FTSE Russell

WGBI inclusion confirms China's arrival on global bond stage

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Introduction

In earlier research papers[1] we have discussed the impact of inclusion of the Chinese government bond market in global bond indexes, and the internationalization of the renminbi. In this paper, we assess the impact in more detail, after the recent announcement that Chinese government bonds will join the FTSE Russell World government bond index, or WGBI, over a period of 36 months from October 2021—we consider both private sector and official holdings.

Given that foreign holdings of Chinese government bonds have been low historically, there is the potential for them to rise significantly. These increased holdings could amount to US$130-160 billion to match China's inclusion in the WGBI alone, and a further US$207 billion in central bank inflows, assuming private investors seek to move to benchmark index weight, and central banks closer to the renminbi's special drawing rights weight over time.

[1] See "Chinese government bonds; characteristics and evolution," FTSE Russell, March 2021.

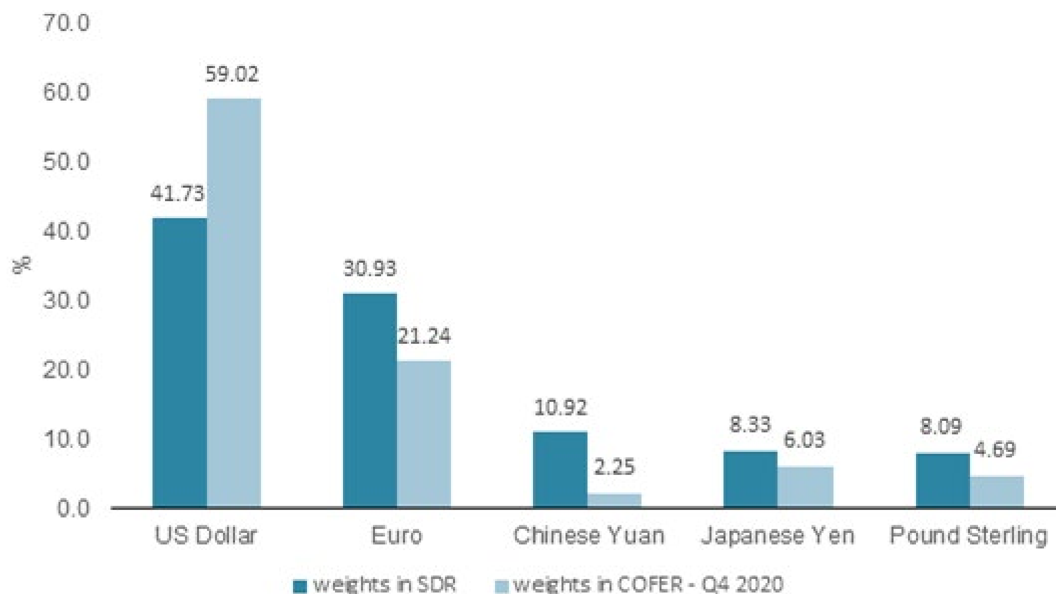
Defining the issue – private sector and central bank holdings of RMB assets remain low vs benchmarks

Foreign private sector holdings have remained low in renminbi assets generally, particularly in Chinese government bonds, relative to other major markets[2]. This remains the case despite a sharp increase in foreign holdings in recent years. There has been less analysis of public sector holdings of renminbi assets, but IMF data shows central banks' foreign exchange reserve assets denominated in RMB are also low. They reached US$267.5 billion in Q4 2020—only about 2.25% of allocated reserves of US$11.9 trillion.

Although this figure represents an approximate doubling of reserves held in RMB assets since 2016, when the renminbi joined the IMF's special drawing rights (SDR), it is much lower than the assigned weighting in the IMF's SDR for the renminbi of 10.92%.

It is true that to compensate for the big overweight in the US dollar, reserve weightings in other currencies are also below SDR weights, but compared to other SDR components this is a substantial underweight in the renminbi, as Chart 1 shows. The tendency for the primary reserve currency to dominate these official weightings makes the overweight in the US dollar less surprising, particularly given that the US Treasury market is the largest, and perceived to be the most liquid, of major government bond markets.

Chart 1. Foreign reserve weightings in SDR components vs Weights in COFER



Source: IMF as of March 31, 2021.

[2] "China deepens global finance links as it joins benchmark indexes," IMF blog, June 2019, Sally Chen, Dimitris Drakopoulos, and Rohit Goel.

