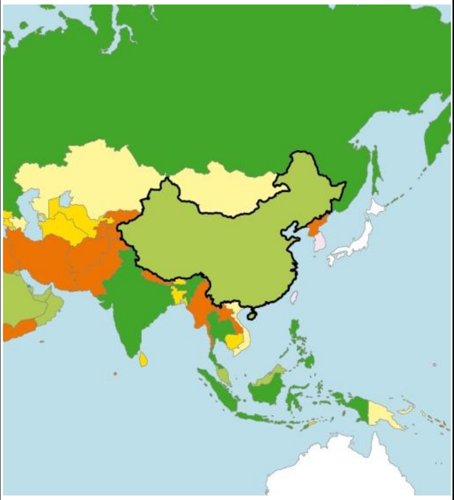
COUNTRY RISK ANALYSIS

China

CREATING CONFIDENCE IN YOUR EXPORTS



COUNTRY RISK CATEGORY

2/7

The country risk categories range from 0 to 7. The lower number the better the credit rating of the country.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES ON THE COUNTRY

Short-term transactions: SEK 92 million

Medium and long-term transactions: SEK 443 million

EKN'S POLICY

Sovereign risks: Standard risk assessment

Other public risks: Restrictive risk assessment

Bank risks: Restrictive risk assessment

Corporate risks: Restrictive risk assessment

See also "EKN'S POLICY" section

DATE

24/10/2013

Growth at the cost of increased imbalances

China's new leadership faces the task of addressing the threats to financial stability and growth. After the financial crisis, a hard landing of the economy has been avoided. Growth has been sustained through investments and credits although at the cost of rising domestic debt levels and an exacerbation of the imbalances in the economy. The situation entails an increased risk of a slowdown and I s also contributing to a downward shift in growth to levels at around six to eight per cent. Another contributing factor to the slowdown is the structural rebalancing that is still in its infancy. To manage this transition while maintaining macro stability is a major challenge. A positive factor is that the reform activity is expected to intensify in the period ahead. The financial weaknesses are essentially domestic and are mostly concentrated in state dominated sectors. Despite institutional and structural weaknesses, China's s strong external position and financial buffers remain key strengths in tackling the challenges.

STRENGTHS

- External surpluses and low external debt
- Significant buffer in large international reserves and moderate public debt
- Track record of continuous reform and still strong growth potential

WEAKNESSES

- Significant distortions and imbalances in the domestic economy
- Rapidly growing domestic debt and rising credit risks
- Lack of transparency entails uncertainty in our assessment
- Deficiencies in the business environment relative to the strong country risk classification

POLITICS

The new leadership faces major challenges

With the leadership shift now completed, the outline of the new leadership's reform agenda for the next few years is expected to emerge towards the end of 2013. The overall course of the five-year plan for 2011-2015 remains in place. This includes a downward adjustment of the long-term GDP growth target to seven per cent in connection with a gradual rebalancing of China's growth model. The conservative tone that General Secretary Xi Jinping and Premier Li Keqiang have struck in their first period in power hardly heralds any political reform in a liberal direction. Under the pretext of an anti-corruption campaign, there has been a purge within the top party elite of a kind that has not been seen for decades. This development, together with the trial of the former leading party member Bo Xilai, suggests not only that corruption may have reached the highest level of power, but also points to the rivalry between different party factions. It casts a shadow on the institutionalisation of the handover of power that has evolved over a few decades. Apart from the need to strengthen the party's image, actions may indicate that Xi and Li are in the process of strengthening their positions to enable them to push through the sensitive reforms that are required to rebalance the economy.

