

People's Republic of China

Sovereign Risk Review / Economic Assessment Research Bulletin

Prepared By
Sovereign Advisers

People's Republic of China

Economic Outlook
And
Sovereign Risk Review

JUSTIFICATION FOR REVIEW OF SOVEREIGN CREDIT RISK AND ECONOMIC OUTLOOK OF THE PEOPLE'S REPUBLIC OF CHINA

ATTACHMENTS:

1. Export Revenue Sensitivity Analysis: PRC Dependency on U.S. Consumer Spending.
2. Commodity Price Trend Analysis: Food and Energy Sector Inflation Rates.
3. United States Congress' Senate Concurrent Resolution 78 and House Resolution 1179: Reclassification of Chinese Government's Sovereign Credit Rating into 'Selective Default'.

June 19, 2008.

ECONOMIC ASSESSMENT AND OUTLOOK:

Certain recent developments in conjunction with prevailing global economic trends appear sufficiently serious to warrant a current economic assessment of the People's Republic of China (PRC) and a review of China's sovereign credit risk.

U.S. ECONOMIC TRENDS

The U.S. economy is experiencing a significant contraction as U.S. consumer spending continues to decline. Housing prices have plummeted as the rate of both residential and commercial mortgage delinquencies continues to increase. At the end of the first quarter of this year, nearly nine million borrowers held mortgages exceeding the value of their homes, and this number is expected to increase significantly. The U.S. economy shed 80,000 jobs in March according to the U.S. Department of Labor, the largest loss in five years. Average U.S. household debt is 85% higher than in 2001, and continues to increase as consumers take on greater levels of debt in response to rising commodity prices, particularly food and energy costs. Delinquency and default rates for credit card debt, automobile loans and student loans continue to rise rapidly, as delinquencies have increased from less than \$300 billion in 2005, to \$715 billion in 2008; representing an increase of nearly 150% within 36 months. The present economic stress will likely be compounded by an expected record number of bank failures. U.S. consumer spending is predicted to continue to decline as consumers experience increasing commodity price inflation and credit contraction.

In a report dated May 19th, Oppenheimer analyst Meredith Whitney warned:

"The real harrowing days of the credit crisis are still ahead of us and will prove more widespread in effect than anything yet seen. Just as strained liquidity pushed so many small and mid-sized specialty finance companies to the brink, we believe it will do the same to the U.S. consumer. We believe losses will only accelerate further and far worse than the most draconian estimates."¹

CHINA'S ECONOMY DEPENDENT ON U.S. CONSUMER SPENDING

The significance of the negative short- and mid-term U.S. economic outlook is especially troubling to China's export sector, which is the primary hard currency earnings producer for the Chinese government. As U.S. consumer spending continues to retreat, the economic effect is anticipated to produce severe structural pressures on China's export-driven domestic economy due to significantly decreasing external demand.

PERVASIVE INFLATION IN CHINA'S DOMESTIC MARKET

China's economy continues to experience pervasive inflation which is particularly manifest in such consumer sensitive sectors as energy (e.g., petroleum prices which have more than doubled over the past twelve months) and food staples (e.g., the price of food, which increased 23% just during

¹ Ms. Whitney also estimates about \$2 trillion of credit card lines will be removed by 2010, cutting the credit available to U.S. consumers by nearly half.

the month of February). Chinese consumers have benefitted from the state control of energy prices, which has also resulted in the loss of over 50% of the value of Sinopec shares within the last six months as the government continues its attempt to control fuel costs for consumers. Such trends are unsustainable for a country with a population in excess of 1.3 billion and which imports approximately 78% of its petroleum. Data published by the U.S. Energy Information Administration indicates that China's increase in oil demand represents a majority of the total global increase in demand. With increasing demand and relatively flat domestic production since 1986, China's reliance on petroleum imports is expected to continue, subjecting the government to additional economic stress. In its semi-annual Economic Outlook published this month, the Paris-based Organisation for Economic Co-operation and Development (OECD) expressed concern regarding the threat posed by persistent inflationary pressures manifest in China's domestic market. China's consumer price index was officially reported at 7.7% in May and 8.5% during April, and remains above its January level of 7.1%. Taking into account China's industrial consumption of commodities and that China produces very few commodities domestically and is therefore reliant on global sourcing at prevailing prices to procure raw materials for its manufacturing industry, the OECD expects wage and price inflation to erode China's export competitiveness. The OECD report states: "Coupled with ongoing weakness in external demand, exports and the pace of market share gains are projected to slow markedly". Such an outcome raises the risk of political instability resulting from increases in urban unemployment and other factors as discussed in this assessment.

ACTION

The following trends and events are identified as material to an assessment of China's near- and mid-term economic outlook:

1. The extent of dependency of the Chinese government on hard currency earnings derived from manufactured exports supported largely by U.S. consumer spending.
2. The depth of the retreat in U.S. consumer spending and the high probability of a prolonged contraction of the U.S. economy.
3. The fundamental dynamics responsible for China's domestic wage and price inflation and the increased risk of political instability attributable to the rising cost of imported consumer and industrial commodities, reduced demand for export products, and a significant increase in urban unemployment.
4. The rate of increase of China's petroleum consumption and the dependency of China's export manufacturing sector on petroleum imports.
5. China's ability to maintain the global competitiveness of Chinese manufactured goods in the face of rapidly increasing transportation costs.
6. Government debt statistics evidencing an unsustainable overreliance on debt financing, particularly short-term debt, to sustain economic growth.
7. Repudiation by the Government of China of \$260 billion of its sovereign debt and the pending reclassification of the Chinese government's sovereign credit rating into 'Selective Default'.

