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What Evergrande signals about China's economic future

Under Xi Jinping's new economic agenda 'common prosperity', China is cracking down on indebted real estate developers like Evergrande

China's Evergrande has long been an icon. It is not only a real estate developer, but a conglomerate that has embarked in many different ventures, including the production of electric vehicles.

Unfortunately, reaching such a huge size has come at the prize of huge leverage. Leverage is the use of debt in order to undertake an investment or project. At the same time, leverage will also multiply the potential downside risk in case the investment does not pan out. Evergrande was 'highly leveraged,' meaning that it has more debt than equity.

This did not seem to worry anybody until mid-2017 when President Xi created a high-level commission to deleverage Chinese corporates. The reality is, however, that corporate leverage continued unabated until the Covid-19 pandemic hit the economy, including in the real estate sector and, of course, Evergrande.

The Chinese real estate sector

The Chinese real estate sector has long been too big and too risky. This is not coincidental. It was central in the Chinese leadership's plan to reflate the economy from the global financial crisis in 2008. Increasing the supply of housing, as well as commercial real estate, were easy ways to earn money as the local governments were keen to see employment creation and growth.

Common prosperity is Xi Jinping's new economic mantra to highlight the importance of better

As a result, the Chinese economy clearly overheated by 2010 because of, in good part, the construction boom. This led regulators to limit banks' lending to the already over-leveraged real estate sector. Developers *income distribution and more equal opportunities.*

found other ways to solve the funding constraints, by pushing pre-sales aggressively as well as embarking in large bond issuance. As the domestic bond market required regulatory greenlight, many moved offshore to the USD bond market.

The demand for housing in China was secured in as far as it has become the most important asset for investors to place their savings in the light of the still draconian controls to capital outflows. Investment in housing has been an El Dorado for Chinese households as prices have been on the rise nearly continuously until recently.

Common prosperity

In 2021, housing prices suddenly decelerated. This has several reasons.

First and foremost, the sudden regulatory push to control the overstretched balance-sheets of real estate developers has resulted in the restructuring of some large real estate companies, such as China Fortune Land – even before Evergrande got into trouble. In other words, Chinese households – even if flooded by a still rosy picture of the real estate sector and the Chinese economy in the local media – are increasingly wary about investing in real estate.

The second reason is that the tighter controls do not only affect developers but also buyers of real estate who need to deal with huge down payments as well as the fear of a nation-wide property tax, which has been rumored for quite some time.

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Finally, Chinese households are feeling the brunt of an economy that has been decelerating rapidly for the last few years, pushed by its own overcapacity but also the US-led trade and tech war as well as, more recently, the pandemic. In fact, the Chinese government's crackdown on the real estate sector, through the introduction of the so-called 'three red lines' to limit their leverage, dependance on pre-sales and short-term funding, comes in the context of China's rapidly changing long-term economic goal from growth to common prosperity.

Common prosperity is Xi Jinping's new economic mantra to highlight the importance of better income distribution and more equal opportunities. Excessively high – and growing – housing prices are probably the most important source of income inequality in China. Access to housing – or the lack thereof – is a key factor in explaining income disparity.

China's crackdown

In this context, Evergrande was a prime target of the government's crackdown for a number of reasons.

First, it is simply the largest real estate developer.

Secondly, it is the most leveraged developer and does not fulfill any of the aforementioned three red lines.

Thirdly, Evergrande is heavily exposed to foreign investors, whether through the Hong Kong stock exchange or bonds issued in Hong Kong's offshore market. The latter, which account to close to USD 20 billion, mostly denominated in USD, have mainly bought by foreign private banks and asset managers for their high net-worth clients.

It seems clear, after the lack of payment of a USD bond coupon last Thursday, that Evergrande's offshore debt will go through a restructuring. Based on the example of China Fortune Land, which is finishing its own restructuring, this might not necessarily entail a nominal haircut but an extension of the maturity and the reduction of the interest due. Foreign investors will probably be relieved if such restructuring is announced, since they now have no clarity as to the future of their investment in Evergrande.

In short, economic success is no longer the goal and financial excess will be penalised.

Still, most of Evergrande's debt (USD 300bn in total) is domestic and will need to be served, especially the equivalent of USD 200bn received by Evergrande in pre-sales from Chinese households. Close to 1.5 million Chinese households are waiting for Evergrande to finish their units. This will certainly happen because other real estate developers rely massively on pre-sales, so that if Evergrande were not to deliver on its promises, pre-sales of housing units would dry up in China pushing most real estate developers to the brink.
Moreover, common prosperity is really not about dumping the losses on

the households. As such, the Chinese government has already given clear signs that local governments will take care of the unfinished projects.

China's new economic policy

There are two main takeaways concerning the future of China's economy.

First, China's real estate sector is not bound to collapse from Evergrande's demise, as public money is going to be put to work to solve its systemic consequences within China. This does not mean, however, that everybody, especially not foreign investors, will be fully bailed out. Evergrande needs to serve as a warning signal of the cost of excessive leverage.

The second, and final, take away is that China's growth will suffer from all of this. Not only the real estate sector, which is a key contributor to China's investment, employment, and growth, is going to slow down after Evergrande's demise, but also investors in general will be increasingly wary of China's drastic change in priorities.

In short, economic success is no longer the goal and financial excess will be penalised. Contributing to common prosperity is now the key objective, even at the cost of disgruntled private investors and, thereby, a potential stagnation of the economy.

Alicia Herrero
Hong Kong

Alicia García Herrero is a Senior Fellow at European think-tank BRUEGEL. She is also the Chief Economist for Asia Pacific at Natixis and non-resident Research Fellow at Madrid-based political think tank Real Instituto Elcano.

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