Research Report on China

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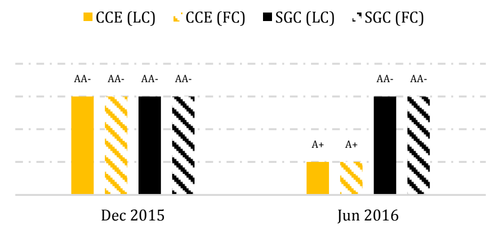
Ratings

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

* These ratings are unsolicited

Ratings dynamics



Main Economic Indicators of China

Macro indicators	2013	2014	2015
Gross gov. debt, CNY bn	23266	26345	30024
Nominal GDP, CNY bn	58974	64070	68392
Real GDP growth, %	7,7	7,3	6,9
Gross gov. debt/GDP, %	39,5	41,1	43,9
Deficit (surplus)/GDP, %	-0,8	-0,9	-2,7
Inflation rate, %	2,5	1,5	1,6
Current Account Balance/GDP, %	1,6	2,1	2,7
External debt, USD bn	-	-	1416

Development indicators	2015
HDI	0,73
GDP per capita, USD th	14,1

Default indicator	03.06.2016
5-Year CDS spread, Bp	123
10Y Gov Bond Yield, %	3,02

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

Summary

China's 'AA-' sovereign government credit ratings indicate the prevailing solid stance of the economy, the authorities' wide range of tools and buffers to manage recent – and potential future – external and domestic shocks and the acceptable levels of government debt. Even though the amount of debt has increased and the fiscal deficit has widened, both figures remain very much acceptable. Furthermore, the banking system remains profitable and well capitalized and inflation, as well as unemployment, remain low and stable.

However, the ratings also reflect high contingent liabilities related to SOEs' and regional and local governments (RLGs) debt as well as to the banking system, high and increasing levels of domestic credit and uncertainty regarding monetary and fiscal policies. Both policies are accommodative and could further increase private debt augmenting risks of increased NPLs and defaults in the future.

On the other hand, the downgrade of local and foreign currency CCE ratings (from 'AA-' to 'A+') reflects the sustained increase in private sector debt and deterioration of the business environment. Both factors combined caused an increase of 25% in corporate insolvencies in 2015.

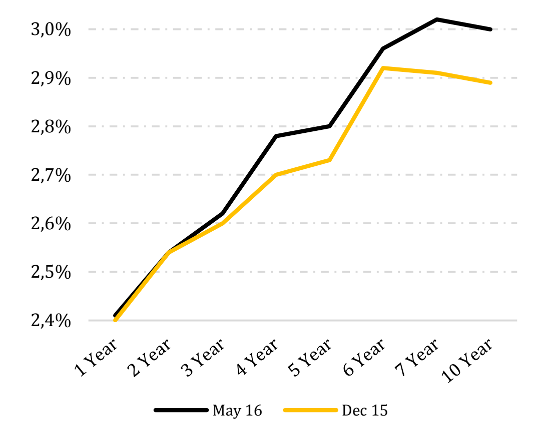
Government debt is acceptable but increasing and contingent liabilities remain a concern. Gross government debt was 150% of budget revenues and 43,9% of GDP in 2015, a moderate figure and the second lowest debt to GDP ratio among its BRICS peers (see table 1). Despite this, it has been constantly increasing since 2010 and is expected to continue the same trend in the coming years due to the loose fiscal policy set by the authorities in order to maintain stable GDP growth. The market concerns regarding the increase in government debt have been already reflected in rising government bond yields (see graph 1). Furthermore, short-term debt from the central government remained low at 1,6% of GDP in 2Q 2015 and is well covered by FX reserves (19x).