Upon an evaluation of the foregoing, Sovereign Advisers issues a **Negative Outlook** for the domestic economic prospects of the People's Republic of China and a **Negative Outlook** for the safety and performance of government bonds issued by the People's Republic of China.

JUSTIFICATION FOR NEGATIVE ECONOMIC OUTLOOK AND INCREASED SOVEREIGN CREDIT RISK OF THE PEOPLE'S REPUBLIC OF CHINA

We identify the following indicators as relevant to assessing the impact of economic trend-line events on China's near- and mid-term economic and political stability:

1. U.S. Economic Slowdown.

The International Monetary Fund (IMF) forecasts that U.S. growth will slow to 1.5% for 2008, which is considerably below the IMF's benchmark for identifying the onset of an economic recession. Economic data released by the U.S. government reveal that the United States has entered into a significant economic slowdown and faces the probability of an imminent and potentially prolonged recession in the midst of global commodity pricing resets.

(a) Domestic Price Inflation, Particularly Food and Oil.

Crude oil prices have risen 40% thus far in 2008, draining an estimated \$30 billion out of U.S. household cash flow per quarter. Food inflation, presently running at an annualized rate of 9%, is draining an additional \$20 billion per quarter. Household spending constitutes more than two-thirds of U.S. economic activity.

(b) Decline in Domestic Employment.

The U.S. Department of Labor reported the loss of 49,000 jobs in May, the fifth straight month of U.S. job losses. The U.S. economic slowdown is the primary factor responsible for the loss of an average of 41,000 manufacturing jobs per month so far this year, which is nearly double the rate for 2007.

(c) Consumer Spending Decline.

The U.S. has already entered a recession according to the International Monetary Fund, which generally considers a period during which economic growth is less than 2.5%-3% to constitute a recession. Sales of automobiles, the largest retail sector in the U.S., were down nearly 11% in May from the previous year. According to the Case-Shiller Index, home prices in the first quarter fell 14% nationwide. The continuing decline in home prices has already removed an estimated \$2.5 trillion from U.S. household wealth, according to Mark Zandi, chief economist for Moody's Economy.com, representing approximately \$25,000 per homeowner. If the downward trend continues as most economists now expect, and housing prices drop 30% nationwide; the market will suffer the loss of \$6.5 trillion in aggregate value and reduce household spending by \$300 billion (further reducing GDP by at least another full percentage point).

The housing market decline has terminated the ability of many consumers to utilize home equity to support consumer spending patterns, further inhibiting the prospect for a near-term resurgence in consumer spending. Retail trends indicate that consumers are now purchasing necessities and foregoing discretionary items. It is reasonable to expect this trend to continue as a result of domestic credit contraction. In addition to the contraction in consumer credit, rising food and energy prices are contributing to the squeeze felt by U.S. consumers. According to Oppenheimer's Ms. Whitley, banks have become reliant on securitization markets to fund consumer lending. With the virtual suspension of the securitized debt market in the wake of the global credit crisis, banks will experience difficulty in attempting to match the funding from their own balance sheets, removing an estimated \$3 trillion of liquidity from capital markets by the end of the year. Banks' losses will worsen as consumers will be unable to repay debt with fresh loans.

2. PRC Economic and Political Stability Dependent on U.S. Consumer Spending.

Export manufacturing constitutes approximately 38% of China's gross domestic product (GDP). This activity remains China's primary economic activity and also provides the central government with foreign exchange earnings with which to repay its outstanding external sovereign debt. Even with wages growing at an annual rate of 20% in China, just 8% of China's population earns enough income to exert a positive effect on the overall economy. The effect of a prolonged slowdown in the U.S. on the export sector of China's economy is expected to be both pronounced and protracted.

A significant decrease in export sector earnings by the Chinese government will impede the ability of the government to service its outstanding domestic debt without further stimulating inflationary pressures by increasing the money supply. A substantial decrease in export-generated foreign currency earnings may have a significant and adverse effect on the government's ability to service its existing external debt and also impair the government's ability to contract new external foreign currency debt.

A further economic threat to China is posed by the emerging emphasis on 'fair' versus 'free' trade policies by the Legislative Branch of the United States Government and the potential ramifications to China's mercantilist trade practices as a result of the emerging transition in policy emphasis favoring fair trade.

3. Domestic Effect of Increasing Global Commodity Prices, Particularly Food and Energy.

As discussed above, both domestic as well as global economic trends are causing significant inflation within China's domestic market. According to the United Nations' Food and Agriculture Organization (FAO), global food prices have risen 65% since 2002. In 2007 alone, according to the FAO's world food index, dairy prices rose nearly 80% and grain rose 42%. Such increases may be partially attributable to the emergence of a middle class in less developed countries, seeking a more robust diet comprised of a greater proportion of animal protein (requiring an increased consumption of grain in order to produce animal feed).

(a) China's Domestic Inflation Rate Continues to Increase.

In a report dated June 12th entitled, "China is Nowhere Close to Victory on Inflation", Bloomberg News columnist Andy Mukherjee wrote:

"China's producer-price index rose 8.2 percent from a year earlier in May, the quickest pace in more than three years. That announcement caused China's benchmark stock index to fall 2 percent yesterday, taking the total decline so far in 2008 to almost 38 percent, making China the third-worst-performing market in the world this year after Vietnam and Iceland. Rising costs of coal, steel and labor are crimping corporate profitability. Pretax-profit growth for publicly traded companies slowed to 17 percent in the first quarter from 49 percent in 2007, says Jing Ulrich, chairwoman of China equities at JPMorgan Chase & Co. in Hong Kong. The future may hold even more pain because at present Chinese companies don't have to bear the true cost of energy. ``Price controls on refined oil have kept a lid on the impact of higher global oil prices on producer prices," Ms. Ulrich says. "The relaxation of price controls would open the door to further increases in the producer price index and the consumer price index."

