Understanding Evergrande

Xi Jinping's Political Economy, Systemic Financial Risk, and Implications for the Chinese and Global Economy

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I'm speaking today about Evergrande, the Chinese property giant with $300 billion in debt which has to date missed two offshore bond payments[1], threatening to thrust the company into default.

Evergrande has become important for both financial markets and policymakers. That's because the developer has $669 million in payments[2] coming due through the end of this year. It has liabilities involving more than 128 banks and over 121 non-banking institutions. And it threatens a sector which represents approximately 29 percent of Chinese GDP, some 41 percent of all Chinese bank loans, and 78 percent of the wealth invested by urban Chinese. Evergrande's difficulties, therefore, are triggering broader concerns about Chinese and global financial stability.

Today I want to locate the Evergrande "crisis" in the wider remit of China's current politics, macro-policy settings, and its perception of financial risk within those parameters. As well as to indicate where it seems the Chinese system is headed in terms of the long-term

[1] Evergrande subsequently missed a third bond payment on October 12, but successfully made a payment of $83.5 million on October 21, narrowly averting default within the 30-day grace period of its bonds.
[2] As of October 22, it now faces $489.5 million in payments due through the rest of 2021.

management of Evergrande and the problems that it presents to Chinese President Xi Jinping.

So where is Evergrande situated in terms of China's current macro challenges? If you are sitting in Xi Jinping's seat in *Zhongnanhai* at the moment, there are three big ones:

First: "How do I get reelected as General Secretary of the Communist Party in about 12 months from now?" Reelection, one way or another, is a question that always looms large in the minds of politicians.

Second: "How do I deal with a slowing Chinese economy?"

And third: "How do I deal with an increasingly adversarial geostrategic environment?"

During Xi Jinping's period in office, he has taken Chinese politics to the left, Chinese economics to the left (albeit more recently so), and has moved nationalism – as expressed through Chinese foreign, security, and international economic policy – to the right. It is useful to keep this frame in mind as we look at the Evergrande phenomenon.

Chinese Economic Policy Moves to the Left

On moving the Chinese political-economy's center of gravity to the left, we see this reflected in Xi Jinping's Marxist-Leninist ideological worldview.

We see it in his increasingly statist view of how best to respond to China's growing array of national challenges.

We also see Xi wrestling with the problems of Chinese demography: a shrinking workforce and potentially an overall population that is shrinking, or soon will be.

To try to conceptualize where Evergrande and macro-financial risk sits within Xi's overall economic worldview, there are a few concepts we first need to familiarize ourselves with.

One is what Xi Jinping now routinely calls the "New Development Concept" (NDC). This has in many respects come to replace, as a standard phrase, the period of "Reform and Opening" that we became familiar with from 1978 to 2018. What we now see is the NDC increasingly becoming the replacement idea for the "new period" of China's economic development.

The NDC also has some subsidiary concepts: the "Dual Circulation Economy," the "Common Prosperity" doctrine, as well as "Security and Development." I spoke on these at some length in my previous remarks on "*Xi Jinping's Pivot to the State*."

What are all these new terms code language for?

The Dual Circulation Economy essentially means greater and greater levels of Chinese economic "self-reliance." It also means less exposure and vulnerability to international supply chains and the risk of being on the receiving end of decisions in Washington. This is to be done primarily by making domestic consumption the primary driver of Chinese economic growth. Additionally, it is designed to ensure the world continues to grow more reliant on economic exchange with China by turning its vast internal market into what Xi has called a "gravitational field" for global products, resources, and capital markets.

Xi's Common Prosperity agenda is code language for greater equality within the Chinese system and a greater redistribution of wealth (given that some 600 million Chinese people still live on incomes under around $155 per month, according to Premier Li Keqiang).

While Security and Development signifies the prioritization of the national security of the Chinese state – including its national financial security and freedom from externally manipulated financial and economic risk – above all other concerns.

These terms have become almost universal in Chinese public discourse over the last several months.

Meanwhile, at a more micro level, we've witnessed parallel shifts in Chinese official attitudes toward its state-owned enterprise (SOE) sector, private sector, and its approach to "industrial policy." The latter is turbocharged by industrial-scale "industry-guidance" funds through which the Chinese state, usually through SOEs, now engages in large-scale, strategic industry investments.

