People's Republic of China
Rating Report

A+ NEGATIVE OUTLOOK

Credit strengths
• Large, 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, diversified economy: China's rating is supported by its large, highly diversified, competitive economy. Despite a gradual decline towards more sustainable growth potential, 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 a significant degree of control in some sectors. This can support the implementation of effective reforms, including extraordinary macroprudential measures. While this increases the ability to bring about fundamental reform when tackling high levels of leverage, it can also have credit-negative implications if it leads to lower quality of governance and policymaking.

Rating challenges include: i) large structural public sector deficits and an increasing public sector debt stock over 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		Reserve currency	Qualitative*	Final rating
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	aaa	CNY [+1]	+3/3	A+
Public Finance Risk		20%	bb-		0	
External Economic Risk		10%	aa+		+3/3	
Financial Stability Risk		10%	bbb-		0	
ESG Risk	Environmental Factors	5%	bb-		-1/3	
	Social Factors	7.5%	a		0	
	Governance Factors	12.5%	c		0	
Indicative outcome		a-			+2	
Additional considerations					0	

* Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's Sovereign Rating Methodology. Source: Scope Ratings

Outlook and rating triggers

The Negative Outlook reflects our view that risks to the ratings are tilted to the downside.

Positive rating-change drivers
• Improvement in public finances, resulting in an improved fiscal outlook, including a downward trajectory of public debt • Economic and financial reforms that strengthen financial stability and the economic growth outlook • Substantive gains by the renminbi as a reserve currency

Negative rating-change drivers
• A financial or economic shock that impairs economic growth and the fiscal outlook • Protracted fiscal deterioration and/or crystallisation of contingent liabilities, leading to weaker debt sustainability • 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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Domestic Economic Risks

- **Growth outlook:** Following an economic slowdown in 2020 when GDP increased by only 2.2%, China's economy easily exceeded the 'above 6%' growth target set by the authorities in 2021 when economic output rebounded by 8.1%, driven by increased exports and investments. Momentum began to fade 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. Several Covid-19 waves of infection and the strict lockdowns implemented under China's zero-Covid policy resulted in materially weaker domestic demand. The authorities' 2022 annual growth rate target of 5.5% remains out of reach given lower private consumption coupled with a significant downturn in the real estate sector as real estate production and property services represent around 29% of China's GDP. We expect economic output to increase by 3.2% in 2022 and rise by 4.3% in 2023.

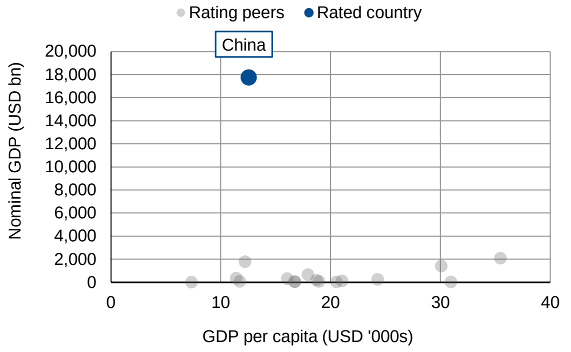
- **Inflation and monetary policy:** Annual CPI inflation increased in 2022 and stood at 2.1% in October on the back of higher food and energy prices, although it remained well below the government's 3% inflation ceiling. Amid slowing economic growth, inflationary pressures have remained significantly lower compared with other large economies. Official figures show little sign of any rise in core inflation (excluding food and energy prices), which averaged just 0.2% year to date. Aiming to ease pressure on debt burdens and the slowing housing market, the People's Bank of China announced several interest rate cuts in August. The benchmark five-year and one-year loan prime rates (LPR) were lowered by 15 bps and 5 bps respectively, to 4.3% and 3.65%. The five-year LPR is used as the reference rate for housing loans. In addition, the one-year medium-term lending facility rate, which allows commercial banks to access secured medium-term credit, was cut by 10 bps to 2.75%. We expect key interest rates to remain stable in the short term as a widening monetary policy divergence from other central banks, especially the Fed, could further weaken the renminbi.

- **Labour markets:** The official survey-based national urban unemployment rate stood at 5.5% in October, down from its 6.1% peak in April. However, the unemployment rate in the 31 largest cities increased in recent months from 5.4% in August to 6% in October. Labour demand and supply both faced headwinds due to Covid-19 restrictions, especially in the labour-intensive service sectors. These sectors were particularly affected by a significant drop in the number of migrant workers, which account for 30% of the total labour force. We expect the unemployment rate to average 5.6% this year and rise slightly to 5.7% in 2023.

