Banking Watch
China

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Economic Analysis

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Is China ready for asset sales to address its local government debt?

- **Local governments have much more debt today than we thought they had during the last assessment in 2011.**

  At the end of 2013 the National Audit Office (NAO) issued a long-awaited report on China's public debt, updating its previous report from June 2011. Due to a combination of a more comprehensive assessment and new borrowing by local governments, the latest NAO report resulted in an increase in local government debt to RMB 17.9 trillion (31.5% of GDP) as of June 2013 from RMB 10.9 trillion (26.7% of GDP) at end-2010.

- **We see three risks arising from the increase in local government debt: maturity mismatches, rising interest burdens, and repayment difficulties.**

  Difficulties are most acute in the case of LGFVs, where short-term borrowing is used to finance long-term infrastructure projects. According to the latest NAO report, around 60% of local government debt will come due in the next two years, which may pose liquidity pressure on some local governments if they are unable to roll over existing credits.

- **Drawing on our previous calculations, we update two extreme scenarios to deal with the local government debt, the first being a full bail-out by the central government and the other passing on the cost to the banks.**

  Although the most likely outcome will involve a combination of the two scenarios, we still find it useful to analyze the two extreme cases so as to estimate the upper band of the costs for the public finances and the banks. In the first scenario, in which the central government bears the full cost, public debt would go from 22% of GDP at present to a still-manageable 53% of GDP. However, this excludes SOEs debt and any that related to public pensions. In the second scenario, in which banks take the losses, we make the hypothesis that 50% of local government debts turn bad. The banks would need RMB 1.4 trillion in new capital to cover the write-offs. For comparison, we note that Chinese banks have raised RMB 880 billion during the last wave of banks' capital replenishment in 2010-11. Alternatively, if banks were to keep problem loans on their books, the average NPL ratio would rise by 3.6 percentage points above our baseline scenario (which already shows a steep increase from current levels) to the order of 7.3% by end-2018.

- **The authorities have stepped up efforts to tackle local government debt but more needs to be done to defuse the risks.**

  At the recent Third Plenum and National People's Congress the government has prioritized the overhaul of the fiscal relationship between the central and local governments within a long list of reforms. Local governments will be entitled to more tax revenue, and some local governments are being allowed to issue long-term municipal bonds to replace their existing debts. These measures will help prevent local government debt from become too burdensome in the future. However, it will be equally important to address the existing stock problem. To that end, the huge amount of SOEs' net assets in the hands of the central and local governments (up to RMB 32 trillion by end-2013) could be partially divested to help debt repayment. This would also have the benefit of boosting productivity and enhancing the role of the private sector in the economy, a key goal laid out at the Third Plenum meeting.

Introduction

At the end of 2013 the National Audit Office (NAO) issued a long-awaited report on China's public debt, updating its previous report from June 2011. Due to a combination of a more comprehensive assessment and new borrowing by local governments, the latest NAO report resulted in an increase in local government debt to RMB 17.9 trillion (31.5% of GDP) as of June 2013 from RMB 10.9 trillion (26.7% of GDP) at end-2010.

