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CHINA MONTHLY

APRIL 2024

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Casting The Light On LGFV Debt

The Big Picture

Xpeng's AeroHT flying car – Shenzhen in 2024 announced China's first regulations for the low-altitude economy, a part of broader efforts to advance China's plans to be a global player in drones, autonomous vehicles, and civil aviation.

THE BRIEFING

China Invites Deeper MNC Footholds

Premier Li Qiang said at the China Development Forum that China welcomes companies from all countries to invest and deepen their foothold in China, and that Beijing has also been carefully studying issues that foreign companies in China have raised, such as cross-border data flow and limited market access. Xi Jinping also met with a group of about 20 US business leaders and assured them “China’s reforms will not stall, and our opening up will not stop”.

China-Australia Relations Thaw

Discussions on tariffs and regional security between Chinese Foreign Minister Wang Yi and his Australian counterpart Penny Wong in March marked the first high-level visit by a Chinese official to Canberra in seven years. In a sign that relations between the two countries are finally returning to a degree of normalcy, Australia will prepare for a visit by China's Premier Li Qiang this year, said Wong. Tariffs imposed in 2020 on Australian wine are expected to be lifted shortly.

China CPI Rebounds

China’s Consumer Price Index (CPI) increased by 0.7% in February from a year earlier, versus a rise of 0.3% forecast in a Reuters poll. This was the first time the index has shown prices rising, rather than flatlining or falling, since August 2023. PBOC governor Pan Gongsheng said in March that the central bank would maintain a supportive stance on monetary easing, suggesting that it could cut rates further this year to bolster the economy.

Northbound Flows

Foreign money is flowing back into Chinese stocks, with CNY1.8 billion of inflows in early March, while Morgan Stanley said global long-term investors had taken a pause in selling China, with some funds getting less bearish. If the trend lasts, it will mark two straight months of net buying after a record six-month streak of outflows till January. Data shows the economy is on the mend, with inflation back in positive territory for the first time since August and manufacturing and services no longer in a deep slump.

GDP Target

China’s economic expansion target of “around 5%” for 2024 – similar to last year’s growth target – was announced by Chinese Premier Li Qiang at the annual week-long National People’s Congress (NPC) gathering in Beijing. “Stability is of overall importance, as it is the basis for everything we do,” Li said during the delivery of his maiden work report. “In particular, we must push ahead with transforming the growth model, making structural adjustments, improving quality, and enhancing performance.”

CASTING THE LIGHT ON LGFV DEBT

By Kevin Jiang

China’s local government financing vehicles (LGFVs) are not well understood by investors. This APS China Monthly piece is intended to cast the light on it, and in the process, debunk some of the myths.

Moody’s in December 2023 lowered the outlook for China’s credit rating to negative from stable, citing the increased risk from local governments (LGs). Investors often cite LGFVs and their debt as a primary concern. Is this a pivotal issue? What are its roots and the solutions, both short-term and long-term?

Land Revenue Addiction – Cold Turkey

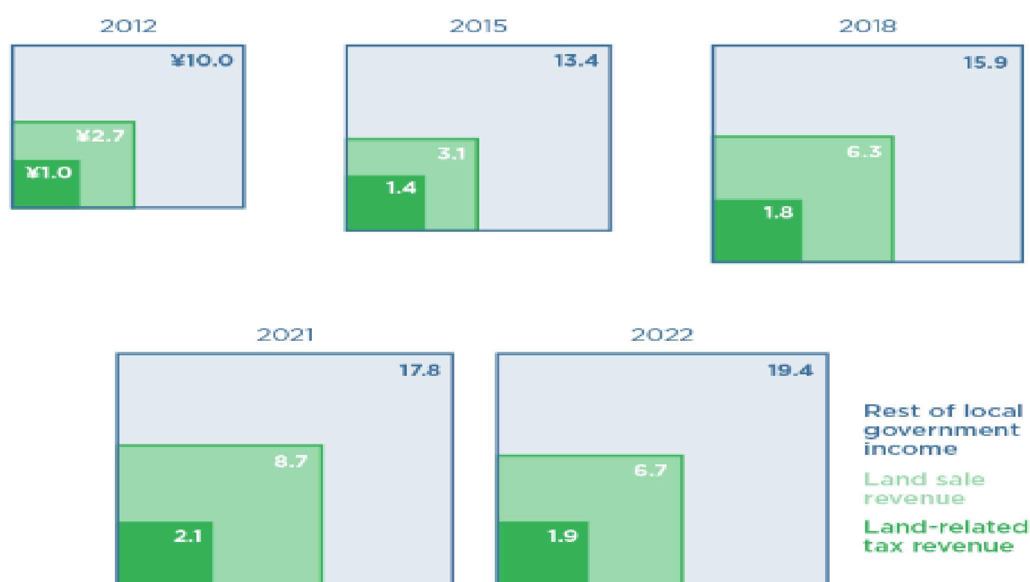
China's LGs are laboring under the weight of having to service and rollover their share of LGFV debt of USD7 trillion to USD11 tn, according to the International Monetary Fund and local credit rating firms’ estimates. This pressure has attracted investor concern as LGs’ revenues were severely dented by the three-year property market slump and pandemic relief spending.

