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China's Real Estate Bubble

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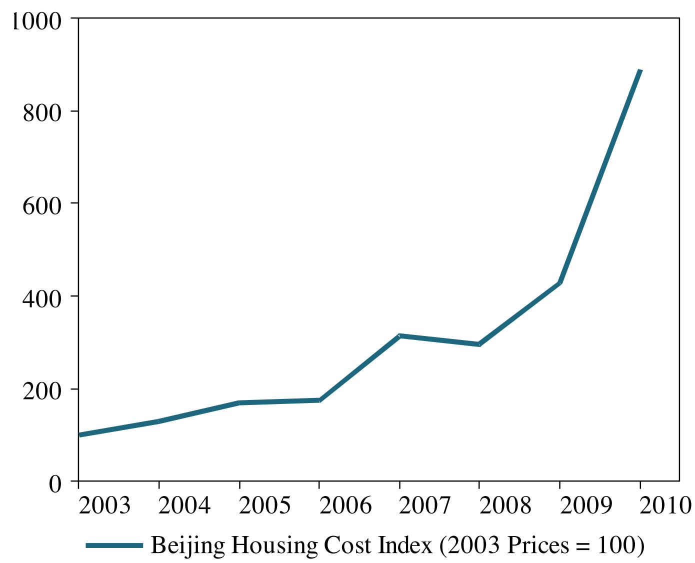
What will be the consequences of China's real estate bubble deflating? One is tempted to equate the Chinese real estate bubble with the U.S. experience, but the differences are striking and will likely lead to a very different, and a much more moderate, outcome.

The boom and bust of American real estate played a central role in the Great (and global) Recession. The collapse of the 2004-2007 bubble led to a widespread contraction in the financial sector. This contraction was largely due to balance sheet exposure of financial firms through the securitization of mortgages, and the dramatic increase in subprime lending during the final few years of the bubble. China has seen the rise of its own real estate bubble in recent years. Will China's banks experience a similar fate?

China's real estate bubble is now in the first stage of deflation. A recent report by Deng, Gyourko and Wu provides ample evidence to convince even the die-hard optimists of the reality of the bubble.[1] In Beijing, for example, between 2003 and the first quarter of 2010, real estate prices rose by 350% to 900%, depending on how one accounts for the changing attributes of real estate deals over this time period. (See figure.) Price appreciation accelerated in 2009 after the Chinese government embarked on a massive fiscal stimulus to counter falling demand for exports. (Relative to the size of the economy or government operations, the Chinese stimulus is much bigger than its U.S. counterpart.) The evidence for the role of government stimulus in inflating the bubble further appears convincing as well. In Beijing, for example, state owned enterprises (SOEs), have paid much higher prices (by 27%) for equivalent residential land than have private developers.

[1] Deng, Yongheng, Joseph Gyourko, and Jing Wu (July 28, 2010) Just how risky are China's housing markets? VoxEU: http://www.voxeu.org/index.php?q=node/5353.

Other indicators of a real estate bubble, like price-to-rent ratios or price-to-income ratios, are also sounding an alarm. In eight major Chinese cities for which the authors have data, these ratios have gone up between 50% and 200%. In the last few months, however, demand for housing has dropped precipitously—by 42% in Shanghai in the first seven months of 2010—although prices have only declined moderately. Many analysts now predict a price collapse of between 20% and 60% in the urban housing markets that have increased the most. This sequence of events, declining volume of sales followed by a lagged decline in prices, is not unlike the sequence of events in the U.S. bubble, where the market slowed down significantly with prices starting to drop appreciably only a year later.



BEIJING HOUSING COST INDEX

What will be the consequences of China's real estate bubble deflating? One is tempted to equate the Chinese real estate bubble with the U.S. experience, but the differences between the Chinese and American real-estate and financial sectors are striking and will likely lead to a very different, and a much more moderate, outcome.

To begin with, until the last 4-5 years most residential properties in China were bought with cash; therefore nobody, except the new owners of these units, was exposed to the risk of prices falling. Even in the last few years with the spread of (fixed rate) residential mortgages, the down payments required in order to buy a property have been significantly higher than in the U.S. and in most other industrialized countries. Even a 20-30% decline in prices is unlikely to generate "underwater" mortgages, defaults, foreclosures, and bankruptcies as in the U.S. case.

An aggressive relaxation of constraints on the housing market was implemented in early 2009 as part of the Chinese stimulus package (the idea was to counter the large drop in the external demand for Chinese exports by increasing internal demand for goods and services), but these were quickly reversed once the bubble became apparent to policymakers. The Chinese government has undertaken a set of policies to attempt to deflate the bubble gradually, or at least stop it from inflating further. Furthermore, unlike the United States recently, or Japan in the late 1980s, China is still a poor country in per-capita terms with high growth rates and a rapidly urbanizing population. Roughly 15 million people move into the cities each year in what is often described as the largest internal migration in human history. Continuing growth in demand for urban housing is likely to limit the housing price declines that one can expect in coming years.

Commercial property developers are admittedly more debt-exposed, as are the developers of large residential projects. Many of these developers, however, are local governments or state owned enterprises, a situation dramatically different from the United States. Ironically, in the U.S. the deflation of the real estate bubble led to semi-nationalizations and bailouts of a number of financial institutions that had heavy exposure to real estate mortgages or mortgage backed securities. In China, many of these institutions are already state-owned, and have lent money to the state owned enterprises, following instructions from the state, rather than because of a mistaken assessment of the health of the real estate sector.

The participation of local government in the real estate sector gave rise to a conflict of interest between the local and central government; while the central government was deeply worried about the housing bubble, local government was profiting from it. This tension is unlikely to disappear, but one suspects that in this battle, like in many others, the central government will prevail and measures to address the bubble will be enforced.

Stress tests conducted on Chinese banks appear to confirm their relative stability. In the tests a 30% decline in home prices had only modest effects on banks' balance sheets; for example, a 1.2 percentage points increase in the ratio of non-performing loans to all loans outstanding. Moreover, not only are Chinese banks not as heavily exposed to the real estate sector as were American banks in 2007, the direct impact of a slowdown in the housing sector is likely to be smaller given the smaller share of this sector in China's GDP.

In short, while doomsayers certainly exist, the evidence suggests that a deflation of the Chinese real estate market is unlikely to generate the dramatic financial market and economic fallout that we have painfully experienced all too recently here in the United States.

—Ilan Noy, Ph.D.

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