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China's real estate crisis and the risks to growth

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Overview

The sudden, sharp decline in China's GDP growth rate can largely be explained by the deterioration in the property market, not exports. Export growth rates held up at around 20 per cent throughout most of 2008 before plummeting to a negative 2.2 per cent year-on-year in November. By contrast, the real estate investment cycle turned in mid-2008, falling precipitately from a 38 per cent rate of growth in June to November's 7.7 per cent.

We believe achieving a turnaround in the property sector is the key to sustaining China's GDP growth in 2009. The government's plans in this regard face two critical challenges:

1. Resolving the lack of funding for the affordable housing initiative contained in the recent Rmb4 trillion (US\$580 billion) stimulus package
2. Facilitating a further 15-20 per cent decline in prices of existing housing units in order to attract new buyers and to boost transaction volumes

We believe the government will address these issues via a series of ad hoc, stop-gap measures that will delay the hoped-for rebound in the economy to late 2009 or 2010.

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Core Case

Resolving the property market crisis must be the government's top priority in its strategy to sustain growth through the current global recession

Assumptions and Evidence

China's public housing system explained

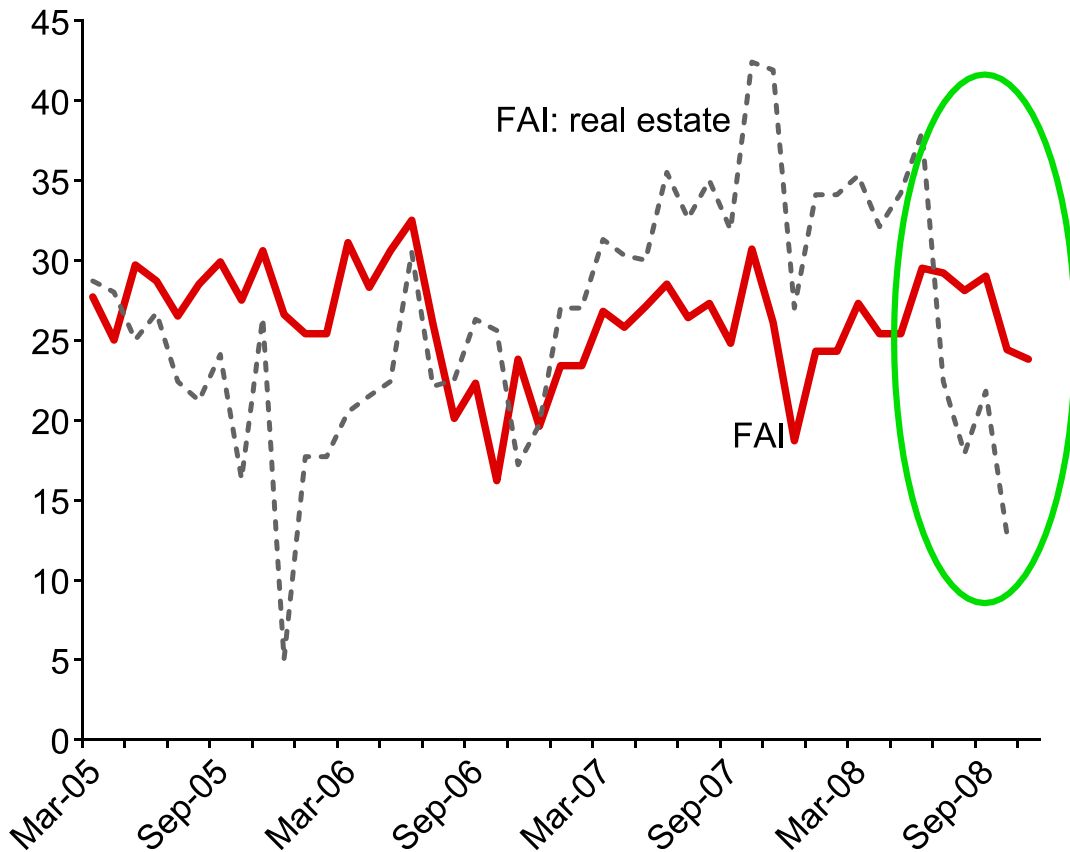
Core Case

Since 2003 rapid economic growth in China has been driven primarily by investment, with exports playing an important supporting role. With export growth currently plummeting because of the global recession, prospects for Chinese growth depend critically on the government's ability to sustain domestic investment in the short and medium term and on identifying and developing new consumption-led growth drivers in the longer term.

Resolving the crisis in the property sector is essential to the success of this effort. Although the weakening of external demand is often cited as the source of the current slowdown, it is not the primary reason for the recent, sharp deterioration in underlying economic activity. The deceleration in exports has been gradual and dates back to mid-2007, but plummeting real estate investment since this June has been the primary factor behind the recent slackening of GDP growth. Other factors also amplified the sudden downturn, especially a massive inventory buildup before the Olympics and the intensification of the global financial crisis in September.

Chart 1 highlights divergent trends in urban fixed asset investment (FAI). Total FAI is still relatively strong, up 23.8 per cent year on year in November. By contrast, real estate FAI has fallen dramatically, to an estimated 7.7 per cent year-on-year growth rate, down from 38 per cent in June. The surprising resilience in FAI in part reflects a pickup in recently initiated projects. But it is doubtful that such activity will be capable of offsetting the slowdown in FAI that is in the pipeline, judging by the sharp fall in industrial production growth to 5.4 per cent in November, down from 14.7 per cent as recently as July.

Chart 1: Total FAI vs real estate FAI growth (per cent change yoy), March 2005-September 2008



Source: Bloomberg.

The strength of investment, particularly in the property sector, is the key to gauging the sustainability of China's growth in the near term. Given weak external demand and the emergence of excess capacity in a number of industries such as steel, there is little doubt that FAI will be weakening steadily in the coming months as the slowdown in industrial production affects companies' future investment plans. The new investment projects associated with the government's Rmb4 trillion (US\$580 billion) stimulus package can offset part of this decline but not all of it, especially since it will take until the middle of 2009 for many of the projects on the drawing board to get under way.

