# CHINA ECONOMIC UPDATE SEPTEMBER 2022

Buyers fight back: Mortgage strike points to property sector's weak underpinnings

NAB Group Economics

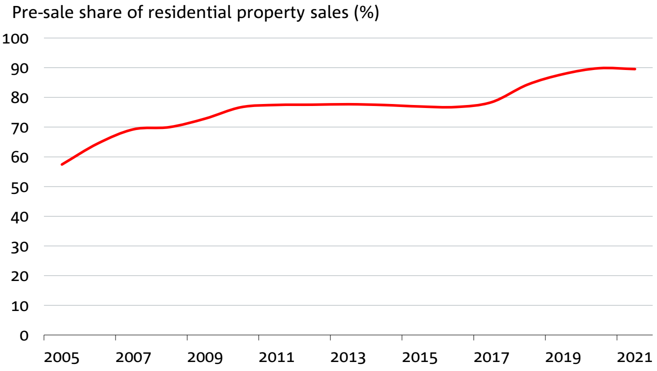
A recent mortgage strike – related to the failure of property developers to deliver pre-sold apartments to their purchasers – has fuelled fears of a financial crisis in China. While these fears appear somewhat overblown, as mortgages impacted by the strike represent a small share of lending, deteriorating confidence could impact property activity and drag on China's economic growth going forward.

## MORTGAGE HOLDERS STRIKE ON UNDELIVERED PROPERTIES

In late June, a group of residents in Jingdezhen, a mid-sized city in Jiangxi province, commenced an unprecedented mortgage strike, refusing to repay their loans for an Evergrande developed property project where construction had been stalled for more than a year. This was an extremely unusual action, given that officials generally do not tolerate any form of protest in China. Despite efforts to censor news regarding this action in both traditional and social media, the mortgage strike has quickly spread. While there is no official data to confirm the scale of these protests, an independent data project on GitHub titled "WeNeedHome" is tracking the progress, with 343 projects (potentially representing hundreds of thousands of individuals) in 119 cities involved in the strike as of 21 September. The value of the mortgages associated with the strike is more difficult to ascertain – with estimates in a range from around US$150 billion to US$400 billion.

## CHINA PROPERTY SALES

**Pre-sales dominate property transactions**



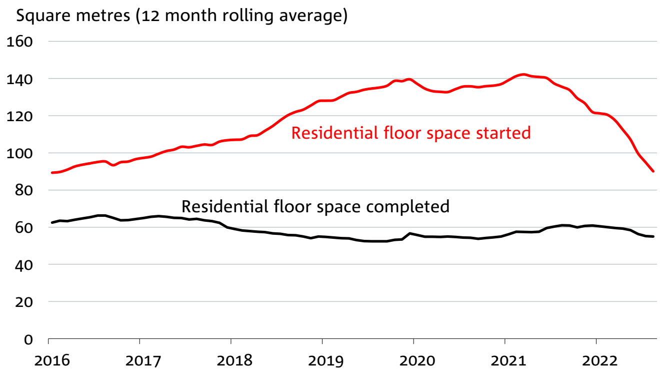

Source: Macrobond, NAB Economics

These projects have been developed by a range of different firms but share some common characteristics. In particular, these projects have been pre-sold – with many requiring full payment ahead of project commencing – but have remained unfinished by the developer. Official data show that pre-sales have accounted for around 90% of new property purchases in 2021, compared with less than 60% in 2005.

Failure to complete property projects is far from unprecedented – according to estimates by Nomura, China's developers only delivered around 60% of the total pre-sold residential properties between 2013 and 2020. A survey by Chinese tech firm Tencent suggested that around 45% of homebuyers experience problems of unfinished buildings to differing degrees.

## CHINA REAL ESTATE CONSTRUCTION

**Long running disparity between construction starts and completions**




Source: Macrobond, NAB Economics

A large part of this problem reflects a lack of appropriate supervision over the finances of property developers over recent years. In theory, the pre-sale payments made by purchasers should be held in escrow-type accounts and only accessible to the developers to make payments at specified times during the process of completing projects. In practice, developers have frequently been permitted to access these funds for other purposes – including as collateral for loans for land purchases or new developments. The importance of land sales as a key source of local government revenue and new projects as a source of local and provincial economic growth may explain this practice.

