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Squeeze on local government finances could mean risk of further downward pressure on the Chinese economy

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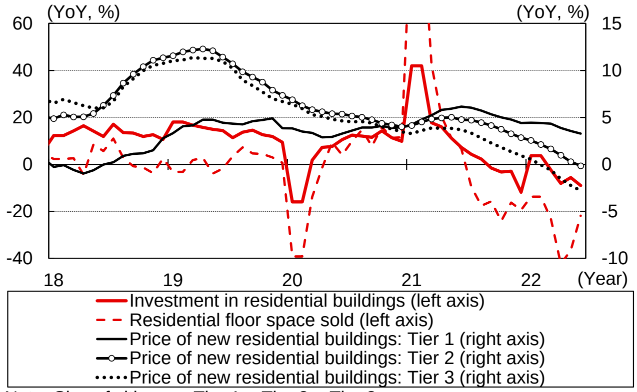
China's real GDP growth rate for the April-June quarter was 0.4% YoY. While it narrowly avoided a contraction, this was the lowest growth since the first quarter of the pandemic (-6.9% YoY in January-March 2020). There appears to be some deep scars from the stringent restrictions on movement as part of China's "zero COVID-19" policy, which aimed to control the spread of infection.

Since June, the number of cases has fallen to low levels and economic disruption is slowly dissipating. However, the situation in the real estate market, which has been a risk for longer than the pandemic, continues to be a cause for concern. Since China tightened restrictions related to real estate in 2020, there has been a marked deterioration in large property developers' balance sheets. This has resulted in a rapid worsening of investment and sales in the property market from the latter half of 2021 (Chart 1), and there were new defaults recorded among large developers in July this year.

The direct impacts of this deterioration of the real estate market are huge since the real estate and construction industries account for around 10% of nominal GDP. On top of this, it is also important to not overlook the concerns about downward pressure on the economy from the squeeze on local government finances. Local government finances were previously referred to as "land finance" because the main source of funding are the proceeds from the sale of state-owned land use rights (accounts for 40% of local government revenue). Income from the January-June period remained sluggish, with a slump in the real estate market of -31.4% YoY (Chart 2), and it appears the situation is particularly severe in regional cities (Tiers 2 and 3) where there is considerable worsening of market conditions. Public health measures to address the COVID-19 pandemic and financial support for the private sector have already put a strain on local governments' finances, and there are cases where cities with limited financial resources are effectively bankrupt.

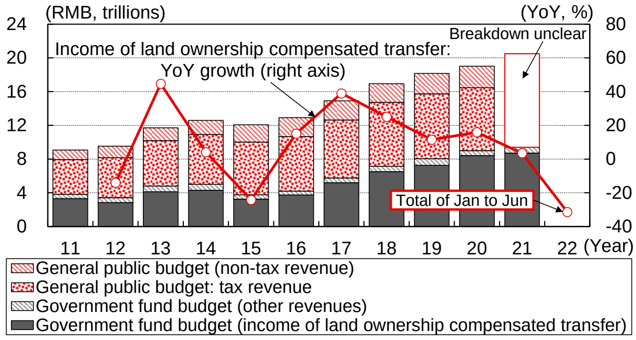
China has used mostly infrastructure investment by local governments as the main driving force behind its economic recovery up until now, which was also the case with its economic stimulus package of RMB 4 trillion during the global financial crisis. This time, the central government will accelerate its issuing of special local government bonds as another source of financing for infrastructure investment to support its economic recovery during the latter half of the year, and has instructed that all the funds raised are to be used in August. However, the deterioration in local governments' finances mentioned above will be an obstacle in carrying out stable investment in infrastructure and there is a possibility that they will not be able to fully realise the effectiveness of this policy. In addition, it will also be important to keep an eye on the rise of medium-term risks related to the repayment of interest on the funds raised.

Chart 1: Indicators Related to China's Real Estate Sector



Note: Size of cities are Tier 1 > Tier 2 > Tier 3
Source: National Bureau of Statistics of China,
MUFG Bank Economic Research Office

Chart 2: Local Governments' Revenue



Note: 1. The general public budget is used for general operation of the state with tax revenue as the main source of income (equivalent to Japan's general account).The government fund budget is used for public works based on assets collected from specific subjects (equivalent to Japan's special account)
2. Excludes revenue from transfers from the central government and issuance of local government bonds
Source: Ministry of Finance of the Peoples Republic of China,
MUFG Bank Economic Research Office

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