

Rating Action: Moody's downgrades China's rating to A1 from Aa3 and changes outlook to stable from negative

Global Credit Research - 24 May 2017

Singapore, May 24, 2017 -- Moody's Investors Service has today downgraded China's long-term local currency and foreign currency issuer ratings to A1 from Aa3 and changed the outlook to stable from negative.

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. 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 stable outlook reflects our assessment that, at the A1 rating level, risks are balanced. The erosion in China's credit profile will be gradual and, we expect, eventually contained as reforms deepen. The strengths of its credit profile will allow the sovereign to remain resilient to negative shocks, with GDP growth likely to stay strong compared to other sovereigns, still considerable scope for policy to adapt to support the economy, and a largely closed capital account.

China's local currency and foreign currency senior unsecured debt ratings are downgraded to A1 from Aa3. The senior unsecured foreign currency shelf rating is also downgraded to (P)A1 from (P)Aa3.

China's local currency bond and deposit ceilings remain at Aa3. The foreign currency bond ceiling remains at Aa3. The foreign currency deposit ceiling is lowered to A1 from Aa3. China's short-term foreign currency bond and bank deposit ceilings remain Prime-1 (P-1).

RATINGS RATIONALE

RATIONALE FOR THE RATING DOWNGRADE TO A1

Moody's expects that economy-wide leverage will increase further over the coming years. The planned reform program is likely to slow, but not prevent, the rise in leverage. 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.

RISING DEBT WILL ERODE CHINA'S CREDIT METRICS, WITH ROBUST GROWTH INCREASINGLY RELIANT ON POLICY STIMULUS

While China's GDP will remain very large, and growth will remain high compared to other sovereigns, potential growth is likely to fall in the coming years. The importance the Chinese authorities attach to growth suggests that the corresponding fall in official growth targets is likely to be more gradual, rendering the economy increasingly reliant on policy stimulus. At least over the near term, with monetary policy limited by the risk of fuelling renewed capital outflows, the burden of supporting growth will fall largely on fiscal policy, with spending by government and government-related entities -- including policy banks and state-owned enterprises (SOEs) - rising.

GDP growth has decelerated in recent years from a peak of 10.6% in 2010 to 6.7% in 2016. This slowdown largely reflects a structural adjustment that we expect to continue. Looking ahead, we expect China's growth potential to decline to close to 5% over the next five years, for three reasons. First, capital stock formation will slow as investment accounts for a diminishing share of total expenditure. Second, the fall in the working age population that started in 2014 will accelerate. Third, we do not expect a reversal in the productivity slowdown that has taken place in the last few years, despite additional investment and higher skills.

Official GDP growth targets have also adjusted downwards gradually and the authorities' emphasis is progressively shifting towards the quality rather than the quantity of growth. However, the adjustment in official targets is unlikely to be as fast as the slowdown in potential growth as robust economic growth is essential to fulfilment of the current Five Year Plan and appears to be considered by the authorities as important for the maintenance of economic and social stability.

As a consequence, notwithstanding the moderate general government budget deficit in 2016 of around 3% of GDP, we expect the government's direct debt burden to rise gradually towards 40% of GDP by 2018 and closer to 45% by the end of the decade, in line with the 2016 debt burden for the median of A-rated sovereigns (40.7%) and higher than the median of Aa-rated sovereigns (36.7%).

We also expect indirect and contingent liabilities to increase. We estimate that in 2016 the outstanding amount of policy bank loans and of bonds issued by Local Government Financing Vehicles (LGFVs) increased by a combined 6.2% of 2015 GDP, after 5.5% the previous year. In addition to investment by LGFVs, investment by other SOEs increased markedly. Similar increases in financing and spending by the broader public sector are likely to continue in the next few years in order to maintain GDP growth around the official targets.

More broadly, we forecast that economy-wide debt of the government, households and non-financial corporates will continue to rise, from 256% of GDP at the end of last year according to the Institute of International Finance. This is consistent with the gradual approach to deleveraging being taken by the Chinese authorities and will happen because economic activity is largely financed by debt in the absence of a sizeable equity market and sufficiently large surpluses in the corporate and government sectors. While such debt levels are not uncommon in highly-rated countries, they tend to be seen in countries which have much higher per capita incomes, deeper financial markets and stronger institutions than China's, features which enhance debt-servicing capacity and reduce the risk of contagion in the event of a negative shock.

