

Market Summaries

People's Republic of China—Update

Yield Movements

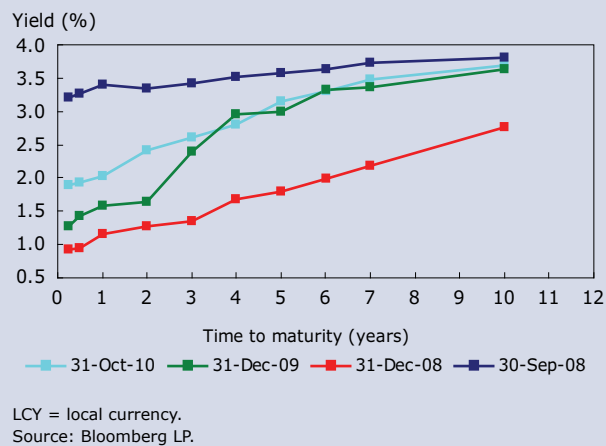
The government bond yield curve for the People's Republic of China (PRC) flattened between end-December 2009 and end-October 2010. Yields for all tenors rose except for the 4-year tenor, which fell 15 basis points, and the 6-year tenor, which was barely unchanged, fell 1 basis point. Yields rose strongly at the shorter-end of the curve with the 1-year tenor rising 44 basis points and the 2-year tenor rising 77 basis points. Yields for the 7-year tenor rose 12 basis points, while yields for the 10-year tenor rose 6 basis points (**Figure 1**). On 20 October, the PRC surprised markets by raising policy rates by 25 basis points. The 1-year lending rate was increased to 5.56% from 5.31%, while the 1-year deposit rate rose to 2.50% from 2.25%.

Due to a stronger rise in short-term yields versus yields for longer-term bonds, the spread between 2- and 10-year government bonds decreased to 128 basis points from 199 basis points at end-December.

In 3Q10, the PRC's gross domestic product (GDP) growth rate moderated to 9.6% year-on-year (y-o-y) after having surged to 10.3% in 2Q10.

Recent economic data has fueled concerns over inflation. The PRC's new loans for October amounted to CNY587.7 billion, bringing total new loans for the first 10 months of the year to CNY6.89 trillion. This amount is already 91.9% of the PRC's full-year loan target of CNY7.5 trillion. The PRC's M2 money supply growth accelerated to 19.3% in October versus 19.0% in September. In addition, industrial output grew by 16.1% in the January–October

Figure 1: People's Republic of China's Benchmark Yield Curve—LCY Government Bonds



period. Output growth was 11.0% in 2009. Due to high food prices, consumer price inflation hit a 25-month high of 4.4% in October, up sharply from 3.6% in September. Property prices also increased 0.2% month-on-month (m-o-m) in October, slightly down from September's 0.5% m-o-m growth. Property prices declined in June on a monthly basis and remained unchanged in July and August. In response to rising inflation, the People's Bank of China (PBOC) hiked the reserve requirement for all banks twice in the month of November by 50 basis points each time.

Other than rising inflation, the PRC has also expressed concern over potential hot money inflows. On 5 August, the State Administration of Foreign Exchange (SAFE) announced that it would continue to maintain pressure on speculative fund inflows. SAFE reiterated its stance again in a report released on 12 October, saying that it would continue to stop inflows of speculative money and crackdown on illegal foreign exchange activities. SAFE attributed the inflows of hot money to bets on

Table 1: Size and Composition of the LCY Bond Market in the People's Republic of China

