Chinese Real Estate "Bubble"

By Sean Ahn

China's rapid development has led to massive construction projects across the country.

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It is a monstrous threat looming over the world economy, a real estate bubble ready to burst. It will be a financial shock sending economic tremors throughout the global economy. For almost a decade, these images have gradually permeated the minds of economists around the world, as real estate prices in China have soared higher and higher. What is interesting about these images and predictions is that homebuyers in China, middle-class and savvy as they may be, totally dismiss much of the world's warnings and keep on buying. Are the masses caught up in what world-renowned economist John Maynard Keynes would call animal spirits? Is there an irrational expectation of endless wealth resulting in a frenzy of real estate speculation? Or are the "conventional" economic models, designed to explain Western market behavior and capitalist financial systems, not fully capturing the Chinese phenomenon, and thus rendering the very notion of a Chinese real estate bubble irrelevant?

Origins and Causes

In the mid-2000s, the Chinese stock market plummeted, as the key index, a major indicator of the overall performance of the market, fell by more than 50%.[1] It was apparent that China's outdated financial sector could not (and some argue, still cannot) provide alternative investment venues for people with money in their hands. There is simply the bank or the real estate market. The government-owned banking system offers fixed interest rates below the inflation level, in order to offer cheap finance to the massive government-owned industrial sector. This may be good for the industrial sector, but it is bad for the individual depositor who hopes for high interest rates on his monetary accounts. Since the bank interest rate is below the annual inflation rate, which in China could be as high as 10% in a given year, any money deposit is depreciating, or losing value, rapidly. Thus, the collapse of the stock market forced people with savings to turn to buying real estate, which unlike a bank deposit will, at the very least, keep up with inflation. As a result, land and property prices doubled in those early years of the Chinese real estate boom, as a massive amount of money was reallocated to real estate. A second wave of price explosion (doubling or tripling, depending on location) started in early 2009, when the government put forth a 4 trillion Yuan ($635 billion) stimulus package in response to the global financial crisis. The stimulus mandated new lending and authorized new infrastructure projects (i.e. the world's most extensive bullet train network).[2] In economics terminology, this increase in government spending had a multiplying effect on output and income, which rippled through the economy and kept it red-hot. Eventually, the economic equilibrium moved to an even higher level of output and income. Simply put, the stimulus was a government overreaction that resulted in a frenzy of real estate buying. This frenzy has not exactly ended, but has rather been kept at bay by government restrictions on home ownership. Another round of frenzied purchases occurred in early 2013, when new leadership promised wage increases for the general work force.

A Deeper Look at Market Forces

While on the surface the Chinese phenomenon may have eerie similarities to the pre-2008 U.S. situation, with financial sector dysfunction and consumer over-optimism, there are significant underlying economic and social factors that make the Chinese situation rather different. As government decisions and faulty financial mechanisms were pushing money towards real estate, a 300 million strong Chinese middle class, the size of the entire U.S. population, was simultaneously emerging. The Chinese economy has been growing at an average of 8% a year over the past 3 decades. With such dizzying economic growth comes a hunger for consumption, and the number one goal of any Chinese family is to own a home. In addition, quick and massive rural-to-urban migration has generated a waitlist of eager real estate buyers.[3] In other words, much of what appears to be frenzied real estate speculation (in the context of advanced economies) is simply natural growth in a developing economy. This

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U.S. dollar and Chinese renminbi notes difference is important because natural growth has a sustainable foundation, while speculation is destined to collapse. To further clarify, we must take a closer look at the numbers.

