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Quarterly Report on China's Macro Leverage Ratio, Q2 2020

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Macro Leverage Ratio Growth Slows amid Increasing Misallocation between Credit and the Real Economy

Key Takeaways

In the first half of 2020, China's leverage ratio increased by 21 percentage points to reach 266.4%, up from 245.4% at the end of the previous year. In Q2 2020, China's leverage ratio climbed by 7.1 percentage points, down from the 13.9 percentage points increase in Q1. Slowing growth in the leverage ratio in Q2 despite a small increase in debt growth over Q1 mainly arose from economic growth returning to the positive territory. If the economic recovery continues in the second half of 2020, we may expect slowing growth, and even a quarterly decrease, in the macro leverage ratio.

The rising corporate leverage ratio contributed 70% to the 13.9 percentage point increase in China's macro leverage ratio in Q1 2020, while the government leverage ratio contributed 16% and the household leverage ratio contributed 14%. Increase in the corporate leverage ratio contributed 46% to the 7.1 percentage points increase in China's macro leverage ratio in Q2, while increase in the government leverage ratio contributed 25% and increase in the household leverage ratio contributed 28%. Compared with Q1, the marginal contributions of the household and government sectors to the macro leverage ratio increased in Q2, prompting a reasonable adjustment in the leverage ratio structure.

While policy authorities have set a much higher credit growth target than in previous years, the sluggish real economy offers limited room for credit absorption, giving rise to a misallocation between credit supply and the real economy. This may lead to a substantial increase in the overall leverage ratio, financial arbitrage, and rising asset prices.

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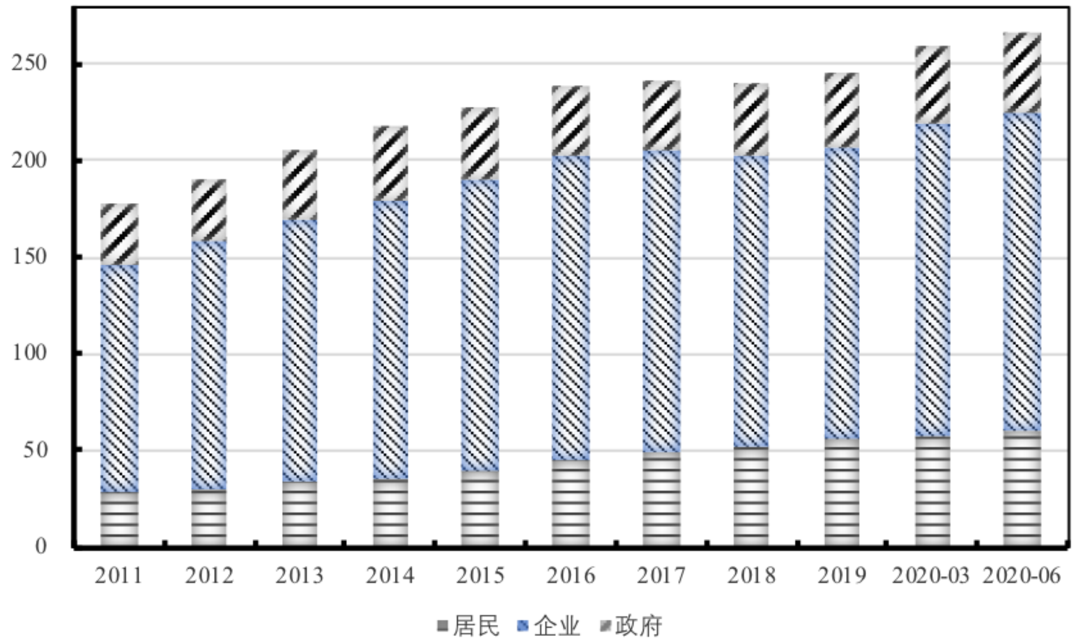
1. Overall Assessment: Leverage Structure Improved amid Slowing Growth in the Real-Economy Leverage Ratio

In Q2 2020, China's real-economy leverage ratio increased by 7.1 percentage points to reach 266.4%, up from 259.3% at the end of Q1. Sector-wise, the household leverage ratio rose by 2.0 percentage points, up from 57.7% to reach 59.7% at the end of Q1; the non-financial corporations' (NFCs) leverage ratio increased by 3.3 percentage points, up from 161.1% to reach 164.4% at the end of Q1; the government leverage ratio rose 1.8 percentage points, up from 40.5% to reach 42.3% at the end of Q1. Meanwhile, the M2/GDP ratio rose by 3.8 percentage points, up from 212.5% to reach 216.3% at the end of Q1; aggregate financing to the real economy/GDP ratio increased by 7.6 percentage points, up from 267.8% to reach 275.4% at the end of Q1.

In Q1 2020, China's real-economy leverage ratio climbed by 13.9 percentage points, the second-highest since Q1 2009. In Q2 2020, the growth slowed to 7.1 percentage points, or about half that in Q1. Two factors usually drive change in the leverage ratio - debt (the numerator) and economic growth (the denominator). As far as Q2 economic performance is concerned, **debt or credit expansion gathered strength without letup**. Total debt of the real economy grew by 12.4% year-on-year at the end of Q2, total debt of the M2 grew by 11.1%, and total debt of aggregate financing to the real economy grew by 12.8%,, which are respectively higher than the year-on-year growth rates of total debt of the real economy of 11.1%, total debt of the M2 of 10.1% and total debt of aggregate financing to the real economy of 11.5% in Q1 2020. Therefore, it can be inferred that **the slowing growth in the leverage ratio was driven by a reversal from negative to positive economic growth rates as the denominator of the leverage ratio played a bigger role. If the economy further recovers in the second half of the year, we may expect slowing growth, and even a quarterly decrease, in the macro leverage ratio.**

The corporate leverage ratio contributed 70% to the 13.9 percentage points increase in China's macro-leverage ratio in Q1 2020, while the government leverage ratio contributed 16% and the household leverage ratio contributed 14%. The increase in the corporate leverage ratio contributed 46% to the 7.1 percentage point rise in the macro-leverage ratio in Q2 2020, increase in the government leverage ratio contributed 25%, and increase in the household leverage ratio contributed 28%. **Compared with Q1, the marginal contributions of the household leverage ratio and the government leverage ratio increased in Q2, improving the overall leverage structure.**



居民 Household 企业 Corporate 政府 Government

Figure 1: Leverage Ratios of Real-Economy Sectors (%)

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 (CNBS).

2. Analysis of Sectoral Leverage Ratios

2.1 Household Leverage Ratio Grew at a Faster Pace

In the first half of 2020, China's household leverage ratio rose by 3.9 percentage points (1.9 percentage points in Q1 and and 2.0 percentage points in Q2) to reach 59.7%, up from 55.8% at the end of the previous year. Amid the slowing growth of the corporate leverage ratio and the government leverage ratio, China's household leverage ratio grew at a faster rate, contributing more to the overall leverage growth. The rising household leverage ratio mainly arose from strong demand for housing loans.

