NYU SCHOOL OF PROFESSIONAL STUDIES

Country Risk Review: China

Scher - April 12, 2022

China: a snapshot

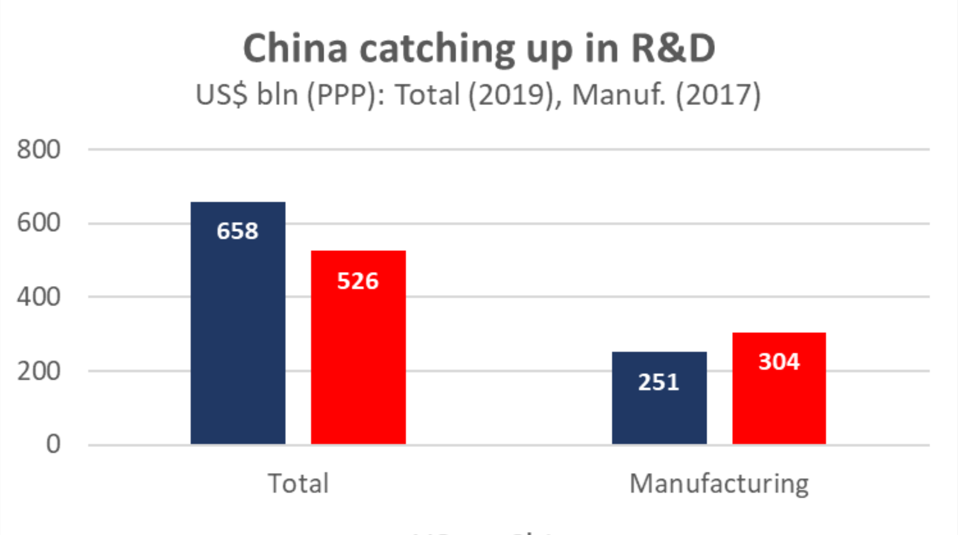
Strengths

- History of strong GDP growth
- Rapid transformation of economy – lowering of poverty
- Effective government -- strategic planning; capacity to manage crises / reforms
- Innovation ecosystem; competitive technology companies
- Robust R&D; favorable science & engineering education
- High national savings / sizable govt assets
- Favorable external finances
- Effective COVID vaccine program
- Policy space to stimulate economy in M-T

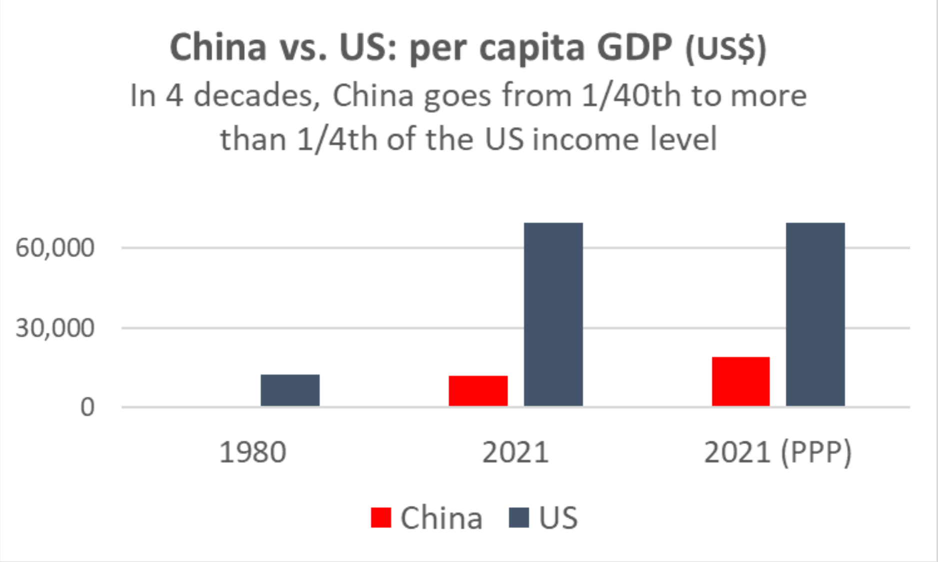
Weaknesses

- Growth heavily reliant on credit, exports, real estate (RE), fossil fuels & state-led investment -- directional uncertainty
- Productivity growth has declined; tech decoupling could accelerate trend
- High government deficits / debt (IMF's "adjusted" basis); heavy leverage economy-wide
- Opaque financial sector & asset quality issues
- Substantial capital controls
- Political model avoids polarization & stalemate seen in some participatory democracies, but rests heavily on performance legitimacy – risking instability in the event of slow growth
- External tensions related to human rights, geopolitics & trade

