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Report on China's Leverage Ratio, Q2 2019

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Economic Growth Concerns Rise as Leverage Ratio Growth Stalls:

- Report on China's Leverage Ratio, Q2 2019

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In the first quarter of 2019, China's macro leverage ratio jumped by 5.1 percentage points. In the second quarter, however, the growth slowed to 0.7 percentage points. In the first half of 2019, China's leverage ratio increased by a total of 5.8 percentage points. **China's macro-leverage ratio had been tamed from 2017 until the first half of 2019, when another spike occurred.** This increase marks a significant shift in the trend of China's leverage ratio against the backdrop of domestic and international shocks.

Notably, the sharp increase in the macro-leverage ratio in Q1 2019 corresponds to China's better-than-expected economic performance then. Yet the stalling growth of leverage ratio in Q2 2019 will weigh on future economic growth. We foresee that single-quarter leverage ratio growth of 0.7 percentage points will be hard to sustain. **To undergird growth, therefore, we should tolerate a moderate increase in the leverage ratio, particularly the central government's macro-leverage ratio, and strike a dynamic equilibrium between shoring up growth and stabilizing the leverage ratio, giving priority to institutional, structural and efficiency improvements.**

I. Overall Assessment: Real-Economy Leverage Ratio Modestly Increased, and Financial Sector's Leverage Ratio Kept Falling

In Q1 2019, China saw a sharp increase in its real-economy leverage ratio, which went up 5.1 percentage points. Meanwhile, the M2/GDP ratio rose by 3.4 percentage points, and aggregate financing to the economy as a share of GDP increased by 4.6 percentage points. However, the upward trend abated in the second quarter. Compared with the end of Q1 2019, China's macro-leverage ratio in Q2 2019 climbed from 248.8% to 249.5%, up 0.7 percentage points. The M2/GDP ratio dropped from 206.3% to 205.7%, down 0.6 percentage points. Total financing of the economy as a share of GDP rose from 227.6% to 228.3%, up 0.8 percentage points. As can be seen from these figures, the previously excessive increases in China's leverage ratio have been tamed, resulting in a stable overall debt level.

Sector-wise, the household leverage ratio in Q2 2019 increased to 55.3% from 54.3% in Q1, up 1.0 percentage point. The leverage ratio of non-financial corporations dropped by 1.1 percentage points, down from 156.9% to 155.7%. The government leverage ratio rose from 37.7% to 38.5%, up 0.8 percentage points. In the first half of 2019, the leverage ratio of non-financial corporations increased by 2.2 percentage points on a cumulative basis, demonstrating a slowing trend compared with the significant rebound in the first quarter. The household leverage ratio rose by 2.1 percentage points, and the government leverage ratio increased by 1.5 percentage points. Also, the local government leverage ratio rose by 1.6 percentage points, while the central government leverage ratio stayed flat compared to the end of 2018.

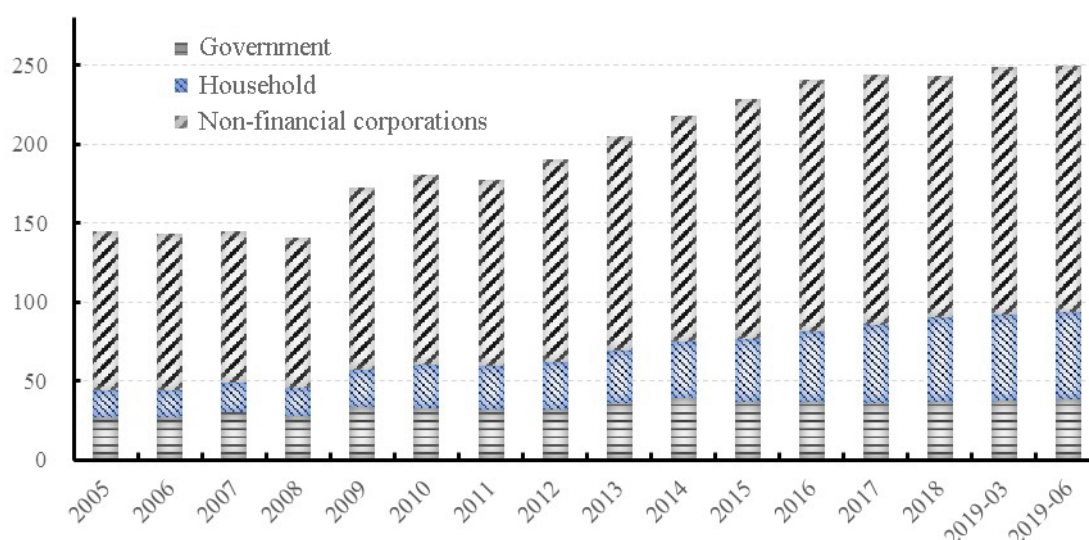


Figure 1: Real-Economy Leverage Ratio and Distribution (%)

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

However, the financial sector's leverage ratio has been falling. Since 2017, China's financial leverage ratio, measured on both the asset and liability sides, has maintained a falling trend. Specifically, the asset-side leverage ratio fell to 58.74%, which was down from 60.64% at the end of 2018. The liability-side leverage ratio dropped from 60.94% to 58.73% , down 2.21 percentage points.

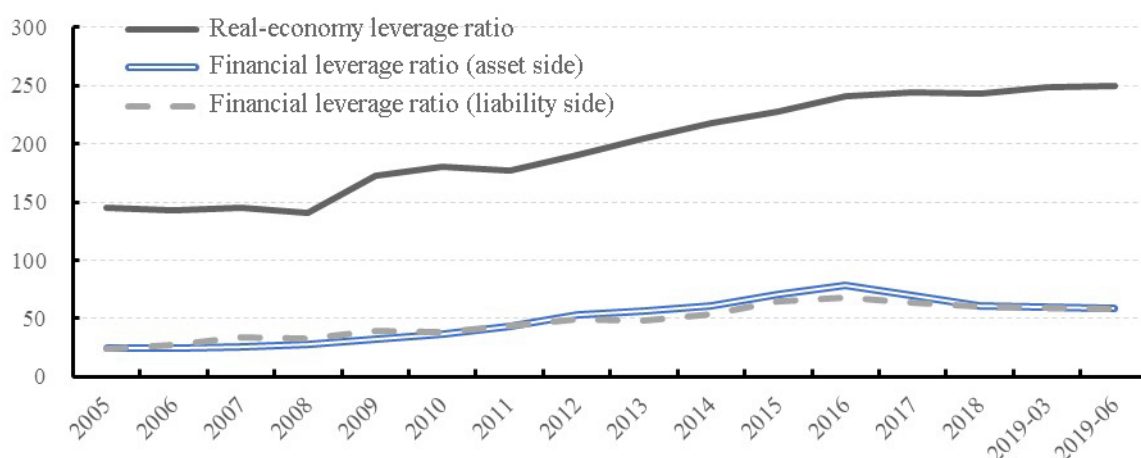


Figure 2: Real-Economy Leverage Ratio and Financial Sector Leverage Ratio (%)

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

II. Sector-Specific Leverage Risk Analysis

(1) Household Leverage Ratio Continued to Rise at the Same Rate Year-on-Year

The household leverage ratio continued to increase from 53.2% at the end of 2018 to 55.3% in Q2 2019; this is up 2.1 percentage points on a cumulative basis in the first half of 2019 and is generally consistent with the growth rate of 2.0 percentage points in Q2 2018. Short-term consumer loans remained a key driver of the household leverage ratio.

