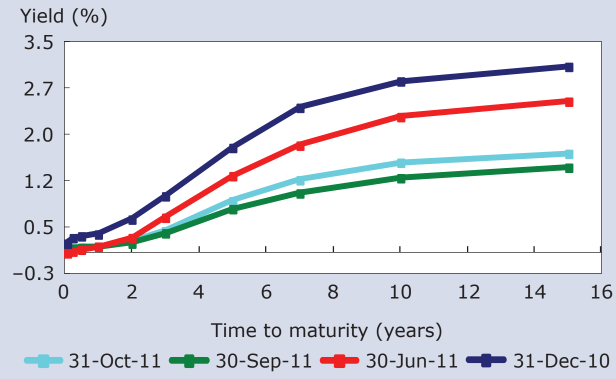
Hong Kong, China—Update

Yield Movements

The yield curve for Hong Kong, China's Exchange Fund Bills and Notes (EFBNs) rose for most maturities in October, with the exception of maturities at the very short-end of the curve. The 10-year tenor rose the most at 26 basis points (bps), followed by the 15-year tenor, which rose 23 bps **(Figure 1)**. Yields in the middle of the curve (3- to 7-years) rose an average of 12 bps. In contrast, yields for the 6-month and 1-year tenor remained unchanged, while shorter-term tenors fell 1 bp–4 bps. Due to the large drop in yields at the longer-end of the curve, the spread between the 2- and 10-year maturities rose to 129 bps from 107 bps at end-September.

Figure 1: Hong Kong, China's Benchmark Yield Curve—EFBNs



EFBN = Exchange Fund Bills and Notes.
Source: Bloomberg LP.

The yield curve's movement from end-June to end-September showed a strong shift downward, especially at the longer-end. The downward shift, in spite of rising consumer prices, was due to the Special Administrative Region's currency peg to the United States (US) dollar and its status as an international finance center. As a result, interest rates in Hong Kong, China are highly correlated with US interest rates. The US yield curve shifted downward from end-June to end-September, particularly at the longer-end, where the 10-year tenor fell 105 bps. However, in October the yield curve rose slightly, with the 10-year tenor rising 20 bps.

Consumer price inflation in Hong Kong, China hit an all-time high in July, rising to 7.9% year-on-year (y-o-y) from 5.6% in June. The rise in inflation was strongly influenced by a lower base for rental prices in July 2010 due to government relief measures. In August, consumer price inflation fell to 5.6% y-o-y, comparable to the inflation rate in June, but still higher than in prior years.

On the other hand, if the government's relief measures are excluded, consumer price inflation actually rose in August to 6.3% y-o-y from 5.8% in July. The rise in consumer prices has been driven mostly by increases in food prices as well as housing related costs such as rentals and utilities.

Local demand continues to remain robust as indicated by strong retail sales growth. The average growth rate in sales for 2Q11 was 28.1% y-o-y, with sales growth accelerating in July and August to 29.1% and 29.0%, respectively. Demand was further helped by strong spending in the tourism sector. However, demand was negatively affected by the continued slowdown in developed markets, leading to weakened export growth. On a quarter-on-quarter (q-o-q) basis, exports fell 9.4% in 2Q11. On a y-o-y basis, export growth fell to 7.7% in 2Q11 from 24.6% in 1Q11. Slower export growth led to weakening gross domestic product (GDP) growth for the last two quarters with GDP growth at 4.3% in 3Q11 and 5.3% in 2Q11 from 7.5% in 1Q11.

Table 1: Size and Composition of the LCY Bond Market in Hong Kong, China

	Amount (billion)								Growth Rate (%)						
	Jun-11		Jul-11		Aug-11		Sep-11		Jun-11		Jul-11	Aug-11	Sep-11		
	HKD	US$	HKD	US$	HKD	US$	HKD	US$	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	1,300	167	1,311	168	1,315	169	1,320	170	5.4	0.5	0.9	0.3	5.7	1.6	0.4
Government	684	88	694	89	697	90	697	90	2.6	0.5	1.5	0.4	3.8	1.9	0.0
Exchange Fund Bills	585	75	585	75	585	75	585	75	0.6	0.2	0.01	0.0	0.6	0.1	0.0
Exchange Fund Notes	70	9	70	9	70	9	70	9	(0.9)	(0.4)	0.0	0.0	(0.9)	0.0	0.0
HKSAR Bonds	30	4	40	5	43	5	43	5	87.5	9.1	33.3	6.3	117.9	41.7	0.0
Corporate	615	79	616	79	617	79	623	80.0	8.7	0.5	0.2	0.2	7.8	1.2	0.9

HKSAR = Hong Kong Special Administrative Region, LCY = local currency, m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Notes:
1. Calculated using data from national sources.
2. Bloomberg LP end-of-period LCY–US$ rates are used.
3. Growth rates are calculated from LCY base and do not include currency effects.
4. The amount of corporate bonds outstanding for July, August, and September were estimated based on the compounded monthly growth rate between March and June.
Source: Hong Kong Monetary Authority and Bloomberg LP.

