**Summary:** China's risk score has held up as the country has dealt efficiently with the Covid-19 crisis, but it hasn't achieved as much improvement as its economic rebound would suggest.

# Country risk: Why China is not as safe as it should be

**Analysts explain why the country's ability to get on top of Covid-19 and return to strong growth have not sparked a bigger improvement to its risk profile.**

China's recovery from the coronavirus is nothing short of spectacular. An authoritarian approach to eradicating the disease helped to bring it under control and the economy is back up to speed.

Despite an unprecedented contraction in the first months of 2020, caused by the lockdown, GDP still managed to grow by 2.3% in real terms last year as most other countries declined, underpinned by an enviable fourth-quarter expansion of 6.5% year on year.

Consequently, China's country risk score held up while other countries floundered, with analysts exuding confidence in its growth potential.

Not only that, but "China's economic structure is continuing to change", says Alessandro Rebucci, an associate professor of finance at Johns Hopkins Carey Business School, and one of the survey contributors.

"It is shifting away from exports towards services and personal consumption – a medium-term factor that provides a reliable hedge against the persistently depressed demand in advanced economies in the months ahead."

He adds: "This process is driven by technological advances, reforms supporting the spreading of the economic gains of the past decades with the west part of the country and lower-income segments of the population, as well as evolving household tastes and preferences."

Yet China is still only the 50th least risky country on Euromoney's country risk survey global rankings table, on a par with Bermuda and Paraguay, which have both improved substantially during the pandemic.

Moreover, its total risk score is down by a point on a five-year trend basis and by just over six points during the past decade.

**Euromoney's global risk rankings**

| | Q4 ECR score | ECR rank | -------Risk score change------- 2020 ytd | 5-yrs | 10-yrs | --------Credit ratings-------- S&P | Moody's | Fitch |
|---|---|---|---|---|---|---|---|---|
| **Bermuda** | 59.04 | 48 | 13.03 | 0.28 | 0.05 | A+ | A2 | n.r. |
| **Paraguay** | 58.86 | 49 | 13.16 | 12.81 | 17.91 | BB | Ba1 | BB+ |
| **China** | 58.62 | 50 | 0.56 | -1.05 | -6.13 | A+ | A1 | A+ |
| **Morocco** | 56.84 | 51 | 7.57 | 9.45 | 3.30 | BBB- | Ba1 | BB+ |
| **Costa Rica** | 56.35 | 52 | 6.77 | 8.44 | 5.31 | B | B2 | B |

Source: Euromoney Country Risk, credit rating agencies

Survey contributor Sher Mehta, founder and CEO of Virtuoso Economics, helps to explain why this is the case.

Although he – along with other experts – sees China registering strong economic growth this year, he points out the currency as a principal risk to export competitiveness.

More appreciation against the US dollar is expected in 2021, due to the interest-rate differential between developed countries and China, stronger economic growth and relatively higher productivity in China, and the ongoing opening of China's financial markets boosting capital inflows.

However, China's risks are much more multi-faceted.

Mehta, for instance, points out the inequality gap posing risks for social stability, notably between urban and rural areas. He is also concerned by excessive leverage, particularly in the property sector, as well as the surge in non-financial corporate debt with implications for the financial sector.

According to the Institute of International Finance, non-financial corporate debt in China increased from 150.4% of GDP in Q3 2019 to 166.3% of GDP in Q3 2020.

Adding in household, government and financial sector debts, the total debt burden is a staggering 337.4% of GDP.

"As a result of this overhang, managing deleveraging over the coming years – which could have implications for economic activity – could be rather challenging for policymakers in China," says Mehta, who fears bank sector and corporate defaults will spark a tightening of credit conditions.

**External risks**

Mehta also sees downside risks from China signing the Regional Comprehensive Economic Partnership trade pact – alongside US allies Japan and Singapore – and an investment deal with the EU, which increases resilience against trade-related shocks and is likely to boost foreign direct investment.

"The downside risk of these developments is that with the trade pact, China's political and economic influence will become further elevated in east Asia and the investment deal could end up harming the EU's relationship with the US and make it difficult for them to work closely on issues pertaining to China," he says.

As a result, China will likely become more assertive in its territorial claims in disputed regions, which could then exacerbate geopolitical tensions with the US.

This could create unintended escalations with associated economic implications via supply chains, investment and confidence. The end result would be to dampen global economic growth and increase global financial market volatility, with increased risk aversion.

Another key external risk Mehta points out is China's substantial dependence on the US dollar for trade and finance.

Political frictions between the two superpowers could create financial risks in the event of US sanctions, "increasing the cost of dollar funding for the banking and non-financial sectors, and adversely impacting market access to dollar funding, through for example international bond markets".

Also, less trade and cross-border investment, and a partial decoupling of the US from China, would likely have a bigger downside impact on the Chinese economy compared with the US over the coming years.

As well as pointing out the risk of currency appreciation, Johns Hopkins' Rebucci highlights China's politics as a big risk.

The survey’s scores for several political indicators – aside from government stability enhanced by the one-party state and predictable leadership succession – are quite low, certainly in comparison with large western democracies.

“China could fall prey to its own ability to control society firmly, especially if the Hong Kong situation were to deteriorate further,” says Rebucci.

“Excessive confidence in its ability to control protests in an authoritarian way could spiral out of control, including leading to a serious confrontation with a restored, united western diplomatic front.”

Rebucci sees the handling of Alibaba and its founder Jack Ma as the critical development to monitor in the coming months. It will provide an important pointer to assess the system’s ability to reconcile economic freedom with progressively tighter and rigid political control.

Consequently, while China continues to attract inbound capital chasing an economy growing robustly again, it seems wise to remember there are considerable medium- and longer-term risks than simply assuming the status quo will persist indefinitely.