

**MONTHLY HIGHLIGHTS**

- TR/HKEX RXY Global CNH index rose 0.09 per cent to 95.85 while the People’s Bank of China (PBOC) USD/CNY Fixing increased 0.30 per cent to 6.6511 in July 2016.
- HKEX’s Chief China Economist, Dr Ba Shusong, sees that in the current low interest rate environment across the globe, the bond market opening will increase the policy flexibility to support China’s leverage transfer, facilitate price discovery of the equilibrium RMB exchange rates and promote the process of RMB internationalisation.
- In the Expert Corner, Bank of Communications’ Chief Economist, Mr Lian Ping, sees that monetary policies of China should remain generally robust with an easing bias, while structural and directional adjustment should be strengthened to guide capital into the real economy and needy sectors.

**FROM THE CHIEF CHINA ECONOMIST’S VANTAGE POINT**

**Bond Markets Opening Support Discovery of Equilibrium RMB Exchange Rates and China’s Leverage Transfer**

**Dr Ba Shusong, Chief China Economist, HKEX**

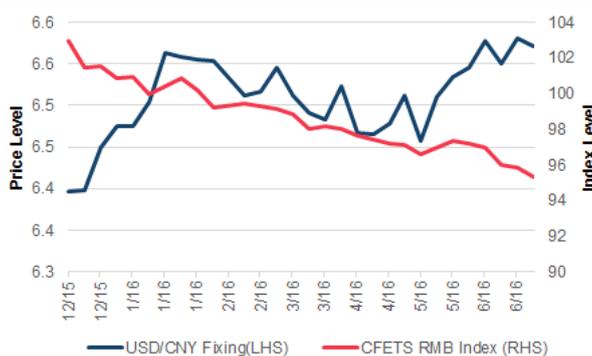
Since the beginning of 2016, Mainland policies have been supporting the opening up of the Mainland bond market. Research shows that in the current low interest rate environment across the globe, stepping up bond market opening will increase the flexibility of policies that support China’s leverage transfer, help to discover the balanced RMB exchange rates and promote the process of RMB internationalisation.

**Promoting the diversification of the investor structure would help improve the efficiency of discovering the market equilibrium price for RMB exchange rate**

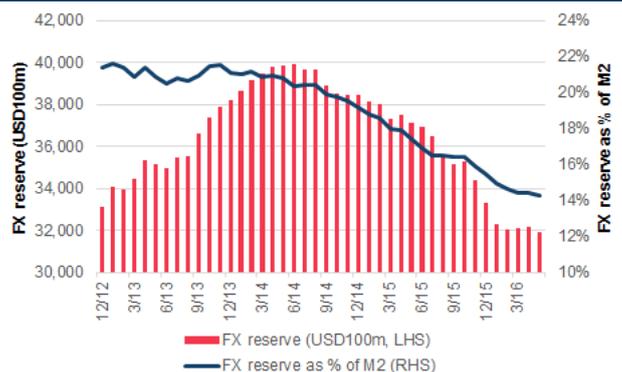
After the exchange rate reform on 11 August 2015, the spot rate of USD/RMB has fluctuated within a broader trading band (Fig. 1), reflecting that FX market participants did not expect much fluctuation in the RMB exchange rate in the short term. According to the 2016 Q1 China Monetary Policy Implementation Report released by the PBOC on 6 May 2016, the formation mechanism of the current RMB/USD fixing is a combination of the close price of RMB/USD rate and the exchange rate movements of a basket of currencies. The close price of the RMB/USD rate reflects the demand and supply in the FX market while the exchange rate movements of a basket of currencies indicate the adjustment required to maintain the stability of the RMB’s exchange rates against a basket of currencies. It implies the effective exchange rates of the RMB against a basket of currencies are meant to achieve policy objectives, mainly to improve exchange rate policy flexibilities and monetary policy effectiveness. The discussions around RMB/USD rate are largely about the demand and supply in the FX market and movements in the US dollar’s exchange rates, with the key being the demand and supply reflected in the international balance of payments. In this context, although China Foreign Exchange Trade System (CFETS)’s RMB index does not suggest any substantial decline in the intrinsic value of the RMB, FX trading indicates that there are expectations of RMB depreciation.

Market saw increased fluctuations in the foreign exchange reserve during this period. Continuous FX interference dragged down China’s foreign exchange reserve adequacy ratio (FX reserve/ M2) from 18.80 per cent in early 2015 to 14.26 per cent at the end of May 2016 (Fig. 2). While it is still within the reasonable range of 10-20 per cent, it shows the PBOC requires new hedging forces to offset the trend besides its interference in the FX market. In the current market environment, further opening up the bond market can help.

**Fig 1: USD/CNY Fixing and CFETS RMB Index**



**Fig 2: FX Reserve Level and FX Reserve Adequacy Ratio**



(to be continued on page 9)

Fig 3: Chart of the Month: TR/HKEX RXY Global CNH vs US Dollar Currency Index

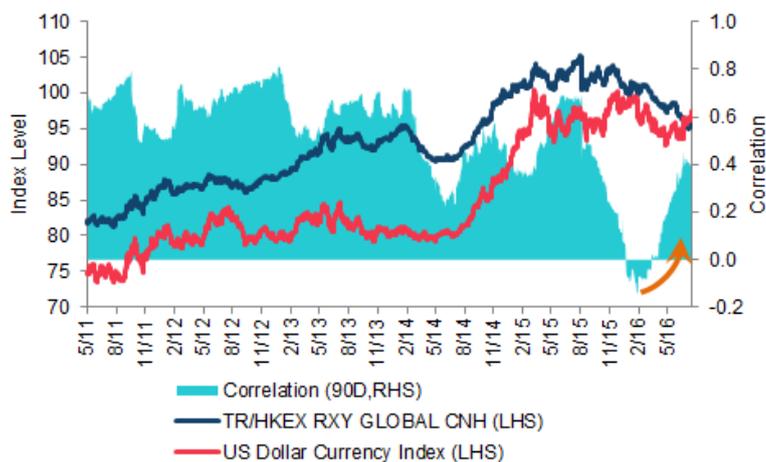
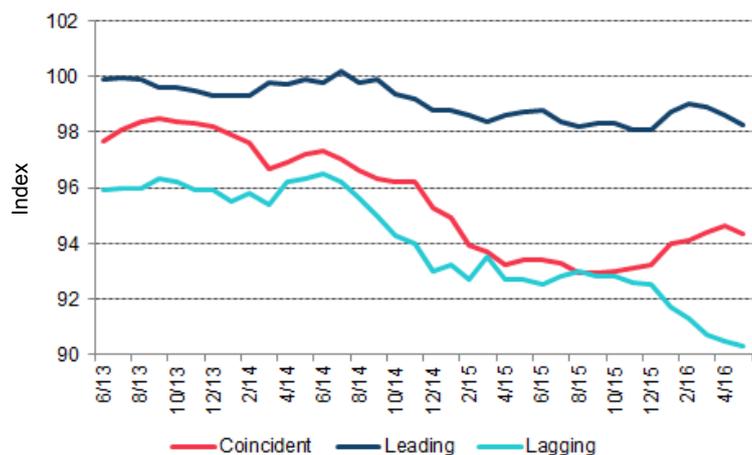


Fig 4: China's Macro-Economic Climate Index



- The coincident index is the index reflecting the current basic trend of the economy, and it is calculated using the following data: (1) industrial production; (2) employment; (3) social demands (including investment, consumption and foreign trade); and (4) social incomes (including the government taxes, profits of enterprises and income of residents).
- The leading index is calculated using a group of leading indicators, which take a lead before the coincident index, and is used for forecasting the future economic trend.
- The lagging index is calculated using the lagging indicators, which lag behind the coincident index, and is mainly used for confirming the peak and trough of the economic cycle.

