Limitations of China's Growth Patterns Revealed by Excess Debt
—SOE and housing speculation threaten the feet of the Xi Jinping administration—

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Summary

1. The Chinese government has announced that it will change its stance on "implicit government guarantees" and proceed with the liquidation of zombie companies. But there are still many zombie companies, and the liquidation process is not easy. The government is not moving toward the abolition of "implicit government guarantees" but only temporarily reducing the scope of coverage.

2. Debt default is not the "exit" from the resolution of the excessive corporate debt problem, but the "entry point" of a long process toward resolution. The extent to which debt, including bank loans, has been reduced must be examined to determine whether the liquidation of zombie companies is progressing.

3. In the wake of the COVID-19 pandemic, the volume of outstanding total social financing, which indicates the amount of funds supplied to the real economy, has recorded the most significant increase since the collapse of Lehman Brothers. At the end of 2020, corporate debt outstanding reached 163.2% of GDP, entering uncharted territory.

4. "Implicit government guarantees" are given not only to corporate bonds but also to bank loans. Even if deleveraging proceeds, the problem of excessive debt will not be resolved because debt is unevenly distributed to companies with low repayment capacity. The difficulty of raising funds depends on whether or not the government has invested in them, and it can be said that the problem of excessive debt is caused by state-owned enterprises.

5. State-owned enterprises have little presence in China's real estate development. However, the government cannot afford to sit back and watch the default or bankruptcy of real estate developers because the rise and fall of the real estate development industry, which accounts for a high percentage of GDP, have a serious impact on the economy and society.

6. In response to the overheated real estate market, the government tried to control the inflow of funds into the real estate market by regulating the total amount of real estate-related loans and through the "three red lines," which specify the debt reduction target. These efforts have produced certain results.

7. The problem of the excessive debt of state-owned enterprises and soaring house prices has never previously been a drag on economic growth. However, since the proportion of state-owned enterprises in the economy has stopped falling, and it is difficult to expect a virtuous cycle in which real estate investment and house prices continue to rise, China will be exposed to more downward pressure than expected.

8. In order to prevent China from falling into a prolonged slump, it is essential to restructure the ownership system of state-owned enterprises and control house prices by introducing real estate and inheritance taxes. However, it is unlikely that the ownership system will be reformed. In addition, while the government is willing to introduce a real estate tax, it may be undermined by being a low tax rate.

Introduction

There have been frequent defaults in the Chinese corporate bond market. According to Chinese financial information service company Wind, the default amount for the period between January and mid-July 2021 was 160.9 billion yuan, higher than the record 124.8 billion yuan for the same period in 2020. In April 2021, the fear of default by the non-performing loan disposal company, China Huarong Asset Management Co., Ltd.(1), which was established with investment from the Ministry of Finance, increased(2), leading to a widespread view that the "implicit government guarantees," under which state-owned enterprises would eventually be bailed out, may be reviewed.

In September 2021, the fear of default by the Evergrande Group, one of the major property developers, revived(3), contributing to a worldwide decline in stock prices. The Evergrande Group is a private enterprise, but it is the second largest enterprise in the industry(4) based on the 2020 comprehensive evaluation by the China Real Estate Association (CREA). With total liabilities of 1,966.5 billion yuan as of June 2021(5), and foreign investors also holding large amounts of dollar-denominated corporate bonds of the Group, attention was focused on whether the Group would default and enter bankruptcy proceedings or some other form of remedy would be taken.

According to the Bank for International Settlements (BIS) statistics available for international comparison, China's bond issuance at the end of 2020 stood at 18.6 trillion dollars, the second largest in the world after the United States at 47 trillion dollars. According to the People's Bank of China, the central bank, China's bond market consists of three main components: 1) government bonds issued by the central government and local governments; 2) financial bonds issued by financial institutions, including public-sector financial institutions such as the China Development Bank; and 3) corporate bonds issued by companies.

As of April 2021, the proportion of outstanding issues was 39.0%, 36.2%, and 24.7%(6), respectively, with corporate bonds accounting for one-fourth of the bond market. Because government bonds and financial bonds are stable, an increase in corporate bond defaults does not destabilize the bond market. However, China's outstanding corporate bonds stood at 4.5 trillion dollars at the end of 2020, second only to the 7.3 trillion dollars of the United States(7). The review of implicit government guarantees is expected to contribute to the soundness of the corporate bond market in the long run, but in the short run, it will depress the growth rate of the Chinese economy and ultimately that of the global economy.

However, it is premature to conclude that an increase in corporate defaults is the result of the government's policy to eliminate implicit government guarantees. In China, there are still many so-called zombie companies ("僵屍企業" in Chinese) that have huge debts and lack the potential for business improvement. The increase in defaults is merely an emphasis on the government's stricter stance toward state-owned enterprises that continue to be lax in management and banks that lend to such enterprises, and it cannot be seen that the government has turned to the abandonment of zombie companies through the abolition of guarantees.

"Implicit government guarantees" is not a question of whether all state-owned enterprises should be given guarantees or not, but rather a question of how much the scope of such guarantees should be reduced. In fact, since 2014, when the corporate bonds of Shanxi Zhenfu Energy Group Ltd., a state-owned enterprise, defaulted(8), and regarded as the "China's first year of corporate defaults(9)," the government has repeatedly expanded or contracted its implicit guarantees depending on whether it placed more importance on the risk of credit uncertainty or the impact on corporate financing. It is reasonable to regard this increase in defaults as a temporary reduction in implicit government guarantees that had been seen several times in the past.

But that doesn't mean we don't have to take this default seriously. The simple argument linking an increase in corporate defaults to the degree of implicit government guarantees does not reveal the essence of problems faced by the Chinese economy. Thus, this paper regards it necessary to examine the debt repayment capacity of enterprises in terms of total debt, including bank loans, to find out why the problem of excessive debt has not been resolved, and to look at the future growth trajectory.

This paper first points out that (1.) an increase in corporate bond defaults does not mean that implicit government guarantees will disappear. Then, it will be clarified that (2.) implicit government guarantees on bank loans underlie the problem of excessive debt, and that (3.) state-owned enterprises are the culprit. Then, (4.) the government's countermeasures against the overheating of the real estate market and their results will be verified by focusing on real estate developers, where the problem of excessive debt is becoming more serious. Finally, (5.) the view will be presented that the downward pressure on growth will intensify as drastic policy changes are not expected although China has entered a phase where the conventional economic growth pattern is not working due to the reform of state-owned enterprises and the stagnation of real estate development.

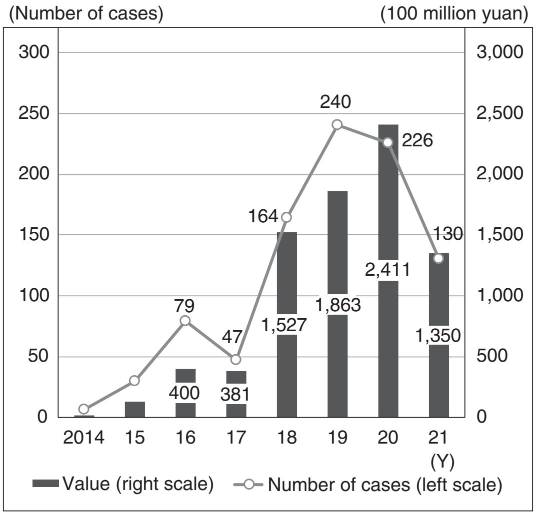
1. Implicit government guarantees will not disappear

Although the market is increasingly concerned about the future due to a series of corporate bond defaults, it is premature to think that implicit government guarantees will disappear as the liquidation of zombie companies has not progressed. In addition, an increase in defaults is not likely to intensify downward pressure on the Chinese economy.

(1) Growing defaults and growing anxiety

In China, corporate defaults have been occurring frequently since 2018 (Fig. 1). In 2020, there were 226 cases and 241.1 billion yuan in default,

Fig. 1 Changes in Corporate Defaults in China



Notes: Data for 2021 covers the period until July 19.
Source: Prepared by The Japan Research Institute, Limited based on Wind

which is four times more in number of cases and 3.5 times more in value than in 2017. As of mid-July 2021, there have been 130 cases valued at 135.0 billion yuan in default, representing a 23.8% year-on-year increase in the number of cases and a 29.0% year-on-year increase in value, increasing at a pace that exceeds that of the previous year's record-high increase.

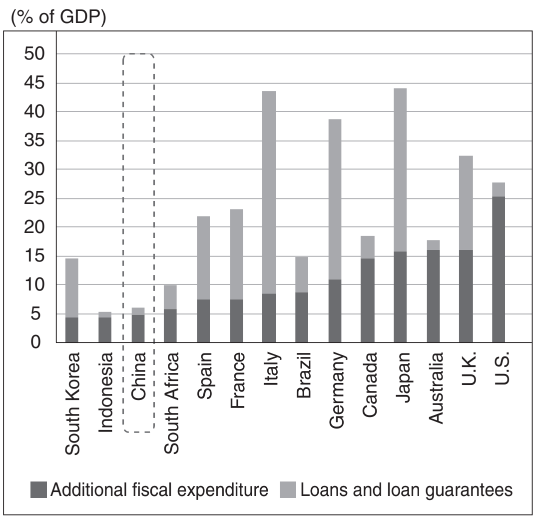
As one of the reasons for this, the termination of the financial support launched by the government in response to the spread of the COVID-19 is often mentioned. However, thanks in part to the small cumulative number of COVID-19 cases, China's economic stimulus package was only 6.1% of GDP, much smaller than Japan's 22.1% and the United States' 25.5% (Fig. 2). It is reasonable to understand that the market is increasingly concerned about the future due to a new change that the number of the default of corporate bonds issued by state-owned enterprises(10) is increasing.

In 2019, state-owned enterprises accounted for only 7.1% corporate bond defaults in terms of number of cases and 10.6% in value terms, but in 2020, they jumped to 38.1% and 43.9%, respectively (Fig. 3). A typical example of default in corporate bonds issued by state-owned enterprises is that of Huachen Automotive Group Holdings, also known as Brilliance Auto Group[11].

Brilliance Auto Group is a state-owned enterprise established in 2002 with investment from the Liaoning provincial government and has three listed companies and more than 100 subsidiaries. It is an automobile manufacturer selected as a joint venture partner of BMW, a German automobile manufacturer. As a result of a total of 14 defaults since October 2019, in November 2020, the Group applied to the court for and received "重整, " a restructuring-type insolvency procedure in which the debtor makes repayment of debt while continuously operating the business.

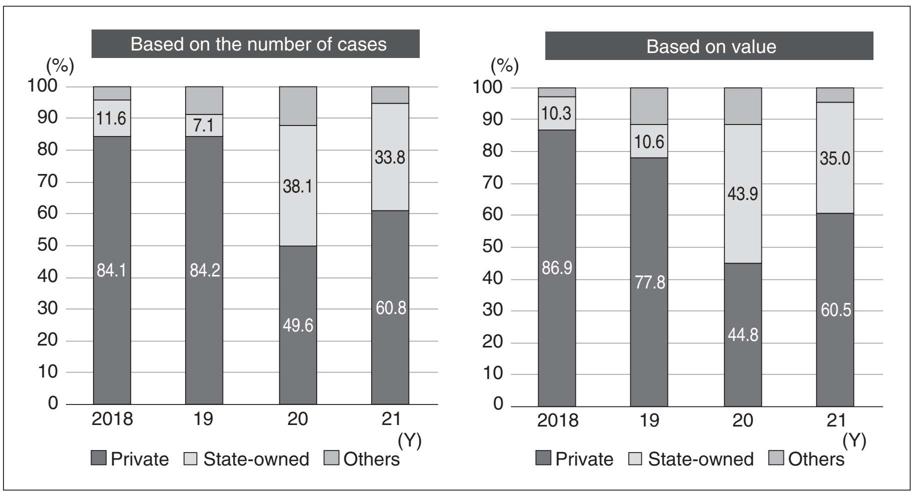
Although the ratio of state-owned enterprises defaulting on corporate bonds declined in 2021, many enterprises are believed to be on the verge of default, as is the case with China Huarong Asset Management, which was introduced at the beginning of this paper, and the situation remains unpredictable. The case of China Huarong Asset Management was seen as a sign that the government was sending out a message that even state-owned enterprises invested in by the Ministry of Finance would not necessarily be bailed out. In other words, it indicated the possibility that myths such as "国企信仰," which means state-owned enterprises would not default, or "刚性兌付," which means bonds would be redeemed without fail, could collapse.

Fig. 2 Scale of Economic Stimulus Packages in Response to the Pandemic



Notes: Data from 2020 to March 17, 2021
Source: Prepared by The Japan Research Institute, Limited based on IMF [2021b]

Fig. 3 Breakdown of Defaulted Corporate Bonds (by Ownership Type)



Notes: Data for 2021 covers the period until July 19.
Source: Prepared by The Japan Research Institute, Limited based on Wind

(2) Review of guarantees is temporary

Market uncertainty has been exacerbated by an increase in defaults on the corporate bonds of state-owned enterprises in response to the government's emphasis on the review of implicit government guarantees.

At the end of 2018, the National Development and Reform Commission (NDRC), together with the Ministry of Industry and Information Technology and the Ministry of Finance, issued a "Notice on Further Improvement of Debt Settlement Operations of 'Zombie Companies' and Companies with Excessive Capacity." It called for the liquidation of zombie companies in order to effectively prevent and resolve corporate debt risks and promote improvements in the quality and efficiency of the economy(12). This was confirmed at a meeting of the politburo of the Central Committee of the Communist Party of China in July 2019(13).