The overall pattern we see, therefore, is a macro and micro policy shift to the left: back toward the party-state and away from the market.

However, the reality is that China's political-economy is not so tame a beast.

Xi Jinping also has to wrestle with macro-financial risk. This includes any individual financial institution or property-financial conglomerate becoming a structural risk for the wider Chinese financial system.

China now has debt-to-GDP levels of some 285 percent. This is large by global standards. And it has been of growing concern to the Chinese leadership over the last seven years.

It is these two things – Xi moving China's macro- and micro-policy settings to the left, and the leadership's continuing concern over managing systemic financial risk – that create the wider economic context within which Xi now confronts the Evergrande problem.

Evergrande and Xi Jinping's Three Worlds

Evergrande intersects with Xi's political world, because he does not want to have a domestic financial crisis in the 12 months leading up to his reelection next November for a third term.

Evergrande intersects with Xi's left-leaning economic world because it is symptomatic of the excesses of the billionaire class that Xi is now targeting with his Common Prosperity campaign.

It directly impacts his campaign for greater economic equality in achieving housing affordability for working families.

It impacts too his concept of how to solve China's demographic challenges by making it more possible for families to have the disposable income necessary to have more children.

And it affects other elements of Xi's overall economic reset as he seeks to redirect what he would describe as "unproductive" forms of speculative investment into more "productive" ones.

Evergrande also intersects directly with the abiding concern of the Party to avoid systemic financial risk. An estimated 41 percent of China's $45 trillion in banking sector assets are exposed in one way or another to the property market. While around 27 percent of its $30 trillion in loans are also tied up in the property market.

As for the international environment Xi faces, he wants to avoid any external perceptions of domestic economic weakness, let alone a perception that China could suffer from the same financial affliction as the United States did in 2008. Indeed, the party has based a large part of its legitimacy on convincing the Chinese people that China now has a far more sophisticated system for dealing with crises (whether pandemic or economic) than the West.

In other words, all these concerns bring Evergrande directly into sharp focus for Xi and the rest of the Chinese leadership.

Evergrande and the "Real Economy"

Xi Jinping, in a parallel debate, has also emphasized the critical importance of what he calls the "Real Economy" (*shiti jingji*), as opposed to what he calls the "Fictitious Economy" (*xuni jingji*).

In his definition, seen through a Marxist lens, the Real Economy is about advanced manufacturing, infrastructure, technology, and deep economic transformation – or what he describes as building a "modern" economic system.

Meanwhile the Fictitious Economy (a term with a long Marxist pedigree, originating in *Das Capital*) is about speculative bubbles – asset bubbles, property bubbles, financial bubbles, etc.

After 2015, Xi began decrying the fact that "a large amount of capital flows to the fictitious economy, which makes asset bubbles expand and financial risks gradually appear."

When Xi and party cadres decry a "reckless expansion of capital" (now a commonly used phrase) this is what they are complaining about.

This ideological debate on what constitutes productive economic and financial activity reached its conclusion in 2017 when Xi declared simply that: "houses are for living in, not for speculation."

This is the ideological framework within which Xi looks at the Evergrande question.

Evergrande – The Problem

In terms of Evergrande's current circumstances, it's important to summarize where we are up to today.

- Evergrande was founded in Guangzhou in 1996 by Chinese billionaire Xu Jiaying, and is one of China's biggest property developers.
- As of 2020, it had accumulated some $300 billion in total liabilities. And, as of the end of June 2021, the equivalent of around $89 billion in interest-bearing borrowings.
- As of 2020, Evergrande owned more than 1,300 developments across the nation, many in lower-tier cities. It had some 200,000 staff, and hired around 3.8 million people every year for project developments.
- In November 2018, the People's Bank of China had named the company in a report as one of the few financial holding conglomerates that could cause systemic risk to China's financial system.
- In August 2020, Beijing unveiled its "Three Red Lines" policy, introducing implicit caps on three debt ratios: debt to cash, net debt to equity, and debt to assets. This would become a fateful event for Evergrande.
- The next month, a letter purportedly from Evergrande addressed to the Guangzhou provincial government circulated on Chinese social media and brought Evergrande's troubles into the public view for the first time. The letter requested help from the Guangdong provincial government regarding a potential Evergrande mainland subsidiary listing, and also warned that it could face a cash crunch which could lead to systemic risks.

