Research Report on China

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Responsible Expert:

Hector Alvarez

For further information contact:

Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

Ratings

Sovereign Government Credit (LC)	AA-
Sovereign Government Credit (FC)	AA-
Country Credit Environment (LC)	AA-
Country Credit Environment (FC)	AA-

* These ratings are unsolicited

Main Economic Indicators of China

Macro indicators	2012	2013	2014
Gross gov. debt, CNY bn	19790	23179	26173
Nominal GDP, CNY bn	53412	58802	63614
Real GDP growth, %	7,7	7,7	7,3
Gross gov. debt/GDP, %	37,1	39,4	41,1
Deficit (surplus)/GDP, %	0,0	-1,1	-1,2
Inflation rate, %	2,5	2,5	1,5
Current Account Balance/GDP, %	2,5	1,6	2,1
External debt, USD bn	-	-	949

Development indicators	2014
Inequality adj. HDI	0,72
GDP per capita, USD th	13,2

Default indicator	11.12.2015
5-Year CDS spread, Bp	104
10Y Gov Bond Yield, %	3,05

Source: RAEX (Europe) calculations based on data from the IMF, CIA, Deutsche Bank, Trading Economics

Summary

China's 'AA-' ratings reflect a long track record of stable and robust economic growth, sound macroeconomic indicators and an exceptionally strong sovereign external position. The ratings also reflect elevated leverage of the economy, government's high contingent liabilities, relatively low GDP per capita and structural imbalances inherent to a developing economy.

China's external position remains outstanding as shown by positive trade and current account balances, the high level of FX reserves and the low amount of FX denominated government debt. Moreover, CNY's addition into the IMF SDR basket will further improve China's international position as an issuer of a global reserve currency in the long-term.

Growth in China has been stable and the economy has shown signs of rebalancing from investments and exports driven growth to the model based on internal consumption.

In addition, low inflation and unemployment remain solid indicators of stability. Private credit has eased along with shadow banking as a result of the authorities' actions to tackle this issue.

Monetary and fiscal policies remain sound to alleviate public finances and gradually liberalize the economy which will better serve the PBOC on the transmission mechanism of their policy.

Stable official government debt but high contingent liabilities. Official government debt to GDP has remained low and stable over the past six years increasing by only 5p.p. to 41,1% of GDP at end-2014 However, as mentioned in our previous report[1], this indicator is set to gradually increase due to additional local government debt and slower economic growth. Official local government debt increase is partly positive due to its transition from off-budget debt to formalized bond issuance.

Exceptionally strong external position. China's economy remains characterized by a strong external position. Its sovereign balance sheet boasts FX reserves of USD 3,5tn equivalent to more than 83% of general government debt. Additionally, government FX debt represents only 1,1% of GDP and it is vastly covered by FX reserves (by 31x). The reserves have declined since 2013 (see graph 1), but they still provide deep buffers

[1] Research report on China from 12 June 2015 (http://raexpert.eu/reports/Research_report_China_12.06.2015.pdf)

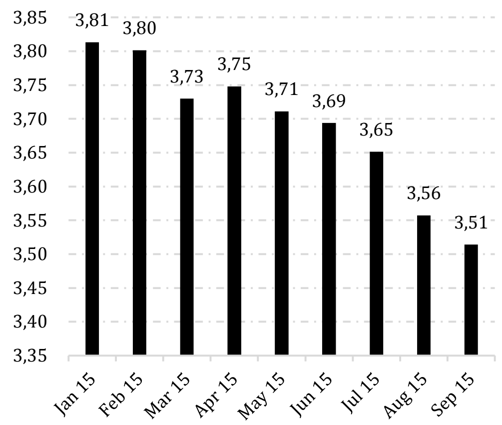
against most possible risks and place China among the top net creditor nations of the world.

China's current account has presented an average annual surplus of 2,8% of GDP over the last six years. Furthermore, the country's trade surplus was 3,7% of GDP in 2014 and 2,5% of GDP in 2013.

The Bank for International Settlements real effective exchange rate calculation shows that the CNY has been continuously appreciating in real terms to a stage that is no longer considered undervalued[2], it is more internationalized and becoming more freely traded. These, among other factors, led to the inclusion of the CNY in the SDR basket. However, the exchange rate is still managed by the monetary authorities and is far from a free floating system.

