FTSE Russell

# Mind the gap – Chinese and G7 bond yields conundrum

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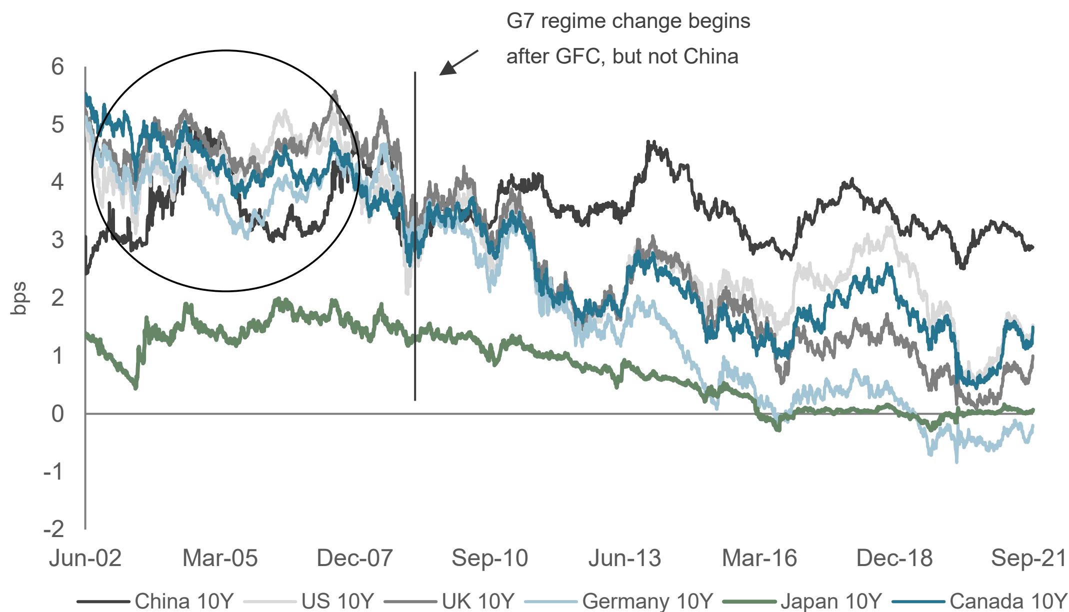
## Introduction

Several factors have caused Chinese government bond yields to stand well above G7 yields, particularly since the Global Financial Crisis. Although yield differentials fell a little during the reflation trade in Q1, when G7 yields rose sharply, they remain substantial. The level of Chinese government bond yields appears high compared to those in the G7, given China's A+ credit rating, and its lower market duration. In addition, China has the same sovereign rating as Japan, but higher local currency government bonds yield compared to near zero in Japan. Why is this?

# Why are Chinese government bond yields so much higher than G7 yields…

In previous papers, we addressed the low correlation of Chinese yields with G7 yields, since the global financial crisis (GFC), and notably during the COVID-19 crisis, and how China's inclusion into the World Government Bond Index (WGBI) may increase this correlation[1][2]. A related, but different, issue is why Chinese government bond yields remain well above G7 yield levels, particularly as Chinese government bond yields were lower than US Treasury yields in the early-2000s, as Chart 1 shows.

**Chart 1: G7 and Chinese government bond yields since 2002**




Source: Refinitiv, September 28, 2021.

## … given favorable Chinese government credit ratings and short index duration

The level of Chinese government bond yields appears high versus those in the G7, given China's A+ credit rating, and the market's overall index duration of only 5.41, as Table 1 shows. This compares with much longer market duration in the UK particularly, but also the US and Europe. In addition, China has the same sovereign rating as Japan, but local currency government bonds yield of 2.71%, compared to near zero in Japan.

[1] See "China bond market; characteristics and evolution," July 2020.

[2] See "China bond market comes of age with WGBI index inclusion," FTSE Russell, June 2021.

**Table 1: Major government bond markets, credit ratings, yields and duration**

| | FTSE market index capitalization (USD, trillion) | FTSE market index duration | Index credit rating | Current index yield (%) |
|---|---|---|---|---|
| **Chinese Govt Bond** | **1.59** | **5.41** | **A+** | **2.71** |
| EM Govt Bond | 3.04 | 5.50 | A- | 3.98 |
| US Treasury | 9.82 | 6.88 | AA+ | 0.84 |
| Eurozone Govt Bond | 8.81 | 8.67 | AA- | -0.07 |
| Japanese Govt Bond | 4.39 | 11.97 | A+ | 0.15 |
| UK Govt Bond | 1.37 | 13.71 | AA | 0.74 |
| German Govt Bond | 1.62 | 8.40 | AAA | -0.50 |

Source: FTSE Russell as of August 31, 2021.

