Allison Nathan: China's property sector accounts for a whopping 30 percent of the economy versus 15 percent in the US. And this hugely important sector has remained under pressure, hobbling the country's recovery and weighing on global economic growth. So, what's the road ahead and the implications for investors?

Ken Ho: Could we see a systemic or some kind of banking crisis in China? For us, the answer is no. And I think it's important to be aware that policymakers in China, they're very focused on making sure systemic risks don't emerge.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges.
To help explain the significant of China's property market crisis and what it means for the broader economy on financial markets I'm sitting down with my colleagues in Goldman Sachs Research Hui Shan, our chief China economist, Ken Ho, our Asia credit strategist, and Yi Wang, who leads the China real estate team and is the co-head of greater China equity research.

Hui and Ken are joining me remotely from Hong Kong. And Yi is joining me remotely from Shanghai. Hui, Ken, and Yi, welcome to the program.

**Hui Shan:** Thanks for having us.

**Allison Nathan:** So, Hui, maybe we could just kick off by getting some understanding of why the property sector troubles are so important here.

**Hui Shan:** Sure. Let me try to answer it from three different angles. One is that the Chinese economy is very important for the global economy. China's GDP is close to
20 percent of the global GDP. And then as you mentioned earlier, property is a large chunk of the Chinese economy.

The second reason is that unlike in a lot of different economies, in China, property has linkages to many parts of the economy, including, for example, local governments sell land as part of their revenue. So, you can see the linkages from property to local governments and fiscal revenue, and for spending. And there's also these linkages with consumption through confidence, through house wealth effects, through when you're moving, you buy your furniture and home appliances. So, in addition to construction, the upstream steel, cement. So, it's all connected with the many parts of the economy. That's the second reason why it's so important.

And lastly, I think when I talk to, especially, offshore investors, many investors have the memory of housing downturn is going to be super damaging to the economy and the financial system. Think about the global financial crisis triggered by the US subprime crisis. And think about Ireland and Spain housing bust. So, that memory makes investors very cautious on China due to the ongoing slowdown. So, I think that's a third reason why it matters
so much, not only for the economy, but also for asset markets.

**Allison Nathan:** And so, when we say property sector downturn, are we talking about primarily housing here? And what does homeownership really look like in China?

**Hui Shan:** The homeownership rate is actually quite high in China. In the US, the homeownership rate should be in the 60s. But in China, it should be in the 80s. So, most urban households own their own apartment.

And depending on which survey you look at, the number varies, but somewhere between 60 to 70 percent of a household's total assets are in properties. So, there's a common notion that Chinese households save a lot. They save 30 percent of their disposable income. And once they accumulate that savings, they almost exclusively put it in property or bank deposits. You look at other kinds of assets, those are a tiny share of the household balance sheet.

**Allison Nathan:** Right. So, homeownership is a big deal in China. So, troubles in the property sector have, again,
been in the headlines. That's why we're having this conversation. And they seem to be getting worse. But this is many years in the making. So, Hui, just give us a quick history of how we got to this point.

**Hui Shan:** It's a relatively short history just given China's fast pace of development. I want to take you back to 1998. That's when the housing reforms started in China. Most of the homes were pretty much provided by employers. So, we didn't really have this commercial or what investors typically think about, private housing market.

So, starting in 1998 when China's urbanization rate was only 33 percent, the rapid pace of urbanization, by 2001, China entering WTO, all that mixed together drove the spectacular growth in China. Income was growing. And people want to have good quality, bigger, better apartments. And so, the property sector expanded dramatically from the 2000s all the way to, let's say, mid 2010s.

By 2016/'17, that's when the leadership started to talk about housing for a living and not for speculation. The
undesirable side effects of having this housing boom started to show, meaning housing becomes so unaffordable, especially in the big cities. And also, because prices had been increasing so rapidly, a lot of people think it's not worth investing in manufacturing or real economy. Just buy land. Buy apartments. You can make money quickly and almost surely. So, that's crowding out normal economic activities. And so, the leadership really looked at this and think, we need to do something about it.

