GLOBAL MARKET REPORT

"Overview of the 2023 Chinese housing market and debt crisis"

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OVERVIEW OF THE 2023 CHINESE HOUSING AND DEBT CRISIS

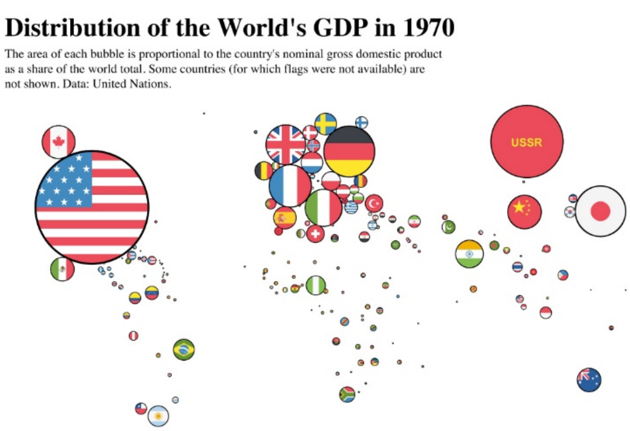
China's History and Rise to Power

Let's go back in time to 1970 and look at China. At that time, an agriculturally based, undeveloped country with a world's GDP share barely higher than Spain or Canada. With no connections to other countries and international markets, the progress was slow, and half of the country faced extreme poverty or homelessness. However, after the death of the infamous Mao Zedong, Deng Xiaoping took power and became famous for his far-reaching market-economy reforms. He opened the economy to foreign investors, encouraged international cooperation, and started the process of making China the global powerhouse as the "Architect of Modern China".

China heavily invested in infrastructure, roads, ports, and telecommunications. Thanks to that, it could achieve economic growth and low-cost manufacturing. It also adopted an expert-led strategy to become the "world's factory" by leveraging a large and cheap workforce. This fuelled further industrialisation in an astonishingly short time, leading to a spike in exports.

In the next decades, when the world became more globalised, China saw an opportunity. Using their comparative advantages and easy access to labour, they attracted foreign investors to become integrated into various Global Value Chains. China has also made substantial contributions to the research and development of advanced technologies. The country has become a leader in telecommunication, e-commerce, and renewable energy. This attracted further investment from abroad and expanded into manufacturers taking space in even more lucrative industries with higher added value. Then, to sustain it, the Chinese government ensured uplifting millions of people out of poverty and provided facilities and opportunities to the rural population.

The main factors that contributed to this transformation were the strategies created by Chinese authorities. They realised that what makes them stand out from other countries is the ability to easily mobilise their human and natural resources to obtain their ambitious goals. China was ready for future challenges, and with an increasingly stronger position internationally, they sought to establish themselves as a force to be reckoned with. The population expanded rapidly, and the fast economic reform led to growth and increased mobility. Hence, China has achieved the largest population in the world, further bolstering its position as a global factory with cheap and efficient labour. Additionally, it meant that China became a huge consumer market, with more and more people increasing their purchasing power and attracting businesses searching for a vast and growing market. China became a major trading partner for many countries. Hence, its economic and political performance has ripple effects worldwide, as we will see soon.



The Structure of the Chinese Housing Market

The Chinese housing market presents a complex picture, marked by significant government involvement, high homeownership rates, speculative investment, and a recent shift in buyer motivations.

Significant government involvement

The Chinese government plays a pivotal role in controlling land supply and imposing regulations. This can sometimes lead to market distortions. Measures include supporting property developers during crises, easing curbs on home purchases, and reducing mortgage borrowing costs. The Chinese government owns all the land in the country and grants land use rights to developers, individuals, and businesses for a fixed period of time, usually 40 to 70 years. This means that the government can control the supply and price of land, which affects the profitability and liquidity of developers and the affordability and availability of housing for consumers. The Chinese government also regulates the real estate market through various policies, such as setting limits on home purchases, restricting credit and financing, imposing taxes, and fees, and enforcing quality and safety standards. These policies are intended to prevent speculation, curb excessive debt, stabilise prices, and promote social welfare.

