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China's market, among the worst performers in the world this year, is waiting for another shoe to drop before a substantive rally is possible. As investors have sold off shares of real estate and banks amid Beijing's bids to decelerate frenzied property chase and home profiteering, a new woe is propping up on the horizon – revelation of cascading debts incurred by local governments.

China's law does not enact the provincial-, city- and county-level governments sell debts on the market, but, mysteriously, Beijing has allowed localities to raise money through their financing and investing arms. Nobody knows exactly how much they have borrowed, including mostly bank loans, diversions from other sources and even IOUs.

Entering 2010, Beijing has been alerted, and alarmed too, by a local debt that is reportedly ballooning by the day. The country's bank regulators blew the whistle first, as they found steeply rising loans “bestowed” to the local financing units that were guaranteed by provincial, city and county governments. The local debt expanded to 7.38 trillion yuan at the end of last year, said the country's banking regulatory commission, and has perhaps well exceeded 8 trillion yuan by the end of May, according to analysts.

It's no secret that China's banks, mostly state majority-owned, tend to rain loans on government-sponsored projects, while shun private businesses. The bankers often do not balk at government borrowing, because past experiences have emboldened them to ignore risks of any bad loans, which are borne by governments and tend to be written off by Beijing.

However, the colossal indebtedness of local governments, skyrocketing more than 70 percent in last year alone, has spooked economists and Central Government officials who are worried about viability of the loans, negative impact on the bank system health, and ripple effects on the broad economy.

Chinese leaders know perfectly well that the debts suffered by U.S. banks in 2008, and now suffocating some Euro-zone economies, could be financially perilous, which if not replenished with adequate funds, may wreck the boat.

The problem of amounting local debts is particularly acute now, at a time as Beijing has launched a campaign to rein in runaway home prices. As housing sales have tumbled, and prices spiral down, local governments' land-selling revenue, a major income for them, will dry up.

On June 10, Premier Wen Jiabao's State Council issued a decree, ordering all provinces to implement a thorough check of their debts, plug all loopholes of illicit fund-raising acts, clear irregular local financing and investing arms, and report to Beijing by the end of 2010 their efforts of fixing debt woes.

A house clearing-up at present stage is very necessary, as financing of local repetitive and energy-guzzling industrial projects will be terminated, and the ability of local governments' repaying bank debts be enhanced. It is strongly recommended that the number of more than 5,000 local financing and investing companies, affiliated to various levels of government, be reduced by at least half.

Some outside observers may worry about the bulging debt could drag China down, and wreck havoc on China's overall economy. The danger is unlikely to materialize, as rescue measures are being taken, and China's Central Government is well financed, among the best in the world, to stonewall any worsening of the debts.

Nevertheless, Beijing's order to repudiate some local projects, while concentrating on completing mostly infrastructure projects, will slow down the economy. It also serves as a wind-down of Beijing's US\$586 billion stimulus plan.

Chinese authorities should draw lessons from the awkwardness of the heavy local debts, disseminate the need for strict fiscal discipline and financial oversight at all levels of government, and set quotas or ceilings for each provincial government's borrowing from banks.

In the long run, systematic reform of China's central-local government finances should be done, with the Central Government now taking a predominantly majority of tax revenues to be changed. Will Beijing do it? The psycho goes if the local governments get bigger slices of the pie, the authority of the centralized government will diminish, first economically and then politically.

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