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Bond Issuance by Local Authorities in China

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Background Briefing: Bond Issuance by Local Authorities in China

Executive Summary

The massive fiscal and monetary expansion used to promote growth in 2009-10 has had important repercussions on government finances, particularly for local authorities that were at the forefront of the surge in expenditure. The deficit spending of local governments was largely hidden at the time but now appears to have cumulated to at least RMB (renminbi) 10.7 trillion (1.3 trillion euro) for 2009 and 2010. This was only made possible through substantial financial support in the form of both overt bank loans and covert "irregular borrowing", amassed within investment vehicles (said to total 6,500 units[1]) set up to bypass the Budget Law enacted in 1994, which forbade local authorities from running deficits and issuing debt.

Borrowing through investment vehicles has not only obscured the scale of local authority debt but has added to concerns over further hidden risks. In addition, the possibility of a slump in the property market has exacerbated worries about local authority finances. Property has provided collateral for loans while authorities' revenues have been boosted by land sales, which now appear to have come to a standstill in the regions worst affected by the cooling in the real estate sector[2].

Although central government debt remained steady at about 17% of GDP from 2008 to 2011, incorporating all of the recent surge in local authority borrowing into official statistics probably implies that total government debt more than doubled over this period to reach 45-50% of GDP[3] at the end of 2011. While China is clearly a long way from crisis levels of debt and draconian fiscal austerity, such a rapid swing in public sector finances, amid revelations of unexpectedly high debts and irregularities on the part of local authorities as well as nervous international financial conditions, has served to alarm many observers and may even threaten China's sovereign debt rating[4].

However, these financial problems are being addressed:

[1] Bloomberg, 4 January 2012.
[2] For example, in a Financial Times report from Guangzhou, 7 December 2011, it was suggested that land sales, which account for as much as 40% of local government revenues, might have dropped in 2011 to a third of the level seen in 2010.
[3] GDP for 2011 was just over RMB 47 trillion (data released January 2012)
[4] Standard and Poors, one of the leading rating agencies, confirmed China's sovereign debt rating of AA- in December 2011 (it was upgraded at the end of 2010 from A+ following a similar move by Moodys). However, Fitch has warned of possible future downgrades to its AA- rating for China on concerns over rising bad debts.

- Local authorities considerably reduced irregularities and some debts during 2011 (according to information released by the audit office[5]), and borrowing may have been exaggerated in certain cases due to misinterpretation of financial accounts.
- Anecdotal evidence points to banks extending loan repayment dates although the central government has cracked down on loans for new projects (with the exception of affordable housing) on concern over excess investments and debt.
- A key group of authorities were given permission in the autumn of 2011 to raise funds through bond issues guaranteed by the central government. So far, some RMB 22.9 billion (2.8 billion euro[6]) appears to have been raised by four regional governments[7] at yields of 3-3.5% (in line with central government bonds but around half the rate on bank debt).
- With spending constraints in place, coupled with new avenues of funding, local government finances should begin to decouple from the property market, with spending being brought more closely into line with non-property related revenues and funds.

The landmark decision for the central government to allow local authority bond issuance represents an important break with the 1994 Budget Law and shows recognition of the heavy financial burden on local authorities and the need to limit financing of debt through costly short-term loans. If the pilot project for local authority bonds is expanded, then the growing government debt market may have further important implications for the position of China in the global financial system.

To summarise, the key anticipated effects of the issuance of bonds by local authorities include:

- The opportunity for local authorities to reduce interest costs on debts incurred during 2009-10 and to delay repayment for at least the duration of the bonds (typically 3-5 years). This will relieve payment pressures during a period of more sluggish growth in the economy and in government revenues.
- An improvement in transparency regarding local authorities' financial dealings and scale of debt. This in itself will bolster market sentiment.

[5] Reported by Bloomberg on 4 January, 2012
[6] Current exchange rates are used unless otherwise stated: 8.3 RMB/euro, 6.3 RMB/dollar.
[7] Shanghai (RMB7.1billion), Zhejiang (RMB6.7billion), Guangdong (RMB6.9billion) and Shenzen (RMB2.2billion).

