Market Summaries

Peoples Republic of China—Update

Yield Movements

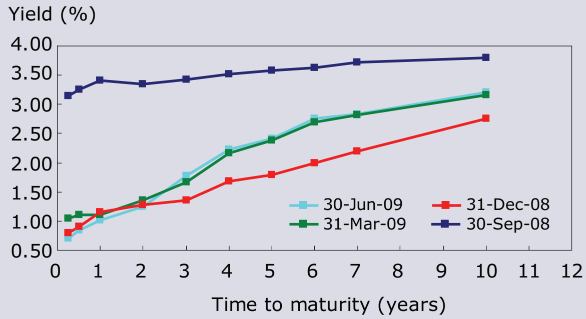
Economic data releases from the People's Republic of China (PRC) in June appeared to show that measures to stimulate the country's economy are taking hold. In the first half of the year, the PRC's economy grew 7.1%, driven by strong fixed asset investment, which was pushed forward by a massive expansion of credit.

Second quarter gross domestic product (GDP) grew 7.9% year-on-year (y-o-y), compared to a 1Q09 GDP growth rate of 6.1%, which was the lowest quarterly rate in a decade.

The People's Bank of China (PBOC), which in 4Q08 had twice cut its lending and deposit benchmark rates to 5.31% and 2.25%, respectively, kept its benchmark rates at these levels through June 2009. Meanwhile, June headline inflation, as measured by the consumer price index (CPI), was reported at −1.7% y-o-y, which represents the lowest level since 1999 and the fifth successive month of decline since February.

To encourage banks to boost lending in support of the government's CNY4 trillion stimulus program announced in November 2008, regulations on lending were eased in 4Q08. PRC banks responded by extending a total of CNY4.58 trillion in new loans by the end of 1Q09. Credit expansion subsequently slowed, with new loans in April and May amounting to CNY591.8 billion and CNY664.5 billion, respectively, before lending rebounded in June to reach CNY1.53 trillion. Data from 2Q09 brings the PRC's new loan total for the first 6 months of the year to CNY7.37 trillion, which is well above the government's annual target for 2009 of CNY5 trillion.

Figure 1: Benchmark Yield Curve—Local Currency Government Bonds

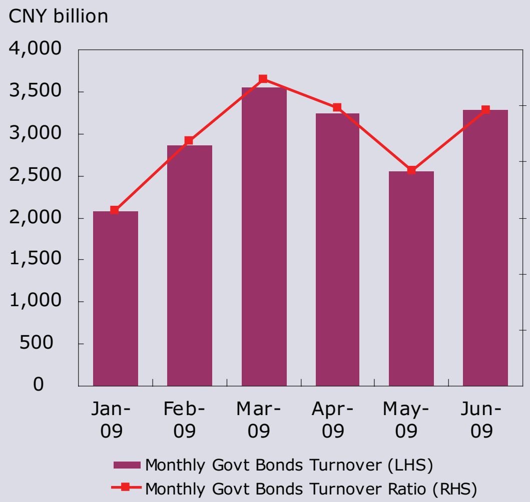


Source: Bloomberg LP.

The spike in June lending was, as in previous months, attributable primarily to activity related to the economic stimulus program, especially real estate and government-sponsored construction projects. In line with the growth in bank lending, M2 grew at a record rate of 28.5% y-o-y in June. Reflecting the country's expansionary monetary policies in the first half of the year, y-o-y growth rates for M2 increased 18.8% in January and 20.48% in February, and ranged between 25.0% and 26.0% in the succeeding 3 months.

The combination of historically low policy rates, declining inflation, and domestic liquidity in the first half resulted in heightened demand for bonds, particularly short-dated instruments, and resulted in declining short-term yields and a steepened yield curve **(Figure 1)**. Medium- to long-term yields rose significantly compared to their end-2008 levels and increased slightly over their March 2009 levels.

Figure 2: Government Bond Trading Volume and Turnover Ratio



Source: *ChinaBond*.

The spread between 2- and 10-year government bonds widened to 196 basis points at the end of June, compared to spreads of 149 and 181 basis points at end-2008 and March 2009, respectively. In March, the share of government bonds with maturities of 3–5 years increased as a percentage of bonds outstanding, contributing to the rise in yields at the belly of the curve.

