China's economy: the fallout from the Evergrande crisis

The crackdown on real estate ordered by Xi Jinping is putting growing pressure on local governments and many companies

Sun Yu in Shijiazhuang and **Tom Mitchell** in Singapore 9 HOURS AGO

Last month, China's State Council, the government's most powerful organ, unleashed its wrath on an unusually small target, accusing officials in a county of just 660,000 people of effectively extorting private sector businesses.

In a long and detailed statement issued on December 17, the State Council said the local government in Bazhou, situated just 90km south of Beijing in Hebei province, had seriously violated both government and Chinese Communist party orders by embarking on a fee-collection spree from small and medium-sized enterprises in order to offset its own declining land-sale and tax revenues.

Like many jurisdictions across the country, Bazhou had been hit hard by the party's year-long crackdown on highly leveraged real estate developers such as China Evergrande Group, a colossus that teetered for months before it finally defaulted on bond payments on December 6 and entered into a formal restructuring process.

According to China's cabinet, in October the Bazhou government ordered officials to drum up Rmb300m ($47m) in new revenues, mainly through the imposition of arbitrary fees and fines. Over the course of nine weeks more than 2,500 local businesses were hit with penalties totalling Rmb67m, compared with the just Rmb6m in penalties collected over the first nine months of the year.

"Every government department has a way to make up for lost revenues," says Martin Li, who runs a chemical factory in Bazhou and was forced by the local meteorological bureau to buy an expensive lightning rod from a government-designated supplier. The rod cost Rmb1,100, far more than comparable units he could have purchased online for just Rmb200.

In targeting entrepreneurs such as Li, the State Council said Bazhou had "seriously hurt the interest of small businesses, severely damaged the local business environment and undermined the credibility of the party and [central] government".

The local government in Bazhou has been hit hard by the Communist party's year-long crackdown on highly leveraged real estate developers © Quehure Costfoto/SIPA USA/PA Images

China's cabinet, however, said nothing about the central government policies that had caused the county's desperate scramble for revenues in the first place.

Over the past two years, President Xi Jinping's administration has launched a series of campaigns that target different areas of business — from the country's largest private-sector technology platforms in late 2020 to education providers and ride-hailing giant Didi last summer. And all that was before it became apparent in September that government-imposed debt limits might bring down Evergrande.

China's second-largest developer is now on the cusp of becoming the country's biggest ever bankruptcy case, and its downfall has sparked a broader crisis in the real estate sector. It has accumulated liabilities of about Rmb2tn, equivalent to 2 per cent of gross domestic product, which are owed to creditors ranging from individuals who bought high-yielding investment products from the group to the country's largest construction companies and banks.

The collective impact of all these crackdowns has been to pile unprecedented levels of pressure on some of the country's largest employers, local governments and corporate contributors to economic growth.

A Beijing housing complex built by Evergrande, which defaulted on bond payments on December 6 © Noel Celis/AFP via Getty Images

Outwardly, officials insist that all is going to plan. In April, the party's politburo said China's strong rebound from the pandemic had presented a "window of opportunity" to tackle critical structural challenges. They also note that the Chinese economy is on track to exceed the government's full-year growth target of more than 6 per cent. Xi's various crackdowns are justified by officials as necessary elements of a larger party campaign to eliminate financial risks that could implode if not addressed, eradicate chronic income inequality and realise "common prosperity".

Yet more and more warning indicators are blinking, from the financial stresses appearing in places such as Bazhou to key economic indicators. China's third-quarter economic output expanded 4.9 per cent year-on-year and just 0.2 per cent on a quarter-on-quarter basis, down from 7.9 per cent and 1.3 respectively in the second quarter.

This raises the question of whether, as Xi seeks an unprecedented third term as head of the party, military and government later this year, the economic consequences of his common prosperity campaign are beginning to spiral out of control.

China's growth is now below pre-pandemic levels

Year-on-year GDP growth, by quarter, with components of change (%)

Real GDP growth Consumption expenditure
Investment (gross capital formation) Net trade in goods & services

FINANCIAL TIMES

Source: Haver Analytics

"Beijing is discovering the huge costs of rectifying imbalances in a sector that it had long relied upon to prop up growth, boost local government revenues and contribute to household wealth accumulation," says Eswar Prasad, a former head of the IMF's China division now at Cornell University. "The [real estate] sector's influence over practically every aspect of the economy, financial markets and society makes it a hugely thorny issue to fix."

China's property sector is estimated to account for about 30 per cent of total economic output. In 2020 local governments raised Rmb8.4tn from land sales, accounting for about a third of their total revenues.

