Research Report on China

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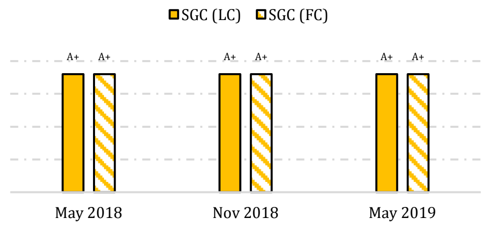
Ratings

Sovereign Government Credit (LC)	A+
Sovereign Government Credit (FC)	A+
Outlook (LC)	Stable
Outlook (FC)	Stable

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of China

Macro indicators	2016	2017	2018
Gross gov. debt, CNY bn	32940	38143	44762
Nominal GDP, CNY bn	74563	81526	88703
Real GDP growth, %	6,7	6,8	6,6
Gross gov. debt/GDP, %	44,2	46,8	50,5
Deficit (surplus)/GDP, %	-3,7	-3,9	-4,8
Inflation rate, %	2,1	1,8	1,9
Current Account Balance/GDP, %	-	-	0,4
External debt, USD bn	-	-	1965,2

Development indicators	2018
Inequality adj. HDI	0,75
GDP per capita, USD th	18,1

Default indicator	03.05.2019
5-Year CDS spread, Bp	41,2
10Y Gov Bond Yield, %	3,4

Source: RAEX-Europe calculations based on data from the IMF, State Administration of Foreign Exchange, Cbonds, Trading Economics, UN

Summary

The confirmation of China's ratings at 'A+' reflects the still solid, albeit slowing, economic performance despite trade tensions with the U.S. and a global economic slowdown. It also shows the outstanding strength of the external position with high levels of international reserves, widely positive net international investment position (NIIP) and positive trade and current account balances, as well as its high level of competitiveness.

Nonetheless, despite the pace of credit growth having slightly declined and shadow banking having reigned in, the economy remains highly leveraged. In addition, the risk of contingent liabilities' materialization remains in place; however, this has also been reduced as a result of the wipeout of "zombie" companies and the increase in local government bonds issuance quota.

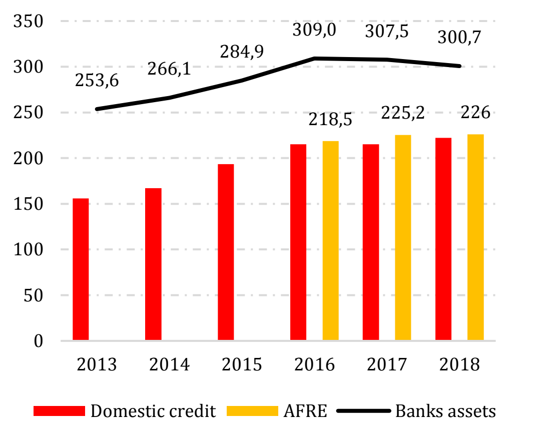
Credit to economy stable and banking system solid. Leverage of both the public and private sectors remains high in China. The total social financing or aggregate financing to the real economy (AFRE) stood at 226% of GDP in 2018 as we predicted in our previous report[1]. The reading continued to increase at a stable rate at the beginning of 2019 as it grew by 10,7% y-o-y as of March 2019. Moreover, domestic debt to GDP is estimated to have ended 2018 at around 222%, an expected hike of 6p.p. from a year before. From this figure, corporate debt remains the highest at 153% to GDP 3Q 2018. In addition, total banks' assets to GDP in 2018 stood at 301%, a decline of 5p.p. from 2017, in line with our forecast back in November 2018 (see graph 1). Also, total external debt of the economy remained moderate at 15% of GDP.

In regard to the shadow banking, we have noticed a continued decrease in this type of funding. As of March 2019, entrusted and trust loans have declined by 11% and 7,9% y-o-y respectively, showing the government's continued commitment to deleverage the economy.