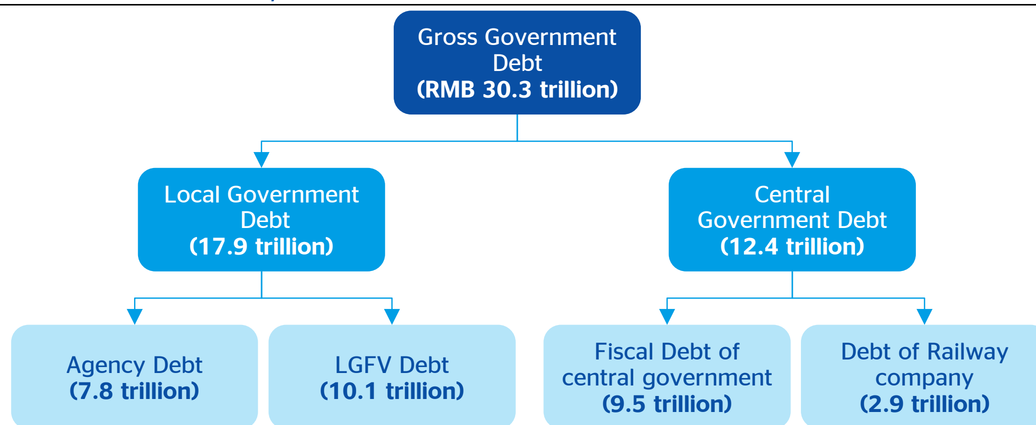
The remainder of this note is an update of our July 2011 report, *Who will pay the bill for local governments' fiscal stimulus?* In that report, we noted that a clean-up of local government debt was eventually likely to require a combination of a bailout by the central government and bank write-offs. Local government debt figure (RMB 17.9 trillion) revealed in the latest NAO report has made us believe that a resolution to this level of debt is still manageable given the large scale of public sector assets and the healthy balance sheet of the central government. Nevertheless, the magnitude of local government debt reduces the room for fiscal stimulus and policy flexibility.

Updating the size and composition of local government debt

According to the latest NAO report, total local government debt (excluding SOEs debt and contingent debt of pension, which are not covered in the NAO report) increased to RMB 17.9 trillion (31.5% of GDP) at end-June 2013 from 10.9 trillion at end-2010 (26.7% of GDP), up more than 60% since end-2010 (Chart 1). The NAO report subdivides local government debt into direct, government guaranteed, and contingent debt. The borrowers of the latter two consist mainly of local government financing vehicles (LGFVs).Moreover, the NAO report also reports the debt level of the central government (RMB 12.4 trillion, or 21.8% of GDP), which include both general fiscal debt of the central government (RMB 9.5 trillion, or 16.7% of GDP) and the debt of the national railway company (RMB 2.9 trillion, or 5.1% of GDP).

Following the classification used in our previous report, we categorize local government debt into agency debt (direct borrowing by local government agencies such as schools and hospitals), and debt of LGFVs, used to finance infrastructure projects. According to the latest NAO report, agency debt rose by 37% since June 2010, to RMB 7.8 trillion as of end-June 2013 while LGFV debt doubled to RMB 10.1 trillion. The fast growth in LGFV debt reflects the authorities' use of infrastructure investment to counter economic downturns over the past several years. (Chart 1)

Table 1
Debt Structure of China (by June 2013)



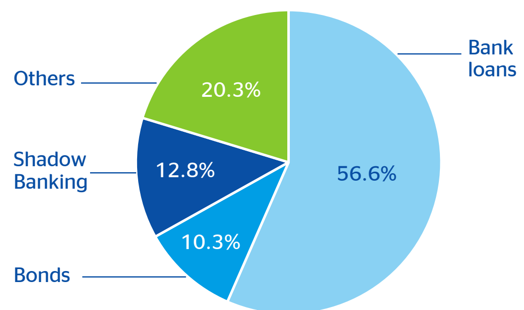
Source: BBVA Research

The NAO report also provides a breakdown of local government debt by funding source. Bank loans still account for the bulk of local government debt, but its share has dropped to 57% of total outstanding local government debt at end-June 2013 from 79% at end-2010. Bond issuance and various forms of shadow banking activities (such as trust loans, borrowing from security firms, insurance companies, and lease financing), have been an increasing source of finance for local governments (Chart 2).

Chart 1
Infrastructure investment and debt accumulation of local governments

Source: NAO reports, CEIC and BBVA Research

Chart 2
Bonds and shadow banking have become new important funding sources



Source: NAO Reports and BBVA Research

Why worry about the rise in local government debt?

