People's Republic of China – Beware of the Risks

December 8, 2016

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Population (2015)	**1,374mil**
Gross Domestic Product (2015)	**11,182$bn.**
GDP Per Capita (2015)	**14,340$**
CDS Spread	**118 BP**
S&P Credit Rating, March – 16	**AA- , Negative**
Moody's Credit Rating, March - 16	**Aa3 , Negative**
Fitch Credit Rating, Nov - 16	**A+ , Stable**

	2011	**2012**	**2013**	**2014**	**2015**	**2016F**	**2017F**
GDP growth (%change)	9.5	7.9	7.8	7.3	6.9	6.6	6.2
CPI inflation (%, average)	5.4	2.7	2.6	2.0	1.4	2.1	2.3
Govt. balance (as % of GDP)	-0.1	-0.7	-0.8	-0.9	-2.7	-3.0	-3.3
Govt. Debt/GDP (%), inc. Local Govt.	33.1	34.0	36.9	39.8	42.9	46.3	49.9
CA balance (as % of GDP)	1.8	2.5	1.5	2.6	3.0	2.4	1.6
Source: IMF, October – 2016 Outlook							

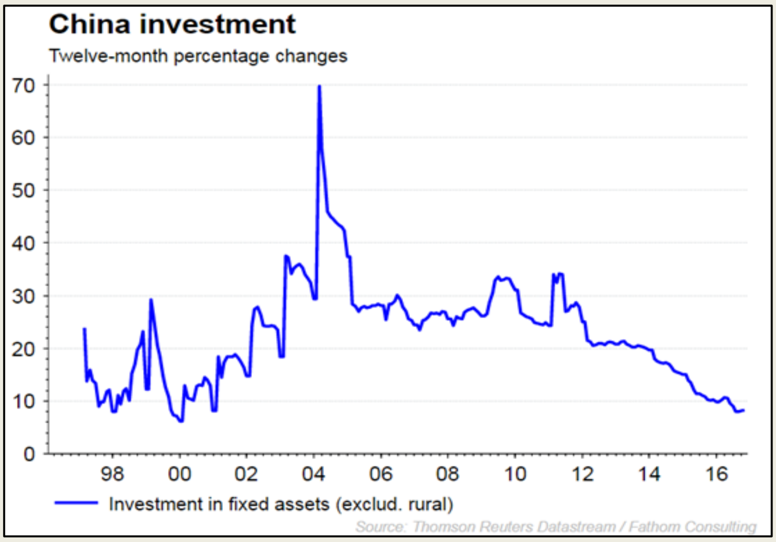
Strengths:

- High foreign currency reserves (but on a downward trend).
- Positive net external assets and credit.
- Current account surplus (but on a downward trend).
- Structural reforms that could support economic activity in the medium-term

Weaknesses:

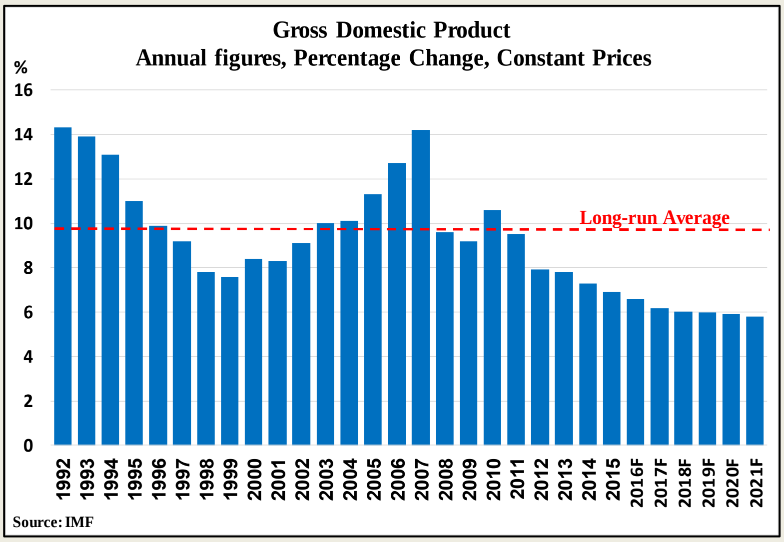
- A deterioration in economic conditions could cause a rise in political risk.
- Low level of policy transparency, and doubts regarding the veracity of the economic data.
- Ranked 83rd in the global corruption index.
- Credit risks have increased in recent years.
- Concerns exist regarding bubbles in the financial and housing markets.
- An aging population and a low population growth rate.
- Households' financial flexibility is limited.
- Bureaucratic difficulties in conducting business – ranked 78th out of 190 countries in the index on conducting business.
- The risk of global "trade wars"

Trend of substantial moderation in economic activity in recent years: According to the official figures, the Chinese economy grew 6.7% y/y in the third quarter of 2016, similar to the growth rate in the two preceding quarters. This is in continuation of the long-term trend of moderation in economic activity since the breakout of the global crisis in 2007 – 2008.



