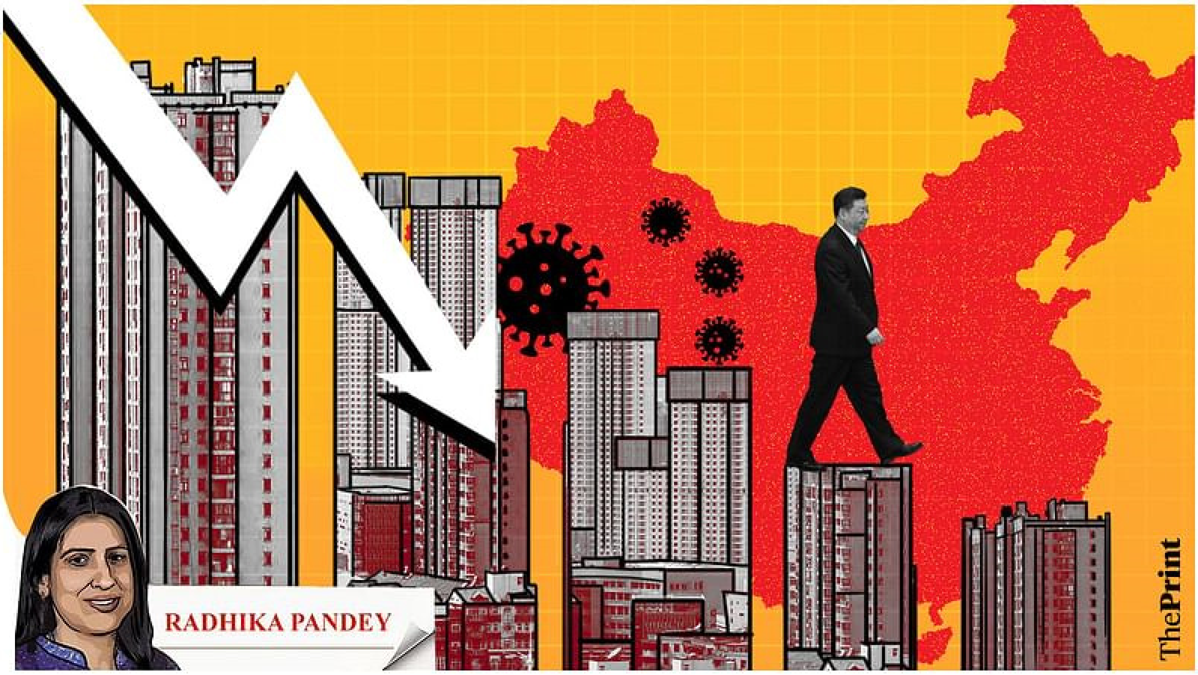
Chinese economy has been hit by a perfect storm: Property shock, Zero Covid, climate, Taiwan

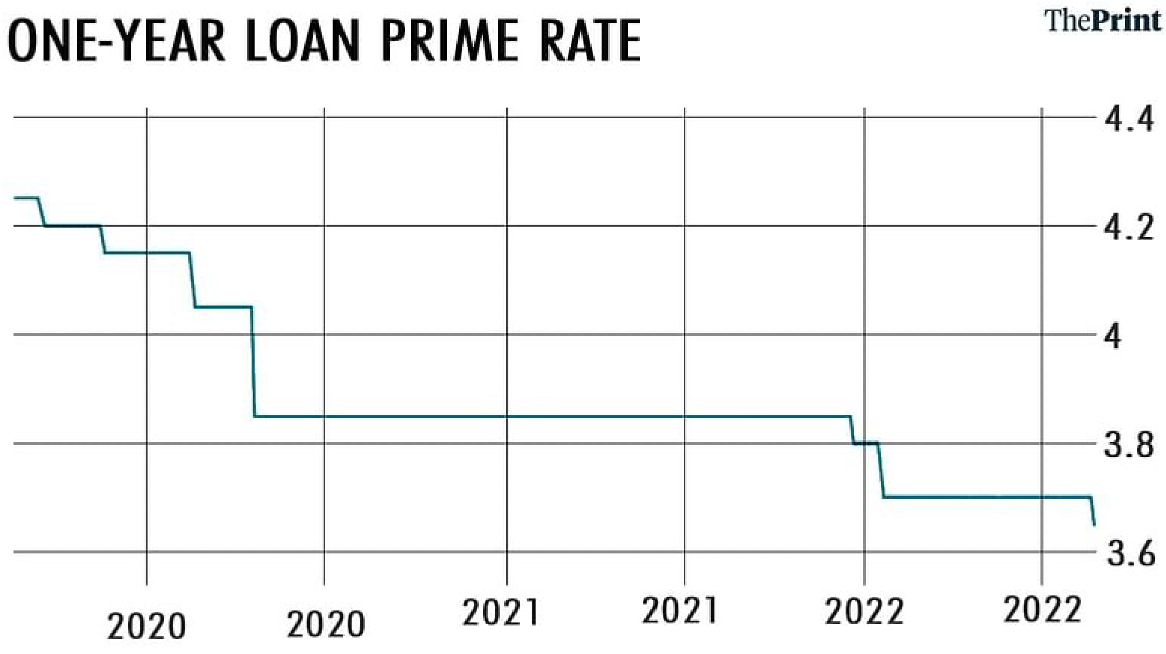
The world's second largest economy is in crisis, hit by lockdowns, impaired supply chains, slump in real estate sector and geo-political tensions.

