China's Coming Property Correction: A Managed Soft Landing

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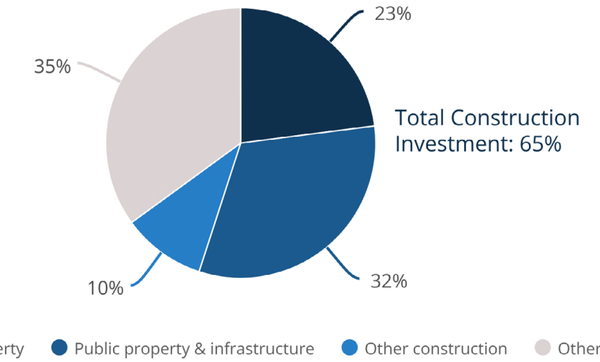
With China's Evergrande moving into what appears to be a managed default process, as we had previously anticipated, it's time to look at the future of the property sector. Even without the Evergrande crisis, the property sector is bound to see a correction. The crisis simply made the writing on the wall clearer. Such a correction means that China's notoriously outsized investment-driven model will have to be "right-sized."

The right-sizing of investment, which mainly refers to fixed-capital formation that makes up about 43% of GDP, will inevitably hurt growth (see Figure 1). Getting a handle on the magnitude of the growth impact, therefore, will be key to any analysis of China's economic future. To do so requires examining construction-related investment, which is composed mainly of private property investment and local government investment (including public housing and infrastructure).

Figure 1. Construction Investment Makes Up 2/3 of Fixed Capital Formation



Source: National Bureau of Statistics and MacroPolo.

Our baseline scenario assumes a 30% decline in private property construction through 2025. In total construction volume terms, that means a correction from 100 million units to roughly 70 million units. Such a correction will lead to annual property sales falling from 15% to 10% of GDP by 2025, which is basically the same level as in 2010. In other words, China intends to roll back the decade of rapid property sector growth in the next five years.

As a result, local government investment, which is basically public spending on infrastructure that depends largely on land revenue derived from private property investment, will likely decline by 3% of GDP over the same period. Combined with the property correction, we expect overall construction investment to be down by 6% of GDP.

But this decline will be buffered by growth in other areas, including consumption, so that the net growth impact in our baseline is a Chinese economy that will be 2.8% smaller by 2025 than it otherwise would be without the property correction. This in turn shaves off -0.6 percentage points (ppt) to average annual growth over the next five years (see Table 1).

Table 1. Growth Drags and Offsets Resulting from Property Correction by 2025

	Baseline (% GDP)	Downside (% GDP)
Net Cumulative Growth Impact	**-2.8**	**-5.14**
Average Annual Growth Impact	**-0.6 ppt**	**-1 ppt**
Drags		
Private Property Investment	-3	-4.05
Local Government Investment	-3	-4.05
Total Drag	-6	-8.1
Offsets		
Labor Re-employment	0.9	0.97
Growth Regions		
Consumption Growth	0.26	0.4
Cheaper Commodities	0.2	0.4
Shrinking Regions		
Consumption Growth	1.84	1.19
Total Offsets	3.2	2.96

Notes: All figures are represented as % of GDP except for the average annual growth rates, represented in percentage points. The baseline scenario assumes a -30% decline in property construction through 2025, and the downside scenario assumes a -40% decline. These are aggressive projections because they omit certain upside factors, such as monetary easing, and exclude the replacement of aging property in the property demand forecast that would further offset the growth slowdown.
Source: Author.

That the overall growth impact will be smaller than the headline drop in investment constitutes what we call a “managed soft landing” scenario. What follows is a comprehensive assessment of the coming correction in the property sector that examines the drag on growth from the fall in investment and the offsets in other areas that should cushion the blow.

The Property Reset Will Be Unevenly Distributed

Over the years, China’s property sector has been repeatedly subject to the “boy who cried wolf” syndrome. That is, the bubble was always supposed to pop at any time. The sector certainly had bumps but it was usually silly to bet against its growth.

But this time, the wolf has finally arrived in the form of secular trends and policy headwinds.

One such secular trend is demographics. China’s working-age population, the main consumers of property, has been declining and will continue to do so at an accelerating pace. That has knock-on effects on China’s urbanization, which has been the main propellant for property growth.

Now that China is already two-thirds urbanized, we expect an average urbanization rate of 0.85% through 2025, which is sharply slower than the 1.4% over the past five years. Housing demand should naturally adjust as a result.

The excessive size of the property sector has also unnerved policymakers. Guo Shuqing, China’s top financial regulator, did not mince any words when he recently called out property as the biggest financial risk for China.

