Reforms of China's Corporate Sector and the Application of State Support

FIN377 Teaching Note

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This teaching note describes various stages of reform over the past quarter century of China's corporate sector. We also summarize changes in the manner in which China's central and local governments have offered state support to the corporate sector, with distinctions between state owned enterprises (SOEs) and private owned enterprises (POEs).

Pre-2007

The period preceding 1998 was characterized by relatively moderate reforms of China's corporate sector, such as increasing managerial discretion, opening up sectors to competition, and fostering an increasing reliance by firms on their own financial resources (Hsieh and Song, 2015). Starting in 1998, we construct a timeline of a "dual-track liberalization" that supported the winnowing of weaker SOEs, the strengthening of surviving SOEs, and a boom among POEs (Lardy, 2014; Song and Xiong, 2018). We will trace how, over the past decade, this liberalization became episodic, sometimes sidetracked by systemic risk and other macroeconomic stresses. China's socio-political priorities also changed. Correspondingly, as we outline in this note, the degree to which SOEs benefit, relative to POEs, from advantageous access to credit has also ebbed and flowed.

An era of larger economic reforms was ushered by the 15th Congress of the Chinese Communist Party of 1997, which legalized reforms of state-owned enterprises (Zhu, 2012). More than 83% of SOEs were shut down or privatized by 2007, as part of a policy initiated by Premier Zhu Rongji associated with the slogan *zhuā dà fàng xiǎo* (grasp the large, release the small). China established the State-owned Assets Supervision and Administration Commission (SASAC), directly under the State Council, to supervise SOEs. Almost half of the surviving SOEs in 2007 were "corporatized," meaning registered as private firms, although still in most cases majority-owned and controlled by the state.

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Although these reforms had only moderate effects on growth, they increased total factor productivity (Hsieh and Klenow, 2009). By the end of 2007, the labor productivity of surviving SOEs, including privatized SOEs, had converged to that of POEs. Capital productivity of SOEs, by contrast, remained about 40% lower than that of POEs. This might reflect the preferential access to credit of SOEs, which exhibited 41% lower revenue productivity and 14.4% lower physical productivity than POEs between 1998 and 2005. The growth of POEs relative to SOEs boosted total aggregate factor productivity growth in the manufacturing sector by around 2 percentage points per year over that period (Hsieh and Klenow, 2009).

2007-2012

The period between 2007 and 2012 was marked by a slowdown of reforms and by the large stimulus package of 2009 (Naughton, 2009), which was designed to neutralize the impact on China of the global recession caused by the Great Financial Crisis of 2008-2009. First, the reform slowdown decelerated the privatization process and led to a reduction in labor market productivity (Hsieh and Song, 2015). Second, the giant 4 trillion RMB stimulus plan reallocated bank credit in China's economy from more productive private firms to less productive POEs and SOEs (Cong et al., 2019; Chen et al., 2020a). Furthermore, the stimulus spurred massive investments by local governments, which financed new projects with bank debt (Chen et al., 2020b; Huang et al., 2020). As the pressure of this debt mounted in 2012, local governments resorted to non-bank loans to rollover their debt. This in turn triggered the growth of both corporate bonds and of shadow banking (Chen et al., 2019). Most of the new local government debt was issued through "off-balance-sheet" local government financing vehicles (LGFVs), causing the true magnitude of local government debt to be understated. By the end of 2019, LGFV debt had reached about $6 trillion, despite the effort of the central government to get local governments to convert LGFV debt to official local government debt.[1] Finally, Huang et al. (2020) find that local-government bank debt crowded out private investment.[2] By 2018, SOEs alone had total corporate debt of 125% of GDP (Molnar and Lu, 2019), with overall corporate debt above 150% of GDP, high above typical international levels.

Loan-level evidence reveals that softer credit constraints on SOEs, leading to a crowding out credit to POEs, is not specific to the stimulus program (Gao et al., 2019). This crowding out of POE credit is exacerbated by the segmentation of China's bank credit market (Huang et al., 2020). For instance, the entry of joint-stock banks into certain regions in 2009 caused an initial short-term increase in lending to less efficient SOEs in deregulated cities (Gao et al., 2019). The soft budget constraints of SOEs, through government support, make SOEs more attractive to lenders, especially when lacking information about borrowers' financial strength. The higher lending standards that lenders applied to POEs further supports this hypothesis (Gao et al., 2019). Similarly, loans to SOEs by the China Development Bank (CDB) crowd out private firms in the same industry, but "crowd in" POEs in downstream industries (Ru, 2018). On average, a 1 RMB increase in CDB SOE loans contributes to a 0.20 RMB decrease in private firms' assets. In general, firms that received government subsidies have a lower cost of debt and more overstaffing relative to firms that do not (Lim et al., 2018). Since about 2015, the state has been funneling even greater amounts of capital

[1]See this WSJ article for more information.

