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Report on China's Leverage Ratio, Q1 2019

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Macro Leverage Ratio Climbs Again as Policy Priority Shifts toward Growth Stability

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“There is no free lunch in the world.” The first quarter marks a good beginning for China's economy in 2019. However, economic growth above expectations came at the expense of another significant increase of macro leverage ratio. In the context of growing internal and external uncertainties - not least the sudden escalation in China-U.S. trade war - and downward pressures on economy, there is no doubt that growth stability needs priority. How to press ahead with structural deleveraging to strike a balance between steady growth and a sound leverage ratio still presents stern challenges to policymakers.

I. Overall Assessment: Macro Leverage Ratio Climbs Again, and Leverage Ratio of Non-financial Corporations Substantially Rebounds

Overall, the real economy sector saw its leverage ratio rise substantially in Q1 2019, reaching a record high. Correspondingly, China's M2/GDP ratio also registered significant growth, approaching the record high of 2016. Aggregate financing to the real economy/GDP ratio also reached a record high. The real economy's leverage ratio, including the household sector, non-financial corporations, and the government sector, increased to 248.83%, up 5.1 percentage points from 243.70% at the end of 2018. China's M2/GDP ratio reached 206.31%, up 3.4 percentage points from 202.90% at the end of 2018. The stock of aggregate financing to the real economy as a share in GDP rose to 227.57%, up 4.6 percentage points from 222.98% at the end of 2018. As can be seen from the above indicators, China's macro leverage ratio rebounded significantly in Q1 2019.

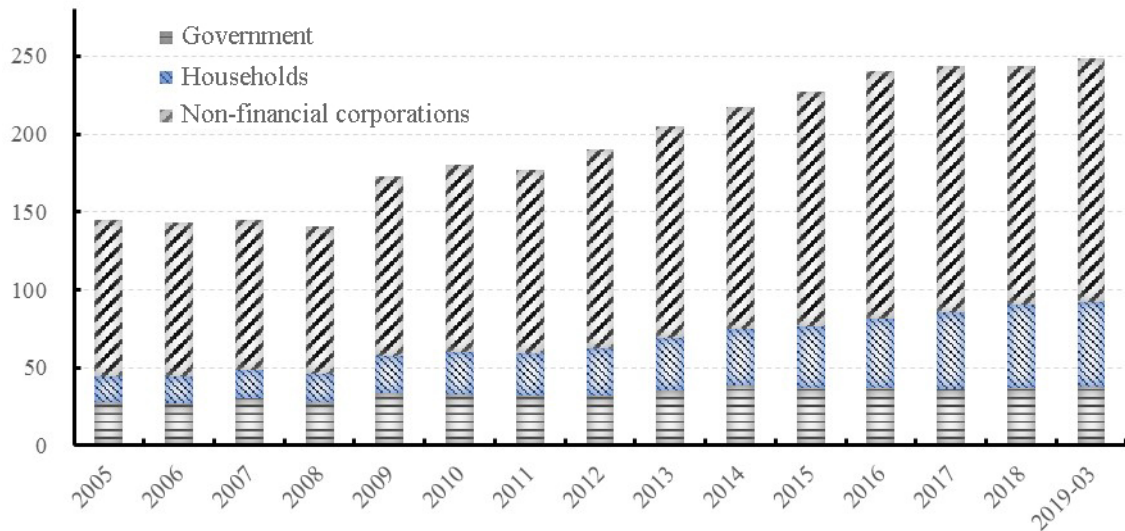


Figure 1: Real-Economy Leverage Ratio and Distribution (%)

Source: The People's Bank of China (PBoC), the National Bureau of Statistics (NBS), the Ministry of Finance, Wind; the Center for National Balance Sheet of China (CNBC).

Structurally, the leverage ratio of non-financial corporations rebounded the most, while those of households and local governments also rose remarkably. Specifically, the leverage ratio of non-financial corporations increased to 156.88%, up 3.3 percentage points from 153.55% at the end of 2018. Government leverage ratio rose to 37.67%, up 0.7 percentage points from 36.95% at the end of 2018. Local government leverage ratio climbed by 1.0 percentage point, and central government leverage ratio fell by 0.3 percentage points. The household leverage ratio climbed by 1.1 percentage points to reach 54.28%, up from 53.20% at the end of 2018. The financial sector's leverage ratio kept falling. The financial sector's leverage ratios from asset and liability sides both continued to decline. While the asset-side leverage ratio fell from 60.64% at the end of 2018 to 60.54%, liability-side leverage ratio dropped from 60.94% to 59.42%, down 0.1 and 1.5 percentage points respectively.

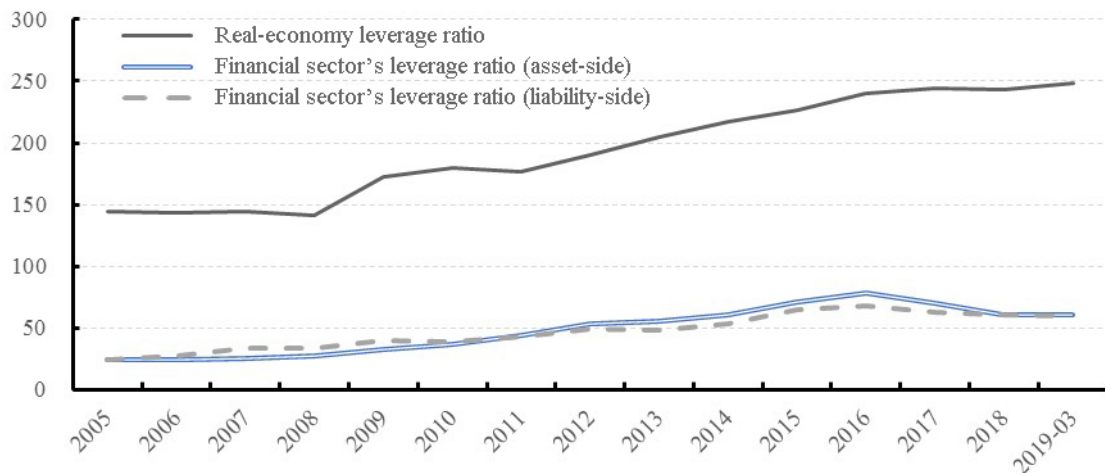


Figure 2: Real-Economy Leverage Ratio and Financial Sector Leverage Ratio (%)

Source: PBoC, NBS, the Ministry of Finance, Wind; the Center for National Balance Sheet of China (CNBC).

II. Explanation on the Rebound of Macro Leverage Ratio

Thanks to the deleveraging of non-financial corporations, China's overall leverage ratio dropped for the first time in 2018, exhibiting a significant effect of structural deleveraging. In Q1 2019, however, leverage ratios substantially rebounded in all sectors. A fundamental explanation is that policy priority shifted toward growth stability. The rebound can be attributed to the denominator, numerator, and seasonal factors.

(1) China's Nominal GDP Growth Slows amid Stable Start of Macroeconomic Performance

In Q1 2019, China's real GDP growth reached 6.4%, which was more or less the same as growth in Q4 2018 and marks a good beginning for 2019. Meanwhile, China's nominal GDP growth slowed to 7.8% in Q1 2019, down from 9.2% in Q4 2018. Accordingly, China's GDP deflator significantly reduced to 1.35%, down from 2.90% in 2018 - a reason behind the falling nominal GDP growth. The price factor, therefore, is one of the reasons behind the sharp increase in China's leverage ratio in Q1 2019. As a result of the falling price level, the growth of nominal GDP, which is the denominator of macro leverage ratio, slowed amid relatively stable actual GDP growth, contributing to the rise of the leverage ratio.

We believe that the impact of price factor is neutral. First, low inflation is a common conundrum facing all countries. China's CPI has stayed around 2 over recent years, and as the hog cycle exerts a weakening impact on China's price index, the cyclical nature of its price index has weakened. Second, China's price index has seen significant quarterly improvements in terms of both CPI and PPI. In February, China's quarterly CPI growth stood at 1.0%. In March, China's quarterly PPI growth turned from negative to positive, an indication of improving economic performance. We reckon China's price level will continue to rebound in Q2 2019 to prevent nominal GDP growth from falling further and thus keep the rapid increase of macro leverage ratio in check. On the other hand, pressures from the external environment will challenge China's economy. In the long run, the primary contradictions facing China's economy stem from endogenous factors in the transition from a debt-driven to a supply-side driven approach of development. In the short run, however, abrupt changes in the external environment will also destabilize China's macroeconomic performance, creating uncertainties to its nominal GDP growth in 2019. In the worst case scenario, nominal GDP growth may continue to slow, which is a cause for concern.

