

An Introduction to Chinese Local Government Debt

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1 Introduction

The growth of Chinese local government debt has accelerated over the last five years, reaching RMB 24 trillion² (\$3.81 trillion) in 2014, or 37.7% of GDP.³ Set against a backdrop of a Chinese economy that is growing at its lowest rate since the economic reform of the 1980s, the high debt levels have become a policy concern both within China and internationally. Chinese policymakers have taken several steps to mitigate the risks to the Chinese financial and fiscal systems, but further measures will likely be necessary. This paper describes key aspects of Chinese local government debt including the reasons for the buildup, statistics related to its distribution and impact, and policy actions that are being taken or proposed to address the buildup and avert defaults.

Governments at all levels in China rely to a greater or lesser extent on debt financing. China has five levels of government. From top to bottom those are central, provincial, prefectural/municipal, county, and township/village. The central government has political and financial control over all lower levels. Here by “Chinese local government debt” (henceforth “local debt”), we refer collectively to obligations of the lower four levels. In fact, central government debt is also significant, and in some cases, debt can be shifted between central and local governments’ balance sheets. For example, according to official data from China National Audit Office (NAO), the size of outstanding central government debt was RMB 12.38 trillion in June 2013, versus RMB 17.89 trillion of local debt in the same period. Therefore, taking into account the size and trajectory of central government debt is also important in assessing sustainability. However, the analysis here focuses entirely on local debt.

Limited data availability prevents a thorough dissection of local debt, and hence the analysis provides summary statistics rather than a fuller econometric analysis. Nevertheless, the available data is sufficient to provide a basic understanding of magnitudes and trends. Part 2 of this report gives an aggregate overview of local debt while Part 3 decomposes it at the provincial level. Part 4 considers future growth trends and summarizes recent policy developments aimed at controlling the buildup.

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² According to a report presented by Lou Jiwei, China’s Minister of Finance, to the National People’s Congress on August 24, 2015. Source (in Chinese): http://www.npc.gov.cn/npc/xinwen/2015-09/07/content_1945886.htm. For media English reports on this topic, see: http://en.xinfinance.com/html/In_depth/2015/136273.shtml.

³ The exchange rate is set at USD/CNY=6.3.

2 Nationwide Situation

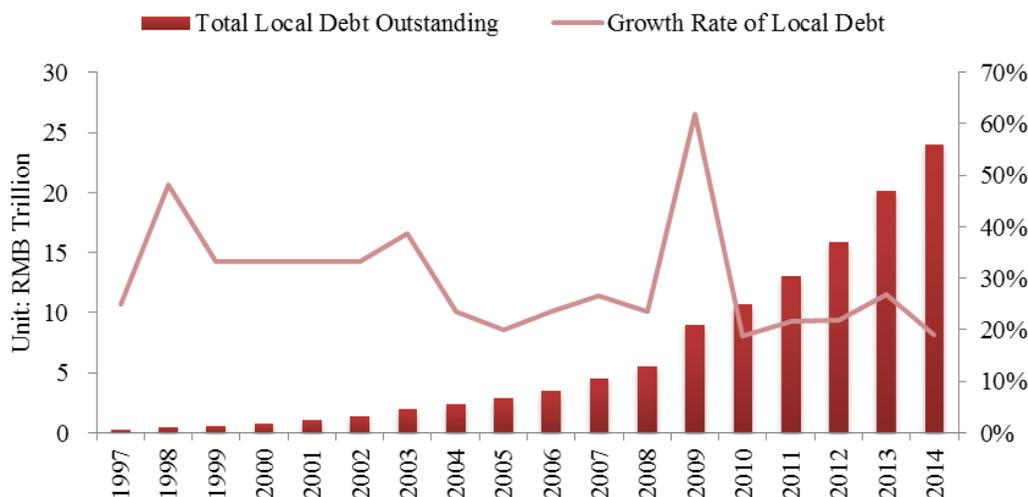
Here we provide aggregate statistics on the amounts and uses of local government debt, discuss the root causes of the buildup, and assess the capacity for repayment.

2.1 Aggregate Local Debt

Although the topic of local debt is hotly debated in China, little official data has been made public. Reports published in 2011 and 2013 by NAO provide some information for local debt totals in 2010, 2012, and June 2013. Those annual totals are RMB 10.72 trillion, RMB 15.89 trillion, RMB 17.89 trillion respectively.⁴ The Minister of Finance reports outstanding local debt at the end of 2014 of RMB 24 trillion. NAO (2011) also reports debt growth rate in 1997, 1998, 2008, 2009, 2010, and the average growth rates during 1998-2002, 2002-2007. Given those reported rates, we extrapolate backwards to estimate approximate outstanding local debt totals from 1998 to 2007.

Nevertheless, those numbers may understate the true magnitudes; Local governments can borrow in a variety of opaque ways, including through the shadow banking system, which has expanded rapidly in the recent years. Unofficial estimates of the debt or estimates from other official agencies are significantly higher. For example, People's Bank of China estimates the size of local debt in 2010 to be RMB 14 trillion. Li et al (2012a, 2012b) estimate the size to be RMB 14.8 trillion in 2010. Various estimates by investment banks and other institutions are also higher than NAO data.

Figure 1: Total Local Debt Outstanding and Growth Rate

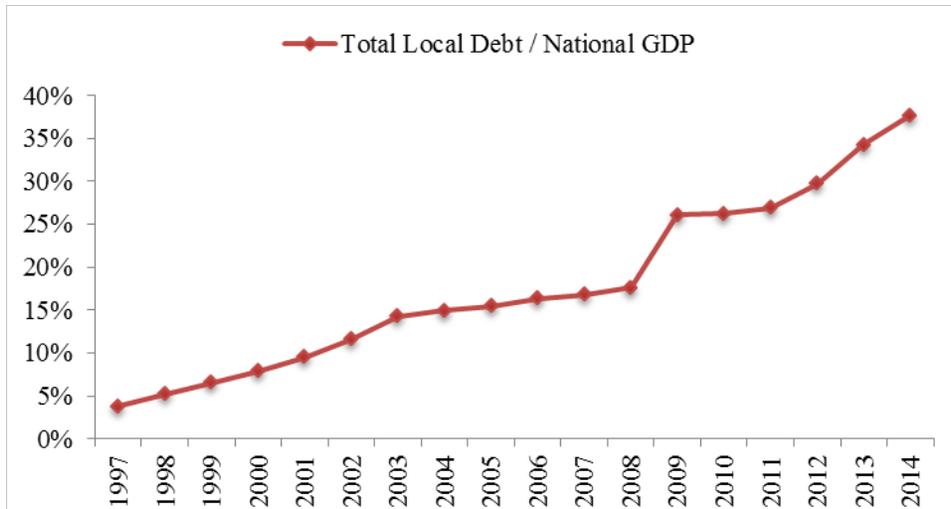


Source: NAO and author estimation

⁴ NAO classifies the local government debt into three categories: debt that government has direct responsibility of repayment for, debt that government has guarantee responsibility for, debt that government has possible governmental rescue responsibility for. NAO defines the last two kinds of debt as local government contingent debt. Here we do not differentiate among the three categories. By June 2013, the sizes of local debt under the three categories are respectively RMB 10.89 trillion, 2.67 trillion, 4.34 trillion.

