Launch of Local Government Bonds in China

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I. Establishment of local government bond market

In November 2008 the Chinese government announced an economic stimulus package worth RMB4trn, which is due to be implemented over two years. As funding such a package presented problems, the government eventually decided that the cost should be shared, principally by central and local government, the corporate sector and the banking industry.

It was against this background that, in its report on government activity at its 2nd Plenary Session in March 2009, the 11th National People's Congress (NPC, China's parliament) agreed that RMB1,180bn of the cost (i.e., the net new spending) should be borne by the central government. The NPC also agreed that, in order to ensure that the aggressive fiscal spending planned for 2009 was implemented, the Ministry of Finance (with the approval of the central government) would issue a total of RMB200bn in local government bonds on behalf of all the local governments and that this would be included in the budgets of province-level governments (see below).

Article 28 of China's *Budget Law*, which was promulgated in 1994, stipulates (1) that "the local budgets at various levels shall be compiled according to the principles of keeping expenditures within the limits of revenues and maintaining a balance between revenues and expenditures, and shall not contain deficit" and (2) that "the local governments may not issue local government bonds, except as otherwise prescribed by laws or the State Council" (Figure 1). 2009 is therefore a milestone in that it marks the launch of local government bonds in China, albeit "prescribed by laws or the State Council." This report examines, first of all, the state of local government finances in China as well as the financial results for fiscal 2008 and the budget for fiscal 2009[1]. It then looks at the regulations governing the issue of local government bonds as well as the actual issuance of such bonds. Finally, it considers the challenges facing the local government bond market in China.

[1] Calendar year from January to December.

Figure 1: *Budget Law* rules on local government finance

Legislation	*Budget Law of the People's Republic of China*
Enacting body	National People's Congress
Promulgation date	22 March 1994
Effective date	1 January 1995
Article 28	(Paragraph 1) The local budgets at various levels shall be compiled according to the principles of keeping expenditures within the limits of revenues and maintaining a balance between revenues and expenditures, and shall not contain deficit. (Paragraph 2) The local governments may not issue local government bonds, except as otherwise prescribed by laws or the State Council.

Source: Nomura Institute of Capital Markets Research, based on data from China's Ministry of Finance

II. State of local government finances and budget for fiscal 2009

1. Local government and local government finance in China

1) Local government

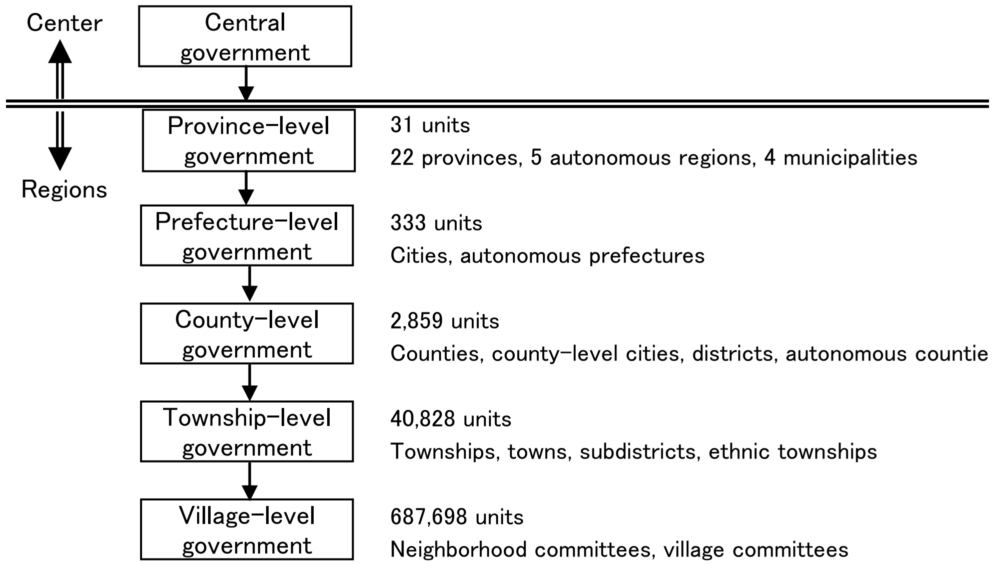
In China, there are five different levels of local government: province level, prefecture level, county level, township level, and village level (Figure 2). First (in descending order), province-level government. As of end-2008, China (under the central government) was divided into 31 units: 22 provinces, five autonomous regions, and four municipalities. These province-level units are, in turn, divided into 333 prefecture-level units, 2,859 county-level units, 40,828 township-level units, and 687,698 village-level units. Under this system, higher levels of government direct lower levels.

2) Local government finance

China's fiscal year begins in January and ends in December. Public finance is no exception. The budget is divided into a central government budget and a local government budget, with the latter subdivided according to the different levels of local government (Figure 3). The budget is drafted by the Central Economic Work Conference, which is convened by the CPC Central Committee and State Council by December of the preceding year. Local people's congresses (i.e., local government assemblies) begin discussing local government budgets every January and pass them before the NPC meets in March. The Ministry of Finance drafts the central government budget on the basis of the local government budgets and the requests of central government departments. The central government budget and the local government budgets are then discussed and passed by the NPC when it meets in early

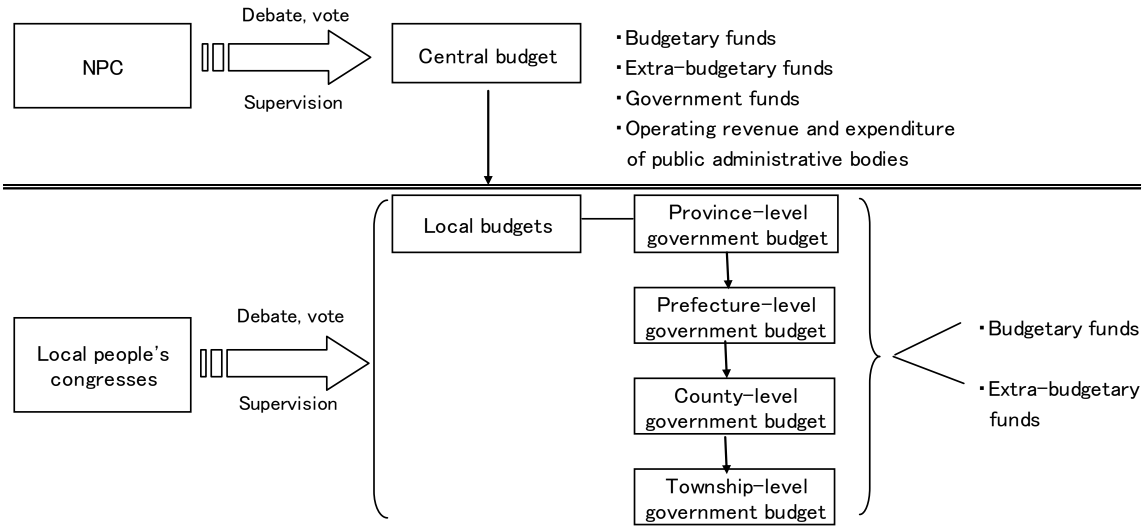
March each year. The NPC is responsible for overseeing central government finances, while local people's congresses are responsible for overseeing local government finances.