(2) Growth of Bank Balance Sheet Loans Accelerates, Shadow Banking Stabilizes

By the end of Q1 2019, the stock of aggregate financing to the real economy grew by 10.7% YoY. Specifically, renminbi loans, corporate bonds, and special local government bonds increased by 13.8%, 10.5%, and 40.4% respectively. Given the relatively small size of corporate bonds and special local government bonds, renminbi loans serve as a key driver of growth in aggregate financing to the real economy. Entrusted loans, trust loans, and discounted bank acceptance bills related to shadow banking fell by 11.0%, 7.9%, and 12.1% respectively. China's increasing leverage ratio in Q1 2019 should be attributed to the renminbi loans on the balance sheet of banks. Shadow banking business continued to decrease, and so did the financial system's leverage ratio. Accordingly, the financial system's leverage ratio in our statistics also continued to decline in Q1 2019, which is consistent with the above conclusion.

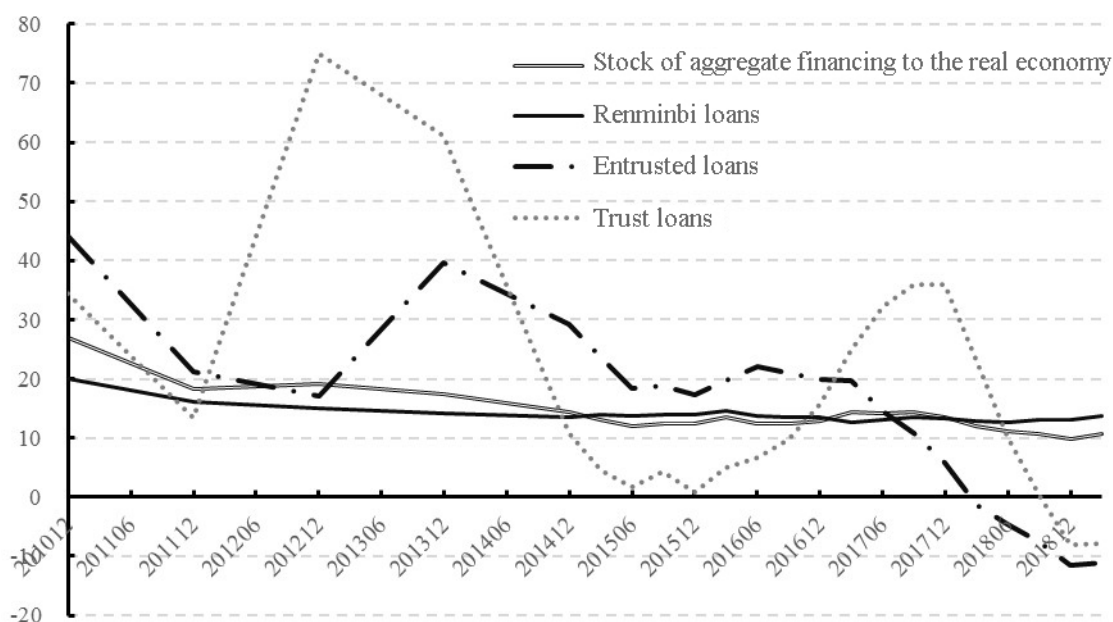


Figure 3: YoY Growth of Key Elements of the Stock of Aggregate Financing to the Real Economy (%)

Source: PBoC; the Center for National Balance Sheet of China (CNBC).

In Q1 2019, renminbi loans increased by 6.3 trillion yuan to reach a record high, indicating a relaxed credit environment. Growth in renminbi loans can be interpreted from the following perspectives: First, rising on-balance-sheet loans were accompanied by falling off-balance-sheet business as required by financial deleveraging. China's financial deleveraging process initiated since 2018 focuses on resolving the issue of a multi-nested financial system and reducing the tidal flow of funds between banks and shadow banks. As a result of financial deleveraging, off-balance-sheet financing represented by trust loans and entrusted loans continuously reduced in proportion, and the consequent credit gaps need to be replenished with bank loans, thus incurring a rapid rise in bank loans.

Second, China's credit environment was tight throughout the whole year of 2018, while bank loans increased by a mere 13.2% and the stock of aggregate financing to the real economy grew by a record low of 9.8%. Tight credit environment played a positive role in structural deleveraging. But it also created a drag on short-term macroeconomic performance, as evidenced in the consumption and investment slumps. In Q1 2019, the Chinese government encouraged credit issuance as a means to shore up growth, and the seasonal factor of credit issuance was also at play, reflecting the belief that early investment yields early return. These two factors contributed to the rebound of bank loans and aggregate financing to the real economy.

Third, the ratio of debt growth to nominal GDP used to be highly stable before 2010 stayed within a band between 20% to 30%. Additional M2 issuance and nominal GDP also had a similar ratio. The ratio of new debt and money supply to GDP was significant in Q1 2019 but well below the record high and only represented a normal volatility in this quarter. In our view, debt and money growth as a share in GDP also has great significance since the two variables are all economic growth concepts. According to Keynes's national income identity, GDP can be decomposed into consumption and investment, and a considerable portion of investment is supported by debt growth. In this sense, there is an intrinsic theoretical correlation between debt growth and GDP, which is a more stable relationship in the long-term.

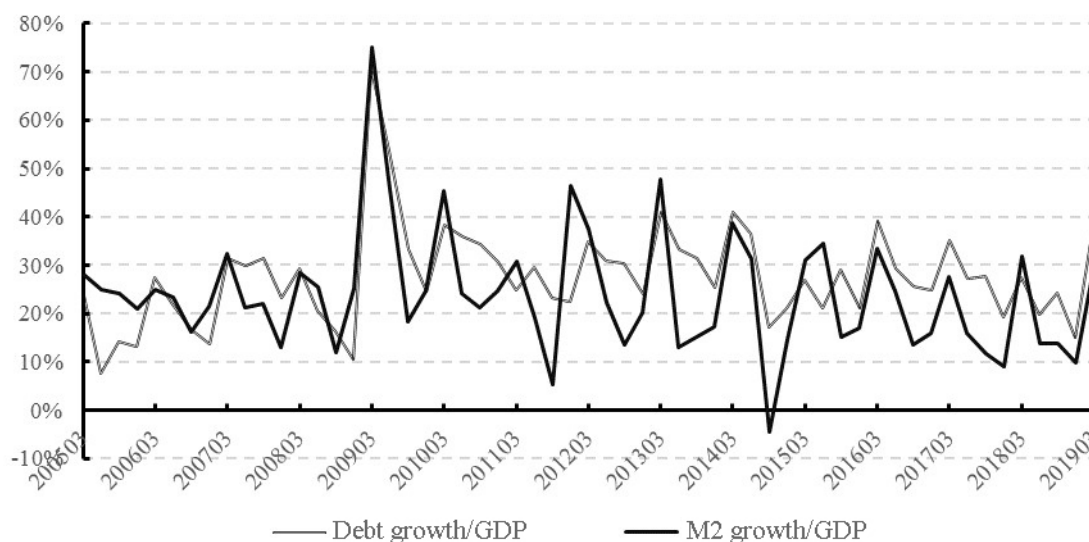


Figure 4: Debt and Money Growth as a Share in GDP (%)

Source: PBoC, NBS, Wind; the Center for National Balance Sheet of China (CNBC).

(3) Seasonal Factor

Rising leverage ratio in Q1 2019 is also attributable to the seasonal factor. Since 1995, China's first-quarter leverage ratios all tended to be higher than normal with the exception of 2000 and 2011 when intensive deleveraging operations were carried out. First, numerator factor: At the beginning of 2019, financial institutions usually have more funds and credit availability, resulting in a higher growth rate of loans during this period. Second, denominator factor: The first quarter coincides with the Chinese Spring Festival and has fewer workdays. Normally, the first-quarter GDP is between 21% to 22% of whole-year GDP.

