

**IMF Office for Asia and the Pacific
Tokyo
Alfred Schipke and ZHANG Longmei
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The Future of China's Bond Market

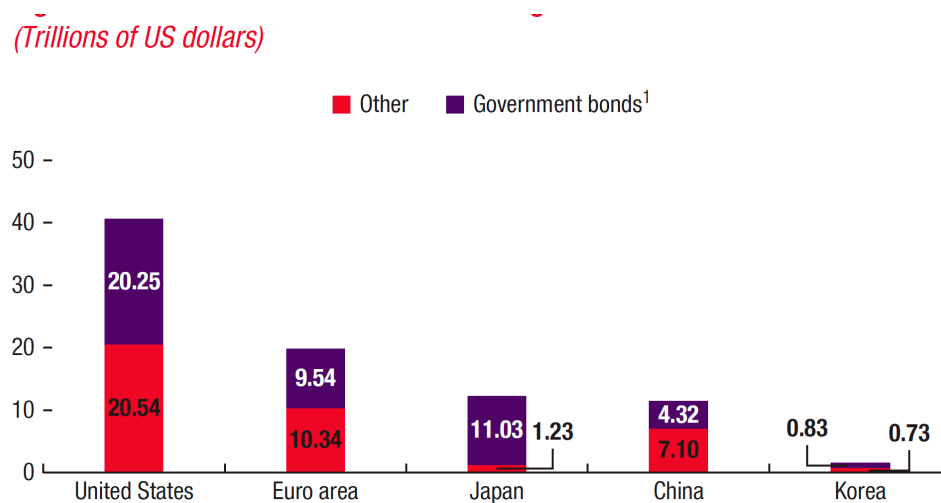
Roadmap

- Setting the stage
- Bond market characteristics, government bond, and LGFV
- Credit market, latest developments, and reforms
- Takeaways

Setting the stage

Capital market development and opening up

- In the past, high economic growth, trade and product integration...
- ..mirrored by rapid financial sector development
 - Largest banks
 - Second largest equity market
 - Bond market already third largest
- *Yet...*



Sources: Bank of Japan; Financial Supervisory Service, Korea; European Central Bank; People's Bank of China; and Securities Industry and Financial Markets Association.

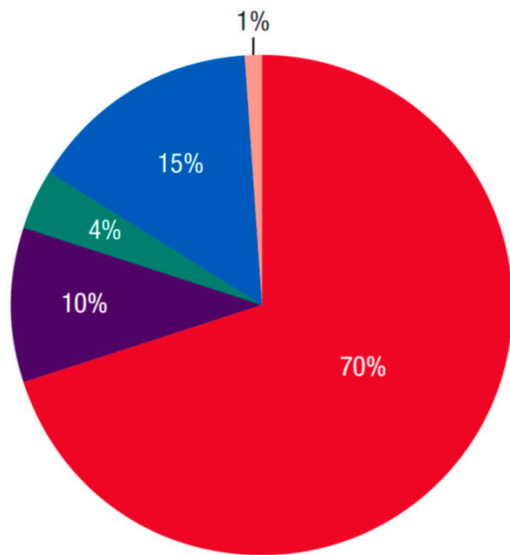
Note:

¹ Government bonds cover bonds issued by the general government (central, state, and local government accounts; social security funds; and nonmarket, nonprofit institutions controlled and mainly financed by government units).

...financial system bank-centric and little integrated globally

Corporate Financing (share of total)

■ Loan ■ Bond ■ Equity ■ Shadow banking ■ Other

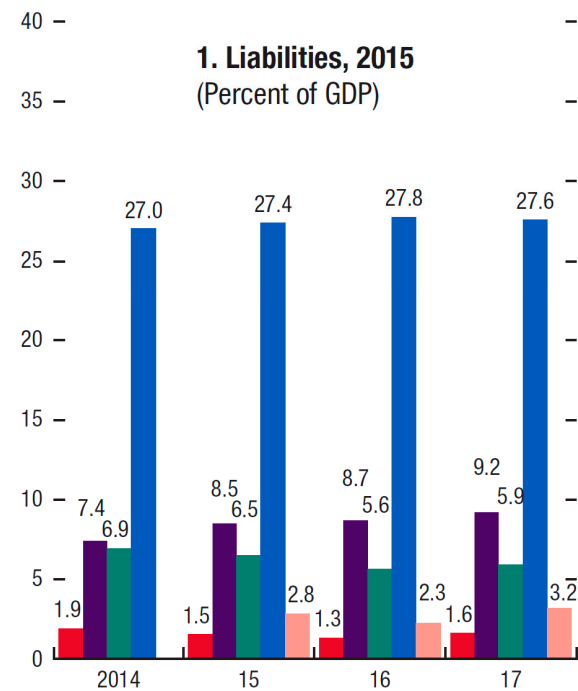


Source: People's Bank of China 2017.

