Financial Repression Still: Policy Concerns and Stagnation in China’s Corporate Bond Market

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At a 2005 Bank for International Settlement (BIS) conference on Asia's corporate bond market, People’s Bank of China (PBOC) governor Zhou Xiaochuan bluntly stated that "China’s underdeveloped corporate bond market has distorted the financing structure in the economy, which poses a threat to financial stability..." (Zhou 2006). The relatively new central bank governor clearly saw the deepening of China's corporate bond market as a desirable development over his tenure. Yet, at the end of his tenure in early 2018, corporate bonds continued to be an anemic corner of China's enormous financial system and only accounted for a small share of China's bond market. Despite repeated policy statements calling for the liberalization of the bond market and the development of a deep and market-driven corporate bond market over Zhou’s tenure (eg People's Bank of China 2017), policy concerns such as stability and low financing costs for state financial institutions drove policy makers into “quota allocation, administrative approval, and government intervention,” practices which Zhou knew in 2005 would render “the prospects for the bond market ...dismal” (Zhou 2006).

This outcome was an expected one according to the central bank independence literature. From a central bank independence perspective, a central bank whose top officials are intimately beholden to the political authorities will be pressured to put political priorities above technical objectives, such as inflation and market efficiency (Cukierman 1994; Alesina and Summers 1993; Adolph 2003). In few other countries is the political control over the central bank stricter than in China, where top central bankers are also Communist Party cadres and where a party organ, the Central Finance and Economic Leading Group, oversees the activities of the central bank (Heilmann 2005; Shih 2008). Economists Goodfriend and Prasad (2007) predicted accurately that a politically subjugated PBOC would be compelled to do the following:

(i) it might be directed to buy government debt, i.e., to finance a government deficit in whole or in part with newly created bank reserves; (ii) it might be directed to lend to banks, nonfinancial firms, or state enterprises; or (iii) it might be obliged to buy foreign assets to support a managed or fixed exchange rate.

As it turned out, the PBOC was pressured to do all of the above over Zhou’s tenure, and on an enormous scale. Central bank intervention in the above three ways, especially the first two, ultimately led to the shriveling of the corporate bond market for several reasons. First, by constantly intervening in the financial market for policy reasons, the PBOC prevented the market from establishing a yield curve. The yield curve, such as it was, was almost entirely the product of daily interventions by the PBOC, which meant investors found it difficult to price medium term macro and inflation risks accurately in the bond yields (Walter and Howie 2011).

Although central banks around the world intervene in the money market, few major central banks conduct daily, ad hoc operations to ensure absolute smoothness in the money market. As the 2017 Q4 PBOC Report on the Implementation of Monetary Policy states, “the PBOC closely monitored the supply and demand of banking system liquidity and changes in market expectations and used medium term lending facilities (MLF), pledged supplement lending (PSL) and other tools to make up medium term liquidity shortages in the banking system while using reverse repos dominated by the 7-day terms to carry out open market operation in a flexible way....” (People's Bank of China 2018). The deep distrust in the market’s ability to adjust itself led to constantly interventions by the PBOC on both the short-end and the long-end of the yield curve on a daily basis. In this tightly managed environment, bond investors’ trading became a guessing game of what the PBOC would do next. Alternatively, bond
investors illegally arbitragd small differences in bond prices to personally profit by setting up personal accounts on the repo market (Yi 2013).

Related, because market participants knew that the PBOC was under enormous pressure to ensure absolute stability in the interbank bond market, they also expected the central bank to bail out any major distressed debtor, especially in the interbank bond market. This incentivized investors and credit rating agencies to treat all issuers as low risks, thus compressing yields between issuers (Xie 2017; Walter and Howie 2011). In other words, the very success of the PBOC’s backstop of debtors decreased creditors’ interest in corporate bonds because the returns were not very attractive. Finally, as discussed in detail below, large scale PBOC interventions to force major creditors, i.e. the banks, to buy certain types of bonds crowded out corporate issuers, causing a shriveling of the corporate bond market after 2015.

In the following discussion, I first provide an overview of China’s corporate bond market as it stood at the end of 2017, relative to the overall bond market and China’s financial system as a whole. In essence, the role of corporate bond waned over time after an initial take-off period between 2005 and 2011. In recent years, corporate bonds have been rendered marginal in China’s overall bond market because of the over-riding need to lower the costs of local government debt via the debt conversion program launched in 2014. Furthermore, banks, which constantly needed recapitalization, began to rely heavily on the bond market. The enormity of these two policy demands marginalized corporate issuers. In order to partially compensate banks, which lost trillions in high yielding assets in the conversion program, the PBOC also created a profitability carry trade opportunity for bond investors by injecting an enormous amount of liquidity into the interbank market. However, this in turn led to over-leveraging among non-bank financial institutions.