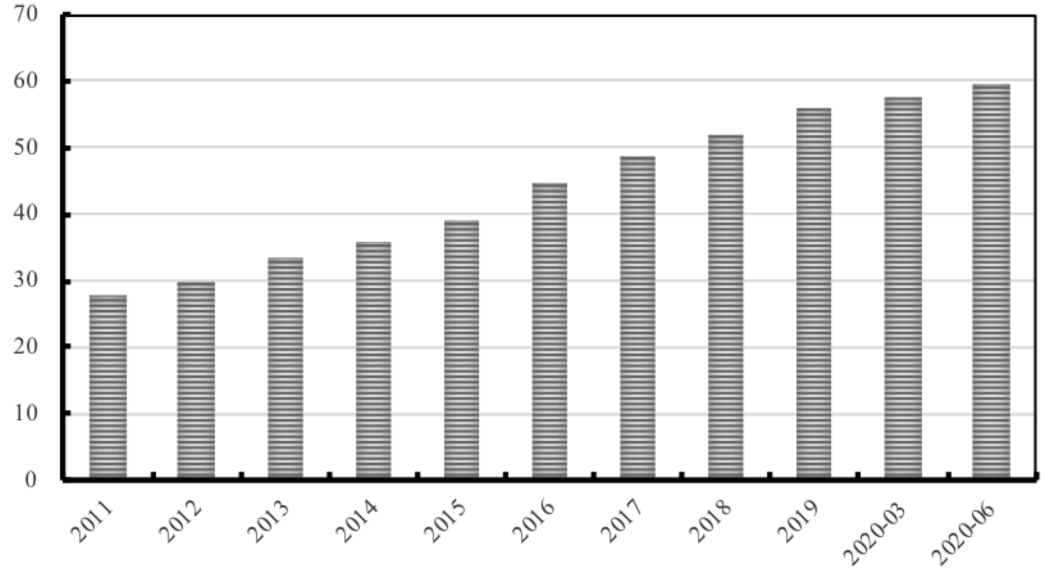
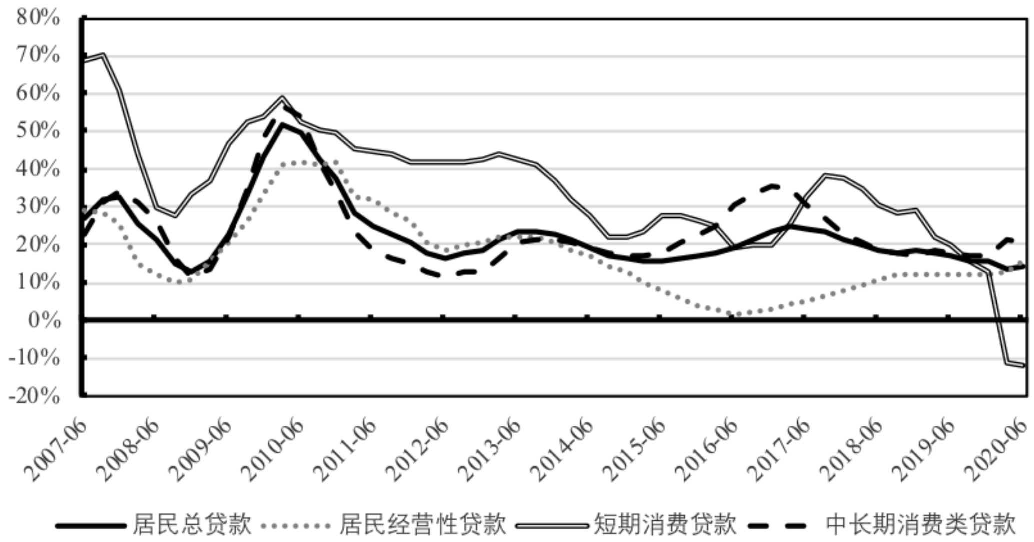


Figure 2: Household Leverage Ratio (%)

Source: PBoC, and NBS, Wind; CNBS.

2.1.1 Household short-term consumption loans stayed in the negative growth territory

The first two quarters of 2020 saw negative year-on-year growth in short-term household consumption loans, which increased by less than -10%. The other two types of loans - mid- and long-term consumption loans and operating loans - both maintained rapid year-on-year growth rates of above 15% in Q2.



居民总贷款 Total household loans

居民经营性贷款 Household operating loans

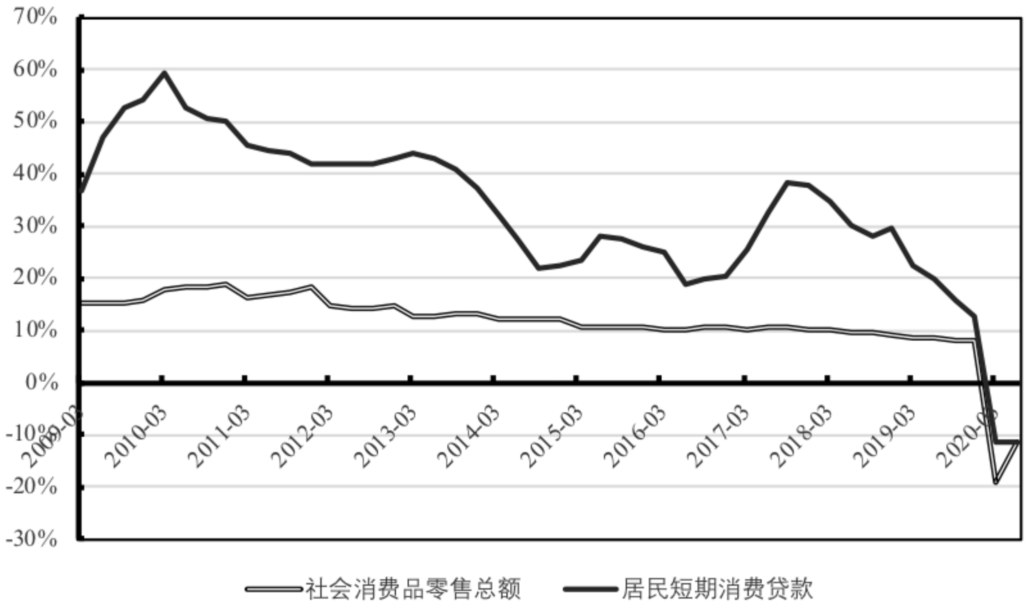
短期消费贷款 Short-term consumption loans

中长期消费类贷款 Mid- and long-term consumption loans

Figure 3: Year-on-Year Growth Rates of Household Loans

Source: PBoC, Wind; CNBS.

The negative growth in short-term consumption loans corresponds to a fall in household consumption. In Q2 2020, the wholesale and retail sector reported a year-on-year growth rate of 1.2% and the hotel and restaurant sector reported a year-on-year growth rate of -18.0%, both of which are far below the overall Q2 GDP growth. Both sectors are highly correlated with household consumption. In the first half of the year, the total retail sales of consumer goods stayed in the negative growth territory of -11.4%. Judging by data of various years, the total retail sales of consumer goods has been growing consistently with the balance of the short-term household debt. Despite a modest recovery, growth in household consumption remained in the negative territory and was only partly responsible for the rising household leverage ratio.



