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# Policy Brief

ADB

OFFICE OF REGIONAL ECONOMIC INTEGRATION (OREI)

## Key Points:

- The comments from the US Federal Reserve Chairman that quantitative easing could soon be tapering off resulted in an outflow of funds from emerging markets, leading to falling currencies and rising bond yields.
- The turmoil in global financial markets is making it harder and more expensive for companies to issue foreign currency bonds. However, the impact on local currency bonds may be less significant.
- Bond markets in the region are more resilient now than during the 1997/98 Asian Financial Crisis as the growing use of local currency bonds has reduced currency mismatches.
- An orderly withdrawal of quantitative easing in line with a recovering US economy would help reduce the inflows of speculative funds in the region.
- Faced with the outflow of funds, policymakers will need to strike a careful balance between maintaining confidence in their currencies and sustaining growth momentum.
- Raising interest rates may help deflect some of the downward pressure on currencies but could also potentially derail growth.
- The region needs to continue to promote alternative and stable sources of financing, and better utilize the large pool of savings available to finance investment needs.

**OREI Policy Briefs** are based on papers or notes prepared by ADB staff. The series is designed to provide brief, nontechnical accounts of macro-financial, capital markets, regional cooperation and other relevant policy issues of topical interest, with a view to stimulate debate.

# Impact on Asian bond markets from tighter US monetary policy

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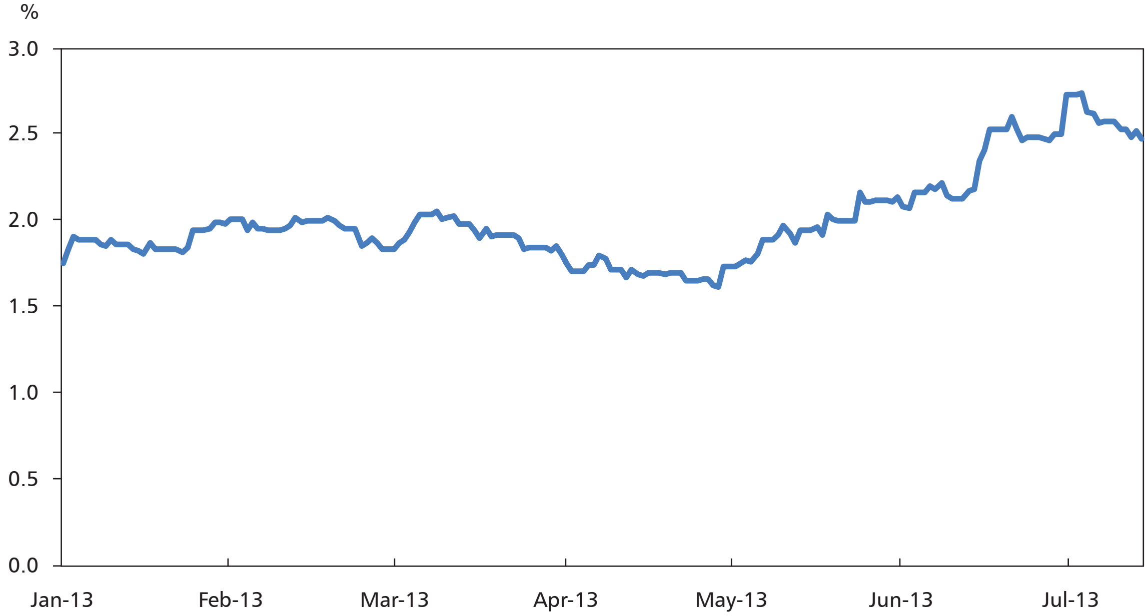
The region has witnessed an outflow of funds following the remarks of United States (US) Federal Reserve Chairman Ben Bernanke on 19 June that US monetary policy could soon be tightened. Assuming that economic conditions do not worsen, the Federal Reserve could start tapering its quantitative easing program toward the end of the year and end its asset purchases by the middle of 2014. These remarks sparked a sell-off in bond markets in the US, with bond yields rising from 2.13% at the beginning of June to 2.74% on 8 July. Interest rates have since eased a little, settling at around 2.5% on 19 July, after the Federal Reserve clarified that the start of tapering is not imminent and will remain dependent on economic conditions. Both the US economic recovery and the expected phasing-out of quantitative easing have had the effect of pushing up bond yields. The key question is whether the Federal Reserve may act too soon in tightening policy. With unemployment still high and inflation low, the fear is that the rise in interest rates could stunt the recovery that is just getting underway.

While the initial trigger for capital outflows from the region may have been the Federal Reserve's announcement that the end of its quantitative easing may be near, weaker economic prospects in the region, especially in the People's Republic of China (PRC), have also contributed to the outflows. Interbank interest rates in the PRC spiked in June as the authorities tried to engineer a slowdown in the rapid expansion of credit. This raised worries that the PRC's growth could also slow considerably, which would have repercussions for other economies in the region. In July, the PRC reported that economic growth in the second quarter of 2013 had slowed to 7.5%.

