

Exclusive: China to clean up billions worth of local debt



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BEIJING (Reuters) - China's regulators plan to shift 2-3 trillion yuan (\$308-463 billion) of debt off local governments, sources said, reducing the risk of a wave of defaults that would threaten the stability of the world's second-biggest economy.

As part of Beijing's overhaul of the finances of heavily-indebted local governments, the central government will pay off some of their loans and state banks including some of the "Big Four" will be forced to take some losses on the bad debt, said the sources, both of whom have direct knowledge of the plans.

Part of the debt will also be shifted to newly created companies, while private investors would be welcomed in projects previously off-limits to them, sources said. Beijing will also lift a ban on provincial and municipal governments selling bonds, a step aimed at bolstering their finances with more transparent sources of funding.

Many analysts see China's pile of local government bad debt as a major risk to the economy, especially as the economy slows, but few see widespread banking fallout as they believe cash-rich Beijing can step in to soak up losses.

The clean-up plan could boost investor confidence in Chinese banks, which have provided many of their loans as part of the massive economic stimulus program launched by Beijing in late 2008 to counter the global financial crisis.

The program resulted in unfettered lending to local government financing vehicles, hybrid government-company bodies that governments used to get around official borrowing restrictions.

After a months'-long investigation into local government liabilities, Beijing has determined that local governments have borrowed around 10 trillion yuan, said one of the sources.

Chinese media have reported that the governments may default on around 2 trillion yuan worth of those loans.

The source said that three government bodies -- the bank regulator, the Finance Ministry and the National Development and Reform Commission, China's state economic planner -- plan to start cleaning up the debt in June and finish in September. The second source said the program may take longer.

"It's to rescue local government finances, not banks. It's different in nature from the bailout of the four big (state) banks in the late 1990s before they listed (on stock markets)," the first source told Reuters, requesting anonymity because he is not authorized to talk to reporters.

In 1999, China set up asset management companies to clear 1.4 trillion yuan in bad loans off the books of the large state-owned banks, which were saddled with piles of debt after decades of politically motivated lending.

The Big Four are Industrial and Commercial Bank of China (601398.SS: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) (1398.HK: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)), Bank of China (3988.HK: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) (601988.SS: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)), China Construction Bank (0939.HK: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) (601939.SS: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) and Agricultural Bank of China (1288.HK: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)) (601288.SS: [Quote](#), [Profile](#), [Research](#), [Stock Buzz](#)).

The banking regulator, the Finance Ministry and the state planner declined immediate comment when reached by telephone.

CLEANING UP

Planners are still ironing out details about how the sour loans would be written off, the source said.

"The central government will swallow some of it," he said, and "some local governments will be allowed to issue bonds."

"The government hopes to resolve this problem before the 18th Congress next year," the second source said, referring to the Communist Party's key conclave where a leadership reshuffle is expected.

Details on the firms that will be created to manage the debt were not immediately known, but the first source said they may receive funds from private investors. State-owned China Development Bank accounts for about one-third of all local government loans, said one of the sources, with the rest being extended by big state-owned banks and city commercial banks.

Worried these loans could strain China's public finances if they sour, China's cabinet has instructed banks to clamp down on lending to local governments, an order which Chinese banks say they are abiding by.

State media previously reported that as part of Beijing's clean up of the local government debt mess, it will consolidate about 3,800 local government financing vehicles.

Guo Tianyong, an economist at the Central University of Finance and Economics, said that while the debt overhauling exercise might take the bad debt off the local governments' books, it wouldn't necessarily resolve the question of who would ultimately pay.

"I feel it won't fundamentally solve the problem by hiving off and selling the debt to other investors," Guo said.

Underscoring worries that China's public finances may be strained by bad debt, Fitch last month cut the outlook for China's local currency rating to "negative." Standard & Poor's said this month the non-performing loan ratio among Chinese banks could reach 5-10 percent in the next three years [ID:nL3E7GP0CV].

Some analysts also believe China's central bank is wary of raising interest rates too forcefully for fear of burdening local governments with growing interest payments. The stash of local government debt is still growing, however. The Economic Observer newspaper said it may hit 12 trillion yuan by the end of 2011, citing unnamed experts.

(\$1 = 6.483 yuan)

(Additional reporting by Koh Gui Qing; Editing by Don Durfee & Kim Coghill)

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