China converging…

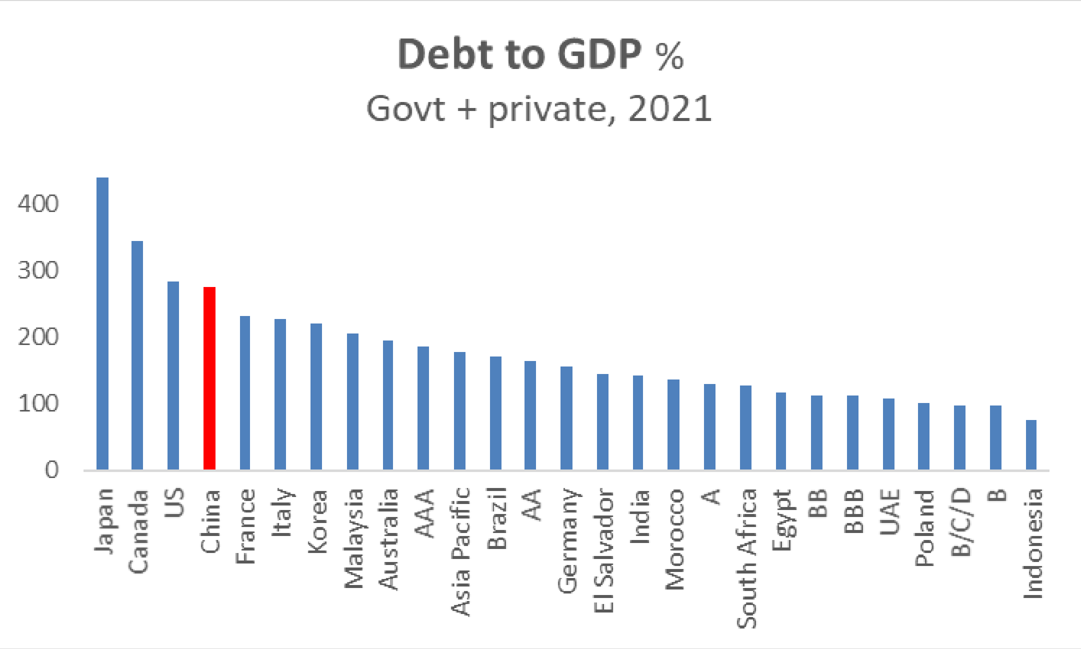


Source: NSF S&E, 2020-22



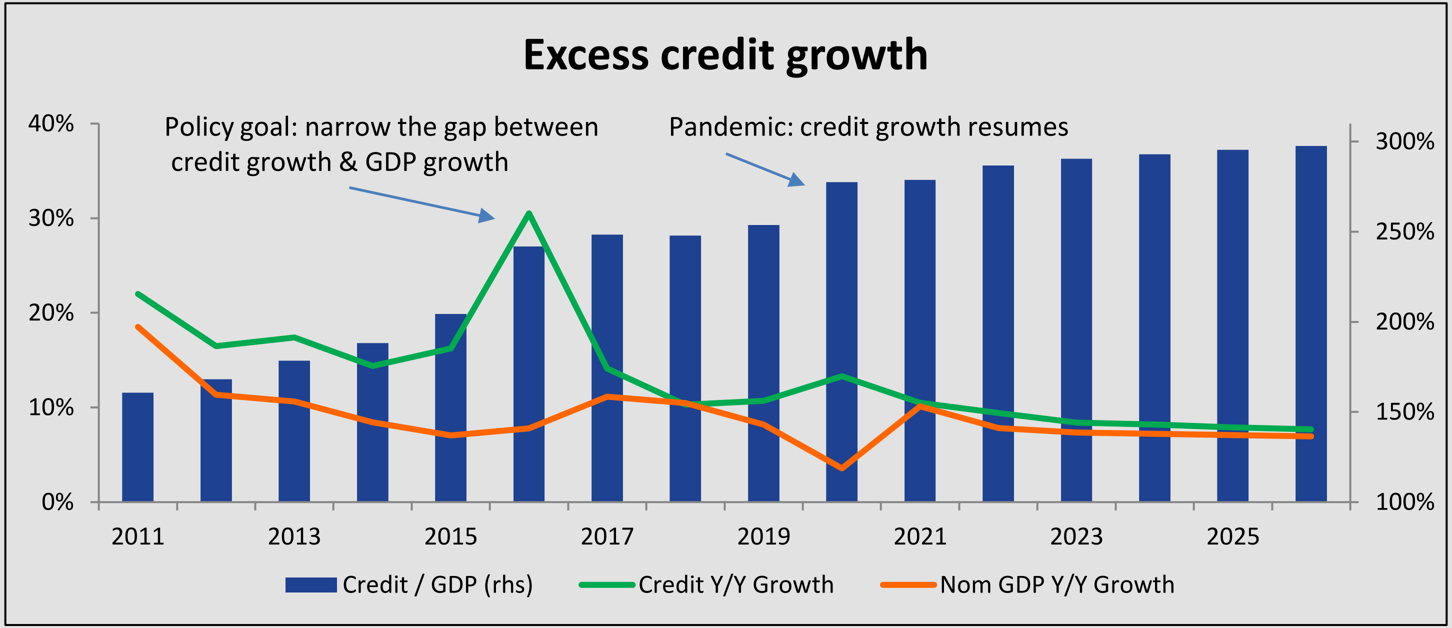
Sources: NSF S&E 2020 & 2022 reports, R&D on PPP basis; IMF WEO Oct 2021, pc GDP market exchange rates & PPP in 2021; China pc GDP in 1980 was $307; PPP is purchasing power parity, i.e. figures are adjusted for differences in prices & exchange rates across countries.

