

Defaults raise concerns on financial markets over Chinese debt

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A series of defaults over the past month on loans by companies that were thought to have state backing for their debts has sent a tremor through Chinese capitalism's financial markets and raised significant questions for international investors.

According to Fitch Ratings, state-owned firms defaulted on a record \$6.1 billion worth of bonds between January and October, an amount as much as the previous two years combined. But in November the problems significantly worsened, with defaults by three major companies.

The first sign of deeper trouble surfaced last month when the state-owned coal company Yongcheng Coal and Electricity Holding Group, located in central China, defaulted on a bond worth \$152 million.

Two weeks later the high-profile state-owned technology group Tsinghua Unigroup said it would default on a domestic bond worth the equivalent of \$199 million.

Yet worse was to come. Last week the company announced that it did not expect to pay interest or principal on \$450 million worth of bonds. This would also trigger cross defaults on a further \$2 billion of dollar bonds coming due between 2021 and 2028.

Tsinghua Unigroup is a major player in China's drive to achieve self-reliance in the supply of semi-conductors. It is majority owned by Tsinghua University, one of China's most prestigious academic institutions. The company has enjoyed backing from the government and in 2015 made a \$23 billion bid for the US chip-maker Micron Technology.

The third major default by a state-backed firm was by Brilliance Auto Holdings, which is linked to the major German auto company BMW. It failed to repay a domestic debt due in November.

The defaults have triggered concerns in money

markets about the degree to which the Chinese government and financial authorities are prepared to let market forces run their course so as to put the country's financial system on a sounder footing without sparking a general crisis.

Following the Tsinghua Unigroup default, Chinese Vice-Premier Liu He, who has been tasked with cleaning up the financial system, warned companies that Beijing would take a "zero tolerance" approach to misconduct in financing deals or attempts at debt evasion.

The *Financial Times* reported that the attitude of authorities had "rattled China's nearly \$4 trillion debt market of which state-owned enterprises are estimated to account for more than half." It noted that in the week after the default by Yongcheng Coal at least 20 Chinese companies suspended plans for new debt issues totalling \$2.4 billion, citing "recent market turmoil."

The state sector of the Chinese economy is a major component of the financial system. State-owned enterprises account for about a third of gross domestic product (GDP) but more than half of bank loans in China and some 90 percent of corporate bonds. They have been regarded as sound investments because of what were seen as implicit government guarantees.

In comments reported by CNN last week, Logan Wright, director of market research at the Rhodium Group, noted: "The credibility of government guarantees has been the most important bulwark against [financial] crisis so far. Now we are seeing signs that this credibility is eroding."

It appears that the government is prepared to allow at least some previously-backed firms to collapse. There are major risks involved, however.

Wright wrote in a recent research note: "Although authorities want market discipline for riskier firms, they

cannot know how much credit risk might create broader contagion. No one can know this line clearly, given that there is no precedent for this risk in China's financial system."

The slowdown in the Chinese economy due to the coronavirus—growth is expected to come in around 2 percent this year compared to more than 6 percent last year—is the proximate cause of the debt problems. But debt in major Chinese enterprises has been building since the massive expansion of credit launched in response to the global financial crisis of 2008.

In a recent report, analysts at the Japanese financial firm Nomura said they viewed the recent defaults as "inevitable" as the government had been propping up enterprises with billions of dollars' worth of stimulus. However, one of the problems for the government is that the stimulus measures are not generating the GDP increases they did in the past, so the debt burden on the economy becomes progressively greater.

In a report on the growing debt crisis, the *Financial Times* (FT) noted that a decade ago Yongcheng Coal was regarded as one China's leading energy companies. But today its financial difficulties are seen as the harbinger of major problems.

According to an FT report published last week, Yongcheng Coal's defaults have "ricocheted through China's financial system," with analysts saying that state-linked companies face difficulties in raising capital because the assumption that the government will always bail them out no longer applies.

The newspaper cited one analyst who warned that Yongcheng's failure could be replicated by any state-owned enterprise with "weak fundamentals" and that a "lot more defaults could be in the pipeline."

The debt problems are not confined to major companies. Moody's Investor Services, which tracks local government debt in China, issued a report earlier this month putting a "negative outlook" for local and regional government debt for next year.

A report in the *South China Morning Post* last week cited comments by former vice-finance minister Zhang Hongli who said that local authorities had "relied on new borrowing to repay old debts" in about 60 percent of cases for the first 10 months of 2020.

This is a sure sign that local governments cannot generate enough revenue to cover debt repayments. There have been warnings that there could be a

significant increase in defaults on loans raised through so-called local government financing vehicles in the coming year.



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