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Could China Be Headed for a Lehman-Style Crisis? This Property Bust Is Different.

By Reshma Kapadia Follow Updated July 24, 2022 9:41 am ET / Original July 24, 2022 7:00 am ET

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The downturn in China's property market is unlikely to lead to a meltdown that triggers a financial crisis.
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China's property slump and suffering economy is leading some to wonder if China could be on the brink of its own Lehman-style crisis. While the troubles facing China's economy are substantial, it's unlikely to push China into the type of meltdown that sends the country's financial system into a tailspin.

The debt that has fueled China's property boom—and as a result its economic growth—has long been a source of concern for long-term investors. They aren't alone: Chinese policy makers had been trying to tackle the debt in its economy—a reason they were much more restrained in providing Covid-related stimulus in 2020 and the reason for the property crackdown that sparked the current slump.

But policy makers face a bind as boycotts on mortgage payments spread to roughly 300 unfinished projects in 90 cities. Authorities are trying to balance two contradictory goals: keeping a lid—or even lowering—the amount of debt in its property sector while also supporting property developers to finish projects and avert further social unrest, Pavilion Global strategists write in a note to clients. Property developers' debt is piling up rapidly, while net income falls.

Mortgage suspensions is a different feature than during past bumps in the housing market, and Eswar Prasad, former head of China for the International Monetary Fund and currently an economics professor at Cornell University, worries it could constrain developers of even viable projects that end up getting stalled because of the lack of financing. That could create further ripples in a market where housing prices are already slumping and economic uncertainty is high after Covid-related lockdowns led to anemic second quarter economic growth.

There is no denying the economic risk given that the property market is a major engine of growth. Defaults could rise as tighter liquidity stresses developers and some banks could also suffer, though Prasad notes that many are state-owned and the government can easily infuse liquidity, limiting the risk of a systemic financial crisis.

Plus, unlike the U.S. global financial crisis, the amount of leverage propping up speculative investments is much more limited and households' balance sheets and high savings rates act as a buffer, Prasad says. Down payment requirements are also so large that even a significant further decline in prices wouldn't put a lot of mortgages underwater, he adds.

"A Lehman moment may come some day, but I have come to appreciate how many policy levers they have," Prasad says. "We will see lots of stumbles and accidents because of unbalanced policy responses, but is there going to be a real Lehman moment where the financial system comes apart? I think not."

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The bigger concern is the hit to the economy. Economists are keeping close watch on how the troubles in the property market seep into consumer sentiment because real estate is a major source of Chinese wealth.

A survey by the People's Bank of China of urban depositors three years ago found roughly three times as many people expected prices to rise as expected prices to fall, but last month 16% expected prices to rise and 16% expected prices to fall. Though volatile, the survey offers a gauge of sentiment among urban Chinese—and it's clear there has been a major change among how they think about the property market, writes Michael Pettis, Peking University finance professor, in a recent note.

The troubles in the property market and economy more broadly could weigh on Chinese stocks. Domestic A-shares are trading at a premium to H-shares in Hong Kong, and leverage as measured by net debt to earnings ratios is two to three times higher in mainland China versus the U.S. or even emerging markets outside of China, according to Pavilion Global strategists. In a note to clients, they said the domestic A-shares market offers a better short than long opportunity for investors.

The iShares MSCI China A-shares exchange-traded fund (CNYA) is down 17% so far this year, a bit worse than the iShares MSCI China ETF (MCHI), which is down 15% year-to-date.

China's housing rout isn't like the one suffered in the U.S. during the global financial crisis, and Beijing has a vast toolbox to avoid a Lehman-like crisis, but that doesn't mean it won't be messy.

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