China Economic Update

National Australia Bank

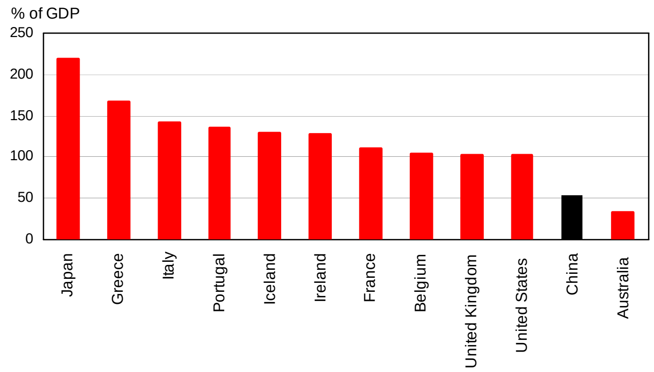
Growing local government debt a degree of concern, but it can be carefully managed

In late December, China's National Audit Office (NAO) released a comprehensive and long awaited review of the debt of the country's local governments. Concerns have been raised by the rapid growth in local government liabilities in recent years, with questions around the stability and security of China's sub-sovereign debt, and the risk that a potential default could trigger a broader financial crisis. Such concerns appear excessive, in part as the risks associated with local government debt appear to be weighted towards the short term, and with careful regulatory and fiscal reform, including greater transparency and accountability, these risks can be reduced significantly over the next five to ten years.

China's local governments – comprising a broad range of authorities at provincial, city, county and village & town level – have a critical role in China's economic development, as they are responsible for the majority of the country's infrastructure development. However under current regulations, they are prohibited from either borrowing directly from financial institutions or issuing bonds (except with specific approval from Beijing).

According to the NAO, China's local government debt totalled RMB 17.9 trillion (or around 31% of GDP) at the end of June 2013, up from RMB 15.9 trillion at the end of 2012 and RMB 10.7 trillion at the end of 2010. Combined with Central Government debt of RMB 12.4 trillion, China's total government debt was around 53% of GDP in mid-2013. Compared with the considerably higher debt levels in a range of advanced economies – where there are debt-to-GDP ratios in excess of 100% – this debt level is not overwhelmingly concerning, with a ratio of 60% generally viewed as sustainable (the EU target level under the Maastricht treaty). In addition, the vast majority of government debt is denominated in RMB terms and is held by domestic parties.

China's gov't debt more favourable than advanced economies



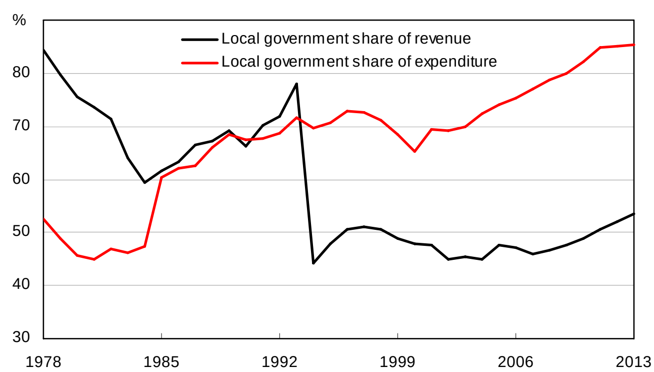
Sources: OECD, NAO, NAB Economics

That said, the debt picture is not entirely transparent. According to the NAO, local governments have direct responsibility to repay around RMB 10.9 trillion (around 60% of the total), with the remainder being contingent liabilities (debts that these governments have a responsibility to guarantee, either officially or implicitly). The NAO notes that these guarantees do not directly translate into debts, as the guarantees only cover a portion of the total liability (historically around 19% of officially guaranteed debt and less than 15% of implicitly guaranteed), which somewhat reduces the concerns around contingent debt. Assuming these historical trends continued, this would reduce total government debt to around 41% of GDP.

While the scale of debt may not be too troubling, the pace of this growth has been a major concern, with debts increasing more rapidly between 2010 and 2012 than either GDP or government revenues – leading to a decline in the capacity of some governments to service these debts.

Local government funding has been a longer term issue, with constraints on revenue largely originating with the 1994 Budget Law. In the decade leading up to the Budget Law, the central government's share of total tax revenues declined, and these measures were designed to arrest this trend, along with simplifying the tax system, increasing the tax revenue to GDP ratio and increasing the transparency between central and local government funding. Further changes in 2002 increased the central government's share of personal and enterprise income tax. Since the introduction of these regulations, local government funding has been a significant issue, with the World Bank estimating that local governments are responsible for 80% of spending from around 40% of tax revenue.

