Deflating China's housing bubble

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By Emily Kaiser, Asia Economics Correspondent

REUTERS - Unlike in the United States, Chinese home buyers typically put down at least 40 percent of the purchase price. That means they don't have to worry about a modest decline wiping out all their equity, and banks have little reason to fear an influx of "jingle mail" from defaulting homeowners returning the keys.

Household debt amounts to less than 20 percent of China's gross domestic product, according to the International Monetary Fund, one fifth of the U.S. ratio.

"In the United States, housing was a borrowing vehicle for households. In China, it's a savings vehicle," said Stephen Green, an economist with Standard Chartered in Hong Kong.

This is a vital distinction. It was leverage that turned the U.S. housing slump into a global financial crisis. That suggests even if China's housing market suffers a similar slide, the economic consequences would be far less severe.

That doesn't mean it would be painless.

There are a couple of trouble spots. China's new home sales have fallen sharply in some cities, putting property developers in greater danger of default. Local governments counting on land sales to help repay $1.5 trillion in loans may find the money flow slows, saddling banks with bad debts.

But Beijing appears to be ready, willing and able to limit the economic fallout. Over the past 18 months, China has clamped down on property speculators to try to cool prices.

If it stays on that course, China could become one of the few countries to successfully deflate a property bubble before it bursts. If there is a global recession, all bets are off.

THE FROTH

Nationwide data suggests China's housing affordability is not that much different from Britain's and only marginally worse than that of the United States, where house prices have fallen precipitously over the past five years.

But in major cities such as Beijing and Shanghai, it is off the charts. IMF figures show that a 70 square meter home in Beijing costs about 20 times the average annual household disposable income, quadruple the national ratio and almost seven times higher than in the United States.

Beijing, Shanghai and Hangzhou look worse than even notoriously pricey Tokyo on the affordability scale.

A People's Bank of China survey in mid-September showed 76 percent of urban residents saw property prices as too high, and 38 percent expected them to keep rising this year. Both readings were higher than in the PBOC's mid-June poll.

For China, expensive housing may pose a bigger threat to social stability than financial. When the average city resident is priced out of the property market, the risk of unrest rises, and that sounds alarms in the ruling Communist Party.

That helps explain why Beijing was quick to try to stamp out speculation while other countries have left it up to market forces to squeeze out the excess -- sometimes with catastrophic economic consequences, as the United States can attest.

In July, China extended the list of cities where it limits the number of homes a family can buy. There are now 40 cities with such restrictions in place, including Beijing and Shanghai.

In January, it raised the minimum down-payment for second homes to 60 percent from 50 percent.

Compare that with the United States, where at the height of the housing boom speculators could buy with no money down. Some even obtained mortgages for more than the purchase price.

Now, 22.5 percent of U.S. homeowners owe more on their mortgages than their homes were worth, according to data analysis company CoreLogic. These "underwater" borrowers are more likely to default than those with positive equity.

In China, it would take a house price drop in the 40 percent range before negative equity became a serious concern, said Barend Janssens, head of wealth management for emerging markets at Royal Bank of Canada.

"There is a lot of fat, and people will lose some of that," Janssens said at the Reuters Global Wealth Management Summit in Singapore this week.

Rising wages also play in China's favor. The U.S. housing bust coincided with a severe spike in unemployment, and wages stagnated. In China, double-digit annual wage increases are the norm, so income should rise faster than housing costs.

WHAT HAPPENS NEXT?

China has a built-in propensity toward property over-investment because there are few other options available to most citizens. The stock market has been extraordinarily volatile, capital markets are underdeveloped, and bank deposit rates are too low to compensate for rising inflation.

"The problem with China is that it tells people it doesn't want them to invest in housing, but it doesn't tell people what else to invest in," said John Woods, chief Asian strategist at Citi Private Bank.

The IMF's housing policy recommendations to Beijing earlier this year were to raise interest rates, develop financial markets, and introduce a broad-based property tax.

