China

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS Nov 20, 2013

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The recent party congress has emphasized the urgent need for new reforms to address mounting economic and financial imbalances. While most observers dismiss the likelihood of an imminent collapse, they agree on bumpy path forward in terms of growth and overall stability.

Summary and conclusion

Growth holds up for now on rapid credit expansion and fiscal profligacy. In the current year, growth will likely tick in at slightly above the government's target of 7,5%, and many expect that to be repeated in 2014 provided a reasonably healthy external environment. That said, over the short to medium term there are only limited prospects for a significant reorientation of the economy to one based on domestic demand led by private consumption away from the now widely accepted failed export and investment led growth model. Last year, the share of GDP rose to an unprecedented 48.5% of GDP, much higher than seen in any comparable country at a similar development stage, including Korea and Japan in the past. Leverage in the economy has risen from 129% to 200% of GDP over the last four years.

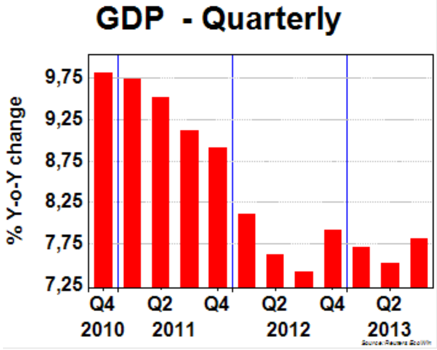
Deteriorating fiscal balances. The state, including its many commercial enterprises and banks, stands behind much of this development. While the central government can still boast of healthy finances, local governments are now running annual deficits around 8-10% of GDP with the total government debt ratio already in the range of 45-65%. At this speed and in view of trailing growth, the debt ratio could exceed 90%/GDP before the end of the decade leaving the government with little fiscal space to meet the challenges of economic reorientation.

The Third Plenum announces major reforms: Against this background, it is most welcome that the new leadership at a recent party conference – the Third Plenum – declared its readiness to change course in economic and social policies. Documents released so far emphasize an enhanced role for the private sector with improving prospects for living standards and consumption. But, as any political document it is lacking in details on implementation and course of action. Sequencing and timing of financial reforms are key for the introduction of market based interest rates, opening of the capital account and greater exchange rate flexibility. Experience of other countries are stories of policy mistakes followed by financial disruptions and crises.

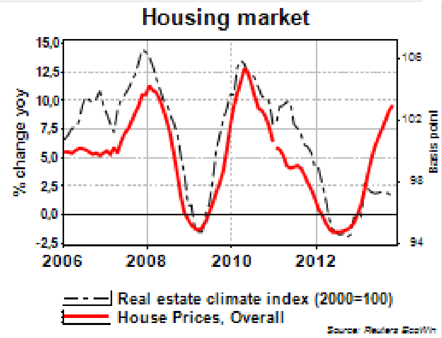
Weaker ratings ahead? Based on present policies Fitch foresees negative pressure building on the sovereign rating. Moody's changed the rating from positive to stable outlook last April, but reacted with enthusiasm to the new policy documents.. As regards country risk, we can see pressure in both directions depending on government's further actions.

Recent economic developments

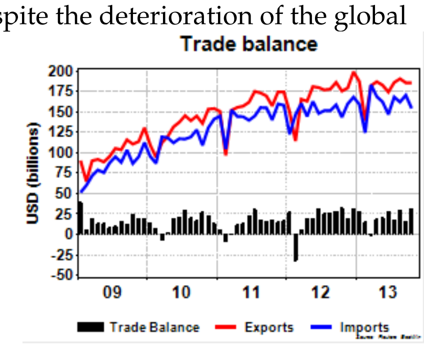
Growth momentum weakens: Since the last bout of super growth in 2009-2010, annual growth rates have come down from almost 10% to well below 8%, but so far still slightly better than the government's target of 7,5%. After a weak start to the year, growth is expected to pick up in the second half leaving the average at 7.6%, only slightly below last year's achievement at 7,7%. The variations of quarter-on-quarter growth is much a reflection of the authorities stop-go policies on the housing market and credit extension from banks. As such, the lending binge of the first several months of 2013, in particular from the shadow banking system, has raised observers' estimate for growth in the second half of this year. Renewed rapid credit extension of recent months after a short pause in June and July, has convinced many observers that economic growth may continue well into 2014 at the present clip spearheaded by government investments with – perhaps -- fledgling support from private consumption and exports.



