鹏元國際 PENGYUAN

Reinforcing Proactive Fiscal Approaches Unlikely to Strain Chinese Local Governments' Credit Profiles in 2022

Contents

Summary

Augmenting fixed assets investment (FAI) is set to sustain the economic growth in 2022 with provincial regions facing diverse pressure to meet their GDP targets. Headwinds in the second half of 2021 such as the see-saw pandemic ride and weakened global demand have mired the country's economic recovery. With economic stabilisation as the pivotal goal in 2022, the central government has shown substantial inclination to expand FAI using fiscal and monetary measures, and the provincial regions have stated relatively high economic growth targets in 2022. Only 10 provincial regions' average GDP growth during the period of 2020-2021 met 6%, while more than 20 regions set their GDP growth goals at around 6% or more in 2022. This necessitates proactive fiscal approaches and enhancement of FAI in some provincial regions whose economic ambition does not correspond to their economic momentum.

To execute the national fiscal expansion scheme, local governments' (LGs) deficit is expected to widen substantially but remains manageable in 2022. The economic revival and fiscal retrenchment in 2021 have generally decompressed the fiscal pressure on LGs and partly prepared them for the potential deficit swell in 2022 owing to the resumption of proactive fiscal strategy. However, the intensifying fiscal imbalance could be a significant challenge to some LGs, which have onerous and inefficient revenue generation. In our opinion, the downswing in LGs' land sales caused by the turmoil of the property market is likely to prolong for a few months and rally thereafter in 2022. We believe the central government has eased its grip over the real estate sector since the end of 2021 in order to stabilise the economic progression. This should render the land sales of LGs to gradually resume and become more polarised than before since the real estate developers tend to concentrate their land acquisition on wealthier and lucrative regions.

LGs' debt issuance is expediting, while debt level is mounting. The RMB1.46 trillion of advanced incremental bond limit and massive funds carried over from debt issuance by the end of 2021 should ensure LGs' liquidity in the first half of 2022. The central government has prodded the LGs to issue bonds earlier this year to support the infrastructure construction and play an active role in bolstering the economic growth. We project the LGs' special bond and general bond ceilings to be lifted by RMB3.8 trillion and RMB900 billion respectively in 2022, and roughly 80% of incremental debt limits of this year to be utilised in the first half. LGs' leverage will generally increase by the end of 2022, pressurising those with already-high debt levels, such as Tianjin and Guizhou.

Stable outlook is set for LGs' creditworthiness in China in 2022 with increasing tail risk. Although deficit and debt levels are to be elevated, the LGs' generally ameliorated credit profiles in 2021 have braced themselves for the fiscal stimulus in 2022. The dovish monetary conditions and the potentially rising debt ceilings will facilitate LGs in accessing the external financing and securing the liquidity. We believe the central government's effort to decouple the credit profiles between local government financing vehicles (LGFVs) and LGs should not be imperative in 2022, when the country's urge is to maintain the economic growth and FAI expansion in which LGFVs play indispensable roles. While the stable creditworthiness of LGs can potentially underpin LGFVs, the divergence among different LGs and LGFVs is broadening.

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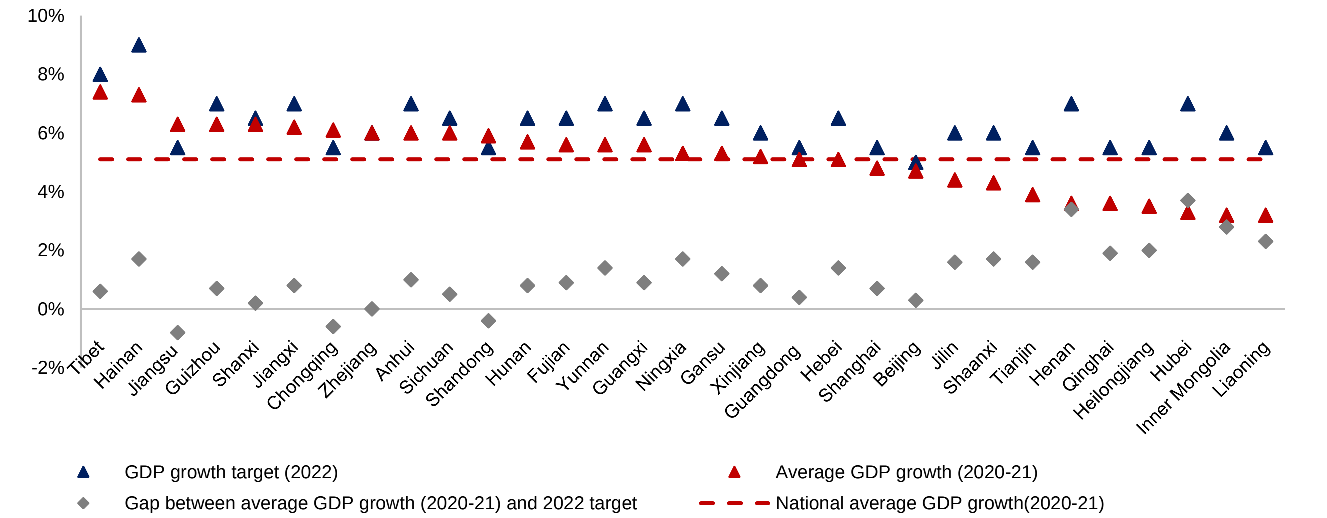
Provincial regions apply themselves to maintain stable economic growth in 2022

