

Corporate Financing Choices in the Low-Interest-Rate Era

Huanqun Mei^{1,a,*}

¹*School of Accounting, Anhui University of Finance and Economics, Dongsheng Street, Cao Shan Road, Anhui, China*

a. 2452646768@qq.com

**corresponding author*

Abstract: Since 2024, an increasing number of companies have opted to raise funds by issuing bonds while repaying bank loans. This trend can be attributed to the current floating interest rate mechanism for loans, contrasted with the fixed-rate system for debt securities. In an era of steadily declining Loan Prime Rates (LPR), many companies are choosing to issue bonds to lock in long-term low rates, thereby reducing financing costs. In this context, this paper combines the macroeconomic variable of interest rates with the microeconomic variable of corporate financing choices to explain the new preferences that companies exhibit in the low-interest-rate era. It also analyzes potential issues, such as depreciation tendencies and the risk of debt default, and offers relevant recommendations, such as establishing a sound debt management system and strictly controlling borrowing scale. From a theoretical perspective, this paper examines the process of interest rate liberalization in China since the 1980s, using theories such as the Modigliani-Miller theorem, tax shield theory. It outlines the path toward a fully market-based interest rate system. Based on multiple LPR cuts, this year's sharp decline in renminbi loans, and the increased use of bond financing, the paper concludes that China's interest rate liberalization has reached a relatively mature stage. It suggests that for the foreseeable future, China will remain in a low-interest-rate period, with companies continuing to adjust financing strategies in response to interest rate movements, increasingly opting for bonds over loans to secure low rates and achieve further capital expansion.

Keywords: Capital Structure, Low-Interest-Rate Era, Interest Rate Liberalization.

1. Introduction

Capital structure is a key topic in corporate finance research. Classical capital structure theories, such as the Modigliani-Miller (MM) theorem and the bankruptcy cost theory, focus on the balance between equity and debt. However, in China, debt financing—especially indirect debt financing—predominates. Since 2024, a growing number of companies have chosen to finance by issuing bonds while repaying bank loans. One possible reason is that China's current loan interest rates follow a floating rate system, whereas bond debt operates on a fixed-rate system. With a steadily declining Loan Prime Rate (LPR), more companies are opting to issue bonds to secure long-term low rates, thereby lowering their financing costs. This study focuses on whether Chinese companies, which primarily rely on debt financing, will actively choose between loans and bond issuance when faced with changing capital costs.

Through theoretical analysis and data, this paper demonstrates that: first, interest rate liberalization reforms in China have reached a relatively mature stage; second, China is currently in a low-interest-rate period; third, in this low-interest-rate environment, companies are likely to adjust their financing strategies based on interest rate changes, favoring bonds over loans to lock in low rates.

The contributions of this paper are as follows: First, it treats interest rates as a macroeconomic variable. While interest rates are often discussed in relation to their impacts on funding costs, financial institutions' profit models, capital flows, and exchange rates—macroeconomic variables—this paper combines interest rates with corporate financing choices, a microeconomic variable, to explain the new options companies exhibit in a low-interest-rate era. Second, it examines the choice between loans and bond financing, rather than equity and bond financing, within the context of China's unique capital market system, thereby addressing the issue of capital structure choices under China's specific market conditions.

The remainder of this paper is organized as follows: Section 2 provides a literature review on capital structure, interest rate liberalization, and the low-interest-rate era. Section 3 discusses China's interest rate liberalization reforms and the arrival of the low-interest-rate period, analyzing the process of interest rate liberalization in China and revealing companies' choices to lock in low rates by studying LPR trends and recent changes in corporate financing options. Section 4 elaborates on corporate financing choices in China's low-interest-rate era. Section 5 presents the conclusions and outlook of this study.

2. Literature Review

2.1. Review of Literature on Capital Structure

The concept of capital structure originates from modern financial management and corporate finance theory, with roots tracing back to early economic theories in the 20th century. As industrialization accelerated and large corporations emerged, capital acquisition became a central issue in corporate management. The first specialized theory on capital structure was proposed in 1958 when Franco Modigliani and Merton Miller introduced the well-known Modigliani-Miller (MM) theorem. The MM theory states that under a perfect capital market assumption (no transaction costs, no taxes, and no bankruptcy costs), a company's capital structure does not affect its overall value or weighted average cost of capital (WACC) [1]. However, this theory overlooks several real-world constraints, such as taxes, bankruptcy costs, and agency costs. Subsequent research modified and expanded upon this theory. Michael C. Jensen and William H. Meckling introduced the tax shield theory, explaining that interest on debt can be deducted before taxes, while dividends cannot, giving debt financing a tax advantage. The bankruptcy cost theory then posited that high debt levels increase the likelihood and cost of bankruptcy, thus influencing capital structure decisions. Myers proposed the pecking order theory, which suggests that companies prefer internal financing first, followed by debt, and issue new equity last to minimize the negative effects of information asymmetry and market reaction [2].

