S&P Global
Ratings

RatingsDirect®

Research Update:

People's Republic of China 'AA-/A-1+' Ratings Affirmed; Outlook Remains Negative

Primary Credit Analyst:
KimEng Tan, Singapore (65) 6239-6350; kimeng.tan@spglobal.com

Secondary Contact:
Xin Liu, Beijing (86) 10 65692956; xin.liu@spglobal.com

Table Of Contents

Research Update:

People's Republic of China 'AA-/A-1+' Ratings Affirmed; Outlook Remains Negative

Overview

- China's reforms to its fiscal and monetary policies, coupled with its anti-corruption campaign, should help support its sovereign creditworthiness.
- We are therefore affirming our 'AA-/A-1+' sovereign credit ratings on China.
- However, reliance on credit-fueled growth poses the downside risk of a hard landing for the economy.
- The negative rating outlook reflects our view of gradually increasing economic and financial risks to the government's creditworthiness, which could result in a downgrade this year or next.

Rating Action

On Jan. 26, 2017, S&P Global Ratings affirmed the 'AA-' long-term and 'A-1+' short-term sovereign credit ratings on China. The outlook on the long-term rating remains negative. We also affirmed the 'cnAAA' long-term and 'cnA-1+' short-term Greater China regional scale ratings on China. Our transfer and convertibility risk assessment on China is 'AA-'.

Rationale

China continues to rely on credit growth and public investment to sustain high economic growth. Nevertheless, growth of corporate leverage appears to have moderated over 2016 and the authorities have increased policy emphasis on reducing corporate leverage. The government also appears to be more open to accepting a further slowdown in economic growth. These changes have the potential to lower credit growth in the near future and reduce the related vulnerabilities to the sovereign ratings.

We project that China's economic growth over the next three years will remain at or above 5.5% annually. Given the uncertain external economic environment, supporting this growth could require the government to maintain heavy public investment. In this scenario, government and corporate leverage ratios would continue to deteriorate and the investment rate could remain well above what we believe to be sustainable levels. In our opinion, such trends could weaken the Chinese economy's resilience to shocks, limit the government's policy options, and increase the likelihood of a sharper decline in the trend growth rate.

The ratings on China reflect our view of the government's reform agenda, growth prospects, and strong external metrics. On the other hand, we weigh these strengths against certain credit factors that are weaker than what is typical for similarly rated peers. For example, China has lower average income, less transparency, and a more restricted flow of information.

The Chinese government is taking steps to bolster its economic and fiscal resilience. Most importantly, we view the government's anti-corruption campaign as a significant move to improve governance at state agencies and state-owned enterprises (SOEs). Over time, this could translate into greater confidence in the rule of law, improvements in the private-sector business environment, more efficient resource allocation, and a stronger social contract.

The government continues to make significant reforms to its budgetary framework and the financial sector. These changes could yield long-term benefits for China's economic development. The government also appears to be signaling that it will allow SOEs with lesser policy importance to exit the market either through merger, closure, or default in order to allocate resources more efficiently. However, our negative outlook is partly motivated by our opinion that the pace and depth of SOE reform may be insufficient to attenuate the risks of credit-fueled growth.

China's policymaking has helped it maintain consistently strong economic performances since the late 1970s. However, coordination issues between the line ministries and the State Council sometimes lead to unpredictable and abrupt policy implementation. The authorities also have yet to develop an effective communication channel with the market to convey policy intent, heightening financial volatility at times. Moreover, China does not benefit from the checks and balances usually coming from the free flow of information. These characteristics can lead to the misallocation of resources and foster discontent over time.

We expect China's economic growth to remain strong at 5.5% or more annually through at least 2020, corresponding to per capita real GDP growth of above 5% each year. We project per capita GDP to rise to more than US$10,000 by 2020, from a projected US$8,300 for 2017, given our assumptions about growth and the continued strength of the renminbi's real effective exchange rate. Over the next three years, we expect final consumption's contribution to economic growth to increase. However, we believe the gross domestic investment rate is likely to remain above 40% of GDP. We also expect credit growth in China to outpace that of nominal GDP over this period.