The banking system's financial soundness indicators reflect once again a solid sector. Profitability was positive, ROA stood at 0,9% and ROE was 11,7%. In terms of asset quality, official NPLs to total loans stood at 1,84% by end-2018, showing a slight reduction as compared to 1H 2018. However, bad debt in small regional banks has increased as of late as a result of slower economic growth. In spite of this, we do not consider that

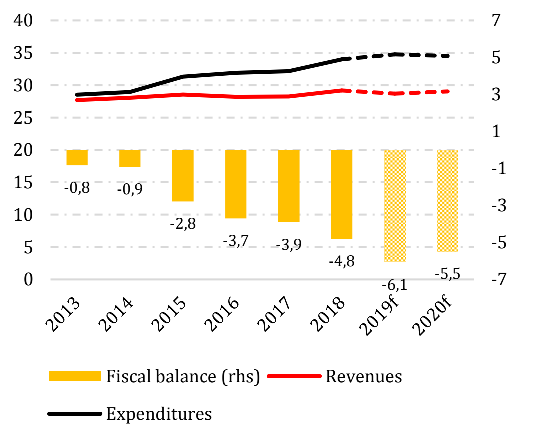
[1] "As of September 2018 it had grown by only 10,6% y-o-y in absolute terms and we forecast it to reach 226% of GDP in 2018." Research report on China from 9 November 2018: https://raexpert.eu/reports/Research_report_China_09.11.2018.pdf

Graph 1: Credit to the economy dynamic, % of GDP



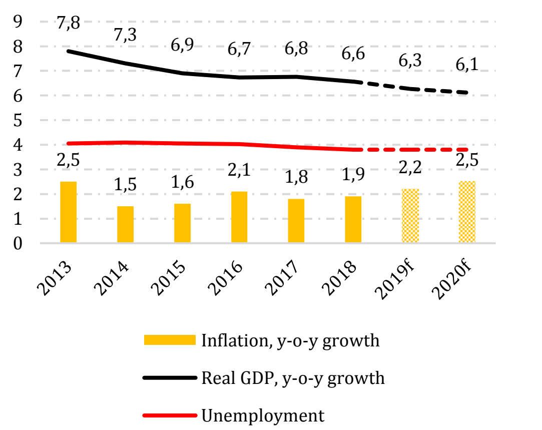
Source: RAEX-Europe calculations based on data from the PBOC and WB

Graph 2: Fiscal budget dynamics, % of GDP



Source: RAEX-Europe calculations based on data from the IMF

Graph 3: Macroeconomic indicators, %



Source: RAEX-Europe calculations based on data from the IMF

this will carry a substantial impact over the banking system. However, state owned banks continue to dominate the sector which creates lack of competition and preferential credit conditions for SOEs.

China has also continued to open the financial sector. According to the country's plans, the government will remove limits of ownership in banks and it will allow foreign financial institutions to invest in non-Chinese insurers within the country.

Fiscal position is acceptable. We anticipate the government's fiscal policy to remain lose in order to continue to support economic growth. This will mainly remain backed through public spending and tax cuts. As a consequence of the lingering expansionary fiscal stance, the fiscal balance stood at -4,8% of GDP in 2018 and we expect it to widen further in 2019 (see graph 2).

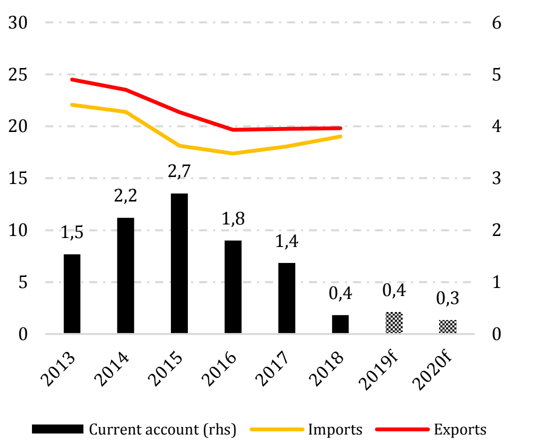
Economy remains strong despite adversities. As of end-2018, the real economy recovered slightly and grew at a higher pace than 3Q 2018 posting a year-end figure of 6,6% y-o-y. However, it was lower than 2017 as a consequence of the economic rebalancing process the country is going through (see graph 3). This can be confirmed by the continued and solid increase of the tertiary sector which grew by 9% y-o-y while the primary sector grew by only 2,5% y-o-y by the end of 1Q 2019. The tertiary sector now accounts for 57% of the GDP value added. Moreover, the economic deleveraging efforts by the authorities and trade tensions with the U.S. also contributed to a slower growth. Despite all of this, we still consider that economic growth remains solid and that the government has enough tools and buffers to boost the economy while, at the same time, achieving rebalancing and deleveraging objectives.

