中証鵬元國際
CSPI Ratings

Non-rating Action Commentary: China Is Reshaping Its Public Debt Structure

Central Government Takes the Lead in Restructuring China's Public Debt Landscape

We project that the future evolution of China's public sector debt will be guided by a strategic framework characterised by the active increase of debt by the central government (CG), appropriate expansion of direct debt by local governments (LGs), and rigorous approaches to control and resolve LG implicit debt[1]. As of the first quarter of 2024, China's direct government debt ratio stands at 56.7%, while the broad debt ratio[2] is estimated to exceed 100%, positioning it at a relatively high level internationally. Although the overall debt level is manageable, the current debt structure reveals certain inefficiencies, with a disproportionate share of high-interest, short-term implicit debt and a relatively lower proportion of CG debt. Given the current backdrop of sluggish economic growth and inadequate domestic demand, it has become imperative to reinforce proactive fiscal policies and increase leverage for the public sector.

CG's utilisation of ultra-long special bonds as a key mechanism for increasing leverage is projected to raise CG's debt ratio by approximately 5 percentage points in the long run. According to the 2024 National Budget, the budget for general public expenditure is set at RMB28.5 trillion, reflecting a 4% year-on-year increase. Notably, government fund expenditure is budgeted at RMB12 trillion, indicating a surge of 18.6% compared to the previous year. The broad budget deficit is expected to reach RMB11.1 trillion, marking a substantial 25% increase from the preceding year, underscoring the robustness of the proactive fiscal policy for the current fiscal year (Exhibit 1).

Regarding the deficit sources, carried-over income and transferred funds from the previous year contribute RMB2.1 trillion, while the planned increase in total government debt amounts to around RMB8.96 trillion (RMB4.34 trillion for CG bonds and RMB4.62 trillion for LG bonds). The CG's proportion in assuming this debt stands at approximately 48.4%, the highest proportion witnessed in recent years (Exhibit 2). This trend indicates that the CG's increased borrowing will lay a solid foundation for the sustained implementation of proactive fiscal policies in the future.

Commencing in 2024, the CG will initiate the issuance of ultra-long special bonds, with an initial issuance of RMB1 trillion. These bonds are expected to be continuously issued over the following years. Our projections suggest that the continuous issuance period for the CG ultra-long special bonds will span between 5 and 10 years, resulting in a gradual increase of approximately 5 percentage points in the CG's debt ratio. It is worth noting that China's current CG debt ratio remains at a relatively low level, allowing for a significant borrowing capacity. Moreover, CG bonds offer lower issue yield compared to LG bonds, facilitating the structural reduction of government debt costs and improving the debt structure of the government sector. The infusion of long-term capital also supports the alignment of strategic, long-cycle sectors within the economy.

Exhibit 1: The national fiscal revenue and expenditure (RMB trill.)

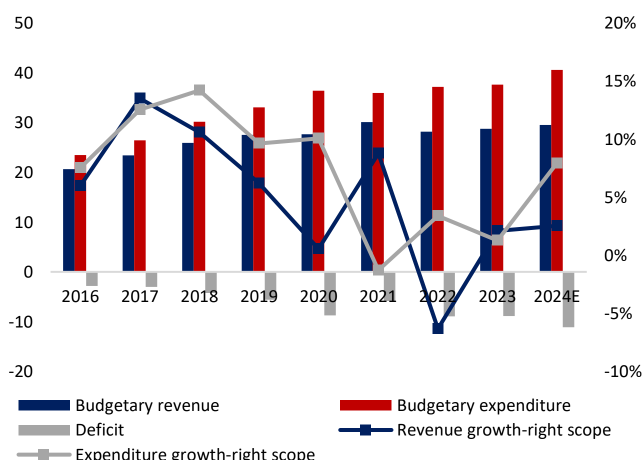
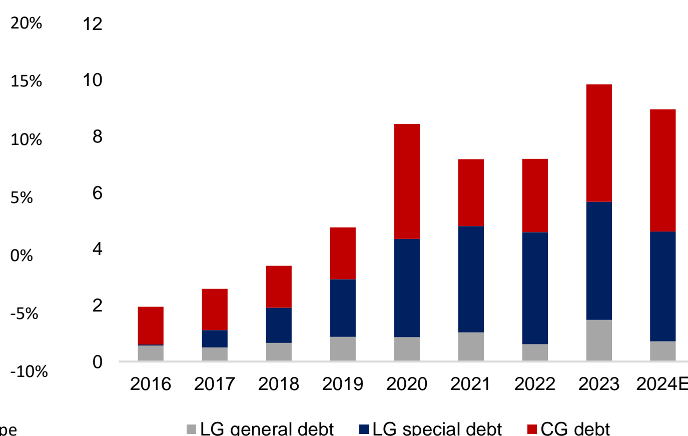


Exhibit 2: The structure of yearly government debt issuance (RMB trill.)