In the 1990s, domestic scholars in China began to recognize concepts related to capital structure, reshaping corporate decision-making since the onset of economic reforms. First, this broadened the scope of financing channels, as companies, in addition to traditional bank loans, began to explore the bond market, equity financing, and innovative financing methods such as asset securitization and crowdfunding. Second, it facilitated the adjustment of debt-to-equity ratios for Chinese companies, as corporate managers learned to dynamically adjust these ratios on their balance sheets based on industry characteristics, market environment, and tax policies, aiming to minimize capital costs and maximize corporate value. Third, it influenced government policy-making at a macro level; to support corporate growth and improve market efficiency, the Chinese government has continuously deepened financial market reforms, such as easing conditions for corporate bond issuance, launching the STAR

Market, and implementing the registration-based IPO system. These efforts aim to provide companies with more diverse financing options and a more relaxed financing environment. Fourth, it led to adjustments in tax policy; recognizing the tax advantages highlighted in capital structure theory, government bodies have made timely revisions to corporate income tax and related regulations to encourage reasonable use of debt financing while mitigating risks associated with excessive leverage.

2.2. Literature Review on Interest Rate Liberalization Reform

Mehrling has outlined the critical role of interest rate liberalization in optimizing the transmission mechanisms of monetary policy, establishing a solid theoretical foundation for its application [3]. He demonstrated the central role of interest rates in monetary and banking economics, particularly how, under market economy conditions, interest rates are influenced by the dynamics of supply and demand, central bank policies, and other macroeconomic variables. He discussed the effectiveness of interest rates as a monetary policy tool and proposed various strategies to maximize the coherence and impact of monetary policy under liberalized interest rates. Mehrling further emphasized the importance of interest rate liberalization for enhancing the efficiency of financial resource allocation and promoting economic stability. Capie and colleagues, drawing on historical experiences from the European Monetary Union, argued for the indispensable role of interest rate liberalization in deepening financial markets, enhancing liquidity, and strengthening the stability of financial systems. He analyzed how independent central banks in small, open economies should formulate interest rate rules to maintain price stability and promote economic growth. Capie explored the impact of interest rate liberalization on central bank independence and monetary policy strategies, especially how central banks should adjust interest rates to stabilize domestic economies amid external shocks. His research also examined interest rate differentials within the Eurozone and their implications for monetary policy consistency and effectiveness. Based on these findings, Capie discussed how interest rate liberalization has facilitated capital flow and financial integration within the Eurozone [4].

In the Chinese context, researchers have vividly illustrated that the aim of interest rate liberalization reform is to disrupt the entrenched interest margin framework of state-owned banks, invigorate market competition, and comprehensively enhance the quality and efficiency of financial services. As the understanding of interest rate liberalization reform in China deepened, scholars analyzed the complex yet crucial interactions between the interest rate corridor, policy rates, and market rates, stressing the necessity and urgency of establishing a sound interest rate transmission mechanism. They examined the profound impact of interest rate liberalization on banks' business models, profitability, and risk management strategies, while cautioning against systemic risks associated with the reforms. The findings confirmed the substantive contributions of a rational interest rate pricing mechanism in stimulating investment activity, optimizing resource allocation, and promoting economic growth. Wu Xiaoling systematically reviewed how interest rate liberalization has comprehensively boosted the depth, breadth, and efficiency of financial markets, highlighting the significant achievements in expanding direct financing channels and optimizing market structure. Zhou Xiaochuan addressed the new challenges that interest rate liberalization poses to central bank macro-prudential management and countercyclical measures, advocating for innovative and flexible applications of monetary policy tools. Consequently, the localization of interest rate liberalization theory in China has largely taken shape, with primary discussions focusing on how a market-based interest rate system serves as a crucial economic beacon. This system promptly reflects various macroeconomic indicators, market expectations, and risk assessments, facilitating rational decision-making by market participants. This information feedback mechanism accelerates information flow within the economy, enhancing market transparency and responsiveness. Additionally, in a liberalized environment, interest rates serve as a vital benchmark for assessing credit risk, allowing for differentiated pricing based on borrowers' credit quality. This enables financial institutions to

adopt tailored lending standards, effectively dispersing and managing credit risk, thus strengthening the financial system's resilience to shocks and promoting its long-term stability. This environment also guides transformations in monetary policy execution and the strategic adjustments of financial institutions.

