

# Reassessing China's Sovereign Risk: Emerging Global and Domestic Trends Threaten the “Chinese Miracle”

Today, thanks in part to its investment-grade sovereign credit rating, China is seen as a strong credit risk. But is this just a mirage? **Kevin O'Brien** argues that political, social, environmental and economic trends — including “artificial” ratings, massive amounts of non-performing loans in the state banking sector and the Chinese government's default on billions of dollars worth of credit sovereign debt — make China very risky.

Contrary to the prevailing perception of China as a relatively benign credit risk, recent research<sup>1</sup> demonstrates that the country has been subject to troubling trends — including escalating incidences of civil unrest; adverse labor demographic; severe environmental degradation; wage inflation; soaring transportation costs; failure to address state institutions' bad debt; a transparently artificial sovereign credit rating; and the erosion of Beijing's central authority — that represent an ominous threat to its economic outlook.

In fact, the myth of China's ever-expanding economy belies sustainability issues that comprise the core of China's economic development. This article summarizes some of the key global and domestic trends impacting China's political economy and reveals why the so-called Chinese Miracle may be facing the very real threat of a dramatic reversal.

One of the greatest problems facing China is the government's failure to acknowledge and effectively address the true extent of state institutions' bad debt. China's financial system continues to generate many non-perform-



## China: A Summary of Emerging Risks

Here's a quick look at an important group of risks that could have a negative impact on China's sovereign credit rating:

- *Dependency on export manufacturing in the face of rising global transportation costs, and the prospect of a prolonged economic slowdown of China's primary export markets.* As a producer nation and net importer of oil, China is acutely vulnerable to commodity price inflation, and its economic and political stability is dependent upon hard currency earnings derived from export manufacturing. Rising transportation costs have already prompted the relocation of some foreign-owned factories out of China — factories that have moved closer to US and European consumer markets — and this trend is expected to intensify as long as oil prices (and, thus, shipping costs) remain high. The cost of shipping a standard 40-foot container from East Asia to the North American East Coast has already tripled since 2000.<sup>2</sup>

A recent report by the Organization for Economic Cooperation and Development (OECD) predicts the end of China's competitive advantage in manufacturing, citing wage and price inflation. "The Asian outsourcing game is over," Jeff Rubin, the chief economist at CIBC World Markets, recently said.<sup>3</sup>

China's new vehicle stockpile is at a four-year high, low-margin manufacturers have closed factories and the government recently announced plans for a possible economic stimulus package.<sup>4</sup> With a per capita income of just \$2,800, domestic demand is far too small to replace the loss of demand from export markets, as the vast majority of the country's population remain too poor to participate in China's nascent consumer culture. Indeed, a recent World Bank study reported that nearly 300 million Chinese exist on less than \$1 per day.<sup>5</sup>

It also appears doubtful that the economic contraction under way in China's primary export markets, particularly the United States, will end soon. Oppenheimer analyst Meredith Whitney forecasts that \$2 trillion of credit card lines will be removed by 2010, cutting the credit available to US consumers by nearly half. The bursting of the US housing bubble and the disappearance of the "home equity ATM" has occurred in tandem with escalating food and energy prices, and Fitch Ratings reports that the majority of adjustable-rate mortgages originated between 2004 to 2007 will reset to higher payments in 2009 and 2010, translating

into an additional \$1,053 monthly payment for borrowers (which will likely be causing another wave of mortgage defaults).<sup>6</sup>

- *The rate of increase of China's petroleum consumption and the dependency of China's export manufacturing sector on petroleum imports.* China is now the world's second largest consumer of oil, after the US, and is dependent on imported petroleum for nearly half of its domestic oil consumption. What's more, according to the US Energy Information Administration, China suffered the world's second largest decline in oil reserves (8.0 billion barrels) for the period 2000-2007.

China's net imports of crude oil in the first eight months of 2007 soared more than 18%, as demand for petroleum products to fuel the country's economy continued to increase. It's reliance on imported oil has doubled from 2004 to 2007, with approximately 60% derived from the volatile Middle East. By 2010, China will likely rely on oil for more than half of its total energy needs, according to Gao Shixian, the director of energy economics and development strategy at China's National Development and Reform Commission. Shixian also predicts that China will become an importer of natural gas by 2010.

In order to sustain economic growth, China's demand for petroleum imports will have to continue to increase substantially: at the same time, however, the Paris-based International Energy Agency is preparing a sharp downward revision of its oil-supply forecast.<sup>7</sup> Since petroleum is consumed in both manufacturing and transportation of export products, China's export manufacturing sector will come under further duress if global petroleum prices continue upwards, as predicted.

