

The Hong Kong Debt Market in 2018

by the Financial Infrastructure Department

The international bond market was weighed down for most of 2018 by the tightened monetary policy stance of the US Federal Reserve. Bond markets in emerging market economies were also hit by capital outflows, the escalating US-China trade tensions, and a slowdown in the Mainland economy. In Hong Kong, the total issuance volume of Hong Kong dollar debt instruments rose, mainly due to the increased issuance of Exchange Fund Bills and Notes. The Government also introduced a number of initiatives to support the development of the bond market.

Overview of the international bond market

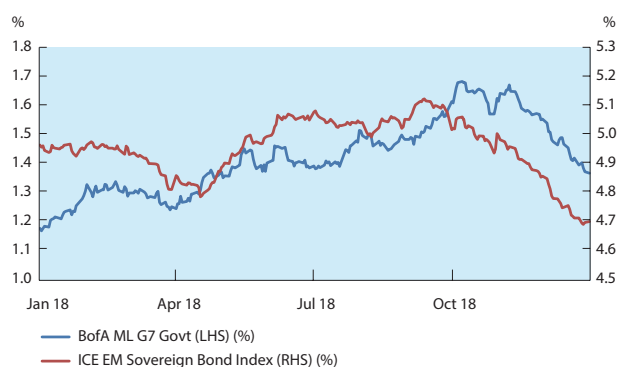
Global economic expansion continued in 2018, although becoming less synchronised. In developed economies, sovereign bond yields rose gradually during the first three quarters, but decreased markedly in the fourth quarter (Chart 1). In the US, the US Federal Reserve (Fed) raised interest rates four times and continued the gradual normalisation of its balance sheet. Short-term US Treasury yields rose notably, while long-term yields increased to a lesser extent, resulting in a flattening of the yield curve during the year and, indeed, an inverted yield curve over some maturities towards the end of the year. In Europe, the European Central Bank ended its net asset purchase programme in December, while maintaining an accommodative monetary policy. As a result, government bond yields of major European economies decreased moderately in 2018.

Sovereign bond yields in emerging markets had surged since the second quarter, before returning to lower levels in the fourth quarter in tandem with US treasury yields (Chart 1). In emerging Asia, capital outflows from debt market were observed amid the tightening US monetary policy stance and higher yields in the US. Meanwhile, investors have become more risk averse amid continuing uncertainties over

US-China trade tensions and an economic slowdown in Mainland China, which weighed on the bond market.

CHART 1

Average borrowing costs in developed and emerging markets



Notes:

1. Average yields of the BofA Merrill Lynch G7 Government index are used as proxies to the yield levels of developed markets.
2. Average yields of ICE BofA Merrill Lynch emerging market sovereign bond index are used as proxies to the yield levels of emerging markets.

Sources: Thomson Reuters, Bloomberg, Bank of America Merrill Lynch.

Hong Kong Debt Market Review

Since the global financial crisis, a massive amount of funds have flowed into the Hong Kong dollar. In 2018, however, there were signs of capital outflows,

especially in the second and third quarters. As the aggregate balance declined, Hong Kong dollar interest rates rose across the board. Correspondingly, the Government Bond yield curve also showed an upward trend during the year. The negative yield spread between US Treasuries and Hong Kong Government Bonds narrowed, making it relatively more attractive to invest in Hong Kong dollar bonds.

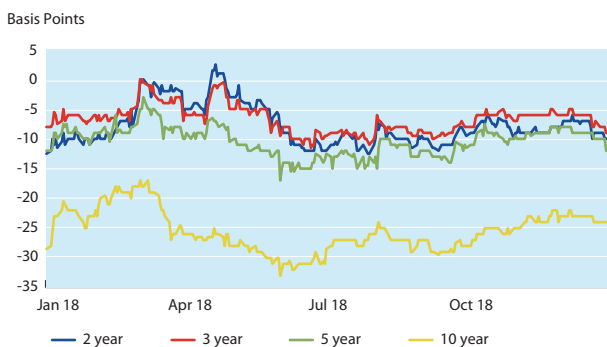
Despite the capital outflows, liquidity remained ample during the year. Hong Kong dollar debt issuance increased for the tenth consecutive year to HK\$3.56 trillion, a rise of 6.6% over 2017, largely driven by increased issuance of Exchange Fund Bills and Notes.

