Market Summaries

People's Republic of China

Yield Movements

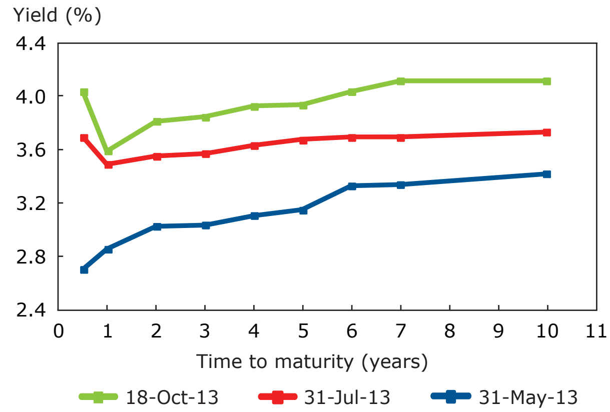
The government bond yield curve for the People's Republic of China (PRC) dramatically shifted upward between end-May and end-July **(Figure 1)**. At the shorter-end of the curve, yields rose between 63 basis points (bps) and 111 bps for tenors of 1 year or less. Yields rose between 31 bps and 53 bps for tenors longer than 1 year.

The steep rise in yields between end-May and end-July was the result of the SHIBOR shock event in June. The overnight SHIBOR rate was 4.6% and the 7-day interbank repurchase (repo) rate was 4.8% at the beginning of June. By 8 June, liquidity demands had driven the SHIBOR rate up to 7.5% and the 7-day repo rate to 7.8%. The People's Bank of China's (PBOC) issuance of bills in June for the first time since 2011 exacerbated the situation, further reducing liquidity in the market.

Yields between end-July and 18 October also rose, particularly for the 6-month tenor, which rose 34 bps. Yields rose between 26 bps and 42 bps for tenors longer than 1 year. Yields have risen due to both economic and regulatory factors. In May, the government launched a crackdown on illegal bond trading activities, causing a reduction in trading volumes. Policy measures were taken including the removal of the interbank trading accounts of non-financial companies. Trading volumes have also declined due to uncertainty over the United States (US) Federal Reserve's monetary policy as well as concern over the recent confrontation in the US Congress over renewing approval of the federal government's borrowing authority.

At the same time, yields have risen, particularly at the shorter-end of the curve, on concerns that the PBOC might tighten the money supply. On 17 October, the PBOC suspended reverse repo operations, reducing overall liquidity in the system. The market is concerned that the central bank may tighten in response to rising inflation and amid a gross domestic product (GDP) growth outlook that remains stable. As a result, at the start of October the 1-week SHIBOR stood at 4.4%, but by 28 October had risen to 4.9%. The 1-week interbank repo rate rose from 4.4% to 5.6% in the same period. In order to calm the market, the PBOC resumed reverse repo operations in the last week of October.

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



LCY = local currency.
Source: Bloomberg LP.

GDP grew 7.8% year-on-year (y-o-y) in 3Q13 following 7.5% growth in 2Q13. The year-to-date GDP growth rate stood at 7.7% at end-September, exceeding the government's target of 7.5%. Domestic demand is driving growth as the government seeks to rebalance the country's economy amid concern over the external environment. Demand from developed nations remains weak, with exports from the PRC falling 0.3% y-o-y in September from 7.1% in August.

Consumer price inflation rose to 3.1% y-o-y in September from 2.6% in August. The increase in prices for September was mostly due to rising food prices.

Size and Composition

The amount of outstanding local currency (LCY) bonds in the PRC market reached CNY26.4 trillion (US$4.3 trillion) at end-September, an increase of 3.0% quarter-on-quarter (q-o-q) and 14.4% y-o-y, largely driven by growth in policy bank and corporate bonds **(Table 1)**.