Size and Composition

At the end of June 2009, the amount of the PRC's outstanding local currency (LCY) bonds stood at CNY15.77 trillion—up 5.3% quarter-on-quarter (q-o-q) and 14.8% y-o-y **(Table 1)**. In the first 6 months of 2009, corporate bonds posted a record growth rate of 90.9% y-o-y, with the stock of corporate paper rising to CNY2.426 trillion in June. Total government bonds outstanding, however, increased by a more moderate 7.0% y-o-y in the first half of the year.

Turnover of Government Bonds

As of June 2009, the year-to-date aggregate trading volume of spot government bills and bonds on the interbank market stood at CNY17.55 trillion—11% higher than for the same period last year. The trading of government bills and bonds peaked in March at CNY3.559 trillion, declined significantly in May, and rebounded to CNY3.281 trillion in June, when trading reached its second-highest monthly level of the year **(Figure 2)**.

Treasury Investor Profile

The first 6 months of the year saw a noteworthy shift in the profile of investors in treasury bonds **(Figure 3)**, with banks holding a larger share of Treasury bonds than they did at the end of 2008. In June 2009, commercial banks, which are traditionally the largest investor in treasury instruments, held 56.3% of treasury bonds outstanding, compared to their 51.9% share in December 2008. Underscoring the dominance of banks as investors in the treasury bond market, all other investor classes held a lower percentage share of the treasury debt stock in June compared to December 2008.

Corporate Bonds

The first half of 2009 was marked by a remarkable expansion in the amount of corporate bonds outstanding. With the exception of commercial paper and asset-backed securities, the outstanding amount of corporate bonds across key sectors in June 2009 significantly outstripped their levels in December 2008. The rise in the amount of outstanding medium-term notes (MTNs), local corporate bonds, and commercial bank bonds in June 2009 as compared to end-2008 levels is particularly noteworthy **(Table 2)**.

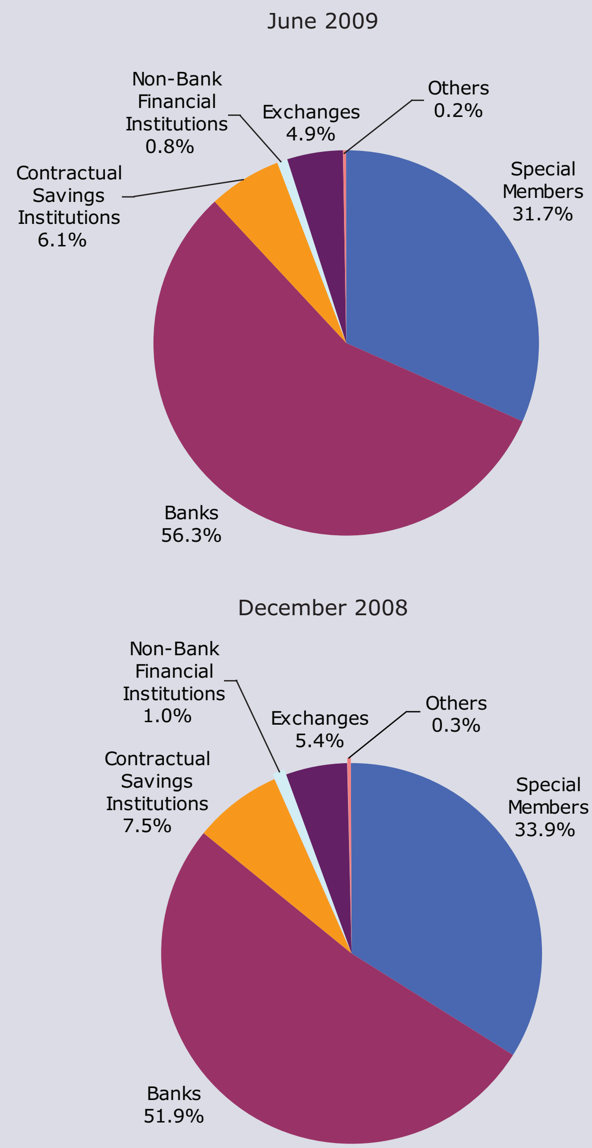
Table 1: Size and Composition of Local Currency Bond Markets

