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# Local Debt in China

## How Will China Resolve the Impending Crisis?

Summary

China officially has 17 trillion yuan in local debt. Almost half of the debt has been incurred by off-balance sheet companies, known as Local Government Financing Vehicles (LGFVs). We visited a number of these local projects and collected data on a wider group. The objective was to understand their source of capital – banks, trusts, bonds, and whether this source of debt represents a systemic risk to the Chinese economy. In addition, we also analyzed the structure and history of local government financing, with the aim of predicting how the leadership will handle the debt burden under the circumstances of a slowing economy. We conclude:

- **High Cost.** We estimate local debt is costing China 1.3 trillion yuan per year.
- **Lack of Responsibility.** In a debt recapitalization, the central government will avoid adding debt to the central budget.
- **Difficult Policy Choices.** None of the alternatives – including asset sales, higher tax redistribution from Beijing, and state bank intervention – will be easy to implement.
- **More State Intervention to Come.** We expect this to be a messy process and Beijing will delay any resolution as long as possible, partly through continued but controlled monetary and fiscal stimuli.


**Headquarters of the an LGFV in Kunming, Yunnan Province**

# A Visit to Chinese LGFVs

## Explosive Growth

China has more than 10,000 local, off-balance sheet companies. The National Accounting Office 2013 survey estimates they account for 39 percent of the 17 trillion yuan in local debt, but that figure may underestimate additional debt that is connected to local governments. The first of these companies was established in Shanghai in 1992. Called the General Corporation of Shanghai Municipal Corporation, it was set up to coordinate construction of municipal infrastructure projects, including water, sewage, roads, and other utilities. It received both municipal funds and the authority to borrow from banks, and by 1994 had 38 billion yuan in assets. As Christine Wong of the University of New South Wales notes, "Over time, the model spread to other municipalities. By the turn of the century, most cities had established LICs (Local Investment Companies), and they came to play an increasingly key role in financing urbanization in many localities." As they became more accepted, their separation from local governments was relaxed, and the local governments began to guarantee bank loans.

Although a number of them were shuttered in the 1990s under the disciplined hand of Premier Zhu Rongji, their number and size gradually rose in the 2000s, until they exploded in size during the post-2009 fiscal crisis. Encouraged by the central government to act as funnels for the government's fiscal stimulus, in 2009 they were instrumental in spending 3 trillion yuan in new credit, and in the first quarter of 2010 they were responsible for 40 percent of new credit nationwide. China's current government budget law requires local governments to balance their budgets while not allowing them to borrow directly. The central government recently began imposing ceilings on local government borrowing (quota for bond issuance) and, in principle, promised not to bail out local governments.

However, as the amount of money spent rose faster than the ability to find reasonable projects, their economic function has become questionable. Much of their debt is unlikely to be repaid. Most of these companies act either as conduits for municipal investment in infrastructure – whose benefits are unproven -- or speculative ventures designed to take advantage of China's (until recently) roaring property market, both residential and commercial.

We visited a handful of these LGFV projects and collected data on a number of others to understand their make-up. We also analyze official data to come to conclusions about the outcome of rising local non-performing loans.

## LGFV Example One: The Jiangnang "1000 Tree Farm"

About 30 minutes outside of Nanjing sits the "1000 Tree Farm." It is a self-described "echo-tourism" site established partly with Shadow Funds -- 284.3 million yuan ($47 million) from the China Finance Jiacheng Real Estate Fund No.1 Collective Trust Plan. The Trust product was issued by one of the larger Trusts in China, Cofco Trust and administered by a local LGFV, Kunshan Chungao Investment and Development Co., Ltd. The project at this stage has been designated a non-performing loan by the Trust. During our visit, the front gate was locked but we managed to find a back entrance. Inside, a long dirt road wound through trees and land empty apart from a few pools that had been designed four tourists to fish. We finally located a worker's canteen and the leader of the group told us the place had been shuttered for several months. "It's a private company," she said. It was a relatively remote area from Nanjing to be considered parkland and clearly there was not many visitors from elsewhere given there were few attractions. Nor was there much capital investment in evidence.

