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## Mainland China's Housing Market Outlook

**Economic uncertainty is a restraint on residential investment. Prospective homebuyers with expectations of further declines in house prices would weigh on the demand for housing.**

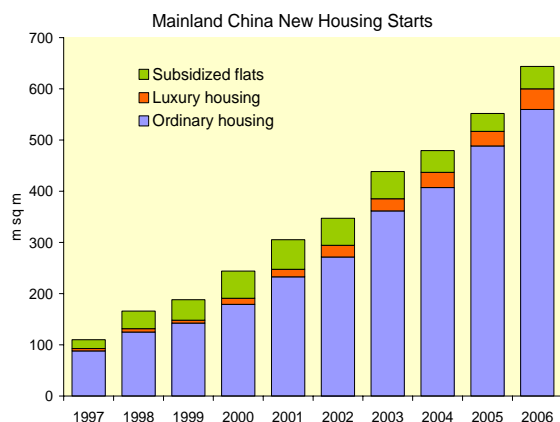
**With regard to the supply, financial constraints facing homebuilders could lead to contraction in residential construction. Property developers may also slow down homebuilding activity in response to lower prices they foresee in the future.**

**Overall, uncertainty about the near-term outlook has increased. The housing demand would weaken further, but the adverse impact could be partly offset by a slowing of construction.**

**The current downturn may have a few quarters to go before we see some signs of sustainable recovery.**

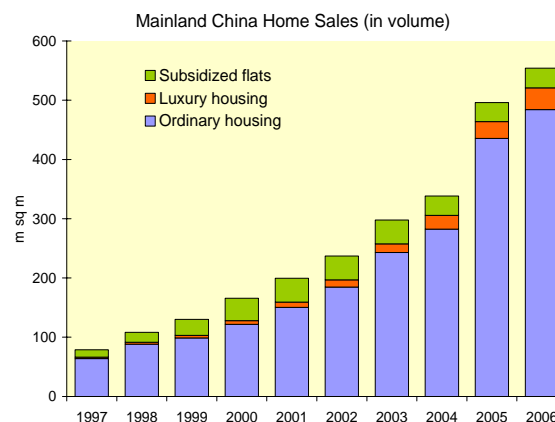
Since the beginning of the year, residential real estate activity in mainland China has decelerated, accompanied by a slowdown in economic growth and a decline in equities. It is interesting to see what factors are affecting the housing demand and supply, and then to assess the outlook for the housing market in the near term.

**Exhibit 1**



Source: China Statistical Yearbook, Hang Seng Bank

**Exhibit 2**



Source: China Statistical Yearbook, Hang Seng Bank





## Developments in the housing market

In mainland China, there are three types of housing: public rental housing, subsidized flats, and private housing. For public rental housing, the government subsidizes rental payments or offers public housing units for low-income families. Based on our estimates, less than 1% of urban households live in public rental housing.<sup>1</sup> For subsidized flats, the government provides incentives, such as a waiver of some administration fees, to real estate developers for building units targeted at low-income families.<sup>2</sup> Over the past few years, this type of housing accounted for about 6 to 7% of housing starts or sales volume respectively (Exhibit 1, 2). That being said, private housing takes the largest portion of the residential property market in the country.<sup>3</sup>

Following a housing reform in the 1990s, the private property market began to expand rapidly. Homebuilding activity maintained a double-digit pace of growth and overall house price followed an upward trajectory (Exhibit 3). Economic expansion was a major reason for the ongoing growth and development. From 1998 to 2007, the Mainland economy kept a high and stable rate of growth averaging 9.5% per year, resulting in higher household incomes.

In 2005, the government issued guidelines to contain the rapid increase in house prices. One of the steps was to penalize property developers for leaving residential sites vacant for more than a year. Another major move was to impose a business tax on home sellers for selling a property within two years of purchase.<sup>4</sup> The impact of these measures on the housing market was significant. House prices decelerated to an annual growth rate of 6% in the first quarter of 2007, from 11.1% in the fourth quarter of 2004. Fixed asset investments in real estate and residential construction also slowed, in part reflecting homebuilders' lack of confidence in the industry.

The adjustment in the residential market was temporary, however, as house prices picked up to a double-digit growth in the fourth quarter of 2007. Residential construction also expanded rapidly, compared with a year earlier or so. A reason for the short-lived adjustment was a persistent improvement in housing affordability as rises in household income outpaced house price growth, leading to stronger demand for housing.

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<sup>1</sup> “廉租住房制度使 95 萬戶低收入家庭受益”; <http://big5.cri.cn/gate/big5/gb.cri.cn/18824/2008/03/17/3285@1980617.htm>

<sup>2</sup> There are some constraints on the size and the selling price for this type of housing. In particular, profits for property developers are capped at 3%. Although subsidized flats are a kind of private property in the Mainland's housing market, this is regarded as another type of housing for classification purposes in this paper.