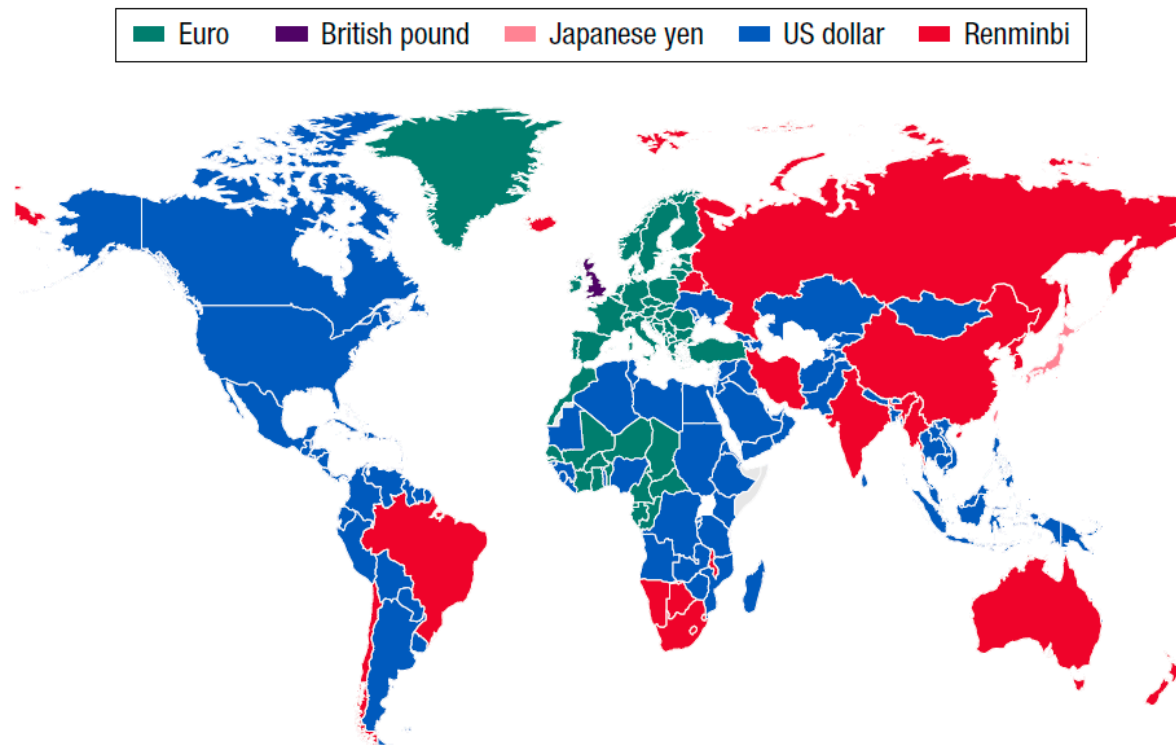
■ China ■ Japan ■ Korea ■ United States ■ India

2. Bond Market²

(Holdings as a percentage of total value of bonds outstanding)



...but exchange rate co-movement suggests move toward a tri-polar mon. system



Source: Tovar and Nor 2018.

Bond market developments going forward

- Financial sector opening up (President Xi, April 2018)
- Further bond market development and opening (Premier Li March 2018/19)
- Bond market inclusion in global indices
 - Bloomberg Barclays Global Aggregate Index in April 2019
- Next decade China's financial sector integration

Macro-financial and global context

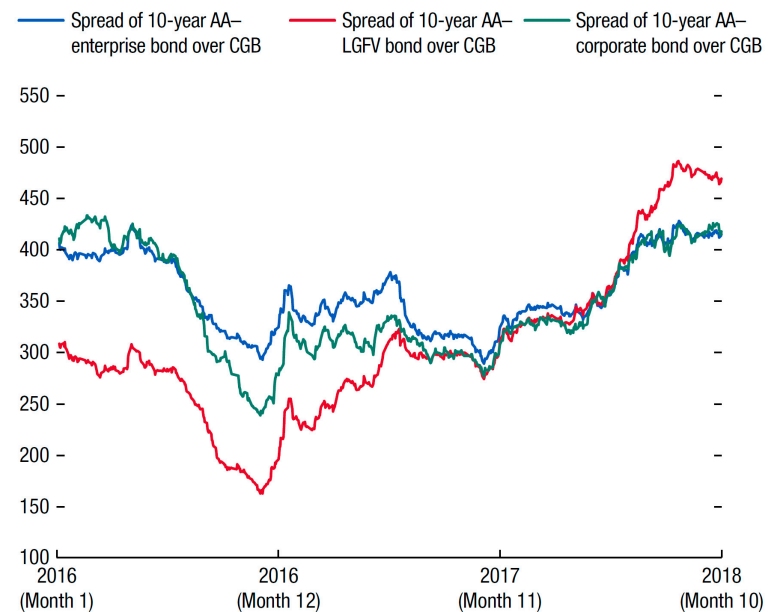
Domestic:

- Multi-year deleveraging campaign
- Bond default increase
- Credit spread widening
- Recent calibration of policies

External:

