Orient Capital Research

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Is Nanjing a Chanos Moment?

Local Finances in Disarray

Is Nanjing an Example of a Chanos Moment?
Early in the debate on China, the most vehement bear was probably Jim Chanos, who in a Fortune Magazine article called China "Dubai Times 1000." Most analysts in this debate -- along with the Chinese government -- are focusing on the property market. While many of the broad arguments are well known -- overlending, property as proxy for savings, rising interest rates -- my belief is that analyzing China's property market using macro data provides only part of the picture. Many of the most pressing issues are really best understood as local issues. How much debt is there, who holds it, how much housing supply is coming onstream? I understand from recent trips to China that these issues are being hotly debated locally among the three most interested parties: the local government (municipal or city), the local branches of the state banks, and the local arm of the PBOC. ("We all meet every week on this," one banker in Henan Province told me in October.)

While the outcome of the discussions are unknown, we assembled data on one city - Nanjing -- to see what it can tell us about the impact of the property market on the economy. It is pretty clear that Nanjing -- and most likely many other cities -- is spending more than its revenue in the hope that property values will appreciate and they can repay their bank loans.

The Nanjing Example
We looked at Nanjing because it is a fairly typical, albeit wealthy, tier 2 city with a population of 7 million. It is more tied to the healthy eastern seaboard than some other cities such as Wuhan and Xian, but it is not immune to the issues from the property boom of the past two years. We assembled total government revenue, including listed land sales. The conclusion is Nanjing is currently spending in excess of its fiscal revenues.

Fiscal revenue (tax and other receipts) for Nanjing 9M 2009 was RMB65 billion, rising in 9M 2010 to RMB79 billion. Infrastructure investment for the same periods was RMBRMB195 billion and RMB 233 billion. Basically, Nanjing is spending more than 2x its income on fixed asset investment, of which real estate is a significant portion.

Nanjing Fiscal Budget (RMB Mln)	9M 09	9M 10
Fiscal Income	65,765	79,782
(+/-) YoY%	20.0%	21.3%
Infrastructure Investment	195,842	233,845
(+/-) YoY%	21.8%	19.4%
of which Real Estate	44,145	56,641
(+/-) YoY%	16.1%	28.3%

A Further Breakdown of the Numbers - Private versus Public Expenditure

There are several problems with this broad analysis. First, how much of the expenditure is paid by the local government, and how much by other entities, such as private companies and the central government?

We can assume that most of the infrastructure investment is going to be local government related, including government buildings, roads, subways. Beijing has offered to pay only for intercity rail. Some highways are privately funded. In addition, as Victor Shih of Northwestern University notes, some infrastructure projects traditionally have been funded by State Owned Enterprises, such as the oil majors,, although this is declining. I think it's fair to assume, though, that most projects, however, are either direct government creations or are quasi-government entities called "platform" companies (Local Government Funded Vehicles).

However, much of the property investment is likely to be privately funded and for argument's sake shouldn't be included on the local balance sheet. So for arguments sake we can eliminate real estate as a government obligation. That still leaves us with RMB151B and RMB177B of infrastructure investment (we're using 9M figures here for arguments sake), which equates to more than 2x government revenue.

Land Sales as the Panacea

We have left out one important source of revenue that presumably is expected to prop up the whole house of cards: revenue from land sales. The official Nanjing data puts a fairly modest value of land sale revenue at RMB 3.9B in 9M 2009 and RMB 10.4B in 2010. Independent company Soufun cites a much higher number, of RMB45B in 2010. Let's assume Soufun is correct. If we add that back to government revenue, that gets us up to approximately RMB120B in 2010 -- still about two-thirds of infrastructure expenditure (ex-property) of RMB175B. That's an annual shortfall of RMB50B, or US$7.5B, about 40% of government revenue including land sales.

I would argue the figure is probably higher (for Nanjing and other cities) as there are likely off balance sheet investments that are not even included in the city data but should be regarded as government debt. In addition, Nanjing is better situated geographically than many cities in China due to its proximity to the wealthier coast. If we assume US$10B of growing debt per year, multipled by 50 cities, that is US$500B a year in rising debt. That is a significant portion of a US$6 trillion economy.

Clearly, this is unsustainable. It is in the interest of local governments to keep land prices high to sustain the illusion they can pay off their debt burden in sales of future appreciated land. But stricter lending standards, higher interest rates, and tighter rules by the PBOC and CBRC regarding off-balance sheet financing will make it difficult for property to continue to appreciate at this rate. This is particularly true if the central government follows through on its plan to support an increase in available land supply which will put downward pressure on property prices.

Chanos may be right.

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