Research Report on China

INTERNATIONAL GROUP OF RATING AGENCIES
RAEX EXPERT RA RATING AGENTUR EUROPE
Moscow - Ekaterinburg - Almaty - Minsk - Frankfurt - Hong-Kong

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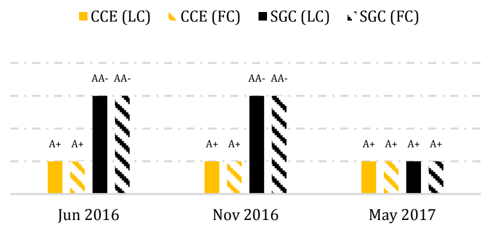
Ratings

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	2014	2015	2016
Gross gov. debt, CNY bn	25835	28710	33052
Nominal GDP, CNY bn	64718	69911	74631
Real GDP growth, %	7,3	6,9	6,7
Gross gov. debt/GDP, %	39,9	41,1	44,3
Deficit (surplus)/GDP, %	-0,9	-2,8	-3,7
Inflation rate, %	1,5	1,6	2,1
Current Account Balance/GDP, %	2,2	2,7	1,7
External debt, USD bn	-	-	1420

Development indicators	2016
Inequality adj. HDI	0,73
GDP per capita, USD th	15,4

Default indicator	17.11.2017
5-Year CDS spread, Bp	62,8
10Y Gov Bond Yield, %	4,00

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

Summary

The Agency has decided to downgrade the SGC ratings of China to 'A+' to the same level of our CCE ratings, which were downgraded on the review from June 2016. The decision is based on the constant increase in leverage of the economy – especially in private credit – and our expectations that this will remain in an upward trend. Moreover, fiscal metrics have also deteriorated on the back of the authorities' prolonged stimulus; government debt, despite remaining bearable, has hiked and the fiscal deficit has widened, we anticipate both metrics to continue in the same path.

Despite this, macroeconomic indicators remain strong with low levels of unemployment and inflation as well as a solid, albeit declining, GDP growth. Additionally, competitiveness remains a key strength for the Chinese economy and the external position remains strong. Finally, we still consider that the government has sufficient tools to mitigate sudden shocks.

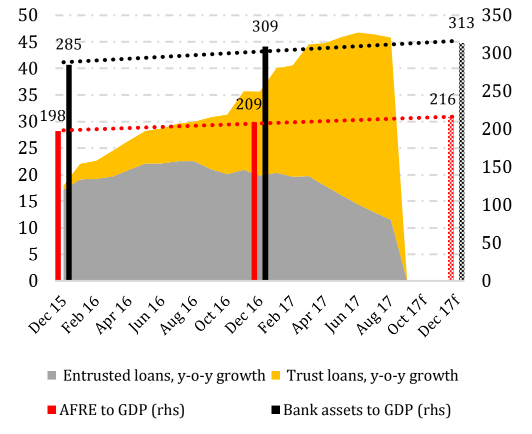
The main threat to the country's creditworthiness remains the high leverage in the economy. The overall aggregate financing to the real economy (AFRE) continues to rise and we project it to end the year at around 216% of GDP, 7p.p. higher than in 2016. Moreover, even though the growth on trust and entrusted loans halted in mid-2017 as authorities' effort to curve this have so far succeeded, it remains a risk for the financial system, as it is difficult to regulate and measure. Furthermore, we estimate bank assets to GDP to increase as well up to 313% of GDP by end-2017 which presents 4p.p. higher than in 2016 (see graph 1). These figures show the continued growth in leverage at a higher pace than economic growth.

On the other hand, the banking sector remains stable and well capitalized. As of end-2016, ROA was 1,2%, NPLs ratio equaled 1,7% and capital adequacy ratio stood at 13,4%. Despite liquidity and stability, shadow banking still represents a key risk for the banking sector.

The number of bankruptcies has steadily risen over the 2017. Hence, the government has put further efforts to resolve unviable "zombie companies" which contribute to a higher level of bankruptcies.

