Market Summaries

People's Republic of China—Update

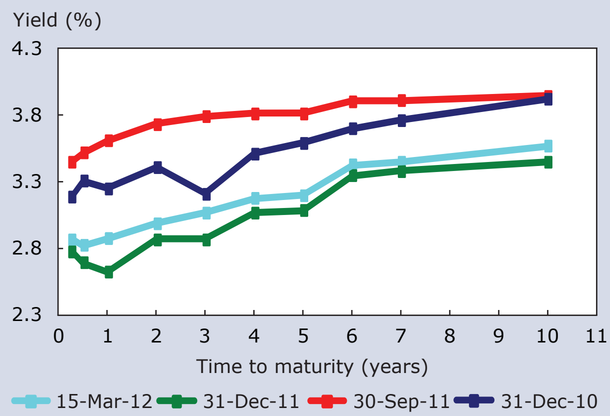
Yield Movements

The People's Republic of China's (PRC) government bond yield curve shifted upward between the beginning of 2011 and end-September 2011, particularly at the short-end of the curve, due to rising inflation **(Figure 1)**. On tenors of 2 years or less, the yield curve rose an average of 29 basis points (bps). However, from end-September to end-December, yields fell as inflation tapered off toward the end of the year. In addition, the People's Bank of China (PBOC) began easing monetary policy. In October, the PBOC temporarily suspended sales of 3-year central bank bonds. The PBOC also slashed the reserve requirement ratio by 50 bps for the first time in 3 years in December. Thus, from end-September to end-December, yields declined the most at the short-end and belly of the curve, falling between 67 bps and 98 bps on tenors of 5 years or less. For tenors longer than 5 years, yields fell 49 bps–55 bps.

The market continues to keep a close watch on monetary policy action and economic data. The PRC's gross domestic product (GDP) growth fell to 8.9% in 4Q11 from 9.1% in 3Q11, while consumer price inflation continued to drop in 4Q11: from 5.5% year-on-year (y-o-y) in October to 4.2% in November and 4.1% in December. There was a brief spike in inflation in January due to the Lunar New Year as inflation hit 4.5% y-o-y. But inflation has come down again with February registering a 3.2% y-o-y rise in consumer prices and March registering a 3.6% rise.

Markets were surprised, when the PBOC left the reserve requirement ratio unchanged before the start of the Lunar New Year in January. Monetary authorities remain concerned about underlying inflationary pressures, and also have yet to ease any of their policy rates. Thus, yields rose between the beginning of the year and 15 March but rose more at the short-end than at the long-end of the curve, resulting in a flatter yield curve.

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



LCY = local currency.
Source: Bloomberg LP.

The yield curve rose 9 bps–25 bps on tenors of 1 year or less while yields rose 8 bps–12 bps on tenors longer than 5 years. The yield spread between the 2- and 10-year rate remained unchanged at 58 bps on 15 March from its end-December levels.

New loans disbursed in January totaled CNY738.1 billion, while new loans disbursed in February were lower at CNY710.7 billion.

In response to emerging economic data, the PBOC reduced the reserve requirement ratio of banks by 15 bps on 18 February. On 21 March, the PBOC expanded its differentiated reserve requirement scheme for Agricultural Bank of China. The move effectively reduced the reserve requirement ratio for 565 banks by 200 bps.

