Local Debt Restructuring:
A Case of Ongoing Authoritarian Reform

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Local debt restructuring is a key part of the ambitious fiscal reforms proposed by Minister of Finance Lou Jiwei. The initial program (Debt Swap 1.0) turned out to be too ambitious, and could not be sustained in the face of increasing worries about economic slowdown. After a crucial Politburo Meeting on April 30, 2015, a new program (Debt Swap 2.0) was instituted that included a much bigger bailout for local governments. This program experienced quick uptake during May and June. The case is a cautionary tale about what authoritarian reforms can achieve.

There should now be no remaining doubt that Xi Jinping and Li Keqiang are serious economic reformers who have committed to significant changes in China's economic system. The low ebb of economic reform impetus that characterized the 2002–2012 Hu Jintao-Wen Jiabao administration has now passed, and a new tide of reform effort has risen. The agenda is enormous: and given that so many things need to be done, it is likely that some of these reform efforts will succeed, and substantially improve the Chinese economic system. However, a successful program of economic reform requires far more than leadership commitment. Leadership commitment is a precondition, rather than a guarantee of success. Xi Jinping has displayed the commitment—a process can go forward, but that is just the beginning.

Xi Jinping's reform is obviously an authoritarian reform, driven from the top and subject to the priorities and limitations that the top leader imposes. It is perhaps natural to believe that a reform program is *easier* to carry out, and easier to accomplish, when it is backed by a powerful and determined top leader, but that is not necessarily so. There are conditions under which top-down reform may be advantageous, and other conditions under which it can be a handicap. Successful economic reforms must be crafted in a way that conforms to economic needs (structural and macroeconomic) and that gives birth to new institutions which must thrive and build credibility. To phrase it in an obviously unbalanced way: Authoritarian reformers do not necessarily have an easier time of it than reformers working with a broad and active coalition of grass-roots supporters.

These big issues are beyond the scope of a short piece like this, but they can be useful in setting the scene for the discussion of a single, important case: the effort to restructure local government debt in the last part of 2014 and the first half of 2015. This is an important reform effort, as flagged in the previous issue of *CLM*. However, the actual implementation of the reform has been very different from that envisaged by reformers last year. In some respects, it is a cautionary tale. In this piece, I describe the progress so far, and trace the main outcomes. This provides the basis for a brief concluding section that speculates on some of the provisional lessons from this episode.

Local Debt Restructuring 1.0: The Plan

During 2014, Minister of Finance Lou Jiwei laid out a grand vision of fiscal restructuring, which was approved by the Communist Party Deepening Reform Leadership Small Group (chaired by Xi Jinping) and the State Council (chaired by Li Keqiang). Subsequently, most parts of the vision were incorporated in State Council Document No. 43. One very important part of that vision was the local debt restructuring plan. In and of itself, local government debt restructuring was an extremely ambitious program, since it was designed to get to the heart of the interlinked problems of excess debt, unclear responsibility for debt, and high funding costs. Essentially, it had three components:

1. Accounting for local government debt. Each province was to
    a. audit local debt as of December 31, 2014;
    b. classify it into "general" municipal debt, specific project bonds, and enterprise debt; and
    c. report the totals to the central Ministry of Finance.
2. Capping bank borrowing by local governments. Borrowing from banks and from other sources was to be capped at the total level reported by the provinces in the previous step. Local government financing vehicles (LGFV), the ambiguous local government-controlled investment corporations, were to cease new borrowing altogether, and their debt was to be gradually converted to government or enterprise debt as it came due.
3. Debt swap. A first tranche of 1 trillion RMB of existing debt was to be swapped for new local government general obligation bonds and enterprise bonds.[1] This first tranche was designed to be about half of the local government debt that was anticipated to come due in 2015, and of course additional tranches would follow.

