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# The Looming Local Debt Problem in China

Presentation at the IFHC, Sao Paulo, Brazil  
12/8/2009

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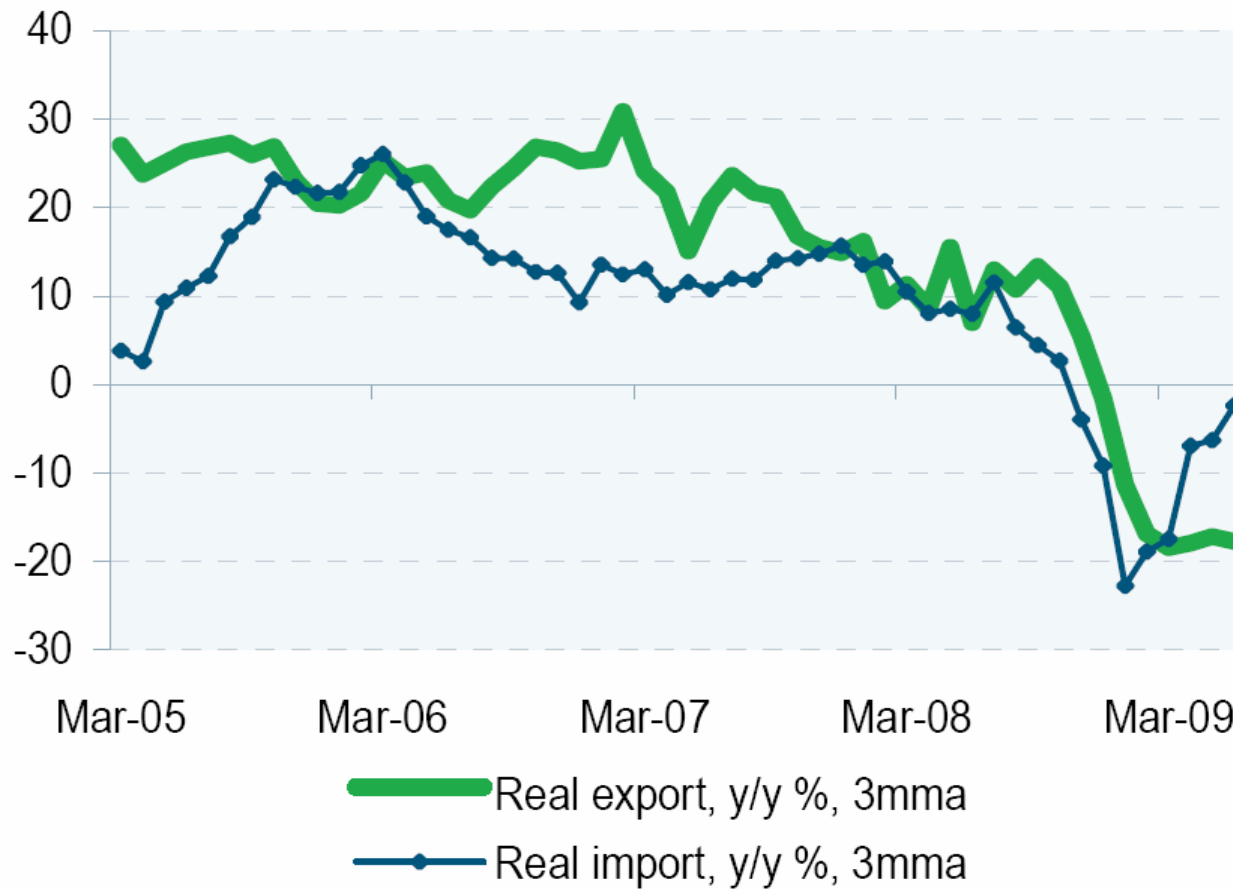
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# Summary

- Although China seems to have emerged from the crisis unscathed, the government in fact borrowed heavily to finance stimulus like their Western counterparts.
  - This leveraging is done in a highly un-transparent way
  - The banking system in China will bear the brunt of the fall-out, necessitating a massive bailout from China's foreign exchange reserve
  - China's 2+ trillion dollar foreign exchange reserve won't seem so large relative to this problem
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# Export remains weak

