The Economist

Local-government debt

Counting ghosts

China opens the books of its big-spending local governments

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From the print edition

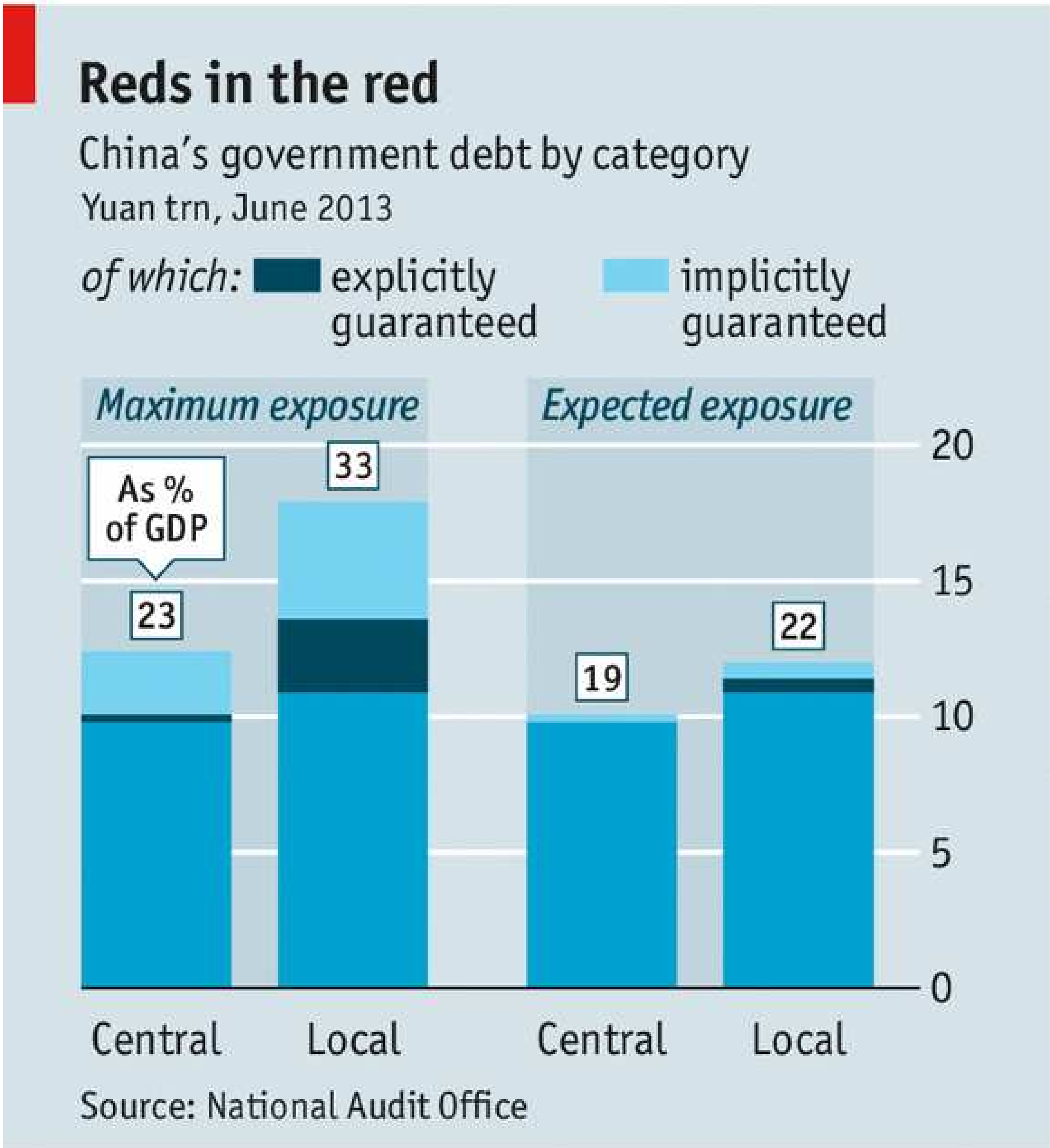
IN MANY countries, governments struggle to contain their debt. In China, the authorities struggle even to count it. Last August and September, 54,400 auditors fanned out across the country, quizzing local officials, scrutinising their books and inspecting their pet projects in an effort to tally the Chinese government's liabilities. They went from top to bottom, examining 31 provincial-level governments (which are typically responsible for tens of millions of people), 391 cities (often home to a million or more), 2,778 counties (with populations of hundreds of thousands) and over 33,000 townships (which are typically home to about 10,000 people). Never has so much been audited by so many.