There is little reason to expect movement on the first two any time soon. As for the property tax, a pilot program in Chongqing has been credited with helping to cool price rises, and the mayor told Reuters last week it may eventually be rolled out across the country.

That change will come too late to address the current situation, but there is cause for optimism that Beijing's housing restrictions are working. Property prices have begun to ease in some of the frothiest cities, including Beijing.

Barclays Capital economist Jian Chang expects a 10 percent decline from the 2011 peak by the end of this year.

"I don't see a sudden bursting of the bubble near term," she said. "I see a gradual deflating."

The property sector makes up about 12 percent of China's GDP, but its impact spreads wider. Housing construction is an important source of demand for steel, cement, copper and other commodities. Real estate -- both mortgages and loans to developers -- accounts for about 18 percent of banks' credit portfolios, according to the IMF.

That implies a 10 percent decline in house prices could potentially shave 1.2 percentage points off of China's GDP. Many economists have already factored a weaker housing market into their 2012 forecasts, which show China's growth easing to around 8.5 percent from the current pace of 9.5 percent.

But even as commercial housing construction falls, China is ramping up development of so-called "social housing" for lower-income households. It has targeted 10 million units for this year alone, and 36 million by 2015. That will take up some of the slack from slowing private-sector development.

A steeper price drop -- say, 20 or 30 percent -- would be a different story. Ratings agency Standard & Poor's said in September that a decline of 30 percent may be the breaking point for many property developers.

That would become a significant risk for creditors, both banks and the informal lenders who have provided an increasingly large fraction of China's credit as Beijing cracks down on traditional forms of lending.

Already, developers are hesitating over buying parcels of land from local governments as the pace of new home sales slows.

Barclays' Chang recently visited northern China to gauge the degree of the housing slowdown there and found property developers and agents growing increasingly pessimistic about sales prospects in the coming months.

"They all wanted to complete projects and sell as fast as possible because expectations changed," she said.

Well-known China bear Marc Faber, publisher of the Gloom, Boom and Doom report, paints an even darker scenario.

"Some real estate markets will blow up, and massively so, where prices could easily drop 40 to 50 percent," he said in a Reuters Insider interview on Sept. 27.

If there is a global recession, China's housing troubles become more significant. Barclays thinks a worldwide downturn would push China's GDP growth down to 7 percent, a level considered a "hard landing" because it is too weak to generate sufficient jobs to keep up with urban migration.

Such a sharp slowdown could set off a negative feedback loop, where spooked investors sell everything -- property included. Panic selling would drive down housing prices even more, taking a deeper bite out of economic growth.

But because of China's relatively low household leverage, the risk of forced sales is limited. The bigger financial stability risk comes from the corporate side. If hundreds or thousands of property developers go bust, banks might grow more reluctant to lend, which would feed the downward spiral.

WHAT WOULD BEIJING DO?

The predominant view among China economists is that Beijing would step in well before conditions got that bad. It could relax some of the home buying restrictions it placed over the past 18 months, or cut banks' reserve requirements, which stand at a record high of 21.5 percent for large banks.

"China is trying to cause real estate prices to go sideways," said Paul Schulte, head of financial strategy at the investment banking arm of CCB, China's biggest mortgage lender. "It is not trying to kill the market."

Standard Chartered's Green said Beijing is aware that it needs to hold the line on property controls a little while longer to ensure that prices don't keep climbing.

"Maybe Beijing needs to see some pain in the sector before it considers loosening," he said, adding that there will no doubt be failures and consolidation among property developers.

A sharp downturn in the global economy would send a strong signal to Beijing to ease up on credit conditions for the entire economy, not just housing.

The trigger could be a reading below 50 in the government's monthly purchasing managers' index, Green said. The index rose to 51.2 in September, suggesting China's economy is still growing solidly.

That, in turn, bodes well for China's ability to gradually let the air out of the housing bubble.

"It is hard to see problems in China's housing market unraveling in a manner that sets off a major crisis," said Eswar Prasad, a former head of the IMF's China division who now teaches trade policy at Cornell University in New York.

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