China, P.R.: Mainland

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS Nov. 26, 2015

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The mishandling of the stock-market crash last June and the recent data release indicating growth surprisingly in line with political targets have dented investor confidence in the authorities objectives and ability to handle the economy with its increasingly complex interlinks with the financial sector.

Summary and conclusions

The cooling of the economy continues at a gradual pace if official estimates are to be believed. In Q3, growth slowed by 0,1pp to 6,9% annualized expansion well in line with the political target of “about 7%”. That was against all odds of most observers who had believed in a more pronounced negative effect following the stock market crash in June and the on-going housing market weakness. But services, except financial services, saved the day combined with growing net exports.

The slowdown has been predicted for more than a year. It is helping ease vulnerabilities, but observers have begun to comment that what has been achieved so far is merely to slow the accumulation of vulnerabilities not to arrest their growth in terms of corporate leverage, bad loans in the banks and a likely expanding glut of unsold housing units. In contrast, many observers believe that China still has fiscal space to protect the country against shocks. The IMF even warns the government against consolidating the budget too rapidly despite having reached 10%/GDP including also local governments.

We have some reservation at this point. The IMF projections of government debt rely on budget financing in part covered by privatization receipts and land sales. Should that prove too optimistic, the debt would accumulate faster from 57%/GDP in 2014 to 82%/GDP in 2020. At this debt level other countries in the past have proved vulnerable to shocks including the call for governments to rescue banks.

Political stability has for many decades been the strong point of any China rating but that argument is beginning to show cracks. The anti-corruption campaign since president Xi took office in 2012 has gone on much longer and reached farther than first excepted. The party apparatus is reportedly suffering from reform fatigue and lack of initiative as sticking out may attract unwanted attraction. Numbers of membership applications are reportedly falling while opposition within the party is on the rise. The new president has ignored unwritten rules of leadership behaviour since the days of Deng Xiaoping. He is still widely popular in the public, though.

Despite the incipient threats to government balances, the sovereign ratings have remained stable. But diminishing clear government commitments to fiscal prudence, these ratings are likely to come under growing strain within the foreseeable future. That has ramification also for country risk, although the situation has not yet developed beyond “the point of no return”.

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Recent economic developments

Growth continues along official targets: To much surprise for most observers, the official economic growth estimate for the third quarter came out close in line with official targets of "about 7%". The small deviation presented by the quarterly estimate of 0,1% below the target was not sufficient to damp the impression that politics had played a role in the statistical calculations. The stock-market crash alone was expected to reduce quarterly growth by some 0,3pp (percentage points) as it had been broadly assumed to contribute by 0,5pp when booming during the first half of the year. After the mid-June crash, turn-over in the two stock exchanges more than halved.

But other services to the rescue? Services, in general, made a strong performance rising to an annualized rate of 8,6% from 7,5% in Q2. Due to lack of granularity official data does not make it clear what kind of services -- they now count for more than half of the economy, spearheaded the rise. Retail sales and the recent success of e-commerce, present plausible explanations compared with the increase of private consumption to 8,6% on a 7,7% jump in real disposable household incomes. But at the same time real investments continued slowing to 4,8% annualized growth down from 5,8% in Q2 which would likely have had a negative effect on growth of freight transportation in line with slowing industrial and construction activity and shrinking foreign trade. (Conf. Box 1) In the event, many observers have stuck to their first estimates and continue to see real growth underperforming official targets despite the government's new efforts to stimulate the economy in the remaining months of the year. However, these measures follow traditional remedies, for example reduced taxes on new autos, that may no longer have the same effect as before. Our own estimate for the current year is based on IMF's latest update showing a growth rate at 6,8% as we find little merit in elaborating on such numbers. The important thing, in our view, is that markets have begun to exhibit growing skepticism to official data.

