Box A

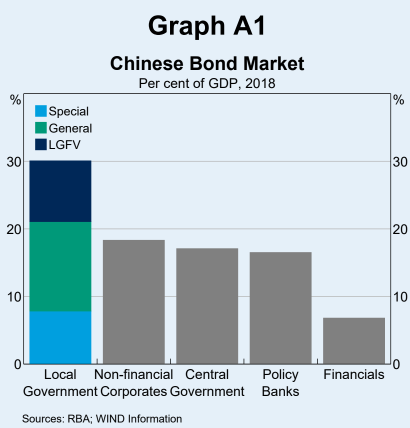
China's Local Government Bond Market

The local government bond market in China has grown rapidly in recent years and is now China's largest bond market (Graph A1). It is also the largest municipal bond market in the world. The emergence of China's local government bond market reflects regulatory changes in 2014 that encouraged local governments to raise debt directly from bond markets (subject to annual quotas).[1] Before these changes, most local governments had no direct access to bond financing and, instead, raised funds by forming off-balance sheet entities known as local government financing vehicles (LGFVs). These LGFVs sourced credit, in large part, from outside the regular banking system. Such funding is known as 'shadow financing' and is subject to limited prudential oversight. In recent years, the authorities have actively discouraged the use of LGFVs in favour of more transparent financing through the local government bond market, with a view to reducing financial stability risks. In addition, the authorities have allowed local governments to convert the debt of LGFVs into bonds as part of a local government 'debt-swap' program, which concluded recently.[2]

At the National People's Congress in March, in order to support infrastructure investment, the Chinese authorities significantly increased the quota for local government bond issuance in 2019. The authorities set the quota at CNY3.1 trillion (approximately 3 per cent of GDP), almost one-third larger than for 2018 (Graph A2).[3] This reflected a sharp increase in the quota for 'special bonds' that finance infrastructure investments, and a small increase in the quota for 'general bonds' that finance general government spending. The authorities have been encouraging local governments to increase their infrastructure investment, which had slowed over the course of the past year or so. Local governments undertake the bulk of public infrastructure investment in China and are responsible for around 85 per cent of total government spending.[4]

Despite the recent rapid growth in issuance, the local government bond market in China is still developing in some key respects:

- There tends to be little difference in market pricing of credit risk, both across types of bonds (special and general bonds) and across issuers. In particular, spreads of local government bonds to Chinese government bonds (CGBs) are similar across Chinese provinces, despite significant variation in provincial debt burdens and risk profiles (Graph A3). The

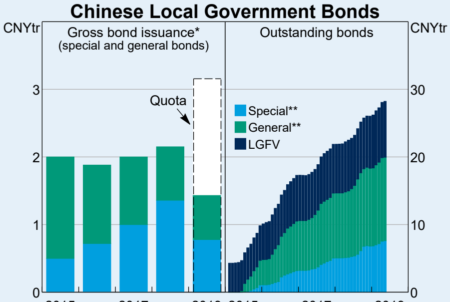


lack of discrimination in pricing for different levels of credit risk is likely to reflect the widely held expectation that, if needed, the central government will intervene to prevent local governments from missing bond payments. This implicit guarantee reduces borrowing costs for some local governments but could also contribute to moral hazard over the medium term.

- The local government bond market has a narrow investor base, with China's commercial banks holding almost 80 per cent of outstanding securities (Graph A4). This can be attributed to bank purchases under the debt-swap program and also capital regulations that assign lower risk weights to local government bonds than other types of credit exposures, such as residential and commercial loans.[5] Accordingly, Chinese commercial banks have significant exposure to local government bonds, which represent around 7 per cent of their total assets, on average.[6]
- Local government bonds tend to trade infrequently in the secondary market and are relatively illiquid. In 2018, average turnover was equivalent to around 25 per cent of outstanding local government bonds, compared with around 75 per cent for US municipal bonds and 50 per cent for Japanese municipal bonds (Graph A5). Bid-ask spreads are typically also wider for Chinese local government bonds. In part, the lack of market liquidity reflects the tendency of China's commercial banks to buy local government bonds with the intention of holding the securities to maturity. This is likely to be due to the perceived low risk of default by local governments, as well as the low risk weights assigned to local government bonds under China's capital regulations.

