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Property Bubble: The Chinese Approach

Introduction

Rising prices of real estate in China since a long time and a weak secondary market for real estate leading to residential and commercial establishments remaining empty has sent strong signals of an inherent property bubble being created in China. A property or real estate bubble is characterised by rising prices of real estate like housing and land till the extent the price rise becomes unsustainable and then prices fall. The macroeconomic impact is that there is a positive wealth effect at the peak levels of prices. However, a downfall of property prices leads not only to a negative wealth effect for the investors, but also jolts the financial system that provides secured loans against property.

The rise in real estate prices in China was triggered by credit infusion in 2009 to enhance economic growth amidst US financial crisis. However, there is evidence of price rise occurring in China even before 2008. Wu *et al.* (2010) estimated an eight-fold increase in land values since 2003, based on the micro data on over 300 land auctions dating back to 2003. Nonetheless, the economic stimulus along with a loose monetary policy provided an impetus to existing property price rise in China fuelled by the increased borrowings by the local governments, builders and industrial companies. Figure 1 (taken from Societe Generale) portrays the movement of property sales in China and the monetary policy followed by the government in various years, indicating a co-relation between the two.

The phase of loose monetary policy and the economic stimulus in China in the post-US financial crisis years has created a spiral of increased availability of credit and rising prices. Although the rising inflation may indicate rising costs of construction and production causing a hike in housing prices, official estimates according to Wu *et al.* (2010) indicate no correlation between the rising prices of houses and rising production costs. This spiral, therefore, unfolded an era of a boom in the housing construction sector.

During the housing boom, the construction sector and the ancillary sectors flourished in China in 2010. According CEMBUREAU of Europe, the country produced 1.87 billion tonnes of cement-56 per cent of the world's total; and 627 million tonnes of steel in 2010 (National Bureau of Statistics, NBS), or 45 per cent of the world's output. It manufactured 43 per cent of the world's construction machinery such as excavators and bulldozers. The speculative housing boom also bolstered spending by the urban middle class, driving up the demand for cars and, therefore, contributing to further inflation in the country.

As a result, in the first 10 months of 2011, 3.6 billion square metres of property were under construction—compared to sales of just 709 million square metres, pointing to massive overcapacity about to hit the market. At the same time, unaffordability of housing started to become an issue in China. According to the data on sale price indices of buildings in the NBS, there was a 6 per cent rise in the aggregate price of housing units, with some cities registering a growth rate of more than 10 per cent. The property prices grew even more in 2011 at the rate of 7.7 per cent at the end of the year. Based on earlier prices of 2011, it would take

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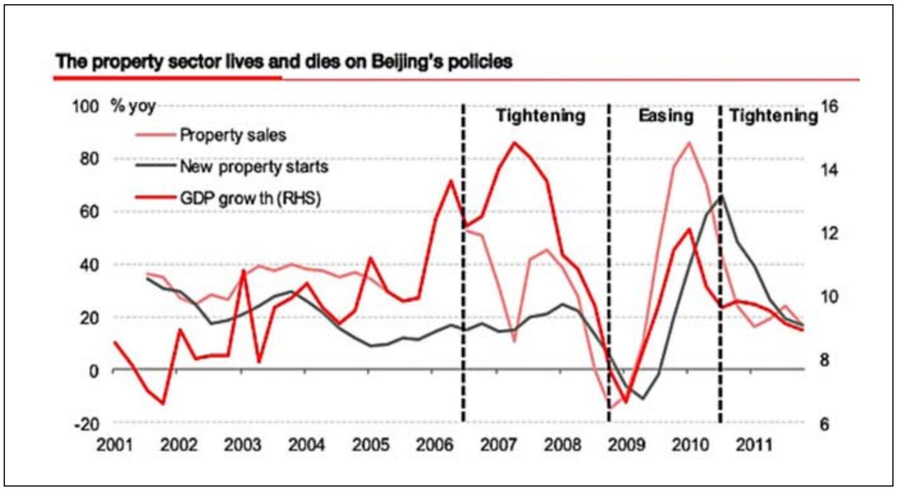
This *Policy Brief* has been prepared by Ms. Ramaa Arun Kumar, Consultant, RIS.

Figure 1: Trends in Monetary Policy and Property Prices in China for Last Ten Years



Source: Badkar (2012).

the average wage earner in Beijing 36 years to pay for an average residence, compared to 18 years in Singapore, 12 in New York and five in Frankfurt (Chan 2012).

The effect of the rising prices of property led to an increasing number of houses lying idle in China on the speculation of securing even higher prices in the future. Another explanation provided by Patrick Chovanec of Tsinghua University is that there is no cost of holding property indefinitely in China, thus making it an attractive option to invest money in, especially when the alternatives available to Chinese people for investments are very limited.

On the other hand, the urban population of China has been consistently rising. The total urban population of China was 691 million or 51.3 per cent of the total population by end of 2011. Therefore, providing affordable housing has become a necessity to tackle the growing housing needs of the people migrating to cities. China has taken major policy initiatives to curb the rising pressure on housing prices due to the speculative behaviour of the buyers and has placed appropriate safeguards in the banking sector to contain the possibility of default on the part of borrowers. The policy interventions include:

- Increased down payments from 20 per cent to 30 per cent for purchase of first house, from 40 per cent to 50 per cent for second homes and general discouragement of the use of any leverage on third homes by those buyers who do not intend to live in the housing units they intend to purchase.
- Mortgages for third home purchases are prohibited.
- Rules to restrict property developers from hoarding land or housing units. For example, local authorities have started implementing a policy allowing repossession of land that has been idle for more than two years. This will curb hoarding by developers expecting price gains.
- The benchmark lending rate for 6 months to one year was raised for the third time during the year to 6.56 per cent in July 2011.