Box 1: The services industry

%growth yoy	Transport	Hospitality	Finance	Real estate	Others
2014Q3	11.90	0.70	10.40	6.90	14.1
2014Q4	11.70	0.80	10.70	6.20	14.4
2015Q1	12.80	0.90	9.10	5.50	16.2
2015Q2	12.80	1.40	10.50	2.90	19.9
2015Q3	11.90	1.40	9.70	2.30	19.2

The table shows that most services sector except "real estate" and "others" show only minor variations over the recent 12 month period contrary to what would have been expected. For example the stock market boom and bust is not reflected in "Finance" as would have been expected. Only "Real estate" shows the expected sharp cooling. "Others" probably include "retail sales" which suggests that a consumer boom has taken off. But then again the weak development for the Hospitality industry does not underpin that story. More granular data are not published by China's statistical services.

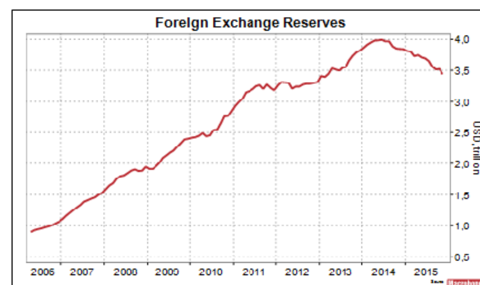
Headline inflation appears to stabilize: In Q3 headline CPI inflation edged up to 1,7% year-on-year (yoy) in a sign that deflationary trends may have been bucked at least for consumer goods. Producer prices, by contrast, continued their relentless "race to the bottom" with the latest data showing the annualized deflation trend accelerating to-5,7% in Q3 from 4,7% in Q2. That is in part reflecting global raw material prices and soft demand from other countries. However, growing domestic overcapacity, perhaps as much as 100% in many enterprises is also playing a role. Close peers, including Korea, are experiencing similar price trends, though.

Real estate market still in the doldrums? Recent months have seen fledgling signs that the downturn in the real estate markets since late 2014 may be about to bottom. Prices in tier 1 cities which include metropolises like Beijing, and Shanghai have started to pick up modestly. That could be in response to recent policy actions to boost demand by reducing down-payment requirements for bank loans, cutting interest rates and lifting loan to value ratios while shanty town renovation is sped up. However, in

tier 3 and 4 cities -- the many smaller cities spread out over the country, demand is still very weak after sharp price corrections over the last year. They dominate 50% of the national housing market and have an excess supply of about 3 years of normal sales, more than twice the oversupply in tier 1 and 2 cities. Construction of residential homes has declined further but as long as the growth rate remains positive new houses are still adding to the glut.

Trade balance improves: Exports declined almost 4% in the third quarter continuing the trend from the second quarter when China's quarterly export performance turned negative for the first time since 2009. In real terms the drop was even more pronounced indicating that also other drags than negative price developments played a role. Compared with a drop of world imports of more than 11% Chinese exporters managed quite well despite the likely overvaluation of the yuan. Chinese imports, on the other hand, plunged a massive 13% on the heels of even sharper drops in the first half of the year. That reflected entirely price effects as real imports actually rose 1% presenting evidence of very positive terms of trade effects due to falling energy and raw material prices. Provided these trends continue through the rest of the year, the result for 2015 will mark a healthy improvement to the trade balance more than offsetting a weakening of the services balance as Chinese tourists continue to spend ever more money abroad. As a result the current account balance will stage a new record in 2015 since the Global Financial Crisis (GFC) of $330bn., equivalent to 3%/GDP.

Balance of payments weakens. Despite an impressive surplus on the basic account estimated at more than $0,5tr. when combining the current account with the net inflows of foreign direct investments (FDI), the level of reserves is still likely to fall by some $0,5tr. to $3,4tr. by the end of the year. That is because of largescale capital outflows to repay foreign loans falling due or otherwise hedge against further adverse exchange rate movements in particular the much anticipated appreciation of the dollar.



Renewed capital outflows: These outflows again accelerated after the mini devaluation in mid-August which looked much like spontaneous capital flight notwithstanding strict capital controls to prevent such transactions. This prompted large central bank interventions to maintain orderly conditions in the domestic forex market which has continued in fits and starts in subsequent months. This volatility, which is quite new for China, has prompted concerns about reserves no longer be large enough despite an impressive import coverage of nearly two years. This concern is prompted by the high level of money in the economy at more than 130% of GDP -- much above the US at 80%/GDP and the potential pent-up demand for diversification among Chinese savers. In reteurn, China's net international investment position (NIIP) is still relatively strong a[1]t 14%/GDP but that number masks pockets of problem sectors, in particular among real estate developers which have borrowed from abroad and face a heavy maturity profile over the next few years without offsetting cash reserves.

