

## China Focus

### China's Government Debt: Level Manageable, Trends Alarming

**Economics**

China

**Tao Wang**  
 Economist

  
 +852-2971 7525

#### I. The stock of local government debt is still manageable

China's National Audit Office (NAO) released the much awaited government debt audit results on December 30 (Figure 1). Local government debt, including guarantees and other contingent liabilities, totalled RMB 15.9 trillion at end 2012 and RMB 17.9 trillion at end June 2013 (33% of GDP), largely in line with our estimates (UBS's RMB 16.5 trillion at end 2012 and RMB 19 trillion at end June 2013), and lower than the figures reported recently by a few media outlets. Including central government debt (RMB 11.9 trillion by 2012 and 12.4 trillion by June 2013), China's overall government debt stood at RMB 27.8 trillion at end 2012 and 30.3 trillion at end June 2013 (56% of GDP).

**Figure 1: Government debt audit result and UBS estimate**

		Total	Government indebted	Government guaranteed	Other contingent	UBS's
		RMB trillion	RMB trillion	RMB trillion	RMB trillion	RMB trillion
2010	Local	10.72	6.71	2.34	1.67	
	Central	11.88	9.44	0.28	2.16	12.1
2012	Local	15.89	9.63	2.49	3.77	16.6
	Total	27.77	19.07	2.77	5.93	28.7
2013 June	Local	17.89	10.89	2.67	4.34	19.0
	Total	30.27	20.70	2.93	6.65	
		% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
2010	Local	26.7	16.7	5.8	4.2	
	Central	22.9	18.2	0.5	4.2	23.3
2012	Local	30.6	18.6	4.8	7.3	32.0
	Total	53.5	36.7	5.3	11.4	55.2
2013 June	Local	33.2	20.2	4.9	8.1	35.3
	Total	56.2	38.4	5.4	12.3	

Source: NAO, UBS estimates

The 2013 Audit is more comprehensive than the previous one released in 2011, bringing the debt of the central government (including the Ministry of Railway) and village- and township- level governments into coverage for the first time. That said, state pension liabilities and policy bank debt were still left out. But as we have pointed out before, although the former could become potentially sizable in the coming decades without proper reforms, they do not constitute much of an actual deficit or debt for now. The latter, meanwhile, are used largely to finance policy banks' lending to either local governments or state-owned enterprises, which are already included in government or corporate debt statistics.

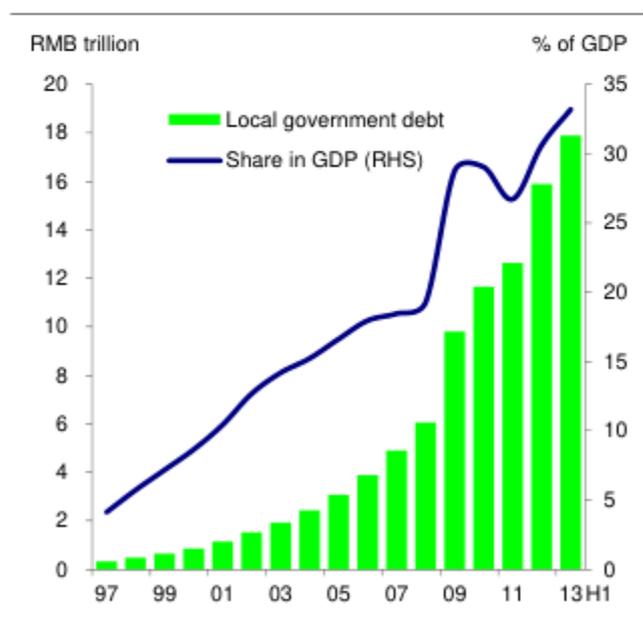
We believe that China's overall government debt and local government debt levels, at 56% and 33% of GDP respectively, remain manageable. Debt financing in the domestic market has been relatively easy given China's high saving rate and a largely closed capital account. In addition, nominal GDP is still growing at about 10% (even after having slowed down significantly in recent years), a level that is still higher than the weighted average debt financing interest rate, which is about 7.3% (UBS). However, the latter may rise in the future due to China's ongoing interest rate liberalization, which will start to squeeze government debt repayment capacity later down the road. This is an important reason why China must contain the pace of leverage increase, even if the impact in the near future should be limited. Going forwards, to reduce the burden of debt servicing and to address some local government cash flow issues, the central government can choose to securitize certain local government debt.

To reduce the overall stock of debt itself, China's government can sell some of its considerable stock of assets (such as shares in listed and unlisted state-owned enterprises). The central government can choose to, if necessary, help reduce local governments' debt burden by taking over some of their debt either directly or through banks (via bad debt write-off's). However, at this moment, we do not foresee it as an imminent solution given that there are still local-central fiscal relations and moral hazard issues to be worked out.

## II. The pace of debt flow is alarming

While the stock of general and local government debt is manageable, the pace of debt accumulation in recent years has been alarming. From RMB 10.7 trillion at end 2010 to RMB 17.9 trillion at June 2013, local debt surged by 67% in only 2.5 years. Even excluding village level debt which was not covered in the 2011 Audit, the resulting RMB 17.5 trillion-increase still represents a 64% growth rate, or a CAGR of 21.8%, far exceeding nominal GDP growth (Figure 2). This means that despite the imposition of stricter rules upon bank lending to local government financing vehicles (LGFVs) in the past 2-3 years, local debt has not been effectively controlled. This is because LGFVs found different ways to tap, and became increasingly "innovative" at tapping, the large amounts of liquidity in China's financial system.

