China Leadership Monitor

China's Balance Sheet Challenge

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After a decade of rapid credit growth, China is now much more indebted than countries at similar levels of economic development. The slowdown in the economy over the past year has increased pressure on overleveraged borrowers, posing risks for the financial system. China has three main options to address these problems: using the central government's balance sheet, readjusting the fiscal balance sheet, or selling state assets. If instead Beijing chooses to simply muddle through, it faces the risk of a Japanese-style lost decade. Policymakers should embrace the debt challenge as an impetus to reform China's fiscal system and adjust the role of government in the economy. These changes could once again set China on a path to more rapid growth. Doing so, however, would require a major shift in the Xi administration's ideological approach to the economy.

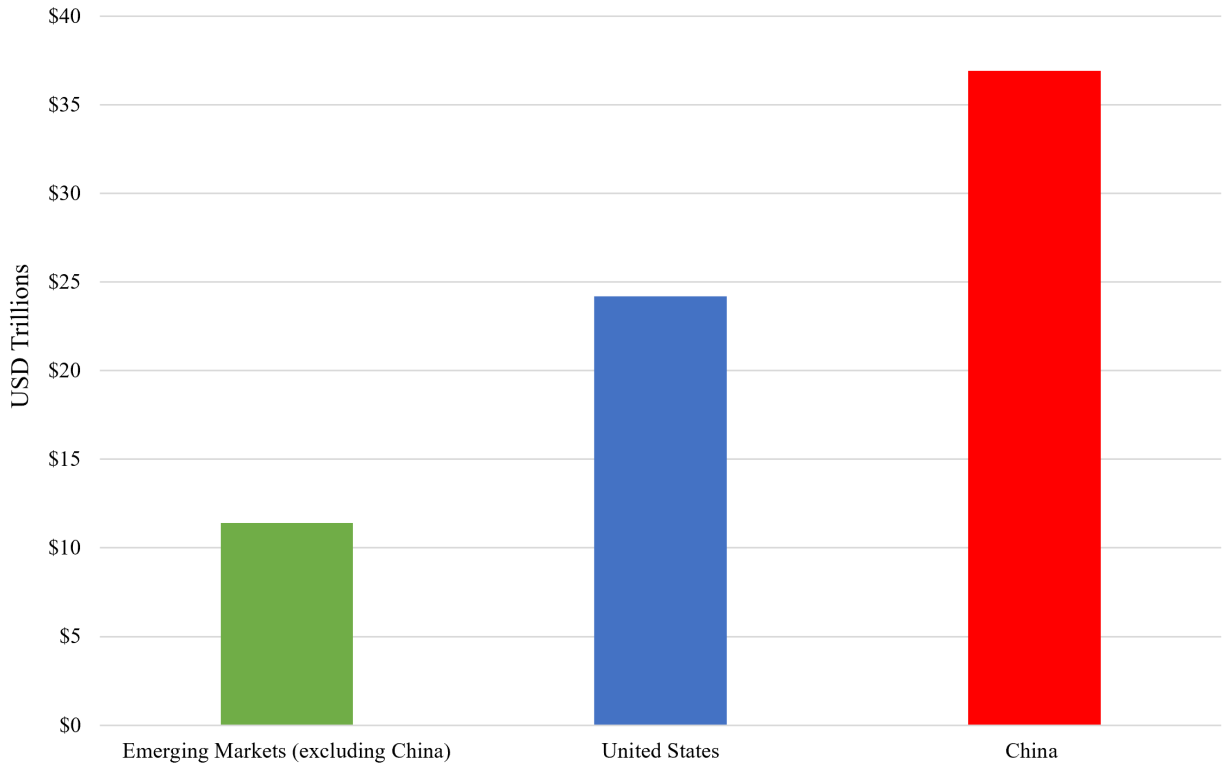
High debt levels and a slowing economy pose growing financial risks to China. After a decade of rapid credit growth, China is now much more indebted than countries at similar levels of economic development. The economic slowdown of the past year, exacerbated by several policy mistakes, has increased pressure on overleveraged borrowers. The most vulnerable borrowers are state-owned enterprises (SOEs), real estate developers, and local government financing vehicles (LGFVs), many of which are in financial distress or are already in bankruptcy.

To preserve financial stability, Beijing must expeditiously help these risky borrowers strengthen their balance sheets. The three main options available to the central government require difficult political and economic reforms. These reforms could reduce the central government's control over local governments and critical parts of the economy. If the Chinese government does not act decisively, however, it faces the risk of an extended period of slow economic growth.

China's debt increased by an astounding $37 trillion between 2012 and 2022 (Figure 1). As of June 30, 2022, it reached around $52 trillion, 75 percent greater than the outstanding stock of

debt in all other emerging markets combined.[1] (For comparison, the total assets of all commercial banks in the United States was around $23 trillion at the end of 2022.)[2]

Figure 1: Increase in Debt between June 2012 and June 2022
Emerging Markets (excluding China), United States, and China



Source: Bank for International Settlements.[3]

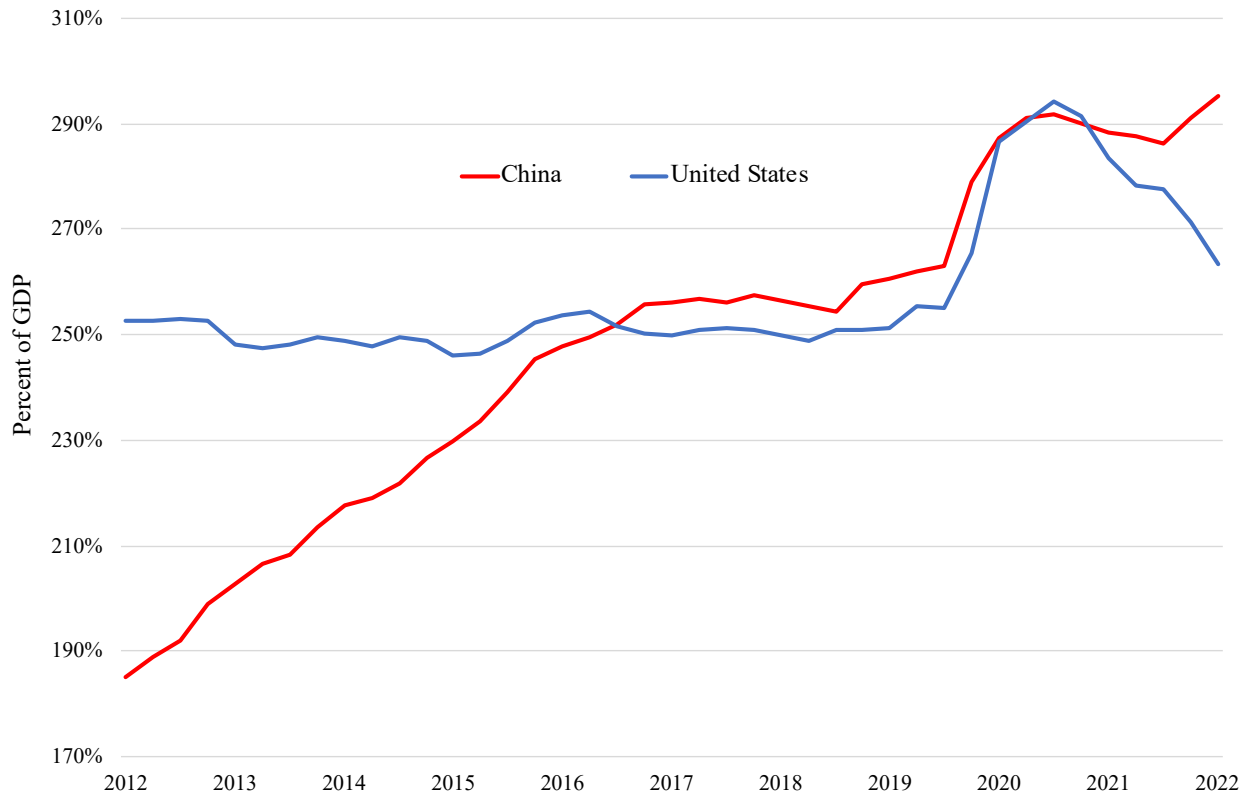
China's debt is massive in both absolute terms and relative to the size of its economy. Its debt levels are also high compared with those of other emerging markets, the United States, and the average for the G20 economies (Figure 2).

