

Discussion of

China's Emerging Domestic Debt Markets: Facts and Issues

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Summary (1)

- China's domestic debt market has recently come a long way
 - Domestic government bond issues jumped from RMB 31.5 billion in 1993 to more than RMB billion 500 by early years of new millennium
 - Turnover in government bonds rose from 34 *billion* in 1991 to 13 *trillion* in 2002

Summary (2)

- But still have a long way to go ...
 - Bank deposits dominate asset holdings
 - Government bonds are 95% of traded debt
 - Limited non-bond debt markets
- Evidence of excess supply of funds ...
 - Turnover in government bonds dominated by repurchase agreements
 - Secondary market yields on government bonds are low

Summary (3)

- Important implications for economy
 - “holes” in yield curve
 - Cost of capital to enterprises is high
 - Enterprises find it difficult to manage liquidity
 - Trade debts and receivables not tradable
 - Recapitalization of banks difficult
 - Limited potential for asset backed securities
 - Limits Central bank ability to conduct OMO

Managing Further Development

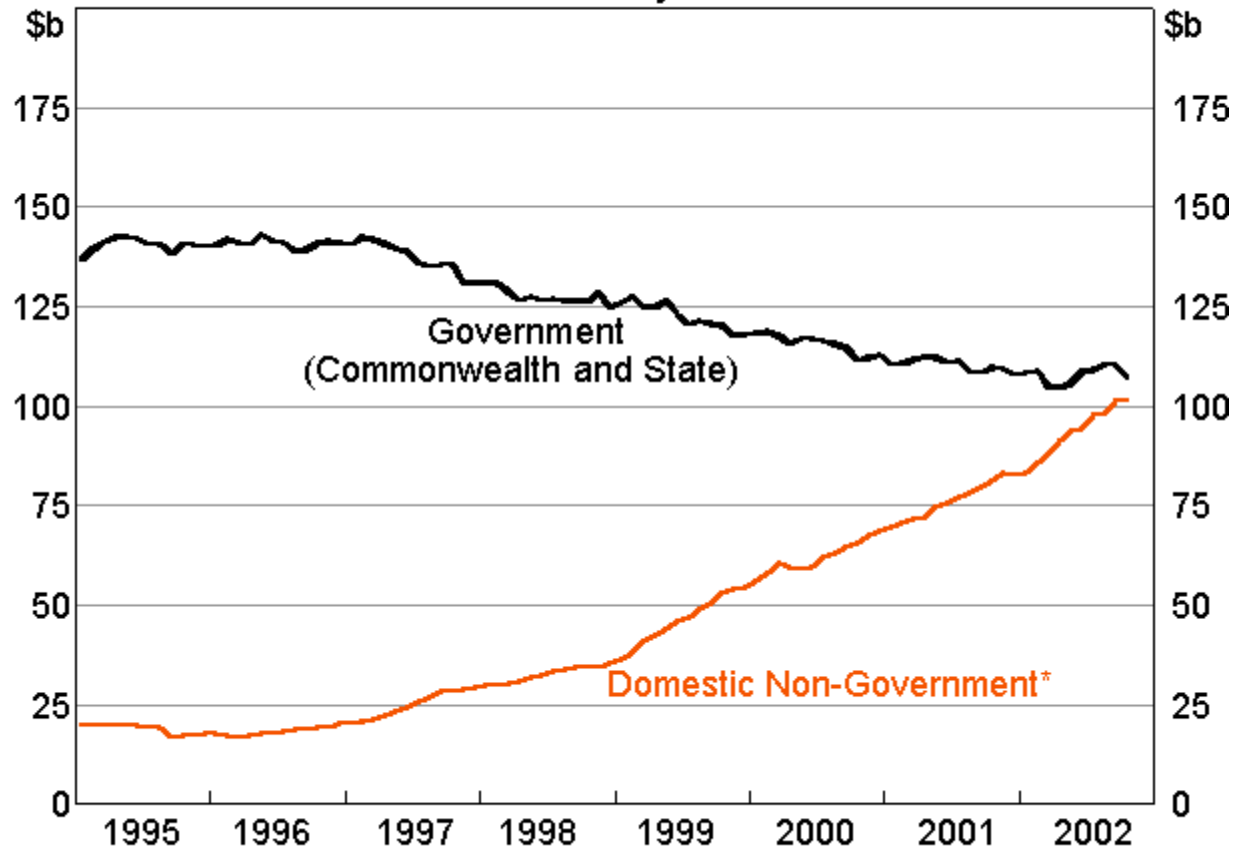
- Case for expanded access to debt/fixed income markets seems overwhelming
- What can we *reasonably* expect further development of domestic debt markets to achieve?
 - At least in short term
- How do we manage this development?
 - Expand savings opportunities without further eroding bank capital?
 - Expand corporate borrowing without dramatically reducing credit quality?
 - Expand provincial/municipal borrowing without creating over-borrowing problems?

