China P.R. Mainland

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **May 12, 2017**

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Reports from private and official observers have become increasingly wary of growing vulnerabilities in China's financial system as long as the government remains fixated on growth regardless of possible consequences for banks and other financial institutions. Expectations are still for a turn-about following the party-conference in next fall.

Summary and conclusions

Right on target: Last year the growth rate of GDP ended right on target, 6,7%, i.e. the midpoint between the promised range of 6,5% and 7% with an upswing in the last quarter to 6,8%. That momentum continued into the first quarter of the current year as activity quickened to 6,9% driven by private consumption and government infrastructure projects. The economy responded with higher industrial production although services and construction slowed as the government's cooling measures of late 2016 to damp housing market buoyancy began to take effect. For the rest of the current year expectations are for still solid but slightly lower growth around 6,4%.

Rising concerns are not about any immediate disruption to growth or financial balances. They are rather related to present policies to uphold growth "whatever it takes" that cannot go on forever. Consensus appears to be that up to the party conference in a few months' time, nothing must sow doubts about the government's ability to manage the economy. But after that, it should stop pump-priming demand using vehicles like state-owned enterprises and banks, and rather return to its reform path. Inflated financial sector imbalances are not yet beyond repair, but the point of no return is much closer today than it was some five years ago.

Latest: May 24, Moodys downgraded the sovereign of China one notch to A1, the first downgrade in 26 years, referring to a material rise in economic wide debt, and the consequent increase in contingent liabilities for the government.

The financial sector growing too fast. Growth is slowing but still solid. Financial balances, by contrast, and many of them are deep imbalances,. have grown almost twice as fast in an ever more complicated, opaque and interwoven financial sector including weakly regulated shadow banks. Research cited by the IMF notes that China today displays almost all of the characteristics of an emerging market economy in its pre-crisis stage. For our own account we would dare to add "any developed market economy" as well.

Political events are not coming to the rescue. While Pr. Xi has cleverly managed the relationship to Pr. Trump, his only ally, North Korea, may still put spanners in the works and by accident or intent put Pr. Xi in a very difficult position.

Ratings: Since last fall there have been no rating actions on the sovereign. As such, the waiting game continues which also relates to country risk..

Recent economic developments

Healthy momentum continues into 2017: At the end of last year activity quickened with 4th quarter growth ending up at 6,8% year-on-year (yoy) slightly higher than the full year average of 6,7%. The momentum continued into the first quarter of the current year as activity quickened further to 6,9% yoy. That was spearheaded by residential real estate and construction including government infrastructure projects. As a result, industrial activity powered forward riding on an uptick of 9% in investment demand while private consumption rose only by 7% in a rare deviation from trend since 2012 when consumption has passed investments in dominating GDP growth.

Unlikely to be sustained: However, this was before the effects of last year's cooling had time to show its full effect and before the central bank's tightening of interbank liquidity had penetrated bank's lending behavior. As these begin to take its toll on demand, activity will begin to cool off with growth trailing toward 6% yoy by year end, leaving the full year average at 6,3%.

Moderate price pressure: Inflation as measured by the consumer price index (CPI) is likely to remain comfortably low for the central banks inflation fighting credentials at 3% or less for the current year -- only slightly above last year's 2% achievement. Housing prices, by contrast, soared by up to 30% in 2016 in the five main cities, tier-1, including Beijing and Shanghai, and were up by 7% even in the smallest but most numerous tier-4 cities. However, price pressure appears now to be tapering and in early months of the current year prices were falling rapidly in tier-1 cities and moderating in others with the effect to leave the average flat. As a result and seen over time, the housing market in China has been on a yo-yo mode over the current decade with alternating boosts and busts in two-years cycles.

Unemployment steady: Last year the rate of unemployment recorded by official statistics fell slightly after having been constant at 4% since 2011. That could have been an effect of a tightening labor market where demographics now will restrain supply going forward unless the participation rate can be increased. The latter may prove unlikely after the authorities eased the restrictions on family planning (the one-child family). This change could hold back more women from seeking employment as they may prioritize having another child. As a result of both events, the labor market could tighten considerably over coming years. That is after a steep rise in wages over the last decade raising the average from $1,3/hour in 2006 to $5,5/hour in 2016. India in the same time frame experienced a wage growth from $1,6/hour to $3,6/hour.