- If handled well, increased bond issuance could be a very positive step towards the creation of a larger and more liquid government bond market in China – a potential competitor to the government bond markets of Europe and eventually to that of the USA that would help balance regional wealth and asset markets compared with a so far wealth-heavy but asset-lite Asia.
- A large, liquid bond market will also help foster the development of the renminbi as an international currency. Compared with China's dominance in world trade, the renminbi still plays a very minor role in global trade settlements and the financial system in general. This is already changing thanks to growth in the offshore RMB market but a larger domestic bond market and further opening of the capital account would speed progress.

China's international partners should welcome moves that reduce the risk of instability and improve clarity of financial statistics and operations in China – and also boost the longer-term potential for China's bond market to become a key part of a better balanced global financial system.

Introduction: the rise in local authority debt

In response to the global crisis of 2008-09, China embarked on a rapid expansion in government spending accompanied by an equally massive relaxation in bank lending. The announced fiscal package (initially targeted to be about 13-14% of gross domestic product (GDP), spread over 2009-10) was accompanied by a rise in total bank loans from RMB 30 trillion at the end of 2008 to RMB 58 trillion (RMB 55 trillion excluding foreign currency loans) by the end of 2011. In 2009 alone, the expansion in bank lending soared to RMB 10 trillion (growth of more than 30%).

Of the three year increase of almost RMB 30 trillion in lending, at least one third (possibly as much as a half), was handed out to local authorities' investment vehicles[8], implying that the two-year fiscal stimulus started in 2009 was roughly double that initially intended, or more if additional local authority land sales swelled the total spend. The true consolidated budget deficit for China was not the modest 1-2% reported for the last three years. It reached over 12% of GDP in 2009 and only fell to about 3.5% in 2011 thanks to strong economic growth. In spite of the present brake on spending, the government may find it hard to cut the 2012 deficit below 2% (not alarmingly high but still about double previous estimates for the deficit, for example, from the International Monetary Fund (IMF)).

This effort did successfully push GDP growth up from around 6-6.5% in late 2008 and the first quarter of 2009 to rates in the 9-12% range from mid-2009 to the end of 2011. The momentum behind domestic demand rose sharply and the gains generated more than offset large losses in exports during the global recession. However, growth peaked in the first quarter of 2010 (when GDP growth over the previous twelve months reached an average of 12.1%) and the pace has now fallen back to more manageable rates, with GDP up by just 8.9% in the last quarter of 2011.

While the stimulus was successful in forcing up both the pace of growth and global confidence when these were most urgently required, the scale arguably turned out far bigger than it needed to be to offset the risk of recession and achieve non-inflationary growth rates of around 8.5-9% in 2009-10. A much smaller stimulus could have sufficed. In fact, the substantial surge in growth stoked overheating problems, while extremely rapid loans growth brought fears that the boom would turn into a flood of bad debts.

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[8] This annual borrowing of RMB 3-5 trillion should be compared with local authorities annual revenues from taxes in this period of RMB 3-4 trillion,

Concerns about the potential for escalating bad debts heightened in 2011 as the clampdown on bank lending restricted borrowers' potential to use top up loans as a means of masking repayment problems and avoiding delinquency. The sharp slowdown in global trade and in the Chinese economy in late 2011, combined with rapid cooling in China's property market and construction sector, only added to these fears.

While property developers, companies with extended borrowing and the banking sector are key areas of concern, local authorities are also at risk.

Speculation over the scale of local authorities' borrowing – including irregular loans – began to emerge in the international press last year and some details were officially released by China's audit office during the second half of 2011[9]. In particular, it was confirmed that outstanding borrowing by local authorities surged to RMB 10.7 trillion at the end of 2010, with irregular debts assessed at RMB 531 billion. Yet private analysts (in particular Moody's) continued to suggest that a further RMB 3-4 trillion in debt was likely.

On the positive side, in early January the audit office announced that about half of irregular debts had been cleared during the course of 2011. However, the worrisome revelations of the scale of local authority debt have served to turn the spotlight on the threat posed by such borrowings, both in terms of potential repayment difficulties and a possible escalation in central government debt.