[1] "Credit to the Non-Financial Sector," Bank for International Settlements, December 5, 2022, accessed January 8, 2023, https://www.bis.org/statistics/totcredit.htm The emerging markets included in this dataset are Argentina, Brazil, Chile, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, South Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand, and Turkey.

[2] "Assets and Liabilities of Commercial Banks in the United States," Board of Governors of the Federal Reserve System, January 6, 2023, accessed January 8, 2023, https://www.federalreserve.gov/releases/h8/current/

[3] "Credit to the Non-Financial Sector," Bank for International Settlements, December 5, 2022, accessed January 8, 2023, https://www.bis.org/statistics/totcredit.htm

Figure 2: Total Debt-to-GDP Ratio in China and the United States
June 2012 – June 2022



Source: Bank for International Settlements.[4]

The growth in debt during this period was concentrated among specific borrowers, with three-quarters of the $36 trillion increase coming from corporate and governmental borrowers. Although household debt grew as well, household savings remained extraordinarily high, serving as a buffer against financial risks.[5]

Where Are China's Weakest Balance Sheets?

SOEs, real estate developers, and local governments and their associated financing vehicles accounted for much of China's borrowing over the past decade. Each is susceptible to financial distress.

[4] Ibid.

[5] Nicholas Borst, "How Strong Is China's Household Balance Sheet?" Seafarer Capital Partners, March 2022, accessed January 31, 2023, https://www.seafarerfunds.com/prevailing-winds/chinas-household-balance-sheet/

1. *State-owned Enterprises*

SOEs have weak balance sheets because of high debt levels and low profitability. With more than $29 trillion in liabilities at the end of 2021, they are the largest corporate borrowers in China.[6]

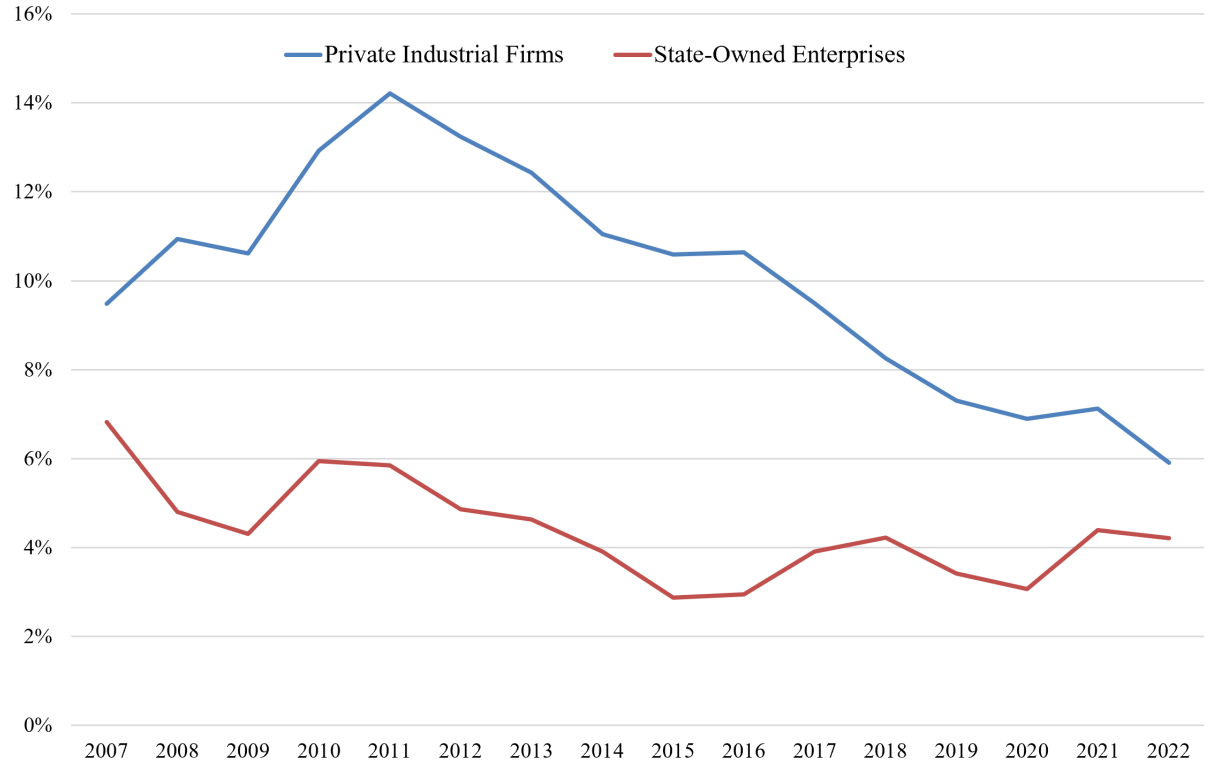
Most SOEs are significantly less efficient and profitable than private firms.[7] Data for the industrial sector, which are the most comprehensive available, show that over the past decade, more than one-third of SOEs were unprofitable at any given time.[8] The return on assets for SOEs in the industrial sector consistently lags that of their private counterparts (Figure 3).

[6] "Comprehensive Report of the State Council on the Management of State-owned Assets in FY 2021" (国务院关于 2021 年度国有资产管理情况的综合报告), State-Owned Assets Supervision and Administration Commission of the State Council (国务院国有资产监督管理委员会), November 16, 2022, accessed January 31, 2023, http://www.sasac.gov.cn/n2588025/n2588119/c26496596/content.html

[7] Emilia Jurzyk and Cian Ruane, "Resource Misallocation Among Listed Firms in China: The Evolving Role of State-Owned Enterprises," International Monetary Fund, March 12, 2021, accessed January 31, 2023, https://www.imf.org/en/Publications/WP/Issues/2021/03/12/Resource-Misallocation-Among-Listed-Firms-in-China-The-Evolving-Role-of-State-Owned-50167

[8] Data from CEIC (for both SOEs and state holding enterprises), accessed January 8, 2023.

Figure 3: Return on Assets of State-owned Enterprises and Private Industrial Firms in China
2007 – 2022



Source: CEIC.[9]

Although they are poor credit risks, SOEs are able to continue borrowing massive amounts because of implicit guarantees and other forms of support from the government. Lending from regional financial institutions to SOEs in the same locality has been a significant driver of the increase in corporate debt. This type of lending is vulnerable to political influence from local government officials and a significant portion is directed toward low productivity SOEs.[10] A recent survey by S&P of more than 6,000 Chinese companies estimates that 90 percent of the SOEs in the sample were stuck in a debt trap, meaning they are forced to borrow more to repay existing debts.[11] Absent financial support from the government or forbearance by the banks, the amount of the non-performing loans of SOEs will increase significantly.

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[9] Data from CEIC (for both state-holding enterprises and private enterprises), accessed January 20, 2023.

[10] Nicholas Lardy, *The State Strikes Back: The End of Economic Reform in China?* (Washington, DC: Peterson Institute for International Economics, 2019).

[11] Terence Chan, Eunice Tan, and Christine Ip, "China's SOEs Are Stuck in a Debt Trap," S&P Global Ratings, September 20, 2022, accessed January 31, 2023, https://www.spglobal.com/_assets/documents/ratings/research/global-debt-leverage-1.pdf

2. *Real Estate Developers*

Real estate developers are highly leveraged and susceptible to liquidity pressures. Due to concerns about financial risks and housing speculation, regulators have sought to limit their borrowing from banks. Property developers thus borrow as much as possible from the shadow banking sector or from offshore bond markets, often at exorbitant rates, and they use the funds to acquire large land banks for future projects. They also pre-sell apartments in projects that are under development as another form of financing.