This ambitious program sought to balance the multiple objectives that any large-scale debt restructuring must take into consideration. In the first place, it must clear away the burden of bad debt, in order to put the indebted organizations onto a sustainable basis. That is generally achieved by some combination of debt write-off and extended payment time at lower interest. Second, the program must create expectations that the organizations' budget constraints will be *hard* going forward; that is, although they have been given a break this time, they should not expect to get a break in the future. Of course, these first and second objectives are in tension: the more debt forgiven this time, the harder it is to credibly convince the debtor that this really is the last time, and vice versa. Finally, large-scale debt restructuring must take into account the macroeconomic impacts of the program. Generally speaking, debt restructuring is *expansionary* to the extent that it relieves debt burdens and wipes bad assets off the balance sheets of banks while usually recapitalizing the banks and enabling them to lend again; but it is *contractionary* to the extent that remaining or newly restructured debt must now be taken more seriously by debtors, and because some debtors may have been pushed into bankruptcy.

By this standard, it can be seen that the original program promulgated by the Ministry of Finance and Minister Lou Jiwei was quite tough: it did not give much away to local governments and it did not have much (or any) expansionary impact. Local governments got no debt forgiveness whatsoever, but only the possibility that funding costs would be reduced. Even the reduction of funding costs was not 100 percent guaranteed, since it depended on the bond market accepting new debt that carried a lower interest rate. In return, the local governments were confronted with strict limitations on future borrowing. To be sure, local governments would still try to get as much debt as possible qualified for the program, because any debt left outside would be at risk of being cut loose without any central government support at all. Overall, though, local governments could not have been pleased by the program with which they were confronted.

Finally, as described in the previous issue of the *Monitor*, this was an ambitious program designed not only to restructure local government debt, but also to jump-start the bond market. In government publicity about the debt swap, it was emphasized that the ultimate market for these securities would be broad, including social security and pension funds, insurance companies, and households. The national social security fund quota for government debt was increased from 10 percent of total assets under management to 20 percent. In total, then, the original program was large-scale and technically complex, and it did not give much away to local governments or stimulate the economy. In the previous *CLM*, we suggested that this plan might have been overambitious, and in fact, so it turned out to be.

Accounting for Local Government Debt: Early Failure

Ever since October 2014, when the Ministry of Finance issued procedures for handling local government debt, the central Ministry and the provinces have been engaged in an intense tug-of-war about counting, classification, and management of debt. Both sides were working from the same baseline: When the State Audit Bureau went through local government debt as of the end of June 2013, they came up with a total of 10.89 trillion RMB, or just over 19 percent of 2013 GDP. Now, the provinces were instructed to self-report and update the debt figure to December 31, 2014. Moreover, they were told to report to the Ministry during January 2015. As described in *CLM* 46, the provinces now had an incentive to report the largest possible number at this stage, since this would be the basis both for loan term concessions and for their new bank debt ceiling.[2] Moreover, local governments tend to report virtually all the debt as "government debt," and very little as "enterprise debt." That is, they try to pull debt onto the government's balance sheet, so that it can qualify for whatever bailouts or partial bailouts may be coming, and reduce possible headaches from future payment defaults.[3]

When the provincial reports came back, the Ministry of Finance was not happy. Officially, the numbers have not been disclosed, but press accounts say the provinces reported in aggregate that between June 2013 and December 2014, local government debt had jumped 47 percent to 16 trillion (or 25 percent of 2014 GDP).[4] The Ministry of Finance just said no. The self-reported numbers were returned to the provincial governments with the instruction that they re-audit and resubmit more-accurate debt totals by March 8. The message was clear: submit a smaller number. Local governments did not meet the March 8 deadline, either. Really, what could they report in such a short time period without looking foolish?[5]

Without good local numbers, the central government promptly took back the power to do the re-audit. In early March, a joint document went out from the Ministry of Finance, National Development and Reform Commission (NDRC), People's Bank of China (PBC) and the China Bank Regulatory Commission (CBRC), mandating a new audit process. In the new setup, debt is to be approached through a three-sided survey. The local fiscal departments will be responsible for only a narrow slice of the work, setting up special departments to audit payments and accounts payable for project financing and buy-transfer (BT) projects. The NDRC will audit enterprise debt, including LGFVs, while the PBC and the CBRC will audit the bank loans and short-term commercial paper.[6] The process was designed to be carried out with high priority, but it clearly will take some time. For now, the idea of a reliably audited total debt figure is receding into the future.