The stock market crash in June: Since late 2014, China's two official stock exchanges had soared by more than 150% despite weakening fundamentals as we pointed out in our update of last May. In June, the market crashed and suddenly dropped by more than 40% before staging a recent partial recovery. The main point here is not market behaviour, but the way the government mishandled the crash

[1] Conf. our mini update of September 2015.

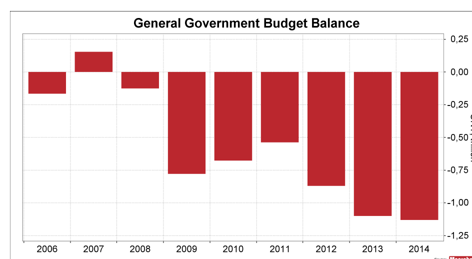
having first enthused over the shot-in-the-arm stimulus to the economy – in particular the jailing of brokers and analysts who had warned of overvaluations. There are signs of growing mistrust among domestic and foreign investors about the authorities' ability and willingness to respect the laws of free markets.

Policies:

Fiscal space narrowing: According to official accounts the fiscal stance is very prudent with a deficit around 2% of GDP and debt in the range of 15-20% of GDP. However, that does not include the much larger deficits run by local governments (LG) at various levels and often kept off-balance. To account for this anomaly the IMF has begun to calculate the so-called "augmented deficit" which should include all transactions which fiscal authorities are ultimately responsible for. This deficit has grown since it first escalated when the central government (CG) launched a huge anti-crisis stimulus plan in 2008 to be carried out by LG while leaving them on their own to provide for financing. That action marked the start of the exponential growth of the shadow banking industry as local authorities were prohibited by law to borrow in own name. Last year, this deficit reached 10%/GDP for which the CG accounted for less than 2%/GDP. In the current year this deficit will probably double to about 3%/GDP as the CG increases transfers to LGs according to the new budget law of 2014, but the sum of the two – LG and CG balances – will remain about unchanged relative to the size of the economy.

IMF warns against rapid consolidation: Having done a good job in establishing the true fiscal position of the general government (GG = CG + LG), the IMF is surprisingly relaxed about the need to rein it in. In fact the organization warns the government against any rapid fiscal consolidation apparently with an eye to the economy's growing vulnerability on other fronts. It also argues that fiscal space is still available in terms of relatively modest GG debt estimated at 57% of GDP which will not grow to more than 71% of GDP in 2020 under the proposed consolidation plan of annual 0,3pp cut in the GG deficit each year to the end of the decade.

But IMF projections could prove over-optimistic: IMF's fiscal debt projections come with provisions regarding annual privatization and land sales revenues of some 2%/GDP. These could prove too optimistic. In particular land sales are important to local government finances representing a quarter of their revenues. They have grown rapidly in the past, but last year rose only 3% and have so far contracted by 35% in the three first quarter of the current year. That has been accompanied by softening real estate business conducted by local governments. At some 40% of the total in 2014, they are even more important to LG budget revenues. It is still premature to warn of a fiscal crisis in China but without land-sales and privatization receipts LGs may have no alternative but to finance the entire annual deficits by issuing debt or borrow from the financial system. A technical projection shows this will raise the government debt ratio to 83% of GDP in 2020. Should that combine with the standard IMF test of fiscalizing 10% of domestic bank assets in a potential financial sector crisis, general government debt will breach the 100%/GDP mark before the end of the decade. It is therefore our belief that China still has some fiscal space but this can soon disappear without a sharper consolidation path.



Fiscal cliff: An important objective of the fiscal law adapted in 2014 was to present more orderly fiscal financing alternatives for LGs. It has already helped LGs to swap (refinance) RMB3,3tr of debt into bonds -- about an eight of the total -- contracted in previous years through special financial vehicles. The bonds have mostly been purchased by regular banks although often reluctantly so as they often yield 4%pa. less when replacing other bank claims and still have no explicit CG guarantee. In addition LGs have been allowed to issue other bonds to cover a part of their running deficits. Last May, CG also allowed banks to extend new credits to ongoing LG infrastructure projects which otherwise threatened to seize up presenting many LGs with a fiscal ultimatum or "cliff". All-in-all this leaves the impression that the authorities still have some way to go to bring China's fiscal accounts in good order.

