Quarterly Report on China's Deleveraging (Q1 2018)

Centre for National Balance Sheetss

National Institution for Finance & Development

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I. Overall Leverage Ratio Slightly Increased with Significant Progress in Structural Deleveraging

Although the Chinese government announced the deleveraging goal in October 2015, China's overall leverage ratio did not abate until 2017, when the leverage ratio only increased by 2.3 percentage points. This growth rate has reduced substantially compared with the annual average growth rate of 12.3 percentage points since the eruption of the global financial crisis. Q1 2018 marked a good beginning for China's deleveraging process. Despite a slight increase in overall leverage ratio, structural deleveraging made significant progress.

First, overall real-economy leverage ratio slightly increased. In Q1 2018, the real-economy leverage ratio encompassing the household sector, non-financial enterprises and the government sector increased to 243.7%, up 1.6 percentage points from 242.1% at the end of 2017. The uptrend was relatively stable. The leverage ratios of the household sector and non-financial enterprises both increased: Compared with the end of 2017, household sector leverage ratio increased by 1.0 percentage point, and the leverage ratio of non-financial enterprises rose by 1.2 percentage points. The leverage ratio variations of various sectors are shown in Figure 1.

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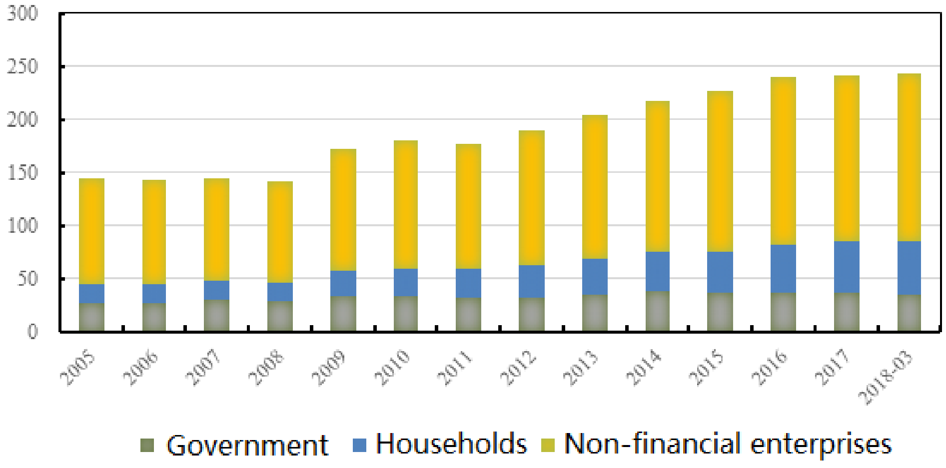

Figure 1 Real-Economy Leverage Ratio and Distribution (%)

Source: PBoC, NBS, the Ministry of Finance, Wind; CNBS.

Continued progress was made in structural deleveraging. Government sector leverage ratio reduced from 36.2% to 35.5%, down 0.6 percentage points. Financial sector leverage ratio kept falling. Financial sector leverage ratio reduced from both asset and liability sides. Measured from asset side, financial sector leverage ratio dropped to 66.8%, down from 69.7% in 2017. Measured from liability side, it reduced from 62.9% to 61.7%, as shown in Figure 2. The reduction measured from asset side is more significant, but the gap between asset side and liability side measurements further narrowed.

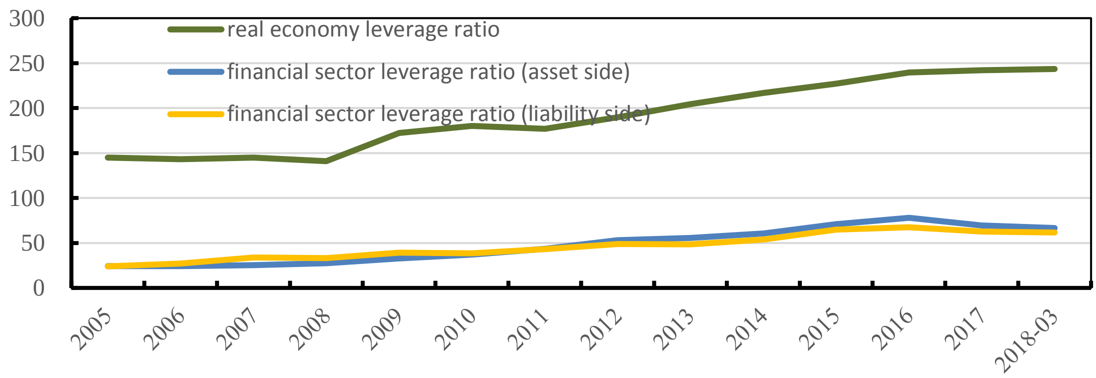

Figure 2 Real-Economy Leverage Ratio and Financial Sector Leverage Ratio (%)

Source: PBoC, NBS, the Ministry of Finance, Wind; CNBS.

