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Should China Take a Tough Stance on the Debt Market?

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Abstract

Against the backdrop of surging global debt risks, this paper explores whether China should adopt a tough regulatory stance on its domestic debt market, combining international macro data, domestic debt cases, historical policy practices and cross-country experience for comprehensive analysis. By the end of 2024, global debt hit USD 318 trillion, equivalent to 290% of global GDP, fueled by long-term quantitative easing and pandemic stimulus. As a dual player in global debt governance, China has provided over USD 800 billion financing for Belt and Road countries while facing prominent domestic debt hazards: its non-financial sector debt expanded to USD 362.6 trillion in 2023, with risks concentrated in local government financing vehicles (LGFVs), highly leveraged real estate developers and private financial conglomerates. Defaults of Evergrande and Zhongzhi Group exposed industry contagion effects and regulatory loopholes, and opaque implicit debts of LGFVs have become a major hidden systemic risk. This research reviews China's past debt governance practices including the 1990s SOE debt-to-equity swaps and the post-2008 four-trillion stimulus, then elaborates two opposing arguments. A strict regulatory approach helps curb moral hazard, break implicit guarantee expectations, eliminate low-efficiency zombie firms and safeguard overseas financial assets. However, overly harsh policies may push up corporate financing costs, drag down infrastructure investment, suppress consumption and slow cross-border cooperation under the Belt and Road Initiative. Drawing lessons from the U.S. dollar hegemony debt model, Japan's high-debt stagnation and Latin American sovereign debt crises, the study proposes targeted policy mixes: differentiated bailout criteria, coordinated macroprudential and market-based instruments, and improved legal frameworks for debt restructuring. The conclusion stresses that China's debt governance requires balanced, targeted regulation rather than one-size-fits-all tough policies. Authorities must combine rigid risk containment with flexible counter-cyclical adjustments to defuse systemic risks while stabilizing growth and supporting high-quality economic development.

Keywords

Debt Regulation; LGFV; Systemic Financial Risk.

1. Introduction

As the world's second-largest economy, China plays a pivotal dual role in both the international and domestic debt markets. On the international front, since the launch of the Belt and Road Initiative (BRI) in 2013, China has actively engaged in global infrastructure development, primarily through its policy banks, by extending substantial financial support to participating countries. According to data from AidData, China has provided over USD 800 billion in financing to more than 150 countries over the past decade, much of which has taken the form of non-concessional loans.

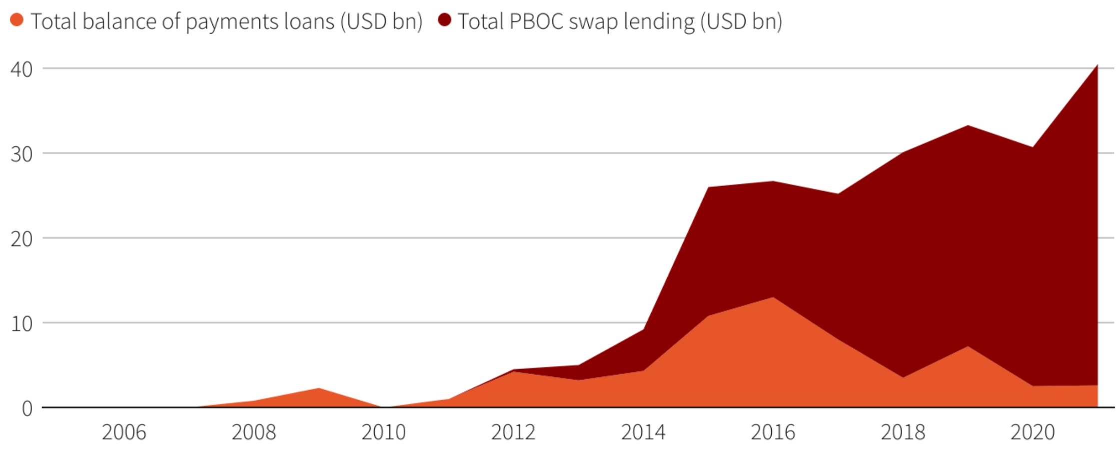

Figure 1 China's Rescue Financing Amount
Source: "China as an International Lender of Last Resort" (2023)

