Macro Leverage Ratio and Systemic Financial Risk*

Zhiqiang Zhu[1,**] Cui Min[1]

[1] *Shandong Technology and Business University, Yantai, Shandong 264005, China*
[**] *Corresponding author. Email: zhuzhiq308@sdtbu.edu.cn*

ABSTRACT

In carrying out economic work, China attaches great importance to the prevention and resolution of major financial risks. In recent years, due to the rapid rise in China's macro-leverage ratio, among which the residents' leverage ratio has risen the most rapidly, and there may be some financial risks, therefore, from the perspective of residents, non-financial enterprises and local governments, this paper further explains the causes of deleveraging, and in order to prevent systemic financial risks caused by excessive macro-leverage in China, in particular, this paper puts forward some corresponding policy suggestions for the potential sources of financial risks in China.

Keywords: *Macroeconomic leverage, Systemic financial risk, Policy proposals.*

1. INTRODUCTION

Avoiding systemic financial risks is an important issue in China's financial work. It is necessary to promote the deleveraging of China's economy and continue to implement a prudent monetary policy, solve the basic relations of steady growth, internal structure adjustment and total quantity control. Since the 19th CPC National Congress, the CPC Central Committee has attached great importance to stability and security in the financial field. On December 8, 2017, the Politburo conference clearly put forward three major challenges for 2018, namely, "Prevention and mitigation of major risks, precision poverty alleviation, and pollution prevention and control." Among them, "to prevent and defuse major risks, the country's macro-leverage ratio should be effectively controlled, the financial service entity's economic capacity should be improved, and positive results should be achieved in risk prevention". It is an important historical experience accumulated in China's financial development since the reform and opening-up, and an important strategy to be carried out in the reform and development of China's financial industry in the new era. It can be seen that how to balance the macro-leverage ratio and systemic financial risk is an important issue in the development of China's financial stability.

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2. STUDYING THE TREND OF MACRO-LEVERAGE RATIO AND THE FINANCIAL RISK

2.1 Analysis of the Trend of Macro Leverage Ratio in China

Recently, the National Finance and Development Laboratory, a state think-tank in China, published a research report, "Leverage under the triple pressure may enter an upward cycle-the 2021 leverage report". The report contains a large amount of information, through the data, we have the following ideas.

First, the national macro leverage ratio was 270.1% at the end of 2020, while the national macro leverage ratio at the end of 2020 was 263.8%, with an average decrease of 6.3 percentage points, thus achieving deleveraging to a certain extent. There are two main reasons for this: (1) in 2020, fiscal and monetary policy were combined as a result of the impact of the epidemic, leading to a sharp increase in macro leverage of 23.6% , it is the biggest increase since the expansionary policies of the 2009 financial crisis. So while the 2021's leverage ratio has fallen, and it has indeed fallen from a high base in 2020, its absolute value is still at historic highs. (2) 2021 real debt (numerator) is growing more slowly, while nominal GDP (denominator) is growing more rapidly because of factors such as inflation, leading to a reduction in leverage. 2021, broad money climbed 9.5 percent, the stock of social financing rose 11.8 percent, and total debt for all three sectors rose 10.0 percent, near the slowest rate of debt growth since 1991. Overall, nominal GDP rose by 12.8% in the same year, far ahead of market expectations. As a result, the 2021 has done something about deleveraging. Historically, leverage has continued to rise as the economy has grown, but at a reasonable rate. ("Figure 1", "Figure 2")