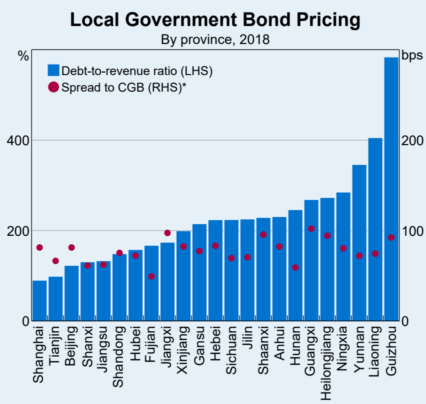
In recent years, partly in response to these issues, the Chinese authorities have sought to improve the functioning of the local government bond market. The authorities have attempted to reduce implicit guarantees and encourage risk-based pricing of local government bonds. For example, they have prohibited local governments

Graph A2



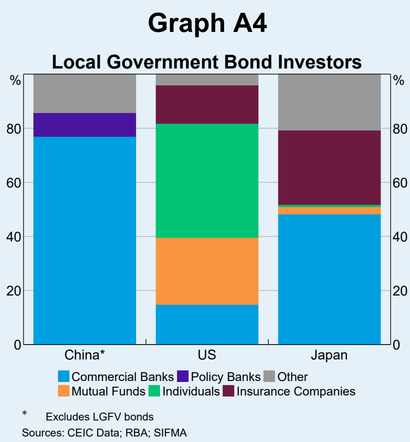
* Excludes debt-swap and LGFV bonds
** Includes new and debt-swap bonds
Sources: RBA; WIND Information

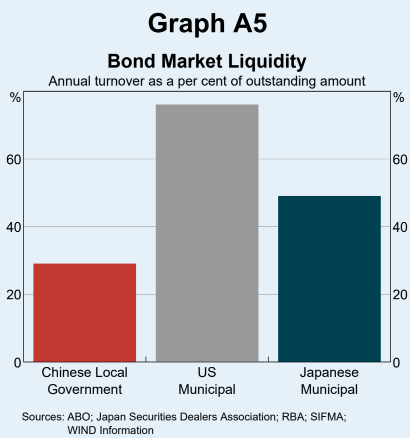
Graph A3



* Based on a 5-year new local government bond
Sources: CEIC Data; RBA; WIND Information

from guaranteeing LGFV debt and encouraged the use of special bonds that have repayments linked explicitly to the revenues of the relevant project, as opposed to local government budgets.[7] The authorities have also tried to expand the investor base and improve liquidity by: encouraging greater disclosure of issuers' financial positions; permitting issuance of longer-term bonds; opening the market to retail investors; and developing an over-the-counter market for local government bonds.





While seeking to enhance market functioning in these various ways, the authorities also have been conscious of minimising the risk of significant market disruptions. Given their significant holdings of local government bonds, China's commercial banks could be adversely affected by abrupt changes in policy (however unlikely) that allows defaults by local governments or causes a revaluation of implicit guarantees (to the extent that securities are revalued in banks' books). Higher funding costs for some local governments could also weigh on infrastructure investment.

The local government bond market is likely to continue to grow, given the decentralised nature of China's fiscal arrangements, and in line with the authorities' efforts to reduce moral hazard and make local government borrowing more transparent. This is expected to be supported by further policy measures aimed at facilitating the development of what is an increasingly important segment of China's fast-growing capital markets. ✠

Endnotes

[1] This followed a pilot program that permitted limited bond issuance by several provincial governments from 2011 onward.

[2] Bowman J, M Hack and M Waring (2018), 'Non-bank Financing in China', RBA *Bulletin*, March, viewed 11 October 2018. Available at <https://www.rba.gov.au/publications/

bulletin/2018/mar/non-bank-financing-in-china.html>.

[3] Historically, local governments have used their full quota for bond issuance.

[4] See Wilkins K and A Zurawski (2014), 'Infrastructure Investment in China', RBA *Bulletin*, June, viewed 21 March 2019. Available at <https://www.rba.gov.au/publications/bulletin/2014/jun/pdf/bu-0614-4.pdf>.

[5] Local government bonds in China are subject to a risk weighting of 20 per cent, compared with 50 per cent for residential mortgages and 100 per cent for corporate loans.

[6] In contrast, US commercial bank holdings of municipal bonds represent approximately 2 per cent of total assets.

[7] RBA (2018), 'Box A: Evolving Financial Conditions in China', *Statement on Monetary Policy*, November, pp 21–23. Available at <https://www.rba.gov.au/publications/smp/2018/nov/box-a-evolving-financial-conditions-in-china.html>.