For example, China supported the development of port infrastructure in Gwadar, Pakistan, boosting local employment and trade. The China-Laos Railway, with a total investment of approximately RMB 50.54 billion, significantly improved Laos' transportation network and regional connectivity. However, as some borrowing countries face repayment difficulties, China has increasingly engaged in international debt restructuring and bilateral negotiations, reflecting its growing influence and responsibility in global financial governance.

In China's debt structure, local government financing vehicles (LGFVs) and real estate enterprises have long been the primary conduits for high leverage accumulation. Li (2017) notes that the fiscal imbalance caused by the tax-sharing reform led to the rapid expansion of LGFVs, and post-2008 economic stimulus policies further accelerated their debt growth. The mismatch between low-return infrastructure investments and diverse financing channels has exacerbated repayment pressures. According to the Institute of International Finance (IIF), as of 2024, China's total debt-to-GDP ratio approached 90%, with local governments' off-balance-sheet debt constituting a major source of potential systemic risk due to its opacity and volatile cash flows.

Besides, the liquidity crisis faced by major property developers such as Evergrande has exposed the fragility of high-leverage business models. found that Evergrande's balance sheet was severely distorted, with total liabilities exceeding assets by approximately RMB 600 billion in 2023. This was compounded by its excessive reliance on pre-sale funds and weak internal risk controls, ultimately leading to default and triggering chain reactions across financial institutions and the broader supply chain.

This study focuses on the debt market challenges currently facing China, particularly under the mounting pressure of risky assets and high leverage. It aims to examine whether a more assertive policy stance is necessary in this context. The research seeks to provide policy recommendations for improving China's future debt risk management and macroeconomic policy formulation.

Under the combined pressures of global capital flow volatility, divergent China–U.S. monetary policies, and domestic economic restructuring, balancing financial stability and risk containment has become a central challenge in China's debt governance.

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2. Current Landscape and Key Challenges of China's Debt Market

2.1. Debt Market Size and Structure

Over the past two decades, China's total debt stock—including government, household, and corporate debt—has expanded rapidly, rising from RMB 24 trillion in 2004 to RMB 363 trillion in 2023, representing an average annual growth rate of 15.3%. Notably, over 98% of this debt is domestic in nature.

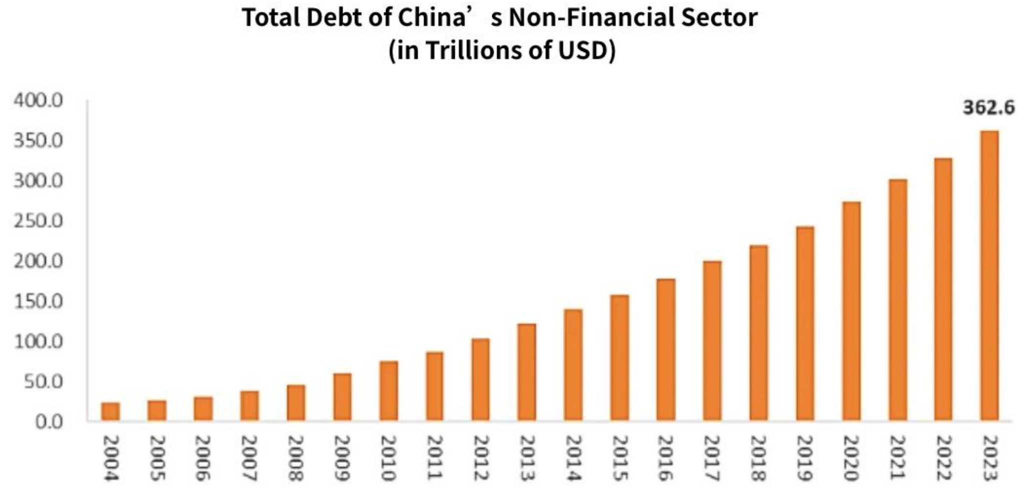

Figure2 : Total Debt of China's Non-Financial Sector (in Trillions of USD)
Source: China Finance 40 Forum