This situation has also highlighted divisions between central and local government policy priorities, revenue sharing and access to funding. Excluding operations undertaken via investment vehicles, funding of local authorities' expenditure has been largely from tax revenues (roughly divided between central and local governments) and from land sales (around 40% of total spending). Now the latter looks set to provide a much lower contribution.

Tensions between local and central government over policies and revenue sharing

There are clearly increasing tensions between the local authorities' perspective – the promotion of high activity rates, large scale projects and the ever more advanced development of their region – and that of the central government, which, having initially encouraged a spending surge to offset the recession risk, has become increasingly concerned over the last couple of years about over-investment, the build up of excess capacity and hidden debt risks. Exercising its power, the central government is now directing banks not to permit lending to local authorities (or their non-commercial investment vehicles) for new infrastructure projects (with some exceptions such as the new national priority of affordable housing). It is also reining in the property sector, which will act as a further restrainer on local governments' funding potential and further development plans. These constraints are putting a brake not only on China's rate of investment and growth but also on local authorities' autonomy.

In turn, local authorities complain about their low retention rate for taxes, the rising cost of social policies for which they shoulder the burden and the constraints on investment now imposed by the central government:

- Since the mid-1980s, when local authority and central government spending were roughly equivalent, local authority spending has risen at a far faster pace: by 2000, it was roughly double that of central government and today, it is about four times greater. About a third of reported budget expenditure is on education, social safety nets, pensions and medical costs.
- Yet the revenues at the disposal of local authorities remain about the same as the revenues attributed to central government. While the lower spending of the central government has left it with very small budget deficits, for local authorities, the gap between spending and revenues has had to be met from land sales (as much as 40% of the budget), which could shrink dramatically if the property sector slumps.
- One of the issues that has typically been raised by local authority leaders both historically and more recently (in the context of their deficit spending), is the amount of tax revenues paid over to the central government. Local authorities see this as unfair and one of the reasons they have to find alternative funding and rely on land sales.
- The central government's major source of revenue (over 50%) is the return of VAT and consumer tax receipts while local authorities keep only about 20% of these revenues. In contrast, local government keeps about 75% of business and corporate taxes. Income taxes are more equally divided but account for less than 10% of total government revenues versus roughly 30% for business and corporate taxes and almost 40% for VAT and consumer taxes.

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[9] This has coincided with, and may even be associated with, the handover of power to the next generation of leaders, which culminates in changes at the very top of the party in 2012.

The problem for Guangzhou and other city governments is that they must hand over a portion of the VAT and other taxes they collect to Beijing, but they still need to finance huge construction projects. This leaves them overly dependent on land sales…

The Financial Times, December 7, 2011

Rising revenues and limited responsibility for expenditure other than defence (about a third of the reported central government budget) have enabled China's central government to maintain very modest levels of debt, with total borrowing typically in the range 16-18% of GDP (currently about RMB 7-8 billion) according to data reported by the national statistics office and international institutions[10]. And very little of this debt is borrowed abroad (less than 1%), while the central bank now holds external wealth of 3.2 trillion dollars in the form of foreign exchange reserves.

Many analysts point to the potential for government debt to approximately double if the central authorities have to absorb all the debt built up by local authorities over the last three years and take responsibility for some deficit spending if property markets and therefore land sales remain weak.

Combining official figures for local authorities' outstanding debt (quoted at RMB 10.7 trillion at the end of 2010[11]) together with estimates of additional hidden borrowing (possibly worth an additional RMB 3-4 trillion) and central government's outstanding debt of RMB 7-8 trillion implies that (in a worst case) total government borrowing may be as high as RMB 20-25 trillion, that is, about 45-50% of GDP. And ongoing budget deficits could be 2-3% of GDP rather than the 1-2% previously expected.

However, if the central government were to effectively guarantee all local authority borrowing, official bank bail outs would probably be unnecessary, eliminating the second perceived threat to government finances. Overall government debt would still remain manageable, especially for a still fast developing country.