社会消费品零售总额 Total retail sales of consumer goods

居民短期消费贷款 Short-term household consumption loans

Figure 4: Year-on-Year Growth Rates of Short-Term Household Consumption Loans and Total Retail Sales of Consumer Goods

Source: PBoC, NBS, Wind; CNBS.

2.1.2 Rapid recovery in real estate transactions drove up household indebtedness

After the deep slump from January to February, real estate transactions have recovered quickly since March. In Q2 2020, commercial housing transactions surpassed the level of the same period in the previous year. With lockdowns imposed after COVID-19 outbreak, China’s household real estate transactions slumped in January and February. February 2020 commercial housing transactions in the top 10 cities were less than half those of the same period in 2019. Yet this tendency was swiftly reversed in March. In Q2, commercial housing transactions became highly vibrant with more transactions in May in the top 10 cities than in the same period of the previous year. In June, housing transactions jumped by 30%, and growth was particularly robust in tier-2 cities.

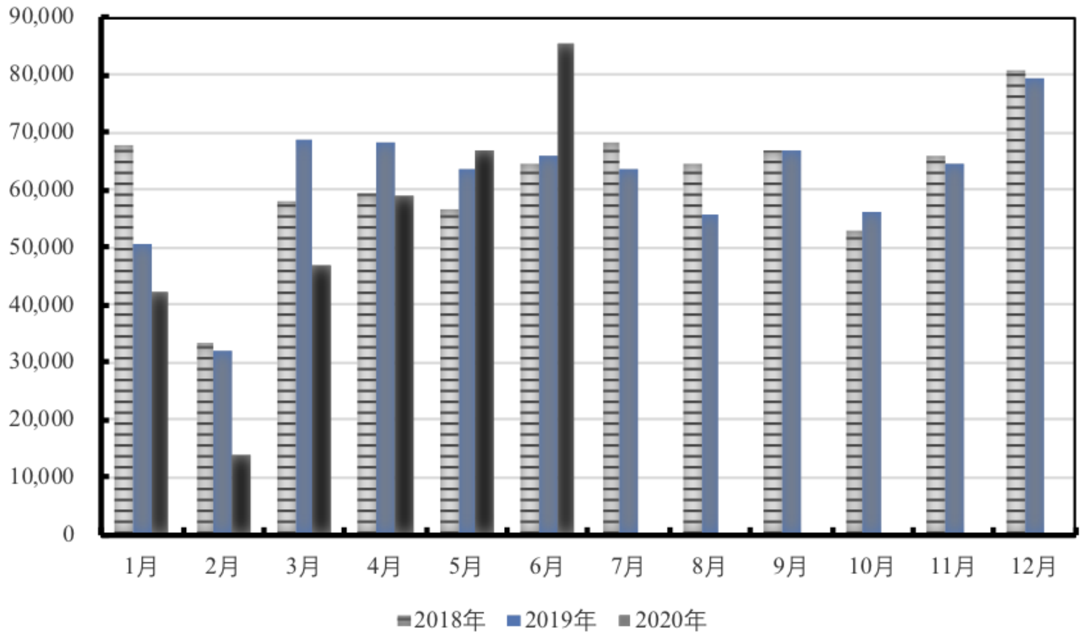


Figure 5: Commercial Housing Transactions in the Top 10 cities

Source: NBS, Wind; CNBS.

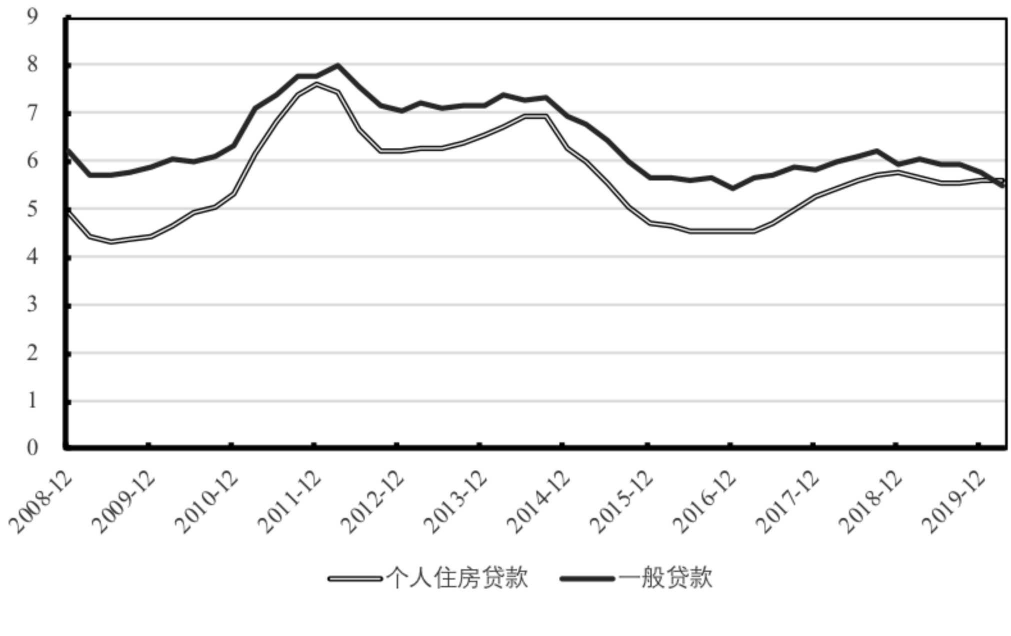
In the first half of the year, the rapid growth in housing loans served as a primary driver of the rising household leverage ratio. Despite sluggish real estate transactions in Q1, mid- and long-term household consumption loans, mainly housing mortgage loans, increased by 21.1% year-on-year. In Q2, mid- and long-term household consumption loans rose by 20.7% amid vibrant real estate transactions. Housing loans are more stable than short-term consumption loans and less vulnerable to the pandemic’s impact, economic volatility and short-term swings in housing transactions. To the extent permitted by policy, commercial banks are keener to issue housing loans.

We have repeated in previous reports that the key to stabilizing the household leverage ratio is to stabilize housing prices. In fighting COVID-19, vibrant real estate transactions and a moderate increase in the household leverage ratio are conducive to economic recovery, but attention should be paid to housing price anomalies in key cities to prevent speculation and excessive price hikes. **Notably, China’s easy monetary policy and the real economy’s lack of credit absorption capacity mean that swelling asset prices are a high-probability event at the macro level and cannot simply be blamed on regulatory practices in certain regions or cities as inappropriate.**

2.1.3 Mortgage loan interest rate above operating loan interest rate: a cause for concern

Normally, housing loan interest rates should be lower than operating loan interest rates. Financial institutions are keener to issue personal housing loans backed by real properties and generally stable personal cash flows. Yet the current environment presents a dilemma. On the one hand, financial institutions must help the real economy recover from COVID-19's impact by lowering the costs of financing for individual, and small and micro businesses, thus driving down operating loan interest rates. On the other hand, housing market regulation requires higher interest rate costs for the purchase of second homes in tier-1 cities. The overlapped effects of these two factors have caused housing loan interest rates to exceed operating loan interest rates.