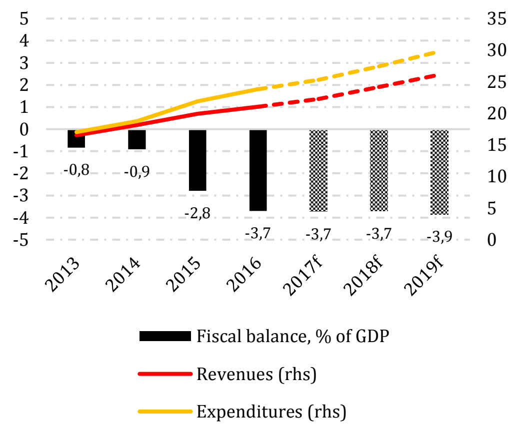
Fiscal deficit to widen further. We expect the fiscal stance to continue in the same trend with expenditures growing at a higher pace than revenues. As of 2Q 2017 expenditures and revenues grew by 13,1% and 9,8%

Graph 1: Credit to the economy



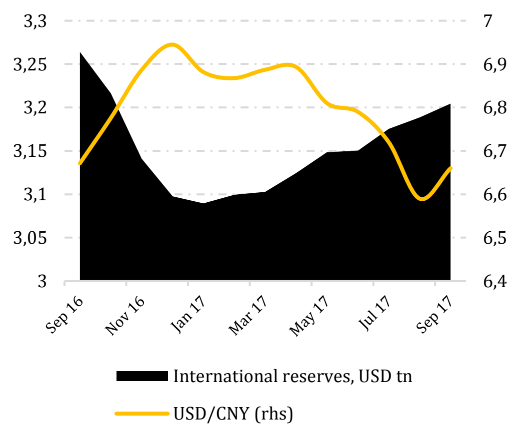
Source: RAEX (Europe) calculations based on data from the PBC and IMF

Graph 2: Fiscal budget, CNY tn



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

Graph 3: Int. reserves and USD/CNY exchange rate



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

respectively from a year before. In regard to the distribution of expenditures, the main area of investment is infrastructural projects while, on the other hand, social spending continues to lag behind international standards.

According to recent IMF projections, the fiscal deficit will stand at around 3,7% of GDP in 2017, similar to the figure posted in 2016, but we also anticipate further widening in the long-term perspective (see graph 2). Moreover, the IMF's estimated augmented balance is set to be around -12,6% of GDP in 2017 due to an increase in off-budget investments.

Real GDP growth expected to close the year strong. After a 6,7% growth in 2016, we can expect the Chinese economy to end 2017 with a similar growth rate, above the initial authorities' forecast of 6,5%, following the fiscal and monetary stimulus which resulted in solid infrastructure and real estate investments. Going forward, however, we anticipate a slowdown on yearly growth rates as a result of the government's rebalancing efforts.

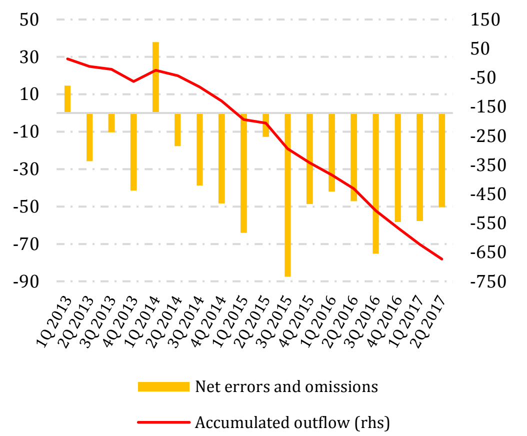
Furthermore, China's environmental issues remain a concern as they continue to impact economic activity. China ranks 109th in the latest Environmental Performance Index prepared by Yale and Columbia Universities. However, the authorities have made strides, such as providing subsidies for renewable energies and implementing environmental taxes, in order to improve environmental conditions.

Additionally, inflation has been stable over the year and it is expected to stand at 2,3% as of end-2017, while unemployment is expected to remain low at around 4% in 2017.

China's external position is still solid. In 2017 exports and imports have continued to grow as compared to 2016. As of September 2017 exports grew by 7,5% and imports by 17,3% (y-o-y) driven by the increase in domestic demand. Given this trend, we expect the trade surplus to shrink further going forward along with the current account balance, which we anticipate will finish 2017 at 1,4%.

