Credit Conditions Asia-Pacific:

China Slows, A Chill Wind Blows

Regional Credit Conditions Chair

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Key Takeaways

- **Overall:** COVID-19 trends and policy responses, contagion risk from Chinese property woes, and rising inflation expectations have introduced regional uncertainty.
- **New COVID variant:** The omicron variant threatens the reimposition of mobility and travel restrictions, just as Asia-Pacific authorities are seeking to reopen their economies. Meanwhile, China and Hong Kong's zero-COVID policy underpins localized lockdowns and tight border restrictions. Still soft domestic consumption and dependence of exports points to uneven recovery patterns among geographies and industry sectors.
- **Inflation worries:** While inflationary pressures remain controlled in the region, persistently high input prices could hike inflation expectations. This could propel demand for higher risk premiums. A disorderly reset of financial and real assets repricing could hit financing conditions for the region's borrowers, particularly highly leveraged ones.
- **China real estate woes:** China's recent wave of property developer-related defaults point to mounting liquidity and funding challenges. Slower real estate sales, and recent enforcement of socioeconomic policies to promote "common prosperity" have increased uncertainty about the credit and growth trajectories of the country and individual borrowers. Consequently, we lowered China's GDP growth to 4.9% in 2022.
- **Credit outlook:** Credit quality of the rated portfolio remains steady with a net rating outlook bias of negative 5%. However, the contagion fears from China's real estate crackdown and spillovers from above-mentioned risks cloud the outlook.

(Editor's Note: S&P Global Ratings' Asia-Pacific Credit Conditions Committee took place on November 23, 2021.)

Financing costs could mount on the back of inflation concerns and contagion effects from China's real estate sector woes.

COVID trends. The omicron variant is threatening the reimposition of extended mobility and border restrictions by Asia-Pacific governments, just as they are seeking to ease mobility and border restrictions (resuming economic activities) on the back of higher vaccination rates. In contrast, China and Hong Kong's zero-Covid tolerance stance points to the occasional imposition of localized lockdowns regardless of variant. These lockdowns disrupt supply chains and depress consumer spending, particularly for the discretionary and mobility-dependent sectors. Wariness in allowing broad resumption of international travel could dent recovery for tourism-dependent sectors and economies.

China slowdown. Persistent funding woes continue to haunt China's real estate developers as authorities maintain firm grip over debt built-up. These measures hit property developers' liquidity, sparking a wave of defaults. Slower unit sales and contagion fears could keep investors and lenders at bay, exacerbating already tight financing access. Consequently, we revised down China's economic growth forecast to 4.9% in 2022 from 5.1%. The country's 'common prosperity' policy directives to reduce income disparity underpins lower private sector income and tolerance for slower economic growth. While recent re-engagement between U.S.-China seems cordial, geopolitical disputes pertaining to South China Sea area could derail the momentum.

Cost spikes. High input prices will likely squeeze corporates, which are finding it difficult to fully pass on higher costs to customers, amid still soft domestic demand. Rising inflation expectations could transpire into higher wage demands, denting profit margins further. Disorderly reset in expectations around economic growth, inflation, and interest rates, could see financial and real assets repricing – prompting higher risk premia demands by investors and lenders. Particularly for emerging market borrowers reliant on U.S. dollar funding, weak domestic currency and higher interest payments will intensify refinancing costs.

Carbon limits. Governments are likely to accelerate efforts to control carbon emissions, intensifying efforts to curtail carbon-intensive segments. China's imposition of environmental regulations led to power outages, impacting manufacturing and supply chains. Carbon-intensive sectors (such as oil and gas, fossil-fuel intensive utilities, and metals and mining firms) could see narrowing funding access as investors limit their exposures.

Top Asia-Pacific Risks

Risk level			Risk trend		
Very high	High	Elevated	Improving	Unchanged	Worsening

Risk levels are based on the likelihood and systemic impact of such an event occurring over the next one to two years. Typically, these risks are not factored into our base case rating assumptions unless the risk level is very high. Risk trend reflects our current view on whether the risk level could increase or decrease over the next 12 months.

