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POLICY MEMO

Xi Jinping's Evergrande Dilemma

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September 2021

Evergrande is one of the top-two real estate developers in a still highly fragmented Chinese sector. Its main strategy is to achieve ever-increasing scale (rather than profitability) in order to move ahead of and crowd out commercial competitors. It has also amassed the largest land reserves of all Chinese developers, which were financed through massive borrowings. By 2018, Evergrande held 822 pieces of undeveloped land in 228 cities, with a planned gross floor area of 3.28 billion square feet of new homes—the equivalent of 10 percent of Germany's entire housing stock. It paid $75 billion just for this undeveloped land.[1]

Although Evergrande's market share is only around 4 percent, its borrowings stand out. Its current balance sheet liabilities amount to an estimated 2 percent of China's gross domestic product (GDP), while its off-balance-sheet liabilities could be another 1 percent of China's GDP. This makes Evergrande the most indebted property developer in the world.[2]

Burdened by this debt, struggling to meet its debt interest and repayment obligations, and viable only if property asset values and sales continue to increase, Evergrande faces possible financial collapse—an event bound to have flow-on effects for the Chinese economy. However, the unusually high global interest in Evergrande has arisen because its woes are increasingly seen as symptomatic of those faced by the broader Chinese economy, which is struggling with enormous levels of indebtedness and overreliance on the real estate sector.

Debt held by nonfinancial institutions in China increased from about 115 percent of GDP in 2010 to around 160 percent of GDP currently. This is the most rapid and largest increase in a 10-year period for any major economy and makes the level of debt held by Chinese nonfinancial institutions one of the highest in the world.[3] The real estate sector accounts for around 15 percent of GDP, while property services account for another 14 percent—the highest in any developing economy.[4] The share of the real estate sector as a proportion of GDP was only about 4 percent in 1997 and 9 percent in 2008. Since 2008, up to a third of all domestic fixed investment has gone into real estate, and up to half of total national debt is linked to the real estate sector.[5]

What Evergrande Reveals about the Chinese Political Economy

Evergrande's distress is not just a financial or sectoral problem; it is one that goes to the heart of the resilience and robustness of the Chinese political economy, and to the competence of the Chinese Communist Party and its stewardship over the country's state-led economy. In many respects, the remarkable rise of Evergrande is a microcosm of all that is impressive but also fragile and flawed about the Chinese political economy.

Evergrande was recently held up as a company helping to fast-track the Chinese dream of home ownership in a rapidly urbanizing country. Indeed, Evergrande gained national recognition in 2009 after it managed to complete a major development project—from government approval to land acquisition to construction to sales and then the owners moving in—within 12 months.

More broadly, it was widely assumed that Evergrande's model of "three highs and one low" (high debt, high leverage, high turnover, and low cost) was ready-made for a period of rapid urbanization, and that this rapid Chinese transformation from rural to urban was driving the enormous investments in real estate.

This is only partly true. With real urbanization advancing at a steady rate of only 1–1.5 percent each year, the massive recent increases in real estate construction are not primarily driven by urbanization needs.[6] Instead, they reflect local governments' efforts to raise revenue by appropriating rural land to rezone for industrial or residential construction and use—regardless of actual housing demand. In the decade leading up to 2005, an estimated 40–70 million farmers were forcibly evicted from their land for this reason, often with inadequate compensation or no compensation at all.[7]

The recent record makes clear that rezoning from rural to urban has little to do with the demands of urbanization. From 2001 to 2008, proceeds from land use rights (for both industrial and real estate projects) represented 40.5 percent of local government income averaged across all localities. Within two years of the 2008 government-ordered fiscal and monetary stimulus (a response to the global financial crisis and stagnation in China's major North American and European export markets), proceeds from rezoning of land from rural to urban dramatically increased—to 61 percent of local government income, and possibly 70 percent by 2014. Currently, the real estate sector is responsible for up to one-third of all local government revenues.

Local governments increased their reliance on land sales and residential development by creating an estimated 155,000 local government financing vehicles (LGVFs) to get around restrictions on their assumption of debt. LGVFs became major recipients of the credit binge ordered by the central government, and many of these entities (which are effectively local state-owned enterprises, or SOEs) forged commercial partnerships with property developers such as Evergrande to gain a share of real estate sales built on rezoned land.

