Subnational Debt of China:
The Politics-Finance Nexus

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Discussion by

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Motivation

- Very important question linking politics and finance:
  - External rules of the game are not fixed
    - Changing nature of the rules is important
  - Political gains is what makes the rules change

- Implications for strategic behavior:
  - In this case politicians in China

- Paper is very timely, but not just for China!
  - Potential bright side of state capitalism?
  - Implications for other countries?
  - Seems to be arguing for more intermediation through policy lending?

- Nevertheless, importance of topic does not lower the bar for rigor
  - In fact, it makes it higher since the odds and impact are potentially higher

This Paper

- Examines a large dataset on local government finance vehicle debt service (LGFVs) debt service –60% of total government debt
  - Compare outcomes for development loans and commercial bank loans
- Clear and well documented stylized fact:
  - Large statistical discrepancy between development and commercial bank delinquency rates
- LGFVs more likely to default on commercial loans than development loans
  - Delinquency rate 1.8% for commercial loans, 0.3% for development loans
- In contrast to non-LGFVs lending, development loans default rates are no different than commercial bank loans (Table 2A)

This Paper

- Some evidence that local officials borrow from commercial banks to avoid direct default on policy loans
  - Implication is that default on commercial bank loans is “selective”

- Paper explains discrepancy as reluctance by local officials to default on government debt

- Interpretation:
  - Official debt service has implications for promotion
  - Level of development loans is associated with:
    - Long-term growth performances (GDP)
    - Probability of promotion of local officials

- Providing an economic interpretation to the stylized fact is key
  - And where the paper needs to do a better job…

Selection Issues: Borrowers

- Borrowers are different: Local Governments
  - We know that local governments have different financing needs and face different shocks so one has to be very careful
    - Example: Chicago vs Detroit
  - In particular, how do the Determinants of Loan Default in Table 2B correlate with development loans vs commercial loans?

- Are borrowers different in terms of capital structure?
  - Are they different based on both the LHS and RHS of their balance sheets?

- Do the borrowers in question all borrow from *both* development and commercial banks?

Selection Issues: Borrowers

- Appear to be different loans:
  - Development loans typically longer term
  - Development loans not-profit oriented
  - Infrastructure loans of “bottlenecked industries” with negative NPV projects
  - Focus on undeveloped areas

Selection Issues: Lenders

- Unclear what is the utility function of development banks vs. commercial banks
  - Development lenders are non-profit oriented
  - But commercial banks are state-owned –still unclear what they maximize! How do they monitor loans?

- Authors argue that development banks are more likely to “repeat” lending and are strategically more important
  - Development lenders may target different borrowers than commercial banks, **but** also have more stringent standards around governance, which could include default
  - The positive and negative supply shocks from commercial banks also shows that commercial bank lending is more volatile…
  - Having a good relationship with development banks is important
    - I am not sure that this is “relationship banking” and learning type in the way we always think about it…

Selection Issues: Lenders

- I wonder if development banks have more stringent requirements around default?
  - A single default on development bank debt may rule out borrowing from any development bank
    - Table 7 needs to be developed in this regard (Availability of Credit Conditional on Default)

- Table 5 worries me…
  - LGFVs with larger use of development loans are correlated with secretaries receiving promotion
  - Let's assume that politicians get promoted because they do well, i.e. strong GDP as stated on page 4. This suggests that development banks are able to better select strong LGFVs, who have stronger GDP and therefore lower defaults. But GDP doesn't load… so loan use itself explains promotion? Why?
  - Also, are lender's forcing borrowers to internalize political agency?

Selection Issues: Lenders

	Politician Promotion			
	Rank Based		Rank Plus GDP Based	
	(1)	(2)	(3)	(4)
Log(CDB Loan)	0.319***		0.256***	
	(3.01)		(2.71)	
CDB/Total Loan		0.313*		0.322**
		(1.93)		(2.25)
Male	-0.601	-0.603	0.145	0.124
	(-1.59)	(-1.60)	(0.40)	(0.34)
Age>=50	-1.095***	-1.105***	-0.645***	-0.659***
	(-5.37)	(-5.46)	(-3.73)	(-3.82)
Local Politician	-0.120	-0.130	0.242	0.225
	(-0.54)	(-0.58)	(1.29)	(1.21)
High Education	1.598	1.562	1.683**	1.674**
	(1.50)	(1.48)	(2.21)	(2.20)
Oversea Experience	-0.309	-0.319	-0.324	-0.318
	(-0.95)	(-0.97)	(-1.19)	(-1.16)
Log(Local GDP)	0.064	0.248*	-0.014	0.151
	(0.40)	(1.67)	(-0.10)	(1.17)
Local Expense/Revenue	-0.035	-0.085	-0.024	-0.053
	(-0.51)	(-1.21)	(-0.47)	(-1.03)
Tertiary sector/GDP	0.023*	0.033***	0.006	0.015
	(1.80)	(2.68)	(0.55)	(1.40)
Year Fixed	Yes	Yes	Yes	Yes
Region Fixed	Yes	Yes	Yes	Yes
No. Obs.	657	657	657	657
Pseudo. R2	0.122	0.110	0.053	0.046

