

Atradius Country Report

China – October 2013



China: Atradius STAR Political Risk Rating*:

3 (Good) - Stable

* The STAR rating runs on a scale from 1 to 10, where 1 represents the lowest risk and 10 the highest risk.

The 10 rating steps are aggregated into five broad categories to facilitate their interpretation in terms of credit quality. Starting from the most benign part of the quality spectrum, these categories range from 'High Quality', 'Good', 'Adequate', 'Impaired' to 'Prohibitive Conditions', with a separate grade reserved for 'Off Cover.'

In addition to the 10-point scale, there are rating modifiers associated with each scale step: 'Positive', 'Stable', and 'Negative'. These rating modifiers allow further granularity and differentiate more finely between countries in terms of risk.

For further information about the Atradius STAR rating, please [click here](#)

Overview

General information

Capital:	Beijing
Government type:	Communist state
Currency:	Yuan (CNY), also referred to as renminbi (RNB)
Population:	1.36 billion
Status:	Lower middle income country (GDP/capita: US\$ 6,786 in 2013)

Most important sectors (2012, % of GDP)

Services:	40 %
Industry/mining:	49 %
Agriculture:	11 %

Main import sources (2012, % of total)

Japan:	9.8 %
South Korea:	9.2 %
USA:	7.1 %
Germany:	5.1 %
Australia:	4.3 %

Main export markets (2012, % of total)

USA:	17.2 %
Hong Kong:	15.8 %
Japan:	7.4 %
South Korea:	4.3 %
Germany:	4.0 %

Main expenses of foreign exchange

Electrical machinery, petroleum and petroleum products, industrial machinery, textiles

Main sources of foreign exchange

Machinery and equipment, clothing and garments, yarn and textiles

Key indicators

	2010	2011	2012	2013*	2014*
GDP (US\$ million)	5,950,022	7,314,388	8,358,804	9,354,670	10,472,830
Real GDP growth (%)	10.4	9.1	7.8	7.5	7.3
GDP per capita (US\$)	4,394	5,369	6,100	6,786	7,559
Inflation p.a. (%)	3.2	5.5	2.6	2.7	3.6
Fiscal balance (% of GDP)	-1.7	-1.1	-1.6	-2.1	-2.1
Total foreign debt (US\$ million)	558,344	685,418	728,911	783,324	835,640
Foreign debt/GDP (%)	9.4	9.4	8.7	8.4	8.0
Foreign debt/XGS (%)	31.2	32.1	31.3	31.2	30.7
Short-term debt/inter. reserves (%)	12.2	14.5	14.8	14.7	15.8
Debt service ratio (%)	3.6	3.7	1.7	2.0	2.2
Current account balance (US\$ million)	237,812	136,097	193,142	191,938	185,466
Current account/GDP (%)	4.0	1.9	2.3	2.1	1.8
Nom. exchange rate to US\$ (average)	6.77	6.46	6.31	6.22	6.19
International reserves (US\$ million)	2,841,238	3,295,220	3,321,601	3,526,290	3,445,080
In months of merchandise imports	26.4	24.0	23.0	22.9	20.5

* forecast

Source: Economist Intelligence Unit (EIU), International Monetary Fund (IMF)

Political situation: Stable

Head of state:	President and General Secretary of the Chinese Communist Party (CCP) Xi Jinping (since 14 March 2013)
Head of government:	Prime Minister Li Keqiang (since 16 March 2013)
Form of government:	One-party system, ruled by the CCP

Power transition at the top of the state

Overall, the domestic political situation in China is stable, with a smooth transition to the top positions of power: the appointment of new president Xi Jinping, succeeding Hu Jintao, and new Prime Minister Li Keqiang, succeeding Wen Jiabao.

The new government has launched a campaign against corruption and extravagance by top party officials, which has led to the recent conviction on corruption charges of Bo Xilai, a former Politburo member and Communist Party Secretary of the city of Chongqing. His ousting also points to some tensions within the ruling Communist Party (CCP).

To prevent any major social unrest, the administration's main aim is to preserve high economic growth to create jobs, combat inflation and develop a public welfare safety net. The protests and uprising in the Middle East and North Africa have made the Chinese government acutely aware of the potential for similar developments in China. While it has become more

difficult to prevent public demonstrations and criticism of the government (via the internet), a major difference between China and the affected Middle Eastern countries is that the living standards of many Chinese people have improved: GDP per capita has risen from US\$ 847 in 2000 to US\$ 7,559 in 2013. Nevertheless, there is sharp income disparity between the rural and the urban population, and between the coastal provinces and the Western parts of the country. In recent years, social discontent has grown in several provinces, fuelled by corruption in local government, environmental problems and weak protection of property and land rights. In many cases, farmland has been illicitly expropriated by the local authorities for commercial use but so far protests have flared up only locally and have been swiftly contained by the security forces.