Monetary policy easing and deregulation: The slowing economy and falling inflation have prompted the Peoples Bank of China (PBoC) – central bank – to ease monetary policies by cutting policy rates six times over the recent 12 months period until last October. It has also lowered reserve requirements for banks to 17,5% thus releasing liquidity for banks to lend out. As a structural measure it has now abolished all limits on loan and deposit rates. The removal of the interest ceiling on deposits was the last remaining regulation when lifted in November 2015. However, banks are still subject to credit quotas but at the present time they are not generally binding due to soft credit demand.

But can the central bank hold its promises? Reports are that PBoC has continued to lean on banks whenever it perceives aggressive competition for funding in particular among smaller banks which often suffer from limited access to the interbank market. While such meddling with market forces is not unheard of even among highly developed OECD countries, it may come at an infortune moment of rising market scepticism to the authorities' reform commitments. That is an important issue as long as various distortions continue to riddle the financial system. IMF points out that "*Implicit guarantees are prevalent throughout the financial system leading to mispricing of risks and misallocation of resources*. " Such mispricing lies at the ground of the mercurial rise of the shadow banking industry of recent years which eventually prompted the monetary authorities to clamp down on some of its dominant members, including the trust industry.[2]

Banks recapture markets: After several years of losing business to shadow banks – although often at the initiative of banks themselves, the regulated banking industry has begun to claw back market shares. In Q3 credit extension from banks rose almost 16%. That was lower than in previous years but still faster than total social financing (TSF). [3] At the same time total net profits growth slowed to 1,5% yoy – and to only 0,8% for top banks – which was down from 9,6% in 2014. Return on assets also declined to 1,23% mainly due to rising impairment charges but also to the narrowing interest margins following further interest liberalization from the PBoC. Nevertheless, Chinese banks managed to maintain a relatively strong capital position with an average capital adequacy ratio at 13%, above the regulatory minimum of 10,5%.

Bad loans growing: The problem for many banks is the growing ratio of non-performing loans (NPL) to total loans. Although still small compared to peers in other countries, they have almost doubled over the last year. Including also "special mention loans" loans still performing but for example only after restructuring of ailing clients, the ratio rises to 5,5%. Experience from other countries is that such debtors often fail again. The rise in bad loans has various causes. The authorities

[2] For other monetary policy actions of recent quarters including the introduction of a general deposit guarantee pls. confer our recent September update
[3] A Chinese statistical measure of total credit intermediation of the country.

have leaned on banks to take back business previously placed off-balance through banks' own affiliates among shadow banks. These loans may be of weaker quality. In addition many of the banks' old clients are struggling under the economic slowdown including many state-owned enterprises (SOE) within heavy industries and also many real estate developers and construction companies. The latter are highly leveraged and many of them have reportedly negative cash-flow.

High corporate debt is causing concerns: At 110%/GDP corporate debt is high, even higher than in Japan, and the debt ratio is still rising. This gives rise to growing concerns about the soundness of corporate balance sheets. Moreover, since 2011 payable to sales have skyrocketed among commercial firms as they have been unable to pay suppliers. It is argued that cleaning up this means lower capital expenditures and/or the need to shed labour. While such a clean-up would eventually be beneficial for each company it may exacerbate the situation for the economy at large at least in the short to medium term. But without restructuring these companies will further reduce their ability to service debt and procrastination now risks increasing the cost of any resolution in the future. This could look like a "Ponzi-scheme".

