Quarterly Report on China's Deleveraging (2017 Q2)

ZHANG Xiaojing, CHANG Xin, LIU Lei[1]

Rsearch Center for National Balance Sheet,
National Institution for Finance & Development,
Chinese Academy of Social Sciences (CASS)

Deleveraging is a key priority of economic work for the Chinese government and identified as a key indicator for evaluating supply-side structural reforms and financial risk. Recently (August 2017), IMF Article IV Consultation Staff Report issued a warning against China's debt surge based on its leverage ratio. Growing domestic and international concerns with China's deleveraging prompted us to publish reports more frequently and closely follow changing leverage ratio.

According our analysis, China should proactively and prudently follow a "three-step" strategy in its deleveraging process: firstly, slow down the growth of leverage ratio; secondly, stabilize leverage ratio; and thirdly, reduce leverage ratio. Currently, China is in the second stage: overall leverage ratio remains relatively stable with improving the structure of sectoral leverage ratios, resulting in falling risks. Hence, **we stress that in discussing China's debt (leverage) risks, conclusions drawn solely based on overall leverage ratio without recognizing structural improvement are biased.**

I. Overall Assessment: Aggregate Leverage Ratio of Real Economy Stabilized with Improved Internal Structure

- **Aggregate Leverage Ratio Stabilized with Improving Internal Structure.** In Q2 2017, the real economy including households, non-financial enterprises and government sectors registered an increase of leverage ratio from 237.5% at the end of Q1 to 238.2%, up 0.7 percentage points - the

[1] ZHANG Xiaojing, Deputy Director-General of National Institution for Finance & Development, and Director of Reseach Center for National Balance Sheet (RCNBC). CHANG Xin, Deputy Director of RCNBC. LIU Lei, Senior Research Fellow of RCNBC.

overall trend stabilized. Meanwhile, leverage ratio transferred between households and non-financial enterprises: In Q2, the leverage ratio of household sector increased by 1.3 percentage points over Q1, while the leverage ratio of non-financial enterprises dropped by 1.4 percentage points, indicating a structural improvement.

- **Deleveraging of Financial Sector Accelerated.** By asset-side statistics, the leverage ratio of financial sector decreased from 77.3% in Q1 to 74.2% in Q2, down 3.1 percentage points; by liability-side statistics, it fell from 65.6% in Q1 to 64.3% in Q2, down 1.3 percentage points. Compared with the decrease of leverage ratio by about one percentage point in Q1, the deleveraging process of financial sector accelerated in Q2.

II. Analysis of Sectoral Leverage Ratios

- **Household Sector Leverage Ratio Continued to Increase and Consumption Credit May Have Become a Disguised Form of Housing Loans.**

  The leverage ratio of household sector continued to increase, up from 46.1% in Q1 to 47.4% in Q2, an increase of 1.3 percentage points over the previous quarter or 2.6 percentage points for the first half of year. Among all sectors of the real economy, household sector leverage still increased rapidly.

  The risk that short-term consumption credit may have become a disguised form of housing loans is a cause for concern. In H1 2017, short-term consumption loans increased by RMB 0.9 trillion and the balance grew by 32.7% YoY. In comparison, such loans only increased by RMB 0.8 trillion for the whole year of 2016. Obviously, while short-term consumption loans cannot constitute the major cause of change in household leverage ratio (mortgage loans account for 61% of household consumption loans and short-term consumption credit only accounts for 16%), their marginal influence is growing. In the context of tightening real estate regulation and restricted mortgage loan quota, some households may have withdrawn funds to purchase houses under the disguise of short-term consumption loans. The possibility for funds from home mortgage loans and down payment loans to irregularly flow into real estate market has increased. Given the different nature from mortgage loans, consumption loans are subject to higher interest rates and risks. Currently, much of consumption credit is issued in the form of cash loans to users. In particular, unsecured credit loans offered by Internet finance platforms have increased default probability. The potential risks warrant great attention from regulators. Cooling real estate market and tightening regulation will curb the leverage ratio of housing sector, slowing down its increase.

- **Leverage Ratio of Non-Financial Enterprises Reduced but SOE Deleveraging Achieved Little Progress**

The leverage ratio of non-financial enterprises dropped from 157.7% at the end of Q1 to 156.3% at the end of Q2, down 1.4 percentage points. Since financial supervision will cause firms to move off-balance-sheet liabilities into the balance sheet, the actual decrease of leverage ratio for firms could be bigger than what we have estimated.

In H1 2017, the key reason behind the falling leverage ratio of corporate sector is the negative growth of corporate bonds; in aggregate financing to the economy, financing from corporate bonds registered negative growth in the first two quarters of this year. This mainly resulted from the chain effect after financial supervision tightened.

