

A sharp turn in China property market turmoil

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The ongoing and interlinked property development and financial crisis in China has taken a new turn with the announcement by the failed Evergrande conglomerate that one of its subsidiaries has failed to make a payment on an offshore bond.

Evergrande, one of China's largest real estate and property developers, defaulted on debts in 2021. It has been the subject of a restructuring operation aimed at trying to prevent its liquidation because that would set off turbulence through the financial system with unknown consequences.

On Monday it was announced that Hengda Real Estate, one of Evergrande's subsidiaries, had defaulted on a 4-billion-yuan (\$547 million) repayment due in principal and interest on a bond issued in 2020.

In March it had missed an interest payment on the loan and said it would "actively" seek to negotiate with bondholders, but the latest development indicates that no solution has been found.

In its report on the default, Bloomberg, which closely follows Chinese real estate developments, said: "Evergrande is running out of time to get what would be one of the nation's biggest-ever restructurings back on track after setbacks in recent days have raised the risk of a potential liquidation."

Evergrande is trying to reach an agreement with creditors and with regulators so that it can issue new bonds to restructure around \$30 billion in offshore debt. Creditors would receive new securities in place of the ones that are failing.

The issuing of "new notes" by Evergrande is essential because without it the restructuring process cannot go ahead. Troubles first surfaced on Sunday evening when Evergrande said it could not issue "new notes" because Hengda was being investigated by the China Securities Regulatory Commission.

This brought an incredulous response from one of the people close to the negotiations, cited by the *Financial Times*.

They asked: "How can a process that has run for two years ... [with] a whole army of offshore and onshore advisers ... suddenly be derailed at the eleventh hour?"

As the Bloomberg report noted, the clock is ticking on the Evergrande restructuring because on October 30 the company faces a court hearing in Hong Kong on a winding up petition that could force it into liquidation.

Last week, Evergrande cancelled meetings with key creditors, saying it had to reassess the proposed restructuring. Its sales had also "not been as expected."

According to Jonathan Leitch, a Hong Kong lawyer specialising in debt restructuring, cited by Bloomberg: "A huge amount of work has gone into the planning and formulation of Evergrande's restructuring plans, but if the sales forecasts underpinning the turnaround now appear unachievable, it is better to revisit the deal terms before scheme meetings are held."

Creditors could expect a downward revision in terms and a further lengthening of repayment periods which would "create uncertainty" and "further test the patience of bondholders," Leitch said.

The restructuring of Evergrande, which revealed in July that it had incurred losses of \$81 billion over the two-year period of 2021-2022, is being closely watched because of implications for the debt restructuring of other property developers.

Chinese authorities have taken some measures to try to boost the property markets, including the reduction in some interest rates for home buyers, but nothing that can bring a sustained boost.

There was an immediate market response to the news of the Hengda default. A Bloomberg index of property developer shares fell by 7.1 percent on Monday taking

the total loss for the year to almost \$56 billion.

Evergrande shares dropped by 22 percent and shares in the China Aoyuan Group, in which trading resumed after an 18-month break, plunged by 72 percent.

There has been a stream of negative news including an announcement by Chinese regulators that they are launching an inquiry into Ping An Real Estate over a loan replacement. China Oceanwide also said it faced liquidation after a court in Bermuda issued a wind-up order.

While it managed to avoid a default on two dollar bonds earlier this month, the real estate developer Country Garden, the country's biggest and hitherto regarded as among the safest, is by no means out of the woods. It recorded a \$6.7 billion loss for the first six months of the year—its highest ever.

Having dodged a bullet, Country Garden is reported to be still trying to stave off a debt default.

The property market slump is feeding into the financial system, hitting so called shadow banks. One of these, Zhingrong, has missed debt repayments at least partly because investments it has made with property developers have gone sour.

The crisis in the property market has invited comparisons with the lead up to the 2008 financial crisis which started in the US mortgage market. Questions have been raised as to whether China might soon face a “Lehman moment”—a reference to the failure of the US investment bank which triggered the meltdown.

Such comparisons are, at least at this stage, premature. Most of the debt is held domestically and the government has mechanisms available through which it can intervene.

Nevertheless, there are serious problems. The real estate and property development sector has been a mainstay of the Chinese economy over the past decade and a half. When its connections to other industries are taken into account, it comprises about 25 percent of the Chinese economy.

Its crisis both contributes to, and is a product of, the slowing economy. The official target for economic growth this year is 5 percent—the lowest in three decades—and there are doubts among analysts it will even reach this level. The World Economic Forum, for example, predicts growth of only 2.7 percent this year and 2.9 percent in 2024.

And the debt mountain in the property sector is symptomatic of a much broader phenomenon.

It has been estimated that Local Government Financing Vehicles, the means through which local authorities fund infrastructure projects, have a total of \$10 trillion in debt. Overall Chinese debt is estimated to be 300 percent of GDP and comprises 15 percent of total global debt.

So, while there may not be the immediate prospect of a financial meltdown there is certainly the potential for major disturbances which will have a global impact.



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