

On the Recent Rise in China's Real Estate Prices

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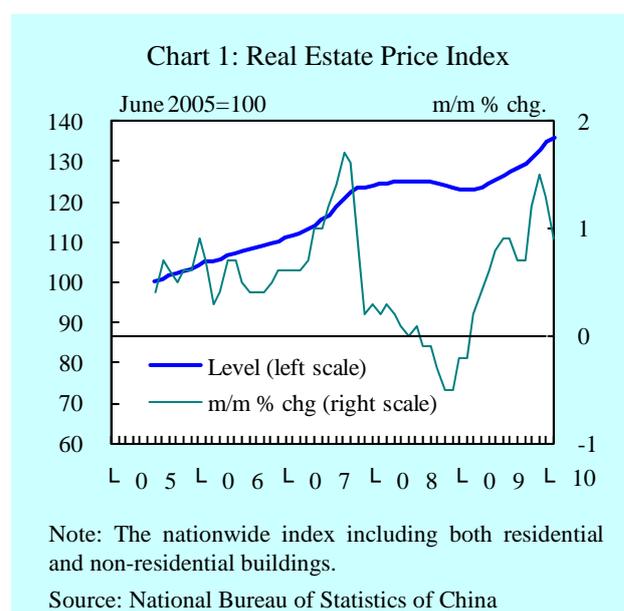
Real estate prices in China have recently risen sharply, especially in urban areas, and the Chinese government has implemented a series of measures to prevent the property market from overheating. In terms of the genuine demand for property and the levels of leverage in the private sector, the current situation in China's real estate market resembles that of Japan in the early 1970s, when property prices surged dramatically due to "the plan for remodeling the Japanese archipelago." Although real estate prices in Japan dropped after the first oil crisis, they soon resumed an upward trend. The upward trend of real estate prices was supported by the strong housing demand accompanying urbanization, and the fact that there was no significant pressure of balance sheet adjustment since the leverage levels of both the household and corporate sectors were quite low. Since China today is characterized by the same two factors, it could be argued that if there should be a downward adjustment in China's property market in the future, it would not be as severe as the bursting of the bubble in Japan in the 1990s. However, there are some factors in China that did not exist in Japan in the early 1970s that could lead to overheating in the property market, such as local governments' strong incentive for real estate development and the influx of speculative money from overseas. It is worth monitoring how these factors and government measures influence China's real estate market.

1. Introduction

Real estate prices in China, especially in urban areas, have recently shown a marked rise. The nationwide real estate price index declined from the summer of 2008 to the beginning of 2009 due to the preceding property boom and the abrupt slowdown of the Chinese economy hit by the global financial crisis, but then resumed its rise and the rise accelerated in late 2009 and early 2010. Real estate prices have already exceeded their previous record-highs reached during the property boom from 2007 to 2008 (Chart 1).

The recent surge in real estate prices has led to increasing concerns over the possible effects of adjustments in the property market. The Chinese government this year has introduced a series of measures to prevent the property market from

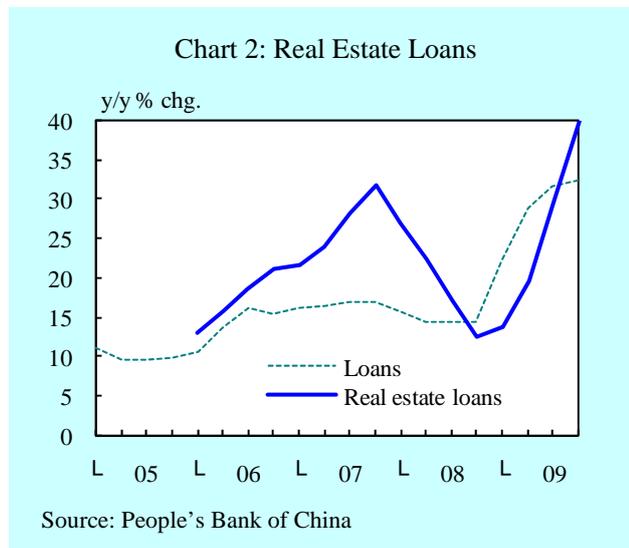
overheating, such as raising the required reserve ratios as well as intensifying "window guidance" on financial institutions that sharply increased lending.



