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. Despite the continued decline in the overall value of exports (-7,6% y-o-y) and imports (-8% y-o-y) by September 2016, the trade balance continues to present a surplus. China is also ranked 28th out of 140 countries in the Global Competitiveness Index report prepared by the World Economic Forum;
- Economic growth has been robust as of late driven by retail sales, investment and industrial production. Despite this, growth is expected to continue in a downward trend given the government's rebalancing efforts and weak external demand;
- International reserves remain strong at around 67% of total government debt. Despite this, they have been constantly declining due to the downward pressure on the CNY;
- Central government short-term debt remains low at 1,8% of GDP in 2Q 2016 and is well covered by FX reserves (16x);
- The fiscal balance is expected to end the current year around -2,9% given the continued fiscal stimulus provided by the government. Additionally, the augmented deficit is also expected to widen due to increased off budget transactions by local governments;
- 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 supported by the following figures: ROA of 1,2%, NPLs ratio equal to 1,7% and capital adequacy ratio at 13,4% by 3Q 2016. Nonetheless, even though the shadow banking system started to curb in 2015, it has reemerged with new schemes and remains a latent risk for the stability of the financial system as it is difficult to regulate and measure;
- The price level remains stable. It has averaged a y-o-y monthly increase of 1,9% along 2016. Despite this, it is expected to increase gradually in the following years;
- Unemployment remains low (4,1% in 2015).

Restricting factors:

- Official general government debt remains at acceptable levels amounting to 42,9% of GDP and 149% of budget revenues as of end-2015. However it is expected to gradually increase due to fiscal stimulus to support growth (IMF estimations stand at 46% of GDP and 167% of revenues for 2016);

- Fiscal policy remains loose with expenditures growing at a higher pace than revenues throughout 2016 (accumulated y-o-y growth for 9M 2016 was 12,5% for expenditures and 5,9% for revenues). New fiscal reform is being implemented which includes the new budget law to improve transparency, tax reform to support the rebalancing of the economy and social security reform;
- Aggregate financing to the real economy (AFRE) increased at an average pace of 12,7% y-o-y for the past 10 months while nominal GDP grew at an average of 7,4% in the first 9M of 2016. The ratio of banks´ assets to GDP stood at 286% and domestic credit to GDP at 196% in 2015. These figures clearly indicate excessive leverage of the economy. Furthermore, shadow banking liabilities and products continue to rise;
- The PBC has continued to maintain a prudent monetary policy in order to support economic growth – along with a loose fiscal stance. While loose monetary and fiscal policies have aided economic stability, they have also propelled increased leverage in the market and could lead to a hike in – official and unofficial (shadow banking) – NPL levels.

Negative factors:

- Debt from SOEs' and local governments continue to rise and has increased the risk of contingent liabilities' materialization. SOEs' debt has increased by 9,9% in the first 9M of 2016. However, the Ministry of Finance has recently made it clear that implicit guarantees on this type of debt should not be expected by investors. Additionally, still solid volume of international reserves and the liquidity of SOEs' assets contribute to mitigate the risk of these liabilities if they were to materialize;
- 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, despite being gradually liberalized, is mostly state-owned and the government still has a certain control over it.

Support factors:

- Substantially high level of FX reserves (USD 3,216 tn in October 2016 including a substantial amount of US government debt) (weak support-factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Negative factors:

- Numerous government restrictions on free flow of capital and operation of capital markets are still in place. However, these have been gradually reduced;
- 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;
- Recent bankruptcies have escalated substantially. As mentioned before, corporate debt levels at a record high and there was an increase in bankruptcies by 52% in 1Q 2016;
- 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).

Restricting factors:

- After the stock market steep decline of 2015, it has recovered and shown stability against recent external shocks. The CSI 300 index has climbed by around 16% since February 2016.

Positive factors:

- Real interest rates remain stable (4,8% in 2015).

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Gradual deleverage of the economy combined with a decline in shadow banking;
- Contraction of debt from SOEs and off-budget debt from local governments.

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 private debt combined with a further decline in FX reserves and sustained capital outflows.

"Strong macroeconomic fundamentals, policy flexibility and a still solid external stance are the main factors that underpinned the confirmation of China's ratings. Despite the slight deterioration of fiscal metrics, projected levels of government debt along with fiscal balances are expected to remain acceptable.

Nevertheless, the amount of leverage of the economy, still latent risks arising from contingent liabilities from LGFVs and SOEs and the overheating of the property market, are seen as potential threats to the stability of China's creditworthiness." – 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_25.11.2016.pdf

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	**Foreign currency**	**National currency**	**Foreign currency**
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 22 November 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, 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.

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.

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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.

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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.