Operating loan interest rates backed by housing mortgages are generally 4%-7%. With current policy incentives, some loan interest rates may fall below 4% for up to 30 years. Housing mortgage loans are required to follow the minimum benchmark interest rate of 4.75%, not to mention interest rate markups for second homes or policy-restricted loans. According to China's central bank PBoC, the weighted average interest rate of personal housing loans reached 5.6%, while the weighted average interest rate of general loans fell to 5.48%. This interest rate difference may give rise to personal housing mortgage loans disguised as mortgage-backed operating loans to individual, and small and micro businesses.

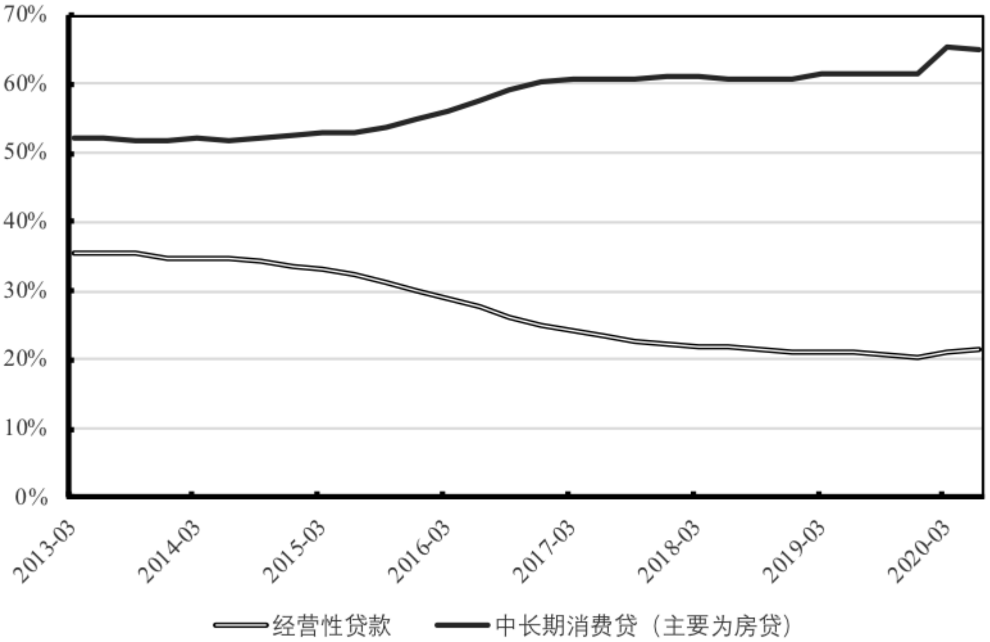


个人住房贷款Personal housing loans 一般贷款General loans

Figure 6: Weighted Average Interest Rates of Renminbi Loans (%)

Source: PBoC, Wind; CNBS.

By the end of Q2 2020, the year-on-year growth of household operating loans rose to 15.9%, which was only below the growth rate of housing loans and hit a record high since 2015. The balance of operating loans as a share of total household loans also increased from 20.5% at the end of 2019 to 21.3% at the end of Q2 2020. This sharp increase partially arose from the illegal flow of certain operating loans into the real estate market.



经营性贷款Operating loans
中长期消费贷（主要为房贷） Mid- and long-term consumption loans (primarily housing loans)

Figure 7: Operating Loans and Housing Loans as a Share of Total Household Loans

Source: PBoC, Wind; CNBS.

2.2 Slowing Growth in the Leverage Ratio of Non-Financial Corporations (NFCs)

In Q1 and Q2 2020, the leverage ratios of non-financial corporations (NFCs) increased by 9.8 percentage points and 3.3 percentage points, respectively, or 13.1 percentage points for the first half of the year to reach 164.4%, up from 151.3% at the end of the previous year. Corporate debt and leverage ratio growth rates both fell steeply in Q2. NFC bank loans maintained steady growth. Shadow bank financing kept on decreasing. Corporate bill financing grew a little bit.

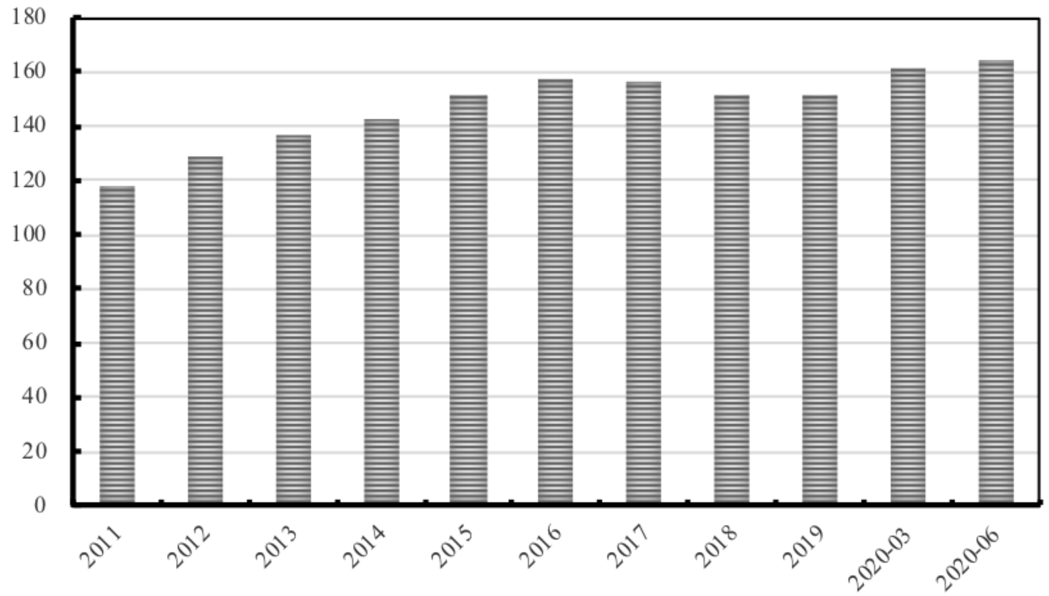
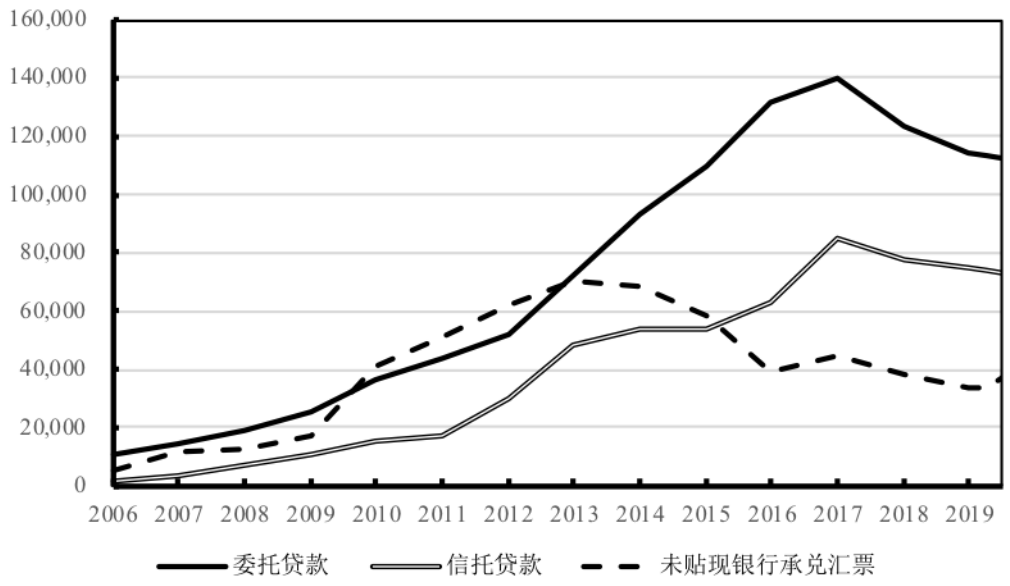