China's credit challenge



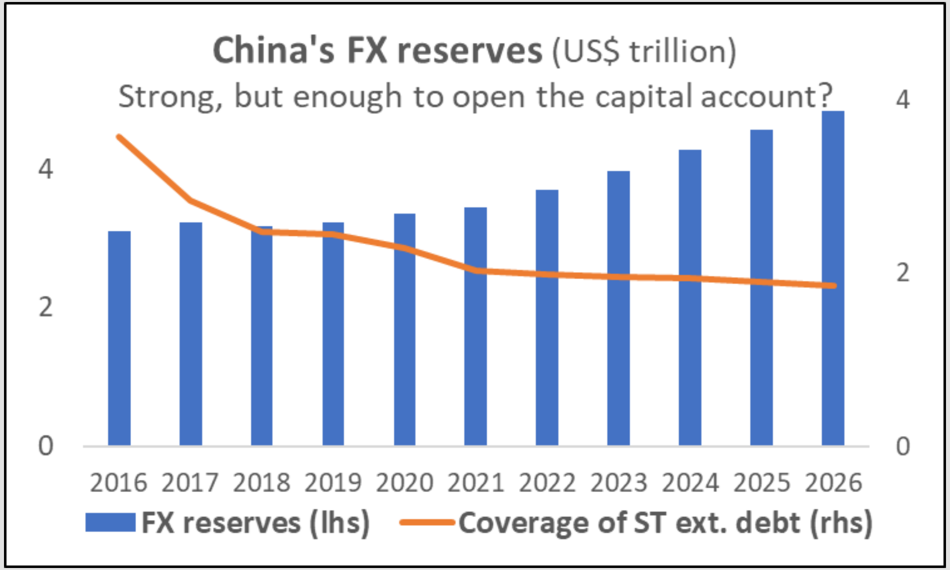
Sources: Fitch; China from IMF Art IV Jan 2022; US from Fed Flow of Funds, Mar 2022. Debt tolerance is lower for poorer countries. Countries with higher economy-wide debt to GDP are much richer than China: Per capita GDP (on a PPP basis) was larger than China's by 3.6x (US), 2.8x (Canada) and 2.4x (Japan) in 2021. Rating medians are Fitch's.

