China, P.R.: Mainland

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS May 14, 2013

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Recent data provide a mixed picture of the economy in the first half of 2013, but a hard landing in the near term is unlikely. That said warnings from reputable analysts of a more unpredictable situation in 2014-15 with roots in the financial sector are getting louder. That is based on very rapid rise of new credits from the shadow banking industry. This is viewed with great concern also by the§ authorities who are facing a dilemma: clamp down on it and growth may suffer too much.

Summary and conclusions

Markets cheered when growth recovered to 8,1% at the end of 2012, but economic developments so far in the current year have presented a mixed bag. Growth moderated to 7,7% in Q1, prompting observers to adjust whole year projections down to less than 8% but still above the 7,5% official target. More important than the actual deceleration, is the fact that any meaningful rebalancing toward less investments and more private consumption appears to be lagging while the external sector now contributes only marginally to growth. The exchange rate has nevertheless remained strong, helping suppress overall price pressure.

The financial system, by contrast, has become the main concern of both authorities and observers. The mercurial growth of the shadow banking system over a couple of years only to dominate about a quarter of total credit intermediation has unfortunate parallels to the financial crisis in the west. Moreover, combined with the need for credits in the economy to maintain growth at a level that will keep both social disturbances and non-performing loans in the banking system at bay, the authorities are facing the challenge to strike a very fine balance. Hopes are that the Chinese system will prove more resilient than the financial system in the West, and the authorities better at handling it, but uncertainty about both is rising.

As in the West, it may be questioned whether the rise of shadow banking is the cause or the symptom of what is wrong with the economy. As to China, we think suffices to say that growing imbalances with roots in overreliance on exports and investments for growth were likely to create financial sector problems at some stage.

In domestic politics calm has prevailed since late 2012, while foreign disputes have rambled on in particular with India and Japan. Whoever is right, few analysts see any near term amicable solution. Some even point out that what matters is economic strength and success is unlikely to damp assertiveness on either side.

In recent months, two rating agencies have announced negative sovereign rating actions on China mainly because of financial sector developments. We sign up to such worries and even more so as concerns country risk.

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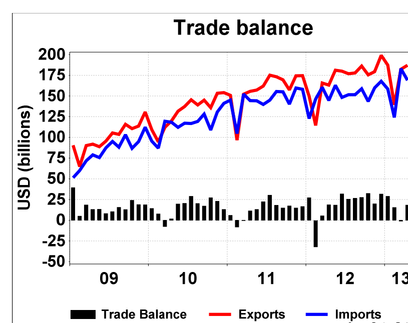
Research

Recent economic and financial developments

Economists downgrade growth projections: The high hopes for continued strong growth following the recovery of late 2012, posting a rate of expansion at 8,1% year-on-year (yoy) in Q4, were dashed as the first quarter of the current year yielded only 7,7% growth, against expectations of at least 7,9% among most observers. The 0,2percentage point (pp) difference may be well within the margin of statistical errors but combined with slowing industrial production to 9,5% yoy from 12,5% last year it has prompted economist to adjust their whole year growth projection to 7,8%. That is 0,3pp above the official target and, of course, still quite a strong performance. Price pressure as measured by the consumer price index has so far in the current year abated as volatile and recently high food prices have been offset with lower prices of other products including manufacturing products. In the January-April period the CPI rose by only 2% down from more than 3% one year earlier.

No clear signs of rebalancing: In 2012, the overall investment ratio inched up to 46%/GDP. So far this year preliminary indicators indicate it may not yet have dropped. Investment demand rose slightly to 20.6% in the January-April period from about 20,2% in the corresponding period of 2012. By contrast, growth of re**tail sales** in nominal values – and early predictor of private consumption, fell 3 pp. to 12,5% yoy in January-April. That can to some extent be explained by easing price pressure, but slowing disposable income growth from 12,6% yoy in 2012 to 9,3% in 2013Q1 is likely to have caused a real effect as well. Anecdotal evidence of less luxurious dinner parties among higher party cadres may have played a role after the new political leadership instilled discipline and austerity in late 2012. In all, this indicates that the good intentions of the communist party's recent five-years plans to tilt the economy toward more consumption and less investments have yet to bear fruits.

