Market Summaries

People's Republic of China

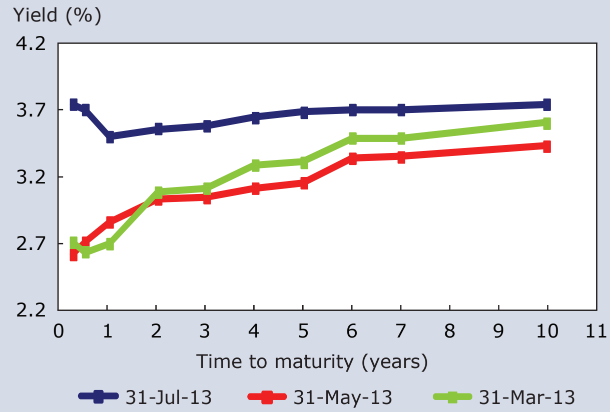
Yield Movements

The government bond yield curve of the People's Republic of China (PRC) was relatively unchanged between end-March and end-May **(Table 1)**. On the shorter-end, yields rose slightly for the 6-month and 1-year tenors, rising 7 basis points (bps) and 16 bps, respectively. Yields for the 2- and 3-year tenors, however, fell 5 bps and 7 bps, respectively. For tenors of 4 years and longer, yields rose between 14 bps and 17 bps.

A major change in the yield curve occurred between end-May and end-July, particularly at the shorter-end of the curve where yields rose between 63 bps and 111 bps for tenors of 1-year or less. In comparison, yields rose between 31 bps and 53 bps for tenors longer than 1-year. Meanwhile, the spread on 2- versus 10-year yields narrowed to 18 bps at end-July from 39 bps at end-May due to the significant rise in yields at the shorter-end of the curve.

The steep rise at the shorter-end of the yield curve was due to the lingering effects of the Shanghai Interbank Offered Rate (SHIBOR) shock event in late June. Bank liquidity requirements rose in June due to withdrawals in advance of the Dragon Boat holiday as well as the maturation of wealth products. At the beginning of June, the overnight SHIBOR rate was 4.6% and the 7-day interbank repo rate was 4.8%. By 8 June, liquidity demands had driven the SHIBOR rate up to 7.5% and the 7-day repo rate to 7.8%. Markets expected the People's Bank of China (PBOC) to step in and provide additional liquidity to the market; instead, the PBOC issued central bank bills on 18 June for the first time since 2011. The issuance sent a signal to markets regarding the PBOC's stance toward liquidity, resulting in a rise in the SHIBOR rate to a high of 13.4% on 20 June, while the

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



LCY = local currency.
Source: Bloomberg LP.

7-day repo rate rose to 11.2%. United States (US) Federal Reserve Chairman's Ben Bernanke's statements regarding the possibility of tapering its quantitative easing program also served to increase market anxiety, which led to an increase in yields at the longer-end of the curve.

The PBOC released a statement on 26 June that sought to clarify its actions by stating that the rise in money market rates was due to temporary seasonal factors and rapid loan growth, but claimed that overall liquidity in the system was sufficient. The PBOC also said that banks needed to be more prudent in their liquidity management.

At the longer-end of the curve, the rise in yields also reflected concerns about somewhat higher levels of inflation and a lack of policy stimulus despite weak economic growth. Even with gross domestic product (GDP) growth falling to 7.5% year-on-year (y-o-y) in 2Q13 from 7.7% in 1Q13, and exports falling 3.1% y-o-y in June, consumer price inflation rose to 2.7% y-o-y in June from 2.1% in May.

