Up in the air: China’s property market

An Economist Corporate Network Report
China’s first-tier cities, as well as some second-tier municipalities, are currently experiencing very rapid housing price increases. In a focus group discussion on September 13, 2016, we asked several Shanghai Economist Corporate Network members from the property/building materials sector for their insights on China’s property outlook. The following is a summary of the discussion, with additional information excerpted from the Property chapter of the Economist Intelligence Unit’s publication China Hand.

Two-tiered markets

In general, China’s urban property market is in the midst of another cyclical downturn, the latest in a series of boom-and-bust swings since China’s real-estate market was resurrected in 1988 after nearly four decades of dormancy. That year, both the Constitution of the People’s Republic of China and the Land Administration Law were changed to allow for the creation and recognition of rights of private entities to use land owned by the state and to permit the transfer of those rights on the open market. China has allowed municipal authorities to sell local land-use rights since 1992. These sales have become a crucial source of financing for local government budgets. In addition to providing cash income, local governments use land as collateral for loans, and land auction revenues as cash flow for loan payments. This over-dependence on land sales to underpin local-government finance encourages excessive property speculation. It also amplifies loan risks during property market downturns.

In our focus group discussion, several participants highlighted the ebb and flow in the property market over the past few years, with some ruefully noting missed personal investment opportunities. The last decade has been particularly volatile for property markets: in 2006, as real-estate prices rose steeply, the government ordered banks to stop lending to developers, triggering a slide in prices that accelerated with the onset of the global economic crisis in late 2008. Fearing an economic crash, the government quickly changed course, loosening monetary policy and authorising state banks to provide trillions of dollars of new lending. With more easy money prompting a further bout of rising prices, authorities again moved to rein in bank lending in mid-2011. Since then, the pattern has been replayed a few times. Interest rate cuts in mid-2012 marked the end of that round of tight lending policy, leading to a property boom that ran to the end of 2013, when authorities again imposed cooling measures. These featured increases in minimum down-payments, new restrictions on purchases by non-local residents, and a pre-sale ban for luxury homes in large cities. Thereafter, property markets again cooled, with prices remaining weak in many cities. According to the National Bureau of Statistics, nationwide inventories of unsold homes stood at 452.5m sq metres at the end of 2015, up 11.2% year on year. In addition, total gross floor area, with permit to sell but not yet completed or sold, stood at 3.6bn sq metres, according to a report by the Chinese Academy of Social Sciences, implying a four-year supply of housing inventory.

What has spurred the most recent boom? The property sector received a fresh boost in early 2016. After identifying inventory destocking as a priority, authorities introduced various housing-sector
stimulus measures, including downward adjustments to mortgage down-payment requirements, a lowering of transaction taxes, and relaxed household registration (hukou) regulations. With interest rates at multi-year lows following five base-rate cuts in 2015, property markets responded positively, especially in first-tier cities, where both prices and transaction volumes have surged.

Indeed double-digit price gains have become the norm in China’s hottest housing markets, but cities excluded from the boom still suffer from falling prices and stubbornly high inventories of unsold properties. Which cities are booming, and which are not? The lack of reliable price data has made calculating the extent of recent property price movements difficult. Considering the importance of the sector to the overall economy, there is a surprising amount that we don’t know. There is no national Registry of Properties, so statistical data on the sector at the national level is extremely poor. Various indices track property values on a selected basis—sales in the 100 major cities in China are tracked by the China Index Academy, but there are over 660 cities in China and our knowledge of market conditions in the vast majority of these cities is sketchy. In aggregate, China’s 100 major cities have seen property price rises of 14% year on year, much higher than the GDP growth recorded in the past 12 months or the urban income growth from the same period. Nor have these cities had a significant influx of new migrants needing housing.

Valuation models commonly applied in developed markets suggest there is a bubble. According to an IMF working paper published in April 2015, average nationwide housing prices in China registered 22 times the average annual disposable income in 2013, with first-tier cities reaching as high as 30 times. Further price increases since then have exacerbated housing price:disposable income imbalances. Moreover property valuations bear little relationship to their \textit{in situ} economic fundamentals. For example, why would residential property prices in Xiamen rise by 40% in the past 12 months? The city’s economy is one of the country’s best-performing, growing at 7.2% in 2015, but it has not received any recent major population inflows—thus it appears its soaring per square meter valuations are not derived from any market-based calculations of housing demand and supply.

