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Evergrande

Just when people thought that the turmoil in China was about to quiet down, the country shocked the world yet again. China came out with new regulations on the gaming sector. It also banned all crypto transactions which are now to be considered as illicit financial activity. More importantly, the potential default of Evergrande sent jitters to global financial markets.

Crackdown reaches Macau

As part of China's regulatory clampdown, the Macau government initiated a 45-day consultation period on the law that will end on October 29. The concessionaires – Sands China, Wynn Macau, Galaxy Entertainment, SJM Holdings, Melco International Development, and MGM China – would have to rebid for their licenses when these expire on June 22. Among the proposed changes is the deployment of government representatives to supervise daily casino operations. The government is also putting pressure on gaming firms to boost non-gaming investments. Macau casinos have fallen by as much as 31% since the announcement of the new regulations.

All-out ban on crypto

Last Friday, China announced a ban on crypto currencies and crypto transactions, including the mining of digital assets. According to the website of the People's Bank of China (PBOC), crypto transactions, including services provided by off-shore exchanges, will now be considered illegal. China seeks to curb fraud, money laundering, and excessively high energy consumption that are associated with crypto currencies and transactions. Many technology companies whose revenue streams are dependent on crypto transactions will be affected by this ban.

What is Evergrande?

Evergrande is China's second biggest property developer and is listed in the Hong Kong Stock Exchange. It has 1,300 real estate projects in over 280 cities. The company has 200,000 employees and is indirectly responsible for more than 3.8 million jobs. As Evergrande got bigger, it relied on cheap credit to expand into various non-core businesses such as electric vehicles, healthcare, consumer products, video production, and even a theme park. Following its debt-fueled expansion, Evergrande became China's most indebted developer, with more than US$300 billion in liabilities.

Too big to fail?

Both Fitch and Moody's flagged an Evergrande default as probable, but the company announced last week that its payment to domestic bond investors was "settled through negotiations." There are concerns that the property giant's default may exacerbate an ongoing slowdown in the property sector. In addition, a cross-default scenario may occur where an Evergrande default may trigger similar defaults in other companies or sectors, thereby resulting in a contagion.

Evergrande – China's Lehman moment?

Due to its size and massive debt, Evergrande is being compared by some analysts to Lehman Brothers, a US investment bank whose failure sparked the 2008 global financial crisis. However, we note that there are key differences between the two. On the one hand, Lehman was an investment bank which held large positions in subprime mortgages. It was rated AAA so its collapse stunned everyone. Lehman was an active participant in the derivatives market and was party to derivative transactions with a notional value of $35 trillion. Consequently, its failure sparked a domino effect in financial markets which led to a global credit crunch. It is widely believed that the Fed made a crucial mistake in letting Lehman fall.

On the other hand, Evergrande's troubles have been brewing for a while now. Its huge debt load, financial woes, potential default, and possible debt restructuring were already known in the financial community. While an outright bailout may be unlikely, the government can utilize several tools to contain the spillover. The PBOC injected 120 billion yuan into the banking system to ensure adequate liquidity. In addition, regulators are mandating Evergrande to take measures to avoid a near-term default on its dollar bonds while focusing on project delivery and repayment of investors. S&P said that China's banking system can absorb the default of Evergrande if it is an isolated event. The rating agency believes that the government would only provide direct support to leveraged developers if there was a high likelihood of systemic risk to the economy.

Property sector reform – part of common prosperity

Reining in Evergrande is part of a wider agenda to reform the country's property sector. To this end, the government introduced the "three red lines" which are key debt metrics that borrowing developers have to comply with. Policymakers have been trying to cool property prices which have risen sharply alongside China's brisk economic expansion. A stable property market supports Xi Jinping's agenda of common prosperity by discouraging speculation and making houses affordable to more citizens.

Limited fallout

Though markets dropped sharply last Monday on fears of an Evergrande default, China's CSI 300 was surprisingly flat for the week. Stocks in Hong Kong, where Evergrande is listed, dropped as the Hang Seng Index fell 2.9%. The Dow and the S&P 500 recovered and were weekly gainers. The Euro Stoxx 50 likewise advanced, EEM was down 1.1%, while the PSEi closed slightly higher. Instead of sparking a contagion similar to Lehman in 2008, the fallout has been mostly confined to Evergrande and other highly-leveraged property companies in China. Ray Dalio, fund manager of Bridgewater Associates, said that the Evergrande debt crisis remains manageable even though Evergrande investors may be stung by its debt restructuring.

Bangko Sentral ng Pilipinas (BSP) Governor Ben Diokno said that Evergrande is unlikely to have a big impact on Philippine banks, with total exposure to China and its Special Administrative Regions at only 0.86% of the banking system's total assets. European Central Bank (ECB) President Christine Lagarde stated that they are seeing a "China-centric impact" and that Europe's direct exposure to Evergrande is limited. Meanwhile, Fed Chair Jay Powell clarified, “In terms of implications for us, there’s not a lot of direct United States exposure.”

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