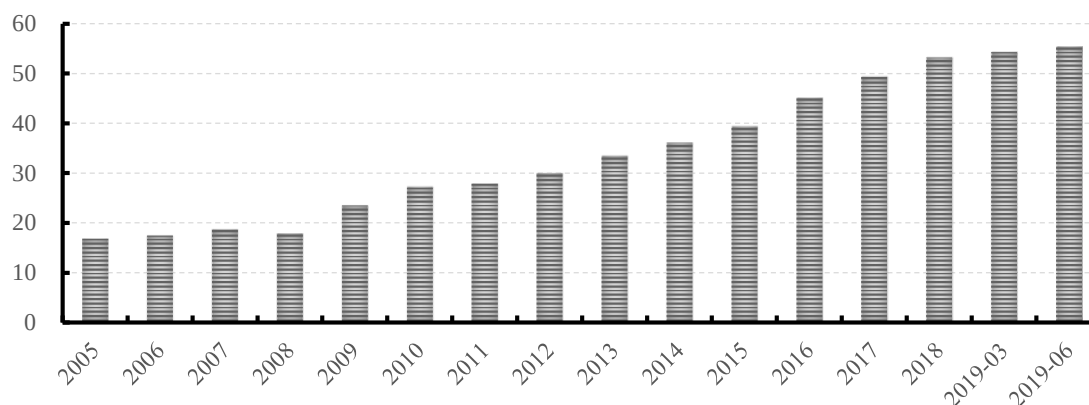


Figure 3: Household Leverage Ratio (%)

Source: PBoC, NBS, Wind; CNBS.

Household loans reached 51.7 trillion yuan, including 31.7 trillion yuan in mid- and long-term consumer loans, or 61%, and 9.1 trillion yuan in short-term consumer loans, or 18%. Housing mortgage loans are the bulk of mid- and long-term consumer loans, totalling 25.8 trillion yuan by the end of 2018 and representing 54% of total household loans. The year-on-year (YoY) growth rate of household loans fell to 17.0%, which was down from 18.2% at the end of 2018. Specifically, the growth rate of short-term consumer loans decreased the most, down to 19.7% from 29.3% at the end of 2018. The growth rate of operating loans remained stable with a modest decrease from 12.3% at the end of 2018 to 12.2%. The growth rate of mid- and long-term consumer loans rose slightly to 18.0%, up from 17.3% at the end of 2018; yet compared to Q1 2019, the growth rate has slowed.

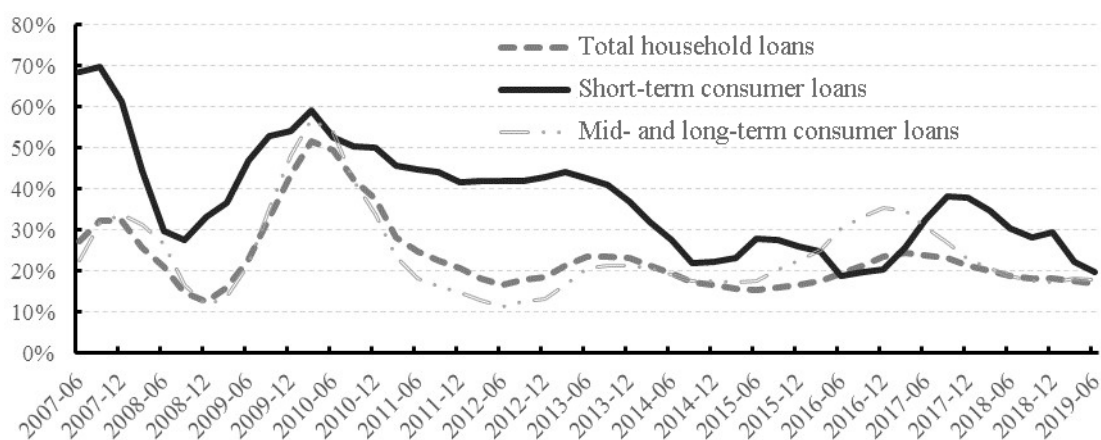


Figure 4: YoY Growth Rates of Household Sector Loans (%)

Source: PBoC, Wind; CNBS.

Short-term consumer loans remained a key contributor to the increased scales of household loans, but the extent of their contribution started to fall. The difference between the YoY growth rates of short-term consumer loans and total household loans narrowed, down from 11.1 percentage points at the end of 2018 to 2.6 percentage points in Q2 2019. Interestingly, China has experienced a boom in short-term consumer loans since 2017, with the YoY growth rate exceeding 40%.

On a positive note, short-term consumer loans correspond to actual household consumption and represent a catalyst for China's transition from an investment-driven growth model into a consumption-driven model. Operating loans and mortgage loans both correspond to investment in the traditional sense without making a direct contribution to household consumption. As the initial forms of short-term consumer loans, automobile loans and credit card loans make exactly a contribution to household consumption. In particular, a sharp increase in housing transactions is usually followed by a spike in home decoration spending.

Yet from a risk perspective, the rapid increase in short-term consumer loans does not fully correspond to the levels of real household consumption since a considerable portion of consumer loans have become an alternative to housing loans. In 2017 local governments introduced housing loan restrictions, and banks tightened real estate credit lines while lengthening the loan approval duration. Some homebuyers, whose home purchase power was stymied by the restrictive policies, resorted to non-mortgage loans as alternatives to pay for their homes. Such loans have included short-term consumer loans to make up for down payments, known as "down payment loans," as well as bridge loans for temporary capital turnover, due to lengthened loan approval duration. Unlike traditional housing mortgage loans that offer enough collateral and relatively low interest rate cost, consumer loans are riskier for banks and costlier for households, which adds to the risks of the household leverage ratio. Aware of these risks, regulators ramped up their efforts to prevent households from borrowing consumer loans to finance real estate down payments, thus curbing the growth of short-term consumer loans.

We believe that as the gap in the growth rate of short-term consumer loans and total household loans closes, consumer loans have ceased to flow into the housing sector and stoke the rising household leverage ratio. The Chinese leadership has steadfastly followed the principle that housing is for living in and not for speculation, and has refrained from using real estate developments to jumpstart the economy. In this context, China has recently tightened real estate financing policy to keep both mortgage loans and consumer loans in check.

With the development of internet finance and online lending, such as peer to peer (P2P) and microcredit loans, the majority of such consumer loans have appeared in the form of personal loans, which has pushed up the level of overall household indebtedness and the real household leverage ratio. Some media agencies and researchers have thus concluded that China's greater financial risks lie in the household sector. In our view, the rise of internet finance has led to an uptick in the indebtedness of some households, but this is limited and confined mainly to the internal claims and liabilities within the household sector. To date, household leverage presents little risk to the Chinese financial system. There are two reasons for this.

First, household debts are primarily financed by the banks; credit support from the non-banking system remains paltry. According to statistics from the "Online Lending Home"¹ website, a Chinese P2P online lending portal, the outstanding balance of lawful and compliant P2P loans peaked in May 2018 at over one trillion yuan.

¹ <https://www.wdzj.com/>

With tightening regulations and continued deleveraging in 2018, this amount started to shrink. By the end of June 2019, the outstanding balance of P2P loans stood at a mere 700 billion yuan, or less than 1% of the GDP. According to the PBoC, the balance of microcredit loans experienced no further growth after peaking at over 900 billion yuan in Q3 2014. By the end of Q1 2019, this amount had only reached 930 billion yuan. According to the Securities Association of China (SAC), the balance of stock-pledged repossession transactions amounted to 1.6 trillion yuan by the end of 2017. The limited credit supply from the nonbanking system to households is not expected to generate any excessive financial risks.

Second, unlike bank loans, the emerging financial instruments are nonbanking credit instruments in the realm of private lending activities without the intervention of banks as intermediaries, except for the stock-pledged repo business of securities brokers. The nature of such a credit supply is disintermediated financing, and it will not upend the financial system even if defaults occur. The risks of private lending are confined to wealth transfer within the private sector. As far as the household leverage ratio is concerned, China's priority is to ward off bank risks. Defaults of private loans will not disrupt the country's financial stability as long as the size of the defaults is insignificant and the financial system remains insulated from private lending risks.

