Challenges to and Opportunities for Investing in China Bond Markets

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I will give an overview of China bond market development, its achievements and the future prospects of China bond fund market. Furthermore, I will discuss the challenges to and opportunities for investing in China bond markets via QFII scheme based on my experience running China first bond fund.

Background and Story of Growth

China bond market started in 1981 when the government resumed issuing government debt, and it has been continuously developing throughout the last 20 years. This development has been through three major stages: the preliminary bearer bonds OTC market, the stock exchange as a main trading place, and the current inter-bank OTC market. In the last two or three years, the Chinese bond market has gained significantly in both its depth and width. At the end of the year 2002, the outstanding balance of China Government (CGB), Financial Policy and Corporate Bonds are 1933.6 billion RMB, 1005.4 billion RMB and 133.3 billion RMB respectively. Among which the Corporate Bond accounts for less than 5%. (*See table one*). In 2002, the CGB issuance was 593.4 billion RMB, which was 21.5% higher than the amount issued in 2001. It broke the historical record and accounted for 18.9% of GDP, while the total outstanding balance of the CGB is 61.3% of GDP. (*See Table two*). In the first half of 2003, cash bonds trading volume is RMB 1.01 trillion, increasing by RMB 761.5 Billion, a 300% increase than the same period of 2002 and REPO volume is RMB 5.04 Trillion, increase by 15.6%. Various forms of products of the CGB and the Policy Financial Bond have been created in 2002 including fixed-rated, floating-rated, puttable, callable, and stripable. Complete yield curves have been established with their maturities ranging from one year to 30 years, though the rationality of the shape of the curves is debatable. (*See Figure one*). The convertible bond as an alternative financing tool re-emerged after many years of hibernation, raising 4.3 billion RMB in 2002. The convertible bond issuance has picked up dramatically with different features and provisions introduced in 2003 and the total issuance as of August 2003 has surpassed RMB 25 billion. Lastly, the Mortgages Backed Securities (MBS) and Assets Backed Securities (ABS) are expected to roll out soon.

Secondary bond market trading has been getting much more active with spot trading and REPO trading volumes at 1312 billion RMB and 12630 billion RMB respectively. While they are 132% and 127% higher than year 2001, the trading liquidity has a long way to go to catch up with the more developed markets such as the U.S. and South Korea. The spot turnover rate in China is only 0.4 which is much less than 22 of the U.S. and 12 of the South Korea. (*See Table Three*).

Table 1: China's Bond Market Scope and Structure

Year	CGB Balance	CGB Percentage	Policy Financial Bond Balance	Policy Financial Bond Percentage	Corporate Bond Balance	Corporate Bond Percentage
1997	5548	57.4%	3491	36.1%	633	6.5%
1998	7766	57.3%	5121	37.8%	677	5.0%
1999	10524	59.3%	6447	36.3%	779	4.4%
2000	13674	62.4%	7383	33.7%	862	3.9%
2001	15618	62.1%	8534	33.9%	1009	4.0%
2002	19336	62.9%	10054	32.7%	1334	4.3%

Sources: Quarterly statistics reports from the People's Bank of China

Table 2: Statistics of China's Government Bond Issuance (Unit: 100M RMB)

Year	Issued Amounts	Maturities	Balance	Balance/GDP
1997	2412	2-10y	5548	7.5%
1998	3809	3-10y	7766	9.9%
1999	4015	3-10y	10524	12.8%
2000	4657	1-10y	13674	15.3%
2001	4884	3-20y	15618	16.3%
2002	5934	3-30y	19336	18.9%

Note: 20 billion one year bill was issued in year 2000

Sources: Quarterly statistics reports from the People's Bank of China, Sorted by Dr. Zhang Jingguo