For example, in 2020, the Chinese government introduced the "three red lines" policy, which set caps on three financial ratios for developers: debt-to-asset ratio, net debt-to-equity ratio, and cash-to-short-term debt ratio. Developers that crossed these red lines faced restrictions on borrowing and expansion. This policy aimed to reduce the leverage and risk of the sector, but it also squeezed the cash flow and profitability of many developers, especially the smaller and weaker ones. Another example is the "housing is for living in, not for speculation" principle, which was reiterated by the Chinese government in 2017. This principle guided the implementation of various measures to cool down the overheated housing market, such as limiting the number of homes that individuals can buy, raising the down payment and mortgage rates, and increasing the taxes and fees on property transactions. These measures aimed to curb the demand and speculation, but they also reduced the affordability and accessibility of housing for many potential buyers, especially the young and low-income groups.

Therefore, the Chinese government faces a delicate balance between supporting the real estate sector, which is vital for the economy and social stability, and regulating the market, which is necessary for preventing bubbles and crises. The government has recently signalled a greater focus on housing demand, rather than supply, and announced some steps to ease the financing and tax burdens for developers and buyers. However, the challenges and uncertainties remain, and the outlook for the property market in 2022 is still unclear.

Supply Side Analysis

Overbuilding and "Ghost Cities"

There has been significant overbuilding in some areas, leading to "ghost cities" – underpopulated or empty urban areas. This represents a misallocation of resources, tying up capital in unproductive investments.

One of the most notorious ghost cities is Kangbashi district in Ordos, Inner Mongolia, which was built using profits from the coal industry boom. The district was planned to house more than one million people, but currently houses less than 100,000. The district has many extravagant monuments, spacious parks, modern buildings, and interconnected roads, but lacks the vitality and activity of a

normal city. Another ghost city is Tianducheng in Hangzhou, Zhejiang province, which was designed to mimic Paris, France. The city has a replica of the Eiffel Tower, a fountain inspired by the Versailles Palace, and Parisian-style architecture. However, the city has been largely vacant since its completion in 2007, and only has a few thousand residents.
Some analysts argue that the ghost cities phenomenon is overblown, and that some of these cities will eventually fill up and become vibrant communities. They point out that China has a huge demand for urban housing, as millions of rural migrants move to cities every year. They also cite examples of former ghost cities that have successfully attracted residents and businesses, such as Zhengdong New District in Zhengzhou, Henan province, and Yujiapu Financial District in Tianjin. However, other analysts warn that the ghost cities pose serious risks for China's economy and society. They argue that the ghost cities reflect the inefficiency and waste of China's top-down planning, the lack of market mechanisms, and the distortion of incentives for local officials and developers. They also contend that the ghost cities could trigger a debt crisis, a property bubble, and social unrest, as many people are priced out of the housing market or left with negative equity.

Market Reshuffle:

The real estate sector is undergoing significant changes. The previous high-turnover, high-debt business model is no longer sustainable, prompting a shift towards more stable operations and affordable housing, particularly for younger residents.
According to a report by the Financial Times, China's property market is facing a "structural shift" as the government tightens regulations and curbs speculation. The report cites analysts who say that the era of rapid growth and high profits for developers is over, and that the sector needs to adapt to a new reality of lower demand, lower prices, and lower margins.
The report also notes that the government is pushing for more affordable housing, especially for young people who are struggling to buy their first homes. The government has announced plans to build 36 million units of affordable housing by 2025, and to increase the supply of rental housing in major cities.
The report quotes Zhang Dawei, chief analyst at Centaline Property, who says that the property sector is undergoing a "great transformation" from a high-turnover, high-debt model to a low-turnover, low-debt model. He says that developers will have to focus more on quality, service, and innovation, rather than on scale and speed. Another report by the Wall Street Journal echoes the same view and adds that the shift in the property sector will have profound implications for China's economy and society. The report says that the property sector accounts for about a quarter of China's GDP, and that its slowdown will affect many related industries, such as construction, steel, cement, and furniture. The report also says that the shift in the property sector will affect the wealth and consumption of millions of Chinese households, who have invested heavily in real estate as a store of value and a source of income. The report cites a survey by the China Household Finance Survey Center, which found that the average urban household owns 1.3 homes, and that 22% of urban households own more than one home.
The report suggests that the shift in the property sector will require a rebalancing of China's economy, from investment-led growth to consumption-led growth, and from real estate to other sectors, such as technology, services, and green energy.