Meeting economic aims could be arduous tasks for some provincial regions in 2022

We consider the average GDP growth between 2020 and 2021 a better indicator to reflect the economic performance over the past two years, as a longer horizon captures both the pandemic's impact and the economic recovery, and helps to smooth the fluctuations (Exhibit 1). Tibet and Hainan stick out on the back of their unique locations, strong recovery of tourism and favourable national policies. More than half of the provincial regions registered average GDP growth surpassing 5.5% over the past two years with Zhejiang, Jiangsu and Fujian in the spotlight. The three wealthy provinces have already achieved advanced economic development among their peers and still managed to maintain a fast pace of economic growth leveraging on the exuberant international trade and vigorously revival of domestic consumption. On the right-hand side of Exhibit 1, the provinces of Henan and Shaanxi have seen material economic slowdown over the past few years owing to the local resurgence of pandemic confirmed cases and relatively weak momentum in their economies.

Successively, provincial regions have announced their GDP growth goals for 2022 with over 20 of them targeting their economic growth of around 6% or more, demonstrating the LGs' strong determination to maintain a proper GDP expansion under the national and global economic complications. A few provinces are more conservative than their peers in setting their targets, such as Jiangsu, Chongqing and Shandong which considered their expected economic growth in 2022 lower than their average growth since the pandemic. Most provincial regions tend to be cautious and set rational economic goals that are basically in line with their economic trajectories. However, some provinces are being ambitious in our view. For instance, Henan, Inner Mongolia and Liaoning set their GDP growth targets of 2022 at two percentage points above their average rates of 2020 and 2021. This may require rather proactive fiscal stimulus and enhancement of FAI, which should push up these regions' debt and deficit levels to a greater extent than their peers.

Exhibit 1: Majority of provincial regions target economic growth in a range of 6%-7% in 2022



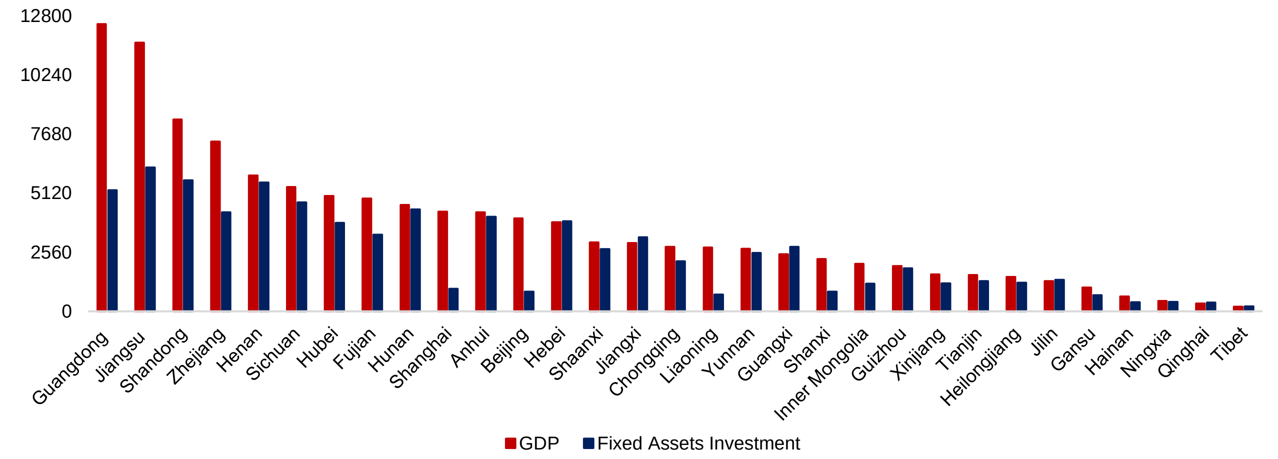
Sources: Bureau of Statistics, Pengyuan International's estimates

FAI is set to serve as a primary driver and stabiliser in the economy this year

The sporadic and incessant pandemic outbreak is rattling the economic fundamentals of the country and dampening the domestic consumption. The high cost of materials and energy shortage put sand in the wheels in the industrial production, and the prospect of export is not so sanguine amid the raging on global pandemic and economic uncertainties in 2022. Under the material economic downward pressure, economic stabilisation has become the prime mission for the central government. This is the reason it pins its hope on the proactive fiscal policies and the structurally easing monetary policies, which are all set to boost the FAI expansion in 2022 and are posing diverse impacts on provincial regions.