One Chinese government policy adviser said officials' public reassurances about the economy were belied by increasing nervousness behind closed doors.

“They appear more relaxed than they really are,” says the adviser. “In private, they are asking about the housing downturn, higher debt levels and slower growth.

“The major problems are all interconnected: debt, local government finances, housing prices and consumption. Which one do you solve first? The pressure is coming from many directions.”

So far Xi’s economic advisers, led by vice-premier Liu He, have been relatively restrained in their policy response to the real estate slump and the larger economic slowdown it has exacerbated. Last month the central bank cut its benchmark one-year loan prime rate for the first time since early 2020, but only by five basis points while leaving the five-year rate, used to price mortgages, unchanged.

The party’s year-end economic planning conference reiterated that the government would continue to refrain from “flood-like stimulus” and also continue its battles against “the disorderly expansion of capital” — party-speak for its various crackdowns on private-sector businesses — as well as speculation and high leverage in the real estate industry.

China's property sector is disproportionately large

Real estate related activities' share of GDP (%)

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Source: Rogoff & Yang: 'Peak China Housing' (NBER 2020)

That all promises little respite for regional and local officials who must bear the brunt of Xi's policy onslaught. In private, and occasionally in public, they argue that they are dealing with a crisis that was not of their own making and doing the best they can under increasingly difficult circumstances.

"The real estate downturn has taken a huge toll on the local economy," says a municipal official in Shijiazhuang, Hebei's provincial capital, who asked not to be identified. "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." Over the first 11 months of last year, Shijiazhuang's land sale revenues were down almost 30 per cent compared with the same period in 2020.

The official added that he and his civil servant colleagues, who generally make about Rmb5,000 a month, were paying a personal price. "For the first time ever we have cancelled our annual bonus of Rmb10,000," the official says. "It is a big deal for us. Our salaries are not high."

President Xi Jinping's economic advisers, led by vice-premier Liu He, left, have been restrained in their policy response to the real estate slump © Jason Lee/Pool/AFP via Getty Images

Assessing the damage

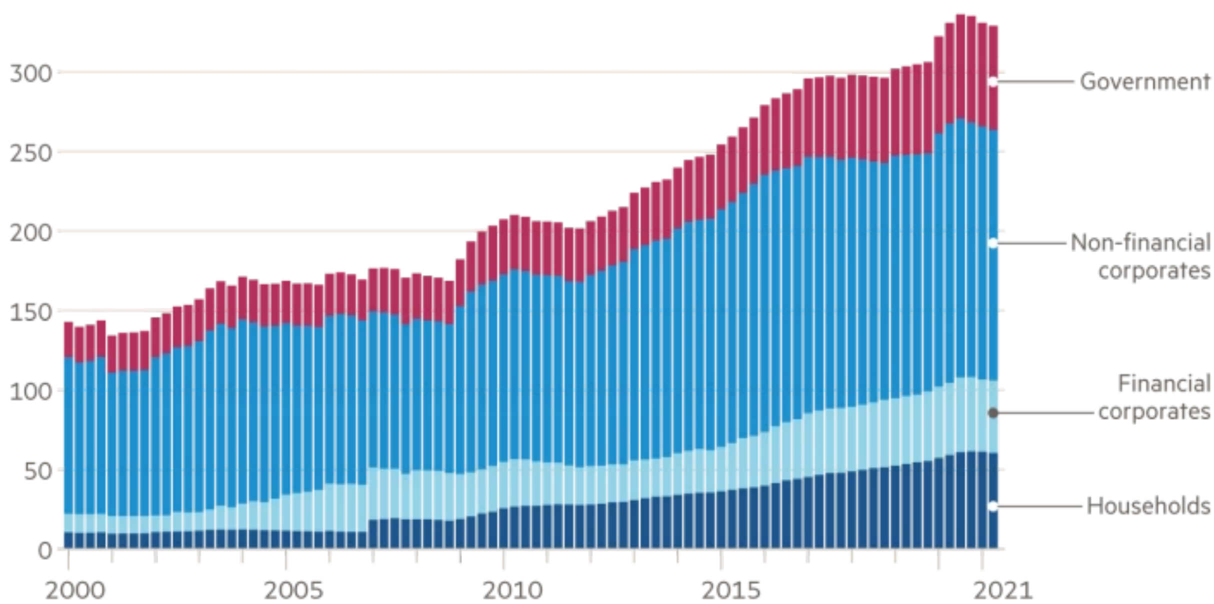
The impact from the Evergrande crisis is being felt across the country: the developer has almost 800 projects in more than 230 cities.

