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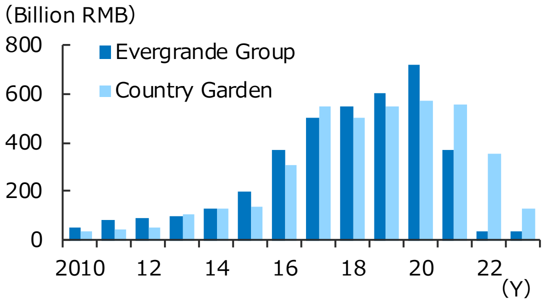
Topics *Risks posed by China's measures to prevent defaults*

The Xi Jinping administration, wary of the prospect of a financial crisis triggered by defaults by real-estate developers, has beefed up measures to support the companies. However, the series of policies the government has taken are merely pushing the risks into the future.

■ Country Garden, the biggest developer, has also defaulted

In China, there has been a spate of defaults by real-estate development companies. In the second half of 2023, fears of a default by real-estate development giant Evergrande Group re-emerged, and in October, Country Garden, China's largest property developer, was finally confirmed to have defaulted on its dollar-denominated bonds. Both companies, which had been vying for the top position in China's real-estate development sector, have seen their performance deteriorate sharply, with Evergrande Group's residential sales down 48.4% year over year (YoY) in 2021 and Country Garden's sliding 39.5% YoY in 2022. And their sales have remained in freefall since then. These events suggest that the real-estate development sector, which has been a driving force for the Chinese economy, is approaching a turning point.

<Value of Home Sales by Evergrande Group and Country Garden>



Source: Prepared by JRI based on local media reports
Note: Figures for 2023 are for January-June

In January-June 2023, Country Garden's consolidated net sales recovered to RMB226.3 billion, up 39.4% YoY. However, due to the depreciation of its real-estate holdings, selling expenses soared 72.6% YoY to RMB250.6 billion, exceeding the net sales. As a result, the company's bottom line plunged from a RMB600 million profit in the same period of the preceding year to a loss of RMB48.9 billion. The firm's total liabilities amounted to RMB1,364.2 billion against total assets of RMB1,618.5 billion as of the end of June 2023, for a debt-to-asset ratio of 84.2%.

Country Garden's short-term debt solvency ratio, which is cash and deposits divided by short-term interest-bearing debt, stood at 145.3% at the end of June 2023, ranking 34th among the 100 real-estate development companies with the heftiest interest-bearing debt, and much higher than Evergrande Group's 0.7%, which puts the latter firm in the 100th place. Country Garden has thus been viewed as a blue-chip company. Nevertheless, it defaulted, which was the result of the backfiring of its "low-margin, high-volume" business model of earning thin profit margins on high sales volume in small and medium-sized cities. Sales in tier-3 and -4 cities account for 63% of its total sales, which put it at risk.

A look at housing area sold during the eight consecutive holidays starting at the end of September 2023 following the Mid-Autumn Festival and National Day reveals that the tier-1 cities of Shanghai, Beijing, Guangzhou, and Shenzhen saw significant recoveries, with a 62% YoY increase and a 113% rise compared to the same period in pre-COVID 2019, while tier-3 and -4 cities saw the figures continue to decline, registering decreases of 50% and 59% over the same periods respectively. The background to this is the polarization of the housing market into two geographical segments: large coastal cities, where housing demand is expected to remain solid due to population inflows, and small and medium-sized inland cities, where falling demand is viewed as inevitable due to population outflows.

■ Increasing number of developers on the verge of default

A background factor to the ongoing defaults by real-estate development companies is the fact that both area and value sold have fallen for two consecutive years, creating a difficult environment that these firms have never experienced before. Residential area sold in the first nine months of 2023 was down 15.1% YoY, and this followed a 26.8% YoY drop in the previous year. The value of home sales also saw negative growth, falling 8.9% YoY, again following a 28.3% YoY decline the year before. Real-estate development companies had been leveraging themselves to generate more profit, investing many times more than they had on hand through loans and other forms of financing. This behavior was based on the assumption of steady growth in the housing market, but has now resulted in developers across the board running short of funds.