External surplus in decline: after several fat years the annual current account surplus is set to decline. Last year it fell 1pp to 1,9%/GDP and for the current year most observers project a further weakening to 1,5%/GDP. That is despite a real depreciation that should have made exports more competitive and import more expensive. However, rapid wage growth as noted above may have offset much of this advantage.

Capital outflows tamed: Since mid- 2014, Peoples Bank of China (PBoC) -- central bank – have lost $1,4tr of reserves which have fallen to slightly above $3 trillion. That is still enough to cover almost 2 years of merchandise imports but only half of all demand deposits in banks although still regarded as sufficient by IMF metrics. Much of this loss, almost a half of it, is estimated to have been the result of hedging activities from Chinese companies with external debt as it became clear a few years ago that the Renminbi probably had reached its summit. Last year, however, such hedging came to an end and the observed capital flight was more likely the result of active portfolio allocations by domestic investors, individuals as well as firms imposing new regulations and enforcing existing seemed to have stopped much of this drain in reserves. In the first quarter of the current year, PBoC lost only $29bn. of reserves. Other net outflows have occurred; inflows of foreign direct investments last year declined 40% to $151bn while outflows of the same kind rose 12% to $211bn. In total that left the net inflows of FDI in negative territory to the tune of $59bn. That means that for the first time since the beginning of the statistical series Chinese investors are now spending more money abroad than foreigners do in China, a trend that is likely to continue through the rest of the decade.

Moderate debt but a heavy repayment schedule. External debt at only 13% of GDP (not counting stock of FDI inflows as debt) and fully covered by official reserves, is a continued credit strength of China. In the short term, however, Chinese companies appear to be facing a heavy repayment schedule on existing debt. . That may be accompanied by a repeated wave of potential outflows should the President Trump make good on promises of curbing China's exports to the US or if he gives US companies a tax break for bringing back money from abroad. They have been important investment partners for China over several decades in the past.

Policies

Fiscal deficit rises: The budget for the current year is likely to see the deficit rise substantially to almost 5%/GDP against the outcome of 4% in 2016. That presentation, however, covers only the central government. The fiscal position of local governments is not covered by regular statistics. Based on various information sources the IMF has presented estimates that have added some 7%/GDP to the total general government balance when including also local governments.

Debt and deficit financing: According to these estimates, general government debt reached more than 55%/GDP in 2015. The official number for the same is 52,5% by the end of last year. Both estimates include local governments' contingent liabilities to the financing vehicles they have used to fund growing deficits in recent years. To solve local governments' mounting debt burden, the central government allowed them a couple of years ago to issue debt in own name and also launched a bond-swap program for them. Such measures will improve transparency but not change the fundamentals of the problem, namely that debt will continue to accumulate as long as the fiscal policy stimulus does.

Monetary policy easing and tightening: Last year, aggregate credit expansion reached almost 16% in 2016. That was before the PBoC slammed the breaks by letting liquidity dry up in the interbank market. For the current year, credit growth targets have been lowered to 15%. That will still raise the overall credit in the economy by more than 9pp to about 200%/GDP, a high number for an economy like China not only in comparison with peers but also when compared with more developed countries. This growth has almost doubled the credit penetration of the economy from 114%/GDP in 2008 and has been the result of recent years' policies of upholding growth or at least cushion its decline. This has also been accomplished by leaning on the state owned banks (SOB) to support the growing numbers of unviable state owned enterprises (SOE) particularly in heavy industries and other sector related to construction. However, by so doing the central bank is now finding itself in a quandary. Raising interest rates for domestic reasons may also strengthen the currency more than desired in view of weakening competitiveness of exports and import competing industries.