LGs’ current over-reliance on land sales revenue is rooted in then premier Zhu Rongji’s 1994 Tax Sharing Reform, which was introduced to overhaul the nation’s fiscal and taxation regime to consolidate Beijing’s control over the economy by increasing its share of tax income. In 1994, the new regime saw Beijing’s fiscal revenue share more than double to 56% from 22% a year ago, while its share of expenditures increased only two percentage points. In the following decade, the central government (CG) continued to tax more than it spent. As this unbalanced relationship grew, it forced LGs to find off-budget revenue sources to fund their operating budgets, as well as to meet GDP growth targets set by Beijing.

The CG’s CNY4 tn fiscal stimulus package in response to the 2008-09 Global Financial Crisis marked the start of massive fiscal stimulus and employment targets imposed by Beijing on LGs, with many turning to infrastructure projects. This sparked the mushrooming of LGFVs and triggered a shadow banking system supporting large-scale infrastructure and real estate projects. Such debt at that time was primarily backed by LGs’ land sales revenue.

Putting together the revenue from the CG’s and LGs’ general public budgets and government-managed funds, the aggregate revenue contribution from land sales and land-related taxes peaked at 38% in 2021, from 27% in 2012.

Chart 1: LG Income Derived from Land (2012-2022)



Source: PIIE

China's CG recognized that this rising LG land revenue reliance was unsustainable and has since been addressing it over the past decade, introducing measures like the LGFV debt swap program (2015-18), standardizing the classification and regulation of explicit and hidden debt (since 2018), as well as the introduction of LG special-purpose bonds for refinancing purposes (2020), among others.

To head off the risk of a real estate bubble, Beijing instituted the draconian three red lines policy, which forced the real estate sector's deleveraging process from mid-2021. This saw LGs' land sales revenue falling by about a third from CNY8.7 tn in 2021 to CNY5.8 tn in 2023.

This led to a CNY3 tn fiscal revenue shortfall for the LGs, equivalent to 10% of China's total fiscal income of CNY28.8 tn in 2023. Outstanding LG explicit general and special bonds amounted to CNY40 tn, with implicit LGFV balances at CNY65 tn, assuming a growth rate of around 10% YoY in 2023. This implies that LGs' debt repayment capability has likely weakened by 3 percentage points against the aggregate debt exposure.

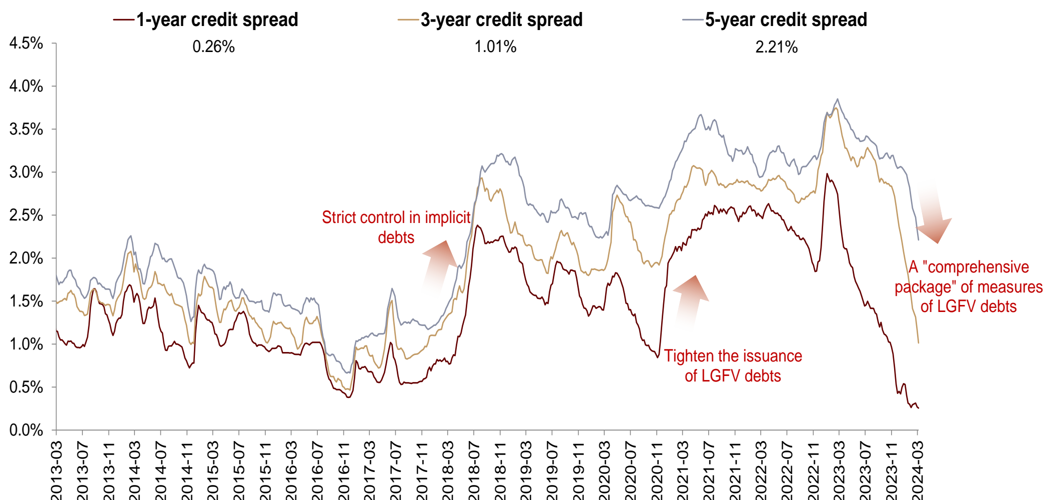
Not an ideal outcome, but neither is it alarming.

Trading Space For Time

The July 2023 Politburo Meeting saw China's top leadership focus on LG finances, emphasizing the importance of LG debt rebalancing. Banks have been helping convert LGFV debt back onto their balance sheets or rolling over the existing debt. This has helped lower LG debt funding

costs by roughly 100 basis points per annum on average, with savings ranging from 50 bps to 300 bps, depending on each region's credit spreads (Chart 2).

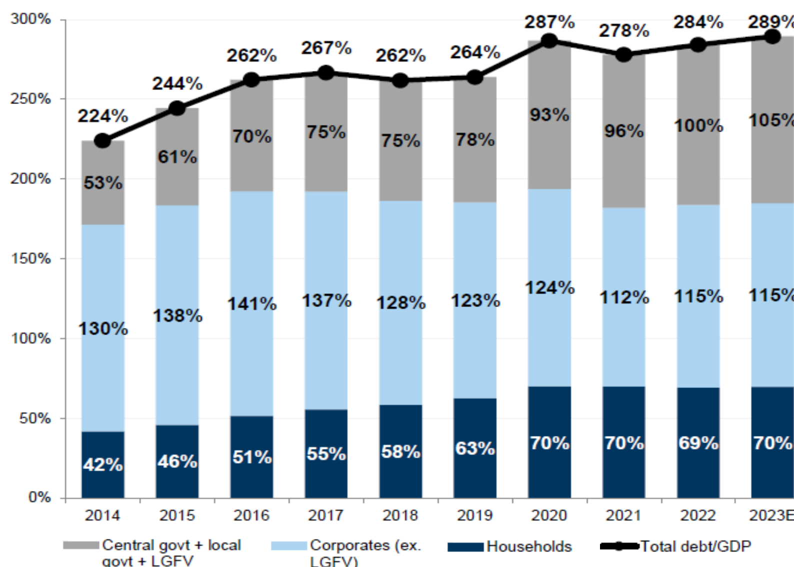
Chart 2: LGFV Bonds Credit Spread: AAA versus AA-