These methods of financing are vulnerable to liquidity disruptions, many of which have occurred over the past two years. In late 2020, the Chinese government implemented restrictive policies, including the Three Red Lines policy, to force property developers to deleverage.[12] As a result of the policy, many developers found their access to credit severely restricted. Both state-owned and private developers felt the effect, but it disproportionately affected private developers who lack the implicit guarantees from the government that state-owned developers enjoy. Adoption of these policies reduced the willingness of banks and other lenders to lend to private developers.

The scale of the problem is enormous. In early 2022, the International Monetary Fund (IMF) estimated that Chinese real estate developers had liabilities at risk of default worth more than 12 percent of GDP.[13] The situation for real estate developers deteriorated sharply throughout 2022, with many of the country's largest developers in bankruptcy. In late 2022, in an attempt to prevent widespread bankruptcies, the Chinese government established various bailout funds targeting the real estate sector and developers.

3. *Local Governments and Local Government Financing Vehicles*

Many local governments and their associated LGFVs have problematic balance sheets because of the severe imbalances in the Chinese fiscal system. Beginning with the budgetary reforms of 1994, local governments have faced chronic spending requirements that significantly outstrip their official revenues. Compounding the problem, local governments have largely been prohibited from borrowing directly. Local governments established various non-tax revenue streams and off-balance sheet borrowing channels to compensate for this shortfall. These alternative revenue and financing sources often far exceeded official tax revenues.[14]

One way that local governments circumvented borrowing restrictions was to establish shell companies (LGFVs), which can borrow off-balance sheet on behalf of local governments. With China's renminbi (RMB) 4 trillion ($580 million) economic stimulus during the 2008 global financial crisis, local governments used LGFVs to borrow massively. By 2013, long after the

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[12] The Three Red Lines was a series of balance sheet restrictions for property developers, specifying liabilities-to-assets, net debt-to-equity, and cash-to-short-term debt.

[13] "Global Financial Stability Report, April 2022," International Monetary Fund, April 19, 2022, accessed January 31, 2023, https://www.imf.org/en/Publications/GFSR/Issues/2022/04/19/global-financial-stability-report-april-2022

[14] Carl E. Walter, *The Red Dream: The Chinese Communist Party and the Financial Deterioration of* China (Hoboken, NJ: Wiley, 2022).

stimulus-linked lending was supposed to be over, a national audit estimated that local governments had accumulated RMB 17.9 trillion ($2.6 trillion) in debt via LGFVs and other channels.[15]

In 2015, the central government tried to end off-balance sheet borrowing by LGFVs. A large portion of the LGFV debt was officially recognized, and a swap program was established whereby LGFV debt could be exchanged for government bonds that were longer term and had lower interest rates.[16] The policy led to the creation of a new type of bond issued by local governments, subject to central government approval.

This fledgling local government bond market expanded rapidly in the following years. Widespread off-balance sheet borrowing by LGFVs continued to occur, however, despite repeated efforts by Beijing to crack down on this type of debt. Local governments and LGFVs issued nearly $5 trillion in debt in less than a decade, an amount larger than that of the US municipal bond market (Figure 4).[17]

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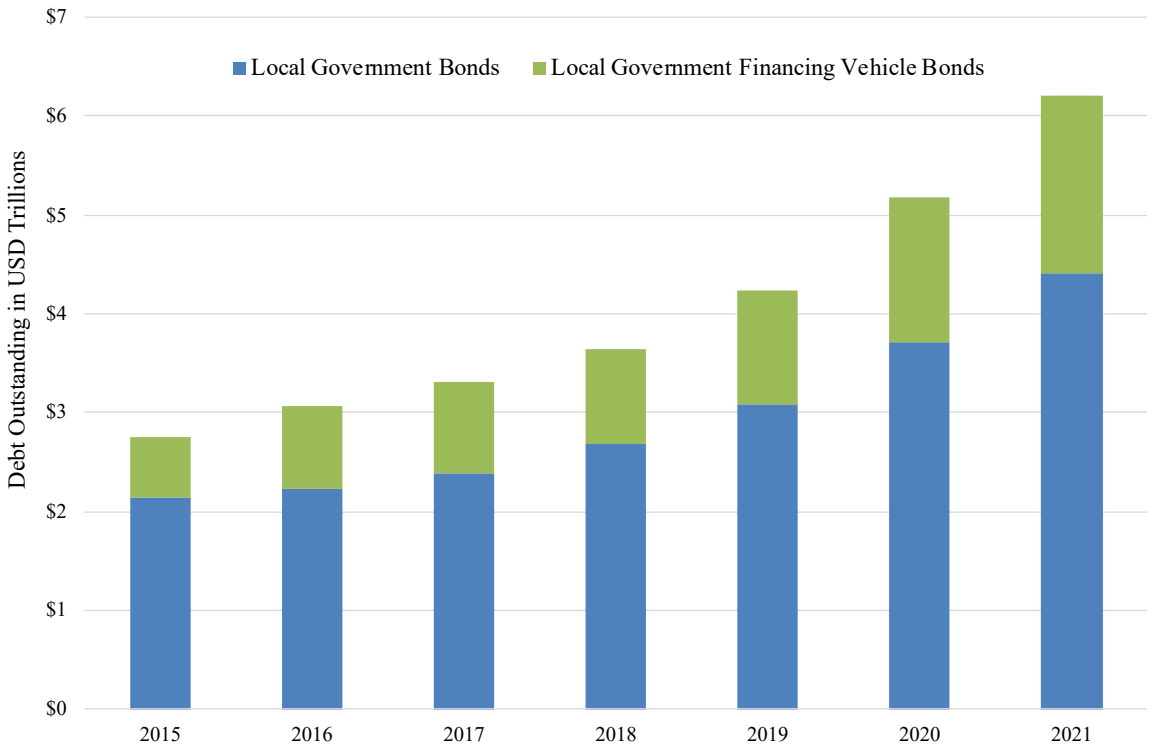
[15] "National Government Debt Audit Results" (全国政府性债务审计结果), National Audit Office of the People's Republic of China (中华人民共和国审计署), December 30, 2013, accessed January 31, 2023, https://www.audit.gov.cn/n5/n25/c63642/part/27403.pdf

[16] W. Raphael Lam and Jingsen Wang, "China's Local Government Bond Market," International Monetary Fund, September 28, 2018, accessed January 31, 2023, https://www.imf.org/en/Publications/WP/Issues/2018/09/28/China-s-Local-Government-Bond-Market-46275

[17] "U.S. Municipal Bond Statistics," Securities Industry and Financial Markets Association (SIFMA), December 5, 2022, accessed January 8, 2023, https://www.sifma.org/resources/research/us-municipal-bonds-statistics/

