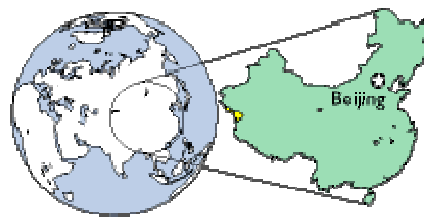


# COUNTRY REVIEW

## China



23 August 2011

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**EULER HERMES COUNTRY RISK GRADE: B**

**EULER HERMES COUNTRY RISK LEVEL: LOW**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
Country Risk Levels are on a scale of LOW, MEDIUM, SENSITIVE, HIGH

## Basic indicators

Selected economic indicators	2008	2009	2010	2011f	2012f
Nominal GDP (USD mn)	4,531,797	5,051,596	5,878,321	7,010,571	8,343,149
Population (mn)	1,337.40	1,345.80	1,354.25	1,362.76	1,371.32
GDP per capita (USD)	3,389	3,754	4,341	5,144	6,084
Real GDP growth (% yr/yr)	9.6	9.2	10.3	9.0	8.5
Inflation (% annual average)	5.9	-0.7	3.3	5.5	4.1
Fiscal balance (% of GDP)	-0.8	-2.0	-2.3	-1.5	-1.3
Current account balance (% of GDP)	9.1	5.2	5.2	4.5	4.5
External debt/GDP (%)	8	7	10	9	8
External debt/Exports of goods & services (%)	23	27	33	30	27
Interest payments/Exports of goods & services (%)	1	1	1	1	1
Foreign exchange reserves (USD bn)	1,949	2,416	2,866	3,320	3,833
Import cover (months)	14.9	21.0	19.1	18.2	17.9
Exchange rate assumption, RMB:USD (av)	6.95	6.83	6.77	6.50	6.15
f: CRU central forecast					

Sources: National, IMF, World Bank, ADB, Euler Hermes Country Risk Unit

## CHINA: UPDATE

### 1. GOVERNMENT DEBT AND BANK LENDING

#### Local government debt

There have been several measures of local government debt cited recently:

- *Variant 1.* The National Audit Office (NAO) in July 2011 published estimates of local government debt. The total outstanding was put at RMB10.7 trillion (trn.) or 27% of GDP at end-2010, of which RMB5trn was owed by local government financing vehicles (LGFVs). LGFVs are special purpose vehicles set up to borrow, usually from banks, as local governments technically are not permitted to run fiscal deficits under the Budget Law. These figures are from an official source.
- *Variant 2.* There were reports (cited by a local investment bank) that the China Banking Regulatory Commission put loans to LGFVs at RMB9.7 trn at end-November 2010. This figure has not been confirmed by the CBRC.
- *Variant 3.* In June 2011 the PBOC (Central Bank) in its annual regional finance report suggested that up to 30% of total bank assets at end-2010 could be loans to LGFVs. That would put outstanding debt of LGFVs at RMB14.4trn or 36% of GDP. This is a maximum and some local analysts have suggested that the PBOC were referring to 30% per region maximum.
- *Variant 4.* Also in June 2011 Moody's put estimated LGFV debt RMB3.5trn higher than the NAO figure, which would put total Local government debt at RMB14.2trn. The estimate was based on the discrepancy between the NAO data and estimates based on the PBOC figure, though at a press conference the Moody's analyst said that they had taken 25% rather than 30%.

Only variant 1 is verifiably official, but may not have included debt that was not guaranteed by, but in some other way is or may become the responsibility of the central government. So we are left with estimates. The high end of the range can be put at total outstanding LG debt of RMD19.9trn or about 50% of GDP, based on the estimate of non-LGFV debt by the NAO of RMB5.8trn plus the LGFV debt estimated using the PBOC's maximum LGFV debt of RMB14.4trn. The low end of the range is that of the NAO of RMB10.7trn or 27%.

## Central government debt

Central government debt was RMB7.1trn at end-2010 or 17.7% of GDP and is projected to be RMB7.8trn at end-2011 or 17.1% of GDP (IMF data).

## General government debt

Local government debt and central government debt together gives an end-2010 range of RMB17.8trn or 44.6% of GDP (low) and RMB27.3bn or 69% of GDP (high). There is no real way of knowing which of these estimates is closest to the actual figure, though it is reasonable to conclude that the high estimate probably overstates the number and the low estimate understates. If we took the difference between the estimate based on the CBRC and PBOC figures for LGFVs and added the NAO data for non-LGFV we would get a figure of RMB18.8trn for local government debt, which added to the RMB7.1trn central government debt would give a total of RMB18.8trn or 61% of GDP. This might be a reasonable “working” estimate. There are also other off-balance sheet items which makes estimation of the total public sector debt even more challenging.

Even if we take the high estimate the debt-GDP ratio of 69% it is well below that of even strong Western economies such as Germany. The fiscal deficit is also relatively small at less than 2% of GDP and growth is relatively strong. The growth of lending to LGFVs slowed in 2010 compared with 2009. Overall, general government debt is much higher than usually reported in official figures, but does not appear to be at unsustainable levels.