| | Amount (billion) | | | | | | Growth Rates (%) | | | | | | | | |
|---------------------------------|------------------|-------|--------|-------|--------|-------|------------------|-------|--------|-------|--------|-------|--------|-------|-------|
| | Jun-10 | | Jul-10 | | Aug-10 | | Jun-10 | | Jul-10 | | Aug-10 | | Sep-10 | | |
| | CNY | USD | CNY | USD | CNY | USD | Y-o-y | Q-o-q | M-o-m | Q-o-q | M-o-m | Q-o-q | Y-o-y | M-o-m | |
| Total | 19,316 | 2,848 | 19,498 | 2,878 | 19,958 | 2,930 | 20,013 | 2,991 | 22.5 | 6.9 | 0.9 | 2.4 | 21.4 | 3.6 | 0.3 |
| Government | 15,611 | 2,302 | 15,799 | 2,332 | 16,108 | 2,365 | 15,905 | 2,377 | 17.0 | 6.0 | 1.2 | 2.0 | 15.6 | 1.9 | (1.3) |
| Treasury Bonds | 6,069 | 895 | 6,110 | 902 | 6,336 | 930 | 6,398 | 956 | 13.5 | 6.1 | 0.7 | 3.7 | 13.1 | 5.4 | 1.0 |
| Central Bank Bonds | 4,743 | 699 | 4,795 | 708 | 4,776 | 701 | 4,442 | 664 | 14.0 | 8.3 | 1.1 | (0.4) | 10.5 | (6.3) | (7.0) |
| Policy Bank Bonds | 4,800 | 708 | 4,894 | 722 | 4,997 | 734 | 5,064 | 757 | 25.1 | 3.8 | 2.0 | 2.1 | 24.2 | 5.5 | 1.3 |
| Corporate | 3,705 | 546 | 3,700 | 546 | 3,850 | 565 | 4,108 | 614 | 52.7 | 10.4 | (0.1) | 4.1 | 50.5 | 10.9 | 6.7 |
| Policy Bank Bonds | | | | | | | | | | | | | | | |
| China Development Bank | 3,462 | 510 | 3,542 | 523 | 3,647 | 535 | 3,662 | 547 | 25.0 | 2.3 | 2.3 | 3.0 | 24.6 | 5.8 | 0.4 |
| Export-Import Bank of China | 481 | 71 | 477 | 70 | 480 | 70 | 509 | 76 | 42.1 | 10.9 | (0.8) | 0.6 | 36.3 | 5.9 | 6.1 |
| Agricultural Dvt. Bank of China | 857 | 126 | 876 | 129 | 870 | 128 | 892 | 133 | 17.3 | 3.3 | 2.1 | (0.6) | 16.5 | 4.1 | 2.5 |

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. 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.

the yuan's appreciation, which hit an all-time high versus the United States (US) dollar of CNY6.6249 on 11 November.

Size and Composition

The outstanding amount of local currency (LCY) bonds in the PRC market reached CNY20.01 trillion at the end of September, representing a y-o-y increase of 21.4% and a quarter-on-quarter (q-o-q) rise of 3.6% (**Table 1**).

Government bonds outstanding increased 15.6% y-o-y and 1.9% q-o-q, while corporate bonds rose 50.5% y-o-y and 10.9% q-o-q. In the government sector, policy bank bonds posted the highest y-o-y increase, expanding 24.2%, followed by treasury bonds and central bank bonds, which posted growth rates of 13.1% and 10.5%, respectively. On a q-o-q basis, however, the growth rate of central bank bonds was actually negative, with central bank bonds declining 6.3%. The quarterly growth rate for policy bank bonds slightly outpaced that of treasury bonds, posting 5.5% growth versus 5.4% for treasury bonds.

Corporate Bonds

With the exception of asset- and mortgage-backed securities and commercial bank bonds, key sectors of the corporate bond market grew by double digits in 3Q10. Medium-term notes (MTNs) grew by 73.8% y-o-y, while commercial paper and local corporate bonds posted y-o-y growth rates of 89.9% and 52.5%, respectively. State-owned corporate bonds (or SOE bonds) grew 36.1% y-o-y, and commercial bank bonds grew 3.4%. In contrast to other sectors, the amount of asset- and mortgage-backed securities has been on a steady decline, with no new issuance since 4Q08.

