Local Government Special Bond Issuance Gained Pace amid Cross-cyclical Adjustments, Land Market Chill to Weigh on Local Public Finance

Hong Kong, 22 October 2021 -- A report titled "Local Government Special Bond Issuance Gained Pace amid Cross-cyclical Adjustments, Land Market Chill to Weigh on Local Public Finance: Local Government Special Bonds Review and Outlook 2021Q1-Q3" has been recently published by the Research Institute of China Chengxin International Credit Rating Co. Ltd. ("CCXI Research Institute"). The report holds that, given the downward economic pressure, local government special bonds (hereinafter referred to as "special bonds") as an importance source of infrastructure funding are a crucial tool to strengthen weaker areas, adjust structure and stabilize investment. The issuance of special bonds made a slow start to the year followed by an acceleration, but the new special bonds still lag behind, leading to a delayed effect in driving infrastructure investment. Under the policy requirement that "the issuance of local government special bonds should be completed by the end of November, with no quota reserved for December", the bond issuance will be expanded in Q4 and more concentrated on key fields and major projects while supporting debt rollover. In addition, the stringent real estate curb has led to increasing liquidity stress among property developers, having big impact on land auctions, especially in Central and Western China as well as third-tier and fourth-tier cities. The situation may further worsen the fiscal balance of local governments. The special bond projects and modes relying on land sales revenues will face more challenges, posing potential risks that require ongoing monitoring.

The report points out that the special bonds issuance gained pace notably in Q2 and Q3 under the cross-cyclical adjustment policy with a highly visible trend of going short-term, and the interest rate liberalization showed good momentum. RMB5.63 trillion of local government bonds were issued in aggregate in the first three quarters of 2021, slightly down RMB50 billion year-on-year. The issuance of special bonds totaled RMB3.38 trillion over the period, down RMB0.32 trillion or 10% year-on-year. **Bond terms shortened year-on-year.** Due to the tardiness in issuance of new special bonds with longer terms, the weighted average term of special bonds was shortened by 1.39 years to 13.61 years. 10-year and longer-term bonds accounted for 60.33%, down 20 percentage points from one year ago, or down nearly 10 percentage points from H1. **In terms of issuance costs,** the issuance cost of special bonds in the first three quarters dropped to a level flat with 3.42% recorded one year ago. The term structure was flattening, with the coupon rates rising markedly for 3-year, 5-year, 7-year and 10-year special bonds year-on-year, but moving lower for 20-year and 30-year bonds than a year ago, possibly due to intuitional investors preferring longer-duration local government bonds amid the asset shortage. In addition, all of the 31 provincial governments have broken the "25-bps ceiling" on the valuation spread of local government bonds since Q3, showing sound momentum for coupon rate liberalization of local government bonds.

The report also notes that the refinancing special bonds have accounted for 30%, the issuance of new special bonds remains tardy, the use of proceeds is focused on newly commenced projects and the proportion of shantytown redevelopment bonds have retreated from high. RMB1.01 trillion of refinancing special bonds were issued in aggregate in the first three quarters, three times that recorded one year ago and accounting for 29.93% special bonds, up 21 percentage points year-on-year. Over 70% of their proceeds were used to repay bond principal when due, with the remainder used to pay off outstanding government debts. New special bonds totaled RMB2.37 trillion, down RMB1 trillion from one year ago, and representing 64.82% of the annual quota, down 25 percentage points year-on-year. **By geography,** Shandong, Guangdong, Henan, Anhui and Jiangsu were the largest issuers, with Shandong and Guangdong exceeding RMB300 billion in issuance size each. **By structure,** 30 provinces, excluding Ningxia, issued new special bonds, with Guangdong, Shandong, Henan, Anhui, Zhejiang, Fujian and Hebei exceeding RMB100 billion in issuance size. Under debt pressure, all the 31 provinces issued refinancing special bonds. Regions under higher pressure from debt rollover recorded a bigger proportion of refinancing bonds. **By sector,** about 75% (2021H1: 80%) of new special bonds were invested in existing projects, mainly including municipal industrial parks, transportation, shantytown redevelopment and public wellbeing. The special bonds earmarked for shantytown redevelopment that mainly invested in existing projects fell to 15% from 18% recorded in H1. Notably, a total of 20 provinces have issued RMB210 billions of special bonds for small and medium-sized banks since 2020, benefiting 315 small and medium-sized banks, including RMB159.4 billion issued in the first three quarters of 2021. Now the quota has been exhausted. In addition, the first three quarters of 2021 saw a moderate decline in special bond proceeds used as project capital and a slightly smaller number of supported projects when compared with one year ago, and a lower proportion of investments in transport infrastructure.

Looking forward, the report holds that, under the policy requirement that "the issuance of special bonds should be completed by the end of November, with no quota reserved for December", the issuance of special bonds will be expanded in Q4 and more concentrated on key fields and major projects while supporting debt rollover. Their boost to infrastructure investment will likely be felt in Q4 or early next year. The report forecasts the size and pace of special bond issuance in Q4. The unused quota for **new special bonds** was RMB1.28 trillion at the end of September. Under the current policy requirements, RMB640 billion of new special bonds should be issued on average a month in October and November. Under the pressure from maturing bonds, at least RMB0.14 trillion of **refinancing special bonds** should be issued to fund the principal redemption of matured bonds. The issuance of refinancing special bonds earmarked for repaying outstanding debts has shrunk abruptly since Q3, and is unlikely to continue into Q4. **As for usage of proceeds,** infrastructure-backed growth is expected with higher certainty as economic data has weakened since Q3. Special bonds will remain focused on infrastructure. **In addition,** with shantytown redevelopment bonds expected to shrink, the report estimates that special bonds may theoretically support RMB5.5 trillion to RMB5.6 trillion of infrastructure investment. But the actual effect is subject to such restrictions as quota availability, target fields, capital use and project progress, which requiring ongoing attention.

The report finally warns of the potential risks in special bonds as the problem of low yields on special bond projects cannot be rooted out in the short term, coupled by the

downward economic pressure and land market chill. First, the local governments' reliance on land finance gas been passively weakened amid stringent regulation of real estate. Local governments may remain under fiscal pressure to pay off their bonds. The special bond projects and modes relying on land sales revenue will face more challenges. **Second,** a larger proportion of special bonds have been refinanced. We should watch out for the possibility of breaking the refinancing ceiling. Moreover, the deferred debt service will significantly add to the interest costs of bonds and spark uncertainty in debt repayment. **Third,** the ongoing control over special bonds has been intensifying this year, posing new challenges to local governments' governance capacity. If local governments are unprepared, weak in control, late in monitoring or lax in management, their application for special bond issuance may be rejected and their future quota may be reduced, which will become a drag on local economic growth.

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