Therefore, stable real estate market expectations are crucial to preventing the household leverage ratio from rising. Of course, we should also beware of risks from consumer loans. While they were transforming their retail businesses, the commercial banks saw a surge in their credit lending business; the penetration of credit loans is particularly striking among the young and low-income groups, giving rise to a regional increase in the leverage and nonperforming loan (NPL) ratios that require special attention.

(2) Slowing Rebound in the Leverage Ratio of Non-financial corporations

The leverage ratio of non-financial corporations rose from 153.6% at the end of 2018 to 155.7% at the end of Q2 2019, up 2.1 percentage points in half a year; this is a slower rate compared to the rebound of 3.3 percentage points in Q1 2019. Non-financial corporations returned to a deleveraging path in Q2 2019 after a decrease of 1.1 percentage points in the first quarter.

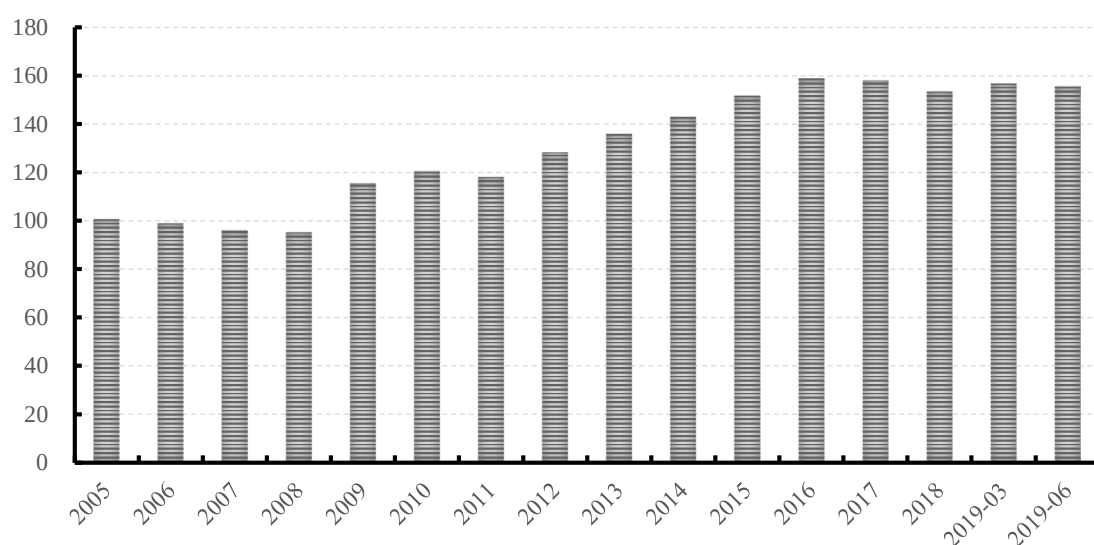


Figure 5: Leverage Ratio of Non-financial Corporations (%)

Source: PBoC, NBS, Wind; CNBS.

In the first half of 2019 there was a stable amount of shadow bank financing instruments such as trust loans, entrusted loans, and undiscounted bankers acceptance bills, whose ratio to the GDP dropped considerably. Specifically, trust loans stayed at the same level of 7.9 trillion yuan since the end of 2018 with the ratio to the nominal GDP down from 8.7% to 8.4%. Entrusted loans reduced from 12.4 trillion yuan to 11.9 trillion yuan with the ratio to GDP down from 13.7% to 12.7%. Undiscounted bankers acceptance bills reduced from 3.81 trillion yuan to 3.77 trillion yuan with the ratio to nominal GDP dropped down from 4.2% to 4.0%. The aggregate of the three shadow bank financing instruments dropped from 24.0 trillion yuan at the end of 2018 to 23.5 trillion yuan with the ratio to nominal GDP down from 26.7% to 25.2%. As shown in Figure 6 below, a few categories of non-standard financing have served as the key factors behind the falling leverage ratio of non-financial corporations since China started to deleverage in 2017. In comparison, corporate bond financing remained relatively stable, and the balance of corporate bonds increased from 20.1 trillion yuan to 21.3 trillion yuan with its share of the GDP slightly up from 22.4% to 22.8%.

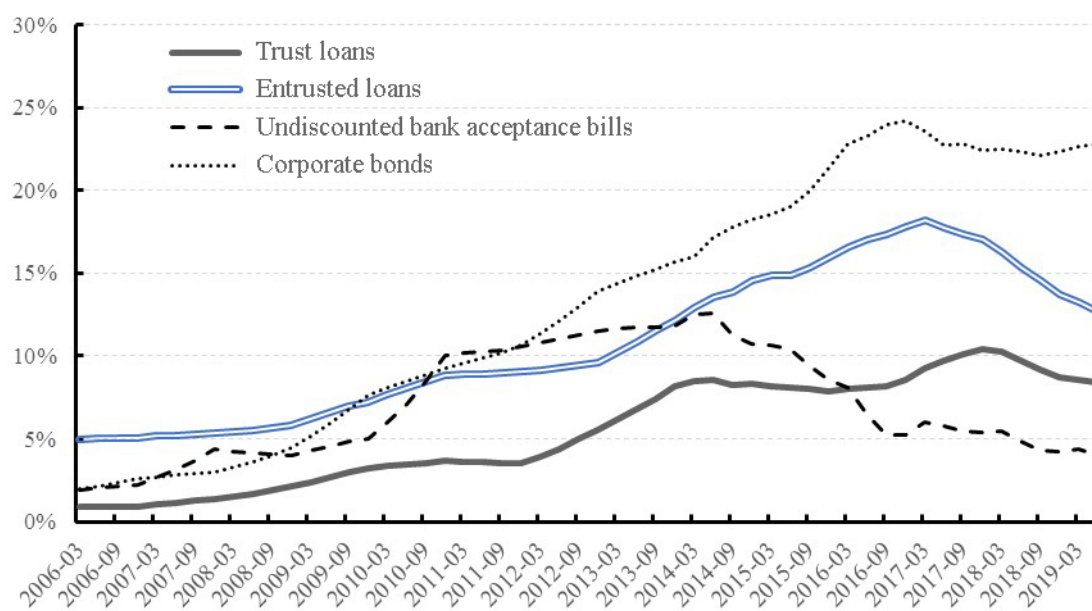


Figure 6: Balance of Non-Standard Financing as a Share in GDP for Various Types of Non-financial corporations

Source: PBoC, NBS, Wind; CNBS.

On the other hand, the balance of bank loans continued to grow at a fast pace, pushing up the leverage ratio even further. By the end of Q2 2019, loans to non-financial corporations had grown by 10.5%, and its share of the GDP had climbed from 98.9% to 102.0%. Q1 2019 saw a sharp rise in bank loans that was up 11.2% YoY by the end of March, contributing to an increase of 3.1 percentage points in the leverage ratio for non-financial corporations.

Given the changes in these various financing instruments, we believe that China's tightening financial regulation and deleveraging are yielding positive effects, which are twofold: First, financial regulation has prompted banks to move off-balance-sheet funds back to their balance sheets. In comparison, and far from being a real financial innovation, the shadow bank financing that spiked in China merely transferred on-balance-sheet funds off the balance sheet, and redirected funds to areas that were restricted for the on-balance-sheet funds of

banks. This process not only eroded the effectiveness of financial regulation, it also increased the financing costs of the real economy as a whole. Bank's funds flowed into enterprises through such channels as trusts, brokers, and insurance. The longer the chain is, the more markup costs there are from intermediaries, and the costlier access to capital becomes for the real economy. At the fundamental level, this problem stems from inconsistent regulatory rules under a separate regulatory system, as well as a regulatory arbitrage arising from the conflicting priorities of financial regulation versus economic development.

