

# EM Themes

## Economic policy and strategy

### Analysts

#### Larry Brainard

Chief Economist  
+ 44 (0) 203 008 6092  
lb@trustedsources.co.uk

#### Bo Zhuang

Economist  
+44 (0)203 1707 250  
bz@trustedsources.co.uk

For more information please  
contact Sales:

sales1@trustedsources.co.uk  
+44 (0) 20 3170 7254

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## Property: China's best option to counter the coming slowdown in growth

*Property comes into focus as the lynchpin of the government's efforts to sustain rapid growth*

### Key judgements

- ▣ Growth in China will strengthen during the second half of this year and into early 2010, moving into a 9-10 per cent year-on-year range.
- ▣ Near-term policy initiatives will reflect "fine tuning" rather than broad-based monetary tightening; "loose" monetary policies will continue into next year.
- ▣ The current stimulus will show signs of peaking early next year and growth will begin to fall back, tracing the second downward leg of a W-shaped pattern.
- ▣ Policy will attempt to cushion the coming fall in growth rates by ramping up investment in the residential property sector in the coming quarters.

# Context

## The story so far

Four months ago we advanced the [thesis](#) that China's growth trajectory would trace a W-shaped pattern rather than the V-shaped rebound that was then conventional wisdom. Although we were in the minority at the time, recently the consensus has swung towards our view. Indeed some have gone overboard, predicting that the Chinese authorities will undermine the recovery by seeking to rein in bank credit expansion.

Here is our current thinking about the near-term outlook:

1. Growth will strengthen in the coming quarters, moving towards the upper end of a 9-10 per cent range (measured in year-on-year rates).
2. Infrastructure spending will peak in H1/10, leading to a decline in GDP growth during the second half of the year.
3. Monetary policy will remain "loose" but a repeat of the explosion of bank lending in H1/09 is not feasible; policy initiatives will be more in the nature of "fine tuning" than of broad-based monetary tightening.
4. Personal consumption will continue strong but with a slight declining trend reflecting slower growth of personal incomes and the ending of various one-off programmes to boost consumer spending.
5. Growth rates in H2/10 will fall back to a still respectable 7-8 per cent range; the slowdown will reflect both the sluggish recovery of global trade and the base effect; that is, the high base likely to be set in H2/09 will make it difficult to achieve high year-on-year growth.

## Why the explosion in bank credit?

In our view, the explosion in bank lending earlier this year was primarily responsible for the rapid turnaround in the economy. By any measure it was chaotic and uncharacteristic of China's usually cautious monetary policy.

Why? Our sense is that policy was driven by a judgement that the collapse of global trade that hit China in Q4/08 would be reversed in 18-24 months, once developed economies had passed the worst of the recession. What was needed was a stimulus programme to bridge the shortfall until the expected recovery in demand for Chinese exports could take hold.

With the Q4/08 collapse of external demand creating an urgent need to act, the only viable option was to boost investment since measures to pump up private consumption would inevitably take much longer to impact. This meant that local authorities would have to be given the green light to launch pet projects previously denied funding and newly devised initiatives that could not be adequately vetted, let alone supervised.

## The political imperative: prevent a sharp rise in unemployment

Although many in the West have been quick to pour praise on the Chinese leadership for its decisive action to boost demand, future evaluations of the

stimulus measures will undoubtedly reveal shocking shortcomings. Yu Yongding, Director of the Institute of World Economics and Politics of the Chinese Academy of Social Sciences (and former member of the People's Bank of China Monetary Policy Committee), commented in the "[Financial Times](#)" last month that waste in infrastructure construction is "ubiquitous" and that such investments have "less than promising investment returns".

China's impressive growth numbers expected for H2/09 are not being driven by what could be termed productive investment. Indeed the waste and misallocation of capital are taking on a monumental scale, but the cost in terms of rising non-performing loans in the banking system will conveniently be deferred to the future.

The unprecedented nature of the monetary stimulus highlights the acute sensitivity of the Chinese leadership to potential unrest associated with rising unemployment. The resulting surge in fixed asset investment (FAI), up 36 per cent in the first half, is likely to push the country's investment rate close to 50 per cent of GDP this year, roughly the same level as total consumption. This is an unprecedented result, probably unmatched since the days of Stalin's first five-year plans or Mao's Great Leap Forward.