- Global financial cycle

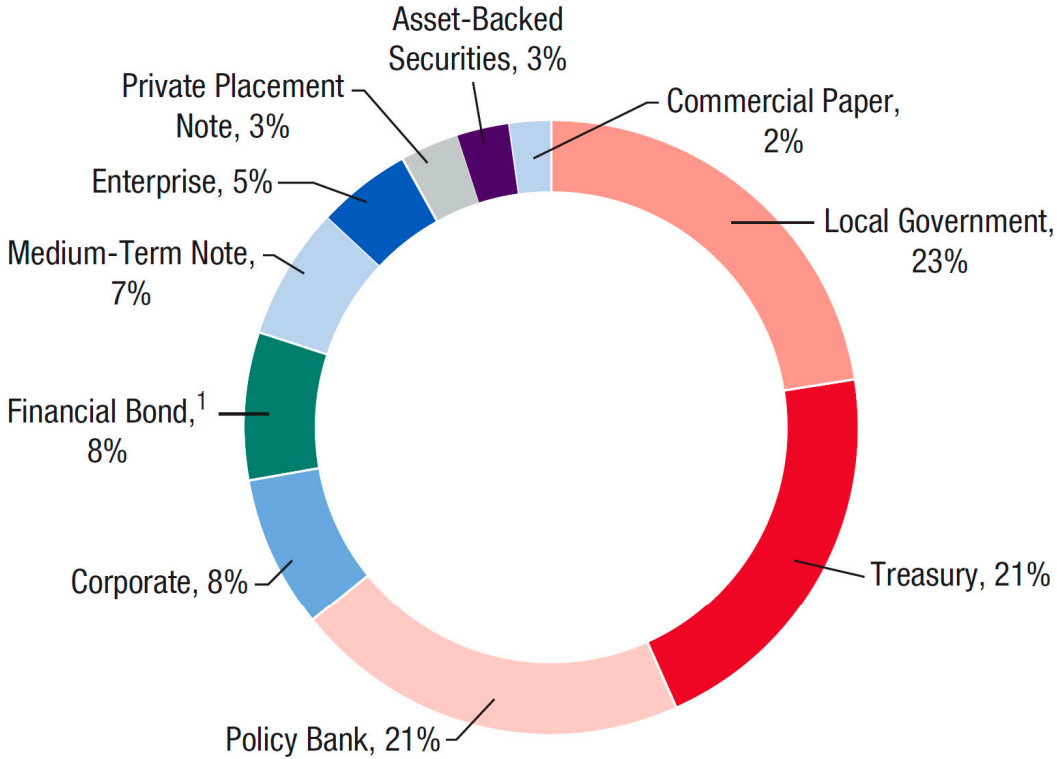
(Basis points)



Sources: WIND Economic Database (www.wind.com.cn); and authors' estimates.
Note: CGB = China government bond.

Bond market characteristics, government bonds, and LGFV

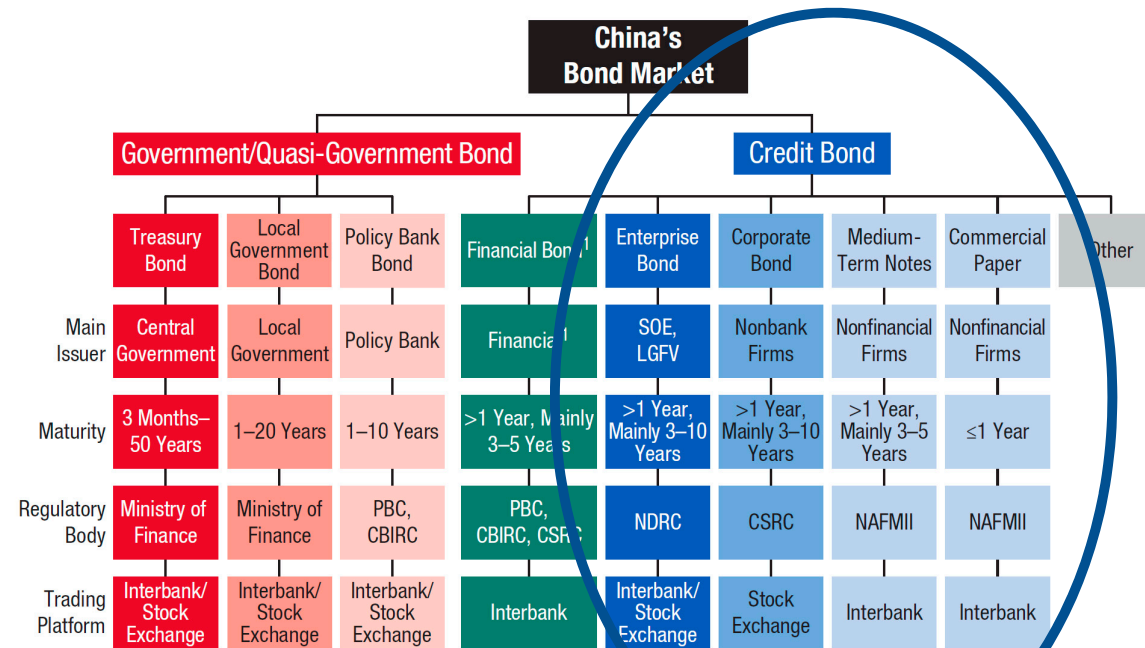
Government/quasi govt. dominate (share of total)



Source: WIND Economic Database (www.wind.com.cn).

¹ Excluding policy bank bonds.

Bonds market segmentation



Source: Authors.

Note: CBIRC = China Banking and Insurance Regulatory Commission; CSRC = China Securities Regulatory Commission; LGFV = local government financing vehicle; NAFMII = National Association of Financial Market Institutional Investors; NDRC = National Development and Reform Commission; PBC = People's Bank of China; SOE = state-owned enterprise.

¹Excluding policy bank bonds.