Government Bonds. LCY government bonds outstanding grew 2.7% q-o-q and 5.8% y-o-y in 3Q13, largely driven by growth in policy bank bonds, which expanded 3.1% q-o-q and 13.8% y-o-y, and treasury bonds, which rose 5.4% q-o-q and 12.4% y-o-y. Central bank bonds fell 30.3% q-o-q and 64.7% y-o-y. The PBOC, due to the SHIBOR shock event in June, allowed a number of central bank bills and bonds to mature while issuing only 3-year bonds in 3Q13. At end-September, there were no central bank bills outstanding.

Corporate Bonds. Corporate bonds outstanding grew 3.9% q-o-q and 39.1% y-o-y in 3Q13 **(Table 2)**. Growth was driven mainly by increases of 5.6% q-o-q and 58.3% y-o-y in medium-term notes, and a 2.9% q-o-q and 47.4% y-o-y

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

	Outstanding Amount (billion)						**Growth Rates** (%)			
	3Q12		**2Q13**		**3Q13**		**3Q12**		**3Q13**	
	CNY	**US$**	**CNY**	**US$**	**CNY**	**US$**	**q-o-q**	**y-o-y**	**q-o-q**	**y-o-y**
Total	**23,046**	**3,667**	**25,584**	**4,168**	**26,364**	**4,307**	**4.6**	**11.2**	**3.0**	**14.4**
Government	17,119	2,724	17,644	2,875	18,117	2,960	4.4	8.4	2.7	5.8
Treasury Bonds	7,915	1,259	8,438	1,375	8,895	1,453	5.5	8.8	5.4	12.4
Central Bank Bonds	1,597	254	809	132	564	92	(2.9)	(24.5)	(30.3)	(64.7)
Policy Bank Bonds	7,606	1,210	8,397	1,368	8,658	1,415	4.9	18.9	3.1	13.8
Corporate	5,927	943	7,940	1,294	8,247	1,347	5.0	20.2	3.9	39.1
Policy Bank Bonds										
China Development Bank	5,142	818	5,525	900	5,678	928	4.5	15.4	2.8	10.4
Export–Import Bank of China	1,008	160	1,268	207	1,277	209	8.4	29.2	0.7	26.7
Agricultural Devt. Bank of China	1,457	232	1,604	261	1,703	278	4.1	25.4	6.2	16.9

( ) = 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 3Q13 was CNY1.5 trillion based on data from *Wind*.
Sources*:* Bloomberg LP, *ChinaBond,* and *Wind*.

Table 2: Corporate Bonds Outstanding in Key Sectors

	Outstanding Amount (CNY billion)				**Growth Rates** (%)				
					q-o-q				**y-o-y**
	4Q12	**1Q13**	**2Q13**	**3Q13**	**4Q12**	**1Q13**	**2Q13**	**3Q13**	**3Q13**
Commercial Bank Bonds	1,265	1,304	1,329	1,299	14.4	3.1	1.9	(2.2)	17.5
State-Owned Corporate Bonds	993	1,024	653	647	0.2	3.2	(36.3)	(0.9)	(34.7)
Local Corporate Bonds	1,305	1,484	1,580	1,626	18.3	13.7	6.4	2.9	47.4
Medium-Term Notes	2,492	2,662	3,509	3,705	6.5	6.8	31.8	5.6	58.3

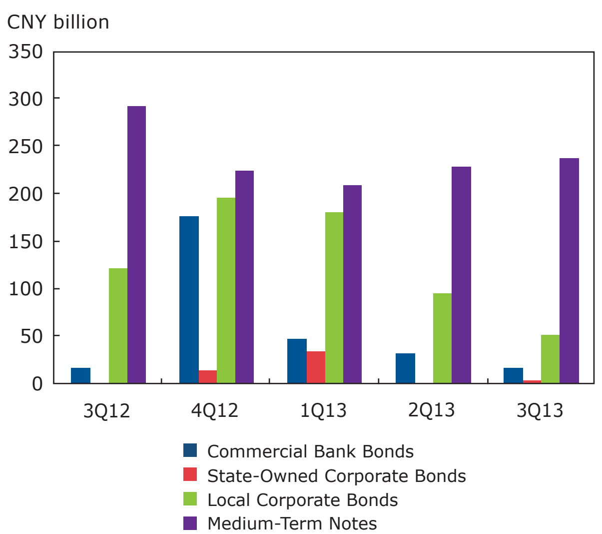
( ) = negative, – = not available, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Source: *ChinaBond.*