Xi Jinping, General Secretary of the Central Committee of the Communist Party of China, said at a seminar for party leaders held in January 2019 that the 14th Five-Year Plan (2021-2025) had made a good start, but urged caution against "black swans" and "gray rhinos(14)." The former is a rare but devastating problem, while the latter is a highly probable and devastating problem that is often neglected. Excess corporate debt and real estate bubbles attributable to implicit government guarantees fall into the latter category.

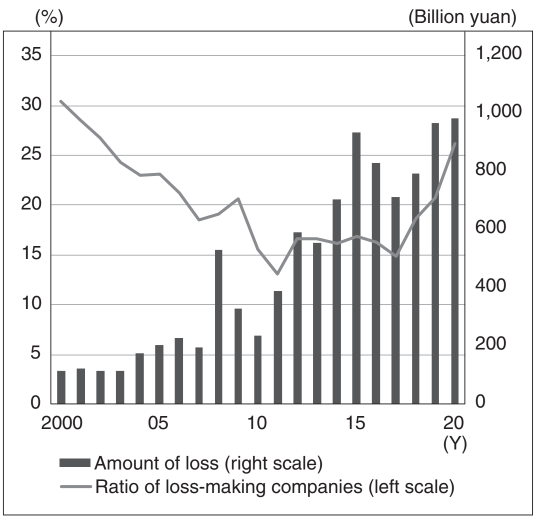
Despite the government and the Communist Party calling for the liquidation of zombie companies, they failed to meet expectations. The People's Bank of China stated in its November 2020 Financial Stability Report that "zombie companies should be liquidated in accordance with the law. The era when corporate survival depends on 'faith' is over, and the reconstruction of bond markets, where orderly market-based defaults become the new norm, begins" (People's Bank of China [2020]). As there was a limit to getting the zombie companies out of the market upon request, they took a hard-line stance of enforcing the law.

Still, the liquidation of zombie companies is not expected to proceed easily. There are still many zombie companies, and pushing them out of the market in accordance with the law could have a serious impact on the economy. According to my research of listed companies conducted when the problem of excessive production capacity became apparent, the percentage of zombie companies between 2013 and 2015 was around 10%(15) (Miura [2017]). This issue has since lost attention, but that doesn't mean zombie companies are on the decline.

In the mining and manufacturing industries, the ratio of loss-making companies among companies of a certain size or larger started to rise in 2018 and reached 26.2% in 2020 (Fig. 4). The definition of loss-making companies and zombie companies is not the same, but as the former increases, the latter will increase as a matter of fact. While the Chinese economy is considered to have recovered quickly from the COVID-19 pandemic, companies have been in a difficult situation where the ratio of loss-making companies has risen and the amount of losses has increased even before the COVID-19 outbreak.

Unless market-based defaults become the norm,

Fig. 4 Ratio of Loss-making Companies in the Mining and Manufacturing Industries and Amount of Loss



Notes: The ratio of loss-making companies is based on annual average, while the amount of loss is based on the amount at year end.
Source: Prepared by The Japan Research Institute, Limited based on CEIC

the review of implicit government guarantees is only temporary. For this reason, it is clearly irrelevant to expect that the number of defaults will continue to increase as a result of the review of implicit government guarantees or that an increase in defaults is a step toward enhancing the soundness of the corporate bond market.

The liquidation of zombie companies, which began in 2016, was supposed to be completed in 2019[16]. That the issue is unresolved shows how difficult it is to get zombie companies out of the market. In August 2021, it was decided that the state-owned enterprise China Huarong Asset Management, mentioned earlier in this report, would issue new shares to China International Trust and Investment Corporation (CITIC), one of the central state-owned enterprises, in order to strengthen its capital base and avoid default[17].

It should also be noted that even though the number of defaults is increasing, measures have been taken to avoid them in advance. In China, creditors sometimes agree to refinance loans to avoid default.

One example of this is Evergrande Group. In November 2020, the Group agreed with creditors to convert most of the 130.0 billion yuan bonds that would be redeemed by the end of January 2021 into convertible bonds[18]. Because demand for real estate is stable against the backdrop of urbanization and business performance is expected to recover in the long run, creditors are believed to have moved to avoid default. The Group is not a state-run company, but the “myth” that real estate prices will continue to rise made it possible to refinance.

Another problem is that expectations for implicit government guarantees tend to favor postponing the maturity rather than immediately entering bankruptcy proceedings after default.

One example is Shandong Ruyi Technology Group Co., Ltd., a major textile manufacturer. The Group, known for its acquisition of Renown, has agreed with creditors to extend the maturity of its bonds due in March 2021 by three months[19]. This Group is also not a state-owned enterprise, but with more than 30,000 employees, it is one of the leading enterprises in Shandong Province, ranking 302nd among the top 500 Chinese enterprises by sales amount in 2019[20]. This indicates that it is possible for large enterprises supporting a region to be allowed to extend the redemption period even if they are not state-owned enterprises.

It is said that only 7.2% of defaulting companies (in terms of the number of cases) successfully raise funds and repay the promised principal and interest[21], so it is clear that refinancing and postponing the redemption date are just postponements of the problem. Nevertheless, there is a constant movement to prolong the lives of zombie companies. In July 2020, central state-owned enterprises established a credit guarantee fund for central state-owned enterprises[22] with the aim of supporting each other in raising funds, and similar funds have been established by state-owned enterprises and banks at the local level[23].

These credit guarantee funds institutionalize government guarantees that were supposed to be “implicit,” which clearly contradicts the government’s message that zombie companies should liquidate. The government emphasizes that it does not contradict the above message by excluding zombie companies from the scope of guarantees provided by the credit guarantee fund for central state-owned enterprises[24]. However, the distinction between zombie and non-zombie companies is ambiguous, and there are concerns that the credit guarantee fund may be used to rescue zombie companies as a result of political judgments taking into account the importance of employment and industrial policy.

(3) The pessimistic scenario is unlikely

In Japan, the prevailing view is that an increase in defaults in the corporate bond market will result in downward pressure on the Chinese economy. There is no doubt that the prices of low-rated bonds will decline (yields will rise) due to stricter screening based on the issuers’ ability to repay. The confusion surrounding the market has not abated, with the Evergrande Group’s default attracting attention in September 2021, following the default of China Huarong Asset Management, and contributing to the simultaneous fall in global stock prices temporary(25).

However, when looking at the corporate bond market as a whole, it is premature to assume a pessimistic scenario in which defaults will continue to increase, which will impact corporate financing and put downward pressure on the Chinese economy. The Japanese media emphasized the size of the Evergrande Group's 1,966.5 billion yuan debt, which is equivalent to 2% of China's GDP, but at the end of 2020, the Group's debt due within one year was 335.5 billion yuan(26), accounting for only 4.2% of China's total corporate debt redemption in the same year.

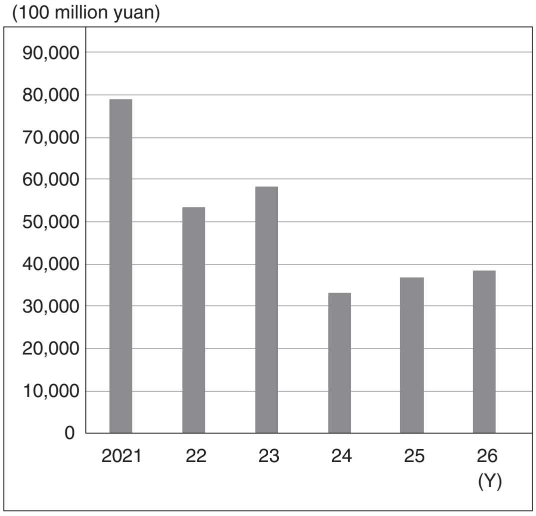
Given that bond redemption will peak in 2021 (Fig. 5) and that the default rate of Chinese corporate bonds has been low, the pessimistic scenario is not likely. The default rate, which is calculated by dividing defaulting bonds by maturing bonds, remained at 0.3% in terms of the number of cases and 0.5% in terms of value in 2020 (Fig. 6)(27), well below the international default rate for corporate bonds of 2.7%(28).

Chinese bonds have long been regarded as highly profitable investments that are not tied to bonds issued in developed countries (Xin [2021], Cheng [2021]). According to the People's Bank of China, as of June 2021, yuan-denominated financial assets held by corporations and individuals outside of China totaled 3.8 trillion yuan in both stock and bond markets (Fig. 7). The assets held in the bond market expanded 4.3 times from before the launch of Bond Connect, a system for trading mainland Chinese securities via Hong Kong established in July 2017.

The valuation of corporate bonds is also stable. The S&P China Corporate Bond Index, which represents the performance of yuan-denominated corporate bonds provided by Standard & Poor's in the United States, has been rising since March 2021 (Fig. 8). At least as of the end of September 2021, Evergrande Group's default concerns had not caused any significant volatility in the corporate bond market.

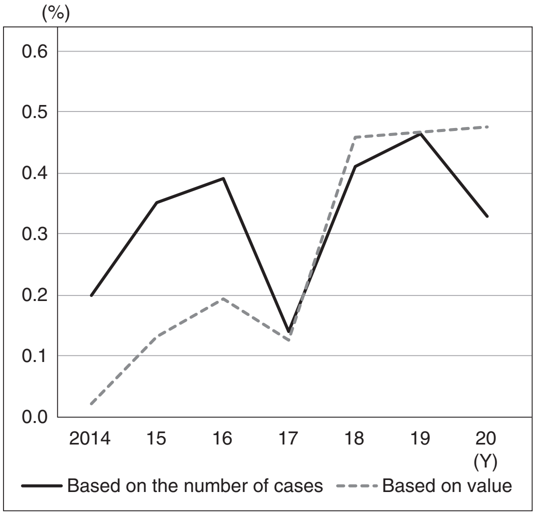
Strong bond issuance is also a positive factor. According to the People's Bank of China, bonds issued in 2020 increased 26.5% year on year to 53.7 trillion yuan (about 7.7 trillion dollars), the highest growth since 2016 (People's Bank of China [2021]). Of the total, government bonds increased 75.0% year on year to 7 trillion yuan, local government bonds decreased 7.2% year on year to 6.4 trillion yuan, financial bonds increased 34.8% year on year to 9.3 trillion yuan, and cor-

Fig. 5 Redemption of Corporate Bonds



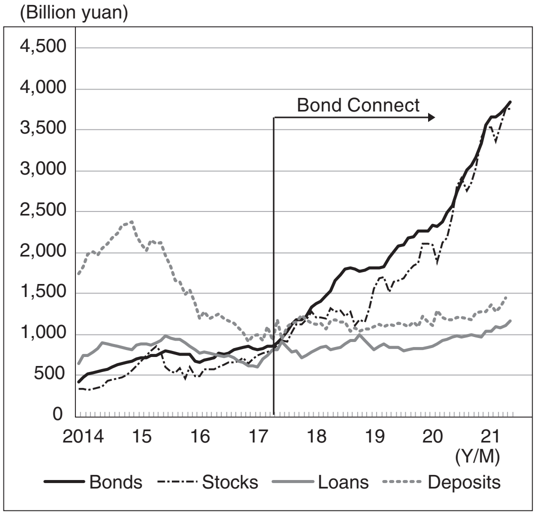
Source: Prepared by The Japan Research Institute, Limited based on local media reports

Fig. 6 Changes in Default Rate



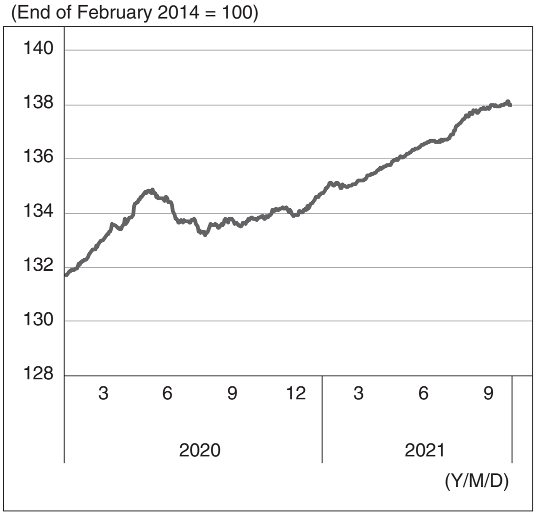
Source: Prepared by The Japan Research Institute, Limited based on local media reports

Fig. 7 Domestic Yuan-denominated Financial Assets Held by Corporations and Individuals Outside China



Source: Prepared by The Japan Research Institute, Limited based on materials from the People's Bank of China

Fig. 8 S&P China Corporate Bond Index



Source: Prepared by The Japan Research Institute, Limited based on materials from S&P

porate bonds increased 25.8% year on year to 12.2 trillion yuan, indicating the strong performance of corporate bonds. Corporate bonds issued during the period between January and July 2021 increased by 2.7% from the same period of the previous year to 7.5 trillion yuan, maintaining positive growth despite a considerable slowdown.

The market reaction to the Evergrande Group issue seems to be overly sensitive from the perspective of the overall corporate bond market. Behind this, there seems to be concern that the United States' reversal of its quantitative easing policies (tapering) overlaps with the limits of economic growth of China, which had been significantly leveraged. The Chair of the Federal Reserve Jerome Powell indicated in September 2021 that the Fed will begin tapering by the end of the year. If the United States moves to raise interest rates in 2023 as predicted, funds are expected to flow out of emerging markets, including China. Fear of global shock waves from the Evergrande crisis is a sign of market sentiment that worries about the extent to which China will be able to prevent such outflow of funds.

2. The problem of excessive debt exacerbates amid growing default

If implicit government guarantees are only a matter of degree, the debate must focus on whether an increase in defaults leads to a reduction in excess debt through the liquidation of zombie companies. Using the case of Tsinghua Unigroup, one of the leading semiconductor manufacturers, as an example, I would like to review how this problem should be viewed, and then point out that the problem of excessive debt is not being resolved amid an increase in defaults.