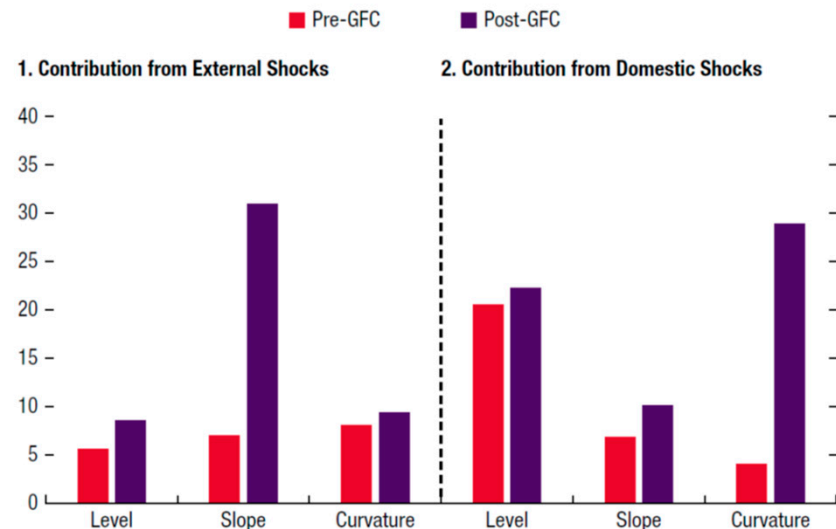
Government bonds: large but liquidity concentrated

- Account for 20 percent of domestic bond market
- Maturities from 3 months to 50 years
- Market liquidity concentrated at the short-end of the yield curve
- Banks hold 70 percent, secondary market liquidity limited
- Policy bank bonds more liquid providing a de factor benchmark

Government bonds: empirical evidence reveals:

- Sovereign bond yields anticipate macroeconomic conditions
- Monetary policy transmission from policy rates to bond rates has become stronger
- Stronger link to global financial conditions after GFC, in particular VIX

Figure 3.12. Contributions from External and Domestic Shocks to Variance of Forecast Error of Yield Curve Factors, before and after the Global Financial Crisis
(Percent, 12-month average)

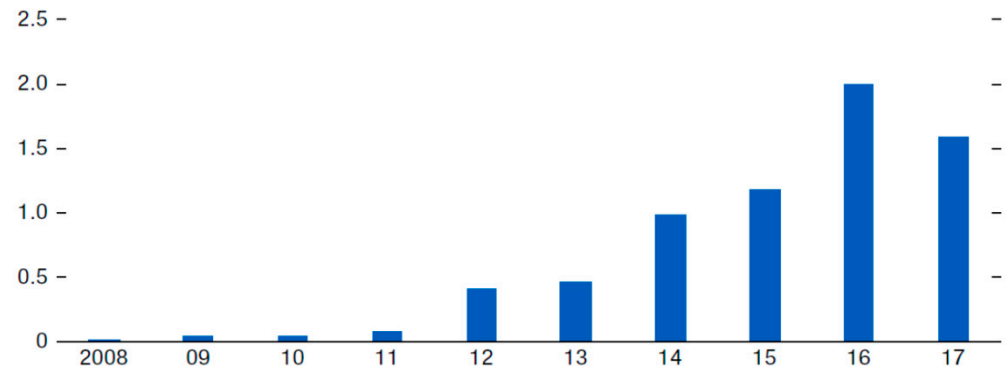


Source: IMF staff calculations.
Note: GFC = global financial crisis.

Credit bonds: LGFVs (chengtou) following GFC

- Special type of credit bonds issued by LGFV (SOEs)
- Surge following global financial crisis to circumvent borrowing constraints
- Market perception of implicit guarantee
- Tightening of regulation
- Effectively no LGFV defaults

(Trillions of renminbi)

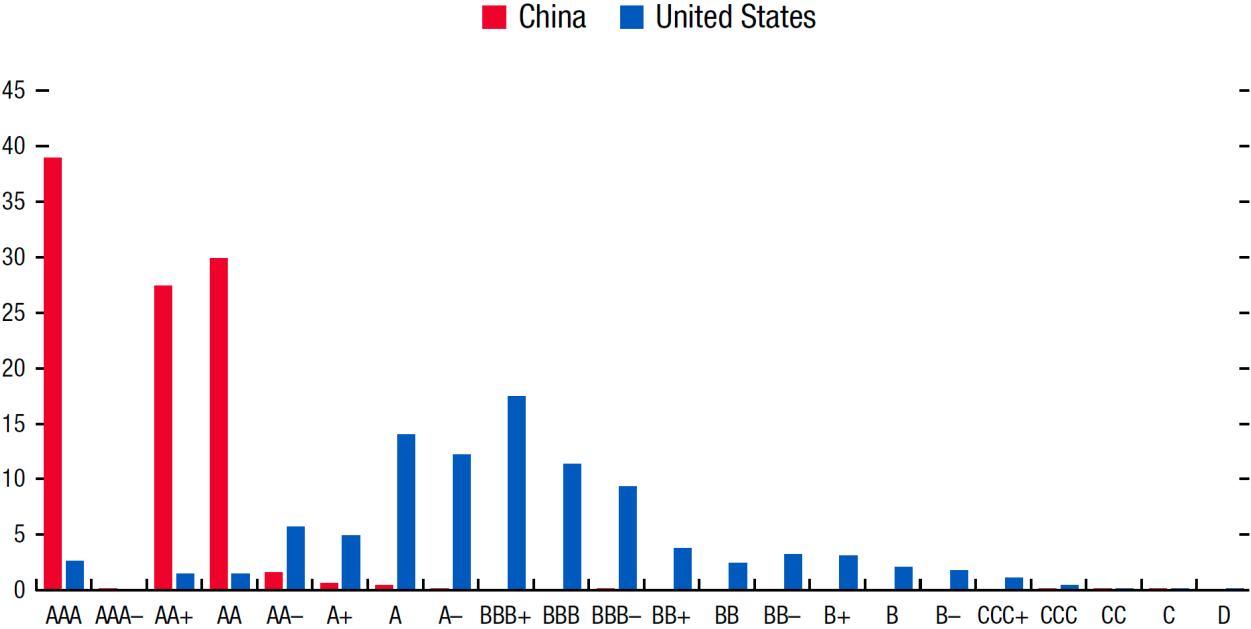


Source: WIND Economic Database (www.wind.com.cn).