These policies are set to encourage mortgage loans for first time buyers at lower rates, while discouraging hoarding of housing units by people who want to park their funds by buying houses and keeping them idle. The regulators have also made it easier for developers building normal housing to get bank loans.

In addition, the local governments have also placed some restrictions on purchasing of housing units. For example, Shanghai imposed limitation on the second-home option to locals, or those born in the city or who worked for an extended period of time and were officially recognised as locals, without specifying guidelines for non-locals. However, recently Shanghai has eased this restriction by loosening its definition of locals to let residence permit holders who have lived in the city for at least three years to buy a second home.

As a result of such policies, there have been some indications of cooling of prices of real estate in different cities. According to the January 2012 estimates of the NBS, from among 70 medium and large-sized cities, the sales prices of newly constructed residential buildings declined in 48 cities while that of 22 cities remained at the same level. Figure 2 shows the progress in the reduction of property prices in 70 Chinese cities over the year 2011 till January 2012.

The eastern city of Wenzhou posted the biggest drop, with new home prices declining by 0.6 per cent in January 2012 from the last month, according to the statistics bureau. Shanghai and Beijing saw a 0.1 per cent reduction in prices in January 2012, compared to December 2011. This trend is commensurate with falling investments in real estate in 2011. Real estate investment forms a significant part (approximately 25 per cent) of the total investments in fixed assets in China. Investment growth rate in this sector was about 30 per cent in 2011, compared to 36 per cent in 2010.

However, the outlook of the property sector cooling down to contain the property bubble owing to the purchase restrictions imposed by the government and other measures may not come true, at least in the near future. According to Kwong and Li (2012) in their study on China's property outlook in 2012, the price corrections have not materialised even with the key themes of "go-Tier-3/4 cities", mass-market focus, and low leverage. Even after 18 months of policy and credit tightening, housing prices are still holding up. The recent admission by Chinese Premier Wen Jiabao that the house prices were far from reasonable, far from an amount that related to an ordinary person's disposable income confirms the assertion.

While on the demand side of the property market, the government has tried to regulate the demand by particularly emphasising on the availability of credit to genuine buyers, whereas in trying to restrict speculative buying, on the supply side, the Chinese government vowed to build 36 million affordable housing units during the period from 2011 to 2015 in order to enable more middle and low-income households to be able to access housing and stabilise rising property prices.

During 2011 and 2012, the government planned to build 10 million units, although the number of housing units planned to be constructed in 2012 has been reduced to 7 million. To this end, China Development

Figure 2: Property Prices Varition, month-on-month, in 70 major cities

Source: NBS Zhangye/China Daily.

Bank (CDB) would extend 100 billion yuan (15.87 billion U.S. dollars) in loans to finance the government's affordable housing projects in 2012. As of the end of 2011, its outstanding loans to affordable housing projects amounted to 213.6 billion yuan, or 61 per cent of the total granted by the country's banks.

However, reports indicate that many of the affordable housing units that China claims to have built in 2011 are plagued by very low quality construction. Many units that are dormitories are being reclassified as affordable housing and much of the construction being taken up under the pretext of affordable housing projects is already planned construction. Thus, the expectation of the massive construction projects boosting ancillary industries like steel, cement and other metals may be jeopardised.

Secondly, the massive investment planned by the government is worrisome, given the falling revenues of local governments owing to a drop in land sales due to tightening of monetary controls and correction in property market. The burden of raising funds for the construction is on the local governments, while the Central government would invest only a small portion of the total estimated investment of around 1.3 trillion yuan for 10 million housing units.

Therefore, there are reasons to question the sustainability of this corrective step taken by the government given that the local governments are already under pressure of racked up debts for the last two years. Already the government has cut the target of new housing units to be constructed in 2012 from 10 million to 7 million. Additionally, the ceiling on private profits of the developers in these projects has been set at no more than 3 per cent which may limit foreign participation in these projects and compromise on quality of construction to cut corners are already evident.

Another factor that casts a doubt on the possibility of a recovery from the property bubble is growth of credit through the informal and unregulated shadow banking system. In the past, shadow banking system played an important function in channeling credit to businesses, especially SMEs that would otherwise have been credit constrained. However, for the last two years the lending activity has proliferated into providing credit for the real estate developers. They have been facing challenges to sell their property units below their expected prices due to the corrective steps being taken by the Chinese government, including tightening of monetary policy since 2010. It now accounts for one-fifth of total credit available in the economy (Garcia, 2012).

Conclusion

Although the policies directed towards cooling off the property prices in China have been much focused and are far sighted, the underlying weaknesses to ensure the sustainability of such move are worrisome. Even if property prices cool down in a few years averting a property bubble burst, a lack of proper safeguards in financing such projects successfully may spell a disaster for China's economy. This would only reinforce the expectation of a "hard-landing" for the Chinese economy.

The need of the hour for China is to allow sufficient incentives to the real estate developers to build affordable housing units while maintaining minimum quality of houses to tackle this situation. A balanced monetary policy would be very essential as excess liquidity would neutralise the effort taken by the government to control prices, while a lack of liquidity would come in the way of meeting the real demand for housing, rather than speculative demand. On the demand side, the government needs to regulate the demand by giving sufficient flexibility to buyers to borrow from traditional banking system, while discouraging buying for speculative purpose.

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Core IV-B, Fourth Floor
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Ph. 91-11-24682177-80
Fax: 91-11-24682173-74-75
Email: publication@ris.org.in
Websites: http://www.ris.org.in