China's Evergrande Conundrum*

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China's Evergrande group, identified as the world's most indebted property company with accumulated liabilities in excess of $300 billion, missed an interest payment instalment due on September 23, 2021 on bonds borrowed through US dollar bond markets. Though the company enjoys a 30-day grace period to pay up and avoid being in default, the absence as yet of any clarification on the missed instalment has increased uncertainty. Markets seem sceptical that the firm would meet in full the $129 million of interest payments on its bond issues due this month and the $850 million due by year end. Evergrande's share prices have collapsed by more than 85 per cent over the last year.

An Evergrande default and possible bankruptcy can have repercussions in China as well as abroad, so the global media has been obsessed with this one company for weeks now. The domestic fallout would be influenced by the fact that sheer size makes Evergrande a crucial component of China's real estate sector which is estimated to contribute more than a quarter of the country's GDP. Property sector investment accounts for a large share of the more than 40 per cent of GDP devoted to fixed capital formation and drives China's growth. Debt has been a core element of this growth trajectory. Property developers borrow heavily to buy and accumulate land for construction of offices and houses which are acquired by buyers, whose purchases were more often than not financed with debt, easy access to which fuelled a speculative bubble reflected in soaring property prices in multiple urban locations. Land was sold to developers by local governments, which depended on receipts from such sales for revenues that were then used to service debt totalling more than $8 trillion taken on by special-purpose Local Government Financing Vehicles (LGFVs). The LGFVs were the financing route that provincial governments used to implement huge "prestige projects" that were launched to build and shore up the reputations of provincial party and government leaders. China's growth rode on this web of debt.

The failure of a property giant like Evergrande can tear that web apart. But this would not be the only damage. A collapse in construction would curtail demand for everything needed in construction from cement and steel to glass and fittings, adversely affecting those providing these inputs. Banks and other financial intermediaries that lent to property developers would lose heavily in the event of default. That would affect credit flow from the financial sector to businesses and households. Individual property buyers who have paid advance instalments, but have still to be given possession of their property, and retail investors who bought into the wealth management products sold by the property developers, will take a hit from Evergrande's failure. Eighty thousand Chinese, including employees of Evergrande, reportedly hold around Rmb40 billion worth of the company's wealth management products. Many of them have been protesting outside Evergrande's offices demanding their money be paid back. With their savings tied up, the consumption and investment spending by investors who suffer losses because of default would depress demand even further. And Evergrande, though the biggest, is not the only property company that can fail. China Fortune Land Development defaulted in February 2021, and other construction firms are in line to follow, aggravating the crisis. All told, the end of the property bubble can cut short the revival of growth in China after a longish slowdown that followed the high growth years of the 2000s and earlier.

The adverse effects of a property market bust would not be restricted to China's economy. To start with, demand from China has been an important driver of global growth. So, any recession in China will have repercussions for economic performance in the rest of the world. Moreover, foreign financial firms and investors, who have been plied with cheap credit by central banks pursuing easy money policies to revive depressed economies, have been diverting a chunk of that money to the Chinese market. A consequence has been significant foreign exposure to China's financial system, with property developers alone, including Evergrande, having raised more than $220 billion in debt from the US dollar bond market. Any shock to the Chinese economy and financial system will reverberate in global markets, with analysts seeing the Evergrande saga as contributing to volatility in stock markets worldwide.

Given this fallout, global players have been surprised by the absence as of now of any concerted effort on the part of the Chinese government to intervene and bail out Evergrande, which is seen by many as being "too big to fail". In fact, Evergrande's troubles are being seen as China's 'Lehman moment', referring to the mayhem that followed the bankruptcy of Lehman Brothers at the time of the global financial crisis of 2008. There are similarities and differences. Riding on debt, China's property development has expanded at a pace that has resulted in oversupply relative to the actual needs of the population. But this did not appear to be a problem as investors looking to benefit from appreciation in property prices, and facilitated with access to credit, acquired multiple properties with no intention to stay in them. Evergrande's own difficulties arose not only because it is overleveraged, or because it has accumulated too much debt. It is also because the government decided to rein in the debt financed speculative bubble in China's property markets. To that end the government implemented its "three red lines" policy in 2020, under which the liabilities to assets ratio of property companies had to be kept below 70 per cent, the net debt to equity ratio below 100 per cent and the cash to short term debt ratio above 100 per cent. The intention was to limit leverage of property developers. Simultaneously, lending for property purchases has been curtailed, and property buyers are finding it increasingly difficult to access mortgage finance. A combination of uncertainty among buyers about the viability of developers over the long term during which they build the assets for which advance payments are made, and the brakes that are being applied on increases in mortgage lending, have slowed sales in property markets. With cash inflows to developers squeezed, and non-bank lenders holding back, servicing debt has become a problem for the likes of Evergrande, precipitating a situation of near default.

As has been the case in the past, many analysts see in the troubles in China's property and financial sector the beginning of the end of the country's growth story driven by credit financed speculation by local governments and the private sector. However, the Chinese government is not faced with a problem that it finds difficult to address. Rather, by clamping down on excess borrowing the government has created the crisis in the property sector. Moreover, the government as of now shows no signs of pulling back from its policy of reigning in the speculative surge in property markets, nor is it rushing to bail out Evergrande, buying into the argument that the company is too big to fail. This reticence is visible despite the possibility that if the property bubble suddenly bursts, the fall in prices could wipe out the wealth of many ordinary Chinese who bought property when prices were high, or who have invested in financial products property companies sold with the promise of high returns. Though expectations are that the government would finally relent and intervene, the delay in its intervention has resulted in palpable uncertainty in markets within and outside China. Would the government relent, that is the Evergrande conundrum.

The thinking behind the actions of the Chinese government or the absence of them is not all too clear, other than for the fact that it has clearly decided to rein in the speculative bubble. One explanation for the government's stance is that it perceives inequality as having reached levels where it threatens its legitimacy and that of the Communist Party, with the unaffordability of housing for the ordinary citizen being an aspect of that problem. This is in keeping with the recent official emphasis on the pursuit of "common prosperity" rather than just growth and wealth creation. Another explanation could be the need to rein in wealth accumulation by private sector barons, China's version of the Russian oligarchs, who might seek to extend their power and influence to the political arena. As President Xi Jinping consolidates control over state and party to ensure a long innings in power, it possibly is not enough to keep party insiders under control. The increasingly powerful billionaires in the business world need to be reined in and the accumulation of excess wealth that gives them power curbed. Moves against a range of tech giants such as the Ant Group and Didi Chuxing suggest that this is high on Xi's agenda. It also could be one motivation for new policies in the property sector.

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