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Rethinking China's Debt

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Local government debt is the latest smoking gun for those predicting China's economy will eventually run aground.

China's high economic growth may continue to smooth over any problems. But that isn't a fix Beijing can keep counting on.

The issue is rooted in last year's massive expansion of bank lending. Much of this went to local government-backed investment vehicles, which then funded infrastructure projects across China.

Victor Shih, an assistant professor of political science at Northwestern University, reckons debt at these entities reached $1.7 trillion by the end of 2009. Most will need continuing funding, so that figure could more than double by the end of 2011.

Because Beijing supports both the banks and the local governments, this lending should arguably be added to the central government's debt figures. Doing that, Mr. Shih estimates, would make China's debt-to-GDP ratio, around 20% in 2009, closer to 71%. By 2011 that could rise to 96%.

Acknowledging this as part of the central government's liabilities does give a truer picture of China's fiscal position. But it still isn't particularly worrying by international standards. The U.S. and U.K., for example, expect similar debt-to-GDP ratios in coming years. Japan's is already far higher.

Anyway, the debt will be a problem for Beijing only if the loans go bad and the central government is forced to recapitalize local governments or the banks. Anecdotal evidence of misplaced investment and corruption make some fear eventual heavy write-offs. But optimists suggest most of the projects that have received funding will prove viable.

China's faced similar bad debt problems in the past, and has grown its way out of them. What's left of the nonperforming loans piled up in the late 1990s accounts for a much smaller percentage of GDP now than it did a decade ago.

The same trick could work again, analysts at Gavekal Research figure. Even if China's growth slows to 7% per year on average in the next decade, nonperforming loans will still only rise to a manageable 9% of GDP by 2019, they estimate.

Beijing, though, shouldn't imagine such tactics can work forever. One big drawback of China's current debt-fueled growth is that it has set back the cause of making China's banking sector more commercially oriented. The reform path needs to be found again if China's economy is to find a more sustainable long-term footing.