China

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Following a rapid recovery from the pandemic, growth momentum in the economy is slowing. This is partly due to shifting policy priorities which may create some uncertainty over the medium-term. Geopolitical tensions have risen on the back of an intensified international rivalry and military build-up.

Country Risk Analysis

Summary and conclusions

Following a swift economic recovery late last year, growth has gradually slowed in 2021. Apart from cyclical and temporary factors, policies aimed at reducing leverage and prioritising the quality of growth rather than its pace is starting to bite. While these policies may cause some regulatory uncertainty and weigh on activity in the medium-term, GDP growth in 2021 will be among the highest in the world, helped by favourable base effects. The rebalancing may ultimately be beneficial for longer-term growth. Still, long-standing growth challenges such as a declining working age population and lower productivity growth remain.

Developments in the external balances over the past year have further cemented China's strong position. The current account remains in a healthy surplus, foreign direct investments into the economy remain sizeable while FX reserves have edged up from already high levels.

Debt levels across the economy have been exacerbated by the pandemic. The deterioration has come across virtually all government bodies included in the official budget as well as quasi and extra budgetary entities. This trend is likely to persist in the near-term. In the highly indebted corporate sector, non-financial state-owned enterprises, already standing for the lion share of debt, have also increased their leverage. Debt related challenges in the real-estate sector have recently sparked concerns about broader effects on banks, house prices and economic activity. We assume that the authorities have the tools to orchestrate an orderly winding down of distressed corporates in the sector.

Geopolitical risk remain important as tensions have increased between China and a broad range of the major economies. Risks are evident that a continued US-China decoupling will impact economic and business activity. China's increased military capacity is shifting geopolitical balances in their favour.

Recent economic developments

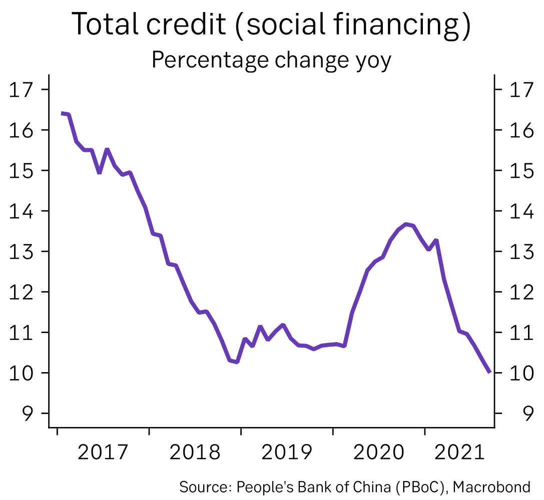
Pace of recovery is slowing. The economy continued to recover in the first half of 2021. Household spending fuelled by rapid increases in real incomes and exports were the main growth drivers. However, since the summer, the recovery has lost some steam. In Q3 real GDP growth slowed to 4.9% yoy, from 7.9%. Cyclical and temporary factors such as electricity shortages have had an effect. Equally important though is that policies aimed at reducing leverage and financial risks in the economy are starting to bite. The cooling of the real estate sector is just one example.

Last year's slowdown led to a decline in inflation. Inflation, particularly core inflation, was low prior to the pandemic. After averaging 2.5% in 2020, consumer prices have recently been rising steadily at about 1% in yoy terms. Producer prices on the other hand have shot up in 2021, rising at double digit rates, largely a reflection of higher commodity prices. So far, the spill-over from these price increases to finished products have been modest.

External balances remain a key country risk strength. Developments in the external balances over the past year have further cemented China's strong position. Strong exports lead to a doubling of the current account surplus to 1.9% of GDP in 2020. China's global export market share has risen compared to 2018 when the trade war with the US started. Developments so far in 2021 point to a broadly stable current account surplus, helped by a surprisingly high surplus in the trade account. Inward foreign direct investment (FDI) rose in 2020 and were roughly of the same magnitude as global FDI into the US. They picked up in net terms too, and are on track to reach long-term highs in 2021. Foreign corporates operating in China and reinvesting a large part of their export earnings are reported to make up an important share of these FDIs. China's gross external debt is minimal and the country remains a large *net* external creditor.