By the Numbers

According to the 2012 IMF Global Stability Report, the house price to income ratio for Shanghai was 15.9 and 22.3 for Beijing, which is almost triple and quadruple the ratios for L.A. and New York, respectively (Figure 1).[4] Such numbers in a developed world economy would surely suggest the market is over-priced, but since China is an emerging economy growing at an unprecedented pace, long-term commodities, such as real estate, are managed in anticipation of future values. The economic growth rate in China for the past 30 years has been roughly 8% a year (15% in some regions). Wage increases between 1998-2010 were 13.8% (12.3% for 2011, 14% for 2012). Simply put, the high ratios for a unique case like China do not necessarily mean the market is overpriced.[5,6]

A concept to further consider is that real estate in China may naturally be worth more because of different cultural sentiments and consumer preferences. In China, home ownership is not only the center of the Chinese dream, but also the foundation of a family's sense of security. In fact, the prerequisite for most marriages in China is that the groom (sometimes with the bride's help) must purchase a home. People avoid renting at any cost, which leads to the next question.

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Is There A Bubble?

After all is said and done, the crucial question is whether the Chinese homeowner has the ability to pay back the loans he has taken out. Again, the situation in China is remarkably different from that of the U.S. before the 2008 meltdown. Firstly, Chinese banks have a stringent standard for loan applicants, and, depending on which category a borrower falls into, require a 30-50% down payment for a mortgage. Secondly, the ability of the buyer to pay back the mortgage is a key difference, though tough to measure quantitatively. Besides a high saving tendency, the Chinese household can also rely on a reservoir of extended family and friends who offer no-interest loans (grounded in personal trust and family relationships) and flat-out grants. This unique difference in the Chinese social structure, compared to most of the Western world, affects real economic outcomes and must be given its place in analysis models. An astounding 50% of the homes bought in China were paid in full with cash at the time of purchase.[7] Finally, as a last shield against financial collapse, the central banks have the backing of a determined government with the world's largest foreign currency reserve in U.S. dollars.

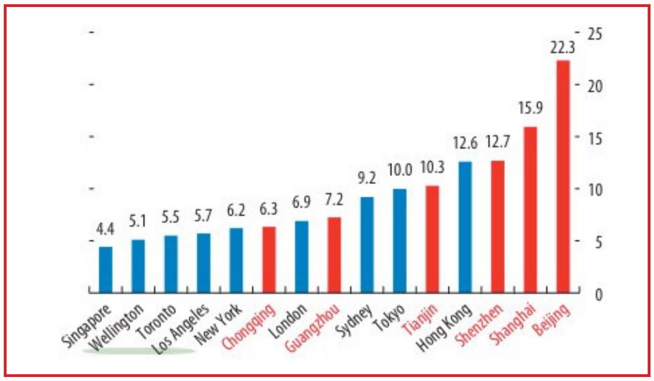

Figure 1: Ratio of House Price to Annual Household Income for Selected Cities, 2011

The World Bank has concluded that real estate price increases are supportable thanks to the rapid urbanization and income gains in

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China.[8] Nevertheless, this does not mean the Chinese market is healthy. As previously stated, the government-controlled banking system is dysfunctional. It provides fixed rates below the inflation rate that are geared towards providing cheap loans to state-owned industries. In the long term, the Chinese financial sector needs to be reformed to provide more transparency and investment products for money holders. Right now, the most effective action to take would be allowing interest rates to be more reflective of market forces. Setting loose interest rates would weaken real money demand, pulling money out of the real estate sector and back into banks, dramatically deflating real estate prices. The trade-off is that the massive, state-owned industrial firms would then have to fend for themselves in the broader market.

While on the surface the Chinese real estate boom has certain characteristics of a housing bubble, there are some crucial differences in the Chinese case that escape the conventional definition. Many key indicators are designed to interpret market and financial behaviors of a Western, capitalist society. China is neither Western nor a complete system of free market capitalism. Considering the relative sustainability of China's real estate market, a more likely scenario is a gradual deflation, as the government curbs inflationary pressures and GDP catches up over time, rather than a catastrophic collapse.

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Figure 1: International Monetary Fund. "Global Financial Stability Report, April, 2012: The Quest for Lasting Stability".
Image 3: http://static.panoramio.com/photos/large/4283203.jpg