(1) Default is only an "entry point" into the process of solving the excessive debt problem—Case of Tsinghua Unigroup

The fact that the increase in corporate defaults is not the result of the policy to eliminate implicit government guarantees can be confirmed by looking back at the background behind Tsinghua Unigroup's default and bankruptcy proceedings. Tsinghua Unigroup's case shows that expectations for "implicit government guarantees" still persist in China, and that the liquidation of zombie companies does not proceed easily and, as a result, the problem of excessive debt is not easily resolved.

Since November 2020, Tsinghua Unigroup has been unable to redeem six bonds(29), each time deferring the redemption date(30). The reason why creditors did not take bankruptcy procedures immediately is that Tsinghua Unigroup is a state-owned enterprise funded by prestigious Tsinghua University and plays a part in the semiconductor industry, which is the most important area of China's industrial policy. There is no doubt that expectations for implicit government guarantees existed before default.

Expectations for implicit government guarantees also exist after default. Tsinghua Unigroup continued to engage in so-called "短貸長投" portfolio management, by conducting a series of high-risk mergers and acquisitions while increasing short-term borrowings. As of June 2021, total liabilities stood at 202.9 billion yuan, up 44 times from the end of 2012(31). The bankruptcy proceedings were settled in July 2021, eight months after the initial default, even though the total debt was high and it was clear that postponing the maturity would not solve the problem. This suggests that there had been moves within the government to avoid bankruptcy proceedings, and that adjustments had taken time.

The case of Tsinghua Unigroup also shows that there were strong expectations for implicit government guarantees even after the start of bankruptcy proceedings. China's bankruptcy proceedings include 1) "清算," which is equivalent to Japan's bankruptcy, and in which pro-rata payments are made to creditors in proportion to the amount of their claims; 2) "重整," in which the creditors seek rehabilitation in accordance with a plan approved by the court; and 3) "和議," which is equivalent to settlement(32). In July 2021, it was decided that Tsinghua Unigroup would adopt "重整," instead of "清算."(33)

For the rehabilitation of Tsinghua Unigroup, a policy of soliciting strategic investors with total assets of 50.0 billion yuan and net assets of 20.0 billion yuan to take over the business was presented(34). According to the statistics of enterprises in the mining and manufacturing industries for which statistics have been compiled, the total assets of Chinese enterprises averaged only 300 million yuan in 2019, and the largest total assets owned by a wholly state-owned enterprise were 3.3 billion yuan. Therefore, only central state-owned enterprises would meet the conditions for this solicitation.

However, central state-owned enterprises are the most likely to be influenced by the government in term of personnel and business management, while being able to secure profits through monopolies and oligopolies. Although there is a way to bring in outside experts, it is questionable whether the involvement of central state-owned enterprises will facilitate rehabilitation. Although it is possible to make it look like Tsinghua Unigroup's management has regained soundness through the capital strength of central state-owned enterprises, it is highly uncertain whether it will be able to achieve its original rehabilitation goal of driving China's semiconductor industry.

In China, there are many schemes to give preferential treatment to state-owned enterprises. To see if default leads to the liquidation of a zombie company, we also need to look at what happens after default and bankruptcy proceedings. Fewer than 20% of defaulting companies went into bankruptcy proceedings, and 60% of them left outstanding debt unsettled (Xin [2021]). Because default does not mean immediate termination of bank transactions, defaulting companies can continue to operate as they did before default(35).

Because default in China does not have the weight as in developed countries, default is not an "exit" from the problem of excessive corporate debt, but only an "entry point" into the long process of resolution. Even if the number of defaults on corporate bonds increases and implicit government guarantees are reviewed, it does not necessarily mean that the liquidation of zombie companies is progressing and the problem of excessive debt is being resolved. To see China's growth trajectory, we need to look at the problem of excessive debt, instead of defaults or implicit government guarantees.

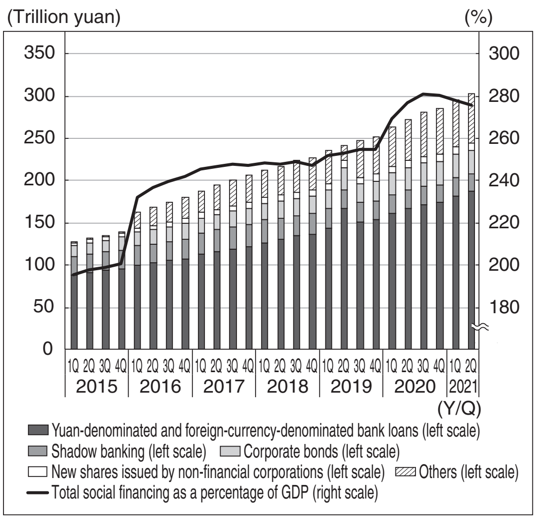
(2) The problem of excess debt is moving into uncharted territory

In China, indirect financing, in which funds are borrowed from banks, has become the mainstream of financing rather than direct financing, in which funds are raised directly from investors through the issuance of corporate bonds. It is bank lending that is important in determining whether the problem of excessive debt is being resolved. The volume of outstanding total social financing published by the People's Bank of China shows how much money was supplied to the real economy by financing methods such as bank loans, corporate bonds, and shadow banking. The balance of bank loans stood at 187 trillion yuan as of the end of June 2021, six times more than the 29 trillion yuan balance of corporate bond issuance (Fig. 9).

Fig. 10 shows that China's outstanding total social financing increased rapidly in response to the COVID-19 pandemic. The balance, which was 254.8% of GDP at the end of 2019 before the outbreak, rose 26.2% points to 281.0% at the end of September 2020. This is the first significant increase since 2009, when a large-scale economic stimulus package was launched following the collapse of Lehman Brothers, except in 2016, when the statistics were revised(36).

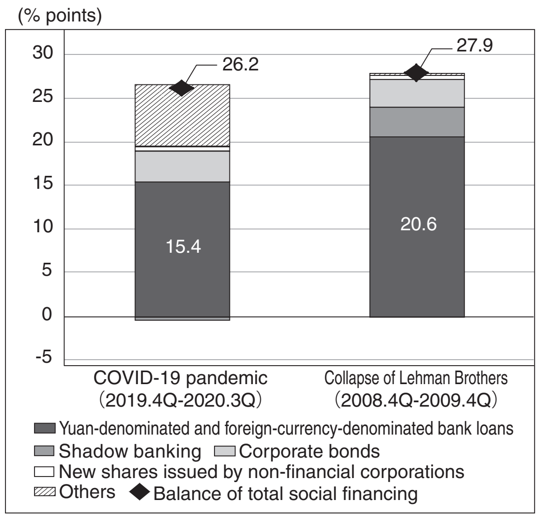
However, since Fig. 9 and 10 both include household debt, it is not clear how much corporate debt has increased. Looking at the BIS statistics, which show the outstanding amount of debt by borrowers such as non-financial corporations, governments, and households, it is clear that it was companies that increased debt (Fig. 11). Both domestic and foreign media, including that of Japan, are paying attention to whether the government will review its implicit government guarantees in

Fig. 9 Balance of Total Social Financing and Percentage of GDP



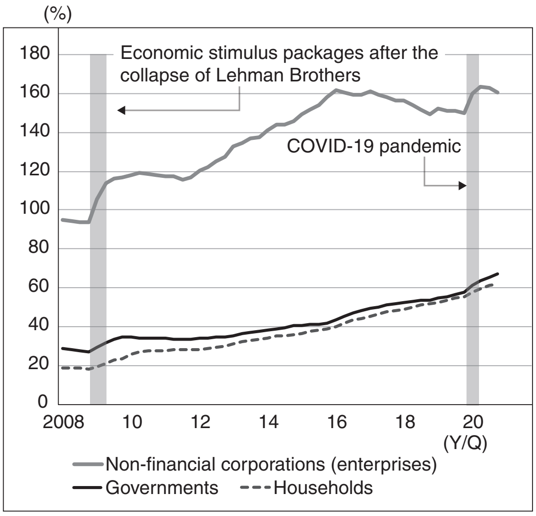
Notes: "Shadow banking" includes entrusted loans, trust loans, and banker's acceptance. "Others" include government bonds and municipal bonds. The percentage of GDP is calculated independently.
Source: Prepared by The Japan Research Institute, Limited based on materials from the People's Bank of China (PBC) and the National Bureau of Statistics (NBS)

Fig. 10 Comparison of Increase in Balance of Total Social Financing (Year-end vs. Beginning of Year)



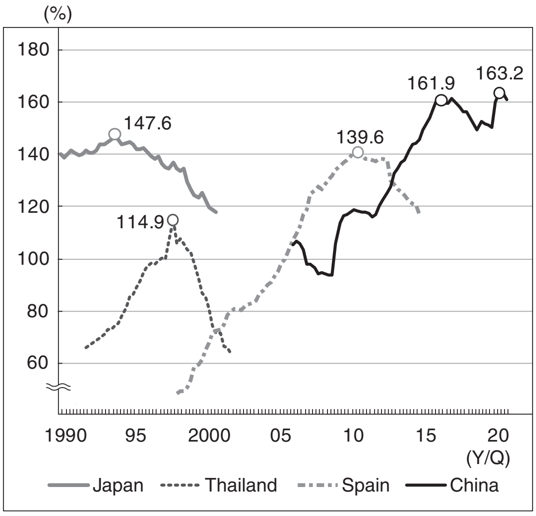
Notes: Government bonds and municipal bonds are not included in the balance of total social financing at the time of the collapse of Lehman Brothers.
Source: Prepared by The Japan Research Institute, Limited based on materials from the People's Bank of China (PBC) and the National Bureau of Statistics (NBS)

Fig. 11 **Changes in Outstanding Debt (as a Percentage of GDP) by Borrower**



Source: Prepared by The Japan Research Institute, Limited based on materials from BIS

Fig. 12 **Changes in Outstanding Corporate Debt (as a Percentage of GDP) in Countries with an Excessive Debt Problem**



Source: Prepared by The Japan Research Institute, Limited based on materials from BIS

the face of an increase in corporate defaults, but they are overlooking the fact that the problem of excessive debt has never been more serious.

The problem of excessive corporate debt has entered uncharted territory. According to BIS statistics, which enable international comparisons, the outstanding debt of Chinese companies as a percentage of GDP was 163.2% at the end of 2020, surpassing that of Japan, Thailand, and Spain at the time when they were forced to reduce their debt due to the surging problem of excessive debt (Fig. 12). In addition, the ratio, which seemed to have peaked at 161.9% at the end of March 2017, rose again in the wake of the COVID-19 pandemic, and the debt reduction (deleveraging) efforts by the Chinese government over the past few years have been basically wiped out.

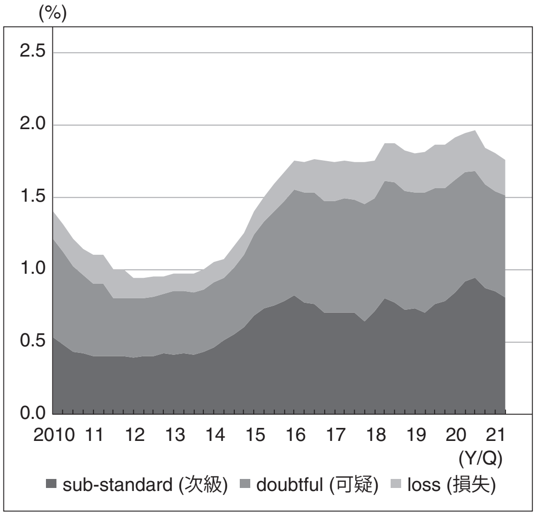
Is it possible to maintain this situation? In 2016, the BIS said "a crisis could occur within three years" (BIS [2016]), and the International Monetary Fund (IMF) also said "urgent and comprehensive measures are needed to solve the ever increasing corporate debt problem" (Maliszewski and others [2016]). Despite these warnings, China is facing the same situation once again. The IMF said in its report issued at the end of 2020 that "urgent action is needed to address the problem of excessive debt" (IMF [2020]). Xi Jinping's statement that it is necessary to prepare for the "gray rhinos" is not a threat at all.

(3) The problem is the guarantee of bank loans

If defaults on corporate bonds are at an all-time high, banks' non-performing loans (NPLs) should increase in tandem. However, China's NPL ratio stood at 1.75% as of the end of June 2021, down from 1.96% at the end of September 2020 (Fig. 13). In China, loans are classified into five categories in descending order of borrowers' ability to repay: 1) normal (正常), 2) special mention (関注), 3) sub-standard (次級), 4) doubtful (可疑), and 5) loss (損失). Those classified in the bottom three categories are non-performing loans.

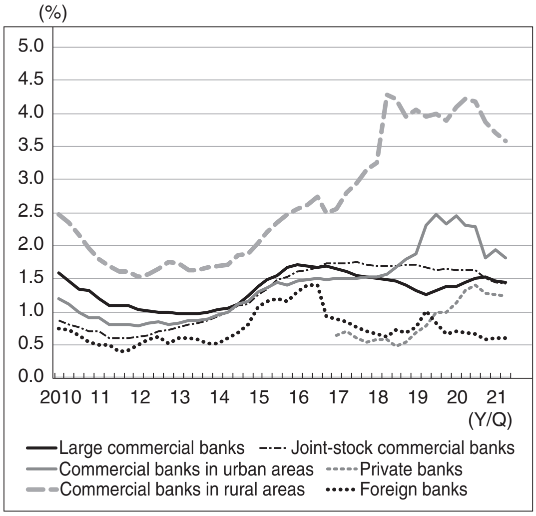
Of these, "sub-standard (次級)" refers to claims for which a certain amount of loss is incurred even if collateral is executed, "doubtful (可疑)" refers to claims for which a relatively large amount of loss is incurred even if collateral is executed, and

Fig. 13 NPL Ratio



Source: Prepared by The Japan Research Institute, Limited based on CEIC

Fig. 14 NPL Ratio by Bank Type



Source: Prepared by The Japan Research Institute, Limited based on CEIC

"loss (損失)" refers to claims for which recovery is literally impossible. Meanwhile, "special mention (関注)" refers to loans that fall between "normal (正常)" and non-performing loans and are not classified as non-performing loans but have a risk of becoming non-performing loans. When "special mention (関注)" are included in non-performing loans, China's NPL ratio was 4.13% as of the end of June 2021, but it actually declined from 4.61% at the end of September 2020.