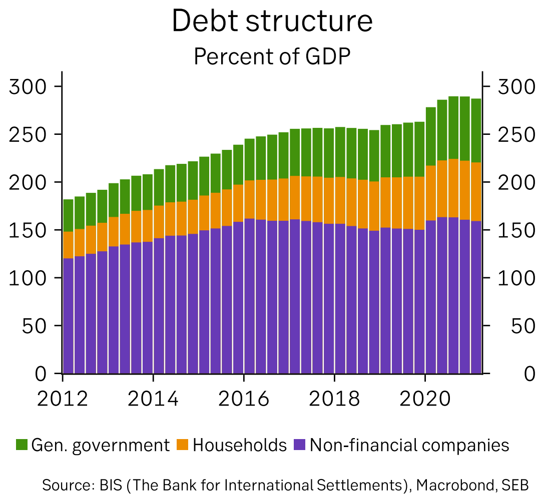
Stronger yuan and higher reserves. These developments have contributed to an appreciation of the exchange rate to the strongest levels in several years, and helped to keep foreign exchange reserves on an upward trend, reaching USD 3.4 tn recently. This more than covers the country's total external debt.

Banking sector. Aggregate financial sector soundness indicators have largely moved sideways over the past year. Credit growth which accelerated during the pandemic has slowed. Total social financing (includes bank loans, shadow bank lending, government and corporate bonds, and equity financing) was rising 10% yoy in October. This is broadly in line with nominal GDP growth. The pace of new lending to the real estate sector and housing loans has steadily



declined over the past few years. Still, household debt/GDP has continued on its rising trend.

Pressures on highly indebted corporates may spill over on banks. High corporate sector debt has for long been a key country risk negative. The accelerated credit growth in 2020 fuelled a further rise in non-financial corporate sector debt. The rise was mainly attributed to state-owned enterprises (SOE), already standing for roughly two thirds of the debt. However, corporate debt as a share of GDP has edged down recently. The government's intensified focus on reducing financial risks and leverage in the economy is putting pressure on companies active in the most indebted and/or higher risks sectors. The financial woes of Evergrande is one example. SOEs have not been spared which was reflected in a rising number of bankruptcies in late 2020. Pressures on the corporate sector has raised the risk for banks exposed to those industries.



Sovereign ratings stable. The major sovereign credit rating agencies have all kept their sovereign ratings unchanged over the past year.

Economic policies

Favouring stabilisation and reorientation over growth. Reducing financial risks is but one of several of the government's policy priorities. The conflict between the various objectives have grown following the pandemic and probably has been further amplified by rising geopolitical tensions. Nevertheless, following the announcement of the 14th 5-year plan, which included a lower target for economic growth (at least 6%), most observers concluded that a stabilisation of the economy and a reorientation of growth have gotten the upper hand on the overall pace of GDP growth.

Other policy priorities can be derived from the overarching objectives "dual circulation" and "common prosperity". The "dual circulation" strategy launched in mid-2020 is intended to reduce China's reliance on the rest of the world and at the same time becoming more attractive as a destination for FDI. The strategy includes promoting household spending as the main growth driver. The aim of the more recent "common prosperity" drive is to redistribute wealth and deal with excessively high incomes. This policy objective is likely to be pursued mainly by scaling up existing reform plans related to public services, taxes, protection of labour, and regulation. Recent trials of a property tax are in this spirit.

New policies reflecting increased regulatory uncertainty? The past year's new regulations on various business sectors, including in the tech and private education industries, are also in this spirit. These restrictions have been put in place while the authorities have been affirming their support for private sector activity in general. Hence, few observers expect that these events mean the start of a purge of private businesses in general but rather see them as a consequence of the broader policy goals. However, several observers have expressed concerns that they may herald a period of higher regulatory uncertainty.

Fiscal policy is relaxed. Following years of a gradual widening, government fiscal deficits swelled considerably in 2020. The tangled web of public finances complicates a full assessment but it appears that a deterioration has come across virtually all government bodies included in the official budget as well as quasi and extra budgetary entities. While the "official" deficit only increased to 3.7% of GDP from 2.8% in 2019, the consolidated deficit of the entire general government doubled last year to 11.2% of GDP (IMF definition). In 2021, the economic recovery have helped raise revenues, so far producing a declining official government deficit.

