People's Republic of China
Rating Report

SCOPE A+ STABLE OUTLOOK

Credit strengths

- Large and diversified economy with continued 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 and rising 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 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 allows for the implementation of effective reforms, including extraordinary macroprudential measures such as the three-red-lines policy. While this bolsters reform momentum near term, it can hold credit-negative implications over 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 over the long run; and ii) financial imbalances including high and rising 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%	aa+		+3/3	A+
Public Finance Risk		25%	bb-		0	
External Economic Risk		10%	aaa		+3/3	
Financial Stability Risk		10%	bb+		0	
ESG Risk	Environmental Risk	5%	bb		-1/3	
	Social Risk	5%	a+		0	
	Governance Risk	10%	c		0	
Overall outcome		**bbb+**		**+1**	**+2**	

Note: The sum of the qualitative adjustments, capped at 1 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.
For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Stable Outlook reflects our view that risks to the ratings are balanced over the next 12 to 18 months.

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 strengthen financial stability and the economic growth outlook
- Substantive gains of the renminbi as a reserve currency

Negative rating-change drivers

- A financial or economic shock materializes, impairing economic growth and fiscal outlook
- Protracted fiscal deterioration and/or crystallisation of contingent liabilities, leading to weakened debt sustainability
- Material weakening of China's external resilience

Ratings and Outlook

Local and foreign currency

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

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Bloomberg: RESP SCOP

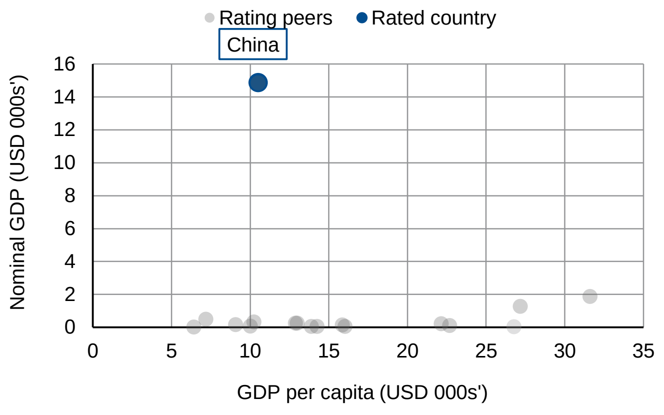
Domestic Economic Risks

- **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, reaching only 2.3% in 2020. We expect a strong rebound in 2021 of 8.0%, followed by 5.2% in 2022. Growth was already on a declining trend in the run up to the pandemic, falling steadily from more than 10% in 2010 to just under 6% in 2019. This gradual decline in economic growth is intentional as the authorities attempt to reign in excessive, debt-fueled growth leading to financial imbalances. The 14th five-year plan, covering 2021-2025, and China's Vision 2035 were affirmed by the National People's Congress in March 2021. For the first time, no explicit growth target was set but was only implicitly provided by the Vision 2035, which established the objective to double the size of the economy by 2035. Based on our current forecasts, this implies an annual growth rate averaging just under 5% over 2023-2035. The five-year plan also underlined a commitment to achieving balanced growth focusing on urban as well as rural development.
- **Inflation and monetary policy:** Monetary policy has been effective at maintaining inflation rates below 3% in recent years and the IMF expects consumer price inflation to remain subdued at below 2% over the next few years. In light of the low levels of inflation, we believe that monetary policy will remain accommodative through liquidity support when needed, but without large-scale asset purchases.
- **Labour market:** The official survey-based urban unemployment rate averaged 5.6% in 2020, reaching a high of 6.2% at the onset of the pandemic in February 2020. The rate has improved to 4.9% in October 2021, below the pre-pandemic level. However, this likely underestimates the full impact of the crisis on labour markets as job losses among migrant workers are not fully captured. New urban job creation during the first three quarters of 2021 remains below levels before the pandemic in 2019.