**1000 Tree Farm (Clockwise from top left): Welcome sign: "Beautiful Life"; Closed front entrance; Dining hall; Parkland.**

1000 Tree Farm owes its existence as much to its position within the government structure as to the idea of an "echo-tourism" site itself. That's because – as locals are proud to note -- it sits within the Jiangning Economic Development Zone, outside of Nanjing. The Nanjing Jiangning Economic and Technological Development Zone was established in 1992. Initially it was funded locally, but now claims it has 7 billion yuan in investment from a number of sources. It also claims to have received $3.5 billion of FDI. The echo tourism site has benefited from its relationship to Jiangning . "With the purpose of developing the zone into an ecological-oriented garden park, the zone has been stressing a lot on the evaluation and examination of projects," the zone's literature states. From our visit, it appears the "1000 Tree Farm" raised capital from outside investors due to its apparent connection with the Jiangning Economic Development Zone – a concept that appears to be a complete write-off.

### LGFV Example Two: The Kunming Chengtou Investment Company

Kunming is the capital of Yunnan Province in China's Southwest. Yunnan is a backpacker's heaven -- home to ancient towns, mountains bordering Tibet, and rolling fields filled with high quality tea from the town of Puer. It also is enjoying a building boom complements of the Kunming Chengtou Investment Company, an LGFV. The headquarters consist of a massive, new building in contrast to much of the rest of the city.

**Kunming Chengtou Investment Company Headquarters – One of the Newest and Largest Buildings in Kunming**

Kunming Chengtou's projects include:

- Kunming second ring road
- Longquan Road project.
- Huanhu South Road.
- Guannan Road Project.
- Baishan District Development。

There seems to be greater emphasis in Kunming than in some other districts on infrastructure investment. Apart from the road projects listed above, the Kunming LGFV is investing in a number of hydroelectric power projects as Yunnan Province is endowed with mountains and rivers. However, it is hard to make comparisons on investment between different regions because there is no official or published data.

**The Yunnan LGFV Investment in Real Estate**

Another project under the Kunming LGFV is property. The Yunnan Cheng Tou Longjiang real estate development Ltd, which is the wholly-own subsidiary of Yunnan Chengtou Ltd, invested 2.444 billion yuan to develop the Zhongba Village and Shangba Village Urban

Village Renovation. To be combined into the North Landscape New Town project, the 2.13 million square meter development is a large real estate investment involving a number of private property developers. As with many property developments, the LGFV is claiming it will bring in company headquarters and provide services including technology, administration, culture, business, environment, and entertainment. Two-year construction ends in mid-2015 with businesses moving in during 2016. The media reports say the project is dominated by state government funding.

## What Did We Learn from Our Visits?

These projects in Kunming and Nanjing are examples of a universe of thousands of LGFV investments across China. While hard to generalize from a few examples, we note that:

1) **Differing Investments.** There is a widespread difference in investment targets among LGFVs depending on local political and investment factors.

2) **Maturity Mismatch.** Lead times are often several years out. This allows local officials to report GDP-accretive projects without being responsible for their completion or success. It also suggests a mismatch between short-term shadow and bank loans and long-term project returns.

3) **Property Focus.** Most projects involve property and are conducted in conjunction with private property developers.

4) **"Concept" Investing.** Grandiose themes are used to a) sell the projects to investors; b) convince senior government officials there is a policy rationale for them and that they will attract non-local capital.