Corporate Borrowing

- Instructive to look at experience of another country that has experienced substantial recent large in its domestic bond market
 - Australia
- Share of bonds outstanding shifted dramatically towards private sector
 - As large debtor country, mostly marketed to foreign investors
 - Increase in onshore bonds paralleled by increases in offshore bonds
 - Onshore and offshore bonds of different character

Domestic Bonds Outstanding

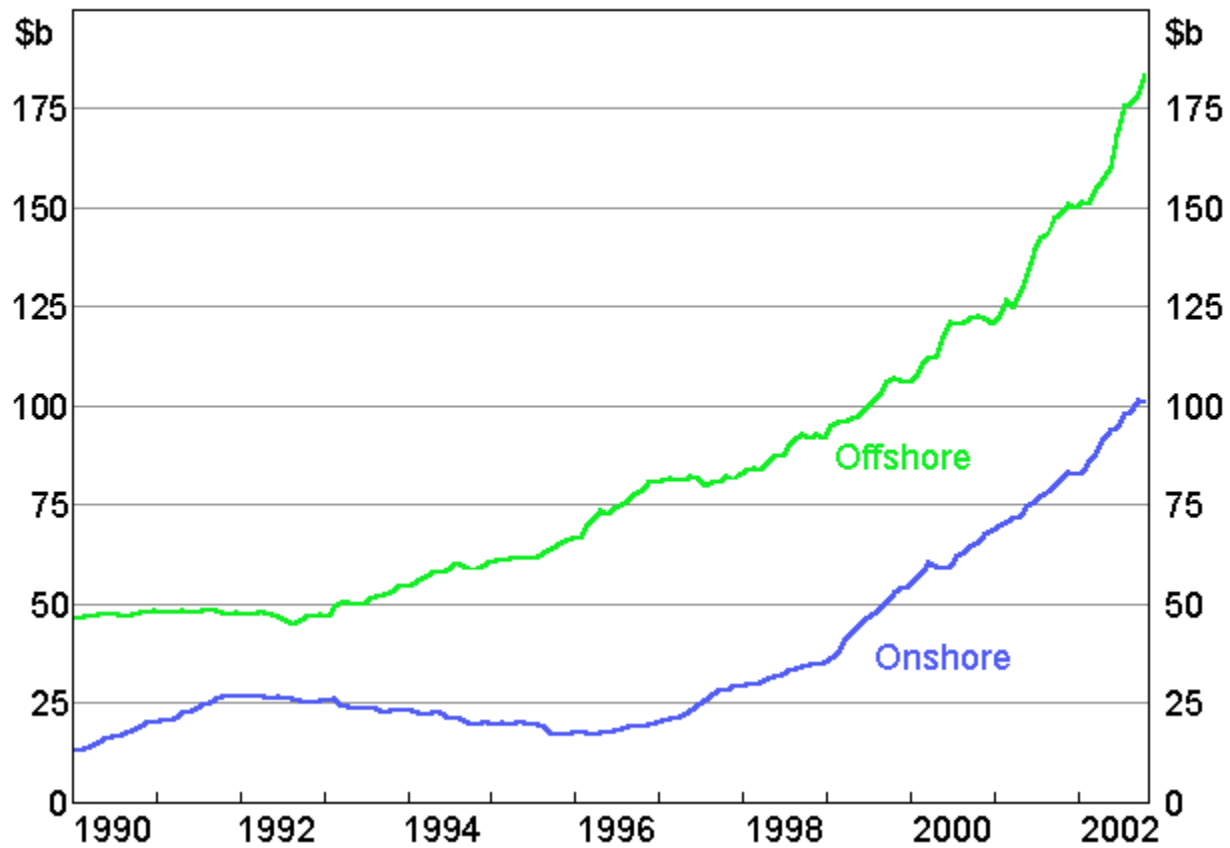
Monthly



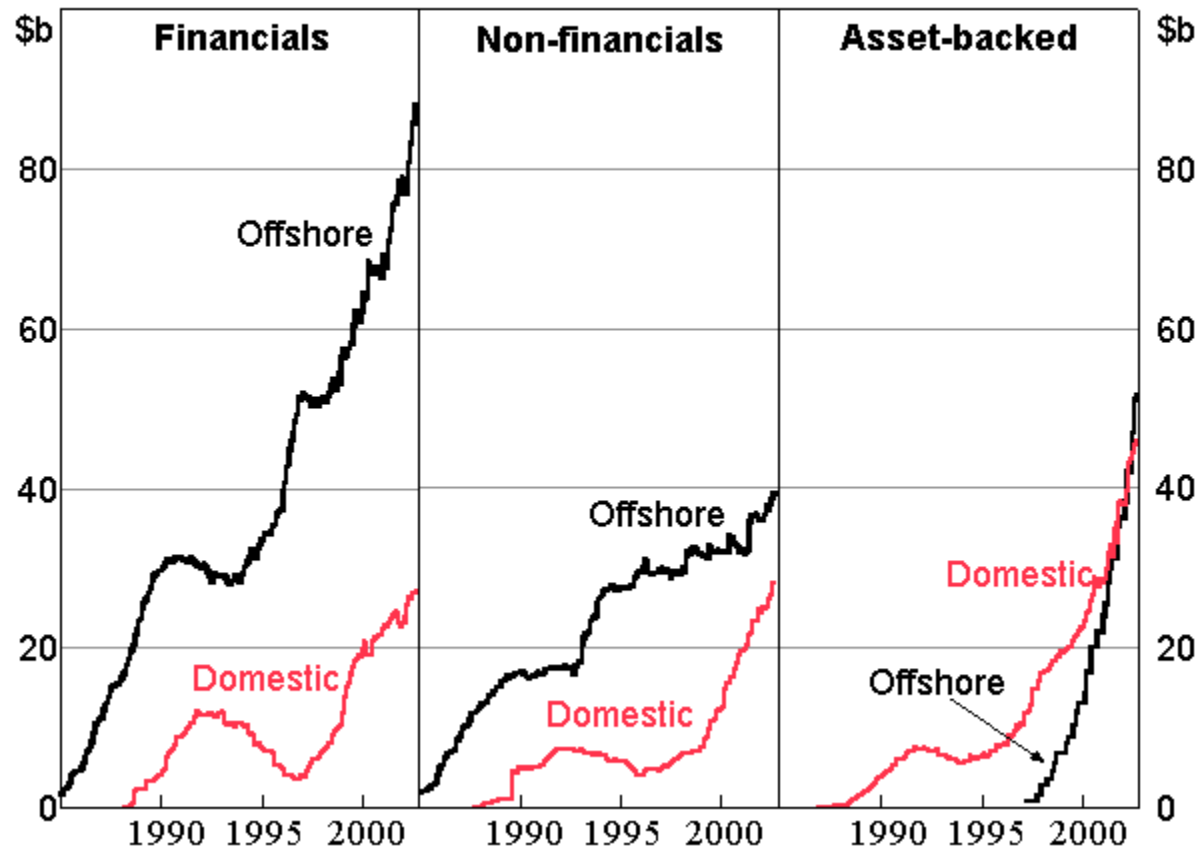
* Excludes Issues in Australia by non-residents

