The Next Steps On Hidden Local Debt

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In 2021, China's central government is gearing up to once again to tackle the hidden debts of local authorities. These debts, largely the result of a decade of off-budget spending on infrastructure and other projects, have long been acknowledged as a sizable problem, but progress has been uneven at best. The central authorities are unwilling to deliver a full-scale bailout of unauthorized local borrowing, but neither are they eager to see the financial stress that would result from widespread defaults on those debts. The solution is likely to be a mixed one, combining limits on new borrowing, partial bailouts of some debt, and a lot of kicking the can down the road.

That's going to result in a divergence of fortunes between borrowers that have strong finances or access to government support, and those that do not. China's credit markets will increasingly price in the differences among state-owned enterprises and local government financing vehicles. This process will also increase the pressure on the People's Bank of China to keep liquidity loose and to avoid tightening monetary policy.

Hidden in plain sight

The hidden debt of local governments likely amounts to 40-50% of GDP

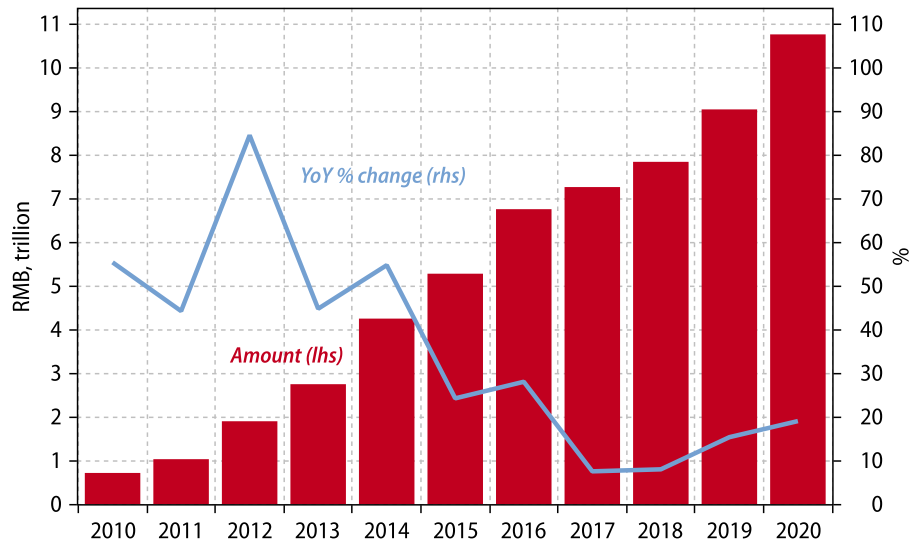
By definition, no one knows the exact size of hidden local government debt, but there's no question it is sizable, probably around 40-50% of GDP. While the IMF reports that China's official government debt was a relatively modest 45% of GDP at the end of 2020, its estimate of "augmented debt"—which includes LGFVs and government funds—is 92% of GDP. Those figures are consistent with the domestic estimates available for hidden debt, which are in the range of RMB30-RMB50trn for 2017-18, or 35-60% of GDP. And that's after a sizable portion of hidden debt was swapped into official debt: from 2015-18, local governments issued a total of RMB12.2trn in "replacement bonds" that swapped off-budget debt for formal government debt, at much lower interest rates. The partial bailout was paired with fiscal reforms that aimed to limit off-budget borrowing and give localities access to new methods of financing investment projects (see **A New Tool For Infrastructure Funding**).

The central government relaxed its limits on local borrowing in 2018 as priorities shifted toward supporting growth

The Ministry of Finance has continued to monitor hidden local government debt since then, with finance minister Liu Kun proposing in 2018 a two-pronged strategy to "resolutely curb the increase of hidden debt" and "appropriately resolve the stock of hidden debt." Some local governments, such as Inner Mongolia, have reported progress in dealing with their hidden debts. But the government's overall stance toward local debt relaxed as priorities shifted to stabilizing economic growth, with the State Council in July 2018 actually urging banks to support LGFVs and ensure funding for construction projects. As a result, the 2015 fiscal reforms did not completely stop local governments from using LGFVs and other forms of off-budget borrowing, and hidden debt has continued to expand. The most transparent form of hidden debt, outstanding LGFV bonds, grew 15% in 2019 and 19% in 2020.