In Bazhou, the effects of Xi's crackdown on the property sector were being felt months before it became apparent in September that Evergrande's debt crisis might prove terminal.

Over the first six months of last year, the county's land sale revenues plunged 90 per cent compared with the same period in 2020. "The land market has been consistently weak," Meng Xianguo, director of Bazhou's finance bureau, said in a speech in mid-August. "Developers are taking a wait-and-see attitude and are reluctant to buy land. There have also been more land auction failures because of developers' funding shortages."

Debt levels remain a concern across all sectors

Chinese debt as a % of GDP, by sector

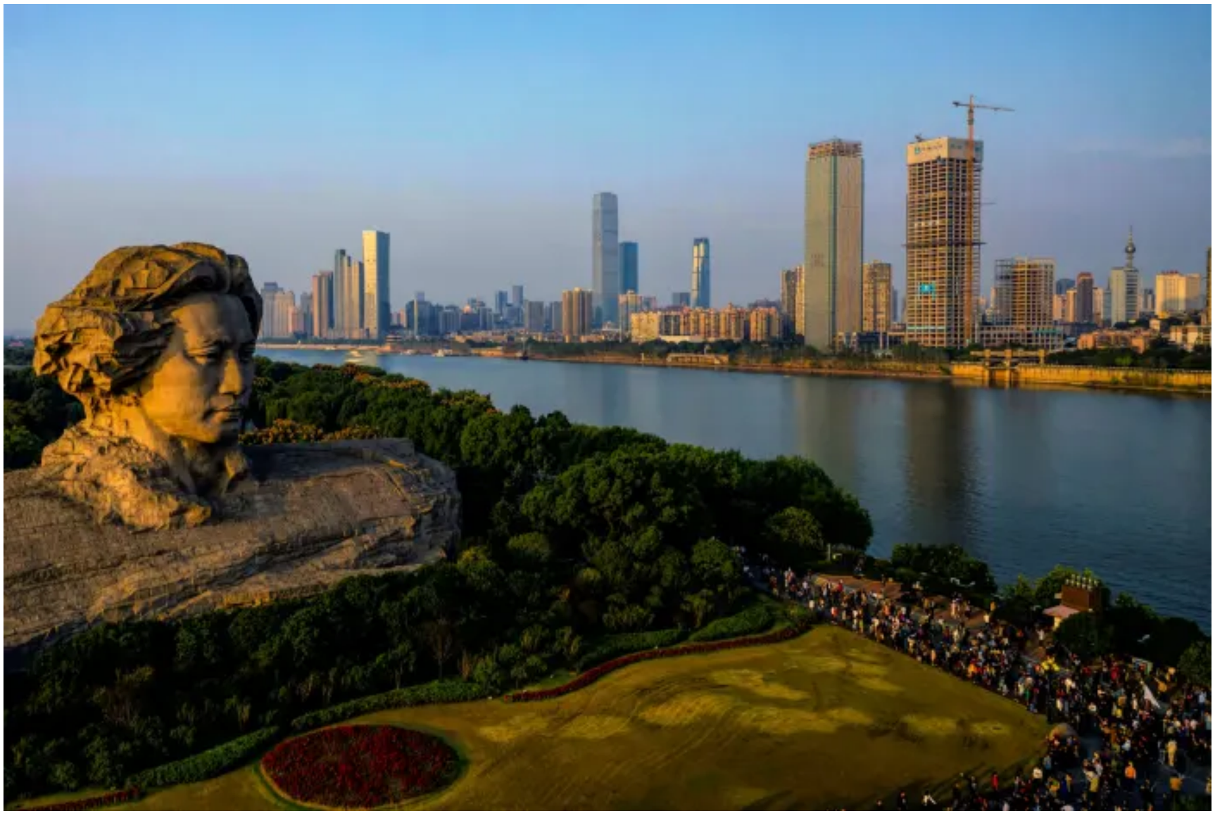


Source: Institute of International Finance

Local party and government officials also complain that they, not their bosses in Beijing, have to foot the increasingly expensive bill for Evergrande's collapse. Wei He, an analyst at Gavekal Dragonomics in Beijing, notes that when central government officials say that all pre-paid homes must be delivered to their nervous buyers, "this responsibility ultimately falls on local governments who may have to pay for construction themselves if developers cannot".

In Huaihua, a small city in Hunan province, the municipal finance bureau recently loaned Evergrande's local subsidiary Rmb50m to help it complete projects, according to one person familiar with the developer's operations there.

