



## Prospects and Impact of the Opening of the Mainland's Bond Market

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In recent years, the Mainland's bond market has developed rapidly, with bond issuance and outstanding amount ranked top in the world. However, the depth and breadth of the Mainland's bond market need to be improved. Report of the 19<sup>th</sup> National Congress of the Communist Party of China put forward the concept of building a modern economic system and promoting a new stage of all-round opening up. Accelerating the opening of the bond market can enhance the efficiency of resource allocation, better serve the real economy, and accelerate RMB internationalization. Therefore, the bond market is becoming the main field of the Mainland's financial opening.

### Characteristics of the development of the Mainland's bond market

Fixed income products are the largest asset category and also important investments. As of the end of 2016, the scale of the global bond market was close to US \$100 trillion, exceeding the total amount of US \$67 trillion of global stock market. In recent years, the Mainland's bond market has developed rapidly and has become the third largest bond market in the world.

#### 1. The absolute scale is expanding, and there is room for relative scale

By the end of 2017, outstanding amount of Mainland's bond market was 74 trillion yuan, increasing 16% over the same period last year, with its growth rate far higher than that of GDP. Issuance of various types of bonds amounted to 40.8 trillion yuan, up 13% from the same period last year. In terms of the relative scale, the proportion of the Mainland's bond market to GDP rose from 20% in 2011 to 90% in 2017 but still lags behind the level of 100%-200% of developed countries such as Europe and the US.

#### 2. Structure of investors is relatively simple and trading is inactive

Major investors in the Mainland's bond market include commercial banks, securities companies, fund houses and insurance companies and etc. Commercial banks play a dominant role, accounting for over 60% of bond holdings. Commercial banks generally prefer to hold the bonds till maturity and are not interested in bond trading. The turnover rate of Chinese government bonds lies between 0.3 and 1.9, while the rates of US treasury bonds and Japanese government bonds are 12 and 6 respectively. The liquidity of the Mainland's bond market is affected by factors such as a single structure of investors, restrictions on bond borrowing, and no unified trading platform.

#### 3. Proportion of foreign investors is relatively low

Of the outstanding amount of US\$ 11 trillion of the Mainland's bond market, domestic RMB bonds held by overseas investors are 1245.7 billion yuan, accounting for about 1.85% of the whole market, far less than that of developed countries. At present, the proportion of foreign investors in German and British bond markets are 68% and 41% respectively. The number of US is 29%, but the proportion of overseas investors in Treasury and corporate bonds are about 45% and 30% respectively. In some emerging markets such as Malaysia and Indonesia, the proportion of foreign investors is also between 25%-30%. Besides, most

overseas commercial investors in the Mainland's bond market are Chinese overseas enterprises.

### **Evaluation of the extent of opening of the Mainland's bond market**

Since 2005, the Mainland has gradually opened its bond market. It allowed international development agencies to issue RMB bonds in the national inter-bank bond market and broaden the scope of foreign investment institutions. In 2017, in order to enhance the function of the RMB's status as an international reserve currency, the Mainland launched the Bond Connect as an important link between the Mainland's bond market and overseas.

In general, there are three perspectives for evaluating the extent of the opening of the Mainland's bond market. First is the scale and development of the offshore RMB bond market. Second is the number and size of non-resident issuers and investors in the onshore bond market. Third is the scope and extent of the connectivity between offshore and onshore markets.

#### **1. Offshore bond markets lead the opening of China's bond market**

The opening of the Mainland's bond market goes hand in hand with RMB internationalization. Offshore RMB currency bond markets once led the opening of onshore bond market, forming an offshore RMB bond system with Dim Sum bonds, Lion City bonds and Formosa bonds. Offshore bond markets can perform its role of financing and facilitating the use of offshore RMB funds with its liquidity and convenience. About 30 sovereign agencies publicly announced the purchase of RMB assets in the offshore markets before the RMB joined the SDR. In October 2017, the Mainland's Ministry of Finance announced the issuance of US\$2 billion of sovereign debt and 14 billion yuan of government bonds in Hong Kong. The issuance increases the variety of the offshore bond markets, provides more quality options for international investors, and offers pricing reference for Chinese enterprises in international markets.

