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Special Comments

Fiscal policy in 2023H2 continues to emphasize on resolving local government debt risks

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On 30 August 2023, the Ministry of Finance released *the Report on the Implementation of China's Fiscal Policy in 2023H1*, which clearly proposed to increase the intensity of macro-policy regulation, intensify efforts to improve efficiency and implement proactive fiscal policies, and continue to promote ongoing improvement in economic performance, enhance endogenous power, improve social expectations, and resolve hidden risks. Fiscal policy in the second half of the year will focus on three major directions: first, accelerating the issuance and use of local government special purpose bonds; second, improving the efficiency of special bond funds; third, preventing and solving local government debt risks.

In conclusion, fiscal policy in 2023H2 will continue to emphasize on solving local debt risks, and strictly regulating hidden debts. The issuance of local government special purpose bonds may accelerate, and fiscal instruments such as development financial instruments are expected to be launched. However, under the background of weak economic recovery and fiscal balance, the debt risks in regions with weak economic and fiscal strength and high debt maturity pressure are noteworthy.

Accelerating the issuance and use of local government special purpose bonds

The overall issuance of local government special purpose bonds slowed down in 2023Q2. As of 31 August 2023, RMB2.9 trillion of special purpose bonds (excluding small and medium-sized banks' debts) were issued, completing 77% out of total year's progress, while the amount of issuance and progress were much lower than that of last year. Affected by this situation, the growth rate of infrastructure investment slowed down this year. Hence, the Report proposed to "accelerate the issuance and use of local government special bonds". Recently, the Ministry of Finance also stated that the new special bonds should be mostly issued before the end of September, and the special funds for project construction will be used up by the end of October. The Ministry of Finance has previously issued quota of RMB3.7 trillion for project construction this year. As of the end of August, there was unused special funds of about RMB0.76 trillion. It is expected that new special bonds will be issued in September. As the issuance and use of special bonds accelerates, the growth rate of fiscal expenses will also grow up.

Improving the efficiency of special bond funds

The Report proposes to expand investment areas and in 2023H1, the investment areas of special bonds have entered consumption and new infrastructure. It is expected that usage of special bond support may further expand to food security, energy security and industrial chain supply chain security sector. At the same time, it may focus on scientific and technological research, education development, culture, sports, sustainable development and other sectors to meet needs for a better life. Insufficient reserves and insufficient willingness of social capital to participate in new fields need to be focused. We need to establish a long-term mechanism for project reserves and an investment and financing docking mechanism to better utilize the function of special bonds in new fields. In addition, the recently disclosed national audit reports proposed that special bonds problems such as illegal use and misappropriation still exist, and the efficiency of "debt-to-asset" conversion still needs to be improved. In the future, it is still necessary to improve the quality of project reserves and regularize strict regulation.

Preventing and solving local government debt risks

Since the beginning of this year, market and policy have continued to pay more attention to local government debt issues. The Central Economic Work Conference clearly stated "accelerating the disposal of existing hidden debts." The Political Bureau meeting on 24 July proposed to resolve local debts risks, implement package of debt resolving plans effectively. The Report proposed more detailed that "supervise local governments to use funds, assets, resources and various supporting policies, increase attention on cities and counties level, optimize the maturity structure, reduce interest burden, and gradually mitigate debt risks." Under large-scale and high-cost existing hidden debts, exchanging time for space and exchanging low interest rates for high interest rates are still the main logic of current debt refinancing. In the short term, replacement with local debt may be accelerated.

The first direction is to accelerate the issuance of local debt issuance and guide the hidden debt to become transparent. As of the end of 2022, the unused quota for local government was approximately RMB2.59 trillion, which can be used to improve fiscal status and allocated across regions through the transferring mechanism. It is expected that debt risks will be relatively high, credit events will occur frequently, and the limit will be reached within the end of this year. Regions with large due debts are expected to receive more support. It is necessary to strengthen risk management in the future, such as strictly controlling new government investment projects. The release and use of funds will be supervised throughout the entire process.

The second direction is to increase the synergy between monetary and financial policies, strengthening financial cooperation, and reducing debts. The Report proposes to strengthen the coordination of fiscal and monetary policies, strengthen expectation management. Banks can be cautiously promoted in some high-risk areas for debt restructuring; at the same time, central bank can increase financial support appropriately, such as issuing special bonds to supplement the capital of banks, establishing special support plans and continue to provide low interest rate environment to solve local debt risks by continuing to reduce interest rates.

The third direction is to actively vitalize existing state-owned assets and increase debt repayment funds to mitigate debt risks, vitalizing state-owned assets and increasing financial resources of local governments; at the same time, state-owned enterprises should operate state-owned assets effectively, establish credit enhancement funds, increase state-owned assets turnover rate, equity transfers, and increase the efforts of REITs to vitalize existing assets. In addition, the Report proposes to strengthen cross-department supervision and establish a long-term regulatory framework. It is expected that a more systematic and coordinated local government debt supervision framework will be established. Departments should conduct consolidated supervision to improve supervision efficiency.

In conclusion, fiscal policy in 2023H2 will continue to emphasize on solving local debt risks, and strictly regulating hidden debts. The issuance of local government special purpose bonds may accelerate, and fiscal instruments such as development financial instruments are expected to be launched. However, under the background of weak economic recovery and fiscal balance, the debt risks in regions with weak economic and fiscal strength and high debt maturity pressure are noteworthy.

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