Demand Side Analysis

High Ownership Rates

Homeownership rates in China are exceptionally high, often exceeding 90%. This is influenced by cultural, economic, and policy factors. However, there's been a shift in buyer motivations due to government policies curbing speculation.
China had a home ownership rate of 89.68 percent in 2018, which was the tenth highest in the world and the highest among the major economies.
China's home ownership rate decreased to 89.68 percent in 2018 from 90 percent in 2014 but remained above the average of 89.89 percent from 2013 until 2018. The PBOC study estimated that China's urban home ownership rate reached 96 percent in 2019, which was likely the first country to achieve such a high level.
These facts show that homeownership rates in China are exceptionally high, often exceeding 90%. This is influenced by cultural, economic, and policy factors. However, there has been a shift in buyer motivations due to government policies curbing speculation.

Speculative Investment

Real estate is often seen as a safer investment than other options in China, such as the stock market, which is volatile and prone to manipulation, or the banking system, which offers low interest rates and limited deposit insurance. Real estate is also influenced by cultural factors, such as the preference for owning property over renting, the desire for social status and prestige, and the tradition of providing housing for children and parents. Real estate is also affected by policy factors, such as the government's control over land supply and financing, the lack of property taxes and capital gains taxes, and the restrictions on foreign exchange and overseas investment.
These factors have led to high demand and soaring property prices in major cities, especially in the first-tier cities, such as Beijing, Shanghai, Guangzhou, and Shenzhen. According to the National Bureau of Statistics of China, the average price of new homes in these four cities rose by 27.5% year-on-year in July 2023, compared with 4.8% for the whole country.

The high property prices have also attracted a lot of speculative investment, both from domestic and foreign investors, who hope to profit from the appreciation of real estate assets. According to a report by the Financial Times, China's property market saw a record $17.4 billion of foreign investment in 2022, up 38% from 2021.

Change in Buyer Motivations

The government's anti-speculation stance has altered buyer motivations. People are now purchasing homes more for living than as investments, influencing apartment designs to emphasise functional rooms. It is also reflected in various policies and measures that aim to curb the demand and speculation in the property market, such as limiting the number of homes that individuals can buy, raising the down payment and mortgage rates, and increasing the taxes and fees on property transactions. According to a survey by the People's Bank of China, the share of respondents planning to buy a home in the next three months rose to 17.5% in the first quarter of 2023, up from 16% in the fourth quarter of 2022, and the highest since the first quarter of 2021. The survey also found that 18.5% of respondents anticipated an increase in house prices, up sharply from 14% in the fourth quarter of 2022, and the highest since the third quarter of 2020.
The survey results indicate that more people in China want to buy houses again, but for different reasons than before. The survey found that the main motivations for buying a home were to improve

living conditions (58.8%), to meet family needs (18.3%), and to take advantage of favourable policies (10.9%). Only 5.4% of respondents said they wanted to buy a home for investment purposes, down from 6.6% in the fourth quarter of 2022, and the lowest since the survey began in 1999. The change in buyer motivations has also influenced the apartment designs to emphasise functional rooms, such as bedrooms, kitchens, and bathrooms, rather than decorative or luxury features, such as balconies, gardens, or swimming pools. According to a report by the Financial Times, developers are responding to the demand for more practical and affordable housing by reducing the size and price of their units, and by offering more flexible layouts and customisation options. The report cites examples of developers who have launched new projects that cater to the needs and preferences of the new generation of homebuyers, such as Country Garden, which has introduced a "micro-apartment" concept that allows buyers to choose from different modules and configurations, and Vanke, which has launched a "smart home" project that integrates digital technology and smart devices into the living space.

