Super Debt Cities

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Extended Abstract

In response to the global financial crisis, the Chinese government launched a gigantic fiscal stimulus and the big four government-owned banks considerably expanded their lending. We show that this lending boom contributed significantly to the house-price boom across China since 2009.

To identify the causal impact of the aggregate lending boom on local economies, we exploit variation across cities in the degree of political connections to the central government. We show that cities with strong political connections benefited more from the lending boom. In these cities we see stronger increases in local government debt and, at the same time, higher increases in residential land and housing prices. By contrast, industrial land prices largely stayed flat. These results hold after controlling for a host of confounding factors that could be correlated with either political connections or the lending supply shock, such as local GDP and population growth, the relative population and GDP of cities or the pre-sample market share of the big four banks in these cities etc.

To explain our findings, we turn to the land supply policies of local governments. In China, promotion of local officials largely depends on local economic performance. The fiscal stimulus provided strong incentives to local officials to quickly expand their local economies. While local governments are

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not allowed to directly borrow in financial markets, they are the monopoly suppliers of land lease rights. In many lower-tier cities, however, selling land to private enterprise would not have raised sufficient funds for a strong expansion of government expenditure. For this reason, local governments took recourse to local government financing vehicles which borrowed massively by posting industrial land as collateral at inflated valuations. This allowed local governments to increase borrowing for infrastructure and industrial development very quickly, but it also led to a scarcity of residential land, driving up prices.

Our mechanism can explain why residential land and housing prices increased particularly strongly in lower tier cities. Our results also suggest that these price increases are ultimately the reflection of a massive distortion in land markets. Given the centrality of land prices for private firms' access to credit as well as for consumer finance, our results could have important implications for financial stability.