The bond market sell-off in the US has subsequently spread to emerging markets, with the immediate impact being depreciating currencies and falling bond prices. Since the Federal Reserve's announcement, the Indonesian rupiah and Malaysian ringgit have experienced the most significant depreciation, with most other currencies in the region depreciating as well. Furthermore, Thailand kept its policy rate unchanged on 10 July amid concerns about a slowing economy. On the other hand, Indonesia raised its policy rate by 50 basis points on 11 July to 6.5% following a 25–basis–point rise in June.

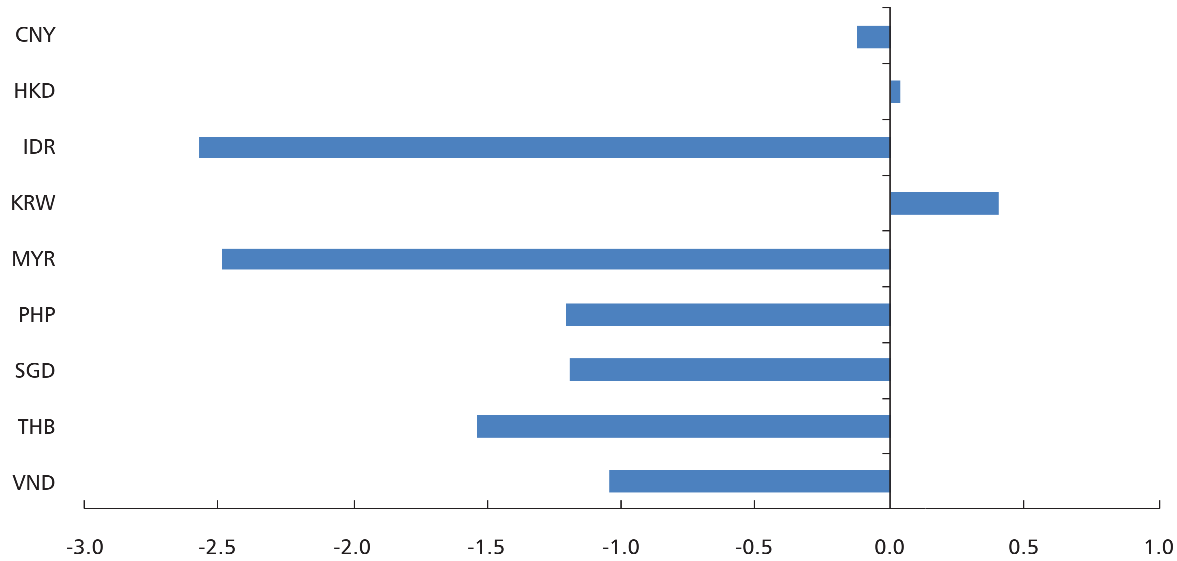
Bond yields have surged in recent months in several economies in the Association of Southeast Asian Nations (ASEAN). Indonesia saw the largest jump in bond yields, with the 10-year yield rising from less than 6.0% at the beginning of June to almost 7.9% on 19 July. Singapore and the Philippines also saw 10-year yields rise significantly, while yields for Malaysian and Thai bonds remained relatively

## 10-Year LCY Bond Yields




Source: Based on data from Bloomberg LP.

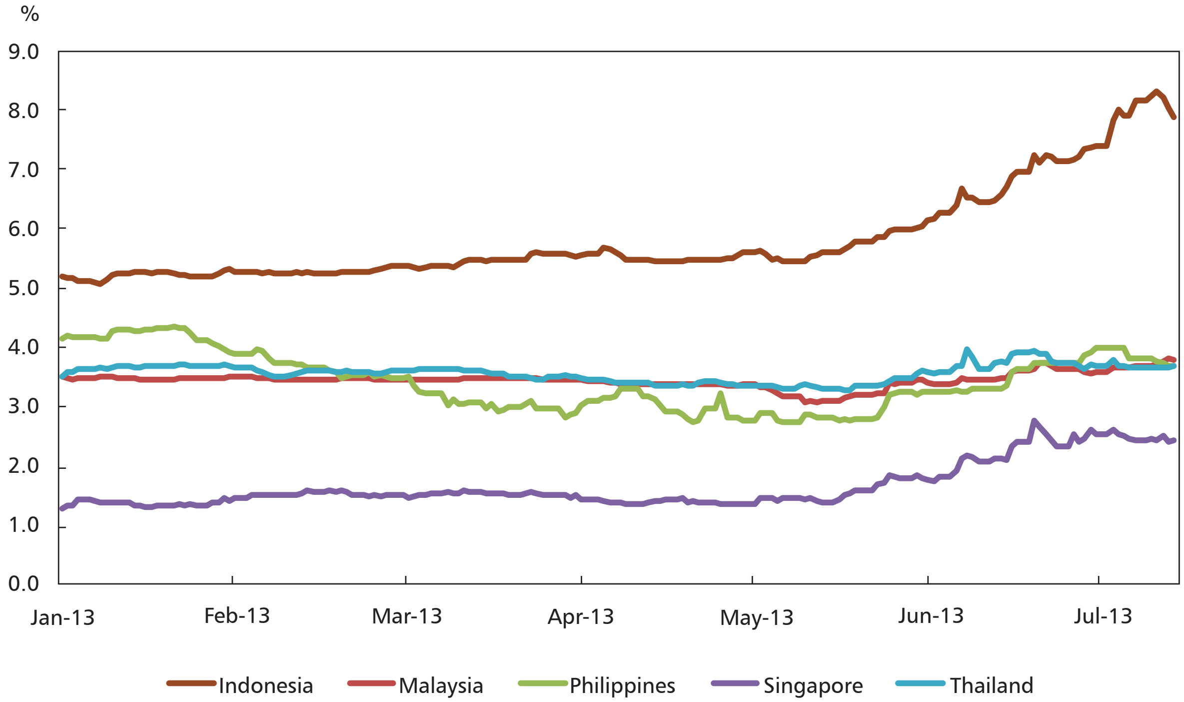
## Exchange Rate Change (14 June–19 July 2013)




