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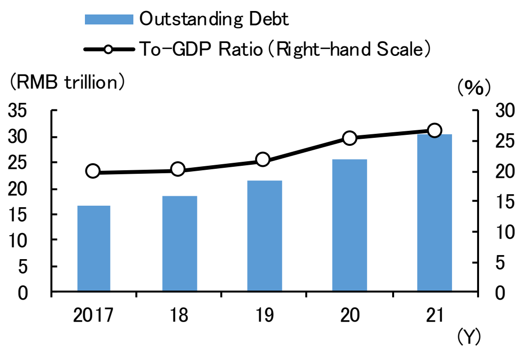
Topics Debt owed by China's local governments reaches alarming levels

In China, local government debt has increased significantly, with debt ratios ringing alarm bells in many regions. As a result, the economic growth model based on aggressive investment expansion by local governments is becoming unsustainable.

■ Local government debt is rising

In China, aggressive investment expansion by local governments has driven economic growth. Strong demand for infrastructure such as railways, roads, and ports, and on the fiscal front, higher revenues from land-use in conjunction with the expansion of the real estate market and ample room for debt increases have long encouraged local governments to boost public investment. Infrastructure investment, including public-private partnerships (PPP), was estimated to be worth RMB 15.4 trillion in 2021 (13.5% of GDP). Increased investment by local governments has spurred urban development projects and corporate capital expenditures, and the ratio of fixed capital formation to GDP hit 42.0% in 2021.

<Narrowly-defined Outstanding Local Government Debt>



Source: Prepared by JRI based on data from China's Ministry of Finance
Note: Total of local governments' general debt and special debt 。

On the other hand, this expansion in public investment has also pushed up local government debt levels substantially. According to China's Ministry of Finance (below, "CMoF), at the end of 2021, local governments were shouldered with RMB 30.5 trillion in debt as narrowly defined, marking a 1.8-fold increase from the figure of RMB 16.5 trillion in 2017. And the ratio to GDP rose from 19.8% in 2017 to 26.6% during the same period.

The breakdown is as follows: general bonds outstanding amounted to RMB 13.8 trillion, and special bonds amounted to RMB 16.7 trillion. General bonds are used to fund non-revenue-generating public projects and are included in the general public budget. Special bonds, meanwhile, are issued to procure cash to finance profit-earning projects, with the profits used to service the debt, according to the official definition.

A problem with local government debt is the existence of "hidden debt" that the CMoF is not fully aware of, and if this debt is included to give a figure for outstanding debt in the broad sense, the number is likely far higher than that for outstanding debt in the narrow sense. The reason for this "hidden debt" is that local governments have provided implicit government guarantees for the respective debts of 1) non-bank companies, known as "local-government financing vehicles," that raise funds for urban development, 2) state-owned companies under their control, and (3) funds established to promote industry.

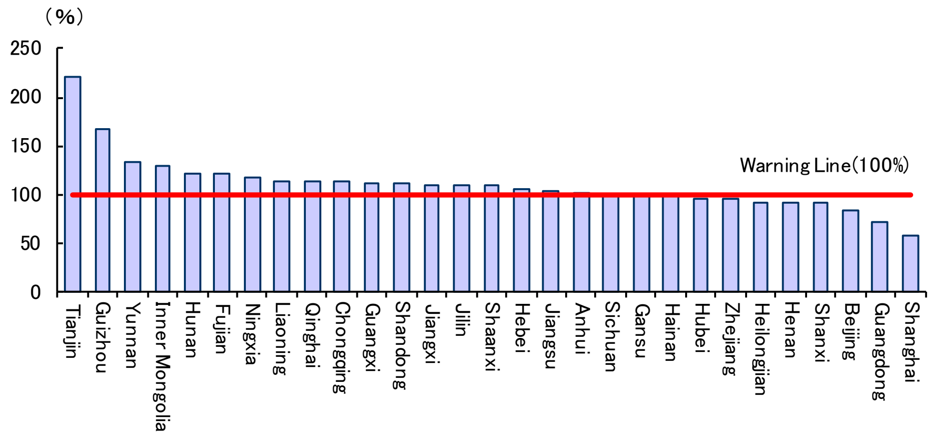
■ Debt ratios in many regions have reached alarming levels

Taking into account "hidden debt," debt ratios in many regions appear to have reached the level at which warnings start to sound. In general, the debt ratio is the ratio of outstanding debt to total fiscal capacity. Total fiscal capacity is the sum of general public budget revenues and governmental fund revenues. The ratio can be interpreted as the size of the debt relative to the debt service capacity. The CMoF has set 100% as the level at which the ratio becomes a cause for concern.

