Box 1.1

THE SLOWDOWN IN CHINA'S REAL ESTATE SECTOR AND ITS POTENTIAL CHANNELS OF DOMESTIC AND INTERNATIONAL TRANSMISSION

The main Chinese economic indicators have recorded negative surprises in recent months, after recovering early in the year thanks to the economic reopening once the country abandoned its zero-COVID policy. Specifically, consumption and investment have begun to show signs of exhaustion as growth drivers. Exports have also suffered in the face of weak global demand and geopolitical tensions.

The economic uncertainty has been exacerbated by the problems currently facing the country's real estate sector, which appear to be getting worse. These difficulties began to emerge in the summer of 2020, when the Chinese Government, seeking to curb speculative pressures and deleverage the sector, introduced its "three red lines" policy,[1] which compelled property developers to adopt financial sustainability standards, thus limiting their debt capacity.

As a result, some property developers experienced serious liquidity problems. In fact, in September 2021 concerns over the solvency of Evergrande, then one of China's largest property developers by size and debt, fuelled fears that the problems might spread to a broader swathe of the real estate sector, with the emerging threat of disorderly defaults posing a global systemic risk.

Since then, faltering confidence in the sector's solvency and its capacity to complete the construction projects under way have made it increasingly challenging for property developers to access financing. Indeed, there has been a significant decline in the financing raised by the sector both on the markets and from bank and non-bank financial intermediaries, as well as through "pre-sales" (off-plan sales where the buyer puts down a deposit for a large share of the housing unit's value) (see Chart 1).

The reappearance this summer of liquidity problems at some of the country's main property developers – notably including Country Garden, which had to request that its payment obligations be delayed – and the non-bank intermediaries that financed them revived the issue of ailing confidence in the sector. Indeed, housing sales have slowed markedly in recent months, all other sources of property developer financing have tightened sharply and the heavy declines in land sales, new construction starts and real estate investment all point to a downturn in the sector (see Chart 2). In this context, house prices have stagnated in recent quarters (see Chart 3).

The problems seem mainly concentrated among private developers, which find themselves in the most financial distress. According to the International Monetary Fund (IMF),[2] in 2023 a group of property developers jointly accounting for around 30% of total sector assets were at risk of insolvency (understood as those with negative equity). The situation facing property developers has already had ramifications for non-bank intermediaries, which are comparatively more exposed to this sector. Indeed, some financial institutions, such as Zhongrong Trust,[3] also appear to have struggled this summer.

The contribution of the real estate sector to the Chinese economy has grown notably in recent decades, and therefore its difficulties have led to a wave of pessimism over the potential ramifications for global growth and financial stability. It is estimated that the real estate sector accounts for around 15% of Chinese GDP and employment, although some studies suggest an even greater contribution factoring in its indirect effects on other sectors.[4]

The problems at property developers could feed through to the bank and non-bank financial intermediation sectors in particular. However, bank loans to property developers make up a small share of the total (5%-8%, depending on the year) and the banking sector appears to have limited its exposure to such loans in recent years (see Chart 4). Non-bank financial intermediaries are subject to less banking regulation and have therefore been able to build more exposure to higher-risk sectors, such as lending to

1 In particular, property developers' debt capacity was restricted based on three ratios: (i) the liability-to-asset ratio must not exceed 70% (excluding advance payments), (ii) net debt (debt less equity) must be lower than 100% of equity, and (iii) the cash-to-short-term debt ratio must be at least 100%.

2 IMF (2023). "Global Financial Stability Report 2023: Safeguarding financial stability amid high inflation and geopolitical risks".

3 Zhongrong Trust is a Chinese wealth management company that, through its investment activity, is an important source of non-bank financing. At end-2022 it had $87 billion worth of funds under management. It is, in turn, linked to Zhongzhi, a large Chinese private conglomerate with interests in the financial sector, mining and vehicles.

4 In Kenneth Rogoff and Yuanchen Yang. (2021). "Has China's housing production peaked?" *China and the World Economy 21 (1): 1-31,* the authors use input-output tables to assess the effects of a real estate sector shock considering not only the first-order effects but also the indirect effects of its interaction with other sectors, finding that the real estate sector accounted for around 29% of GDP in 2017.