Price pressure remains well contained: In 2012, the rate of consumer price inflation moderated to 2,6% and the development so far in the current year points to a repeat performance. The continued appreciation of the reminbi combined with growing overcapacity in many sectors keep a lid on the price pressure despite continued hefty wage raises at around 20% a year among urban manufacturing workers. The latter wage hikes may, however, explain some of the resurgence of property prices. Their growth rates are about to bounce back to previous heights. That is despite government efforts to curb speculative activities but seen as ineffective by most people. The overall picture nationwide is still relatively benign, but that masks hefty price rises of 20% or more in main cities.



Current account still showing solid surplus. Despite the deterioration of the global economic environment, China's trade surplus has been holding up quite well, but has been trailing relative to the growth of foreign trade. Since 2009, exports have increased by more than 50%, while imports have almost doubled but from a lower level. A shrinking trade surplus has combined with a rising deficit in services as many Chinese have taken advantage of the strengthening exchange rate to "see the world" and domestic companies upgraded production technologies by importing business services. As a result the current account surplus has declined to about 2-3% of GDP. In 2012 it ticked in at 2,3% of GDP, and expectations are for it to improve to 2,6% of



GDP in 2013, a result beaten by only a handful of developed countries, including Germany and Sweden.

Balance of payments once again on the way up: Combined with a growing current account surplus and also "hot" money circumventing a somewhat porous capital control regime the balance of payment is expected to improve on last year's unusually poor result. That is despite some weakening this year of net foreign direct investments inflows (FDI) to $165bn. (2,4% of GDP).. As a result, reserves are set to rise $260bn in the current year, doubling last year's reserve growth. In both cases reserves are very large by any measure, sufficient to cover two years of imports or five times the amount of external debt falling due in 2014.

Financial markets remain unspectacular:. Apart from the flurry of activities in the shadow banking system, financial markets have remained dreary, including the stock market where bears continue to dominate. From its peak in 2007 at 6000, Shanghai stocks have continued a downward trend, recently touching the 2000 level.

Financial policies:

While the monetary authorities at least struggle to keep a lid on sectors under its mandate fiscal authorities may appear to have lost all control.

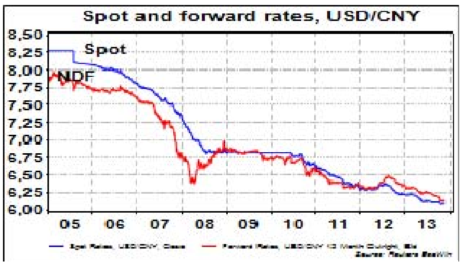
Local governments lift the fiscal deficit to 10% of GDP: For many years markets have been content with being presented the official numbers for the general government fiscal position. It now appears, however, that these numbers may be a far cry from the real picture. While the official numbers showed the annual deficit around 2% of GDP, those estimates became unreasonable in 2009 and 2010 when the central government mandated local government to undertake a fiscal expansion to rescue the economy from the global financial crisis (GFC). New estimates by the IMF demonstrate that recent years' annual deficits may have been much higher and reached almost 10% of GDP in 2012 including also all new lower level government debt, i.e. at provincial and municipality levels. . That was up from 5%/GDP the year before but lower than the peak at 15%/GDP of 2010. If continued, such results would be increasingly worrisome even though still high nominal growth of the economy mitigate some of the concerns.

General government debt set to rise fast: As with the annual deficit the actual debt level depends on scope and method of estimation. For example, the IMF presents an estimate for general government debt at 45% of GDP, but that estimate now excludes the debt originally contracted by the Railways Ministry before this was reorganized into a state owned enterprise (SOE) in early 2013. Following the formal commercialization of the Ministry debt,. 5%/GDP has been taken out of general government debt as IMF methodology does not allow for inclusion of SOE debt. . Other estimates by contrast have produced higher numbers. The development Research Center, the research wing and advisory body of the China's State Council, recently published an estimate for general government debt standing at 59% at the end of 2010. Since then, continued large deficits would likely have hiked that estimate significantly if updated. At a recent conference in Washington DC arranged by the Institute of International Finance (IIF) the chief economist of Agricultural Bank of China stated that the deficit was now standing at 65% of GDP. *The point here is that the debt ratio is rising and probably quite fast so as the nominal economic growth rate decelerates. The government, in return, seems reluctant to slam the brakes on continued fiscal stimulus mainly in the form of infrastructure projects and housing. The financing of the*

resulting deficits predominantly from the shadow banking system is also a source of concern in particular because of intransparency and the potential for mispricing of risks.
.. . .. .
Monetary policies face continued challenges: Over many years, the Peoples bank of China (PBoC) – the central bank – has struggled to contain growth of money stemming from large external payment surpluses. Recently its endeavors have also been challenged by money and credit creating financial institutions outside its control and remits, so-called "shadow banks" (conf. our report of May 2013). While growing overcapacity has prevented this from pushing up prices in product markets, the result has shown up as steep price rises of real estate and residential housing similar to housing bubbles in other countries. In the case of China, lack of other savings opportunities has added to housing market price pressure.