Size and Composition

The size of Hong Kong, China's local currency (LCY) bond market grew 5.7% y-o-y to reach HKD1.3 trillion (USD170.0 billion) at end-September **(Table 1)**. On a q-o-q basis, LCY bonds outstanding grew at a pace of 1.6%.

Total LCY government bonds outstanding rose 3.8% y-o-y as of end-September, while q-o-q growth was 1.9%. Government bonds include Exchange Fund Bills (EFBs), Exchange Fund Notes (EFNs), and bonds issued under the Institutional Bond Issuance Programme (HKSAR Bonds).

The growth in total government bonds outstanding was largely attributed to the growth of HKSAR Bonds, which expanded 117.9% y-o-y to HKD42.5 billion as of end-September. On the other hand, the stock of EFNs declined slightly by 0.9% to HKD69.6 billion. EFBs grew only slightly by 0.6% y-o-y in the same period.

HKD10.0 billion worth of 3-year HKSAR Bonds were issued in July, HKD2.5 billion in 10-year bonds were sold in August, and HKD3.5 billion of 20-year HKSAR bonds were sold in September.

LCY corporate bonds outstanding reached HKD622.9 billion at end-September, reflecting growth of 7.8% y-o-y and 1.2% q-o-q. The top 18 non-bank corporate issuers in Hong Kong, China accounted for about 14% of total corporate bonds outstanding (Table 2). Hong Kong, China's top corporate issuer of LCY bonds was the state-owned Hong Kong Mortgage Corporation (HKMC), with bonds valued at HKD22.3 billion at end-September. Sun Hung Kai Properties (Capital Market) Ltd. was the next largest issuer with outstanding bonds of HKD12.4 billion, while CLP Power Hong Kong Financing Ltd. was in the third spot with HKD9.9 billion.

Financial firms dominated the list of the top 18 non-bank corporate issuers, accounting for all but four of the firms. Six state-owned companies were included on the list, while 12 were privately owned. Among the companies included in Table 2, only one is listed on the Hong Kong Exchange.

Table 2: Top 18 Non-Bank Corporate Issuers in Hong Kong, China (as of September 2011)

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed Company	Type of Industry
	LCY Bonds (HKD billion)	LCY Bonds (US$ billion)				
1. The Hong Kong Mortgage Corporate Ltd.	22.32	2.87	Yes	No	No	Finance
2. Sun Hung Kai Properties (Capital Market) Ltd.	12.37	1.59	No	Yes	No	Finance
3. CLP Power Hong Kong Financing Ltd.	9.90	1.27	No	Yes	No	Finance
4. Kowloon-Canton Railway Corporation	6.60	0.85	Yes	No	No	Transportation
5. MTR Corporation (C.I.) Ltd.	5.20	0.67	Yes	No	Yes	Transportation
6. Swire Pacific MTN Financing Ltd.	4.30	0.55	No	Yes	No	Finance
7. Hongkong Electric Finance Ltd.	4.21	0.54	No	Yes	No	Finance
8. The Link Finance (Cayman) 2009 Ltd.	3.98	0.51	No	Yes	No	Finance
9. HKCG (Finance) Limited	2.76	0.35	No	Yes	No	Finance
10. Airport Authority Hong Kong	2.75	0.35	Yes	No	No	Trannsportation
11. Cheung Kong Bond Finance Ltd.	2.45	0.31	No	Yes	No	Finance
12. Wharf Finance Ltd.	2.29	0.29	No	Yes	No	Finance
13. Hysan (MTN) Ltd.	1.80	0.23	No	Yes	No	Finance
14. Urban Renewal Authority	1.70	0.22	Yes	No	No	Property Development
15. Bauhinia MBS Ltd.	1.56	0.20	Yes	No	No	Finance
16. Cheung Kong Finance (MTN) Ltd.	1.51	0.19	No	Yes	No	Finance
17. Henderson Land MTN Ltd.	0.88	0.11	No	Yes	No	Finance
18. The Hongkong Land Notes Company Ltd.	0.20	0.03	No	Yes	No	Finance
Total Top 18 Non-Bank LCY Corporate Issuers	**86.57**	**11.12**				
Total LCY Corporate Bonds	**622.92**	**80.01**				
Top 18 as % of Total LCY Corporate Bonds	**13.9%**	**13.9%**				

LCY = local currency.
Note: Based on Central Money Markets Unit data on tradeable non-bank debt securities issued and outstanding as of 1 July 2011.
Source: Hong Kong Monetary Authority.