In this paper, we first provide an overview of the recent real estate market in China. We then discuss how severe potential adjustments in China's property market could be by comparing the current situation in China with the Japanese economy during past periods when property prices surged. Lastly we suggest key factors for preventing overheating in China's real estate market and for achieving sustained economic growth of the Chinese economy.

2. Recent Developments in China's Real Estate Market

In response to the global financial crisis that peaked in the fall of 2008, the Chinese authorities lowered the policy interest rate several times, lifted quotas on annual lending by commercial banks, and promoted loans. As a result, bank lending surged from the end of 2008, financing infrastructure projects within the RMB 4 trillion economic stimulus package (Chart 2).

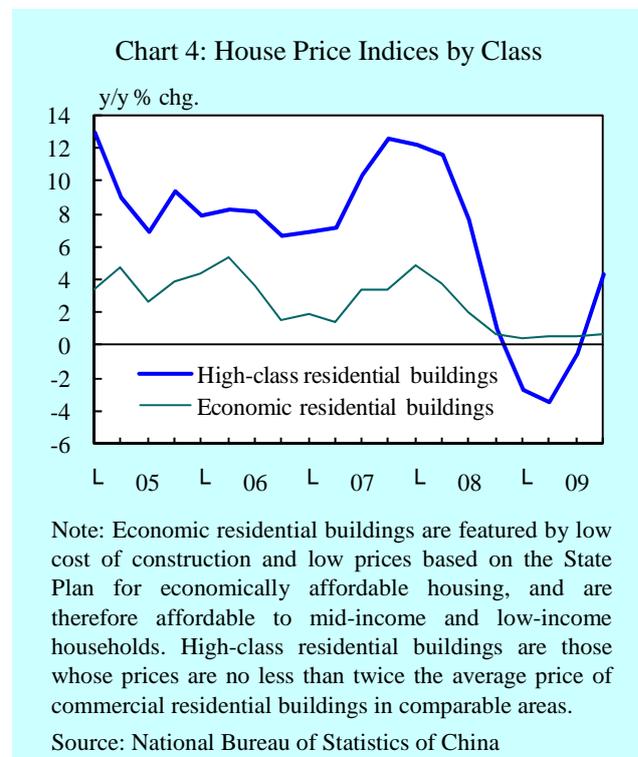
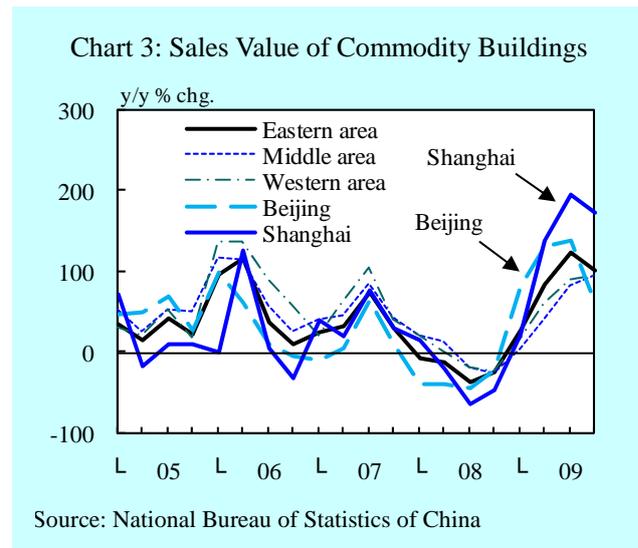


Meanwhile, the year-on-year growth rate of real estate loans kept declining from the fall of 2007 to 2008 partly due to window guidance by the authorities. However, in 2009, especially toward the end of the year, the growth of real estate loans accelerated and surpassed the growth rate of total bank loans, backed by the highly accommodative monetary environment.

Real estate sales have rapidly increased as well. The eastern area, including large cities such as

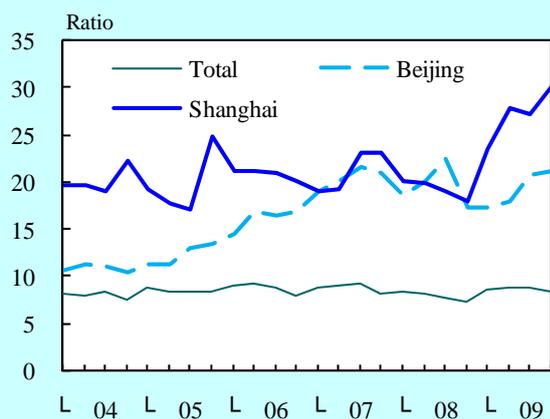
Shanghai and Beijing, has shown the strongest increase in sales, followed by the Middle and Western areas, where property sales have accelerated more recently (Chart 3).