Rebalancing has been a guiding word for some time. A shift to a growth model that is less resource intensive and less reliant on investments and exports is needed to ensure a more sustainable growth. Increased domestic consumption, as well as social and environmental considerations are viewed as important ingredients in this shift, and a series of reforms to strengthen household incomes and social safety nets were initiated under the previous leadership. However, the overall progress remains modest. Influential vested interests in local governments and in the state enterprise sector, as well as a plethora of other institutional factors are inhibiting changes to existing structures. At the same time, widening income differentials, environmental problems, local irregularities and abuse of power are all sources of social tensions that appear to be on the increase. An emerging urban middle class is also placing increasing demands on policy makers. Widespread corruption, not just in bureaucracy, but also among the party elite, has become increasingly high profile in recent years and is creating a deep-rooted distrust of authority. With increasing information flows in society, the situation contains seeds of instability. Nevertheless, the State has at its disposal an extensive control apparatus that has remained capable of preventing the growth of alternative movements and propagation of local incidents. As long as economic growth can be maintained at reasonably robust levels, the party's track record of coping with significant pressures of change suggests that stability will be maintained.

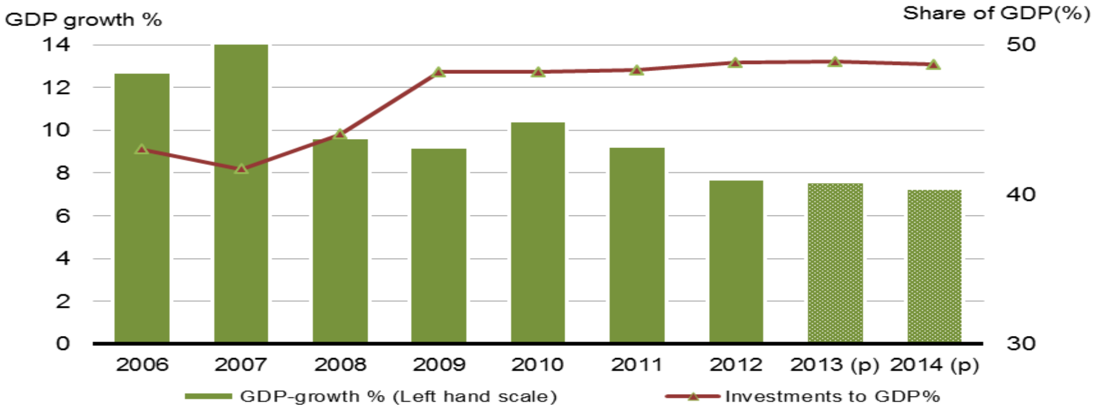
ECONOMY

Diminishing margins of safety as imbalances increase

Both the Chinese think tanks and the IMF warn that threats to macro stability are on the increase. China is undeniably exhibiting many symptoms that tend to herald financial crises. After the global financial crisis, growth has largely been sustained through a mixture of stimulus policies, investments and credits. Productivity growth has fallen, while the investment-to-GDP ratio has approached very high levels close to 50 per cent. Credits in the economy have rapidly risen to an estimated 200 per cent of GDP in 2012 (approx. 130 per cent in 2008). These factors have given rise to a series of interconnected imbalances. There has been a build-up in over-capacity in parts of the corporate sector. The property sector shows recurrent signs of overheating. Local governments have accumulated large debts in their eagerness to invest. The authorities' perennial balancing act between stimulating growth and trying to curb the imbalances has nevertheless met with some success. At the same time, the financial system is becoming increasingly complex and a growing proportion of funding is coming from other sources than banks in the less regulated shadow banking sector. In consequence, it is becoming increasingly difficult for the central government authorities to control lending and to prevent the build-up of systemic risks.

The increase in debt has weakened balance sheets in the banking and corporate sectors and among local governments. The economy has become more vulnerable to a slowdown in the credit merry-go-round and growth. As the debts are essentially domestic and the majority of creditors and debtors are government-related, the assessment is that an external balance of payments or currency crisis is an unlikely scenario in the event of a crisis. A more plausible scenario would be that a disturbance triggers a downward spiral of stress in the financial system, followed by a decline in lending, demand, investments and growth. This could ultimately lead to a period of deeper economic slowdown. The handling of the debt overhang could be expected to burden public debt. According to estimates from the IMF and other analysts, the public debt is already at least three to four times as high as the official figure for central government debt (15 per cent of GDP).