Over the longer term China faces the challenge of rebalancing strategy from its traditional investment-led focus to a consumption-led one. For a transition period of several years, however, it will have to find ways to sustain investment in order to meet its self-imposed minimum growth target of 8 per cent. The government's success in turning around a slumping real estate sector will be a critical component in this effort.

The challenge that lies ahead

From January to November FAI grew at 26.8 per cent year on year. Within this total real estate

investment rose by a still impressive 22.7 per cent, though there was a steep drop-off in November to an estimated 7.7 per cent. This evident slowdown in real estate investment is a major risk to sustaining growth in 2009, as overall investment will increasingly be affected by the sharp decline in exports. Currently investment accounts for 40 per cent of total GDP, with manufacturing and real estate investment combined accounting for more than half of the total. Investment in manufacturing - 30 per cent of total investment in 2007, equating to 12 per cent of GDP - is the component most exposed to the fall-off in external demand. The current slowdown in exports, therefore, will with several months lag weaken exporters' appetite for new investments. By contrast, real estate investment, 22 per cent of FAI or 9 per cent of GDP, is overwhelmingly driven by domestic factors.

A third important component of investment is infrastructure. Infrastructure projects are different from other types of investment in one important aspect: they are carried out by local governments and are financed to a significant degree by revenues from land sales and property-related taxes. And because of the important role played by local authorities, the financing of such investments is the critical bottleneck that must be resolved in order for such investment to move forward.

The health of the property market, in turn, is a major factor determining the fiscal strength of local governments (Table 1). A booming property market boosts land sales, pushes up land prices and increases the tax revenues of local authorities. In 2007 the collection of property-related taxes amounted to more than one-third of local government tax revenues. The importance of the property sector to the overall growth outlook is thus based both on the significant role of property investment in total investment and on the indirect impact of the property market on infrastructure investment via its importance for the fiscal revenues of local authorities.

Table 1: Local government tax revenue by type of tax

City maintenance and construction tax	6.0%
House property tax	3.0%
Urban land use tax	2.0%
Land appreciation tax	2.1%
Deed tax	6.3%
Business tax on real estate industry*	8.4%
Business tax on construction industry*	7.7%
Others	64.5%

*Business taxes on the real estate and construction sectors are collected both by the central and local governments; only those taxes collected by local governments are included above.

Sources: State Administration of Taxation, Ministry of Finance and TS estimates.

Characteristics of the property crisis

The difficulties facing the property sector are very clear: weak transaction volumes, funding constraints and an uncertain outlook for real estate prices. In order for property transactions to stabilise and start recovering two developments are necessary:

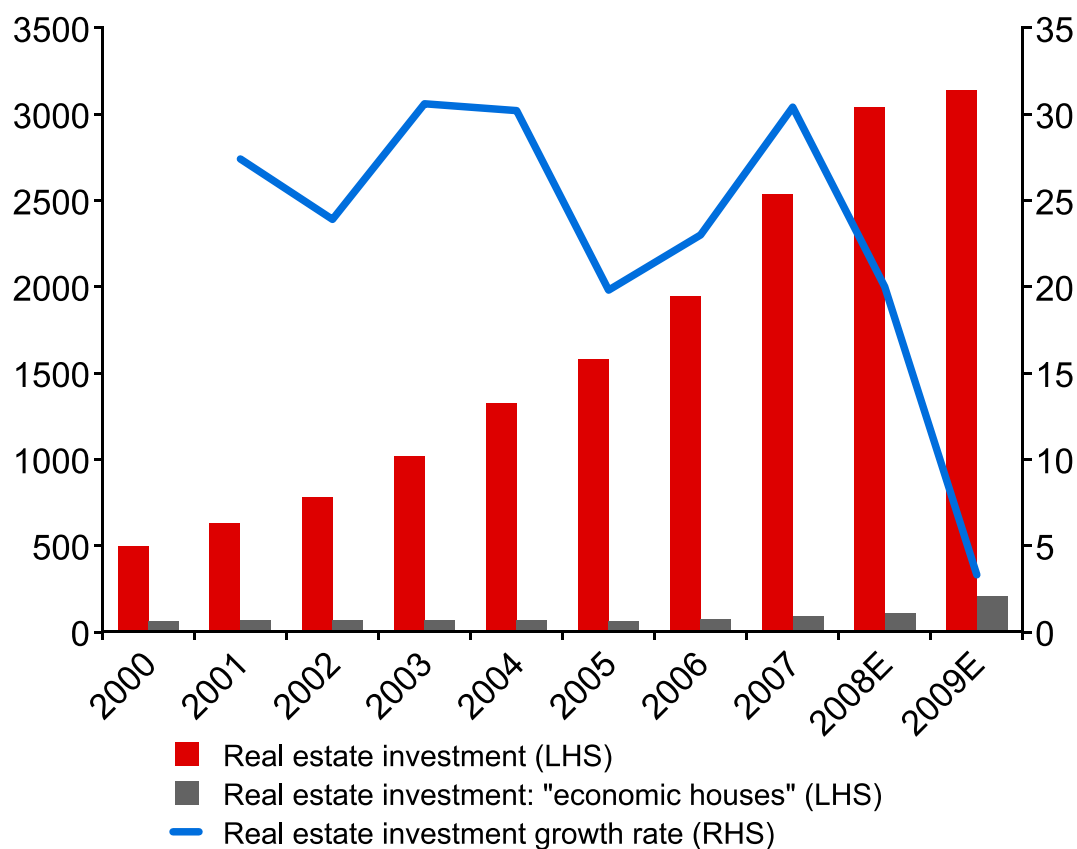
1. An improvement in affordability for buyers through a decline both in prices and in financing costs
2. Developers need easier access to credit and possibly other tax or income breaks that would make them more willing to reduce prices in order to move unsold units

We project that the volume of property transactions will start recovering only from the second half of 2009. In our view property prices need to decline by another 15-20 per cent in order to attract new buyers and to boost transaction volumes.

