

# The Financing of Local Government in China: Stimulus Loan Wanes and Shadow Banking Waxes\*

Zhuo Chen

Zhiguo He

Chun Liu

June 2017

## Abstract

China's four-trillion-yuan stimulus package fueled by bank loans in 2009 has led to the rapid growth of shadow banking activities in China after 2012. The local governments in China financed the stimulus plan mainly through bank loans in 2009, and resorted to non-bank debt financing after 2012 given the mounting rollover pressure from bank debt coming due, a manifestation of the stimulus-loan-hangover effect. Cross-sectionally, provinces with abnormally greater bank loan growth in 2009 experienced more Municipal Corporate Bonds issuance during 2012-2015, as well as more shadow banking activities including Entrusted loans and Wealth Management Products. We highlight the market forces behind the regulation changes on local government debt post 2012, together with the expedited reform on interest rate liberalization during that period.

Keywords: Local Government Financing Vehicles, Trust and Entrusted Loans, Shadow Banking in China

---

\*Chen: PBC School of Finance, Tsinghua University, 43 Chengfu Road, Haidian District, Beijing, 100083, P. R. China; E-mail: [chenzh@pbcfs.tsinghua.edu.cn](mailto:chenzh@pbcfs.tsinghua.edu.cn). He: Booth School of Business, University of Chicago, and NBER; 5807 South Woodlawn Avenue, Chicago, IL 60637; Email: [Zhiguo.He@ChicagoBooth.edu](mailto:Zhiguo.He@ChicagoBooth.edu). Liu: School of Economics and Management, Tsinghua University, Beijing, 100084, P. R. China; Email: [liuch@sem.tsinghua.edu.cn](mailto:liuch@sem.tsinghua.edu.cn). We thank Chong-En Bai, Jennifer Carpenter, Will Cong, Kinda Hachem, Chang-tai Hsieh, Zheng Liu, Jacopo Ponticelli, Zheng Michael Song, Jun Qian, Nancy Qian, Rengming Xie, Zhishu Yang, and participants at the 2016 Nankai University School of Finance Annual Conference, Shanghai University of Finance and Economics, Central University of Finance and Economics School of Finance, Renmin University of China Hanqing Institute, 2017 NBER Chinese Economy working group (Boston meeting), the 2nd IMF-Atlanta Fed Research Workshop on China's Economy, and 2017 Asian Bureau of Finance and Economic Research Conference for helpful comments. Chen gratefully acknowledge the support from Minsheng Wealth Management Research Center at Tsinghua University, and He gratefully acknowledge financial support from the Center for Research in Security Price at the University of Chicago Booth School of Business.

# 1 Introduction

Right after the 2007/08 global financial crisis hit the export-driven Chinese economy heavily, the State Council of China announced the unprecedented four-trillion fiscal plan on November 2008, mainly on infrastructure projects, in order to stimulate China's economy to maintain its "usual" above-9% annual growth rate. Most of the massive 2009 stimulus package was implemented through China's local governments who finance the infrastructure investment by bank loans via the off-balance-sheet Local Government Financing Vehicles (LGFVs thereafter); see, e.g., [Bai et al. \(2016\)](#). Although this aggressive fiscal expansion helped bolster the slumping Chinese economy (and perhaps even the world economy), the resulting swelling local government debt in China followed by this massive plan caught wide attention of scholars and practitioners all over the world, and about five years later more and more studies emerged on the unintended consequences of the 2009 stimulus package on the China's economy growth post 2009.

This paper argues that one of these unintended consequences is the unprecedented rapid growth of shadow banking activities in China after 2012. The start of shadow banking in China around 2008 can be attributed to other reasons (e.g., [Hachem and Song \(2017\)](#)); however, China's shadow banking activities have experienced accelerated growth after 2012. For instance, Wealth Management Products (WMPs), a widely-used tool to attract off-balance-sheet deposits by commercial banks in China, grew by 3.5 trillion RMB during the three-year period from 2008 to 2011, but increased by 2.5 trillion in 2012 and 3.1 trillion in 2013.

In particular, this paper zooms in on the composition shift of the liability side of China's local governments since 2009, and shows that the stimulus-loan-hangover effect pushed them toward non-bank debt financing after 2012. The stimulus-loan-hangover effects include the financing demand to continue the long-term infrastructure projects started in 2009, as well as the rollover pressure of maturing bank loans that were taken on by LGFVs at that time. These forces fostered the rapid growth of shadow banking activities in China after 2012, and most of these non-bank debt financing sources are related to Trust and/or WMPs, two off-balance-sheet items that are often regarded as the barometers of the shadow banking activities in China.

We started by explaining the background of the 2009 four-trillion stimulus package and its connections to local governments in China. Due to the public-goods nature of the infrastructure-investment-centric stimulus package, it is local governments that carried out the four-trillion expansion in 2009. However, according to the 1994 budget law, local governments are not allowed to borrow. To facilitate and expedite the stimulus plan,

Beijing explicitly encouraged local governments to borrow from banks through their LGFVs, an important group of state-owned enterprises (SOEs) in China. As planned, bank loans and investment soared in 2009, but local governments were left with mounting bank debt. One estimate by Bai et al. (2016) is that 90% of the newly increased local government debts during the stimulus period were in the form of bank loans.

Facing the rising warnings of local government debt, starting in the second half of 2010 Beijing reverted its ultra-expansive credit policy back to its normal level, and National Audit Office (NAO) conducted two comprehensive surveys on local government debt. These two official reports, dated December 2010 and June 2013, are the most authoritative documents that shape all discussions on this topic. Based on the mid-2013 report, we focus on four different categories of debt that are sitting on the liability side of local governments: *Bank loans*, *Munibonds*, *Municipal Corporate Bonds*, and *Trust loans*, with the latter three types being non-bank debts.

We highlight the third kind of debt, i.e., Municipal Corporate Bonds (MCBs hereafter) in our paper.<sup>1</sup> These bonds are issued by LGFVs, and hence are corporate bonds legally; but of course they have implicit guarantees from corresponding local governments, hence enjoy the extra safety of municipal bonds. These bail-out expectations, especially for LGFVs that are both SOEs and backed by local governments, are widely spread and particularly relevant in China.<sup>2</sup>

Based on the two NAO reports, together with various sources, we fill in the detailed amount of each debt category mentioned above over the period of 2008-2016. Consistent with the hypothesis of stimulus-loan-hangover effect, we observe a robust pattern of the composition change of local government debt, i.e., a shift from bank loans to non-bank debt obligations over time. Our analysis highlights the rollover channel particularly:<sup>3</sup> following the back-to-normal credit policy after 2009, local governments need to

---

<sup>1</sup>It is “Cheng-Tou-Zhai” in Chinese, or “city investment bonds” by a literal word-for-word translation. We adopt “Municipal Corporate Bond” from the English translation the “Cheng-Tou-Zhai” index provided by the China Securities Index Company Limited (CSI), which is the leading index provider in China (e.g., CSI300 index) jointly owned by the Shenzhen Stock Exchange and the Shanghai Stock Exchange. In the literature, papers have been using different translations; for instance, local government bond by Huang et al. (2016), Chengtou bond by Ang et al. (2016), and urban construction and investment bond by Gao et al. (2016). Some practitioners’ articles also use the term LGFV bond.

<sup>2</sup>Up to early 2017 there have been no single case of MCB default yet; and thanks to the debt-swap-program pushed by Ministry of Finance starting 2015, we do not expect MCB default in the future either. On the other hand, Chinese investors are learning to embrace the default risk on corporate bonds. Because of the slowdown of the Chinese economy in the recent five years, firms—whether privately owned or state owned—started default sporadically in 2014, and in the year of 2016 there are 34 firms that are defaulting on their bonds in China’s corporate bond market. Although, there are still heavy involvement of local governments in bankruptcy resolutions, as many defaulting enterprises have strong ties to local governments.

<sup>3</sup>The rollover risk emanating from refinancing maturing debt is an active research area in corporate

refinance/rollover their three-to-five-year-maturity bank loans coming due, by non-bank debt sources that include Trust loans and MCBs. With the help of MCB prospectus, we document the direct evidence that MCBs issued for “repaying bank loans” rose quickly around 2014. Our view of “stimulus-loan-hangover effect” is also confirmed with the post-2013 rapid growth of Trust loans as reported in “Aggregate Financing to the Real Economy” by China’s central bank.

The hypothesis of stimulus-loan-hangover effect has the following cross-sectional prediction: the areas with more bank-loan-fueled stimulus in 2009, whether demand-driven or supply-driven, should have more MCB issuances several years later as the after-effect of stimulus package. This prediction is confirmed in the data, a result that is robust at both regional and provincial levels, and with relevant controls (e.g., controlling provincial GDP growth in later years). Yield spreads of MCB at issuance, on the other hand, are largely determined by risk profiles of each individual bond, consistent with little province-level segmentation for corporate bond investors in China. We further decompose the MCB issuance by its purpose, and find that only the repaying-bank-loans component is related to the 2009-stimulus bank loans cross-sectionally, after controlling the provincial economic activities (e.g. GDP growth). In terms of economic magnitude, we find that one more dollar of bank loans in 2009 leads to about 13 cents more issuance of MCB to repay bank loans in later years. This implies about a loan maturity of about 4 years, consistent with Kroeber (2016) who document that China’s localities often take three- to five-years loans to fund decade-long infrastructure projects.

Section 4.4 provides some evidence linking our findings to China’s overall shadow banking activities after 2012. The non-bank local government debt becomes increasingly significant relative to shadow banking activities in the overall Chinese economy, rising from 1.5% in 2008 to 48% in 2016. Cross-sectionally, provinces with more bank-loan-fueled stimulus in 2009 were experiencing more entrusted loan growth during later years. Finally, from publicly available data, in December 2016 there are 62% (or 4.2 trillion RMB) of MCBs invested by WMPs.<sup>4</sup>

This paper paints a broad picture that links the 2007/08 financial crisis in US, the 2009 four-trillion stimulus expansion in China, and the surging shadow banking activities in China after 2012. Although both WMPs and Trust loans existed in China’s financial markets before 2008, and increased slightly during the period of the 2009 stimulus plan, finance, especially after 2007/08 financial crisis; e.g., Diamond (1991); He and Xiong (2012); Diamond and He (2014).

<sup>4</sup>Due to its shortcoming of statistical criteria (e.g., not including WMP investment in some special-purpose-vehicles which can in turn purchase MCBs), this number is bound to be an underestimate; one estimate from an anecdotal but trustworthy source is about 70%.

our perspective helps understand why these shadow banking activities experienced “barbarous growth” after 2012. In short, the inelastic demand for continuing the long-term infrastructure project started in 2009, together with the mounting rollover pressure of LGFVs that needed to repay maturing bank loans about four or five years later, played an important role in driving the surging shadow banking activities in China at that time.

We are not saying that the stimulus-loan-hangover effect is the only mechanism that explains the rapid development of Chinese financial market post 2012. In general, China’s growth is just far too sophisticated to be explained by one single force (see literature review for several alternative views). In Concluding Remarks we argue that the hangover of stimulus-loan has affected the way the government regulated the financial markets in China. For instance, in 2010 the strict enforcement of regulations on LGFV successfully restrained the MCB issuance; but in 2014, facing the mounting rollover pressure, (various) regulators started proposing conflicting rule changes which intentionally facilitated LGFVs to borrow from the MCB market. This interesting observation highlights the power of market force in shaping the regulation in China, which becomes more and more endogenous in later years. This market force, which fundamentally is about how to place traditional banking in a market economy, is perhaps also responsible for the rapid growth of the interbank market and the expedited process of interest rate liberalization after 2012.

**Literature review** This paper belongs to three different but yet connected strands of literatures in the recent development of Chinese economy and financial markets; each of them has been fast-growing in the past years. First, our paper analyzes one of the unintended consequences of China’s four-trillion stimulus package in 2009. [Bai et al. \(2016\)](#) offer a comprehensive account of this unprecedented fiscal stimulus package. In contrast to our paper which focuses on the liability side of stimulus plan, [Bai et al. \(2016\)](#) emphasize the asset side and its resulting inefficiency. According to [Bai et al. \(2016\)](#), local government may have facilitated access to capital to favored firms and hence worsened the overall efficiency of capital allocation, with a potential permanent decline in the growth rate of China’s aggregate productivity and GDP growth. [Deng et al. \(2015\)](#) emphasize the feature of “state control” of the 2009 stimulus package, with state-owned banks extending credit to SOEs and real estate in a massive way. Similarly, based on firm-level data, [Cong and Ponticelli \(2016\)](#) document that following the 2009 credit expansion in China new credit was allocated disproportionately more towards state-owned, low-productivity firms than towards privately-owned, high-productivity firms. This represents a reversal of the trend observed before 2008 during which capital allocations

improved over time.

Second, the major evidence that this paper relies on is MCBs, the corporate bonds that are issued by LGFVs. [Zhang and Barnett \(2014\)](#) provide a detailed description of local government debts, especially those taken by LGFVs. [Ambrose et al. \(2015\)](#) study the unique local government financing channel in China by investigating LGFVs' borrowing backed by land sales. [Ang et al. \(2016\)](#) examine the cross-sectional pricing properties of MCBs, emphasizing the role of real estate dependence of local economy and local political risk associated with the post-2012 anti-corruption campaign. In contrast to [Ang et al. \(2016\)](#), our paper focuses on the quantity of MCBs, and relate its unprecedented growth to the 2009 stimulus plan. [Huang et al. \(2016\)](#) observe a crowd-out effect of massive public debt issuance on private firms' investment post the four-trillion stimulus. They argue that such a negative impact is especially severe for firms more dependent on external funding, suggesting that the stimulus-driven public debt sapped long-term growth in China. Lastly, [Gao et al. \(2016\)](#) study how the political nexus between local politicians and policy bank officials affects local governments' default decisions on bank loans.

Finally our paper belongs to the burgeoning literature that studies China's fast growing shadow banking activities, including both WMPs and entrusted loans. [Hachem and Song \(2017\)](#) highlight the asymmetric competition between the Big-4 banks and their relatively smaller peers in China, and explain how stricter liquidity regulation can generate shadow banking, tighter interbank markets, and credit growth as unintended consequences. [Acharya et al. \(2016\)](#) analyze a proprietary panel data on the wealth management products issued by each bank, showing that the four-trillion stimulus package in 2009 also boosted China's shadow banking activities. [Wang et al. \(2016\)](#) propose a theoretical framework to understand these shadow banking activities as a part of the "dual-track" interest rate reform, in which wealth management products and trust/entrusted loans are ways to channel funds toward more efficient privately-owned firms, but at a higher interest rate than the bank rate offered to state-owned enterprises.

Entrusted loans, referring to the loans between two non-bank parties (e.g., industrial firms) using a bank as an intermediate, are another form of shadow banking that grow rapidly after the 2009 bank-loan-fueled stimulus. A couple of recent papers use entrusted loans as the platform to study China's shadow banking system. [Chen et al. \(2016\)](#) document commercial banks' engagement in intermediating entrusted loans and the various incentives of small and large banks in providing such service. [Allen et al. \(2016\)](#) focus more on the pricing side of entrusted loans and find that entrusted loans between two parties without any relationship charge higher interest rates potentially to compensate

for fundamental and informational risks.

## 2 Institutional Background

We briefly describe the background of China’s four-trillion stimulus package in 2009, and its connections to local governments and their financing vehicles. We then move on to document the evolution of the debt assumed by the local governments after 2009.

### 2.1 Four-Trillion Stimulus and Local Government Financing Vehicles

In the fall of 2008, China’s export-driven economy experienced a head-on blow by the 2007/08 financial crisis which dragged the US economy into the Great Recession. Panel A in Figure 1 shows that China’s annualized GDP growth rate dropped from 9.5% in 2008Q3 to 6.4% in 2009Q1, as total export almost more than halved from Sept 2008 to Feb 2009.<sup>5</sup>

In response, in November 2008 the Chinese premier Wen Jiabao announced to great fanfare a four trillion RMB fiscal stimulus to be spent by 2010, with about 1.5 trillion RMB to be spent on railway, road, airport, water conservancy and urban power grids; 1 trillion on post-disaster reconstruction (Wenchuan earthquake occurred in May 2008); 1.14 trillion on indemnificatory and comfortable housing, rural livelihood and infrastructure; and 0.36 trillion on environment protection and education. As shown in Figure ??, the massive stimulus brought an immediate acceleration in China’s GDP growth, which recovered to 11.9% in 2009Q4 but later slowly landed to 6.7% in 2016.

Right after the announcement in November 2008, Dominique Strauss-Kahn, the then managing director of the International Monetary Fund, stated that “*it will have an influence not only on the world economy in supporting demand but also a lot of influence on the Chinese economy itself, and I think it is good news for correcting imbalances.*”<sup>6</sup> Indeed, in the short run many prominent researchers and policy makers viewed the China’s massive fiscal stimulus helped preventing the world recession from deteriorating.<sup>7</sup> However, less than a decade later, more and more studies have shown the unintended

---

<sup>5</sup>According to the General Administration of Customs of People’s Republic of China, the total export drops from 136.7 billion USD in Sept 2008 to 64.86 billion USD in Feb 2009.

<sup>6</sup>New York Times, November 9, 2008, “China plans \$586 billion economic stimulus.”

