# Research Report on China

**19 May 2017**

**Responsible Expert:**

Hector Alvarez
Rating Associate

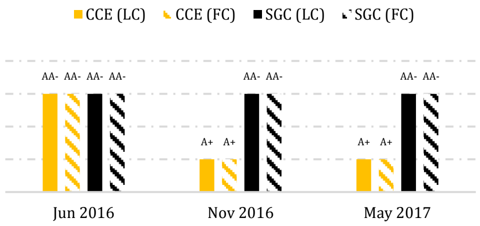
**For further information contact:**
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

**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 | 2014 | 2015 | 2016 |
|---|---|---|---|
| Gross gov. debt, CNY bn | 25835 | 29787 | 34461 |
| Nominal GDP, CNY bn | 64718 | 69911 | 74540 |
| Real GDP growth, % | 7,3 | 6,9 | 6,7 |
| Gross gov. debt/GDP, % | 39,9 | 42,6 | 46,2 |
| 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 | 1,8 |
| External debt, USD bn | - | - | 1420 |

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

| Default indicator | 18.05.2017 |
|---|---|
| 5-Year CDS spread, Bp | 79,3 |
| 10Y Gov Bond Yield, % | 3,65 |

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

## Summary

The Agency confirms the SGC ratings of China at 'AA-'. Despite the downturn in fiscal and private debt metrics, these figures remain in line with our previous expectations and we believe the authorities still have enough tools to control the economic transition and adverse external shocks. Furthermore, macroeconomic indicators remain solid, the external stance is strong and official government debt levels are still acceptable.

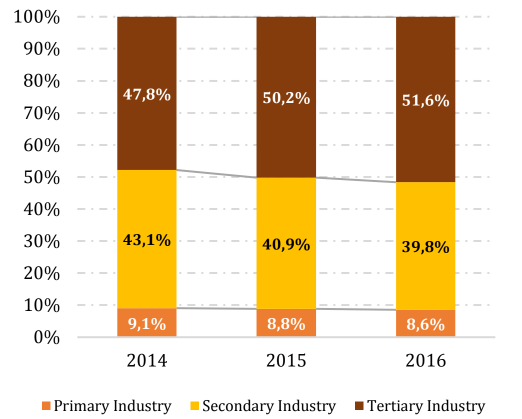
However, we also believe that these tools are diminishing and that the economy's strength to cushion sudden shock events is declining. Moreover, the economy remains highly leveraged and contingent liabilities materialization risks are still in place.

**The fiscal balance continues to deteriorate.** The fiscal deficit keeps widening and it finished 2016 with a lower figure than we initially anticipated. As a result of increased government spending, the fiscal balance posted a figure of -3,7% as compared with an initial estimation of -2,9% for 2016. Furthermore, the augmented fiscal deficit is estimated by the IMF to be above 8% given the increase in local governments' off-budget financing.

The authorities continue to maintain a loose fiscal policy based on expenditure and tax cuts in order to maintain high rates of economic growth. The accumulated growth rate of expenditures for 1Q 2017 was 21% while revenues grew by 14,1% in the same period. It is too early to evaluate the effects of fiscal reform which includes the new budget law to improve transparency, tax reforms to support the rebalancing of the economy as well as the social security reform.

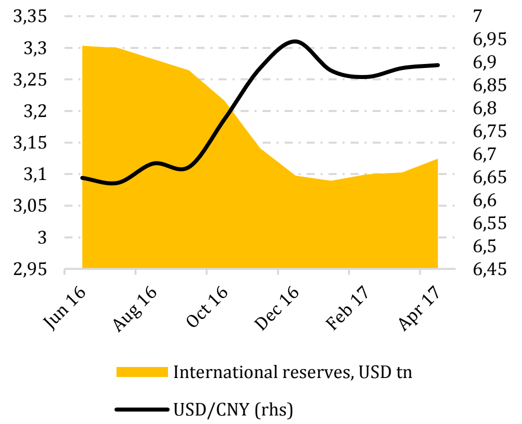
**Economic growth remains solid but trending downwards**. The Chinese economy grew by 6,7% in 2016, aligned with the government's target range of 6,5%-7%, supported by accommodative fiscal and monetary policies and a substantial boom in the property market. In 1Q 2017 economic growth stayed steady fueled by urban investment and a strong manufacturing output while retail sales lowered. Furthermore, the tertiary sector's added value share in the economy increased up to 51,6% in 2016 (see graph 1) and the services PMI remains above 50; both figures support the rebalancing efforts from the authorities. In addition, the

