Are we witnessing early signs of Japan-style deflation in China?

Marco Barbieri, Director of SA Equities

The comparison between China's housing market and Japan's property bubble of the early 1990s has been much debated, but has taken a new dimension following Evergrande's recent default and China's policy response to property market distress. Although this downturn is less likely to translate into a debt crisis, as it did for Japan during the 1990s, we think that lower structural property growth coupled with tighter global liquidity conditions will prove to be deflationary and have meaningful global spillover effects.

A comparison to Japan of the 1980s

During the 1980s, Japan experienced a period of strong growth which saw GDP-per-capita rise five times, the Nikkei four times and real estate prices increase as much as six to seven times. Following the Plaza Accord in 1985, the Yen rapidly appreciated against the US dollar (from 240 to 120 Yen), prompting the Bank of Japan to aggressively cut interest rates in 1987 from 5.0% to 2.5%. Loose monetary conditions and subsequent tax rate cuts resulted in strong real estate demand which fueled an already buoyant property sector. In an attempt to arrest the growing property bubble, various policies were introduced to curb funding and transaction activity. The impact of such policies as well as tighter monetary conditions had a pervasive effect and resulted in a dramatic correction in asset prices and a significant spike in bank bad debts. What had started as a property bubble in Japan, by the mid-1990s had transformed into a full blown debt crisis.

China's remarkable rise over the past two decades saw property prices increase over six times since 2002. Strikingly, property prices-to-median income ratios for China's top five tier 1 cities are two to three times higher than the ratio of global cities such as London and Paris. Similar to Japan's policy response of the late 1980s, faced with an overheated property sector, Beijing tabled various policies aimed at curbing liquidity and moderating funding. Importantly, the "three red lines" policy (August 2020), which was introduced to create a more sustainable model and moderate the pace of sector growth, set financial health guidelines for real estate developers which included net-debt-to-equity limits and borrowing constraints. The outcome of this policy however proved to be very negative as many developers which had been operating outside policy guidelines found it difficult to borrow under the new rules and faced cash flow constraints. In December 2021, China's largest property developer, Evergrande, defaulted on interest payments due to its offshore bondholders. The impact of property prices and activity levels has been significant with real estate prices collapsing 30% to 40% over the past year.

Key differences

While China's policy response may have been a misjudgment so far, as was Japan's during the late 1980s, current dynamics are less likely to escalate into a debt crisis. Unlike Japan, China's ownership of its banks effectively allows it to control the risk transfer mechanism between householders and banks. The state's ability to instruct financial institutions to restructure bad loans ensures that it can reduce the immediate impact of property distress on the banking system. Secondly, China has managed to exert significant administrative influence over property transactions over the years with measures such as price restrictions and guidance to control for significant price movements. What is perhaps more concerning from a systemic risk perspective, is the structure of China's real estate developers funding. With banks only accounting for 25% of developers funding, households are exposed to potential distress via different mechanisms.

China's ability to support the property market

China's property distress comes at a time when the country is facing headwinds from geo-political tensions with the US, the effects of its zero-Covid policy and tighter global liquidity conditions. It's ability to support the local property sector and ultimately prevent deflationary pressures is a function of its willingness and global liquidity conditions. While last month's announcement of 300bn Yuan in new infrastructure spend and an extension of borrowing to local governments worth 500bn Yuan has gone a long way in addressing its willingness, international liquidity conditions are currently a firm headwind.

Following the spike in global excess US dollar liquidity in 2020 (sum of world economies money supply, converted into US dollar) as a result of the advent of Covid-19, tighter liquidity conditions have persisted as the Fed and other central banks have aggressively raised interest rates in light of rampant inflation. A stronger US dollar and tighter global US dollar liquidity have weighed on China FX reserves, which have started to decline as a result of an increase in net outflows. While China is able to print domestic currency to reflate the system, in a tight US dollar environment, this process will tend to weaken the currency, lower the US dollar value of domestic money supply and accelerate capital outflows further reducing FX reserves. As ongoing global macro conditions remain challenging, despite China's willingness, its ability to help the local property market and prevent deflationary pressures is not unlimited and will come at a cost.

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NORTHSTAR ASSET MANAGEMENT

Northstar Asset Management (Pty) Ltd
Registration No. 1996/001423/07 | FSP number 601
Suite 1A, Madison Place, Alphen Office Park, Constantia Road,
Constantia PostNet Suite #784, Private Bag X16, Constantia 7848
Tel +27 (0)21 810 8400 | Fax +27 (0)21 794 2885
info@northstar.co.za | www.northstar.co.za

SANLAM COLLECTIVE INVESTMENTS

Sanlam Collective Investments (RF) (Pty) Ltd
Registration No. 1967/002865/07
2 Strand Street Bellville, 7530 PO Box 30, Sanlamhof, Bellville, 7532
Tel +27 (0)21 916 1800 Fax +27 (0)21 947 8224
service@sci.sanlam.com, www.sanlaminvestments.com
Please refer to our website for directors & company secretary details

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