Policy, Institutional, and Regulatory Developments

Hong Kong, China's Role as Offshore Renminbi Center Expanded

On 17 August, the People's Republic of China's (PRC) Vice Premier Li Keqiang gave special attention to Hong Kong, China during his keynote speech at the Forum on the 12th Five Year Plan and economic, trade, and financial cooperation and development between the PRC and Hong Kong, China. He stressed that plans for expanding Hong Kong, China's already important role as an offshore financial center would give Hong Kong, China an advantage as an offshore renminbi center. The plans mentioned include allowing Hong Kong, China's insurance companies to open branches in the PRC; the issuance of more sovereign bonds in Hong Kong, China; and the launch of the mini-Qualified Foreign Institutional Investor Program with an initial quota of CNH20 billion.

Box 1: Offshore Renminbi Bond Market

The first steps to create an offshore renminbi market were taken in 2003 when banks in Hong Kong, China were permitted to offer renminbi deposits. The amount of these deposits jumped in 2009 after PRC authorities introduced a pilot trade settlement scheme that was subsequently liberalized and expanded. As a result, the renminbi is now deliverable in Hong Kong, China. By 2010 the range of renminbi products was expanded, allowing for the creation of renminbi-denominated insurance and investment products. The CNH traded at a premium against the CNY spot rate,[1] indicating strong demand for the renminbi in the offshore market in Hong Kong, China **(Figure B1.1)**. However, increased market volatility in September has led to the CNH currently trading at a discount. The CNH market is unique as no country has attempted an offshore currency market while retaining capital controls and a tight grip on its onshore currency market.

The rapid growth of CNH deposits derives from anticipated appreciation of the renminbi and its expanded use in trade settlement. In 2004 CNH deposits totaled CNH895 million **(Figure B1.2)**. By September 2011 they totaled CNH622.2 billion. The two critical factors driving CNH market growth have been (i) speculation over the renminbi's appreciation and (ii) expansion in cross-border renminbi trade settlement, resulting in a sharp rise in CNH remittances into Hong Kong, China **(Figure B1.3)**. The proportion of renminbi trade settlement in total trade in goods at the end of 2Q11 was about 8% compared with 1.3% in 2Q10. Demand for CNH has also been in helped in part by regulations released in July 2010 allowing corporations unlimited renminbi purchases in Hong Kong, China.

Offshore renminbi bond market growth is critical for CNH market development. In 2007 PRC authorities began allowing financial institutions, such as policy and commercial banks, to issue renminbi bonds in Hong Kong, China. By 2010 issuance rules were liberalized to allow foreign companies to issue CNH bonds, with McDonalds first in line. In August 2011 mainland non-financial companies were allowed to issue CNH bonds; the first to issue was Baosteel Group. The "dim sum bond market," as it was christened by market participants, has grown phenomenally, supported by burgeoning CNH deposits. In 2007 bonds totaling CNH10 billion were issued in the dim sum market **(Figure B1.4)**. As of September 2011 there were 325 dim sum bond issues from 85 issuers for a total of CNH228 billion (CNH160 billion worth of

Figure B1.1: CNH versus CNY, August 2010-September 2011

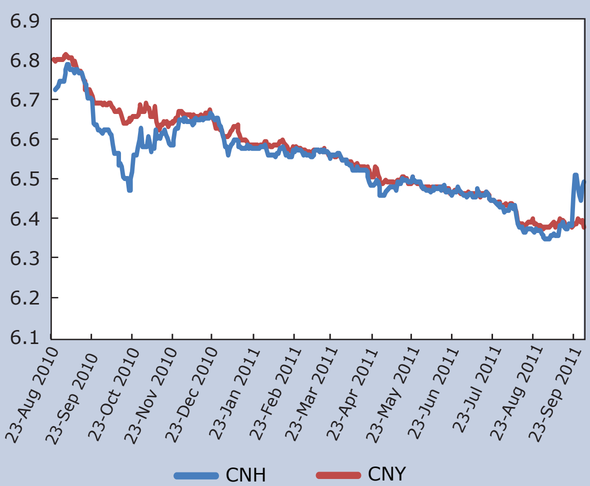
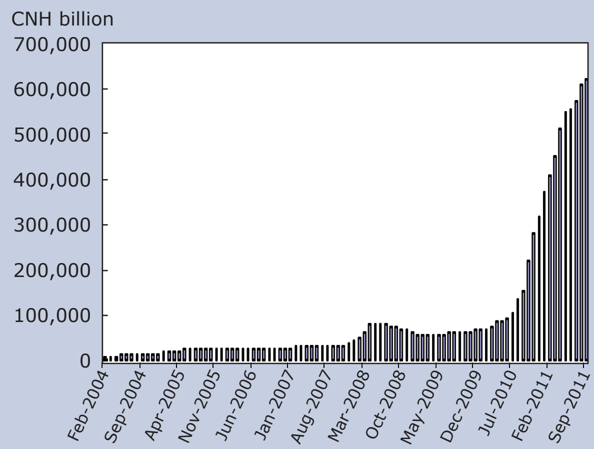