<sup>7</sup>Paul Krugman wrote that China responded by “much more aggressive stimulus than any Western nation – and it has worked out well.” See <http://krugman.blogs.nytimes.com/2010/07/24/keynes-in-asia/>.

consequences of this vast four-trillion stimulus package. One of these consequences is the massive debt burden assumed by local governments, which is the focus on our paper.

### 2.1.1 Local governments and their financial vehicles

The four-trillion stimulus package and the mounting debt burden of local governments in China are just two sides of the same coin. Since the major component of the stimulus package is infrastructure projects, including urban and rural, almost all investment spending is naturally implemented and financed through local governments. Only about 1 out of 4 trillion comes out of the budget of the central government, implying a financing gap of three trillion.<sup>8</sup> What is more, given the institutional background of national budget law explained below, local governments were not allowed to borrow by themselves at that time, and hence were forced to finance their investment spending via the so-called LGFVs.

There are several excellent papers explaining the history and peculiarity of the financing of local governments in China. Here, we briefly mention the related institutional details on the regulations faced by local governments and their counter-measures when they are in need of financing. [Bai et al. \(2016\)](#) offer a greater recount of these legal details, and the following exposition is based on their paper.

Before 1994, local governments in China enjoyed much freedom in the allocation of local tax revenues. The “tax sharing reform” in 1994 overhauled the budget law and removed control of local governments over local tax revenues. As a result, the tax share of local governments fell from about 80 percent to 40 to 50 percent in 1994. Not surprisingly, local governments responded by looking for other sources of revenues. One prominent and controversial channel is land sales, i.e., the seizure by local governments of land from farmers and urban residents and the resale/lease of the land to, say, developers ([Zhang and Barnett \(2014\)](#); [Ambrose et al. \(2015\)](#)). Nevertheless, land sales, which cannot be elevated immediately, are not the major financing source for local governments in implementing the 2009 stimulus package within such a short time.

The 1994 budget law also pushed the LGFVs onto the stage. Although the 1994 budget law made it illegal for local governments to run budget deficits, municipals can run implicit deficits by establishing LGFVs and borrowing against them. Legally, LGFV is a state-owned enterprise with the corresponding local government as the only or dominant shareholder, with its shares usually held by the State-owned Assets Supervision

---

<sup>8</sup>Still, this inference begs the question whether China successfully carried out the four-trillion stimulus package in full over the two years in 2009 and 2010. Numerous articles and sources suggested so; for instance, [Bai et al. \(2016\)](#) show that the gross abnormal investment amount in 2009 and 2010 roughly matches the planned stimulus.



and Administration Committee (SASAC).<sup>9</sup> Prior to 2009, these LGFVs were severely restricted to limited financing activities.<sup>10</sup>

Things became quite different starting 2009. To push the four-trillion stimulus package, the central government decided to circumvent the 1994 budget law. Beijing encouraged local governments to use LGFVs to take on bank loans, which are essentially off-balance-sheet borrowing of local governments. Somewhat interestingly, the central government orchestrated the relaxation of regulation from two directions: Ministry of Finance who is in charge of budgetary issues of local governments, and China Bank Regulation Committee (CBRC) who is in charge of commercial banks in China. On one hand, Ministry of Finance issued a regulation that allowed local government to finance investment projects using all sources of funds, including budgetary revenue, land revenue, and funds borrowed by local financing vehicles:

*“Allowing local government to finance the investment projects by essentially all sources of funds, including budgetary revenue, land revenue and fund borrowed by local financing vehicles.”* — Document 631, Department of Construction, Ministry of Finance, October 12, 2009.

In the meantime, to encourage banks to extend credit, CBRC made the following public announcement:

*“Encourage local governments to attract and to incentivize banking and financial institutions to increase their lending to the investment projects set up by the central government. This can be done by a variety of ways including increasing local fiscal subsidy to interest payment, improving rewarding mechanism for loans and establishing government investment and financing platforms compliant with regulations.”* — Document No. 92, CBRC, March 18, 2009.

Local governments had been keen to promote local economic growth over the past several decades (Li and Zhou (2005)). Given these green lights and, to some extent, explicit encouragement by Beijing, local governments implemented the unprecedented stimulus

---

<sup>9</sup>One example of LGFV in Bai et al. (2016) is the Beijing Capital Group Company ("Capital Group") owned by the local government of Beijing. The Capital Group owns the Beijing subway, two toll highways (from Beijing to Tianjin and from Beijing to Tongzhou), and a company that specializes in building urban roads and rain and sewage infrastructure. However, the Capital Group also has three subsidiaries that are essentially real-estate developers and another four financial service companies.

<sup>10</sup>There were only 12 LGFVs that issued bonds in 2008, while this number rose to 516 in 2013. Before 2008, there are only two types of financing vehicles being allowed for LGFVs: i) companies specialized in road and bridge construction, and ii) investment companies specialized in urban development.

package through their LGFVs by taking on a massive amount of loans extended by the banking system.

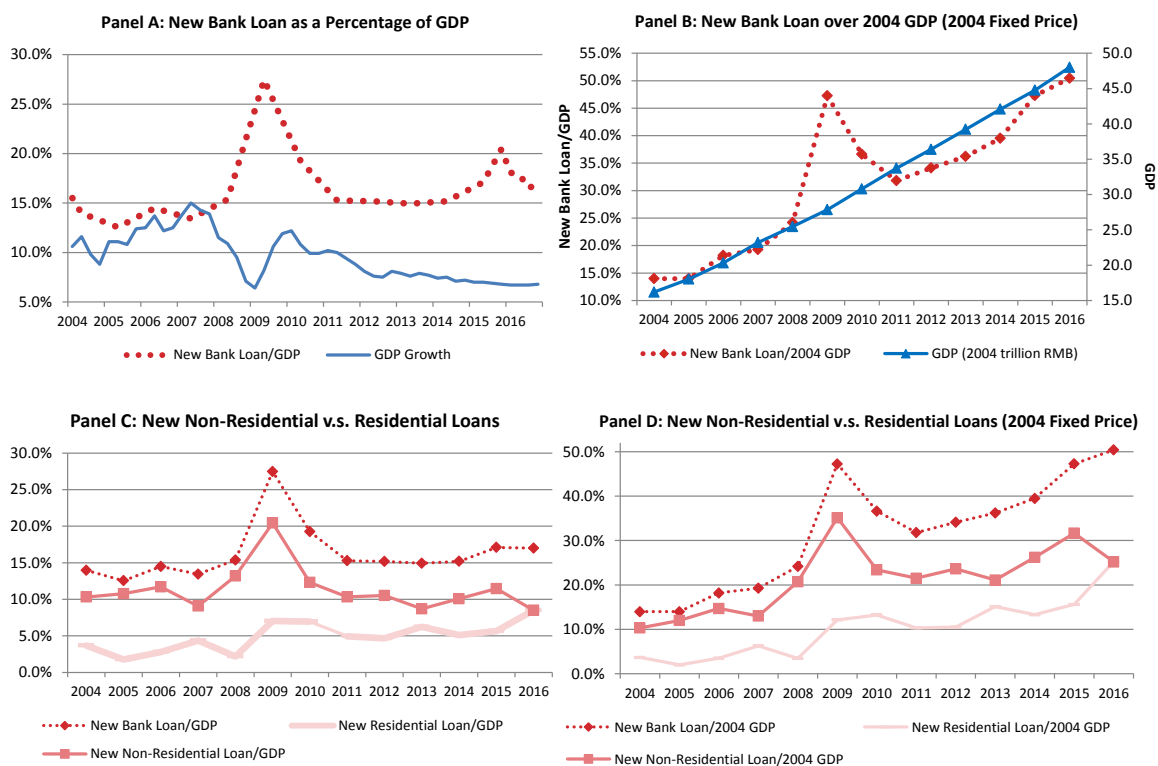


Figure 1: **New Bank Loan Growth in China, 2004-2016.** Panel A plots annual new bank loan over GDP and quarterly GDP growth; Panel B plots new bank loan over 2004 GDP (left scale) and GDP in trillion RMB in 2004 fixed price (right scale); Panel C plots new bank loan, new non-residential bank, and new residential bank loan, all over GDP; and Panel D plots new bank loan, new non-residential bank loan, and new residential bank loan, all over 2004 GDP and in 2004 fixed price. Numbers in fixed 2004 price are converted using GDP deflator. Data source: People’s Bank of China (bank loans) and China National Bureau of Statistics (GDP and GDP deflator).

### 2.1.2 Stimulus package in 2009 fueled by bank loans

Bai et al. (2016) estimate that about 90% of local government investment was financed via bank loans in 2009. Most of the new credit was released by China’s big-four state-owned banks and three policy banks.<sup>11</sup> The stimulus package causes a sudden dramatic

<sup>11</sup>The big-four state-owned commercial banks are Industrial and Commercial Bank of China, Bank of China, Construction Bank of China, and Agricultural Bank of China; the three policy banks are Agricultural Development Bank of China, China Development Bank, and the Export-Import Bank of China. These banks, especially the latter three policy ones, are in general expected to support the country’s economic and political agenda besides the usual goal of profit-maximization.

increase of newly issued bank loans in 2009, which is visualized in Figure 1.

Panel A plots the annual new bank loans scaled by GDP of that year together with the time-series of GDP growth, over the period of 2004-2016. While in normal years new bank loans are about 15% of the GDP in China, this number clearly stands out in 2009 (27.5%) and 2010 (19.2%).<sup>12</sup> To address the concern that the unusually high ratio of new bank loans to GDP in 2009 might be driven by lower GDP that year, Panel B in Figure 1 plots new bank loans each year scaled by 2004 GDP in 2004 fixed price (left scale), together with GDP levels for later years but in 2004 fixed price (right scale). The pattern is even more striking: new bank loans in the two years after 2008, especially 2009, stood out abnormally high. Finally, Panels C and D show that most of the increase of new bank loans in 2009 are toward the non-residential sector (instead of the residential sector, which would be the case after the housing-related credit boom in 2016), consistent with the stimulus package being predominantly infrastructure-investment oriented.<sup>13</sup>

Although this paper focuses on the financing of local governments during and after the 2009 stimulus plan, it is worth pointing out that not all additional new bank loans that year went to local governments. The easy monetary policy, which was pushed by Beijing to help local governments obtain bank financing to implement the fiscal expansion, also led to abnormal bank credit growth to other sectors in China (see, e.g., in [Cong and Ponticelli \(2016\)](#)).<sup>14</sup> Figure 2 provides the breakdown of 2009 abnormal new bank loans to various sectors as a result of stimulus package. We estimate that a total of 4.7 trillion RMB extra new bank loan was extended to the Chinese economy in 2009. LGFVs obtained roughly 2.3 trillion of extra new bank loans in 2009, among which 2.06 (0.26) trillion came from commercial (policy) banks. Non-residential sector (excluding LGFVs) received about 1 trillion of extra new bank loans, and the rest 1.4 trillion went to the residential sector (mainly in the form of mortgage loan). Appendix A provides details on how the sector-level abnormal bank loans in 2009 are estimated.

Several years later the consequences of mounting debt obligations, to which we turn next, surfaced.

---

<sup>12</sup>The newly issued bank loans in 2009 almost doubled from that of 2008, rises from 4.9 trillion RMB in 2008 to 9.6 trillion RMB in 2009.

<sup>13</sup>Heavy infrastructure investment in 2009, which could be considered as part of the long-standing urbanization plan in China, is consistent with the rising land prices around 2009-2010 ([Deng et al. \(2015\)](#)), even without heated residential lending (to the household sector).

<sup>14</sup>As Premier Jiabao Wen stated in 2009 Davos World Economic Forum, the success of 2009 stimulus was due to the combination of “the proactive fiscal policy and moderately easy monetary policy.”

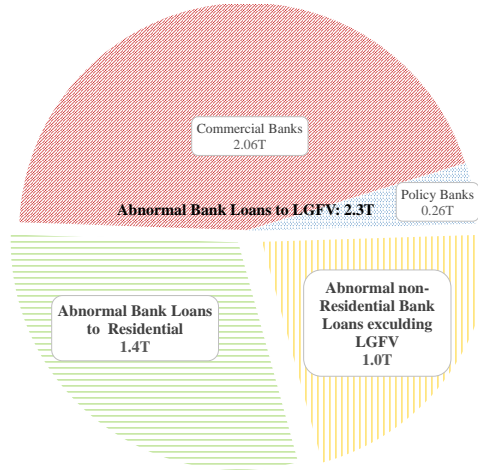


Figure 2: **Decomposition of abnormal 2009 new bank loans extended to various sectors in Chinese economy, with a total of 4.7 trillion RMB.** See Appendix A for details on how the sector-level abnormal bank loans in 2009 are estimated.

## 2.2 Categories of Local Government Debt

Shortly after the stimulus package got successfully implemented via LGFVs in mid 2010, many economists and practitioners raised alarming warnings on the solvency of local governments, as it may jeopardize the steady growth of Chinese economy. What is worse, at that time the central government had no direct statistics to even gauge the aggregate debt balance of local governments, let alone monitoring the potential default risk of the LGFVs. This pushed the National Audit Office (NAO) to conduct the first nation-wide survey on local government debt on December 2010. Another somewhat more detailed official report, dated June 2013, was published by the same office. These two NAO reports are the most authoritative documents that shape all discussions on this topic, and they provide detailed breakdown of China’s local government debt in these two snapshots. We reproduce these information in Table 1.

### 2.2.1 Categories of debt obligations

We investigate the composition shift of four debt obligations reflected in the 2013 report: *Bank loans*, *Municipal corporate bonds (MCBs)*, *Munibonds*, and *Trust*.<sup>15</sup> As we explain shortly, all of them are in the form of debt with implicit bail-out expectations from

<sup>15</sup>There are several liability items that are significant but excluded from our later analysis. “*Accounts receivable*” is excluded due to its nature of working capital (not debt). “*Built-to-transfer*” is the usual source of financing in the Public-Private-Partnership (PPP); it is in the same nature as “*Borrowing from entities & individuals*,” which involves private entities and local government. We, unfortunately, have no data source on this item. Finally, “*Fiscal on-lending*” captures borrowing from higher authorities (like Ministry of Finance).

government, either local or central; and all of them are under the “shadow” of the traditional banking business one way or another.

MCBs are public bonds issued by LGFVs (including *corporate bonds*, *mid-term notes*, and *short-term bills* in the mid-2013 report; see Table 1). One example of LGFVs is given in footnote 9; up to now there has been no single case of MCB default in China. We will turn to MCB in more details in Section 3.1. A conservative estimate in Section 4.4 shows that in 2016 about 62% of MCB are invested by Wealth Management Products, which are sold through commercial banks and considered as the most important form of shadow banking in China (e.g., Acharya et al. (2016); Hachem and Song (2017)).

Munibonds stand for Municipal Bonds issued by local governments. As explained, the 1994 Budget Law prohibited local governments in China from borrowing by themselves, but they may issue Munibonds via Ministry of Finance. In October 2014, Ministry of Finance released its authority fully back to several municipalities, who were then allowed to issue and repay Munibonds by themselves. As we argue shortly, this reform is likely a response to the stimulus-hangover-effect,<sup>16</sup> and starting 2015 we observe a rapid growth of Munibonds under the so-called local government bond-swap program (i.e., issuing Munibonds to repay existing due debt) overseen by Ministry of Finance. We will discuss this bond-swap program in Conclusion.

Finally, Trust debt includes both Trust loans (individuals to firms) and Entrusted loans (firms to firms); both help channel funds to the non-financial sector outside the traditional commercial banking sector.<sup>17</sup> Section 4.4 explains that traditional commercial banks play an important intermediating role in channeling both forms of loans, and hence they are widely considered the barometer of shadow banking activities in China. Starting from 2010, given the surging financing demand of LGFVs backed by local governments, one particular form of Trust loans, termed Trust-Municipality cooperation, becomes popular.<sup>18</sup>

### 2.2.2 Contingency of debt obligations

There is another dimension of break-down of local government debt in NAO reports: “*fully guaranteed*,” “*contingent obligation*,” or “*contingent bailout obligation*.” The mere existence of these categories reflects the uncertainty toward the nature of debts assumed

---

<sup>16</sup>This reform can be traced back to late 2011 when Ministry of Finance started allowing several selected provinces and prefectures to issue Munibonds by themselves, but was still in charge of the debt repayments.

<sup>17</sup>Allen et al. (2017) examine how implicit guarantee distorts the risk-return relation for trust products and thus encourages the shadow banking boom in China.

<sup>18</sup>In this Trust-Municipality cooperation, a trust company raises fund from investors directly or via WMPs (sold by commercial banks), and in turn invests the fund into the LGFVs.

by LGFVs. Are they municipality debt? Or just corporate debt? In China the rules and regulations are in flux, and it is unclear to what extent local governments are liable for the debt assumed by LGFVs. Given that LGFVs are enticed to implement the stimulus plan pushed forward by Beijing, who is the ultimate rule maker, investors naturally expect some forms of bail-out from local or central governments in case LGFVs default (which has not occurred so far).

