



Beijing's New Challenge: China's Post-Crisis Housing Bubble

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Summary

- China's residential property bubble (concentrated in major eastern cities) is mainly the result of excessive domestic credit expansion in 2009. Contributing factors are significant "hot money" inflows from abroad, low (government mandated) bank deposit rates, a widespread property speculation mania, corruption, and incentives for local governments to drive up land prices to augment local fiscal revenues.
- Beijing is keenly aware of the associated risks and is determined to control the property bubble. The central bank has begun to tighten monetary policy, but cautiously, so as not to kill recovery in the broader economy. Around the middle of April 2010, the State Council (China's Cabinet) introduced tough administrative measures aimed at curbing property speculation—mainly by reducing credit availability and increasing its cost—and announced plans to significantly increase housing supply, especially at the lower end of the market.
- China does not share Alan Greenspan's pre-subprime crisis view that financial regulators cannot recognize a bubble, are unable to effectively control one if they see one, and that it is easier to clean up the mess after it has burst than to deflate a bubble.
- Given the central government's apparent political will to control the bubble and the considerable arsenal of policy tools at its disposal, a "soft landing" is unlikely. If Beijing can keep the bubble within bounds, it is likely that an uncontrolled meltdown will be avoided, though a market correction (of 20–30 percent on average) over the next 6–12 months is likely.
- Social issues associated with China's property bubble are at this point as or more compelling than financial issues. Housing affordability for first-time home buyers in major eastern cities has become a major social and political issue. It is a source of potentially destabilizing public discontent, even if the property bubble can be controlled.

Background to the Current Bubble

Property markets and property bubbles are relatively new to the PRC. Most residential and commercial real estate in urban China was state-owned until the late 1990s; the allocation of apartments (and rent levels) was determined by “work-units” of the state. In the wake of the Asian financial crisis of 1997–1998, the government significantly accelerated urban housing privatization. This was accomplished in only a few years, in most cases by simply transferring ownership of apartments to current occupants, far below (potential) market value.¹ At the same time, the government encouraged the development of a commercial housing industry and mortgage financing. The motivation behind these major urban housing reforms—probably the largest privatization and wealth transfer in history—was to make state-owned enterprises—until then responsible for the housing of their employees—more competitive by relieving them of costly social burdens. A secondary objective was to create a large source of domestic demand for home improvement and new construction to counterbalance the negative effects of the Asian crisis on China’s economy.

By 2003 a vibrant commercial housing market, supported by a rapidly growing mortgage industry, had developed and private home ownership had become the norm. Labor mobility, productivity, and international competitiveness increased significantly as a result. When initial ownership restrictions expired after a few years, many middle class families capitalized on the implicit wealth transfer they had received and began to acquire one or more additional apartments for investment purposes, often with the help of mortgage loans. For numerous ordinary Chinese families, wealth accumulation started in this way. Rich families, including many overseas Chinese, also began to see apartments in China as attractive investments.

In spite of high and rising vacancy rates, urban house prices increased briskly (estimated at about 30 percent per year on average in big cities between 2002 and 2006).² By the first half of 2007, asset price inflation was getting out of hand. The economy was overheating and property markets (residential and commercial) were booming into bubble territory, as was the stock market. The government became concerned that the bubble might burst and drag the economy into a slump as had happened in Japan after its twin (real estate and equity price) bubbles burst in 1990–1991. In the second half of 2007 and early 2008, to cool property markets, the government tightened monetary policy and imposed restrictions on developer loans and retail mortgages. The effect of these measures was to drive down property prices (but only moderately), while significantly slowing construction and broader economic growth. The stock market collapsed at the end of October. The government had over-achieved its objective of cooling property markets, a lesson that plays a significant role in the conduct of monetary policy at present.

To compound China’s economic problems in the first half of 2008, export orders began to fall, as the U.S. financial crisis was building. When the

economy slowed more sharply than expected, Beijing became very concerned. To protect export jobs, it re-instated the dollar peg that had been discontinued on July 21, 2005. Then, in September 2008, after the collapse of Lehman Brothers, global financial markets froze and exports collapsed. The economy almost came to a standstill in the last quarter of 2008 (Chart 1). When the government announced its RMB4 trillion (\$586 billion) stimulus program in the first week of November 2008, the measures that had been taken in late 2007 and early 2008 to cool the property sector were reversed. Beijing understandably thought that the best way to quickly increase domestic demand and create jobs—countering the effects of the property slump and falling external demand—was to revive the urban housing market and new construction with various incentives.