In order to survive during the property market downturn, developers are delaying new construction and reducing or even stopping new land acquisitions. The government's new affordable housing initiative targets Rmb900 billion in new spending over the next three years out of the total Rmb4 trillion stimulus package. The primary barrier to achieving this target is the lack of funding available to local authorities to carry out such ventures. According to the funding model being imposed on affordable housing projects, 25 per cent of funding is to come from the central budget, another 25 per cent from local authorities and the rest from market sources, either bank loans or bonds. We doubt that many local authorities have sufficient resources to meet the funding share being imposed on them. For this reason a strong rebound in real estate investment in 2009 is doubtful, even if property transactions pick up.

We estimate that real estate investment growth will fall to the range of 0-5 per cent in 2009, down from an estimated 20 per cent-plus growth in 2008 (Chart 2). We think the Rmb900 billion (US\$130 billion) allocated to affordable housing projects will face delays in being disbursed, owing to financing bottlenecks. We believe this drop will drag down GDP growth by an estimated 1.8 per cent. Although we expect the contribution of net exports to be close to nil in real terms in 2009, overall investment growth should still hold up relatively well: a significant slowdown in real estate investment will be offset to some extent by a pick-up in infrastructure investment associated with the fiscal spending package, primarily in the second half of the year.

Chart 2: Real estate investment value (Rmb billion) and growth (per cent change yoy)



Note: Investment in "economic houses" is one of three components of affordable housing. See Assumptions and Evidence below for details.

Source: CEIC.

In view of current policies, we think China's property market will remain in a slump during 2009. Beijing must go beyond its affordable housing initiative, both to facilitate the downward price adjustment for unsold housing units and to resolve the bottlenecks in local funding for new housing construction.

The longer-term outlook, however, is still relatively optimistic, as urbanization and sustained growth in incomes and savings are likely. During the transition from an investment-led economic model to one potentially led by domestic consumption, there will be large-scale movements of rural labour into urban areas. This will buoy demand for urban infrastructure as well as services. These trends will translate into strong demand for urban residential housing and services. The key bottleneck to meeting these demands is the lack of adequate long-term funding for local governments. The resolution of this problem requires fundamental fiscal reforms that will take 5-10 years to implement.

Property market fundamentals

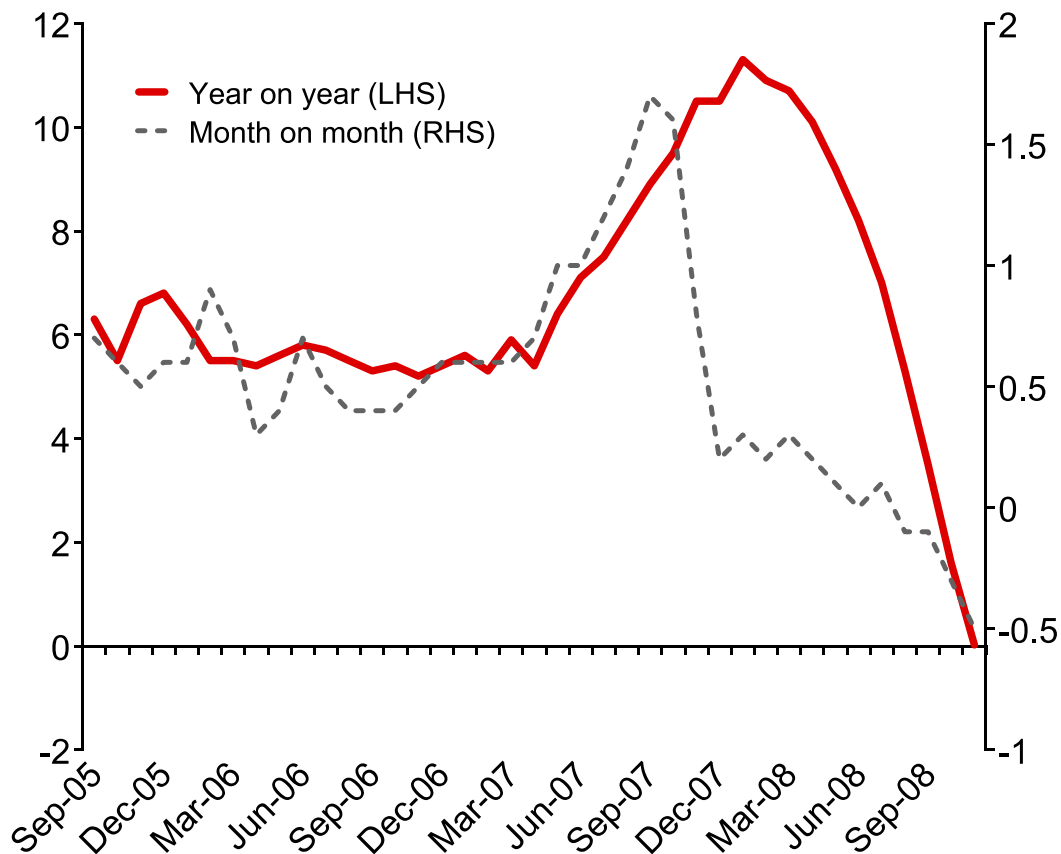
Since the 1998 reform that allowed private housing for the first time, China's real estate sector has been in an uninterrupted growth boom. Particularly from 2003 to 2007 prices in many major cities accelerated owing to increased speculative interest from property investors. Both offshore

money and domestic capital poured into the sector, pushing up real estate FAI fivefold compared to 2000. The growth rate of real estate investment peaked at 30.4 per cent in 2007.

