China, P.R.: Mainland

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS June 3, 2016

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Fiscal and monetary stimulus helped the economy in the first months of the current year overcome its apparent accelerating weakness in late 2015 but recent data show the momentum moderating anew. It is not clear which actions the government will remedy at this stage, well aware that continued stimulus will exasperate the underlying economic/financial problems, raising the risk of a hard landing.

Summary and conclusions

Financial stimulus keep the economy humming: Short term stimulus since late 2015 appears to have rescued what increasingly looked like a tanking economy. Helped by sky-rocketing credit growth GDP managed to expand by 6,7% in the first quarter, down from 6,9% for the full year 2015, supported in particular by a recovering housing market in the largest tier-1 cities. However, the effect of the stimulus does not seem to have been long lasting and already April data signal fading momentum but so far perhaps not enough to seriously challenge President Xi’s pledge to maintain growth at 6,5% through the rest of the decade.

Financial intermediaries finding new channels: Unsurprisingly, where the authorities tries to plug loop-holes the financial system finds new channels. Where the regulators have succeeded in taming the shadow banking system, this has found new ways of directing credits. This has fomented the wealth management product industry to grow outside its traditional perimeters thus attracting the participation of banks. They have sensed an opportunity to prop up earnings to remedy weakening profits and the creeping rise of bad loans. The regulatory clampdown on entrusted loans, in return, has stimulated intercompany lending, often outside official control. In any financial system, such trends are poised to raise complexity and reduce transparency.

Hard landing –unlikely near term: However, few observers are willing to declare China beyond redemption and any hard landing is not the most likely scenario at least in the short term. But the authorities’ response so far, propping up the economy with more money while leaving reforms on the back burner, may at least present the risk of falling into a “Japanese sinkhole” perhaps for coming decades.

Politics, the hidden joker: Next year’ upcoming Communist Party Congress could reveal the strength of President Xi’s hold on power and whether his intensive anti-corruption campaign, sometimes described as disruptive as the Cultural Revolution, have produced more enemies than he has been able to eliminate. As to external security regional neighbours with the exception of North Korea, have all ganged up against Beijing in various ways including by tying up to US security apparatus.

Ratings: Two rating agencies have now signalled a possible down grade of the sovereign over a 1-2year’s horizon. The same may be relevant for country risk unless the authorities now change attitude and stop employing short term remedies to prop up growth and accept the inevitable cooling to let imbalances reduce and set the economy on a firmer footing for the longer term future.

Recent economic developments

Stimulus supported growth: After 6,9% growth ticked in for 2015, slightly below the 7% target with a noted deceleration toward the end of the year, it appears that the authorities lost patience and staged a massive fiscal and in particular monetary stimulus stunt. While interest rates and other key parameters were not changed significantly, banks were strongly encouraged to kick-start lending. In the event, loan growth shot up by an annualized rate of 63% in the first three months of the current year. That supported in particular developers and construction companies and the many ailing state-owned mega-enterprises in related industries such as steel, cement and glass, many of them were probably at the verge of buckling. New credits to developers and eased credit terms from banks for house buyers propelled the housing market in tier-1cities, while vacancies and overcapacity in smaller cities and rural areas remained high. This vigorous house market reaction to the relatively limited policy easing at least in large cities was probably also related to stock market developments as explained below.

Growth keeping up but the momentum seems fading: In the event, the authorities succeeded in maintaining overall buoyant growth at 6,8% yoy (Year-on-year) in the first quarter of the current year, beginning the year on a reasonably strong note. In April, by contrast, the economic momentum seemed to be fading. While real estate fixed asses investments (FAI) slowed to 10%, the same for manufacturing was down to only 5,3%. Also private consumption fell slightly to an estimated 7,8% in real terms yoy 0,3% down on the first quarter in parallel with retail sales.

Investment ratio declining but too timid: Faster consumption than investment growth has prompted some observers to taper concerns about China's economy being too focused on real investments. As a percentage of GDP these have actually fallen from a peak of 48% in 2010 to 44% in 2015 which, however, still remains a far cry from the 30% share considered appropriate for a country at China's stage of development when compared to peers such as Japan and Korea some decades back. The problem is not only the waste of resources as seen in the overcapacity in many industries which actually are still expanding production capacity in many places. It is also the crowding out of private enterprises with less access to the reasonably priced bank loans. As such, rebalancing has still a long way to go and the continued support for loss making industrial sectors has prompted rising numbers of observers to compare China to Japan in the early 1990s when loss-making companies too often were not allowed to fail. This may now be paving the way for what has been named Japan's "zombie economy" although with Chinese characteristics. It is also noted that a part of this decline in the China's investment share could be more a price effect than a real one.