Credit market, latest developments, and reforms

Credit bonds: credit ratings are skewed

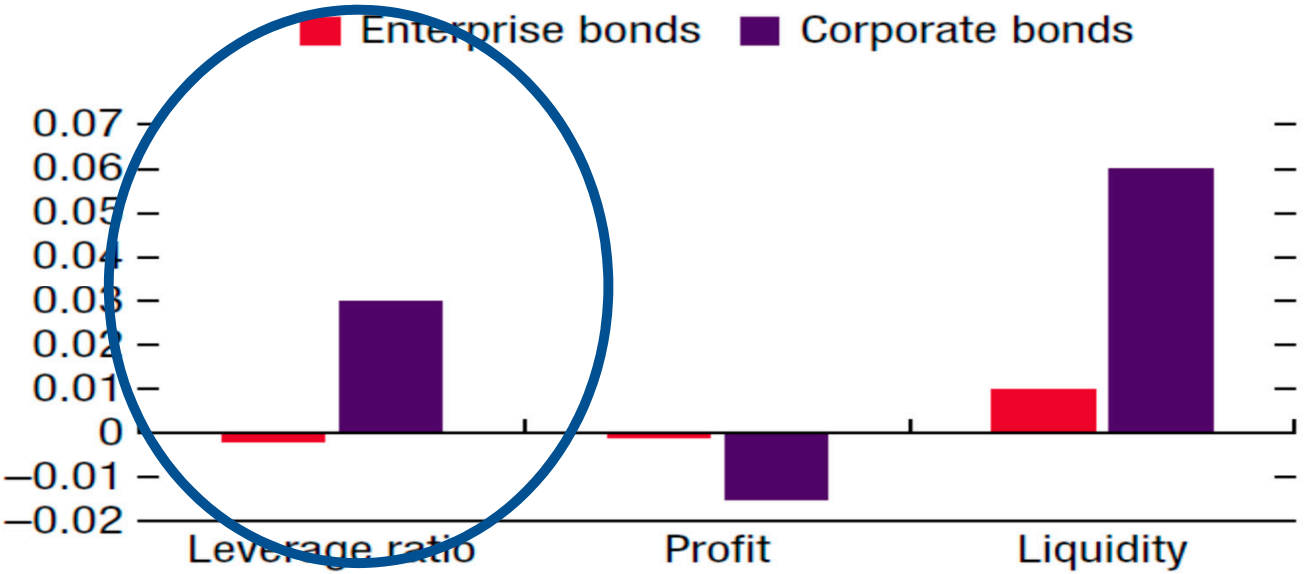
(Percent)



Source: Bloomberg L.P. 2017.

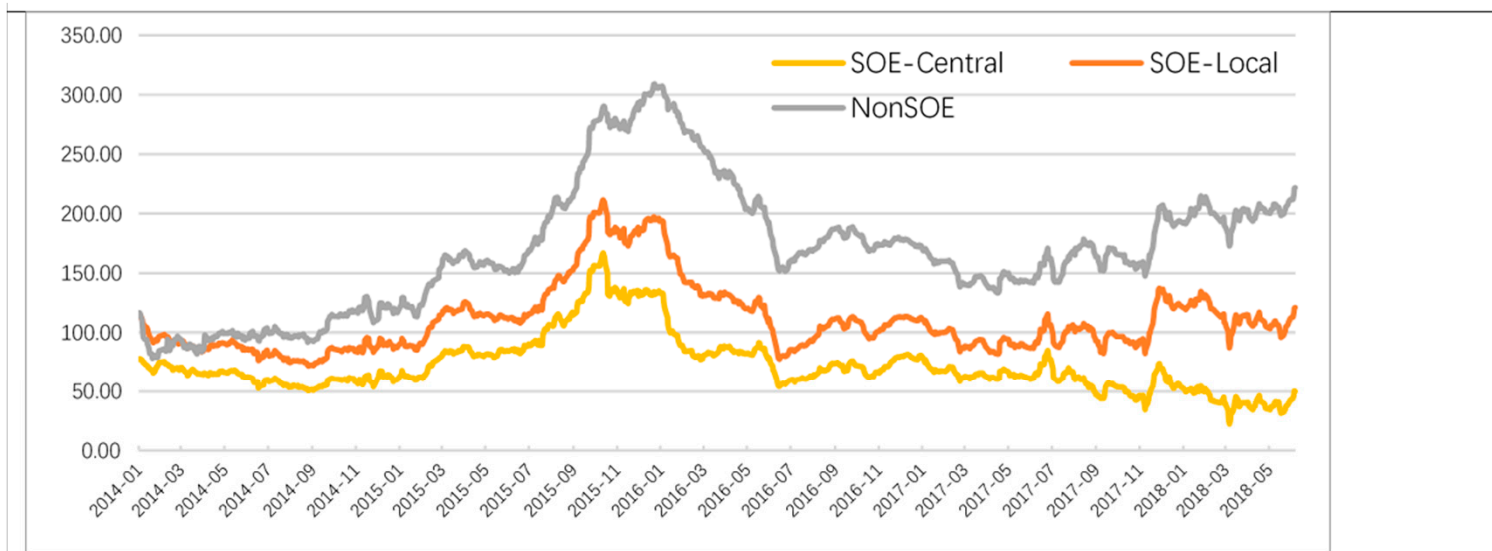
Credit bonds: limited pricing of credit risks/liquidity

(Percentage points)



Source: Authors' estimates.

