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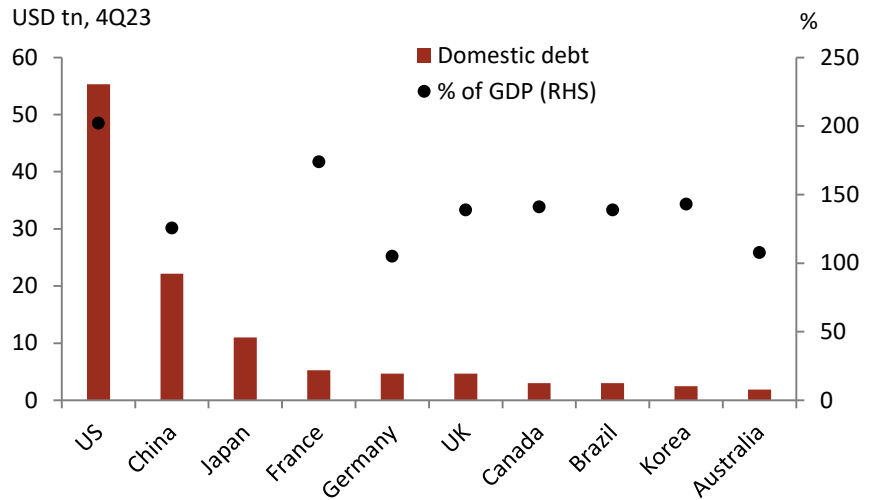
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Overview of China's onshore bond market

Market size

China's domestic bond market is currently the second largest in the world with a depository balance reaching almost CNY150trn. The outstanding market size stood at USD22tn at 4Q23 (126% of GDP).

Top 10 debt securities markets in the world (domestic debt)

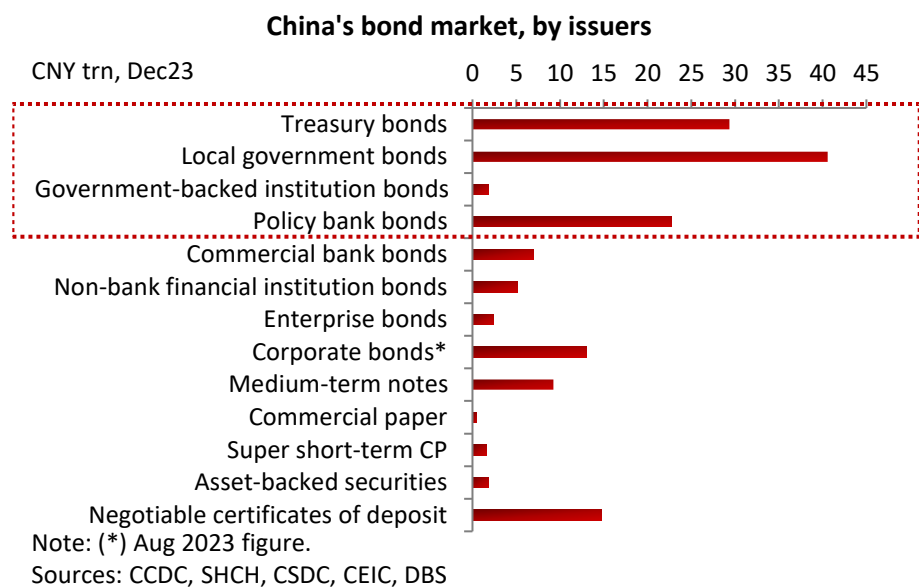


Sources: BIS, IMF, DBS

Cash bond issuers

Public sector issuers account for almost 70% of the total bond market

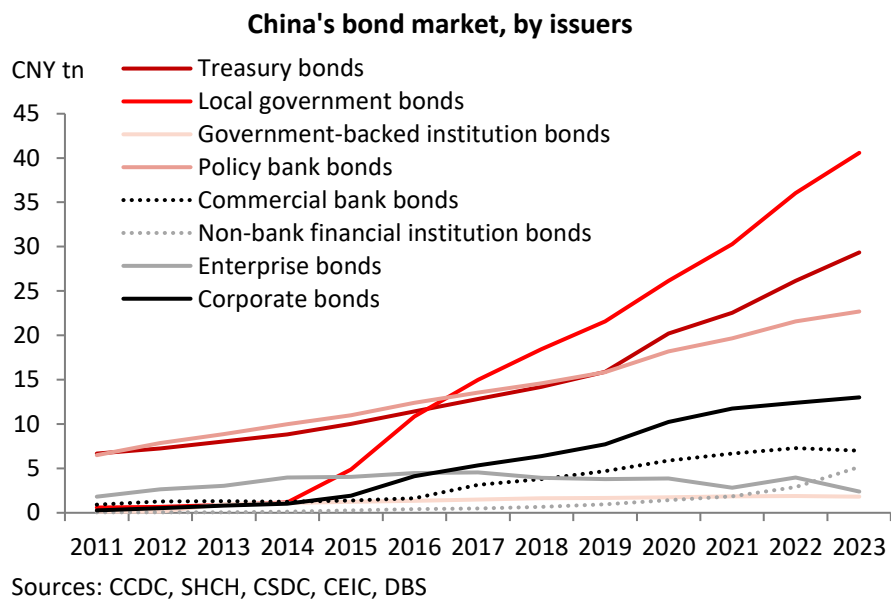
Issuance of treasury bonds, local government bonds, and policy bank bonds accelerated across the board even as pandemic-related spending wound down. As of end-2023, central government, local governments, policy banks, and government-backed institutions accounted for 67.3% of the total bond market. Continued stimulus spending is likely to sustain robust bond issuance from public sector.



Local governments remain the largest issuer. Their issuance surged in recent years following the introduction of the debt-for-bond swap program 2015. However, growth is expected to ease amid wariness over local government debt. Reportedly, there are over 12 provinces being discouraged from issuing new bonds.

China has seen a continuous rise in treasury bond issuances due to the introduction of treasury futures in 2013. Looking ahead, the central government (treasury bonds) will claim a larger market share as it shoulders more responsibility to boost growth. After all, China's central government debt-to-GDP ratio, at 23% in 3Q23, is much lower than the G20 average of over 70%. This is best evidenced by the CNY1tn in ultra-long term special central government bond issuances pledged at the Two Sessions in March. Issuance of policy bank bonds, which are backed by the central government and perceived by investors to be risk-free, has increased steadily to support infrastructure investments over the past 10 years.

Issuance of treasury bonds is set to increase alongside Beijing's commitment to stimulus growth



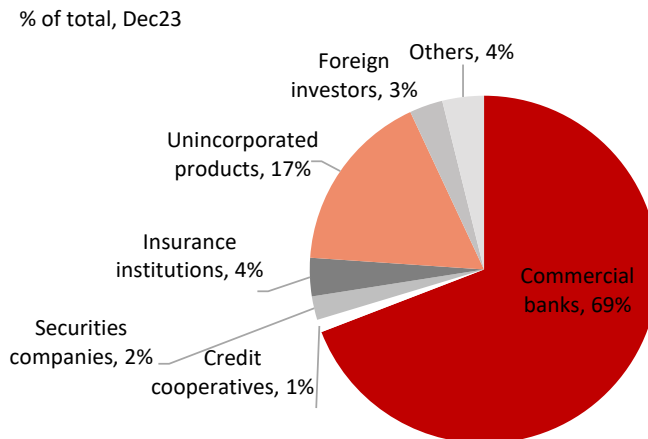
Issuance of corporate bonds has been abating since 2022 amid lingering concerns over bond defaults in the property sector. The outstanding corporate bond growth has slowed from double-digit during 2012-2021 to around 5% in 2022 and 2023. Despite defaults being mainly attributed to USD bonds, onshore market appetite remains weak. The elevated USD rates and ongoing deleveraging also discourages corporate bond issuance.

Investors

Domestic commercial banks are the biggest owners of China's bond market, holding almost 70% of the total outstanding bonds. Meanwhile, there has been an ongoing increase in bonds as part of their asset allocation (see Box Article 1.1). The remainder of the investor base is mainly made up of unincorporated products, insurance institutions, and brokerages.