Does this mean China’s housing market is a bubble? Certainly the classic ingredients—demand, speculation plus exuberant confidence that “this time, it will be different”—all seem to be present. Lurid local media reports have documented the more extravagant manifestations of the phenomenon: sales of “pigeon loft” apartments (six metre square apartments) for Rmb 880,000 in Shenzhen, as well as married couples queuing to divorce so that they could benefit from increased quotas for additional housing purchases.

Why is there a bubble?

Participants in our focus group discussion were unanimous in pinpointing China’s financial sector anomalies as the main reason for the current residential property bubble, but local cultural preference for bricks and mortar investments was also felt to play a role. Chinese real estate has an enviable track record for delivering extraordinary capital gains, and property assets overwhelm most households’ investment portfolios—one participant shared an anecdote about a Guangzhou-based driver who

\footnote{Shanghai Municipal Planning and Land Resources Administration recently announced new property registration rules, requiring property owners to register their real estate ownership rather than properties, receiving “certificate of property rights” and “real estate registration certificate”. This is seen as a preliminary step in a national property registration system which is to be introduced by 2017.}
boasted ownership of five properties: two were “legacy” flats allocated through housing reform in the 1990’s, while the remaining three were subsequently financed through savings and capital gains. All five flats were intended for future use by family members. In contrast, many speculative purchases of property are not for self-use, or even as a source of rental income, but instead are kept vacant as stored-value assets.

The 2015 collapse in China’s capital markets left investors with a serious lack of investment alternatives. Too much money is now chasing the sorts of returns that the depressed stock market and low-interest bank deposits are unable to deliver. This situation has since worsened thanks to stricter enforcement of foreign exchange regulations curbing capital outflows, thus “cooping up” the Renminbi for use in solely domestic markets—either as direct investment in property, or in Wealth Management Funds (WMF), most of which are linked to the property market.

High risk, high returns?

It is not just property prices that are escalating. Land prices are also extremely high, with land auction prices in certain cities hitting record levels, to the extent that land costs are higher than the per square metre prices for finished homes. This phenomenon has been identified by Zhang Zhiwei, Chief China Economist at Deutsche Bank, as “flour being more expensive than bread”—and while high land prices are good news for local governments, assisting them in their deleveraging efforts, it raises debt for property developers to even riskier levels. Participants in the focus group discussion noted that paying extremely high land prices is much more common amongst smaller property developers, with the larger (and better capitalised) companies avoiding this behaviour. Such precarious financing is worsened when the developers pay only a minimum down payment, then get loans using land as collateral (although technically such loans are illegal), in order to refinance debt.

How much property investment is based on airy financing? Bank lending for property developers’ land purchases has been formally curbed (or diverted to reliance on WMF as a source of capital), but bank lending for construction continues. Mortgage lending has surged, and now makes up 70% of recent bank lending, much of it apparently for speculative purchases of second homes. As with so much that goes on in the property market, lending decisions are extremely localized—focus group participants pointed out variations in lending policies by local branches of the China Banking Regulating Commission, with more latitude in regions where property markets were considered “pillar” industries in the local economy. In addition, local banks are often keen to boost their loan books with more mortgages, to make up for shortfalls in corporate lending in overcapacity sectors. Anecdotal reports claim informal syndicates of individual investors are frenziedly maxing out their credit lines in order to make down-payments for collective residential real estate purchases. According to local media reports, reliance on non-conventional credit peer-to-peer loans grew in September 2016 by 153.5% year on year, to reach Rmb 956bn, with interest rates averaging 8.7%. Of the 2,300 P2P platforms involved, over one-third reportedly had “operating problems”.

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Government response

What has been government’s response to escalating property prices? At a national level, there have been surprisingly few policy measures, tantamount to a policy vacuum. Similar to previous property boom-bust cycles, implementing measures have been left to local governments. In lieu of significant nation-wide measures, local governments have resorted to reliance on hukou-based purchasing restrictions, and tinkering with down-payment requirements. In the autumn of 2016, city after city has rolled out housing restrictions: Nanjing has limited purchasers without local hukou to one apartment, and local buyers who already have two or more homes are barred from additional purchases; Beijing has increased minimum down-payments for first-time buyers to 35%; Hefei has raised minimum down-payments to 30%, and will ban sales to local residents who already own 2 or more properties; Wuxi has raised the minimum down-payment for 2nd homes to 40%. In some instances measures are also directed against “land kings” (property developers)—Hangzhou now requires land purchase payments to be made in full within a month, while Chengdu will apply penalties for allowing land to sit idle, without development. Another variant of local cooling measures has been to crack down on local real estate agents, monitoring their WeChat accounts for evidence of “rumour mongering” about impending buying restrictions.

