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China's Hidden Domestic Public Debt: Some Perspective on the Risks It Poses

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China's local government liabilities—now the subject of hot debate—have been a big unknown for some time, and the country's banking system probably has more risk than generally thought. There are offsetting factors, however, which in our view help to minimize the systemic risk of bad debts.

The risk posed by China's hidden domestic public debt has quickly become a hotly debated topic in financial markets, sparked by Professor Victor Shih of Northwestern University in Illinois, US. Shih conducted on-the-ground research in China to dig out the off-balance sheet liabilities of local governments, and the contingent liability to central government of public entities such as development banks and the Ministry of Railways.

His estimate of the size of China's domestic government debt is shockingly negative. While total debt outstanding in 2009 is generally perceived to have been around 25% of GDP, Shih's estimate for 2011 is four times bigger at 96%. His bottom line is that, in the worst-case scenario, China may face a large-scale debt crisis two years from now.

Missing Items

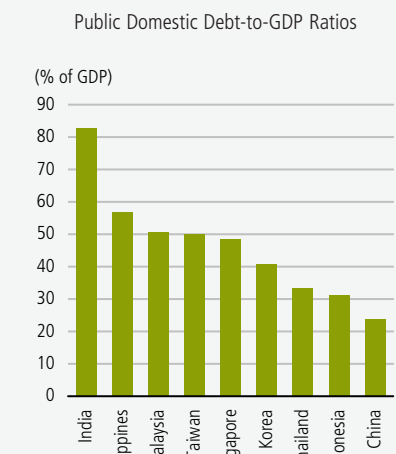
Shih forecasts total public debt to reach RMB39.8 trillion (US\$5.8 trillion) in 2011 and implies that between US\$4 trillion and US\$4.5 trillion are missing from the official

debt figure. Admittedly, local government liabilities—which are not included in official public debt statistics—have been a big unknown in China; also, the size of the contingent liability to central government is not fully disclosed, although most assessments of China's sovereign credit-worthiness cite the item as a risk factor. While we are not at this moment in a position to follow Shih's footsteps and dig in the same corners to compare notes, we can nevertheless highlight a number of important points to provide some perspective on the issue.

Wake-Up Call or False Alarm?

First, Shih estimates that total outstanding local government debt stood at RMB11.4 trillion at end-2009 (US\$1.7 trillion, 34% of GDP)—double the amount recently acknowledged by Ministry of Finance officials. Shih's study, however, also adds to the total liability figure credit lines agreed between local governments and banks, estimated at another RMB12.8 trillion (US\$1.9 trillion, 38% of GDP). We note that undrawn credits are not yet liabilities

Display
How China Compares: The Market View



Source: CEIC Data, Fitch and AllianceBernstein estimates

and that Shih's assumption that they will be fully drawn in future greatly inflates China's current debt problem.

If we exclude future credits, China's public debt should be about 59% of GDP (that is, 96% minus 38%). This, of course, still points to China's banking system having much more risk than generally thought. This brings us to our second point, which is that China's public debt-to-GDP ratio does not look too extreme when compared with the ratios of Asia's other A-rated sovereigns such as Korea, Taiwan and Malaysia (**Display**) which are all in the

40%–50% of GDP range. Even at 59%, China fares better than BBB-rated India, where domestic public debt-to-GDP is likely to reach 83% this year.

Third, China's strong economic growth, high domestic savings, fiscal strength and huge government assets (such as foreign exchange reserves) will help minimize the

macroeconomic disruption of the debt problem, in our view. Importantly, strong GDP growth will not only be a boost to the debt-ratio denominator: economic reforms that lead to structural change and secular sectoral growth will also help minimize the systemic risk of existing bad debts. Chinese banks are well capitalized and, we believe, capable of carrying forward the impact of

nonperforming loans for several years, by which time enough economic growth from structural change should have occurred to help cover losses. This has been the case in China in the past (and we would argue that the absence of similar circumstances in Japan in the 1980s was a contributor to that country's prolonged debt crisis at the time). ■

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