2.3. Literature Review on the Low-Interest-Rate Era

Low interest rates mainly originated from the unprecedented low-interest-rate environment encountered by many major global economies in recent decades. This phenomenon not only reshaped the framework of macroeconomic theory but also catalyzed a broad academic dialogue spanning fields such as monetary policy, financial stability, economic growth paradigms, and global capital allocation. The core of this discussion lies in the long-term stagnation theory proposed by Summers, which systematically explained the essence of the theory, namely that the global economy may be entering a new era of scarce investment opportunities and weak effective demand. This state laid the theoretical foundation for the prolonged existence of low interest rates. Summers further pointed out that, despite central banks' efforts to stimulate economic activity by lowering interest rates, in the absence of demand momentum at the fundamental level, low interest rates gradually evolve into a norm rather than an occasional occurrence[5]. Other related research includes Bernanke's analysis of unconventional monetary policies and financial stability considerations, such as quantitative easing and negative interest rate policies. These tools, within the current low-interest-rate context, have proven necessary for maintaining economic stability and recovery, while also cautiously warning the industry of their potential negative effects on the profitability of financial institutions and the overall stability of financial markets[6]. Eichengreen, based on global capital flows and the phenomenon of excess savings, developed the excess savings theory through rigorous historical data analysis. This theory effectively elucidated the intrinsic logic of long-term global low interest rates. They argued that the mismatch between the higher savings tendency in emerging market economies and the relatively lower investment demand in mature markets is a key driver of the global low-interest-rate phenomenon[7]. Borio and Disyatat, focusing on the relationship between financial cycles and asset pricing mechanisms, aimed to clarify the inherent link between global financial cycles and asset price fluctuations and their potential amplification in a low-interest-rate environment. They emphasized that prolonged low interest rates could foster asset price bubbles, significantly increasing the vulnerability of the entire financial system[8].

In conclusion, the theoretical research on the low-interest-rate era spans multiple interdisciplinary fields, including macroeconomic principles, monetary policy design, technological innovation dynamics, and financial market resilience. In contemporary China, this theory is also applied to corporate bond issues. Under the low-interest-rate environment, the bond financing costs for Chinese enterprises have significantly decreased, greatly expanding the channels for companies to obtain low-cost funds, particularly benefiting key projects focused on the country's strategic emerging industries, infrastructure modernization, and scientific research breakthroughs.

However, this also brings the potential for increased corporate debt burdens, manifested in a moderate rise in average leverage ratios. This undoubtedly raises higher demands for corporate financial health and long-term competitiveness. With the implementation of low-interest-rate policies, the yield gap between corporate bonds of different credit ratings tends to narrow, leading to a decline in the efficiency of information transmission between high-quality and subprime credit entities. During the low-interest-rate period, the profitability of financial institutions, especially banks, suffers as the interest rate spread between deposits and loans shrinks, forcing the industry to explore new business models and cost-control measures. Low-interest-rate policies are often accompanied by domestic currency depreciation trends, which pose severe challenges to export-oriented enterprises, further exacerbating volatility in the foreign exchange market. For enterprises themselves, borrowing

costs have significantly decreased. On the surface, this seems advantageous for capital expansion and debt restructuring. However, it also makes companies more susceptible to the trap of excessive debt, especially for those enterprises that previously relied on high-interest borrowing to maintain operations, which may face a severe risk of breaking their capital chains. Coupled with macroeconomic fluctuations and industry cyclical adjustments, the incidence of corporate bond defaults is showing signs of localized escalation. In this situation, enterprises should make full use of the advantage of low-cost funds while establishing a sound debt management system, strictly controlling the scale of borrowing, ensuring sufficient cash flow and financial flexibility, and enhancing capital structure resilience. They should also deepen income diversification, actively explore non-traditional revenue channels such as e-commerce driven by digital technology, service innovation, and brand value enhancement to increase corporate resilience and market competitiveness. At the same time, investors' ability to accurately assess credit risk is also put to the test. During this phase, the returns from fixed-income assets such as government bonds and savings deposits sharply decline, directly affecting investor groups that rely on such stable investments for steady income, forcing them to face a return contraction dilemma. Meanwhile, frequent financial market fluctuations and mounting inflation concerns have diminished the attractiveness of traditionally conservative safe-haven assets, prompting investors to shift toward relatively higher-risk investment areas in pursuit of substantial excess returns. However, this also amplifies the overall risk of investment portfolios. The abundant market liquidity, however, has significantly increased the trading activity of corporate bonds, providing investors with a more convenient buying and selling experience. Driven by the desire for excess returns, high-yield debt products such as green bonds and perpetual notes are increasingly sought after, reflecting the wisdom of market participants in seeking a balance between risk and return. Similarly, this wisdom extends to the moderate increase in the allocation of risky assets, strengthening financial management planning, and broadly diversifying across asset classes such as stocks, bonds, commodities, real estate, and alternative investments to create a diversified, cautious investment approach aimed at balancing investment risk and return, reducing the impact of specific market sector downturns.

