Research Report on China

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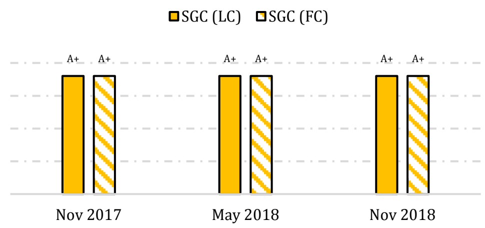
Ratings

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	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	-	-	1870*

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

Default indicator	09.11.2018
5-Year CDS spread, Bp	63,3
10Y Gov Bond Yield, %	3,5

Source: RAEX-Europe calculations based on data from the IMF, State Administration of Foreign Exchange, Deutsche Bank, Trading Economics, UN
* Figure for 2Q 2018

Summary

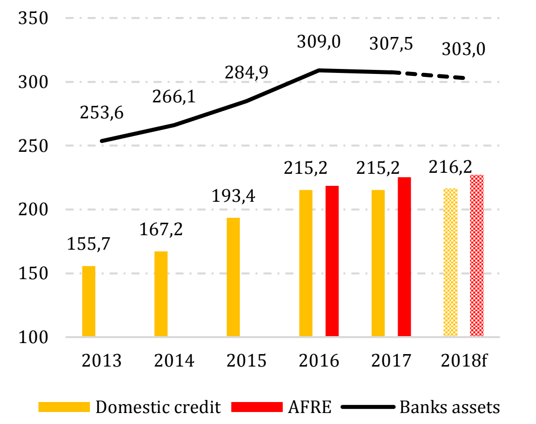
The Agency confirmed the ratings of China at ‘A+’ and assigned a stable outlook as a result of the stable macro economy performance, and still tolerable government debt burden and overall fiscal stance. Moreover, the competitiveness of the economy and the external position continue to be the key positive driver for China and we still consider that the government has enough mechanisms to manage potential headwinds.

However, despite the credit growth pace having decreased, the high overall indebtedness of the economy together with the high amount of contingent liabilities remains the most compelling factors against the creditworthiness of the sovereign. Despite this, there are signs showing that the volume of shadow banking is shrinking.

The economy’s leverage keeps increasing, but at a slower pace. The overall aggregate financing to the real economy (AFRE) continued to increase in 2018, yet at a much slower pace. 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, 1p.p. higher than the reading from 2017. Moreover, domestic credit to GDP remained constant posting a figure of 215% of GDP in 2018 and we expect total assets growth to continue slowing down harmonizing credit and economic expansion. We project the ratio of assets to GDP at the end of 2018 at approximately 303% (see graph 1). While the total stock is increasing due to the higher volume of CNY-denominated loans, other important components like entrusted and trusted loans have decreased by around 4,5% y-o-y. The reduction in these types of financing vehicles reflects a shrinking of the shadow banking sector as a result of the policies put in place by the government to contract this sector. Furthermore, despite corporate debt having stabilized, it remains the highest indebted sector at 161% of GDP at the end of 2017. Since 2016, the total amount of outstanding debt issued by Chinese companies increased y-o-y by more than 12% for domestic securities and by 39% for international. Such tendency has forced companies to merge with the state, increasing the already high contingent liabilities.

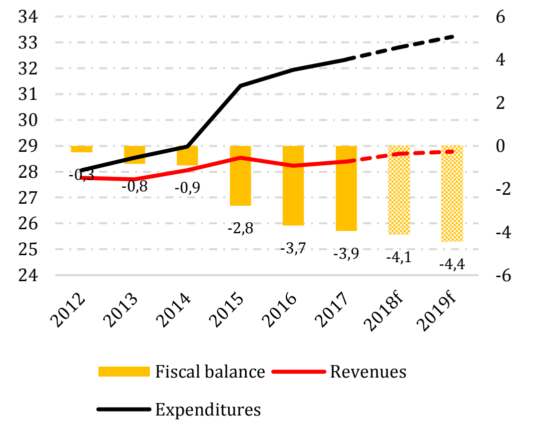
At the end of 1H 2018, Chinese commercial banks remained stable and cost-effective with profit margin and capital adequacy rates at 1,03% and 13,7% respectively; additionally, ROA was 0,92% in 2017. On the other hand, asset quality slightly deteriorated as NPLs reached 1,9 % as a result