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

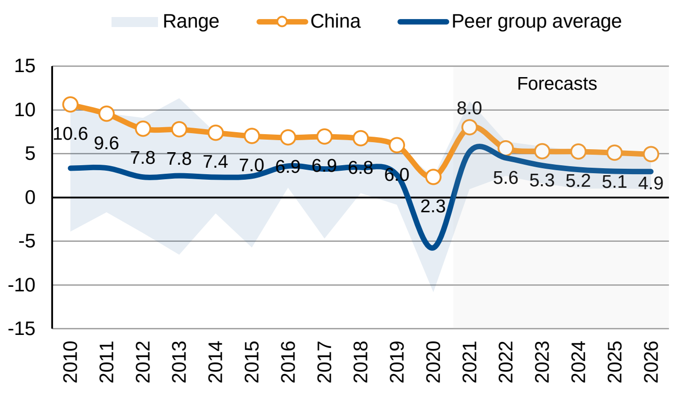
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Growth potential of the economy	Strong	+1/3	Growth potential is still high, despite the structural decline
	Monetary policy framework	Strong	+1/3	Effective monetary and exchange-rate policy, focus on maintaining financial 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

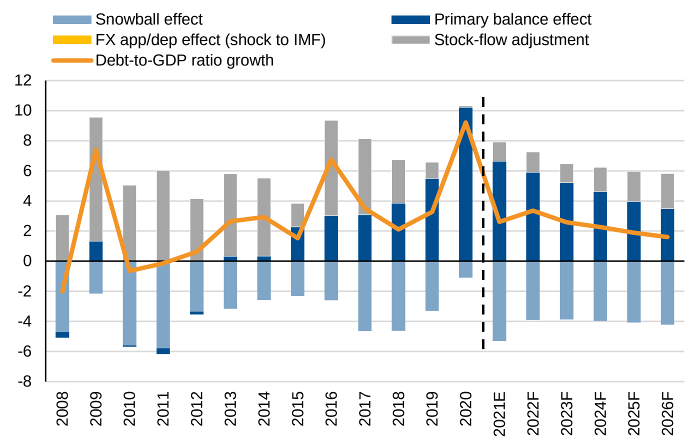
Public Finance Risks

- **Fiscal outlook:** Measures to support the economy at the onset of the pandemic resulted in a large increase in budget deficits, reaching 11.2% of GDP in 2020. An estimated RMB 4.9trn (or 4.7% of GDP) of discretionary fiscal measures were announced to counter Covid-19 including increased social security spending and higher levels of public investment. China is expected to continue running significant deficits, with the budget balance averaging -6.9% of GDP over 2021-2023. 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 18.2% of GDP in 2020. The authorities have taken steps to reduce the high levels of leverage taken on by LGFVs. Even though the government has a low tolerance for allowing a more widespread bankruptcy event in the LGFV sector, we note that defaults might occur in the medium term as the central government has signaled that it would allow selective defaults of some heavily indebted LGFVs.
- **Debt trajectory:** Debt levels were on a rising trajectory in the decade before the pandemic. Under a narrower definition, China's general government debt increased from 34% of GDP in 2010 to 57% in 2019. The fiscal stimulus in response to the crisis raised debt levels to 66% of GDP and we expect the pre-pandemic trend to continue, with debt reaching around 80% of GDP by 2026. Under the IMF's broader definition, including LGFVs and other off-balance-sheet entities, the government's 'augmented debt' stood at an elevated 91.7% of GDP in 2020 and is expected to exceed 100% by 2022.
- **Market access:** China's benchmark 10-year yield stands at 2.9%, below pre-crisis levels. Central government debt has an average maturity of 6.4 years, 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 LGFVs, often with shorter remaining maturities.

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

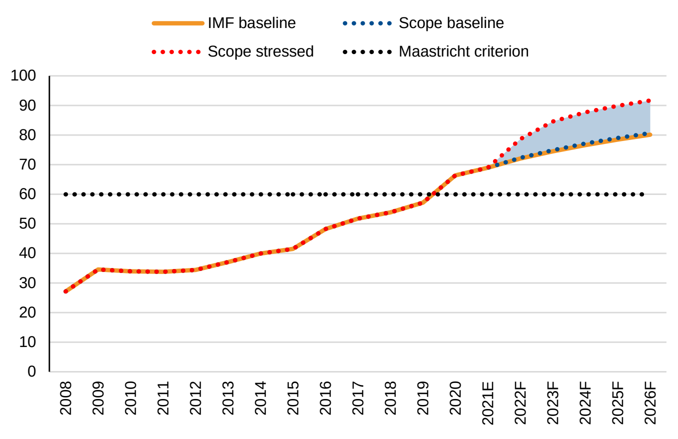
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Fiscal policy framework	Weak	-1/3	Significant structural deficits, wider augmented budget deficits with inclusion of off-balance-sheet spending
	Debt sustainability	Neutral	0	Rising public debt ratio, significant off-balance-sheet debt, but moderate explicit central government debt
	Debt profile and market access	Strong	+1/3	Elevated 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

