Economic Analysis

China's authorities clarified "no bail-out" principle in their new rules on local government debt

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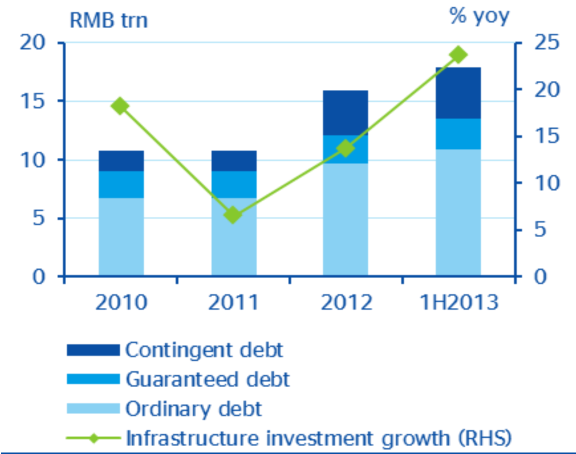
On October 2nd, China's State Council, the country's cabinet, promulgated a set of new rules to regulate local government debt. Chief among them is the central government's "no-bailout" principle toward debt obligations of local governments. Furthermore, it is reported that an unspecified transition period will be given to local governments before their full compliance with the new rules. Overall, we consider it a positive development because these new rules not only provide a long-term solution for the debt overhang of local governments but also initiate the long-awaited overhaul of the fiscal relationship between the central and local governments. Nevertheless, operational uncertainties in the transition period could discourage banks or other funding sources from extending new credit to local governments, which could lead to growing liquidity risks and weigh on short-term growth outlook.

- **Several points need to be underscored in the new rules:** (i) the central government makes it clear that they will not bail out the local governments in financial distress; (ii) provincial-level local governments are allowed to issue municipal bonds (up to certain quota mandated by the central government) to meet financing demand for capital expenditure or repayment of existing debt but not for general government expenses; (iii) other forms of borrowing by local governments, in particular through local government financing vehicles (LGFVs), are to be banned; and (iv) regarding the existing LGFV debt, local governments need to identify whether they belong to government debt or SOE's corporate debt, and include the former part in their budget.
- **New rules provide a long-term solution to the local government debt problem.** As reported in our previous note (see our China Banking Watch), China's local government debt has risen rapidly in the past several years and now constitutes one of the important financial fragilities to the economy. (Figure 1) In addition to its vast size (official figures reveal the total local government debt amounted to RMB 17.9 trillion or 32% of GDP as of end-June 2013), local government debt has become increasingly reliant on the shadow banking sector as a fund source and therefore needs to pay high interest rates, which will exert great pressure on fiscal sustainability of local governments. (Figure 2) Allowing local governments to issue municipal bonds can effectively lower financing costs of local governments and help them to restore financial soundness in the long run. Moreover, the establishment of the "no-bail-out" principle will mitigate the moral hazard problem of local governments and prevent their over-borrowing behaviors.
- **Some issues in implementation need to be addressed to minimize related risks.** First of all, the authorities should clarify the transition period so as to help the market to form consistent expectations; second, some transitional arrangements should be deployed during the transition period, in order to help LGFVs to meet their funding demand and avoid a large-scale forced liquidation of their ongoing projects; and last but

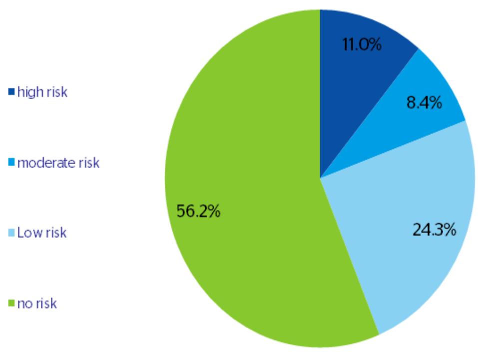
not least, more structural reforms on the fiscal front should be implemented to align local governments' expense obligation with their financial capacity.

Figure 1
China's local government debt has risen rapidly in the past several years



Source: CEIC and BBVA Research

Figure 2
Local government debt has exerted pressure on fiscal sustainability and increased financial risk



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