Figure 2: Administrative divisions of China (as of end-2008)



Source: Nomura Institute of Capital Markets Research, based on *China Statistical Abstract 2009*

Figure 3: System of public finance in China



Source: Nomura Institute of Capital Markets Research, based on data from China's Ministry of Finance

China's budget consists of "budgetary funds" and "extra-budgetary funds"[2]. The former is the government budget based on the *Budget Law* and corresponds to the general account budget in Japan. The latter is the charges levied by government agencies (including parliament, the judicature, the Communist Party, and everything related to the People's Liberation Army as well as government departments) following official procedures and with official approval. Extra-budgetary funds are distinguished from budgetary funds and regarded as a supplement to the government budget. They go back to the 1950s and have been adopted by both central and local government as a means of achieving fiscal flexibility. Also, just because these funds are "extra"-budgetary does not mean that they are not subject to any controls. The government manages them as part of the fiscal system in accordance with the pertinent regulations.

3) Fiscal transfers to the regions in accordance with the distinction between central and local government taxes

China's present system of local government finance, and especially fiscal transfers by central government, is based on the distinction between central and local government taxes that was introduced in 1994 to strengthen the fiscal position of central government and reduce regional inequalities[3]. Under this system, the proportions of fiscal revenue regarded as central government fixed revenue, local government fixed revenue, and shared (central and local government) fixed revenue are decided on an item-by-item basis. In addition, central government revenue is transferred as local government revenue in the form of tax rebates and transfer payments (Figure 4).

The former returns some of central government's revenue (rebased to 1993) to local governments to ensure that they are not disadvantaged as a result of the adoption of the distinction between central and local government taxes. The latter consists of two main types of transfer payments. The first is "fiscal transfers," of which "general transfers" are a principal example[4]. General transfers are calculated on the basis of objective factors using a standard formula and are not restricted in how they may be used. They correspond to the Japanese system of revenue transfers to local governments. The second is "special transfers," subsidies whose use is specified.

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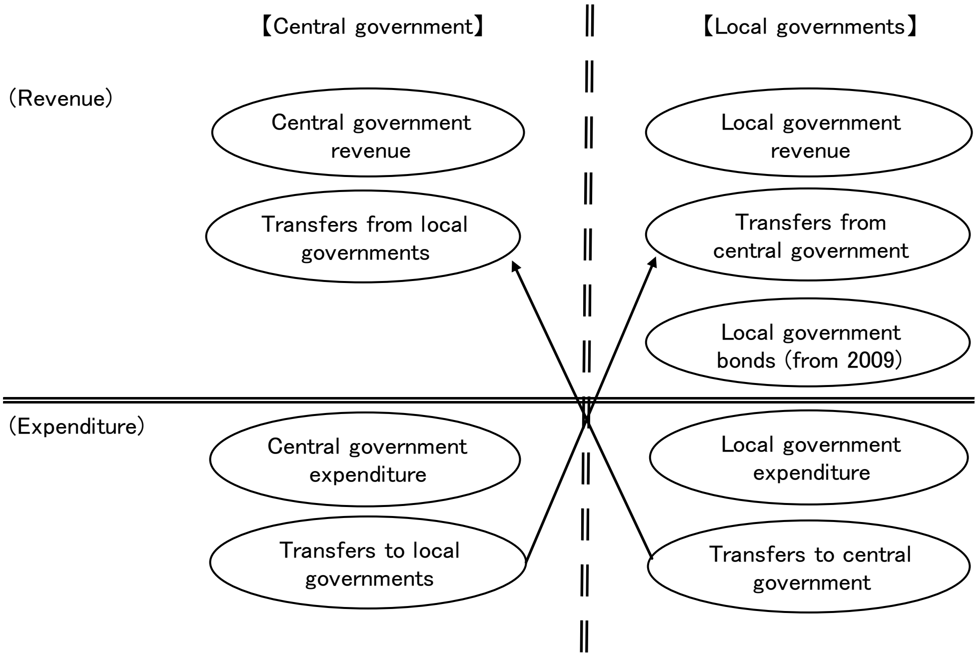
2 See Onishi (2004) for further details of China's system of public finance. As well as "budgetary funds" and "extra-budgetary funds" there are "government funds" and "operating revenue and expenditure of public administrative bodies". "Government funds" corresponds to Japan's "special accounts," while "operating revenue and expenditure of public administrative bodies" corresponds to the revenue and expenditure of incorporated administrative agencies, public service corporations and authorized corporations in Japan.

3 See Jingu and Ri (2007) for further details of the historical background and the distinction between central and local government taxes.

4 Beginning with the budget for fiscal 2009, what used to be called "fiscal transfers" will be renamed and redefined as "general transfers," while what used to be called "general transfers" will be renamed and redefined as "equilibrium transfers."

Figure 4: Schematic diagram of local government revenue and expenditure in China



Source: Nomura Institute of Capital Markets Research, based on data from Chinese Ministry of Finance and other sources

2. Current state of local government finances

1) Central government revenue and expenditure, and transfers to local governments

Let us take a closer look at central government revenue and expenditure (Figure 5). According to an announcement at the March 2009 NPC, central government fiscal revenue (i.e., revenue from the central government's own resources) in 2008 was RMB3,267.2bn while transfers from local governments to the central government amounted to RMB94bn. Similarly, central government expenditure consisted of RMB1,337.4bn in fiscal expenditure (i.e., expenditure from the central government's own resources) and RMB2,294.6bn in transfers to local governments.

The budget for fiscal 2009 envisages central government fiscal revenue of RMB3,586bn and transfers from local governments to the central government of RMB98.2bn. Similarly, it envisages RMB1,497.6bn in central government fiscal expenditure and RMB2,987.1bn in transfers to local governments (excluding an allowance for transfers from local governments).

