Economic Analysis

China's budget law is amended to allow for municipal bond issuance

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On August 31th, China's parliament, National People's Congress, formally approved the amendment of the budget law, allowing local governments at provincial level to issue municipal bonds directly (effective from January 2015). Indeed, long before the amendment of the budget law, regulators have already started to roll out a pilot program to allow a number of selected local governments to issue their municipal bonds in the market. (Table 1) The amendment to the budget law last Sunday will expand the scope of the pilot program to all of the 31 provincial governments. The new law stipulates that provincial governments can only issue bonds to finance public investment but not other forms of public expenditure. Prospective municipal bonds will have maturities of five, seven or ten years with a ratio of 4:3:3 while the total amount of issuance is to be capped by the central government.

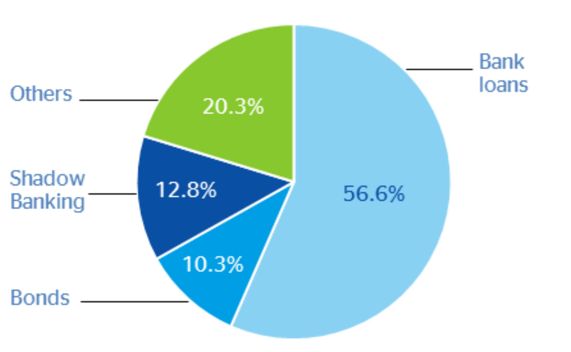
- **The amended budget law is able to help local governments reduce their financing costs and mitigate maturity mismatch risks.** In the past, local governments had to establish local government financing vehicles (LGFVs) to finance infrastructure projects so as to circumvent the central government's ban on their direct borrowings. As revealed by the National Audit Office (Figure 2), banks and the shadow banking sector were the largest lenders to LGFVs, which exposed local governments to high borrowing costs and serious maturity mismatch risks, as the underlying projects substantially outlived permissible maximum maturities of bank loans (3-5 years) and shadow banking lending(less than 1 year) . By allowing for the issuance of municipal bonds with longer maturities, the new budget law will enable local governments to mitigate maturity mismatch risks and to better lock in financing costs of the underlying investment projects. Moreover, given that municipal bonds explicitly bear the credit of local governments, they tend to carry lower costs than bank loans and shadow banking lending.
- **However, there are still daunting challenges in the way to solve local government debt problem.** The existing stock of local government debt is enormous, which amounted to 17.9 trillion yuan (31.5% of GDP) as of June 2013 and continued to rise afterwards. Municipal bond issuance can at most replace a small fraction of existing local government debt. (Figure 2) That said, other complementary methods (for example SOE asset sales as we suggested in our China Banking Watch) need to be implemented to tackle the indebtedness of local governments. Furthermore, the new budget law doesn't provide a clearly defined oversight framework of municipal bond issuance. It adds investors' worries that provincial authorities could abuse this new power and fail to put raised funds into good use.

Table 1
The development of China's local government municipal bonds

Before 1994	Local governments were allowed to borrow from banks and issue bonds on their own but a huge debt build-up and several high-profile scandals prompted Beijing to ban local borrowing in 1994.
1994	Provincial and prefecture governments in China were forbidden from borrowing.
2011	Ministry of Finance chose 4 cities and provinces-- Shanghai, Zhejiang, Guangdong and Shenzhen-- to trial a program under which the central government issued bonds on behalf of local governments and took repayment responsibility
May 2014	The trial program was expanded to 10 provinces and cities: including Shanghai, Guangdong, Shenzhen, Jiangsu, Shandong, Zhejiang, Ningxia, Qingdao, Jiangxi and Beijing. Moreover, the local governments are liable for repaying the debt.
Aug 2014	China's National People's Congress amended the budget law to allow all the provincial local governments to issue municipal bonds, effective from January 2015.

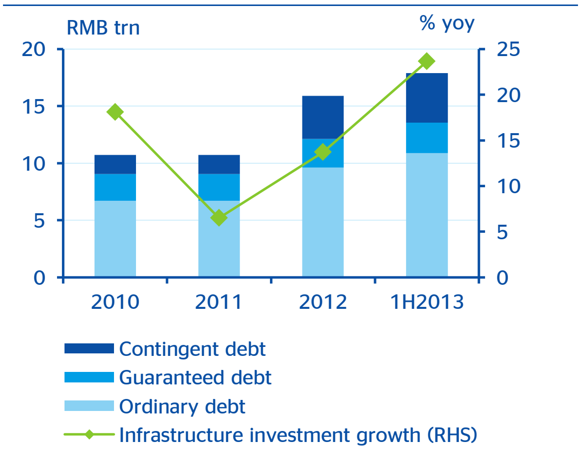
Sources: Regulator's website and BBVA Research

Figure 1
Bank loans and shadow banking are the most important funding sources of LGFVs



Source: NBS and BBVA Research

Figure 2
Local government debt is borrowed to finance infrastructure projects



Source: NBS and BBVA Research