Normalizing debt levels by GDP allows its burden to be assessed in economic terms. As shown in Figure 2, local debt now totals about 40 percent of China’s GDP. By comparison, in the U.S. the most indebted state governments have a debt-to-local GDP of 26.53% (New York), 23.22% (Rhode Island), and 22.42% (Kentucky) in 2014.⁵

Figure 2: Size of Total Local Debt relative to China’s GDP



Source: NAO and China National Bureau of Statistics (NBS)

The last five years has seen particularly rapid growth in local debt. Debt totals almost doubled between 2008 and 2009, when China undertook the so-called “RMB 4 trillion” fiscal stimulus plan to counteract the negative impact of the global financial crisis on the Chinese economy. The fiscal plan emphasized infrastructure investment, large-scale engineering projects, and social welfare housing construction. Over 60 percent of funding for those projects came from local governments, which issued additional debt to pay for them. At that time, the central government encouraged local governments to establish more local government financing vehicles (LGFVs). For their definitions, see Table 1. It also began a period when most local governments increased investments by borrowing so as to compete with each other for best short-term economic performance.

2.2 Characteristics and Uses of Local Debt

The 2013 NAO report gives a snapshot of some key features of local debt, including debtor identities, financing channels, funds usage, and debt maturities for all local debt outstanding raised through June of that year.

Table 1 defines and explains the identities of debtors. Figure 3a shows that LGFVs are the largest single borrowing vehicles. Local government agencies often use LGFVs as a tool to finance the gap between desired expenditures and revenues. The debt issued by LGFVs is backed by the sponsoring local government, either directly or indirectly. Many local government agencies shift

⁵ Source: http://www.usgovernmentsspending.com/compare_state_spending_2014pH0d

land resources to LGFVs to serve as collateral, or pledge future government fiscal revenues when LGFVs borrow from capital markets. Local government agencies are also big borrowers. However, in the past, Chinese law forbade most local government agencies from directly issuing bonds in the capital market or borrowing from banks.⁶ Those who are eligible for issuing bonds must go through the strict approval procedure of the Ministry of Finance and the size of the quota is small. Therefore, circumventing those restrictions is one important reason why local governments borrow through LGFVs and SOEs.

Table 1: Definitions and Explanations of Debtors

Debtor	Definition and Explanation
LGFV (Local Government Financial Vehicle)	LGFVs are companies set up, fully owned, and operated by local governments that borrow money from the banking and financial system to engage in businesses that are fiscal in nature, like infrastructure investment and public affairs.
Local Government Agency	Local government agencies make up the official organizations of governments and execute their administrative functions. They include government entities (e.g., Beijing Municipal Government) and their executive branches (e.g., Shanghai Administration of Customs).
Fiscal Subsidized Institution	Fiscal subsidized institutions are set up by government to serve for public ends and their operating expenses are included (fully or partially) in the government fiscal budget. Some examples are government owned academic institutes, hospitals, media agencies, etc.
SOE (State-Owned Enterprise)	SOEs are enterprises that undertake commercial activities and perhaps also have public policy objectives. Local Governments are their main stockholders and have substantial controls over their operations.
Others	Other entities that fall out of the above main categories, like electric power plants, water supply plants, telecommunication offices, etc.

Figure 3b shows that the most important lenders to local governments are banks—both commercial banks and government-run policy banks (primarily the China Development Bank). Other financing channels include “build and transfer” (BT) financing, bonds, and trust companies.⁷ The actual percentage of financing coming from the banking system exceeds the reported percentage because banks also establish off-balance-sheet structures to finance local government projects. For example, banks sell wealth management products to the public and then lend the money to local governments. Banks can also lend to trust companies, which then make loans to local governments. Those assets appear as investments in corporate securities rather than as loans on the banks’ balance sheets. In recent years, banks have developed these more complex structures

⁶ The rules have since been liberalized. See subsection 4.2.

⁷ Bonds include both local government bonds (issued by local government agencies) and corporate bonds (issued by LGFVs and SOEs). The category of “Others” includes financing channels such as private institutional and individual loans, deferred payment, borrowing through non-bank financial institutions (investment banks, insurance companies, etc.), transferred proceeds of sovereign debt, financial leases, social fund raising, etc.

and turned to shadow banking to avoid the tightening regulations that restrict bank loans to local governments and other out-of-favor industries. Apparently, the banks believe that local governments will find a way to make good on their obligations despite the very high debt levels and limited revenue sources.

