Economic Analysis

China | Guidelines issued to tackle rising corporate debt

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China's State Council yesterday issued a set of guidelines, seeking to lower corporate sector leverage and tackle its ballooning corporate debt, which, we estimate, at around 160% of GDP at end-2015. The guidelines have established three principles in dealing with firms' debt problems, namely (i) taking a market-oriented approach; (ii) complying with the existing legal framework; and (iii) coordinating with other reform measures. In the ensuing press conference, senior officials from a number of government agencies including the National Development and Reform Committee (NDRC), Ministry of Finance (MoF), the central bank and banking regulator, provided greater details about the guidelines and its implementation.

Generally, the latest announcement reflects authorities' increasing concern over China's alarming corporate debt level and its potential threat to financial stability. Reassuringly, authorities are now shifting focus towards containing rising financial sector vulnerabilities as recent stabilization of growth has made this year's 6.5% official annual GDP growth target attainable. Interestingly, the PBoC representative, in the press conference, implied that it will be acceptable if credit growth falls short of its annual target of 13% due to loan reliefs, consistent with Governor Zhou Xiaochuan's remarks at the IMF a couple of days ago.

- **Guidelines suggest multi-pronged approach for firms to tackle excessive debt:** Such an approach includes, (i) Encouraging mergers and acquisitions; (i) facilitating firms' balance sheet adjustment by themselves; (ii) Conducting debt-to-equity swaps in an "orderly" manner; (iii) Developing equity financing; and (v) Allowing bankruptcies and liquidation. In particular, the guidelines forbid banks to conduct debt-to-equity swaps directly. Banks can only transfer their loans to other non-bank financial institutions for the latter to convert these loans to equity. Moreover, the guidelines emphasize that the program of debt-to-equity swap should be conducted in a market oriented manner and should not be used to support "zombie companies".
- **Implementation remains the key:** While the latest guidelines attempt to provide a comprehensive and feasible solution to China's rapid accumulation of corporate debt, it still leaves ample grey areas which could hamper its effective implementation. For example, the guidelines don't give clear answers to whether the practice of debt-to-equity will permit a change of ownership of the distressed SOEs. This could lead to more uncertainties surrounding the guidelines' implementation and as a consequence exclude private capital from the debt-to-equity program. For deeper perspective, see our previous watch – Equity for Debt swap – A pareto-optimal solution to China's banking sector woes?
- **Awaiting the real game changers:** If implemented as intended, we expect the guidelines to mitigate the leverage problem in China's corporate sector and buy more time for authorities' striving to sustain financial and economic stability. Nevertheless, we believe that the ultimate solution of rising corporate debt level lie in two game-changing reforms:(i) the authorities need to withdraw their implicit guarantees for all the SOEs and allow them to go bankrupt as their private peers; and (ii) a regulatory umbrella should be established to effectively curtail the shadow banking activities and prevent banks from taking excessive risks. A positive start in this regard is the bankruptcy announcement of Dongbei Special Steel Group in Liaoning province on September 29th. The bankruptcy restructuring can be perceived as a harbinger of the market oriented approach taken by Chinese authorities towards tackling the debt issues of troubled Chinese State Owned Enterprises (SOEs). While the current stance of Chinese authorities towards supporting SOEs reflects greater discern and differentiation, the real test of implementation lies ahead.

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