#### **2. The opening of onshore bond market accelerates**

Since 2005, the Chinese government has gradually deepened the opening of the Mainland's bond market, reflected by the growth of issuance of Panda bonds and increasing participation of foreign investors.

As for opening to overseas issuers, in 2005, the Chinese government allowed international development agencies to issue RMB bonds in the national inter-bank bond market; in 2013, the Chinese government simplified the issuance process of Panda bonds. Since the second half of 2015, the scope of Panda bond issuers has been expanded from international multilateral financial institutions to international commercial banks, foreign non-financial enterprises, financial institutions and foreign governments. In 2016, issuance of Panda bonds increased by 12 times to 130 billion yuan. In the future, reform of Panda bonds may focus on 3 key issues including expanding the scope of issuers, adjusting accounting standards and addressing problems about capital flow. It is estimated that a 100 billion yuan Panda bond market will come to shape.

As for opening to overseas investors, the Chinese government has gradually allowed qualified foreign institutional investors (QFII) and RMB qualified overseas institutional investors (RQFII) to invest in the inter-bank bond market and expanded the scope of foreign institutional investors to commercial banks, insurance companies and other financial institutions as well as medium and long term investors approved by the Chinese Central Bank. In July 2015, the Chinese Central Bank allowed three types of institutions, including foreign banks, international financial organizations and sovereign wealth funds, to enter the interbank market and to carry out transactions such as bond repurchase, bond lending, bond forward, and interest rate swaps, with no restrictions on the scale of investment.

#### **3. New progress has been made in the connectivity of bond markets**

In July 2017, the Bond Connect between the Mainland and Hong Kong was launched. Bond Connect has removed the technical barriers linking onshore and offshore bond markets, providing a platform for offshore

funds to buy RMB bonds. Bond Connect gives overseas investors more flexibility because it does not have any capital requirements such as initial fund remittance, capital outflow limits, and pre-specified investment contents.

Foreign investors do not have to open accounts in the Mainland and can trade through their accounts in Hong Kong or overseas electronic trading platforms. Bond Connect implements multi-level custody and allows foreign investors to invest in the RMB or foreign currencies. If foreign currencies are used, offshore clearing banks can close their position in the inter-bank foreign exchange market. This arrangement can ensure the stability of offshore RMB pool, reduce exchange rate risk, and increase the efficiency of foreign exchange settlement.

Since the launch of the Bond Connect, the proportion of foreign investors in the Mainland's bond market has risen from 1.35% to 1.85%, and nearly 40% of transactions have been made through Bond Connect. This indicates the Bond Connect has become an important part of the opening of the Mainland's bond market.

### **Potential impacts of the opening of China's bond market**

The opening of the Mainland's bond market is conducive to improving the interest of foreign investors in RMB bonds, attracting overseas funds to Mainland's capital market, and promoting international and diversified development of the Mainland's financial markets.

#### **1. Enhance attraction of Mainland's bond market to international capital**

At the end of May 2016, China's Central Bank issued detailed implementation rules for the opening of China's inter-bank bond market. At present, the only restriction on capital repatriation is to keep the currency structure consistent.

At present, there are three major overseas bond indices, the Citigroup World Government Bond Index (Citi WGBI), the JPMorgan Government Bond Index-Emerging Markets (JPM GBI-EM) indices, and Bloomberg Barclays Global Aggregate Index. In March 2018, Bloomberg announced that it would add Chinese RMB-denominated government and policy bank securities to the Bloomberg Barclays Global Aggregate Index starting from April 2019. It is estimated that around 390 Chinese securities will be included and represent 5.5% of the US\$54 trillion index. This will make the RMB the fourth largest currency component following the US dollar, Euro and Japanese yen.