Structural policies in the backwaters: Since President Xi launched his first bold reform policies at the "Third Plenum" two years ago, the initiative has become a shadow of itself. Admittedly, some reforms have seen daylight including in the financial industry and social security has been extended to almost universal coverage although with significant qualifications.[4] Nevertheless, Pres. Xi's main message: give markets a "decisive" role -- seems to have run into trouble. This may be for political reasons or may simply reflect the realization among the country's leadership that reforms could have short term costs nobody is willing to sponsor. It was therefore to not much surprise when the "Fifth plenum" in late October ended in a fizz rather than the bang of 2013. The fallout was dismissed as "talking the talk without walking the walk".[5] Chinese authorities point out, though, that the registration of new companies has recently picked up sharply and see in this a sign of growing entrepreneurship.

Political developments

The anti-corruption campaign rumbles on: Pres. Xi's other main political initiative was to clean the Communist Party from endemic corruption and other sleaze. However, some of the most prominent victims appear to have been the new president's political opponents. Some observers now describe the anti-corruption campaign as outright intra-party war. While few have much to say in defence of the victims probity, the problem with this on-going campaign is that it seems to distract the leadership's attention from other burning questions, in particular the economy. According to some reports the absence of new reform initiatives at the Fifth Plenum was to be found in political resistance and reform fatigue within the party bureaucracy. It has also been argued that Pres. XI's policies represent less of genuine reforms but rather false nostalgia harking back to the early days of communism when party cadres supposedly served party and people unselfishly.[6] Since party membership was opened for business people in the early 2000 membership climbed fast. In recent times membership applications have subsided significantly. Could this spell rising political uncertainty going forward? At least one may say that Pres. Xi has reversed the leadership approach moulded by the elderly statesman, Deng Xiaoping when he took over as the first among equals in 1978 in the wake of the chaos left over by the Cultural Revolution.

[4] Reports suggests social security pension cover only 5% of pensions for salary earners.
[5] China Spotlight, IFF Washington DC, Nov 2015
[6] Oxford Analytica, "Xi may push Party too far in asserting control" October 2015

External frictions: China's tensions with neighbouring countries and the US have shifted focus to the South China Sea but otherwise remained overall unchanged. Over the last 12 months China has built military grade landing strips on more islands in disputed waters. The US navy recently tested the Chinese resolve to claim sovereignty over the surrounding waters but without causing any incident. We are not in a position to judge whether this means rising or subsiding intensification of a potential conflict but refer to a report of BCA, -- the consultancy in business since 1949 – which concludes ".. markets have not priced in the real risk of confrontation.." in Sino-American tensions.[7]

Outlook

Growth slows further: How close the final estimate for growth in the current year will come to the official target of "About 7%" down from a target of 7,5% in 2014, is more of a question of political science than economics. We keep to the IMF estimate of 6,8% which has also been implicitly condoned by the government without that making it sacrosanct. Going forward, we also find support in the IMF projection of 6,3% growth in 2016 and continued cooling to the end of the decade. That would not necessarily sow the seeds of any sharp deterioration or outright crisis. The labour stock is slowly decreasing for demographic reasons and the migrant labour is apparently quite adaptive according to IMF research reducing the risk of amassing of job-seekers in cities.[8] The external current account balance will remain in surplus to the end of the decade, leaving the central bank with wider options to deregulate capital controls and free up the exchange rate likely with the aim to administer depreciation of the effective yuan rate. However, the fiscal situation remains in our view a dynamic risk that should be reduced faster than recommended by the IMF.

Scenarios: What is said above does not necessarily imply plain sailing for coming years. Attempting to per into the future we find it useful to think in scenarios:

Scenario 1: Government projections combined with a revamped reform agenda: We take the government's growth projections to the end of the decade with a 6,5% annual growth target for 2016-2020 at face value provided this is combined with stepped-up reforms and a new push for a "decisive role" for markets in a way that appears credible to investors.

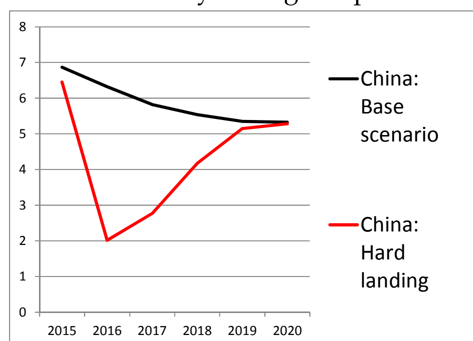
Scenario 2: Muddle through. The rebalancing of the economy to services away from China's outdated growth model -- investments and exports led growth, will cause a temporary growth recession that may last some years before private consumption leads the economy back to a higher and sustainable growth path. After this, the economy could grow faster than in Scenario 1, but the transition might raise political and social risks.