Source: *AsianBondsOnline* computations based on Bloomberg LP data.

stable. The contrast between the performances of Malaysian and Indonesian bonds is quite interesting since both countries have a high level of foreign ownership in their local currency (LCY) government bond markets: 31.2% and 32.6%, respectively, as of end-March 2013. However, Malaysian bonds seem to have avoided the sell-off so far, suggesting that foreign investors may not be selling indiscriminately. Instead, the selling may be restricted to markets perceived to be riskier. Indonesia, with its rising inflation and current account deficit, is considered to be more risky than Malaysia. Also, current bond yields in Indonesia are barely keeping up with the rate of inflation once the impact of the removal of fuel subsidies is factored in. On the other hand, inflation in Malaysia has remained more moderate and bonds are still offering a decent real return to investors. Malaysia also runs a current account surplus, which means it does not have to rely on external funding to finance growth. Thailand is another market that has thus far avoided the sell-off. It also has

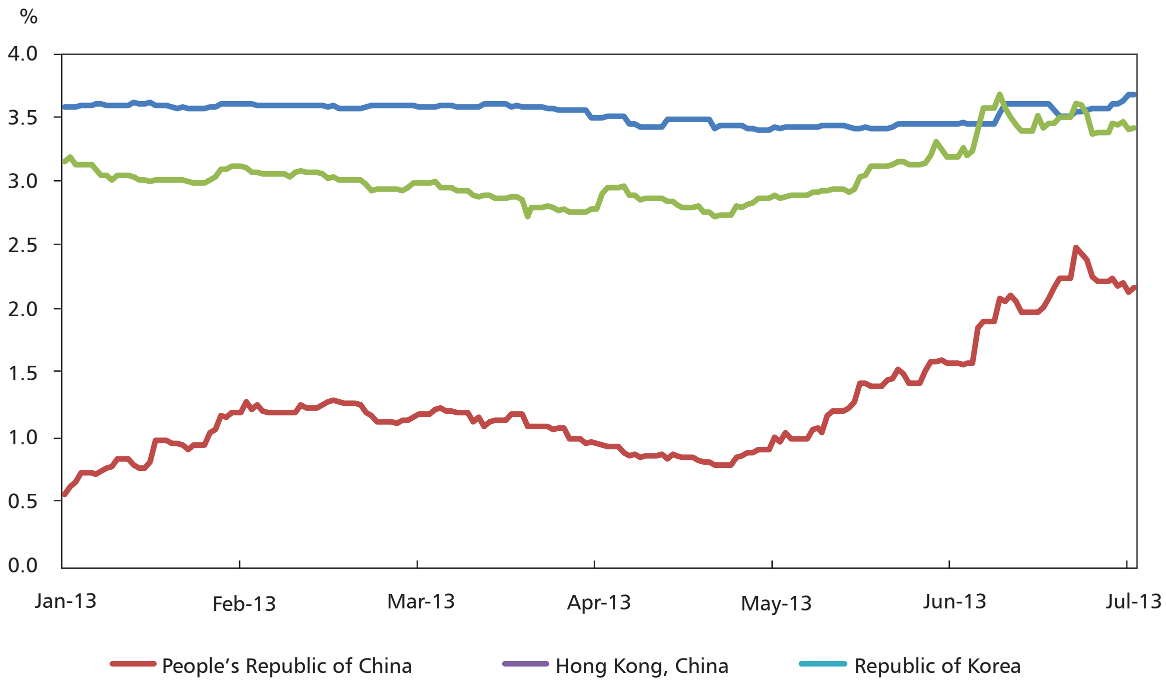
## 10-Year LCY Bond Yields—ASEAN 5




ASEAN = Association of Southeast Asian Nations, LCY = local currency.