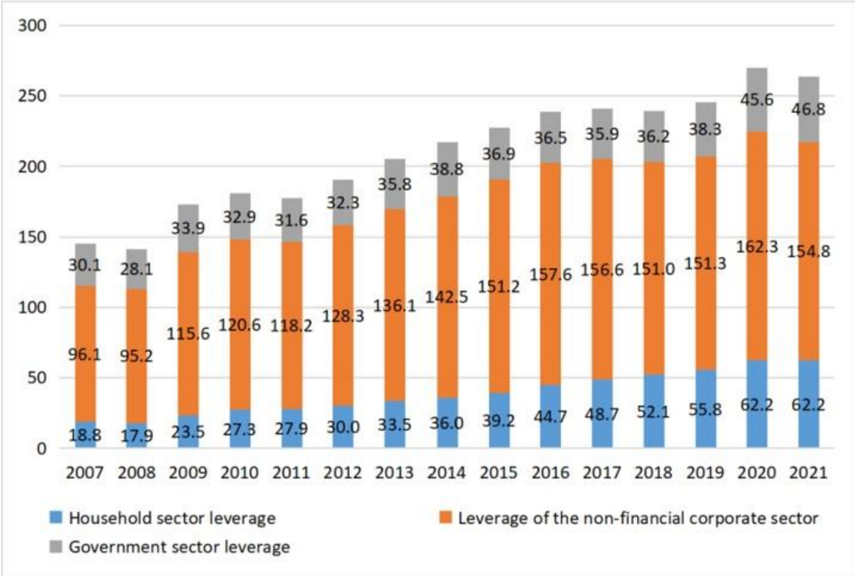

Figure 1 2007-2021 macro leverage.

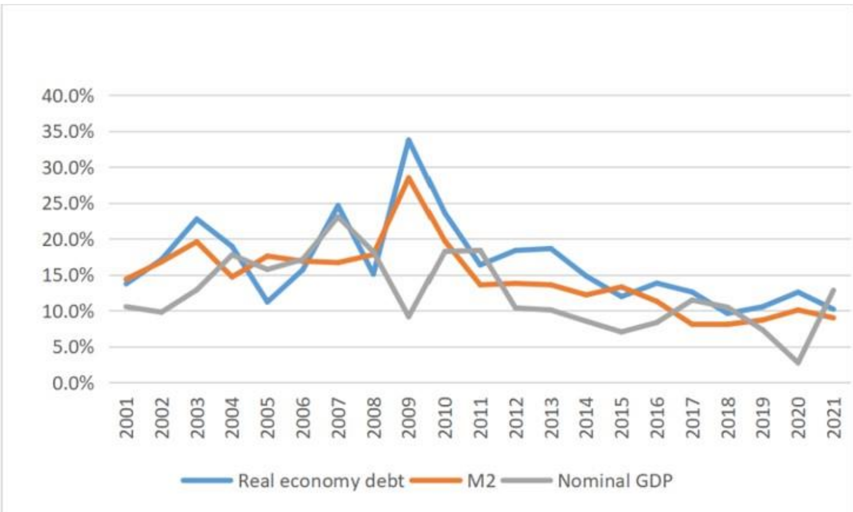

Figure 2 Year-on-year growth in debt, money and GDP.

a Sources: People's Bank of China, National Bureau of Statistics of the People's Republic of China; state balance sheet research center.

Second, household leverage is rising fastest and is structurally unbalanced. Research by Zhang Ming (2020) found that macro leverage soared in China and other emerging-market countries after the 2008 crisis, and that China's rise was much greater than in other emerging-market countries. [1] Yu Yang (2020) through research also believes that our country has been deleveraging in recent years, although there have been some achievements, but the macro-level leverage still remains high, there are outstanding problems of structural contradiction in the leverage ratio among various departments, leverage is riskier. [2] Among them, the risk of residents' leverage ratio is relatively high, and it is expected that in the future, even if an expansionary policy is implemented, there will still be more strict control over residents' leverage in buying houses. Over the past few years, the fastest growth in all sectors has been in China's household sector, which has risen from less than 5% in 2000 to 62.2% now. This shows that China's household leverage ratio, although far less than the developed countries, but also to a large extent more than the emerging market countries, and close to the level of the euro area. ("Figure 3", "Figure 4")

