CHINA NEWS

Xi Faces Test Over China's Local Debt

Risks From Debt Are Still Controllable, Audit Office Says

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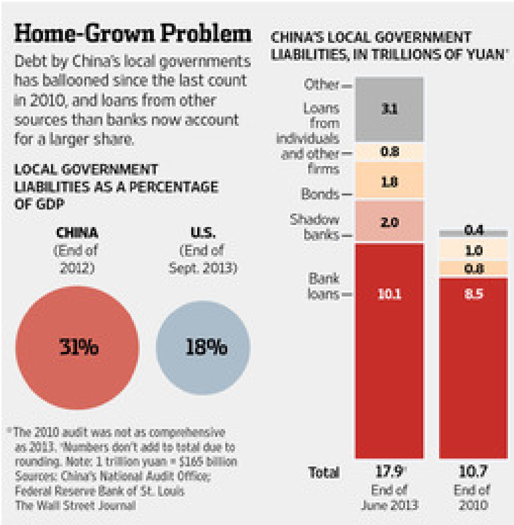
Updated Dec. 30, 2013 2:40 p.m. ET

The Inner Mongolia ghost town of Ordos exemplifies how local governments have embarked on runaway construction, often driving up their debt. *Reuters*

BEIJING—Chinese President Xi Jinping, named on Monday to head the committee overseeing China's economic overhaul, must quickly figure out how to keep China's burgeoning local government debt from tanking the world's second-largest economy.

Shortly before the announcement of Mr. Xi's new job, China's National Audit Office said debt and guarantees issued by local governments rocketed 67% to 17.9 trillion yuan ($2.95 trillion) midyear 2013 since the last tally at the end of 2010, when it was 10.7 trillion yuan. The audit tracked the results of greater spending on everything from swank government offices and multilane highways to city parks. The spree was on all local levels, from provinces to China's 33,000 townships.

China's world-beating record of about 10% annual growth for the past three decades is based in large part



on local governments spending heavily on such building projects. But since the global financial crisis of 2008, that construction has depended more and more on heavy borrowing and often resulted in dead-end projects that have a tough time paying their bills, economists say. Nearly half of the debt comes due by the end of 2014. Standard Chartered economist Stephen Green says there is a better-than-50% chance that a local-government bond will default in 2014. That would be a first for China, where government officials often step in to order financial institutions to help troubled borrowers.

It is hard to gauge what the effect of a bond default would be: On the one hand, it could have the effect of raising awareness of the risks and accomplish the tamp-down in lending that other government moves have failed to fully bring about. But signs of tightening liquidity in China have tended to frighten markets in unpredictable ways and any resulting panic could be hard for Beijing policy makers to control.

Reining in local-government projects has been tricky for Beijing. China is dotted with vacant or underutilized housing developments, industrial parks, business districts and even entire cities, the product of overambitious plans by local governments. In the short term, the construction of empty buildings helped boost output. But longer term, many of those projects have become a financial burden, soaking up money to repay lenders and leaving many local governments short of funds for social spending, which in turn creates the potential for local unrest.

Mr. Xi's appointment on Monday to head what is called the "leading group" for overall reform—which will take a key role in pushing reforms outlined last month by top Communist Party leaders—is the latest signal that he has taken control of economic policy, which over the past two decades has been the preserve of China's No. 2 official, the premier.

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The swelling debt problem presents Mr. Xi with a menu of bad choices, say economists. He can essentially try to muddle through and avoid a bust by providing somewhat more central government funds and using regulation and backroom orders to banks to tighten restrictions on loans. But that would make local governments more dependent on loans from trust companies, leasing firms and informal lenders—so-called shadow bankers—which charge higher interest rates than banks. As a result, debt levels could rise further.

Or he could attack the problem aggressively by raising taxes, selling off assets and allowing some defaults as a way to warn financial firms or local governments of the risks involved. Currently, economists say, lenders believe the central government will always step in to forestall default, which encourages further risky lending. But allowing a default could backfire if other lenders get spooked and demand higher interest rates for new loans or bonds.

"The risk is that costs suddenly go up for a lot of these local-government vehicles and more go broke," says Mr. Green.

Cornell University China expert Eswar Prasad says that while "China has enough resources to prevent the local-government debt problem from turning into a full-blown debt crisis," the rapid growth in China's debt "poses significant risks for the stability of China's financial system."

China's local government debt relative to economic output has ballooned. At the end of 2012, borrowing equaled about 31% of China's gross domestic product, up from 26.6% in 2010. In the U.S., state and local debt was about 18% of GDP at the end of September, according to the St. Louis Federal Reserve Bank.

As of June 2013, China's local governments were liable for 10.12 trillion yuan worth of bank loans, accounting for about 56.6% of local governments' total debt. That is well down from the almost 80% share at the end of 2010 when local governments owed 8.47 trillion yuan to the banks.

Instead, loans from shadow bankers have become a more important source of finance, accounting for 11% of new lending. Such lending wasn't specifically counted in the 2010 audit. Loans from such shadow banking sources typically carry higher interest rates than those from banks, often in excess of 10%.

Shadow lenders usually hold less capital against potential default while making more risky loans than banks, giving them less of a cushion if the local governments aren't able to pay their bills.

Bond issuance by local governments has also increased, accounting for 10.3% of local government liabilities at the end of June, up from 7.1% at the end of 2010.

Overall, China's domestic debt, including local governments, state-owned enterprises, real-estate developers and individuals has ballooned to 216% of GDP this year from 128% in 2008 and could climb to 271% by 2017 if not corrected, according to Fitch Ratings. Economists note similar credit run-ups in countries in Europe, Asia and Latin America have ended in crashes, although few predict an imminent crisis in China.

Beijing has said that controlling local debt is a policy priority for 2014. A statement issued by meeting of top Communist Party officials earlier in December said China would "strictly control the process by which governments' raise debt," but didn't suggest a bailout was likely. "Every level of government will be responsible for their own debt," the statement said.

The audit office didn't give any policy direction, saying that the accumulation of debt in recent years had been in the national interest by supporting economic development and improving people's livelihoods.

UBS economist Tao Wang says China's choice of a growth target for 2014 is an important indicator of how forcefully the government will deal with the debt issue. China is expected to show growth for 2013 of 7.6%, slightly higher than the target of 7.5%.

Should China cut the target next year to 7%, says Ms. Wang, it would suggest that the government is ready to crack down, knowing that will slow growth. But if it the government retains the 7.5% growth numbers—as many economists believe it will—it indicates "the government may delay reforms or let structural worsen for the sake of growth."

Mr. Xi has made austerity an important part of his reform agenda. Earlier in 2013, Beijing warned local governments against building overly elaborate offices that sometimes copy famous buildings from overseas, like the U.S. Congress. People in China often scoff that new government buildings in their town have more rooms than employees.

—Richard Silk and Grace Zhu contributed to this article.

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