III. Risk Analysis of Sectoral Leverage Ratios

In Q1 2019, China's overall leverage ratio increased primarily due to the rising leverage ratio of non-financial corporations. Household and government leverage ratios continued to increase by a small margin. Changes in sectoral leverage ratios demonstrate the following characteristics:

(1) Household Leverage Ratio Continues to Increase Rapidly

The upward trend of household leverage ratio persisted. In Q1 2019, household leverage ratio increased by 1.1 percentage points, up from 53.2% to 54.3%. Household leverage ratio rose by a total of 35.3 percentage points in 10 years from 2008 to 2018, up 3.5 percentage points on an annual average basis. Obviously, the increase of household leverage ratio in Q1 2019 is roughly consistent with average growth over the past 10 years.

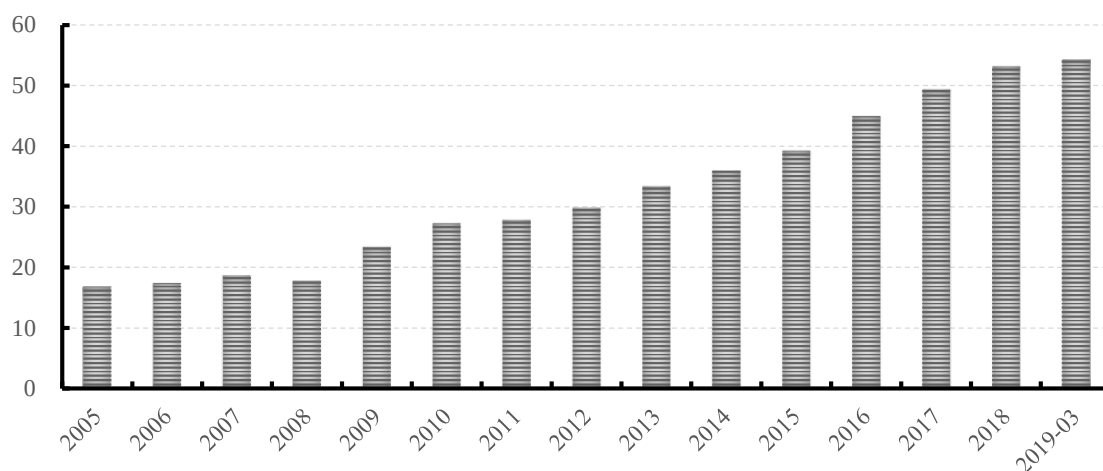


Figure 5: Household Leverage Ratio (%)

Source: PBoC, NBS, Wind; the Center for National Balance Sheet of China (CNBC).

In Q1 2019, the amount of household loans reached 49.7 trillion yuan, including long-term consumer loans worth 30.5 trillion yuan, which account for 61%, and short-term consumer loans worth 8.7 trillion yuan, which make up for 18%. Housing mortgage loans were the bulk of mid-and long-term consumer loans, totaling 25.8 trillion yuan by the end of 2018 and representing 54% of total household loans. YoY growth of household loans fell to 17.6%, down from 18.2% at the end of 2018. Specifically, the growth of short-term consumer loans decreased the most, down to 22.1% from 29.3% at the end of 2018. Growth of operating loans remained stable with a slight decrease from 12.3% at the end of 2018 to 12.2%. Growth of mid- and long-term loans rose to 18.2%, up from 17.3% at the end of 2018.

Despite slowing growth, short-term consumer loans remained a key driver of growth in the loan balance. Rising short-term consumer loans had positive significance as it reflects broader household access to banks' lending services, a manifestation of financial deepening. China's housing loan restrictions introduced in the wake of the housing boom in 2017 crowded out some housing loan demand to short-term consumer loans, causing the growth of short-term consumer loans to exceed 40%. This diversion prompted regulators to rein in consumer loans, which were used as house down payment, resulting in a substantial reduction in the growth of short-term consumer loans.

Nevertheless, risks from household short-term consumer loans still warranted great attention. First, short-term consumer loans were associated with higher default rates. Compared with personal loans and personal mortgage loans, credit card and consumer finance had higher NPL ratios, which may continue to rise in the future.

Second, such factors as the development of internet finance and retail banking will all cause short-term consumer loans to grow at a faster pace than overall household loans.

Third, younger-generation consumers had a greater propensity to borrow despite limited means for repayment. Such reckless desire to borrow found expression in the rampant growth of "campus loans" and "714 Missiles" - an online lending scheme that requires payment of the principal and interest in seven or 14 days and traps borrowers with skyrocket-high interest rates. Online microloans of such types all had extremely high NPL ratios. In addition, some short-term loans, especially microloans, still found their way into the housing and stock

markets, breeding risks that must be closely followed. In the context of financial supply-side structural reforms, measures should be taken on all fronts to prevent financial risks in the household sector. Regulators should not only keep high-interest-rate internet loans in check and prevent illegal lending but bolster the risk control capacity of formal financial institutions such as banks and reduce NPL ratios by developing big data and other financial infrastructures.

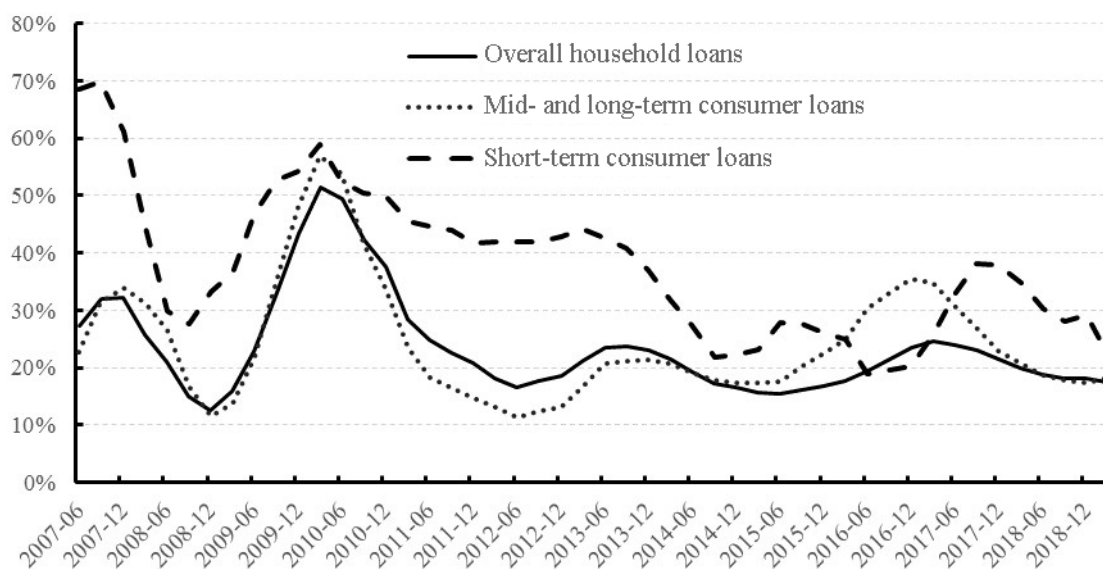


Figure 6: YoY Growth Rates of Household Sector Loans (%)

Source: PBoC, Wind; the Center for National Balance Sheet of China (CNBC).

New liabilities as a share in GDP have risen to a new level since 2016 largely due to the housing market boom. But under the effects of regulatory policy to curb excessive housing market speculation and a shift from monetary compensation for shantytown redevelopment, the growth of housing mortgage loans may slide, thus easing the rise of the household leverage ratio.