The government was as effective in reviving the housing market in early 2009 as it had been in cooling the market a year earlier. Major factors that helped turn the economy around quickly were: (1) the near-perfect alignment of interests between the central government in Beijing and local governments wanting to take advantage of stimulus programs, and (2) the considerable experience that existed at all levels of government in the preparation and implementation of stimulus projects.³ The alignment of interests broke down in the second half of 2009 when Beijing became once again concerned about economic overheating, while many local governments were stoking local real estate markets and driving up land values to increase revenues from land leases.⁴ There are similar conflicts of interest between Beijing, large property developers, and apartment owners. Such conflicts of interest can only be overcome if Beijing is prepared to exercise strong “political will.” Indications are that, in its efforts to keep the current property bubble within bounds, Beijing is determined to prevail.

Features of the Current Bubble

Fueled by about 30 percent (stimulus-related) money and credit expansion in 2009—more than double the “normal” rate—property prices climbed steeply in 2009 after they had stopped falling around March.⁵

The speculative nature of much housing demand is illustrated by high vacancy rates in many towns and cities. Apartment vacancy rates of 30–40 percent are apparently not uncommon in some eastern cities. Sometimes, finished apartment buildings are kept off the market by developers who expect to get a higher price next month; other apartments are left unoccupied by absentee home owners/investors with plenty of money.

The bubble is also fueled by “hot” money inflows from abroad (due, in part, to the U.S. Federal Reserve’s current low interest policy which has unintentionally turned the U.S. dollar into a “carry trade” currency in recent years), expectations of exchange rate appreciation and speculation (sometimes by state-owned enterprises or local governments anxious to drive up land values so as to increase local revenues). Most urban governments in China

derive a significant part of their revenues from long-term land leases for development purposes.⁶ Average housing prices and the rate of change in prices differ a lot from city to city. (Chart 2).

Facing an overheating economy and red-hot residential property markets once again, Beijing began to tighten monetary policy in early 2010 and is trying hard to reduce speculative demand for housing through a variety of administrative measures, incentives, and instructions to local governments to make more land available for low-cost (subsidized) rental housing and “economy” commercial housing.⁷ State owned corporations involved in property speculation were ordered to exit the market after completing projects under construction. At the same time, Beijing announced plans to significantly increase the supply of land for property development and of state-sponsored low-cost housing (the plan includes 470,000 low-rent housing units, 2.5 million “economy” housing units, and 2.8 million units in renovated shanty towns). China’s stimulus plan of November 2008 included a large amount of central government subsidies for low cost housing for the first time.

The introduction of a western-style property tax is under active consideration; in the second half of April the government designated 4 cities (Beijing, Chongqing, Shenzhen, and Shanghai—after the EXPO) to begin property tax experiments.⁸

In assessing the central government’s ability to control the current property bubble, it should also be remembered that Beijing can, and often does, exercise considerable influence over markets and the behavior of local governments through political (Communist Party) channels.

The immediate effect of the April measures by the State Council was to suppress demand for commercial housing and to slow applications for new development licenses. Market turnover declined sharply. There is anecdotal evidence of modest (5–10 percent) price declines in some cities, but in Shenzhen prices reportedly continued to rise. The strongest market reaction, however, came in the form of a 5 percent price one-day drop on the Shanghai stock exchange the day after the announcement of measures to reduce property speculation.⁹ In some cities there are reports of developers offering buyers an implicit discount in the form of free or subsidized furniture for the apartment.

Uncontrolled Collapse of Housing and Financial Markets Unlikely

Parallels between America’s housing bubble earlier this decade and China’s now are weak. A more meaningful comparison is with Japan’s property bubble in the late 1980s, but even there, there are significant differences. The biggest is that Japan was already rich and fully urbanized when its property market collapsed in 1991; China is still rather poor (average per capita income

is only about \$3,500), rapidly growing and rapidly urbanizing. China's urban population is expected to grow by several hundred million over the next 20 years. Demand for urban housing will be very strong for many years to come. This will put a floor under the lower end of the market. Moreover, space for urban development in eastern China (where the bulk of the population lives) is limited. If China continues to grow fast, it is probable that its high-end urban real estate will rank among the most expensive in the world.

