FOCUS · Is Chinese public debt a source of risk?

In a context of slowing Chinese growth, which has gone from 10.8% year-on-year during the period 2001-2007 to 6.7% expected in 2015, the country's debt has risen considerably. Since 2007 China has increased its total debt by 20.8 billion dollars, bringing it to 282% of GDP (from 158% in 2007), a figure that moves the country away from the average for the rest of the emerging economies (around 100% of GDP). Given these numbers, it comes as no surprise that doubts are steadily growing regarding China's financial stability.

Public debt in particular represents one of the main sources of uncertainty. Although this is at a reasonable level of 55% of GDP, in the last few years its growth has almost exclusively been due to local government debt which now accounts for more than half of all public debt. This debt position is worrying for three reasons. Firstly, one of the main sources of financing for local administrations is by selling land, something which, given the risk of an abrupt correction in the real estate sector, would jeopardise their ability to repay. Secondly, a significant proportion of this local government debt is off balance sheet via financial vehicles (known as local government financing vehicles or LGFVs), making it difficult to calculate and control all local debt. A large number of these vehicles have also resorted to shadow banking for their financing, which tends to invest in riskier projects than the banking sector on average. Thirdly, it is worrying that a large proportion of local corporation debt is short-term.

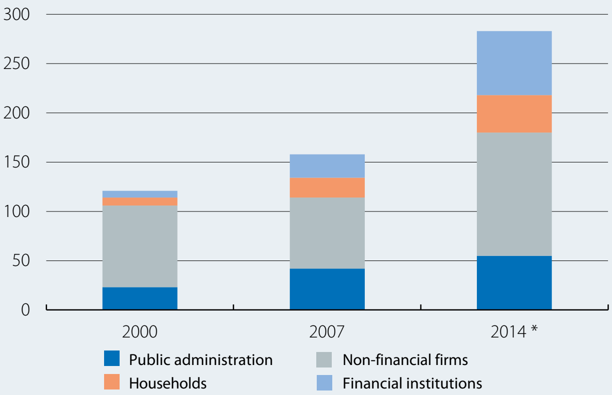
In addition to this already complex panorama is the limited capacity of local governments to raise revenue. Aware of this situation, the Chinese government has started to take measures to improve the finances of these organisms, especially forbidding the use of LGFVs (since October 2014) and allowing the issuance of municipal bonds. In addition to these measures, one advisable strategy would be to allow them to increase taxes, especially on property whose revenue is stable and easy to administer.

Although local government debt is high on the whole, it is important to note the big differences between provinces. Based on the ratio of local government debt to local government revenue (which measures their capacity to repay debt) and the balance of public accounts, the provinces of Chongqing, Guizhou, Beijing, its neighbour Hebei, Hunan, Hubei and Yunnan are among the most problematic with their total debt reaching 5.7% of China's GDP (560 billion dollars). On the other hand coastal provinces such as Canton, Jiangsu (north of Shanghai), Shandong (north-eastern China) and Zhejiang are among the most prosperous and dynamic, accounting for 33% of China's GDP and in a better financial situation.

In short, although the sharp increase in debt may seem alarming, a more detailed analysis alters this perception of risk. The financial position of most of the regions is relatively comfortable and the Chinese government can make use of a wide range of measures to improve the functioning of the local financing system. However, this is an area which, given its potential impact, must be watched very closely especially considering the doubts concerning official figures and how exposed China's financial sector is to local government debt: China's four large retail banks have a debt of 300 billion dollars on their books in financing vehicles for local governments.

China: debt by sector

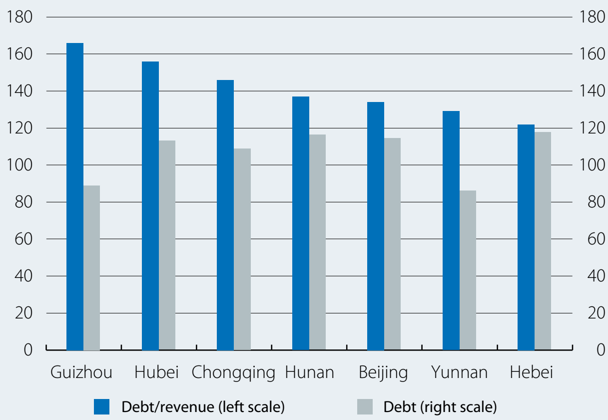
(% of GDP)



Note: ** Second quarter.*
Source: *"la Caixa" Research, based on data from McKinsey and the National Statistics Office of China.*

China: debt by province

(%) *(Billion dollars)*



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