Unlike G7 government markets, foreign holdings of Chinese government bonds are much lower

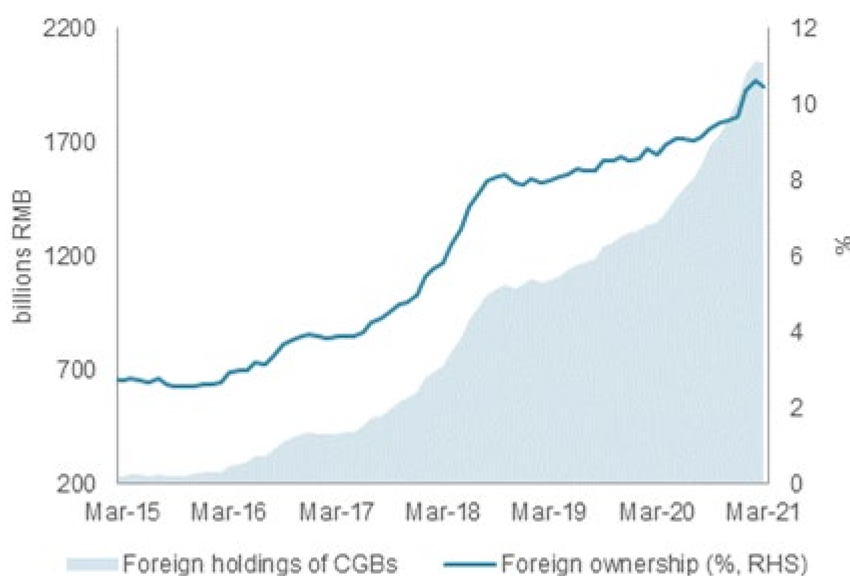
Foreign private sector holdings of Chinese government bonds tell a similar story of rapid growth since 2016, as reforms have accelerated, but from very low levels. So current foreign holdings of Chinese government bonds have now reached about 10% of the total outstanding as of Q4 2020, compared with only 2% in 2016. This figure of 10% compares with foreign holdings nearer to 30% in major G7 government bond markets, like the UK and US markets (Table 1). It means foreign investors hold RMB 2.044 trillion (US$312 billion) in Chinese government bonds, as Chart 3 shows.

Table 1: Foreign holdings of major government bond markets

Government bond market	China	Japan	Germany	US	UK
% held by foreign residents	10.0%	12.7%	44.0%*	26.4%	27.0%

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

Chart 3: Foreign holdings of Chinese government bonds



Source: CCDC as of March 31, 2021.

Why?...there are good reasons for this historical underweight position

Given the renminbi only joined the SDR as recently as 2016, Chinese financial markets were relatively inaccessible to foreign investors until recent reforms, and the renminbi has had limited tradability. As a result, the low weighting in renminbi assets and Chinese government bonds is unsurprising. Concerns about liquidity in Chinese government bonds has been another factor, reducing foreign ownership. Chinese government bonds have also been designated an Emerging Market (EM) for bond index purposes and therefore not featured in global indexes until recently. Thus, China joined the FTSE Russell Emerging Market government bond index in January 2018 but will not enter the FTSE Russell World Government Bond Index (WGBI) until October 2021.

Are investors likely to move quickly to benchmark weights?

Whether, and indeed how quickly, private investors and official entities like central banks might move towards benchmark/SDR weights will depend on a range of factors. The main factors would seem market valuation and returns, ease of access for investors, currency convertibility and outlook, and market liquidity in renminbi assets.

High relative yields for China's sovereign credit ratings and the relative short duration of market indexes are a clear contrast with G7 bonds (as Table 2 shows). These high yields, despite the market's short duration and A+ rating, suggest the Chinese market is modestly rated versus G7 markets. Low foreign participation in the Chinese government bond market also means the correlation of returns between Chinese and G7 bond markets has been low[3]. Indeed, Chinese bonds withstood the recent sharp back-up in US treasury yields, with yields barely rising[4], and low correlation of returns also offers portfolio diversification benefits.

Table 2: Major govt bond markets, ratings, valuations and duration

	FTSE market index capitalization (USD, trillion)	FTSE market index duration (years)	Credit rating	Current index yield (%)
China Govt Bond (CGBI)	1.77	5.62	A+	3.01
EM Govt Bond (EMGBI)	3.15	5.56	A-	3.96
US Treasury, USD	8.93	6.53	AA+	0.99
Eurozone Govt Bond	8.47	8.55	AA-	-0.03
Japan Govt Bond	4.25	11.76	A+	0.20
UK Govt Bond	1.37	12.92	AA	0.89
German Govt Bond	1.56	8.06	AAA	-0.42

Source: FTSE Russell as of March 31, 2021.

Continuing market reforms and improving access for foreign investors are also evident, with restrictions on renminbi convertibility easing. Given China's favorable net international investment position, currency reserves of over US$3 trillion, and ongoing trade surplus, pronounced weakness of the renminbi would also appear unlikely. Indeed, it could be expected to attract international opprobrium. The Balassa/Samuelson effect also suggests currency risks for foreign investors are relatively low[5].