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

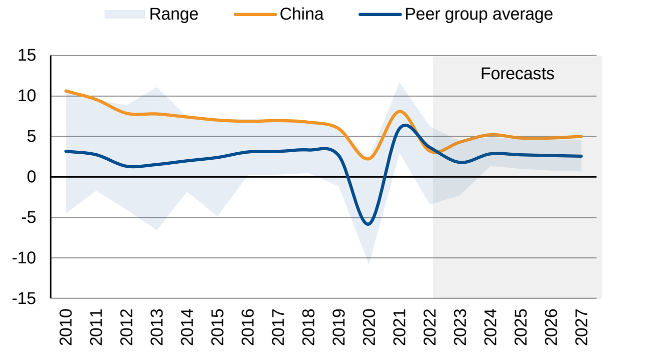
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Growth potential of the economy	Strong	+1/3	Growth potential is still high despite structural decline
	Monetary policy framework	Strong	+1/3	Effective monetary policy and exchange-rate policy, focus on maintaining financial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

Nominal GDP and GDP per capita, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

Public Finance Risks

- **Fiscal outlook:** The general government deficit as measured by the IMF (which also includes some off-budget spending by local governments) increased to 9.7% of GDP in 2020 after averaging around 2.2% in the decade before the pandemic. Large-scale fiscal measures were needed to support the economy during the crisis, and the deficit remained elevated at 6.1% of GDP in 2021 and is expected to reach 8.9% in 2022. The accommodative fiscal stance counteracts the impact of China's zero-Covid policy and the wider economic slowdown. Support measures include tax cuts and fiscal relief for businesses, such as postponed social security payments, particularly for small and medium-sized firms. Local government finances have been significantly impaired by the sharp decline in land sale revenues amid the real estate market downturn. Part of the resulting decline in revenues is being compensated for through central transfers that are budgeted at RMB 9.8trn in 2022 (up 18% from 2021). We expect fiscal policy to remain supportive in 2023 amid a challenging outlook for the large real estate sector and as authorities continue to address Covid-19 outbreaks.

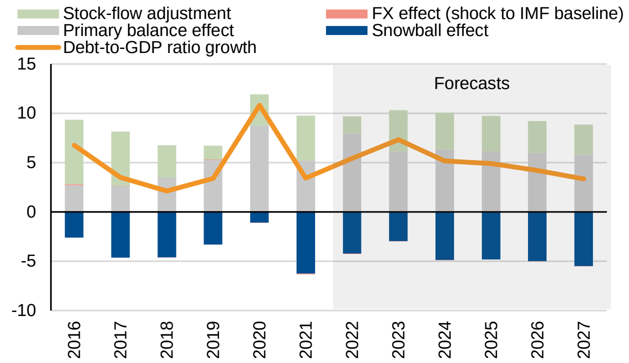
- **Debt trajectory:** Debt levels were on a rising trajectory in the decade before the pandemic. While central government debt remains low at 20.3% of GDP as of Q1 2022, China's general government debt increased from 34% of GDP in 2010 to 57% in 2019. This public debt estimate by the IMF includes central government debt as reported by the ministry of finance, explicit local government debt, and shares of contingent liabilities the government may incur based on estimates from the national audit office. The fiscal stimulus in response to the Covid-19 pandemic and the subsequent slowdown in real estate markets has continued to push up debt levels, which are expected to reach 77% in 2022. We expect the rising trend from recent years to continue, with debt reaching around 102% of GDP by 2027.

- **Market access:** China's benchmark 10-year yield remained stable at around 2.8% in 2022, below pre-crisis levels. The average maturity of central government debt has remained stable over the past two years and stood at 6.3 years in September 2022, up from around five years before the pandemic. The country issues mainly in renminbi, although there has been increasing foreign-currency issuance (US dollars, euros, Hong Kong dollars and Japanese yen). These include more significant dollar issuances in recent years by local authorities and local government financing vehicles, often with shorter remaining maturities. Local governments will face a peak in debt maturing in 2023 along with an aggregate reported budgetary gap of RMB 6.74trn (8% of 2021 GDP) in the first eight months of 2022.