Box 1.1

THE SLOWDOWN IN CHINA'S REAL ESTATE SECTOR AND ITS POTENTIAL CHANNELS OF DOMESTIC AND INTERNATIONAL TRANSMISSION (cont'd)

Chart 1
Sources of financing for property developers (a)

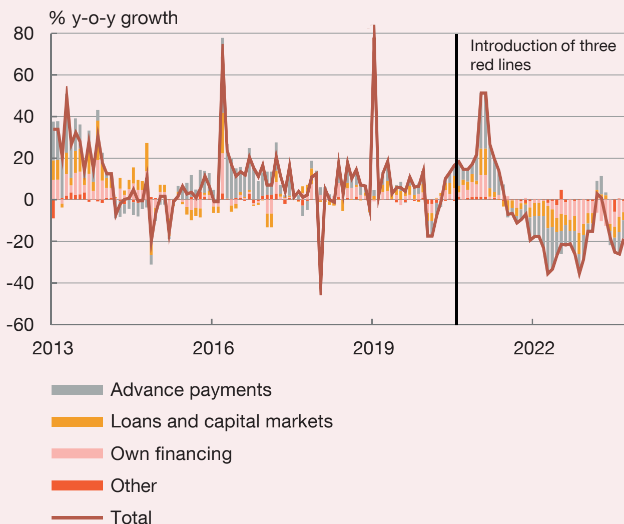


Chart 2
Real estate market situation: Volumes

Chart 3
Real estate market situation: Prices

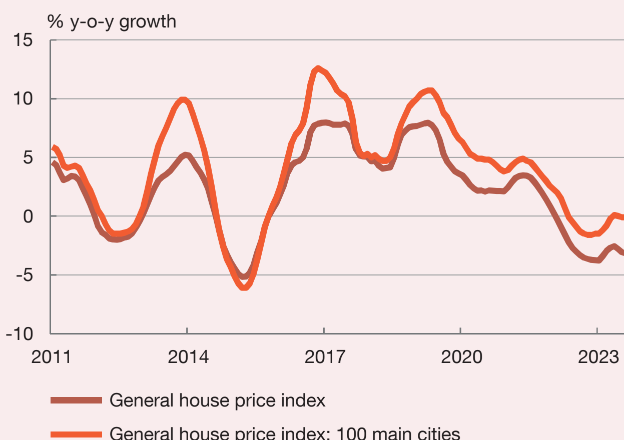
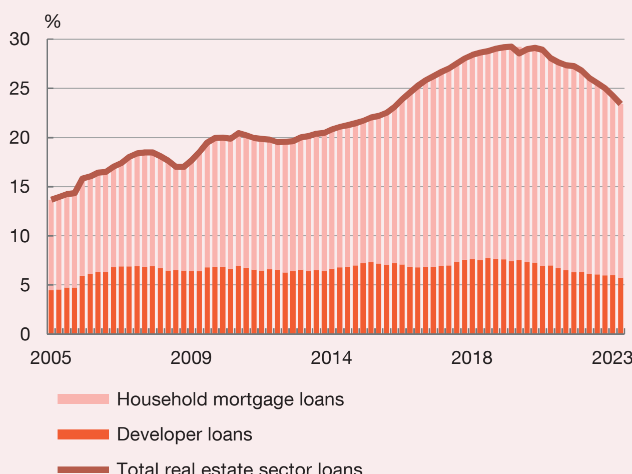


Chart 4
Real estate sector loans as a percentage of total loans. Banking Sector



SOURCES: CEIC and Refinitiv Eikon.

a "Loans and capital markets" includes domestic and foreign loans, along with other foreign funds received for construction and fixed asset investment. "Own financing" refers mainly to extra-budgetary funds received by ministries, local governments, firms and institutions. "Other" includes other sources of financing such as capital raised through bond issuance by firms or financial institutions, funds raised from individuals through donations and funds transferred by other units.

property developers and local public debt. However, non-bank financial intermediation accounts for 5% of the Chinese financial system, a figure that regulators have succeeded in bringing down in recent years (see Chart 5) by introducing more stringent measures to mitigate the financial risks posed by this industry.[5]

5 See Jacopo Timini. (2017). "China's economic imbalances and the role of the financial sector". *Economic Bulletin - Banco de España,* 4/2017, Analytical Article for a description based on a longer time horizon.