In response to this wide-spread perception, the State Council of China issued the 43th Document, “Opinions of the State Council on Strengthening the Administration of Local Government Debts”, on September 2014. The “No. 43 Document” and the following regulatory rules banned local governments from providing guarantee to LGFVs’ bond offerings, prohibited local governments from raising debt via LGFVs, and ordered local governments to restructure and substitute existing debt with Munibonds. However, it is unclear how strict these rules are implemented. As explained in Section 5, some other new orders were coming out from other regulatory bodies to counter this strict ruling, and the government’s implicit bailing-out on MCB and related debt was still widely expected among Chinese investors. As a result, while the net MCB issuance dropped to 1.1 trillion in 2015 from the peak of 1.7 trillion in 2014, the number jumped back to around 1.5 trillion in 2016.

### **3 Bank Loan Wanes and Shadow Banking Waxes**

After describing our data sources, this section shows the time-series pattern that the debt liability of local governments in China has slowly shifted from mostly bank loans in 2009 to a significant fraction of non-banks debt after 2012. We then present evidence from various dimensions that is consistent with the stimulus-loan-hangover effect.

#### **3.1 Data Sources**

Our data come from various sources. Details of variable constructions can be found in Appendix B.

##### **3.1.1 Municipal corporate bond data**

LGFVs issue MCBs in five forms including corporate bond, enterprise bond, medium-term note, short-term financing bill, and private placement note. Throughout the paper we use the term “corporate bonds” to refer to all of the above bonds, which are publicly traded in either exchanges or the interbank market. For each MCB issuance WIND

provides the bond-specific information, including actual issuing amount, issuing date, maturity date, issuer’s province, bond rating, issuer’s rating, and the purpose of raised funds.<sup>19</sup>

Mainland China has 31 provincial-level administrative divisions that have MCBs issued by LGFVs.<sup>20</sup> We drop Xizang as it only has one MCB ever issued in our sample, leading to 30 provinces in our final sample. Following common practice, we also classify these 30 provinces of mainland China into seven geographic regions: North China, East China, South China, Center China, Northeast, Northwest, and Southwest.

For all MCBs except the private placement notes, the bond issuance prospectus provides information on the purpose of issuance proceeds. We manually read the prospectus and classify the issuance purpose into three categories: repayment of existing bank loan, investment in projects such as rebuilding shanty areas or constructing infrastructure, and others (including replenishing working capital, repaying trust, repaying bank acceptance bill, and repaying other liabilities without information on debt types). However, caution needs to be taken in interpreting these voluntary disclosures.

### 3.1.2 Bank loans and other data

Country-wide and province bank loan data are from the People’s Bank of China (PBOC) and provided by WIND. Annual new trust loan and new entrusted loan data are from the Aggregate Financing to the Real Economy released by PBOC since 2011.

Data on real GDP growth and GDP RMB value at the country and province level are from National Bureau of Statistics of China. Other macroeconomic variables reported by National Bureau of Statistics include provincial fiscal deficit measured as the fiscal expense minus the fiscal revenue, fixed asset investment, and local government’s land sale RMB value.

The structure of local government debt is estimated from 2008 to 2016, with details provided in Appendix B. The National Auditing Office provides two official auditing reports on local government debt that we recreate in Table 1. We fill in other years with

---

<sup>19</sup>Strictly speaking, the bonds issued by these non-listed LGFVs are often translated to “enterprise bonds,” as “corporate bonds” in China refer to bonds that are issued by publicly listed companies. These two bonds used to be traded on different platforms (exchanges or the interbank market), but nowadays this is no longer the case. Another important difference between corporate bonds and enterprise bonds is the different regulatory bodies: the former is overseen by China Securities Regulatory Commission (CSRC), while the latter by the National Development and Reform Commission. Finally, WIND records the same bond traded on both exchange and inter-bank market as two different bonds; and we drop those duplicate bonds.

<sup>20</sup>China has 34 provincial-level administrative divisions, including 23 provinces, 5 autonomous regions, 4 direct-controlled municipalities (Beijing, Shanghai, Tianjin, and Chongqing), and two special administrative regions (Hong Kong and Macau).

several data sources. Annual Municipality-Trust cooperation data are reported officially by China Trustee Association and available on WIND. Data on bank loan balance of LGFV before 2012 are from various validated news sources and collected by WIND. Individual Munibonds and MCBs are downloaded from WIND.

Finally, the aggregate Wealth Management Product (WMP) balance and the year-end balance of credit bonds by ratings are from WIND. We get the WMPs' holding in credit bonds by rating from China Commercial Bank Wealth Management Products Annual Reports issued by China Banking Wealth Management Registration System.

### 3.1.3 Summary statistics

Table 2 reports the summary statistics of the data used in this paper. Panels A (B) presents information on MCB issuances by regions (provinces). East China, which has the largest economic share, issued around 38% of total MCB. The Southwest region that experienced the Wenchuan earthquake in 2008 has the second largest share of MCB issuance (15%).

Panels C and D present the summary statistics of the raw/abnormal values of various variables at the provincial level (abnormal is defined as the excess value over the 2004-2008 average). Each year, on average a province issued MCBs worth of 2.2% of its GDP over the period of 2012-2015. The number is quite similar (2.1%) if we subtract the average of 2004-2008 MCB/GDP, suggesting that LGFVs issued few MCBs in early years. The cross-provincial average 2009 bank loan (BL)/GDP is 27.5% with an abnormal BL/GDP of 16.4%, which is around 1.5 times increase from the 2004-2008 average of 11.1%. In contrast, we do not see much increase in the 2008Q1-Q3 BL/GDP.

## 3.2 Evolution of Debt Obligations of Local Governments

### 3.2.1 Credit policy tightening and rollover pressure

Witnessing the wild surge of bank credit in 2009, the central government realized that the policy-driven credit boom may grow out of control, with potential distortions and liquidity overhang devastating to the economy. As early as January 10, 2010, a Financial Times article titled “Beijing Seeks to Curtail Bank Lending ‘Binge’ ” reported that banks were expecting the government to tighten the monetary policy in the following months.<sup>21</sup> Here, the word “tightening” does not mean banks stopped extending credit; it

---

<sup>21</sup>The report writes “*the authorities (CBRC) had ordered some Chinese banks temporarily to halt lending altogether after the sector extended a total of 1.1 trillion RMB in new loans in just the first two weeks of January.*” The beginning-of-the-year abnormal loan growth in 2010 is exacerbated



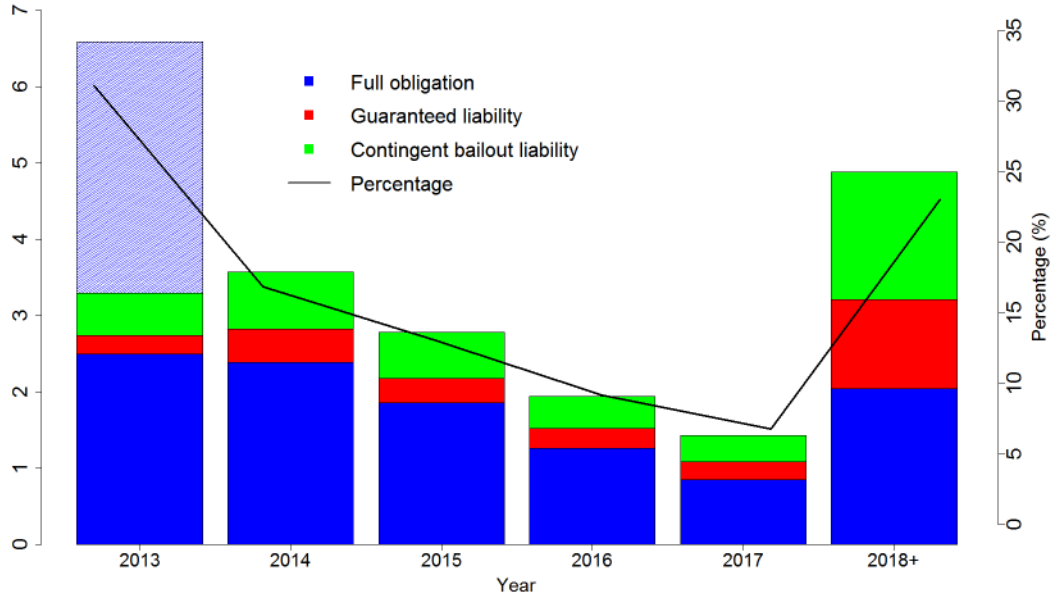


Figure 3: **Local Government Debt Due Schedule as of June 30, 2013.** The total outstanding local government debts are classified into three categories: full obligation, guaranteed liability, and contingent bailout liability. We assume the debt due at the first half of 2013 is the same as the debt due at the second half of 2013. Data source: local government debt auditing report in 2013 issued by National Audit Office of China.

was “tighter” relative to the extremely slack credit policy of 2009. In Figure 1 we observe that the new bank loan over GDP, following the unprecedentedly high level of 27.2% in 2009, dropped to 19.2% in 2010 (which still exceeded the normal level). Afterwards, the credit policy in China seemed to revert to normal, as shown in Figure 1.

The somewhat unexpected credit tightening following 2009 pushed local governments to explore other sources of financing for their on-going investment. Shortly, we will present evidence that LGFVs are issuing MCBs to fund their projects, potentially the continuation of initial investment in 2009.

Our paper highlights another more distinct channel. These stimulus loans were backed by infrastructure projects whose cash-inflows likely occur in the remote future. Kroeber (2016) explains this classic “maturity mis-match” of Chinese local governments by writing “Localities often used three- to five-year bank loans to finance infrastructure projects whose economic benefits (and revenue streams, if any) would only materialize over two or three decades” on page 122, Chapter 6. Naturally, LGFVs faced unprece-

by the banks’ expectation that the government will tighten monetary policy in the coming months. By Jamil Anderlini, January 10, 2010. URL: [http://www.ft.com/cms/s/0/320cf850-0a1a-11df-8b23-00144feabdc0.html?ft\\_site=falcon&desktop=true#axzz4SeC0xGT8](http://www.ft.com/cms/s/0/320cf850-0a1a-11df-8b23-00144feabdc0.html?ft_site=falcon&desktop=true#axzz4SeC0xGT8).

dented heavy pressure to rollover the loans coming due about three to five years later.<sup>22</sup>

Figure 3 gives the detailed debt due schedules standing at June 30th, 2013. Because June 2013 is the mid of that year, we simply double the debt due in the second half of 2013 to proxy for the debt due that year (indicated by the hatched area). The magnitude of rollover pressure starting from 2013 was enormous. Local governments needed to pay back about 3.25 trillion RMB of debt in the second half of 2013 (so about 6.5 trillion in the whole year of 2013), and about 3.5 trillion in 2014. To put these numbers into perspective, they account for about 45% of local government debt obligations, and most of these soon-to-be-due debt obligations are bank loans. More importantly, they were comparable relative to the sum of other non-bank financing sources (Munibonds, MCB, and Trust loans), which was about 5 trillion at the end of 2013. This mounting rollover pressure is why at that time leading economists in many institutions were concerned about the debt situation of China's local government debt.

### 3.2.2 Bank loans down, non-bank debt up

Facing tightening/normal credit policy, local governments responded by resorting to non-bank debt mentioned above, either to refinance part of maturing bank loans or finance their continuation investments. For LGFVs with a full flexibility to choose who to borrow and/or refinance from, what matters is the easiness and the rate at which they can obtain financing. The trade-off has slowly leaned toward non-bank sources since 2012; for instance, from loan pricing terms it has become more attractive to tap credit from MCBs than bank loans.<sup>23</sup>

As the main result of this section, Figure 4 depicts the evolution of total local government debt balance and the composition of each category (Panel A), and the evolution of the percentage for each category (Panel B). We indicate NAO (i.e., National Audit Office) on Dec 2010 and June 2013 to highlight that these two snapshots are authoritative numbers from national auditing reports. We have tried our best (as explained below) to fill in the entire time series for each category from 2008 to 2016; for details,

---

<sup>22</sup>Written in August 2012, [Chen and Gu \(2012\)](#) analyze in length the situation of local government debt after the 2009 stimulus plan, together with its potential impact on the commercial banking system in China. In that paper, according to an internal report by CBRC, standing at Nov 2010 the bank loan due schedules for LGFVs are 0.8 trillion RMB due in one year, 2.2 trillion due after one year but before three years, 3.5 trillion after three years but before 10 years, and 2.6 trillion after 10 years (see their Figure 12).

<sup>23</sup>According to practitioners, the loan rate that LGFVs can obtain from banks is about 110~115% of the benchmark lending rate set by PBOC. In 2012, based on the information of prevailing benchmark lending rate and MCB rate, we find that the LGFV bank borrowing rate exceeds MCB rate by about 2 percentage points.

see Appendix A.<sup>24</sup>

The data of total local government debt are from the two NAO auditing reports (2008, 2009, 2010, 2012), interpolation (2011, 2013), and public news release (2014, 2015, 2016) from regulators.<sup>25</sup> WIND provides the accurate issuance data for Munibonds and MCBs. The evolution of Trust loans is estimated by combining the snap-shot of the total Trust loans to local government in the mid-2013 NAO auditing report, together with the annual outstanding balances of Municipality-Trust cooperation; see Appendix B.5 for details.

For bank debt, the president of CBRC (Fulin Shang) regularly reveals the aggregate exposure of the banking system to local governments via the official website of CBRC (and WIND recorded this information over time) before June 2013. Afterwards it seems that this information started becoming sensitive and hence is no longer available on the CBRC website. Instead, we resort to the annual reports of listed commercial banks, hoping that some banks keep reporting their loan exposures to local governments. Only one of the Big-4 banks (Construction Bank of China) reported this information, based on which we construct the outstanding bank loans to local governments of the entire banking sector after June 2013. We acknowledge that it is much less accurate than the numbers before June 2013, and hence indicate them with dashed line in both panels of Figure 4.<sup>26</sup>

Figure 4 serves two purposes. The first is more for fact-recording, as we have produced perhaps the most reliable estimates (based on public information only) for local government debt and its various compositions. The second is our main point: starting in 2012, besides the fast growth of total debt balance of Chinese local governments (from 5.6 trillion in 2008, 17.4% of GDP, to 26.8 trillion in 2016, 36.0% of GDP), there is also a steady and noticeable composition shift from bank loans to non-bank debt. In fact, this point is already quite evident based on the two NAO reports only. Bank loans were about 80% of total local government debt at the end of 2010, which dropped to below 60% in the mid-2013 report; in contrast, the fraction of bonds rose from 7% in 2010 to 10% by mid-2013 (and grew dramatically afterwards).

---

<sup>24</sup>In Panel A of Figure 4, there is a gap between the solid line (the total debt obligations of local governments) and the sum of bars (aggregating over four debt categories). As explained in Section 2.2.1, it is because we miss several other debt liability items, such as build-to-transfer and fiscal on-lending.

<sup>25</sup>In the literature there are several other academic papers (e.g., [Chen and Gu \(2012\)](#); [Bai et al. \(2016\)](#); etc) that report numbers on total debt obligations assumed by local governments, and we confirm that our numbers are close to theirs.

<sup>26</sup>The potentially poor estimate of bank loans to local governments after June 2013 does not affect the estimated percentage of non-bank debt as a fraction of total local government debt obligations, as both inputs (non-bank debt and total debt) are rather accurate.

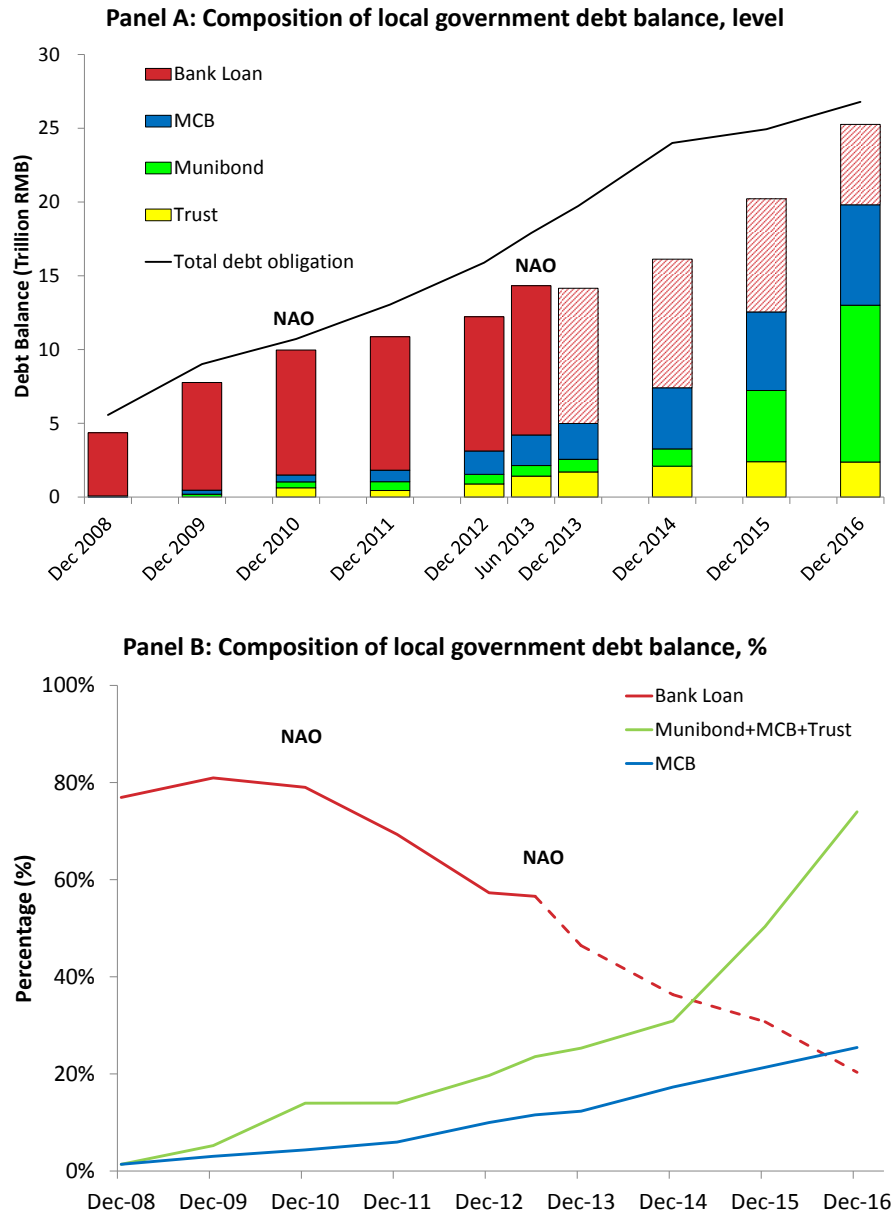


Figure 4: **Local Government Debt Composition, 2008-2016.** Panel A plots the composition of local government debt balance in trillion RMB and Panel B plots the percentage of local government debt balance by composition. Four forms of local government liability include bank loan, municipal corporate bond, municipal bond, and trust. The data construction details are in Appendix A.