Taken together, we expect direct government, indirect and economy-wide debt to continue to rise, signalling an erosion of China's credit profile which is best reflected now in an A1 rating.

REFORMS WILL NOT FULLY OFFSET THE RISE IN ECONOMIC AND FINANCIAL RISK

The authorities are part of the way through a reform program intended to sustain and enhance the quality of growth over the longer term, as well as to reduce the risks to the economy and the financial system posed by high corporate and, in particular, SOE debt. One related objective is to contain, and ultimately reduce, SOE leverage.

The authorities' commitment to reform is clear. It is quite likely that their efforts will, over time, improve the allocation of capital in the economy. Over the nearer term, the authorities have taken steps to contain the rise in SOE debt and to discourage some SOEs from further domestic and external investment, particularly in over capacity sectors.

However, we do not think that the reform effort will have sufficient impact, sufficiently quickly, to contain the erosion of credit strength associated with the combination of rising economy-wide leverage and slower growth. In particular, in our view, the key measures introduced to date will have a limited impact on productivity and the efficiency with which capital is allocated over the foreseeable future.

For example, one key set of reforms is the program of debt-equity swaps which aims to lower leverage in parts of the SOE sector, transferring the associated risks to the banking sector. At present, we estimate that the value of swaps announced is a very small fraction -- around 1% -- of SOE liabilities. Moreover, there is very little transparency about the terms of these transactions or their likely impact on SOEs' and banks' creditworthiness.

Other measures intended to improve investment allocation include negative lists on investment in excess capacity sectors and the introduction of mixed ownership. The former will likely reduce the major losses on investments of the past. However, excess capacity sectors only account for a small proportion of total investment. Only limited improvement in the allocation of capital would result from such measures. Meanwhile, mixed ownership is at a very preliminary stage, having been introduced in only a few dozen SOEs, and on too small a scale for now to have any impact on productivity in the economy as a whole.

Looking beyond the corporate sector, the financial sector remains under-developed, notwithstanding reforms introduced to improve the provision of credit; pricing of risk remains incomplete, with the cost of debt still partly determined by assumptions of government support to public sector or other entities perceived to be strategic. And with increased scrutiny of capital outflows, the capital account remains largely closed. While that insulates the economy and financial system from global volatility, it also constrains the development of domestic capital markets by limiting the flow of inward and outbound capital.

Overall, we believe that the authorities' reform efforts are likely, over time, to achieve some measure of economic rebalancing and improvement in the allocation of capital. But we think that progress will be too slow

to arrest the rise in economy-wide leverage.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects our assessment that, at the A1 rating level, risks are balanced.

China's credit profile incorporates a number of important 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. In particular, 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.

Large household savings at around 40% of incomes, according to the IMF and OECD, reinvested within China, provide ample financing for new debt. As long as liquidity can be quickly funnelled to where it is needed, financial stability risks will remain low.

In addition, China's sizeable foreign exchange reserves of around \$3 trillion give the central bank abundant financial power to preserve the stability of the currency and thereby avoid financially destabilising scenarios of capital flight.

WHAT COULD CHANGE THE RATING UP/DOWN

The stable outlook denotes broadly balanced upside and downside risks. Evidence that structural reforms are effectively stemming the rise in leverage without an increase in risks in the banking and shadow banking sectors could be positive for China's credit profile and rating.

Conversely, negative rating pressures could stem from leverage continuing to rise faster than we currently expect and continuing to involve significant misallocation of capital that weighs on growth in the medium term. In particular, in this scenario, the risk of financial tensions and contagion from specific credit events could rise, potentially to levels no longer consistent with an A1 rating.

GDP per capita (PPP basis, US\$): 15,399 (2016 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 6.7% (2016 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 2.1% (2016 Actual)

Gen. Gov. Financial Balance/GDP: -2.9% (2016 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 1.8% (2016 Actual) (also known as External Balance)

External debt/GDP: 12.7% (2016 Actual)

Level of economic development: Very High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 21 May 2017, a rating committee was called to discuss the rating of the China, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, have not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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