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

	Amount (billion)								Growth Rates (%)						
	Sep-11		Oct-11		Nov-11		Dec-11		Sep-11		Oct-11	Nov-11	Dec-11		
	CNY	US$	CNY	US$	CNY	US$	CNY	US$	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	20,720	3,247	20,845	3,238	21,011	3,294	21,354	3,392	3.5	0.5	0.6	0.8	5.9	3.1	1.6
Government	15,788	2,474	15,770	2,450	15,771	2,473	15,991	2,540	(0.7)	0.1	(0.1)	0.01	0.5	1.3	1.4
Treasury Bonds	7,276	1,140	7,323	1,138	7,326	1,149	7,384	1,173	13.7	4.8	0.6	0.04	10.8	1.5	0.8
Central Bank Bonds	2,116	332	2,016	313	2,015	316	2,129	338	(52.4)	(24.0)	(4.7)	(0.05)	(47.9)	0.6	5.7
Policy Bank Bonds	6,396	1,002	6,431	999	6,430	1,008	6,478	1,029	26.3	5.8	0.5	(0.01)	25.5	1.3	0.7
Corporate	4,932	773	5,074	788	5,239	821	5,363	852	20.0	1.8	2.9	3.3	26.0	8.7	2.4
Policy Bank Bonds															
China Development Bank	4,455	698	4,474	704	4,455	698	4,443	706	21.6	4.0	0.4	(0.4)	20.7	(0.3)	(0.3)
Export–Import Bank of China	780	122	795	125	811	127	833	132	53.2	14.0	1.9	2.0	50.7	6.9	2.7
Agricultural Devt. Bank of China	1,162	182	1,162	183	1,164	182	1,201	191	30.2	7.9	0.04	0.2	29.6	3.4	3.2

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–US$ rate is used.
4. Growth rates are calculated from LCY base and do not include currency effects.
Source: *ChinaBond* and Bloomberg LP.

Weaker external demand from advanced economies has also pressured the PBOC into taking policy actions. Export growth slowed in 4Q11 before turning negative in the first month of the new year, with y-o-y growth in exports in October, November, December, and January at 15.9%, 13.8%, 13.4%, and –0.5%, respectively. However, February exports posted a recovery, growing 18.4% y-o-y. Foreign direct investment (FDI) in the PRC also posted negative y-o-y growth rates in November, December, January, and February, declining most recently by 0.9% in February.

Size and Composition

The amount of outstanding local currency (LCY) bonds in the PRC market reached CNY21.4 trillion (US$3.4 trillion) at end-2011, representing a y-o-y increase of 5.9% and a quarter-on-quarter (q-o-q) rise of 3.1% **(Table 1)**.

LCY government bonds outstanding grew 0.5% y-o-y and 1.3% q-o-q in 4Q11, while corporate bonds rose 26.0% y-o-y and 8.7% q-o-q. In the government sector, marginal y-o-y growth was due to a drop in central bank bonds outstanding, which fell 47.9% y-o-y and only rose 0.6% q-o-q. In contrast, treasury bonds grew 10.8% y-o-y and 1.5% q-o-q, while policy bank bonds grew 25.5% y-o-y and 1.3% q-o-q.

Corporate Bonds. Overall, corporate bonds outstanding grew 26.0% y-o-y in 4Q11. Growth was driven mainly by an increase in outstanding commercial bank bonds and medium-term notes (MTNs). Commercial bank bonds grew 51.6% y-o-y in 4Q11, due largely to issuances of subordinated notes as banks sought to bolster their capital base in advance of the PRC's implementation in 2012 of stricter capital rules under Basel III.

Local corporate bonds grew 37.3% and MTNs grew 45.9% y-o-y in 4Q11, while state-owned corporate bonds grew only 1.7% **(Table 2)**. Commercial paper outstanding fell 23.1% y-o-y and asset- and mortgage-backed securities outstanding fell 47.7% due to a lack of issuance in the last quarter of the year.

Table 2: Corporate Bonds Outstanding in Key Sectors

	Amount (CNY billion)						Growth Rates (%)					
							q-o-q					y-o-y
	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	4Q10	1Q11	2Q11	3Q11	4Q11	4Q11
Commercial Bank Bonds	609.0	609.5	625.0	758.8	755.2	924.3	0.1	2.5	21.4	(0.5)	22.4	51.6
State-Owned Corporate Bonds	842.6	879.6	879.6	877.1	876.4	894.4	4.4	–	(0.3)	(0.1)	2.1	1.7
Local Corporate Bonds	501.3	569.4	653.1	714.1	727.3	782.1	13.6	14.7	9.3	1.8	7.5	37.3
Commercial Paper	670.6	653.0	683.3	687.1	616.5	502.4	(2.6)	4.6	0.6	(10.3)	(18.5)	(23.1)
Asset- and Mortgage-Backed Securities	21.9	18.2	10.8	10.1	9.9	9.5	(16.8)	(41.0)	(6.1)	(2.3)	(3.5)	(47.7)
Medium-Term Notes	1,289.5	1,353.6	1,532.5	1,621.4	1,768.6	1,974.3	5.0	13.2	5.8	9.1	11.6	45.9

