Opening-up Domestic Bond Market in the Support of China’s Supply-Side Reform

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This paper studies the opening-up of domestic bond market in the support of China’s supply-side reform by examining the five core elements about the reform, namely overcapacity trimming, inventory de-stocking, financial deleveraging, cost reduction, and improvement of weak links in the economy. By examining the relationship between bond market opening-up and each element of the reform, the paper comes to the conclusion that the opening-up of domestic bond market is supportive to China’s supply-side reform.

Keywords: opening-up bond market, China’s supply-side reform, Panda Bond

Introduction

Since 2010, the recovery of the global economy from the global financial crisis has slowed down and the global demand has remained at low level. In China, with the rate of economic growth also moving downward from almost 10% to below 7% most recent years, problems have shown in the supply side of the economy and the disequilibrium between supply and demand has become more severe than ever before. The disequilibrium is featured by the supply side excessive in the low-end and shortage in the high-end, and corporates are suffering from high costs of operating and financing. Besides, factors such as the imperfect financial supply, especially the simple financing structure and imperfect capital market have aggravated the supply-side problems. Specifically, as compared with the stock market, China’s bond market remains relatively closed to the outside world, with overseas investment accounting for below 1.5% of the total.

To address challenges, during the state’s 11th meeting among the leading group for financial and economic affairs in November 2015, President Xi Jinpin has for the first time proposed the notion of Supply-Side Structural Reform (the Reform hereinafter). The Reform is focused on improving the quality and efficiency of the economic supply, promoting sustainable economic growth, and further boosting productivity in China. In December 2015, President Xi further defined the five main aspects of the Reform, namely overcapacity trimming, inventory de-stocking, financial deleveraging, cost reduction, and improvement of weak links in the economy, which has provided a better and clearer direction for the Reform.

This article articulates the relationship between the opening-up of Chinese domestic bond market and the Reform. Moreover, the bond market opening-up can be further narrowed down to the market opening-up to overseas issuers and to overseas investors. Adopting the method of deductive reasoning, this article came to the conclusion that China’s bond market “opening-up to overseas issuers” and “opening-up to overseas
investors (Panda Bond)\(^1\) would collectively contribute to the five aspects of the Reform, namely cutting overcapacity, de-stocking, financial deleveraging, cost lowering, and the improvement of weak links of the economy.

In terms of the analytic significance, the article is valuable in both policy and academic aspects. For policy makers, the article investigated the relationship between the bond-market opening-up and the Reform, which could, to some extent, make guidance to the financial policy-making for better implementation of the Reform. For academia, this article for the first time drew together the notions of bond market opening-up and the Reform, and constructed general framework for further empirical researches into this area.

**China’s Domestic Bond Market**

Currently, China’s bond market is the 3rd largest worldwide, with the overall outstanding bonds amounting to over 60 trillion Yuan as at the end of 2016. The market consists of two sections, inter-bank bond market mainly for wholesale and exchange market main for retail. The opening-up of China’s bond market has to do with two aspects, namely the opening-up to overseas issuers for them to issue bond in Chinese bond market, and the opening-up to the overseas investors for them to invest in the Chinese bonds in the market.

In October 2005, International Financial Corporation and Asian Development Bank issued bonds using RMB in the inter-bank bond market. This news caused an extensive market repercussion. This is the first time for Chinese bond market to have foreign-invested enterprises issuing bonds, and it is a beneficial attempt and essential movement for Chinese bond market to open up. The Panda Bond market is growing fast; last year the circulation had reached 130 billion RMB and we expect 50 percent more in 2017. Similarly, in recent years, the degree of opening-up to the foreign investors is becoming higher and there are a number of foreign investors that have already entered the Chinese bond market. From the scope of the investment, the variety of bonds for foreign investors also becomes richer. The stock exchange bond market is relatively more open to the QFII and RQFII. In the short-term, the attraction of Chinese bond market to the foreign capital is not that strong and the main decisive factors for foreign investors to decide whether to enter Chinese market are exchange rate and rate of interest.