Source: Wind

The remaining shortfall can be covered by increasing the CG's transfer payments to the LGs. To this end, the CG rolled out the issuance of CNY1 tn of special treasury bonds, which might lift the general fiscal deficit ratio from 3.0% to 3.8% of GDP by late-October 2023. The 2024 National People's Congress in March 2024 also signaled the issuance of ultra-long treasury bonds later in 2024 and beyond, starting with a CNY1 tn quota for 2024.

Chart 3: China Total Debt to GDP Breakdown



Sources: Wind, Bloomberg, BIS

Ultimately, China's Ministry of Finance and state-owned banks would likely foot the bill. The ongoing rescue efforts by China's major banks and CG transfer payments have significantly alleviated LGs' debt repayment pressures since July 2023. This is undoubtably the best policy choice currently.

Ironically, China's proactive initiatives to control and suppress its property bubble and manage its opaque, off-balance-sheet debt in recent years have been widely interpreted in 2023 as pushing China to "Japanification", when they are essentially and ironically pre-emptive moves to avoid that fate.

China's initiatives to strategically shift resources and development plans away from the property industry and infrastructure demonstrate the Chinese government's resolute long-term thinking in moving towards an innovative, technologically advanced, and sustainable economy.

To assert that Beijing is drifting and heading aimlessly towards Japanification is, in our assessment, way off the mark.

Despite the short-term challenges faced in this ambitious and needed transition, China's past track record should give us confidence that its plans to build an innovative, high-value-add economy, and in the process modernize its economy, should have at least a 70% chance of success.

China's Robust Balance Sheet

China's CG has the resources to comfortably backstop the gradual digestion of LG debt, given its strong balance sheet, especially in comparison with the US and Japan. What is not well known is that according to the "China National Balance Sheet Report 2020", China's total national assets amounted to CNY1,695 tn at end-2019, while total net assets reached CNY662 tn. China's households owned the largest share of assets, with a respectable net worth of CNY513 tn, and the government (CG and LG combined) owns an enviable net worth of CNY163 tn!

Looking at the national leverage ratio (total assets/net assets) at end-2019, China's 2.6x was significantly lower and healthier than America's 3.6x and Japan's 3.1x. This same ratio for China's government sector was 1.2x, while the net worth of the US government at end-2019 was deep into negative territory to the tune of USD15 tn, versus total assets of USD6 tn. Japan's ratio was 14.8x.

Although the absolute size of the Chinese government's debt is still expanding, with a total debt-to-GDP ratio similar to America's 270%-280% but much smaller than Japan's 450%, the Chinese government owns massive assets.