Banks gradually feeling the pain: Over the last year, banks have continued to grow briskly while at the same time being hit by struggling clients not least from SOEs which constitute more than 40% of their corporate exposure. Last year, their non-performing loans (NPL) rose to 3% of their loan book but that is still well provisioned for in most banks. Including also "*special mentioned loans*" raises the number to 5%. This is not provisioned for in all banks but is not yet alarming. However, many observers find reason to also include loans to companies with interest coverage ratio (ICR) less than one (i.e. interest due/EBITA). That raises the ratio of doubtful credits to more than 15% on average.

Small and medium-sized banks hit hardest: To bolster softening profit margins, small- and medium-sized banks have been the most aggressive investors in shadow banking products (conf. below) where returns are often around 10%pa compared with funding costs at 2-4%pa. . Such exposure has left them with an impression of being potentially shaky. Combined with the popular belief that the five systemic state owned bank (SOB) would be the most protected in case of a financial sector crisis, many depositors have turned to these banks which traditionally dominate 57% of the domestic loan market. Flush with liquidity the latter have on-lent the cash to the smaller banks through the interbank market. This has had the effect to make the smaller banks more dependent on very short term funding – much of it on no more than 7 days maturity -- for their somewhat longer term lending into wealth management products (WMP). 80% of the outstanding RMB37 trillion (2016) WMP market is on six months maturity. As such, their maturity mismatch has deteriorated and increased their vulnerability to the ongoing monetary tightening centered on the interbank market.

Box 1: Shadow banking: The rapid rise in credit expansion is also related to the growing share of shadow banks in the financial sector now accounting for about one thirds of financial market activities up from almost nil ten years ago. Even though such activities may represent a sound development in general, its rise has happened in an environment of inadequate supervision and often as a way for regular banks to circumvent regulations. In more recent times it has also mushroomed on potential market imperfections including the growing mass of weak companies in obtaining loans in the regular credit market.

Mortgage market: Since 2014, the mortgage market has seen a remarkable growth and dominates now about a third of total lending. This is a quite new exposure of most banks and one would expect the regulatory authorities to take a keen interest in, not least now as it seems that the housing market is losing momentum.

Improving supervision: The authorities have made several attempts at controlling the total financial sector including shadow banks, but they have experienced that new products pop up or gain unintended prominence when old products come under scrutiny. (Conf Box 1) Last year it clamped down on WMP often regarded as the more obscure part of the market only to see trust and entrusted loans take greater market shares. Such loans are mainly between companies that are supposed to know each other well (i.e. like suppliers' credits). That may feel reassuring in normal times but in an environment of trailing growth such lending could as well be a means to hold suppliers afloat to maintain your own production. Such developments are often prompted by opportunities for regulatory arbitrage. Last February, the PBoC took initiative to assemble a variety of financial supervisory authorities under one roof to improve regulatory consistency and transparency in general.

Exchange rate policies: The PBoC's exchange rate policy since officially abandoning the peg to the US-dollar several years ago has fluctuated between a dirty float and a quite managed one. At the present, the central bank follows a model wherein the morning fixing depends on the previous day's outcome with an overlay of discretion. Through most of last year that implied a gradual weakening until November 8, the day of US elections. Since then the RMB has regained some strength and followed the greenback more closely, giving rise to speculations that the central bank would not give cheap arguments to the new president for naming China a currency manipulator for unwarranted competitive advantage. That has been a longstanding threat but was recently abandoned by the White House. In October 2016, PBoC also achieved its longtime coveted goal of seeing the RMB (Yuan) included in the IMF's Special Drawing Rights unit and even in its Currency Composition of Official Foreign Exchange Reserves (COFER) to bestow it with reserve currency status a measure that could help counter capital outflows.

Structural policies on the back-burner: Observers generally agree that structural policies have been put on the back-burner since a comprehensive program was launched shortly after President Xi's appointment in 2013. The priority now is more likely to stabilize the economy and manage the slowdown. There may also be significant opposition from vested interests including from SOEs and SOBs. Such internal party politics will have to wait for clarification at the next party conference later this year.

Politics

Domestic politics: There is little new information worth reporting at this side of the noted party conference, the exact timing of which has yet to be announced. Expectations are for Pres. Xi to be reappointed for another five years' term. Whether he also has bolstered his inner party support can probably be seen in the cadres he is able to get rid of and also the politics he will pursue in its aftermath. A revival of the reform program probably means that he has drawn the longer straw.