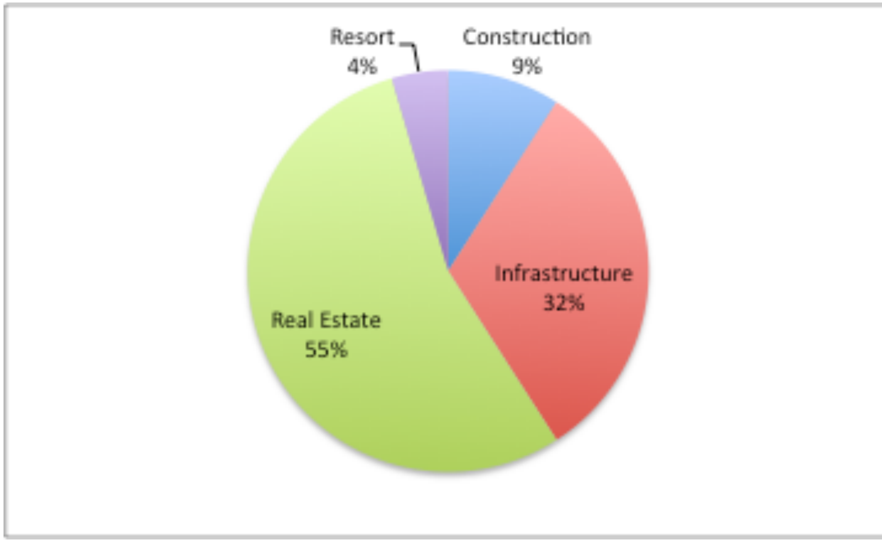
In addition to conducting site visits, we collected data on 22 LGFVs, focusing mainly on their sources of capital. The purpose is to evaluate the potential for risk. Some of these issued bonds but most did not. This is a crucial distinction, as most of the data analyzed on LGFVs relies on those that issue bonds, which creates a bias towards the financially healthier LGFVs. For example, the widely used Chinese Wind Database has information on 374 LGFVs but all have outstanding  bonds. We can't argue that our small subset is necessarily representative but it does avoid that bias.

**Survey of 22 LGFVs in China**

| | |
|---|---|
| Yunnan Metropolitan Real Estate Development Co.,Ltd（云南城投） | Yunnan |
| Shanghai Chengtou Holding Co., Ltd.（上海城投控股） | Shanghai |
| ——Subsidiariy Chengtouzhidi（上海城投置地集团） | Shanghai |
| Tibet Urban Development and Investment Co.,LTD（西藏城投） | Tibet |
| Linxi Jinshuihe Property Limited Company(临沂市金水河置业有限公司 | Linxi |
| Kunming City Haifang real estate development Limited Company（昆 | Kunming |
| Yunnan Jianzhan real estate development Limited Company(云南建展 | Yunnan |
| Fuyang Chengnan Development(阜阳城南新区项目开发管理公司） | Fuyang, Anhui |
| Fengxian Development（丰县经开投发公司） | Xuzhou, Jiangsu |
| Xiangtan Chengtou （湘潭市城市建设投资经营有限责任公司） | Xiangtan, Hunan |
| Linxi Jinshuihe Property Limited Company(临沂市金水河置业有限公司 | Linxi, Anhui |
| Zhuoyue City Investment Co.,LTD（卓越城（天津）投资有限公司） | Tianjing |
| Hezezhongsheng real estate development Limited Company(菏泽中盛 | Heze, Shandong |
| Guiyang Hongyi real estate development Limited Company(贵阳宏益 | Guizhou |
| Neimenggu Hongyun Project Development and Investment Co.,LTD （ | Neimenggu |
| Zhangjiakou Senior Highway Asset Management Center（张家口市高 | Zhangjiakou, Hebei |
| Chongqing Ruizhou Construction Investment LTD(重庆瑞洲建设投资 | Chongqing |
| Wuhai Guanghao real estate development Limited Company(乌海市广 | Wuhai, Inner Mongolia |
| Fuzhou Hongji real estate development Limited Company(抚州市宏基 | Shanghai |
| Zunyi State-owned Asset Management Company(遵义市国有资产投融 | Zunyi, Guizhou |
| International Tourist Islands Tangshan Bay Investment Ltd.Co.(唐山湾 | Tangshan, Hebei |
| Guizhou Tourist Investment Limited Holding Company（贵州旅游投资 | Guizhou |

The breakdown by investment targeted was, as expected, mainly in infrastructure and real estate.