Figure 4: Local Government and LGFV Bonds Outstanding in China
2015 – 2021



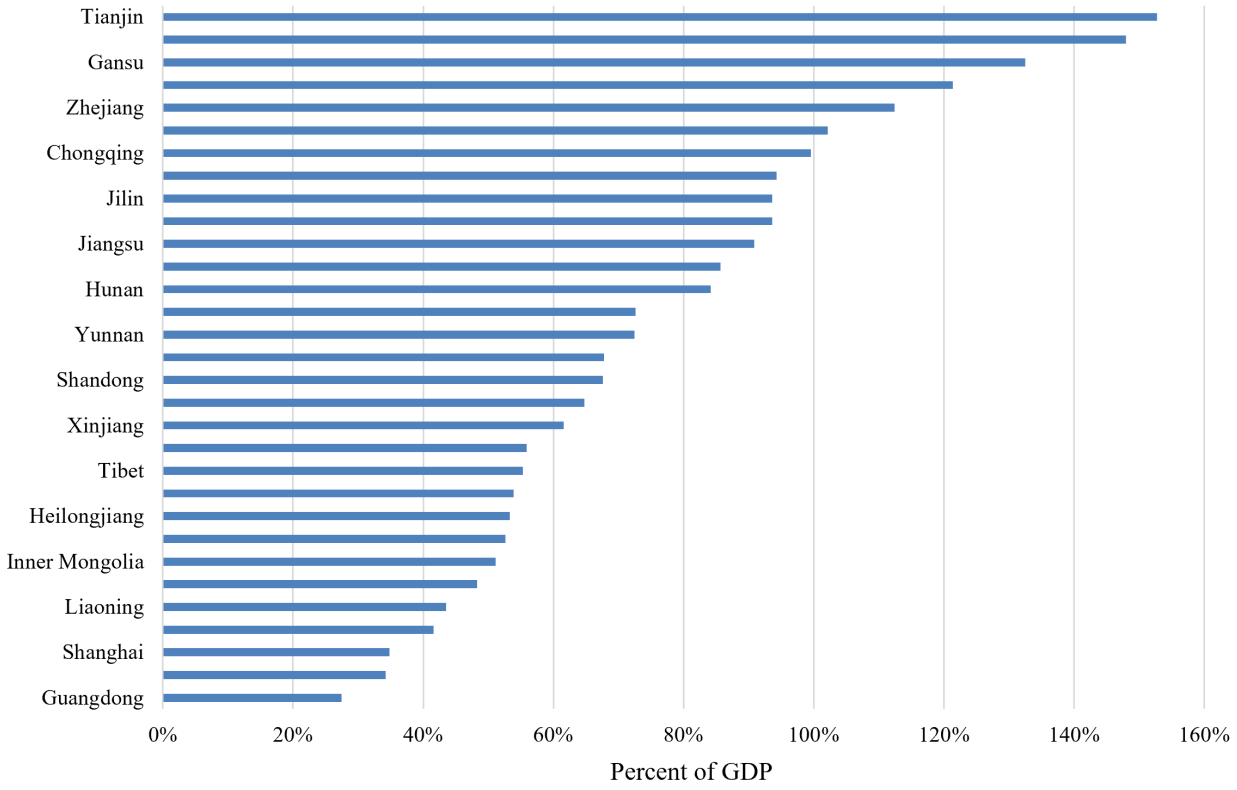
Sources: CEIC, Wind.
Note: Figure 4 does not include bank loans to LGFVs, which are not well reported.

LGFVs often invest in infrastructure that may provide social goods, such as less traffic and cleaner water, but such infrastructure does not necessarily generate sufficient revenues to service their debt. Recent analysis by the IMF highlights that LGFVs issue new debt to cover 80–90 percent of their spending because income from their operating activities is minimal.[18] LGFVs are therefore reliant on new borrowing, and the financial support from local governments that underpins that borrowing, to remain financially viable.

During the past year, fiscal situation of local governments has deteriorated due to increasing expenses and declining revenues. The high debt load of many localities jeopardizes their ability to continue to provide financial support to LGFVs (Figure 5).

[18] "People's Republic of China: Selected Issues," International Monetary Fund, February 4, 2022, accessed January 31, 2023, https://www.imf.org/en/Publications/CR/Issues/2022/01/26/Peoples-Republic-of-China-Selected-Issues-512253

Figure 5: Local Government Debt-to-GDP Ratio in China, selected regions
2021



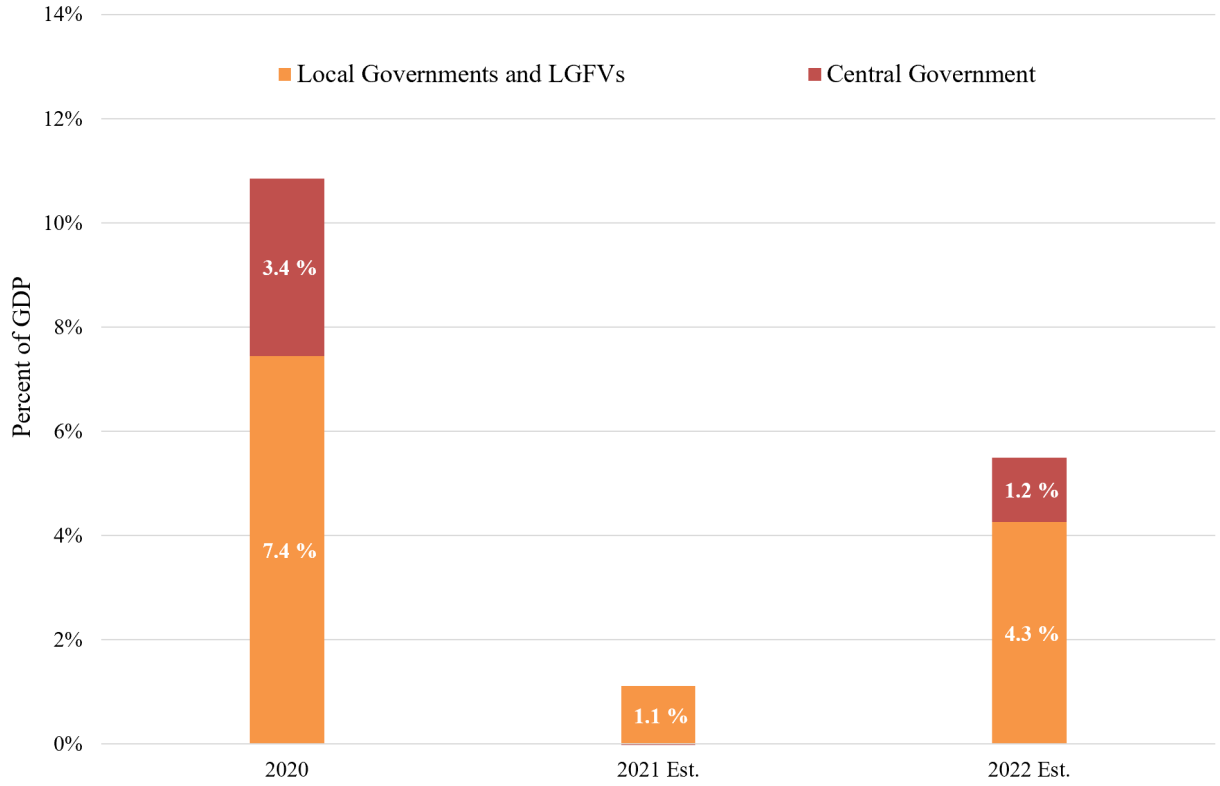
Source: Wind.
Note: Debt includes official debt and interest-bearing LGFV debt.

Policy Mistakes Have Increased China's Balance Sheet Challenge

Over the past three years, several ill-conceived policies have increased China's balance sheet challenge by slowing economic growth and lowering corporate profits.

First, the central government delegated the bulk of Covid spending and the economic stimulus to local governments, without a proportionate increase to their revenue streams. Relying on local governments to handle most stimulus spending is part of Beijing's historical pattern, stretching back to at least 2008 in response to the global financial crisis. Over the past three years, local governments borrowed large amounts to meet Beijing's spending expectations (Figure 6). They issued debt directly in the municipal bond market or off-balance sheet through LGFVs.