Since 2017, China's financial regulations have shifted from institutional to functional regulation and from sector-specific to unified regulations according to the nature of the financial instruments. Regulatory coordination has also increased along with this process. The formulation of unified rules according to the types of products rather than institutions has helped to reduce both regulatory vacuums and arbitrage. In this context, the size of the shadow bank assets reduced, and so did the amount of bank funds circulating within the financial sector rather than entering the real economy. Moreover, the transition has facilitated monetary policy transmission. By prolonging the fund flow chain and causing bank funds to circulate within the financial system, regulatory arbitrage has added to the complexity of monetary policy transmission, thus making it difficult for short-term monetary policy instruments to influence long-term credit market interest rates. That explains why China frequently resorted to using benchmark deposit and lending interest rates to directly adjust the bank interest rate level before 2015.

However, the benchmark deposit and lending interest rates coexisted with market-based money market interest rates. This "double track" system created barriers to interest rate liberalization, and resulted in a persistent "last mile" problem of monetary policy transmission. Once the monetary policy transmission becomes smoother, the central bank will rely on monetary policy instruments for effective market-based regulation without much need to adjust the deposit and lending interest rates directly. As the traditional benchmark deposit and lending interest rates become obsolete, we expect to see greater progress in interest rate liberalization, more effective guidance of loan prime rate (LPR) quotations, and a shift of the regulated credit market interest rate into the market-based interest rate.

Corporate bond defaults have continued to occur frequently. In the first half of 2019, over 80 corporate bonds valued at over 60 billion yuan had defaulted, which is consistent with the size and magnitude of corporate bond defaults that occurred in 2018. In 2018, a total of 125 corporate bonds worth 120.96 billion yuan had defaulted, exceeding the total corporate bond defaults of 84.6 billion yuan in the three years from 2015 to 2017. Corporate bond defaults culminated in 2018 and continue to rage to the present day.

Sector-wise, the manufacturing sector and the wholesale and retail sectors are heavily affected by bond defaults, and their sum is close to half of the total bond defaults. Notably, private enterprises still represent the majority of the defaults.

We ascribe the surge in corporate bond defaults to three underlying factors. The first and foremost factor is the current economic downturn. The economic slowdown, in the context of internal and external shocks, inevitably weighs on the effective demand for products made by firms, denting their profitability and, in serious cases, triggering bond defaults.

The second factor has to do with the removal of implicit guarantees. Overall the size and ratio of China's bond market defaults remain low. In 2018, for instance, the stock of corporate bonds at the end of the year reached 20.1 trillion yuan, while the total of the defaulting bonds was a mere 120.96 billion yuan, or 0.6%,

which is dwarfed by the NPL ratio of the banks. Considering that most corporate bond defaults only involved defaults of a certain amount of principal or interest payable, the actual proportion of the defaulting bonds is even smaller.

Over the years, investors have purchased corporate bonds under the “implicit guarantee” assumption that their losses, if any, would be covered by the banks. As China strives to remove implicit guarantees, bond defaults will become the norm.

Third, the lag effect of financial deleveraging has also contributed to the spike in corporate bond defaults. The credit crunch made it harder for firms to access financing, solidifying the “financing divide” that favors state-owned enterprises (SOEs) over private firms. Tight financing constraints gave rise to the default risks of enterprises, especially in private firms. In the second half of 2019 we expect downward economic pressures to persist, and corporate bond defaults to continue rising.

For most of the time in 2010, the new liabilities of non-financial corporations as a share of GDP stayed at about 20%. Yet since 2018, this ratio has fallen substantially as a result of slowing debt growth. The rebound in Q1 2019 has mostly offset the shortfall of debt growth in 2018. In Q2 2019, this ratio dropped to the level of mid-2018. China’s economy continued to move toward the direction of structural deleveraging.

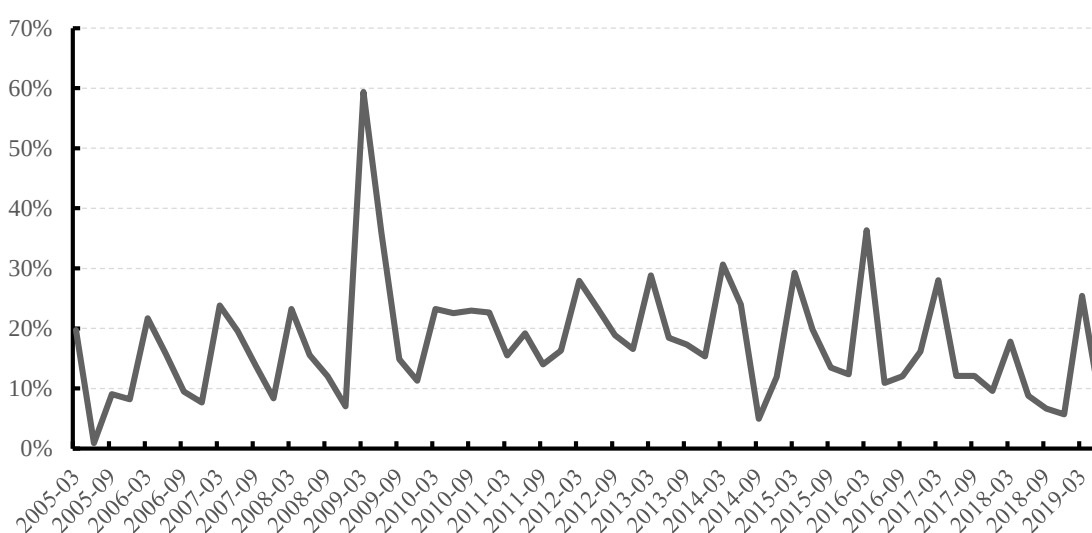


Figure 7: New Liabilities of Non-financial corporations/GDP

Source: PBoC, Wind; CNBS.

The debt-to-assets ratios of SOEs and private enterprises remained stable, but the share of SOEs’ liabilities continued to rise. SOEs saw their debt-to-assets ratio reduce from 64.7% at the end of 2018 to 64.4% at the end of Q1 2019 and 64.5% at the end of Q2 2019. The ratio stabilized, putting an end to the decrease that occurred throughout 2018. Meanwhile, the debt-to-asset ratio of the industrial enterprises remained roughly stable with only a modest increase, as shown in Figure 8. The following specific factors influenced the debt-to-asset ratio: The total assets and liabilities of SOEs increased by 9.1% and 8.8% respectively on a quarterly basis over the end of 2018, while those of industrial enterprises only rose by 0.6% and 1.5%. The speed at which SOEs expanded their balance sheets far outstripped that of private firms represented by industrial enterprises. Q2 2019 saw decreases in the growth of both the assets and liabilities of SOEs, and the growth for industrial enterprises stayed at roughly the same level with Q1 2019. The gap between the two narrowed to some extent.

China's structural deleveraging in 2018 was mainly manifested in the falling debt-to-asset ratio of SOEs. As mentioned in our previous report, such a decline stemmed from a more rapid expansion of SOE assets, which can be partially ascribed to a change in profit distribution arising from supply-side adjustment policies since 2016, such as forced removal of overcapacity and production cuts to meet emission requirements. Amid the supply contraction resulting from the forced production cuts, upstream and midstream industries posted considerable profit growth. This also led to a remarkable improvement in the profit growth of SOEs, which accounted for a bulk of upstream and midstream enterprises, and contributed to equity capital accumulation and asset expansion. We reckon that such a deleveraging path is unsustainable and unfavorable to the healthy transition of economic structure.