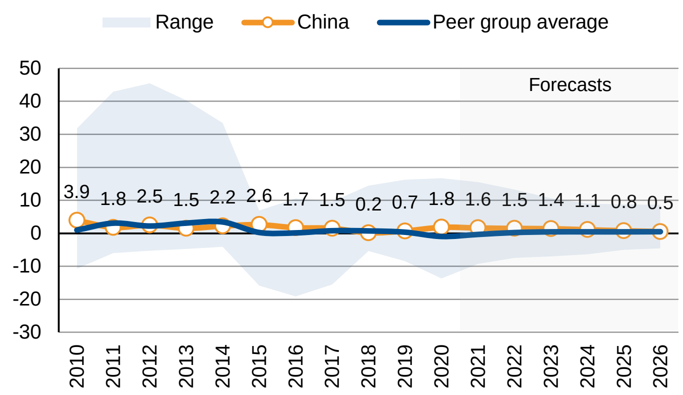
External Economic Risks

- **Current account:** China's current account balance stood at 1.8% of GDP in 2020, up from 0.7% in 2019. The improvement is largely due to an increase in the trade-in-goods surplus, which stood at 3.5% of GDP in 2020. This largely reflects the strong rebound in global trade from the second half of 2020, combined with the sudden collapse in outbound travel spending. Strong overseas demand in 2021 continued to support exports which have repeatedly exceeded expectations with an increase of 27% in the year to October 2021. This resulted in the trade-in-goods surplus averaging 3.2% of GDP during the first three quarters of the year. We expect continued modest current account surpluses of close to 2% in 2021 and 2022, followed by a gradual decline as the effects of the drop in outbound travel and the surge in exports wane, with the economy continuing to rebalance towards consumption-driven growth.
- **External position:** China's net international investment position declined to 14.5% of GDP in 2020, gradually falling from 24.5% in 2010. The decline reflects higher inward direct investment and securities investment received amid relatively robust GDP growth after Q1 2020. The international investment position is expected to remain positive, and above the peer group average, with a continued modest decline over the medium term.
- **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 October 2021, and its low external debt of USD 2.7trn (16.2% of GDP) as of Q2 2021. 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 while also enhancing 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*

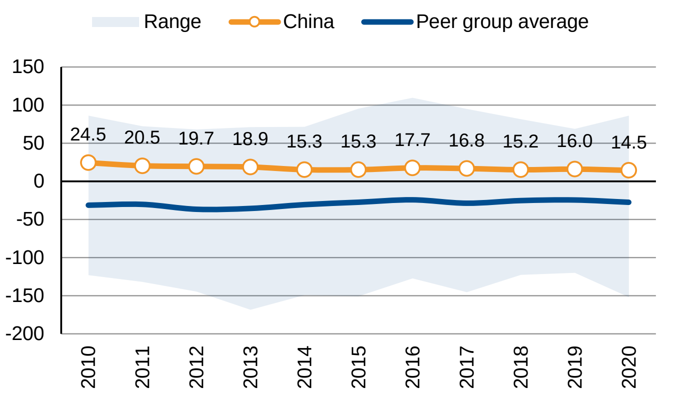
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Current account resilience	Strong	+1/3	Diversified and competitive export base, current account surpluses, risk from periods of capital outflow
	External debt structure	Strong	+1/3	Very low external debt, public and 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