We project the economic growth of provinces, such as Jiangxi, Henan, Hebei and Sichuan to be fuelled by the FAI expansion to a greater extent versus their peers given their relatively large FAI size compared to their GDP value (Exhibit 2). The projection also takes their relatively manageable debt and deficit levels into consideration, which should facilitate them in augmenting the local FAI. On the flip side, the nation-wide FAI expansion should not have substantial implications to the regions such as Beijing, Shanghai and Guangdong whose economies are largely driven by consumption.

Exhibit 2: GDP and FAI of provincial regions in 2021 (RMB billion)



Sources: Bureau of Statistics, Pengyuan International's estimates

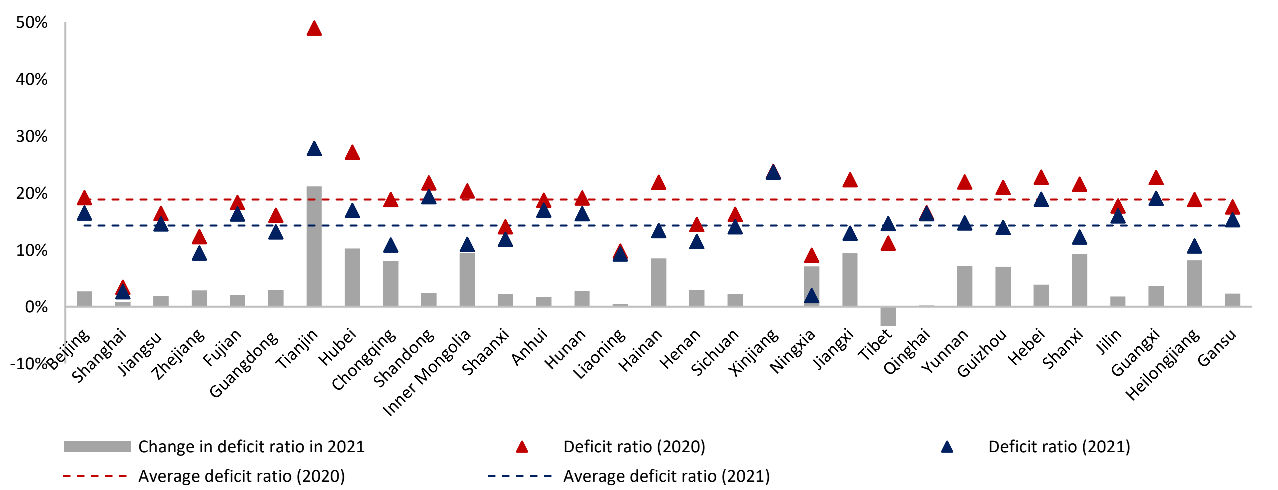
Proactive fiscal strategy is to weigh on LGs extensively and divergently

Most LGs are in better budgetary position to carry out the fiscal expansion than a year ago

"The proactive fiscal policy should enhance efficacy and to be more precise and sustainable. The intensity of government spending should be ensured, and the pace of spending should be accelerated," according to the central government statement regarding its fiscal strategy for 2022. Since the economic stability has been identified as the overarching goal in 2022, the central government has shown a strong determination to spur the slowing economic progression by leveraging on proactive fiscal approaches. We expect to see an intensive governmental investment, particularly in the field of infrastructure construction this year, and the LGs are quickly responsive and taking actions to speed up their budgetary expenditure arrangement.

Fortunately, LGs' fiscal balance was partially restored, and their fiscal strength was improved by the end of 2021. The national general public budgetary revenue grew 10.7% and the general public budgetary expenditure increased 0.3% in 2021. Along with the economic recovery, many LGs' general public revenue surged in 2021, which was accompanied by a wide range of fiscal retrenchment with many LGs curtailing their general public budgetary expenditure in 2021. We believe the fiscal austerity and economic revival in 2021 have allowed the LGs to financially decompress after two years of proactive budgetary strategy. In general, LGs are expected to be more capable and better-prepared for lifting their deficit level in 2022 versus a year ago. Still, the fiscal expansion is posing burden over LGs extensively and divergently this year. Some governments are well positioned for the proactive fiscal measures since their deficit levels decreased at a point lower than most of their peers by the end of 2021, such as Shanghai, Zhejiang, Chongqing and Liaoning. However, LGs such as Tianjin, Xinjiang, Hebei and Guangxi should be under greater fiscal pressure than their peers if they further expand their deficits in 2022 (Exhibit 3).