Chart 4: National Balance Sheet of China, US and Japan

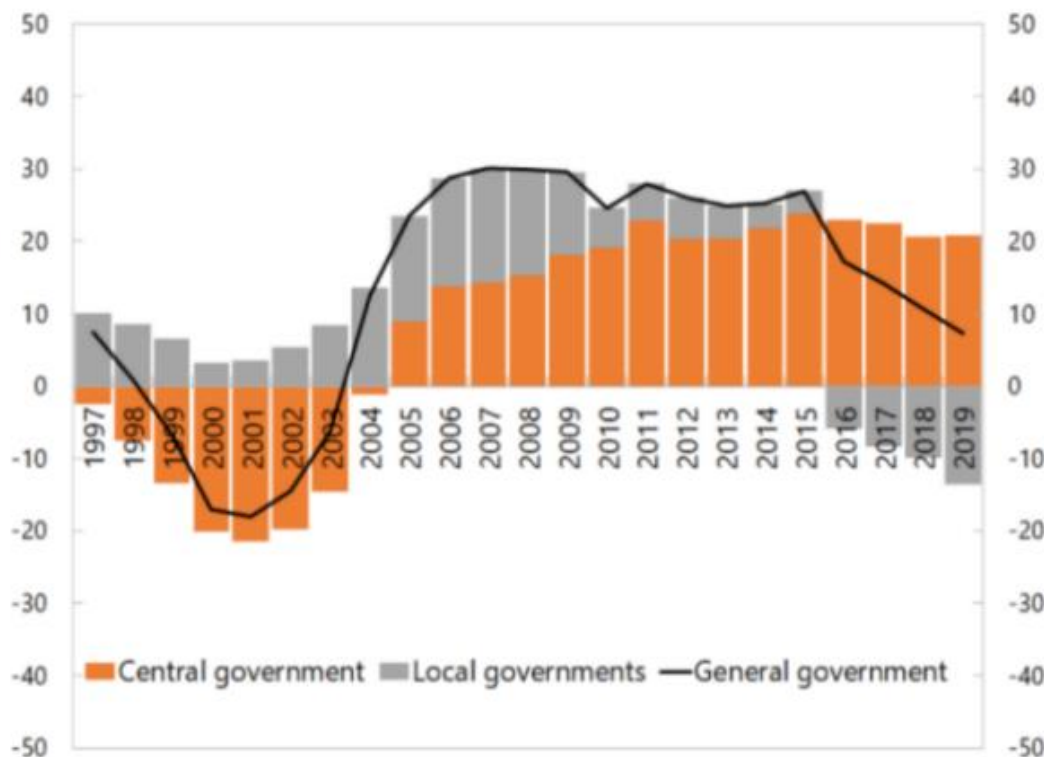
2019 National balance sheet	China	China - Gov only	US	US - Gov only	Japan	Japan - Gov only
Total assets	CNY1,695tn ≈USD242tn	CNY201tn ≈USD29tn	USD371tn	USD6tn	JPY11,350tn ≈USD104tn	JPY1,432tn ≈USD13tn
Of which: Financial assets	*CNY1,033tn ≈USD148tn*	*CNY134tn ≈USD19tn*	*USD274tn*	*USD3tn*	*JPY8,030tn ≈USD73tn*	*JPY649tn ≈USD6tn*
Non-financial assets	*CNY662tn ≈USD95tn*	*CNY67tn ≈USD10tn*	*USD97tn*	*USD4tn*	*JPY3,319tn ≈USD30tn*	*JPY783tn ≈USD7tn*
Total liabilities	CNY1,033tn ≈USD148tn	CNY38tn ≈USD5tn	USD269tn	USD22tn	JPY7,671tn ≈USD70tn	JPY1,336tn ≈USD12tn
Net worth	CNY662tn ≈USD95tn	CNY163tn ≈USD23tn	USD102tn	USD-15tn	JPY3,679tn ≈USD34tn	JPY97tn ≈USD1tn

Sources: Wind; National Institution for Finance & Development (NIFD); National Bureau of Economic Research (NBER); Cabinet Office, Government of Japan.

Note: USDCNY=7.00, USDJPY=109.41 (2019)

Moreover, China's CG has maintained a healthy net financial worth over the past decade, after flipping into positive territory following the Tax Sharing Reform as well as the drastic restructuring of state-owned enterprise (SOEs) and state-owned banks. The LGs also benefitted as their net financial worth started climbing from the year 2000 (Chart 5).

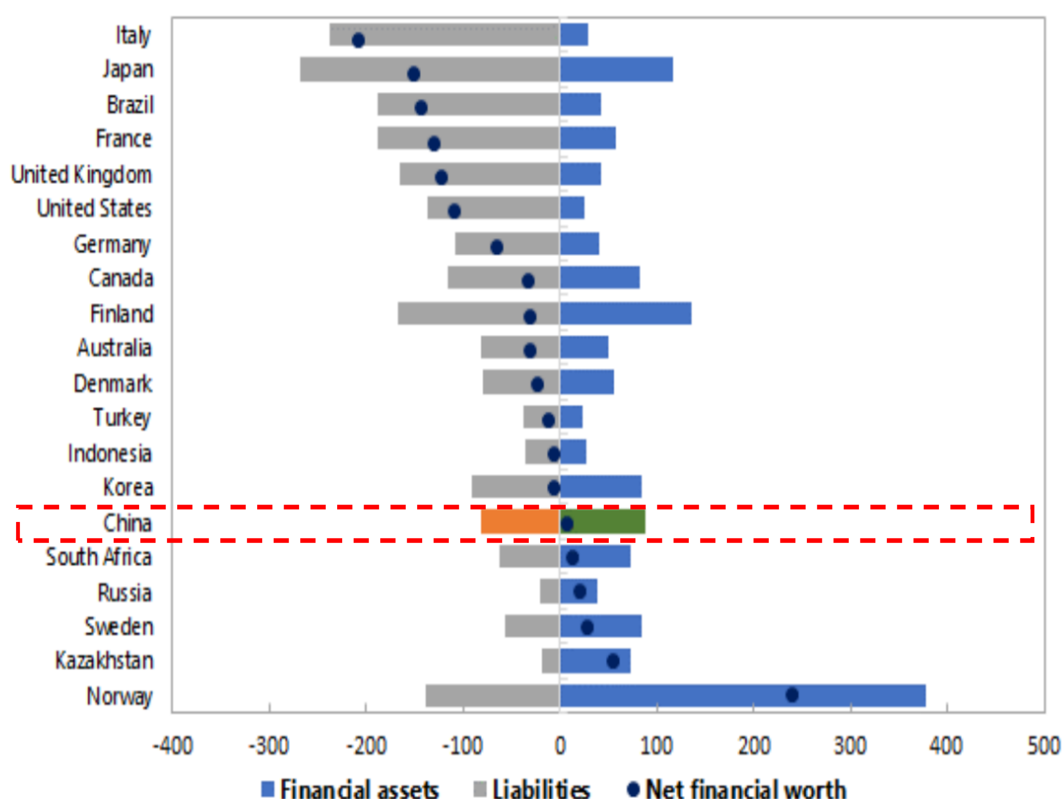
Chart 5: China's Net Financial Worth by the CG And LGs (% of GDP)



Sources: IMF, CEIC

That said, LG net worth began to be eroded by the investment-led stimulus plans post GFC. The overall government net assets-to-GDP ratio started to gradually decline after 2015. This matches the start of Beijing stepping in to regulate LGFV debt and curb the growth of shadow banking. In 2019, the China government sector's (CG and LG combined) net financial worth-to-GDP ratio was 7%, which still ranked among the top 15% of select major economies. As an illustration, Chart 6 shows Beijing's net financial worth-to-GDP ratio is more in keeping with that of the Nordic nations of Norway, Sweden, and Denmark. The US, UK, France, Japan, and Italy appear as polar opposites in this chart.