Price stability remains favorable in China. As of the end of 2018, inflation stood at 1,9% and we expect the growth in consumer prices to continue to follow the same trend in the following years in order to reach the 3% target set by the government.

External position remains outstanding. The solid external stance continues to be one of the key strengths of the sovereign. Both the current account and trade balances remained positive despite exports growing at a slower pace while imports grew at an increasing rate. In 2018, imports of goods and services grew by 15,2% y-o-y while exports increased by 9,1% (see graph 4). These dynamics are a result of higher domestic consumption and lower external demand due to trade tensions with the U.S. and a global economic slowdown. Moreover, China's net international investment position (NIIP) continued to recover and stood at around 16% of GDP, a figure higher than our previous projection of 13% of GDP. This reflects the strong position of China as an important creditor nation. Also, international reserves resumed an upward trend since November 2018 and, as of March 2019, they reached a level of USD 3,19 tn.

Government debt continues to climb. Official government debt, hiked up to 50,5% of GDP in 2018, a 4p.p. increase as compared to 2017, and debt to budget revenues was around 7p.p. higher posting a figure of 173% (see graph 5). Both figures stood in line with what we anticipated in our previous revision of the sovereign. Moreover, the government debt's structure is still acceptable as short-term debt stood still at a level of 2% of GDP and external debt was 1,5% of GDP by the end of 2018. Moreover, external debt remains well covered by international reserves by around 16x.

Graph 4: External sector indicators, % of GDP

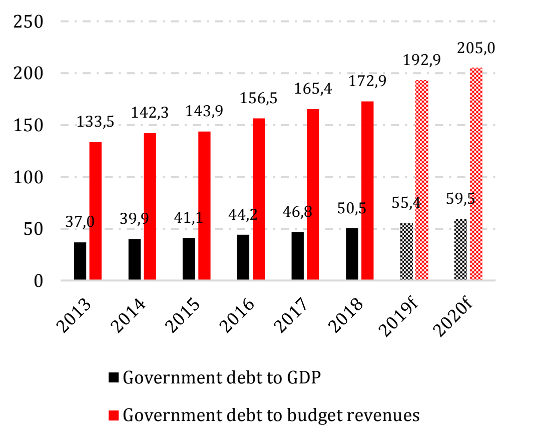


Source: RAEX-Europe calculations based on data from the IMF

The materialization of contingent liabilities remains a latent risk for the government; however, the risk has alleviated slightly. The main contingent liabilities arise from two main sources, namely, SOEs and local government off-budget funding. The former source of risk has just barely eased as, in 2018, SOEs posted better profitability figures as a ROA was 3,9%, 0,1p.p. higher than a year before and the liabilities-to-assets ratio was 64,7%, a slight reduction of 0,2p.p. This was mainly a result of higher domestic growth as well as benefit stemming from the government supportive measures.

Additionally, the authorities have increased efforts to clean-up the system of the so-called "zombie" companies in order to increase efficiency by letting unprofitable companies leave the market. In 2018, around 2000 "zombie" companies disappeared. We expect this wipe-out to continue in 2019.

Graph 5: Government debt dynamics, %



Source: RAEX-Europe calculations based on data from the IMF

In regard to local government funding, even though off-budget financing is still being used, the central government has tightened restrictions on these and also increased the allowance for formal borrowing through bonds issuance (up to CNY 2,2 tn from CNY 1,4 tn). However, lower expected budget revenues could cause local governments to be underfunded even with the greater bond quota and may cause them to increase off-budget funding.

Monetary policy still effective. We anticipate the monetary policy to remain prudent along 2019 in order to maintain economic growth and, at the same time, contribute to deleverage the economy. The People's Bank of China (PBOC) trimmed the reserve requirement ratios (RRR) for the fifth time in 12 months back in January 2019. The RRRs currently stand at 14,5% for large institutions and 12,5% for smaller banks in order to propel the economy. Moreover, last month, the PBOC injected around CNY 267,4 bn through a targeted medium-term lending facility as a measure to expand credit for SMEs. This measure, alongside a highly accommodative fiscal policy, reduces the possibility of further cuts to the RRR.

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_03.05.2019.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.