Hong Kong, China—Update

Yield Movements

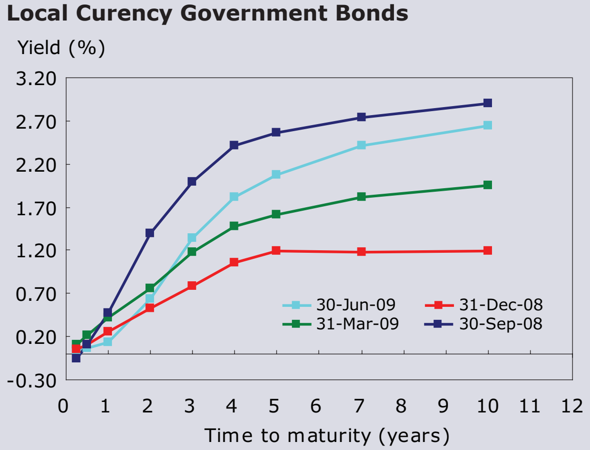
The Hong Kong, China yield curve steepened considerably in 2Q09 from the previous quarter, as yields declined at the short-end and rose from the 3-year tenor through the rest of the curve **(Figure 1)**.

At the end of June, yields on 3-month, 6-month, 1-year, and 2-year Exchange Fund bills and notes (EFBNs) fell from their end-March levels, with the yield on 1-year Exchange Fund bills declining the most at 29 basis points. In contrast, yields on the 3- to 10-year tenors rose progressively with their maturities.

Yields on 3-year notes rose 16 basis points, those on 5-year notes increased 45 basis points, and yields on 10-year notes increased 69 basis points. The steepened curve is reflected by the spread between 2- and 10-year Exchange Fund paper, which stood at 200 basis points as of end-June compared to 119 basis points as of end-March.

The tightening of the EFBN yield curve at the short-end, and its widening along the rest of the curve, is attributable mainly to banks' strong demand for short-term liquidity. Exchange Fund bills are key instruments in bank liquidity management, since they can be used as collateral when borrowing from the Hong Kong Monetary Authority (HKMA) through repurchase agreements.

Figure 1: Benchmark Yield Curve—Local Curency Government Bonds



Source: Bloomberg LP.

Size and Composition

As of end-June 2009, the amount of EFBNs outstanding reached HKD288.42 billion, almost double the EFBN stock in June 2008. The rise in the outstanding amount of EFBNs is due to continued issuance of Exchange Fund bills by HKMA to meet strong bank demand. Banks in Hong Kong, China are currently awash with cash, as indicated by their burgeoning reserve accounts with HKMA. The high level of liquidity in Hong Kong, China's financial system is due mainly to large capital inflows in 2Q09.

In the wake of the Lehman Brothers bankruptcy in September of last year, demand for Exchange Fund instruments shot up, as concerns about counterparty risk led banks to invest surplus funds in Exchange Fund instruments, which are considered to be a safe haven, rather than engage in inter-bank lending. HKMA addressed the need for its paper by increasing issuance.

Demand for short-dated Exchange Fund paper continued to rise through June of this year, although it has been driven not by concerns about counterparty risk, but instead by banks' need for instruments to manage intra-day liquidity. As shown in **Table 1**, the increase in the aggregate amount of government bonds outstanding as of June is attributable to the growth in issuance of Exchange Fund bills. In June, the outstanding amount of Exchange Fund bills totaled HKD219.82 billion—up 178.3% year-on-year (y-o-y) and 45.6% quarter-on-quarter (q-o-q). By contrast, the stock of Exchange Fund notes in June grew only 1.0% on q-o-q and month-on-month (m-o-m) basis, and increased by only 5.1% y-o-y.

