A Chinese Swap Meet

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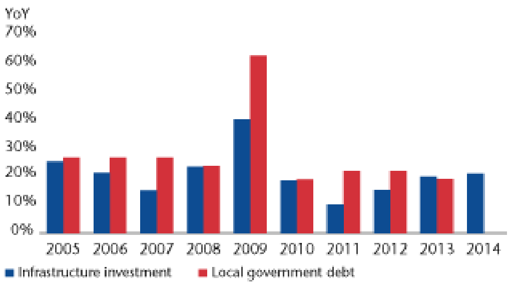
China has begun a program designed to clarify the size of its local government debt burden and reduce its financing costs. Swapping cheaper bonds for more expensive loans is an important step toward creating a healthier fiscal system. But it is equally important to understand what this program will not do. It isn't a bailout, it won't lead to local government defaults and it isn't a Chinese version of quantitative easing (QE).

How the Debt Built Up

The accumulation of local government debt was the result of three policy choices made by the Communist Party. First, in the 1990s, power over local revenue collection and spending was recentralized in Beijing, in an effort to reduce unnecessary local spending. Second, when the Global Financial Crisis struck in 2008 and tens of millions of workers were laid off as demand for China's exports collapsed, the Party undertook the world's largest Keynesian stimulus, accelerating construction of public infrastructure projects in order to reduce unemployment. Third, the Party chose to fund that huge stimulus via loans from the Party-controlled banking system. All of this led to a dramatic rise in local government debt.

Figure 1. MORE PUBLIC INFRASTRUCTURE CONSTRUCTION, MORE LOCAL DEBT

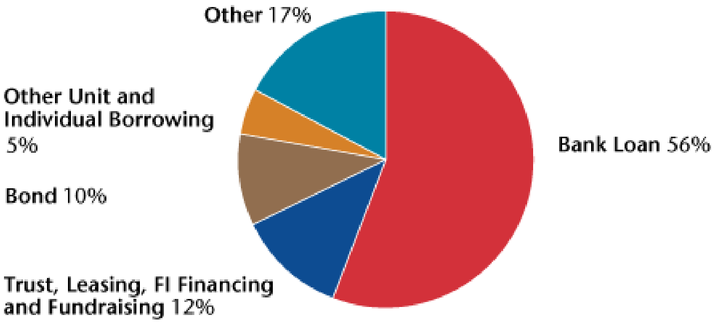


Sources: CEIC, National Audit Office, MICM estimates

Raising Transparency, Lowering Debt Burdens

The new swap program is the Party's latest effort to manage this debt. The key objectives are 1) to make the amount and structure of local government debt more transparent, and 2) to reduce the financing burden of local government debt. The mechanism is to convert existing loans, from banks and trust companies into bonds, as this will improve the Party's ability to track local government debt, and will reduce the financing costs. This is not a bailout as the Party will remain responsible for the debts. At the same time, I do not expect the existing debt to be abandoned by the Party in this process, so it will not lead to local government defaults.

Figure 2. MORE THAN HALF OF LOCAL GOVERNMENT DEBT IS IN THE FORM OF BANK LOANS



Source: National Audit Office

Not Chinese QE

Although some of the mechanical aspects of this loans-to-bonds swap may appear similar to quantitative easing (QE) measures deployed by the European Central Bank, this is not Chinese QE. Chinese banks—all of which are controlled by the Party—are not lacking liquidity. Household bank deposits, for example, are the RMB equivalent of about US$8.8 trillion, which is greater than the combined GDPs of Russia, Brazil, India and Italy. Corporate bank deposits are even larger.

Bank lending is constrained by Party policy, via a loan quota to which all banks must adhere, not by liquidity. While total credit outstanding is rising by more than 10% year-on-year, the Party has been steadily guiding this growth rate lower, in line with gradually slower GDP growth. And QE is the last resort of a central bank that has no room to reduce interest rates, which is clearly not the case in China. This is why China's central bankers have frequently stated that they are not engaging in QE.