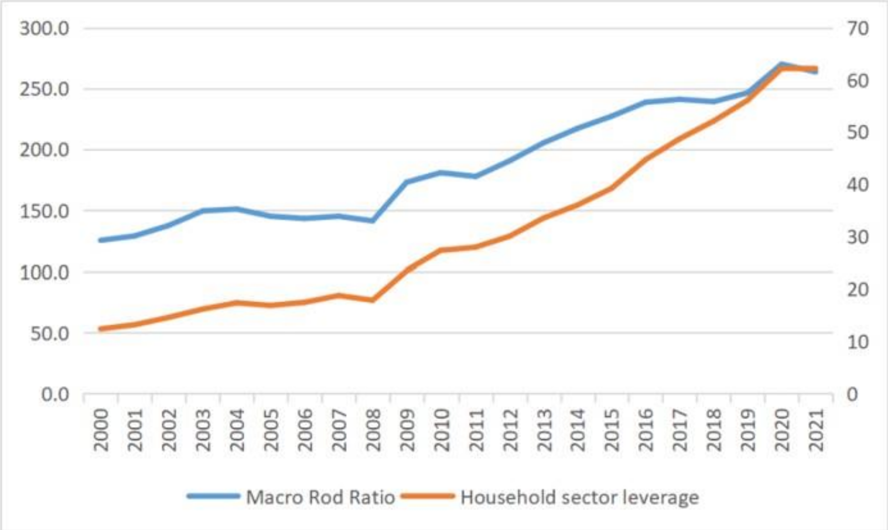

Figure 3 Trends in macro leverage and household sector leverage in China.

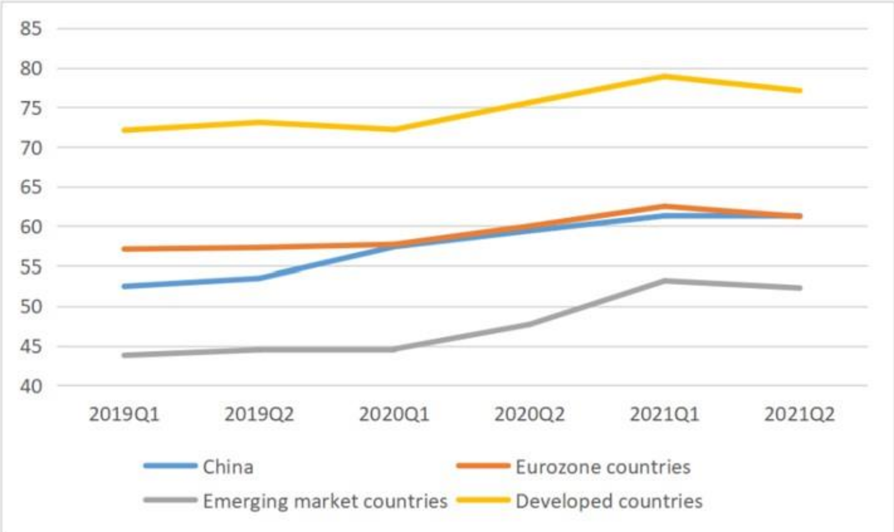

Figure 4 Household sector leverage by country.

a Source: National Balance Sheet Research Centre.

2.2 *Financial Risks*

Regarding the definition of financial risk, Li Yutai (2019) thinks that refers to the possibility of loss caused by uncertain factors in the process of financial transaction. [3] Zheng Liansheng et al. (2018) believe that the systemic financial risk is an endogenous risk, which is manifested in the risk of the inter-bank market or the debt market, the real estate bubble, the Shadow Bank Risk, the local debt problem and so on. [4] Li Liangyan et al (2020) think that the financial risk will be magnified, especially the systemic financial risk, when the economy goes down, which threatens the political and economic security of our country seriously. [5] The following are some problems in the financial field of China at present.