Table 1: Size and Composition of Local Currency Bond Market

	Amount (billion)								**Growth Rate** (%)						
	Mar-09		**Apr-09**		**May-09**		**Jun-09**		**Mar-09**		**Apr-09**	**May-09**	**Jun-09**		
	HKD	**USD**	**HKD**	**USD**	**HKD**	**USD**	**HKD**	**USD**	**y-o-y**	**q-o-q**	**m-o-m**	**m-o-m**	**y-o-y**	**q-o-q**	**m-o-m**
Total Government	218.90	28.24	226.57	29.23	247.77	31.96	288.42	37.22	52.8	38.8	3.5	9.4	99.9	31.8	16.4
Government															
Exchange Fund Notes	67.9	8.76	67.90	8.76	67.90	8.76	68.60	8.85	4.9	1.5	0.0	0.0	5.1	1.0	1.0
Exchange Fund Bills	151.00	19.48	158.67	20.47	179.87	23.20	219.82	28.36	92.2	66.4	5.1	13.4	178.3	45.6	22.2
Corporate	566.92	73.15	—	—	—	—	574.06	74.07	(2.8)	1.4	—	—	(0.7)	1.3	—

— = data not available, y-o-y = year-on-year, q-o-q =quarter-on-quarter, m-o-m = month-on-month.

Note:
1. Calculated using data from national sources.
2. Bloomberg end-of-period LCY–USD rate is used.
3. Growth rates are calculated from LCY base and do not include currency effects.

Source: Hong Kong Monetary Authority and Bloomberg LP.

The corporate sector of the bond market was relatively subdued in the first half. The amount of corporate bonds outstanding grew 1.3% q-o-q and declined by a slight 0.7% y-o-y. New issuance of corporate bonds in 2Q09—despite being the most since 2Q07—appears to have simply offset prepayments and maturities, resulting in the flat growth of corporate debt stock.

According to data from the Central Money Markets Unit, HKMA's clearing group, the largest issuers of tradable, non-bank, HKD-denominated debt securities are involved in mortgage financing, railways, electric power, and property **(Table 2)**. Six companies (or their financing arms) account for the bulk of the outstanding amount of these securities: the Hong Kong Mortgage Corporation (HKMC), a public entity; CLP Power, which is the Special Administrative Region's largest electric power utility; the MTR Corporation, operator

Table 2: Top 10 Non-Bank Corporate Issuers
(USD billion)

Issuer	Amount Outstanding
1. The Hong Kong Mortgage Corporation	4.06
2. CLP Power Hong Kong Financing	1.06
3. Sun Hung Kai Properties	0.97
4. MTR Corporation	0.88
5. Kowloon-Canton Railway Corporation	0.72
6. Swire Pacific MTN Financing	0.61
7. Bauhinia MBS	0.49
8. Airport Authority Hong Kong	0.48
9. Cheung Kong Bond Finance	0.38
10. HongKong Electric Finance	0.35
Total	**11.37**
Subtotal: Top 10 non-bank, tradable debt securitities	**10.01**
Total 10 non-bank, tradable debt securitities[1]	**0.88**
Total corporate sector bonds[2]	**74.07**
Top 10 Issuers as % of corporate bond market	**13.5%**

Note:
[1]Based on Central Money Markets Unit (CMU) data on non-bank debt securities issued and still outstanding as of 13 August 2009.
[2]See Table 1.

Source:
Central Money Markets Unit.

of Hong Kong, China's subway system; the Kowloon–Canton Railway Corporation; Sung Hung Kai Properties; and the Swire Pacific group. In addition to the HKMC, another public entity, Airport Authority Hong Kong, is also a significant issuer.

Turnover

EFBN trading volume (or turnover) in the first half of the year totaled HKD13.319 trillion, which is more than double the HKD6.4 trillion posted in the first half of 2008. From HKD1.27 trillion in January, trading volume climbed to HKD2.48 trillion in March, remained at similar levels through May, and rose sharply to HKD3.015 trillion in June.

Trading activity, as measured by the government bond turnover ratio, peaked at 11.97 in March before falling off to 10.60 in May, and again rising to 11.25 in June. These double digit ratios highlight the increased activity of government bond trading in the first half of the year compared to the latter half of 2008, when turnover ratios ranged between 6.23 and 8.11.