*Real export and import growth, y/y % 3mma*



Source: Standard Chartered

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## Unemployment Rose Rapidly in China

- Over 4% or 12.6 million official urban unemployed
  - The central government estimated that as of January of 2009, some 20 million unemployed migrant workers
  - Of the 5 million or so college graduates in 2008, only 70% received employment
  - Total unemployment in 1H2009: at least 33 million
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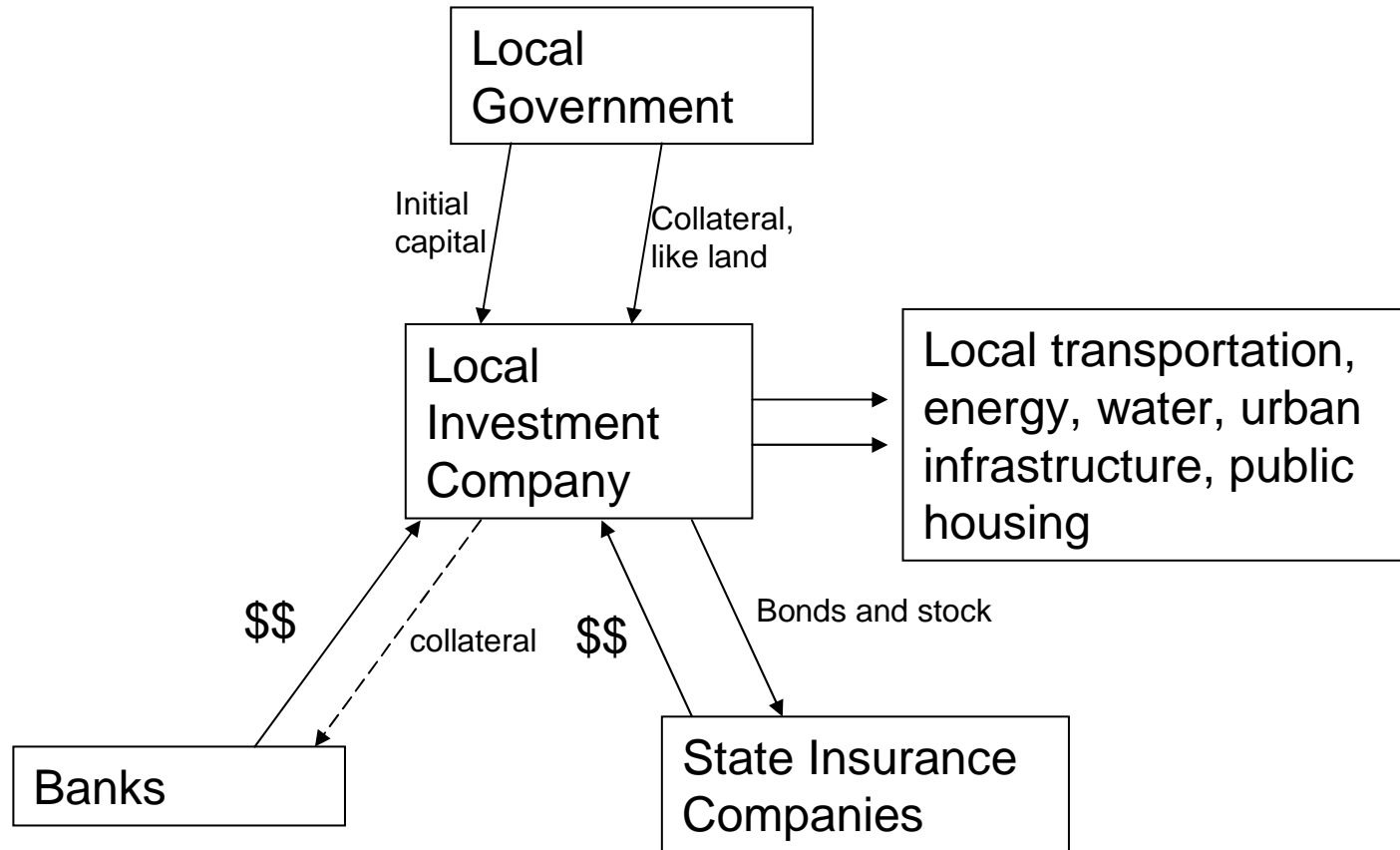
## So, the Chinese Government Responded with Massive Stimulus