The extent of the debt racked up by local governments and their LGFVs is not widely appreciated outside China. In two years, from the beginning of 2008 to the end of 2009, the local government loan balance increased to approximately $1.19 trillion, an increase of 70 percent.[8] By mid-2013, local government debt had reached an estimated $2.89 trillion.[9] By the end of 2020, the official figure was $3.97 trillion, though the real figure (which includes hidden or concealed debt) is closer to $7 trillion.[10]

By 2016, the total market value of Chinese real estate accounted for around 411 percent of GDP; this compares to a global average of 260 percent.[11] The undeveloped nature of Chinese financial and corporate bond markets, which offer individuals and firms few attractive options for investing and/or

parking savings, means that real estate is widely treated as a speculative asset rather than one based on fundamental value or traditional measures such as yield. Hence price controls and restrictions on numbers of properties bought have proved to be only temporary speedbumps for China's booming real estate markets.

Indeed, it is estimated there are presently enough empty homes in China to house 90 million people, which would meet the country's urbanization needs for the next decade and beyond based on current urbanization rates.[12]

It is also important to understand the link between the debt held by the large property developing firms and the so-called shadow banking system, which is beyond regulatory oversight and the reach of government. This shadow banking system refers to all credit extended outside the formal and regulated banking system, even though state-owned banks are generally the starting point for shadow bank lending and reap the ultimate rewards and risks of such loans.[13]

Chinese shadow banking has grown exponentially since around 2010 for several reasons. First, by ramping up lending in a loose credit environment while still charging high—even exorbitant—interest rates, well above ceilings imposed by authorities for formal bank loans, it allowed banks to circumvent regulatory scrutiny and prudential restrictions in the rush to maximize profits.

It also allowed banks to create off-balance-sheet wealth management products (WMPs) and trust products to sell to investors. These offer short-term investment returns 5 to 15 times those of bank deposit rates, while the bank-owned entities selling these WMPs and trust products can charge a high interest rate to borrowers unable to secure sufficient credit from commercial banks. For private firms starved of formal capital, WMPs were one way of gaining a line of credit to tap into a booming economy. For other private firms, SOEs, and LGFVs, they provided an easy way of acquiring additional finance to achieve rapid gains from the property market.

Starting in 2008, shadow banking loans in China grew at above 30 percent each year, and they had more than tripled in volume by early 2014. By 2016, shadow bank loans reached over 60 percent of GDP before falling to around 45 percent of GDP currently.[14]

The Tide Turns for Evergrande

The Chinese Communist Party (CCP) loathes instability, unpredictability, and loss of control in all economic and financial contexts. Alarmed at the unprecedented growth in corporate debt and soaring real estate asset prices, Beijing began efforts to deleverage its economy in 2015, in part by reducing shadow financing and cooling the property market. The deleveraging campaign explains the relative decline in reliance on these unregulated sources of finance as a proportion of GDP from 2016 onward.

Just as local governments, private firms, and real estate developers had been the primary beneficiaries of easy access to credit, they also bore the brunt of the central government's deleveraging policies.[15] To ensure continued access to sources for fiscal revenues and local projects, local governments were permitted to issue their own bonds to fund infrastructure and real estate projects. This accounts for the increase of local government bonds issued, from about $2.5 trillion in 2015 to over $5 trillion currently. But this approach meant that rising indebtedness was merely shifted away from the formal banking and shadow banking sectors toward the local government bond sector, where most bonds are implicitly guaranteed by the central government (and are off-the-books liabilities for state-owned banks). The bottom line is that local governments continue to be major players in financing the real estate bubble and profiting from it.