- In June 2021, China's top financial regulator, the Financial Stability and Development Committee (FSDC), met with and instructed Xu Jiaying to solve his company's debt problems as quickly as possible.
- By then, Evergrande was failing on all three metrics of the Three Red Lines, and was therefore forbidden from raising additional debt – triggering its current crisis.
- On August 12, China's central government instructed authorities in Guangdong province to map out a plan to manage Evergrande's debt problems. Simultaneously, at least three major creditors agreed to give the developer extensions on some project loans.
- On August 19, the People's Bank of China and China Banking and Insurance Regulatory Commission summoned Evergrande senior executives to a meeting and instructed them to resolve Evergrande's debt issues without destabilizing the property and financial markets. A brief statement following the meeting acknowledged Evergrande's industry-leading position and responsibility to ensure the real-estate market is stable and healthy, and that it does not harm China's broader financial stability.
- The Ministry of Housing and Urban-Rural Development then instructed local subsidiaries across the country to supervise funds for Evergrande's property projects in special escrow accounts, signaling that homeowners come first on Beijing's priority list for managing the Evergrande crisis.
- In early September, the FSDC ordered provincial governments to establish working groups to monitor social and economic instability around Evergrande.
- On September 13, Evergrande's troubles again exploded into the public view following reports of social unrest breaking out at several of Evergrande's offices in Shenzhen, Nanchang, Zhengzhou, Qingdao, and Chengdu.
- Following angry investor protests at several of its offices on September 13, Evergrande hired outside financial advisers from a U.S. investment bank and a Hong Kong firm, suggesting that Evergrande had begun working on a debt restructuring plan.
- On September 22, at least two local governments in China – districts in Guangzhou and in Zhuhai – took control of sales revenue from Evergrande's properties to block potential misuse of funds.
- On September 23, Chinese authorities ordered local governments to "get ready for the possible storm," referring to the possibility of an Evergrande default. With the company facing a potential default on interest payments due (after a 30-day grace period), Beijing ordered local governments and state-owned enterprises to prepare to

take over real-estate projects and set up law-enforcement teams to monitor public anger and contain "mass incidents" in the event of Evergrande's collapse.

- That same day, Evergrande missed its first offshore bond interest payment, worth $83.5 million.
- On September 27, the People's Bank of China, released a statement vowing to ensure a "healthy property market" and protect home buyers' lawful rights. The statement did not mention Evergrande by name, but emphasized healthy development of the real-estate market.
- On September 28, sources familiar with the matter informed Reuters that Beijing was prodding government-owned firms and state-backed property developers to purchase some of Evergrande's assets. According to the source, a handful of government-owned enterprises conducted due diligence on Evergrande assets in Guangzhou.
- On September 29, Evergrande missed a second offshore bond payment, this time worth $47.5 million.
- By September 29, the People's Bank of China had injected 750 billion Yuan (around $116 billion) into the financial system via consecutive open market operations since September 17, aimed at helping calm China's financial markets by ensuring they remain liquid.
- On October 4, Evergrande suspended trading of its Property Services Group's stock in Hong Kong, stating in a stock exchange filing that the move was taken ahead of "a possible general offer" for the property group, which was recently valued at around $7.1 billion. This raised speculation that the company could be on the verge of being split up and sold off to a mix of private or state-owned buyers.

Evergrande – The Prognosis

It is important to understand that Beijing has had an on-again, off-again history in dealing with deleveraging the Chinese financial sector.

It began after the 2015 financial market crash.

Progress was made in 2016 and 2017. But as the trade war with the United States took hold in 2018, the pressure of the deleveraging campaign began to taper off.

With the advent of COVID-19, it slowed even further.

But deleveraging in order to de-risk the financial system still remains the overriding objective.

Beijing has over the last several years also accumulated considerable experience in dealing with institutions facing potential financial collapse: with Anbang, Baoshang, HNA, and Huarong.

With Anbang, it is important to remember how big that insurance conglomerate was. It had more than $329 billion in total liabilities. It was brought under state control in 2018 and restructured for sale. Its former chief executive Wu Xiaohui was sentenced to 18 years in prison.