Exhibit 3: Most LGs' deficit levels decreased in 2021



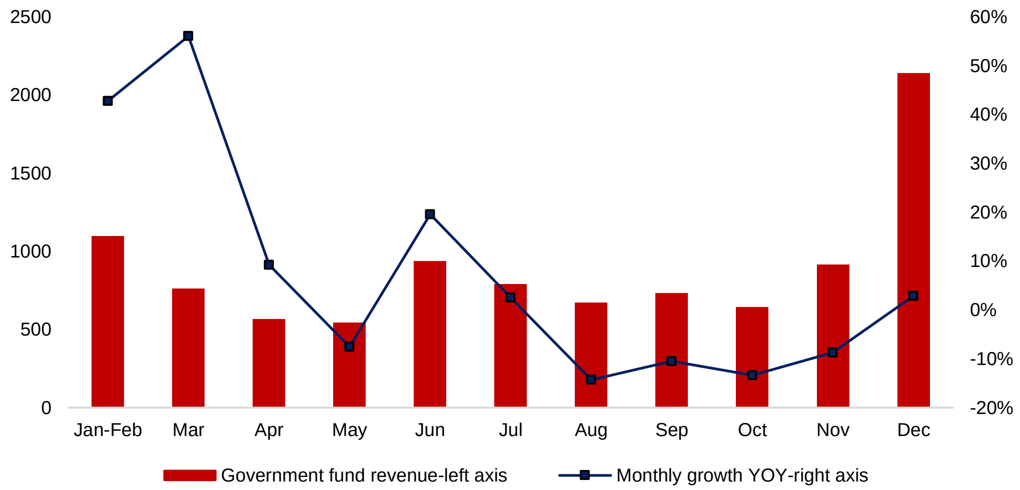
Note: 1, Deficit ratio=deficit/budgetary revenue. 2, The budgetary revenue includes general public budgetary revenue, refunds and transfers from the central government and government fund revenue. 3, The budgetary expenditure includes the general public budgetary expenditure and government fund expenditure. 4. The budgetary figures of 2021 are estimated data.
Source: Local governments' bureaus, Wind, Pengyuan International's estimates

Land sales are likely to remain sluggish in the first quarter and rally thereafter in 2022

LGs' government fund revenue is mainly derived from land sales, which have been dampened by the depressing real estate market since the second half of 2021. The tight funding limitations on real estate developers (such as the 'Three Red Lines' policy) as well as unswerving home-purchase restrictions have sparked a sweeping turbulence in the property market with many real estate developers being inflicted with financial owes and even facing defaults. This has constrained the dynamic of real estate developers in land acquisition, which in turn triggered a downswing in LG's government fund revenue in the second half of 2021. The national government fund revenue has registered a consecutive decrease since August, and the impact from the bleak property market is dragging on in the first quarter of 2022 (Exhibit 4).

Nevertheless, we hold a cautious upbeat view for the LGs' land sales after the first quarter in 2022, as we believe the central government has eased its grip on the real estate sector by the end of 2021 when the economic stability has become a pivotal task for 2022. The stabilisation of economic development and implementation of proactive fiscal approaches are hard-pressed to carry through without a healthy and growing real estate sector which accounts for a mammoth volume in China's GDP. Confidence improvement, risk prevention and growth promotion are the fundamental guidelines from the central government regarding the real estate market. The official stance is becoming more dovish, so are the monetary policies. As such, the potentially releasing restrictions and ameliorating financing condition are restoring the confidence in the real estate market, and the land purchase is expected to resume vibrancy gradually in 2022. However, following the market upheavals over the past few years, the property developers are inclined to be more discreet than before in land acquisition, and to focus on more profitable projects and richer regions. This should render the growth of government fund revenue across different provincial regions to be more diverse than that of the previous years. We project the richer regions' government fund revenue to outperform in 2022.

