Rating-Agentur Expert RA confirmed at 'A+' the ratings of China. The rating outlook is stable.

Rating-Agentur Expert RA 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. The rating outlook is stable which means that in the mid-term perspective there is a high probability of maintaining the rating score.

MAJOR FACTORS THAT INFLUENCED BOTH TYPES OF RATINGS:

Positive factors:

- Competitiveness of the economy remains a key strength for China. Exports and imports have continued to grow as a result of external demand and domestic consumption. The strength of the latter has caused the trade balance to continue to shrink, nonetheless, it remains at a surplus and we expect it to post a figure of around 3,3% of GDP in 2018. Solid export figures show that the direct effect from U.S. – China trade tension has been so far limited. 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 has slowed down but remains strong as it grew at a pace of 6,5% y-o-y as of 3Q 2018. The services sector (tertiary sector) continued to grow at a solid pace substantially supporting the government's rebalancing efforts;
- International reserves have decreased in 2018 reaching USD 3,17 tn as of September 2018, a decrease of 1,8% from year-end 2017. Despite this, the decline has mostly been a result of asset revaluation and the amount of reserves is still very solid;
- 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;
- In 1H 2018 profitability and stability financial indicators of the banking system remain solid. The average profit margin was 1,03% (ROA was 0,92% in 2017) and capital adequacy ratio stood at 13,57%. Nevertheless, banks' asset quality slightly deteriorated as the NPLs to total loans ratio reached 1,9%, an increase of 0,12p.p. from the end of 2017;
- Inflation has risen gradually in 2018. As of September 2018 it reached a y-o-y growth of 2,5% showing prolonged price stability. 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;
- Unemployment remained low at 4% in 2017 and we expect it to remain stable.

Restricting factors:

- Official government debt levels continue to rise. We anticipate official government debt to GDP to be around 50% in 2018, around 2p.p. higher than in 2017. Moreover, debt to budget revenues is expected to increase by around 9p.p. to about 182%;
- Government debt is well-structured: central government short-term debt is around 2% of GDP and the government's external debt to GDP was only 1,4% and it was well covered by FX reserves (18x) by end-2017;
- 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 reforms to

reduce VAT and personal income taxes. Moreover, in the wake of the recent economic slowdown, we also expect fiscal stimulus to continue in order to shore up the economy. As a result, the fiscal deficit is expected to widen further in 2018 and additionally in 2019. Despite this, China's government has enough buffers to back the supportive policy;

- In October 2018 the People's Bank of China (PBOC) trimmed the reserve requirement ratios for the fourth time this year down to 15,5% for large institutions and 13,5% for smaller banks in order to boost slowing investment and economic growth. Moreover, as pressures have mounted on the CNY given the trade spat with the U.S., the PBOC reintroduced the FX risk reserve ratio back in August 2018 to prevent further depreciation of the CNY (CNY lost 6% against the USD since the beginning of 2018). Despite this, the Chinese government has not shown more aggressive signs of defending the currency. This depreciation can resume pressure on capital outflows;
- China's institutional strength remains neutral, reflected 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:

- Contingent liabilities' materialization risk is still a key potential threat to the stability of public finances. Even though SOEs remain substantially less profitable than private sector corporates, ROA of government owned corporations posted a figure of 2,4% in September 2018, 0,2p.p. higher than the average of the previous two years. Moreover, leverage of these enterprises has increased at a slower pace; as of September 2018 they had grown by 2,4% y-o-y compared to an increase of 6,9% y-o-y in the same period of 2017. We expect bankruptcies to increase further as a result of the government's efforts to improve the efficiency of the economy by eliminating "zombie" companies. The number of bankruptcies among SOEs increased by 59% in 2017. On the other hand, even though financing through local government financing vehicles (LGFVs) is set to continue increasing, the Chinese authorities continue to indicate that these products have no government implicit guarantees;
- State owned banks continue to dominate the banking sector, which has a direct impact on the amount of the government's contingent liabilities;
- The economy remains highly leveraged; nonetheless, overall credit to the economy has slowed down. We forecast aggregate financing to the real economy (AFRE)[1] to rise up to 226% of GDP in 2018; which would represent an increase of around 1p.p. from 2017. Also, domestic credit to GDP stood at 215% in 2017, unchanged from the reading posted in 2016. In regard to shadow banking, trust and entrusted loans (a proxy of shadow banking developments) declined by 4,5% y-o-y as of September 2018, a result of successful efforts from the government to curve shadow financing. However, even though it stabilized, corporate debt reached 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.

Support factors:

- Substantially high level of FX reserves (USD 3,17 tn by September 2018) provides the authorities with the ability to support the national currency. Despite the current trend being negative, the overall stance is very solid (moderately weak support factor).

SENSITIVITY ASSESSMENT:

[1] Also referred to as "Total social financing" is the overall volume of financing provided by the domestic financial system to the private sector of the economy.

The following developments could lead to an upgrade:

- Continued and sustained decrease in credit in the economy combined with a substantial and transparent contraction of the shadow banking sector;
- Overall improvement in fiscal metrics including total government debt and contingent liabilities.

The following developments could lead to a downgrade:

- Increase of credit to the economy which would become unsustainable;
- Steep slowdown of the economy which could hurt public finances.

"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." – Clarified Hector Alvarez, Rating Associate of Rating-Agentur Expert RA GmbH.

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

Reviewer: Olena Kolokolova, Rating Analyst of Rating-Agentur Expert RA

Research report on China is available at:

https://raexpert.eu/reports/Research_report_China_09.11.2018.pdf

Next scheduled rating publication: TBD in December 2018.

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RATING HISTORY:

Date	Review reason	SGC		Outlook	
		National currency	Foreign currency	National currency	Foreign currency
11.05.2018	Scheduled review of both types of ratings for the country	A+	A+	NA	NA
17.11.2017	Scheduled review of both types of ratings for the country	A+	A+	NA	NA
19.05.2017	Scheduled review of both types of ratings for the country	AA-	AA-	NA	NA
25.11.2016	Scheduled review of both types of ratings for the country	AA-	AA-	NA	NA
03.06.2016	Scheduled review of both types of ratings for the country	AA-	AA-	NA	NA
11.12.2015	First assignment of both types of ratings for the country	AA-	AA-	NA	NA

Minute's summary

The rating committee for China was held on 8 November 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 – Full Public Version (from May 2018) can be found under the following link: https://raexpert.eu/files/methodology/Methodology_Full_Sovereign_V3.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

SGC ratings can be used for regulatory purposes according to the ESMA definition.

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.

Rating-Agentur Expert RA GmbH is completely independent from the activities of other agencies of the RAEX group.

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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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The European Securities and Markets Authority (ESMA), the EU's direct supervisor of credit rating agencies (CRAs), has registered Rating-Agentur Expert RA GmbH as a CRA under Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, with effect from 1 December 2015.

Rating-Agentur Expert RA GmbH applies the Code of Conduct Fundamentals for credit rating agencies issued by the International Organization of Securities Commissions (IOSCO Code) and includes the basic principles of IOSCO Code in its Code of Conduct.