According to the Chinese Academy of Social Sciences, a government-affiliated think tank, 19 of the 29 provinces, municipalities, and autonomous regions have a debt ratio of 100% or higher in 2020. So there are 10 regions with debt ratios below 100%, including the cities of Shanghai, Guangdong, and Beijing.

Although these debt ratios also include "hidden debt," the scope of the repayment burden of local governments is limited to a portion of the outstanding "city investment bonds" issued by local-government financing vehicles to raise funds. Despite these estimates being based on conservative assumptions, debt ratios in most regions have reached alarming levels. Among them, the debt ratios of Tianjin and Guizhou

＜Local Government Debt Ratios (2020)＞



Source: Prepared by JRI based on data from China's Ministry of Finance, Zhang Ming and Kong Dapeng, "China's Local Government Debt: Characteristics, Risks, and Countermeasures," Liaoning University Academic Journal (Philosophy Social Sciences Edition), 2021, 4th quarter
Note: Debt ratio = outstanding debt / total fiscal capacity. Outstanding debt includes "hidden debt."

are well above the CMoF's warning line, standing at 220% and 168%, respectively. Yunnan, Inner Mongolia, Hunan, Fujian, and Ningxia Hui follow with 133%, 130%, 122%, 122%, and 118%, respectively.

Incidentally, although the debt ratios of some large administrative divisions (provinces, municipalities, and autonomous regions) are below the warning line, even these include several prefecture-level cities (second level of the administrative structure) where the debt ratio has crossed the warning line. According to Guosheng Securities, the number of prefecture-level cities in Heilongjiang Province with debt ratios exceeding 300% is comparable to that of the Inner Mongolia Autonomous Region, although the scope of "hidden debt" differs from that of the Chinese Academy of Social Sciences.

■ Pressure for fiscal consolidation is growing

Against this backdrop, it is expected that the Chinese government will increase its financial support to local governments to stave off local government defaults in the future. Because the Chinese government has more fiscal leeway than local governments, general transfer payments, i.e., tax allocations to local governments, have already increased substantially. In the unlikely event that a local government defaults on its debt, financial institutions under its control may no longer be able to obtain sufficient public funding. And if the regional financial system ceases to function properly, the risk of business failures and a sharp rise in unemployment would rise.

In addition, financial support for local governments by the monetary authorities is expected to be beefed up to ensure that local governments do not default on their debt. Once long-term interest rates rise, the burden of debt repayment will soar, and a number of local governments could default. The monetary authorities will have limited room to raise policy rates even if prices skyrocket. There is also a risk that financial institutions will curtail their investments in local government bonds, and the Chinese government is likely to ask state-owned commercial banks and policy banks to provide support to local governments.

On the other hand, local governments are expected to focus more on fiscal restructuring to lower their debt ratios. Already in 2016, the Chinese government proposed measures to control local government debt risk, which require a local government to implement a fiscal restructuring program if its interest expenses exceed 10% of its total expenditures. Such programs call for tough measures such as paring back public investment, reviewing the pay and conditions of public servants, and selling off shareholdings in local state-owned enterprises. Under this framework, the end of 2021 saw the city of Hegang in Heilongjiang Province, announce that it would implement a fiscal restructuring program that included a halt to the hiring of new employees. More such cases are likely to be seen in the future.

Given this fiscal restructuring stance, the problem of excessive local government debt will be a drag on economic growth. Looking ahead, it will be difficult for China to continue with its traditional investment-driven economic growth model. Instead, it will need to pursue a consumption-driven growth model.

