CHINA ECONOMIC UPDATE OCTOBER 2021

Debt bomb – managing the fallout from Evergrande will be a key challenge for Chinese authorities

NAB Group Economics

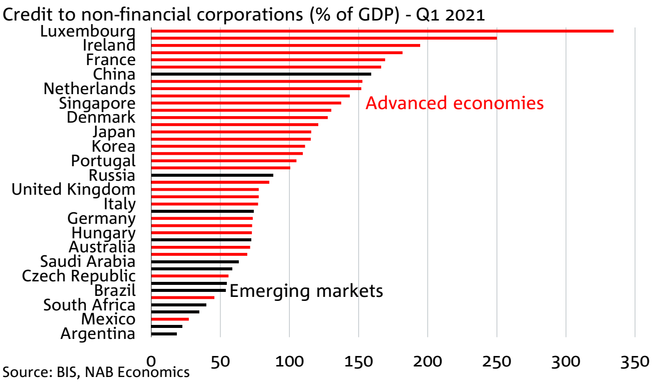
In late September, Evergrande, China's second largest property developer, was on the brink of default when it appeared unable to make interest payments on offshore and domestic bonds. Although there is a slim possibility that default could be avoided in the near term, a collapse seems inevitable in coming months – given the company's dire financial position. This issue has highlighted concerns around the China's broader corporate debt levels and raised fears of financial contagion – which if fully realised could negatively impact the broader construction sector, as well as the Chinese and global economies. These fears also extend beyond just one company – with looming debt obligations in coming years an issue for Chinese authorities.

CHINA'S CORPORATE DEBT BURDEN HAS GROWN

China's corporate sector has been highly indebted for many years. According to data from the Bank for International Settlements, credit to non-financial corporations totalled almost 160% of GDP in the first quarter of 2021 (compared with levels near 100% in 2006), which places China among the upper echelon of advanced economies and far above other emerging markets (with Russia second at just 88% of GDP).

CHINA'S CORPORATE DEBT

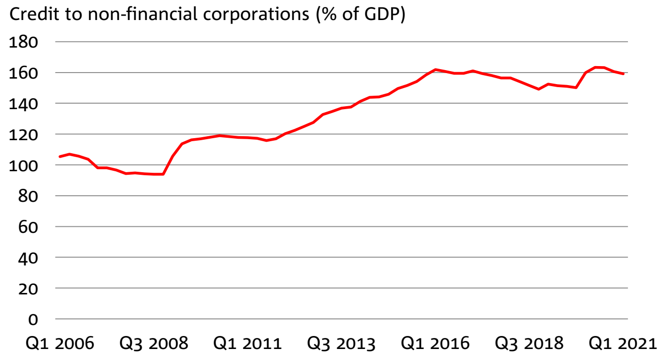
Debt far higher than other emerging markets



Source: BIS, NAB Economics

CHINA'S CORPORATE DEBT

Steady increase in debt between 2012 and 2016



Source: BIS, NAB Economics

It is possible that this figure under-estimates the total stock of China's corporate debt – given the rapid growth of the country's shadow banking sector between 2012 and 2017. Estimates of the scale of shadow banking debt differ widely, with considerable opacity around lending practices. Real estate is a sector with considerable shadow bank borrowing – given regulatory measures introduced to limit bank lending to the sector. According to reports, Evergrande has attempted to satisfy its obligations to some non-bank lenders (such as its wealth management asset investors) with apartments from its unsold inventory.

It should be noted that in many ways Evergrande is not representative of the broader Chinese corporate sector. Firstly, it is a privately owned company and the dominant share of corporate debt is held by state-owned enterprises (SOEs) – almost 85% of total non-financial corporation debt in 2020 (IIF). Secondly, Evergrande rapidly expanded its operations and leverage during the recent property boom, to become (according to reports) the most indebted property company in the world – which would suggest it is not entirely representative of the property sector.

Evergrande's total liabilities – which include its debts, its pre-sold but uncompleted apartments and accounts payable to suppliers – reportedly exceed RMB 2 trillion, equivalent to around 2% of China's gross domestic product. In August 2020, Chinese authorities implemented the "three red lines" – a series of regulations designed to control excessive debt in the property sector – which appears to have contributed to the current near default – although the sheer scale of the company's liabilities may have made this inevitable regardless of the regulatory change.

The three red lines specify conditions on property developers' liability-to-asset ratio, net gearing ratio and cash-to-short-term debt ratio. Firms who pass all three criteria are permitted to their debts by up to 15%, while each red line a firm fails to meet would reduce this total by 5% (meaning that firms failing all three criteria would be unable to expand their debt). According to reports, only one of the 15 largest property developers passed all three criteria and Evergrande failed to pass either two or three of the lines, limiting its ability to borrow to meet its interest payment obligations.

