Yield Movements

Despite low policy rates and ample liquidity, yields rose across all maturities at end 3Q09, resulting in an almost parallel shift of the yield curve upward from June levels (Figure 1). At the shorter end of the curve, yields rose by a high of 54 basis points for 1-year paper and a low of 39 basis points for 2-year maturities. Yields further out along the curve increased by similar amounts, although the yield on the 10-year tenor increased by only 30 basis points, which was the smallest increase along the curve.

The widening out of the yield curve is attributable to concerns about future inflation, potential monetary tightening, and the apparent shift by investors into equities and other asset classes. The spread between 2- and 10-year government bonds declined to 187 basis points at the end of September as compared to a spread of 196 basis points at the end of June.

For the first three quarters of 2009, the People’s Republic of China’s (PRC) economy expanded 7.7% year-on-year (y-o-y) on the back of an aggressive government economic stimulus program and rapid credit expansion in the banking system. Gross domestic product (GDP) in 3Q09 grew 8.9% y-o-y. This compares with GDP growth of 7.9% in 2Q09 and 6.1% in 1Q09.

After twice lowering its lending and deposit benchmark rates late last year, the People’s Bank of China (PBOC) maintained these benchmark rates at 5.31% and 2.25%, respectively, at the end of September. Consumer price inflation, which first turned negative in February, was reported at –0.8% y-o-y in September. This represented an uptick from inflation rates of –1.2% in August and –1.8% in July. Total new loans extended in the first three quarters of the year stood at CNY8.67 trillion, which was 73.4% above the government’s initial annual target of CNY5 trillion. M2 money supply growth in September was 29.31% y-o-y, continuing the upward trend seen in previous months.

Size and Composition

At the end of September 2009, the amount of the PRC’s outstanding local currency (LCY) bonds stood at CNY16.483 trillion for a y-o-y rise of 13.9% and a quarter-on-quarter (q-o-q) increase of 4.5% (Table 1). The amount of government bonds outstanding increased 5.7% y-o-y and 3.1% q-o-q. Reflecting the explosion of corporate issuance in 2Q09 and continued high issuance in 3Q09, the stock of corporate paper rose 87.7% y-o-y and 12.5% q-o-q.
### Table 1: Size and Composition of Local Currency Bond Market in the People's Republic of China

<table>
<thead>
<tr>
<th>Amount (billion)</th>
<th>Growth Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jun-09</td>
</tr>
<tr>
<td>CNY</td>
<td>USD</td>
</tr>
<tr>
<td>Total</td>
<td>15,770</td>
</tr>
<tr>
<td>Government</td>
<td>13,344</td>
</tr>
<tr>
<td>Treasury Bonds</td>
<td>5,345</td>
</tr>
<tr>
<td>Central Bank Bonds</td>
<td>4,161</td>
</tr>
<tr>
<td>Policy Bank Bonds</td>
<td>3,838</td>
</tr>
<tr>
<td>Corporate</td>
<td>2,426</td>
</tr>
</tbody>
</table>

**Memo item: Policy Bank Bonds**

<table>
<thead>
<tr>
<th></th>
<th>Jun-09</th>
<th>Jul-09</th>
<th>Aug-09</th>
<th>Sep-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>China Development Bank</td>
<td>2,769</td>
<td>405</td>
<td>2,769</td>
<td>405</td>
</tr>
<tr>
<td>Export-Import Bank of China</td>
<td>338</td>
<td>50</td>
<td>338</td>
<td>50</td>
</tr>
<tr>
<td>Agricultural Dvt. Bank of China</td>
<td>731</td>
<td>107</td>
<td>749</td>
<td>110</td>
</tr>
</tbody>
</table>

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.

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### Corporate Bonds

The first three quarters of 2009 saw an unprecedented expansion in the outstanding amount of corporate bonds, with medium-term notes (MTNs) leading the way (Table 2). The explosive growth of MTNs, particularly in 2Q09, was due to the shift in issuance from the window involving approval by the National Development and Reform Commission (NDRC) towards 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.

In 3Q09, however, issuance of MTNs dropped off considerably compared to issuance levels in the previous quarter, although issuance of commercial bank, state-owned corporate bonds, and commercial paper picked up (Figure 3). While y-o-y growth rates of corporate bonds outstanding have remained robust, most categories of corporate bonds experienced a decline in their q-o-q growth rates in 3Q09, with the exception of medium-term notes (MTNs) leading the way (Table 2). The explosive growth of MTNs, particularly in 2Q09, was due to the shift in issuance from the window involving approval by the National Development and Reform Commission (NDRC) towards 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.