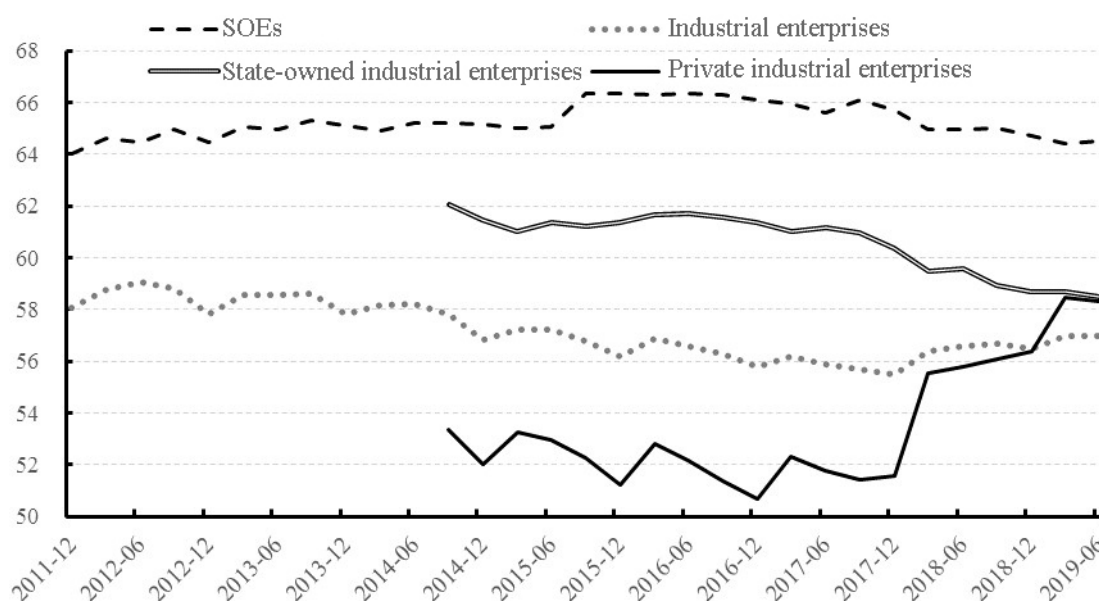


Figure 8: Debt-to-Asset Ratio of Industrial Enterprises (%)

Source: NBS, MOF, Wind; CNBS.

Given the faster growth, the SOEs' share of the total liabilities of non-financial corporations jumped to 69%, as shown in Figure 9. Since the economic fine-tuning in the second half of 2018, the Chinese government has introduced a variety of measures to make access to financing more affordable for small and micro businesses. Commercial banks also increased their credit support to small and micro businesses and strove to reduce their actual interest rates and overall cost of financing. As a result of these maneuvers, the terminal interest rate has moved downward. At the end of Q2 2019, the weighted average loan interest rate stood at 5.66%, down 0.28 percentage points YoY. Also, the cost of financing decreased for small and micro businesses. By the end of Q2 2019, the interest rates for inclusive loans to small and micro businesses newly issued by the "big five" commercial banks averaged 4.78%, which is below the average loan interest rate and was 0.66 percentage points lower from the average rate of 2018.

Both the central bank's monetary policy instruments and policy implementations at the level of commercial banks have worked in curbing cost of financing for private enterprises and small and micro businesses. However, the progress is limited within the interest rate. As the SOEs' liabilities pile up at a faster speed, private enterprises account for a falling share of the total liabilities. The implication is that if the risk premium therein cannot be reasonably compensated, private enterprises and small and micro businesses will find it even harder to financing despite the falling cost of financing.

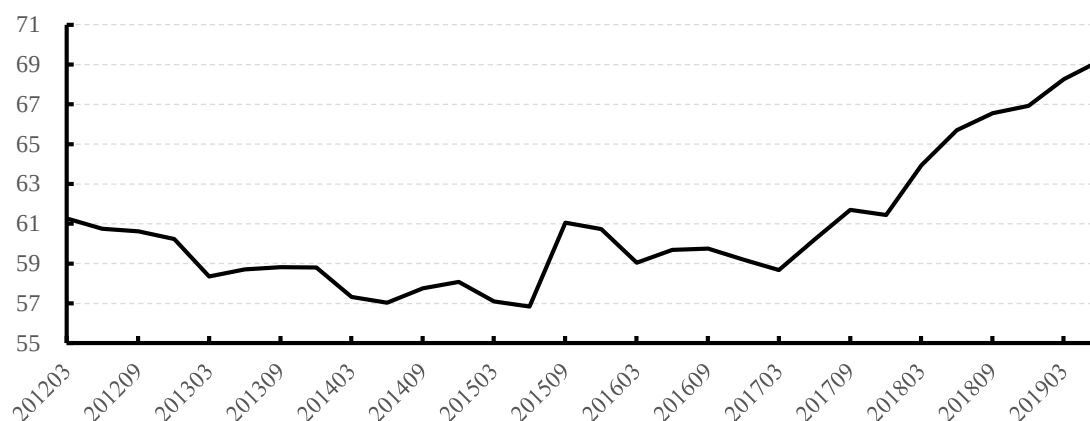


Figure 9: SOEs' Liabilities as a Share of Total Liabilities of Non-financial corporations (%)

Source: PBoC, MOF, Wind; CNBS.

We believe that China's financial policy priority should shift from price regulation to quantitative control. While reducing the cost of financing for private enterprises, policymakers should strive to increase the proportion of private enterprises in the total liabilities and keep the rising share of SOEs' in check. Achieving this goal will require a faster pace of getting rid of "zombie companies" that need bailouts to survive and supporting SOEs to liquidate the zombie companies that have been struggling to survive. While increasing efficiency in the use of debt capital, China should repair the SOE sector's balance sheet by reducing its debt-to-asset ratio. Meanwhile, China should also extend greater credit support to private enterprises by addressing distortions in credit discriminating requirements and reshaping the financial business model in favor of small to medium-sized enterprises (SMEs) and micro businesses.

(3) Government Leverage Ratio Continues to Rise

The general government leverage ratio increased to 38.5% by the end of Q2 2019, up 0.8 percentage points from 37.7% at the end of Q1 2019, and increased by 1.5 percentage points in this year's first half from the end of 2018. The rising government leverage ratio mainly stemmed from increases in the local government leverage ratio, which rose to 22.0%, up 1.6 percentage points on a cumulative basis in half a year from 20.4% at the end of 2018. Yet the central government leverage ratio dropped slightly by 0.04 percentage points.

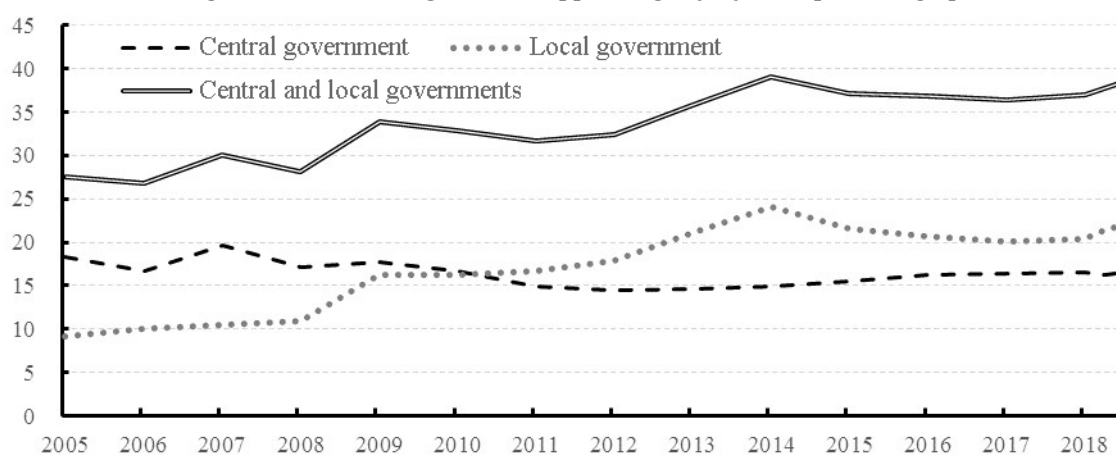


Figure 10: Government Sector Leverage Ratio (%)

Source: PBoC, NBC, MOF, Wind; CNBS.

