

A Simple Analysis of The Latest Problems and Countermeasure in Chinese Bond Market

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Abstract. The bonds play a pivotal role as an important financial instrument in the global financial market. Chinese bond market has rapidly expanded in recent years, becoming the global second-largest bond market. It has played an important role in supporting national development of infrastructure and effective allocation of resources. Yet with the market growing fast, issues such as credit risk, liquidity pressure, the accumulation of local government debt, and regulatory uncertainties have become increasingly prominent. The article provides an analysis of these critical challenges facing Chinese bond market and proposes a range of countermeasures to address, such as strengthening the credit rating system, improving default resolution mechanisms, expanding the base of market participants, and optimizing the debt structure of local governments. They are designed to increase market transparency, enhance liquidity, and reduce systemic risks, so promoting the healthy development of Chinese bond market. This research provides a practical guidance for the government, enterprises and investors, contributing to the robustness and sustainable growth of Chinese financial system.

Keywords: Chinese bond market; Credit risk; Liquidity; Financial supervision.

1. Introduction

The bond as a financial instrument has always been a vital component of the global financial markets, and it plays an essential role in the modern economic development. It not only provides an effective means for governments, businesses, and other institutions to raise capital, while offering investors diverse options for asset allocation and risk management. The bond market provides a stable source of funding for governments, offers companies a low-cost financing channel for operations and expansion, and gives a relatively safe investment choice for individual and institutional investors. Usually, the size and liquidity of the bond market could reflect the stability and maturity of an economy. And it significantly influences macroeconomic policy, the regulation to the interest rate, and the stability of the financial system.

With the rapidly development of the Chinese economy, the role of the bond market has become increasingly significant, making it the second-largest bond market in the world. It has played a vital role in supporting national infrastructure construction, optimizing resource allocation and promoting capital market development. The growth of Chinese bond market has not only provided the government and enterprises a different financing channel, but also created ample investment opportunities for both domestic and international investors. In 2023, the total issuance of various types of bonds in China reached 71.04 trillion yuan, a historical high, with a year-on-year growth rate of 15.44 percent, the highest in recent years [1]. By the end of 2023, the total market value of Chinese bond market had exceeded 150 trillion RMB, accounting for nearly 20 percent of the total size of global bond market. The swiftly expanding market has been instrumental in bolstering the stability of Chinese financial system while also offering global investors a broader range of investment opportunities.

Despite the significant achievements of Chinese bond market since the reform and opening-up, many challenges remain. Specifically, issues such as credit and default risks, liquidity pressures, local government debt, and regulatory and policy uncertainties still need to be addressed. Consequently,



this article would analyze these challenges, explore their impact on Chinese bond market, and propose countermeasures, with the aim of promoting the healthy development and progress of Chinese financial market.

2. Problems

2.1. Credit and Default Risks

Overrated Corporate Credit Ratings: Domestic credit rating agencies in China tend to assign higher ratings to companies, which leads leading investors to underestimate the actual credit risks. When operating condition of a company deteriorates or the economic environment worsens, the risk of default increases. Additionally, contributing factors to bond market defaults in China also include inadequate information systems, insufficient risk awareness, incomplete risk monitoring policies, insufficient disclosure by rating agencies, and an underdeveloped credit guarantee system. These issues severely compromise investor interests [2]. According to data from 2023, over 60% of corporate bonds rated by domestic agencies were assigned a AAA rating, far exceeding international standards. This high proportion of top ratings leads the market to undervalue the real credit risks of these enterprises. Particularly during economic downturns, the default rate of these highly-rated bonds might rise. By the end of 2022, the default rate for AAA-rated corporate bonds had increased from 0.5% in 2021 to 1.3%.

Frequent Defaults: As economic growth has slowed and deleveraging policies have taken effect in recent years, companies' debt repayment capabilities have weakened, leading to an increase in bond defaults. The scope of defaulting enterprises has also widened, its main body extends from primarily small, private enterprises to larger firms [3]. This not only undermines investor confidence, but also risks triggering broader market panic. In 2023, over 120 corporate bond defaults occurred in Chinese bond market, with the total default exceeding 200 billion yuan. The majority of these defaults were concentrated in private enterprises, particularly in highly leveraged sectors such as real estate and manufacturing, which severely impacts market confidence. Among the defaulted debts, private placement bonds account for the largest proportion, and the industry characteristics of the defaulting companies are not prominent. Meanwhile, the proportion of defaults among state-owned enterprises (SOEs) has significantly increased. The defaults by SOEs with large-scale outstanding bonds have severely impacted market confidence in the perceived security of SOE bonds [4].

