetary Fund
JBIC	Japan Bank for International Cooperation
KHFC	Korea Housing Finance Corporation
MGS	Malaysian Government Securities
MSB	monetary stabilization bond
NAFTA	North American Free Trade Agreement
OTC	over-the-counter
PAIF	Pan-Asian Bond Index Fund
PBC	People's Bank of China
QFII	Qualified Foreign Institutional Investor
REIT	real estate investment trust
RMBS	residential mortgage-backed securities
SDRC	State Development and Reform Commission
STRIPS	Separate Trading of Registered Interest and Principal of Securities

Note: To conform with market practice, the *Asia Bond Monitor* uses three-letter official ISO currency codes rather than ADB's standard symbols.

Monitoring Financial Integration in East Asia

- In East Asia, cross-market differentials in interest rates and bond yields are significant, and intraregional cross-border portfolio investment is small relative to the region's total cross-border portfolio flows. These suggest that the level of financial integration remains low.
- Yet, cross-market differentials in interest rates and bond yields are declining, cross-market co-movements in money and bond markets are increasing, and intraregional cross-border portfolio investment is growing. These indicate some progress toward financial integration. East Asian investors also purchase a significant proportion of USD- and EUR-denominated debt issued by East Asian issuers. And the region's banks are major participants in the region's syndicated loan markets.
- East Asian equity markets are more integrated than money markets or bond markets, with a higher level of cross-market co-movements in stock returns than money market rates or bond yields. A higher proportion of the region's total cross-border equity investment is directed to the region itself compared with fixed-income investment.
- The low level of financial integration in East Asia is partly a result of institutional and regulatory barriers to cross-border capital flows.
 - Among the 10 East Asian economies examined, Japan; Singapore; and Hong Kong, China are the most open markets, with no or minimal restrictions on cross-border investment by either residents or nonresidents. Korea has also increasingly opened its markets to cross-border investment.
 - In other markets, various restrictions remain, despite progress in liberalizing financial sectors and opening capital accounts. This is particularly true for residents investing abroad.
- The relatively small size, low liquidity, and various structural weaknesses of the region's financial markets also hinder financial integration, as these limit investor choice, increase transaction costs, and lead to high perceived risks.
- Continued policy and institutional reform is the key to accelerating East Asian financial integration. East Asian governments should continue efforts aimed at capital market development and financial liberalization, with a well-sequenced program supported by a strong institutional and regulatory framework.
- Regional cooperation is important in facilitating East Asian financial market development and integration. Monetary and financial cooperation has indeed moved forward, especially under the ASEAN+3 Finance Ministers' Process, with many initiatives filtering into reform agendas. These efforts should be applauded, and accelerated.