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Chinese *Risk*

The truth behind China's massive local government debt.

Debt crisis worries are not limited to Europe these days. China's local government debts are also creating jitters, especially after Moody's issued a report in July 2011, saying that China's official National Audit Office had under-reported local government debts by ¥3.5 trillion (US$538 billion) and that Chinese banks' non-performing loans could soar to 12–18 percent of total assets because of their heavy exposure to local government borrowing. This potential danger from Chinese debts seems to underscore China's problems of being an opaque system with hidden debts and rustic economic management policy.

Details of China's local government debts are still scanty, despite the National Audit Office's revelation. So any attempts to quantify the risk of these debts are risky themselves. Macro indicators argue that, at less than 60 percent of GDP, China total public debt (central and local government debt, plus local government financing vehicles) is within manageable limits. China's fiscal and public debt positions also compare favorably with other countries.

The true risks of the local government debts lie in the balance-sheet mismatch of their debt structure, with governments in the central and western regions having the highest risk as they have borrowed beyond their ability to repay. Local government financing vehicle debt risk cannot be ignored, but overall it is not imminent because the government has massive assets on its balance sheet and favorable debt dynamics on its side—namely a nominal interest rate significantly below the nominal GDP growth rate.

THE CONFUSION

The release of debt data for local governments and local government financing vehicles in early July has stirred confusion in the market, leading some to argue that China has massive hidden government liabilities that could blow up any time and crush the banking system. This perception owes much to the lack of consistent data reported by various Chinese government agencies.

The National Audit Office released its estimate of ¥10.7 trillion total outstanding local government and local government financing vehicle debts as of the end of 2010, with the latter accounting for 46.4 percent (or ¥4.97 trillion). Within this ¥10.7 trillion total, 79 percent or ¥8.5 trillion were in the form of bank loans. But in its regional report released before the National Audit Office report, the People's Bank of China reported that its estimate for the local government financing vehicle debt was ¥14.4 trillion. Meanwhile, the China Banking Regulatory Commission had its local government financing vehicle debt estimate at ¥9.09 trillion.

This confusion has led some analysts, such as Moody's, to reestimate the "true picture" of the total

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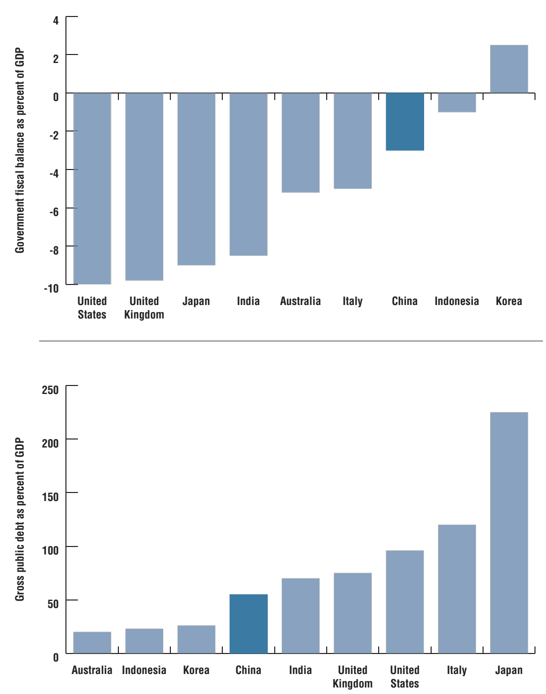
local government debts. Moody's concluded that the National Audit Office had underestimated the local government financing vehicle debt by ¥3.5 trillion, and that these under-reported loans had the biggest default risk. The impact on China's banking sector, according to the Moody's assessment, could be large with potential non-performing loans reaching 8–12 percent of total loans.

OVERALL DEBT RISK MANAGEABLE

Despite being comprehensive, the National Audit Office data are still incomplete so that any attempt to quantify the total amount of local government debts is more of a guessing game than an accurate assessment of systemic risk. However, macro data can still help give a qualitative assessment. The National Audit Office data show that total local government and local government financing vehicle debts account for about 27 percent of GDP. Official data show that central government public debt is another 25–30 percent of GDP. Thus, total public debt is between 50–60 percent of GDP, a manageable burden by international standards (which sets 60 percent of GDP as a dangerous debt threshold). Further, China's public debt burden and fiscal balance compare favorably with many other economies (see figure).