The current property bubble will probably lead to price corrections later in 2010 and/or 2011. Corrections at the higher end of the market will be more pronounced than in middle and lower ranges. Because the bubble is not national in scope, there is no need for correction in many secondary cities and towns. Average residential property prices in bubble areas might fall by 20–30 percent, which would be significant. For comparison, the average urban housing price drop in 2007–2008 when the government took measures to cool the property market, as explained above, was only about 3 percent.

Since the privatization of urban housing in China, loan/value ratios have typically been very low (about 34 percent on average for the period 2003–2009), but the latest reports indicate that the average loan/value ratio for newly purchased residential properties in eastern China increased to 66 percent in the first quarter of 2010. If there is a significant across-the-board property market correction in the near term, the government will probably try to limit the correction to about 30 percent, to avoid putting recent home buyers “under water,” as happened in the U.S. subprime mortgage market when housing prices began to fall in the second half of 2006.¹⁰ There are no subprime mortgages in China, no ARMs and mortgage securitization is still in its infancy.

Industry sources suggest that property development companies are generally not over-leveraged. The share of equity in their total financing fluctuates between 20 and 30 percent, and prepayments (for which developers do not have to pay interest) likely account for an additional 20–35 percent. Moreover, China's banking regulator (CBRC) recently required banks to make sure that developers have adequate capital of their own when obtaining bank financing for new projects.

There are no indications that the government will rely to any significant extent on interest rate policy in its efforts to control inflation and the property bubble. Small upward adjustments in the coming months may well be made, but reliance on administrative tools will probably continue to dominate. A fairly significant increase of real interest rates is needed to counter China's tendency to over-invest, especially in manufacturing, to promote economic restructuring and to channel more income to the household sector. On Monday June 21, the People's Bank of China resumed a more flexible exchange rate policy, as had been announced the preceding Friday. It is likely, however, that China will make only small and very gradual adjustments. There are no publicly available statistics on mortgage defaults in China, but

the ratio is understood to be very low. In addition, China's financial system is better protected than America's was in 2007 and 2008, because exposure to the real estate sector is estimated to be less than 25 percent (of total bank loans outstanding in April 2010).¹¹ This ratio is low, because China's mortgage industry is still very young and because of a cultural bias against living on borrowed funds.¹² A 30 percent drop in urban property values over a short period of time will cause significant private wealth loss, but is unlikely to trigger a financial crisis in China, as happened in the United States and the UK in 2007–2008. At the macroeconomic level, the most serious effect of a downward price correction or the expectation thereof would be a slowdown in economic growth, which would result in a temporary drop in Chinese import demand (and global market prices) for commodities and general imports.

Direct and indirect contributions to GDP from the real estate industry in China was less than 16 percent in 2007 (much lower than in the United States), so the real economy impact of a real estate correction could be quite limited if the fallout for consumer spending and corporate balance sheets were contained (Chart 3). The negative domestic growth and global demand (and price) effects would probably be only temporary, because China's housing demand is expected to recover quickly and remain strong for years to come.