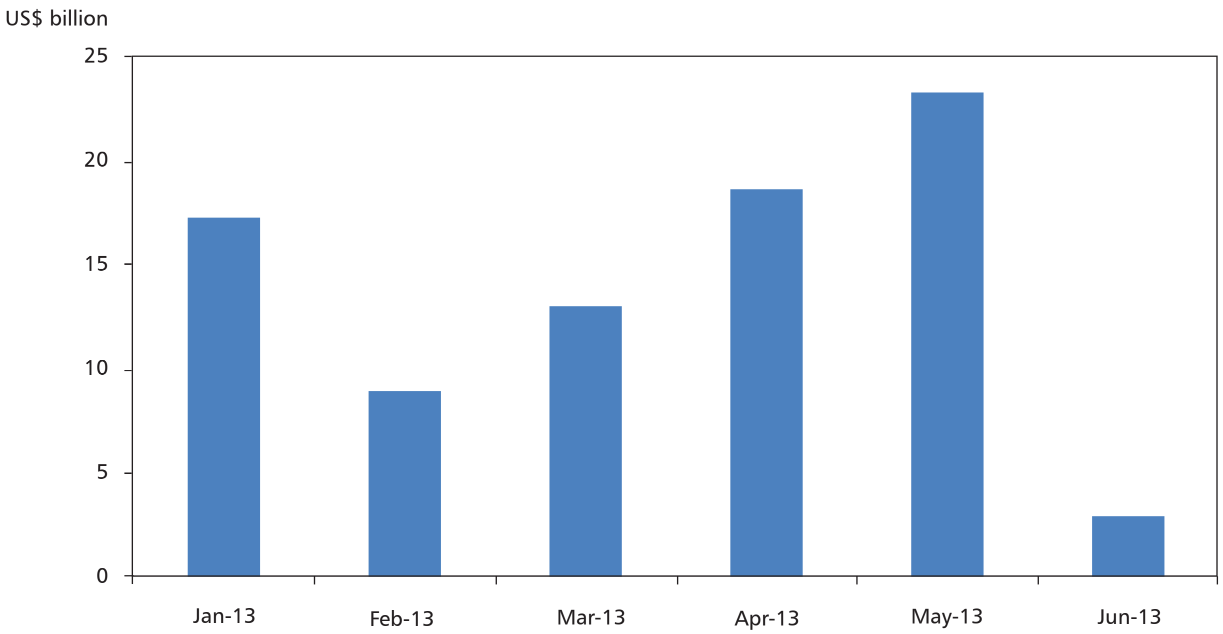
Source: Based on data from Bloomberg LP.

## 10-Year LCY Bond Yields—East Asia




Source: Based on data from Bloomberg LP.

## G3 Currency Bond Issuance




Source: *AsianBondsOnline* computations based on Bloomberg LP data.

substantial foreign ownership of its LCY government bonds, albeit at a lower level of 17.6%. Like Malaysia, Thailand has a current account surplus and low inflation, contributing to the perception that its bond market is less risky.

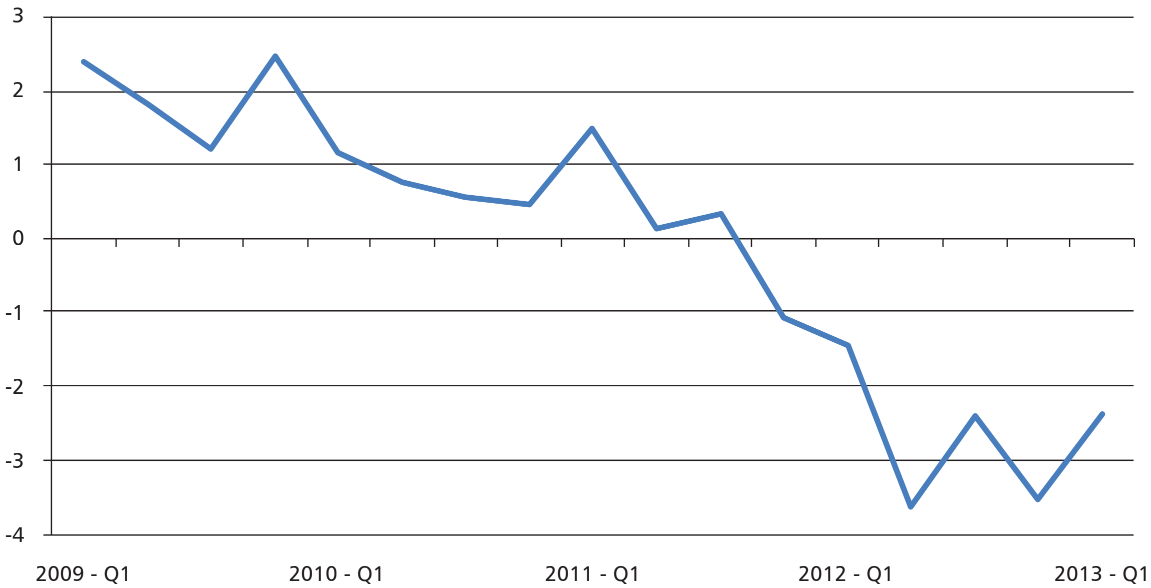
Even the yields of Singaporean bonds, which are traditionally seen as a safe haven in the region, have risen. The rise in yields is likely due to a reassessment of the risk in the region. Singapore's 10-year bonds have been yielding about 50 basis points less than US 10-year bonds since the beginning of the year, but the differential has since narrowed to less than 20 basis points. While there are no foreign ownership data available for Singapore, being an international financial center would suggest that foreign participation in the market is significant, making it vulnerable to changes in foreign investors' sentiments. The bonds of Hong Kong, China, another international financial center, have exhibited a similar pattern to that of Singapore, suggesting that movements in bond yields in both economies are being driven by capital outflows.