What kind of investments? However, the total investment number masks a notable decline in the growth rate of **private** investments to 24% yoy in the January-April period from 27% one year earlier. That is most likely a consequence of continued low capacity utilization of only 60%, down from 80% some years ago, and suggests rising dominance of government investments mainly in infrastructure. The usefulness of such investments is being increasingly scrutinized even by the government itself.[1] As usual, the very high growth numbers for investments are likely to reflect land sales which do not affect the nation's productive capacity and as such are not "investments" in an economic sense.



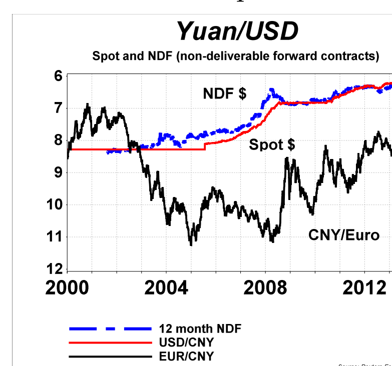
The trade balance remains in steady surplus. The trade surplus has come down from extraordinary highs in the 2000s but still remains clearly in the black. Concerns about it turning red, may seem premature at this stage. In 2012, the trade surplus rose by a half to $230 bn. (4,5% of GDP), but as the income and services account turned slightly negative, in part reflecting the rising tides of middle class Chinese going on shopping sprees to Hong Kong and other metropolis around the world, the current

[1] The Chinese authorities have called for a reduction in "redundant" public investment. (IMF WP/13/83 "China's Path to Consumer-Based Growth: Reorienting investment and enhancing efficiency")

account ended up only by a fraction at 2,7% of GDP. So far this year, seasonal factors dominate the trade developments and do not merit analysis of long term trends. Some observers still worry that the rapid rise of wages in China's export hubs along its coastal areas is beginning to have an impact on competitiveness, referring to reports of Chinese wages already exceeding corresponding wages in Mexico and other countries closer to consumer markets in the West.

FDI inflows continue strong: Despite growing concerns about the world economy as well as China over the last several quarters, it appears that foreign direct investors have remained undeterred and continued investing a total of some $150-200bn. a year into China, representing 3-4% of GDP. As often noted, similar to large export numbers, also healthy numbers for capital inflows have often been suspected of hiding money flows motivated by tax evasion and circumventing capital regulations.

Reserves once again on the rise. In any event, the total of the surpluses on the current and capital accounts turned slightly positive last year as the central bank once again after a year-long hiatus was forced to intervene in the foreign exchange markets to stem the market pressure for a higher value of the remnimbi. That has continued into the current year with the effect to lift reserves at the Peoples' Bank (central bank) by some $0,2tr. to $3,4tr. The central bank has over the last two years indicated that it sees no rationale for accumulating more reserves which already cover around 18 months of imports. When it all the same goes against its own preaching the hope is probably that by not giving in to market pressure it can continue damping speculative market behaviour the success of which is seen in the close relationship between the spot and the NDF (non-deliverable forward) markets since 2009.



Policies:

Recent years' fiscal and monetary policies have followed in the unstable path that began with the generous anti-crisis stimulus package of 2009-2010.

Fiscal policies -- local government qualms: Judged by the central government finances, the fiscal stance has remained strong with the balance in a healthy surplus of 2,4% of GDP in 2012 and a debt to GDP ratio of less than 17%. The problem arises when local government finances are brought into the picture. These have deteriorated significantly in recent years and raised total government debt to 50% of GDP, including off-budget ministerial expenditures financed by special bonds often presumed to carry a government guarantee. This rise happened as local governments were charged with carrying out central government policies without being provided budgetary resources and as such had to find other forms of financing. Being legally barred from approaching private capital markets, they ended up borrowing via local government enterprises including various "financial vehicles", which again were funded by commercial banks and finance companies. The local governments were also able to ride on an on-going housing bubble by buying land cheaply from farmers and selling it at fat profits to developers.

All these financing methods, and in particular the latter, remain operative today even though the central government has made efforts to limit their uses. The

problem they portend is that many of the projects thus financed are unlikely to generate any cash-flow anytime soon commensurate with their financing costs. That situation is exasperated by the medium term maturity profile of most local government borrowing. So when loans began to fall due over the last two years, many of them, perhaps most, had to be rolled over to avoid local government defaults. By the end of 2010, an official audit found that over two years local government debt had almost doubled to CNY10,7 tr. By the end of last year the number had reportedly increased to CNY12,6 tr. -- around 25% of GDP. That was recently challenged by a widely reported statement by a former finance minister claiming that the debt was closer to CNY20tr. (40%/GDP). That would bring total general government debt to 57%/GDP.