Dwyfor Evans, a macro strategist at State Street Global Markets in Hong Kong, states in reference to China that the money that remains in the local banking system and is not mopped up by the sale of government bonds "will make its way to domestic credit, which has risen consistently over recent years. This opens up a potential monetary source of inflation."

(b) Rapidly Escalating Global Food and Energy Prices Create Economic and Political Stress.

Global food and energy prices continue to sharply escalate from increased demand. Consumer food prices in China have risen dramatically over the past year, and in the event the state relaxes its oil price subsidy program, fuel prices will surge as well causing Chinese consumers to face increases in domestic energy prices and adding to the potential for domestic unrest and resultant political instability. China's consumer price index rose 8.5% during April and 7.7 % during May, although the consumer price of rice has risen by over 50% within the past year and most vegetables and food staples are reported to have doubled in price from last year. Food prices, a key component in the consumer price index, climbed 19.9 percent in May from a year earlier, down slightly from a 22.1 percent increase in April according to China's National Bureau of Statistics. On average, Chinese families spend approximately 50% of their total household income on food.

"There are other price pressures out there that are being severely repressed" according to Stephen Green, China economist for Standard Chartered Bank in Shanghai, in a report dated June 12th. "There is a lot more bottled up inflation in this economy than meets the eye", Green states. Fertilizer prices remain frozen by the central government in an attempt to insulate farmers from the global increase in fertilizer prices. China's imports of U.S. agricultural products are expected to undergo substantial price increases attributable primarily to a rise in U.S. fertilizer prices; six consecutive weeks of Midwest floods and abandonment of large quantities of crops in the fields; reduced exports as a result of crops allocated from food production to ethanol production; and tight supplies resulting from soaring global demand for wheat, corn and other staple agricultural products. Reduction in the availability of corn and other animal feed products will act to significantly increase prices of beef and animal protein stocks.

With inflation already accelerating at the fastest pace in 12 years, the rate of increase of domestic commodity prices is expected to be exacerbated by the increased demand for building materials and other commodities resulting from reconstruction of the Sichuan Province earthquake devastation zone, including rebuilding housing for an estimated five million people.¹ Sichuan Province is also a major agricultural producer for China's domestic market, including pork, rice, oilseeds and vegetables. The landslide devastation of terraced farmland resulting from the quake, along with destruction of irrigation infrastructure, is expected to create further upward pressure on domestic food prices.

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. "You know those complaints you've been hearing about high food prices? They've just begun," according to Jason Ward, an analyst with Northstar Commodity in Minneapolis, Minnesota. The U.S. Department of Agriculture this week cut its yield forecast for corn, estimating the 2008 crop at 11.7 billion bushels, down 390 million bushels from last month's forecast with the amount deemed 'excellent' only half that of the 2007 crop. High oil prices are also responsible for increased food prices as the cost of transportation continues to increase. The transportation cost increment of agricultural products will be particularly acute for countries which are grain and animal protein importers, such as China.

¹ The Chinese government reported that crude oil imports surged 25% in May, following the earthquake.

(c) China's Declining Oil Reserves and Reliance on Imported Oil.

China remains a net oil importer since 1993 and 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. China is now the world's second largest consumer of oil, after the U.S., and is dependent on imported petroleum for nearly half of its domestic oil consumption. China's reliance on imported oil has doubled from 2004 to 2007, with approximately 60% derived from the volatile Middle East.

China is predicted to rely on oil for over half of its total energy needs by 2010, according to Gao Shixian, director of energy economics and development strategy at China's National Development and Reform Commission. Mr. Shixian also predicts that China will become an importer of natural gas by 2010. In order to sustain economic growth (see Exhibit 1, below), demand for petroleum imports will have to continue to increase substantially. 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 by industry players.²

Exhibit 1
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 (16 May 2008).

According to the U.S. Energy Information Administration, China suffered the world's second largest decline in oil reserves (8.0 billion barrels) for the period 2000-2007. China is forecast to account for the fastest growth in total global oil consumption, and is expected to continue to increase its degree of dependency on imports each year.³ Oil produced from China's overseas investments accounts

² See, e.g., "Gazprom Predicts Oil Will Reach \$250". *Financial Times* (June 10, 2008). The report states that Russia's gas monopoly (and the world's largest gas producer) expects the price of crude oil to double within the next 18 months, attributable to increasing global demand. See also, Goldman Sachs recent forecast that oil could reach \$200 per barrel within the near to mid term, based in part on price-insulated non-OECD demand (e.g., China's state consumer price controls). See also, the forecast by former Citigroup analyst Louise Yamada, who predicts oil rising to over \$450 per barrel within a decade, based largely upon fundamental demand. Ms. Yamada was the top-ranked market technician at Smith Barney for four years. Note the following remark by Bo Lin, an energy specialist at the Asian Development Bank: "More than a billion Chinese are joining the oil market. How can prices go down?"

