China: on the beat, Issue No. 44

Channel check: policy loosening, the impact on local government financing

Investment Strategy

06 August 2018

Govt. stimulus spending may disappoint equity market

This is the 44th issue of our "*China: on the beat*" series – your eyes and ears in China. Recently, there have been signs that the govt. may loosen control over local govt. debt to stimulate demand (State Council meeting, Jul 25). To gauge the impact, we spoke to several contacts including officials, bank officers and bond investors. Our key takeaway is that fiscal stimulus this time, if any, may largely be financed by muni bond and local govt. funding vehicle (LGFV) bonds as other funding channels remain restricted. In 1H18, the balance of these bonds rose by Rmb0.5tr vs. Rmb1.9tr in 2017 (Table 1), so they would need to surge by Rmb1.4tr in 2H18 for bond financed spending to be neutral vs. 2017. Even if this happens, overall local govt. spending this year could still come in below last year given a likely funding reduction from other sources. Thus, we would expect local govt. spending to disappoint, and we stay cautious on investment-led equity sectors, eg, resources, building materials & contractors.

Local government has many borrowing channels

The main forms of local government debt include commercial & policy bank loans, entrusted loans, bonds (muni & LGFV), build-and-transfer contracts & accounts payable, "investment" in public-private partnership (PPP) projects and from government-sponsored investment funds (GSIFs) – for the latter two, although much of the funding is recorded as investment, they are more debt in nature in our view due to a perceived implicit guarantee of repayment (2018 Year Ahead: A cyclical peak, Jan 16). Over the past few years, wealth management products (WMPs) have become an increasingly important funding source for some of these debt instruments.

Limited loosening on commercial & policy bank loans

So far the feedback we have received is that banks have not loosened their lending standards for LGFV loans, e.g., an LGFV still has to put up 20-25% equity for a project. As the usual shadow banking channels that help LGFVs secure equity contributions remain tightly controlled, most of them still struggle to borrow from commercial banks. For this, we need to monitor closely whether the special construction fund, which can be used as equity, is restarted (Special Construction Fund, 1 Apr, 2016). There has been little loosening of policy bank loans to local governments for shantytown reconstructing as far as we are aware. On the other hand, the government has been urging banks to grant loans to private companies & SMEs; some of these loans could flow to LGFVs eventually.

Muni/LGFV issuance may rise on govt. lending guidance

Premier Li recently urged financial institutions (FIs) to satisfy LGFVs' legitimate funding needs and promoted infrastructure investment in Central and Western regions. Market risk perception of LGFV bonds improved as a result, as evidenced by a decline in their yield. In addition, the central bank's Jul 20 guideline on WMPs allows money market products (MMPs) to be priced using the amortized cost method. This means that the return of MMPs can appear fairly stable, enhancing their attractiveness to potential investors. MMPs predominately invest in bonds.

Control over PPP & GSIF remains tight

The Jul 20 WMP guideline reaffirms the ban on pooling & duration mismatch (New WMP rules, Apr 30), making loosening of LGFV funding via PPP or GSIF unlikely, in our view.

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Timestamp: 06 August 2018 12:28AM EDT

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Table 1: Local government muni bond & LGFV bond outstanding and net issuances (Rmb bn)

	Local govt muni bond balance, Rmb bn	Used for the debt swap	Muni bond	LGFV bond balance, Rmb bn	Muni bond ex debt swap balance increase	LGFV bond balance increase
2009	**200**	-	200	**194**		
2010	**400**	-	400	**379**	200	185
2011	**600**	-	600	**678**	200	299
2012	**650**	-	650	**1460**	50	782
2013	**862**	-	862	**2285**	212	825
2014	**1,162**	-	1,162	**3915**	301	1,630
2015	**4,826**	3,221	1,605	**5034**	443	1,119
2016	**10,625**	8,112	2,513	**6500**	908	1,466
2017	**14,742**	10,865	3,876	**7025**	1,363	525
1H18	**15,996**	11,804	4,192	**7208**	316	183