The Chinese Bond Market: An Overview

As an economy and market institutions mature, the development of a corporate bond market becomes desirable because firms can rely on a much wider array of investors to provide financing besides the banks, which on average reduces the costs of financing (Goodfriend 2006). Moreover, the development of a bond market creates competition for banks, making banks more efficient allocators of money (Sundaresan 2006). Finally, since bond investors demand a high degree of transparency from the issuers, a well-functioning corporate bond market provides information about the short-term and long-term solvency of companies, which may make the entire market more resilient in the face of sudden liquidity shocks (Flannery 1986; Sundaresan 2006).

For Zhou Xiaochuan and China’s financial regulators in the early 2000s, the development of the corporate bond market also served to push forward needed reform in the financial sector, including bankruptcy laws, better accounting standards, a market-based yield curve, and the diminution of administrative intervention, especially by the National Development and Reform Commission (NDRC) (Zhou 2006; Walter and Howie 2011). Even in the early 2000s, firms which wanted to issue a bond needed approvals by governments at multiple levels, and the funds raised often could not be spent without government approval (Zhang 2000). On top of that, bond yields were tightly pegged to the
administratively determined interest rates set by the PBOC (Xie 2001). Zhou wanted to reform these features of the Chinese financial system.

Yet, although accounting standards improved and interest rates liberalized to some extent over the years (Mu 2006), the vision of a deep and liquid corporate bond market still did not materialize at the beginning of 2018 at the end of Zhou’s tenure. Rampant moral hazard, quota allocation, and administrative interventions still plagued the bond market, preventing its organic growth. Instead of creating a deeply liquid bond market which corrected itself, the Chinese government has fostered a market where participants still mainly reacted to policy signals, as the account below shows.

Figure 1 shows that although corporate bond issuance became dominant in the bond market from 2005 to 2010, its role in the bond market began to wane in 2011. After the middle of 2015, average monthly gross issuance of corporate bonds fell to only 10% of gross monthly issuance. But if not corporations, who were issuing bonds? Starting around 2014, the Chinese government, especially local governments, began to issue a torrent of bonds. Into 2015, because banks needed another round of recapitalization to enable continual balance sheet expansion, banks and non-bank financial institutions also began to issue a large amount of bonds, thus eclipsing issuance by non-financial corporations (Figure 1). As detailed below, this did not reflect an organic shift in the preferences of investors, but rather was the result of administrative interventions by the Chinese government.

**Figure 1: 6 Month Moving Average of Corporate Bond Issuance as a Share of Monthly Gross Issuance**

![Image of Figure 1](image-url)

Source: CEIC
Figure 2 reveals clearly the results of having government and financial issuance dominate the bond market. By the end of 2017, while corporate bonds outstanding hovered around 10% of GDP, the overall bond market has grown to 80% of nominal GDP from around 50% at the beginning of 2010s. This was not always the case. Corporate notes outstanding rose very rapidly from 2007 to 2011, but its share of the bond market was then eclipsed by the other categories of issuers. In essence Figure 2 shows that central and local governments, as well as the wide array of mostly state-owned financial institutions, had debt outstanding to the tune of 70% of GDP by the end of 2017. Just as Zhou Xiaochuan had feared, the corporate bond market as of the end of 2017 remained “dismal” (Zhou 2006).

**Figure 2: Corporate and All Bonds Outstanding as a Share of Nominal GDP (%)**

![Graph showing corporate and all bonds outstanding as a share of GDP](image)

Source: CEIC

In terms of corporate bonds’ role in financing the “real economy,” its contribution to the average monthly total social finance (TSF), the PBOC’s flow metric of financing to the “real economy,” hovered between 10 and 30% in recent years (Figure 3). Since the middle of 2016, however, corporate bond’s contribution to monthly TSF fell to below 10% and even briefly entered negative territory. This was a strange collapse in the absence of a financial crisis and suggests a sudden turn in financial policy. Figure 1 through Figure 3 show nothing short of a marginalization of corporate bonds in China’s financial landscape, which was a strange outcome in a financial system with assets well over 3 times GDP. While the slow-down in corporate bond issuance between 2011 and 2015 likely had something to do with general moral hazard in the bond market and yields compression, we focus on the total marginalization of corporate bonds after 2015 in the discussion below.
Policy Conundrums: Local Debt Conversion and Liquidity Withdrawal in 2015