With the property sector attracting some 40% of total bank lending and the concern over leverage that the Evergrande crisis revealed, it is no surprise that financial regulators want to tame the sector. It is a virtual given that more draconian policies beyond the so-called “three redlines” will be imposed in coming years to rein in the sector.

All these factors point to a more significant slowdown of the property sector, but the effects will manifest differently across China, with the aggregate impact on headline growth more modest than meets the eye (see below).

For regions that have seen significant population outflows over the last decade, the property reset will be felt more severely. At the same time, nearly 50 million working-age Chinese flowed into growth regions over the last decade, which should support demand for property.

In addition, expected *hukou* relaxation and the concentration of opportunities will continue to attract population to those growth regions. In other words, this massive internal migration should help cushion the blow from the property correction nationally.

Given these secular trends, the rest of the analysis first assesses the scope of the property correction and then the aggregate impact on growth in our baseline scenario.

Scope of Property Correction: Down 30% by 2025

To grasp the overall drag on China's growth from an investment slowdown requires decomposing construction investment into its two main constituent parts: private property and local government investment. It's important to look at property first because the sector is inextricably linked to local finances, which in turn determines infrastructure investment.

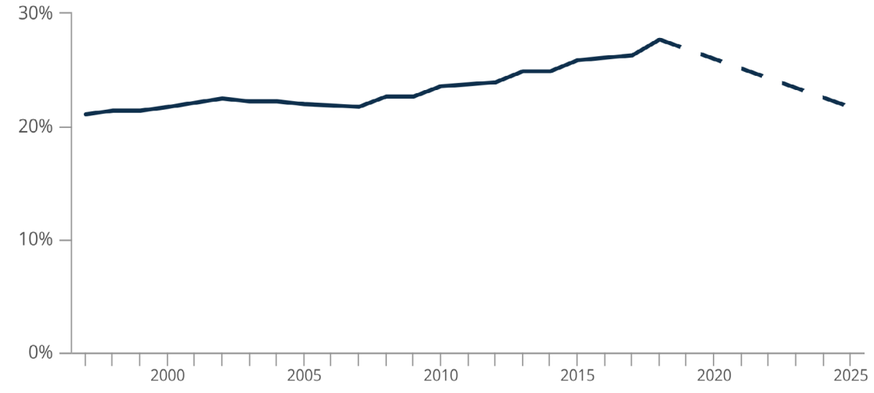
Our baseline projection sees private property construction falling by 30% from 2020 to 2025, from 1 million hectares to 700,000 hectares (including commercial real estate such as malls). That translates into a drop from 100 million to 70 million units when converted to total housing volume. Most of that decline will be concentrated in weaker regions with population outflows.

Property sales will adjust accordingly, falling from 15% in 2020 to 10% of GDP in 2025 (property sales for 2020 have been adjusted because we believe they were exaggerated by about 15%). Although sales will be more concentrated in the expensive growth regions, average property price growth will lag GDP growth by a bit. (In the downside scenario of 40% decline, property construction falls to 600,000 hectares and the property sale/GDP ratio will fall to 8% of GDP.)

Such a property correction will lead to net land revenue decline of 1% of GDP in the baseline scenario. That's important because it directly affects local government coffers, as land revenue from private property development is then used to invest in everything from public affordable housing to infrastructure.

For every yuan loss in land revenue, that amounts to a loss of roughly three yuan in government investment. As such, local government investment will see a decline of about 3% of GDP by 2025. Combined with the expected drop in private property investment above, total construction investment is projected to fall by 6% of GDP under the baseline (8.1% in the downside scenario). This means that by 2025, the construction investment/GDP ratio will revert to the level not seen since 2007 (see Figure 2).

Figure 2. Construction Investment as % of GDP Expected to Return to 2007 Level



Source: National Bureau of Statistics and MacroPolo.

Construction Slowdown's Impact on Growth

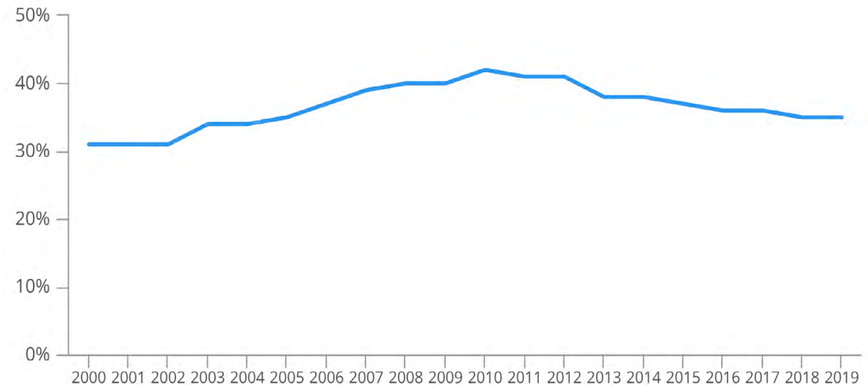
The construction investment slowdown resulting from the property correction will shave -0.6 ppt off of the average growth rate over the next five years. As such, China's GDP will be 2.8% smaller by 2025 than it otherwise would be without the correction. (In the downside scenario, it will be -1 ppt in average growth rate and a -5.1% hit to GDP.)