**Graph 1:** Share of the economy by industry



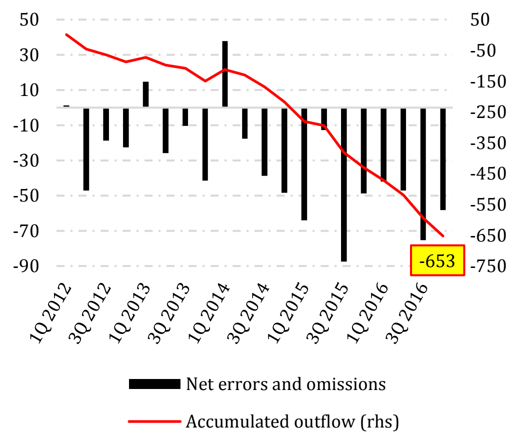

Source: RAEX (Europe) calculations based on data from the National Bureau of Statistics of China

**Graph 2:** Int. reserves and USD/CNY exchange rate




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

**Graph 3:** Net errors and omissions, USD bn




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

inflation and unemployment rates remain at satisfactory levels at 2,1% and 4% respectively as of end-2016.

However, due to the government's measures to stabilize housing prices we expect real GDP growth to increase at a slower pace going forward.

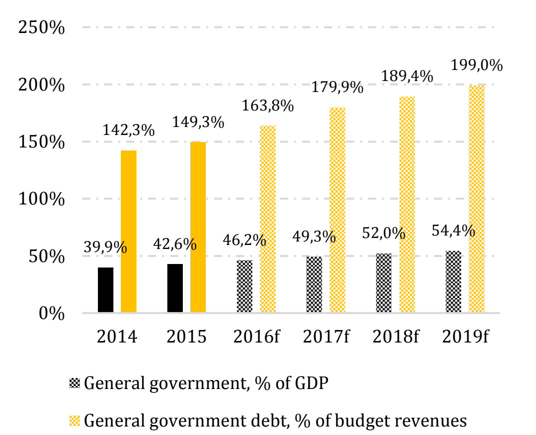
**The external position remains a key strength for China.** As of March 2017, exports grew by around 16% y-o-y driven by an increase in global demand, its largest growth rate since the beginning of 2015. Imports also had an important growth of about 20% due to higher domestic demand and an increase in commodity prices. In addition, the current account balance remained positive at 1,75% of GDP in 2016.

Official capital outflows have eased due to imposed capital controls causing the CNY to stabilize and international reserves to pick up again in February 2017 after a prolonged period of decline (see graph 2). As a result, international reserves stood at USD 3,12 tn as of April 2017 covering gross external debt by 25x and amounting to 62% of gross government debt. Besides, the net international investment position (NIIP) remains strong and it improved up to USD 1,8 tn as of end-2016. However, the figure of net errors and omissions continues to increase and, as of end-2016, it had accumulated USD 653 bn over the past five years (see graph 3), which may be signaling higher capital outflows than the official figures reflect. Moreover, there are still latent risks of additional official outflows if the CNY were to depreciate further against the USD.

We still see an upside on China's role in the world's trade and we consider that the risk of trade war with the United States has almost faded. In addition, even though we still assess the internationalization of the CNY as positive, recent capital controls imposed by the government may further hamper this process.

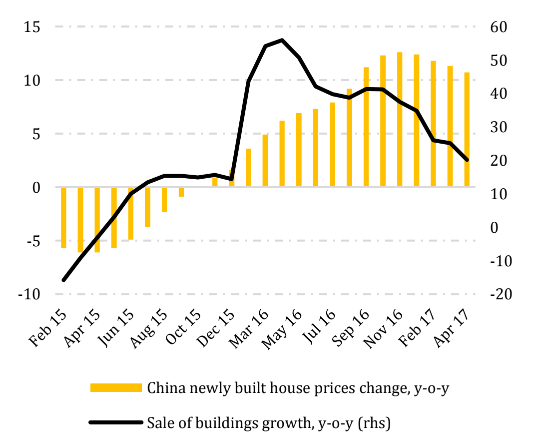
**Contingent liabilities remain a risk, while official government debt levels are still acceptable**. The potential materialization of China's contingent liabilities remains a potential risk for the economy. One of the sources of risk is still the highly leveraged and low-profitable SOEs; however, their debt has stabilized and the second round of reform is set to begin in order to change the ownership structure and reduce concentration of these types of enterprises. The second risk factor is the increased local government debt through Local Government Financial Vehicles (LGFVs) with an already high debt burden and decreased demand on their issues. Even though the Ministry of Finance has made it clear that the government is not responsible for the debt issued by these Special Purpose Vehicles (SPVs), we are still cautious on whether or not there could be government interventions in case of defaults.