(Shinichi Seki)

Topics *Population dynamics of China and India after the pandemic*

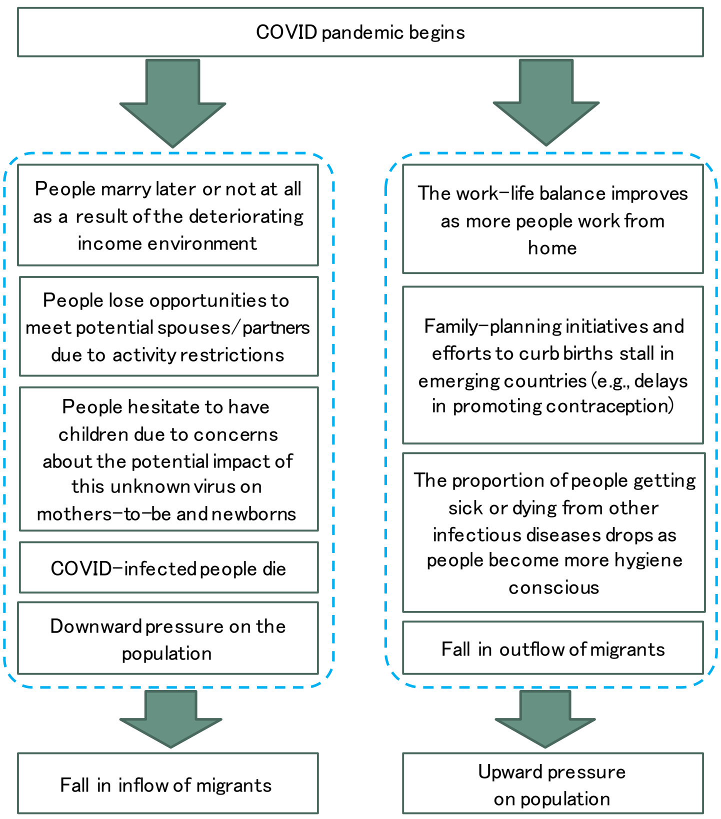
In the near future, it is regarded as certain that India will surpass China as the world's most populous country, but the population gap between the two countries may then widen at a faster pace than had been expected.

■ The COVID pandemic has influenced population dynamics

The COVID pandemic has shaped the demographics of countries via various pathways. The effects are not uniform and vary according to the stage of each country's economic and social development.

Pathways via which the pandemic has suppressed births include 1) the loss of opportunities to meet potential partners/spouses due to worsening incomes and the imposition of activity restrictions, which will lead to people marrying later in life or remaining single, and 2) reluctance to have children due to the possible adverse impact of this unknown virus on pregnant women and newborns.

＜Impact of COVID Pandemic on Population Dynamics＞



Source: Prepared by JRI

Fertility decline via these pathways is especially likely to occur in emerging economies with lower income levels. However, it is also necessary to take into account the impact of stalled efforts to control births in emerging economies. At the outset of the COVID pandemic, it was thought that activity restrictions would lead to widespread shortages of contraceptive pills and devices, and that this would trigger a spike in unplanned pregnancies, resulting in large numbers of births in countries with strict restrictions on abortion. In Southeast Asia, in particular, the possibility of baby booms received media coverage in the Philippines and Indonesia. So far, statistics have not confirmed any such trends, and it is believed that birth rates are declining in emerging countries as well. However, considering the underdeveloped family registration systems in Africa and South Asia and the possibility of births not being registered due to activity restrictions, statistical trends regarding numbers of births need to be viewed with a certain degree of skepticism.

Next, looking at the impact of the pandemic on deaths, we find that numbers of deaths have risen across the world, but especially in countries where caseloads were high and medical systems were frail. However, in some countries where rates of severe illness and mortality due to COVID remained low, increased hygiene awareness among the population and various efforts to prevent infection led to decreases in the prevalence of other infectious diseases, resulting in an overall drop in mortality rates.

In addition to this, the pandemic caused a reduction in the international movement of people, which put upward and downward pressure on the populations of both countries that accept immigrants receiving and the countries from which they originate.

As the pandemic winds down, its impact on population dynamics is expected to decline, but changes in values concerning human life, lifestyles, and healthcare delivery systems will probably continue to affect fertility and mortality rates over the medium to long term.