Exhibit 4: National government fund revenue's monthly year-on-year growth in 2021 (RMB billion)



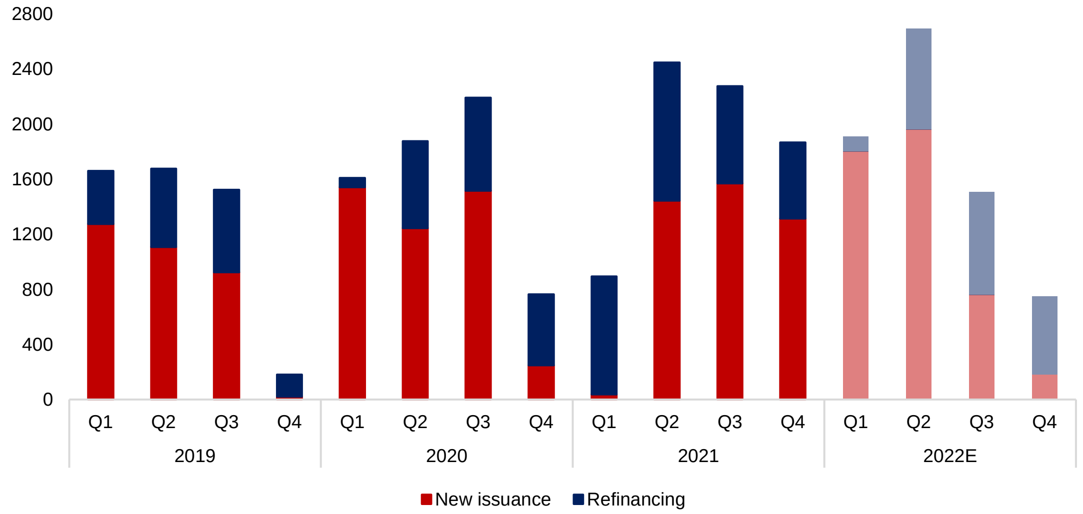
Sources: Local governments' bureaus, Wind, Pengyuan International's estimates

Accelerating and increasing debt issuance to exacerbate LGs' debt burden

A bulk of LG debt issuance to be slated for the first half of 2022

LGs generally delayed debt issuance in 2021 mainly due to two culprits. First, LGs had sufficient funds at the beginning of 2021 as a result of the massive increment of debt issuance in 2020; second, the propitiously recovered economy in the first half of 2021 made the fiscal stimulus unnecessary. By and large, LGs' major debt issuance shifted to the second half of 2021 and had seen a substantial increase in the fourth quarter over the same period of the previous years. Therefore, a great amount of funds should have been carried over for the fiscal usage at the beginning of 2022. Moreover, the Ministry of Finance announced in December 2021 that it has given the advance incremental special bond limit of RMB1.46 trillion to the LGs, allowing them to raise debt to bolster their fiscal expansion in the first quarter of 2022. As a result, we believe most LGs should remain very liquid in the first half of 2022. The central government has prompted the LGs to issue bonds earlier this year to support the infrastructure construction and play an active role in sustaining economic growth. "Early, Precise, Fast" is the central government's guidance for the debt issuance of LGs in 2022, and a few LGs such as Shanghai, have vowed to complete the whole-year scheme of debt issuance in the first half of the year. Therefore, we expect the debt issuance to be intense in the first half of 2022 and to see a sweeping enablement of infrastructure projects concurrently. In 2022, the LG's special bond ceiling is to be lifted by RMB3.8 trillion and the general bond ceiling is to be lifted by RMB900 billion by our estimates. The debt issuance will be arranged ahead (Exhibit 5), and the LGs are expected to utilise roughly 80% of their incremental debt limits in the first half of 2022.

Exhibit 5: Debt issuance is expected to be arranged ahead in 2022 (RMB billion)

