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Nearly RMB5 Trillion Special Bonds to be Issued, Government Should Forestall Risks in Future Expansion of Special Bonds after the Pandemic

Hong Kong, 16 April 2021 -- A report titled "Special Bonds for Refinancing Take up Over Ninety Percent under Debt Payment Pressure, and Government Should Forestall Risks in Future Expansion of Special Bonds Against the Backdrop of Maintaining Stable Growth and Reducing Leverage in the Post-pandemic Era: Overview of Local Government Special Bonds in Q1 and Outlook" has been recently published by the Research Institute of China Chengxin International Credit Rating Co. Ltd. ("CCXI Research Institute"). According to the report, as an important source of funds for infrastructure construction, special bonds will still be an essential instrument used to improve areas of weakness and maintain stable growth in the post-pandemic recovery period, and when some local governments still have budgetary deficits and face great repayment pressure, special bonds for refinancing can play an important role in mitigating local government debt risks. Therefore, against the backdrop of maintaining stable growth, reducing leverage and forestalling risks, special bonds are expected to expand faster in 2021 and nearly RMB5 trillion more is expected to be issued, which will continue to focus on the construction of new infrastructure, new urbanization initiatives and major projects as well as projects concerning people's livelihood while supporting local governments in defusing debts. However, as special bonds increase further in scale, it's necessary to guard against risks to promote high-quality development in the post-pandemic era.

The report points out that given the pressure of maintaining stable growth and continuous fund demand of existing projects after the pandemic, the quota for new special bonds is expected to maintain at a high level this year. However, because the quota for early issuance of special bonds was released late, the issuance of special bonds clearly slowed down in Q1, and the issue volume fell dramatically year on year, with that of short-term bonds increasing significantly. In Q1, a total of RMB895.11 billion local government bonds were issued, a sharp decrease of RMB715.4 billion from the RMB1.6 trillion in the corresponding period last year. The issue volume of special bonds was RMB0.37 trillion, only one third of the RMB1.1 trillion that was issued in the corresponding period last year. **The terms of bonds issued clearly shortened.** As the issuance of new special bonds with a relatively longer term slowed markedly, the weighted average term of special bonds shortened by 5.6 to 8.6 years year on year. Special bonds with a term of over 10 years accounted for 1.8%, significantly down 40 percentage points from the 42.5% in the corresponding period last year. **In terms of issue cost,** with the economy gradually recovering, the credit cycle started to change and the interest rates of the bond market began to move upward. In addition, affected by a low base number in the corresponding period last year, the interest rates of special bonds rose year on year, and monthly year-on-year growth gradually expanded. The interest rates of special bonds of all terms rose year on year but were divergent, with those of short- and medium-term special bonds witnessing a greater rise.

In the meantime, the report states that local governments are still under financial pressure after the pandemic. Under debt repayment pressure, special bonds for

refinancing accounted for over ninety percent, and most of the proceeds were used to repay existing government debts. A small amount of new special bonds were issued. Besides providing continuous support to the development of small and medium banks, the proceeds were mostly invested in renovation of shanty towns and generally in existing projects and were not used as project capital funds. In Q1, a total of RMB0.35 trillion worth special bonds for refinancing were issued, of which nearly sixty percent was used to repay existing local government debts and the remaining to repay the principal of partial mature bonds. RMB26.4 billion new special bonds were issued, a year-on-year decrease of over RMB1 trillion. They accounted for only 0.8% of the quota for early issuance and 0.4% of the quota for new special bonds of the year, much lower than those completed in the corresponding period last year. Special bonds for swap were not issued yet. **By region,** 24 provinces including Jiangsu and Sichuan issued special bonds, and 7 provinces including Gansu and Hainan haven't issued any special bonds yet. In terms of issue structure, of the 24 provinces, only Sichuan and Hubei issued new special bonds. There is certain correlational relationship between the issue volume of special bonds for refinancing and the pressure of maturity of special bonds among provinces. In provinces like Qinghai and Inner Mongolia who have relatively weak financial strength, less quota for early issuance, and smaller pressure of maturity of special bonds, their proceeds from issuance of special bonds for refinancing were mostly used to repay existing local government debts. **By variety,** besides being continuously used to replenish small and medium banks' capital funds, the quota for new special bonds this year was mainly invested in the fields of renovation of shanty towns, transportation, municipal industrial parks, etc., of which over fifty percent was used in renovation of shanty towns. In the meantime, the fundraising projects were basically existing projects, which had high fund continuation demand. Besides, it's worth noting that no special bonds were used as capital funds of projects in Q1, and the reason may be because currently most special bonds are used in projects in process and their capital funds are already in place.

