China’s infrastructure plan likely to raise government’s contingent liabilities

by Edoardo Campanella, Economist (UniCredit Bank, Milan)

- At its December meeting, China’s Central Economic Work Conference promised to boost infrastructure spending to counter the growth slowdown.
- While China’s infrastructure investment is high for its level of development, there is room to undertake new projects and upgrade existing physical assets.
- Any such plan poses two challenges. First, the Chinese government will likely rely on SOEs to deliver it, with a risk of misallocating resources and undertaking projects with a low marginal return.
- Second, despite a financial innovation like special purpose bonds (which do not imply a government guarantee) to fund these projects, Beijing risks to see a rise in its contingent liabilities.
- As a matter of fact, the market for this kind of bonds is still underdeveloped. This raises the odds that either Chinese banks, which are de facto controlled by Beijing, are pushed to buy them, or that provinces resort to off-budget financing tools, which are implicitly backed by the state.
- In both cases, China’s augmented public debt risks being lifted towards 80% of GDP.

China’s economy continues to cool. In 2018, annual GDP growth decelerated to 6.6% – the slowest pace since 1990. Furthermore, the latest string of indicators this year, from the manufacturing PMI and industrial profits to trade figures, has surprised to the downside, confirming the loss of momentum. The structural growth slowdown, which is the result of an ageing population, a shrinking workforce and the middle-income trap, is probably arriving faster than the party leadership expected. And the trade skirmish with Washington is simply reinforcing these dynamics.

Beijing is now trying to arrest the slowdown by resorting to its traditional engine of growth, investment. In late November the State Council asked local governments and authorities to invest in the construction of roads and waterways, while expanding its railway freight capacity in order to ease traffic congestion and pollution. More than USD 120bn of rail projects across the country, the equivalent of 1% of GDP, were approved in December only, which would add 6,800km of track in 2019. Moreover, in December the Central Economic Work Conference, which maps out financial and economic goals for the coming year, promised “rather large” (but unspecified) increases in bond sales to fund infrastructure projects (like subways, roads and railways), along with tax reductions.

Markets initially interpreted the vague wording as a signal that Beijing was unlikely to adopt a massive stimulus to deliver a strong rebound in growth and it would rather opt for small incremental steps to arrest the slowdown, using tax cuts as the first line of defense. However, the growing signs of weakness might force Beijing to adopt a more ambitious strategy than in 2018 – probably similar to the stimulus adopted in 2009, when the focus was primarily on high-speed railways. While it is possible to make an economic case for a further expansion of China’s infrastructure stock, any such plan poses two challenges. First, China will likely rely on SOEs to deliver it, with a risk of further misallocating resources and undertaking projects with a low return. Second, despite a financial innovation like special purpose bonds, Beijing risks to see a significant rise in its contingent liabilities, and so in its augmented public debt.

A change of policy course from 2018

In early 2018, Beijing largely reduced its support to the economy, letting growth in fixed-asset investment (FAI) drop to roughly 5% (the lowest level since the current version of the FAI started to be recorded), with state investment remaining stagnant for several months (Chart 1). After his reelection as leader of the country, Mr. Xi wanted to reduce the credit stimulus in order to address the financial risks stemming from rising corporate debt, particularly SOEs’. Almost all of the slowdown in FAI came from weakness in infrastructure spending, which intensified last spring, when it was imposed a crackdown on local government borrowing.

CHART 1: FALLING INVESTMENT IN INFRASTRUCTURE
THE MAIN DRIVER OF THE SLOWDOWN

<table>
<thead>
<tr>
<th>FAI (yoy, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure</td>
</tr>
<tr>
<td>Feb-11</td>
</tr>
<tr>
<td>50</td>
</tr>
</tbody>
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Source: CBS, UniCredit Research

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1. Reuters, “China spends $328 billion on transport infrastructure from January to September: ministry”, 26 Oct 2018

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However, the deterioration in the global outlook in 2H18, which was largely driven by the trade war with the US, forced China to change policy course. With exports slowing down amid Washington’s import tariffs, Beijing reactivated the investment growth engine. In July, the Communist party’s politburo – its top policymaking body – called for a boost to infrastructure spending and at its October meeting it omitted any mention of “deleveraging”. At the end of 2018, as shown by the leg up in chart 1, there were already tentative signs of a bottoming out in the growth of infrastructure investment.