2015 was an unusually challenging year for China’s technocrats. They were faced with challenging policy demands even if there had not been the equity sell-off and shocks in the foreign exchange (FX) market. In reality, they had to meet these policy demands even in the midst of these shocks. From a liquidity perspective, the foreign exchange (FX) outflows, which drastically slowed the pace of money creation, posed a greater challenge for the PBOC than the stock market sell-off. While a sell-off can be stopped with administrative decrees and PBOC liquidity injections to brokers, outflows decreased money supply even as the central bank had a mandate to create sufficient liquidity to finance growth and the massive debt conversion program for local government debt.

As seen on Figure 4, FX outflows in late 2014 and early 2015 led to some of the slowest growth rates in reserve money since the beginning of the reform. FX inflows had been a steady creator of high-power money in China via PBOC purchase of net inflows with RMB, which both led to the accumulation of China’s FX reserves and money supply creation. This process essentially unraveled starting the fourth quarter of 2014 as FX outflows rapidly depleted China’s reserve money (Figure 4). By the second half of 2015, reserve money saw consecutive months of negative growth averaging around negative 300 billion RMB per month (Figure 4). China would have careened into a financial crisis had that pace of monetary contraction continued unabated.
In addition to a rapidly contracting money supply, the PBOC also faced two enormous new sinkholes for liquidity in 2015. First, the stock market collapse in mid-2015 required the PBOC to inject hundreds of billions of RMB into the stock market via the China Securities Finance Corporation, Central Huijin Corporation, and the various state-owned brokers (Reuters 2015). However, the scale of the July 2015 bailout was dwarfed by the liquidity need of the local debt conversion program, which saw a net increase of 3.7 trillion RMB in municipal bonds in 2015 alone (Euromoney Institutional Investor PLC 2018). The PBOC had to ensure sufficient liquidity in the bond market to absorb this enormous wave of local debt issuance even in the midst of serious turmoil.

As observers had noted as early as 2010, China sustained growth during the 2009 global financial crisis due to extremely high level of leveraging fueled by borrowing by local government financing vehicles (LGFVs), which were arms of the local governments structured as SOEs (Shih 2010). By 2012, outside observers estimated that outstanding LGFV debt stood at 19 trillion RMB, some 37% of China’s GDP (Zhang et al. 2013; Shih 2010). As the Chinese government uncovered the horrendous extent of the local debt problems, the Hu-Wen leadership began to explore various remedies. Not wanting a growth slow down, however, local debt continued to grow unabated through the Hu-Wen years. A half-hearted government audit in 2011 uncovered only 10 trillion RMB in local debt (Jia 2013). When the new administration came to power in late 2012, they immediately ordered a thorough audit, which uncovered over 18 trillion RMB in local debt by mid-2013, still a low estimate in all likelihood.

Initially, the new administration put the China Banking Regulatory Commission (CBRC) in charge of the local debt problem in order to prevent LGFVs from increasing their borrowing via trust products and wealth management products (WMPs) (Yi et al. 2013). From the government’s perspective, local
borrowing through these high-yield channels presented two major problems. First, these channels exacerbated debt level because local governments in most cases lacked the ability to service high interest payments, which meant unpaid interest needed to be capitalized into new debt. Second, the ultimate creditors in trust products and WMPs were often households, who would protest in the event of defaults. Over time, however, the CBRC discovered that it could not resolve the underlying problem of heavy local indebtedness. For one, the political leadership continued to demand local governments to invest more so as to maintain economic growth. In 2014, for example, Premier Li Keqiang called for a growth target of 7.5% (Li 2014). In order to reach the growth target, the thousands of local governments still needed to increase the scale of wasteful investment, which banks needed to finance.

As the local debt problem grew in 2011-13, experts in the Ministry of Finance began to explore the approach of “open the front door, close the back door.” This approach converted local debt parked in high yielding trust products and WMPs into official municipal bonds. (Jia 2013). Because the newly issued municipal bonds were guaranteed by the central government, their yields were significantly lower, thus saving local governments hundreds of billions in interest payments. The mechanism for the debt conversion proceeded in the following way. First, local governments issued municipal debt on a large scale according to a Ministry of Finance (MOF) debt issuance plan. Second, the proceeds of the issuance were used to repay high interest bank and trust loans, again according to the MOF plan (Ministry of Finance 2016). The borrower could not divert bond proceeds for other uses.

