CCXI & CCXAP – Research & Commentary

The Quota of New Special Bonds Shouldn't be Cut Significantly and Attention Should be Paid to Risk Prevention If More Special Bonds Are Issued

Hong Kong, 8 January 2021 -- The Research Institute of China Chengxin International Credit Rating Co., Ltd. ("CCXI") released a report titled "Special Bonds Greatly Expanded to Assist Infrastructure Construction, and Risk Prevention should be Taken into Consideration when Special Bonds Continue to Make Efforts: Review of Local Government Special Bonds in 2020 and Outlook for 2021".

According to the report, **as an important source of funds for infrastructure construction, special bonds played an important role in fighting the pandemic and maintaining stable growth in the special period of 2020. When the domestic economy is still recovering and is unable to grow on its own yet and the fiscal policy needs to be more sustainable, special bonds are expected to remain one of the important instruments to be used to maintain stable growth in 2021. In view of multiple factors such as adjustment to deficit-to-GDP ratio and continuation of projects in process, the report suggests reducing the quota of new special bonds for the year slightly to RMB3.2 trillion and continuing to support infrastructure construction, especially construction of new infrastructure, new urbanization and key projects such as transportation and water conservancy. However, in the process of further expansion, we should pay attention to potential problems and strictly guard against risks to promote high-quality development of special bonds.**

The report points out that since 2020, against the backdrop of increasing economic downward pressure due to the impact of the pandemic, the proactive fiscal policy has continued to play its role well. In 2020, over RMB4 trillion special bonds were issued, most of which have a long term, and the proportion of those used as capital funds of projects increased significantly from 2019. In 2020, a total of RMB4.14 trillion special bonds were issued, a substantial increase of RMB1.55 trillion year on year and nearly double the issue volume of general bonds. **Most of the special bonds have a long term.** Those with a term of 10 years or above accounted for 81%, over 40 percentage point higher than that in the same period last year, indicating that they match better with project fund needs and terms. **In terms of issue cost,** in early 2020, against the backdrop of an easing credit policy, an easing fiscal policy and an easing monetary policy, the interest rates of special bonds declined month by month but rose continuously starting in April. Since November, with the central bank continuing to supply liquidity on a large scale, the interest rates have declined again. Currently, they are slightly higher than those in the corresponding period last year, and the overall movement is basically consistent with the term. The interest rates of special bonds with different terms fell year on year but were more differentiated. Those with a longer term saw less decline. **Most importantly,** the proportion of special bonds used as capital funds of projects increased significantly from last year. Over RMB200 billion special bonds were invested in nearly 800 projects as capital funds. The scope of projects invested was further expanded, and projects in the transportation field such as railway received the most investment. In the meantime, the income source structure of projects improved, with less dependence on land transfer income, which can help relieve local governments' fiscal pressure and continue to play its important role in maintaining stable infrastructure construction.

While the scale of special bonds was expanding, the issue structure was further optimized. The proportion of new special bonds accounted for nearly ninety percent. They continued to tilt toward infrastructure and there were more diversified varieties. As China worked to maintain stable growth and improve areas of weakness, the proportion of special bonds in the fields of new infrastructure, new urbanization and key projects such as transportation and water conservancy increased significantly, and the new use as supplementary funds to small and medium-sized banks was added. In 2020, a total of RMB3.6 trillion new special bonds were issued, an increase of RMB1.45 trillion year on year, accounting for nearly 90% of all special bonds issued in the year. Of the RMB3.75 trillion for the year, RMB200 billion were planned to supplement the capital funds of small and medium-sized banks, and the remaining RMB149.4 billion is yet to be issued. A total of RMB538.6 billion refinancing bonds were issued, which exceeds the upper limit prescribed by the Ministry of Finance. In December, the purposes of use of the funds of 11 refinancing bonds were adjusted to "repaying governments' outstanding debts". Replacement bonds were not issued. **By region,** Shandong and Guangdong issued the most special bonds, while Ningxia and Qinghai issued the least. In terms of issue structure, most of the special bonds issued by most provinces were new special bonds, while the proportion of refinancing bonds was relatively higher in Liaoning and Ningxia, which may be attributed to the greater pressure they faced in rollover of local government debts upon maturity. **By variety,** special bonds continued to tilt toward infrastructure and there were more diversified varieties. The proportion of special bonds used in the fields of new infrastructure, new urbanization and key projects such as transportation and water conservancy that stimulate consumption, benefit the people, adjust the structure and bolster future development exceeded forty percent, of which over half were used in the transportation field and particularly in railway related construction, while the proportion used in new infrastructure construction, especially in information infrastructure construction, was still low. In the meantime, the new purpose of use as supplementary funds to small and medium-sized banks was developed; as at the end of 2020, the issue volume of such special bonds accounted for 1.4% of that of new special bonds.

Looking into future, the report believes that as the pressure on stable growth is still large, the proactive fiscal policy needs to be sustained and should not take a sharp turn. In 2021, special bonds are expected to remain a focus of the fiscal policy. The quota of new special bonds is likely to decrease slightly to RMB3.2 trillion. In investment, they will continue to support the construction of new infrastructure, new urbanization and key projects. The report has forecast the issue structure of special bonds in 2021: the largest issue volume of replacement bonds is expected to be RMB191.5 billion, but it's very likely that zero or few replacement bonds will be issued in 2021; the issue volume of refinancing bonds is expected to approach RMB1 trillion and increase significantly from 2020. In particular, attention should be paid to the refinancing pressure in the second and third quarter; the quota of new special bonds is likely to decline slightly to RMB3.2 trillion. If the retained quota of new special bonds in support of small and medium-sized banks is considered, RMB3.35 trillion new special bonds are expected to be issued throughout 2021. In terms of fund investment direction, they will be probably used primarily in infrastructure construction and areas of weakness to continue to support the construction of new infrastructure, new urbanization and key projects. **Moreover,** based on the forecast volume and investment direction of new special bonds, the report has estimated the infrastructure investment that can be mobilized in 2021, which is, theoretically, about RMB5.4 trillion. However, in reality, it will be restricted by such factors as the proportion of special bonds used as capital funds, whether project funds are paid in, project construction progress and construction of supporting facilities.

The report finally notes that some problems and risks have accumulated in the rapid expansion of special bonds. For example, with local finance still under pressure, the arrival of the peak season for maturity of special bonds and poor solvency of projects are likely to further increase the pressure on local governments to repay bonds with interests. In the meantime, projects using funds from special bonds are faced with such problems as that funds are left idle or embezzled or that income is less than expected. Under repayment pressure, projects may still need to rely on income from land transfer. It's necessary to be watchful for the comeback of "land finance". The report suggests selecting projects that have strong profitability, clear cash flows and guarantee, reducing the burdens of local finance to repay loans with interests, and doing a good job in the risk prevention and management throughout the whole lifecycle of projects using funds from special bonds, to strictly guard against risks and accelerate the formation of a development pattern featuring high-quality "domestic circulation".

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

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