2.2. Liquidity Pressure

Insufficient Market Liquidity: The investor base in China's bond market is relatively single, dominated by banks and financial institution, which leading the trading activity is low and secondary market liquidity is weak. What is more, homogeneous investment behaviors exacerbate liquidity shocks during extreme market conditions, increasing correlations among market participants and assets [5]. Investors that needing to liquidate assets might face greater liquidity pressures. According to the data of the People's Bank of China, the average daily trading volume in Chinese bond market in 2023 was only about 20 percent of that in the U.S. bond market. And most of them was concentrated in government and policy bank bonds. The daily trading volume for corporate and credit bonds was less than 10 percent of the total market volume, which means that the secondary market suffers from significant liquidity challenges.

High Market Concentration: The money in the bond market is heavily concentrated in a few high-rated bonds and government bonds, while lower-rated or corporate bonds have relatively poor money, resulting in an imbalance in market liquidity. In 2023, more than 80 percent of corporation bonds was held by banks and large financial institutions, which meaning that it is a lower participation for individual and institutional investors. Moreover, the liquidity issues of credit bond market are even more prominent, which weakens the price discovery function of the market.

2.3. Local Government Debt

Local government debt is not only a prominent problem in China's fiscal field but also an important threat to the stability of the financial system and economic security [6].

Accumulation of Hidden Debt: Local governments have accumulated substantial debt that are not fully reflected in official statistics through financing platforms and other hidden channels, which increases concerns about their ability to repay. By the end of 2023, it is estimated that hidden local government debt had reached 15 trillion yuan, accounting for approximately 15 percent of GDP. In particular, debt financing through financing platform companies and other non-public channels would lead to a further expansion of debt and lack of transparency. This increase in hidden debt heightens market concerns about the credit risk of local governments.

Unbalanced Debt Structure: The maturity structure of local government debt is imbalanced, and with a high proportion of short-term debt, which leads to increasing repayment pressures during economic downturns or periods of reduced fiscal revenue.

According to the data from the Ministry of Finance, more than 30 percent of local local government debt in 2023 was short-term (less than one year), while long-term debt (over five years) accounted for less than 50 percent. This unreasonable maturity structure obviously increases the financial pressure on local governments during the peak of debt repayment.

2.4. Regulatory and Policy Uncertainties

Frequent Policy Changes: The foundation of high-quality financial development and the building of a strong financial system lies in strengthening the supply of basic institutions, which means that the stability of basic institutions [7]. However, frequent adjustments in regulatory policies in Chinese bond market have made it difficult for market participants to predict policy directions, increasing market uncertainty. This may lead to cautious investor sentiment and lower market activity. In recent years, financial regulatory policies have frequently changed. For instance, in 2023, the central bank has adjusted the reserve requirement ratio three times, while the China Banking and Insurance Regulatory Commission (CBIRC) has introduced several new regulations. These unpredictable policy changes increase investment uncertainty.

Regulatory arbitrage: Some market participants might exploit blank area in policies and regulations to engage in arbitrage activities, which increases systemic risk. For example, some enterprises issue bonds overseas to evade edomestic financing restrictions, or engage in off-balance-sheet financing through shadow banking channels, thereby raising systemic risk in the market.

3. Countermeasures

3.1. Addressing Credit Risks

Enhancing the Credit Rating System: It is essential to recognize the crucial role of credit rating agencies in accessing private information and to enhance their information-gathering capabilities and data sharing among relevant departments and rating agencies for improving the quality of bond credit ratings. Meanwhile, the supervision of the rating process should be strengthened to ensure transparency and compliance, in addition to improving the recruitment and training of talent within rating agencies to raise their professional standards. Additionally, it is urgent to reduce the implicit guarantee of the government on bond issuance, break the rigid payment and establish a market-driven pricing mechanism for default risk. These measures will fundamentally improve the effectiveness of credit ratings and promote the high-quality development of the bond market [8]. Specific measures include conducting regular examination of rating agencies' models and requiring them to expose their rating criteria and methods.

