People's Republic of China
Rating Report

SCOPE A+ NEGATIVE OUTLOOK

Credit strengths

- Large and diversified economy with strong growth potential
- High external resilience and large foreign exchange reserves
- Government control in some sectors may facilitate effective reform

Credit challenges

- Large public sector deficits and rising public debt
- Financial imbalances including high levels of non-financial sector debt

Rating rationale:

Large and diversified economy: China's rating is supported by its large, highly diversified and competitive economy. Despite the gradual decline towards a more sustainable growth model, medium-term growth expectations remain high compared with similarly rated peer countries.

High external resilience: The country's high external resilience is underpinned by high foreign exchange reserves, low external debt and consistent current account surpluses.

Government's scope to implement reforms: China's central government exerts significant control over some sectors. This can support the implementation of effective reforms, including extraordinary macroprudential measures. While this can bolster reform momentum in the near term, it can have credit-negative implications in the longer run by reducing the quality of governance and policymaking.

Rating challenges include: i) large structural public sector deficits and an increasing public sector debt stock in the long run and ii) financial imbalances including high levels of total non-financial sector debt since 2008.

China's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aaa		+3/3	
Public Finance Risk		25%	b		0	
External Economic Risk		10%	aaa		+3/3	
Financial Stability Risk		10%	bbb-		0	A+
ESG Risk	Environmental Risk	5%	bb		-1/3	
	Social Risk	5%	aa-		0	
	Governance Risk	10%	c		0	
Overall outcome		bbb+		+1	+2	

Note: The sum of the qualitative adjustments, capped at one notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. In line with our methodology, movements between indicative ratings are not immediate but are executed after analyst review of CVS results. The rating committee approved an implied core variable scorecard (CVS) rating of 'bbb+'.
For details, see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Negative Outlook reflects Scope's view that risks to the ratings are tilted to the downside over the next 12 to 18 months.

Positive rating-change drivers

- Strengthened public finances, resulting in an improved public debt trajectory
- Economic and financial reforms strengthen financial stability and/or the economic growth outlook
- Substantive gains of the renminbi as a reserve currency

Negative rating-change drivers

- A financial or economic shock materialises, impairing economic growth over the medium term
- Protracted fiscal deterioration and/or crystallisation of contingent liabilities, leading to weakened fiscal outlook
- Material weakening of China's external resilience

Ratings and Outlook

Foreign currency

Long-term issuer rating	A+/Negative
Senior unsecured debt	A+/Negative
Short-term issuer rating	S-1+/Negative

Local currency

Long-term issuer rating	A+/Negative
Senior unsecured debt	A+/Negative
Short-term issuer rating	S-1+/Negative

