Rebalancing China: International Lessons in Corporate Debt

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Introduction

I would like to thank the Chinese Economists Society for this warm welcome. I am honored to join you today for this discussion of Sustainable Development in China and the World.

Shenzhen is a most appropriate place for this subject. The city is a symbol of China's rapid rise to prosperity. It has gone from farmland to financial center in a generation, embodying the hopes of modernization and opportunity.

But Shenzhen is also emblematic of what it means to face China's changing economic and financial landscape. Over the past year the city has faced unaccustomed uncertainty. Financial markets have lost ground, and rising costs have led some high-profile corporate citizens to shift operations elsewhere in China. These developments underline the challenges that must be addressed to ensure a secure future in a rapidly growing city.

The same can be said of China as it looks to achieve sustained and sustainable development. The same financial market tremors that shook Shenzhen led many Chinese to question how certain they were about China's future path. Now some wonder what rebalancing will bring and whether issues like corporate indebtedness and financial sector weakness could alter the trajectory of China's "new normal."

China's challenges are manageable. But rebalancing requires a range of actions – not just making way for the new, but also the smooth downsizing of whatever is outmoded or overbuilt. Each needs to be done in a timely fashion if China is to move along a desirable path and avoid dangerous detours. Whether you look at the history of economic transformations or the aftermath of the Global Financial Crisis, bold and determined action is rewarded—while missteps are penalized.

What I propose to do today is discuss the debt issue by taking three themes in turn:

- First, describing the IMF view of China's economic rebalancing effort;
- Second, outlining the scale of the debt issue; and

- Third, examining some strategies for addressing corporate indebtedness in light of international experience.

My purpose is to offer the IMF's perspective on policies that have proven effective in other countries facing issues in their development that may have relevance for China's. I say this acknowledging that China's situation is unique and the scale and stakes of its rebalancing unparalleled.
Rebalancing is an issue that is crucially important to China's future—and for the global economy. We have learned over and over in the past 20 years how disruptions in one country's economy and markets can reverberate worldwide, witness the spillovers from last year's sudden instability in Chinese markets. The point is that any discussion of sustainable development must take into account the vulnerabilities facing a systemically important economy—and the steps needed to remedy them.

Assessing Rebalancing

Let's begin with the economic rebalancing at the heart of the 13th Five Year Plan, the blueprint for China's ongoing development. The strategy is rooted in the understanding that China needs to rebalance its economy. How is this effort progressing?

Growth remains strong by any standard, perhaps with the sole exception being the last 25 years in China itself. Growth in China last year alone added to GDP an amount equivalent to an entire mid-sized European country like Sweden. So it is important to maintain a sense of perspective during this time of change.

On the external front there has been substantial adjustment. The current account surplus has come down from the peak of 10 percent of GDP in 2007 to around 2-3 percent in recent years, and the contribution of net exports, formerly a key driver of growth, has been fluctuating around zero. Last year's surge of capital outflows has slowed, and the effective exchange rate has remained broadly stable. A measure of China's progress was recognized by the IMF's decision last year to include the renminbi in the basket of currencies making up the Special Drawing Rights after determining it is a freely usable currency.

At the same time, the results of China's domestic rebalancing have been mixed. There is moderate progress reorienting the economy from investment to consumption, with the latter having contributed about two-thirds of growth in 2015. Growth is being driven less by heavy industry and exports and more by services and manufacturing for household consumption than in the past. These are important developments.

An area that has seen limited progress, and the one I want to delve into here today, is addressing corporate indebtedness and restructuring. The government is rolling out a reform plan for State-Owned Enterprises and has announced

capacity reduction targets in the coal and steel sectors. Yet, with the rapid increase in credit growth in 2015 and early 2016, and the continued high rates of investment, the problem is growing. This is a key fault line in the Chinese economy. It is surely within China's powers to address this problem. And it is important that China tackles it soon. The question is how best to do so.

China's Debt Problem

To get a handle on the issue, let's take a closer look at China's debt profile. Overall, total debt is equal to about 225 percent of GDP. Of that, government debt represents about 40 percent of GDP. Meanwhile, households are about 40 percent. Both are not particularly high by international standards.

Corporate debt is a different matter: about 145 percent of GDP, which is very high by any measure.

By IMF calculations, state-owned enterprises account for about 55 percent of corporate debt. That is far greater than their 22 percent share of economic output. These corporates are also far less profitable than private enterprises. In a setting of slower economic growth, the combination of declining earnings and rising indebtedness is undermining the ability of companies to pay suppliers or service their debts. Banks are holding more and more nonperforming loans, or NPLs. The past year's credit boom is just extending the problem. Already many SOEs are essentially on life support.