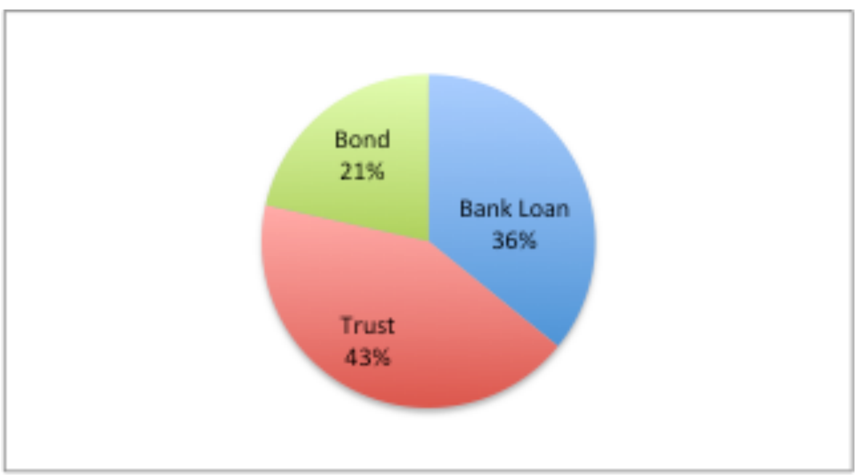
**LGFV Sector Breakdown**




## Where is the Money Coming From?

More interesting was the source of capital for these hybrid companies. LGFVs that issued public bonds accounted for only four of the total, with most of the capital almost evenly split between bank loans and trusts.

**LGFV Sources of Capital – Survey Results**




We are excluding here other sources of funding, including interbank loans, securities and insurance loans. They did not appear as capital sources in our survey although they may have been a form of loan given to some LGFVs.

**LGFV Sources of Capital – Bond Prospectus**

The reported data generally available on LGFVs is obtained from their bond prospectuses. This data doesn't categorize the data by source of loan, however, so it doesn't include bank and Trust loans.

The 371 LGFVs for which there is data show median registered capital of 510.1 million yuan and 73.5 billion in outstanding bonds, or a median of 150 million yuan per bond. However, there is very little information on loans from Trusts or banks in the database.

| **Registered Capital (RMB MLN)** | |
|---|---|
| Total | 496,157 |
| Median | 510 |
| **Bond Balance** | |
| Total | 73,487 |
| Median | 150 |
| **Revenue** | |
| Total | 476,403 |
| Median | 819 |
| **Net Assets** | |
| Total | 4,104,809 |
| Median | 8,288 |

## What is the Cost of Local Debt?

To calculate the cost of local debt, we need to divide the debt into categories. In 2010, China's National Accounting Office (NAO) conducted a survey of debt. Their survey said 80 percent of debt was from bank loans, 7 percent from bonds, and 13 percent from private sources. A 2013 audit from the same agency examined 223 local government financing vehicles, 1,249 institutions backed by local government funding, 903 government agencies and departments and more than 22,000 projects. The audit found that the 36 governments had taken on debt totaling 3.85 trillion yuan as of the end of 2012, up 12.9% from the end of 2010. The survey said bank loans were 56.6 percent and "other" loans were 43.4 percent.

**National Audit Office – Local Debt Survey**

| Lender (RMB Tln) | 2010 | 2013 | % Total |
|---|---|---|---|
| Bank | 8.47 | 10.12 | 56.6% |
| Other (Bonds, Trusts, etc.) | 2.25 | 7.77 | 43.4% |
| | **10.72** | **17.89** | |

The NAO has a higher figure for bank loans – 56.6% -- than our figure of 36.0%. However, a year later, it is quite likely that shadow, or non-bank lending, has grown substantially in the past year, as tighter regulations restricted bank loans and the shadow market skyrocketed.