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

	Outstanding Amount (billion)						**Growth Rates** (%)			
	2Q12		**1Q13**		**2Q13**		**2Q12**		**2Q13**	
	CNY	**US$**	**CNY**	**US$**	**CNY**	**US$**	**q-o-q**	**y-o-y**	**q-o-q**	**y-o-y**
Total	22,042	3,469	24,448	3,937	24,825	4,045	1.5	6.9	1.5	12.6
Government	16,396	2,580	17,555	2,827	17,644	2,875	1.1	3.9	0.5	7.6
Treasury Bonds	7,500	1,180	8,071	1,300	8,438	1,375	1.1	8.0	4.5	12.5
Central Bank Bonds	1,644	259	1,338	215	809	132	(14.7)	(41.0)	(39.5)	(50.8)
Policy Bank Bonds	7,251	1,141	8,146	1,312	8,397	1,368	5.6	20.0	3.1	15.8
Corporate	5,646	889	6,893	1,110	7,180	1,170	2.6	16.5	4.2	27.2
Memo Item: Local Government Bonds including Treasury Bonds Issued on Behalf of Local Government	455	72	650	105	664	108	(23.8)	13.7	2.1	45.9
Policy Bank Bonds										
China Development Bank	4,921	775	5,422	873	5,525	900	5.2	14.9	1.9	12.3
Export–Import Bank of China	930	146	1,183	191	1,268	207	3.1	36.0	7.2	36.4
Agricultural Devt. Bank of China	1,400	220	1,541	248	1,604	261	8.4	30.0	4.1	14.5

( ) = negative, LCY = local currency, 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 an LCY base and do not include currency effects.
5. The balance of outstanding commercial paper as of 2Q13 was CNY1.5 trillion based on data from *Wind*.
Sources*: ChinaBond* and Bloomberg LP.

More recent data, however, has suggested a slight rebound in the PRC's economy. Exports rose 5.1% y-o-y and imports rose 10.9% in July, while consumer price inflation remained at 2.7%. Also, the Purchasing Managers' Index (PMI) for manufacturing showed improvement in July, rising to 50.3 from 50.1 in June, while the services PMI rose to 54.1 from 53.9 in the previous month.

The government has undertaken a number of policy measures to improve the outlook for continued economic and financial stability. In a recent statement supporting the development of small and medium-sized enterprises (SMEs), the PBOC said that it would continue to ensure a sound monetary policy and keep monetary and aggregate credit at a reasonable level. On 22 June, the PBOC removed the floor on the bank lending rates but maintained the floor on interest rates for mortgages. The PBOC took these steps to curb investment and speculative demand in the real estate market. On 6 May, the State Administration of Foreign Exchange (SAFE) instituted a new rule requiring banks with foreign currency (FCY) loan-to-deposit ratios exceeding a certain level to maintain an FCY net open position greater than zero.

Size and Composition

The amount of outstanding local currency (LCY) bonds in the PRC market reached CNY25 trillion (US$4.0 trillion) at end-June, an increase of 12.6% y-o-y and 1.5% quarter-on-quarter (q-o-q), largely driven by growth in policy bank and corporate bonds.

Government Bonds. LCY government bonds outstanding grew 7.6% y-o-y and 0.5% q-o-q in 2Q13, largely driven by growth in policy bank bonds, which expanded 15.8% y-o-y and 3.1% q-o-q. Central bank bonds continued to act as a drag on government bond growth, falling 50.8% y-o-y and 39.5% q-o-q due to a lack of issuance as the PBOC elected to use other means to affect monetary policy. Meanwhile, treasury bonds increased 12.5% y-o-y and 4.6% q-o-q.

Less than 10% of treasury bonds consist of bonds issued by the central government on behalf of local governments and bonds issued directly by local governments. While many companies owned by local governments issue bonds in the corporate bond market, only a few provinces and municipalities are permitted to issue bonds in

Table 2: Corporate Bonds Outstanding in Key Sectors

	Outstanding Amount (CNY billion)				Growth Rates (%)				
					q-o-q				y-o-y
	3Q12	4Q12	1Q13	2Q13	3Q12	4Q12	1Q13	2Q13	2Q13
Commercial Bank Bonds	1,106.2	1,265.3	1,304.5	1,329.0	0.6	14.4	3.1	1.9	20.8
State-Owned Corporate Bonds	991.4	992.9	1,024.4	652.9	(0.1)	0.2	3.2	(36.3)	(34.2)
Local Corporate Bonds	1,103.2	1,304.9	1,484.3	1,579.6	11.8	18.3	13.7	6.4	60.0
Asset- and Mortgage-Backed Securities	8.2	7.6	5.0	5.0	–	(7.5)	(35.0)	–	(39.8)
Medium-Term Notes	2,340.1	2,492.2	2,661.5	2,749.5	9.9	6.5	6.8	3.3	29.1