Official public debt rises but remains moderate. The official government debt is moderate despite the rise to about 46% of GDP by end-2020 from about 38% of GDP. About half of this debt is central and roughly half is local government debt. The debt is mainly funded domestically and in local currency. This is a strength.

Broader public sector debt reflects significant underlying leverage. In order to more fully capture the leverage of the public sector, we rely on the IMF's broader estimates which include a range of local government borrowing, including off-budget liabilities. Local governments' liabilities include the debt of their financing vehicles and other enterprises they own. Although the central government has sought to restrict the reliance on local financing vehicles, the IMF estimated such debt at 38% of GDP at year-end 2020. As a consequence, the IMF's so called augmented public debt summarised to more than 90% of GDP in 2020. Previous progress in reducing debt among the state-owned enterprises (SOE) reversed during the pandemic. Despite the default of some SOEs in 2020, most observers assume high implicit government support for them.

Little change in monetary policy. Although the main policy rates have been kept unchanged in 2021, the People's Bank of China cut the reserve requirement ratio for banks in July thereby increasing liquidity in the financial system.

Structural policies and institutions

Some progress on reform. Over the past couple of years, the authorities have made progress in opening up the financial sector to foreign investment, transactions and ownership. Labour market reforms have also advanced, for example by easing access to the labour market for migrants. In addition, the IMF reports that there was progress on fiscal reforms even during the pandemic, including improvements to transparency and budget planning. Reforms relating to the large SOE sector, however, has only made slow progress.

Quality of governance and institutions are weaker than average. Government effectiveness is high but most other governance related indicators are weaker than average among country risk peers. However, apart from the World Bank's voice and accountability indicator, all indicators have been on an improving trend over the past decade. Separately, lower policy transparency and restrictions on information weigh on country risk.

Per capita incomes still lower than average. Given a broadly unchanged population, GDP per capita continued to rise in 2020. Still, incomes per capita are significantly lower than average among country risk peers.

Political and security situation

Xi Jinping setting the stage for re-election. Over the past year, political manoeuvring has increased the probability that Presiden Xi Jinping will be elected a third term as leader when the Party Committee convenes in October 2022.

Geopolitical tensions have risen. The government's dual circulation policy partly comes out of the rising geopolitical tensions. An increasing number of western countries have begun to see China as a threat, and has responded by tightening regulation and security, and in some cases by sending warships to East Asia. Meanwhile, China has been expanding its military and developed new weapons which is seen as shifting the geopolitical balances in their favour. Tensions and rivalry with the US have not decreased under the Biden administration although relations are less confrontational. The trade war is still simmering on several fronts. Trade and security tensions with Australia and the EU have also escalated. In addition to China's tightened control over Hong Kong, other long-standing areas of confrontation has come to the fore. These areas include unsettled borders with India, Japan and most of the countries around the South China Sea.

Taiwan in focus. Key in this area is Taiwan, were the Chinese leadership has recently repeated calls for a unification. The US maintains a formal ambiguity regarding defending the country should it be attacked by China. While President Biden at two occasions recently has stated that the US has such an obligation, Congress has not made any formal commitment. China's Taiwan related rhetoric has gone hand in hand with a record number of aircraft intrusions in Taiwan's air defense identification zone.

Outlook

Economy facing bumpy near-term recovery. Forecasters have been cutting their near-term growth forecasts recently as government measures to rein in the credit expansion have started to bite. Uncertainties related to supply chain disruptions are also clouding the outlook but SEB expects a real GDP expansion of 8.2% in 2021 and 5.2% in 2022. This would still make the economy one of the fastest growing economies globally. This scenario assumes that the government will manage to gradually reduce real estate sector's footprint while avoiding a harder landing.