China's dependency on external oil suppliers, particularly Iran, creates exposure to supply disruptions that would likely result from a future conflict between Israel or the United States and Iran.

- *Health risks from China's pervasive and severe environmental degradation.* A recent study conducted by the World Bank identified the human health risks associated with China's environmental contamination; this study was subsequently suppressed at the request of the Chinese government, which feared political fallout if the report was circulated publicly.

One-third of the Chinese mainland suffers from exposure to acid rain, half the water of China's seven largest

rivers is completely useless; one-fourth of Chinese citizens lack access to clean drinking water; and one-third of the urban population is breathing polluted air. In Beijing alone, between 70% and 80% of all deadly cancer cases are related to the environment. Pan Yue, deputy director of China's state environmental protection administration, believes that these problems will soon overwhelm the country and create millions of "environmental refugees."<sup>8</sup>

- *Global commodities price inflation and China's domestic consumer price inflation, particularly with regard to food and energy.* According to the United Nations food and agriculture organization (FAO), global food prices have risen 65% since 2002. Consumer food prices in China have risen dramatically over the past year, adding to the potential for domestic unrest and resultant political instability. China's consumer price of rice, for example, has risen by more than 50% within the past year, and most vegetables and food staples are reported to have doubled in price from last year.

On average, Chinese families spend approximately 50% of their total household income on food. Moreover, the prevailing fundamentals in most primary producer markets are causing many analysts to believe recent price increases are merely the beginning of a much longer term trend.

- *Social instability stemming from income inequality and wealth disparity.* China's wage and income inequality is responsible for the emergence of "two Chinas," comprised of a small and relatively prosperous urban class and a vastly more populous rural poor class. As this situation worsens, perceptions of discontent and general disenfranchisement on behalf of a majority of the population may reasonably be expected to lead to an escalation of civil disturbances and the erosion of the Chinese communist party's centralized authority; in fact, this erosion already appears to be under way.<sup>9</sup>

- *Population demographics and shrinking labor surplus.* Chinese factory managers have recently complained of labor shortages, and wages have been rising more rapidly than in the past. The country's "one child" policy, introduced in 1979, has caused the growth in its labor supply to slow sharply. The growth in the working-age population is forecast to drop from an annual rate of 1.3% in 2005 to 0.1% by 2015.<sup>10</sup>

ing loans (NPLs) in the state banking sector. In fact, a 2006 report by government auditors at Ernst & Young (E&Y) identified nearly \$1 trillion in state institutions' bad debts in the form of NPLs.<sup>11</sup> Prior to being pressured by the Chinese government into retracting the report, E&Y's Jack Rodman (a managing director) said: "I think the numbers will be a big surprise because China has been giving the impression [with its banks' listing overseas] that the [NPL] problem is behind us. China has not really resolved the issue — they have just moved it from one state enterprise to another."<sup>12</sup>

According to the report, in 2006, China's NPL level was equal to 40% of its GDP. At that time, moreover, the four major state-owned commercial banks accounted for \$358 billion of bad loans — nearly three times the figures these banks officially reported. E&Y stated that its higher estimation of China's bad debt was based on access to broader information, including data on the rapid growth of loans in recent years and details of distressed debt companies (such as rural credit cooperatives) attached to major banks.

The continuation of speculative investment and increasing levels of bad debts are the inevitable result of the Chinese government's fiscal policies, which have been designed to maintain disproportionate inflows of foreign investment and unsustainable economic growth rates. Although the Chinese government claims to have cleared in excess of \$560 billion in bad debts since 1999 and injected fresh capital into the major state banks from the central bank's foreign currency reserves, it is evident that much of this "reduction" has been through transfers to other state-owned disposal agencies (and has been nullified by surges in new lending).

The growth of massive bad debts in China's banking system has exposed the fact that China's apparently strong economic performance rests on a fragile financial foundation.<sup>13</sup> China's Ministry of Finance continues to guarantee hundreds of billions of dollars in bonds issued to the state banks at the time the bad assets were transferred. The government's reforms have merely addressed the symptoms of China's financial fragility; what's more, exacerbating the situation further, Chinese institutions, by some estimates, may have as much as \$1 trillion in exposure to US subprime debt.<sup>14</sup>

China's four largest state banks originated an additional \$225 billion in risky new loans (one-third in real estate) between 2002 and 2004, the nature of which the Chinese banking authorities attempted to obscure by classifying them as "special mention."<sup>15</sup> The most serious speculative bubble is in real estate, where prices have risen largely on the basis of the prospect of Yuan revaluation and the 2008 Beijing Olympic Games.