### The Cost of Local Debt

We estimate the cost of debt using data for the average interest rate for each source of capital. Our estimate suggests total local debt -- including LGFVs and other government debt -- is costing China 1.3 trillion yuan per year.

**Breakdown of Local Debt (Orient Capital Research)**

| RMB Bln | % Total | By Source | Rate | Interest Cost |
|---|---|---|---|---|
| Bank Loan | 36.0% | 6,120 | 6.00% | 367.20 |
| Trust | 42.8% | 7,276 | 9.81% | 713.78 |
| Bond | 21.6% | 3,672 | 6.70% | 246.02 |
| Total Local Debt | 17,000 | | | **1,327** |
| | | | | |
| Total National Fiscal Revenue (2012) | | | | 18,270 |
| Local debt interest cost as % of revenue | | | | 7.3% |

However, not all local debt was incurred by LGFVs. The NAO survey provided the following breakdown:

**Breakdown of Local Debt (NAO Survey, 2013)**

| Borrower (RMB Tln) | 2010 | 2013 | % Total |
|---|---|---|---|
| LGFV | 4.97 | 6.97 | 39.0% |
| Local Govt Agency | 2.5 | 4.06 | 22.7% |
| Non-administrative Govt Agency | 1.97 | 2.72 | 15.2% |
| SOE | 1.28 | 4.14 | 23.1% |
| | **10.72** | **17.89** | |

If we recalculate the debt to include only LGFV loans, interest costs are 518 billion yuan, one-third as much:

**Interest Costs of LGFV Debt (Based on NAO Survey, 2013 and OCR Survey)**

| RMB Bln | % Total | By Source | Rate | Interest Cost |
|---|---|---|---|---|
| Bank Loan | 36.0% | 2,387 | 6.00% | 143.21 |
| Trust | 42.8% | 2,838 | 9.81% | 278.37 |
| Bond | 21.6% | 1,432 | 6.70% | 95.95 |
| Total Local Debt | 6,630 | | | **518** |
| | | | | |
| Total National Fiscal Revenue (2012) | | | | 18,270 |
| Local debt interest cost as % of revenue | | | | 2.8% |

## Do Local Governments Have the Funds to Pay for the Debt?

How does the cost of local debt compare with local revenue?

In 2012, China's total national and local fiscal revenue from all sources (e.g., taxes, land sales, etc.) was 18.3 trillion yuan. Local debt is thus costing 7.3% of annual revenue, both local and central. Alternatively, it is 2.3% of China's 2013 GDP of 56.9 trillion yuan.

Given that this is, in fact, local debt, another way to look at it is to estimate the fiscal resources available to Provincial and sub-provincial governments.

Each province's fiscal resources and debt obligations differs. A report from the **Lincoln Institute** in the United States has calculated that the ratio of Provincial debt to revenue in China in 2010 ranged from 2x to as much as 9x. That figure undoubtedly has escalated since then as the 2009 stimulus injected US$400 billion into the economy and Beijing encouraged increasing debt by local governments as part of the stimulus.

According to the Wind database, China's 2013 provincial revenue was 1.54 trillion yuan. This appears to exclude non-tax sources of revenue such as land sales. Just using this estimate of regular fiscal revenue, this source of revenue is only 1.2x higher than our estimate of interest costs. Of course, this doesn't include payment of principal. ***Clearly, local debt is a tremendous burden on local governments.***

**Land Revenue.** For the past decade, land has functioned as a giant piggy bank for local governments to pay for needed social services. The IMF estimates that from 1998 to 2011 there was an 18 trillion yuan gap between local government revenue and expenditure. Land sales accounted for 13 trillion yuan of that required revenue, with bank loans at 5 trillion yuan. The rough average of 1 trillion yuan per year in land revenue is almost sufficient to pay the interest costs on local debt. However, as we have noted in previous reports, that land revenue is beginning to decline.