Figure 3a: Debtor Identity

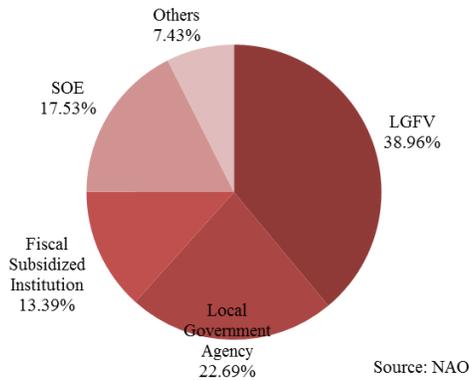


Figure 3b: Financing Channel

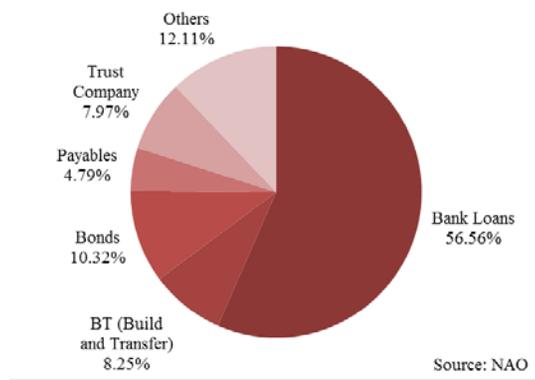


Figure 3c: Funds Usage

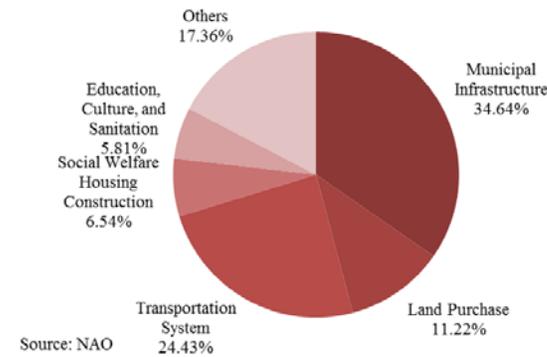


Figure 3d: Maturity Date

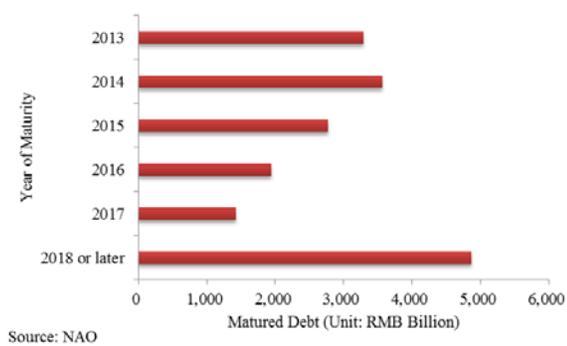


Figure 3c shows the uses of borrowed funds by local governments. Infrastructure investments⁸ and property market-related activities⁹ account for the majority of spending. As discussed below, infrastructure and housing investments are the most common ways local governments seek to stimulate the economy. Because the ability to raise revenue is limited, debt issues are the primary source of funds.

Figure 3d shows the distribution of debt maturity dates. A large amount of debt that was borrowed during the financial crisis came due between 2013 and 2015. Because local governments roll over old debt as well as issue new debt, the current situation may be different than this 2013 snapshot.

⁸ Includes municipal infrastructure, transportation system, and some of “others” including water conservancy, environment protection, large industrial and energy projects.

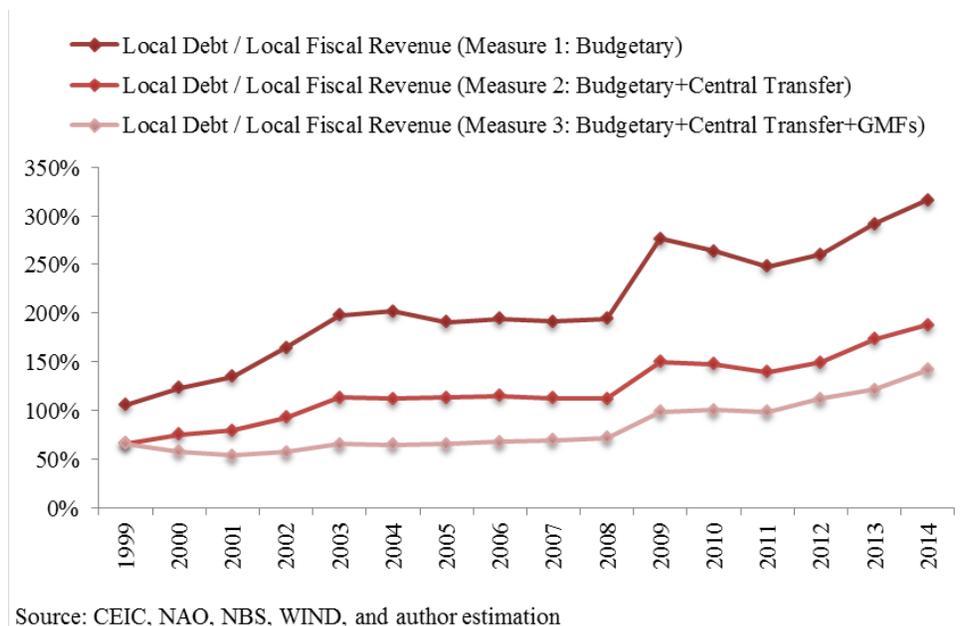
⁹ Includes land purchase and social welfare housing construction.

2.3 Repayment Ability of Local Government

Ultimately the ability of local governments to repay their debts depends on fiscal revenues. Under the current Chinese fiscal and tax system, the total fiscal revenue of local government consists of three parts: budgetary fiscal revenue, central government transfers, and government managed funds (GMFs). Local tax revenue accounts for most of budgetary fiscal revenues. After the 1994 fiscal regime reform, local governments receive only around 50% of all tax revenue in China, but are responsible for around 80% of total fiscal expenditures. The gap has to be filled from other sources. Central government transfers are sometimes assigned for specific local projects and cannot be used for other purposes. Local governments have more discretion over GMFs, funds that were previously off-budget but that are now reported. In recent years, approximately 80% of GMF revenues were raised from local government land sales, a situation that is not sustainable in the long run. The rest of GMF revenues come from fees charged by local governments for supporting public services like education and cultural activities, providing housing for government employees, maintenance of public transportation system, etc.

Figure 4 shows the growing ratio of local debt to local government fiscal revenue, where revenue is measured in several ways. The narrowest measure counts only budgetary fiscal revenue. The second counts both budgetary revenue and central government transfers. The third counts all kinds of fiscal revenue of local governments. The current local debt is respectively 3.37, 2.00, and 1.51 times local fiscal revenue.

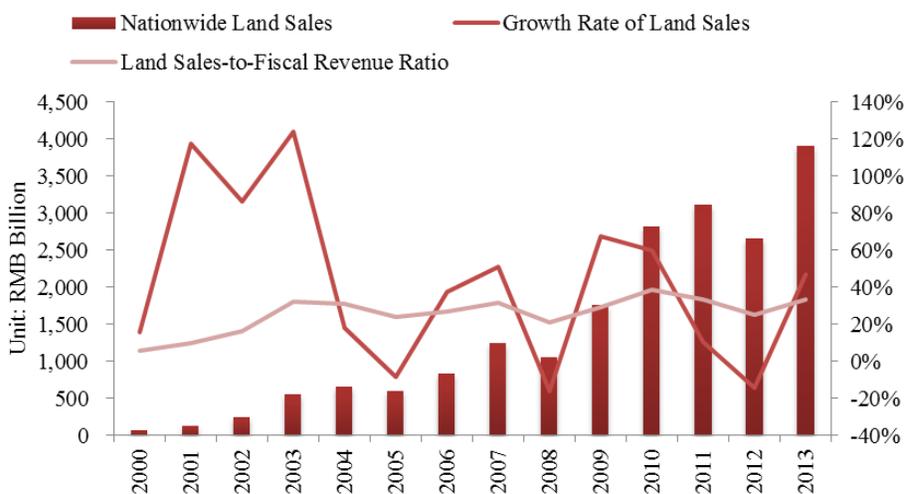
Figure 4: Size of Local Debt relative to Local Fiscal Revenue



Local governments' heavy reliance on so-called land sales is a major concern for fiscal sustainability. Generally, local governments own large areas of land and can lease it to the private

sector, hence the transactions are not a true sale.¹⁰ Land is also used as collateral for bank loans. Those activities have accelerated in recent years with the pressure to finance investments and repay debt. Figure 5 shows that the growth rate of land sales was as high as 60% in some recent years.¹¹ Unlike tax revenue, land supply is not renewable.¹² The exhaustion of land resources and a cooling property market could end in fiscal distress if alternative revenue streams are not developed.