Although yield differentials fell a little during the reflation trade in Q1, when G7 yields rose sharply, they remain substantial. Why is this? Several factors may help to explain...

## Various factors contributed to this yield differential, including low integration of Chinese banks into the global economic cycle

Firstly, the Chinese government bond market developed since the early 2000s in a monetary and economic regime with little integration into the global economic and financial cycle[3]. Although the shadow banking system has developed apace in China since the GFC, Chinese banks largely missed it, and there are only four Chinese banks in the Financial Stability Board's list of the 30 Globally Systemically Important Banks[4] (G-SIBs). Thus, most of the asset growth in Chinese banks has come from lending to finance domestic growth, with overseas asset exposure only about 10%[5], or less of total assets in most major banks, like Industrial and Commercial Bank of China, China Construction Bank, Bank of China and Agricultural Bank of China.

Low global asset exposure of Chinese banks makes the domestic economy and financial system less exposed to shocks in other jurisdictions, and the sheer size largely explains the presence of Chinese banks in the G-SIBs. (In contrast, US and European banks particularly have much higher foreign exposures, increasing their presence in the G-SIBs listing.)

## The independence of Chinese monetary policy from the G7 also important…

Secondly, despite the global financial cycle and sensitivity of EMs to foreign shocks[6], China has had more limited exposure to this global financial cycle. This means Chinese interest rates and monetary policy have been set largely independently of the G7 and particularly since the GFC, by

[3] See Characteristics and Evolution of the China govt bond market paper.

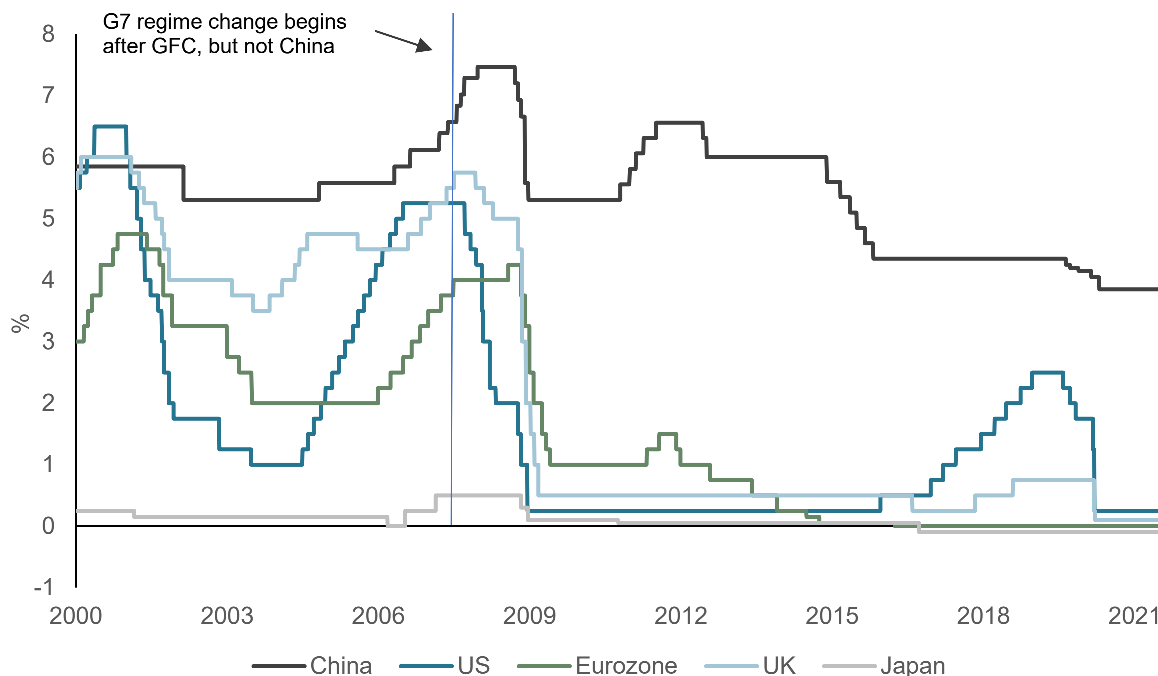
[4] Financial Stability Board 2020 list of G-SIBs; www.fsb.org/wp-content/uploads/P111120.pdf)

[5] End-2019 data, BIS.

[6] See "In the face of spillovers: prudential policies in emerging economies," Andra Colman, Simon P.Lloyd, ECB Working Paper Series, No 2339, December 2019.

the PBOC, as Chart 2 shows. And unlike the G7, the Chinese financial system did not experience major regime change after the GFC, as G7 policy interest rates fell to zero (or below in some cases), and central banks adopted QE programs. So, although Chinese interest rates and bond yields were quite closely correlated with those of the G7 until 2008, a major structural break occurred after the GFC, as both Charts 1 and 2 illustrate. A related development has been the acceleration in Chinese credit growth after the GFC in 2008/09, as the Chinese authorities sought to shift the main engine of growth away from net exports, to domestic demand. This is in stark contrast to the collapse in G7 credit growth after the G7 banking system collapsed, which required policy rates to be kept near zero until 2016 in the US.