[2]This finding is not supported by Bai et al. (2016).

to SOEs (Lardy, 2019). President Xi Jinping pledged to keep SOEs "stronger, better and bigger" (Batson, 2020).

Government guarantees and other forms of credit support have not been restricted to SOEs and LGFVs. While it is well documented that SOEs enjoy softer budget constraints than POEs (Lin and Tan, 1999; Huang et al., 2017; Wen, 2020), government guarantees are also often extended to POEs. Indeed, the period since 1998 witnessed the emergence of "special deals" between POEs and China's government (Bai et al., 2016) and conglomerates whose expansions propelled growth, reallocated resources, and removed entry barriers (Bai et al., 2019).

2013-2019

Since 2012, China's economy has been transitioning to a new model based on slower economic growth, higher debt, and greater priority on consumption (Lardy, 2019; Batson, 2014). China launched a decade of continual reforms under the rule of Xi Jinping. This can be traced to the Third Plenum of November 2013, which generated a comprehensive blueprint of financial, fiscal, structural, and external-facing reforms. First, financial-sector reforms ranged from interest rate liberalization and deposit insurance to "strengthening financial supervision and resolution framework" (International Monetary Fund, 2014). Second, fiscal reforms included a commitment to limit LGFV borrowing, liberating local governments from financial obligations to these entities. This commitment was cemented into the 2014 Budget Law, later amended in August 2015 to allow local governments to issue municipal bonds and rein in LGFV-fueled shadow banking.[3] Third, structural reforms aimed to "level the playing field" between SOEs and POEs by reducing barriers to entry and foster the end of zombie SOEs[4] (International Monetary Fund, 2019). Lastly, external-facing reforms included a widening of the trading band of the renminbi (International Monetary Fund, 2014).

In accordance with these market-oriented liberalization policies, China's economy has witnessed numerous regulatory overhauls since the Third Plenum. Deposit insurance[5] went into effect in May 2015. Interest rates were liberalized by October 2015,[6] although the Peoples Bank of China (PBoC) continues to provide substantial guidance to banks on their lending rates and on sectors to which banks should prioritize credit provision.

In 2019, reform programs for SOEs promoted increased dividend payouts to the public budget and tighter rules on compensation.[7] Bankruptcy-specialized courts emerged across China, which caused a higher rate of liquidation of SOEs controlled by local government SOEs (Li and Ponticelli, 2020). The China Trust Protection Fund Company, a state-run bailout fund whose mandate is to prevent and resolve shadow banking risks, was established in 2014.[8]

President Xi also initiated an anti-corruption campaign. Initial evidence suggests that this campaign forced more merit-based allocation of bank credit (Li et al., 2017) and led

[3] See BBVA report for more details.

[4] Using international evidence, Banerjee et al. (2020) analyze the characteristics and performance of zombie firms. They find that zombies have globally proliferated since the 1980s.

[5] See here for more information.

[6] See Box 2 in International Monetary Fund (2016).

[7] See media coverage and International Monetary Fund (2016) for reports on progress of SOE reforms.

[8] See Caixin article.

to a reallocation of bank credit from less productive SOEs to more productive private firms (Li et al., 2017). Directive 43, issued in October 2014, cast such severe doubt on government guarantees to LGFVs that two such entities associated with the local governments of Changzhou and Ürümqi, responded by delaying and canceling debt offerings, respectively.[9] A crackdown on rampant shadow margin financing of equity investments [10] caused a crash in China's stock market in the summer of 2015 that erased around 30% of the market's value (Bian et al., 2018).

The Third Plenum, coupled with exceptionally high corporate leverage, increased the incidence of corporate defaults. Between 2000 and 2014, defaults by large firms had been almost non-existent. Jin et al. (2018) estimate implicit government guarantees at 1.45% to 1.77% of bond value. Those guarantees are higher in industries with excess capacity, in firms with higher default risk, and in firms that are less reliant on bank financing. The reduction of these subsidies after the first default of an SOE in 2015 initially reduced the debt issuance of SOEs, increased their cash hoarding, and improved their investment efficiency. However, despite the increased defaults of both SOEs and POEs, there remains a severe difference in the credit spreads of SOEs and POEs, after controlling for default risk, which significantly disadvantages POE access to credit (Geng and Pan, 2019).

The reform blueprint of the Third Plenum was adjusted by the 13$^{\text{th}}$ Five-Year Plan for 2016-2020. Concerned with the systemic consequences of excessive leverage and risk-taking, the Five Year Plan adopted a two-pronged approach of "deleveraging" and "de-risking" to address these respective concerns (International Monetary Fund, 2018). The Plan was seen by some observers as a step back from the reforms outlined in the Third Plenum. Whereas the intention of the Third Plenum was to allow the "market to play a decisive role in allocating resources," the Five Year Plan reiterated "the Chinese Communist Party's central role in China's economic and social development" (Koleski, 2017).[11] But the pace of reforms did not abate.