Scenario 3: Muddle, muddle… As spelled out before on these pages, this is a future where the hard political choices are kept on the back-burner without ever being resolved. The economy is propped up on fiscal and monetary steroids to avoid a sharper slowdown which means that the stimuli has to be administered in increasingly larger dozes as their effect gradually weakens. Already today their effect is weaker than when first applied in 2008. For example more liquidity to the economy from the central bank today is likely to mean stepped up deleveraging rather than more credits for productive investments ax banks remain wary of weak corporate clients. This is the scenario of Japan some 20 years back when the "super-rich" country thought it could spend its way out of the problems after its financial

[7] Underestimating Sino-American Tensions; BCA Research, Montreal, November 2015
[8] China's Labor Market in the "New Normal"; Working Paper No. 15/151, Washington DC, July 2015

crisis in the early 1990s. This scenario was reportedly a week ago by the chief IMF economist, Mr. Maurice Obstfeld. [9]

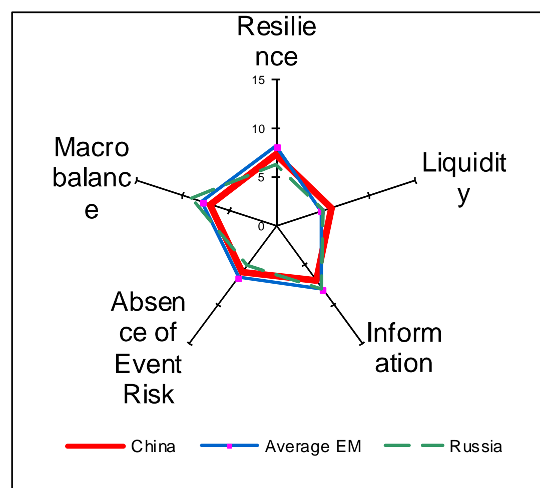
Scenario 4: A Lehman moment – We define this as a situation where investor confidence collapses and a critical mass of financial activity seizes up. This is still an unlikely near term risk but one that could happen before the end of the decade triggered for example by a mismanaged bank run or inability to disguise political in-fighting from the public eye. It goes without saying that a crisis cannot be predicted, for were it to be it would rather be resolved gradually ahead of time. Many argue this cannot happen to China – the powerful communist party will prevent it in pure self-preservation. In addition the country has large foreign reserves for its defence. A scenario of this type would likely be a "hard landing scenario" as presented in Chart 5.



Among these we attach most confidence in Scenario 2 and 3 without excluding scenario 4. As to the latter it is useful to be reminded that Lehman Brothers was still A-rated when it declared bankruptcy in 2008 and that the US government had as much reserves as it could print.

In recent months it has become increasingly common to emphasize China-risks. That may be a temporary phenomenon. What is important is not new but well expressed by the IMF in the following words addressing the need for progress on reforms and rebalancing: "… in most areas the progress has just succeeded in slowing the pace at which vulnerabilities rise. Further progress, therefore, is needed to put vulnerabilities on a downward path…"

Key ratios	**2015**
Population (mill.)	1376.8
GDP/capita ($)	7853
GDP (%chg.)	6.8%
Inflation	1.5%
Trade balance/GDP	3.1%
Reserves/imports (months)	32
Budget balance/GDP*	-4%
Government net debt/GDP*	16%



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

Peers:
UAE
Latvia
Italy

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.