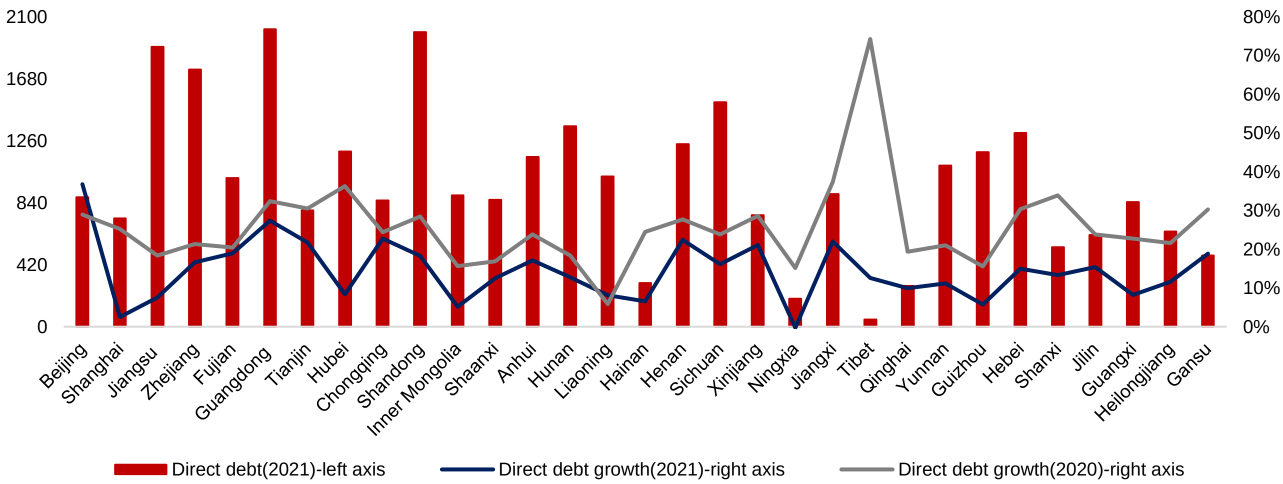


Sources: Local governments' bureaus, Wind, Pengyuan International's estimates

LGs' debt growth to accelerate and leverage to rise materially in 2022

Except Beijing and Liaoning, provincial-level regions' debt grew slower in 2021 over 2020 when the LGs strived to cope with the pandemic and its aftermath (Exhibit 6). About half of the provincial-level regions' debt growth declined over 10 percentage points from that of 2020. Still, some LGs' debt growth surpassed 20% in 2021, such as Guangdong, Tianjin, Chongqing, Henan and Jiangxi. The slowdown of debt increment has given the LGs' a breather in 2021 after a tough year fighting against the pandemic and stabilised the debt levels of most LGs.

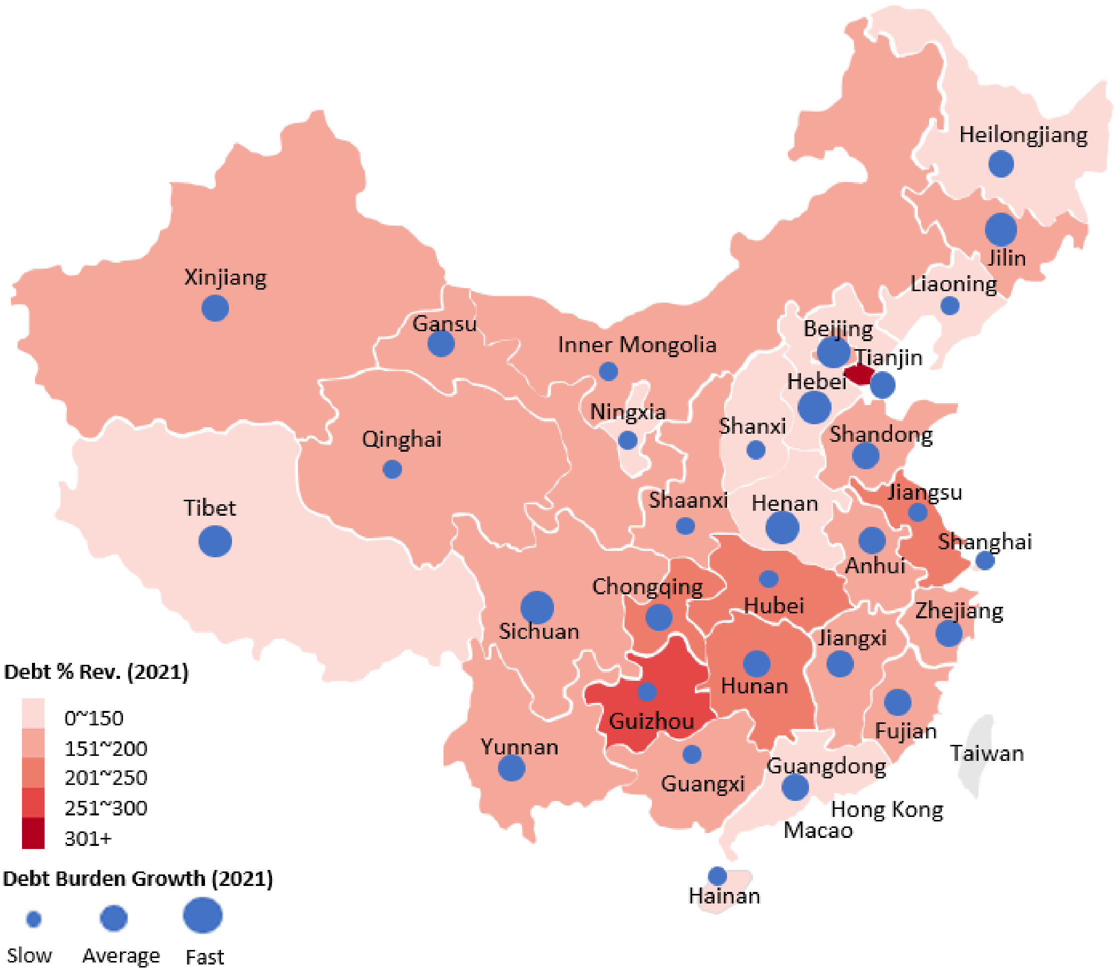
Exhibit 6: Direct debt growth slowed in most provincial regions in 2021