Overseas entities

Overseas entities are cost sensitive and their issuance tends to be opportunistic by nature. Although Hong Kong dollar interest rates, such as Hong Kong Interbank Offered Rate (HIBOR) and Government Bond yields were lower than their US dollar counterparts, the US dollar/Hong Kong dollar basis spreads remained negative during the year (Chart 2). As a result, the Hong Kong dollar market was less attractive for overseas issuers seeking US dollar funds through the Hong Kong market, compared with tapping the US dollar market directly. A decrease in bond issuance by overseas issuers, including mainly financial institutions and corporates, was observed during the year. On the other hand, multilateral development banks, led by the World Bank and the Asian Development Bank, tapped the market in 2018 and increased their issuance.

CHART 2

Key tenors of US dollar/Hong Kong dollar basis spreads



Source: Bloomberg.

Local corporates and authorized institutions (AIs)

On the back of robust economic growth, local corporates expanded their funding scale in the local debt market, with the issuance volume increasing by 35% in 2018 year on year. Many large corporates had access to the international bond market, and would tap the Hong Kong dollar market only when the cost was low. "Pre-refinancing" activities were buoyant in the first half of the year to take advantage of the low local interest rates. However, worries about US-China trade tensions and a slowdown in the Mainland economy dampened bond market sentiment in the second half. The rise in interest rates also meant there was less chance of obtaining cheap funding from the Hong Kong dollar bond market. Likewise, statutory bodies and government-owned corporations reduced their reliance on the bond market because they remained well-funded. AI's fund-raising activities to support their funding needs also decreased by 6% year on year, while some chose to re-finance by issuing papers in US dollars.

Other developments

Since its introduction, Bond Connect has become an important channel through which international investors gain exposure to the Mainland bond market while taking advantage of the market infrastructure and financial services in Hong Kong. As at end-2018, 503 investors had registered as eligible Bond Connect investors. Daily turnover averaged RMB3.5 billion in 2018, compared with RMB1.5 billion during its initial launch in July 2017. In August, several major enhancements were made, including the full implementation of the real-time delivery versus payment settlement model, which substantially reduces settlement risk and enhances efficiency, and is critical in drawing major overseas institutional investors to Bond Connect. Other enhancements included the launch of block trade functionality and the State Council's announcement of a tax waiver for overseas investors investing in the Mainland onshore bond market. In November, an additional electronic trading platform was announced to be added to Bond Connect, offering more choices to investors. The convenience and flexibility offered by Bond Connect,

coupled with the enhancements this year, prepared the ground for Mainland bonds to be included in major fixed income indices, thereby accelerating the allocation to renminbi assets by passive portfolio managers and active managers alike.

In early 2018, the Government and the HKMA announced a number of initiatives designed to promote bond issuances and the development of the bond market in Hong Kong. The initiatives included the launch of a three-year Pilot Bond Grant Scheme to attract local, Mainland and overseas enterprises to issue bonds in Hong Kong. The Scheme covers eligible enterprises issuing bonds in Hong Kong for the first time. The grant amount for each bond issue is equivalent to half the eligible issuance expenses, up to HK\$2.5 million if the bond, its issuer or its guarantor(s) possesses a credit rating by a rating agency recognised by the HKMA; or HK\$1.25 million if none of the bond, its issuer or its guarantor(s) possesses a credit rating by a rating agency recognised by the HKMA.

In addition, the Qualifying Debt Instruments (QDI) Scheme was improved by (i) exempting profits tax from debt instruments, regardless of their tenors; and (ii) allowing debt instruments listed on the Stock Exchange of Hong Kong Limited as well as for instruments lodged with and cleared by the Central Moneymarkets Unit, to be qualified for tax exemption. The new arrangements apply to QDIs issued on or after 1 April 2018.

In November 2018, the Legislative Council approved the Government Green Bond Programme. Its primary objective is to promote the development of green finance in Hong Kong by encouraging issuers to arrange financing for their green projects through Hong Kong's capital markets and growing the local green investor base.

Government Bond (GB) Programme

The HKMA continued to implement the GB Programme to promote further sustainable development of the local bond market. At the end of 2018, the total outstanding amount of 12 issues of institutional bonds reached HK\$87.1 billion. The Government has also issued three Islamic bonds under the GB Programme, each with an issuance size of US\$1 billion.

During the year, the Government issued the third batch of Silver Bond, an inflation-linked bond with a minimum annual interest rate of 3%, aimed at Hong Kong residents aged 65 or above. The size of the issuance was HK\$3 billion, with a tenor of three years. It was also the first time securities brokers participated in the bond placement. The number of valid applications was 45,488, with total subscription of more than HK\$6.2 billion. The results were very satisfactory against the backdrop of rising bank deposit rates, and demonstrated the immense potential of the silver market that the financial sector could tap into.