II. Sector-Specific Leverage Ratio Risk Analysis

(1) Rapid increase in household leverage ratio abated, and emerging structural deposits boosted solvency

Rapid increase in household sector leverage ratio abated. Household sector leverage ratio increased from 49.0% at the end of 2017 to 50.0% in Q1 2018, up 1.0 percentage point, as shown in Figure 3.

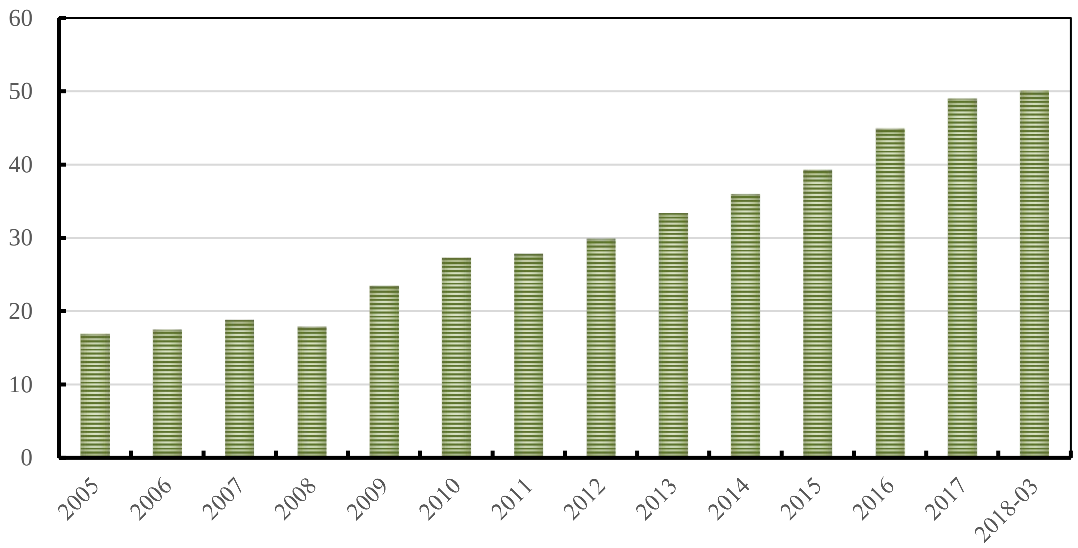

Figure 3 Household Sector Leverage Ratio (%)

Source: PBoC, NBS, Wind; CNBS.

By the end of Q1 2018, China's household sector loan balance stood at 42.3 trillion yuan, up 20.0% YoY - the growth rate remained on the decline. Growth of short-term consumer loans slowed to 34.9%, and growth of mid-and long-term consumer loans slowed to 20.6%. The turning point in the growth of household loans occurred in February 2017 at the height of China's real estate market boom, which was followed by house purchase and loan restrictions introduced at various localities. Tight house loan restrictions led to a reversal in the growth of house loans. Meanwhile, short-term loans started to replace mid-and long-term house loans. From less than 20% in January 2017, household short-term consumer loans rapidly increased, peaking at over 40% in Q4 2017. Regulators have attached great importance to the spike in short-term loans, promptly enhanced supervision on short-term household consumer loans, and curbed the trend of households using short-term loans to support house purchase. In 2018, this problem started to abate. By the end of Q1, the growth rate of short-term consumer loans reduced by six percentage points from the height at the end of October 2017, as shown in

Figure 4.

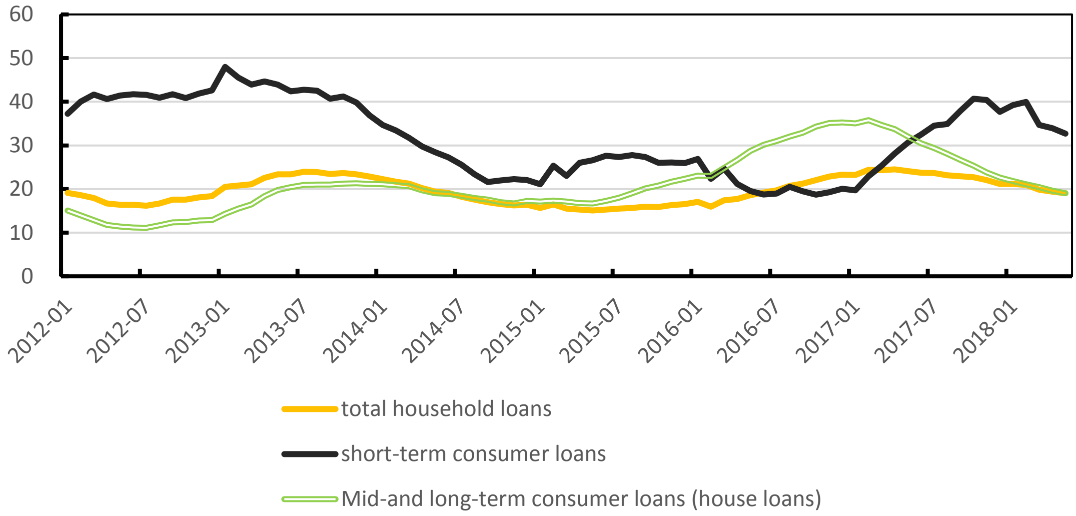

Figure 4 YoY Growth Rates of Household Sector Loans (%)

Source: PBoC, Wind; CNBS.