Although concern over a debt disaster may be exaggerated, the debt scare could imply that the sharp curbs on government borrowing (especially the crack down on local authority's

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[10] Under the budget law of 1994, local authorities were not supposed to incur deficit spending, hence their substantial borrowing has not been included in national debt estimates.

project financing) will remain in force. If this persists in the longer term, it will lead to a permanent slowdown in both the rate of investment and GDP growth.

Thus a shift towards more restrictive fiscal policy and lower long-run growth projections – rather than a debt crisis - may be the most likely downside scenario to emerge from the local authority debt scare.

China's savings structure and implications for bond issues

China's bank deposits are massive, reaching about RMB 81 trillion (RMB 83 billion including foreign currency deposits) at the end of 2011, almost double GDP (RMB 47 trillion in 2011), and these deposits are still rising strongly at just under 15% per annum. Other financial assets are bonds (less than 20% of GDP) and equities (with the stock market capitalisation[i] displaying considerable volatility, varying from the current, unusually low, valuation of around 50% of GDP, or RMB 23 trillion, to a more normal 100% of GDP during past peaks such as 2007[ii]). With low foreign participation, most of these assets, worth in total about two and a half times GDP, are held by Chinese investors.

Official external wealth, largely held by the central bank in the form of US, European and other government bonds, was reported as 3.2 trillion dollars at the end of 2011. Private external wealth is likely to be higher than officially recognised thanks to long-term leakages of capital out of the country: the total could well be more than 1 trillion dollars, about 5% of financial wealth.

The structure of China's domestic financial system is most obviously "bond-lite" (and bank deposit "heavy") compared with other large markets such as the US, Japan and the EU, where as much as 60-100% of GDP[iii] is typically held in government bonds alone (the instruments preferred in many pension funds). In total, it is typical for about 25-30% of financial wealth to be invested in the form of bonds, compared with current holdings in China of less than 10%. The potential for change is illustrated below.

Comparison with other economic blocs would suggest that Chinese savers might reasonably hold a lower proportion of financial wealth in bank deposits and as much as 50-60% of GDP in government bonds. But this can only change

[11] About equivalent to the annual increase in bank lending over the previous year.

if more government bonds are made available to savers either directly or through investment products such as pension funds and insurance policies.

The table below presents a stylised schema for China's asset markets, demonstrating how asset holdings could begin to shift over the next four years (to 2015) if the government were to gradually convert local authority debt into government bonds over this period. Such a shift in the structure of wealth is unlikely to happen quickly, but it is important to consider the potential for such a change in China's financial markets and its implications. It is certainly viable to envisage a larger bond share in wealth, although yields could tick up slightly towards 4% (*ceteris paribus*) and new issues would need to be timed carefully to avoid greater price volatility.

A stylised comparison of China's financial asset holdings versus a hypothetical schema for the future (estimates in RMB trillion)

	Value	*Potential value*	
	End 2011	2013	2015
RMB BANK DEPOSITS	81	95	110
EQUITY MARKET CAPITALISATION	23	45	70
GOVERNMENT BOND MARKET	8	15	25
TOTAL FINANCIAL WEALTH	112	155	205
Compared with			
ANNUAL GDP in 2011	47	59	73
FINANCIAL WEALTH as % GDP	238	263	280

The structure of assets and savings in China, with substantial holdings of highly liquid bank deposits, matters for economic and financial stability. This concern has been raised in the past as well as today.

In the late 1990s, many feared that poorly performing banks, weighed down by non-performing loans, might suffer from bank runs – fortunately, these did not materialise as bank deposits were backed by government guarantees and the government also stepped in with bail outs for the banks. The storm passed. But the threat remains.

Concern over a possible mobilisation of the large pool of liquid savings may also be an important factor holding back the full opening up of the capital account of the balance of payments (and thus exchange rate liberalisation).

Once China fully liberalises the capital account, private savers will be able to freely transfer funds out of the country into foreign investments. Some portfolio diversification would be expected - and considered normal given low (official) holdings of wealth abroad. Capital inflows from abroad would likely also rise.

However, large holdings in liquid bank accounts in China could turn a moderate outflow into a flood of money moving abroad – with highly disruptive consequences for China but also for recipient countries. These would probably be better anchored in domestic savings instruments (as they would be in the US or Europe) before the capital account is fully opened.