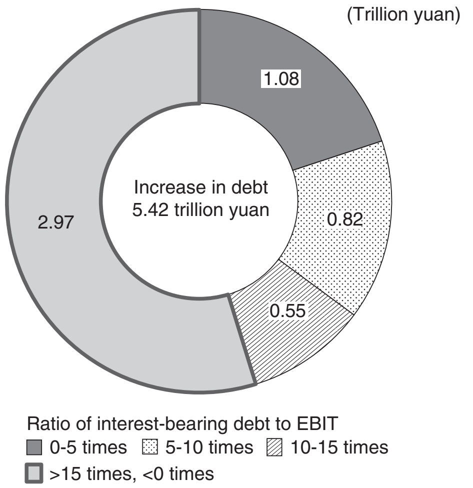
Despite the decline in the NPL ratio, the authorities are concerned about the future of the financial system. At the Boao Forum for Asia held in April 2021, Xiao Yuanqi, Vice Chairman of the China Banking and Insurance Regulatory Commission (CBIRC), said, "Banks need to be prepared in advance as pressure from a rebound of non-performing loans is growing." Small and medium-sized banks with weak business foundations are the first to face the problem of loan quality. By type of bank, the NPL ratio of commercial banks in urban areas and commercial banks in rural areas has been rising significantly (Fig. 14).

The IMF said loan quality deteriorated due to the measures introduced in the wake of the COVID-19 pandemic, including a moratorium on repayments and increased tolerance for bad loans (IMF [2021a]). The government allowed financial institutions to issue perpetual bonds with no maturity, which will never be redeemed unless the issuers redeem them before maturity(37), and urged them to increase their equity capital. At the same time, China's first financial institution bankruptcy law was on the agenda at the National People's Congress (NPC; equivalent to the Diet) held in March 2021(38), as part of its efforts to curb the increase in non-performing loans by adopting both soft-line and hard-line policies.

The biggest problem with non-performing loans is the increase in loans to companies that have a risk of delay in repayment. According to a survey of 4,400 corporate bond issuers conducted by the IMF, firms with high leverage ratios experienced significant debt increases from the end of 2019 to the end of September 2020. Specifically, the debt of enterprises whose ratio of interest-bearing debt to EBIT, which is calculated by dividing net liabilities, or total liabilities minus cash and deposits, by earnings before interest and taxes (EBIT), exceeds 15 times or is negative (below zero) is 3.0 trillion yuan, accounting for 53.7% of the 5.4 trillion yuan of debt that increased during the same period (Fig. 15).

When the ratio of interest-bearing debt to EBIT is over 15 times, it means that net liabilities are 15 times or more of EBIT, and that the debt burden is

Fig. 15 Breakdown of Increase in Debt Based on the Ratio of Interest-bearing Debt to EBIT (End of 2019 – End of September 2020)



Notes: The ratio of interest-bearing debt to EBIT is based on the average between 2018 and 2019.
Source: Prepared by The Japan Research Institute, Limited based on IMF [2021a]

very large. When the ratio is less than 0, it means that EBIT in the denominator is negative. In both cases, companies are highly likely to fall behind in repayment. The debt of these companies has increased because implicit government guarantees are given not only to corporate bonds but also to bank loans. Given that China's NPL ratio does not reflect the actual situation and is undervalued (Miura [2018], Kauko [2020]), we cannot afford to be optimistic about the future of the country just because its NPL ratio is declining.

The government also needs to review its implicit government guarantees for bank loans, but the impact is far greater than corporate bonds, so it can only proceed in stages. In reality, as a result of neglecting to tackle the problem of excessive debt, the financial consequences have become so great that the government is unable to move on. The Xi Jinping administration is under pressure to steer the economy back to a stable growth path as companies become stuck in debt repayment everywhere and the risk of undermining the stability of the financial system increases.

3. The source of excess debt is state-owned enterprises

Why can't the problem of excessive debt be resolved? After its mechanisms are scrutinized, it will be explained that the problem of excessive debt will not be resolved because preferential treatment is given to government-funded companies in funding.

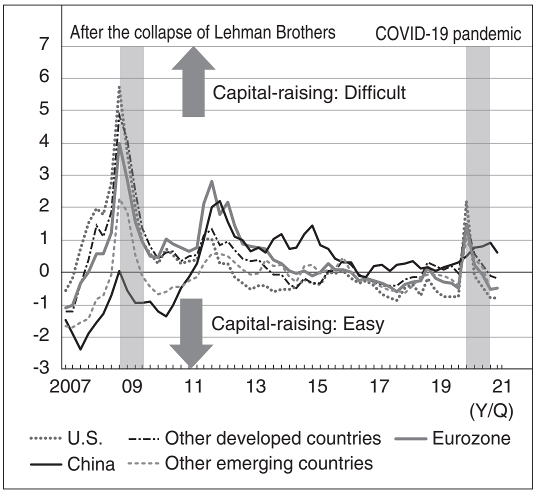
(1) Mechanism that causes excessive debt

The slow pace of resolution of China's excessive debt problem has been underscored by a surge in bank lending under the guise of overcoming the COVID-19 pandemic ahead of the rest of the world, despite the fact that corporate funding conditions had not been eased. This is similar to the situation after the collapse of Lehman Brothers, when the Chinese government sought to publicize the resilience of its economy at home and abroad by launching a 4 trillion yuan economic stimulus package.

In the wake of the COVID-19 pandemic, measures were taken in China to stabilize financial markets and support small and medium-sized enterprises by providing liquidity to the financial system through open market operations, lowering interest rates, and expanding credit lines. In addition, the government urged banks to bail out companies suffering from poor business performance by extending grace periods for repayment of principal and interest, raising the allowance for non-performing loans, and reducing the scope of provisions for doubtful accounts (IMF [2021c]).

However, these measures do not mean that it has become easier for companies to raise funds. The IMF's Financial Condition Index (FCI), which indicates how easy it is to raise funds in the market, using various interest rate spreads, showed that Chinese firms still had difficulty in raising capital even during the COVID-19 pandemic in 2020 (Fig. 16). The government was cau-

Fig. 16 Changes in Financial Condition Index (FCI) in Major Countries/Regions



Source: Prepared by The Japan Research Institute, Limited based on IMF [2021a]

tious about excessive monetary easing because the number of COVID-19 cases was relatively small and it had been implementing deleveraging since 2017.

Nevertheless, the sharp increase in corporate debt caused by the expansion of bank loans in 2020 shows that the problem of the Chinese economy has not been resolved, that is, if the central government relaxes its reins on local governments, companies, and financial institutions in the face of unavoidable slowdown in growth, such as the spread of COVID-19 infections, the amount of funds supplied to the real economy will surge. Unlike the situation after the collapse of Lehman Brothers, corporate debt increased in an environment where it was not easy to raise funds, showing how deep-rooted this problem is.

The People's Bank of China is positioned as one of the government agencies under the State Council (Cabinet) just like the Ministry of Commerce, so it cannot be said that the bank is highly independent, and its monetary policy tends to be subordinate to other policies such as industrial policy and employment policy. This problem is more likely to surface as concerns about slowing growth increase. In fact, although the People's Bank of China warned against the problem of excessive debt and instructed other banks to restrain their lending[39], new yuan-denominated loans continued to increase at a pace faster than market expectations until June 2021[40].

(2) Expectations for resolution of debt problem are low

China's leverage ratio is so high that the outstanding corporate debt as a percentage of GDP exceeds 160% (see Fig. 11). Management that actively uses bank loans and corporate bonds to expand investment leads to the maximization of profits in an environment where business performance is expected to rise steadily, but when business performance becomes unstable, debt repayment reaches an impasse. An increase in corporate defaults suggests that Chinese companies are in this situation, and credit risk is unlikely to decrease.

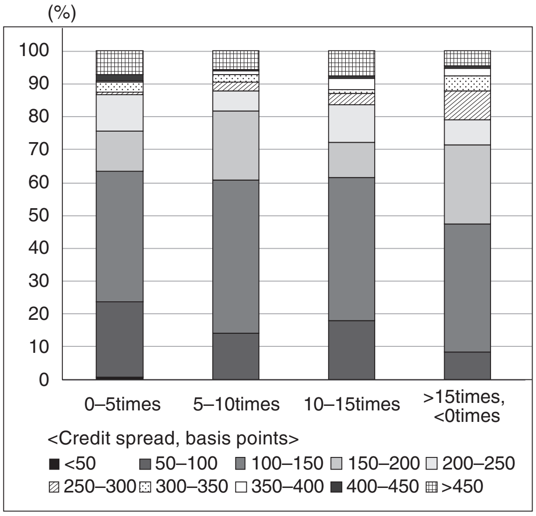
The outstanding volume of social financing as a percentage of GDP has been gradually decreasing since the latter half of 2020 (see Fig. 9), and deleveraging may be accelerated by the regulation on the total amount of real estate-related loans and the "three red lines" that encourages real estate development companies to reduce their debts, to be described later. It is the scenario envisioned by the Xi Jinping administration that the problem of excessive debt will be resolved by curbing the supply of funds to companies, and thereby putting the Chinese economy back to a stable growth path.

However, it is unlikely that the problem of excessive debt will be resolved in accordance with this scenario. A decline in the outstanding volume of social financing as a percentage of GDP and regulation of the total amount of loans to real estate developers are among the necessary conditions to resolve the problem of excessive debt, but they are not sufficient conditions. As shown in Fig. 15 above, in China, companies that are unable to repay their debts are most eager to raise funds, and the market had responded to such needs positively. As a result, even if the outstanding volume of social financing as a percentage of GDP decreases and deleveraging progresses, debt will not decrease as expected because debt is unevenly distributed to companies with low repayment capacity and additional lending is required.

In fact, using the IMF data presented in Fig. 15, if we look at the ratio of interest-bearing debt to EBIT of bond issuers and their credit spread, which is the difference in interest rate between corporate bonds and government bonds, based on the balance of corporate bonds issued as of the end of September 2020, we can see that there is no correlation between the two. In other words, even if a company's debt repayment capacity is high, it is not necessarily possible to raise funds at low interest rates. Assuming that if the credit spread is 200 basis points or less, a company has financed at low interest rates, 70% of companies with a ratio of interest-bearing debt to EBIT of more than 15 times or even below zero are included in this category, and the ratio is not much different from companies with a ratio of interest-bearing debt to EBIT of five times or less (Fig. 17).

Companies rated as "CCC" (triple C) by international rating agencies have an average ratio of interest-bearing debt to EBIT of six times (IMF [2020a]). In light of this, the Chinese corporate bond market is a mixed bag as companies with low debt repayment capacity are included as players. Although the government issued the Administrative Measures for the Issuance and Trading of Corporate Bonds at the end of 2020 and established basic requirements and legal responsibilities for information disclosure, such as the requirements, content, timing, and frequency of information disclosure, the mixed-bag situation will not likely change unless implicit government guarantees are eliminated.

Fig. 17 Breakdown of Corporate Bonds Based on the Ratio of Interest-bearing Debt to EBIT by Credit Spread (Balance as of the End of September 2020)



Notes: The ratio of interest-bearing debt to EBIT is based on the average between 2018 and 2019.
Source: Prepared by The Japan Research Institute, Limited based on IMF [2021a]

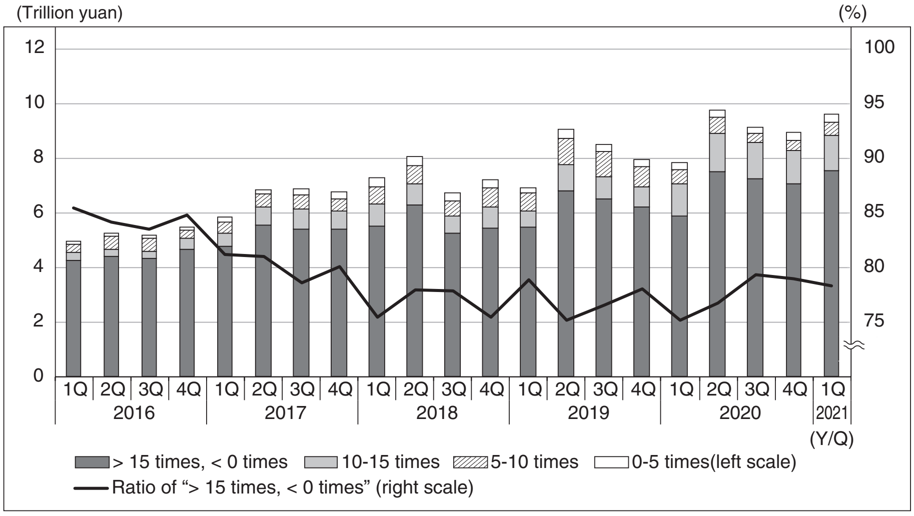
(3) Prominent preferential treatment for government-funded companies

Amid growing concerns about the elimination of implicit government guarantees, the structure in which funds are concentrated on companies with low debt repayment capacity has not changed, as can be seen from data from 2016 to the January-March 2021 period for about 4,200 companies excluding financial institutions listed on the Shanghai and Shenzhen stock exchanges. If both companies and financial institutions are serious about debt reduction, the net liabilities of companies with high ratios of interest-bearing debt to EBIT should decrease, the problem of excessive debt should improve, and credit risk should be mitigated.

