

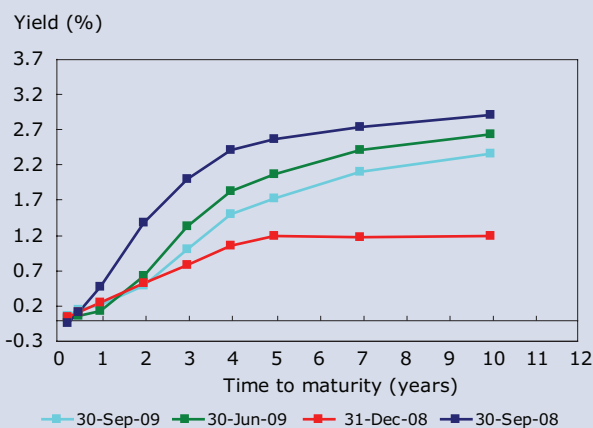
Hong Kong, China—Update

Yield Movements

The yield curve for Hong Kong, China's Exchange Fund Bills and Notes (EFBNs) flattened at the end of September from the 2-year tenor through the rest of the curve compared to yield levels at the end of June (**Figure 1**). Yields at the shorter end of the curve, however, increased slightly from their end-June levels, with yields on 3-month, 6-month, and 1-year paper rising by 3, 9, and 9 basis points, respectively.

Yields on 2-year notes declined 14 basis points between end-June and end-September, while the decline on yields for maturities of 3 years and longer ranged between 29 basis points (10-year notes) and 34 basis points (5-year notes). The flatter yield curve is reflected by the spread between 2- and 10-year EFBNs, which stood at 187 basis points as of end-September compared to 201 basis points as of end-June.

Figure 1: Hong Kong, China's EFBN Yield Curve



EFBN=Exchange Fund Bills and Notes.

Source: Bloomberg, LP.

Size and Composition

As of end-September, the outstanding amount of government bonds, comprising EFBNs and bonds issued under Hong Kong's newly-introduced Institutional Issuance Program, reached HKD416.54 billion, which represented a 187.3% year-on-year (y-o-y) increase (**Table 1**). The rise in government bonds outstanding is due largely to issuance of Exchange Fund bills by the Hong Kong Monetary Authority (HKMA) to meet strong bank demand.

The demand for Exchange Fund bills soared in the wake of the Lehman Brothers bankruptcy in September 2008 as concerns about counterparty risk led banks to invest surplus funds in these instruments, which were viewed as a safe haven, instead of lending in the interbank market. HKMA responded by increasing issuance of its paper. With banks' HKMA reserve accounts increasing as a result of the substantial capital inflows into Hong Kong, China since 2Q09, bank demand for short-dated EFBNs has remained high. Exchange Fund bills are key instruments in bank liquidity management since they can be used as collateral by banks when borrowing from HKMA through repurchase agreements.

In September, the amount of Exchange Fund bills outstanding totaled HKD343.44 billion—up 333.2% y-o-y and 56.2% quarter-on-quarter (q-o-q). By contrast, the stock of Exchange Fund notes at end-September grew more modestly—5.9% and 1.5% on a y-o-y and q-o-q basis, respectively. In September, HKMA announced that it would further expand issuance of Exchange Fund bills in October by a total of HKD23.1 billion.

In September, Hong Kong, China issued a total of HKD3.5 billion in 2-year bonds in the first sale of government paper in 5 years. The sale was also the first under the Special Administrative Region's Institutional Issuance Program (the program is

Table 1: Size and Composition of the Local Currency Bond Market in Hong Kong, China

	Amount (billion)						Growth Rate (%)									
	Jun-09		Jul-09		Aug-09		Sep-09		Jun-09		Jul-09		Aug-09		Sep-09	
	HKD	USD	HKD	USD	HKD	USD	HKD	USD	Y-o-Y	Q-o-Q	M-o-M	Y-o-Y	Q-o-Q	M-o-M	Y-o-Y	Q-o-Q
Total	862.48	111.29	926.04	119.49	968.67	124.98	128.52	996.01	128.52	19.4	9.8	7.4	4.6	39.0	15.5	2.8
Government	288.42	37.22	350.18	45.18	391.01	50.45	53.75	416.54	53.75	99.9	31.8	21.4	11.7	187.3	44.4	6.5
Exchange Fund Notes	68.6	8.85	68.60	8.85	69.20	8.93	8.98	69.60	8.98	5.1	1.0	0.0	0.9	5.9	1.5	0.6
Exchange Fund Bills	219.82	28.36	281.58	36.33	321.81	41.52	44.31	343.44	44.31	178.2	45.6	28.1	14.3	333.2	56.2	6.7
HKSAR Bonds	—	—	—	—	—	—	3.50	0.45	—	—	—	—	—	—	—	—
Corporate	574.06	74.07	575.86	74.30	577.66	74.53	74.77	579.47	74.77	-0.7	1.3	0.3	0.3	1.4	0.9	0.3

— = data not applicable, Y-o-Y = year-on-year, Q-o-Q = quarter-on-quarter, M-o-M = month-on-month, HKSAR = Hong Kong Special Administrative Region.

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.
4. The amount of corporate bonds outstanding for July-09 and Aug-09 were estimated based on the compounded monthly growth rate between Jun-08 and Sep-09.

Source: Hong Kong Monetary Authority (HKMA), and Bloomberg LP.

discussed further under the Policy, Institutional, and Regulatory Developments heading below).

The amount of outstanding corporate paper in 3Q09 stood at HKD579.47 billion, up 1.4% y-o-y and 0.9% q-o-q.

Policy, Institutional, and Regulatory Developments

Institutional Issuance Program Bonds

In July, Hong Kong, China's Legislative Council approved the Special Administrative Region's Institutional Issuance Program. The program calls for issuance of government debt totaling HKD100 billion over the next few years, with a view towards developing the domestic bond market and providing a benchmark for the pricing of corporate debt.

Bonds issued under the program are liabilities of the Government of the Hong Kong Special Administrative Region and are distinct from EFBNs, which are backed by foreign reserves under Hong Kong, China's currency board system.

Following the initial sale in September of HKD3.5 billion of bonds under the program, another HKD2 billion of 5-year bonds were issued in November.

Yuan Trade Settlement

The People's Republic of China (PRC) and Hong Kong, China signed an agreement in June establishing a pilot scheme to permit the yuan to be used for settling cross-border trade transactions. Prior to the deal, banks based in Hong Kong, China could take yuan deposits and provide other yuan-denominated services on a limited basis, but were not allowed to engage in cross-border yuan trade settlement.

In July, the People's Bank of China (PBOC) began to allow 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 transactions occurred on 6 July.

By September, the PRC units of HSBC, Standard Chartered Bank, and the Bank of East Asia, as well as 10 domestic PRC banks, had qualified to conduct cross-border trade settlement in yuan. Forty-three banks in Hong Kong, China participate in the yuan settlement clearing system and can course transactions either through correspondent banks in the PRC mainland or through clearing banks in Hong Kong, China. (At the time of writing, only the Hong Kong, China unit of the Bank of China serves as a clearing bank for yuan settlements in the Special Administrative Region).

Issuance of PRC Treasury Bonds in Hong Kong, China

The PRC's Ministry of Finance reported on 20 October that its CNY6 billion Treasury bond offering in Hong Kong, China attracted subscriptions totaling CNY18 billion—three times the offered amount. The sale, which capitalizes on Hong Kong, China's role as an international financial center, is seen as part of the PRC's efforts to broaden the use of the yuan internationally and to help further develop the Hong Kong, China bond market.