The economic case for more infrastructure spending

With overinvestment being one of China’s major macroeconomic challenges, an investment stimulus, even if centered around new infrastructure and not new factories or real estate assets, does not sound as the wisest policy path (chart 2). At 45% China’s investment-to-GDP ratio is almost twice as high as in the main advanced and emerging economies.

CHART 2. AN OVERINVESTMENT PROBLEM

In just ten years, the investment ratio has surged from about 30% to 45% of GDP, which is significantly higher even compared to the experience of Japan and Korea – two economies that followed similar investment-led, export-oriented growth models (Chart 3). What is interesting is that, while until a decade ago the ratio was in line with that recorded by Korea and Japan during their high-development phases, its pace of growth in China in recent years has outstripped that of the other two countries.

CHART 3: A GROWTH MODEL GONE TOO FAR

Signs of overinvestment can be seen from a credit perspective. The investment elasticity to money – i.e. the way investment reacts to an expansion in the M2 monetary base – has been declining for quite some time and it has now reached historical lows (below 1 from a peak of 2.5 in 2005). Therefore, even if monetary conditions continue to improve, the pass-through to investment might be limited. Equally, the incremental capital-output ratio, which is a useful estimate of the productivity of capital, more than doubled between 2008 and 2017 – meaning that less and less productive capital has been added to the stock in recent years (chart 4).

CHART 4: FALLING INVESTMENT EFFICIENCY

However, high investment ratios do not necessarily imply lack of scope for more spending on infrastructure. By international standards, China is certainly investing much more in infrastructure than most of its peers, both developing and advanced economies.

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2 The incremental capital output ratio (ICOR) explains the relationship between the level of investment made in the economy and the consequent increase in GDP. ICOR indicates the additional unit of capital or investment needed to produce an additional unit of output. See IMF Working Papers, “Rebalancing in China—Progress and Prospects”
The IMF estimates that the Chinese public capital stock (Chart 5), comprising economic and social infrastructure, was 13.4% of GDP in 2015, compared with an average of just 3.2% in the other BRICS countries. However, in per capita terms, it stood at just under USD 20,000, similar to the level recorded in advanced economies (China’s true benchmarks in the coming years) such as the UK and Germany, but far below countries like the US or Japan.

CHART 5: STILL SOME ROOM FOR EXPANSION

Therefore, despite China’s infrastructure investment being very high relative to the country’s level of development (as implied by the size of its GDP), in the future there will still be need for more infrastructure and for the upgrade of existing physical assets to match those of its direct rivals in the global arena (as implied by the size of a country’s population). China is still urbanizing and more infrastructure will be necessary to absorb migrants from the countryside. Moreover, most international sources recognize that the country’s infrastructure development remains sub-par. China ranked 47th overall in the World Economic Forum’s 2017 Quality of Infrastructure Ranking, scoring poorly in all subsectors other than railways.

There are two elements of concern, though. First, most projects will likely be taken on by state-owned-enterprises as they are considered by the government as the most reliable agents to deliver this sort of stimulus. But SOEs tend to misallocate resources and might risk ending up undertaking projects with a low return. A number of studies have shown that SOEs, which have substantially contributed to the rise in China’s corporate debt, tend to crowd out private investment, contribute to lower productivity growth, and hinder competition.\(^3\) As a result the cost of opting for these companies will be implicitly borne by small and medium-sized enterprises, which are more dynamic and have better growth prospects than those under state control.

For instance, in 2015 industrial SOEs generated a return on assets of 2.9% compared with 10.3% for private industrial enterprises. The second issue has to do with a likely rise in contingent liabilities for the central government to fund these projects, despite many attempts to avoid it.\(^4\)

Rising contingent liabilities

When in the summer 2018 Beijing decided to reactivate the investment engine, it instructed local governments to accelerate the issuance of special-purpose bonds with proceeds earmarked for specific infrastructure projects and that could not be used for general expenditure (Chart 6). Special purpose bonds differ from traditional local government bonds in that they are repaid by returns on projects instead of by the government. The issuance of special-purpose bonds peaked in October and then declined sharply in November.