³ The APS Review's publication *Oil Market Trends* (November 8, 2004) offers an insightful historical perspective regarding China's emerging dependency on imported oil and the state subsidy responsible for an artificial consumer price: "China's oil imports doubled over the past five years and surged nearly 40% in the first half of 2004 alone. The IEA on Oct. 26 said China's 11% increase in oil use in 2003 and a 15% increase in the first half of 2004 was a "major cause" of the recent price spike. Yet the government in Beijing still has no coherent energy strategy, with a Communist culture of secrecy continuing to blind Chinese consumers to the

for just 5% of China's total imported oil, with 95% being purchased on the open market at the prevailing rate. China's state-owned oil companies have been unsuccessful in attempting to acquire Russian oil production assets. China's largest oil refiner, PetroChina, recently announced that it would issue up to 60 billion yuan worth of corporate bonds to raise cash, raising the question as to how long the central government can continue to underwrite China's consumer oil subsidy.

The vast majority of China's purchases of oil imports are denominated in U.S. dollars, creating an especially acute strain on the government, since China faces the increasing allocation of its dollar reserves toward ever larger purchases of oil imports at the same time a declining dollar reduces the purchasing power of the government's dollar reserves. In addition, further economic stress results from the fact that the decline in the value of the U.S. dollar has added price inflation pressures to global commodities (e.g., oil) as investors seek assets which provide a hedge against the U.S. currency.

(d) Asian Development Bank Reports China Losing Labor Force Advantage.

The Asian Development Banks' "Asian Development Outlook 2008" annual report reveals that China is losing its labor force advantage as it also faces the challenges presented by an aging population and a shortage of skilled and semi-skilled labor, resulting in degradation in the quality of industrial goods. The ADB findings are corroborated by a 2007 study conducted by Chinese Academy of Social Sciences and referenced in an article published in the Beijing-based China Youth Daily. The report stated that not only coastal cities but also mainland areas are experiencing a decline in the number of young and middle-aged people entering the labor market.

The year 2004 witnessed the first decrease in the growth rate of the population segment aged 15-59. The working-age population is estimated to stop growing altogether around 2011. China's "demographic dividend" is forecast to turn into a demographic liability in 2013.⁴ From 2021-onward, China's population is forecast to continue to decline, according to the report. The Pearl River Delta, a hub of labor-intensive industries, first faced a shortage of rural labor force in 2004, followed by the Yangtze River Delta. The phenomenon is spreading gradually from coastal areas to mainland provinces including Jiangxi, Anhui, Hunan, and Hubei. According to a survey by the Labor and Social Security Department of Hubei Province, the province runs short of 400,000 laboreres annually. The rate of labor shortages in the provincial economic development zone has risen to 38%.

Commenting on the China Youth Daily article, Deng Xiaogang, a social science professor at the University of Massachusetts (Boston) stated, "China's economic growth and foreign trade rely heavily on its labor-intensive products with the cheap labor. When the demographic structure changes entirely, the whole economic structure will encounter dramatic changes and the country will be running short of a labor force. China will be unlikely to properly adjust its economic structure in a short period of ten years. China is not optimistic in the future."

risks of their high consumption of gasoline, heating oil, coal and LPG." This same report also states: "The country's industrial base is gobbling up vast amounts of petrochemicals to make everything from fertiliser to Barbie dolls. But, more important where oil is concerned, China is consuming too much gasoline relative to the size of the nation's per capita GDP. The number of cars on mainland roads - about 20m - is expected to increase by 2.5m this year alone." The report also states that output from China's four largest oilfields is in decline, and that some estimates show China's current proven reserves becoming totally depleted by 2018.

⁴ The phrase, "demographic dividend" is defined as the economic benefit produced when a decreasing birth rate alters the population age structure, so that fewer investments are needed to meet the consuming population's needs and labor resources are released for investment in economic development and family welfare.

(e) OECD Predicts Erosion of China's Export Manufacturing Sector Competitiveness.

As predicted by the OECD, the effect of increasing domestic wage and price levels will decrease the competitiveness of China's export sector, causing further economic stress as a result of constrained Government revenues and the migration of labor-intensive manufacturing activities to low-wage venues located closer to end-user consumer markets in response to increasing transportation costs. Oil supply/demand fundamentals aren't forecast to improve measurably over the next 12 to 18 months according to Weeden & Co. energy analyst Charles Maxwell, who predicts retail gasoline prices eventually reaching \$15 per gallon, owing to decreasing discoveries and increased demand, an unprecedented state of affairs. Maxwell predicts that the current state will endure until around 2010, when equilibrium will end and the problem will hit hard, with (U.S.) retail prices reaching \$6 to \$7 per gallon by 2012. Maxwell attributes his outlook to the demand for petroleum from emerging economies over the past 4 to 5 years and the lack of a compensating increase in new discoveries. Energy analyst Kevin Book states that the current oil market is operating at 96.5% of capacity and further noted that retail gasoline and diesel prices are subsidized by many emerging economies, notably China where an increasing population is placing greater duress on the government's ability to subsidize consumer prices.

Increasing oil prices are also responsible for the emerging migration of manufacturing operations from Asia to North America, as shipping and transportation costs spiral upward.