Figure B1.2: CNH Deposits, February 2004-September 2011



Source: Hong Kong Monetary Authority and Bloomberg LP.

[1] CNH is the three-letter currency code commonly used for offshore renminbi. CNY refers to onshore renminbi traded within the PRC.

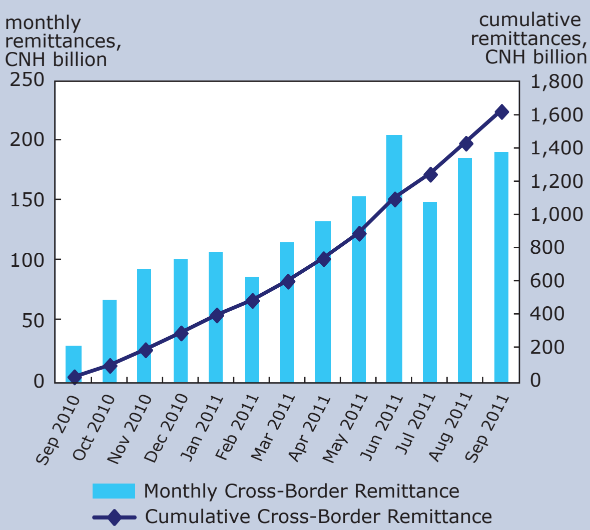
bonds and CNH68 billion worth of certificates of deposit.)

Strong demand for CNH bonds has led to lower yields versus CNY bonds, making them an attractive source of debt finance. In December 2009 the Asian Development Bank (ADB) issued onshore CNY bonds with a spread of 57 basis points (bps) over comparable PRC onshore government bonds. However, in October 2010 ADB's offshore CNH bonds were issued 81 bps below comparable PRC onshore government bonds. The International Finance Corporation (IFC) has issued a CNY bond with a spread of 45 bps over comparable PRC government bonds, while its CNH bond, issued in January 2011, had a spread of 182 bps below comparable PRC government bonds. More recently, in August the PRC government conducted a multi-tranche CNH bond auction. The 3-year bonds were issued at a coupon of 0.6% while the prevailing yield on the mainland was 3.65%. The 5-year bonds were issued at a rate of 1.40% while the prevailing onshore yield was 3.80%. The 7-year and 10-year bonds were issued at coupon rates of 1.94% and 2.36%, respectively, while the comparable onshore yields were at 3.90% and 3.94%, respectively. On average the PRC issued the bonds at a spread of 225 bps lower than onshore borrowing costs.

There are limits on available sourcing of CNH to limit speculative flows. Individual purchases are still limited by the CNH20,000 per day cap. While corporations may buy any amount of CNH, banks must note whether the purchase will be used for trade settlement or for other purposes. Banks may square their short positions in CNH from trade settlement transactions with the Clearing Bank (Bank of China [Hong Kong]), but their ability to do so is constrained by the existing supply of CNH for non-trade transactions. Furthermore, banks are limited in their open position to 10% of their renminbi assets or liabilities (depending on whether the bank is net long or net short). Access to the mainland bond and equity markets are subject to approval and quotas (such as through the Qualified Foreign Institutional Investor [QFII] Programme). In October the PRC released rules allowing CNH funds to be used as direct investment into the mainland.

The CNH bond market is still relatively young in terms of duration and issue size. The duration of CNH bonds issued (excluding certificates of deposit) is on the relatively short-end, with 2 years being the most common tenor. In 2007 the average tenor was 2.1 years. By September 20111 it had lengthened slightly to 3.6 years **(Table B1.1)**.

Figure B1.3: CNH Remittances



Source: Hong Kong Monetary Authority and Bloomberg LP.