Aging Buyer Demographic

The average age of home buyers in Chinese major cities is between 36 and 38 years, indicating that many tenants have been renting for over a decade. This suggests a significant reshuffle in the real estate sector, as the demand and supply of housing may change, and the preferences and needs of buyers may differ from those of previous generations.

The average age of first-time buyers in China was 30 in 2019, up from 28 in 2013. This means that many young people have been postponing or giving up their home ownership plans, due to the high property prices, the tight credit conditions, and the government's anti-speculation policies. The average age of home buyers in Beijing was 36.5 in 2021, up from 35.5 in 2018. The average age of home buyers in Shanghai was 37.6 in 2021, up from 36.9 in 2018. The average age of home buyers in Guangzhou was 38.1 in 2021, up from 37.4 in 2018. These figures show that the home buyers in the first-tier cities are older than the national average, and that they have been renting for longer periods of time before buying their own homes.

The aging buyer demographic has implications for the real estate sector, as it may lead to a decline in the demand and price of housing in the long run, and a shift in the preferences and needs of buyers in the short run. For example, older buyers may prefer larger and more comfortable homes, rather than smaller and cheaper ones, and they may value the quality and location of the property, rather than the potential for appreciation and investment.

The Chinese housing market's current state underscores the risks of excessive reliance on real estate for economic growth and the dangers of unchecked speculative investments. The market is experiencing a transition period, marked by a need for policy reforms, market corrections, and a shift towards more sustainable growth drivers. Balancing growth with long-term market stability is crucial for the health of the Chinese economy.

Evergrande and Country Garden's Debt Crisis

Evergrande's Rise and Fall:

Evergrande, once a top-selling developer in China, followed a business model that heavily relied on accruing significant amounts of debt. Initially, Evergrande's aggressive expansion strategy, fuelled by massive borrowing, propelled it to the top of China's property market. This strategy initially paid off as home prices soared in China, but it eventually led to an unsustainable debt load. By 2021, Evergrande had accumulated debts totalling $300 billion, making it the most indebted property developer globally. The company's financial crisis became public in 2021, causing a major liquidity crisis in China's property sector and fears of it spreading to the country's banks. The crisis became evident starting in August, when many Evergrande projects across the country halted construction due to late payments. Then, in September 2021, the company missed two offshore bond coupon payments totalling $131 million. This led to a significant erosion of market confidence and raised serious questions about the sustainability of debt growth models in the real estate sector. Uncertainty increased further in March 2022, when Evergrande suspended trading in its shares, citing an inability to publish audit results before March 31. In addition, during the same period, an investigation into the property management business, which led to the seizure of 13.4 billion yuan of deposits by banks, contributed to raising uncertainty in the market.

As if that were not enough, after attempting to restore confidence in the market by announcing the resumption of work on 631 pre-sold and undelivered projects, in January 2023 Evergrande declared that the then auditor PricewaterhouseCoopers had resigned due to disagreements over issues related to the 2021 audit fuelling even more existing fears. After that, in March 2023, it proposed a debt restructuring plan, offering offshore creditors options to convert their debt into new securities. This proposal received considerable backing from the majority (77%) of class-A debt holders and a portion (30%) of class-C debt holders. However, the company's financial troubles deepened as it reported massive net losses for 2021 (476 billion yuan) and 2022 (105.9 billion yuan), starkly contrasting with its profitable operations in 2020 (+8.1 billion yuan).