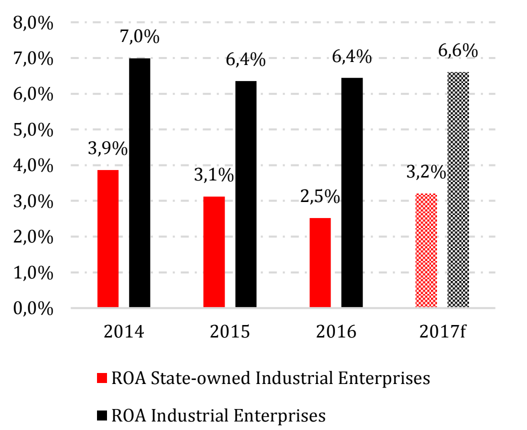
Even though controls on the flow of capital have eased, these are still in place and have supported the reduction of official outflows from the country. Moreover, international reserves continued to increase reaching a record high in September 2017 when they stood at USD 3,2 tn continuing with the upward trend since January 2017. At the same time, there was a rapid appreciation of the CNY during the year following the country's strong economic fundamentals (see graph 3). The net international investment position (NIIP) remains strong despite a small slip as of mid-2017 when it stood at USD 1,7 tn compared to end-2016 (USD 1,8 tn).

Graph 4: Net errors and omissions, USD bn



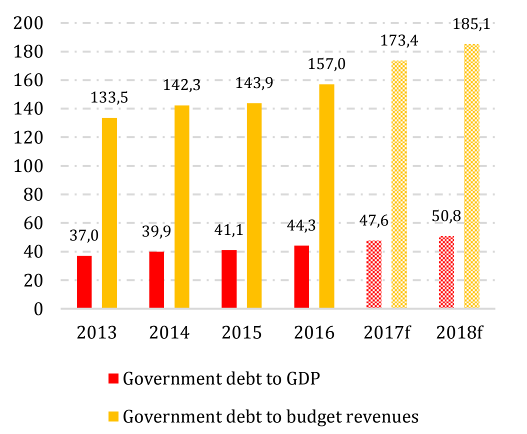
Source: RAEX (Europe) calculations based on data from the State Administration of Foreign Exchange

Graph 5: SOEs vs all industrial companies' profitability



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

Graph 6: Official government debt levels



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

Despite this, there are still concerns about the outflow of unaccounted-for funds as the net errors and omissions account in the balance of payments (our proxy of underground capital flows) continues to post negative figures. This account showed a net outflow of USD 58 bn and USD 50 bn in 1Q 2017 and 2Q 2017 respectively (see graph 4).

With the intention of the authorities to transition towards a more sustainable growth course, rising protectionist trade policies are less probable. However, the significant obstacle to the full liberalisation of the economy and internationalisation of the Chinese currency are capital controls.

Contingent liabilities materialization risk remains elevated. Despite the stabilization of state owned enterprises' debt and further reforms regarding the ownership structure and concentration, SOEs still represent a key source of contingent liabilities risk for the Chinese economy. These types of companies remain highly leveraged and with low profitability (see graph 5) which is shown by the low amount of profit paid to the fiscal budget. These transfers are currently far below the government's 30% target by 2020. Furthermore, the profitability of SOEs does not show signs of recovery, which is worrying due to the fact that substantial implicit support is received from the central government, estimated by IMF at about 3% of GDP.

Despite the government having clearly stated that it will not support any LGFV defaults, the Agency still considers LGFVs as a potential contingent liabilities risk considering that the debt through LGFVs keeps increasing and it is not certain whether or not the government will intervene in case an elevated number of defaults occur.

Government debt remains bearable but it continues to increase and it gets close to the level of 50% of GDP. In line with IMF forecasts, we expect debt to GDP ratio at around 48% and debt to revenues of 174% as of end-2017 (see graph 6). The increase is mostly driven by the government's loose fiscal policy with large investment in infrastructure in order to fuel economic growth. As of 2Q 2017 short-term debt increased slightly and stood at around 3% of GDP and was well covered by FX reserves by around 10x.

Monetary policy remains loose. The interest rate PBC (base rate) remains at 4,35% and the 7-day repo rate at 2,45%, following an increase in 1Q 2017. However, this short-term repo rate is barely positive in real terms. Moreover, the banking authorities' recently slashed the reserve requirement for some banks in order to facilitate credit for smaller companies. Low rates and easing of credit to small firms reflect the still accommodative policy of the People's Bank of China (PBC).

In our view, the current monetary policy strikes a balance of avoiding an even more rapid increase in credit to the economy and capital outflows.

Overall, we believe that the PBC keeps a credible and effective monetary policy. However, as mentioned previously, further steps towards a flexible exchange rate and less capital controls are needed in order to improve monetary transmission in China.

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_17.11.2017.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.