Figure 6: Annual Increase in Chinese Government Debt Relative to GDP, by Source



Sources: Author, based on IMF data.[19]

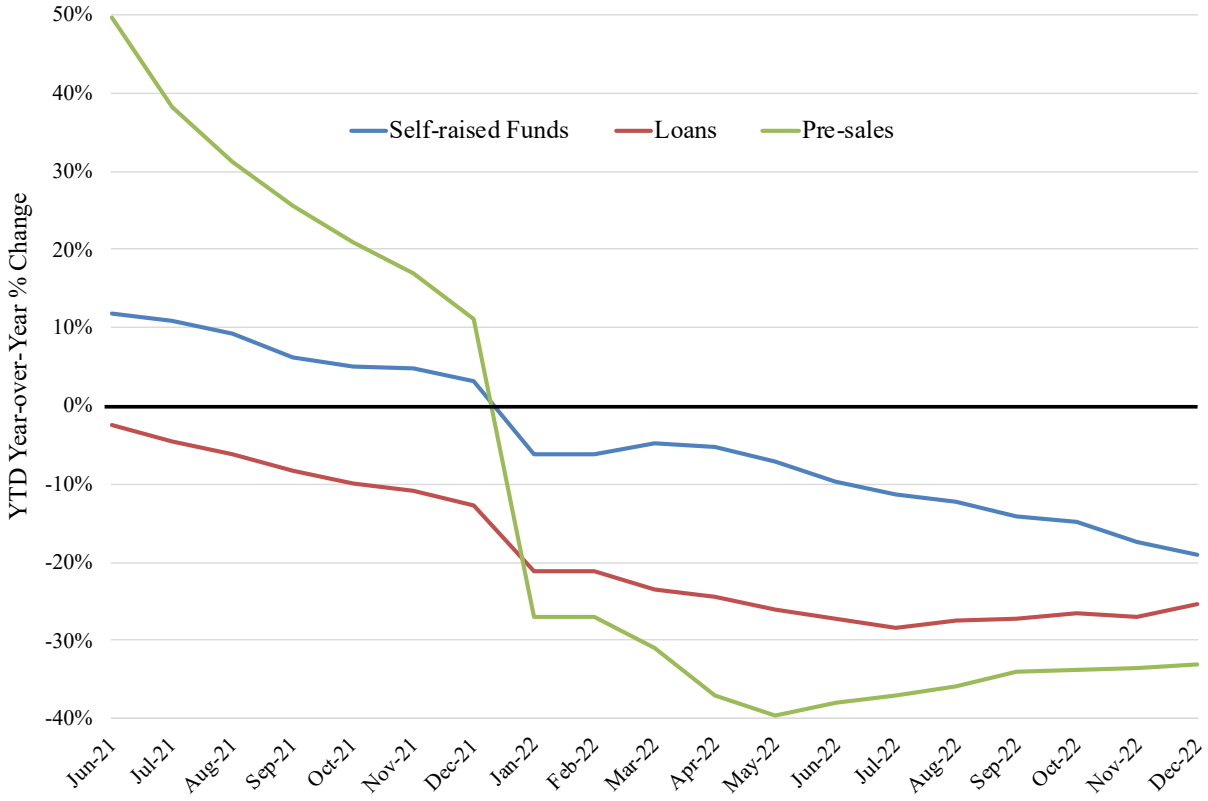
Second, the broad-based crackdown on the real estate sector—epitomized by the Three Red Lines policy announced in late 2020—has damaged the balance sheets of both real estate developers and local governments. Regulators implemented policies in order to reduce leverage by property developers and to clamp down on real estate speculation. But the policy caused a severe financing crisis among property developers. The value of all three primary sources of financing for developers—pre-sales, loans, and bonds—plummeted (Figure 7). As a result, the entire sector now faces a financing crisis, with construction projects stalled and pre-sale homebuyers refusing to pay their mortgages because of fear that their homes will not be completed. Local governments, which derive revenue from land sales, have also taken a significant financial hit. Belatedly, the government relaxed some of these policies, established a national bailout fund, and instructed banks to increase their lending to real estate developers.[20]

[19] "People's Republic of China: 2021 Article IV Consultation," International Monetary Fund, January 28, 2022, accessed January 31, 2023, https://www.imf.org/en/Publications/CR/Issues/2022/01/26/Peoples-Republic-of-China-2021-Article-IV-Consultation-Press-Release-Staff-Report-and-512248 Author's calculations.

[20] "China Vows to Speed Up Delayed Housing With Special Loans," *Caixin Global*, September 30, 2022, accessed January 31, 2023, https://www.caixinglobal.com/2022-09-30/china-vows-to-speed-up-delayed-housing-with-special-loans-101946665.html

But the damage to the balance sheets of property developers and local governments has already occurred.

Figure 7: Major Sources of Funding for Real Estate Developers in China
June 2021 – December 2022



Source: CEIC.

Third, China's delay in adapting its draconian zero-Covid policies to the changing realities of the virus was a significant drag on the economy. China proved effective in stopping the spread of the virus in early 2020. But Beijing failed to change course as it became clear that Covid-19 would not be eliminated and the world would have to adapt to living with it. While much of the rest of the global economy returned to a more normal stance in 2022, China continued to impose widespread lockdowns, which dragged down both consumption and investment. The policy inflicted tremendous damage on the economy throughout 2022, as many indebted borrowers were already struggling with their debt loads. It also put financial stress on local governments, which were forced to bear the enormous costs of testing and quarantines.

Driven by protests and a rapidly decelerating economy, China began to change course in November 2022, chaotically abandoning the zero-Covid policy. With most of country's Covid restrictions now removed, the negative drag on the economy will abate significantly.

Fourth, starting in the second half of 2020, China began a capricious crackdown on private sector business, significantly weakening business confidence. In November of that year, Beijing took regulatory action against Ant Financial, China's most prominent fintech payments firm. As a result, Ant was forced to cancel its much-anticipated initial public offering days before it was scheduled to raise tens of billions of dollars.[21] Following the crackdown on Ant, Chinese regulators took aggressive regulatory actions against a broad swathe of private Chinese companies, including social media, payments, education, ride-hailing, film and television, gaming, and e-commerce firms. The severity and unknown scope of the regulatory campaign surprised investors. As a result, many companies saw their market capitalization and corporate profits fall precipitously, hobbling many of the most dynamic and innovative portions of the Chinese economy precisely when more growth was needed to help deal with its debt problems.

Distressed Balance Sheets Pose a Threat to the Banking System

Solvency problems, liquidity problems, or some combination of the two may eventually endanger companies with weak balance sheets. Solvency is a borrower's ability to meet long-term debt obligations through income, the sale of assets, or borrowing. Borrowers with positive net worth are generally considered solvent. During periods of financial distress, net worth may be ephemeral because asset prices may decline rapidly.

Liquidity is a borrower's ability to meet its short-term debt obligations. A borrower's net worth may be positive on paper, but if its revenues are volatile and its assets illiquid, the borrower may not be able to meet its short-term obligations and thus will go bankrupt. Assets are illiquid if they take a long time to liquidate or if liquidating them entails high costs, they cannot easily be sold off in chunks, or they cannot be sold without significantly affecting their price. Revenue volatility and asset illiquidity may increase during periods of financial distress.

