Moody's Credit Downgrade of China First in Almost 30 Years

Moody's Investors Service, one of the big three credit-rating services in the country, downgraded China's creditworthiness one full notch on Wednesday. It moved the world's second-largest economy from Aa3 ("high quality [with] very low risk") to A1 (Upper-medium grade [with] low credit risk"). It explained why:

> The downgrade reflects Moody's expectations that China's financial strength will erode somewhat over the coming years, with economy-wide debt continuing to grow as potential growth slows.

That "potential growth" has been slowing since at least 2010. In that year Chinese government agencies reported growth in excess of 10 percent. By 2014, it had slowed to 7.3 percent, to 6.9 percent in 2015, and is now at a reported 6.7 percent.

Moody's is late to the game. It has maintained China's Aa3 rating since 1989. Fitch Ratings dropped its rating on China a full notch seven years ago. Standard & Poor's has had China on negative outlook since February last year.

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When asked about the downgrade on CNBC's *Street Signs* on Wednesday, Moody's Senior Vice President Marie Diron said it's likely that China's economy would continue to slow to just 5 percent by 2022. She added:

> Official [Chinese government] growth targets are also moving down … so the economy is increasingly reliant on policy stimulus [borrowing].
>
> It's really the size of the leverage, the trends in the leverage as well as the debt servicing capacities of the institutions that have debt. When growth slows, then that points to toward slower revenue growth, probably lower profitability, and … weaker debt servicing capacity.

China's so-called economic miracle began in 1978 when the communist government began introducing free market principles into the stagnant moribund Third World economy. Applied initially to agriculture in the form of privatization and allowing peasants to keep their profits, the economy responded smartly when the party allowed foreign investors to build factories to take advantage of China's cheap labor. Then came investments in power plants to serve the growing economy. This was followed by enormous investments in cities, as well as in basic industries such as steel and cement.

Nothing grows to the sky, and when the economy began to slow, new Five Year Plans were implemented, along with government loans to keep the economy growing. During the 2008 global financial crisis, those government loans were expanded, with proceeds flowing through government banks to state-owned enterprises (SOE). Since a directed economy has no ability to project prices accurately, the loans were based upon assumptions rather than reality. What Moody's has come to learn, albeit lately, is that the conflict between reality and those Five Year Plans is likely to set off "contagion" where the failure of one bank could lead, like dominoes, to the failure of others. This would put more pressure on the central government to bail them out — after all, they're part of the government apparatus — expanding debt just at a time when the ability to service it is declining.

Keith Bradshear, writing in the *New York Times*, got it exactly right:

> With its economy maturing, China has to pile on ever more debt to keep its growth going at a pace that could prove unsustainable. And the money is increasingly flowing through opaque channels that operate outside the regulated banking system ["shadow" banking], leaving China vulnerable to blowups.

But over time additional debt loses its ability to stimulate the economy. In the early stages, it is indistinguishable from private capital, fooling entrepreneurs and managers of those SOEs into thinking that real growth can be obtained, sustained, and maintained with additional insertions of borrowed money. Not so, wrote Bradshear:

> But debt no longer packs the same economic punch for China. An aging workforce, smaller productivity gains and the sheer math of diminishing returns mean [the government] must borrow more money to achieve less growth.

Moody's at least sees that the problem is a politically managed economy that tries to impose a Five Year Plan with little idea or ability to know where the best prospects for growth really are. Only entrepreneurs, through trial and error, are able to do that. Here's Moody's justification for its downgrade from its statement:

> 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….
>
> China's … potential growth is likely to fall in the coming years … rendering the economy increasingly reliant on policy stimulus. Over the near term … 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 — rising.

China faces other problems as well, including the aging population and the declining productivity referred to by Bradshear. Noted Moody's: "We expect China's growth potential to decline to close to 5% over the next five years [due to] the fall in the working age population that started in 2014. 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."

There it is again: More borrowing to "stimulate" the economy will no longer "pack the punch" it once did, with demographics and declining productivity only hastening the day of reckoning.

Naturally, China's Finance Ministry said that Moody's has got it all wrong, that its "views that China's … debt will rise rapidly and that the government would continue to maintain growth via stimulus measures are exaggerating difficulties facing the Chinese economy." The Ministry said it has that wonderful Keynesian remedy available to solve the problem: supply-side economics:

> [Moody's is] underestimating the Chinese government's ability to deepen supply-side structural reform and appropriately expand aggregate demand.

This is the phony solution accurately alluded to by Bradshear: that economic growth can most effectively by created by borrowing to invest in capital, reducing the cost of production of goods and services and thence their retail costs. The idea is phony on its face: It's based on the assumption that the government knows exactly where that additional borrowed capital is best applied to get the biggest return.

But government is run by bureaucrats who know little or nothing at all about what consumers want and are willing to pay for. In a thousand years of trying, no government on Earth could ever have come up with Apple's iPhone!

Moody's has revealed a managed economy's fatal assumption: that government bureaucrats do think they know what they are doing, that the economy can be "managed" successfully. It has discovered that instead China's economy is losing both altitude and airspeed, and its downgrade is a warning of its eventual cratering.

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