2.2.1 Local Government Debt Risk

Under the circumstances of slow income growth, high pressure on expenditure and debt repayment, some local debt risk problems still exist, especially the large scale of hidden debt, which will take time to resolve. Yu Yang (2020) argues that this is not only bad for central government regulation and control, but could also induce systemic financial risk.[2]

2.2.2 Credit Risk of Enterprises in Some Industries

Liu Yan (2019) found that high leverage and high debt stress can lead to a degree of financial and credit risk from a micro perspective.[6] Jiang Hongli (2019) through theoretical analysis that enterprises in the economic upturn will borrow to expand the scale of development, after which there may be "borrowing new to pay back the old" phenomenon, which will make new investment account for less, this leads to a decline in the rate of investment, in addition to the fact that excessive leverage can cause financial institutions to reduce the size of their credit, and that companies are faced with the problem of paying off their debts and may not be able to sell goods at low prices, which can easily lead to the risk of default, it can even accumulate financial risk.[7]

2.2.3 Risks for Small and Medium-sized Enterprises Arising From the Outbreak of the COVID-19

O Chin-u (2021) argues that as macroeconomic growth slows, more real economic risk will flow to small financial institutions, which focus on small and micro companies, to some extent, the emergence of COVID-19 has also led to the increase of liquidity risk and credit risk of small financial institutions. [8]And because the disclosure of non-performing loan risk has a certain time lag, so for small and medium-sized institutions are likely to face a long time in the future increase in non-performing assets and deal with the enormous pressure.

2.2.4 The Global Political and Economic Situation Is Still Complicated, Especially the Increasing Uncertainty of Sino-U.S. Trade Friction

Yu Yang (2020) that the United States in trade issues against China frequently, hold up the banner of trade protectionism, increase the containment of China, China's participation in international economic competition in the external environment has become increasingly complex and changeable, will pose a challenge to peace and development in our country.[2] Under the pretext of trade imbalance between China and the United States, the United States seeks to continue to dominate the technological progress of future industrial development, in essence, to maintain its global hegemony.

3. REASONS FOR DELEVERAGING AND POTENTIAL SOURCES OF FINANCIAL RISK

3.1 Reasons for Deleveraging

From the perspective of the residential sector, Cheng Xuejun (2021) believes that the continuous increase in medium-and long-term consumer loans is the main reason for the high leverage ratio of residents, and mortgage purchase accounts for the highest proportion of medium-and long-term consumer loans. [9] But deleveraging doesn't mean we can't borrow money to buy a house, instead, a higher down payment would reduce the number of people with access to credit and, in turn, lower the bad debt ratio, helping to stabilize the housing market.

From the perspective of the non-financial corporate sector, during periods of macroeconomic upturn, the Chinese government usually introduces proactive fiscal and monetary policies to stimulate the economy. For small and medium-sized enterprises means easy to borrow more funds, small and medium-sized enterprises will increase the leverage of market expansion. Deleveraging is when the macro economy is under downward pressure, if the government indulges in easy credit, small and medium-sized enterprises are more likely to become insolvent, the bad debt ratio will rise, and the banks will not be able to get their money back, in the end, it may lead to serious consequences. When the state deleverages the enterprises, the financial risk will be eliminated and the stability of the financial market will be ensured.

From the perspective of government departments, in recent years, the size and specific data of the debts of some local governments have been increasing, in addition to the rule-based explicit government debts, there are also many "hidden debts" that are difficult to measure accurately, which have a very negative impact on the follow-up work of the government. Reducing the leverage ratio of government departments can relieve the hidden debt pressure of local governments.

3.2 Potential Sources of Financial Risks

3.2.1 Liquidity Risk

In a downturn, liquidity in the financial system becomes tighter and the credit channel becomes a vehicle for amplifying financial risk, and liquidity may dry up.