RADHIKA PANDEY

26 August, 2022 08:31 am IST

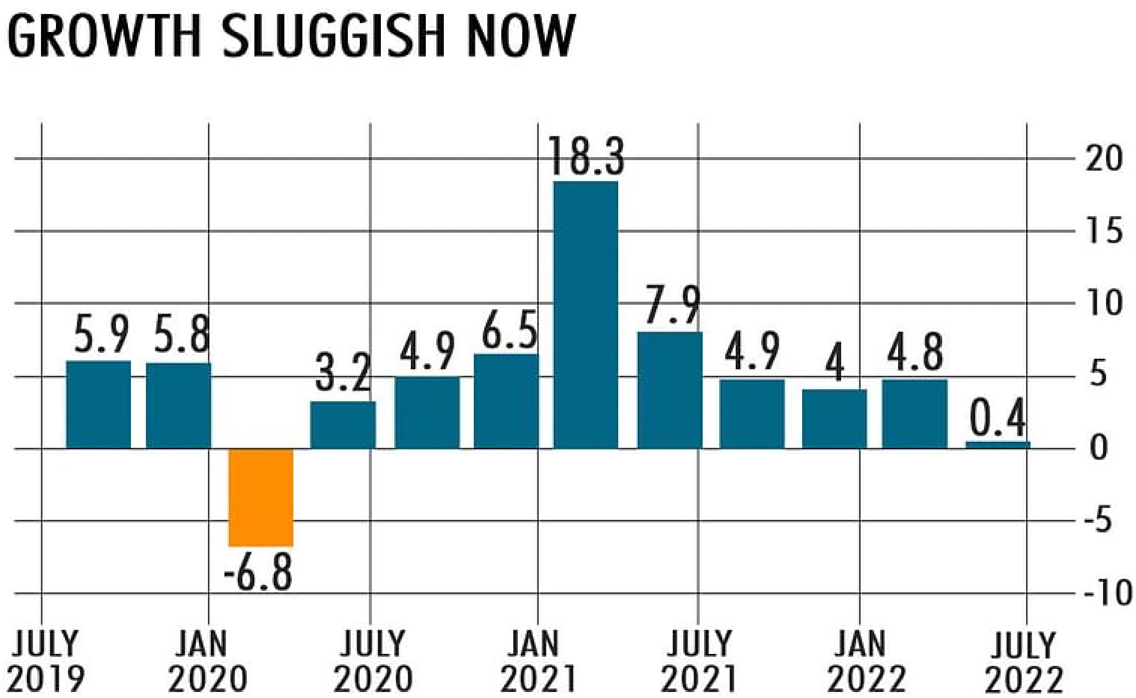


Earlier this week, China's central bank cut its key lending rates, days after it slashed two interest rates to boost demand in an economy hurt by extended COVID-19 lockdowns and a distressed property market. The neighbouring country seems to be in a perfect storm situation where lockdowns, impaired supply chains, slump in the real estate sector and geo-political tensions could potentially result in a prolonged slowdown.



SOURCE: TRADINGECONOMICS.COM | NATIONAL BUREAU OF STATISTICS CHINA

China's economy grew at the weakest pace since it was first hit by the COVID-19 pandemic two years ago as the economy recorded a year-on-year growth of 0.4 per cent in the April-June quarter. This was the worst performance since the March quarter of 2020 when the economy contracted by 6.8 per cent.



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The sharp slowdown is a painful setback for China which was one of the first major economies to recover from the COVID-19 pandemic in 2020.

The challenging macroeconomic backdrop has led to downward revisions in China's growth outlook this year.

Goldman Sachs lowered its projection for GDP growth to 3 per cent from 3.3 per cent, Nomura slashed its forecast from 3.3 per cent to 2.8 per cent. The projections are significantly lower than the official growth target of 5.5 per cent for the current year.