Examples:

1. Claude Hayes, president of the retail heating division at DESA LLC, is quoted as stating that "My cost of getting a shipping container here from China just keeps going up-and I don't see any end in sight".⁵ His company joined the emerging trend of relocating manufacturing operations out of China and closer to consumer markets when it recently moved most of its production back to the U.S. where, according the article, Mr. Hayes says the company was lucky to have held onto its manufacturing machinery. The article singled out China in particular as
2. Edward Zaninelli, vice president of trans-Pacific westbound trade at Orient Overseas Container Lines, a major shipping line, acknowledged that he is aware of production moving out of China, but states that it won't be only transportation costs responsible for the trend, "because other production costs continue to increase and that companies are beginning to realize that they can have better control over their production when it is closer to home."
3. Emerson, a U.S. manufacturer of electrical equipment, recently shifted a portion of its production operations out of Asia and into the U.S. and Mexico, citing logistics costs associated with transportation of finished goods. Other manufacturers are following suit as evidenced by the CIBC report which shows a significant decline in China's freight-intensive exports to the U.S. over just the past 12 months.⁶ The CIBC research report also reveals that oil prices have already driven up shipping costs so much that Chinese imports are now high-cost and losing market share, predicting that the

⁵ See article entitled, "Stung by Soaring Transport Costs, Factories Bring Jobs Home Again", Wall Street Journal (June 13, 2008).

⁶ Defined as goods that carry a relatively high freight cost.

expected continued rise in transportation costs will completely erode China's low-wage economic advantage and may also remove the single most important brake on domestic inflation over the last decade – wage arbitration with China.

4. Bremen Castings Inc., a family-owned foundry Bremen Indiana, is witnessing a wave of customers bringing work back from China. According to J.B. Brown, the company's president, one customer (a pump manufacturer) which had been operating a metal casting plant in China called to reactivate production facilities in the U.S., stating that the cost of transport from overseas was the "straw that broke the camel's back" - and that "they didn't see it going back down any time soon".

Higher fuel costs are expected to slow the outsourcing of goods in the future according to Daniel Meckstroth, an economist at the manufacturers Alliance/MAPI, a public policy group in Arlington, Virginia. A prime example is Craftmaster Furniture in Taylorsville, North Carolina, which was bought two years ago by a Chinese manufacturer which intended to shift 40% of its production to China before the end of this year or early next year. With the planned move only half done, the shift has stopped cold. "We're getting hit with increases up and down the system," states Roy Kalcain, the company's president. "It's changing our whole equation for where we produce."

As revealed in the OECD study, emerging economic trends and the underlying dynamics evidence the early stages of a major structural shift in global trade fundamentals, as the erosion of China's manufacturing cost advantage continues to accelerate.⁷ Many analysts now expect to see a reversal of the 30-year trend of offshore manufacturing by U.S. companies. For example, in the recent CIBC research report cited above, CIBC World Markets chief economist Jeff Rubin states that the cost of shipping a standard 40-foot container from Asia to the East Coast has already tripled since 2000 and is expected to soon double yet again.

"This is going to cause a major re-think for people who have re-jigged their supply lines to China", CIBC's Mr. Rubin says, noting that Chinese steel exports to the U.S. dropped by 20% during the past 12 months. Manufacturers will seek venues (e.g., Mexico) which are located in closer proximity to consumer markets as transportation costs continue to increase, further reducing the incentive to manufacture export products in China. Mr. Rubin predicts that Mexico will be "the biggest winner of all" as increased transportation costs make China uncompetitive. Richard Cookson, a strategist at HSBC, advises clients to slash their Asian exposure, stating, "Inflation looks like a very real problem in Asia, and the risk is that investors will lose faith in the region's currencies. Although markets have fallen savagely from their peaks, they're still looking pricey. We're lopping exposure even further, to zero."

⁷ China uses five times as much energy as the U.S. to produce a unit of GDP, and is therefore acutely vulnerable to increasing energy costs. A quarter of the 800 shoe factories in the Guangdong region have shut down in recent months, and several thousand textile shops are battling to stay afloat. Hong Kong's industry federation has warned that 10,000 firms operating in the South of China may soon go out of business. In an article entitled "Emerging Markets Face Inflation Meltdown" (*Telegraph*; June 13, 2008), Ambrose Evans-Pritchard writes that "There is a dawning realization that China is facing a major storm as inflation (7.7 pc), the rising yuan (up 5pc this year), soaring oil prices, and an economic downturn in the key export markets of North America and Europe all combine to crush profit margins."

4. Pending Reclassification of China's Sovereign Credit Rating into 'Selective Default'.

Following the recent repudiation by the Chinese government of \$260 billion of China's full faith and credit sovereign debt, the government is facing the threat of reclassification of its sovereign credit rating. In response to the Chinese government's refusal to repay its binding sovereign obligations in contravention of international law, both houses of the legislative branch of the United States government have concurrently called for the reclassification of the Chinese government's sovereign credit rating into the proper category of 'Selective Default' (see United States Senate Concurrent Resolution 78 and House Resolution 1179 introduced in the 110th Congress, second session).

Enforcement Brief:

http://www.globalsecuritieswatch.org/SEC_Conference_Brief.pdf

Resolution of the United States Senate:

<http://globalsecuritieswatch.org/S.Con.Res.78.pdf>

Resolution of the United States House of Representatives:

http://globalsecuritieswatch.org/House_Con_Res_1179.pdf

The prevailing sovereign credit rating classifications assigned to the long-term foreign currency obligations of the Chinese government contravene both the published metrics (e.g., evaluation of an issuer's willingness to repay debt which it is lawfully obligated to repay) and published criteria (e.g., see comparative definitions of the prevailing credit rating classifications assigned to the Chinese government by the NRSROs). An additional risk posed by China's repudiated debt is the threat of seizure by defaulted bondholders of discriminatory interest payments made by the Chinese government to holders of newly-issued Chinese government bonds.