The house price indices by class show that the prices of high-class residential buildings sharply rose toward the end of 2009 while the prices of economic residential buildings under state control remained stable (Chart 4).



As a result, house prices at the higher end of the market have risen to a level that is unaffordable for average local citizens. In Beijing and Shanghai, for instance, average house prices have reached as high

Chart 5: House Price to Income Ratio



Note: (Average house price in each area)/(disposable income per household in each area).

Source: National Bureau of Statistics of China

as 20 to 30 times the annual income per household; in Shanghai, the ratio of house prices to income shot up during 2009¹ (Chart 5). Given the fact that real estate speculation tends to target high-class property, the recent surge in property prices in China may have been partly supported by speculative demand based on expectations of higher prices in the future.

In response, the Chinese authorities have introduced a series of measures to prevent the property market from overheating, especially since the beginning of this year; the measures taken so far include raising the reserve requirement ratio, intensifying window guidance on bank lending, and

raising the minimum down-payment requirements on second houses².

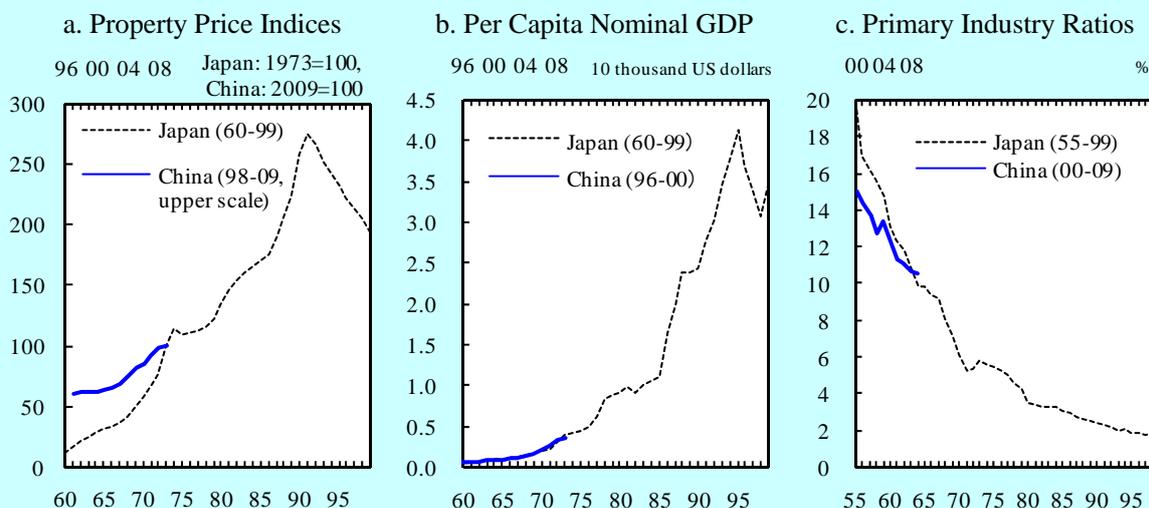
3. Assessing the Possibility of Adjustments in the Real Estate Market: Comparison with the Periods of Rising Property Prices in Japan

In this section, we examine how severe an adjustment in China's property market could be in the future by comparing the current situation in China with the past periods in Japan, when real estate prices were rising significantly.

The data show that Japan experienced a marked rise in property prices from the late 1960s to the early 1970s, and also in the late 1980s (Chart 6-a). These two periods of surging property prices differ significantly in terms of the adjustments that ensued. Regarding the former period, real estate prices peaked in 1973, dropped in 1974 due to the first oil crisis, but then quickly resumed an upward trend. On the other hand, the major surge in real estate prices in the late 1980s that peaked in 1990 was followed by a large and prolonged decline in property prices throughout the 1990s.