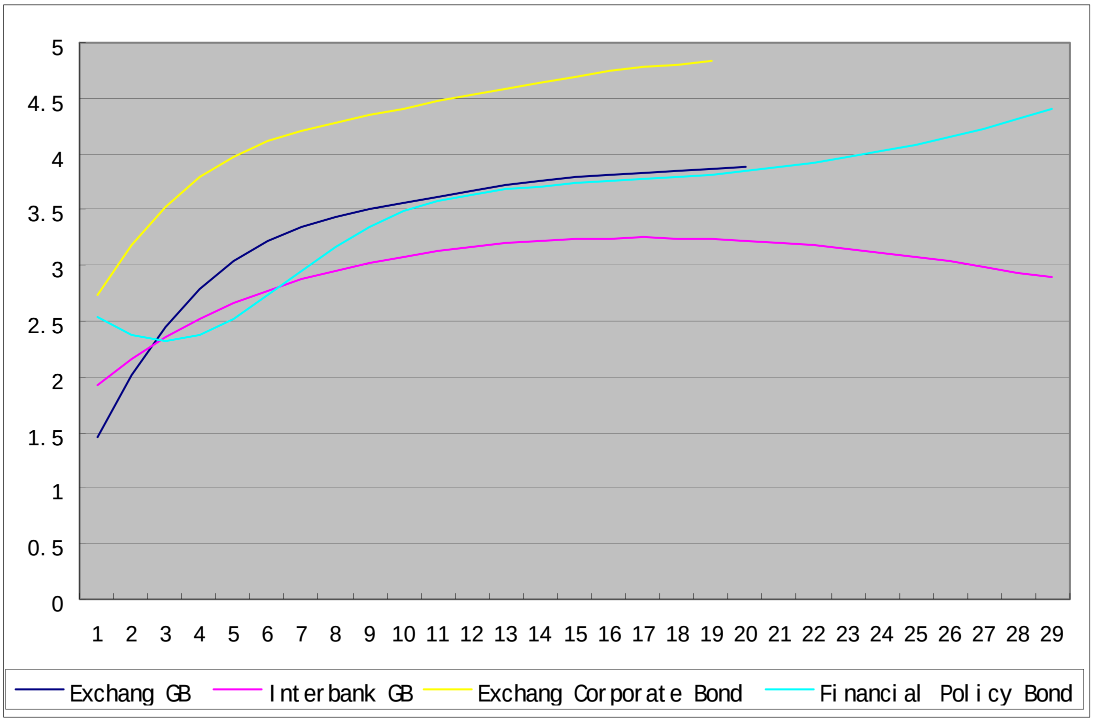
Table 3: Statistics of China's Bond Market Development (Unit: 100M RMB)

Year	Balance	Growth Rate	Spot Trading	Growth Rate	Repo	Growth Rate	Spot Trading/Balance
1999	17750	31%	5376	-12%	16745	1%	30%
2000	21919	24%	4840	-10%	30515	82%	22%
2001	25161	15%	5655	17%	55621	82%	23%
2002	30724	22%	13120	132%	126305	127%	43%

Note: Data includes interbank and exchange places

Sources: Quarterly statistics report from the People Bank of China

Figure 1: Spot Curves of China Bond Market (As of Sept. 24th, 2003)



Sources: Huiyang Quant LTD

Market Development

Since 1999, particularly since China joined the WTO, the China bond market infrastructure has improved substantially. Below are just some measures that have been carried out in recent years: a primary dealership system, two-way quoters or a preliminary market makers system, a clean price trading and a master REPO agreement. The year 2002 witnessed a lot of innovation: American style auctions, old issues reopening, trading commission reduction, cross markets custodian and trial of Delivery vs. Payment (DVP) settlement by China Government Securities Depository Trust & Clearing Co., LTD. Since the beginning of 2003, the newly formed 4th generation leaders are in place and Dr. Zhou Xiaochuan, new appointed governor of the People Bank of China (PBC), and Mr. Shang Fulin, new Chairman of the China Securities Regulatory Commission (CSRC), are clearly focusing on reforming more of the bond market. Fiscal and monetary policies will be carried out accordingly as China economy faces more uncertainties down the road. Meanwhile, the bond market as part of the capital market will play a more and more important role in helping both the State Owned Enterprises (SOEs) and the Small Medium Enterprises (SMEs) with their financing needs. Improving monetary transforming mechanism and liberating interest rate gradually are on the top of their agenda, and as a result market development has, and will continue to be accelerated. Since the beginning of 2003, the Ministry of Finance announced the CGB auction timetable with 7-year notes to be issued every quarter, the PBC is having Open Market Operation happen twice a week, and both exchanges allowed the Corporate Bond can be REPOed and rolled out new Bond Indices. All these reforms and measures are very helpful for both the bond market and bond fund market.

