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

Research Report on China

25 November 2016

Responsible Expert:

Hector Alvarez
Rating Associate

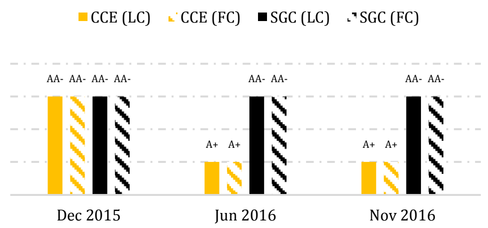
For further information contact:
Rating-Agentur Expert RA GmbH
Walter-Kolb-Strasse 9-11,
60594 Frankfurt am Main, Germany
+49 (69) 3085-45-00
E-mail: info@raexpert.eu
www.raexpert.eu

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	2013	2014	2015
Gross gov. debt, USD bn	22045	25830	29885
Nominal GDP, USD bn	59696	64849	69630
Real GDP growth, %	7,8	7,3	6,9
Gross gov. debt/GDP, %	36,9	39,8	42,9
Deficit (surplus)/GDP, %	-0,8	-0,9	-2,7
Inflation rate, %	2,5	1,5	1,6
Current Account Balance/GDP, %	1,5	2,6	3,0
External debt, USD bn	-	-	

Development indicators	2015
Inequality adj. HDI	0,73
GDP per capita, USD th	14,3

Default indicator	25.11.2016
5-Year CDS spread, Bp	118
10Y Gov Bond Yield, %	2,87

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

Summary

Strong macroeconomic fundamentals, policy flexibility and a still solid external stance are the main factors that underpinned the confirmation of China's ratings. Despite the slight deterioration of fiscal metrics, projected levels of government debt along with fiscal balances are expected to remain acceptable.

Nevertheless, the amount of leverage of the economy, still latent risks arising from contingent liabilities from LGFVs and SOEs and the overheating of the property market, are seen as potential threats to the stability of China's creditworthiness.

The impact on creditworthiness from government debt levels and contingent liabilities remains unchanged. As mentioned in our previous China review[1], official government debt figures are expected to continue in an upward trend. The Agency expects the debt load to stand above 50% of GDP and 180% of budget revenues by 2018. Despite this, we consider current (42,9% of GDP and 149% of budget revenues in 2015) and projected levels will remain acceptable and lower than the country's BRICS peers (see graph 1).

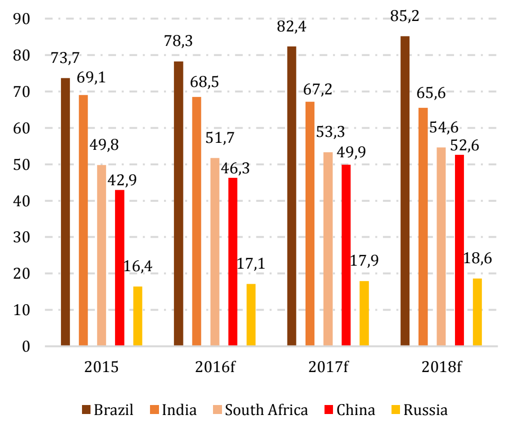
Despite this, the off-budget debt from regional local governments (RLGs) and obligations from SOEs augment the risk of contingent liabilities. This remains a key issue despite an effort to curve the use of local government financing vehicles (LGFVs) by swapping this kind of liabilities to official bond issuance. These products have been growing and, since the slide of the CNY, more USD denominated bonds have been issued by these SPVs. In addition, debt from SOEs (which increased by 9,9% in the first 9M 2016) and local governments continue to rise and still represent a risk of contingent liabilities' materialization.

The appetite for these instruments is explained by the fact that investors factored in the implicit guarantee of the government over these bonds. However, the Ministry of Finance has recently made clear that investors should not expect implicit guarantees on this type of debt, including debt from SOEs.

Strong external position despite increased capital outflows. China posted a trade surplus of 5,4% of GDP and a current account surplus of 2,9% in 2015. Despite imports and exports constantly declining in 2016 (-

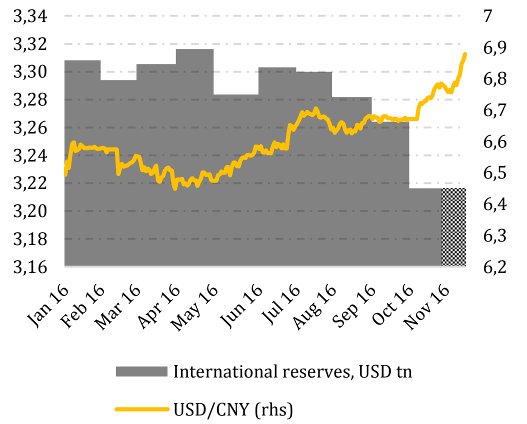
[1] Research report on China from 3 June 2016 (http://raexpert.eu/reports/Research_report_China_03.06.2016.pdf).