What is the potential for taxes to cool overheated prices? Focus group participants mentioned the experiments underway in other markets (Hong Kong, Singapore, Vancouver) to use stamp duties or other tax measures to rein in prices. One participant claimed that the Singaporean experience (high down-payment requirements for second homes, as well as higher stamp duties) has been positive, and has helped to stabilise prices, but others were of the opinion that such measures were only short term, and did not solve the underlying problem.

So far China’s experiment with property taxes has been brief, although the current Five-Year Plan does mention rolling out such taxes on a national level. In 2011 Shanghai and Chongqing were selected as pilot venues for an annual property tax—in both cities the tax has been very narrowly focused (e.g. Shanghai’s tax is only applied on the value of second or later purchases where the price exceeds a floor-space: registered household member threshold, and is set at 0.6% of 70% of the previous year’s average market transaction value). The monetary impact of the tax in both cities has been negligible.

Deed taxes have been used by central and local governments as a means of stimulating or suppressing real estate markets, often at a dizzying pace as the property market has heated and cooled. Other tax measures have been watered down at the local level. China’s Individual Income Tax Law requires that individuals pay a hefty 20% tax on capital gains derived from residential sales. However, local governments have been reluctant to apply this tax, or have done so at a lower rate (typically at 1%-2% of the new purchase price). In March 2013 the State Council issued a notice ordering local authorities to enforce the (generally higher) 20% rate on capital gains as required by law. The tax is only levied on properties sold by individuals within five years. Implementation of this rule remains inconsistent, however.
Forecasts

The prospect of a sharp downturn in the real-estate sector remains a major risk for China’s economy. Property construction is estimated to represent at least 15% of GDP (compared to 6% at its peak in the US). Add in related sectors such as steel, cement and home outfitting and the figure increases to as much as 30% of GDP.

Some adjustments are well underway, with industrial and commercial properties already reacting to market realities of oversupply, poor location or increased demand—for example, more distribution centres are being built to support the burgeoning logistics sector, but an estimated 30% of shopping malls are likely to fail. Industrial land prices have declined in most regions, as China’s manufacturing sector adjusts to a “new normal” of slower growth. However, with a home ownership rate over 80%, it is the far more politically sensitive residential sector that presents the most difficult policy challenges.

Residential purchasers are adapting to local pricing realities. As first-tier cities become less competitive for employers, they force relocation decisions at a company and an individual level. Thanks to improved transport links, commuting between lower-priced suburban homes and expensive urban centres is increasingly feasible, especially when suburban areas can offer high-quality schools and medical care. In some instances (e.g. Jiading district, Shanghai) district governments subsidise housing costs for selected professionals, in order to boost local business prospects.

Recent statements by Zhou Xiaochuan, governor of the People’s Bank of China, indicated anxiety about the overheated property market, but gave no clue as to what further regulations might be forthcoming. It should be recalled that in June 2015, Governor Zhou made repeated warnings about margin trading in the local stockmarket before ordering securities firms to stop trades for clients that had borrowed from “umbrella trusts”, initiating the share sell-off. It is unlikely that Governor Zhou will want to repeat that precedent with the property market.

Focus group participants agreed that the dilemma facing government is that China’s two-tiered housing market requires both stimulus and cooling at the same time. Stimulating the property market in depressed regions is an economic priority, but too much stimulus will exacerbate soaring prices in overheated cities. At the moment, using localized stringent mortgage criteria and purchasing restrictions are the government’s preferred strategies to cool down prices and let some air out of the housing bubble.

How long can China tolerate rising home prices, and when will a major correction come? The next meeting of the Central Economic Work Conference in December 2016 may give further indications of policy direction, but ensuring stability ahead of the 19th Party Congress session in late 2017 is a key government priority, making it unlikely that any radical intervention in the market will be attempted in the next several months. Incremental moves to widen investment channels (e.g. through a Shenzhen–Hong Kong stock market link and new IPO listings) may help to divert investment away from property—almost certainly this will be the wish of Beijing’s policy makers, as a severe correction could cause a full-blown financial crisis. The Economist Intelligence Unit is now forecasting much slower growth for China in 2018, declining to 4.2%. It will be very hard to sustain high property prices against such a background.
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