

**CHINA'S CORPORATE DEBT:
RECENT DEVELOPMENTS
AND IMPLICATIONS**

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Executive Summary

1. China's corporate debt has risen steadily and rapidly since the mid-2000s, fuelled by state-driven stimulus and rapid expansion of credit. Measured as a proportion to gross domestic product (GDP), the ratio reached 168%, higher than that of the United States (around 72%) and Japan (99%) as at the second quarter of 2016.
2. The rise in corporate debt in recent years is particularly significant for firms facing overcapacity such as mining (coal and steel), retail and wholesale (mainly industrial trading companies) and real estate.
3. The debt surge has led to concerns that China will reach its "Minsky" moment soon; countries with similar episodes of surging credit growth tend to experience asset market correction, debt defaults, banking problems or a currency crisis. However, a systemic debt crisis is unlikely given China's high domestic savings, high degree of government control over the financial sector and capital controls.
4. However, this does not imply that China can continue to run an increasing debt infinitely without major problems. The fact that debt is rising much faster than output and an increasing share of the debt is accounted for by the non-productive or excess capacity sectors implies that resources may have been wasted and more potential bad debts are being created.
5. A large debt overhang is a serious drag on economic growth. If lending to an increasingly weak corporate sector continues, actual and potential economic growth will be undermined since an increasing share of new credit will be used just to roll over existing debts instead of being used to finance new or productive investment.
6. Without structural reforms to address rising corporate sector vulnerabilities, China could experience a protracted period of low productivity and mediocre growth performance if the debt issue remains unresolved. Corporate debt restructuring measures like the debt-to-equity swaps may only temporarily relieve the debt burden for financially distressed companies.

7. The debt-to-GDP ratio is unlikely to stabilise or fall in the next 1-2 years if credit growth remains strong and economic growth moderates. Further, reform of the state-owned enterprises (SOEs) is likely to be gradual while facilitating faster non-performing loans' write-offs through the debt-equity swap is not easy and may lead to moral hazard (i.e., companies may over-borrow in the knowledge that banks would go to their rescue).
8. The government would have to balance the need to stabilise growth and manage the degree of credit expansion whilst carrying out the necessary reforms.
9. It would need to restructure the stock of debt including writing off bad debts, shutting down non-viable enterprises, imposing hard budget constraints on SOEs (by removing implicit guarantees and subsidies) and improving banks' lending practices. Reforms would inevitably cause growth in the near term to be weaker but long-term growth and debt would be more sustainable.