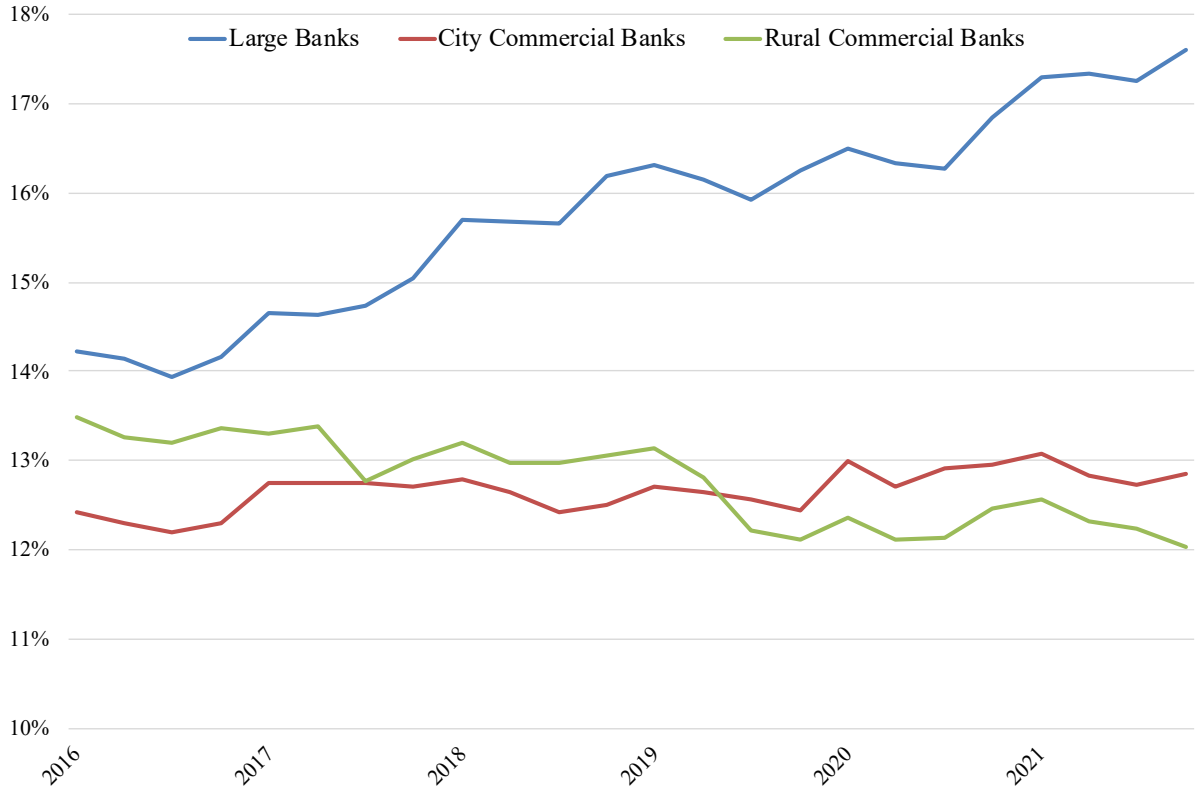
A balance sheet crisis in China will involve a mix of solvency and liquidity factors—precisely what real estate developers experienced over the past year. Many property developers, such as Evergrande, ran highly leveraged balance sheets that were vulnerable to liquidity disruptions. As the government's restrictions came into effect and the real estate market slowed, Evergrande and other developers began to face both solvency and liquidity pressures. These issues then affected the entire industry as project completions slowed down and pre-sales of new homes collapsed. The pressure spread to even seemingly healthy developers, as banks began to reduce lending to the entire sector.

Balance sheet pressures ultimately manifest themselves in the banking system. Distressed borrowers will default on their loans or bonds, many of which are held by banks. These losses may cause insolvency in those banks that lack sufficient capital. Chinese banks are well-

[21] Raymond Zhong, "Why China Halted Ant's IPO, Dealing Jack Ma a Blow," *New York Times*, December 24, 2020, accessed January 31, 2023, https://www.nytimes.com/2020/11/06/technology/china-ant-group-ipo.html

capitalized by international standards, according to official statistics, but the differences in the capitalization of large and smaller banks are large (Figure 8).

Figure 8: Total Capital Adequacy Ratios for Chinese Banks
December 2016 – September 2022



Source: CEIC.

Over the past few years, several smaller banks, including Baoshang Bank, Bank of Jinzhou, and Shengjing Bank, have fallen into financial distress. Their problems reveal that smaller banks

often have high exposure to individual borrowers, concentrated exposure to a specific geographic area, and weaker funding bases than larger banks. In some cases, a private conglomerate may be subject to undue influence from a controlling shareholder, such as Shengjing Bank and Evergrande, or a local government. If a wave of balance sheet–driven defaults occurs, small banks will likely suffer the most.

Former Strategies Are Yielding Diminishing Returns

In recent years, Beijing's preferred course of action for dealing with weak balance sheets has been to support distressed borrowers indirectly. But this approach is now facing diminishing returns.

In the past, when debt problems in a specific sector or across the entire economy reached a critical point, Beijing preferred to mobilize support through the use of balance sheets other than its own, usually those of local governments, banks, or asset management companies. When the property market ran into trouble in 2014–15, for example, the government orchestrated a massive slum redevelopment program to absorb much of the excess inventory in the market. The program was financed via lending from the People's Bank of China to the China Development Bank and from loans from commercial banks acting under Beijing's direction.[22] LGFVs and property developers then borrowed those funds to finance the slum redevelopment projects. The direct claims back to the central government's balance sheet were remote, in accord with Beijing's preference.

Banks and asset management companies are convenient channels to conduct indirect bailouts. As the controlling shareholder of China's largest banks, Beijing operates China's banks as public utilities. Banks face pressure to lend to preferred sectors and help resolve troubled debt in a way that does not threaten financial or social stability. They are directed to put the central government's interests ahead of their own commercial interests. As a result, publicly listed banks trade at much lower valuations than their more market-oriented international peers.

The Chinese government also uses the balance sheets of asset management companies to warehouse problem assets. Beijing controls the national-level asset management companies, which were instrumental in taking loans off the banks' balance sheets in the late 1990s and early 2000s. More recently, Beijing authorized the creation of local-level asset management companies, which are supervised by and under the control of the local governments. These companies serve the same purpose as their national counterparts, working with banks and distressed borrowers to resolve non-performing loans. Ideally, these types of transactions should be made on market terms; the close relationship between the banks, the asset management companies, and the government provides ample opportunity for the impaired assets to be shifted around and disguised.

Resolving debt issues indirectly via multiple balance sheets is increasingly challenging to orchestrate as the entities that Beijing relies upon to support struggling borrowers increasingly need bailouts themselves. Many Chinese banks, particularly smaller ones, are financially vulnerable; China's asset management companies are in equally bad shape. One of China's

[22] Thomas Orlik, *China: The Bubble that Never Pops* (New York: Oxford University Press, 2020).

largest asset management companies, Huarong, fell into financial distress shortly after its chairman was arrested and executed for corruption. Its difficulties point to much deeper structural problems for the other asset management companies. Local governments are cash-strapped and face huge contingent liabilities from their LGFVs. Outside of the central government itself, no party may be able to provide the financial support needed to resolve China's debt problem.

Options for China to Strengthen Its Weak Balance Sheets

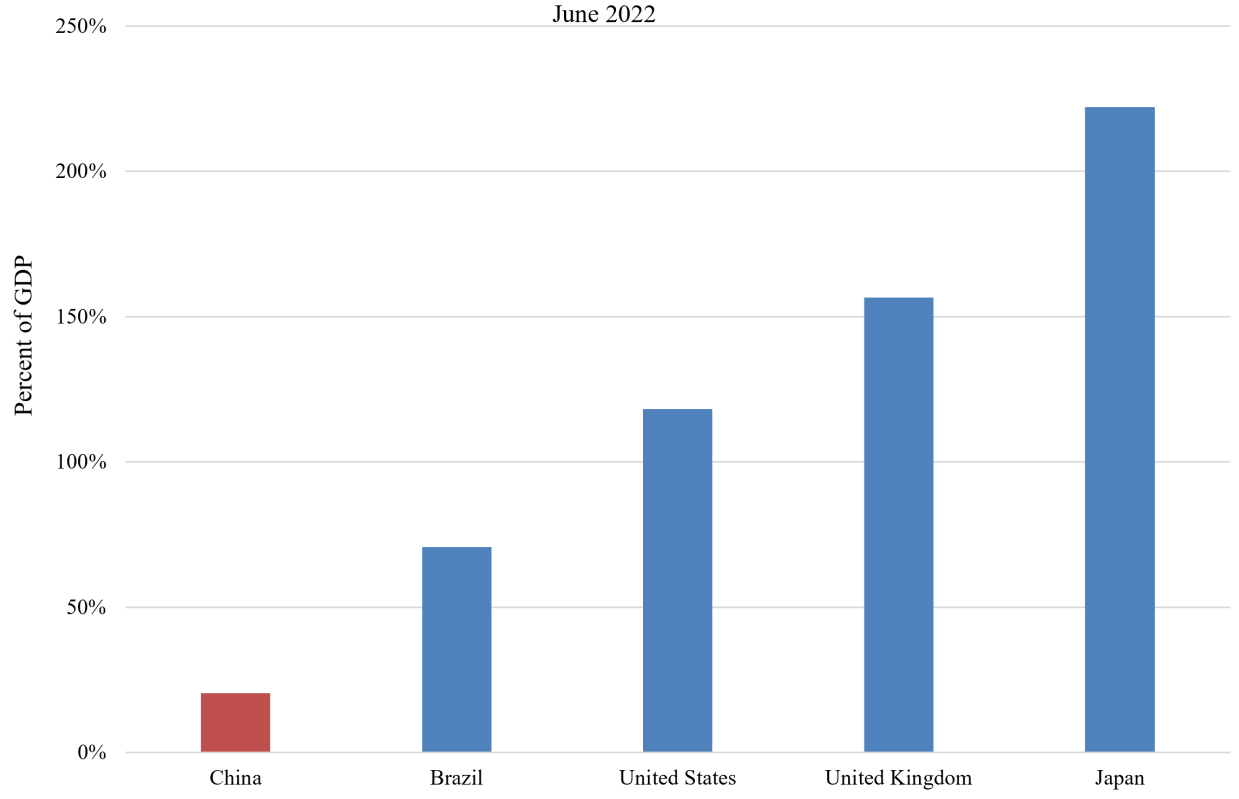
To strengthen the many weak balance sheets throughout the economy, Beijing must change its approach and embrace more significant reforms at a more structural level. It can deal with the country's debt problem in three ways.

