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A tale of two debt burdens: a day of reckoning for China's debt-fueled infrastructure development at home and abroad

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From its development in recent years of the most extensive network in the world of high-speed railways to its gleaming new, ultra-modern airports in cities large and small across China, to what is reputed to be the longest sea-crossing bridge in the world, China has developed a global reputation as a master builder of infrastructure. Yet, in light of China's history, this should not be a surprising development since China has long had a reputation as a master builder of impressive public works as reflected, for example, in the Grand Canal, the Forbidden City, and, of course, the Great Wall of China that were constructed by Chinese dynasties in ancient times.

In the current era, China has undertaken large-scale infrastructure development both at home and abroad. Overseas, China has undertaken massive infrastructure development around the globe under the umbrella of its widely heralded Belt and Road Initiative (BRI), a signature initiative of Xi Jinping's tenure as the leader of China.

The BRI has supported the construction of, among other things, ports, airports, highways, railways, power projects, and special economic zones in numerous countries extending from Asia to Africa to Latin America and points in-between. Within China itself, a significant amount of infrastructure development has been carried out at the level of local governments, principally through entities known as Local Government Financing Vehicles (LGFVs).

This development of infrastructure, whether in China or abroad, has involved raising massive amounts of debt. Specifically, with respect to BRI projects, Chinese financial institutions, principally its so-called "policy banks" (e.g., China Development Bank, Export-Import Bank of China, etc.) and its large, leading state-owned commercial banks (e.g., ICBC, China Construction Bank, etc.) have loaned BRI borrower countries, mostly developing countries and emerging economies, on the order of approximately a trillion dollars.[1] LGFVs, on the other hand, have issued bonds and borrowed money on a truly staggering scale, with the IMF, for example, estimating that LGFVs have total outstanding debt of approximately nine trillion dollars.[2]

To be sure, the incurrence of large amounts of debt to finance infrastructure development is not in and of itself problematic. On the contrary, it is virtually a sine qua non of infrastructure development that, in addition to whatever equity may be invested in an infrastructure project, a certain amount of debt will be also necessary to finance the development and construction of infrastructure projects.

The concern arises, though, when the borrowing entities become overleveraged and encounter serious problems in their ability to repay outstanding debt, i.e., when borrowers begin to experience financial distress and face debt sustainability challenges. Unfortunately, that is exactly where things stand today with many BRI borrower countries and LGFVs as a whole: they are now facing serious financial distress and huge debt sustainability challenges.

In the world of infrastructure development, borrowers are not likely to have an unsustainable debt burden if the underlying infrastructure project is generating adequate cash flow to repay the outstanding debt. Generally, before lenders and investors put money into infrastructure projects, they will (or should) conduct an economic feasibility study to determine whether the proposed project will be economically viable.

This involves undertaking a careful and thorough analysis of the project's ability to generate sufficient revenues over the life of the project both to repay debt to the project's lenders and produce an equity return for the project's investors, and this in turn requires an assessment or forecast of whether there will be adequate demand for a project's services or outputs (as well as an assessment, for example, of the costs of constructing and operating the project and the price or tariff for the project's output or services and the costs for any project inputs).[3]

If there is not such adequate demand (or if there are other problems affecting the project's economics such as cost overruns and construction delays) and consequently not a sufficient revenue stream to service debt and provide equity returns, then the infrastructure project in question may become economically unviable and therefore unable to service its debt, as we will see in greater detail in our discussion below of specific BRI projects. In a worst-case scenario where there is inadequate demand for a project's output, such a project may develop into an under-utilised or even unused asset, i.e., a 'white elephant' (assuming that the project does not receive revenues from other sources such as government subsidies or cash or equity infusions).

There are many factors that have contributed to the serious financial stress currently being experienced by BRI borrower countries and LGFVs. In this article, however, we will focus on one important factor: namely, the underlying financial/economic viability (or the lack thereof) of Chinese infrastructure projects overseas (i.e., BRI-financed projects) and domestically (i.e., LGFV-financed projects) and how this has seriously affected the debt sustainability of the respective debt burdens of specific BRI projects and LGFVs as a whole.

In other words, we will consider how the debt distress being experienced by BRI countries, on the one hand, and LGFVs, on the other hand, can in many ways be traced back to the lack of economic/financial viability of the underlying infrastructure projects.

BRI projects

There are many BRI borrower countries around the globe that are experiencing some degree of sovereign debt distress. And within a number of BRI countries, there are many BRI projects that have proven to be uneconomic – whether due to construction delays, cost overruns, the failure to produce anticipated revenues, and so forth – and which are therefore unable to service their outstanding debt. In turn, this has been a major contributing factor to the sovereign debt distress being experienced by a range of these BRI countries.

