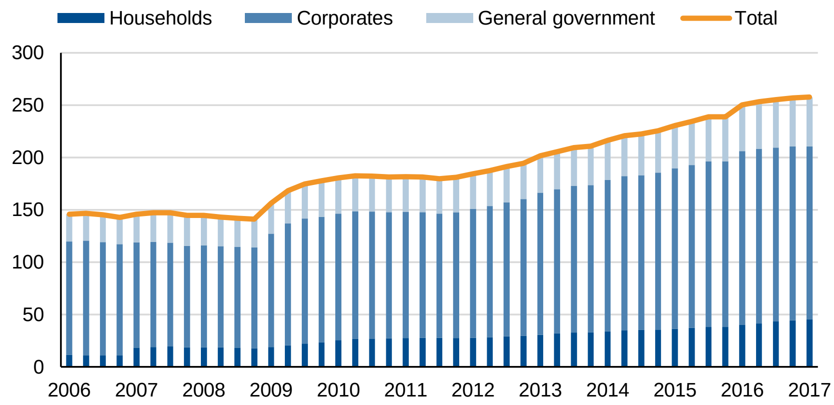
China's Sovereign Ratings Hinge on Deleveraging Initiatives

In Scope's downgrade of China to 'A+' in September, we identified the '*extent to which a continued unfavourable debt trajectory is redressed through the proactive initiatives of authorities*' to be a key factor in Scope's forward-looking assessment. While President Xi's consolidation of power after the 19th National Congress affords the opportunity to deepen deleveraging initiatives – which support China's ratings, Scope considers meaningful long-term risks to remain.

On 29 September 2017, Scope downgraded China's long-term ratings to A+ from AA-, on the basis of high and continued rises in levels of economy-wide debt.

China's debt risks start at the government level, where under a narrow definition, general government debt totalled 44% of GDP in 2016. However, including the off-balance sheet debt of local governments, the government's 'augmented debt' stood at 62% of GDP in 2016 and is projected to substantially rise to 92% of GDP by 2022, driven by on- and off-balance sheet budget deficits. In addition, total non-financial sector debt rose to 258% of GDP as of Q1 2017 (Figure 1), according to data from the Bank for International Settlements (BIS), having risen sharply from 141% of GDP as of Q4 2008. The IMF estimated total non-financial sector debt (which under its definition stood at a lower 236% of GDP at end-2016) to continue its rise to 297% of GDP by 2022. Such significant debt increases over a short time have been associated with sharp growth slowdowns and, frequently, financial crises.

Figure 1: Non-financial sector debt by sectoral contribution, % of GDP



Source: BIS, Scope Ratings AG calculations

Important supervisory and regulatory action has been taken to contain critical segments of financial sector risks. The government's commitment and ability to reform represents a continued credit strength. The tightening in financial conditions has sharply cut intra-financial sector credit. In addition, total lending in China to the non-financial sector rose 11.1% YoY in September 2017, a drop from the more than 17% YoY growth in late 2015.

President Xi Jinping's significant consolidation of power surrounding October's 19th National Congress represents the opportunity to push ahead with far-reaching reforms, including efforts to redress macroeconomic imbalances and excessive leverage. Such initiatives support China's A+ ratings. However, Scope's view is that only segments of the main structural challenges are being actively corrected, with total economy-wide debt still increasing (albeit more gradually). In addition, continued significant consolidation of power, even if it bolsters important reforms in the near term, holds credit-negative implications over the long term, in Scope's view, threatening the delicate consensus-driven leadership structure in place for the decades of China's economic miracle.