Price developments flatten: In the first quarter of the current year, consumer price inflation rose slightly to 2,1% thereby keeping fears of outright deflation at bay. Producer prices, by contrast continued falling but at 4,8% this was at a less rapid pace than in 2015. However, the long held view by many China watchers that the steady deflation trend at factory gates over several years was mainly due to the fall of global commodity prices, may no longer feel entirely convincing. Last year global non-fuel raw material price index fell at its fastest rate – 18% yoy - since the Global Financial Crisis (GFS) in 2009. But from now on the Chinese PPP will likely be as much related to growing overcapacity in Chinese industries.

Unemployment steady: The official unemployment numbers have for many years remained unusually stable at slightly above 4%. That is despite wide variations in annual GDP growth dropping from a peak of 14% in 2007 to less than half that rate today. The slight drop in the demographic labour force does not explain much of the conundrum inasmuch as the labour supply actually has continued growing due to rising participation rate. However, the growth over the last decade of more labour intensive services industries goes a long way of explaining continued low unemployment. The unemployment numbers still look suspiciously stable, though, which may reflect the political sensitivity attached to them. Officials continue from time to time to warn against mass unemployment as tracked by leading think tanks including China Academy of Social Sciences (CASS). According to the unofficial Hong Kong based "China Labour Bulletin" incidents of strikes and labour disputes rose to an all-time high at the start of the current year, but has since fallen back.

External trade and investments: In 2015 the surplus on the trade balance reduced slightly but remained high at more than 3% of GDP as moderate import growth continued in contrast to export revenues which fell somewhat back in line with weakening foreign markets including in Brazil, Japan and parts of Europe. Due to a rapidly deteriorating services balance, not least including the expenses of a growing flow of Chinese tourists visiting neighbouring countries, including Japan, the surplus on the current account balance slipped to 2,7%/GDP, or $331bn. That combined with net inflows of foreign direct investments (FDI) of $62bn. and a fall of reserves of more than $500bn. through 2015, giving rise to estimates of extraordinary capital outflows of around $700bn.[1] These abated in the first four months of the current year as investor stopped panicking about the threat of an imminent major devaluation of the yuan and despite continued sluggish exports dropping 12% in the first quarter.

Stock market remains weak: Following the crash in June of last summer the stock market has weakened further to an average of around 3000 on the Shanghai index, down about a half since the peak. With moderate volatility and mediocre prospects it may appear to have reverted to a new longer period of modest activity. That means losing its allure to domestic investors apparently including many non-institutional who will look for other investment vehicles, including the upscale housing market.

Policies:

Modest fiscal stimulus: The demarcation line between monetary and fiscal policies in a state dominated economy like China may not always be clear-cut. Policy guided credit support to state-owned or "strategic" enterprises may look like monetary policy but can in reality be as much fiscal policies if the enterprises benefit from (perceived) government guarantees. As such, touted fiscal stimulus may appear more moderate than advertised. Taking into account that budget information from the government is be hard to interpret, at face value the fiscal stance for 2016 looks like a real expansion from last year's fiscal fallout. Last year the budget deficit ended at about 3% of GDP. For this year it will rise to 5% according to our data sources. The oft-stated rationale for this fiscal stimulus is to ensure the completion of many ongoing infrastructure projects.

[1] Not adjusted for valuations effects from exchange rate movements among third countries.

Box 1: Government debt -- how large?
An appendix to the latest IMF report on China of November 2015 shows total general government debt growing to 57%/GDP at the end of 2014, up from about 30% in 2008 of which less than 20%/GDP on the central government.[1] These numbers have now apparently been challenged by other estimates of the same institution. The latest Global Financial Stability Assessment of April 2016 quotes a number for "public sector debt" at 43%/GDP.

However, these budget numbers apparently refer only to the central government deficit fiscal accounts. The much larger deficits of local government budgets have come under intensified scrutiny from Beijing. The new restraints as of last year imposed by Beijing on local government deficit financing has probably reined in much of their fiscal largesse and prompted central government support lest local governments severely limit their provisions of social services at the risk to social stability. As a result and pending any evidence to the contrary, we believe that the fiscal stance of the general government (including both central and local governments) will remain relatively unchanged for the current year with a total fiscal deficit of about 10% of GDP, the average level since the start of the GFC. This is very high and once again a reminder of Japan's experience of a rapidly eroding fiscal situation in the 1990s when that country struggled to overcome the collapse of its previous high speed economy.