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

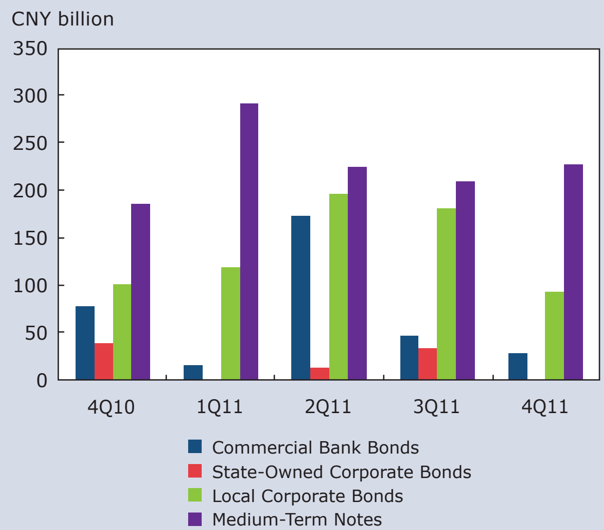
their own name. Those that are permitted include Guangzhou, Zheijiang, Shanghai, and Shangdong. Whether or not local governments should be allowed to issue bonds more freely is currently an important policy question.

Corporate Bonds. Corporate bonds outstanding grew 4.2% q-o-q and 27.2% y-o-y in 2Q13 **(Table 2)**. Growth was driven mainly by increases of 6.4% q-o-q and 60.0% y-o-y in outstanding local corporate bonds. Commercial bank bonds grew 20.8% y-o-y, largely due to the issuance of subordinated notes in 2012 as the PRC's banks sought to bolster capital bases amid the implementation of Basel III capital adequacy requirements. State-owned enterprise (SOE) bonds outstanding fell 34.2% y-o-y and 36.3% q-o-q in 2Q13. Medium-term notes (MTNs) expanded 29.1% y-o-y. Outstanding asset-backed securities (ABS) continued to decline, falling 39.8% y-o-y due to a lack of issuance that began in 2008 when ABS issuance was halted by the government. ABS issuance resumed in 4Q12.

The issuance of corporate bonds was down in 2Q13 on a q-o-q basis **(Figure 2)**, with the exception of MTNs. Issuance was negatively affected by tighter liquidity conditions and higher interest rates brought about by the June SHIBOR shock.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. At end-June, the top 30 corporate bond issuers accounted for CNY4 trillion worth of corporate bonds outstanding, or about 58% of the market. Among the top 30 corporate issuers, the 10 largest accounted for CNY3.5 trillion worth of bonds outstanding.

Figure 2: Corporate Bond Issuance in Key Sectors



Source: *ChinaBond.*

State-owned companies—defined as majority-owned by the government—continued to dominate the corporate bond market in 2Q13. Among the top 30 corporate issuers at end-June, 23 were state-owned, with a total of CNY3.3 trillion worth of bonds outstanding.

Table 4 presents the most significant issuances of 2Q13.