We should take note of the rapid increase in household structural deposits that may present solvency problems. Structural deposits generally take the form of "traditional deposit + embedded option derivatives (interest rate, exchange rate, etc.)". In addition to the basic fixed return, depositors may also enjoy high investment return provided that they accept certain risks, forming a "low risk and low return + high risk and high return" asset portfolio. According to the *Credit Income and Expenditure Statistics for Financial Institutions* released by China's central bank, there has been a robust growth in the structural deposits of Chinese nationwide banks since 2H 2017, up from nearly zero growth prior to February 2017 to about 50% growth in March 2018. In the first three months, China's structural deposits increased by 1.84 trillion yuan, which surpassed the increase of 1.8 trillion yuan for the whole year of 2017. Personal structural deposits grew at a faster pace, reaching 60% at the end of March 2018, and this figure was 75% for small and medium-sized banks. An important reason for the spike in structural loans is that enhanced regulation created great pressures on the liability side of banks, forcing them to develop new debt instruments to substitute their on-balance-sheet capital-guaranteed investment products. In addition, the development of Internet finance and money funds also posed a challenge to banks in attracting personal deposits. As evidenced in the above changes in the financial asset structure of household deposits after the tightening of asset management regulation, household balance sheet remains robust and the foundation for household solvency remains as strong as ever.

(2) SOE debt to assets ratio reduced, but debt to income ratio remains high

Leverage ratio of non-financial enterprises increased from 156.9% by the end of 2017 to 158.2% by the end of Q1 2018, up 1.2 percentage points, as shown in Figure 5. Corporate bank loans and debt financing grew rapidly on a QoQ basis, and so did corporate external debts.

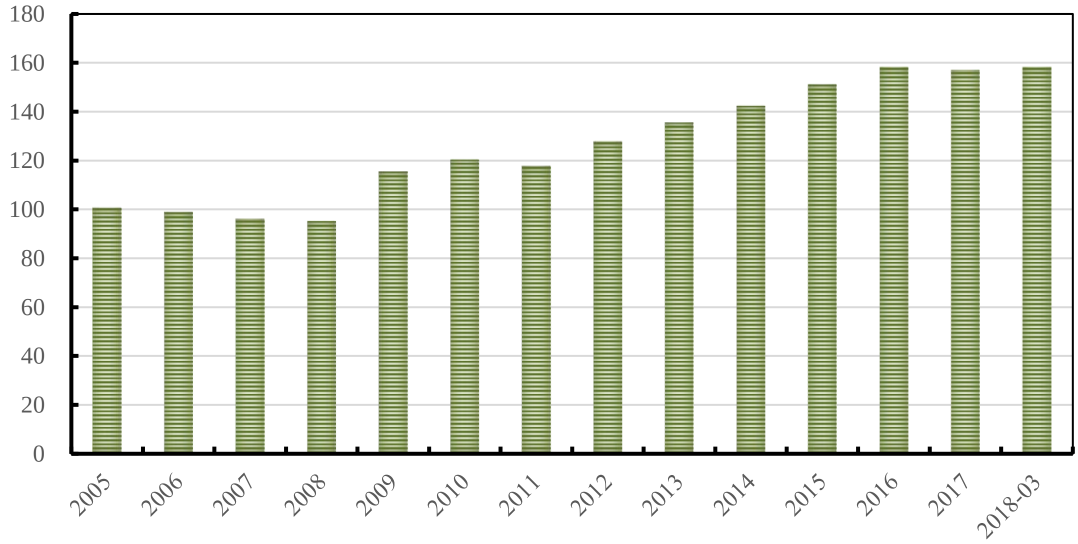

Figure 5 Leverage Ratio of Non-Financial Enterprises (%)

Source: PBoC, NBS, Wind; CNBS.

Bank loans account for a lion's share of the liabilities of non-financial enterprises. By the end of Q1 2018, the balance of bank loans amounted to 84.1 trillion yuan, up 8.9%. Compared with the QoQ growth of 3.8% in December 2017, the growth of corporate loans picked up speed - an indication that the off-balance-sheet assets of banks continued to be converted into on-balance-sheet assets. Balance of corporate liabilities reached 18.9 trillion yuan, up 5.6% YoY or 2.7% QoQ. In the first two quarters of 2017, corporate bond financing posted negative values. However, this trend started to abate since the second half of 2017. In Q1 of this year, corporate bond financing rebounded to 537.1 billion yuan, as shown in Figure 6. This has also led to an increase in the leverage ratio of non-financial enterprises.

