Moody’s downgrades China’s debt rating

Nick Beams
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The downgrading of Chinese sovereign debt by the credit rating agency Moody’s has underscored the dilemmas facing the regime of Xi Jinping as it tries to maintain economic growth on the one hand and comply with the demands of international financial capital to reduce its debt levels and open up its financial system on the other.

On Wednesday Moody’s reduced its rating of Chinese debt by a notch from Aa3 to A1, its fifth highest rating, in the first such downgrade since 1989. At the same time, it softened the blow somewhat by changing its outlook from “negative” to “stability.”

The news, which initially saw a fall in markets before they staged a recovery, brought an immediate reaction from the Chinese finance ministry. It stated Moody’s had “overestimated the difficulties faced by China’s economy and underestimated the government’s ability to deepen reforms.” The agency, the foreign ministry continued, had not given sufficient credit for the “steady upward momentum” for growth, with stronger than expected results in the first quarter, and the year’s “strong beginning” showing the “achievement of China’s reforms.”

In its statement on the downgrade, Moody’s said that economy-wide debt, which includes that of state-owned enterprises, would continue to rise, notwithstanding reforms to the financial system, as the growth potential of the Chinese economy slowed.

“While ongoing progress on reforms is likely to transform the economy and financial system over time, it is not likely to prevent a further material rise in economy-wide debt, and the consequent increase in contingent liabilities for the government.”

It said the government’s direct debt burden would rise to about 45 percent of the economy by 2020 from a level of 40 percent in 2018.

It acknowledged that the government had been seeking to make changes to the financial system to cut back debt levels and while these changes would slow the rise they would not reduce it. This is because the government would use increased debt to try to boost the economy under conditions where growth is slowing.

Criticising the regime for its inability to allocate capital efficiently to areas of the economy which needed it most, it said: “The key measures introduced to date will have a limited impact on the productivity and efficiency with which capital is allocated over the foreseeable future.”

Last year the Chinese economy recorded an expansion of 6.7 percent, its lowest rate in more than a quarter of a century and, notwithstanding the better than expected results for the first quarter, the trend appears to be continuing this year with factory output, fixed investment and retail sales showing lower growth in April than for the first three months.

The government provided some stimulus measures in 2016 but their effect is now wearing off with president Xi calling on authorities to prioritise “financial security.” However the prevailing view in financial circles is that the government is proceeding too slowly in clearing away non-performing loans.

Moody’s expects that the growth potential for the Chinese economy will decline to close to 5 percent over the next five years, compared to the levels of over 10 percent reached in 2010 and the government’s stated target of growth rates of “around” 6.5 percent. But lower growth will see further government measures to try to boost the economy.

“The importance the authorities attach to maintaining robust growth will result in sustained policy stimulus, given the growing structural impediments to achieving current growth targets. Such stimulus will contribute to rising debt across the economy as a whole,” it stated.

According to Moody’s, one of the reasons for the rise in debt is that it is needed to finance economic expansion in the absence of significant capital raising through a large equity market and the lack of sufficiently large surpluses in the corporate and government sectors. At present total Chinese debt levels are estimated be 258 percent of gross domestic product.

While Moody's did not suggest that the downgrade implied any immediate major problems and financial markets generally took the decision in their stride, Marie Diron, an associate managing director for the sovereign risk group at the agency, told Bloomberg that "the combination of slower growth and higher debt poses some contingent liabilities for the government."

However the downgrade does point to rising financial risks in the longer term.

Eswar Prasad, economics professor at Cornell University and former head of the International Monetary Fund's China division told the *Financial Times*: "The ratings downgrade is a stark warning of the risks posed by rapidly rising leverage that could prove costly even if it does not result in a financial crisis. The slow and uneven pace of banking and financial sectors reform suggests that little progress has been made in improving the quality of bank lending."

Longer-term issues concerning the economy and the financial system are intertwined with political and social relations affecting the stability of the regime itself.

Since the restoration of capitalism under the direction of the Communist Party of China and the abandonment of any commitment to social equality, the regime has been able to maintain a base of support to the extent that it has been able to promote economic growth.

The stimulus measures, based on the rapid increase in debt which expanded after the 2008 financial crisis in response to the loss of more than 23 million jobs in 2008-2009, have been motivated by the regime's fear that a major economic crisis will lead to a social explosion. The official position used to be that at least 8 percent growth was needed to maintain social stability. Now growth is down to between 6.5 and 7 percent and is expected to go lower.

At the same time, however, the regime recognises that its stimulus measures, based on debt expansion, are losing their effectiveness and continued economic growth, on which its stability depends, require the closer integration of its financial system into global financial relations.

Hence its moves to comply with the demands for a greater opening of the country's financial system. But this means containing credit expansion and taking action on bad debt and non-performing loans which signifies the closure of whole sections of industry threatening social and political stability.

The Moody's downgrade and the sharp reaction of the regime to it point to the intensification of these contradictions.