Real estate crisis

China's real estate sector is amongst the most crucial sectors as it accounts for one-third of the country's GDP. Also, 70 per cent of the household wealth is invested in property. China encouraged households to buy property by keeping returns on other investment options unattractive. This policy resulted in a real estate boom.

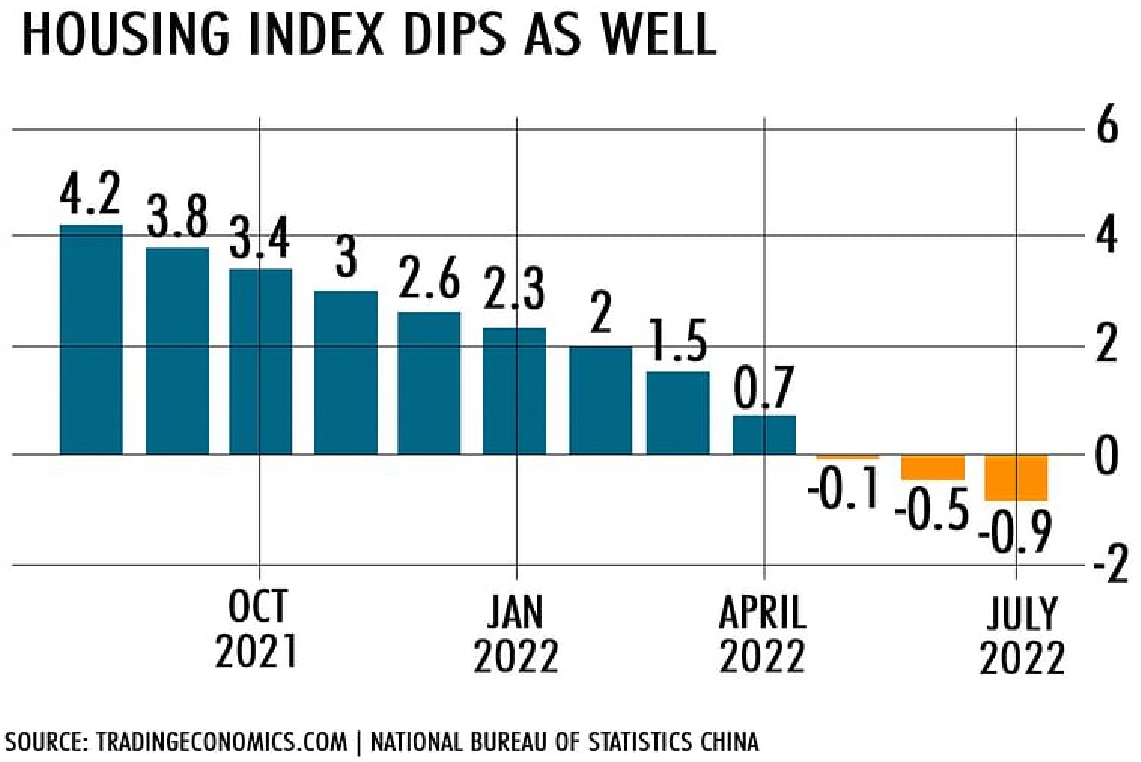
The financing model for the property sector was considered to be inherently unsustainable. Typically, property developers collected the full price of an apartment before starting construction. The funds thus collected were used to buy land and to invest in other activities.

The sales proceeds collected on another project could then be used to finance construction of the first project and so on in a continuous cycle. The financing model also led to a surge in bank credit for housing projects. Against this backdrop, the last decade (2011-2020) saw exponential growth in the sector, marked by rising housing prices, land prices and growing debt level of real estate developers.

Concerned that the real estate market was overheated, the People's Bank of China and the government introduced the Three Red Lines Policy in August 2020. The aim of the policy was to improve the financial health of real estate developers by reducing debt and improving liquidity.

Under the policy, further access to financing by real estate developers was conditional on them meeting the three red lines — a debt-to-asset ratio of 70 per cent or lower, a 100 per cent cap on net debt to equity, and enough cash on hand to satisfy short-term borrowing.

With the change in rules, real estate developers' access to credit was constrained, resulting in debt defaults and stalled projects. In 2021, China's biggest real estate developer Evergrande announced that it would default on loans worth USD 300 billion. Along with Evergrande, several other real estate companies also expressed their inability to deliver the promised homes.



The growing pile of unfinished houses became a source of discontent and anger for the middle class and snowballed into a "mortgage boycott" in China. Home buyers' refusal to repay loans after getting frustrated by the delays impacted the already distressed banks' balance-sheets. Demand for houses and housing prices have slumped due to lack of confidence in the real estate sector.

