KIEP

WORLD ECONOMY UPDATE

January 23, 2015 | Vol. 5 No. 2

The Changes in China's Bond and Foreign Exchange Market and Their Effects on Korea

ISSN 2233-9140

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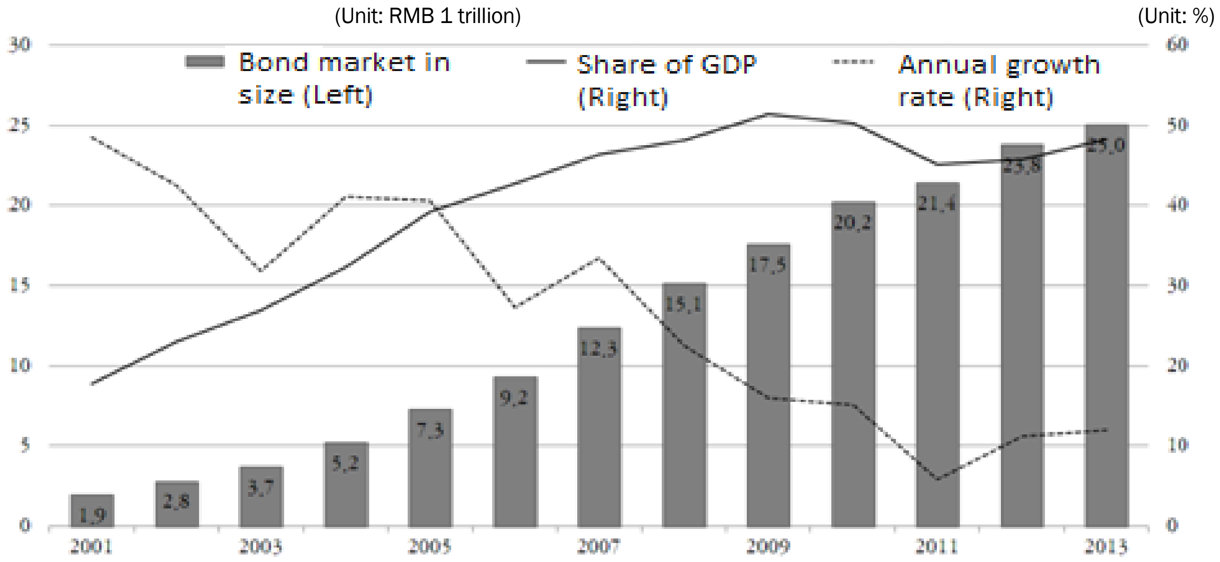
1. Developments in the Bond Market

The Chinese bond market has entered a phase of full-fledged growth following the establishment of an interbank market in 1997, and China's accession to WTO in 2001. The Chinese government took measures to bolster the bond market by gradually opening up the interbank bond market - the most active of secondary markets - to a wider range of participants, and by diversifying financial instruments into asset-backed securities, medium-term notes, collective bonds, corporate bonds and so forth. Many regulations, however, still restrict foreign investors seeking to invest in Chinese bonds or private companies looking to issue corporate bonds. While the size of the bond market has grown swiftly, its development is still slow given the scale of the Chinese economy. This is illustrated in the fact that although China accounts for about 10% of global GDP, it only takes up roughly 5% of the global bond market. Aside from the question of size, another notable problem is that the market suffers from structural imbalance. In terms of amounts outstanding, 74% of bonds were government and financial bonds, and only 9% was accounted for by corporate bonds.

Most corporate bonds are issued by state-run companies, and this indicates that the bond market is not yet functioning properly as a channel for credit creation by the private sector. The same goes for the composition of players in the bond market; which is mostly state-owned commercial banks. On top of this, the bond market is largely closed off to the outer world, allowing foreign investors extremely limited access. Recently, the interbank market - the largest secondary market in China - was opened to QFIIs (Qualified Foreign Institutional Investors), but the quota for total portfolio investment is a mere 1.1% of amounts outstanding in the bond market.