Looking ahead

Looking into 2019, the risks and uncertainties that negatively affected the bond market in 2018, such as tightened financial conditions, capital outflows, US-China trade tensions, and a slowdown in the Mainland economy, could continue. However, the US Fed has signalled a more gradual pace of rate hikes, and hence investor sentiment may improve. In addition, local infrastructure projects may create new opportunities for bond financing. The HKMA will continue to support the development of the local bond market through the implementation of various initiatives.

APPENDIX (see notes)

Table B1: Issuance of Hong Kong dollar debt instruments (in HK\$ million)

	(A) Exchange Fund	(B) Government	(A) + (B) Public Segment (year-on- year rate of change)	(C) Authorized Institutions	(D) Local corporates	(E) MDBs	(F) Non-MDB overseas issuers	(G) Statutory bodies & government- owned corporations	(C) to (G) Non-public Segment (year-on- year rate of change)	Total (year-on- year rate of change)
1998	316,850	0	316,850	34,359	0	44,502	12,856	9,171	100,888	417,738
1999	261,443	0	261,443 (-17.5%)	82,838	6,744	15,920	39,123	8,931	153,556 (52.2%)	414,999 (-0.7%)
2000	275,036	0	275,036 (5.2%)	97,881	3,900	19,330	51,474	8,325	180,910 (17.8%)	455,946 (9.9%)
2001	237,009	0	237,009 (-13.8%)	74,134	1,000	7,462	45,139	24,075	151,810 (-16.1%)	388,818 (-14.7%)
2002	216,228	0	216,228 (-8.8%)	96,608	6,354	5,200	51,401	20,760	180,323 (18.8%)	396,551 (2.0%)
2003	219,648	0	219,648 (1.6%)	94,479	1,570	2,641	55,750	15,724	170,164 (-5.6%)	389,811 (-1.7%)
2004	205,986	10,250	216,236 (-1.6%)	75,670	6,699	3,530	56,890	17,799	160,588 (-5.6%)	376,824 (-3.3%)
2005	213,761	0	213,761 (-1.1%)	101,039	11,574	1,800	65,263	8,560	188,236 (17.2%)	401,997 (6.7%)
2006	220,415	0	220,415 (3.1%)	83,442	22,624	2,950	107,244	17,419	233,679 (24.1%)	454,094 (13.0%)
2007	223,521	0	223,521 (1.4%)	99,586	18,153	1,700	82,459	19,368	221,266 (-5.3%)	444,787 (-2.0%)
2008	285,875	0	285,875 (27.9%)	67,524	5,966	3,000	37,687	24,308	138,485 (-37.4%)	424,360 (-4.6%)
2009	1,047,728	5,500	1,053,228 (268.4%)	74,836	13,861	13,145	57,152	29,852	188,846 (36.4%)	1,242,073 (192.7%)
2010	1,816,752	18,500	1,835,252 (74.3%)	102,913	15,464	315	30,841	11,187	160,720 (-14.9%)	1,995,972 (60.7%)
2011	1,841,278	27,500	1,868,778 (1.8%)	134,638	22,429	0	25,304	20,195	202,566 (26.0%)	2,071,345 (3.8%)
2012	1,851,575	26,000	1,877,575 (0.5%)	190,833	16,512	790	32,640	12,027	252,802 (24.8%)	2,130,377 (2.8%)
2013	2,123,448	30,000	2,153,448 (14.7%)	143,978	19,638	940	28,105	10,665	203,326 (-19.6%)	2,356,774 (10.6%)
2014	2,177,293	30,800	2,208,093 (2.5%)	124,248	28,871	1,337	57,818	9,647	221,921 (9.1%)	2,430,015 (3.1%)
2015	2,242,206	30,400	2,272,606 (2.9%)	136,350	12,481	0	60,564	12,015	221,410 (-0.2%)	2,494,017 (2.6%)
2016	2,689,622	29,400	2,719,022 (19.6%)	181,346	15,431	5,529	111,339	20,898	333,543 (50.6%)	3,052,565 (22.4%)
2017	3,000,429	19,600	3,020,029 (11.1%)	185,892	9,316	3,230	95,292	21,542	315,271 (-5.5%)	3,335,300 (9.3%)
2018	3,232,955	19,600	3,252,555 (7.7%)	174,580	12,574	5,000	90,625	19,785	302,564 (-4.0%)	3,555,119 (6.6%)

Table B2: Outstanding size of Hong Kong dollar debt instruments (in HK\$ million)