Figure 5: Size and Growth Rate of Land Sales



Source: CEIC, WIND, and author estimation

2.4 Behind the Buildup

The rise in Chinese local government debt can be attributed to a complex combination of political, economic, and financial causes.¹³ Here we highlight several of the key drivers that include local governments' large scale involvement in economic development and huge infrastructure investments, juxtaposed with the limited revenue generating capacity previously

¹⁰ China's land regime is different from other countries in that the ownership and usage right of land are separated. By Chinese law, ownership of land belongs to either the nation or the farmers collectively (collective ownership of land by farmers is only suitable for agricultural land), so private entities or persons cannot "own" the land. Ownerships cannot be traded, transferred, or abandoned. However, private entities or persons can purchase the "usage rights" of land. After purchase, they can operate the land for a finite length of time. Therefore, by local governments selling the land, we mean that local governments can lease the usage rights of land to private sectors in return for revenues, but the ownerships of land are always kept by local governments.

¹¹ Fiscal revenue is based on measure 2.

¹² There are newly developed lands each year, but attractive land is in limited supply.

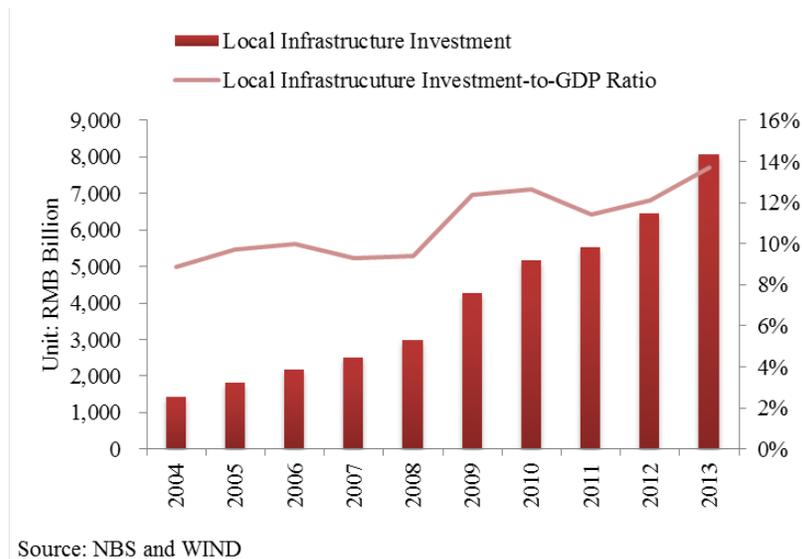
¹³ To name a few: 1. Chinese government is still playing a dominant role in many fields of the economy, and its role is extended during economic recessions. Therefore, the government relies more on debt financing to increase public investment and improve economic condition. 2. Under the political regime, there's no bankruptcy law for local governments. They are generally considered to have implicit guarantees from the central government. This results in moral hazard problems and local governments have a tendency to borrow more. 3. After the 1994 tax regime reform, local governments receive around 50% of all the China's tax revenues but need to pay for over 70% of all the public spending (over 80% in the most recent five years). The fiscal transfers from the central government to local governments are not sufficient to fill up the gap for some local governments, so they are forced to raise debt. 4. The Chinese banking system is mostly controlled by the government. The banks maintain good relationships with local governments and usually favor lending to governmental projects.

discussed.

Figure 6 shows the acceleration in local infrastructure investment in recent years.¹⁴ Between 2004 and 2008 the ratio of local infrastructure investment to GDP was fairly stable but it has soared since then. A contributing factor was the 2008 “RMB 4 trillion” fiscal stimulus plan that promoted infrastructure spending.

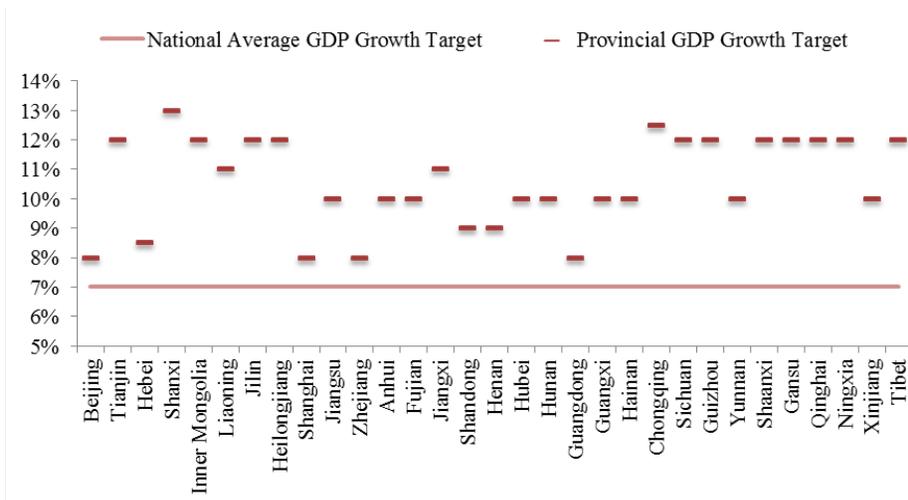
Local government officials compete with each other on economic performance, motivated by concerns over promotions and political pressures from higher levels of government. Pressures to outperform have led to unachievable goals and probably to overinvestment. As shown in Figure 7a & 7b, when making the second “Five-Year Plan” (2011-2015), the Chinese central government targeted a 7% national GDP growth rate, but all the provinces set higher GDP growth rate targets, ranging from 8% to 13%. Those pressures also appear to have resulted in inflated provincial statistics. Aggregating provincial GDP in all the 31 provinces, the sum exceeds China’s national GDP in each of the past ten years by a percentage of about 7%.

