Research Report on China

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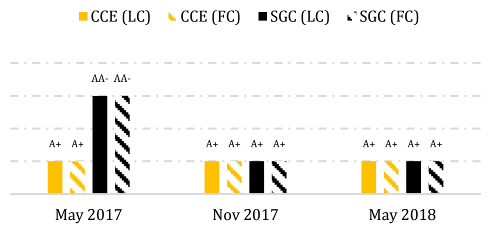
Ratings

Sovereign Government Credit (LC)	A+
Sovereign Government Credit (FC)	A+
Country Credit Environment (LC)	A+
Country Credit Environment (FC)	A+

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of China

Macro indicators	2015	2016	2017
Gross gov. debt, CNY bn	28710	33049	38807
Nominal GDP, CNY bn	69911	74563	81204
Real GDP growth, %	6,9	6,7	6,9
Gross gov. debt/GDP, %	41,1	44,3	47,8
Deficit (surplus)/GDP, %	-2,8	-3,7	-4,0
Inflation rate, %	1,6	2,1	1,8
Current Account Balance/GDP, %	2,7	1,8	1,4
External debt, USD bn	-	-	1710

Development indicators	2017
Inequality adj. HDI	0,73
GDP per capita, USD th	16,7

Default indicator	11.05.2018
5-Year CDS spread, Bp	59,1
10Y Gov Bond Yield, %	3,7

Source: RAEX (Europe) calculations based on data from the IMF, State Administration of Foreign Exchange, Deutsche Bank, Trading Economics, UN

Summary

The Agency confirmed the ratings of China at 'A+' mainly supported by strong and better than expected GDP growth. Despite having deteriorated compared to the previous rating revision, the debt position and the fiscal budget stance remain bearable and we believe that the government still has enough space to mitigate potential risks which could potentially arise. The external position and the competitiveness of the economy remain the key strengths of China.

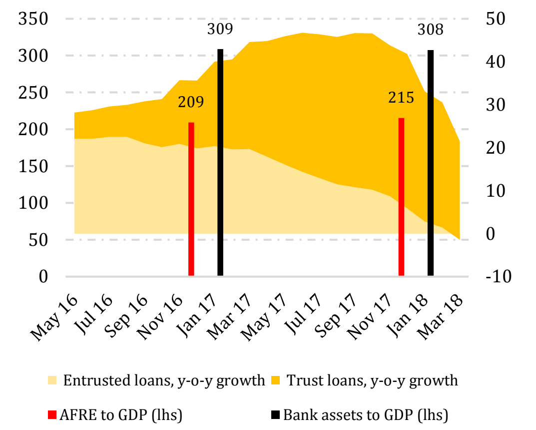
However, the overall indebtedness of the economy continues to increase and the banking sector remains highly leveraged which, along with the high amount of contingent liabilities, stand as the major key negative factors for the creditworthiness of China.

Leverage of the economy continues to increase. The overall aggregate financing to the real economy (AFRE) continued to increase, reaching 174 trillion (215% of GDP) as of December 2017. This represents a 12% increase compared to the same period of the previous year and reflects the shrinking of shadow banking on the back of the tightening regulation. Entrusted loans finally showed a y-o-y decrease in March 2018 when they declined by 1,4%. Moreover, even though trust loans increased by 23% as of the same date, the pace of growth has been gradually declining (see graph 1).

Chinese banks remained profitable and stable in 2017 as ROA and the capital adequacy ratio stood at 1,04% and 13,7% respectively, while the NPLs ratio was flat around the same level as in 2016 (1,7%). However, the sector remains highly leveraged as banks' assets were reported at 309% of GDP by end-2017, representing a serious risk to the overall stability of the country.

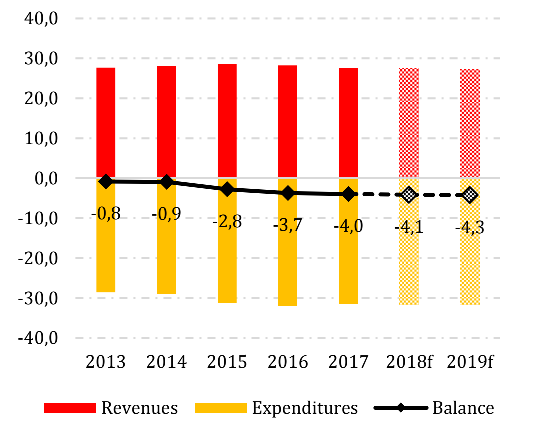
Fiscal stance remains negative. The Chinese fiscal deficit widened further in 2017 when it stood at 4% of GDP as a result of the expansionary fiscal policy from the government. Despite China's authorities having announced plans to cut the budget deficit target, we expect the augmented fiscal deficit to continue to expand and wide fiscal deficits to prevail (see graph 2). The cut could reflect expectations to further tight controls on debt of the local governments, while government investment should remain a key driver of the economic growth.

Graph 1: Credit to the economy



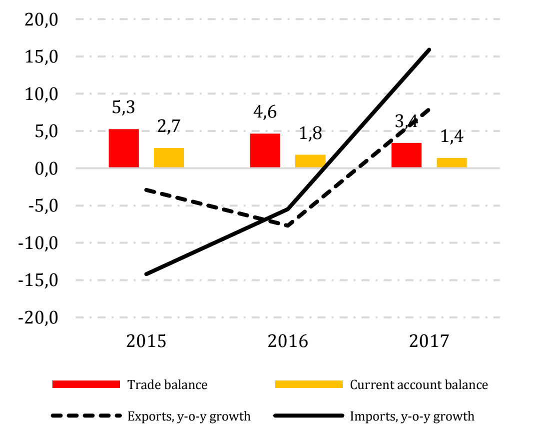
Source: RAEX (Europe) calculations based on data from the PBC and IMF

Graph 2: Fiscal stance, % of GDP



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

Graph 3: Trade and current account, % of GDP



Source: RAEX (Europe) calculations based on data from the IMF and the National Bureau of Statistics of China

We anticipate China to continue with a proactive fiscal policy going forward as the government has stepped up the approval of new investment projects and the issuance of bonds through local government financing vehicles (LGFVs) has also increased in order to finance them.