– = not available, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Source: *ChinaBond.*

MTNs continued to have higher growth rates than other types of corporate bonds due to regulatory arbitrage, given that the facility benefits from an ease of issuance and a quick approval processes. In fact, MTNs have consistently enjoyed double digit q-o-q growth rates since 3Q08.

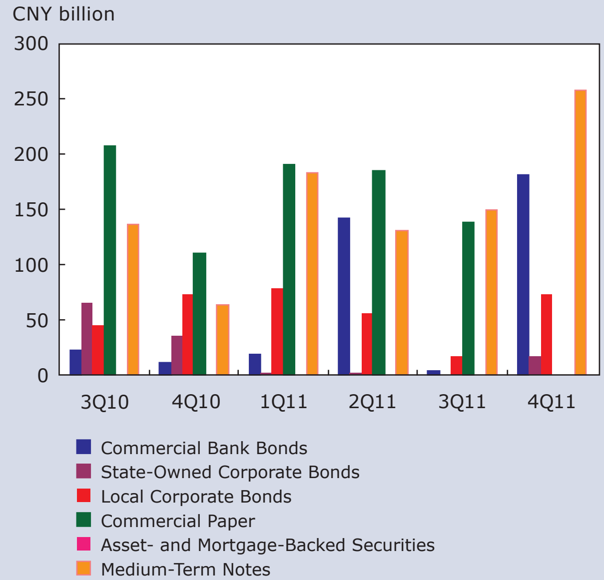
On a q-o-q basis, most categories of outstanding corporate bonds grew in 4Q11, with the exception of commercial paper and asset- and mortgage-backed securities. Local corporate bonds grew 7.5%, MTNs grew 11.6%, and state-owned enterprise bonds grew 2.1%.

Issuance of corporate bonds was up in 4Q11 from 3Q11 levels **(Figure 2)**, with the exception of commercial paper and asset- and mortgage-back securities, as there was no new issuance of either of these types of corporate bonds in 4Q11. Commercial bank bond issuance was up dramatically from 3Q11 due to banks' capital-raising efforts in light of expected increases in capital requirements in 2012 resulting from Basel III.

At end-December, the top 30 corporate bond issuers accounted for CNY3.04 trillion, or about 57%, of total corporate bonds outstanding **(Table 3)**. Among the top 30 corporate issuers, the 10 largest issuers accounted for CNY2.1 trillion, or 69%, of the bonds outstanding of the top 30 issuers.

State-owned companies (defined as majority-owned by the government), in particular, dominate the corporate bond market in the PRC. Among the top 30 corporate bond issuers, 25 are state-owned, with a total of CNY2.77 trillion worth of bonds outstanding at end-December.

Figure 2: Corporate Bond Issuance in Key Sectors, 3Q10–4Q11



Source: *ChinaBond.*

The top issuers are from the infrastructure, energy, and banking sectors **(Figure 3)**. This is consistent with the fact that all of these industries are capital intensive with extensive financing needs.

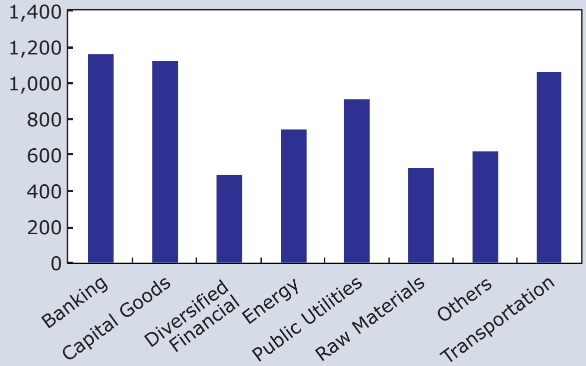
Bid–Ask Spreads. Bid–ask spreads continued to fall for most government bond categories from

