



Economic Letter

China's Sputtering Housing Boom Poses Broad Economic Challenge

by Janet Koech and Jian Wang

ABSTRACT: China's economic slowdown and changing demographics cloud its housing market's long-term prospects. While urbanization and a lack of alternative investment opportunities provide short-run support, the housing sector's difficulties imperil China's financial sector and the global recovery.

After a 20-year boom, signs abound of a cooling Chinese housing market. New-home prices fell in 35 of 70 cities the government tracked in the second quarter, compared with declines in only three cities in the first quarter. The biggest second-quarter drop occurred in Hangzhou, a popular tourist destination close to Shanghai, where prices fell 1.6 percent.¹

The slowing housing market is worrisome for both the Chinese and the global economies. China has experienced double-digit economic growth over the past three decades, becoming the world's second-largest economy. Its real estate sector, which accounts for about 20 percent of gross domestic product (GDP) growth, has become a particularly significant driver of economic development over the past 10 years. The impact of a sudden deceleration of this sector would extend well beyond China.

Amid warnings from government officials and some economists of a housing bubble, many in China remain optimistic and point to several factors to justify still buoyant prices.² Real estate prosperity is built on China's unprecedented industrialization, increased urbanization, rising personal income and wealth creation as well as limited domestic investment opportunities and a widely held desire to own property.

Still, as Chinese economic growth slows over the longer term and its young population demographic shrinks, the housing market's prospects do not seem as promising. Recent broad-based price declines have sparked discussion that the housing market has peaked, giving rise to the possibility of severe economic and social consequences.

China's Property Sector

China's housing market has a fairly short history. The government first allowed private purchase of residential property in the 1990s, and by 2004, nearly all residential property was sold in private markets rather than through government allocation, as it was previously. Now, close to 90 percent of Chinese families live in their own homes, according to a study by China's Southwestern University of Finance and Economics. The rate is significantly higher than the world average of 63 percent.³

As privatization took hold, home prices increased substantially. Average house prices in 2014 are triple what they were in 2000, having risen at an annual growth rate of 8 percent for more than 10 years. The rapid appreciation was largely led by increases in big cities such as Beijing and Shanghai, where prices of residential buildings more than quadrupled, expanding at an annual average rate of about 13 percent.

Soaring house prices are not unusual for a rapidly expanding economy—similar increases occurred in Japan and South Korea in the 1990s. China's robust overall growth in the past two decades has lifted overall income levels, especially for urban dwellers. Per capita urban nominal disposable income has increased almost five times to over 24,000 yuan in 2012 from slightly under 5,000 yuan in the 1990s (*Chart 1*). Thus, rising household wealth may support higher home prices.

However, income increases in many regions have not kept pace with house prices, diminishing affordability. House prices in urban areas are roughly 11 times annual disposable income; in large cities such as Beijing and Shanghai, the price-to-income ratio is as high as 20-to-1.⁴ By comparison, Tokyo's house prices were 15 times income when the Japanese housing bubble burst in 1990, while U.S. house prices were about six times income levels before the 2007 housing crisis.

Urbanization and Cultural Demands

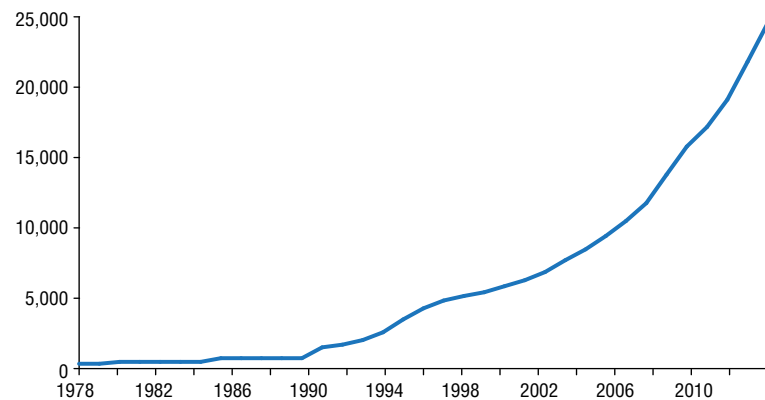
Urbanization, culture and a lack of alternative investment opportunities are often cited as factors that support China's house prices.⁵ China has rapidly urbanized over the last three decades, contributing to its robust economic growth and transformation. More than 400 million people have moved from rural to urban areas since 1990, pushing up the urban population share to 54 percent in 2013 from just over 26 percent (*Chart 2*). This has increased demand for urban housing, pulling up prices. The World Bank estimates that 250 million more people will relocate to urban centers over the next two decades, further supporting demand.

