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Opinion

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Avoiding the pain of China's housing crisis risks infecting the wider economy

- The growing housing crisis threatens to spread like previous financial contagions and damage economies across the globe
- Policymakers need to let poor performers suffer the consequences of bad bets while looking after solvent banks and enacting land and property reforms

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Illustration: Stephen Case

History has shown that financial crises are often the story of either a housing bust or stock market collapse – or both. Think of the crash of 1929 that started as a Florida-driven housing boom-and-bust cycle and morphed into a stock market collapse that shook the United States and the world.

Or consider the 2008 global financial crisis, which started with complex derivatives in subprime mortgages and was rapidly transmitted from bank to bank and market to market as investor panic rose. In 2022, the latest iteration of a damaging housing price collapse is unfolding in China. It will be felt widely, slowing other economies and radiating outwards.

What started with US$300 billion in debt held by Evergrande is spreading quickly and dangerously as developer after developer defaults. The knock-on effects are real and growing. When builders default, they stop paying their suppliers, those companies fail to pay their workers and the lay-offs start.

With construction making a significant contribution to China's economy, defaulting developers are just the beginning. With developers in trouble, investors and Chinese mortgage holders are losing confidence in firms and the country's economic outlook.

Chinese borrowers are already revolting. Hundreds of thousands are refusing to pay their mortgages, worried they might never see their flats completed. Many buyers in China purchase flats before they are built, and the developer then uses the cash to complete the construction. Buyers are rightly alarmed that firms will go bust before the dwellings are complete.

Buyers today in mainland China are alarmed as they look at falling prices, which were down 0.9 per cent year on year in June across major cities. With as much as 70 per cent of Chinese wealth tied up in housing, price falls and a collapse in sentiment could be very bad news.

Research has demonstrated the key dynamic at play. Your house is a leveraged asset. As prices begin to fall, this magnifies owners' losses and they can become "underwater", owing more than the asset is worth.

Even where this does not happen, losses mount. Homeowners respond by cutting spending – what economists call the marginal propensity to consume – and the economy stalls as consumers pull back, shocked by housing losses. It is this slashing of consumer spending that creates the worst cascading effects, slowing the economy, shaking bank stability and viability.

What are Chinese regulators doing? The People's Bank of China has announced a US$150 billion bailout of developers aimed at completing unfinished flats.

But look a little deeper and it appears regulators are repurposing the "convoy" approach to bank bailouts pioneered by Japan in the 1990s. The central bank is forcing larger, more solvent banks to inject funds into failing developers and local banks. This is an effort to limit the damage and the costs to government.

Unfortunately, this might not be a good solution. By making good banks bail out failing local banks overburdened by bad real estate bets, China risks infecting stronger banks with the troubles of the weak. In Japan, the convoy system slowed lending by the remaining larger banks, and this adversely affected growth in the economy as whole.

China needs to avoid creating risk-averse banks that carry unwanted assets or, worse still, spawn zombie banks and firms that stagger on. This scenario could begin to play out in China. Instead of clarifying and stabilising, the convoy approach could slow recovery and spread the damaging effects.

Chinese authorities are also trying to limit price falls in the housing market. This looks sensible on the face of it – limit the downside, limit panic.

Residential buildings under construction at Tahoe Group's Cathay Courtyard development in Shanghai on July 27. Many buyers in China purchase flats before they are built, and the developer uses the cash to complete construction. Photo: Bloomberg

But such manipulation can stop developers from cutting prices to revive buyers' interest and limit firms' ability to generate funds to complete developments or service debts. The danger is that authorities might not be able to stop the erosion of confidence in property prices. Since so much rests on this foundation, a growing lack of confidence will have real implications for the wider economy.

As they work their way through, Chinese authorities should also consider a bad bank structure to take toxic assets off the books of banks that hold them. In taking this route, China's policymakers would be copying what premier Zhu Rongji did in the 1990s by using asset management companies to take over bad debts. It worked then and could do so again.

Investors should pay the price for bad bets. This type of structure would punish poor performers while not undermining prudent, solvent banks. Ultimately, real estate firms, banks and poorly run local authorities need to be allowed to bear the downside risk and go bust, be restructured and send market signals for the future. At present, an effort to avoid

pain risks infecting the wider economy, not strengthening it.

At the same time, authorities should consider reforms that address the extent to which the national and local economies rely on land and property sales for financing. Part of those reforms should extend to the design of a more progressive income tax system for the rich and middle class. If China is to pay for needed public goods as well as bank bailouts, the tax system needs reforming.

Property busts are painful. This one will test China's policymakers. Can they deal with the pain and limit its spread, and do so in a manner that allows market signals to work?

At this stage, the economic downsides are growing, the regulators are playing catch-up and policy designs are not ideal. China's growth is slowing dramatically and at an expected 3.3 per cent growth in 2022 – the slowest rate in 40 years, according to the International Monetary Fund – it will fall well below the official 5.5 per cent target. As China's economy stutters, the rest of the world will be negatively affected.

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