Establishing a Robust Default Disposal Mechanism: By refining the procedures for handling defaulted bonds, providing a more transparent and efficient default disposal mechanism, ensuring that

investors could receive timely settlements or compensation, thereby mitigating market volatility triggered by defaults. For example, the government could establish dedicated debt restructuring and liquidation agencies to centrally manage default cases accelerate the asset disposal of defaulting companies. The "Guidelines for the Market-Based Disposal of Defaulted Bonds" published in 2023 is fairly a positive step. Hence, it is recommended that the mechanism should be further improved to enhance its execution efficiency.

3.2. Mitigating Liquidity Risks

Expanding the Base of Market Participants: For enhancing the overall market liquidity, it is necessary to attracting more individual investors and small-to-medium-sized institutions by lowering the entry barriers for bond investment, which would increase the market breadth and depth. And the government could encourage long-term funds (pension funds and social security funds) to enter the bond market through tax incentives. In 2023, the share of individual investors in the bond market increased from 5 percent in 2020 to 10 percent, which deserves further promotion.

Promoting Bond Product Innovation: In order to help investors manage liquidity risks better, more liquidity management tools, such as bond collateral financing and repurchase agreements, should be developed. Although Chinese bond market liquidity levels still lag behind those of the United States, recent efforts by regulators and market institutions have made key maturity interest rate bond internationally competitive [9]. In 2023, the market launch in more liquidity management tools, such as "bond collateral repos" and "credit bond collateral financing." These tools have helped investors improve capital efficiency.

3.3. Managing Debt Risks

Improving Debt Transparency: Local governments should take the initiative to fully disclose their debt situations, including hidden liabilities, to increase market transparency and enable investors to assess risks more accurately. The "Local Government Debt Information Disclosure Regulations" introduced in 2022 require local governments to publicly disclose debt data on a quarterly basis, but enforcement needs to be strengthened. Additionally, ensuring the authenticity and completeness of the information by introducing third-party audit firms to verify debt data.

Optimizing Debt Structure: To mitigate and address local government debt risks, it is essential to clearly delineate the functions and fiscal powers of local governments, promote economic decentralization, and transform local government roles. Additionally, fiscal expenditure responsibilities should be regulated. Simultaneously, efforts should be made to accelerate the transformation of the economic growth model, reduce excessive reliance on investment, prioritize the restructuring of investment portfolios, and promote balanced, demand-driven growth. Encouraging private investment is crucial to enhancing the economy's endogenous growth potential [6]. Additionally, measures such as debt replacement and extension should be adopted to lengthen the maturity of local government debt, so as to reduce short-term repayment pressures. In 2023, the Ministry of Finance initiated a local debt swap program with a scale of 1.2 trillion yuan.

3.4. Addressing Regulatory and Policy Risks

Stabilizing Policy Expectations: Legal institutions provide the foundation for the implementation of debt contracts [10]. It is suggested that financial regulatory authorities engage in thorough market communication before introducing new policies, which could reduce the impact of policy changes on the market by using methods such as policy previews and draft solicitations. For enhancing policy transparency and continuity, the "Policy Stability Guidelines" introduced in 2022 should be rigorously implemented.

Strengthening Cross-Departmental Regulatory Coordination: Enhancing coordination among financial regulatory bodies is of importance to eliminate regulatory blind spots and arbitrage opportunities, ensuring the consistency and effectiveness of regulatory policies. For instance, the

country should establish a cross-departmental Financial Stability Committee to coordinate the policy measures of various regulatory agencies, which could prevent regulatory arbitrage. And it could issue a quarterly financial stability report, assess systemic risks in the market, and propose corresponding policy recommendations.

4. Conclusion

In recent years, Chinese bond market has experienced remarkable growth, becoming the global second-largest bond market. It offers diverse options of financing and investment for governments, enterprises and investors. However, as the market expands, various risks have gradually surfaced, requiring systematic solutions. This article analyzes the main challenges currently facing Chinese bond market, including credit and default risks, liquidity pressures, local government debt issues, and regulatory and policy uncertainties. In response, it proposes a series of countermeasures, such as strengthening the credit rating system, improving default resolution mechanisms, broadening the base of market participants, and optimizing the structure of local government debt. They aim to enhance market transparency, boost liquidity, reduce systemic risk, and promote the healthy development of Chinese bond market. Ultimately, only through joint efforts could Chinese bond market maintain its crucial role in the global financial system, supporting both economic stability and sustainable development.

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