As discussed, China’s goal was probably to attenuate the negative spillovers from the underlying GDP slowdown without delivering a strong growth rebound.

CHART 6: FUNDING NEW INFRASTRUCTURE

In particular, Beijing wanted special-purpose bonds to reduce the reliance on off-budget borrowing through local government financing vehicles (LGFVs), whose debt servicing responsibilities are shared by the central government, either directly or indirectly. Most local governments have to resort to LGFVs because they face structural revenue shortfalls relative to their spending needs for two reasons. The intergovernmental transfer system relies on revenue-sharing and tax rebate transfers, which put pressure on provinces with low tax capacity. And repayment abilities of many local governments are weakened by slower fiscal revenue growth and smaller land sales incomes amid an economic slowdown.

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\(^4\) In general, China is the most decentralized country in the world in terms of expenditure shares, with subnational governments responsible for 85 percent of government spending.
In the recent past, LGFVs have contributed to increasing China’s contingent liabilities. The IMF, in its latest Article IV Consultation, highlighted that while the official public debt figure in China in 2018 was around 40% of GDP, the augmented debt (which takes into account LGFVs) was about 75% (Chart 7). And infrastructure spending accounts for roughly two-thirds of the gap between the two measures of public debt.

CHART 7: RISING DEBT TRAJECTORY, ALTHOUGH STILL MANAGEABLE

![Rising Debt Trajectory Chart]

Source: IMF, UniCredit Research

The truth is that the market for local government bonds is still underdeveloped as a result of low liquidity, weak credit discipline and structural fiscal deficits of provinces. Special purpose bonds, in particular, create even greater challenges. Local infrastructure projects, some of which are potentially loss-making, often take years to generate investment returns, raising the risk of default as it is poorly collateralised and project cash flow estimates are often overstated. Not surprisingly, as shown by Chart 8, in 2018 special-purpose bonds covered less than 15% of the funding needs of local governments to pay for physical infrastructure. If the past is of any guide, local governments might end up paying for new roads and railways by resorting to LGFVs. If so, Beijing will be forced to reluctantly take on these liabilities.

Therefore, Beijing might be forced to intervene and guarantee this debt to avoid serial defaults. Or, as it did last summer, it will pass on the burden to commercial banks (which are de facto controlled by the government). After Beijing’s instructions to local governments last July to accelerate issuance, regulators followed up with policy tweaks designed to support such sales. These included eliminating a 20% limit on the share of any local government bond sale that bank underwriters could purchase for their own balance sheets. Also, and according to media reports that should be taken with a pinch of salt, since these bonds have low yields and are not very liquid, local governments have exerted political pressure to ensure robust demand from banks.

For now, markets remain unconcerned. Specifically, the yields on bonds issued by policy banks – the state-owned banks that help implement economic policies of the government – have been declining alongside government bond yields (chart 9). Moreover, the spread of such bonds have been tightening vis-à-vis the sovereign. This implies two takeaways. First, the policy banks are facing no pressing issue at present in securing funding, which, in turn, could be used to purchases the bonds issued by local governments. Second, the rally in sovereign bonds suggests that markets are focusing more on weaker growth and inflation, rather than any potential fiscal risks in the longer term.

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5 S&P Global, “China’s hidden subnational debt suggest more LGFV defaults are likely”, 15 October 2018
6 https://www.ft.com/content/8e3e2dae-ba58-11e8-94b2-17176bf93f15
Conclusion

Beijing seems torn between resorting to its old ways by boosting investment and changing policy course. The short-term benefits of the investment plan in terms of growth might not offset the long-term cost stemming from possible resource misallocation and growing financial risks. SOEs might end up undertaking projects with a low marginal return, while it seems premature to rely on a financial instrument like special purpose bonds whose market is still underdeveloped. The risk is to force local authorities to resort to LGFVs in order to meet the growth targets set by the central government or, if special purpose bonds are actually issued, commercial banks, which are de facto controlled by the government, might be forced to purchase them as it happened last summer. In both cases, China’s augmented public debt would trend higher.

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