Australian Bonds Outstanding

Monthly



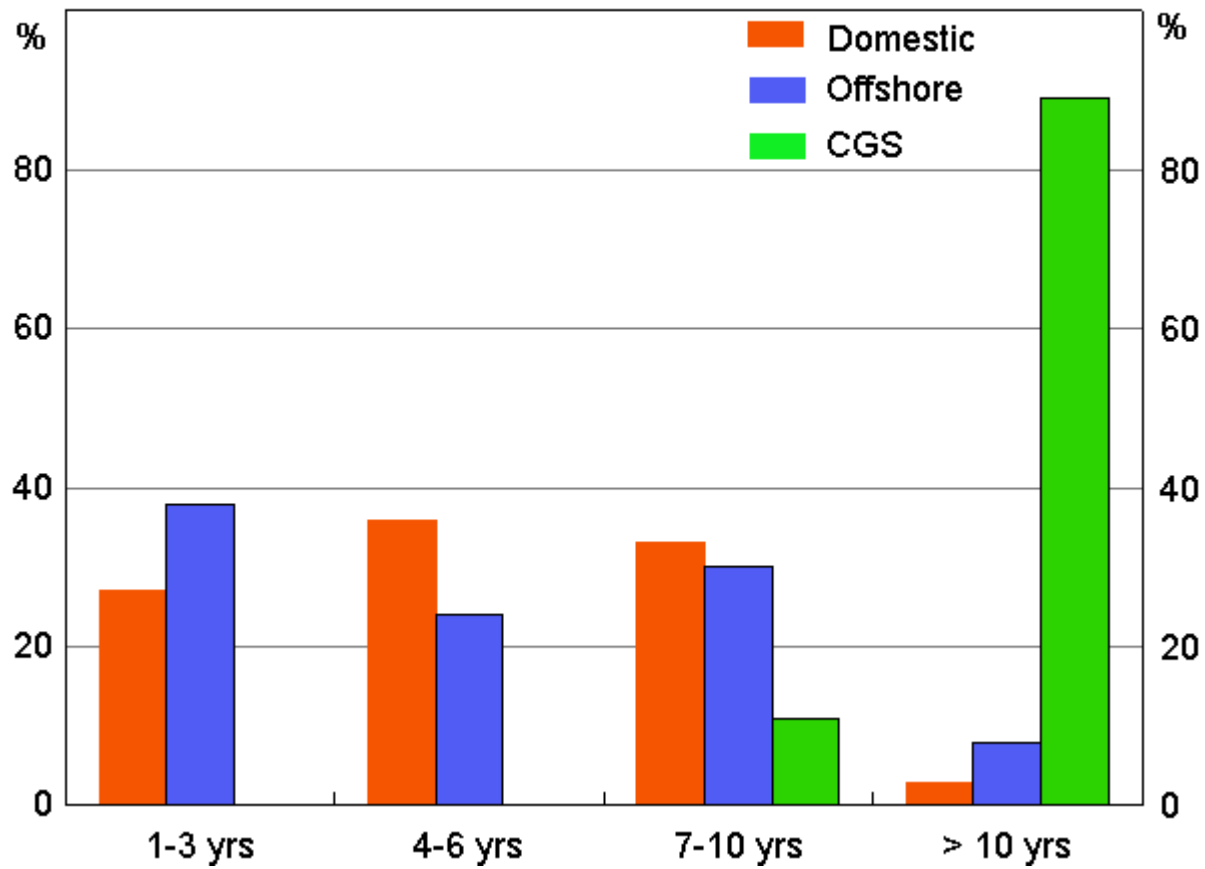
Non-Government Bonds Outstanding



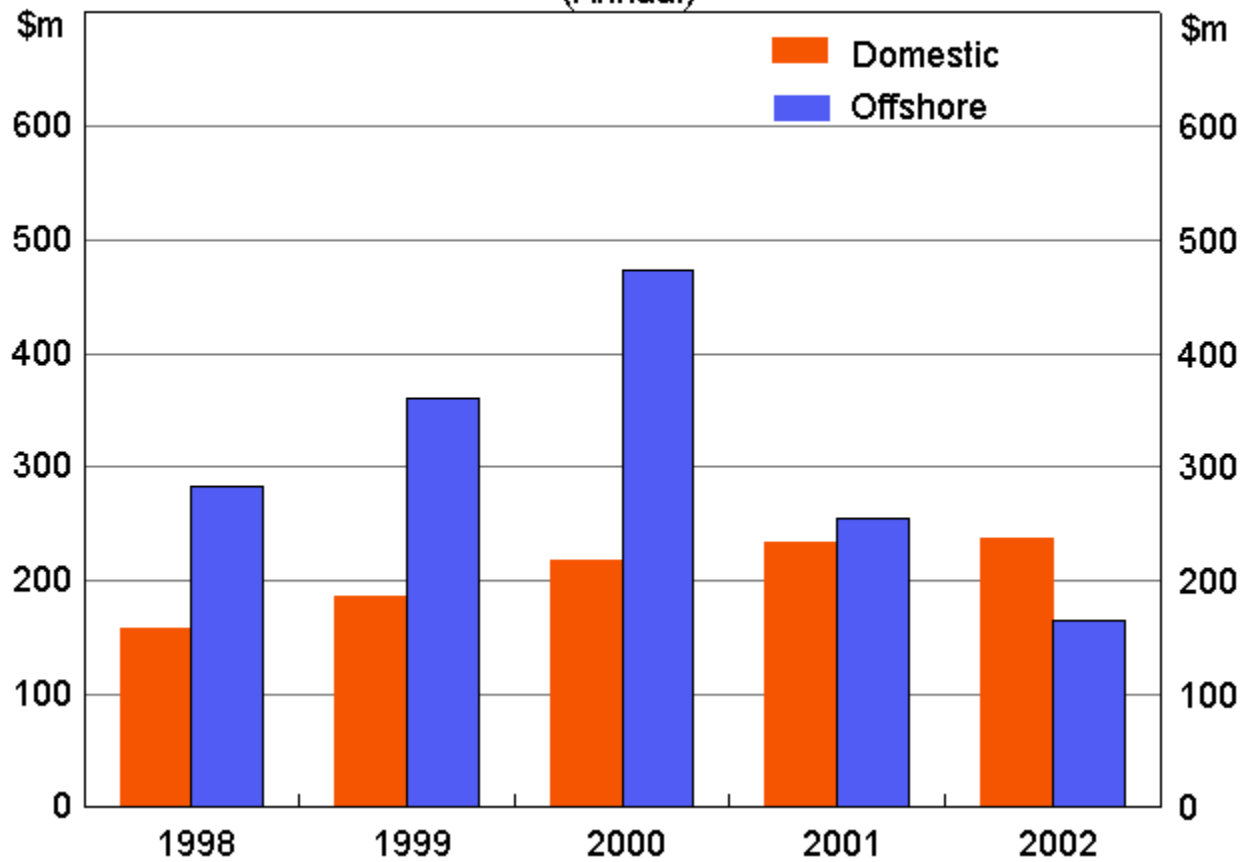
Importance of offshore vs foreign

- Choice of onshore *versus* offshore is partly (but not entirely) a question of
 - Maturity
 - Issue size
- Choice is also driven by issues in
 - Credit quality
 - Foreign exchange exposure
 - Latter seems very important in the light of “original sin” and “conflicted virtue”