Monetary policies – less bang for the buck: Since the active devaluation of the international value of the yuan in last August, monetary policies have remained quite stable in terms of policy rates and reserve requirements. The easing has been more in terms of the central bank leaning on the banks, not least the state owned mega banks, to provide credits to the SOEs in particular in overcapacity sectors. This was so effective that regular credit growth skyrocketed in the first three months of the year to 63% on an annualized basis and apparently had to be reined in as other parts of the country's economic and financial authorities raised red flags. As noted above, this probably much helped to stem a sharper deceleration of overall economic activity at the beginning of the current year but at a price in terms of potential future costs to financial stability.

Shadow banking industry finds new channels. Despite the bout of new lending from regular sources, total social financing -- the Chinese concept of all kinds of institutionalized financing sources to the economy -- have decelerated in recent quarters. However, Moody's (the global rating agency) points out that as the authorities clamped down on much of the regulated shadow banking industry, markets have found new ways to channel credits to the higher bidders outside the authorities' direct control. In the second half of 2015, this rose quickly to dominate almost 60% of total shadow banking, itself a vital part of China's total financial sector. This is apparently for the most parts outside the authorities perimeters. While any financial system will have poorly regulated and registered areas on the peripheries, in China this appears to be quite integrated with the regulated part of it. In particular, many banks, not least mid-sized and smaller ones, have been active participants in these new credit channels to prop up weak profitability through regulatory arbitrage. The rating agency asks what could be the consequences for the implicated banks if this market should collapse.

Trusted loans: This is an old part of the shadow banking system which the authorities have tried to rein in by forcing banks to take back more of it onto their own books in cases where this had increasingly taking place off-balance. More often than not these transactions originate and end up as loans and credits among larger companies including among loss-making SOEs. Forcing them back into the books of the banks has apparently reduced banks' appetite for them thus squeezing more of this activity out into the unregulated enterprise-to-enterprise market. The IMF points out that weakening payment capacity among these is often impeding cash flows to their suppliers and thus transmitting stress across the system. As a result payable days have increased steadily from a median of 53 days in 2011 to 72 days in 2015. [2]

Non-performing loans represent a growing uncertainty: Officially recognized non-performing loans (NPL) have been growing for the last couple of years but still represented less than 2% of total in 2015 and were so far well provisioned for. Observers, however, point to regulatory forbearance and underreporting of bad loans, including as "investment receivables", as ways to hide the true level of NPLs, They estimate the potential rise in the overall levels of NPLs to rise to somewhere between 14% and 20% in a stress situation which could imply losses of about the half of those magnitudes. That is still something the authorities would be able to handle, but continued financial expansion including through new and lightly regulated channels could bring the situation to a tipping point.

Exchange rate policies – what is the central bank up to? Following the surprising devaluation in August 2015, markets have been asking what are the authorities aiming at. Was this a one off or have they adopted a new exchange rate policy? This uncertainty has probably led to more market volatility than necessary, in particular in the fall of 2015. It has driven speculations about a possibly much larger devaluation in the offing to shore up competitiveness among China's exporters. While China can still boast of a healthy trade balance and a solid reserve level, growing exports would still be helpful to support the economy in case private consumption does not pick up to fill the space left behind by trailing investment demand. On the other hand, a new devaluation would produce enormous protestations from Washington and China's government would probably like to wait for the results of upcoming US elections before contemplating any such move.

Structural policies: Despite continued lip-service, the great reform ambitions expressed by president Xi at the beginning of his term in 2013 seem to have been mainly shelved for now. Admittedly, the much vaunted deregulation of deposit rates at banks finally took place in late 2015. So far, however, this has apparently had little effect. Bank clients vying for higher yields have rather headed for the WMP market as noted above.

