

Market Focus – China’s local government debt

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Is the problem worrying?

- ◆ Media has given wide coverage to the risks of China’s hidden local government debt mountain this year. Local governments in 2009 set up numerous special purpose investment vehicles (SPVs) to finance the massive fiscal package announced in November 2008 to combat the global credit crisis (local governments are not allowed to directly issue bonds nor borrow from banks).
- ◆ It is estimated by officials that the total liabilities of these SPVs amount to RMB 6 trillion, up from around RMB 1 trillion before the crisis. Some analysts even forecast the total number to be as high as RMB 11 trillion. However, it is still difficult to come up with the exact number given their opaque structure, and therefore this is causing concern to the market. Nevertheless, we think investors are overworried about the problem for the following reasons:-
 - (1) It is irrational to assume all local government borrowing will become non-performing loans (NPLs). Many of the infrastructure projects launched last year had been put on hold in previous years due to concerns of overheating, but they had successfully passed feasibility studies.
 - (2) Even in the worst scenario that all local government debts turn bad and are transferred to the central government’s balance sheet (local government debt is guaranteed by the central government), China still has lots of room to increase government borrowing given the very low public debt-to-GDP (36% in 2008).
 - (3) Also, the government has achieved an average of 20% revenue growth over the past 10 years. And if necessary Beijing can always increase revenues further through land sales, privatisation of state-owned enterprises and selling some of their controlling stakes in listed companies.
 - (4) It is possible that some local funding companies will be closed and the banks will then bear the burden of their loans (the majority of their liabilities are bank lending). CLSA have done a stress test on China’s banking system. Assuming 50% of loans from the stimulus package (RMB 2 trillion with loan-to-value ratio of 80%) turn bad and adding back off balance-sheet bad debts, NPLs would climb from the current 1.6% to 7.2%, a still-manageable NPL ratio.
 - (5) A vast default by local government is politically unacceptable. So the central government would bail them out if necessary. Also, local governments may well be given some rights to issue bonds in the near future, given China’s massive domestic savings. Thus it is not difficult to solve the infrastructure funding shortage problem, which only exists in the eyes of foreign investors.
- ◆ The mismatch between local and central government budgeting has long been a structural problem in China. It is unlikely to lead to a serious systematic risk for China’s banking system nor to derail the fiscal health in the near term.
- ◆ Although the problem has long been identified, the reform progress has been very slow. The recent concerns could be a trigger for more decisive reform measures by the Chinese central authorities. Also, the government’s scrutiny of new local government borrowing earlier this year is a very positive sign as the officials are addressing a potential problem early.