These projections reflect our view that the Chinese government may seek to support the economy through debt-financed public investment. Although some officials have voiced concerns over rising leverage in China, the latest Chinese five-year plan calls for average growth of about 6.5% annually in the 2016-2020 period. We believe that achieving this rate of growth may require credit growth to outpace nominal GDP growth in the period.

China's external profile remains a key credit strength despite the recent decline of China's foreign exchange reserves. We partly attribute the fall in reserves to increased expectations of renminbi depreciation. Consequently, some private sector firms reduced or hedged their dollar debt and exporters kept a greater share of their proceeds in foreign exchange. We also attribute the accommodation of SOE and private sector demand for foreign exchange as a willingness of officials to diversify China's external assets away from holdings of U.S. government debt to other investments of the financial and private sectors.

China remains a large external creditor. We expect financial assets held by the public and financial sectors to exceed total external debt by a little more than 90% of current account receipts (CAR) at the end of 2017. At the same time, we estimate that China's total external assets exceeded its external liabilities by almost 50% of its CAR. China's external liquidity position is equally robust. We expect the country to sustain its current account surplus at more than 1% of GDP in 2017-2020. We project annual gross external financing needs in 2017-2020 to total less than 60% of CAR plus usable reserves.

The increasing global use of the renminbi (RMB) also bolsters China's external financial resilience. According to the Bank for International Settlement's (BIS) "Triennial Central Bank Survey," published 2016, the renminbi is traded in 4% of spot foreign exchange transactions globally. Demand for renminbi-denominated assets from both official and private-sector creditors could rise with the inclusion of the renminbi in the IMF's Special Drawing Rights basket of currencies.

We expect the share of renminbi-denominated official reserves to rise over time. If the renminbi achieves reserve currency status (which we define as more than 3% of aggregated allocated international foreign exchange reserves), it could strengthen external and monetary support for the sovereign ratings. Although the People's Bank of China (the central bank) does not operate a fully floating foreign exchange regime, over the past decade, it has allowed greater flexibility in the nominal exchange rate. Based on estimates from the BIS, the real effective exchange rate has appreciated by close to 14% since the end of 2011 and any future weakness of the renminbi needs to be analyzed in this light.

China is gradually implementing an ambitious fiscal reform to improve fiscal transparency, budgetary planning and execution, and subnational debt management. These reforms could help the government to manage slower growth of fiscal revenue and lower its reliance on revenues from land sales.

In 2017-2020, we expect the Chinese government to keep the reported general government deficit to within 3% of GDP. However, off-balance-sheet borrowing could continue for the next two to three years. This reflects both the financing needs of public works started before 2015 as well as some new projects that the central government is willing to authorize to support growth. Consequently, we project the increase in general government debt in each of these years at 2.8%-3.6% of GDP.

Due to these projected increases over the next few years, the government's debt as a share of GDP could rise moderately. Since 2015, we have included the entire sum of RMB16 trillion (US$2.5 trillion, or approximately 23% of 2015 GDP) of direct debt assumed or to be assumed by provincial governments for their financing vehicles in general government debt. This step-rise in debt followed the finance minister's announcement that these subnational governments will issue bonds to refinance bank debt largely owed by local government financing vehicles over the next three years. We project net general government debt will plateau at below 40% of GDP and interest cost to government revenues will remain below 5% throughout the forecast horizon. These forecasts in turn follow from our assumptions regarding real growth and ample domestic liquidity keeping financing cost low for the government.

Although the fiscalization of the local government financing vehicles has raised our figure for general government debt, it has simultaneously decreased our estimates for contingent liabilities to the government from this sector. Entities with weak financial metrics owe much of the financing vehicle loans that are being redeemed through government bond issuance. By putting these loans on its balance sheet, the government has significantly reduced the banks' credit risks, in our view.