Selection Issues: Lenders

- Do development banks have restrictions around capital structure? Are they more stringent?
  - This related to “are borrowers different in terms of capital structure?”

- Are development banks better at enforcement and recovery than commercial state-owned banks?

- **Bottom Line:** The authors need to rule out all of this before moving onto political agency

Treatment Effect

- Ideal Experiment:
  - Two borrowers, identical in terms of real economic activity and capital structure. Both receive the same negative shock.
    - Only difference is that one has an politically incentivized CEO and the other does not
    - Who defaults and on what loan?

- This is very difficult. Why?
  - If political agency does matter, then lenders know this and will force borrowers to internalize the cost
  - Development banks will lend more debt knowing that political agency makes their loans safer; Commercial banks will do the same
  - So political agency has an impact on default and the loans themselves, so finding a counterfactual is very hard

Treatment Effect

- Table 6 is the best they have when they condition on politicians being closer to turnover
  - However, the mechanism is unclear to me
  - Need to explore the dynamics (Quarter-Year Dummies Interactions - Construct a clock of quarter year to turnover)

- If promotion = f(GDP), and GDP = f(development debt), then it would seem that politicians should become less bothered about default on development loans closer to turnover and should stop caring at all once they know they are promoted
  - If the tenure is 5 years, then poor performance, default and the related future financial constraints will impact promotion more so if they occur in year 1 and than year 5

Treatment Effect

- On page 34 the authors claim:
  - *"Ru (2017) finds that city secretaries borrow more from the CDB during early periods of their tenure. In China, a loan default event could damage the image of politicians and has a negative influence on promotion."*

- This is where I got lost:
  - So it must be that default affects promotion beyond the impact on GDP, but why? Or…
  - Is lower default linked to lower usage in later years, following Ru? Or…
  - Do politicians care about leaving with an intact reputation so that they can raise debt at their next post?
    - If so, this is problematic because the career concern style game at play is different to the one the authors describe!

- **Bottom line:** Economic motivation for the identification is not tight so it is hard to interpret the results the way they do

Treatment Effect

- So based on Ru (2017), promotion depends on default which explains use of development debt early in the cycle.
  - So the statement in this paper "*In China, a loan default event could damage the image of politicians and has a negative influence on promotion*" seems unfounded
  - In fact a politician would want to avoid default only because it helps her borrow at her next post to increase GDP there.

- Is development lending related to the politician or the region is a <u>**very**</u> interesting question…
  - Maybe the politician herself has access to credit, and building her reputation is important

Implementation Issues

- Table 6: Very important but less interesting for a discussion…
  - Ideally they should estimate within borrower-time so that they compare commercial and development loan performances within a borrower-time, *i.e.* borrower-time FE
  - **<u>Or</u>** if they are using region as "borrower" then region-industry-year FE else region-year FE and industry-year FE

- Without this FE structure it is very easy to argue that economic shocks drive everything…

Other Issues

- I do not find the shocks that interesting, other than for studying shocks and substitutability of debt

- If the debt is off balance sheet, what is the recourse? Does recourse differ across bank type?

Conclusion

- A very nice and timely descriptive analysis of the role of development and commercial banks in China
  - Nice stylized fact

- It could benefit a bit more from:
  - helping the reader tease out borrower and lender selection issues
  - discussion on the economic interpretation of the strategic default by politician (treatment effect)

- I do not think the authors can say anything on the performance of commercial vs. development banks
  - No info on pricing, NPV of loans, do not know if banks make borrowers internalize agency
  - No evidence on the implications for overall defaults

- Looking forward to reading the next version of the paper