Hambantota Port Project (Sri Lanka)

Of course, the poster child for this phenomenon has been the now-infamous Hambantota port project in southern Sri Lanka. There was hardly any vessel traffic coming into the port in its first few years of operations, and what vessel traffic there was fell far below what had been fairly healthy projections for anticipated vessel traffic[4] on the order of 2500 vessels annually.[5]

In fact, it was reported that, in all of 2012, only 34 vessels (or less than one vessel a week) in total berthed at the Hambantota port,[6] hardly the type of vessel traffic that could be reasonably be expected to support such a costly and expansive port project. (The Hambantota port project was completed and went into service in the early 2010s even before the formal launch of the BRI program in 2013, but it is generally thought of as a BRI project because the Chinese government folded the project into the BRI program after its official launch.)

A key problem with the Hambantota port project was that shipping companies saw no need to call on the Hambantota port which was located in a relatively remote part of Sri Lanka whereas Sri Lanka's other major port, the port in the capital city of Colombo, was much more easily accessible and had much greater capacity and infrastructure to handle a decent flow of vessel traffic.

There has been widespread speculation that the Hambantota port project was sited in such a remote location in Sri Lanka because the Hambantota area of Sri Lanka was the political home base of the Rajapaksa family, the political dynasty that ruled Sri Lanka for many years until President Gotabaya Rajapaksa was forced to flee Sri Lanka in July 2022 in the face of massive demonstrations against his rule.

The net result was that the Hambantota port generated scant revenues and therefore found itself unable to service its outstanding debt on schedule. In 2017, the financial difficulties of the Hambantota port project ultimately led to what has widely (but not universally[7]) been referred to as a debt-for-equity swap. Under the debt-for-equity narrative, the Sri Lankan borrower, the Sri Lanka Ports Authority, was forced to give up control of the port in exchange for a substantial write-off of the outstanding debt owed to Chinese lenders.

This narrative further provides that a Chinese state-owned company, China Merchants Port Holdings Company Limited, was granted a 99-year lease concession on the port and surrounding land in return for the Chinese lenders in question agreeing to write off a significant portion of the outstanding debt that they were owed (the total debt for the project amounted to approximately US$1.3bn or more).

Crucially though, whether or not one subscribes to the debt-for-equity narrative or to an alternative one, the Chinese government gained control of an asset with potentially great strategic significance as the Hambantota port sits astride important shipping lanes in the Indian Ocean and is in relatively close proximity to India, a geopolitical rival of China.

Other troubled BRI projects

Apart from the Hambantota project, there have been a host of other BRI projects that have proven to be economically unviable or that have otherwise been beset by major problems such as significant cost overruns on construction, lengthy delays in completing construction, contractor disputes, and governance/corruption issues.

Standard Gauge Railway (Kenya)

Africa has been home to numerous BRI projects, but many of these BRI projects have encountered significant difficulties that have rendered the projects uneconomic and/or financially distressed with serious debt sustainability challenges.

A case in point has been the Standard Gauge Railway (SGR) project in Kenya stretching over a route of approximately 480 kilometers that was designed to connect Nairobi, Kenya's capital city and commercial center, with Mombasa, its major port on the Indian Ocean. The SGR was intended to serve as a replacement for a railway along the same route dating to the British colonial era that was in a state of serious disrepair. As was intended, the SGR has dramatically improved travel times by rail between Nairobi and Mombasa, cutting them roughly in half.[8]

However, the SGR project has been plagued by a wide range of problems. Among other issues, passenger and freight volumes on the SGR came in far below projections. For example, in its early years at least, the SGR ended up carrying only four to five million tons of cargo annually, "implying that the SGR was seriously underutilised and thus not generating expected revenues", according to a Council on Foreign Relations report.[9]

In addition, there have been major delays and cost overruns in construction of the project, and competition from road and air transport on the Nairobi-Mombasa route has been greater than expected, especially in light of the fact that shipping costs by road have proven to be less expensive than by rail transport via the SGR.[10] Furthermore, non-governmental organisations (NGOs) have long expressed concerns about, and the Kenyan parliament has launched inquiries into, the lack of transparency in the procurement process[11] for the construction and development of the SGR as well as allegations of corruption that have shadowed the SGR from the outset.

The SGR has thus experienced increased project costs and lower-than-expected revenues, with the result that the SGR has had difficulty in covering its operating costs. Moreover, the failure of the SGR to generate the expected revenues has adversely affected the ability of the Kenyan government to service the sovereign debt that it owes to Chinese lenders. To support the development of the SGR, the Kenyan government incurred debt of at least US$3bn, which is not an insignificant amount of debt for an economy of Kenya's size.