Note: Budgetary revenue and expenditure incorporate general public and government fund budgets
Sources: MOF, LG departments, CSPI Ratings estimates

[1] *Largely assumed by local government financing vehicles (LGFVs)*
[2] *Including the direct debt and estimated implicit debt*

The LG Direct Debt to Maintain Growth with Taxation Reform Being a Key to Improve Fiscal Sustainability

The overall fiscal equilibrium of LGs will be upheld while deficit and debt pressures persist. In 2023, the CG increased its transfer payments to LGs, providing an opportunity for LG fiscal recuperation and reserving space for a new round of fiscal expansion by LGs in 2024. Anticipated for 2024, the tax and fee reduction policies are expected to transition into a more targeted approach, with a reduced magnitude compared to the RMB2.2 trillion implemented in 2023. This adjustment aims to stabilise the macroeconomic tax level and fortify government finances. Nevertheless, the deceleration of nominal GDP growth and prolonged fragility in the real estate market will continue to impede the revenue growth of LGs. Consequently, the fiscal expansion of LGs in 2024 hinges upon the increased issuance of ultra-long special bonds by the CG and the escalated issuance of LG bonds.

The transfer payments from the CG to LGs in 2024 are set at RMB10.2 trillion, reflecting a 4.1% increase compared to the previous year. Additionally, RMB500 billion of ultra-long special bonds issued in 2024 will be allocated for LG utilisation. The proportion of transfer payments in LG fiscal revenue is projected to steadily rise, bolstering LG's capacity to maintain a balanced income and expenditure framework (Exhibit 3). Concurrently, the introduction of RMB4.6 trillion in LG bond issuance will further elevate the debt ratio of LG. Notably, RMB3.9 trillion of the additional LG special bonds will be directed towards initiatives focused on enhancing quality and efficiency. The special bond quota will be allocated in advance, expediting their issuance and utilisation, thereby ensuring the requisite intensity of fiscal expenditure. Our projections indicate that the growth rate of LGs' direct debt in 2024 will reach 11.3%, resulting in a direct debt ratio of 151% (Exhibit 4).

We contend that resolving the short-term fiscal challenges and debt pressures of LGs necessitates a combination of augmenting revenue streams, reducing expenditures, and bolstering central transfer payments. However, the long-term solution lies in fundamental fiscal and tax system reforms. The Central Economic Conference has put forth the vision of "a New Round of Fiscal and Tax System Reforms," which aims to clarify the responsibilities of both central and local governments, curbing the ongoing expansion of LG expenditure obligations. Potential measures may include the CG assuming certain fiscal and expenditure responsibilities, standardizing transfer payments, and expanding the tax base for LGs, among other strategic initiatives.

Exhibit 3: The fiscal income sources of LG

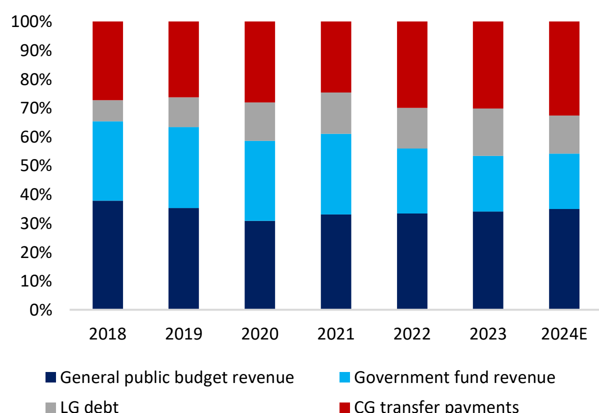
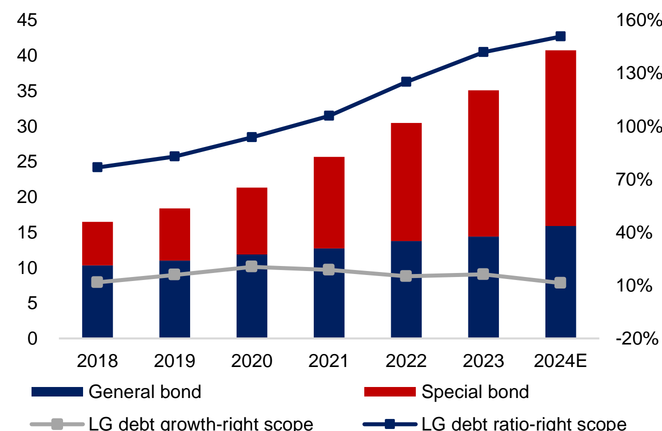


Exhibit 4: The LG debt ratio continues an upward trajectory (RMB trill.)



