China Economic Update October 2022

Vicious cycle: falling land sales hitting local government revenues

NAB Group Economics

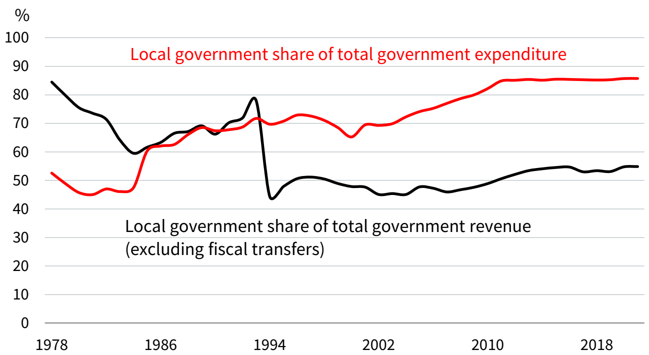
Deteriorating conditions in China's residential property sector since mid-2021 has seen new construction activity and land sales decline in year-on-year terms. While the former points to weaker near-term economic growth prospects, the latter is a major concern for local government revenues as many of these authorities are highly dependent on revenue from land sales. The composition of buyers also points to concerns around the longer-term sustainability of local government balance sheets.

Government coffers dependent on real estate growth

There have long been issues regarding the funding of local governments. The 1994 Budget Law and subsequent changes in the early 2000s saw China's central government increase its share of total revenues, despite local governments being responsible for the bulk of expenditures (including the costs associated with managing COVID-19). Until 2014, most local governments were prohibited from issuing bonds (aside from those participating in pilot programs), and they remain unable to borrow directly from financial institutions.

Local government finances

Revenues have lagged expenditures since mid-90s



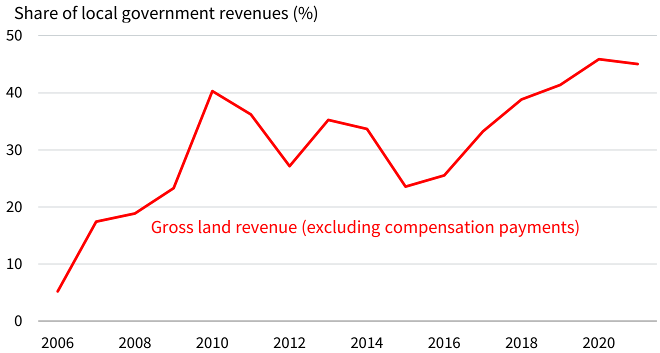
Source: CEIC, NAB Economics

These constraints led to the creation of Local Government Financing Vehicles (LGFVs) – companies controlled by these governments that could borrow funds on their behalf. These funds have typically been used to finance infrastructure developments, commonly using land as collateral for the loans. The discovery of large-scale debts associated with LGFVs, following a National Audit Office investigation in late 2013, lead to fears of a debt crisis in the early months of 2014. However, these fears were somewhat mitigated by expanding local government bond issuance and transfers from the central government.

Despite these reforms, local government revenue has remained highly dependent on land sales. Incentives to maximise land sale revenue permitted the lax regulatory oversight that allowed property developers to abandon uncompleted projects, leading to the current mortgage strikes. Official data show that land sales totalled RMB 8.7 trillion in 2021 – an increase of 3.5% – with this total (which excludes any costs associated with these transactions) accounting for around 45% of local government revenues, slightly down from the record high recorded in 2020.

Land sales revenue

Gross land sales account for a large share of total revenues



Source: CEIC, NAB Economics

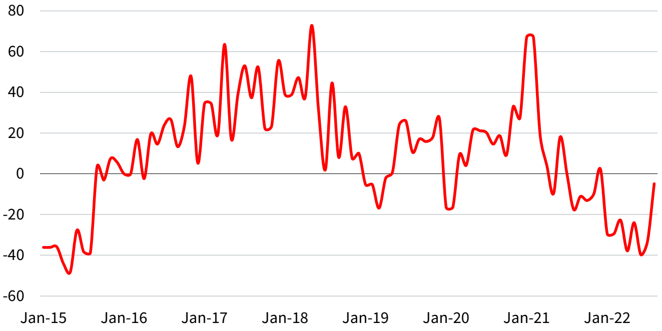
That said, there were wide disparities in land sales in differing parts of the country. Research by Tianfeng Securities suggested strong (double-digit) growth in major cities such as Beijing, Shanghai and Tianjin in 2021, while thirteen provinces recorded falls in excess of 20%.

