CHAPTER 1

China’s Bond Market: Characteristics, Prospects, and Reforms

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In 2018, China marked the fortieth anniversary of “reform and opening up,” which launched a growth miracle that has put the country on a path—absent major shocks—to becoming the world’s largest economy by 2030. This rapid economic development has been mirrored in the growing size of the financial system, which is now home to the world’s largest banks and the second-largest equity market. The prospects for China’s bond market, already the third largest in the world, are the focus of this book.

Two important issues stand out: First, although China has become a main contributor to global trade and product integration, financial sector integration has been limited. Except for bank lending to some Asian and African countries, the financial system is little integrated globally and remains relatively closed. Reflecting China’s increasing global footprint, however, the next decade is likely to be driven by greater global financial sector integration. President XI Jinping made this point clear at the Boao Forum for Asia in 2018, highlighting China’s intention to further open up its financial system (XI 2018).

Second, despite its size, China’s financial system remains largely bank based. As the country seeks to improve the allocation of savings and investment to better serve the economy, the structure of the financial system is likely to change. This does not mean that the financial system will—similar to the United States—become capital-market centric. Rather, it implies that capital markets in relative terms will play a more important role in allocating savings and investment. Premier LI Keqiang reiterated this policy direction when he emphasized the government’s intention to “develop a multi-tiered capital market and promote the development of the bond and futures markets” (LI 2018, 29).

In the context of China’s global financial market integration and further capital market development, its bond market will play a critical role. The inclusion of its bonds in global indices, starting with the renminbi (RMB) sovereign and policy bank bonds in the Bloomberg Barclays Global Aggregate Bond Index in April 2019, is a milestone in global financial sector integration. This will create big opportunities for both China and the world, but requires a good
understanding of the bond market structure, its unique characteristics, and future reform areas.

Further bond market development and opening will foster the allocation of resources and allow for diversification of assets. To maximize the benefits, while minimizing risks, the process needs to be carefully managed and calibrated. It will require stronger institutions and regulation, as well as supervision and capacity building.

**MACRO-FINANCIAL AND GLOBAL CONTEXT**

A robust and liquid bond market will benefit the domestic economy and foster global asset diversification. It will also contribute to global stability, including through the supply of safe assets. To provide context for the discussion on the future of China’s bond market, the following reviews the country’s macro-financial as well as the global context.¹

**Macro-Financial Context**

After four decades of rapid GDP growth (about 10 percent annually, on average), the country is transitioning from high-speed to high-quality growth. But especially since the large stimulus package implemented in response to the global financial crisis of 2008–09, the country relied too much on credit-financed investment to support growth, which led to rising debt levels, increasing financial sector vulnerabilities, and deteriorating credit allocation. Corporate debt, for example, increased to about 145 percent of GDP in 2016, one of the highest levels in the world (Figure 1.1).² Associated with the rise in corporate debt was an increasingly inefficient allocation of credit.³

Faced with these challenges, in 2017, the authorities declared financial sector stability a key priority⁴ and announced a multiyear deleveraging campaign aimed at stabilizing the debt-to-GDP ratio over the next few years. This included a significant tightening of financial sector regulation and the financing of local governments. In the financial sector, the authorities announced, for example, new asset-management rules to curtail shadow banking activities. In the case of local governments, the aim has been to rein in off-budget spending by local

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¹ On the macro-economic context see also IMF (2018).

² For surveillance purposes, the IMF includes debt issued by local government financing vehicles (LGFVs) as part of the government rather than the corporate sector. For a discussion on the perimeter of government see Mano and Stokoe (2017).

³ The overall credit intensity of the economy, calculated as total credit to the economy divided by nominal GDP, jumped from about one in 2006 to about four in 2017. See IMF (2018).

government financing vehicles (LGFVs) (see the discussion later in this chapter). Tighter regulation, in turn, was associated with a slowdown in credit growth and increased bond defaults. In addition, there was some meaningful credit spread widening affecting lower-quality borrowers (Figure 1.2). While overall default rates remained relatively low, it was the private sector, rather than state-owned enterprises (SOEs), that took the biggest hit.\(^5\)

China’s deleveraging process is likely to be calibrated over the coming years.\(^6\) While this might be warranted, it will be important not to undo progress in addressing leverage and financial sector risks. Ensuring financial system stability, after all—combined with better pricing of risk—is also crucial to the development of a sound bond market. This likewise calls for the implementation of complementary macro-financial structural reforms, such as imposing hard budget constraints, that is, allowing nonperforming companies, including SOEs, to exit.

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\(^5\) In 2018, private sector default rates were estimated to have reached 4.3 percent, compared to only 0.1 percent for SOEs (see HO and CUI 2018).

\(^6\) For example, in light of a slowing economy in the second half of 2018, the authorities softened some envisaged financial sector reforms (largely by extending implementation periods), eased monetary policy (for example, by cutting reserve requirement rates), provided additional fiscal support (including through tax cuts), and started a campaign to provide targeted support to the private sector, especially small and medium enterprises.
A further opening of China’s bond market should also consider global trends and developments and, in the current context, the impact of interest rate normalization in advanced economies. This is because unconventional monetary policy in the past has been associated with significant portfolio inflows into emerging markets. While most emerging markets should be able to cope with a reversal of portfolio flows, sudden increases in risk aversion could become more challenging, including for China. This raises questions about how sensitive China is to the global financial cycle and the implications for further liberalization (Chapter 2). Reflecting the country’s still-limited exposure to foreign investors, its portfolio flows in general and debt inflows in particular are only marginally affected by the global financial cycle. Despite limited cross-border portfolio flows, however, evidence suggests that the yield curve is becoming increasingly sensitive to global factors; hence, normalization of monetary policy in advanced economies and tighter global financial conditions will have an important influence on domestic bond yields in the years ahead (Chapter 3).

Of course, with increased liberalization, it is expected that China’s bond market will become more sensitive to such cycles. Some have even argued that this
could lead to financial stability risks and reduce the scope for independent monetary policy (Rey 2016). But the cost, in loss of monetary policy autonomy, should be limited, especially if China continues—as it should—to move toward a more flexible exchange system supported by a well-articulated monetary policy framework and stronger financial sector regulation and supervision. The discussion that follows reviews key insights from the book chapters.

