CHINA'S DEBT ISSUE

CONCERNS ABOUT CHINESE DEBT HAVE CULMINATED IN A SOVEREIGN RATING DOWNGRADE. WARUT PROMBOON EXAMINES HOW AND WHY CHINA LAGS BEHIND ITS INDUSTRIALISED PEERS IN TERMS OF THE CREDIT UNDERWRITING DISCIPLINE

Moody's downgrade of China's local currency and foreign currency senior unsecured debt rating to A1 (from Aa3) in May confirms sentiment that China's economic improvement will not develop fast enough to outpace its debt problems. Economic improvements result from rising productivity, which may not necessarily be created by adding more debt. Debt problems, meanwhile, derive from a lack of credit underwriting disciplines, ie the credit culture.

Overly kind critics

Despite Moody's downgrade, much of China's macro data has recently improved. Many sell-side economists have seen the downgrade as a turning point and expect the renminbi to stop depreciating. They are correct, except that they have made that call based on official data. China's data is a far cry from the developed market standard, and China's credit risk has not receded, we believe. Complacency is dangerous; if analysts pay no attention to data integrity, research can amount to a 'garbage in, garbage out' process, especially when the Asian bond spread is at its tightest in recent years. It seems clear that analysts and economists have been too kind on China.

Credit culture (or the lack of)

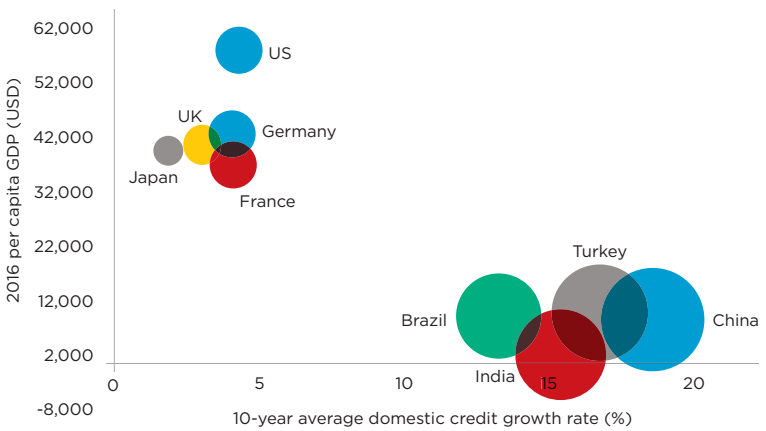
The underlying problem is that China has grown its debt without improving its credit culture. A sound credit culture is one that has developed a pool of qualified credit analysts (including qualified credit rating agencies), where differences of opinions are cherished, and data is transparent.

However, Chinese rating agencies are well known for assigning too many AAA ratings to onshore issuers. We should first examine those AAA ratings, as these are awarded nationally, not internationally. A national issuer rating is assigned by ranking a Chinese issuer against its domestic peers, not international ones, so we simply cannot compare national ratings against international ones. The market convention has it that any AAA national rating should be mapped from BBB- to AAA on an international scale.

But here are the problems. Many national ratings are incorrectly labelled as international, because many analysts lack knowledge of what an international rating actually constitutes. In addition, AAA national ratings account for the majority of all rated entities in China, which tells us these agencies have not done a good job. Perhaps they seek to represent onshore issuers rather than investors. Local rating reports often lack credit arguments and do not set out clearly why an issuer deserves an AAA rating. The fact that onshore investors only look for AAA ratings leads to a lack of credit quality differentiation. Furthermore, China's culture of no debate leads to a lack of criticism of local rating agencies and that prevents those agencies from reaching the international standard.

We have seen government-owned asset managers subscribe to bonds issued by government-owned entities at a time when no international investors wanted exposure to China. Since many Chinese issuers are either government-owned or government-influenced, it is difficult for local rating agencies to issue negative opinions on China, let alone state-owned enterprises and local governments. We understand Chinese regulators plan to allow international credit rating agencies to rate

FIGURE 1 – CHINA'S GDP VS ITS PEERS



SOURCE: CEIC, BONDCRITIC ESTIMATES

China's senior unsecured credit ratings	Local currency	Foreign currency	Outlook	Last reviewed
S&P	AA-	AA-	Negative	31 March 2016
Moody's	A1	A1	Stable	24 May 2017
Fitch	A+	A+	Stable	15 October 2013

SOURCE: BLOOMBERG

onshore issuers and we view this policy development as positive for China's debt market. Nevertheless, we doubt the government will want to get rid of its overly kind analysts altogether. Rating liberalisation will occur when the criticism is heeded or when the Chinese economy is back on track, a scenario that may not occur this year.

China's economy has grown faster than its efforts to create a functional financial market in the past 10 years. Differences of opinions make the market; therefore, without these, there is no market. The result is inefficient capital allocations, where credit risk cannot be properly priced and a capital cushion for non-performing loans can be a shot in the dark.

This lack of willingness and ability to produce good-quality information is reflected in Transparency International's Corruption Perception Index. In 2016, China was ranked 79th, the same level as Belarus, Brazil and India. China scored 40 points out of a total score of 100 (versus 37 points the year before). The biggest annual improvement between 2011-2016 is 3 points or 8.1%. If we assume an 8.1% improvement to 43 points in 2017, the peer group can be extended to include Turkey. That said, we see Brazil, India and Turkey as China's closest peers in terms of financial market development.

Figure 1 (opposite) shows China against its peers (Brazil, India and Turkey), as well as major G7 countries (of which China is a member) in terms of the 10-year average credit growth versus 2016 per capita GDP. The bigger the circle on the chart, the stronger the credit growth over the past 10 years.

China's average credit growth rate of almost 20% over the past 10 years is the highest among its peers. The chart shows that China has grown its debt beyond its productivity. True, China (along with Brazil, India and Turkey) remains a developing country, which needs to grow its credit at a quicker pace in order to support its faster GDP growth. However, Brazil (BB/Ba2/BB by Standard & Poor's, Moody's and Fitch), India (BBB-/Baa3/BBB-) and Turkey (rated BB/Ba1/BB+) all have credit ratings a few notches below China's. China's small per capita GDP tells us the country's credit growth in the past 10 years has not made its population more well off than those in Brazil and Turkey, despite China's gigantic FX reserves.

China's economy has grown faster than its efforts to create a functional financial market

The first domino to fall

Moody's downgraded China's sovereign rating to A1 from Aa3 on 24 May, the first downgrade on China by Moody's since 1989. The outlook, meanwhile, was revised from negative to stable. 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."

We agree with Moody's view. The Chinese government and local rating agencies have come out in defence of China's credit ratings, but, in our view, the more they come out, the more credible Moody's position has become. China's worsening debt problem is clear, and the market's strengthening conviction on the debt crisis seems likely to quicken capital outflows out of China. Moody's could be the first of a few more negative rating actions for China in the near term. Credit ratings of Chinese state-owned enterprises are implicitly supported by the Chinese government and, therefore, all deserve a one-notch downgrade, in our view. This wholesale downgrade event will cause a repricing event for Chinese credits as a result. In our judgement, rating downgrade risk poses asymmetric downside risk for Chinese-related assets in the near term.

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