Rating-Agentur Expert RA GmbH confirmed at 'AA-' the sovereign government rating and downgraded to 'A+' the credit climate rating of China

Rating-Agentur Expert RA GmbH confirmed the sovereign government credit rating (SGC) of China at 'AA-' (Very high level of creditworthiness of the government) in national currency and at 'AA-' (Very high level of creditworthiness of the government) in foreign currency.

Rating-Agentur Expert RA GmbH downgraded the country credit environment rating (CCE) of China from 'AA-' (Very high quality of credit environment of the country) to 'A+' (High quality of credit environment of the country) in national currency and from 'AA-' (Very high quality of credit environment of the country) to 'A+' (High quality of creditworthiness of the government) in foreign currency.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- China's economy remains highly competitive. The trade surplus was equal to 5,4% of GDP in 2015 showing that the reduction in exports was less than that of imports due to lower domestic demand. China is ranked 28th out 140 countries in the Global Competitiveness Index report prepared by the World Economic Forum;
- Real GDP grew at a 6,9% rate in 2015, still a very solid figure; however, the downward trend is expected to continue due to the global slowdown, weaker domestic demand and the authorities' effort to rebalance the economy reflected by the higher share of the tertiary sector in the economy at 50,5% in 2015, around 6p.p. higher than in 2011;
- The sovereign balance sheet remains strong. Even though, FX reserves have been in a downward trend, they stood at USD 3,2 tn as of January 2016 equivalent to more than 71% of total government debt;
- Central government short-term debt was as low as 1,6% of GDP in 2Q 2015 and is well covered by FX reserves (19x);
- The fiscal performance remains sound despite wider deficit in 2015 due to looser fiscal policy (2,7% of GDP). However, the fiscal balance could be even wider if off-budget operations were to be included as estimated by the IMF;
- The inclusion of the CNY in the SDR basket continues to be a positive factor, however, we expect to see benefits from this in the mid- and long-term perspective;
- The banking system continues to be profitable (ROA of 1,1% in 2015) and, according to official figures, well capitalized (capital adequacy ratio equaled 13,5% in 2015) and with low NPLs to total loans ratio (1,7% in 2015). Nonetheless, concerns remain over the amount of bad assets from the shadow banking sector;
- Low and stable inflation over the past four years (1,6% in 2015). Even though the CPI index grew by 2,3% y-o-y in April 2015 due to an increment in food prices, it is not expected to be a sustained price increase and, thus, will not reverse the accommodative monetary policy in place;
- The unemployment rate remains low (4,1% in 2015).

Restricting factors:

- Even though general government debt remains at acceptable levels amounting to 43,9% of GDP and 150,0% of budget revenues as of end-2015, it has gradually increased since

2010 and we expect it to continue in that trend in the mid- and long-term perspective, especially if economic growth is weaker than expected by the government;

- The authorities have established to increase the fiscal stimulus in 2016 in order to maintain economic growth. Furthermore, a big tax overhaul will occur in China in order to relieve fiscal burden on services companies and encourage the manufacturing industry to innovate (another step towards rebalancing of the economy). However, the ease of taxes on companies may hurt local governments' revenues;
- Credit to the economy continues to increase. The ratio of banks´ assets to GDP stood at 291% and domestic credit to GDP at 202% in 2015, an increase of 22,4p.p. and 32,8p.p. respectively. Both ratios clearly indicate excessive leverage of the Chinese economy and, if off-balance sheet liabilities (mainly wealth management products) were taken into account, these amounts of debt would be even higher;
- Positive economic indicators in the beginning of 2016 caused the PBC to go from a loose monetary policy position to a prudent stance with the possibility of further easing if needed. While loose monetary and fiscal policies have aided economic stability, they have also taken private debt to higher levels and could augment risks of increased NPLs and defaults in the future.

Negative factors:

- Contingent liabilities related to SOEs' and local governments' debt as well as to the banking system continue to pose potential risks to the central government. Even though local governments' bond issuance and debt cap have contributed to reduce continent liabilities' risks[1], SOEs' debt continues to mount. It increased by 1,7% from April 2015 to April 2016 and the debt to assets ratio increased by 1,3p.p. over the same time span. However, the still strong level of sovereign reserves and the liquidity of SOEs' assets are factors which contribute to mitigate the risk of these liabilities, if they were to materialize;
- Environmental issues such as water and air pollution remain as a negative factor as, according to a study from RAND Corporation, it costs China around 6,5% GDP per year;
- The banking sector is mostly state-owned and the government still has a grip on it. Nevertheless, the elimination of restrictions in interest rates reflects progress in the liberalization of the banking system.