Kenya's debt to GDP ratio nearly doubled as a result of its BRI-related and other borrowings, from 37% in 2010 to 68% in 2021, according to *Bloomberg*.[12]. It has also been reported that in 2024 a projected one-third of total government revenues will be needed for the servicing of interest alone on outstanding debt, thereby limiting the Kenyan government's resources that are available for expenditures on health, education, social welfare, and other important priorities.[13]

China-Pakistan Economic Corridor (Pakistan)

The China-Pakistan Economic Corridor (CPEC) has widely been seen as the flagship project of the entire Belt and Road Initiative. In reality, the CPEC consists not just of one project but rather a score of ambitious projects across a range of sectors. The CPEC encompasses power projects (including hydro, coal, and solar) and transmission lines, highways, railways, a major deep-sea port (Gwadar), industrial parks, and a fiber optic network – all meant, in one way or another, to advance the economic development of Pakistan, whether for instance through increased power generation, increased connectivity, or increased international trade and commerce.

Nonetheless, a number of BRI projects under CPEC have suffered from a range of problems such as cost overruns, delays in project completion, questions about the competitiveness of the projects vis-à-vis the existing alternatives, environmental concerns, and land acquisition challenges.

Furthermore, there have been questions and concerns as to whether there is adequate demand for the service or output that various CPEC projects are providing. Many of these various problems have contributed to the fact that a number of the CPEC projects have not generated the cash flows that they were expected to generate, and this in turn has complicated Pakistan's ability to repay its BRI-related debt.

In connection with CPEC projects, Pakistan has incurred a huge mountain of debt, with estimates ranging from US$50bn-US$60bn or more,[14] and Pakistan has certainly faced serious debt sustainability challenges in the last few years. Just under a year ago, Pakistan came literally within days of defaulting on its outstanding external debt but was saved from that eventuality at the last minute by new funding from the IMF as well as from certain Middle Eastern countries. But even so, observers still believe that Pakistan, at the present time, continues to be in very dire straits.[15]

And yet a silver lining for China in BRI project difficulties

Even though BRI countries may experience financial distress as a result of unsustainable BRI loans, the Chinese government may see BRI lending as furthering certain broader objectives.

'String of Pearls' strategy and overarching geopolitical considerations

Outside analysts have posited that, for many years now, the Chinese government has been guided by a so-called "String of Pearls" strategy in which, for commercial reasons and/or naval force projection purposes, China has sought to exert control over ports along crucial waterways and sea lanes, particularly in the Indian Ocean but even extending through the Middle East to Africa.

China's gaining control of the Hambantota port in Sri Lanka via the so-called debt-for-equity swap discussed above would be totally consistent with this 'String of Pearls' strategy, as well as with the objectives of the Maritime Silk Road component of the overall Belt and Road Initiative.

Furthermore, beyond the Hambantota port project, China has several other BRI port projects underway, including among others the Djibouti port project in the Horn of Africa and at the mouth of the Red Sea and the Gwadar port project in Pakistan overlooking the Arabian Sea, that would support this 'String of Pearls' narrative given the strategically important locations of these ports which sit astride important sea lanes and so-called maritime choke points. (The strategic importance of Djibouti's location in particular was underlined by the fact that, in 2017, China opened its first-ever overseas naval base in that faraway locale.)

To be sure, in order for China ultimately to gain control over these ports (at least in a commercial, non-military context), the Chinese lenders would have to foreclose on collateral (if the ports themselves were pledged as collateral for the loans) or, for instance, otherwise effectuate a debt-for-equity swap-type transaction along the lines of the deal that was struck with respect to the Hambantota port.

Another way in which China might potentially gain control over a key infrastructure project is a situation in which a Chinese contractor becomes indispensable in providing ongoing, on-site maintenance and repair following completion of the local infrastructure project where the local parties cannot properly provide such services. A lack of maintenance has been seen recently in the dysfunction and disrepair of the BRI-financed metro system in Addis Ababa, Ethiopia where Chinese companies have stepped in to provide technical support and spare parts to help address these problems. [16]

'Debt trap diplomacy'

For Chinese lenders and the Chinese government itself, the inability of the BRI projects to generate adequate cash flow may not have been of any particular concern. In fact, various observers and critics of the BRI program have speculated the BRI program was designed with exactly this in mind – namely, what has generally been referred to as the 'debt trap diplomacy' (or simply the 'debt trap' thesis, as is it sometimes referred to) pursued by the Chinese government.

Nonetheless, whether or not one agrees with this thesis (and opinion has been sharply divided on its validity[17]), to the extent that China can gain control of an important asset, such as a port in a geopolitically strategic position in the world (e.g., the Hambantota port on the Indian Ocean at relatively close distance to India) or can otherwise render BRI countries financially and/or economically dependent on China due to debt repayment or other economic and financial difficulties, then China will have achieved an important geopolitical objective. It will also have achieved an important political objective if the indebted country aligns itself more closely with China on matters of foreign policy, such as the China-Taiwan dispute.