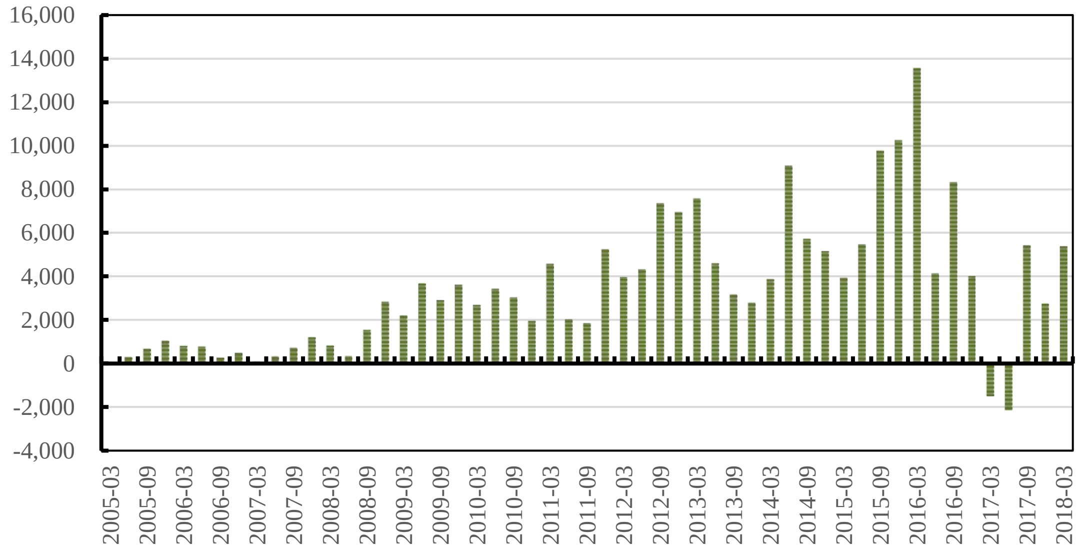

Figure 6 Bond Financing for Non-Financial Enterprises (100 Million Yuan)

Source: PBoC, Wind; CNBS.

Judging by investment structure, we are more optimistic about China's future economic outlook. Given the stable investment in Q1, the growth rate of private fixed asset investment increased. In the first three months, the cumulative YoY growth of private fixed asset investment in China reached 8.9%, the highest since 2016. Booming private investment also caused non-financial enterprises to increase leverage.

Increase in the leverage ratio of non-financial enterprises may also be manifested in the debt to assets ratio of industrial enterprises. By the end of Q1, the debt to assets ratio of industrial enterprises bottomed out, recovering from 55.5% at the end of 2017 to 56.4%. This trend is consistent with the recovery of private investment growth. Meanwhile, the debt to assets ratio of SOEs declined more significantly, down from 65.7% at the end of the previous year to 65.0%, as shown in Figure 7.

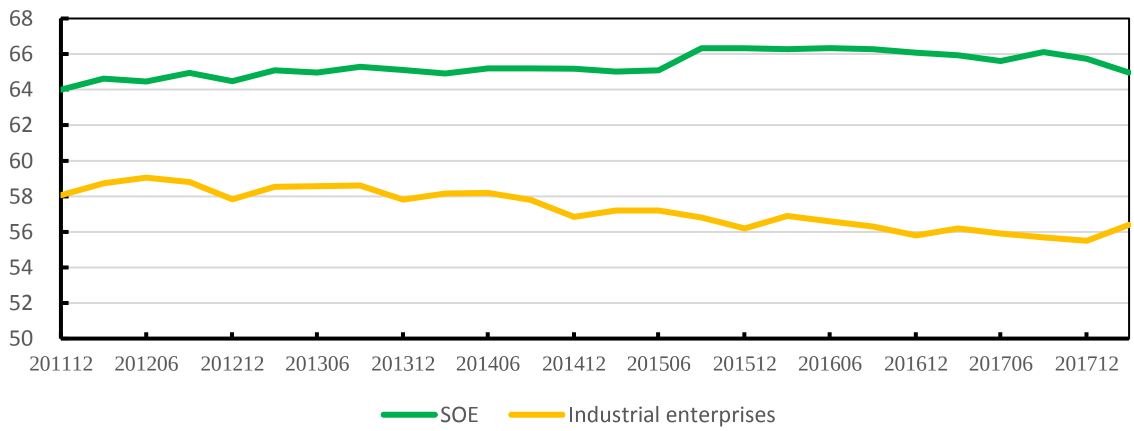

Figure 7 Debt to Assets Ratios of State-Owned Industrial Enterprises and Non-State-Owned Industrial Enterprises (%)

Source: NBS, the Ministry of Finance, Wind; CNBS.