GDP GROWTH AND INVESTMENTS



Growth is slowing. The investment ratio is very high and the annual supply of new credits to the economy has been approx. 1/3 of GDP since 2009. Data: IMF

The new leadership faces the task of curbing the financial risks. They also need to push through the transition to more efficient resource allocation and growth that is more productivity-driven. A number of measures indicate that the financial risks are in focus. Despite the economic slowdown, austerity measures remain in place in the property sector. Stricter supervision and regulation is being introduced for several segments in the shadow banking sector and local government finances. It appears likely that the leadership is now inclined to tolerate slightly lower growth – and therefore refrain from large stimulus measures to the very last – and that the time has come to step up structural reforms in more sensitive areas such as state enterprises and the financial sector.

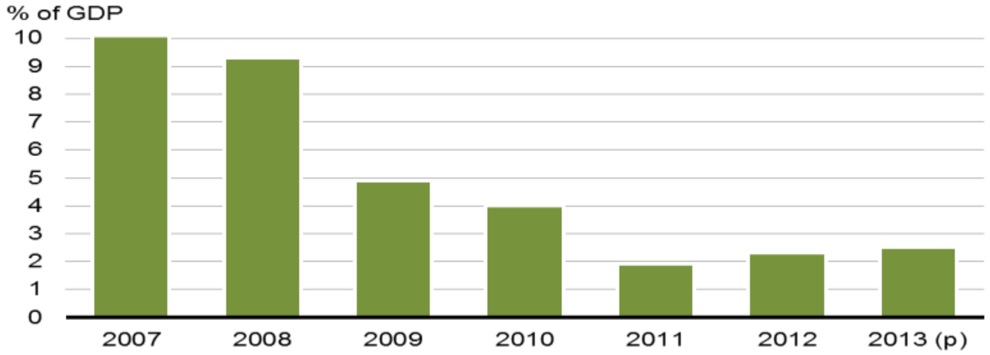
Although such reforms can only be gradual, a number of factors speak in China's favour. High domestic savings and large state buffers offer space to cope with disruptions. Steady growth in consumption and urbanisation are expected to contribute as growth engines. New dynamics may be released if the plans to allow an expansion of the private sector in areas such as the services sector are realised. Although, the transition involves risks, in the baseline scenario the reform process is expected avoid the worst pitfalls, with the growth rate shifting from just over ten per cent (2002-2011) down to levels around six to eight per cent.

BALANCE OF PAYMENTS AND DEBT ISSUES

China's external position remains strong

China's exports have become more advanced and diversified in both content and markets. Emerging countries account for a growing proportion of exports, currently one third. China's cost advantage is diminishing against a backdrop of rising wage costs, increasing environmental requirements and currency appreciation. At the same time, China has become a global production hub and the investments in production capacity during the past decade point to that the export sector will remain significant. The current account surplus that has been maintained since 1994 has declined in relation to GDP. The surplus is expected to continue but shrink further to the extent that reforms successfully drive the rebalancing of the economy.

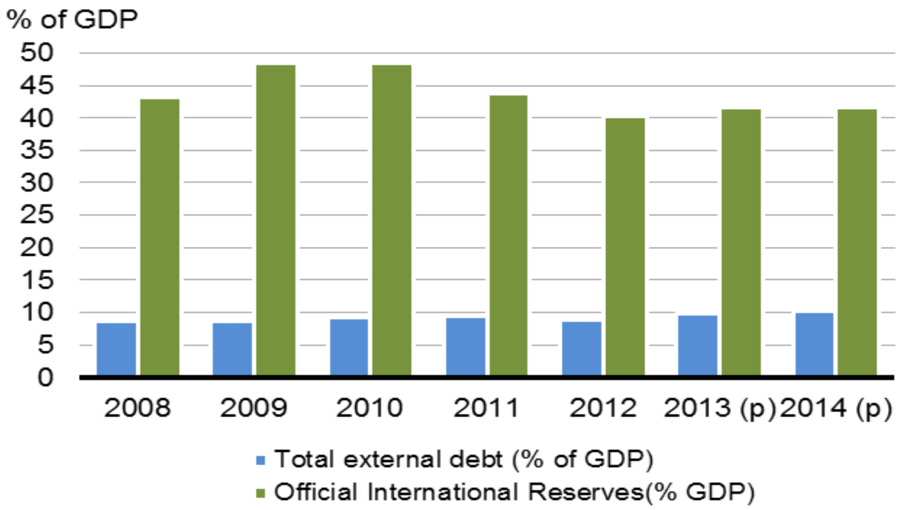
CURRENT ACCOUNT BALANCE



The current account surplus is still there but has declined since the peak in 2007 Data: IMF

