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Accelerating Issuance of Local Government Special Bonds under Cross-cyclical Adjustments, Forestall Risks in Front-loaded Spending under Growth Stabilization Policy

Hong Kong, 10 January 2022 -- The Research Institute of China Chengxin International Credit Rating Co., Ltd has recently issued a report entitled "Accelerating Issuance of Local Government Special Bonds under Cross-cyclical Adjustments, Forestall Risks in Front-loaded Spending under Growth Stabilization Policy --2021 Review and 2022 Outlook on Local Government Special Bonds". The report notes that, with a focus on the post-epidemic economic development and the demand for shoring up weaker areas, special bonds gave priority to supporting existing projects in 2021, actively promoted the development of new-era infrastructure, new-type urbanization and major projects and were innovatively applied to the capital replenishment of small and medium-sized banks, rural vitalization, green and low-carbon fields. Offshore RMB special bonds were innovatively issued to effectively strengthen weaker areas, adjust structure and stabilize investment. In 2022, the proactive fiscal policy should be more effective with a keener focus on accuracy and sustainability. The quota for new special bonds is expected to reach RMB3.50-3.75 trillion. The focus will remain on infrastructure, especially new starts and provincial/municipal projects. With the size growing bigger, we need to pay attention to such problems as low efficiency of capital use and poor quality of project revenue, insufficient efforts to leverage private-sector capital and high debt service pressure of grassroots governments, so as to firmly guard against risks.

The report points out that under the framework of cross-cyclical regulation, the issuance of local bonds, especially new special bonds, featured a pattern of "ramping up after a slow start" in 2021. The year saw more flexible pace and timing of issuance with shorter tenors overall and lower coupon rates. In addition, offshore RMB special bonds have been issued this year, officially kicking off the internationalization of local government bonds. By issue size, local government bonds issued in the year totaled RMB7.48 trillion, an increase of RMB1.04 trillion over the previous year. Of them, special bonds totaled RMB4.92 trillion, nearly double the size of general bonds, an increase of RMB0.78 trillion over the previous year. **By bond tenor,** due to policy restrictions and expansion of refinancing bonds, the weighted average tenor of local government special bonds was shortened by 0.45 year to 14.17 years. The 10-year and longer-tenor bonds accounted for 74.46%, down 6.78 percentage points from one year ago. **By issue cost,** the coupon rates of special bonds fluctuated downwards throughout the year, down 3 bps year-on-year to 3.41%. The term structure of interest rates was generally flattened, with the long-term rates falling more than the short-term ones. Since June, local government bonds have become market-oriented at a faster pace, with the spread of special bonds issued reaching 24.1 bps in the year, narrowing by 0.9 bp year-on-year. **By product innovation,** Shenzhen issued RMB5 billion of offshore RMB special bonds and Guangdong Province issued RMB2.2 billion of offshore RMB general bonds, kicking off the internationalization of local government bonds and opening up new channels for local government financing.

