

# China's property sector crisis can be contained

The sector is in disarray after several large property developers defaulted on their bonds amid the Covid-19 pandemic and because government policies to control debt squeezed their liquidity

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For The Straits Times

In the last week of July, the politburo of the Communist Party of China is set to meet to discuss economic policies before the leadership takes off to coastal Beidaihe to discuss political matters.

The politburo has a lot to talk about. Second-quarter gross domestic product (GDP) growth was barely positive at 0.4 per cent year on year, and achieving the government's 5.5 per cent target now seems increasingly difficult.

Premier Li Keqiang said as much in a meeting with world leaders organised by the World Economic Forum. To reach the 5.5 per cent target, China's economy would have to grow by more than 8 per cent in the second half, which would require a major stimulus effort that seems unlikely, and is probably not desirable.

China's property sector is in disarray and among all the downward pressures on the country's economy, it stands out.

It is in disarray after several large property developers defaulted on their bonds.

The developers had run into problems because of Covid-19 and because government policies to control debt (like the so-called "three red lines" policy) had squeezed their liquidity.

Some have abandoned half-built projects, leaving buyers who made down payments on those properties stranded.

In response, some buyers decided to halt payments on the mortgages they had taken out to pay for unfinished apartments.

According to the "WeNeedHome" crowdsourcing project, some 319 projects in 113 cities were affected as at last Saturday.

These projects are spread all over China, but concentrated in the central provinces, especially Henan. Furthermore, suppliers to the stalled projects are also reported to have halted payments.

The shock to buyers' confidence has been large. Sales of new apartments had been down by some 35 per cent in the first five months of this year compared with last year, though the June data was slightly better at 20 per cent down year on year.

In the year until June, housing prices declined in more than two-thirds of China's 70 large and medium-sized cities that the National Bureau of Statistics monitors. The situation in tertiary cities and those where populations are declining is probably worse.

The sales slowdown is further squeezing developers. More than half of the listed Chinese property developers that have so far issued first-half earnings estimates expect to have made a loss during the period, according to Yicai, a news website.



A residential development in Shanghai. Over half of the listed Chinese property developers that have issued first-half earnings estimates expect to have made a loss in the period. Developers have slowed new construction as a result, with new housing project starts falling 45 per cent year on year last month. PHOTO: BLOOMBERG

As a result, developers have slowed new construction. New housing project starts dropped 45 per cent year on year in June, which is a major drag on the economy.

Investment banks estimate that directly and indirectly, property could make up 25 per cent to 30 per cent of GDP. Even if these estimates are on the high side, a slowdown in property would obviously cause major economic problems.

It would also spell trouble for local governments. Property developers have slowed buying land for future development, and land sales, which make up some one-third of local government revenues, were down by 65 per cent from June last year.

In addition, a quarter of local tax revenues come from taxes on property sales.

A property slowdown therefore has a major impact on local government financing and spending.

Professor Christine Wong of the East Asian Institute estimates that local government spending in the year until May was 18 per cent below target.

So is this the end of real estate development in China? Or worse, is the growing movement to stop mortgage payments the beginning of the bursting of The Bubble That Never Pops, as Tom Orlik's 2020 book put it?

## SERIOUS RISKS

The risks are not trivial. Most observers would agree that a correction in real estate development was overdue, but a disorderly correction could drag the economy into a recession.

And the mortgage strike, the first in China, could hurt the banks.

Total mortgages outstanding by the end of the second quarter amounted to 41 trillion yuan (\$58.4 trillion), or some 40 per cent of GDP.

Total household debt is about 60 per cent of GDP, or 114 per cent of household disposable income.

While this is still moderate compared with many Organisation for Economic Cooperation and Development countries, it has risen steeply since the 2008 global financial crisis.

Given the lack of hard data and the fluid situation, it is no surprise that estimates of the proportion of mortgages that could be affected by mortgage strikes vary widely, from 2 per cent to 10 per cent.

But even at the higher end of these estimates, China's banking system as a whole could absorb the losses.

The banks have been profitable in recent years. They are well provisioned for non-performing loans and their Tier 1 capital far exceeds what is needed under Basel III, according to Mr Chi Lo of BNP Paribas.

So in aggregate, the banking system is sound. But if the crisis worsens, aggregates hardly matter. Although many banks will be fine, some will still face problems, as is already apparent in Henan province, where some banks were unable to pay depositors, which led to riots and heavy-handed intervention by the local authorities.

