Asia Bond Monitor Executive Summary

Emerging East Asia's Local Currency Bond Yields Diverge Amid Disparate Monetary Policy Stances and Rising Global Uncertainty

Emerging East Asia's local (LCY) bond yields diverged between 1 June and 15 August, largely due to the differing responses of the region's central banks to the United States (US) Federal Reserve's monetary tightening and rising global economic uncertainty.[1]

Among advanced economies, the US continued to post the strongest growth, with advanced estimates showing that US gross domestic product (GDP) grew at an annual rate of 4.1% in the second quarter (Q2) of 2018, up from 2.1% in the previous quarter. In response, the Federal Reserve maintained its monetary policy normalization, raising the federal funds rate target range by 25 basis points at its 13–14 June meeting.

Economic growth has been stable in the euro area, albeit with GDP growth slowing in Q2 2018 to 2.2% year-on-year from 2.5% year-on-year in the first quarter (Q1) of 2018. The European Central Bank announced on 14 June that its quantitative easing program will end in December. Japan's GDP grew at an annual rate of 3.0% in Q2 2018, rebounding from a 0.9% contraction in Q1 2018. However, the Bank of Japan signaled that normalization may begin later than previously expected.

Continued monetary tightening in the US and signs that the euro area will begin tightening contributed to the depreciation of most emerging East Asian currencies during the review period.

While advanced economies are tightening their monetary policies, global economic uncertainty has increased due to ongoing trade tensions between the US and its economic partners. Financial instability in Argentina, Turkey, and other emerging markets is an additional source of uncertainty. Uncertainty also played a role in longer-term yield declines in the US and some select European markets.

This issue of the Asia Bond Monitor includes three special discussion boxes. Box 1 discusses the impact on financial markets of ongoing global trade tensions between the People's Republic of China (PRC) and the US.

Box 2 discusses green bond issuance in Asia, examining the growing diversity of projects financed by green bonds as well as the existence of a green bond premium.

Box 3 looks at the rising popularity of cryptocurrencies and their effect on financial markets and the actions of regulators.

While emerging East Asia continues to enjoy economic stability, some risks loom on the horizon. These include (i) the risk of spillovers from financial turbulence in emerging markets outside the region, (ii) escalating global trade tensions, (iii) rising private debt levels, and (iv) volatility in global oil prices.

Emerging East Asia's Local Currency Bond Market Posts Moderate Growth in Q2 2018

Emerging East Asia's LCY bond market reached a size of USD12.6 trillion at the end of June, posting moderate growth of 3.2% quarter-to-quarter (q-o-q). Growth accelerated from 1.1% q-o-q in Q1 2018 due to a jump in the region's aggregate issuance. All markets in the region posted q-o-q growth rates in Q2 2018 except Viet Nam.

The PRC remained home to the largest bond market in the region in Q2 2018, comprising 72% of the regional total. Total outstanding LCY bonds in the PRC rose 3.8% q-o-q, following growth of 1.3% q-o-q in Q1 2018. Growth was largely driven by a surge in the issuance of local government bonds as the debt-for-bond swap program neared its completion in August.

Government bonds continued to dominate the region's LCY bond market in Q2 2018, accounting for 67.0% of the total at the end of June on robust growth of 4.0% q-o-q to reach USD8.4 trillion. The region's corporate bond market posted slower growth of 1.8% q-o-q to reach USD4.1 trillion at the end of June.

The share of emerging East Asia's LCY bond market to the region's GDP rose to 71.2% in Q2 2018 from

[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.

70.4% in Q1 2018. The Republic of Korea and Malaysia continued to have the highest shares of bonds-to-GDP in the region.

Total LCY bond issuance in the region rebounded in Q2 2018, posting a 26.5% q-o-q increase to reach USD1.2 trillion, following a contraction in Q1 2018. Growth was driven by the jump in issuance in large economies such as the PRC and the Republic of Korea. Issuance of government bonds increased 39.4% q-o-q, while corporate bond issuance rose 3.3% q-o-q.

Net Foreign Bond Flows Mixed in Q2 2018, Inflows Dominate in July

Foreign fund flows into the LCY bond markets of select economies in the region were mixed in Q2 2018. Nonresident holdings of LCY bonds in Indonesia and Malaysia were lower in Q2 2018 than in Q1 2018 due to foreign outflows from both markets. In Indonesia, foreign investors were cautious over the continued depreciation of the Indonesian rupiah and the deterioration of the current account. In Malaysia, uncertainty over the new government's economic policies kept foreign investors at bay.

The Republic of Korea and Thailand continued to attract foreign investors, with their foreign investor shares slightly increasing, owing to their solid economic fundamentals. Foreign holdings in the PRC and the Philippines remained low but continued on an upward trend in Q2 2018.

In July, all markets in the region for which data are available posted net inflows except Thailand, which saw marginal outflows. In Malaysia, foreign investors returned to the market on improved sentiments about the new government. Recent rate hikes by Bank Indonesia to defend the rupiah brought some foreign investors back to Indonesia.

Local Currency Bond Yields Diverge in Emerging East Asia

Emerging East Asia's LCY bond yields diverged in emerging East Asia between 1 June and 15 August amid disparate monetary policy stances and heightened global uncertainty due to rising trade tensions and other factors.

In response to global uncertainty, some central banks left monetary policy rates unchanged and adopted a wait-and-see approach. Malaysia left policy rates unchanged after an initial rate hike in January. The PRC, which is likely to be hit hardest by trade tensions with the US, reduced reserve requirement ratios in April and June. The PRC also saw the largest decline in yields.

Indonesia, the Philippines, and Viet Nam experienced the largest yield increases during the review period. The central banks in Indonesia and the Philippines raised policy rates four times and three times, respectively, between May and August. Both central banks acted to mitigate currency depreciation, and in the Philippines to also reduce inflationary pressures.

Box 1: Effect of Global Trade Tensions on Financial Markets

Global trade tensions have intensified. Of particular concern for emerging East Asia are the escalating tensions between the PRC and the US. This box examines the effect of ongoing PRC–US trade tensions on financial markets, finding that emerging East Asian equity markets are being negatively affected by the implementation of protectionist measures.

Box 2: Strong Growth in the Asian Green Bond Market Supports Global Push to Reach USD1 Trillion in Annual Issuance by 2020

Asian green bond issuance has risen since 2007. While Japan and India have traditionally been key players in the market, the role of the PRC in green bond issuance has become more visible recently. The PRC accounted for over 70% of green bond issuance in Asia in the first half of 2018. Green bond issuance among members of the Association of Southeast Asian Nations is also expected to accelerate in light of policy developments. This box finds that diversity in global green bond issuance has risen, with the proceeds of green bonds financing a greater variety of infrastructure projects, including buildings and low-carbon transport.

Box 3: Are Cryptocurrencies a Threat to Financial Stability?

This box discusses the emergence of Bitcoin and other cryptocurrencies. Pronounced price volatility and the potential misuse of cryptocurrencies for tax evasion and other illegal activities has led a number of Asian governments to impose restrictions. However, the overall size of the cryptocurrency market remains limited and, hence, they do not yet pose a threat to financial market stability.