Despite falling debt to assets ratio, SOE liabilities remain significant on absolute terms. SOE liabilities as a share in GDP reached 126.0% at the end of Q1 2018, and the uptrend is continuing. Obviously, the more rapid increase in assets, rather than the reduction of liabilities, served as a key driver of falling SOE debt to assets ratio. While the ratio between total liabilities and operating revenues remained as high as 199.1% for SOEs, this ratio was only 52.9% for industrial enterprises, as shown in Figure 8. As far as solvency is concerned, therefore, SOE debt risks cannot be overlooked, and SOE deleveraging will continue to be a priority of deleveraging operations for non-financial enterprises.

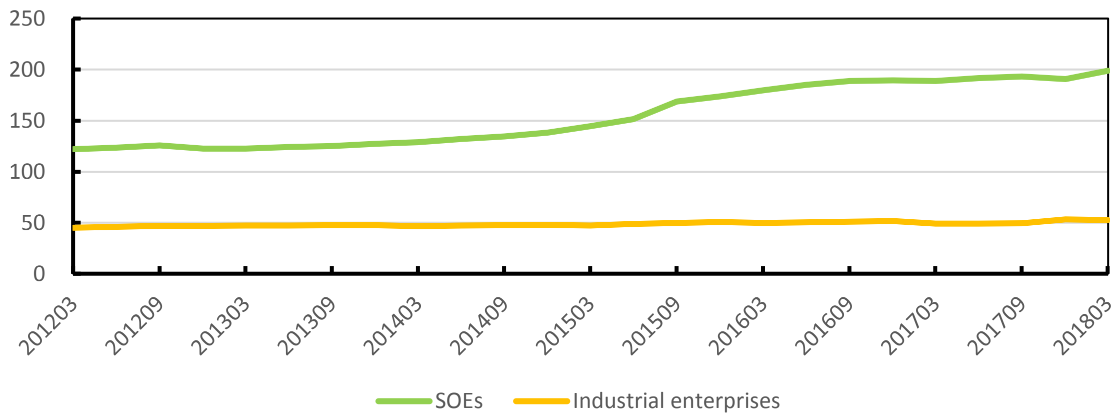

Figure 8 Ratio between Total Liabilities and Operating Revenue for SOEs and Industrial Enterprises (%)

Source: NBS, the Ministry of Finance, Wind; CNBS.

China's vigorous deleveraging operations and rising domestic bond market interest rates in 2017 led to an accelerated growth in the issuance of corporate external bonds. For the whole year, the USD bond issuance by Chinese companies in the international bond market increased by about 80% YoY - such an increase was largely driven by city investment enterprises. In 2018, growth in the issuance of overseas urban construction investment bonds showed signs of further acceleration. We have identified a fairly rapid increase in the growth of external financing for enterprises in Q1 based on the structured data of corporate bond holders from China Central Depository & Clearing Co., Ltd. (CCDC) and Shanghai Clearing House, as well as the foreign debt data of some listed companies. Considering that the external exposure of credit risks may increase, the State Administration of Foreign Exchange (SAFE) has enhanced oversight on the borrowing of foreign debts in key sectors. At the release of Q1 foreign exchange income and expenditure data, the SAFE stressed that "unless otherwise stipulated, no real estate enterprise or local government financing platforms may raise foreign debts". Subsequently, the NDRC and the Ministry of Finance jointly released the *Notice on Improving Market Restraint and Preventing Foreign Debt Risks and Local Debt Risks*, and made it more difficult for local government financing platforms to continue issuing overseas bonds. With the impediments to their financing channels, the financing platform companies may find it difficult to extend existing debts and borrow new loans to repay old ones. This may lead to insufficient liquidity for bond repayment, which warrants attention.

(3) Government leverage ratio reduced on a quarterly basis, and slowing investment growth posed a test to the determination for deleveraging operations

China's overall government leverage ratio fell from 36.2% to 35.5%, down 0.6 percentage points in total. Specifically: Central government leverage ratio reduced to 15.9%, down 0.3 percentage points from 16.2% at the end of 2017. Local government leverage ratio decreased to 19.6%, down 0.3 percentage points from 19.9% at the end of 2017, as shown in Figure 9.

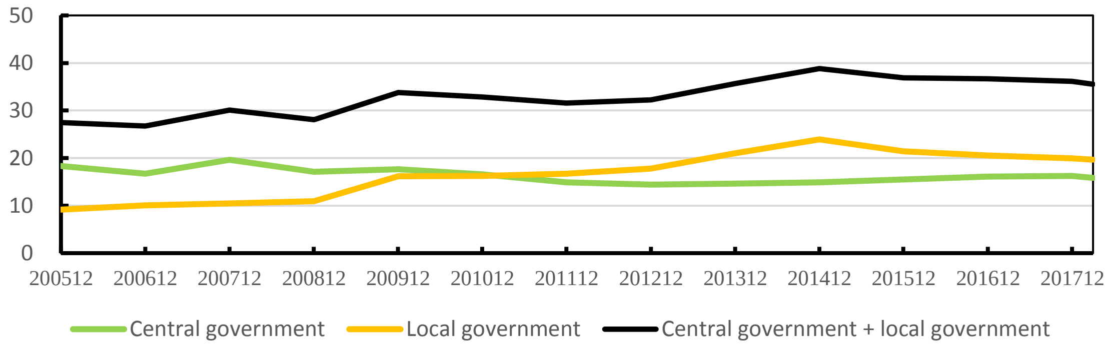

Figure 9 of Government Leverage Ratio (%)

Source: PBoC, NBS, the Ministry of Finance, Wind; CNBS.