And a flood of money from China would only add to the waves of carry trades that have emerged in recent years: these have already been heavily criticised for their destabilising effects in countries such as Brazil, Indonesia and Turkey.

[i] Calculated as the combined valuation of the Shanghai and Shenzen stockmarket capitalisations, as quotes on the stock exchange websites.

[ii] International comparisons (see technical appendix) show stock market capitalisations tend to be around 100% of GDP except for financial centres including listings of large numbers of foreign companies.

[iii] Shares have risen during the crisis and Japan's government bond market is now around 200% of GDP.

From the threat of a debt disaster to new opportunities in world markets

So far, most of the public discussion about China's financial trends – especially the unexpectedly high local authority debt burden - has focussed on the threat posed to stability and growth in China. That is, the focus has been on worst case scenarios.

However, compared with these much-discussed worst case scenarios for the Chinese economy, more positive outcomes are possible.

For example, the property sector in particular and bad debts in general would become less of a threat if confidence in the growth outlook improves. The currently weak stock market would also see rapid price gains, adding to more positive sentiment and prosperity.

Apart from being influenced by growth expectations, the property market will benefit from continuing rapid urbanisation. Although there are difficult spots, the market may be less over-supplied and over-priced on a nationwide basis than some analysis suggests: the number of housing units being built each year (7-8 million) remains commensurate with the needs of expanding city populations and requirements for replacement and upgrading[12].

Official recognition of the status of migrants into urban areas might provide a further boost to the property market (although probably chiefly at the bottom end of the market) although there would be higher annual social costs incurred by local governments. And local authorities will be able to obtain loans to develop affordable housing, benefiting the construction sector.

A firm property market would restore confidence in local authority finances and the viability of projects. What currently appears as a serious debt risk could quickly become a minor incident in public sector finance.

In addition, the move to permit local authorities to issue bonds (guaranteed by central government) could be turned into a benign shift in China's savings trends and bond market presence. Issues could become part of an important restructuring into long-term investments and away from highly liquid bank deposits.

Government bonds bear much lower interest costs than rates on bank loans (6.5% or more), commensurate with the maximum rate on savings deposits (typically less than 3.5%, which is below recent consumer inflation rates of 4-5%). They offer benefits both for local authorities doing the borrowing (reducing interest costs) and for private and institutional investors seeking a steady yield on their savings.

Expansion of this new segment of the government bond market compares favourably in terms of transparency and regulation with the high-risk informal banking sector, which nevertheless appears to have attracted sizeable funding from private investors hungry to earn higher returns but not necessarily appreciating the risks involved.

From the Chinese government's perspective, encouraging households and companies to lock away more of their cash in relatively secure long-term instruments will help reduce the risk posed by the massive pool of liquid savings both for the domestic financial system and, as capital flows move towards full liberalisation, for balance of payments and exchange rate stability.

Conclusion: Is China moving towards a debt crisis or a strengthening in its influence on the global financial system?

Sharply conflicting views about the scenarios that might emerge from the present situation in China have been presented here:

- Most analysis focuses on difficulties ahead and the potentially apocalyptic explosion in bad debts and excess capacity in China's infrastructure and property markets.
- However, similar "debt disaster" scenarios were common in the late 1990s: in fact, in spite of substantial non-performing loans in the banking system, the central government managed to recapitalise the banks and restore high rates of economic growth.
- Although the financial strength of the government has been tarnished (possibly impaired) by the rise in local authority debt, the debt position should be manageable unless there is more serious damage to the economic growth outlook and thus to the potential for the economy to absorb excess capacity and debt.
- As long as growth picks up, current tensions should be quickly resolved – and the government even has the potential to turn the increase in government debt issuance to its advantage in terms of building up an important presence in world bond markets.
- But if growth stalls and capacity cannot be absorbed, the repercussions will be felt not only in terms of crimping China's financial strength but also in the policy directions that will adopted by China's new leadership for 2013 and beyond.

Rather than adopting one scenario or the other, it is more important to examine the indicators that might point to which path China is following in the months ahead.

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[12] See the review of the housing market referenced at the end of this briefing for further arguments over housing demand and the valuation of the housing market.