## What's wrong with the stimulus strategy?

Looking beyond the immediate boost to growth that is already in the pipeline, investors should give two issues closer scrutiny. One is that the success of the Chinese leadership's investment-push strategy rests on a very weak foundation: the recovery of spending by US consumers. The second is that today's policy of boosting investment ignores long-standing structural economic imbalances which need serious attention, namely industrial overcapacity and the rebalancing of the economy towards household consumption, services and the creation of a social safety net.

In our view, personal savings rates in the US will continue rising in coming years as household balance sheets are gradually repaired and banks reduce the rate of growth of consumer debt by hiking its cost and limiting its availability. We do not expect the recovery in consumer spending in the US and elsewhere to provide the same boost to demand for Chinese exports that it has in recent years.

A [study](#) last month by two IMF economists estimated that during 2001-08 net exports and investment predominantly linked to building capacity in tradable goods sectors accounted for over 60 per cent of China's growth. This compares with 30 per cent for the euro area and 35 per cent for the rest of Asia. A recovery in Chinese exports is to be expected, but they cannot regain their past role as a primary growth driver.

For China to sustain such export-related growth would require dramatic export price reductions in order to gain market share, given a much slower expansion of global trade. For example, the IMF authors estimate that world steel prices would have to fall by a cumulative 45 per cent during 2011-20 to accommodate China's exports.

Such a result may be ruled out for the simple reason that affected countries will not allow it. These countries' steel companies will fight such developments and their governments will provide them with strong political backing.

The Chinese leadership's failure to address the country's overcapacity problems has two important implications for global markets. As we argued [last month](#), cut-throat competition among exporting nations will lead to deflation in

the prices of tradable manufactures, not only in steel products but also in a wide range of consumer products and machine tools. Second, China's export push will lead to increasing trade frictions as affected countries bring dumping charges against Chinese exporters and impose ad hoc restrictions.

### **The policy options**

How will China's leadership react to signs that infrastructure spending is peaking and that the recovery of exports it hoped for is not materialising?

An initial consideration is that the political calculus does not support launching new initiatives at this time to achieve the needed restructuring of the country's guiding economic strategy. As China research director Jonathan Fenby points out in a recent [note](#), President Hu Jintao is fighting to shore up his legacy ahead of the 2012 leadership transition. It is doubtful that Hu will push reforms that would come to fruition during the incumbency of his successor, who is expected to be current Vice-President Xi Jinping, the leader of the coastal faction and the rival to Hu's own support base.

A short-term fix is therefore preferable to sacrificing near-term growth. That means continuing the current "loose monetary policies" while fine-tuning lending policy via "window guidance" to clamp down on speculative and blatantly wasteful activities. Further tightening of monetary policy can be ruled out unless export demand recovers much faster than we expect.

An additional consideration is that economic restructuring will impose costs in terms of slower growth and economic dislocations. A [report](#) in "China Daily" on overcapacity problems in the cement industry noted that China's eastern provinces boast 88 new high-tech cement plants able to produce 160 million tonnes of cement, far beyond the region's demand for some 100 million tonnes.

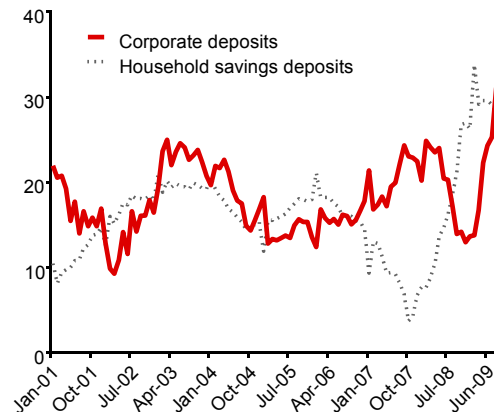
Excess capacity problems in cement highlight a difficult dilemma for the politicians. Reducing excess capacities means either closing some of the country's most efficient plants or creating economic dislocations and unemployment in other regions where alternative job prospects are limited. Provincial authorities in other regions will fight tooth and nail to protect their local inefficient polluting cement factories out of concern for jobs.