The numbers tell a pretty dismal story. To add fuel to the fire, within the past decade the burden of local debt began moving lower down the political hierarchy. Where previous to 2007 most LGFVs were Provincially-owned, the majority are now sub-Provincial, residing among the 40,000 towns and villages across China. These smaller places have less political power and fewer sources of revenue. According to the Lincoln Institute, lower levels of government have become responsible for rising amounts of social services and expenditure:

- **Heavy Local Expenditure.** In 2013, most Chinese governmental expenditure occurred in the smallest political unit: Central (20%); Provincial (18%); Municipal (22%); Township/Village (40%).

- **Declining Local Budgets (Percent of GDP)**: 1978 (18%); 1988 (13%); 1995 (8%).

- **Declining Transfers from Beijing.** From 1994 to 1997, intergovernmental transfers fell to less than 1 percent of GDP.

- **Land Revenue Has Filled the Gap.** The four taxes levied on land and real estate produced 17 percent of tax revenues at the prefectural level and 16 percent at the county level in 2007. Nationwide, the total government budget expenditure has grown from 27.2 percent of GDP in 2006 to 34.9 percent in 2010. Most of the extra expenditure was paid by land revenues came from land.

Clearly, the precariousness of local debt is increasing. What is China likely to do?

# The Politics of Local Debt in China – What Does the Future Hold?

## Debt Resolution in China Will Like Be Herding Cats….

There is a widespread assumption that the government ultimately will have to guarantee all debt in China through the banking system. As a broad statement, this may be true. However, how the local debt crisis is resolved in China will have a significant impact on the ***timing*** and ***nature*** of the outcome, and ultimately, on GDP growth. A quick central government recapitalization through the Ministry of Finance – as we saw with the listing of the four state banks a decade ago – is not possible with local debt. Debt workouts will require a more complicated implementation than that bank recapitalization. In this section, we will discuss the historical patterns of economic decision-making and make some educated guesses as to how the current crisis will be resolved.

**History as Guide.** Political scientist Victor Shih has argued that most political decisions in China are short-term and designed to keep political leaders in power for their brief tenures. When analyzing the recent history of economic decisions, it is clear that the leadership at all levels is intent on avoiding large-scale changes, preferring incremental band aids that push problems into the future. During the debate over cleaning up the state banking system prior to privatization, Shih lists four proposals that were rejected by the leadership that are evidence of this theory. These were:

- **Securitization.** The banks would securitize their bad loans into bonds and sell them to the public. This was rejected because it may have required the government to make public the financials of ailing state firms. It would also expand the government budget deficit – a big no in government policy circles.

- **Bank Bonds.** Under this proposal, the government would issue bonds and use the capital to purchase NPLs from state banks. It could then convert NPLs into state shares, thereby digesting the NPLs. This was rejected for the same reasons as above – adding to the deficit.

- **Debt for Equity Swaps.** A second solution would be to swap bank debt for equity and establish asset management departments within banks to oversee companies as shareholders. However, it was felt that this solution would further tie banks to the fate of SOEs, encouraging them to lend more to failing SOEs.

- **New "Bad" Banks**. Establish financial companies to take over the asset management companies which had previously given either bonds or stocks to the banks in exchange for bad debts. This would clean up the bank's balance sheet and separate bad debts from the banks. Alternatively, the government considered using private financial companies to purchase NPLs from banks at a highly discounted rate. These options, once again, would require increase the explicit deficit due to the capital injections required.

### Here's the Answer -- Hide the Problem!

The ultimate solution was to create four asset management companies, funded with 10 billion yuan each, that combined would purchase 1.4 trillion of NPLs at face value. The AMCs had a charter of ten years and were suppose to recover as many of the NPLs as possible through debt-to-equity swaps, bankruptcy and restructuring debt. This solution was very clever. By controlling which SOEs would obtain a swap, Beijing held controlled the process. Also, by creating bonds, the state kept the debt from appearing on the explicit budget. As Shih notes:

> The concentration of rent allocation authorities in a few agencies under the Premier's direct control makes it much harder for other Politburo members to play a direct role in allocating rent. They become more dependent on the top technocrat, ***which gives him much more political leverage over the rest of the Politburo*****…..**After the politicization of a financial problem, one would expect the top bureaucrats to adopt policies that ***maximize central power***, maximize the apparent improvement of the situation without jeopardizing their ability to resolve other pressing issues, and ***minimize the short-term cost*** of solving the problem with little regard to the long-term consequences.