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Scope downgrades China's newly published credit rating to A+ from AA- and changes Outlook to Stable – 29 September 2017

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The most significant risk to China's ratings

Scope's forward assessment concentrates on debt

On 29 September 2017, Scope downgraded China's long-term ratings to A+ from AA-, on the basis of high and continued rises in levels of economy-wide debt, representing both direct and contingent liabilities of the government. In the decision, Scope identified the 'extent to which a continued unfavourable debt trajectory is redressed through the proactive initiatives of authorities' to be a key factor in its forward-looking assessment of China's ratings and outlook. If economic and financial reforms accelerate significantly, including moves away from 'hard' growth targets (which drive leverage), with these reforms improving productivity growth, reducing financial imbalances and breaking the trajectory of rising debt, Scope could affirm China's rating at A+, and/or consider rating upgrades in the long run. Conversely, Scope identified that if the trajectory of rising non-financial-sector debt ratios is maintained, threatening financial stability, this could be a main trigger for further negative revisions in the ratings or outlooks.

19th National Congress

Continuity in policy shifts after party congress

Deliberations during October's 19th National Congress came at a moment when the necessity for reform to China's economic model has become apparent. In President Xi Jinping's work report on the Congress's opening day, he laid out a far-reaching vision to transform China into a global power by 2050 in innovation, influence and military prowess. He restated, moreover, commitments to open up to foreign businesses, deepen state-owned enterprise (SOE) reform and strengthen financial sector regulation, representing continuity in policy shifts we've seen.

Reform announcements were broad and unspecific, in line with previous party congress addresses, with limited new information on the details of initiatives to address debt and unbalanced growth. For that, we may need to wait on the period leading up to and during the Central Economic Work Conference in December, if not the National People's Congress in March 2018 or the Third Plenum in the autumn of 2018, for greater clarity on the post-congress policy agenda. This month, China announced an opening of its financial system to increased foreign ownership in domestic financial institutions.

Gradual shifts from quantity to quality of economic growth

However, President Xi did in his speech at the National Congress silently drop a commitment made by his predecessor, Hu Jintao, to double the size of China's economy. In 2012, former President Hu committed China to 'double its 2010 gross domestic product and per capita income for both urban and rural residents' by 2020. In China's existing Five-Year Plan, this dictated average growth of around 6.5% over the 2016-20 period. While the absence of the 2020 GDP commitment does not mean that China lowers its growth objectives (which if so, would be supportive of China's ratings), it does signal greater flexibility and a continued gradual shift from concentration on the quantity to the quality of economic growth – with increasing emphasis placed on the quality of citizens' lives, including on addressing pollution, combating corruption and reducing income inequality.

In Scope's September rating downgrade decision, we identified elevated, above-potential economic growth targets to represent a continued risk to China's creditworthiness, due to the consequential demand for credit and investment to offset evolving structural impediments. Scope estimates potential growth in China to be on a trend towards 5% in the medium run, meaning that for real growth – currently at 6.8% YoY as of Q3 2017 – to continue to meet prevailing objectives (in 2017, the objective was growth of around 6.5% 'or higher if possible in practice'), this necessitates pro-cyclical policy accommodation. Were growth objectives in the next years to stay elevated (even if slowly dropping), this is credit negative in Scope's view. Conversely, were China's policymakers to tolerate growth taking another step down to 5% to 6% in the next five years, that would provide greater room to fix structural issues and make growth sustainable – credit positive, in Scope's view. On this, Scope views constructively President Xi's ongoing signals of a shift away from hard growth targets and greater emphasis on the quality of growth, though we hold continued concern surrounding the speed of this shift and the comprehensiveness of deleveraging programmes.

