China Debt Dynamics

Beijing's Strategy For Dealing With Local Government Debt – No Bailouts, But A Helping Hand

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In July, China's Politburo said it would roll out a "basket of measures" to defuse risks arising from local government debt. Since then, the components of the Politburo's "basket" have gradually been made public.

Over that period, Beijing's strategy for dealing with local government debt has become increasingly clear. In short, it wants to reduce debt servicing costs enough so that the debt burden of most local governments becomes sustainable. Those local governments that still can't meet their financial obligations will get support but will also be pushed to pay down their debt by selling assets. The one thing Beijing wants to avoid at all cost? Bailouts.

The story thus far

Between the mid-1990s and 2015, local governments weren't technically allowed to borrow but they needed funding in order to build much needed infrastructure. They got around the moratorium on debt by borrowing through "local government financing vehicles" (LGFVs) - corporate entities owned by local authorities. LGFVs borrowed freely from banks, the bond market, and shadow banking channels to fund local government projects. To this day, LGFV debts don't appear on local government balance sheets, but local governments are implicitly responsible for ensuring LGFVs meet their financial obligations.

In 2015, the Ministry of Finance (MoF) allowed local governments to issue bonds for the first time. Funds raised from the bonds were used to pay down LGFV debt as part of an effort to make implicit debts formal. However, eight years later, the stock of formal local government debt and hidden debt - that is implicit debt borrowed by LGFVs and other SOEs - has ballooned.

According to IMF estimates, local governments and LGFVs held a combined RMB 92 trillion in debt at the end of 2022, equivalent to 76% of China's GDP. That's up from 62.9% in 2019.

A coordinated effort from Beijing to deal with local government debt is well overdue. Since 2022, the pandemic-induced economic downturn and the property market slump have dealt a huge blow to localities' finances, and to local government financing vehicles (LGFVs), leaving many struggling to service their debts.

Local governments were traditionally able to service their loans - both formal and implicit - with funds raised from land sales. However, the property sector slump has resulted in a decline in demand for land from developers, dealing a blow to local government finances.

No LGFV has as yet defaulted on its bonds - but they've come close. In recent months, LGFVs from cities in Guizhou, Yunnan, and Guangxi have received last-minute bailouts from provincial authorities to avert default. However, LGFV defaults on shadow banking loans is common, and many LGFVs owe arrears to suppliers and contractors. Other local governments have withheld salaries to government employees or imposed arbitrary fees and fines on local businesses in order to cover debt payments.

Foreign observers often assume that at some point the central government will swoop in with a bailout, either for individual local governments or the system as a whole. That's unlikely. MoF has repeatedly said that there will be "no central bailout." In January, then-Finance Minister Liu Kun vowed to break market expectations that the central government will eventually come to the rescue of struggling LGFVs.

Helping local governments help themselves

Beijing intends to take a very different approach. The way Chinese authorities see it, most local governments don't need help. In November, PBoC Governor Pan Gongsheng said:

"Most local government debts are concentrated in provinces with large economies and fast economic growth. They're able to resolve their debts on their own."

The PBoC is striving to put in place conditions under which most local governments - those with robust economies - can help themselves. Central to the strategy is reducing LGFVs' debt servicing costs. The approach has three components.

1. **Refinancing bonds:** Beijing has created a mechanism to migrate LGFV debt onto local government balance sheets. This year, provincial governments are permitted to issue up to RMB 1.5 trillion worth of bonds and use the funds to pay down LGFV debt. The program helps reduce the debt burden of distressed LGFVs, thereby freeing up resources for them to service their remaining financial obligations. Meanwhile, the coupon on bonds issued by LGFVs can be as much as 4 or 5 percentage points higher than that of bonds issued by the local government that backs them. Swapping LGFV debt for explicit local government debt reduces the overall debt burden. It's likely local governments will be allowed to issue more refinancing bonds next year.
2. **Cutting the cord:** Beijing wants as many LGFVs as possible to stand on their own two feet and not be dependent on local government support. Consequently, it's encouraging LGFVs to divest their government responsibility and achieve financial independence through mergers, acquisitions, asset injections, and reorganizations.
3. **Loan renegotiations:** The PBoC has instructed banks to rollover maturing LGFV loans at lower interest rates and to provide LGFVs with new loans to repay borrowings from shadow banking channels, which typically have higher interest rates.

The hope is that these measures will reduce the monthly debt servicing costs of most local governments and their LGFVs to a permanently sustainable level. However, for some provinces, municipalities, and counties, it won't be enough.

The bottom of the class

Of China's 31 provinces and provincial level entities (not including Taiwan, Hong Kong, and Macau), Beijing regards 12 as being heavily indebted, a group that includes Liaoning, Chongqing, Tianjin, and Yunnan. Local authorities in these provinces can only borrow for major projects approved by the State Council, although they have discretion over borrowing to fund projects in a handful of key areas, like urban neighborhood redevelopment and affordable housing. Beijing is pushing the provinces to repay LGFV debt maturing this year.

The PBoC has also said it wants local governments to sell assets to pay down debt, something the group of 12 heavily indebted provinces will especially be pushed to do. China's local governments own a huge stock of assets, including equity in more than 100,000 companies. Equity in these state firms is most likely to be sold off to raise funds.

The PBoC has also promised to use its own balance sheet to provide liquidity to local governments when needed. In November, PBoC Gov. Pan said:

"When necessary, the PBoC will provide emergency loans to areas with relatively heavy debt burdens."

The PBoC hasn't yet provided any details about how the loan facility will work. However, Pan's comments partially confirm media reports that the PBoC is considering setting up a special purpose vehicle (SPV) to help local governments under funding pressure.

Of course, it remains to be seen whether this will be enough. Even if authorities can reduce debt servicing costs to a level low enough for local governments to manage, the scale of monthly interest payments will nonetheless erode local governments' ability to provide public services. To bring the debt crisis to an end, the central government may have to overhaul the division of responsibilities between Beijing and local governments, with Beijing taking on responsibility for funding many of the services that traditionally fell to local authorities. The net effect will be that local government finances improve, and central government debt increases - an outcome not dissimilar to a bailout.

Still, that's likely to be the final stage of the local government debt cleanup and will need to be part of a broader reform of the tax system.

Conclusion

The cleanup of local government debt will be a long, drawn-out process. Moreover, it will proceed at a different pace in different parts of the country. Some provinces may be able to get their debts under control quite quickly. For others, it will weigh on the local economy for years to come.

One of the major challenges facing Beijing is that infrastructure investment funded by local government borrowing continues to make an important contribution to economic growth. However, that requires local authorities to take on large amounts of additional debt each year, even as they try to bring the existing stock of debt under control. Beijing needs to take on a greater share of infrastructure financing. It might already be moving in that direction.

In November, the National People's Congress - China's parliament - approved the issuance of RMB 1 trillion worth of sovereign bonds to fund disaster relief and prevention projects. The funds are to be distributed to local governments to spend. Much of it will go toward infrastructure projects, with a focus on flood prevention and water conservation.

Still, it's earlier days. But if Beijing is serious about reining in local government debt, it needs to play a role in limiting its expansion.

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