Figure 6: Size of Local Infrastructure Investment



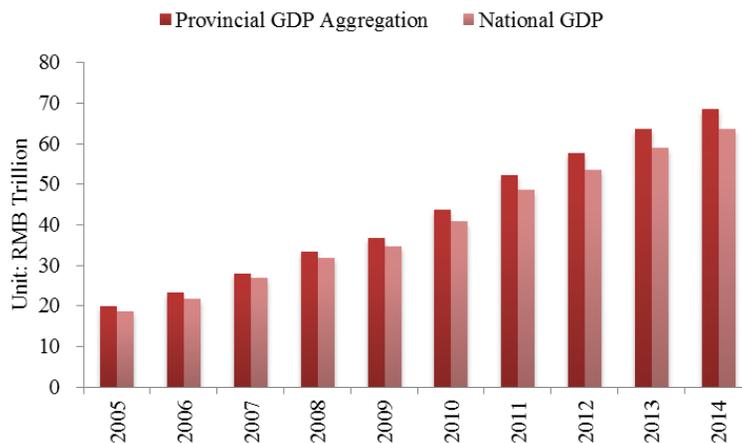
¹⁴ The infrastructure investment data is from the WIND database (Website: <http://www.wind.com.cn/En/Default.aspx>. Subscription required). Infrastructure investment includes investments under three directories: production, supply of electricity, gas, and water; transportation, storage, and postal service; water conservancy, environment, and public utility.

Figure 7a: National and Provincial GDP Growth Targets during 12nd “Five-Year Plan”



Source: Li et al (2012)

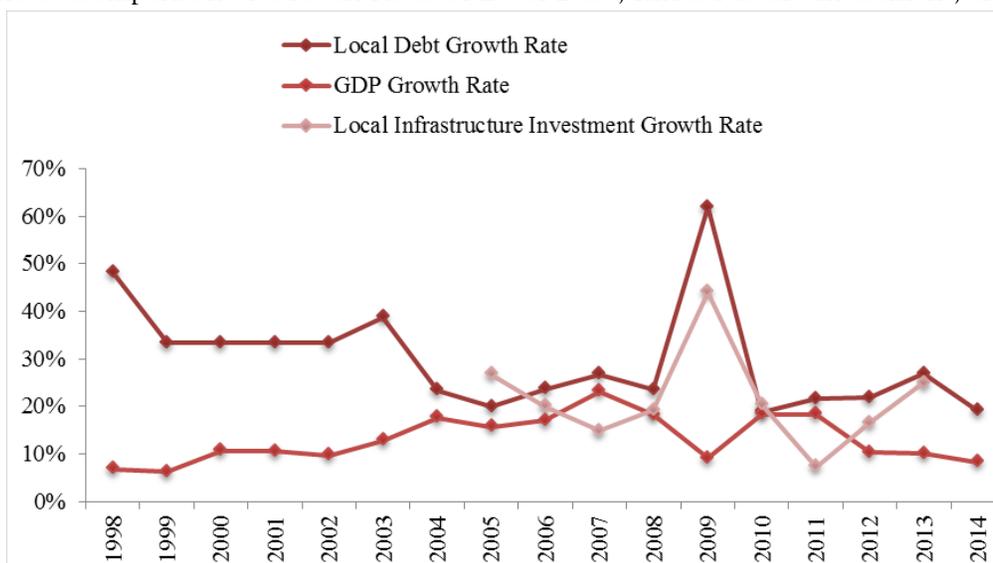
Figure 7b: Aggregate Provincial GDP Compared with National GDP



Source: NBS

Figure 8 shows a negative correlation between local debt growth and GDP growth. A similar negative correlation exists between local infrastructure growth and GDP growth. Those relationships appear more significant after 2008, and suggest that local governments increasingly use debt-financed investment as a countercyclical policy tool. Infrastructure investing is one of a limited set of fiscal tools that are mostly at the discretion of local governments and that can be used to stimulate the economy in the short run, which may help to explain its popularity with local governments nationwide.

Figure 8: Comparison of Growth Rates of Local Debt, Infrastructure Investment, and GDP



Source: NAO, NBS, WIND, and author estimation

While competition between local governments has helped China achieve economic success and encouraged local innovation over the past several decades (see Montinola, Qian, and Weingast (1995), Zhou (2007), among many others), many observers believe that its excesses, including the massive debt buildup, have become a net negative force on the Chinese economy. However, to the extent that China may have underinvested in infrastructure in the past and the pace of new investment will fall as the country fills in those gaps, the ratio of investment to GDP, and hence debt levels, could return to more sustainable levels.

3 Local Debt Distribution across Provinces

The volume of local debt varies across provinces. Our measure of provincial debt aggregates across all local government agencies within that province (i.e.: provincial, prefectural/municipal, county, and township/village) and is only available for 2013.

3.1 Size of Local Debt across Provinces

Figure 9 shows the size local debt by province as of June 2013, reported by NAO, while Figure 10 shows local debt as a share of local GDP. We list provinces by region--eastern, middle, or western region--and within each region order the provinces by local debt size.¹⁵ The more

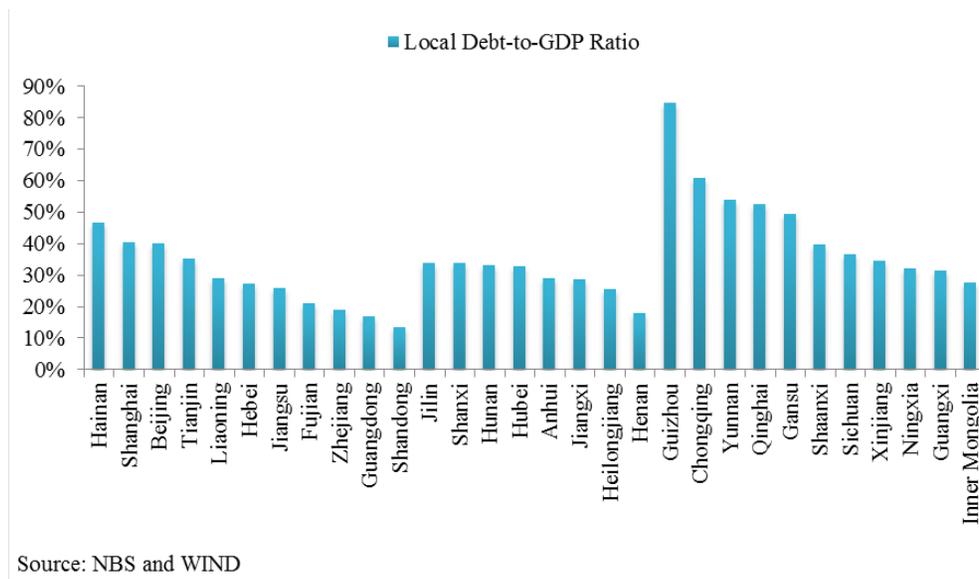
¹⁵ The eastern/middle/western region classification is generally used in many Chinese statistics. This classification approximately captures both the geographic division and economic development differences. The eastern region is most economic developed, while the western region which is inland and least economic developed. The eastern region includes Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong, Hainan. The middle region includes Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan. The western region includes Inner Mongolia, Guangxi, Chongqing, Sichuan, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang, Tibet. Tibet is not included in the figures due to lack of data.

affluent eastern provinces have the most local debt in absolute terms, but the smallest amount as a share of local GDP. The poorer western provinces actually have the highest debt burden as a share of GDP.