	Amount (billion)								**Growth Rate** (%)						
	Mar-09		Apr-09		May-09		Jun-09		Mar-09		Apr-09	May-09	Jun-09		
	CNY	USD	CNY	USD	CNY	USD	CNY	USD	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	14,978	2,192	15,311	2,244	15,623	2,287	15,770	2,309	13.1	(0.9)	2.2	2.0	14.8	5.3	0.9
Government	12,974	1,899	13,143	1,926	13,319	1,950	13,344	1,954	8.0	(2.9)	1.3	1.3	7.0	2.9	0.2
Treasury Bonds	4,900	717	5,015	735	5,170	757	5,345	782	5.4	0.5	2.4	3.1	12.5	9.1	3.4
Central Bank Bonds	4,345	636	4,354	638	4,342	636	4,161	609	4.2	(9.7)	0.2	(0.3)	(5.5)	(4.2)	(4.2)
Policy Bank Bonds	3,729	546	3,774	553	3,808	558	3,838	562	16.8	1.6	1.2	0.9	15.9	2.9	0.8
Corporate	2,004	293	2,168	318	2,303	337	2,426	355	63.2	14.7	8.2	6.2	90.9	21.1	5.3
Memo Item: Policy Bank Bonds															
China Development Bank	2,694	394	2,734	401	2,764	405	2769	405	9.8	(0.5)	1.5	1.1	9.8	2.8	0.2
Export–Import Bank of China	322	47	337	49	338	50	338	50	47.4	1.9	4.5	0.5	60.7	5.1	0.0
Agricultural Dvt. Bank of China	713	104	704	103	706	103	731	107	36.7	9.8	(1.3)	0.3	25.9	2.4	3.5

y-o-y = year-on-year, q-o-q =quarter-on-quarter, m-o-m = month-on-month.
Note:
1. Calculated using data from national sources.
2. Treasury bonds include savings bonds and local government bonds
3. Bloomberg end-of-period LCY–USD rate is used.
4. Growth rates are calculated from LCY base and do not include currency effects.

Source: *ChinaBond* and Bloomberg LP.

Figure 3: Treasury Bond Investor Profile



Note: Special Members include the People's Bank of China, Ministry of Finance, policy banks, China Government Securities Depository Trust and Clearing Co., and China Securities Depository & Clearing Corporation.

Source: *ChinaBond*.

The explosive growth of MTNs can be seen more clearly in **Table 3** and **Figure 4**, which present corporate bond issuance over the last 6 quarters. Issuance through the window involving approval by the National Development and Reform Commission (NDRC) and Corporate Securities Regulatory Commission (CSRC) has dropped dramatically,

Table 2: Corporate Bonds Outstanding in Key Sectors (CNY billion)

	Mar-08	Jun-08	Sep-08	Dec-08	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	June-09 Growth y-o-y (%)
Commercial Bank Bonds	314.47	327.47	384.47	388.67	388.67	429.67	437.67	438.67	479.87	486.37	48.52
State-Owned Corporate Bonds	376.10	376.60	446.60	521.90	524.20	525.20	526.50	539.90	563.20	565.30	50.11
Local Corporate Bonds	92.76	100.25	125.25	158.45	162.05	173.05	196.95	229.28	255.27	295.67	194.95
Commercial Paper	371.61	313.38	344.76	420.31	422.59	429.03	409.36	414.23	414.93	384.28	22.62
Asset-Backed Securities/ Mortgage-Backed Securities	37.16	43.44	43.44	55.11	54.61	56.61	56.61	56.61	55.41	55.41	27.55
Medium-Term Notes	0.00	73.50	73.50	167.20	220.50	234.30	340.80	453.30	493.50	592.10	705.58

y-o-y = year-on-year.
Source: *ChinaBond*.