Foreign politics and external security issues: Since the increasingly more aggressive posturing over recent months of the North Korean leader, Kim Yung Un, including

> **Box 2: North Korea -- any solution?** To both Beijing and Washington North Korea and Taiwan have looked like two cases with the common denominator that they were both stable and functioning although in very different ways. The strategy was the same in both cases, do nothing and hope that the issue would resolve itself. That is no longer possible North Korea could soon have the means to hit Japan and then the US with nuclear weapons. A new question has come to the fore: If Beijing is still able to control Pyongyang, would Washington be prepared to present deep concessions to Beijing for having North Korea denuclearized? Such concessions might include tearing up the US defense agreements with Japan, Korea and any other regional countries and in general withdraw from any military assets in the region while stop interfering with China as it extends its influence among neighbors. Being under the threat of a nuclear attack, such a scenario would not be unthinkable. This has been forwarded as an argument that Beijing should now seize a rare window of opportunity to regain its historical supremacy over the region.
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> However, there may be reasons for Beijing to hold back. For the US to give such concessions it would most likely demand verifiable assurances that all nukes had been removed from North Korea. But after that Beijing might fear the US could reverse the suspension of defense agreement etc. with whomever. If so, Beijing could retaliate by returning the nukes to which Washington's response might be resolute before the devices were properly installed. In short, quick solutions (no matter how much Mr. Trump might cherish them) could be highly destabilizing and the likelihood is rather for all parties to continue making sure status quo prevails as long as possible.

long range missile tests, North Korea has taken center stage in both the East Asian security debate as well as on the global stage. The issue is well covered in media and elsewhere. At this point, suffice to bring only one example that illustrates how things may look easy on paper but can be devilishly difficult when implemented in practice. (Conf. Box 2 above)

Outlook and concluding comments:

Near term main scenario: For the present year and to the end of the decade we project growth to gradually slow from 6,4% to about 5% in 2020. That is provided a stable environment without events that could trigger disturbances with origins in domestic financial markets. In this main scenario, nonviable companies will be taken care of not by subsidies and more loans but rather by being unwound while reforms pave the way for new enterprises in other production lines or services.

Unemployment threat: The premise for this is an environment of political calm in which markets would not be disappointed in their beliefs of the president's preference for economic reforms. The often cited scarecrow in such a scenario is mass unemployment and social anger when companies lay off workers. However, the 8mn. persons employed in identified nonviable SOEs represent hardly more than 1% of the Chinese working age population and should not constitute an overwhelming macroeconomic challenge. That said, the problem is concentrated to three provinces, including resistive Inner Mongolia and could present a threat to local authorities. Such unemployment would probably also be exploited by any inner party opposition against the leadership.

Financial sector threat: Observers note that economic growth of recent years has been accompanied by the build-up of massive imbalances as a result of unprecedented direct fiscal and quasi-fiscal stimuli with the occasional support of monetary policies. Still nine years after its inception much of this remains shrouded in a cloud of opaqueness. The direct fiscal deficit of the central government is well known, but the annual deficits of local governments are not made public. That would have been a minor problem had they been small which is the norm in most countries..

Local government predicaments: In China, by contrast, the fiscal stimulus over recent years has mainly been operating through local government budgets where deficits quickly escalated in 2009-10 to some three times the central government deficit. Because of low debt levels, that was admissible at that time. However, the deficits did not fall back but has remained at elevated levels in following years. It remains to be seen if the rise in the central government deficit since 2015 could reflect some burden sharing with local governments. Otherwise the total fiscal deficit may now be rising to levels well above 10%/GDP and, if not corrected, fiscal vulnerability will approach the present levels of some Southern European countries like France and Spain early next decade. Then again, China still has ample room to reverse these imbalances but not without creating the rise in general unemployment it sought to avoid when the GFC (global financial crisis) hit eight years ago.