China's debt market exhibits a diversified structure, primarily comprising local government debt, corporate debt, and real estate-related debt. As of the end of 2024, data from the Budget Department of the Ministry of Finance indicates that the outstanding balance of local government debt nationwide stood at RMB 47.54 trillion, accounting for approximately 35.46% of China's GDP in 2024. This total includes RMB 16.70 trillion in general debt and RMB 30.83 trillion in special-purpose debt. Local government bonds, as standardized financing instruments, play a key role in supporting infrastructure development and public projects at the local level.

The chart shows a steady increase in both general and special-purpose bonds issued by local governments in China. Special-purpose bonds initially grew rapidly due to strong infrastructure investment but have slowed in recent years amid tighter revenue scrutiny. Local debt remains mainly composed of government bonds, with manageable maturity and interest structures. As economic restructuring and fiscal pressures intensify, enhancing the structure and sustainability of local debt management has become increasingly urgent.

In the corporate debt segment, data from the People's Bank of China indicates that by the end of 2024, the size of the corporate bond market had reached approximately RMB 32.3 trillion. This market includes a variety of instruments such as debt financing instruments issued by non-financial enterprises, corporate bonds, and enterprise bonds. Among them, non-financial enterprise debt financing instruments have become a key channel for direct corporate financing due to their high issuance efficiency and strong flexibility, thereby playing an important role in supporting the development of the real economy.

In the real estate debt segment, financing pressures have intensified across the sector. According to the China Index Academy, the total bond financing by real estate enterprises in 2024 amounted to approximately RMB 565.31 billion. Under the continued impact of the "Three Red Lines" policy, financing channels for property developers have tightened, leading to a year-on-year decline in bond issuance. In 2024, the issuance of credit bonds, offshore bonds, and asset-backed securities (ABS) fell by 18.5%, 69.5%, and 13.6% respectively. Their overall share in the debt market has also decreased accordingly.

Figure 3: Government Leverage Ratio in 2022
Source: Zhongtai Securities Institute for Financial Studies

2.2. Debt Risks and Key Case Studies

2.2.1. Evergrande & Zhongzhi Group: Default Case Analysis

The debt default of Evergrande Group represents a typical case of concentrated risk exposure in China's real estate sector. As of 2021, Evergrande's total liabilities had reached RMB 1.97 trillion. According to research by Xinhua Zhang (2023), a 10% decline in Evergrande's sales revenue recovery rate would result in a cash flow shortfall exceeding RMB 100 billion, reflecting the unsustainability of its "high-leverage, high-turnover" model amid market saturation, tightening regulations, and the waning demographic dividend. Under the constraints of the "Three Red Lines" policy, Evergrande's aggressive land acquisitions and diversified expansion strategies further heightened financial risks. In 2021, its cash collection dropped by over 40% year-on-year, eventually leading to a complete liquidity crunch.

At the same time, Xiao Lu (2024) found that defaults by major developers exhibit significant contagion effects both within the industry and across sectors. Evergrande's default not only plunged the company into operational distress but also resulted in over 2,000 of its partner firms experiencing an average accounts receivable delay of more than 90 days. Bond yields for real estate firms rose by approximately 1.5 percentage points, with ripple effects hitting upstream industries such as banking and steel, severely undermining overall market confidence.