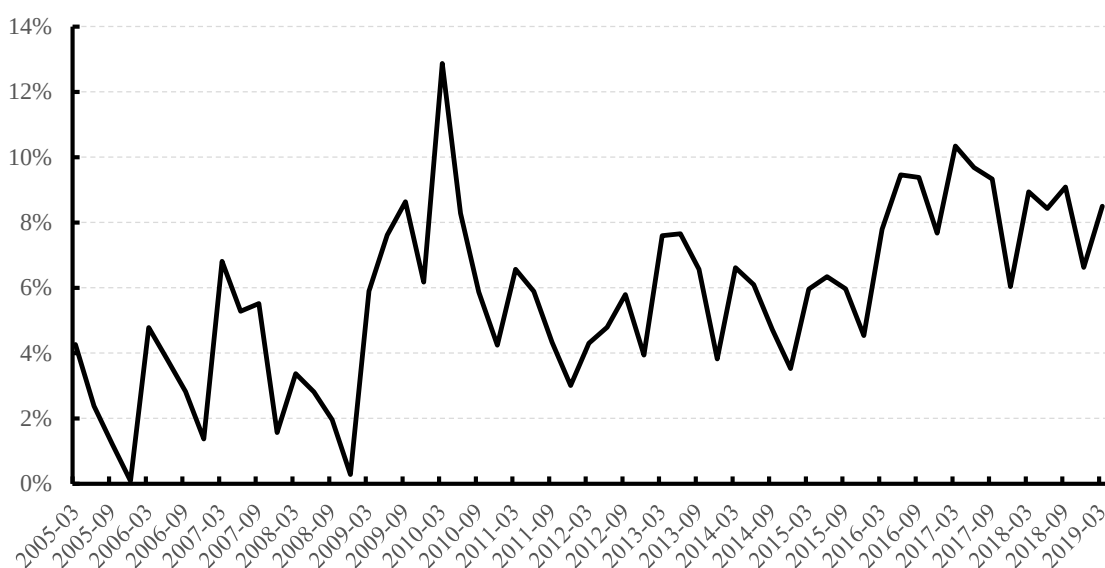


Figure 7: New Household Sector Liabilities/GDP

Source: PBoC, Wind; the Center for National Balance Sheet of China (CNBC).

(2) Leverage Ratio of Non-financial corporations Rebounds

The leverage ratio of non-financial corporations rebounded significantly from 153.6% to 156.9%, up 3.3 percentage points in a single quarter.

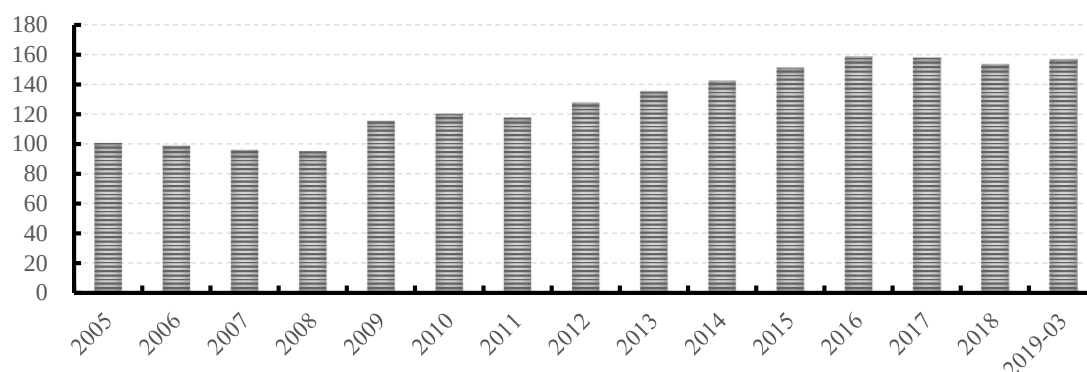


Figure 8: Leverage Ratio of Non-financial corporations (%)

Source: PBoC, NBS, Wind; the Center for National Balance Sheet of China (CNBC).

Judging by financing instruments, the rising leverage ratio of non-financial corporations was mainly attributable to the growth of loans, while shadow banking's financing instruments like trust loans, entrusted loans, and undiscounted bank acceptance bills were generally stable. Specifically, trust loans increased to 7.88 trillion yuan, up from 7.85 trillion yuan at the end of 2018; entrusted loans reduced from 12.36 trillion yuan to 12.15 trillion yuan; undiscounted bank acceptance bills rose from 3.81 trillion yuan to 4.01 trillion yuan. Their total amount reached 24.04 trillion yuan, slightly up from 24.02 trillion yuan at the end of 2018, with a share in GDP down from 26.7% to 26.2%. The balance of corporate liabilities increased from 20.13 trillion yuan at the end of 2018 to 20.79 trillion yuan, with a share in GDP up from 22.4% to 22.7%.

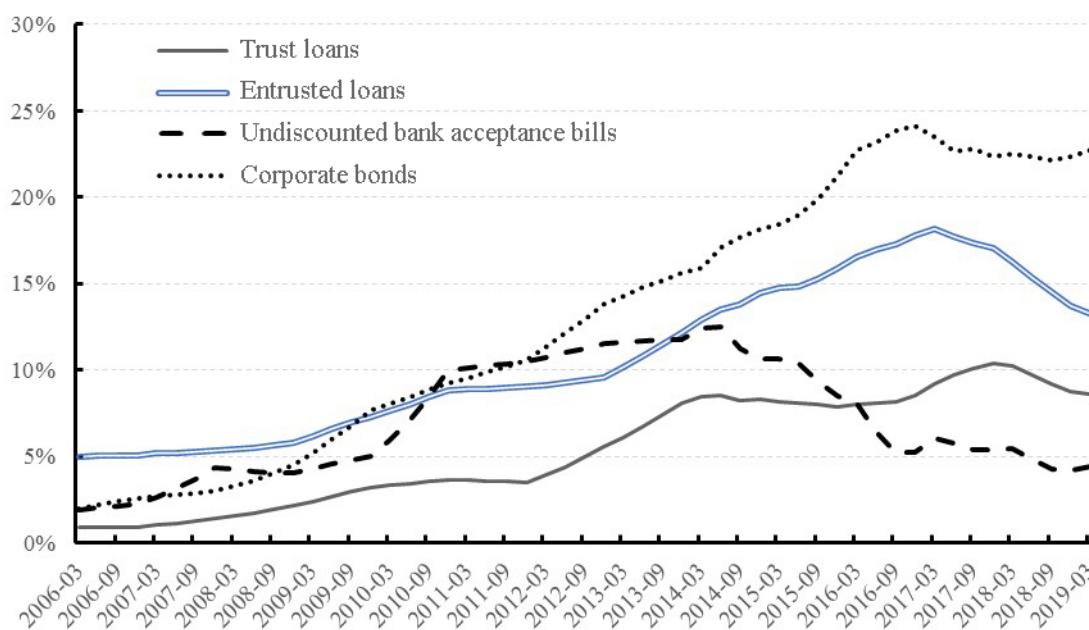


Figure 9: Balance of Non-Standard Financing by Various Types of Non-financial corporations as a Share in GDP

Source: PBoC, NBS, Wind; the Center for National Balance Sheet of China (CNBC).

Correspondingly, the balance of corporate loans acquired from banks grew by 17.6% YoY, and corporate loans as a share in GDP increased from 98.9% to 102.1% - a major contributor to the rising corporate leverage ratio. In the context of sluggish investment and consumption due to downward pressures on the economy, the easy credit environment in Q1 2019 allowed more loans to be issued to firms, which was highly necessary for stabilizing growth. As General Secretary Xi Jinping remarked in a speech on supply-side structural reforms in February, “healthy development of the real economy is the foundation for preventing and resolving risks. Importance should be attached to risk prevention on the basis of ensuring growth stability. We should enhance the countercyclical regulatory effects of fiscal and monetary policies to keep economic operation within a reasonable range, and persistently prevent and resolve risks through high-quality development.” In Q1 2019, credit supply to the corporate sector was intended to bring about a countercyclical regulatory effect of monetary policy to maintain a reasonable range of economic growth. In the period, China’s macroeconomic performance showed signs of recovery on both demand and supply sides.

Corporate bond defaults still occurred frequently. By April 2019, a total of 58 corporate bonds had defaulted, involving funds worth 35.95 billion yuan. In 2018, a total of 125 corporate bonds had defaulted, involving funds worth 120.96 billion yuan. In comparison, the total amount of defaulting bonds over the 2015-2017 period only reached 84.6 billion yuan. Since 2018, corporate credit bond defaults had culminated and in Q1 2019 continued unabated. As China’s macroeconomic performance stabilizes and easing credit contraction unleashes more liquidity, the impact on the probability of corporate bond defaults is expected to be neutral. Yet the occurrence of bond market defaults currently remains limited, and with the removal of implicit guarantee, bond defaults will become normalized.