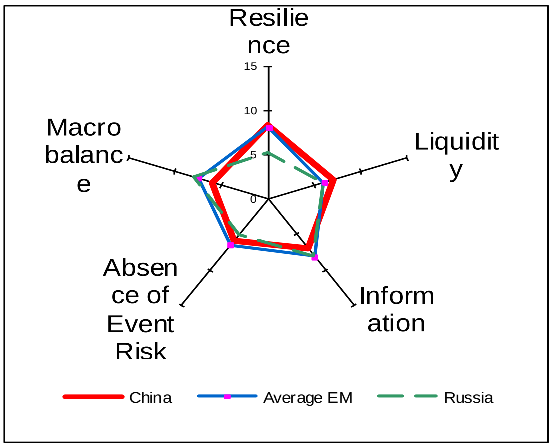
The quasi fiscal deficit: The more immediate problem is the quasi fiscal deficit: This is not only limited to the government sector but involves also parts of the financial system including lending through the SOBs. These are not necessarily only direct links but as importantly indirect links. Being less transparent the latter can trigger investor panic which feeds into other parts of the financial market, even if they were not a part of the problem in the first place, e.g. the foreign exchange markets. What started with leniency of state banks towards state owned enterprises, that is "all within the family", has spread to weakly regulated non-banks. They have grown rapidly often in response to the monetary authorities attempts at taming the activity of regular banks. Shadow banks now dominate a third of China's inflated financial system and large parts of their activity are regarded as highly speculative and likely under-priced, i.e. without properly factoring in risk in the pricing of their products. . As noted above, the authorities' attempts at steering them is often not very effective and have proved prone to create unexpected results.

All interrelated: That could still have been acceptable, if the shadow banking system represented an isolated island in the financial sector. On the contrary, it is highly integrated in part because the regulated parts of the system, the banks, have seen the shadow banks as both a funding source and investment opportunity to beef up profits. This has proliferated as the smaller and medium-sized city banks have lost deposits to the large state owned banks perceived as safer. But the latter have again used the excess liquidity from those inflows to fund the smaller and medium sized banks usually on a very short term basis. As such, a disruption that starts in one part of the system would have the potential to spread quickly leaving no financial institution untouched.

Parallels to other pre-crisis situations: The situation presented above has certain parallels to similar developments which have led to deep economic and financial disruptions in the past of other countries. IMF research [1] published in 2016 notes that out of 43 economies where Credit/GDP rose by more than 30pp over five years, 38 experienced severe financial crisis and/or economic slowdowns. . In China the credit/GDP ratio rose from 150% in 2009 to 190% in 2015. Probability of a deeper crisis also rises if the boom lasts longer than 6 years, starts from a higher level and develops faster. The IMF paper notes that China meets all criteria.

Mitigants also important: China has still ample foreign reserves and a cautious central bank that has so far proved vigilant to lurking dangers. Some observers also table the argument that a well-organized one-man or one-party rule country can better meet a crisis should it occur inasmuch as it also can suppress media and thus the flow of information in order to tame investor panic. Against the latter, however, one may also point to Indonesia before the Asian crisis, where one-man rule and repression did not save the country from being the worst hit.

Key ratios	**2017**
Population (mill.)	1388.8
GDP/capita ($)	8362
GDP (%chg.)	6.4%
Inflation	2.4%
Trade balance/GDP	1.5%
Reserves/imports (months)	29
Budget balance/GDP*	-5%
Government net debt/GDP*	19%



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.