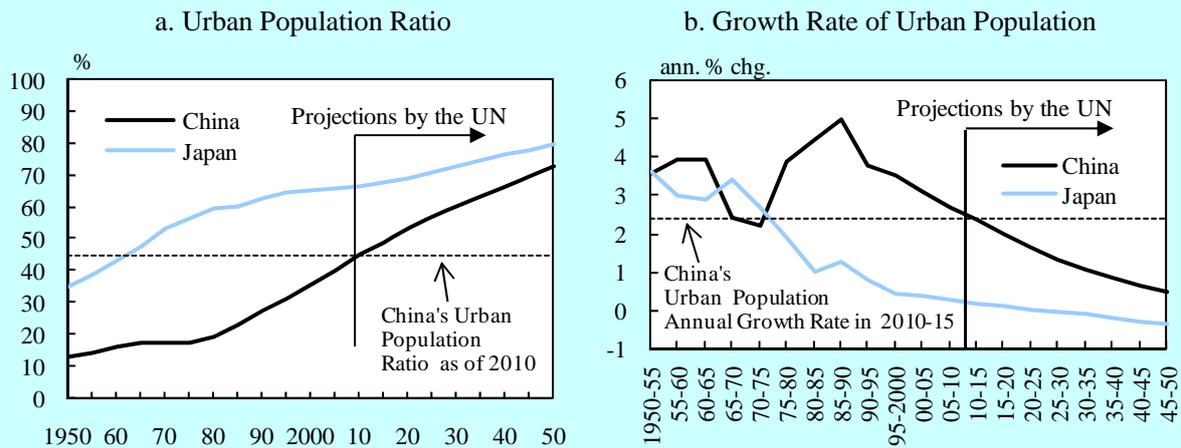
The major difference in the length and depth of adjustment can be accounted for by the difference in the stage of economic development between the two periods. In the early 1970s, though the

Chart 6: Comparison with the Period of Rising Property Prices in Japan



Sources: Cabinet Office (Government of Japan), Japan Real Estate Institute, National Bureau of Statistics of China

Chart 7: Urbanization



Source: United Nations “World Urbanization Prospects: The 2007 Revision Population Database”

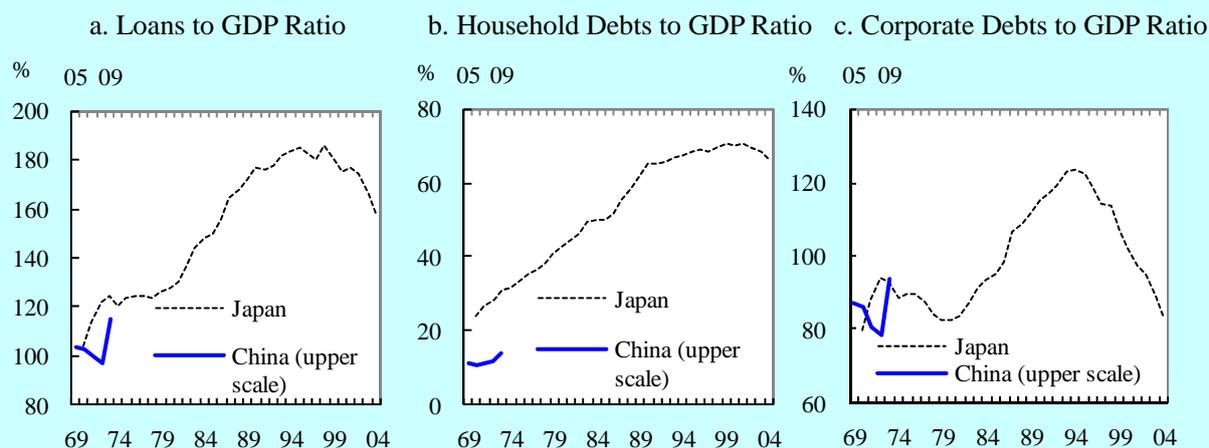
Japanese economy was shifting from the high growth era to an era of relatively stable growth, it still enjoyed a high potential growth rate; there existed a natural upward pressure on property prices with urbanization and upgrading of industrial structures under way along the lines of “the plan for remodeling the Japanese archipelago.” In contrast, in the late 1980s, urbanization and advancement of industrial structure slowed down; without the high potential growth of the past, the ensuing property market adjustment was significant and lasted over a prolonged period. A comparison of the two periods suggests that the length and depth of adjustment that follows overheating in the property market depend on the stage of economic development.