■ China's population is set to decline, while India's is expected to grow

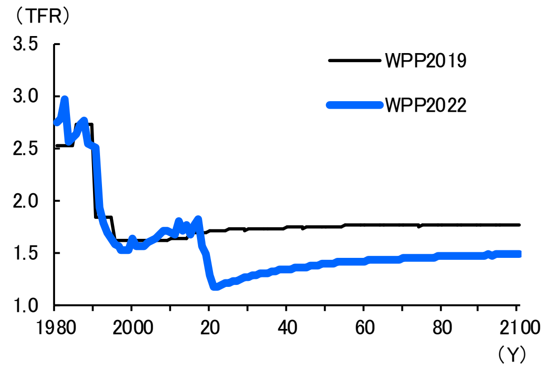
Against this backdrop, in July 2022, the UN revised its World Population Prospects (WPP) for the first time in three years. While there is no change in the view that the world population will continue to grow over the medium to long term, the latest outlook has been revised to a projection where the number of people tops out at 10.4 billion in the late 2080s, whereas the previous outlook (median estimate) forecast that the population would reach about 11 billion by 2100.

The biggest factor behind this downward revision of the future world population is the accelerating pace of population decline in China. The UN had previously thought that China's total fertility rate would remain stable at between 1.7 and 1.8 over the medium to long term, and that the country's population would still be above one billion in 2100. In contrast, the latest estimates have been revised to predict that the pace of recovery in fertility, which fell sharply amid the COVID pandemic, will be only gradual, and that the population will fall to about 800 million by 2100.

On the other hand, the population outlook for India, which is certain to surpass China as the world's most populous country in the near future, was revised upward. India's projected total population was revised upward despite its projected birth rate being revised downward, and one of the reasons for this is a lowering of the crude death rate projection. Although the country's mortality rate has temporarily increased due to the impact of COVID, medium- to long-term death rates are expected to be lower than previously projected, as the pandemic has accelerated moves to develop medical infrastructure.

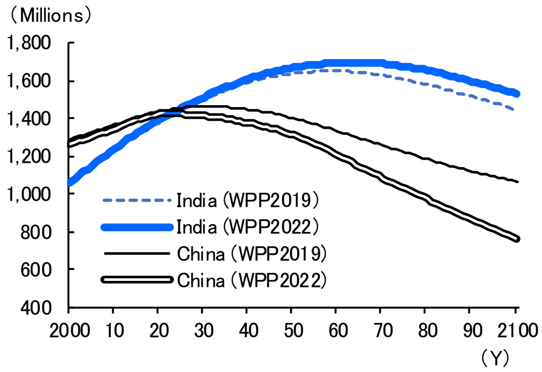
The revised population projections suggest that after India overtakes China, the population gap between the two countries may widen more rapidly than previously expected. Given the economic and social issues and business environment challenges that India faces due to its large population, and the possibility that automated production technology will be the key to industrial development in the future, it is by no means certain that the change in the population gap between the two countries will be accompanied by a shift in the locus of the Asian economy from China to India. However, there is no doubt that India will become even more important in a wide variety of global areas, including global food, energy, and environmental issues.

＜China's Total Fertility Rate＞



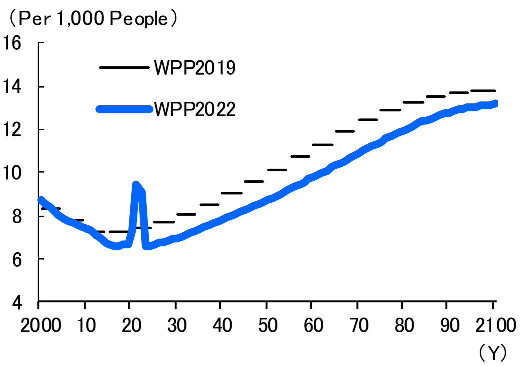
Source:United Nations "World Population Prospects" (Medium Variant)

＜China and India's Population)＞



Source:United Nations "World Population Prospects" (Medium Variant)

＜India's Crude Death Rate＞



Source:United Nations "World Population Prospects" (Medium Variant)

(Shotaro Kumagai)