However, there is no such tendency. Looking at changes in net liabilities of enterprises with increased net liabilities in accordance with the average ratio of interest-bearing debt to EBIT of the last quarter, net liabilities increased for companies whose ratio of interest-bearing debt to EBIT exceeded 15 times or was negative in the January-March 2021 period, and the amount of their liabilities accounted for 78.4% of the total (Fig. 18). This percentage has changed little since 2018, confirming that the problem of excessive debt is unlikely to improve.

Behind this is the favorable funding environ-

Fig. 18 Breakdown of Net Liabilities Based on the Ratio of Interest-bearing Debt to EBIT



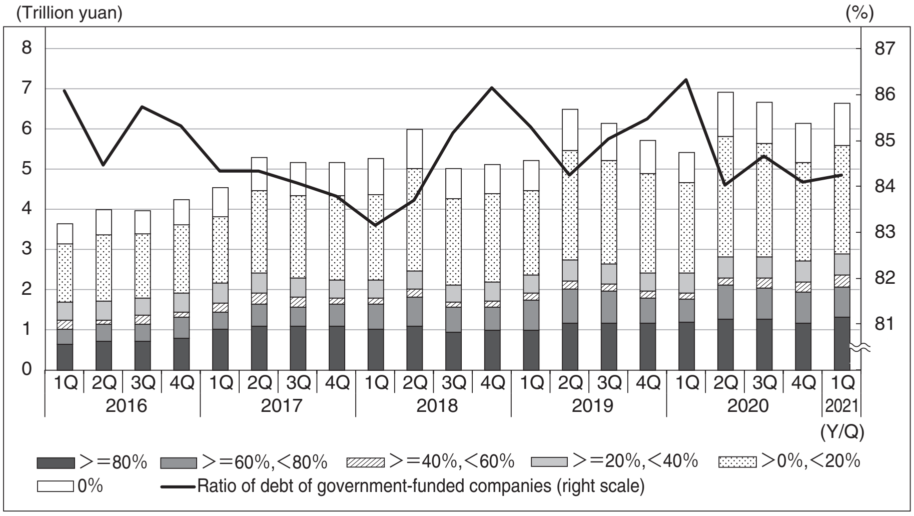
Notes: The ratio of interest-bearing debt to EBIT is based on the weighted average of the past four quarters. Companies with negative net liabilities are excluded.

ment for state-owned enterprises. When extracting the companies with a ratio of interest-bearing debt to EBIT exceeding 15 times from Fig. 18, net liabilities for January-March 2021 period (6,647.9 billion yuan) can be broken down by the government ownership ratio as follows: 1) 1,315.6 billion yuan, 3.2% of the total, for companies with a government ownership ratio of 80% or more; 2) 772.2 billion yuan, or 11.6% of the total, for companies with a government ownership ratio of 60% or more and less than 80%; 3) 285.9 billion yuan, or 4.3% of total, for companies with a government ownership ratio of 40% or more and less than 60%; 4) 529.5 billion yuan, or 8.0% of total, for companies with a government ownership ratio of 20% or more and less than 40%; 5) 2,696.8 billion yuan, or 40.6% of total, for companies with a government ownership ratio of more than 0% and less than 20%; and 6) 1,047.8 billion yuan, or 15.8% of total, for companies with a government ownership ratio of 0% (Fig. 19).

At first glance, it appears that there is no correlation between the government ownership ratio and the debtor's ability to repay. However, because the government ownership ratio is 0% for 63.9% of listed companies, Fig. 19 shows that companies funded by the government have no difficulty raising funds even if their ratio of interest-bearing debt to EBIT exceeds 15 times. In other words, it indicates that they are protected by implicit government guarantees, and that so-called "additional lending" is being actively conducted. The ease of funding for a company does not depend on the government ownership ratio, but on whether it is funded by the government or not. As a result, debt of government-funded companies always accounts for more than 80% of net liabilities, as shown by the line graph of Fig. 19.

Implicit government guarantees can be said to be the biggest cause of "*Guo jin min tui*," in which state-owned enterprises advance while private enterprises are gradually forced to retreat. According to the statistics of enterprises in the mining and manufacturing industries, for which detailed data by ownership type can be obtained, state-owned enterprises accounted for only 26.4% of total sales as of the end of 2020, but they accounted for 39.9% of debt[41]. This also shows that state-owned enterprises are in a more favorable environment than private enterprises in terms of financing. The problem of excessive debt is a result of "*Guo jin min tui*," and it can be said that it is difficult to solve the problem under the Xi Jinping administration, which emphasizes state-owned enterprises.

Fig. 19 Net Liabilities of companies with the Ratio of Interest-bearing Debt to EBIT Exceeding 15 Times (Breakdown by Government Ownership Ratio)



Notes: Data for 2021 covers the period through June 2021. Government-funded companies mean companies with government ownership ratio above zero (> 0).
Source: Prepared by The Japan Research Institute, Limited based on materials from Bloomberg

4. Overheating of the real estate market

Real estate developers, such as Evergrande Group, are growing increasingly prominent in the corporate debt problem. After analyzing the characteristics of China's real estate market, how the government is taking measures against the overheating of the real estate market and its results will be examined.

(1) Real estate development is led by private enterprises

Real estate development in China is being promoted mainly by private enterprises. For this reason, the structure, which has been pointed out, that the problem of excessive debt cannot be resolved due to the existence of state-owned enterprises whose liquidation has not progressed despite the favorable financing environment does not apply to the real estate development industry. State-owned enterprises do not have a strong presence in the real estate development industry, and according to the China Statistical Yearbook 2020 published by the National Bureau of Statistics of China, they accounted for only 0.7% of total number of enterprises and 0.9% of total number of workers in 2019.

Since there are three to four state-owned enterprises in the top 10 in terms of sales amount and sales area in 2020, most of small and medium-sized developers are private enterprises. As real estate development, like IT, was a new business for state-owned enterprises, the entry of state-owned enterprises was delayed and the market was formed with private enterprises as the main players. The only two state-owned enterprises specialized exclusively in real estate development are Vanke(42), whose dominant shareholder is Shenzhen Metro Group, and Poly Developments and Holdings Group, which is a central state-owned enterprise (Table 1).

Private enterprises are not subject to implicit government guarantees, but the government cannot afford to sit back and watch the default or bankruptcy of major real estate developers simply because they are not state-owned enterprises.

First, the excessive debt problem is serious

Table1 Top 10 Chinese Real Estate Developers in Terms of Sales Amount and Sales Area (2020)

Rank	Company name	Type	Sales amount (100 million yuan)
1	Country Garden	Private	7,888
2	Evergrande Group	Private	7,038
3	Vanke	State-owned	7,011
4	Sunac China Holdings	Private	5,750
5	Poly Developments and Holdings Group	State-owned	5,028
6	China Overseas Estate	State-owned	3,603
7	Greenland Holdings	Mixed	3,567
8	Shimao Group Holdings	Private	3,003
9	China Resources Land	State-owned	2,900
10	Greentown China Holdings	Private	2,892

Rank	Company name	Type	Sales area (10,000 m^2)
1	Country Garden	Private	8,421
2	Evergrande Group	Private	7,834
3	Vanke	State-owned	4,328
4	Sunac China Holdings	Private	4,148
5	Poly Developments and Holdings Group	State-owned	3,405
6	Greenland Holdings	Mixed	2,800
7	Seazen Holdings	Private	2,353
8	Jinke Property Group	Private	2,230
9	China Overseas Estate	State-owned	1,925
10	Shimao Group Holdings	Private	1,713

Notes: Companies included in “Hurun China 500 Most Valuable Private Companies 2020” (Hurun Report) are categorized as “private companies.”
Source: Prepared by The Japan Research Institute, Limited based on local media reports

in the real estate development industry. The total debt of the real estate development industry reached 67.4 trillion yuan in 2018, exceeding that of the mining and manufacturing industries of 65.4 trillion yuan (Fig. 20 Left). The debt of the real estate development industry tends to increase due to the nature of its business. However, given the fact that the total debt of the real estate development industry is larger than that of the mining and manufacturing industries even though the real estate development industry’s share of GDP represents only one-fifth of that of the mining and manufacturing industries, it is obvious that the real estate development industry has adopted significant leveraging in its business.

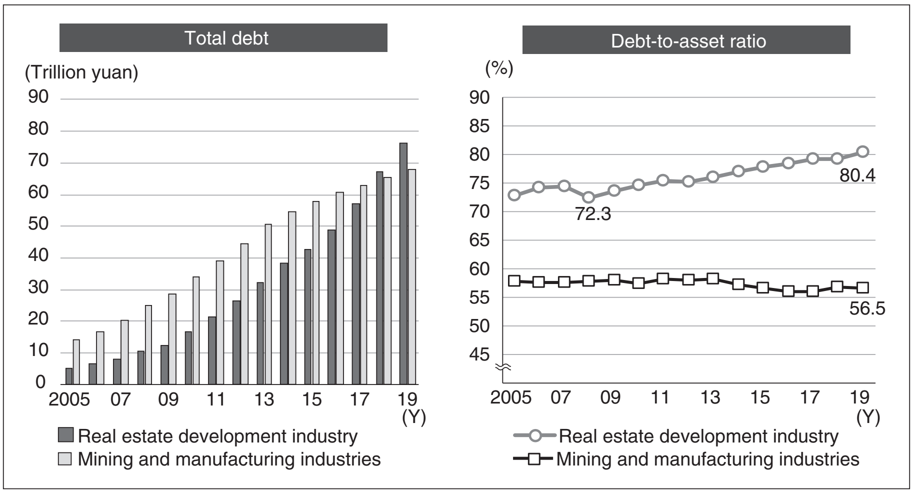
Moreover, the debt-to-asset ratio in the real estate development industry rose by 8.1% over 10 years, in contrast to that in the mining and manufacturing industries (Fig. 20 Right). While debt servicing capacity varies from company to company, credit uncertainty could spread to other industry giants if Evergrande Group defaults on multiple bonds and ends up with “清算,” in which pro-rata payments are made to creditors in proportion to the amount of their claims.

Second, the real estate development industry accounts for a large proportion of the Chinese economy. The added value created by the real estate development industry was 6.5 trillion yuan in 2018, accounting for 7.1% of GDP. The real estate development industry is one of the leading industries in China’s economy since it accounted for 5.6% of GDP in 2000. About half of Evergrande Group’s total debt of 1,966.5 billion yuan, or 951.1 billion yuan, is said to be accounts payable to construction companies(43), which indicates that the real estate development industry has a large ripple effect on other industries. If the construction industry, which has close ties with the real estate development industry, is included, the real estate development industry accounts for 14.3% of GDP and is second only to the mining and manufacturing industries at 30.3%.

Third, since real estate-related loans account for a large proportion of bank loans, the turmoil in the real estate market could affect the stability of the financial system. Real estate-related loans can be divided into development loans for companies and housing loans for households. Their share of outstanding loans, which was less than 15% in 2005, rose to nearly 30% in 2019 as mortgage lending expanded (Fig. 21). Given that real estate development acounts for 5.6% of GDP, bank’s dependence on real estate is serious.

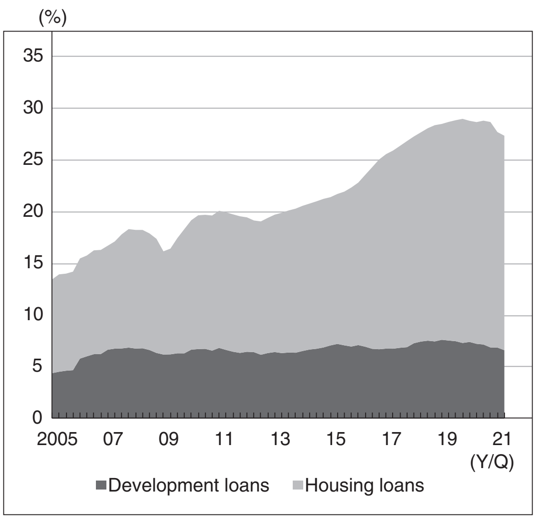
Fourth, housing demand in China is supported not by actual demand for housing, but by speculation, or investment aimed at money-making, and thus is vulnerable to price fluctuations. A survey of household assets conducted in 2019 by the People’s Bank of China(44) found that 96% of house-

Fig. 20 Total Debt and Debt-to-asset Ratio in the Real Estate Development Industry



Notes: Debt-to-asset ratio = Total debt / total assets x 100
Source: Prepared by The Japan Research Institute, Limited based on materials from NBS

Fig. 21 Ratio of Real Estate-related Loans to Bank Loans



Notes: Data for 2021 covers the period through June 2021.
Source: Prepared by The Japan Research Institute, Limited based on CEIC (original source: People's Bank of China)

holds in urban areas own a home. If the market turmoil continues and house prices fall for a long period of time, there is a danger that the repayment capacity of households with housing loans backed by housing will deteriorate and the NPL ratio of banks will increase.

Fifth, whether housing development and sales proceed smoothly has a great impact on people's lives. In China, an increasing number of people have no place to live because their houses have not been completed despite the fact that they made down payments due to a series of bankruptcies of real estate developers. One of the reasons for this is that real estate developers can get a down payment before the house is completed because the advance sale system is widespread. Although real estate developers have used these down payments for their future new investment projects, after 2019, many companies began to find themselves cash-strapped from such hand-to-mouth operations. In order to prevent the problem from spreading, Hainan Province has decided to only allow the sale of completed properties going forward[(45)].

(2) Anxiety over the continued overheating of the market

A number of real estate developers have gone bankrupt since 2019. In 2020, about 500 developers, mainly small and medium-sized private companies, went bankrupt[(46)], bringing the total to 1,000 when combined with the number of developers that failed in 2019[(47)]. In 2021, more than 200 developers have gone bankrupt through June(48). Behind the increase in bankruptcies was the emergence of funding problems due to the deteriorating financing environment.