Because most foreign institutional investors prefer passive investment strategy, if RMB bonds are included in major overseas bond indices, investors need to increase the proportion of RMB bonds in their portfolio correspondingly. It is estimated that more than US\$5 trillion of assets are tracking the world's three largest bond indices at present. If RMB bonds can be successfully incorporated into these indices, it is expected the proportion of foreign investors in the Mainland bond market will reach 5%-10%, with about 3 to 6 trillion yuan of related capital inflow to the Mainland.

#### **2. Affect RMB asset allocation of overseas investors**

According to the IMF, RMB assets held in global official reserves has increased 19% from US\$90.7 billion to US\$107.9 billion from the end of 2016, and the total amount of RMB bonds held by overseas investors rose 32% to 1022.4 billion yuan from 772.6 billion yuan in the same period. Most of the RMB assets held by foreign central banks should be RMB bonds.

As for asset allocation, the attraction of RMB bonds to foreign investors is increasing. During 2014 to 2017, the average annual growth rate of RMB bonds held by overseas institutions was about 33%, and the proportion of RMB bonds to total RMB assets held by foreign institutions increased steadily from 16% in 2015 to 28% in 2017.

Compared with stocks, bonds have lower volatility, less risk and higher storage value, so bonds are more attractive to foreign capital. Therefore, opening the bond market is the fastest and most effective way to open the Mainland's capital market.

### **3. Optimize the price discovery function of the bond market**

Accuracy of the Mainland's bond yield pricing is affected by imperfect government bond yield curve, shortage of market liquidity, and inferior standards of the Mainland's rating agencies.

Encouraging more overseas entities to issue and invest in the Mainland's bond market can build a huge investor network and enrich types of investors. At the same time, overseas investors can become market makers and enhance market liquidity, thus improving the price discovery function of the bond market.

## **Prospects of the opening of Mainland's bond market**

### **1. The new era of the Chinese economy provides broad space for the development of the bond market**

China's economy has shifted from rapid growth to quality development, and the importance of the bond market in the financial system will increasingly grow. The further opening of the bond market is the key to optimizing financing structure and improving international competitiveness of the capital market. It will help to broaden the direct financing channels of the real economy and improve the current financing structure that is overly reliant on the banking system. To certain extent, it can relieve the pressure of debt accumulation on the financial system and enhance the efficiency of monetary policy transmission.

### **2. RMB internationalization needs continuous push from bond market opening**

Historical experience shows that the success of currency internationalization can't be separated from huge economic scale and strong international trade, but a stable and orderly financial market is more important. Since the RMB joined the SDR basket of currencies, RMB internationalization has officially shifted to a higher gear. International markets, the IMF and other international organizations have increased their allocation to RMB assets according to the proportion of the SDR currency basket. In June 2017, the European Central Bank announced the reduction of US dollar reserves and the purchase of RMB assets equivalent of EUR500 million. At present, more than 60 Central Banks have held the RMB, reflecting the rising status of the RMB as an international currency.

However, the degree of the opening of the Mainland's bond market has not yet kept pace with the development of the RMB's international status. The weight of the RMB in the SDR currency basket is 10.92%, but RMB assets account for only 1.1% of global official reserves. According to the proportion in the SDR, RMB assets will eventually account for 10% of official foreign exchange reserves. Assuming all RMB assets held by foreign officials are bonds, foreign Central Banks should account for 10% of the Mainland's bond market. If non-sovereign institutions are considered, the proportion of RMB bonds held by foreign investors should be 20% or more.

Obviously, the promotion of the international reserve currency function requires the dual support of offshore financial markets and mature onshore capital market, providing international investors with more financial options, more smooth trading channels, and more abundant market liquidity. Therefore, to coordinate RMB internationalization, the degree of the Mainland's bond market's opening needs to deepen.