In late September, Evergrande were scheduled to pay interest on two tranches of bonds – the first being on US dollar denominated issuances in offshore markets, worth almost US$84 million, and the second in the domestic market, worth the equivalent of US$36 million. Reports suggest that the company arranged a deal to meet the domestic bond payments, however at the time of writing, it appears likely that they will default on the offshore bonds (which would officially occur in late October, once payment is 30 days past due). Further payments are due before the end of the year – with the two interest payments in September accounting for less than 20% of the total due. Following instructions from Beijing, local governments are reportedly establishing taskforces of lawyers and accountants to examine the impact of, and prepare for, an Evergrande failure in their regions– a further sign of the highly likelihood of this outcome.

CONCLUSIONS

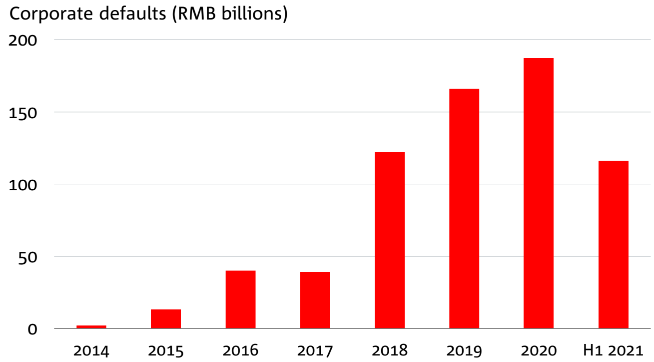
Given that it appears likely that Evergrande will default, the question is how China's authorities will manage the fallout – with a lack of clarity from regulators triggering volatility in China's financial markets. It is widely believed that China's government will not bail out the company – preferring to make an example of it – but attempt to prevent wider damage.

This will likely include selling Evergrande assets to other firms, raising funds to partially compensate creditors. However, it is likely that these creditors will be forced to take a haircut. We expect government intervention will be limited to ensure that banks (and probably non-bank lenders) remain solvent.

Historically, defaults by Chinese firms were relatively uncommon – which reflected both the dominant share of SOEs in total borrowing and the implicit guarantee of governments (at the central and local level) to underwrite these debts. However, conscious of the negative consequences of moral hazard, regulators have allowed struggling firms to default – leading to an increasing total value of defaults since 2018. According to data from Shanghai DZH, defaults in the first half of 2021 were at a record high – totalling around RMB 116 billion – and it is anticipated that defaults will exceed the full year record from 2020 (given that the value of Evergrande's defaults alone would far exceed this level).

CHINA'S CORPORATE DEBT

Steady increase in debt between 2012 and 2016



Source: Shanghai DZH, NAB Economics

The People's Bank of China's 2018 Financial Stability report identified Evergrande as one of the few conglomerates that posed systematic risk for the country's financial sector (others included HNA Group, Fosun International, Ant Financial Services Group, Tencent Holdings and JD.com). This is highlighted by the broad range of direct lenders to the firm – having borrowed from around 170 domestic banks and over 120 non-bank financial firms (Economist Intelligence Unit).

This highlights the concerns around financial contagion, with actual losses for these lenders potentially limiting their capacity to lend to other firms, as well as potentially disrupting interbank markets – should lenders lose confidence due to potential counterparty risk. In a worse-case scenario, this could result in a credit crisis similar to the one that followed the collapse of Lehman Brothers in 2008 – with fears that it could spill over into global financial markets. Such a risk could provide incentives for authorities to intervene to limit the damage – something that arguably has commenced, with the People's Bank of China pumping liquidity into interbank markets in recent weeks.

There are also concerns that the failure of Evergrande could bring additional scrutiny on other property developers – many of whom are also highly indebted (if not to the same extent as Evergrande). A severe downturn in activity within the property sector would impact demand for steel – and by extension – demand for Australian iron ore, negatively impacting Australia's economy.

Given the broad scale of China's corporate debt, and the risk that weaker economic growth in coming years could impact the capacity of firms to service this debt, there is the potential for default risks similar to Evergrande in coming years. According to Nikkei, US$2.14 trillion worth of corporate bonds will mature by the end of 2023, a total that is around 60% larger than the total that matured between 2018 and 2020. Attempts to deleverage the corporate sector – which was most evident between 2016 and 2018 – were somewhat derailed by the US-China trade war and the country's response to COVID-19. Further deleveraging may be necessary to reduce the risks around China's corporate debt.

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