TABLE 1

China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.7	6.7	↔	10/19/2016
CPI (yoy %)	1.9	2.0	↓	08/09/2016
PPI (yoy %)	-2.6	-2.8	↑	08/09/2016
Industrial Production (yoy %)	6.2	6.0	↑	08/12/2016
FAI (yoy %)	9.0	9.6	↓	08/12/2016
Foreign Investment (yoy %)	9.7	-1	↑	08/08/2016
CFLP Manufacturing PMI	49.9	50.0	↓	08/01/2016
PBOC Bankers Confidence Index	43.7	38.1	↑	TBC
PBOC Bankers Loan Demand Index	56.7	62.7	↓	TBC
Share of Payments via SWIFT in CNY (%)	1.72	1.90	↓	08/25/2016
Exports (yoy %)	-4.8	-4.1	↓	08/08/2016
Imports (yoy %)	-8.4	-0.4	↓	08/08/2016
M2 Money Supply (yoy %)	11.8	11.8	↔	08/10/2016
Retail Sales (yoy %)	10.6	10.0	↑	08/12/2016
Consumer Confidence Index	114.0	115.9	↓	08/31/2016
Regulated Reserve Ratio (%)	17.5	18.0	↓	Infrequent
Official Foreign Exchange Reserves (USD bn)	3205.2	3191.7	↑	08/07/2016
Three-Month SHIBOR (%)	2.84	2.96	↓	Continuous
10-Year Gov't Bond Yield (%)	2.80	2.95	↓	Continuous
CNY/USD Exchange Rate	6.63	6.57	↑	Continuous
TR/HKEX RXY Global CNH Index	95.85	95.76	↑	Continuous

CHART OF THE MONTH

- The correlation between TR/HKEX RXY Global CNH and US Dollar Currency Index was relatively high, with a historical average level of 0.75. Following the PBOC's USD/CNY fixing regime reform announced on 11 August 2015, the correlation had dropped significantly to the negative territory before rebounding back to 0.4, which is still lower than its historical average level.

REGULATORY/POLICY DEVELOPMENTS

- China's FX market regulator, State Administration of Foreign Exchange (SAFE), stated on 21 July 2016 that cross-border capital outflow pressure has been steadily easing. The quarterly net FX sales by Mainland commercial banks has dropped from USD124.8 billion in Q1 2016 to USD49.0 billion in Q2 2016. China will be able to keep cross-border capital flows steady given its relatively sound economic fundamentals, solid current account surplus and ample foreign exchange reserves, said SAFE spokeswoman Wang Chunying.
- The PBOC's Governor, Zhou Xiaochuan, said at the G20 meeting of finance ministers and central bankers on 24 July 2016 that China would continue to refer to a currency basket in the USD/CNY fixing. He further stated that the regulator would continue to promote transparency of FX regulation and improve communications with market participants.
- The CFETS will require foreign banks that trade RMB forwards to keep an amount equivalent to 20 percent of their positions in reserve, increasing the cost of speculations against RMB. CFETS, which is run by the PBOC, said the rule will apply to foreign banks which conduct forward sales offshore and offset these with onshore counter-trades. It came into effect on 15 August.

MACRO ECONOMIC UPDATE

- Sheng Songcheng, head of the PBOC's statistics and analysis department, acknowledged at the 2016 China Asset Management Annual Conference on 17 July 2016 that monetary policy in China is facing a 'liquidity trap', with substantial money supply failing to lift real growth. He said that rapid M1 growth is due to multiple factors, including corporates' weak investment appetite, narrowing interest rates between demand deposits and time deposits, local government debt-swap plans, and a surge in property sales. Sheng argued that to achieve growth, proactive fiscal policy is needed to accompany the already-accommodative monetary policy.

MARKET/PRODUCT DEVELOPMENTS

- The PBOC's Governor, Zhou Xiaochuan, said at the G20 meeting of finance ministers and central bankers on 24 July 2016 that China is studying the possibility of introducing SDR-denominated bonds in the domestic market. This will help to further improve RMB's role as a reserve currency in the post-Brexit world.
- Data from Society for Worldwide Interbank Financial Telecommunication (SWIFT)'s RMB Tracker for July 2016 shows that despite RMB's continued growth globally, the Canadian dollar has overtaken the RMB with a 1.96 per cent share of world payments currencies, leaving the RMB at a position of number six with a 1.72 per cent share in June. The data marks a gradual, but expected, slowdown for the currency in 2016 as it continues on its path to internationalisation.

## RMB FX MARKET DYNAMICS

### OFFSHORE USD/RMB

- In July 2016, USD/CNY fixings moved between 6.6472 and 6.6971, and CNH was trading 0.6 per cent higher versus the US dollar from a month ago, as the PBOC lowered the CNY fixing to 6.6971 on 19 July 2016, the weakest level in five-and-a-half years. Subsequently, the CNY rose to a three-week high on 28 July 2016, as the US Federal Reserve left the benchmark rate unchanged.
- The International Monetary Fund (IMF) said in its 2016 External Sector Report on 27 July 2016 that the RMB was broadly in line with fundamentals and desirable policies. It is expected that pressure on China's foreign exchange reserves will remain manageable, as the volume of capital outflows is expected to be broadly steady with residents' portfolio rebalancing toward foreign assets due to the gradual opening of the capital account.

Fig 5: Onshore/Offshore RMB Price Range

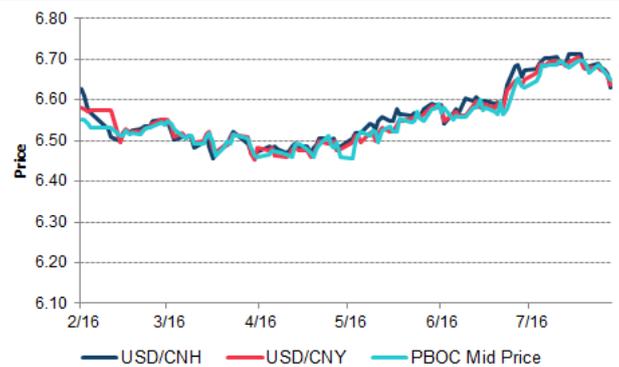


Fig 6: Implied Volatilities of OTC USD/CNH ATM Options

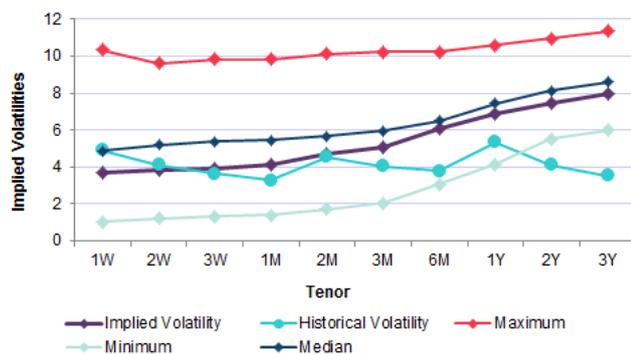


Fig 7: Market Forecasts for the Level of USD/CNH



## HKEX'S USD/CNH FUTURES

### PRODUCT HIGHLIGHTS

- Open interest (OI) was 27,467 contracts (US\$2.7 billion notional) as of the end of July 2016.
- Trading volume was high in the Aug-16, Sep-16, and Dec-16 contracts, which accounted for 63.3 per cent of total volume in July 2016. Open interest concentrated in the Sep-16, Dec-16, and Mar-17 contracts, accounting for 74.6 per cent of total open interest at the end of July 2016.

