

# Flash Comment

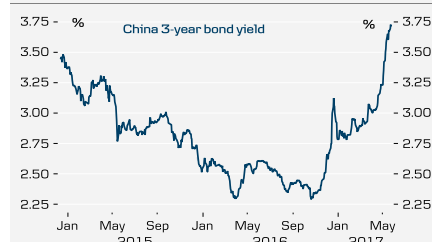
## Downgrade of China puts focus back on financial risks

- **Overnight Moody's downgraded China by one notch from Aa3 to A1** – the first downgrade since 1989 (see [link](#)). It changed the outlook from negative to stable.
- The rationale behind the downgrade is rising debt and Moody's expectation of a continuing increase in leverage in coming years, which will erode China's financial strength. Moody's also highlights that the growth target the government is pursuing in the Five-Year Plan will rely on continued stimulus and rising leverage. '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.'
- The move by Moody's does not seem to relate to the recent bouts of financial stress but is based more on a long-term sustainability analysis.
- S&P could soon follow, as it now has a one-notch higher rating than both Moody's and Fitch.

### Our take on China's financial risks

- **We expect focus to return to China's financial risks this year, as growth slows down.** We continue to see downside risks to Chinese growth based on the policy tightening already done and the current stress in bond markets. We do not expect a big financial crisis in the short term (next one to two years), as we believe China is likely to take a step back on regulatory tightening if stress gets too high and threatens the economy ahead of the 19th National Congress of the Communist Party in the autumn.
- Nevertheless, **we expect China to be an increasing drag on global growth and risk appetite this year.** On a three- to five-year horizon, we still see a 50% risk of a financial crisis in China or a lost decade of growth (Japan scenario) as the economy deleverages.

### Moody's downgrade adds to worries on recent financial stress



Source: Macrobond Financial, Danske Bank

### Recent research on China

*Strategy: Downside risks to China - and what it means for markets, 11 May.*

*Research China: Financial stress on the rise again, 4 May.*

*Research: China leading indicators - the slowdown is a reality, 2 May.*

### Corporate debt has been on a steeply rising path over the past five years



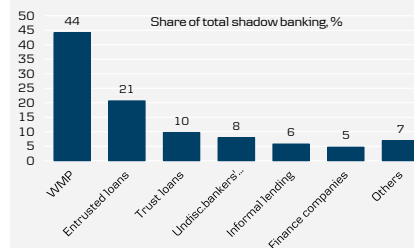
Source: BIS, Danske Bank

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- **Our concern does not relate only to the rapid rise in corporate debt that has taken place but also to it happening alongside a rapid growth in shadow banking**, where the safety net is much smaller than in the traditional banking system. Shadow banking is all intermediation between savers and borrowers that takes place outside the traditional banking system.
- A lot of China’s debt has been intermediated through wealth management products (WMP), which have seen average growth of 50% since 2012. In order to deliver the promised return, WMP invest in higher risk loans. However, Chinese households putting money into WMP expect them to be government guaranteed. **If losses start to mount in some of these loans, the promised returns will not be delivered and households could quickly pull their money out of these products again, leading to a liquidity crisis** where companies struggle to roll debt, which could trigger a negative spiral of higher yields, rising defaults, economic slowdown, even more bankruptcies and so on.
- The **development in China’s financial system needs close monitoring** and we expect it to become an increasing focus this year when growth slows down.
- The medium-term risks and structural downside pressure on growth are the main reasons **we continue to look for a continued gradual weakening of the CNY** versus both the USD and EUR over the coming years and recommend to hedge CNY receivables.

**Wealth management products close to half of shadow banking**



Source: Moody's, Danske Bank

**Rapid growth in shadow banking in recent years**

	Shadowbanking, % of total bank assets		Average annual growth
	End H1 2016	End 2012	
Wealth Management Products	12.2	3	51.5
Entrusted loans	5.7	3.9	20.6
Trust loans	2.7	2.3	14.9
Undiscounted bankers' acceptances	2.2	4.7	-6.1
Informal lending	1.6	2.6	0.0
Loans by finance companies	1.3	0.8	25.7
Other	1.9	1	29.1
<b>All shadow banking</b>	<b>27.6</b>	<b>18.3</b>	<b>21.9</b>

Source: Moody's, Danske Bank

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### Expected updates

None.

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