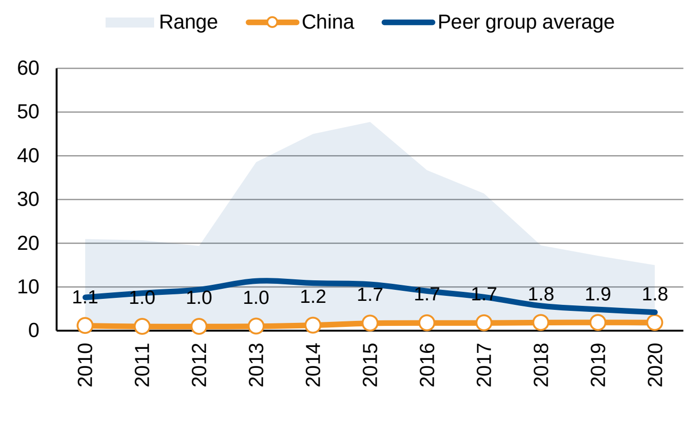
Financial Stability Risks

- **Banking sector**: On average, the banking sector maintained stable Tier 1 capital levels of just under 12% throughout the pandemic crisis. Non-performing loans have also remained low at less than 2%, consistently staying below the peer group average. Aggregate social financing, a broad measure of credit and liquidity in the economy, rose 9.0% YoY in October 2021 – reduced from August 2020 peaks of 12.6%, as the central bank provided guidance in private discussions with banks to rein in loan growth.
- **Private debt**: Non-financial sector debt is high at around 270% of GDP at end-2020. It declined slightly to 264% in Q3 2021 but is expected to rise to around 300% of GDP by 2025. The authorities' more restrictive approach to credit growth has led to an increase in informal interest rates, which reflect tighter credit conditions for smaller private companies. Real estate price growth has also slowed significantly from double-digit growth in the first half of the year to -0.2% in October 2021 compared with the previous year. Real estate investments also slowed significantly. Corporate bond defaults have increased, and we believe that orderly defaults will help to improve risk pricing, underlining the government's commitment to reform.
- **Financial imbalances**: Recent credit events in the real estate sector are evidence of the deliberate state objective to enhance financial sector discipline, transparency, market-based price dynamics and the pursuit of a 'soft landing' for China's large-scale debt accrual since the global financial crisis. The three-red-lines policy, introduced in 2020, is part of the macroprudential framework imposed on real estate developers, restricting their access to credit based on the size of their liabilities, debt levels and cash holdings. Similar approaches are being used to rein in local government spending for infrastructure projects through off-balance-sheet financing. Evergrande Group, with total liabilities of nearly 2% of Chinese 2020 GDP, was the most prominent real estate developer to face repayment difficulties as a result. We believe that some form of managed default remains the most likely outcome for Evergrande. However, the authorities will need to carefully balance risks to avoid a more severe spill-over of risks across China's large real estate sector.

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

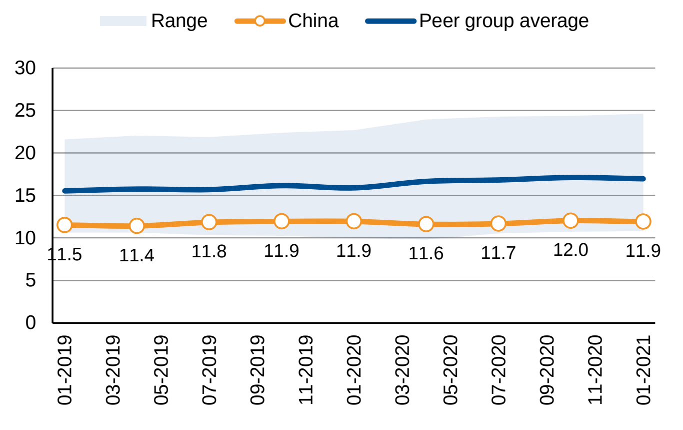
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Banking sector performance	Neutral	0	Low (reported) non-performing loans, strengthened bank capital adequacy
	Banking sector oversight	Strong	+1/3	Significant commitment and ability to counteract financial system risk, improvements in financial supervisory regime
	Financial imbalances	Weak	-1/3	Rising non-financial sector debt, increased defaults, but slowing 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 CO_2 emissions. However, meaningful progress is being made in cutting the carbon intensity of the economy, with China pledging that overall emissions will peak by around 2030. The new 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. 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.