Fig 8: USD/CNH Futures Turnover and Open Interest



Fig 9: HKEX USD/CNH Futures Contract Provides Best Liquidity in Volatile Market

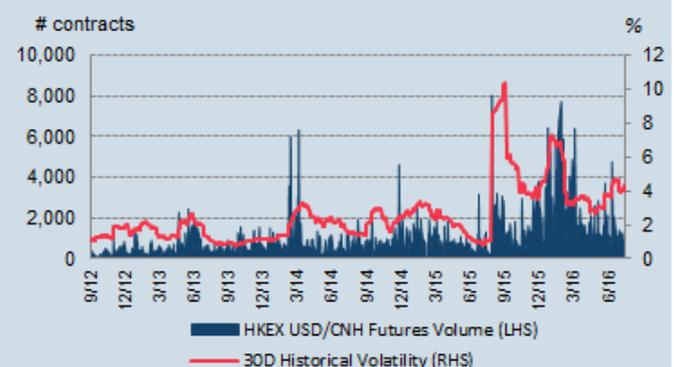


Fig 10: Breakdown of Volume by Contract Month (7/2016)

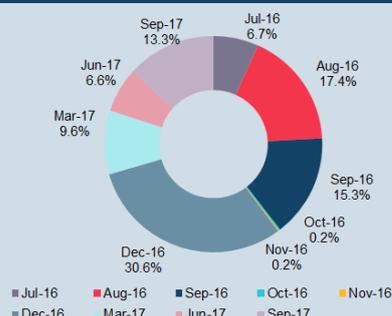
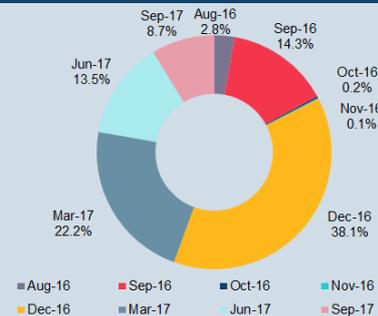


Fig 11: Breakdown of OI by Contract Month (29/7/2016)



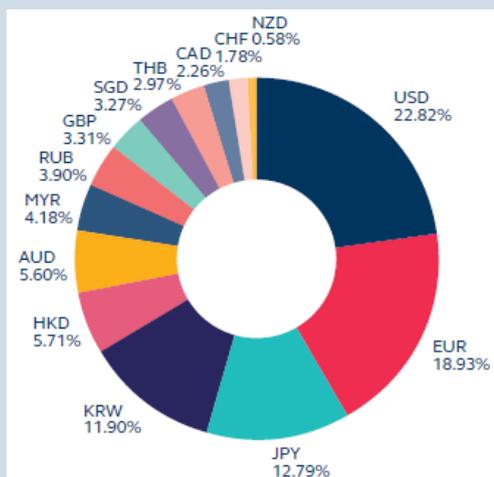
## TR/HKEX RMB CURRENCY INDICES (RXY)

### PRODUCT HIGHLIGHTS

- The RXY indices offer independent, transparent and timely benchmarks for RMB against Mainland China's most important trade partners' currencies.
- The indices are calculated based on WM/Reuters foreign exchange rates (WM/Reuters FX Rates) and managed in accordance with the IOSCO (International Organisation of Securities Commissions) principles for financial benchmarks.
- The RXY indices are designed to be the basis for investment and trading products such as futures, options and exchange traded funds.

Fig 12: TR/HKEX RXY Global CNH Currency Index

Index Weights: Valid Until 30 September 2016



- TR/HKEX RXY Global CNH index rose 0.09 per cent to 95.85 while the PBOC USD/CNY Fixing increased 0.30 per cent to 6.6511 in July 2016.
- The largest contributor to the performance of the TR/HKEX RXY Global CNH Index in July 2016 was the KRW, which appreciated 2.75 per cent against the USD during the same period of time.

## METHODOLOGY

- Calculation Method:** Geometric Average
- Weighting Method:** Bilateral trade weighted with adjustment for Hong Kong re-exports
- Trade Data Source:** UN Comtrade, Hong Kong Census and Statistics Department
- Weighting Rebalance:** Annual review. Announcement in June, Implementation on the first business day of Q4
- Calculation Frequency:** Hourly
- FX Rate Data Source:** WM/Reuters FX Rates
- Base Date:** 100 as of 31 December 2014

For more details, a complete methodology document is available at: [financial.thomsonreuters.com/fxindices](http://financial.thomsonreuters.com/fxindices)

TABLE 2: Index Weights

Currency	RXY Global Currency Indices	RXY Reference Currency Indices	CFETS RMB Index
USD	22.82%	25.89%	26.40%
EUR	18.93%	21.49%	21.39%
JPY	12.79%	14.52%	14.68%
KRW	11.90%	0.00%	0.00%
HKD	5.71%	6.48%	6.55%
AUD	5.60%	6.36%	6.27%
MYR	4.18%	4.74%	4.67%
RUB	3.90%	4.43%	4.36%
GBP	3.31%	3.75%	3.86%
SGD	3.27%	3.71%	3.82%
THB	2.97%	3.38%	3.33%
CAD	2.26%	2.57%	2.53%
CHF	1.78%	2.02%	1.51%
NZD	0.58%	0.66%	0.65%

TABLE 3: Summary Table for TR/HKEX RMB CURRENCY INDICES

Indices	Return					Risk				
	2016/7/1 - 2016/7/29 (Month)	2016/6/1 - 2016/6/30 (Month)	Chg	MTD	YTD	30-Day Realized Volatility (as of 2016/7/29)	30-Day Realized Volatility (as of 2016/6/30)	Chg	Correlation with China Foreign Exchange Trade System (CFETS) RMB Index	Beta <sup>(1)</sup> vs CFETS RMB Index
TR/HKEX RXY Global CNH (RXYH)	0.09%	-2.72%	↑	0.09%	-4.68%	3.44%	3.44%	↑	0.98	0.69
TR/HKEX RXY Global CNY (RXYC)	-0.05%	-2.57%	↑	-0.05%	-5.73%	3.40%	3.79%	↓	0.98	0.67
TR/HKEX RXY Reference CNH (RXYRH)	0.48%	-2.50%	↑	0.48%	-4.54%	3.31%	4.22%	↓	0.98	0.64
TR/HKEX RXY Reference CNY (RXYRY)	0.34%	-2.34%	↑	0.34%	-5.60%	3.55%	3.13%	↑	0.98	0.71

Fig 13: Performance: TR/HKEX RXY Global CNH, CFETS RMB Index and USD/CNH

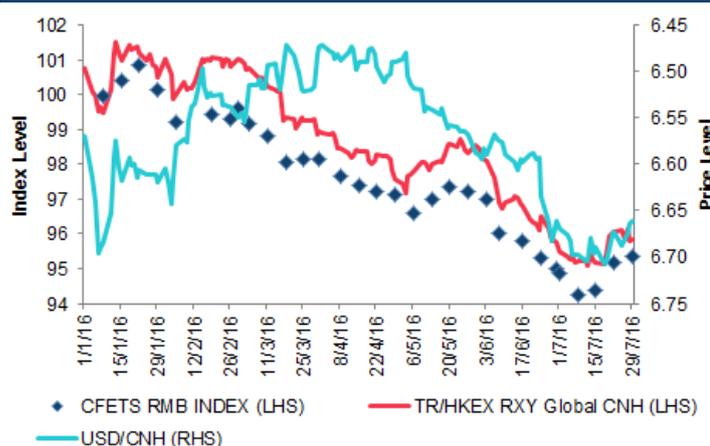
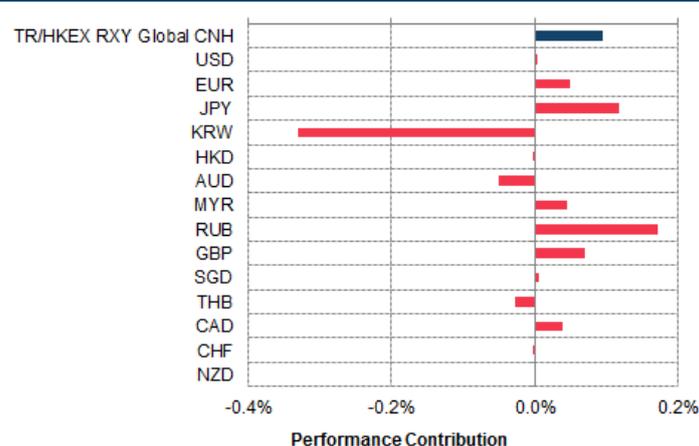