Table 1: Peer comparison of BRICS for 2015

Factors	China	Brazil	India	Russia	South Africa
Government debt/GDP	43,9%	73,7%	67,2%	17,7%	50,1%
Inflation rate (%)	1,6%	10,7%	5,4%	12,9%	4,9%
Current acc/GDP	2,7%	-3,3%	-1,3%	5,0%	-4,4%
Fiscal balance/GDP	-2,7%	-10,3%	-7,2%	-3,5%	-4,0%
External Debt/GDP	9,1%	29,5%	22,5%	29,5%	41,4%
FX reserves/GDP	35,5%	20,0%	15,5%	29,2%	13,3%
FX reserves, m of imports	19,19	11,37	6,61	8,53	4,44

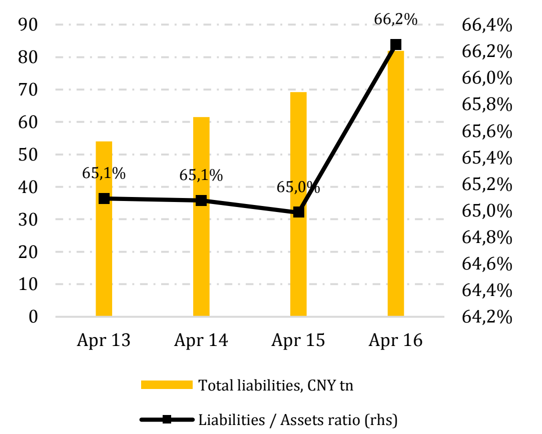
Source: RAEX (Europe) calculations based on data from the IMF, WB, State Administration of Foreign Exchange, PBC

Graph 1: Chinese LC Government Bonds yield curve



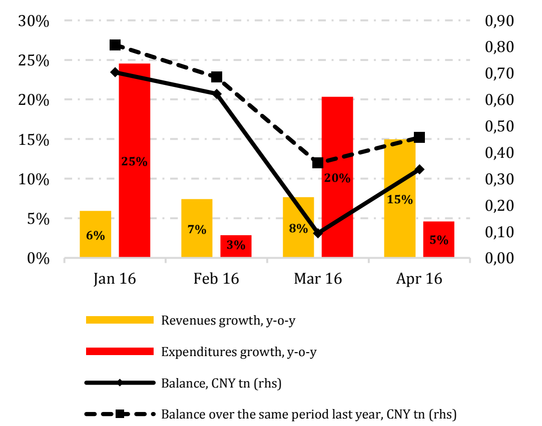
Source: RAEX (Europe) calculations based on data from AsianBondsOnline

Graph 2: China's SOEs' liabilities



Source: RAEX (Europe) calculations based on data from the Ministry of Finance of the People's Republic of China

Graph 3: Budget dynamics



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

The risk of materialization of contingent liabilities related to SOEs' and RLGs' debt as well as to the banking system remains high for China. As mentioned in our previous reports, in 2015 around 50% of debt from RLGs was swapped from banks and local government financing vehicles (LGFVs) into bonds with lower cost and longer maturities; also, a debt ceiling was established for these entities. Even though these actions have contributed to reduce central government continent liabilities related to RLGs, SOEs' debt continues to pile up. Liabilities of these organizations increased by 1,7% from April 2015 to April 2016 and the debt to assets ratio increased by 1,2p.p. over the same time span (see graph 2).

Furthermore, while one of the structural reforms released by the Chinese authorities includes a plan to revamp the operating model of these entities – which includes mixed ownership and the participation of private capital – the fact is that the authorities have not shown willingness to let go of these companies completely, especially the major ones. As a result, the government's burden of contingent liabilities related to this sector of the economy will remain in place.

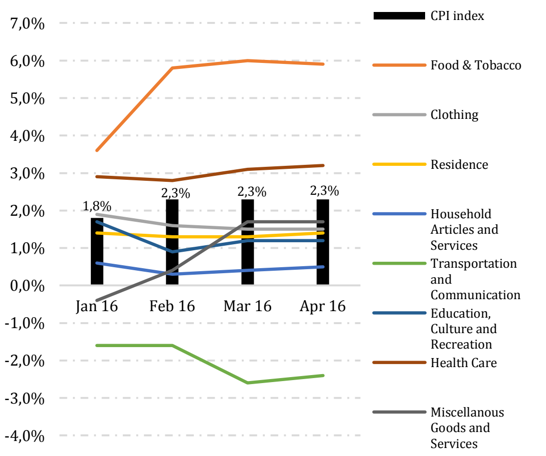
Fiscal and monetary policies to remain accommodative. China has been characterized by employing a sound fiscal policy resulting in stable official budget balances and achieving economic growth for the past years. Even though the 2015 budget presented a fiscal deficit of 2,7% of GDP, it is still manageable and in line with the government's objective of increasing spending and reducing taxes (see graph 3) in order to maintain growth. This, however, will take a toll in the amount of public debt as previously mentioned. In addition, off-budget liabilities remain a concern with respect to the augmented fiscal balance[1].