Figure 9: Size of Local Debt in Each Province (Time: June 2013)



Figure 10: Debt-to-GDP Ratio in Each Province (Time: June 2013)



3.2 Debt Repayment Ability of Provinces

The ratio of local debt to local fiscal revenues is also suggestive of the capacity for repayment.

Revenues are measured as budgetary revenues (Figure 11a), or budgetary revenues plus central government transfers (Figure 11b). Including central government transfers tends to equalize the debt repayment capability across provinces. However, provinces have less discretion in spending central government transfers and those funds are less predictable. Based only on budgetary revenue, some western provinces like Guizhou, Gansu, and Qinghai have debt-to-fiscal revenue ratios higher than 500%. Land sales revenues are not available at the provincial level for 2013, but they would be unlikely to change the conclusion that the largest stresses are on some of the poorer western provinces.

Figure 11a: Size of Local Debt vs. Provincial Fiscal Revenue (Measure 1. June 2013)

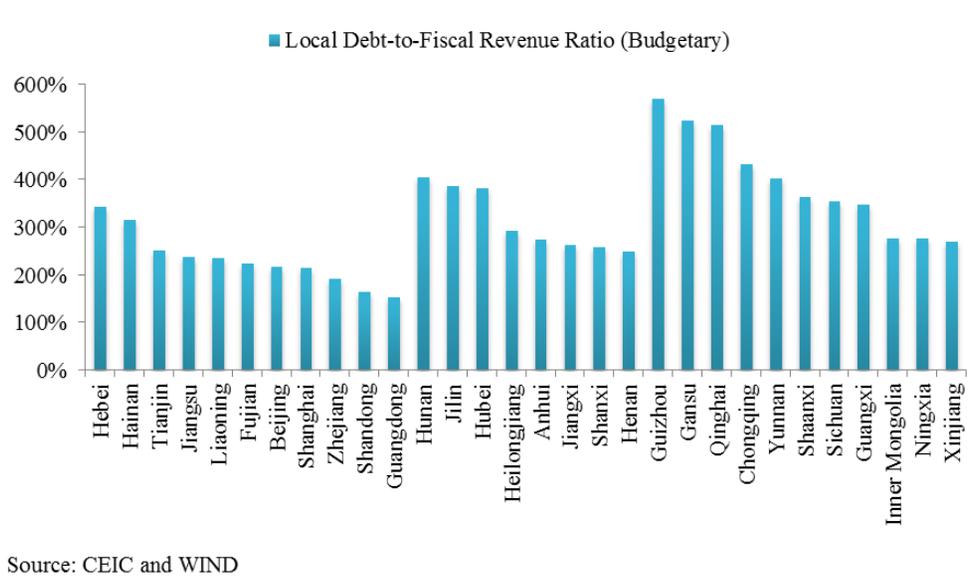
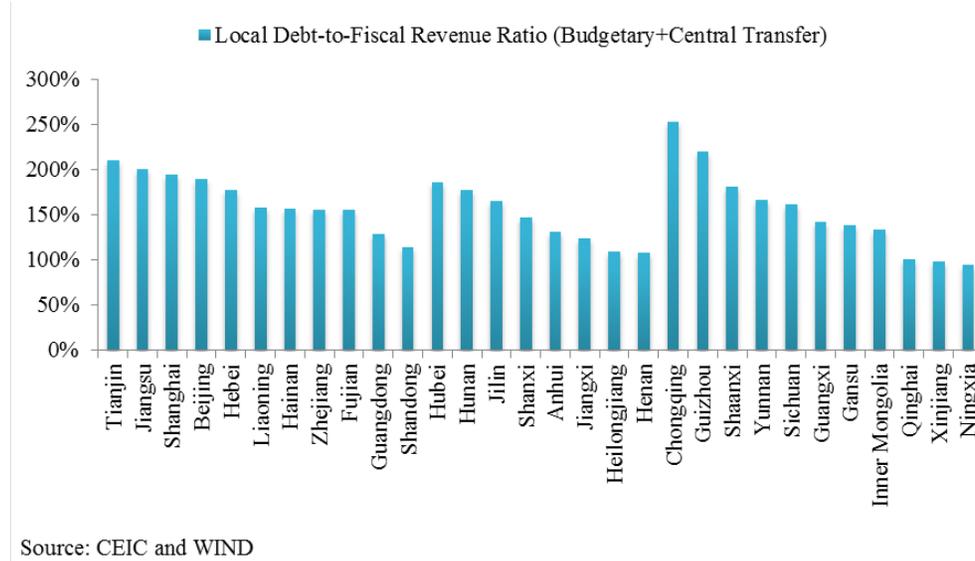
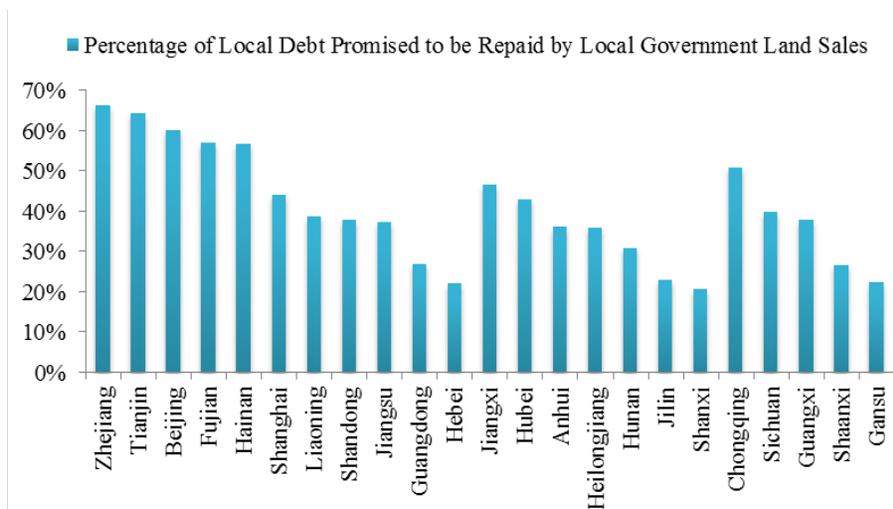


Figure 11b: Size of Local Debt vs. Provincial Fiscal Revenue (Measure 2. June 2013)



Local governments' reliance on land sales to finance debt can also be clearly seen at the provincial level (Figure 12). For the 23 provinces that report data, on average they promise their creditors to repay 40.31% of debt using land sales. Some provinces rely on land sales to repay more than 60% of local debt.

