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Report Answers Questions On Credit Impact Of China's Declining Foreign Exchange Reserves

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SINGAPORE (S&P Global Ratings) Feb. 16, 2017--China's dwindling foreign-exchange reserves should only pose a financial threat if the country's leaders make policy errors in dealing with the trend, S&P Global Ratings said today in a report titled, "China's $3 Trillion Question: Will Declining Reserves Undermine Credit Support?".

"As long as China's leaders do not overreact to falling foreign-exchange reserves, we do not see the trend as posing a near-term risk to the sovereign ratings. The country's liquid external assets continue to outsize its total external debt by a comfortable margin, and the current account remains in a surplus position," said S&P Global Ratings' sovereign credit analyst Kim Eng Tan.

China still holds more foreign-exchange reserves than other country, and by a large margin. But the level has fallen by more than US$1 trillion in the past two years, and recently slipped below US$3 trillion. This retracement has raised questions about the knock-on effect on interest rates, credit growth, banks' balance sheets, and policy risk.

Among the issues on investors' minds is whether capital outflows will put upward pressures on interest rates. In its article, S&P Global Ratings noted that yields on Chinese bonds and interbank rates have been rising in the past several months. Tightening liquidity could lead to some mark-to-market losses

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on banks' treasury holdings, but funding stress will remain limited, the report said.

"Interest rates have already gone up a lot since October, but in our view, this is mainly due to preemptive measures by Chinese policymakers to curb interbank borrowing. Capital outflows are only a secondary factor because there are significant funding and liquidity buffers in the banking sector that can be leveraged to keep money costs steady," said S&P Global Ratings credit analyst Qiang Liao.

S&P Global Ratings recently affirmed its 'AA-/A-1+' sovereign credit rating on China, based on fiscal and monetary policies aimed at deleveraging the corporate sector and reducing financial risk. The credit rating of the country remains on negative outlook, however, in light of the gradually increasing risk of an economic hard landing. Moreover, Chinese banks' historically ample funding buffers are thinning as credit creation continues to outpace GDP growth.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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