Towards the end of 2007 the central government became concerned about the danger of a developing bubble. In order to dampen the bubble and counter overheating, credit availability for property was tightened in October 2007. Since then the property sector moved into adjustment mode: transaction volumes declined sharply and after a few months prices started to soften.

Even though a single universally accepted property price index for China does not exist, we think that the index from the National Development and Reform Commission (NDRC) is accurate in highlighting trends. This index shows that price growth has slowed markedly since late 2007 (Chart 3). In particular year-on-year growth in property prices fell to 0.2 per cent in November 2008 from 11.3 per cent at the end of 2007. However there is significant variability among regions: price trends have varied according to project locations, with property prices in city centres holding up better than in suburban locations.

Chart 3: Property prices in 70 large and medium cities (per cent change), September 2005- November 2008



Source: NDRC.

Against this backdrop the authorities have made drastic changes in their policy mix in the past few months. Expansionary monetary and fiscal measures have been implemented by the leadership in Beijing and supportive measures for the property market have been forthcoming both from the local and central governments targeting the reduction of transaction taxes and

payments. Local authorities have also been given free rein to introduce their own supportive measures. These new steps reflect the government's increasing anxiety about the slowdown in FAI growth driven by the deceleration of real estate investment.

New policies improve affordability

The housing affordability ratio has been widely used as a key indicator in assessing whether a property price bubble exists. The accuracy of such figures is debatable: reported income, and in turn affordability, are frequently distorted by "grey income" (income not included in the statistical calculation of disposable income). Thus we believe that it makes more sense to focus on changes in the ratio than on the absolute figures.

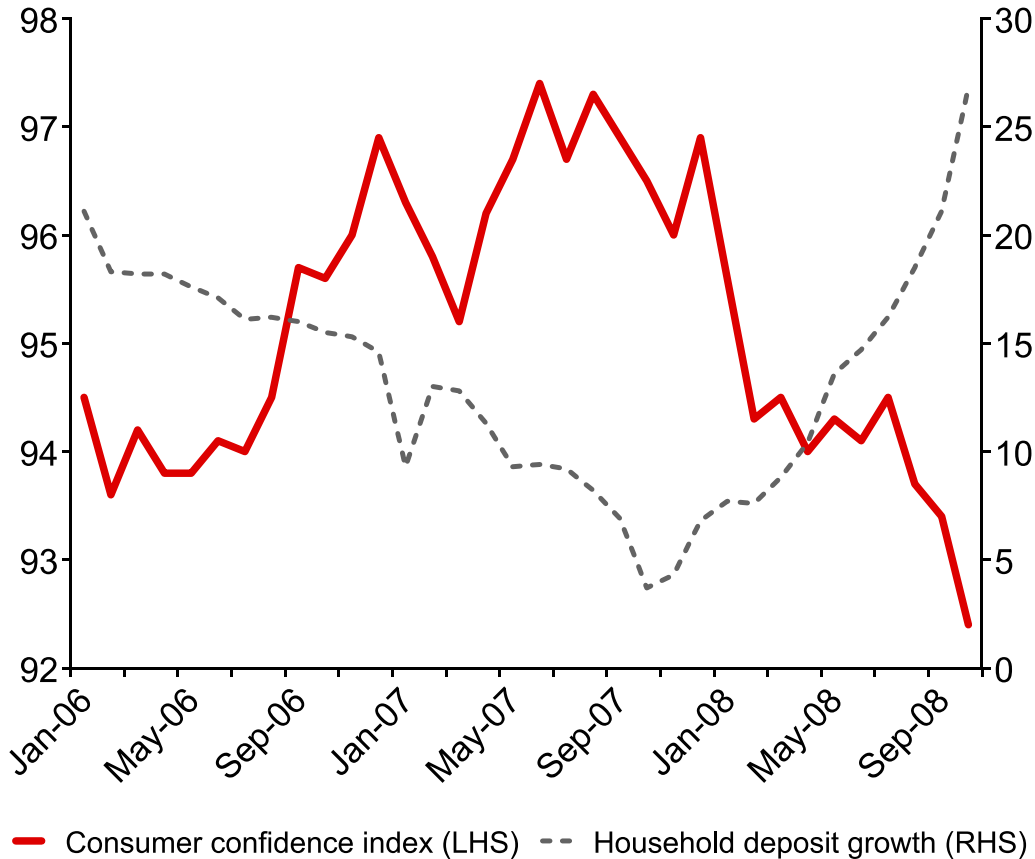
Four interest rate cuts since September have brought the prime lending rate down to 6.12 per cent from 7.83 per cent at the beginning of 2008. The "effective mortgage rate" has gone even lower, to 4.28 per cent, the lowest in the past five years (for loans longer than five years, the "effective rate" is set at 0.7 times the base lending rate). Housing affordability in most cities is improving because of the decline in mortgage rates, property tax cuts and the correction in prices. The significant drop in "effective mortgage rates" has resulted in a 15-20 per cent saving in monthly mortgage instalments. This implies an indirect 20-25 per cent decline in the cost of buying a property compared with the market peak. Moreover, developers appear to be growing more pragmatic about boosting sales by cutting prices aggressively.

Though encouraging, this process of improving affordability has to run further in order for property market fundamentals to turn around. The reason is simple: buyers will remain reluctant to spend until they think prices have bottomed out.

The outlook for consumer sentiment

In contrast to many other countries, potential housing demand in China is relatively strong and many prospective buyers have the money necessary to purchase housing for cash (Chart 4). However, relatively few are inclined to buy now because they expect prices to undergo a further correction. In addition many homebuyers anticipate that new government support measures for the sector will be forthcoming. As a result, prospective homebuyers remain on the sidelines, and transactions are unlikely to pick up substantially until prices are seen to have reached their trough.