The First Workaround

The initial debt swap of a trillion RMB was supposed to be based on the year-end 2014 local government audit figures. With the audit process delayed, it was essential to find a way to move forward without it. Even by the strictest calculation, 1.85 trillion in debt was coming due in 2015, with the peak repayment in the second quarter (this was the figure from the State Audit Bureau's calculation of debt in mid-2013, which had totaled 10.89 trillion). The workaround was simply to calculate 1 trillion divided by 1.85 trillion, or 53 percent, of the amount of debt each province showed coming due in 2015, and use this to distribute a debt swap quota to every province and *danlie* city, which was done in March.[7] This allowed the debt swap process to go forward, but it inevitably weakened the idea of a cap on total debt, since the figures being used could no longer pretend to be accurate. Inevitably, but without announcement, the cap on total debt was eased, initially through stipulations that big projects under construction could continue to tap into new bank lending.[8] In this way, the crucial debt swap could keep on going.

Debt Swap 1.0 Stumbles

Provinces were having difficulty structuring bonds and then selling them into the market. Local governments wanted low interest rates (to reduce their funding costs), while the market wanted to be compensated for the risk and uncertainty of these new products with high interest rates. This broad problem came to a head on April 23, when Jiangsu Province's offering of 64.8 billion in debt swap bonds failed. Nobody wanted the bonds at the rate Jiangsu was willing to offer. After all, why should anybody buy low-interest bonds when there were still plenty of medium high-yielding "urban construction" bonds with implicit guarantees?[9] For the first time, it was clear that the Debt Swap program, as structured, wasn't working.

A Politburo Meeting

On April 30, the Politburo held a meeting specifically to consider the economic situation, and particularly the rapidly cooling economy.[10] There is no specific indication that the Politburo meeting was related to the failed offering of local debt by Jiangsu Province. However, the typically brief skeletal meeting minutes published gave several signals that the party was adopting a more expansionary policy: the fiscal policy stance was described as something that should include increased public outlays and accelerated tax cuts, and the leaders re-emphasized the central function of investment. There was also a call for an acceleration of reform. Some commentators proclaimed this a watershed meeting, marking the shift to an overall more expansionary policy to pump up aggregate demand.[11] Supporting this interpretation was the fact that the same Politburo meeting approved the plan—closely associated with Xi Jinping himself—to reconstruct the Beijing-Tianjin-Hebei region, beginning with the transportation network. Although the plan itself was not released, the press was throwing around huge figures for total investment contemplated: one source claimed that the Ministry of Finance had estimated that 42 trillion RMB would be invested over the next six years: essentially a trillion U.S. dollars a year.[12] However, this claim was denied by the Ministry of Finance, which described it as a misunderstanding and misinterpretation of the data.

While the specifics of the Politburo meeting are not a matter of public record, it is clear that the meeting represented a significant policy turning point. Responding to the weak economic data of the first part of 2015, the meeting emphasized the need to adapt policy to help combat that weakness. It is inconceivable that a policy as important as local debt restructuring would not be affected by such a shift. In fact, policy reformulation was quick to emerge.

Debt Swap 2.0

Within two weeks, cooperating with the PBC and CBRC, the Ministry of Finance rolled out a revised and very different version of a debt swap.[13] Instead of debt being offered on the open marketplace, the new debt was allocated to those who held the existing bank loans. The principle we might call, "you cooked it, you eat it." Existing debt-holders, overwhelmingly banks, were responsible for taking the bonds that replaced the loans they had originally extended. A lead syndicate was to be established to handle the bonds, but the ultimate responsibility was to rest with the originators. Indeed, the bonds were temporarily not allowed to circulate on the marketplace. The banks not only had to take the bonds in the first place, they had to hold them on their books for an unspecified period.

The interest rate on the new bonds was to be "negotiated," mutually agreed by the banks and the local government. This was portrayed as a "market conforming" type of price-determination. This is not convincing. In the first place, the national regulations specified benchmarks for the range of acceptable interest rates: the new debt was to be priced with interest rates between central government bonds and China Development Bank bonds, that is, at interest rates consistent with low risk levels. Moreover, the banks had virtually no alternative. Their loans were coming due anyway, and they could hardly refuse to participate in this centrally mandated process and still get their money back. This was the only game in town if they wished to keep their balance sheets looking healthy. Even so, the government threw in some important sweeteners to keep the banks on board. It was made clear that government deposits (quite a substantial sum) would go to banks that participated in the program, and only to those banks. Crucially, the PBC declared that the new bonds would be accepted as collateral in any future re-lending or repo operations. The banks quickly signed on.