Uneven income and profit recovery amplify debt overhang

With debt levels high, some borrowers remain vulnerable to credit deterioration and defaults if income recovers more slowly than expected—especially if the cost of debt starts to rise. As extraordinary government stimulus tapers, pressures will build up on industries that may not fully recover earnings before late 2022. Domestic consumption in China and some developed economies remains lackluster. Highly indebted SMEs may be unable to rebuild revenues and earnings before their financing costs rise to more normal, pre-COVID levels.

Recurring COVID outbreaks weigh on recovery expectations

The emergent omicron variant threatens the reimposition of extended mobility and border restrictions by governments, given the uncertain efficacy of existing vaccines against it. This runs against the preference ("living with COVID") of many Asia-Pacific governments seeking to ease such restrictions on the back of higher vaccination rates. In contrast, China and Hong Kong's zero-Covid tolerance stance points to the occasional imposition of localized lockdowns regardless of variants. Consequently the risk of economic disruption from reimposed restrictions remains high.

Higher inflationary pressures and interest rates

Inflationary pressures in the region are not yet as evident as elsewhere in the world. Nevertheless, persistently high input prices (e.g. raw materials and energy) driven by global high demand and supply bottlenecks, could fuel higher inflation expectations. Consequently, major central banks may be forced to tighten monetary policy while investors may demand higher premiums or tighten financing as they reset expectations about growth, risk, and monetary policy (e.g. Fed tapering). Financial and real assets repricing could hit currency exchange rates and capital flows, exposing borrowers reliant on U.S. dollar funding to higher debt servicing costs. In addition, mounting inflation will pressures corporates which are unable to fully pass on higher costs to customers.

China policy stance clouds credit and growth trajectories

The Chinese government's intent to reduce income disparity and aligning social values ("common prosperity") and reduce dependence on foreign technology and economies ("dual circulation") increases the likelihood of lower economic and income growth. First, crackdown on real estate, technology, gaming, and education may widen to other private-sector industries. While curbs on overborrowing may moderate the debt overhang, rapid execution of new policies could affect business and consumer confidence, fuel contagion risk. Second, on "dual circulation", further weakening of U.S.-China relations would raise the cost of trade, intellectual property, investments, and financial transactions between these economies. Third, China's enforcement of environmental regulations has led to power outages, affecting production and supply chains. Fourth, should geopolitical disputes over the South China Sea area intensify, it would be detrimental for investment, trade and supply flows within and outside the area. Beyond China, its policy and economic developments affect others reliant on the country for exports or finance (e.g., emerging markets) and imports (e.g., component parts).

Structural Risks

Climate change and government environmental policies imposes business costs

Climate change and global drive towards carbon-neutrality has intensified focus on energy transition and the changes required (e.g., policy, legal, technology, market, reputation risks). The recent COP26 event further validated these ongoing concerns. Governments are likely to impose environmental policies affecting business operations and costs. More financing providers shying away from presumed non-climate friendly industries and borrowers (such as coal and oil). Furthermore, low-carbon developments (e.g., electric vehicles and carbon capture and storages) can challenge established business models. Adverse climate events, including hurricanes, wildfires and droughts are happening more frequently and producing more losses, these could impact economic activity, and likely raise insurance costs.

Technology disruption and cyber-attacks exposes business vulnerabilities

Advances in digitalization, artificial intelligence, and other technologies (e.g., new materials) raise the risk that borrowers may fail to adapt to technological changes, and threats, such as cyberattacks. Business models for banks and corporates remain vulnerable to technological disruption while cyber risk could pose as a systemic threat and significant single-entity event risk. Separately, intensifying technology race between U.S.- China could impact supply chains (e.g., semiconductor manufacturing) and restrict access to intellectual property and markets.

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