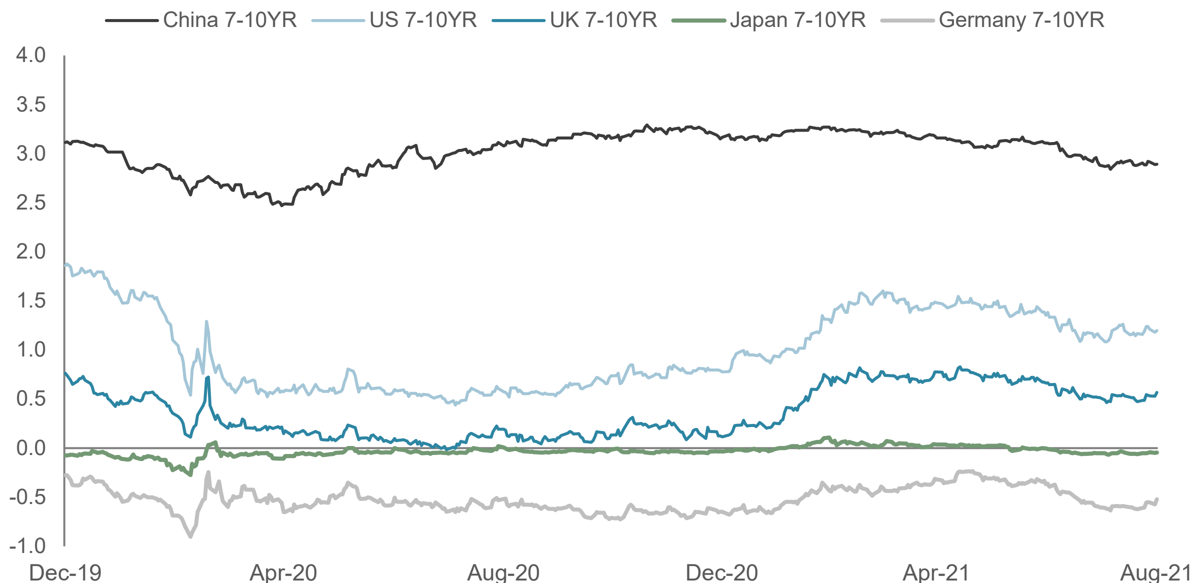
**Chart 2: PBOC, and selected G7 policy interest rates since 2000**




Source: Refinitiv.

Experience since the COVID-19 shock has again shown continuing divergence between China and the G7, with China largely missing the second and third COVID waves that have bedevilled much of the G7. This meant Chinese GDP growth rebounded strongly in Q4 2020, reducing pressure on the PBOC to decrease interest rates further in 2021, after only a modest 30bps policy easing in Q1 2020, when the virus first appeared in China. Therefore, bond yields have remained more stable in China during the COVID-19 period, in contrast with the G7, as Chart 3 shows.

**Chart 3: China and G7 7-10yr government bond yields since COVID**




Source: FTSE Russell.

## … and low foreign ownership of Chinese bonds reduced spillover effects from G7 QE

Thirdly, although spillover effects from G7 QE may have held down EM yields, after the GFC, they had much less impact on Chinese government bond yields[7]. This may be because of low foreign participation in Chinese financial markets, caused by limited access for foreign investors before the capital markets reform program and convertibility of the RMB developed in earnest, and the RMB joined the IMF's Special Drawing Right, from 2016. So foreign ownership of the Chinese government bond market was only 2% as recently as 2016, and remains low relative to other major markets, at 10.9% (by end-August 2021), as Table 2 shows. WGBI inclusion for Chinese government bonds may help to increase the connectivity to the G7 cycle, since it will likely increase foreign capital inflows into the market[8], and the share of foreign ownership.

**Table 2: Foreign holdings in major, and selected EM, government bond markets**

| Government bond market | China | Japan | Germany | US | UK | Malaysia |
|---|---|---|---|---|---|---|
| % held by foreign residents | 10.9% | 12.7% | 44.0%* | 26.4% | 27.0% | 40.4% |

Sources: US Treasury Dept., Japan MoF, UK DMO, CCDC, Bundesbank, BNM; *Non-Eurozone holders 2018.

## A related question that might be asked: Is China a typical EM, if not a DM, given its bond yield characteristics?

China is classified as an Emerging Market (EM) by index providers, and not a Developed Market (DM), largely because per capita income places it into the EM bucket[9]. In the case of FTSE

[7] Characteristics and Evolution of Emerging Market fixed income, FTSE Russell 2020 paper.