Chart 6: General Government Financial Balance Sheet for Selected Countries (% of 2019 GDP)



Sources: IMF, CEIC

We estimate China's net financial worth cushion remained healthy at around 6% in 2023, thanks to relatively steady GDP growth and Beijing's restraint in debt expansion. On top of this, Beijing still has substantial non-financial assets that can be tapped if need be.

China's Coastal-Inland Gap

The imbalance in economic development and debt conditions also exists between the coastal and inland areas. At end 2022, the outstanding explicit LG debts of the coastal provinces of

Guangdong, Shandong, Jiangsu, and Zhejiang had each exceeded CNY2 tn, which were the four largest in the country in absolute terms (Chart 7). Inclusive of LGFV debt, they also ranked among the top five. However, they were also much wealthier provinces, maintaining a relatively lower explicit debt-to-GDP ratio of 17%-27% versus the national provincial average of 36%, as well as healthier debt-to-fiscal revenue ratios, with Shandong being the exception.

Chart 7: China GDP, Fiscal and Debt Data by Province (2022)

Region	GDP		General public budget revenue		Revenue/ expenditure in budget		Explicit debt		Debt/GDP		Debt/ fiscal revenue*	
	CNYbn	Rank	CNYbn	Rank	(%)	Rank	CNYbn	Rank	(%)	Rank	(%)	Rank
Guangdong	12,951	1	1,326	1	71.6%	3	2,507	1	19.4%	3	116.8%	11
Jiangsu	12,209	2	926	2	62.1%	6	2,069	3	16.8%	1	88.0%	3
Shandong	8,758	3	710	5	58.6%	9	2,359	2	27.0%	11	138.2%	17
Zhejiang	7,806	4	804	3	66.9%	5	2,017	4	26.0%	9	100.7%	5
Henan	5,822	5	425	8	39.9%	18	1,513	8	24.7%	6	124.1%	14
Sichuan	5,661	6	488	7	41.0%	15	1,771	5	31.2%	14	109.4%	6
Hubei	5,274	7	328	14	38.1%	20	1,390	9	25.9%	8	120.9%	12
Fujian	5,177	8	334	12	58.7%	8	1,190	13	22.4%	4	152.7%	26
Hunan	4,756	9	310	15	34.5%	21	1,541	7	31.7%	15	139.3%	18
Shanghai	4,481	10	761	4	81.0%	1	854	23	19.1%	2	65.7%	2
Anhui	4,461	11	359	10	42.8%	14	1,330	10	29.5%	12	123.3%	13
Hebei	4,199	12	406	9	43.6%	12	1,575	6	37.2%	19	149.1%	23
Beijing	4,154	13	571	6	76.5%	2	1,057	16	25.4%	7	110.3%	7
Shaanxi	3,284	14	331	13	49.0%	10	979	18	29.9%	13	114.5%	10
Jiangxi	3,121	15	295	16	40.5%	16	1,086	15	33.9%	16	113.8%	9
Liaoning	2,883	16	253	18	40.3%	17	1,098	14	37.9%	20	168.8%	28
Chongqing	2,858	17	210	19	43.0%	13	1,007	17	34.6%	17	151.5%	25
Yunnan	2,856	18	195	20	29.1%	24	1,210	12	41.8%	23	171.7%	29
Guangxi	2,619	19	169	24	28.6%	26	972	19	37.0%	18	143.7%	20
Shanxi	2,558	20	345	11	58.8%	7	629	26	24.5%	5	94.3%	4
Inner Mongolia	2,339	21	282	17	48.0%	11	934	20	40.3%	22	141.9%	19
Guizhou	2,001	22	189	21	32.2%	22	1,247	11	61.9%	30	164.1%	27
Xinjiang	1,804	23	169	23	29.6%	23	900	21	50.7%	25	147.5%	22
Tianjin	1,613	24	185	22	67.7%	4	865	22	53.0%	27	295.6%	31
Heilongjiang	1,583	25	129	25	23.7%	27	729	24	45.9%	24	128.9%	15
Jilin	1,282	26	85	27	21.0%	29	717	25	54.8%	29	174.0%	30
Gansu	1,112	27	91	26	21.3%	28	609	27	54.3%	28	135.8%	16
Hainan	689	28	83	28	39.7%	19	349	28	51.1%	26	145.3%	21
Ningxia	511	29	46	29	29.0%	25	200	30	39.4%	21	112.2%	8
Qinghai	362	30	33	30	16.7%	30	304	29	84.3%	31	151.0%	24
Tibet	215	31	18	31	6.9%	31	57	31	26.6%	10	20.6%	1
Median	**2,883**		**295**		**40.5%**		**1,057**		**31.7%**		**128.9%**	
Average	**3,852**		**350**		**43.2%**		**1,131**		**35.8%**		**129.6%**	

Source: Wind

Notes: Fiscal revenue = general public budget income + government-managed fund income + transfer payments. Budget execution data is used for provinces that have not made disclosures yet. Ningxia's fiscal revenue did not include government-managed fund income and transfer payments.