Fig 14: Monthly Performance Contribution Breakdown: TR/HKEX RXY Global CNH



## OFFSHORE RMB AGAINST OTHER CURRENCIES

### EUR/CNH

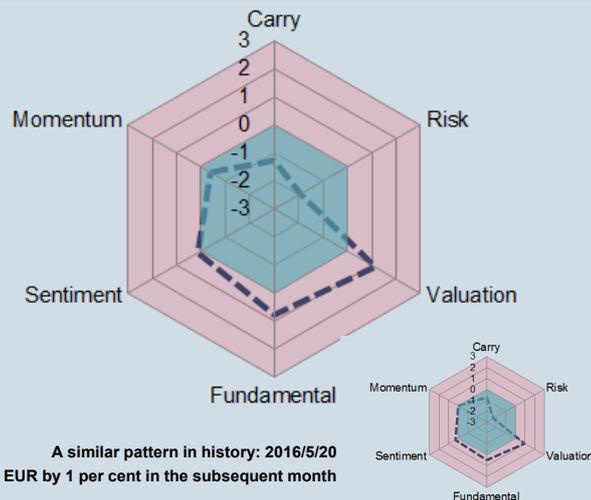
- The CNH was trading 0.02 per cent higher against the EUR in June 2016 from a month ago and remained in a relatively tight range of 7.34 to 7.45.
- The implied volatility of 3M OTC options decreased to near 8 per cent in July 2016. On 21 July 2016, the European Central Bank (ECB) kept rates on hold in its first monetary policy decision following the UK's vote to leave the European Union.
- On the FX radar, the fundamental and valuation factors were well above their historical average, while the carry and risk factors were below their historical average.

**Monthly CNH Performance vs EUR**

↑ **0.02%**

**Implied Volatility**  
**8.3%**

**Fig 15: FX Radar\***

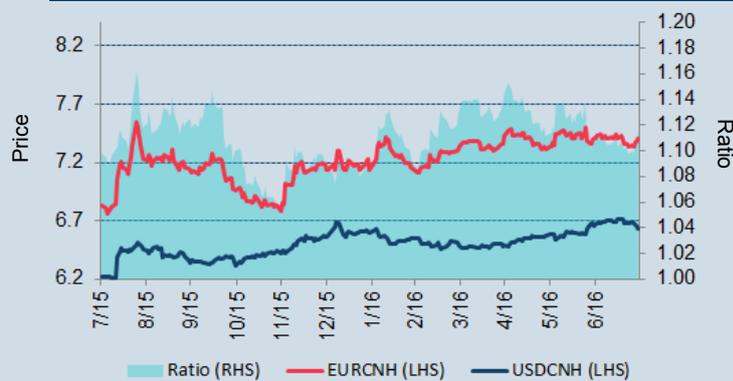


A similar pattern in history: 2016/5/20  
The CNH depreciated against EUR by 1 per cent in the subsequent month

**Fig 16: FX Volatility (3M Implied, %)**



**Fig 17: Price Ratio: EURCNH / USDCNH**



### AUD/CNH

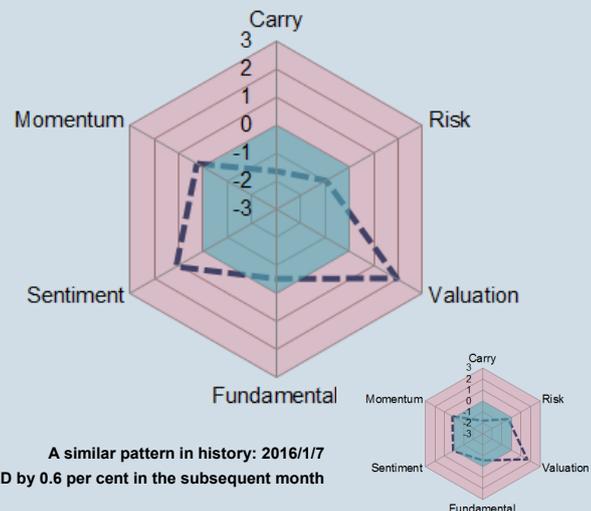
- The CNH continued its downward trend and was trading 1.25 per cent lower against the Australian dollar (AUD) in July 2016 from a month ago. Australia's manufacturing data climbed higher than the previous month while new home sales soared helping to support the AUD.
- The implied volatility decreased to near 10 per cent in July 2016.
- On the FX radar, the risk and carry factors were below their historical average, while the valuation and sentiment factors were above their historical average.

**Monthly CNH Performance vs AUD**

↓ **-1.25%**

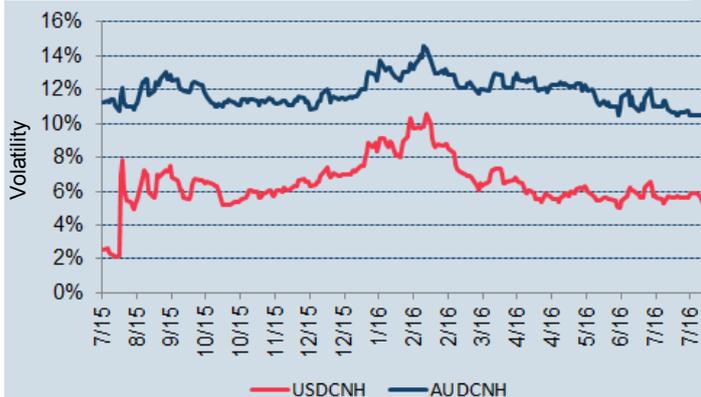
**Implied Volatility**  
**10.5%**

**Fig 18: FX Radar\***

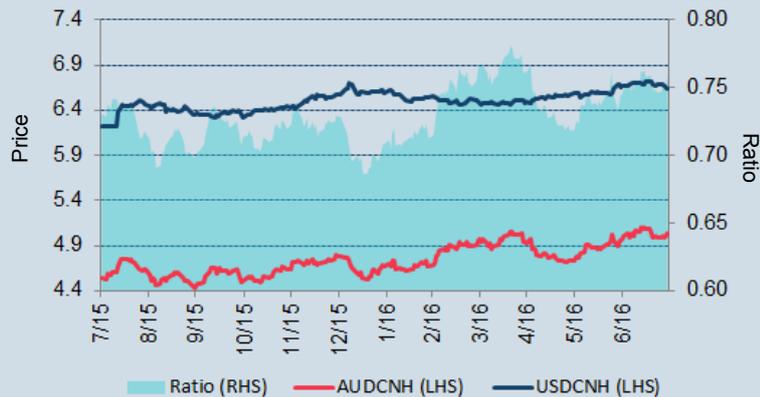


A similar pattern in history: 2016/1/7  
The CNH depreciated against AUD by 0.6 per cent in the subsequent month

**Fig 19: FX Volatility (3M Implied, %)**



**Fig 20: Price Ratio: AUDCNH / USDCNH**



## JPY/CNH

- The CNH was trading 0.48 per cent lower against the JPY in July 2016 from a month ago, after JPY/CNH reached its one-year high of 6.67 on 8 July 2016. The strength of the yen continues to stress the Bank of Japan and the Finance Ministry as a stronger yen will weigh on exports.
- The 3-month implied volatility OTC options surged to near 14 per cent in July 2016.
- On the FX radar, the momentum, risk, sentiment, and fundamental factors were above their historical average, while the valuation and carry factors were below their historical average.