Unfortunately, we had 2018/2019, that was the trade war and China growth was facing downward pressure. The timing, you can only do so much. You cannot aggressively tighten the property sector. And then 2020 we had COVID.

By the end of 2020, there was a window of opportunity in policymakers' minds. Chinese economy is doing great. Exports were booming. And the domestic activity was strong. So, policymakers wanted to take that window of opportunity to really tighten the property sector. Not just the property sector, think about internet regulation and think about energy regulation. We had power outages in 2021.
So, in 2021 we had a lot of tightening policies. And by 2022, the zero COVID Policy that worked in 2020 and 2021 stopped working.

So, fast forward today we're in this very depressed property market situation. That's a long-winded answer to your question, a short history about how we got here.

**Allison Nathan:** Yes. Long, but short given that you covered many, many years. Yi, let me bring you into the conversation. What have you been seeing on the ground in the property sector as these policies shifts have been taking place over the last several years?

**Yi Wang:** I think the market probably peaked in summer 2021 for all the cities. Actually, lower tier cities started the price decline since 2019. But the larger ones peaked in the summer of 2021.

And since then, if we look at the construction activities, new starts came down by about 50 - 60 percent from the peak. Land sales have also come down more than 40 percent from the peak. Property prices in secondary markets in key cities, also have come down about 20
percent from July 2021.

And more important, I think if you look at the top 100 developers, which account for almost half of the market share, before this downturn, almost 70 percent of them are private developers. And now all of these two sorts of top 100 developers, we see a majority of them, more or less, are having liquidity troubles. Already defaulted on their either offshore bonds or onshore bonds.

**Allison Nathan:** Well, Ken, can you dig into that a little bit more? Because my understanding is leverage played a key role in the downturn that we're seeing right now and the crisis we're seeing right now. So, talk us through how a build up in debt and leverage played a role in the current crisis.

**Ken Ho:** We're living through the aftermath of one of the largest ever recorded credit boom. So, if you look at, for example, in the decade post the global financial crisis, China's nonfinancial debt to GDP level rose from around 150 percent to 260 percent in about slightly under a decade. And the real estate debt that built up was very much a part of that.
So, if we look at developer debt plus mortgages, let's look at 2006 before the global financial crisis. If you add those two together, developer mortgage debt added to just over 10 percent of China's GDP. At the peak, at around late 2020, we estimate that this rose to around 55 percent of GDP. So, that's a very large increase in property related debt. And obviously, this is also in the context of this very large credit boom.

And so, the last few years as we see policymakers looking to try and contain leverage and focus a little bit more on deleveraging, naturally, the real estate sector has become a focus, especially given that it's a very levered part of growth.

And in terms of numbers, we estimate at the end of last year, the total amount of mortgage and property developer debt outstanding is around $8.4 trillion US dollars. So, there's definitely quite a bit of work that's needed in terms of trying to contain deleveraged growth and the fallout from the deleveraging efforts.

**Allison Nathan:** So, leverage has played a large role here.
And Hui, you mentioned the past housing downturns, and in particular, the major housing downturn in the US. And that generated a financial crisis, as have other housing downturns.

So, the key question is, is China on the same trajectory? Will we see a financial crisis stemming from the property troubles here?

**Hui Shan:** I think it's different. If you think about the way housing crises played out in other economies, especially in the subprime crisis, they have several steps. The first step, prices start to fall and we also saw construction activity plummeted and having an impact on the real economy.

And the second step, once the prices started to fall, you started to see homeowners defaulting on their mortgages, or walking way, and the foreclosure crisis triggering financial issues for banks and the financial system. And in the third step, you started to see banks had to tighten credit. And then that just generated additional tightening impulse in the economy. This negative feedback loop spiraled out of control. That's how we think about the
traditional or the US subprime crisis.

Now, you map into China, I think the first step in China, may be even worse than the US financial crisis. Why do I say that? As you mentioned, the Chinese economy, property is just more prominent with more linkages. It's even having these linkages with local government finances. So, I think if you have something that's 30 percent of the economy and that just contracted and collapsed, then that's going to have a much bigger impact on the real economies.