3.2.2 Risk of a Real Estate Bubble

China's real estate involves all aspects of the problem, and financial risks, finance and land are very much related to the real estate industry instability will endanger the entire macro-economy. When the U. S. sub-prime mortgage crisis broke out, the fuse is the U. S. real estate bubble. The relatively large bubble is the core issue of China's real estate industry, many people are not motivated by housing but speculation.

3.2.3 Shadow Banking Risk

Compared with the overseas shadow banking system, the shadow banking system in China is also quite different. On the one hand, there is a close relationship between the domestic Shadow Bank and the Commercial Bank, and the shadow business of the Commercial Bank is basically in charge of by them, thus forming the non-traditional credit system. Shadow banks, on the other hand, face huge regulatory arbitrage.

3.2.4 Local Government Debt Risk

In order to support the development of infrastructure projects and related industries, the government investment and financing platform has been deeply involved in the capital market. However, as the financing is carried out with the help of government credit, it is easy to cause the soft constraint of government budget, the accumulation of financial risks of local governments to be too large and too fast, and social moral risks, etc., and all these factors may produce hidden debt risk.

4. POLICY PROPOSALS

4.1 Adopting a Relatively Stable Monetary Policy To Maintain the Liquidity of Economic Development

Monetary policy will continue to support aggregate demand in the short to medium term. We should rationalize the transmission mechanism of monetary policy and guide other financial institutions so as to give more support to the development of the real economy, especially to small and micro enterprises, innovation, green and other related fields, to open up the financial resources allocation to the "last kilometer" of the real economy, thus promoting the formation of the financial virtuous circle of the real economy.

4.2 Cracking Down on the Housing Bubble and Reducing the Potential Risks to the Financial System

With real estate finance as the core, especially the regulation of funds for real estate enterprises in the 2021 has achieved remarkable results. Only the property market moderate rise in order to achieve a virtuous circle of the real estate industry. Out of the psychology of buying up rather than buying down, house prices do not rise or fall, will increase the buyer's wait-and-see mood, which will cause house prices to accelerate the downward, the emergence of systemic financial risks. So the best course of action would be to let house prices rise modestly, rather than inflating the economic damage. Housing prices rise more slowly than GDP, allowing wages to exceed the real increase in housing prices, which is the real virtuous circle.

4.3 Tightening Financial Regulation and Regulating Shadow Banking

Improving supervision and regulating shadow banking has been a key task in the field of financial services in China. Attention should be paid to unifying regulatory norms, unifying the leverage ratio of similar products, effectively controlling and reducing the arbitrage space in financial regulation, gradually eliminating the rigid payments commonly used by local financial institutions, and constructing the policy of equal access to capital management, in order to supervise the Shadow Bank strictly, we should reduce the multi-layer nested rent-seeking behavior space, control the channel business strictly, and carry out the management strategy such as penetrating supervision.

4.4 Controlling the Scale of Local Government Financing and Prohibiting Illegal and Irregular Guarantees

The rapid growth of local government debt not only directly leads to the increase of government leverage, but also indirectly leads to the increase of non-financial corporate leverage. Standardizing local government debt management is an urgent task to reduce macroeconomic leverage ratio. First of all, it controls the scale of the debt-issuing projects of local government departments, strictly defines the debt-raising procedures and financing purposes of local government departments, and classifies the debt-issuing projects of local government departments into full-scope budget control Secondly, we should control and dissolve the local government debt risk, and establish the early-warning mechanism and disposal mechanism of local government debt risk.

5. CONCLUSION

China's macro leverage ratio has risen rapidly, and there are some financial risks. From the perspective of residents, non-financial enterprises and government departments, it is necessary to deleverage. It mainly prevents financial risks from stabilizing monetary policy, cracking down on the real estate foam, regulating shadow banking, and controlling the financing scale of local governments.

AUTHORS' CONTRIBUTIONS

Zhiqiang Zhu is responsible for manuscript, and Cui Min contributed to revising and editing.

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