Table 3: Top 30 Issuers of LCY Corporate Bonds in the People's Republic of China

Issuers	Outstanding Amount		State-Owned	Listed Company	Type of Industry
	LCY Bonds (CNY billion)	LCY Bonds (US$ billion)			
1. China Railway	747.00	120.29	Yes	No	Transportation
2. China National Petroleum	380.00	61.19	Yes	No	Energy
3. State Grid Corporation of China	349.50	56.28	Yes	No	Public Utilities
4. Industrial and Commercial Bank of China	230.00	37.04	Yes	Yes	Banking
5. Bank of China	219.93	35.41	Yes	Yes	Banking
6. China Construction Bank	200.00	32.21	Yes	Yes	Banking
7. Agricultural Bank of China	150.00	24.15	Yes	Yes	Banking
8. China Petroleum & Chemical	144.70	23.30	Yes	Yes	Energy
9. Central Huijin Investment	109.00	17.55	Yes	No	Diversified Financial
10. Petrochina	107.50	17.31	Yes	Yes	Energy
11. Shenhua Group	105.00	16.91	Yes	No	Energy
12. China Guodian	103.20	16.62	Yes	No	Public Utilities
13. China Minsheng Bank	102.31	16.47	No	Yes	Banking
14. Shanghai Pudong Development Bank	79.20	12.75	No	Yes	Banking
15. Bank of Communications	76.00	12.24	No	Yes	Banking
16. China Three Gorges Project	75.50	12.16	Yes	No	Public Utilities
17. Industrial Bank	72.08	11.61	No	Yes	Banking
18. China Life	68.00	10.95	Yes	Yes	Insurance
19. China Power Investment	67.30	10.84	Yes	No	Public Utilities
20. China Merchants Bank	61.70	9.94	No	Yes	Banking
21. China Southern Power Grid	60.50	9.74	Yes	No	Public Utilities
22. State-Owned Capital Operation and Management Center of Beijing	58.50	9.42	Yes	No	Diversified Financial
23. Huaneng Power International	54.20	8.73	Yes	Yes	Public Utilities
24. Citic Group	53.50	8.61	Yes	No	Diversified Financial
25. Bank of Beijing	53.50	8.61	No	Yes	Banking
26. China Huaneng Group	53.00	8.53	Yes	No	Public Utilities
27. China Everbright Bank	52.70	8.49	No	Yes	Banking
28. China United Network Communications	50.00	8.05	Yes	Yes	Telecommunications
29. China Citic Bank	42.50	6.84	No	Yes	Banking
30. China Datang	42.20	6.80	Yes	No	Public Utilities
Total Top 30 LCY Corporate Issuers	**3,968.52**	**639.03**			
Total LCY Corporate Bonds	**6,892.54**	**1,109.87**			
Top 30 as % of Total LCY Corporate Bonds	**57.6%**	**57.6%**			

LCY = local currency.
Notes:
1. Data as of end-June 2013.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on *Wind* data.

Table 4: Notable LCY Corporate Bond Issuance in 2Q13

Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
China National Petroleum		
6-year bond	4.7	20
China Railway		
5-year bond	4.5	20
China Railway Construction		
7-year bond	5.1	10
Anshan Iron and Steel Group		
3-year bond	4.4	5
China Three Gorges		
5-year bond	4.4	5
Tianjin Bohai State-owned Assets Management		
5-year bond	4.8	5
Datong Coal Mining Group		
15-year bond	5.2	5
Shanxi Lu'an Mining Group		
10-year bond	5.2	3
Changsha Metro Group		
10-year bond	6.2	2.5

LCY = local currency.
Source: *Wind*.

In 2011, the PRC's Audit Office released the results of its audit on the indebtedness of the country's local governments. The report found that local governments had an outstanding debt obligation of CNY10.7 trillion at the end of 2010. Of this amount, CNY6.7 trillion comprised direct obligations of local governments, CNY2.3 trillion came from local government guarantees, and CNY1.7 trillion came from other contingent liabilities.

Local government debt increased at a slower pace of 18.9% y-o-y in 2010 from 61.9% in 2009. The report also shows that the bulk of local government borrowing came from corporations set up for the sole purpose of raising funds: 46.4% of the debt was funded through local-government-owned corporations and 23.3% came from the local government agencies.

By instrument, bank loans were the primary source of the local government funding, comprising 79% of total loans versus 7% for bonds. In June 2013, the audit office released a partial audit report for 36 local government units. The estimated debt of the 36 local governments under review grew 12.9% y-o-y to CNY3.8 trillion at the end of 2012. CNY1.8 trillion comprised direct obligations of the local government and CNY0.9 trillion comprised guarantees.