Rather than sacrificing growth and stirring up the opposition of local party cadres, the leadership will be desperate to find new sectors capable of providing an investment boost once infrastructure spending begins peaking by mid-2010.

### **Property investment, the best option for sustaining rapid growth**

In our view, property investment provides policymakers with the best option for sustaining growth in the 2010-12 timeframe. In contrast to the US and some other developed economies, China still has pent-up demand for residential housing, with little evidence of a housing overhang or a shortage of personal savings or mortgage financing. As Chart 1 highlights, household savings have been growing at roughly 30 per cent year on year in recent months.

**Chart 1: Domestic corporate and household savings deposits, January 2001 - July 2009 (per cent change, yoy)**

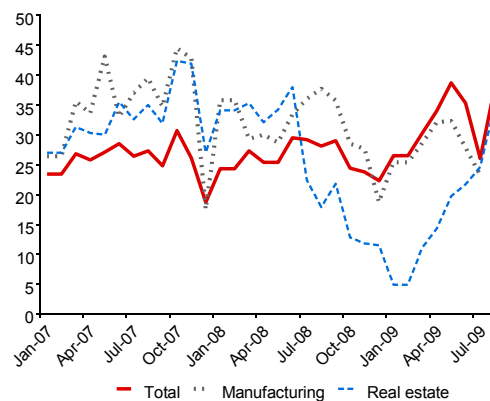


Source: CEIC.

As we highlight in the attached Appendix, the cycle in residential housing has already hit bottom: prices for residential units have turned up, the backlog of unsold units has been trimmed substantially and developers are responding by bidding aggressively for building lots and stepping up their investment in new projects.

For these reasons we expect the government to continue to broaden its policy support for the property sector in the coming quarters. As we outline below, the bulk of such initiatives are likely to involve supply-side measures to speed up the pace of residential construction. Early signs of such a policy shift can be found in recent data, as Chart 2 highlights.

**Chart 2: Urban FAI, January 2007 - July 2009 (per cent change, yoy)**



Source: CEIC.

## Risks of a property bubble?

Although property development is similar to infrastructure spending in its impact on the overall investment rate, the demand side of the equation is almost wholly in private hands. This is why the government must proceed cautiously in ramping up investment in the sector. The possibility of a boom-bust cycle is clearly present.

How a government initiative to step up property investment might play out over the coming few years and how big a contribution it might make in

counteracting a slowing growth rate is still uncertain. Our sense is that such an initiative would be capable of keeping growth rates at a respectable 7-8 per cent level. This is below the government's target but still impressive in any international comparison.

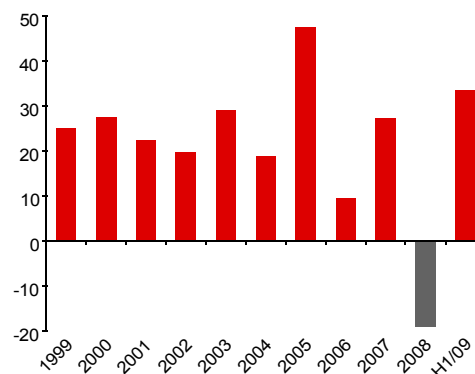
# Appendix

## Recent developments in the property sector

During 2000-07 China experienced a strong residential property boom fuelled by two primary developments. The first was a reform introduced in 1998 that gave individuals the unprecedented opportunity to purchase their own dwelling. Previously urban housing units were developed and sold by individual government entities only for their employees. The second was strong economic expansion that boosted household incomes significantly during this period.

The property boom peaked in early 2008 when the government tightened monetary policy to cool down an overheated property market and to fight rising inflation. This initiative was shortly followed by the global economic crisis that hit China after mid-year. As a result the volume of residential floor space sold fell sharply: in 2008 sales dropped by 19.1 per cent year on year, the first decline in the short history of China's housing market.

**Chart 3: Growth in residential floor space sold, 1999-2009 (per cent change, yoy)**



Source: CEIC.