DEVELOPMENT AND STRUCTURE OF CHINA’S BOND MARKET

As is clear from the discussion so far, China’s bond market is still developing. While the first sovereign bonds were introduced in 1954, it was only in 1983 that credit bonds emerged with the issuance of the first enterprise bond (discussed below) by a state-owned company to support the country’s national development strategy (Figure 1.3). Since then, different segments of the market have not only become large, but also offer a wide range of products and maturities to public, domestic, and, increasingly, foreign investors (Figure 1.4). An over-the-counter market, the so-called interbank bond market, now accounts for 90 percent of bond financing and is complemented by an exchange market. As China increasingly relies on direct

**Figure 1.3. Bond Market Development, 1954–2018**

- Government/quasi-government entities
- Nonfinancial corporations
- Financial corporations
- Asset-backed securities
- Bond futures
- Private placement notes

Source: Authors.

1 Ceased in 1995.

2 Reintroduced.

3 Excluding policy bonds.
financing and its bond market goes global, it will be important to understand its unique characteristics and the country’s overall reform priorities. The discussion that follows summarizes the development and structure of China’s bond market (Figure 1.5). It looks at (1) government and quasi-government bonds, (2) credit bonds, (3) financial bonds issued by financial institutions, (4) Treasury futures, (5) green bonds, and (6) asset-backed securities.

1. Government and Quasi-Government Bonds

Accounting for more than 60 percent of the total bond market, the public sector dominates the bond market, comprising sovereign, policy bank, and rapidly growing local government bond markets. Each are discussed in subsections that follow.

**Sovereign Bonds (China Government Bonds)**

A well-functioning government Treasury market is the linchpin for the development of any capital market, and sovereign bonds are used as a risk-free benchmark for other fixed income securities. China government bonds account for about 20 percent of the domestic bond market, with maturities ranging from 3 months to 50 years (Chapter 3). Market liquidity, however, is still thin and concentrated at the short end of the yield curve. With banks holding 70 percent of the bonds—often until maturity—secondary market trading and, hence, information processing, is more limited.
Despite these shortcomings, empirical analysis reveals that the linkages between China’s government bond yields and macroeconomic developments, as well as global financial market conditions, have become stronger in recent years. The information content of China government bonds has increased, with these securities anticipating changes in macroeconomic conditions. And the transmission of monetary policy to bond market yields has become stronger. For example, changes in the 7-day repurchase (repo) rate have had significant and persistent impacts on short-dated China government bond yields. Also notable is the close link between China government bond yields and external market conditions, including the 10-year US Treasury yield and the Chicago Board Options Exchange Volatility Index.

Further reforms to boost the liquidity of China’s sovereign bond market will improve the overall efficiency of its capital market, providing a crucial benchmark for credit pricing that the country needs as economic reforms continue and credit allocation improves. In addition to creating a benchmark yield curve, further developing the China government bond market would enhance market liquidity by providing general collateral that can be used to broaden liquidity management (for example, repos, secured lending, and swaps) as well as the derivatives, hedges, futures, and other related markets.

Figure 1.5. Overview of China’s Bond Market

Source: Authors.

1Excluding policy bank bonds.
Policy Bank Bonds

Policy bank bonds (part of financial bonds) play an important part in China’s bond market. Since investors assume that they are backed by the government and, hence, are risk free, they are also used as benchmarks for the pricing of other securities. Unlike sovereign bonds, policy bank bonds are not tax exempt. The first policy bank bonds were issued in 1994 by the China Development Bank and now include those issued by the Export-Import Bank and the China Agricultural Development Bank.

The size of the market is similar to that of the sovereign bond market, but it turns out that policy bonds are actually more liquid. Possibly reflecting higher market trading, policy bank bonds tend to be more responsive to changes in macroeconomic fundamentals, as proxied by industrial production, as well as monetary policy signals (7-day repo rate). This reinforces the view that improving trading liquidity will be key to boosting the information efficiency and policy transmission mechanism of the China government bond market.

Local Government Bonds

China’s local government bond market—regulated by the Ministry of Finance—developed almost overnight and now exceeds the size of sovereign bonds (Chapter 5). Before 2015, local governments were largely prohibited from borrowing. Instead, and especially since the large stimulus program following the global financial crisis, they have relied on off–balance sheet activities through LGFVs, effectively circumventing borrowing constraints. To reduce reliance on LGFVs and minimize financial sector risks, local governments can issue bonds subject to an annual ceiling set by the National People’s Congress, a strategy introduced under the motto “opening the front door” while “closing the back door.” To facilitate the transition, the government announced a large-scale debt-swap program, reaching RMB 15 trillion (23 percent of GDP in 2017), making China’s local government bond market one of the largest in the world.

Local government bonds fall into two different categories: general bonds and special purpose bonds. General bonds finance projects without expected revenue and, hence, rely on general government revenue for debt service. Special purpose bonds are expected to be repaid by project revenue and not reflected in the headline government deficit. Both general and special purpose bonds are subject to the debt ceiling set by local provincial bodies and the National People’s Congress. Special project bond issuance has surged rapidly recently. Despite the rapid growth in local government bonds, nonetheless, severe impediments still hinder

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7 China’s fiscal budgets consist of four separate books. The General Public Budget covers expenditures for general public services such as national defense, education, health, and others. Government-managed funds include various funds covering expenditure on public projects such as railroads, airlines, and irrigation facilities. The State Capital Operation Budget covers expenditures in state-owned capital management. The Social Security Fund Budget covers social security expenditures.

8 Special purpose bonds are included in the so-called government-managed-fund budget,
bond market development, including low liquidity, weak credit culture, and a narrow investor base. It bears reiterating, therefore, that developing a sound government bond market is important for subnational government financing and securing fiscal sustainability. At the same time, structural fiscal reforms to rein in off-budget borrowing and to resolve intergovernmental imbalances between spending and revenue are necessary to contain fiscal risks.

2. Credit Bonds

China’s credit bond market is unique, reflecting its development and successive waves of financial sector development and liberalization (Chapter 4). Today, firms can issue instruments with similar characteristics and maturities in different segments, each governed by a different regulatory agency, subject to different issuance and rules, and traded on different platforms. The different segments encompass the enterprise and corporate bond markets, as well as the market for medium-term notes.

- **Enterprise bonds.** Since the launch of the first credit bond in 1983, the market has developed rapidly. The enterprise bond market is almost exclusively for SOEs (though SOEs can also issue bonds in the other segments of the market); 80 percent of enterprise bonds have been issued by LGFVs, a special type of SOE (discussed in the next subsection). Enterprise bonds are regulated by the National Development and Reform Commission, China’s equivalent to a planning ministry, and issuance still needs approval. Enterprise bonds can be traded on both the interbank and exchange markets.

- **Corporate bonds.** Successive waves of financial sector liberalization have led to the establishment of new segments, spearheaded by other regulatory agencies. In 2004, the State Council issued opinions on promoting opening up and developing capital markets. Three years later, China started pilot issues of corporate bonds, which were issued and traded on the exchange market and regulated by the China Securities Regulatory Commission (CSRC).

