

CHINA

3

PAINFUL ADJUSTMENTS

The Chinese economy is in the midst of a period of major adjustments. They arose after Beijing tightened regulations in a variety of sectors, from housing to certain new technologies and activities linked to the societal challenges facing the country. The adjustments can also be attributed to the debt excess problem of some state-owned and private enterprises, and reflect the authorities' determination to tighten their access to credit and to clean up practices in the financial sector. As a result, an increasing number of corporates is defaulting, and the troubles of the property developer Evergrande are symptomatic of the changes under way. For the authorities, the challenge is to maintain control over these events and to contain their negative impact on confidence in the financial system, on credit conditions for other economic agents and on economic growth.

NEW THREATS TO GROWTH

China's post-Covid economic rebound peaked earlier this year and growth rates have gradually returned to normal levels since March. However, the slowdown was particularly abrupt during the summer months and spread to all sectors. It can be attributed to both temporary factors as well as more lasting causes.

Lockdown measures and travel restrictions, which were reintroduced in August in response to the resurgence of the pandemic and the threat of the Delta variant, dealt another hard blow to private consumption. Growth in retail sales volumes slowed to 0.9% year-on-year in August, down from 6.4% in July and 11.9% in Q2 2021. Activity in the services sector was also hard hit by the lockdown measures (+4.8% y/y in August, down from 7.8% in July and 13.9% in Q2). The services sector has also been hit by regulatory changes in such industries as online services, tutoring and video gaming.

The tighter macro-prudential framework and credit conditions have also hit the property market while the tightening of fiscal policy in H1 2021 led to a major slowdown in investment in public infrastructure projects (see chart). As a matter of fact, after last year's post-Covid economic rebound, the authorities rapidly adjusted their economic policy to shift priority to debt reduction efforts by both local governments and corporates – notably property developers and state-owned enterprises.

Lastly, supply-side constraints have disrupted the industrial sector. Factories have been hit by an increasing number of power outages in recent weeks, as a result of strong demand, rising coal prices constraining energy production, rationing measures introduced in some provinces in order to comply with targets to reduce greenhouse gas emissions. Through August, however, industrial production growth slowed only moderately (+5.3% y/y, vs 6.4% in July and 9% in Q2) as it kept pace with persistently solid performance in exports (which still rose by 25% y/y in value in August). Moreover, investment growth in the manufacturing sector was also robust over the summer, bolstered by good corporate profit growth and historically high production capacity utilisation rates (78.4% in Q2 2021).

Although households are still extremely cautious, consumption and activity in the services sector should pick up as of September as most lockdown measures and travel restrictions are lifted. To a lesser extent, they should also get a boost from the advancement of the vaccination campaign (more than 70% of the population has received two doses). Consumer price inflation is still very low (+0.8% y/y in August), which may also encourage spending. In addition, the authorities are expected to support domestic demand again, mainly via carefully targeted measures to facilitate lending and a rebound in public investment.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	6.0	2.3	7.8	5.6
Inflation (CPI, year average, %)	2.9	2.5	1.2	2.8
Official budget balance / GDP (%)	-2.8	-3.7	-3.2	-3.0
Central government debt / GDP (%)	17.0	20.6	21.0	21.7
Current account balance / GDP (%)	0.7	1.9	1.9	1.7
Total external debt / GDP (%)	14.5	16.3	15.1	15.8
Forex reserves (USD bn)	3 108	3 217	3 282	3 322
Forex reserves, in months of imports	14.9	16.3	14.0	12.9

TABLE 1

e: ESTIMATES & FORECASTS

SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

DOMESTIC INVESTMENT

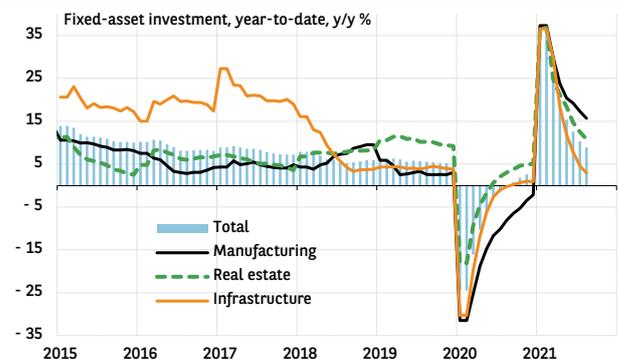


CHART 1

SOURCE: NBS

In the industrial sector, in contrast, supply-side constraints could persist for several more months. Above all, the adjustments being pushed by the authorities are placing new constraints on economic growth, at least in the short term.

First, the regulatory environment is becoming less predictable and less favourable for private investment in a number of sectors regarded as sensitive by Beijing. They include certain new technologies offering consumer services, data collection and activities pertaining to societal issues (such as education or wealth distribution).

Second, the number of payment difficulties and defaults, by both state-owned and private corporates, are on the rise due to: i) their heavy



debt burden¹ and the deterioration in their financial performance after last year's crisis, combined with ii) government measures to reduce leverage levels in certain sectors by tightening their credit conditions, as well as to clean-up practices in the financial system (for example, by letting non-viable firms enter bankruptcy, and by weakening implicit state guarantees).