5. Increased Political Risk Stemming From Indications of Emerging Social Instability.

China's uneven income distribution relative to urban versus rural populations appears to be fostering a sentiment of wage and wealth disparity and an increasing perception of deprivation by specific segments of the population, as evidenced by the increasing reported incidence and severity of public unrest and civil disturbance. In excess of 58,000 incidents of civil disobedience were publicly reported in 2003, representing an increase of 15% over reported incidents in 2002 and a sevenfold increase over the figure reported just a decade ago. The RAND Corporation reports that the incidents are growing markedly in both size and in violence.⁸ During 2007, over 80,000 such incidents were reported, representing an increase of 38% over the previous five year period. The continued migration of a significant portion of the rural population into urban concentrations and the rapidly increasing speed and scale of communication capabilities among large population segments concentrated within urban environments materially increases both the potential for, as well as the magnitude of incidents of civil unrest, further threatening political stability.

The upward trend in the reported incidence of civil disturbance is expected to continue to rise as unemployment also rises.⁹ A 2006 World Bank study revealed that China requires an ever-

⁸ In an article entitled "Civil Unrest Challenges China's Party Leadership", the Washington Post reports that civil protests in China are growing larger, more frequent, and more violent.

⁹ In a survey released by China's National Development and Reform Commission, the 2006 forecast for persons seeking employment in urban areas nationwide is about 25 million people. However, there are only 11

increasing economic growth rate to generate an adequate level of employment. The study estimated that 25 million people would enter China's labor market in 2006, yet only 11 million would successfully secure a job. In order to prevent unemployment from rising further, the government continues to maintain inefficient state-owned enterprises (SOEs) which account for more than 70% of the primarily state bank-issued loans. The productivity of China's SOEs has fallen to just a quarter of China's total GDP over the past decade. The government is reluctant to engage in a 'fire sale' privatization of the state sector, which has already shed in excess of 30 million jobs over the past 10 years, fearing such action would threaten social stability.

China is estimated to presently be consuming more than twice what its ecosystems can sustainably supply, according to a report co-published by the World Wildlife Fund and the China Council for International Cooperation on Environment and Development. The study states that if China were to emulate the United States, China would require the available capacity of the entire planet. According to a separate study conducted by the World Bank, environmental degradation has passed a point where large segments of China's rural as well as urban populations are exposed to serious health risks, and is responsible for an estimated 400,000 premature deaths each year related to air pollution.

As social tensions resulting from China's vast income inequality (as well as tensions resulting from a myriad of other grievances including withholding of pension entitlements; land seizures, conversion, and forced relocation; substandard working conditions; relations between the Han ethnic majority and other ethnic groups; persistent government corruption including at the local level; unemployment resulting from the transition from socialism to capitalism; et al.) continue to escalate, the likelihood for coalescence of incidents of civil disturbance into large-scale organized opposition to the communist party also increases dramatically. The party, under the leadership of President Hu Jintao, has ruled out democratic reform as an option. Political stability will become less certain and the potential for the failure of the communist party, and thereby the central government, will increase significantly as stated in a recent report prepared by the Central Committee for senior communist party officials, which warned that "the life and death of the party" is at stake.

A comparative review of the structural factors responsible for the collapse of the Soviet Union is revealing, including an enduring one-party political system; rigid governance; a general decline in the ability to govern; popular disenfranchisement with local officials; and the government's mounting isolation from the masses. China is not a homogenous society; for example, there are between 200 and 300 languages spoken in China (depending upon the manner in which the data is interpreted). The risk of collapse of the communist party has prompted alarm at the highest levels of the government. He Zengke, executive director of the China Center for Comparative Politics and Economics in Beijing, recently stated "we all know the importance and urgency of the problem". Pointedly, the most recent approach employed by the party to quell incidents of civil disturbance (i.e., offering concessions to demonstrators, referred to as "buying stability") communicates the perception that protests are the most effective manner in which to seek redress from the government and the greater the number of people involved, the more effective such protests will be.

A significant and prolonged decline in the trading price of Chinese equities may also be expected to exert an adverse effect on the attitude of many of the individual Chinese citizens who invested in the stock market in response to the active encouragement of the central government. Since most

million expected job openings, which indicates an oversupply of 14 million job hunters. Compared with 2005, this is an increase of one million jobless.

of the publicly-listed shares on China's stock exchange are those of state-owned enterprises, investors may blame the state for a collapse in price.

6. Failure of the PRC to Acknowledge and Effectively Address the True Extent of State Institutions' Bad Debt.

China's financial system continues to generate non-performing loans (NPLs) in the state banking sector as evidenced by the audit results produced by government auditors Ernst & Young prior to being pressured by the Chinese government to retract its 2006 report which identified nearly \$1 trillion in state institutions' bad debts in the form of NPLs. Prior to his firm's retraction, Jack Rodman, managing director of Ernst & Young, commented: "I think the numbers will be a big surprise because China has been giving the impression [with its banks listing overseas] that the problem is behind us. China has not really resolved the issue - they have just moved it from one state enterprise to another." According to the report, China's current NPL level is equal to 40% of GDP, and was almost double the 2002 figure of \$480 billion. The four major state-owned commercial banks accounted for \$358 billion of bad loans – nearly three times the officially reported figures.¹⁰ "With the exception of China, every market covered in the 2004 report has witnessed a reduction in its levels of NPLs written before 1997", the report stated. Ernst & Young stated that its higher estimation of Chinese bad debt was based on access to broader information, including the rapid growth of loans in recent years and details of distressed debt companies (such as rural credit cooperatives) attached to major banks. These had been excluded from previous reports.

