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Credit Q&A:

# What Signal is Sent by the 10-trillion-RMB Debt-Relieving Package?

**November 11, 2024**

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On November 8, the 12th session of the 14th National People's Congress ("NPC") Standing Committee approved the State Council's proposal on raising local government debt quota for replacing existing hidden debt ("the proposal"). The proposal calls for reinforced accountability of local authorities and a 6-trillion-RMB local government debt quota to be added for replacing existing hidden debt. For this fiscal stimulus to be implemented smoothly and make an impact as soon as possible, the new debt quota, all arranged for special debt issuance, has been approved as a whole package and will be used within three years. Accordingly, the local government special bond quota by the end of 2024 would increase to 35.52 trillion RMB from the previous 29.52 trillion RMB. In addition, the Minister of Finance announced a plan to set aside 800 billion RMB per annum from the proceeds of newly issued special bonds in 5 straight years starting from 2024, which would be aimed solely at resolving debt and expected to replace 4-trillion-RMB hidden debt in total. This, combined with the lately approved 6-trillion-RMB quota, has expanded the overall fiscal resources to 10 trillion RMB for relieving local governments' debt burden.

We view this round of debt swap as the largest one in terms of scale in recent years and it would not be difficult for local governments to remove all hidden debt by 2028. The new debt replacement policy would help improve local debt structure, enhance the visibility of hidden debt, and encourage a more standardized and transparent debt management. Prior to 2028, total hidden debt to be addressed would sharply decline to 2.3 trillion RMB from an elevated level of 14.3 trillion RMB. The average amount to be removed each year would be slashed to 460 billion RMB, less than one sixth of the previous 2.86 trillion RMB, substantially lifting local governments' debt-relieving burden.

In this article, we share our views on some of the questions that the market concerns most about the latest fiscal policy.

## How is the Latest Fiscal Policy Different from the Previous Ones?

We think the new debt swap plan marks the shift in the central government's approach to addressing local government debt. The policy stimulus has become more proactive and focused more on regional development, representing an attempt to resolve debts by boosting economic growth. How this new debt quota will be allocated attracts attention and we expect it to be skewed toward economically advanced regions. Since the second half of 2023, the local debt risk has been considerably reduced along with the introduction of special refinancing bonds and supportive policies such as the "No.35 Document". February to date, the central government has vowed to maintain local debt risk at a controllable level on many occasions. In our view, the current debt replacement plan reflects a change in the central government's rationale for relieving debts, where more active steps will be taken to address debt risk in a forward-looking manner, instead of taking actions only when risk incidents have emerged. More resources would be used for supporting regional growth, so that the debt issue would be eventually resolved through continuous development. Debt swap is not equal to debt cut, meaning local governments still need to prioritize

their growth goals and maintain their debt scales at a level consistent with their economic and fiscal positions.

## Who will be Held Accountable for This Round of Debt-Relieving Effort, the Local Governments or Central Government?

We think local governments will be responsible for debt resolution and the central government will reinforce its inspection on hidden debt to prevent moral hazard across local governments in managing their debts. The proposal stressed the principle of reinforced accountability of local authorities. Additionally, the debt replacement will be conducted at local government level rather than depending on massive transfer payments from the central government. This indicates that local governments will still be held accountable for resolving debts, without the central government stepping in to rescue. Meanwhile, the NPC Standing Committee meeting has reviewed the Amendment to the Law on Supervision by the NPC Standing Committees at All Levels, which includes a revision that requires refined supervision on government debt, demanding the State Council and local governments above the county level to report to the NPC Standing Committee at their corresponding levels on debt management on an annual basis. Through enhancing the oversight by the NPC at the local level, the central government intends to prevent such a risk where new debts continue to occur while old debts are being removed. From the recent cases involving hidden debt increase uncovered by the Ministry of Finance and the statement of the Minister of Finance at the press conference on October 18, we expect the central government to impose stricter supervision and punishment on local debt management going forward.

## Which Provinces Would Benefit Most from the Implementation of Debt-Relieving Measures? How Would the Creditworthiness of Local Governments be Impacted in a Long Run?

We think the debt replacement quota arranged for the next 1-2 years is likely to be allocated first to regions enjoying greater growth potential, particularly provinces in East China. Some provinces that accomplish the debt resolution task earlier could leverage more resources to facilitate economic growth. Over 1.7 trillion RMB in special refinancing bonds that have been issued 2023 to date comes primarily from heavily indebted provinces, such as Guizhou, Yunnan, and Inner Mongolia. Economically strong provinces in East China, such as Jiangsu, Shandong, and Zhejiang, have only a modest scale of such bonds outstanding. This round of 10-trillion-RMB debt swap plan is designed to achieve dual goals, i.e. alleviating local governments' debt burden while at the same time promoting economic growth. As such, a more comprehensive consideration would be needed for allocating this debt quota. In our view, provinces in East China perform a critical role in driving the economy and may conduct debt replacement at large scale. Meanwhile, there's possibility that regions with "zero" hidden debt could also obtain some debt replacement quota and the use of proceeds from special refinancing bonds would be extended.

We view the approved debt quota this time as a tool for replacing existing debts rather than a pure permission for issuing new debt. The reduced borrowing cost, improved det structure, and enhanced transparency have demonstrated the positive trend for local debt management in China.