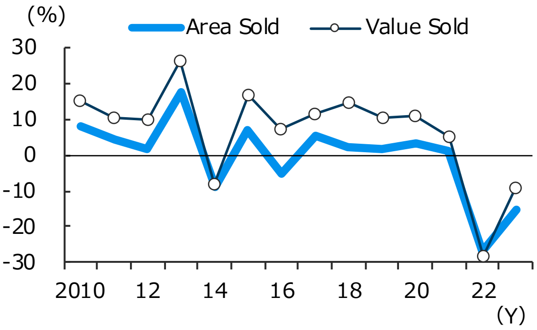
The slump in the housing market is expected to continue in 2024. Standard & Poor's (S&P) is forecasting a YoY decline of 2% in residential area sold in 2024. According to its projections, while the area sold in tier-1 cities will recover, rising by 3%, that in tier-2 cities will edge up by just a fraction of a percent, and that in tier-3 and lower cities will see a 5% decrease, so the outlook for sales depends on the size of the city. As for the value of homes sold, since tier-3 and lower cities account for 50% of the total, S&P expects the value sold to decline 5% YoY and home prices to fall 3% YoY in 2024.

Given this situation, the number of real-estate development companies classified as "on the verge of default," i.e., ones that could default at any time, looks set to increase steadily. It is not surprising that the Xi Jinping administration is worried about a financial crisis stemming from defaults by real-estate developers.

■ Default avoidance is risk postponement

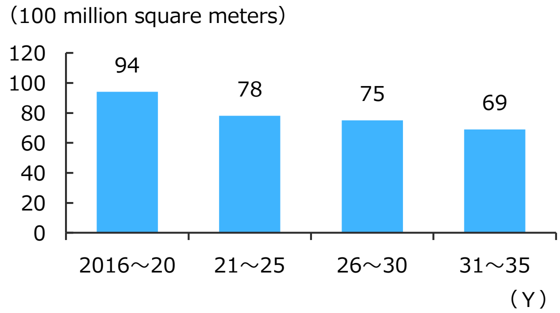
In response to the deterioration in the financial positions of real-estate developers, the Chinese government adopted policies in 2021 to stave off defaults by stimulating housing demand while providing cash-flow support to the developers. Although these measures had some effect, the subsequent market slump further damaged the liquidity of real-estate development companies. The government has therefore taken additional steps since 2022, including (1) establishing new bank credit lines for real-estate development companies, (2) extending the repayment deadlines of bank loans to real-estate developers by one year, and (3) allowing wealthy individuals to purchase more than one home.

＜Growth in Area and Value of Home Sales in China＞



Source: Prepared by JRI based on data from CEIC
Note: Figures for 2023 are for January-September

＜Long-term Estimates of Housing Demand in China＞



Source: Prepared by JRI based on data from Beike Research Institute
Note: Figures for 2021-25 and onwards are projections

While this set of policies helped alleviate the cash-flow headaches faced by real-estate developers and reduce defaults in the near term, all the measures basically do is push the risk into the future. While real-estate development companies' short-term interest-bearing debt increased to RMB2,832.9 billion in January-June 2023, swelling by RMB765.6 billion from 2020, their cash holdings totaled RMB1,875.6 billion, down RMB1,116.4 billion from 2020, so the default prevention measures have failed to improve the financial health of these companies.

And given the situation with housing demand, the real-estate sector is urgently in need of a shake-up. Beike Research Institute, a think-tank specializing in real estate, has released a long-term housing demand forecast for China, in which it predicted that housing demand would gradually fall from 9.4 billion square meters over the five-year period 2016-2020 to 6.9 billion square meters in the five-year period 2031-2035.

Recognizing the declining demand for housing, the Chinese government must focus not on how to stave off defaults, but on the central issue of how to reorganize real-estate development companies while limiting the economic and social impact.