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Bloomberg: RESP SCOP

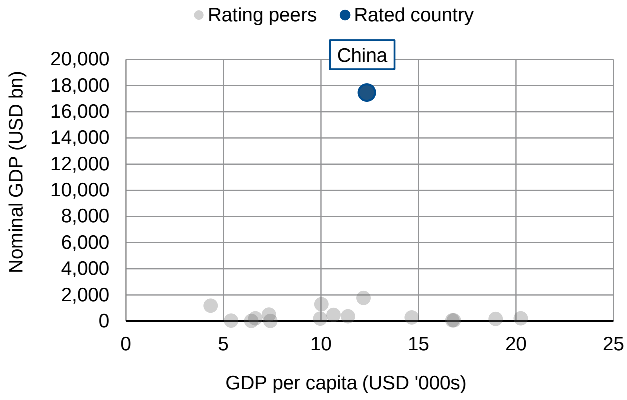
Domestic Economic Risks

- **Growth outlook:** With the second highest nominal GDP in the world, China's rating is supported by its large, highly diversified and competitive economy. The pandemic has resulted in the slowest economic growth for several decades, although China's economy was among the very few worldwide to still grow in 2020, expanding by 2.2%. Growth rebounded by 8.1% in 2021, driven by increased exports and investments, and easily exceeded the growth target of above 6% set by the authorities. The economy lost some momentum in the second half of 2021, mostly on the back of declining real estate investments given the introduction of policy measures aimed at deleveraging the real estate sector. Following slightly faster-than-expected growth in Q1 2022, several outbreaks of the Omicron Covid-19 variant and the continued implementation of the zero-Covid policy led to a significant slowdown. Consumption weakened as reflected by an 11% drop in retail sales in April compared with the previous year and industrial production decreased by 2.9%. We see significant challenges in reaching this year's 5.5% growth rate target set by authorities and expects slower growth of around 4.2% in 2022 with output expanding near its potential at 5.1% next year.
- **Inflation and monetary policy:** Monetary policy has been effective at maintaining inflation rates below 3% over the past years and inflationary pressures have remained subdued in recent months compared with peers. CPI inflation reached 2.1% in April 2022, up from 1.5% in March, mostly due to rising food prices and supply bottlenecks amid Covid-19 restrictions. Some monetary policy easing measures have been taken to support the slowing recovery. These include a reduction of banks' reserve requirements by 25bp and a reduction of the five-year lending rate from 4.6% to 4.45% in May. The reduction of the five-year lending rate should result in lower costs for mortgage borrowers, thereby supporting the slowing real estate market.
- **Labour market:** The official survey-based urban unemployment rate averaged 5.1% in 2021 and has been increasing in 2022 amid the zero-Covid policy restrictions, reaching 6.1% in April. Supporting the weakening labour market has become an important policy focus and all government departments and regions have been instructed to prioritise measures to help businesses retain jobs. We expect the unemployment rate to average 5.7% this year and fall to 5.6% in 2023.

Overview of Scope's qualitative assessments for China's *Domestic Economic Risks*

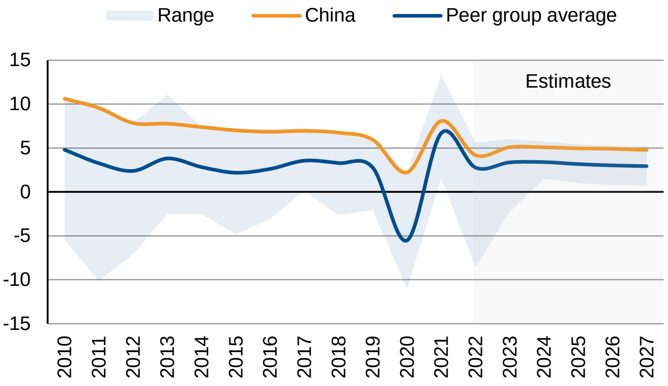
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Strong	+1/3	Growth potential is still high, despite the structural decline
	Monetary policy framework	Strong	+1/3	Effective monetary and exchange-rate policy, focus on maintaining financial stability
	Macro-economic stability and sustainability	Strong	+1/3	Highly diversified and competitive economy, significant economic size, labour market rigidities