Figure 8: Leverage Ratio of Non-Financial Corporations (NFCs) (%)

Source: PBoC, and NBS, Wind; CNBS.

2.2.1 Bank loans grew moderately, and shadow banks' debt kept on the decrease

The debt growth of non-financial corporations (NFCs) steadily returned to normal. In Q1 2020, their corporate debt rose by 5.3% on a quarterly basis. In Q2, this growth rate fell to 2.8%. Direct financing increased the most. Their corporate debt financing rose by 7.4% on a quarterly basis in Q1 and continued to increase by 6.3% in Q2. The balance of corporate debt grew from 23.5 trillion yuan at the end of 2019 to reach 26.8 trillion yuan at the end of Q2 2020. In contrast, shadow bank financing decreased with the balance of financing from entrusted loans down 130 billion yuan from the end of Q1 2020 and with the balance of financing from trust loans down 110 billion yuan from the end of Q1 2020, or 2.8 trillion yuan and 1.1 trillion yuan, respectively, below the peak levels at the end of 2017.



委托贷款Entrusted loans 信托贷款Trust loans 未贴现银行承兑汇票Undiscounted bank acceptance notes

Figure 9: Financing of Non-Financial Corporations (NFCs) from Shadow Banks (100 million yuan)

Source: PBoC, Wind; CNBS.

This year's central government work report called for "innovative monetary policy instruments that directly reach the real economy" to help small, medium-sized and micro businesses access financing amid COVID-19. For this reason, China's central bank has created four direct monetary policy instruments with relevant monetary policy attributes to more precisely reach the real economy in the first half of the year. These four monetary policy instruments are: a special relending program for fighting COVID-19 worth 300 billion yuan; a relending and rediscount program worth 1.5 trillion yuan; an inclusive loan extension support instrument for small and micro businesses worth 40 billion yuan; and an inclusive credit support program for small and micro businesses worth 400 billion yuan.

A special relending program for fighting COVID-19 with a total amount of 300 billion yuan was established on January 31 for financial institutions to offer low-cost loans to designated enterprises involved in combating COVID-19. The central bank's relending interest rate is the loan prime rate (LPR) minus one percentage point with a 50% loan interest rate discount from the central government. In this manner, the actual cost of financing for designated enterprises is below 1.6%. This policy instrument has already been implemented.

Relending and rediscount: Relending was established on February 26 and rediscount was established on March 21, with a total amount of 1.5 trillion yuan, including an additional special relending and rediscount quota of 500 billion yuan and an additional relending and rediscount quota of 1 trillion yuan for small and medium-sized banks. The 500 billion yuan relending and rediscount quota created on February 26 includes 100 billion yuan to support agriculture and 300 billion yuan to support small and micro businesses, as well as a rediscount quota of 100 billion yuan. With financing interest rates no higher than LPR+50 basis points, the instrument allows commercial banks to apply for relending from the PBoC equal to loan amounts. This instrument has been implemented. Moreover, the PBoC announced a plan to issue inclusive relending and rediscount worth 1 trillion yuan on March 31, of which 374.7 billion yuan has been issued as of July 7, including agriculture-related loans worth 47.7 billion yuan, poverty relief loans worth 23.5 billion yuan, inclusive small and micro business loans worth 192.7 billion yuan, and discount worth 110.7 billion yuan.

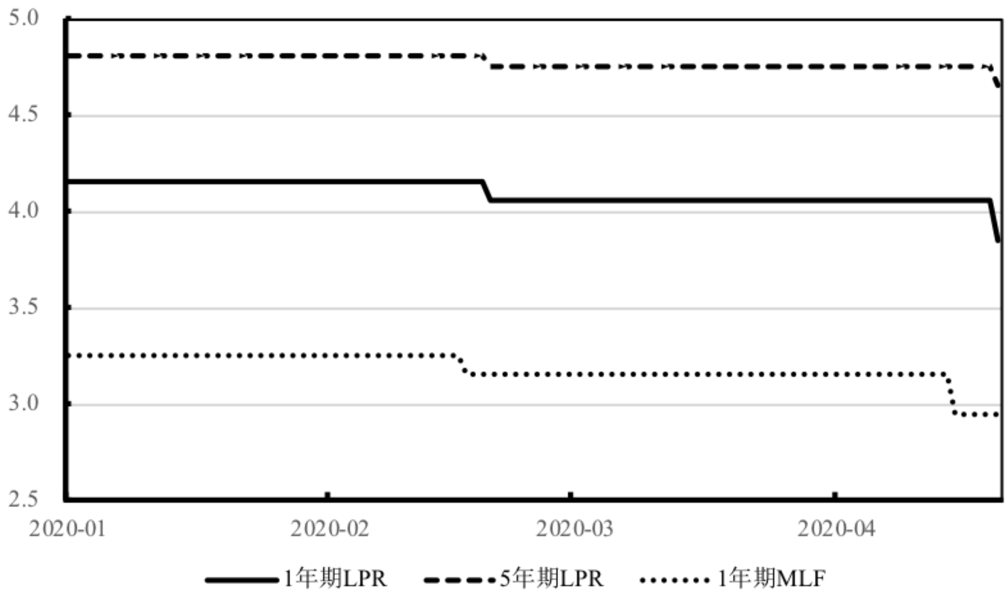
An inclusive loan extension support instrument for small and micro businesses was created on June 1 with a total amount of 40 billion yuan primarily for local legal-person banks to process the postponement of repayment in principal and interest of inclusive loans to small and micro businesses by subsidizing interest rates under interest rate swap agreements.

An inclusive credit loan support program for small and micro businesses was created on June 1 with a total amount of 400 billion yuan primarily to purchase credit loans for small and micro businesses held by local legal-person banks through special-purpose vehicles (SPV) for a term of one year. By purchasing a 40% quota of inclusive credit loans for small and micro businesses issued by local legal-person banks, the central bank has encouraged commercial banks to issue more credit loans to small and micro businesses, thus giving more stability to jobs they offer. This recently enacted policy is being implemented with growing intensity.

