

China's local government debt

Economic note

27th July 2011

The size of China's local government debt has recently surprised many observers. As a result a number of ratings agencies have moved to highlight their concerns about the creditworthiness of the debt. The problem is, definitely, smaller than the problems that currently beset the US and Europe. But it is a problem for which it is necessary that China finds a solution and this solution will play a role in determining the future direction of the Chinese economy – particularly the role that government and investment spending will play.

In June, China's National Audit Office announced the extent of local government indebtedness at RMB 10.7 trillion or US\$1.7 trillion. Now Moody's estimate that total local government debt is even bigger by a magnitude of perhaps 35% higher. This would put local government debt at between 24% and 29% of China's GDP. Moody's higher estimate is based on lending by banks that is not easily attributable to a particular borrower but is, in all likelihood, the responsibility of local governments. These loans seem to be underwritten poorly and are at high risk of default.

China got to this point as a result of the post Lehman crisis. Prior to 2009, funding for local governments came, generally, from the centre with limited ability for provincial governments to borrow. But with a clear mandate to get money moving in the economy provincial governments were allowed to establish off balance sheet vehicles as a means of borrowing from banks. These vehicles borrowed aggressively, largely to finance public investment in infrastructure.

Now, the ratings agencies believe a large proportion of these loans will go bad. Moody's estimate that the total of non-performing loans in the economy to between 8% and 12%. This is based on default rates in the local government sector of between 10% and 70% and a rise from a current level of 1.14% to 5% in the non-government sector.

Local governments had aimed, and I think this has validity, to re-pay loans through land sales. Land sales have received a lot of criticism. They are considered to be unsustainable and dependent upon a continuing property bubble. Certainly, there is some truth to this. But as valid is the importance of infrastructure to land improvement and so higher land values. Land connected to a motorway, high speed railway or connected to utilities becomes more valuable.

Back in 2009 I heard a story about a district in Yunnan province. The district had recently benefited from a motorway link to the provincial capital of Kunming that cut travel time between the district and Kunming airport by four hours. This cut in travel time was sufficient to allow the district to export its rare mushrooms to Japan. The mushrooms went from a near zero value to \$100 per box. This new income stream, obviously, led to an increase in land values.

Similarly, in India a 60-year airport license was sold to an investment consortium. The consortium raised the value of the license fee within just three years from selling land adjacent to the new airport. The government and market had failed to fully comprehend the value of the land once improved.

So, I am a little more hopeful than Moody's that land sales will be somewhat effective at covering loan payments than they expect. There can, however, be little doubt that loan loss rates will rise and a joint solution by banks and government will be required.

On one hand the government could easily step in and provide support to local governments and banks to help them cope with the rising NPLs. China's US\$3.2 trillion stockpile of foreign reserves is more than sufficient to cover the problem debt, even in a worse case scenario.

But Moody's rightly identify the emergence of moral hazard if such a solution were to be used. Their alternative solution is to allow the loans to wash through the system. This would mean local governments establishing alternative revenue sources and the banks re-capitalising through retained earnings or capital raising. Such a solution may increase short term volatility but provide a more sustainable basis for investment in China in coming years. Given, however, the lack of movement on interest rates, this seems a less likely outcome.

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