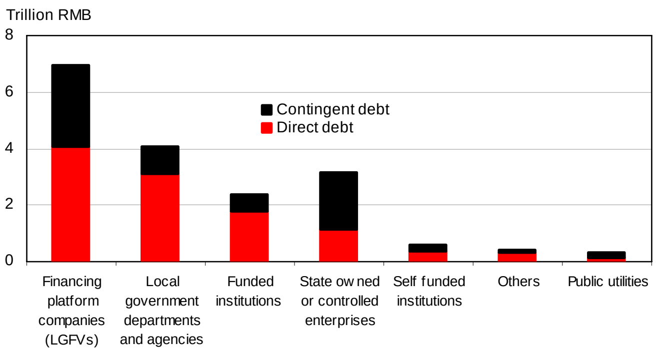
Mismatch between local gov't revenue and expenditure



Sources: CEIC, NAB Economics

The main sources of funding for local governments have been Local Government Financial Vehicles (LGFVs), corporate entities that are controlled by local governments but avoid Budget Law borrowing restrictions. However, since the debts are off government balance sheets, there is a lack of regulatory oversight. The LGFV sector grew strongly during the post-GFC stimulus period, with estimates that there were at least 3800 individual entities in mid-2009 (IMF). According to the NAO audit, LGFV debt totalled RMB 7 trillion at the end of June 2013, around 39% of the total. The financial stability of LGFVs varies widely – some are profitable, with sufficient operating incomes to make loan and debt repayments, while others receive support from local governments – including setting aside future revenues to provide subsidies.

LGFVs the largest borrowers

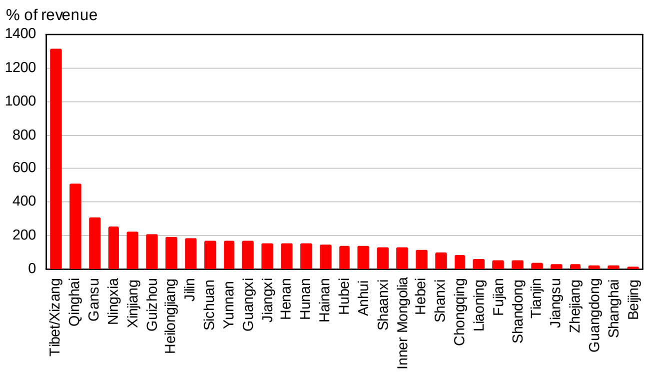


Source: NAO, NAB Economics

According to the IMF, the main sources for local government debt repayment are receipts from the sale of land lease rights, meaning that the capacity of local governments to service debt is related to the performance of real estate markets. This implies a greater level of risk associated with a correction in Chinese property markets than would be the case in other countries. In addition, the Central Government's reform agenda outlined plans to reform land rights, particularly in rural areas of China, which could place greater restrictions on local government land sales.

More generally local government revenues and expenditure differ widely across the country. This can be highlighted in part by the contrasting provincial fiscal gaps – the level to which expenditures exceed revenues (as a percentage of revenue). The local governments of major population centres – Beijing, Shanghai and Guangdong – have the lowest fiscal gaps, while the scale is considerably higher in provinces such as Tibet/Xizang, Qinghai, Gansu and Ningxia – located in the north-western parts of the country.

Significant differences in stability of local gov't revenues

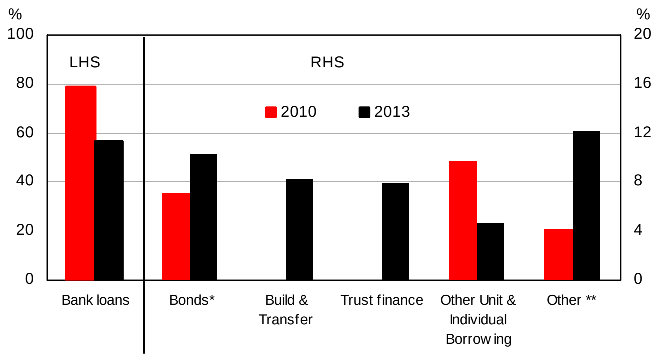


Sources: CEIC, NAB Economics

The restrictions around local government borrowing can create some negative short term incentives. The IMF note that local government officials are promoted based on their performances in maintaining local economic growth, employment and social stability. These standards can provide incentives for officials to approve credit intensive projects that inflate growth, with the responsibility for debt obligations likely to fall to their successors.