However, general government debt levels appear likely to be a constraint on government action should there be another abrupt slowdown as in early 2009, as there is some risk to bank NPLs owing to doubts over the quality of some of this lending to LGFVs

## Bank lending and NPLs

Following the release of the NAO data Moody's raised their estimate of banking sector NPLs to 8-12%, against a previous estimate of 5-8%. Official data puts NPLs at just over 1%. It is not at all clear how much of the lending to LGFVs is poor quality, but it is fairly safe to assume that NPLs are higher than the official level. As the IMF noted in its recent article IV consultation document, given the large expansion in credit in the past 21/2 years, a co-ordinated shock on multiple fronts (including lower growth, a sharp real estate downturn and higher interest rates) would leave some of the smaller private banks with insufficient capital to meet regulatory requirements.

It is also important to note from a macroeconomic policy perspective that credit to the private sector was 131% of GDP at end-2010 compared with 103% at end-2008, an indication of the massive credit expansion underpinning the stimulus in 2009. This will also constrain the policy response in the event of an abrupt slowdown.

## Impact on macroeconomic policy actions

The increase in local government debt, bank credit and possible bank NPLs, would seem to shift the focus of a future stimulus in the event of an abrupt economic slowdown towards a more orthodox fiscal expansion. There is scope for this kind of expansion, but it would probably take more time to feed through than the stimulus in 2009. For the time being the authorities remain focused on inflation, though monetary policy tightening as probably run its course, as inflation appears to be peaking. In the event of the global slowdown gathering pace it is likely that the authorities will quickly relax policies, albeit, necessarily, more cautiously than before.

## 2. GDP GROWTH AND INFLATION

The economy is clearly slowing, but not too abruptly so far. In Q2 2011 real GDP increased by 9.5% yr/yr, down slightly on 9.7% yr/yr in Q1. Qtr/qtr (seasonally adjusted) the increase was 2.2%, slightly up on a revised 2.1% for Q1. Q3 data so far suggest that the economy is continuing to slow in yr/yr on terms. Much will depend on export growth in the coming months and the potential knock-on effects, if the US and EU slip into renewed recession. Construction also remains a potential source of weakness, were prices to fall abruptly in the property market.

Inflation has been the main focus policy for some time, as the yr/yr rate of increase of consumer prices accelerated to 6.5% in July 2011. Non-food inflation, however, remains quite low and overall inflation should peak shortly. That will allow the authorities to shift the policy focus back towards growth in the event of a sharp fall in export growth (see above).

Absent a slide into global recession, growth is likely to be around 9.0% followed in 2011 followed by 8-8.5% in 2012.

### **3. EXTERNAL BALANCE AND EXTERNAL DEBT**

Export growth is slowing but it is unlikely that a sharp fall in exports consequent on the global slowdown gathering pace—should this occur—would shift the trade balance into deficit, as imports will probably fall at least as much (in fact in 2009 imports fell more than exports). It is unlikely in such a scenario that commodity prices would continue to rise which was one of the key factors behind the stronger growth of imports earlier this year. Overall, the current account surplus is expected to remain around 4.5% of GDP in 2011 and 2012 (5.2% 2010).

Net FDI inflows are also strong and, despite some ongoing capital flight there has been a steady increase in FX reserves, which provide 18 months import cover and are more than 6 times external debt repayments falling due in 2012. The exchange rate has appreciated slowly for much of 2011. Slow appreciation is likely to remain the trend, although a pause is likely if exports slow abruptly. External debt is low at 9% of GDP and 30% of exports of goods and services. Interest payments are less than 1% of exports of goods and services.

### **4. STRUCTURAL BUSINESS ENVIRONMENT**

The Structural Business Environment is below average in our assessment.

Based on data and definitions from the World Bank's 2011 Doing Business Survey, Protecting Investors and Paying Taxes were weaker areas, ranking below average, and Starting a Business and Dealing with Construction Permits were particularly weak. The World Bank Institute's Governance Research Indicator puts Regulatory Quality above but Rule of Law and Control of Corruption below the average for the East Asia region. Regulatory Quality and Rule of Law are above but Control of Corruption is below average for the Upper Middle Income group of countries.

### **5. POLITICAL STABILITY**

The transition from the fourth to fifth generation leadership is underway. The two front-runners of the fifth generation of leadership are Xi Jinping and Li Keqiang. China's Vice-President Xi Jinping was appointed as vice-chairman of the Central Military Commission in October 2010, bolstering his position in line to become communist party secretary in 2012 at the 18<sup>th</sup> Party Congress, and president in 2013, both in succession to Hu Jintao. Li Keqiang is expected to succeed Wen Jiabao as PM. At this point there is little to suggest a succession crisis.

Nonetheless, the huge social transformation within China poses serious medium-term challenges for the one-party system, reflecting the inherent tension between liberal economic policies and the CPP's desire to maintain tight political control. High growth, essential to CPP dominance, will almost inevitably raise expectations of greater political expression and representation among those in the market economy and potential for social discontent among those disadvantaged or displaced. The risk is that the leadership will put one party control first and fail to keep pace with the demands of economic reality. In the near-term the key challenge to maintain the balance between adequate growth and controlled inflation, as failure on either front will increase the risk of social unrest.

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