Chart 4: Household bank deposits (per cent change yoy) and consumer confidence index, January 2006-September 2008

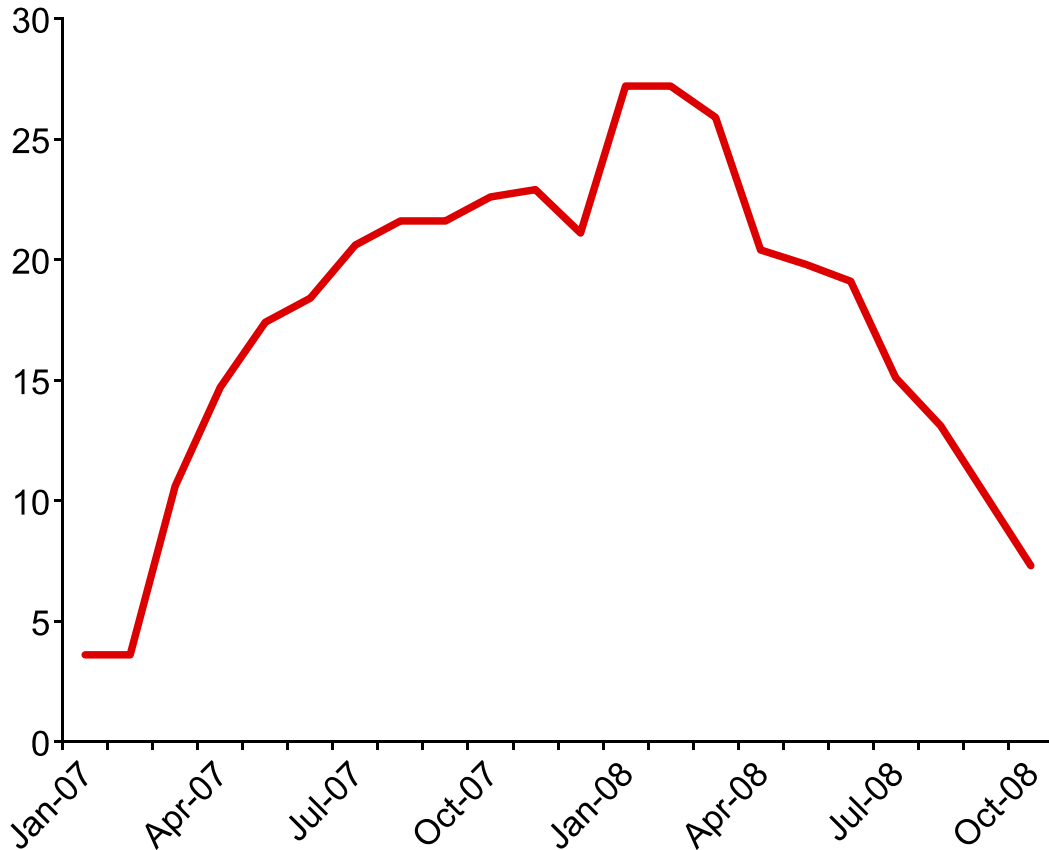


Source: CEIC.

Rebalancing demand and supply takes time

The supply and demand picture for residential properties in key cities has worsened in the past three months, with a sluggish take-up rate and a growing pool of properties available for sale. Although developers have already deferred the launch of some projects to 2009 after lacklustre sales in 2008, the overheated pace of investment over the past two years means that substantial new supply is still in the pipeline for 2009. With an average construction cycle of around 18-24 months, we expect the housing supply to peak in 2009 given that developers started to scale back the pace of construction only in early 2008 (Chart 5).

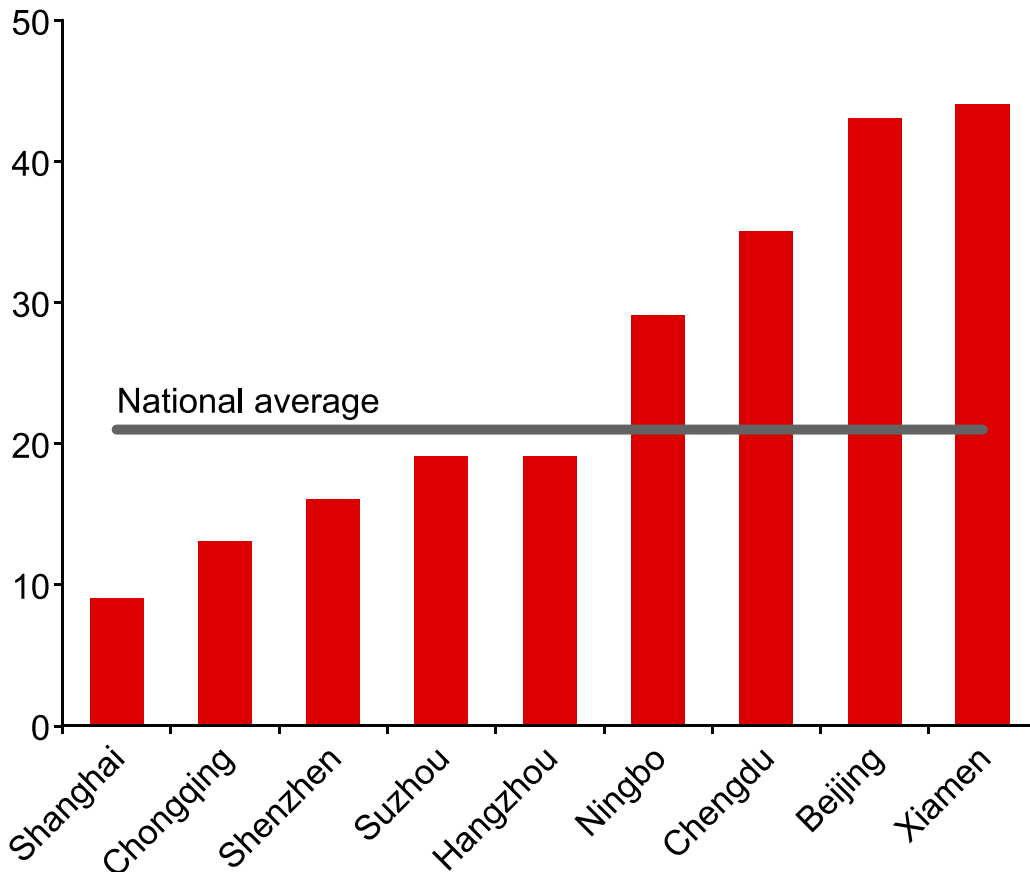
Chart 5: Housing starts (yoy per cent change in Gross Floor Area), January 2007-October 2008



Source: CEIC.