3. The Marketization of Interest Rates in China and the Arrival of the Low-Interest-Rate Era

3.1. The Process of Interest Rate Marketization in China

China's initial attempts at interest rate marketization began in the 1980s. In 1996, the People's Bank of China removed the upper limit on the interbank lending rate for RMB, marking the official first step in China's interest rate marketization reform. In the new century, the central bank further relaxed the upper and lower limits on interest rates, and the reform of interest rate marketization continued to advance. In 2007, the introduction of Shibor marked a crucial step in China's adoption of international interest rate markets and the building and improvement of a market-based interest rate system. Additionally, the further reduction of domestic data manipulation risks allowed China's interest rate marketization reform to enter a phase of comprehensive implementation and optimization. Measures such as relaxing the issuance rate limits for large negotiable certificates of deposit, expanding the deposit rate floating range, and improving the LPR formation mechanism were also introduced.

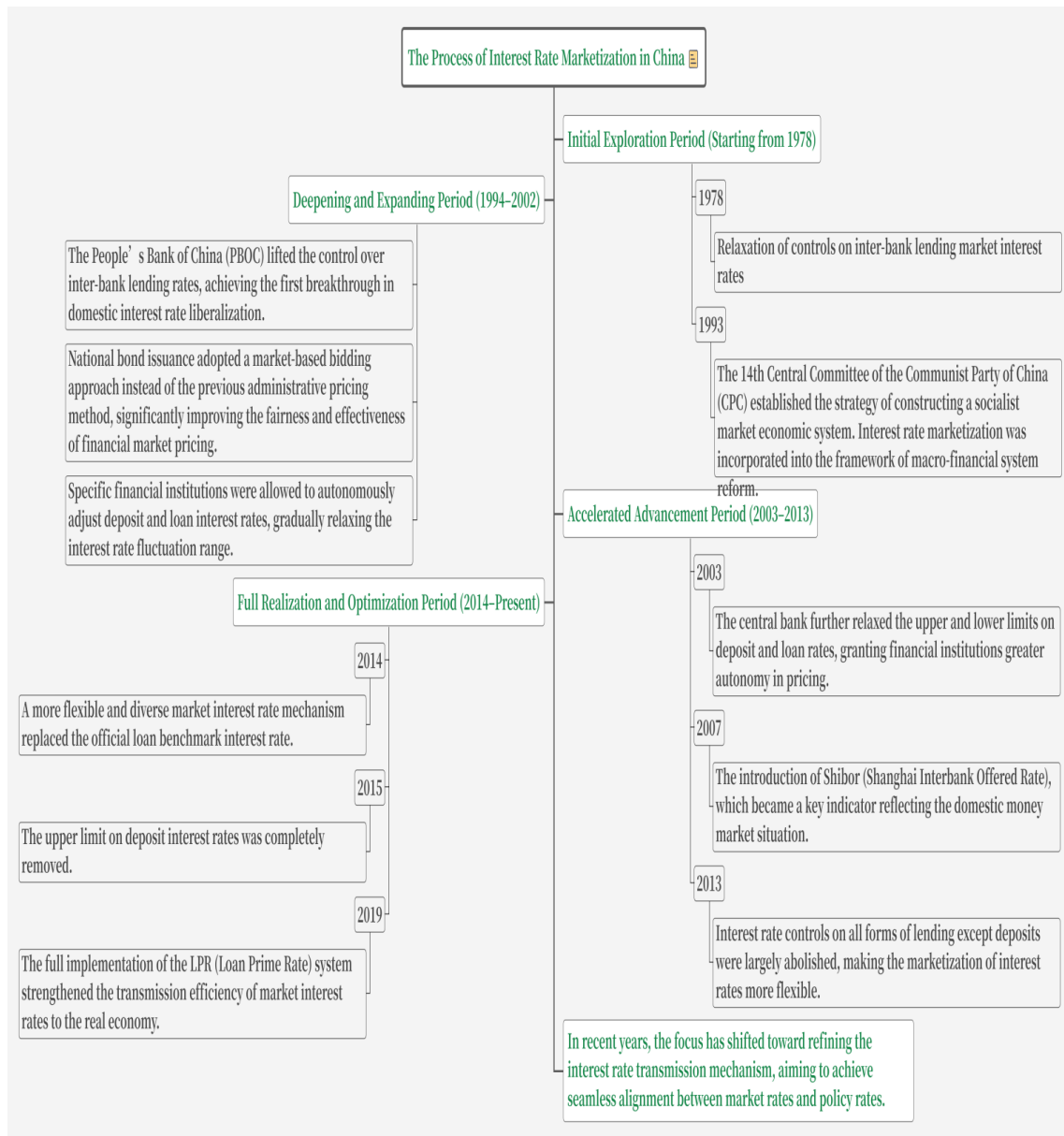


Figure 1: The Process of Interest Rate Marketization in China

3.2. Current Interest Rates in China

LPR, or the Loan Prime Rate, as an advanced benchmark rate generation mechanism, has played an increasingly important role in China's financial market since its reform in August 2019. The core components of the LPR system include the one-year LPR and the five-year-and-above LPR. The one-year LPR serves as the primary reference for pricing short