Shell game

Beijing signals a crackdown on borrowing by local governments.

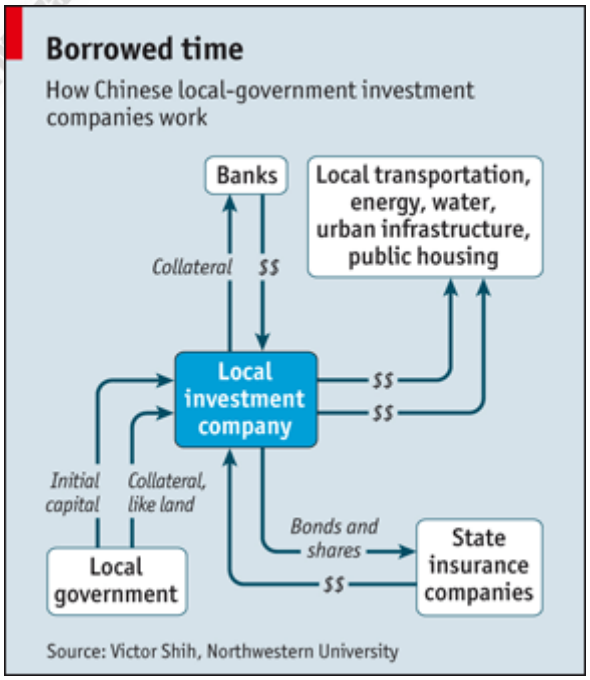
ENDLESS arcane pronouncements spew forth from China's bureaucracies. But some matter much more than others. In recent weeks a number of the country's senior leaders and regulators have signalled an end to the practice of local governments extending guarantees on loans taken out by their special financing entities. That could spell big trouble for Chinese banks.

The comments have focused attention on research done by Victor Shih, a professor of Northwestern University in America, into China's local investment companies. These financing vehicles allow municipalities to circumvent central-government restrictions on direct borrowing. As many as 8,000 of these investment companies may exist, estimates Mr Shih, whose work draws on regulatory filings and various government announcements.

More alarmingly, he reckons that these entities have outstanding debt of 11.4 trillion yuan ($1.7 trillion), and commitments for a further 12.7 trillion yuan, much of it tied to infrastructure projects designed to stimulate the economy. For comparison, China's heavily publicised national stimulus plan was worth 4 trillion yuan, 1 trillion yuan of which came from the central government. If Mr Shih's estimates are even close to accurate, the scope of China's spending spree is far larger than thought.

So are the potential consequences. Because loans were issued with guarantees during a period when the national policy was to encourage lending, credit scrutiny by the banks would have been minimal. Mr Shih reckons a quarter of the borrowing already done by local investment companies will go bad. The loss of municipal guarantees would shift this credit exposure from governments to lenders. If land used to collateralise much of their borrowing falls in value or is laid claim to by several lenders, that would probably prompt at least some financial entities to fail.

To some extent, this shuffling of debt is a bit of an accounting shell game, says Michael Kurtz, head of China research for Macquarie Securities, an investment bank. Regardless of whether the loans are the responsibility of local entities or banks, they are ultimately—in a state-run system—obligations of the central government.



But in other ways a shift would have real meaning. It could provide a better sense of just how precarious China's finances may be. It also raises the prospect that Chinese banks, which statistically appear quite strong, may need even more capital than many had anticipated.

And even if the bears are wrong, an end to guarantees would mark a transfer in authority for who can raise and allocate credit from local to national authorities. In recent years Beijing has turned a blind eye as municipal governments created structures to avoid laws limiting their financial flexibility. A decision has apparently been made that such freedom has gone too far.

Precisely how the municipally sponsored financing entities work is only dimly understood, despite Mr Shih's efforts (see chart). Some of their ongoing funding is apparently tied to land sales: moving away from local approvals could pre-empt corrupt deals between local officials and developers and contractors. Reining in municipalities' investment companies might therefore win some local applause. But the clean-up could be very ugly.

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