Table 3: Top 30 Issuers of LCY Corporate Bonds in the People's Republic of China (as of end-December 2011)

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed Company	Type of Industry
	LCY Bonds (CNY billion)	LCY Bonds (US$ billion)				
1. Ministry of Railways	617.0	96.69	Yes	No	No	Transportation
2. State Grid Corporation of China	294.5	46.15	Yes	No	No	Public Utilities
3. Industrial and Commercial Bank of China	210.0	32.91	Yes	No	Yes	Banking
4. Bank of China	196.9	30.86	Yes	No	Yes	Banking
5. China National Petroleum	191.0	29.93	Yes	No	No	Energy
6. China Construction Bank	160.0	25.07	Yes	No	Yes	Banking
7. China Petroleum & Chemical	131.5	20.61	Yes	No	Yes	Energy
8. Central Huijin Investment	109.0	17.08	Yes	No	No	Diversified Financial
9. Agricultural Bank of China	100.0	15.67	Yes	No	Yes	Banking
10. Petrochina	97.5	15.28	Yes	No	Yes	Energy
11. Industrial Bank	84.1	13.18	No	Yes	Yes	Banking
12. Bank of Communications	76.0	11.91	No	Yes	Yes	Banking
13. China Guodian	74.6	11.69	Yes	No	No	Public Utilities
14. China United Network Communications	53.0	8.31	Yes	No	Yes	Telecommunications
15. China Southern Power Grid	51.0	7.99	Yes	No	No	Public Utilities
16. State-Owned Capital Operation and Management Center of Beijing	50.0	7.84	Yes	No	No	Diversified Financial
17. China Three Gorges Project	49.5	7.76	Yes	No	No	Public Utilities
18. Shenhua Group	48.4	7.58	Yes	No	No	Energy
19. Citic Group	44.5	6.97	Yes	No	No	Diversified Financial
20. Shougang Group	42.0	6.58	Yes	No	No	Raw Materials
21. China Huaneng Group	41.2	6.46	Yes	No	No	Public Utilities
22. China Power Investment	40.1	6.28	Yes	No	No	Public Utilities
23. China Telecom	40.0	6.27	Yes	No	Yes	Telecommunications
24. China Minsheng Bank	38.3	6.00	No	Yes	Yes	Banking
25. Shanghai Pudong Development Bank	37.2	5.83	No	Yes	Yes	Banking
26. Metallurgical Corporation of China	35.2	5.52	Yes	No	Yes	Capital Goods
27. China Guangdong Nuclear Power Holding	32.7	5.12	Yes	No	No	Public Utilities
28. Beijing Infrastructure Investment	32.0	5.01	Yes	No	No	Capital Goods
29. Aluminum Corporation of China	31.0	4.86	Yes	No	No	Raw Materials
30. China Merchants Bank	30.0	4.70	No	Yes	Yes	Banking
Total Top 30 LCY Corporate Issuers	**3,038.2**	**476.12**				
Total LCY Corporate Bonds	**5,362.9**	**840.42**				
Top 30 as % of Total LCY Corporate Bonds	**56.7%**	**56.7%**				

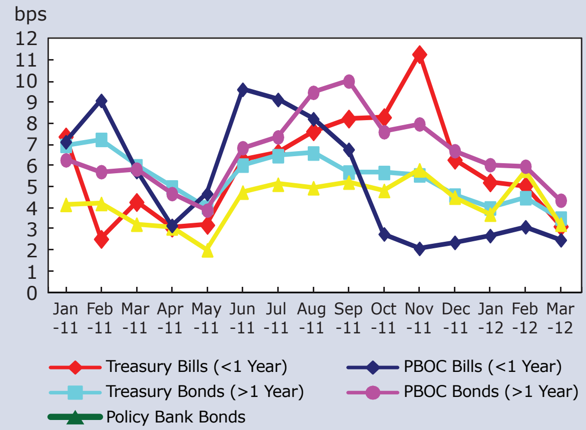
LCY = local currency.
Source: Bloomberg LP and Wind.

