ARGUMENT

An expert's point of view on a current event.

China's Property Sector Has Bigger Problems Than Evergrande

Chinese economic troubles may come far faster than the markets expect.

By **Logan Wright**, director of China markets research at Rhodium Group.

SEPTEMBER 29, 2021, 12:17 PM

The late Massachusetts Institute of Technology professor Rudi Dornbusch famously remarked, "The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought." Last week's market panic over China's property market and its largest and most indebted developer, Evergrande, was a case in point. Informed China observers have been concerned about the imbalances in China's property market, often described as one of the largest financial bubbles in history, for over a decade. But it was just last week that markets suddenly and collectively decided that China's property sector now posed a meaningful risk to the global recovery—and to China's long-term growth prospects.

The story of how China's property market reached this point is an illustration of both Beijing's power over market forces and its limitations. The property market kept expanding because investors and developers generally thought that it was far too important for Beijing, which depended on it to maintain rapid rates of economic growth and households' net worth, so any downturn would be short-lived. The government, after all, had stepped in to prop up faltering financial markets and enterprises before out of fear of social or economic disaster, such as its response to the stock market meltdown of 2015 and the massive monetary and fiscal stimulus in 2008-2009.

But as Beijing struggled to contain the speculative fervor and rapidly rising prices that resulted from the property bubble, Chinese authorities eventually turned to harsher and blunter measures that are now creating punishing economic costs. And after a summer of aggressive regulatory actions against several dynamic private sector firms, financial markets are grappling with the question of how far Beijing will go.

China's property market is fundamentally imbalanced: too much housing, too little demand among owner-occupiers, and not enough people moving to the places where housing is oversupplied. China's urbanization rates and household formation rates arguably peaked around the time that the working-age population began declining, between 2013 and 2015. But the rate of new residential building projects just kept rising, and construction kept powering the economy. Such projects hit a new high only in 2019, with developers initiating construction of around 18 million to 19 million units, and the COVID-19 pandemic only slowed new construction marginally in 2020.

But there are not enough young people likely to buy those apartments in the future. The Rhodium Group, where I direct China markets research, estimates future urban household formation rates at around 5 million to 7 million per year over the next decade, compared to around 9 million to 10 million a decade ago, and declining over time. Urbanization rates are slowing, and annual marriages in China have already declined by 40% from their peak in 2013, according to China's Ministry of Civil Affairs. Household formation projections are difficult, and we may be wrong by 1 million to 2 million per year. But there are still far fewer people likely to need new houses and far too many homes being built, mostly at prices that exclude many buyers in a country where incomes only just edged above the global average.

The gap between construction and demand among owner-occupiers has been filled by two types of buyers over the past decade: investment-driven or speculative demand, with buyers believing that prices will continue to rise, and demand from existing homeowners who want to upgrade, sometimes encouraged by forced government relocations.

Both are now under pressure. Speculators and investors are being blocked by government policies in cities where they want to buy, and some are increasingly concerned that developers will be unable to complete the units they are promising to build. Relocations are now far more expensive for local governments, given high housing prices. Homeowners who want to upgrade are also constrained by the availability of new credit. China's households have added $6.4 trillion in borrowing just since 2015, according to China's central bank, comparable to the increase in debt in the United States from 2003 to 2008. On a national level, it will be difficult to continue this pace of borrowing to buy houses, and the central bank has already warned that households do not have the capacity to do so.

Real estate is typically a debt-funded industry. Since 2008, China has seen the largest credit expansion in a single country for at least a century. From 2008 to today, China's banks have collectively quintupled in size and added over $41 trillion in assets, equivalent to around half of global economic output. Data from the central bank shows that at least 27 percent of bank lending likely goes to the property sector in China, and a significant proportion of nonbank lending from trust companies and other asset management companies goes to developers as well. But credit growth has slowed substantially in China since a concerted effort to reduce systemic financial risk commenced in 2017. It was reasonable to expect that the property sector would be hard-hit by the slowdown in credit.

But developers found another trick to extend their business model. To replace the lost source of financing from banks and nonbank lenders, they increased their reliance on pre-construction sales. This essentially meant that homebuyers themselves provided an alternative source of financing for construction. But it also exacerbated the imbalances in the housing market—you have to start building new units to try to sell them in advance.

