The Bursting of China's Housing Bubble*

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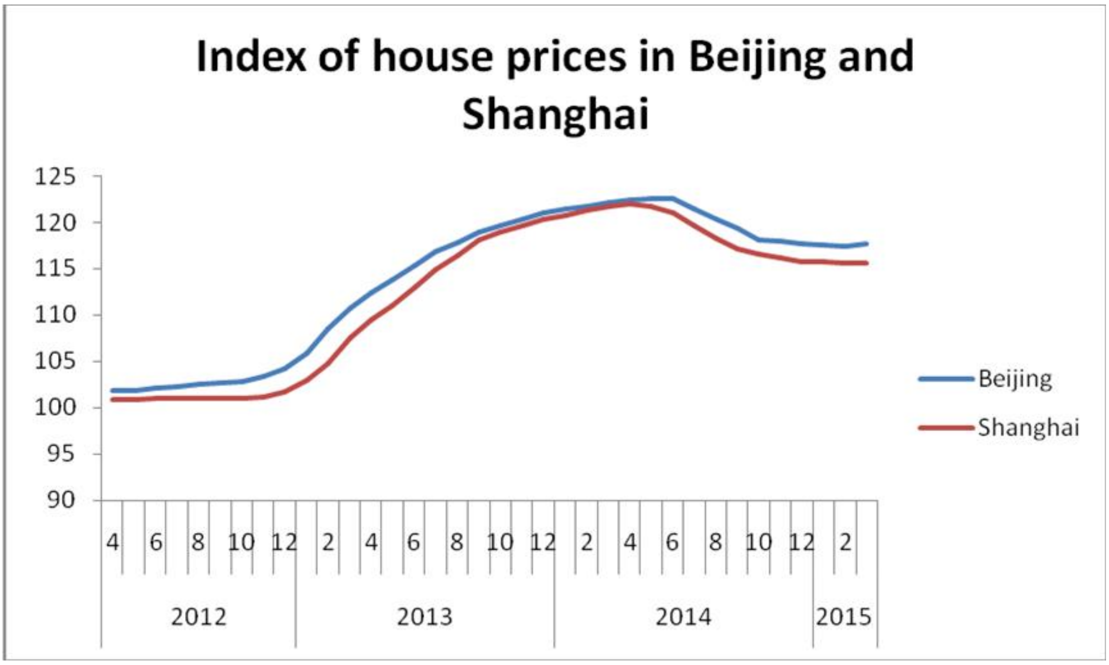
A significant part of China's recent recovery and boom after the Global Financial Crisis was driven by construction and real estate. As the economy slowed down, it was obvious that these sectors would also decelerate. But the slowdown in real estate has been much sharper, and now threatens a new front that could further add to the economic dilemmas facing the Chinese government.

For it seems that the property bubble is clearly over in China, at least for the time being. Real estate prices in many Chinese cities have been falling continuously for at least seven months, despite several rounds of quantitative easing and various policy measures designed to boost the market. According to the National Bureau of Statistics, total property sales in China fell by 7.6 percent in 2014. New land purchases by developers fell by 31.7 per cent year-on-year in the first two months of 2015.

The index of housing prices for 70 cities shows that average new home prices in China's 70 major cities dropped 6.1 percent in March compared to the earlier year. This was the seventh consecutive monthly fall, and followed February's 5.7 percent decline and the 5.1 per cent fall in January, which were already seen as too sharp.

Chart 1 shows the extent of house price declines in the two biggest cities of Beijing and Shanghai, at between 4-5 per cent in the period since May-June 2014. But house prices declines have been even bigger (more than 8 per cent) in some second-tier cities – such as Hangzhou, Shenyang, Shaoguan, Guilin, Dandong and Quanzhou – suggesting that the problem is widespread.

Chart 1: House prices in the biggest cities have been falling more than seven months



Source BIS 2015 Online Dataset on nominal residential property prices, accessed on 26 April 2015

Associated with this, many Chinese developers are facing financial difficulties, and some like the Kaisa Group have already defaulted on some of their loans. Various real estate companies have turned to new measures like internet marketing, and some are offering discounts that implicitly involve further price cuts on purchases in new buildings.