[9] Wall Street Journal, November 18, 2015

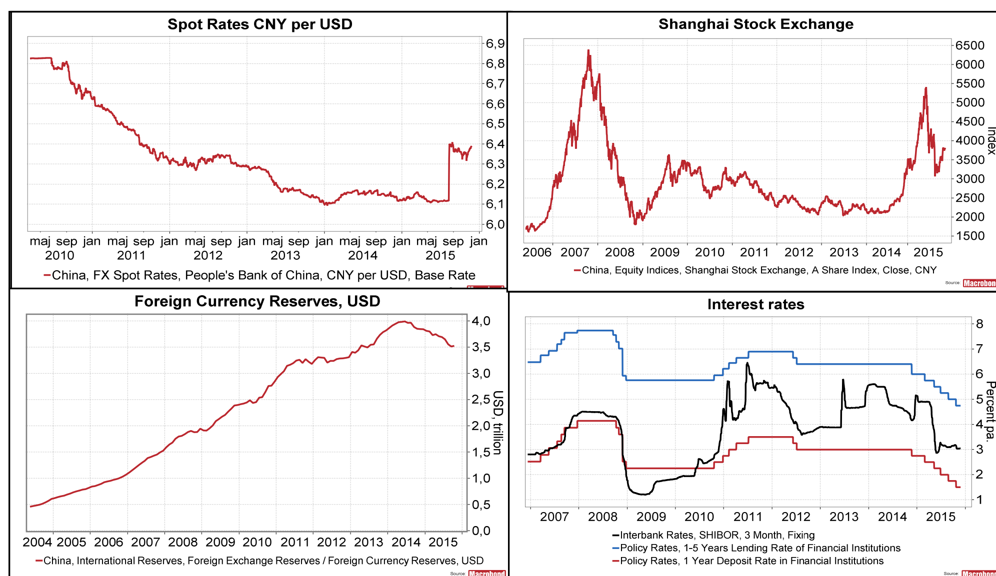
Key data:	2012	2013	2014	2015	2016	2017	2018
GDP (mill.US$)	8469	9572	10324	10812	11102	12005	13118
GDP/capita (US$)	6244	7020	7534	7853	8028	8644	9408
GDP (%chg.)	7.7%	7.7%	7.3%	6.8%	6.3%	5.8%	5.5%
Investments/GDP	48%	49%	49%	48%	49%	48%	48%
Budget balance/GDP*	-2%	-2%	-2%	-4%	-5%	-5%	-5%
Govt net debt/GDP*	14%	14%	15%	16%	18%	22%	25%
CPI inflation (%chg.)	2.6%	2.6%	2.0%	1.5%	1.8%	2.2%	2.6%
Money demand (%chg.)	10.6%	8.5%	4.4%	7.3%	6.7%	3.9%	3.8%
Stock prices (%chg.)	2221	2197	2231	3695			
Interest rates	4.6%	5.0%	5.1%	4.1%	3.1%	3.1%	3.6%
Exch. Rate ($)	6.31	6.15	6.16	6.29	6.61	6.62	6.55
Trade/GDP (%)	43%	41%	39%	34%	32%	30%	30%
Oil price (Brent)	$112	$109	$99	$54	$53	$59	$63
Millions US $							
Export of goods	1 973 520	2 148 590	2 243 760	2 129 100	2 034 940	2 071 300	2 241 140
Imports of goods	1 661 950	1 789 610	1 808 720	1 547 210	1 508 670	1 582 830	1 723 000
Other:	-96 178	-210 776	-215 363	-251 652	-275 592	-313 183	-357 429
Current account ($ mill)	**215 392**	**148 204**	**219 677**	**330 238**	**250 678**	**175 287**	**160 711**
(% of GDP)	2.5%	1.5%	2.1%	3.1%	2.3%	1.5%	1.2%
FDI	176 251	217 957	208 678	189 423	185 952	192 397	196 649
Loan repayments	-35 519	-33 395	-34 300	-37 589	-41 455	-45 656	-50 215
Net other capital flows	-228 374	-14 346	-83 155	-752 892	-493 105	-269 548	-219 735
Balance of payments	**127 750**	**318 420**	**310 900**	**-270 820**	**-97 930**	**52 480**	**87 410**
Reserves	3 305 930	3 624 350	3 935 250	3 664 430	3 566 500	3 618 980	3 706 390
Total debt	735 554	828 069	947 794	1 058 510	1 174 350	1 302 660	1 444 660
o/w short term debt	497 337	581 546	664 337	726 735	789 904	854 941	922 032

Source: OEF (Oxford Economic Forecasting) and SEB estimates.
* Central government only

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