Baoshang, a regional lending bank, had $32 billion in debts. It, however, was allowed to go bankrupt. It was not seen as systemically significant, and Beijing was determined to send a message to the rest of the financial system. Baoshang was owned by Xiao Jianhua, renditioned from Hong Kong in 2017 and arrested.

HNA, one of China's largest global asset buyers, with some $77 billion in debts, was taken under the control of state bankruptcy regulators and forced to split into four separate entities. Its chairman and chief executive were both arrested in September 2021.

Then Huarong, the asset manager with $150 billion in debt, was partially bailed out by the government through state-owned investor groups. That process is ongoing. Its chairman, Lai Xiaomin, was executed for corruption in January 2021.

Therefore, drawing upon this most recent institutional experience, what are we likely to see unfold in relation to China's handling of Evergrande?

If you look at the expert commentary from a number of international investment banks and institutions, including the International Monetary Fund, the general consensus is that Evergrande in itself does not pose a direct risk to the broader financial system. Not yet.

The IMF has expressed confidence that Beijing has the capacity to handle the situation, stating on September 21 that "China has the tools and the policy space to prevent this turning into a systemic crisis."

Industry analysts are also confident that China's banking sector has the capacity to digest an Evergrande default, given that the sector's exposure to Evergrande is well distributed.

Strategists at Citigroup, Barclays, and UBS Group have maintained that Evergrande's debt crisis is unlikely to become China's "Lehman moment," with Barclays macro strategists writing that: "The conditions are simply not in place for even a large default to be China's Lehman moment."

Nonetheless, China is deeply risk-averse. Chinese regulators are concerned about possible policy missteps. Or how their policy actions, real or perceived, will impact the rest of the financial system.

So as the Chinese policy community gather to look at the current challenges presented by Evergrande, there will be arguments in favor of propping the company up. These are based on Evergrande being "too big to fail."

There are also arguments in favor of allowing Evergrande to go bankrupt. These are based on moral hazard – the need to send a clear signal to the rest of the industry that it really is time to bring their house in order.

There will also be arguments in favor of a third way: an orderly distribution of Evergrande's assets, facilitated by the state.

This approach is based on precedent (as applied in the cases of Anbang, HNA, and Huarong).

We also see it in the behavior so far by Chinese officials at both the provincial and local levels responding to instructions from Beijing to prepare to purchase distressed Evergrande assets to head off social unrest.

Therefore (although I hasten to add this is not financial or market advice), if you look at the evidence of where all this is headed, the most likely outcome, on balance, is an orderly distribution of assets to a mix of private and state buyers.

We also need to be mindful of the disciplines likely to be applied – and there is likely to be a differential treatment of the stakeholders involved.

The political priority is likely to be for those that have apartments owed to them by Evergrande and which have already been paid for. The Chinese state believes these Chinese families have an entitlement to receive those homes.

As for domestic creditors, bondholders, and shareholders, the emerging evidence is that they will be preferenced second – though it is likely they will receive a haircut.

But coming third and last will be foreign bondholders and shareholders where the haircut is likely to be the sharpest.

Indeed we already know this, given that both sets of payments missed so far by Evergrande have been for offshore bonds. Their haircut is likely to be far more significant. And you don't have to be a Rhodes Scholar to work out how that this differential treatment of foreign and domestic stakeholders is likely to impact international market perceptions of investing in China.

Finally, there is another, new element at play with Evergrande that is also important for us to note.

The anti-corruption apparatus, directed by the Central Commission of Discipline Inspection (CCDI), has now been unleashed across China's financial and property corporate landscape to identify malfeasance across the sector.

On September 26, CCDI head Zhao Leji stated that his inspection teams' focus should now include "promoting the three tasks of serving the real economy, preventing and controlling financial risks and deepening financial reform."

This, he said, includes: "strengthening the party's leadership in financial work, safeguarding the national economic and financial security, promoting the high-quality development of the financial industry, and promoting the punishment of financial corruption and the prevention and control of financial risks."

He added that, "We should thoroughly find out the political deviations existing in the party committee in performing the party's leadership responsibilities and the prominent problems that affect and restrict the high-quality development of the financial industry, and urge financial units to put the party's political construction in the first position."