Table 3: Corporate Bond Issuance (CNY billion)

	1Q08	2Q08	3Q08	4Q08	2008	1Q09	2Q09	1H09 Total	1H09 as % of end-08
Commercial Bank Bonds	7.70	8.50	62.00	19.20	97.40	49.00	61.70	110.70	114
State-Owned Corporate Bonds	20.00	0.50	74.00	73.80	168.30	8.00	35.90	43.90	26
Local Corporate Bonds	1.99	7.10	27.50	31.80	68.39	58.23	81.55	139.78	204
Commercial Paper	111.59	60.43	122.67	138.46	433.15	92.50	57.35	149.85	35
Asset-Backed Securities/Mortgage-Backed Securities	12.77	3.77	0.00	13.67	30.20	0.00	0.00	0.00	0
Medium-Term Notes	0.00	73.50	0.00	100.20	173.70	167.10	268.60	435.70	251

Source: ChinaBond.

while corporate issuance appears to have shifted to the MTN window regulated by the National Association of Financial Market Institutional Investors (NAFMII).

One apparent reason for this shift is that the approval process for the MTN window is much quicker, and can often be completed in 1–2 months. Total issuance of MTNs in the first half of 2009 reached CNY435.70 billion, or 251% of the full-year total for 2008. Issuance of local corporate bonds and commercial bank bonds—the bulk of the latter in the form of subordinated debt—exhibited a similar trend, with issuance through June 2009 representing 204% and 114%, respectively, of their corresponding 2008 totals.

In line with the PRC's rapid loan growth, subordinated bond issuance by major PRC banks has increased. The CNY50 billion of new bonds issued by the Agricultural Bank of China in May is one example of this trend, with additional subordinated debt issues expected from other major banks in the second half of 2009.

Issuance of commercial paper in 1Q09 and in 2Q09 was lower than that for the same periods last year, with 1Q09 issuance amounting to CNY92.50 billion and 2Q09 issuance totaling CNY57.35 billion. This compares with issuance of CNY111.59 billion and CNY60.43 billion in 1Q08 and 2Q08, respectively.

Turnover of Corporate Bonds

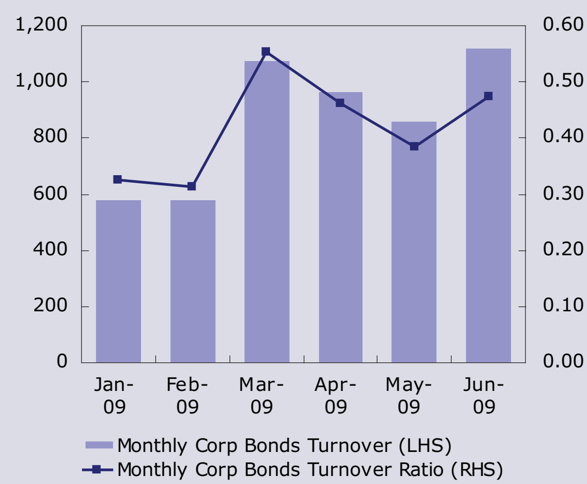
The year-to-date volume of spot corporate bond trading on the interbank market totaled CNY5.17 trillion through June 2009, equivalent

Figure 4: Quarterly Corporate Bond Issuance (CNY billion)

Source: *ChinaBond.*

to 111% of the full-year 2008 corporate bond trading volume of CNY4.65 trillion. The rise in trading volume is consistent with the growth of corporate issuance in the first 6 months of 2009. Trading volume of corporate bonds followed a similar pattern as government bonds, although the rebound in corporate bond trading volume in June was more pronounced, with trading volume climbing to its highest monthly level in the first half of the year **(Figure 5)**.

Figure 5: Corporate Bond Trading Volume and Turnover Ratio (CNY billion)



Source: *ChinaBond.*

Policy, Institutional, and Regulatory Developments

Foreign Participation in Bond Trading and Issuance

In January 2009, the PRC announced that it would allow foreign banks to underwrite CNY-denominated bonds and trade corporate bonds in the country's interbank market. Previously, foreign banks could trade only government bonds, central bank bills, bonds issued by financial institutions, and some derivative instruments on the local bond market.