Commercial banks hold almost 70% of outstanding bonds

China interbank bond market: Investor structure

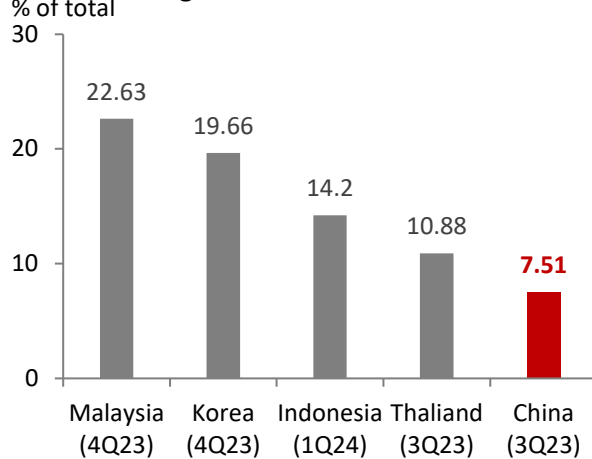


Sources: CCDC, CEIC, DBS

Foreign ownership ratio has rebounded

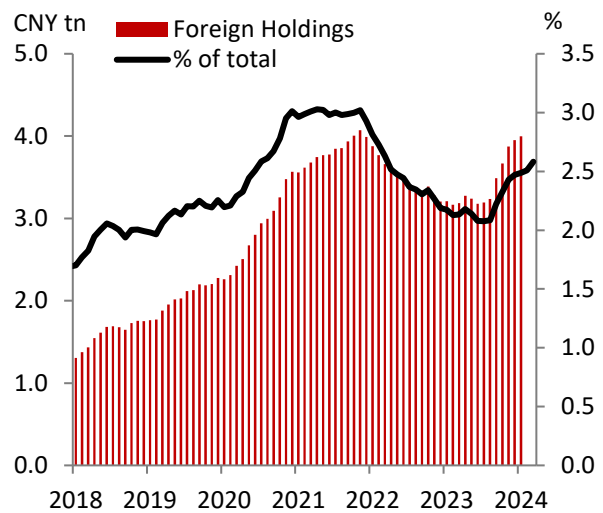
After the initial sell-off last year, interest from foreign investors has returned. Their share among total bond holdings rebounded from the post-COVID low of 2.08% in Aug23 to 2.58% in May24. The strong rate cut expectation to support Beijing's 5% growth target has lured overseas fund managers to re-enter the market. High frequency fund flow data from EPFR indicates that foreign domicile funds have added USD89mn position into China government bonds year-to-date. The inflow is particularly palpable (USD248bn) since May amid recovering bond market sentiment. The continuous relaxation of regulations and barriers to foreign investment will attract foreign holdings in China's bond market over the long run.

Asia: Foreign holdings in local currency government bonds



Sources: AsianBondsOnline, DBS

China: Bond foreign holdings



Sources: CCDC, SHCH, CEIC, DBS

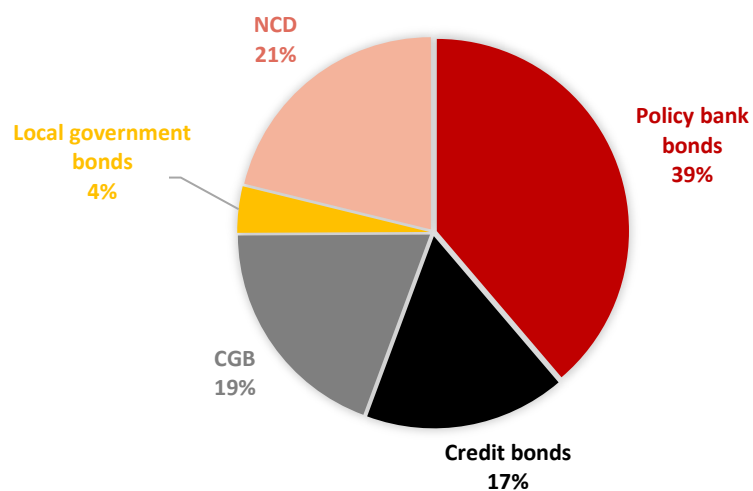
Types of instruments

1. Cash bonds

- *Central government bonds: >1 year to 50 years*
- *Local government bonds: 1-30 years*
- *Policy bank bonds: 3 months to 50 years*
- *Financial bonds: > 1 year, mainly 3-5 years*
- *Enterprise bonds: > 1 year, mainly 3-10 years*
- *Corporate bonds: > 1 year, mainly 3-10 years*
- *Medium-term notes: > 1 year, mainly 3-5 years*
- *Commercial papers: ≤ 1 year*
- *Negotiable certificates of deposit: 1 month to 1 year*

Cash bonds are the most-traded instruments. Amongst all, policy bank bonds and CGBs have the best liquidity. These two types of bonds accounted for 38.8% and 19.3% of total turnover, respectively. Meanwhile, local government bonds are less liquid, despite provincial governments being the largest issuers. Note that they only accounted for 3.9% of total turnover.

Turnover by products in 3Q23



Source: CFETS, DBS

Repo

- *Available up to 1Y. Overnight and 7D are most common*
- *For interbank repo contracts, interest rate bonds are the dominant form of collateral; Increased usage of credit bonds as collateral*

There are two types of repos in the China Interbank Bond Market (CIBM) – pledged repo and outright repo. While pledged repo does not change the ownership of bonds, outright repo does. Pledged repo is the major liquidity management tool, accounting for around 99% of total repo trading. In terms of tenors, overnight and 7-day repos account for 97% of the total.

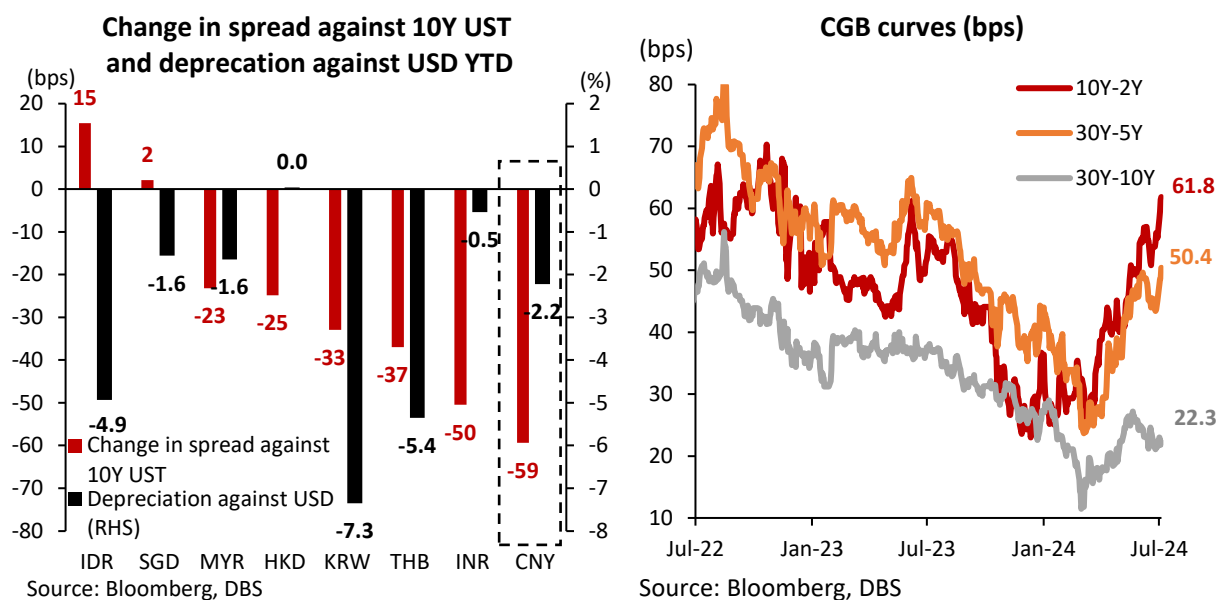
2. Derivatives

- *Bond futures: Available in 2Y, 5Y and 10Y*
- *Bond forwards: Available up to 1Y*
- *Forward rate agreements (FRA): Available up to 1Y*
- *Interest rate swaps (IRS): Available up to 10Y*
- *Bond lending: Available up to 1Y*
- *Credit derivatives: CRMA, CRMW, CDS, and CLN*

IRS is the most traded hedging derivatives. Major reference rates include FR007, SHIBOR 3M & Overnight, 1Y and 5Y LPR. As for tenors, short-end IRS below 1Y are the most actively traded products. For credit derivatives, CIBM has spared no effort in enhancing the product range. Since 2019, CIBM launched CDS Index products focusing on credit rating, enterprise nature, and geographic locations. Key indices include CFETS-SHCHGTJA High Grade CDS Index, CFETS-SHCH Private Enterprise CDS Index, and CFETS-SHCH-CBR Yangtze River delta Region CDS Index.

