**debt, financial/债(Zhài)**

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| Chinese Perspective | YAO Yang | 09 May 2022 |

Economic ties between China and the rest of the world are the most significant among China’s foreign relations. Many of China’s current economic and financial institutions are modeled on their western counterparts. As a result, the discrepancies between China and the West are relatively small in terms of economic terms. However, subtle differences do exist in some areas and have led to different human behavior and government policies. The understanding of financial/economic debt is one of such areas.

China has a tradition of avoiding debt. Debt is often depicted by literature works as an evil that always dooms a poor family. This is certainly related to the usury that prevails in the informal lending market. Usury rates are so high that a poor family is almost for certain not able to repay the debt and interest by the end of the borrowing term. As a result, the family has to borrow new debt to repay the old debt and thus embarks on a road to perish. Although bank finance today is made available to most people, ordinary families are still cautious to take debt. Until very recently, there were still people who took cash to buy homes. The flip side is that Chinese people save a lot. At the highest point in the recent decades, an average household saved 37% of its disposable income and it used about 40% of its savings to buy new homes.

This is changing among younger generations, though. Thanks to the prevalence of digital finance, it becomes easy for young people to borrow. Most of their borrowings are spent on trendy goods such as new mobile phones and other electronic products. It is possible that Chinese people will give up their shrift culture and embrace a consumer culture that is very much like the one prevailing in the West.

Government policy in China is still influenced by ideas formed in the planning period. Economic planning does not need finance. In the beginning of each year, the planning agencies set up production targets according to the revenue obtained last year as well as the goal of the coming year. The central bank is the state’s cashier that allots money to factories according to the production targets they have received. By the end of the year, factories pay back the money after fulfilling their production targets. As such, money in a planning economy is distinctively different from what it is in a market economy.

Debt in the west has undergone tremendous changes over the last century. During the period of gold standards, money had an intrinsic value in itself. The collapse of the gold standards and the subsequent establishment of the modern central banking system in the 1920s changed the meaning of money. It no longer bears value in itself, but is instead only a symbol of credit/debt. China created paper money in the Song dynasty and made it popular in Yuan dynasty. But paper money at that time still carried real values because it was backed by precious metals. In a modern-day market economy, the central bank can produce bank notes bearing whatever values it desires, and commercial banks can create extra money, usually in electronic forms, by issuing new debts. Money and debt are equivalent, and money creates money by way of new debts.

At this stage, debt is created to serve the real economy --- in China, this means the economic sectors that produce tangible goods and services for the society. When a company borrows from a bank, the debt thus created is expected to be matched by future economic output that is enough to cover its repayment. Many Chinese hold this as a doctrine for financial market development. The government repeatedly calls for the financial sector to serve the real economy.

The development of financial transactions, and the rise of derivatives in particular, however, has broadened the scope of debt. Consequently, more financial transactions happen among financial institutions than between companies and banks. Financial experts in the West, exemplified by those working on the Wall Street, believe that speculations among financial institutions are necessary for the economy to gain full efficiency. In China, however, such speculations have been given the term “virtual economy” --- the internal circulation within the financial sector. It carries an obvious negative connotation and is contrasted by the real economy. For many Chinese, it is immoral for the financial sector to make money simply by exchanging money. In the extreme case, the financial sector is regarded as a parasite to the society. This negative view has an impact on the government’s policy toward the financial sector and debt.

Most China’s policy makers still hold on to the classical definition of debt, i.e., debt is backed by future output in a one-to-one manner. They are quite vigilant about the virtual economy that is believed to produce money by exchanging money. This had led to a deleveraging campaign on shadow banking in 2018. Shadow banking was created in China when banks were allowed to divert their assets to off-balance sheet activities. It played a critical role to liberalize China’s interest rate regime. Interest rates were regulated for banks’ balance-sheet activities, but were not for their off-balance sheet activities. However, the development of shadow banking also created many new issues. One of them was the internal circulation of money/debt within the financial sector. Banks and other financial institutions conducted complex transactions in order to circumvent government regulations, creating a large amount of extra debts. The deleveraging campaign set stringent regulations on banks and almost instantly shrank the size of shadow banking.

The classical understanding of debt also makes regulators reluctant to promote digital finance. China is one of the world’s leaders in the digital economy. One of the advantages of digital finance is its low marginal costs on both sides of its business. It gets investors more cheaply than the traditional form of finance. Instead of working on a few large investors, digital finance can gather funds from a numerous number of small investors. Using its advantage of large networks and large volumes of data, digital finance has a better capacity than traditional finance to judge and control risk. However, digital finance itself has a potential risk --- its network effects may amplify the participation on both ends of its business and cause a financial tsunami. Consequently, the regulators prefer a contained development path for China’s digital finance.

The aversion of debt is also reflected by the government’s prudence about its own debt. Government regular debts are about 40% of GDP in recent years, much lower than in most industrial countries. Since the Central Bank Law was passed in 1994, the government has never resorted to the central bank’s monetary expansion for fiscal finance. In recent years, the Modern Monetary Theory (MMT) has gained popularity in the United States, mostly propelled by the Federal Reserves’ flood-like monetary expansion to combat possible recession caused by COVID-19. There are resonant discussions in China. However, the majority view is to reject the MMT as a theory leading to perishing consequences. The memory of the fall of Yuan dynasty and the Kuomintang government is still fresh in the Chinese mind.

Local governments do borrow more than the central government, though. In addition to the regular government debts approved by the central government, local governments often raise debts through local financial vehicles (LFVs) --- local government-owned financial companies that can issue corporate debts on the open markets. Most debts raised by LFVs are spent on building local infrastructure. But LFV debts are commercial debts that usually have short terms. This discrepancy creates a constant stress on local public finance.

While the government does use debt to finance social spending, it is very cautious to spend debt directly on people. During the course of COVID-19, many industrial countries raised debts and distributed them to ordinary people. China also increased the level of government debt, but most of it has been spent on infrastructural building and enterprises. To most Chinese, raising debt to finance consumption is a symbol of desperation and should be avoided whenever it is possible. This conviction is reflected by government policy.

In summary, the main stream view of debt still is that debt should be issued by financial institutions to help the real economy. Government borrowings are mostly spent on building up physical capital instead of being spent on people. Most Chinese families still hold on to a shrift culture, but younger generations are embracing a new consumer culture.