The cultural view that homeownership is a necessity and not a privilege or luxury has helped to sustain demand and support prices. Homeownership conveys benefits such as better education for children and improved marriage prospects for males—especially in a country with a male-skewed gender ratio among the young that enhances competition for prospective brides.⁶

Additionally, Chinese households have few options for where to store their savings, further enhancing the value of houses and other real estate. China's state-dominated banking system offers poor returns on sav-

Chart 1 Chinese Urban Household Disposable Income Has Increased Substantially

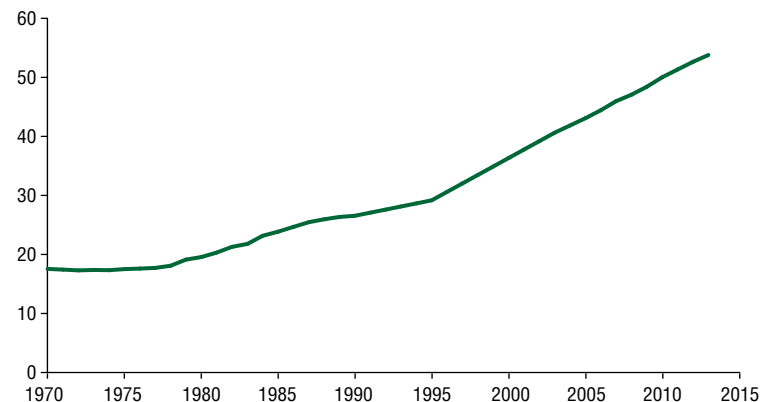
Per capita urban disposable income (yuan)



SOURCES: China National Bureau of Statistics; Haver Analytics.

Chart 2 China's Urban Population Growing Rapidly

Urban population as a share of total population (percent)



SOURCES: China National Bureau of Statistics; Haver Analytics.

ings, at rates barely above inflation. Wildly swinging equity prices have scared away many ordinary investors from the stock market. The Shanghai stock index rose to about 6,000 in 2007 from 1,000 in 2005, and then tumbled to less than 2,000 within a year. Since the crash, investors have avoided the stock market, and the index remains far below its precrisis level. Moreover, ordinary Chinese confront capital controls that make investments abroad difficult.

Demographics and the Economy

Despite the favorable demand factors supporting the property market, the long-term outlook may not be as rosy as many Chinese believe. Changing demographics will adversely affect future housing

demand and prices. China's population is aging quickly, mostly because of the one-child policy implemented over the last 30 years. The percentage of the population above age 65 increased to 9 percent in 2013 from 7 percent in 2000 and is expected to further rise.

By comparison, young people (those age 24 and under) account for 41 percent of the Chinese population, down 8 percentage points from a decade ago. This sharp decline indicates reduced future demand for housing as fewer families will be formed (*Chart 3*). Indeed, China's birth rate peaked in 1987, and because people usually marry when they are between 25 and 30 years old, household formation may have topped out in the last decade.

China's economic slowdown poses an additional risk to sustained house price increases. The country's long-run economic expansion is expected to ease as the export- and investment-driven growth model of the last 30 years runs its course. Household income growth will decline as the economy slows and will fail to sustain the current pace of house price appreciation. Just as housing booms in Japan and South Korea burst during the Asian financial crisis of the late 1990s, China faces the risk of a similar occurrence.