increase in local corporate bonds outstanding. Commercial bank bonds fell 2.2% q-o-q but grew 17.5% y-o-y, largely due a carryover effect from the issuance of subordinated notes in 2012 as the PRC's banks sought to bolster their capital bases ahead of the implementation of Basel III capital adequacy requirements. State-owned enterprise (SOE) bonds outstanding fell 0.9% q-o-q and 34.7% y-o-y in 3Q13.

The overall issuance of corporate bonds was lower in 3Q13 compared with 2Q13 **(Figure 2)**, with the exception of medium-term notes (MTNs) and SOE bonds. Commercial bank bonds have been on the decline; 4Q12 was the last time banks issued bonds ahead of the implementation of Basel III requirements.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. As of 3Q13, the top 30 corporate bond issuers accounted for CNY4 trillion worth of corporate bonds outstanding, or about 49% of the market. Among the top 30 corporate issuers, the 10 largest accounted for CNY2.6 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 3Q13. Among the top 30 corporate issuers at end-September, 23 were state-owned, with a total of CNY3.5 trillion worth of bonds outstanding.

Table 4 presents the most significant issuances of 3Q13.

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 3Q13 (77.3%) than at the end of 3Q12 (77.0%) **(Figure 3)**. The share held by special members fell to 9.7% from 10.8% 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 3Q13, albeit with a comparatively smaller share than their holdings of treasury bonds and policy bank bonds. Banks' share of corporate bonds fell to 30.7% at the end of 3Q13 from 38.5% a year earlier **(Figure 4)**. The second largest holder of corporate bonds was insurance companies, with a 15.8% share at end-September, down from their 24.9% share at end-September 2012.

Figure 5 presents the investor profile across different bond categories. Based on the latest data available, banks were the largest holders of MTNs at end-September with more than 50% of MTNs. 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

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	827.0	135.11	Yes	No	Transportation
2. China National Petroleum	340.0	55.55	Yes	No	Energy
3. State Grid Corporation of China	339.5	55.47	Yes	No	Public Utilities
4. Industrial and Commercial Bank of China	230.0	37.58	Yes	Yes	Banking
5. Bank of China	219.9	35.93	Yes	Yes	Banking
6. China Construction Bank	200.0	32.67	Yes	Yes	Banking
7. Agricultural Bank of China	150.0	24.51	Yes	Yes	Banking
8. China Petroleum & Chemical	134.7	22.01	Yes	Yes	Energy
9. Central Huijin Investment	109.0	17.81	Yes	No	Diversified Financial
10. Petrochina	107.5	17.56	Yes	Yes	Energy
11. China Guodian	107.1	17.50	Yes	No	Public Utilities
12. China Minsheng Bank	102.3	16.71	No	Yes	Banking
13. Shenhua Group	92.0	15.03	Yes	No	Energy
14. China Power Investment	87.9	14.36	Yes	No	Public Utilities
15. Bank of Communications	86.0	14.05	No	Yes	Banking
16. Shanghai Pudong Development Bank	79.2	12.94	No	Yes	Banking
17. China Three Gorges Project	77.5	12.66	Yes	No	Public Utilities
18. China Southern Power Grid	70.5	11.52	Yes	No	Public Utilities
19. Industrial Bank	68.0	11.11	No	Yes	Banking
20. China Life	68.0	11.11	Yes	Yes	Insurance
21. China Merchants Bank	61.7	10.08	No	Yes	Banking
22. State-Owned Capital Operation and Management Center of Beijing	58.5	9.56	Yes	No	Diversified Financial
23. China Huaneng Group	58.2	9.51	Yes	No	Public Utilities
24. Citic Group	53.5	8.74	Yes	No	Diversified Financial
25. Huaneng Power International	53.0	8.66	Yes	Yes	Public Utilities
26. China Everbright Bank	52.7	8.61	No	Yes	Banking
27. Tianjin Infrastructure Investment Group	47.8	7.81	Yes	No	Capital Goods
28. China Datang	45.7	7.47	Yes	No	Public Utilities
29. Bank of Beijing	43.5	7.11	No	Yes	Banking
30. Aluminum Corporation of China Limited	43.0	7.03	Yes	Yes	Raw Materials
Total Top 30 LCY Corporate Issuers	**4,013.74**	**655.74**			
Total LCY Corporate Bonds	**8,246.74**	**1,347.31**			
Top 30 as % of Total LCY Corporate Bonds	**49%**	**49%**			