Given China's recent moves to internationalize the yuan, open the capital account, and take a new approach to economic transition, the Chinese bond market is expected to move in the direction of fostering the offshore bond market, opening the onshore bond market and issuing more corporate bonds. Continued demand for the yuan is necessary for China's currency internationalization plan to remain viable, and this in turn calls for building the yuan's role as an investment currency. Case examples of countries like Japan, Germany and Australia show that efforts to internationalize their currencies were preceded by encouragement of domestic bond issues by nonresidents. Likewise, the Chinese government is predicted to work on expanding the offshore yuan bond market. Meanwhile, new channels of economic growth are expected to be found in the increase of corporate bond issues by SMEs, which had difficulty raising capital under the existing system.

Figure 1. China's Bond Market in Size



Author's Note:

1) In terms of amounts outstanding on yuan-denominated bonds (amounts outstanding on US dollar-denominated bonds is a mere RMB 1.365 billion as of the end of July 2013).

2) Statistics for 2013 are as of the end of July. Share of GDP for July 2013 was calculated based on GDP from 2012. The annual growth rate was calculated based on July 2012.

Source: China Central Depository & Clearing Co., Ltd. (http://www.chinabond.cn); CEIC DB (Data retrieved on Aug. 23, 2013).

2. Developments in the Foreign Exchange Market

China's exchange rate system has undergone changes in line with the country's reform and open-door policies, and still continues to do so. It was unified in January 1994, and since then the country adopted a managed floating exchange-rate regime, implementing a fixed exchange rate and managed floating exchange rate that fixed or floated daily movement in accordance with economic circumstances and progress in reform. As for opening up the capital account, gradual progress is a likely scenario considering the low level of development in China's financial market and the government's caution toward possible side effects. Reform in the exchange rate system is projected to take place gradually, as the capital account opens up and interest rates are liberalized.

Table 1. Development of China's Exchange Rate System (since 1981)

Period	System	Key Measures	Daily Fluctuation Limit
JAN 1981-DEC 1993	Dual Exchange Rate Regime	- Different internal/external exchange rates applied - Yuan assessed to have been overvalued prior to 1980, depreciation by adopting dual exchange rate	
JAN 1994-DEC 1997	Managed Floating Exchange Rate Regime	- Dual exchange rate abolished, exchange rates unified	±0.3%
DEC 1997-JULY 2005	De Facto Fixed Exchange Rate Regime	- Pegged to 8.28 yuan/dollar rate	-
JULY 2005-MAY 2007	Managed Floating Exchange Rate Regime	- Pegged to a basket of 11 currencies - Appreciated 17.5% in three years	±0.3%
MAY 2007-JUNE 2008		- Expanded to daily movement of ±0.5%	±0.5%
JULY 2008-MAY 2010	De Facto Fixed Exchange Rate Regime	- Pegged to 6.83 yuan/dollar rate	-
JUNE 2010-MAR 2012	Managed Floating Exchange Rate Regime	- Returned to basket system of multiple currencies	±0.5%
APR 2012		- Expanded daily movement	±1%

Source: Compiled by author based on KIEP (2010, p. 37) and Bank of Korea(2012, p. 271).

3. Impact on Korea

The first scenario to be analyzed was how fluctuations in China's bond interest rates would affect bond interest rates in Korea. Empirical analysis results revealed there was not much of a direct connection, but the indirect impact arising from economy and price coupling or policy coupling was statistically significant. Aside from these two channels, however, China's bond interest rate fluctuations overall did not have a statistically significant influence on Korea's bond interest rates. In conclusion, there was no direct link between the two, but China's bond interest rates are projected to gain influence over the Korean bond market in the future. As of now, the US dollar is exerting power as an international currency, serving as a refinancing rate. If, under such circumstances, China succeeds in internationalizing the yuan and opens up its financial market by liberalizing interest rates, Korea's bond market will likely be more affected through channels other than economy, price and policy coupling.

Second, an empirical analysis of determinants of the won/yuan exchange rate found that differences in bond interest rates and base rates were causes behind its fluctuation. Differences in bond interest rates in the two countries had the same effect as projected under interest rate parity. Meanwhile, differences in base rates - which reflect monetary policies - went against projections, due to the circumstances under which the monetary policies were carried out and the time difference between when the effects showed. However, only the difference in base rates was statistically significant when adding the won/dollar exchange rate to explanatory variable. It can thus be inferred that the won/dollar exchange rate plays a large part in the analysis of determinants of won/yuan exchange rate fluctuations, and that the difference in liquidity serves as a more important variable than fluctuations in the bond market.

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