PBoC slam the brakes but is forced to retreat: When it appeared that a new large-scale credit extension had occurred in the first five months of the current year, half of which through shadow banks, the PBoC slammed the breaks on liquidity supply. As a result, the interbank almost dried up, creating a spike in overnight rates to more than 20% pa. .Rumors hold that the government then stepped in and forced the PBoC to retreat lest high rates trigger bank failures and threaten the stability of the financial system at large. The subsequent back-pedaling of the central bank was interpreted by many observers as an unexpected dent in its independence and integrity. Numbers for August indicate that rapid credit expansion was back in full swing after the June/July incident despite rising market interest rates.

Foreign exchange policies staying the course. PBoC has let the reminbi appreciate further against the dollar and thus avoided US censure by the regular Treasury exercise. In trade weighted terms, by contrast, it has remained more stable. At about CNY6,15 to the USD the IMF still considers the reminbi somewhat undervalued, but no longer significantly so. Since mid-2012, the 12-month non deliverable forward market (NDF) has trailed the spot market indicating investor skepticism to further appreciation.



Structural policies. As expected, the so-called "Third Plenum" of China's Communist Party in last November created a flurry of interpretations and enthusiasm. Released documents show what many would characterize as a down to earth and pragmatic discussion about the further path forward for China's economy and societal development. Except for the supremacy of the communist party, one could say most taboos were lifted.

- <u>Hukou system</u>: In the late 1950s the Chinese communists adopted the Soviet system of residential permits aimed at keeping poor and often hungry villagers and rural workers away from the better fed city populations. However, planners now see the system as a stumbling block for China's further urbanization which is a prerequisite for continued strong growth. As the system also gives rise to social grievances, also politicians seem to embrace the idea of abolishing, or at least liberalizing the system. That, however, may be to little avail as long as many farmers are reluctant to leave their land without proper compensation. But, that again would collide with the right of local governments to expropriate the land and sell it on to developers at clear mark-up with the aim to raise government revenues.

- Local government finances: Growing debt of local governments has raised the issue of how to finance their deficits. So far province leaders have used much ingenuity to work around the corners of the law which in principle forbids local governments raising loans in their own name. Instead they have been using local SOE's and other quasi government agencies as financing vehicles. .The SOEs, in return, have often approached shadow banks for credits at high interest and mainly on quite short terms. The resulting lack of transparency has motivated the central government to launch a nationwide audit, the results of which are expected before the end of the current year. The Third Plenum suggests to amend the law to permit local governments raise loans in own name. Observers (including the IIF) agree that would be helpful for transparency but doubt the wisdom of doing so in a situation of lacking financial market discipline (see below) and the potential for corrupt interactions among shadow banks, developers and local governments
- Financial reforms:. The authorities appear increasingly willing to consider financial reforms, including the freeing of interest setting and the introduction of general deposit insurance. They have also mulled letting the exchange rate float more freely and opening up for capital account liberalization. Motivation for the latter includes providing domestic investors with alternative investment opportunities in order to ease the pressure on the housing market. While much of this may seem straight forward, experience of other countries show that financial sector liberalization present choppy waters to navigate and can end in financial crises. For example freeing of interest rates on loans might be the death spell of many SOEs,.the main clients of the state owned banks (SOBs). . Introducing deposit insurance could level the playing field of regular banks versus shadow banks. to the detriment of the former's ability to attract funding at low rates. Easing the capital regulations, in return, could expose unprepared companies and banks to exchange rate volatility. Rumors are that the authorities disagree on how fast to move on creating a more competitive financial system with the PBoC representing the more cautious side while the China Banking Regulatory Commission, the financial regulatory body, advocating faster reforms.
- Rebalancing toward private consumption: Party rhetoric has now turned from growth at all costs to "balanced growth" led by domestic demand and in particular private consumption. But the question not heard often is how this is to be accomplished. While it is administratively easy to roll out government investment projects, building roads and bridges, even in a communist society private consumers have the choice not to spend any extra money. And that they may do if they for example are uncertain about the future employment situation. That uncertainty could rise as the cutting of government investment programs would likely put people out of work faster than new jobs are created, for example in the services industries. In our scenario analysis (forthcoming) of rebalancing China's growth, the country will go thru a period of clearly higher unemployment while not necessarily so high as to create serious social tensions as judged by experience of other countries.