to medium-term loans and is widely used for short-term working capital loans, credit package loans, and other short-term financing activities. Its notable feature is its high adjustment frequency, which allows it to respond quickly to fluctuations in market liquidity and adjustments in central bank monetary policy. The five-year-and-above LPR is designed for long-term loans, particularly for residential mortgages, corporate fixed asset investment loans, and other medium to long-term financing needs. Due to its far-reaching influence and careful adjustments, this rate category aims to provide a stable and reliable long-term loan pricing standard, shielding borrowers from the negative effects of short-term market fluctuations. The long-

term trend of the LPR is downward. From 2019 to early 2020, as a new mechanism, the LPR showed a more flexible adjustment pattern, especially after the outbreak of the COVID-19 pandemic, when, in response to the economic impact, the People's Bank of China adopted a series of loose monetary policies, including multiple reductions in the LPR. Between the end of 2020 and 2021, as the pandemic control measures showed results and the Chinese economy gradually recovered, the LPR entered a relatively stable phase. From 2022 onwards, with the appearance of many uncertainties and risks globally, the People's Bank of China adopted a flexible and appropriate monetary policy toolkit, including targeted reserve requirement ratio cuts, re-loans, and re-discounts, with an overall downward trend that continues to this day. Its latest figures are: one-year LPR: 3.1%, and five-year-and-above LPR: 3.6%.