New liabilities of non-financial corporations as a share in GDP had been around 20% since 2010. In 2018, the new liabilities of non-financial corporations as a share in GDP were rather limited - an indication of effective deleveraging operations. The rebound in Q1 2019 can be seen as compensation for the shortfall of new liabilities in the previous year. Overall, the direction of structural deleveraging had experienced no fundamental shift.

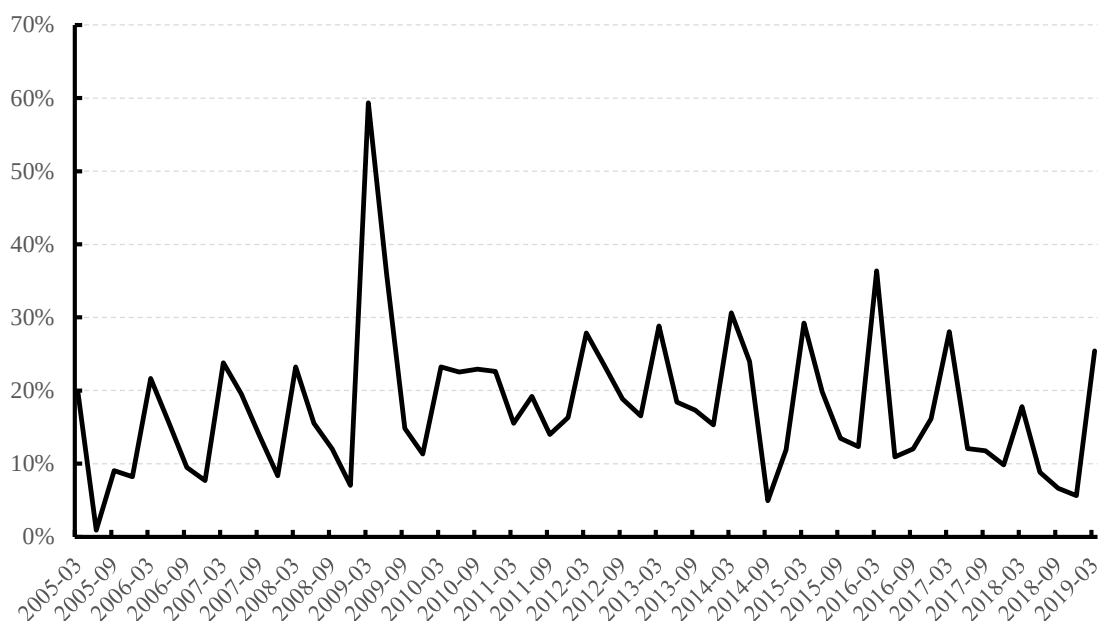


Figure 10: New Liabilities of Non-financial corporations/GDP

Source: PBoC, Wind; the Center for National Balance Sheet of China (CNBC).

Divergence in the leverage ratios of SOEs and private enterprises still persisted. The debt-to-assets ratio of SOEs fell from 64.7% at the end of 2018 to 64.4% at the end of Q1 2019, and the debt-to-assets ratio of industrial enterprises which mainly comprise private enterprises went up from 56.5% to 57.0% (SOEs account for 40% of the total assets and liabilities of industrial enterprises, as well as some 25% of their business revenues)

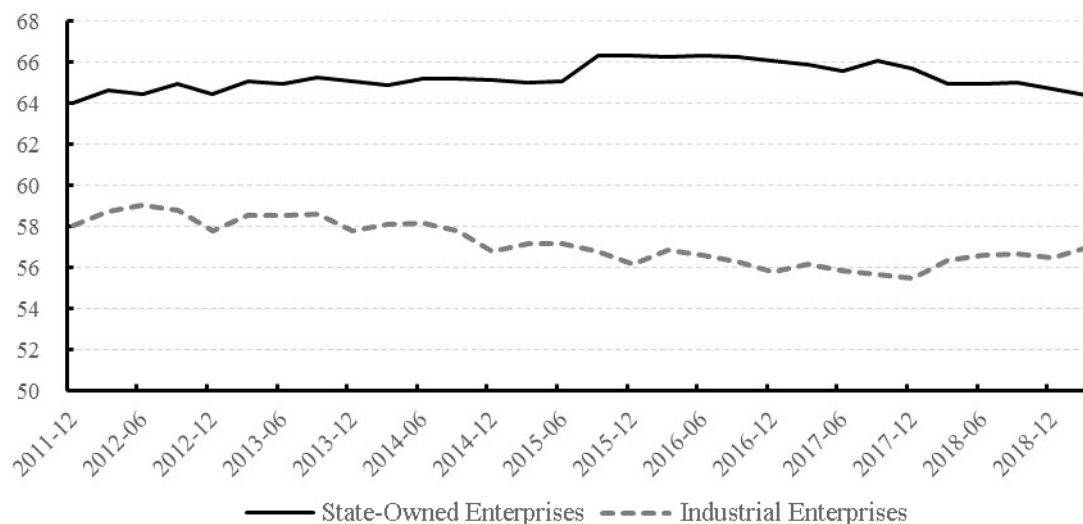


Figure 11: Debt-to-Assets Ratios of State-Owned Enterprises and Industrial Enterprises (%)

Source: NBS, the Ministry of Finance, Wind; the Center for National Balance Sheet of China (CNBC).

From liability perspective alone, SOE liabilities as a share in the total liabilities of non-financial corporations further increased to 68.2%, up from 66.9% at the end of 2018. In Q1 2019, SOE liabilities increased by 15.0% YoY, and those of industrial enterprise, most of which are privately owned, only moved up by 5.6%. This contrast led to a rising share of SOE liabilities.

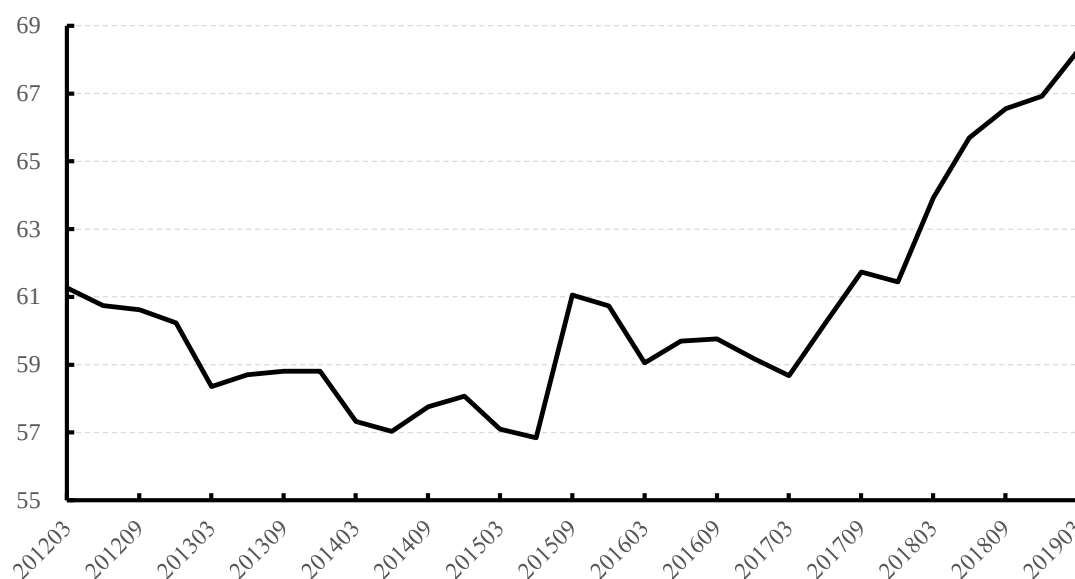


Figure 12: SOEs' Liabilities as a Share in Total Liabilities of Non-financial corporations (%)

Source: PBoC, the Ministry of Finance, Wind; the Center for National Balance Sheet of China (CNBC).