Box 1.1 China Government Bonds 2H Outlook

Only a handful of Asia EMs could resist the pull of higher rates and weaker currency year-to-date. CGBs are the rare outperformers. CGB yields continue to fall alongside mixed data prints. While export growth and trade balance provide some comfort, the weak investment and consumption sentiment warrant investors' concern. RRR and rate cut expectations are building up. The spread between 10Y CGB and UST YTD has compressed at a much faster pace amongst major Asia peers. Yet, CNY only depreciated moderately by around 2% against the USD alongside PBOC's effort in stabilizing the currency. These have made CGB the outperformer in the region from a total return perspective.

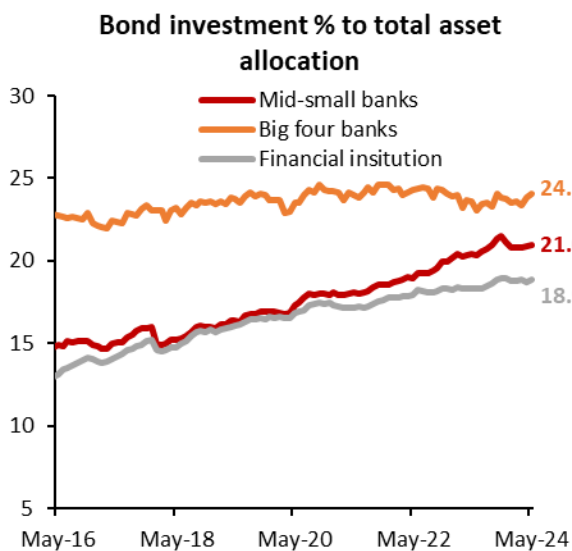


Strategy-wise, we maintain our core view of steepening. Short-end yields (2Y) will likely see downward pressure amid potential rate cut. The window for MLF cut is now opened as major central banks are on track with rate cuts cycle. CNY exchange rates could take a breather from depreciation, and subsequent capital outflow could moderate. Meanwhile, the belly of the curve (5Y) will stay rich given a modest growth momentum.

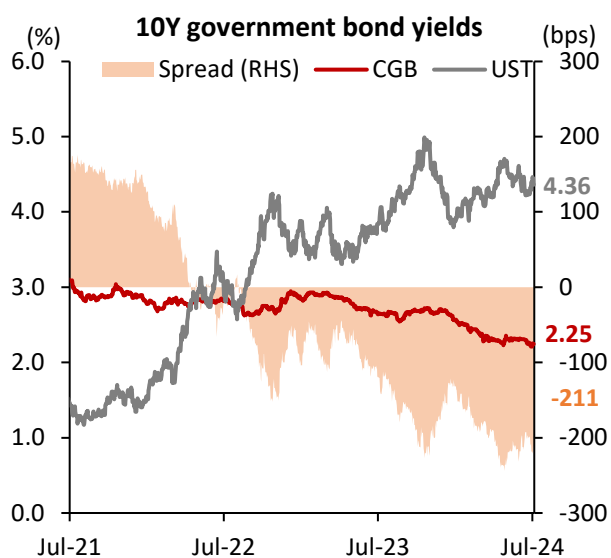
Yet, long-end yields are expected to stay elevated amid increasing supply. The central government has started issuing the RMB1trn ultra-long special CGBs to finance infrastructure investment and stimulate growth. Beijing will assume a bigger role is supporting the economy given a relatively healthy debt level. Note that the central government's debt-to-GDP ratio was less than 25% last year, compared to over 70% of the G20 average. In contrast, local government debt has reached over 80% of GDP. In fact, public spending by the central government went up by 10.2% YoY YTD in May, outpacing the 2.4% of local governments.

Box 1.1 China Government Bonds 2H Outlook

The PBOC **bond borrowing from primary dealers and sales will help stabilizing the long-end yield**. Such policy change echoes the PBOC Governor's earlier speech on deepening monetary policy tools through CGB transactions. **The market interprets the long-end bond borrowing as a prelude to bond sales to cool the CGB rally and the subsequent duration risk**. Note that the assets allocated to bonds of mid-small banks have increased from 15% in 2015 to 21% as of May 2024. From a FX perspective, higher CGB yields and a narrower spread against UST counterparts could help **alleviate pressure on CNY exchange rates**.



Source: WIND, DBS



Source: Bloomberg, DBS

Trading and settlement platforms

Interbank market accounts for over 90% of total bond trading, with CFETS functioning as the trading platform

China's bond market is comprised of an over-the-counter (OTC) market and an exchange market. The OTC market includes an interbank market and a commercial bank OTC market, and is dominated by large institutional investors making transactions. The exchange market consists of the Shanghai Stock Exchange and the Shenzhen Stock Exchange. These exchange markets are more retail, largely composed of smaller institutional investors.

The China Foreign Exchange Trade System (CFETS) functions as the only interbank bond trading platform in the China Interbank Bond Market (CIBM). Under the strategic goal of becoming the "major global trading platform and pricing center for RMB and related products", CFETS provides front-to-back services including trading, issuance, post-trade processing, information disclosure, market benchmark, and professional trainings.

- Trading hours (cash bonds, repo, bond forwards, bond lending): 9:00-12:00, 13:30-16:50 CST (T+0); 9:00-12:00, 13:30-17:00 CST (T+1)
- Trading hours (interest rate swaps): 9:00-12:00, 13:30-17:00
- Trading hours (forward rate agreements): 9:00-12:00, 13:30-16:30

The interbank bond market is now the main trading platform for bonds, accounting for almost 90% of the China's total bond depository balance. The majority of Central Government Bonds (CGBs), local government bonds, policy bank bonds, financial bond and credit bond trading occurring within the interbank market. Transactions in the interbank market are often settled via a real-time gross settlement, while transactions in the exchange market are usually settled on a net basis.

In January 2022, authorities announced measures to lay the foundation for an Interbank-Exchange Bond Market Connect. This initiative will enable investors to buy and sell tradable bonds in the two markets through interconnection of the front and back-end infrastructure. Institutional investors on both markets will be entitled to "one-click access" without opening accounts on both sides. This will help facilitate cross-market issuance and trading of bonds, promote free flow of capital, form an integrated market, and unify prices.

Depository and settlement services

CCDC, SHCH and CSDC provide the depository and settlement services

China Central Depository and Clearing Corporation (CCDC) and Shanghai Clearing House (SHCH) provide the registration, depository and settlement services for the interbank market. China Securities Depository and Clearing (CSDC) provides the same services for the exchange market.

The CCDC is responsible for government, financial, and enterprise bonds, the SHCH oversees commercial papers, medium-term notes and NCDs, and the CSDC covers government and corporate bonds.

Regulatory authorities

Key regulators include PBOC, NAFR, CSRC, NAFMII, and SAFE

China's bond market is regulated by multiple agencies: the People's Bank of China (PBOC), the National Administration of Financial regulation (NAFR), the China Securities Regulatory Commission (CSRC), National Association of Financial Market Institutional Investors (NAFMII), and State Administration of Foreign Exchange (SAFE).

The PBOC is mainly responsible for formulating and implementing monetary policies, preventing and resolving financial risks, maintaining financial stability, and regulating the interbank market. The central bank also exercises macro-prudential management of investment by overseas institutional investors in China's bond market.

The NAFR is directly managed by the State Council, regulates the financial sector except for securities, and coordinates the protection of financial consumer rights. The CSRC regulates the investment conduct of securities and futures markets, while the SAFE is responsible for products related to foreign exchange payments, receipts, and remittances. The NAFMII serves as the self-regulatory organization for the interbank bond market and interbank lending market.