The deteriorating conditions in the property sector – including the fallout from the collapse of Evergrande, the mortgage strike and declining sales and new construction – has flowed through to falling land sales in 2022 to date. In the first eight months of the year, total land sales fell by almost 32% yoy.

Land sales revenue

Steep contractions in sales in 2022

Local government land sales revenue (% yoy)

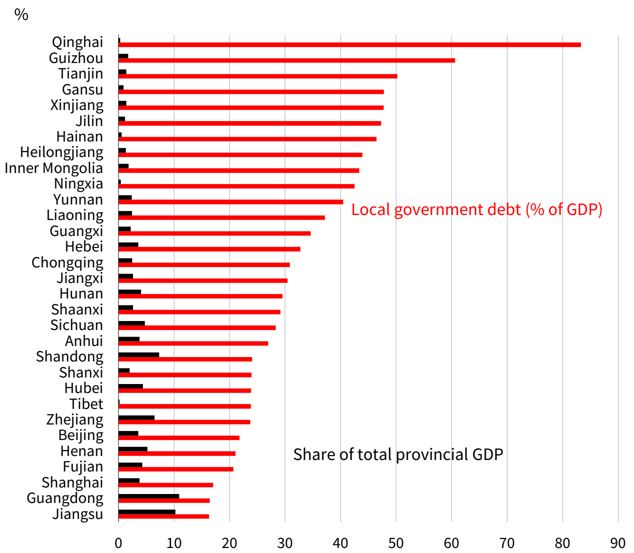


Source: CEIC, NAB Economics

Given the importance of land sales to local government revenues, and the likely weaker tax revenue associated with both lower economic growth and stimulatory tax breaks in 2022, this suggests that shortfalls in fiscal revenues will have to be funded by increased debt. At an aggregate level, local government debt has risen in recent years – up from around 20% of GDP in late 2018 to around 29% of GDP in mid-2022. That said, there is considerable variability in debt levels by province – with lower debt in larger, more prosperous provinces such as Jiangsu and Guangdong on the coast, and higher debt in smaller inland regions such as Qinghai, Guizhou and Gansu. It is also important to note that these debt levels do not take into account LGFV debts – as these are considered to be corporate debts – despite local governments having obligations for these repayments.

Local government debt

Higher debt in smaller provinces



Source: CEIC, NAB Economics

The capacity of local governments to service this debt going forward could be challenging if property and land market conditions remain subdued. As noted in last month's report, China's largest steel maker has warned that the downturn to the sector could be prolonged – lasting several years. According to S&P Global, between 10% and 30% of local governments could have interest burdens exceeding of 10% of their budgets at the end of 2022 (compared with less than 5% in 2020) – a trigger point for implementing fiscal consolidation plans (requiring a cut in spending) under a policy introduced by the State Council in 2016. It is not clear whether the State Council will offer any leeway around this policy to reflect current challenges – particularly ongoing COVID-19 policies.

Land sale data does not paint the full picture

In the past, private sector property developers dominated land purchases, however purchases by the country's 100 largest property firms fell by around 60% yoy in the first half of 2022. While state-owned enterprises may have increased purchases, there was also a notable increase among local government financing vehicles – increasing by 70% yoy to around RMB 400 billion in the first half of 2022. If these purchases were excluded, land sales would have fallen by almost 39% yoy over this period (compared with the 31.4% yoy decline for total sales). Reports suggest that LGFVs accounted for a majority share of sales in some smaller cities – effectively masking in increase in off-balance sheet debt in regions with weaker capacity to service it.

More generally there are also concerns around the sustainability of this LGFV debt. A report in the Financial Times in July noted that traditional lenders and bond investors have become increasingly wary of loans to LGFVs in recent times, leading to these firms to offer wealth management products directly to retail investors at interest rates far higher than those of typical business loans.

This has raised fears that financially weaker local governments or LGFVs could default on their debt. The Centre for Strategic and International Studies has suggested that the impact of declining land sales means that an LGFV default is "only a matter of time." As with previous bond defaults in China, a key question would be how much financial support the central government is willing to provide – which would risk ongoing moral hazard issues – to minimise the risk of contagion in financial markets that could collapse domestic bond markets.

Conclusions

Even if China is able to avoid a financial crisis related to this issue, the downturn in land sales once again highlights the precarious state of local government revenues and the urgent need for reform in funding. Various policy agencies have pushed for the introduction of a property tax for almost two decades but have faced resistance within the bureaucracy. In October 2021, a five-year pilot program in a range of unidentified cities was announced, however this was deferred in March due to the volatility in property markets. Such a tax would provide a more stable basis for revenue.

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