

Chinese real estate developer on brink of collapse

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The impending collapse of a Chinese real estate developer with more than half a billion dollars in debt has heightened fears about the stability of the country's property market. There is concern that the company's demise could be the start of a major financial crisis.

Government officials told Reuters on Tuesday that the Zhejiang Xingrun Real Estate Company, based in the coastal city of Ningbo, could not repay a total of 3.5 billion yuan (\$566 million) to domestic banks and individual investors. The company is holding talks with China's central bank and one of its largest state lenders to try to resolve the crisis through a bailout.

Opinion is divided on the fallout from the collapse, with some market commentators claiming the effects will not be large. They argue that the company's position was exceptional because its chairman and his son were arrested in November and January on charges of "illegal fundraising."

Others maintain that the collapse, less than two weeks after the solar panels maker, Solar Chaori, defaulted on loan interest repayments, points to growing problems in real estate investment, and financial markets more generally.

Premier Li Keqiang admitted last week that "isolated cases of default may be unavoidable." Any financial crisis is likely to be very difficult to contain, however. Over the past five years credit growth has increased by an average of 20 percent per year in China, more than double the rate of economic growth over the same period.

Credit has grown by \$14 trillion over that period—an amount equivalent to the size of the US banking system. Fitch Ratings estimated that the ratio of debt to gross domestic product (GDP) will be 270 percent by 2017, with interest payments equivalent to 20 percent of GDP by that time.

Commenting on the Xingrun default, Credit Agricole senior economist and strategist Dariusz Kowalczyk told CNBC: "As demand slows, more and more developers will feel financial strain. I'm concerned the default will trigger a string of similar distressed situations across weaker companies in the property sector."

Zhiwei Zhang, the chief China economist at the major Japanese financial corporation Nomura, said: "This news supports our view that property sector over-investment is currently China's top risk. As far as we know, this is the largest property developer in recent years that is at the risk of bankruptcy."

According to Nomura, the problems for property development companies could start in so-called third- and fourth-tier cities. These companies face more serious financing and oversupply problems than those in the large cities, such as Shanghai and Beijing, where the real estate markets still appear to be booming.

Nevertheless, collapses in the less prominent markets will have a significant impact. Last year, third- and fourth-tier cities accounted for two-thirds of all housing under construction in China.

"This risk does not seem to be fully recognised in the market partly because data are not readily available for these cities, and some investors may be misled by the boom in first-tier cities," Zhang said.

A collapse in the property market will have a major impact on the economy as a whole. According to Nomura's calculations, it accounted for 16 percent of China's GDP, 33 percent of fixed asset investment and 26 percent of new loans in 2013.

While any financial crisis is expected to strike first at less well-known companies, it could soon extend, because many Chinese debt contracts are guaranteed by third parties.

Minxin Pei, professor of government at Claremont College in southern California, noted in the *Financial Times* on Monday: “If one borrower is unable to make good on its promises, the event could trigger a series of future failures, as entities that have stood behind the defaulting borrower are themselves unable to fulfill their obligations. Systemic risks could be bigger than the Chinese authorities assume, and may reside in unexpected corners of the financial system.”

The property market is not the only cause for concern. Overcapacity is emerging throughout China’s industrial sectors, especially steel, where Haixin Steel has already defaulted on loan repayments and is looking for a bailout.

If the yuan (renminbi) continues to fall, as it has in past months, and reaches a level of 6.20 to the dollar, major losses on hedging products may result. The danger arises from “targeted redemption forwards” (TRFs)—complex products anticipating a rise in the value of the Chinese currency.

Making money that way seemed certain when funds moved out of other “emerging markets” into China on the basis that the yuan would continue to rise. However, a decline in China’s exports and slower economic growth, coupled with a decision of the central bank to widen the daily trading band of the currency from 1 percent to 2 percent, means that the fund movements could reverse.

Morgan Stanley estimates that the potential losses to TRF holders could total \$200 million a month for every 0.1 fall in the Yuan’s value beyond the 6.20 level. This would amount to \$5 billion if the low rate were sustained over the 24-month period of a TRF contract.

Such is the interconnectedness of financial markets that major turbulence in Chinese markets will feed into the global financial system. It is increasingly clear that the financial markets boom, which has poured billions of dollars into the hands of the ultra-wealthy around the world as a result of the “quantitative easing” program of the US Federal Reserve and other central banks, cannot go on indefinitely.

Writing in the *Financial Times* last week, Miles Johnson cited a letter by Seth Karman, the manager of a \$27 billion hedge fund, to his clients, saying investors may wake up to find they were living in a “Truman Show market”. (In the late 1990s movie *The Truman Show*, the central character gradually discovers that his

pleasant world of suburbia is in fact the film set for a “reality” television show.)

“All the Trumans—the economists, fund managers, traders, market pundits—know at some level the environment in which they operate is not what it seems on the surface,” Klarman wrote. “But the zeitgeist is so damn pleasant, the days so resplendent, the mood so euphoric, the returns so irresistible, that no one wants it to end.”

Earlier this week, announcing a shake-up in the structure of the Bank of England (BoE), newly-appointed governor Mark Carney warned that risks were developing in housing markets and the international financial system. Low interest rates had “contributed to the gradual build-up of financial vulnerabilities in the past,” he said. “It doesn’t take a genius to see that similar risks exist today.”

Carney insisted that the BoE would keep rates low for a long time, but said this policy was creating “a tremendous burden on microprudential and macroprudential management” to maintain financial stability.

In other words, the central bank has to intervene directly, not only to oversee individual financial institutions, but also at the “macroprudential” level of the financial system as a whole, to try to prevent a crisis arising out of its very low-interest rate regime. The events in China over the past weeks could well signal the start of such an unraveling.



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