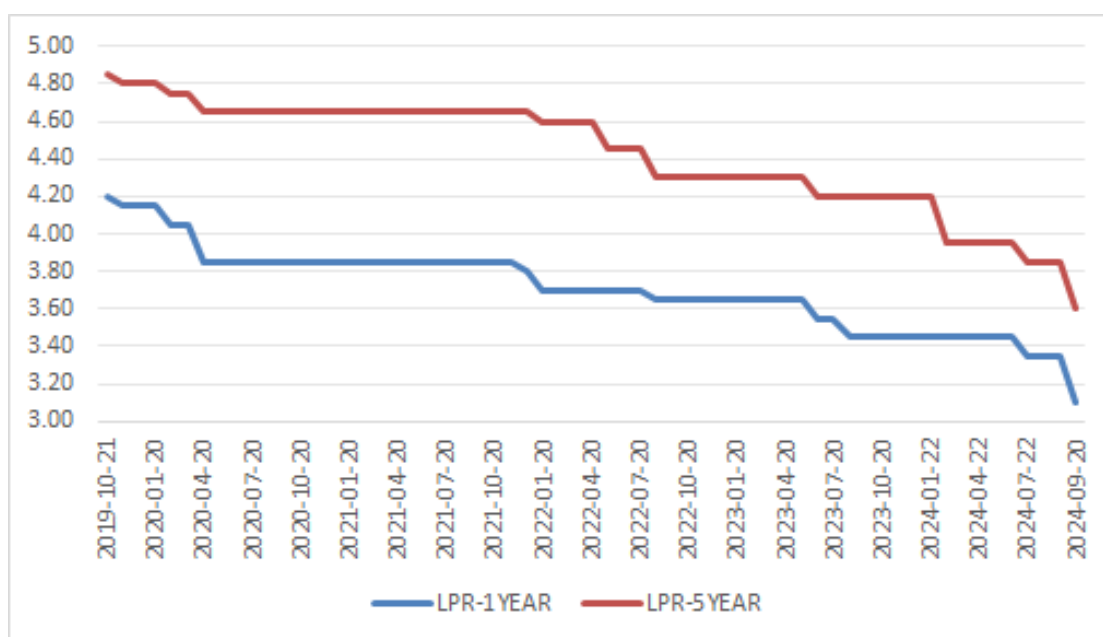


Figure 2: LPR Trends in China (1-year + 5-year)

Note: The blue line represents the Loan Prime Rate (LPR) for 1 year. The orange line represents the Loan Prime Rate (LPR) for 5 years.

4. Financing Options for Chinese Enterprises in the Low-Interest-Rate Era

From the perspective of social financing, Chinese enterprises have various financing options, including RMB loans, off-balance-sheet financing, debt financing by enterprises and governments, equity financing, trust loans, and entrusted loans. Among these, RMB loans have always accounted for the highest share, indicating that indirect financing remains dominant. Since the interest rate decline in 2021, a divergence in new financing has emerged. The most obvious change is the significant reduction in RMB loans in 2024 compared to 2023, while corporate bond financing has increased. This suggests that enterprises are striving to ensure sufficient cash flow and financial flexibility under a stable low-interest-rate model, with efforts focused on locking in low interest rates. Based on this, a possible conclusion is that enterprises are seeking to maintain low financing costs. Given that the interest rate cycle remains downward, this trend is likely to continue or even become more pronounced.

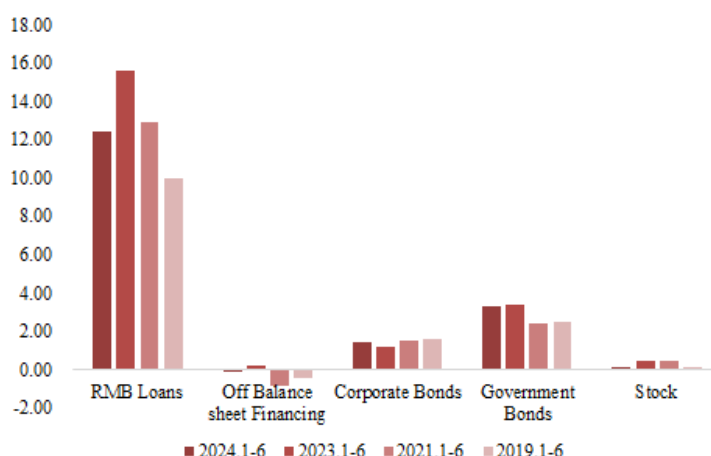


Figure 3: Social Financing in China

Note: The horizontal axis of the bar chart, from left to right, represents: RMB loans, off-balance-sheet financing, corporate bonds, government bonds, and stock financing. The legend, from left to right, represents: January-June 2024, January-June 2023, January-June 2021, and January-June 2019.

5. Conclusion

In the current domestic financial environment, low interest rates have become one of the dominant characteristics, prompting many enterprises to turn to the debt market to seek financing options. The significant decrease in borrowing costs has provided enterprises with an unprecedented advantage in financing costs. The marketization of interest rates has matured to a relatively advanced stage. For enterprises seeking capital expansion or restructuring of existing debt structures, they are able to raise funds at a lower cost than before, which can support operational expansion, investment projects, or replace high-cost debt, effectively reducing the financial burden and improving cash flow performance. At the same time, the low interest rate environment has sparked enterprises' interest in financial leverage. A moderate increase in debt ratios can amplify the return on investment (ROI) without affecting the equity structure, especially when capital returns exceed borrowing costs, making this strategy particularly attractive. This is essentially an effort to optimize the capital structure, with the potential to create higher shareholder value at the enterprise level. However, along with the wave of low interest rates comes the increasing accumulation of debt stock. If enterprises excessively rely on debt financing without reasonably planning their capital structure, they may face financial difficulties when interest rates rise in the future. Enterprises should take full advantage of the low-cost capital while establishing a sound debt management system, strictly controlling borrowing scales, ensuring sufficient cash flow and financial flexibility, and enhancing the resilience of the capital structure. They should also deepen income structure diversification and actively develop new revenue channels to enhance enterprise stability and competitiveness.

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