Nominal GDP and GDP per capita, USD '000s



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

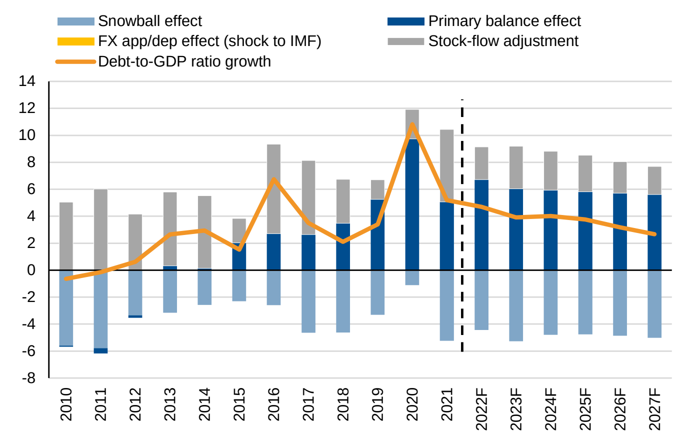
Public Finance Risks

- **Fiscal outlook:** Measures to support the economy at the onset of the pandemic resulted in a large increase in budget deficits, reaching 10.7% of GDP in 2020. Fiscal policy became significantly more contractionary in early 2021 as policymakers shifted focus towards deleveraging. While some targeted fiscal support remained, including for small firms, the deficit decreased to 6% in 2021 driven by lower levels of public investment. In light of a slowing economy, we expect fiscal policy to be more expansionary this year as nationwide tax and fee cuts raise the deficit to 7.7%. The IMF's augmented net lending/borrowing metric for China aims to account for infrastructure spending, financed through off-balance-sheet local government financing vehicles (LGFVs), special construction funds and government guided debt issuance. According to this measure, China's fiscal deficit stood at 16.5% of GDP in 2021, down from 19.9% in 2020, and only gradually falling towards 13% by 2026. The authorities have implemented new restrictions on off balance sheet financing channels to reduce the high levels of leverage taken on by LGFVs. The recent real estate market downturn places local governments in greater financial difficulty due to the expected drop in land sale revenue. To soften the impact, the central government plans to make large transfers to local governments, estimated at RMB 9.8tn for 2022 (up 18% from 2021).
- **Debt trajectory:** government debt increased from 34% of GDP in 2010 to 57% in 2019. The fiscal stimulus in response to the pandemic raised debt levels to 73% of GDP in 2021 and we expect debt to reach around 93% of GDP by 2026, reflecting a steepening debt trajectory. Under the IMF's broader definition, including LGFVs and other off-balance-sheet entities, the government's 'augmented debt' stood at 95.7% of GDP in 2020 and, following a steepening debt trajectory, is expected to reach 129% by 2026.
- **Market access:** China's benchmark 10-year yield stands at 2.8%, below pre-crisis levels. Central government debt has an average maturity of 6.1 years, up from around 5 years before the pandemic. The country issues mainly in renminbi although there has been an increase in foreign currency issuances (US dollars, euros, Hong Kong dollars and Japanese yen). These include more significant dollar issuances in recent years by local authorities and LGFVs, often with shorter remaining maturities.

Overview of Scope's qualitative assessments for China's *Public Finance Risks*

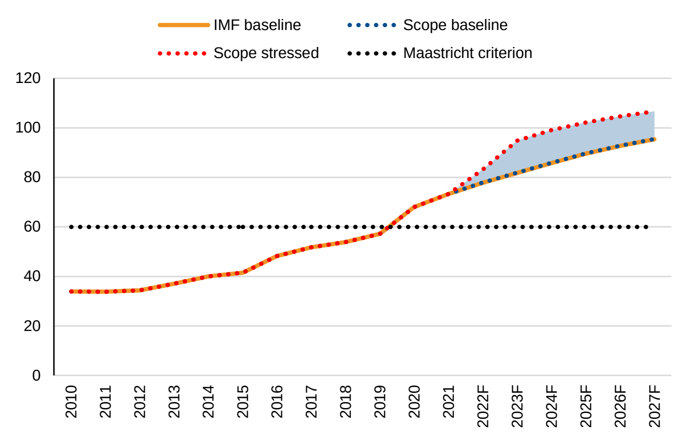
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Fiscal policy framework	Weak	-1/3	Significant structural deficits, wider augmented budget deficits with inclusion of off-balance-sheet spending
	Debt sustainability	Neutral	0	Rising public debt ratio, significant off-balance-sheet debt, but moderate explicit central government debt
	Debt profile and market access	Strong	+1/3	High government financing needs but most issuance in local currency, significant government assets, development of domestic bond market