Credit bonds: persistent credit spreads of SOEs/non-SOES (bps)



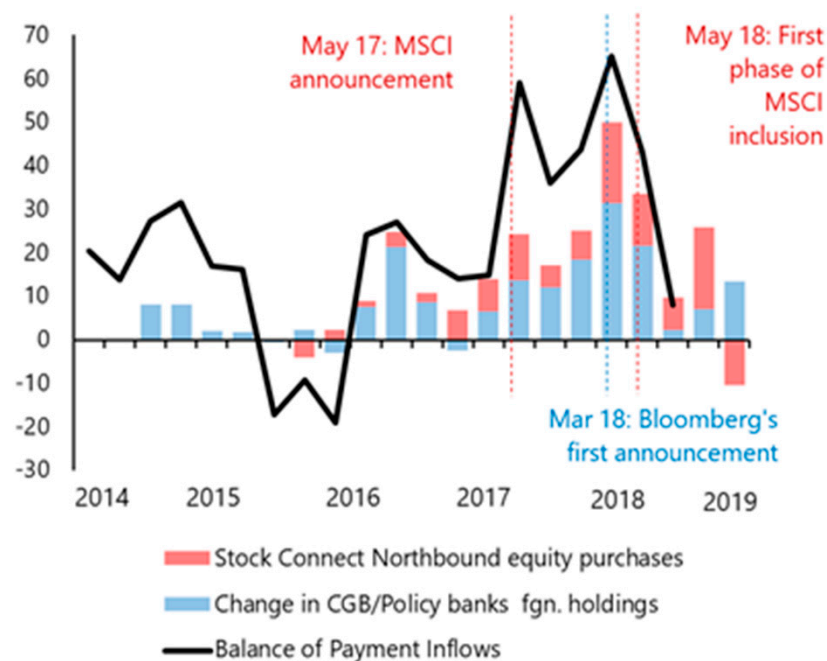
Data: Wind Statistics

Note: Bonds in each company type are aggregated through weighted balance of outstanding balance.

Latest developments: strong portfolio inflows

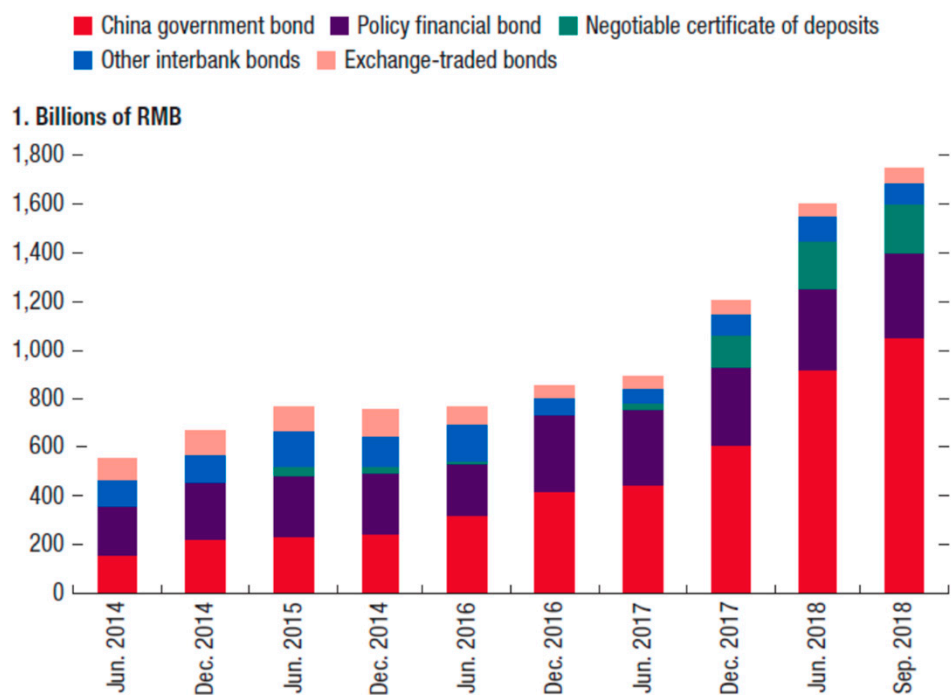
Surge in portfolio inflows, especially following expectations of inclusion into Bloomberg Barclays Global Index

Increased RMB holdings by central banks (following ECB)