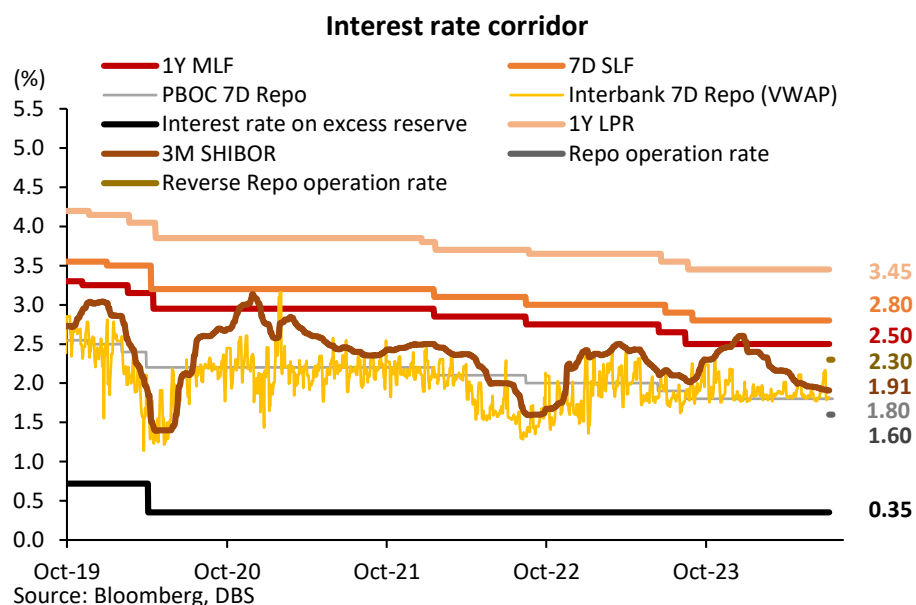
Each of these regulatory authorities is responsible for different types of bond issuances, a regulatory strategy known as "multi-head". The PBOC is mainly responsible for interbank and financial bonds. The MOF mainly covers central and local government bonds, while the NDRC assumes responsibility for enterprise bonds. The CSRC regulates corporate and financial bonds and the NAFMII is responsible for medium-term notes and commercial papers.

Box 1.2 China's monetary policy framework

According to the law of the People's Bank of China, the objective of monetary policy is to maintain currency stability and to promote economic growth. On 8 July 2024, the PBOC announced a temporary daily repo and reverse repo in addition to the traditional morning operations. Such tools aim at helping the central bank to improve liquidity management and better guide market interest rates. The reverse repo operation rate is set at 7D Repo rate +50bps, while the repo operation rate is set at 7D Repo rate -20bps. While it is yet to be confirmed as the new interest rate corridor, the new repo/reverse repo operation rates should help manage the volatility of the short-end market rate such as 7 Day repo rate. Note that the existing interest rate corridor is as wide as 245bps (2.80% of 1Y SLF rate vs 0.35% of interest rate on excess reserve).

Here is a list of tools used by the PBOC to control money supply and interest rates:

- **Loan Prime Rate (LPR):** A new reference rate for setting the prices of loans, which has replaced benchmark lending rate. Major tenors include 1 year and 5 years.
- **Open Market Operations (OMOs):** The PBOC uses OMOs and the corresponding 7-day repo/reverse repo rate to signal policy changes.
- **Reserve Requirement Ratio (RRR):** The proportion of deposits that banks must keep with the PBOC as reserves.
- **Excess Reserve Rate:** Interest rates paid by the PBOC on banks' excess reserves. Seen as the lower bound of China's interest rate corridor.
- **Standing Lending Facility (SLF):** A type of PBOC lending to banks to manage short-term liquidity. Seen as the upper bound of interest rate corridor.
- **Medium-term Lending Facility (MLF):** A type of PBOC lending to banks to manage medium-term liquidity.
- **Pledged Supplementary Lending (PSL):** Long-term loans provided by the PBOC to banks that are directed towards specific sectors.

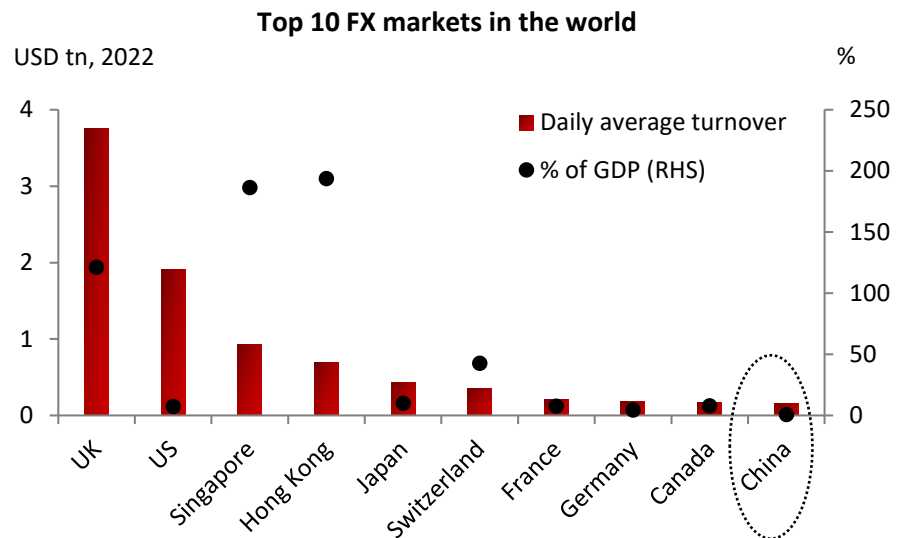


Overview of China's onshore FX market

Market size

China's FX market is the 4th largest in Asia, but remains small in comparison to developed economies

China's onshore FX market is the fourth largest in Asia, after Singapore, Hong Kong, and Japan. Trading volume in the interbank FX market stood at CNY253tn in 2023, a 9% rise compared to the previous year.



Sources: BIS, IMF, DBS

Participants

Commercial banks are the biggest participants in China's interbank FX market

China's interbank FX market works on a membership basis and its participants include FX-designated banks, qualified non-bank financial institutions and non-financial enterprises. There are 770 members in the FX spot market as of March 2024, including more than 100 from overseas.

Types of instruments

FX spot

- 29 currency pairs. USD/CNY accounts for over 90%
- FX spot market trade volume accounts for around 29% of market trade volume (2023)

FX derivatives

- FX forwards: 26 currency pairs
- FX swaps: 26 currency pairs
- Cross currency swaps: 7 currency pairs (USD/CNY, EUR/CNY, JPY/CNY, HKD/CNY, GBP/CNY, AUD/CNY, CNY/IDR)

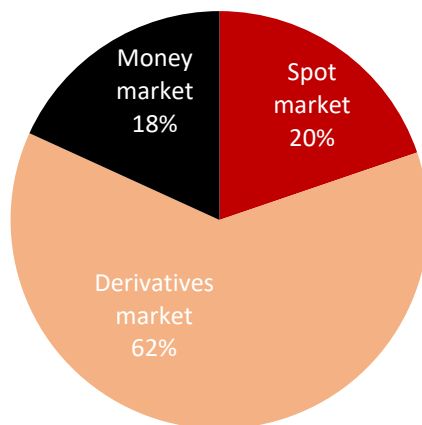
- *FX options: 5 currency pairs (USD/CNY, EUR/CNY, JPY/CNY, HKD/CNY, GBP/CNY)*
- *FX derivatives make up more than half of the market trade volume*
- *Nearly all of the FX derivatives market's trade volume is FX swaps, with options and forwards accounting for just 4%*

Foreign currency lending

- *Accounts for 18% of FX market trade volume in Jan-Apr 2024*

China's interbank FX market

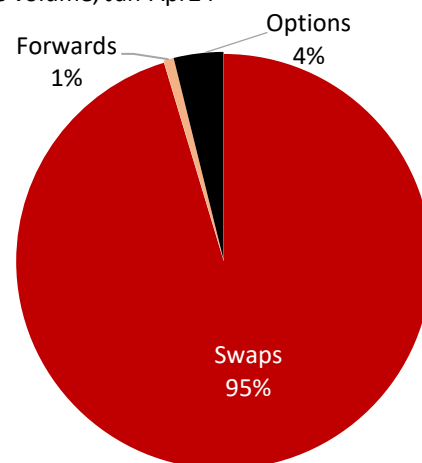
Trade volume, Jan-Apr24



Sources: CFETS, DBS

China's interbank FX market: Derivatives

Trade volume, Jan-Apr24



Sources: CFETS, DBS

Trading and settlement platforms

China's FX market is comprised of the interbank market and the retail market. The majority of trading (about 90%) occurs on the interbank market.

CFETS functions as the trading platform for the interbank market.

- PBOC announces the central parity rate at 9:15am. The daily trading band of CNY against the USD is $\pm 2\%$ around the central parity rate.
- Trading hours (FX spot and derivatives): 9:30-03:00 CST

There are two main modes of transaction on the CFETS platform: quote-driven (matchmaking based on independent quotations, with priority given to price and time) and inquiry (bilateral credit extension and settlement).

