COVER STORY

BRINGING DEBT DOWN

A nationwide audit raises alarms over risks from local government debts By Zhou Xiaoyan

If you ask China watchers to list threats to the country's economy, you would probably get this one item on everyone's list—hefty local government debt.

China released the results of a long-awaited nationwide audit on government debts in an attempt to ease mounting market concerns over the amount of debt and its possible impact.

Local governments' direct debts—debt that will be repaid by the government's fiscal revenue—reached 10.9 trillion yuan ($1.79 trillion) by the end of June 2013, with the government holding another 7 trillion yuan ($1.16 trillion) in contingent debts, according to the National Audit Office (NAO) on December 30, 2013. The contingent debt includes debt for which local governments issued official guarantees (2.7 trillion yuan, or $450 billion) and debt with implicit government guarantees (4.3 trillion yuan, or $710 billion). China's local government debt and contingent liabilities grew 67 percent from a previous audit result at the end of 2010, which calculated it to be 10.7 trillion yuan ($1.77 trillion) .

Combined with another 9.8 trillion yuan in direct central government debt, 260 billion yuan ($42.95 billion) in central government-backed debt and 2.3 trillion yuan ($370.1 billion) in debt with implicit central government guarantee, China's total government debt as of June 2013 stands at 30.27 trillion yuan ($5 trillion).

China's new leaders are aiming for a stable growth of the economy as they aim to transform it into one driven by consumption rather than a reliance on investment and exports. But they face a series of challenges, among which the rise of debt at all levels of government is seen as the biggest threat to the country's financial stability.

Under China's laws, local governments are barred from borrowing directly from banks or investors, even though they are responsible for most public spending while receiving around half of the fiscal income. The funding shortfall has forced local authorities to take on debts to pay for public works.

There had been no official update on the

extent of the local government debt since 2011. Market fears that China's banking system will be compromised if a portion of the government debt is not repaid were amplified by a dearth of information.

As investors have long viewed China's pile of local government debt as one of the biggest threats to its economy, the new leadership which took office in March 2013 pledged to keep a close eye on the issue and ordered a comprehensive review of all government balance sheets in August 2013, the first such audit since June 2011.

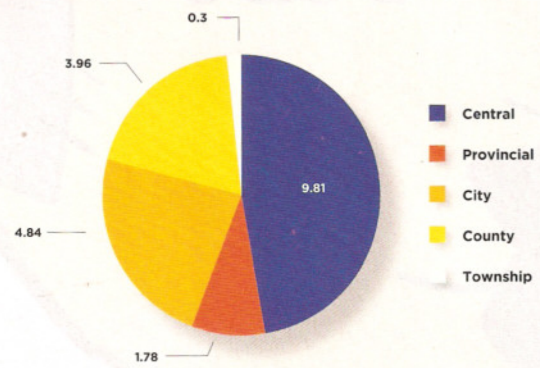
The latest audit is even more comprehensive than the one in 2011 because it includes money borrowed by more than 33,000 township governments. In total, the auditor reviewed the finances of more than 36,000 local government units to compile the figures.

The latest audit shows China's determination to mop up fiscal troubles, giving it needed room to start the other bold financial reforms promised at the Third Plenary Session of the 18th Central Committee of the Communist Party of China (CPC) held in Beijing last November.

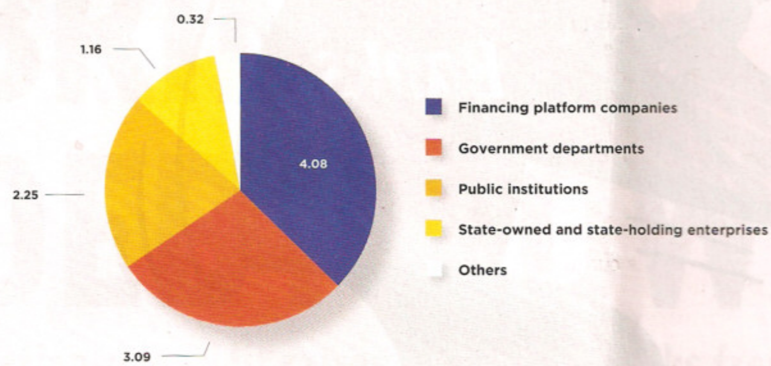
The debt load

The NAO said direct government debt at the end of 2012 was 105.66 percent of govern- ▶▶

