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Corporate debt needs bold action

SOEs and vulnerable sectors must be targeted to identify risks and push ahead with structural reforms

By **CHAIPAT POONPATPIBUL, LI WENLONG** and **SIMON LIU**

China's nonfinancial corporate debt has reached a record high. While this is unlikely to lead to a systemic crisis in the short term, it is still a worrying sign for the economy.

The ratio of corporate debt-to-GDP was as high as 155 percent last year, according to an estimate by the ASEAN+3 Macroeconomic Research Office (AMRO). Since the beginning of this year, this has started to flatten and the growth in corporate debt began to slow due to stepped-up regulation and supervision by the authorities and declining leverage in the financial sector.

However, challenges remain as the improvement has resulted from higher nominal GDP growth rather than a decline in corporate debt.

Based on solvency and liquidity indicators as well as nonperforming loan ratios, the bulk of corporate debt is not risky. Nonetheless, the problem is concentrated and more severe in some sectors where credits have built up while profitability and repayment capacities have declined, as noted by AMRO in its recent study titled *High Corporate Debt in China: Macro and Sectoral Risk Assessments*.

Those are prioritized sectors under the investment-led growth model. Manufacturing accounts for the most significant share of total corporate debt at 20 percent, followed by real estate (15 percent), utilities (14 percent), construction (12 percent) and transport (12 percent).

Despite the declining efficiency and repayment capacities of borrowing enterprises, some financial institutions might still think "high risk, high return".

Bank loans are the main source of financing for corporations, but their share of total financing has declined, while the shares of bonds and shadow banking loans have increased sharply to 20 percent and 16 percent, respectively, especially in the vulnerable sectors such as mining, real estate and construction.

Compared with large banks, smaller banks have a higher concentration of loans in the riskier sectors. They have been more aggressive, not only in issuing bank loans, but also in lending through shadow banking.

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The focus of debt deleveraging of corporations should be on the reduction of debt in State-owned enterprises (SOEs) and the vulnerable sectors.

The authorities need to further push ahead with comprehensive structural reforms that help increase investment efficiency. SOE reform should be geared toward market-based mechanisms and strengthened governance.

Successfully cracking down on "zombie" companies and further reducing overcapacity will help improve profitability and market-driven investments, and hence bring down bad debt. And the capital markets should be further developed to provide more sources of corporate equity financing and to reduce the reliance on debt financing.

As for sectoral policy, macro-prudential measures in the real estate sector should be maintained to rein in growing debt. In the utilities, transport and construction sectors, public-private partnership can be an alternative source of financing.

To boost private enterprises' confidence, there should be greater transparency in local government financing vehicles as well as increased financial disclosure and fiscal resources to support vulnerable workers during the deleveraging process.

Stress tests on assets and liabilities can help pinpoint potential losses. Regulators should then require banks with significant risks to raise capital and improve their liquidity profiles.

Strengthening the buffers of financial institutions with high exposures to the vulnerable sectors can help mitigate risks to financial stability. At the same time, tight regulation and the implementation of the macro-prudential assessment should be maintained.

Debt sustainability can be seen as an important indicator of the health of the economy. The world's second-largest economy should take bold actions to curb surging corporate debt and show the market and investors that its growth does not come at high prices.

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Make the best of carbon trading

China needs to find its own green path toward a sophisticated market with innovations that spur enterprises to participate

By **LIN BOQIANG**

Since the Kyoto Protocol, the idea of trading carbon emission quotas has been generating high hopes for curbing greenhouse gas emissions. During the UN Climate Change Conference in Bonn, Germany, in November, China's special representative on climate change Xie Zhenhua said the country's carbon market is near completion and will be probably the world's largest.

As the world's largest energy consumer and carbon emitter, China has launched pilot trading systems for carbon emission quotas in seven provinces and cities since 2013, including Shenzhen, Shanghai and Beijing. China is launching a nationwide carbon trading market equivalent to the United States' Environmental Protection Agency, which will expand to a variety of manufacturing and industrial fields, even as the Donald Trump-led US administration prepares to discard its electricity rule for the carbon sector. China's move could add a new dynamism to the global fight against climate change, especially after the withdrawal of the US from the 2015 Paris agreement.

The capitalization of China's carbon market is estimated to reach 150 billion yuan ($23 billion) and its trading volume could be more than 600 billion yuan if "derivatives" such as futures are taken into account.

China's dedicated approach to build a uniform carbon market is in line with its obligation to reduce greenhouse gas emissions, although the lack of trading data, relevant laws and tested patterns means there is still a long way to go. And market efficiency could suffer a blow if enterprises feel more politically motivated to play along, and the trading costs keep rising when market liquidity is low.

To keep the emerging carbon market alive and prosperous, it is important to build a uniform, effective carbon trading platform. Previous pilot programs have indeed borne fruit in many aspects, but they are still not enough. As of now, most of the deals have been closed between buyers and sellers in private, raising doubts over price-fixing.

Besides, equal attention should be paid to futures and spot trading, as the latter makes up the bulk of China's carbon trading. Given more options, enterprises could manifest extra motivation to pitch in. Involving "carbon sink", which describes the use of forests or other natural or man-made resources to remove carbon dioxide from the atmosphere, emission trading and renewable electricity certificates could be worth a try.

For China's carbon trading to be more effective and sustainable, multiple innovations are a must, as the central government is determined to expedite industrial transformation with the carbon market. For example, the possibility of introducing forward transaction (as opposed to spot transaction) and forward contract, a customized contract between two parties to buy or sell an asset at a specified price on a future date, should be thoroughly discussed.

While learning from the experiences of developed economies' trade in carbon, China needs to find its own path toward a sophisticated carbon market with Chinese characteristics.

A reliable, accessible database and an efficient trading platform play an indispensable role in fixing the flaws in relevant laws, particularly the lack of uniform emission standards. Enterprises, for their part, should train their staff members in carbon emission trading so that they have more incentives and knowledge to participate in the carbon market.

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