

Asia Bond Monitor Executive Summary

The logo for the Asian Development Bank (ADB), consisting of the letters 'ADB' in white serif font on a dark blue square background.

Emerging East Asia's Bond Yields Rise

Local currency (LCY) bond yields rose in all economies in emerging East Asia between 31 August and 15 October, on the back of continued interest rate hikes in the United States (US).¹ The exceptions were the People's Republic of China (PRC), as its central bank reduced reserve requirement ratios, and Viet Nam, which experienced increased interbank liquidity.

The US Federal Reserve continued to hike its policy rate amid the ongoing strengthening of the domestic economy. In the euro area, the European Central Bank reduced its monthly asset purchases to EUR15 billion beginning in October, and will discontinue the program after December. The European Central Bank noted that the end of its asset purchase program would still be conditional on incoming economic data, as growth in the third quarter (Q3) of 2018 slowed further. In Japan, the economy posted strong gross domestic product growth in Q2 2018, reversing the previous quarter's contraction.

Downside risks to emerging East Asia's bond markets are rising. Risk aversion toward emerging market economies has heightened, with the markets of Argentina and Turkey being the most affected. Another risk is the potential for faster-than-expected policy rates hikes in the US given the strength of its economy. Lastly, while global economic growth remains robust, trade tensions could cloud the outlook.

This issue of the *Asia Bond Monitor* includes a theme chapter on the impact of the Asian Bond Markets Initiative (ABMI) on the region's bond market development, a special chapter detailing the results from the *AsianBondsOnline* annual bond market liquidity survey, and three special discussion boxes. Box 1 discusses the Cagamas model in housing financing in Malaysia. Box 2 explores the use of distributed ledger technology in the financial sector. Box 3 examines the relationship between financial cycles and real-economy business cycles.

Local Currency Bond Markets in Emerging East Asia Expand in Q3 2018

Emerging East Asia's local currency (LCY) bond market expanded 4.3% quarter-on-quarter (q-o-q) in the third quarter (Q3) of 2018 to reach a size of USD12.8 trillion at the end of September. This growth rate was higher than the 3.2% q-o-q increase posted in Q2 2018. The PRC continued to drive the region's bond market development, being the largest bond market in emerging East Asia at USD9.2 trillion and comprising 72% of the regional total. The amount of its outstanding bonds rose 5.7% q-o-q in Q3 2018 due to a rebound in issuance in both the government and corporate bond segments. Growth was largely driven by the surge in the issuance of "special bonds" by local governments for infrastructure projects. This program is part of efforts by the government to boost growth amid a slowdown in economic activity and risks posed by ongoing trade disputes with the US.

The aggregate LCY bond market size for Association of Southeast Asian Nations member economies, for which data are available, reached USD1.3 trillion at the end of September on 2.2% q-o-q growth. All economies posted positive q-o-q growth rates in Q3 2018. Thailand remained home to the largest bond market in the Association of Southeast Asian Nations.

The region's bond markets mainly comprise government bonds, which reached an aggregate amount of USD8.6 trillion at the end September on growth of 5.0% q-o-q. Corporate bonds amounted to USD4.2 trillion and posted slower growth of 3.0% q-o-q.

As a share of regional gross domestic product, emerging East Asia's LCY bond market rose to 73.1% in Q3 2018 from 71.2% in the previous quarter. The Republic of Korea and Malaysia continued to have the highest shares in the region at 127.0% and 96.7%, respectively.

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.

Despite tepid issuance in a number of markets that posted q-o-q declines in issuance volume, the region as a whole posted 13.5% q-o-q growth in bond issuance in Q3 2018. The expansion was driven by issuance growth of 27.4% in the PRC, the region's biggest market.

Foreign Holdings in LCY Bond Markets in Emerging East Asia Stabilize in Q3 2018

The shares of foreign investor holdings in LCY bond markets in emerging East Asia stabilized in Q3 2018 as investor sentiments toward the region generally improved. In line with this, net foreign bond inflows were registered for most markets in the region in Q3 2018, with July having the strongest monthly inflows.