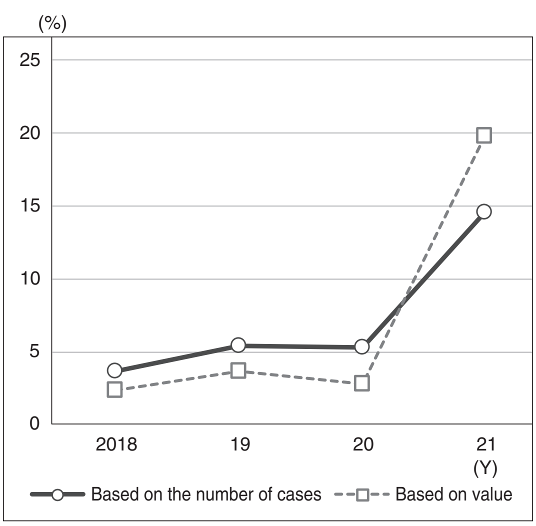
In 2021, the default of real estate developers in the corporate bond market became apparent. As of mid-July 2021, the ratio of real estate developers to the total corporate defaults was 14.3% in terms of the number of cases and 19.9% in terms of value, up from 5.3% and 2.8%, respectively, in the previous year (Fig. 22). Real estate developers had been regarded as supporting the corporate bond market because of their strong business performance due to the steady increase in demand in line with urbanization, but their evaluation has changed and they are now regarded as disruptors.

However, what the government is wary of is not the bankruptcy of real estate development companies but the overheating of the real estate market. The issue even affected party personnel, and in May 2021, senior officials, including the mayor of Shenzhen Municipality, were dismissed for neglecting to prevent overheating of the market(49). As Guo Shuqing, Chairman of the CBIRC, warned at a financial forum hosted by the Shanghai Municipal Government in June 2021 that "those who are betting that house prices will never fall will ultimately pay a heavy price(50)," the government has been continuing to send strong messages on this issue.

House prices in Shenzhen rose 37.7% in January 2021 from a year earlier to 90,049 yuan per square meter, far surpassing those of Beijing (up 2.3% year on year, 66,493 yuan per square meter) and Shanghai (up 10.8% year on year, 61,923 yuan per square meter) in both growth rate and level(51). According to the Shenzhen Statistical Yearbook 2020 (Bureau of Statistics of Shenzhen Municipality), since the average housing area per household in Shenzhen Municipality is 57.6 square meters, the house price is 5.18 million yuan, which is 83 times the average disposable income (62,522 yuan) of the city.

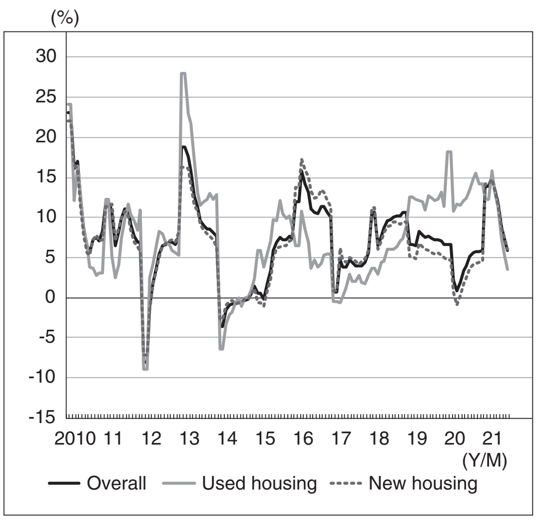
However, the national average published by the National Bureau of Statistics of China shows that the prices of used homes have risen intermittently, but the overall prices including those of new homes have not risen to an unprecedented level (Fig. 23). Nevertheless, the government's concern over the overheating of the real estate market

Fig. 22 Ratio of Real Estate Developers to Total Corporate Defaults



Notes: Data for 2021 covers the period through July 19, 2021.
Source: Prepared by The Japan Research Institute, Limited based on Wind

Fig. 23 Monthly Changes in House Prices (YoY Comparison)



Source: Prepared by The Japan Research Institute, Limited based on CEIC (original source: NBS) seems to be due to the heightened sense of crisis over the continued overheating.

It was back in the summer of 2019 that the Xi Jinping administration warned against the overheating of the market. At a meeting of the Politburo of the Central Committee of the Communist Party of China in July 2019, it was revealed that "real estate is not considered as a means of short-term economic stimulation.(52)" The GDP growth rate for the April-June quarter of the same year was 6.7% compared to the same period of the previous year, the lowest in 27 years, due to sluggish investment and exports reflecting the intensification of trade friction with the United States. However, the government gave up on deregulation of the real estate market out of concern that house prices would rise further.

House prices fell briefly after the Politburo meeting but quickly recovered and continued to rise. While house prices declined again after the summer of 2020 due to the effect of the COVID-19 pandemic, they started to rise again after the beginning of 2021. The policy announced by the Politburo and the impact of the pandemic were limited, and it became clear how strong the "myth" that house prices would not go down is and how housing demand has been underpinned by such myth.

The reason of the real estate market overheating is attributable to the fact that part of the economic stimulus package launched in the wake of the COVID-19 pandemic, which was focused on the support for corporate funding rather than individual income compensation, flowed into the real estate market(53), and that funds were shifted toward investment in housing, which is regarded as a safe asset, in an attempt to avoid the decline in value of assets due to the depreciation of the yuan(54).

For these reasons, the government tried to control the inflow of funds into the real estate market by strengthening regulations on banks and real estate developers.

The regulation on the total amount of real estate-related loans was introduced as a regulation on banks. At the end of 2020, the People's Bank of China set limits on real estate-related loans and mortgages to individuals. Specifically, the following requirements were made: 1) major banks, such as Industrial and Commercial Bank of China (ICBC), are required to limit their real estate-related loans to 40% or less of total loans and their mortgages to individuals to 32.5% or less of total loans; 2) medium-sized banks, such as China Merchants Bank, to limit to 27.5% or less and 20% or less of total loans, respectively; and 3) small-sized banks to limit to 22.5% or less and 17.5% or less of total loans, respectively(55).

The three red lines were introduced in September 2021 to encourage major real estate developers to reduce their debts(56). The three red lines refer to three achievement targets including 1) a debt-to-asset ratio of 70% or less, 2) a net liability ratio of 100% or less, and 3) a short-term debt ratio of 1time or more of cash holdings. Depending on these achievement rates, it will be decided how much a company is allowed to increase interest-bearing debt. Companies that fail to meet the three achievement targets are not allowed to increase interest-bearing debt, but companies that meet the targets can increase interest-bearing debt by up to 115% from the previous year, depending on the degree of achievement of the targets(57).

(3) Achievement of certain targets

Most banks meet the criteria of limits on real estate-related loans and mortgages to individuals (Table 2). A comparison of status at the end of 2020 and at the end of June 2021 shows that among large-sized banks, only China Construction Bank (CCB) and Postal Savings Bank of China (PSBC) have not met the criteria of limit on mortgages to individuals (shaded cells). As for medium-sized banks, China Merchants Bank and Industrial Bank have not met the criteria of limits on real estate-related loans and mortgages to individuals. It is not easy for banks with a high ratio of real estate-related loans to total loans to meet the criteria.

The real estate-related NPL ratio of banks rose against the backdrop of an increase in bankruptcies of real estate developers. Among large-sized

Table 2 Results of Regulation on Total Amount of Real Estate-related Loans Targeting Large- and Medium-sized Banks

(%, % points, 100 million yuan)

Size	Bank name	As of end of 2020				As of end of June 2021					
		Real estate-related loans		Housing loans		Real estate-related loans		Housing loans		Real estate-related non-performing loans	
		%	Excess	%	Excess	%	Excess	%	Excess	100 million yuan	Increase*
Large-sized	Industrial and Commercial Bank of China (ICBC)	35.09	-4.91	30.80	-1.70	33.92	-6.08	30.20	-2.30	319.11	156.73
	China Construction Bank (CCB)	39.40	-0.60	34.73	2.23	37.83	-2.17	33.72	1.22	115.64	25.53
	Bank of Communications	28.07	-11.93	22.12	-10.38	27.88	-12.12	21.86	-10.64	64.61	17.50
	Agricultural Bank of China	36.08	-3.92	30.80	-1.70	35.03	-4.97	29.82	-2.68	132.70	-9.39
	Bank of China	39.17	-0.83	31.15	-1.35	37.83	-2.17	29.94	-2.56	-	-
	Postal Savings Bank of China (PSBC)	35.24	-4.76	33.61	1.11	35.08	-4.92	32.97	0.47	0.12	-0.05
Medium-sized	China Merchants Bank	33.12	5.62	25.35	5.35	32.22	4.72	24.71	4.71	43.28	31.38
	Shanghai Pudong Development Bank	36.73	9.23	18.00	-2.00	26.17	-1.33	18.89	-1.11	104.64	32.92
	China Minsheng Banking	24.76	-2.74	13.37	-6.63	24.09	-3.41	13.75	-6.25	43.49	13.09
	Hua Xia Bank	20.14	-7.36	12.88	-7.12	20.86	-6.64	13.94	-6.06	2.56	2.42
	Ping An Bank	19.28	-8.22	8.98	-11.02	20.45	-7.05	9.65	-10.35	16.61	10.90
	China Zheshang Bank	20.11	-7.39	6.32	-13.68	22.59	-4.91	9.05	-10.95	10.42	8.96
	Industrial Bank	34.56	7.06	26.55	6.55	34.62	7.12	25.95	5.95	24.06	-5.15
	China CITIC Bank	26.51	-0.99	20.88	0.88	25.96	-1.54	19.66	-0.34	92.35	-3.98
	China Everbright Bank	23.82	-3.68	16.36	-3.64	23.47	-4.03	16.52	-3.48	13.66	-2.68

Notes: Increase* indicates changes from the end of 2020. Figures for medium-sized banks are based on an excerpt.
Source: Prepared by The Japan Research Institute, Limited based on local media reports

Table 3 NPL Ratio of Large- and Medium-sized Banks

(%, % points)

Size	Bank name	Overall			Real estate-related		
		End of 2020	June 2021	Increase	End of 2020	June 2021	Increase
Large-sized	Industrial and Commercial Bank of China (ICBC)	1.58	1.54	-0.04	2.32	4.29	1.97
	China Construction Bank (CCB)	1.56	1.53	-0.03	1.31	1.56	0.25
	Bank of Communications	1.67	1.60	-0.07	1.35	1.69	0.34
	Agricultural Bank of China	1.57	1.50	-0.07	1.81	1.54	-0.27
	Postal Savings Bank of China (PSBC)	0.88	0.83	-0.05	0.09	0.06	-0.03
	Bank of China	1.46	1.30	-0.16	-	-	-
Medium-sized	China Merchants Bank	1.07	1.01	-0.06	0.30	1.07	0.77
	Shanghai Pudong Development Bank	1.73	1.64	-0.09	2.07	3.03	0.96
	China Minsheng Banking	1.82	1.80	-0.02	0.69	1.04	0.35
	Hua Xia Bank	1.80	1.78	-0.02	0.01	0.02	0.01
	Ping An Bank	1.18	1.08	-0.10	0.21	0.57	0.36
	China Zheshang Bank	1.42	1.50	0.08	0.09	0.61	0.52
	Industrial Bank	1.25	1.15	-0.10	0.92	0.66	-0.26
	China CITIC Bank	1.64	1.50	-0.14	3.35	3.11	-0.24
	China Everbright Bank	1.38	1.36	-0.02	3.91	3.10	-0.81

Source: Prepared by The Japan Research Institute, Limited based on local media reports

banks, the real estate-related NPL ratio of Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), and Bank of Communications rose, and as for medium-sized banks, the number of banks whose real estate-related NPL ratio has risen is larger than that of banks whose real estate-related NPL ratio has declined. However, the overall NPL ratio at many banks declined due to restraints on real estate-related loans and a decrease in non-performing loans in non-real estate-related sectors (Table 3).

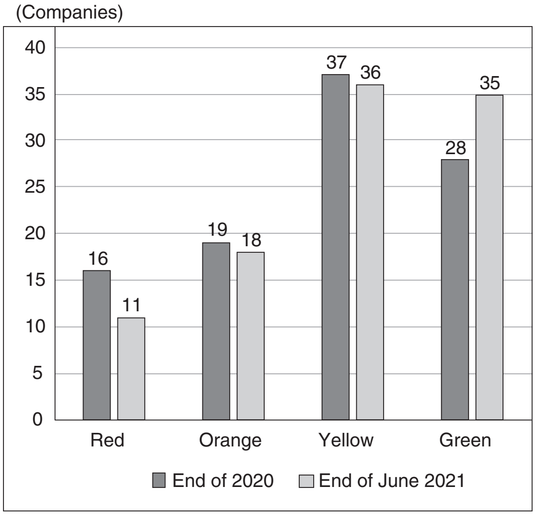
There has also been a certain degree of progress with the three red lines. Among the top 100 listed real estate developers, the number of 1) companies falling under the "red" category that have not achieved any of the three lines, 2) companies falling under the "orange" category that have achieved two lines, and 3) companies falling under the "yellow" category that have achieved one line decreased, while the number of 4) companies falling under the "green" category that have achieved all of the three lines increased (Fig. 24). This is also true of major real estate developers (Table 4). As of the end of June 2020, Evergrande Group and Greenland Holdings fell under the "red" category, but in June 2021, both companies shifted to the "orange" category.

House prices are also on a downward trend. Looking at changes in house prices in 70 cities, an increasing number of cities saw their house prices decline after peaking in June 2021, and the number for "decline" exceeded that for "increase" for used housing (Fig. 25). This seems to be partly due to the fact that real estate developers, which were in financial difficulties, were forced to sell their assets[58], but it is more appropriate to see this as a result of the curtailment of demand due to the regulation on the total amount of real estate-related loans and through the three red lines.

