



Rating Action: Moody's affirms China's A1 rating, changes outlook to negative from stable

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Singapore, December 05, 2023 – Moody's Investors Service ("Moody's") today changed the outlook to negative from stable on China's government credit ratings while affirming China's A1 long-term local and foreign-currency issuer and senior unsecured ratings and the (P)A1 foreign-currency senior unsecured shelf rating.

The change to a negative outlook reflects rising evidence that financial support will be provided by the government and wider public sector to financially-stressed regional and local governments (RLGs) and State-Owned Enterprises (SOEs), posing broad downside risks to China's fiscal, economic and institutional strength. The outlook change also reflects the increased risks related to structurally and persistently lower medium-term economic growth and the ongoing downsizing of the property sector. These trends underscore the increasing risks related to policy effectiveness, including the challenge to design and implement policies that support economic rebalancing while preventing moral hazard and containing the impact on the sovereign's balance sheet. As such, Moody's expects support provided to financially-stressed entities to be more selective, contributing to protracted risks of further strains for SOEs and RLGs.

The affirmation of the A1 rating reflects China's financial and institutional resources to manage the transition in an orderly fashion. Its economy's vast size and robust, albeit slowing, potential growth rate, support its high shock-absorption capacity. This is buttressed by low external risks and financing costs as large domestic savings foster high debt affordability. High economic strength also supports general government revenue which implies that financial resources can be mobilised to support RLGs and, indirectly, local government financing vehicles (LGFVs) if these resources can be effectively allocated. And while policy effectiveness is being tested, a track record of effective policy actions in the past also supports the rating.

China's local- and foreign-currency country ceilings are unchanged at Aaa and Aa1 respectively. The local currency ceiling, four notches above the rating, reflects limited external risks, broadly predictable institutions; offset by a large government footprint and influence in the economy and financial system which could lead to government decisions that are credit negative for non-government issuers. Looking ahead, erosion in the predictability of executive institutions and government actions could point to a lower local currency ceiling. The foreign currency ceiling, one notch below the local currency ceiling, reflects the net impact of strong policy effectiveness, low external debt but also history of capital account controls which point to some, albeit limited, transfer and convertibility risks in a low probability scenario of the sovereign facing very significant financial stress.

RATINGS RATIONALE

RATIONALE FOR NEGATIVE OUTLOOK

FINANCIAL SUPPORT TO FINANCIALLY-STRESSED RLGs AND SOEs LIKELY TO DIMINISH CHINA'S FISCAL STRENGTH AND CHALLENGE POLICY EFFECTIVENESS

In light of China's government's consistently stated policy objective, over the medium term, Moody's expects its property sector to remain smaller in proportion to the entire economy than it was before the property correction that started in 2021. As a result, RLGs face a structural loss of land sales revenue, which accounted for 37% of their revenue (excluding transfers from the central government) in 2022. Regions that relied most heavily on land sales are unable to materially offset the loss in revenue from other sources and will face financial strain for the foreseeable

future, in Moody's view. Loss of land sales revenue reduces the ability of RLGs to support LGFVs and other local SOEs, including some entities highly reliant on RLG funding. Moody's expects further evidence of crystallization of contingent liabilities to materialize, which means that financial support to RLGs and SOEs will be provided by the government and wider public sector.

The risk is that, over the medium term, the crystallization of contingent liabilities comes at more significant costs to the sovereign than consistent with the A1 rating; and/or that the effectiveness of government policies that aim to manage this transition period is lower than Moody's currently assumes, with negative consequences for the economy and, in scenarios that currently have a low probability, financial stability.

Instances of LGFV and local SOE financing stress have increased in the past year, and in Moody's view, market financing will remain challenging for entities from provinces such as Yunnan and Guizhou, where domestic bond market spreads remain very wide. More generally, if RLG support is durably impaired, debt sustainability will be at risk for LGFVs and local SOEs with particularly high leverage and/or low revenue coverage of interest payments.

Moody's estimates that around one third of the amount of SOE debt outstanding – equal to about 40% of GDP – has interest coverage below 1, which generally indicates weak debt sustainability. These estimates are consistent with those of the International Monetary Fund (IMF). While not all SOEs are likely to need direct government support, even a moderate proportion doing so over the medium term would represent a significant crystallization of contingent liabilities for the sovereign, increasing the costs of financial support and diminishing fiscal strength. Furthermore, ensuring that support to local government or SOE debt happens in a timely and orderly, yet targeted fashion in a way that supports growth and investment represents a significant policy challenge.