## What are the Implications for LGFVs, Particularly the Different Impacts on Entities on and off the List?

With the implementation of the debt replacement policy, certain LGFVs may see their liquidity pressure mitigating, with fewer occurrences of negative incidents. A series of debt-relieving measures have been executed since July 2023 and LGFVs have received funding support from the government along the process, putting the tail risk under control. From January to September 2024, local government fund budget revenue dropped by 22.5% YoY to 2.76 trillion RMB, showing sustained fiscal strains among local governments and raising market concern over their liquidity conditions. We observe that LGFV bonds bearing high interest rates have reemerged on the market recently. More than 40 LFGV bonds with yields of over 4% have been issued over the past three months, amounting to roughly 20 billion RMB in aggregate. This debt swap arrangement would provide consistent funding support for local governments and LGFVs over the next 3-5 years and

ease the liquidity pressure facing LGFVs, especially those located in highly leveraged regions, e.g. Guizhou, Tianjin, and Jiangsu, or provinces suffering non-standard-debt-related incidents frequently, e.g. Shandong, Shaanxi, and Henan. Besides positive impacts such as eased investor sentiment and lower bond issue rates, the debt swap plan may also benefit LGFVs' non-standard financing, providing them with more funding support given that they often suffer elevated cost and refinancing difficulty in their non-standard borrowing. This could lead to a reduction in their risk incidents.

Backed by the policy and funding support, LGFVs on the financing platform list may see decreasing refinancing needs in the short term, which may allow them to be taken off the list at a faster pace. As local governments replace hidden debt with newly issued bonds, the LGFVs involved may have less demand for refinancing via bonds or non-standard debt. Some non-standard debt can't be settled easily and may be replaced first. Considering the substantial scale of the current debt swap plan, we expect to see accelerated progress in hidden debt resolution and the removal of LGFVs from the financing platform list. Going forward, there would be more LGFVs announcing to have been released from the list or soliciting creditors' opinions for seeking such a removal.

Despite not being included in the "3899" list or hidden debt list, a large number of LGFVs are not able to expand their debt scales as they fail to meet the regulatory standards for industrial company classification. Certain LGFVs, like some located in the Yangtze River Delta region, are even unable to issue refinancing bonds (mostly on the interbank market). We view these restrictions as the central government's attempt to prevent the formation of new hidden debts, especially those produced by LGFVs relying heavily on government-related business or subsidies. In light of the stringent approval process for issuing bonds (including refinancing bonds) and the local governments' target of debt reduction, the net financing scale of these LGFVs would decrease.

We expect these LGFVs to face relatively tight financing conditions in the future. Looking forward, local governments would confine their funding needs within the budget scope and push forward the market-oriented transition of LGFVs by consistently preventing the formation of new hidden debt and strengthening the hard budget constraint at the local level. Therefore, the rigorous control on bond issuance by these LGFVs may persist for a while. Although the debts of these companies will not be directly replaced through the current debt swap arrangement, their liquidity pressure could be lifted as they might enjoy faster collection of payments from local governments whose financial strains are alleviated.

## How do We View the Transformation of LGFVs in the Context of the Latest Debt-Relieving Policy?

In our view, the stronger central government support for debt-relieving efforts means local governments should place more focus on the market-oriented transformation of LGFVs, despite that this process would encounter difficulties. In late September, multiple media reports mentioned the "No.150 Document" that calls for an accelerated removal of LGFVs from the financing platform list. Subsequently, several LGFVs announced to have solicited creditors' opinions regarding the withdrawal from the list. The direction for debt-relieving policy at the top level has shifted toward a growing emphasis on regional development, thus increasing the necessity of LGFV transformation. We've learned from numerous LGFVs that transformation has become a pervasive trend among LGFVs and has been persistently promoted by local SASACs and finance bureaus.

The first obstacle for LGFV transformation is the debt burden, and this round debt replacement plan has come in time to address this issue. LGFV transformation has been encouraged with consistent policy support for many years but hasn't achieved effective outcomes. One of the primary reasons is that local governments are heavily indebted and many county-level governments, industrial parks, and LGFVs in weak regions face great difficulty in paying interest and lack extra money for industrial development. As a consensus among local governments and LGFVs, lifting debt burden would be the precondition for the transformation. The 10-trillion-RMB package for debt replacement would mitigate liquidity pressure of local governments and allow LGFVs to deploy more resources to propel their transformation.

Another difficulty facing LGFVs is the deficiency of industrial resources. Generally speaking, prefecture-level cities, top 100 districts and counties, and financially strong development zones

(e.g. economic development zones, high-tech zones, and state-level new areas) enjoy ample industrial resources. LGFVs with high administrative level or located in developed regions typically maintain solid relationships with local governments and receive government support in terms of operating asset injection and franchises. They focus on urban construction and operation to develop a business mix spanning construction and engineering, real estate, toll roads, water and gas supply, environmental services, recreation and sport centers, property management and security services, parking lots, and hotels. Some industry-centric LGFVs primarily engage in industrial park operation and equity investment. LGFVs perform an important role in encouraging regional development and most of them won't withdraw from their locally based business to venture into a new sector. However, there are more than 2800 districts and counties in China, and district- and county-level LGFVs have represented a large portion of LGFV bond issuers. The likelihood of a successful transformation for certain LGFVs is low due to their lack of industrial resources and other disadvantages.

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