On a q-o-q basis, all sectors showed slower growth rates in 3Q10 compared with the prior quarter, with the exception of SOE bonds (**Table 2**). SOE bonds grew 7.9% in 3Q10 from 1.3% in 2Q10, and MTNs increased 12.0% compared with 17.9% in 2Q10. Commercial paper showed the greatest change,

Table 2: Corporate Bonds Outstanding in Key Sectors

| | Amount (CNY billion) | | | | | | Growth Rates (%) | | | | | | |
|----------------------------------|-------------------------|-------|-------|-------|---------|---------|------------------|--------|--------|--------|--------|--------|--|
| | | | | | | | q-o-q | | | | | y-o-y | |
| | 2Q09 | 3Q09 | 4Q09 | 1Q10 | 2Q10 | 3Q10 | 3Q09 | 4Q09 | 1Q10 | 2Q10 | 3Q10 | 3Q10 | |
| Commercial Bank Bonds | 486.4 | 589.2 | 588.4 | 589.6 | 608.5 | 609.0 | 21.1 | (0.1) | 0.2 | 3.2 | 0.1 | 3.4 | |
| State-Owned Corporate Bonds | 565.3 | 619.3 | 720.2 | 771.1 | 781.1 | 842.6 | 9.6 | 16.3 | 7.1 | 1.3 | 7.9 | 36.1 | |
| Local Corporate Bonds | 295.7 | 328.8 | 376.9 | 420.0 | 461.7 | 501.3 | 11.2 | 14.6 | 11.4 | 9.9 | 8.6 | 52.5 | |
| Commercial Papers | 384.3 | 353.1 | 456.1 | 508.8 | 615.4 | 670.6 | (8.1) | 29.2 | 11.5 | 21.0 | 9.0 | 89.9 | |
| Asset/Mortgage-Backed Securities | 55.4 | 46.0 | 39.9 | 31.1 | 26.5 | 21.9 | (16.9) | (13.4) | (22.1) | (14.8) | (17.2) | (52.4) | |
| Medium-Term Notes | 592.1 | 742.1 | 862.2 | 976.4 | 1,151.2 | 1,289.5 | 25.3 | 16.2 | 13.2 | 17.9 | 12.0 | 73.8 | |

q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Source: ChinaBond.

growing 9.0% in 3Q10 compared with 21.0% in 2Q10, while commercial bank bonds grew at an anemic rate of 0.1% in 3Q10 from 3.2% in 2Q10.

MTNs have consistently enjoyed double-digit q-o-q growth rates for the past 6 quarters, reflecting continued strong corporate sector demand and the improved access to MTNs facilitated by relatively quick issuance approval processes.

Consistent with the lower growth rate for MTNs outstanding in 3Q10 versus 2Q10, MTN issuance declined from CNY174.1 billion in 2Q10 to CNY138.3 in 3Q10, for a q-o-q decrease of 20.6%. Issuance of MTNs has been on a downward trend since peaking at CNY268.6 billion in 2Q09 (**Figure 2**). Commercial paper issuance reached an all-time high of CNY209.0 billion in 3Q10.

Investor Profile

Banks remained the largest category of treasury bond investors in the PRC market, holding a larger share of these bonds at end-September 2010 (61.5%) than end-September 2009 (59.0%) (**Figure 3**). The share held by special members dropped to 27.2% in September 2010 from 29.9% a year earlier. Special members comprise the PBOC, Ministry of Finance, policy banks, China Government Securities Depository Trust and Clearing Co., and China Securities Depository and Clearing Corporation.

Figure 2: Corporate Bond Issuance in Key Sectors

Rating Changes

On 11 November, ratings agency Moody’s Investors Service upgraded its ratings on PRC government bonds to Aa3 from A1 and said it would maintain its positive outlook on the country’s debt (**Table 3**). It cited what it described as the “resilient performance” of the PRC economy since the onset of the financial crisis, as well as exceptional growth in the nation’s external payment position as reasons for the upgrade. The ratings agency said it had based its view on expectations that trade and currency issues between the PRC and the US could be “constructively managed,” and that it saw little risk of fallout from the PRC’s efforts to prop up its