The reason that the headline growth impact appears modest is due to a number of offsets that should help to cushion the blow. We detail those below.

Offset One: Household Consumption Here To Stay

Contrary to conventional wisdom that Chinese household consumption is mainly geared toward big ticket items like housing, weaker housing sales aren't likely to collapse consumption. This can be seen in the household savings rate, which has fallen from 42% to 35% and is likely to continue descending (see Figure 3). Notably, this decline in the savings rate has occurred even in regions where housing purchases have slowed dramatically, such as Liaoning.

Figure 3. Chinese Household Savings Rate Has Been Trending Down (% of GDP)



Note: Dashed line denotes projection.

Source: NBS.

This implies that households have already started to alter their consumption patterns and the expected fall in housing sales won't necessarily lead to a rebound in the savings rate. In other words, Chinese households' consumption will have more staying power going forward even as property becomes less attractive. As such, Chinese households are nonetheless expected to spend 65% of the savings that would've been otherwise spent on housing.

Of course, expectations on the consumption offset should be tempered in an environment where growth will slow. The main effect of consumption is that it will continue to grow, rather than contract, despite the property correction.

Offset Two: Rapid Labor Market Adjustment

China's housing boom was built on the shoulders of blue-collar and migrant workers, and a less boomy housing market could well mean dislocation for the roughly 50 million construction workers. In fact, worker compensation makes up some 17% of total construction investment.

Yet that concern might be misplaced. China's labor force has been shrinking and blue-collar workers are in short supply, therefore we expect the majority of construction workers to be reallocated to other sectors of the economy fairly rapidly. We assume 85% and 70% of displaced workers will find jobs in other sectors under the baseline and downside scenarios.

Offset Three: Savings from Commodity Imports

Finally, reduced construction activity means less demand for raw and construction materials, such as iron ore and steel. In fact, the so-called "commodity super cycle" of the last decade or so was tethered to China's massive urbanization. But less housing demand will mean less commodities demand, leading to a correction in prices.

We expect imports of commodities, such as iron ore, coal, and lumber, to fall by around 0.5% and 1% of GDP in the baseline and downside scenarios, respectively. Put another way, commodity exporters will have to bear some of the pain for China's construction adjustment.

Main Caveat: Regional Variation

In laggard regions where considerable loss of population is evident, the adjustment will be much more painful. Because they're already economically weaker, these regions will be less capable in tackling the associated problems with a property correction, such as debt and fiscal revenue. They will also have a tougher time adjusting because suppliers to the construction industry, such as steel producers, are concentrated in those regions.

As a result, these shrinking regions, which account for close to 60% of GDP, will experience more significant growth slowdown. This is in part because the above offsets, such as household consumption and lower commodity prices, won't apply as much to these weaker regional economies as they do to the growth regions. We accounted for this regional variation in our overall growth projection.

Making Up the Revenue Shortfall

With the pain of adjustment largely borne by weaker regions, they will likely require support from the central government. Tax revenue decline from the property correction and general growth slowdown is expected to be around 2% of GDP in our baseline scenario. Consequently, we expect Beijing to increase the fiscal deficit to 3% of GDP to make sufficient transfers to local governments to help them weather this adjustment, including servicing their debt and social welfare obligations.

This is already a substantial increase in the fiscal deficit, and further increases should not be expected from Beijing. The central government intends to use its fiscal power mainly as another cushion to ease the adjustment to the investment slowdown rather than as a form of stimulus to juice growth.

A Managed Soft Landing

The coming property correction is inevitable, and the extent of the impact on the overall economy depends highly on how it is managed. Just as the Chinese government has managed Evergrande's default process, we implicitly assume that Beijing will demonstrate relative competence in mitigating systemic risks as part of the property correction.

As such, our baseline scenario is reasonable if not deliberately more aggressive on the downside. For instance, our projection does not account for property demand from replacement of aging property nor factors like monetary easing. Even without accounting for those positive offsets, the overall growth impact is actually similar to that during the US-China trade war.

Therefore, so long as Beijing manages this process well, the Chinese economy will manage through the property correction. Of course, a hard landing is possible if this correction is mismanaged or spins out of control. We will examine the financial risks associated with a hard landing in a future analysis.