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

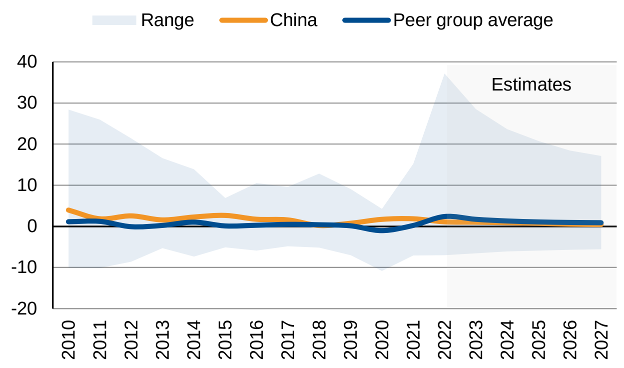
External Economic Risks

- **Current account:** China's current account balance improved at the onset of the pandemic, rising from 0.7% in 2019 to 1.7% in 2020 and remaining at 1.8% in 2021. This was driven by the increase in trade-in-goods surplus at 3.2% of GDP in 2021, and the declining trade deficit for services that stood at 0.6%. This largely reflects the strong rebound in global trade since the second half of 2020, combined with the sudden collapse in outbound travel spending. Strong overseas demand continued to support exports, which slowed down in early 2022 due to Covid-19 lockdowns, but are still up by 20.7% in the 12 months to April compared with the previous year. We expect continued modest current account surpluses of close to 1% in 2022 and 2023, followed by a gradual decline as the effects of the drop in outbound travel and the surge in exports wane, with the economy rebalancing towards consumption-driven growth.
- **External position:** China's net international investment position has gradually fallen over the past 10 years from 24.5% of GDP in 2010 to 11.4% of GDP in 2021. The decline reflects higher inward direct investment and securities investment received amid relatively robust GDP growth. The net international investment position is expected to remain positive, although declining, over the medium term and above the peer group average. FDI inflows reached an all-time high of USD 334bn (1.8% of GDP) in 2021 as the impact of Covid-19 on GDP growth faded and the authorities continued with initiatives to liberalise the economy for foreign firms. However, capital outflows intensified during the first half of 2022 amid renewed Covid-19 restrictions and rising interest rates in other major economies.
- **Resilience to shocks:** Resilience to short-term shocks is bolstered by the country's sizeable foreign exchange reserves, which amounted to USD 3.2trn in March 2022, and its low external debt of USD 2.7trn (16.2% of GDP) as of Q4 2021. Russian sanctions over the Ukraine invasion and hikes in US interest rates have fuelled discussions on a faster reduction of China's reliance on the dollar. Anticipated long-run gains by the renminbi as a global reserve currency are expected to increase the government's capacity to manage higher debt stocks. It would also enhance the currency's resilience and China's external-sector stability, such as reducing vulnerabilities to periods of capital outflows.

Overview of Scope's qualitative assessments for China's *External Economic Risks*

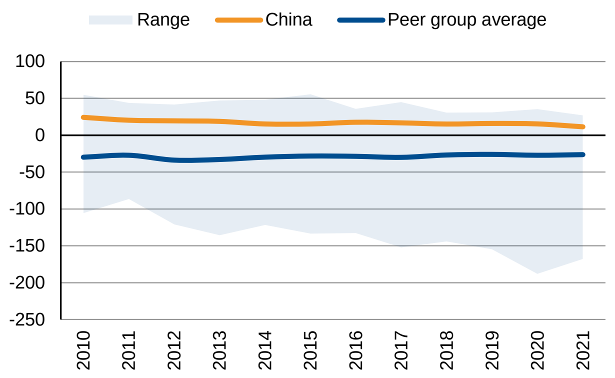
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Current account resilience	Strong	+1/3	Diversified and competitive export base, current account surpluses, risk from periods of capital outflow
	External debt structure	Strong	+1/3	Very low external debt, public and financial sectors have strong liquid external assets
	Resilience to short-term shocks	Strong	+1/3	Sizeable foreign-exchange reserves, rising international use of the renminbi and foreign investment in domestic assets