LCY = local currency.
Notes:
1. Data as of end-September 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 3Q13

Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
China Railway Construction		
7-year bond	5.06	20
7-year bond	5.2	15
10-year bond	4.97	10
10-year bond	5.1	10
20-year bond	5.35	10
China State Grid		
3-year bond	4.68	10
Bank of Communications		
5-year bond	4.37	10
Wuhan Iron and Steel Group		
3-year bond	4.99	7
Shenyin & Wanguo Securities		
6-year bond	5.2	6
Shanghai Shengtong Metro Group		
5-year bond	5.35	6

LCY = local currency.
Source: *Wind*.

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 3Q13, spot turnover ratios for treasury, central bank, and policy bank bonds all fell dramatically due to a government crackdown on illegal bond trading.

Interest Rate Swaps

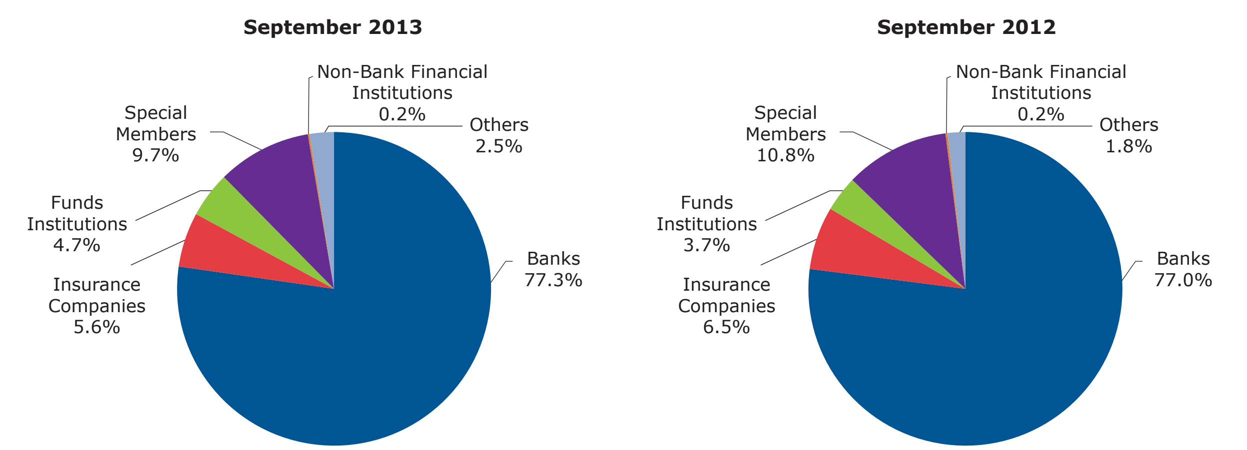
In 3Q13, the total notional amount of signed interest rate swap (IRS) agreements in the PRC reached CNY569.8 billion on 5,634 transactions **(Table 5)**. The most popular benchmark is the 7-day repo, which accounts for 70.9% of all transactions.