	(A) Exchange Fund	(B) Government	(A) + (B) Public Segment (year-on- year rate of change)	(C) Authorized Institutions	(D) Local corporates	(E) MDBs	(F) Non-MDB overseas issuers	(G) Statutory bodies & government- owned corporations	(C) to (G) Non-public Segment (year-on- year rate of change)	Total (year-on- year rate of change)
1998	97,450	0	97,450	175,286	10,283	69,402	29,356	11,366	295,693	393,143
1999	101,874	0	101,874 (4.5%)	186,036	15,477	61,287	54,402	20,117	337,319 (14.1%)	439,192 (11.7%)
2000	108,602	0	108,602 (6.6%)	192,990	13,027	57,062	80,193	20,047	363,319 (7.7%)	471,921 (7.5%)
2001	113,750	0	113,750 (4.7%)	182,682	11,402	51,104	98,758	35,873	379,819 (4.5%)	493,568 (4.6%)
2002	117,476	0	117,476 (3.3%)	190,520	16,156	40,834	117,819	48,212	413,541 (8.9%)	531,018 (7.6%)
2003	120,152	0	120,152 (2.3%)	199,295	13,905	27,855	139,777	56,441	437,273 (5.7%)	557,426 (5.0%)
2004	122,579	10,250	132,829 (10.6%)	209,401	18,914	24,735	161,816	60,186	475,052 (8.6%)	607,880 (9.1%)
2005	126,709	10,250	136,959 (3.1%)	237,942	28,723	21,535	180,648	57,712	526,560 (10.8%)	663,520 (9.2%)
2006	131,788	7,700	139,488 (1.8%)	246,890	47,734	19,555	237,578	56,876	608,633 (15.6%)	748,121 (12.8%)
2007	136,646	7,700	144,346 (3.5%)	255,491	57,632	13,155	234,344	58,476	619,098 (1.7%)	763,443 (2.0%)
2008	157,653	5,000	162,653 (12.7%)	209,089	57,973	14,253	207,616	64,618	553,550 (-10.6%)	716,202 (-6.2%)
2009	534,062	7,000	541,062 (232.6%)	195,915	62,547	24,348	216,777	66,643	566,229 (2.3%)	1,107,291 (54.6%)
2010	653,138	25,500	678,638 (25.4%)	218,641	65,445	15,513	206,521	60,592	566,712 (0.1%)	1,245,350 (12.5%)
2011	655,413	49,500	704,913 (3.9%)	229,416	66,211	14,731	194,323	51,034	555,716 (-1.9%)	1,260,629 (1.2%)
2012	657,384	68,500	725,884 (3.0%)	264,696	76,486	10,271	186,094	45,159	582,705 (4.9%)	1,308,590 (3.8%)
2013	751,151	91,500	842,651 (16.1%)	252,053	88,896	10,214	185,790	39,816	576,769 (-1.0%)	1,419,420 (8.5%)
2014	752,630	98,000	850,630 (0.9%)	233,444	96,486	6,101	182,161	40,990	559,181 (-3.0%)	1,409,812 (-0.7%)
2015	828,421	100,400	928,821 (9.2%)	239,870	95,581	5,301	204,114	43,351	588,216 (5.2%)	1,517,037 (7.6%)
2016	963,098	102,791	1,065,889 (14.8%)	271,352	99,424	10,550	233,342	50,010	664,678 (13.0%)	1,730,567 (14.1%)
2017	1,048,479	106,320	1,154,799 (8.3%)	241,071	99,020	9,854	243,697	53,647	647,289 (-2.6%)	1,802,088 (4.1%)
2018	1,062,715	107,368	1,170,083 (1.3%)	238,174	100,289	13,869	267,628	54,467	674,427 (4.2%)	1,844,510 (2.4%)

Note on the tables:

The debt securities statistics are reclassified in accordance with the latest international statistical standards set forth in the *Handbook of Securities Statistics* published by the Bank for International Settlements, International Monetary Fund and European Central Bank. They may not be comparable with statistics previously published in this report.

