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The Puzzle of Moody's China Downgrade

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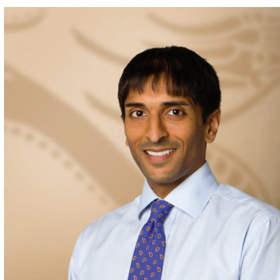

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China's economy is healthy, credit growth is decelerating and the government is cracking down on financial system risks, making this an odd time for rating agency Moody's Investors Service to downgrade China's sovereign rating to A1 from Aa3, while also changing its outlook to stable from negative. The May 24 Moody's Credit Opinion even sounds somewhat defensive—it highlights the strengths of the Chinese economy and reports that "financial stability risks will remain low." Importantly, our fixed income team believes that this downgrade will have limited impact for investors since this is already priced into the credit spread.

According to Moody's, its downgrade reflects their "expectation that China's financial strength will erode somewhat over the coming years," due in part to "high leverage at state-owned enterprises (SOEs)." And while the agency estimates that approximately 10% of SOEs are particularly highly leveraged, large parts of the SOE sector are financially robust, implying that "the total size of SOE liabilities overstates the risks to the sovereign."

The Moody's report describes China's economic strengths in notable detail, and the agency also acknowledges that the Chinese government has made recent progress in managing some potential risks.

Chinese Economic Strengths, according to Moody's May 2017 Report: Government of China – A1 Stable Update

- "China's credit profile incorporates a number of strengths, most notably its very large and still fast-growing economy. The government's control of parts of the economy and financial system and cross-border financial flows provides policy and financial scope to maintain economic, financial and social stability in the near term."
- "Large household savings at around 40% of incomes, according to IMF and OECD, reinvested within China, provide ample financing for new debt. As long as liquidity can be quickly funneled to where it is needed, financial stability risks will remain low."
- "China's largely closed capital account significantly reduces the risks that financial instability could arise as it attempts to reduce leverage when the economy has been reliant on new debt."
- "China's banking system is large and mainly government-owned, although financially weaker small and mid-size banks make up an increasing share of the overall system.
- "We assess China's economic strength to be 'Very High –'. We have adjusted the score upwards from an indicative "High +" to take account of the extremely large size of the economy, which points to a higher capacity to absorb shocks than the scorecard metrics convey."

Additionally, we note that the government has been making progress in slowing the growth of aggregate credit, and in reducing the gap between the growth rates of credit and of nominal GDP.

Unlike downgrades from investment grade to non-investment grade, we believe a single notch downgrade from Aa3 to A1 by Moody's is likely to have very little impact on investor's positioning. The risks highlighted by Moody's have long been understood by the investment community, and the downgrade moves China from the "very low" credit risk bucket to the "low" credit risk bucket. As a result, we do not believe the downgrade will have a material impact on the success of the China-Hong Kong Bond Connect program, which is scheduled to be launched later this year.

Finally, we want to remind investors of our view on China's debt problem, as detailed in our September 2016 issue of Sinology. At the time, we made the assessment that while China's debt problem was serious, we believed the risk of a hard landing or banking crisis to be low considering that the potential bad debts are corporate, not household debts, and made at the direction of the state—by state-controlled banks to state-owned enterprises.

We continue to believe that the state has the ability to manage the timing and pace of recognition of nonperforming loans. It is also important to note that the majority of potential bad debts are to state-owned firms, while the privately owned companies that employ the majority of the workforce and account for the majority of economic growth have been deleveraging. Additional positive factors are that China's banking system is very liquid and that the process of dealing with bad debts has begun.

Cleaning up China's debt problem will be expensive, but this process is likely to result in gradually slower economic growth rates, greater volatility, and a higher fiscal deficit/GDP ratio, not the dramatic hard landing or banking crisis scenarios that make for a more sensational media story.

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