Basically, the decision allowed a **short-term solution** that retained power in the hands of the political elite.

### What Can Beijing Do?

In past bad debt situations, Beijing has rejected many alternatives that would add to the budget deficit, choosing instead to bury it. The NPLs from the bank recapitalization a decade ago turned into bonds that ended up back on the bank balance sheets. This is an implicit debt of the Ministry of Finance – but not explicit – which seems to be the modus operandi for the leadership to handle debt crises.

Given these political imperatives, what is Beijing likely to do?

First, the notion that Xi Jinping is a new, strong leader capable of attacking the root problems of the Chinese economy is probably exaggerated. There is much debate about the purpose and diligence of the anti-corruption crackdown, which implies that there is no consensus on his degree of power within the Politburo or the State Council. If we accept the limits of state power, then Beijing is likely to seek short-term solutions to the long-term problem of debt.

**New Regulations**

There has been an effort to enforce discipline on local government borrowing. Since August 2014, a number of key measures have been rolled out, aiming to regulate future as well as outstanding debt by the local governments. According to the regulations, local governments will have to classify existing debt and implicit debt. The classification results need to be reported to the Ministry of Finance by January 1, 2015. According to a recent Reuters report, a draft ruling would require local governments to continue raising funds for ongoing projects through their original channels (LGFV bonds, bank loans, trust, etc.) until 31 December 2015, after which further financing could only be raised through municipal bonds. Local governments must report any imminent defaults to higher- level governments in a timely manner, and local and higher-level governments must kick-off emergency response systems to contain any risks.

Another rule, Document 45, asks governments to clarify the scope of government income and expenditure in their budgets. In the meantime, every government department will be asked to release details on how they spend fiscal funds in a three year budget. These rules may be helpful but are only a start.

## Here are six possible outcomes to the debt burden, each with their own problems:

### 1) Solution One: Increase Intergovernmental Transfers

One solution would be to restore transfers from Beijing that were lost when Premier Zhu Rongji centralized tax collection in 1994. However, transfers already take up 70% of central revenues, and they are funding a huge chunk of local expenditure – an average of 37%. Also, most of the transfers are earmarked for rural areas. Urban areas with financial deficits won't get much of a sympathetic treatment in Beijing. The transfer program in general involves a broad swath of programs with a variety of vested interested that would be difficult to reevaluate. This appears to be an unworkable solution.

**2) Solution Two: Set up a Trust Fund**

In December, the China Banking Regulatory Commission (CBRC) and the Ministry of Finance announced the establishment of a fund to bailout bankrupt Trusts. The rules require payment of 1 percent of both net assets and capital raised. That assumes only a little above 1 percent of loans will go bad, when the large number of inefficient investments in infrastructure and unused housing and commercial projects exceeds this many fold. Probably too little too late.

**3) Grow the Local Bond Market**

This is the most palatable solution for the leadership as it keeps debt from becoming the responsibility of the state, in line with historical policy decisions. The U.S. has $5 trillion in local state debt compared with China's $3 trillion. However, the U.S. debt is mainly in the form of bonds, traded based on published financial statements of municipal governments. China differs from the U.S. because 80 percent of the debt consists of loans, either from official banks or Trusts and private loans as Wealth Management Products, with little or no transparency.

Until recently, local governments could issue bonds only with special permission – and backing – of the central government. Beijing has begun to allow several pilot cities to issue bonds on their own. However, uncertainty remains about local government responsibility for the debt of LGFVs, which will affect the abilities of governments to issue debt on their own or on behalf of the LGFVs. Since 2010, some provincial local governments have been allowed to issue municipal bonds in a pilot program. Through December 2014, a total of RMB 396bn municipal bonds have been issued by these local governments -- just 2.3 percent of total debt – so the program is off to a slow start.

