

China: Ring-Fencing Local Government Debt

Imposing Guidelines to Regularize Local Government Debt

China's State Council on Thur (2 Oct) published its first ever set of guidelines to ring-fence local government debt/local government-type debt, in its continuing efforts to establish appropriate behavior and parameters in raising, using, and repaying debt (“借、用、还”), mark out the roles and responsibilities, as well as maintain the sustainability of local government debt financing.

As with the case of shadow banking, the Cabinet's statement starts off by noting the positive contributions of local government debt in social development, infrastructure building, and social welfare enhancement.

It then proceeds to lay out the guidelines to ring-fence the types and amount of local government debt that can be raised, their management, and usage of funds. Briefly:

- Allowing local governments to raise debt financing directly, a reversal of previous practice, for the purpose of public infrastructure and facilities, and prohibiting the usage of financing vehicles
- Imposing budgetary controls and pre-approved quantity limits on local government debt financing, usage of which can only be for public development expenditure and not for operating expenses
- Setting up clearly the role and responsibilities of local government debt management and repayment, local government debt risk management system and warning system, to maintain a penalty system for irregularities

It should be noted that the State Council's statement makes a clear distinction between “local government” debt (“地方政府债务”), and “local government-type” debt (“地方政府性债务”). The Cabinet is thus differentiating between debt that is raised directly by local government 地方政府债务, while the latter is broader which includes those that is raised by local government via financing vehicles (融资平台公司) and business units (企事业单位), all of these channels are now prohibited in the new guideline.

Implications:

For years, the lack of transparency, clarity, and proper financing channels and also the prohibition of local government from direct borrowing meant that borrowing costs had been higher than necessarily, and risks have also increased unnecessarily due to lack of transparency, proper risk management, inefficient use of borrowed funds, and mismatch of funds sources and usage.

The issue of local government debt has been swirling about over the past few years, causing much anxiety to the market as to the repayment ability, responsibility, and potential defaults and their implications, among others.

Such uncertainty on local government debt can now be at least partially allayed with the new guidelines from China's Cabinet, which is in time for the 4th plenary session of the 18th Party Congress that is scheduled from 20-23 Oct, with its focus of “rule of law” and economic development.

This guideline should therefore set in motion the establishment of a proper form of local debt financing system with clearly defined roles and responsibilities, towards those already practiced in more advance countries. For instance, the bankruptcy of

Detroit city (and bankruptcies of other US cities in the past) did not create stress at the national level or disrupt significantly the operation at the municipal level, nor did the Federal government compelled to rescue Detroit or any other bankrupt cities in the past.

It is therefore of note that the Chinese central government is now practicing the “no bailout” principle, now that the roles and responsibilities of local government in debt financing are now clearly spelt out.

To recap, past audits done by the National Audit Office (NAO) showed a significant increase in local government/local government-type debt. As shown in the table, the 2013 audit noted that overall local government debt rose by 12.6%, compared to the 4% rise for central government debt.

China: Central And Local Government Debt					
	End-2012 (RMB billions)	End-June 2013 (RMB billions)	% Change from 2012 to 2013	% Share of Total (2012)	% Share of Total (2013)
Central Govt					
Direct Debt	9,437.67	9,812.95	4.0	34.0	32.4
Guaranteed	283.57	260.07	(8.3)	1.0	0.9
Contingent Liab	2,162.12	2,311.08	6.9	7.8	7.6
Total Central Govt (A)	11,883.36	12,384.10	4.2	42.8	40.9
Local Govt					
Direct Debt	9,628.19	10,885.92	13.1	34.7	36.0
Guaranteed	2,487.13	2,665.58	7.2	9.0	8.8
Contingent Liab	3,770.52	4,339.37	15.1	13.6	14.3
Total Local Govt (B)	15,885.83	17,890.87	12.6	57.2	59.1
Total Central and Local Govt (A+B)	27,769.19	30,274.97	9.0	100.0	100.0

Source: National Audit Office (audit report released on 30 Dec 2013), UOB Economics & Markets Research Est

In addition, the table below shows NAO’s audit in 2013, with a wide variety of channels that local government used to raise financing and the ultimate repayment would still reside with these governments as the roles and responsibilities were not clearly spelt out.

China: Platforms of Local Government Debt (as of end-June 2013)					
(RMB billions except where noted)	Direct Debt	Guaranteed	Contingent Liab	Total (by types of lo- cal govt borrowers)	% Share by types of local govt borrowers
Types of Borrowing Platforms					
Local govt financing vehicles (LGFVs)	4,075.55	883.25	2,011.64	6,970.44	39.0
Local govt dept and agencies	3,091.34	968.42	0.00	4,059.76	22.7
Local govt-supported entities	1,776.19	103.17	515.71	2,395.07	13.4
SOEs	1,156.25	575.41	1,403.93	3,135.59	17.5
Self-funded entities	346.29	37.79	218.46	602.55	3.4
Other entities	316.26	83.14	-	399.41	2.2
Public entities	124.03	14.39	189.64	328.05	1.8
Total (by types of debt)	10,885.92	2,665.58	4,339.37	17,890.87	100.0
% Share of Total by types of debt	60.8	14.9	24.3	100.0	

Source: National Audit Office (audit report released on 30 Dec 2013), UOB Global Economics & Markets Research Est

In its latest survey in early 2014, NAO looked at debt of 9 provinces and 9 cities and found that the growth rate of local government debt between end-Jun 2013 to end-Mar 2014 has slowed to 3.79%, substantially below the 12.6% increase in 2013, as shown in the table earlier. This suggests that the local government debt is still manageable at this point, although it should be noted that some of the municipals may have more difficulties than others in managing and repaying their debt, as the headline growth slows across the country along with credit growth.

While it may take some time for the implementation and rehabilitation, the latest development is a positive sign that China is aware of the underlying issues and taking steps to address some of these critical weaknesses. Together with PBoC's earlier move to relax housing mortgage rules (see our report "China: PBoC to the Rescue", dated 1 Oct 2014), these measures would help to reduce further the risks of an economic hard landing in China.

As such, we maintain our full year growth forecast for China at 7.4% for 2014, and 7.5% for 2015. We also expect no change to China's policy rates for now as targeted measures look to be the preferred tools. We look for the headline RRR for major banks to remain at 20%, and benchmark deposit and lending rates unchanged at 3% and 6%, respectively. We are also keeping to our end-2014 RMB forecast to 6.10/USD.

Official Document Sources:

China's State Council Statement on Local Government-type Debt 国务院印发《关于加强地方政府性债务管理的意见》
http://www.gov.cn/xinwen/2014-10/02/content_2759933.htm

Q&A: China State Council's Statement on Local Government-type Debt 财政部就加强地方政府性债务管理有关问题答问
http://www.gov.cn/xinwen/2014-10/02/content_2759867.htm

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