Figure 5: Financial results for fiscal 2008 and budget for fiscal 2009

Units: RMB100mn

	Revenue				Expenditure			
		FY08 results	FY09 budget	(FY09 budget: excluding an allowance for transfers from local governments)		FY08 results	FY09 budget	(FY09 budget: excluding an allowance for transfers from local governments)
Central	Central government fiscal revenue (a)	32,671.99	35,860.00	35,860.00	Central government fiscal expenditure (c)	13,374.31	14,976.00	14,976.00
	Transfers from local governments	939.93		982.00	Transfers to local governments	22,945.61	28,889.00	29,871.00
	Revenue from Central Budgetary Adjustment Fund	1,100.00	505.00	505.00	Transfers to Central Budgetary Adjustment Fund	192.00		
	Total	34,711.92	36,365.00	37,347.00	Total	36,511.92	43,865.00	44,847.00
	Central government fiscal deficit	−1,800.00	−7,500.00	−7,500.00			43,865.00	44,847.00
Local	Local government fiscal revenue (b)	28,644.91	30,370.00	30,370.00	Local government expenditure (d)	49,052.72	61,259.00	61,259.00
	Transfers from central government	22,945.61	28,889.00	29,871.00	Transfers to central government	939.93		982.00
	Income from local government bonds		2,000.00	2,000.00				
	Total	51,590.52	61,259.00	62,241.00	Total	49,992.65	61,259.00	62,241.00
					Reserves and amounts brought forward	1,597.87	61,259.00	62,241.00
Overall	(a) + (b)	61,316.90	66,230.00	66,230.00	(c)+(d)	62,427.03	76,235.00	76,235.00

Note: Beginning with the budget for fiscal 2009, central government revenue in the form of transfers from local governments (RMB98.2bn) will be treated as an allowance for central government expenditure in the form of transfers to local governments.

Source: Nomura Institute for Capital Markets Research, based on Chinese Ministry of Finance data

2) Local government revenue and expenditure

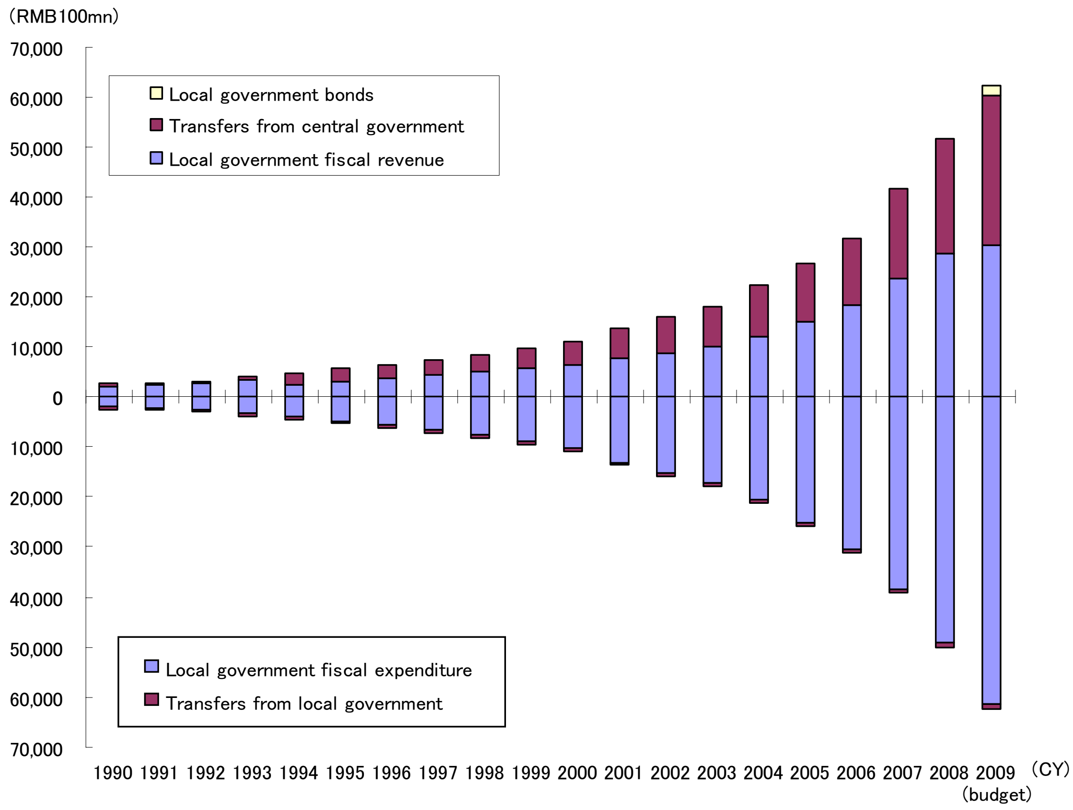
Let us now take a closer look at local government revenue and expenditure (Figure 5, as above). Local government fiscal revenue (i.e., revenue from local governments' own resources) in 2008 was RMB2,864.5bn while transfers from central government amounted to RMB2,294.6bn. Similarly, local government expenditure consisted of RMB4,905.3bn in fiscal expenditure (i.e., expenditure from local governments' own resources) and RMB94.0bn in transfers to central government.

The budget for fiscal 2009 envisages local government fiscal revenue of RMB3,037.0bn, RMB2,987.1bn in transfers from central government (excluding an allowance for transfers from local governments), and RMB200.0bn from the issue of local government bonds, beginning in fiscal 2009. Similarly, it envisages RMB6,125.9bn in local government fiscal expenditure and RMB98.2bn in transfers to central government.

3) Growing importance of local government finances

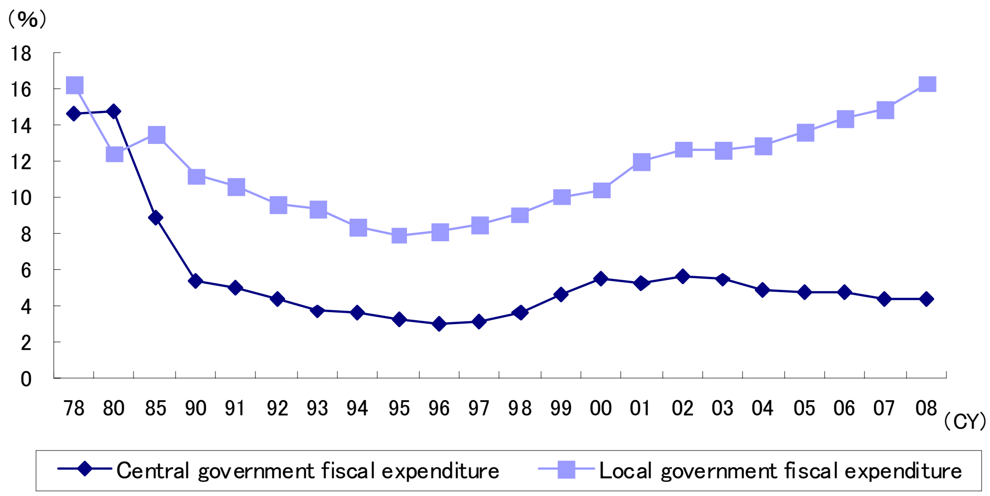
Local government fiscal expenditure has increased in recent years (Figure 6). In addition, it has increased in relation to the size of the economy. As a proportion of GDP it has increased since the adoption of the distinction between central and local government taxes in 1994 (Figure 7). This has been particularly noticeable since President Hu Jintao and Prime Minister Wen Jiabao came to power in 2002 with a pledge to rectify regional inequalities.

