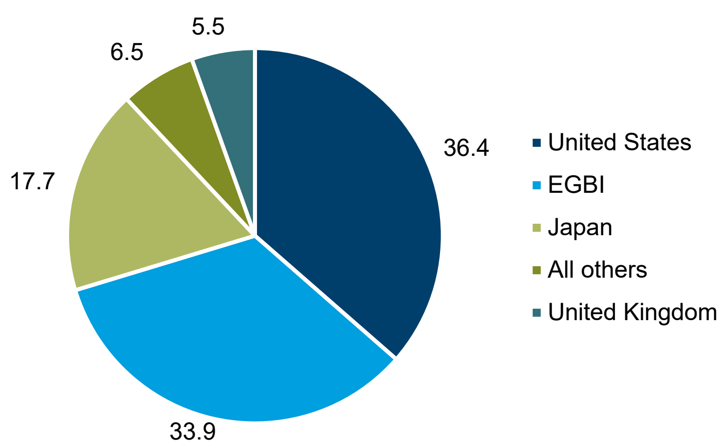
EDWARD AL-HUSSAINY
SENIOR INTEREST RATE AND CURRENCY ANALYST

LIN JING LEONG
SENIOR EM ASIA SOVEREIGN ANALYST

CHINA GOVERNMENT BONDS ARE ADDED TO THE WORLD GOVERNMENT BOND INDEX: BIG DEAL… OR A BIG DEAL?

- FTSE Russell is planning to add Chinese government bonds (CGB) to its World Government Bond Index (WGBI) starting in October 2021 and phasing in the position over the succeeding 12 months.
- Full position size estimates will fluctuate based on market conditions, but FTSE Russell projects it will be approximately 5.7% of the index.[1]
- A 5.7% position implies approximately US$120 billion in inflows to CGB in passive investments.[1]
- This is the third major index to include CGB, following the Bloomberg Barclays Global Aggregate Bond Index and the JPMorgan Government Bond Index-Emerging Markets

Exhibit 1: Current FTSE World Govt. Bond Index geographic weights



Source: FTSE Russell; as of July 31, 2020. EGBI is the EMU Government Bond index comprising Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands and Spain.

With about a 36% market weight as of July 31, the United States is the largest component of the WGBI. The addition of China would mean about a 2% reduction in its index weight and approximately a US$41 billion reduction in flows.[1]

Impact on U.S. and investors

This is a more significant event for China than for the U.S.

A $41 billion potential outflow is a small fraction of the US$20 trillion Treasury bond (UST) market. The European Monetary Union (EMU) and Japanese government bonds (JGB) are the next largest positions and will see some small reductions in size. But foreign holdings of U.S., EMU and JGB debt are large enough to digest the outflows, and the impact is likely to be minimal. We estimate that the potential index outflows from UST and EMU debt resulting from CGB inclusion are likely to be less than 1% of the current foreign holdings in those issues, and the weight of UST and EMU in the WGBI will each still remain above 30%.

Significance for China

For the Chinese market, this is another step toward international normalization.

The index inclusion is a part of China's broader renminbi (RMB) internationalization plan that started in 2009. The pace of progress has ebbed and flowed; however, it seems to have picked up again recently.

The increase in foreign investors could eventually increase liquidity and lower the bond yields of the China bond market. In the short term, the liberalization and flexibility of previously regulated measures, making it easier for foreign investors to access this asset class, is the more significant development.

Global Implications

Global investors are unlikely to replace UST with CGB as a cash holding in portfolios.

Index inclusion should mean increased foreign participation in China's onshore debt markets, but the market is still illiquid relative to Treasuries — China's capital account is relatively closed and RMB is not a free-floating currency. Most importantly, China lacks a transparent monetary/fiscal policy framework. All of these features make RMB-denominated debt a poor alternative to UST as a safe haven asset, even for China itself. There are no alternative liquid assets for the People's Bank of China to switch into. Even though China's ownership of U.S. Treasuries peaked in 2014, they maintain large UST holdings.

Nor will inclusion result in the U.S. dollar being replaced as the global reserve currency.

The RMB share of cross-border trade and financial transactions is small, and it will remain that way unless China adopts an open capital account and free-floats the RMB. Even then, the dollar will have had to have suffered a collapse in confidence to be replaced as the global reserve currency.

Conclusion

This event holds more long-term than short-term implications. As China continues its assimilation into the global financial community, this is yet another step. With full index inclusion still two years away, we will continue to monitor this development, along with its implications for the Chinese bond market and fixed-income investors.

Reference:

[1] FTSE Russell; Citibank

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