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

Net international investment position, % of GDP



Source: IMF, Scope Ratings GmbH

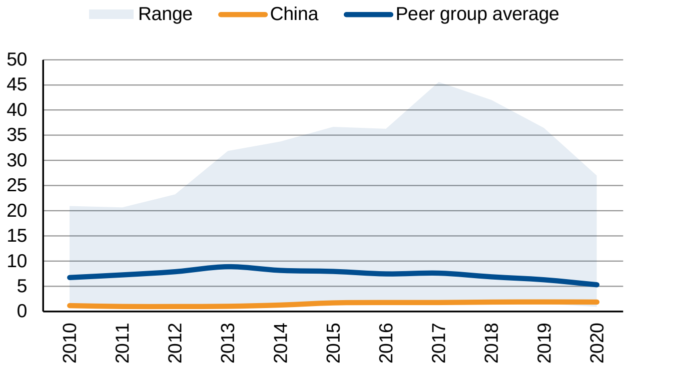
Financial Stability Risks

- **Banking sector**: On average, the banking sector maintained stable Tier 1 capital levels around 12% throughout the pandemic. Non-performing loans have also remained below the peer group average at less than 2%. Aggregate social financing, a broad measure of credit and liquidity in the economy, rose by 8.8% YoY in April 2022 – reduced from August 2020 highs of 12.6%, reflecting efforts from authorities to reduce credit growth. Given the economic slowdown caused by Covid-19 restrictions, the central bank has called for increased credit lending, including to support small businesses, and for stable growth of property loans to help cushion the downturn in real estate markets.
- **Private debt**: Non-financial sector debt is high at around 268% of GDP as of Q1 2022, but slightly lower than the all-time high of 271% reached in Q3 2020. At the end of 2021, debt levels of households and non-financial corporations stood at 221%, which remains far higher than in the United States (68%), the euro area (112%) and in other advanced economies (142%). After continued increases in private debt since the 2008 financial crisis, debt levels began to stabilise in mid-2020 at around 62% of GDP for households and 160% for non-financial corporates. Credit growth is likely to increase over the next months as authorities have eased restrictions previously introduced with a view of supporting the slowing economy. Corporate bond defaults have increased, and further orderly defaults will help to improve risk pricing, underlining the government's commitment to reform.
- **Financial imbalances**: Credit developments in the real estate sector led the authorities to enhance financial sector discipline, transparency and market-based price dynamics in their pursuit of a soft landing for China's large-scale debt accrual since the global financial crisis. At the same time, authorities also aim to reign in local government spending through off-balance-sheet financing. The three red lines policy was introduced in 2020 in order to restrict real estate developers' access to credit based on their liabilities, debt levels and cash holdings. In addition, property lending concentration rules for banks and local-level initiatives to restrict new mortgage approvals were introduced. The broad regulatory campaign triggered financial stress in several property developers, among which the most prominent property developers Evergrande Group and Sunac, who faced severe liquidity stress and ultimately defaulted. Amid sharply falling real estate prices in early 2022, the authorities will need to carefully balance risks to avoid a more severe and continuous spillover of risks across the large and domestically interconnected real estate sector.

Overview of Scope's qualitative assessments for China's *Financial Stability Risks*

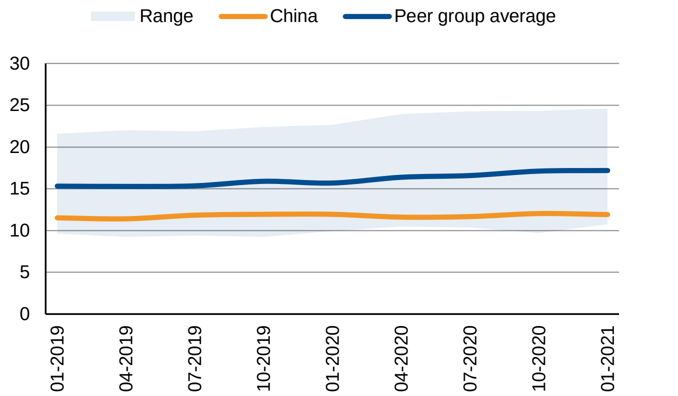
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Banking sector performance	Neutral	0	Low (reported) non-performing loans, stable bank capital adequacy
	Banking sector oversight	Strong	+1/3	Significant commitment and ability to counteract financial system risk, improvements in financial supervisory regime
	Financial imbalances	Weak	-1/3	High non-financial sector debt, increased defaults, but contained credit growth

Non-performing loans, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

ESG Risks

- **Environment:** China is the world's largest emitter of carbon dioxide, accounting for around 28% of global CO2 emissions. However, meaningful progress is being made in cutting the carbon intensity of the economy, with China with China striving to stop the growth in emissions by 2030. The 14th five-year plan set specific targets regarding the energy system and green development, which are broadly in line with China's current climate commitments to carbon neutrality by 2060. However, previous commitments to increase the share of non-fossil energy in primary energy consumption are no longer binding. The focus is now on capping carbon intensity per unit of GDP rather than capping the overall level of emissions.