Figure 6: Local government revenue and expenditure



Source: Nomura Institute for Capital Markets Research, based on Chinese Ministry of Finance data

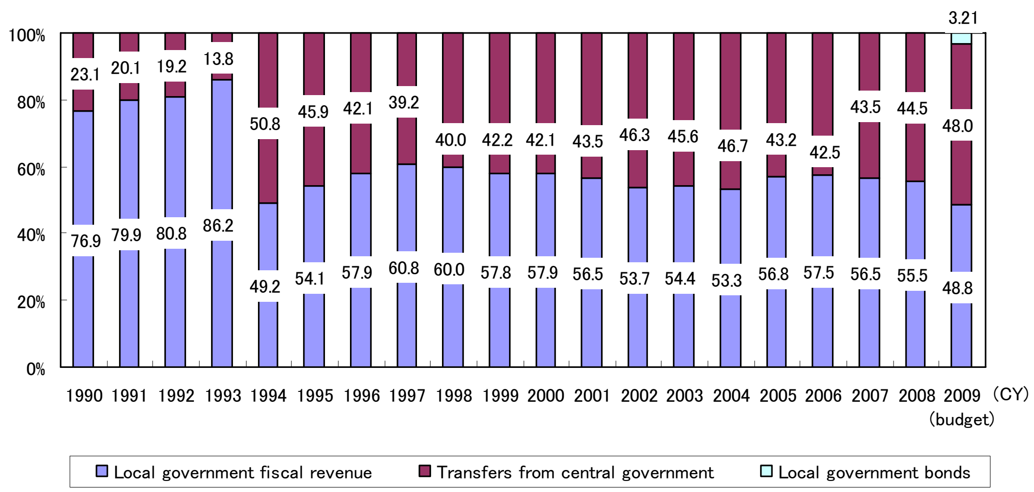
Figure 7: Fiscal expenditure as a percentage of GDP



Source: Nomura Institute of Capital Markets Research, based on data from Chinese Ministry of Finance and National Bureau of Statistics

However, it has also made local government finances more dependent on central government. As a proportion of local government revenue, local government fiscal revenue increased from 49.2% just after the adoption of the distinction between central and local government taxes in 1994 to 60.8% by 1997, after which it declined (Figure 8). The corresponding figure for transfers from central government (excluding an allowance for transfers from local governments) in 1994 was 50.8%. The figure for local government fiscal revenue briefly increased again (to 57.5%) in 2006 but has since declined again and is estimated in the budget for fiscal 2009 to be 48.8%. Local governments therefore need their own sources of revenue as much as ever.

Figure 8: Breakdown of local government revenue



Source: Nomura Institute of Capital Markets Research, based on data from Chinese Ministry of Finance and National Bureau of Statistics

A breakdown of such sources for 2007 reveals that RMB1,925.2bn (81.7%) came from tax revenue while RMB432.1bn (18.3%) came from other sources (Figure 9). In descending order of magnitude, the three most important local government taxes are business tax (27.1%), domestic value-added tax (16.4%), and company income tax (13.3%), which together account for 56.8% of local government revenue. Both business tax and domestic valued-added tax are indirect taxes, the former being on the sales of service industries. Although China needs to increase the proportion of direct taxes such as income tax, we see little prospect of a big increase in income tax in view of the outlook for the economy in the near term. Although local government bonds are expected to account for only 3.21% of local government revenue in fiscal 2009, they are now seen as a source of funds for the government's RMB4trn in emergency stimulus measures as well as of local government fiscal revenue.

Figure 9: Local government fiscal revenue

Units: RMB100mn

	2007	(Breakdown %)
1. Tax revenue	19,252.12	81.67
Domestic value-added tax	3,867.62	16.41
Business tax	6,379.51	27.06
Company income tax	3,132.28	13.29
Personal income tax	1,273.78	5.40
Resource tax	261.15	1.11
Urban maintenance and development tax	1,148.7	4.87
House property tax	575.46	2.44
Stamp tax	316.6	1.34
of which, stamp tax on security exchange	60.16	0.26
Urban land using tax	385.49	1.64
Land appreciation tax	403.1	1.71
Tax on vehicle and vessel use	68.16	0.29
Tax on the use of arable land	185.04	0.78
Tax on contracts	1,206.25	5.12
Tax on tobacco	47.8	0.20
Other tax revenue	1.18	0.01
2. Non-tax revenue	4,320.5	18.33
Special revenue	1,088.16	4.62
Administrative and institutional charges	1,543.69	6.55
Fines and penalties	812.01	3.44
Other non-tax revenue	876.64	3.72
Local government fiscal revenue (1 + 2)	23,572.62	100.00

Source: Nomura Institute of Capital Markets Research, based on data from Chinese Ministry of Finance and National Bureau of Statistics

III. Local government bond issuance

1. Associated legislation

As we saw in Chapter I, "the local governments may not issue local government bonds, except as otherwise prescribed by laws or the State Council." As a result, on 18 February 2009, the Ministry of Finance enacted with immediate effect *Measures for the Budgetary Control of Local Government Bonds in 2009* ("*Control Measures*"), which apply only for fiscal 2009 (Figure 10). In addition, it has published a press release (in FAQ format) on the issuance of local government bonds by proxy and issued rules on fiscal budgeting, accounting and computation as well as on auctions, bids and due diligence.

The proxy issuance of RMB200bn in local government bonds was debated and approved by the NPC, and reported in the fiscal 2008 budget implementation report as well as the draft budget for fiscal 2009.