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

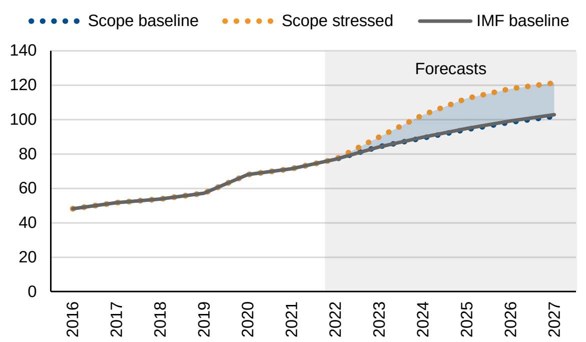
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Fiscal policy framework	Weak	-1/3	Significant structural deficits, wider augmented budget deficits with inclusion of off-balance sheet spending
	Debt sustainability	Neutral	0	Rising public debt ratio, significant off-balance 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: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF WEO, Scope Ratings forecasts

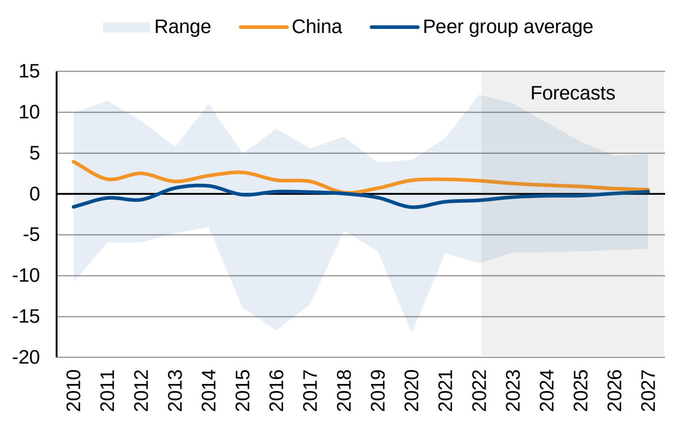
External Economic Risks

- **Current account:** China’s current account surplus increased significantly at the onset of the pandemic, from 0.7% in 2019 to 1.7% in 2020, and it remained elevated at 1.8% in 2021. Pandemic-related factors contributed to the higher surpluses and included increased medical exports at the onset of the pandemic, subdued outbound tourism and a rapid shift in consumption patterns towards goods rather than services among households abroad. Exports continued to grow in 2022 and are up 12.8% in the 12 months to October compared with the same period the previous year. However, we expect growth to moderate as major economies begin to slow and global demand declines. The current account surplus is expected to narrow over the coming years as higher commodity and energy prices raise import costs and China’s economy continues to rebalance towards more consumption-driven growth.
- **External position:** China’s net international investment position (NIIP) gradually fell over the past 10 years from 24.5% of GDP in 2010 to 11.2% of GDP in 2021. The decline reflects higher inward direct investment and securities investment received amid relatively robust GDP growth. The NIIP is expected to remain positive but decline over the medium term, although it is still expected to be above the peer group average. FDI inflows reached an all-time high of USD 334bn in 2021 (1.8% of GDP) as the impact of Covid-19 on GDP growth faded and the authorities implemented initiatives to liberalise the economy for foreign firms. However, inflows slowed during H1 2022, reflecting the impact of continued Covid lockdowns, slowing economic growth and a weakening renminbi as monetary policy divergence continues.
- **Resilience to shocks:** Resilience to short-term shocks is bolstered by the country’s sizeable and stable foreign exchange reserves, which amounted to around USD 3.1trn in October 2022, and its low external debt of USD 2.6trn (14.4% of GDP) as of Q2 2022. Sanctions against Russia over the invasion of Ukraine and hikes in US interest rates have fuelled discussions of a faster reduction of China’s reliance on the dollar system. 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. They would also enhance the currency’s resilience and China’s external-sector stability, e.g by reducing vulnerabilities to periods of capital outflows.