Given the uncertainty, depositors may start pulling money out of even solid banks.

It is worth recalling that the global financial crisis of 2008 started as a small issue in the

sub-prime mortgage market in the United States, which was only 1.5 per cent of the total mortgage market. Yet, as we now know, that "small problem" blew up into a global financial crisis and a recession.

While China is different in many respects, the authorities are keen to contain the problems.

"Preventing the risk of a 'hard landing' in the property sector should be high up among our priorities and given serious attention," said Mr Zhu Guangyao, who was vice-minister of finance between 2010 and 2018 and now adviser to the State Council (China's Cabinet), during an online seminar on July 18, according to a Bloomberg report.

He added that local governments need to "be strictly on guard" to prevent the mortgage boycotts from spreading and triggering a banking crisis.

So what are the authorities doing? There are a host of initiatives and proposals to address the property downturn, and, more specifically, the mortgage strike.

For failed developers, the government prefers a time-tested solution – mergers and acquisitions, for which banks are being encouraged to provide loans.

Apparently, the authorities are considering allowing households to suspend mortgage payments on halted projects.

This is remarkable, given the fact that Chinese mortgages are "full recourse" – unlike mortgages in the US, buyers cannot walk away and leave the property to the bank.

Instead, they are liable for the full mortgage debt on the property, even if it is an unfinished shell. Meanwhile, local banks are

being encouraged to rid themselves of their non-performing loans. If history is any guide, banks facing financial problems will be bailed out by local governments.

There is some discussion of scrapping pre-sales of property, but this could further aggravate the property downturn and add to developers' leverage.

It is understandable that the authorities want to prevent the unwinding of the real estate sector and to control the financial risks involved.

Worsening consumer confidence in real estate could further depress property sales, which would exacerbate the financial troubles of developers and lead to more failures.

In turn, the mortgage strike could expand, which could lead to bigger financial sector problems.

Even worse, the troubles in property development could lead to a more widespread decline in property prices. Given that some 60 per cent to 70 per cent of household wealth is embedded in property, this could become a major drag on already fragile consumption, and a potential source of social unrest.

But providing bailouts for everybody – property developers, prospective buyers and banks – risks perpetuating the misallocation of capital that has been plaguing China for some years now.

Property and infrastructure have accounted for a growing share of total investments in China, which has been a key cause of the decline in productivity during the past decade.

Furthermore, China's ageing demographics suggest that the heyday of its property boom is

over, which may be a major underlying problem in its property market.

## POLICY OPTIONS

So what can be done?

First, the government could revamp demand for property.

The most obvious demand would come from new residents, and the current property troubles are yet another reason to abolish *hukou* restrictions on rural citizens through which they are denied residence permits.

Some cities, including large ones such as Wuhan, have already dropped urban *hukou* as a requirement for buying property.

More are likely to follow. In addition, the government could take the current crisis as an opportunity to accelerate social housing development and use appropriate financing sources such as pension funds for this purpose.

Pension funds invest for the long term, and returns on social housing would fit their needs.

Second, the government could consider isolating households from the whims of a volatile property development sector.

One way to do so is to set up an insurance mechanism against the bankruptcy of property developers.

Such insurance exists in other countries, and at a modest price – as low as 0.45 per cent of the property value in the Netherlands, for example – it insures home buyers against that risk.

Alternatively, the government could consider regularising the option of a mortgage strike. This may sound counter-intuitive, but the logic is that the banks that provide mortgages would be far more careful in their due diligence on the financial health of property developers, which they are better equipped to do than individuals.

The incentives for the banks to do due diligence would be even stronger if China were to change the legal model for mortgages from the full recourse model to a non-recourse model, as in the US, in which the property is the only collateral the bank can take.

An intermediate step could be to allow mortgages to be non-recourse during development, but full recourse after delivery. This would prevent home owners from walking away from their properties for frivolous reasons.

Third, the government could speed up the development of alternative investment products for long-term savings. Many households see real estate as their only means of such savings, particularly for pensions.

Given the modest pensions that the public system provides (even for urban workers), such long-term investment vehicles would be in high demand.

Finally, the government would need to revamp the fiscal system to make local governments less reliant on property development for their revenues.

Alternative revenue sources, including a property tax and a bigger share of taxes from the central government, could be a start. In addition, the central government could find better ways to implement stimulus policies that are independent of the fiscal situation of local governments.

In sum, China's property sector problems are serious, with potentially major implications for its economy. But there are ways in which they can be contained.

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