# CHINA'S LOCAL GOVERNMENT DEBTS: HOW SERIOUS?

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# Executive Summary

1. The enormous bank lending underlined the Chinese government's huge stimulus package and helped it weather the economic downturn. The new loans in 2009 amounted to RMB 9.6 trillion, almost double that of 2008. Another RMB 4.6 trillion credit was extended during the first half of 2010.

2. The recent rescue program is accompanied by many investment projects by the local governments. Since prohibited from borrowing directly from banks or issuing bonds, local governments have raised fund to finance projects through various Urban Development Investment Vehicles (UDIVs).

3. Such off balance sheet liabilities of local governments have soared since late 2008. In 2009, UDIVs may have taken up over a third of all new loans to bring the total outstanding UDIV loans to RMB 7.4 trillion.

4. As a relatively new form of institution, UDIVs have grown rapidly in numbers and varied greatly in their financial strength. By May 2009, according to the China Banking Regulatory Commission (CBRC), there were 8221 UDIVs, among which about 60 percent were set up by prefecture and county-level governments.

5. The UDIV borrowing has been growing fast because local governments have few sources of capital to fund infrastructure projects, which are considered one of the most conspicuous indicators of a successful local leadership. And when local governments pursue rapid economic growth in their localities, they have no worry of economic overheating at the national level.

6. As UDIV loans increased in a relatively short period of time, concerns are rising. On one hand, banks are exposed to higher credit risks, especially since UDIVs lack government supervision and are subject to lower level of information transparency requirement. Moreover, as local governments

usually provide collateral assets, typically land, for UDIV loans, there are additional risks to the banks in case land prices plummet.

7. Large borrowings via UDIVs also pose fiscal risks for some local governments, which in many cases extended implicit guarantees on the loans. Projects that do not generate sufficient cash flow may have to rely on governments' fiscal revenue to cover loan payment.

8. The Chinese authorities are fully aware of the brewing risks and have started to take measures. The Ministry of Finance and CBRC require banks to examine their existing UDIV projects thoroughly. The government has also delayed its approval of new local investment projects. Banks are required to rely on cash flow sources and collaterals when making lending decisions.

9. In the near term, there are no large systemic risks to China's banking industry or fiscal health. First, the central government has been very vigilant over UDIV borrowing. Second, China's fiscal position is relatively strong. And third, the banks are relatively strong after the recent recapitalization.

10. In the longer term, however, there could be another surge in nonperforming loans associated with UDIVs, especially if the overall economic growth slows down markedly. The central government might have to step in and take over the loans eventually. Either way would seriously weaken China's banking sector and may prove costly to the Chinese government.