- **Medium-term notes.** Starting in 2008, a new segment of the credit bond market was established, allowing companies to raise financing through so-called medium-term notes. Medium-term notes are formally classified as nonfinancial enterprise debt-financing instruments, regulated by the National Association of Financial Market Institutional Investors (NAFMII), a self-regulated agency under the People’s Bank of China. These notes are issued on a registration basis and traded on the interbank market. Unlike in other countries, where the interbank market is limited to financial entities, corporations and large institutional investors have access to the market.

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9 Certain private placement corporate bonds are traded outside the exchanges.

10 In addition to medium-term notes, nonfinancial enterprise debt-financing instruments include commercial paper, super and short-term commercial paper, asset-backed securities, and private placement notes.
The Future of China’s Bond Market

Local Government Financing Vehicles (LGFVs)

Among credit bonds, bonds issued by LGFVs (difang zhengfu rongzi pingtai) warrant special discussion (Chapter 5). LGFVs are SOEs established by local governments with capital, land, or other public resources and that in turn either borrow from banks or issue urban construction bonds (chengtou). While chengtou bonds were first issued in 1992, issuance surged following the global financial crisis (Figure 1.6). Legally, they are distinct from local government bonds because they are liabilities of enterprises, albeit government-owned ones. They are issued in all three credit bond segments discussed earlier (enterprise and corporate bonds, as well as short- and medium-term notes).

Initially, local governments relied on LGFVs to circumvent the budget law, which prohibited local governments from borrowing. Markets often assume that those bonds carry an implicit guarantee by the government. In the past, some local governments even explicitly provided “letters of comfort.” However, since the 2014 budget law and subsequent reforms, the government has tried to break the perception of this link. For example, the National Development and Reform Commission and the Ministry of Finance in 2018 jointly reiterated the ban on local government guarantees for LGFVs. Although spreads have risen somewhat, no government financing vehicle has defaulted yet.11

11 On August 13, 2018, a short-term note issued by the Xinjiang Liushi State Capital Operating Co., an SOE perceived as a quasi-LGFV, was not paid in full. Although full payment was made three days later, market participants considered this to be the first technical default of a publicly placed chengtou bond. Following the news, LGFV bond spreads temporarily increased moderately but reverted quickly to previous levels.

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Empirical Assessment of the Credit Bond Market

An empirical assessment using firm-level data provides valuable insights into China’s credit bond market. For example, the analysis suggests that the pass-through from the risk-free benchmark rate to enterprise bonds is almost one to one, while still incomplete for corporate bonds. At the same time, credit risk seems to be more adequately reflected in the pricing of “corporate” rather than similar “enterprise” bonds. This seems to support the view that investors consider enterprise bonds, most of which are issued by SOEs, including LGFVs, as closely linked to the government. The analysis also reveals that yields of SOEs and LGFV bonds are on average some 100 basis points lower than those for private sector firms with similar financial and operating conditions. Neither enterprise nor corporate bonds, however, seem to be sensitive to liquidity risks.

All credit bonds combined still account for only a small share of corporate financing (10 percent), and foreign holdings remain negligible (less than 1 percent) compared to the United States (30 percent). In terms of investors, the market is dominated by collective investment schemes.

Hence, as the economy develops, and the financial system opens further, scope for growth is significant. For the time being, however, the credit bond market is dominated by SOEs (within all three segments of the credit bond market, SOEs accounted for about 80 percent of issuance in 2017). This is despite the fact that SOEs have become less important in the economy, contributing less than 20 percent to overall value added and employment (Lam and Schipke 2017). As such, there will be significant room for a higher share of private bond issuance going forward. At the end of 2018, the government launched a few initiatives to promote private bond issuance, including People’s Bank of China liquidity support for Credit Risk Mitigation Warrants (that is, instruments that are similar to credit default swaps) and hence private bond issuance.

3. Financial Bonds

Financial bonds issued by financial institutions constitute a separate category. This category formally includes policy bank bonds, previously discussed. While banks issue in the interbank market and are regulated by the People’s Bank of China, nonbank financial institutions (such as insurance companies and securities firms) can issue on exchanges and are regulated by the China Banking and Insurance Regulatory Commission and the CSRC. CITIC Group issued the first non–policy-bank financial bonds in 2001.

4. Treasury Futures

The introduction of Treasury futures in 2013 has helped enhance liquidity, improved the efficiency of price discovery, and allowed investors to better manage interest rate risk (Chapter 6). As such, Treasury futures are important in fostering development of the corresponding cash bond market (see the discussion on increasing liquidity later in this chapter). So far, the China Financial Futures...
Exchange has launched 2-year, 5-year, and 10-year Treasury bond futures, with 10-year futures accounting for about 70 percent of the market and about 80 percent of daily trading volume. To ensure price convergence with the cash market, the futures market requires physical settlement based on a bond delivery basket with specified coupon and delivery maturities. Between the first and the last trading day of a delivery month, sellers of an expiring Treasury futures contract hold the right to decide when to deliver and, in 2017, delivery-versus-payment was introduced for eligible positions.

Further advances in the Treasury futures market will not only allow investors to better hedge risk, but also strengthen the underlying cash market. In particular, introducing more diversified products, such as longer-term Treasury bond futures and Treasury futures options with different terms, would meet markets’ diversified risk management needs and strengthen the bond yield curve. Because about 65 percent of Treasury bonds are held by commercial banks, allowing commercial banks to participate in the Treasury futures market will contribute to better interest rate risk management and, in turn, increase the liquidity of the cash market. The same is true of foreign investors, who increasingly have access to the domestic bond market through the different quota schemes and China’s interbank bond market through Bond Connect, but have not been able to participate in the Treasury futures market.

5. Green Bonds

Fighting pollution has become one of the country’s top priorities and green finance can play an important role. The country’s green bond market is still in its infancy but—after the People’s Bank of China launched green bonds in December 2015—has already become the largest in the world (Chapter 7). Project catalogs for green bonds are published by the Green Finance Committee of the China Society for Finance and Banking. Maturities and products include short- and longer-term bonds (up to 15 years) as well as perpetuities and, more recently, asset-backed securities and green covered bonds. According to the data of CBI, China’s green bonds issuance totaled RMB 248.6 billion (USD 37.1 billion) in 2017, accounting for 22% of the global issuance.12

Despite its rapid development, however, the green bond market still faces important obstacles. Several measures can advance the market, ranging from reducing information gaps about the benefits of green bonds, to ensuring that certification and assessment of green bonds is in line with corresponding People’s Bank of China and CSRC guidelines, strengthening the due diligence of green bond issuers, and fostering information disclosure requirements.