It can be seen that the character of Debt Swap 2.0 is dramatically different from that of Debt Swap 1.0, primarily in that it has a much bigger bailout component. Local governments receive much lower interest rates and guaranteed restructuring—that is, much longer repayment periods—for all of the debt they issue within their allocated quota. Moreover, they are simply off the hook: they don't have to worry about packaging and disclosing their debts and making them attractive to the market. Banks, on the other hand, clearly paid a cost. They had to surrender high-interest short-term debt for an illiquid low-interest asset. To be sure, there are some upsides for the banks: the new local government debt has only a 25 percent weighting in risk-adjusted asset classifications, so the banks can hold less capital and still satisfy capital requirements. Moreover, the central government is now providing an implicit guarantee for the debt, and also hinting that the banks might benefit from a more expansionary monetary policy. If the central bank did decide to expand its rediscounting program (providing credit on the collateral of certain approved securities), the banks could be confident that their holdings of local government debt would qualify them for access to funds. Corresponding to its bigger bailout component, this program of debt swap is clearly more expansionary than version 1.0, since it frees local governments to begin spending again.

Easy from Now On

Under these new conditions, the debt swap proceeded quickly. First, Jiangsu moved to float its bonds again. The original offer of 64.8 billion was scaled back slightly to 52.2 billion, and on May 18, the results were announced. The offer was over-subscribed 1.6 times, with five-year bonds prices at 3.12 percent interest.[14] While this was not technically the kind of fixed placement that the overall policy called for, it is clear that the result completely reflects the reality created by the new policy. Bonds that had found no interest three weeks before were suddenly in demand at a much less attractive interest rate. The game had changed.

The new policy and the Jiangsu experience quickly opened the floodgates. Local governments rushed to organize their underwriting committees and place their bonds. Weekly local government debt issuance climbed steadily: 58 billion then 76 billion in the last two weeks of May, then 149 billion; 209 billion; and 229 billion registered in the first three weeks of June.[15] By one calculation, through June 17, a total of 977 billion in debt swap, and 159 billion in new local government debt had been issued already, making a total of 1.13 trillion.[16] On June 10, the Ministry of Finance allocated an additional 1 trillion debt swap quota to the local governments; market expectations remained high that a third trillion RMB quota would be allocated later in the year.[17] Local government debt is being converted to bonds, which are now sitting on the bank balance sheets.

Assessment

We should not judge the new policy too harshly. It achieved its most urgent objective, which is to say that it got done. Local governments, in danger of paralysis due to large debts coming due, were given a pathway to restructure and resume normal activity. Local government financing costs were cut significantly. In a situation where economic momentum was slowing dramatically, that was the right choice to make. The key objective right now for macroeconomic policy-makers is to allow China's economy to slow down toward its sustainable trend rate of growth, without allowing that slowdown to turn into a rout or panic. The abandonment of Debt Swap 1.0 and adoption of Debt Swap 2.0 is a reasonable choice from that standpoint.

However, this should not be confused with a successful reform policy. On the contrary, the debt swap failed to achieve its most essential objectives as market-oriented reform. The basic prerequisite for such a policy is that it imposes some costs on reckless borrowers and makes clear that they will not be allowed to repeat the mistake. Debt swap 2.0 did not achieve those basic objectives. Indeed, in some respects, it made the situation worse, since now the central government has intervened and told both the banks and the local governments what they need to do.

These bonds clearly have the implicit backing of the central government; after all, unlike the LGFV bonds that they replace, this is debt issued by the local governments themselves, for which they have full responsibility. China is not a federal system: local government are subdivisions of the central government. Moreover, the whole process of issuing the bonds had been set up by the central government, and structured from the top down. Therefore, one had to assume the central government backed the process fully: as a result, Moody's (for instance) rated the bonds AAA, the highest investment grade. Moreover, they explained that the rating was explicitly because of the central government backing, rather than the fiscal soundness of the individual provinces.[18] In this sense, the policy represents a movement away from market reform, which requires that less well-managed localities would have to pay a higher market price for debt, because of a risk of forfeiture. Stronger guarantees send the wrong message on soft budget constraints and credibility of policy going forward. Finally, we should not forget that this is an important piece of the puzzle for both economic and political reasons. Without democracy at the local government level, China is relying on market forces to discipline local government borrowing. Debt swap 2.0 loosened the fundamental constraint on local government borrowing (at least compared to Debt Swap 1.0) and therefore sent a message to local governments that their activities are still not subject to significant restraint or oversight.[19]