The Fund's most recent Global Financial Stability Report estimated that the potential losses for Chinese banks' corporate loan portfolios could be equal to about 7 percent of GDP. This is a conservative estimate based on certain assumptions about bad-loan recoveries and excluding potential problem exposures in the "shadow banking" sector.

Lessons from International Experience

While China is unique in many respects, it is not the first country to experience corporate debt difficulties. In fact, there is a range of international experience across advanced, transition, and emerging countries. That experience offers three broad lessons:

- First, act quickly and effectively, or the problem will only worsen. Company debt problems today can become systemic debt problems tomorrow. Systemic debt problems can lead to much lower economic growth, or a banking crisis. Or both.
- Second, when you act, make sure to deal with both creditors and debtors. Some countries have just moved bad loans off bank balance sheets and recapitalized the banks. Companies were left unprofitable. Others have

downsized companies or allowed them to go under. Banks were left undercapitalized. It is best to fix both.

- And third, when you fix corporate and bank balance sheets, address the governance problems in the corporate and banking sectors that gave rise to the problem in the first place. Otherwise, deflating the debt bubble will bring only temporary effect. A new debt bubble will surely re-inflate if unwarranted lending and borrowing can just resume.

Acting Quickly

The first lesson, to act quickly, is gaining recognition in China. The government clearly recognizes the need to address the issue. In a recent interview in the People's Daily, an official described as "an authoritative person" spoke at length of the need to address the problems of "zombie firms" and "debt overhang."

The head of Huarong Asset Management once succinctly described the policy imperative to act immediately on the debt problem: *"NPLs are like ice cream cones. If you don't get rid of them, they melt all over your hands, and you don't have anything left to sell."*

Deal with Creditors and Debtors

The second lesson, treating the problems of both creditors and debtors, is not easy to do quickly, as it requires several preparatory steps. The experience of recent crises points to the importance of what is often called an "enhanced framework" led by the government, but relying on the technical expertise of professionals for assessment and mediation. In other words, the process has to be led by business judgment, and not political favor.

A corporate insolvency framework needs to facilitate the rehabilitation of viable firms and the speedy liquidation of nonviable ones—determined on a company-by-company basis. Corporate restructuring requires an enforcement regime that enables creditors to enforce their claims in a predictable, equitable and transparent manner. This likely will call for both carrots and sticks to enforce payment discipline. Also, banks must always be prudent in recognizing losses and ensure that they have adequate loss-absorbing capacity.

Forms of this enhanced work-out framework were employed here in the Asian region in the aftermath of the 1997-98 crisis. Indonesia, Korea, Malaysia, and Thailand all did so. There was government support for the restructuring process, but that process essentially took place out of court.

Korea offers an interesting example. The controlling shareholders of the conglomerates that dominated the economy—*the chaebol*—lost power because of court-supervised and out-of-court restructuring. They were not bankrupted, but their ability to borrow extensively from their own banks was restricted.

Debt-Equity Conversion and Asset Management Companies

In some countries, debt-equity conversion played a role. By converting debt to equity, firms financial structure was deleveraged and banks' claims were realigned accordingly. But this approach only works if two conditions are fulfilled. First, banks need to be able to assert creditor rights and conduct a triage, distinguishing non-viable firms that need to restructure or shut down. Otherwise the new equity will have no value. And second, banks need the capability to either manage their equity and assert shareholder rights, or the capability to sell equity to investors who can.

In some countries, this has not been possible. More broadly, banks were not motivated to assert their rights as creditors and press for restructuring, either because of cross ownership, conflicts of interest or political factors. In such cases, governments have had to step in and prompt action. In some cases, such as in Indonesia, the situation deteriorated to the point that the banks themselves had to enter the restructuring process, requiring recapitalization.

The recent crises in Europe have placed existing insolvency systems under considerable pressure, leading to the need for government action and legal reforms. In most of these cases, a direct role for government has been limited by the constraints of European competition law. Numerous countries—such as Italy, Spain and Portugal—have approached this by incentivizing out-of-court debt restructuring with minimal judicial intervention.

One more point to make on restructuring: public asset management companies have been employed in many crises, including in the transition countries in Eastern Europe. This is a mechanism that China is familiar with from the earlier effort to resolve NPLs. It is important to keep in mind that an AMC ought not be a warehouse for bad loans. It has to be viewed as a workout house that leads to restructuring of companies wherever that is needed. That can come from AMC action or from assets being sold off to new owners who press for restructuring.

Those processes can be slow because of the difficulty of establishing proper asset valuations, the challenge of selling assets in thin markets, and the social and political pressures that can accompany restructuring. To address these issues, it is essential to put in place strong governance arrangements guided by commercial principles.