- 588 bln dollar stimulus program, of which:
    - 300 bln on transportation infrastructure
    - 120 bln in earthquake reconstruction
    - 54 bln on subsidies to large state-owned firms
    - 29 bln for welfare and environmental protection
  - However, that's not nearly all of it!
  - Local Governments Announced Over 4 trillion dollars in additional stimulus projects, primarily for infrastructure
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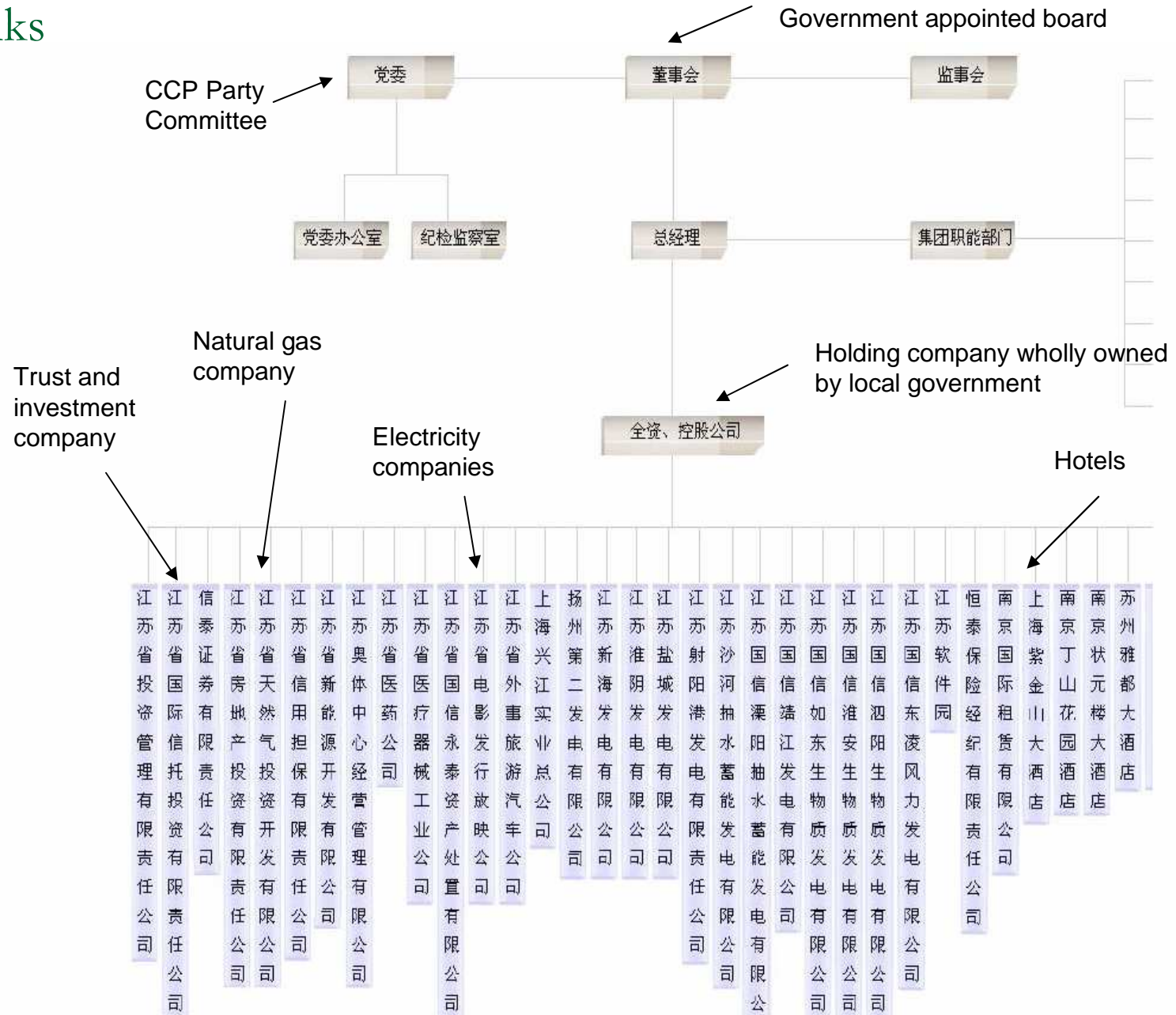
# How is the stimulus financed?