The results appeared on December 30th. They showed a worrying increase in the size and variety of China's local-government debt since 2010 as the ambitions of local officials, for additional roads, bridges, utilities, homes, lucrative business hubs and unoccupied ghost towns, far outstripped their revenues. But such excesses are not shared by the central government. China's government as a whole is able to sustain its debts without undue strain on the economy. The question is whether the new leadership is still happy to do so.

The audit showed that China's local governments (and the investment vehicles they sponsor) owed 10.9 trillion yuan ($1.8 trillion) at the end of June. They had also guaranteed several trillion yuan of debt explicitly and another 4.3 trillion implicitly. Adding these three figures together yields a total of 17.9 trillion yuan, or about a third of China's GDP. But the National Audit Office (NAO) itself was careful not to add these three figures together. The debt guarantees, it pointed out, are only "contingent" liabilities: they will land in officials' laps only if bad things happen, and bad things do not always happen.

Based on past experience, the NAO believes local governments will have to bear only a fraction of these liabilities: 19% of the explicitly guaranteed debt and less than 15% of the implicit obligations. If the NAO is right, then the expected value of local-government debt shrinks to only 12 trillion yuan or 22% of GDP (see chart).

Adding the central



government's debts would bring the total to 56% of GDP, if contingent liabilities are taken at face value, or 41%, if they are counted at their expected value. That is not an alarming number, even if it does leave out a few items, such as the state's pension obligations and the debts of its policy banks.

Moreover, the debt, which is mostly held at home in China's own currency, is borrowed at interest rates below the growth rate of the economy. According to Tao Wang of UBS, the government borrows at an average interest rate of 7.3%, compared with nominal GDP growth of over 10%. In principle, therefore, China's stock of public debt could be rolled over indefinitely and it would still shrink relative to the size of its economy.

The NAO notes tartly that the governments of some countries borrow for "consumption", paying salaries and other outlays that leave nothing durable behind. China's local governments, by contrast, borrow to invest. Over 37% of their direct debt financed municipal building works, another 17% financed "land overhaul and preservation" and 7% paid for affordable housing. Not all the assets will yield decent returns, but they are worth something.

Although the overall levels of debt appear manageable, particular localities are clearly overstretched. The NAO found that three provincial governments, 99 cities, 195 county-level administrations and 3,465 townships had direct debts exceeding 100% of their annual economic output.

Since every debtor requires a creditor, overborrowing can be tackled from two sides: by restraining the borrowers or by disciplining their lenders. To curb the borrowers, China's leaders will no doubt further tighten fiscal controls over lower levels of government. They have also said that in evaluating local officials for promotion, they will now consider the debts they incur as well as the growth they generate.

China's regulators have also tried to impose curbs on lenders, discouraging bank loans to local-government investment vehicles, for example. But local governments have turned instead to the bond market and to shadow lenders, such as trust companies and securities firms. Bank loans, which accounted for three-quarters of their direct debts in 2010, now account for only half. Bonds make up 11%.

To scare the creditors, China's leaders could let one of these bonds go bad. That would send a necessary signal, argues Stephen Green of Standard Chartered. By exposing creditors to risk, a default would force lenders to price it properly. And by charging a higher price for risky borrowing, creditors would help to discourage it.

But an explicit default would represent a rare gamble for China's economic overseers. The country lacks clear legal procedures for resolving municipal insolvency, such as America's "chapter nine" bankruptcy code. Things could get messy.

Making a municipal default more manageable, and therefore thinkable, is one of the many tasks facing China's leaders. The overhaul of China's fiscal system will be overseen by a "leading group" on economic reform. This week President Xi Jin

ping was named head of that group, a responsibility that might previously have fallen to China's prime minister. By taking the role, Mr Xi again showed his keenness to put his stamp on the economic transformation. The creditworthiness of China's townships, counties, cities and provinces depends rather a lot on one man.

From the print edition: China