The conversion would not reduce the overall size of local government debt, but would drastically reduce interest payments and cash flow pressure on the local governments. To be sure, because the substitution of high yielding loans by these bonds reduced banks’ profitability, banks were far from pleased by the development. However, the Ministry of Finance’s “innovation” was to force creditor banks to buy these bonds through “designated allotments” of these securities (Li 2015). The State Council soon ordered creditor banks, many of them smaller local banks, to participate in the debt substitution program, with which banks had no choice but to comply (State Council 2014). This was classic financial repression as banks continued to offer depositors artificially low rates in order to buy low yielding municipal securities in large quantities.

The political leadership apparently saw this as the perfect solution. In July 2015, in the midst of China’s steepest stock market sell-off in recent memory, an excited Li Keqiang announced to a group of economists that “we must increase the scale of (the debt exchange program)” (Cheng 2015). Over the course of 2015, the State Council authorized the Ministry of Finance to oversee the issuance of 3.7 trillion RMB in local municipal debt (Cheng 2015). In 2016, municipal debt outstanding grew by an additional 5.8 trillion RMB. Then Minister of Finance Lou Jiwei victoriously announced in December 2015 that local governments which had undergone debt exchange saw the average interest rate of their debt fall from 10% to 3.5%, drastically reducing the cash flow pressure on these localities (Cheng 2015).

As the debt replacement shifted into high gear in 2015, however, it also coincided with the contraction in reserve money due to foreign exchange outflows from China. The PBOC needed to quickly replace the shrinking money supply with a new source of liquidity. Without new liquidity, banks would have been forced into a painful choice between providing financing to new investment, which was still necessary to maintain growth, and purchasing the newly issued municipal notes, which served the function of rolling over existing debt without large-scale defaults. As Figure 5 shows, once the muni-bond program got going, it on average demanded financial institutions in China to buy 700 to 900 billion RMB in net new notes per month. The shrinking reserve money seen during the second half of 2015
simply would have made this impossible. A government with less ability to intervene in the financial market would have chosen to focus on stabilizing the financial market while delaying the local debt conversion program. With strict control over the PBOC, however, the Chinese Communist Party decided to proceed with the debt conversion even while the PBOC stabilized the financial market. Zhou and his colleagues at the PBOC needed to find a way to finance all the various demands from the party.

Figure 5: 6MMA in the Monthly Net Issuance of Central and Municipal Government Bonds (bln RMB)

Source: CEIC

The Zhou Xiaochuan Put

Throughout the course of Zhou Xiaochuan’s career as the governor of the PBOC, he pushed for many reform. However, as a cadre in the Chinese Communist Party, his ability to carry out fundamental reform was also constrained by the multiple political demands placed on his office by higher level party officials (Shih 2007; Lardy 1998). The political demands made on his office was likely greater in the summer of 2015 than any other time in his tenure, when the stock market crash and tidal waves of FX outflows coincided with the need to finance the trillion yuan debt replacement program. Faced with these impossible demands, the central bank did not allow the market to determine where money flowed. Market forces in the middle of 2015 might well have driven additional hundreds of billions of dollars out of China which would have necessitated a steep devaluation of the RMB. Instead, the PBOC instituted draconian capital controls and intervened in the interbank market to inject trillions in liquidity with the specific purpose of providing banks with liquidity with which to purchase municipal bonds.
The PBOC accomplished this by lending high power money to banks via reverse repo operations. In a reverse repo, the lender, in this case the PBOC or the policy banks, purchases securities from the borrower but at the same time obtains an agreement from the seller (borrower) that she will repurchase the securities in the near future. In essence, reverse repos were loans from the PBOC secured by bonds as collaterals. The PBOC specifically used this tool to inject liquidity because it allowed banks to put up newly purchased municipal bonds as collateral to obtain funding, which can be used to purchase even more municipal bonds. Moreover, as Figure 6 suggests, PBOC injections also allowed banks to lend to one another, especially the deposit-rich large commercial banks such as the Big Four state banks.