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

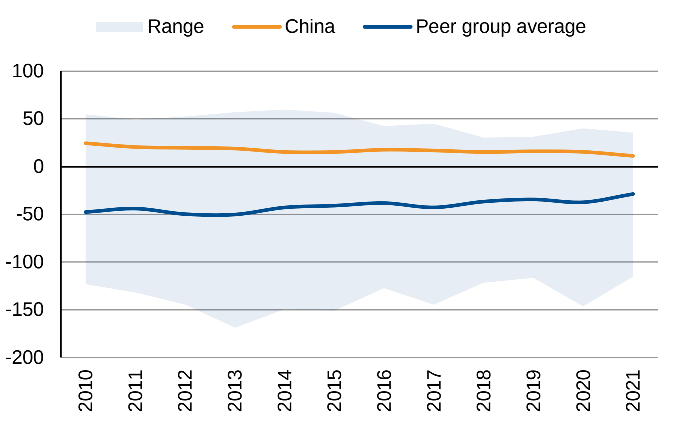
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Current account resilience	Strong	+1/3	Diversified, competitive export base, current account surpluses, risk from periods of capital outflows
	External debt structure	Strong	+1/3	Very low external debt, public and financial sectors have strong liquid external assets
	Resilience to short-term external 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 WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

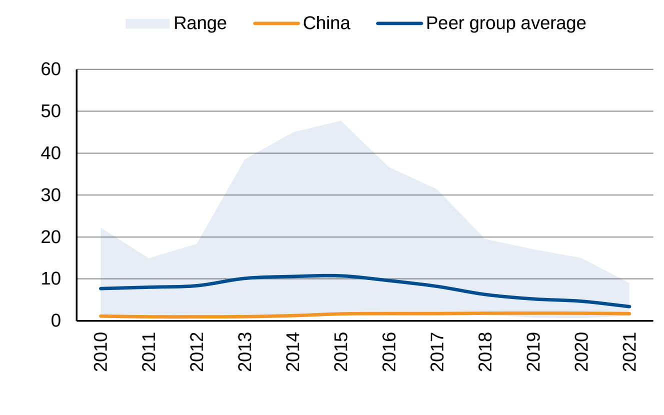
Financial Stability Risks

- **Banking sector:** On average, the banking sector has maintained stable Tier 1 capital levels of around 12% throughout the pandemic crisis. Reported 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, increased by 9.1% YoY in October 2022, remaining below the peak growth rate of 12.6% in August 2020, reflecting efforts by authorities to contain credit growth. However, given the recent economic slowdown, 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 steadily increased and reached an all-time high of 274% of GDP in Q3 2022, exceeding the previous peak of 271% of GDP reached in Q3 2020. Debt levels of private sector households and non-financial corporations stood at 224% of GDP, which is far higher than in the United States (66%), the euro area (109%) and in other advanced economies (145%). Corporates are responsible for most of the increase as non-financial sector debt reached 162% of GDP in Q3 2022, while households' debt remained stable at around 62% of GDP. Credit growth is likely to increase over the coming months as authorities continue to ease restrictive measures previously introduced (see next paragraph) with a view to supporting the slowing economy.
- **Financial imbalances:** Authorities introduced restrictive measures in 2020 including the 'three red lines' policy with the aim of enhancing financial discipline in the real estate sector, strengthening transparency and market-based price dynamics, and pursuing a 'soft landing' for China's large-scale debt accrual since the global financial crisis. These measures limit real estate developers' access to credit based on the size of their liabilities, debt levels and cash holdings. As a consequence, several prominent real estate developers started to experience repayment difficulties and ultimately defaulted. Amid a prolonged decline in real estate prices over 2022, the central bank and the banking regulator introduced a series of 16 measures in November with the objective of stabilising the property sector and reducing liquidity and debt repayment pressures. This reflects the authorities' commitment to contain financial risks in the medium and long term. Over the medium term, it will be important to maintain the previous reform momentum and avoid weakening asset quality through delays in impairment recognition.

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

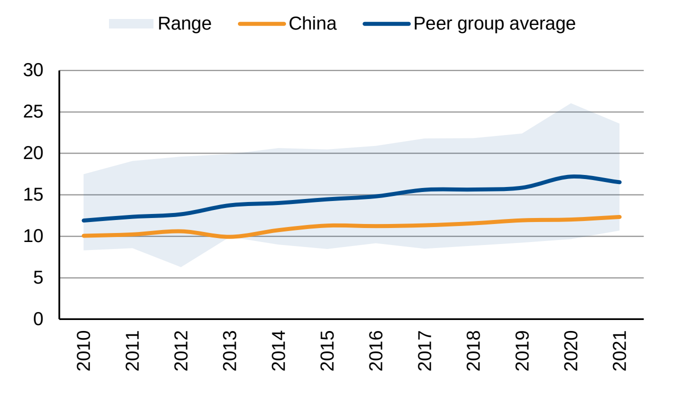
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb-	Banking sector performance	Neutral	0	Low (reported) non-performing loans
	Banking sector oversight	Strong	+1/3	Significant commitment and ability to counteract financial system risks, improvements in financial supervisory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