In Q1 2018, the Chinese government issued treasury bonds worth a total of 490 billion yuan. Compared with the end of 2017, the balance of China's treasury bonds reduced by 21.2 billion yuan, which is a major reason for falling central government leverage ratio. In Q1 2018, the size of treasury bond issuance was more or less the same with a couple of years ago and primarily influenced by seasonal factor, as shown in Figure 10.

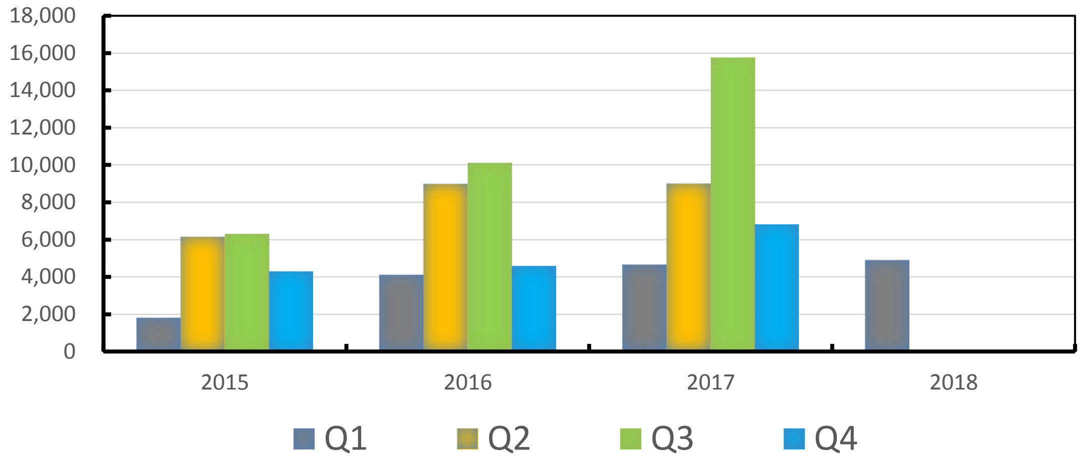

Figure 10 Seasonal Pattern in Treasury Bond Issuance (100 Million Yuan)

Source: PBoC, Wind; CNBS.

In Q1 2018, the growth of local government bonds significantly slowed compared with the couple of years ago, and issuance progress decelerated as well. By the end of Q1 2018, the inventory of local government bonds amounted to 14.96 trillion yuan, up 215.6 billion yuan of the end of the previous year. In Q1 2016 and 2017, local government bonds increased by 900 billion yuan and 400 billion yuan respectively, as shown in Figure 11. The balance of local government liabilities to be swapped only stood at 1.6 trillion yuan. In 2017, the amount of liabilities to be swapped reduced by 2.9 trillion yuan. The limited balance of local government liabilities to be swapped means a smaller demand for local government bond swap issuance. This, together with local government deleveraging operations, led to a reduction in local government leverage ratio.

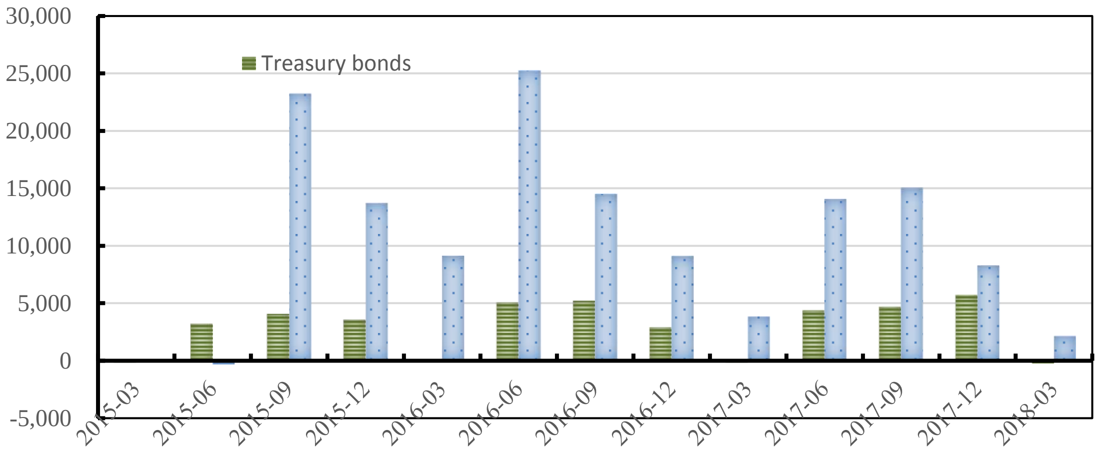

Figure 11 Growth of Government Bonds (100 Million Yuan)

Source: PBoC, Wind; CNBS.