### 3.3 Direct Evidence from MCB Prospectuses

We now present the first evidence on MCB that support the stimulus-loan-hangover effect. Figure 5 Panel A plots the evolution of the MCB issuance activities over the period of 2004 to 2016, with new bank loan over GDP in the background. The solid line depicts how the total gross MCB issuance evolves over time. We start observing a steady growth of MCB issuance only starting 2009, with two notable jumps in 2012 and 2014. The dashed line plots the net MCB issuance (gross issuance minus those matured in that year). The difference between solid and dashed lines are negligible before 2015, indicating that the rollover pressure from maturing MCB is not that much a concern until 2015.

As explained in the data section 3.1.1, since MCB is a public offering, every LGFV who is issuing MCB has to provide a prospectus, in which the bond issuer reveals the purpose of issuance.<sup>27</sup> We group various issuance purposes into three categories: *investment*, *repaying bank loans*, or *others* (e.g., replenishing working capital, repaying bank acceptance bill, repaying trust, etc.); for details see Section 3.1.1. Panel B in Figure 5 plots the time-series of each category over the period from 2008 to 2016. We observe that in the first two years right after stimulus (2009 and 2010) almost all MCB issuance were for investment, which is likely to be continuation of those long-term infrastructure projects started in 2009. But repayment-driven MCB issuance has picked up its pace since 2011; it reached about a quarter of total MCB issuance in 2013, and experienced a blasting growth afterwards. In 2015, almost half of MCB issuance deals are for repaying maturing bank loans.<sup>28</sup>

Although there appears to be a noticeable magnitude difference between bank loan over GDP (left scale) and MCB issuance over GDP (right scale) in Figure 5, it is worth pointing out that quantitatively our story matches with data fairly well. Recall Section 2.1.2 explains that of the total 4.7 trillion abnormal bank loans, 2.3 trillion went to LGFVs. Since the 2009 stimulus loans occurred one-time only, our mechanism implies that the cumulative issuance of non-bank debt instruments (e.g., MCB and Trust) for debt repayment during 2012-2015 should roughly match with this 2.3 trillion number. In the data, the cumulative issuance amount is 2.1 trillion RMB by the end of 2015, with 1.4 trillion from  $MCB_{repay}$  and 0.7 trillion from trust financing.<sup>29</sup>

---

<sup>27</sup>In our sample, about 80% of MCB issuances have prospectus, except the bond is issued in the form of “private placement note” so that the information is only revealed to private investors. “Private placement note” only becomes available after 2014.

<sup>28</sup>Anecdotaly, there are news reporting LGFVs to mis-classify bank-loan repayment to investment in their prospectus. It is hard to quantify the bias, however.

<sup>29</sup>The cumulative LGFV trust debt increase is 1.9 trillion from 2012 to 2015. We do not have

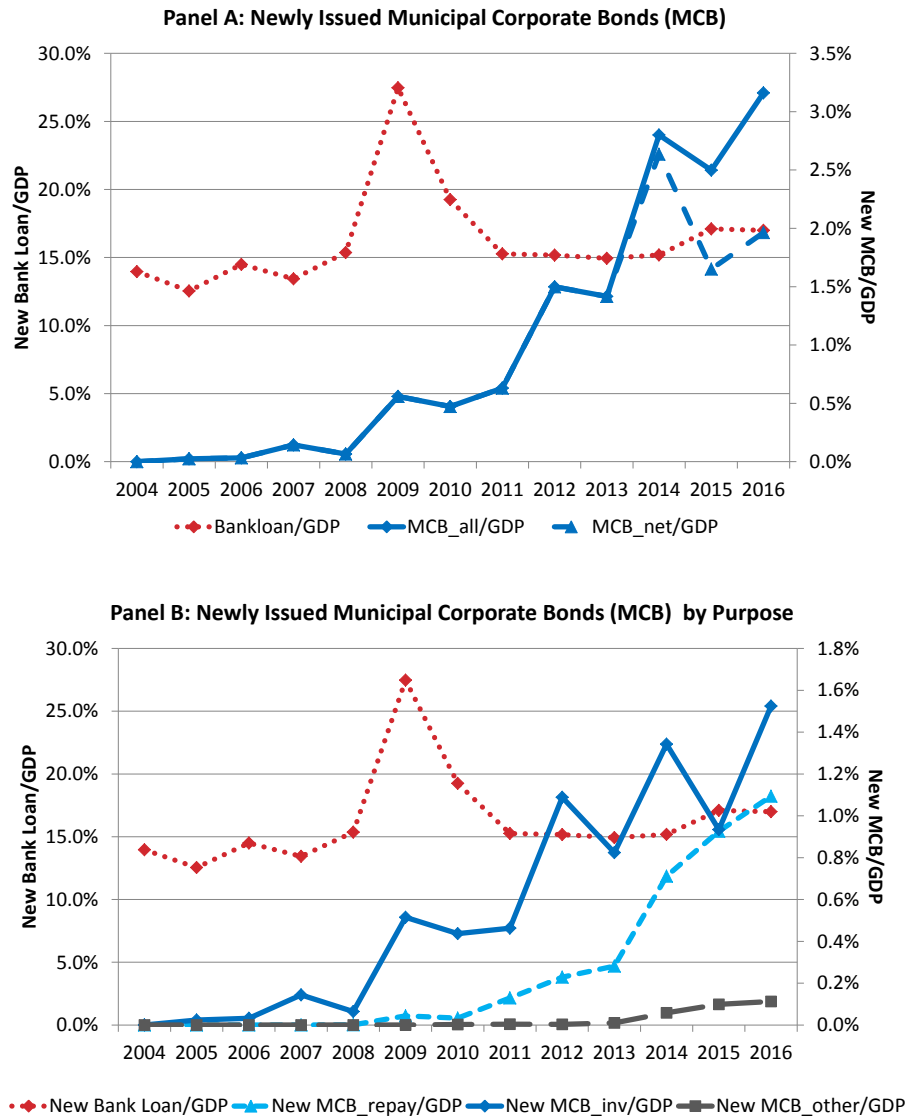


Figure 5: **Municipal Corporate Bond Issuance, 2004-2016.** Panel A plots the total MCB issuance over GDP, the net MCB issuance over GDP, and new bank loan over GDP. Panel B plots the total MCB issuance over GDP by usage, including repayment of bank loans, financing of an investment, and other purposes. The new bank loans over GDP are plotted against left vertical axis and MCB issuance over GDP are plotted against right vertical axis. The annual MCB issuance data are aggregated from individual municipal corporate bonds downloaded from WIND.

## 4 Cross-Sectional Evidence from MCB and Links to Shadow Banking

Taking the stock of time-series evidence so far, we have painted the following picture: in 2009 China’s local governments took on massive stimulus bank loans, and about three-to-five years later they resorted to non-banking financing to either continue their ongoing long-term investment or rollover their maturing bank loans. Based on the municipal-level MCB data, this section explores the cross-sectional implication of the stimulus-loan-hangover mechanism, which predicts that the more the bank loans an area was taking on in 2009, the more the MCBs that area would issue in later years after 2012. In Section 4.4, we connect the shift toward non-bank debt with shadow banking activities in China, which has experienced a “barbarian growth” since 2012.

It is worth emphasizing one additional advantage offered by MCB that is important for our empirical test. In general, for cross-sectional analysis, researchers need to be careful in distinguishing *the source of funds* and *the use of funds*, especially when studying shadow banking. It is quite common for some wealthy individuals in developed coastal cities (say Shanghai) to buy WMPs that are backed by Trust products investing in some projects from underdeveloped inner land cities (say Qinghai). Consider the alternative of collecting data on individual trust products that are also available on WIND. Although the prospectus of a typical trust product also identifies perfectly where the funds get raised, there is only extremely vague information—often nothing at all—on where the funds are used. In contrast, since MCBs are issued for the infrastructure projects in particular prefectures or cities, we know the use of funds, i.e., where the funds go to. This is clearly what our cross-sectional prediction is about.

### 4.1 Main Hypothesis

The stimulus-loan-hangover mechanism discussed above has the following hypothesis with a straightforward cross-sectional prediction.

*Hypothesis. If a region/province was more aggressive in taking on bank loans in 2009, then this region/province will issue more MCBs several years later.*

To test this hypothesis, for each province/region, we first construct the “abnormal” bank loan over GDP at 2009, which is defined as the 2009 value minus its average in the

---

information to obtain the loan repayment part of the LGFV trust issuance. However, the China Trust Association provides the number on the fraction of quarterly loan-type trust balance. We use this number to estimate the cumulative trust issuance for loan repayment to be 0.7 trillion.

past five years (here BL stands for bank loans and “i” indicates province/region):

$$(2009 \text{ Abnormal BL/GDP})_i = (2009 \text{ BL/GDP})_i - (\text{Average BL/GDP } 2004\sim 08)_i \quad (1)$$

Similarly, we construct the provincial/regional “abnormal” MCB over GDP in each future year from 2012 to 2015:

$$(201t \text{ Abnormal MCB/GDP})_i = (201t \text{ MCB/GDP})_i - (\text{Average MCB/GDP } 2004\sim 08)_i,$$

for  $t = 2, 3, 4, 5$ . Our regressions treat (2009 Abnormal BL/GDP) as the independent variable while (201t Abnormal MCB/GDP) as the dependent variable, i.e.,

$$(201t \text{ Abnormal MCB/GDP})_{i,t} = \alpha_t + \beta_t (2009 \text{ Abnormal BL/GDP})_i + \text{Controls}_{i,t} + \epsilon_{i,t}. \quad (2)$$

Later we also run a panel regression in which we pool observations from different years 2012-2015 altogether (so that  $\alpha_t$  and  $\beta_t$  no longer depend on  $t$ ), and report standard errors robust to two-way clustering at the province-year level.<sup>30</sup>

To address the potential concern of a significant cross-region disparity in financial development in China, we have taken out the past-five-year average of BL/GDP for each province when constructing the key independent variable (i.e., 2009 Abnormal BL/GDP) in (1). In other words, (2009 Abnormal BL/GDP) captures the heterogeneous deviations—here, the aggressiveness in credit expansion—in response to the stimulus plan away from the province-dependent steady state. This treatment is particularly attractive in light of Panel B in Figure 1 which shows a steady pattern between new bank loans and GDP in China.

We emphasize that it matters little whether the variation in (2009 Abnormal BL/GDP) was driven by demand-side shocks (e.g., LGFVs in some provinces were aggressive to launch some infrastructure projects in 2009) or supply-side shocks (e.g., banks in some provinces were pushed by Beijing to lower their lending standards). Either way, the rollover channel says that bank loans taken in 2009 need to be repayed when these bank loans become due, giving rise to heterogeneous rollover pressures in later years across provinces. What concerns  $\beta_t$  in (2) to be biased is that, at the province level, (201t Abnormal MCB/GDP)—which may be neither for loan repayment nor for continuing phases of 2009 infrastructure projects—is correlated with (2009 Abnormal BL/GDP) given regional disparity in China. This is why in regression (2) we include province-level

---

<sup>30</sup>To save space, we only report regression results during the period of 2012-2015; the result in 2016 is similar.



economic variables, say province GDP growth, that the prior literature has found to be relevant for MCB issuances.

Nevertheless, it is interesting to mention two arguably exogenous shocks that drive the heterogeneous aggressiveness across areas. The first is the May 2008 Wenchuan earthquake which occurred in the Southwest region of China. Recall that one fourth of stimulus plan is for post-disaster reconstruction, and we will see this Southwest effect shortly. Another important driver, which is particularly relevant in China, is the personal attribute of the party secretary of that province; and the exclusive restriction likely holds because there is a heavy personnel turnover due to the planned government transition in 2012.<sup>31</sup>

## 4.2 Cross-Sectional Evidence: MCB Issuance

Panel A in Figure 6 gives the regional scatter plot between the 2009 abnormal bank loan and MCB issuance for each year from 2012 to 2015. The region of “Southwest”, where the Wenchuan earthquake in May 2008 occurred, had the largest abnormal bank loan growth in 2009 for post-disaster reconstruction. Consistent with our hypothesis, this region ranked top in its abnormal MCB issuance in three out of four later years. Panel B then zooms in further to present the provincial scatter plot.

Table 3 conducts the formal regression analysis for each year. Panel B says that cross-sectionally, the 2009 abnormal bank loan growth positively predicts the abnormal MCB issuance in that province, with 1% level significance in both 2013 and 2014; and magnitude-wise we obtain similar coefficients over years. The statistical insignificance in 2012 but significance in later years is reasonable; according to Figure 5, the stimulus-loan-hangover got intensified after 2012. For 2015, Munibonds issuance due to the new Budget Law passed in late 2014 relieved part of the rollover pressure of local governments.

Panel C of Table 3 presents the results of provincial regressions with economic controls. We follow Bai et al. (2016) to include abnormal fiscal deficit over GDP, abnormal fixed asset investment over GDP, abnormal land sale over fiscal revenue, and GDP growth, all at the same year and the same province as the abnormal MCB issuance.<sup>32</sup> We also include the “corruption index” developed by Ang et al. (2016) as a control; this

---

<sup>31</sup>In unreported results, we have used two province-level dummies as instrumental variables that potentially drive the exogenous variations in 2009 abnormal bank loans across areas. As explained, the first dummy is being in the “Southwest” region (Wenchuan earthquake in May 2008), and the second dummy is the local party secretary’s connection with central government (ever worked in Beijing). Although the second stage results are still positive and significant, we suffer from the “weak instrument” problem as the  $F$ -stat in the first stage is only 2.35 (while the convention is to have a  $F$ -stat above 10).

<sup>32</sup>Throughout the paper, “abnormal” means we take the year  $t$  observation and subtract its average between 2004 and 2008 except specified.

index is a political-rank-weighted number of corrupted officials, capturing the severity of provincial political risk. The 2009 abnormal bank loan growth positively predicts the abnormal MCB issuance in years 2013 to 2015. The coefficient in front of the province GDP growth is always significantly positive across different specifications, reflecting the mechanical relation between economic activities (GDP) and investment (financed by MCB). Corruption index has a positive coefficient and is marginally significant (significant at 5% level for 2013), suggesting that provinces with loose governance were issuing more MCB during 2012-2015.

### 4.3 Robustness Results and Economic Magnitude

We provide further validating evidence for our stimulus-loan-hangover mechanism, and discuss the economic magnitude of our estimated coefficients.

#### 4.3.1 Placebo test of 2008 bank loan growth

Table 4 presents the placebo test which considers the 2008Q1-Q3 abnormal bank loans for each province as the explanatory variable; we focus on the first three quarters of 2008 because the stimulus plan started in November 2008. Similar to the construction of 2009 abnormal bank loans, 2008Q1-Q3 abnormal bank loans at each province are defined as the 2008 first-three-quarter new bank loans over the GDP of that period, minus their average over the past four years (2004-2007). The concern of seasonality is minimal because we are exploiting the cross-province variations in the bank loan growth in the first three quarters.

According to our mechanism, the cross-province pattern of 2008Q1-Q3 abnormal bank loans cannot explain the cross-province pattern of future MCB issuance in 2012-2015; and this test also helps rule out the standard concern that there is some pre-trend for the cross-province distribution of 2009 abnormal bank loans. Panel A in Table 4 first replaces the independent variable with the 2008Q1-Q3 abnormal bank loans. As expected, none of the coefficient in front of the new explanatory variable is significant for years 2012-2015. Panel B further combines both 2008Q1-Q3 and 2009 abnormal bank loans in the regression, and provides a formal statistical test for the hypothesis of equal coefficients in front of two abnormal bank loans. The  $F$ -statistics reported in Panel B reject this hypothesis at the 10% level for 2012 and 2013, 1% level for 2014, and 5% level for 2015.