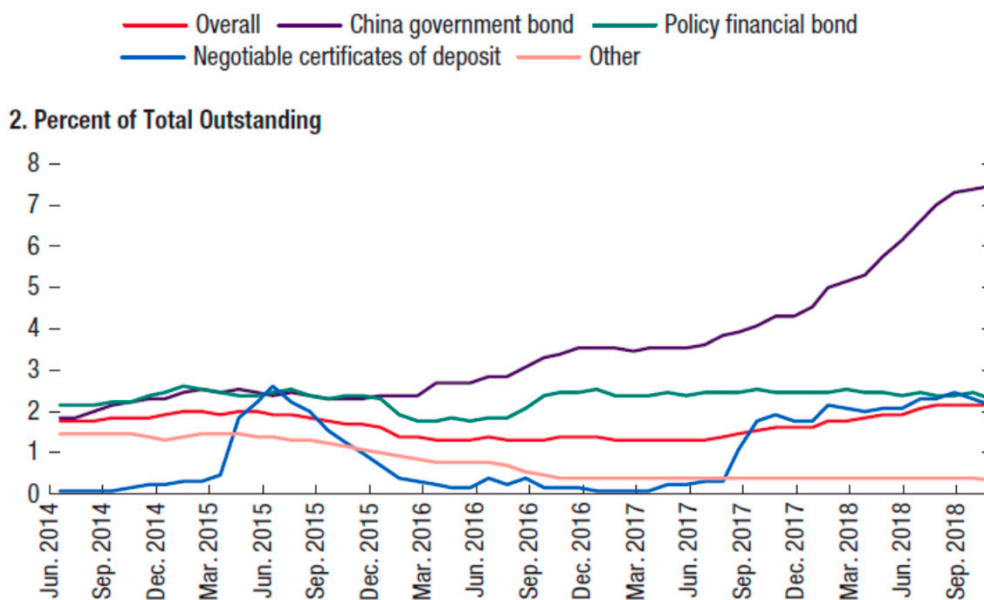


Latest developments: foreign inflows on a rise

Figure 11.2. Foreign Ownership of Onshore Bonds, by Bond Type, 2014–18



Sources: People's Bank of China; China Central Depository and Clearing Corporation; Shanghai Clearing House; and Standard Chartered Research.

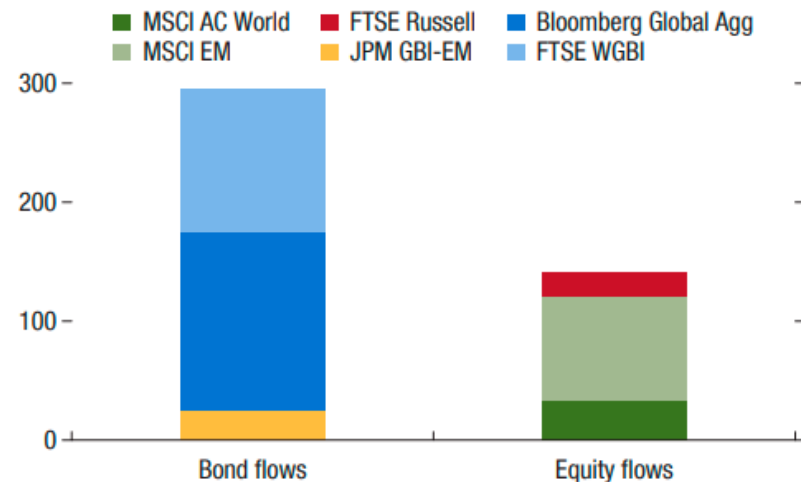


Sources: China Central Depository and Clearing Corporation; People's Bank of China; Shanghai Clearing House; Standard Chartered Research; and WIND Economic Database (www.wind.com.cn).

Latest developments: index inclusion supports a further increase

	Bloomberg Barclays Global Aggregate Index	JP Morgan Government Bond-Emerging Market Index (GBI-EM)	Citi World Government Bond Index (WGBI)
Tracking AUM	USD 2tn	USD 200bn	USD 2-4tn
Expected potential inflows	c.USD 120bn	USD 14-20bn	c.USD 159bn
Instruments	Investment-grade sovereign and corporate bonds	Investment-grade government bonds	Sovereign bonds
Maturity	At least one year	Greater than 13 months	At least one year
Potential weighting	6.03%	7-10% (capped)	c.5.3%

- Index-related inflows in billion of U.S. dollars

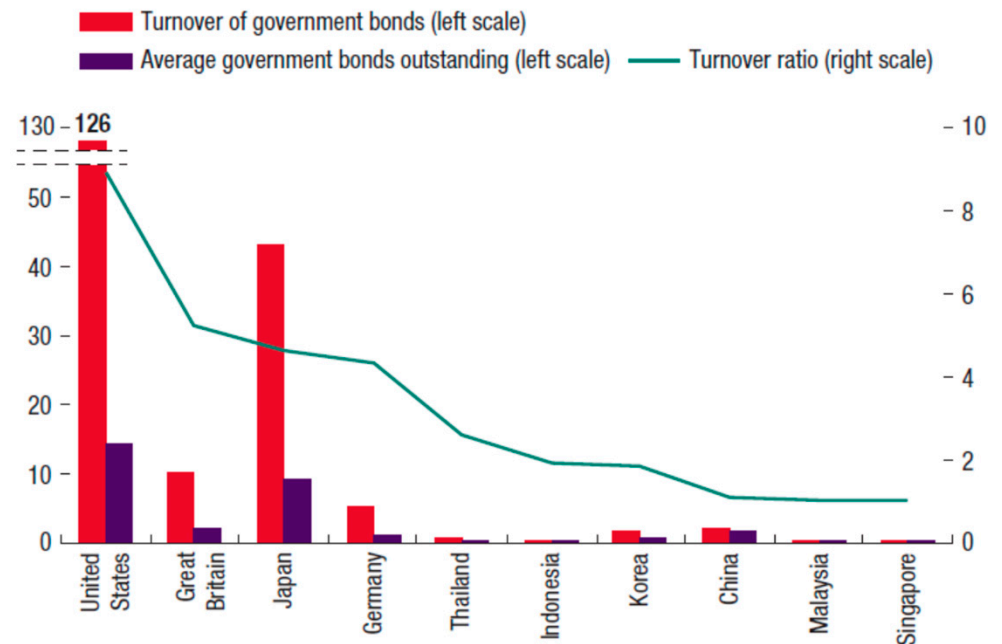


Source: JP Morgan Chase & Co; IMF Staff Estimates

Reforms: there are also hurdles

- Tax uncertainties
- Treasury bond liquidity
- Various access schemes
- Market fragmentation
- Difficult credit analysis
- Effective FX and interest rate hedging

