# CHINA ECONOMICS UPDATE

## Country Garden is Evergrande-lite but worse-timed

- **Financial problems at Country Garden, once considered among China's strongest developers, will further undermine confidence among homebuyers and creditors, exacerbating the property downturn. The sector has already gone through a wrenching adjustment and its problems are now widely known, so the impact of Country Garden's woes is unlikely to be as severe as the fallout from Evergrande's default two years ago. Still, with the economy in worse shape now than it was then, even a smaller hit could be destabilising.**
- Country Garden, China's largest developer by sales as recently as last year, missed interest payments on two offshore bond last week. It then issued a profit warning for the first half of 2023, hired an external advisor to restructure its public debt and suspended trading on eleven onshore bonds. Its stock price has fallen 49% since the start of the month and its bonds now trade at less than 10% of face value.
- This is noteworthy because, in addition to its size, Country Garden was previously viewed as being in relatively good shape compared to most other private developers. Last November, it was included in an official list of "high quality" developers that were made eligible for additional credit assistance from state banks and government guarantees on their bond issuance. **Country Garden's problems underscore just how bad financial strains in the property sector have become, as well as the failings of existing policy support measures**.
- **If the situation at Country Garden spirals, it may end up being the straw that breaks the camel's back in terms of support for private developers**. Policymakers have so far refrained from state-funded bailouts, opting for more modest and indirect support instead. But this approach clearly isn't working as well as officials had hoped. They may conclude that, with the economy in the doldrums, they have little choice but to change tack and deploy government funds to prevent another wave of private developer failures.
- **That still seems unlikely, however**. Policymakers are keen to avoid moral hazard and let the market discipline private developers. They have also shown a great deal of restraint in response to recent economic headwinds – it seems their tolerance for slower growth is much higher than in the past. **To the extent that they do roll out greater stimulus, they would surely prefer to do so via other channels**, such as increased infrastructure spending.
- **This points to a second, more likely scenario, in which Country Garden faces a slow-motion collapse** via a drawn-out restructuring process, similar to Evergrande. **This would further undermine the confidence of homebuyers and creditors in private developers**, exacerbating their liquidity problems and making it harder for policymakers to put a floor beneath property sales and construction.
- Country Garden's woes will encourage an even higher share of households and lenders to avoid dealings with developers altogether. Others may still be willing to do business with state developers, which are perceived as being safer. But the state developers don't have large enough inventories to make up for fewer sales by their private counterparts. And even state firms are reluctant to acquire more assets (and therefore debt) in the current environment.
- **Another wave of private developer failures will also strain the balance sheets of financial institutions**. Foreign investors have mostly already jumped ship. But domestic players still have significant exposures. Outstanding credit to developers represents around 12% of GDP, the bulk of which is ultimately held by onshore commercial banks and institutional investors.
- Because Chinese banks benefit from an implicit government backstop, a further increase in their losses on property-related loans and investments need not result in major bank failures – even technically insolvent

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banks can continue operating provided they retain access to cheap funding. But a deterioration in their asset quality does make them more vulnerable to any future attempt by policymakers to withdraw state backing. And many non-bank financial institutions with property exposure, such as trust companies, do not benefit from the same degree of state support and so we could see them fail in greater numbers.

- **On the whole though, the hit to economic activity and financial sector balance sheets from Country Garden's woes is unlikely to be as severe as the fallout following Evergrande's default two years ago**. The latter set in motion a wrenching adjustment in home sales – which have since fallen 42% – and in developers' access to affordable financing – offshore yields soared while domestic creditors pared back their exposure to the sector.
- Unlike in mid-2021, the challenges facing Chinese developers are now widely known. Prior to the Country Garden news, offshore high-yield bonds were already trading at less than 40 cents on the dollar. (See Chart 1.) While the firm's troubles are a sign that the situation is even worse than many previously thought, **the resulting repricing of counter-party risk, not just in the credit markets but also in the minds of potential homebuyers, is likely to be far smaller than it was after Evergrande's default**.
- **Meanwhile, although domestic financial institutions still have sizeable exposures to property developers, these aren't as large as they used to be** – lending to developers now represents 5.1% of commercial bank loan books, down from 6.6% a couple of years ago. As such, even a similar rise in the non-performing share of developer loans would have a smaller impact on banks' aggregate NPL ratios.
- If anything, fewer delinquencies are likely this time given that policymakers have since pivoted from actively curtailing developers' access to financing toward promoting it, making it easier for developers to stay afloat. Following this shift to a more supportive stance late last year, developer bond defaults have dropped back. (See Chart 2.)
- **Although the direct fallout from Country Garden is likely to be more modest than Evergrande, it comes at a more inopportune time** when the wider economy is much weaker and the balance sheets of corporates and financial institutions are in worse shape. As such, **a hit to growth that would normally be manageable risks tipping the economy into a viscous cycle between falling output, deleveraging and deflation**.
- **Our base case assumes that such an outcome will be avoided**, with a step-up in wider policy support resulting in a modest reacceleration in growth over the coming quarters. **But Country Garden's woes raise the risk that policymakers miscalculate and fail to do enough to cushion the impact**.

**Chart 1: ICE BofA High Yield China Corporate Issuers Index (4th Jan. 21 = 100)**

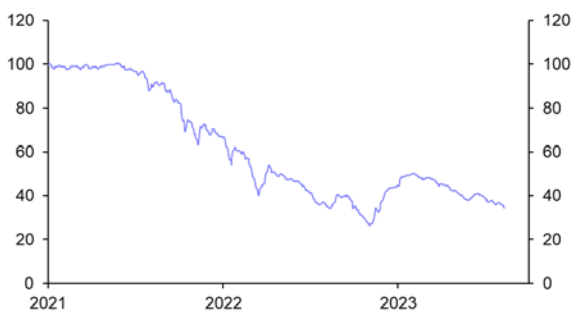
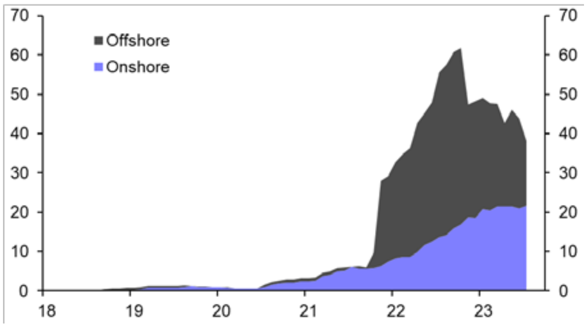



**Chart 2: Real Estate Sector Bond Defaults (RMB bn, 12m rolling ave.)**




Sources: Refinitiv, WIND, Capital Economics