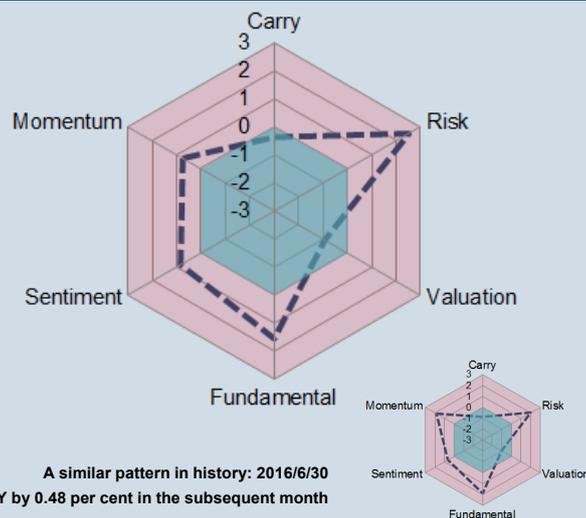
### Monthly CNH Performance vs JPY

↓ -0.48%

### Implied Volatility

13.6%

Fig 21: FX Radar\*



A similar pattern in history: 2016/6/30  
The CNH depreciated against JPY by 0.48 per cent in the subsequent month

Fig 22: FX Volatility (3M Implied, %)



Fig 23: Price Ratio: JPYCNH / USDCNH

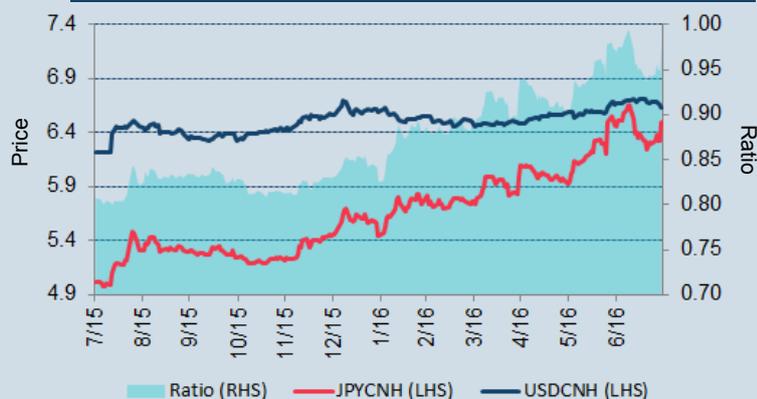


TABLE 4: Summary Table for RMB Currency Pairs

Performance						
	July	June	Chg	Prior 3 Month	YTD	Correlation with USDCNH
USDCNH	0.61%	-1.29%	↑	-2.22%	-0.96%	1.00
EURCNH	0.02%	-1.03%	↑	0.27%	-3.15%	0.30
AUDCNH	-1.25%	-4.33%	↑	-2.01%	-5.15%	0.02
JPYCNH	-0.48%	-8.68%	↑	-6.58%	-19.20%	0.40

Volatility						
	Implied	Prior	Chg	Historical	Prior	Chg
USDCNH	5.2%	5.7%	↓	3.6%	3.6%	↑
EURCNH	8.3%	9.8%	↓	6.2%	6.9%	↓
AUDCNH	10.5%	11.0%	↓	10.6%	10.9%	↓
JPYCNH	13.6%	12.2%	↑	14.4%	13.4%	↑



## OFFSHORE BOND MARKET DYNAMICS

### OFFSHORE RMB BOND MARKET COMMENTS

- After months of inactivity, the dim sum bond market regains traction in July with two Chinese issuers announcing transactions: Chongqing Grain Group issued Rmb1bn (USD150m) worth of dim sum bonds on 14 July 2016, while Bank of China raised USD3bn in currencies including offshore RMB, dollars, and euros in early July 2016.
- RMB deposits in Hong Kong decreased by 2.8 per cent month-on-month to RMB711.5 billion in June 2016. The total remittances of RMB for cross-border trade settlement amounted to RMB459.2 billion in June 2016, compared to RMB417.3 billion in May 2016.

Fig 24: Offshore RMB Deposits vs Outstanding Dim Sum Bonds

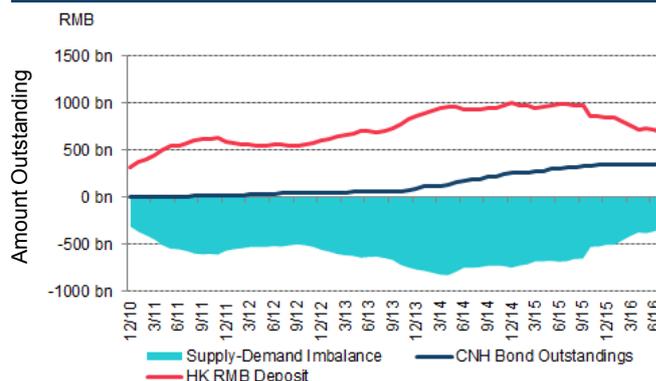


Fig 25: RMB Bond Issuances by Issuer Type

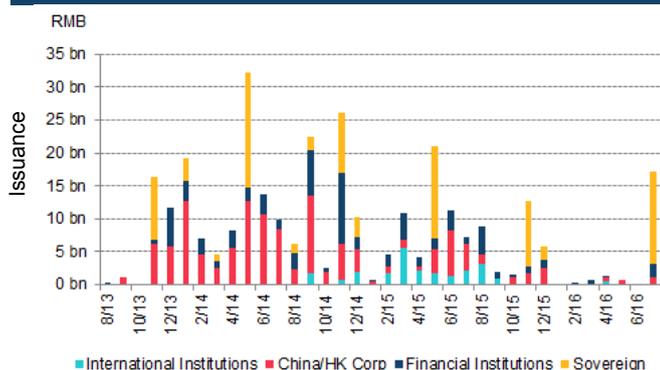
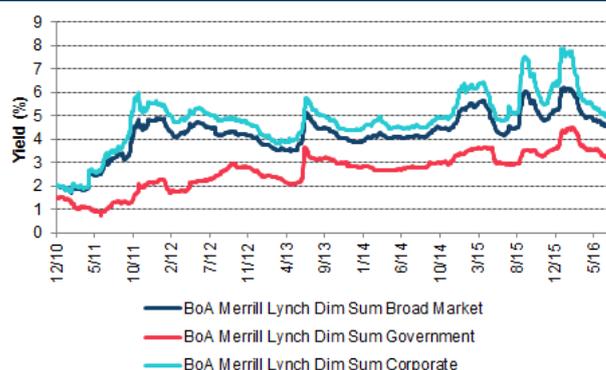


Fig 26: Dim Sum Bond Performance



## ONSHORE BOND MARKET DYNAMICS

### ONSHORE RMB BOND MARKET COMMENTS

- Onshore bond issuance increased 33.8 per cent to RMB 3.0 trillion in July 2016 from RMB 2.2 trillion in July 2015. Certificates of deposit (CDs) issuance in July 2016 was up 82 per cent from a year ago.
- The onshore/offshore five-year Ministry of Finance (MoF) Treasury Bond (T-Bond) yield spread continued to narrow in July 2016. The spread narrowed to around 0.33 per cent, as the five-year MoF T-Bonds were trading at 2.75 per cent onshore versus 3.08 per cent offshore towards the end of July 2016.

Fig 27: MoF T-Bonds Yield 5Y: Onshore vs Offshore (%)

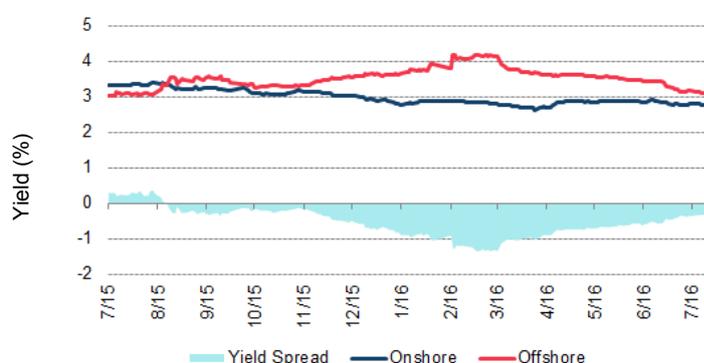


TABLE 5

Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types, for July)			
Bond Type	Number of Deals	Trading Value(RMB 100M)	Yield to Maturity(%)
Policy Financial Bond	60,312	55,101.77	2.8916
Treasury Bond	10,526	10,698.53	2.6519
Medium-term Note	12,237	8,208.24	4.8458
Corporate Bond	10,316	5,911.26	4.7557
CDs	6,918	16,305.37	2.9951
Commercial Paper	16,847	13,880.17	3.5907
Central Bank Paper	134	563.97	2.3824
Others	4,582	4,640.28	3.4315
<b>Total</b>	<b>121,872</b>	<b>115,309.59</b>	<b>3.2957</b>

