

Continuing problems for China's real estate sector

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The problems of the Chinese property market, highlighted by the default of Evergrande the country's second largest real estate developer and its most indebted, continue to grow, setting in motion what a comment in the *Financial Times* (FT) characterised as a "slow motion financial crisis."

Last Thursday, the Shanghai Stock Exchange suspended trading in three renminbi-denominated bonds of the real estate developer Shimao after it had failed to make a payment. The suspension was significant because up until recently it had enjoyed an investment-grade rating.

In its report on the suspension, the FT said Shimao's problems suggested that "China's real estate woes, which have mainly affected companies with riskier credit ratings such as Evergrande and Kaisa Group, could spread to more highly rated developers as they grapple with a slump in housing sales and a loss of investor confidence."

Unlike Evergrande, whose affairs are now under the control of a government appointed risk committee, Shimao had not breached any of the "three red lines" on credit and borrowings imposed by financial authorities in August 2020 in order to bring down inflated debt levels in the real estate sector.

But the company has been heavily impacted by the general decline in the property market. Based in Shanghai, it experienced a fall of 10 percent for its sales in 2021, with sales for the month of December recording a 68 percent decline.

Last month, the international rating agency Fitch said Shimao faced "diminished investor confidence" that could affect its capacity to refinance and, unlike other property developers that had resumed issuing debt securities, that avenue may not be available to it.

While the immediate problems surrounding

Evergrande appear to have been contained, at least for the present, the effects of the decline in the real estate sector are rippling through the broader economy.

The Chinese property sector is estimated to account for about 30 percent of the country's economic output once flow-on effects are taken into account. Local governments, which are responsible for much of the country's infrastructure development, are heavily affected because it has been calculated that around one-third of the money needed for such projects comes from land sales.

They now face added problems because the central government has insisted they are responsible for completing pre-paid housing projects if developers are unable to do so under conditions where their revenues are falling.

The problems facing local governments were highlighted by the comments to the FT by an unnamed municipal official in Shijiazhuang, the capital of the Hebei province, who said the real estate downturn had taken a "huge toll" on the local economy.

"Beijing says we need to keep the government up and running. But if land sales continue to weaken, we will have real trouble making ends meet," the official said. Land sales in the city are down almost 30 percent compared to the same period last year.

Long-time China analyst Eswar Prasad has pointed to the mounting problems for the central government as its tries to move away from dependence on real estate development.

In comments reported by the FT, he said: "Beijing is discovering the huge costs in rectifying the imbalances in a sector that it had long relied upon to prop up growth, boost local government revenues and contribute to household wealth accumulation.

"The sector's influence over practically every aspect

of the economy, financial markets and society make in a hugely thorny issue to fix.”

Apart from the immediate fallout from the failure of real estate firms to meet their debts, there is the potential for a financial crisis arising from the practice of companies issuing commercial paper—short-term debt obligations—to get around “red line” restrictions.

The larger companies force smaller sub-contractors and suppliers to accept commercial paper in lieu of cash payments. These companies then use the commercial paper to finance their own transactions, setting up the conditions for a chain reaction if the major firm fails to make good on its cash obligations.

According to the Shanghai Commercial Paper Exchange, China’s 20 largest real estate firms issued 40 percent more commercial paper in 2020 than they did in 2019.

The FT cited an unnamed government policy adviser who said despite reassurances about the state of the economy there was growing nervousness in official circles.

“They appear more relaxed than they really are. In private, they are asking about the housing downturn, high debt levels and slower growth. The major problems are all interconnected: debt, local government finances and consumption. Which one do you solve first? The pressure is coming from many directions.”

The problems for the economy as a whole are indicated by the latest gross domestic product (GDP) data. In the third quarter China’s economy expanded 4.9 percent year-on-year, compared to 7.9 percent in the second. And the rate of growth is slowing. On a quarter-by-quarter basis the economy expanded by only 0.2 percent compared to the previous three months.

For many years, the central government maintained that a growth rate of around 8 percent was necessary to maintain “social stability.” Those days have now long gone, and it appears that, in the words of one financial analyst, a growth rate of 6 or 7 percent has also “gone forever” as the government struggles to maintain a 5 percent target.

The present trend will continue over the longer term. According to an analysis by Houze Song of the Paulson Institute, even without the Evergrande crisis the property sector was bound to contract and Evergrande “simply made the writing on the wall clearer.”

“Our baseline scenario assumes a 30 percent decline

in private property construction through 2025. In total construction volume terms, that means a correction from 100 million units to roughly 70 million units. Such a correction will lead to annual property sales falling from 15 percent to 10 percent of GDP, which is basically the same as in 2010. In other words, China intends to roll back the decade of rapid property sector growth in the next five years.”

As a result, it is expected that local government spending on infrastructure, which is largely dependent on revenue from land sales, will decline by 3 percent of GDP over the same period which, combined with the fall in property development, will lead to an overall decline in construction investment of 6 percent of GDP.

Song noted that over the years China’s property sector had been subject to the “boy who cried wolf syndrome” but this time the wolf has finally arrived, citing recent remarks by Guo Shuqing, the chairman of the China Banking and Insurance Regulatory Commission, that property was the greatest danger to the country’s financial system.



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