**Figure 6: 6MMA of Net Repo Outstanding by the PBOC/Policy Banks and by Large Commercial Banks (bln RMB)**

![Graph showing 6MMA of Net Repo Outstanding by the PBOC/Policy Banks and by Large Commercial Banks](image)

Source: CEIC

As one can see on Figure 6, the liquidity injections were enormous in scale. PBOC net repo (net borrowing) on the interbank market fell from an average of negative 4 trillion RMB in November of 2014 to an average of negative 12 trillion RMB one year later. That represented a net injection (lending) of 8 trillion RMB in one year to China’s financial institutions, equivalent to 11% of China’s nominal GDP in 2015. Of course, the flood of liquidity provided by the PBOC also prevented the collapse of high power money and deposits in the commercial banks, as one can see on Figure 4. This further empowered large commercial banks to lend an additional 7 trillion RMB into the interbank market. All told, PBOC reverse repo operations directly or indirectly injected 15 trillion RMB into the interbank market from late 2014
to late 2015. This massive easing operation reversed the negative growth in reserve money by early 2016 such that reserve money enjoyed average monthly growth of above 100 billion RMB (Figure 4). This took place even as the foreign exchange reserves continued its depletion in 2016.

But which financial institutions took advantage of this flood of liquidity to purchase government bonds? As Figure 7 reveals, the main borrowers included city commercial banks (CCBs) and non-bank financial institutions (NBFIs) such as brokers, insurance companies, and asset managers. CCB net repo (net borrowing) jumped from 5 trillion RMB at the beginning of 2015 to 15 trillion RMB by May. This was not surprising considering that CCBs were major lenders to local governments, which had forced CCBs into lending trillions to local projects (Shih 2010). In the debt conversion program, CCBs were under great pressure to convert their high interest loans to local government into low yield municipal bonds. With much less ability to absorb new deposits to finance the debt purchase, the PBOC needed to provide CCBs with a helping hand totaling over 10 trillion RMB. CCB net repo further rose to close to 20 trillion RMB by the middle of 2016 (Figure 7). Meanwhile, NBFIs, which did not even have deposits, saw their net repos jumped from 1.5 trillion RMB to close to 6 trillion RMB by late 2015.

**Figure 7: Net Repo Outstanding of City Commercial Banks and Non-Bank Financial Institutions (bln RMB)**

![Figure 7: Net Repo Outstanding of City Commercial Banks and Non-Bank Financial Institutions (bln RMB)](image)

Source: CEIC

While NBFIs borrowed from the PBOC as part of the stock rescue program in 2015, they also did so out of profit considerations. Figure 8 shows the 7-day repo rates, which were heavily influenced by reverse
repo rates and quantity set by the PBOC on a daily basis, and 10-year Chinese treasury yields, which reflected longer term market expectation on interest rates. One can see clearly that starting in early 2015, the PBOC made sure that daily operations drove 7-day repo rates well below 10-year treasury yields, which roughly reflected the yields of the newly issued municipal debt. The lowering of 7-day repo rates allowed all financial institutions, but especially NBFIs which traded actively on the repo market, to profit from the carry trade. In this carry trade, banks or NBFIs borrowed cheaply on the repo market and used the proceeds to purchase higher yielding treasuries or municipal bonds. Because the newly purchased securities were essentially risk-free, the carry trade provided a spread between short-term borrowing costs and long-term yields without incurring any default risks. As long as the annualized borrowing costs were below the yields of the purchased bonds, investors earned a spread.

For the city commercial banks, the spread likely represented a minor compensation from the PBOC to banks which were compelled to participate in the debt conversion program. Banks were lending at the 7-10% range to lower level LGFVs. Suddenly, they had to accept the 3-4% returns of the municipal debt. The spread at least partially compensated CCBs for the collapse in returns on assets.

For non-bank financial institutions (NBFIs) which never lent very much to local governments, however, the carry trade incentivized them to borrow more on the interbank market to buy newly issued debt. In essence, lightly regulated NBFIs could put up a tranche of bonds as collateral to borrow funds from the PBOC or banks, the proceeds of which can be used to purchase another tranche, which in turn was used to borrow more money and so on. The ability of NBFIs to multiply their balance sheets without provision created very healthy appetite for bonds. As Figure 8 shows, the spread was rather healthy at over 1% (100 bps) for much of 2015, thus providing a very attractive investment option for NBFIs which engaged in levered bets on bonds. Not surprisingly, net repo of NBFIs jumped from 1.5 trillion at the end of 2014 to as high as 6 trillion RMB at the end of 2015 (Figure 7). These transactions, however, represented highly risky bets because while banks had deposits, NBFIs were purely borrowing very short-term funds from the interbank market to finance their bond purchases. If short-term rates were to spike up, their cash flows would invert, forcing them to liquidate at steep losses.