One impact of the turmoil in global financial markets is that it has become harder and more expensive for companies to issue bonds. This is particularly the case for foreign currency (FCY) bond issuance. After US$81 billion of issuance in the first 5 months of 2013, FCY bond issuance fell substantially to less than US$3 billion in June 2013. One particular corner of the FCY market that has been badly affected is the high-yield market, which is nearly at a standstill. This represents a big change from the situation at the beginning of the year when high-yield bonds in Asia were popular with global investors hunting for yield in a low interest rate environment. The change in the Federal Reserve's stance will likely make it more difficult for Asian companies to issue non-investment grade bonds to fund their financing needs.

Concerns about low-rated firms having difficulty raising funds have prompted the Government of the Republic of Korea to set up a KRW850 billion (US$800 million) fund to buy the bonds of firms that are finding it difficult to refinance. While this might only be a short-term measure to ensure sufficient liquidity for firms, it could turn into an open-ended commitment by the government to continue buying corporate bonds. With total corporate bonds accounting for more than half of the country's gross domestic product (GDP), even a small proportion would represent a substantial burden for the government.

The end of quantitative easing in the US may have less of an impact on the issuance of investment grade bonds and LCY bonds. Yields will be higher, but funding is still likely to be available. The economic fundamentals of the region's economies remain strong. Growth in the region is comfortably outpacing that of the developed economies and most measures of fiscal and financial vulnerabilities remain favorable. Almost all economies in the region continue to run current account surpluses, meaning that there is sufficient domestic savings to finance investment needs. One exception is Indonesia, which has been running a current account deficit since the fourth quarter of 2011. At the end of the first quarter of 2013, the current account deficit was equal to 2.4% of GDP. The weakness in Indonesia's external account may have contributed to its bond markets being among the worst affected. On 11 July, Indonesia sold US$1 billion worth of US$-denominated bonds at a yield of 5.45%. This represents a significant increase from the yield of 3.5% that

**Indonesia: Current Account Balance (% of GDP)**




GDP = gross domestic product.
Source: Haver Analytics.

**LCY Bonds Share of Total Bonds (US$ million)**

| | LCY | FCY | Total | LCY as % of Total Bonds |
|---|---|---|---|---|
| **China, People's Republic of** | 3811.34 | 148.37 | 3959.71 | 96.25 |
| **Hong Kong, China** | 177.49 | 123.94 | 301.43 | 58.88 |
| **Indonesia** | 111.31 | 50.21 | 161.52 | 68.91 |
| **Korea, Republic of** | 1470.97 | 150.79 | 1621.76 | 90.70 |
| **Malaysia** | 326.93 | 30.41 | 357.34 | 91.49 |
| **Philippines** | 99.12 | 42.86 | 141.98 | 69.81 |
| **Singapore** | 243.1 | 38.85 | 281.95 | 86.22 |
| **Thailand** | 278.53 | 12.7 | 291.23 | 95.64 |
| **Viet Nam** | 25.12 | 2.73 | 27.85 | 90.20 |