- Of the 588 billion in central projects, only  $\frac{1}{4}$  is financed from the central budget
- Local bond issuance and company debt finance another 10% of it.
- The rest— bank loans
- What about financing of local stimulus programs?— bank loans because most local governments run perennial deficits
- Basically, both central and local governments finance debt OFF BALANCE SHEET by setting up “urban investment companies” which borrow heavily from banks to finance stimulus projects
- Thus, just like the US and Europe, the Chinese government borrowed heavily to finance the stimulus, but using off balance sheet methods to hide their debt

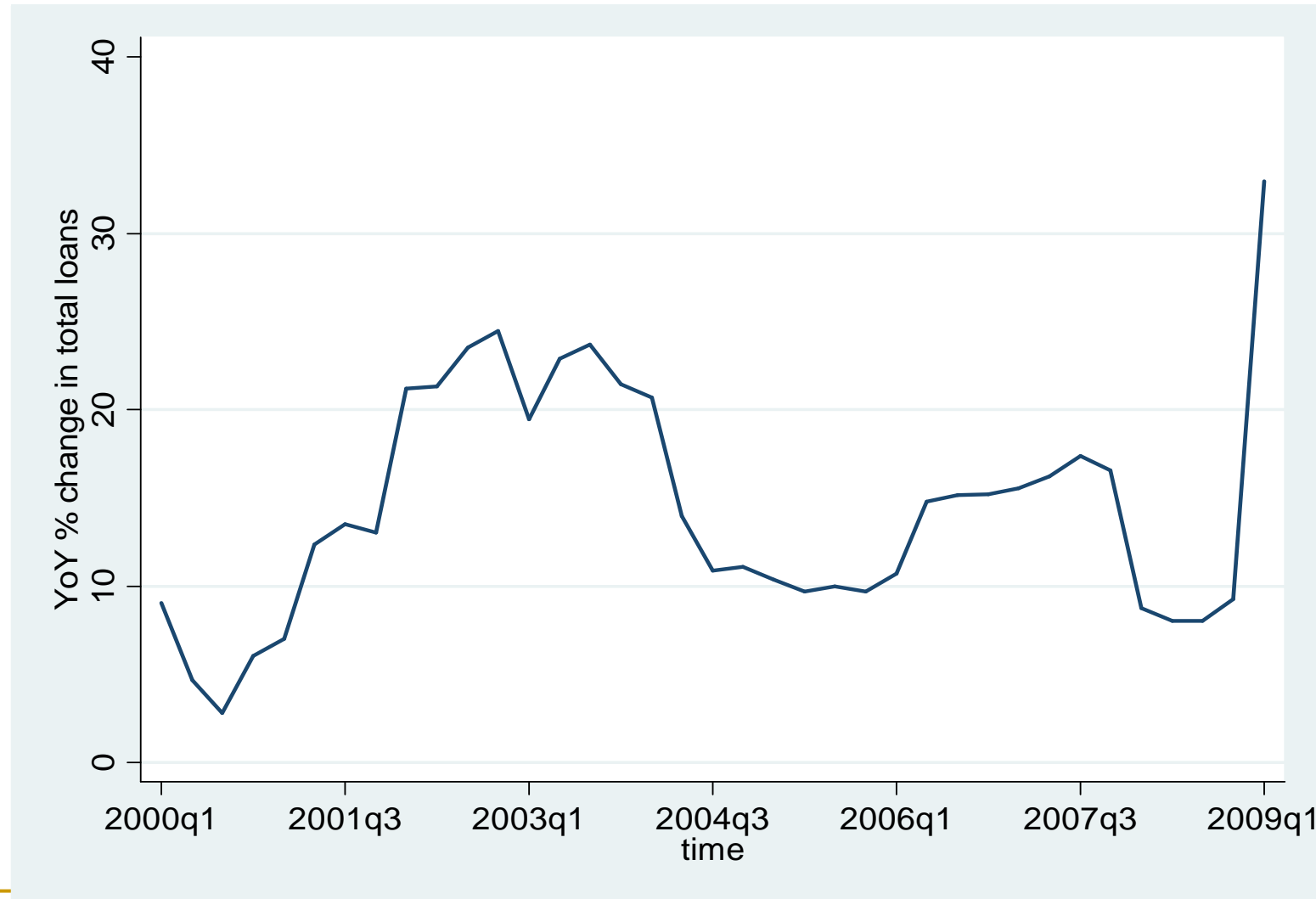
# How it works



# Local Government Holding Companies—Used to borrow money from banks

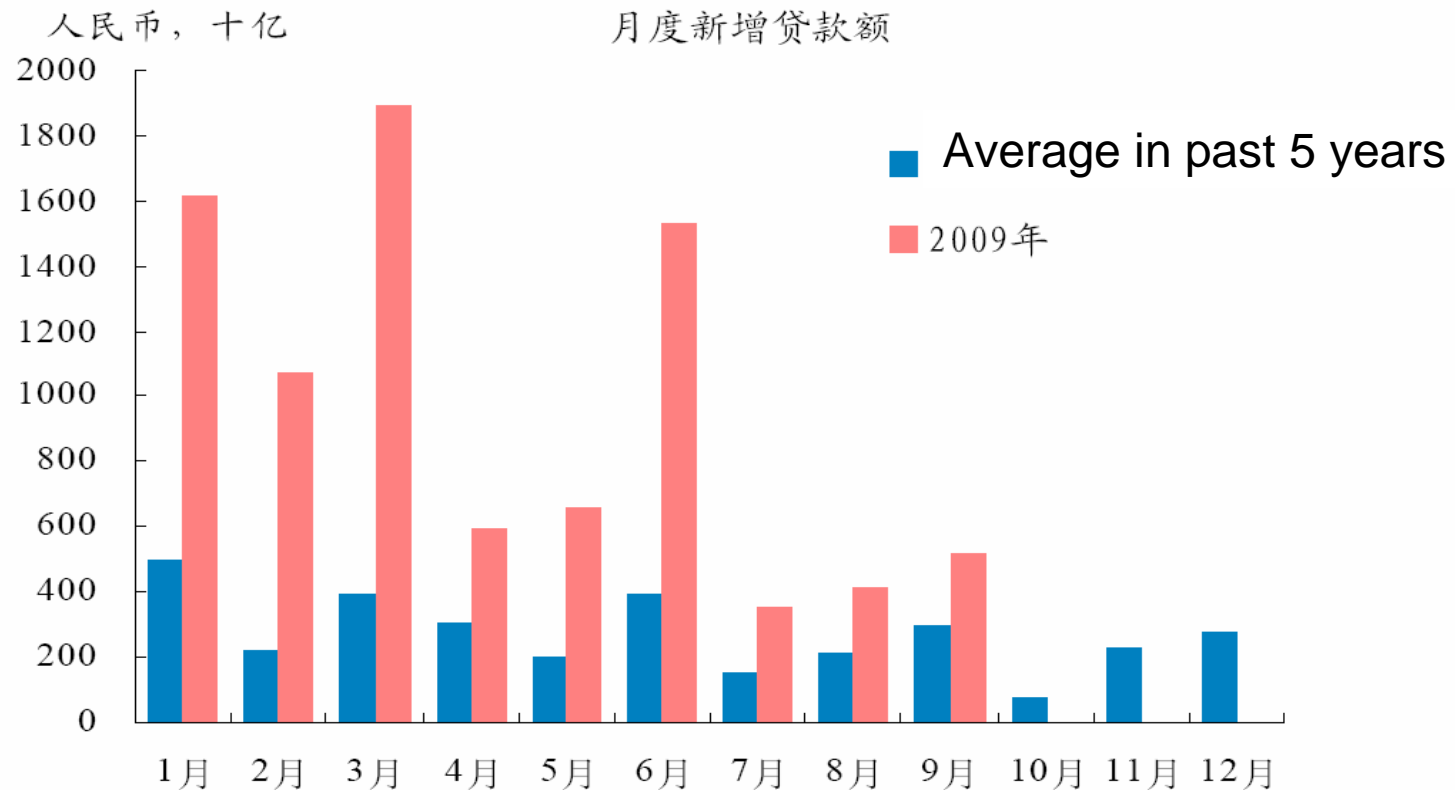


# Mad Money: 30+% Increase in Lending This Year



Source: DAC, PBOC

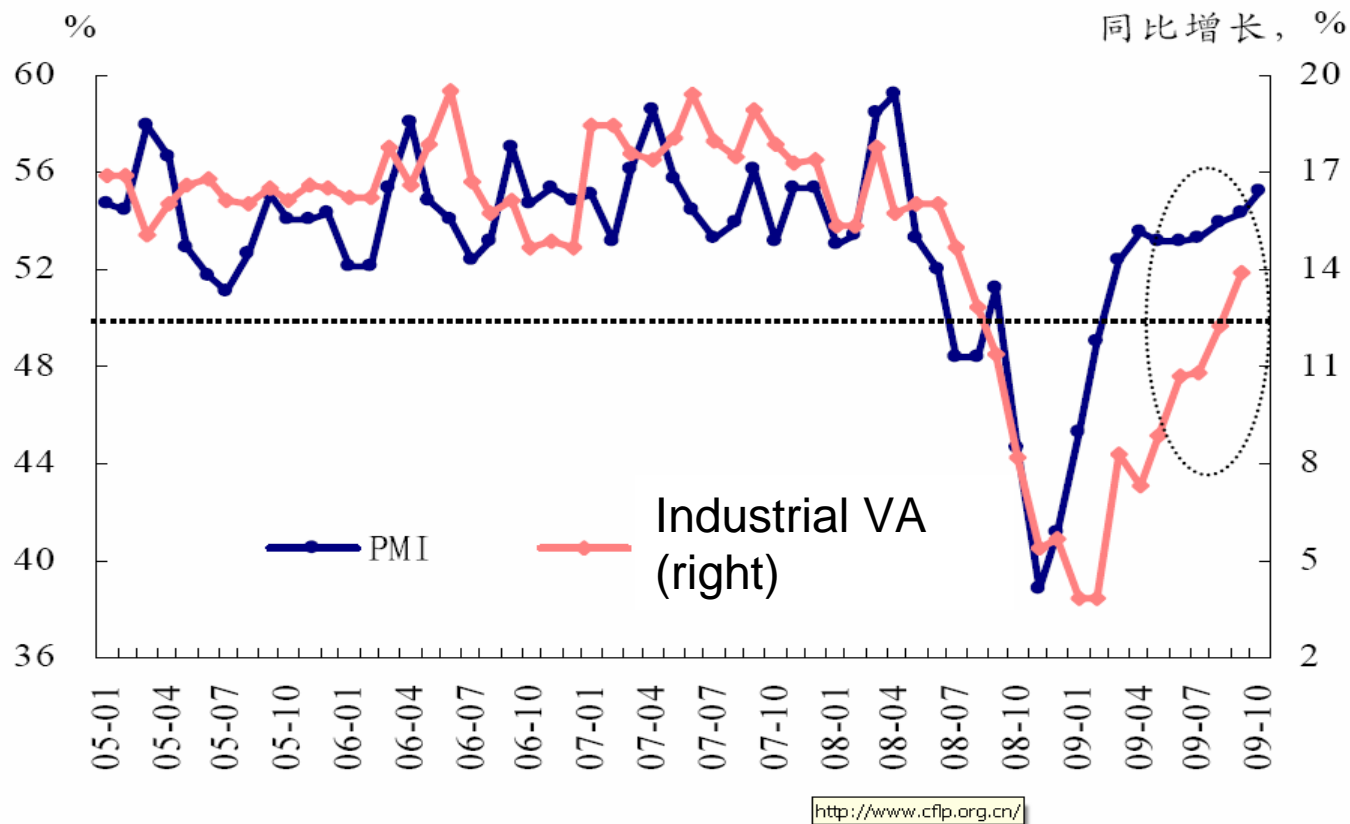
# 2009 Monthly Lending Compared with Average in the Past 5 Years