Financial losses for state-owned banks as a 'cost of doing business'

The fact that China's BRI lenders, mostly state-controlled entities such as the 'policy banks' and large state-owned commercial banks, may have to suffer financial losses on BRI projects might be viewed by Chinese policymakers as a mere "cost of doing business."

Such financial losses might be viewed by Chinese policymakers as an acceptable cost if they are incurred in service of a greater cause, i.e., permitting China to expand its geopolitical footprint, influence, and position in world affairs. In this context, Chinese policymakers might be seen as prioritising China's geopolitical interests over the purely financial or economic interests of its leading financial institutions (which are state-owned in any case).

Nonetheless, while it has not necessarily been the only factor contributing to their sovereign debt distress, the lack of economic viability of BRI projects in their countries has left many BRI borrower countries saddled with sovereign debt burdens that they cannot possibly service.

As I discussed in my article in this publication last year,[18] it has also left other countries bogged down in sovereign debt restructurings (e.g., restructurings involving Zambia, Sri Lanka, Ghana, etc.) that have taken much longer than usual to complete or even to make significant progress. China has been a central player in several of these restructurings by virtue of the fact that it is often one of the largest, if not the largest, creditor to the sovereigns in question.

LGFV debt and LGFV-financed projects

While China's central government funds most infrastructure in China that has a nationwide scope, much of China's infrastructure development of a local scope is not funded by the central government but rather is funded at the local level. And it is not even provincial governments or municipalities which fund most of the infrastructure development at the local level. Instead, it is a Chinese entity known as a Local Government Financing Vehicle (LGFV).

Essentially, LGFVs are special-purpose vehicles set up by local governments for the purpose of financing the development of a wide array of infrastructure projects (e.g., roads, bridges, public buildings, etc.) but basically without the constraints facing local governments, particularly in their ability to incur debt.[19]

In recent years, however, LGFVs have become a major concern of Chinese government officials, from President Xi Jinping on down, in light of the sheer scale of the debt issued by LGFVs as well as issues about the ability of LGFVs to continue to service their outstanding debt on a timely basis. It remains to be seen whether recent strong pronouncements from the leaders in Beijing will be translated into concrete results at the local government level with respect to reining in the debt excesses of LGFVs. This will certainly be one of the most pressing and complex financial/economic challenges confronting the Chinese leadership in Beijing in the next few years.

LGFVs also become a major focus of the credit rating agencies that rate Chinese government debt. In fact, last December when Moody's downgraded its 'outlook' on China's sovereign debt rating from 'stable' to 'negative' on an A1 rating (its third-highest rating), it specifically mentioned local government debt as one of the factors that contributed to its decision since a bailout of LGFVs by the central government would weigh on the Chinese government's finances.[20] Fitch took a similar action in early April and also cited the issue of LGFVs as a contributing factor to its decision.[21]

Obviously, the ratings assigned by the rating agencies to bonds are important because they can potentially affect the pricing on debt issuances (with lower ratings generally translating into more expensive debt for the issuer). Thus, the Chinese government will presumably be very attuned to any future actions by the rating agencies on China's sovereign debt and the potential impact that any future government actions might have on China's credit ratings.

Staggering LFGV debt burden and broader effects

Over the years, LGFVs have incurred a truly staggering amount of debt (consisting principally of both publicly issued bonds and bank loans), with the International Monetary Fund estimating that outstanding LGFV debt overall totals approximately US$9 trillion dollars.[22] And to put the enormity of that LGFV debt burden into broader perspective, a debt-to-GDP ratio involving only LGFV debt (and not Chinese government debt or even local government debt) generally would be just over fifty percent.[23]

The absolute amount of outstanding LGFV debt and the LGFV debt-to-GDP ratio represent high (and potentially worrisome) numbers from the standpoint of the soundness of China's overall financial system given the significant exposure of Chinese banks to LGFVs both through their purchase of LGFV bonds and their bank loans to LGFVs. If there were ever to be widespread defaults and/or restructurings with significant haircuts with respect to LGFV debt, that could potentially affect the capital position of the banks in light of the resulting requirement for the banks to take loan losses or set aside loan provisions.

It also could, in a worst-case scenario, potentially lead to financial stability concerns for the Chinese banking system if the relevant stakeholders ever were to lose confidence in Chinese banks. That is what has probably concentrated the minds of Chinese policymakers in recent times since they certainly do not want to see a financial crisis at any time but particularly now when then the economy is in a relatively fragile state.

The LGFV problem could also have a potentially adverse impact on GDP growth in China. Earlier this year, *Bloomberg* reported that the financial problems facing the LGFVs could weigh down China's GDP growth in 2024 since it is likely to lead to less infrastructure investment by LGFVs,[24] but the *Bloomberg* report did not specify the size of any such potential drop in GDP. Since the Chinese economy is already facing strong headwinds, a LGFV-induced drop in GDP would not be welcome news by Chinese policymakers as they grapple with a sluggish post-COVID economic recovery, deflationary pressures in the economy, and continued troubles in the property market.