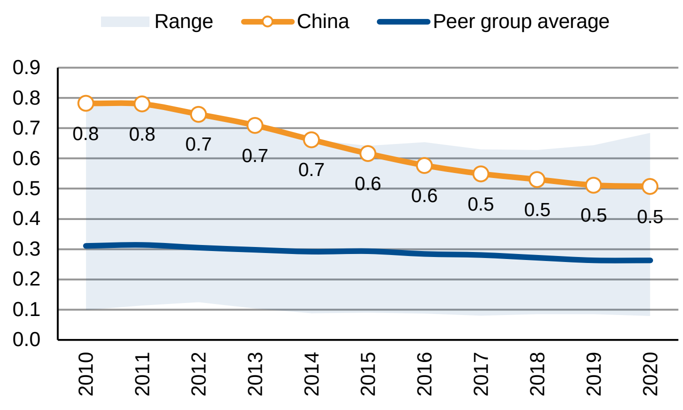
- **Social:** Significant social progress has been achieved, including improvements in poverty, education, and health. Moreover, the five-year plan is shifting towards a greater focus on the quality and efficiency of economic growth and citizens' lives (including concentrating on GDP per capita), with priorities such as boosting social safety nets, reducing urban-rural inequality and property rights reform. Social safety nets remain inadequate as only around 10% of unemployed workers receive unemployment benefits, while China's welfare and health expenditures remain low at about 3.5% of GDP (compared with an average of more than 6% of GDP for other emerging market economies). Even though China's old age dependency ratio is 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 weakly on the World Bank's Worldwide Governance Indicators. Even if the power consolidation achieved by President Xi Jinping bolsters reform momentum in the near term, it has credit-negative implications over the longer run. We believe it may undermine the delicate collective leadership structure underpinning China's decade-long economic miracle and also reduce the quality of governance and policymaking in the long term.

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

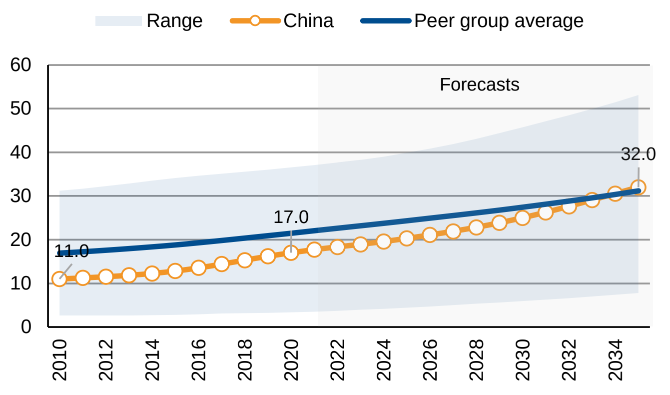
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Environmental risks	Weak	-1/3	Significant transition risks in greening the economy but progress made has been substantive and objectives are ambitious
	Social risks	Neutral	0	High income and urban-rural inequalities, declining working age population, but strong educational attainment and reduction of poverty, effective Covid-19 response
	Institutional and political risks	Neutral	0	Improved government effectiveness, President Xi's power consolidation poses longer-term governance risk