Source: CEIC, Minsitry of Finance

Impact from PBoC's detailed guideline on WMPs

On Jul 20, the People's Bank of China (PBoC) published a detailed guideline for its new WMP rules released in April. The guideline allows MMPs to be valued using the the amortized cost method. In the April announcement, such products were required to be valued based on a net value basis. Due to this change, MMPs, which predominantly invest in bonds, can show fairly stable returns. In addition, there is no restriction on MMPs' duration, which means that they can have a much shorter duration than that of non-standard credit asset (NSCA) products, further enhancing their attractiveness to WMP investors. If the AUM growth of MMPs accelerates, it could mean more demand for bonds, including muni and LGFV bonds. This should help the government to raise financing via the bond market.

On the other hand, WMP rules from both the PBoC and the China Banking and Insurance Regulatory Commission (CBIRC) continue to 1) ban pooling and duration mismatch; 2) restrict WMP funding to unlisted equity investments; and 3) restrict layering and leverage-up. These largely block WMP funding for PPPs and GSIFs, by our assessment (Interview takeaways on Government-Sponsored Industry Fund, Jun 25). These had been the main channels through which banks lent to LGFVs off balance sheet.

Actually, one of the main intentions of the financial regulators' new WMP rules is to drive investment out of the less transparent NSCAs and unlisted equity into the more transparent bond market so they can better direct where credit goes. In the past, a significant portion of the less transparent investments went to discouraged areas including property and unapproved local government projects. This is also in line with the intention of the Ministry of Finance to better monitor and control local government debt. This is one of the major reasons why we believe that this round of the stimulus, if any, is likely to be largely be financed by the bond market.

Impact from PBOC's loan loosening

Local media reported on July 4 that PBOC has asked banks to grant more loans. However, so far it seems that banks have not loosened their lending standards when granting LGFV loans: such loans have to be project based; and an LGFV has to put up 20-25% equity for the project before qualifying to receive a loan. Recently, some LGFVs have struggled to fund equity contributions. In the past, an LGFV could borrow from WMPs via GSIF, and the GSIF's investment in a project could serve as the equity. However, this practice is now banned by PBoC's new WMP rules.

The PBoC has been encouraging banks to lend to private companies and SMEs. It's possible that some of these firms may consider using their loans to support LGFVs, for example, by being a PPP investor in LGFV projects. This is clearly not the government's intention. For example, on May 17, the National Development and Reform Commission (NDRC) issued a directive banning companies from issuing bonds on LGFVs' behalf. That said, in practice, the regulators may find it difficult to control such arrangements effectively, especially if the overall government policy thrust is to stimuluate investment demand. Unfortunately, it's difficult to quantify such indirect arrangements.

Impact from the State Council's July 23 order

In 1H18, some LGFV bond issuances were cancelled due to challenging market conditions. This forced some LGFVs to hoard cash and cut back on infrastructure spending.

On July 23, Premier Li stated at a State Council's meeting that the government would guide FIs to satisfy LGFVs' reasonable funding demands, i.e., by existing approved projects. During his trip in Tibet on July 25-27, he said that infrastructure investment in Central and Western China is a good choice for stimulus. Both comments significantly improved investors' perception of LGFVs and lowered LGFV bond yields by 20-50bps. This situation could see LGFVs issue more bonds going forward.

Impact from shantytown reconstruction policy change

In many regions, China Development Bank (CDB) seems to have centralized/tightened the approval on shantytown reconstruction (STR) loans, after the program had largely served its purpose, i.e., to help low-tier cities to destock.

For local governments, STR loans were a large and cheap funding source with a low borrowing threshold. Accoridng to CDB, it granted Rmb880bn such loans in 2017, vs. a Rmb200bn special construction bond approved by the National Development and Reform Commission (NDRC). The lending rate is around 4.1-4.9% p.a., and the borrower doesn't need to pay back any principal during the first 3 years. When granting the STR loans, local branches of the CDB seldom focused on assessing local government's repayment capacity (Caixin, Jul 2).

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