The capital account remains in surplus even though Chinese foreign investment is increasing. The growth in international reserves is likely to slow in the future, although the reserves are very large, amounting to over USD 3,500 billion, which is equivalent to 40 per cent of GDP, or four times the entire external debt. This means that China has a significant buffer for managing disruptions and the uncertainties arising from increasing liberalisation of capital flows. Overall, the risk of balance of payments or currency crises is considered to be limited in the medium term.

EXTERNAL DEBT AND INTERNATIONAL RESERVES



External debt is low and with the world's largest international reserves, China is a major creditor to the rest of the world. Data: IMF

CURRENCY POLICY

Currency reforms aimed at increased convertibility

Reforms to strengthen the flexibility and convertibility of the renminbi (CNY) have accelerated in recent years. Since 2005, when the USD peg was abandoned, the CNY has essentially followed a *crawling peg* system. This means that daily currency fluctuations are allowed to within a narrow band against the USD with and reference to a basket of currencies. In 2012, the fluctuation band was increased slightly (to ± 1%). Other similar steps are expected in the next few years as increased flexibility is an important building block in the reforms of the financial system and currency convertibility. Since 2005, the CNY has recorded a nominal appreciation of approx. 35 per cent against the USD. It is the IMF's assessment that the currency remains somewhat undervalued. However it is China's priorities with regard to reforms, growth and employment that guide what appreciation rate will be tolerated. Against the backdrop of weak international demand, it is likely that the appreciation rate will slow down in the coming years.

Convertibility is also gradually increasing. Since 2010, the international role of the CNY has been promoted by allowing a growing volume of trade transactions to be settled in CNY (12 per cent of foreign trade in 2012). This has created the basis for offshore markets, first established in Hong Kong and then in Singapore, London and Taipei. Government bonds in local currency are now issued regularly in these markets. At the same time, China is maintaining a system of capital controls that circumscribe both portfolio inflows and external borrowing by Chinese entities. Selective liberalisation is being undertaken gradually, in order to facilitate reinvestment of CNY liquidity that has accumulated abroad. The authorities have announced that a roadmap towards full convertibility will be developed during the current five-year plan. An extension of ongoing regional pilot tests for the liberalisation of the financial sector and capital flows to a free trade zone in Shanghai has begun. Thus the strategy of gradual, albeit somewhat faster, development continues in order to avoid jeopardising financial stability.

EKN does not have any experience in guaranteeing transactions in local currency. The CNY is convertible for current account transactions, i.e., trade in goods and services. The currency is not fully convertible and may not be transferred outside the country. China's capital controls, with authorisation requirements and quota systems for loans with foreign creditors, mean that guarantees for loans in local currency appear difficult to extend. However, the ongoing liberalisation may change the situation going forward.

FINANCIAL SECTOR

Increasingly diversified and complex financial sector

In pace with China's rapid economic development, the financial sector is deepening with a growing capital market, money market and interbank market and an increasing number of intermediaries and products. The system is bank-dominated, although the banks' share of new credit to the economy has fallen from 95 per cent in 2002 to approx. 55 per cent in 2013. In a longer perspective, this is a positive development. In the short term, supervision and monetary policy tools are lagging behind. The shift from funding from banks is driven partly by a desire to circumvent regulations that restrict financing to sectors that the authorities consider should be cooled off. The shortcomings in the transparency of the financial and banking sector make it challenging to assess the risks. The strong credit expansion and a growing but not particularly transparent or regulated shadow banking sector with obscure links to the banking system mean that the risks of financial instability appear to be growing.