Figure 3: LCY Government Bonds Investor Profile

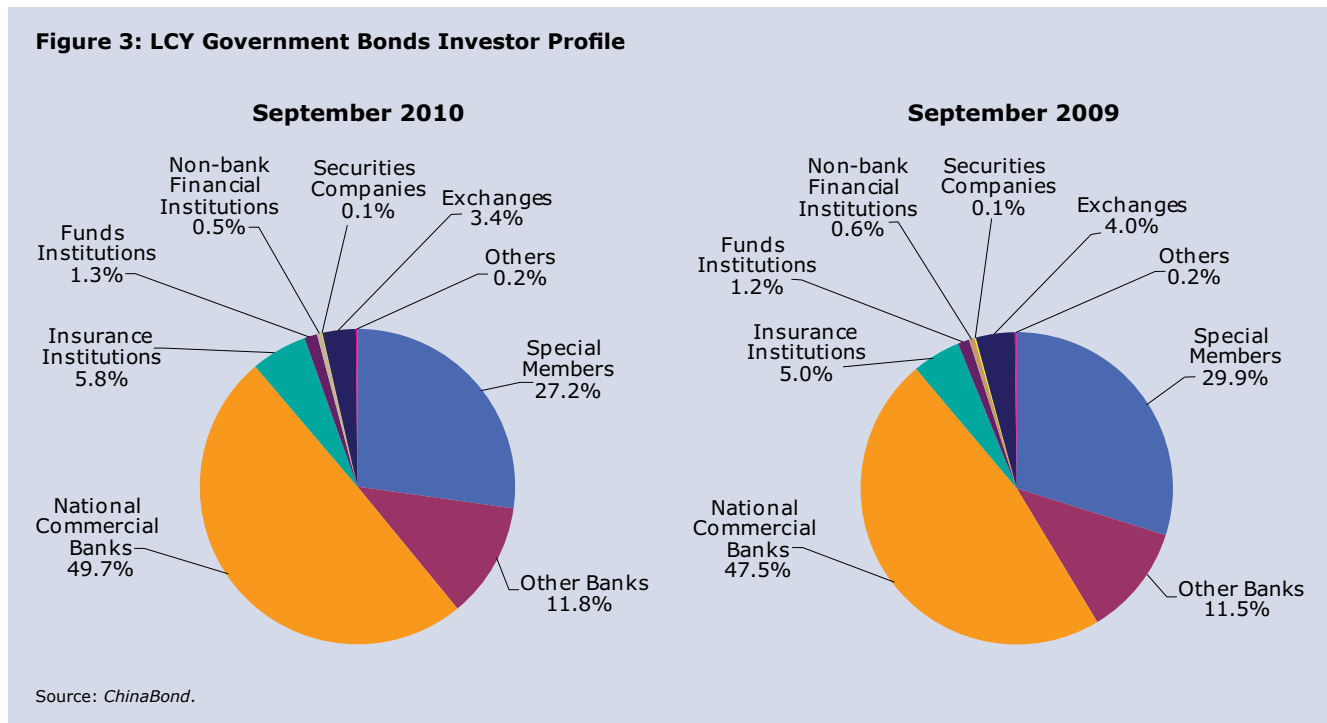


Table 3: Selected Sovereign Ratings and Outlook for the People’s Republic of China

| | Moody’s | S&P | Fitch |
|--------------------------|----------|--------|--------|
| Sovereign FCY LT Ratings | Aa3 | A+ | A+ |
| Outlook | Positive | Stable | Stable |

FCY = foreign currency, LT = long-term.
Source: Rating agencies

economy through “extraordinary credit expansion” in 2009.

Policy, Institutional, and Regulatory Developments Ratings Upgrade

PBOC Allows Banks to Sell Loans to Each Other

On 25 September, the PBOC launched its interbank loan transfer system to allow banks to sell loans to each other. The loan transfers will allow lenders to keep a handle on risks and promote the liberalization of interest rates, according to central bank governor Zhou Xiaochun. At the time of the launch, 21 banks had signed up for the system.

Clearstream and Euroclear Enable Settlement of CNY-Denominated Securities

On 27 September, Clearstream and Euroclear allowed the settlement and clearance of CNY-denominated securities issued outside of the PRC, including Eurobonds and securities issued in Hong Kong, China. Prior to this move, foreign investors could only settle in Hong Kong dollars for securities listed on the Shenzhen Stock Exchange and US dollars for securities listed on the Shanghai Stock Exchange.