Housing Affordability

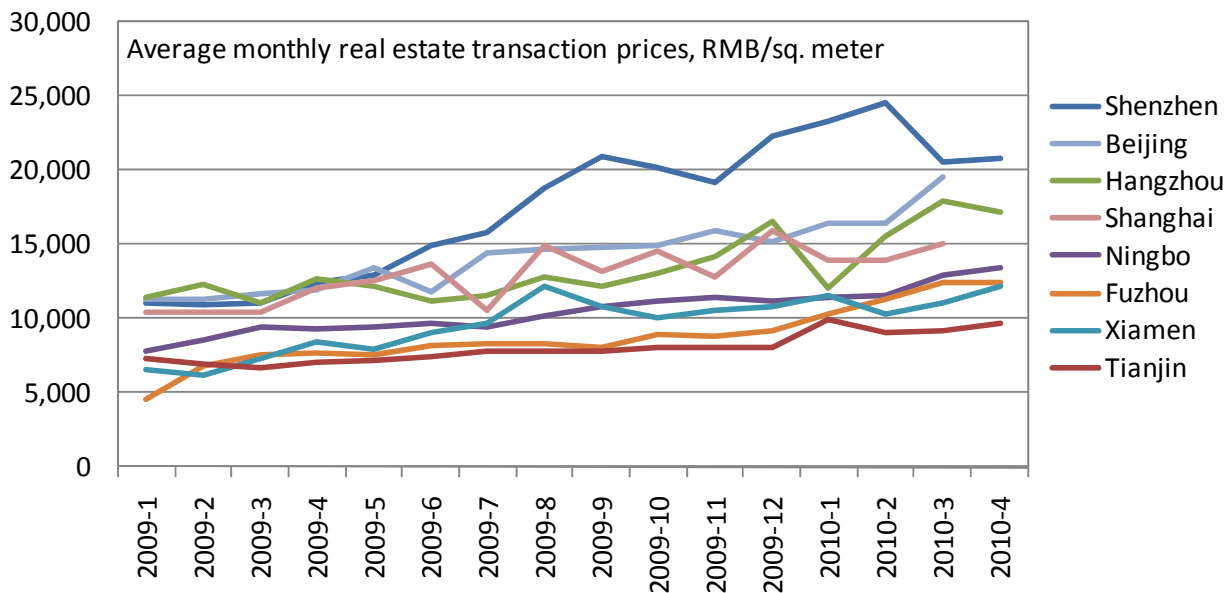
There is anecdotal evidence of widespread public discontent and anxiety over housing affordability for young couples and other first-time home buyers, particularly in large eastern cities. In an angry debate over housing prices during the recent meeting (early March) of the National People's Congress in Beijing, the head of China's National Bureau of Statistics Ma Jiantang admitted to skeptical NPC questioners that NBS' housing price index for 70 cities was not a reliable indicator of what was happening to housing prices and housing affordability in major cities. Affordability is often expressed as the ratio of house price over annual income of the prospective buyer. In major eastern cities the average ratio has increased from around 4–6 a few years ago to well over ten at present. In the more desirable parts of Beijing and Shanghai, the ratio is much higher. Given the scarcity of land and high population density in eastern China, residential property prices will tend to be high relative to incomes, even if there is a market correction in the near term.

Since housing affordability is likely to remain a serious problem in major Chinese cities, the government launched a major program to increase the supply of low-cost rental housing, and other "economy" housing. This program, which is still evolving, is increasingly moving to center stage in China's overall housing policies. In the months and years ahead, it seems likely that the proportion of private home ownership in urban China will fall.¹³ Widespread discontent over housing affordability could become a source of social instability and is for that reason very much on the government's radar screen.