The macroeconomic situation, diversification of the financial sector and increased credit risks in the economy are signs that a series of challenges await the banking sector. Profitability is being squeezed as a result of interest rate liberalisation and increased competition for deposits. A deterioration in asset quality is likely in the period ahead, although this may not necessarily be reflected in banks' public reporting. With bank operations expanding from traditional deposits and lending, the banks are becoming more exposed to new risks outside their core business. To protect the banks against systemic risks, the authorities introduced a series of regulations in 2011 aimed at increasing the transparency of the shadow banking sector and restricting the ability of banks to keep off-balance sheet assets. In addition, restrictions have been imposed on loans to the property sector, local governments and sectors showing overcapacity. A financial sector regulatory coordination council has been recently established. The central bank has also sent a warning signal to the banks in the form of a rare liquidity crunch in summer 2013.

The main vulnerabilities appear to lie with the medium-sized and small banks. Their credit expansion has been more aggressive, while exposures to high-risk segments and liquidity risks are high. At the aggregated sector level, standard stability indicators still appear strong. Bad loans have fallen to one per cent of the loan portfolio and the dominant large banks have strong buffers in the form of good capitalisation and loss reserves. The combination of these factors and the state's financial muscle means that there is scope for managing the credit clean-up that can be expected.

BUSINESS ENVIRONMENT

Credit risk increasing in a harsher economic climate

Figures from the IMF show falling earnings relative to the interest burden in the corporate sector since 2007. In market analyses, for example, a sample of 1,132 publicly listed non-financial companies showed that operating income was lower than interest costs in a quarter of the companies (2012). This deterioration in the debt servicing ability reflects a sharp increase in debt and prolonged profitability pressure in the wake of a multi-year wave of investment and credit. The profitability pressure is due to a combination of rising costs and price pressure driven by the excess capacity that has arisen in a number of sectors, particularly in heavy industry, but also e.g. in solar panels and shipbuilding. A few of the largest listed companies in these sectors have defaulted on bond payments or have been rescued by government measures during the past year. Financial weaknesses are also being reported in the construction and property sector. Increased regulation has reduced the availability of bank loans in these sectors. The shadow banking sector has become a growing channel for both financing and investments among companies. In consequence there may be an increase in the exposure to liquidity risks in the financial sector and property sector, and also in seemingly unrelated industry segments. All in all, the economic slowdown and harsher financial climate are expected to increase credit risk in the corporate sector in the period ahead.

The credit environment has institutional weaknesses that are more significant than would normally be expected in countries that EKN has placed in country risk category 2. China introduced a modernised bankruptcy law in 2007, but the bankruptcy institute is used relatively infrequently and foreign lenders' ability to win a case appears uncertain, particularly when local political interests are involved. There is also a law on collateral. However, the process of registering and perfecting the collateral is complex and decentralised. There is no central register. A number of agencies at different administrative levels are involved according to the type of collateral. Discrepancies are reported between how different regions' courts choose to interpret the law and the order of priority appears unclear. Corruption also affects the reliability of the system. Evaluations from the IFC suggest that these circumstances make the system unreliable, time consuming, difficult to search and dependent on local bureaucracy. Finally, it is not uncommon for Chinese companies to seek financing through subsidiaries established abroad. Capital controls complicates the provision of collateral in, and guarantees from, parent companies in China. Consequently, such loans are subordinated to domestic loans, which usually have collateral, and this should be taken into consideration in the credit analysis.

SMEs often seem to operate outside the official system (taxation, accounting etc.), making them vulnerable to government intervention and corruption. In addition, the availability of funding tends to be limited to informal channels with high interest rates. For large companies, the line between government and business is occasionally blurred, particularly at the local level. Political priorities and a state company's position in the state hierarchy are still relevant credit factors. There are examples of a growing preparedness not to support state-owned companies, and this trend is expected to increase in the future. Therefore, the credit analysis should be less and less based on assumptions of government support. Instead financial transparency is required. However, this is limited and its quality varies. The lack of information is particularly noticeable for SMEs. In corporate groups and conglomerates, ownership and corporate structures are often complex and non-transparent. Ownership concentration to a key person or family is not uncommon, which can then give rise to concerns about governance. The recent accounting scandals concerning Chinese companies which came under the intense scrutiny of foreign investors also point to disclosure problems. The introduction of financial reporting standards largely in line with IFRS for listed companies and large state-owned enterprises in 2007-08 *(Accounting Standards for Business Enterprises,* ASBE 2006) and other reforms of areas such as bond market development are steps in a positive direction. The challenges at institutional level mean that improvements in practice are expected to be gradual.