Under pressure from Beijing, Ernst & Young withdrew the report, which had been labeled as damaging to the "image" of China's banking assets by the People's Bank of China, and promised that "such an embarrassing situation will not happen again." At the time the report was withdrawn, Ernst & Young had a lucrative contract to audit the Industrial and Commercial Bank, China's largest lender. The incident revealed Beijing's extreme sensitivity to any comment critical of its financial system.¹¹

The continuation of speculative investment and increasing levels bad debts are the inevitable result of the Chinese government's fiscal policies designed to maintain disproportionate inflows of foreign investment and unsustainable economic growth rates. Previously, the Chinese central bank admitted that for the period of 2000-2001, "politically-directed" bank lending accounted for 60% of bad loans, and according to the World Bank, approximately one-third of China's fixed asset investment in infrastructure in the 1990s was wasted. Although the 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 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. 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

¹⁰ The four largest commercial lending institutions are the Bank of China, Industrial and Commercial Bank of China, China Construction Bank, and the Agricultural Bank of China. There are also three separate policy lending banks: the Long-Term Development and Credit Bank, Import-Export Bank, and the Agricultural Development Bank.

¹¹ According to an article published by the *Financial Times* shortly before the Ernst & Young report was withdrawn, the report was consistent with a number of other recent studies, including a report issued by the corporate consultancy firm, McKinsey & Company the same week as the Ernst & Young report. The McKinsey report stated that the core causes for the massive creation of NPLs had still not been effectively addressed.

merely addressed the symptoms of China's financial fragility.

Although poor business practices are generally cited as the root cause for the growth in NPLs, the actual source is political. So long as the communist party relies on state-controlled banks to maintain an unreformed core of a command economy, Chinese banks may be expected to continue to engage in practices which generate more bad loans. Systemic economic waste, bank lending practices, political patronage, and the survival of a one-party state are inseparably intertwined in China. The communist party, aware that it is no longer able to secure the loyalty of its 70 million members via ideological indoctrination, employs material perks and careers in government and state-owned enterprises to engender loyalty. After 30 years of economic reform, the state continues to own 56 % of the fixed capital stock. The unreformed core of the economy is the base of political patronage. Government figures reveal that in 2003, 5.3 million party officials held executive positions in SOEs. The party continues to appoint approximately 80% of the chief executives in SOEs and approximately 56% of all senior corporate executives. Recent corporate governance reforms, which mimic "Western-style" practices yet fail in substance, have not cured the endemic defects of China's economic foundation. Approximately 70% of large and mid-sized SOEs, ostensibly restructured into Western-style companies, continue to appoint members of party committees to the boards of directors. China has shed in excess of 30 million industrial jobs since the late 1990s, yet few party officials have suffered adverse consequences.¹²

China's four largest state banks have originated an additional \$225 billion in risky new loans (one-third in real estate), the nature of which the Chinese banking authorities attempted to obscure by classifying them as of "special mention". 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 lending, representing 17% of GDP. The National Bureau of Statistics warned that unsold residential space across China had risen by nearly 25%. A collapse of the property bubble could have catastrophic consequences for the country's fragile banking system.

7. Increased Foreign Borrowing and Growing Reliance on Short-Term Debt.

China's debt to the outside world rose again in 2007, with higher-risk, short-term borrowing comprising a greater share of overall borrowing. China's outstanding foreign debt, excluding its repudiated debt, reached US\$345.7 billion at the end of September, up 7% from the end of 2006. Of this amount, short-term debt (i.e., maturity of less than one year) accounted for 57.2 %. At the end of 2006, short-term debt stood at 56.9% of the total, according to data from the State Administration of Foreign Exchange. Including its repudiated debt, China's total obligation to foreign creditors totals US\$605 billion.

Since the mid-1990s, China has adopted a proactive fiscal policy, raising large amounts of debt for public investments to drive economic growth. Ministry of Finance data reveal that cumulative long term construction debt rose from 100 billion yuan (\$12.2 billion) in 1998 to 990 billion yuan (\$123.6 billion) by 2005, a tenfold increase in seven years.

Beginning in 2005, China's Ministry of Finance began retiring the 18th issuance of national debts, marking the start of a five-year peak debt repayment period. Between 2005 and 2009, the Finance Ministry's annual debt repayment obligation will amount to approximately 400 billion yuan (\$50

¹² Source: "China's Bad Debt Mountain". [The Australian](#) (May 9, 2006).

billion). The monetary impact on the Chinese domestic economy will be significant unless new national debt is issued during this period.¹³

To date, a relatively insignificant portion of China's overall national debt has been allocated to support social development and environmental preservation, which has contributed to serious imbalances. Much of the national debt has been apportioned to financing local infrastructure and real estate development projects and redundant industrial and commercial ventures that did not fit into a coordinated national plan. Thus, the high GDP growth rate has become a problem in itself, rather than an index that reflects balanced national growth.

Furthermore, the national debt-to-GDP ratio does not include potential financial burdens such as contingent or implicit liabilities (e.g., the national debt that the central government lends to municipal governments for infrastructure construction; special national debt used for systemic bank reform including losses from the state-owned banks' massive non-performing loan portfolios in their transition to commercial banks; approximately \$60 billion borrowed from the World Bank, Asian Development Bank and various foreign governments which is excluded from the government budget; debt due to wage-payment arrears by local government and state-owned enterprises; losses due to government grain-price support and petroleum-price support; and a serious funding shortage in social security and health care obligations.