China's government debt risks

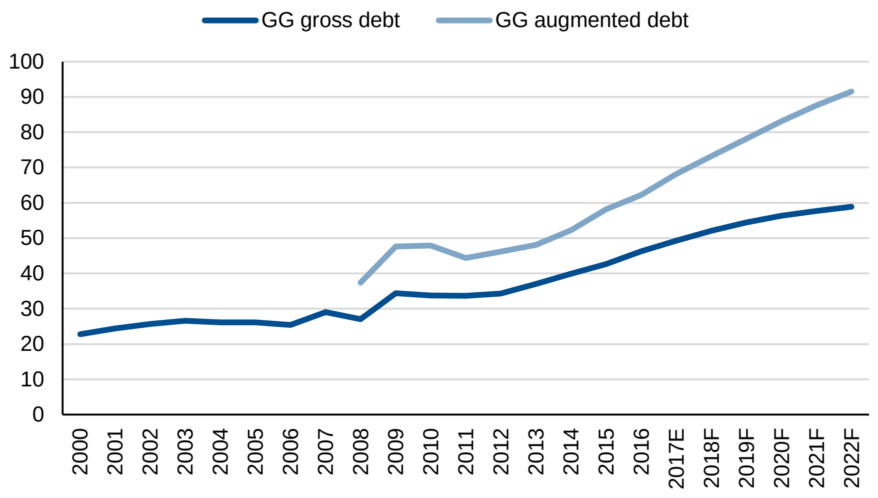
Higher fiscal deficits

China's debt risks begin at the government level. China's general government deficit increased significantly to 3.8% of GDP in 2016, from a deficit of 1.8% of GDP as of 2014. The higher deficit was driven by slowing revenue growth and an increase in expenditures since 2014 – partly to support economic activity. China's official deficit statistics, however, moreover exclude specific off-balance sheet activities of local governments. To address this, the IMF's 'augmented' deficit measure for China – including infrastructure spending financed by local government financing vehicle (LGFV) debt – amounted to a much more significant 10.4% of GDP in 2016[1], an increase on an augmented deficit of 7.2% of GDP in 2014. Moreover, Scope considers there to be significant risk that the 2017 general government deficit exceeds a 3% of GDP target, even were spending to recede following October's party congress (though China's official accounting allows it to transfer unspent money from previous years and funds from a budget stabilisation fund to the general budget, permitting it to report a final deficit in line with the target).

Public debt ratios on the rise

Under a narrow definition, China's general government debt totalled 44% of GDP in 2016 – which remains low compared to sovereign peers, but projected to rise to 62% of GDP by 2022. However, including the debt of LGFVs and other off-balance sheet entities, the government's 'augmented debt' according to the IMF stood at 62% of GDP in 2016. And, given larger augmented deficits (if local authorities retain high investment levels), augmented debt is projected to rise substantially more to 92% of GDP by 2022 (Figure 2).

Figure 2: General government debt and IMF augmented definition, % of GDP



Source: IMF (with latest Article IV forecasts to 2022)

Multiple initiatives have attempted to tackle the LGFV debt issue

The government's initiatives to disentangle LGFVs from the public-sector balance sheet resulted in several new guidelines restricting local governments from extending direct support to LGFVs[2] and stating the government's desire for LGFVs to be treated by

[1] International Monetary Fund. 'People's Republic of China: 2017 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China'. IMF Country Report No. 17/247, August 2017.
[2] Under the Budget Law, the debt of LGFVs should be paid by the state-owned enterprises themselves, with the government stating that local governments should not cover the liabilities.

creditors as separate from the government balance sheet. In addition, public-private partnerships have been promoted as substitutes to fund infrastructure. However, the continued implicit support for LGFVs means that Scope considers augmented debt metrics in its assessment of China's creditworthiness.

Debt at the local government level, moreover, is subject to rollover risk: debt issued by the local government financing vehicles have tenors of around three years. Despite initiatives to enhance the transparency of outstanding local government debt, and better financing terms through a debt swap programme started in 2015, the short maturity of China's local government debt remains a concern. While Scope considers positively continued initiatives to ease local government debt risks, many such efforts have only shifted debt to alternate platforms or onto other public sector-linked balance sheets.

China has significant assets, but much of these are illiquid

The Chinese Academy of Social Sciences (CASS), a government think-tank in Beijing, estimated in a recent report[3] that Chinese government assets stood at about RMB 125trn (USD 19trn) in 2015, or about 182% of 2015 GDP. CASS therefore assessed that government net assets amounted to more than 80% of GDP, concluding that these assets offset rising debt risks. However, many of the assets included in CASS's review – including buildings, cars, land and oilfields – cannot be easily liquidated. Consequently, the metric overestimates the utility of such assets at assumed values in a stressed scenario. Scope notes, however, that China has a more modest balance of liquid assets, including cash held in deposits, the social security fund, and financial institutions.