1. *Using the Central Government's Balance Sheet*

The most immediate way to address the country's debt problem is to harness the strength of the central government's balance sheet to support local governments, indebted SOEs, and distressed property developers—something that is already happening to some extent. By global standards, the balance sheet of China's central government is exceptionally robust, with a debt-to-GDP ratio that is significantly lower than that of any other major economy (Figure 9).

Figure 9: Ratio of Debt-to-GDP of China's Central Government and Selected Countries

June 2022



Source: CEIC.

Historically, the central government has been reluctant to encumber its balance sheet. After the 1994 fiscal reform, it took control of the majority of total revenues.[23] As a result, its fiscal position has substantially improved in the intervening years at the expense of local governments.

Beijing values the security and optionality of having a strong balance sheet. The examples of other governments weakened by debt crises—including several of China's neighbors during the Asian financial crisis—remains a potent deterrent to compromising its balance sheet.

Beijing also recognizes that the demand for funds from risky borrowers is potentially enormous. As strong as the central government's balance sheet is, it is not strong enough to bail out every contingent liability in China. Moreover, a one-off series of bailouts would increase moral hazards and not change the underlying dynamics that led to the problem in the first place.

The case for Beijing to directly mobilize its fiscal resources is compelling, however. The central government can borrow at low rates over long durations. China's Ministry of Finance is currently able to issue 10-year bonds at lower interest rates than the US Treasury.[24] The central government could likely increase its borrowing moderately without substantially increasing its borrowing costs. It could use its expanded budget in several ways: creating bailout funds to support local governments and SOEs; moving debt from local governments onto its balance sheet; or capitalizing the banks, policy banks, and asset management companies to provide more lending support to restructure bankrupt entities.

There is a historical precedent for this type of approach. In the late 1990s, under the direction of Premier Zhu Rongji, the central government used its balance sheet to finance a significant restructuring of the SOE sector and the banking system. As part of the "Grasping the Large, Releasing the Small" policy, thousands of bankrupt and inefficient SOEs were shut down.[25] The Ministry of Finance capitalized the four asset management companies that had been set up to purchase the non-performing loans of the SOEs and took them off the large banks' balance sheets.[26] The central government also recapitalized the banks to strengthen their capital buffers. The funding provided by the central government allowed this restructuring to occur without bringing down the financial system.

2. *Readjusting the Fiscal Balance*

A second option for addressing China's debt problem is to alter the tax system to benefit local governments. One straightforward approach would be to grant local governments control over a larger share of the total tax revenues at the expense of the central government. Despite having a

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[23] Christine Wong, "Plus Ça Change: Three Decades of Fiscal Policy and Central–Local Relations in China," *China: An International Journal* 19, no. 4 (November 2021): 1–31, https://doi.org/10.1353/chn.2021.0039

[24] CEIC data, accessed January 10, 2023.

[25] Nicholas Lardy, *Markets Over Mao: The Rise of Private Business in China* (Washington, DC: Peterson Institute for International Economics, 2014).

[26] Guonan Ma and Ben SC Fung, "China's Asset Management Corporations," Bank for International Settlements, August 2002, https://www.bis.org/publ/work115.pdf

highly centralized political system, China's fiscal system is among the most decentralized in the world, with the vast majority of government spending happening at the local levels.[27] Local governments face a perpetual funding gap, which Beijing partially helps to fill through transfers to local governments that account for over 40 percent of local government revenues.[28] Beijing's reluctance to permanently alter the distribution of revenues is driven by concerns that doing so will weaken its control over China's fractious and often independent-minded localities. Keeping local governments dependent on central government subsidies is a critical lever of power for Beijing.

If Beijing is unwilling to adjust the current fiscal balance, it could instead establish more sustainable sources of revenue for local governments. Local governments' dependence on land sales has been a primary driver of the housing bubble. Municipalities are heavily incentivized to promote land transactions because they generate revenue and GDP growth. In 2021, land sales were estimated to account for nearly 30 percent of consolidated fiscal revenues, with some localities deriving even larger shares of revenue from this activity.[29] Land sales are a poor funding source for local governments because they are highly cyclical and they are a significant entry point for corruption between local governments and property developers.

A more sustainable form of financing would be a residential real estate tax that taxes existing properties based on a periodic assessment of value—a common form of financing for local governments worldwide. China has unsuccessfully tried to implement a property tax for over a decade. In 2011, a pilot program for a real estate tax was launched in Shanghai and Chongqing. The program was narrowly targeted, failed to raise much revenue, and was not expanded to other localities.

In 2021, the central government again declared its desire to establish a property tax system.[30] Specific legislation for this policy has yet to be introduced, however. Implementing the tax at this time could put significant pressure on the housing market, just as property developers already have stressed balance sheets.

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[27] Philippe Wingender, "Intergovernmental Fiscal Reform in China," International Monetary Fund, April 13, 2018, accessed January 31, 2023, https://www.imf.org/en/Publications/WP/Issues/2018/04/13/Intergovernmental-Fiscal-Reform-in-China-45743

[28] Nicholas Borst, "The Balance Sheet Constraints on China's Economic Stimulus," Seafarer Capital Partners, August 2022, accessed January 31, 2023, https://www.seafarerfunds.com/prevailing-winds/the-balance-sheet-constraints-on-chinas-economic-stimulus

[29] "China Economic Update: Between Shocks and Stimulus," The World Bank, June 2022, https://thedocs.worldbank.org/en/doc/9b7191d416b0dbfd7d36f1a935464ea0-0070012022/original/CEU-June-2022-EN.pdf

[30] Frank Tang, "How Does China's Property Tax Plan Fit Beijing's 'Common Prosperity' Drive?" *South China Morning Post*, October 27, 2021, accessed January 31, 2023, https://www.scmp.com/economy/china-economy/article/3153886/why-chinas-property-tax-plan-key-pillar-its-common-prosperity

It would also require a transparency that Chinese officials may be reluctant to embrace, as a property tax system requires disclosure of property holdings by individuals. Such disclosures could reveal that many government officials own far more property than their official salaries justify.

3. *Selling State Assets*

The third principal option available to Beijing to help resolve the country's debt problem is to authorize the sale of state assets. Collectively, the central and local governments held around $19 trillion in financial assets at the end of 2019, according to estimates from a think-tank associated with the Chinese government.[31] Of that amount, $13.5 trillion is the listed and unlisted equity of SOEs and other securities. It is doubtful that anywhere near that amount could be sold. Much of this equity is illiquid and may be overvalued. Applying heavy discounts to the amount of assets that can be sold will still leave a significant stock of assets that could potentially be sold to help meet the financial burdens of indebted local governments and SOEs, however.