The debt numbers referred to above do not include contingent liabilities, which could be considerable should the government have to bail out the many non-profitable state owned enterprises (SOE). Moreover, the potential level of problem assets in the banking system of up to 40% according to estimates by Standard & Poors, the rating agency, equivalent to 60% of GDP would put government finances under severe distress should the government have to bail out the banks.[2] Against this many observers note that government debt dynamics are still extraordinary favourable as seen in the so-called (r-g) factor where "r" denote the rate of real interest and "g" the rate of real economic growth. When (r-g) is negative as clearly in the case of China, the government debt ratio is on an automatic downward path, unless new debt is contracted. However, for this equation to hold for the longer term "r" should reflect a free market interest rate and g the sustainable economic growth rate. That is likely to mean that "r" -- government's refinancing rate, should be higher and "g" the growth rate smaller, reducing the favourable effect on debt dynamics.

Monetary policies – too many goals? Monetary policies as conducted by the Peoples' Bank of China (PBoC) have increasingly been caught in the pinch between

1. Keeping a lid on inflation
2. Avoiding volatility and to rapid appreciation of the exchange rate
3. Limiting spill-over effects on local liquidity from foreign exchange markets
4. Containing spill-over effects from monetary policies on SOE profitability
5. Containing spill-over effects from monetary policies on banks' profitability
6. Limiting high credit growth that may endanger financial system stability
7. Maintaining orderly and a manageable environment in the financial sector
8. Fostering a competitive market for credit to improve total capital allocation

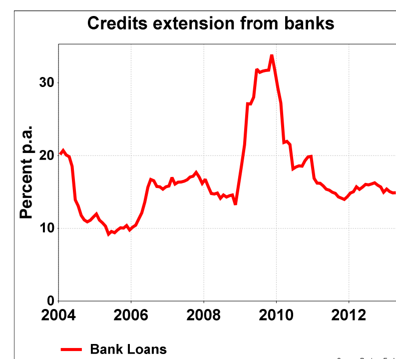
This is not the place to discuss each and one of them, but suffices to note that even though they all hang together they are unlikely to be managed with a limited set of tools at the disposal of a central bank. To the contrary, managing one of them could be to the detriment of the others and striking a balance could simply be impossible. Here we make just a few notes of importance to country risk assessment.

Keeping a lid on inflation: PBoC has been reasonably successful. However, to achieve this it could not use the interest weapon freely if that were to conflict with (2) and as importantly with (4) as many SOEs would not manage to pay higher interest rates if needed. As such, the PBoC has resorted to other instruments such as hiking banks' reserve requirements up to more than 20%, very high by any comparison. But

[2] A financial stability framework study of the IMF published in 2010 estimated that losses from NPLs and other contingent liabilities could contribute to a rise of public debt by more than 40% of GDP over a six years period.

that has impinged on banks profitability. PBoC has therefore been forced to regulate banks funding costs, mainly the deposit rates, to below the lending rates determined by SOE profitability. The result has been deposit rates around 3% and lending rates at around 6%. So far that worked up to a point. But China is no longer in the grips of the Cultural Revolution and people are no longer shot for pursuing their own business interests. Private market participants saw the unreasonable wedges that PBoC imposed on market solutions and seized the opportunities by circumventing the wedges. When the global financial crisis hit in 2009 many SME's suffered. Their requests for loans were turned down by regular banks which were unwilling or unable to take such credit risks. At the same time inflation soared partly for exogenous reasons and many savers were disgusted by low deposit rates offered by banks. Some people saw the opportunity to link savers demanding higher interest with borrowers with little alternative but to pay it. In recent years the market for such non-bank financial transactions has sky-rocketed and PBoC has unwittingly created a competitive side-market -- objective (8). At the same time it has created a dual financial market with opaque interlinks and lack of transparency. Compared to the situation in the mid-2000s goal (7) has slipped.