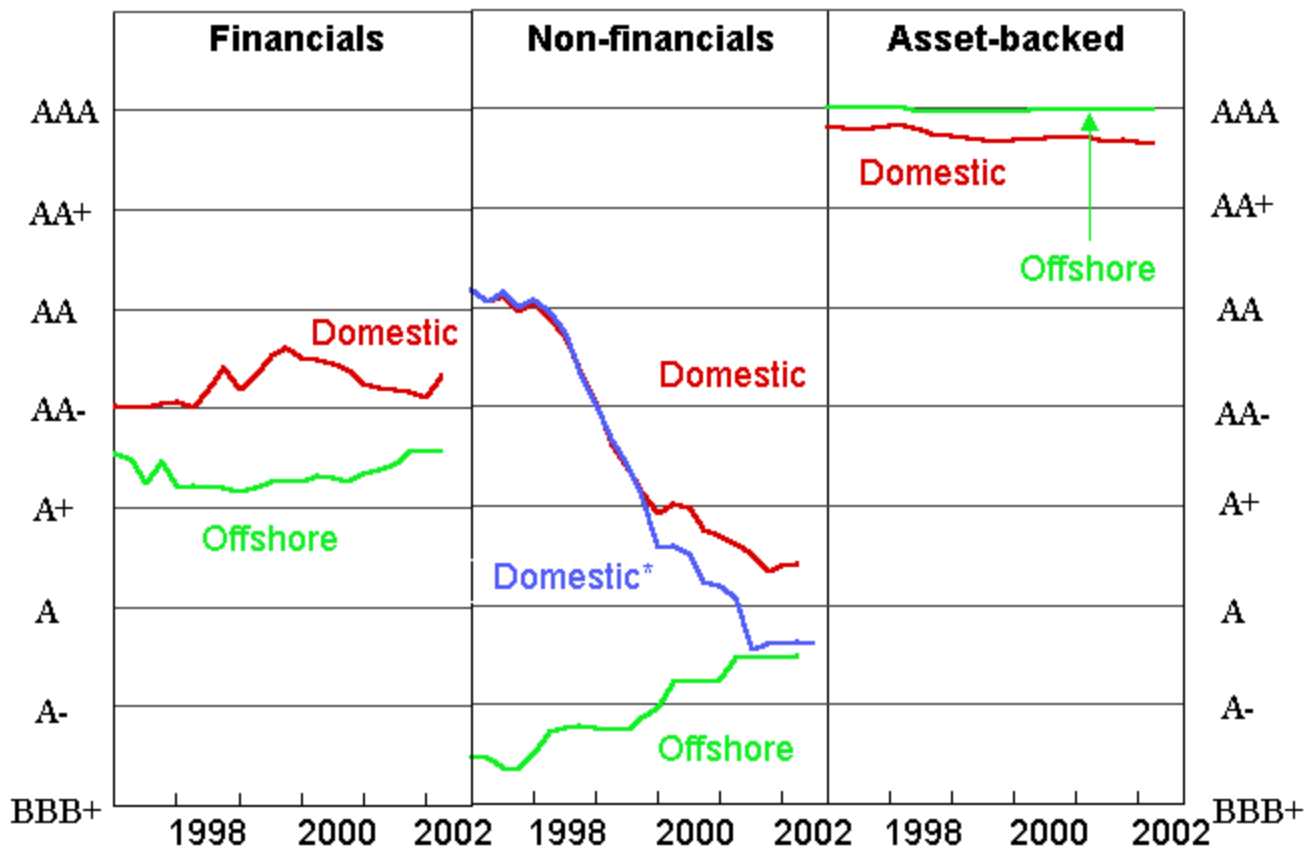
Australian Bond Issuance 2001 - 2002 By Term to Maturity (Yrs)



Average Issue Size (Annual)