Nonetheless, it should be noted that, for more than a decade, observers have been cautioning about or predicting an imminent LGFV debt crisis, and until now such a crisis has not yet materialised. But this moment may be different because LGFVs are currently facing a 'perfect storm,' as more fully discussed below, and will thus present Chinese policymakers with a supreme test of the their ability to avert a serious LGFV debt crisis.

Recent debt servicing challenges for LGFVs

So far there have been no outright payment defaults by LGFVs on outstanding bonds, but there have been some payment defaults on other less significant debt obligations of LGFVs,[25] and there have also been several instances of LGFVs making their debt service payments at the last minute. Moreover, certain LGFVs, particularly those in China's poorer, less economically developed regions such as the provinces of Guizhou, Yunnan, Gansu, and Inner Mongolia, have begun to explore debt restructuring and debt refinancing options with their banks and government officials in view of the financial difficulties that they have been facing.

For example, certain LGFVs have restructured their debt with banks so that debt with maturities of, say, ten years is stretched out to debt with a maturity of twenty or twenty-five years or longer,[26] accompanied possibly by lower interest rates and multi-year grace periods on the payment of principal. In addition, some outstanding LGFV debt is starting to be refinanced by new debt issued by the related local governments, so that off-balance sheet LGFV debt is taken onto the balance sheets of local governments, and this is something that is being encouraged by central government authorities.

Separately, certain local governments, due to their budgetary pressures, have fallen far behind in their wage payments to workers, in some cases by several months, and there have also been sharp cutbacks in services offered by certain local governments.[27] Although this is not strictly a problem of the LGFVs, it is emblematic of the financial difficulties facing local governments and helps explain why they do not have resources available to channel to LGFVs for the repayment of LGFV debt obligations.

Limited investment returns and other financial constraints facing LGFVs

A fundamental problem with LGFVs is that generally they generate truly negligible[28] and somewhat uncertain investment returns – returns that, crucially, are reported to be significantly lower than the borrowing costs of LGFVs.[29] In the past, when investment returns were not sufficient to service their debt, the LGFVs could rely on financial support from the related local government.

Yet, as discussed more fully below, local governments no longer have such resources at their disposal to support LGFVs in servicing their debt due to sharply decreased revenues that local government have been receiving from land sales in the current troubled property market. Thus, LGFVs no longer have that extra cushion for servicing their outstanding debt.

One explanation for the low investment returns from LGFVs is that LGFVs focus on developing infrastructure that will provide public services at affordable prices (without regard to prospective investment returns), while a second explanation is an argument that the management of LGFVs simply make unwise investment decisions. A third explanation is that LGFVs make investment decisions strictly based on political considerations. A fourth explanation is that the infrastructure projects being financed by LGFVs are considered long-term assets that generate returns over a lengthy period of time (such as 20 to 30 years) and high start-up costs for such projects can eat into returns in the early years of a project. This presents particular problems when LGFVs borrow in short-term debt since this creates a mismatch between a long-term asset and a short-term liability.

One area of immediate concern is that LGFVs are facing a wall of maturities in the coming years. In 2024 alone, LGFVs will face principal repayment obligations of approximately US$650bn (which represents a 13% increase over the amount of LGFV debt that fell due in 2023), according to *Bloomberg*.[30]

In addition, LGFVs are not maintaining healthy debt service coverage ratios which is an important metric in determining whether a borrower will be able to service its debt without difficulty. Indeed, a June 2023 report from the Rhodium Group indicated that "[n]early four fifths of LGFVs do not appear to have sufficient cash flows to cover interest payments."[31]

Another major area of concern stems from the fact that land sales by local governments have dropped precipitously in the last few years,[32] and this is closely connected in many ways to the recent slump, if not collapse, in the Chinese property market. With property developers in straitened circumstances and with several dozen property developers having defaulted on their debt in the last few years[33] as well as with property prices in China at severely depressed levels, local governments have not been able to find many willing buyers for land since so many Chinese property developers are on the sidelines in view of their current weakened financial condition.

This has had a deeply adverse impact on the ability of LGFVs to repay their debt. The proceeds from land sales have historically been a major source of revenue for local governments, and, with these revenues, local governments have used their budgets to help provide financial support to LGFVs for the repayment of their outstanding debt obligations. Investment returns from the LGFV projects themselves have been the other major source of funds for repaying LGFV debt, but, as discussed above, the flow of such investment returns from LGFV-financed projects has long been highly uncertain and is perhaps even more so in the current sluggish economic environment in China. Yet, without the financial support from local governments that they have received in the past, LGFVs have recently had a much-diminished capacity to repay their outstanding debt and hence the current financial difficulties of LGFVs.