China's shadow banking system: Over the last couple of years the total of so-called shadow financial transactions have sky-rocketed to dominate at least a quarter of what in Chinese statistics goes under the terms "Total Social Financial Transactions" or TSF. This includes all transactions identified as some kind of loans, but excludes equity transactions. Shadow banking has come to include the total of TSF not reported by banks. That means that shadow banking includes also off-balance sheet transactions by banks including guarantees and fee-based activity where banks act as middlemen bringing savers and borrowers together , often arranging loan documents etc. Such activities are not necessarily illegal but may not be in line with the monetary and supervisory authorities' intentions.



For two years, during the anti-crisis fiscal and monetary stimulus package of 2009-2010, banks loan activity soared raising total amount of credit extension by 58% to CNY48tr. (120% of GDP), of which about a third went to local governments as explained above. However, as the authorities clamped down on this rapid growth, fearing banks were about to amass bad loans (NPL) some years down the road, the shadow banking system stepped in as high demand for credit continued while savers had already discovered they did not have to accept the low interest offered by established banks. Since then shadow banking has quadrupled to an estimated CNY20tr by the end of 2012. (A global investment bank reports this even higher at CNY30tr.) In that year bank loans represented only 55% of total credit extension according to official estimates. In the first quarter of 2013, that share has reportedly dropped to one half. Observers see TSF rising another 45% of GDP in 2013, from 200% of GDP at year-end 2012, of which shadow banking would make up almost one third barring government interference.

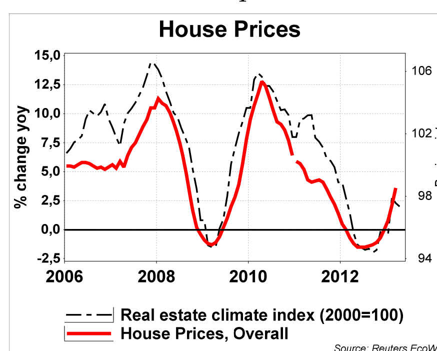
Shadow banking comes under different names: wealth management products, bankers' acceptances, trust funds etc. Each product may target different investors and borrowers but essentially share the same purpose: to create a market where government regulations prevent it or where banks, in particular the state owned

which together dominate about half of the regular banking system, are prevented to act efficiently due to their quasi fiscal responsibility for the SOEs.

The curious thing about the growth of China's shadow banking is that it appears as a repeat performance of what happened in the developed market economies in the run-up to the global financial crisis in 2008-9. The global size of the shadow financial market comprising various kinds of non-bank intermediaries has been estimated to $65 tr. or about a quarter of total financial assets.[3] While it has not been as buoyant as its Chinese counterpart (growing at a cumulative rate of only 10% a year since 2002) the two developments share many idiosyncrasies in terms of lack of transparency and regulatory oversight. Product names may differ but the intrinsic *raison d'etre* is the same: to create markets where governments or established institutions bar them.

They also share another unfortunate feature: unreasonable euphoria on the part of investors as to the safety of their placements. In the West, shadow banks gave the impression of safety almost at par with treasuries by means of securitization. That worked well in peace times but when confidence collapsed correlations went the same way -- a tail event few had hedged against. China's shadow banks have also tried to build an image of solidity along similar lines. In addition, they are too often perceived as the banks' long arm because involvement of those in clinching deals often at the banks' own premises. That may prompt unreasonable risk taking. A collapse of confidence for whatever reason could create runs on the shadow banks.

A booming housing market carries also some similarities with the pre-crisis West, except that in the latter it served mainly the function of a cash machine for more private consumption. In China the housing market has become a savings vehicle for the wealthy middle class and a cherished investment object for high-yielding WMPs. So far the ups-and-downs in the Chinese housing market reflecting frequent changes in government regulations have apparently not caused serious spill-over effects.



