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2020H1 China's Local Government Special Bonds Review and Outlook: RMB2 Trillion Special Bonds Go to Infrastructure Construction and More to Be Expected in 2020H2 to Maintain Stable Growth

Hong Kong, 24 July 2020 -- China Chengxin International Credit Rating Co., Ltd. ("CCXI") issued a report entitled *"2020H1 Review and Outlook of Local Government Special Bonds: RMB2 Trillion Special Bonds Go to Infrastructure Construction and More to Be Expected in H2 to Maintain Stable Growth"*. In the Report, CCXI indicated that given the globally sweeping COVID-19 pandemic and the stark pressure from economic downturn, special bonds as an important tool of proactive fiscal policy have gradually grown into one of major stabilizers for economic growth.

According to the Report, **there will be more special bonds in H2 with the annual issues expected to exceed RMB4 trillion. The raised funds will be preferentially channeled to new infrastructure and new urbanization initiatives as well as major projects. At the same time, active explorations will be made to find out new ways to help small and medium banks replenish their capital. Under the expectation that the proportion of special bonds used as project capital is expected to go up, nearly RMB6 trillion infrastructure construction investments may be leveraged throughout the year theoretically. While playing the role of special bonds as an economic stabilizer, it is necessary to keep a close grip on various risks and get more out of the proactive fiscal policy.**

China's Local Government Special Bonds Review in 2020H1

Despite the grim pandemic situation and the continuously mounting pressure from economic downturn, the proactive fiscal policy kept playing its due role in H1, with local government special bonds growing fast. The issues of such bonds exceeded RMB2 trillion. These bonds matched the cycle of infrastructure projects better, and the proportion of these bonds used as project capital were elevated further. In H1, special bond issues totaled RMB2.37 trillion, representing a year-on-year surge of RMB821.1 billion and more than doubling general bond issues, with the preset issuance target basically fulfilled ahead of schedule. **Issuance periods**: Newly issued bonds tend to have longer terms in general. The 10-year and longer bonds combined accounted for 87% of the total, representing a sharp increase of 50 percentage points over the same period of last year. The bond terms therefore became more aligned with the actual periods of projects to which these bonds would go. This change will not only boost the efficiency of fund utilization, but also mitigate the risks brought by bunched maturities. **Issuance costs**: Against a backdrop of loose credit, fiscal and monetary policies, the issuance interest rates of special bonds declined month by month until April when a gradual pickup started, so there formed a V-shaped trend. At the same time, a greater gap of issuance interest rate appeared among different terms of bonds. Short-to-mid-term bonds see their issuance interest rates plummeting on a year-on-year basis. **Of particular importance** was a higher proportion of special bonds used as project capital. The project yield-based bonds totaling nearly RMB110 billion were diverted to over 280 projects as capital, signaling a marked rise compared with a year earlier. Besides, these bonds also went to a wider range of fields, especially to the construction of many transportation projects such as railways. In the meantime, the sources of project income witnessed a slightly structural improvement, which would ease local fiscal pressure brought about by the pandemic response and continue playing the role of a stabilizer for infrastructure construction.

The structure of special bond issues was constantly adjusted and optimized as the macro background evolved, and the new issues of such bonds rallied up remarkably year on year, which made it possible for China to expand infrastructure facility investments continuously. In H1, new special bonds amounted to RMB2.23 trillion, representing a marked rise of RMB800 billion, accounting for more than 94% of the total. The refinancing bond issues totaled RMB141.3 billion, and no replacement bonds have been issued so far. **From the regional point of view**, some provinces such as Guangdong and Shandong issued special bonds at large scale, while those including Ningxia and Qinghai proved otherwise. When it came to the structure of bonds issued, new special bonds made the bulk in most provinces, but refinancing bonds took a lion's share in some provinces like Liaoning and Hubei, which might be related to the fact that these places faced the mounting pressure from debt rollover. **In terms of bond types**, project yield-based bonds issued in H1 amounted to RMB1.82 billion, accounting for 82% of the total new bonds. Of these, 90% went to the infrastructure construction projects. To be specific, the bonds used for the projects of municipal and park construction hosted the highest proportion, followed by the transportation projects, especially railway projects. This conformed to the requirement that "priority will be given to major projects" proposed in the Report on the Work of Government (2020). The project yield-based bonds in new infrastructure only accounted for about 9% of the total, although relevant policies stressed to speed up the issues of such bonds repeatedly. The Report identified that with the policy taking effect continuously, the proportion of special bonds in the infrastructure fields, particularly new infrastructure and new urbanization initiatives, will be further increased in the period to come, thus laying a solid foundation for the ensuing economic growth.