Risks from non-financial sector debt

Rising non-financial sector debt is a core concern

In addition to an ongoing assessment of government debt risks, Scope pointed in September's rating decision to high and rising economy-wide debt as a primary driver of the rating downgrade, and continued subject of attention. Economy-wide non-financial sector debt rose to 258% of GDP as of Q1 2017, according to data from the BIS, having risen quickly from 141% of GDP as of Q4 2008. Alongside rising general government sector debt stocks, non-financial corporate debt rose sharply to 165% of GDP in Q1 2017 from 96% of GDP in 2008 (with much of this debt tied to the SOE sector). Increases in corporate leverage moderated over 2016 and 2017 owing to tighter scrutiny. However, household debt has continued to increase rapidly to 46% of GDP in Q1 2017, from a low base of 18% of GDP as of 2008.

In the latest Article IV[4], the IMF estimated total non-financial sector debt (which under its definition stood at a lower 236% of GDP at end-2016) to continue its rise to 297% of GDP by 2022. Such significant debt increases over a short time (since 2008) have been associated with sharp growth slowdowns and, frequently, financial crises. While China's debt levels are not uncommon in highly rated countries, they are less frequent in countries with China's per-capita income and financial market depth, bolstering the urgency of authorities' deleveraging initiatives. Moreover, latent risks exist hidden from sight, based on People's Bank of China Governor Zhou Xiaochuan's assessment[5].

The government's commitment to reform is a credit strength

Important supervisory and regulatory action has, however, been taken to contain segments of financial sector risks. The government's commitment and ability (in light of still-pervasive ownership and influence across the financial system) to reform represents a continued credit strength, in Scope's view. Moreover, the capital account remains largely closed with investors in the bond market mostly being domestic institutions, shielding the economy from global financial volatility.

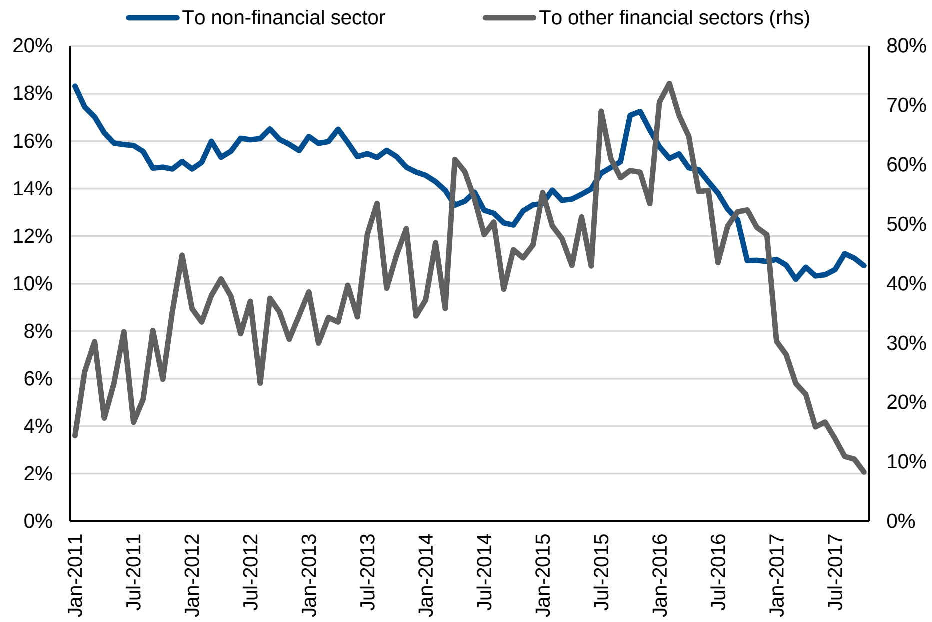
[3] http://www.cass.cn/keyandongtai/xueshuhuiyi/201709/t20170901_3627142.html
[4] International Monetary Fund. 'People's Republic of China: 2017 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China'. IMF Country Report No. 17/247, August 2017.
[5] http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3410388/index.html