(Yuji Miura)

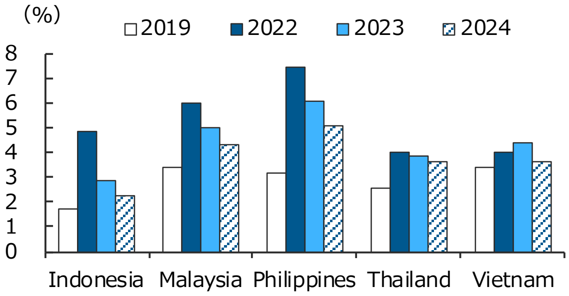
Topics *Feasibility of austerity in ASEAN countries is uncertain*

A look at the budget plans of ASEAN countries reveals that on the whole, budget deficits (as a percentage of GDP) are shrinking. It should be noted, however, that revenue projections in Indonesia, the Philippines, and Thailand are overly optimistic, and fiscal deficits can actually be widen.

■ Asian budget deficits are shrinking

The draft budgets for 2024 announced by ASEAN countries indicate reductions in budget deficits (as a percentage of GDP). Budget deficits had been increasing through 2022. Background factors included a decrease in revenue as a result of stalled economic activity due to the COVID pandemic, as well as a rise in expenditures for the purpose of tackling the virus and keeping economies afloat. During this period, restrictions on fiscal spending were also eased in many of the countries. Indonesia, for instance, allowed its budget deficit to exceed the legal ceiling (3% of GDP) for the three years from 2020 to 2022. Malaysia took a similar measure, raising the statutory ceiling on government debt from 55% of GDP to 65%.

<Budget Deficits (Government Draft Budgets, % of GDP)>



Source: Prepared by JRI based on data from each country's government and media reports
Note: Thailand's fiscal year runs from October to the following September

These expansionary fiscal stances began being modified as the pandemic came to an end, and efforts toward fiscal consolidation are underway in many of the countries. Indonesia reintroduced the budget deficit cap from the 2023 budget. In Malaysia, too, a bill was passed in October 2023 stipulating that budget deficits be limited to no more than 5% of GDP and debt curtailed to 60% or less of GDP within three to five years. Many ASEAN countries share a common history of tightening fiscal discipline to stabilize their foreign exchange markets in the wake of the 1997 Asian currency crisis, and these latest moves toward fiscal consolidation are in accord with that history.

■ Expenditures are continuing to rise in some countries

However, a closer look at the draft budgets shows that while Malaysia and Vietnam are trying to keep a lid on their spending, Indonesia, the Philippines, and Thailand are all set to increase their expenditures by 10%. It is therefore uncertain whether austerity will be achieved in these latter countries.

<Budgets for Revenue/Expenditure>

(Change from previous year's budget, %)

		2023 budget	2024 budget
Indonesia	Expenditure	12.3	8.6
	Revenue	32.8	13.8
Malaysia	Expenditure	16.3	2.0
	Revenue	24.6	5.5
Philippines	Expenditure	2.6	10.7
	Revenue	10.4	17.6
Thailand	Expenditure	2.7	9.3
	Revenue	3.8	11.9
Vietnam	Expenditure	16.3	2.1
	Revenue	14.8	5.0

Source: Prepared by JRI based on data from each country's government

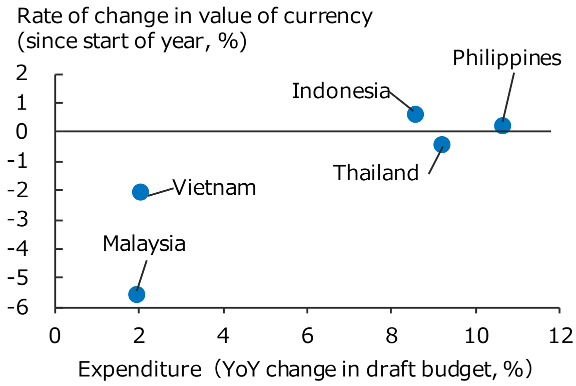
There are a number of factors behind the higher government spending in these three nations, the first of which is exchange rate stability. All three countries have been enjoying relatively stable exchange rates against the U.S. dollar recently, and the margin of depreciation of their currencies has narrowed since the beginning of 2023. Interest rate cuts are expected in the U.S. in 2024, which will further ease the downward pressure on their currencies. As a result, the governments may be feeling less urgency about ensuring fiscal discipline, despite its importance for currency stability.