Re-balancing could benefit the longer-term growth prospects. Estimates of the real-estate sector's contribution to economic growth vary but is in the range of 20-30% of GDP. Consequently, the policy shift will most likely weigh on medium-term growth. However, a rebalancing of the economy may well be beneficial in the longer term as it could make growth more sustainable. This would be positive as the economy, for other reasons, is set to grow much slower in the coming decade than in the past. Headwinds to growth include that the economy's catching-up phase is coming to an end (growth normally slows as real incomes per capita rise), the working age population is declining and productivity growth is decreasing. On demographics, the government has announced a number of measures over the past year to increase birth rates, but analysts generally agree that they will have a very small impact. Therefore, most estimates of long-term growth put it at 4-5%.

Risks from cooling the real-estate sector. Pressures on corporates in the real-estate sector is expected to persist as long as the authorities stick to the three "red lines" policy. However, we assume that the authorities have the tools to orchestrate an orderly winding down of distressed corporates. An evident near-term risk, however, relates to the woes of weaker real-estate developers escalating and raising broader financial stress to the extent that it spills over on the economy and the financial sector. For example, a sudden further tightening of financing conditions for a broad range of real-estate developers could lead to a housing market correction. This would mainly weigh on household spending and economic growth but could also hurt banks' balance sheets.

Risks coming from decoupling. There are several risks to the outlook related to geopolitical developments. While a potential upside scenario implying an improvement from today's situation of US-China rivalry is possible, the main risks are on the downside. A key risk relates to the ongoing decoupling between the US and China, including through the tightening of access to important technologies. By increasingly closing off China and disrupting supply chains such a development is likely to weigh on productivity and on economic growth. This is already happening, but an intensification of the rivalry beyond expectations is a risk. This would include US-China political relations and decoupling worsening to a point where some systems, data protection and financial regulations become incompatible. An escalated trade war in such a scenario, possibly reinforced by new US sanctions, would depress bilateral trade and investment flows into China. These factors in combination with a raft of new laws relating to data privacy, data security and cyber security could put strain on foreign entities resulting in companies choosing to decouple their China operations from their global ones.

Risks of a military intervention. Two alternative and more negative risk scenarios involve military intervention. In the first we envisage China engaging in minor military hostilities for a limited period of time. For example, this could involve an assault on Taiwan's outlying islands. Such an assault would likely be too quick for any military response from Taiwan's allies but would result in broad sanctions on China from the western world. The second scenario is the tail risk event of an outright war. This could for example be triggered by an accident or a human error in a tense military situation. In this scenario, most of the trade and investment flows to and from the region would be brought to a halt and financial markets could freeze.

Climate change risks. China is often classified as one of the top 10 countries in the world facing the risk of natural disasters with severe economic consequences. Climate change could lead to more extreme weather which, for example, could increase the already high frequency of floodings. It could also lead to increasingly binding water scarcity.

China: Key Economic Indicators

	2017	2018	2019	2020	2021	2022	2023	2024	2025
Macroeconomic									
GDP (% chg)	6,9	6,8	6,0	2,0	8,2	5,2	5,4	5,4	5,0
GDP (USD bn)	12337	13880	14267	14768	17808	19657	20938	22635	24408
GDP/capita (USD)	8676	9717	9945	10254	12326	13567	14415	15550	16738
Investments/GDP	42%	43%	43%	43%	40%	40%	39%	39%	39%
Trade/GDP	32%	32%	31%	30%	33%	32%	31%	30%	30%
Oil production, bpd ('000)	3788,7	3716,1	3768,5	3832,0	3952,8	3920,8	3798,2	3685,1	3582,0
Money & Prices									
CPI inflation (%)	1,6	2,1	2,9	2,5	1,1	2,9	2,5	2,4	2,3
Money supply, M2 (% chg)	9,0	8,1	8,7	10,1	8,4	8,6	8,3	7,8	7,4
Interest rates, short-term	4,72	4,02	3,07	2,57	2,69	2,74	3,18	3,37	3,55
Oil price (USD, Brent)	54,3	71,1	64,4	41,8	71,0	72,5	63,6	60,1	61,0
Government Finances									
Budget balance/GDP	-3,8	-4,7	-6,3	-11,2	-7,5	-6,9	-6,2	-5,6	-5,0
General gov't budgetary debt	36%	37%	38%	45%	47%	50%	51%	53%	54%
Interest rate costs/revenues	3%	2%	3%	4%	4%	4%	4%	4%	5%
Balance of Payments (USD bn)									
Current account	188,7	24,1	102,9	274,0	336,4	342,6	240,9	240,7	293,2
as % of GDP	1,5	0,1	0,7	1,7	1,9	1,7	1,1	1,0	1,1
Exports of goods	2216,2	2417,4	2386,6	2497,2	3189,7	3406,0	3519,8	3733,8	3985,4
Imports of goods	1740,3	2037,4	1993,6	1982,2	2623,3	2812,1	2913,4	3048,9	3228,9
FDI, net	27,8	92,3	50,3	102,6	209,4	123,0	87,1	88,5	90,7
as % of GDP	0,2	0,7	0,4	0,7	1,2	0,6	0,4	0,4	0,4
Loan repayments	144,7	160,5	180,6	180,8	162,4	162,4	162,4	162,4	162,4
External Debt & Liquidity (USD bn)									
Total debt	1704,5	1961,5	2114,2	2349,4	2583,9	2823,3	3071,7	3327,3	3588,4
o/w short term debt	1030,6	1218,9	1205,3	1236,2	1271,4	1307,3	1344,6	1382,9	1422,1
as % of GDP	12,0	13,1	13,5	13,1	12,7	12,9	13,1	13,1	13,1
Reserves (ave.)	3140,0	3072,7	3107,9	3216,5	3217,3	3234,5	3240,1	3248,9	3260,7
months of imports	16,8	14,6	14,9	16,0	12,6	11,8	11,0	10,3	9,7
Exchange rate vs USD	6,76	6,61	6,91	6,90	6,46	6,37	6,34	6,32	6,29