Origins of the proliferation of LGFVs and the massive issuance of LGFV debt

In the Chinese system, local governments face certain major restrictions on their borrowing ability.[34] LGFVs, by contrast, have in the past generally not faced such restrictions on their ability to borrow. Until recently, LGFVs have been able to borrow from banks and issue bonds essentially without any significant limitations.

For local governments, borrowing through LGFVs is considered advantageous because such borrowing does not show up on their balance sheets. Rather, for local governments, LGFV borrowing is considered an 'off-balance sheet' item and thus, in Chinese government parlance, LGFV debt is for all intents and purposes considered a form of 'hidden debt.'[35]

In 1994, the Chinese government, under the leadership of Premier Zhu Rongji, realigned

China's fiscal system so that more local government revenues would flow to the central government instead of remaining with local governments.[36] This created an incentive for local governments to make greater use of LGFVs as an off-balance sheet borrowing vehicle for funding expenses that their now-constrained budgets could not fund.

However, it was the global financial crisis of 2008-09 that provided a new, key impetus for the proliferation of LGFVs. At the time, the Chinese central government wanted to use new infrastructure construction and development as a means of stimulus for the Chinese economy so that the Chinese economy did not experience the same type of economic slowdown that much of the rest of the world was then experiencing. Ironically, during and after the global financial crisis, the Chinese government, leading a so-called 'socialist market' economy in a communist political system, was probably one of the most ardent practitioners of Keynesian economics among national governments.

China's central government looked in large part to the local governments to undertake this massive program of infrastructure construction and development. And the local governments in turn created multitudes of LGFVs that would be responsible for raising the finance for the development and construction of these infrastructure projects.

However, as the local governments in particular did not have the necessary funds in their budgets and were restricted by the central government in their borrowing activities, the LGFVs were in a sense largely on their own to raise the financing for these infrastructure projects. As a consequence, the LGFVs raised huge amounts of debt finance through the issuance of bonds as well as through loans from banks to support this construction and development of infrastructure. They also relied upon high-interest rate products offered by 'shadow banks,' including so-called 'wealth management products,' particularly when access to financing from banks was not readily available.

In the 15 years since the global financial crisis, LGFVs have truly taken on a life of their own. The number of LGFVs in existence has increased very significantly, rising to thousands of LGFVs, and, as noted above, the amount of debt that these LGFVs are carrying has skyrocketed in recent years into the trillions of dollars (as noted above, nine trillion dollars, according to the IMF's estimate).

For many years, China's central government has been trying to get a firm handle on the world of LGFVs. In fact, since the early 2010s, the central government has undertaken several national 'audits' for precisely the purpose of understanding the true scope of the LGFV debt problem. But it has presumably been challenging for the central government to get a comprehensive and accurate picture of the LGFV debt problem since LGFVs may not be completely open and transparent about their finances.

Options for addressing LGFV debt problem

China's central government is encouraging local governments and LGFVs to explore restructuring and refinancing options to address the debt problems of the LGFVs. The Chinese government is also restricting the amount of debt that LGFVs can issue, particularly LGFVs in weaker economic regions. In addition, the central government is also instructing LGFVs and the local governments in the economically distressed or weaker regions to cease further work on infrastructure projects that are not considered essential and to not undertake any new infrastructure projects.

Further, local governments are starting to conduct more extensive audits of LGFVs within their jurisdictions, and the central government plans to dispatch experts from various government ministries and agencies to consult with officials of local governments where the local debt issues are most acute on how to address their financial challenges. Moreover, the central government has allowed provinces to issue approximately US$139bn of bonds that can be used to refinance outstanding LGFV debt. Clearly though, while that may be a welcome step, that amount of new bonds barely makes a dent in the overall multi-trillion dollar debt burden of LGFVs.

Fundamentally, however, Chinese authorities may wish to go beyond some of the measures now being discussed and instead consider more structural options outlined below for addressing the major debt travails facing LGFVs and avoiding future problems with LGFV debt.

First, as has been discussed by various analysts, the entire fiscal relationship between local governments and the central government probably needs to be re-examined. The objective would be to strengthen the financial position of local governments so that, for example, local governments are able to retain more of the revenues that they raise through taxes and fees instead of reallocating a not insignificant portion of those revenues to the central government.

In addition, to the extent that local governments are responsible at the behest of the central government for certain expenditures designed to benefit their local populations but for which they are not reimbursed, such unfunded mandates should be re-evaluated.

Second, as to the debt restructuring of LGFV debt, that process could be handled on a less ad hoc, less localised basis. The central government might consider establishing a new national agency to take the lead on coordinating restructuring discussions between LGFVs and their creditors or at least provide a platform for such discussions to take place.