It should be noted that according to a number of global economic and financial institutions, the "actual" economic growth rate in China (measured and calculated according to various economic data that are not necessarily collected by Chinese government bodies) is below the official figure of the Chinese government. According to these sources, the actual growth rate is below 6%. The factors weighing on Chinese economic growth are the substantial slowdowns in domestic demand, and mainly in investment, which slowly correcting after a long period of "over-investment".

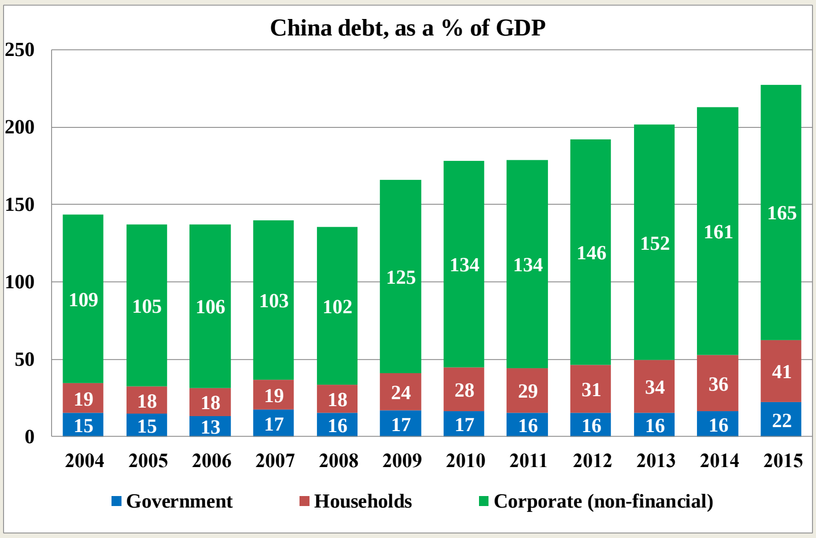
Looking forward, the Chinese economy is expected to grow 6.6% this year (as measured in official GDP terms), which is 0.3% percentage points below the growth rate measured in 2015. In the years 2017 – 2021 growth is expected to average 6%. For the sake of comparison, the average growth rate in China equaled 11.3% during the years 2003 – 2008. It should be noted that there are more pessimistic estimates regarding the economic development of China for the coming years.



The Economist Intelligence Unit (EIU) estimates that the 19th National Congress of the Chinese Communist Party, to be held in October 2017 (held once every five years), within the framework of which changes of government members will be made, will enable the president of China, Xi Jinping, to carry out changes in economic policy in the coming years. The primary change that is expected is a new government focus on slowing the rise in credit in the economy that has caused a substantial increase in debt in recent years. Due to this policy, the EIU expects the economic growth rate will fall to 4.2% in 2018 compared to a growth rate of 6.2% in 2017. Mismanagement of this policy is likely to lead to broad negative effects in both the local and global economies (damage to the manufacture of goods and to China's primary trade partners).

A substantial rise in risks in recent years. Below are a number of challenges that are expected to weigh on the Chinese economy in coming years:

- ***The main risk to the Chinese economy is the rise in leverage that has occurred in recent years.*** According to official data, business sector debt (excluding the financial sector debt) equaled 165% of GDP in 2015, compared to 102% in 2008. Household debt also increased substantially in recent years, recently crossing the 40% of GDP level, compared to 18% prior to the breakout of the global economic crisis of 2008.



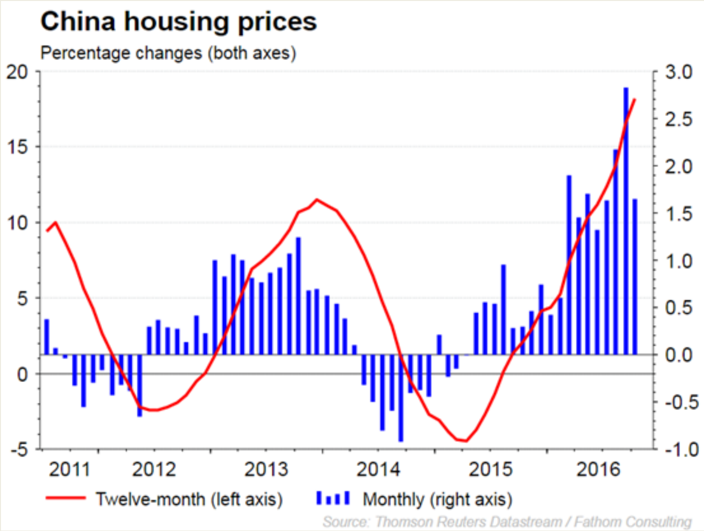
  In our opinion, there are substantial risks to the Chinese economy from credit market developments. Specifically, this pertains to the rapid increase in debt, while credit risk management in China does not seem to be up to par with that of advanced economies. This is apparent in the substantial rise in the financial leverage of the business sector (inclusive of local government debt-- LGFV) and of households over recent years. At the same time, while economic growth slows, there is evidence that the credit market is characterized by irregularities, lack of transparency, and the absence of proper risk management.