The overall inventory level is also trending upwards because pre-sales in 2008 fell behind developers' expectations. The ratio of new homes available for sale to monthly new home sales has surged. As highlighted in Chart 6, it will take an average of 21 months to clear the stock of homes available for sale, based on the average pace of sales from September to November. If sales stay at current levels, we estimate the current housing stock in the major cities will take between 9 and 44 months "to be absorbed by the market", depending on the city.

Chart 6: Housing inventory in months (based on average monthly rate of sales September-November 2008)



Sources: Soufun, TS estimates.

In the light of abundant supply and softening sales, a meaningful recovery for the property sector is still a remote prospect. The government's support for the housing market has limited the decline in sales volume, but downwards pressure on prices still exists despite a 20-30 per cent correction in some cities from the peak in October 2007. During the next 12 months we expect a further 15-20 per cent overall drop in property prices from the current levels, although the actual decline will be influenced by local demand and supply imbalances. High-end housing is particularly affected by weaker consumer sentiment. Nevertheless, sales volumes at well-located projects could see some improvement given that affordability is improving. We expect overall property sales to remain flat in 2009.

The new affordable housing initiative

In November 2008 the State Council announced that it would implement measures in 10 priority areas in order to boost domestic demand, targeting total spending of Rmb4 trillion (US\$580 billion) over the next two years, equivalent to 16 per cent of 2007 GDP. Affordable housing was listed as the top priority, followed by rural and transport infrastructure. Later, the Ministry of Housing and Urban-Rural Development (MOHURD) announced that Rmb900 billion would be allocated to fund the development of affordable government housing projects in the next three

years, covering three categories (described below): public rental housing, "economic housing" and "capped-price housing".

The government hopes that this initiative will stimulate spending on housing while averting the potential risk of another property bubble forming. It expects that the increased investment in affordable housing will spur higher FAI and help to create 2-3 million new jobs, thus boosting local consumption and ultimately GDP growth. However some analysts are concerned that the affordable housing initiative could dampen the recovery in the property market by flooding the market with an excess supply of housing, thus undercutting prospects for sales of existing and about-to-be completed units.

According to the MOHURD, the new housing programme is to be funded mainly by local governments and bank loans, although the central government plans to make some transfer payments. As with many other policy initiatives, the effectiveness of the programme depends on the financial strength of local governments. In the past their financing of affordable housing relied on revenue associated with land sales. The depressed housing market and poor response to land sales has diminished the viability of such funding sources for the present.

Recently there have been an increasing number of cases in which local authorities are allowing developers to delay land premium payments; occasionally they have returned deposits to developers when they returned their land sites, which was not the case previously. Therefore unless major changes are implemented in the funding channels for such initiatives, the delivery of affordable housing by individual provinces on a scale envisaged by Beijing will not take place.

Financing is key to implementing the successful long-term development of a public housing system. Local governments need steady, dependable sources of revenue within their jurisdiction. This means that reforms of local tax and fiscal arrangement are a necessary precondition for the longer-term evolution of both local housing and urban infrastructure more broadly.

More important even if stop-gap solutions are found to help local governments fund new projects in the next three years, an average annual investment on the scale of Rmb300 billion will not fully offset the potential fall in private real estate investment. This suggests that the allocation of additional funding will be needed. We draw the following conclusions:

1. The government's affordable housing initiative is both feasible and economically viable, but not in the timeframe suggested by Beijing's recent announcements
2. Fundamental reform of local tax and fiscal rules is a precondition for the longer-term implementation of the government's plans. These reforms will take a number of years to implement
3. Stop-gap measures to resolve fiscal bottlenecks are likely by way of ad hoc injections of funds and guarantees to bank loans to housing developments. Such measures will delay the implementation of the original programme

The way ahead - additional measures are necessary

Although initiatives by central and local governments to support the property sector may boost sentiment somewhat, they are not sufficient to resolve the two fundamental bottlenecks facing the property sector: low transaction volumes and funding constraints. For this reason we expect that central and local governments will introduce additional measures from time to time to address the property crisis. Such measures are likely to include an easing in the availability and cost of financing, including lower interest rates, a relaxation of lending guidelines and reduced down payments, transfer taxes and fees.

Transaction fees and taxes paid by buyers in the secondary market offer more room for adjustment, as they can be as high as 10 per cent of the value of a property. Developers currently pay 5-15 per cent of property sales as a land appreciation tax. A lowering of the tax rate would strengthen the developers' cash flow. A reduction in transaction fees would help to boost

affordability for potential buyers.

The government tightened credit availability for second-home buyers in late 2007 by raising the down payment to 40 per cent from 30 per cent and lifting the mortgage rate to 1.1 times the benchmark lending rate. Recently the People's Bank of China has implicitly relaxed the tighter policy on second mortgages by allowing banks more flexibility in determining lending profiles for "upgraders" (i.e., those who buy a second home so as to improve their living conditions), as long the property is for owner occupation. Such adjustments in credit availability are likely to enhance buyer sentiment. Other measures that could help improve conditions in the housing market include shortening the required holding period for secondary transactions and granting resident status ("hukou") to people from rural areas. As this report was being readied for publication, there was news that the government was reducing the tax on home sales and cutting the holding period for secondary transactions from five to two years. These new rules will be effective for a period of one year.