Seeking amnesty, Evergrande aimed to utilise Chapter 15 of the U.S. bankruptcy code to protect itself from lawsuits and asset seizures in the U.S. This move came alongside the resumption of its stock trading after a 17-month halt, which saw a drastic reduction in market value. The Chinese government took significant steps, with the National Administration of Financial Regulation establishing a state-owned insurer to manage the assets and liabilities of Evergrande Life Insurance. Additionally, there were legal developments, including the detention of staff from Evergrande Financial Wealth Management and the postponement of a key restructuring meeting. This situation was compounded by offshore creditors considering a court petition to liquidate the company unless a revised debt restructuring plan was presented, highlighting the ongoing challenges and complexities in resolving Evergrande's financial crisis.

Country Garden's Struggle Amid Sector-wide Turmoil:

Country Garden, which was China's largest developer by sales through 2023, also faced significant financial strains, although its liabilities were only 59 percent of Evergrande's (about $194 billion in mid-2023). The company's systemic importance is underscored by its 3,103 projects across China, compared to Evergrande's 800. In addition, according to its recent annual report, the company is responsible for many jobs in China, with about 300,000 employees. But the once seemingly bulletproof firm has been struggling with a cash crunch in recent times. Its sales of apartments fell by 81% in September, compared with the same month last year. The developer reported a record $7 billion loss for the first half of 2023.

Country Garden's troubles are reminiscent of those of Evergrande. The company's struggles were highlighted as it faced 108.7 billion yuan ($14.9 billion) in debts due within 12 months while its cash levels were around 101.1 billion yuan, missed two-dollar payments and needed to negotiate with creditors to extend a 3.9-billion-yuan private bond. It also had monthly offshore bond payments due for the rest of 2023, and onshore bond payments totalling 12.6 billion yuan by year-end, according to CreditSights.

These financial strains were a major concern for the market, as a default by Country Garden could have severe implications for the entire Chinese economy. Consequently, Moody's downgraded Country Garden's credit ratings by three notches to Ca from Caa1 due to concerns about liquidity and the potential for default. Despite this, Beijing has not directly bailed out private developers like Country Garden. However, the Chinese government introduced measures such as mortgage rate cuts and eased home purchase restrictions to revive the market. This situation highlighted a broader issue in the Chinese real estate market: even financially robust companies were not immune to the sector's downturn, underscoring systemic risks and the need for a more sustainable financial approach. To sum-up, the debt crises of Evergrande and Country Garden are symptomatic of a broader problem in China's real estate sector, reflecting systemic risks and vulnerabilities. The scale of their debt and the systemic importance of these developers have significant implications for the Chinese economy and the global financial market. The unfolding situation demands close monitoring and may require more substantive interventions to stabilise the market and mitigate broader economic impacts.

Bear Market at the Stock Exchange

The crisis in the property sector has significantly impacted China's stock market. Major real estate companies have seen a sharp decline in their stock values, reflecting a loss of investor confidence. In fact, this decline reflected investors' concerns about the over-leveraged nature of the sector and its vulnerability to market changes. Moreover, the real estate sector's downturn was seen as indicative of broader economic challenges facing China, given the sector's substantial contribution to the national GDP and its linkages with various other industries.

One of the causes can be attributed to the policies pursued by the government in the last years. Indeed, the Chinese government's introduction of the "three red lines" policy in 2020, which limits borrowing based on a developer's debt levels, has contributed to the credit crunch faced by developers. Over 60% of developers hit at least one debt threshold set by this policy, further exacerbating their financial stress. Chinese authorities have several policy tools to control housing prices, but the crisis has shown that these measures are only effective with sufficient market transparency, and this is for sure not the case of China's market. In fact, it has been found that there is a notable discrepancy between official government statistics and private data on home prices. While official figures show a moderate decline, private data indicate a steeper fall in home prices in major cities. This gap has led to uncertainty and hindered effective policymaking.

