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MARKET COMMENTARY

Ashmore

Killing five birds with one stone

By Jan Dehn

One of the most exciting developments in China today is taking place in the local bond market.[1]

The much-discussed RMB 1trn swap of local government debt into municipal bonds is likely to be the start of a multi-year program, which should eventually see most of China's RMB 11trn local government debt universe converted into fully tradable securities.[2] This means that China's muni bond market could eventually grow as large as the entire dollar denominated Emerging Markets (EM) corporate bond market.

The RMB swap program is therefore an extremely important development, which we believe will "kill five birds with one stone". Specifically, we believe the swap will:

1. **Reduce local government refinancing risks**
   Some 54% of all local government debt will be refinanced under the swap. Banks will be required to subscribe to the new bonds on a pro-rata basis with their existing commitments with local governments, thus ensuring demand for the new paper. The maturities of local government debt will also be increased and the new bonds will be benchmark securities with standard maturities of 1, 3, 5, 7 and 10 years.

2. **Take China a major step closer to creating a muni bond market by converting non-tradable securities into fully tradable bonds**
   The swap does not complete this process; the yields on the new bonds will only become freely determined once an ongoing root and branch audit of local government finances has been completed. Yields for the new bonds will initially be set at 30% above the yield on China's government bonds (China 5 year bonds currently trade at a yield of 3.17%, down from 4.5% in January 2014).

3. **Discipline local governments**
   China's local governments will now face higher borrowing costs if they mismanage their finances or conceal information, but lower financing costs if they manage their finances transparently and well.

4. **Aid in the transmission of monetary policy**
   As China's bond markets deepen and broaden interest rates will become far more effective in transmitting PBOC interest rate changes into the real economy.

5. **Stimulate consumption**
   The rapid development of China's bond market takes place alongside the emergence of a mutual fund industry in China. The mutual funds will introduce bonds into the savings portfolios of ordinary Chinese savers, who have so far mainly been invested in highly pro-cyclical stocks and property. We believe the introduction of bonds into savings portfolios will stabilise overall returns and thus reduce precautionary savings rates and stimulate consumption. Note that the new local government bonds will be eligible as collateral for open market operations and liquidity injections via the Mid-term Loan Facility and the Pledged Supplementary Lending program, so the new paper should not crowd out lending to the private sector, though the duration impact may impact the shape of the local curve (steepening).

There has been considerable speculation that the local government swap constitutes Quantitative Easing (QE). This speculation is unfounded. China has some of the highest real rates in the world and does not need to engage in US or European or Japanese style QE; it can simply cut rates. As the size of the muni bond market grows, however, overall bank liquidity will likely increase (due to the collateral status of these new bonds). In turn, this will increase financing available for the private sector. The Chinese economy is currently motoring along with a 7% real GDP growth rate and the level of central government debt is less than 30% of GDP.

China is developing its local bond markets as a core element in the country's preparations for the world of tomorrow, where the currency implications of QE in the Western world will become apparent for all to see. Specifically, China is taking the realistic view that it will have to rotate its economy away from reliance on exports, which will become challenged as the CNY rallies against Western currencies, towards domestic demand. The greater reliance on domestic demand-led growth in turn gives China's local bond market a central role in macroeconomic management. A largely closed economy, China's domestic demand is far more sensitive to interest rates than to exchange rates, but only if there is a bond market to transmit PBOC rate changes into the wider economy.

[1] *See 'Probably the best bond market in the world'*, The Emerging View, September 2014.
[2] *See 'China's financial influence grows ever stronger'*, Weekly Investor Research, 23 March 2015.

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