These direct monetary policy instruments have realized credit loan issuance worth over 1 trillion yuan in the first half of 2020, which is to be followed by a loan issuance quota in excess of 1 trillion yuan in the second half of the year. The direct credit issuance effects thus achieved are remarkable. With the direct monetary policies, the central bank has managed to ease the money supply and the credit supply at the same time.

2.2.2 Loans became redistricted to meet short-term liquidity needs amid falling cost of financing to the real economy

Since the beginning of 2020, China has lowered the interest rate on one-year mid-term lending facility (MLF) loans from 3.25% to 3.15% in February and down to 2.95% in April, down 30 basis points in total. The loan prime rate (LPR) was lowered twice in February and April. In February, one-year and five-year interest rates were both lowered by five basis points. In April, one-year interest rates were lowered by 20 basis points and five-year interest rates were lowered by 10 basis points. More substantial cuts were made in short-term lending interest rates to curb real estate investment (most housing mortgage loans are long-term loans) and increase lending support to business operations.



1年期LPR　One-year LPR　5年期LPR　Five-year LPR 1年期MLF　 One-year MLF

Figure 10: MLF and LPR Rates (%)

Source: PBoC, Wind; CNBS.

In June, a State Council executive meeting called for financial institutions to surrender 1.5 trillion yuan of profits to businesses, including an interest rate cut worth 930 billion yuan. With the leverage ratio being stable, lower interest rates on loans and corporate bonds have reduced corporate financial cost and the financial burden of small and medium-sized enterprises (SMEs). This year, small and medium-sized banks have supplemented capital funds, which helps increase the credit supply to SMEs and extend greater support to economic recovery.

A slowing economy and sluggish recovery in household consumption have lessened corporate confidence in growth prospects. Although the overall Purchasing Manager's Index (PMI) was 50.9% at the end of June - an indication that the economy was expanding, the PMI for small businesses was 48.9% - a sign of business contraction. It can thus be inferred that **loan demand from small and micro businesses was intended to address the temporary liquidity demand, i.e. to service existing loans with new low-interest loans, rather than to support an expansion in business activity. Such an increase in debt has caused the corporate leverage ratio to rise, i.e. corporate debt growth outstripping GDP growth, as well as the unintended consequences of financial arbitrage and an asset price hike. These risks should be closely followed in the context of an easy monetary environment.**

2.2.3 Swelling bill financing: beware of capital circulating within the financial system

The sharp rise in bill financing in Q2 2020 was driven not only by financial institutions' support for SMEs, but also by capital circulating within the financial system in the form of bills and structural deposits. In Q2 2020, undiscounted bank acceptance notes rose by 10.7% to reach 3.72 trillion yuan, up from 336 trillion yuan at the end of Q1 2020. Meanwhile, the balance of financial institutions' bill discount financing also rose sharply from 7.6 trillion yuan at the end of 2019 to 8.6 trillion yuan at the end of Q2 2020, up 12.7% on a quarterly basis in half a year. Bills are an important financing avenue for SMEs. The central bank also stepped up rediscount and lowered the rediscount policy interest rate by 25 basis points to 2.0% on July 1 to increase SMEs' access to low-cost financing.

Yet the interest rate on bill financing being below the deposit interest rate has led to capital circulation within the financial system. At the end of Q1 2020, the weighted average interest rate of bill financing dropped to 2.94%. Meanwhile, structural deposit interest rates remained high. According to market statistics, renminbi structural deposits issued in March 2020 were expected to yield up to 5.1% on average, exceeding 5% for the first time in recent years. Specifically, the average expected maximum yields were 5.9% for state-owned banks and 4.4% for joint-stock banks. The widening gap between interest rates on bill financing and structural deposits motivates firms to exploit the arbitrage opportunity.

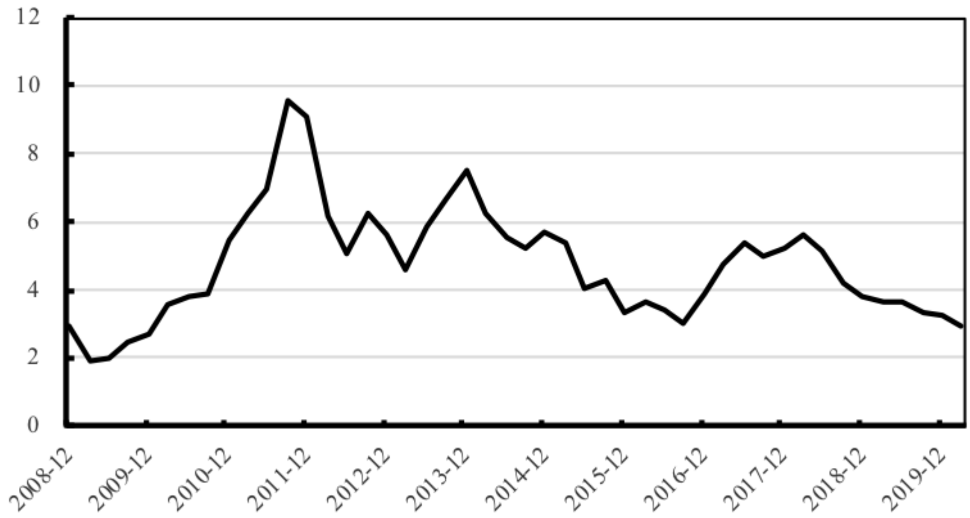


Figure 11: Weighted Average Interest Rate on Bill Financing (%)

Source: PBoC, Wind; CNBS.

Swelling corporate bill financing was accompanied by a sharp increase in the balance of corporate structural deposits in the first half of 2020. According to the PBoC, the balance of corporate structural deposits at China's large national banks increased from 1.3 trillion yuan at the end of 2019 to 1.7 trillion yuan at the end of Q2 2020, up 32.9% on a quarterly basis. The structural deposits at small and medium-sized banks across the country increased from 4.1 trillion yuan at the end of 2019 to 5.1 trillion yuan at the end of Q1 2020 before falling to 4.8 trillion yuan in Q2, up 16.5% on a quarterly basis in the first half of the year. With structural deposits as collateral, firms obtained bill financing from banks, which again ended up as structural deposits after discount. This process can be repeated indefinitely.

Traditionally, capital flowed within the financial system based on the claim-obligation relationship between banks and shadow banks. Yet arbitrage between bill financing and structural deposits has led to a new form of capital circulation relationship between financial and non-financial systems.

This new form of capital circulation is a byproduct of structural monetary policy, whose goal is to make financing more accessible and affordable for small and micro businesses and less accessible for traditional industries and the real estate sector. **Yet structural monetary policy is predicated upon "effective" market segmentation, which encourages non-market-based interest rates. The coexistence of market-based interest rates and policy interest rates has led to rate gaps between operating loans and housing loans and between bill financing and structural deposits.** Despite early regulatory interventions, such rate gaps can hardly be eliminated. The limitations of structural monetary policy, which are responsible for causing such rate gaps, warrant special attention from monetary authorities.