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



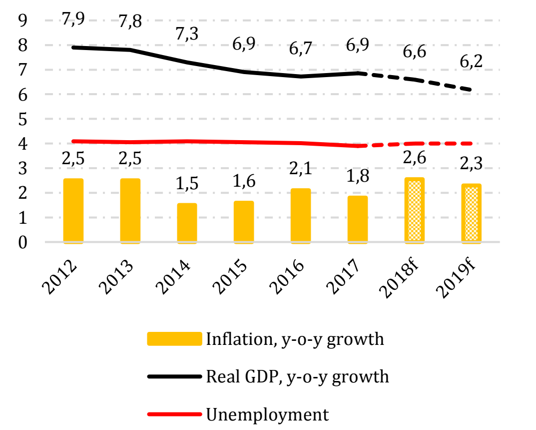
Source: RAEX-Europe calculations based on data from the PBOC and WB

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

of higher volumes of mortgages and loans to riskier export-import oriented companies and small private enterprises.

Fiscal stance remains bearable. The fiscal deficit is expected to expand up to 4,1% of GDP in 2018 as the government continues with its proactive fiscal policy (see graph 2). As mentioned in our previous review, even though China's authorities announced a course to cut budget deficit, the authorities have continued the expansionary policy as new tax cuts were announced in 2018 which includes VAT and personal income tax reductions. What is more, in the wake of the recent economic slowdown, we anticipate fiscal stimulus to continue in order to shore up the economy. Thus, proactive fiscal policy will remain a key driver of economic growth and we expect it to remain so. Despite this, China's government has enough buffers to back the supportive policy and any other potential risk which may arise.

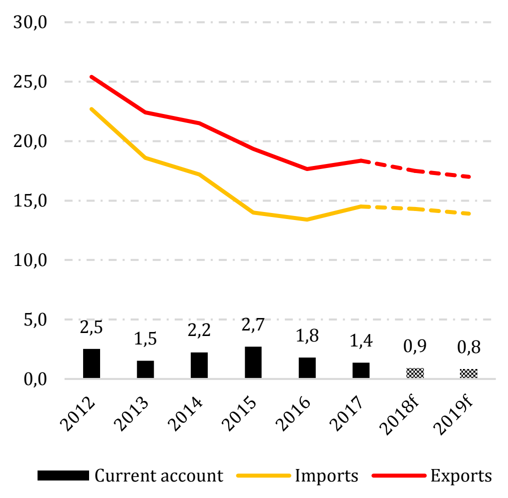
Macroeconomic variables continue to be stable. The Chinese economy slowed down but growth remained substantial as real GDP increased at a pace of 6,5% y-o-y as of 3Q 2018. The highest growth for this period at 10% in terms of value added belongs to tertiary sector (service), indicating a positive transition from the primary sector (manufacturing and agriculture) to a more service and consumption oriented economy. Moreover, the information technology sector grew by 23% supporting further the rebalancing efforts. As a result of the rebalancing and deleveraging plans, we anticipate the economy to continue to have solid growth but at a slower pace (see graph 3).

In addition, we also consider that the implementation of the environmental program, which might decrease output from main carbon dioxide producers, and potential lower export income due to the U.S. – China trade tensions may have a direct but moderate impact on GDP output.

Inflation has risen and as of September 2018 it reached a y-o-y growth of 2,5% showing prolonged price stability (see graph 3). Price increases were mainly broad-based. We expect the metric to continue to follow the same trend in the following years in order to reach the 3% target set by the government we expect levels of unemployment to remain practically unchanged by year-end 2018.

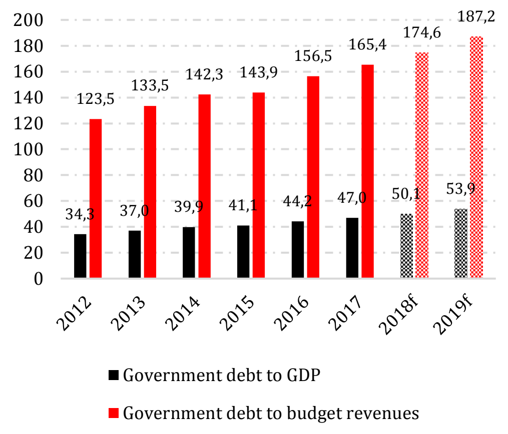
Solid external position remains a key strength. Exports and imports have continued to grow as a result of external demand and domestic consumption. However, these have been outpaced by GDP causing imports and exports to shrink relative to GDP: in 2018 they will account for about 14,5% and 18,4% of GDP respectively. Due to the higher demand