Of course, fiscal restructuring is not over. This has just been one round of a repeated game, and the Ministry of Finance will be back to try again. Still, this is a cautionary tale about what can go wrong with authoritarian reforms. There was a failure of policy design: the initial conception, while bold, was too complicated and ambitious. It relied on several steps of implementation, in each of which the top levels were instructing lower levels how to proceed and naively expecting them to comply. Closely related, there was a political failure, in the sense that policy-makers did not adequately anticipate passive opposition and foot-dragging, or cope with them effectively, even though these are potent weapons of political struggle in any bureaucratic system. Finally, the policy was overwhelmed by external economic events: a slowing economy ultimately trumped other considerations about what kinds of market reform policies were desirable. Even for an authoritarian leader and his highly qualified lieutenants, market reforms are not easy.

Notes

[1] General obligation bonds are not backed by any specific asset or collateral, but rather by the local governments' promise to repay from general revenues; enterprise and project bonds are to be repaid from a specific revenue stream, and there is generally some form of collateral associated with the bond.

[2] None of the provincial debt figures have been disclosed, except for that of Hainan, which grew "only" 22 percent from mid-2013. The Ministry of Finance is thus sending this out as a benchmark for what they think an appropriate growth rate of debt might be.

[3] Specific source that asserts this.

[4]Li Xiaoyu 李晓喻. "Ministry of Finance: The Total of Local Government Self-Reported Debt is 16 trillion RMB" (财政部：中国地方政府自行上报债务总额16万亿元), *China News Net Weibo* (*中国新闻网 微博*), April 25, 2015, accessed at http://finance.sina.com.cn/china/dfjj/20150425/185322044899.shtml; Du Tao 杜涛, "A trillion RMB of local debt will be exchanged; the Ministry of Finance's 'combination punch' to control debt," (万亿地方债务置换 财政部控债"组合拳). *Economic Observer* (经济观察报), March 14, 2015, accessed at http://www.eeo.com.cn/2015/0314/273639.shtml.

[5] Chen Ying 陈颖, "Ma Weihua says local government debt is not transparent, and we banks are quite concerned," (《马蔚华：地方债不透明 银行很捉急》南方都市报), March 4, 2015, accessed at http://epaper.oeeee.com/epaper/A/html/2015-03/04/content_3391792.htm?div=-1.

[6] Du Tao, "A trillion RMB of local government debt."

[7]Total number. Ministry of Finance, "Temporary Methods for Managing General Local Government Bonds" (地方政府一般债券发行管理暂行办法), March 12, 2015 财库 (2015) 64号, accessed at http://gks.mof.gov.cn/redianzhuanti/guozaiguanli/difangzheng fuzhaiquan/201503/t20150316_1202773.html; and Ministry of Finance, "Budgetary Management Methods for 2015 Local Government Specialized Bonds" (2015年地方政府专项债券预算管理办法), March 18, 2015. 财预 (2015) 32号, accessed at http://yss.mof.gov.cn/zhengwuxinxi/zhengceguizhang/201503/t20150324_1206376.html.

[8] Ma Yuanyue and Yue Pinyu 马元月 岳品瑜, "The first batch of debt swaps go off at better than expected interest rate; the whole bond market is invigorated" (地方债置换首单利率好于预期 提振整个债券市场), *China Daily* (中国日报), May 19, 2015, accessed at http://www.chinadaily.com.cn/hqcj/xfly/2015-05-19/content_13715774.html.

[9] There are 3.4 trillion in circulating "urban construction," so-called *chengtou* (城投), bonds. These are the most important subset of LGFV fixed-income securities. Their average interest rate in April 2015 was 5.63 percent.

[10] 政治局会议：高度重视应对经济下行压力 加大定向调控力度，http://economy.caijing.com.cn/20150430/3873225.shtml.