Borrowing by LGFVs continued to expand quickly after 2015

Outstanding bonds of local government financing vehicles (LGFVs)



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The official rhetoric is now signaling the return of a tougher approach to hidden local debt in 2021

The tone has now changed, and the government is signaling a tougher approach in 2021. The Central Economic Work Conference in December urged officials to "firmly grasp and implement the work of resolving the risks of hidden local government debt." By comparison, in the 2019 conference the issue was not mentioned at all. In a speech in January, finance minister Liu Kun repeated the latest slogan and said "this work must be persistent, consistent and not leave behind problems for the future." In an interview in January, Liu acknowledged that some regions had seen an increase in hidden debt and that he was on "high alert." That shift in rhetoric likely means a return to the two-pronged strategy of controlling the increase in hidden debt, and finding ways to resolve the stock of existing debt.

As the past few years have demonstrated, it is difficult to put a hard cap on the growth of hidden debt. The structural issue is that many local governments have larger fiscal responsibilities than their formal income can support: they end up using disguised borrowing through SOEs and other companies to build infrastructure, as well as other projects like schools and slum renovation. Such borrowing is already off to a strong start in 2021, with LGFVs issuing a net RMB289.5bn in bonds in January according to Wind, 76% more than the figure for the first month of 2020.

LGFV bond issues have gotten off to a rapid start this year, but are going to have to slow down

But given the shifting policy stance, such a fast pace of bond issuance is unsustainable, and LGFVs are likely to face a tighter funding environment. There are reports that financial regulators will set new controls on LGFV bond sales, banning those with high hidden debt risk from issuing new debt. Whatever the final measures, the regulatory environment in 2021 is likely to be similar to 2017, when LGFV bond sales slowed significantly.

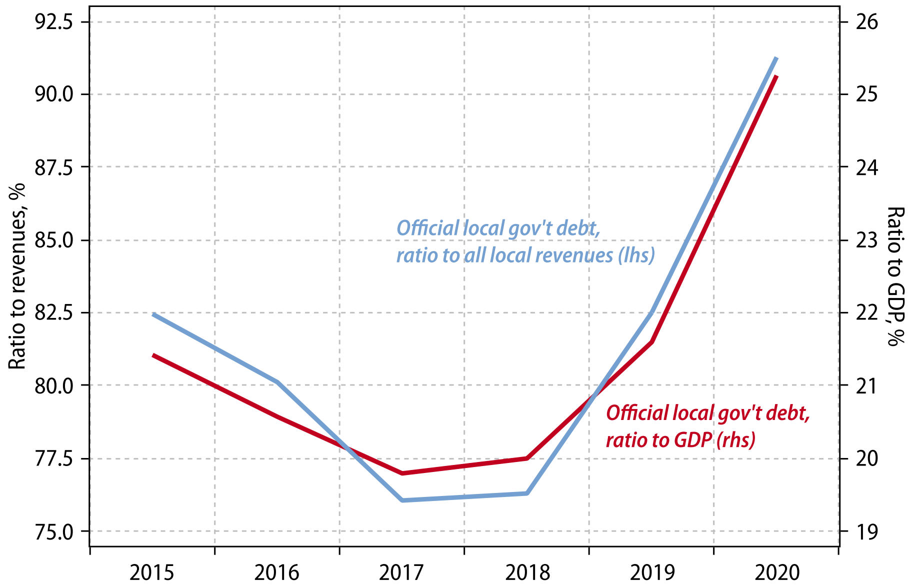
Dealing with the stock of existing hidden debt is much more complicated. Much off-budget debt is tied up in infrastructure projects, which take a long time to build and start generating financial returns. The return on assets of SOEs in infrastructure sectors has been consistently around 1.7%, much lower

Infrastructure projects usually generate low financial returns, so they need financial support from governments

than the interest rates available on corporate loans and bonds (see **The State Of The State Sector**). It is therefore often difficult for infrastructure projects to pay back their debts using their own cash flows, which is why they rely on implicit government backing. But the fiscal situation of local governments has worsened in recent years, and there are limits to how much fiscal revenue or land-sale proceeds they can mobilize to repay off-budget debts. The official on-budget debt that local governments have to repay already amounts to over RMB25trn as of 2020, equivalent to over 90% of all local revenue and 25% of national GDP. As a result, there is constant pressure to roll over hidden debts as they come due, to avoid either forcing LGFVs to default or local governments to make good on their implicit guarantee.