EKN'S EXPOSURE

Declining exposure

Despite growing Swedish exports to China over the past decade, EKN's exposure has declined from SEK 9.5 billion in 2003 to just under SEK 610 million in September 2013. Much of the decline is likely due to China having become self-sufficient in many industrial areas, particularly in telecom and power equipment which dominated EKN:s exposure in the past. Increasing relocation of Swedish production to China for local sales is also a contributing factor. The business inflow consists of SME transactions, projects in the food sector as well as transactions for which EKN guarantees confirmed letters of credit. Letter of credit guarantees relate mainly to transactions in the transport sector.

The sectors that dominate the existing exposure are power (57 per cent), dairy (19 per cent) and transport (13 per cent). Calculated according to where the credit risk ultimately lies, Chinese banks are counterparties in approx. 38 per cent of the exposure, 25 per cent of which relates to longer transactions with state-associated banks. Credit risks relating to companies represent just under 25 per cent, the majority being project-risk type transactions in the food sector. Guarantees for unfair calling, mostly for state-owned companies in the power sector, represent over 35 per cent of the exposure.

EXPOSURE AT 31 DECEMBER, MSEK

The inflow of new large transactions has slowed and given way to smaller and shorter transactions.

PAYMENT EXPERIENCE

EKN's payment experience is good. Over the past eleven years (2003-2013), EKN has issued guarantees totalling SEK 8.3 billion, while losses have amounted to just under SEK 15 million. The proportion of arrears has risen a little since 2008, and is mostly concentrated in the shipbuilding or food sector. A major factor behind the positive experience may be that the majority of guarantees have had strong counterparties such as banks, mostly large state-associated banks, or large state-owned companies in the power sector. Pure corporate risks are estimated at 10 per cent of the guarantee volume during the period. As EKN's losses only relate to corporate risks, the estimated proportion of the corporate risks that have incurred losses is 2 per cent.

EKN's experiences also indicate that transparency of finances and ownership structures tends to be weak both for state-owned and private companies. In addition, debtors have made changes to corporate and collateral structures in transactions without consulting the guarantee holder. Confirmed letter of credit guarantees with Chinese banks as counterparties represent approx. 17 per cent of the total guarantees issued. In recent years, counterparties have often been "third tier" banks that are considerably weaker than the large banks. However, payment experience remains good.

Data from other OECD institutes supports this picture. Overall payment experience is good. However, experience relating to private companies, particularly in the Chinese SME sector and since 2008, is reported to be significantly worse on the basis of anecdotal evidence from commercial credit insurers. In the financial sector, one would have to go back to the 1990s to find examples where external creditors have been affected.

EKN'S POLICY

EKN has classified China in country risk category two since 2003, when the country was upgraded from country risk category three. Since then, the position has been in line with the classification made in collaboration with other OECD countries.

For transactions with central state debtors, such as the central bank or finance ministry, EKN does not have any specific general restrictions. The same applies to transactions with banks, with each transaction assessed on its own merits. However, the credit risk of individual banks differs substantially and certain restrictiveness in the risk assessment applies to medium and small banks that are so called *Joint Stock Commercial and City and Rural Commercial* Banks. This is on the basis that these banks are generally not likely to be able to count on the same state support as the large state banks, and they tend to be more exposed to credit and liquidity risks.

The policy includes certain restrictions on other public purchasers (i.e. sub sovereigns such as other ministries or local governments) as well as companies. EKN normally requires government or bank guarantees for transactions with other public buyers. EKN's more restrictive approach is motivated by the difficulty in assessing the local governments' financial position and ability to fulfil current contracts, as well as the reported debt issues in this sector. In addition, Chinese regulations do not normally allow local governments to take out or guarantee loans.