The case of Zhongzhi Group further exposed regulatory blind spots within China's private financial conglomerates. With insolvency estimated at RMB 220–260 billion and affecting over 150,000 high-net-worth investors, the incident highlighted severe deficiencies in risk control under a complex financing structure, as well as significant regulatory lag. As the real estate market entered a downward cycle, numerous Zhongzhi-related projects were abandoned due to liquidity shortages, ultimately triggering a systemic crisis. This case underscores the weaknesses in risk management among private financial institutions and the pressing challenges faced by China's regulatory framework.

2.2.2. Debt Distress of Local Government Financing Vehicles (LGFVs)

Local Government Financing Vehicles (LGFVs) have emerged as a major source of risk in China's debt market. Wang (2025) points out that during the transitional period, these platforms commonly face challenges such as low asset liquidity and high repayment pressure. By 2023, LGFV debt ratios in several provinces had exceeded warning thresholds. In one province, declining land transfer revenues forced the platform to rely solely on special refinancing bonds to ease its liquidity crisis.

Hu (2024) further argues that insufficient regulation and a lack of transparency have allowed a large volume of implicit debt to evade oversight through mechanisms such as “equity in name, debt in essence.” This has made it difficult for the central government to effectively implement debt governance policies. In some regions, the scale of implicit debt has already surpassed that of explicit debt, underscoring the urgent need for stronger regulatory measures.

3. Government Intervention in the Debt Market

3.1. Historical Interventions and Outcomes

3.1.1. The State-Owned Enterprise (SOE) Debt Reform in the 1990s: Measures and Results

In the 1990s, China’s state-owned enterprises (SOEs) faced a dual crisis of high debt and low efficiency, with debt risks steadily accumulating. By 1997, the average asset-liability ratio of small and medium-sized SOEs had approached 80%, and some had already become insolvent.

To resolve this structural risk, the government launched a series of reform measures. The most prominent was the “debt-to-equity swap” initiative, through which four major asset management companies (AMCs) were established. These entities assumed RMB 1.4 trillion in non-performing assets from state-owned banks and converted SOE bank loans into equity stakes. This policy significantly reduced corporate debt ratios and improved financial conditions. Concurrently, the government promoted shareholding reform of SOEs by introducing diversified investors and establishing modern corporate governance structures. By 2004, the average asset-liability ratio of SOEs had declined to 57%, demonstrating the effectiveness of the reforms. However, the process also revealed challenges, including excessive local government intervention and low efficiency in asset disposal by AMCs.

3.1.2. Post-2008 Financial Crisis: Debt-Fueled Stimulus and Subsequent Regulation

Following the outbreak of the global financial crisis in 2008, China faced significant downward economic pressure. To stabilize growth, the government swiftly introduced a “4 trillion plan”, relying on expanded public debt and relaxed corporate financing restrictions to boost domestic demand.

According to official data, the issuance of local government urban investment bonds surged to RMB 430.49 billion in 2009[Bank of China Research Institute. (2023). The Development History, Risk Analysis and Relevant Suggestions of China's Urban Investment Platforms. In the same year, loans extended to non-financial corporations and other sectors rose by RMB 7.14 trillion. These aggressive measures effectively curbed economic contraction, lifting China’s GDP growth rate to 9.2% in 2009 despite the global downturn.

However, the rapid expansion of debt also generated a series of structural issues. Risks associated with implicit debts of local government financing vehicles (LGFVs) intensified, corporate leverage continued to rise, and sectors such as real estate and heavy industry experienced excessive debt accumulation.

In response, starting in 2010, the government shifted its policy stance toward “risk control and structural adjustment.” Measures included tightening oversight of financing platforms, advancing corporate deleveraging, and implementing the revised Budget Law. These actions reflected the government’s effort to strike a balance between short-term economic stimulus and long-term financial stability.

3.2. Rationale and Implications of Government Intervention

Government policies exert a strong expectation-guiding effect on the debt market. For example, during the liquidity easing period of the COVID-19 pandemic in 2020, corporate bond issuance increased by 26% year-on-year; in contrast, the deleveraging campaign of 2017–2018 led to a sharp contraction in local government financing vehicle (LGFV) bond issuance. This reflects the dual role of policy in both stimulating and constraining debt expansion.

