The world sweats during China's vacation

The impact of the policy-remedy to China's property market excesses is spreading across global markets. But they would bounce hard on any evidence of a mitigation plan from Beijing. We may have to wait for that though...

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Any crumbs of comfort?

Markets across the world are selling off as the fear-gauge rises in response to the debt repayment problems of China's property development giant, Evergrande. And comparisons of this episode with past events are flying thick and fast. Is this LTCM? Is this Lehman's? Well, obviously it is neither. It is China and it is Evergrande. I find these comparisons somewhat unhelpful though I suppose it is natural that people gravitate towards them.

So are there any helpful remarks that can be made?

One is not to take too much comfort in the scale of Evergrande's outstanding debt as a proportion of GDP or any other yardstick. The sum usually quoted is around $300bn. And yes, it is small compared to say Chinese GDP of $14.3tr, amounting to only about 2% of that total.

But I remember similar calculations leading you to draw the wrong conclusions in the past. In 2007 I read, and then disappointingly related to colleagues, a broker piece written at the beginning of the US subprime crisis, the precursor to the global financial crisis. This noted that the subprime mortgage market outstanding was only about 11% of the total US mortgage market. That turns out to have been a slight underestimate, I believe it was nearer 12% and the total of subprime mortgages was about $1.3tr, close to 9% of 2008 GDP. But even then, it wasn't just the scale of the US subprime mortgage market that caused the damage. Instead, it was the incredibly tangled web of financial interlinkages that subsequently led to the complete loss of trust in interbank and other markets, which then shut down leading to a catastrophic drying up of market liquidity. Does anyone remember monoline insurance? Mortgage wraps? SPVs?

So yes, by all means, look at the scale of the underlying liabilities, but then ask yourself if that is the full extent of the problem?

In China's case, one factor that is somewhat encouraging, despite the clear evidence of excesses in the property development sector, is that this has not come after a sudden and dramatic surge in prices/activity. This does not appear to be a market bubble bursting, even if there is strong evidence of froth. Indeed, the latest policy measures that are a partial catalyst for what is going on are just an extension of previous measures put into motion long before the Covid-pandemic. What we are seeing now, is partly explained by a return to those deleveraging policies as the economy recovers, together with a tightening embodied in the "three red lines policy" for property companies which limits their debt accumulation and access to land auctions.

Those policies were designed to try to prevent the market from ever getting to a sub-prime type situation, but they don't preclude some market pain during periods like this. And maybe since the GFC, we have become so used to policymakers in the West sheltering us from any market hit with ever more accommodative policies, that our pain threshold has dropped. I could go on at length about that and how ultimately I think that the relentless attempt to smooth the business cycle and markets will ultimately cost more in lost output than occasional bouts of discomfort. But that can wait for another day.

The tendrils of China's property development companies will, for sure, extend deeper than just the property market and financials, though those alone are significant elements of the economy and certainly worth worrying about.

But what I think delivered the hammer blow during events such as those I've mentioned above, or for example, Japan's property bubble and subsequent bust is the degree to which financial interlinkages acted to create a domino-run as losses in one sector were transmitted to another and then another. For example, you can trace the beginnings of Japan's property bubble burst back to the innocuous-sounding "Jusen crisis" of local savings institutions. My guess is that while those interlinkages exist in China, they won't be quite as pervasive as they were in either the US or Japan back then.

And finally, given that there is an element of policy choice about this whole episode, there is perhaps a much greater ability for the authorities to turn back the policy dial on property development companies a few notches. Discussions about "moral hazard" are all well and good. But the consequences of corporate malfeasance in China are often severe. No one is talking about individuals being let off the hook in the event of some form of restructuring package. And given the recent pivot to "Common Prosperity", my guess is that any restructuring will aim to soften the blow for small investors - though again, the extent to which property has become a channel for household savings has perhaps grown to an unhealthy extent. That has been an issue in a number of historical global property crashes, including in Australia in the not too distant past. So some lessons will also need to be learned here that property is not a risk-free investment asset for household savers.

If we want to look for historical comparisons to make sense of what is going on right now, perhaps we don't need to look too far. The Huarong restructuring earlier this year may be instructive. Here, the fate of the asset management company was left hanging for some time before a restructuring deal was eventually constructed. There was a palpable sense of warning in that wait - don't expect to suffer no losses - before the eventual rescue was put in place.

China is on vacation today and tomorrow, so global markets will likely continue to sweat through this one. And it is probably too early to anticipate much more than some soothing words when policymakers return on Thursday. But if Huarong is any guide, then the playbook for this will be an uncomfortable wait, but one that eventually delivers an outcome that is better than the worst fears that grow during that wait.

In the very short term, the easiest concrete measures that are likely to be taken are more PBoC liquidity injections. These, and the government's strong control over the banking system strongly suggest that a sudden liquidity loss like we witnessed during the global financial crisis, should be avoided.

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