

## **Homework #2: China Evergrande Group**

*Note: Assignment completed on 9/25*

### **1. Briefly explain why economists worry that the event could impact U.S. and global growth.**

Economists are worried about the Chinese company Evergrande Group, and its impact on US and global growth because of the company's recent financial difficulties and potential outcomes that would result from the company defaulting. Evergrande Group is a real-estate development company that currently owns more than 1,300 projects in over 280 cities throughout many Chinese districts. Important to note is the massive size of the company, which is highlighted by the fact that the value of the company's assets are currently equivalent to 2% of China's GDP. Unfortunately, Evergrande has recently been under significant financial pressure as it recently missed an interest payment this past Thursday. The company, which currently has over \$300B in liabilities, now has 30-days to make this payment before bondholders can call a default. Reports that there are ~1.4 million property owners who have made deposits and have yet to receive delivery of Evergrande properties, along with concern over the massive debt and missed interest payments, is leading economists to worry that the company may be spiraling towards a default. An Evergrande default could have a substantial impact on the growth of US and global economies through global financial markets, investor sentiment, the Chinese housing market and subsequently the Chinese economy.

### **2. Discuss “contagion,” how a potential crisis could spread to other parts of the economy or across borders.**

‘Contagion’ is defined as “the spread of an economic crisis from one market or region to another and can occur at both a domestic or international level.” There are many potential concerns and ways in which this crisis could impact the Chinese and Global economy.

The most immediate impact of Evergrande defaulting would be seen (and has already begun to be seen) in the financial markets. Evergrande's shares are down more than 84% this year, and its dollar-bonds are trading at below 30 cents (different maturities). The effect of a default would likely lead to two main outcomes in financial markets moving forward. One, financial institutions are likely to become more risk averse, potentially making the financing of high risk endeavors in China in the future more difficult/expensive. And two, Chinese companies may have a more difficult time financing their debt with foreign investment.

Evergrande defaulting would also likely impact the housing market in China, another area of the economy that accounts for nearly 30% of China's GDP. With the company currently in the

process of building thousands of housing units, questions are being raised as to whether or not these units will be completed. This, along with panic from home-buyers and investors is more than likely to hit prices, particularly if the company were to default. With the housing market making up such a large part of China's consumption, any hit to the market could have a significant impact on the economy.

In terms of how this potential crisis could affect foreign countries, the first most obvious impact would be the loss on investment many foreign investors would likely see if Evergrande were to default. The company has over 19B in foreign debt, and foreign investors are owed 7.4B dollars in bond payments just next year alone, so this loss of capital is substantial. Recovery on these notes in the case of default is not expected to be significant, as Beijing authorities have indicated they are no longer willing to bail out bondholders, and generally these foreign investors would be low on the list of creditors in any bankruptcy proceedings where assets were distributed. A second way the crisis could affect foreign countries is if China were to experience economic turmoil or a recession. China is a massive player in the Global markets, so any potential economic disaster in the country would ripple throughout global economies.

### **3. What is the chance that the event becomes a major economic disruption for the U.S?**

Many economists believe the risk of significant disruption from a potential Evergrande default is low. This is primarily because Chinese central banks have reduced exposure to troubled developers and limited overall property debt. As a result, an Evergrande failure should have less of an impact on the Chinese financial system as a whole.

An interest comparison to think about is the current Evergrande situation and the 2008 collapse of the Lehman Brothers, which led to a global financial crisis. Experts are less concerned about the potential contagion (and thus disruption to the United States) of the Evergrande situation for two reasons. One, Evergrande owns physical assets, whereas the Lehman brothers owned highly leveraged financial assets. The argument here is that the value of land and housing projects is far more stable than that of financial instruments. Experts also note that Evergrande has \$220 billion in assets, and would likely be able to sell these if needed, particularly if it can complete outstanding housing projects. The second reason economists believe the comparison is unreasonable is the strength of involvement from the Chinese government. Although the government seems unlikely to bail out the company itself, economists note that the Chinese banking system has an annual profit of \$293B, and can easily absorb or manage any potential Evergrande losses. Ultimately, the Chinese government's high level of involvement in situations of potential crisis, the banking system's limited exposure to property debt and Evergrande's large sum of tangible assets makes it unlikely that Evergrande's difficulties will impact the United States.

### **4. How might Central Banks (the Fed or others) think about this risk when conducting policy?**

According to the Wall Street Journal, the Chinese government has stated that they are 'reluctant to bail out the developer, but want to avoid a disorderly unraveling that could create social instability or serious problems for ordinary people who could be affected by the company's failure.' This quote highlights the opposing arguments, and risks, that central banks have to consider when making policy decisions in a situation like this one. On the one hand, bailing out Evergrande creates future risk in the economy because big businesses will believe they can take on higher levels of risk, with the ability to fall back on the central government if needed. On the other hand, not bailing out a large company that is highly involved in the economy is likely to 'create social instability or serious problems', as well as have potential global impacts, many of which I've discussed in the above paragraphs. Both of these risks must be heavily weighed before policy decisions are made.

## REFERENCES

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