资料来源：CEIC、中金公司研究部

Source: CICC

# China PMI and Industrial Production Improving



资料来源：中国物流与采购网 <http://www.cflp.org.cn/>，中金公司研究部

Source: CICC

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# Some Worrying Signs

- Total new lending projected at 10 trillion RMB (1470 bln USD) this year, roughly 1/3 of China's GDP in 2008
  - Over half went to stimulus projects, which are public goods with poor cash flows (though not no cash flows)
  - It remains unclear how many of these projects can pay interest regularly, much less repay principal
  - Many of these loans are collateralized, but the same collaterals are used for multiple loans. Some collaterals are fake or have wildly exaggerated values, like CDOs in the US.
  - Central Bank Governor Zhou Xiaochuan recently said that “urban investment companies are basically not following the rules and will encounter problems in the future, especially in repaying loans”
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# Trouble on the Horizon: Special Mentioned Loans

SMLs total 1/5 of SDB loans

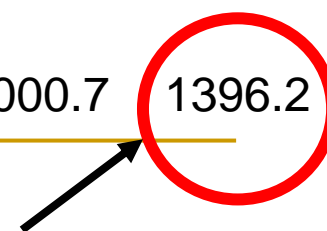
	2008	2007
Pass grade	2,310,637	1,811,615
Special-mention grade	568,915	453,104
	<u>2,879,452</u>	<u>2,264,719</u>

# NPL Scenarios by the end of 2010 with 53 trn RMB in Loans Outstanding

NPL scenarios	2.04%	3%	4%	5%	7%	9%	10%	15%
New NPLs (bln)	1081.2	1590	2120	2650	3710	4770	5300	7950
Total NPLs (bln RMB)	2486.4	2995.2	3525.2	4055.2	5115.2	6175.2	6705.2	9355.2
Total NPLs (bln USD)	371.10	447.04	526.14	605.25	763.46	921.67	1000.7	1396.2

Source: DAC, PBOC

**Over half of China's FX reserve!**



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# Implications

- Once again, the Chinese government has opted to hide its deficit by financing public goods through banks
  - But this exposes banks to insolvency, which requires massive bailouts from the budget and the fx reserve
  - Already, the Chinese government spent nearly 400 billion USD bailing out banks
  - Even if a modest wave of NPLs hits the banking system, over half of China's fx reserve would have to be used to bail out banks
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# China the “Super Power?”

- Before we call China a “super power,” we must recognize that its economy still has many weaknesses, which require fundamental reform to fix
  - A key reform will be to make local debt explicit by allowing local governments to issue bonds directly to the market
  - However, few have incentive to carry out this reform, so local debt remains a hidden problem until it develops into a major banking crisis.
  - China still has the capacity to weather a crisis of the current proportion, but if more money is ploughed into these local development companies, the size of the crisis may become too big for China’s existing fiscal and monetary resources
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