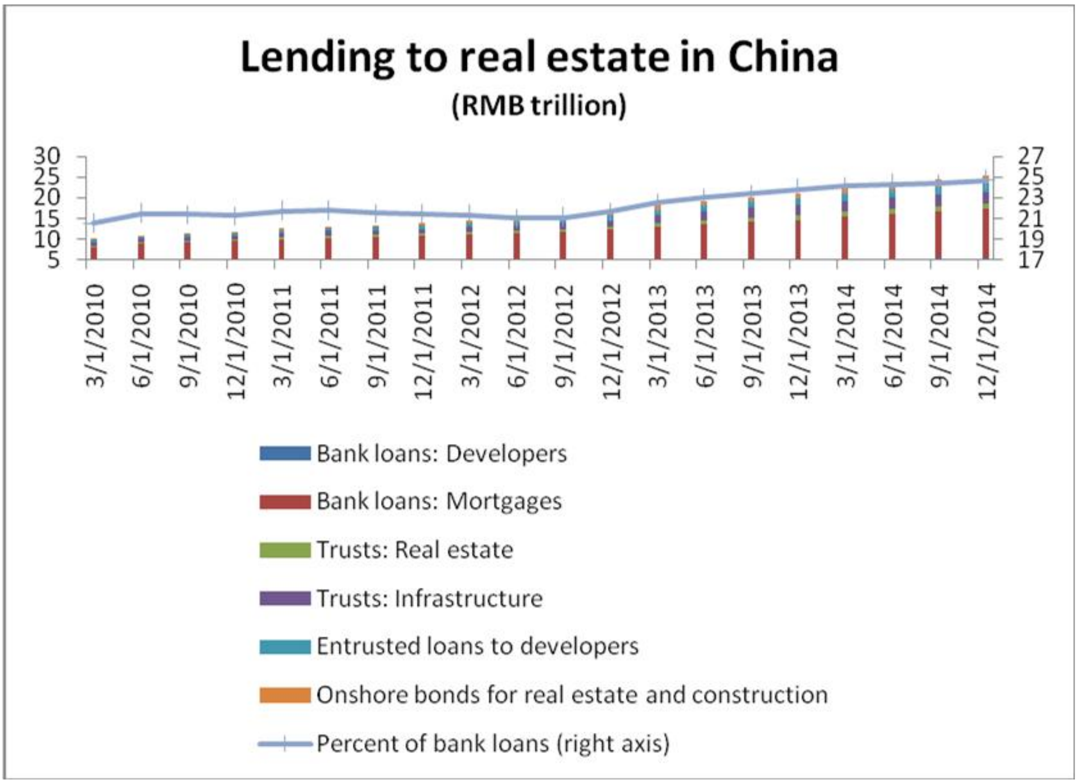
Some of this decline was clearly inevitable. Residential and commercial property prices in major urban areas had risen so rapidly that they became unaffordable for all but the very rich. And the frenetic almost steroid-driven pace of construction had created massive oversupply. The “ghost cities” of massive roads and half-finished buildings that are now globally remarked upon are only one indication of this oversupply. Across the country, the chosen form of economic expansion has become construction, and property developers were egged on both by national and provincial governments eager to show higher GDP figures and by developments in banking and finance that provided easy access to credit for such development.

The property boom and now possible bust have created a dilemma for the government. The property sector is estimated to account for around 15 percent of China’s economic output, and land sales are critically important for Chinese local governments, amounting to more than 40 per cent of their revenues. So the government needs to prevent bubbles from growing too large and then bursting, but also cannot really handle too much of a decline in real estate prices.

As a result, the government has gone in for a range of measures designed to revive the property market, mostly directed to the banking and financial conditions of housing sales. In 2009, the Central Bank of China and the China Banking Regulatory Commission had earlier halted the process of securitisation of housing loans by banks, after the US financial crisis exposed the risks involved in this. On 30 September 2014 they announced that this curb had been lifted and they would now encourage lenders to issue mortgage-backed securities. Chinese banks were allowed to relax the rules on loans for people purchasing their first home, and to offer discount rates and seek lower down-payments on second home loans in urban areas other than the top metros.

Interest rates were cut in November 2014. In January the reserve requirements of major banks - or the minimum amount of cash banks need to hold back from lending – were reduced. Most recently, on 30 March 2015, another slew of measures was announced. The required down payment for some second homes was brought down to 40 percent from 60 percent and the minimum down payment for first-home buyers using public housing funds was cut from 30 to 20 per cent. The Finance Ministry removed the 5.6 per cent sales tax on homes that had been owned for more than two years, reversing a policy introduced in 2011 to cool the “overheating” market.

But so far, banks have not passed on interest rate cuts and lower down-payment requirements to home buyers, and one survey has found that a majority of banks continue to charge rates above the benchmark level. Since they now have possibilities for higher returns from stock market investments given the current securities boom, they are less interested in pushing housing loans. It may well be that, with real estate accounting for 25 per cent of total lending (as shown in Chart 2) they are reluctant to increase their exposure further. Since they are also exposed to the shadow banking system of trusts and other entities that dominantly provide housing loans, this may in fact be prudent.



Source: IMF Global Financial Stability Report 2015, Chapter 1.

A different strategy is the proposal that has been mooted of converting unsold properties into "social housing" as part of its goal of providing millions of subsidised and affordable homes for people. Unsurprisingly, private real estate developers have been reluctant to participate in this plan, finding potential profits too low.

However, this set of policies may be missing the point. Further easing of banking regulations and providing more credit for housing may not be successful in reviving the housing market because of the basic and growing imbalance between real earning and prices of assets like houses. Indeed, trying to generate more housing debt is really kicking the can down the road in terms of hoping to create another credit-driven bubble. The more realistic and viable solution would be to resolve that basic imbalance, by encouraging wages and real earnings to increase so that housing become more affordable relative to current incomes.

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