By vehicle, the bulk of local government funding came from corporations owned by local government, which comprised 45.7% of the total, followed by government agencies at 25.4%.

By instrument, bank loans were still the largest source of debt, comprising 78% of the total, while bonds comprised 12%.

By region, the largest issuances of local corporate bonds come from the Greater Shanghai region, which accounted for 34% of outstanding local corporate bonds in 2Q13. Within the Greater Shanghai region, outstanding bonds from Jiangsu alone comprised 14% of all local corporate bonds **(Table 5)**.

Investor Profile

Treasury Bonds. Banks remained the largest category of investors in the PRC's treasury bond market, which includes policy bank bonds, holding a slightly larger share of these bonds at the end of 2Q13 (77.7%) than at the end of 2Q12 (76.7%) **(Figure 3)**. The share held by special members fell to 10.0% from 11.2% during the same period. Special members comprise the PBOC, Ministry of Finance, policy banks, China Government Securities Depository Trust and Clearing Company, and China Securities Depository and Clearing Corporation.

Corporate Bonds. Banks were also the largest holder of corporate bonds at the end of 2Q13, albeit with a comparatively smaller share than their holdings of treasury bonds and policy bank bonds. Banks' share of corporate bonds fell to 31.3% at the end of 2Q13 from 40.1% a year earlier **(Figure 4)**. The second largest holder of corporate bonds were insurance companies, with a 16.1% share at end-June, which was less than their 26.3% share at end-June 2012.

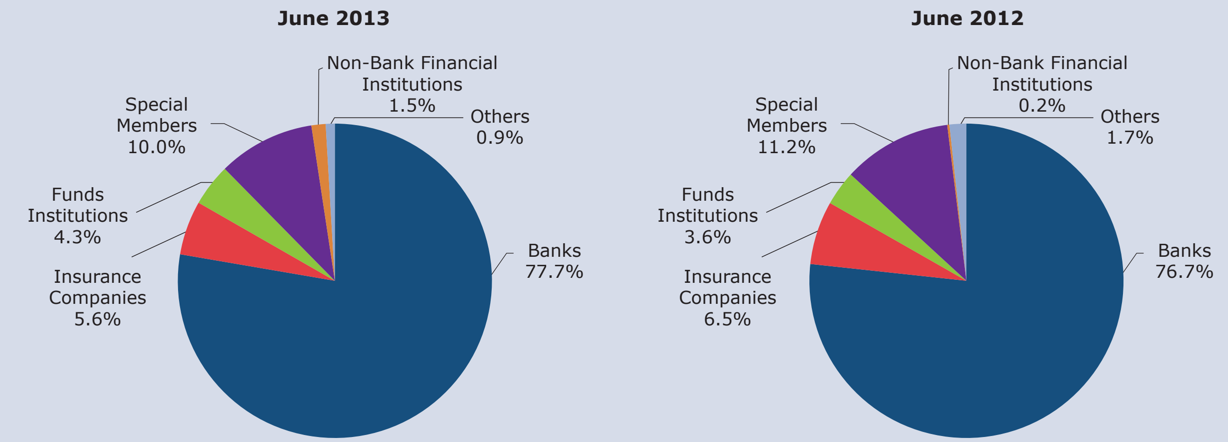
Figure 5 presents the investor profile across different bond categories. Based on the latest data available, banks were the largest holders of