\* January to July

Property developers were badly overextended and faced serious cash flow problems; to survive, they cut selling prices, slowed work on projects under construction and delayed building starts. Residential floor space under construction in 2008 rose by 16 per cent, down from a 23 per cent rate of expansion in 2007. Residential starts (measured in terms of floor space) increased by just 1 per cent in 2008 vs the 22 per cent rise registered a year before. Land area purchased in 2008 dropped by 9 per cent against the 27 per cent increase in 2007. All these comparisons are based on year-on-year changes.

The first signs of improvement in the property sector began to emerge in early 2009 due to government regulatory intervention. Given a correction that was the worst in the past 30 years, policy initiatives were introduced by both central and local authorities. These changes were aimed at encouraging residential purchases, as well as relaxing rules and regulations to ease the financial burden on developers: during the first half of 2009 mortgage lending rates and property transaction taxes were lowered, the minimum equity capital requirement for residential housing development was cut from 35 per cent to 20 per cent and second home purchase restrictions were relaxed.

Part of the massive monetary stimulus in early 2009 found its way into property investment via state-owned enterprises (SOEs). According to the State-owned Assets and Supervision Administration Commission, nearly 70 per cent of its 120 non-property SOEs had property ventures; fully 60 per cent of the land auctions in H1/09 were won by SOEs. With secure access to bank funding and implicit support by the government of such activities, the SOEs played a dominant role in supporting new property development. In Q2/09 SOEs' income derived from property accounted for some 30 per cent of their total income.

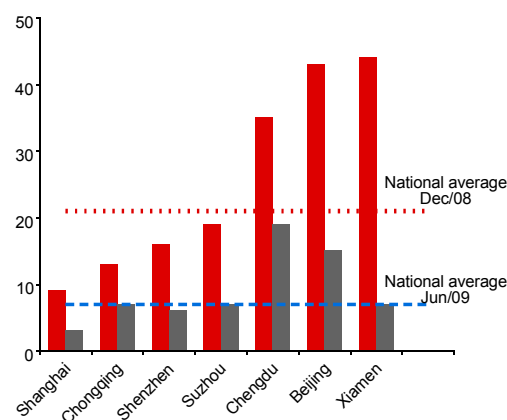
These initiatives quickly restored market confidence during the first half of 2009. Consequently no major bankruptcies among major Chinese developers resulted from the 2008 downturn which hit bottom in June as total floor space started in the last 12 months turned positive. In our view, the worst is over for the residential property market.

The quick turnaround in the property sector reflected the fact that the inventory of unsold units was relatively small compared to the pent-up demand of potential buyers. This contrasts sharply with the situation in the United States. To tap this potential demand the government acted to lower the cost of residential units via reductions in mortgage lending rates and property taxes. Lower prices also played a role but they were not the key factor that drove up housing sales.

## The housing overhang has eased

Property transaction volumes this year recovered much more quickly than we expected. Indeed the pace became fast and furious in Q2/09. Total residential gross floor space sold increased by 33.4 per cent year on year to 315 million square metres in H1/09. In our December research [note](#) we identified the overhang of unsold housing units as the biggest threat to the sector. The recovery in sales volume coupled with the aggressive cutback in new supply last year quickly lessened this overhang. Based on monthly sales volume, the average inventory level dropped to seven months' supply at the end of June from 21 months in November 2008.

**Chart 4: Housing inventory, measured in months, based on average monthly rate of sales, December 2008 and June 2009**



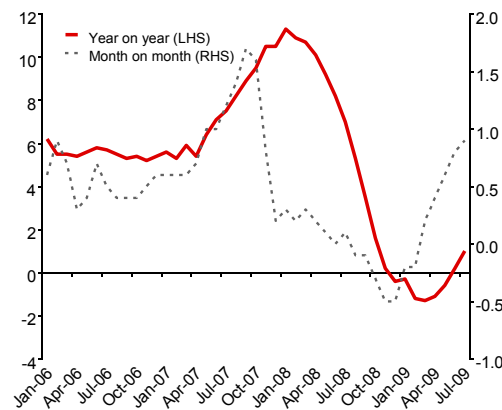
Source: TS estimates.

While the amount of residential floor space sold rose significantly in H1/09, floor space under construction grew at a much slower pace of only 11.4 per cent year on year and new housing starts declined by 10.4 per cent year on

year. At the same time land sales remained weak, with the area purchased down 26.5 per cent year on year.