The situation had been complicated by widely divergent valuations of the group's local assets, according to a transcript of an internal government meeting seen by the Financial Times. Lu Anzhi, a senior official in Huaihua's housing bureau, said Evergrande valued its local assets at Rmb850m while third-party appraisals estimated them to be worth less than half that amount.



In Changsha, Hunan's provincial capital, officials recently said they could pay contractors to complete a dozen unfinished Evergrande projects © Alex Plaveski/EPA-EFE

In Changsha, Hunan's provincial capital, officials recently said they could pay contractors to complete a dozen unfinished Evergrande projects — but lacked the funds to pay off the debts the developer still owes them for previous work. "We hope you will have faith in Evergrande and the government," Huang Ge, a senior Changsha housing official, told a group of suppliers at a meeting in November, according to minutes reviewed by the FT. "We will get through these difficulties together and you will make a smaller loss or even a small profit."

An executive at a construction firm contracted to do work by Evergrande in Suzhou, a wealthy city in the Yangtze river delta near Shanghai, says his firm is refusing similar entreaties from local governments to resume work unless it is paid in advance. The contractor, Suzhou Gold Mantis Construction Decoration Co, is suing Evergrande for missed payments totalling Rmb645m.

"We are also requesting higher prices for our services because of inflation," the executive adds. "There hasn't been much progress because Evergrande and local authorities are facing funding shortages. But we are not going to bankroll Evergrande projects further because we are under significant financial stress ourselves."

Early signs of inflationary pressure

Per cent

FINANCIAL TIMES

Source: Haver Analytics

In Shaoyang, another city in Hunan, local officials are trying to auction their Evergrande problems away. On December 24 they announced that they would sell off the developer's four projects in their jurisdiction. "Neither the government nor Evergrande has money," one local official told the FT. "Someone else needs to fill the vacuum."

Ripple effect

The debt crisis in China's property sector is also reverberating through the economy via special off-balance sheet financial instruments used by developers to evade the industry debt caps imposed by regulators in the summer of 2020. It is a classic example of how, for every central government regulatory action in China, there is often a market-driven reaction that helps the companies targeted to work around it.

In response to the "red line" limits on developer leverage, the country's 20 largest real estate firms issued "commercial paper" totalling Rmb336bn in 2020, almost 40 per cent more than in 2019, according to the Shanghai Commercial Paper Exchange.

In Shaoyang, a city in Hunan, local officials are trying to auction their Evergrande problems away © Zhenliang Lei/Barcroft Media via Getty Images

In China developers often force their suppliers to accept commercial paper in lieu of cash payments, which they promise to make good on by a future date. The supplier can also use the commercial paper for its own payments, provided it endorses it by stamping a company chop on the back of the document. But if Evergrande fails to pay the eventual holder of the paper when it comes due, the holder can sue Evergrande and every other company that endorsed it — potentially freezing assets worth many times more than the original debt.

In an open letter to Evergrande, the owner of an architecture firm in eastern Shandong province described the "devastating blow" the developer's default was dealing to companies like his that had endorsed its commercial paper.

"An Rmb10m commercial paper will often be endorsed ten times before it ends up with the final holder," Li Menghe wrote. "The holder can then freeze Rmb10m at each of the ten endorsers, [or] Rmb100m in total . . . Most of the endorsers are construction firms and, because of Covid, need liquidity more than ever. Evergrande's failure to repay commercial paper is pushing countless companies to the edge of bankruptcy." Li and his firm, Qingdao Wanhe Construction and Decoration Group, did not respond to requests for further comment.

Unfinished apartment buildings at the construction site of an Evergrande development in Wuhan, China © Andrea Verdelli/Bloomberg

In 2020 the total amount of commercial paper issued by Chinese companies reached Rmb3.6tn — equivalent to 3.5 per cent of GDP. Evergrande alone accounted for more than 60 per cent of issuance by top-20 real estate developers.

Wang Qiang, the owner of an Evergrande contractor in Zhengzhou, capital of central Henan province, said small companies like his had no choice but to accept commercial paper from large developers. His company's future now hinges on whether he can collect the Rmb7.5m Evergrande owes him, but he is just one of many creditors in a very long queue. All creditor suits against Evergrande must be processed by a court in the southern city of Guangzhou, where there is already a backlog of 367 cases with claims totalling Rmb84bn.

"As small suppliers, we either accepted [developers'] commercial paper or we didn't get contracts," Wang says. "Evergrande set off a chain reaction. We can hold on for a few more months, but not much longer than that."

Additional reporting by Xinning Liu in Beijing