Table 5: Local Corporate Bonds Outstanding by Region

	Number of Issuers	Number of Issuances	Outstanding Amount (CNY billion) 4Q12	2Q13	% Change
Greater Shanghai					
Shanghai	26	36	50	51	1.1
Zhejiang	105	126	114	139	21.4
Jiangsu	146	180	192	229	19.3
Anhui	45	68	69	76	10.2
Jiangxi	32	40	36	47	30.2
Subtotal	**354**	**450**	**461**	**541**	**17.3**
Greater Beijing					
Beijing	35	45	78	84	8.2
Tianjin	23	34	42	62	44.9
Hebei	21	29	29	33	15.2
Subtotal	**79**	**108**	**149**	**179**	**20.0**
Greater Guangdong					
Guangdong	36	38	37	52	39.9
Fujian	40	44	27	42	52.8
Hunan	49	65	73	82	13.0
Guangxi	19	26	26	27	3.9
Subtotal	**144**	**173**	**164**	**203**	**24.4**
The Southwest					
Chongqing	42	56	63	76	20.9
Yunnan	33	39	37	43	16.7
Sichuan	36	46	39	49	23.6
Subtotal	**111**	**141**	**140**	**168**	**20.5**
Central					
Henan	39	44	39	47	21.4
Hubei	31	36	26	34	28.8
Shaanxi	25	31	26	33	30.0
Subtotal	**95**	**111**	**91**	**114**	**26.0**
The West					
Inner Mongolia	26	32	31	36	18.6
Gansu	4	5	6	7	12.7
Xinjiang	22	23	20	24	22.9
Qinghai	5	7	5	6	12.0
Ningxia	6	9	9	9	0.0
Subtotal	**63**	**76**	**71**	**82**	**16.5**
The Northeast					
Jilin	11	13	13	15	13.4
Liaoning	35	49	62	72	17.1
Heilongjiang	17	23	26	28	9.8
Subtotal	**63**	**85**	**101**	**115**	**14.7**
Others					
Shangdong	69	89	70	89	26.1
Hainan	8	9	7	12	85.0
Shanxi	25	31	34	50	49.0
Guizhou	26	28	28	33	18.5
Xizang	0	0	0	0	–
Subtotal	**128**	**157**	**139**	**185**	**32.9**

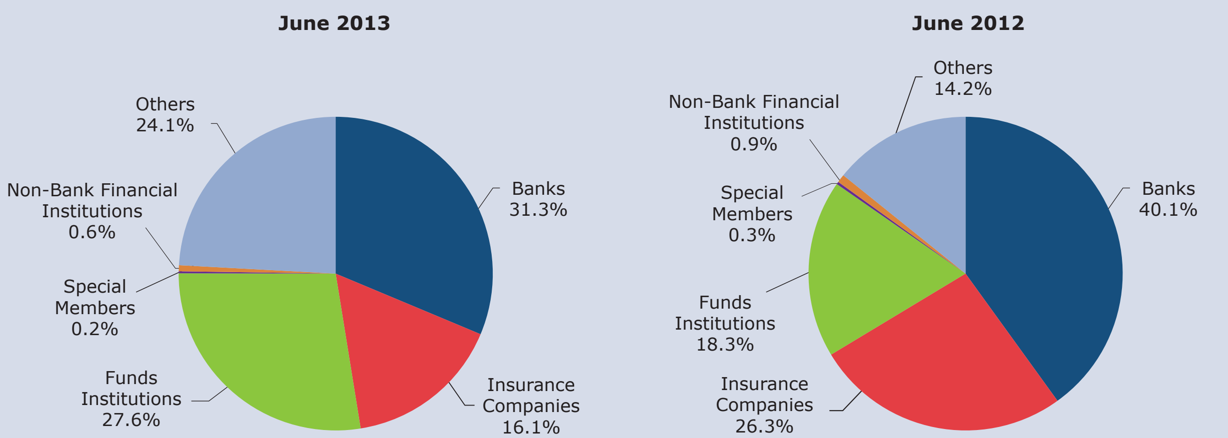
– = not applicable.
Notes:
1. Data as of end-June 2013.
2. Local corporate bonds are bonds approved by the China Securities Regulatory Commission, and are tradable on the exchanges. They exclude bonds issued by state-owned corporations.
Source: *Wind*.

Figure 3: LCY Treasury Bonds Investor Profile



LCY = local currency.
Source: *ChinaBond*.