**Bond Market Opening-up and Supply-Side Reform**

As can be seen, the current China’s bond market is still rather closed to foreign entities, and its further opening-up will have multiple benefits among which the realization of the Reform is an important one. In specific, it is to be analyzed below that the opening-up could help achieve overcapacity trimming, inventory de-stocking, financial deleveraging, cost reduction, and improvement of weak links in the economy, which are considered as five core elements of the Reform.

**Capacity Trimming**

In recent years, over capacity industries in China not only include steel, coal, cement, and some tradition industries, but are also extended to some emerging industries like photo-voltaic and wind power. Some industries in China are overcapacity because of the impact of financial crisis, for example, the coal mining industries and steel industries; the products that are produced are much more than the demand. To solve this

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\(^1\) A Panda Bond is a Chinese renminbi-denominated bond from a non-Chinese issuer, sold in the People’s Republic of China.
problem, the Chinese companies will shift the factories from China to foreign countries that need those products, but for the first step for them to reach that goal, they need to raise money for the new building and the transport costs of the products. And if they can issue Panda Bonds easily, they are more willing to open new factories in foreign countries because it is much easier to get the money.

The opening-up of domestic bond market will help resolve the issue through international capacity cooperation. Traditionally, it is regulated by the central bank that the proceeds from Panda Bonds be only used for domestic activities. However, these days, with central banks’ loosening of capital account control, some Panda Bond issuers are allowed to deploy the proceeds for overseas business. Thus, it is suggested that the foreign subsidiaries of large Chinese enterprise issue Panda Bond in the domestic bond market, and deploy the proceeds overseas for international capacity cooperation by means of merger, acquisition, or opening-up local factories in the industries that are over-capacity in China but under-capacity in the target market.

Issuing Panda Bond has various benefits for Chinese businesses located overseas. As compared to bank loans, the funding costs are lower in the bond market. Moreover, the M&A and investment activities in countries where certain capacity is insufficient would bring mutual benefit to both countries as for China, the domestically over-capacity corporates could be relieved from weak demand and excessive production, and for the target country, the supply could be leveled up to fill in demand gap. Specifically, the international capacity cooperation is promising in the context of China’s Belt and Road Initiative (the Initiative). The Initiative is proposed by Chinese President Xi Jinping and is focused on the cooperation among Eurasian countries to create political mutual trust and economic integration with shared interests, future, and responsibility.

Additionally, the opening-up of domestic bond market will also help achieve capacity trimming by accelerating the RMB internationalization, which could further boost overseas investment by domestic corporates. On the one hand, allowing offshore investors to invest in the RMB-denominated Panda Bond will widen the investment channels of the offshore RMB. On the other hand, allowing Panda Bond issuers to utilize either offshore RMB for the principal and interest payment will also vitality the offshore RMB market. Once RMB has become an international-wise accepted and utilized currency in transactions, the currency risks would be mitigated; thus domestic corporates will have more incentives to invest overseas among with the over-capacity corporates which would possibly have their way out.

In summary, opening up domestic bond market to overseas issuers and investors will provide extra funding source to domestic corporates as well as boost the course of RMB internationalization which would in turn encourage overseas investment by domestic corporates. All these measures will facilitate the international capacity cooperation between China as a capacity-export country and other capacity-insufficient countries. By this means, the over-capacity trimming goal of the Reform is more likely to be achieved.

**Inventory De-stocking**

Up to September 2015, the total inventories of real estate in China were 680 million square meters among which 444 million square meters were residence. Another report from an expert worked in Beijing Normal University showed that if we conclude the projects under construction, the inventories would reach 8,500 to 9,000 square meters in a short term. The team calculated the selling speed according to the last three years’ data, and concluded that it would need seven years to sell all of the inventories in China’s domestic real estate market. As such, the current problem of inventory de-stocking in China’s real estate market is rather grave.
Currently for international investors, most of their investment in China’s fixed-income products is still focused on sovereign level such as bonds issued by Chinese Ministry of Finance and the major policy banks. Further opening-up China’s bond market and encouraging international investors to invest in local government bonds will help reduce the level of real estate stock. The reasons are as follows.

