Capital Markets Insight

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China's Debt Dilemma

Since the middle of the last decade, the Chinese government has taken steps to reduce moral hazard, the presumption that the state will bailout companies if a default would be sufficiently disruptive to the financial system. Recently, Chinese authorities have allowed several firms to default on their debts without providing any assistance, even state-owned enterprises, but the authorities have engineered selective bailouts to forestall all-out bankruptcies of firms it deems to be systemically important by arranging rescues by state-owned lenders.

The case of Evergrande, the large, highly indebted Chinese property developer, is a particularly difficult one. As much as authorities may want to allow the firm to go under in order to rid the system of corporate excesses, such an action could leave hundreds of thousands of Chinese citizens in the lurch as many have placed down payments on apartments that Evergrande has yet to complete. Banks and suppliers would also be heavily impacted, creating the prospect of contagion and systemic risks to the Chinese economy. Given the heavy exposure to real estate among Chinese citizens (the Economist estimates that 75% of Chinese household wealth is committed to real estate) and the role that sector plays in China's GDP (about 15%), a disorderly Evergrande collapsed could reverberate through the Chinese, and global, economies.

China's leaders will need to weigh the potential for social unrest stemming from a disorderly winddown of Evergrande against the potential for exacerbating moral hazard by sponsoring a government-supported resolution. So far, the Chinese state media has warned that "Evergrande should use market means to save itself," and to date, some lenders have agreed to extend the payment terms on Evergrande's debt several times, but with over $140 billion in debt and payables coming due over the next year, the company has its work cut out for it. It has embarked on a series of asset sales, but those efforts have proven insufficient to stave off the growing debt crisis.

The Evergrande problem is symptomatic of years of corporate excess that have only begun to be corrected. Without a doubt, the company's overleveraged balance sheet has made it vulnerable, but its speedy deterioration has been accelerated by government policies such as the three "red-lines" imposed on developers — a 70% ceiling on the ratio of liabilities to assets, a cap of 100% on debt-to-equity ratios and a cash-to-short-term borrowing ratio of at least 1 — and property lending limits imposed on banks. These policies have led to a liquidity squeeze for the broader Chinese real estate sector. Several weaker developers that have near-term refinancing needs are showing signs of distress. So far in 2021, three publicly listed Chinese real estate developers have defaulted on their debts, and we estimate as many as 11 defaults this year, totaling $30 billion of bonds (a 23% default rate for the sector) if the policy environment remains tight and the sector loses market access to credit.

China's policymakers, who cannot afford to make a policy error at this critical juncture, seem to be trying to thread the needle by inflicting sufficient discomfort on property developers through a painful debt restructuring to limit their future risk-taking without setting off a cascading credit crisis that significantly disrupts economic growth. In our view, Chinese officials are likely to stop well short of a direct bailout of Evergrande while helping to facilitate a restructuring. The MFS investment team continues to closely monitor the situation.