Note：LG debt ratio=LG direct debt/ budgetary revenue
Sources: MOF, LG departments, CSPI Ratings estimates

Implicit Debt Resolution Alleviates LGFV Liquidity Risk with Strategic Manoeuvring Between CG and LG to Continue

The prolonged strategic manoeuvring between the central and local governments serves as the fundamental basis for debt resolution. Our calculations indicate that by the end of 2023, the interest-bearing debt of LGFVs is estimated to range between RMB60 to 70 trillion. This segment of debt is characterised by short maturities, high interest rates, and imbalances across regions, posing significant challenges to effective debt resolution. Given the current context of fiscal and financial negotiations between the central and local governments, as well as the sluggish LG land sales, the resolution of the LG implicit debt necessitates a comprehensive top-down approach. The implementation of the "Package of Debt Resolution Schemes" in July 2023 exemplifies the proactive measures taken by the CG to mitigate the burden of LG debt. This initiative is expected to promote the debt structure of LGs, reduce the interest costs of their broad debt, and alleviate their fiscal pressures. However, it is important to acknowledge that debt resolution measures may inadvertently give rise to moral hazards and potentially foster opportunistic behaviour among LGs.

As of April 2024, a total of RMB1.48 trillion in LGs' special refinancing bonds have been issued. The issuance pattern indicates a relative concentration of these bonds among a handful of LGs, with the top five provincial governments accounting for over 50% of the total issuance. Notably, provinces such as Guizhou, Tianjin, and Yunnan have obtained larger debt replacement quotas due to their prior history of more aggressive borrowing. Conversely, regions with better control over implicit debt have received smaller quotas. Looking ahead, the sustained resolution of implicit debt relies on a harmonious division of responsibilities between the central and local governments. The CG should play a pivotal role in safeguarding against financial risks, ensuring stable economic growth in critical periods, and facilitating effective pressure transmission from the top down. Meanwhile, LGs should adopt an active approach towards pursuing development, reducing implicit debt, and striving for resource allocation from the bottom up. Such collaborative efforts form the bedrock for achieving long-term and sustainable debt resolution.

The implementation of the "Package of Debt Resolution Schemes" has bolstered the government's accountability in managing general debt, receiving widespread recognition in the market as a confidence boost for LGFVs. Consequently, the plan has led to a notable contraction in the credit spreads of LGFV bonds, thereby mitigating liquidity risks associated with LGFVs. It is worth noting that prior instances of LG implicit debt resolution in 2014 and 2018 were also followed by an overall decrease in the credit spreads of LGFV bonds. However, during those periods, the scale of LGFV bonds did not diminish but instead continued to expand, serving as a cautionary tale from previous debt resolution policies. Therefore, in the current debt resolution endeavours, it is of utmost importance to prioritise measures that not only resolve existing implicit debts but also effectively curb the growth of new implicit debts. Recent measures undertaken to control LGFV debt indicate that the CG has intensified its oversight of new LGFV bond issuance, underscoring its resolute commitment to curbing debt expansion.

As the strategic interactions between the central and local governments persist, the future landscape suggests that commercialised state-owned enterprises may emerge as the primary drivers of local leveraging efforts. While we anticipate increased challenges in securing new financing for LGFV in the future, the strengthened management of LGFV debt by the government will help maintain the overall credit stability of existing LGFV debts. The backdrop of continued stringent regulatory oversight focused on resolving existing debt burdens and curbing debt growth, combined with the transition of regional economic growth engines, will propel LGFV towards market-oriented transformation. This transformation, in turn, will foster the development and fortification of regional commercialised state-owned enterprises.

The central and local governments are expected to increase their direct leverage and benefit from a supportive monetary environment for future infrastructure investments. Nevertheless, the pressing need for sustained transformational development and stable economic growth at the LG level, alongside the persistent issue of fiscal power and responsibility mismatch, will sustain fiscal tensions between the central and local governments.

Consequently, we anticipate an increasing presence of local commercialised state-owned enterprises in the capital market, gradually delineating the boundaries between these entities and LGFVs. Such a shift will introduce distinct risk characteristics, potentially prompting a reevaluation and reshaping of credit analysis dimensions.

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