Stable international relations, but growing Chinese assertiveness in the region

Sino-US relations are generally stable, despite some regularly emerging tensions over US arms sales to Taiwan and human rights issues. Little progress has been made in disputed Sino-US economic issues such as the exchange rate and the Chinese trade surplus. The Yuan is still linked to a basket of currencies and has slowly appreciated – but too slowly in the view of both the US administration and Congress, which are continuing to exert some pressure to accelerate progress.

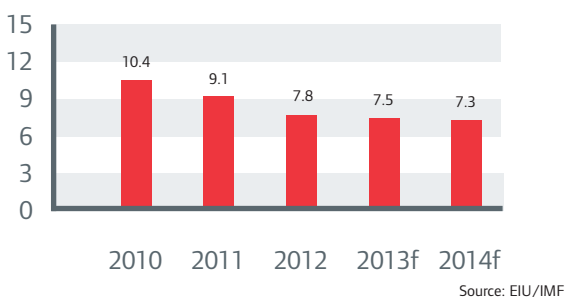
During the last three years, the US military has become increasingly concerned about Beijing’s military build-up: especially the implication of China’s naval and air force capabilities for power projection in the Pacific. The recent shift in US defence strategy, with a renewed focus on Asia-Pacific, is motivated mainly by Washington’s aim to balance rising Chinese power in the region.

One issue is Beijing’s increasing assertiveness in the South China Sea, where it claims sovereignty over a large U-shaped area, bringing it into dispute with several neighbouring countries. Since 2012 tensions with the Philippines and Vietnam have increased again over disputed islands in that area.

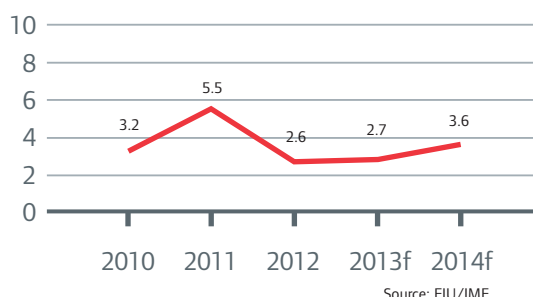
At the same time, relations with Japan have deteriorated since 2012 over the Senkaku//Diaoyu islands claimed by both sides. Currently neither China nor Japan shows signs of compromise and regular incursions of Chinese ships into Japanese-claimed territorial waters around the islands have increased the danger of a clash.

Internal economic situation: Growth is slowing down

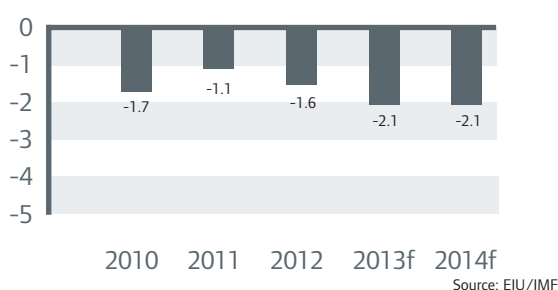
Real GDP growth (%)



Inflation p.a. (%)



Fiscal balance (% of GDP)



Lower official growth targets in 2013 and 2014

In 2012 Chinese economic growth slowed to 7.8% year-on-year, after 9.1% in 2011. Growth is expected to decelerate further - to 7.5% in 2013 and 7.3% in 2014 - as investment and government spending decrease. However, economic performance will be sustained by rising private consumption, which will be supported by higher wages. Urbanisation is one of the government's key ways of stimulating private consumption. With increasing domestic demand, import growth will outpace export growth and the external balance will detract from GDP growth.

Because of earlier tightening of monetary policy, inflation has fallen since late 2011 and is now expected to be 2.7% this year, after 2.6% in 2012. This modest inflation means that the central bank, the People's Bank of China, can maintain its relaxed monetary stance: it is possible that it will cut rates later this year to reduce financing costs for struggling Chinese businesses.

However, residential house prices have again increased sharply. In China's biggest cities, prices increased almost 20% year-on-year in August this year, despite the administrative measures already in place to constrain the surge in housing prices. As a result, affordable housing is currently a serious issue.

Economic policy still focused on rebalancing

It is important for China to rebalance its economy. The enormous stimulus package of 2008/09 has aggravated the imbalances in the economy by promoting investment and this constitutes a major economic risk. Together with massive credit expansion over the past four years, inefficient investments have created a bubble in the property market.

As in 2012, the government is keeping to the official GDP growth target of 7.5% for 2013, so that it has some leeway for economic restructuring. This - by Chinese standards - relatively low percentage is an indication of the government's ambition to steer the economy towards what it sees as a slower, steadier and healthier growth pattern. Both President Xi and Prime Minister Li have repeatedly emphasised that the government is ready to accept slower growth as it rebalances away from an investment-driven, export-dependent economy, to a more services-oriented and consumption driven economy.