Efforts to control house prices are also being made by local governments, such as setting ceilings on the selling prices of used housing[59] and disqualifying firms that have not yet achieved the three red lines from bidding on the transfer of land use rights[60]. In the second half of 2021, housing supply and prices are expected to decline, while debt reduction by real estate developers will likely advance.

China has avoided overheating of the real estate

Fig. 24 Status of Achievement of the Three Red Lines by 100 Listed Real Estate Developers



Source: Prepared by The Japan Research Institute, Limited based on local media reports

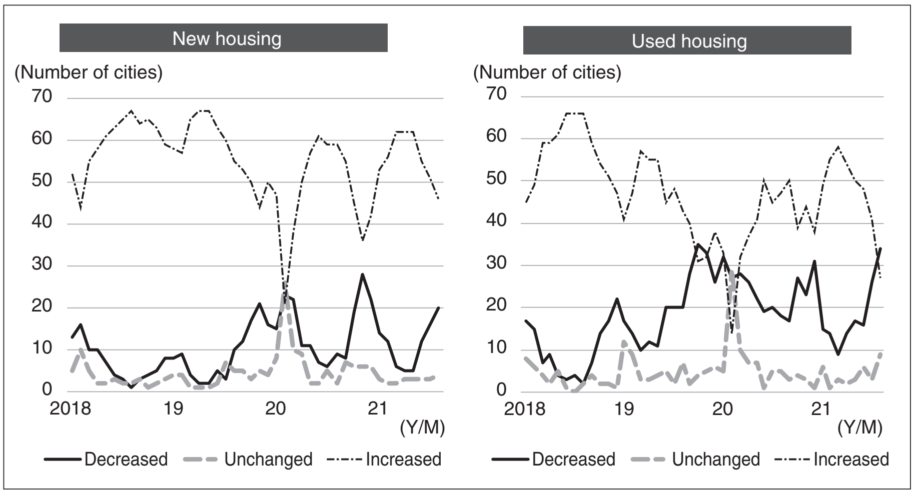
Table 4 Status of Achievement of the Three Red Lines by Top 10 Real Estate Developers

(%, times)

Rank	Company name	Type	June 2020				June 2021			
			Debt-to-asset ratio	Net liability ratio	Short-term debt ratio	Status	Debt-to-asset ratio	Net liability ratio	Short-term debt ratio	Status
1	Country Garden	Private	81.6	58.1	1.94	Yellow	78.5	49.7	2.15	Yellow
2	Evergrande Group	Private	85.3	219.5	0.52	Red	81.0	99.8	0.67	Orange
3	Vanke	State-owned	75.5	27.0	2.01	Yellow	69.8	20.2	2.32	Green
4	Sunac China Holdings	Private	82.2	149.0	0.86	Red	76.0	86.6	1.11	Yellow
5	Poly Developments and Holdings Group	State-owned	67.4	72.1	1.96	Green	67.6	59.0	2.59	Green
6	China Overseas Estate	State-owned	53.8	31.6	3.33	Green	53.4	33.8	2.60	Green
7	Greenland Holdings	Mixed	82.7	180.3	0.72	Red	82.8	120.0	1.34	Orange
8	Shimao Group Holdings	Private	70.8	57.8	1.77	Yellow	68.0	50.9	1.19	Green
9	China Resources Land	State-owned	59.7	45.9	1.47	Green	60.9	37.4	2.27	Green
10	Greentown China Holdings	Private	74.2	66.1	1.40	Yellow	72.5	75.2	2.01	Yellow

Source: Prepared by The Japan Research Institute, Limited based on local media reports

Fig. 25 Month-over-month Changes in House Prices in 70 Cities



Source: Prepared by The Japan Research Institute, Limited based on CEIC (original source: NBS)

market by tightening regulations on households, banks and real estate developers each time the risk of a bursting of the real estate bubble has been pointed out. The government seems to think that it can avoid the collapse of the bubble again this time.

5. Limitations of conventional growth patterns

Excess debt and soaring house prices have never previously been a drag on China's economic growth. However, China is in a situation where this rule of thumb does not apply these days, making it difficult to maintain traditional growth patterns. As drastic reforms are unlikely to be carried out, China is likely to face pressure to lower its growth more than expected.

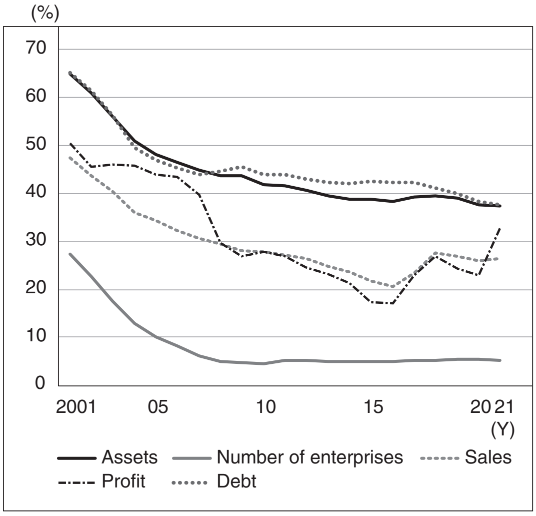
(1) Decline in the ratio of state-owned enterprises has stopped

One of the reasons why the conventional growth pattern cannot be maintained is that the proportion of state-owned enterprises in the economy has stopped declining. In the latter half of the 1990s, under Premier Zhu Rongji, China implemented an ownership reform in which state-owned enterprises were privatized, and with the remarkable rise of private enterprises, the percentage of state-owned enterprises in the economy declined intermittently. However, looking at the ratio of state-owned enterprises in the mining and manufacturing industries, the decline in assets, the number of enterprises, sales, profits, and liabilities has slowed since around 2010 (Fig. 26).

On the other hand, when looking at the return on assets (ROA), which shows how much profit is made by using total assets, the ROA of state-owned enterprises has been consistently lower than that of small private enterprises (Fig. 27). This indicates that state-owned enterprises have less profitable assets than small private enterprises, and that their assets have not been utilized effectively. It is desirable to compare state-owned enterprises with private enterprises, but it is difficult to extract private enterprises due to statistical constraints (Miura [2020]). Therefore, it should be noted that in Fig. 27, private enterprises are substituted by small private enterprises, which account for the largest share of private enterprises in both sales and profits.

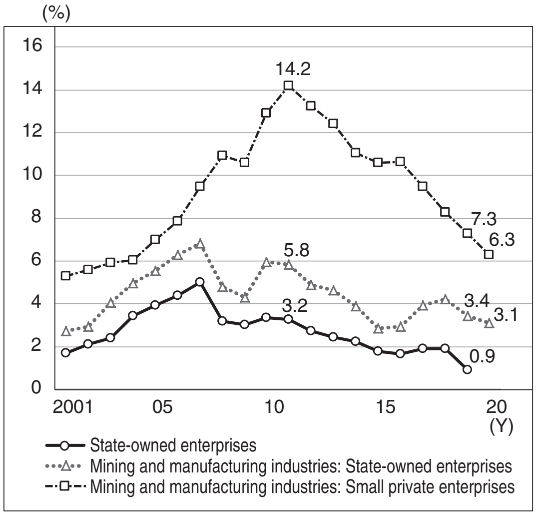
Despite the decline in the efficiency of state-

Fig. 26 Ratio of State-owned Enterprises in the Mining and Manufacturing Industries



Notes: State-owned enterprises include state-owned holding enterprises. Data for 2021 indicates figures as of the end of June 2021.
Source: Prepared by The Japan Research Institute, Limited based on CEIC (original source: NBS)

Fig.27 Comparison of ROA Between State-owned Enterprises and Small Private Enterprises



Notes: State-owned enterprises include state-owned holding enterprises.
Source: Prepared by The Japan Research Institute, Limited based on materials from CEIC and the IMF (original source: Ministry of Finance of China, NBS)

owned enterprises, China was able to maintain high growth only because the ratio of state-owned enterprises in the economy declined. The impact of the low capital efficiency of state-owned enterprises became less noticeable as the ratio of state-owned enterprises declined, and private enterprises with high efficiency and rapid growth led the growth. However, if the ratio of state-owned enterprises in the economy does not decline as it has been doing in the past, the inefficiency of state-owned enterprises will become conspicuous.

The decline in ROA of small private enterprises has added to this. The ROA of small private enterprises in the mining and manufacturing industries in 2020 was 6.3%, less than half of the ROA of 14.2% in 2011 (Fig. 27). Although their ROA is still higher than that of state-owned enterprises, the decline in ROA since 2011 indicates that the growth engine of small private enterprises is rapidly weakening.

Behind this is said to be the deteriorating funding environment and the strengthening of environmental regulations(61). However, as shown in Fig. 26, the fact that the proportion of state-owned enterprises in the economy has stopped falling is not irrelevant. Since its inauguration in November 2012, the Xi Jinping administration has emphasized the importance of state-owned enterprises, saying that state-owned enterprises will be transformed from “大而不強” (large but not strong) to “做強做優做大” (strong, excellent and great). It is no wonder if this has been translated into tangible and intangible pressure on small private enterprises, resulting in less profits.

While the Xi Jinping administration ostensibly wants to encourage the development of companies with various forms of ownership, it does not necessarily aim to boost the growth engine of private companies. In the 14th Five-Year Plan adopted at the National People’s Congress (NPC) held in March 2021, the slogan “大衆創業・万衆創新” (mass entrepreneurship and universal innovation) disappeared, while it was indicated again that state-owned enterprises are the driving force of the Chinese economy, saying that the growth rate of R&D in central state-owned enterprises should not fall below the overall growth rate.

It should also be noted that the proportion of state-owned enterprises in the Chinese economy may be higher than the level shown in Fig. 26. In

2020, shareholders of 321 listed companies (A-shares)[62] changed, and controlling shareholders of 48 of them were replaced by state-owned capital[63]. Given that the number was 44 among 165 in 2019[64], state-owned capital has been steadily increasing its presence as a shareholder of listed companies.

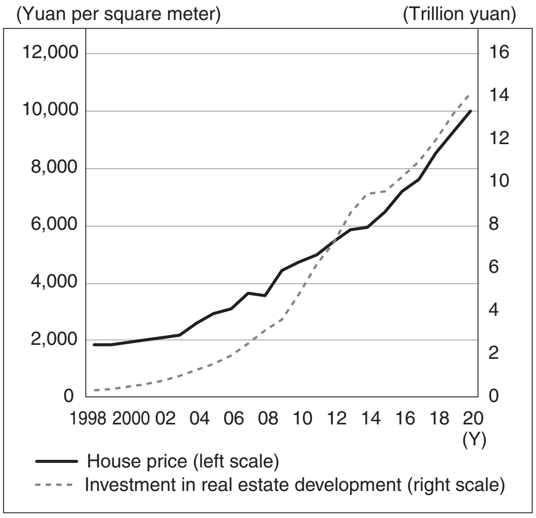
In China's industrial statistics, an enterprise is not recognized as a "state-owned holding enterprise" unless the government or state-owned enterprise is the dominant shareholder[65]. Therefore, enterprises whose dominant shareholder is the government or a state-owned enterprise are not included in Fig. 26. As in Fig. 20, if state-owned enterprises are defined as enterprises with state-owned capital, their share of the economy is expected to significantly exceed the percentage shown in Fig. 26.

It is expected that "*Guo jin min tui*" (state-owned enterprises advance, while private enterprises are gradually forced to retreat) will continue to progress in an invisible manner, contributing to the proliferation and prolongation of the lives of inefficient state-owned enterprises while causing the decline of private enterprises. In this case, the situation that the negative impact of the inefficiency of state-owned enterprises is smaller than the positive impact of highly efficient private enterprises will not hold. Unless China drastically revises its policy of emphasizing state-owned enterprises, it will be exposed to more downward pressure on economic growth than expected.

(2) The virtuous cycle of real estate cannot continue

Another reason why the conventional growth pattern has become difficult to maintain is that it is difficult to expect a virtuous cycle in which real estate investment and house prices continue to rise. Real estate investment and house prices in China have continued to rise steadily in terms of the annual national average (Fig. 28). From the viewpoint of real estate developers, China's economic growth has been supported by active in-

Fig. 28 Changes in House Prices and Investment in Real Estate Development



Source: Prepared by The Japan Research Institute, Limited based on materials from the National Bureau of Statistics (NBS), etc.

vestment based on the assumption that housing is regarded as a safe and high-return asset for households and that house prices are rising.

However, it is premature to expect that by curbing the rise in house prices, the two curves shown in Fig. 28 will continue to rise. Even in China, there is a view that a soft landing would be difficult because 1) the house-price-to-income ratio is well above the international level of 3-6 times, 2) the size of the housing market in 2018 was 356% of GDP, close to 391%, the level recorded before the collapse of Japan's bubble economy, and 3) the outstanding amount of housing loans at the end of 2020 was 40.1% of GDP, up from 15.9% in 2010, surpassing the level in the United States when subprime loans became an issue[66].