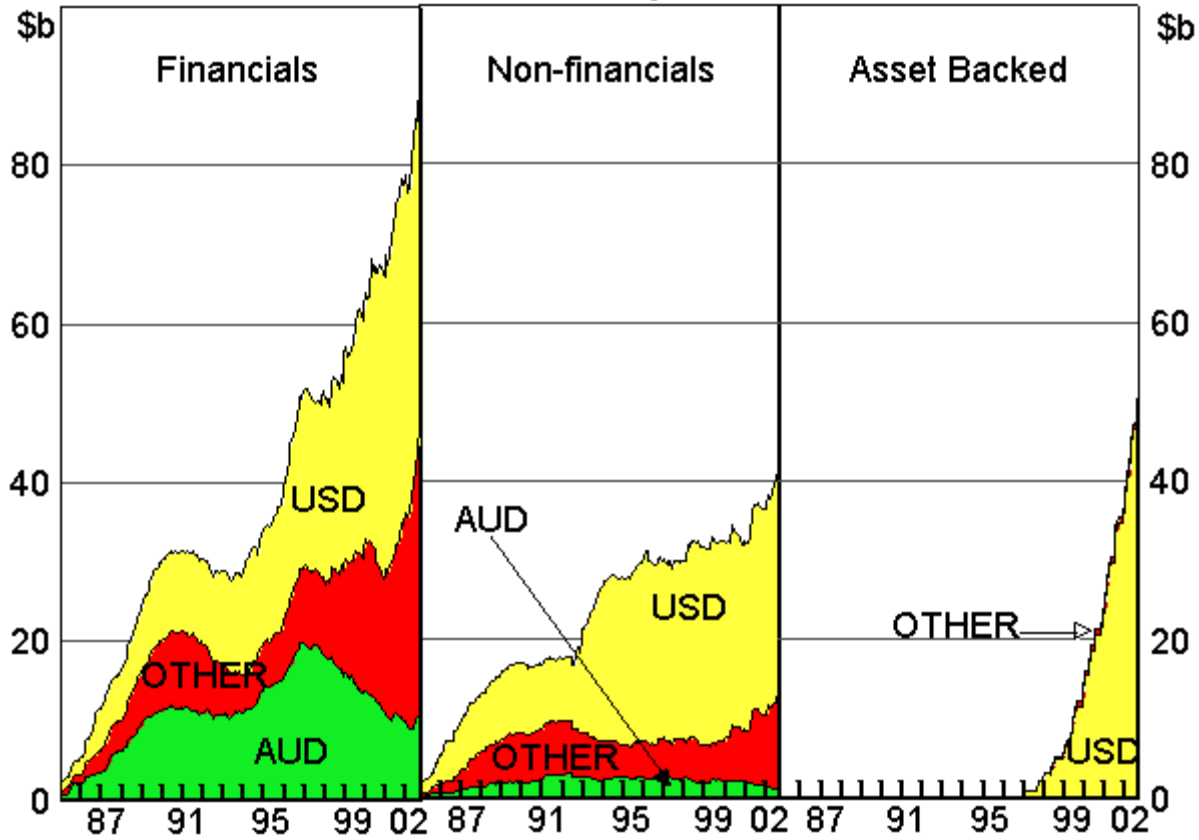
Weighted Average Credit Rating



* Credit-wrapped issues recorded at credit rating of the issuer.

Denomination of Offshore Bonds Outstanding

Monthly



Lessons for China?

- Implications for cost and types of corporate borrowing
 - Limits our expectations of what private domestic debt can achieve
- Offshore markets are probably more suited (at least in short term) to handle private borrowing at
 - Longer maturities
 - Larger amounts
 - Lower credit quality
 - Different currency denominations

Lower Level Governments (1)

- In China, nominally restricted from borrowing
- In practice, borrowing amounts to 3 - 4% GDP through dummy entities and trade credit
- In addition to expanding supply of investment instruments, allowing local/provincial borrowing would
 - Subject current unofficial borrowing to more scrutiny
 - Facilitate decentralized decision making
 - Subject these levels of government to market discipline
- But also needs to be regulated ...

Lower Level Governments (2)

- Expansion in borrowing by lower level governments has historically led to debt/default problems
 - US States in 1840's
 - Response: constitutional and legislative limits
 - Australian States in 1930's and 1990's
 - Response in 1930s: centralize all borrowing in Loans Council
 - Response in 1990s: decentralize all borrowing!
 - Argentine provinces
 - Brazilian provinces
- Common resource (central government revenues) problem

Lower Level Governments (3)

- Credible commitment from central government not to bailout provincial and local governments
 - Is this ever really possible? EU and Mexico
- Form of restrictions
 - Current *versus* capital expenditure
 - Constitutional *or* legislative
 - Balanced budget: planned *versus* actual
 - Ability to borrow through corporate entities
 - Australian state of Victoria: government owned corporation near default in 1990s
 - New York State “sold” toll road to development corporation