When pre-sale funds from individual projects have been exhausted, there has previously been little incentive (either financial or regulatory) for property developers to complete the projects. This has allowed developers to delay completion or simply abandon projects, moving on to more profitable activities elsewhere.

## MORTGAGE STRIKE APPEARS UNLIKELY TO TRIGGER FINANCIAL CRISIS

In such an environment, property developer debt ballooned over recent years. In an effort to curb the excesses of the sector, Chinese authorities introduced the "three red lines" policy in August 2020. This introduced a series of debt ratios that companies had to meet or exceed to avoid restrictions on lending. Subsequently various property developers have defaulted on corporate bond repayments, with Evergrande – at the time the country's second largest developer – the most high profile example in December 2021.

Given the scale of property sector debt and the way it has been intertwined through the shadow banking sector, there have been various concerns that property developer defaults could escalate into a financial crisis. So far, authorities have been able to manage the fallout from these defaults – in part due to bailout payments made to domestic bond holders.

Despite the attention the mortgage strike has generated in global media, it appears unlikely that it is large enough to have a significant impact on China's financial sector. A recent study by Standard & Poor's estimated that there were around RMB 4.9 trillion worth of residential mortgage loans tied to unfinished projects by distressed property developers at the end of 2021, of which they note a portion of these projects would be delayed rather than abandoned.

These identified loans account for almost 13% of total mortgages and just 2.6% of total lending – meaning that from a broad financial sector perspective, any losses associated with these loans being non-performing should be easily absorbed. This view has been presented by major banks, such as China Construction Bank, Agricultural Bank of China and Industrial Bank, however it is possible that smaller institutions could face greater challenges associated with these mortgages.

## CONCLUSIONS

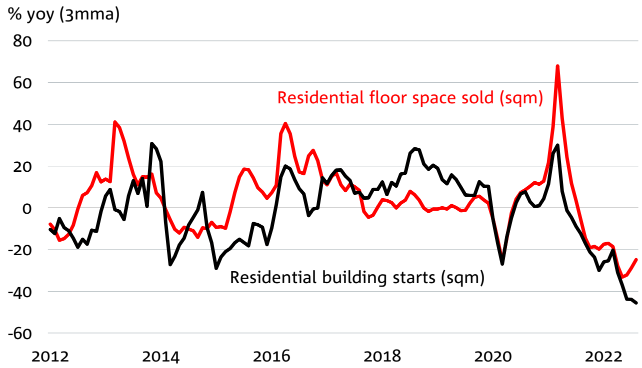
At the late July meeting of the Politburo, Beijing instructed local governments to ensure timely delivery of homes under construction that had already been paid for. Various local governments appear to be working with banks, state-owned enterprises, asset management firms and property developer shareholders to fund unfinished projects, however the scope of these efforts and progress is so far unclear.

While some think tanks and domestic analysts have urged bailouts for property developers, such a move maybe unpopular particularly given the risk of moral hazard. However, failing to do so could result in a large number of bankruptcies – given the high debt of the sector, deterioration in property market conditions and the impact of the "three red lines" policies – and further strain local government finances. It remains to be seen whether this argument has support among policy makers.

Regardless of any decisions around financial support for property developers, a key concern regards consumer sentiment towards property going forward. New construction activity has slowed significantly – the total area of new residential starts fell by over 47% yoy in August – while property sales have also sharply contracted.

## PROPERTY TRENDS DETERIORATING

**Sales and construction starts contracting**




Source: CEIC, NAB Economics

Given the importance of property to China's economy, this has the potential to drag on growth for some time. A protracted slowdown in construction activity would have a flow on impact for household goods manufacturing and retail as well as global commodity demand – particularly Australian iron ore feeding China's steel industry. Executives of China

Baowu – the country's largest steel maker – warned at a conference in June that China could experience a multi-year property slump, which would negatively impact steel demand.

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