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

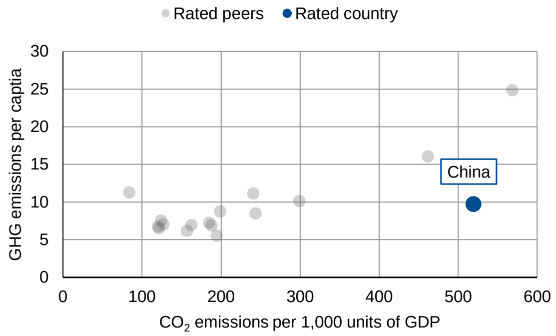
ESG Risks

- **Environment:** China is the world's largest emitter of carbon dioxide, accounting for around 27% of global CO_2 emissions. However, meaningful progress is being made in cutting the carbon intensity of the economy, with China striving to reach peak carbon emissions before 2030. The 14th five-year plan set specific targets regarding the energy system and green development that are broadly in line with China's current climate commitments to carbon neutrality by 2060. Nonetheless, 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 the overall level of emissions. In theory, China is well positioned to advance low-carbon energy supply and mobility, having one third of the world's installed wind power and a quarter of its solar energy capacity. It is also becoming a leader in green finance with a steady increase in green bond issuance, which rose by 111% in 2022.
- **Social:** Significant social progress has been achieved over the past decade, including improvements in poverty, education and health. Moreover, the current five-year plan places greater focus on the quality and efficiency of economic growth and citizens' lives (including concentrating on GDP per capita). Priorities include boosting social safety nets, reducing urban-rural inequality and property rights reform. Social safety nets remain inadequate given that less than half of urban employees are covered by unemployment insurance, with much lower rates for rural households. China's health expenditure of about 5.3% of GDP remains below other upper middle-income countries (5.9%), although the gap has narrowed in recent years. While China's old-age dependency ratio is currently more favourable than those of advanced economies, its 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 18th Communist Party Congress allowed President Xi Jinping to solidify his power, securing a third term for the first time in the history of the People's Republic of China. The politburo's standing committee mainly consists of loyal allies of the president. While such power consolidation can simplify the implementation of some reforms, it has credit-negative implications over the longer run. We believe it may undermine the delicate collective leadership structure underpinning China's decades-long economic miracle and reduce the quality of governance and policymaking in the long term.

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

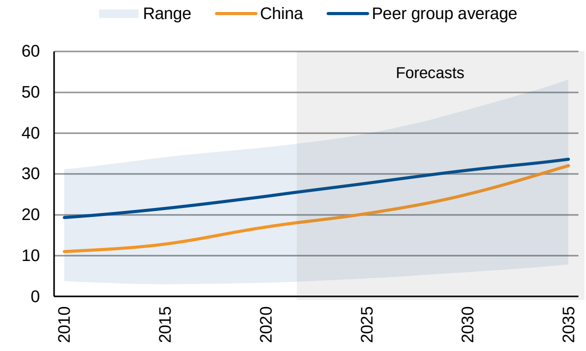
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Environmental factors	Weak	-1/3	Significant transitions risks in greening the economy but progress made has been substantive and objectives are ambitious
	Social factors	Neutral	0	High income and urban-rural inequalities,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

