

China's QE Lite II. Jiangsu Successfully Issues 52 billion RMB of Muni Bonds

On Monday, 18 May, Jiangsu province successfully sold 52 billion RMB of municipal bonds.

Recently, the Chinese government has accelerated a municipal bond program that effectively is a debt swap for some 1.7 trillion RMB of existing local government debt. Cost of debt for the local governments is expected to fall by some 250-300 basis points.

There is some logic behind what is effectively a system wide restructuring. The municipal bonds yield less than the maturing or retired debt, however, they also have a lower risk weight of 20% or less and thus consume a lot less capital.

For a bank seeking to maintain profitability, it would have to extend more loans for every dollar notional of restructured debt. The municipal bonds are financed at highly advantageous rates and haircuts. Naively, if risk weights were reduced to 20%, a bank could make 5 times the loans it used to with the same capital and fund itself cheaply, not with deposits where reform is raising rates, but with medium to long term repos with the PBOC, namely the MLF and PSL. Impact on bank profitability would be neutral, balance sheets would expand, loan growth would rise, credit quality would improve, and the impact will likely be felt across the economy as a whole and drive the stock market even further.

At the same time, the Chinese regulators have relaxed funding conditions by allowing banks to refinance existing LGFVs in respect of projects started prior to the end of 2014. This is likely a stop gap measure as the PSLs are unlikely to be able to absorb the volume of refinancings of

what is essentially the substantial majority of local government debt in the system.