Sources: Local governments' bureaus, Wind, Pengyuan International's estimates

Guizhou and Tianjin are estimated to have the heaviest debt burden in the country by the end of 2021 with their debt to revenue ratios at over 300% (Exhibit 7). They are not likely to deleverage in 2022 due to their inclination to maintain the growth of economy and intensity of fiscal expenditure. The fiscal burden of these two regions is expected to remain substantial and to strain their overall debt and liquidity management. Jiangsu, Chongqing, Hunan and Hubei are also laden with more debt than most of their peers, but their relatively benign economic status should help them to borrow and refinance. The debt level remains manageable in general, but it is rising rapidly in some provinces, such as Gansu, Sichuan and Jilin.

Exhibit 7: Debt levels are divergent across the country



Note: 1, The data are estimated. 2, The debt includes direct debt and hidden debt. 3, The debt burden growth is gauged by percentage change of the debt/GDP ratio in 2021: "slow" means debt burden growth<0; "Average" means 0⩽debt burden growth⩽3; "Fast" means debt burden growth>3
Sources: Local governments' bureaus, Wind, Pengyuan International's estimates

LGs' stable creditworthiness underpins the credit profiles of LGFVs

Stable outlook is set for LGs' creditworthiness in 2022 but divergence is enlarging

LGs are undertaking increasingly important responsibilities to drive the local economy, leveraging on the reinforcing fiscal measures in 2022. The slowing economic growth and constant tax and fee cuts tend to restrain the revenue collection of LGs, and the bleak property market is yet to revive, sapping the LGs' land sales. Hence, the fiscal expansion can only be fuelled by additional debt raises and the debt level of LGs will reach to an all-time high this year. Fortunately, the fiscal retrenchment and economic recovery in 2021 had alleviated most LGs' debt and deficit pressure and entrenched their creditworthiness, which had paved the way for the fiscal stimulus in 2022. The loosening monetary conditions and the potentially increasing debt ceilings will facilitate the LGs in accessing the external financing and securing the liquidity. Therefore, despite the negative conditions and lumping uncertainties ahead, we set a stable outlook for LGs' creditworthiness in 2022.

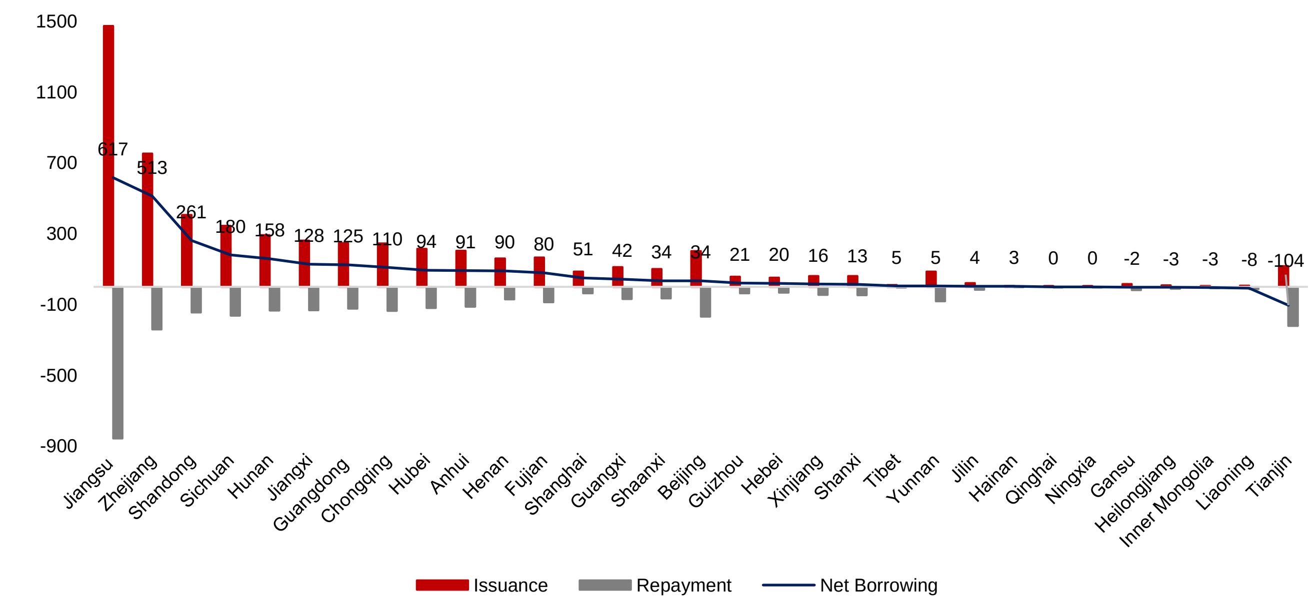
However, some weaknesses in certain LGs should be vigilant. For instance, Guizhou and Tianjin's heavy debt burden is likely to further exacerbate in 2022, straining their debt and liquidity management; Henan, Heilongjiang and Liaoning have been afflicted by material economic slowdown in the past few years and will struggle to meet their economic targets in 2022. The enhancement in FAI can potentially inflict financial risk for them due to their relatively feeble revenue collection.