Spots are traded through both bilateral and matching modes. FX forwards and swaps are traded on both a bilateral and matching basis,

options are traded through the bilateral inquiry mode, and cross-currency swaps are traded on a bilateral basis.

SHCH offers the clearing services for FX transactions in the interbank market. For anonymous trading, SHCH offers clearing services as a central counterparty (CCP); but for inquiry trading, the trading parties themselves may opt to clear bilaterally or use SHCH as a CCP.

Regulatory authorities

The PBOC and the State Administration of Foreign Exchange (SAFE) are the two main regulatory bodies that cover foreign exchange, SAFE being a subsidiary of the PBOC. SAFE is authorized by the PBOC to oversee FX transactions, manage China's FX reserves, and seek to promote policies to boost the convertibility of the renminbi. The PBOC directly regulates the interbank trading platform – CFETS, while SAFE oversees both the interbank and retail markets.

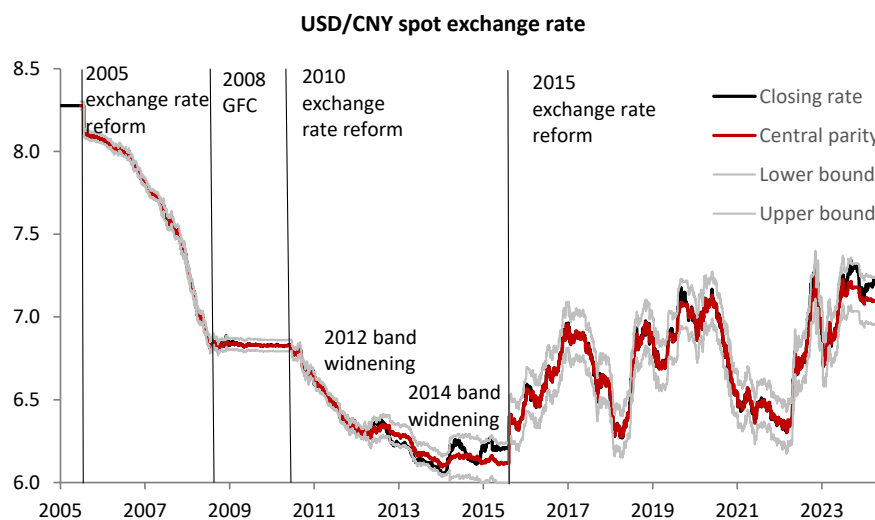
All FX transactions are classified under China's current control system under two categories: capital account and current account items. Participants in China's FX market require SAFE's approval in order to partake in both inbound and outbound cross-border capital account transactions. SAFE also approves certain current account items, but normally current account transactions do not require approval.

Box 2.1 China's exchange rate regime

China's exchange rate regime has undergone gradual reforms since moving away from the fixed exchange rate system in 2005. RMB has generally become more flexible over time, but policymakers may sometimes choose to stabilize the RMB to lean against excessive sentiment and outflows. The PBOC sets the central parity rate on a daily basis and allows the RMB to fluctuate around the central parity rate within a band.

Timeline of China's exchange rate reforms:

- **2005** Shifted to a managed floating exchange rate regime
- **2007** Widened the daily trading band of USD/CNY to 0.5% from 0.3%
- **2008-09** Temporarily adopted a fixed exchange rate system after the Global Financial Crisis
- **2010** Returned to the managed floating exchange rate regime
- **2012** Widened the daily trading band of USD/CNY to 1% from 0.5%
- **2014** Widened the daily trading band of USD/CNY to 2% from 1%
- **2015** Changed the calculation method of the central parity rate, setting it based on the closing rate of the previous day and movement of the currency basket
- **2017** Improved the calculation of the central parity rate – closing rate of the previous day, movement of the currency basket, and the counter-cyclical factor
- **2020** Phased out the use of counter-cyclical factor in the calculation of the central parity rate
- **2023** Central parity rates turned more stable to reinforce RMB stability



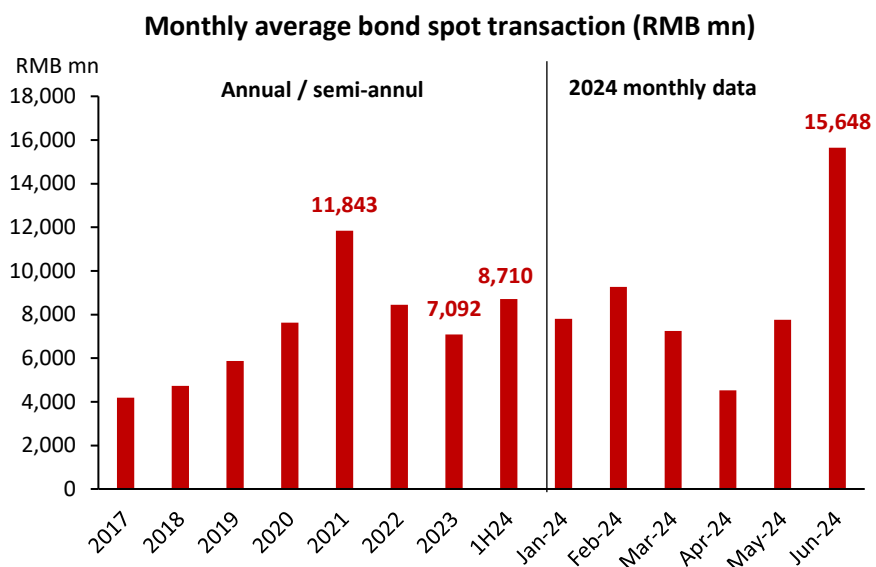
Opportunities and risks

China's bond and FX market opening

Increasingly more foreign investors have entered into China's onshore bond and FX markets

China has increasingly opened its onshore bond and FX markets to more foreign investors over the past decade, through establishment of the Qualified Foreign Institutional Investor Scheme (QFII) in 2002, the RMB Qualified Foreign Institutional Investor Scheme (RQFII) in 2011, the China Interbank Bond Market Direct (CIBM Direct) in 2016, and Bond Connect in 2017. Recently in 2020, the authorities combined the QFII and RQFII into a collective regime called the QFI Qualified Foreign Investor scheme (QFI). Since May 2023, the offshore investors are enabled to hedge against interest rate movement through the Swap Connect.

Relaxation and consolidation of regulations have made it easier for foreign investors to operate in China



Source: CEIC, DBS

The total bond transaction under QFII and RQFII has recently regained traction. Monthly average transaction rebounded to RMB8,710mn in 1H24 from the trough of RMB7,092mn in 2023. With the recent issuance of the RMB1trn special government bond, the transaction amount almost reached a historical high in June 2024. The total number of international investors registered on the Northbound Bond Connect scheme has reached over 800, with an average daily turnover of CNY47bn as of May 2024.

The increase in foreign investor presence in the Chinese bond and FX markets can be attributed to relaxed and more harmonized regulations. Further to the removal of the QFII and RQFII 20% monthly cap on

repatriations and the three-month lock-up period since 2018, the investment quota system for QFIIs and RQFIIs has been abolished in May 2020. Effective November 2020, QFII and RQFII qualifications and regulations have been unified under the new QFI program.

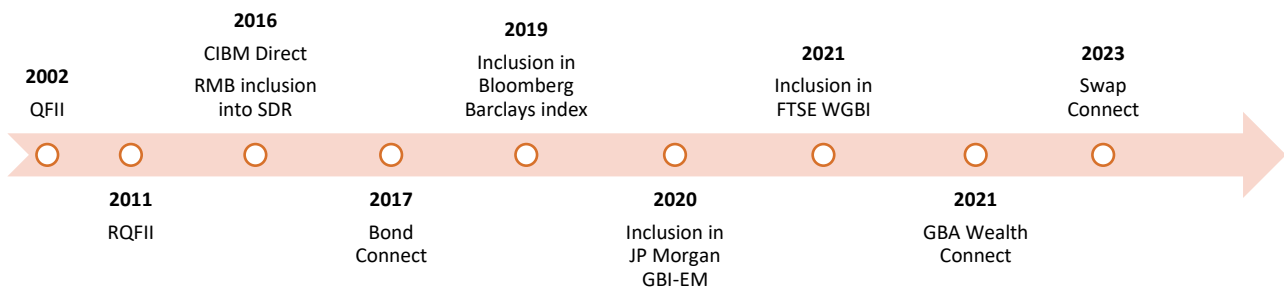
In November 2023, the PBOC and SAFE jointly announced a proposal to streamline the process for QFI investors to register their funds with SAFE. Also, the authorities will consolidate the depository account for securities and derivatives trading. On remittance of onshore earnings, foreign investors will be enabled to remit the funds in RMB in addition to foreign currencies. The ratio of foreign currency remitted outward to the foreign currency remitted inward is also upward adjusted from 110% to 120% for investors that remit in both RMB and foreign currency.