We believe that China's monetary policy is largely credible and effective, as demonstrated by its track record of low inflation and its pursuit of financial sector reform. Consumer price index inflation is likely to remain at 2%-3% annually over 2017-2020. Although the central government--through the State Council--has the final say in setting rates, we find that the central bank has significant operational independence, especially regarding open-market operations. These operations affect the economy through a largely responsive interbank market and a sizable and fast-expanding domestic bond market. The liberalization of deposit rates at banks in recent years is an important reform that could further improve monetary transmission in China.

Outlook

The negative outlook reflects our view of gradually increasing economic and financial risks to the government's creditworthiness, which could result in a downgrade this year or next.

A downgrade could ensue if we see a higher likelihood that China will seek to stabilize growth at or above 6.5% by allowing credit to increase significantly faster than the nominal GDP growth, such that the investment-to-GDP ratio remains well above 40% through public investment. Such trends could weaken the Chinese economy's resilience to shocks, limit the government's policy options, and increase the likelihood of a sharper decline in the trend growth rate.

The ratings could stabilize at this level if the central government successfully adopts policies to moderate credit growth to a pace more in line with nominal GDP growth, accompanied by signs that economic rebalancing will progress quicker than we currently expect. This could allow the investment ratio to come down to levels that we believe to be more sustainable.

We would also see a higher likelihood that China's credit metrics will stabilize at the current rating level if the government continues to implement reforms that lead to much greater reliance on market-based macroeconomic management tools. Better transparency, improved information availability, deeper liberalization of the financial market, and greater official use of renminbi for reserve management would support such reforms.

Key Statistics

Table 1

People's Republic of China--Selected Indicators

ECONOMIC INDICATORS (%)	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Nominal GDP (bil. LC)	48,930	54,037	59,524	64,397	68,551	73,937	80,021	87,382	94,896	102,327
Nominal GDP (bil. $)	7,573	8,560	9,607	10,482	11,008	11,125	11,518	12,273	13,581	14,830
GDP per capita (000s $)	5.6	6.3	7.1	7.7	8.0	8.1	8.3	8.8	9.7	10.5
Real GDP growth	9.5	7.9	7.8	7.3	6.9	6.7	6.4	6.1	5.9	5.7
Real GDP per capita growth	9.0	7.4	7.3	6.7	6.4	6.2	5.9	5.6	5.5	5.2
Real investment growth	9.4	7.9	8.2	6.0	3.4	6.1	5.7	6.0	4.6	4.5
Investment/GDP	47.7	47.2	47.4	47.0	45.7	45.0	44.7	44.5	44.5	44.0
Savings/GDP	49.5	49.8	48.9	49.7	48.7	46.7	45.9	46.4	46.4	46.2
Exports/GDP	26.5	25.4	24.5	24.1	22.1	20.5	20.2	20.1	19.2	18.7
Real exports growth	10.6	2.5	3.8	5.2	(3.1)	2.9	4.1	3.7	3.6	3.4
Unemployment rate	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
EXTERNAL INDICATORS (%)										
Current account balance/GDP	1.8	2.5	1.5	2.6	3.0	1.6	1.3	1.9	1.9	2.1
Current account balance/CARs	6.2	9.0	5.7	9.9	12.3	7.1	5.7	8.3	8.9	10.1
CARs/GDP	29.2	28.0	27.0	26.8	24.5	22.7	22.4	22.7	21.7	21.2
Trade balance/GDP	3.0	3.6	3.7	4.2	5.2	4.3	4.0	4.1	3.9	3.9
Net FDI/GDP	3.1	2.1	2.3	1.4	0.6	0.3	1.1	0.7	0.5	0.5
Net portfolio equity inflow/GDP	0.1	0.4	0.3	0.5	(0.2)	(0.3)	(0.5)	(0.8)	(0.8)	(0.8)
Gross external financing needs/CARs plus usable reserves	52.8	54.2	53.8	52.7	55.9	54.4	58.4	59.8	59.9	59.8
Narrow net external debt/CARs	(122.8)	(118.2)	(115.4)	(97.0)	(98.0)	(102.0)	(92.0)	(92.1)	(94.0)	(91.9)

Table 1

People's Republic of China--Selected Indicators (cont.)