Fig 28: MoF T-Bond Outstanding Split by Tenor

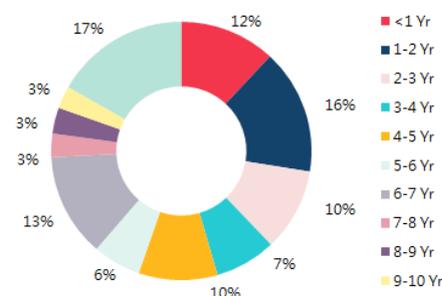


TABLE 6

NAFMII Guidance for Non Fixed Income Debt Issuing (as of 2016/7/27)																
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	2.94	↓	3.44	↓	3.65	↓	4.05	↓	4.31	↓	4.94	↓	5.11	↓	5.36	↓
AAA	3.14	↓	3.58	↓	3.85	↓	4.38	↓	4.62	↓	5.25	↓	5.57	↓	5.86	↓
AA+	3.36	↓	3.96	↓	4.32	↓	4.86	↓	5.24	↓	5.87	↓	6.26	↓	6.59	↓
AA	3.87	↓	4.51	↓	4.87	↓	5.53	↓	5.78	↓	6.61	↓	6.97	↓	7.43	↓
AA-	5.29	↓	5.89	↓	6.34	↓	7.28	↓	7.64	↓	8.29	↓	8.68	↓	8.97	↓

NAFMII – National Association of Financial Market Institutional Investors



## ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

### ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- Hong Kong's overnight Treasury Markets Association CNH HIBOR overnight jumped to 4.83 per cent on 13 July 2016, the highest level since February 2016, as banks set aside cash for regulatory requirements and on speculation that Chinese authorities are tightening funding conditions to curb declines in the CNH.
- The PBOC has been exploring an 'interest-rate corridor' mechanism as a new priced-based monetary policy framework, and the market expected that the PBOC's 7-day pledged repo rate would become the new policy rate as an anchor for money market rates.

Fig 29: CNH Implied Yield vs. USD/CNH

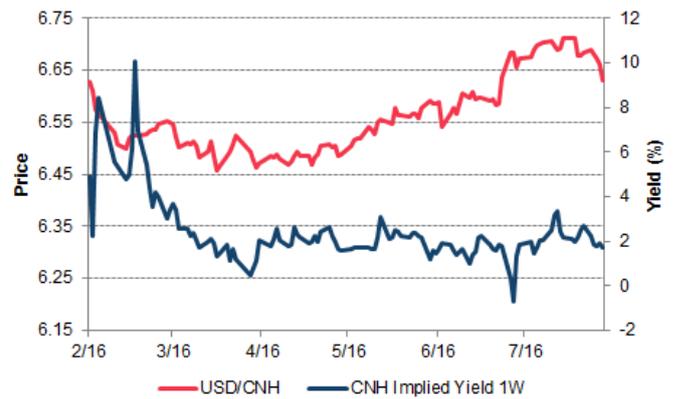


Fig 30: CNY SHIBOR Yield Curves

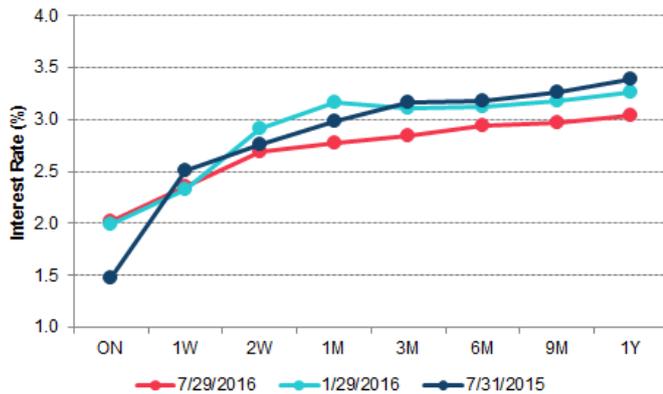


Fig 31: CNH HIBOR Yield Curves

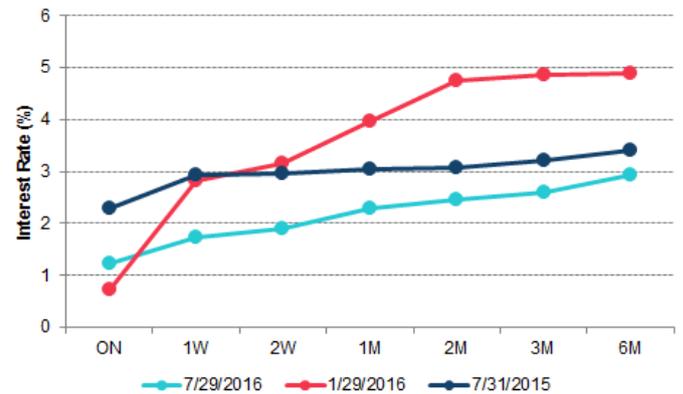


Fig 32: Onshore IRS (7D Repo) Yield Curves

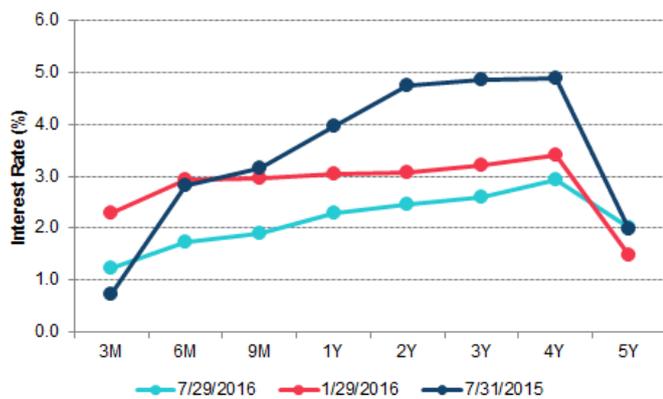


Fig 33: Onshore IRS Trading Notional Principal

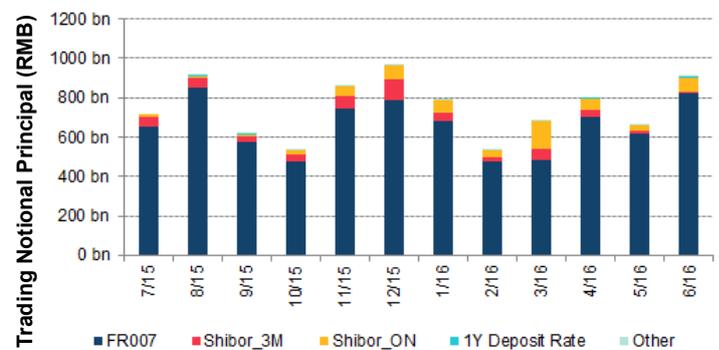


Fig 34: CNY SHIBOR vs CNH HIBOR

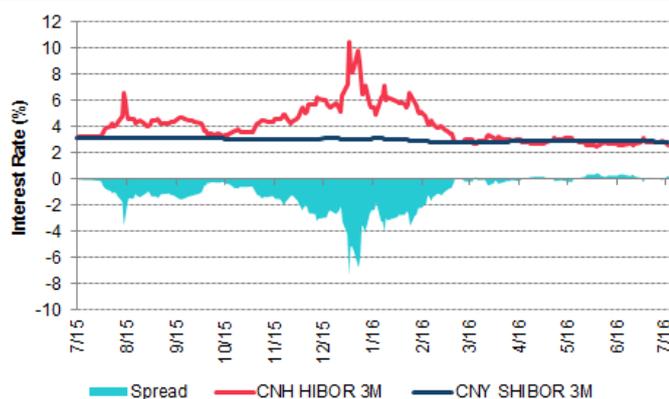
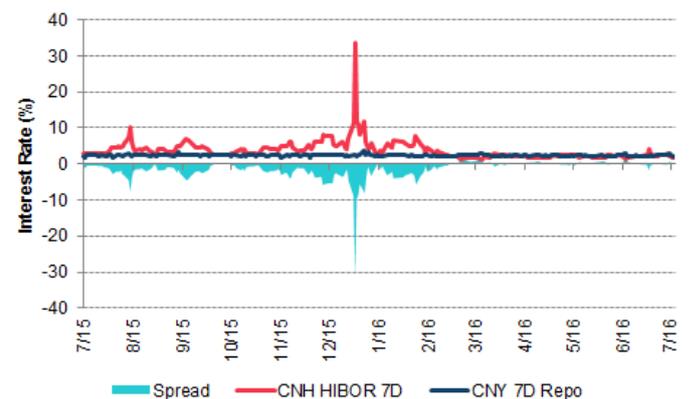