The prevalence of the "rolling over debt" model among local governments stems from fiscal imbalances and GDP-oriented performance evaluations. Following the tax-sharing reform, local governments increasingly relied on debt financing to support infrastructure development and economic growth. By 2022, over 80% of newly issued LGFV bonds were used to repay maturing debt, exacerbating fiscal pressure and reducing the efficiency of resource allocation.

In addressing debt risks, the government has sought a dynamic balance between "market clearing" and "policy support." In the case of Evergrande's debt crisis, authorities opted for market-based restructuring to break the expectation of implicit guarantees. However, for LGFV bonds related to public services and infrastructure, the central government has employed refinancing bonds and debt-resolution funds to maintain financial stability and support essential projects.

China's macroeconomic governance emphasizes coordinated management and risk controllability. Since the implementation of the revised Budget Law in 2014, local government debt has been brought under budgetary oversight, forming an integrated framework of borrowing, usage, and repayment. Through a gradual "pilot-to-promotion" reform approach—such as debt swaps and LGFV restructuring—the government has aimed to mitigate risks while sustaining economic growth.

4. Arguments For and Against a Tough Stance on the Debt Market

4.1. Arguments Supporting a Tough Stance

On the domestic front, adopting a tough stance serves as a critical instrument for preventing systemic financial risks. According to research by the International Monetary Fund (IMF, 2025), elevated debt levels significantly increase a country's fiscal vulnerability under extreme conditions. Strengthening regulation, curbing leverage, and limiting excessive credit expansion can effectively mitigate cross-market risk transmission. For instance, during the 2017–2018 deleveraging campaign, stricter oversight helped rein in shadow banking activities, thereby substantially enhancing the stability of the financial system. Moreover, regulatory tightening has been reflected in institutional reforms—such as the imposition of stringent bond issuance and disclosure requirements—which serve to curb excessive financing and improve market transparency.

At the international level, a tough stance contributes to safeguarding overseas assets and enhancing China's role in global financial governance. As of 2024, China's total external financial assets have surpassed USD 10 trillion, with investments under the Belt and Road Initiative continuing to expand. Strengthening domestic debt regulation encourages financial institutions to conduct more prudent risk assessments, thereby mitigating potential negative spillovers to overseas assets.

From the perspective of economic restructuring, strict regulation can accelerate the exit of inefficient enterprises. Statistical data show that some steel and coal companies have long maintained debt ratios exceeding 80%, consuming substantial resources while operating at low efficiency. During the 2016–2018 coal capacity reduction campaign, strict debt control led to the elimination of over 800 million tons of coal production capacity nationwide. At the same time, it facilitated industry upgrading and transformation, demonstrating the positive impact of debt governance on industrial restructuring.

4.2. Arguments Opposing a Tough Stance

In the short-term economic dimension, a tough regulatory stance may suppress investment and consumption while delaying infrastructure progress. According to the OECD, tightened debt regulation raises corporate financing costs and dampens investment appetite. Since 2017, infrastructure investment growth has slowed, with the annual growth rate in the three major infrastructure sectors falling to 1.79% by the end of 2018. Financial constraints on enterprises have also negatively affected employment and wages, weakening consumer expectations.

In terms of international cooperation, stricter oversight may reduce the funding availability and efficiency of Belt and Road Initiative (BRI) projects. Infrastructure projects in some participating countries have experienced delays of 1–2 years due to prolonged approval processes, affecting mutual trust. Overly conservative financial policies may also hinder the internationalization of the Renminbi.

Within the financial system, abrupt policy tightening could trigger funding disruptions and a rise in non-performing loans. Data from the former China Banking Regulatory Commission (CBRC) show that following the 2013 “liquidity crunch,” commercial banks’ non-performing loan ratios rose to 1%. At the same time, increased difficulty in bond issuance and heightened market volatility could impair liquidity and undermine investor confidence.