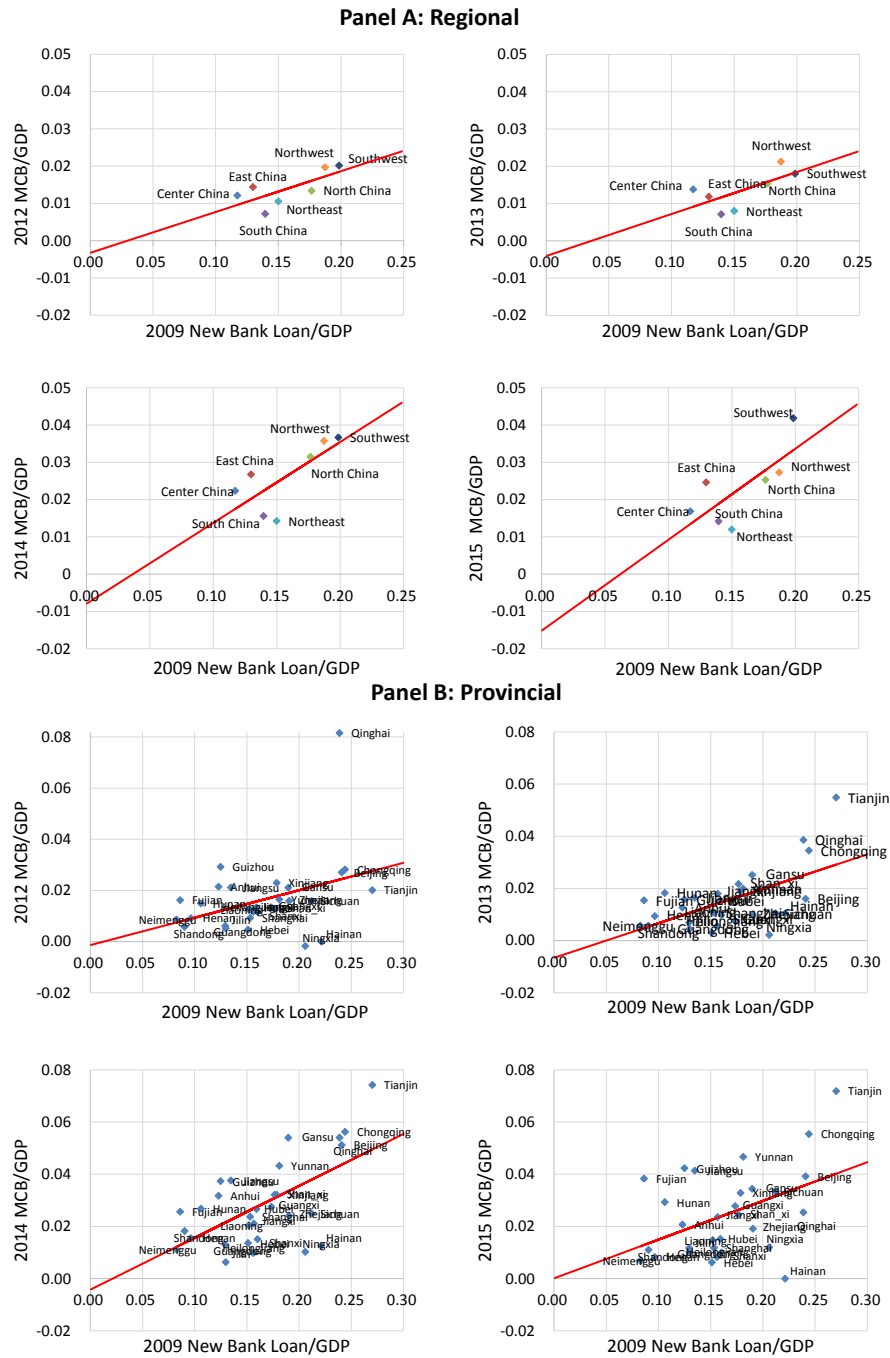


Figure 6: **2009 Abnormal New Bank Loan and 2012-2015 Abnormal Municipal Corporate Bond Issuance.** Panel A (B) presents the scatter plot with a fitted line for regional (provincial) data. Abnormal new bank loan and abnormal MCB issuance (as a percentage of GDP) are calculated over their average values between 2004 and 2008, respectively. The bank loan data are from the People’s Bank of China and the MCB issuance data are from WIND.

### 4.3.2 Panel regression results

Table 5 reports the panel regression results when we group the MCB issuance observations for years 2012-15 altogether, with province-level controls that are relevant for the MCB issuance by local governments. The first column has no controls, while the second column we include the same control variables as in Panel C of Table 3; both give a statistically significant coefficient in front of (2009 Abnormal BL/GDP). We include the year fixed effect in the regression, and report  $t$ -statistics double-clustered at province and year levels (so errors can be correlated for the same province or the same year).

Comparing our panel regression result in Table 5 to those separate regressions in Table 3, we find it interesting that the coefficient for (2009 Abnormal BL/GDP), which is about 0.15, is relatively stable across all specifications, either panel or year-by-year regression, with control or without. This lends further support for the robustness of our result.

### 4.3.3 MCB issuance by purposes

Recall that we have information on why LGFVs are issuing MCB, as about 80% of MCB issuances publish prospectuses revealing their issuance purposes (except private placement notes; see Section 3.3). The MCB sample with prospectus information is representative of our entire MCB sample.<sup>33</sup>

We repeat the same cross-sectional analysis for three different kinds of usage: investment ( $MCB_{inv}$ ), bank loan repayment ( $MCB_{repay}$ ), and others ( $MCB_{others}$ ), and present the results in the next three columns in Table 5. In our framework, the stimulus-loan-hangover effect is reflected in  $MCB_{repay}$  and part of  $MCB_{inv}$ , as the latter includes the MCB issuance for continuing investment started in 2009. However, we expect only  $MCB_{repay}$  to be significant in our regression, a prediction confirmed in Column 3 to Column 5 in Table 5. This is because we have controlled local economic activities (e.g., local GDP growth) which should have absorbed the effect of continuing investment in that region.

---

<sup>33</sup>The fraction of MCB with prospectus information, i.e., issuances excluding private placement notes, is 81.6% in RMB value and 79.7% in number of bonds, indicating no systemic size bias in the sample with prospectus information. And there should be little concern about whether LGFVs use private placement notes to avoid releasing the loan rollover information, because this type of information is required to be revealed to private investors anyway even in private placement notes.

#### 4.3.4 Economic magnitude

The last column in Table 5 provides the economic interpretation of our regression coefficient. In a crude sense, the coefficient in front of (2009 Abnormal BL/GDP) in the regression of  $MCB_{repay}$  reflects the annual bank loan repayment, which corresponds to the inverse of loan maturity. To facilitate this interpretation, we make two crucial adjustments to our regression. First, for each province we scale future MCB issuance by its 2009 GDP, which is the same scaling as the explanatory variable (2009 Abnormal BL/GDP). Second, ideally, the regression coefficient should be identified from different bank loans taken by different provinces in 2009, rather than the cross-sectional divergences in provincial GDP levels. To mitigate the GDP-driven divergence of observed abnormal BL/GDP, we sort provinces based on their 2009 GDP and take the ten provinces that have the most similar level of GDP in 2009.<sup>34</sup>

The resulting coefficient for 2009 abnormal bank loans, when explaining the MCB issuance for bank loan repayment, is 0.13. Taking into account that about half of the abnormal bank loans goes to LGFVs (see Figure 2), this implies that if an LGFV borrows an extra dollar in 2009, then after 2012 this LGFV needs to issue 26 cents more MCB each year to pay back bank loans. This estimate implies an average maturity of 4 years, which squares surprisingly well with the reported three- to five-year bank loan maturity discussed in Section 3.2.1.

#### 4.3.5 Does abnormal 2009 BL/GDP matter for MCB pricing?

We have so far focused on the quantity of MCBs, as we are mainly interested in studying the composition shift of local government debt. It is natural to ask whether the extra MCB issuance from provinces with aggressive bank credit in 2009 affects the prices that these provinces receive, above and beyond the risk-profile of individual MCBs. However, MCBs are issued and traded in a national-level corporate bond market (either the interbank market or exchanges), implying little province-level investor segmentation in these markets in China (for instance, WMPs are an important investor for MCB). Hence the standard asset pricing argument suggests that only the risk-profiles, but not relative quantities, matter.

---

<sup>34</sup>These ten provinces are Yunnan, Chongqing, Jilin, Shanxi, Tianjin, Jiangxi, Guangxi, Shan\_xi, Heilongjiang, Neimenggu. To select the ten provinces with the most similar level of GDP in 2009, we first rank all 30 provinces according to their 2009 GDP values. We then examine groups containing ten sequentially sorted provinces, i.e., group one contains province 1 (highest GDP value) to province 10, group two contains province 2 to province 11, etc. The selected group (15<sup>th</sup>) has the smallest “divergence” ratio, which is defined as the difference between the top and the bottom GDP divided by the mean GDP.

Table 6 investigates this question. In Column 1, we first pool all observations in 2012-2015 together and regress the issuing yield spread of each individual MCB bond on its various risk profiles, i.e., credit ratings and bond maturities; we also include other variables from Ang et al. (2016) that potentially capture the repayment ability of local governments. We observe that credit rating stands out as the most significant driver of MCB yield spreads.<sup>35</sup> Column 2 then includes 2009 BL/GDP as an extra explanatory variable, which is insignificant, with almost no effect on adjusted R-square. Consistent with the fact that there is little province-level segmentation in China’s corporate bond market, the quantity measure 2009 BL/GDP is insignificant in explaining the yield spread of MCBs cross-sectionally. Columns 3 to Column 6 repeat the same exercise for each year and reach the same conclusion.

#### 4.4 Linking to Shadow Banking in China

This section attempts to connect the non-bank debts on the liability side of local governments to the recent surging shadow banking activities in China. We approach this from the following two angles.

The first one is the off-balance-sheet Trust loans (including entrusted and trust loans); often time, these deals are arranged via banks to move the resulting loans out of their balance sheets. Since 2011, the Statistics and Analysis Department at PBOC has started releasing the quarterly statistics of Aggregate Financing to the Real Economy, which measures the total amount of financing that the real economy receives from the financial system in a given period. This measure is divided into four categories: on-balance-sheet financing (e.g., bank loans), off-balance-sheet financing (e.g., trust and entrusted loans), direct financing (e.g., bond and equity issuance), and others. Historical statistics dating back to 2002 became available in 2012, and more importantly, PBOC started releasing these statistics at the province level in 2013.

The second angle is the so-called WMPs (i.e., Wealth Management Products), which are often sold by China’s commercial banks to unsophisticated household investors at a

---

<sup>35</sup>There are two points worth highlighting. First, in China, the risk-free benchmark with the same maturity is the bond yield offered by China Development Bank (rather than that of Treasury bond due to differential tax treatment). Second, we observe unusually large t-statistics for credit ratings in Table 6, which is perhaps a result of some peculiar institutional practice in China. Starting June 2010, National Association of Financial Market Institutional Investors (the self-regulatory body of the interbank market) publishes the “guidance curve” for corporate bond yield as a function of bond rating, which is closely followed by LGFVs who are issuing MCBs in the interbank market. This anchoring explains the almost perfect one-to-one relationship between MCB ratings and their issuance yields. In unreported results, we find that the unusually large t-statistics disappears for corporate bonds that are issued in exchanges and hence are not subject to this “guidance curve.”

rate higher than the deposit rate. Banks then turn around to lend the proceeds to firms, or invest them in corporate bonds or other assets, including WMPs themselves. This activity is widely recognized as a form of regulatory arbitrage, because these transactions are considered to be off-balance sheet and hence face much less regulatory restrictions than traditional banks (e.g., Acharya et al. (2016); Hachem and Song (2017)). Another reason that WMPs are considered as the symbol of China’s shadow banking activities is for its potentially sophisticated structure, especially when financial institutions develop WMPs together with Trust or other financial innovations.<sup>36</sup>

#### 4.4.1 Shadow banking activities and local government non-bank debt

Panel A of Figure 7 plots the new Trust loans and increase of WMPs over 2004-2016, together with new bank loans, all scaled by GDP. Both Trust loans and WMPs are growing much faster than the GDP growth starting 2012, a pattern consistent with the mechanism proposed by this paper. At the end of 2015, the magnitude of these two shadow banking activities becomes comparable to the traditional on-balance sheet credit extended by banks.<sup>37</sup>

Connecting China’s shadow banking activities back to local government debt, Panel B of Figure 7 plots the fraction of local government non-bank debt, which is the sum of MCB, Munibond, and Trust in Figure 4, relative to the sum of three items in the “Aggregate Financing to the Real Economy” that proxies for shadow banking activities in China: Trust loans (trust and entrusted loans) as mentioned above, Undiscounted bankers’ acceptances, and Corporate bonds.<sup>38</sup> We observe a steady growth of local government non-bank debt as a fraction of shadow banking balance in China, starting from a negligible 1.5% in 2008 to 22% in 2014 and 48% in 2016. This suggests that local government non-bank debt is crucial to understand the recent surge of shadow banking activities in China.

---

<sup>36</sup>See “Four Fresh Worries About China’s Shadow Banking System” by Bloomberg, September 7th, 2016. Note that because WMPs do not represent the ultimate financing received by the real sector, it is not one of the items of the Aggregate Financing to the Real Economy mentioned above.

<sup>37</sup>After 2013 we observe some sharp decline of new Trust loans but rapid rise of new WMPs. This is a result of substitution from Trust loans toward WMPs after China Banking Regulatory Commission tightened the regulation on trust products in 2014 (the 99th Document “Directive Opinions on the Regulation of Trust Companies’ Risk Management,” May 8th, 2014, by the CBRC), and it is interesting to see the similar magnitude between the decline of Trust and the rise of WMPs in Panel A post 2014.

<sup>38</sup>Undiscounted bankers’ acceptances, which are only about 2.5% of Aggregate Financing to the Real Economy (5.2% of GDP) in 2016, represent contingent credit to the real sector, in the sense that firms can use bankers’ acceptances as collateral to obtain loans from banks (which then will be recorded as on-balance bank loans). We also include aggregate outstanding corporate bonds in calculation, which are about 11.5% of Aggregate Financing to the Real Economy (24.1% of GDP) in 2016, as MCB in local government debt is counted as part of Corporate bonds.

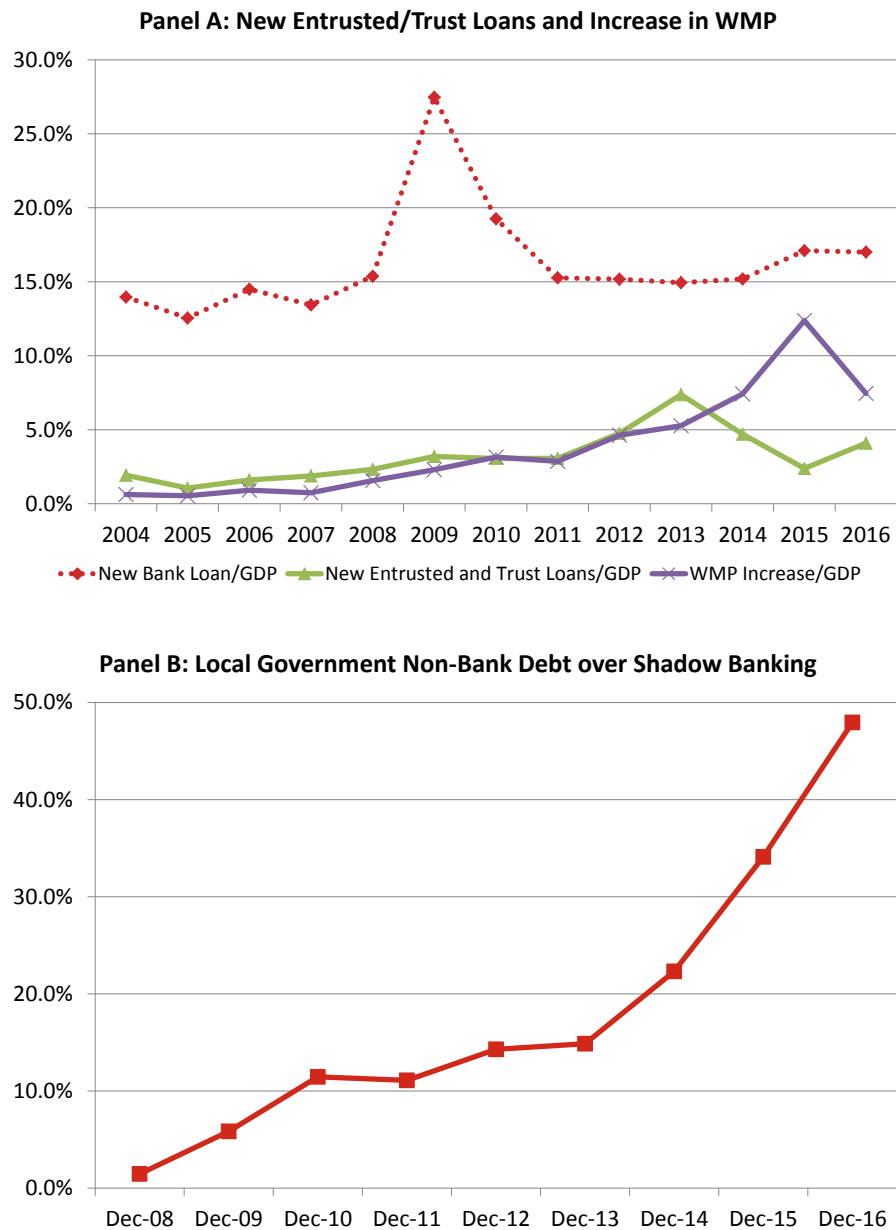


Figure 7: **Shadow Banking Activities and Local Government Non-Bank Debt.** Panel A plots new trust loans (entrusted and trust loans) and change in WMPs over GDP from 2004 to 2016. The aggregate new bank loan over GDP is also plotted for comparison. Panel B plots local government non-bank debt balance as a fraction of China’s shadow banking balance from 2008 to 2016. Local government non-bank debt is the sum of MCBs, Munibonds, and local government trust balance. Shadow banking balance is proxied by three items in Aggregate Financing to the Real Economy, including trust loans (trust and entrusted loans), undiscounted bank’s acceptable bills, and corporate bonds. The annual WMP balance data are from China Commercial Banks’ Wealth Management Products Annual Report issued by China Banking Wealth Management Registration System. The Aggregate Financing to the Real Economy by category data are from People’s Bank of China.