The LCY bond markets in Malaysia and Indonesia saw foreign holdings as a share of the total slightly easing in Q3 2018. In Malaysia, investor confidence eventually improved after the May elections but was still dampened by external volatility. The steps taken by Bank Indonesia to defend its currency somewhat improved investor sentiment, resulting in a rise in its foreign investor holdings. However, the amount of outstanding bonds rose at a faster pace.

Foreign holdings in the PRC, while still small as a share of the total, continued to rise on the back of the gradual liberalization of its bond market. In the Philippines, foreign holdings inched upward from a marginal base as the aggressive rate hikes by the Bangko Sentral ng Pilipinas helped temper investor concerns. The Republic of Korea and Thailand registered slight increases in their respective foreign holding shares in Q2 2018, the latest quarter for which data are available.

AsianBondsOnline Annual Bond Market Liquidity Survey

AsianBondsOnline conducts an annual survey to assess liquidity conditions in the region's LCY bond markets and to identify potential issues that impact their further development. This year's survey was conducted between the last week of September and the first 2 weeks of October.

The overall liquidity condition assessment of market participants was mixed. Stable to slightly worse liquidity conditions were noted in Indonesia, the Republic of Korea,

Malaysia, and the Philippines, largely due to continued rate hikes in the US and uncertainties in the global economy. Better liquidity conditions were noted in the PRC; Hong Kong, China; Singapore; Thailand; and Viet Nam.

The region's average bid-ask spread for government bonds narrowed in this year's survey to 4.7 basis points, while it slightly fell for corporate bonds. Changes in the average transaction size were mixed for government bonds, while the average transaction size increased for corporate bonds in most markets.

Among qualitative indicators, the lack of well-functioning hedging mechanisms for both government and corporate bonds was identified as the most important common structural issue that requires attention from regional authorities. Other identified structural problems include the lack of a diversified investor base for both government and corporate bonds.

Theme Chapter: Assessing the Impact of the Asian Bond Markets Initiative on Bond Market Development in Asia

ABMI was developed to mitigate the currency and maturity mismatches that contributed to the 1997/98 Asian financial crisis. While the role of ABMI in the region's bond market development is widely recognized, there are very few studies that empirically assess the initiative's impact on the development of bond markets in the region. The theme chapter assesses the impact by comparing and analyzing bond market development in Asia and Latin America. While economies in Asia have collectively tried to develop and integrate their bond markets through a regional platform, Latin American economies have attempted to individually develop their bond markets.

After controlling for the major determinants of bond market development, the empirical results indicate that ABMI significantly contributed to corporate bond market development in Asia by facilitating more issuance. This result is consistent with earlier studies, such as Mizen and Tsoukas (2014), which find that ABMI contributed to the increased issuance of corporate bonds in the region. However, due to strict regulations on transactions in domestic currencies with and between nonresidents, most Asian economies are not yet able to borrow abroad in their domestic currency even though their LCY bond market has grown in size.

Box 1: The Cagamas Model

This box discusses the brief history of Cagamas, the National Mortgage Corporation of Malaysia, which provides liquidity to financial institutions to help them lend to home buyers at a reasonable cost. Cagamas has also contributed to the rapid development of Malaysia's corporate bond market through its regular issuance of private debt securities. Moreover, it has been a major issuer of *sukuk* (Islamic bonds) and has thus promoted the development of the *sukuk* market. This box discusses important lessons from the Cagamas model on how other developing economies can establish their own secondary mortgage market.

Box 2: The Promise of Distributed Ledger Technology for Financial Development

This box discusses how distributed ledger technology (DLT) can contribute to financial sector development. In particular, the box explores some promising areas for DLT in developing economies, including remittances, emergency aid delivery, microcredit, and trade finance. A number of specific applications of DLT are presented for each potential area of development.

Box 3: Financial Business Cycles versus Normal Business Cycles—An Empirical Comparison

Box 3 analyzes the impact of financial cycles and business cycles on the real economy. The study finds that financial recessions inflict greater damage on the real economy than business cycle recessions. Furthermore, the study shows that financial recessions associated with corporate debt buildup are at least as damaging to the real economy as financial recessions associated with household debt buildup.