Is China heading for a financial crisis? In the methodology of FitchRatings Chinese banks scores the highest risk of a banking crisis, mainly because of very high credit growth over a short span of time which is likely to have produced many potential bad loans. The similarity of the financial developments with the pre-crisis West is another ominous sign. Still it can be argued that the differences between China and the pre-crisis situations of other countries that eventually ended up in financial crisis over the last few decades, are also important. Some of them are summarized below:

China	Other countries 1-2 years before crisis
Trade surplus, independent of foreign capital, large foreign reserves not yet significant competitiveness problems	Asian "Tigers" before 1997 and "peripherals" before 2009: significant trade deficits and growing competitiveness problems Japan before its financial collapse in early 1990s: trade surplus and strong reserves Argentina before 2001: rising reserves but serious competitiveness problems

[3] IMF December 4, 2012: "Shadow Banking; Economics and Policy"

This list has no pretensions of being complete but gives the impression that there is no predetermined prescription of a financial crisis. But one possible "wisdom" is that China could be more prone to follow in the footsteps of Japan than the "peripherals" of the Asian "tigers".

Outlook:

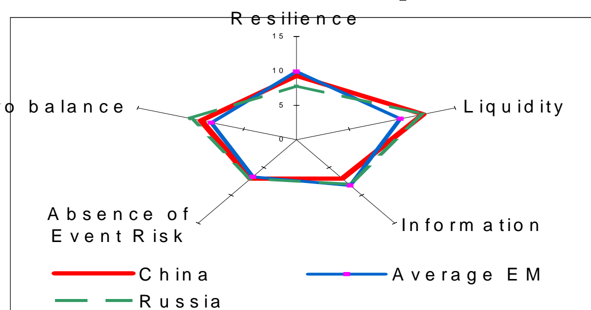
For 2013 most observers including ourselves are reasonably confident that the government will at least achieve its 7,5% growth target. That is of course much lower than the average over the last decade, but those high growth days are now gone. For the next few years a growing chorus of observers, including several old-china hands, are becoming more outspoken pessimistic and some see rising medium terms risks, first of all in terms of growing financial and economic imbalances. The country has become too addicted to new credits for growth, while financial expansion along the lines of recent years might prove imprudent without more efficient capital allocation than can be expected from SOEs and bureaucrats.

It is being pointed out, including from within, that it is not a given that it is smart to build more steel mills, cement plants or manufacturing plants in the inland. Perhaps agriculture would be a better idea. Also, it is no point building more highways, airports or high speed trains if consumers cannot afford buying cars or the tickets. In short, China needs to speed up the rebalancing toward consumption as the main driver of economic growth but it is not obvious that is done overnight or fast enough to fill the space left over when investments have to be scaled down. It has been commonplace to present some 6-7% annual GDP growth as the minimum to maintain low unemployment and social stability, but it could prove as urgent to maintain reasonable growth to keep accumulation of bad loans in banks at bay.

That said, we note that the new leadership like its predecessor is also expressing due concern over China's development. It recently issued new regulations to address the more speculative parts of shadow banking. That, however, has been met with a "wait-and- see" attitude by many observers as to the efficacy of implementation.

Other issues: The spats over maritime and land borders with neighbours could intensify with little advance notice, but most analysts appear confident that a near-term major scale-up is unlikely. That is unless any of the antagonists, in particular Japan and China but with India and the US at a close second, see a window of opportunity to settle scores in own favour. -- Weak demographics, by contrast, is a longer term issue. In 2012, the labour force declined for the first time in modern history but it will remain at about this new level for the rest of the present decade.

Key ratios	2013
Population (mill.)	1380.8
GDP/capita ($)	6609
GDP (% chg.)	8.0%
Inflation	2.6%
Trade balance/GDP	2.9%
Reserves/imports (months)	21
Budget balance/GDP	-3%
Government net debt/GDP	16%



External ratings:
Fitch: A+
Moody's: Aa3/Pos

Peers:
Korea
Estonia
Chile

Graph: China scores above average on macro balance and liquidity, but is weaker than the average on reliable information. Resilience is about the average of emerging markets but event risk is weaker.