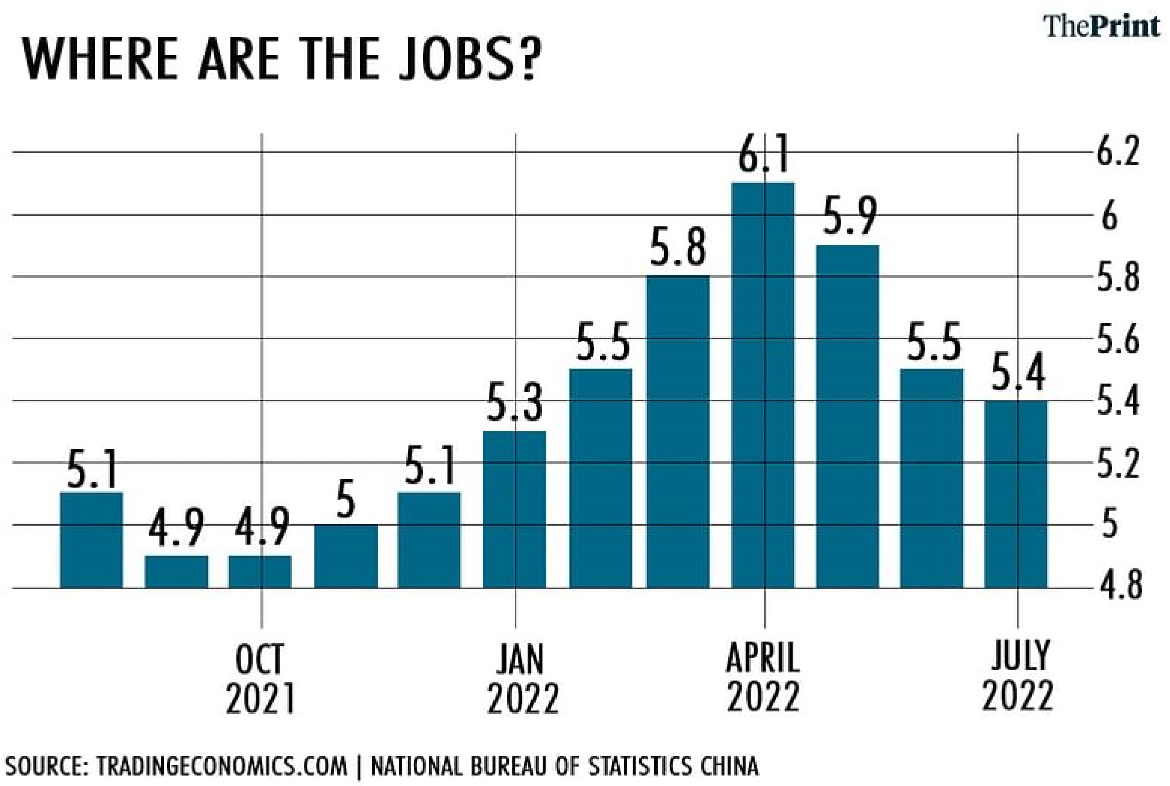
Zero Covid policy

The challenging economic environment got further hit due to China's zero-Covid policy, which has led to repeated lockdowns, hurting household income and economic growth.

According to an estimate, lockdowns cost China 3.1 per cent of GDP per month, assuming the highest GDP contributing cities are under quarantine.

Delayed production, labour shortages and disruptions in logistics have occurred.

Against the backdrop of severe lockdowns, firms are hiring less. As a result, youth unemployment has touched a record high. Overall unemployment eased in July but continued to remain high.



Fuelled by fears of subdued growth and repeated lockdowns, foreign investors are cutting their exposure to China. Rate cuts are also triggering capital outflows from China, leading to downward pressure on the Yuan against the dollar. The lockdowns have shut down ports, and roads in some places and prevented foreign employees from entering the country or visiting their China offices.

Geo-political conflicts

The recent visit of the US House of Representatives Speaker to Taiwan has intensified the friction between the US and China and has triggered military drills. Taiwan is a key manufacturer and supplier of semiconductors and electronic components to several countries, including China. A blockade or slowdown of shipments from Taiwan owing to the repeated military drills could lead to supply disruptions and exacerbate the slowdown in China.

Record heatwave and severe drought

Since early July, China has been grappling with record high temperatures that have led to power outages. As an outcome, many cities have been forced to cut power supplies to factories. Several construction projects have been halted due to power shortage.

The country issued its first national drought alert of the year. Rivers have dried up. Cities like Sichuan, which are dependent on hydropower for 80 per cent of their energy needs, are facing a serious energy crisis. The drought has also impacted shipping. The drop in water levels could have an adverse impact on logistics and global supply chains.

China has been a crucial part of the global supply chain. Escalation of the Taiwan-China conflict could impact shipments of industrial raw materials leading to a build-up of supply-side inflation.

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Views are personal.