Banks and Mortgage Defaults

A unique and unprecedented form of protest took root in China's real estate sector as over 300 groups of homeowners began refusing to pay mortgages. These were mainly for properties that were sold under the presale system but remained unbuilt, a practice common in China's real estate market. The total value of these disputed mortgages was estimated to be between $150 billion and $370 billion, representing a significant portion of the property market's value. This unprecedented situation posed a significant challenge to the banking sector in China, threatening to substantially increase the prevalence of bad debts and highlighting the fragility of the country's real estate financing system. The mortgage strikes put almost 1 trillion yuan (approximately $150 billion) in bank loans at risk. This scenario posed a limited direct threat to Chinese banks, with potential at-risk mortgages comprising just 1.3% of banks' total loan book. However, the implications were more concerning. Indeed, even though banks announced minimal direct impact from the mortgage boycotts initially, the potential for the effects to spread was a significant concern. The strikes indicated weakening confidence among homebuyers and could potentially dent the sales of even stronger developers, prolonging the sector's recovery. Distressed developers, not yet affected by the boycotts, might become targets, deterring banks from providing mortgage loans to developments and halting sales. This could increase defaults among developers and their supporting firms, further straining the financial system. An in-depth analysis showed that at the end of 2021, about 4.9 trillion yuan of residential mortgage loans were linked to unfinished projects by distressed developers. A portion of this, around 974 billion yuan or 0.5% of the banking sector's outstanding loans, was related to delayed projects. In a stressed scenario, this risk could encompass about 2.4 trillion yuan in bank mortgages, a significant figure even for large state-owned lenders active in mortgages.

Stalled Real Estate Projects

The stalling of real estate projects in China's housing market, a sector that accounts for about 29% of the country's GDP, has had profound socio-economic impacts. The sharp decline in the market since its peak in 2018 disrupted an economic ecosystem that construction workers, real estate agents, and various other professionals depend on.

This downturn is not limited to major developers like Evergrande but extends across the sector. Companies like Fantasia Holdings, Sinic Holdings Group, Modern Land, and Sunac have either defaulted or are on the brink of it. This widespread distress among developers reflects systemic issues within the sector and raises concerns about its overall stability and resilience. These stalled projects symbolise more than just uncompleted buildings; they represent a breakdown in the financial and operational mechanisms of China's real estate industry. The phenomenon highlights the vulnerability of a wide range of stakeholders, from investors to everyday citizens who have invested their savings in these properties. The need for robust regulatory frameworks to protect these interests is more evident than ever, as is the requirement for a sustainable approach to real estate development and financing.

Challenges Facing China in Upcoming Years

China's Population Decline

China's shrinking population is a significant demographic shift with far-reaching economic consequences. The decline, the first since the 1960s, is primarily driven by a falling fertility rate, which has dropped to the lowest in the world among countries with over 100 million people. This trend is expected to continue, leading to an aging population and a shrinking labour force. There are numerous economic impacts of China's shrinking population. Firstly, labour shortage. A shrinking labour force could lead to labour shortages in certain sectors, particularly in manufacturing and construction. This could drive up wages and make it more difficult for businesses to find and retain qualified workers. Then there is the reduced economic growth threat. A smaller population could lead to slower economic growth as there will be fewer consumers and workers contributing to the economy. This could also impact China's global economic competitiveness. The Chinese government has implemented various policies to address the population decline and its potential economic consequences. The one-child policy has been gradually eliminated with now the possibility of having in some cases even three children. Moreover, the government is providing financial incentives to couples to have more children, such as tax breaks and childcare subsidies.

Youth Unemployment Record High

China's youth unemployment rate has reached a record high of 21.3% in June 2023 for people aged 16-24, a stark indicator of the country's economic challenges. This surge in unemployment is particularly concerning for China's future as it reflects a growing mismatch between the skills and qualifications of young people and the available job opportunities.

The high youth unemployment rate has some severe repercussions for China's economy, starting with reduced consumption. Unemployed youth have less disposable income, which can dampen consumption spending. This can further weaken the economy and exacerbate the unemployment problem. A second problem could be brain drain. Some unemployed youth may be forced to migrate to other countries in search of better opportunities, leading to a "brain drain" of skilled labour. This can hinder China's innovation and technological advancement, as well as its attractiveness to minds from other countries.

Consumer Confidence Record Low

China's consumer confidence has plummeted to a record low, reflecting a growing pessimism among Chinese households about the economy's outlook.