Figure 4: LCY Corporate Bonds Investor Profile



LCY = local currency.
Source: *ChinaBond*.

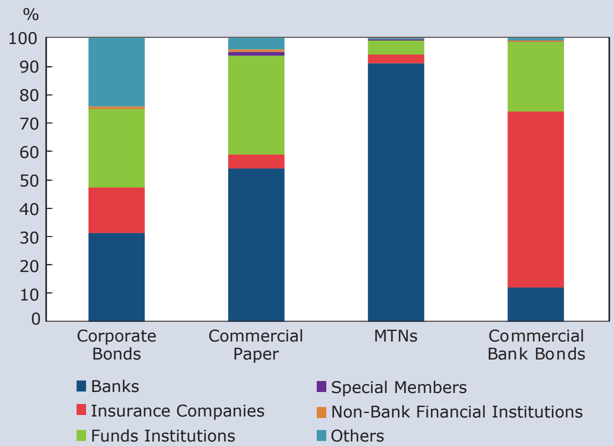
MTNs and policy bank bonds at end-December 2012 with more than 80% of MTNs and policy bank bonds outstanding. Meanwhile, insurance companies were the largest holders of commercial bank bonds.

Liquidity

Figure 6 presents the turnover ratio for government bonds, including both spot trading and repo trading volumes. The volume of repo trading is larger than that of spot trading in the PRC bond market, and the repo market is also the more active of the two. In 2Q13, spot turnover ratios for treasury, central bank, and policy bank bonds all fell due to concerns over potential US monetary policy tightening and local liquidity conditions. Tight liquidity conditions in 2Q13 also prompted a rise in the repo turnover ratio.

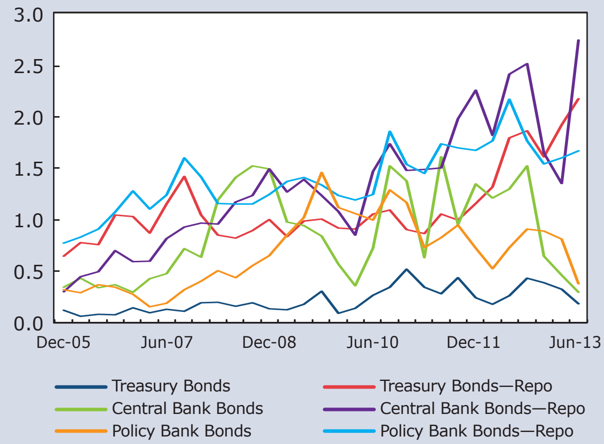
Bid–ask spreads rose in June, reflecting tight liquidity conditions domestically and negative sentiment created by the possibility of US monetary policy tightening **(Figure 7)**. Bid–ask

Figure 5: Investor Profile across Bond Categories



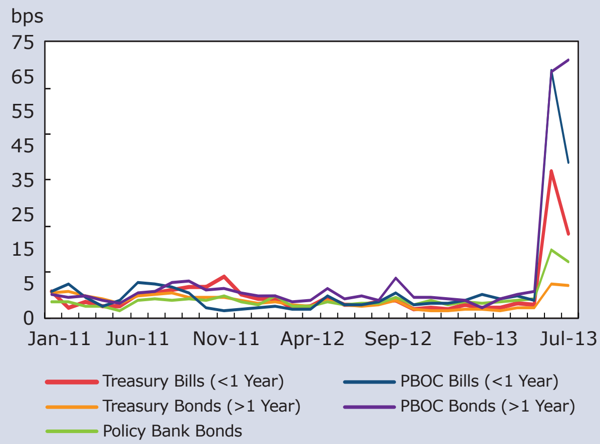
bps = basis points, MTNs = medium-term notes.
Note: Data as of end-June 2013.
Source: *ChinaBond*.

Figure 6: Turnover Ratios for Government Bonds



Repo = repurchase.
Source: *ChinaBond*.