Box 1.1

THE SLOWDOWN IN CHINA'S REAL ESTATE SECTOR AND ITS POTENTIAL CHANNELS OF DOMESTIC AND INTERNATIONAL TRANSMISSION (cont'd)

The situation in the real estate sector may also affect households via a number of channels. The solvency and strength of household balance sheets will largely depend on house price developments in the event of a significant real estate correction. In the past, however, Chinese housing market corrections have largely been felt in terms of transaction volume (i.e. the number of properties sold), whereas prices tend to be more stable (see Charts 2 and 3). Indeed, since 2011 no price correction episode has exceeded 5%, far less than the corrections seen in the United States and Spain following the 2008 financial crisis. However, as noted above, the real estate sector could account for as much as 15% of total employment. Therefore, a significant correction in construction and housing sales could have an impact on households by substantially reducing their income.

As for household mortgage loans, the risk of widespread defaults seems limited for the time being. First, because banks have reduced their exposure to such loans in recent years (see Chart 4), just as they have to property developers. Second, macroprudential controls in China and the widespread adoption of the pre-sales system have kept loan-to-value (LTV) ratios relatively contained.[6] This, coupled with steady house price growth in recent decades, has given household wealth a sizeable boost thanks to assets growing in value more than liabilities (see Chart 6). However, household debt has risen significantly in recent decades, standing close to the average for advanced economies (see Chart 7).

According to some estimates, under a severe scenario of defaults among households and property developers, the overall banking system would be materially affected but would remain resilient. The IMF estimates that, under a scenario in which 10% of exposures to distressed property developers and 10% of mortgage loans to households become non-performing, 15% of banks would no longer meet minimum capital requirements.[7]

The bulk of these would be small banks and "domestic systemically important institutions", while larger banks[8] – which tend to have higher capital adequacy ratios than their smaller counterparts (see Chart 8) – would show resilience. In any event, for the time being non-performing loan (NPL) ratios remain subdued, although they are somewhat higher among rural institutions (see Chart 9).

The slowdown in the real estate sector could also aggravate the funding strains on local governments, with ramifications for the financial sector owing to "local government financing vehicles" (LGFVs). These LGFVs, which finance local government infrastructure and construction projects, buy up land from municipal governments and often use it as collateral to raise financing through bank credit or via bond issuance. The exponential growth in the debt of LGFVs, which the IMF estimates to represent around 45% of GDP in 2022, has raised concerns about their high leverage given their limited revenue-generating capacity and their reliance on local governments.

In China, land sales represent an important share of local government revenue, especially in smaller municipalities where such revenue can represent more than 40% of the total (see Chart 10). The real estate market downturn is likely to reduce that revenue, possibly aggravating the financial strains on local governments and limiting their fiscal policy headroom, as well as posing additional risks to the Chinese financial system.

For instance, estimates suggest that a substantial share of LGFVs would not be viable without central government support and restructuring. According to the IMF, the upshot of banks ultimately absorbing half of the debt restructuring costs would be considerable bank losses, particularly among local banks whose capital ratios might fall below the minimum requirements.

The Chinese Government has launched a package of measures to counter the potential adverse impacts on the country's economy and preserve financial stability.

These include restructuring the debt of the most distressed property developers and providing liquidity to help them complete projects already under way. Further, in order to

6 The average LTV ratio for primary homes stands at 63%, compared with 38% for second homes. See Kaiji Chen, Qing Wang, Tong Xu and Tao Zha. (2020). "Aggregate and distributional impacts of LTV policy: evidence from China's micro data". NBER Working Paper Series, 28092, National Bureau of Economic Research.

7 IMF (2022). "Global Financial Stability Report 2022: Navigating the high inflation environment".

8 Including those classified as "global systemically important banks".

Box 1.1

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Chart 5
Financing from non-bank financial intermediaries as percentage of total

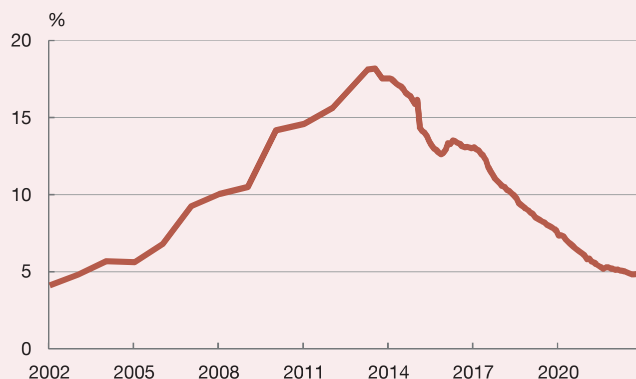


Chart 6
Household financial accounts (a)