Don't Sweat the Details

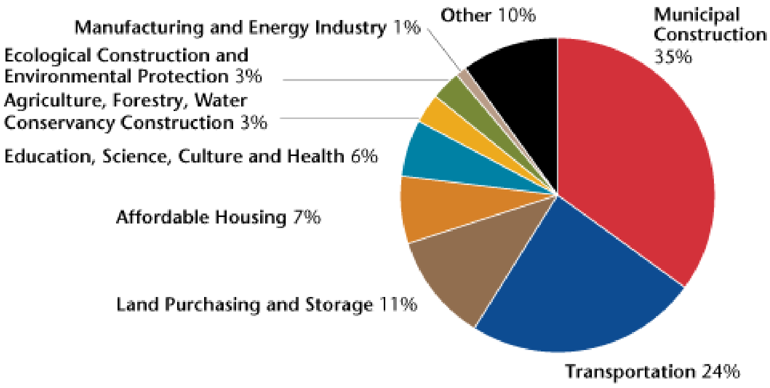
There is little reason for investors to spend a lot of time trying to master the details of the swap program. The program is in its early stages, few details have been released and new programs like this typically go through significant change as policymakers observe the obstacles encountered during the trial run. The media is likely to view these changes as signs that the Party is losing its nerve, while the reality is that the changes are more likely to reflect the Party's pragmatic approach to new programs. The initial swap is to cover about RMB 1 trillion (US$161 billion) of existing local government debt, with a reported RMB 1.86 trillion of local government debt coming due this year.

Changing Investors' Perception of Risk

A key positive of this evolving swap program is that it is likely to persuade more investors that there is little risk of default by local governments. This risk has always been negligible, in my view, because local governments are branch offices of the Party, not independent political jurisdictions. In China, there is no separate municipal political, legal or financial structure, so it is a mistake to apply a U.S. framework to Chinese municipal finance. This is why, after a decade of double-digit growth in loan-financed public infrastructure construction, there has not been a single default.

These local government projects are not similar to a punt by Lehman bankers or a bond floated by the city of Detroit. The loans were made when a Party official in Beijing encouraged a Party-controlled bank branch to lend to a Party-approved infrastructure project, to be built by a Party-controlled local government. And while Detroit's financial position was separate from those of the U.S. state of Michigan and the federal government, Chinese local government obligations are backstopped by the full faith and credit of the Party (which is itself probably the world's most liquid financial institution).

Figure 3. MOST LOCAL DEBT WAS TO FINANCE INFRASTRUCTURE CONSTRUCTION



Source: National Audit Office

Chinese bankers always knew that most infrastructure projects would not, on their own, generate sufficient revenue to cover the loan, but they also knew that the loan would be repaid from general revenue transfers from the central government to its municipal branches. This is how the Party has chosen to finance its enormous infrastructure build-out—basically building in a decade or so the equivalent of what spanned over a century of the U.S. building its intercontinental railways, Eisenhower interstate highways, urban subways, as well as TVA and EPA-related projects.

Not American Munis, Yet

These local government bonds are not, however, U.S.-style municipal bonds (munis). China does not yet have the legal and political infrastructure to support true munis, where only the local government is responsible for the bonds, not provincial or central government authorities. Local governments have limited revenue-raising authority, and there is no transparency for local government budgets, meaning it would be impossible for an investor to price risk—unless the investor assumes that the central government/Party will backstop the bond, as has been the case with loans in the past.

Chinese officials have told us that the swap is an important step toward the eventual establishment of true munis, but this would require the Party to devolve far more political and fiscal freedom to local officials, a process that is likely to move ahead at a very cautious pace. At this point, all of these bonds will be backstopped by the Party. The handful of initial bonds sold under this swap process have been at yields very close to those for traditional Ministry of Finance bonds, reflecting both the low risk and that the buyers are all Party-controlled institutions.

Modest Impact on Banks

The impact of this swap program on China's banks is unclear, but is likely to be modest. Because loans with higher interest rates will be swapped for bonds at lower yields, it is possible that bank profitability will suffer. But it is also likely that the swap process will free up a significant share of the loan quota to be lent instead to private firms, at even higher interest rates, mitigating the impact. We will continue to monitor this.

Not the End of Infrastructure Construction

Banks will continue to grant new loans and roll over existing debt as the swap process unfolds because the swap program is not intended to stop Party financing of public infrastructure. The peak in infrastructure investment has passed but the Party still plans to build a lot more subways, wastewater treatment plants and other projects. Despite the incredible pace of construction in recent years, the total length of China's railway network is only half of that in the U.S., and of the 150 Chinese cities with a population of more than 1 million, only 22 have operational systems for subways or other rapid transit.

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