China’s Fiscal Sustainability: Problems around the Corner?

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Overview

• China’s fiscal situation going forward
  – Widening in fiscal deficit
  – Slowdown in economic growth
  – Balancing between the short- and long-term

• Main challenges
  – Local government finance
  – SOEs
  – Central government’s implicit guarantees
  – Social securities

• Solutions
  – Reform, transparency, accountability, equitability
China’s fiscal situation (I)
Not the Natural Candidate

- Fast economic growth
- Chinese government’s net asset is estimated to be between 6 and 69 trillion CNY
- Up to an estimated 85 trillion CNY worth of State-owned-enterprises’ assets
- Over $ 4 trillion foreign reserve
China’s fiscal situation (II)  
cash flow balances

• 2012:
  – Fiscal income grew by 12.8 percent in 2012 (as compared to 24.9 percent in 2011)
  – Fiscal expenditures grew by 15.1 percent (as compared to 21.2 percent in 2011)
  – Both growth were among the slowest in the past decade.
  – Fiscal deficit = 1.5 % of GDP (1.5% in 2011; 2.1% in 2013)
China’s fiscal situation (II)
Most up-to-dates

• 2015
  – Fiscal income grew by 7 percent in 2015
  – Fiscal expenditure grew by 10.4 percent
  – Expenditure grows at a faster pace than income
  – Fiscal deficit = 2.3% of GDP (2.1% in 2014)
Future trends: Fiscal Income

• Fiscal income
  – Slowdown in GDP growth
  – Slowdown in land sale
  – Uncertainties in alternative tax sources (property tax) and their implications
Future trends: Fiscal expenditures

- Government’s vow to boost
  - Environment protection
  - Public education
  - Health care
  - Social security and related programs
  - Other structural reforms (local debt exchange program)
Main challenges (I)
Sub-National Financing

• 17.9 trillion CNY in late 2013, probably over 20 trillion CNY by now

• Local government finance through:
  – On budget items
  – Central government appropriation
  – LGFV
  – Local government SOE
  – Local government bond issuance (pilot program, limited amount, subject to special approval, commitment)
China: government and household debt

RMB billion

- Local government debt
- Central government debt
- Mortgages
- Other consumer loans

Sub-National Financing: Why do they borrow so much?

• Necessity
  – Split tax reform in 1994 leaves local government ‘under-funded’
  – Increasing need for growth and social programs
  – The land sale “perpetual motion machine”
  – Investment driven growth model

• Desire
  – GDP tournament
  – Limited tenure and short-termism
Local Government Financing Vehicle (LGFV)

• Enterprises set up and managed by the government. Mostly dedicated to infrastructure and real-estate related projects

• Critical in improving prospect of real estate development, key to land appreciation and local government revenues

• Poor cash flow, illiquid assets, and increasing dependence on shadow banking

• Implicit guarantees from local governments
Main challenges (II)  
State Owned Enterprises (SOEs)

- Almost 100 ranked among Fortune 500 list 2014 (more than 20 sustaining losses)
- Many from regulated sectors such as resources, finance, transportation, and utilities
- Deteriorating profits and staggering debt
- Over-capacity
- Crowding out of private enterprises
Main challenges (III)
Government Implicit Guarantee

• Pilot local government bond ‘safer’ than treasuries
• Bet on dual credit from local AND central government
• Similar bailouts in real estate, securities markets, and shadow banking sector
• The financial distress of the Chinese railway system
Main challenges (III)
Government Implicit Guarantee

• Parallel financial system
  – Financial repression to small and medium enterprises
  – Regulated and subsidized interest rate to SOEs and favored borrowers
• Implicit guarantees provides cheap or free put options aimed at enhancing distorting risk preference
• Implicit guarantees induce high level of risk tolerance and speculation
• The government-led bull market
Main challenges (VI)
Social Securities

• Aging population
• Fragmented and incomplete coverage
  – Four different systems
  – Lack of mobility among systems
• Insufficient funding, especially at the local government level
• Limited investment choices
  – Very strictly requirement for investment in Chinese treasury bonds
  – Negative real returns
Main challenges (V)
The unknown unknown

• Lack of historical precedents
• Lack of disclosure transparency
• Lack of trust in the statistics
• Lack of check and balance at Sub-National government
• Lack of understanding of correlation
  – 2008 sub-prime crisis, LTCM, GS Global Alpha
  – Real estate, banks, shadow banking, stock market, private lending, SOE, local government, central government.....
Reforms

• Economic growth model
  – From investment driven to consumption propelled

• Fiscal reform
  – Division of fiscal revenues and expenditures between the central and local government
  – Property tax
  – Exit from guarantees

• Financial reform
  – Municipal bond market and corporate bond market
  – Multi-layered capital market
Reforms (II)

• Transparency
  – binding budget
  – Fully disclosed financing

• Accountability
  – Funding purposes and auditing
  – Short-term ‘GDP tournament’ mentality
  – Current and future generations

• Equitability
  – Alignment of revenues and expenditures
  – Balance of the state and people
The Guaranteed Bubble?
Thank you!