CHART B1

Proportions of Hong Kong dollar debt issuance activities (by type of issuers)

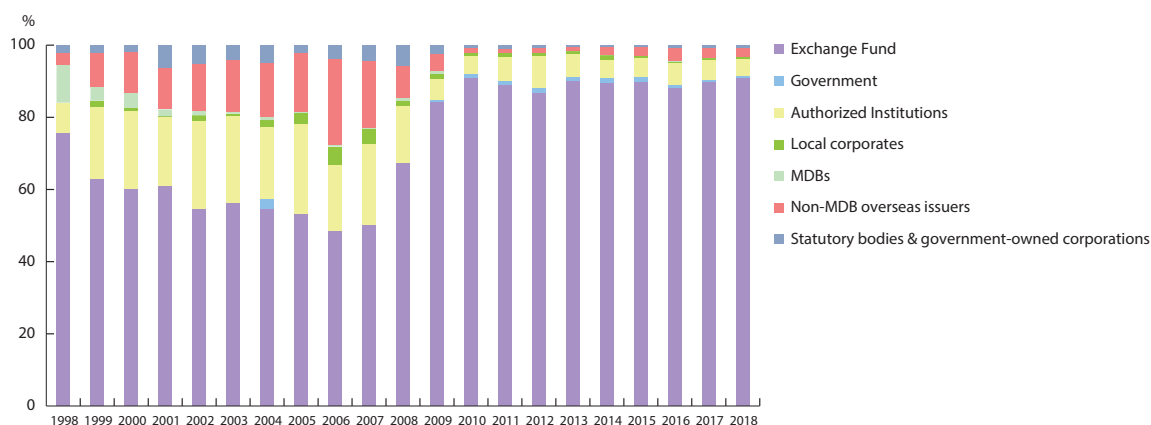
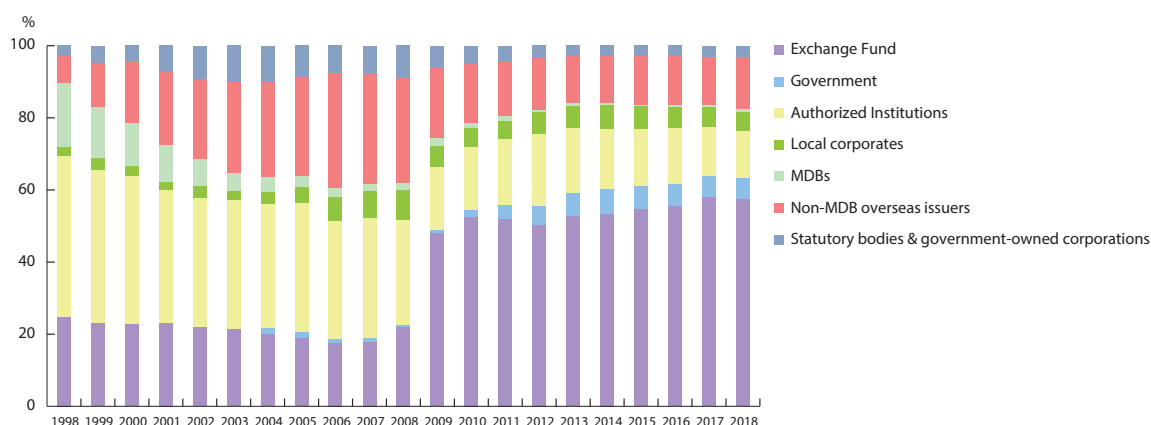


CHART B2

Proportions of outstanding Hong Kong dollar debt instruments (by type of issuers)



Notes:

1. Authorized institutions include licensed banks, restricted licence banks and deposit-taking companies.
2. Multilateral Development Banks (MDBs) refer to the Asian Development Bank, the Council of Europe Development Bank (formerly known as the Council of Europe Social Development Fund), the European Company for the Financing of Railroad Rolling Stock, the European Investment Bank, the European Bank for Reconstruction and Development, the Inter-American Development Bank, the International Bank for Reconstruction and Development, the International Finance Corporation, the African Development Bank, the Nordic Investment Bank, and the CAF - Development Bank of Latin America. Income earned on Hong Kong dollar debt securities issued by the MDBs is exempt from profits tax.
3. Statutory bodies and government-owned corporations include Bauhinia Mortgage-backed Securities Limited, The Hong Kong Mortgage Corporation, Airport Authority Hong Kong, Hong Kong Link 2004 Limited, Kowloon-Canton Railway Corporation, MTR Corporation Limited, Hong Kong Interbank Clearing Limited, Urban Renewal Authority, Hong Kong Housing Society, and the Hong Kong Science and Technology Parks Corporation. It should be noted that while the issuers are public bodies in the legal sense, they are typically considered as non-public issuers by the market. Hence, they are categorised under the "non-public" segment in the tables above.
4. Figures may not add up to total because of rounding.
5. The debt securities statistics are reclassified in accordance with the latest international statistical standards set forth in the *Handbook of Securities Statistics* published by the Bank for International Settlements, International Monetary Fund and European Central Bank. They may not be comparable with statistics previously published in this report.