The natural temptation is to compare the current stage of economic development in China to that of Japan in the past. China’s per capita nominal GDP in 2009 was about 3,500 US dollars, which is closest to the level of 1973 (about 3,800 US dollars) in Japan (Chart 6-b). In terms of the real GDP growth rate, China’s average growth rate in the past 10 years (2000–2009) is 9.9%, comparable to that of Japan in the 10 years ending in 1973 (1964–1973, 9.3%). Concerning advancement of the industrial structure, the ratio of primary industry to the nominal GDP in China stood at about 11% in 2008, around the same level as that in Japan in the mid 1960s (Chart 6-c). The urban population ratio in

China (about 45%) compares to that of Japan at the beginning of the 1960s (Chart 7-a). Although we should refrain from simply comparing the two economies, based on the aforementioned indicators as a whole, which suggest that China is likely to be currently at the stage of economic development where Japan was during or before the early 1970s, it would be fair to judge that its economic growth potential is still quite high.

Especially, it is worth noting that genuine demand for housing accompanying urbanization seems to have contributed a great deal to the recent rise in China’s property prices. China’s urban population ratio (currently about 45%) is expected to continue to grow rapidly in the long term (Chart 7-a). Just as the massive migration from agricultural areas to large cities resulted in strong genuine demand for housing during the high economic growth period in Japan, the rapid urbanization in China has helped push up property prices through creating genuine residential demand. By comparison, the annual growth rate in the urban population of Japan in the late 1980s was no higher than 1% on average, indicating that urbanization had already reached a mature stage. Hence, the period of Japan’s asset price bubble in the 1980s should be distinguished from the early 1970s in Japan or the current situation in China because Japan in the 1980s lacked large genuine demand for housing accompanying urbanization.

Chart 8: Levels of Leverage in China and Japan



Sources: Bank of Japan, Cabinet Office (Gov. of Japan), People's Bank of China, National Bureau of Statistics of China

Finally, leverage levels of debtors, or debt financing ratios, should also be examined in assessing the severity of a possible adjustment of the property market. It is clear from the examples of the Japanese asset price bubble in the 1980s or the current situation in the US and Europe after the financial crisis, that a significant rise in the leverage levels in the corporate or household sector might deepen the ensuing adjustment in the property market with the debt service burden forcing corporations and households to cut back on expenditure.

In this regard, the leverage level of debtors in China measured as the ratio of loans to nominal GDP currently stands at 110–120%. This is close to the leverage level of Japan in the early 1970s and is lower than that of Japan since the late 1980s, when the ratio peaked at over 180% (Chart 8). The ratio of household debt to nominal GDP in China is just below 20%, less than one third the leverage level of the household sector in Japan since the late 1980s³.

On the other hand, the leverage level of China's corporate sector, measured as the ratio of corporate debts to nominal GDP, has recently risen due to the massive increase in bank lending during 2009. However, in comparison with the past periods in Japan, corporate leverage in China is approximately the same as in Japan in the early 1970s and is still lower than that of Japan in the 1980s when the leverage level rose steeply. In the late 1980s,

companies in Japan took out bank loans on a massive scale, resulting in prolonged debt overhangs and retrenchment in investment expenditure after the bubble burst. In China, in contrast, the proportion of corporations that finance investment by retained earnings⁴ is relatively high, especially among large corporations, and thus the leverage level of China's corporate sector is lower than that during past asset price bubbles in Japan⁵. This means that pressure to reduce debts remains relatively low in China's corporate sector.

4. Factors that Could Fuel Overheating in China's Real Estate Market

The aforementioned factors such as the high economic growth potential and the low levels of leverage in China may suggest that any downward adjustment in China's property market is unlikely to be as severe as the bursting of the bubble in Japan in the 1990s. However, there are some factors in China that did not exist in Japan in the early 1970s and could cause the property market to overheat.

First, local governments have a strong incentive to develop real estate. Ever since the fiscal recentralization in 1994, in which the revenue-sharing rule between the central and local governments was changed, local governments in China, especially governments below the county level, have suffered structural revenue shortfalls. Real estate development has recently served as an

important source of revenue to offset this shortfall.