Favorable debt dynamics are also on China's side. Its nominal GDP growth rate averages about 13 percent per year.

Government Fiscal Balance and Gross Public Debt, 2010



Source: IMF

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But the average funding cost of the public debt is about 6 percent. With nominal interest rates significantly lower than the nominal GDP growth rate, China can easily run a budget deficit, financed by borrowing, far higher than it is doing today, and the public debt will still be sustainable. The exception was 2009, due to the government's stimulus program that pushed up the growth of local government debt sharply. But it was an unusual year, and Beijing has embarked on significant normalization measures to rein in borrowing.

Finally, one should not forget that the government has enormous financial resources, and owns the country's land along with controlling stakes in many listed companies. These assets can be privatized, if necessary, to raise funds to fend off any fiscal or debt crisis. In the worst case, even when China had to monetize its debt, its huge current account surplus (a reflection of China being a net creditor to the rest of the world) would ensure that no external-driven crisis would crush the domestic system.

WHERE ARE THE RISKS?

Though it posts no imminent risks, local government financing vehicle debt is not a negligible problem. The key risk comes from the balance-sheet mismatch of the debt structure. According to National Audit Office data, over 50 percent of the local government financing vehicle debt (including that in the form of bank lending) will mature in the next two and one-half years. But these borrowings were invested in long-term projects, mainly social and infrastructure, which can hardly generate enough cash flows to service the debt. And banks are on the hook as almost 80 percent of the local government financing vehicle debt is from bank loans. In addition, when China's interest rate cycle turns up, this balance-sheet mismatch debt structure will inflict a negative shock on the banks, just as the Asian crisis pulled the rug from under the feet of Asia's banking sector in 1997–98.

Continued on page 63

Continued from page 45

Debts of the local governments in the central and western regions are the most risky. They account for 23 percent and 27 percent, respectively, of total local government financing vehicle debt, but only 18.9 percent and 18.6 percent, respectively, of all local fiscal revenues. This means that the interior regional governments have borrowed beyond their means to pay and, thus, are more susceptible to credit or interest rate shocks than the eastern regional governments.

However, the balance-sheet mismatch problem is limited to a liquidity problem for now, as the extent of the structural mismatch loans on the banks' balance sheets is not too serious (only about half of the total local government financing vehicle debt is maturing in 2.5 years). Degeneration into solvency problems is unlikely given the government's massive resources.

WHAT'S NEXT?

Bailouts will be inevitable to resolve the local government debt problem. But unlike the developed world, where governments' hands are tied by their dire financial positions and huge debt burden, China has many options, including funding from governments, asset sales, and refinancing. Local governments may also be allowed to issue bonds soon to finance their social projects and replace their bank borrowing.

Since land sales are the key revenue source for the local governments, Beijing's policy tightening in the property sector may force some local governments into difficulty servicing their debts if land sales were to be cut back under Beijing's tightening directive. Non-performing loans in the banking sector will likely rise but the impact on banks may not be too big. This is because banks may not need to make significant non-performing loan write-offs due to the availability that Beijing has of other bailout options. Further, social projects are the responsibility of the government, but should not be off-balance-sheet spending funded by bank lending. Beijing may in the end come to the rescue of some of the projects funded by bank loans so that the non-performing loan impact on bank balance sheets would be limited.

The surfacing of the local government financing vehicle debt problem has hurt sentiment in the offshore renminbi (or CNH) bond market further on the back of a wave of fraud allegations relating to many Chinese firms listed in North America and Hong Kong since late 2010. A rush of junk-grade CNH bond issuance in the CNH bond market early this year did not help. Recent sales of high-yield CNH bonds have slumped. The market has come to realize that there is default risk, and investment in dim sum bonds is not a simple proxy play for renminbi appreciation anymore.

However, China's public debt situation is well within manageable limits. There is little risk of China hitting a debt wall any time soon, as happened recently in the United States. But when the local governments are given the green light to tap the bond market as part of the solution for the local government financing vehicle debt problem, the central and western regional governments will have to pay a higher risk premium commensurate with their higher profiles. ◆