Another major concern is the mismatch between the relatively short maturity of local government debt and the longer term nature of infrastructure projects. Bank loans remain the largest source of financing – totalling RMB 10.1 trillion at the end of June 2013, however the share of bank loans to local government debt has declined since 2010, down to 57% recently (from around 79%). An emerging funding source has been trust products – a component of the broader shadow banking sector – which accounted for around 8% of the total in mid-2013. There is a significant mismatch between the typically short duration of trust products – the average maturity is two years – and the longer payoff period for infrastructure. More generally, there is also considerable concern due to the minimal regulatory oversight of shadow banking.

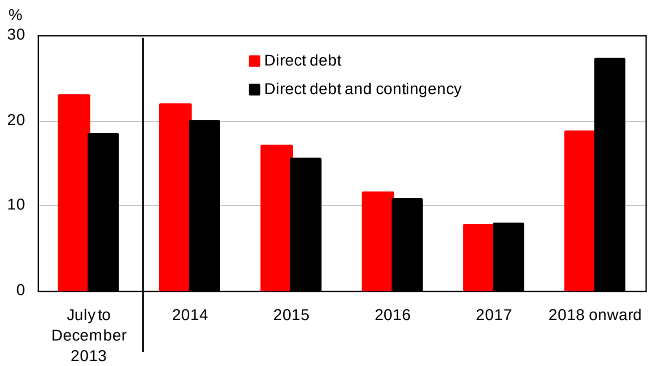
Bank loans losing share of local government financing



* Excludes local gov't bonds and corporate bonds for a like-for-like comparison. ** Largely central government loans in 2010 Sources: CEIC, NAO, NAB Economics

In total, almost 62% of direct local government debt is set to mature by the end of 2015 (including 23% of which matured in the six months to December 2013). When contingencies are included, this level declines to 54%, reflecting a comparatively large share of contingent debts set to expire in 2018 and beyond.

Short term nature of local government debt

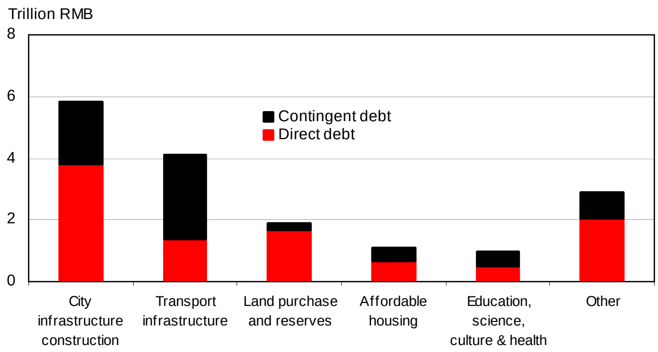


Sources: NAO, NAB Economics

The growth in debt in recent years has largely been infrastructure focused. This was particularly the case following the Global Financial Crisis, when infrastructure development was prioritised to counter the negative effects of slowing exports. During the GFC, the central government introduced a RMB 4 trillion stimulus package, of which central government funding was around RMB 1.18 trillion. Most of the remainder was generated at the local government level, via LGFVs (IMF). Similarly, the mid 2013 mini-stimulus program likely contributed significantly to the debt increase in the first half of the year.

The heavy emphasis on infrastructure development has some positive features when comparing China's government debts to those of other economies (where debt levels have typically risen due to increased consumption), since the liability is somewhat offset by the acquisition of the infrastructure as an asset. However, asset quality is difficult to assess, with high profile examples of so-called ghost cities highlighting the risks of inappropriate infrastructure developments. Infrastructure development accounted for around 59% of total local government debt, followed by land purchases at 11% and public housing at 7%.

Infrastructure the main use of debt funding



Source: NAO, NAB Economics

The broad reform agenda outlined at last year's Third Plenum is likely to improve local government finances longer term, however these reforms are likely to be made cautiously, as they could elevate some of the short term concerns. For example, the gradual liberalisation that is currently occurring in Chinese money markets has contributed to a tightening in liquidity, driving market interest rates higher. This could put direct pressure on authorities in terms of interest costs, as well as impacting on real estate markets that underpin the revenues of many local governments.

Moves to allow local governments to issue bonds would allow a greater degree of security for local government debt, as well as reducing the mismatch between the long term infrastructure investment and short term debt horizons. It could also reduce requirements to borrow from the shadow banking sector, providing a considerable improvement in transparency. In January, the National Development and Reform Commission suggested that it would give local governments more leeway in terms of bond issues. The IMF argue that while sound local governments should be allowed to introduce market priced bonds, the central government should explicitly not guarantee them, so as to reduce the risk of moral hazard at the local level.