Graph 1: BRICS peers government debt, % of GDP



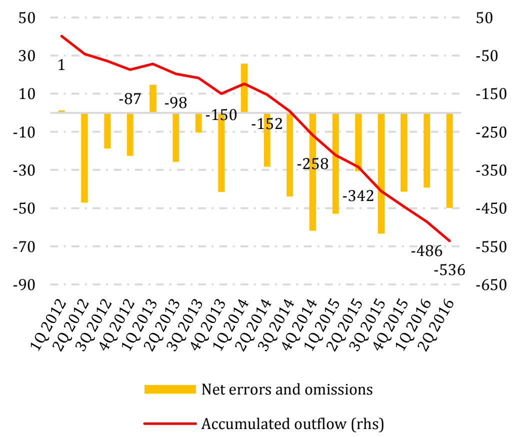
Source: RAEX (Europe) calculations based on data from the IMF

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

7,6% in exports and -8% in imports by September 2016) China's trade balance remained positive at USD 396,4 bn during the first 9M 2016.

Furthermore, we could see the role of China in world trade increase given the imminent withdrawal of the US from the Trans-Pacific Partnership (TPP). This will encourage other nations to back the Regional Comprehensive Economic Partnership (RCEP), a China led trade deal that could put the country in a very advantageous position regarding its influence to impose rules in the Pacific Rim commercial relationships.

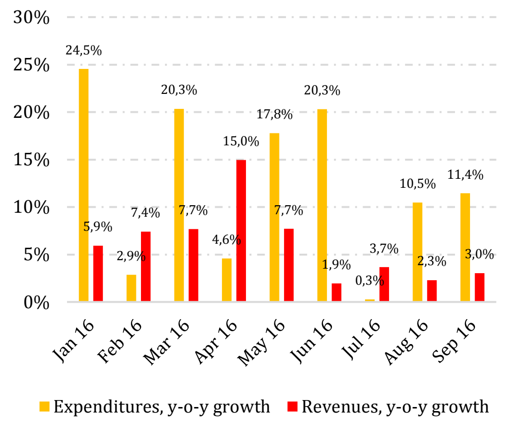
China's international reserves remain high at USD 3,2 tn by October 2016, enough to cover 67% of total government debt and close to 19 months of imports. Nonetheless, this number has been continuously declining given different factors (such as pressures on capital outflows, the Fed interest rate hike speculation, monetary policy clarity, Brexit and Donald Trump's election) which all translate in exchange rate pressures. This, as a result, has caused the People's Bank of China (PBC) to use reserves in order to slowdown the depreciation pace of the CNY (see graph 2). In fact, we expect the level of reserves to be even lower at end-November given the burden the election of Trump recently put on the Chinese currency.

As mentioned, capital outflows have continued to increase and the net errors and omission account on the BoP keeps accumulating, which is a proxy for unaccounted capital outflows (see graph 3).

In addition, CNY internationalization enhances flexibility. Now part of the SDR basket and in the near future its incorporation in the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) will make the CNY an official currency to be held by foreign central banks as reserve assets.

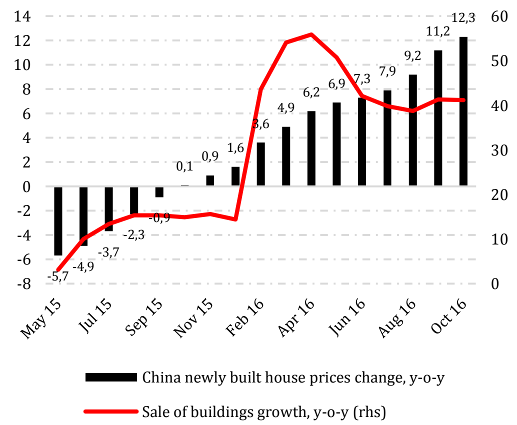
GDP growth to meet authorities' target, but set to slowdown. GDP growth has been robust as of late driven by retail sales, investment and industrial production (6,7% in 3Q 2016) and is in line to reach the authorities' target between 6,5% and 7,0%. However, one of the key drivers of growth has been the property market where, supported by policy stimulus, prices and sold items have substantially increased recently and could be unsustainable. Furthermore, the average increase in the level of prices has been 1,9% y-o-y for 9M 2016 and unemployment was as low as 4,1% in 2015. We expect growth to continue in a downward trend given the government's rebalancing efforts and weak external demand. In regard to rebalancing, we observe that this process has continued given the lower Purchasing Managers' Indexes (PMI) for manufacturing (51,2 in October 2016) and higher for the services sector (54 in October 2016).