So, the first, I actually think China is in worse shape than the US. But the good news is that the second step, think about the defaulting on foreclosures that people just can't keep making their mortgages. That doesn't seem to be happening in China. Again, the background matters. You think about Chinese households. They save 30 percent of their disposable income. There are people borrowing a lot of mortgages, just because the property price is so high, they had to borrow mortgages.

But the vast majority of people, especially those who bought second homes and third homes, fourth homes, they
don't really have a lot of leverage because the mortgage terms have been stringent.

I'll give you an example. In the first-tier cities, if you buy a second home, third home, you have to pay, I think, 70 percent downpayment to purchase those properties. A lot of people bought with cash. So, I don't necessarily think as housing prices start to decline you're going to see waves of foreclosure and people are fire selling their apartments. That just doesn't happen.

And the third linkage is also not really happening in China, meaning banks are tightening lending across the board. If anything, in economic downturns, in the Chinese system, the central bank is going to ask banks to lend more, not less. So, I think that mechanism is also very different.

So, to your question, I think the initial stage of hurting construction, hurting the upstream or the whole supply chain related to property construction, China might be worse off. But the second stage and the third stage, I think China doesn't have the issues that really generated that downward spiral, or the negative feedback look that we saw in other economies.
Allison Nathan: But we may not be seeing defaults on the household side. But Ken, we have seen some large developers coming very close to default or technically defaulting. So, what's your view? Do you think this could be a catalyst for a financial crisis?

Ken Ho: There's certainly some parallels that one can draw in terms of how China has developed relative to the US and Japan. For example, Japan in 1990, US/UK, for example, around sort of 2007/2008, what you saw was after the bubble burst, you had government leverage rising very sharply. And you had private sector leverage going down. Which makes sense because the private sector needs to delever after a bubble. And the government's lever up to ensure growth is sustained.

And we've seen that in China starting a few years ago. So, if you match the timing of when the property downturn happens and you look at private and public sector leverage, actually, China's following a pretty similar path.

And so, for China, I think a large part of this is will they start to recognize and clean up a lot of the banks and a lot
of the potential non-performing loans in the system? And if they do that, I think they will avoid a similar path.

Could we see a systemic or some kind of banking crisis in China? For us, the answer is no. And I think it's important to be aware that policymakers in China, they're very focused on making sure systemic risks don't emerge. So, this has been our view, a key policy objective.

And we think they are very vigilant. And we think a lot of these potential stressors are in the smaller banks. If you look at the rural city level banks, they're around a quarter of the banking system. That's where potentially a lot of the problems could come through if we start to get more defaults and so on. But we do think policymakers are very, very much on top of that. And, obviously, our belief is that they would deal with these in a timely manner so that you don't end up in a Japan-like scenario.

Allison Nathan: And in fact, we have seen policymakers come into the economy in a big way in past downturns. In 2008, the fiscal stimulus was enormous to help shore up the economy. But we haven't really seen that to the same extent here. What's guiding them there? Hui, maybe you
Hui Shan: I think the reaction function is somewhat different. We get a lot of questions from clients about why the Chinese government still hasn't pulled out their bazooka yet. But if you think about the experience and the memory of policymakers, the lesson they seem to take away from their 2008/2009 big stimulus and then the 2015 to '18 they did a major round of shantytown redevelopment, basically giving people cash so that they could buy apartments in the lower tier cities.

The lesson they drew from those experiences is that we did too much. And we built this big leverage. And look at the mess we're in today. So, if that's the lesson, then the natural reaction is let's avoid doing too much. And also on the housing front, in previous rounds of housing downturns, as soon as policy starts to ease, the property market quickly rebounded. So, the muscle memory for policymakers is that if we loosen, chances are it's going to be loosened too much and the property market's going to rebound again. Prices are going to go up. The affordability may deteriorate. So, this whole housing for living and not for speculation, under that mantra, we shouldn't do that.
But I think a big part of this is that experience. And another part of it is that you think about the urbanization, the property infra-driven growth, clearly that's not sustainable. We can argue, is that another five years of runway? Ten years of runway? But it's not going to be able to drive China's growth forever.