The Chinese government might look to a model developed by Japan in the early 2000s when it established a quasi-governmental agency, the Industrial Revitalisation Corporation of Japan (IRCJ) that was led by Dr. Shinjiro Takagi. The basic purpose of ICRJ was to help restructure companies that were fundamentally viable but to liquidate companies that were that were overindebted and not viable over the long term (otherwise known as 'zombie companies').[37]

Third, the Chinese government might wish to consider how local infrastructure is financed generally: should it be solely or largely the responsibility of local governments as it is currently (with the much of that financing provided by LGFVs), or should the central government play a more important role in financing such infrastructure investment?

This issue comes into sharper focus when one considers that the central government has, as noted above, from time to time directed local governments to undertake infrastructure investment and development as a matter of national fiscal policy in order to stimulate the Chinese economy. The Chinese government has done this particularly during periods of economic slowdown when it has used infrastructure spending as a countercyclical economic policy measure.

There are different modalities that China's central government might use to steer the financing of local infrastructure investment and development away from the local level to the national level. For instance, the Chinese government might consider establishing, on the one hand, a national infrastructure development bank which could support local infrastructure development (i.e., a potential domestic counterpart to the Chinese-sponsored Asian Infrastructure Investment Bank (AIIB)), or, on the other hand, a national financing agency dedicated to raising finance for local infrastructure development (which might potentially benefit from the credit rating of the national government).

Of course, the central government would presumably not want to become directly involved in the decision-making on the financing of thousands of individual infrastructure projects that local governments undertake across China as a whole. Nonetheless, any national financing mechanisms such as those discussed above could allocate blocs of financing (i.e., on-lend financing) to localities to undertake the development of a range of individual projects.

Furthermore, specifically with respect to a national infrastructure financing agency, the Chinese central government would want to ensure that any borrowings by the agency would not have the effect of overleveraging the Chinese government's balance sheet.

Fourth, the Chinese government and the Chinese Communist Party itself might revisit the criteria for the promotion of local government officials and/or local party cadres. Although there has been considerable controversy and debate surrounding this issue, it has been posited by some observers that one criterion used in this process is how much the local officials and/or party cadres have fostered economic growth (i.e., GDP growth) in their localities during their term of office, with the more growth supposedly leading to better career prospects for the local officials and/or party cadres in question.[38]

To the extent that this criterion for promotion based on GDP growth actually exists and is enforced by senior government/party officials in practice, a lessened emphasis on this criterion for promotion might attenuate the urge by local officials and/or party cadres to undertake unnecessary infrastructure investment and development (as well as incurring excessive debt) as a way of increasing local GDP. In any event, whatever the relevant criteria for promotions, local officials and/or party cadres should not get any credit for infrastructure investments which are unproductive economically.[39]

Finally, the Chinese government might consider enacting a new bankruptcy law for municipalities to supplement China's existing bankruptcy law for corporations, namely the Enterprise Bankruptcy Law. China does not currently have a municipal bankruptcy law, but such a law is present in certain other jurisdictions, perhaps most notably in the US in the form of Chapter 9 of the US Bankruptcy Code. The LGFV debt crisis has shone a spotlight on the precarious finances of local governments across China, including municipalities in China. A new Chinese bankruptcy law directed specifically at municipalities could be used as a last resort to provide a financially distressed municipality protection from its creditors while it works out a plan of adjustment of its debts with those creditors. It should not be overlooked, though, that Chapter 9 of the US Bankruptcy Code provides an important safeguard for the municipality to continue providing 'essential services' to its residents during the Chapter 9 bankruptcy proceeding.

Importantly, if creditors know that the municipality could end up in bankruptcy, they will be more careful in their lending decisions concerning municipalities since they will not be able to assume that the distressed municipality will be bailed out by a higher governmental authority. That, in turn, could help wring out of the system whatever moral hazard exists in relation to municipalities.

Notes

1. See, e.g., "China Owed More Than US$1 trillion in Belt and Road Debt: Report," Agence-France Presse (AFP), August 11, 2023. See also Bradley Park, et al., "Belt and Road Reboot: Beijing's Bid to De-Risk Its Global Infrastructure Initiative," AidData (William & Mary), November 6, 2023 (available at https://www.aiddata.org/publications/belt-and-road-reboot)(indicating that estimates suggest that up to 75% of loans will be in the principal repayment period by 2030, with a total outstanding debt of US$1.1 to US$1.5 trillion).
2. "China to Replace US$140bn LGFV Debt with Local Bonds - Bloomberg News," Reuters, August 11, 2023 (the IMF "estimates 66 trillion yuan (US$9.1 trillion) in total debt is held by LGFVs…").
3. See generally John M. Niehuss, International Project Finance in a Nutshell (3rd edition), West Academic Publishing (2020), p. 20 (describing features of a feasibility study for a proposed project, including market studies and "an assessment of the basic economic viability of the project").

[4] See, e.g., Shihar Amaz, Sri Lanka Takes Next Step to Opening Strategic China-Built Port," Reuters, March 4, 2013 ("[t[housands of ships were meant to use Hambantota port soon after its November 2010 launch").