Despite falling leverage ratio of non-financial enterprises, SOE deleveraging made little progress. For instance, the asset-liability ratio of non-state-owned industrial enterprises reached 52%, which was below average level, while this figure was as high as 61% for state-owned industrial enterprises. Moreover, SOEs had a much higher debt-to-revenue ratio compared with non-SOEs. By the end of Q2, the aggregate debt-to-revenue ratio for SOEs as large industrial enterprises reached 101%, while this figure was only 35% for non-SOEs. Obviously, debt repayment risks are concentrated among SOEs. Furthermore, the share of SOE liabilities in the liabilities of non-financial enterprises kept increasing, up from 60% in Q1 to 62% in Q2. Judging by the overall trend, the share of SOE liabilities started to increase significantly since 2015.

- **Government Sector Leverage Ratio Kept Stable while Faces Pressures to**

Increase in H2

Central government leverage ratio increased from 15.7% at the end of Q1 to 15.8%, up 0.1 percentage point; the leverage ratio of local governments is still 22.0% from the end of Q1. Aggregate government leverage ratio rose from 37.7% in Q1 to 37.8% in Q2, up 0.1 percentage point.

Slowing government bond issuance is a key reason for the slow increase of government sector leverage ratio. Q3 will witness intensive issuance of treasury bonds. In H2, the issuance of treasury bonds is expected to account for more than half of total issuance for the year, which, together with the small volume of maturing bonds, will lead to great pressures for the net increase of treasury bonds in H2. Given the slow issuance of local government bonds in H1 which accounts for less than one third of planned issuance for the whole year, pressures for follow-up issuance in H2 will increase accordingly. In the context of tightening supervision on the illegal and irregular fundraising by local governments, local governments will become more dependent on bond financing, thus increasing bond supply. This implies that government leverage ratio is under certain upward pressures in H2.

It needs to be noted that as PPP became a popular financing model for local government, the risks cannot be overlooked. The size of PPP projects increased from RMB 8 trillion in the early 2016 to RMB 16.4 trillion by the end of Q2 2017, up RMB 1.8 trillion in H1 2017. PPP projects having entered into implementation stage are worth RMB 3.5 trillion, or almost one fifth of the total value of all PPP projects. Since PPP projects are funded by policy banks, government funds, private capital and SOEs yet controlled by the government, attention should be given to local governments continuing to provide implicit guarantee to PPP projects.

III. Policy Suggestions: Fundamentally Transform Credit-Driven Growth Model

In order to proactively and prudently deleverage, a “three-step” strategy must be followed: In the short term, the growth of leverage ratio must slow down; in the mid-term, aggregate leverage ratio must keep stable, focusing on the adjustment of internal structure; in the long term, aggregate leverage ratio should be reduced.

Currently, we are in the second stage, i.e. stabilizing leverage ratio and improving structure. This stage is characterized by the following: While maintaining the relative stability of leverage ratio and aggregate demand, risks will fall as a result of changing structure. How does improving internal structure reduce risks without change in overall leverage ratio? The reason is that debt capacity and operational efficiency vary among different entities in different sectors, resulting in different risk tolerance. For instance, the transfer of leverage ratio to government sector which has greater resources and debt capacity will reduce risks to some extent. Similarly, moderate increase of leverage ratio in the household sector whose leverage remains low will also reduce overall leverage ratio risks. When government and household sectors increase leverage, corporate sector deleveraging will gain more time and room. Within corporate sector, if inefficient firms reduce leverage and more efficient firms increase leverage, risks will fall while the overall leverage ratio is stable. Hence, we argue that in the discussion of China's debt (leverage) risks, conclusions drawn solely based on overall leverage ratio without recognizing structural improvement are biased.

In order to achieve the "three-step" strategy of proactive and prudent deleveraging, credit-driven growth model must be fundamentally transformed. China's credit-driven growth model is not unique. In fact, since financial liberalization in the 1980s, growth driven by credit (as well as related real estate sector) has become a global phenomenon. The reason that financial cycles become so popular globally is that the core aspect of financial cycles is credit and real estate cycles. In comparison, peculiarities of China's credit-driven growth are just more conspicuous. The question is how to escape from credit-driven growth model? The key is to transform development pattern from investment-driven to consumption-driven growth. As long as growth is driven by investment, growth will rely on credit, resulting in rising leverage ratio; if growth is driven by consumption, however, it will rely on income, the key issue of which is income distribution rather than credit growth. Though credit growth will also bring about rising income to some extent, it will worsen income distribution as well.