The significance of this statement cannot be understated.

It indicates that the anti-corruption campaign will now be wielded to add serious criminal penalties, beyond financial penalties, to firms and executives that fail to deleverage and de-risk.

It means that Xi has run out of patience with the speculators of the "fictitious economy" that he has already attacked and is determined to rein them in forcefully.

Beyond Evergrande – The Rest of the Property Sector

Evergrande is not the end of China's problems with the property sector. It may just be the end of the beginning. Particularly as China's deleveraging campaign continues.

Indeed, we've now already seen another mid-size real estate developer, Fantasia Holdings, fail to make a $206 million bond payment on October 4, raising concerns that Evergrande's failure could already be spreading through the property market.[3]

It may be worthwhile for policymakers in Beijing to consider carefully the law of unintended consequences when it comes to their own deleveraging policies – in particular the "Three Red Lines" of August 2020.

[3] As of October 22, three additional Chinese property companies have defaulted or have warned they may imminently default, including Modern Land Co., China Properties Group Ltd., and Sinic Holdings (Group) Co.

The parallel campaign by CCDI is likely to add to this pressure, impacting further on the confidence of the financial services industry in general as well as the property sector in particular.

Six months from now, we will still be talking about Evergrande. But we are also likely to be talking about a longer list of other institutions that have also fallen afoul of the Three Red Lines and the CCDI.

Even if an orderly distribution of Evergrande's assets manages to keep Chinese and international financial markets stable, the spotlight will turn to the rest of the Chinese property and finance sectors which are also highly leveraged.

The question then becomes: what happens to the rest of the property market and similar firms in similar trouble? It would be difficult to replicate a similarly orderly outcome across the entire sector for every troubled firm, given that the property sector is so vast and its aggregate level of indebtedness so great.

In other words, can the state afford a much broader set of interventions to head off a crisis? Or can it find a way to do this through the hand of the market instead, and still retain control? At nearly a third of GDP, can it afford *not* to?

Wider Impacts

If the Chinese property sector slows or contracts, the implications for global economic growth for the decade ahead will be significant.

China's growth represented 28 percent of all global growth between 2013 and 2018, twice that of the United States.

Therefore a slowing property sector, given its significance to overall GDP, would inevitably feed through to a slowing global growth rate, including global commodity prices that many developing economies rely on for export-driven growth.

Meanwhile, for China itself, the political and economic challenges arising from Evergrande will continue.

Political stability in China can be maintained if a financial crisis is avoided.

But if this means suspending for the third time since 2015 the implementation of Xi's long-planned deleveraging campaign for the financial sector as the cost of maintaining that stability, the can will simply be kicked down the road one more time.

Herein lies Xi's policy and political dilemma – to continue to deleverage the sector for the long term, or to secure short-term stability.

Economists like Michael Pettis project that, on the current trend, for China to meet Xi's big goal of doubling the economy by 2035, the current development model of investment-led growth would require China's debt-to-GDP level to surpass 400 percent.

No major economy has ever done this in history.

That's because their economies have all crumbled under the weight of that debt before it reached such a level.

China may be *sui generis*, but in economics the notion that "this time it's different" is rarely right.

China's reform-minded economic technocrats of course understand this very well, hence why they have preached the need simultaneously to both deleverage the financial system and shift China's development model in a more reformist direction for so long.

But the second part of this formula is not part of Xi's macro-policy direction.

Xi's increasingly left-leaning populist economic agenda, as noted previously, is based on greater state intervention, greater income equality, and greater national economic self-reliance.

This strategy is likely to slow overall economic growth in the years ahead, given their collective impact on business confidence and private sector investment, innovation, and productivity growth.

That is before long-term demographic drag begins to slow the economy.

And slowing growth will be exacerbated by a slowing property sector.

Xi's new economic agenda, which is currently replacing 40 years of Deng Xiaoping's "reform and opening: strategy therefore now poses a bigger question mark than before for China's ability to surpass the United States and become the preeminent global economy.

It is here that Xi's political ideology seems increasingly likely to run headlong into the cold hard facts of economic reality and the untamable animal spirits that have animated it for much of the last 35 years.