Recent developments are consistent with Moody's assessment that contingent liability risks are increasing, with negative implications for the sovereign's fiscal strength. These developments include the central government's approval for RLG bond issuances of over RMB1.3 trillion between 1 October and 7 November 2023 for repayment of upcoming LGFV bond maturities for the weakest provinces; the central government's announcement of a planned RMB1.0 trillion special treasury bond issuance to fund RLG post disaster construction; and a RMB1.6 trillion increase in central government transfers to RLGs in 2022 compared to 2021, which partly but only temporarily offset the RMB2.0 trillion of lost land sales revenue. Not all of this financing is new, and not all of it is intended to support LGFVs or RLGs in financial stress directly. However, indirectly at least, these funds will support the economy and entities at a local level. The costs of financial support are also borne across the wider public sector. The so-called asset revitalization program whereby Asset Management Companies (AMCs) provide support to distressed property developers, and state-owned banks restructuring of LGFV loans at very low cost and longer maturities, are examples of support by and costs to the broader public sector.

While these financial support measures will alleviate the most acute instances of liquidity stress at a local level in the near term, the amounts at stake are small relative to the size of LGFV and local SOE debt potentially at risk, and their one-off and short-term nature means that they do not address local government debt sustainability issues, in Moody's view.

Considering the policy challenge posed by local government debt, the central government is focused on preventing financial instability and likely has detailed insights in the financial health of LGFVs. Still, maintaining financial market stability while avoiding moral hazard and containing fiscal costs of support, is very challenging. Moreover, contingent liabilities raise a complex policy dilemma. Moody's assesses that central government support will be more selective and lower than in the past (for instance than in the 2015-18 LGFV debt swap operation), as several government directives have re-emphasized the need for RLGs to manage debt issues in their own jurisdictions. These policy directives are consistent with the government's objective of deleveraging and de-risking the government sector. But while contained support will limit the near- to medium-term fiscal costs, it also means that contingent liability risks will linger.

Overall, in Moody's view the risk of more significant contingent liability crystallisation has increased. Absorbing a

significant portion of these contingent liabilities across the public sector would come at material costs, which would undermine China's fiscal strength and potentially its creditworthiness. However, designing a policy that effectively addresses the issue of LGFV debt sustainability while minimizing financial risk, and doing so while maintaining the policy objective of deleveraging and derisking the government sector, is very challenging. Meanwhile, contingent liability risks will remain as long as the fundamental driver of this risk remains unresolved.

RISKS TO GROWTH STEM FROM REFORM AND DELEVERAGING CHALLENGES WHILE ECONOMY TRANSITIONS AWAY FROM PROPERTY, EXACERBATED BY A LACK OF PREDICTABILITY OF GOVERNMENT DECISIONS

Moody's expects that China's annual GDP growth will be 4.0% in 2024 and 2025, and average 3.8% from 2026 to 2030, with structural factors including weaker demographics driving a decline in potential growth to around 3.5% by 2030. To offset the diminished role of the property sector over the medium term, substantial and coordinated reforms will be needed for consumption and higher value-added production to drive growth. While Moody's estimates of potential growth assume some effectiveness of reforms in these directions, significant execution risk exists, exacerbated by unpredictability surrounding how and what reform measures will be taken. Moreover, in the near term, downside risks to growth remain, as the downsizing of the property sector is a major structural shift in China's growth drivers which is ongoing and could represent a more significant drag to China's overall economic growth rate than currently assessed. In turn, a more pronounced slowdown in growth in the near to medium term would exacerbate local government deficits and debt further.

Reforms that would support a shift in China's growth drivers from property and investment towards consumer demand are those which boost disposable income and lower precautionary savings. The Chinese government aims to lift consumer demand by building the "social safety net," supporting employment levels and skills, as well as increasing education quality. Key reforms to drive the shift to higher-value sectors include enhancing education performance and fostering the private sector to drive innovation. China has also introduced a wide variety of policies to support the development of higher value-added manufacturing sectors and technology-related sectors in recent years to replace declining sectors such as property and low-wage manufacturing.

Execution risk is rising, particularly as spillovers from the property sector downturn amplify the challenge of implementing such broad and complex reforms. The cost of measures to expand the social safety net will increase as growth is slowing, the tax base remains narrow and a weak outlook for the property sector dampens households' confidence to spend. In addition, restrictions on trade in technology driven by geopolitical tensions will curb the kind of information sharing that is crucial to the rapid development of high-tech manufacturing sectors.

