

# Local government debts expose China's financial instability

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Mounting local government debts further expose any notion that China has weathered the global economic storm.

After a rush to set up investment vehicles to borrow from state banks as part of the 2008-09 stimulus packages, the debts reached 9.1 trillion yuan (\$US1.46 trillion) by the end of 2010. According to China's official figures released last month, however, the total has since risen to 10.7 trillion yuan or \$1.7 trillion.

The surge of debt during 2012 is a sign of financial distress, as many local governments struggle with a slowing economy, and borrow greater amounts in order to repay maturing loans.

A *Financial Times* investigative article in late January found that Chinese banks had rolled over an estimated 3 trillion yuan, or more, in loans that were due by the end of last year. "[T]he vast majority of local government loans that were to come due over the past two years have simply been extended," it noted.

Beijing resorted to a massive stimulus package following the 2008 Wall Street crash, when the resulting "financial tsunami" hit China's export-led economy, quickly wiping out more than 20 million jobs. Through injections of cheap credit, the Chinese Communist Party (CCP) regime restored growth, but one of the consequences has been huge local government debts, incurred in financing infrastructure or, in many instances, speculative real estate development.

By the official figures, the total local government debt is more than 40 percent larger than Spain's sovereign debt (over \$1 trillion last year), which plunged that country into deep turmoil. The situation may be even worse. The *Financial Times* said its calculations were far from precise because the China Banking Regulatory Commission does not publish data

on refinancing or interest payments.

According to a Haitong Securities estimate, cited by *China Daily*, local government debt has grown to 13 trillion yuan, or 25 percent of China's gross domestic product (GDP). The newspaper warned that "if the loans cannot be repaid, the banks will have to be bailed out by Beijing, meaning the central bank will have to print money, which will in turn create inflation—already a major headache for policymakers."

Global credit rating agencies have issued warnings. Moody's analyst Katie Chan forecast another high rollover rate at Chinese banks this year because local governments were having difficulty repaying the debts.

Terry Gao, an associate director of Fitch, told Hong Kong's *South China Morning Post* that the debts of four Chinese provinces—Hubei, Jilin, Hainan and Hunan—were "fairly high" and could result in "high financial risks." According to Fitch, the debt-to-fiscal revenue ratio for Hubei, for instance, had reached 181 percent, comparable with recession-hit European countries such as Britain and France.

Fitch warned investors that even in western Chinese provinces, where debt-to-revenue ratios were relatively low, or less than 100 percent, they should not be optimistic, since these impoverished provinces depended on central government subsidies.

Fitch said two of the three main sources of local government income—land sales and central government transfer—were stagnating. Land sales fell by 14 percent, year on year, in 2012. As all urban land is state-owned, selling land use rights to property developers has been a major source of revenue. However, Fitch estimated that the margins made by selling such rights to developers were set to decline to 20 percent, from over 40 percent five years ago.

The speculative real estate bubble is unravelling

throughout the country. In early January, the National Audit Office found that 530.9 billion yuan of local government debt had been misused illegally in property and capital markets, including through “fake” investments.

Among the “fake” investments were various Ponzi-style “wealth management products” (WMPs) that have alarmed the Chinese regulatory authorities. Many WMPs offered high-yield returns based on speculative property investment. Companies, as well as local governments struggling with cash problems, have used them to repay maturing loans.

A China Banking Regulatory Commission department director, Wang Yanxiu, admitted at a forum in late January that WMPs outstanding totalled 7.4 trillion yuan, up from 7.1 trillion yuan at the end of 2012, and only 500 billion yuan in 2007. These figures do not include vast sums issued by trust companies.

Another commission official, Yan Qingming, tried to play down concerns over these dubious financial products, insisting that the WMPs of major state banks had “channeled funds that might otherwise flow into high-interest underground loans, illegal fundraising and commodity speculation, and upheld financial stability.” But he admitted that some banks “have problems such as insufficient disclosures, inadequate risk warning, non-standard sales practices and improper ‘asset pool’ wealth management business, which has blurred risk awareness.”

The fundamental problem, however, lies not in these particular practices, but the lack of profitable investment in manufacturing and other productive channels. With China’s largest exports markets in Europe and America mired in slump, the country’s economic growth slowed to 7.4 percent last year. China’s National Development and Reform Commission has approved further stimulus measures, mainly in infrastructure, to boost growth, yet that response will only deepen the debt problem.

Since 2008, about half of China’s GDP has been composed of building new highways, shopping malls, apartments and factories. No economy, however, can devote half its GDP to new physical capital without causing massive overcapacities.

The dilemma facing the CCP regime is that while the financial risks from the previous stimulus package are rising, any attempt to reduce the debts will slow

economic growth even more, leading to huge job losses that are certain to fuel working class unrest.



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