So, in the back of the mind of the government, they want to figure out how do we transform the economy? How do we find a new engine of growth when we run out of urbanization dividends and property infra no longer contribute significantly to growth? So, that's another reason they're holding back. They don't want to go back to the old playbook, let's do another bunch of infrastructure. Let's stimulate the property again. So, those are the two reasons, in my mind, why we're seeing such piecemeal or incremental or reluctant easing style that we have been seeing over the past year or two.

**Allison Nathan:** Yi, maybe you can review what they actually have done though and the impact you're seeing on the ground.
Yi Wang: So far since this downturn, they launched these 16 measures so in order to inject liquidity to developer industry. And by the end of August this year, they also started to relax mortgage restrictions and also further remove the home purchase restrictions in order to boost the demand, especially in high tier cities.

But if you look at the pace that they're doing this relaxation, it's a lot slower than what happened in 2014/2015 downturn. So, that's different. And the reason for that, as Hui just explained, that they just don't want to stimulate too quickly and too massively to cause another trouble. Because if you look at the current supply capacity of the industry, obviously, that's excessive against the long-term demographic-driven potential.

So, I think in order to avoid a huge collapse down the road, they want to rein in the market today. But I think the experience for the Chinese government is all about the primary markets in the past cycles. The risk, I think, this round is really about the secondary market, that the government has a lot less control. The primary market, they can control the lend price. They can even control developers' selling price. But in secondary markets,
because this is all consumer behavior, it's very difficult for them to control.

So, this is something we need to watch closely, where the government can recognize the potential supply increase in the secondary market that eventually causes a lot bigger supply and demand mismatch and then cause more property price decline, which further translates into lower property sales in the primary markets and developer illiquidity situations, construction negativity, value chain, everything to feed back to the whole economy.

So, this is something that we need to watch very closely for 2024. And these are the key differences, I think, for this cycle versus the previous two downturns.

Allison Nathan: And so, just to clarify, by primary market you mean actual home building and secondary market you mean people buying and selling existing homes?

Yi Wang: Yes, correct.

Allison Nathan: So, what are you seeing in the data right now though? Have the measures that they've been taking
started to improve the data in the sector? Or are we still seeing further deterioration?

**Yi Wang:** We're seeing further deterioration at the moment. We see rising supply in the secondary market. Property prices are also still very weak. In the for primary market, our new home market, we continuously see in October, after two months of policy easing by the government, October sales are very weak, seasonal adjusted. So, we haven't seen much impact from government easing this cycle, partly because the government is so slow, partly because the micro backdrop is so weak.

And more importantly, I think household leverage, household debt service burden is a lot higher than the previous two down cycles as well.

**Allison Nathan:** And so, let's talk a bit about the economic impact of this all. Hui, as you said, massive sector in a steep decline. So, what are the actual implications for growth?

**Hui Shan:** In terms of the property sector's impact on Chinese growth, we did an estimate by adding up all the
different channels. Right? We talked about there's construction. There's the real estate service, when you buy and sell there are generated service fees. And then there's a consumption channel. And then there's that local government's finances/infrastructure channel.

So, when we add those up, we saw in 2022 there is over 2 percentage points drag to GDP growth. And then 2023, another 1.5 percentage point. So, this is saying that for the next few years, a property slowdown is going to have a sizable impact on China’s GDP growth. And then second point, if you think about the potential growth, you think of a potential growth as the average of the five-year growth, property used to be a driver of growth. Take 2019 as this example. 2019, the Chinese economy grew 6 percent. And one out of six was property driven.

So, now you have about a 1 point drag from property sector. Which means all else equal, you can only grow 4 percent. That's a simplistic way of saying it. But the point being when you have this large segment of the economy contracting and it's going to take years to get back to normal, your potential growth takes a big hit. So, that's why we think Chinese growth, the potential growth now
may be settling at around 4 percent. That's the second big impact from the property to the economy.

And I think in terms of global implication, I like the statistic that if you think about copper demand, before the downturn, Chinese copper demand, just in the property sector, was even more than the entire copper demand from the US. The entire US demand for copper, including property, manufacturing, infrastructure, everything. Not even equivalent to the copper demand just in the Chinese property market.