A bond issue by an LGFV in 2014 illustrates the confusion. In December, a local government-financing vehicle in China's eastern Jiangsu province delayed a bond sale after authorities ruled it wouldn't be backed by the state. Changzhou Tianning Construction Development Co. said it wouldn't go ahead with the 1.2 billion yuan ($194 million) offering planned for Dec. 15 because of market volatility, according to a statement posted on Chinabond's website. On Dec. 11, the finance bureau of Tianning district in Changzhou city said on the district's website the bonds wouldn't be categorized as government debt and the local government wouldn't be responsible for repayment, reversing a statement sent the previous day. That reversal indicates the growing concern – and confusion – over the implicit debt obligations incurred by the LGFVs.

The confusion over who is really backing these bonds will hamper the market. Also, most bonds in China are purchased by banks, making them implicit bank debt.

**5) Recapitalize on a Case-by-Case Basis**

As there is no clear policy in Beijing toward debt, the various bureaucracies have been left scrambling to find solutions on an ad-hoc basis. A 3 billion yuan loan called "Credit Equals Gold No. 1" arranged by China Credit Trust for a mining venture was finally bailed out months after it went bust. But the bailout was arranged by Huarong Asset Management, one of the so-called "bad banks" established a decade ago to help recapitalize the state banks before they went public, even though Huarong had nothing to do with the original loan. Huarong bought the loan at 95 cents on the dollar with the help of a 3 billion yuan loan from ICBC, the bank that had convinced investors to buy into the China Credit Trust product.

The bailout was significant because a) it involved an unrelated third party that is based in Beijing and b) it took months to arrange; c) the bank that distributed the trust backed the loan. This is clearly not a systemic approach to debt recapitalization would be difficult with 10,000 LGFVs. Would the banks that distributed the trusts be willing to take it on balance-sheet? Unlikely.

**6) Sell NPLs through Local Asset Management Companies.** Like the central AMCs created a decade ago, Beijing has authorized local governments to create local AMCs. In November 2014, the China Banking Regulatory Commission cleared governments in Beijing, Chongqing, Tianjin, Fujian and Liaoning to set up AMCs. The second wave of approvals comes after Zhejiang, Jiangsu, Anhui, Guangdong and Shanghai established locally controlled firms in July. While the concept appears sound the execution is likely to be weak.

- First, local governments are unlikely to offload NPLs at valuations that will attract buyers.
- Second, local and state banks may be forced to acquire the bonds, turning them into bank debt.
- Third, unlike the bank recap in Beijing, when NPL sales were directed by bank headquarters under the guidance of the Ministry of Finance, meaningful sales of local NPLs would take considerable time to execute as local officials drag their feet.

**7) Raise the Property Tax.** Beijing has been discussing a local property tax for several years and is now testing it in several regions. This would provide a sounder foundation for local government financing. But it is opposed by developers and some government officials due to the impact it would have on the property market.

## What Will Really Happen?

While all of these are valid solutions, Beijing so far has taken the "muddling through" approach. There are a series of stops-and-starts as proposals are pushed through and then forced back. The stimulus measures are one example. Opposed by the PBOC, they have been slowly pushed through by the State Council, but often in moderated form through central government agencies. The same is likely to apply to local debt.

The state banks are likely to be the holders of this bad debt in the end. According to bank statements, LGFV loans accounted for an average of 6.1 percent of their loan book, but the implicit debt is much higher, particularly if the off-balance sheet wealth management products they sold are included.

The banks will slowly begin acquiring and writing off the loans over time. If we assume half of LGFV debt are NPLs, that 8.5 trillion yuan would reduce the state bank assets of 75 trillion yuan by more than 10 percent. This will lower the amount of capital available for loans for others in the economic system – another dagger in the heart of GDP growth. It's going to be a long and messy resolution.

**END**