#### 4.4.2 Bank loan wanes and trust loans waxes

Panel A in Figure 7 presents the similar time-series pattern of “bank loan down and shadow banking up” when stepping outside the box of local governments. We further perform a cross-sectional test in this subsection, following the same idea as in Section 4 but replacing MCB issuance by new entrusted loans at the corresponding province (which might go to LGFVs). Because we do not have provincial information for entrusted loans before 2013, and because entrusted loans were tiny before 2008 anyway, we take the entrusted loans in future years (2013-2015) as “abnormal” and scale them by the corresponding provincial GDP directly as the dependent variables.

Table 7 shows that the stimulus-loan-hangover effect holds for entrusted loans, both each year and over the period of 2013-2015, implying that areas with more stimulus bank loans in 2009 ended up engaging with more entrusted loans in later years. The magnitude identified from this regression is greater, suggesting that entrusted loans are more important than MCBs as financing tools at the economy-wide level. Column 6 further provides a placebo test, which shows that (2009 abnormal BL/GDP) cannot explain the cross-sectional pattern of new bank loans in later years. This is consistent with the premise of our paper, which says that China’s credit policy reverted back to normal in later years and induced shadow banking to fill the gap.

We perform the cross-sectional test for entrusted loans, not trust loans. Magnitude wise, each year there were always more new entrusted loans than there were new trust loans over the past decades; standing at the end of 2016, the newly issued entrusted loans are about 2.3 trillion RMB (3.1% of GDP), compared to trust loans being 0.9 trillion RMB (1.2% of GDP).<sup>39</sup> But there is a deeper economic reason why we pick entrusted loans for our cross-sectional test. As we discussed at the beginning of Section 4, the way these statistics are reported is that the region of a trust loan is where the trust gets financed (i.e., location of source), not where the trust funds go (i.e., location of use).<sup>40</sup> Our mechanism relies on identifying the location of fund use, and hence this source-use mismatch of locations is devastating for our purpose. Entrusted loans suffer the same problem, but it is much less severe. This is because entrusted loans are firm-to-firm credit, and these firms tend to be intermediated by the same bank. Given that banks

---

<sup>39</sup>Even in 2013 when the new trust loan reaches its peak, the number is 1.8 trillion RMB (3.1% of GDP) while the number for entrusted loan is 2.5 trillion RMB (4.3% of GDP).

<sup>40</sup>For trust data from Aggregate Financing to the Real Economy, we checked with the Statistics and Analysis Department at PBOC, the way they collected the data is from the reporting of local CBRCs which receive the trust prospectus information from trust companies that are geographically located in a province. As a result, the provincial trust data only reflects the fund raising place instead of the fund using place.

typically finance local firms only (easier monitoring, less information asymmetry), the location of source should be more correlated with the location of use.<sup>41</sup>

#### 4.4.3 WMPs invested in MCB via interbank market

MCBs, as one type of corporate bonds, are mostly traded by qualified financial institutions (including banks, mutual funds, insurance companies, etc) in China's interbank market.<sup>42</sup> We now give a brief institutional background on this financial market, which has grown rapidly in recent years and become the third largest in the world by May 2016, behind only the United States and Japan (Borst (2016)).

There are two major classes of bonds traded in China's interbank market. Government bonds and financial bonds are considered riskless and often called "interest rate bonds",<sup>43</sup> while corporate bonds issued by non-financial firms are called "credit bonds" for their potential credit risk. MCB, which stands for Municipal Corporate Bond, becomes interesting as it sits in between these two categories. From its name, it has the feature of "interest rate bonds" which enjoys the implicit backing of the corresponding local government (the word Municipal), but in a strict legal sense it is issued by the LGFV entities, which are just corporations like other credit bonds issuers (the word Corporate). What is more, MCB represents a significant fraction of credit bonds in China: it accounted for 61.5% of total credit bonds at the end of 2016. This fraction has been rising dramatically in the past five years, with only 12.6% at the end of 2010, likely to be explained by our stimulus-loan-hangover story.

It is widely reported that WMPs, sold by commercial banks in China, are aggressively investing in MCB. Thanks to the hide-and-seek games between the regulators and financial institutions (outside and inside the interbank market), the list of qualified participants in China's bond market has been constantly changing during the past years. In February 2014, in response to the rapidly growing demand of investment in the interbank market, PBOC opened the interbank market access to 16 large commercial banks for their own WMPs. But unqualified smaller banks can easily circumvent this regulation by engaging with the "counterpart" business with qualified large banks. Two years later in May 2016, facing more and more complicated financing structures created to channel WMPs into the interbank market, PBOC removed the previous restrictions and allowed

---

<sup>41</sup> Indeed, Allen et al. (2016) find that entrusted loans tend to be provided to firms within the same area in China.

<sup>42</sup> Only a small part of corporate bonds are traded in exchanges in Shenzhen and Shanghai.

<sup>43</sup> Government bonds include Treasuries and Munibonds, and financial bonds are corporate bonds issued by financial institutions (policy banks, commercial banks, securities companies, insurance companies, etc.).

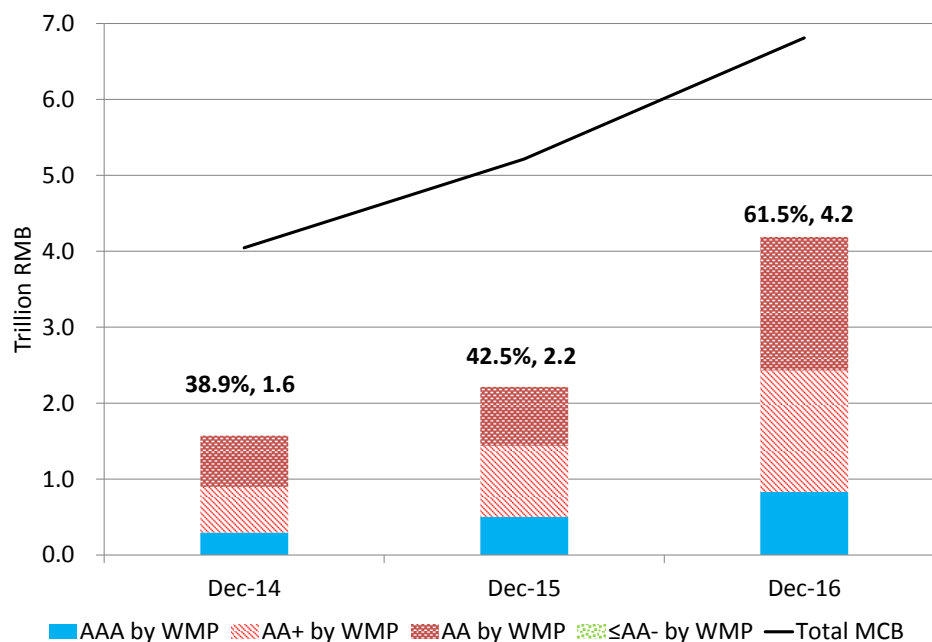


Figure 8: **Wealth Management Product Investment in Municipal Corporate Bonds, from 2014 to 2016.** The solid line plots the total MCB balance, and bars represents WMP invested in MCB with various ratings. The percentage and RMB value (trillion) of MCB held by WMP are given above the bars. The MCB data are from WIND, and the WMP investment data are from China Commercial Bank Wealth Management Products Annual Report issued by China Banking Wealth Management Registration System. More estimation details are in Appendix C.

all qualified institutional investors, including WMPs and trust companies, to participate directly in the interbank market and invest in corporate bonds. This deregulation propelled another round of expansion of WMPs and “innovative” trading strategies, as WMPs started Repo transactions with embedded leverage for juicy returns.<sup>44</sup> This soon caught wide attention of many economists and regulators, triggering another round of regulation by PBOC to include the off-balance-sheet WMPs in its Macro Prudential Assessment (MPA) system in early 2017.

Gauging the risk exposure of shadow banking activities is always a challenge; and there is no difference for WMPs which in principal could invest in everything, including other WMPs. Fortunately, since 2014, China Banking Wealth Management Registration System has started issuing annual official statistics on WMPs. Combining these annual reports together with the rating information of MCB, we estimate the MCB holdings by WMP, which are plotted in Figure 8 together with the corresponding MCB outstanding

<sup>44</sup><https://www.bloomberg.com/news/articles/2016-09-07/four-fresh-worries-about-china-s-shadow-banking-system>.

balance.

Figure 8 shows that WMPs are mainly investing in high-quality MCBs, as almost all of them are above AA-rating. The official reports suggest that about 40% of MCB was held by WMP by the end of 2014; this fraction rose to more than 60% by the end of 2016. Nevertheless, these numbers are quite likely to represent an underestimation of the extent to which WMPs are investing in MCB. It is because before the May 2016 deregulation, it was popular for managers of WMPs (raised by some small banks) to invest these funds in some Trusts, which lend the money to another bigger bank who then eventually invest in MCB. From reading the way the statistics are reported, the Annual Report ignores this indirect exposure of WMPs in MCB (hence introducing a downward bias of our estimate). Anecdotally, one personal friend of ours who is a trader in one of the biggest banks in China estimates that about 70% of MCBs are invested by WMPs.

## 5 Discussions and Concluding Remarks

This paper paints a broad picture that connects the 2007/08 financial crisis in US, the 2009 four-trillion stimulus loans in China, and the surging shadow banking activities in China after 2012. Although both WMPs and Trust loans existed in China's financial markets before 2008, and increased slightly during the period of 2009 stimulus plan, our perspective highlighting the stimulus-loan-hangover effect helps understand why these activities experienced "barbarous growth" after 2012. We believe that the economic force we demonstrate here is likely to be more fundamental compared to other alternative explanations such as regulatory arbitrage.

We conclude this paper by providing discussions on the potential systemic risk of local government debt, some interesting political economics on marketization of financial system, and the process of interest rate liberalization in China.

**Systemic risk of local governments debt.** The potential systemic risk of China's local governments debt is an extremely important question of broad interest, but it is not the focus of this paper. Local governments have been relying heavily on land sales to balance their budget (e.g., [Zhang and Barnett \(2014\)](#); [Ambrose et al. \(2015\)](#)), which is unlikely to be sustainable in the long-run. Of course, the issue is more than the simple default risk. These debts are backed by governments at different authority levels, explicitly or implicitly. The market participants, whether those naive WMP investors who do not even know what they are buying or sophisticated bond fund managers who

study the default risk of LGFVs extensively, all have “bail-out” expectations, implying that either banks (who sold WMPs) or local governments (who sold MCBs) are bearing the loss ultimately. Since 2015, Ministry of Finance has started the “swap program,” which allows local governments to issue Munibonds to replace their maturing “qualified” debt. The wide-spread understanding is that these Munibonds are ultimately fully backed by the central government, who seems to have plenty of resources to absorb the losses. This greatly reduces the uncertainty of the local governments’ repayment ability and the default risk of MCB.<sup>45</sup>

On the other hand, the potential default risk of local government could be systemic, because as explained China’s local government debts are either hidden at the banks’ off-balance sheets—like MCBs through WMPs, or even directly sitting on their on-balance sheets—it is intriguing that about 87% of Munibonds with full government guarantee are directly held by banks as of 2016.<sup>46</sup> Gao et al. (2016) have provided direct evidence of LGFVs defaulted on their bank loans before 2014. The situation is likely to be worse after 2014, as the “swap program” mentioned above has severed certain MCBs from explicit government guarantees, and it is widely believed that unprofitable LGFVs will experience difficulties in repaying their maturing MCBs in the near term. This is exactly why market participants and regulators are keeping an close eye on the recent development of the local government debt in China.

**The political economics of regulation and market forces.** There is no doubt that over the past forty years China has made tremendous progress in building a market-based economy. Unfortunately, due to the history of being an economy with central planning, almost all economic activities, including LGFVs and MCBs, are linked back to certain regulation and/or the intention of regulators.

We emphasize that regulations themselves are endogenous, and mostly are responses to the underlying market forces. Consider the evolution of regulations and the actual implementations when dealing with the explosive growth of debt taken by LGFVs after 2009. In June 2010, the State Council issued the No. 19 Document on LGFVs, underscoring the importance of regulating and monitoring the mounting debt raised by LGFVs. The market responded by little MCB issuance during 2010-11, as shown in Figure 5. But MCBs grew even faster starting 2014; why? It is not because the regulator

---

<sup>45</sup>One upper-bound estimate of the default risk is from the “contingent bailout liability” which consists of about 24% of total debt standing at mid-2013 (Table 1). The “bail-out” expectation can be fulfilled as long as local governments themselves are able to cover the potential losses of these “contingent bailout liability,” which is likely to be “unqualified” for replacement of Munibonds.

<sup>46</sup>Data source: China Central Depository and Clearing Corporation.

deemed the LGFVs being safer after 2014. In fact, as mentioned in Section 2.2.2, the State Council issued No. 43 Document on September 2014 prohibited local governments from raising debt via LGFVs, and ordered them to swap existing debt with more transparent Munibonds. It is far from smooth in implementing the swap program; the budget of Munibonds for 2015 were preapproved at the end of 2014, and in 2015 it became apparent that the preapproved amount was not enough to absorb all the refinancing needs by LGFVs. Beijing in turn issued other “conflicting” regulation changes that aimed to facilitate the LGFVs to borrow via MCBs.<sup>47</sup>

Our paper delivers a fresh view on why regulators successfully suppressed MCB growth around 2010 but somehow failed to do so after 2013. This is because LGFVs had to rollover their bank loans due around 2013 and 2014, a market force that demanded full respect and had to be released one way or another. There is some trade-off between putting these debt back to the banks’ balance sheets and finding support from non-bank (or even shadow banking) financing sources, and it seemed that Beijing has pick the latter.

**Interest rate liberalization.** Our paper offers a perspective in understanding the pace of interest rate liberalization in China. China’s interest rates liberalization can be traced back to the establishment of the interbank market (mentioned in Section 4.4.3) in 1996, which in early 2007 launched Shanghai Interbank Offered Rate (Shibor) serving as the benchmark rate in China’s capital market. On the other front, banks’ lending rates started a slow reform around 1998-99, experienced several aggressive deregulating steps thanks to China joining WTO in 2001, and became fully liberalized in 2013.

Similar to other developed countries like US and Japan, deposit rate liberalization is the last step of marketization of interest rates in China. Although the lower limit of deposit rate got removed as early as in 2004, the upper limit was tightly controlled until 2012 when banks were allowed to raise their deposit rates up to 1.1 times the base rate set by PBOC. The upper limit of deposit rate was further raised to 1.2 times in 2014 and 1.5 times in 2015; and in October 2015, the upper limit was fully removed. During the same time, China established the deposit insurance scheme in May 2015, which provides the same level-playing field for small-and-medium banks against their big-four peers.

We highlight that the pace of liberalization process has tremendously taken up ever

---

<sup>47</sup>For instance, the interbank market relaxed the restrictions on eligible LGFVs to issue MCB in early 2015; similar relaxations were reflected in a series of documents released by National Development and Reform Commission (the regulatory body of MCB traded in the interbank market) and Ministry of Finance. For a complete list of regulations and documents released after 2014, see “MCB Regulation, Review, and Outlook” by Qiming Liu in PengYuan Research, Feb 2016.

since 2012, especially for the deposit rate liberalization. From the perspective of our paper, this can be thought of an unintended (but good) consequence of the 2009 stimulus plan. The resulting barbarian growth of WMPs starting 2012 offered households an attractive savings vehicle, with market-based interest rates that are way higher than those offered by bank deposits at that time. This imposes an unprecedented threat to the traditional banking sector which has been heavily subsidized by cheap deposits for more than half a decade. Facing heavy legacy regulations, individual banks engaged in competing with each other by selling WMPs to households in order to expand their off-balance-sheet activities.<sup>48</sup> On the positive side, this process benefits not only households but also those small- and midium-sized banks (especially joint-stock and large urban commercial banks) who are now able to compete with big-four banks in China. However, these off-balance-sheet activities seemed to be overly aggressive, and regulators realize that the market force has unleashed itself fully so that it is the right timing to expedite the process of interest rate liberalization.