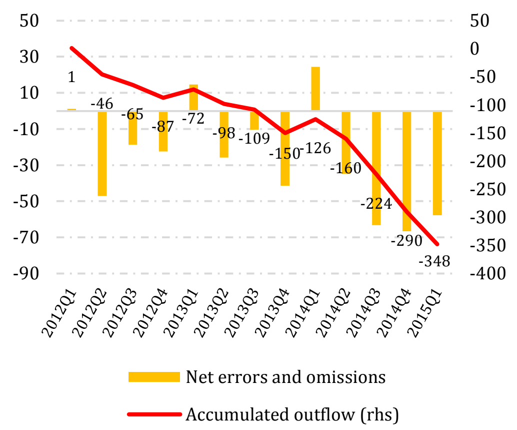
Capital controls exercised by China lead to significant capital flight in addition to official capital flows. China's balance of payments under the "errors and omissions" account has been negatively accumulating since 2012 reflecting an outflow of unaccounted funds exceeding USD 300bn (see graph 2).

Graph 1: FX reserves, USD tn



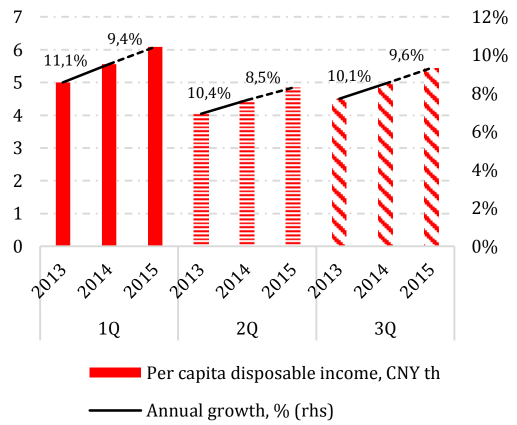
Source: RAEX (Europe) calculations based on data from the State Administration of Foreign Exchange

Graph 2: Net errors and omissions, USD bn



Source: RAEX (Europe) calculations based on data from the PBOC

Graph 3: Disposable income



Source: RAEX (Europe) calculations based on data from the National Bureau of Statistics of the People's Republic of China

Moderating but stable economic growth. Economic growth in China has been solid and stable for the past two decades. GDP growth in 2014 was 7,4%. Although it is projected to slowdown in the medium term, this is partly a result of the authorities' actions to rebalance the economy from a credit and investment-based model to a consumer-based model (see graph 3).

Lower inflation and stable unemployment. Inflation has decelerated in 2015 caused by supply side shocks due to lower food and energy prices and not necessarily reflecting the economic slump in the country. Besides, unemployment has been historically low and stable (4,1% in 2014).

Private credit, including shadow banking, has been curbed. The investment-driven economic growth model in China leads to high leverage. Bank´s assets to GDP were about 280% at end-2014 and the volume of private credit from the banking sector was 169% of GDP in 2014, excluding shadow banking. However, credit growth has eased due to tighter financial conditions and actions by the authorities to regulate shadow banking activities, as well as gradual rebalancing of the economy towards a consumption-driven growth.

The banking system is profitable with an average ROA of 1,2% in 2014 and is moderately concentrated - 30,1% of the total assets are concentrated in the three largest banks. The official reported figure of non-performing

[2] See the previous research report for further explanation and a chart of the REER.
Research report on China from 12 June 2015 (http://raexpert.eu/reports/Research_report_China_12.06.2015.pdf)

loans (NPLs) remains low at 1,1% in 2014. However, the credit risk stemming from bad assets of shadow lenders is hard to estimate.

Sound fiscal policy and low deficit. New fiscal reforms allowed local governments to issue their own bonds, while setting debt limits. This leads to more transparency regarding local government financing activities and reduces financing costs for sub-national governments as large part of their debt is bank related and carries relatively high interest rates. However, a rapid transition might cause a sudden halt to local government spending and slow down the economy.

Evolving monetary policy. The PBOC has made important strides towards a more open and competitive financial system. Even though there are still implicit guarantees and preferential rates to SOEs, lending interest rates are now fully liberalized and the ceiling on the deposit rates has recently been lifted. These steps were among the factors that led the IMF to include CNY in the SDR basket paving the way for CNY to become a global reserve currency in the long-term. However, maintaining capital controls, managed exchange rate and other administrative measures fundamentally contradict PBOC's ambitions to become the issuer of global reserve currency.

Important note for sovereign ratings

This Research Report shall be treated as a supplementary part of the published Press Release included in the following link:

http://raexpert.eu/reports/Press_release_China_11.12.2015.pdf

Both documents shall be treated as essential parts of each other.

For further information on the factors, their weights, methodologies, risks and limitations of these ratings, and other regulatory disclosures, please refer to the Press Release and the website of the agency.