Fig 35: CNY 7D Repo vs CNH HIBOR



(Continued from page 1)

The wider fluctuation of the RMB exchange rate has led to a stage slowdown in the RMB internationalisation in the offshore market. Opening up the bond market now and allowing offshore institutions to invest in the interbank bond market will help the RMB evolve from an international settlement currency into an international investment currency in line with the RMB internationalisation strategy. Especially after expectations in the RMB's exchange rate have stabilised and before the new SDR basket takes effect, opening up the bond market will increase the supply of RMB assets in the FX market enabling offshore investors to meet their investment need for RMB assets after the RMB's effective entry into the SDR basket.

### More financing channels will support China's leverage transfer with improved flexibilities

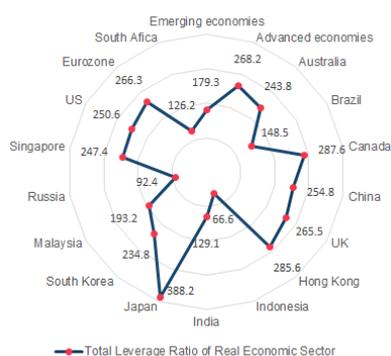
Judging by the real economy leverage ratio of key global economies (figure 36), the Bank of International Settlements (BIS) calculated that at the end of December 2015, China's real economy (mainly enterprise) leverage ratio was at a mid-stream level of 254.8 per cent which is relatively high in terms of emerging economies. As for the increment, since the global financial crisis, China's debt ratio has been climbing rapidly, and leverage distribution among different economic sectors has been unequal (figure 37). In terms of both absolute levels and the growth rate, the enterprise sector mainly accounts for the high leverage. On the one hand, it is believed improvement of the finance structure will help the enterprise sector deleverage. In the current stage, it includes gradually opening up the bond market especially expanding the investment scope by overseas qualified investors and introducing incremental funds into the capital market. In the long term, this may lower corporate financing costs and increase the ratio of direct financing thereby reducing the financial intermediary systemic risks that have been built up during the deleveraging of the enterprise sector. On the other, to meet the objective of stabilising general demand, the government and household sectors will add leverage to create the conditions for deleveraging of the enterprise sector in a growth environment and improve leverage distribution hence successfully addressing risks in the deleveraging process. Opening up the bond market to QFIIs now can introduce incremental capital into the Mainland market. As QFIIs mainly invest in treasury bonds when investing in the Mainland bond market (figure 38), opening up the Mainland bond market will facilitate the shifting of the leverage ratio to the central government and expand the implementation room of fiscal policies via the treasury bond channel.

### The continuing global low interest rates environment helps to expand the Mainland bond markets by attracting more foreign investors

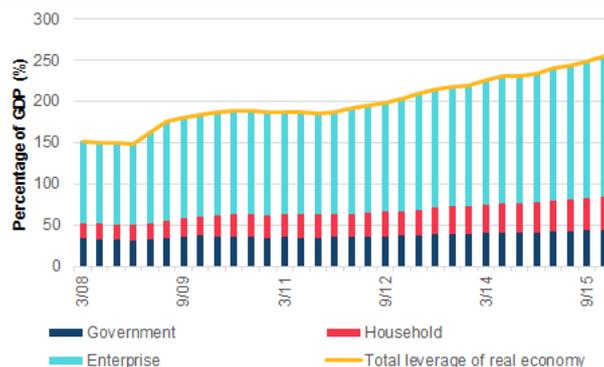
The continuing global environment of low interest rates, especially negative interest rates deepening further, have widened the yield differences between Mainland bonds and international bonds and increased global investors' demand for RMB-denominated assets. The spread of low or even negative interest rates among the world's major economies has drawn institutional investors' attention to foreign bonds with higher yields. The yields of China Treasury bonds continue to stand at two to three per cent compared to the zero or negative interest rates offered by other major economies. As the spread between offshore and onshore RMB exchange rates narrowing, the value of the RMB began to stabilise. Foreign investors' demand for China bonds is expected to pick up rapidly after expectations of depreciation in the RMB have fallen.

In this context, it is now time to open up the bond market and there is room to do so. According to Wind statistics, as of May 2016, China treasury bonds among all China government bonds have the highest percentage of foreign institutional holdings (yet only 2.99 per cent), followed by policy bonds (about 1.72 per cent). The percentage of foreign institutional holdings in credit bonds and other bonds is less than 1 per cent, much lower than the percentages of foreign holdings in other Asian bonds. Even during the period when there was notable capital outflow from emerging markets after the end of quantitative easing by major developed economies, and even as the fluctuation of the currencies of emerging economies has widened since the second half of 2015, the percentage of foreign holdings in government bonds, predominantly a market for medium to long term investors, has not dropped significantly. This shows the main considerations of medium to long term investors are risk hedging functions and yield differences between markets under exchange rate neutrality, instead of simple speculation on the directions of exchange rate movements. Opening up the Mainland bond markets under the low interest rates environment across the globe can be expected to have the following outcomes: On the one hand, increased participation by medium to long term international investors in Mainland bond markets will improve the price discovery mechanism of the yield curve of these bonds. On the other, rising demands for RMB assets will speed up the discovery of equilibrium price for RMB exchange rates and the currency's internationalisation process.

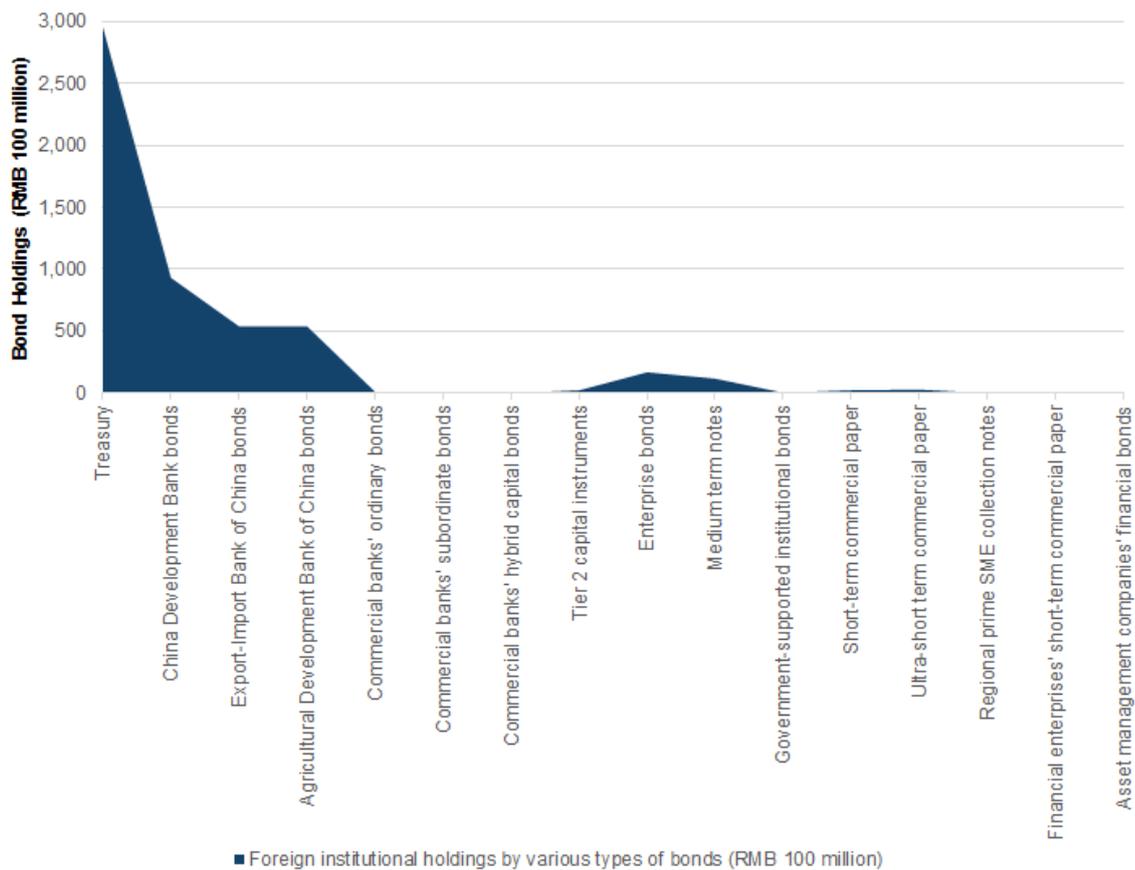
**Fig 36: Comparison of Total Real Economy Leverage Between China and Other Major Economies**