Since 2017, SOE liabilities had represented a growing share in the total liabilities of non-financial corporations. This change was initially related to the reduction of corporate overcapacity, which required obsolete productions to exit the market, and private enterprises accounted for a significant share of those obsolete productions. After 2018, the rising share of SOE liabilities was partly due to tightened financial regulation, resulting in a contraction in the overall credit environment that mostly affected private enterprises. Both assets and liabilities of private enterprises grew at a much slower pace compared with those of SOEs. This trend warrants great attention. The central government called for extending financial support to private enterprises, making access to finance for SMEs easier and less costly, and promoting supply-side financial structural reforms. Indeed, we may notice that the growth of non-SOE liabilities started to pick up. However, SOE liabilities continued to grow rapidly, up around 15% YoY in Q1 2019 - higher than that of private enterprises and nominal GDP growth during the same period. Rapid rise of SOE liabilities is a chief reason for the increasing leverage ratio of non-financial corporations.

(3) Local Government Leverage Ratio Spikes due to Bond Issuance ahead of time

In Q1 2019, Central government leverage ratio dropped to 16.2%, down 0.3 percentage points from 16.5% at the end of 2018. Local government leverage ratio increased to 21.4%, up one percentage point from 20.4% at the end of 2018. Overall government leverage ratio rose to 37.7%, up 0.7 percentage points from 37.0%.

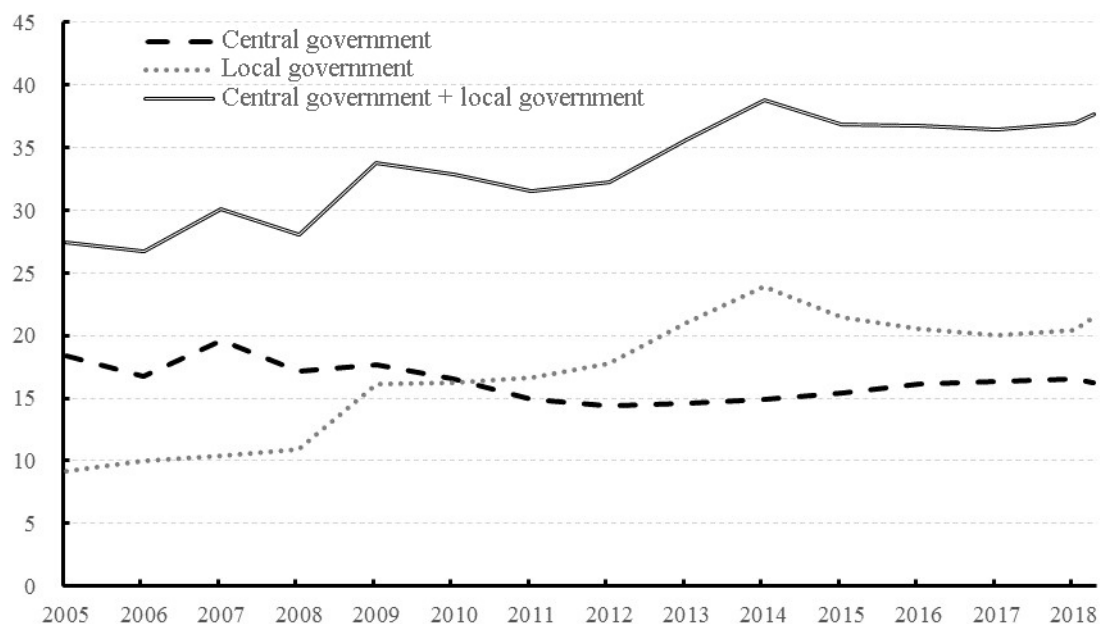


Figure 13: Government Leverage Ratio

Source: PBoC, NBS, the Ministry of Finance, Wind; the Center for National Balance Sheet of China (CNBC).

To stabilize growth and promote infrastructure investment, local governments issued bonds intensively in Q1 2019. Local governments issued local government bonds worth 1,184.7 billion yuan then (including general bonds worth 518.7 billion yuan and special bonds worth 666 billion yuan), which were equivalent to 85% of the limit of new local government liabilities for 2019 set at the end of 2018, or 38% of the limit of new local government liabilities for 2019 as determined during China's annual legislative sessions. Moreover, China issued local government swap bonds worth 221.9 billion yuan (including general bonds worth 170.8 billion

yuan and special bonds worth 51.1 billion yuan). In Q1 2019, the issuance of local government bonds totaled 1,406.6 billion yuan, up 1.85 times on a quarterly basis or 4.41 times YoY. The balance of local government bonds increased from 18.1 trillion yuan to 19.3 trillion yuan, up 7% in the quarter. Meanwhile, treasury bonds and urban construction investment bonds increased by 0% and 4% respectively. In 2017, local government bonds surpassed treasury bonds in size, becoming the biggest product in the bond market, and the gap between the two further widened.

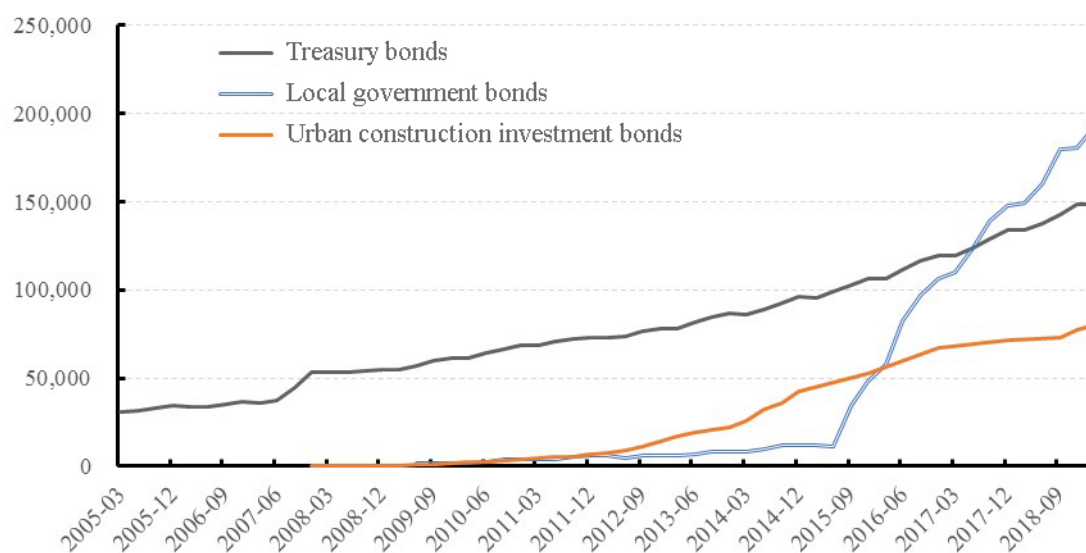


Figure 14: Size of Government Bonds (in 100 million yuan)

Source: Wind; the Center for National Balance Sheet of China (CNBC).

Thanks to the proactive fiscal policy and relaxed monetary policy, the issuance of urban construction investment bonds in Q1 2019 continued the growth trend since Q4 2018. The stock of urban construction investment bonds expanded from 7.7 trillion yuan to 8.0 trillion yuan, up 300 billion yuan or 4% on a quarterly basis. In comparison, urban construction investment bonds increased by less than 500 billion yuan in the whole year of 2018. Obviously, the policy option to stabilize growth was to relax regulation on local government implicit liabilities. After policies on local government financing vehicles tightened in 2018, such policies then became marginally relaxed. Relaxed financing constraint assured an adequate source of loans for local government financing vehicles (LGFVs), strengthening the financing function of urban construction investment bonds. Overall interest rate level and credit spread became restored to some extent.

Judging by the expenditure of government funds, China's infrastructure investment growth somewhat recovered in Q1 2019. According to our estimate, about 15% of infrastructure construction funds were budgetary funds, and some 5% was from government funds (mainly local government land sales revenues). The remainder was from private capital. Such private capital more or less involves local government implicit liabilities and either had priority compensation under PPP, formed investment under LGFVs, or even contained funds with an implicit local government guarantee. In 2018, local government finance came under closer scrutiny; a lifelong accountability system for local government officials was implemented; shadow banks saw a sudden contraction in their financing channels. These factors throttled private capital sources for infrastructure investment. In 2018, infrastructure investments only grew by 1.8%, and infrastructure investments excluding electric power increased by 3.8%. In Q1 2019, the growth rates of these two types of investment recovered to reach 3.0% and 4.4% respectively.