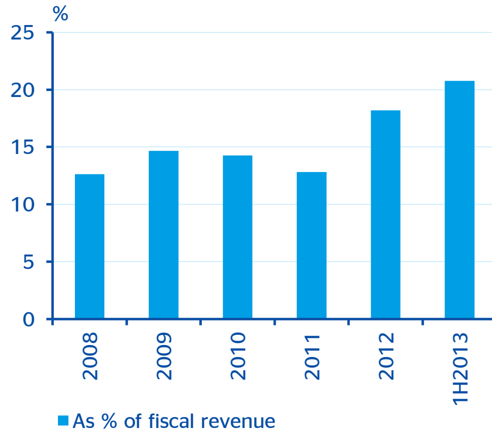
We see three risks arising from the increase in local government debt. First, maturity mismatches are present, especially in the case of LGFVs, where short-term borrowing is used to finance long-term infrastructure projects. According to the latest NAO report, around 60% of local government debt will come due in the next two years, which may pose liquidity pressure on some local governments if they are unable to roll over existing credits.

Second, interest rate payments are adding pressure on local government balance sheets. According to the IMF[1], local governments pay around 6%-8% on average, higher than the average interest rate paid by the central government (4-5%) and above the benchmark lending rate (6%). Moreover, local governments who turn to the shadow banking sector pay even higher interest rates. We estimate that the interest payments of local governments have risen to 20% of their fiscal revenue (Chart 3).

Third, as revealed by the NAO report, a large portion of local government debt (37.2% by end-2012) needs to be repaid through proceeds of land sales, which is apparently not sustainable in the long run. Also, any downward adjustment in the property market might exert an adverse impact on local governments' land sales revenue and dampen local governments' capability of debt servicing.

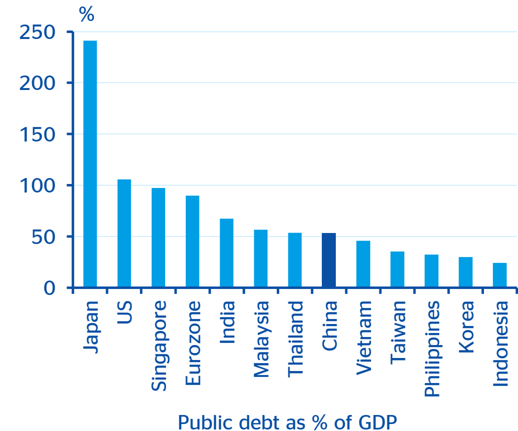
1: See *Fiscal Vulnerabilities and Risks from Local Government Financing in China*, by Yuanyan Sophia Zhang and Steven Barnett , IMF Working Paper, 2014

Chart 3
Interest payment of local government debt has exceeds 20% of their fiscal revenue



Source: CEIC and BBVA Research

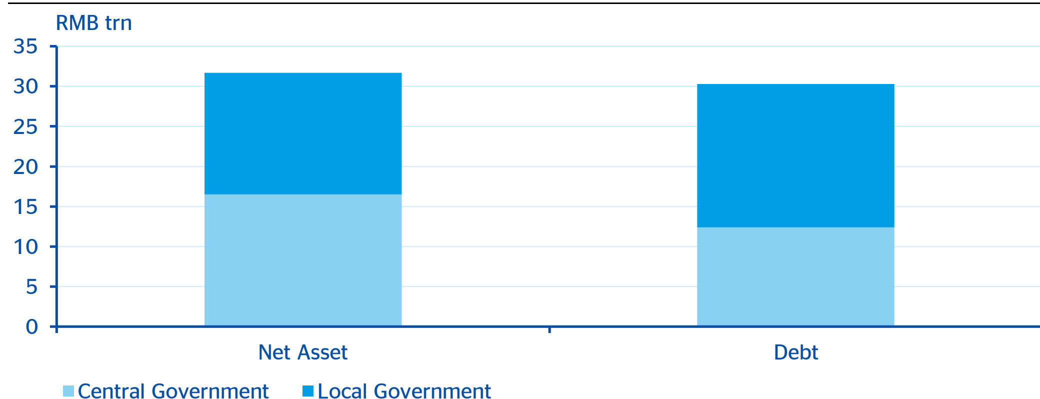
Chart 4
China's total public debt remains manageable compared to other countries



Source: Bloomberg and BBVA Research

Given the lack of resources, local governments will need help from the central government to address their debt burden. The good news is that the central government is in a position to help. In particular, the central government balance sheet is still in good shape given that their outstanding debt only stands at around 21.8% of GDP (RMB 12.4 trillion). Combined with local government debt, total public debt amounted to 53.3% of GDP, which is still not high compared to other countries (Chart 4). Moreover, according to the Ministry of Finance, net assets of SOEs under the control of the central and local governments amounted to RMB 16.5 trillion and RMB 15.2 trillion at end-2013 respectively, more than sufficient to cover local government outstanding debt of RMB 17.9 trillion. (Chart 5)

Chart 5
Governments' Net assets vs. Debt



Source: CEIC and BBVA Research

Who will pay the bill?