Chinese central bank statistics published at the end of 2005 reported approximately \$400 billion in property



**Figure 1: PRC — Key Economic Data**

People's Republic of China  
Industrial Economic Statistics

Estimated 2007 Gross Domestic Product	11.4%
Industrial Concentration	49.2%
Industrial Sector Growth Rate (2007)	12.9%
Domestic Oil Consumption (2007 est.)	6.93 Million Barrels Per Day
Imported Oil (2007)	3.19 Million Barrels Per Day

Estimated figures for the period of January 1, 2007 through December 31, 2007.  
Source: United States Central Intelligence Agency World Fact Book (16 May 2008).

People's Republic of China  
Foreign Debt (Billions of Dollars)

Foreign Debt	Dec 2007	Sep 2007	Jun 2007	Mar 2007	Dec 2006
Total	373.6	345.7	327.8	331.6	323.0
Short Term	220.1	197.7	184.9	190.6	183.6

Source: State Administration of Foreign Exchange.  
Above figures exclude Hong Kong and Macau.

People's Republic of China  
National Debt Statistics

National Debt to GDP Ratio	Exceeds 100 % <sup>1</sup>
National Debt Dependency Ratio	78 % <sup>2</sup>
National Debt Service Ratio	17.05 % (est.) <sup>3</sup>

Statistics as of December 31, 2007. Source: State Treasury Department except as otherwise indicated.

<sup>1</sup> Figure is inclusive of the Chinese government's total liability including both explicit and implicit liabilities as of November 2005, as estimated by the World Bank.

<sup>2</sup> Figure represents the central government's fiscal expenditure only, and does not include local government fiscal expenditure. The current figure is extrapolated from the trend since 1998. The generally accepted safety range by international standards is below 25-35 %.

<sup>3</sup> The generally accepted safety range by international standards is 8-10 %.

lending, representing 17% of the country's GDP. At that same time, however, China's National Bureau of Statistics warned that unsold residential space across China had risen by nearly 25%.

Recently, China's central bank reportedly sought a major capital infusion,<sup>16</sup> and a collapse of the property bubble could have catastrophic consequences for the country's fragile banking system.

## \$260 Billion of Sovereign Debt

The prevailing sovereign credit rating classifications assigned to the government of China by Standard & Poor's, Moody's Investors Service and Fitch Ratings (the three primary nationally recognized statistical rating organizations, or NRSROs, which collectively control 95% of the credit ratings industry) conceal the fact that the Chinese government is presently in default on approximately \$260 billion of full faith and credit sovereign debt that was issued by the Republic of China (in the form of bonds due to mature in 1960) and that were sold to individual investors around the world, including the United States.

“The publication of artificial ‘investment-grade’ sovereign credit ratings assigned to China ... has enabled the Chinese government to avoid repayment of its defaulted sovereign debt.”

The repayment obligation was inherited by the People's Republic of China (PRC), when the communists took control in 1949. The successor government doctrine of settled international law affirms continuity of obligations among internationally recognized successive governments. The PRC is the internationally recognized successor government to the predecessor government of the Republic of China, which contracted the credit sovereign debt of the Chinese government and which had a loan agreement that states that such debt is intended to be “a binding engagement upon the Republic of China and its successors.”

These bonds were excluded from the broad 1979 US-China Agreement that settled other obligations of the Chinese government. In 1987, however, the Chinese government concluded a discriminatory settlement accord with bondholders in Great Britain — an agreement that excluded from settlement any bonds held by non-UK citizens.

On November 12, 2006, the Chinese Ministry of Finance issued an official communiqué addressed to “the Embassy of the United States of America in China,” in which the Chinese government formally repudiated China's defaulted full faith and credit sovereign debt and announced that it would not repay any debt held by American citizens. This issue was the topic of a hearing conducted on July 17, 2008, by the Subcommittee on Terrorism, Nonproliferation and Trade of the United States House of Representatives Committee on Foreign Relations.

This is a case of the PRC committing selective default — a practice whereby a government selectively defaults on one specific class of full faith and credit sovereign obligations (e.g., previously issued sovereign bonds), yet honors repayment to selected creditors of a separate class of obligations (e.g., recently issued sovereign bonds).

