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China government bond swap may drain liquidity out of economy

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High risk, low yield debt seen as tough sell, with total likely to be 30pc higher than last reported

China's proposed local government bond swap plan may end up being a reshuffling exercise between various state entities and suck liquidity out of the economy just when it's needed most.

A long mooted Ministry of Finance programme aims to swap 1 trillion yuan (HK$1.25 trillion) of local government debt into bonds this year in an effort to clarify and restrain local debt levels.

Who will buy the bonds is the question people need to now ask, argues Orient Capital Research managing director Andrew Collier in a report.

Analysts and central government officials, including finance Minister Lou Jiwei, earlier said the bonds would be commercially attractive to local and international investors.

"This is currently anyone's guess, but it is unlikely investors or domestic institutions will be big buyers. This would be a bet on a risky tranche of debt…for low yields," wrote Collier.

Total local government debt, including off balance sheet investment vehicles, is likely much higher than the 17.9 trillion yuan last reported by the National Audit Office in mid-2013, possibly as much as 30 per cent higher, writes Collier.

Investors want to know bond issuers' liabilities, otherwise it will be hard to assess whether local governments can make the coupon payments.

Guarantees in the event of default are opaque as it is not clear that governments - and certainly non-governments - can guarantee bond debt, wrote Collier, citing research by Chinese law professor Donald Clarke that indicates legislative amendments need to be made before provincial governments can guarantee bonds.

This pushes up the bonds risk profile, and without clear government backing in the event of default, many buyers may shy away.

"So we're probably talking about the banks stepping in to fill the gaps," wrote Collier, who broadly welcomes the debt for bond swap idea.

This threatens to drain liquidity from an economy already growing at its slowest rate in two decades.

One option might be for the banks to buy bonds and then pledge them for loans from the People's Bank of China, said Collier, citing a recent *Wall Street Journal* report of just such a scheme.

"They want to keep liquidity in the system but stop debt overwhelming the system," Collier told the *South China Morning Post* in a follow up interview.

"It's just like the old shell game. They are moving the shells around but it's all under the same three shells," he said.

This means that in the end most local bonds will end up on state bank balance sheets, likely negating some of the market rigours that the scheme was originally designed to impose.

"Are [the banks] really going to force local governments or local government funding vehicles into bankruptcy if they don't pay interest? Doubtful," he wrote.

"That means the banks will be holding worthless paper - while pretending these are valuable assets."

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