In 2016, the authorities tightened macroprudential measures in the real estate sector and also emphasized that the main functions of SOEs are "social" and "commercial." This refined the mandates of SOEs and reduced the pressure for their reform (International Monetary Fund, 2017). The government prepared a list of zombie SOEs in the coal and steel industries, and emphasized "competitive neutrality"[12] as the guiding principle of SOE structural reforms. These moves were accompanied by a flurry of notices and circulars from the China Banking Regulatory Commission (CBRC), with the goal of eliminating regulatory loopholes and dealing with non-performing loans (NPLs), a pervasive and ongoing problem for China's banks.[13] A popular method for handling NPLs is to transfer them from the balance sheets

[9] See WSJ for more information.

[10] See media coverage.

[11] See the related staff report of the U.S.-China Economic and Security Review Commission, a congressional committee, for more information.

[12] Competitive neutrality refers to the concept of all market participants being treated equally. See the speech of the CBIRC chairman, Guo Shuqing, on May 25, 2019 for reference.

[13] Among the numerous policies implemented by the China Banking Regulatory Commission (CBRC), three particularly stand out in regards to NPLs. First, CBRC Circular 56, issued in March 2016, encourages market resolution and fair pricing of NPLs through AMCs, and prohibits AMCs from circumventing regulations. The circular can be found here in Chinese. Technical reports on the circular can be found here. CBRC Circular 82, issued in April 2016, cracks down on illegal practices designed to conceal NPLs. See the text of

of banks to special-purpose government asset management companies (AMCs). Industry reports[14] estimate NPL transfers to AMCs of \$77 billion in 2016, \$83 billion in 2017, and \$333 billion over the period 2013-2017.

This shift in the stance of regulators spurred financial innovation in China's credit markets. The reforms stimulated distressed debt funds, such as Oaktree Capital Group and ShoreVest Partners, to enter the market.[15] They also prompted the development of credit-risk hedging tools such as credit insurance (analogous to credit default swaps used in the U.S. and Europe) and credit-risk mitigation warrants.[16]

This swift pace of reforms, however, stumbled in the second half of 2018 (International Monetary Fund, 2019). The economy slowed further, partly due to financial reforms and also because of worsening trade tensions with the United States. Facing these headwinds, the authorities momentarily paused their deleveraging campaign. The focus shifted to supporting growth, after setting[17] a lower growth target in the range of 6.0% to 6.5% for 2019. China still, however, pursued de-risking reforms (International Monetary Fund, 2018). Regulatory oversight was reorganized and tightened. The CBRC and the China Insurance Regulatory Commission (CIRC) merged to form[18] the China Banking and Insurance Regulatory Commission (CBIRC) in March 2018. Overall, 15 reform measures pertaining to the banking and insurance sectors were announced in 2018, with 12 additional measures by May 2019.[19]

This pause in the de-risking campaign reflected the authorities' caution towards insolvent SOEs. Instead of exposing them to bankruptcy proceedings, the authorities eliminated zombie SOEs mostly by mergers and acquisitions (International Monetary Fund, 2019),[20] harkening back to Premier Zhu Rongi's program of "grasp the large, release the small" (Batson, 2020). China tightened restrictions on the leverage of SOEs and further announced that the social functions of central SOEs would be phased out by 2020.[21] They followed a similar route with the weakest banks, boosting their capital with acquisitions instead of bankruptcies (International Monetary Fund, 2019). The government nevertheless cracked down on bank lending to heavily levered private conglomerates, such as Baoshang Bank, which was forced into bankruptcy.[22]

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the circular here in Chinese for more information. CBRC Circular 45, issued in the spring of 2017, announced internal audits and on-site examinations of banks, with specific penalties in case of non-compliance. See the text, in Chinese, here. More information on these notices and circulars can be found in this article. See Stent (2016) for further information on China's banking sector.

[14]Deutsche Bank research, as reported by ShoreVest Partners, can be found here.

[15]See Bloomberg report for further details.

[16]See Bloomberg report for details.

[17]See media coverage for details.

[18]See here for media coverage.

[19]See here for the official source (speech of Guo Shuqing, quoted above in footnote 11) and Appendix III in International Monetary Fund (2018) for a list of measures.

[20]Some commentators have attributed such M&A activity to political economy considerations. See this article published by the Peterson Institute for International Research (PIIE) for further information.

[21]International Monetary Fund (2018) reports that SOEs are required to decrease their average assets-liabilities ratios by 2 percentage points by 2020. The State-owned Assets Supervision and Administration Commission (SASAC) further imposed a cap on leverage of SOEs. See Moody's announcement on SASAC's decision.