China's refusal to honor repayment of its full faith and credit sovereign debt to American bondholders is best characterized by a statement that appeared in a recent news article: “*When it comes to territory, China claims Tibet and Taiwan based on historical claims predating the current Communist government assuming power, but when it comes to debts owed to American citizens, it's a different story.*”<sup>17</sup>

## The Culpability of Rating Agencies

Despite the actions of repudiation and selective default by the government of the PRC, and despite China's continuing practice of engaging in discriminatory and exclusionary payments to selected creditors, S&P upgraded China's long-term foreign currency sovereign credit rating from “A” to “A+” on July 31 of this year. S&P, however, was far from alone in assigning incorrect ratings. In fact, the publication of artificial “investment-grade” sovereign credit ratings assigned to China by all three primary NRSROs has enabled the Chinese government to evade repayment of its defaulted sovereign debt.

Interestingly, the publication of false sovereign credit ratings for the Asian region is not without precedent. During the Asian Crisis in 1997, for example, the ratings assigned by the three primary NRSROs misstated the true credit risk of the governments of Thailand and Korea.

China's repudiation of its defaulted full faith and credit sovereign debt in the face of its investment-grade rating is obviously a sensitive issue for rating agencies.<sup>18</sup> Logically, you might ask how the three primary NRSROs have thus far been able to escape an immediate enforcement action for publishing knowingly false, misleading and injurious ratings in the instance of China. The answer is directly related to the fact that, until very recently, the agencies have been exempt from regulation by the United States Securities and Exchange Commission (SEC) and have operated outside the supervisory jurisdiction of any other regulatory body. The rating agencies claim to be “publishers” whose ratings constitute “editorials,” thus invoking the right to free speech provided by the First Amendment to the United States Constitution.

When considering why rating agencies would intentionally publish knowingly false sovereign credit ratings, it is important to remember that the entire ratings revenue stream derived from a specific country is dependent upon that country's sovereign rating; this rating estab-





lishes a “sovereign ceiling” that constrains the ratings of domestic corporates and directly affects their ability to issue debt (for which a rating agency is commissioned and paid).<sup>19</sup> Thus, the ratings revenue derived from a country by rating agencies is directly dependent upon the sovereign ceiling; however, the incentive to assign higher ratings than merited by the facts represents a clear and demonstrable conflict of interest in violation of the Investment Advisers Act, under which each of the three primary NRSROs are registrants.

### Attempts to Resolve Ratings Problems

Prior to adopting a legislative solution, in an attempt to reform the wrongful actions of the credit rating agencies, the chairman of the Joint Economic Committee (JEC) of the United States Congress sought to initiate an investigation and subsequent enforcement action by the SEC.<sup>20</sup> In response, the SEC not only explicitly disclaimed any jurisdiction over the practices of the rating agencies, but also rejected the adoption of a proposed rule requiring NRSROs to employ “*systematic procedures designed to ensure credible and reliable ratings.*”

If the proposed rule had been adopted, it would have acted to curtail many of the abusive practices engaged in by the rating agencies; these actions were detailed, in part, in a report released in July by the SEC Office of Compliance, Inspections and Examinations. This report describes numerous instances comprising conflicts of interest, intentional misapplication of rating methodologies and other self-serving practices intended to increase revenue for the agencies.

In response to the enforcement failure by the SEC and in a bid to prevent yet another credit contagion from spreading through world financial markets, members of Congress have taken action to reform the publication of demonstrably false sovereign credit ratings assigned to the government of China, restoring a much-needed measure of integrity to the ratings process and ensuring the conformity of rating classifications with published metrics and published definitions.

These efforts have resulted in the introduction of two concurrent resolutions: Resolution 78 in the United States Senate and House Resolution 1179 in the United States House of Representatives. The resolutions read,

in part, that the NSROs have published an “artificial” investment-grade sovereign credit rating for China — a ratings classification that has “improperly concealed” the “wrongful actions” of the government of the PRC and given it incentive to “*avoid a negotiated settlement with United States citizens regarding China’s default on its sovereign debt obligations.*”<sup>21</sup>

The concurrent House and Senate resolutions also express the belief of the Congress that the selective default status of China’s repudiated sovereign debt should be treated as a material fact of disclosure by the SEC, thereby subjecting the rating agencies to an enforcement action under the federal securities fraud statutes for publishing knowingly false ratings; more specifically, the resolutions note that the agencies have violated Rule 10b-5 and Section 10(b) of the Exchange Act, which prohibit disclosing materially incomplete statements (“half-truths”) and omissions of material facts.<sup>22</sup>

### The Bottom Line

Absent a voluntary reclassification by the rating agencies of China’s sovereign debt rating into the factually correct rating of “selective default,” the SEC — acting on facts presented by the US Congress — is expected to bring an enforcement action against the three primary

NRSROs; this action will be consistent with the regulatory mandate provided by other recent legislation (including the Credit Rating Agency Reform Act) that has strengthened the regulatory powers of the SEC over the activities of the credit rating agencies.