2.3 Government Leverage Ratio Increased Rapidly

In Q1 2020, the government leverage ratio rose by 2.2 percentage points and in Q2, it rose by 1.8 percentage points, to reach 42.3%, up 4.0 percentage points in the first half of the year from 38.3% at the end of the previous year. In Q2 2020, the central government's leverage ratio rose by 0.6 percentage points to reach 17.8%, up from 17.2%, and the local government leverage ratio rose by 1.2 percentage points to reach 24.5%, up from 23.8%. Rising government deficit and debt have pushed up the leverage ratios.

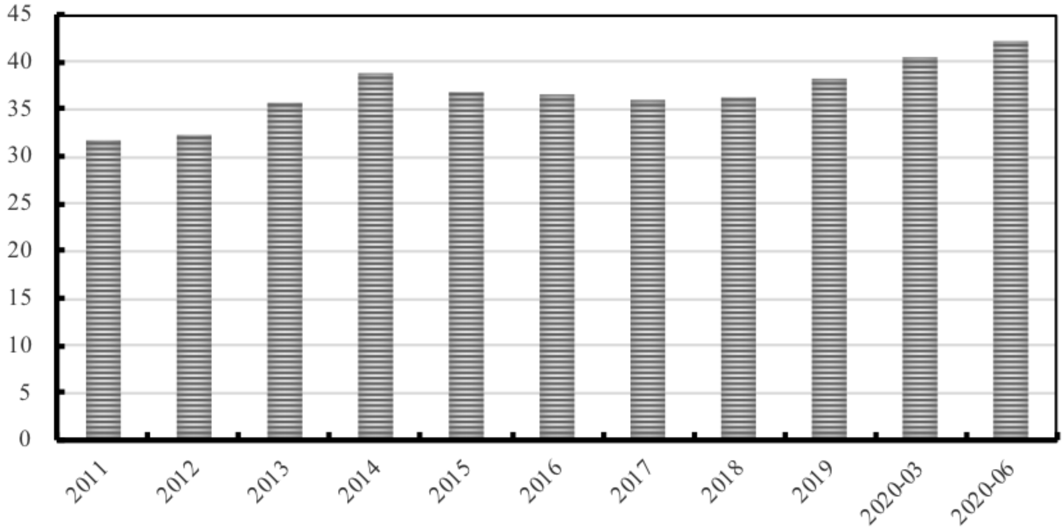


Figure 12: Government Leverage Ratio (%)

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

This year's annual national legislative sessions have set the target deficit ratio above 3.6% and plan to increase the fiscal deficit by 1 trillion yuan over the previous year, issue special treasury bonds worth 1 trillion yuan for fighting COVID-19, and raise the quota of special local government bonds by 1.6 trillion yuan over the previous year. In total, the government debt ceiling has been raised by 3.6 trillion yuan over the previous year, so the additional debt quota is 8.5 trillion yuan. The actual balance of government debt left over from 2019 was 38.1 trillion yuan, which is 3.5 trillion yuan below the debt ceiling of 41.6 trillion yuan (17.5 trillion yuan for the central government and 24.1 trillion yuan for local governments). That is to say, **the aggregate government debt ceiling for 2020 is 12.0 trillion yuan (the balances of treasury bonds and local debt may increase by 4.5 trillion yuan and 7.5 trillion yuan, respectively), and the government deficit rate in the broad sense (including special treasury bonds and special local government bonds) may reach a maximum of around 12%.**

In the first half of 2020, local governments raised debt at a much faster rate over the previous year. The balance of local government general debt grew by 612.8 billion yuan, and special debt rose by 2.2 trillion yuan, which add up to 2.9 trillion yuan. Obviously, local governments proactively raised debt this year. The local government leverage ratio also increased rapidly by 3.0 percentage points in half a year. In contrast, the balance of central government treasury bonds only increased by 823 billion yuan in the first half of the year.

Given the annual additional debt ceiling of 3.78 trillion yuan, the balance of treasury bonds is expected to increase substantially in the second half of the year.

Table 1: Balance of Local Government Debt (100 million yuan)

		Treasury bonds	Local government debt	General debt	Special debt	Total
2019	Debt ceiling	175,208	240,774	133,089	107,685	415,983
	Year-end debt balance	168,038	213,072	118,694	94,378	381,110
	New debt	17,702	29,210	8,755	20,455	46,912
	Limit of new debt	18,300	30,800	9,300	21,500	49,100
2020	**Debt limit**	**213,008**	**288,074**	**142,889**	**145,185**	**501,083**
	Debt balance at the end of Q2	176,268	241,583	124,822	116,761	41,7851
	Increase in the first half of 2020	8,230	28,511	6,128	22,383	36,741
	Limit for 2020 - balance at the end of 2019 (maximum deficit in the broad sense)	44,970	75,002	24,195	50,807	119,973
	Remaining quota for the second half of 2020	36,741	46,491	18,067	28,424	83,232
	Limit of new debt	37,800	47,300	9,800	37,500	85,100

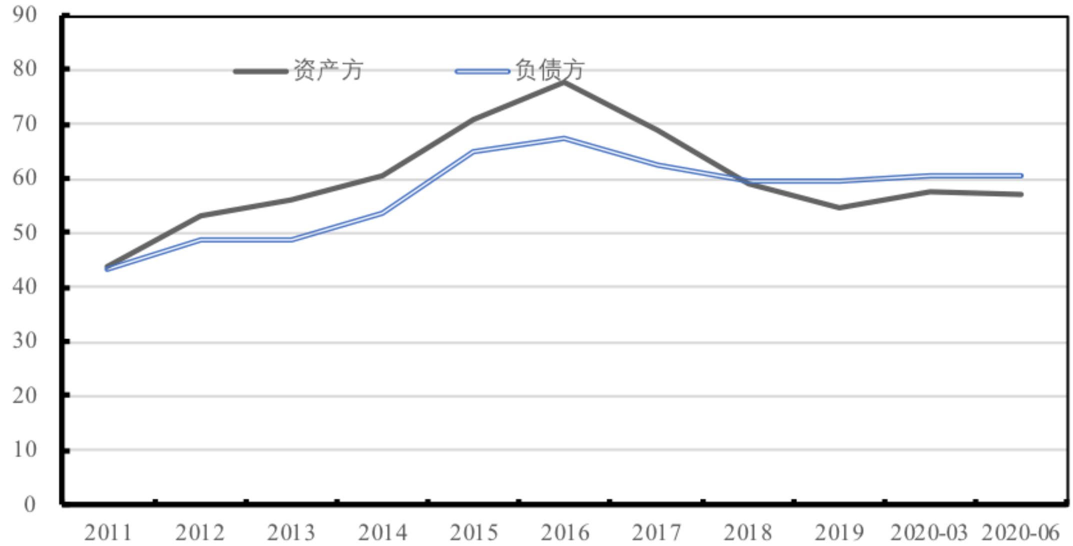
Source: The Ministry of Finance, Wind, CNBS

The International Monetary Fund (IMF) forecast in April this year that COVID-19 will cause the government leverage ratio in the broad sense to swell from 105.2% to 122.4% in advanced economies and from 53.2% to 62.0% in emerging economies, both of which are higher than the increases triggered by the global financial crisis of 2008. Meanwhile, China's government leverage ratio is expected to rise by 10.5 percentage points. According to our estimate, if the nominal GDP increases by 3% for the whole year, China's government leverage ratio will reach 49% at the end of the year, up close to 11 percentage points for the whole year, which is relatively close to the IMF's forecast.