In this regard, the Chinese government has executed policies to make public finances more transparent (mainly at the regional level) and to reduce the augmented non-official fiscal balance which includes off-budget operations, as mentioned in our previous report. In addition, following the rebalancing path, a big tax overhaul will occur in China whose objective is to relieve fiscal burden on services companies and encourage the manufacturing industry to innovate. Nonetheless, the measures could cause RLGs to collect less revenues which, combined with a renewed decline in the real estate market, may hurt the development of these entities.

With respect to monetary policy, in March 2016 the People's Bank of China (PBC) slashed reserve requirement ratios to 17% for the biggest banks, showing continued easing. However, positive economic indicators

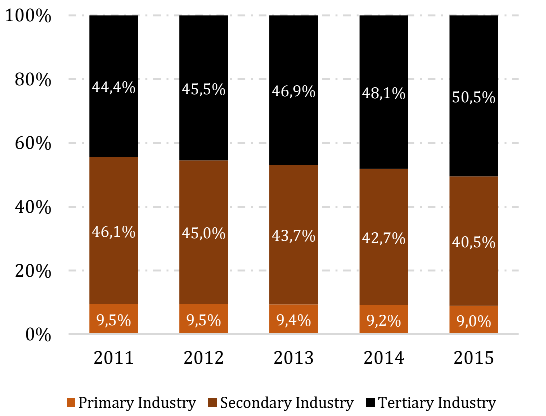
[1] Augmented balance includes all funding that is not included in the budget which is done through special financing vehicles especially at the local government level. This is calculated by the IMF.

Graph 4: CPI index dynamics



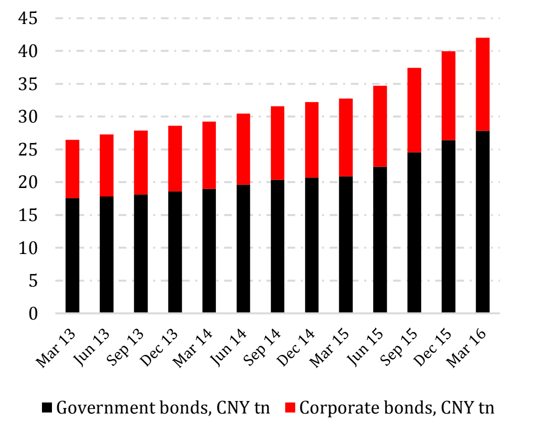
Source: RAEX (Europe) calculations based on data from the National Bureau of Statistics of China

Graph 5: Share of the economy by industry



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

Graph 6: Chinese bond market size



Source: RAEX (Europe) calculations based on data from AsianBondsOnline

in 1Q 2016 caused the PBC to go from a loose monetary policy position to a prudent stance with the possibility of further easing if needed. The PBC's monetary objectives for the year are to increase the money supply by 13% and a CPI index growth of 3%. Inflation stood at 2,3% y-o-y in April 2016, close to the authorities' target; however, the increase was mainly due to a steep increase in food prices and we do not expect this price increase to sustain in the long term (see graph 4).

While loose monetary and fiscal policies have maintained economic growth so far, they have also taken private debt to higher levels and could augment risks of increased NPLs and defaults in the future.

Economic growth remains firm but in a downward trend. Efforts from the central government to rebalance the economy from an investment driven economy to one driven by consumption combined with the global economic slowdown and weaker domestic demand have caused the economy to grow at a slower pace in real terms (6,9% in 2015) and it is expected to continue this trend in the mid and long term. However, signs of rebalancing can already be observed in the increase in the share of the tertiary sector in the economy which stood at 50,5% in 2015, around 6p.p. higher than in 2011 (see graph 5).