[5] "Sri Lanka launches new port in Hambantota," DW.com, August 16, 2010 (available at https://www.dw.com/en/sri-lanka-launches-new-port-in-hambantota/a-5915470) ("[t]he new harbor has been designed to initially handle 2,500 ships a year to take off some of the pressure from the country's only port in Colombo, which handles some 6,000 ships annually").

[6] Maria Abi-Habib, "How China Got Sri Lanka to Cough Up a Port," New York Times, June 25, 2018.

[7] See, e.g., Maria Adele Carrai, "Questioning the Debt-Trap Diplomacy Rhetoric Surrounding Hambantota Port," Georgetown Journal of International Affairs, June 5, 2021 (available at https://gjia.georgetown.edu/2021/06/05/questioning-the-debt-trap-diplomacy-rhetoric-surrounding-hambantota-port/).

[8] Mwamoyo Hamza, "New Railway Halves Travel Time from Nairobi to Mombasa" Voice of America News, June 4, 2017 (available at https://www.voanews.com/a/new-railway-halves-travel-time-from-nairobi-to-mombasa/3881432.html) ("[previously, passenger train service between Mombasa and Nairobi took 10 hours. Kenya says the new service will complete the 440-kilometer (275 miles) trip in five").

[9] Oscar Otele, "China's Approach to Development in Africa: A Case Study of Kenya's Standard Gauge Railway" Council on Foreign Relations, October 13, 2021 (available at https://www.cfr.org/sites/default/files/pdf/Otele_A%20Case%20Study%20of%20Kenya%E2%80%99s%20Standard%20Gauge%20Railway.pdf). The paper states, "In 2018, only 5.039m tons of cargo were ferried from Mombasa to Nairobi, while 3.25 million tons of cargo were transported between January and September 2019, implying that the SGR was seriously underutilised and thus not generating expected revenues."

[10] See, e.g., Ian Goreki, "Kenya's Standard Gauge Railway: The Promise and Risks of Rail Megaprojects," The Wilson Center (blog post), September 24, 2020 (indicating that 'last-mile' costs of delivery have made cargo delivery by the SGR more expensive than by trucking); Duncan Miri, "Kenya Forcing Importers to Use Costly New Chinese Railway, Businessmen Say," Reuters, December 3, 2019.

[11] See Oscar Otele, supra note 9.

[12] David Herbling, "World Bank urges Kenya to Cut High Debt Levels Sapping Economic Growth," Bloomberg, October 17, 2023.

[13] Rachel Savage and Mark Jones, "Kenya's Double-Digit Debt Costs Sign of the Tough Times," Reuters, February 15, 2024.

[14] Asif Shahzad, "Pakistan Says China Has Rolled Over US$2.4bn Loan for Two Years," Reuters, July 27, 2023 (indicating that China has pledged over US$60bn for BRI projects in Pakistan). Note: pledged amounts do not necessarily translate into disbursed loan amounts.

[15] Reuters, "How Bad is Pakistan's Debt Crisis and Can the IMF Save It?," February 14, 2024 ("…the risk of a full-scale economic crisis remains").

[16] See, e.g., Jevans Nyabiage, "China Hands a Lifeline to Ethiopian Capital's Crumbling Light Rail," South China Morning Post, February 17, 2023 ("China has come to the rescue of the Chinese-built Addis Ababa light rail transport service, agreeing to provide spare parts worth 155 million yuan (US$23m) for the struggling network's rolling stock"); Linda Poon, "Addis Ababa's China-Funded Metro Is Crumbling," Bloomberg, April 12, 2024.

[17] See, e.g., Lee Jones and Shahar Hameiri, "Debunking the Myth of 'Debt-trap Diplomacy,'" Chatham House, December 14, 2020 (available at https://www.chathamhouse.

org/2020/08/debunking-myth-debt-trap-diplomacy/4-sri-lanka-and-bri).

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32 Iori Kawate, "China Tries to Defuse Local Debt Risk with US$200bn Refinancing Tool," Asia Nikkei, September 3, 2023 ("Revenue from [the sale of land use rights] was down 45% in the July-January period of [2023] compared with two years earlier").

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[36] See, e.g., Di Lu, "China's Local Government Credit Dilemma," East Asia Forum, November 5, 2023 (available at https://eastasiaforum.org/2023/11/03/chinas-local-government-credit-dilemma/) ("China's tax revenue sharing reform, orchestrated by then premier Zhu Rongji in 1994, restructured China's fiscal system to bolster central control of taxation, significantly diminishing local governments' share of tax revenues and weakening their fiscal strength"). See also Qiu Lige, supra note 34, p. 426 (new system introduced in 19994 "reduced local governments' share of revenues" but "left their expenditure responsibilities unchanged" and thereby "...created a fiscal gap for local governments...").

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