To be sure, government issuers were not the only beneficiaries of the carry trade engineered by the PBOC. Figure 3 shows that corporate issuers also enjoyed healthy demand for their bonds in 2015 and 2016. Yet, as Figure 1 shows, corporate note issuance was still dwarfed by government and financial institution issuance after 2015. Again, this was the result of the government ordering banks to buy up local government issuance, financed by PBOC reverse repos. Left on their own, banks likely would have preferred to purchase higher yielding corporate notes.
After the Deluge: The Consequences of Heavy Policy Interventions in the Money Market

Instead of fostering a deep and liberalized corporate bond market, policy demands leading up to 2015 compelled the PBOC to inject massive liquidity into the interbank bond market in 2015. Creditor banks then used the new liquidity to purchase newly issued municipal bonds in accordance to Ministry of Finance plans. As Figures 1 and Figure 3 reveal, a by-product of the local debt conversion program was the marginalization of corporate debt. This of course meant that a transparent market, which objectively rated the credit-worthiness of and efficiently allocated capital to China’s corporate sector would not be forth-coming in the near future.

Another consequence was that the combination of the carry trade, engineered by the PBOC, and the usual assumption of risk-free bonds encouraged NBFIs to engage in highly risky levered bets in China’s bond market. Figure 9 shows that NBFIs’ use of borrowed money (via repos) to purchase bonds rose from 20% in late 2014 to close to 40% in mid-2015. On top of that, in an environment of cheap short-term capital, NBFIs began to lend money to each other using unofficial repos, called daichis (holding on behalf), which might have topped 1 trillion RMB by late 2016 (Shen 2017). Unofficial repo had the advantage that the borrower could use one tranche of bonds to lever up infinitely, as long as she found
new counterparties willing to lend. If repo rates continued to be low and bond yields trended downward, investors in a heavily levered bet stood to gain enormous profits.

Knowing that these dangerous positions were building up, the PBOC began to slow the pace of liquidity injection in late 2016, which led to spikes in the 7-day repo rates (Figure 8). The sudden escalation of short-term interest signaled to the market the end of the bond bull market, 10-year treasury yields also began to go up (Figure 8). Investors which had borrowed heavily to buy 10-year notes suddenly found themselves paying much higher interest while still receiving the same interest payments from bonds purchased prior to the second half of 2016. Their cash flows, which had been positive from the carry trade, turned negative. Some funds which had borrowed heavily on the unofficial repo market defaulted on their creditors, necessitating CSRC and PBOC interventions to stave off a crisis (Shen 2017). Overall bond issuance, including municipal bonds, screeched to a halt in the first quarter of 2017 as a result of deep deleveraging by NBFIs in late 2016 (Figure 9). Although this episode was not nearly as severe as the challenge China faced in 2015, it yet again illustrated the unhealthy cycle of bailout by the PBOC, followed by rapid leveraging and the emergence of a new bubble, which necessitates another round of bailout.

Figure 9: The Degree of Leveraging by NBFIs

Despite the short-term effectiveness of the local debt conversion program, the underlying problem was not solved. According to Tsinghua University economist Bai Chong’en and coauthors, local government debt, whether recognized by the government or not, had grown to 45 trillion RMB by the end of 2015, or 67% of China’s nominal GDP (Bai et al. 2016). In combination with China’s official debt of 10 trillion RMB, China’s governmental debt to GDP ratio reached 82% by the end of 2015, well above the
international warning line of 60%. The alarming debt level will create problems for the newly appointed technocrats of China, including PBOC Governor Yi Gang and PBOC party secretary Guo Shuqing. Furthermore, the debt exchange program had meant to “close the back door” of LGFV borrowing. However, disclosures from the bond market showed that LGFVs continued to issue their own debt as corporate debt to the tune of tens of billions of RMB per month, sometimes exceeding even 100 billion per month. This meant that corporate debt issued by non-infrastructure companies represented a tiny proportion of bond issuance every month. Knowing that the PBOC will always come to the rescue, the local governments and even the Ministry of Finance have no incentive to put a genuine ceiling on local government borrowing. After all, when the central bank has no independence, rising tides will lift all boats.

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