Moody's Debt Downgrade Will Only Make China's Problem Worse

For the first time in thirty years Moody's has downgraded China's debt. *Bloomberg* discusses the ramifications of **China's downgrade** from A1 to Aa3.

> *The downgrade of China's debt by Moody's Investors Service may push Chinese companies to borrow even more money from domestic banks as overseas debt becomes more expensive, increasing risks for the nation's finance industry.*
>
> *With growing indebtedness at home, compounded by a slowing economy, there's a risk of a "negative feedback loop," said Khoon Goh, head of Asia research for Australia & New Zealand Banking Group who sees state-owned enterprises and property developers feeling the biggest impact. The downgrade will particularly hurt airlines and shipping companies, said Corrine Png, chief executive officer of Crucial Perspective in Singapore.*

China's economy kept going during the 2008 financial crisis and thereafter by borrowing money. Corporate debt was 100 percent of GDP in 2008 and today it is 156 percent. State owned companies took on most of this debt so the government is at risk in case of defaults.

The underlying problem for China is its business model. For decades the *land of managed capitalism* has borrowed and grown as its markets expanded. But there comes a time when markets are saturated and add in the worst recession in 75 years. Then you have an obsolete business model and a lot of leftover debt. A lower debt rating means higher interest rates at a time when China's debt is at historic highs. This could descend into a negative feedback loop in which companies borrow more and more money at higher and higher interest rates until they go bankrupt. What does this mean for the rest of us outside of China?

Economic Size versus Growth

The problem for the rest of us if China's economy tanks is that China has been the growth engine for the last decades. *Forbes* notes that while China is 15% of the global economy it has constituted **25-30% of global growth**. We can see now that this growth has come on the back of ever increasing debt.

Much of Chinese growth simply has to do with producing, buying and selling within China. However, China has been the world's second largest importer next to the USA according to *OEC* report on **China**.

> *In 2015 China imported $1.27T, making it the 2nd largest importer in the world. During the last five years the imports of China have increased at an annualized rate of 2.3%, from $1.1T in 2010 to $1.27T in 2015. The most recent imports are led by Crude Petroleum which represents 9.4% of the total imports of China, followed by Integrated Circuits, which account for 7.48%.*

How Moody's debt downgrade matters to the rest of us depends on what we want to sell to China. Australia, for example, hurts every time China reduces iron ore and coal imports. And while the USA has a negative trade balance with China there are American companies that make money in China. For example General Motors' largest market is China and not North America as it increases sales to 10 million vehicles per year. China's problems with its debt may get worse and the fallout will affect companies and countries across the globe.