Major Chinese property developer on the brink of default

Nick Beams
9 September 2021

The Chinese bond market and its financial system more broadly are coming under increasing pressure because of the crisis at Evergrande, one of the country's largest property developers, with potential flow-on effects for international markets.

The company, which has more than $300 billion in debts, came under scrutiny in August when the government ordered it to take action to resolve its debt problems.

The company said that with the "coordination and support of the government" it was working with suppliers and construction companies to resume work on its property developments. It has 778 projects across 233 cities in China.

In its earnings report, issued at the end of last month, it reported a fall in net profits for the year and warned that if work did not resume there was a risk of "impairment" on the projects and problems for its liquidity.

Since then, the situation has gone from bad to worse. The company is engaged in a desperate scramble to sell off assets and raise cash while warning it faces the risk of default on bonds that are about to fall due.

In its report on the crisis the *Financial Times* warned that a default, exposing the perilous state of China's property market, would be a "debacle that could cascade across global markets."

This week shares in the company fell below their 2009 initial public offering, following downgrades by the major credit rating agencies and warnings of a debt default. Shares in the company have dropped by 76 percent this year and the price of many of its bonds has fallen to around 30 cents on the dollar.

Fitch Ratings has again cut the rating on Evergrande bonds to CC, warning of a default.

"The downgrade reflects our view that a default of some kind appears probable," the Fitch statement said. "We believe credit risk is high given tight liquidity, declining contracted sales, pressure to address payments to suppliers and contractors, and limited progress on asset disposals."

The day before the Fitch move, Moody's cut Evergrande's credit rating by three notches, its third downgrade of the property giant since June. It said its current rating implied that Evergrande was "likely in or very near default."

The property developer, one of China's biggest borrowers on international markets, has been one of the most prominent of the giant real estate firms that have emerged in the past two decades. It was founded in 1996 by Hui Ka Yan, who built a financial empire on massive borrowing and land acquisitions, with support from high officials in the government, and at one point became the richest man in the country.

But it has been heavily affected by moves initiated by Beijing to rein in speculation, particularly in real estate and property development, because of the dangers it poses to the financial system as a whole.

Financial authorities imposed new regulations, known as the three red lines, that determined whether companies could take on additional debt, with stipulations covering cash reserves, equity and assets.

Evergrande is not the only property developer experiencing major problems. This week the bonds of Guangzhou R&F Properties fell by more than 20 percent in a single day and are now trading at 60 percent of their face value. The plunge came after Moody's downgraded its credit rating and warned about the company's ability to refinance itself.

Fantasia, another property developer, is also in financial difficulty and told the Hong Kong stock exchange earlier this week it had made purchases of $6

© World Socialist Web Site

million of its own bonds.

The impact of the new regulations is widespread. According to a report in Bloomberg, Morgan Stanley has calculated that property firms defaulted on $6.2 billion worth of risky debt in the year to mid-August, about $1.3 billion more than the previous 12 years combined.

Economists at the Japanese financial giant, Nomura, have warned that the restrictions on property developers are going too far and are "unnecessarily aggressive." They have even called it a "Volcker moment"—a reference to the high-interest rate regime introduced at the beginning of the 1980s by Fed chair Paul Volker that devastated the US economy and led to the highest unemployment rates since the 1930s.

The implications of the crackdown on property development borrowing for the Chinese economy were pointed to in an article by *Wall Street Journal* writer Jacky Wong published earlier this week.

Characterising property development as "arguably the most crucial industry in China," he noted that when related businesses like construction material and housing appliances are included, "the sector accounted for 16.4 percent of China's economy last year, according to Nomura."

The tightening of restrictions by the Xi Jinping regime is being conducted under the banner "housing is for living, not for speculation." This is part of efforts by the regime to be seen to be tackling the rise of inequality in China. But having promoted the very speculation that it is now seeking to curb the government is caught in a trap of its own making.

Its efforts to reduce speculation threaten to stifle one of key engines of Chinese economic growth over the past period. Developers are reported to have sold 21 percent fewer homes in August compared to a year before. The extent of the housing boom is reflected in the rise of household borrowing which is now 62 percent of gross domestic product compared to 44 percent just five years ago.

The problem for the government, as Wong's article noted, is that "property is already so entwined with China's economy that a sudden stop could be extremely dangerous" and if the regulatory "on" button were pressed for too long this could have "very serious consequences for financial stability and growth."

Similar views are being voiced elsewhere. A note by two Bank of America economists on Tuesday warned that a rapid slowdown in the property market could have "significant spillover effects. While the motivation such credit tightening was to stabilise leverage and rebalance the economy, the risk is rising for growth instability amid fast deleveraging."

A comment by *Australian Financial Review* columnist Karen Maley drew attention to the international ramifications of the Evergrande crisis. Foreign investors were becoming "fretful" that Beijing was preparing to separate out Evergrande's real estate arm from any rescue operation, leaving the holding company, in which they are heavily invested, with the debt. This would mean they would incur substantial losses.

Consequently, they are "stampeding towards the exits" and seeking to sell off their bonds. As she noted, the problem for Beijing is that "while it may be able to limit the damage that an Evergrande default inflicts on the local economy, it is powerless to limit the impact of the country's $12 trillion bond market."

To contact the WSWS and the Socialist Equality Party visit:

wsws.org/contact

© World Socialist Web Site