Since 2018, the Chinese government has continued to maintain high pressures on the standardization of local debt financing. The Ministry of Finance has called for cracking down upon illegal or disguised forms of debt raising in 2018 (Directive No.34), and offered standardization for the financing activities of financial enterprises for local governments and SOEs (Directive No.23). These measures have largely curbed the government-dominated sources of funds for capital construction projects. In addition, the recent program to review PPP projects has also led to the cancellation or postponement of some projects. Against this backdrop, China's slowing infrastructure investment growth since 2017 further dropped to 13% in Q1 2018, down 10.5 percentage points YoY. Growth of fixed asset investment was also heavily affected and approached the lowest level ever. In Q1 2018, aggregate capital formation contributed 31.3% to China's economic growth, down 0.8 percentage points YoY. Given the uncertainties of external demand, the diminishing role of net export in economic growth and sudden downward pressures on consumption, China's slowing fixed asset investment growth is likely to cause its economic growth rate to slide further. In this context, we need to continue observing whether China's economy is able to withstand the pressures, become less dependent on investment as a growth driver, and avoid resorting to investment stimulus and an investment-driven growth pattern whenever investment slows.

(IV) Financial Sector Leverage Ratio Kept Falling, and Asset Management Regulation Intensified

Financial sector leverage ratio offers a reflection of the relationship between assets and liabilities for financial institutions. From the asset side, the leverage ratio decreased from 69.7% at the end of 2017 to 66.8% in Q1 2018, down 2.9 percentage points. From the liability side, the leverage ratio reduced from 62.9% at the end of 2017 to 61.7% in Q1 2018, down 1.2 percentage points, as shown in Figure 12. Financial sector deleveraging remained significant. Gap between leverage ratio from asset side and leverage ratio from liability side continued to narrow, as manifested in the return of off-balance sheet businesses to on-balance-sheet businesses.

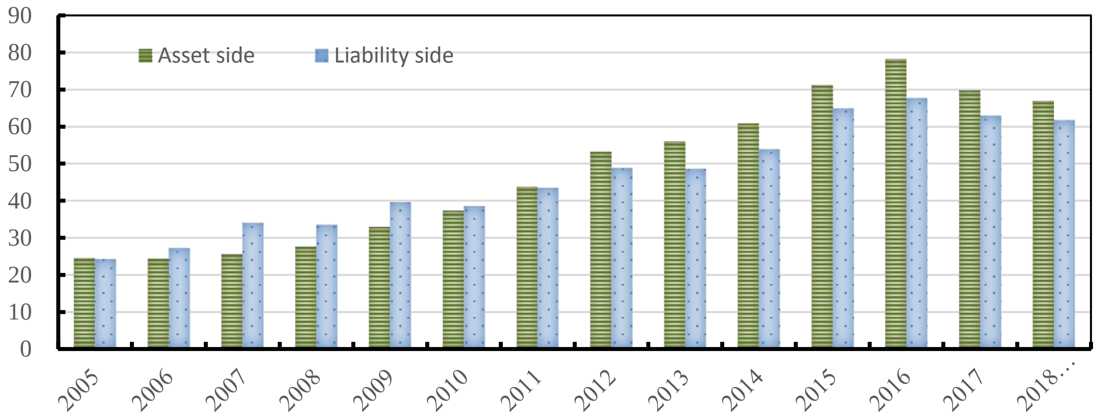

Figure 12 Financial Sector Leverage Ratio by the Broad Scope (%)

Source: PBoC, NBS, Wind; CNBS.

The most striking manifestation of commercial sector deleveraging is the continuous slowdown in the growth of total bank assets. By the end of Q1 2018, the total assets of commercial banks stood at 253.2 trillion yuan, up 7.3% YoY. The growth continued to slow. Reduction in the total assets of banks was primarily due to falling interbank assets. By the end of 2016, the interbank assets of commercial banks stood at 31.6 trillion yuan, and the claims of commercial banks against nonbanking financial institutions reached 26.5 trillion yuan. However, by the end of Q1 2018, these figures were 28.3 trillion yuan and 28.2 trillion yuan respectively - the growth rate and share both declined, as shown in Figure 13.