Furthermore, the application of green bond indices and development of asset-backed securities could make the market even more attractive. As in other

segments of China’s bond market, it is important to increase the investor base and strengthen international cooperation on green bonds. The country’s green bond market can help advance environmentally friendly growth and contribute to global initiatives in green finance.

6. Asset-Backed Securities

The asset-backed securities (ABS) market consists of both credit and corporate ABS, with the former being issued and traded on the interbank market, regulated by the People’s Bank of China and the China Banking and Insurance Regulatory Commission, and the latter issued and traded on the exchange market and regulated by the CSRC. Both credit ABS and corporate ABS were formally launched in 2005 but suspended in 2009 in light of the global financial crisis (Chapter 8). A corporate ABS pilot resumed in 2011 and credit ABS resumed in 2012, and new rules and regulations were introduced (such as a requirement that each security receive two ratings) to strengthen risk prevention. At the end of 2014, the issuance of ABS changed from an approval-based to a registration-based system. Also, the types of underlying assets have been expanded and the pool of investors has grown increasingly diverse. The market now plays an increasing role in reviving illiquid assets and promoting inclusive finance. Nevertheless, it still has a lot of room to develop given the large amount of available Chinese bank credit assets and substantial corporate financing needs.

Compared to mature markets in countries such as the United States, ABS have had a late start and important elements remain to be developed. Apart from the need to strengthen legal frameworks to close loopholes and enhance certainty, market liquidity needs to be increased by promoting market makers and understandable product valuation systems and improving the structure of investors. Also, information disclosure should be strengthened comprehensively to improve transparency, timeliness, and standardization. Attention to international best practices, especially in the areas of credit rating agencies and provision of structures that ensure appropriate incentives for asset originators, would encourage the sustainable development of the ABS market.

OPENING UP OF CHINA’S BOND MARKET AND FOREIGN PARTICIPATION

The opening up of China’s bond market has been integral to its broader capital account liberalization strategy, which has been gradual, sequenced, and asymmetric. Broadly in line with the IMF’s institutional view on capital flow management (IMF 2012, 2017), the country liberalized portfolio flows after liberalizing foreign direct investment, and allowed inflows before outflows. A unique feature of its capital account liberalization strategy has been the use of quotas, that is, limiting the size of the flows as well as targeting particular investor groups. This strategy has also applied to bond market opening (see Chapter 9). At its inception in 2002, China allowed Qualified Foreign Institutional Investors (QFII) to invest
in its exchange and interbank bond markets through a quota system; in 2011, the Renminbi Qualified Foreign Institutional Investors (RQFII) program was introduced, allowing institutional investors to use their renminbi to invest in the domestic bond markets. In addition, since 2010, central banks and sovereign wealth funds have had unlimited access to China’s interbank bond market—through the China Interbank Bond Market Direct program (CIBM Direct).

To allow renminbi-denominated bond issuance by non-Chinese entities, China launched the panda bond market in 2005. Since then, it has amended rules and regulations to facilitate market development, allowing companies, foreign banks, multilateral institutions, and sovereigns to issue the bonds. At the end of 2017, the total amount of panda bonds issued in the interbank market reached some RMB 125 billion.

The launch of Bond Connect in mid-2017, meanwhile, now allows foreign investors to buy and sell bonds traded in Hong Kong SAR and the mainland through the bond market infrastructure connect. While the program so far is asymmetric, allowing inflows (northbound), it is envisaged that further liberalization will allow residents to buy assets abroad (southbound). These measures have been associated with a significant surge in inflows. At the same time, prospects for continued large inflows remain high given that overall foreign bond holdings amount to only about 2 percent, compared to more than 25 percent in the United States and 5 percent in Korea; the global holdings of Chinese sovereign bonds, at about 7 percent, also trail other important currencies (the US dollar, Japanese yen, euro, and the British pound), which range from 10 percent to 60 percent.

**RMB Internationalization and Special Drawing Rights**

The inclusion of the renminbi in the special drawing rights (SDR) basket in November 2016 was a milestone for both China and the global financial system and recognized the significant advances made in China’s reforms. At the same time, it was associated with operational improvements in China’s bond market and has triggered a surge in global investor interest. For example, the Ministry of Finance started regular issuance of three-month China government bonds to strengthen the sovereign yield curve, along with the elimination of other obstacles, making foreign investments more attractive. Renminbi holdings by foreign central banks jumped by about 115 percent since 2016, reaching almost US$200 billion at mid-2018, or 1.8 percent of total holdings.

Also notable is the increasing use of the RMB as a reserve currency, seen by many as evidence of the international monetary system’s move away from the bipolar US dollar and the euro blocs to a tripolar system (Tovar and Nor 2018) (Figure 1.7). Also, an increasing number of central banks have increased their RMB reserve targets, including the European Central Bank (ECB 2017). Overall, China’s sovereign bond holdings by overseas institutions accounted for 5.4 percent at the end of 2017. If demand for RMB bonds as official reserves were that for those of other countries (for example, Australian-dollar-denominated reserves or those of the British pound), additional inflows would be quite sizable.
Inclusion in Global Bond Indices

Inclusion in global bond indices will boost foreign participation in the sovereign bond market.13 In March 2018, Bloomberg announced it would include RMB government bonds and policy bank bonds in the Bloomberg Barclays Global Aggregate Bond Index beginning in April 2019. The inclusion will have a 20-month phase-in period, starting with a scaling factor of 5 percent and increasing in 5 percent increments each month. At full inclusion, China’s weight would likely reach 5.49 percent of the index, the fourth-largest currency after the US dollar, the euro, and the Japanese yen, estimated to lead to inflows of some US$90 billion–US$130 billion during the phasing-in period.

In addition to the Bloomberg Barclays index (with assets under management of US$2.5 trillion), there are two other major global bond indices. These include the FTSE World Government Bond Index (WGBI) (assets under management of US$2 trillion–US$2.5 trillion) and the JPMorgan Government Bond Index-Emerging Markets (GBI-EM) (assets under management of US$250 billion). The inclusion of RMB bonds in these two indices could lead to passive

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13 The inclusion in global bond indices is closely related to China’s opening of its capital account. To qualify for inclusion in the Global Aggregate Index, a local currency debt market must be classified as investment grade and its currency must be freely tradable, convertible, hedge-able, and free of capital controls.
inflows of an additional US$130 billion–US$180 billion once the inclusion is approved.\textsuperscript{14}

**The Belt and Road Initiative**

The Belt and Road Initiative is likely to boost transactions in both China’s offshore markets and onshore markets.\textsuperscript{15} Large infrastructure gaps in partner countries generate significant demand for financing, and bond issuance can efficiently mobilize resources. Since 2017, the China Development Bank and other Chinese commercial banks have issued offshore bonds in US dollars and euros to finance Belt and Road projects, and increasingly also resort to the onshore RMB bond market.

