

China's QE Lite. PSL, MLF, SLF a.k.a LTR0, MRO

China is initiating QE lite mimicking the ECB's LTR0 programs. The objectives are clearly to lower borrowing costs for local governments, and to establish a liquid municipal bond market as part of a reorganization of the funding mechanism for local governments which until now had used opaque, off balance sheet, so-called Local Government Funding Vehicles (LGFVs). The opacity of LGFVs lead to uncertain priority of claim and difficulty in measuring systemic risks. The side effects of QE Lite will include expanding liquidity and bank lending through the eligibility of municipal bonds as collateral in PBOC repo operations.

The PBOC has effectively halted the creation of new LGFVs, is encouraging local governments and their creditors, mostly commercial banks, to exchange LGFV debt for municipal bonds. It is also encouraging private commercial banks to invest in municipal bonds which are eligible for repo and thus provide a nexus between the PBOC and local governments.

Initial efforts have been clumsy due to the inexperience of the parties, the banks, the local governments and the PBOC. For the strategy to work, the banks have to be de facto guaranteed a return on capital exceeding borrowing costs for buying the muni bonds.

1. The bonds have to offer sufficient yield over the repo rate and other competing investments consuming the same amount of capital. This would include treasuries.
2. The capital consumption, or the risk weight assigned to these municipal bonds has to be sufficiently low so that, returns notwithstanding, they consume little or no capital.
3. The collateral standards have to be sufficiently

accommodative.

The above conditions have to be in place before any muni issuance takes place. The PBOC may need to bootstrap the process by communicating and educating the banks.

Next week, on May 18, the Jiangsu government will issue 52 billion RMB of bonds, 30.8 billion of which are refinancings. The bond issue was initially planned for Apr 23 but was postponed for lack of interest. We wish the Jiangsu government and the PBOC a healthy bid to cover.