The second factor is greater willingness on the part of the governments to spend money as a means of winning popular support. In Thailand, a new government took the helm in 2023, and in

2024 it plans to follow through on an election pledge to provide citizens with a digital cash handout. The cost of this measure is huge, running to approximately 3% of GDP. And in Indonesia, work on relocation of the capital city, a pet project of President Joko, is in full swing, and expenditures related to the plan are increasing. In addition, with a presidential election and general election set for February 2024, the government is offering various cash benefits and distributing food in an effort to bolster its approval ratings. New untargeted handouts could also be in the works, in which case the probability of the budget deficit moving toward expansion will rise even higher. Meanwhile, in the Philippines, President Marcos has maintained former President Duterte's "Build! Build! Build!" infrastructure program, rebranding it as "Build Better More," and government spending, especially infrastructure investment, is continuing to grow.

The third factor is optimistic forecasts for tax revenue. In contrast to Malaysia and Vietnam, which saw low growth in 2023 due to sluggish exports, Indonesia and the Philippines recorded high rates of growth, driven by robust domestic demand. With their tax revenues rising as a result of the economic recoveries, the governments of these two countries expect their economies to continue rebounding and their tax revenues to keep rising in 2024. Their budget plans are based on double-digit growth in tax revenues, allowing for reductions in budget deficits even with increased spending. The government of the Philippines has a particularly rosy view, basing its draft budget on projected real GDP growth of 6.5-8.0%. This range is higher than forecasts from international organizations (IMF: +5.9%, World Bank: +5.8%), and must be seen as considerably optimistic.

<Margin of Expenditure Expansion and Rate of Change in Value of Currency>

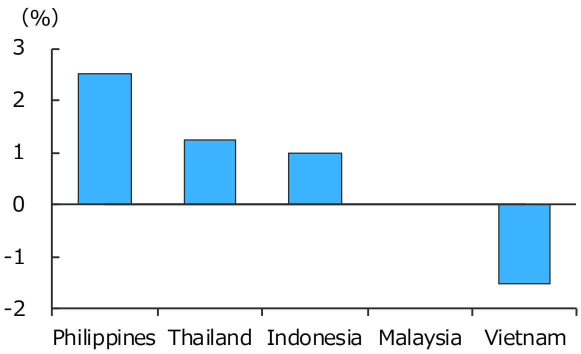


Source: Prepared by JRI based on data from each country's government and Bloomberg L.P
.Note: Rates of change in value of currency are the percentage changes between the start and end of 2023

■ Widening budget deficits will create downward economic pressure

Given the above factors, caution is required concerning the risk that Indonesia, the Philippines, and Thailand could see their budget deficits grow contrary to their plans. In these three countries in particular, interest rates have risen significantly, so their economies could experience downturns, which would prevent revenues from increasing by as much as planned. In fact, policy rates are higher than they were before the COVID pandemic, and this has pushed up market interest rates. In addition, the risk remains that factors such as abnormal weather events caused by the El Niño phenomenon or India's restrictions on rice exports could cause an acceleration in inflation, which would lead to further upward pressure on interest rates.

<Rate of Change from End-2019 for Policy Interest Rate in Each Country>



Source: Prepared by JRI based on data from CEIC

There is a danger that if budget deficits widen and doubts about fiscal sustainability spread among market participants, interest rates could go even higher. Not only would this cause capital and housing investment to decline, but the resultant currency depreciation could also exacerbate imported inflation, creating another pathway for downward economic pressure. Attention therefore needs to be paid to the risk of economic retreat leading to further tax revenue declines and fiscal health deterioration, triggering a downward fiscal and economic spiral in the three countries.

(Tomoki Kumazawa)