In March 2018, both the Shanghai and Shenzhen Exchanges issued notices on the pilot of the “Belt and Road” bonds, which not only supports companies and financial institutions incorporated in countries or regions along the Belt and Road to issue corporate bonds, but also supports domestic firms to raise funds for the Belt and Road Initiative. The two exchanges are envisaging the development of a special market for Belt and Road Initiative bonds and the release of a Belt and Road Initiative bond price index. In China’s interbank market, the Philippine and Hungarian governments, as well as many corporations in partner countries, have already issued panda bonds for initiative projects.

Reflecting the longer maturity of Belt and Road Initiative infrastructure projects, it will be particularly important to bring in institutional investors, such as insurance companies and pension funds, to provide stable long-term financing. Proper risk pricing of bonds related to the Belt and Road Initiative is also crucial, given repayment risks from some partner countries. To minimize risks, an overarching framework to foster coordination, as well as issues of fiscal sustainability and the framework conditions for productive investment in partner countries, will be important.

**BOND MARKET DEVELOPMENT AND MARKET OPENING**

In line with “crossing the river by touching the stones,” as China’s successful development strategy has been described, China’s financial sector reform and opening up has not been linear and has experienced setbacks and changes, most notably in 2013 and 2015–16. Given the size and increasing complexity of the financial system and China’s increasing global footprint, such shifts are increasingly felt abroad. Going forward, the country’s financial sector development and

\textsuperscript{14} For estimates of potential inflows, see also Suwanapruti and others (2018).

\textsuperscript{15} President XI Jinping proposed the Belt and Road Initiative in 2013. While the name refers to ancient trade routes, the initiative transcends trade and encompasses five areas to advance the initiative: (1) policy coordination, (2) facilities connectivity, (3) unimpeded trade, (4) financial connectivity, and (5) people-to-people bonds (PBC 2018).
opening up could continue to be bumpy; however, a careful sequencing of reforms, constant calibration of policies, and appropriate macro-financial management will minimize risks. At the same time, overemphasizing stability is not without cost and can lead to a mispricing of risk, misallocation of resources, depletion of buffers, and higher economic costs in the long term, including sharp adjustments and financial stress. Bond market development and opening up should therefore be accompanied by a clear strategy of containing vulnerabilities and building greater resilience (Chapter 10).

**Opening Up and Removing Obstacles**

Bond market development is taking place in the context of China’s broader economic and financial reforms and opening up policies to establish a mature market (Chapter 9). The bond market already plays a role in market-based financing, has reduced the cost of financing, facilitates macroeconomic management, and enhances resources available to support the economy. But important shortcomings still exist. Addressing these will not only be important to maintain financial stability and promote economic development, but will also be needed to foster use of the renminbi as a reserve currency.

The reform agenda is large, but should focus on improving market access, including for foreign investors; strengthening market liquidity and risk hedging; and moving toward a multitier custodian model. Other important areas are reducing investors’ information costs, as well as strengthening legal and accounting systems. And to ensure that foreign investors can confidently exit the market, a gradual further liberalization of the capital account will be needed.

From a foreign investor’s perspective, many hurdles to accessing China’s domestic capital market could be resolved in the short term because they tend to be more practical than regulatory or policy based (Chapter 11). Doing so would go a long way toward securing international investors’ commitment to China’s capital markets. Some of the obstacles, for example, include issues related to uncertainties about tax treatment. While at the end of 2018 the authorities announced a temporary three-year exemption for foreign institutional investors, many tax regulations—some of them preceding the launch of the CIBM Direct and Bond Connect programs—are difficult to interpret, leaving important questions about potential tax rates, calculation, and collection methodologies. In addition, while foreign official investors can access the China interbank foreign exchange and interest rate derivatives markets without constraints and foreign private sector investors can hedge in the onshore market up to the amount of their onshore cash bond holdings, in practice access has been very limited. Here, measures such as accepting the International Swaps and Derivatives Association’s master agreement—in addition to the one issued by the National Association of

16 On November 7, 2018, the Ministry of Finance and the State Administration of Taxation announced that the interest derived by foreign institutional investors from investments in China’s bond market would be exempt from withholding and value-added tax for three years.
Financial Market Institutional Investors—and allowing overall hedging limits at the investor or product level (that is, combining all positions under various programs) would make a big difference.

In general, fostering dialogue with market participants, particularly intermediaries such as commercial banks and global custodians, would allow authorities to issue more specific rules and guidelines on what can and cannot be done and minimize room for interpretation by the industry. In the current, increasingly stringent regulatory environment, general guidance is usually interpreted as strictly as possible by foreign market participants, making it difficult—if not impossible—for them to perform investment and hedging activities. Some practical suggestions include publishing positive lists of the practices allowed under each scenario based on real business cases and updating them regularly as new cases emerge. In addition, the authorities could consider using case studies to illustrate the required processes for application, investment, repatriation, and hedging. Experience shows that case studies are among the most effective tools to clarify rules and procedures, leading to faster take-up by the industry. Also, building on existing platforms when further opening up the domestic bond market would minimize additional setup costs.

**Strengthening Financial Market Stability**

The rapid development of the financial system presents constant challenges for financial regulators (Chapter 10). For example, at the end of 2016 a security brokerage firm (Sealand Securities) experienced a credit event on a repo, which quickly undermined market confidence. Banks began reducing short-term lending to nonbank financial institutions. Despite a coordinated credit rollover to prevent insolvency, interest rates surged, and repo and bond market liquidity quickly dried up.

Faced with such challenges, the Chinese authorities began tightening financial sector regulation in 2017, including by issuing new unified rules on collective investment vehicles, which had become an important vehicle for fixed income investors, as they typically promised fixed rates of return. The vehicles in turn hold most of China’s credit bonds in their investment portfolios. Regular reforms have largely contained financial stability risks, but given the dynamism of the financial system, it will be important to remain vigilant, and implementation of new unified rules on asset management products will be critical. In particular, it will be important to monitor rollover, default, and liquidity risks that could give rise to bond market volatility. In the case of rollover risks until 2020, credit bond rollover requirements will be high. With tightened regulation—especially for wealth management products—but also higher interest rates driven by the global tightening cycle, low-rated borrowers could face financing difficulties.