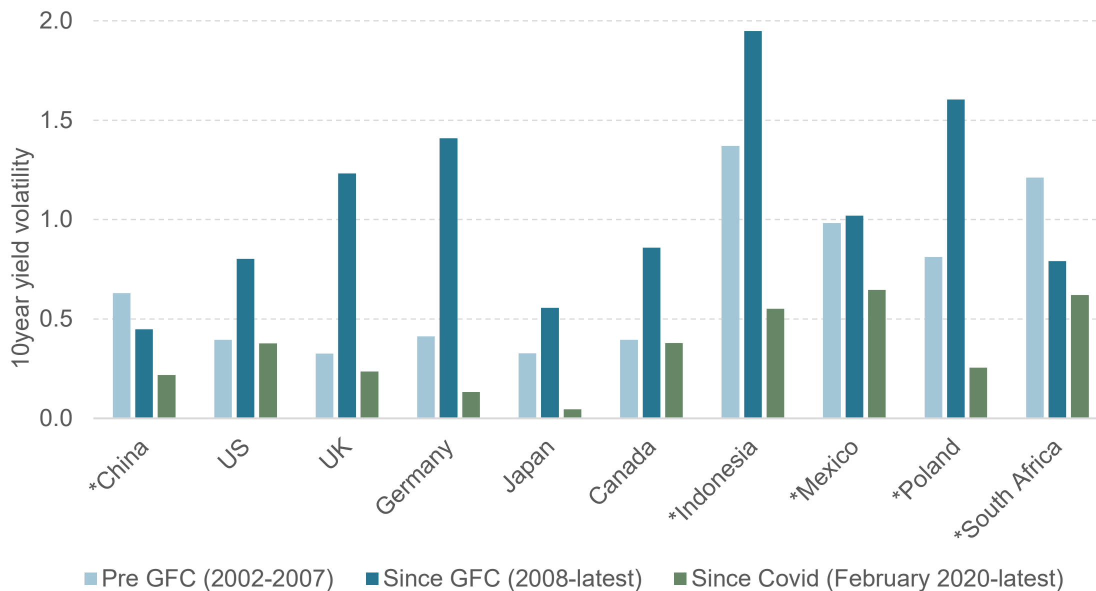
[8] See "China bond market comes of age with WGBI index inclusion," FTSE Russell, June 2021.

[9] See FTSE Russell criteria for EM index inclusion & FTSE Classification of Fixed Income Markets.

Russell, for example, China has joined the FTSE Russell EM index in April 2018, on the basis of its EM country classification. In addition, the weight of emerging markets in the WGBI[10] index will be boosted with China's inclusion into WGBI, effective the end of October 2021, although the full weighting will only be phased in over 36 months.

In the meantime, from a yield perspective, Chinese government bond has traded at a level somewhere between EM (local currency) and DM government bond yields, in recent years. Yet both China's strong financial position (with substantial trade and current account surpluses in the last 25 years), strong net international investment claims on other nations, due to overseas direct investment and the export of capital in this period, and appreciating RMB suggest China is far from a typical EM. Furthermore, although there are good economic reasons for classifying China as an EM, rather than a DM, the low standard deviation/volatility of Chinese government bond yields is more consistent with a DM, than an EM, as Chart 4 shows.

**Chart 4: Standard deviation of 10-year yields in China and selected DM & EM govt bond markets**




Source: Refinitiv, FTSE Russell as of September 6, 2021. *EM markets.

[10] Market values of EM markets account for 1.5% in WGBI, as of August 31, 2021.

# Conclusion

Several factors have caused Chinese government bond yields to stand well above G7 yields, particularly since the GFC.

Diverse developments in monetary, economic and financial regimes between China and the G7, and China's low exposure to the global financial cycle have perhaps been key.

The Group of Seven banking system asset exposures to the US sub-prime and housing market crash required zero interest rate policy (ZIRP) in the G7 and central banks to adopt QE asset purchases, for much of the period since 2008/09. In contrast, China largely escaped the GFC, so the PBOC was not obliged to adopt either ZIRP or QE asset purchases, and Chinese policy interest rates have never been below 3.85% since 2000. Chinese banks continue to hold low global asset exposures.

Foreign access to the Chinese onshore government bond market, and convertibility of the RMB, have also been limited, causing foreign holdings of Chinese government bonds to be much lower, at 10.9%, than in other major bond markets, again reducing the connectivity with G7 yields.

China joined EM indexes because of its EM classification by index providers, and its inclusion into FTSE WGBI is estimated to increase the emerging market share in the index.

Chinese government bond yields share several characteristics with DM, including low volatility, despite the country's bond market is classified as an EM on economic grounds.

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