Recent Housing Weakness

The housing market softened in recent months, as prices declined during July in 74 cities out of the 100 that China's Index Academy tracks; more than half recorded declines for three consecutive months. Corrections in some places were deep. Home prices in Wenzhou, a city famous for private entrepreneurship in China, have declined 35 percent since January 2012 (Chart 4).

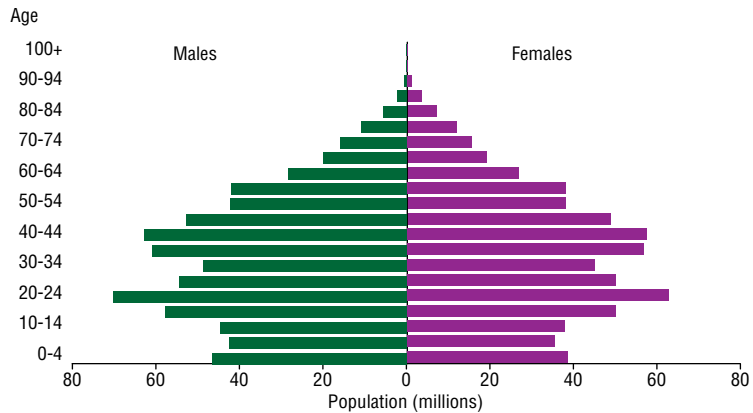
The property price weakness has been preceded by sharp declines in real estate sales and investment. A similar pattern of decreasing home sales, investment and prices was observed in the U.S. and other countries before their housing bubbles burst, raising concerns about the future of China's housing market.

A 4-trillion-yuan economic stimulus plan in 2009 successfully cushioned China's economy after its export trade experienced a freefall during the global financial crisis. However, the stimulus also further inflated already-red-hot house prices and ignited another round of infrastructure and real estate investment. When real estate sales slowed at the beginning of 2014, the inventory of newly built apartments piled up and real estate investment softened. An easing was also evident in vacant commercial and residential floor space, which almost tripled following four years of sharply higher real estate investment (Chart 5).

Far-Reaching Impacts

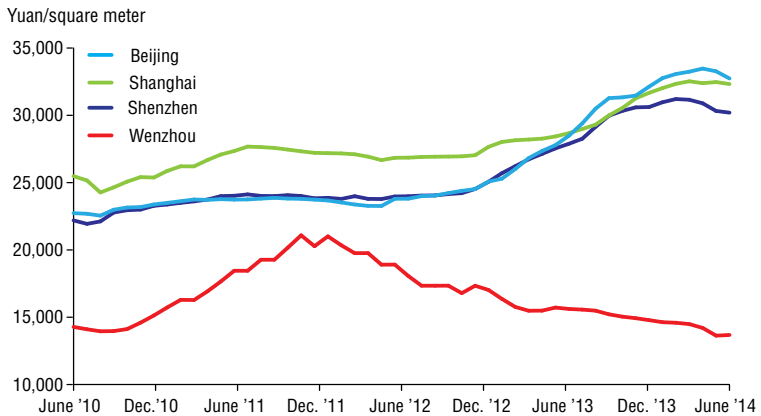
A China housing market slowdown seems inevitable. As a result, real estate investment will grow at a slower pace, dimming the country's short-term growth prospects and immediately impacting several related industrial and service sectors.

Chart 3 China's Decreasing Young Population Poses Risk for Housing Demand



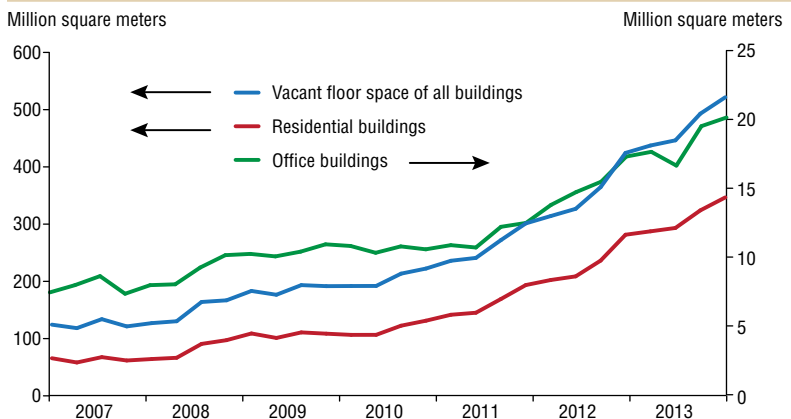
NOTE: Data are for 2010, the latest available.
SOURCE: United Nations' *World Population Prospects* data.