Since 2017, the Bond Connect also gives offshore foreign investors access to China's onshore bond market ('northbound' trading). With much fewer restrictions – no quota condition, repatriation limit, or need for investors to declare the investment amount – it is an ideal program to encourage offshore foreign investor participation in the bond market.

*Swap Connect
enables investors to
hedge against
interest rate risks*

Northbound Trading of Swap Connect (IRS market) was launched in May 2023 to facilitate global investors' management of interest rate risks arising from their allocation to Mainland bonds through Bond Connect. Products include CNY Fixed-to-Floating IRS on 7-day Repo (FR007), SIBOR 3-Month (Shibor3M), and SHIBOR Overnight (ShiborO/N). There have been several enhancements since July 2023, including the introduction of the Northbound Bond Connect Settlement Failure Reporting One-stop Online Service and basket trading function. These market-oriented enhancements improved operational efficiency and user experience.

In January 2024, the PBOC and HKMA jointly announced the further opening up of the onshore repo market to all CIBM foreign institutional investors (including Bond Connect investors). The authorities also expanded the list of eligible collateral for the HKMA's RMB Liquidity Facility to include RMB bonds issued onshore by the Ministry of Finance and the policy banks.



On the retail front, the GBA Cross-Border Wealth Management Connect Scheme (WMC Scheme), launched in September 2021, has witnessed robust demand from Northbound investors seeking to diversify their wealth management portfolios. The market capitalization of investment products under the scheme has surged by 4.5 times, jumping from RMB5.1bn in 2022 to RMB22.8bn in 2023. Earlier this year, GBA Wealth Management Connect 2.0 was introduced to 1) triple the investment quota from RMB1 million to RMB3 million, 2) expand the Northbound eligible products from R1-R3 to R1-R4, and 3) lower the investment threshold.

GBA Wealth Connect

	Northbound	Southbound
Eligible investors	Hong Kong permanent and non-permanent residents	GBA residents with at least 2 years of investment experience
Threshold	N/A	Net household financial asset >RMB1mn in the past 3 months, or; Average personal annual income >RMB400,000 in the past years Household financial asset > RMB2mn in the past 3 months, or;
Investment products	Products issued by Mainland wealth management companies, with risk rating of "R1" to "R3", including public fixed income wealth management products, public equity wealth management products Public securities investment funds with risk rating of "R1" to "R4" (excl. commodity futures funds) RMB deposit products offered by Mainland banks	Non-complex funds domiciled in Hong Kong and authorised by the SFC, including Funds primarily invest in Greater China equity, low- to medium-high-risk funds, excl. single emerging market equity funds and high yield bond funds Low- to medium-risk and non complex bonds RMB, HKD and foreign currency deposits offered by Hong Kong banks
Eligible Institutions	Eligible banks and securities firms can participate in Cross-boundary WMC	
Aggregate quota	Northbound and Southbound Schemes are each subject to a quota of RMB 150 billion, shared by Hong Kong and Macao	
Individual investor quota	Each investor is subject to a quota of RMB 3 million. If an investor simultaneously selects both a bank and a securities firm for investment under cross-boundary WMC, individual investor quota allocated between the bank and the securities firm will each be RMB 1.5 million	

Source: HKMA, DBS

Inclusion into global bond indices

Inclusion of Chinese bonds in major bond indices could generate around USD300bn inflows

In April 2019, Chinese government bonds and policy bank bonds were included in the Bloomberg Barclays Global Aggregate Index for the first time, of which China is projected to comprise around 6% upon full inclusion. This could generate around USD150bn in potential inflows as these Chinese bonds are phased in.

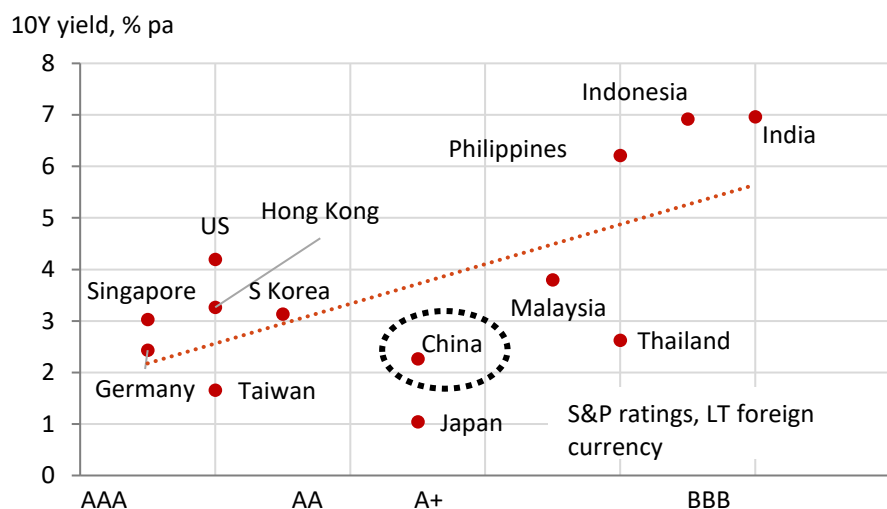
JP Morgan added Chinese government bonds into its Global Bond Emerging Market Index in February 2020. And since 2021 a phased inclusion of Chinese debt into the FTSE Russell World Government Bond Index has been in train. Inclusion of Chinese bonds in all the three major indices is estimated to bring a total of USD300bn inflows.

Potential impact of index inclusion

	Bloomberg Barclays Global Aggregate Index	FTSE WGBI	JP Morgan GBI-EM
AUM	USD2.5tn	> USD2.5tn	USD200bn
China's weight	6%	5%	10%
Fund inflows (estimate)	USD150bn	> USD130bn	USD20bn

Sources: Reuters, Bloomberg, DBS

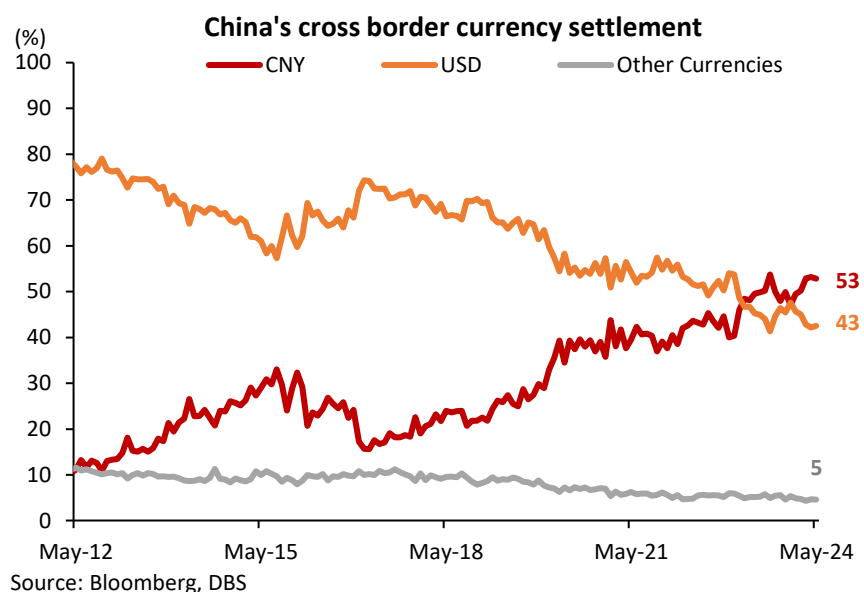
Government bond yields vs sovereign ratings