Figure 11.4. Global Government Bond Turnover, Outstanding Bonds, and Turnover Ratio, Global and Asian Peers, 2017
(Trillions of US dollars, left scale; percent, right scale)



Sources: AsianBondsOnline; China Central Depository and Clearing Corporation; Deutsche Finanzagentur; Securities Industry and Financial Markets Association; Standard Chartered Research; and United Kingdom Debt Management Office.

Reforms: foreign appetite for credit bonds has been low

- Credit differentiation remain insufficient, in spite of rising defaults
- Credit rating severely skewed towards the high side

TABLE 11.4.

China's Domestic Credit Rating Agencies						
Agency	Market Share (%)		Regulatory Approvals			
	By bonds outstanding	By number of issuers	NAFMII	CSRC	NDRC	CIRC
China Chengxin Securities Rating				✓		✓
China Chengxin International Credit Rating	30	24	✓		✓	✓
China United Ratings				✓		✓
China Lianhe Credit Rating	28	21	✓		✓	✓
Dagong Global Credit Rating	23	14	✓	✓	✓	✓
Shanghai Brilliance Credit Rating	8	14	✓	✓	✓	✓
Pengyuan Credit Rating	8	20		✓	✓	✓
Golden Credit Rating	3	6	✓	✓	✓	✓
China Bond Rating Corporation		NA		NA		

Sources: Standard Chartered Research; and WIND Economic Database (www.wind.com.cn).

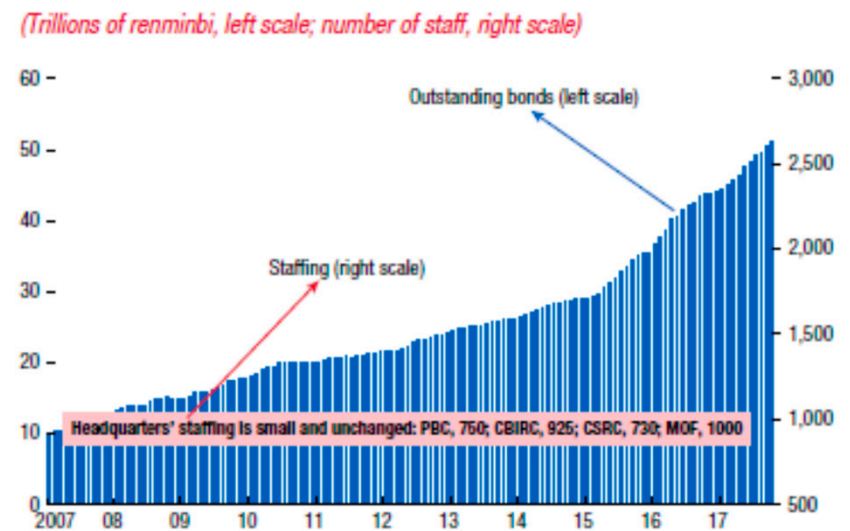
Note: CIRC = China Insurance Regulatory Commission; CSRC = China Securities Regulatory Commission; NA = not available; NAFMII = National Association of Financial Market Institutional Investors; NDRC = National Development and Reform Commission.

Further developing the bond market

- Further clarifying rules and tax treatments
- Specific guidelines and case studies (demonstrating process for application, investment, repatriation, hedging)
- Eliminating hurdles (practical solutions/engage with market participants)
- Harmonization of rules among regulatory agencies
- Strengthening credit ratings
- Strengthening corporate governance
- Improving integrity of information/data
- Gradually removing implicit guarantees/allowing defaults
- Better communication

Reforms: strengthening capacity

- Capital markets continue to become more sophisticated
- Development of hedging instruments important to boost liquidity
- Needs to go hand-in-hand with strengthened regulation and capacity building



Sources: People's Bank of China (PBC); China Banking and Insurance Regulatory Commission (CBIRC); China Securities Regulatory Commission (CSRC); and Ministry of Finance (MOF).
Note: In 2018, the China Banking Regulatory Commission and the China Insurance Regulatory Commission were merged to become the new China Banking and Insurance Regulatory Commission. In the process, overall staffing was reduced by about 12 percent.

Reforms: recent developments

- Committee spearheaded by PBC to unify regulation (Sep. 2017)
- Clarification of taxation for foreign bond holders, exempt for three years (Aug. 2018)
- Opening up market for foreign credit rating agencies (Jan. 2019) and S&P License
- Improved communication, launch of new PBC English webpage, timely translation of decisions (Jan. 2019):

<http://www.pbc.gov.cn/en/3688006/index.html>

- 2019 National People's Congress: aim to further open up and develop the bond market (March 2019)
- Measures to increase the liquidity (bond futures market and market making)

Takeaways

- China's bond market has great potential
- Further development and opening up envisaged by leadership
- Inclusion in global indices a further boost
- Significant benefits (better serving the real economy, facilitating diversification, RMB internationalization, and Belt and Road financing)
- Key reforms: harmonizing and clarifying rules, removing implicit guarantees, strengthening corporate governance, increasing foreign participation, and continued improved communication

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Thank you