ECONOMIC INDICATORS (%)	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Net external liabilities/CARs	(76.4)	(78.0)	(77.0)	(50.2)	(50.9)	(54.2)	(49.1)	(54.6)	(62.1)	(69.1)
Short-term external debt by remaining maturity/CARs	28.5	37.0	29.8	35.5	49.1	36.7	36.8	36.2	35.7	35.0
Reserves/CAPs (months)	16.9	17.9	16.6	18.4	19.8	17.8	15.8	14.9	14.7	14.5
Reserves (mil. $)	3,256,148	3,387,513	3,880,267	3,899,811	3,489,822	3,207,685	3,168,131	3,290,859	3,426,668	3,574,968
FISCAL INDICATORS (%, General government)										
Balance/GDP	0.2	(0.2)	(0.4)	(0.6)	(2.6)	(3.0)	(2.8)	(2.5)	(2.5)	(2.5)
Change in debt/GDP	1.2	1.0	1.5	1.7	23.2	3.8	3.6	3.1	2.8	2.9
Primary balance/GDP	0.7	0.2	0.0	(0.1)	(2.2)	(2.3)	(1.9)	(1.5)	(1.5)	(1.5)
Revenue/GDP	26.4	27.4	28.6	28.8	29.0	27.8	27.5	27.5	27.5	27.5
Expenditures/GDP	26.1	27.6	29.0	29.3	31.5	30.8	30.3	30.0	30.0	30.0
Interest /revenues	1.6	1.6	1.6	1.6	1.4	2.6	3.1	3.7	3.8	3.8
Debt/GDP	17.5	16.8	16.8	17.3	39.4	40.3	40.8	40.5	40.2	40.1
Debt/Revenue	66.4	61.5	59.0	60.1	136.1	145.0	148.5	147.4	146.0	145.8
Net debt/GDP	12.2	12.3	11.8	11.7	34.4	35.9	37.0	37.1	37.2	37.5
Liquid assets/GDP	5.4	4.5	5.1	5.5	5.0	4.4	3.9	3.4	3.0	2.6
MONETARY INDICATORS (%)										
CPI growth	5.4	2.6	2.6	2.0	1.4	2.0	2.1	2.2	2.3	2.3
GDP deflator growth	8.2	2.4	2.2	0.8	(0.4)	1.1	1.7	2.9	2.5	2.0
Exchange rate, year-end (LC/$)	6.3	6.3	6.1	6.1	6.5	6.9	7.0	7.2	6.9	6.9
Banks' claims on resident non-gov't sector growth	17.3	17.3	16.7	16.7	14.1	6.9	12.7	17.2	10.5	10.5
Banks' claims on resident non-gov't sector/GDP	129.8	137.8	146.0	157.5	168.8	167.3	174.2	186.9	190.1	194.8
Foreign currency share of claims by banks on residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Table 1

People's Republic of China--Selected Indicators (cont.)

ECONOMIC INDICATORS (%)	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Real effective exchange rate growth	2.7	5.6	6.3	3.2	10.6	N/A	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

People's Republic of China - Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Strength
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Strength
Monetary assessment	Neutral

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014 , summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, June 01, 2016
- Criteria - Governments - Sovereigns: Sovereign Rating Methodology, Dec. 23, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that all key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed

China (People's Republic of)	
Sovereign Credit Rating	AA-/Negative/A-1+
Greater China Regional Scale	cnAAA/--/cnA-1+
China (People's Republic of)	
Senior Unsecured |U	AA-
Senior Unsecured	AA-
Senior Unsecured |U	cnAAA
Senior Unsecured	cnAAA

|U   Unsolicited ratings.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.