But local governments face rising official claims on their limited fiscal resources, so they have little to spare for hidden debts

Even official debt is putting rising pressure on local government finances



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After some defaults by local SOEs and amid tighter liquidity, it's getting harder to roll over hidden debts

"Extend and pretend" has generally been a successful strategy for local governments: historically there have been very few public cases of local SOEs or LGFVs defaulting. There have been some technical defaults on LGFV bonds, but the investors were usually paid back quickly, reinforcing investors' belief that local governments will support them when needed. Yet rolling over debt is now getting more complicated. After a string of unusual defaults by local SOEs in late 2020, investors are questioning local governments' willingness and ability to support borrowers (see **Eroding The Implicit Guarantee**). The credit cycle also peaked in October and credit growth has decelerated since then, which means liquidity is becoming tighter at the margin. That is increasing the pressure for local governments to step in with bailouts that turn questionable hidden debt into more official government debt.

Since December, 24 provincial governments have issued bonds whose prospectus states they are to be used to "roll over existing government debt," amounting to a total of over RMB500bn by early February. Such refinancing bonds are normally issued to roll over maturing official bonds, but the change in language suggests these bonds will be used to replace some hidden debts.

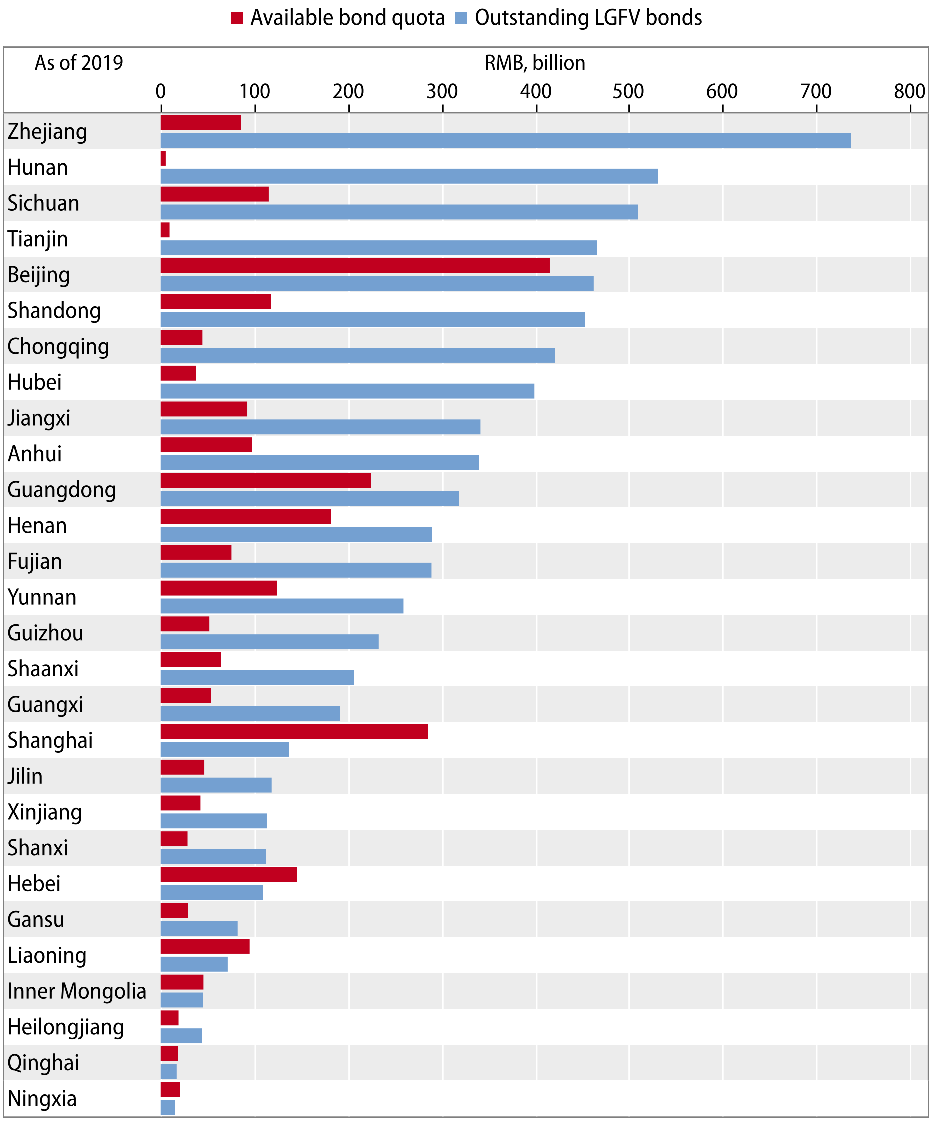
Provinces have already issued about RMB500bn in refinancing bonds that could restructure hidden debts

