Rating-Agentur Expert RA GmbH confirmed at 'A+' the ratings of China

Rating-Agentur Expert RA GmbH confirmed the sovereign government credit rating (SGC) of China at 'A+' (High level of creditworthiness of the government) in national currency and at 'A+' (High level of creditworthiness of the government) in foreign currency.

Rating-Agentur Expert RA GmbH confirmed the country credit environment rating (CCE) of China at 'A+' (High quality of credit environment of the country) in national currency and at 'A+' (High quality of credit environment of the country) in foreign currency.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- The Chinese economy remains highly competitive in the global scenario. Throughout 2017 and 1Q 2018, both exports and imports grew further with-y-o-y growth at 12,9% and 19,1% respectively as of March 2018. As it can be seen, import growth remains buoyant as a result of increasing domestic demand. The trade balance shrunk to 3,4% of GDP in 2017. China is also ranked 27th out 140 countries according to the 2017-2018 Global Competitiveness Index report prepared by the World Economic Forum;
- Real GDP continued to be solid as it grew at a pace of 6,8% in 2017, well above the authorities' forecast of 6,5%. Private consumption and the services sector continue to spur growth substantially supporting the government's rebalancing efforts;
- International reserves continued to increase in 2017 reaching USD 3,2 tn by year-end. The prevailing strength of the CNY has discouraged additional outflows from the country;
- Central government short-term debt stood at 3% of GDP and was well covered by FX reserves (10x) as of 2Q 2017;
- The 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;
- Profitability and stability of the financial sector remains solid. ROA was 1,04%, official NPLs ratio remained stable at 1,7% and capital adequacy ratio stood at 13,7%;
- Inflation dropped below 2% and as of end-2017 stood at 1,8%, showing prolonged price stability;
- Unemployment remained low at a rate of 4% in 2017.

Restricting factors:

- Official government debt levels continue to increase and reached 47,8% of GDP in 2017, an increase of 3,5p.p as compared to 2016. As previously mentioned, we expect that if debt to GDP continues to grow at the current rate, it will break our internal threshold as soon as 2018. Debt to budget revenues also hiked in 2017, the metric stood at 173,3%, 16,3p.p. higher than a year before;
- We anticipate China to continue with a proactive fiscal policy going forward as the government has stepped up the approval of new investment projects and the issuance of bonds through local government financing vehicles (LGFVs) has also increased in order to finance them;
- The People's Bank of China (PBOC) recently slashed the reserve requirement ratios to

16% for large institutions and 14% for smaller banks showing its continuous loose policy stance. However, the PBC had previously raised rate on the 7-day Repo up to 2,55%;

- The fiscal deficit widened further in 2017 when it stood at 4% of GDP as a result of the expansionary fiscal policy from the government. Despite China's authorities having announced plans to cut the budget deficit target, we expect the augmented fiscal deficit to continue to expand and wide fiscal deficits to prevail;
- China's institutional strength, albeit remaining neutral, has slightly deteriorated as shown by the moderately low level of the rule of law index and government effectiveness index. Moreover, these indicators could further deteriorate if the authorities do not follow through with the planed reforms.

Negative factors:

- The materialization of contingent liabilities remains a latent risk for the Chinese government. Total liabilities from SOEs increased further in 2017 as they hiked by 9,5%. Moreover, LGFVs continue to be used by local government to finance projects. Despite this, the central government has continued to crack down on these entities. The ministry of finance recently prohibited the LGFVs' bond prospectus to include information of the financial health of the regions as to unwind them from any association between the two;
- State owned banks continue to dominate the banking sector, which has a direct impact on the government's contingent liabilities;
- In line with our projection in the previous rating revision, the overall aggregate financing to the real economy (AFRE) rose to 215% of GDP in 2017. Trust and entrusted loans (a form of shadow banking) continued to decline, a positive sign of the authorities reigning in shadow financing; nonetheless, we still consider this a risk to the stability of the financial system. Moreover, the bank assets to GDP ratio stayed almost unchanged in 2017 as it posted a figure of 308%.

Support factors:

- Substantially high level of FX reserves (USD 3,24 tn by March 2018) (weak support-factor).

ADDITIONAL FACTORS THAT INFLUENCED CCE RATINGS:

Positive factors:

- Real interest rates remain stable (2,6% in 2017).

Restricting factors:

- We still consider the restrictions on free flow of capital and operation of capital markets as non-positive factor. However important strides have been made to open market and the financial system; thus, this factor was moved from negative to restricting;
- The CSI 300 index has increased by around 21% in 2017 from end-2016 showing that the stock market recovery continues;
- We expect bankruptcies to increase further. However, as mentioned in previous reviews, these events are also connected to improving the efficiency of the economy by eliminating "zombie" companies.