For firms such as Evergrande, the central government's attempts to restrict access to easy finance were potentially

an existential threat to operations. Before the 2016 leverage clampdown, Evergrande was the most leveraged real estate developer in China, with a gearing ratio more than double that of its major competitors.[16] Evergrande evidently remained dependent on the shadow banking system, as it was revealed that $44 billion of debt from shadow lenders was due to be repaid in 2019.[17]

In 2018, its financing cost remained over 8 percent,[18] one of the highest among property developers in the country; this reflected both assessments of the severity of its leveraged position and the deteriorating outlook for the property sector, a function of periodic government efforts to deflate the bubble. Real estate developers were also hit with supply-side restrictions imposed by Beijing on formal and shadow providers of credit. To remain solvent in this situation, Evergrande became even more dependent on increasing scale and quickly selling even more built and off-the-plan developments.

Beijing's Dilemma

Beijing's objective of deleveraging the economy by focusing on the overheated real estate sector is understandable. China's debt-to-GDP ratio is around 300 percent, and corporate debt of nonfinancial institutions is more than 160 percent of GDP (it had been hovering around 90 percent of GDP for the 10 years leading up to 2008.) It is estimated that more than a quarter of that debt is directly linked to real estate.[19] Chinese corporations have been defaulting on bond payments at the fastest rate on record. While 2021 is the fourth consecutive year for bond defaults totaling at least RMB 100 billion, that level of bonds in default was reached in April, as compared to the last quarter in the previous three years.[20]

Evergrande is a major issuer of RMB-denominated bonds and has become China's largest issuer of high-yield dollar-denominated bonds. In the last three months of this year alone, Evergrande has interest payments of about $670 million due on the back of dollar-denominated bonds issued.[21]

The problem for the CCP is that it has enabled the emergence of giant, inefficient, and debt-laden firms such as Evergrande. To explain how, consider the common and accurate description of the economic situation in China: "the state advances—the private sector retreats."[22] Under Xi Jinping, the unequal treatment of the private sector has been extended further: state-owned firms and well-connected private firms are being offered easier and cheaper access to credit, privileged access to some of the most lucrative sectors in the economy, and regulatory and legal protection from local and central governments.[23]

This trend is demonstrated by data showing that profits in the genuine private sector have been generally declining since around late 2014 (they fell by 22 percent in 2018, the largest decline since 1978), while profits of state-controlled firms have been increasing since late 2015. This is occurring even though private firms have a return on assets around three times better than that of state-controlled firms, and their use of capital is twice as efficient.[24] These trends are a reversal of what occurred during the three decades prior to 2014.

In macroeconomic and fiscal terms, this is a problem for Beijing. The private sector accounts for about half of the country's tax revenue, about 60 percent of GDP, and 80 percent of urban employment. These political priorities also create serious challenges for Beijing's efforts to achieve sustainable economic growth and manage debt and fiscal issues in the medium-to-longer term. In the short term, they render Beijing even more reliant on a booming property sector despite fears of where that might lead.

This is how Evergrande has risen. Although Evergrande is a private firm, its intimate connections with CCP elites and

approach of "three highs and one low" is really the well-trodden pathway for growth and success under CCP rule.[25] As chairman and founder Xu Jiayin once declared, "everything the company possessed was given by the Party."[26]

Like Evergrande, much of the Chinese political economy is driven by churn and forced activity; measurements such as return on capital or profitability are not used to allocate resources or guide commercial decision making. Price and market signals in major sectors are suppressed to achieve political objectives.

Until recently, Evergrande obtained cheap and abundant access to capital because it was favored by the Chinese leadership, and lenders assumed that the firm was too big and important to be allowed to fail. Beijing needed a booming real estate sector to achieve growth and meet fiscal targets, and Evergrande was a huge and prominent part of that process. In this sense, lending to Evergrande was perceived to be almost as secure as lending to a centrally backed SOE.

This goes to the heart of Beijing's dilemma. Clipping the wings of Evergrande by indicating that it will not bail out or assist the indebted giant will be treated as a universal signal to lenders that they need to find borrowers who are more profitable and commercially worthy—and not in the real estate sector. It will cause lenders to fundamentally reconsider their lending to other large property developers, which they did largely on the assumption that these developers were too big and important to fail, and that they received implicit backing from the government.

