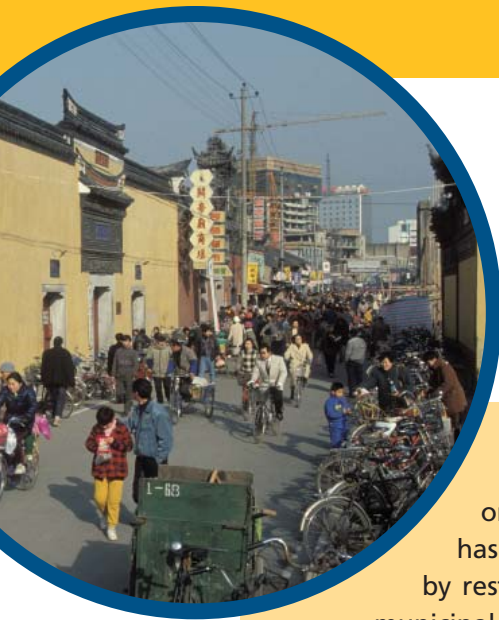


IMPACT STORIES



PPIAF Helps the Chinese Government Move Toward Credit-Based Borrowing by Sub-National Entities

One valuable impact generated by PPIAF's work is to help clients avoid expensive mistakes when it comes to engaging the private sector in infrastructure financing or management. In China, PPIAF's Sub-National Technical Assistance (SNTA) program has helped the central government manage sub-national liabilities more effectively by restricting risky borrowing deals undertaken by local investment companies used by municipal officials to raise money for infrastructure and other kinds of urban services. These restrictions will allow national officials to begin work on much needed reforms of the regulatory framework for such borrowing.

Chinese budget law prohibits sub-national governments from borrowing, but many do so indirectly and off-budget, by using Urban Development Investment Corporations (UDICs). As many as 8,000 UDICs now exist in China where this kind of financing accounts for 80-90% of urban infrastructure finance. UDICs help account for off-budget sub-national liabilities that are estimated to equal up to 34% of GDP and accounted for 30% of record new bank lending in 2009.

Central government officials have become concerned about contingent liabilities that might be lurking among the massive amounts of UDIC debt. UDICs in large coastal cities are well-funded, and many are publicly-traded subsidiaries that can raise capital from the markets and rely less on bank loans. But UDICs in the poorer areas of northern and western China are of particular concern because they rely more heavily on bank loans backed primarily by guarantees rather than assets or future project revenues. Many of these loans were issued at a time when the central government seemed to be encouraging lending, particularly for infrastructure projects that would have economic stimulus effects. But as a result, credit analysis by banks was minimal. Some observers estimate that a quarter of this borrowing may go into default, and a 25-30% default rate would wipe out the paid-in capital of many of China's largest banks.

PPIAF SUPPORT

The Public-Private Infrastructure Advisory Facility (PPIAF)'s SNTA program has helped in two ways: First, at the request of the Chinese Ministry of Finance (MOF), SNTA co-sponsored an International Forum on Sub-National Debt Management in Zhuhai, China (one of China's four original Special Economic Zones) on September 21, 2009. The government paid for 85 officials to attend the Forum, including senior officials from the MOF and budgetary department chiefs of all provinces and large municipalities. The Chinese participants were led by the MOF's Deputy Director General in charge of inter-governmental fiscal relations and its Director of Sub-National Debt Management. The forum focused on international experiences with regulatory and institutional frameworks for sub-national borrowing designed to facilitate sustainable infrastructure finance while managing risks and contingent liabilities to the national macroeconomic framework.

On the second day of the Forum, the Chinese participants held all-day internal discussions reflecting on the international experiences presented on the first day, and put together a list of questions on policy, regulatory and institutional frameworks. A follow-up meeting focusing on these questions was held in Beijing on September 25. Participants included senior officials of the MOF, the World Bank, and all of the international experts who had participated at the International Forum.

A second parallel focus of SNTA assistance has been to help central and municipal officials better understand the financial situation of UDICs by sponsoring credit ratings of six of these entities by international credit rating agency Standard & Poors. The ratings documented the fact that UDICs often borrow more debt than they can service with their own revenues and rely on guarantees from parent municipalities to finance projects that do not generate cash flows sufficient to cover their costs.

A key recommendation of this work was to move UDICs away from open-ended guarantees by parent municipalities, and toward credit-based borrowing practices. The idea is to ensure that UDIC borrowing is fully vetted via credit-worthiness assessment by lenders, as well as realistic assessments by the UDICs and their municipal parents regarding the willingness and ability of these special purpose vehicles to repay debts in a timely fashion.

DONOR COORDINATION

The Forum was jointly financed by the Chinese MOF, PPIAF's SNTA program, and the China Country Management Unit. It was also supported by the Guangdong Provincial Government and Zhuhai municipality.

Since 1999 PPIAF, a multidonor technical assistance facility, has helped developing countries use public-private partnerships to improve their infrastructure. A key focus has been upstream technical assistance to support the development of an enabling environment for such partnerships.

This series highlights how PPIAF's support has made an impact on the ground.

OUTCOMES

In a meeting with banking regulators on February 25, 2010, the MOF announced its intention to prohibit local government guarantees for UDIC borrowing, as a way of restricting local non-credit-backed borrowing until a comprehensive regulatory framework can be put in place.

At the opening of the annual parliamentary meetings a week later, Premier Wen Jiabao announced that the central government would sell 200 billion yuan (\$30 billion) of bonds for a second year to on-lend to local governments for infrastructure projects.

This kind of financing was also discussed with the international experts in Zhuhai and represents an intermediate way of controlling local borrowing, while creating a situation where these entities must plan investments, pay back debts and operate according to the basic tenets of a credit culture.

IMPACTS

The Chinese government needs to do more work to establish a comprehensive regulatory framework that facilitates prudent sub-national finance activity by UDICs. PPIAF's SNTA program has contributed to a policy note prepared by the World Bank covering the key issues for attention by the MOF. But in the meantime, an extremely risky form of borrowing has been sharply curtailed and an important sub-national finance reform process begun.

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- 2008: Urban Development Investment Corporations Credit Ratings (SNTA), **\$350,000**
- 2009: Sub-National Borrowing and Debt Management (SNTA), **\$75,000**

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