Figure 7: Bid–Ask Spreads among Market Makers



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

spreads for treasury bills and PBOC bills rose the most, owing to their short-term nature. The SHIBOR shock in June led to higher interest rates at the shorter-end of the yield curve, prompting market participants to become bearish on shorter-dated securities.

Interest Rate Swaps

In 2Q13, the total notional amount of signed interest rate swap (IRS) agreements in the PRC reached CNY795.8 billion on 7,005 transactions **(Table 6)**. The most popular benchmark was the 7-day repo, which accounted for 66% of all transactions.

Rating Changes

On 9 April, Fitch Ratings (Fitch) affirmed the PRC's FCY rating of A+ with a stable outlook. However, Fitch downgraded the LCY rating to A+ from AA–. Fitch said that its affirmation of the country's FCY ratings reflects the central government's strong FCY balance sheet that includes significant foreign reserves. However, the LCY rating was affected by a worsening outlook for the PRC's financial stability due to rapid credit growth in bank balance sheets and local government liabilities. Also, the country's revenues are more volatile than its peers.

Moody's Investors Service (Moody's) downgraded the PRC's FCY rating outlook to stable from positive, but affirmed the rating at AA– on 16 April. Moody's rationale for the downgrade in outlook was similar to that of Fitch for the rating downgrade, including concerns over the level of credit growth and risks associated with the liabilities of local government units.

Table 6: Notional Values of the PRC's Interest Rate Swap Market in 2Q13

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	% of Total Notional Amount	Number of Transactions	Growth Rate (%)	
	2Q13			q-o-q	y-o-y
7-Day Repo Rate	532.8	66.9	5,524	29.9	53.3
Overnight SHIBOR	179.1	22.5	440	(21.7)	(23.3)
3-Month SHIBOR	73.8	9.3	749	(17.3)	(2.3)
1-Year Term Deposit Rate	3.8	0.5	26	313.5	(82.0)
1-Year Lending Rate	5.3	0.7	259	(27.0)	122.1
3-Year Lending Rate	0.9	0.1	6	32.4	105.0
Above 5-Year Lending Rate	0.2	0.03	1	43.9	(68.3)
Total	**795.8**	**100.0**	**7,005**	**7.9**	**16.7**

( ) = negative, 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.
Sources: *AsianBondsOnline* and *ChinaMoney*.

Policy, Institutional, and Regulatory Developments

SAFE Issues New Requirements on Net Open Position

On 6 May, SAFE announced that local banks with FCY loan-to-deposit ratios exceeding 75% and foreign banks with FCY loan-to-deposit ratios exceeding 100% would be required to maintain a net open position on FCY holdings of at least zero.

SMEs Allowed to Issue Exchangeable Bonds

On 31 May, the Shenzhen Stock Exchange announced that it would allow SMEs to issue exchangeable bonds. Exchangeable bonds are bonds collateralized with the listed equity securities of other companies. The coupon rate for the bonds cannot be three times higher than the relevant benchmark rate and the tenor must be at least 1 year. The bond conversion price also cannot be less than 90% of the 20-day average trading price of the collateral.

CSRC Increases QFII Quota

On 12 July, the China Securities Regulatory Commission (CSRC) announced that it would increase the Qualified Foreign Institutional Investor (QFII) Program's quota to US$150 billion. It also expanded the Renminbi Qualified Foreign Institutional Investor (RQFII) Program. (For more detail, see the Hong Kong, China Market Summary.)

PBOC Removes Lending Rate Floor

On 20 July, the PBOC announced that it would remove the floor on lending rates. Previously, banks could not set lending rates lower than 30% of the benchmark rate. The PBOC also removed the limits on interest rates for bill discounting. However, the PBOC did not remove the floor on mortgage interest rates. The PBOC said that the moves were part of the PRC's policy of moving toward a market-based interest rate regime.

The PRC to Audit Local Government Debt

On 26 July, the PRC ordered a nationwide audit of local government debt. The National Audit Office said the last audit found that local governments had a total of CNY10.7 trillion in outstanding debt at the end of 2010.