The report also points out that refinancing as a percentage of total special bonds has increased significantly to nearly 30% under rollover pressure. Nearly 80% of new special bonds went to existing projects and nearly 40% to new-era infrastructure, new-type urbanization and major projects. RMB1.34 trillion of refinancing local government special bonds were issued in aggregate in 2021, 2.5 times that recorded one year ago and accounting for 27% of local government special bonds, up 14 percentage points year-on-year. Over 66% of their proceeds were used to repay bond principal when due, with the remainder used to pay off outstanding government debts. A record-high 83.89% of refinancing local government special bonds were used for repaying mature bonds and outstanding debts, compared with 76.68% last year. A total of RMB3.58 trillion of new special bonds were issued, including RMB149.4 billion of quota carried forward from the previous year for capital replenishment of small and medium-sized banks. As a result, the actual issue size was RMB3.43 trillion, down RMB0.17 trillion from the previous year, representing 99% of the full-year quota. **In terms of geography,** Guangdong, Shandong, Zhejiang, Beijing and Sichuan were among top performers by issue size, with Guangdong and Shandong exceeding RMB400 billion each. By structure, 30 provinces excluding Ningxia issued new special bonds, which exceeded RMB200 billion in Guangdong, Shandong and Zhejiang. Under the debt service pressure, a total of 31 provinces issued refinancing special bonds. Beijing, Guangdong, Shandong, Jiangsu and Guizhou were among the largest issuers. Specifically, Beijing issued RMB172.1 billion of refinancing special bonds in December to pay off outstanding debts. As the "Zero Hidden Debt Pilot Program" kicked off, Beijing's move is estimated to prepare for downsizing implicit debts. **In terms of category,** about 80% of new special bonds were invested in existing projects, mainly including municipal industrial parks, transportation, shantytown redevelopment and people's livelihood. Compared with 2020, municipal projects and transportation took up a significantly lower percentage, while shantytown redevelopment gained a bigger proportion. Nearly 40% went to new-era infrastructure, new-type urbanization and major projects. Major projects accounted for 45%, with a focus on transportation infrastructure projects. New-style urbanization accounted for more than 40%, with a focus on shantytown redevelopment. New-era infrastructure investments only accounted for over 10%. In addition, the scale and number of special bonds earmarked as project capital in 2021 were significantly lower than a year ago. The main cause might be the smaller issuance of special bonds for transportation and the limited capital demand of existing projects.

Looking forward to 2022, the report believes that special bonds will remain a focus of the proactive fiscal policy, and the new quota will remain high and continue to play its role in stabilizing growth, adjusting structure, strengthening weaker areas and promoting transformation. The report forecasts the issue size of local government special bonds in 2022. Given the **quota for new local government special bonds** estimated to be RMB3.50 trillion to RMB3.75 trillion alongside the unused quota for 2021, the new local government special bonds to be issued in 2022 may reach RMB3.73 trillion to RMB3.98 trillion. Under the pressure from maturing bonds, at least RMB0.9 trillion of **refinancing local government special bonds** should be issued to fund the principal redemption of matured bonds. The local government bond issuance is estimated to reach RMB7.4 trillion as maximum in 2022, and the total issuance may exceed RMB8 trillion taking into account the refinancing bonds earmarked for servicing outstanding debts. **As for usage of proceeds,** under the Central Economic Work Conference's requirement of "carrying out infrastructure investment moderately ahead of time", the expectation of infrastructure bolstering the economy is a bigger certainty. It is expected that special bonds will continue to focus on infrastructure construction and moderately increase support for water conservancy, urban pipe network and affordable housing. **In addition,** the report estimates that local government special bonds may theoretically support RMB6.17 trillion to RMB6.26 trillion of infrastructure investment. Infrastructure spending will be front-loaded, but the actual effect is subject to such restrictions as quota availability, target fields, capital use and project progress.

At the end of the report, it was reminded that the current problem of inefficiency use of special bond proceeds and poor quality of project revenue has not been reversed. It is still necessary to watch the potential risks in special bonds amid heavier downward economic pressure, continuing real estate curbs, local government bonds about to peak and stronger efforts to address hidden debts. First, as the tight fiscal balance persists, due attention should be paid to the debt service pressure of local governments, especially the grassroots governments. **Second,** as the land finance model continues to weaken under tough real estate curbs, due attention should be paid to risk of declining yield on special bonds. **Third,** as the proportion of special bonds used as project capital remains low, due attention should be paid to the government sector's insufficient efforts to leverage private-sector capital. **Fourth,** given the imminent peak of debt servicing and growing demand for hidden debt resolution, due attention should be paid to post-rollover debt service risk and sustainability of debts.

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

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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 19 楼 1904-1909 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 1904-1909, 19/F, Jardine House,
1 Connaught Place, Central, Hong Kong
Tel: (852) 2860 7111
Fax: (852) 2868 0656
Website: http://www.ccxap.com