**Figure 2: Local government debt, as share in GDP**



Source: NAO, UBS estimates

Although bank lending to LGFVs has been strictly controlled, local governments have quickly found alternative financing channels. As revealed in the latest Audit report, local governments have been increasingly using the bond market and other more complicated off-balance sheet credit products to bypass tightened LGFV loan regulations. While the share of bank loans in local government debt dropped from 79% in 2010 to 57% by June 2013, the share of bond financing has increased from 7% to 10%, as both the shares of BT and trust financing have each risen to 8% of total local debt, respectively. In addition, while the traditional LGFV loans have grown more slowly (14.5% CAGR), debt that are more hidden (through BT or other innovative channels with implicit government guarantees) grew more rapidly at 45% a year.

The reliance on land revenue has also increased significantly, as the Audit finds that the proportion of debt guaranteed by land sales revenue has increased from 23.8% in 2010 to 32.2% in 2012.

In addition to the alarmingly rapid pace of growth in overall local government debt, we think the recent trends in local government debt-raising have brought three key risks to the economy:

- (a) As more and more financing activities have taken place off balance sheet under inadequate supervision, their asset quality may have worsened and associated potential credit risk risen;
- (b) An implicit central government guarantee, coupled with local governments' insensitivity to financing cost due to the lack of binding budget constraint, have endowed the latter with an unfair advantage in obtaining new credit, crowding out other sectors/players in credit allocation and hindering the transformation of China's growth model;
- (c) With their robust credit demand unchecked, local governments have played a major role behind China's ever-rising leverage ratio, which could threaten the systematic health of China's financial system and economy further down the road.

### **III. How to resolve the flow issue of local government debt**

#### *What's the authorities' plan?*

At the Central Economic Work Conference, controlling local government debt risk was highlighted as a key task for 2014. The Conference decided to bring local government debt under official budgetary management, to tighten procedures for local government debt raising, and to hold senior local government officials responsible for any debt increase. More fundamentally, the comprehensive reform package outlined at the 3rd Plenum's Decision highlighted a number of measures to rein in growth of local government debt. We see these efforts concentrated on the following three angles:

- (1) to reduce local governments' spending needs and expedite the transfer of some local spending responsibilities to the central level, de-emphasizing the importance of GDP growth target for some regions, and tightening local government budget constraints through increased transparency and stricter budgetary management;
- (2) to increase local governments' sources of income by gradually establishing local tax revenue sources (such as property tax, resource tax and consumption tax), and requiring locally-owned SOEs to pay dividends to local government budgets;
- (3) to address local governments' debt payment issues by allowing them a greater reliance on the long term bond market, for example through the issuance of long-term construction bonds.

In addition, reforms outlined in the Decision could potentially change the role of the government and alter behaviors at the local level, which could fundamentally address the issues of perpetuating local government debt. These include reducing the government's role in production (for example, by divesting some state-owned shares to the private sector through mixed ownership structures) and linking the performance of local officials to new debt accumulation and environmental issues, in addition to GDP.

#### *Policy dilemma and likely impact in 2014*

Although the government seems determined to rein in local government debt, we think the progress will likely be slow as the government tries to balance a range of conflicting policy objectives. For example, on the one hand, the rapid accumulation of local debt has become a key risk to China's macro stability, leading to the lining up of various measures to curtail this growth. On the other hand, however, the central government continues to place significant emphasis on GDP growth (with the 2014 growth target reportedly set again at 7.5%), with local governments still expected to play a leading role in expanding infrastructure, social housing and other urbanization and growth-related investment. If the later objectives are deemed more important, one cannot expect much progress towards reining in China's local government debt in 2014, at least not in reality even if on surface local debt is contained (much like how LGFV loans have slowed since 2010, but alongside accelerating use of other types of local government debt financing instruments).

How do we gauge on the seriousness of the government's effort in containing local debt and what are the likely impacts on growth in 2014? Instead of an exhausting analysis through the many types of debt financing innovations which may spring

up, two key indicators should be focused upon instead, and monitored closely to ascertain whether local government debt is being effectively contained. First, we should look at China's overall credit expansion – in an economy where private sector demand is not super strong and profit margins have continued to face downward pressure, a rapid increase in overall credit levels may indicate the continued rapid accumulation of debt held by government-related entities. To monitor overall credit, we should look at the growth of total social financing (excluding equity) and beyond, as TSF fails to capture certain new credit activities (such as credit extended by securities companies). Second, we should monitor the pace of infrastructure investment, as that is largely carried out by local governments and financed by debt.

For 2014, we expect some but not significant progress in China's efforts to restrict local government debt growth. As such, we expect growth in infrastructure investment to slow relative to 2013, but not sharply enough to outweigh the impact of improving export and consumption growth. Therefore, we maintain our 2014 GDP growth forecast of 7.8%. If the government is more serious about addressing local debt issue than we are envisaging now, then the introduction of measures to restrict local government debt financing for example, could bring downside risk to investment and our GDP growth forecast. On the upside, if the government continues to focus on the 7.5% growth target (which inevitably gets pushed up at each local level of implementation), then local governments will likely find more innovative ways to raise debt through the financial markets in support of investment.

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		SELL protection	tighten by 5 bps or more	
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\* Europe - iBoxx NonSovereign € and NonGilt £ universe measured on a curve-adjusted, excess return basis

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