---

<sup>48</sup>Acharya et al. (2016) and Hachem and Song (2017) offer interesting studies on competition within the banking sector as well as its implications on WMPs issuance before and around 2009. For later years, see a financial time article “China takes step to financial reform” by Anderlini and Hook, dated July 19, 2013.

## References

- Acharya, V Viral, Jun Qian, and Zhishu Yang, 2016, In the shadow of banks: wealth management products and issuing banks' risk in China, Working paper.
- Allen, Franklin, Xian Gu, Jun Qian, and Yiming Qian, 2017, Implicit guarantee and shadow banking: the case of trust products, Working paper.
- Allen, Franklin, Yiming Qian, Guoqian Tu, and Frank Yu, 2016, Entrusted loans: A close look at China's shadow banking system, Working paper.
- Ambrose, Brent W, Yongheng Deng, and Jing Wu, 2015, Understanding the risk of china's local government debts and its linkage with property markets, Working paper.
- Ang, Andrew, Jennie Bai, and Hao Zhou, 2016, The great wall of debt: Real estate, corruption, and Chinese local government credit spreads, Working paper.
- Bai, Chong-En, Chang-Tai Hsieh, and Zheng(Michael) Song, 2016, The long shadow of a fiscal expansion, *Brookings Papers on Economic Activity* 60, 309–327.
- Borst, Nicholas, 2016, China's bond market: Larger, more open, and riskier, Technical report, Federal Reserve Bank of San Francisco.
- Chen, Kaiji, Jue Ren, and Tao Zha, 2016, What we learn from China's rising shadow banking: exploring the nexus of monetary tightening and banks' role in entrusted lending, Working paper.
- Chen, Long, and Chongqing Gu, 2012, The impact of loans by local government financing vehicals on bank valuations, Working Paper, CKGSB.
- Cong, Will, and Jacopo Ponticelli, 2016, Credit allocation under economic stimulus: Evidence from China, Working paper, Booth School of Business, University of Chicago.
- Deng, Yongheng, Randall Morck, Jing Wu, and Bernard Yeung, 2015, China's pseudo-monetary policy, *Review of Finance* 19, 55–93.
- Diamond, Douglas W., 1991, Debt maturity structure and liquidity risk, *Quarterly Journal of Economics* 106, 709–737.
- Diamond, Douglas W., and Zhiguo He, 2014, A theory of debt maturity: The long and short of debt overhang, *Journal of Finance* 69, 719–762.



- Gao, Haoyu, Hong Ru, and Dragon Yongjun Tang, 2016, Subnational debt of China: The politics-finance nexus, Working paper, City University of Hong Kong and Nanyang Technological University and The University of Hong Kong.
- Hachem, Kinda, and Zheng Michael Song, 2017, Liquidity regulation and credit booms: Theory and evidence from china, Working paper.
- He, Zhiguo, and Wei Xiong, 2012, Rollover risk and credit risk, *Journal of Finance* 67, 391–429.
- Huang, Yi, Marco Pagano, and Ugo Panizza, 2016, Public debt and private firm funding: Evidence from Chinese cities, Working paper, The Graduate Institute (Geneva) and University of Naples Federico II.
- Kroeber, Arthur, 2016, *China's Economy: What Everyone Needs to Know* (Oxford University Press).
- Li, Hongbin, and Li-An Zhou, 2005, Political turnover and economic performance: the incentive role of personnel control in china, *Journal of Public Economics* 89, 1743–1762.
- Wang, Hao, Honglin Wang, Lisheng Wang, and Hao Zhou, 2016, Shadow banking: China's dual-track interest rate liberalization, Working paper.
- Zhang, Yuanyan, and Steven A Barnett, 2014, Fiscal vulnerabilities and risks from local government finance in China, Working paper.

Table 1: **Local Government Debts from NAO Reports**

This table reports sources of local government debt from two reports issued by the National Auditing Office of China. Panel A (B) reports the auditing results as of December 31, 2010 (June 30, 2013).

Panel A: Local government debt balance as of December 31, 2010 (billion RMB)

	Full Obligation	Contingent Liability		<i>Total Debt</i>
		Guaranteed Liability	Contingent Bailout Liability	
Bank loan	5,023	1,913	1,532	<i>8,468</i>
Fiscal on-lending	213	235	0	<i>448</i>
Bond	551	107	99	<i>757</i>
Other entity and individual borrowing	924	82	39	<i>1,045</i>
<b>Total</b>	<b>6,711</b>	<b>2,337</b>	<b>1,670</b>	<b><i>10,717</i></b>

Panel B: Local government debt balance as of June 30, 2013 (billion RMB)

	Full Obligation	Contingent Liability		<i>Total Debt</i>
		Guaranteed Liability	Contingent Bailout Liability	
Bank loan	5,525	1,909	2,685	<i>10,119</i>
Build & Transfer	1,215	47	215	<i>1,476</i>
Bond	1,166	167	512	<i>1,846</i>
MuniBond	615	49	0	<i>664</i>
Corporate bond (MCB)	459	81	343	<i>883</i>
Mid-term note (MCB)	58	34	102	<i>194</i>
Short-term bill (MCB)	12	1	22	<i>36</i>
Accounts payable	778	9	70	<i>857</i>
Trust	762	253	410	<i>1,425</i>
Other entity and individual borrowing	668	55	116	<i>839</i>
Construction loan	327	1	48	<i>376</i>
Other financial institution borrowing	200	31	106	<i>337</i>
Fiscal on-lending	133	171	0	<i>303</i>
Capital lease	75	19	137	<i>232</i>
Other fund raising	37	4	39	<i>80</i>
<b>Total</b>	<b>10,886</b>	<b>2,666</b>	<b>4,339</b>	<b><i>17,891</i></b>

Table 2: **Summary Statistics of Municipal Corporate Bond Issuance**

This table reports the summary statistics of municipal corporate bond (MCB) issuance and other variables. Panel A reports total MCB issuance amount, MCB issuance amount by purpose (repayment of bank loan, investment, and other), and outstanding MCB balance by year. Panels A and B report MCB issuance number, issuance amount (billion RMB), and issuance amount by purpose (repayment of existing bank loan, investment, and other) for 7 regions and 30 provinces, respectively. Total issuance amount is greater than the sum of three purposes because only about 80% of MCBs are with disclosure. Panels C and D report the 2012-2015 raw values and the abnormal values over the 2004-2008 average for various variables. Variables include provincial MCB/GDP, MCB for repayment of bank loan over GDP, MCB for investment over GDP, MCB for other purpose over GDP, 2009 provincial bank loan over GDP, 2008Q1-Q3 provincial bank loan over GDP, provincial fiscal deficit over GDP (FD/GDP), provincial fixed asset investment over GDP (FAI/GDP), provincial land sale over fiscal revenue (LS/FR), provincial GDP growth (DGDP), and provincial entrusted loan over GDP (EL/GDP).

Province	Number of Bonds	Amount (total)	Amount (repay)	Amount (inv)	Amount (other)
Center China	554	635.9	109.7	371.8	6.4
East China	2428	2272.9	610.0	1268.7	54.1
North China	630	1004.7	234.5	493.3	26.8
South China	404	448.0	138.5	258.4	6.2
Northeast	245	292.5	48.0	193.8	1.9
Northwest	393	428.3	101.4	205.2	4.3
Southwest	800	845.1	235.4	449.9	16.5
Total	5454	5927.3	1477.5	3241.2	116.1

Panel B: MCB Issuance by Province

Province	Number of Bonds	Amount (total)	Amount (repay)	Amount (inv)	Amount (other)
Anhui	206	218.7	55.6	131.6	5.1
Beijing	210	368.0	99.5	201.2	4.9
Chongqing	265	287.8	87.2	147.4	6.0
Fujian	293	244.3	93.3	114.7	9.3
Gansu	78	97.6	21.4	44.3	3.0
Guangdong	232	303.2	114.6	168.1	2.7
Guangxi	165	135.6	23.0	82.0	3.5
Guizhou	89	118.1	17.2	85.8	1.5
Hainan	7	9.2	0.9	8.3	0.0
Hebei	93	98.4	12.1	67.1	2.4
Heilongjiang	58	61.4	3.6	51.7	0.0
Henan	143	156.3	30.1	78.9	0.4
Hubei	198	204.7	35.9	117.8	0.2
Hunan	213	274.9	43.7	175.1	5.8
Jiangsu	997	859.0	203.5	447.9	17.0
Jiangxi	136	140.2	29.8	95.0	2.9
Jilin	36	42.9	14.0	18.7	0.5
Liaoning	151	188.2	30.4	123.5	1.4
Neimenggu	64	70.5	6.9	54.3	0.0
Ningxia	9	12.1	0.5	11.6	0.0
Qinghai	36	44.9	23.7	15.2	0.0
Shan_xi	149	176.4	41.3	69.9	0.9
Shandong	251	273.3	75.0	158.0	9.2
Shanghai	165	202.3	83.1	95.1	3.3
Shanxi	51	67.7	5.2	38.0	1.5
Sichuan	275	265.5	87.3	133.2	3.7
Tianjin	212	400.0	110.7	132.8	18.0
Xinjiang	121	97.4	14.5	64.2	0.4
Yunnan	171	173.7	43.7	83.5	5.2
Zhejiang	380	335.0	69.8	226.3	7.2

Panel C: Summary Statistics of Variables' Raw Values

	Obs	Mean	SD	Min	P25	Median	P75	Max
MCB/GDP	120	0.022	0.016	0.000	0.011	0.016	0.028	0.083
MCB_repay/GDP	120	0.006	0.007	0.000	0.001	0.004	0.008	0.037
MCB_inv/GDP	120	0.011	0.006	0.000	0.006	0.010	0.014	0.035
MCB_other/GDP	120	0.000	0.001	0.000	0.000	0.000	0.000	0.009
2009 BL/GDP	30	0.275	0.082	0.158	0.219	0.259	0.330	0.452
2008Q1-Q3 BL/GDP	30	0.151	0.051	0.076	0.115	0.143	0.190	0.239
FD/GDP	120	0.127	0.100	0.014	0.045	0.117	0.150	0.529
FAI/GDP	120	0.794	0.220	0.254	0.684	0.821	0.917	1.301
LS/FR	120	0.173	0.118	0.035	0.096	0.144	0.194	0.650
DGDP	120	0.089	0.038	-0.007	0.066	0.089	0.113	0.202
EL/GDP	90	0.033	0.026	-0.018	0.017	0.027	0.041	0.142

Panel D: Summary Statistics of Variables' Abnormal Values

	Obs	Mean	SD	Min	P25	Median	P75	Max
MCB/GDP	120	0.021	0.016	-0.002	0.010	0.016	0.027	0.081
MCB_repay/GDP	120	0.006	0.007	0.000	0.001	0.004	0.008	0.037
MCB_inv/GDP	120	0.010	0.006	-0.002	0.005	0.010	0.014	0.035
MCB_other/GDP	120	0.000	0.001	0.000	0.000	0.000	0.000	0.009
2009 BL/GDP	30	0.164	0.050	0.083	0.129	0.158	0.190	0.270
2008Q1-Q3 BL/GDP	30	0.041	0.029	-0.020	0.022	0.032	0.060	0.101
FD/GDP	120	0.042	0.046	-0.007	0.013	0.030	0.055	0.265
FAI/GDP	120	0.301	0.177	-0.111	0.204	0.307	0.424	0.799
LS/FR	120	0.001	0.075	-0.147	-0.043	-0.013	0.024	0.411

**Table 3: The Effects of 2009 Abnormal Bank Loan on Future Municipal Corporate Bond Issuance, Year-by-Year Regressions**

This table reports the year-by-year regressions of 2012 to 2015 provincial municipal corporate bond (MCB) issuance on 2009 bank loan. The dependent variable is the abnormal MCB issuance scaled by GDP in years 2012 to 2015 compared to the average value between 2004 and 2008. Annual MCB issuance at the provincial/regional level are aggregated over individual MCB bonds. The independent variable is the abnormal new bank loan scaled by GDP in 2009 compared to the average value between 2004 and 2008. Panels A and B report the cross-regional and the cross-provincial results, respectively. Panel C reports the cross-provincial results with control variables, including abnormal fiscal deficit (FD) scaled by GDP, abnormal fixed asset investment (FAI) scaled by GDP, abnormal local government land sale income (LS) scaled by fiscal revenue (FR), GDP growth, and the corruption index constructed by Ang et al. (2016). Data about bank loan are obtained from PBOC, data about MCB are obtained from Wind, and data about control variables are obtained from National Bureau of Statistics of China. Heteroscedasticity consistent  $t$ -statistics are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

Panel A: 2009 bank loan and 2012-2015 MCB issuance, regional				
	(1)	(2)	(3)	(4)
	MCB <sub>2012</sub>	MCB <sub>2013</sub>	MCB <sub>2014</sub>	MCB <sub>2015</sub>
2009 BL/GDP	0.11*** (2.66)	0.11** (2.24)	0.22*** (3.29)	0.24** (2.52)
Constant	0.00 (-0.46)	0.00 (-0.47)	-0.01 (-0.65)	-0.02 (-0.99)
Observations	7	7	7	7
Adj. R <sup>2</sup>	0.42	0.35	0.44	0.46

Panel B: 2009 bank loan and 2012-2015 MCB issuance, provincial				
	(1)	(2)	(3)	(4)
	MCB <sub>2012</sub>	MCB <sub>2013</sub>	MCB <sub>2014</sub>	MCB <sub>2015</sub>
2009 BL/GDP	0.11 (1.55)	0.13*** (2.61)	0.20*** (3.45)	0.15** (2.05)
Constant	0.00 (-0.15)	-0.01 (-0.89)	0.00 (-0.50)	0.00 (0.01)
Observations	30	30	30	30
Adj. R <sup>2</sup>	0.10	0.31	0.34	0.17

Table 2 continued

Panel C: 2009 bank loan and 2012-2015 MCB issuance, with controls

	(1) MCB <sub>2012</sub>	(2) MCB <sub>2013</sub>	(3) MCB <sub>2014</sub>	(4) MCB <sub>2015</sub>
2009 BL/GDP	0.02 (0.64)	0.09** (2.34)	0.16*** (2.75)	0.19*** (3.05)
FD/GDP	0.23*** (3.240)	0.02 (0.35)	0.04 (0.71)	-0.09** (-2.14)
FAI/GDP	-0.03** (-2.11)	-0.00 (-0.22)	-0.01 (-0.37)	0.02 (1.52)
LS/FR	0.04 (1.01)	-0.01 (-0.22)	-0.01 (-0.26)	-0.06** (-2.04)
$\Delta$ GDP	0.08 (1.56)	0.14** (2.26)	0.24*** (4.23)	0.22*** (3.23)
Corruption index	0.01 (1.60)	0.01** (2.12)	0.01 (1.52)	0.01 (1.27)
Constant	-0.01 (1.55)	-0.04** (-2.33)	-0.04** (-2.27)	-0.04*** (-3.05)
Observations	30	30	30	30
Adj. R <sup>2</sup>	0.56	0.48	0.46	0.50

Table 4: **The Effects of 2009 Abnormal Bank Loan on Future Municipal Corporate Bond Issuance, Placebo Tests**

This table reports the year-by-year regressions of 2012 to 2015 provincial municipal corporate bond (MCB) issuance in 2008 first-to-third-quarter bank loans. The dependent variable is the abnormal MCB issuance scaled by GDP in years 2012 to 2015 compared to the average value between 2004 and 2008. Annual MCB issuance at the provincial/regional level are aggregated over individual MCB bonds. The independent variable is the abnormal new bank loan scaled by GDP in 2008 Q1-Q3 compared to the average value between 2004 and 2007. Panel A reports the cross-provincial results of 2008 Q1-Q3 abnormal bank loan. Panel B reports the cross-provincial results of both 2009 and 2008 Q1-Q3 abnormal bank loans, where the  $F$ -stat and the associated  $p$ -values for the hypothesis of equal coefficients of 2009 bank loan and 2008Q1-Q3 bank loan are also reported. Data about bank loan are obtained from PBOC and data about MCB are obtained from Wind. Heteroscedasticity consistent  $t$ -statistics are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

Panel A: 2008 Q1-Q3 bank loan and 2012-2015 MCB issuance				
	(1)	(2)	(3)	(4)
	MCB <sub>2012</sub>	MCB <sub>2013</sub>	MCB <sub>2014</sub>	MCB <sub>2015</sub>
2008Q1-Q3 BL/GDP	0.07 (0.74)	-0.00 (-0.01)	-0.01 (-0.09)	-0.06 (-0.36)
Constant	0.01*** (5.02)	0.02** (2.53)	0.03*** (3.86)	0.03*** (3.43)
Observations	30	30	30	30
Adj. R <sup>2</sup>	-0.02	-0.04	-0.04	-0.03
Panel B: 2009 and 2008Q1-Q3 bank loan and 2012-2015 MCB issuance				
	(1)	(2)	(3)	(4)
	MCB <sub>2012</sub>	MCB <sub>2013</sub>	MCB <sub>2014</sub>	MCB <sub>2015</sub>
2009 BL/GDP	0.11* (1.68)	0.15*** (2.73)	0.23*** (4.72)	0.18*** (2.74)
2008Q1-Q3 BL/GDP	0.01 (0.12)	-0.09 (-0.98)	-0.15 (-1.61)	-0.16 (-1.50)
Constant	-0.00 (-0.14)	-0.01 (-0.92)	-0.00 (-0.40)	0.00 (0.14)
$F$ -test $\beta^{09} = \beta^{08Q1-Q3}$	2.94*	3.20*	11.69***	6.08**
$p$ -value	0.10	0.08	0.00	0.02
Observations	30	30	30	30
Adj. R <sup>2</sup>	0.07	0.34	0.38	0.24