Policy, Institutional, and Regulatory Developments

The PRC Tightens Rules on Interbank Bond Trading

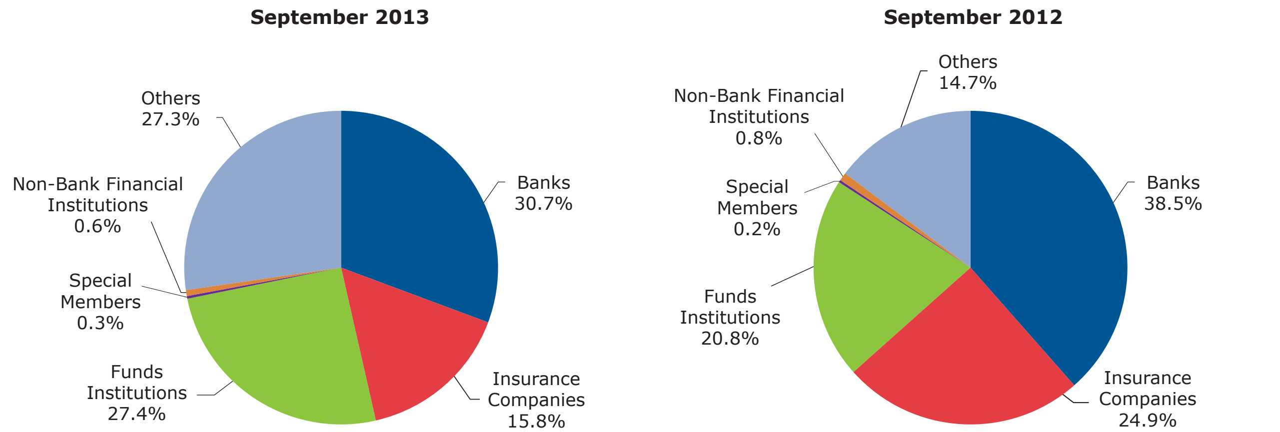
On 9 May, the PRC suspended trading of bond accounts by non-financial institutions on the interbank bond market. On 9 July, the PBOC issued rules requiring interbank bond market participants to conduct all trades through the National Interbank Funding Center. The move is part of the government's crackdown on illegal bond trading activities. Among the activities that the government is targeting are the use of third parties by financial managers to move bonds off their balance sheets to manipulate profits and trading volumes, and the use of client funds to skim profits for personal gain.

Figure 3: LCY Treasury Bonds Investor Profile



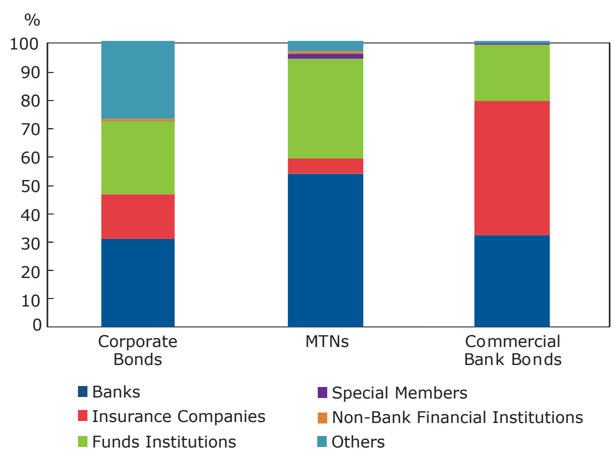
LCY = local currency.
Source: *ChinaBond*.

Figure 4: LCY Corporate Bonds Investor Profile



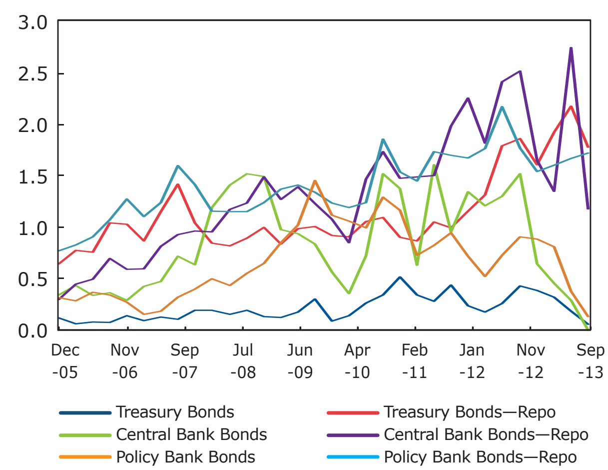
LCY = local currency.
Source: *ChinaBond*.