Macroeconomic indicators remain positive. The Chinese economy grew in 2017 at 6,8%, above the 6,5% forecast from the authorities. However, we still expect the growth to slow down in the upcoming years as a combined result of the reduction of the credit supply aimed at deleveraging the economy and the government's transition to have a more service-based economy. Another force which might drive GDP slowdown is China's determination to tackle the environmental issues. This still represents a key risk for the Chinese economic activity and therefore the government is arranging industrial clean-ups, which might ultimately fuel lower industry output, especially the in the metal industry.

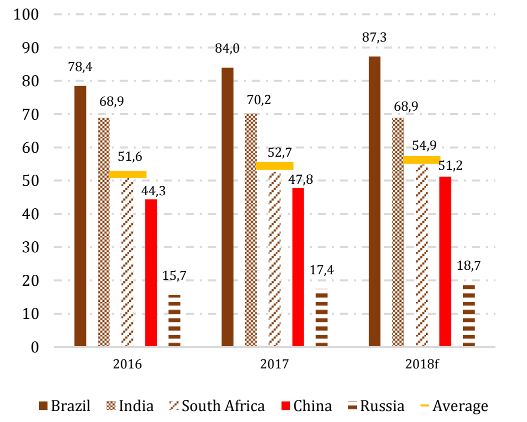
Inflation dropped below 2% and as of end-2017 stood at 1,8%, however already in February 2018 accelerated up to 2,9% (y-o-y) driven by food, tobacco and alcohol prices. Unemployment dropped to 3,9% in 2017 from 4% from the year before.

External position remains solid. Imports and exports continued to grow by 14,8% and 18,2% of GDP respectively in 2017. As we anticipated in our previous report, imports grew at a faster pace than exports, which contributed to further shrink the trade and current account surpluses as of end-2017 (see graph 3). International reserves continued to increase and reached USD 3,24 tn by March 2018 on the back of a stronger currency which has provided additional certainty to investors. The net international investment position (NIIP) is still solid and stood at around USD 1,8 tn as of end-2017. Nevertheless, the figure of net errors and omissions, a proxy for unaccounted capital outflows, remains high and in 2017 reached USD 2,2 tn,.

The effects of the U.S.-China trade dispute is still uncertain. However, the issue reached a different tone in April when the U.S. brought up tariffs on more than USD 45 bn of imports from China. Still, these figures are not a serious threat to the stability of these two large economics; however, the corporate sector's sales, investment and employment could be vastly hurt if the issue is not resolved.

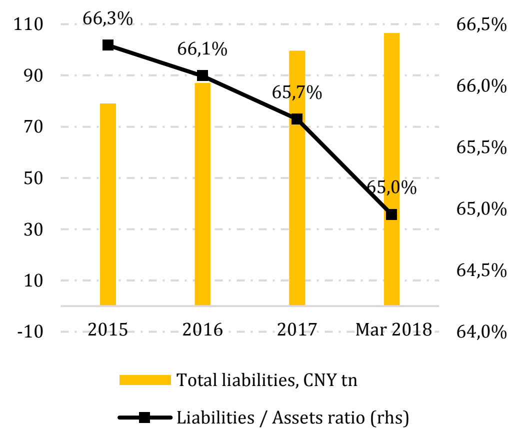
Government debt increased. Mostly driven by government investments, mainly in large infrastructure projects, government debt increased in 2017 to 47,8% of GDP and 173% of budget revenues. This level of debt burden is bearable for the Chinese economy and remains lower than the average of its peers (see graph 4).

Graph 4: Government debt vs peers, % of GDP



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

Graph 5: Indebtedness of SOEs



Source: RAEX (Europe) calculations based on data from the Ministry of Finance

SOEs remain a key source of contingent liabilities' materialization risk. Profitability of SOEs remains sluggish with ROA around 3,2% as of end-2017 compared to ROA of other industrial enterprises which averages around 6,7%. This indicates still low profit transfers to the fiscal budget. Moreover, even though indebtedness of these companies has slightly declined as a % of assets, debt remains high (see graph 5). The authorities show additional determination by improving coordination and supervision with local governments and SOEs to speed up efforts to deleverage. However, the pressures to keep these firms operating under the state support are high, the key reason being the sustainability of employment levels.

Despite this, we still expect the number of bankruptcies to increase during 2018 following the government's efforts to make the public sector more efficient. With further mergers, restructuring and closure of "zombie" firms, the profitability of SOE should improve further.

Another source of contingent liability risk remains the level of local government debt through the so-called Local Government Financial Vehicles (LGFVs) as well as the Government Guided Funds to issue debt. Despite this, the central government has continued to crack down on these entities. The ministry of finance recently prohibited the local government financing vehicles (LGFVs) bond prospectus to include information of the financial health of the regions as to unwind them from any association between the two.

Monetary policy is accommodative. In April 2017, the People's Bank of China (PBOC) cut the reserve requirement ratios to 16% for large institutions and 14% for smaller banks in order to inject liquidity. Even though the current monetary policy remains credible and effective in controlling capital outflows and leverage of the economy, we expect further efforts to be done in the direction of flexible exchange rate and abolishment of capital controls.

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:

https://raexpert.eu/reports/Press_release_China_11.15.2018.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.