[11] For an especially extravagant commentary, see Minsheng Macroeconomics, "Minsheng Macro Interprets the Politburo Meeting: The policy focus shifts back to economic construction; everything springs to life," 民生宏观解读政治局会议：政策重心重回经济建设 万物生长, Eastern Wealthnet (东方财富网), April 30, 2015, accessed at http://economy.caijing.com.cn/20150430/3873292.shtml.

[12] Wall Street Seen and Heard (华尔街见闻). "The outline harmonized development plan for Beijing-Tianjin-Hebei was approved; Ministry of Finance says future investment of 42 trillion over six year," (京津冀协同发展规划纲要获批 财政部未来6年投42万亿), April 30, 2015, accessed at http://economy.caijing.com.cn/20150430/3873154.shtml.

[13] There is already a large literature on this policy. The account here draws mainly from the following sources. Ministry of Finance Information Office, "The Ministry of Finance, PBC and CBRC Jointly Issue a Regulation Specifying the Fixed Placement with Lead Underwriters Method for Local Government Debt" (财政部 中国人民银行 银监会联合印发通知明确2015年采用定向承销方式发行地方政府债券有关事宜), May 15, 2015, accessed at http://www.mof.gov.cn/zhengwuxinxi/caizhengxinwen/201505/t20150515_1232661.html; Du Tao 杜涛, "Three Ministries/Commissions Push for Fixed Placement; the Document doesn't mention accompanying increases to liquidity by the Central Bank" (三部委强推定向承销 文件未提及央行流动性配合), *Economic Observer* (经济观察报), May 17, 2015, accessed at http://finance.sina.com.cn/china/20150517/002822196942.shtml; Xu Gao 徐高, "Four perspectives for understanding the fixed placement of local government debt" (理解地方债定向发行的四个角度首席经济学家论坛 | 作者:徐高 |), May 14, 2015, accessed at http://www.21ccom.net/plus/wapview.php?aid=124694.

[14] "The first batch of local debt is 1.6 times oversubscribed, and demand is relatively good," (年内首单地方债获超1.6倍认购 需求结果较好), May 18, 2015, accessed at http://money.163.com/15/0519/01/APUKJ96300253B0H.html.

[15] "Local government debt issuance accelerates; hidden worries about long end yields" (地方债发行加速 长端收益率隐忧), CITIC Securities (中信建投), June 17, 2015, accessed at http://sc.stock.cnfol.com/gppdgdzx/20150617/20958608.shtml.

[16] Zhou Xiaoxiao 周潇枭, "The first allocation of 1 trillion local debt swap is nearing completion; locals are eagerly looking forward to a third quota allocation" (首批1万亿地方债置换收尾 地方热盼第三批下发), *Twenty-first Century Business Herald* (21世纪经济报道), June 18, 2015, accessed at http://business.sohu.com/20150618/n415224432.shtml.

[17] Ironically, as late as May 22, Liu Shangxi 刘尚希, the head of the Fiscal Science Research Institute of the Ministry of Finance, declared that this type of debt swap was just one means of addressing the debt problem, and that the Ministry would wait and see whether it was necessary to issue another debt swap quota. Less than three weeks later, a new trillion RMB swap quota was authorized. Shang Jing 商灏, "Liu Shangxi says Debt Swaps will revitalize the stock of debt and stimulate the initiative of localities" (刘尚希：置换债激活存量激发地方积极性), *China Times* (华夏时报), May 22, 2015, accessed at http://bond.hexun.com/2015-05-22/176076255.html.

[18] "Moody's: Why is all the local debt rated AAA?" (穆迪：地方债评级为什么都是AAA? Citing Moody's vice-general manager Zhu Shuning 诸蜀宁), *China Business News* (一财网), June 12, 2015, accessed at http://bond.cnfol.com/zhaiquanzixun/20150612/20926553.shtml.

[19] Liu Shangxi, of the Ministry of Finance, would not agree with this assessment, but his analysis is in many ways congruent with it. Of course, he is more optimistic. Shang Jing 商灏, "Liu Shangxi says Debt Swaps will revitalize the stock of debt and stimulate the initiative of localities" (刘尚希：置换债激活存量激发地方积极性), *China Times* (华夏时报), May 22, 2015, accessed at http://bond.hexun.com/2015-05-22/176076255.html.