Liquidity metrics for both the government, and policy bank bond markets, suggest some improvement in recent years, as foreign participation has increased, and the PBOC now conducts monthly secondary auctions with market makers, designed to improve liquidity. However, longer dated government bonds tend to be less liquid, with lower free floats, since high proportions of these issues are held by domestic insurance institutions and are not frequently traded. This may slow the speed with which investors move to benchmark weights, although liquidity in G7 government bond markets has not been guaranteed at all times during the COVID-19 crisis.

[3] See Chinese government bonds – characteristics and evolution, FTSE Russell, March 2021.

[4] See China Fixed Income Monthly, FTSE Russell, April 2021.

[5] The Balassa/Samuelson effect implies that rapidly expanding economies tend to have appreciating exchange rates.

Potential scale of portfolio flows is substantial, even if at benchmark weights, or below

To assess potential portfolio flows, it is assumed private investors aim to achieve global benchmark index weights for Chinese government bonds. (Given the modest rating of the market, and high relative yields, a case could be made for an overweight position, but assume a benchmark weight is required by investors.)

For the FTSE Russell WGBI index, that would mean a benchmark weight of about 5.25% in the index, over 36 months, from October 2021 to 2024, as Table 2 shows. Estimates[6] vary but suggest about US$2.5-3 trillion in private sector assets currently track the WGBI index, which would equate to about US$130-160 billion in inflows over 36 months, or US$3.6-4.4 billion monthly for the WGBI index alone. For other global indexes, much hinges on whether the portfolio adjustment is now complete since the Chinese government bond market has now been fully incorporated into these indexes.

Central bank inflows from adjustment of currency reserves could exceed index matching flows

For public sector investors, like central banks, potential inflows are also substantial, although these projections are more speculative. They hinge on how far central banks and other public sector investors would wish to expand RMB weightings in their official reserves, in a currency that is not yet fully convertible. It seems reasonable to assume some increase in holdings is likely, however, and particularly if the Chinese current account moves into deficit over time, so that China becomes a net capital importer.

Assuming public investors seek a RMB weighting in currency reserves in line with the average weights in yen, sterling and euro (Table 3), relative to their SDR weights (which are all underweight) would give a desired weighting of 7.25% in RMB assets, versus the 10.9% SDR weighting. Moving to 7.25% in RMB assets would increase holdings by US$415 billion.

A further assumption is required for the share of government bonds in the total official allocations to renminbi assets. Let us assume the share of government bonds in reserve allocation in RMB is about 50% (reflecting the safety of government bonds)[7]. So, if 50% of the US$415 billion in official portfolio flows were to be invested in Chinese government bonds, this would add a further US$207.5 billion in foreign holdings.

[6] HSBC estimate, Asian Fixed income Watch, October 2020. State Street estimate, A.Khumar, MD, State Street Global Advisers, September 2020, quoted in Pensions & Investments, September 2020.

[7] Managing foreign exchange reserves in the crisis and after, Robert Macauley and Jean Francois Rigaudy, BIS Research paper No 58.

Table 3: Potential portfolio flows into Chinese government bonds from index inclusion & official inflows

Portfolio flows from private sector required to match index weight			Other potential portfolio inflows
	FTSE WGBI	(Other global indexes)*	Central bank/official
Estimated AUM tracking the index (US$ trillions)	2.5-3.0trn	2.2trn	Global FX reserves ex China = US$8.6tr
Phased-in period	36 months	10-20 months to end-2020	Open-ended
China's weight upon full inclusion (%)	5.25%bn	6.0%bn	Assume 7.25% versus IMF SDR RMB weight = 10.9%
Total potential inflows (US$ billions)	**130-158bn**	**141bn**	**207.5bn**
Estimated monthly inflows over 36-months from Oct 2021 (US$ billions)	3.65-4.40bn	6.03-8.05bn	5.7bn monthly (if completed over 36 months)

Source: FTSE Russell calculation. *China has already joined two other global bond indexes as of end of 2020 and we assume portfolio flows to match those indexes may therefore be complete.

Another impact may be to change the nature of the asset allocation decision for global investors

So even with relatively cautious assumptions on desired index benchmark weights, and central bank reserve adjustments to renminbi weights, overall foreign inflows into Chinese government bonds could reach US$337-365 billion in the three years from October 2021. Since foreign holdings in Chinese government bonds currently represent just over US$ 300 billion, this would more than double foreign holdings to over 20%, taking them nearer to typical G7 levels. Given China's relatively low government debt/GDP ratio of around 45.8%[8], and ongoing economic development, China's weighting in global indexes may also increase from current levels, and particularly if (state guaranteed) policy bank bonds are also included.

Finally, China's arrival in global indexes also changes the nature of the asset allocation decision for global investors benchmarked against these indexes, since investors may now need reasons to justify not investing strategically in Chinese government bonds, rather than a justification for doing so, tactically, when they were not included in benchmark indexes.

[8] China Ministry of Finance (and includes both central and local govt debt).

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