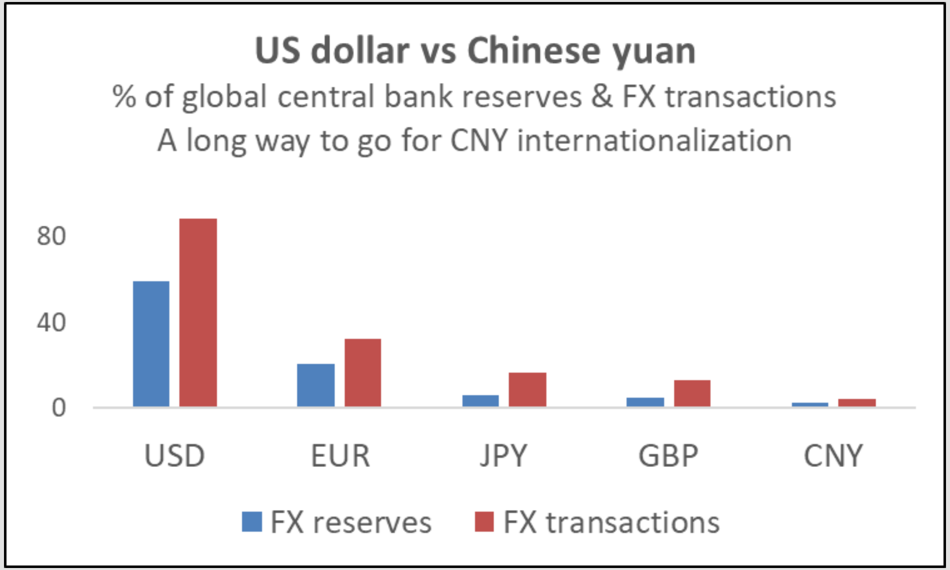
Credit bubble deflating?...



Credit is "Total Social Financing", including bank loans (>60% of total), shadow banking, corporate bonds & equities, govt bonds, etc. Sources: IMF Art IV & WEO, forecasts are IMF's; Scher GE presentation 2015, Haver