The credit environment in the country appears to be deteriorating. Financing to the economy continues to increase. The ratio of banks´ assets to GDP stood at 291% and domestic credit to GDP at 202% in 2015 (and, according to our estimations, around 290% of GDP if we include debt to the financial sector), an increase of 22,4p.p. and 32,8p.p. respectively. Both ratios clearly indicate excessive leverage of the Chinese economy and, if off-balance sheet liabilities (mainly wealth management products) were taken into account, this amount of debt would be even higher.

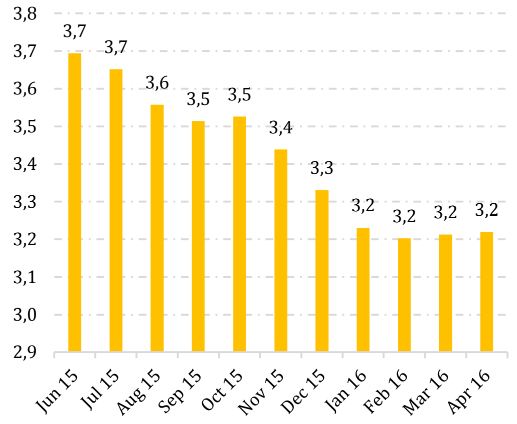
Not only is private debt issued by financial institutions set to increase even further with the loose monetary policy stance, but the local currency corporate debt market is also growing at a fast pace representing around CNY 14 tn by March 2016 (see graph 6) with yields starting to climb.

Furthermore, despite the stock market recovery in the beginning of 2016, last year's crash and continued volatility exposed structural risks in China. Finally, the increase of 25% on corporate insolvencies in 2015, rounds up the factors which have negatively affected the credit environment in the country driving a downgrade in the CCE rating.

Acceptable performance of the banking sector. The banking system continues to be profitable (ROA of 1,1% in 2015) and, according to official figures, well capitalized (capital adequacy ratio equaled 13,5% in 2015) and with low NPLs to total loans ratio (1,7% in 2015). However, concerns remain over the amount of bad assets from the shadow banking system.

External position remains solid but with growing concerns. The Chinese economy remains very competitive. It posted a trade surplus of 5,4% of GDP and current account surplus of 2,7% of GDP in 2015 driven by a steeper decline in imports (-9,6% from 2014) than exports (-3,8% from 2014) caused by a reduction in global and domestic demand.

Graph 7: FX reserves, USD tn



Source: RAEX (Europe) calculations based on data from State Administration of Foreign Exchange

China continues to have a positive net international investment position (NIIP) and a still strong level of FX reserves at USD 3,3 tn as of January 2016 (more than 71% of gross government debt) and representing 19,2 months of imports, the highest among its BRICS peers (see table 1). Despite this, instability in the economy caused by global forces, lack of clear policy communication from the authorities and recent stock market developments, have caused FX reserves to continue to evaporate. Reserves fell by more than 13% from June 2015 (USD 3,69 tn) to March 2016 (USD 3,21 tn) (see graph 7). Additionally, this turmoil has also resulted in an accumulated net capital outflow of USD 735 bn in 2015 (included unrecorded outflows which represent a high share of the funds[2]) as estimated by the Institute of International Finance.

An additional concern is the potential impact of the Federal Reserve' federal funds rate move in the next weeks. As seen after last year's federal funds rate increase, emerging markets were hit hard and it caused instability in these economies. We have yet to see how investors react in regard to China after the Fed's next move, which may further destabilize the economy and could cause further devaluation of the CNY by the PBC.

SDR inclusion benefits will not be reflected soon. 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.

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:

http://www.raexpert.eu/reports/Press_release_China_03.06.2016.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.

[2] In our previous report we touched on this issue by mentioning that "Capital controls exercised by China lead to significant capital flight in addition to official capital flows. China's balance of payments under the "errors and omissions" account has been negatively accumulating since 2012 reflecting an outflow of unaccounted funds exceeding USD 300bn"