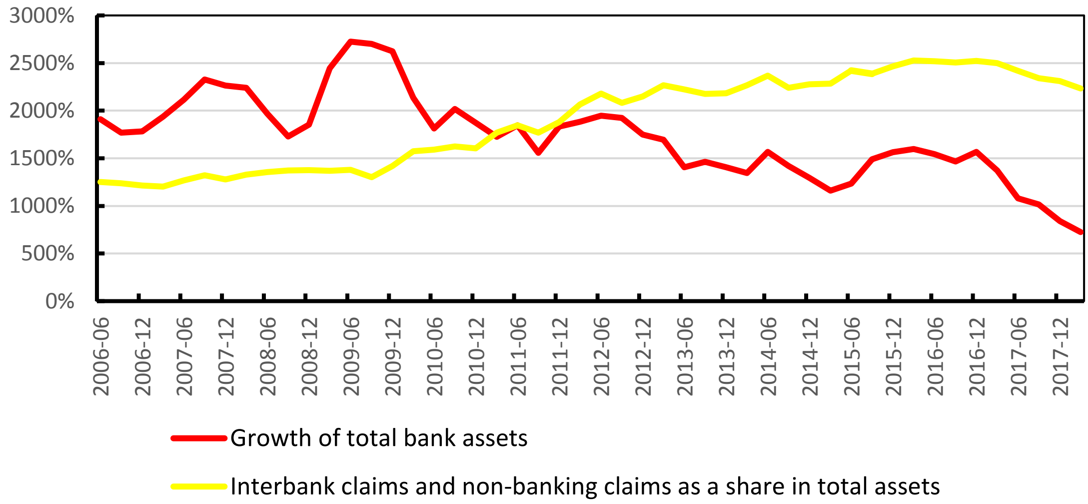

Figure 13 Growth in the Total Assets of Commercial Banks and Share of Interbank Assets (%)

Source: PBoC, Wind; CNBS.

In April 2018, China's central bank issued the *Guidelines on Standardizing the Asset Management Business of Financial Institutions*. The *Guidelines* are intended to ensure the consistency of regulatory policies, apply the same set of rules for the same category of products, and relax asset management restrictions for the wealth management funds of banks. The *Guidelines* make it both illegal and unnecessary for banks to rely on brokers, trust funds and fund channels in offering wealth management services as they did before. Foreseeably, China's financial sector leverage ratio is expected to further reduce.

The new regulation has tightened restrictions on off-balance-sheet businesses and shadow banks. The future trend is that non-standardized products will become converted into standardized products through asset securitization and other methods. This will reduce the size of debt financing from shadow banks for the real economy and facilitate regulatory oversight on traditional credit business. Changing financial environment is also conducive to the allocation of household financial assets. Under the new rules, traditional wealth management, trust funds and other quasi-loan businesses should not promise guaranteed payment to customers, and are insufficient to meet household asset allocation demand. As a result, net-asset-value products with a better risk-return profile will become more attractive (at least for less risk-adverse investors), and households will increase the share of equity products in their investment allocation. This will help the real economy to deleverage steadily.

III. Structural Deleveraging and Risk Prevention

The new regulation on asset management business marks a continuation of financial deleveraging. For the banking financial institutions, their liability-side pressures increased. While restoring some kind of financial repression, the new regulation will also restrain the negotiable certificates of deposit (NCD) and off-balance-sheet wealth management business, and curb Internet finance and money funds to some extent. Phasing out guaranteed payment has an even more far-reaching influence on the competition over deposits. Pressures also exist on the asset side. Tightening capital constraint and rising risk aversion have compromised the ability of banks to issue loans. Channel businesses, non-standard financing and nonbanking money creation also face restrictions. With the financial cycle having passed its turning point, the liquidation of corporate liabilities is fraught with uncertainties in the process of credit contraction and deleveraging amid tight regulation. Since 2018, there have been quite a few instances of solvency deterioration that led to payment difficulties and even default not only in the credit bond market but for many asset management products as well (involving broker asset management, private equity products and trust plans, etc.). Hence, we must beware of secondary risks such as contractionary repercussions arising from the burst of debt bubbles, and prevent individual cases and regional risks from spreading and individual rationality from evolving into collective irrationality. Notably, the intensity of regulation in the deleveraging process must be appropriate to prevent systemic financial risks and promote the benign interactions between the real economy and the financial sector. Excessive regulation that may harm the real economy should be avoided. As mentioned at the first session of the Central Financial and Economic Committee, differentiated and targeted solutions must be adopted for different sectors and financial risks. This approach reflects the intention of structural deleveraging.

Among China's various priorities in the upcoming three years, preventing and resolving major risks, particularly systemic financial risks, top the agenda. Deleveraging is an important way to mitigate systemic financial risks. The importance of deleveraging, therefore, cannot be emphasized more. At least before 2020, deleveraging will dominate the agenda of the Chinese government. Given this policy consideration, we have reasons to believe that China's economy will enter into a plateau of stable development by 2020 under the assumptions of improving regulatory system, comprehensive policy implementation, effective control of overall leverage ratio and decisive progress in risk prevention and disposal. By then, China may need to adjust its policy priority to promote financial sector's vitality and efficiency in the context of financial openness and international competition. In this manner, greater premium will be put on efficiency and innovation over risks and stability in policy-making considerations. Of course, this is an optimistic expectation. Without substantive progress in risk prevention and achievement of policy targets, the tough battle of deleveraging cannot end. Judging by the long cycle of changing leverage ratios for advanced economies and the experience of the recent round of global financial crisis, deleveraging should be as a swift rather than protracted battle.