CO2 emissions per GDP, mtCO2e



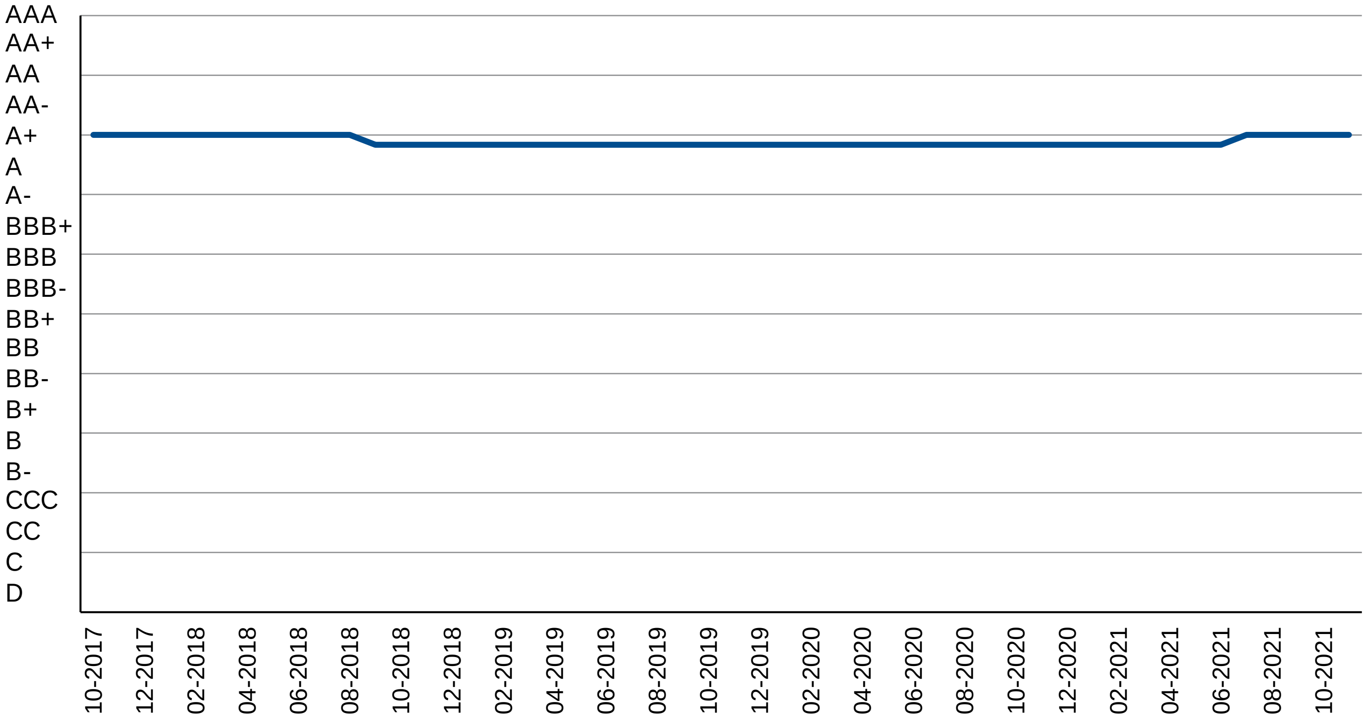
Source: European Commission, Scope Ratings GmbH

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
Bulgaria
China
Croatia
Cyprus
Hungary
Italy
Portugal
Romania
Spain

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	2021F	2022F
Domestic Economic Risk							
GDP per capita, USD '000s	8.1	8.8	9.8	10.2	10.5	11.9	13.0
Nominal GDP, USD bn	11,226.9	12,265.3	13,841.8	14,340.6	14,866.7	16,863.0	18,463.1
Real growth, %[1]	6.9	6.9	6.8	6.0	2.3	8.0	5.2
CPI inflation, %	2.0	1.6	2.1	2.9	2.4	1.1	1.8
Unemployment rate, %[1]	5.2	5.1	4.9	5.2	5.6	5.1	5.2
Public Finance Risk							
Public debt, % of GDP[1]	48.2	51.7	53.8	57.1	66.3	69.0	72.3
Interest payment, % of government revenue	2.4	2.7	2.9	3.1	3.8	3.5	3.6
Primary balance, % of GDP[1]	-3.0	-3.1	-3.8	-5.5	-10.2	-7.5	-6.8
External Economic Risk							
Current account balance, % of GDP	1.7	1.5	0.2	0.7	1.8	1.6	1.5
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	14.5	-	-
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	11.9	-
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	-	-	-	-	-	-
Labour force participation rate, %	76.2	76.1	76.0	75.9	-	-	-
Old age dependency ratio, %	30.5	31.2	31.9	32.6	33.3	33.9	34.5
Composite governance indicator[2]	-0.4	-0.3	-0.3	-0.4	1.1	-	-

[1] Forecasted values are produced by Scope and may differ from those presented in the charts of the previous sections
[2] 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	Advanced economy
5y USD CDS spread (bps) as of 10 December 2021	48.9

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