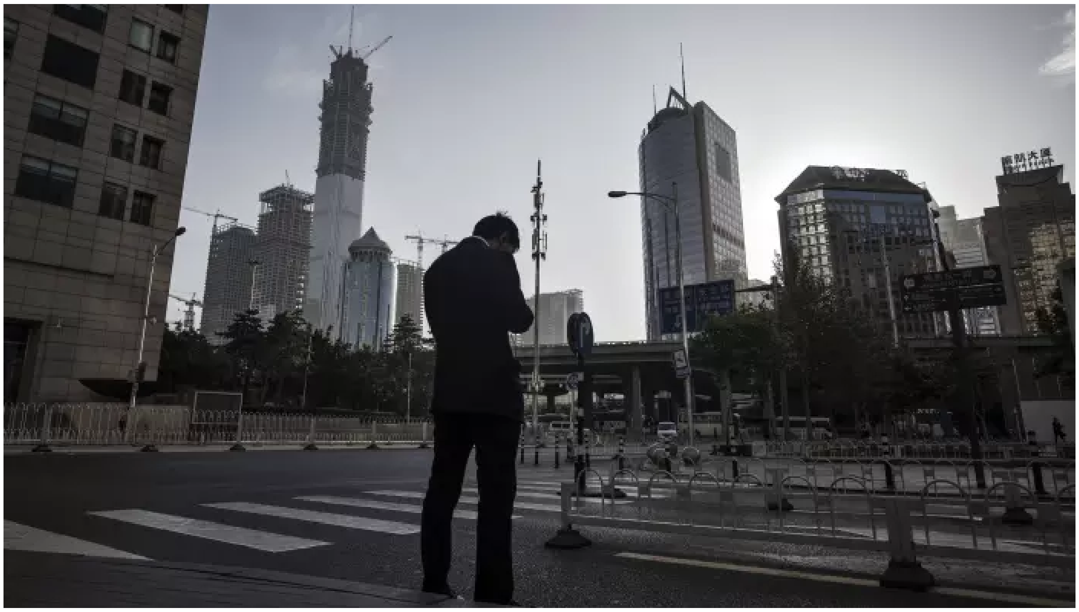
Chinese Economy

China's sovereign debt downgraded by Moody's

Beijing condemns rating agency decision that could curb foreign appetite for bonds



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MAY 24, 2017 by: Gabriel Wildau in Shanghai and Tom Mitchell in Beijing

China's finance ministry chastised Moody's on Wednesday after the US rating agency downgraded Beijing's sovereign credit rating, highlighting investor concerns over rising debt and the slow pace of economic reforms intended to transform the country's growth model.

"Moody's has overestimated the difficulties faced by China's economy and underestimated the government's ability to deepen reforms," the ministry said in response to the downgrade, which initially rattled China's stock markets and currency.

Moody's downgraded China one notch from Aa3 to A1, its fifth-highest rating. On the credit scale used by rival agencies Fitch Ratings and Standard and Poor's, the move is equivalent to a downgrade from double A minus to A plus. S&P still rates China at double A minus although with a negative outlook, while Fitch already had China at A plus.

"The downgrade reflects Moody's expectation that China's financial strength will erode somewhat over the coming years, with economy-wide debt continuing to rise as potential growth slows," Marie Diron, the agency's associate managing director for sovereign risk, wrote in an announcement on Wednesday.

“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.”

The news initially unnerved Chinese investors. The yield on benchmark Chinese five-year government bonds rose from 3.8 per cent to 3.95 per cent in the minutes following the announcement, but had returned to the previous level by midday, according to the National Interbank Funding Center.

Domestic investors generally ignore foreign ratings of Chinese bonds. Foreign penetration of China’s bond market remains tiny, with foreigners owning about Rmb424bn ($61.5bn) of Chinese government bonds at the end of April, equal to 4 per cent of the outstanding total, according to China Central Depository and Clearing.

Moody’s shifted its ratings outlook for China to negative in March last year, with S&P following suit four weeks later. Fitch, which has generally been more bearish on China than its counterparts, has maintained its A plus ratings with stable outlook since 2007.

While Moody’s acknowledged China’s efforts to rebalance its economy away from reliance on debt-fuelled stimulus, the agency believes progress is too slow to arrest deterioration in its financial strength.

“The planned reform programme is likely to slow, but not prevent, the rise in leverage,” the agency said. “The importance the authorities attach to maintaining robust growth will result in sustained policy stimulus. Such stimulus will contribute to rising debt across the economy as a whole.”

Luke Spajic, who heads Pimco’s emerging Asia portfolio, said the risks highlighted by Moody’s had already been “well flagged” by the market.

“Markets have been anxious about policy tightening and the upcoming political changes,” Mr Spajic said, referring to a Chinese Communist party congress that will select President Xi Jinping’s leadership team for his second term in office.

Moody’s statement also noted that capital outflows and renminbi depreciation pressures had limited China’s scope for using monetary policy to stimulate the economy. It said this limitation would force authorities to rely more on fiscal spending.

Moody's expects China's direct fiscal debt to reach 40 per cent of gross domestic product by the end of next year and 45 per cent by 2020, in line with a median debt level of 41 per cent in 2016 for A rated sovereigns but above the 37 per cent median for those with double A ratings.

In addition, it notes that China's reliance on disguised fiscal spending through off-budget special purpose vehicles owned by local governments is likely to persist. The Financial Times reported this month on a confidential World Bank assessment warning of risks from so-called local government financing vehicles.

Moody's also referred to quasi-fiscal spending by other state-owned enterprises, which the agency views as contingent liabilities for the central government.

The agency mentioned slow progress on financial reforms designed to improve credit pricing and allocation, citing distortions caused by widespread assumptions that the government would bail out certain borrowers to prevent default.

"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," said Eswar Prasad, economics professor at Cornell University and former head of the International Monetary Fund's China division. "The slow and uneven pace of banking and broader financial sector reforms suggests that little progress has been made in improving the quality of bank lending."

Additional reporting by Peter Wells in Hong Kong

This article has been amended since initial publication to reflect that A1 is Moody's fifth-highest rating

Twitter: @gabewildau