The authorities have rightly focused on addressing rising leverage in the economy, especially in the corporate sector and related to local state-owned companies. While the default rate is still relatively low, with continued deleveraging and allowing weak firms to exit, defaults are likely to increase. At the same time,
removing widespread implicit guarantees—paramount to ensuring better risk pricing and allocation of capital—can lead to repricing of credit risk in the bond market. As mentioned, bond market liquidity is relatively low and reflects the homogeneous investor base (collective investment vehicles and banks), which tends to hold bonds to maturity. Also, given perceived low credit risk, there is little incentive to actively manage credit risks through trading. Among other things, the implementation of the new regulatory regime could increase redemption pressure and hence lead to increased volatility.

**Trading Patterns**

Chinese bond market trading activity—as measured by the turnover ratio—is volatile by international standards and may pose risks to financial stability (Chapter 12). Bond trading volumes tend to fluctuate in sync with funding market conditions, falling during periods of tightening monetary conditions and rising during periods of easing. This cyclicality is likely shaped by several market structure features: the predominance of leveraged buy-to-hold investors (including investment vehicles), the lack of adequate hedging or shorting tools available to investors, and limited market-making activities.

Episodes of deteriorating bond trading volumes and market liquidity could amplify adverse shocks. In particular, the tendency for both trading and funding conditions to weaken at the same time implies that, in times of stress, market participants facing funding pressures could experience difficulties accessing liquidity when they need it most. This risks procyclical deterioration of both trading and funding liquidity that could lead to defaults. In the past, the authorities have injected liquidity to limit this vulnerability and avoid a pernicious tightening cycle. Such liquidity injections help stabilize markets but reinforce the perception of implicit guarantees.

To address financial vulnerabilities, including implicit guarantees, and enhance the transmission channel of monetary policy, Chinese policymakers should make improving bond market liquidity a priority. These measures should be aimed at increasing the availability of liquidity as well as at diversifying and broadening the investor base, especially by attracting more institutional investors, to foster demand for liquidity. Key supply-side priorities include strengthening market making and market structure, including by deepening derivatives and securities financing markets. Demand-side efforts should revolve around measures to broaden the set of investors sensitive to market prices, including foreign investors.

**Harmonizing Regulation**

As mentioned, China’s bond market is regulated by a multitude of agencies: the People’s Bank of China, the China Securities Regulatory Commission, the National Development and Reform Commission, and the Ministry of Finance; the National Association of Financial Market Institutional Investors also assumes part of the regulatory role through registration-based practices. The current
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regulatory structure is a reflection of China’s financial sector reform and liberalization strategy, as well as political economy considerations. For example, at a time when the CSRC was focusing on the development of the equity rather than the bond market, the People's Bank of China pressed ahead and established a separate interbank bond market.

Today, differences in rules and regulations are associated with higher information costs, market segmentation, and the potential for regulatory arbitrage. This calls for a harmonization of rules and regulations of, for example, bond issuance and information disclosures across different credit bonds. In September of 2017, an interministerial committee spearheaded by the People's Bank of China was tasked to work on unifying regulation.

Rating Agencies and Rating Issues

A well-functioning credit rating industry is crucial for the development of bond markets. In China, ratings from approved agencies are mandatory for most bond issuance, and often must meet a minimum rating requirement. Reflecting the development of the bond market, the rating industry has also gone through rapid expansion; at the end of 2017, there were 12 rating agencies (10 are domestic firms and 2 are joint ventures with foreign rating agencies). Until recently, while foreign rating agencies were permitted to rate Chinese bonds directly, these ratings were not recognized in the domestic market for regulatory purposes. Foreign investors—in turn—could only hold minority shares in joint ventures rather than majority-owned rating agencies. The nascent rating industry faces a few issues.

First, ratings of credit bonds appear highly skewed, with more than 95 percent of credit bonds rated AA or above, compared to less than 6 percent in the United States. This reflects both stringent issuance requirements and implicit guarantees constraining private sector access; in effect, China has been lacking a high-yielding market. Interestingly, though, despite the condensed rating distribution, there are relatively large variations of credit spreads within each rating category (Chapter 4). There is also a lack of dynamic adjustment in ratings, as often bonds are still rated at investment grade right before a default.

Second, reflecting the segmentation in the credit bond market, the regulation of rating agencies is also highly segmented. Rating companies need approval from different agencies to rate different types of credit bonds. For example, they need the CSRC’s approval to rate corporate bonds and the National Development and Reform Commission’s approval to rate enterprise bonds. Reflecting the

17 There are unrated private placements though.
18 Since April 2018, China has announced additional opening up measures, including removing foreign shareholding limits in the automobile industry, banks, and financial asset management companies, among others.
complicated approval process, so far only three rating agencies have approvals from all regulators and can rate the whole universe of credit bonds.\(^{19}\)

Following further opening measures in 2018, the three major global rating agencies (S&P, Moody’s, and Fitch) applied for licenses to establish wholly owned companies in China. Once established, these will help strengthen the credit culture and rating quality in the industry. The government has started to unify the regulation of rating agencies in the interbank and exchange markets, which will greatly benefit the rating industry and potentially lead to some consolidation within the industry, as the numerous agencies currently operating provide opportunities for rate shopping.

**SUPPORTING REFORMS AND STRENGTHENING POLICY FRAMEWORKS**

China’s bond market development is intricately linked to the successful implementation of supporting reforms, including strengthening corporate governance, reforming SOEs, and enacting measures to ensure the integrity and reliability of information about the performance of entities that issue bonds. As in any country, many of these reforms are difficult to implement because they face significant opposition from entrenched interest groups and, hence, require determination and political capital. In addition, communicating these steps ahead of time, combined with increasing consumer education about the rewards and risks of different types of financial investment, is also key.

Among measures that can be taken are tapering implicit guarantees, improving monetary and exchange rate frameworks, fostering communication, and strengthening capacity development.

**Tapering Implicit Guarantees**

The perception of implicit guarantees is deeply entrenched in the financial system, fostering widespread moral hazard and excessive risk taking by households, corporations, local governments, and financial institutions (Chapter 13). In the corporate bond market, such guarantees are evidenced by the low bond default rate, generous credit ratings, and compressed risk premiums. Even though the central government has repeatedly stated its ban on local government guarantees of corporate debt, SOEs and LGFVs are still largely shielded from default risk.

The dependence of local governments on central government fiscal support to achieve annual growth targets in the past highlights the challenge in dismantling implicit guarantees.

The authorities have taken steps to develop the institutional framework necessary for effective implementation of the corporate insolvency framework,\(^{19}\) China Chengxin International Credit Rating and China United Ratings conduct ratings on the exchange market through their subsidiaries.

\(^{19}\) China Chengxin International Credit Rating and China United Ratings conduct ratings on the exchange market through their subsidiaries.
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including enhancing the capacity of the judiciary to handle insolvency cases. And the number of insolvency cases has been increasing significantly, while until 2016 there were very few (Figure 1.8). Nonetheless, the total default rate in the corporate bond market remains low and the correlation between bond spreads and default events is still weak.