**Fig 37: China's Total Leverage Ratio Climbed Rapidly Since Global Financial Crisis**



**Fig 38: Bonds Held by Foreign Institutions (as of 2016/5/31)**



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## EXPERT CORNER

### DELEVERAGING OF THE CAPITAL MARKET IN CHINA

Contributed by Lian Ping, Chief Economist of Bank of Communications

Britain's vote to leave the EU has sent shockwaves across markets adding uncertainty to the world economy. The second half of 2016 will continue to be tumultuous for the international financial market. The Brexit vote will see its first effects, some Italian banks may run into troubles and a US rate hike is still likely. Increasing risk aversion and downward pressure on the Mainland economy will to a certain extent encourage capital outflow from the Mainland, but given support from market reforms/opening-up and urbanisation, a substantial decline of Mainland economic growth is unlikely. The Mainland capital market is still opening up, the range of foreign institutional investors interested in China will broaden and the Mainland's foreign exchange reserves remain abundant. In general, capital flows will stabilise. There will be no massive outflow of capital.

Impacted by the appreciation of the US dollar due to capital outflow and increasing risk aversion, the RMB/USD rate is under pressure to fall. At a time when the RMB's exchange rate is increasingly driven by market forces and the central bank is reducing intervention in the market, the RMB's depreciation against the US dollar should be seen as normal and should not be over-interpreted. Under the RMB pricing model that references both the US dollar and a basket of currencies, two-way movements in the exchange rate of the RMB will become marked and the RMB's exchange rates against a basket of currencies will remain basically stable.

Strong housing sales in the first half of the year boosted the growth of medium to long term residential loans. Although the size of corporate loans fluctuates, the amount of new corporate loans is actually not small when bond swaps are taken into account. Residential loans are expected to maintain rapid growth for some time in the second half due to the delayed effect of the housing market rally in the earlier period, but the growth will be smaller compared to the first half. Under the policy of stable growth, medium to long term corporate loans will hopefully increase steadily. The amount of Total Social Financing and new credit for the whole year are expected to reach RMB17 trillion and RMB12.5 trillion respectively. The growth rate for M2 is expected to range between 12.5 and 13 per cent at the end of the year.

There is a need to guard against the spread of bond defaults. The first bond defaults happened in the second half of last year and the trend continued this year. In the last two months, over 30 bonds defaulted involving principal valued more than RMB20 billion. The frequency of the defaults, especially those involving state enterprises, has at one point sent the market into panic. More credit risks are expected to expose in the second half after the first defaults and a new wave of defaults are expected. That said, bond defaults call for rational treatment as they are normal market phenomena that eliminate bad debts. The first companies to default are those with poor operations. Their default helps the industry improve efficiency and steers funds in the capital market towards quality companies. However, repeated credit risk events may undermine market confidence and spread to other financial markets. It is necessary to be prepared and prevent systemic risks from happening.

Due to a significant slowdown in manufacturing investments and private investments, investments in the housing market have been weak. Downward pressure on the Mainland economy will continue to be considerable in the second half requiring monetary policy support. However, in the presence of economic structural problems, high corporate debt ratios and excessive asset price surges in some sectors, it is unwise for monetary policies to be excessively loose as marginal utilities diminish with each round of easing and easy money increases leverage and inflates asset bubbles. Monetary policies should remain generally robust with an easing bias, while structural and directional adjustment should be strengthened to guide capital into the real economy and needy sectors. Considering benchmark interest rates are at historic low, interest rates in the monetary market are at low levels, food prices may rise and the further lowering of interest rates could add to the pressure of currency depreciation, benchmark interest rates should remain stable. The base currency growth rate continued to fall in the first half due mainly to a continuous reduction of funds outstanding for foreign exchange. At the end of March, the base currency balance decreased 4.39 per cent year on year. It was the third consecutive quarter for which a negative growth was reported. Declining growth in the base currency is a major reason why M2 growth has slowed. Considering M2 growth may further slow in the second half, open market operations alone cannot offset the reduction in foreign exchange, and the reserve requirement ratio is still considered high, further due reduction of the reserve requirement ratio at an appropriate time is necessary.

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Mr Lian Ping holds a PhD degree and is a professor and doctoral supervisor. He is the Chief Economist of Bank of Communications Co., Ltd., a fellow of the China Finance 40 Forum, the Director of the China Banking Association's Industry Development Research Committee, the President of the China Chief Economist Forum, a member of the China Financial Forum, the Director of the National Institute for Finance & Development (a national think tank), an academic member of the Lujiazui Institute of the Chinese Academy of Social Sciences, and a member of the China New Supply-side Economist 50 Forum. He plays an advisory role with the Shanghai Municipal Government on policy-making. He is also a part-time Doctoral Supervisor at the Shanghai Academy of Social Sciences.

Mr Lian's primary research interests are in macroeconomics, foreign exchange and rate policies, offshore finance, development strategies and management of commercial banks. He has published over 450 academic articles and 12 books in China and overseas, and has managed and completed over 20 award-winning research projects at the provincial-level and above. He won the special prize at the 2014 Development and Research Distinctive Achievement Award of China Banking Industry for his book named "Interest Rate Liberalization: What is the Domination?". He was awarded the Annual Leading Economist at the Best Banking Awards from Sina Finance in 2015 and the top forecaster from Mainland Chinese institutions in the ranking of Top Forecasters of the Chinese Economy by Bloomberg in 2015.

Mr Lian has often been invited to attend expert panels chaired by the Premier of the State Council and frequently participates in expert advisory meetings organized by different parties including the Office of the Central Leading Group on Financial and Economic Affairs, National Development and Reform Commission, People's Bank of China, Research Office of the State Council, Financial and Economic Committee of the National People's Congress, the China Banking Regulatory Commission and more.

## APPENDIX: DEFINITION OF THE FX RADAR

We selected a number of factors that drive RMB currency pairs, including carry (yield spread), risk (volatility), valuation (terms of trade), fundamentals (trade balance), sentiment (risk reversal), and momentum (three-month return). Factor values were normalized based on the most recent one-year data and plotted on our FX radar graph. For example, a factor value of 1 for “carry” indicates that the current yield spread is one standard deviation above its mean over the past year.

The black dotted line represents the prevailing factor dynamics of the specific RMB FX pair. Against the current factor dynamics, we identified the most similar patterns in past history by means of optimization across the six driving factors. The historical price movement of that particular period is shown for reference.

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