Editorial

Chinese Adventure for Cutting Massive Corporate Debt

The recent attempt of the Chinese government to bail out its vast and ailing corporate sector, reeling under an unsustainable pile of huge debt, is quite adventurous and beyond imagination. But, nothing less than such an unprecedented financial adventure- or mis-adventure-can save the second largest economy of the world, at a time when corporate China is sitting on a pile of $ 18 trillion in debt, equivalent to about 170% of its GDP; when global demand is sagging and 60% of its output is based upon export led demand. As a result majority of its companies find it almost impossible to survive under such heavy debt servicing liability, when their capacities are highly under-utilized due to global recession. This huge pile of corporate debt, is otherwise capable of triggering a ceaseless spate of corporate closures, which could erode and destablise the entire Chinese economy. The loss to the economy in monetary terms then would be much more than that being incurred in the proposed debt restructuring, and the consequent corporate closure on account of huge debt could wipe out its (Chinese) vast production capacities and erode most of its exports, and wipe out its trade surplus and forex reserves and invite doomsday. To avert any such fateful spate of economic mishaps only, China unveiled the debt structuring guidelines recently to trim the rising corporate debt levels. Though, several analysts still fear that it would also destabilize the Chinese economy. But, anything less than it or any further delay in it can trigger a more fateful spate of destabilizing mishaps in the Chinese economy. The government has therefore, proposed to take a multi-pronged approach for cutting company debts, including encouraging mergers and acquisitions, bankruptcies, debt-to-equity swaps and debt securitization by issue of new guidelines by State Council, or the cabinet.

International institutions have been warning Beijing since long to stop financing weak firms, especially inefficient state-owned enterprises, which also tended to crowd out, the private sector. Inspite of these warnings China has hitherto failed to curb excesses in its credit system and therefore, it now faces mounting risk of a full-blown banking crisis. As per a key gauge of the Chinese credit vulnerability, it is now three times over the danger threshold in China, and continues to deteriorate, despite pledges by Chinese premier Li Keqiang to wean the economy off debt-driven growth before it was too late.

As per the Bank for International Settlements, China's "credit to GDP gap" has reached 30.1, the highest to date. It is much more and significantly higher than the scores in East Asia's speculative boom on 1997 or in the US subprime bubble before the Lehman crisis. China's total credit had also reached 255% of their GDP at the end of last year with a jump of 107 percentage points over last eight years. This is an extremely high level for a developing as well as developed economy and is still rising fast. Outstanding loans of China have reached to $28 trillion, as much as the size of commercial banking systems of the US and Japan combined. The scale is enough to threaten a worldwide shock if China ever loses control.

High debt levels have added to operating difficulties for some Chinese firms, increasing their debt risks, as per statement of the National Development and Reform Commission (NDRC) of China released during a news briefing in Beijing. Therefore, the NDRC holds that “market-oriented debt-to-equity swaps will be one of the important measures to reduce corporate leverage,” NDRC's vice chairman Lian Weiliang said during the briefing. It is indeed a revolutionary proposal to convert debt into equity and relieve the ailing companies from unsustainable debt servicing. Though, Lian has also warned that the swaps are not a “free lunch” for troubled companies, clearly adding that loss-making “zombie” firms are strictly forbidden from such exchanges, which will be used mainly to help high-quality firms that face temporary difficulties. He also clarified that the government will not be responsible for any losses occurred during the swap process in a bid to prevent “moral hazard”.

Unfortunately, China's bond markets have also worked hitherto for years on the assumption that issuers were effectively guaranteed by the state. Of late, since 2014, though, Beijing has been cautiously trying to change that perception by allowing some issuers to default. Bond yields in the major economies normally track the growth rate of nominal GDP, but they are now far lower in China. Roughly $10 trillion is trading at negative rates and this has spread into corporate debts. This historical anomaly is underpinning richly-valued stock markets at a time when profit growth has collapsed.

China also proposes to combine deleveraging with overcapacity reductions, and the government will also provide preferential tax treatment to help firms cut debt levels, as per official's statements. The central bank will create a favorable monetary policy environment for this debt reduction as per Fan Yifei, a Vice Governor of the People's Bank of China. Banks will also be encouraged to transfer bad loans to asset management companies and push forward the securitisation of bad assets, in pursuance with cabinet guidelines. However, banks can never be forced to conduct the swaps, and it has been also made clear that the government will prevent a shift of risks from non-financial firms to banks under the debt-to-equity swaps.

China had earlier also experimented with debt-to-equity swaps in the late 1990s as part of its sweeping reforms in the state sector that led to around 28 million layoffs over five years then. But, experts said the program made state-owned firms less willing to find ways to pay back debts.

One bright spot is a repayment of foreign debt denominated in dollars. Cross-border bank credit to China has fallen by a third to $698bn since peaking in late 2014 as companies scramble to slash their liabilities before the US Federal Reserve raises rates.

But, China's problem is its internal credit. The risk is that a fresh spate of capital outflows might force the central bank to sell foreign exchange reserves to defend the exchange rates of yuan, automatically necessitating tightening of monetary policy. But, inspite of all the measures underway yet the China is emerging as the epicenter of risk, vulnerable to face a full blown banking crisis any time.

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