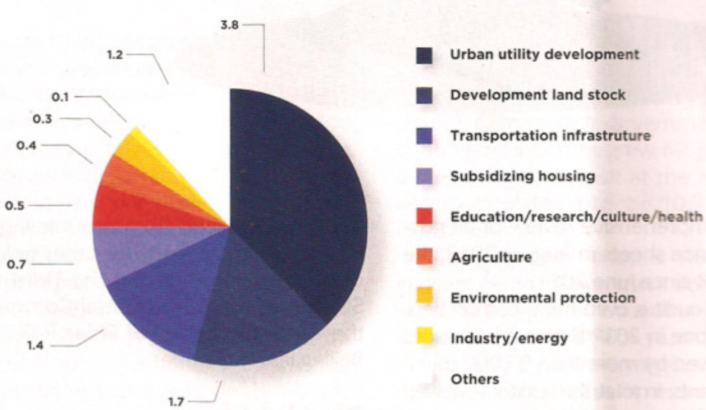
Distribution of Direct Government Debt (tln yuan)



Debtors of Local Governments' Direct Debt (tln yuan)



Purposes of Local Government Finance (tln yuan)



(Source: *National Audit Office, as of the end of June 2013*)

ment fiscal revenue, while a 90-150 percent ratio is considered safe internationally. Direct government debt as a ratio of the GDP stood at 36.74 percent, well below the 60 percent international standard.

In addition, the repayment of government debt is backed by China's stable and relatively fast economic growth. Also, government debt is mainly used for infrastructure construction, which creates a large amount of high-quality government assets that also guarantee the repayment of debts, the NAO commented.

Therefore, overall China's government debt risks are under control, it said.

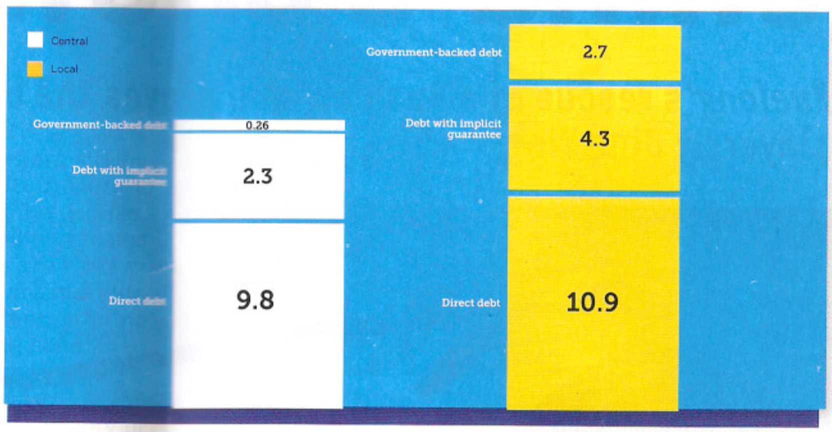
The NAO, however, added that there are potential risks in some places, referring to the high growth of local government debt.

Other risks listed by the NAO include local governments using new loans to repay more than a fifth of their debt, heavy debt burdens in some unnamed regions and sectors, and heavy dependence on land sales to repay loans. About 37 percent of debt repayment involved land sale revenue, a level that was deemed too high. Two provinces, 31 prefectures and 29 counties had repaid more than 20 percent of their debts by raising new debt in 2012. Of all debt directly incurred by China's central and local governments, 5.4 percent are overdue and have not been repaid.