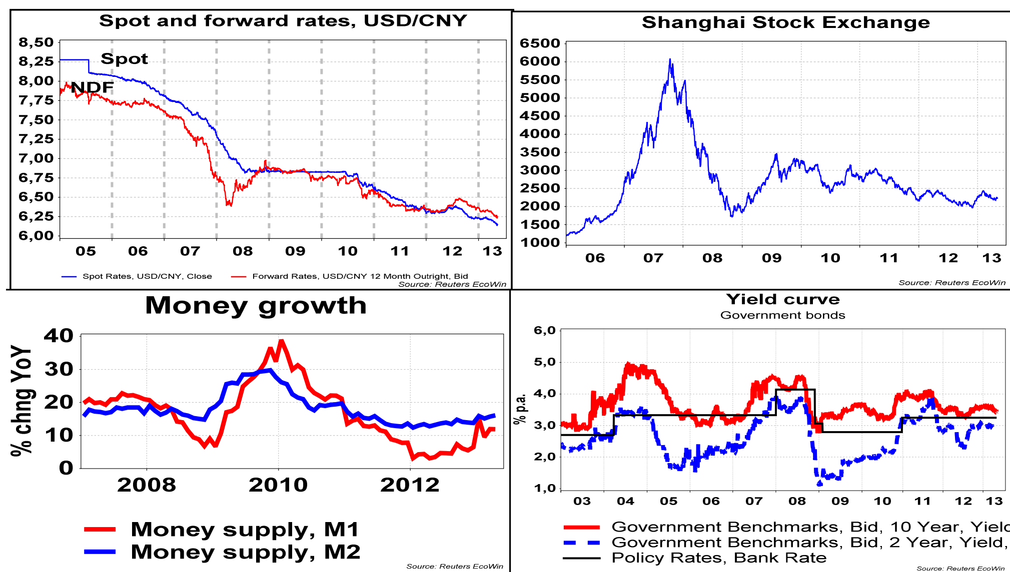
Key data:	2008	2009	2010	2011	2012	2013	2014
GDP (mill.US$)	4530	4991	5943	7336	8240	9512	10880
GDP/capita (US$)	3384	3706	4385	5379	6004	6889	7833
GDP (%chg.)	9.6%	9.2%	10.4%	9.3%	7.8%	7.7%	7.7%
Investments/GDP	44%	48%	48%	49%	49%	48%	49%
Budget balance/GDP	0%	-2%	-2%	-1%	-3%	-3%	-2%
Govt net debt/GDP	17%	17%	16%	15%	15%	16%	16%
CPI inflation (%chg.)	5.9%	-0.7%	3.3%	5.4%	2.6%	3.2%	4.0%
Money demand (%chg.)	11.4%	12.5%	15.5%	13.8%	10.6%	12.8%	11.2%
Stock prices (%chg.)	3057	2751	2836	2669	2223		
Interest rates	4.3%	1.9%	2.7%	5.4%	4.6%	4.2%	4.2%
Exch. Rate ($)	6.95	6.83	6.77	6.46	6.31	6.17	5.98
Trade/GDP (%)	57%	44%	50%	50%	47%	46%	45%
Oil price (Brent)	$97	$62	$80	$111	$112	$106	$108
Millions US $							
Export of goods	1 429 180	1 202 050	1 578 450	1 899 280	2 050 110	2 349 510	2 612 400
Imports of goods	1 131 840	1 003 890	1 393 910	1 741 410	1 817 340	1 991 070	2 252 820
Other:	123 228	45 097	53 270	43 844	-18 970	-34 363	-39 686
Current account ($ mill)	**420 568**	**243 257**	**237 810**	**201 714**	**213 800**	**324 077**	**319 894**
(% of GDP)	9.3%	4.9%	4.0%	2.7%	2.6%	3.4%	2.9%
FDI	114 792	87 167	185 700	170 400	170 352	175 945	184 043
Loan repayments	-23 959	-33 449	-29 511	-39 320	-54 461	-81 178	-114 401
Net other capital flows	-49 451	64 084	23 791	228 456	-201 941	-182 964	-52 016
Balance of payments	**461 950**	**361 060**	**417 790**	**561 250**	**127 750**	**235 880**	**337 520**
Reserves	1 838 080	2 199 140	2 616 930	3 178 180	3 305 930	3 541 810	3 879 330
Total debt	377 650	419 534	515 148	637 765	737 592	826 122	920 806
o/w short term debt	193 379	220 514	307 393	428 391	513 357	572 427	632 421

Source: OEF (Oxford Economic Forecasting) and SEB estimates.

Rating history					
Fitch (eoy)	A-	A-	A	A+	A+
Moody's (eoy)	A2	A1	A1	Aa3	Aa3

Type of government: Communism. Leaders re-elected or replaced at next party-conference in 2017.
Next elections N/A

Other:
Latest PC deal None
Recent IMF programs None



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