Source: Oxford Economics, IMF and SEB

Rating history				
Fitch (eoy)	A+	A+	A+	A+
Moody's (eoy)	A1	A1	A1	A1

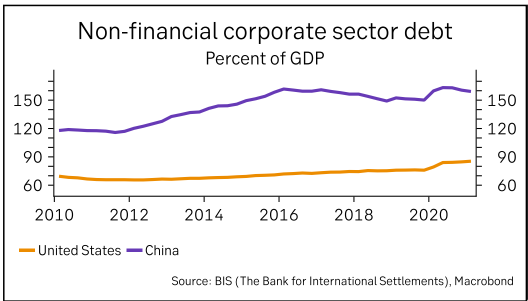
Type of government:

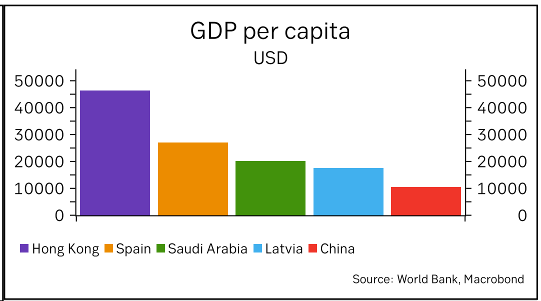
Next elections N/A

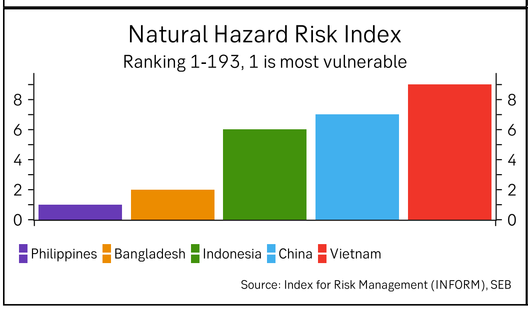
Other:

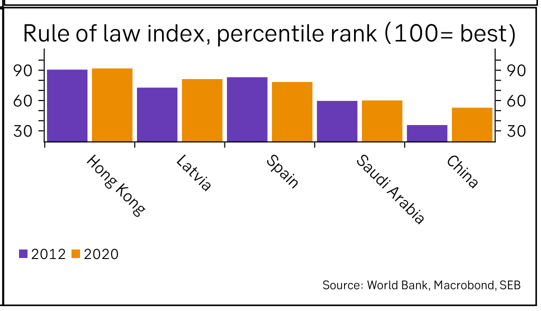
Latest PC deal None

Recent IMF programs Stand-By arrangement, expired 1987









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