Source: Bloomberg, DBS, as of Jul 19, 2024

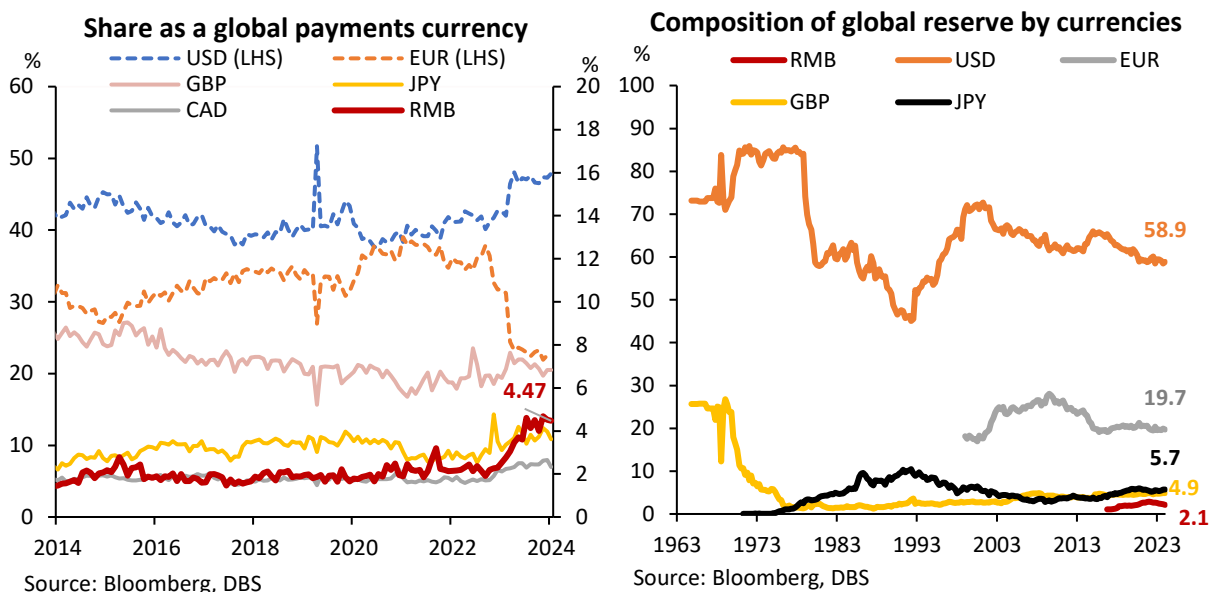
RMB internationalisation

The accelerating internationalisation of the RMB will bring fresh impetus to RMB assets. The Chinese government is encouraging the internationalization of the renminbi through trade and investment especially within the Belt and Road Initiative (BRI). According to SWIFT, the RMB is now ranked the 4th major global payment currency. Its share has doubled from 1.9% in Jan 2023 to 4.47% in May 2024. This is in line with SAFE's data that the CNY has overtaken the USD as the major currency used bilaterally in China's cross-border currency settlements since July 2023.



RMB weight in the world's foreign reserve allocations has increased to 2.15%

With the increasing usage of RMB in international trade and investment, central banks are gearing up holdings of RMB assets in their reserves. Coupled with the increased weighting of the RMB (from 10.92% to 12.28%) within the IMF's SDR currency basket since May 14, 2022, RMB positions by international central banks has increased by 188% to USD247bn between 4Q16 and 1Q23. Its share has also expanded twofold from 1.08% to 2.15%. Assuming the renminbi's weight in global foreign reserves rises further to 5% in the next 5-10 years (largely on par with that of the GBP and JPY), it would mean more than USD355bn in inflows into RMB assets, including about USD140bn in Chinese bonds.

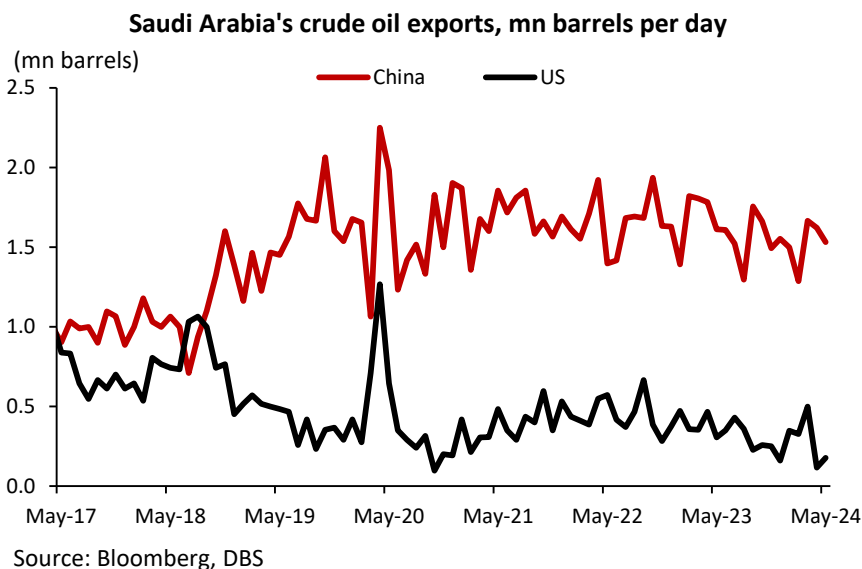


The use of RMB is accelerating in following 4 sectors. Financial institutions are key enablers in these cross-border transactions by facilitating cross-border settlement and capital market activities such as RMB denominated bond issuance.

1. Oil & Gas

The petrol-CNY system is the key driving force of RMB internationalization. Middle East and other BRI participant countries have started settling part of their oil trades with China in RMB. In 2022, Saudi Arabian oil giants have already entered the RMB oil futures market and have signed RMB settlement agreements with China. This is not completely out of expectation as China has become the top importer of oil from Saudi Arabia since 2018.

The petrol-CNY system is the key driving force of RMB internationalization

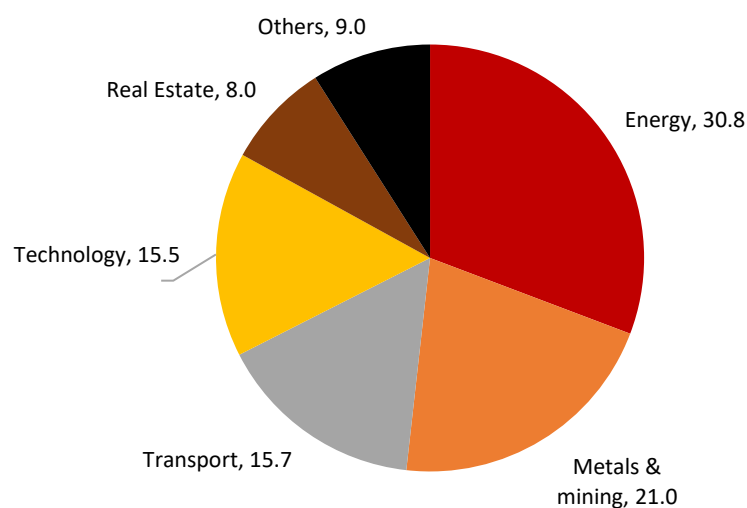


Use of RMB will gain traction in Middle East's infrastructure investment

2. Infrastructure

According to Fudan University, transport accounted for 16% of total Chinese outward investment to BRI countries in 2023. Middle Eastern countries continued to be major recipients of Chinese construction engagement, receiving 36.7% of total BRI construction engagement in 2023. Chinese infrastructure companies, mainly SOEs, have funded/constructed numerous Middle East projects including the Saudi Vision 2030 NEOM New City project.

Sector shares of BRI engagement in 2023



Source: Fudan University, DBS

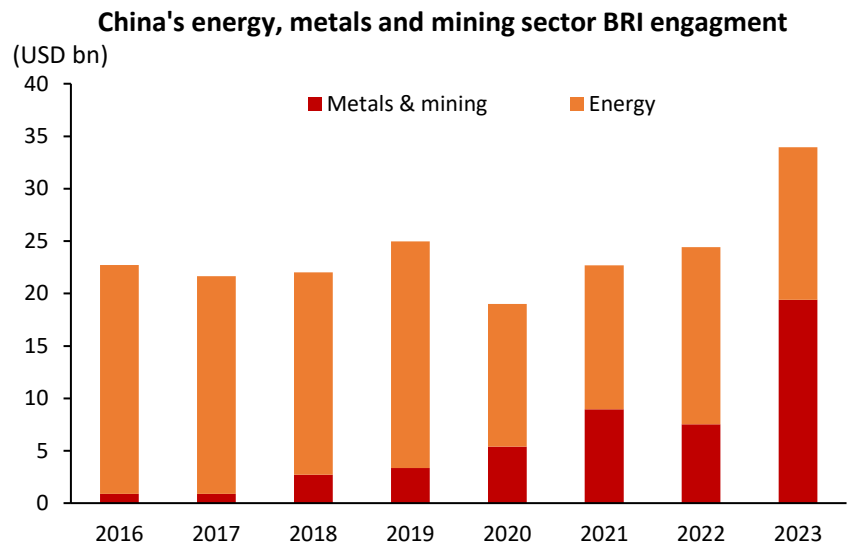
3. Renewable energy

The next building block of RMB internationalisation is green energy investment

The next building block is green energy investment in both the Middle East and Latin America. The Saudi government pledges to achieve net-zero emissions by 2060 by investing more than USD186bn in the green economy over that time. Chinese involvement is best exemplified by the Silk Road Fund's acquisition of a 49% stake in a Saudi state-controlled renewables arm.