A lack of predictability in the tools and commitment to support the private sector, in Moody's view, illustrated in recent internet platform and private education sector regulatory changes, could constrain investment and in turn productivity growth more severely than Moody's assumes. Regulatory uncertainties – particularly around the private sector – risk undermining consumers' willingness to spend and investors' readiness to invest.

Delays or shortcomings in executing reforms could lead to lower growth than Moody's forecasts, especially since over the medium term, structurally lower growth will reflect the declining labour force, moderate productivity growth, and a maturing of China's capital stock. Lower than expected growth would amplify fiscal pressures, constraining efforts to deleverage the government sector and complicating further the task of managing contingent liability risks.

RATIONALE FOR RATING AFFIRMATION

The affirmation of the A1 rating reflects China's financial and institutional resources to manage the transition in an orderly fashion.

Despite the execution risks associated with the complexity of reforms, Moody's expects gradual reforms to continue to enhance innovation and technological development, educational quality, further rebalancing of growth towards high value manufacturing and services sectors and the productivity of SOEs, which will support productivity and GDP

growth and allow living standards to continue to rise.

And while growth will be lower than previously expected, it will remain robust compared with other A-rated peers. The scale of China's economy and growth in per capita GDP, which will occur in a context of ongoing structural change towards higher value sectors will continue to support Moody's assessment of China's economic strength.

In Moody's view, China's institutional and governance strengths will remain backed by the broad control which the state has over key state assets including the state-owned enterprises and the financial system, which enables it to mobilize significant resources to address potential financial stress. Despite execution challenges stemming from the transition costs related to reducing the economic role of the property sector and an increased focus on de-leverage issues, China's government has a track record of effectively deploying its vast resources to meet policy challenges. The net of these institutional and governance strengths and challenges in a context of increasingly difficult policy environment is reflected in a 'baa' score for China's quality of legislative and executive institutions.

China's other key strengths include low external risks and financing costs as large domestic savings foster high debt affordability. Large fiscal and foreign exchange reserves, and the government's control of parts of the economy and financial system, lend effectiveness to measures aimed at stemming financial, and ultimately social stability risks.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

China's ESG Credit Impact Score reflects moderate exposure to environmental and social risks that is partly mitigated by institutional and financial resilience.

China's exposure to environmental risks may raise credit risks in future posing significant challenges to the authorities. They could also, over the long term, raise fiscal costs and constrain economic growth in affected regions and consequently the credit outlook.

Exposure to social risks is also a potential source of future credit risks as a result of its ageing population and shrinking workforce. These factors will increasingly weigh on growth and could result in large increases in social security spending, though the government's capacity to deliver support mitigates these negative impacts.

Governance is broadly in line with other sovereigns and does not pose specific risks although the effectiveness of China's executive institutions is being stretched by a range of difficult issues including structural changes in the property sector, and the coordination and execution of policy between the central, and regional and local governments. At the same time, China has a track record of relatively effective macroeconomic policy.

GDP per capita (PPP basis, US\$): 21,404 (2022) (also known as Per Capita Income)

Real GDP growth (% change): 3% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.8% (2022)

Gen. Gov. Financial Balance/GDP: -2.8% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: 2.2% (2022) (also known as External Balance)

External debt/GDP: 13.7% (2022)

Economic resiliency: a2

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 30 November 2023, a rating committee was called to discuss the rating of the China, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have

not materially changed. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially decreased.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The negative outlook indicates that an upgrade is unlikely in the near term. The outlook could be changed to stable if it became increasingly likely that the central and regional and local governments were able to deliver financial support to LGFVs and local SOEs, at moderate costs for the public sector and without raising financial stability concerns. This scenario is likely to involve evidence of a shift towards a comprehensive and credible plan to address local government debts, including effective central government and RLG policy coordination and long term management of local government deficits and debt.

Negative pressure on the rating would stem from growing evidence that material public sector financial resources are required to manage debt sustainability in the local SOE and particularly the LGFV sector, while contingent liability risks remained material. Evidence that the challenges of sustaining economic expansion, reducing leverage, and improving the effective coordination and execution of policy, including at the RLG level, were not being met, would also place negative pressure on the rating. Rising risks of financial, social and economic instability would be credit-negative.

The principal methodology used in these ratings was Sovereigns published in November 2022 and available at <https://ratings.moodys.com/rmc-documents/395819>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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