On the demand side, growing distress for firms like Evergrande will increase fears that the era of guaranteed capital appreciation for real estate assets is over, and will add to the perception that the cost of capital is due to increase and access to finance is tightening. This creates the danger of too rapid a cooling of the real estate boom, which could lead to systemic failures in several contexts beyond the sector's role in overall growth and contribution to fiscal requirements. For example, purchases of existing and off-the-plan properties are used extensively as collateral for further borrowings, and any deflation in asset values could pose a profound risk to the entire economy. Households have also plowed much of their savings into real estate given the paucity of investment options. The real estate bubble has helped to underpin private domestic consumption, so deflating the property bubble lessens the capacity for private consumption to pick up the economic slack.

More broadly, the subsequent slowing of credit and increase in the cost of capital resulting from rapid declines in real estate values will mean even more LGFVs and property developers will be unable to meet their debt obligations and will face the same problems encountered by Evergrande. Simultaneously, credit-issuing institutions, including those in both the formal banking sector and the informal shadow banking sector, would suffer a growing number of defaults by borrowers, which in turn would affect their capacity to issue new loans. That would spell severe trouble for the entire Chinese model of growth, which is heavily reliant on the inefficient but rapid deployment of capital for fixed investment.

Another growth model is proposed in the claim that China will seek "high-quality" development rather than merely rapid growth.[27] This claim is often associated with Xi Jinping's attempts to address moral hazard by allowing giants to fail, to reduce profligate lending, and to dampen dangerously high asset prices. Rather than relying on ever-increasing capital inputs, this approach would prioritize improvements in total factor productivity (i.e., using labor and capital inputs more efficiently and innovatively) and eliminate sources of systemic risk at the same time.

This would mean the repudiation of Xi Jinping's "party-corporate conglomerate"[28]—that is, a political economy that

enables the CCP to exert control over the entire economic system, allows SOEs and national champions to flourish in key sectors at the expense of an independent private sector, and utilizes national economic activity and resources to achieve domestic and external political objectives.

The problem regarding Evergrande is symptomatic of the diabolical problems facing the entire Chinese political economy, problems overwhelmingly created and exacerbated by the CCP's determination to tighten its hold on the reins and levers of economic power.

Conclusion

Over the past few weeks, Beijing has been determined to ensure that Evergrande's problems do not lead to any greater systemic difficulties. The People's Bank of China has been injecting billions into the state-owned banks to ensure liquidity. Beijing has been conducting thorough forensic investigations into the holders of bonds issued by Evergrande. It has also been warning officials to brace for social unrest should Evergrande fall and leave bond holders and purchasers of off-the-plan properties with nothing.

The strong odds are that China can avoid any Lehmann Brothers moment: the collapse of a giant that led to a severe liquidity crunch in the system. The CCP can instruct state-owned banks to continue to lend to each other and borrowers and can force the rollover of loans and extension of bond interest payments to prevent defaults appearing on the ledger. That is the perverse resilience of the Chinese economy even if it means kicking the can down the road and creating a more severe reckoning for future generations. The CCP also has ample coercive apparatus and powers to prevent anger from spiraling out of control.

Even so, and as a symptom of what ails the Chinese political economy, Evergrande's plight is further strong evidence of the structural slowdown that China will endure. This will have longer-term implications for the resources the CCP can direct toward domestic security and external strategic objectives, given overspending on the former and sustained underspending on social and public goods. That underspending will become more glaring as Chinese society begins to rapidly age.[29]

It is also clear that the CCP's stated goal of reducing inequality will not be achieved even if billionaires such as Evergrande's Xu Jiayin and Alibaba's Jack Ma are brought to heel and cut down in size. The primary cause of inequality in China is entrenched privileges for SOEs and well-connected private firms in the form of exclusive access to capital and commercial opportunity at the expense of the truly independent private sector. Until discrimination against the latter is reduced, wealth will not be more evenly distributed, and household income (relative to the revenues of SOEs and well-connected firms) will not increase sufficiently to fuel and sustain the domestic consumption-led growth promised by Chinese leaders.

Evergrande's turmoil offers a revealing insight into the true workings of the Chinese political economy. It is a reminder that China under the CCP is a formidable rival with enormous resources and immense ambition, but is building its power and future on still fragile foundations. This makes a China ruled by Xi Jinping more vulnerable, paranoid, and impatient—and therefore more dangerous to the United States and the region.

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