Support factors:

- Substantially high level of FX reserves (USD 3,2tn in January 2016 including a considerable amount of US government debt) (weak support-factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Negative factors:

- Despite the stock market stabilization in the beginning of 2016, last year's crash and continued volatility in the stock market exposed structural risks in China;
- Numerous government restrictions on free flow of capitals and operation of capital markets are still in place;
- Low quality of investor's protection – China is ranked 134th out of 180 in protecting interests of minority investors according to the WB Doing Business 2016 report;
- Corporate insolvencies rose by 25% in 2015;
- The debt of the non-financial private sector in China, according to the Chinese authorities, was as high as 202% of GDP in 2015 (and, according to our estimations, around 290% of GDP if we include debt to the financial sector).

[1] In 2015, around 50% of debt from regional and local governments was swapped from banks and special purpose vehicles into bonds with lower cost and longer maturities.

Positive factors:

- Real interest rates remain stable (2,8% in 2015).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Sustained gradual reduction in private credit, especially in the shadow banking sector, without hampering economic growth;
- Reduction of contingent liabilities following the structural reform on SOEs and local governments' debt.

The following developments could lead to a downgrade:

- General government debt and private debt levels are very close to our internal thresholds. A continued increase in these two indicators – slightly higher than the Agency's expectations – combined with a further decline in FX reserves and sustained capital outflows, would trigger a downgrade of the SGC rating in the next rating review.

"China's 'AA-' sovereign government credit ratings indicate the prevailing solid stance of the economy, the authorities' wide range of tools and buffers to manage recent – and potential future – external and domestic shocks and the acceptable levels of government debt. Even though the amount of debt has increased and the fiscal deficit has widened, both figures remain manageable. Furthermore, the banking system remains profitable and well capitalized and inflation, as well as unemployment, remain low and stable.

However, the ratings also reflect high contingent liabilities related to SOEs' and regional and local governments' (RLGs) debt as well as to the banking system, high and increasing levels of domestic credit and uncertainty regarding monetary and fiscal policies. Both policies are accommodative and could further increase private debt augmenting risks of increased NPLs and defaults in the future.

On the other hand, the downgrade of local and foreign currency CCE ratings (from 'AA-' to 'A+') reflects the sustained increase in private sector debt and deterioration of the business environment. Both factors combined caused an increase of 25% in corporate insolvencies in 2015.**"** – clarified Hector Alvarez, Expert of Rating-Agentur Expert RA GmbH.

Responsible expert: Hector Alvarez, Expert of Rating-Agentur Expert RA GmbH

Reviewer: Vladimir Gorchakov, Lead Expert of Rating-Agentur Expert RA GmbH

Research report on China is available at:

http://raexpert.eu/reports/Research_report_China_03.06.2016.pdf

Next scheduled rating publication: 25 November 2016. The full sovereign rating calendar can be found at http://raexpert.eu/sovereign.php#conf-tab-5.

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	**Foreign currency**	**National currency**	**Foreign currency**
11.12.2015	First assignment of both types of ratings for the country	AA-	AA-	AA-	AA-

Minute's summary

The rating committee for China was held on 3 June 2016. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings and Country Credit Environment Ratings. Short Public Version (from April 2015) can be found under the following link: http://raexpert.eu/files/methodology/Methodology-Short-Sovereign.pdf. Descriptions and definitions of all rating categories can be found under the following link: http://raexpert.eu/sovereign.php under the "Rating scale" section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: International Monetary Fund, World Bank, Trading Economics (www.tradingeconomics.com), World Economic Forum, Doing Business, United Nations, Transparency international, People's Bank of China, China Banking Regulatory Commission, State Administration of Foreign Exchange, National Bureau of Statistics of the People's Republic of China, Ministry of Finance of the People's Republic of China, AsiaBondsOnline.

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Despite similar methodologies, credit ratings of China from RAEX (Moscow) (both SGC and CCE) may be different from those assigned by Rating-Agentur Expert RA GmbH due to:

- Possible differences in expert assessments of individual factors;
- Some differences in methodologies (methodologies are similar but not identical);
- Differences in the date/period of assessment for individual factors.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

Risk warning

The Agency disclaims all liability in connection with any consequences, interpretations, conclusions, recommendations and other actions directly or indirectly related to the conclusions and opinions contained in the Agency's Research Reports.

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

Rating-Agentur Expert RA GmbH is a credit rating agency established in Germany and therefore shall comply with all applicable regulations currently in force in the European Union.

The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.