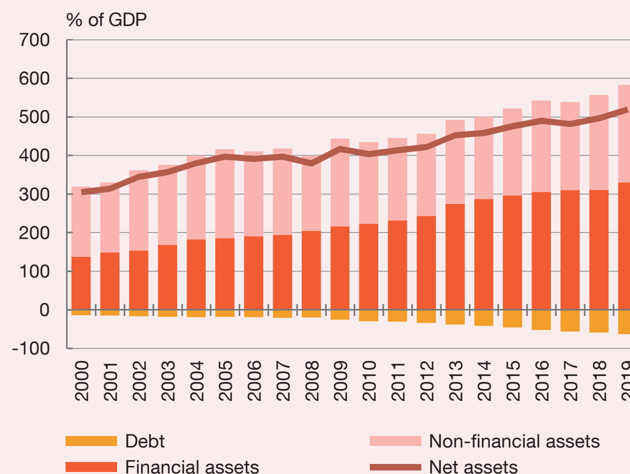


Chart 7
Household debt (b)

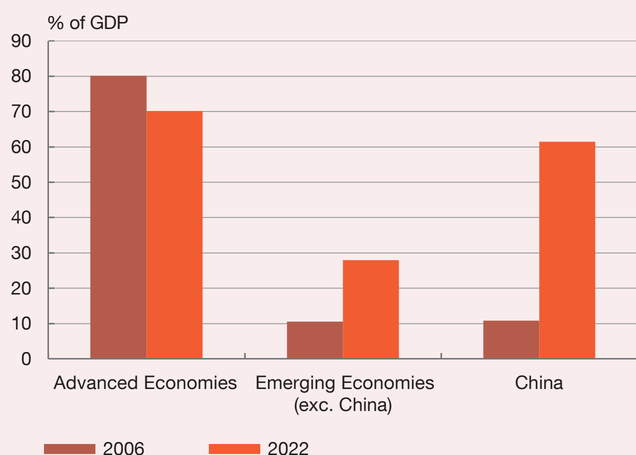
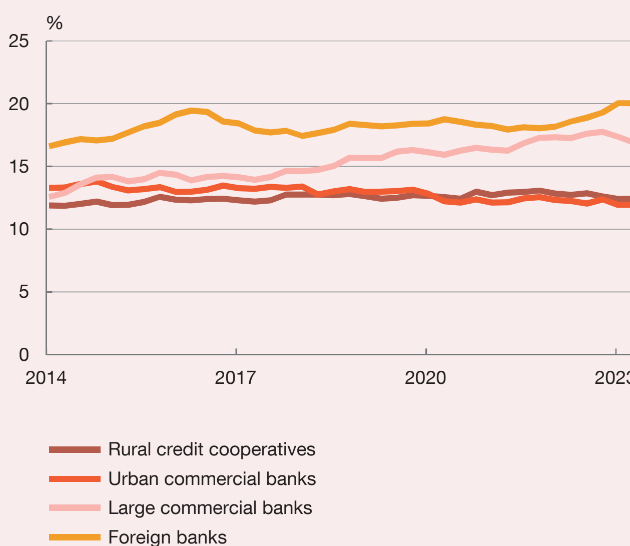


Chart 8
Total capital ratio (c)



SOURCES: CEIC and IMF.

a Virtually all of households' non-financial assets are homes and just a small share is comprised of other assets such as vehicles or agricultural equipment. See "China's National Balance Sheet – 2020", *Center for National Balance Sheet, National Institution for Finance and Development, Chinese Academy of Social Sciences.*
b The group of advanced economies comprises the United States, Japan, United Kingdom, Germany, France, Italy, Canada and Spain, weighted by GDP valued at purchasing power parities. The group of emerging economies excluding China comprises India, Russia, Indonesia, Brazil and Mexico.
c In China, rural credit cooperatives tend to be small, while urban commercial banks tend to be medium sized.

boost housing demand by improving households' access to financing, in September 2023 the Chinese Government implemented some of the most substantial easing of housing market regulations since 2015, such as lowering the minimum down payments for house purchases and reducing the regulatory floor for mortgage rates. The Government may reassess these measures based on sector developments in order to stave of potential medium and long-term imbalances.

