Discussion of “Subnational Debt of China: The Politics-Finance Nexus”

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Overview

- This paper examines performance of debts to China local governments – an issue attracted much attention.

- Summary of main findings:
  - Development bank loans have lower delinquency rates;
  - Distressed governments choose to default on commercial loans;
  - Such a strategic default pattern can be explained by promotion incentives of local politicians.

- Overview:
  - Uniqueness and richness of loan data;
  - Very interesting and reasonable findings;
  - Comments mainly on interpretations of the findings.
Analytical Framework

- Politicians’ utility function: maximize social-economical value to enhance promotion chance

- Government policy bank (CDB):
  - The main long-term financing source;
  - Share the same social-economical goal;
  - Subsidized interest rate, longer maturity

- Commercial banks (CBs):
  - Sporadic source of operation financing;
  - Mostly active during the 2008-2010 “4 trillion” stimulus program;
  - Shareholder value-maximizing;
  - More market-oriented lending with stringent loan contract terms
Analytical Framework

- Politicians’ goal perfectly aligned with CDB’s.

- Why would local governments borrow from commercial banks?
  - Unless they have to

- One selection issue:
  - Governments borrowing from CBs tend to be more risky;
  - Lead to more delinquency

- Question 1: Do distressed governments get to choose which loans to postpone repayment with?
Main comment 1: Do governments get to choose which loans to default?

- It is likely that CDB screens borrowers and lends to risky governments with
  - higher loan seniority;
  - more bargaining power.

Possibly not the government’s choice to default less on CDB loans

- CBs select to lend to risky governments if risks well managed and compensated
  - Ultimate default is rare (implicit guarantee)
  - Higher interest rates
  - More collaterals (e.g., government lands)

- More information required on loan contract terms to judge.
Main comment 2: Can governments afford defaulting on CDB loans?

- Question 2: Even if governments get to choose, can they afford defaulting on CDB loans?
  - CDB: single source of main and subsidized financing
  - CBs: multiple sources of supplementary financing

- Key: Hard budget constraint of CDB
  - If CDB loans defaulted, fewer future loans (shown in the paper)
  - Policy banks often regarded as having soft budget constraint
  - Can be explained by CDB managers’ own political career concern
  - CBs’ continuing lending to “defaulting” borrowers less affected as long as risks well managed and compensated

- Cannot afford defaulting on the single source of main financing in case of hard budget constraint of CDB.
Main comment 3: Is It About the Political Power of CDB?

- Arguments made that CDB is at the ministerial level and have more political leverage and powers than CBs.

- Unclear how a policy bank affects local political promotion
  - Lower-level promotion determined by province

- Evidence against the arguments
  - When CBs became the major source of financing during 2008-2010, governments tend to default on CDB loans too
  - Inconsistent with CDB’s influence on political promotion

- Local GDP growth is the key to promotion, while CDB loans are the key to local GDP growth.
  - CDB loans, but not CDB per se, matter.
Main comment 4: Political Promotion and CDB Loans

- Political promotion is positively associated with CDB loans.
  - CDB loans enhance promotion

- Interpretations
  - Selection: CDB choose politicians in lending decisions
  - Reverse causality: Areas with better growth prospects (and hence higher potential for political promotion) are more funded by CDB
  - Omitted variable: Unobservables (e.g., politician’s ability) lead to both CDB loans and promotion

- At minimum, GDP growth rate shall be controlled in explaining political promotion (Table 5).
Minor comments

- Provide more summary statistics on sizes and contract terms of CDB and Commercial loans.

- CDB loans are even less defaulted at time of political turnover
  - Timing of CDB loan origination?
  - Maturity of CDB loans, coincident with political turnover?
  - CDB loans originated at the start of the politician’s term may not yet mature by the end of her term.

- Some useful cross-sectional analyses of varying impacts on the CDB-default relation:
  - Regions: Relative importance of CDB loans for different regions
  - Politicians: Varying career concerns (e.g., young vs. retiring)
Concluding Remarks

- A unique study on debts to China local governments with rich information
- Interesting findings that link politics and finance in China
- Look forward to reading a revised version in a top journal again