### **3. "Belt and Road Initiative" provides new impetus for the bond market's further opening**

"Belt and Road Initiative" promotes bringing in and going out, and it plays an essential role in the new stage of full opening. Countries along "One Belt One Road" have huge demand for funds, but issues such as low savings rates and underdeveloped financial markets make it difficult for existing financing models to meet the needs. Moreover, financing support provided by Asian Infrastructure Investment bank, Silk Road fund and etc. are rather limited. Therefore, the bond market (such as Panda Bonds), which is sustainable, transparent, highly efficient and risk diversified, can become the main channel for project financing of "Belt and Road Initiative".

# 主要經濟指標 (Key Economic Indicators)

	2016	2017	2017/Q3	2017/Q4
<b>一. 本地生產總值 GDP</b>				
總量 (億元) GDP(\$100 Million)	23,586	25,432	6,470	6,806
升幅 (%) Change(%)	1.9	3.8	3.7	3.4
<b>二. 對外貿易 External Trade</b>			<b>2018/3</b>	<b>2018/1-3</b>
外貿總值 (億元) Total trade(\$100 Million)				
總出口 Total exports	35,882	38,759	3,477	9,430
進口 Total imports	40,084	43,570	4,032	10,730
貿易差額 Trade balance	-4,201	-4,811	-555	-1,300
年增長率 (%) YOY Growth(%)				
總出口 Total exports	-0.5	8.0	8.0	9.7
進口 Imports	-0.9	8.7	10.7	10.6
<b>三. 消費物價 Consumer Price</b>			<b>2018/3</b>	<b>2018/1-3</b>
綜合消費物價升幅 (%) Change in Composite CPI(%)	2.4	1.5	2.6	2.4
<b>四. 樓宇買賣 Sale &amp; Purchase of Building Units</b>			<b>2018/3</b>	<b>2018/1-3</b>
合約宗數 (宗) No. of agreements	73,004	83,815	6,415	21,094
年升幅 (%) Change(%)	-4.1	14.8	-15.6	14.4
<b>五. 勞動就業 Employment</b>			<b>2017/12-2018/2</b>	<b>2018/1-2018/3</b>
失業人數 (萬人) Unemployed(ten thousands)	13.3	11	10.7	11.2
失業率 (%) Unemployment rate(%)	3.4	2.9	2.9	2.9
就業不足率 (%) Underemployment rate(%)	1.4	1.1	1.0	1.0
<b>六. 零售市場 Retail Market</b>			<b>2018/3</b>	<b>2018/1-3</b>
零售額升幅 (%) Change in value of total sales(%)	-8.1	2.2	11.4	14.3
零售量升幅 (%) Change in volume of total sales(%)	-7.1	1.9	10	12.7
<b>七. 訪港遊客 Visitors</b>			<b>2018/2</b>	<b>2018/1-2</b>
總人數 (萬人次) arrivals (ten thousands)	5,665	5,847	528.1	1,061.5
年升幅 (%) Change(%)	-4.5	3.2	26.3	9.9
<b>八. 金融市場 Financial Market</b>			<b>2018/2</b>	<b>2018/3</b>
港幣匯價 (US\$100=HK\$)				
H.K. Dollar Exchange Rate (US\$100 = HK\$)	775.6	781.4	783	784.9
貨幣供應量升幅 (%) change in Money Supply(%)				
M1	12.3	9.8	12.2	11
M2	7.7	10	9.4	9.6
M3	7.7	10	9.3	7.8
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	9.1	8.7	8.3	6.8
港元存款 In HK\$	9.4	11.6	12.3	9.4
外幣存款 In foreign currency	8.8	5.9	4.4	4.2
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	6.5	16.1	15.7	15.0
當地放款 use in HK	7.4	15.5	15.8	15.1
海外放款 use outside HK	4.5	17.4	15.5	14.9
貿易有關放款 Trade financing	0.2	8.7	13.9	11.9
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	22,000	29,919	30,845	30,093