The IMF recommend a range of reforms, including improving the transparency, predictability and reliability of transfers between the central and local governments, greater clarity as to the expenditure responsibilities of local governments, introducing property taxes (a key tax for local governments in many countries) to reduce the reliance on land sales and greater regulation and supervision of local government budgets. The organisation also recommends developing a credible mechanism to resolve local government insolvencies, should they occur.

In conclusion, local government debt appears to be less an immediate sovereign debt risk than a moderate but growing concern that will require careful consideration within the broader reform agenda to correctly address and reduce its potential impact.

Recent economic data

Due to the Chinese New Year holiday period, there was limited economic data released this month. The holiday period falls at a different time each year – either in January or February – and therefore it can provide significant distortion to the results.

In the absence of industrial production data, manufacturing PMIs are the only indicator of industrial activity. The official NBS PMI eased slightly in January – down to 50.5 points (from 51 points in December), while the HSBC Markit PMI fell more significantly – down to 49.5 points (from 50.5 points previously). Both measures have declined from recent highs in October and indicate a continued softening trend in the industrial sector.

China's trade data was surprisingly strong in January – considerably outpacing market expectations. The trade surplus expanded again – to US$31.9 billion (compared with $25.6 billion in December) – only a little behind the four year high recorded in November.

Export growth was expected to be weak in January – reflecting the efforts from mid-2013 to crackdown on false invoices used to avoid capital controls (a trend which artificially inflated export growth in the first half of the year). Instead merchandise exports (in US dollar terms) grew by 10.6% yoy in January – compared with expectations of just 0.1% in the Bloomberg survey.

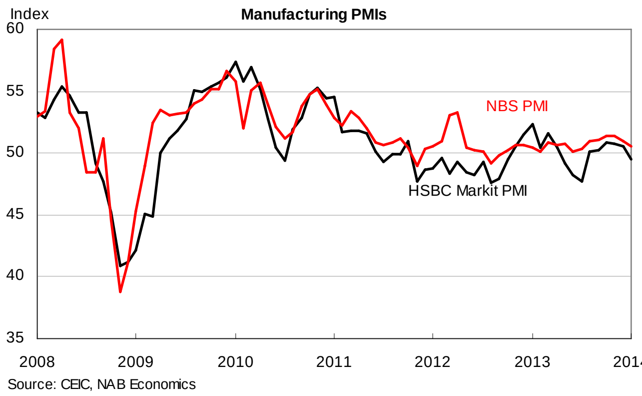
The strength of this increase was met with considerable scepticism from analysts and commentators – particularly given the slowing trends in the industrial sector signalled by weaker PMIs. There has been speculation that financial flows may have influenced the export growth – a charge denied by China's Ministry of Commerce.

Similarly, growth in imports was stronger than expected – with imports increasing by 10% yoy (compared with market expectations of 4%). Commodity imports were particularly strong – with industrial consumers taking advantage of relatively low prices to stockpile raw materials – with copper increasing by 53% yoy, iron ore by 32% yoy and coal by 18% yoy.

Inflationary pressures were stable in January – with the headline CPI at 2.5% yoy (the same level recorded in December). Food price inflation has continued to ease – with the food index increasing by 3.7% in January (compared with 4.1% in December and the recent peak of 6.5% in October). Non-food inflation was a little stronger – at 1.9% yoy (up from 1.7% last month).

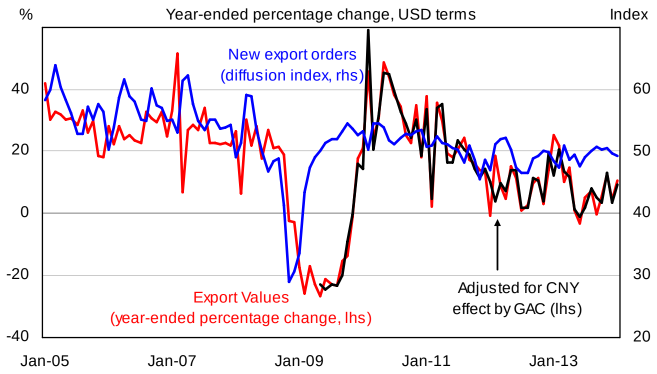
Producer prices have continued to decline – at -1.6% yoy in January (compared with -1.4% in December). This trend has persisted for almost two years – with producer price trends closely correlated to falling commodity prices. The Reserve Bank of Australia's Commodity Price Index fell by almost 10% yoy in January.