Fix It for Good

Governance is the third lesson of restructuring. To quote the philosopher George Santayana: "*Those who cannot remember the past are condemned to repeat it..*"

In other words, if a country doesn't address the governance issues at the heart of a debt problem, then that problem will inevitably recur. Look at China's

experience. Early in this century the government relieved the big banks of their legacy of state-owned enterprise NPLs. But here we are again, talking about the threat posed by SOE indebtedness.

So once a problem is fixed, it is essential to take the steps to ensure that it does not re-emerge in the future. As painful as fixing can be, it is often easier than what follows. In part, that's because it is harder to reform once the crisis has eased.

In a different setting, the G-20 is instructive in this regard. At the height of the Global Financial Crisis in 2009, policy makers were under intense pressure to act. At the London Summit of the G-20 that spring, the leaders took important steps that helped turn the tide—endorsing a massive stimulus to the world economy, boosting resources to the IMF, and agreeing on measures to strengthen national and global oversight of financial markets. But there was also a need to fix governance--by instituting the concrete financial reforms that would prevent crisis from recurring. That has taken more work and proved longer to achieve, but it was essential. In the U.S., the Dodd-Frank legislation helped strengthen government oversight of financial institutions. In Europe, key steps toward banking union are well advanced, though there is more to do there to strengthen banks. And the IMF and the Financial Stability Board have, in their own areas, brought countries together to help safeguard the global financial system.

China's reforms over the past several decades have been sweeping and widespread. But those reforms have done more to liberalize economic activity, creating markets and freedom to compete, than to impose disciplines and hard budget constraints on borrowers. In short, to shore up governance. The lesson that China needs to internalize if it is to avoid a repeating cycle of credit growth, indebtedness, and corporate restructuring, is to improve corporate governance.

Governance certainly must be based on a robust legal framework: the laws and regulations that establish an effective system of insolvency and enforcement that help create payment discipline. But governance also means regulatory and supervisory policies that promote the proper assessment and pricing of risk at the individual loan level. It means robust accounting, loan classification, loan loss provisioning, and disclosure rules. It means a system that avoids moral hazard.

More Than Laws

But governance is not just a matter of laws on the books. It is also about how laws and regulations are implemented. It is the impartiality that transcends special interests and connections. It is the commitment to fix flaws in the system as they emerge—and not when they cause a crisis. And it is a matter of strengthening the institutions of corporate governance, particularly to enhance shareholder rights and make public disclosure a priority. All of these factors

protect creditors—and borrowers—and ensure that the gears of the financial system operate smoothly.

In a system with state-owned enterprises, proper governance also becomes a matter of making companies live within their means and ending government subsidies, including by enforcing hard budget constraints. This is what Poland and other countries in Central Europe did in the 1990s as they made the transition to a market economy. It was an effective approach that helped create impressive and durable economic success stories.

As the restructuring process moves forward, it is perhaps too easy to lump together all SOEs. Rather, it is important to distinguish between well run and badly run companies. Debt can help fuel a well-run business. So it is essential to know what companies are doing with debt: Are they papering over losses? Building capacity that adds to a global surplus? What is their exposure to shadow banking products?

These are the issues that must be addressed as any country makes hard, restructuring decisions. Inevitably, these decisions must be based on hard facts and competent analysis—inputs that usually can only be provided reliably by independent experts with experience in valuation, restructuring and debt workouts.

They are also issues that have significant social implications. Corporate restructuring affects the lives of working people and their families. So it is important to ensure that policies are put in place to mitigate the impact of restructuring. The days of China's iron rice bowl are gone, but there is still an obligation to ensure that rice bowls are full. In this regard, it is important to note the government's 100 billion Renminbi restructuring fund to absorb the expected welfare costs for an expected 1.8 million affected workers.

One final point: there will always be the temptation to merge a weak state enterprise with a stronger company. But if the going concern simply becomes the rich uncle—subsidizing the other company's losses with its own profits—the problem is not being solved. You are just undermining the profitability of the well-to-do company and depriving the rest of the economy of resources that could be better spent elsewhere. For this type of M&A strategy to work, the strong SOE must have the authority to restructure the loss-making company. Otherwise, it's sometimes just best to let a company fail.

Conclusion

To sum up, China faces an extraordinary set of challenges. Growth is slowing, but to a speed that would be the envy of any advanced economy. Nonetheless, corporate debt remains a serious—and growing—problem that must be addressed immediately and with a commitment to serious reforms.

As I have tried to illustrate today, there is a wealth of experience with corporate restructuring in the global economy, including at the IMF. There is expertise drawn from any number of settings, including economies making the transition from state dominated to market driven. The issue is how much a country is prepared to do to avoid repeating mistakes and put in place reforms that can reinvigorate growth.

China has demonstrated an extraordinary capacity to adapt and evolve over the past generation. There is every reason to believe that it can make this transition and ensure that the new normal of the Chinese economy is sustainable development that benefits both China and the world.