Banks Barred from Providing Mortgages to Third Home Buyers

On 30 September, the State Council of China ordered banks to stop providing mortgages to buyers seeking to purchase a third (or more) home. Also, first-time home buyers must now make a down payment of 30% of the house’s price compared with the previous requirement of 20%.

PRC Revises Rules on CNY-Denominated Bonds Issued by Foreign Institutions

The PRC issued revisions to CNY-denominated bonds issued by foreign institutions in the PRC. The revised rules allow international organizations, such as the World Bank and Asian Development Bank, to convert the yuan proceeds in a different currency and transfer the funds overseas with the approval of SAFE, conditional upon the bond having a rating of AA from at least two rating agencies, one of which should be registered in the PRC to rate CNY-denominated bonds.

PRC Allows Foreign Institutions to Open Yuan Accounts

The PBOC issued regulations on 6 October that allow foreign institutions to open cross-border settlement accounts at locally registered banks. According to the rules, foreign institutions can either open an account with a domestic bank or the local unit of a foreign bank. There are, however, restrictions imposed on the accounts. Institutions cannot convert the yuan in the accounts to a different currency or withdraw it as cash. The PBOC said that these rules do not apply to CNY-settled accounts opened by foreign central banks, interbank settlement accounts set up by foreign banks, special yuan accounts opened by qualified foreign institutional investors for trading securities in the PRC, or special accounts for investing in the PRC's interbank bond market.

Chinese Insurers Barred from Property Speculation

The China Insurance Regulatory Commission issued regulations barring Chinese insurance companies from speculating in the property sector. According to the rules, insurers are allowed to invest up to 10% of their assets in elderly citizen communities and the medical services sector, but are not allowed to invest in commercial or residential properties, nor are they allowed to set up real estate enterprises.

Banks Return to Exchanges

On 27 October, the China Securities Regulatory Commission allowed banks to trade bonds listed on domestic exchanges, ending a 13-year ban. Prior to this, banks were only allowed to trade on the interbank bond market. The new ruling is expected to improve liquidity on the exchange as the current participants are mostly retail investors and 95% of the PRC's bonds are traded on the interbank market.

PRC Launches Credit Default Swaps

On 29 October, the PRC recently unveiled guidelines for the creation of its own version of Credit Default Swaps on a trial basis. Under the rules, companies who wish to trade the instrument must have a net capital of at least CNY800 million and companies who wish to originate the instrument must have a net capital of at least CNY4 billion. By 5 November, nine financial institutions had participated: Minsheng Bank, Deutsche Bank, Bank of Communications, Everbright, Industrial and Commercial Bank, Industrial Bank, China Development Bank, China Construction Bank and China Bond Insurance. Twenty contracts were traded with a notional value of CNY1.84 billion. The swaps will be settled through the Shanghai interbank clearing system, the first time that credit default swaps will be settled through a central clearing party.

PRC Tightens Controls over Overseas Fund Inflows

On 9 November, the SAFE announced on its website that it will introduce additional rules on currency provisioning and tighten management of banks' foreign debt-quotas. The regulator said that it will also regulate Chinese special purpose vehicles overseas and tighten controls on equity investments by foreign companies in the PRC.

PRC Limits Hot Money Flows into Real Estate Market

On 12 November, the SAFE and the Ministry of Housing and Urban-Rural Development issued a joint notice that foreign individuals will now be only allowed to purchase one residential property. Also, overseas institutions will only be allowed to purchase non-residential property in the city where it is registered.

PBOC Hikes Reserve Requirement Ratios

The PRC hiked its reserve requirement ratio by 50 basis points for all banks and another 50 basis points for a select few bank in response to accelerating inflation. The PBOC initially hiked by 50 basis points the reserve requirements of the four big state banks and one other bank—China Construction Bank, Bank of China, Agricultural Bank of China, and Bank of Communications on 10 November—effective 15 November. The PRC subsequently announced a 50-basis-point hike for all lenders, effective 16 November. On 19 November, the PRC again hiked the reserve requirement ratio by 50 basis points. This effectively brings the reserve requirement rate of the four big state banks to 18.5%, and to 18.0% for other large financial institutions, and 16.0% for small and medium-sized financial institutions.