Careful sequencing of reforms is therefore needed to dismantle implicit guarantees. Radical change of the perception that guarantees are in place could lead to disruptive withdrawals—such as by retail investors from investment products or by short-term repo lenders—and quickly undermine the solvency of financial institutions and corporations. But implementing reforms gradually, before lifting implicit guarantees, could mitigate risks. Critically, these sequenced reforms should include strengthening market discipline and making further progress on developing legal and institutional insolvency frameworks that can promote timely restructuring of viable companies while ensuring effective and speedy exit of nonviable (zombie) firms.

Other reforms include improving data quality, increasing bank capital buffers to absorb losses associated with the removal of implicit guarantees (IMF 2017), establishing a financial sector resolution framework (including a robust framework for bond defaults at a time of potential market stress), and taking further steps to develop the institutional framework for corporate insolvency by enhancing the capacity of the judiciary to handle insolvency cases. These steps should go hand in hand with strengthening the social safety net so that, as incentives to keep nonviable firms open are eliminated, hardships on the population are minimized.

**Improving Monetary and Exchange Rate Frameworks**

The development of a country’s bond market and strengthening of its monetary policy frameworks are mutually reinforcing. On the one hand, a developed bond market helps in the efficient transmission of monetary policy to the economy; on the other, a modern interest rate–based monetary policy framework supports the development of bond markets.

In China, successive waves of interest rate liberalization have facilitated the transition to such a modern, price-based monetary policy framework (Chapter 14). While this process is not complete, the government in 2018 reiterated its commitment to deepen reforms and to make interest and exchange rates more market based (LI 2018). More recent progress, for example, includes deemphasizing

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20 China’s 2016 Enterprise Bankruptcy Law does not seem to deviate too much from best international practice. At the same time, it is a very concise law that might not provide responses for many complex problems in insolvency practice. See Maliszewski and others (2016).

21 Developing a robust CGB market would also have macroeconomic implications for fiscal policy and public debt management. Further strengthening the fiscal framework would also enhance market stability and macroeconomic policy effectiveness (see van Eden, Gentry, and Gupta 2017).
quantitative targets such as M2 (a broad measure of money supply that covers cash in circulation and all deposits) and total social financing.

Building on the progress made, managing liquidity by targeting a short-term interest rate—such as the 7-day interbank reverse-repo rate—and allowing other rates along the yield curve to adjust based on market conditions will strengthen monetary policy transmission and, hence, bond market development. These steps should be combined with less reliance on window guidance and deemphasizing benchmark interest rates.

As noted, bond market opening is part of China’s strategy to liberalize its capital accounts. Further capital account opening in turn needs to be carefully sequenced. Among other things, and in addition to an effective monetary policy framework and a resilient financial system, this calls for increased two-way exchange rate flexibility. This will minimize the risk from further global financial integration and ensure that monetary policy can respond based on domestic economic conditions.22

Figure 1.8. Credit Events, by Issuer, 2015–18
(Billions of renminbi)

Sources: WIND Economic Database (www.wind.com.cn); and authors’ estimates.

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22 See IMF (2018) for further discussion of strengthening China’s policy frameworks.
Fostering Communication

Bond markets transmit important signals of monetary policy to the broader economy. To increase the effectiveness of monetary policy and reduce financial market volatility, central banks increasingly use communication as an important lever (Chapter 14). The same is true for the People’s Bank of China. The People’s Bank of China also increasingly uses social media, where China already has more followers than the US Federal Reserve, the European Central Bank, and the Bank of England combined. Further strengthening China’s monetary policy communication will not only increase the efficiency of monetary policy, but will also positively affect bond market development itself by reducing uncertainty, making it more attractive for both domestic and foreign investors.

An empirical event study analyzing the impact of China’s traditional monetary policy communication channels on financial markets shows that changes in policy instruments are associated with market news (see Chapter 14). At the same time, they do not move the market too much, suggesting that the effectiveness of the People’s Bank of China’s communication remains limited.23 The release of the quarterly Monetary Policy Executive Report in turn reduces market volatility, suggesting that it contains operational details and sometimes forward guidance. Furthermore, oral communication through public speeches and press conferences calms markets. However, it is irregular and usually determined by market conditions. That even relatively small improvements in communication can be very beneficial is reflected in the impact of short “informative notices” that since 2016 have accompanied the People’s Bank of China’s open market operations. These short notices have strengthened the transmission channel of People’s Bank of China intervention to the market.

Overall, the analysis suggests that while the People’s Bank of China has made several improvements to its communication, it has not yet become as potent a policy tool as in many advanced economies and some important emerging markets. Greater operational central bank independence and transparency would help improve the effectiveness of the People’s Bank of China, including through forward guidance. Even though institutional changes take time and require significant political capital, “low-hanging fruit” exists that could be implemented quickly, such as making information available in a timely fashion, in one place, and in English; expanding the People’s Bank of China’s economic forecasting capacity and publishing forecasts regularly (as was done by the Bank of England before its independence), as well as making information available about the associated framework and models; and holding regular press conferences.

23 Traditional channels are Monetary Policy Executive Reports, press releases on monetary policy committee meetings, and speeches and press conferences. A novel channel is open market operation notices, with daily notices standard since January 2016. To better explain the rationale for these operations, the notices increasingly provide contextual information, such as, “given ample liquidity, the PBC intervenes to keep liquidity stable.”
More recently, the People’s Bank of China has taken additional steps to guide market expectations, including through more press conferences and interviews, explaining deeper analysis, and more informative Monetary Policy Executive Reports. In addition, at the end of 2018, the central bank set up a new working group to translate policy statements and news releases into English to better provide information to international investors (Bloomberg 2018).

**Strengthening Capacity**

The advent of new financial products often leads to a migration of risks, regulatory arbitrage, and the development of new risks that need to be monitored and appropriately regulated. Case studies from other countries show how important it is that financial sector liberalization and development is not only accompanied by a constant upgrading of regulation and supervision, but also by strengthening the capacity of regulators and supervisors.24

As noted, China’s bond market has developed very rapidly. This trend is likely to continue and be combined with the development of new and more complex products and markets such as the derivatives market. The latter will be important to boost bond liquidity and allow investors to better hedge risks. Yet, as in other countries, these developments present constant challenges for regulators and supervisors. As highlighted in the 2017 Financial Sector Assessment Program (IMF 2017), an important challenge is staffing. Headquarters staffing at key regulatory agencies, such as the CSRC, the China Banking and Insurance Regulatory Commission, the People’s Bank of China, and the Ministry of Finance, is very small in absolute and relative terms (between 700 and 1,000 people). In addition, the staffing levels have remained broadly constant despite the rapid development of the bond market (Figure 1.9).