COMMON PROSPERITY, REAL ESTATE AND EVERGRANDE

Under this environment, the real estate sector is highly exposed. This is partly because the housing market plays a major role in the country's medium-term development strategy: moderate house price inflation and improvements in housing affordability are due to help stimulate household consumption and reduce inequalities, in compliance with Beijing's new priority to promote "common prosperity".

Second, the real estate sector is one of the most heavily indebted sectors, and it has largely benefited from the monetary easing measures introduced during the H1 2020 health crisis. Consequently, the authorities sharply tightened credit conditions and the prudential framework beginning in Q3 2020. They placed new limits on the banks' sector exposure² and imposed three "red lines" that property developers must comply with in terms of financial ratios³. Many provinces have also set up measures to discourage speculative transactions and moderate the rise in house prices.

In this increasingly restrictive environment, enterprises of the real estate sector have faced increasing financing and cash-flow problems in recent months. Growth in bank loans to property developers (which account for only part of the sector's financing sources) fell to 2.8% y/y in mid-2021, down from 8.4% in mid-2020. Growth in mortgage loans slowed to 8.6% from 14.8% during the same period. This downward correction should worsen in H2 2021. Meanwhile, housing construction and transactions have slowed, further reducing developers' liquidity levels (see chart).

The Evergrande case is symptomatic of the property sector's troubles. In the last days of September, Evergrande, which is the country's largest and most heavily-indebted developer, failed to pay part of the interests due to local creditors and on its US dollar bonds. The Chinese government did not grant any direct support.

WHAT IS THE FALLOUT?

Corporate deleveraging efforts and the clean-up of financial-sector practices are positive trends that should lead to a better allocation of capital in the medium term. Yet the adjustments are painful in the short term. Evergrande's first defaults had a severe impact on confidence and the financial markets, if for no other reason than the company's size (which accounted for nearly 5% of the total value of China's real estate transactions in 2020), its heavy debt and debt profile (which is mainly short-term)⁴. Evergrande's troubles have also impacted its payments to suppliers and shadow banking credits, thus accelerating the spread of liquidity pressures to other institutions.

In recent weeks, local bond markets have been increasingly differentiating between property developers based on their credit rating. As a result, a certain number of small firms in the sector have found themselves cut off from access to financing and are in danger of defaulting. Bond issuers in other sectors, in contrast, do not seem to have been affected much so far. Moreover, the banking sector is stable.

HOUSING MARKET CORRECTION

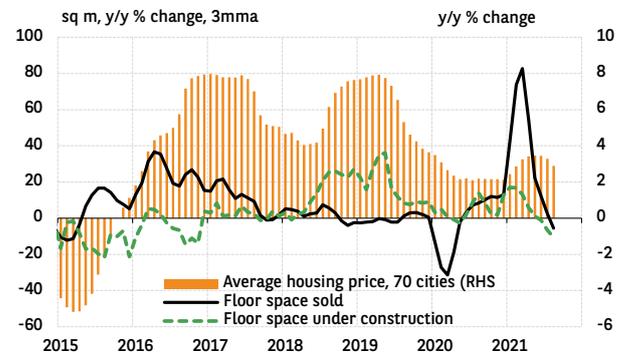


CHART 2

SOURCE: NBS

It is highly exposed to the real estate sector, which represented 28% of total bank loans outstanding in H1 2021 (of which 21% are mortgage loans and 7% are loans to developers), or 46% of GDP. Although some of the small banks may face severe difficulties due to property developers' troubles, China's largest banks have sufficient capital and provisions, and are robust enough to withstand the shock (and their direct exposure to Evergrande is manageable).

Above all, the authorities have the capacity to contain spill-over effects to financing conditions for the rest of the economy and to prevent instability risks in the financial system. The central bank has injected liquidity continuously in recent days, and the government is taking part in the negotiations between Evergrande and its creditors and in the debt restructuring process (asset sales, fund injections by other firms, etc.).

The Evergrande shock is unlikely to trigger a widespread liquidity crisis in the financial system. On the other hand, the forced deleveraging process for developers will have consequences on economic growth. Land sales, construction and housing transactions should continue to weaken in the short term. Yet the construction and real estate sectors are key growth engines for the Chinese economy. They account for 15% of GDP, and even 25% if we include indirectly linked activities. Real estate investment accounts for nearly a quarter of total investment. Moreover, land sales proceeds are a major source of revenue for local governments, and the majority of household wealth, especially in urban areas, is invested in real estate. Therefore, while allowing the weakest property developers to go bankrupt, the authorities are likely to take action to avoid a lasting contraction of the sector (by easing mortgage loan conditions, for example, or providing liquidity support for the most solid firms). Completing Evergrande's already existing construction projects is also likely to be one of the authorities' priorities, to address the discontent of families waiting for the delivery of their houses.

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¹ China's corporate debt (most denominated in local currency) represented 159% of GDP in mid-2021, up from 152% at year-end 2019.

² The ceiling on real estate loans (property developers + household mortgages) as a share of total loans varies depending on the size of the bank.

³ The property developers must comply with three ratios: debt/assets <70%, liquidity/short-term debt >1 and net debt/equity <100%. Developers have 2 years to improve their ratios. The more a developer exceeds these limits, the tighter the restrictions on its access to credit. In H1 2021, 7 of China's 50 biggest property developers exceeded the three "red lines".

⁴ Evergrande's debt and liabilities total nearly USD 300 bn, or 2% of Chinese GDP.