Graph 4: Budget execution



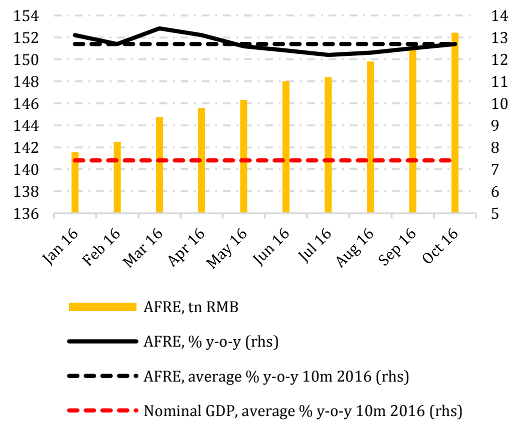
Source: RAEX (Europe) calculations based on data from the National Bureau of Statistics of China

Graph 5: Real estate market dynamics



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

Graph 6: Credit / GDP gap



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

Fiscal budget expected to widen due to loose policies. The fiscal balance is expected to end the current year around -2,9% given the continued fiscal stimulus provided by the government (even though this has gradually decreased). Additionally, the augmented deficit, as calculated by the IMF, is also expected to widen due to increased off-budget transactions by local governments.

Fiscal policy remains loose with expenditures growing at a higher pace than revenues throughout 2016; accumulated y-o-y growth for 9M 2016 was 12,5% for expenditures and 5,9% for revenues (see graph 4). A new fiscal reform is being implemented, which includes the new budget law to improve transparency, a tax reform to support the rebalancing of the economy and a social security reform.

Monetary policy turned neutral in order to maintain growth and avoid financial and real estate bubbles. The last time the PBC adjusted the required reserves ratio (RRR) was in March 2016. However, in the wake of tightening liquidity, the PBC has been injecting money into the market with different tools such as repo agreements.

The ease on the monetary policy for long periods has caused economic growth to maintain its pace but at the same time, has propelled a real estate market boom (a major contributor to economic growth as previously mentioned), which could become unbearable. The sale of buildings rose by 41,2% and newly built houses prices increased by 12,3% in October 2016 from a year before (see graph 5).

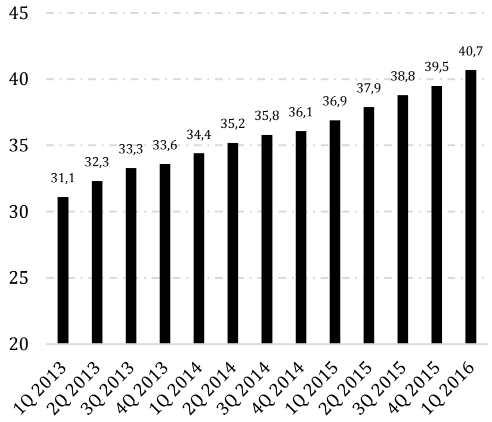
Given the risks stemming from the rise in property prices, the government implemented measures to slow down the price increase. Tightened mortgage standards, higher requirements on down payments and bans on non-local buyers are some of the actions taken to mitigate the risks.

Additionally, as was previously mentioned, the CNY has been pressed by many factors but, as of late, the main pressure has been the election of Donald Trump as the president of the US. In light of this, the PBC raised its CNY fixing showing that the authorities will intervene in order to avoid a steep decline in the domestic currency.

Leverage of the economy and shadow banking remain a concern. Aggregate financing to the real economy (AFRE) increased at an average pace of 12,7% y-o-y for the past 10 months while nominal GDP grew at an average of 7,4% in the first 3Q of 2016 (see graph 6). The ratio of banks´ assets to GDP stood at 286% and domestic credit to GDP at 196% in 2015. These figures clearly indicate excessive leverage of the economy.

However, most of the debt is owned domestically and national savings are around 47% of GDP, which implies that banks still have liquidity. Besides,

Graph 7: Household debt, % of GDP



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

household debt is only 40% of GDP, well below pre-crisis levels in the US (see graph 7).

Additionally, bankruptcies increased by 52,5% in 1Q 2016 as governments tackle the so called "zombie companies". This might be a sign that the authorities will allow more liquidations in order to reduce overcapacity. This events will also provide further protection to borrowers,

Banking system official figures remain stable. The banking system official figures continue to show a sound financial sector. As of 3Q 2016 the figures for the sector were as follows: ROA of 1,2%, NPLs ratio equal to 1,7% and capital adequacy ratio at 13,4%. Nonetheless, even though the shadow banking system started to curb in 2015, it has reemerged with new schemes and remains a latent risk for the stability of the financial system as it is difficult to regulate and measure.

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_25.11.2016.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.