Political developments

Cementing his position or calm before the storm? The absence of much progress on the reform agenda may not necessarily reflect lack of willingness or understanding but rather that the authorities have become consumed by the need to keep the economy humming in the short term. At the same time it has likely been more imperative for President Xi's to fortify his position against potential rivals within the top echelons of the ruling elite. Preparations for next year's party congress held every five years is ongoing with the renewal of the Communist Party's standing committee as top priority. With the exception of Pr. Xi himself and PM LI, the five other members are up for retirement. Four of them, the eldest, are rumoured to have been the previous President Jiang Zemin's protégés. Pr. Xi would probably have little regret seeing the back of them. However, at 67, Wang Qisheng is a border case. Strictly following the rule, he should retire in 2017. But he is pr. Xi's anti-corruption

[2] Global Financial Stability Report, IMF Washington, April 2016

czar, and observers are eager to see if he will be retained as a sign of Pr. Xi's hold on power.

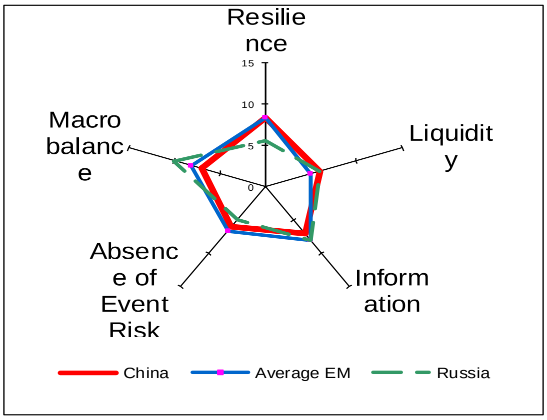
External security: On this issue China has made few scores over recent months. US election rhetoric is mostly anti-China in particular from the Trump campaign. In Taiwan a new president has taken office with a still uncertain policy attitude towards Beijing. Seoul has mostly mended relations with Tokyo for now and agreed purchases of new high tech weapons from Washington which few observers believe are aimed at the threat from North Korea. Vietnam has attained the right to buy sophisticated weapons from the US, and in a few weeks UNCLOS is expected to rule in the case raised by Manila against Beijing's claims in the South China Sea. In a best case scenario all this opposition should pacify Beijing for regional calm to prevail.

Outlook

This year and next, we believe the economy will continue to grow at somewhere in the lower part of the 6-7% range. Real growth may be lower as measured by proxies such and use of electricity etc., but the 6-7% growth will be the official presentation. Major enterprises will not be allowed to fail at least not in cities where they represent the primary employer.

The danger of this attitude is that problems are covered up for too long until they become hard to address either because they have grown too complex or because they have become too big. So far, however, few observers seem prepared to declare that the development has gone too far, beyond the point of no return. Barring any catastrophe the central bank should still be able to prop up the system with adequate liquidity. That is reassuring as no financial crisis is likely anywhere on solvency issues alone. However, this demands that one really have a solid grasp of the size of the problem and the inter-linkages between the various part of the financial system and the real economy. In the case of the Lehman Brothers' bust in the US, a main problem was the inter-linkages between the various parts of the financial system. In China, that may still not be as complicated but is in return compounded by the financial inter-linkages among non-financial enterprises, still in many cases a legacy of the old socialist plan-economic system.

Key ratios	**2016**
Population (mill.)	1382.9
GDP/capita ($)	7893
GDP (%chg.)	6.4%
Inflation	2.4%
Trade balance/GDP	2.7%
Reserves/imports (months)	32
Budget balance/GDP*	-5%
Government net debt/GDP*	18%



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.

