

## Rating-Agentur Expert RA GmbH confirmed at 'AA-' the sovereign government and at 'A+' the credit climate ratings 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 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 have resumed growth; as of 1Q 2017 exports have grown by 8,2% and imports by 24% and the trade surplus remained steady in 2016 at 4,7% of GDP. China is also ranked 28<sup>th</sup> out of 140 countries in the Global Competitiveness Index report prepared by the World Economic Forum;
- Despite slowing down, real GDP growth was solid in 2016 when it grew at a 6,6% rate and, by 1Q 2017, it has also remained quite steady driven by investment. Furthermore, the tertiary sector share continues to grow supporting the government's plan to rebalance the economy;
- After a long period of continued decline of international reserves, these started to pick up again in February 2017. Despite this, reserves have declined relative to total government debt by around 7p.p. from a year ago to stand at 62% of government debt;
- Central government short-term debt remained low at 1,8% of GDP in 2016 and was well covered by FX reserves (16x);
- 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 capital adequacy ratio stood at 13,4%, very stable figures when compared to our previous review. Nonetheless, given the government efforts to curb financial leverage, the shadow banking system has reemerged (off-balance sheet lending increased by CNY 754 bn in March 2017) and remains a latent risk for the stability of the financial system as it is difficult to regulate and measure;
- Inflation remains stable at 2,1% in 2016 and is expected to increase gradually in the following years;
- Unemployment remains low (4% in 2016).

#### Restricting factors:

- Gross government debt remains at acceptable levels but continues to increase and we anticipate it will maintain this trend in the mid-term perspective given the government's proactive fiscal policy. It was estimated by the IMF at 46,2% of GDP and 163,8% of budget revenues as of 2016;
- The authorities continue to maintain a fiscal policy based on expenditure and tax cuts in

order to maintain high rates of economic growth. The accumulated y-o-y growth rate of expenditures for 1Q 2017 was 21% while revenues grew by 14,1% in the same period. It is too early to evaluate the fiscal reform which includes the new budget law to improve transparency, tax reforms to support the rebalancing of the economy as well as a social security reform;

- The economy's leverage continues to increase. As of end-2016, the aggregate financing to the real economy (AFRE) was 209% of GDP and grew by around 13% y-o-y in absolute terms while trust and entrusted loans continue to increase at high paces. Additionally, we estimate that bank assets to GDP grew by 24p.p. from 2015 to 2016, to stay at 309,1% at year-end. On the other hand, nominal GDP only grew by 6,6% according to IMF figures;
- The People's Bank of China (PBC), despite supporting a prudent policy, has recently increased different money market rates in order to discourage short-term financing. However, it has kept the reserve requirement ratio unchanged and may further reduce it if expected growth were to fall. We believe that further easing to meet economic growth goals may drive leverage in the economy and a hike in NPLs;
- The fiscal deficit continues to worsen and it finished 2016 wider than initially expected by the Agency as a result of increased expenditures (3,7% as compared with an initial estimation of 2,9%). Moreover, the augmented fiscal deficit is estimated by the IMF to be above 8% given the increase in local governments' off-budget financing;
- China's institutional strength, albeit remaining neutral, has slightly deteriorated as shown by the negative dynamics 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 reform.

#### Negative factors:

- Contingent liabilities' materialization risk remains in place given the still high indebtedness of SOEs and increased local government debt through Local Government Financial Vehicles (LGFVs). However, SOEs debt has stabilized and reform for this sector is ongoing, additionally, the Chinese authorities have reduced support for LGFVs and implicitly guaranteed instruments;
- China's environmental issues remain a negative factor as, according to a RAND Corporation study, it costs China around 6,5% GDP per year;
- 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 3,124 tn by April 2017 including a significant amount of US government debt) (weak support-factor).

#### ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

##### Positive factors:

- Real interest rates remain stable (2,3% in 2016).

##### Restricting factors:

- After the stock market decline of 2015, it has recovered and has been mostly stable. The CSI 300 index has increased by around 12% as of May 2017;
- Recent bankruptcies continue to increase. These hiked by 54% in 2016. However, these events are also connected to improving the efficiency of the economy by eliminating "zombie" companies.

##### Negative factors:

- Restrictions on free flow of capitals and operation of capital markets, despite being

gradually reduced, are still in place;

- Low quality of investor's protection – China is ranked as 123<sup>rd</sup> 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, 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).

#### SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Gradual deleverage of the economy combined with a decline in shadow banking;
- Successful SOE reform and 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:

- Further than expected deterioration of fiscal metrics such as government debt and fiscal balance;
- A continued increase in credit to the economy combined with a further decline in FX reserves and sustained capital outflows.

“The Agency confirms the SGC ratings of China at ‘AA-’. Despite the downturn in fiscal and private debt metrics, these figures remain in line with our previous expectations and we believe the authorities still have enough tools to control the economic transition and adverse external shocks. Furthermore, macroeconomic indicators remain solid, the external stance is strong and official government debt levels are still acceptable.

However, we also believe that these tools are diminishing and that the economy's strength to cushion sudden shock events is declining. Moreover, the economy remains highly leveraged and contingent liabilities materialization risks are still in place.” – 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:

[http://www.raexpert.eu/reports/Research\\_report\\_China\\_19.05.2017.pdf](http://www.raexpert.eu/reports/Research_report_China_19.05.2017.pdf)

Next scheduled rating publication: 17 November 2017. The full sovereign rating calendar can be found at <http://raexpert.eu/sovereign/#conf-tab-5>

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**RATING HISTORY:**

Date	Review reason	SGC		CCE	
		National currency	Foreign currency	National currency	Foreign currency
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 17 May 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](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 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

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 press-release and research report.

This press-release represents the opinion of Rating-Agentur Expert RA GmbH and is not a recommendation to buy, hold or sell any securities or assets, or to make investment decisions.

## 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.