Assumptions and Evidence

China's public housing system

So-called commodity housing (houses built by developers) replaced state-provided housing after the 1998 reform. Public rental housing, "economic housing" and "capped-price housing" are meant to account for 10 per cent, 20 per cent and 30 per cent of total housing construction respectively (see Table 2 below for definitions). But in recent years the share of public housing has decreased significantly because of the low level of private sector participation in the development of the public housing system.

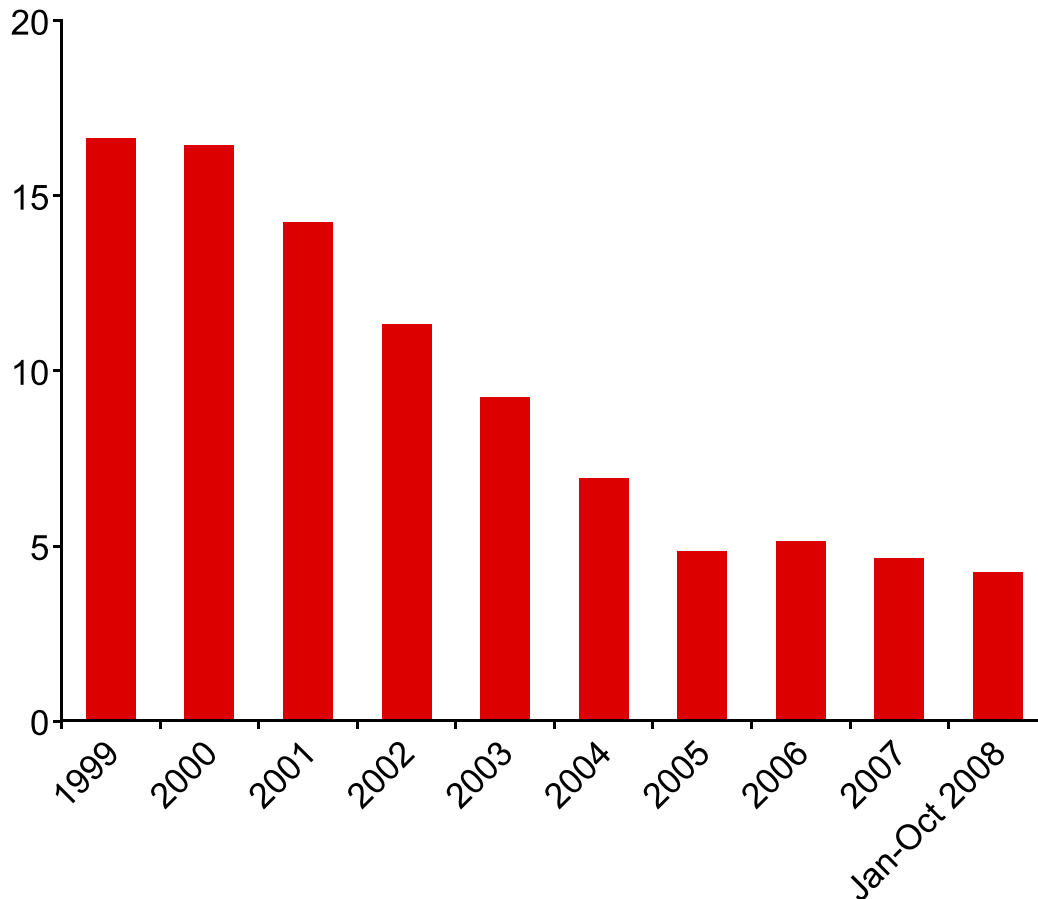
Table 2: Characteristics of alternative low-income housing programmes

	Public rental housing	Economic housing	Capped price housing
Covered	The lowest-income group in cities	Low-income group in cities	Low-income group in cities or those affected by the relocation or city development
Gross floor area (GFA)	<50 sq m	Around 60 sq m	<90 sq m
Funding sources	10 per cent of land sales revenue; fiscal budget and the gain from the public housing reserve	Not specified	Constructed by developers. Land site contributed by government; unit size and prices are restricted
Price	N/A	Cost plus 3 per cent	15-20 per cent lower than market price
Title right	For rental only, managed and allocated by the local governments	Cannot sell within five years after primary purchase; need to pay the land premium to the government if there is secondary sale	Can be traded freely after certain time period

Sources: MOHURD, PBoC, press releases.

The central government started to emphasize the importance of affordable housing in mid-2006. Since then local governments have announced a number of new plans and measures to address this issue. But few of these initiatives have been implemented successfully. The percentage of "economic housing" investment in total residential real estate investment has continued to fall, from 5.1 per cent in 2006 to 4.2 per cent in the first ten months of 2008.

Chart 7: Share of 'economic housing' investment in residential real estate investment (per cent), 1999-2008



Source: CEIC.

The development of public rental housing involves a huge amount of investment, and funding is a critical factor. Under the current support policies local governments take up most of this investment, funded primarily by revenues from land sales and transfers from the fiscal budget. The central government subsidises construction, applying a standard of Rmb300/sq m and Rmb200/sq m for western China and central China respectively.

In November 2008 the State Council's Rmb4 trillion (US\$580 billion) stimulus package allocated Rmb280 billion (US\$41 billion) towards building homes for the low-income population. The government aims to provide public rental housing for 2.87 million households and to subsidise rents for another 4.6 million households. It also plans to build 4 million "economic houses" over the next three years and to renovate old housing for employees of state-owned enterprises in the forestry, coal mining and agricultural development industries, meeting the needs of 2.2 million families. Beijing will make transfer payments to assist the funding of the programme, but the main financing sources are planned to be local governments, households with acute housing needs and their employers.