The vast majority of proceeds from the issuance of national debt have been used to finance local physical infrastructure, while the social infrastructure has been largely and critically neglected in the reform process toward a market economy during the past two decades. China presently exhibits the symptoms of a 19th century boom economy in the age of industrial revolution, including urban slums, migrant workers, working poor, rising unemployment, loss of health care and social security, unequal education opportunity for the young, substandard housing, wages declining relative to inflation, sweatshops, and loss of social benefits attributable to privatization. Income and wealth disparity is rampant and increasing at a rapid rate.

The majority of the social welfare programs created in the early decades of the socialist revolution have been discarded. For China to achieve and function at the level of a modern socialist society, the nation's social liability would exceed a tenfold increase relative to current levels. For China's population, the deteriorating environment resulting from a shortsighted, frenzied rate of industrialization will require enormous sum of money and decades to restore. Economic loss from environmental degradation and industrial pollution is nearing crisis levels.¹⁴

According to central government statistics, China's short-term foreign debt (debt with a maturity of less than one year), in proportion to its total outstanding foreign debt, reached a record 57.5% by the end of March 2007, increasing markedly by \$7 billion to \$190.63 billion and representing an increase as a proportion of total debt by .65 of a percentage point in just three months. At the same time, China's total outstanding foreign debt increased by \$8.57 billion to \$331.56 billion, according to the State Administration of Foreign Exchange.

¹³ Note that as interest rate liberalization has progressed, the People's Bank of China has liberalized, simplified or eliminated 114 categories of interest rates under control since 1996. At present, 34 categories of interest rates remain subject to control by the People's Bank of China.

¹⁴ Source: the World Bank, with particular reference to an environmental health risk assessment researched and prepared by the World Bank, which was subsequently suppressed at the insistence of the Chinese government, which feared the consequences from China's population had the report been published as intended.

During the fourth quarter of 2007, China's foreign borrowing increased by \$27.9 billion, reaching \$373.62 billion by yearend, with a majority of the increase comprising short-term debt which rose by \$22.4 billion to a total of \$220.1 billion over the same period. Overall for 2007, China's total foreign debt increased by \$50.6 billion or 15.7%. For 2007, short-term debt accounted for \$36.5 billion of the 12 month increase, marking an accelerated rate of accumulation of short-term debt in the fourth quarter.

Exhibit 2
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.

China's Ministry of Finance issued a total of 2.35 trillion yuan (\$324.8 billion) in treasury bonds in 2007, representing an increase of 1.46 trillion yuan over 2006. According to a report issued by the ministry and published by China's state-owned Xinhua news service, at the end of 2007 China's aggregated domestic debt balance exceeded five trillion yuan for the first time, doubling the figure from the end of 2003. Also for 2007, China's total transaction volume of treasury bonds reached 19 trillion yuan, nearly 50% over that of 2003.

Under the rules of international competition established by the World Trade Organization, of which China is a member, Chinese commercial banks are required to participate in the global credit derivatives markets.¹⁵

8. Dangerous Levels of 'Total Liability-to-GDP', Debt Dependency Ratio, and Debt Service Ratio.

The central government debt figures reported by the Chinese government reveal that borrowing by the central government has reached an unprecedented and dangerous level relative to international standards, as shown in the table below.¹⁶

¹⁵ China was admitted as a member of the World Trade Organization on December 11, 2001.

¹⁶ See, e.g., the preeminent essay and accompanying economic analysis authored by Ms. He Qinglian, who is perhaps the most esteemed Chinese economic commentator, entitled "China Continues to Borrow Despite Heavy Debt." In her essay, Ms. Qinglian states the following: "There are several methods that corrupt officials use to turn national debt funded projects into bribery generators. The first one is to propose a project (including ghost projects) in order to get funding from the central government. The second is to transform the fund to their own with their authority over the use of the funds. From the above analysis, it is not difficult to see that the so called 'prosperity' in China is completely built upon raising a large volume of national debt. 'Borrow new debt to repay the old one' is one of its basic tactics to maintain economic operations. The tactic could be used for a while, but definitely not for the long term. Any conscientious scholar who understands China's fiscal system would not be optimistic about the economic situation of China." See also, the study by Professor Song Yongming at the People's University of China, in which Professor Yongming reports that "after the economic reform, national debts were mostly used by corrupt officials in conspicuous consumption, and not in construction expenditure as most people expected." According to Henry C. K. Liu's monograph entitled, "China's Internal Debt Problem" (published by [Asia Times Online](#), 2006), there were frequent reports of corrupt officials converting projects funded by national debt into extensive bribery networks and fraud schemes.

Exhibit 3
People's Republic of China
National Debt Statistics

National Debt to GDP Ratio	Exceeds 100 % ¹⁷
National Debt Dependency Ratio	78 % ¹⁸
National Debt Service Ratio	17.05 % (est.) ¹⁹

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

In each category, the present debt position of the Chinese government significantly exceeds the international normative values considered prudent, and the widening trend is accelerating rather than reversing. Of equal or even greater concern, the government's use of debt proceeds appears highly questionable and quite possibly counterproductive to sustained long term economic growth.

In consideration of the foregoing metrics, Sovereign Advisers issues a **negative outlook** regarding the economic prospects of China's internal economy and the future performance of government bonds issued by the People's Republic of China.

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According to Mr. Liu, such corruption is rooted in the absence of a separate independent supervisory and auditing authority in project management.

¹⁷ 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.

¹⁸ 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 %.

¹⁹ The generally accepted safety range by international standards is 8-10 %.