Politics

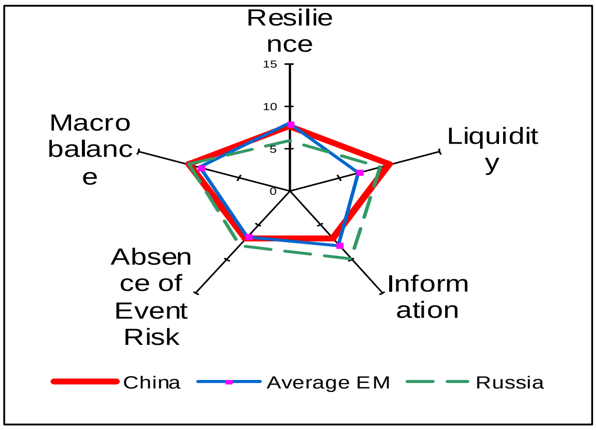
Consolidation of power: The Third Plenum also left the impression of a leadership that has used the last year to effectively getting rid of any opponents. With the sentencing of Bo Xilay, the faction around his mentor and the political grandfather, Jiang Zemin, has most likely suffered a final blow to further aspirations in Chinese politics. Also the ongoing spat with Japan over uninhabited islands should have destroyed the political future of former President Hu, widely suspected of Japan sympathies. The only one to still put spanners in the works for President Xi would be the army. This has vital commercial interest and Mr. Xi is likely to be wary of them in his bid to revamp the economy. However, both he and the army may see a common cause in reviving nationalism should reforms backlash.

Regional security issues: .The conflict with Japan has so far avoided military clashes despite the increased presence of military assets in the disputed waters, but both sides may see an interest in keeping the stand-off alive. The conflict with the Philippines reached a new level as Manila eventually chose to bring charges against Beijing to international courts of arbitration. Also Russia has signaled its orientation by discussing new proposals for a final peace agreement with Japan thereby snubbing Mr. Xi who chose to make Moscow his first diplomatic destination after having been appointed President last March. The situation with India is the only one that still seems to be in less predictable waters. The Sino-Indian border incidence of last April has now been clarified, and so far resulted in more humiliation of Delhi than may be in China's long term interest. (Conf. Report on India2013 (forthcoming)). The situation in Hong Kong could become tense as the administration of that city is not likely to make good on the promise to introduce overall suffrage in 2017. However, barring exceptional other circumstances, Beijing is likely to put maximum constraints on the army to refrain from any violence should Hong Kong become the venue for massive demonstrations over the issue. .

Outlook:

Booming growth is now a thing of the past and optimists do not look for more than 7-8% growth in coming years. Pessimists, by contrast, see the danger of a financial collapse as soon as in 2015 (IIF The three bears, October 2013) and liken China's . economy to a bicycle you have to keep pedalling lest you fall over. Our main case is one of gradually trailing growth while the country begins to rebalance to a more sustainable development spearheaded by private consumption. The transitional period, however, is littered with pit holes as have been the experience of other countries in the past, including many developed countries. That is in particular the case when rebalancing is combined with the opening up of a suppressed financial sector.

Key ratios	**2013**
Population (mill.)	1380.8
GDP/capita ($)	6686
GDP (%chg.)	7.6%
Inflation	2.6%
Trade balance/GDP	2.6%
Reserves/imports (months)	21
Budget balance/GDP	-2%
Government net debt/GDP	15%