Figure 12: Local Governments' Reliance on Land Sales (2012)



Source: WIND

The capacity to repay debt can also be assessed by comparing assets with liabilities. To make that comparison, we construct an abbreviated balance sheet for local governments. The estimates are rough due to limited data. There is no official balance sheet for the Chinese government even at the national level, and the resources that will be made available to local provinces are quite uncertain.¹⁶ A stylized local government balance sheet is shown in Table 2. Assets include fiscal deposits (current assets deposited in banks), governmental fixed assets (e.g., buildings, cars, office facilities), local SOEs fixed assets (local governments' share of equity in local SOEs), and land, which proxies for total natural resources. Lu and Sun (2013) estimate that at the current selling speed, local governments will run out of land resources within ten years. Therefore, as an approximation, we estimate that the value of land is ten times the reported land sales in 2012.¹⁷ On the liability side, we count in only local debt, although local governments also have current liabilities such as employee salaries.

Table 2: Balance Sheet of Local Government

Asset		Liability	
Current Asset		Debt	
	<i>Fiscal Deposit</i>		<i>Local Government Debt</i>

¹⁶ Some academics have constructed a sovereign balance sheet for China. See Li et al (2012a, 2012b).

¹⁷ The balance sheets are constructed for 2012 because of data availability.

Fixed Asset	Others
Governmental Fixed Assets	
Local SOEs Fixed Assets	
Natural Resources (Lands)	Net Position

The result in Figure 13 shows that assets exceed liabilities for all provinces. Because assets do not include capitalized tax revenues, the ratios would be further improved taking it into account. However, the debt-to-asset ratios are considerably higher in the poorer western regions, in part because of the lower land values in those areas.

Figure 13: Debt-to-Asset Ratios of Local Governments (2012)



Source: China Accounting Yearbook, WIND, and author estimation

4 Future Outlook and Recent Developments

The analysis thus far suggests that for many provinces current debt levels are probably manageable, whereas for some they are already reaching unsustainable levels. Extrapolations of current trends suggest that the picture will be less benign in the future without significant policy changes. The Chinese central government has made recent policy changes to begin to address the problem.

4.1 Future Outlook

We extrapolate the ratios of local debt-to-GDP and local debt-to-fiscal revenue based on the data and trends presented in section 1. Three scenarios are considered that vary in the assumptions about debt growth, GDP growth and revenue growth. In the best scenario, the size of local debt grows relatively slowly, while GDP and fiscal revenue grow more quickly. In the worst scenario, local debt grows quickly while GDP and fiscal revenue growth lag behind. In the moderate scenario,

all the growth rates are set to the middle scenario. The assumed parameters are presented in Table 3.¹⁸

Table 3: Assumptions of Variable Growth Rate

	Best Scenario	Moderate Scenario	Worst Scenario
$\Delta(\text{Local Debt})\%$	10%	12%	15%
$\Delta(\text{GDP})\%$	11%	9%	7%
$\Delta(\text{Fiscal Revenue - Short Run})\%$	13%	11%	9%
$\Delta(\text{Fiscal Revenue - Long Run})\%$	11%	9%	7%

The assumptions are based on the following considerations: Over the past decade, local debt has grown at an average annual rate that exceeded 20%. However, because China's central government has and continues to implement policies to control local debt growth,¹⁹ it seems likely that in the future, even in the worst case, local debt growth rate will slow to less than 20%.

The best scenario assumes future local debt growth of only 10% annually, which is still higher than anticipated GDP growth except in the most optimistic scenario. For GDP and fiscal revenue, although China went through an extended economic boom with double-digit annual growth, we expect that future growth will be slower. China's economy is undergoing structural change and real GDP growth has slowed in recent years. Official estimates for real GDP growth in 2015 indicate rates of less than 7%. Fiscal revenue growth (the sum of budgetary revenue and transfers but excluding land sales) exceeded 20% from 2004 to 2011, but from 2012 to 2014, its growth slowed to 14.17%, 9.16%, and 9.91%. Based on those trends, we assume that from the best to worst scenario, nominal GDP growth rates are 11%, 9%, and 7%. Fiscal revenue growth rates in the short run, from 2015 to 2020, are set at 13%, 11%, and 9%. However, in the long-run, fiscal revenue growth rate should not exceed that of GDP, so we assume they drop down correspondingly to 11%, 9%, and 7% from 2021 to 2025. Figure 14: Projection of Local Debt-to-

¹⁸ These are nominal growth rate. Fiscal revenue is based on measure 2.

¹⁹ See subsection 4.2.

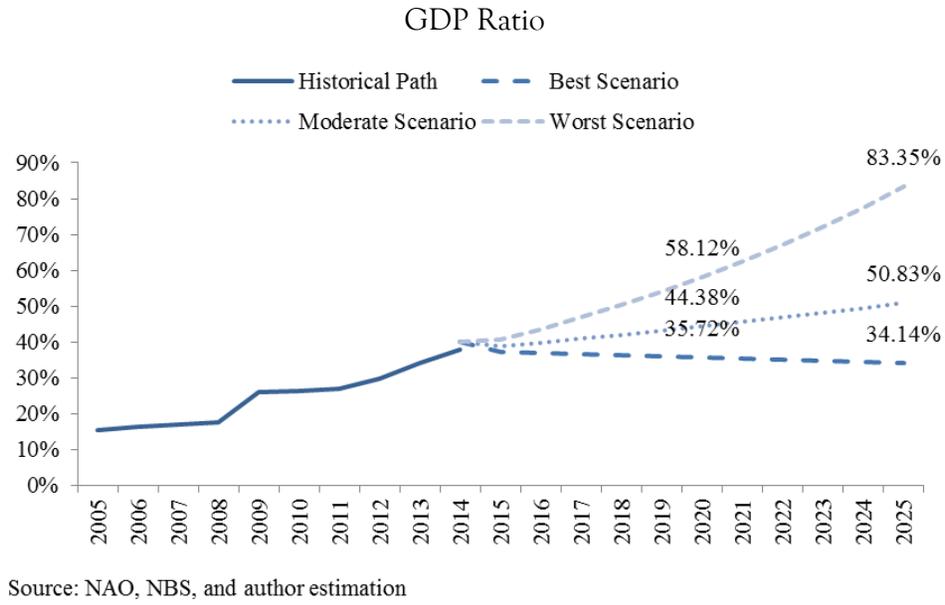
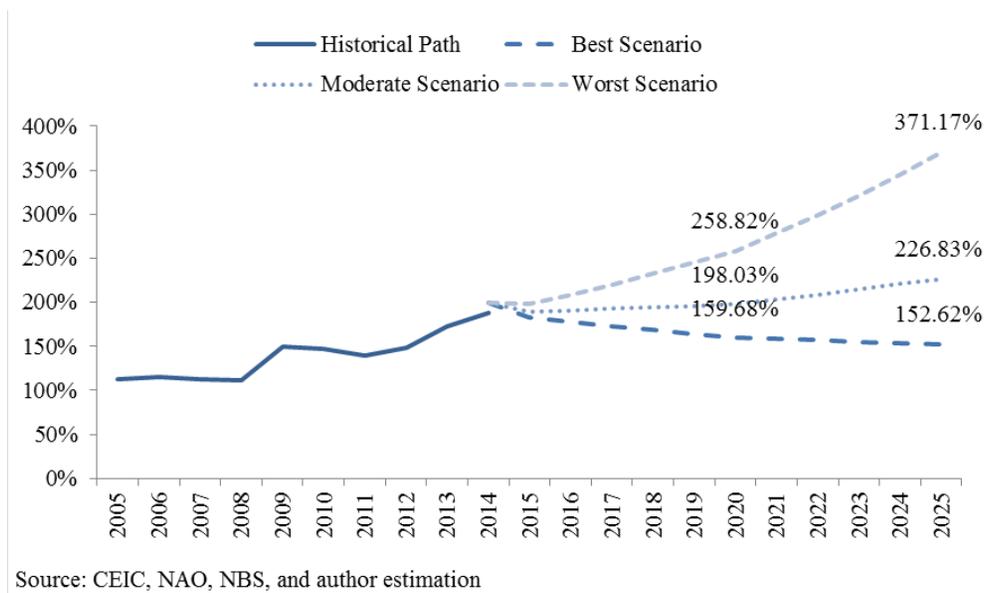