Provinces with weaker debt-to-GDP and debt-to-fiscal revenue ratios included Tianjin, Qinghai, Guizhou, Jilin, Gansu, Yunnan, and Liaoning, most of which were in northeast and southwest China. Most of these less-developed regional economies were dominated by heavy industries and natural resource-reliant industries, which are characterized by their being part of a highly organized and complex LG-dominated business ecosystem. While this non-market-oriented system is quite efficient in implementing Beijing's economic plans, to some extent, it naturally impedes a greater role for market signals in the regional economy. This makes those provinces more prone to inefficiencies, redundancies, and loose fiscal management, resulting in wastage, excessive debt, and corruption.

However, they have a path to durable prosperity. We have noted initiatives to boost the anemic economic development:

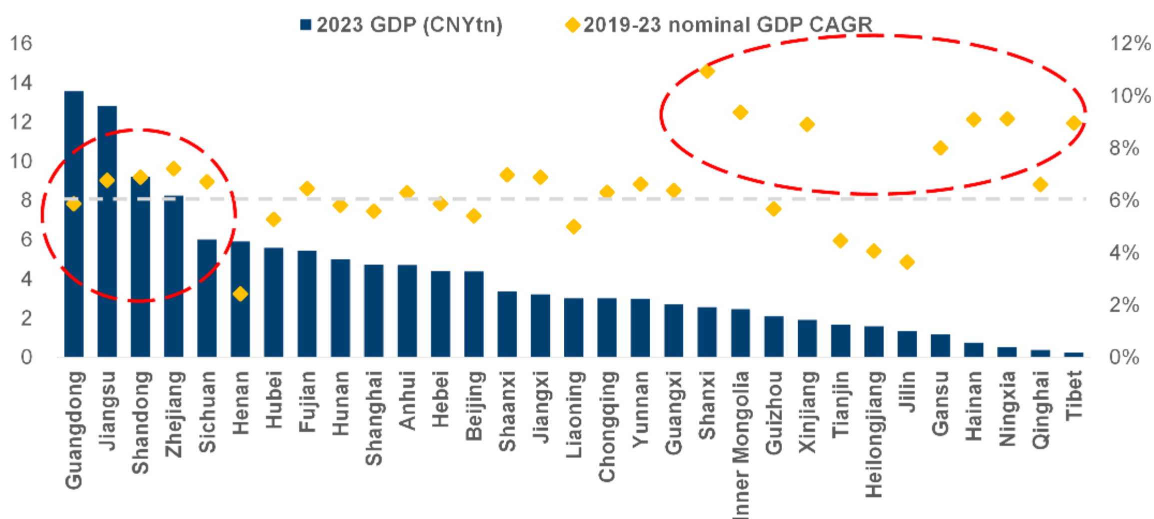
1. Beijing has been guiding the less-developed regions to focus their resources in the areas of poverty alleviation, rural revitalization, and non-traditional infrastructure projects. These efforts paid off as China grappled with the Covid pandemic, when lower-tier cities, towns, and rural areas helped absorb the return of migrant workers from top-tier cities via flexible employment options like part-time or gig work. Even after China’s post-Covid reopening, these so-called “lower-tier markets” (下沉市场), with relatively lower population densities and per capita incomes but spread across a wider geography, are maintaining their steady growth momentum.

2. China committed to establishing a unified domestic market (统一大市场) in 2022, aiming to remove intra-China regional protectionism and smoothening the nation-wide flow of products and resources. This ought to sharpen each province's industrial specializations on the supply side, helping the less-developed regions to develop and make full use of their own industrial and resource advantages.

3. LGs carrying heavy, legacy debt burdens have been upgrading their industrial and technological bases, either supported by more economically developed regions or backed by their own industrial and resource advantages. For instance, Tianjin has been developing its capabilities in cybersecurity, hydrogen energy, automotive semiconductor chips, AI computing centers, and the entire aerospace supply chain, by bringing in R&D knowhow and talent from Beijing, a 2-hour drive away. Moving to China’s west, Yunnan and Sichuan are emerging as world-class green energy hubs following China’s 30/60 carbon neutrality initiatives.

4. Externally, China’s Belt and Road initiative has brought new export opportunities for inland provinces like Yunnan, Guangxi, Xinjiang, Sichuan, Heilongjiang, etc. The rise of multi-polar global trade patterns will open new possibilities for western and northeastern China, unlocking their growth potential.

Chart 8: China 2023 GDP by Province and 2019-23 Nominal GDP CAGR



Source: Wind

Spend Less, Earn Smarter

Although the fiscal income shortfall of CNY3 tn, or a 10% fall in fiscal revenue, can be compensated for by CG transfer payments and reducing LG debt servicing costs, it may have sparked a material tightening of CG purse strings. Various news outlets are more frequently reporting on the reduction of non-essential expenditures, salary and welfare cuts, as well as staff being made redundant at local state-owned enterprises and organizations, at varying levels of seniority.