In our previous note, we considered two extreme scenarios for addressing the local government debt problem, one involving a central government bailout and the other involving bank writeoffs. In reality, we expected the most likely outcome to involve a combination of the two scenarios.

Our conclusions still hold broadly true. The latest NAO report clarified the role of the central government in bearing responsibility. Nevertheless, it seems unlikely that banks will get off scot-free. For the time being, the central government has shown little appetite for a bail out of local governments, probably to avoid exacerbating moral hazard. Instead, the central government has urged local governments to resolve their debt problems, and to that end has allowed local governments to issue municipal bonds to replace existing debt. In the face of mounting repayment pressure, it is likely that local governments will seek to roll over or restructure their bank obligations.

In a worst-case for banks, we consider a scenario in which they, rather than the central government, were to absorb the cost of impaired LGFV debt. In such a scenario, we still assume that the central government would bear responsibility for direct debt of local government agencies (RMB 7.8 trillion) given the nature of central/local fiscal relations and the degree of integration of their budgets. As noted above, it is the case that LGFVs have been turning to other sources of funds such as bond issuance and the shadow banking system. However, ultimately, repayment difficulties related to these sources would appear on bank balance sheets. This is because the bond market is dominated by banks (according to the Asian Development Bank's September 2013 *Asia Bond Monitor*, banks hold nearly 80% of treasury bonds and one-third of corporate bonds).

In our scenario, we assume that 50% of LGFV debt will go bad over the next five years. This is higher than we assumed in our previous assessment (35%) owing to rising risks. With timing passing, good debt has been paid off while bad debt keep rolling over and expanding with accrued interest rate. Other key assumptions include the annual (risk-weighted) asset growth (13%), annual profit growth (1.5% owing to slower GDP growth, narrower net interest margins, and deteriorating asset quality), and no dividend payouts over the next five years.

There are two possibilities open to banks in such a scenario. One is for them to provision and write-off these loans as they come due over the next 5 years. Under this approach, banks would need to raise additional capital of RMB 1.4 trillion over the next 5 years in order to maintain their capital adequacy ratios above the 11.5% minimum regulatory level. This amount of capital compares with RMB 880 billion raised during 2010-11, and is double our previous estimate due to the higher outstanding LGFVs amount and higher assumed loss ratio this time.

A second option would be for banks to carry the problem loans as NPLs for an extended period, rather than writing them off as they come due. All else equal, this would increase the banking sector's NPL ratio by 3.6 percentage points by end-2018, to 7.3%. Such a scenario, of course, would require banks to restructure loans and take capital losses at a later stage.

In the meantime, what is the best way to deal with local government debt?

The authorities have been emphasizing the urgency of the need to tackle local government debt problems. At the recent Third Plenum and National People's Congress they prioritized the overhaul of the fiscal relationship between the central and local governments on the long list of reforms. Local governments will be entitled to more tax revenue, commensurate with their social spending obligations. The authorities are also seeking to reduce the weight of provincial GDP in the performance appraisal system of local government officials, which would help reduce their incentive to engage in wasteful infrastructure projects. Finally, some local governments will be allowed to directly issue long-term municipal bonds instead of through the central government, to replace their existing debts, which should help alleviate the maturity mismatch.

The measures noted above will help prevent local government debt from become too burdensome in the future. However, it will be equally important to address the existing stock problem. In this respect, one solution would be for local governments to sell their controlled SOE assets to raise funds for debt repayment. At the same time, this would have the benefit of boosting productivity and enhancing the role of the private sector in the economy, a key goal laid out at the Third Plenum meeting.

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