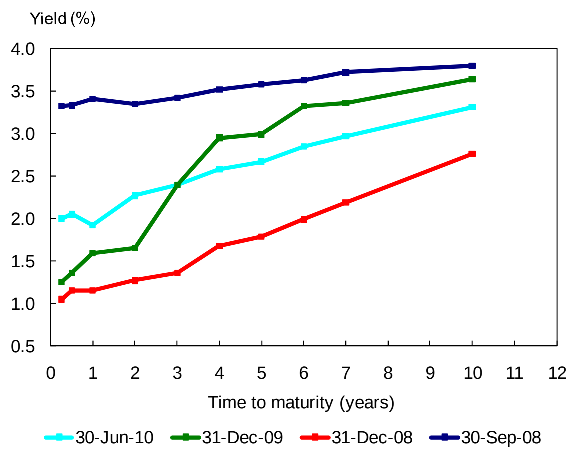
China, People's Rep. of - Update

Yield Movements

The government bond yield curve for the People's Republic of China (PRC) as of end-June had flattened significantly compared with its end-December 2009 levels. Yields for maturities ranging from 3 months to 2 years rose, but fell from the belly through the long end of the curve. At the short end of the curve, the most pronounced yield increase was that of the 3-month tenor, which rose 75 basis points. Yields for 6-month and 2-year paper rose by 69 and 62 basis points, respectively. Yields declined by 47 basis points for 6-year bonds, and by 33 basis points for 10-year bonds **(Figure 1)**.

Figure 1: People's Republic of China's Government Bond Yield Curve – Local Currency Government Bonds



Source: Bloomberg LP.

As a result of the rise in short-term yields and a decline in yields for longer-term bonds, the spread between 2- and 10-year government bonds decreased from 199 basis points at end-December 2009 to 104 basis points as of end-June. The upward movement of the government bond yield curve at its shorter end reflects ongoing concerns over monetary tightening and inflation, as well as investor focus on property and other asset classes.

For the first quarter of 2010, the PRC's gross domestic product (GDP) surged 11.9%, year-on-year (y-o-y) as the impact of the country's stimulus program, which was marked by massive loan growth, continued to be felt. The country posted GDP growth rates of 10.7% y-o-y in 4Q09, 9.1% in 3Q09, 7.9% in 2Q09, and 6.2% in 1Q09.

Consumer price inflation, which had been negative for much of 2009, climbed from 1.5% in January 2010 and rose further to 2.7% in February before declining to 2.4% in March. Consumer price inflation then rose to 2.8% in April and again to 3.1% in May.

With the country's strong growth performance in 2009 and in the first quarter of 2010, policymakers' focus shifted towards addressing consumer and asset price inflation. The People's Bank of China (PBOC) increased banks' reserve ratios by 0.5 percentage points in January—the first such increase since 2008. The PBOC raised reserve ratios an additional 0.5 percentage points in February and by another 0.5 percentage points in May. These hikes brought the reserve ratios required to be maintained by large financial institutions to 17.0%.

Size and Composition

The outstanding amount of local currency (LCY) bonds in the People's Republic of China (PRC) stood at CNY18.08 trillion at the end of the first quarter of 2010 for a quarter-on-quarter (q-o-q) increase of 3.1% and a y-o-y rise of 20.7%% **(Table 1)**. Government bonds outstanding increased 13.5% y-o-y and 2.1% q-o-q, while corporate bonds rose 67.5% y-o-y and 8.2% q-o-q. The most rapidly growing segment of the government bond market was Policy Bank bonds, which rose 24% y-o-y, followed by Treasury bonds, which grew by 16.7%, and Central Bank paper, which increased marginally, by .8% y-o-y. The low growth rate for Central Bank bonds outstanding reflects the 64.5% y-o-y growth of short-dated instruments (bills) which was offset by the 79.1% y-o-y decline of longer-dated Central Bank paper.

