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China's deflating property market threatens wider economic trouble

China's woes could prove to be the global economy's biggest blow.

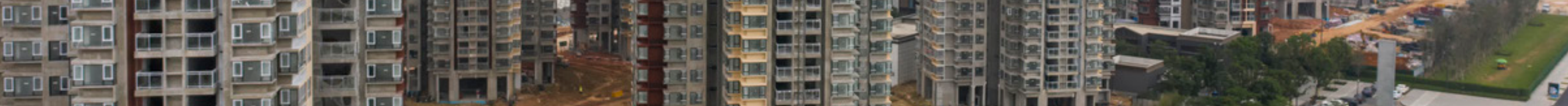
The Reserve Bank of New Zealand a year ago became the first advanced central bank to raise interest rates to cool its economy to tackle inflation. So far, the RBNZ has lifted its key rate seven times. The Bank of England, starting last December, has boosted its benchmark rate seven times too. The Reserve Bank of Australia has hiked the cash rate six times in six months; the Bank of Canada five times in seven months. The Federal Reserve has hoisted interest rates five times over six months. The European Central Bank has conducted two rate increases, one by a record amount. In the emerging world, Banco Central do Brazil has raised its Selic rate by 11.75 percentage points in 12 steps. The tally for El Banco Central de la República Argentina is eight increases that tally to 29.5 percentage points. The Reserve Bank of India has boosted its policy repo rate three times this year. What's the People's Bank of China done? It has loosened monetary policy again and again since late 2021.

In December last year, the PBOC ordered the cut of the one-year loan prime rate, one of two de facto benchmark lending rates.[1] In January, the PBOC forced cuts in the one-year and five-year loan prime rates, where the five-year rate is the other de facto key rate.[2] In April, the PBOC reduced the amount banks must hold as reserves so they had more to lend.[3] In May, the PBOC instructed banks to again cut the five-year loan prime rate.[4] In August, the PBOC orchestrated a spate of rate cuts,[5] instructed banks to keep lending,[6] and organised special loans of up to US$29 billion for property developers.[7] In September, to support a tumbling yuan that trades within a daily PBOC-set band, the central bank cut the bank forex reserve ratio[8] – yet 10 days later the currency still fell below 7 to the US dollar compared with 6.35 at the start of the year. Same month, the PBOC directed state banks to cut deposit rates for the first time since 2015,[9] manoeuvred to support the yuan that still fell to a record low of 7.2 against the greenback the next day,[10] and applied tweaks to encourage lending to first-time home buyers.[11] Over the 10 months, Beijing has repeatedly announced fiscal stimulus.[12]

Policymakers in China are pursuing such remedies because China's economy is hobbled in at least 10 ways. Standing out is the troubled property sector, which drives about 20% of GDP and represents about 66% of urban household wealth. The country is riddled with half-built residential buildings, which is deflating a property bubble. The history behind such worries is that policymakers super-stimulated the property market to compensate for lost exports to get through the global financial crisis of 2008-09. Since 2020, to quell overheating, however, officials under a 'three red lines' policy[13] have restricted credit to property companies, which has dented building activity and bankrupted developers (most notably, China Evergrande Group that has an estimated US$300 billion in liabilities).[14] Home prices have slid every month over the year to August.[15] Since Chinese buy off the plan, many people now own homes yet to be built – The Economist estimates that only 60% of homes pre-sold between 2013 and 2020 have been delivered.[16] Many of these dudded pre-buyers are boycotting mortgage payments – hundreds of thousands of borrowers in more than 100 cities, by some counts.[17] The property crisis so imperils the finances of local governments – they rely on land sales for much of their revenue – cities have implemented about 70 policies to support property, to little avail.[18]

The property crisis highlights a second weakness. The country's business, government and household debts reached 280% of GDP in 2019 and can't rise endlessly. Central government debt at 73% of output in 2022, while low by international standards, curtails Beijing's ability to bail out the property sector[19]

China's debt-fuelled property woes link into a third challenge; the stability of China's banks, especially the country's 4,000 small and mid-sized banks. In April, several small banks in eastern landlocked Henan Province failed. The fact that authorities silenced depositors entitled to compensation shocked China watchers, especially when on July 10 thugs assaulted depositors in front of police when they protested outside the People's Bank branch office in Henan's capital of Zhengzhou.[20] China's largest banks, having lent to property companies and to risky emerging



countries as part of the Belt and Road Initiative, are too shaky to absorb tottering smaller banks. The concern is that a rash of small bank failures could trigger a systemic financial crisis.

The perils surrounding China's banks are amplified by a fourth problem; covid-19. To enforce a zero-covid policy, Chinese authorities have locked down large cities to control the disease because they can't rely on the inferior China-made vaccines and refuse to import foreign ones. These repeated lockdowns of up to 30% of China's population have stifled economic activity, created youth unemployment of 20%, undermined business and consumer confidence, prevented people from scouting for properties and stirred protests. This lockdown blow to the economy blunts the effect of monetary and fiscal stimulus. China's wobbly banks are no longer protected by the double-digit economic growth of yesteryear, or even the 7.1% annual growth from 2011 to 2020.

China's worst-ever heatwave and the linked drought is a fifth economic misfortune, even if a temporary problem.[21] Factories have been forced to cut production because hydro generation has halved.[22] Water levels have dropped enough to impede river trade. Food prices have jumped. Authorities have warned the drought poses a "severe" threat to the coming autumn harvest, when 75% of the country's grain is gathered.[23]

China's sixth trial is that the rate increases implemented by about 90 central banks (according to Bloomberg's tally) are reducing demand for Chinese exports.[24] A seventh worry is that the deglobalisation fanned in part by China-US tensions deters the Western investment that drove China's economic ascension. Higher wages in China, as part of the government's spluttering push to switch from an export-and-investment-led economic model to a consumption-driven protype, deters investment too.