Strong sales have resulted in a rapid depletion of inventory, prompting developers to nudge up prices. Residential price data for 70 cities tracked by the National Development and Reform Commission (NDRC) show the start of an upward trend. According to the latest statistics released by the NDRC, July property prices were up 1 per cent year on year nationally. The rebound in property prices is most visible in Shenzhen where the correction was the steepest. In view of limited inventories, we expect prices to continue moving up.

**Chart 5: Property prices in 70 large and medium cities, per cent change, January 2006 - July 2009**



Source: NDRC.

## Near-term outlook

Strong sales in recent months have been driven mainly by pent-up demand that was held back in 2008 by government policies to curb property speculation. The recent round of price increases has generated some pullback from buyers, so the growth in sales volumes should slow in the coming months.

The need for developers to offload their inventory is less pressing, since they have a lot less to sell than they did last year. But we still believe that developers will keep price hikes low in order not to jeopardise central government support for the overall property market. After the painful lesson of last year, most prefer to engage in a longer-term and more sustainable growth rather than maximising short-term profits.

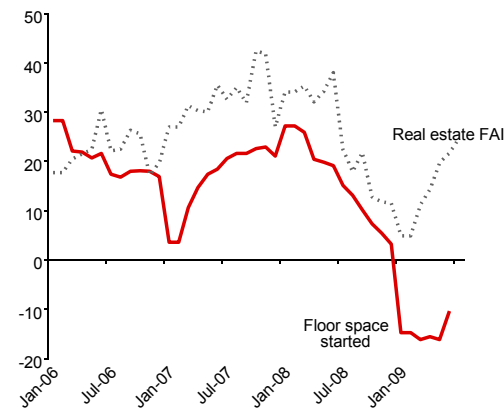
## Developers gradually returning to expansion mode

In view of declining inventories, the focus for developers has gradually shifted from cash conservation to expansion. Since they are sitting on excess cash, land acquisition is a strong signal of how developers see the market outlook. As long as property sales are maintained at a healthy level, homebuilders will accelerate building in H2/09.

The revival of construction activity in the property sector is crucial to support the government's target of 8 per cent GDP growth this year. Official H1/09 data

for the real estate sector suggest that the rundown in housing inventories is now nearing its end. Real estate investment grew in July by 24.6 per cent year on year, up from 15.3 per cent growth in H1/09. During H1/09 construction starts totalled 479 million square metres, down 10.4 per cent year on year. Although growth is still in negative territory, it has bottomed out. The fact that the growth rate remains negative suggests government policies for the property sector will continue supportive in the near term. We expect to see housing starts move up strongly, starting in Q3/09.

**Chart 6: Growth in real estate investment and floor space started, January 2006 – June 2009**



Source: CEIC.

**Chart 7: Growth of housing starts and property sold, January 2007 - June 2009 (per cent change, yoy)**



Source: CEIC.

**Risks to the outlook**

Some observers believe a tightening monetary policy is just around the corner, following the reckless expansion of bank lending earlier this year. As we argued above, we think government policy will continue supportive of the sector for the simple reason that boosting property investment is the primary tool for the government to sustain rapid growth in the coming quarters. In this regard government policy will be instrumental in sustaining market confidence.

Any tightening of policy at this time would undermine the government's goal of sustaining 8 per cent GDP growth. Policy initiatives initially focused on the demand side of the property equation by easing the cost and availability of mortgages and through other incentive schemes to attract buyers back to the

market. In the coming quarters we expect to see the government's focus turn to managing the property sector through supply-side measures, such as those to encourage developers to increase construction starts, to accelerate the pace of projects under construction and to put up more land for auction and tender.

Despite this more positive outlook for the sector, we do see some clouds on the horizon. While land sales are a good barometer of the confidence of developers in long-term prospects, the recent aggressive participation of SOEs in land auctions could negatively affect the recently restored stability of property market. Any resulting escalation of end-product prices could run ahead of underlying demand fundamentals in the market.

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SOURCES

### Trusted Sources UK Limited

Europe +44 (0) 20 7183 5280

The Americas +1 (646) 496 9856

Asia +852 2973 6093 (Enzard Ltd)

info@trustedsources.co.uk

www.trustedsources.co.uk