Figure 3: LCY Corporate Bonds Outstanding by Sector (as of end-December 2011)



Note: Others includes automobiles and automobile parts; consumer services; durable consumption; food, beverage, and tobacco; real estate; retail; and telecommunications.
Source: *Wind*.

Figure 4: Average Bid–Ask Spreads in the PRC, 1 January 2011–15 March 2012



PBOC = People's Bank of China, PRC = People's Republic of China.
Source: *Wind*.

end-December to mid-March **(Figure 4)**. Liquidity for government bonds improved toward end-2011 as the market was expecting the PBOC to ease monetary policy on the back of lower inflation and GDP growth rates.

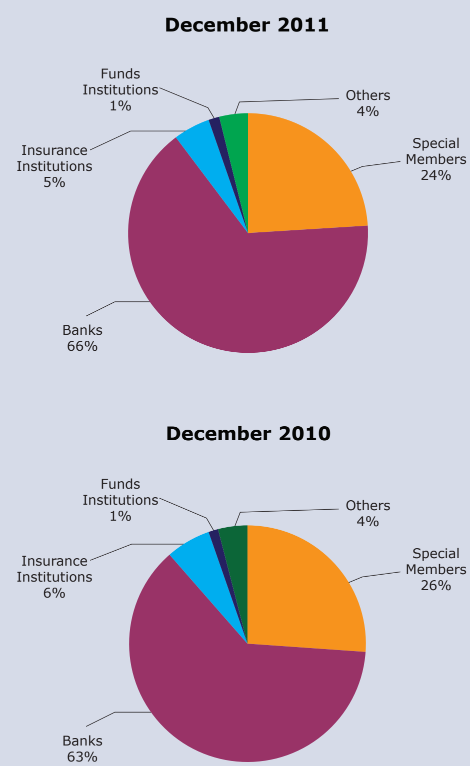
Investor Profile

Treasury Bonds. Banks remained the largest category of investors in the PRC's treasury bond market, holding a slightly larger share of these bonds at end-December 2011 (66%) than at end-December 2010 (63%) **(Figure 5a)**. The shares held by special members remained unchanged at end-December. 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.

Banks are a much more significant holder of policy bank bonds **(Figure 5b)**. As of December 2011, banks held 84% of outstanding policy bank bonds, up from 82% in December 2010. Insurance institutions are the next largest holder, holding 9% in December 2011 from 12% in December 2010.

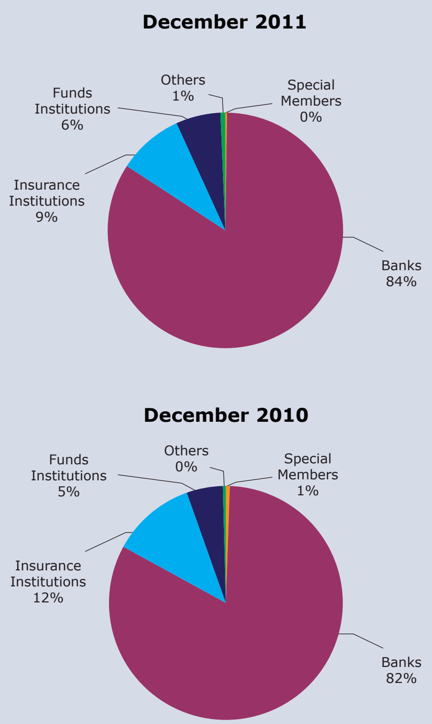
Corporate Bonds. Banks remained the largest holder of corporate bonds in 2011, with a share

