CHINA: Worsening economy adds pressure for politically perilous housing bailout

- July economic data showed the economy weakening across the board, raising difficult choices for policymakers about whether to backslide on earlier promises to avoid "supersize" stimulus.
- Interest-rate cuts have failed to revive credit demand, due to the combination of collapsing public confidence in the housing market and the ongoing impact of zero-Covid restrictions.
- Authorities have the tools for a housing bailout, but after investing significant political capital in seeking to break the economy's addiction to property, leaders are reluctant to reverse course.

The Politburo declined to unveil new stimulus measures at its late July meeting, and its overall tone appeared complacent, possibly reflecting relatively strong monthly economic data for June. The weak July data may now restore a sense of urgency. The central bank announced cuts to two key policy interest rates on the same day as the data release.

Rate cuts fail to stimulate

The concern for policymakers is that credit demand remains weak, despite earlier rate cuts. Housing-market distress has sapped demand for home mortgages. Since would-be homebuyers lack confidence that property developers can deliver promised presale flats, lower mortgage costs are not especially enticing. Corporate loan demand is also weak, due to actual Covid-19 restrictions in some regions and to the lingering threat of future lockdowns. Hainan province, China's preeminent beach tourism destination, has suffered an outbreak in recent weeks, stranding travelers.

We previously noted that the leadership's willingness to accept slower growth this year, thereby avoiding long-term risks from "supersize" stimulus, reflects the likelihood that President Xi Jinping's bid for a third term as general secretary is already a *fait accompli*. But we also noted that if growth threatens to fall below the leadership's unstated bottom line – which might be 4 to 4.5% – policymakers could still flip the switch for heavier stimulus.

Housing bailout to the rescue?

Options for additional stimulus are limited. Large-scale infrastructure stimulus is already underway, household consumption still faces constraints from zero-Covid, and exports – the economy's lone bright spot – are already growing strongly.

That leaves housing stimulus as the most likely next lever to pull. Housing sales by floor area fell 29% year-on-year in July, while construction starts fell 45%. The housing weakness is in turn spilling over to downstream sectors like home furnishings and appliances and to upstream sectors like steel and cement.

Small-bore initiatives to revive the market appear insufficient to turn the tide. Regulators are reportedly formulating a plan to enable around six relatively strong developers to sell bonds – despite the bond market's current aversion to developer debt – by recruiting state-owned enterprises as guarantors. A parallel plan also under consideration would establish a national rescue fund of up to RMB 300bn (USD 44bn) to enable developers to complete unfinished projects. Several local governments are also deploying state-owned asset management companies – policy vehicles created to acquire and restructure bad debts – to purchase stalled housing projects and restart construction. Late last year, regulators also tried to encourage stronger developers to acquire weaker rivals using loans from state-owned banks, but this effort made little progress because strong developers do not want to participate.

Reviving the market will likely require a big-bang bailout plan from the central government. Such a plan would mark a departure from the approach until now, which has relied primarily on local governments, many of which lack the fiscal resources required for decisive action. By some estimates, a decisive intervention would cost around RMB 1tn.

A political dilemma

The decision about whether to embark on a full housing bailout is ultimately a political decision, not a financial one. The central bank and finance ministry have the technical mechanisms and fiscal resources to finance a bailout. The problem is that policymakers have devoted substantial political capital over the last two years trying to break the economy's addiction to housing. This effort has focused on forcing developers to deleverage and making good on Xi's famous slogan that "Houses are for living in, not for speculation." As previously discussed, embracing a bailout now would amount to reversing that hard-won progress.

Recent state media commentaries and policymaker statements hint at the existence of a fierce internal debate over how aggressively to stimulate the housing market. Advocates of a bailout believe it is the only way to interrupt the downward spiral in which weak housing sales cause worsening financial distress among developers, which in turn causes even weaker sales, as would-be homebuyers lose confidence. Youth unemployment (ages 16 to 24) reached 20% in July. Bailout opponents want to avoid reviving the moral hazard that has underpinned developers' debt-heavy business models and caused substantial overbuilding of residential property. Somewhere between 12% and 21% of urban apartments nationwide are vacant.

The outcome of this debate is difficult to forecast and will likely depend on economic data in the coming months. It is still possible that the incremental housing rescue measures described above, combined with diminishing Covid-19 restrictions, manage to keep overall growth above the bottom line. But if the growth picture continues to worsen, political consensus may build for the government to take drastic measures.

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