Table 5: **The Effects of 2009 Abnormal Bank Loan on Future Municipal Corporate Bond Issuance, Panel Regressions**

This table reports the panel regressions of 2012 to 2015 provincial municipal corporate bond (MCB) issuance on 2009 bank loan. The dependent variable is the abnormal MCB issuance scaled by GDP in years 2012 to 2015 compared to the average value between 2004 and 2008. Annual MCB issuance at the provincial level are aggregated over individual MCB bonds. The independent variable is the abnormal new bank loan scaled by GDP in 2009 compared to the average value between 2004 and 2008. Control variables include abnormal fiscal deficit (FD) scaled by GDP, abnormal fixed asset investment (FAI) scaled by GDP, abnormal local government land sale income (LS) scaled by fiscal revenue (FR), GDP growth, and the corruption index constructed by Ang et al. (2016).  $MCB_{repay}$  indicates the proceeds of MCB that are used to pay back bank loans.  $MCB_{inv}$  indicates the proceeds of MCB that are used for investment.  $MCB_{other}$  indicates the proceeds of MCB that are used for other purposes.  $MCB_{repay}^{10}$  includes those ten provinces with the most similar value of GDP in 2009, including Yunnan, Chongqing, Jilin, Shanxi, Tianjin, Jiangxi, Guangxi, Shan Xi, Heilongjiang, and Neimenggu. The denominator to scale  $MCB_{repay}^{10}$  in 2012 to 2015 is the 2009 GDP in each of those 10 provinces. Data about bank loan are obtained from PBOC, data about MCB are obtained from Wind, and data about control variables are obtained from National Bureau of Statistics of China. Year fixed effects are included. Heteroscedasticity consistent  $t$ -statistics clustered by province and year are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	MCB	MCB	$MCB_{repay}$	$MCB_{inv}$	$MCB_{other}$	$MCB_{repay}^{10}$
2009 BL/GDP	0.15*** (3.45)	0.10** (2.10)	0.03* (1.82)	0.02 (1.20)	0.00 (1.49)	0.13*** (4.37)
FD/GDP		0.07 (0.89)	0.07** (1.97)	0.02 (1.30)	-0.01 (-1.32)	-0.13*** (-4.35)
FAI/GDP		-0.01 (-0.65)	-0.01** (-2.46)	0.00 (-0.05)	0.00 (1.07)	0.00 (-0.19)
LS/FR		-0.02 (-0.68)	0.00 (-0.41)	-0.01 (-0.54)	0.00 (0.50)	0.04 (0.98)
GDP growth		0.16*** (3.57)	0.04 (1.49)	0.09*** (5.28)	0.00 (0.93)	0.17** (2.23)
Corruption index		0.01*** (3.17)	0.01*** (3.49)	0.00 (0.79)	0.00 (1.61)	0.01*** (8.17)
Constant	0.00 (1.13)	-0.04*** (-2.98)	-0.02*** (-2.83)	-0.01*** (-2.72)	0.00 (-1.42)	-0.05*** (-3.51)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	120	120	120	120	120	40
Adj. R <sup>2</sup>	0.31	0.49	0.52	0.33	0.23	0.76

Table 6: **The Effects of 2009 Abnormal Bank Loan on Municipal Corporate Bond Excess Yield Spread**

This table reports the regressions of 2012 to 2015 municipal corporate bond (MCB) excess yield spread on 2009 bank loan. The dependent variable is the excess yield spread of MCB over the yield of China Development Bank bond with the same maturity. The independent variable is the abnormal new bank loan scaled by GDP in 2009 compared to the average value between 2004 and 2008. Control variables include bond rating, bond maturity, abnormal fiscal deficit (FD) scaled by GDP, abnormal fixed asset investment (FAI) scaled by GDP, abnormal local government land sale income (LS) scaled by fiscal revenue (FR), and GDP growth. Data about bank loan are obtained from PBOC, data about MCB are obtained from Wind, and data about control variables are obtained from National Bureau of Statistics of China. Year and bond type (corporate bond, enterprise bond, medium-term note, short-term financing bill, and private placement note) fixed effects are included for panel regressions (1) and (2). Bond type fixed effects are included for year-by-year regressions (3) to (6). Heteroscedasticity consistent  $t$ -statistics clustered by province and year are reported in parentheses for regressions (1) and (2). Heteroscedasticity consistent  $t$ -statistics clustered by province are reported in parentheses for regressions (3) and (6). \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	Yield	Yield	Yield <sub>2012</sub>	Yield <sub>2013</sub>	Yield <sub>2014</sub>	Yield <sub>2015</sub>
2009 BL/GDP		-0.02	-0.03	-0.50	-0.33	0.80
		(-0.04)	(-0.05)	(-1.44)	(-0.82)	(1.32)
Rating	0.47***	0.47***	0.46***	0.41***	0.46***	0.47***
	(38.6)	(35.44)	(9.73)	(14.15)	(14.08)	(17.28)
Maturity	-0.01	-0.01	0.02	0.02	0.00	-0.04**
	(-0.73)	(-0.72)	(0.87)	(1.17)	(0.10)	(-2.31)
FD/GDP	-0.32	-0.31	-1.39**	-0.12	0.47	0.52
	(-0.64)	(-0.89)	(-2.24)	(-0.14)	(0.41)	(0.51)
FAI/GDP	0.43	0.42	0.91	0.56	0.49	0.12
	(2.14)	(2.43)	(2.60)	(2.79)	(1.88)	(0.53)
LS/FR	-0.77*	-0.77**	-1.16***	-0.41	-0.36	-1.79***
	(-1.92)	(-1.98)	(-3.29)	(-1.36)	(-1.20)	(-4.67)
GDP growth	0.30	0.30	0.39	-0.57	-0.28	0.43
	(0.46)	(0.47)	(0.34)	(-0.71)	(-0.31)	(0.32)
Constant	1.50***	1.51***	1.46***	0.91***	0.87***	0.94***
	(11.47)	(11.01)	(6.15)	(4.23)	(3.71)	(3.78)
Year FE	Yes	Yes	No	No	No	No
Bond type FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	4788	4788	660	687	1677	1764
Adj. R <sup>2</sup>	0.59	0.59	0.54	0.57	0.64	0.57

Table 7: **The Effects of 2009 Abnormal Bank Loan on Future New Entrust Loans**

This table reports the regression results of new entrusted loans (EL) and abnormal bank loan (BL) on 2009 bank loan. The dependent variable is the new entrusted loan scaled by GDP in years 2013 to 2015 for columns (1) to (5) and abnormal new bank loan scaled by GDP in years 2012 to 2015 for column (6). The independent variable is the abnormal new bank loan scaled by GDP in 2009 compared to the average value between 2004 and 2008. Control variables include abnormal fiscal deficit (FD) scaled by GDP, abnormal fixed asset investment (FAI) scaled by GDP, abnormal local government land sale income (LS) scaled by fiscal revenue (FR), and GDP growth. Results of year-by-year and panel regressions are reported. Data about bank loans and entrusted loans are obtained from PBOC and data about control variables are obtained from National Bureau of Statistics of China. Year fixed effects are included. Heteroscedasticity consistent  $t$ -statistics clustered by province and year are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

	(1)	(2)	(3)	(4)	(5)	(6)
	EL <sub>2013</sub>	EL <sub>2014</sub>	EL <sub>2015</sub>	EL <sub>panel</sub>	EL <sub>panel</sub>	BL <sub>panel</sub>
2009 BL/GDP	0.20** (2.00)	0.23** (2.08)	0.14 (1.37)	0.19** (2.35)	0.20** (2.54)	-0.00 (-0.03)
FD/GDP					-0.04 (-0.48)	0.79*** (5.33)
FAI/GDP					-0.05* (-1.79)	0.12** (2.44)
LS/FR					0.01 (0.26)	0.00 (0.00)
$\Delta$ GDP					0.10 (0.68)	-0.25 (-1.46)
Constant	0.01 (0.41)	-0.00 (-0.25)	0.00 (0.16)	0.00 (0.68)	0.01 (0.83)	0.01 (0.42)
Year FE				Yes	Yes	Yes
Observations	30	30	30	90	90	120
Adj. R <sup>2</sup>	0.13	0.14	0.04	0.14	0.27	0.60

# Internet Appendix to “The Financing of Local Governments in China: Stimulus Loan Wanes and Shadow Banking Waxes”

This Internet Appendix consists of three sections. In Section A, we provide data construction details of total local government debt balance and its four major components. In Section B, we describe how we estimate the investment of wealth management products in municipal corporate bonds. In Section C, additional figures and tables are presented.

## A Estimates of Sector-Level Abnormal Bank Loans in 2009

We estimate that the 2009 stimulus caused 4.7 trillion RMB extra bank loans to the entire Chinese economy; among which, about 2.3 trillion went to LGFVs, about 1 trillion went to the non-residential sector (but excluding LGFVs), and the rest of 1.4 trillion went to the residential sector. It is worth mention that the estimated abnormal LGFV bank loans (i.e., 2.3 trillion) square well with [Gao et al. \(2016\)](#) who have detailed loan-level information for LGFVs in 2009. Finally, with the help of the data in [Gao et al. \(2016\)](#), we estimate that for the 2.3 trillion bank loans to LGFVs, 2.06 trillion came from commercial banks while 0.24 trillion came from policy banks.

The detailed steps to construct the above estimates are as follows. First, the total abnormal new bank loan (4.7 trillion) is the difference between the actual 2009 new bank loan (9.6 trillion) and the estimated 2009 normal new bank loan (4.9 trillion, based on the average BL/GDP ratio in 2004 to 2008). Following the same approach, the 2009 abnormal new non-residential bank loan is estimated at 3.3 trillion, implying an abnormal residential new bank loan of 1.4 trillion (4.7-3.3). Second, we decompose this 3.3 trillion number further into LGFVs and the rest. To this end, we estimate the 2009 normal new bank loan to LGFVs to be 0.75 trillion (the ratio of LGFV new bank loan over new bank loan in 2008 multiplied by the estimated 2009 normal new bank loan; the 2008 LGFV new bank loan is based on the 2010 national audit report and Wind). Taking this number out of the 2009 actual LGFV bank loan 3.05 trillion ([Bai et al. \(2016\)](#), p.14), we estimate the 2009 abnormal LGFV bank loan to be 2.3 trillion (3.05-0.75), which then left 2009 abnormal non-residential (excluding LGFV) new bank loan to be 1 trillion (3.3-2.3).

## **B Construction of Local Government Debt Balance**

### **B.1 Total local government debt balance**

1. The numbers as of the end of 2010, 2012, and 2013H1 are provided by two auditing reports (2011 and 2013) on local government debt issued by National Audit Office (NAO).
2. The numbers as of the end of 2008 and 2009 are calculated according to local government debt growth given in Figure 2 of the 2011 NAO report.
3. The number as of the end of 2014 is from the proposal to the State of Council submitted by the Ministry of Finance (MOF), in which it was said that by the end of 2014 the local government full obligation was 15.4 trillion RMB and the total local government guaranteed/contingent liability was 8.6 trillion RMB.
4. The numbers as of the end of 2015/2016 are calculated according to the 2015/2016 local government full obligation of 16/17.1 trillion and the 2014 fraction of local government full obligation as the total local government debt.
5. The numbers as of the end of 2011 and 2013 are interpolated assuming that the growth rate of local government debt is constant between 2010 and 2012, and between 2012 and 2014.

### **B.2 Local government bank loan balance**

1. The numbers as of the end of 2010 and June, 2013 are from the two NAO reports.
2. The numbers as of the end of 2008, 2009, 2011, and 2012 are adjusted from local government financing vehicle (LGFV) bank loan balance data available from Wind.
  - (a) The ratio between the average 2010 and June, 2013 local government bank loan balance from the NAO reports and the average 2010 and June, 2013 LGFV bank loan balance is used as the adjustment factor.
  - (b) LGFV bank loan balance data are from Wind as of the end of 2008, 2009, and 2012.
  - (c) LGFV bank loan balance as of the end of 2011 are interpolated, assuming that the growth rate between 2010 and 2012 is constant.

3. The numbers as of the end of 2013, 2014, 2015, and 2016 are adjusted from LGFV bank loan balance estimated using China Construction Bank's (CCB) LGFV balance.
  - (a) The country-wide LGFV bank loan balance in commercial bank measurement as of the end of 2013 to 2016 are estimated using CCB's LGFV bank loan balance and CCB's bank loan balance share as of all commercial banks.
  - (b) The growth rates of country-wide LGFV bank loan balance in commercial bank measurement are used to estimate the LGFV bank loan balance in Wind measurement from 2013 to 2016.
  - (c) The numbers of local government bank loan balance as of the end of 2013 to 2016 are estimated from section 3(b) LGFV bank loan balance adjusted by section 2(a) adjustment factor.

### **B.3 Municipal corporate bond balance**

1. Individual municipal corporate bonds, both outstanding and matured, are aggregated over their corresponding outstanding periods to calculate MCB balance as of the end of each year.

### **B.4 Municipal bond balance**

1. Individual municipal bonds, both outstanding and matured, are aggregated over their corresponding outstanding periods to calculate municipal bond balance as of the end of each year.

### **B.5 Local government trust financing balance**

Municipality-Trust cooperation balance are reported officially by China Trustee Association. We assume that the fraction of Municipality-Trust cooperation over total Trust loans remains a constant over years.

1. Quarterly Municipality-Trust cooperation balance data are available since 2010.
2. As of June 30, 2013, the NAO report shows that the total local government trust financing balance is 1.43 trillion and the Municipality-Trust cooperation balance is 0.8 trillion. The adjustment factor is therefore  $1.43/0.8 = 1.77$ .

3. The numbers of Municipality-Trust cooperation balance as of the end of 2010 to 2016 are multiplied by 1.77 to reflect the total local government trust financing balance.

## **C Construction of Wealth Management Product Investment in Municipal Corporate Bonds**

1. Total MCB balance by rating (AAA, AA+, AA, and  $\leq$ AA) are aggregated from individual MCBs using bonds rating at issuance. If a bond does not have rating information at issuance, we use its issuer's rating at issuance as a proxy. Only 1.57% of MCB in terms of RMB issuance value do not have any rating information.
2. Total credit bond balance by rating (AAA, AA+, AA, and  $\leq$ AA) are from China Central Depository and Clearing Corporation, downloaded from WIND.
3. Credit bond balance by rating (AAA, AA+, AA, and  $\leq$ AA) held by WMP are from China Commercial Bank Wealth Management Products Annual Reports issued by China Banking Wealth Management Registration System.
4. Fractions of credit bond balance held by WMP by rating are calculated from numbers in 2 and 3.
5. Assuming that WMP hold MCB with the same percentage as WMP hold all credit bonds, we estimate MCB balance held by WMP from numbers in 1 and 4.

## **D Additional Results**

**Table 8: The Effects of 2009 Abnormal Bank Loan on Future Municipal Corporate Bonds Net Issuance, Year-by-Year Regressions**

This table reports the year-by-year regressions of 2012 to 2015 MCB issuance on 2009 bank loan. The dependent variable is the abnormal MCB issuance scaled by GDP in years 2012 to 2015 compared to the average value between 2004 and 2008. Annual MCB issuance at the regional and provincial levels are aggregated over individual MCB bonds. The independent variable is the abnormal new bank loan scaled by GDP in 2009 compared to the average value between 2004 and 2008. Panel A and Panel B report the regional and provincial results, respectively. Data about bank loan are obtained from PBOC and data about MCB are obtained from Wind. Heteroscedasticity consistent  $t$ -statistics are reported in parentheses. \*\*\*, \*\*, and \* indicate significance at the 1%, 5%, and 10% levels, respectively.

Panel A: 2009 bank loan and 2012-2015 MCB net issuance, regional

	(1)	(2)	(3)	(4)
	$MCB_{2012}^{net}$	$MCB_{2013}^{net}$	$MCB_{2014}^{net}$	$MCB_{2015}^{net}$
2009 BL/GDP	0.11*** (2.66)	0.11** (2.24)	0.21*** (3.20)	0.18* (1.66)
Constant	-0.00 (-0.46)	-0.00 (-0.47)	-0.01 (-0.64)	-0.01 (-0.79)
Observations	7	7	7	7
Adj. R <sup>2</sup>	0.42	0.35	0.47	0.31

Panel B: 2009 bank loan and 2012-2015 MCB net issuance, provincial

	(1)	(2)	(3)	(4)
	$MCB_{2012}^{net}$	$MCB_{2013}^{net}$	$MCB_{2014}^{net}$	$MCB_{2015}^{net}$
2009 BL/GDP	0.11 (1.55)	0.13*** (2.61)	0.18*** (3.65)	0.08 (1.54)
Constant	-0.00 (-0.15)	-0.01 (-0.89)	-0.00 (-0.45)	0.00 (0.52)
Observations	30	30	30	30
Adj. R <sup>2</sup>	0.10	0.31	0.33	0.06