Bond Fund Market

Is China bond market ripe for the investment funds? The answer is yes. The demand for low risk stable return investment vehicles has been tremendous since the Chinese equities market peaked in July of 2001. It is pellucid that the National Warfare Fund, Social Security Fund and Enterprise Annuity Fund (which have 124 billion, 300 billion and 26 billion RMB respectively) need to be invested. The other large chunk of funds comes from the insurance companies. In August of 2002, China Southern Fund Management LTD launched its Baoyuan Fixed Income Fund, China first bond fund, and it was well received. The fund raised 4.92 billion RMB during the one-month subscription period and became the largest fund at the time. In May 2003, Baoyuan Fixed Income Fund issued 3.1 cents dividend, the Principal Guaranteed Fund was launched and RMB 5.2 billion was raised. At the end of August 2003, total bond fund asset is roughly RMB 25 billion that is less than 20% of total mutual fund assets. The prospect for China bond fund market is very bright.

The role of foreign institutions

In spite of China newly earned fame as an emerging market flagship, foreign institutions have left their footprints in the middle kingdom as early as 200 years ago. Citibank, Standard Charters, HSBC were among the earliest commercial banks exploring the waters in old China. As of Aug. 2003, seven western institutions from the US, Europe and Japan were granted the QFII (Qualified Foreign Institutional Investor) status, which entails greater access to China domestic market and flexible foreign exchange arrangements for their capital flows. The trend is clear and the momentum is strong – China financial markets are due to become a world-class platform for investors and institutions from around the globe. China has made impressive progress and will continue doing so in the future years as a newly inducted member of the World Trade Organization (WTO). Along with other globalization initiatives, it has promised to open its financial market on an accelerated schedule. In the next two-three years, foreign investment management companies can hold up to 49% of equity in domestic funds (the current limit is 33%). Foreign securities firms may hold up to 1/3 of equity in a joint-venture that directly conducts equity underwriting, corporate and government underwriting and trading activities, as well as managing investment funds for domestic and foreign investors. In the foreseeable near future, China market environment will become even more favorable to overseas companies. Interest rates will be determined by market supply and demand, the RMB will become fully convertible, market mechanisms will mature to meet the demand of sophisticated investors, and foreign ownership in almost all industries in China will increase significantly. Asset quality will also improve with better transparency and higher liquidity. Overseas investors will gain easier and more reliable access to the market, either to diversify their global investment portfolio, or to participate in China robust growth.

Suggestions

Finally, we are here providing some concrete suggestions on how to improve China bond market liquidity and some other issues. Based on my experience managing China first bond fund, I put forward the following:

1. Unify the exchange place bond market and inter-bank bond market.
2. Issue inflation-indexed CGB.

3 Allow Qualified Foreign Institution Investors (QFII) to participate more.
4 Create inter-dealer brokers (IDB): IDB will provide human interactions between brokers and traders, real and live screen trading, pricing transparency and anonymity in trading. Based on the emerging market such as Brady Bond trading experience, the IDB is the simplest and best way to improve the bond market liquidity.
5 Introduce some basic fixed income derivatives: open style REPO trading and forward trading. Open style REPO trading will improve spot trading liquidity. With forward trading introduced, the cash/forward arbitraging business can be practiced. Because of the existence of no arbitraging, the pricing curve can be constructed to price other financial derivatives such as swaps and bond options.
6 Introduce When-Issued trading (W.I.): W.I. trading can be used to find market expectation of the coming bond auctions and this will greatly reduce the risk of the Winners' Curse which was experienced by many dealers and investors last year.
7 Develop the Corporate Bond Market: Relax the approval process. The restriction that the coupon rate cannot be over 40% higher than the respective bank savings rate should be relaxed; otherwise the credit spread is not wide enough to compensate the default risk. Introduce competitive credit rating mechanisms; use two independent credit rating agencies, review credit ratings annually and remove the corporate bond guarantee by banks for those issuers with a stable cash flow.

In conclusion, China bond market is ripe for investment funds and this is an exciting time to build a franchise in China bond fund business. Thank you.

Biography of John Huai-zhong Li

John Huai-zhong Li, native Chinese, Graduates of Tsinghua University and Carnegie Mellon Business School, have more than 10 years investment and industry experience in the U.S. and China. Held industrial positions at Nestle and Salk Institute and investment management positions at Deutsche Morgan Grenfell, Deutsche Bank Securities, Vega Fund and Southern China Fund Management.

From August 2001 to July 2003, Mr. Li joined Southern China Fund Management (SCFM) as Director of Fund Management and Head of Fixed Income Investing. Mr. Li managed total RMB 8 Billion assets including China first fixed income fund (launched in 2002 and raised 4.94 billion) for both institutional and retailer investors and achieved outstanding track record. Mr. Li is now the Managing Partner of Simon Murray & Co. China LTD focusing on China asset management business.