Negative factors:

- Low quality of investor's protection – China is ranked 119th out of 180 countries in protecting interests of minority investors according to the WB Doing Business report;
- The debt of the non-financial private sector in China stayed constant: as of 3Q 2017 it stood at 211% maintaining the economy's total debt figure at around 257% of GDP.

SENSITIVITY ASSESSMENT:

The following developments could lead to an upgrade:

- Gradual deleverage of the economy combined with a decline in shadow banking;
- Decrease in SOE's debt and increase in profitability alongside a reduction of off-budget debt from local governments which would reduce the government's overall contingent liabilities.

The following developments could lead to a downgrade:

- Deterioration of fiscal metrics due to increased government support and depressed revenues;
- A continued increase in credit to the economy above our current expectations.

"The Agency confirmed the ratings of China at 'A+' mainly supported by strong and better than expected GDP growth. Despite having deteriorated compared to the previous rating revision, the debt position and the fiscal budget stance remain bearable and we believe that the government still has enough space to mitigate potential risks which could potentially arise. The external position and the competitiveness of the economy remain the key strengths of China.

However, the overall indebtedness of the economy continues to increase and the banking sector remains highly leveraged which, along with the high amount of contingent liabilities, stand as the major key negative factors for the creditworthiness of China." – Clarified Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH.

Responsible expert: Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH

Reviewer: Gustavo Angel, Rating Associate of Rating-Agentur Expert RA GmbH

Research report on China is available at:

https://raexpert.eu/reports/Research_Report_China_11.05.2018.pdf

Next scheduled rating publication: 9 November 2018**.** The full sovereign rating calendar can be found at http://raexpert.eu/sovereign/#conf-tab-5

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RATING HISTORY:

Date	Review reason	SGC		CCE	
		National currency	Foreign currency	National currency	Foreign currency
17.11.2017	Scheduled review of both types of ratings for the country	A+	A+	A+	A+
19.05.2017	Scheduled review of both types of ratings for the country	AA-	AA-	A+	A+
25.11.2016	Scheduled review of both types of ratings for the country	AA-	AA-	A+	A+
03.06.2016	Scheduled review of both types of ratings for the country	AA-	AA-	A+	A+
11.12.2015	First assignment of both types of ratings for the country	AA-	AA-	AA-	AA-

Minute's summary

The rating committee for China was held on 11 May 2018. The quorum for the rating committee was present. After the responsible expert presented the factors, which influenced the rating assessment, the members of the committee expressed their opinions and suggestions within the framework of the Sovereign methodology. The chairman of the rating committee ensured that every member of the committee expressed his/her opinion before proceeding to the voting.

The following methodology was used for the rating assessment: Methodology for Assigning Sovereign Government Credit Ratings and Country Credit Environment Ratings – Short Public Version (from April 2017) can be found under the following link: http://raexpert.eu/files/methodology/Methodology_Short_Sovereign_v2.pdf. Descriptions and definitions of all rating categories can be found under the following link: http://raexpert.eu/sovereign.php under the "Rating scale" section. The user of the rating shall read the methodology in order to have a full understanding of the rating procedure.

These ratings are unsolicited. The rated entity did not participate in the rating process.

Main sources of information: International Monetary Fund, World Bank, Trading Economics (www.tradingeconomics.com), World Economic Forum, Doing Business, United Nations, Transparency international, People's Bank of China, China Banking Regulatory Commission, State Administration of Foreign Exchange, National Bureau of Statistics of the People's Republic of China, Ministry of Finance of the People's Republic of China, Asia Bonds Online.

Limits of the Credit Rating

During the rating assignment process, Rating-Agentur Expert RA GmbH (the Agency) used publicly available information that was considered to be reliable, complete and non-biased. The responsible expert performed the rating assessment of the country with information considered as the most reliable and up to date in accordance to the overall position of the country and the Agency's internal criteria for selecting data providers. The information and data used for this specific assessment can be considered as of sufficient quality.

Regulatory use

Only SGC ratings can be used for regulatory purposes according to the ESMA definition. CCE ratings are not considered as credit ratings within the framework of Regulation (EC) No 1060/2009.

Conflict of interest

The responsible expert was neither influenced nor biased by third parties during the rating assessment. All employees involved in the rating assessment and revision of the rated entity have reported absence of conflicts of interests before initiation of the rating process.

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Office responsible for preparing the rating

The office responsible for the preparation and issuance of this credit rating is the office of Rating-Agentur Expert RA GmbH in Frankfurt am Main, Germany.

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