China’s Evergrande problems deepen

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The financial troubles surrounding the Chinese property developer Evergrande continue to worsen as discussion in financial circles focuses on what measures might be taken by the government to prevent a possible financial crisis.

Evergrande, the country’s second largest property developer, with debts of more than $300 billion, has admitted it is on the brink of default and is desperately scrambling to build up cash.

But its efforts do not appear to be succeeding. On Thursday S&P Global Ratings, which has downgraded its rating of the company’s bonds several times over the past three months, announced another downgrade, saying its liquidity and funding access “are shrinking severely.”

Earlier this week, Bloomberg reported that Chinese authorities had told major lenders the company would not be able to meet interest payments on loans due on Monday following a decision by Evergrande to hire debt restructuring advisers.

So far, the government is keeping the details of any possible response close to its chest. Responding to a question on what impact Evergrande could have on the economy at a press conference on Wednesday, National Bureau of Statistics spokesman Fu Linghui said only that some large property enterprises were running into difficulties and the fallout “remains to be seen.”

The press conference was held on the latest national data which showed a worsening slowdown in the Chinese economy in August. Retail sales rose by only 2.5 percent for the month, well below forecasts by economists of a 7 percent rise. Industrial production, one of the main drivers of the economy, increased by 5.3 percent compared to the median forecasts by economists of an increase of 5.8 percent.

The slowdown is expected to continue. Goldman Sachs, which last month downgraded its forecast for growth in the Chinese economy from 5.8 percent to 2.3 percent for the third quarter, has cited a “meaningful slowdown” in industrial indicators such as electricity production and ferrous metal smelting.

So far, the problems surrounding Evergrande have not been transmitted into the banking and financial system. Interbank lending rates remain near average levels, indicating that there is sufficient liquidity. But the Japanese firm Mizuho Financial Group has reported that some banks are hoarding cash preparing for what it called a “liquidity squeeze in crisis mode.”

And there are some signs of broader financial stress. On Thursday, yields on Chinese junk bonds—those with a rating below investment-grade status—climbed to an 18-month high and shares in real estate companies fell sharply after Evergrande had had its rating lowered further and requested a trading halt in its bonds.

All eyes are turning to the response of the government. Bloomberg reported that “even senior officials at state-owned banks say privately that they’re still waiting for guidance on a long-term solution from top leaders in Beijing.”

The Chinese government is facing an acute dilemma. On the one hand, it wants to rein in debt in the highly leveraged property sector as well as other areas of the economy. Some of the problems facing Evergrande arise from the tightening of credit regulations earlier this year. Back in July, vice premier Han Zheng said the property industry should not be used to provide a short-term boost to the economy.

On the other hand, it is fearful of the consequences of a collapse of Evergrande on the property development sector and for the rest of the economy. There are various estimates for its significance, but Bank of America has calculated it makes up around 28 percent of the Chinese economy when both direct and indirect economic effects are considered.

Summing up the problems facing the government, in comments during a recent podcast, Yu Yong, a former

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regulator with the China Banking and Insurance Regulatory Commission, said: “The government has to be very, very careful in balancing support for Evergrande. Property is the biggest bubble that everyone has been talking about in China. So, if anything happens, this could clearly cause a systemic risk to the whole China economy.”

In a warning of the impact of a default by Evergrande in a note issued on Wednesday, Fitch Ratings said smaller banks and weaker property developers would be hurt the most.

But there are fears the damage would not stop there and extend across the entire property sector. As one financial analyst told Bloomberg: “Debt recovery efforts by creditors would lead to fire sales of assets and hit housing prices. Profit margins across the supply chain would be squeezed. It would also lead to panic selling in capital markets.”

On top of the financial ramifications of an Evergrande collapse, the government also must deal with social struggles that could erupt. Already there have been protests at Evergrande offices around the country.

Its modus operandi is to sell apartments off the plan or at least well before completion. This means that owners are confronting a situation where they will have paid out their money, only to be left with an incomplete dwelling. As of last December, Evergrande is reported to have received at least down payments on yet-to-be-finished properties from more than 1.5 million buyers.

Another key issue facing the government is how to prevent the effects of an Evergrande collapse from spreading both within China and internationally.

In 2015, the collapse of a share market bubble, which like the property boom had been promoted by the government, sent ripples through the global financial system. Since then, as a result of the massive speculation of the past 18 months, it has become more fragile and an Evergrande collapse could have major international consequences.

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