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EMERGING MARKETS DEBT | INTERNATIONAL/GLOBAL

China's Economy: Ghosted

By: Emerging Markets Debt | August 25, 2023

Boston - In recent years, President Xi Jinping has been closing the loop on China's multi-year cycle of slowing growth, credit stimulus, overinvestment in property and consequent contraction. He drew a red line (technically three red lines) on a growth model that Chinese policymakers have probably always known to be unsustainable. While stories of ghost cities across China have been exaggerated, the "build it and they will come" strategy had devolved into corruption, money printing and growing indebtedness.

Property developer Evergrande's downfall, starting in the summer of 2021, was the beginning of the end, while Country Garden's recent default is something of a crescendo in what looks like an irreversible restructuring of the entire sector. So what happens next for China's property sector and what will be the fallout for the wider economy and emerging markets (EM) more broadly?

Property pains reverberate

The Chinese property sector, which stands at roughly 25% of GDP, is set to shrink about 30%, according to estimates.[1] The associated losses from this downsizing will have to be absorbed somewhere in the system. So far, local governments have suffered revenue losses, bank profits are being squeezed and households are facing a weaker labor market and depleted wealth. This is a classic demand shock. However, it has yet to be seen whether Beijing will offer bailouts to local governments, banks and households, or whether the People's Bank of China will adopt "Chinese-style quantitative easing." Our best guess is "no" to the former and "yes" to the latter.

What this does not appear to be is a financial crisis. In aggregate, Chinese households have an equity cushion of around 70% in their homes and are therefore unlikely to become forced sellers.[2] And although banks will have large holdings of nonperforming loans on their books, the entire banking system is essentially deposit funded and hence stable. True, local governments need relief on a debt stock of at least 60% of GDP.[3] Here, Chinese regulators provide support by shifting debt around to distribute the pain in small doses and over long periods of time. In our view, this should be sufficient to avert a crisis stemming from local governments.

Beyond China's shores

If China is embarking on years of debt restructuring and lower growth, that must be bad for other EM economies, right? Maybe not. First, fewer of the world's resources will be consumed by the Chinese property machine, which should improve availability elsewhere.

Second, capital access should also improve. For the past 10 years, China has attracted a large share of the capital flowing into EM. The portfolio investors, venture capitalists and banks, who all clamored to get into China, may now open their eyes to the broader universe of EM opportunities.

Third, lower aggregate demand at home is now pushing Chinese manufacturers to sell their inventory overseas. These cheap Chinese goods already appear to be lowering inflation in parts of EM, like Southeast Asia.

Fourth, there's technology. The awesome industriousness of Chinese entrepreneurs will likely migrate from property to higher productivity areas. Chinese nickel miners in Indonesia, software developers in Singapore and aerospace engineers in the mainland will now be ascendant, unlike the rent-seeking property tycoons.

In our view, EM countries with the right policies will benefit on net from the end of the ghost city era in China.

Finally, a word on geopolitics. We can precisely calculate that in three months, after much anticipation and speculation, Xi will set off to a foreign land that has become increasingly less friendly in recent years. His mission is to reshape the entire Asia Pacific landscape forever. If you guessed that we're talking about the Asia-Pacific Economic Cooperation Leader's Meeting in San Francisco, you are right. Property woes have not dented China's confidence on the world stage.

Bottom line: China's large, ailing property sector looks set to continue weighing on the country's economy. However, signs do not point to an imminent financial crisis, just economic malaise. After years of crowding out other emerging economies in global capital markets, China's sluggishness may prove to be a boon for these countries. We will continue to monitor developments in China closely, while seeking out the most compelling country and credit opportunities in the large and differentiated universe of EM debt.

1. National Bureau of Statistics, MarcoPolo. As of December 2021.

2. EM Advisors Group. As of August 2023.

3. IMF. As of March 2023.

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Emerging Markets Debt

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