[1] IMF WP/16/23 Resolving China's Corporate Debt Problem", Washington 2016

Key data:	2013	2014	2015	2016	2017	2018	2019	2020
GDP (mill.US$)	9689	10451	10960	11190	11613	12540	14130	15997
GDP/capita (US$)	7106	7627	7960	8091	8362	8994	10099	11399
GDP (%chg.)	7.8%	7.3%	6.9%	6.8%	6.4%	5.9%	5.7%	5.6%
Investments/GDP	48%	49%	49%	48%	49%	48%	48%	48%
Budget balance/GDP*	-2%	-2%	-3%	-4%	-5%	-5%	-4%	-4%
Govt net debt/GDP*	14%	14%	15%	17%	19%	22%	24%	26%
CPI inflation (%chg.)	2.6%	2.0%	1.4%	2.0%	2.4%	2.6%	2.8%	2.8%
Money demand (%chg.)	8.5%	4.4%	4.4%	6.6%	7.6%	5.1%	4.8%	3.7%
Stock prices (%chg.)	2196	2236	3714	3003				
Interest rates	4.9%	4.8%	3.8%	3.0%	4.1%	4.0%	4.0%	4.2%
Exch. Rate ($)	6.15	6.16	6.28	6.64	7.03	7.10	6.85	6.57
Trade/GDP (%)	41%	39%	34%	31%	31%	30%	29%	28%
Oil price (Brent)	$109	$99	$52	$44	$52	$52	$59	$68
Millions US $								
Export of goods	2 148 590	2 243 760	2 142 750	1 989 070	2 021 550	2 109 810	2 287 360	2 525 470
Imports of goods	1 789 610	1 808 720	1 575 760	1 503 850	1 587 090	1 647 420	1 787 560	1 978 790
Other:	-210 776	-157 607	-236 388	-274 872	-265 687	-292 829	-333 164	-379 108
Current account ($ mill)	**148 204**	**277 433**	**330 602**	**210 348**	**168 773**	**169 561**	**166 636**	**167 572**
(% of GDP)	1.5%	2.7%	3.0%	1.9%	1.5%	1.4%	1.2%	1.0%
FDI	217 957	144 967	62 057	-58 567	-107 262	-89 650	-79 106	-84 015
Loan repayments	-36 681	-38 158	-80 227	-123 717	-77 440	-72 292	-73 749	-75 235
Net other capital flow s	-11 060	-73 342	-665 642	-441 104	-226 001	22 790	60 119	80 477
Balance of payments	**318 420**	**310 900**	**-353 210**	**-413 040**	**-241 930**	**30 410**	**73 900**	**88 800**
Reserves	3 624 350	3 935 250	3 582 040	3 169 000	2 927 070	2 957 480	3 031 380	3 120 180
Total debt	1 346 600	1 658 450	1 550 390	1 249 650	1 214 130	1 379 610	1 596 700	1 823 370
o/w short term debt	970 185	1 178 540	1 040 180	895 326	889 999	914 820	947 383	981 384

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

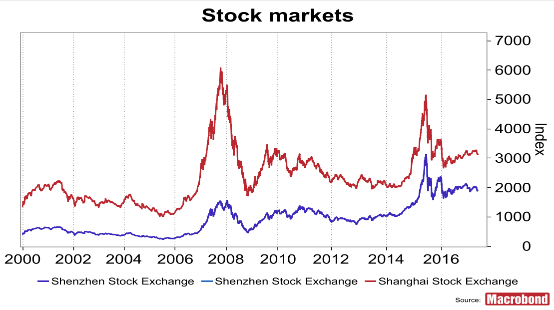
Type of government: Communism. Leaders expected re-elected at next party conference in 2017

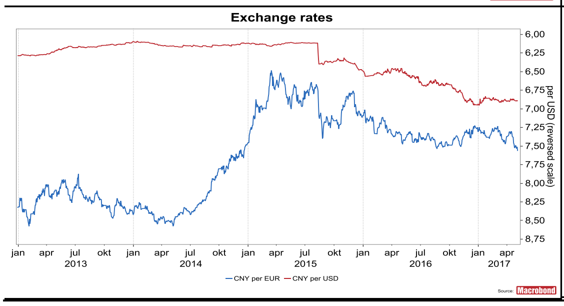
Next elections N/A

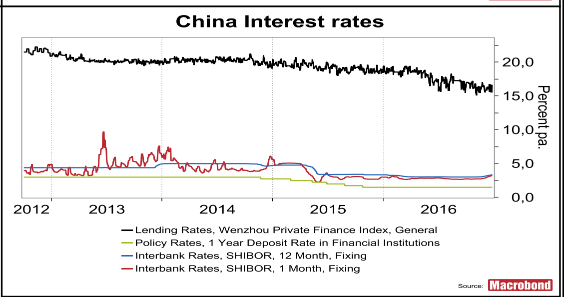
Other:

Latest PC deal None

Recent IMF programs None







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