According to the latest state administrative rules on government borrowing, the provincial governments are allowed to issue special-purposes bonds for urban development, especially for shanty town regeneration. The proceeds will be used as compensate to shanty town dwellers to demolish their houses and regenerate the area. When people get their compensation, majority of them will return to the real estate market and purchase new houses. This process makes a win-win situation: Shanty town dwellers improve their living conditions, the city improves its level of modernization and development, and the real estate stock level is lowered with more purchases from citizens.

If such provincially issued bonds become open to the foreign investors, there will be wider investment choices for them as provincial bonds are normally featured by higher interests than sovereign bonds, and lower risks than corporate bonds. Therefore, more abundant sources of funding will be available for provincial governments to conduct urban renewal projects and ultimately reduce the excessive level of real estate stocks.

To conclude, opening-up bond market will encourage overseas investors to buy special-purposes bonds for urban development as issued by the provincial government, so that there will be more findings available to demolish shanty towns and make compensations to the original dwellers for them to purchase houses. By this means, the real estate stock in major cities will be digested in a smooth and healthy manner.

Financial Deleveraging

By the end of 2015, China’s overall debt amounted to 168.48 trillion Yuan, and the leverage ratio stayed as high as 249% among with the ratio for corporate sectors being 156%, far higher than the 90% global alert line. The financial leverage in China has been among the most severe in the world.

Opening-up domestic bond market and encouraging the development of more types of bonds such as the “hybrid bonds” will help businesses to deleverage efficiently. Specifically, the equity-like features of hybrid bonds can reduce the level of borrowing whilst continue providing findings to corporates. Currently, the hybrid bonds in China’s bond market are still rather underdeveloped because of their long maturity, lack of liquidity, and the capital consumption for commercial banks. Therefore, such bond types are suitable investment targets for long-term sovereign and pension funds which are also rare in the domestic market. However, long-term investors are abundant in the international market, and many of them have strong interests in entering Chinese bond market.

In this sense, if the domestic bond market is further opened up to the overseas long-term investors, the domestic hybrid bond market is more likely to be matured as the demand for such products will be enriched. Consequently, there will be more incentives for corporates to issue hybrid bonds in the likes of perpetual bonds and convertible bonds. Those types of bonds have features of both bond and share and are able to help the business to convert its debt financing into equity financing. With the development and perfection of hybrid bond market following the market opening-up, the deleverage problems can be mitigated.

Cost Reduction

Bank credit service has been a long-lasting problem for small business. Due to the nature of economy of scale for banking business, it is usually difficult and expensive for SMEs to raise money from the bank and
these problems cannot be solved effectively. Compared with indirect financing and shadow banks, bond market can provide long-term and stable source of finance and its interest rates are usually lower than the business loan. Therefore, developing the bond market can give business more choices of direct financing as well as reduce the costs. In this sense, open-up the domestic bond market will be helpful to the maturing and development of China bond market for the following reasons.

First, as for Panda Bond issuers, they are mostly foreign companies or foreign governments who are rather experienced in the bond market. Their issuing bond in China can help China’s bond market to develop up to higher levels. Second, as for international investors who want to play in China’s bond market, they will not get fully involved until the market is fully prepared. In other words, the overseas investors will push the market to become more developed in terms of for instance information disclosure, investors protections, transaction, and settlement. Furthermore, the more foreign participants, be it either issuers or investors, the more developed the Chinese bond market will be.

When the bond market has been well and fully self-developed as well as absorbed enough advanced practices from advanced markets, more companies, whether domestically or abroad, will be willing to raise money in the bond market in replacement of indirect financing from the banking system. This makes the general funding easier and the costs lower than before. Therefore, the cost reduction objective of the Reform could be achieved.