Figure 5: Investor Profile across Bond Categories



MTNs = medium-term notes.
Note: Data as of end-September 2013.
Source: *ChinaBond*.

Figure 6: Turnover Ratios for Government Bonds



Repo = repurchase.
Source: *ChinaBond*.

SME Pilot Bond Program to be Expanded

On 26 August, the China Securities Regulatory Commission said it will expand the number of participating companies in the private placement bond program for small and medium-sized enterprises (SMEs). The list will be expanded to include more companies that are listed on the Third Board.

SAFE Expands QDII Program

On 28 August, the State Administration of Foreign Exchange (SAFE) said that it will relax the requirements of the Qualified Domestic Institutional Investor (QDII) program, making it easier to make foreign investments. Among the changes to be implemented include relaxation on the types of foreign currency to be used, simplified foreign exchange quota applications, and foreign exchange settlement.

Table 5: Notional Values of the PRC's Interest Rate Swap Market in 3Q13

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	% of Total Notional Amount	Number of Transactions	Growth Rate (%)	
	3Q13			q-o-q	y-o-y
7-Day Repo Rate	403.9	70.9	4,518	(24.2)	(4.7)
Overnight SHIBOR	79.0	13.9	156	(55.9)	(68.8)
3-Month SHIBOR	80.1	14.1	833	8.5	1.8
1-Year Term Deposit Rate	4.1	0.7	36	7.9	(84.8)
1-Year Lending Rate	1.7	0.3	82	(68.0)	(87.3)
3-Year Lending Rate	1.0	0.2	9	(8.3)	(70.0)
Total	**569.8**	**100.0**	**5,634**	**(28.4)**	**(28.9)**

( ) = 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*.

The PRC Launches Treasury Bond Futures Trading

On 6 September, the trading of treasury bond futures, previously banned in 1995, resumed. The bond futures contract will be based on a hypothetical 5-year bond but actual bonds with tenors of between 4 years and 7 years will be allowed as the deliverable asset.

PBOC Preparing for Self-Regulatory Pricing Mechanism

On 24 September, the PBOC conducted its first meeting on the Self-Regulatory Pricing Mechanism. The meeting identified tasks to be performed in order to allow a more market-based setting of interest rates. The tasks include setting up a self-regulatory pricing mechanism that will allow coordination among participating financial institutions in setting interest rates. A quotation system for providing lending rate quotes will also be established, expanding the quotation of interest rates from the money market to the include the credit market as well. Finally, the development of tradable certificates of deposit will be promoted. The meeting is widely regarded as the first step toward the PRC government's liberalization of interest rates.

Shanghai Free Trade Zone Launched

On 29 September, the Shanghai Free Trade Zone was officially opened. At the time of the opening, 10 banks had already received approval to operate in the free trade zone. Companies' activities are subject to a "negative list" that details restrictions. Companies are free to conduct their activities so long as the acts are not specifically banned by the list, which includes restrictions on investments in telecommunications and broadcasting. Investments in news portals and online gaming are also banned. Also, foreign auto companies are still limited to a 50% stake in a joint venture and there will be restrictions on investments in financial institutions.

The free trade zone is expected to allow financial institutions to set their own borrowing and lending interest rates, and the freer conversion of the renminbi is also expected.

New Prime Lending Rate Launched

On 25 October, the PRC launched a benchmark lending rate to guide banks in setting lending rates to their prime customers. The benchmark is another step in the liberalization of the PRC's interest rates since it removed the limits on lending rates on 20 July. The new rate has a 1-year tenor and is set by nine commercial banks: Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China, Bank of Communications, Citic Bank, Shanghai Pudong Development Bank, China Merchants Bank, and Industrial Bank.