Table 1: Size and Composition of Local Currency Bond Market

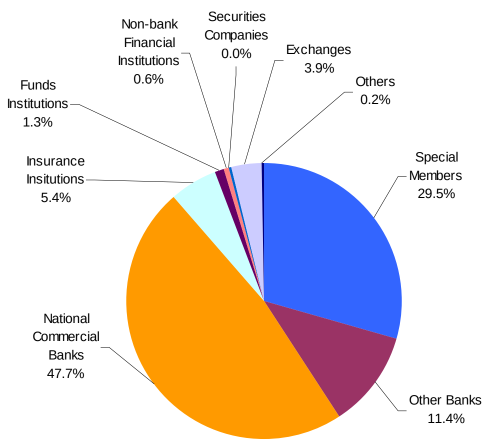
	Amount (in billion)								Growth Rate (%)						
	Dec-09		Jan-10		Feb-10		Mar-10		Dec-09		Jan-10	Feb-10	Mar-10		
	CNY	USD	CNY	USD	CNY	USD	CNY	USD	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	17,525	2,567	17,588	2,576	17,565	2,573	18,077	2,648	16.0	6.3	0.4	(0.1)	20.7	3.1	2.9
Government	14,424	2,113	14,438	2,115	14,318	2,098	14,721	2,157	8.0	4.9	0.1	(0.8)	13.5	2.1	2.8
Treasury Bonds	5,741	841	5,687	833	5,639	826	5,717	837	17.8	1.5	(0.9)	(0.8)	16.7	(0.4)	1.4
Central Bank Bonds	4232.61	620	4,266	625	4,169	611	4,381	642	(12.0)	5.3	0.8	(2.3)	0.8	3.5	5.1
Policy Bank Bonds	4,450	652	4,485	657	4,510	661	4,624	677	21.2	9.1	0.8	0.6	24.0	3.9	2.5
Corporate	3,102	454	3,150	461	3,247	476	3,356	492	77.5	13.6	1.6	3.1	67.5	8.2	3.3

m-om=month-on-on, q-o-q=quarter-on-quarter, y-o-y=year-on-year

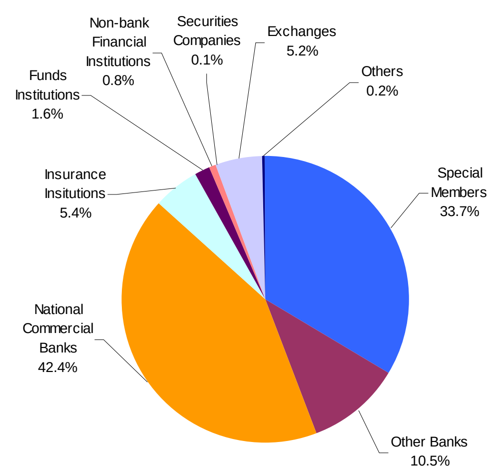
Notes:
1. Calculated using data from national sources.
2. Treasury bonds include savings bonds and local government bonds.
3. Bloomberg LP end-of-period LCY–USD rate is used.
4. Growth rates are calculated from LCY base and do not include currency effects.
Source: *ChinaBond.*

Figure 2: Treasury Bonds Investor Profile

(March 2010)



(March 2009)



Source: *ChinaBond.*

Treasury Investor Profile

Banks remain the largest category of treasury bond investors in the PRC market, holding a larger share of these bonds as of March 2010, compared with end-March 2009 **(Figure 2)**. As of March 2010, banks as a group held 59.1% of treasury bonds outstanding, compared with their March 2009 share of 52.9%. The share held by special members—PBOC, the Ministry of Finance, policy banks, the China Government Securities Depository Trust and Clearing Co., and the China Securities Depository and Clearing Corporation—dropped to 29.5% from 33.7% a year earlier. The shares of most other investor classes fell relative to their year-ago levels.

Corporate Bonds

The first quarter of the year saw a slowdown in the growth of the corporate bond market. As of end-March 2010, the medium-term note (MTN) segment, the largest segment of the corporate bond market, grew 13.2% q-o-q. Although still substantial, this q-o-q growth rate was the lowest in 5 quarters. Most individual sectors of the corporate bond market posted lower q-o-q growth rates in 1Q10, compared with the previous quarter **(Table 2)**.

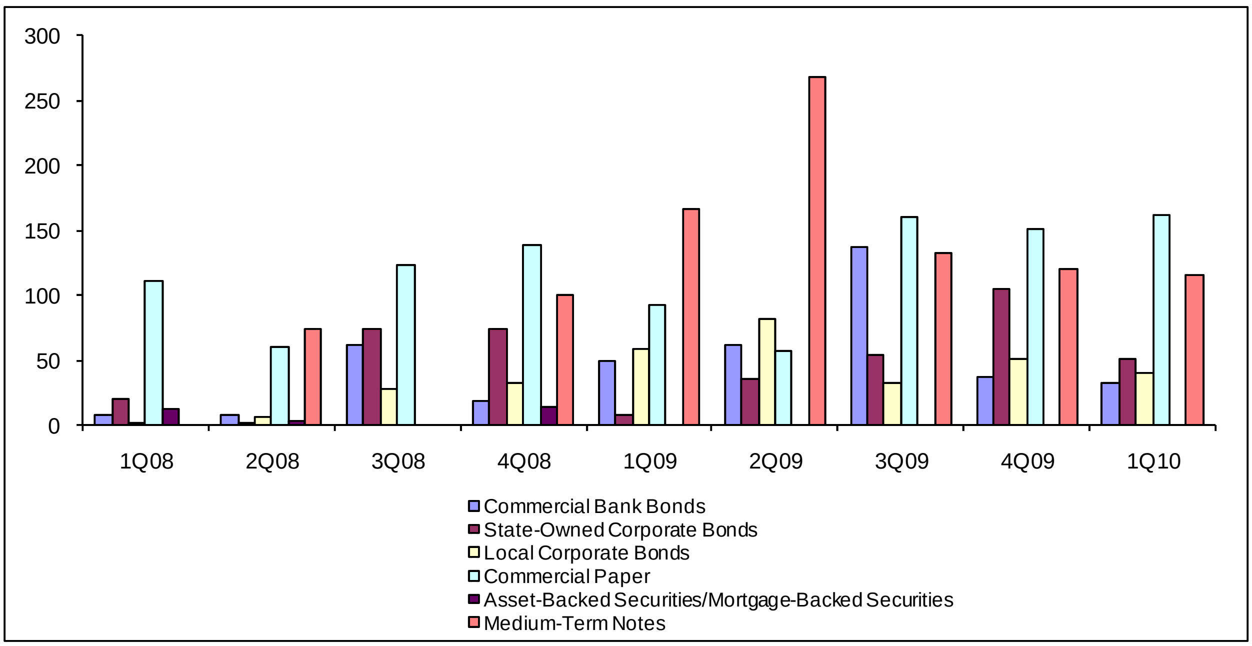
The slowing growth The slowing growth of the PRC corporate bond market is also reflected in issuance trends **(Figure 3)**. After peaking in the second quarter of 2009, the issuance of MTNs has sequentially declined over the last 3 quarters. Similarly, following a spike in issuance of commercial bank bonds in the third quarter of 2009, issuance of commercial bank bonds declined substantially in succeeding quarters.