**Graph 4:** Official government debt levels



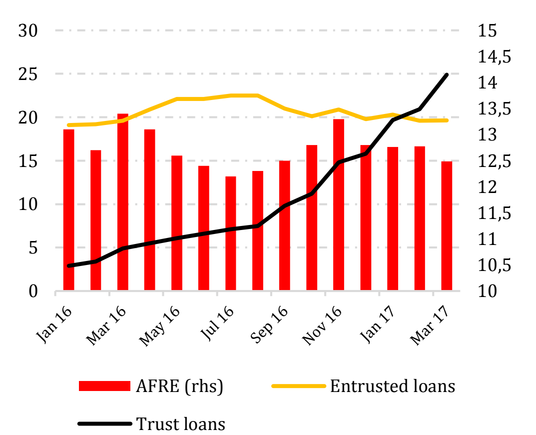

Source: RAEX (Europe) calculations based on data from the IMF

**Graph 5:** Real estate market dynamics, %




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

**Graph 6:** Credit to the economy, y-o-y % growth




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

Official government debt levels, on the other hand, remain stable but continue to increase. We anticipate this trend will remain in place in the mid- and long-term perspective given the government's proactive fiscal policy. Gross government debt was estimated by the IMF at 46,2% of GDP and 163,8% of budget revenues as of 2016, showing an increase of 3,6p.p. and 14,5p.p. respectively (see graph 4) from a year ago. Moreover, Central government short-term debt remained low at 1,8% of GDP in 2016 and was well covered by FX reserves (16x).

**Monetary conditions are still accommodative**. Despite the monetary policy remaining loose, recent tightening from the authorities to avoid imbalances in the economy and to reign in excess leverage, was immediately followed by injection of liquidity in the market due to missed interbank payments. Despite this, the reserve requirement ratio (RRR) remained unchanged in 1Q 2017.

The People's Bank of China (PBC) has lately relied on open-market operations instead of to the interest rates or reserve requirement ratios in order to manage short-term liquidity in the economy.

As mentioned in our previous report[1], loose monetary policy had caused the property market to inflate to risky levels. However, the authorities' actions listed in our report have worked in order to contain a potential bubble and the market has stabilized (see graph 5). This, once again, reflects the powerful tools, given China's political system, which help to mitigate latent or potential risk to the stability of the economy and the financial system.

**The economy remains highly leveraged and shadow banking is still a threat to the financial system**. The aggregate financing to the real economy (AFRE) keeps increasing and at the end of 2016 it was 209% of GDP and grew by around 13% y-o-y in absolute terms. Among the different types of financing to the economy, trust and entrusted loans were the ones which escalated substantially (see graph 6) mainly due to the government's effort to curve financial leverage. These loan deals are between companies and are a proxy for the growth of the shadow banking system. Moreover, this side of the financial sector remains a latent risk for the stability of the financial system as it is difficult to regulate and measure.

Additionally, we estimate that bank assets to GDP grew by 24p.p. from 2015 to 2016, reaching 309,1% by year-end. On the other hand, nominal GDP only grew by 6,6% according to IMF figures, which means that leverage continues to grow at a faster pace than the economy.

[1] Research report on China from 25 November 2016; https://raexpert.eu/reports/Research_report_China_25.11.2016.pdf

In regard to the banking system, official figures reflect a still solid financial sector where the main banks are well-capitalized and liquid. As of end-2016, ROA was 1,2%, NPLs ratio equaled 1,7% and capital adequacy ratio stood at 13,4%, very stable figures as compared to past years.

Furthermore, bankruptcies continued to increase in 2016 as they grew by 54% y-o-y given the government's effort to curve the amount of the so-called "zombie companies".

**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_19.05.2017.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.