Within the total fiscal revenue of RMB 3,258 billion of local governments' budget in 2009, tax revenues from real estate accounted for RMB 481 billion, or about 15%. However, the amount of local governments' revenues from real estate is far greater if revenues outside the budget are included. Local governments typically earn income through real estate development by expropriating land from farmers at around the agricultural productive value of the land and then selling it to either real estate developers or the so-called "urban development investment vehicles" that local governments themselves invest in⁶. Real estate related revenues including those raised through land transfers amounted to RMB 1,396 billion (a year-on-year increase of 35%) in 2009; including such revenues outside the budget, real estate related income is estimated to account for as much as 40% of the total revenues of local governments.

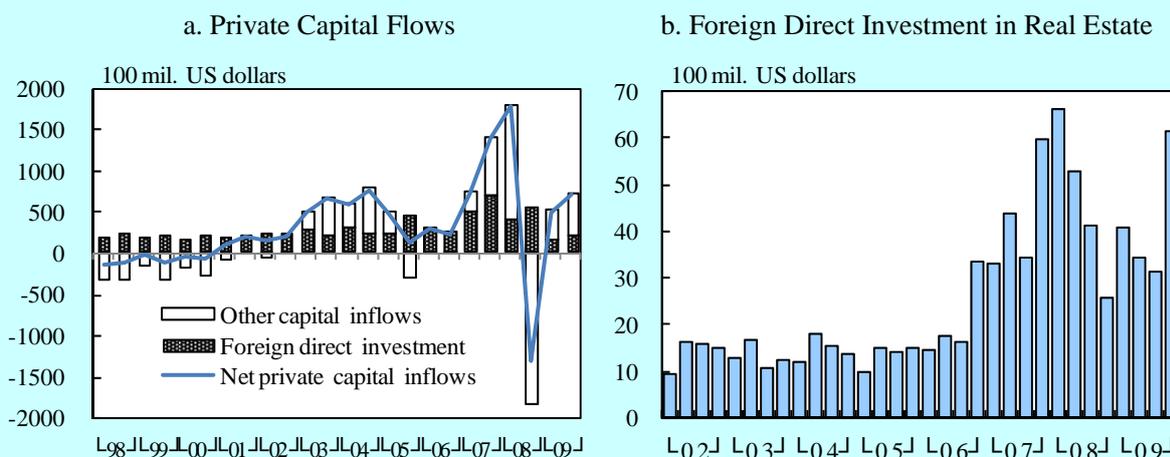
Given such revenue structures, local governments tend to welcome active transactions in the property market; local governments thus have an incentive to promote real estate development by companies and lending to the real estate sector by local commercial banks. Hence, the central government's measures to prevent the property market from overheating such

as window guidance on banks to curb lending might not be as effective as intended because of the difference in incentives between the central and local governments.

The second factor is the influx of funds from overseas. The Chinese government imposes relatively strict restrictions on capital transactions between China and overseas. Still, the volume and volatility of private capital flows have increased due to the greater integration of the Chinese economy into the global economy and the gradual relaxation of capital controls in recent years. In particular, speculative "hot money" from overseas that is not under the control of the authorities has flowed into China's domestic markets bypassing capital regulations as short-term funds. Though China recorded a net private capital outflow in the latter half of 2008 when the global financial crisis hit its peak, it soon returned to a net capital inflow in 2009, and the inflow increased toward the latter half of 2009. The highly volatile "other capital inflows," which exclude foreign direct investment, are considered to include this hot money (Chart 9-a)⁷. In addition, foreign direct investment in China's real estate sector also increased toward the end of 2009 (Chart 9-b).

This influx of funds from overseas has to some

Chart 9: Inflow of Foreign Funds into China's Asset Markets



Note: "Other capital inflows" are calculated as (change in foreign reserves) – (current account balance) – (foreign direct investment). "Net private capital inflows" are calculated as the sum of foreign direct investment and other capital flows.