We expect the announcement of further gradual economic reforms at the Third Plenary Session of the Central Committee in November 2013, especially with regards to urbanisation, the liberalisation of the capital account, resource pricing and allowing private investment in some state-owned monopolies. Such reforms would support industrial upgrading, provide more equality in income distribution and help to establish a more consumption-driven and services-based economic structure, further reducing China's vulnerability to volatility in the global economy. With higher spending on social services, the government is trying to moderate the increasing social inequality as well as rebalance the economy.

Monetary policy: gradual Yuan appreciation to continue

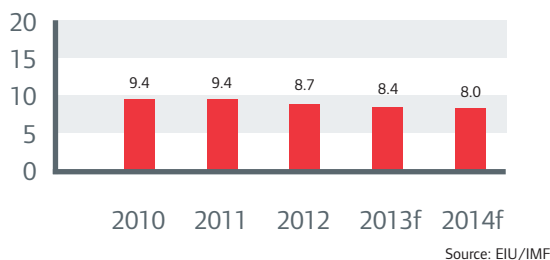
The Yuan is de facto fixed, with a crawling peg to the US\$ that allows some fluctuation within a range of rates. The band in which the Yuan can move against the US\$ each day has been widened to 1% from its previous 0.5%. It is expected that further appreciation will be gradual, as a faster rate would hurt the international competitiveness of Chinese industries and exports.

Rising budget deficit

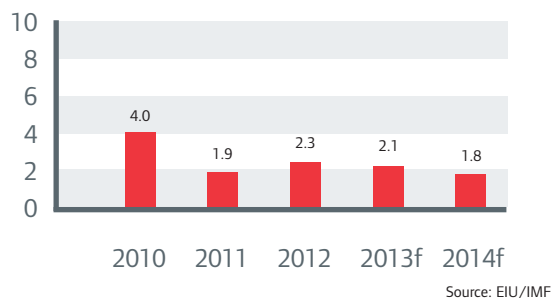
China's budget deficit will increase as spending on social welfare services rises, but remains relatively low at 2.1% of GDP in 2013 and 2014. Government debt is estimated to have been 16% of GDP in 2012. However, some fiscal accounts are far from transparent and it is estimated that there are large contingent liabilities for the central government, especially due to the debt burden of local administrations (see page 7).

External economic situation: Still very strong

Foreign debt/GDP (%)



Current account/GDP (%)



Foreign debt

Level: Low (US\$ 783 billion, 8 % of GDP and 31 % of exports of goods and services in 2013)
Structure: The short-term debt share is 66 % in 2013, but is wholly covered by reserves.
Debt service ratio: Low (2 %, including short-term 20 %)

Remarks:

Debt has increased rapidly since 2009: especially short-term debt (trade credit and trade financing). However, the debt ratio as a percentage of GDP is still good. The country holds enormous foreign reserves (see below) and its solvency and liquidity are sound, with ample capacity to make external payments.

Balance of payments

Trade balance: Large surpluses
Current account: Decreasing surpluses (2.1 % of GDP in 2013)
Capital Account: Surpluses
Total Account: Positive

Remarks:

With imports increasing, the current account surplus has decreased over the last couple of years, and this will continue in 2013 and 2014, as private consumption rises. The services account turned negative in 2011, with many Chinese holidaying abroad. Given the weaknesses in the financial sector, the liberalisation of the capital account will be gradual.

International reserves

In months of imports (cif): China has the largest foreign exchange reserves of any country, due to its strong balance of payments: 22 months of import cover in 2013.

Domestic risk factors – mitigated by strong liquidity and solvency

Although China is by no means immune to weaker external demand, the main risks to future growth are related to the internal market. Local government and the banking sector debts remain contingent liabilities for the central government. Public debt is currently moderate but, when contingent liabilities are taken into account - such as bank restructuring in the event of deterioration in the financial sector and future pension and social security costs - that debt becomes much higher.

The real estate sector

There are ongoing concerns that the perceived property overvaluation may be subject to sharp correction. Moreover, investment in real estate has been a major driver of economic growth in the past and a sharp price correction would have an impact on the whole economy via the banking sector and local governments.