Figure 5a: LCY Treasury Bonds Investor Profile



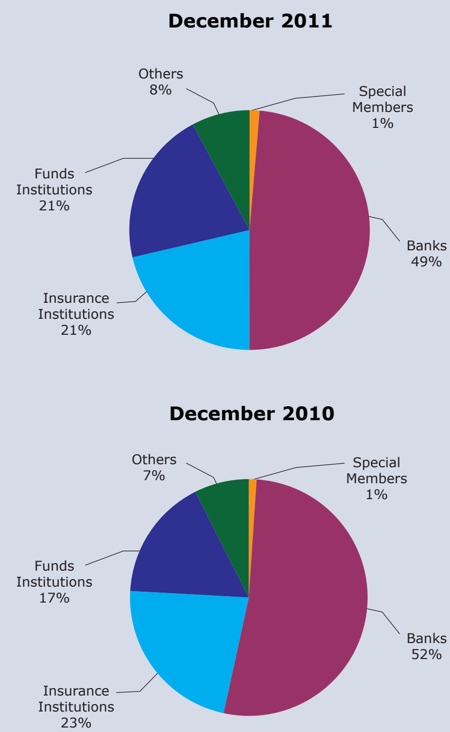
LCY = local currency.
Source: *ChinaBond*.

Figure 5b: LCY Policy Bank Bonds Investor Profile



LCY = local currency.
Source: *ChinaBond*.

Figure 6: LCY Corporate Bonds Investor Profile



LCY = local currency.
Source: *ChinaBond*.

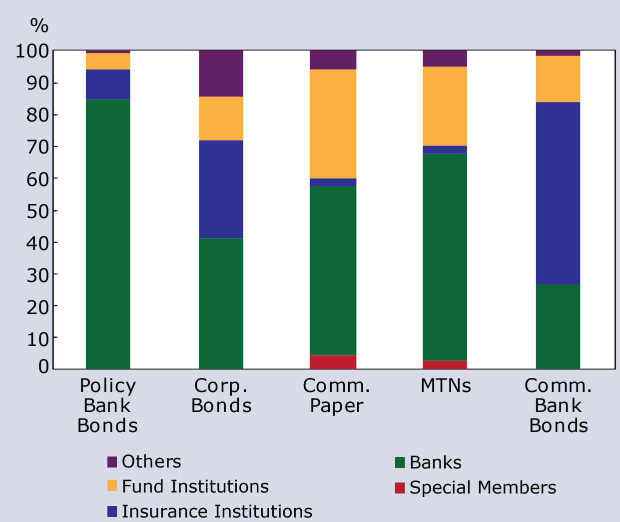
that fell slightly to 49% from 52% in end-December 2010 **(Figure 6)**. The shares held by insurance and fund institutions were each 21% at end-December 2011 after standing at 23% and 17%, respectively, at end-December 2010.

Figure 7 presents the investor profile across different bond categories. Banks were the largest holder of policy bank bonds at end-December, with slightly more than 80% of outstanding policy bank bonds. Meanwhile, insurance institutions were the largest holder of commercial bank bonds.

Interest Rate Swaps

The total notional amount traded in the interest rate swap (IRS) market fell 25.7% y-o-y and 33.9% q-o-q in 4Q11 to CNY521.9 billion, on a total of 3,285 transactions **(Table 4)**. The overnight SHIBOR became the most popular

Figure 7: Investor Profile across Bond Categories (as of end-December 2011)



MTNs = medium-term notes.
Source: *ChinaBond*.

Table 4: Notional Values of the PRC's Interest Rate Swap Market (as of 4Q11)

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	% of Total Notional Amount	Number of Transactions	Growth Rate (%)	
	4Q11			q-o-q	y-o-y
7-Day Repo Rate	176.5	33.8	1,702	(56.5)	(39.7)
Overnight SHIBOR	255.1	48.9	714	(8.5)	(5.3)
3-Month SHIBOR	88.9	17.0	842	(8.8)	(28.9)
1-Year Term Deposit Rate	1.3	0.2	17	(94.4)	(96.7)
1-Year Lending Rate	0.1	0.02	10	(38.2)	(94.7)
Total	**521.9**	**100.0**	**3,285**	**(33.9)**	**(25.7)**

– = not applicable, PRC = People's Republic of China, q-o-q = quarter-on-quarter, repo = repurchase, SHIBOR = Shanghai Interbank Offered Rate, y-o-y = year on year.
Source: *ChinaMoney*, *Wind*, and *AsianBondsOnline*.

benchmark in 4Q11, accounting for 48.9% of the total notional amount traded. The 7-day repurchase (repo) rate accounted for 33.8% of the total. These two benchmarks were the most active in 4Q11 because the primary participants in the PRC's onshore IRS market are commercial banks with funding exposure mainly in the form of repo transactions. Therefore, banks desire to use the repo rate as the base rate to hedge their funding.