To make up for the loss of land sales revenue, Beijing rolled out the “three major projects” (三大工程) real-estate development plan, involving building affordable housing, renovating old urban villages, and constructing dual-use public facilities, with the support of the PBOC’s monetary policy instruments and bank lending.

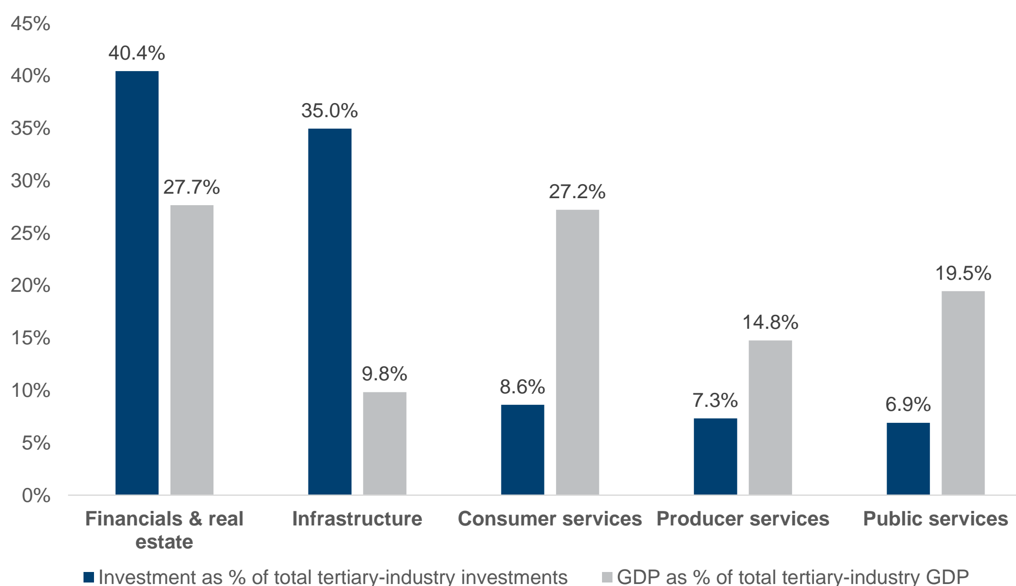
Meanwhile, LGs will have to squeeze out cost savings, as they need to maintain the pace of economic development so that they can successfully transition into the new growth engines that will propel them out of this fiscal revenue tight spot, as CG support is neither indefinite nor unconditional.

Over the past decade, financials and real estate as well as infrastructure sectors accounted for 40% and 35% of total tertiary-industry investments respectively, while contributing only 28% and 10% of the tertiary-industry GDP respectively. Consumer services, producer services, and public services have significantly superior investment-to-GDP ratios among the tertiary industries. ‘Old Out and New In’ is the new way forward.

The LGs’ transition in fiscal spending patterns has already begun. In mid-January 2024, the State Council asked 12 debt-ridden provinces to suspend the construction of fresh infrastructure projects, while retaining investments in livelihood-related projects. At the same time, President Xi Jinping signaled strong fiscal support for efforts to spur large-scale

equipment renewal and trade-ins of consumer goods, as well as lowering logistics costs. This may mark a mid-term structural shift in the direction of China's fiscal spending, with LGs likely to play a significant role.

Chart 9: China's Investment-to-GDP Ratio by Sector (Average Over Past Decade)



Sources: NIFD, CEIC

Besides getting more bang for the buck, we list a few examples of how some LGs are pivoting to boost their fiscal revenue:

1. **Accelerating green development as asset operators**. LGs have accumulated ecological and cultural tourism assets in recent years from their investments in rural revitalization and in implementing Xi's "green development" initiatives. These help LGs accelerate their transition away from an investment-driven growth model to an asset operator model. The domestic tourism booms in numerous cities post-reopening are good examples of this model shift, such as Zibo's (淄博) barbecue skewers culture (Picture 1) and Harbin's ice and snow world. The attempts by the Zibo and Harbin governments have been impressively successful, by not only directing strong customer traffic to their local transportation, catering, accommodation businesses but also to cultural and tourism scenic spots, which also boost the income and debt-servicing capabilities of their cultural- and tourism-focused LGFVs.

