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China Auditor Warns of Risk on 10.7 Trillion Yuan Local Debt (2)
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(Updates with quote in fifth paragraph.)

By Bloomberg News

June 27 (Bloomberg) -- China's first audit of local government debt found liabilities of 10.7 trillion yuan ($1.7 trillion) and warned of repayment risks, including a reliance on land sales and investment in stocks.

A total of 148 financing vehicles set up by regional authorities already had more than 8 billion yuan in overdue debt, while more than 5 percent of such companies used new bank borrowing to repay existing loans, according to an audit report posted on the National Audit Office's website.

"Some local government financing platforms' management is irregular, and their profitability and ability to pay their debt is quite weak," Liu Jiayi, the country's auditor-general said today, according to a transcript of his webcast. Some governments have offered illicit guarantees to such companies, while others rely on land sales to help them repay, Liu said.

Premier Wen Jiabao ordered the first audit of local- government borrowing in March, amid concern spending designed to support the economy following the 2008 global financial crisis would leave a legacy of bad debt. As much as 30 percent of bank loans are expected to turn sour and they are likely to be the biggest source of non-performing assets for the industry, Standard & Poor's said in April.

Local governments, barred from selling bonds or borrowing directly from banks, had set up 6,576 financing vehicles by the end of 2010 to raise money, the audit showed, accounting for 4.97 trillion yuan, 60 percent of which governments have responsibility to repay.

'Time Bomb'

UBS AG estimated in a June 7 report that local government debt could be 30 percent of gross domestic product and may generate around 2 to 3 trillion yuan of non-performing loans.

Credit Suisse AG economist Tao Dong said it was the biggest "time bomb" for China's economy.

"Overall it seems manageable but the real question: is anyone going to manage it?" said Vincent Chan, head of China research at Credit Suisse in Hong Kong. "Everyone wants to solve the problem on the condition that the other two parties pay the bill."

The audit showed 80 percent of local government debt was bank loans and 70 percent will mature in the next five years.

Qu Hongbin, a Hong Kong-based economist for HSBC Holdings Plc, said the biggest problem was transparency and the mismatch between maturities and projected revenue generation.

Maturity Mismatch

“Without real action going towards a restructuring of these debts, banks would face a real risk of defaulting in the coming years,” he wrote in report today.

Governments from 12 provinces, 307 cities and 1,131 townships have pledged to use revenues from land sales to repay a combined outstanding debt of 2.55 trillion yuan. More than 35 billion yuan of money borrowed by local governments went into the stock and property markets or prohibited projects, the report showed. Five of China’s commercial banks have issued 58 billion yuan of loans that violated loan rules, it said.

The yield on the government’s 2.77 percent May 2012 bonds jumped 49 basis points, or 0.49 percentage point, this month to 3.51 percent, as the central bank tightened money supply to curb inflation. Twelve-month non-deliverable yuan forwards have dropped 0.6 percent in June to 6.3987 per dollar.

The cost of five-year credit-default swaps protecting Chinese government bonds from default jumped 16 basis points this month to 89, according to data provider CMA, which is owned by CME Group Inc. and compiles prices quoted by dealers. The contracts protect investors from losses when a company or government fails to pay its debt.

Municipal Sales

Liu proposed that the country study allowing provincial governments and some city authorities to sell an appropriate amount of debt. The plan should get an approval from the State Council, he said.

The financing vehicles will have to pay interest and principal by year-end, said Liu Li-Gang, who formerly worked for the World Bank and is chief China economist at Australia & New Zealand Banking Group Ltd. in Hong Kong. If the local governments can’t issue debt in the next three years, they would have to cut their combined fiscal spending by 5 percent to 7 percent of GDP to meet obligations, he said.

"If the central government can allow local governments to issue long-term debt, then the liquidity problem won’t look very serious," he said. "I don’t think this will necessarily run into a banking crisis in China given the balance sheet condition of the central government is very good at this stage."

The audit gave a number lower than the central bank, which said June 2 that more than 10,000 financing vehicles had been set up. The banking regulator has estimated local government financing vehicle debt at over 7.7 trillion yuan.

“It seems the government doesn’t have a concrete idea what is a local government financing vehicle and what isn’t,” Credit Suisse’s Chan said. “The biggest problem is it’s very difficult to define in China what is private and what is public.”

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