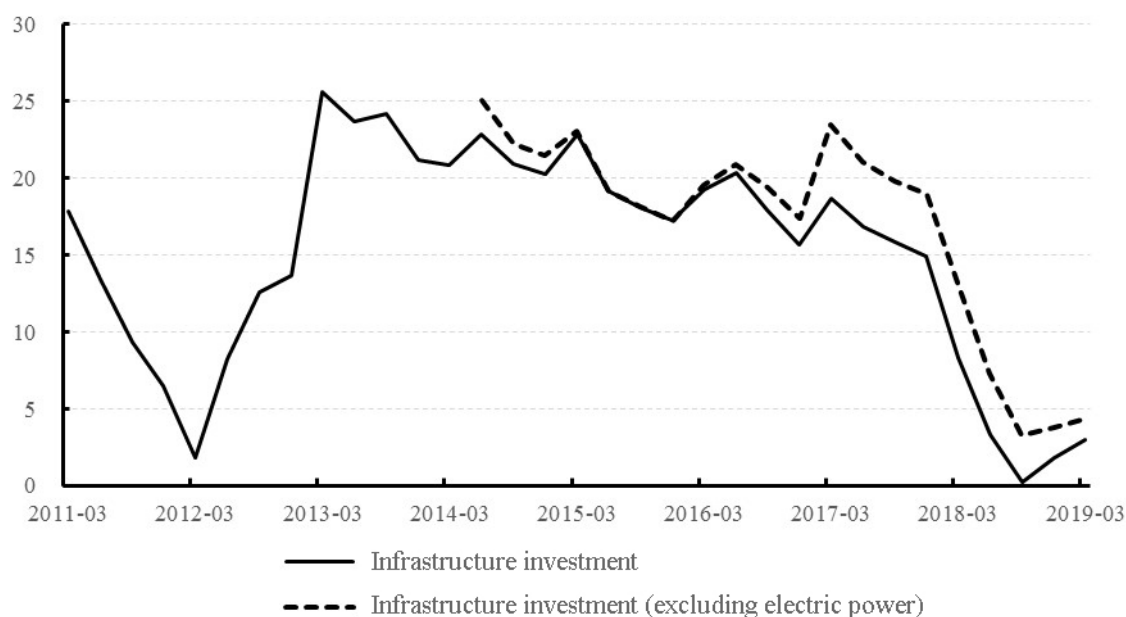


Figure 15: YoY Growth of Fixed Asset Investments (%)

Source: NBS, Wind; the Center for National Balance Sheet of China (CNBC).

Another important dimension for assessing the government sector is government-held financial assets. Figure 16 shows the government leverage ratio (government debts/GDP) and government bank deposits/GDP since 2015. Despite some increases of government leverage ratio over the past decade from 27% to 37%, the depository financial assets held by the government sector have increased at a faster pace from 10% to 36%. Growth of explicit government liabilities is significantly outstripped by growth in government depository assets, which indirectly explains the partial reason for the rising leverage ratio, i.e. some assets are deposited in government accounts and unspent. Otherwise, cash spending would have increased demand and propelled nominal GDP growth.

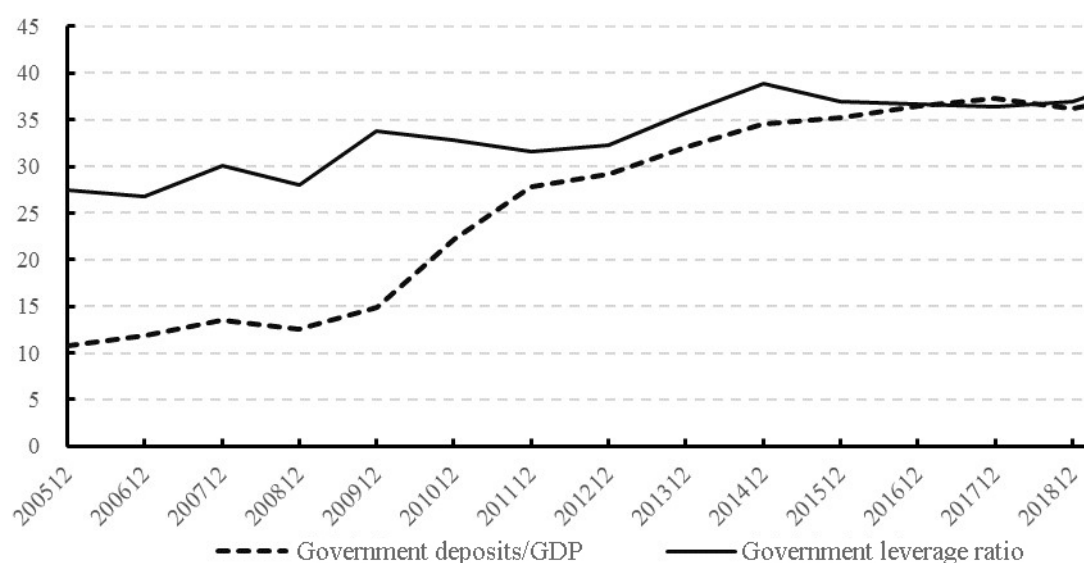


Figure 16: Comparison of Government Sector Liabilities and Assets (%)

Source: PBoC, the Ministry of Finance, Wind; the Center for National Balance Sheet of China (CNBC).

Under the downward pressures on China's economy, we believe that the government sector needs to take further actions. (1) On the liability side, the government should continue to make its implicit liabilities explicit. The central government should issue bonds, which are relatively cheap and long-term funds, to swap the stock of its implicit liabilities. (2) On the asset side, the government should further activate the stock of government funds by accelerating the circulation of public finance and funds held by government institutions. Government spending should be appropriately increased to compensate for the expected export slump. Given the limited fiscal budget deficit and unlikely prospect for an expansion of local government special bonds, the second option appears particularly important. By the end of Q1, China's fiscal deposits amounted to 4.2 trillion yuan, and deposits of government institutions reached 29.3 trillion, combined to be 33.5 trillion yuan, or 36.6% of China's nominal GDP. This account offers a great space of maneuver. It may increase the total demand of the private economy through government procurement, as well as infrastructure investment, and thus boost total demand.

(4) Financial Sector Continued to Shrink the Balance Sheet with Falling Leverage Ratio

The financial sector's leverage ratio depicts the internal asset-liability relationship of the financial sector. It is a reflection of the financial sector's operational efficiency. In Q1 2019, from the asset side, the financial sector's leverage ratio reduced to 60.54%, down 0.1 percentage point from 60.64% at the end of 2018. From the liability side, the financial sector's leverage ratio decreased to 59.42%, down 1.5 percentage points from 60.94% at the end of 2017. Financial leverage ratio continued to decline, and the off-balance-sheet businesses of banks significantly shrank.

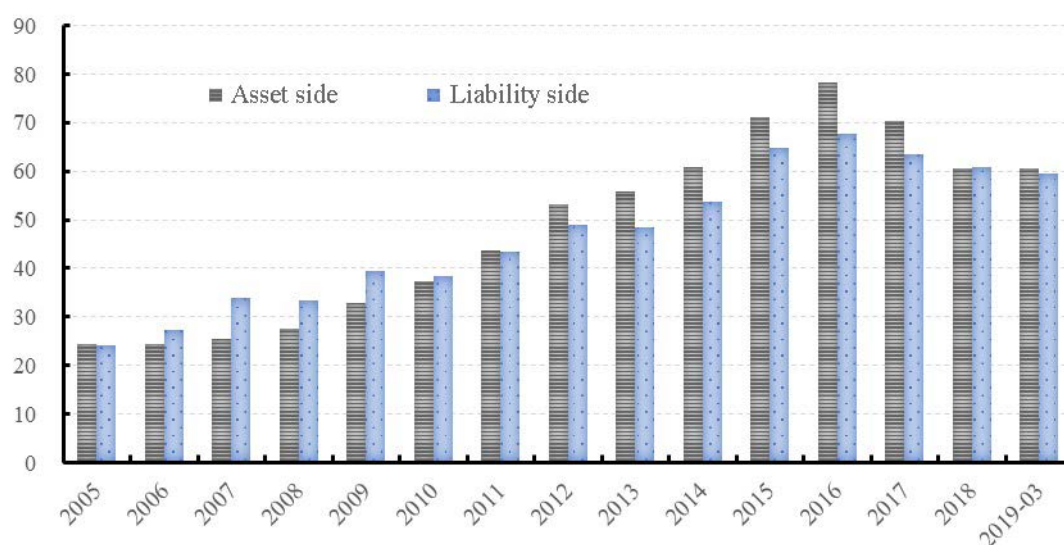


Figure 17: Financial Sector Leverage Ratio by the Broad Scope (%)

Source: PBoC, NBS, Wind; the Center for National Balance Sheet of China (CNBC).