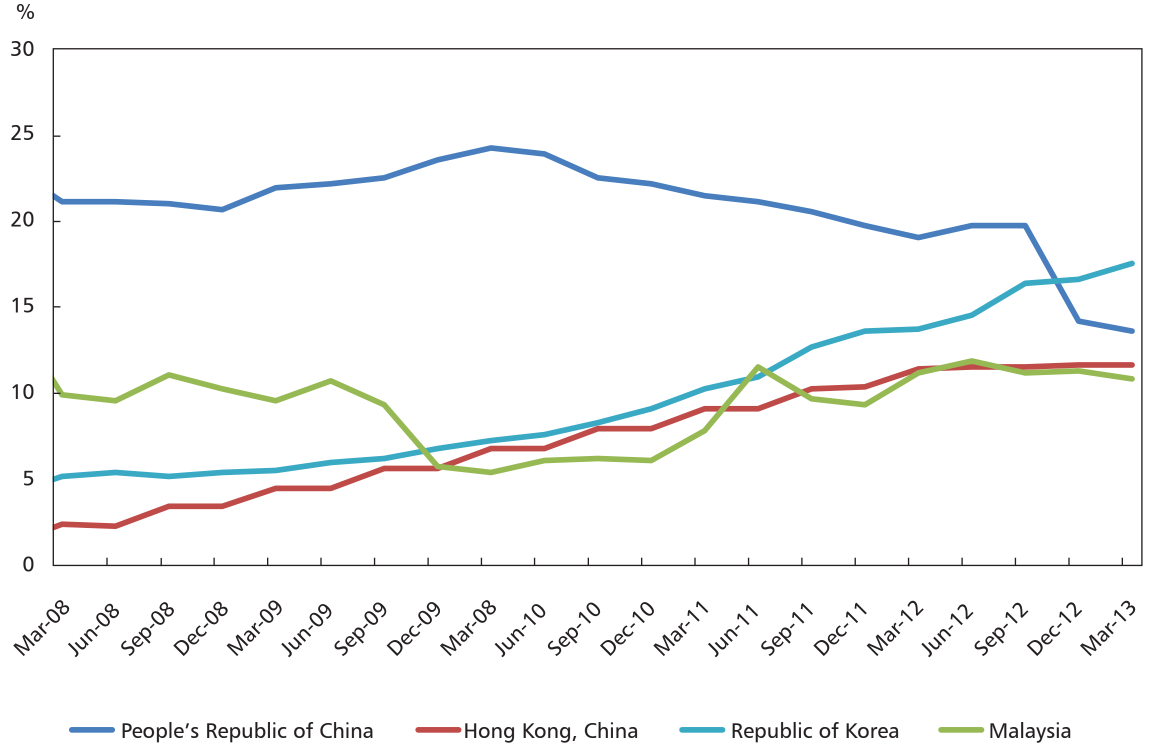
FCY = foreign currency, LCY = local currency.
Source: *AsianBondsOnline*.

was offered for US$1.5 billion in bonds in April. So while investors are still willing to buy the bonds, they are exacting a higher price.

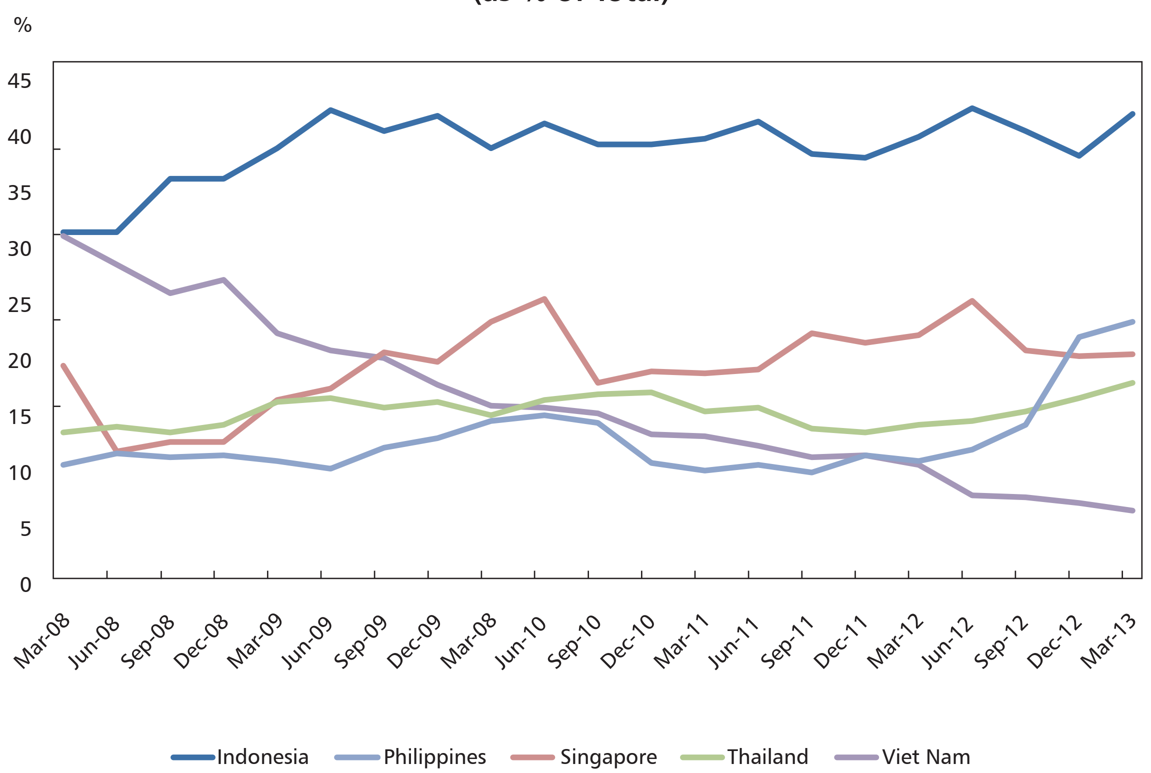
The recent sell-off brings back memories of previous crises in the region. However, the financial system in the region, particularly the bond market, is more resilient this time around. One key difference is that the growing use of LCY bonds means that Asian financial markets are no longer plagued by the problem of currency mismatches. During the 1997/98 Asia financial crisis, currency depreciations meant that government and corporate financial conditions worsened as FCY-denominated liabilities grew. Today, with the vast proportion of debt denominated in LCY, there is less prevalence of currency mismatches. For most economies, LCY bonds account for more than 90% of total bonds. In Indonesia and the Philippines, however, FCY-denominated bonds account for more than 30% of total bonds outstanding. This suggests that they will be more deeply affected by the depreciation of their currencies, which will raise the cost of servicing FCY-denominated loans.