Tricky transition: portfolio rebalancing

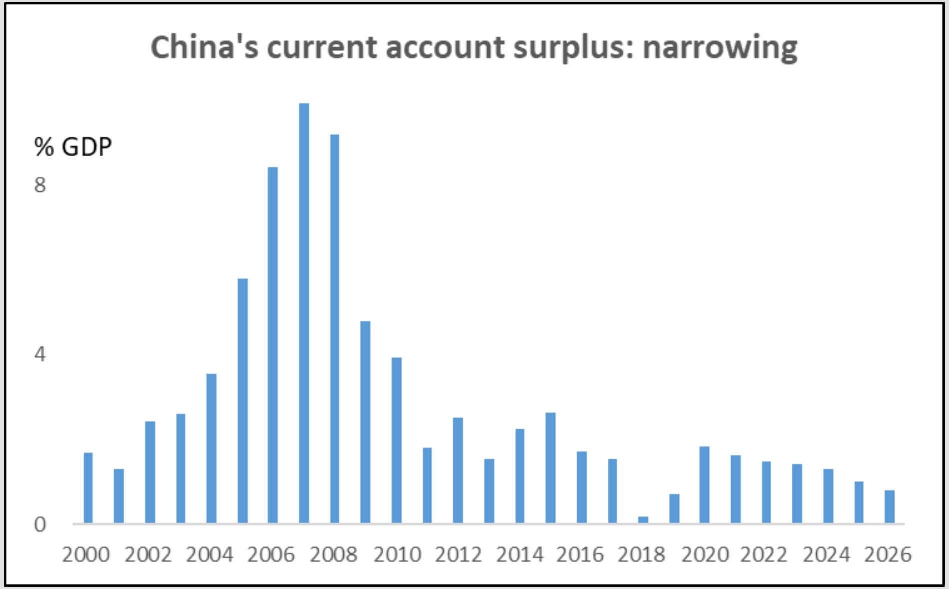




Sequencing reforms is critical. If sequencing is off, this could one day mean large capital outflows that jeopardize China's traditionally strong FX reserves cushion. At end-2021, China had over $3.4 trillion or nearly 12 months coverage of "imports", i.e., current external payments, a comparatively strong position. Likewise, this represented over 2x coverage of ST external debt payments for the year. That figure is represented by the red line & is declining, but still forecast to be strong by the IMF. A sudden opening of the capital account, however -- that is, allowing Chinese residents to rebalance their savings to include a portion invested overseas – could cause a sizable FX reserves decline. Currently, Chinese households are restricted in investing savings overseas. This is where the importance of sequencing reforms comes in. China's financial system is state-controlled & there are sizable bad debts. If the capital account were opened before bank balance sheets were clean, i.e. losses on bad debts recognized & disposed of, & before interest rates & credit spreads were liberalized, then capital outflows could be larger than expected. The Chinese authorities want to internationalize the CNY, but these reforms will have to occur first & will have to be carefully managed. Therein lies the risk.

Source: China IMF Art. IV, Jan 2022, IMF COFER; BIS; Fitch

China's external finances



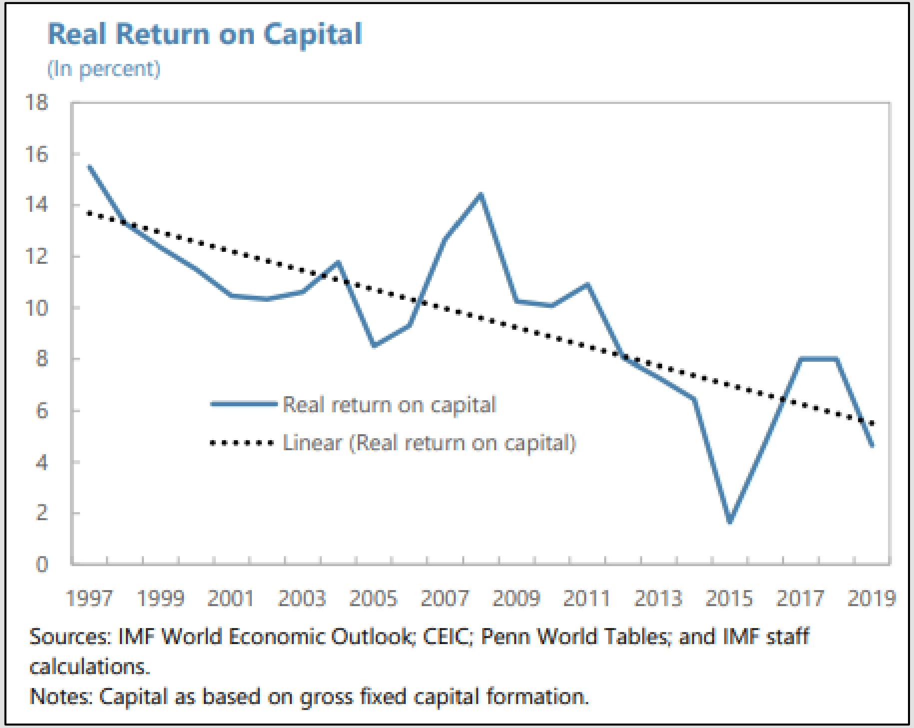
China's external finances are rebalancing…