In the first half of 2019, China issued local government bonds worth 2.8 trillion yuan - general bonds worth 1.29 trillion yuan and special bonds worth 1.55 trillion yuan. Among the total bonds, newly issued bonds reached 2.18 trillion yuan; swapped and refinanced bonds accounted for 0.66 trillion yuan. This year's annual sessions of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) capped new bond issuance at 3.08 trillion yuan for the entire year of 2019. In the first half of the year, however, 71% of the quota has already been used, which is up 55.2 percentage points from the 15.5% YoY. Close to 25 percent of the annual quota was used in June alone, accounting for roughly 33 percent of the cumulative bond issuance in the first half of the year. According to a decision of the State Council executive meeting, the issuance of local government bonds will roughly come to a close for the year by the end of September. Therefore, we foresee that local governments will have a remaining bond issuance quota of 0.9 trillion yuan at their disposal in the third quarter.

This, plus the refinanced and swapped bonds, and the quota of special bonds carried over from the previous year, will continue to push up the local government leverage ratio. As a result of the rapid issuance, the balance of local government bonds rose to 20.2 trillion yuan, up from 18.1 trillion yuan at the end of 2018, and up 12% in half a year. Meanwhile, central government bonds and urban construction investment bonds grew by 4% and 7% respectively. After surpassing central government bonds in size in 2017, local government bonds have become the biggest product in the bond market, and the gap between the two further widened.

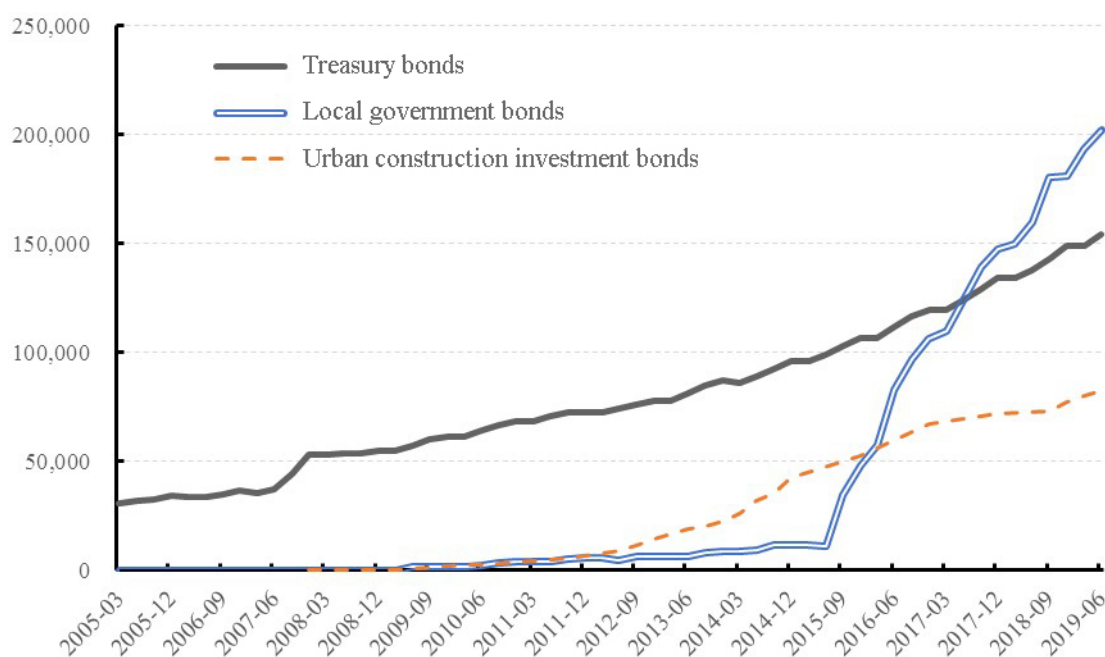


Figure 11: Size of Government Bonds (in 100 million yuan)

Source: Wind; CNBS.

Most of the funds raised via local government bonds went to projects for shoring up growth. According to the Ministry of Finance (MOF), 64.8% of the funds raised from new bonds issued in the first half of 2019 went to projects in the following six areas: social housing, including shantytown renovations; transportation infrastructure, such as railways and highways; urban infrastructure; agriculture and rural development; social and public-interest programs in the fields of education, science, culture, and healthcare; and major water conservancy facilities.

The Government Work Report called for the issuance of special bonds worth 2.15 trillion yuan for the whole year of 2019, up 0.8 trillion yuan from 2018. These funds will support major projects, especially public-interest projects whose expected revenues are not attractive to sources of commercial financing.

In June, the General Office of the Central Committee of the Communist Party of China and the State Council General Office jointly promulgated the Circular on the Issuance of Local Government Special Bonds and Project Financing, which calls for increasing special bond issuance and encouraging financial institutions to provide funds for major projects. The priority is to ensure subsequent financing for ongoing projects and to prevent them from becoming unfinished projects. The document stresses that bond issuance should be compatible with repayment capacity without incurring additional implicit liabilities. In particular, the Circular allows special bonds to constitute a certain percentage of project capital for certain major projects, but prohibits excessive financing for projects whose revenues are insufficient to serve the debts. Moreover, special bonds cannot be used to incur additional debts. The Circular also calls for incentives for the lawful issuance of special bonds to finance projects.

Since the beginning of 2019, one priority of local government debt management is to reduce the stock of local governments' implicit liabilities. Preferred options include introducing a new round of debt swaps and extensions to smooth out implicit debt risks. According to the official statistics from Ministry of Finance, 315.1 billion yuan of local government bonds existed in the form of non-government bonds by the end of June 2019, and local government bond swaps are coming to a conclusion. However, it is widely believed that local governments still have implicit liabilities. Some loans raised from local government financing vehicles (LGFVs) are backed by local government credit and are impossible to be completely pay off by LGFVs themselves. In particular, these loans include implicit liabilities incurred after the implementation of the new Budget Law in 2015 and before the National Financial Work Conference in July 2017, which called for tightening the management of financing by local governments and LGFVs. In 2018, Document No. 46 of the General Office of the Communist Party of China (CPC) Central Committee recommended taking stock of implicit liabilities nationwide. The State Council General Office (Guo Ban Fa) Document No. 101 in October 2018 stipulates that "for existing implicit debts with repayment problems, LGFVs may resort to such measures as appropriate extension and debt restructuring to maintain fund turnover after consultation with financial institutions, provided that such measures will not increase the size of local government implicit debts." These measures aim to mitigate the implicit debt risks from LGFVs from the local government perspective.

In 2019, countermeasures to mitigate implicit debts include swapping bank loans for non-standard assets to reduce the cost of financing and extend the debts' duration. At the beginning of the year a news from China Times report about a plan introduced by Zhenjiang City to deal with its implicit liabilities by annually swapping 20 billion yuan of implicit liabilities for loans from the China Development Bank (CDB) for a term of two years². In June, the General Office of the CPC Central Committee and the State Council General Office jointly promulgated the Circular on the Issuance of Local Government Special Bonds and Project Financing. This document stipulates that LGFVs may continue to provide financing for necessary ongoing projects with existing implicit liabilities after consultation with financial institutions, provided that they terminate unlawful guarantees as strictly required by the law. Later, some commercial banks offered relevant business services³.