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Figure 2: Treasury Bonds Investor Profile

September 2009

- National Commercial Banks: 47.5%
- Special Members: 29.9%
- Other Banks: 11.5%
- Non-bank Financial Institutions: 0.6%
- Insurance Institutions: 5.0%
- Securities Companies: 0.1%
- Exchanges: 4.0%
- Others: 0.2%
- Funds Institutions: 1.2%

December 2008

- National Commercial Banks: 41.3%
- Special Members: 33.9%
- Other Banks: 10.6%
- Non-bank Financial Institutions: 0.8%
- Insurance Institutions: 5.4%
- Securities Companies: 0.2%
- Exchanges: 5.4%
- Others: 0.3%
- Funds Institutions: 2.1%

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

Source: ChinaBond.
quite substantial except for commercial paper and asset-backed securities.

Policy, Institutional, and Regulatory Developments

Relaxation of Rules on Insurance Companies’ Bond Investments

In March, the China Insurance Regulatory Commission (CIRC) said that it would permit insurers in the life and the non-life sectors to invest in paper backed by infrastructure projects, with life insurers and non-life insurers being allowed to invest 6% and 4% of their assets, respectively, in such instruments. To make these investments, insurers would be required to have maintained a solvency ratio above 120% in the previous two years. CIRC also issued regulations allowing smaller insurance companies to invest in stocks directly, subject to meeting solvency ratio requirements. Previously, such insurers could make equity investments only through asset management companies.

In April, CIRC issued regulations expanding the range of bonds insurers can invest in. The regulations allow insurers to invest in bonds issued by local governments and more notably, in unsecured bonds—corporate bonds without third party or bank guarantees. Insurers are allowed to invest 15% of their assets in these instruments.

In October, CIRC raised the cap on PRC insurers’ investments in corporate bonds from 30% of their assets to 40%. However, insurers are limited to investing in bonds of large state-owned enterprises; Hong Kong, China-listed “red chips”; and companies with “H-share” issuance. Furthermore, the bonds eligible for investment must be rated BBB and above.

Re-opening of Bond Issuance by Publicly-Listed Companies

In July, the listed company Shanghai Yuyuan Tourist Mart was approved by CSRC to issue up to CNY1 billion in bonds, which marked 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 about CNY115 billion. CSRC approved these bonds on a preliminary basis, but has yet to give the final permits needed to proceed with issuance. The resumption of listed-company issuance will be accompanied by new regulations on the distribution of these bonds and retail investors’ access to them.

**Foreign Participation in Bond Trading and Issuance**

In January 2009, PBOC 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. The PRC was also considering allowing qualified foreign-funded financial institutions to issue CNY-denominated bonds in the mainland or in Hong Kong, China. By 2Q09, the initial phases of these measures were underway:

- In April, Standard Chartered Bank announced that its Shanghai unit had traded PRC commercial paper, which made it the first foreign bank to participate in the PRC corporate debt market.
- In May, HSBC and the Bank of East Asia gained approval to issue CNY-denominated bonds in Hong Kong, China to become the first non-PRC banks to receive such approval. In mid-July, HSBC issued CNY1 billion in floating rate notes in Hong Kong, China. Also in July, the Bank of East Asia issued bonds worth CNY4 billion. In September, HSBC issued an additional CNY2 billion in fixed rate paper.

**Domestic Bank Participation in Bond Trading on Exchanges**

In a move geared towards providing a bridge between the PRC’s two primary venues for bond trading, the interbank market and stock exchanges, the China Banking Regulatory Commission (CBRC) and CSRC issued a joint set of preliminary rules in January allowing listed banks to trade bonds on the country’s stock exchanges. The interbank bond market is significantly larger than the exchange-traded market. Regulations for the entry of domestic-listed banks into exchange-based bond trading were released in early July.

The opening up of exchange-based bond trading is aimed at strengthening demand for the bonds of listed companies. With banks as active participants in exchange-based trading, large issuers are expected to have increased confidence in the distribution of their bonds on the exchanges.

In early November, three large state-owned banks – the Bank of Communications (BOC), China Construction Bank (CCB), and the Industrial and Commercial Bank of China (ICBC) – won approval from the CBRC to engage in exchange-based bond trading. In addition to approval from regulators, the banks need to be approved by the stock exchanges. BOC and CCB have received approval from the Shanghai Stock Exchange, while ICBC is the process of obtaining stock exchange approval.