An increase in the government leverage ratio is justified by the unprecedented response to the once-in-a-century pandemic. **Our research on the leverage ratio cycles of early industrialized nations over the past 150 years indicates there is a trade-off between public-sector and private-sector leverage ratios. Prompt response in the government leverage ratio during a major crisis or recession is of great importance in bringing about an economic recovery.**

2.4 Financial Leverage Ratio Remained Stable

In the first two quarters of 2020, China's asset-side financial leverage ratio increased by 2.9 and -0.5 percentage points, respectively, up 2.4 percentage points altogether in the first half of the year, and the liability-side financial leverage ratio rose by 1.0 and -0.3 percentage points, respectively, up 0.7 percentage points in the first half of the year. Significant deleveraging in the financial sector has effectively restrained capital circulation within the financial sector.



资产方 Asset-side 负债方 Liability-side

Figure 13: Broad-Scope Financial Leverage Ratio (%)

Source: PBoC, NBS, Wind; CNBS.

2.4.1 Steadfast financial regulation

After deleveraging since 2017, China's financial leverage ratio has reached a reasonable level with various financial anomalies contained. "The financial system is generally sound and capable of resolving various risks." China's financial system is more robust than it was three years ago. Most financial institutions have refocused on their primary businesses. The scale of shadow banking has been brought under control. Since COVID-19's eruption, China's commercial banks have been put under tighter policy guidance to issue loans to companies directly. Shadow banks are more likely to have taken the initiative to scale back due to reluctance to lend over risk concerns.

The regulatory guidelines on new asset management rules released in 2018 provide for a transition period for financial institutions' asset management business, which is three years for asset management products, especially existing asset management products, i.e. from the end of 2017 to the end of 2020. Yet in light of mounting pressures to stabilize economic growth and intensifying countercyclical macroeconomic regulation under COVID-19, there is a considerable possibility that the transition period for new asset management rules will be extended. Irrespective of the length of the extension, financial institutions have already taken steps to transition, as evidenced in their growing net-worth wealth management products. As a future direction, financial supply-side reforms will further regulate the market, develop a direct financing market, restore the appropriate roles of financing and investment businesses, and remove regulatory arbitrage.

2.4.2 NPL risk: a cause for concern

The first half of 2020 saw spikes in both bank loans and deposits with the cumulative year-on-year growth of value-added in the financial sector reaching 6.6%. Value-added in the financial sector as a share of GDP reached 9.26%. Yet, excessive bank credit growth and operating loans to small and micro businesses are likely to drive up the non-performing loan (NPLs) ratio. “We must be prepared for a significant potential rebound in NPLs,” said China’s banking regulator.

Based on Japan’s experience, massive bank NPLs and zombie companies that led to the NPLs are major causes of an economic recession. Moreover, such NPLs cannot be reflected in the financial data reported by banks. As shown in data released by Japan’s Financial Services Agency (FSA), the NPL ratio of Japanese banks peaked at 8.4% in 2001 after the Asian Financial Crisis to reach 35.7 trillion yen. However, most international investment bank analysts believed that Japan’s NPL ratio was close to 100 trillion yen at that time. At the end of Q1 2020, China’s commercial banks reported an NPL ratio of 1.91%, which was higher than in 2019, but still at a fairly low level. We should remember Japan’s lesson and be sober-minded about the actual magnitude of NPLs.

Inclusive loans to small and micro businesses will probably have a higher NPL ratio. While the overall NPL ratio for commercial banks is only 1.91%, the NPL ratio has already reached 2.45% for city commercial banks and 4.09% for agricultural commercial banks. In the first half of this year, inclusive loans to small and micro businesses grew at a much faster rate than general loans. According to the PBoC’s Financial Market Department, the balance of inclusive loans to small and micro businesses stood at 12.9 trillion yuan at the end of May, up 25.4% year-on-year. Further increases in the NPL ratio are inevitable.

3. Policy Advice

In Q2 2020, China’s economic growth turned positive and was better than expected. In addition to spotlighting China’s economic resiliency, its better-than-expected economic performance has been achieved, to a great extent, thanks to various relief measures introduced by the government. It is fair to say that the rapid increase in the macro leverage ratio also represents an initiative taken by the monetary policy to bring about an economic recovery in fighting the once-in-a-century pandemic. Yet credit and debt binges are a double-edged sword that must be used properly.

(1) Economic recovery is vital to long-term stability in the leverage ratio.

Growth in China’s real-economy leverage ratio almost halved from 13.9 percentage points in Q1 2020 to 7.1 percentage points in Q2 2020. Meanwhile, aggregate debt in the real economy, M2 and aggregate financing to the real economy continued to increase at a faster pace - an indication that slowing growth in the leverage ratio in the second quarter was mainly due to an upturn from a negative economic growth rate to a positive economic growth rate. If China's economic growth continues in the second half of the year, we may expect a slowing increase in the macro leverage ratio and even a quarterly decrease in the leverage ratio. **Hence, the future trend in the leverage ratio is primarily subject to economic growth rather than debt expansion. From the perspective of long-term leverage ratio stability, economic recovery should top the agenda.**

(2) Beware of the problems and risks arising from a mismatch between credit and real-economy activities.

Due to the size of the COVID-19 pandemic, it is justifiable for the monetary authority to call for a faster pace of credit growth compared with previous years to support economic recovery. In fact, the limited quantitative easing introduced by major advanced economies went even further. Yet much of the credit demand stemmed from the need to cushion COVID-19's impact, such as paying salaries to employees, servicing debts, or other short-term liquidity needs, rather than supporting an expansion in business activity. Paradoxically, the credit binge was accompanied by a slump in economic activity. The result will be a sharp rise in the macro leverage ratio and regional risks for capital arbitrage and asset price hike.

(3) Banks should prepare for a potential NPL hike.

This year, value-added in the financial sector continued to grow quickly due to the changing accounting system and the falling provision coverage ratio of commercial banks. At the end of Q1 2020, the provision coverage ratio of commercial banks was 183.2%, down about 10 percentage points from the peak of 192.2% in Q1 2019. We believe that preparations should be made for a potential rise in the NPL ratio: First, banks should distribute fewer dividends. As banks' book profits increase rapidly amid a spike in deposits and loans, more significant provisions should be made. Second, the government should extend fiscal support by such means as increasing local legal-person banks' capital with funds raised from special bonds and by extending fiscal and financial support to SMEs. With the price discovery function, financial markets are more efficient at allocating resources. Considering the fiscal policy's structural traits, offering fiscal subsidies to SMEs helps reduce market arbitrage and bad debt that structural financial policies may otherwise bring about. A combination of fiscal and financial measures will be more effective in supporting economic activity.

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