

A sharp slowdown in China's property markets would damp global growth

By Nigel Pain and Elena Rusticelli, OECD Economics Department

Developments in China have a considerable impact on the global outlook, with China accounting for over one-quarter of projected global GDP growth in 2021-23, and around 12.5% of world trade in goods and services. Among the factors that could significantly pull growth down in China, vulnerabilities in the property sector loom large.

The property sector has been a strong source of growth for the Chinese economy for many years, but this has been accompanied by rising leverage of developers and, more recently, households. Concerns about banks' property lending and the balance sheets of property developers have been apparent for some time, with regulatory curbs introduced in the last two years. Despite this, significant risks remain in China's real estate market, with the potential for large cross-sector and cross-border spillovers. The severe liquidity issues faced by some large Chinese real estate developers pose direct risks for financial intermediaries, including foreign ones. These would be amplified if the crisis in the sector were to lead to defaults, as currently appears possible, and a substantial decline in property prices.

Any major default would be managed carefully by the government, but minimising the potential systemic risks to financial stability will nonetheless be challenging given the scale of the debts owed by many developers and the weak state of the property market. Sales and new construction starts are already declining, the unsold stock of housing is increasing, and yields on risky corporate bonds have risen sharply. These

developments are incorporated in the baseline projections in the latest **OECD Economic Outlook**, and are one factor contributing to the projected easing of GDP growth in China from 8.1% in 2021 to around 5% in 2022.

A disorderly default of one or more major property developers, or unexpectedly widespread debt restructuring, would pose significant additional risks to global growth prospects. The construction sector and real estate services each represented between 7-7½ per cent of total value-added output in 2020, with additional linkages stretching into many other parts of the economy. Not all of these activities reflected new real estate development, as construction also includes non-housing activities and real estate services include the management of existing occupied properties. A severe slowdown would, however, significantly impact other parts of the economy, particularly sectors providing materials for construction activity. Final demand would be hit directly, with real estate development representing around 25-30% of total fixed asset investment in 2019 and 2020. Regional and local governments could also face budgetary pressures if the revenue from sales of land rights were to decline substantially, potentially reducing spending on infrastructure investment. Greater uncertainty, tighter financial conditions and lower property prices could also damp domestic demand and production.

Illustrative simulations, using the NiGEM global macroeconomic model, highlight the adverse global effects that a sharper slowdown in China might have:

- An unanticipated decline of 2 percentage points per annum in the growth rate of domestic demand in China for two years, and the associated decline in import demand, could directly lower global GDP growth by over 0.4 percentage points per annum, and global inflation by 0.2 percentage points per annum. The impact on output in Japan, commodity-producing economies and other economies in East Asia would be relatively high (Figure 1),

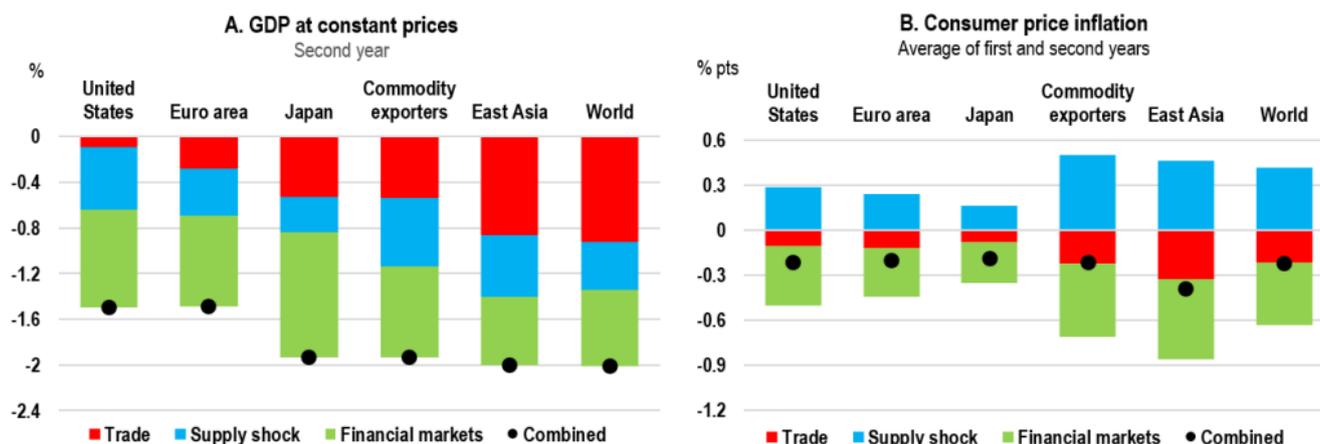
reflecting their strong trade links with China. Lower global commodity prices contribute to the decline in inflation, reflecting the scale of Chinese demand in many commodity markets, with energy prices down by around 5% and metals prices by around 10%.

- If the property sector slowdown in China were to disrupt the domestic production of key intermediate or final products needed in other countries, such as steel or consumer appliances, there could be an adverse global supply shock. In this event, with a supply shock proxied by a 10% rise in Chinese export prices (broadly in line with the estimated change over the year to 2021Q3), the adverse effects on the world economy would intensify, with global GDP growth lowered by close to 0.7 percentage points per annum. Higher export prices from China would directly push up global inflation by around 0.4 percentage points per annum, illustrating the impact of supply bottlenecks, and inflation in the advanced economies by around $\frac{1}{4}$ percentage point per annum.
- If accompanied by tighter global financial conditions due to risk repricing, the impact of the slowdown in China would be greater still. In a scenario with a 10% decline in global equity prices and higher investment risk premia, global GDP growth could be lowered by 1 percentage point per annum on average in the first two years of the shock. The additional shocks would also be deflationary, with the combined impact of all the shocks considered reducing global inflation by around $\frac{1}{4}$ percentage point per annum on average in the first two years.

These simulation results suggest that a sharp slowdown in China is a significant source of potential risk for global economic prospects.

Figure 1. A sharp slowdown in China would result in a sizeable shock to the global economy

Difference from baseline



Note: Simulated impact of a two-year decline of 2 percentage points per annum in domestic demand growth in China, a supply shock in China reflected in a rise of 10% in Chinese export prices, an increase of 50 basis points in global investment risk premia and a decline of 10% in equity prices in all economies. The red bars show the contribution from the direct demand-driven slowdown in trade; the blue bars show the additional contribution from adding higher Chinese export prices; the green bars show the combined contribution from higher uncertainty and lower equity prices. Commodity exporting economies include Argentina, Australia, Brazil, Chile, Indonesia, Russia, South Africa and other non-OECD oil-producing economies. East Asia includes Korea and the Dynamic Asian Economies.

Source: OECD calculations using NiGEM.

References

OECD (2021), *OECD Economic Outlook*, Volume 2021 Issue 2. <https://doi.org/10.1787/66c5ac2c-en>

Photo credit: Featured photo by Fabio Nodari/ Shutterstock.com