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Defusing local government debt risks: What's in the Politburo's basket?

Senior officials are finally getting serious about addressing the country's longstanding local government debt challenges.

The turning point: On July 24, the Politburo met for its quarterly discussion of the Chinese economy. In the readout of the meeting, the Politburo said it would soon roll out a "basket of measures" to defuse risks arising from local government debt.

A coordinated effort from Beijing to deal with local government debt is well overdue. Since 2022, the pandemic-induced economic downturn and the property market slump have dealt a huge blow to localities' finances, and to local government financing vehicles (LGFVs), leaving many struggling to service their debts.

- This comes after years of unsustainable debt build-up among local governments, thanks in large part to expectations that localities would fund high rates of infrastructure investment without adequate fiscal backing.
- The combination of these factors has led, most recently, to LGFVs in Guizhou, Yunnan, and Guangxi reportedly verging on the default of their public debts, before getting last-minute bailouts from provincial authorities.

But what might Beijing's basket of measures actually include?

To answer that question, it's easiest to start with what decidedly won't be in this policy package: a central government bailout.

- Early this year, the Ministry of Finance (MoF) reiterated its stance that there will be "no central bailout."
- And in January, Finance Minister Liu Kun vowed to break market expectations that the central government will eventually come to the rescue of struggling LGFVs.

Instead, Beijing's efforts will focus on:

- Making localities' debt servicing costs more sustainable by reducing funding costs
- Ensuring LGFVs can roll over maturing debt
- Pushing local governments to pay down debt

Based on officials' public statements and media reports, we expect the plan (which is still in the making) will take three key steps:

1. Authorizing high-risk local governments to swap LGFV debt for newly issued refinancing bonds
2. Encouraging state-owned financial institutions to lower LGFVs' debt servicing costs, through loan extensions, interest rate cuts, and credit enhancements
3. Pushing high-risk local governments to raise cash by selling state assets

The problem: Even taken together, these measures probably won't be enough.

That's why we also suspect the People's Bank of China (PBoC) will set up a facility which allows it to – under certain circumstances – buy LGFV bonds, thereby reducing the risk to investors of holding LGFV bonds and making it easier for LGFVs to rollover their bonds when they mature.

We unpack each of these support avenues below.

Authorizing high-risk local governments to issue refinancing bonds

On August 21, Caixin reported that the finance ministry (MoF) has approved 12 heavily indebted provinces to issue RMB 1.5 trillion worth of bonds to refinance so-called hidden debt.

- Hidden debt refers to liabilities local governments are implicitly responsible for repaying, but that don't appear on their books. It includes debt that LGFVs or other state-firms have borrowed on behalf of local authorities.

Some context: From 2018 to H1 2022, Beijing authorized three debt- refinancing programs to help select localities clear their hidden debt. About RMB 1.2 trillion of bonds were issued in total.

- Consequently, in early 2022, Guangdong announced that it no longer had any hidden debt. In January 2023, Beijing followed suit.
- However, many provinces – particularly those with weak economies – still have a long way to go.

With anywhere between RMB 30 trillion and RMB 70 trillion in hidden debt still outstanding, MoF's new RMB 1.5 trillion quota barely scratches the surface.

- So why such a low quota?

MoF is constrained by rules that require it to get legislative approval for new bond issuance above its approved annual quota.

- It can get around that rule by allowing local governments to draw down previously unused debt quotas, which currently stand at about RMB 2.3 trillion.
- That includes RMB 0.9 trillion for special-purpose bonds and RMB 1.4 trillion for general bonds.

The RMB 1.5 trillion in refinancing bonds will be drawn from that latent quota.

- Crucially, the National People's Congress can approve an additional quota if it wishes next year.
- However, officials will likely want to gauge the efficacy of this initial refinancing tranche before moving forward to approve larger-scale funding.

The upshot: RMB 1.5 trillion is likely just the beginning of a bond refinancing program that we expect will continue in some form for several years.

Reducing debt servicing costs via state-owned financial institutions

Earlier this year it was widely anticipated that Beijing would allow banks to restructure LGFV debt into ultra-long-term loans.

- In December, Zunyi Road and Bridge Construction Group – an LGFV that builds infrastructure in Guizhou – avoided default after 21 creditor banks agreed to extend the maturity of RMB 15.6 billion worth of loans to an unprecedented 20 years.
- The new loans reduced Zunyi Road's interest rate by 2 percentage points.