A weak banking sector

The Chinese banking sector remains weak, as high credit growth in previous years could lead to deteriorating asset quality in the financial sector. Although non-performing bank loans are currently low (1%), this percentage will inevitably rise in the medium term. Chinese banks played a prominent role in the massive 2008/2009 stimulus programme, and bank lending has increased sharply since then, including a large share of 'shadow banking', resulting in high investment spending. According to Fitch, the bank credit-to-GDP ratio was 136% of GDP in 2012 and as much as 198% of GDP when off balance sheet credit is included, compared to 125% in 2008. Many loans have been rolled over instead of being repaid, and the questionable quality of assets in the banking sector is a source of concern. With no precise data of shadow banking activities available, the risks to the economy are difficult to assess. However, most activity is linked to the real estate sector, and there are concerns about the banks' large exposure to the property market. Problems in the banking sector could spill over into the broader economy or even lead to the need for state intervention to support the financial system.

High local government debt

Closely intertwined with potential banking sector problems are the finances of local government bodies, which played an important role in the massive stimulus policy of 2008 and 2009. The debt burden of local governments has increased due to high investment spending, financed through borrowing by local government financing vehicles, often via the shadow banking sector. There is a lot of uncertainty about the quality of their investments and reports about high debt levels (Fitch estimates local government debt amounts to 25% of GDP) have created worries about local governments' financial health. It is estimated that about 20-25% of local government investment companies' loans are highly risky.

As land revenues are important for the funding of local government spending, any sharp downward correction in the property market could make funding difficult and would hurt the banking sector as large creditors.

Still room to stimulate the economy

However, in contrast to the situation in many mature markets, the Chinese authorities still have room to provide stimulus to the economy. The central government runs a minor budget deficit, public and external debt is very low, and China has huge international reserves. This creates a cushion for the economy in the event of any external or internal shocks, as the government has the financial muscle to take appropriate countermeasures.

Chinese industry performance: some sectors face serious challenges

Although economic growth is slowing, the Chinese business environment remains generally stable. However, some sectors are facing troubles and, while larger state-owned companies are usually financially healthy, more caution is recommended when dealing with small and medium-sized private businesses, as many of them - even those active in well-performing industries - often suffer from limited financing facilities.

Agriculture

- Healthy consumption growth across most agricultural subsectors.
- High local and global market prices for many of China's core agricultural products will boost future production volumes.
- This is a highly subsidised sector and listed as very important in the twelfth Five-Year Plan period (2011-2015).

Food and drink

- China is the fastest growing food and beverage consuming market of all major Asian countries.
- The expected growth rate of the food and beverage market in the next three years is between 2.7% and 3.6%.
- However food safety, hygiene and poor quality control remain issues.

Pharmaceuticals and healthcare

- China's pharmaceutical market is the third largest in the world.
- The government will continue to increase its investment and expects to lift GDP expenditure on healthcare from 4% in 2011 to 6-7% in 2015.
- The pharmaceuticals distribution sector has been consolidating in recent years
- Bribery scandals have harmed large pharmaceutical sales in China. Investigation of bribery has spread from foreign firms to include domestic pharmaceutical firms as well.

ICT/Electronic machinery

- The Chinese electronic machinery sector sustained growth in 2012.
- China has surpassed the US as the world's largest PC market.
- More sluggish demand in the IT sector resulting from the domestic economic slowdown and weakness of export markets.

Solar

- Affected by poorer European demand and future high customs taxes as the result of anti-dumping and subsidy investigations launched by the US and the EU.
- Overcapacity and lack of vital skills.

Construction & construction materials

- Consumption will decrease as the government introduces measures to cool the bubble in the residential property market.

Steel

- China remained the world's largest steel producer in 2012.
- Overcapacity and huge stockpiles are still major challenges and the main reasons for the continuing deterioration in this industry. Together with rising input costs these are reducing steel producers' margins.
- Financing in the steel sector has become more difficult, as banks slash loans further due to increasing bad debts and the deteriorating market outlook.

Shipping

- Overcapacity and lower demand continue to plague the market.
- The growth forecast for 2013 is slower than in the past decade.
- Expected taxation reform will be launched to reduce the tax burden of domestic shipping companies.

Coal





















- Weakening coal demand as a result of slower economic growth and rising public anger over air pollution from coal burning.
- Overcapacity is a serious problem generated from past overinvestment in the coal sector.
- Due to falling coal prices, the net profits of large and medium sized coal producers decreased by more than 40% in 2012.
- Market condition will not improve in the short term.

Paper

- Slower growth in demand while overinvestment in production has led to overcapacity.
- Some small and medium-sized businesses engaged in producing and trading pulp & paper products have had to leave the market due to the economic slowdown.
- Lower investment in capacity has led to a better situation in 2013. However, balancing the supply/demand relationship will take at least two years.

China industries performance forecast

October 2013

Agriculture	Automotive/ Transport	Chemicals/ Pharma	Construction	Construction Materials	
					 Excellent
Consumer Durables	Electronics/ICT	Financial Services	Food	Machines/ Engineering	 Good
					 Fair
Metals	Paper	Services	Steel	Textiles	 Poor
					 Bleak

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