Thus, adequate headquarters staffing will be critical, along with relevant practical market experience, to stay current. This requires competitive salaries to retain qualified staff, as well as staff with both domestic and global market experience.

**OFFSHORE MARKET**

China’s domestic (onshore) bond market development has been intricately linked to its offshore market. Some of China’s onshore market reforms and opening up, for example, were guided by prior offshore market experiences. Also, in line with the capital account liberalization strategy, China first allowed domestic corporations to tap offshore markets (in both renminbi and in US dollars) before opening up its domestic bond markets to foreign investors. The offshore market will

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24 A well-known example of how developments—following financial sector regulation—can lead to financial stress and the mushrooming of new financial products without upgrading the capacity, resources, and incentives of regulators and supervisors is offered in the United States savings and loan crisis in the 1980s (Mishkin 1999).
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continue to complement the onshore market and play an important role in guiding domestic (onshore) bond market reforms.

Offshore Renminbi Dim Sum Bonds

As in other countries, foreign investors can use offshore markets to raise funds and increase their exposure to a country. This is especially true for the Hong Kong SAR offshore market, where bonds can be issued in renminbi, usually known as dim sum bonds (Chapter 15).\(^\text{25}\) While the first dim sum bonds were issued by the China Development Bank in Hong Kong SAR in 2007, reforms that allowed direct investments—initiated by the People’s Bank of China and the Ministry of Commerce in 2011—initially fostered the rapid growth of the dim sum bond market. This allowed foreign companies in search of offshore renminbi funds to support business in the onshore market (foreign direct investment) and for mainland firms to support outward direct investment through Hong Kong SAR.

Since then, the universe of dim sum bond issuers has diversified and now includes multinationals, mainland Chinese companies, and companies doing

\[^{25}\] Dim sum bonds draw their name from a popular Hong Kong SAR dish. McDonald’s was the first foreign nonfinancial company to issue a dim sum bond, in 2010.
business in Hong Kong SAR. Mainland Chinese firms often set up subsidiaries or special purpose vehicles to raise funds. For this reason, almost 30 percent of bond issuers are nonbank financial institutions. Real estate companies in turn also play an important part, comprising almost 20 percent of bond issuers.26

An empirical analysis suggests that onshore-offshore yield differentials, outward direct investment growth, and mainland China’s macroeconomic conditions are key factors driving the dim sum bond market. So are the renminbi nominal effective exchange rate and hedging costs, as well as policy uncertainty. The growing integration of capital markets between mainland China and Hong Kong SAR, such as through the launch of the Bond Connect program, is expanding the choice of renminbi assets available to offshore investors. Given the free flow of capital, a highly accessible market, and internationally recognized strong legal and regulatory frameworks, even with a further opening of the onshore financial markets, the dim sum bond market is likely to remain an attractive platform for international and mainland issuers to tap renminbi funds outside China.

**Offshore Corporate Dollar Bonds**

Like the dim sum bond market, China’s offshore corporate dollar bond issuance has increased sharply, especially since 2012.27 This trend took place against the backdrop of rising capital flows to emerging market economies, as well as China’s own efforts to liberalize its capital account.

Firm-level analysis suggests that the surge in China’s offshore corporate dollar bonds in 2012–15—and the subsequent contraction in 2015–16—resembled the characteristics of carry trades, in line with experiences in other countries (Chapter 16). Evidence is strong of cyclicality in US dollar bond issuance/re redemption by Chinese nonfinancial corporations, which also has driven China’s capital account balances in recent years. US dollar bond issuance tends to rise when China’s economic policy uncertainty is low, global financial market conditions are accommodative, and the renminbi is strengthening against the US dollar. The analysis also suggests that there are differences across sectors, possibly reflecting firms’ different business models and their unequal access to domestic financing sources. In addition, US dollar bond issuance is negatively correlated with firms’ external financial dependence. This is consistent with the pecking-order

26 In addition, offshore Treasury bonds are an integral part of the dim sum bond market, serving as a pricing benchmark. In 2009, the Ministry of Finance issued RMB 6 billion Treasury bonds in Hong Kong SAR with maturities of two, three, and five years, marking the launch of the offshore China government bond market. Since then, RMB China government bonds have continuously been issued in Hong Kong SAR, becoming an important part of dim sum bonds and providing benchmark pricing for the market.

27 Offshore Treasury bonds in Hong Kong SAR also include China government bonds issued in US dollars. In October 2017, the Ministry of Finance issued $2 billion Treasury bonds in Hong Kong SAR, with maturities of 5 and 10 years, marking the launch of the offshore dollar CGB market in Hong Kong SAR. It was the first dollar-denominated bond issuance since 2004 and helped to provide a benchmark for the pricing of offshore corporate dollar bonds.
theory that the offshore bond market is usually the last resort of financing for corporations. It is surprising that US dollar bond issuers tend to invest less in fixed assets and inventories—another sign that firms tend to view access to the offshore dollar bond market as a channel to conduct carry trade activities rather than as a financing source to support investment.

Since the surge in China's offshore corporate dollar bonds demonstrates characteristics of carry trade rather than longer-term corporate investment, and to the extent that associated capital flows could carry risks for macroeconomic and financial stability—especially if they are large and volatile, as demonstrated by the large swings of China's capital account balance between 2013 and 2015—they need to be carefully managed. Primarily associated capital flow pressures should rely on macroeconomic policies, including an effectively floating exchange rate (IMF 2018). Further strengthening of micro- and macroprudential frameworks could mitigate the procyclical buildup of systemic risk over the financial cycle. The “macroprudential assessment framework for cross-border financing” that the Chinese authorities have developed since 2016 is more predictable and transparent than the previous capital flow management framework and can be used to address risks arising from excessive cross-border financing and mismatches (that is, currency, maturity, on/off balance sheet), but should not be used to actively manage the capital flow cycle and substitute for exchange rate flexibility.

Going forward, the liberalization of China’s capital account should be gradual, carefully sequenced, and paced with supporting reforms that include an effective monetary policy framework, a sound financial system, reduced fiscal dominance, and more exchange rate flexibility (IMF 2018).

CONCLUSIONS

The future of China’s bond market is bright, and its continued development and further opening will bring significant benefits for China and the world. But this needs to go hand in hand with a strengthening and harmonization of financial sector frameworks, supportive macrofinancial structural reforms (including removing implicit guarantees, imposing hard budget constraints, and strengthening corporate governance), the elimination of obstacles for both domestic and foreign investors, good communication, and better capacity building. The following chapters analyze the country’s bond market in depth and—based on best international practice—make practical policy recommendations.

REFERENCES