Figure 10: Local government bond legislation and disclosure documents

Legislation	Enacting body	Promulgation date	Effective date
Report on the Implementation of the Central and Local Budgets for 2008 and on the Draft Central and Local Budgets for 2009	Ministry of Finance	15 March 2009	–
Measures for the Budgetary Control of Local Government Bonds in 2009	Ministry of Finance	18 February 2009	18 February 2009
Press Conference Given by Official in Charge of Issuance of Bonds on Behalf of Local Governments in 2009	Ministry of Finance	17 March 2009	–
Measures for the Comprehensive Fiscal Budgeting, Accounting and Computation of Issuance of Bonds on Behalf of Local Governments by Ministry of	Ministry of Finance	13 March 2009	13 March 2009
Rules on the Auction of, Bidding for and Due Diligence of Bonds Issued on Behalf of Local Governments in 2009	Ministry of Finance	23 March 2009	23 March 2009

Source: Nomura Institute of Capital Markets Research, based on data from Ministry of Finance and National Debt Association of China

2. Issue terms of local government bonds

1) Definition of local government bond

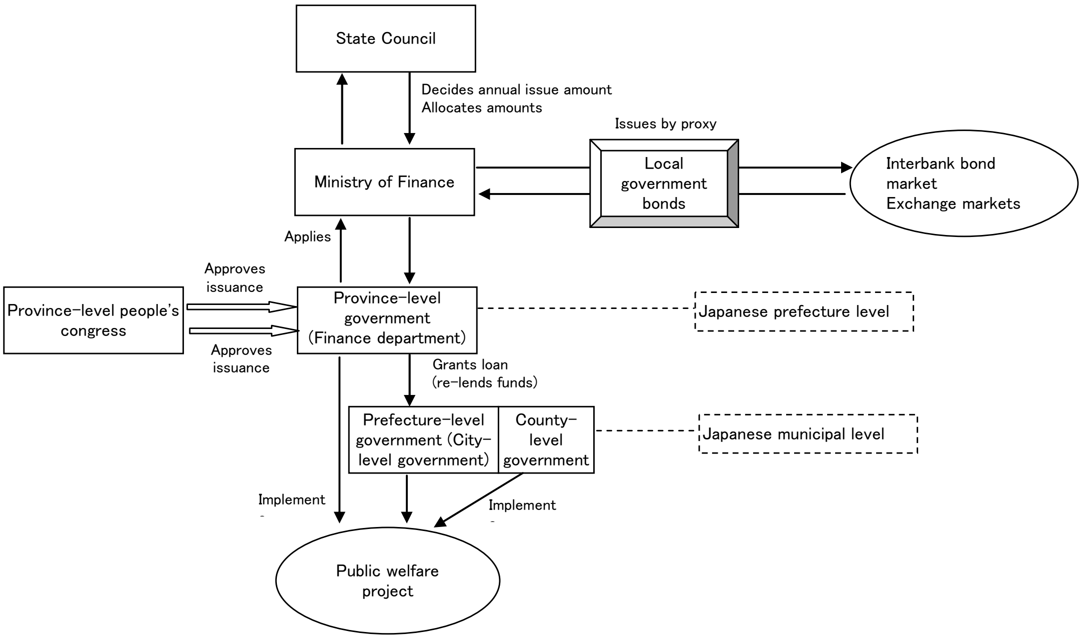
Article 1 of the aforementioned *Control Measures* states their aim. We would paraphrase this as for central government to allocate more funds to local governments and to give central and local governments the investment capacity for the government to implement its proactive fiscal policies. It confirms that the aim of issuing the bonds was to help finance the government's RMB4trn economic stimulus program.

Article 2 defines local government bonds as bonds that are issued and redeemed (1) with the approval of the State Council, (2) on behalf of province-level governments (including those of autonomous regions, municipalities, and designated cities), (3) by the Ministry of Finance, which also pays the principal, interest and issue costs (Figure 11). The main aims of having the Ministry of Finance issue the bonds on behalf of all local governments are to enable it to negotiate the issue terms with the underwriters (see below) on their behalf, to avoid the complication of different credit ratings for different local governments, and to issue the bonds at the same cost as Chinese government bonds by using the central government's credit rating. The actual issuance is to be managed by the Ministry's treasury department.

2) Budgetary control

Revenue and expenditure related to the issuance of local government bonds is to be subject to government budgetary controls (Article 4). Province-level governments will manage all the proceeds of the issue. Province-level governments can either use the proceeds themselves or lend them to prefecture- and county-level governments (Article 3). However, in the latter case, each county-level of government is also responsible for managing the proceeds as part of its budget. Budgetary control is the responsibility of the Ministry's budget department.

Figure 11: Procedure for approving issuance of local government bonds



Source: Nomura Institute of Capital Markets Research, based on data from Chinese Ministry of Finance and National Bureau of Statistics

3) Uses of the issue proceeds

Article 5 stipulates that the issue proceeds must basically be used to further the modification and transformation of the economy in accordance with the concept of "The Scientific Outlook on Development." This is in line with the current administration's aim of trying to focus more on the quality than the pace of economic growth and to improve public welfare.

Uses of the proceeds is limited to (1) public welfare projects in which the central government invests and to which local governments also allocate money, and (2) other public welfare projects for which it is difficult to raise capital from sources other than the government. The use of the proceeds to invest in projects for which funds are available from the markets is strictly controlled, while their use for recurrent spending is prohibited.

Specific examples of permissible uses are for (1) low-cost public housing projects, (2) public welfare and basic infrastructure projects in rural areas, (3) basic healthcare, sanitary, educational, cultural and other public welfare infrastructure, (4) nature conservancy (ecological construction processes), (5) disaster relief projects, and (6) other public welfare projects.

4) Approval and monitoring processes

In order to use issue proceeds, province-level governments are required to apply to the State Council and incorporate in their budgets the amount they are allocated

(Article 5). How much of the RMB200bn each local government is allowed to "issue" in fiscal 2009 will be decided using a formula that takes account of factors such as (1) how much of the public welfare projects funded by the central government should be allocated to the regions, (2) how much of the cost of such projects should be borne by local governments, and (3) how much each region is able to repay. These factors boil down to the number of projects undertaken jointly by central government and each local government, each local government's overall fiscal position, its debt ratio, the rate of improvement in its fiscal position, and the degree of its financial distress. However, the greatest weight is attached to each local government's need for funds to cover its share of the cost of such projects. Furthermore, China's central and western regions will be allocated a particularly high proportion of the issue amount in line with the aims of the economic stimulus program.

Once a local government has been allocated its issue quota for 2009, it needs to redraft its budget if it has not already been approved by the region's people's congress and submit it for approval. If its budget has been approved by the region's people's congress, it will need to incorporate its share of the issue proceeds in the budget and submit an amendment for approval. The proceeds of the 2009 local government bond issues will be incorporated in each local government's budget (see Figure 5 above). There is no explicit guarantee that the central government will repay the principal of, and pay the interest on, local government bond issues.

3. Issuance of local government bonds

1) Mainly for the benefit of China's central and western regions

China's local government bonds will be issued by the Ministry of Finance on behalf of all local governments using the same procedure as for book-entry government bonds. All the issue terms apart from the coupon are decided in advance.