Latin America is another major recipient of Chinese green energy investment. Chinese energy SOEs have been increasing exposure in Brazil, with private companies providing turbine supplies and solar panel. China also plays a pivotal role in the extraction and refinement of lithium. Chinese investment in BRI's mining sector jumped by 158% in 2023. This was largely driven by green-transition related materials in

Latin America. Note that the continent collectively produces up to more than half of the world's lithium.



Source: Fudan University, DBS

4. Agricultural trade

China signed bilateral RMB trade agreements with major agricultural exporters in Brazil and Argentina in 2023

Another key piece of the RMB internationalization puzzle is agricultural trade. China signed bilateral RMB trade agreements with major agricultural exporters such as Brazil and Argentina in 2023. China has become the top trading partner of Brazil, with its total trade value surpassing that of Brazil-US trade since 2009. These two countries alone accounted for 25.6% of China's total agricultural imports in 2023.



Source: CEIC, DBS

Structural and cyclical risks

Access to hedging tools has improved for foreign investors, but liquidity and credit risks remain

- **Bond market liquidity:** There is a low frequency of trading and low liquidity across China's bond market due to banks holding bonds until maturity, limiting the share of bonds traded. This, combined with an underdeveloped financial market infrastructure as well as China's relatively high bid-ask spreads, has led to limited liquidity, particularly for credit bonds. Treasury bonds also are insufficiently liquid, restricting the Chinese government bond yield curve.
- **Credit ratings:** Onshore bond ratings are highly skewed (more than 90% of credit bonds are rated AA or above), reflecting stringent issuance requirements, and a high number of state-owned enterprises.
- **Bond market hedging tools:** China's bond derivatives market has been gradually developing and opening to foreign investors. China's new Swap Connect program allows "northbound" trading in RMB-denominated contracts, up to a daily net cap of CNY20bn. Increased access to onshore rate swaps should help with the management of interest rate risk. Tools for the hedging of credit risks are still limited.
- **Cross-border capital flows:** China's capital account is not fully liberalised. The amount and proportion of funds that can be remitted are still subject to restrictions, reducing the willingness of foreign investors to participate in the bond market. Further, capital flow policies are unpredictable, which raises uncertainty and decreases investor confidence.
- **Tax uncertainty:** Tax policy regarding China's bond market has been unclear. This has consequences for returns and cash flow, as well as for foreign investors' willingness and ability to participate in the onshore markets. The biggest sources of uncertainty for foreign investors are through tax rates (a lack of consolidated notices), tax exemption policy, and tax calculation and collection methods.
- **FX liquidity:** Liquidity of China's onshore FX market remains low in comparison to other countries. Regulation restricts foreign investor access to the FX market, thinning foreign investor trade volume and lowering liquidity. Trading hours have been extended, with market closing at 3am local time the next day, instead of 11.30pm.

Credit risks have passed its peak with greater policy support

The volatility of the RMB is managed

- **FX hedging tools:** Hedging tools in China's FX market remain limited due to regulation and a lack of availability. There is a distinct lack of capacity at global custodian banks, so most are not prepared to offer onshore FX transactions. This leads to hedging via the offshore spot market, which is more volatile and has higher hedging costs.
- **Credit defaults:** The quantum of Chinese credit defaults has eased from a record high of CNY 468bn in 2022, sparked by liquidity stresses faced by real estate developers. In 2024, China has announced more support measures for the real estate sector, which include the relaxing of housing curbs, allowing local government purchases of unsold homes, and promoting loan support for a whitelist of projects. Default risks should have passed its peak, though new home sales remain subdued and the outlook of the property market remains uncertain.
- **Exchange rate volatility:** While the volatility of the renminbi has increased structurally since the exchange rate reform in 2015, policymakers can choose to temper volatility by setting stable central parity rates, as was the case since mid-2023. USD/CNY 1Y historical volatility has eased considerably below levels seen in 2018-2023.

Access channels for foreign investors

QFII/RQFII, CIBM Direct and Bond Connect

Foreign institutional investors can currently access China's onshore debt markets via three main avenues - QFIs, CIBM, and Bond Connect.

Account openings

In order to participate, QFIIs and RQFIIs must obtain CSRC approval and register with SAFE before making investments. Investors looking to participate through CIBM Direct are not subject to approval. Instead, foreign investors are only required to engage in a filing process with PBOC through a bond settlement agent. The agent manages transactions and regulatory reporting, as well as account opening. QFIIs/RQFIIs can also invest in CIBM upon filing with PBOC.

In 2022, the PBOC, SAFE, and CSRC jointly announced "The Matters Concerning Further Facilitating Investment in China's Bond Markets by Overseas Institutional Investors". The authorities are now exploring the establishment of inclusive institutional arrangements compatible with the multi-level custody system. Overseas institutional investors will be enabled to entrust qualified local custodians for bond custody directly, or through their global custodians.

Investment quota and products

There is currently no investment quota restriction for QFIIs and RQFIIs. Effective November 2020, QFII and RQFII qualifications and regulations have been unified and the entry requirements have been loosened. CIBM investors are also not subject to quota.

Bond Connect investors also have no approval or quota requirement and are not required to appoint a local Bond Settlement Agent (they may use an existing offshore custodian). Bond Connect investors can open offshore accounts with the Central Moneymarkets Unit (CMU) in Hong Kong, and trade through international electronic platforms (e.g. Tradeweb, Bloomberg, and MarketAxess).

QFIIs and RQFIIs can invest in any cash bonds available on the onshore market. Effective November 2020, QFIIs/RQFIIs have also been allowed to invest in derivatives on bonds and interest rates traded on the interbank bond market which are deemed eligible by the PBOC for qualified foreign investors, as well as financial futures contracts traded

on the China Financial Futures Exchange. They are also allowed to participate in bond repos, margin trading, and security borrowing.

CIBM Direct offers foreign investors greater access to hedging instruments than Bond Connect. Investors under CIBM Direct are able to invest in cash bonds and also participate in bond lending, forwards, interest rate swaps, forward rate agreements and bond repos in the interbank market. Foreign investors under Bond Connect can only access FX hedging tools.

Comparison of access channels: Eligible investors

	QFII/RQFII	CIBM Direct	Bond Connect
Eligible investors	Foreign institutions meeting the requirements including: <ul style="list-style-type: none"> • Sound financial conditions and good credit standing, with experiences in securities and futures investment • Sound and effective governance structure, internal control system, and compliance management regime • No record of major punishments by regulatory authorities in the latest 3 years 	Foreign institutions meeting the requirements including: <ul style="list-style-type: none"> • Sound structure • Complete internal control system • Not subject to any penalties of government authorities for an illegal act or violation in bond investment business in the latest 3 years • Public sector investors: foreign central banks, sovereign wealth funds, international financial organizations • Private sector investors – Type 1: offshore RMB clearing/ participating banks • Private sector investors – Type 2: commercial banks, securities companies, asset management companies, insurance companies, pension funds, charity funds, endowment funds, other medium- and long-term institutional investors 	Same as CIBM Direct
Regulatory approval	CSRC approval Registration with SAFE	Filing with PBOC Registration with SAFE	Filing with PBOC
Investment quota	No	No	No

Sources: PBOC, SAFE, CSRC, DBS

Comparison of access channels: Eligible products

	QFII/ RQFII	CIBM Direct			Bond Connect
		Public sector investors	Private sector investors – Type 1	Private sector investors – Type 2	
Cash bonds	√	√	√	√	√
Bond lending, Bond forwards, IRS, FRA	√	√	√	√	X
Repos	√	√	√	X	X
FX derivatives	√	√	√	√	√

Sources: PBOC, CSRC, DBS

Tax treatment

The Chinese government has made strides in tax policy to encourage foreign investment

In 2018, the Ministry of Finance announced a three-year withholding tax and value-added tax exemption on foreign institutional investors' interest income derived from China bond investment, in order to boost foreign participation in the onshore bond market. Such tax exemption has now been extended to December 31, 2025.

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