China's Local Government Special Bonds Outlook in 2020H2

Looking to the future, special bonds will develop with quality and efficiency better assured in H2 2020. When preferentially supporting new infrastructure and new urbanization initiatives as well as major projects, they will actively explore for new ways to help small and medium banks replenish their capital. Besides, the scope and range to which project capital is applied is expected to further expand, and nearly RMB6 trillion infrastructure construction investments are theoretically likely to be leveraged at most throughout the year. With regards to issuance, considering such factors as infrastructure demand, government bonds for special purpose, and amount of local government bonds due, the special bonds are projected to go beyond RMB4 trillion at most throughout the year. By bond types, replacement bonds are up to RMB188.9 billion, but zero or small-amount issues of such bonds will be very probable in the year; outstanding refinancing bonds amount to about RMB0.54 trillion at most; and the remaining new special bonds to be issued come in an amount of RMB1.52 trillion, which will usher in another supply peak in August. Furthermore, due to the supply pressure, the annual issuance target cannot be fulfilled until the end of October, as forecast. **Fields to which funds are directed**: Special bonds will be targeted at the further diversified fields. Priority will be given to getting the funds utilized more efficiently in the following two areas: (1) supporting new infrastructure and new urbanization initiatives as well as major projects; (2) helping small and medium banks replenish their capital. In doing so, these bonds are aimed to provide a catalyst for stabilized growth. Additionally, the Report also held that the scale and range to which specialize bonds are used as project capital can be further improved. Assuming the proportion of special bonds in each province used as capital is raised to 25%, up to about RMB5.6 trillion infrastructure investments will be leveraged throughout the year theoretically, which may drive up the nominal GDP by around 4.5 percentage points. **The Report concluded with some prompts. While special bonds are playing their due role, there are certain potential risks, such as project funds sitting idle, yields failing to reach expectation, excessive reliance on land transfer proceeds to repay bonds under some projects, and financial uncertainties brought by capital replenishment at small and medium banks. Against the background of stabilizing growth, the subsequent issuance and utilization of special bonds still need to shift the focus from quantity to quality, keep a close grip on various risks and get more out of the proactive fiscal policy.**

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中诚信国际
CCXI

中诚信国际信用评级有限责任公司

地址：北京市东城区朝阳门内大街
南竹竿胡同 2 号银河 SOHO6 号楼
邮编：100020

电话：(8610) 6642 8877

传真：(8610) 6642 6100

网址：http://www.ccxi.com.cn

China Chengxin International Credit Rating Co., Ltd

Address: Building 6, Galaxy SOHO,
No.2 Nanzhugan hutong, Chaoyangmennei Avenue,
Dongcheng district, Beijing, 100020

Tel: (8610) 6642 8877

Fax: (8610) 6642 6100

Website: http://www.ccxi.com.cn

中誠信亞太
CCXAP

中国诚信(亚太)信用评级有限公司

地址：香港中环康乐广场 1 号
怡和大厦 8 楼 805-808 室

电话：(852) 2860 7111

传真：(852) 2868 0656

网址：http://www.ccxap.com

China Chengxin (Asia Pacific) Credit Ratings Company Limited

Address: Suites 805-808, Jardine House, 1 Connaught Place,
Central, Hong Kong

Tel: (852) 2860 7111

Fax: (852) 2868 0656

Website: http://www.ccxap.com