So, this is going to have some impact on commodity demand as we go through this very painful and lengthy correction in the Chinese housing market.

**Allison Nathan:** And so, you say policymakers want to continue to address this in a piecemeal fashion. But you also said they want to contain and make sure they avoid systemic risk. So, what else needs to be done from here to actually stabilize the sector, which as we've discussed, hasn't happened yet. And will they do it?

**Ken Ho:** I think from a credit perspective, we looked at the
credit problems in terms of two related but distinct problems. So, one's a flow credit issue. The other one is a stock credit issue.

So, what do you mean by flow credit? So, that would be to make sure that there's sufficient money, sufficient credit flowing into the system such that the developers can maintain the construction and make sure the housing are delivered. And if you look at the actual bank lending to property developers, it's increased over the last two to three years.

However, to us a bigger problem is the stock credit problem. So, the stock credit problem is all of that credit that you borrowed over the last decade, all the excess inventory amongst the developers' balance sheets that need to be cleared, because that is potentially a much bigger problem. There's a lot of potential latent NPL, non-performing loans, that could emerge out of that.

So, in order to really clean up the credit within the China property sector, at some point you need to switch from dealing with the flow credit issue to start tackling a lot of the stock credit issue.
**Allison Nathan:** Yi, do you have anything to add?

**Yi Wang:** Yeah. I think on the demand side, we also want to see what we call the stage two easing from government. For stage one, basically government is removing the current restrictions which is happening. But you can see the effectiveness is also quite limited. For stage two easing, we really want to see the government try to do something that really can improve the affordability, especially for larger cities.

Yes, China homeownership is high. But there is a big mismatch between supply and demand, i.e., when people move from rural areas to urban areas, they need to have properties in urban areas. But they probably have properties in the lower tier cities.

In other words, we have a lot lower oversupply issues in the lower tier cities. But we also have affordability issues in high tier cities. So, in order to more effectively boost the demand, we need the government to work on this affordability improvement in the larger cities so that the demand, especially in the secondary market, can stabilize.
On the developer side, in our calculation, the founding gap for these two years will be about the RMB 4 trillion. I don't see any government plan to meet this 4 trillion. At the moment, they're only talking about funding to ensure delivery. And that's about 350 billion RMB. And even for that 350 billion, it's only 50 percent utilized.

So, there's a lot credit and liquidity issues still on the developer side that the government needs to figure out how to solve the problem.

And back to what Ken mentioned on the stock side, if you think about the developers' current inventory, if everything is completed, then that will be about 34 percent of the total household existing housing stock. So, that gives you an idea of how big the scale of the problem is for the Chinese government to eventually deal with at the end.

**Allison Nathan:** Hui, any last words?

**Hui Shan:** Yeah, from a policy implementation, macro point of view, I think there are a few things that the government might want to focus on to fix the property
sector. One is expectation. Even if the people have the money and they have the need to buy an apartment, if they think the price is going to go down and continue to go down, they probably don't want to buy.

There's the intrinsic investment nature of a property or a house. So, how do you manage that expectation? And in this context, I find it funny that sometimes the government will be talking about easing and say, "Oh, we're studying, we're researching. We're debating some easing measures." Guess what, if you keep saying that, people are not going to buy property. They're going to wait for the easing measures to come out and then go to buy.

So, managing expectation and managing how you communicate your easing measures in the market, I think, that has an impact on demand.

And the second, I would say don't just think about a property in isolation because if you continue to do contractionary policies on the, let's say, internet sector or healthcare sector or finance sector with all the anti-corruption for regulatory tightening, that hurts household income. And that's going to hurt the demand for property.
So, policy coordination, if you really want to fix the property sector, you want to boost the demand. You need to fix people's ability to buy property, which is the income and job market aspect. And then you need to fix the expectation. And I think those are the two legs that you need for the property sector to walk again.

**Allison Nathan:**  Hui, Ken, and Yi, thanks so much for joining us.

**Hui Shan:**  Thank you for having us.

**Allison Nathan:** Thanks for listening to another episode of Goldman Sachs Exchanges, recorded on Thursday, November 2nd, 2023.

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