Graph 4: External sector indicators, % of GDP



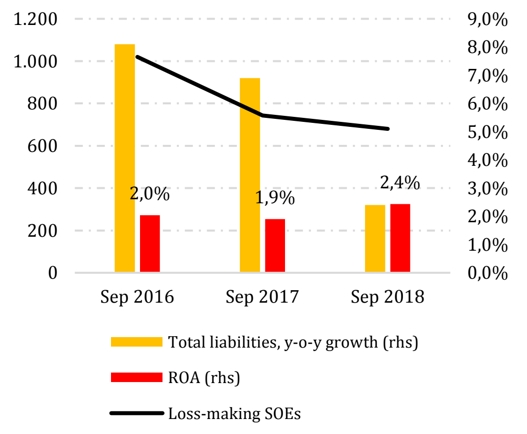
Source: RAEX-Europe calculations based on data from the IMF

Graph 5: Government debt dynamics, %



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

Graph 6: SOEs' statistics



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

on imported raw materials, the trade balance shrunk in 3Q 2018. We expect the balance to continue in this trend and to post a figure of around 3,3% in 2018 (see graph 4). International reserves continued to be substantially high and reached USD 3,18 tn by September 2018. However, the trend of international reserves has been negative, (these have decreased by 1,8% since end-2017). The net international investment position (NIIP) recovered slightly in 1H 2018 increasing by USD 0,17 tn as compared to 1Q 2018. We expect this metric to remain strong and positive and to end 2018 at around 13% of GDP.

Even though there has not been a substantial material effect from the U.S.-China trade dispute as shown by solid export figures, it is still uncertain what the real impact will be if these tensions were to escalate further. Even though the direct effect from the unresolved issues seems limited, it has inevitably spread uncertainty in financial markets, the largest stock index of the country CSI 300 has decreased by 23p.p. since the beginning of 2018.

Government debt in an upward trend. We expect total government debt to reach a figure of around 50% of GDP and 182% budget revenues in 2018, a yearly increase of around 2p.p. and 9p.p. respectively. Such debt level is considered manageable since, as mentioned previously, the government has enough tools and resources to control it (see graph 5).

Despite significantly lower growth of SOEs' liabilities, contingent liabilities will continue to negatively impact financial stability in medium run. Profitability of SOEs remains subdued with a ROA of 2,4% in September 2018, 0,2p.p. higher than the average of the previous two years (see graph 6). However, SOEs continue to be significantly less profitable compared to privately owned peers. As a result, the number of bankruptcies among SOEs increased by 59% y-o-y and we anticipate bankruptcies to increase further as a result of the government's efforts to improve the efficiency of the economy by eliminating "zombie" companies. In general, we expect a positive impact from the current SOE reform which is mainly aimed at equity restructuring and better salary and cost management according to market economy's requirements. However, such government support and preferable conditions for SOEs might damage competition and could cause higher default rates among private companies.

Local Government Financial Vehicles (LGFVs) remain a popular way of financing local infrastructure projects avoiding the limits of local bond issuing set by the Government. Liabilities and obligations of LGFVs are off balance making control and measurement extremely difficult and, thus, causing uncertainty in the market.

It is important to mention that China has relatively low risk on government bonds as yields have declined under the People's Bank of China (PBOC) easing policy, narrowing the spread between U.S. and Chinese securities. In 2018, China sold 10Y sovereign USD-denominated bond just 25 basis points higher than U.S. Treasuries making it attractive for investors.

Monetary policy remains accommodative. The PBOC once again in October 2018 slashed the reserve requirement ratios to 15,5% for large institutions and 13,5% for smaller banks in order to boost slowing investment and economic growth. Moreover, trying to prevent sharp depreciation of CNY (CNY lost 6% against USD since the beginning of 2018) government reintroduced foreign exchange risk reserve ratio on currency forwards that increase the cost foreign currency purchase. Despite this, the Chinese government has not shown more aggressive signs of defending the currency. This depreciation can resume pressure on capital outflows.

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_09.11.2018.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.