Sources: IMF Art. IV, Jan 2022; WEO Oct 2021; IIF; Yahoo Finance

Rebalancing to raise productivity

Productivity from innovation (TFP) is down

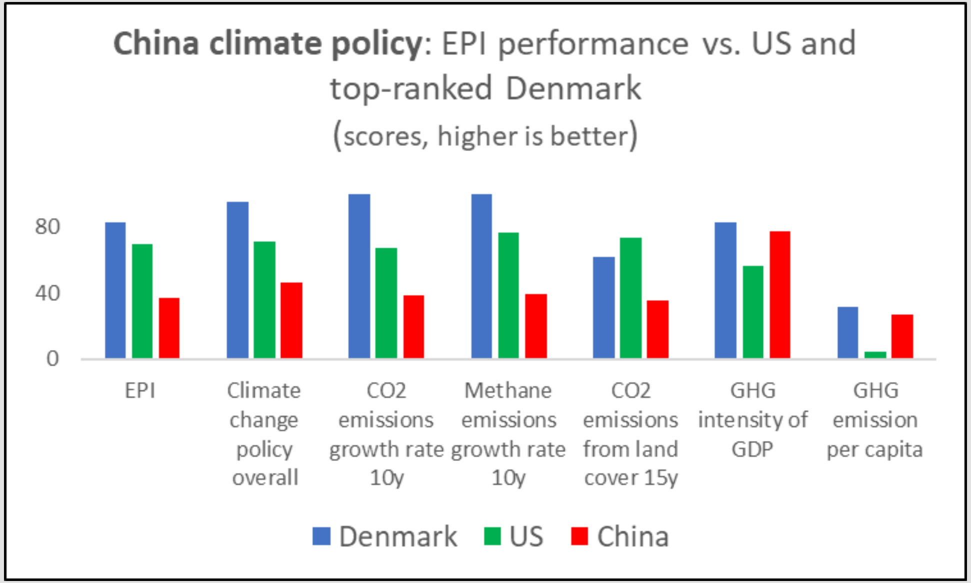
Return on investment has fallen

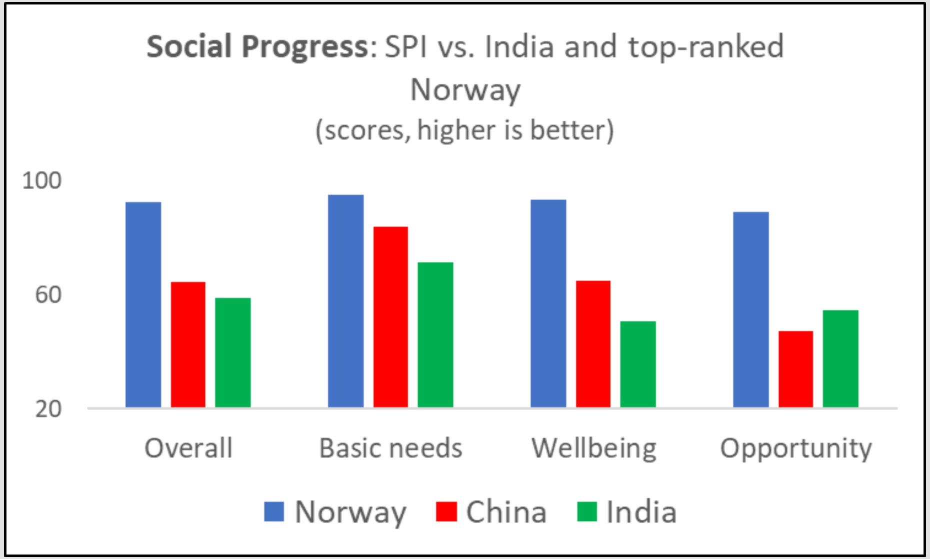


Total factor productivity growth – that is productivity due to innovation -- is way down. Overinvestment in China has caused the return on capital to fall.