A total of 26 issues with a total face value of RMB111.8bn were issued between March and end-May 2009 (Figure 12). In line with the Ministry of Finance's policy, the plan is to initially issue bonds on behalf of inland regions and central/western regions (such as autonomous regions of ethnic minorities) that wish to implement the government's economic stimulus measures but do not have the necessary funds, and then to issue bonds on behalf of the coastal regions (Figure 13). The issue coupon will be a maximum of 9 basis points over the secondary market yield on three-year book-entry government bonds[5].

In all cases, the maturity of the bonds is three years. Issuance of three-year central bank bonds on China's interbank bond market has been suspended since early 2009. According to statistics from the People's Bank of China, RMB968.0bn (or 13.7%) of the RMB7,072.7bn in bonds issued on the interbank market in 2008 consisted of central bank bonds with a maturity of 1–3 years. We therefore think there would be a point in issuing three-year bonds with the same credit rating as that of central bank

5 Ministry of Finance press release dated 27 May 2009.

bonds. The Ministry of Finance has pointed out that a maturity of three years would also satisfy the ALM needs of the commercial banks[6].

Figure 12: Local government bond issues

	Issuer	Issue date	Issue amount (RMB100mn)	Coupon (%)	Maturity (years)
1	Xinjiang Uyghur Autonomous Region (first issue)	2009/3/30	30	1.61	3
2	Anhui Province (first issue)	2009/4/1	40	1.6	3
3	Henan Province (first issue)	2009/4/7	50	1.63	3
4	Sichuan Province (first issue)	2009/4/8	90	1.65	3
5	Chongqing City	2009/4/13	58	1.7	3
6	Liaoning Province (first issue)	2009/4/14	30	1.75	3
7	Tianjin City	2009/4/14	26	1.78	3
8	Shandong Province (first issue)	2009/4/16	30	1.8	3
9	Jiangsu Province	2009/4/20	84	1.82	3
10	Jilin Province (first issue)	2009/4/23	30	1.82	3
11	Qinghai Province	2009/4/23	29	1.82	3
12	Qingdao City	2009/4/23	11	1.82	3
13	Hubei Province (first issue)	2009/4/23	50	1.82	3
14	Hebei Province (first issue)	2009/4/30	40	1.8	3
15	Shaanxi Province (first issue)	2009/4/30	36	1.8	3
16	Inner Mongolia Autonomous Region (first issue)	2009/4/30	30	1.8	3
17	Heilongjiang Province (first issue)	2009/5/11	30	1.77	3
18	Yunnan Province	2009/5/11	84	1.77	3
19	Zhejiang Province (first issue)	2009/5/11	40	1.77	3
20	Dalian City	2009/5/14	10	1.71	3
21	Sichuan Province (second issue)	2009/5/14	90	1.71	3
22	Hubei Province (second issue)	2009/5/14	31	1.71	3
23	Beijing City	2009/5/25	56	1.67	3
24	Shanghai City (first issue)	2009/5/25	40	1.67	3
25	Henan Province (second issue)	2009/5/25	38	1.67	3
26	Guangxi Zhuang Autonomous Region (first issue)	2009/5/25	35	1.67	3

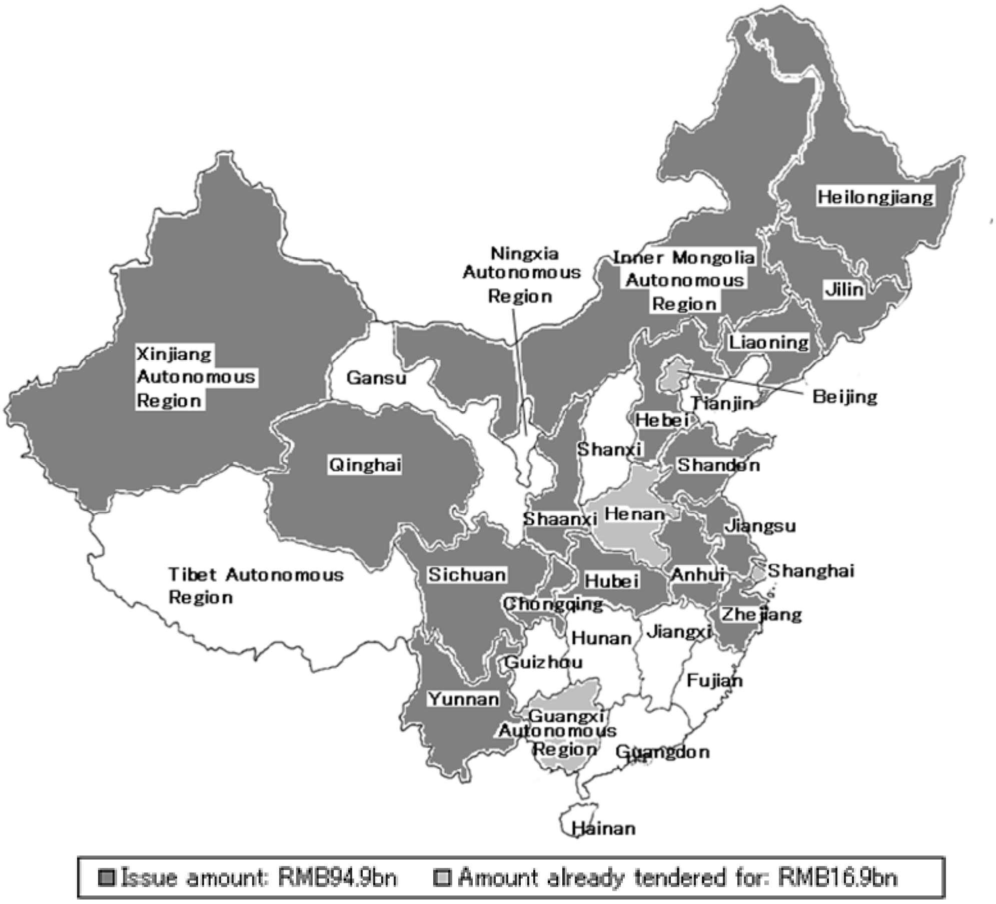
Note: The Beijing, Shanghai, Henan (second issue) and Guangxi bonds were auctioned on 25 May 2009.

Source: Nomura Institute of Capital Markets Research, based on data from Ministry of Finance, Shanghai Wind Information Co, and National Debt Association of China

Also, in view of the period of construction and operation of the public welfare projects for which the issue proceeds are intended, there may well be cases that take more than three years. No details have been published thus far of how the Ministry of Finance intends to refinance the local government bonds that have been or will be issued. However, at a State Council press conference on 27 May 2009 about the state of implementation of the government's economic stimulus measures, Vice Minister of Finance Zhang Shaochun said that the planned issuance of local government bonds after 2009 would depend on how the projects progressed rather than be decided each fiscal year.