The National Development and Reform Commission (NDRC) said on December 31, 2013 that overall debt levels were under control, but it would take measures to keep the debts down, including allowing local government financial companies to issue bonds to replace some existing short-term debt with high interest rates, and encouraging private capital to get involved with infrastructure projects. It will also step up spot checks on local government financing vehicles.

Lu Ting, chief China economist at Bank of America Merrill Lynch, said China's fiscal

Government Debt Breakdown (tln yuan)



(Source: *National Audit Office, as of the end of June 2013*)

situation is under control.

"We believe the markets and the Chinese Government should be alarmed by the rapidly rising leverage, but we do not believe China is on the brink of a debt crisis."

Lu cited the Central Government's "very low" ratio of debt to the GDP, which stands at 21 percent.

Lu added that China is protected by national savings that include $3.5 trillion in foreign exchange reserves. Further, the central and local governments have solid assets, and the country still enjoys high economic and fiscal revenue growth, despite the slowdown, he said.

Song Li, a research fellow with the Academy of Macroeconomic Research under the NDRC, said the growth of the debt is in line with the development of the country's infrastructure and other construction.

"China's urbanization requires huge amounts of investment in infrastructure and other areas. So it is natural to see the rapid rise of debt. Unlike debts in Western countries, which are consumption-based, most of China's debts were transformed into property and can yield stable returns," he said.

Tackling the debt

Many experts have suggested China should boost its municipal bond market to give local governments better access to financing, a method that's regarded more transparent and better regulated. It can also block them from resorting to shadow-banking activities, which are lightly regulated and have much higher borrowing costs.

At present, only 10.3 percent of local government debt involves bond issues, the NAO said.

Qi Bin, director of the research arm of the China Securities Regulatory Commission, said municipal bonds and asset securitization will be the two major standard methods for future borrowing.

The finance ministry and the central bank have been studying the feasibility of implementing measures to give local governments more autonomy in bond issuance, in a bid to make it easier for them to raise funds for urbanization projects, the *Economic Information Daily* reported.

The newspaper reported, citing experts in the knowledge of the matter, that the Central Government may allow local governments to issue municipal bonds independently as early as March 2014. The Central Government is currently testing the ground for such a bond market in Shanghai, Shenzhen and developed provinces including Zhejiang, Guangdong, Jiangsu and Shandong.

Traditionally, the finance ministry has been responsible for the issuance and payment of local government bonds. The role will be handed back to local governments once the new policy is rolled out. The bonds will be paid with local government tax revenues or profits from public projects on which the money raised via the bonds is spent.

The reform plan mapped out at the Third Plenary Session of the 18th CPC Central Committee said that the nation should consider the possibility of establishing policy-oriented financial institutions to address local infrastructure and housing needs.

Experts have also called for more reforms in the fiscal income distribution system, as local governments would have no choice but to borrow when they are obligated to pay for public works that are mandated but not paid for by the Central Government.

In 2010, local governments received 48 percent of total fiscal income but were responsible for 80 percent of public spending, according to a report on China's fiscal policy issued by the Chinese Academy of Social Sciences.

"We expect the government to unveil detailed plans for fiscal reform," said Shen Jianguang, an economist with Mizuho Securities in Hong Kong.

"The key to solving the debt (problem) depends on changing the distribution system for fiscal income between central and local governments, as well as (changing) local governments' over-reliance on land sale revenues."

Zhang Monan, an associate researcher with the China Center for International Economic Exchanges, said "bad debt banks" should be set up to dispose of local government debt and non-performing assets through debt restructuring and external transfers.

"Moreover, the government should establish a management and reserve system of land-transfer fees and compile balance sheets for local governments. And the National People's Congress and the NAO should play a stronger role in the supervision and auditing of land transfers by local governments."

Lu from Bank of America Merrill Lynch suggested China deleverage its local governments while leveraging up the Central Government.

"To maintain both economic growth and financial stability, China should avoid simplistic deleveraging and debt reduction." ■

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