**Improvement of Weak Links in the Economy**

When it comes to the last aspect of the Reform, that is, the improvement of weak links of the economy, China is with no doubt featured by many deficiencies in this economic structure. For instance, in sectors such as high-tech manufacturing and high-end designing, China is well behind the western competitors. If capacity trimming, inventory de-stocking, deleveraging, and cost reduction is doing subtraction on the supply-side, improvements of weak links in the economy is doing addition. It fills the weakness of the supply-side and upgrades the quality of supply.

Opening-up of the domestic bond market can help make improvements to the supply side of the economy in three ways. The first is to encourage reputed manufacturers to issue bonds in the domestic bond market so that they can establish subsidiaries and factories in China. Those companies would have to hire local Chinese workers and managers. By this means, domestic manufacturers could benefit from the knowledge transfer from the advanced manufacturers in terms of technology and knowhow. The second way is to encourage foreign-incorporated but China-invested enterprises to issue panda bonds and allow the raised funds to be used out of China. With the funds raised at the domestic bond market, companies could make international investments such as merger and acquisition with other foreign enterprises for more advanced technologies and skills. The Chinese car manufacturer Geely’s acquisition with Volvo can be a case in point. The last approach is encouraging foreign financial institutions to issue RMB bonds and those funds are to be used to support important sectors or SMEs of the economy, so as to provide more capital on the supply side. When Asian Development Bank issued China’s first Panda Bond in 2005, the proceeds were used for several on-lending projects to domestic borrowers.

When foreign issuers are able to issue Panda Bonds in Chinese bond market, Chinese businesses can get more advanced machinery or experience from foreign businesses as a result of knowledge spill. As a result, Chinese companies can strengthen the weakness in Chinese market to improve the weak links in the economy.
Problems and Challenges

Admittedly, the development of the bond market, although at fast pace, is still faced with some problems and challenges.

The first problem is the institutional absence. The imperfect rules of the bond market make the bonds issuing process complicated and slowly. When the international issuers who usually issue bonds in mature markets step into this new Panda Bond market, they often do not have clear rules to refer to and as a result, may hold back in this new market because of the high potential risks. In the long-run, a mature and stable Panda Bond market needs a system of clearly and easy-to-check rules. A case to follow is HKEX which publishes all the rules on their website so that it is convenient for issuers to search information and solve their basic problems of issuing in this market.

The second barrier is the language. The Panda Bond market is a Chinese domestic market so that the government requires that all the information of issuing and registering needs to be in Chinese. This increases the costs of translation and is very time-consuming. To solve this problem, the market can follow the example of the Samurai bond market practice by allowing issuers use English in the disclosure of certain documents except for the key indicators. Breaking down the language barrier can make the process easier for foreign issuers and investors and it is helpful for the internationalization of the bond market.

The third problem is the accounting standard differences. As the accounting system is supervised by the government and cannot always come together between countries, the process of conversion or immunity can also slow down the entire process.

Additionally, we have to admit that there are also risks in the process of market opening-up. On the capital flow level, if the domestic market is over-trading due to the opening-up, it may have negative effects on the capital market given the fact that China is still under general capital control. On the market level, the opening-up of the domestic bond market is likely to have substitution effect which may encourage the corporates to finance through bond issuing in replacement of the credit businesses.

Summary

This article discusses how the opening-up of the domestic bond market, in the aspect of either foreign issuers or foreign investors, will support the Reform in terms of overcapacity trimming, inventory de-stocking, financial deleveraging, cost reduction, and the improvement of weak links in the economy. As a result, the general conclusion could be drawn that the opening-up of the domestic bond market can support the supply-side reform.

Nevertheless, it has to be admitted that owing to the limitation of time and words, this article mainly uses qualitative method of research. As such, some of information and conclusions can be imperfectly drawn and should only be regarded as indicative or rough. In the further researches, more advanced and accurate methods such as quantitative and empirical analysis could be adopted to improve the depth of the research.
Figure 1. Summary of the relationship between opening-up domestic bond market and supply-side reform.

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OPENING-UP DOMESTIC BOND MARKET

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