Emissions per GDP and per capita, $mtCO_2e$



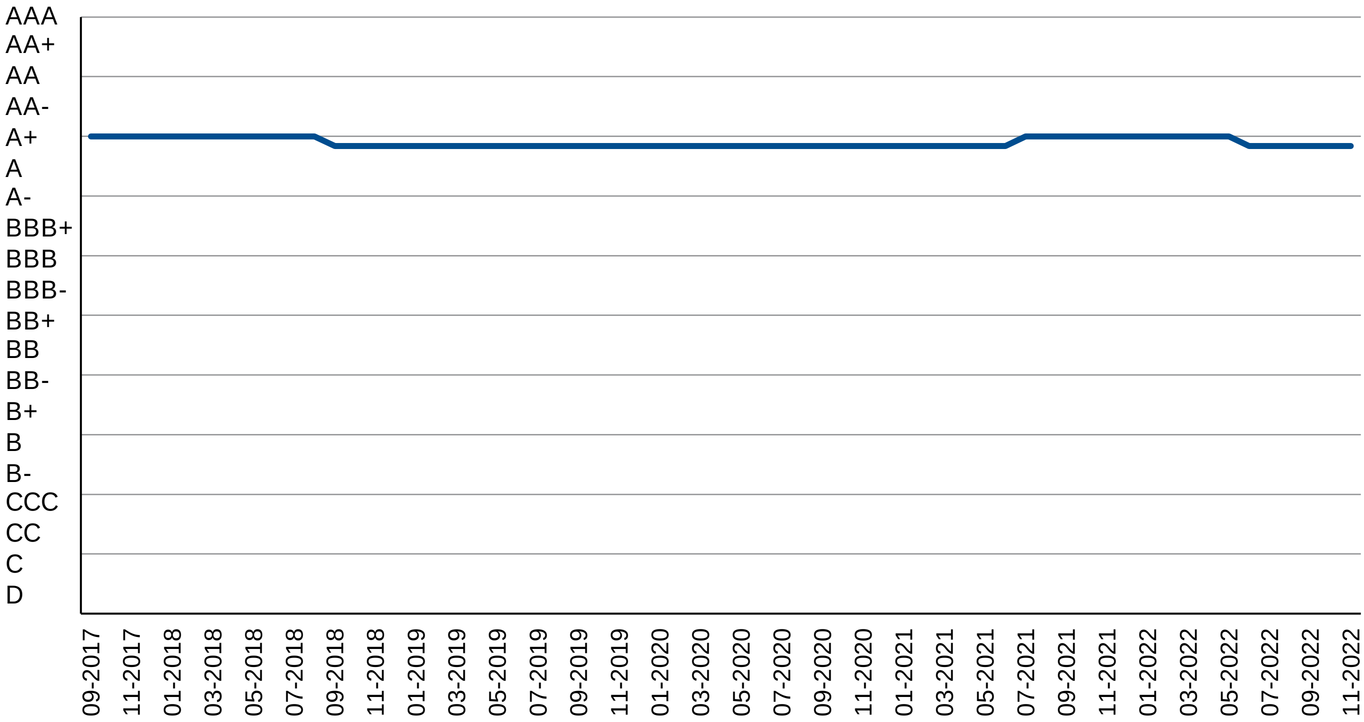
Source: European Commission, Scope Ratings

Old-age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

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, including a methodological reserve-currency adjustment.

Peer group*
Bulgaria
Croatia
Cyprus
Hungary
Italy
Latvia
Poland
Portugal
Slovakia
Spain

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

Appendix III. Statistical table for selected CVS indicators

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD ‘000s**	IMF	8,760	9,849	10,170	10,525	12,562
	Nominal GDP, USD bn	IMF	12,265.3	13,841.8	14,340.6	14,862.6	17,744.6
	Real growth, %	IMF	6.9	6.8	6.0	2.2	8.1
	CPI inflation, %	IMF	1.6	2.1	2.9	2.4	0.9
	Unemployment rate, %	WB	4.4	4.3	4.5	5.0	4.8
Public Finance	**Public debt, % of GDP**	IMF	51.7	53.8	57.2	68.1	71.5
	Interest payment, % of revenue	IMF	2.6	2.8	3.0	3.7	3.4
	Primary balance, % of GDP	IMF	-2.6	-3.5	-5.3	-8.8	-5.2
External Economic	**Current account balance, % of GDP**	IMF	1.5	0.2	0.7	1.7	1.8
	Total reserves, months of imports	IMF	15.4	13.1	13.8	14.7	11.7
	NIIP, % of GDP	IMF	16.8	15.2	16.0	15.4	11.2
Financial Stability	**NPL ratio, % of total loans**	IMF	1.7	1.8	1.9	1.8	1.7
	Tier 1 ratio, % of RWA	IMF	11.2	11.1	11.5	11.9	11.9
	Credit to private sector, % of GDP	WB	154.9	157.8	165.4	182.9	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	555.0	541.7	523.3	519.6	501.4
	Income share of bottom 50%, %	WID	14.4	14.4	14.4	14.4	14.4
	Labour force participation rate, %	WB	76.1	76.0	75.9	-	-
	Old-age dependency ratio, %	UN	14.4	15.3	16.2	17.0	17.7
	Composite governance indicators*	WB	-0.3	-0.3	-0.4	-0.2	-

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope’s quantitative model, the Core Variable Scorecard, in line with Scope’s Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Advanced economy
5y USD CDS spread (bps) as of 25 November:	53.9

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