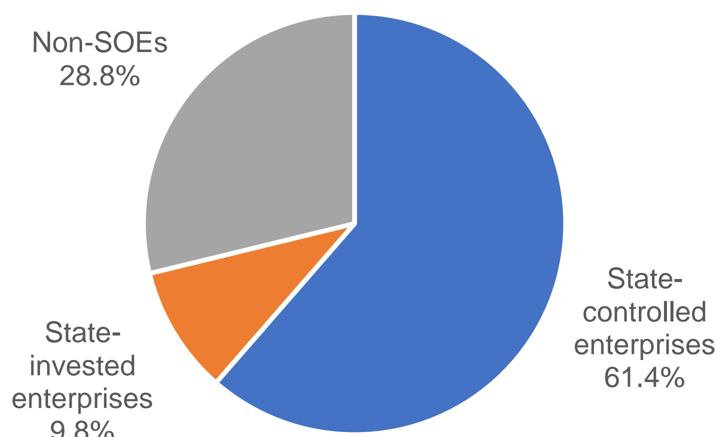
Picture 1: Zibo's BBQ Tourism

Source: Global Times

2. **C-Reits**. The establishment of China's real estate investment trust market is a historic breakthrough for the government and SOEs to revitalize their public assets, which include infrastructure, utilities, green-energy assets, and other franchises. Through C-Reit IPOs, LGs can access direct financing channels to improve balance sheets, transform their role from an asset builder to a market-oriented asset manager, and unlock the value of their hidden assets, like in Singapore and elsewhere. It was estimated by some C-Reits industry experts that China's aggregate public assets eligible for C-Reit listings amount to CNY700 bn to CNY800 bn initially, out of total public assets of approximately CNY37 tn to CNY53 tn. Assuming a 10% securitization rate, the C-Reits market could reach CNY5 tn. Within 36 months of the C-Reits market's kickstart, the total market capitalization of the 30 listed C-Reits reached CNY89 bn as of February 2024.

3. **Optimizing state-owned assets allocation**. LGs are also working to improve the investment efficiency and profitability of their assets. We notice that provincial governments such as Jiangsu, Zhejiang, Anhui, Chongqing, and Hunan are consolidating the management of their assets into a unified platform. To further stimulate the vitality of private investments, the NDRC in September 2023 released a unified platform for promoting projects to private capital, focusing on 4,894 key projects of approximately CNY5.27 tn, to attract private capital. Also, LGs have been actively investing in the Venture Capital/Private Equity market as LPs, especially those in the Pan-Yangtze River Delta region, to enhance returns and introduce innovative industries to their regions.

Chart 10: CNY-denominated Private Equity Funds Raised in 1H23, by Investor Type



Source: Zero2IPO

Note: Includes early-stage, VC, and PE funds.

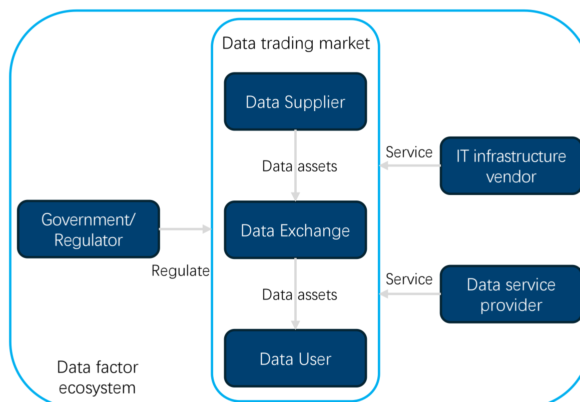
4. **Expanding new types of factors of production**. China in April 2022 is trying to apply commercial rules to create a market for data, which is regarded by Beijing as a new factor of production (FOP), in the same category as land, capital, human labor, and technology. Most LGs have been facilitating the digitization and digitalization of their local economies. They have been formulating a closed loop of data securitization, rights confirmation, licensing, and circulation, as well as a trading mechanism. According to the newly established Shanghai Date Exchange, nationwide fixed assets totaled CNY1,500 tn. If data FOPs become a new on-balance-sheet asset, there would be an incremental value of CNY100 tn. Initial estimates suggest the country's yearly data factor-related expenditure amounted to CNY3.3 tn. If we also consider the evaluation of data assets, pledging, financing, and other derivative services, the total yearly data-factor market size could reach CNY30 tn. Today, many LGs and SOEs have already begun to list different categories of data assets on the shelves of local data exchanges.

Chart 11: Factors of Production Exploited During China's Different Economic Eras

Factors of production	Agricultural economy	Industrial economy	Digital economy
Land	√	√	√
Labour	√	√	√
Capital		√	√
Technology		√	√
Data			√

Source: People's Daily Online

Chart 12: Major Parties in China's Data Factor Industry



Source: CAICT

The Chinafication of China

With the era of growth driven by adrenaline shots of land revenue and hidden debt firmly in the rearview mirror, the LGs' journeys to transform their revenue models and growth drivers will meet with storms, turbulence, potholes, and high seas along the way. It will not be easy, but not insurmountable if their financial assets are flexibly and intelligently deployed together with their drive, resourcefulness, and ingenuity.

China's path of land reforms, urbanization, and industrialization has led it to become the world's factory. The LG debt issue is an ailment that has arisen in the process, and now the country must cleverly transition to an economy which can generate higher returns on its past investments.

China's rise as an industrial power depended on Beijing's unwavering medium- and long-term development strategies, underpinned by effective implementation. These are the very same strengths and track record that will see the successful resolution of this LG debt problem and the concomitant transformation of the LGs' economic development model.

Let me end by paraphrasing APS CIO Wong Kok Hoi's November 2023 essay "The Japanification of China?".

The best approach to tackle China's economic problems at this stage is not a Japan-style mega-dose of fiscal stimulus for the sake of red-hot growth.

The best approach would still be the Chinafication of China.

Although their debts are high, they also own massive assets which can be privatized or securitized. In addition, the central government which is lightly indebted can also extend a helping hand. In conclusion, LGFVs, contrary to conventional wisdom, will not bring down China's economy.

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