For corporate risks, EKN also applies a somewhat more restrictive risk assessment of transactions, with particular consideration of the quality of the financial information. This has its background in the discrepancy between the country's strong country risk rating and the quality of the business environment, such as issues relating to financial transparency and the shortcomings of the legal system.

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

Area: 9,573 km² (21 times Sweden)

Population: 1,350.7 million (2012)

Population growth: 0.51 % (2007-2011)

GDP: USD 8,227 billion, 2012 (Sweden USD 525.7 billion, 2012)

GDP/capita: USD 5,740, 2012 (Sweden USD 56,210, 2012)

CREDIT RATING

	COUNTRY CEILING	SOVEREIGN RATING
Moody's:	Aa3	Aa3
S&P:	AA-	AA-
Fitch:	A+	A+

COUNTRY ANALYST

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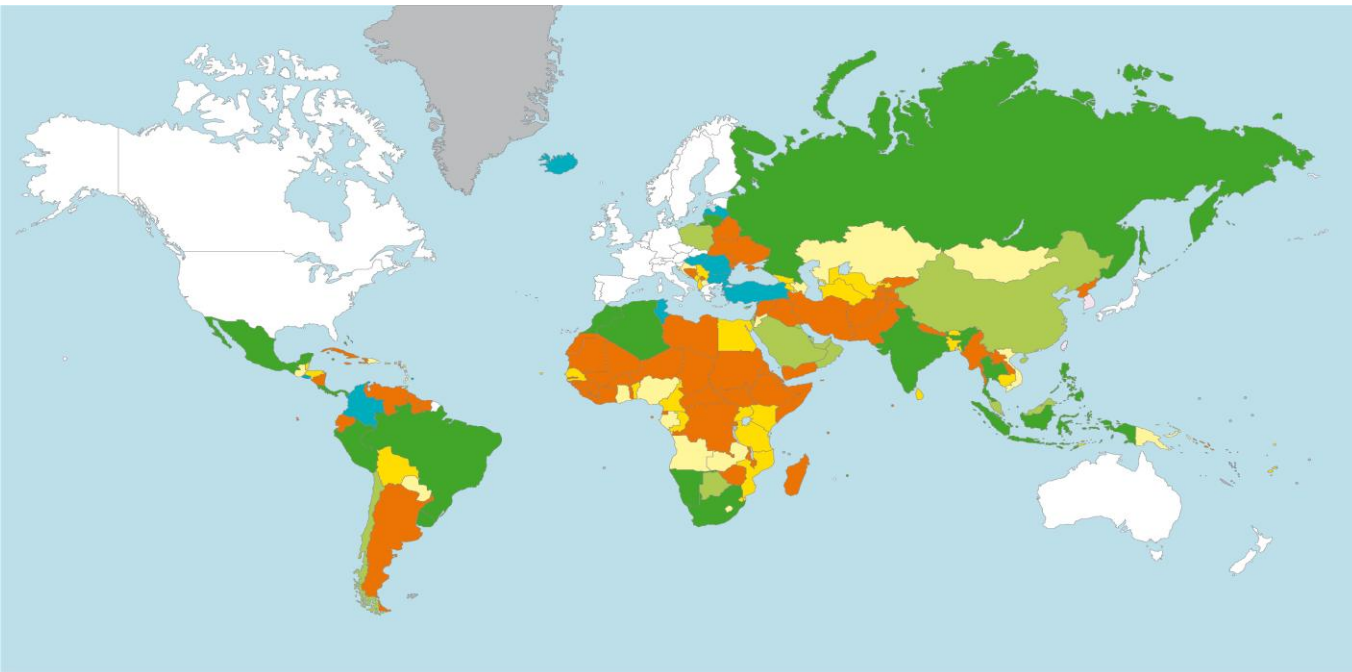
EKN'S VIEW OF THE WORLD



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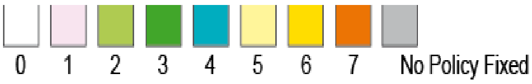

EKN – CREATING CONFIDENCE IN YOUR EXPORTS

EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management. Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

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