

Asia Bond Monitor Executive Summary



Emerging East Asia's Local Currency Bond Yields Rise

Emerging East Asia's local currency (LCY) bond yields rose in all markets, except the People's Republic of China (PRC) and the Republic of Korea, between 1 March and 31 May amid continued global economic growth and United States (US) monetary policy tightening.¹

The US has seen its interest rates rise as the Federal Reserve pursues monetary policy normalization and the domestic economic outlook brightens. In March, the Federal Reserve upgraded its previous growth forecast made in December, with gross domestic product (GDP) expected to grow 2.7% and 2.4% in 2018 and 2019, respectively, compared with 2.5% and 2.1%. As a result, the Federal Reserve increased the federal funds target rate range by 25 basis points (bps) in its 20 March meeting. Minutes from the meeting also raised the prospect of accelerated rate increases given the strength of the US economy.

The growth outlook is also positive in the euro area. In March, the European Central Bank upgraded the euro area's GDP growth for 2017 and 2018 to 2.5% and 2.4%, respectively, from 2.4% and 2.3% in December. However, the outlook in the euro area has been marred by rising political uncertainty in Italy. In Japan, the economic outlook was also recently upgraded.

The political uncertainties in the euro area have led to widening credit default swap spreads and rising interest rates in a number of euro area economies. In addition, strong growth in the US has led to the appreciation of the US dollar and a weakening of emerging East Asian currencies. The negative sentiment surrounding emerging East Asian currencies has resulted in widening credit default swap spreads across the region.

This issue of the *Asia Bond Monitor* includes two special discussion boxes. Box 1 discusses the financial market turbulence in Argentina and Turkey, and the potential impacts in emerging Asia.

Box 2 is a primer on green bonds. The box discusses the purpose and uses of green bonds, and provides statistics on issuers by type and economy.

As emerging East Asia benefits from the current global economic expansion, risks still loom over the horizon. These include (i) financial stresses resulting from US policy rate hikes, (ii) a high level of corporate and household debt in some economies, (iii) rising emerging market currency turmoil as evidenced by Argentina and Turkey, and (iv) possible escalation of trade tensions between the PRC and the US.

Emerging East Asia's Local Currency Bond Market Posts Minimal Growth in the First Quarter of 2018

Emerging East Asia's LCY bond market continued to grow in the first quarter (Q1) of 2018, albeit at a pace of only 1.1% quarter-on-quarter (q-o-q), to reach USD12.8 trillion at the end of March. All markets in the region posted positive q-o-q growth rates in Q1 2018 except Hong Kong, China. Furthermore, the region's growth decelerated from 3.1% q-o-q in the fourth quarter of 2017 as bond issuance was lower in Q1 2018 compared with the previous quarter.

The PRC's LCY bond market, which remains the largest in the region with a 71.5% share of total bonds outstanding, drove the slower regional growth as its bond market expanded only 0.7% q-o-q in Q1 2018 following robust growth of 4.0% q-o-q in the final quarter of 2017. The PRC's slow growth was the result of declining issuance in its government bond market, particularly the issuance of local government bonds, as its debt-to-swap program nears completion.

The region's LCY government bond market expanded 1.3% q-o-q to USD8.5 trillion, comprising 66.9% of the region's aggregate bonds outstanding. The corporate bond market was barely changed, inching up 0.5% q-o-q to USD4.2 trillion.

In line with the minimal growth in emerging East Asia's LCY bond market and faster growth in the region's

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.

aggregate economy, the ratio of LCY bonds outstanding to the region's GDP slipped to 70.1% at the end of March from 70.8% at the end of December. The respective ratios of the region's government bond market and corporate bond market fell to 46.9% and 23.2% from 47.1% and 23.7%.

Total LCY bond issuance in emerging East Asia fell for the second consecutive quarter in Q1 2018, dipping 10.7% q-o-q to USD1.0 trillion. The continued decline was driven by the drop in issuance in both the government and corporate segments of the PRC's LCY bond market, which comprises nearly half the regional total. All other markets in the region, excluding the Philippines, posted higher issuance volume in Q1 2018 compared with the previous quarter.

Net Foreign Investment Inflows Slow in the First Quarter of 2018, Turn Negative in April

The first 4 months of 2018 saw foreign investors gradually reducing their exposure to the region's LCY bond market as a result of higher US interest rates (driven by the Federal Reserve's ongoing monetary policy normalization) and the improved global economic growth.

The shares of foreign investor holdings in most markets in the region slipped in Q1 2018. Indonesia saw the region's largest decline, reflecting concerns over its vulnerability to outflows as almost 40% of its LCY government bonds are held by foreign investors. Indonesia was followed by Malaysia and Thailand, which both saw outflows in reaction to rising US interest rates. The PRC continued to have a small portion of its LCY government bond market held by foreign investors, but this share is on an upward trend.

In Q1 2018, net foreign investment inflows were registered in all market, largely due to the strong inflows in January. In succeeding months, particularly in April when the minutes of the US Federal Reserve's March meeting were released signaling the possibility of accelerated hikes, most markets in the region recorded net bond outflows.

Local Currency Bond Yields Rise in Emerging East Asia

Government bond yield curves shifted upward for nearly all emerging East Asian markets due to continued policy rate hikes in the US. Some markets in emerging East Asia,

such as Indonesia and the Philippines, have subsequently tightened monetary policy. On the other hand, the PRC reduced reserve requirement ratios in April.

Theme Chapter: The Role of Greenness Indicators in Green Bond Market Development

Green bonds are fixed income securities that exclusively fund green projects with environmental or climate-related benefits. They are a hybrid of financial and environmental risk in one financial instrument. Despite rapid expansion in recent years, the green bond market is still immature, with a much smaller amount of bonds outstanding compared with conventional bond markets, as well as a low level of liquidity. The lack of enforcement mechanisms and consistent and widely acknowledged definitions and standards across economies constrain further development of the green bond market.

The theme chapter empirically investigates the green bond premium in green bond markets. It analyzes the liquidity-adjusted yield spread of green bonds over their synthetic conventional counterparts. It further examines possible determinants that drive the green bond premium. This study focuses on proxies for greenness and gauges their impacts on green bond pricing.

Empirical evidence shows that, overall, there is no significant green premium on green bonds compared with their paired conventional bonds. However, green bonds that have an external reviewer are traded at a discount of about 7 bps compared to green bonds without an external reviewer and green bonds that receive a Climate Bonds Initiative certification have a green discount of around 9 bps. In addition, green bonds denominated in euros are generally traded at lower discount.

This study has policy implications for the benefits of a universal greenness measure in the green bond market. Such a measure—whether in the form of certain standards or labels, independent reviewers, or other formats—could help reduce the information asymmetry faced by investors. A commonly recognized greenness measure would not only benefit investors by lowering information costs, but also is expected to lead to more green issuers and a broadening of the investor base. Thus, a well-defined greenness measure can foster the better functioning and further development of the green bond market.