5. International Lessons and Policy Optimization Pathways

5.1. Lessons from Other Countries

The United States has established a unique debt management system by leveraging the dominance of the U.S. dollar. According to research by Li Baowei et al. (2024) based on the stock–flow consistent (SFC) model, the U.S. dollar, as the world’s primary reserve currency, is underpinned by six major pillars—including petrodollars, commodity pricing power, and technological superiority. This enables the U.S. government to issue sovereign debt at low cost on a sustained basis. Between 2006 and 2022, the U.S. achieved an average excess return of 0.397% on its international balance of payments positions. Even amid debt expansion, the U.S. has been able to conduct quantitative easing to export inflation globally, thereby externalizing the cost of domestic economic adjustments.

However, overreliance on dollar hegemony has led to hollowing-out of the real economy and growing concerns over market confidence. The declining effective interest payments on U.S. Treasury debt also signals potential instability in the international monetary system.

Japan has long relied on low interest rates and domestic capital absorption to manage its high debt levels. Japan’s government debt-to-GDP ratio reached 261% in 2022, the highest among major economies. Approximately half of its government bonds are held by the Bank of Japan, reflecting a clear trend of fiscal deficit monetization. While this model has contributed to short-term economic stability, prolonged low interest rates have compressed financial institutions’ profit margins, reduced resource allocation efficiency, and contributed to a “high debt, low growth” dilemma. One of the underlying causes is the imbalance in fiscal structure: the share of tax revenue is relatively low, reliance on government bonds is high, and spending on social security and debt servicing accounts for over half of the national budget—severely crowding out space for public investment.

The Latin American debt crisis provides a critical reference for emerging economies. In the 1970s, many Latin American countries relied heavily on short-term external borrowing to finance infrastructure development. Amid rising oil prices and tightening U.S. monetary policy, structural imbalances led to widespread debt crises. Zhong (2023), in a study covering 32 emerging market economies, found that poorly structured debt significantly undermines economic resilience. Although the current average debt ratio in emerging markets exceeds 60%, prudent debt management and counter-cyclical fiscal policies can help mitigate the impact of crises. Ultimately, the root cause of the Latin American debt crisis lay in the absence of effective risk prevention mechanisms, resulting in prolonged economic recession and social instability.

5.2. Policy Recommendations

5.2.1. Clarifying Debt Bailout Criteria and Improving Budget Constraints

Debt bailouts should be based on a quantitative assessment framework that takes into account the nature, scale, repayment capacity, and systemic importance of the debtor. Drawing on the International Monetary Fund's (IMF) criteria for assessing Systemically Important Financial Institutions (SIFIs), entities whose default may pose systemic risks and that demonstrate sustainable long-term operations should be considered eligible for intervention. At the same time, transparency must be enhanced through improved disclosure requirements. Debtors should regularly publish key data such as their balance sheet composition and cash flow status to inform bailout decisions.

For example, in 2018, the State Council issued the Guiding Opinions on Strengthening the Asset-Liability Constraints of State-Owned Enterprises, which introduced an early warning mechanism based on debt ratios and specified risk thresholds for different industries—offering a policy model for implementing targeted bailouts.

On the budget constraint front, both governmental and corporate constraints must be strengthened. On the government side, strict implementation of the Budget Law is essential. A multi-year budget balance mechanism should be established, and implicit debts must be incorporated into formal budget management to prevent off-budget expenditures from driving unsustainable debt expansion. On the corporate side, debt accounting should be regulated in accordance with the Accounting Standards for Business Enterprises. Firms should build comprehensive debt risk assessment systems to ensure that the scale of debt remains aligned with their operational and financial capacities.

5.2.2. Coordinated Application of Macroprudential and Market-Based Tools

Macroprudential policy serves as a key line of defense against systemic financial risks. Drawing on the Basel III framework, instruments such as dynamic capital adequacy adjustments and countercyclical capital buffers can be employed to curb excessive leverage among financial institutions.

