Earlier this year, rumors of China's impending financial doom – triggered by either a housing-market crash or local-government debt defaults – were rampant. But, in recent months, the economy has stabilized, leaving few doubts about China's ability to grow by more than 7% this year. Given that the Chinese government had ample scope for policy intervention, this turnaround should come as no surprise. But the moment of financial reckoning has merely been postponed, not averted.

The fundamental problems that triggered alarm bells in the first place – including real-estate bubbles, local-government debt, rapid growth in shadow-banking activity, and rising corporate leverage ratios – remain unresolved. Of these, the most immediate threat to China's economic and financial stability is the combination of high borrowing costs, low profitability for nonfinancial corporations, and very high corporate leverage ratios.

According to a study by the Chinese Academy of Social Sciences, the debt/GDP ratio for China's nonfinancial corporations was 113% by the end of 2012. Standard & Poor's found that, a year later, these firms' total debt amounted to $14.2 trillion, eclipsing the $13.1 trillion of outstanding debt in the United States and making China the world's largest issuer of corporate debt.

There is no indication that the ratio will decline anytime soon, which is particularly worrisome, given the low profitability and high borrowing costs that China's industrial enterprises face. Indeed, Chinese firms' profitability amounted to just over 6% last year, with

2012 profits for China's 500 largest (mostly state-owned) corporations barely exceeding 2%.

Meanwhile, interest rates on bank loans to nonfinancial enterprises remain close to 7%, despite having fallen slightly over the last year. And, in the second quarter of this year, the annualized interest rate on loans to small nonfinancial corporations surpassed 25%.

With insufficient profits to use for investment, nonfinancial corporations will become increasingly dependent on external finance. As their leverage ratios increase, so will their risk premiums, causing their borrowing costs to rise and undermining their profitability further. This destructive cycle will be difficult to break. For example, if companies reduce investment, they will weaken growth and boost their leverage ratio further.

To be sure, China overcame a similar challenge in its public sector from 1998 to 2001. It pursued growth-boosting investment in infrastructure and real-estate development to eliminate deflation, while maintaining artificially low interest rates to contain the rise of public debt.

But a lot has changed since then. In fact, the investment-led growth model that facilitated double-digit growth in the decade after 2001 has exacerbated structural weaknesses, which must now be addressed. Indeed, China must stem the pace of real-estate investment, which accounted for more than 13% of GDP in recent years – a move that will undoubtedly lead to slower economic growth and, in turn, reduce the profitability

of China's nonfinancial corporates further.

Moreover, ongoing interest-rate liberalization – which has occurred both openly and surreptitiously – means that artificially low borrowing costs have become far more difficult to maintain. Though the People's Bank of China still officially caps interest rates on deposits, commercial banks – in cooperation with nonbank financial institutions, especially trust companies – are using wealth-management products to attract deposits with *de facto* free-market interest rates. As a result, the PBOC is losing control over interest rates on corporate loans, and thus has few options for constraining leverage ratios.

Despite these risks, it is too early to bet on a corporate-debt crisis in China. For starters, no one knows at what corporate leverage ratio a crisis will be triggered. In 1996, when Japan's public debt/GDP ratio reached 80%, many Japanese economists and officials worried about a looming crisis. Almost two decades later, the ratio has surpassed 200% – and still no crisis has erupted.

Furthermore, China has not yet completed its market-orientated reforms, which could unleash major growth potential in many areas. Given the role that institutional factors play in China's corporate-debt problem, such reforms could go a long way toward resolving it.

China's leaders should take advantage of this respite from instability and low confidence to redouble their reform efforts. Otherwise, they can expect alarm bells to begin ringing again – and, next time, they may not have

the tools they need to silence them.