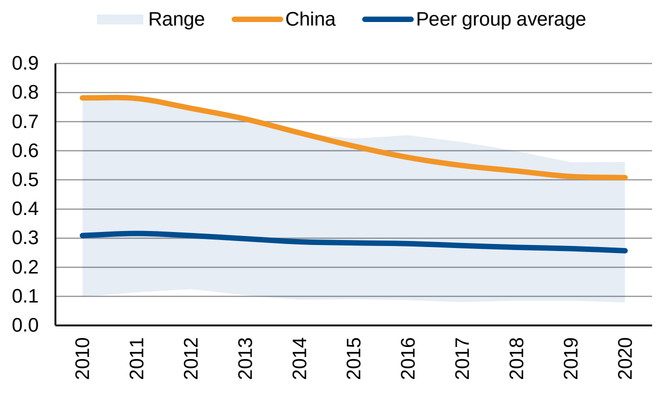
- **Social:** Significant social progress has been achieved, including improvements in poverty, education, and health. Moreover, the five-year plan has shifted towards a greater focus on the quality and efficiency of economic growth and citizens' lives (including concentrating on GDP per capita), with priorities such as boosting social safety nets, reducing urban-rural inequality and property rights reform. Social safety nets remain inadequate as less than half of urban employees are covered by unemployment insurance, with much lower rates for rural households. According to the World Bank, China's health expenditures at about 5.3% of GDP remain below other upper middle income countries (5.9%) although the gap has narrowed in recent years. Even though China's old age dependency ratio is currently healthier than those of advanced economies, the rapidly ageing population will pose challenges for the social security system. The US and other Western nations have repeatedly accused China of human rights violations.

- **Governance:** China has traditionally scored low on the World Bank's Worldwide Governance Indicators. The country ranks particularly poorly on the voice and accountability ranking. Scores on other categories such as political stability, regulatory quality, rule of law and control of corruption have improved in recent years. China achieves its highest ranking in the category of government effectiveness given its effective one-party political system. However, while the power consolidation achieved by President Xi Jinping should strengthen reform momentum in the near term, We believe it may reduce the quality of governance and policymaking in the long term.

Overview of Scope's qualitative assessments for China's *ESG Risks*

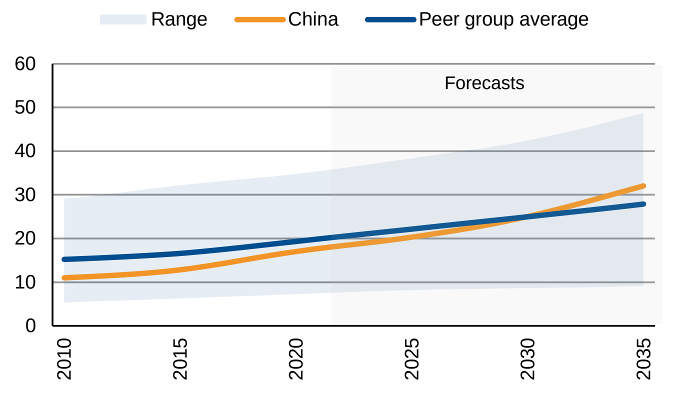
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
B	Environmental risks	Weak	-1/3	Significant transition risks in greening the economy but progress made has been substantive and objectives are ambitious
	Social risks	Neutral	0	High income and urban-rural inequalities, declining working age population, but strong educational attainment and reduction of poverty
	Institutional and political risks	Neutral	0	Improved government effectiveness, President Xi's power consolidation poses longer-term governance risk