Figure 15: Projection of Local Debt-to-Fiscal Revenue Ratio



Figures 14 and 15 show the range of projections from 2015 to 2025. While the worst scenario is unlikely to be realized if China successfully carries out planned policy reforms, it does underscore the need for changes.

4.2 Recent Policy Developments

The Chinese central government has recognized the local debt problem and has instituted a number of policies to address it. Notably, on October 2, 2014, the China State Council issued Rule No. 43, a document which lays out new guidelines for the supervision of local government debt.

This document is seen as a meaningful blueprint for reform. The principles are to create a standard procedure for local governments to raise debt, to clarify the responsibilities of debtors and creditors, to incorporate local debt into the overall management of fiscal budgets, and to put local debt growth on a sustainable path that avoids systemic risk. Specifically, Rule No. 43 calls for:

- *Strictly supervising the financing channels of local governments.* With the approval of the State Council, qualified provincial governments will be allowed to issue government bonds to finance their investment projects. Prefectural and lower levels of governments, if in need of financing, can ask provincial governments to issue bonds on their behalf but they cannot issue government bonds independently.
- *Shutting down non-standardized financing channels.* Local governments are no longer allowed to borrow from firms. (A supplementary document from the Ministry of Finance stipulates that beginning in 2016, LGFVs are forbidden to issue bonds, and LGFVs will be shut down gradually.)
- *Local governments should issue general-purpose bonds to finance social welfare projects that generate little revenue, to be repaid from budgetary fiscal revenue.* For projects that generate adequate cash flows, like some municipal infrastructure projects, local governments are to issue specific-purpose bonds and repay with GMFs revenue or profits from the projects. Introducing private capital into the financing of profitable projects, through the means of public-private partnership (PPP), is also highly encouraged.
- *Local governments cannot provide guarantees for firms, private institutions, or persons without legal authorization.* Except for guarantee for foreign (transferred) loans, which is permitted by Guarantee Law of the People's Republic of China enacted in 1995, all other kinds of guarantees will no longer be legally permitted.
- *A major overhaul of the infrastructure for local government debt.* That includes the local government bond market, the credit rating system, policy measures to cope with local government default, the local fiscal transparency regime, stricter supervision of local government officials, etc.

Besides the Rule No. 43 which targets local debt reform, the Budget Law of the People's Republic of China was amended and enacted on January 1, 2015. The newly amended Budget Law authorizes all provincial governments to issue local government bonds in the capital market. The issuing size of local government bonds must be permitted by the National People's Congress of China and must be included in the local fiscal budget. This is considered a significant legal step to open a more standardized and transparent financing channel for local governments.

Under this stricter regulatory regime, some of the risky and opaque financing channels that facilitated the explosion of local debt after 2008 will be shut down, and it appears likely that certain quasi-fiscal operations will become a legacy of the past.

However, these debt market reforms do not address the underlying fiscal pressures that exacerbated the debt buildup. The structural imbalance between local government spending and access to tax revenues remains a fundamental tension. The ability of local governments to issue

debt (and to sell land) has played an important role in the development of the Chinese economy in the last decade. A successful reform will require more stable and transparent financing channels for local governments. Suppressing debt issuance without supplying an alternative funding source or transferring more government functions to the private sector could have adverse consequences for economic growth.

Furthermore, even though issuing local government bonds in the capital market is now authorized by law, there's not a liquid market for local government bonds. The issuing mechanism, the determination of coupon rates, the size of issuing are under strict control of central government, which means this is not a flexible and market-oriented financing channel for local governments.

Another concern is the systemic risk introduced by high local debt levels in the near term. Although serious reform is under way, it will not be achieved overnight. China's banking regulator has expressed worry that local debt is contributing to a higher non-performing loan ratio in the commercial banking system (the official non-performing loan ratio at the end of 2015Q1 stood at 1.39%)²⁰. The central government is taking measures to restructure local debt this year. Under the guarantee of the Ministry of Finance, two debt-swap deals were launched this year, each valued at RMB 1 trillion, to help local governments replace their short-term, high interest rate bonds with long-term, low interest rate bonds. A third such guaranteed debt-swap is also under consideration.²¹ Besides easing the stress of local governments, these measures serve to improve bank asset quality. They also point to the possibility, and perhaps the likelihood, of a more major central government bailout should debt levels become unmanageable for some provincial governments.

The local government debt problem is set against a backdrop of economic change, as China attempts to turn its government-dominated economic growth model into a market-oriented one. From that perspective, how it manages the local fiscal situation will be telling about the commitment to and speed of those larger changes.

²⁰ Source: <http://www.businesstimes.com.sg/banking-finance/china-top-banking-regulator-warns-of-rising-risks-in-real-estate-finance-local-govt>

²¹ Source: http://news.xinhuanet.com/english/2015-06/10/c_134315160.htm; <http://www.ft.com/intl/cms/s/0/28bc38a6-f920-11e4-8e16-00144feab7de.html#axzz3a12BMAHf>; <http://www.ft.com/intl/cms/s/0/3d7c9d06-c6eb-11e4-9e34-00144feab7de.html#axzz3gD4jbtOH>

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