Other measures, such as cutting the main monetary policy rates, also seem geared towards anchoring the sector

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Chart 9
NPL ratios

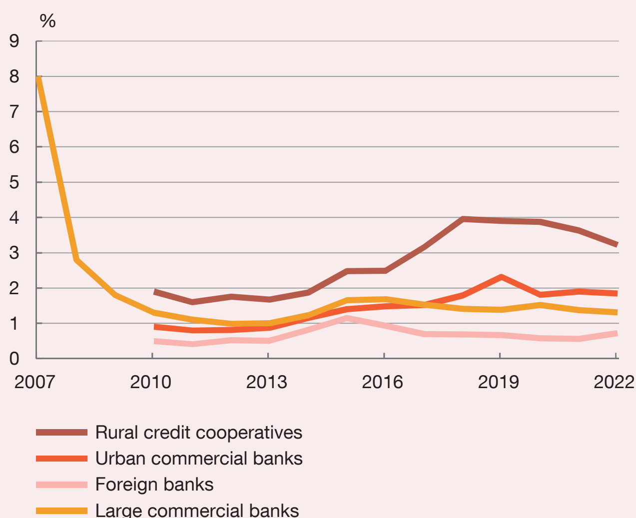

Chart 10
Local government: revenue from land sales (2020) (a)

SOURCES: CEIC and Kenneth Rogoff and Yuanchen Yang (2022).

a Kenneth Rogoff and Yuanchen Yang (2022) classify cities into three tiers based on their size and economic importance. Large cities such as Beijing, Shanghai, Guangzhou and Shenzhen are tier 1. Other medium-sized but historically more economically developed cities, such as the provincial and regional capitals, are tier 2. All other cities belong to tier 3. For a full list, see Kenneth Rogoff and Yuanchen Yang. (2022). "A tale of tier 3 cities". IMF Working Paper WPIEA2022196.

and the economy as a whole. In any event, the outcome of these measures remains highly uncertain, with no estimates as to their effectiveness or economic impact.

These risks could be transmitted through to the global economy via several channels.

First, the trade channel, since the European economy has significant exposure to Chinese demand, both directly (through exports) and indirectly (through sales of goods to countries that export to China). In the case of the euro area, according to Eurostat data, in 2022 China accounted for 16% of non-EU imports and 7.3% of exports.

Second, China is one of the largest buyers of energy and metal commodities. Therefore, a slowdown in Chinese growth is likely to drive down prices, particularly in the case of precious metal commodities which are more sensitive to activity in the Chinese real estate sector.

Lastly, a third channel, that of financial exposures, is less significant due to the Chinese capital account not being fully open. The indirect channels include the potential for greater uncertainty and a deterioration of global confidence, which could trigger a flare-up of risk aversion in international markets, with stock markets declining and risk premia rising.

A significant slowdown in the Chinese economy would have a limited impact on economic growth in Spain and the euro area, except in the most severe scenarios. Estimates by the Banco de España, assessing the impact of a Chinese economic slowdown transmitted through the three above-mentioned channels (trade, commodities and confidence),[9] suggest that a

9 These channels are assessed using a NiGEM global econometric model, simulating a permanent 1 pp drop in Chinese growth, 80% of which is attributable to investment (the trade channel). Shocks of 6.9% in the price of oil and of 7.8% in the price of industrial metals are also introduced, consistent with said 1 pp drop in Chinese growth (the commodities channel). Lastly, it is assumed that the deterioration in confidence and the increase in uncertainty prompted by the slowdown takes the form of a stock market correction of 10% in the Chinese, European, Japanese and US markets, an increase of 50 basis points (bp) in the equity risk premium and of 60 bp in long-term interest rates in emerging market economies (the confidence channel). Bing Xu, Moritz Roth and Daniel Santabárbara. (2019). "Global impact of a slowdown in China". *Economic Bulletin – Banco de España,* 4/2019, Analytical Article.

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1 percentage point (pp) reduction in Chinese growth could reduce growth by around 0.2 pp in Spain and 0.3 pp in the euro area. For its part, the OECD, in its September 2023 report,[10] estimates that an abrupt slowdown in China, based on a tail scenario in which GDP declines by 2 pp together with a rapid tightening of global financing conditions, could reduce euro area growth by around 0.8 pp.

10 OECD (2023). "OECD Economic Outlook, Interim Report September 2023. Confronting Inflation and Low Growth".