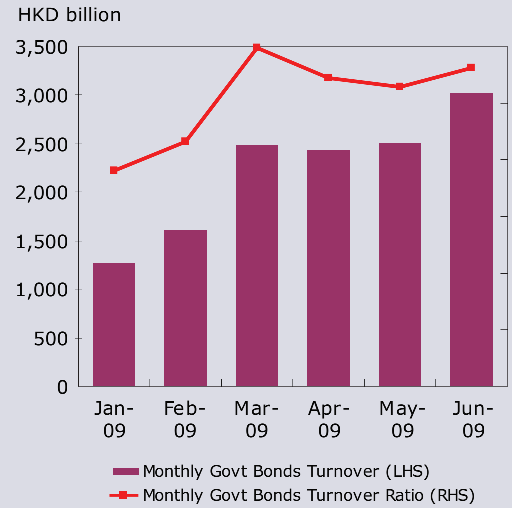
After reaching a trough of HKD3.93 billion in March, corporate trading volume soared in June to its highest level of the year on the back of strong corporate issuance and the recovery of investor appetite for corporate paper. Trading volume in June amounted to HKD12.83 billion, which is more than three times the March figure and almost twice the January trading volume of HKD6.84 billion.

Policy, Institutional, and Regulatory Developments

Cross-Border Payment Arrangements between the People's Republic of China (PRC) and Hong Kong, China

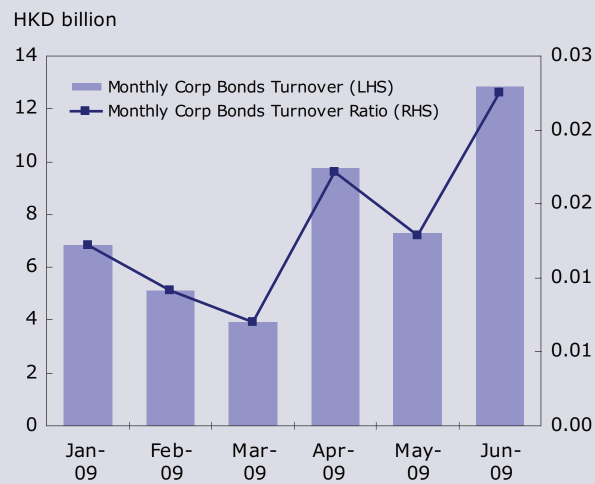
In February 2009, the People's Bank of China (PBOC) and HKMA signed a memorandum of understanding on the establishment of multi-currency, cross-border payment arrangements. The currencies covered by the agreement include the US dollar, Hong Kong dollar, euro, and British pound (see below for developments on yuan settlements).

Figure 2: Government Bond Trading Volume and Turnover Ratio



Source: Hong Kong Monetary Authority.

Figure 3: Corporate Bond Trading Volume and Turnover Ratio



Source: Hong Kong Monetary Authority and *AsianBondsOnline* estimates.

The agreement aims to meet increased demand for cross-border payment services as Hong Kong, China and the People's Republic of China (PRC) develop increasingly close economic and financial links. These services are being offered with a view towards encouraging greater competition among banks as the main providers of payment services, thereby enhancing service quality and resulting in better settlement terms for both banks and their customers.

Furthermore, it is hoped that this agreement will spur the use of cross-border payments services and help expand access to a broader range of market participants. Cross-border services were introduced on 16 March.

Yuan Trade Settlement

The PRC and Hong Kong, China signed an agreement on 29 June to permit the yuan to be used in settling cross-border trade transactions. Prior to the deal, banks based in Hong Kong, China had been permitted—on a limited basis—to take yuan deposits and provide other yuan-denominated services. They were, however, not allowed to engage in cross-border yuan trade settlement transactions.

On 2 July, PBOC began allowing certain companies in Shanghai and four cities in Guangdong province to settle trade transactions with firms in Hong Kong, China; Macau, China; and the 10 member countries of the Association of Southeast Asian Nations (ASEAN). The first yuan settlement transaction occurred on 6 July.

Hong Kong, China's Lawmakers Approve HKD100 Billion Bond Sale

Hong Kong, China's legislative council on 8 July approved a new HKD100 billion debt issue program that aims to provide additional depth to the Hong Kong, China bond market through the issuance of sovereign paper. Bonds issued under the program are expected to offer another benchmark for the pricing of corporate debt, thereby increasing investor confidence and interest in these instruments.

Estimates of the size of new government issuance range from HKD10 billion–HKD20 billion a year. Four bond offerings—with maturities of 2, 10, and 15 years—are planned to be sold annually.

The bonds to be sold under the program will constitute unsecured liabilities of the government of Hong Kong, China and will not be backed by foreign reserves—in contrast to EFBNs. As the new bonds will not have foreign reserve backing, they are expected to pay a premium over EFBNs.