However, it seems Beijing doesn't intend to replicate Zunyi Road's experience. Caixin recently quoted an unnamed central bank (PBoC) official as saying:

- *"The Zunyi model received special permission."*
- *"It won't be rolled out across the country."*

Currently, banks' scope to roll over LGFV debt is limited. According to local media reports:

- Banks can extend LGFV loans by no more than three years.
- Hidden debts can't be extended beyond 2028, at which point Beijing expects all hidden debt to have been eliminated.
- Since 2021, banks have been banned from issuing LGFVs with new working capital loans that can be used to refinance maturing hidden debt.

All that said, we expect some loosening of these rules.

In January, Guo Shuqing – former Party secretary of the central bank (PBoC) and chairman of the China Banking and Insurance Regulatory Commission (CBIRC) – said financial regulators would:

- *"Promote the optimization of [local governments'] debt maturity, and reduce the interest rate burden"*

We're not entirely sure what that will look like. However, we suspect Beijing will:

- Allow banks to extend new loans to refinance the debts of struggling LGFVs.
- Allow banks to extend LGFV loans for more than three years, and perhaps beyond 2028.
- Encourage financial institutions to provide credit enhancements to financially viable LGFVs in order to lower their debt servicing costs and prevent further

defaults.

The bottom line: Banks need to play a central role in any effort to deal with local government debt. The challenge for authorities will be to lighten the debt servicing costs of local governments without excessively eroding bank profits.

Pushing high-risk local governments to sell state assets

In May 2022, the State Council released policy guidelines calling for local governments to "revitalize idle assets" in part to "lower government debt risk."

China's local governments own a huge stock of assets, including equity in more than 100,000 companies. In the past, some localities have sold equity in their state firms to great effect.

- Most notably, in 2014 and 2015, the Chongqing city government raised over RMB 180 billion from selling stakes in state firms – roughly equivalent to half the revenue it raised from land sales over the same period.
- Buyers were mainly state-owned companies from other parts of the country, but also included a mix of foreign and local private companies.

However, selling state assets will prove more difficult in the current economic environment, particularly if many local governments kick off sales at the same time.

- Still, selling state assets is a necessary part of any solution to local governments' debt problems.
- What remains to be seen is whether local authorities will be willing sellers – and how hard Beijing will push them to sell.

Why it matters: There's a huge amount of capital tied up in the equity of locally-owned state firms. Monetizing it could go a long way toward paying down local government debt, as long as there's enough political will to sell – and enough investors to buy.

A new SPV from the PBoC

Finally, we expect that the PBoC will play a role in dealing with local government debt – but so far, we know little about what that role will be.

On August 21, Caixin reported the PBoC is considering setting up a special purpose vehicle (SPV) to provide emergency liquidity to local government financing vehicles (LGFVs).

The SPV will:

- Distribute funds via state-owned banks
- Lower LGFV funding costs

This potential use of an SPV is interesting.

- The PBoC can't lend directly to market entities, so it is precluded from holding corporate debt unless through an SPV.
- It last launched an SPV in 2020, which was used to buy small business loans directly from banks.

Unfortunately, we don't have more concrete details about what the PBoC is considering. But it seems to us that the PBoC is weighing whether to buy and hold LGFV debts under certain, unidentified circumstances.

Why might it do that?

- The biggest challenge LGFVs currently face is rolling over trillions in debt without paying higher interest rates.
- If the PBoC stood ready to purchase certain LGFV bonds from banks – as a buyer of last resort – that could reduce the risk of investors holding LGFV debt, thereby making it easier for LGFVs to rollover their bonds at a lower coupon.

We appreciate we might be getting a little ahead of ourselves on this score, but mobilizing the PBoC's balance sheet to bring down local governments' debt servicing costs would be the cheapest – and most impactful – way of addressing local government financial risks.

Putting it all together

So far, it looks unlikely that the Politburo's forthcoming basket of measures for addressing local government debt will provide a definitive solution to the problem.

Instead, in the near term, officials are looking to make the debt burden sustainable for as many local governments as possible by reducing their cost of funding.

- However, for many local authorities it won't be enough.
- That means these provinces will require additional support down the road.

What to watch: The specifics of this basket of measures will gradually be made public in the months ahead. But regardless of exactly which measures end up being implemented, it's important to understand that authorities will hew to one central principle, namely:

- Local governments should continue to take ultimate responsibility for their own debt loads – and costs to the central government should be kept to the bare minimum.

In the long term, that principle will become increasingly difficult to stick to. But for this initial round of relief, we don't expect any deviation.

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