**China Central Bank Checks Europe Playbook on Credit**

PBOC cuts banks’ reserve ratio by one percentage point while weighing new strategy

By

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BEIJING—China’s central bank is considering taking a page from Europe’s financial-crisis handbook to free up more credit as growth in the world’s second-largest economy slows.

The proposed strategy would allow Chinese banks to swap local-government bailout bonds for cash as a way to bolster liquidity and boost lending, said people familiar with the People’s Bank of China talks.

Adopting the strategy would mark a major shift in the central bank’s money-supply policy and underscore the leadership’s deep concern about missing already lowered growth expectations.

In recent months, China’s leaders have directed the central bank to try to beef up bank lending and lower borrowing costs as the economy slows and capital leaves the country.

But a barrage of easing measures—including two interest-rate cuts since November—has had limited success. Instead of stimulating targeted areas of the economy, such as small businesses, they have helped companies already heavily in debt.

The move also triggered a run-up in China’s stock markets that prompted the top securities regulator last week to rein in speculative stock-trading activities. On Friday, China’s Premier [Li Keqiang](http://topics.wsj.com/person/L/Li-Keqiang/7155) urged Chinese banks to do more to support the “real” economy.

The central bank’s one-percentage-point cut in the reserve requirement, announced Sunday, was the second reduction in less than a quarter and the biggest since December 2008, freeing up about $200 billion for banks to lend. It comes just days after data showing China’s economy decelerated to 7% year-over-year growth in the first quarter, the slowest pace in six years.

The move by Chinese authorities coincided with a weekend of discussions in Washington among top economic policy makers at the semiannual meeting of the International Monetary Fund. One of the resonant themes at this weekend’s conference was a dearth of global demand, and persistent disappointments on growth.

The central bank is concerned about one issue in particular, according to Chinese officials and advisers to the PBOC: preventing a stranglehold on liquidity in the financial system at a time when local governments are about to begin a debt-for-bond replacement program to try to alleviate their repayment burdens.

The debt-restructuring program, announced by China’s finance ministry last month, seeks to reduce localities’ financing costs and stretch out the time they have to pay off debts. But it risks choking off funds available for lending, and could drive up interest rates at a time when many economists say more and cheaper credit is needed.

To stave off the undesirable consequences of the debt plan, the PBOC first tried freeing up more funds for banks to make loans. But officials at the central bank are weighing other ways to help mitigate the potential downsides, according to people with direct knowledge of the discussions.

One option involves giving banks access to long-term loans with the aim of improving lending to sectors that leaders see as crucial for China’s prosperity, such as farming, affordable housing and small and private businesses. To obtain the loans, Chinese banks would use bonds issued by local governments as collateral.

That strategy is similar to the long-term refinancing operations, or LTROs, used by the European Central Bank, the people said. In late 2011, the ECB doled out trillions of dollars in three-year loans through such mechanisms, providing access to cheap funds for struggling European banks.

The Chinese version would be aimed at ensuring adequate liquidity in the system, as the central bank can no longer rely on large amounts of capital inflows to maintain its monetary base. Since late last year, there have been growing signs of money leaving China’s shores. Yuan positions on the PBOC’s balance sheet, a gauge of capital flows, declined a record 251.1 billion yuan, or about $40.5 billion, in the first quarter.

“The LTRO was considered by some as an unconventional monetary-policy tool adopted by the ECB and it was primarily intended to provide temporary liquidity to European banks,” said Larry Hu, China economist at Macquarie Group Ltd. “In China’s context, the PBOC’s main purpose for such a tool would be to create base money.”

Borrowing by China’s various levels of government is a big reason the country’s debt load is expanding. The International Monetary Fund says China’s debt is growing more rapidly than debt in Japan, South Korea and the U.S. did before they tumbled into recession. Local-government borrowing, which totals about $4 trillion by some accounts, is responsible for a quarter of the buildup in China’s overall domestic debt since 2008.

Now, as local governments struggle with plunging land sales, they are increasingly having trouble repaying their debts.

For instance, Haikou, the capital of China’s Hainan province, has warned it might not be able to repay its debt and asked the provincial government to allocate a third of its bond-issuance quota to the city.

Under the debt-for-bond program, localities are allowed to sell 1 trillion yuan of “special” local bonds to replace their existing debts. The program, which likely will be expanded this year, could save China’s local governments a total of up to 50 billion yuan in interest payments a year, the finance ministry estimates.

China’s commercial banks, long the main providers of credit to local governments and a key investor in Chinese bonds, are expected to be the major buyer of those local bonds once they are issued, as the banks would essentially replace the higher-risk loans on their books with bonds with explicit government guarantee.

However, if banks use funds that could otherwise have been used for lending to purchase those bonds, overall money supply would tighten. Meanwhile, given the limited size of China’s bond market, a large-scale bond sale by local governments also risks pushing up market rates just as the authorities are struggling to drive down borrowing costs.

“To offset the monetary contraction resulted from the debt-replacement program, the PBOC has to inject liquidity into the market one way or another,” said Li Daokui, economist at Tsinghua University in Beijing and a former adviser to the central bank.

Under the LTRO-like strategy, commercial banks would be permitted to use local-government bonds they purchase as collateral to take out low-interest-rate, three-year loans from the central bank. By doing so, officials at the PBOC would try to direct the banks to lend to small and private businesses, among other sectors favored by the government. The interest rates on those loans could serve as a medium-term benchmark rate, potentially giving the PBOC another tool to guide interest rates, according to the people with knowledge of the central bank’s thinking. Currently, the PBOC influences market rates mainly through its benchmark lending and deposit rates, and through the rates in the interbank market where banks borrow from each other.

“As China starts to restructure the balance sheets of local governments, the Chinese central bank can, should and likely will play a more active role in the process,” said Liang Hong, chief economist at China International Capital Corp., an investment bank in China.