We estimate that the LGFVs' interest-bearing liabilities amounted to some 43 trillion yuan at the end of

² <https://finance.sina.com.cn/roll/2019-04-18/doc-ihvhiqax3753624.shtml>

³ <https://finance.sina.com.cn/money/bond/market/2019-07-12/doc-ihytcitm1429738.shtml>

2018 (assuming that the liabilities of the bond-issuing LGFVs accounted for 80% of the total LGFV liabilities). With the average financing cost of 6.6%, the annual interest expenses stand at about 3 trillion yuan. The short duration of such liabilities adds to the repayment pressure. We foresee that, the rollover and extension of loans will help to mitigate local financial pressures, prevent local government implicit debt risks (particularly liquidity risks), and avoid the systemic financial risks arising from debt defaults. These measures are essential to reducing the leverage ratio and preventing “risks from risk disposal.”

In other words, we must keep a lid on local government implicit debt while encouraging lawful, market-based sources of financing for development projects. Given the slowing economy, there is a good reason to shore up growth with investments. In 2018, China’s infrastructure investments only grew by 1.8%, and infrastructure investment excluding electric power increased by 3.8%. By the end of June 2019, both figures rebounded to 3.0% and 4.1%, which are still among the lowest on record and reflect the slowed nominal GDP growth. Amid the current economic downturn, local governments are grappling with fiscal deficits. By moderately raising its leverage ratio and assuming the countercyclical regulatory function of fiscal policy, the government sector, particularly the central government, should increase effective investments and avoid the multiplier effect of a government spending contraction that further weighs on growth.

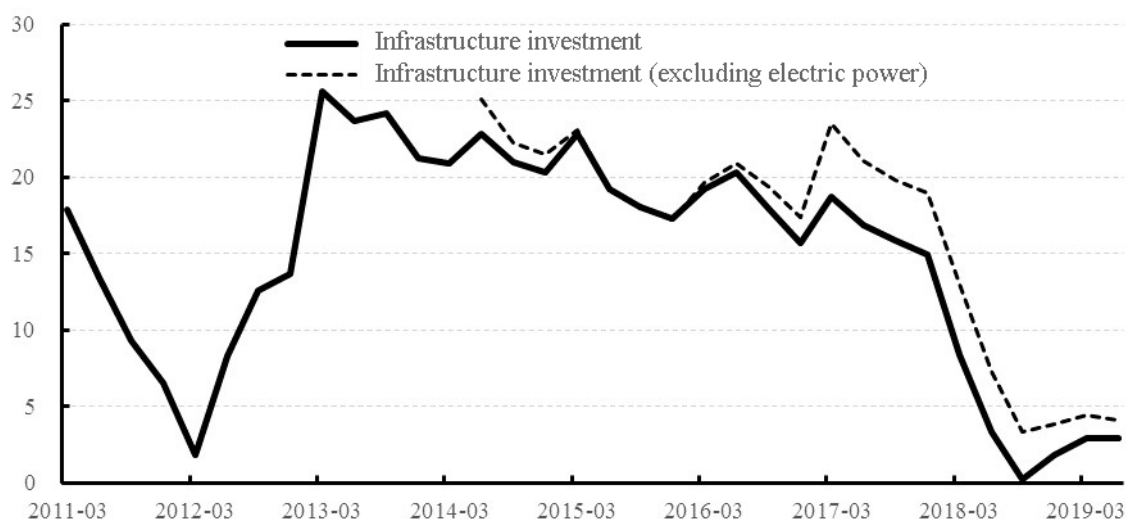


Figure 12: YoY Growth of Fixed Asset Investments (%)

Source: NBS, Wind; CNBS.

Unlike advanced economies in the Western world, China’s government sector boasts vast reserves of assets. Excluding the less liquid non-financial assets and the procyclical SOE equity assets, the total balance of bank deposits held by the Chinese government was 35.1 trillion yuan at the end of June 2019, which is equivalent to our estimate of central and local governments’ explicit debts combined. In other words, government debts increased hand in hand with government assets. There is no doubt that the government should strive to make its implicit liabilities explicit, and swap costlier debts with shorter durations, particularly loans and non-standard liabilities, for less costly medium- and long-term local government bonds. The government should also increase its spending to promote the fiscal policy’s countercyclical effect. Specifically, the government may tolerate higher fiscal deficits, increase explicit liabilities, among other means. Moreover, the government should also make use of the assets at its disposal, enhance the funds’ turnover efficiency, increase the speed of currency circulation, and moderately reduce the proportion of government-held depository financial assets to compensate for falling aggregate demand.

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

The financial sector's leverage ratio depicts the internal asset-liability relationship and reflects the financial sector's operational efficiency. On the asset side, the financial sector's leverage ratio reduced to 58.74% in Q2 2019, down 1.9 percentage points from 60.64% at the end of 2018. On the liability side, the financial sector's leverage ratio decreased to 58.73% in Q2 2019, down 2.2 percentage points from 60.94% at the end of 2018. The difference between the asset-side and the liability-side leverage ratios has reduced. The financial sector's leverage ratio continued to decline, and the banks' off-balance-sheet businesses significantly decreased.

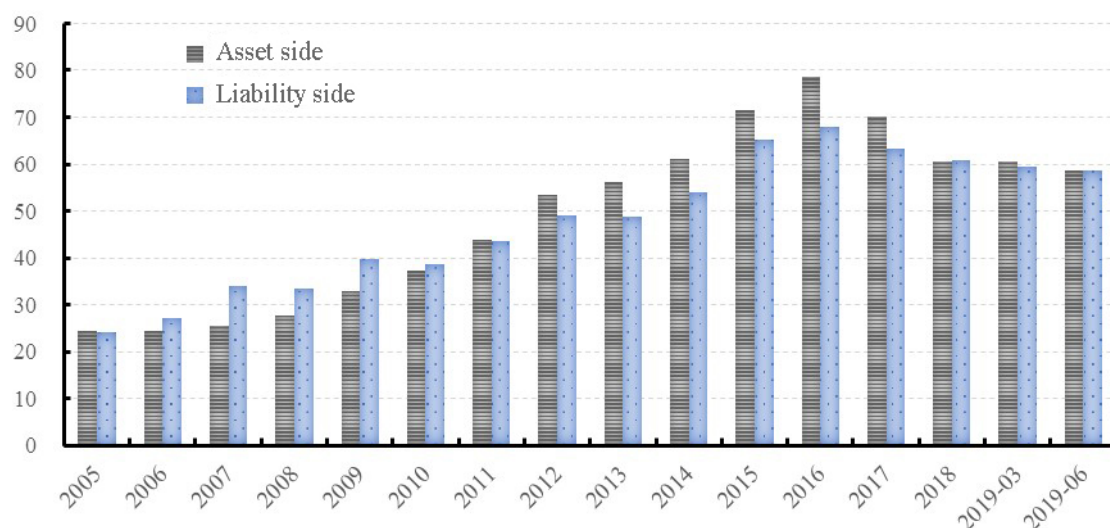


Figure 13: Financial Sector's Leverage Ratio by the Broad Scope (%)

Source: PBoC, NBS, Wind; CNBS.

In Q2 2019, the commercial banks' total assets grew by 8.7% YoY, which is higher compared to the previous year; the increase mainly stemmed from a rise in bank loans. Interbank assets as a share of the total assets fell from 20.5% to 19.6%. In addition to reducing the off-balance-sheet business of banks and shadow banking entities, we suggest moderately easing the credit supply to support private enterprises and small and micro businesses. While SOEs and local governments strive to reduce the amount of implicit liabilities, China should also encourage private enterprises and local governments to increase their explicit liabilities through the traditional bank credit business and on-balance-sheet claims as more efficient means of credit supply.