  It should be noted that in the last year there were a number of signs of specific crises in the business sector, including difficulties among corporations, both government-owned and private, to service their debts (principal or interest) to bond holders; forced conversion of bonds to stocks to the public; heightened oversight on financial funds (for example, restrictions on purchases of bonds below a certain rating); and a continued upward trend in non-performing loans (NPL).

- ***Excessive government investments, primarily in infrastructure, but not only.*** Government reforms have still not been expressed in an easing of the risks to the country rating, and this is primarily because the rapid rise in credit there continues to increase financial risks. China has still not succeeded to diversify the sources of government investment financing. Alongside the large weighting of government investment, which is financed by local bank credit, and the capital raising of local authorities in the domestic bond market, there is also a continuing increase in corporate debt, together with a rise in credit quality risk.

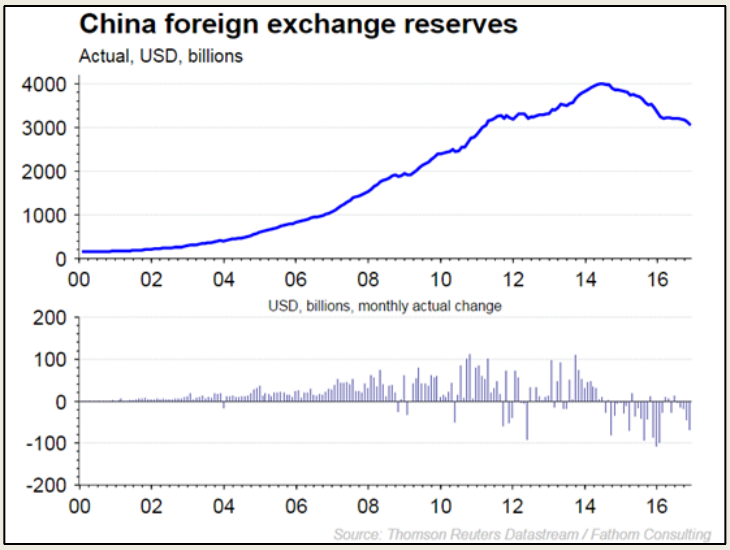
S&P estimates that in the central "mid scenario" Chinese banks have enough financial stability to suffice for the short-term. Another area that is leading to a rapid climb in domestic credit is real estate, as land prices in high-demand areas are rapidly rising, and developers are increasing their amounts of financing and risk (details below).

- ***An additional risk is the rapid upward trend in housing prices last year***, which was supported by heightened demand and an increase in the supply of credit to households and companies. Despite the decline over the last two years in the housing supply, it is still relatively high in most regions of the country and does not support upward pricing pressures. In addition, China's government continues to implement steps in order to moderate the rise in demand by means of heightened regulation on investors, reducing credit risk, and restrictions on construction starts. A too sharp decline in housing prices is likely to hurt consumer confidence, and consequently also local demand. As mentioned above, the trends in real estate prices are expressed in the trends of land prices and the rise in demand for credit related to this matter.



- ***Another central risk is related to the socio-political situation in China.*** In the event the slowdown in economic activity will continue and the living conditions of households deteriorates, characterized by a slower GDP per capita and a generally low standard of living, then social unrest can be expected. In the event the fiscal policies and the reforms of China's government will not bear any fruit, then there will likely be an increase in criticism from the Chinese public. Such a development is likely to weaken the current government and also to ultimately lead the public to demand a new government, which would act for the benefit of the public and would better deal with the problems of China than the previous government. The concern that processes of change such as these will not be gradual, calm, nor smooth leads to fears over developments that are likely to substantially disrupt Chinese economic activity, and not just in the short-term, and this alongside negative global economic impacts.

The trend involving the exit of capital is continuing, alongside a drop in foreign currency reserves: China has been characterized by a surplus in its current account over recent years, and the surplus is expected to be maintained throughout the coming years. In addition, China maintains high net government external credit (lender / net creditor) and holds high foreign currency reserves equal to approximately US$3 trillion. These factors together contribute to China's strength. It should be noted that from mid-2014 there has been a decline in China's foreign currency holdings (in June 2014 China held US$4 trillion) against the backdrop of internal demand from Chinese companies or foreign investors for US dollars, which are supplied by the government from its reserves, but not only from reserves.



Additional factors that have affected China's foreign currency reserves are the changes that have occurred in the foreign currency cross rates in the world from mid-2014 (the reserves are calculated in US dollars; therefore, a strengthening of the dollar leads to a decline in the value of reserves denominated in other currencies). The foreign currency reserves are likely to continue to drop in the event there will be an increase in risks in the economy. However, it should be noted that the government is likely to strengthen regulations on capital outflows through different means, which will likely limit slightly the risks to the stability of the Chinese economy.

Lastly, it should be noted that the degree of transparency of China's government is low, a fact that makes it more difficult for us to deeply analyze the size of the risk down to the micro- level. However, from the macro- point of view, and even before accounting for a possible "trade war" by the new US administration, we estimate risk has grown. As a result of the rise in risk, the trend of net financial outflows of capital from China to other markets is continuing. At the same time, there has been a rise of credit default swap rates (CDS), and China's credit rating outlook was changed from "stable" to "negative" by S&P and Moody's in the past year.

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