17 November 2017

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

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

Rating-Agentur Expert RA GmbH confirmed the country credit environment rating (CCE) of China at 'A+' (High quality of credit environment of the country) in national currency and at 'A+' (High quality of credit environment of the country) in foreign currency.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- Competitiveness remains a key strength for the Chinese economy. Exports and imports continued to grow as compared to 2016 by 7,1% and 17,3% (due to increasing domestic demand) respectively as of September 2017. As a result, we expect the trade surplus to shrink further going forward. China is also ranked 27th out 140 countries according to the 2017-2018 Global Competitiveness Index report prepared by the World Economic Forum;
- Real GDP growth has stood solid and is set to grow above the 6,5% authorities' target in 2017. Moreover, sings of economic rebalancing remain in place as the tertiary sector continues to increase its share in the economy;
- International reserves continued to increase following a rapid appreciation of the CNY during the year as a result of strong economic fundamentals;
- Central government short-term debt increased slightly in 2Q 2017 when it stood at around 3% of GDP and was well covered by FX reserves (10x);
- 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 official figures continue to show a sound financial sector. As of end-2016, ROA was 1,2%, NPLs ratio equaled 1,7% and the average capital adequacy ratio stood at 13,4%. Nonetheless, the shadow banking sector remains a concern;
- Inflation has been stable and is set to finish 2017 at around 2,3% as initially expected;
- Unemployment remained low at a rate of 4,1% in 2016.

Restricting factors:

- Even though the level of government debt is stable, it continues to increase and we expect it to break our internal threshold in the following years given the government's proactive fiscal policy. In 2017, we expect debt to GDP to be at around 48% and debt to revenues at 174%;
- We do not anticipate any radical changes in the accommodative fiscal policy approach as expenditures have continued to increase at a higher pace than revenues by the end of 3Q 2017. The fiscal reform includes a new budget law to improve transparency and tax reforms to support the rebalancing of the economy as well as a social security reform;

- The monetary policy remains loose; the reserve requirement ratio is still at 4,35% and the 7-day repo rate at 2,45% after its increase in 1Q 2017;
- We expect the fiscal deficit to continue to widen going forward given the government's stimulus programs. Moreover, the IMF's estimated augmented balance is set to be around -12,6% of GDP in 2017 due to an increase in off-budget investments;
- China's institutional strength, albeit remaining neutral, has slightly deteriorated as shown by the moderately low level of the rule of law index and government effectiveness index. Moreover, these indicators could further deteriorate if the authorities do not follow through with the planned reforms.

Negative factors:

- Leverage in the economy has continued to grow and we expect it to continue on the same trend for the following years breaking our internal threshold in order to consider it a negative factor instead of restricting. The overall aggregate financing to the real economy (AFRE) continues to rise; according to our forecast, AFRE to GDP will end the year at around 216% of GDP, 7p.p. higher than in 2016. Moreover, even though the growth on trust and entrusted loans (a form of shadow banking) halted in mid-2017 as the authorities' effort to curve this have so-far succeeded, it remains a risk for the financial system as it is difficult to regulate and measure. Additionally, we estimate bank assets to GDP to increase up to 313% by end-2017;
- SOEs debt, despite being stable, remains elevated and local government debt through LGFVs keeps increasing. Thus, the contingent liabilities' materialization risk for the government remains in place. However, the factor is slightly mitigated by the fact that the central government has signaled that it will not intervene financially in case of an LGFV default and that it is willing to let weaker SOEs go into default;
- China's environmental issues remain a negative factor as they continue to impact economic activity; moreover, China ranks 109th in the latest Environmental Performance Index prepared by Yale and Columbia Universities. However, the authorities have made strides, such as providing subsidies for renewable energies and implementing environmental taxes, in order to improve environmental conditions;
- The banking sector remains mainly dominated by policy banks, which augments the governments' contingent liabilities, as mentioned before.

Support factors:

- Substantially high level of FX reserves (USD 3,189 tn by August 2017) (weak support-factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Positive factors:

- Real interest rates remain stable (3,1% in 2016).

Restricting factors:

- We still consider the restrictions on free flow of capital and operation of capital markets as non-positive factor. However important strides have been made to open market and the financial system; thus, this factor was moved from negative to restricting;
- The CSI 300 index has increased by around 39% as of November 2017 from end-2016 showing that the stock market recovery continues;
- Bankruptcies hiked by 54% in 2016. However, these events are also connected to improving the efficiency of the economy by eliminating "zombie" companies.

Negative factors:

- Low quality of investor's protection – China is ranked 123rd out of 180 countries in protecting interests of minority investors according to the WB Doing Business 2017 report;
- The debt of the non-financial private sector in China increased up to 211% of GDP as of 1Q 2017; thus, pushing up the figure of the economy's total debt to around 258% of GDP.

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Gradual deleverage of the economy combined with a decline in shadow banking;
- Decrease in SOE's debt and increase in profitability alongside a reduction of off-budget debt from local governments which would reduce the government's overall contingent liabilities.

The following developments could lead to a downgrade:

- Deterioration of fiscal metrics due to increased government support and depressed revenues;
- A continued increase in credit to the economy above our current expectations.

"The Agency has decided to downgrade the SGC ratings of China to 'A+' to the same level of our CCE ratings, which were downgraded on the review from June 2016. The decision is based on the constant increase in leverage of the economy – especially in private credit – and our expectations that this will remain in an upward trend. Moreover, fiscal metrics have also deteriorated on the back of the authorities' prolonged stimulus; government debt, despite remaining bearable, has hiked and the fiscal deficit has widened, we anticipate both metrics to continue in the same path.

Despite this, macroeconomic indicators remain strong with low levels of unemployment and inflation as well as a solid, albeit declining, GDP growth. Additionally, competitiveness remains a key strength for the Chinese economy and the external position remains strong. Finally, we still consider that the government has sufficient tools to mitigate sudden shocks." – Clarified Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH.

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

Reviewer: Gustavo Angel, Rating Associate of Rating-Agentur Expert RA GmbH

Research report on China is available at:

https://raexpert.eu/reports/Research_report_China_17.11.2017.pdf

Next scheduled rating publication: TBD in December 2017.

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	**Foreign currency**	**National currency**	**Foreign currency**
19.05.2017	Scheduled review of both types of ratings for the country	AA-	AA-	A+	A+
25.11.2016	Scheduled review of both types of ratings for the country	AA-	AA-	A+	A+
03.06.2016	Scheduled review of both types of ratings for the country	AA-	AA-	A+	A+
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 16 November 2017. 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 2017) can be found under the following link: http://raexpert.eu/files/methodology/Methodology_Short_Sovereign_v2.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, Asia Bonds Online.

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.

Regulatory use

Only SGC ratings can be used for regulatory purposes according to the ESMA definition. CCE ratings are not considered as credit ratings within the framework of Regulation (EC) No 1060/2009.

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

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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.