CO2 emissions per GDP, mtCO2e



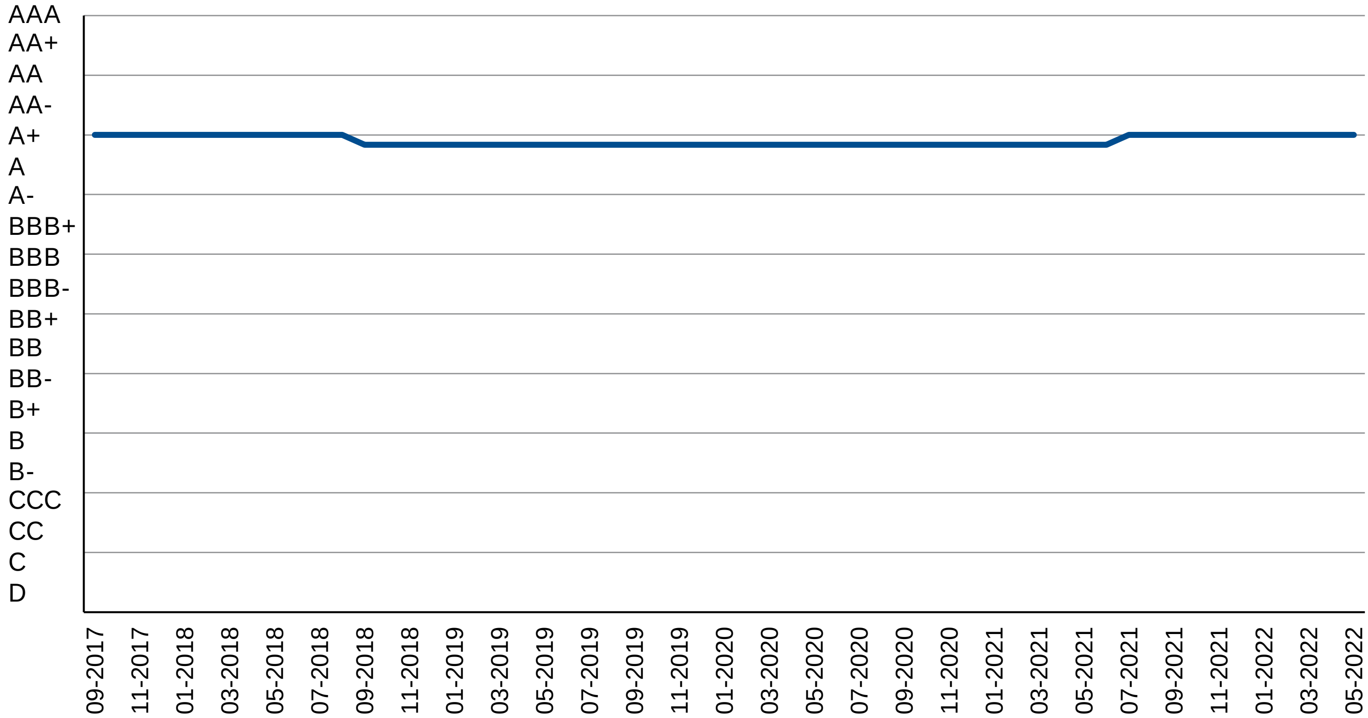
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard.

Peer group*
China
Croatia
Greece
Hungary
Romania
Russia

*Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	8.1	8.8	9.8	10.2	10.5	12.4	14.1	15.5
Nominal GDP, USD bn	11226.9	12265.3	13841.8	14340.6	14862.6	17458.0	19911.6	21865.5
Real growth, %[1]	6.9	6.9	6.8	6.0	2.2	8.1	4.2	5.1
CPI inflation, %	2.0	1.6	2.1	2.9	2.4	0.9	2.1	1.8
Unemployment rate, %[1, 2]	-	5.0	4.9	5.2	5.2	5.1	5.7	5.6
Public Finance Risk								
Public debt, % of GDP[1]	48.2	51.7	53.8	57.2	68.1	73.3	78.0	81.9
Interest payment, % of government revenue	2.4	2.6	2.8	3.0	3.7	3.4	3.8	3.9
Primary balance, % of GDP[1]	-2.7	-2.6	-3.5	-5.3	-9.7	-5.1	-6.7	-6.0
External Economic Risk								
Current account balance, % of GDP	1.7	1.5	0.2	0.7	1.7	1.8	1.1	1.0
Total reserves, months of imports	16.7	15.4	13.1	13.8	14.9	-	-	-
NIIP, % of GDP	17.7	16.8	15.2	16.0	15.4	11.4	-	-
Financial Stability Risk								
NPL ratio, % of total loans	1.7	1.7	1.8	1.9	1.8	-	-	-
Tier 1 ratio, % of risk-weighted assets	11.2	11.1	11.6	11.9	12.0	12.4	-	-
Credit to private sector, % of GDP	156.2	154.9	157.8	165.4	182.4	-	-	-
ESG Risk								
CO_2 per EUR 1,000 of GDP, $mtCO_2e$	577.1	549.2	530.4	511.5	507.6	-	-	-
Income quintile share ratio (S80/S20), x	7.0	7.2	7.0	6.8	-	-	-	-
Labour-force participation rate, %	76.2	76.1	76.0	75.9	-	-	-	-
Old-age dependency ratio, %	13.6	14.4	15.3	16.2	17.0	17.7	18.4	19.0
Composite governance indicator[3]	-0.4	-0.3	-0.3	-0.4	-0.2	-	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections

[2] The unemployment rate shown refers to China's official survey-based urban unemployment rate

[3] Average of the six World Bank Governance Indicators
Source: European Commission, IMF, World Bank, Macrobond, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economy
5y USD CDS spread (bps) as of 3 June 2022	70.4

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