The reliance on presales largely explains how the property market escaped the worst of Beijing's debt reduction campaign and why property kept powering the economy from 2017 to 2019. But it also meant that developers were increasingly dependent on people buying their houses far in advance of actual construction, betting that prices would continue to rise. The overall market became far more speculative as a result. And Beijing now had another reason to worry about the property market's excesses: if developers suddenly failed, people who bought their houses in advance might not see them completed.

As a result of these fundamental imbalances, it was not going to take very much to tip the property market over, nor for construction and prices to decline. Beijing itself knocked over the first domino. Late in 2020, despite the impact of the pandemic, new regulations on developers' financing were imposed based on three key financial ratios, labeled the "three red lines." Rather than targeting lenders to developers, Beijing was now targeting borrowers themselves and limiting their debt growth directly. Deprived of a key source of financing, developers now were forced to obtain even larger shares of revenues from pre-construction apartment sales. They started discounting aggressively to maintain market share, and they scaled back plans for new construction and new land purchases from local governments.

Evergrande is getting all the attention right now, but it is only part of a broader downshift taking place across China's property sector. Sales are falling nationally, by 8 percent in July, 16 percent in August, and around 33 percent (in 30 large cities) through Sept. 25. The months of September and October are known as Golden September and Silver October to China's developers, as they are the peak sales season of the year. If they make their targets, developers can decide how to manage inventory for the rest of the year and maybe even boost prices. If they miss those targets, developers will start to panic, discounting apartments, conserving cash, and cutting back on future construction. Evergrande is exceptional because its $305 billion in liabilities are around the size of the GDP of Greece, but it is not exceptional in its financing methods. Many other developers, particularly those that were more aggressive in expansion during the period from 2017 to 2019, have already defaulted on their debt or are at risk of doing so.

As a result, this is not a familiar economic story of a speculative asset bubble suddenly bursting when prices could no longer sustain gains. That stage hasn't come yet, though it may soon. Housing prices are difficult to monitor in China given data availability, but most indicators show only marginal declines in prices so far, particularly in major cities. Sales are shrinking, but prices aren't. Instead, Beijing's pressure on developers is causing it to discount new properties available for sale and to slow future construction. The greater impact is likely to be seen in weaker economic growth, rather than a sharp decline in property prices, although that is also possible. Transaction volumes will fall, but pricing signals may remain unclear for a while, particularly in secondary markets.

Beijing has clearly indicated its intention to reduce the Chinese economy's reliance on the property sector, as evidenced by the frequent official repetition of Chinese President Xi Jinping's words that "houses are for living, not for speculation." But financial markets are now taking Beijing's threat to the housing market far more seriously because of the events of the past summer impacting Alibaba, Tencent, Didi Chuxing, and the most prominent firms in the education and tutoring industry. Beijing has been very active in regulating some of the most dynamic private sector firms in China's economy, and it is taking sweeping actions toward entire industries, such as ride-hailing apps and video games.

How Beijing chooses to resolve the Evergrande debt crisis will be a sign of its intentions toward the rest of the property market. It is widely assumed that Beijing's priorities will be the homeowners, contractors, and suppliers, rather than Evergrande's shareholders and bond investors. Media reports have already claimed that local governments are preparing to take over some Evergrande projects to ensure that construction is completed. But imposing all of the losses on financial investors would only exacerbate the credit crunch facing the rest of the property sector and would contribute to many more defaults and bankruptcies. Failing to act altogether is not really an option either, as a disorderly default from Evergrande or other developers would lead to hundreds of thousands of angry homeowners and suppliers.

But given that Beijing's actions to reduce the property sector's impact on the economy started this process, it seems highly improbable that China's leadership will suddenly reverse course entirely. If developers are still facing controls on their financing channels, they will be unable to operate as they have in the past. But the fundamental imbalances in China's property market point to far weaker new construction activity ahead over the next two to three years and possibly beyond. And the fact that financial markets are taking Beijing's messaging toward the property sector more seriously means, as Dornbusch warned, that a much weaker Chinese economy may become reality far sooner than most observers expect.

Logan Wright is director of China markets research at Rhodium Group and a non-resident adjunct fellow at the Trustee Chair of Chinese Business and Economics at the Center for Strategic and International Studies.

TAGS: CHINA, ECONOMICS