An eighth handicap is China-US strains are cutting China off from Western technology, especially related to artificial intelligence, microchips and supercomputers. A ninth and durable impediment is China's poor demographics. A record low fertility rate of 7.52 births per 1,000 people mean the country's population of 1.4 billion is ageing and close to shrinking, commonly accepted as drags on economic dynamism.[25]

A tenth handicap is President Xi Jinping's nationalistic and statist ideological bent. Xi favours state intervention in the economy. He has diverted resources to the state sector and preferred industrial ventures while curbing the dynamism of the private sector, especially that of the technology industry. Productivity, the lifeblood of rising living standards, is threatened.

China's troubles mean its economy is expected to expand only about 3% in coming years, effectively at recession levels – the World Bank in October reduced its China growth forecast for 2022 from 5% to 2.8%. Such a slowdown comes with local and global consequences. Within China, the biggest risk is the public's faith in the Chinese Communist Party could be tested, especially people's confidence in Xi, China's most powerful ruler since Mao Zedong. Disagreement over an economic recovery plan is even stirring opposition to Xi inside the Communist Party, including within the supreme Politburo Standing Committee (cabinet). "For the first time since the 1989 Tiananmen Square protests, China's leader is facing not only internal dissent but also an intense popular backlash and a real risk of social unrest," assesses Cai Xia, a professor at the Central (Communist) Party School from 1998 to 2012.[26]

Any China slump would be felt around the world because China's output comprises about 19.6% of global GDP on a purchasing-power-parity basis. Many of the commodities, currencies and other assets, priced on an assumption that China will endlessly expand, could falter. Countries dependent on China (Australia, Brazil and Germany that just recorded its first trade deficit since 1991, to cite two) might struggle. Stressed emerging countries tied to the Belt and Road Initiative could suffer because China, having spent US$1 trillion on the project, is no position to release them from punishing terms.[27] A Xi-led CCP under pressure at home could double-down on 'wolf warrior' diplomacy and nationalism. Some fret it makes an invasion of Taiwan more likely.[28]

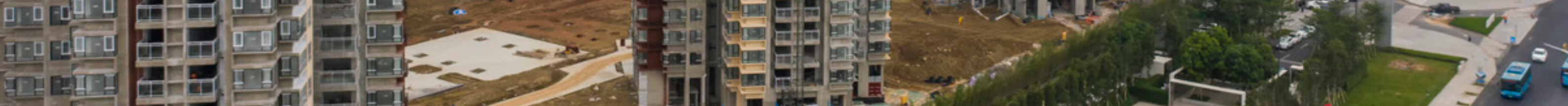
China escaped the worst of the global financial crisis but its reaction may have cultivated a local brew of the same toxicity that makes it unlikely China will become the world's biggest economy any time soon, even ever. At the very least, an era of slow Chinese growth is dawning. At worst, a Chinese implosion could be the biggest blow of all for a fragile world economy.

To be sure, China's economy is still expanding, the manufacturing sector is in fine shape and the country's state-backed financial system can absorb huge losses. A drop in imports is preserving China's trade surplus. China's spending on research and development now reaches 85% of that spent by the US. So innovation must be coming that will spur productivity.[29] There are no signs the masses are unruly. With its surveillance technology, perhaps no autocratic regime has been better equipped to stifle dissent. Xi is expected to cement a third term. But his power might be weakened in the process, perhaps a beneficial outcome. Rather than fuel aggression, China's economic woes might push Beijing towards a rapprochement with Washington.[30] China's slowdown at least helps the world curb inflation. Beijing's move towards a consumption-driven economy is the right long-term solution, as is prioritising high-tech and renewable sectors. But such solutions will take time.

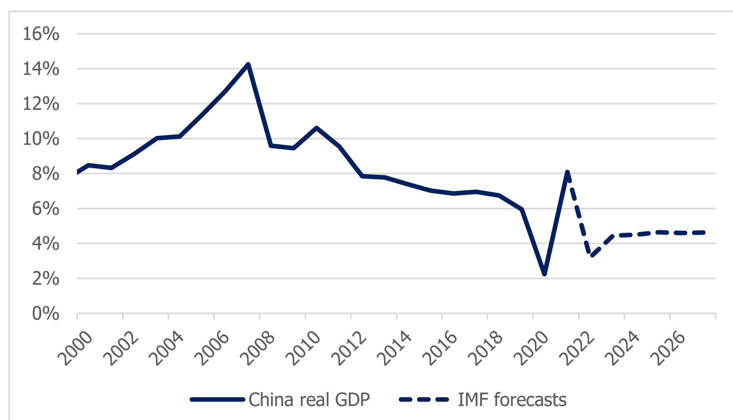
They can't quickly solve that four decades of growth have stirred imbalances that Xi is exacerbating with lockdowns, aggression abroad and an ideology that restrains economic development. Even more PBOC support might be insufficient to avoid the worst.

By Michael Collins, Investment Specialist

Source: China's economic statistics come from the IMF's World Economic Outlook Database released in April 2022 unless otherwise stated. The database can be found at: imf.org/en/Publications/WEO/weo-database/2022/April. China's non-financial company, government and household debts in 2019 are from the Bank of International Settlements.*By Michael Collins, Investment Specialist*



China's slowing economic growth



Source: IMF World Economic Outlook database 2022

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