Chart 4 House Prices Decline in Most Cities; Wenzhou Experiences Sharp Drop



SOURCES: China Index Academy/Soufun; Haver Analytics.

Chart 5 Chinese Real Estate Inventories Increase Sharply



SOURCES: China National Bureau of Statistics; Haver Analytics.

More importantly, a softening real estate market carries risks for China's financial market. The shadow banking sector has grown rapidly in the last few years and is now estimated to account for 25–30 percent of total credit in China.

Shadow banking broadly refers to credit other than through loans reported on banks' balance sheets. In China, this includes commercial banks' off-balance-sheet wealth-management products that are used as a means of circumventing restrictions on lending, and credit by nonbank financial institutions including trust companies and brokerage firms. A large fraction of shadow bank lending is provided to real estate developers and to government-sponsored infrastructure construction. Some of the borrowing is particularly speculative—for example, local governments pledging anticipated revenue from future land development as collateral.⁷

Sharp housing price corrections may trigger panic runs on the shadow banking sector. Although China is not expected to go through a large-scale financial crisis like the U.S. did, collapsing housing market and shadow banking sectors will adversely impact China's economic growth. Local businesses, especially privately owned enterprises that have historically been unable to obtain credit from state-owned banks and have relied on shadow banks, could become particularly vulnerable.

Moreover, such tumult may throw the world's second-largest economy into a deep recession and pose downside risks to the global economy.

China has become more integrated into the global economy through trade and investment. Its total trade now accounts for about 50 percent of its GDP, and it attracted \$117.6 billion in foreign direct investment in 2013. The linkages with Asia-Pacific economies are particularly strong, and a China slowdown would affect trading and financial partners.

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Notes

¹ Reported data are from China's National Bureau of Statistics. Prices of existing residential homes fell in 40 cities in second quarter 2014.

² Economists who have warned of a housing bubble in China include Robert Shiller, a Nobel Prize laureate and professor at Yale University, and Kenneth Rogoff, a Harvard University professor of economics.

³ See "Findings from China's Household Finance Survey," by Li Gan, Southwestern University of Finance and Economics and Texas A&M University, January 2013.

⁴ In 2012, the average house price in 100 cities tracked by the China Index Academy was 9,628 yuan per square meter (\$145 per square foot), 23,822 yuan (\$357) for Beijing, and 26,959 (\$404) in Shanghai. In the same year, the average urban disposable income per capita was 24,565 yuan nationwide, 36,469 yuan in Beijing and 40,188 yuan in Shanghai. Assuming living space per person of about 30 square meters (323 square feet), the ratio of house price to disposable income would be 11.8 for urban dwellers, 19.6 for Beijing and 20.1 in Shanghai.

⁵ Other factors that contribute to China's rising house prices include a relaxation of credit standards—partly

due to the shadow banking system—and an increase in the savings rate. See "What Drives Housing Dynamics in China? A Sign Restrictions VAR Approach," by Timothy Yang Bian and Pedro Gete, working paper, January 2014.

⁶ For additional details, see "Status Competition and Housing Prices," by Shang-Jin Wei, Xiaobo Zhang and Yin Liu, National Bureau of Economic Research, NBER Working Paper no. 18000, April 2012.

⁷ Wealth management products have been a major source of funding for real estate and infrastructure construction, with issuance estimated at 7.6 trillion yuan (approximately \$1.24 trillion) at year-end 2012. See "Chinese Shadow Banking: Understanding KRIs and Risk Scenarios," by Thomson Reuters, January 2014.

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