Factors leading to the decline in Consumer Confidence:

- Economic Slowdown: China's economy has been slowing down in recent years, leading to concerns about job security and income growth.
- Government Crackdowns: The Chinese government's crackdowns on certain industries, such as the technology sector, have raised uncertainty and dampened investment sentiment.
- Rising Costs: Rising living costs, particularly in housing and education, have eroded household disposable income and strained household budgets.

Economic Impact of Low Consumer Confidence:

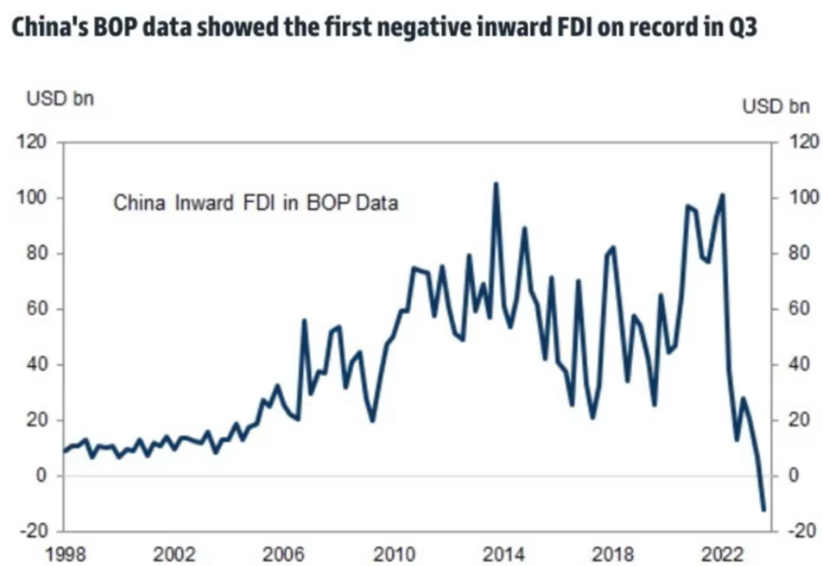
- Reduced Consumption Spending: Pessimistic consumers are less likely to spend money, which can dampen consumer spending and overall economic growth.
- Investment Slowdown: Investors are also more cautious when consumer confidence is low, as they may perceive greater risk in investing in the Chinese economy.
- Reduced Imports. Chinese importations of goods from US, Taiwan, South Korea and Japan have declined 12.8% year over year in June.

Investors Pulling Out of China

Multiple factors have contributed to the recent exodus of investors from China. Certainly, one of those is the government crackdown on technology companies. The Chinese government has cracked down on several technology companies, including Alibaba, Tencent, and Didi. This has led to a loss of confidence among investors, who are concerned about the potential for further government intervention.

Moreover, the slowing Chinese economy is contributing to the decline of investments. China's economy is growing at its slowest pace in decades. This has led to concerns about the country's long-term economic prospects and has prompted many investors to withdraw their money. In addition, geopolitical tensions also play a role. Tensions between China and the United States, as well as China's growing assertiveness in the South China Sea, have also contributed to investor uncertainty.

These factors have led to a significant decline in foreign investment in China. In Q3 2023 Chinese Balance of Payment shows the first, since recorded, negative inward FDI, of approximately -11.8 billion.



Source: CEIC, Goldman Sachs Global Investment Research

Investors leaving China are likely to have a number of negative consequences for the Chinese economy. It could lead to slower economic growth, job losses, and a decline in the value of the Chinese yuan.

China's Economic Future

China's economy is facing a number of challenges, including a slowing growth rate, youth unemployment, a decline in investments, and an aging population. However, the country also has several strengths, such as its large domestic market, its growing middle class, and its world-leading technology sector.

Despite the challenges, it is unlikely that China will collapse. The country has a strong and resilient economy, and it is well-positioned to adapt to the changing global landscape. China's future economic success will depend on its ability to address its challenges and capitalise on its opportunities.

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