Also in January 2009, the PRC began considering allowing qualified foreign-funded financial institutions to issue CNY-denominated bonds in the mainland or in Hong Kong, China. Under the proposal, qualified foreign-funded banks would be allowed to undertake such activities provided they met certain eligibility requirements.

The first half of 2009 saw the initial phases of implementation of these measures, with foreign banks achieving a number of "firsts" in terms of bond trading and issuance:

- In April, Standard Chartered Bank announced that its local unit based in Shanghai had traded PRC corporate debt to complete a commercial paper transaction, making it the first foreign bank to participate in the fast-growing PRC corporate debt market.

- In May, HSBC and the Bank of East Asia became the first non-PRC banks to gain approval to issue CNY-denominated bonds in Hong Kong, China. In March, HSBC issued CNY1 billion in floating-rate notes in Hong Kong, China to become the first foreign bank to issue a CNY-denominated bond in the Special Administrative Region. The Bank of East Asia issued a CNY4 billion bond in Hong Kong, China in late July.

Additionally, in June, Standard Chartered Bank announced plans to issue CNY3.5 billion of financial bonds in the PRC. Upon successful issuance, the bank will become the first foreign bank to issue CNY-denominated debt in the mainland.

Reopening of Bond Issuance by Publicly-Listed Companies

In July, the listed company Shanghai Yuyuan Tourist Mart received CSRC approval to issue up to CNY1 billion in bonds, marking the resumption of listed company bond issuance after a 10-month suspension. As of July, about 35 listed companies were reported to be preparing to issue bonds totaling approximately CNY115 billion. CSRC approved these bonds on a preliminary basis, but had yet to give the final permits needed to proceed with issuance. With the re-opening of listed company issuance, some CNY150 billion of additional issuance is expected this year. The resumption of listed company issuance will be accompanied by new regulations on the distribution of these bonds and retail investors' access to them.

Domestic Bank Participation in Bond Trading on Exchanges

In January, the China Banking Regulatory Commission (CBRC) and CSRC issued a joint set of preliminary rules allowing listed banks to engage in bond trading on the country's stock exchanges, with the aim of providing a bridge between the interbank market and stock exchanges, the PRC's two primary venues for bond trading. The interbank bond market is significantly larger than the exchange-traded market.

Rules for the entry of domestically listed banks into exchange-based bond trading were released in early July. The opening up of exchange-based bond trading is geared towards strengthening demand for the bonds of listed companies. Banks' participation in exchange-based trading is expected to increase large issuers' confidence that their bonds can be fully distributed on the exchanges. The country's 14 listed domestic banks are currently eligible to engage in bond trading on the exchanges, but they must first obtain approval from CBRC and CSRC. The entry of banks into the exchange market comes after a 12-year absence.

New Derivatives Master Agreement

In March, NAFMII released a new master agreement governing activities involving onshore derivatives transactions in the PRC interbank market. The new agreement consolidated and superseded the previous two master agreements published by NAFMII and the China Foreign Exchange Trading System (CFets).

The previous agreements had covered only CNY-denominated foreign exchange and interest rate derivatives, while the new master agreement eliminates overlaps between its predecessors and broadens instruments covered to include credit, gold, bond derivatives, and combinations of these instruments. The inclusion of bond derivatives is aimed at giving PRC bond investors added flexibility in managing their investments.

Outbound Investment Rules Relaxed

The PRC's foreign exchange regulator, the State Administrator of Foreign Exchange (SAFE), said in June that it would allow a wider range of PRC firms to invest their foreign exchange earnings abroad. The regulator said it was relaxing restrictions on overseas investment to enable PRC firms with foreign operations to grow.

Prior to the move, the investment of foreign exchange earnings abroad had been limited to large domestic firms and foreign multinationals. Other PRC foreign exchange earners were required to exchange their earnings for local currency.

Additionally, the regulator said that firms would be allowed to use foreign exchange acquired with yuan for investments in their subsidiaries abroad, increasing the amount of foreign exchange available for overseas investment by PRC firms.

Companies will still need to secure approvals from SAFE, but the processes for approval, as well as for remittances and other related activities, will be simplified.