The region's economies have also been lengthening the maturity profiles of their government bonds. This can help

## Government Bonds with Maturities of More than 10 Years (as % of Total)

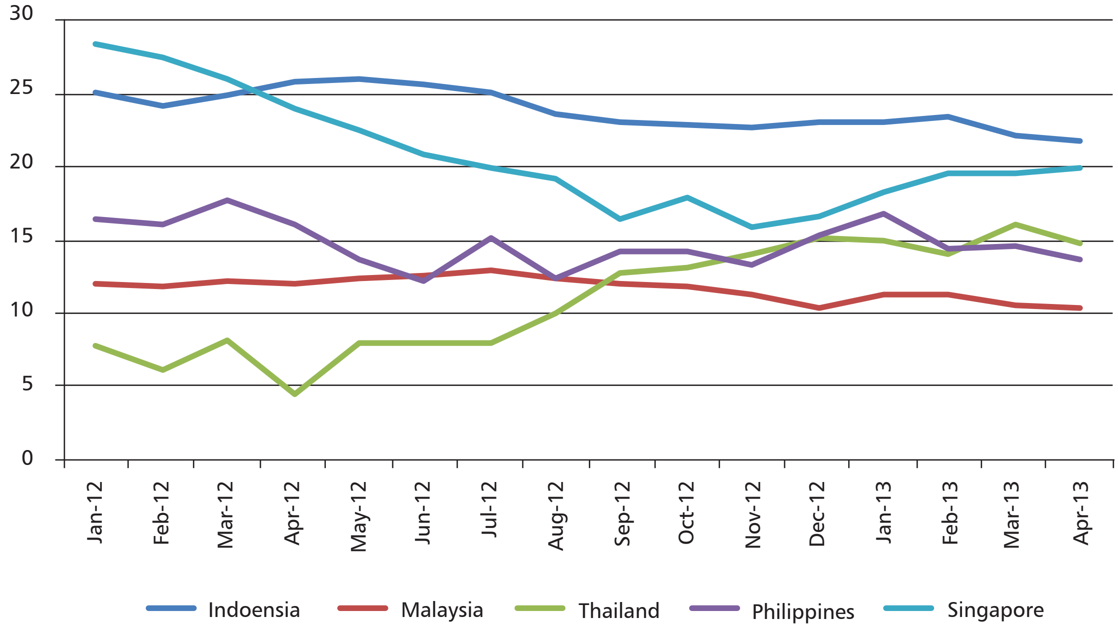



## Government Bonds with Maturities of More than 10 Years (as % of Total)



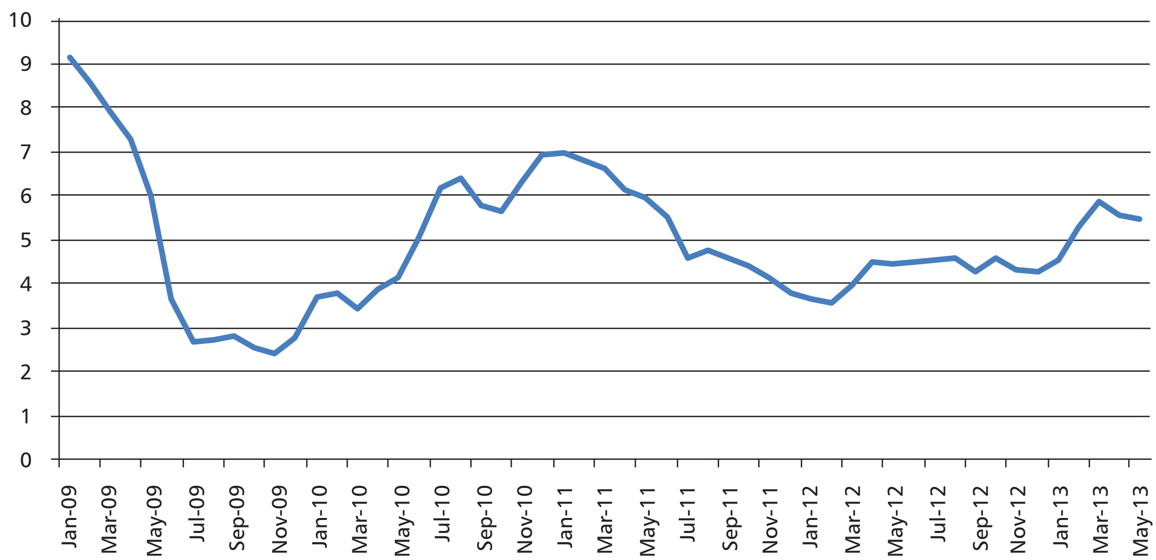

Source: *AsianBondsOnline*.