Critical points will be:

- Economic growth: will this remain high enough to prevent rising unemployment and a serious property crash? If growth dips from the current 8.9% rate towards 8%, concerns will rise – below 8% tensions would escalate.
- Property markets: will prices and activity rates stabilise or could there be a collapse amongst those property developers with poor financial backing?
- Revelations of bad debts: are concerns set to wane or may there be a further flow of bad news on hidden debts and non-performing loans?
- Local authority funding: can an expansion of local authority bond issuance succeed in improving debt management, transparency and interest costs without stressing the bond market? Alternatively, if bond issuance stalls, will bank lending restrictions ease enough to avoid local authority bankruptcies?

The next six to twelve months should reveal important trends that will probably dictate the direction of China's economy, finances and policies over the next decade.

While China is now a major force in the global economy, there is scope to accelerate China's role in the world financial system. What appears to many analysts as an unfavourable, even dangerous, debt situation could be leveraged to China's advantage if it seizes the opportunity to strengthen the government bond market and its position in world markets.

Local authorities' debt issuance could have a substantial impact on global financial markets. Although important for the local authorities involved, the scale of their bond issuance is so far tiny compared with China's overall market size, wealth and GDP. Issues since the autumn of 2011 total less than RMB 23 billion.

If issuance remains small scale, then the local authority bond market will be merely a minor diversion in the history of China's emerging financial system.

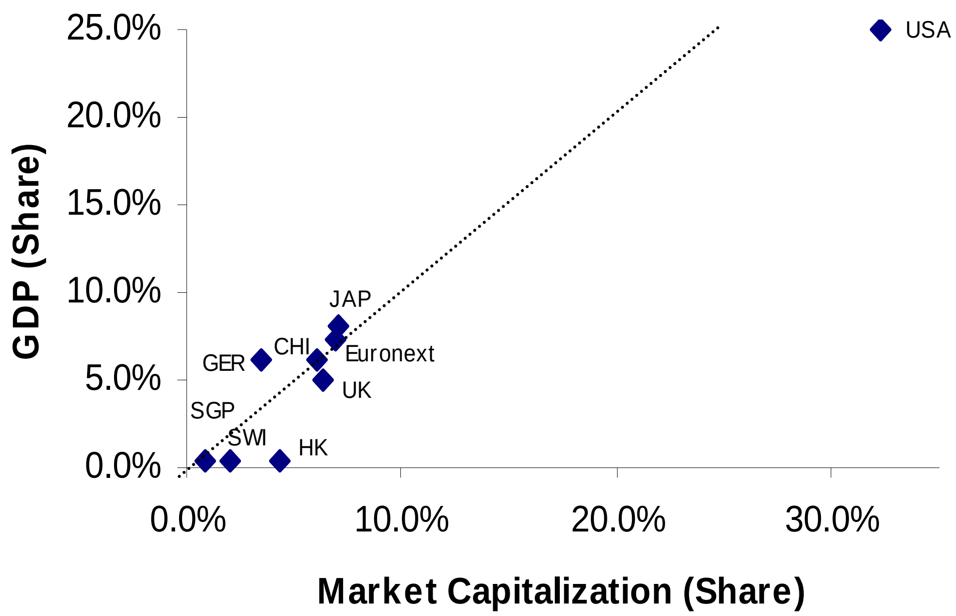
However, there is potential that these first steps could represent the beginnings of a major shift towards the development of a large, liquid government bond market. China may then be in a position to supply the critical missing market in the global system – a large, liquid, active and open government bond market in Asia that could act as a counter balance to the markets of the US and Europe. This would also accelerate the rise of the renminbi as an international currency.

Reference

Vanessa Rossi, Kuangyi Wei and William Jackson "Towards a Sensible Valuation of China's Residential Housing Market", short listed for the annual Society of Business Economists (SBE) prize, 2011 (available from the SBE or the authors)

Technical Appendix

Comparison of country shares in GDP versus shares in Global Equity Market Capitalization (2009 historic data)



Source: Vanessa Rossi "The Outlook for Tokyo as an International Financial Centre" Chatham House report, 2009