PMI measures start the year a little softer



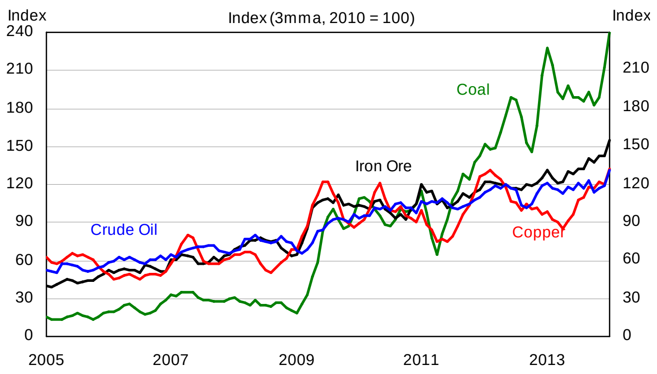
Source: CEIC, NAB Economics

China's exports surprisingly strong in January



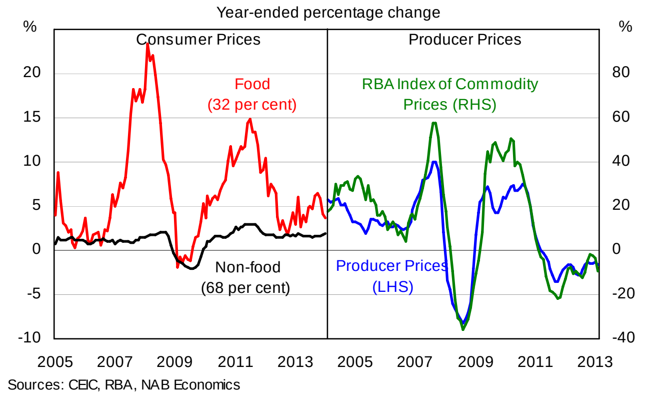
Source: CEIC, NAB Economics

Commodity import volumes supported by investment



Sources: CEIC, NAB Economics

Consumer and Producer Prices have eased



Sources: CEIC, RBA, NAB Economics

Policy expectations:

The People's Bank of China was considerably more active in January – in terms of open market operations – than was observed across 2013, as the bank attempted to avoid a short term credit crunch for the second straight month.

The Shanghai Interbank Offered Rate (Repo) spiked in late December, as demand for cash surged in order to meet end-of-quarter regulatory requirements in the finance sector. There were concerns that similar crunch could have occurred in advance of the Chinese New Year – leading to a large injection of liquidity in late January.

This move was successful in limiting upward pressure on the 7 day Repo rate – which peaked at almost 6.6% on 20 January (prior to the injection), before pulling back to trend at around 5% ahead of the holiday. However in the post-holiday period, rates fell significantly, down to 3.8% on 17 February. In response, the PBoC issued RMB 48 billion worth of 14-day repurchase contracts on 18 February to withdraw liquidity from markets.

The PBoC has continued to signal its intention to 'tame and curb excessive credit expansion', meaning the gradual tightening in market rates is set to continue – particularly given the sizeable increase in aggregate financing, which was RMB 2.58 trillion in January (a new record).

Negotiable Certificates of Deposit (NCDs) are set to become more prevalent in 2014. The pilot at the end of 2013 led to issuances totalling around RMB 34 billion by ten banks. In early 2014, four banks have already announced plans to issue RMB 360 billion worth of NCDs this year, and there is speculation that the system could be further liberalised, allowing small-to-medium sized banks (outside of the initial ten approved institutions) to participate in the future.

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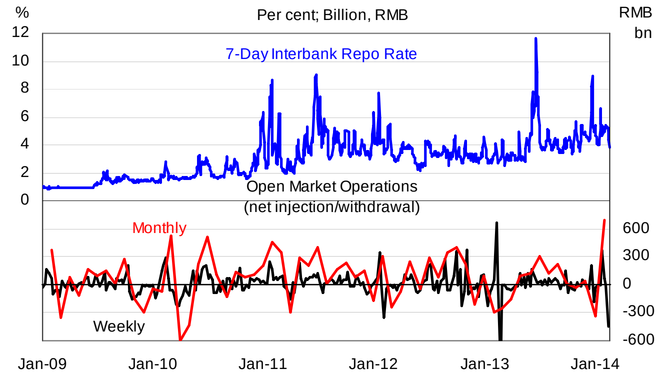
Liquidity conditions



Source: CEIC, NAB Economics

Longer maturity interest rates

Sources: CEIC

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