[22]Baoshang Bank was declared bankrupt in August 2020. See here for the most recent update on Boashang's case at the time of writing.

We examined data on bond issuers, including both listed and unlisted firms, from Wind and ChinaBond Watchlist, for March 2018 through March 2020, for incidences of distress and default of POEs and SOEs. We classify a firm as SOE or POE based on Wind data, bearing on controlling shareholders.[23] Of issuers covered by both data sources, 71 defaulted during our sample period. For our purposes, a firm is "distressed" once downgraded to a ChinaBond Watchlist implied domestic credit rating of AA-minus or lower, which tends to be a distressed rating threshold in China. Rather than defaulting outright, we found that many distressed POEs with higher-quality business prospects (other than with respect to their excessive debt) became SOEs or were acquired by SOEs. This can be viewed as form of state bailout of these higher-quality POEs. For example, our watchlist analysis shows that 6 out of the top 10 POEs in the environmental sector became SOEs.[24] Some distressed listed POEs, such as China Security, Guirenniao, Jinhong, Kangdexin and Kangmei, defaulted without any form of bailout. Other distressed listed SOEs, such as Qinghai Salt and Shenyang Machine, also defaulted. Yet other distressed listed SOEs, including Nanning Sugar and Yingkou Port, instead obtained state support.[25]

From 2020

The economy stumbled again in 2020 at the onset of the Covid-19 pandemic. To combat the crisis and stabilize employment, the government relaxed its growth target and cracked the long-observed budget deficit ceiling of 3% with aggressive fiscal policies.[26] For the first time since 2007, the central government issued off-budget special Treasury bonds to assist local governments in stimulating aggregate demand with infrastructure projects.[27] These moves contrast with the 2009 stimulus package, which centered on corporate credit growth (including LGFV) to combat the Great Recession, and illustrate a more relaxed attitude toward local government debt, especially after the ban on new LGFV debt in 2014.[28]

Regarding the reform blueprint, the authorities once again relaxed their deleveraging campaign but pressed ahead with their de-risking campaign, with a flurry of measures. For instance, a major area of systemic risk and therefore a regulatory focus has long been shadow banking, whose assets totaled RMB 22.17 trillion as of May 2020.[29] Aiming to put

[23]Each issuer reports its final controlling shareholder on its financial statement. We use Wind data on controlling shareholder to classify a firm as SOE or POE. Wind classifies a firm as Central SOE if the actual controller is SASAC or Central Government Institutions. Wind classifies a firm as "Local SOE" if the actual controller is Local SASAC or Local Government Institutions. CSRC provides the following criteria for controlling shareholder: (1) the investor holds more than 50% of the shares, (2) the investor holds more than 30% of the voting rights, (3) the investor can nominate more than half of the board members, (4) the investor can have significant impact on the shareholder meetings, (5) others conditions ascertained by the CSRC. See CSRC Article 84 (in Chinese).

[24]This article in Chinese finds that of the top 20 POEs in the environmental sector, 18 had become SOEs by March 2020.

[25]A day prior to the default of Yongcheng Coal and Electricity, a coal mining SOE, a senior executive reportedly predicted that "There is no way that we will be liquidated according to market principles. We have more than 180,000 employees. If we go under, our workers will lose their jobs... Does the provincial government not know the consequence of this?"

[26]A review of those measures can be found on the PIIE website here.

[27]Details on this issuance can be found in media reports in SCMP here and here, in Reuters and in the Washington Post.

[28]See WSJ report.

[29]Estimates can be found here.

this form of credit provision under closer regulatory oversight, the CBIRC issued window guidance to trust firms in March 2020 to decrease their trust financing business.[30] Another area of regulatory focus has been the institutionalization of bankruptcy procedures.[31] The efficient restructuring of distressed corporations requires more clarity and process uniformity than has been common in China.[32] To this end, in July 2020, China's Supreme Court laid out guidelines for tackling bond disputes. The PBoC encouraged distressed firms to seek voluntary debt restructuring.[33] Simultaneously, the central government sharply pulled back on its goals of deleveraging the economy. In July 2020, China established a bailout fund of 100 billion RMB to rescue distressed central SOEs.[34] While showing a commitment to reform LGFVs, the authorities also desired to contain the credit risk of local governments.[35]

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[30] The source can be found on Caixin.

[31] The first personal bankruptcy legislation is set to take effect starting March 2021.

[32] Bloomberg reports several opaque practices in the absence of hard restructuring rules, such as "prioritizing compensation for individual investors over institutional creditors, or offshore debt over onshore notes, [...] some debtors are negotiating payment extensions with creditors privately instead of resolving their problems publicly through the clearing house."

[33] See Caixin reports here for the Supreme Court announcement and here for the PBoC announcement.

[34] See Caixin.

[35] See Bloomberg for warnings of defaults of LGFVs, also known to be "the last standing faith in China."

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