Selling state assets is a politically charged endeavor in China. Leaders in Beijing view the asset-stripping of SOEs that occurred after the fall of the Soviet Union as a cautionary tale of the dangers of privatization. Reducing state ownership in the economy would also cut against the prevailing trend of the Xi administration to consolidate and strengthen the state-owned economy.

Beijing has indicated some openness to this approach, however, via a few policy initiatives over the past few years. The debt-to-equity swap program was launched in 2016 to help improve the balance sheets of struggling borrowers, especially SOEs. Companies with large debt loads could work with creditors to exchange their debt claims for equity. In effect, the government, as the principal owner of the enterprise, was diluting its ownership stake to reduce the SOEs' indebtedness.

The debt-to-equity swap program has several significant shortcomings. Around $200 billion of debt-to-equity agreements have occurred since 2019, according to official statistics.[32] This amount is equal to around 1 percent of China's current corporate debt load, and therefore it is not enough to meaningfully reduce leverage levels. Moreover, the program does not represent true privatization because most of the participating creditors are state entities.[33] Banks have struggled to attract private capital to participate in the program. Many of the debt-to-equity swaps therefore

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[31] Yang Li and Xiaojing Zhang, 中国国家资产负债表 2020 (China's National Balance Sheet 2020) (Beijing: 中国社会科学出版社 [China Social Sciences Press], 2020).

[32] 国人民银行金融稳定分析小组 (People's Bank of China Financial Stability Analysis Group), "中国金融稳定报告 2020" (China Financial Stability Report 2020), 中国人民银行 (The People's Bank of China), November 7, 2020, accessed January 31, 2023, http://www.gov.cn/xinwen/2020-11/07/5558567/files/d7ba5445e5204c83b37e3f5e07140638.pdf

[33] Tianlei Huang, "Tracking China's Debt-to-Equity Swap Program: 'Great Cry and Little Wool,'" Peterson Institute for International Economics, June 24, 2019, accessed January 31, 2023, https://www.piie.com/blogs/china-economic-watch/tracking-chinas-debt-equity-swap-program-great-cry-and-little-wool

represent a reshuffling of claims on the government's balance sheet rather than a transfer of assets to the private sector.

A second initiative to sell state assets is the mixed ownership policy, which was outlined as part of the Third Plenum of the 18th Central Committee in 2013.[34] As part of this initiative, the Chinese government has encouraged outside investors to take stakes in SOEs. The most notable example of this policy is the China Unicom transaction. In 2017, this state-owned telecom giant raised $11.7 billion in capital from outside investors, including tech giants Alibaba, Tencent, and Baidu, in exchange for three board seats and a 35 percent stake in the company's Shanghai unit.[35] The examples of mixed ownership have been disappointing in terms of the total number of transactions and the performance of the companies with investments. China Unicom is a case in point. As of mid-January 2023, shares of the company's Shanghai-listed subsidiary have consistently traded at substantially lower prices than the prevailing price at the time of the 2017 transaction.[36]

At the macro level, the mixed ownership program has failed to achieve a meaningful change in the ownership structure of Chinese firms. As a result, the state-ownership stake in China's largest listed companies has remained constant over the past decade.[37] The lack of interest in mixed-ownership reform by outside investors and the poor performance of the firms that underwent it indicate that these transactions do not lead to material changes in corporate governance. In mixed-ownership enterprises, private investors are often stuck as noncontrolling minority investors.

Ultimately, the large-scale sale of state assets will require a significant ideological shift in Beijing. The Chinese government will have to become comfortable selling substantial stakes in SOEs and transferring control to new investors. In China's current political environment, it seems highly unlikely that it will be willing to do so, especially as Xi Jinping increasingly views large portions of the Chinese economy as sensitive or strategic.

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[34] "中共中央关于全面深化改革若干重大问题的决定" (Decision of the Central Committee of the Communist Party of China on Some Major Issues Concerning Comprehensively Deepening the Reform), 中华人民共和国中央人民政府 (Central People's Government of the People's Republic of China), November 15, 2013, accessed January 31, 2023, http://www.gov.cn/jrzg/2013-11/15/content_2528179.htm

[35] Lardy, *The State Strikes Back.*

[36] Shares of China United Network Communications. Data from Wind Information, accessed January 18, 2023.

[37] Tianlei Huang, Nicolas Veron, and David Xu, "The Private Sector Advances in China: The Evolving Ownership Structures of the Largest Companies in the Xi Jinping Era," Peterson Institute for International Economics Working Paper 22-3, March 2022, accessed January 31, 2023, https://www.piie.com/publications/working-papers/private-sector-advances-china-evolving-ownership-structures-largest

Opportunity Costs

The Chinese economy is likely to recover somewhat after Beijing's abrupt pullback from many of its most damaging policies in late 2022. China's balance sheet challenge remains pressing and unresolved, however.

If faced with the threat of an imminent financial crisis, the Chinese government is likely to take action to defuse any immediate risks. Absent that type of acute pressure, Beijing's inclination will be to muddle through its debt problems by providing indirect support to problem borrowers and relying on economic growth to reduce overall debt burdens gradually. China's slowing growth trajectory and the encumbered balance sheets of many of the entities Beijing relies upon to provide bailouts mean that this approach will struggle to be effective. Moreover, if China avoids structural reforms to address its balance sheet problems, it faces the risk of a prolonged period of slow economic growth.

Even if they avoid bankruptcy, highly indebted borrowers face the difficult task of repairing their balance sheets, a project that could stretch on for years. These borrowers will be forced to reduce spending and investment slowing economic growth, thereby reducing tax revenues for local governments and further straining their balance sheets. In the real estate sector, in particular, China faces the prospect of a negative feedback loop of lower property prices leading to less investment, less government revenue, and slower growth, which will ultimately put further pressure on property prices.[38]

The net economic effect of many borrowers cutting spending and investment to pay down indebted balance sheets is referred to as a *balance sheet recession*.[39] In this environment, tools frequently used to stimulate the economy, such as an expansionary monetary policy, do little to spur credit growth because of weak demand for new borrowing. As a result, economic growth may remain sluggish for an extended period.

Japan is a cautionary example of this type of situation. After its real estate bubble burst in the late 1980s, the country entered a period of prolonged economic slowdown. The Japanese government, fearing significant unemployment, was reluctant to allow companies to fall into bankruptcy. Japanese banks that should have been insolvent continued operating by extending bad loans. As a result, many overindebted borrowers were spared from bankruptcy, but they were not able to continue to spend and invest at normal levels. Japan's indebted borrowers spent many years repairing their balance sheets and contributing to the country's lost decade of economic growth.

If China chooses to muddle through its debt problem, it faces the risk of a Japanese-style lost decade. Beijing's options for repairing weak balance sheets require difficult reforms, but the alternative of a long period of stagnation is equally costly. The best outcome for China would be

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[38] Michael Pettis, "China's Overextended Real Estate Sector Is a Systemic Problem," Carnegie Endowment for International Peace, August 24, 2022, accessed January 31, 2023, https://carnegieendowment.org/chinafinancialmarkets/87751

[39] Richard Koo, "Balance Sheet Recession Is the Reason for 'Secular Stagnation,'" Centre for Economic Policy Research (CEPR), August 11, 2014, accessed January 31, 2023, https://cepr.org/voxeu/columns/balance-sheet-recession-reason-secular-stagnation

to embrace the debt challenge as an impetus for more comprehensive reforms, akin to what Zhu Rongji did in the late 1990s. The structural reform of the SOEs and the banks set the course for a decade of rapid growth during the 2000s. Using the debt crisis as an opportunity to reform China's fiscal system and reduce the role of the government in the economy via asset sales could once again set China on the path to more rapid growth. It would, however, require a major shift in the Xi administration's ideological approach to the economy.

About the Contributor

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