The decoupling between the creditworthiness of LGs and LGFVs is unlikely to be an urgent task in 2022

The central government's effort to mitigate the risk of hidden debt in LGs by cutting ties between the creditworthiness of LGs and their controlled LGFVs had seemed to be escalated in 2021. The central government instructed to clean up and control the LGFVs and strip off their government financing functions. Bankruptcy, reorganisation or liquidation shall be carried out for those which lose their solvency. Thereafter, several provincial governments followed suit by rolling out guidance with similar gist to manage the LGFVs in their jurisdictions. In addition, the banking system has also tightened the restrictions over financing for LGFVs. These series of policies and actions have stroked a nerve in the financing market regarding LGFVs' creditworthiness and especially, rattled the market belief in LGs' willingness to support to the LGFVs. Market participants were concerned that there would incur the concrete default of LGFV bonds and even bankruptcy.

Nonetheless, in fact, the amount of LGFV bond issuance has reached to an all-time high with no LGFV bond defaults or bankruptcies reported. The value of LGFVs bond issuance amounted to more than RMB5 trillion, with net borrowing exceeding RMB2 trillion in 2021 (Exhibit 8). Economically developed provinces saw continued increase in net financing, of which Jiangsu and Zhejiang accounted for about half of the total net financing amount in 2021. Concurrently, provinces such as Liaoning, Inner Mongolia, Heilongjiang and Tianjin, recorded negative net borrowing, partially indicating their weaker market credibility among others.

Exhibit 8: LGFVs' net borrowing in different provincial regions in 2021 [RMB billion]



Sources: Wind, Pengyuan International

On a positive note, many LGs have established a more sophisticated mechanism to prevent and mitigate the potential risk of solvency in LGFVs than before. We believe the separation of LGFVs from their controlling LGs' creditworthiness is necessary and ongoing, but it should not be imperative in 2022 when the central government's priority is to sustain the economic growth. LGFVs serve as crucial proxies to carry on the governmental investment in term of local infrastructure construction and engage deeply in building the public work and improving the residence's welfare. In order to set forth the FAI expansion, LGFVs' solvency and credit profiles should consistently have LGs' potential support. However, some low-level LGFVs, which have great proportion of non-standard financing in their liabilities, should see continued depression when the non-standard financing avenues further dwindle.

For more research and credit views, the table (table 1) below lists our published LG ratings.

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Table 1: Our published issuer credit ratings for 23 LGs

LGs	Issuer Credit Ratings	Issuer reports
Beijing	AA	https://www.pyrating.com/rating-actions/issuer/Beijing-Municipal-Government-China.html
Shanghai	AA-	https://www.pyrating.com/rating-actions/issuer/Municipal-Government-of-Shanghai-China.html
Hainan	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Hainan-China.html
Shaanxi	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Shaanxi-China.html
Hebei	A	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Hebei-China.html
Hunan	A	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Hunan-China.html
Jiangsu	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Jiangsu-China.html
Jilin	A	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Jilin-China.html
Guangdong	AA-	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Guangdong-China.html
Fujian	AA-	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Fujian-China.html
Henan	A	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Henan-China.html
Zhejiang	AA-	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Zhejiang-China.html
Jiangxi	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Jiangxi-China.html
Shandong	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Shandong-China.html
Shanxi	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Shanxi-China.html
Sichuan	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Sichuan-China.html
Tianjin	A	https://www.pyrating.com/rating-actions/issuer/Municipal-Government-of-Tianjin-China.html
Guizhou	A	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Guizhou-China.html
Yunnan	A+	https://www.pyrating.com/rating-actions/issuer/20200818101436501.html
Guangxi	A	https://www.pyrating.com/rating-actions/issuer/Guangxi-Zhuang-Autonomous-Region-Government-China.html
Heilongjiang	A	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Heilongjiang-China.html
Liaoning	A+	https://www.pyrating.com/rating-actions/issuer/Provincial-Government-of-Liaoning-China.html
Shenzhen	AA-	https://www.pyrating.com/rating-actions/issuer/Municipal-Government-of-Shenzhen.html

Note: The credit ratings are global scale long-term ratings.
Sources: Pengyuan International

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