Recently, tightening in financial conditions has sharply cut intra-financial sector credit, a key channel that financial institutions use to raise leverage while avoiding oversight. Intra-financial system lending dropped to 8.3% YoY in October, from more than 70% YoY in early 2016 (Figure 3). New rules have reduced regulatory arbitrage; the establishment of the Financial Stability and Development Commission has supported intermediation between financial supervisors. Investigations were launched into excessive lending practices and the People's Bank of China started to remove monetary accommodation. In addition, growth in bank claims on non-bank financial institutions and off-balance sheet wealth management products has slowed after booming in recent years.

Areas of credit growth have moderated, and property price growth has cooled

Total lending in China to the non-financial sector rose 10.8% YoY in October 2017 (Figure 3), a drop from the over 17% YoY growth as of late 2015. Mortgages have accounted for a significant share of new loans, adding fuel to the property market boom that has showed signs of cooling, owing to government measures.

Figure 3: Lending to non-financial sector and to other financial sectors, % YoY



Source: People's Bank of China, Scope Ratings AG calculations

Reforms have also included those in the corporate bond market, in which market mechanisms have been dysfunctional due to the government's guarantees on the debts of SOEs. Recently, the government has taken steps to contain the rise in SOE debt and discourage some SOEs from investment, particularly in overcapacity sectors. Importantly, the Chinese government has started to move towards a policy of allowing selective defaults, and the number of corporate bond defaults has risen sharply since the start of 2016[6]. Scope welcomes this financial tightening; however, given the size of growing imbalances, the depth of reforms remains inadequate. Debt-at-risk[7] rose to over 12% of total liabilities in 2016, from about 4% in 2010.

[6] Seki, Shinichi. 'Moral hazards in China from the Perspective of the Corporate Bond Market'. RIM Pacific Business and Industries Vol. XVII, 2017 No. 63.
[7] Defined as the ratio of the borrowings of listed companies with interest coverage ratios of below 1 to the borrowings of total listed companies (for methodology, see the IMF's April 2016 Global Financial Stability Report).

Implications of consolidation of power

President Xi achieved a significant consolidation of power

President Xi Jinping achieved a significant consolidation of his power with late October's announcement of the Politburo Standing Committee (PSC, China's seven-member top decision-making body) for the next five years. Significantly, no obvious successors to Xi were appointed to the PSC, raising the question of whether he may eventually stay on in some top leadership capacity after his second term concludes in 2022 (Xi is required by the Constitution to step down as President after two five-year terms). A new PSC roster absent rivals to Xi spoke to the 'new era' in China's governance. This was echoed in revisions to the Party Constitution to include Xi's doctrines (eponymously titled '*Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era*').

Power consolidation could advance critical reforms near term, but a risk long term

It has been argued that power consolidation is needed so that a unified leadership can push ahead with critical reforms resisted by vested interests. Optimistically, this could include measures to expand further consolidation in the SOE sector, move away from elevated growth targets, boost deleveraging in corporate, local government and other sectors, and crack down on China's financial industry. In Scope's view, should the concentration of power allow for a deepening of productivity-enhancing economic reforms and reinvigorated efforts to correct macroeconomic imbalances, that would be credit positive for the near- to medium-term outlook, and support China's A+ ratings. Efforts taken to date only address segments of the debt dilemma, with total public and private sector debt still rising (albeit more gradually), requiring incisive structural reform.

However, Scope's view is that significant consolidation of power, even if it bolsters important reforms in the near term, holds credit-negative implications over the long term. Since the early 1980s, the Communist Party General Secretary – the position held by Xi – has been technically first among equals in the Standing Committee under a collective leadership model designed to avoid one-man rule, learning the lessons of China's history. Moves back in the direction of strong-man rule undermine the delicate consensus-driven leadership structure in place for the decades of China's economic miracle, and can reduce the quality of governance and economic policymaking over the longer term – representing an important risk.

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