Looking ahead, the report believes that using special bonds well is an important link to maintain stable growth, reduce leverage and forestall risks in the post-pandemic period, and special bonds are expected to expand faster in year and continue to focus on the construction of new infrastructure, new urbanization initiatives and major projects as well as projects concerning people's livelihood while supporting local governments in defusing debts, to expand effective investments and improve areas of weakness in development. The report has forecast the issue volume and pace of special bonds in the year. With the quota reserved to support small and medium banks taken into account, the residual quota for **new special bonds** is RMB3.77 trillion, and the completion of the quota is expected to be delayed to the end of Q4, and the issuance to peak in May to October. After taking into account the volume of mature special bonds and local governments' debt repayment needs, the issue volume of **special bonds for refinancing** is expected to exceed RMB1 trillion in the year, of which RMB0.8 trillion is likely to be used to repay the principal of mature bonds. Investors should pay attention to refinancing pressure in Q2 and Q3. With low demand for issuance of **special bonds for swap**, the issue volume of special bonds for swap is expected to maintain zero in the year. **In terms of the flow direction of proceeds,** this year special bonds will be first used to support projects in process, and their usage scope will be reasonably expanded centering on economic development and weak fields after the pandemic. They will continuously support the construction of new infrastructure, new urbanization initiatives and major projects as well as fields concerning people's livelihood. **Besides,** the report estimates that in theory, about RMB5.5 trillion infrastructure investment can be mobilized throughout the year. However, because issuance of new special bonds currently lags behind, their conduction effect to infrastructure investment is expected to emerge in the second half of the year, and the actual effect will still be restricted by factors like proportion of special bonds used as capital funds, availability of project funds, project progress, completion of supporting facilities, etc., which need to be paid attention to.

The report finally notes that in the post-pandemic recovery period, as special bonds continue to expand, investors should pay close attention to potential problems and risks. For example, issuance of new special bonds lags far behind schedule, which is very likely to postpone infrastructure investment. Moreover, there may be problems that can cause the efficiency of investment to fall short of expectations such as that the quota for new special bonds is not used up, project funds are left unused, few capital funds are used, etc. In the meantime, as the peak of maturity of local government bonds is approaching and the government is reducing leverage and pressing down the growth in implicit debts, some provinces who have weak debt coverage capability and serious budgetary deficits are likely to issue more refinancing bonds than the limited quota. Investors should watch out for their subsequent debt repayment risk. In addition, special bonds are still faced with the problem of less-than-expected project earnings. Under debt repayment pressure, projects are expected to continue to reply on revenue from land transfer. Investors should pay attention to their return to "land finance". **The report advises accelerating issuance of special bonds in the year and doing a good job in risk prevention and management of projects supported by special bonds throughout their whole lifecycles to improve fund utilization efficiency and investment efficiency. In the meantime, it's necessary to arrange the issuance of refinancing bonds reasonably based on specific debt pressure, and to avoid concentration of subsequent debt repayment pressure while mitigating current debt risks. Against the backdrop of maintaining stable growth, reducing leverage and forestalling risks in the post-pandemic era, it's necessary to continue to securely guard against risks of special bonds and promote the high-quality development of special bonds.**

To obtain the full report, please call our Customer Service Hotline +852-2860 7111.

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