Figure B1.4: CNH Issuance per Year, 2007–2011

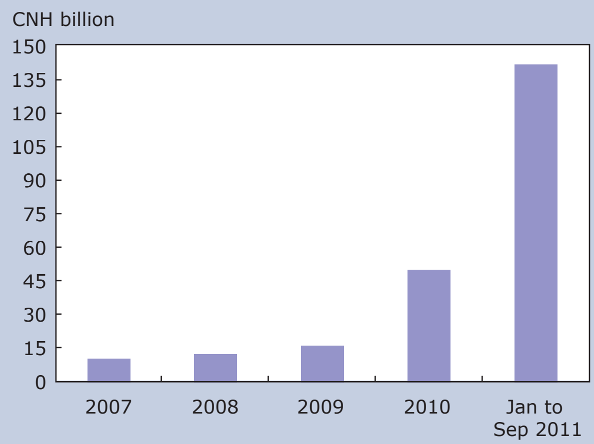


Table B1.1: Weighted Average of CNH Bond Tenor, 2007–2011

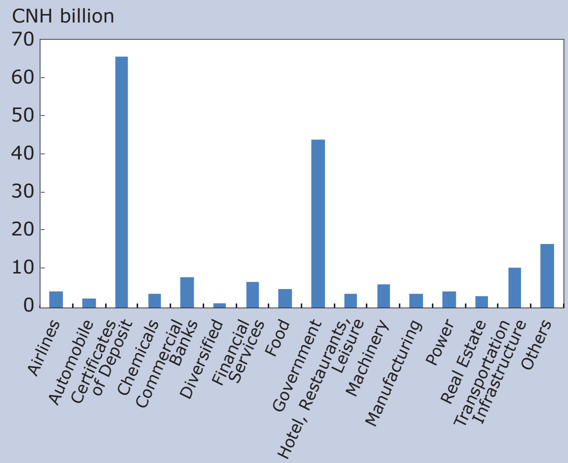
Year	Weighted Average Tenor
2007	2.10
2008	2.33
2009	2.25
2010	3.32
Jan to Sep 2011	3.61

Source: CMU HKMA and *AsianBondsOnline*.

The weighted tenor would be lower if CNH certificates of deposit were included, as these certificates of deposit have tenors as short as 3 months. There are only three 10-year CNH bonds; one issued by ADB and the other two by the PRC government. The short tenors of CNH bonds make the market less attractive for longer-term investors and investment funds. The PRC government still remains the largest issuer in CNH bonds **(Figure B1.5)**. But even PRC government bonds are issued in smaller sizes in the CNH market than in the CNY market. By sector, the largest issuers are the PRC government and commercial banks. One reason for the lack of diversity in issuers is that it was only in August that the PRC began allowing mainland non-financial companies to issue CNH bonds.

The PRC intends to expand and develop the CNH bond market. Hong Kong, China was given special focus at the forum on the 12th Five Year Program for National Economic and Social Development, Trade, and Financial Co-operation and Development between the Mainland and Hong Kong. Top officials have said the PRC will further expand Hong Kong, China's role as an offshore renminbi center. PRC's Vice-Premier Li Keqiang, during a recent visit to Hong Kong, China, indicated a number of measures including (i) launching the RMB QFII/mini-QFII program; (ii) allowing Hong Kong, China insurance companies to enter the mainland market; (iii) expanding of treasury bond auctions in Hong Kong, China; (iv) allowing Hong Kong, China enterprises to invest in the mainland using renminbi; and (v) expanding the trade settlement program nationwide. Also, PBOC governor Zhou Xiaochuan has said that mainland non-financial institutions will be allowed to issue CNH bonds.

Figure B1.5: Outstanding CNH Bonds by Sector (as of August 2011)



Source: Hong Kong Monetary Authority.

Synthetic renminbi bonds have recently appeared in Hong Kong, China. Synthetic renminbi bonds are denominated in renminbi but cleared and settled in US dollars. Most synthetic renminbi bond issuers are PRC-based property companies, which find synthetic bonds advantageous since it is easier to remit US dollar proceeds to the PRC for property purchases than it is to remit CNH proceeds. The advantage for investors is that synthetic renminbi bonds provide investors a way of investing in the CNH bond market without the need to source CNH.

Continued growth in the size of the CNH bond market is expected, while further development of the market will help to promote liquidity. The CNH bond market will continue to grow rapidly as issuers seek lower borrowing costs and investors seek exposure to renminbi assets. A more liquid CNH bond market requires a mature and established benchmark yield curve, a wider base of issuers and investors, and the creation of swap and hedging facilities. The creation of a benchmark yield curve will be further aided by the expansion of CNH treasury bond issuances.