*) Central governmment only

Key data:	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP (mill.US$)	8469	9572	10324	10771	10916	11729	12671
GDP/capita (US$)	6244	7020	7534	7823	7893	8446	9088
GDP (%chg.)	7.7%	7.7%	7.2%	6.8%	6.4%	5.8%	5.7%
Investments/GDP	48%	49%	49%	48%	49%	48%	48%
Budget balance/GDP*	-2%	-2%	-2%	-3%	-5%	-5%	-5%
Govt net debt/GDP*	14%	14%	15%	16%	18%	22%	25%
CPI inflation (%chg.)	2.6%	2.6%	2.0%	1.4%	2.4%	2.6%	2.7%
Money demand (%chg.)	10.6%	8.5%	4.4%	4.4%	5.1%	3.6%	3.9%
Stock prices (%chg.)	2223	2196	2236	3714			
Interest rates	4.2%	4.9%	4.8%	3.8%	2.9%	3.7%	3.3%
Exch. Rate ($)	6.31	6.15	6.16	6.28	6.63	6.61	6.64
Trade/GDP (%)	43%	41%	39%	35%	32%	31%	31%
Oil price (Brent)	$112	$109	$99	$52	$42	$50	$60
Millions US $							
Export of goods	1 973 520	2 148 590	2 243 760	2 142 750	2 017 660	2 105 340	2 233 750
Imports of goods	1 661 950	1 789 610	1 808 720	1 575 760	1 463 430	1 562 370	1 676 640
Other:	-96 178	-210 776	-157 607	-236 388	-264 891	-335 750	-401 034
Current account ($ mill)	**215 392**	**148 204**	**277 433**	**330 602**	**289 339**	**207 220**	**156 076**
(% of GDP)	2.5%	1.5%	2.7%	3.1%	2.7%	1.8%	1.2%
FDI	176 251	217 957	144 967	62 057	-6 601	16 989	49 745
Loan repayments	-35 519	-33 395	-43 975	-57 520	-66 996	-70 709	-72 375
Net other capital flows	-228 374	-14 356	-67 516	-688 350	-569 252	-231 010	-165 846
Balance of payments	**127 750**	**318 410**	**310 910**	**-353 210**	**-353 510**	**-77 510**	**-32 400**
Reserves	3 305 930	3 624 340	3 935 250	3 582 040	3 228 530	3 151 020	3 118 620
Total debt	735 554	825 810	926 262	1 041 640	1 173 090	1 305 110	1 445 390
o/w short term debt	497 337	579 286	660 016	724 303	789 812	855 405	922 238

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

* Central government only

Rating history

	2012	2013	2014	2015
Fitch (eoy)	A-	A	A+	A+
Moody's (eoy)	A1	A1	Aa3	Aa3

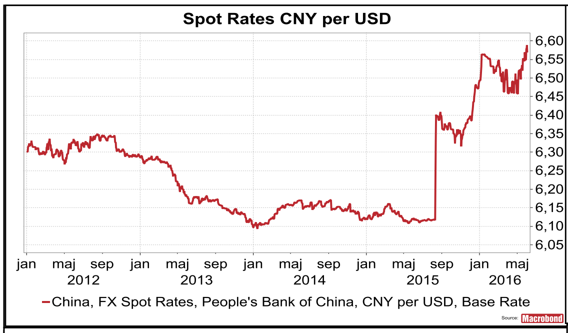
Type of government: Communism. Leaders expected re-elected at next party conference in 2017

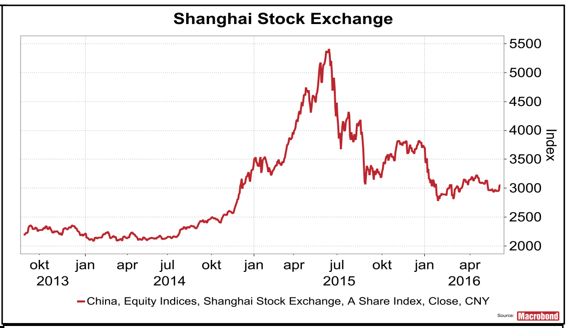
Next elections N/A

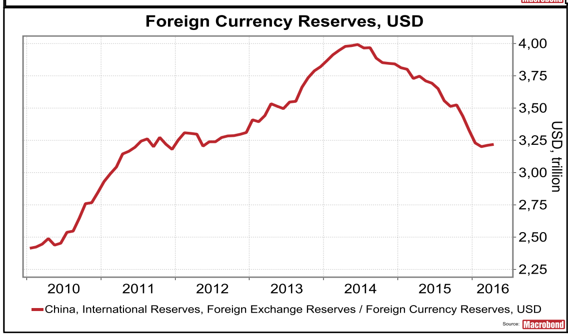
Other:

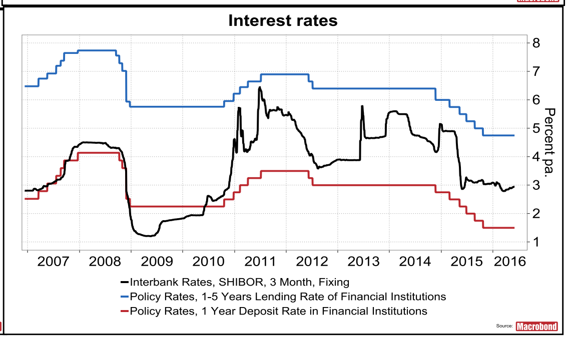
Latest PC deal None

Recent IMF programs None









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