6 See above press release.

Figure 13: Local government bond issuers (as of end-May 2009)



Note: The Beijing, Shanghai, Henan (second issue) and Guangxi bonds were auctioned on 25 May 2009.

Source: Nomura Institute of Capital Markets Research, based on Ministry of Finance data

Figure 14: Local government bond syndicate

Book-entry government bond syndicate (List A)	
1	Industrial & Commercial Bank of China
2	Agricultural Bank of China
3	Bank of China
4	China Construction Bank
5	Bank of Communications
6	China CITIC Bank
7	Industrial Bank
8	Bank of Nanjing
9	China Galaxy Securities
10	Guotai Junan Securities
11	Ping An Securities
12	CITIC Securities
13	BOCI Securities
14	Guohai Securities
15	China Life Insurance
16	China Postal Savings Bank
Special institutions (on a par with List A)	
	National Social Security Fund

Source: Nomura Institute of Capital Markets Research, based on Ministry of Finance data

2) Underwriters

Local government bonds are issued by inviting members of the book-entry government bond syndicate to bid for them by auction (List A) (Figure 14). The syndicate therefore consists of 17 financial institutions: nine banks, six securities companies, one insurance company and one special institution (the National Social Security Fund). Apart from BOCI Securities, all the institutions are based in China. However, although BOCI Securities is a non-Chinese financial institution, the fact that it is ultimately owned by Bank of China, a China-based company, means that, to all intents and purposes, all the members of the local government bond underwriting syndicate are based in China.

3) Investors

Once the bonds have been underwritten, they trade on either the interbank bond market or the stock exchange markets (Shanghai and Shenzhen). According to the Ministry of Finance, RMB111,730mn of the RMB111,800mn in local government bonds already issued is traded on the interbank bond market, with only RMB70mn (two out of 26 issues, namely those issued by the Xinjiang Uyghur Autonomous Region and Anhui Province) being traded on the stock exchange markets. Similarly, the trading value of the 22 issues (worth a total of RMB94.9bn) listed and traded on the markets by 22 May 2009 was RMB37,920mn. Of this, RMB37,861mn was traded on the interbank bond market and RMB59mn on the stock exchange markets[7].

50.3% of the government bonds traded on the interbank bond market are owned by commercial banks, 33.9% by special clearing members[8], and 5.4% by insurance companies. We therefore assume that local government bonds have a similar ownership structure, with the majority being owned by commercial banks.

4) Contribution to economic stimulus measures

According to a report by China's National Audit Office on the state of progress in implementing the economic stimulus measures[9], 94% of the central government budget for 335 new projects in 18 provinces (including municipalities and autonomous regions) had been disbursed as of end-March 2009 but only 48% of the local government budget. Of the RMB24,859mn planned total investment in the 335 projects, RMB8,669mn is due to come from central government, RMB6,894mn from local government, and RMB9,296mn from bank loans and companies' own capital[10].

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7 This information on the issue amount and trading value of local government bonds as of 22 May 2009 is also from the above Ministry of Finance press release.

8 These include the People's Bank of China, the Ministry of Finance, the policy banks, the stock exchanges and China Government Securities Depository Trust & Clearing Co. Ltd.

9 Published on 18 May 2009.

10 According to a National Audit Office announcement at a State Council press conference on 27 May 2009.

Whereas central government is expected to have contributed RMB100.0bn from its budget for 2008 Q4 (Oct–Dec) and RMB130.0bn for 2009 Q1 (Jan–Mar), making a total of RMB230.0bn, local government is expected to have contributed RMB170.0bn. The intermittent issue of local government bonds since the end of March 2009 has helped local governments to raise the funds they need to meet their target.

IV. Challenges and prospects

1. Responsibility for redeeming local government bonds

As we have said, the issue of local government bonds following the promulgation of the 1994 *Budget Law*, special regulations and approval by the State Council has been a milestone in the history of China's bond market. The Chinese government also pursued an aggressive fiscal policy 10 years ago after the Asian currency crisis of 1997, when, from 1998 to 2004, the central government issued construction bonds and lent the issue proceeds to local governments to invest in national projects to stimulate domestic demand. However, although the central government bore the cost of (re)paying the principal and interest on the bonds, the money it lent to local governments from the proceeds was not included in either its own or their budgets. As a result, the resulting central government debt was not recorded as a fiscal deficit. We therefore assume that the Ministry of Finance was very much aware that this issue of construction bonds 10 years ago not only involved a distinction between the issuer and the user of the funds but also blurred the locus of responsibility between the two, with the central government finding itself having to bear the increased cost and risk.