Source: charts from China IMF Art. IV report Jan 2022

Environmental & Social risks



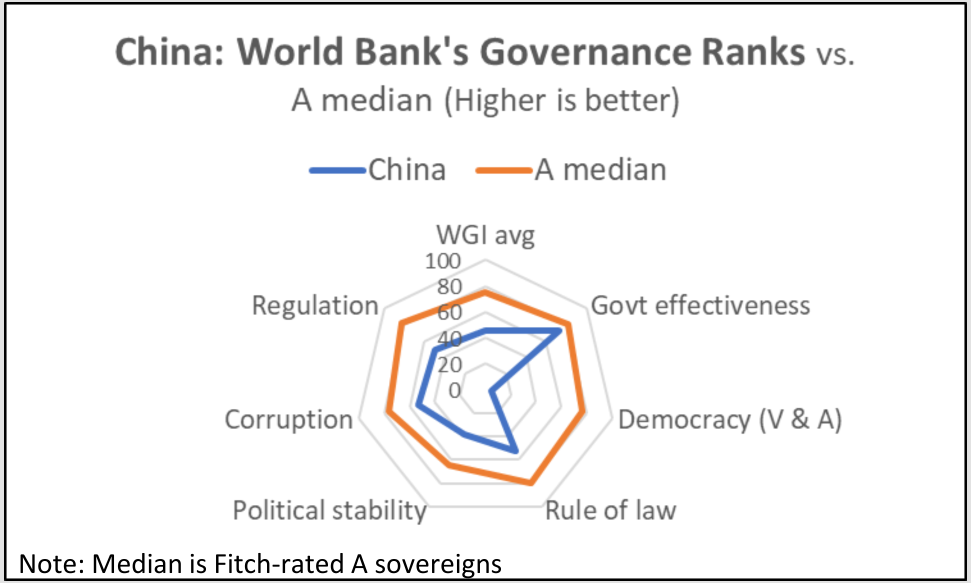


[Moody's](#) **assigns an ESG Credit Impact Score to China of CIS-3**, indicating a moderate negative impact of ESG on the sovereign rating. It assigns Issuer Profile Scores of E-3 (moderately negative), S-3 (moderately negative), and G-2 (neutral to low) risks. IPS scores are Moody's opinions on China's exposure to E, S and G risks.

SPI: Basic needs cover access to nutrition, medical care, water, sanitation, shelter & personal safety. Foundations of wellbeing cover access to basic education, information, health care, wellness & environmental quality. Opportunity covers personal rights & freedoms, inclusiveness & access to advanced education. China gets high scores on nutrition & basic medical, water & sanitation, shelter & basic education; & low scores on personal rights, inclusiveness, environmental quality, & access to advanced education.

EPI, the Environmental Performance Index is prepared by Yale & Columbia universities; 2020 results. **SPI,** Social Progress Index, is advised by top Harvard / MIT academics & corporate members, 2021 results.

Governance



Potential impact of governance issues on the business climate: The IMF, commenting in the Jan 2022 IMF Art. IV report re: the "wide-ranging regulatory policy measures" rolled out in 2021 for online activities and targeting technology companies, noted the: "investor discomfort with a rapidly changing business environment that is viewed by market participants as undercutting the role of private enterprises and paving the way toward more state control over economic activity." Note: V & A stands for "Voice & Accountability" a proxy for the level of participatory democracy.

See WGI

China: Recommendations

Sovereign rating

- **Foreign Currency Rating of A+**
  - China's high national savings & ample government assets provide time for reform
  - Strong innovation could drive future GDP growth
  - Rating downgrade possible if:
    - Rebalancing (toward consumption, services, low carbon, & smaller govt) falters
    - Excessive credit growth resumes & bad debt cleanup – incl. in RE – is delayed
  - "Common prosperity" policy could support rebalancing if focused on social protection / fiscal progressivity / inclusiveness

Country risk category

- **Medium risk**
  - Medium risk balances China's strengths against L-T risk of disorderly transitions; Mod. Low risk possible with successful reforms
  - Reform sequencing is challenging: recognition of bad debts, credit risk repricing, capital controls relaxation
  - Heavy capital outflows, caused by portfolio rebalancing, could impact FX reserves & CNY in L-T
  - A growth slowdown could trigger labor market displacement, stressing the political system
  - Rules changes in politics, arbitrary regulation, bias in favor of SOEs & dom. firms, int'l tensions over geopolitics, human rights & trade can sap investor confidence

Five Country Risk Categories: Low, Moderately Low, Medium, Moderately High, & High risk

Country Risk – end

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