China's LGFV Crisis 2011: The Conflict between Local Autonomy, National Interest and Financial Reforms

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Summary

In 2008, China launched an ambitious economic stimulus package to counter the global financial crisis. Its funding was left largely to local governments which borrowed heavily from the banks in 2009. Much of this lending was illegal or for the account of dubious local government financial vehicles (LGFVs); inadequately secured; and devoted mainly to property and infrastructure projects, leading to a real estate 'bubble'. A surge in inflation and loan defaults became unavoidable.

Long-standing shortfalls in China's administrative and regulatory infrastructures were aggravated, and previous measures to reduce political interference with bank lending and to reduce local governments' involvement in property and other speculative activities were reversed. These unintended consequences of the stimulus package were apparent almost immediately both to senior Chinese bankers and to the IMF but did not represent a major concern until 2011 when comprehensive loan data became available, together with information on potentially insolvent LGFVs.

This paper reviews how a crisis of such dimensions developed so swiftly and why central bankers and financial regulators seemed powerless to intervene. The analysis shows that China's retreat from a 'command economy' has left local governments almost totally responsible for both organising and financing economic and social development. Local officials have a higher political status than local bank staff, who have found themselves compelled to fund local projects and enterprises regardless of their credit-worthiness. The state's write-offs for the inevitable non-performing loans have been substantial.

The 2011 crisis was particularly grave, this paper shows, because almost all restraints on local government funding had been suspended in 2009. The serious threat of systemic instability has since led to reforms in the supervision of both banking and public finances. However, the nation's underdeveloped financial markets mean that the state remains heavily dependent on local administrations to fund the implementation of national development programmes.