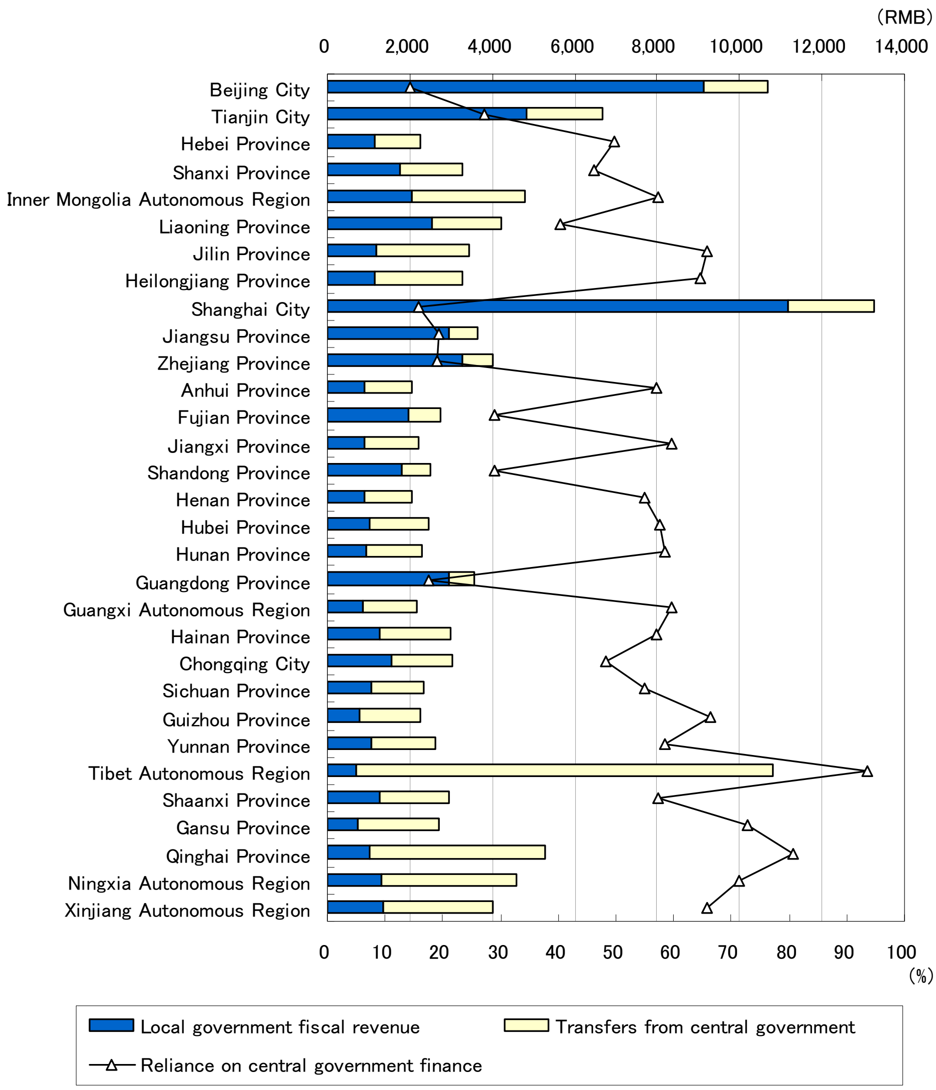
It was therefore careful to ensure that, although it will issue the local government bonds on behalf of all local governments, this will only be after the issues have been properly approved and budgeted, and both the NPC and the local people's congresses have debated and ratified them. However, the low-cost public housing projects and the public welfare and basic infrastructure projects in rural areas for which the issue proceeds are intended will not necessarily generate a high return. Therefore local governments may find themselves without the funds needed to redeem the bonds. If that happened, it is by no means clear whether they would be expected to bear all the responsibility for redeeming the bonds or whether the central government would assume the responsibility. In particular, prefecture- and county-level governments will face interest charges on public welfare projects as they will be lent the money by the province-level governments above them. Investors may assume that these local government bonds are tacitly guaranteed by the central government because the Ministry of Finance has issued them on behalf of local governments. However, if there is any problem with redemption, investors and other market participants will have to find out where the responsibility for redemption lies.

2. Transfer payments

The issue of local government bonds is tied up with that of fiscal transfers from central to local government. As we have mentioned, local government fiscal revenue consists of transfers from central government as well as revenue from local governments' own resources. However, as the fiscal position of local governments seems to get weaker as one goes from the coastal regions to the central and western regions, reflecting regional inequalities, transfers from central government are an essential part of trying to achieve some degree of balance at a national level.

An analysis of each province's per capita fiscal revenue and transfers from central government shows that, with the exception of coastal region municipalities such as Beijing, Tianjin and Shanghai, transfers to the central and western regions as well as the north-east tend to be more generous than those to the coastal regions (Figure 15).

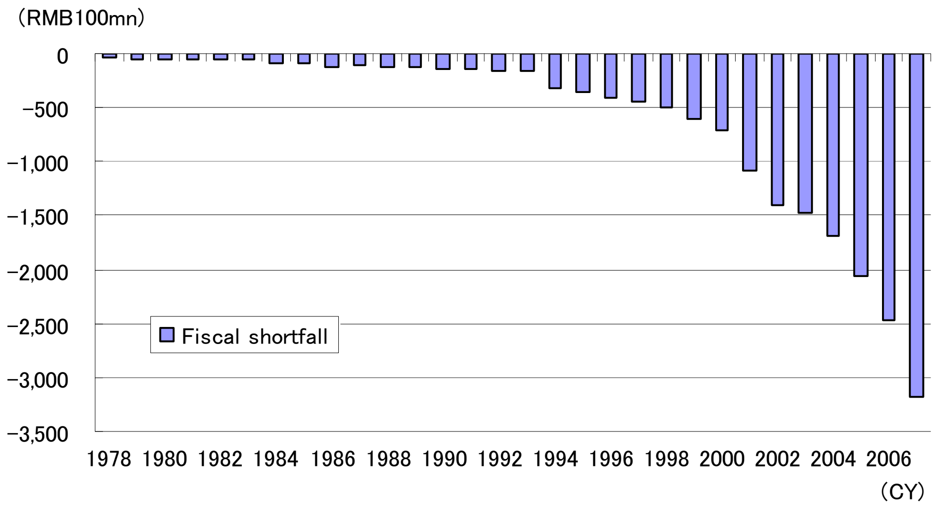
Figure 15: Per capita local government fiscal revenue (as of 2007)



Source: Nomura Institute of Capital Markets Research, based on data from *Finance Yearbook of China* and *China Statistical Abstract*

This is particularly true of the Autonomous Region of Tibet. The economic stability of autonomous regions of ethnic minorities such as Tibet as well as of the autonomous prefectures and autonomous counties in each province, where a large number of ethnic minorities tend to live, is a key policy issue in China. At the same time, however, these autonomous regions of ethnic minorities tend to be concentrated in inaccessible areas, even in the interior and the coastal regions. They therefore tend to lack their own sources of finance and have had to depend on generous fiscal transfers from central government (Figure 16).

Figure 16: Fiscal shortfall of autonomous regions of ethnic minorities (single fiscal year basis)



Source: Nomura Institute of Capital Markets Research, based on data from *Finance Yearbook of China*

Regional inequalities have developed in the 30 years since China adopted its "open door" policy in 1978, and we see little prospect of the central government being able to wean the regions off its generous transfer payments in the foreseeable future. Transfer payments are not just a matter of differences between local governments: they also concern the distribution of fiscal resources between higher and lower levels of government in the same region. Under China's general system of transfer payments, they are derived by multiplying the difference between a region's standard expenditure and standard revenue by the transfer payment coefficient for that region. However, it is debatable whether revenue and expenditure related to local government bonds should be included in this formula.

3. Possible purchases by foreign investors

Having just started in fiscal 2009, China's local government bond market is still in its infancy. For bond investors, however, local government bonds are a new investment option. Foreign investors may be able to purchase the bonds as qualified foreign institutional investors (QFIIs), although they will need permission from the China Securities Regulatory Commission (CSRC) for those bonds traded on securities exchanges. In this connection, foreign investors are unlikely to have forgotten the ITICs (international trust and investment companies), set up in the 1980s as bases for Chinese local governments looking to issue bonds and borrow money overseas, and some of which collapsed and defaulted in 1998 and the years that followed.

We can expect China's local government bond market to continue to go through a series of transformations and will continue to monitor its development.

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