Policy, Institutional, and Regulatory Developments

PRC Allows CNH to Be Used for Cross-Border Investment

On 14 October, the PRC released two sets of regulations paving the way for CNH funds raised in Hong Kong, China to be used for FDI in the PRC. The Notice on Cross-Border Renminbi Foreign Direct Investment was issued by the Ministry of Commerce and the Renminbi Foreign Direct Investment Settlement Rules were issued by the PBOC.

PRC to Provide Support for Small and Micro-Sized Enterprises

On 14 November, the China Regulatory Banking Commission (CBRC) granted three banks authority to issue special bonds for the purpose of funding small-scale enterprises. On 2 February, Premier Wen Jiabao said that the government would provide support for these enterprises through a CNY15 billion fund and the extension of preferential tax policies until 2015.

PRC Launches Trial Program for RQFII

On 31 December, the PRC announced the launch of the Renminbi Qualified Foreign Institutional Investor (RQFII) program with an initial quota of CNY10.7 billion. The program will allow CNH funds to be placed in the PRC's domestic securities market. At least 80% of the funds must be placed in fixed-income investments.

PRC Issues Additional QFII Licenses

On 16 January, the China Securities Regulatory Commission (CSRC) announced that it had issued an additional 14 licenses for the Qualified Foreign Institutional Investors (QFII) program in December. The 14 institutions granted QFII licenses include Canada Pension Plan Investment Board; Van Eck Associates Corp.; Hansberger Global Investors; EARNEST Partners; Bank of Thailand; Kuwait Investment Authority; Northern Trust Global Investments; a life insurance company in Taipei,China; Bank of Korea; Ontario Teachers' Pension Plan Board; Korea Investment Corp.; Russell Investments Ireland; Metzler Asset Management; and HI Asset Management Co.

On 20 January, the CSRC announced that seven more licenses had been granted in January. The institutions granted the license include Shinhan

BNP Paribas Asset Management, Stichting Pensioenfonds voor Huisartsen, Republic of Korea's National Pension Service, Mercuries Life Insurance, Prudential Financial Securities Investment Trust Enterprise, Principal Global Investors, and Hospital Authority Provident Fund Scheme.

PBOC to Provide Support for First-Home Buyers

On 8 February, the PBOC announced that banks must provide mortgage loans to first-time home buyers. The PBOC also said that it would support efforts to construct affordable housing.

PBOC Reduces Reserve Requirement Ratio

On 18 February, the PBOC reduced the reserve requirement ratio of banks by 50 bps, bringing the ratio to 20.5% for larger financial institutions and 18.5% for small and medium-sized banks.

PBOC Expands Cross-Border Settlement Program

On 2 March, the PBOC announced that it had expanded its cross border settlement program to include all companies that are engaged in foreign trade activities.

CSRC to Develop High-Yield Bond Market

On 6 March, the CSRC announced plans to develop a high-yield LCY bond market that will help provide additional financing to small and medium-sized enterprises (SMEs). According to press reports, the CSRC is working on guidelines for the establishment of the market. The bonds are to be issued on the securities exchanges and will be subject to quotas.

PBOC Expands Differentiated Reserve Requirement for Agricultural Bank Branches

On 18 March, the PBOC expanded its differentiated reserve requirement ratio scheme for Agricultural Bank of China to include an additional 379 branches. The PBOC also announced that the reserve requirement ratio for a total of 565 branches will be reduced by 200 bps in an effort to expand the amount of rural credit available by CNY23 billion.

PRC Widens CNY Trading Band

On 16 April, the PBOC began allowing the renminbi to trade within a wider band. The renminbi subsequently began trading in a range of 1.0% above and below a daily reference exchange rate. Previously, the renminbi could only trade in a band of 0.5% above and below the daily reference rate.