In Q1 2019, the total assets of commercial banks grew by 8.2% YoY, which is higher compared with the previous year, but the increase mainly stemmed from a rise in bank loans. Interbank assets as a share in total assets fell from 20.5% to 20.2%, which is the level of 2012. We believe that financial deleveraging then was essentially not at odds with economic growth. While a falling financial leverage ratio may cause some frictional cost in the short run and deprive some real economy sectors of sufficient credit support, such problems can be remedied through internal adjustments of the financial system. A key purpose of the financial sector

deleveraging is to remove and downsize channel business. It is an important way to divert funds from the virtual economy to the real economy and should be carried out continuously. In cleaning up shadow banks, a balance has to be struck between financial innovation and financial risks. All businesses, no matter on or off balance sheet, are necessary supplements to the financial markets as long as they operate in compliance of laws and regulations.

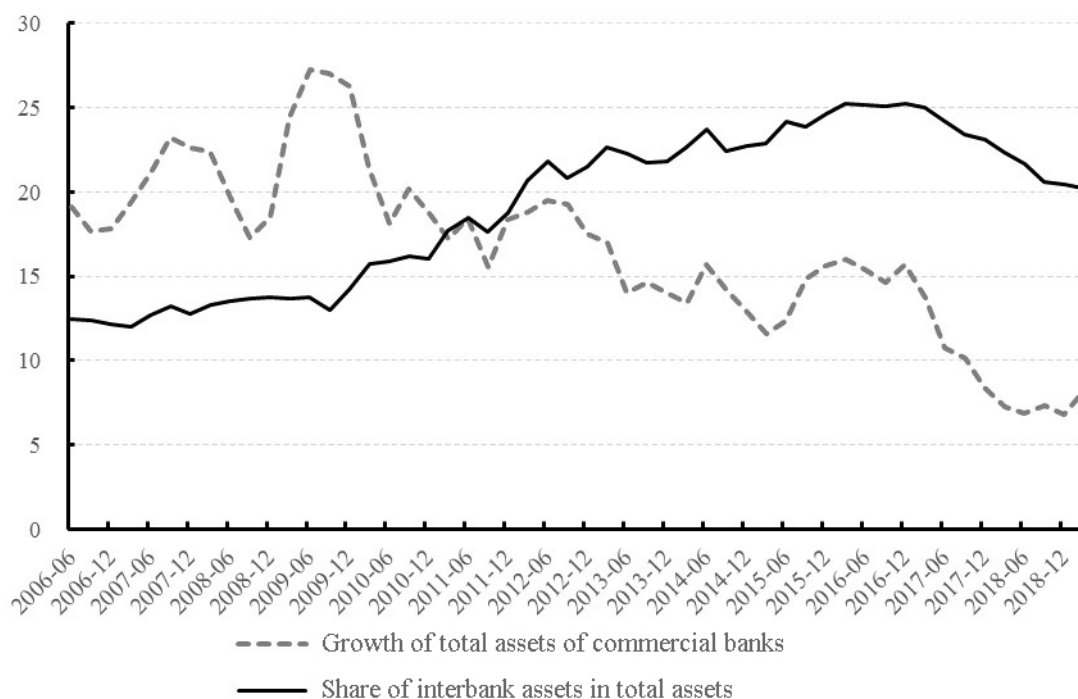


Figure 18: Growth in the Total Assets of Commercial Banks and Share of Interbank Assets (%)

Source: PBoC, Wind; the Center for National Balance Sheet of China (CNBC).

IV. Adhere to Structural Deleveraging and Focus on Institutional Factors

The significant increase of China's macro leverage ratio in Q1 2019 is attributable to a shift of policy focus toward growth stability and the implementation of countercyclical macroeconomic regulation. Apart from the seasonal factor, the denominator reason is a slowdown in China's nominal GDP growth, and the numerator reason is an acceleration in the growth of bank loans. In the future, we believe that China should continue to carry out structural deleveraging as a basic direction and strike a delicate balance between steady growth and a sound leverage ratio.

(1) Balancing Growth and Leverage Ratio Poses Challenge to Policymaking

Steady growth helps maintain a stable leverage ratio, especially when nominal GDP growth is able to maintain a high level. Yet economic growth is more often at odds with the need to stabilize leverage ratio. When the economy is facing internal and external shocks - not least the uncertainties from an escalating China-U.S. trade war - and growing downward pressures on economy, leverage ratio has to be increased in order to shore up growth. Therefore, striking a delicate balance between the two presents a test to policymakers.

China's credit growth in Q1 2019 is a manifestation of its countercyclical regulation. As the economy stabilizes, the intensity of countercyclical regulation once showed signs of marginal adjustment. Given the weakening macroeconomic situation and particularly the significant uncertainties from China-U.S. trade frictions, there is a tendency for the neutral policy to ease again. Restrictions on interbank market funds have been once again relaxed, and leveraged arbitrage has made a comeback. Reversals in policy stimulus have led to volatility in leverage ratio and disrupted market expectations on the structural deleveraging policy, which makes it harder to achieve the policy goal to keep leverage ratio in check and prevent financial risks.

(2) Adhere to Structural Deleveraging

Despite rising government explicit and implicit leverage ratios and recovery in infrastructure investment, such improvements have so far been limited. The government leverage ratio is limited by the 2.8% general public budget deficit ratio and the ceiling of government liabilities (general and special liabilities). Even if the government fiscal deficits in the broad sense, such as government funds, are included, government expenditures are insufficient to cover the gaps caused by the management of implicit liabilities. We believe that structural deleveraging under the premise of stable economic growth still requires an appropriate increase of central government leverage ratio, activation of government funds in stock, effective control of risks from local government liabilities, the vigorous development of the local government bond market, and continued revelation of local government implicit liabilities. Moreover, local government implicit liabilities should continue to be disposed of through asset securitization in accordance with the market-based principles and the rule of law. Asset securitization is an important way of market-based risk sharing to prevent all risks from concentrating on the government (public finance) sector.

(3) Focus on the Institutional Factors

The significant rebound of China's leverage ratio in Q1 2019 mainly stemmed from a sharp rise in the corporate leverage ratio. But the question is: Are businesses the real culprit? If we decompose the corporate leverage ratio, more than 60% (68.2% in Q1 2019) of corporate liabilities are SOE liabilities, and LGFVs account for more than half of SOE liabilities. That is to say, a significant portion of the 160% corporate average ratio is directly linked to SOEs and local governments. To curb rising liabilities, the key is to balance the government-market relationship. Over the past four or even seven decades, China's central government has assumed implicit guarantee obligations in mobilizing resources to develop the economy. In this manner, it has assumed all development risks. This development model is the recipe for China's economic catch-up. Today, whether the government still has the capability to propel economic development by assuming all the risks is a major question facing China's policymakers. From this perspective, if we are to prevent and resolve risks from the rising leverage ratio, the most important solution is to solve the institutional problems facing SOEs and local governments. The central government initiatives to institutionally curb the leverage ratios of SOEs and governments play an important role in tightening constraints, abolishing guaranteed return, and diminishing implicit government guarantee, and such reform endeavors should not be scrapped when policy priority shifts to growth stability.