

China Insights: QE is still unlikely

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Highlights:

- The speculation on QE was derived from the news that the State Council has approved CNY1 trillion quota to allow local governments to roll over their maturing high interest paying debt through issuing the low-interest paying municipal bond.
- We doubt PBoC will directly purchase the municipal bonds for two reasons including prudent monetary policy framework and legal constraints.
- We think commercial banks will participate in the debt swap program. We see higher probability for China to cut reserve requirement ratio.

The news on possible quantitative easing (QE) from PBoC dominated the headline today. The speculation, which was derived from the news that China's Ministry of Finance has approved CNY1 trillion debt swap program for local government, was unfounded in our view.

Local government debt swap

Unlike local governments in most advanced economies, Chinese local governments are not allowed to issue municipal bonds directly under the current budget law to finance its operation. As such, most local government debt exists in form of bank loan and off-balance sheet financing such as trust. As a result of CNY4 trillion stimulus packages rolled out back in 2008/2009, the fiscal stress of local governments have led to the ballooning local government debt. The non-transparency of local government debt has become one of the key risk factors for Chinese economy.

Since 2013, China has conducted the nationwide audit on local government debt twice. Meanwhile, China's State Council also published the regulation 43 in October 2014 to reclassify the local government debt and identify the liabilities of local government. Although the detailed numbers have not been released by central government yet due to overstatement of local government debt during the submission, China's Ministry of Finance as well as provincial governments has already been working on the plans to mitigate the debt problem. For example, during the National People's Congress last week, Shandong Province Governor Guo Shuqing said the provisional government may consider selling assets to repay the debt.

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On 8th March, the Ministry of Finance officially announced in its website that the State Council has approved CNY1 trillion quota to allow local governments to roll over their maturing high interest paying debt through issuing the municipal bond to lower the financing cost for local government. The Ministry of Finance estimated that the local governments will be able to save about CNY400-500 billion interest expense per annum.

Where is QE speculation from?

The speculation mainly came from lack of details about the implementation of local government debt swap. There are two questions to be answered including 1) what kind of maturing local government debt will be swapped and 2) who will buy the new municipal bond.

Based on the estimation from MoF, local governments are expected to save about CNY400-500bn from its CNY1 trillion debt swap. This translates to about 4-5% coupon savings. As such, we think most swapped maturing debt will be high interest paying trust or BT loans.

Previously most trust products were purchased by funds from wealth management products. The significant decline of yields offered after converting high-interest trust product to low-interest local government municipal bond is likely to lose appealing to existing investors seeking higher yields. Therefore, this leads to next question who will buy those municipal bonds.

The QE speculation heightens after some investors believe that Chinese central bank may be the end buyer of those municipal bonds via injecting the liquidity through relending to policy banks to purchase the municipal bonds. This effectively becomes the Chinese version of QE.

Nevertheless, we doubt PBoC will directly purchase the municipal bonds for two reasons. **First**, the market has already started to question the PBoC's prudent monetary policy tone after two interest rate cuts and one full-scale reserve requirement ratio cut within three months. The launch of QE will definitely destroy the image of China's prudent monetary policy. **Second**, under <Law of the People's Republic of China on the People's Bank of China> chapter IV, Article 29 highlights that "The People's Bank of China may not make an overdraft for the government, and may not directly subscribe or underwrite State bonds or other government bonds." As such, we think the PBoC is unlikely to conduct QE under the current legal framework.

Commercial banks to play a part

Having said that, it is still unclear who will buy those municipal bonds. The concern is that banks may be reluctant to pick up those municipal bonds due to supply shocks from the massive issuance of local government debt during the debt swap program. Nevertheless, we believe Chinese policy makers may encourage banks to participate in the debt swap program to hold those municipal bonds. Of course, the sweetener will be the reserve

requirement ratio cut to release more liquidity to facilitate bank's asset allocation. As such, we think there might be more incentives for China to cut the RRR in the coming months to offset the impact of capital outflows and ease liquidity pressure.

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