“The challenge faced by risk managers is to identify and assess [China’s emerging] risks correctly.”

Christopher Cox, chairman of the SEC, recently told the Financial Times that the regulatory authority that the commission has recently been granted over credit rating agencies “extends to their internal controls, their use of models and adherence to their own procedures.”<sup>23</sup>

Looking toward the future, the myriad of emerging country risks endemic to China transcend and far exceed the threat posed by the transient (albeit likely prolonged) economic contraction underway in China’s primary export markets. The challenge faced by risk managers is to identify and assess such risks correctly in order to establish a solid foundation for gauging the true depth and consequences of China’s exposure. ■

### FOOTNOTES

1. The research report entitled “People’s Republic of China Sovereign Risk Review and Economic Outlook Assessment” may be viewed on the World Wide Web at: [http://www.globalsecuritieswatch.org/PRC\\_Sovereign\\_Risk\\_Review.pdf](http://www.globalsecuritieswatch.org/PRC_Sovereign_Risk_Review.pdf).
2. See “Soaring Transportation Costs Will Ignite Inflation: Rubin,” *Financial Post* (May 27, 2008).
3. See “Oil Price Shock Means China is at Risk of Blowing Up,” *Telegraph* (July 7, 2008).
4. See “China Considering 370 Billion Yuan Economic Stimulus Package,” *The Epoch Times* (August 27, 2008). See also “China’s New Vehicle Stockpile Reaches Four-Year High,” *Bloomberg* (July 18, 2008).
5. See “China’s Economy Smaller in New Study: World Bank,” World Bank Press Release (December 18, 2007). The press release is accessible on the World Wide Web at: <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,date:2007-12-18~menuPK:34461~pagePK:34392~piPK:64256810~theSitePK:4607,00.html#Story2>.
6. See “Fitch Forecasts New Wave of Home Loan Defaults,” *The Associated Press* (September 2, 2008).
7. See “Energy Watchdog Warns of Oil-Production Crunch,” *Wall Street Journal* (May 22, 2008).
8. See “The Chinese Miracle Will End Soon” (interview with China’s Deputy Minister of the Environment), *Spiegel* (March 7, 2005).
9. See “China, the Olympics and the Visa Mystery,” *Stratfor Geopolitical Intelligence Report* (July 29, 2008).
10. See “The Great Fall,” *The Economist* (September 5, 2008).
11. See “Ernst & Young Retracts China Bad Loans Report,” accessible on the world wide web at: [http://www.asiabizblog.com/archives/2006/05/ernst\\_and\\_young\\_1.htm](http://www.asiabizblog.com/archives/2006/05/ernst_and_young_1.htm).
12. See “China’s Banks Still Bedeviled by Bad Debts,” *The Australian* (May 5, 2006).
13. See Statement of Gordon G. Chang in testimony before the U.S.-China Economic and Security Review Commission (August 22, 2006).
14. See “Your Vote in November Does Not Matter,” *John Galt’s Shenandoah website* (July 17, 2008).
15. See “Defaulting Loans Rampant Among Chinese Banks,” *The Epoch Times* (May 18, 2006).
16. See “Main Bank of China Is in Need of Capital,” *New York Times* (September 5, 2008).
17. See “Americans Appeal to Congress for Help Collecting China’s Bond Debt,” *All Headline News* (July 17, 2008).
18. See “U.S. Holders Claim on China for Pre-War Bonds,” *EuroWeek* (April 8, 2005). See also “People’s Republic Called to Account,” *Financial Times* (June 7, 2005).
19. See, for example, the conference for Chinese corporates sponsored by Moody’s Investors Service: <http://globalsecuritieswatch.org/Moody%27s-Promotion.pdf>.
20. See letter dated May 24, 2005, accessible on the world wide web at: <http://www.globalsecuritieswatch.org/investigation.pdf>.
21. See Senate Concurrent Resolution 78 at: <http://globalsecuritieswatch.org/S.Con.Res.78.pdf>.
22. See SEC Conference Brief at: [http://www.globalsecuritieswatch.org/SEC\\_Conference\\_Brief.pdf](http://www.globalsecuritieswatch.org/SEC_Conference_Brief.pdf).
23. See “SEC Looks to Subprime Lessons,” *Financial Times* (May 23, 2008).

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