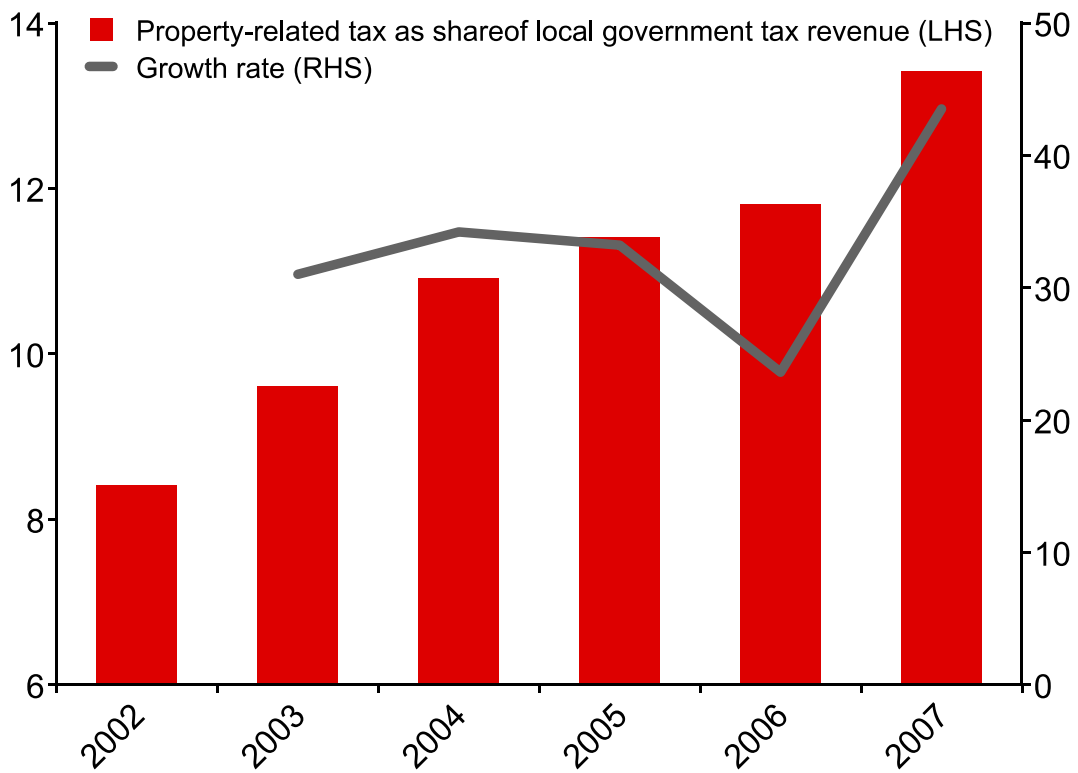
We believe the market is concerned that the increased development of affordable housing could potentially affect housing demand in the private market. These concerns are overblown because

there is little overlap between public housing and private housing owing to differences in income and wealth. Strict rules and restrictions are being imposed by state and local governments on buyers eligible to purchase low-income housing. Furthermore resale transactions on low-income houses are restricted.

Where will the money come from?

Since 2000 income from land sales has become the key funding source for local governments. In 2007 estimated total land sales revenue for local governments was Rmb350-450 billion, equivalent to 15-20 per cent of their revenue. The collection of property taxes, urban land-use taxes, land appreciation taxes and deed taxes has grown strongly in the past few years. In 2007 these taxes rose by 43.5 per cent to account for 13.4 per cent of total local government tax revenue, up from 8.4 per cent in 2002.

Chart 8: Property-related taxes as share of local government revenue (per cent), 2002-2007



Note: Property-related tax includes property tax, urban land-use tax, land appreciation tax and deed tax.

Source: CEIC.

The build-up of a sizeable stock of affordable housing implies that local governments will have to bear a large part of the associated investment. It also means that they will sacrifice income from land sales because more land would be allocated to economic housing and public rental housing construction, leaving less land from which to raise revenue.

To meet the goal of providing public housing to the 7.47 million lowest-income urban households, local governments need to deploy a minimum average of Rmb200 billion (US\$29 billion) each year over the next three years. We expect this to be more than 50 per cent of total land sales revenue in that period, well above the central government's stated requirements for local

government to fund the development of public rental housing with 10 per cent of land sale proceeds.

Therefore a precondition for the successful development of an affordable housing system in China is the presence of strong financing support for local governments via bank lending in the short run, perhaps aided by guarantees from the central government. In the longer term reform of the tax regimes affecting local governments is essential. Without such changes local governments will be unable to support the development of affordable housing.

Private sector affordable housing programmes can be commercially sustainable only when based on cross-subsidy arrangements under which the participating property developers use profits from their commercial housing programmes to cross-subsidise the affordable housing programmes. Under current market conditions developers are interested mostly in participating in government-led affordable housing initiatives. The major reason is that such developments are backed by government policy and are expected to have a much better chance of achieving good sales than purely private projects. Table 4 shows the plans for affordable housing in the major cities.

Table 3: Affordable housing construction plan by city, 2009

Location	Total planned housing	Total planned affordable housing (000 sq m)				Affordable housing as percentage of total
	(000 sq m)	Economic housing	Capped-price housing	Others	Public rental housing	
Beijing	27500	500	3000	4500	3500	42
Tianjin	1857	100	3800	2000	3500	32
Shanghai	20000	4000				20
Guangzhou	8500-11800	80	920-1720			15
Shenzhen	12160		380		1900	19
Chengdu	9500	23	207	770	1080	22
Wuhan	10280	3160		900	30	40
Xian	12810	50	2020		2290	34
Jinan	7330	25	780		1020	24

Sources: Local government websites.

Contact us

If you would like to discuss any of the points made in this note, or ask further questions, please feel free to contact the authors:

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