In particular, the problem of rising house prices is serious, and it is unrealistic to expect further increases. According to a survey of the ratio of house prices to annual income (house-price-to-income ratio) in 504 cities around the world as of June 2021, which was conducted by NUMBEO, a provider of lifestyle-related information for major cities around the world, six Chinese cities turned out to be among the highest ranked (Table 5). Shenzhen ranked second with 46.3 times, fol-

Table 5 Changes in House-price-to-income Ratio of Major Cities in China and Ranking Among Surveyed Cities

(Ratio, rank)

	2009		2012		2015		2018		2021	
	Ratio	Rank	Ratio	Rank	Ratio	Rank	Ratio	Rank	Ratio	Rank
Beijing	22.3	6	28.6	17	33.1	6	48.1	1	41.7	5
Shanghai	18.1	12	30.4	10	26.7	15	42.8	2	36.0	7
Shenzhen	-	-	41.2	3	20.8	34	40.3	4	46.3	2
Guangzhou	-	-	28.1	18	25.4	20	20.9	12	30.5	12
Chengdu	-	-	19.6	30	-	-	-	-	18.2	44
Hangzhou	-	-	-	-	-	-	-	-	26.1	16
Dalian	-	-	-	-	28.8	12	-	-	-	-
Xian	-	-	-	-	10.1	118	-	-	-	-
Wuhan	-	-	-	-	-	-	-	-	22.4	26
Tokyo	10.5	31	19.0	35	8.7	238	13.8	63	15.4	77
New York	7.9	41	10.7	134	8.9	232	12.3	79	10.1	206
London	14.7	23	14.9	59	16.6	63	22.2	8	15.7	74
Average of surveyed cities	12.0	65	10.0	383	9.8	488	10.0	275	10.3	502

Notes: Data for 2021 is as of June 2021. "-" indicates that no data is available.
Source: Prepared by The Japan Research Institute, Limited based on materials from NUMBEO

lowed by Beijing (41.7 times, ranked 5th), Shanghai (36.0 times, ranked 7th), Guangzhou (30.5 times, ranked 12th), Hangzhou (26.1 times, ranked 16th), and Wuhan (22.4 times, ranked 26th).

The survey does not cover all of China's major cities, so it does not necessarily mean that house prices in other cities are cheap. Looking at the house-price-to-income ratio of 50 major cities calculated by a private think tank in China, the house-price-to-income ratio of 38 cities was higher than 10 times. This is the level to be ranked 200th or above among the 504 cities surveyed by NUMBEO(67).

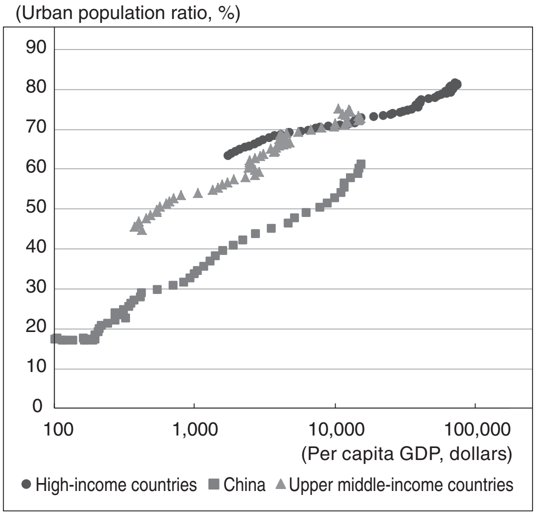
The characteristic of China is that the house-price-to-income ratio in Beijing, Shanghai, Shenzhen and Guangzhou is more than 30 times, and the rate of increase has also been remarkable chronologically. The ratio for Beijing and Shanghai doubled from 2009. This is in contrast to Tokyo, New York, and London, where the ratio has remained at 10-15 times. Another characteristic is that four cities, Beijing, Shanghai, Shenzhen and Guangzhou, consistently rank high. The ratio in some cities in the world is as high as that in China, but few of such cities have ranked high for such a long time.

Another unrealistic reason for rising house prices is the slowing pace of urbanization. Rural-to-urban population inflows, which accelerated in the 1980s, have played a role in supporting the belief that house prices will not fall on the assumption of stable housing demand. China's urban population ratio (based on resident population, not family register population) was 63.9% in 2020, up 44.5% points from 19.4% in 1980. The urban resident population in 2020 was 902 million, an increase of 18 million from the previous year, and this scale of increase is expected to continue for the time being.

However, it is unlikely that urbanization will continue at the same pace. While maintaining the food self-sufficiency rate remains an important issue, the pace of urbanization will inevitably slow down if the population declines at a faster pace than expected. Looking at the relationship between per capita GDP and the urban population ratio, which indicates the stage of development, China's urban population ratio has limited room to rise (Fig. 29).

The urban population growth of 18 million in 2020 was only 60% of that of 29 million in 2011. In addition, the number of so-called "peasant workers" who enter urban areas from farming villages for the purpose of employment decreased by 1.8% from the previous year to 285.6 million in 2020, which is the first decrease since statistics

Fig. 29 Relationship Between Per Capita GDP and Urban Population Ratio (1960-2020)



Notes: The upper middle-income countries are those with GNI per capita between 4,046 dollars and 12,535 dollars per year, while the high-income countries are those with GNI per capita above 12,535 dollars per year. China belongs to the upper middle-income countries, but it is not included in the upper middle-income countries herein.

Source: Prepared by The Japan Research Institute, Limited based on materials from the World Bank

began to be compiled(68). There is no doubt that it was influenced by the COVID-19 pandemic, but the number of peasant workers has been almost flat in recent years, and the surplus of labor in rural areas seems to be almost exhausted.

In addition, the negative economic effects of rising house prices are becoming an issue that cannot be ignored. The IMF believes that in the early stages of economic development, an increase in household debt has the effect of boosting economic growth, but as the stage of development progresses, the positive effect diminishes and fluctuations that impair economic stability tend to occur. China shifted to the latter phase in 2014, and housing loans, along with infinitely higher education and health costs, have been squeezing households and curbing personal consumption (Miura [2019]).

Political and social problems associated with rising house prices are also serious. When the house-price-to-income ratio exceeds 20 times, only the rich will benefit from the price increase, and the middle class has no choice but to take housing loans beyond its capacity. In China, people who can no longer afford to live comfortably due to housing loans are called “房奴” (mortgage slave) (Miura [2019]). Mortgage slave symbolizes the real life of the common people, whose quality of life has declined despite their deceptive wealth, becoming a cause of the generation of young people called “躺平族 (*tang ping*, meaning lying flat)” who lack material greed and are reluctant to compete, work, get married or have children.

It is clear that this will adversely affect the centripetal force of the government and the Communist Party. The Xi Jinping administration has repeatedly said, “房子是用来住的，不是用来炒的” (housing is for living, not for speculation) because it is wary of this issue. The phrase “We will do our best and make efforts to continuously enhance the happiness and security of our people” (Part 14) was included in the 14th Five-Year Plan, not for the sake of formality.

(3) Still, a bold policy shift cannot be expected

In order to prevent China from falling into a prolonged slump, it is necessary to tackle the policy issues that have been avoided up to now, such as raising the efficiency of state-owned enterprises through drastic reforms and curbing house prices by cutting down housing demand for speculative purposes.

As for state-owned enterprises, there have been reforms to improve corporate governance including the establishment of boards of directors. In 2019, 97% of central state-owned enterprises reportedly established boards of directors (IMF [2020]). The aim of this reform is to increase the efficiency of state-owned enterprises by promoting the separation of ownership and management, in which the government invests in state-owned enterprises but is not involved in management. This is one of the pillars of the state-owned enterprise reform that the Xi Jinping administration has been promoting since 2014 (Miura [2015]).

However, as the drop in ROA in Fig. 27 shows, there is no evidence that this reform is paying off. In 2014, the government intended to increase the ratio of after-tax profit submitted from central state-owned enterprises to the government, which is their investor, to 30% by 2020, but in 2019 it was only 7.6%, down from 11.9% in 2015. Reform aimed at revitalizing state-owned enterprises by improving corporate governance has clearly stalled.

The efficiency of state-owned enterprises is not an internal problem such as corporate governance. It cannot be improved without clearing the ambiguous relationship with the government and financial institutions as symbolized by implicit government guarantees, improving the independence of management as an enterprise, and clarifying the responsibility of management accordingly. To this end, it is inevitable to implement an ownership reform by narrowing down the areas to leave for state-owned enterprises and privatizing other areas.

This runs counter to the Xi Jinping administration's emphasis on state-owned enterprises and represents a major policy shift. Looking at the 14th Five-Year Plan, ownership reform is not mentioned and there is little possibility of its realization. The administration must accept a situation in which the efficiency of state-owned enterprises is further reduced and the sustainability of growth is undermined.

Meanwhile, the government needs to drastically change its policies to control house prices. In order to reduce the house-price-to-income ratio, the rate of increase in house prices must be kept below the rate of increase in disposable income. Growth in disposable income has slowed along with slower growth, limiting room for higher house prices. In this environment, it is effective to curb housing demand for speculative purposes by introducing a real estate tax, which is equivalent to Japan's fixed asset tax, and an inheritance tax.

Judging from the high ratio of owner-occupied houses mentioned earlier in this report, China's demand for housing is boosted not by housing needs but by speculation aimed at making a profit, which makes it difficult to control prices through direct intervention targeting banks and real estate developers. Cutting housing demand for speculative purposes through the introduction of real estate and inheritance taxes would not only stabilize the market, but also rectify asset disparities and prevent inter-generational inheritance of such disparities. It can be said that such a measure is in line with "common prosperity (*gongtong fuyu*)" advocated by the Xi Jinping administration.

Real estate taxes have already been introduced in Shanghai and Chongqing. However, the tax rate is low, accounting for only 3.4% and 5.0% of the cities' revenues, respectively[69], and the expansion of the scope of taxation and the target area is an issue. As it was clearly stated in the 14th Five-Year Plan that the introduction of a real estate tax would be promoted and China's Ministry of Finance has also shown a positive attitude[70], Japanese media has also reported that it is highly likely that a tax will be introduced in earnest[71]. However, the 2021 legislative schedule does not include a real estate tax law, so it is unclear whether it will actually be introduced. The real estate tax was said to be ready for drafting in October 2017, but five years have already passed without legislation[72].

If a real estate tax is introduced, the tax burden of wealthy people who own multiple properties will increase significantly, and the growth engine of the real estate development industry will decrease substantially. It is essential to discuss the extent to which such side effects will be accepted when introducing the system, but there seems to be no such discussion in China. In fact, as there was no leader to risk their political fate, the introduction of the tax has been delayed. Even if a real estate tax is introduced, there is a possibility that it will be undermined through its limited scope and low tax rate.

Conclusion: Expansion of implicit government guarantees

The Xi Jinping administration is expected to enter its third term at a party convention to be held in autumn 2022. Although the political base appears to be solid, it is unclear whether the country will be able to achieve stable economic growth as it has in the past. China faces challenges it has never experienced, such as a larger-than-expected population decline and the U.S. encirclement.

The Xi Jinping administration is trying to tackle these issues through "state capitalism," in which the government and companies work together to strengthen national power, while at the same time enhancing centripetal force. State capitalism is often seen as a source of the strength of the Chinese economy, but it also weakens the economy, as state-owned enterprises are at the root of the problem of excessive debt.

This problem may be exacerbated by the expansion of the scope of implicit government guarantees. The case with Evergrande Group, which was introduced in this paper, is a good example. It is not clear at the time of writing this paper (end of September 2021) whether Evergrande Group will avoid default or whether the government will intervene. However, in the last week of September 2021, it became clear that the government was trying to divert public attention from the issue by restricting media coverage on Evergrande Group and access to such information.

Behind this restriction, there are not only economic reasons to limit the volatility of domestic and foreign markets or to prevent problems from spreading to other property developers, but there may also be political reasons that the Evergrande Group's problems could be taken as the responsibility of the government that tightened regulations on banks and property developers, or the responsibility of the government that failed to help the group. Indeed, more than a few senior administration officials would believe that it is not desirable to see on television a mass of investors rushing to Evergrande Group's headquarters for the refund of fees paid for financial products.

Some believe that Evergrande Group is unlikely to be given the leniency of "too big to fail" (Marukawa [2021]). Indeed, the group's share of corporate bond redemption has limited impact on the Chinese bond market. As of June 2021, the group's outstanding bank loans amounted to 240 billion yuan, accounting for only 0.2% of yuan-denominated outstanding loans totaling 184.5 trillion yuan.

However, it is becoming necessary for the government to intervene in private enterprises that have an impact on people's lives in order to minimize the impact of business failures. If the government really believes that "those who are betting that house prices will never fall will ultimately pay a heavy price" (Guo Shuqing, Chairman of the CBIRC), there should be no need to regulate the media reports on Evergrande Group.

The government has been neglecting the rise in house prices due to speculation, despite saying, "housing is for living, not for speculation." For this reason, it is hard to believe that the government deserves to stand by and say that it has no responsibility for Evergrande Group's default and the confusion as a result. Behind the government's restrictions on media coverage, there seems to be a guilty conscience for the mismatch of its words and deeds.

On the other hand, the reality in China is that the survival of firms facing credit risk and whether they will be able to fulfill their obligations are determined not by rules but by the government's discretion. While default is inevitable, it is only natural that expectations for government intervention will increase so that Evergrande Group can avert "清算," in which pro-rata payments are made to creditors in proportion to the amount of their claims.

Will the government intervene or not in Evergrande Group's problem? If it intervenes, where is the landing point and what kind of intervention method will be adopted? When proceeding with bankruptcy proceedings, which method ("清算," "重整," or "和議") will be chosen? Whatever choice is made, there are plenty of problems. China's response to Evergrande Group's problem will be a key to understanding how implicit government guarantees and, ultimately, state capitalism will change in the future.

End Notes

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11. It is a corporate bond named "17華　汽 05" which was issued in October 2019 and had a total issue price of 1.0 billion yuan, a yield of 5.3%, and a maturity of one year. The default by Brilliance Auto Group had chain effects on other corporate bonds, and as of October 2020, there were 14 defaulted bonds with an outstanding balance of 17.2 billion yuan. For details, refer to「17華汽05債未兌付 打破"国企信仰"華晨汽車違約啓示録」October 26, 2020, 経済視察網. (http://www.eeo.com.cn/2020/1026/425769.shtml).

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