Table 2: Corporate Bonds Outstanding in Key Sectors

	Amount (CNY billion)									Growth Rates (%)					
										q-o-q					y-o-y
	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	1Q09	2Q09	3Q09	4Q09	1Q10	1Q10
Commercial Bank Bonds	314.5	327.5	384.5	388.7	437.7	486.4	589.2	588.4	589.6	12.6	11.1	21.1	-0.1	0.2	34.7
State-Owned Corporate Bonds	376.1	376.6	446.6	521.9	526.5	565.3	619.3	720.2	771.1	0.9	7.4	9.6	16.3	7.1	46.4
Local Corporate Bonds	92.8	100.2	125.2	158.4	196.9	295.7	328.8	376.9	420.0	24.3	50.1	11.2	14.6	11.4	113.3
Commercial Paper	371.6	313.4	344.8	420.3	409.4	384.3	353.1	456.1	508.8	-2.6	-6.1	-8.1	29.2	11.5	24.3
Asset/Mortgage-Backed Securities	37.2	43.4	43.4	55.1	56.6	55.4	46.0	39.9	31.1	2.7	-2.1	-16.9	-13.4	-22.1	-45.1
Medium Term Notes	0.0	73.5	73.5	167.2	340.8	592.1	742.1	862.2	976.4	103.8	73.7	25.3	16.2	13.2	186.5

Sources: *ChinaBond.*

Figure 3: Corporate Bond Issuance in Key Sectors
(CNY billion)



Sources: *ChinaBond.*

Policy, Institutional, and Regulatory Developments

China Securities Regulatory Commission Issues Rules on Margin Trading

In January the China Securities Regulatory Commission (CSRC) issued rules on a pilot program for margin trading and short selling. According to the regulations, securities companies engaging in margin trading and short selling must have net assets of at least CNY5 billion. Additionally, such companies must have undergone test runs or trials on the trading network for margin trading and short selling. For the initial phase of the program, the CSRC will select six to seven domestic brokers from the eleven brokers that were chosen by the CSRC to participate in previous trial runs for margin trading in 2008.

Stock Index Futures Launched

In February, the CSRC approved final regulations to enable trading of stock index futures, including investor eligibility requirements for the opening of trading accounts. The CSRC gave the green light for the contracts to be traded and it approved the revised trading rules put forward by the China Financial Futures Exchange, which is the venue for index futures trading. Applications for futures trading accounts began to be accepted on 22 February. To open such trading accounts, investors are required to a have a minimum of CNY500,000 deposited in their accounts. The index futures are based on the CSI 300 Index, which comprises the 300 largest A shares on the Shanghai and Shenzhen exchanges. Trading of the futures began on 16 April.

Shanghai Planning to Allow Foreign Participation in Equity, Bond Markets

Shanghai is reportedly planning to allow foreign firms to list shares and sell bonds in Shanghai, in line with efforts to position Shanghai as a global financial center. Currently, foreign firms face restrictions in selling yuan bonds in the People's Republic of China. Numerous foreign firms across industries are reported to have registered their interest in selling shares in Shanghai.

People's Bank of China Signals Greater Yuan Flexibility

On 20 June, the PBOC announced that the yuan's exchange rate would be allowed to adjust based on floating bands. The announcement signals a move towards a more flexible exchange rate regime. The PBOC, however, ruled out a one-time revaluation of the currency and no timeframe was announced for the shift in policy.