## Bank Lending Growth (%)




Source: Haver Analytics.

## Indonesia: Inflation (%)




Source: Haver Analytics.

ease the refinancing of borrowings during periods of crisis. In most countries in the region, the share of government bonds with a maturity of more than 10 years has been rising. However the share of the PRC's government bonds with a maturity of more than 10 years has been falling from more than 20% at the end of 2009 to slightly above 10% today. Viet Nam's share of longer-dated bonds has also been falling as its recent issues have been mainly shorter-dated bonds.

The recent volatility in global capital markets could pose another test for the region's bond markets. That said, quantitative easing will have to end at some point. The Federal Reserve Chairman's recent remarks has only brought that day forward. An orderly withdrawal of quantitative easing in line with a recovering US economy would be good for the region. Higher interest rates would be needed to mitigate the impact of higher inflation arising from faster growth. The end of quantitative easing will also reduce the inflows of speculative

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Asian Bonds Online
www.asianbondsonline.adb.org

Asia Regional Integration Center
www.aric.adb.org

Asian International Economists Network
www.aienetwork.org

ADB Working Paper Series on Regional Economic Integration
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## About Us

OREI traces its roots to the Regional Economic Monitoring Unit (REMU)—established in the aftermath of the 1997/98 Asian financial crisis. It was upgraded and renamed OREI in April 2005, as ADB expanded its role in promoting regional cooperation and integration (RCI) throughout Asia and the Pacific.

OREI assists its developing member countries in pursuing open regionalism that serves as a building block to global integration.

funds into the region that may be exacerbating asset price bubbles. The main concern is if the Federal Reserve will act too soon to end its monetary stimulus. Ending quantitative easing prematurely could hurt confidence and result in higher interest rates when the US economic recovery still has yet to gain momentum. This could push the US back into recession. Hence, the key question is how strong the US economy is at the moment.

For most of the region's economies, the reversal in capital inflows has helped ease upward pressure on their currencies and tightened liquidity in their financial systems. While the suddenness of the outflows may not be desirable, the departure of "hot money" should help make it easier for central banks to manage monetary policy. One concern has been that the inflow of funds and more easily available credit could fuel asset price bubbles. Most of the region's economies, especially Indonesia and Singapore, have been experiencing rapid credit expansion. The outflow of funds could help rein in the high levels of growth in bank lending.

The response of monetary authorities to the outflow of funds will be determined mostly by the domestic conditions that each economy faces. Domestic authorities will need to strike a careful balance between maintaining confidence in their currencies and sustaining growth momentum. Raising interest rates may help to deflect some of the downward pressure on currencies, but could also potentially derail growth. With growth moderating in the PRC and most other economies in the region, monetary authorities should be cautious about pushing up interest rates. As most of the region's economies are running current account surpluses, there is less pressure on authorities to raise interest rates to prevent the outflow of funds.

So far, most of the region's economies have opted to keep policy rates unchanged, with Indonesia as the exception. However, the recent policy rate increase in Indonesia was an attempt to head off inflationary pressure following the removal of petroleum subsidies as well as an effort to support the rupiah's value. Inflation has been picking up in Indonesia this year and is higher than in most other countries in the region. However, rising interest rates could have the effect of choking off growth in the economy and deteriorating growth prospects may discourage foreign investors. Therefore, Indonesian authorities will have to perform a difficult balancing act.

Another country facing a similar dilemma is India. It also has a current account deficit and high inflation. Growth is moderating and so lower interest rates would be welcome. However, with the rupee continuing to depreciate, thus making imports more expensive, authorities would like to arrest the decline. Reluctant to raise benchmark interest rates, the Reserve Bank of India opted instead to limit the amount that banks are allowed to borrow from it at the benchmark interest rates. Any additional lending above the limit would be at a higher interest rate.

The outflow of funds from the region highlights the need for authorities to continue to promote alternative and more stable sources of funding. The region continues to run an overall current account surplus, which means that there are sufficient funds in the region to fund investment needs. However, underdeveloped financial markets combined with differing rules and regulations have made it unduly difficult for regional investors to invest in regional markets. Instead, they prefer to park their funds in more liquid and developed financial markets. Efforts by the region's governments, such as the Asian Bond Markets Initiative (ABMI) and ASEAN+3 Bond Market Forum (ABMF), which aim to promote intraregional bond investments and harmonize bond markets, respectively, can help facilitate further investment in the region.