These new refinancing bonds appear to be an expansion of a 2019 trial program in which county-level governments in six provinces could apply to have their off-budget debts refinanced by a formal bond issue with permission from the central government. Some localities, such as two districts in Yuxi, Yunnan province, have reported they have been selected for the 2020 trial program. So it does appear that central and provincial authorities are willing to do at least some additional bailout of local hidden debts, on top of what was already handled in 2015-18.

But only a few provinces have significant unused bond quotas to use for this purpose

But the scale of this next round of debt bailouts is unlikely to be anything near as large as that previous one. The provincial governments that are issuing refinancing bonds now are taking advantage of the fact that they have not used up all of the quota of bond sales the central government has allocated in the past. As of end-2020, the gap between the permitted quota and actual outstanding local debt was RMB3.15trn, relatively small compared to the scale of hidden debt. The unused bond quota is also not necessarily available where it is most needed.

Few provinces are able to refinance lots of LGFV debt with official bonds



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Rich provinces like Beijing, Shanghai and Guangdong account for about a third of the total unused quota. Provinces like Guizhou, Yunnan, Sichuan and Inner Mongolia, where there are signs of stress like LGFVs defaulting on trust products, have much less room available. It is also possible that provinces could ask for permission to use some of their special-purpose bond issues, usually used for infrastructure and other projects, to restructure hidden debt; finance minister Liu Kun may have hinted as this option when he called for "appropriately expanding the uses" of such bonds. However the central government's attitude toward approving these kind of interventions has been quite strict.

Stingy with bailouts

The Ministry of Finance has allowed some interventions to restructure local debt, but its attitude remains quite strict

One interesting example that helps show the center's priorities is the case of Shanxi Transportation Group in 2019, when a group of lenders led by China Development Bank replaced around RMB234bn of its debt with lower-cost and longer-term loans. CDB's involvement acted as a signal of central support and put pressure on the commercial banks to extend the company lower-interest loans. CDB was willing to go through a similar process for Zhenjiang, a city in Jiangsu provinces with very high hidden debts, but was rejected by the Ministry of Finance. According to the former head of CDB, Zheng Zhijie, the Shanxi case was approved because the projects involved could generate good cash flow, while those in Jiangsu could not. Clearly, MOF does not want CDB supporting all hidden local debts. Liu Kun wrote in an article in December that policy banks must not help local governments with illegal or disguised financing.

There will be more bailouts of hidden debt in 2021, but they will be smaller and more selective than in 2015-18

While some more bailouts of hidden local government debt are coming in 2021, they will be selective and limited: like the selective bailout of 2015-18, but smaller in scale. The central government does not want to encourage moral hazard by paying for all those hidden debts itself. As in the past, the preferred way of dealing with most existing hidden debts will be to try to roll them over, in hopes that time and economic growth will make the problem easier to solve in the future. But with local fiscal and financial strains rising, and the government's willingness to bail out borrowers limited, it looks inevitable that there will be more bond defaults by local SOEs and LGFVs this year. As more default risks materialize, the bond market will assign a premium to LGFVs that can demonstrate they have either clear public support, strong independent finances, or both.