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

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:	2009	2010	2011	2012	2013	2014	2015
GDP (mill.US$)	4991	5943	7336	8233	9232	10365	11785
GDP/capita (US$)	3706	4385	5379	6000	6686	7462	8436
GDP (%chg.)	9.2%	10.4%	9.3%	7.7%	7.6%	7.3%	7.2%
Investments/GDP	48%	49%	49%	48%	49%	48%	48%
Budget balance/GDP*	-2%	-2%	-1%	-2%	-2%	-2%	-2%
Govt net debt/GDP*	17%	16%	15%	15%	15%	15%	15%
CPI inflation (%chg.)	-0.7%	3.3%	5.4%	2.6%	2.6%	2.9%	2.9%
Money demand (%chg.)	12.5%	15.5%	13.8%	10.6%	8.6%	10.1%	11.6%
Stock prices (%chg.)	2751	2836	2669				
Interest rates	1.9%	2.7%	5.4%	4.6%	4.7%	4.5%	4.5%
Exch. Rate ($)	6.83	6.77	6.46	6.31	6.15	5.99	5.81
Trade/GDP (%)	44%	50%	50%	47%	45%	45%	44%
Oil price (Brent)	$62	$80	$111	$112	$108	$103	$105
Millions US $							
Export of goods	1 202 050	1 578 450	1 899 280	2 050 110	2 225 400	2 482 860	2 775 640
Imports of goods	1 003 890	1 393 910	1 741 410	1 817 340	1 955 510	2 155 270	2 405 770
Other:	45 097	53 270	-21 773	-39 631	-27 315	-35 808	-49 079
Current account ($ mill)	**243 257**	**237 810**	**136 097**	**193 139**	**242 575**	**291 782**	**320 791**
(% of GDP)	4.9%	4.0%	1.9%	2.3%	2.6%	2.8%	2.7%
FDI	87 167	185 750	231 652	191 120	165 859	153 111	169 061
Loan repayments	-33 449	-29 511	-39 320	-54 461	-81 178	-114 401	-148 629
Net other capital flows	64 084	23 741	232 821	-202 048	-68 696	-272	-2 363
Balance of payments	**361 060**	**417 790**	**561 250**	**127 750**	**258 560**	**330 220**	**338 860**
Reserves	2 199 140	2 616 930	3 178 180	3 305 930	3 564 490	3 894 710	4 233 570
Total debt	419 534	515 148	637 765	737 592	826 123	920 806	1 022 170
o/w short term debt	220 514	307 393	428 391	513 357	572 427	632 421	693 417

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

* Central government only

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

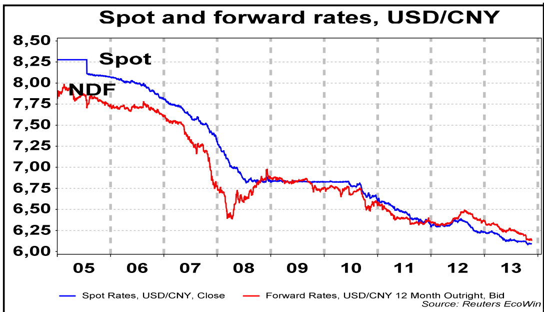
Type of government: Communism. Leaders expected re-elected at next party conference in 2017

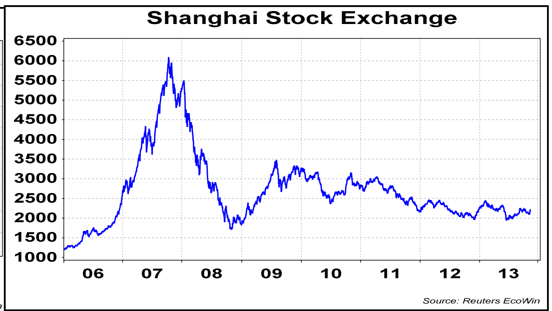
Next elections N/A

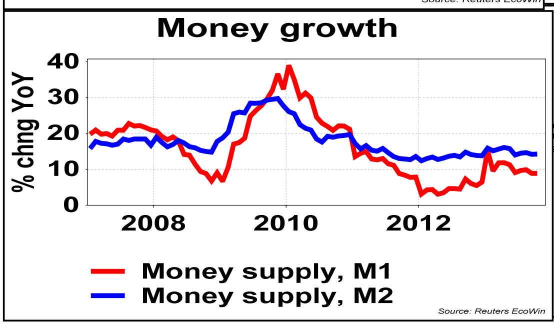
Other:

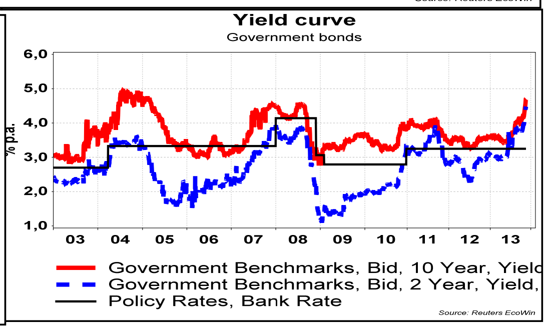
Latest PC deal None

Recent IMF programs None









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