Chart 1: China Quarterly GDP Growth



Chart 2: Average Monthly Real Estate Transaction Prices, RMB/sq meter

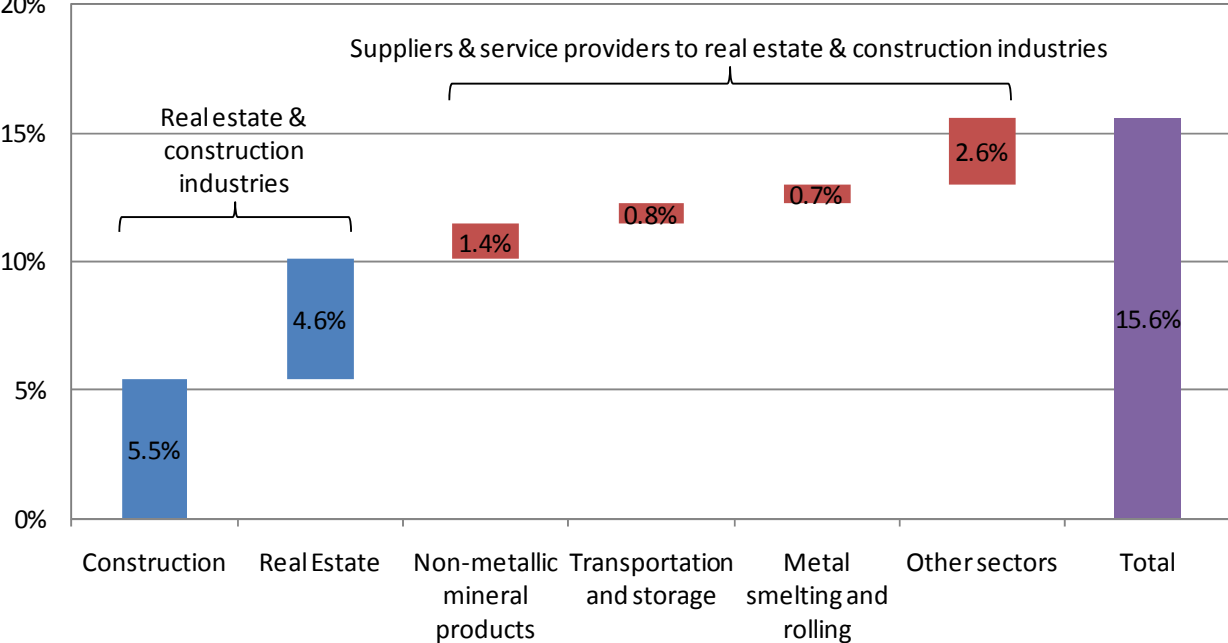


Sources: Various municipal statistical bureaus and real estate exchange, NBS, The Conference Board

Note: April prices include transactions through 2010/04/20

Chart 3: Real estate likely accounts for less than 20% of China's real GDP

Industry share of GDP in real estate & construction value chain, 2007, direct & indirect use from I-O Table



Notes

¹ A mortgage industry had not yet developed and cash wages were still extremely low. Hence, when it had decided to privatize most urban housing, the government had no choice but to transfer ownership at a fraction of (potential) market value, implying a huge wealth transfer from the state to urban residents. Implementation of this mammoth privatization plan was left to local governments. Because of the large implicit wealth transfer, ownership rights were in most cases restricted for the first few years.

² Government statistics on house prices in urban China are a “work in progress.” The National Bureau of Statistics’ main housing price index, started in the early 2,000s for 35 cities, was modified in 2005, now includes 70 cities. Most information and comments on urban housing prices and vacancy rates in urban China included in this note are based on secondary sources and anecdotal evidence. Reliable data on property prices is scarce.

³ This experience was acquired during the period 1998–2003 when China protected its economy against the risk of a major slowdown following the Asian financial crisis of 1997–1998.

⁴ While China is a unitary state, the agendas of local governments and the central government in Beijing do not necessarily coincide, which can be a source of serious problems.

⁵ A rough estimate of excess liquidity growth in 2009 is M2 growth (29 percent), minus GDP growth (8.7 percent) minus CPI (-1.3 percent) = 21.6 percent.

⁶ All land in China is state-owned. Urban land is controlled by municipal governments and (since the late 1980s) made available to developers on the basis of long-term leases (often 70 years), through auctions or otherwise. Agricultural land is controlled by village committees and leased to farmers, usually for 30 years. Urban land is used by local government-owned investment companies as collateral for bank loans to finance infrastructure. Newly completed infrastructure increases the value of surrounding land which permits the process of land-financed local infrastructure development to continue, at least until the supply of unused land is exhausted.

⁷ For example, the minimum down payment for first homes of over 90 square meters was raised to 30 percent (from 20 percent) and to 50 percent (from 30–40 percent) for second homes. Minimum mortgage rate was raised by 10–20 percent. Banks are encouraged to deny mortgages for third properties and required to limit new mortgage loans to local residents in areas where property prices are deemed to be rising “too fast.” Already in March the central government had mandated a high deposit for land purchases and banned banks from lending to developers hoarding land or holding back home sales in the expectation of higher prices.

⁸ Property taxes would provide a steady, more predictable flow of revenues to local governments. Introduction of a property tax system has been delayed by a number of factors, including concern that, given the high vacancy rate, it could induce a disorderly sell-off and depress property values.

⁹ China’s financial system is reasonably well insulated from an equity price collapse, because margin buying was, at least until recently, not allowed. In April 2010 China’s Securities Regulatory Commission introduced—on an experimental basis—limited margin buying, shorting, and securities futures trading on the Shanghai stock exchange.

¹⁰ Although mortgage financing is on the rise in China, a large proportion of real estate transactions in China continues to be on a cash basis and down payments are often higher than the minimum requirement. In China, minimum down payment requirements are set by the state, not by the mortgage industry, as in the United States.

¹¹ Including indirect exposure, i.e., loans to industries that depend on sales to property developers, total bank exposure to the property sector in China is probably around one-third, which is still much lower than in the United States.

¹² This bias appears to be weakening as China urbanizes and the “consumer economy” spreads.

¹³ It was estimated at around 80 percent in 2008.

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