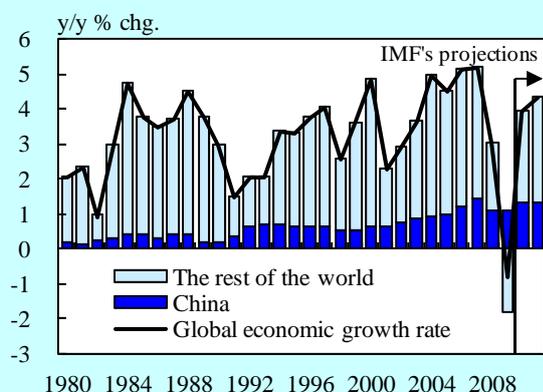
Sources: China's State Administration of Foreign Exchange, People's Bank of China, Ministry of Commerce of the People's Republic of China

extent helped to drive up China's real estate market. In spite of the current relatively strict capital controls, the speed of inflows and outflows of foreign speculative funds has been increasing. Once investor sentiment turns bearish about China's real estate market, a sudden capital outflow could exacerbate the adjustment.

5. Conclusions: the Increasing Presence of China in the Global Economy

In recent years, China has increasingly become the main driver of global economic growth. The contribution of the Chinese economy to world economic growth has steadily risen, overtaking the United States in 2007 to become the largest in the world (Chart 10). Thus, a major economic fluctuation in China triggered, for instance, by a correction in asset markets, could have a significant impact on the global economy.

Chart 10: China's Contribution to World Economic Growth



Note: The IMF's projections for 2010 and 2011 are based on the WEO Update, January 2010.

Source: IMF "World Economic Outlook"

Although land prices in Japan soon started to climb again after dropping in the 1970s, the growth rate of the Japanese economy plunged due to the first oil crisis, recording a negative growth rate in 1974 in a stark contrast with the 8% growth in 1973. Even when the economy has high growth potential and adjustment in asset prices is limited, the possibility of major economic fluctuations cannot be ruled out.

The healthy development of asset markets in

China and stable growth of the Chinese economy are key to maintaining the momentum of the global economic recovery. Policy measures by the Chinese authorities deserve close attention.

¹ House price to income ratios could rise when transactions of a relatively small number of wealthy home buyers drive up house prices. The large income disparities in large cities such as Beijing and Shanghai would partly explain why house prices are especially high relative to residents' income levels in urban areas.

² In addition, China reintroduced a nationwide real estate sales tax in December 2009; the new tax policy requires anyone selling a second-hand apartment or house within five years of its purchase to pay a sales tax, extending the taxable period from the previous two years.

³ According to research on real-estate buyers conducted last year by the Index Research Institute of China and SouFun, about 60% of respondents said they were "self-financed" (i.e., no loan from a bank).

⁴ Louis Kuijs (2006), an economist at the World Bank, argues that "enterprise saving has risen substantially since the end-1990s as profitability has improved, and almost 3/4th of enterprise investment is financed by retained earnings." ("How will China's saving-investment balance evolve?" World Bank Policy Research Working Paper No. 3958.)

⁵ In the late 1980s, Japanese companies also issued a large amount of corporate bonds while the amount of corporate bonds issued in China is still quite limited compared to bank lending. The difference in the levels of leverage in the current Chinese economy and the Japanese economy in the 1980s would be even larger if we were to take this into consideration.

⁶ In China, so-called "urban development investment vehicles" financed by local governments often take charge of infrastructure investment or real estate development, raising funds through bank loans, bond issuance, or joint capital investment with private firms. This makes it possible to implement fixed asset investments highly leveraged against limited public funds. While the complete picture of urban development investment vehicles is unclear, Caijing, one of China's economic magazines, for instance, reported in its November 23, 2009 issue as follows: "the number of urban development investment vehicles established by local governments of different layers such as provinces, cities and provinces has exceeded 8,000 across the country, with loans outstanding to the vehicles of over RMB 6 trillion, of which nearly RMB 5 trillion is intended to fund fixed asset investment."

⁷ A detailed discussion of "hot money" can be found in Yosuke Tsuyuguchi (2009) "The recent flow of "hot money" in China," *Bank of Japan Review*, July 2009. In calculating changes in foreign reserves in Chart 9-a, we adjusted foreign currency swap transactions between the central bank and commercial banks, reserve deposits by commercial banks made in foreign currencies, capital injections to the Sovereign Wealth Fund (CIC) from foreign reserves, and capital injections into state-owned commercial banks.

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