People’s Republic of China

Sovereign Credit Rating
Research Bulletin

Prepared By
Sovereign Advisers

People's Republic of China

Sovereign Downgrade Alert

JUSTIFICATION FOR REVIEW OF SOVEREIGN CREDIT RATING OF THE PEOPLE'S REPUBLIC OF CHINA.

ATTACHMENTS:

1. Legal Opinion Issued by Stites & Harbison PLLC Affirming Validity of U.S. Citizens' Claims Against the People's Republic of China Relating to Defaulted Sovereign Obligations of the Chinese Government.

January 20, 2004.

In light of certain past defaults by the Chinese Government on sovereign debt issues and the continuing refusal of the present government of China to honor payment of defaulted external bond issues as required under international law, it is appropriate at this time to conduct a review of the sovereign rating assigned to long-term debt issued by the national government of the People's Republic of China.

Although there exist numerous defaulted Chinese Government bond issues, the obligations which are specifically the subject of this research bulletin are those obligations issued on a global syndication basis as the "Chinese Government Five Per Cent Reorganization Gold Loan of 1913". These bearer obligations were issued denominated in British pounds sterling, in both £20 and £100 increments and were due to mature in 1960.

The Chinese Government Reorganization Gold Loan Bonds (the "Bonds") were issued as full faith and credit obligations of the Chinese Government. A substantial number of the Bonds are held by United States citizen bondholders which constitute a valid claim under existing international law *(please refer to attached legal opinion issued by Stites & Harbison, PLLC).*

The Bonds are presently in default. The successor government, the People's Republic of China (the "PRC"), has refused and continues to refuse to pay the claims of U.S. citizen bondholders of these obligations. The holders of the Bonds who are U.S. citizens are in the process of asserting a claim against the PRC for payment in full of the defaulted Chinese Government obligations.

The individual bondholders' claims have been consolidated under the auspices of the American Bondholders Foundation, which is pursuing payment of the defaulted securities in conjunction with the Foreign Bondholders Protective Council. The cumulative value of the defaulted Gold Loan Bonds claim being asserted against the PRC by U.S. citizens is approximately $125 billion. The American Bondholders Foundation also represents U.S. citizens who are holders of various other defaulted, U.S. dollar-denominated Chinese Government bond issues in asserting claims for payment.

ACTION

In view of the foregoing factors and for the reasons discussed below and in the attached legal memorandum, Sovereign Advisers at this time issues a **Downgrade Alert** for Long-Term Debt of the People's Republic of China to **sub-investment grade** status.

JUSTIFICATION FOR SOVEREIGN RATING DOWNGRADE OF THE PEOPLE'S REPUBLIC OF CHINA:

1. Refusal by the PRC to Pay Defaulted Sovereign Obligations in Contravention of International Law:

The unwillingness of the Government of the People's Republic of China to honor a legally valid claim asserted by U.S. citizens as holders of the Chinese Government Reorganization Gold Loan Bonds. The Bonds are full faith and credit obligations which under international law are legally binding upon the PRC as the successor government to the National Government of China. The position of the PRC with respect to refusal to pay holders of full faith and credit sovereign obligations is in flagrant violation of international law (see *Restatement (Third) of the Foreign Relations Law of the United States, Section 712(2)* and *Creditors Claims in International Law, The International Lawyer, Volume 34, page 235, Spring 2000)*.

2. Emergence of a Significant Contingent Liability:

Emergence of a significant contingent liability in the form of potential financial impact of bondholder claims on the PRC's external payments position in the event of an eventual settlement of bondholder claims, which would likely exert a material adverse effect on the PRC's external payments position, as well as negatively affecting foreign direct investment and foreign exchange rates.

3. Impaired Ability by the PRC to Implement Monetary Policy Reforms:

The possibility that the PRC's efforts to continue to reform the country's financial system, in part by reducing the generation of new non-performing loans ("NPLs"), may be impaired due to increased difficulties faced by the four asset management companies charged with recovery or disposal of NPLs to repay loan purchases through the issuance of sovereign-supported debt. The pricing and marketability of new debt issues may be adversely affected due to exigencies created by virtue of pre-existing defaulted claims presently in collection. Foreign participation in Chinese financial markets may be discouraged as well, as a direct result of the PRC's posture with respect to refusal of payment of government obligations.

In addition to the foregoing, since full faith and credit obligations of a sovereign issuer are generally held post-Brady Plan restructuring to be *de facto* senior to bank debt, it is appropriate at this time to assign a downgrade to trade credit of the PRC, as well as to outstanding and future debt obligations of state-owned enterprises ("SOEs") of the PRC.[1] The relevant historical fact pattern demonstrates that when the isolationist Chinese communist government (i.e., the PRC) acceded to political power over the Chinese mainland and subsequently repudiated existing external sovereign debt obligations, and then determined to re-access the international capital markets while ignoring payment claims arising from valid pre-existing obligations of the Chinese Government, the probability of future continuity of payments on present and future-issued obligations may reasonably be interpolated from the historical fact pattern as embodying a significant degree of repayment uncertainty which is not reflected in the current PRC debt rating.

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[1] Post-1990 Brady Plan debt restructuring as described in "Appendix A" of the Salomon Smith Barney *Sovereign Credit Risk Analyst's Guide*.

The historical and continuing refusal by the PRC to pay legally valid obligations of the Chinese Government, in violation of international law, represents a form of institutionalized behavior pattern of the PRC, suggesting the probability that such debt defaults presaged upon the unwillingness to pay external obligations may reasonably be expected to recur in the future.
In light of the persistent intransigence of the PRC with respect to payment of defaulted external obligations and the continued unwillingness of the Chinese Government to pay legally valid claims arising from defaulted sovereign obligations, as well as the potential financial impact arising from a contingent liability, the following existing PRC ratings are no longer appropriate:

Credit Rating Agency	**PRC Long-Term Foreign Currency Credit Rating**
Standard & Poor's	BBB/Stable/A-3
Moody's Investors Service	A3/Stable
Fitch, Inc.	A-

The posture of the Government of the People's Republic of China with respect to its continued refusal to pay U.S. citizens' claims arising from defaulted Chinese government debt obligations as required under conventions of international law as described herein and affirmed in the attached legal opinion is neither consistent with, nor indicative of, an investment-grade sovereign.

In light of such posture, Sovereign Advisers issues a **credit watch** for sovereign debt obligations of the PRC and assigns a **downgrade of the PRC debt rating to sub-investment grade** status.

For further information on the American Bondholders Foundation and United States bondholders' claims against the People's Republic of China, please contact the following:

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