The central bank should establish a Macroprudential Assessment (MPA) system that brings shadow banking, off-balance-sheet activities, and other risk-prone sectors under regulatory oversight, enabling real-time monitoring and control of liquidity risks. For example, in 2020, the People's Bank of China implemented a real estate loan concentration management system that set upper limits on banks' exposure to property loans, effectively reducing debt-related risks in the real estate sector.

In market-based debt governance, the key lies in enhancing the price discovery function so that the market can more accurately reflect risk and value. One feasible approach is to leverage credit rating mechanisms to establish an evaluation framework that incorporates both the probability of default and the loss given default, thereby guiding rational market pricing. This not only improves transparency in the bond market but also helps channel capital toward risk-controlled and stable-return opportunities.

In addition, financial institutions should be encouraged to innovate in debt financing instruments—such as perpetual bonds and asset-backed securities (ABS)—to expand corporate financing channels. At the same time, tax incentives can be used to steer capital toward the real economy. For example, exempting interest income on bonds issued by high-tech enterprises from income tax can enhance capital allocation efficiency.

5.2.3. Strengthening the Legal Framework for Default Resolution and Fostering a Credit Culture

A sound legal system is essential for reinforcing market discipline in the debt sector. Drawing on the U.S. Chapter 11 bankruptcy reorganization procedures, China should establish a bankruptcy restructuring mechanism tailored to its national context, including the creation of specialized financial courts to improve the efficiency of debt resolution. Notably, the 2020 Minutes of the Symposium on Bond Dispute Cases issued by the Supreme People's Court clarified the legal standards for determining liability in bond defaults, laying a solid foundation for improving the legal framework through judicial practice.

Fostering a strong credit culture requires coordinated efforts from the government, enterprises, and society. At the governmental level, a unified credit information-sharing platform should be established to integrate data across taxation, judiciary, and financial domains, thereby enhancing the joint disciplinary mechanism for dishonest behavior. Enterprises should incorporate credit management into their long-term strategic planning by regularly publishing Corporate Credit Reports to improve market transparency and build investor confidence. On the societal front, integrity education should be strengthened, with credit awareness integrated into the national education system. Such efforts can fundamentally reduce transaction costs in the debt market.

6. Conclusion

This study investigates whether China should adopt a more hardline stance in its debt market, integrating both theoretical analysis and empirical evidence from domestic and international contexts. The findings suggest that such a stance produces a dual effect on China's current debt governance. On the one hand, leveraging market-based and rule-of-law mechanisms to address high-risk entities can help break the implicit guarantee expectation, curb moral hazard, and accelerate the exit of inefficient production capacity. This, in turn, facilitates the reallocation of resources toward emerging industries, laying the groundwork for structural economic transformation. On the other hand, excessively stringent policies may induce short-term economic pain, increase financing pressures on small and medium-sized enterprises (SMEs), slow infrastructure investment, and introduce friction and uncertainty to international cooperation projects.

Given China's development model—characterized by a state-led market economy and high leverage—the design of debt policy must strike a careful balance between "stabilizing growth" and "containing risks." While maintaining the bottom line of preventing systemic financial crises, policymakers should differentiate between types of debt and risk profiles of debtors, developing a dual-track strategy that integrates targeted bailouts with orderly risk resolution. Simultaneously, institutional reforms are urgently needed, including strengthening the macroprudential regulatory framework, enhancing credit rating and disclosure systems, and cultivating a sound credit culture to build a debt market with endogenous stability.

In conclusion, the key to China's future debt governance lies in organically integrating a firm policy stance with flexible adjustments. Only through precise calibration and coordinated deployment of policy tools can China effectively manage financial risks while enhancing the debt market's capacity to serve the real economy and support high-quality development. This will provide a solid foundation for the new development paradigm centered on domestic circulation and mutually reinforcing domestic–international dual circulation.

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