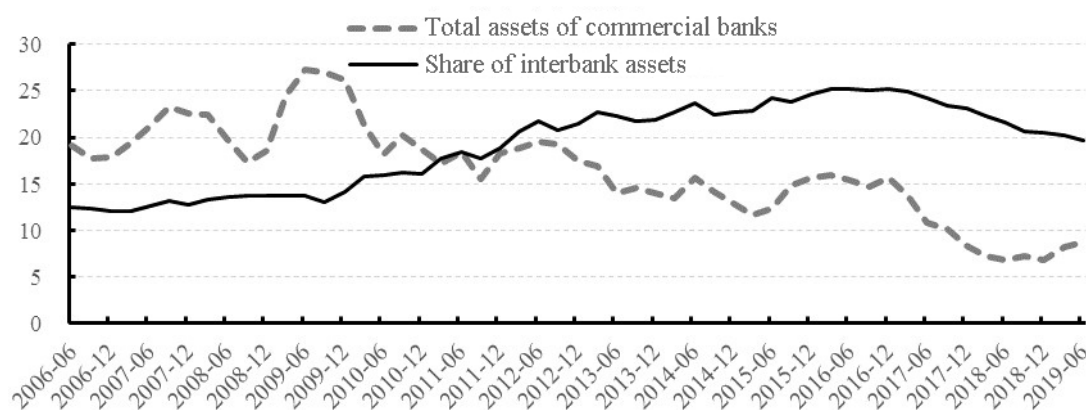


Figure 14: Growth of Total Assets of Commercial Banks and Share of Interbank Assets (%)

Source: PBoC, Wind; CNBS.

Amid the financial deleveraging, the credit risks of small and medium-sized banks have surfaced. In particular, the takeover of Baoshang Bank in May due to serious credit risks was followed by a falling market risk appetite. Some small and medium-sized banks have experienced a decline in their financing capacity. Essentially, financial deleveraging aims to reduce the unreasonable asset and liability chains of financial sectors, restrain the regulatory and policy arbitrage of various forms, and moderate the financial industry value added share of GDP and the financing cost for the real economy. Effective financial deleveraging will not affect the scale and cost of financing in the real economy, nor will it crimp interbank market liquidity. Structural differences exist for the liability side of various types of banks. While big banks with dominant deposit liabilities rely more on the retail business, small and medium-sized banks are more dependent on the wholesale business and the interbank market. In the context of falling risk appetite, small and medium-sized banks suffer greater liquidity shocks under the effect of financial deleveraging.

Given these different impacts of deleveraging, the central bank should adopt structural monetary regulation policies to extend liquidity support to small and medium-sized banks while maintaining reasonable and sufficient overall liquidity. Since June, the central bank has continued its medium-term lending facility (MLF), increased the re-discount quota and the short-term lending facility (SLF) quota, identified interbank negotiable certificates of deposit as SLF collateral, and implemented a cut to the required reserve ratio of rural commercial banks. Since mid-June, small and medium-sized banks have seen a significant improvement in their financing conditions.

In the China Monetary Policy Report Q2 2019, the People's Bank of China (PBoC, China's central bank) called for avoiding a contraction effect among small and medium-sized banks arising from the structural aspect of financial deleveraging. Financial deleveraging should move ahead in a stable liquidity environment. The ultimate goal of financial deleveraging is to prompt financial institutions to standardize their business operations and to serve the real economy more effectively.

III. Striking a Dynamic Equilibrium between Stable Leverage Ratio and Stable Growth

First, we should balance the dialectic relationship between liabilities as the numerator and GDP as the denominator.

The change in China's leverage ratio in the first half of 2019 can be explained by both the numerator and the denominator and their dialectic relationship. In Q1 2019, liabilities on the numerator side increased rapidly. In particular, the balance of bank loans in the home and foreign currencies grew by 13.27%, up 6.0 trillion yuan in a single quarter, reaching a record high and driving up the leverage ratio.

On the denominator side, the nominal GDP growth dived from 9.2% in Q4 2018 to 7.8% in Q1 2019, but rebounded to 8.3% in Q2 2019. Aside from external factors such as the trade war with the US, the excessive regulation of local government implicit liabilities in 2018 also contributed to the slowing nominal GDP growth. Thus, China's deleveraging operations are caught in a dilemma: While trimming debts weighs on both aggregate demand and growth, a slowing nominal GDP growth leads to an uptick in the leverage ratio by reducing the denominator. A deleveraging policy that focuses on the debt level, however well-meaning, is likely to drive up the leverage ratio. Balancing the dialectic relationship between the numerator and the denominator is the key to stabilizing the leverage ratio.

Second, we should strike a dynamic equilibrium between shoring up growth and stabilizing the leverage ratio, giving priority to institutional, structural and efficiency improvements.

In the first half of 2019, China's macro-leverage ratio spiked by a total of 5.8 percentage points, which marks a reversal compared to the increase of nearly 3.8 percentage points in 2017 and the decline of 0.3 percentage points in 2018.

The sharp increase of the leverage ratio in Q1 2019 corresponds to China's better-than-expected economic performance in the same period. Stalling growth of the leverage ratio in Q2 2019 will weigh on future growth momentum. We expect that the single-quarter leverage ratio growth by 0.7 percentage points will be hard to sustain. For the whole year of 2019, the leverage ratio may still increase by 7 to 8 percentage points, or even more, even if deleveraging operations continue unabated.

Therefore, we suggest adopting a holistic approach to stabilize the leverage ratio. To support growth, we should tolerate a moderate increase in the leverage ratio, particularly the central government's leverage ratio. Previous leverage ratio reports repeatedly stressed the following message: The dilemma of the leverage ratio is an institutional one; the problems and risks of China's leverage ratio rest with the structure rather than the absolute level, and the deviation between the macro-leverage ratio and the micro-leverage ratio stems from inefficiency. Hence, we should strike a dynamic equilibrium between shoring up growth and stabilizing the leverage ratio, giving priority to institutional, structural, and efficiency improvements.

Third, we should give prominence to competition neutrality and reverse the mismatch of the leverage ratio.

China's debt-to-income ratio and capital-to-income ratio are higher than the several major advanced countries, and are a manifestation of output inefficiency. In comparison, the return on assets (ROA) varies substantially between China's private enterprises and SOEs. Over the past decade, SOE liabilities as a share of the total liabilities of non-financial corporations has been rising steadily. That is to say, the increasing leverage ratio of China's non-financial corporations is primarily attributable to rising SOE debt. Yet the inefficient SOEs did not generate decent economic performance with the debt capital. As this problem finds expression in the leverage ratio equation, the numerator has been rising at a faster pace than the denominator. To shore up growth without inflating the leverage ratio, we should give prominence to the principle of competition neutrality, reallocate debt capital to raise efficiency and bring down the leverage ratio, and match credit resources to risks.

Fourth, we should avoid collateral damage in conducting financial deleveraging operations and defusing regional risks.

We have noticed that private enterprises such as medium- and low-credit entities have taken the brunt of the financial deleveraging and bond cleanup operations that have dented risk appetite. The takeover of the troubled Baoshang Bank marks an end to the implicit guarantees of interbank deposits. As small and medium-sized banks pass on the rising cost of liabilities to the real economy and shrink their balance sheets, particularly on the asset side, private enterprises have suffered a credit crunch and rising risk premium. Policymakers should avoid excessive and indiscriminate risk-defusing operations to avoid risk contagion and collateral damage to the real economy.