<sup>3</sup> Private housing can be divided into two sub-sectors: ordinary housing and luxury housing. In 2006, ordinary housing represented about 87% of the housing starts and 83% of home sales respectively. That indicated its dominant role in the private real estate sector and even in the whole market.

<sup>4</sup> There were totally eight measures in the announcement. Others included increases in land supply for subsidized flats, prohibitions against the re-sale of property before its completion, more disclosures of information about the supply and prices of land, etc.





In response to the housing market boom, the government introduced new measures in September 2007, particularly trying to limit speculative activities in land and property. Commercial banks are prohibited from providing loans to homebuilders who are accused of hoarding land. Mortgage borrowers are also required to pay a 40% down payment and charged at 110% of the interest rate specified by the People's Bank of China for their second dwelling.

By the start of 2008, the growth of fixed asset investments in real estate has moderated. Residential property prices in the primary market softened to an annual gain of 7.9% in July from 12.2% in January (Exhibit 4). The effects in some cities were more pronounced. For example, the rise in home prices in Guangzhou decelerated to a 0.1% annual rate in July from 7.2% in September last year. In Shanghai, Nanjing, and Shenzhen, home prices also marked a decline on a month-on-month basis.

Exhibit 3

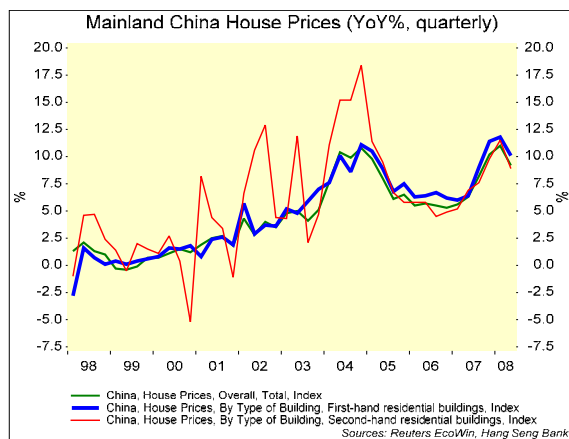
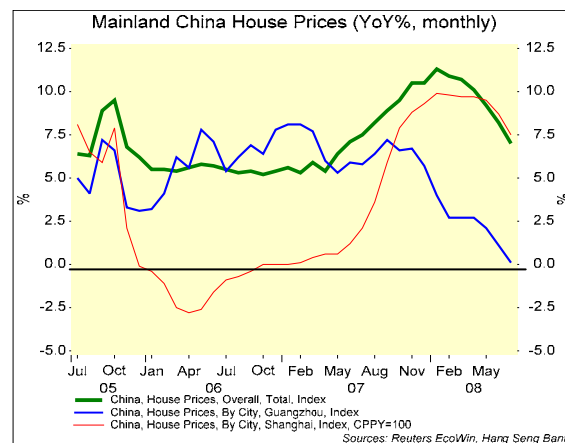


Exhibit 4



## Demand for housing is weakening

The continued economic progress in the Mainland should increase household incomes and boost housing demand in the long run. The ratio of urban personal annual income per capita relative to the average selling price of residential properties, in terms of Chinese yuan per square metre, rose to 3.9 in 2007 from 3.6 in 2004, indicating that a family is more likely to be able to afford the same property than three years ago (Exhibit 5). The ratio of GDP per capita to house prices also stepped up steadily during the same period.

Nevertheless, the current downward adjustment in home prices could help to shape expectations for the future. Prospective homebuyers who expect further declines in property prices are likely to be more risk-averse and therefore may be reluctant to buy a property in the near term. Indeed, the demand for housing has weakened, as reflected in the softening of house prices. The medium and long-term consumption loans to the residential sector, about 90% of which were mortgage loans, have also been soft compared with a year earlier (Exhibit 6).



# ECONOMIC FOCUS

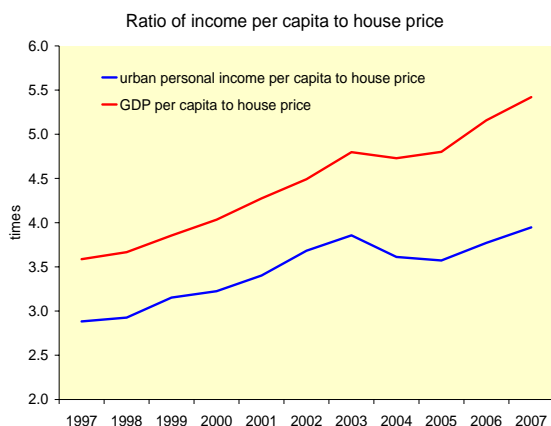
Treasury Division



Unlike the housing downturn in 2005, the uncertainty surrounding the economic outlook also acts as a restraint on home purchases at present. Subdued growth in advanced foreign economies has posed a threat to mainland China's economic outlook. Moreover, equity prices on the Mainland have dropped by over 60% since reaching a peak in October 2007. The resulting slowdown, or even a decline, in household wealth may weigh on housing demand.

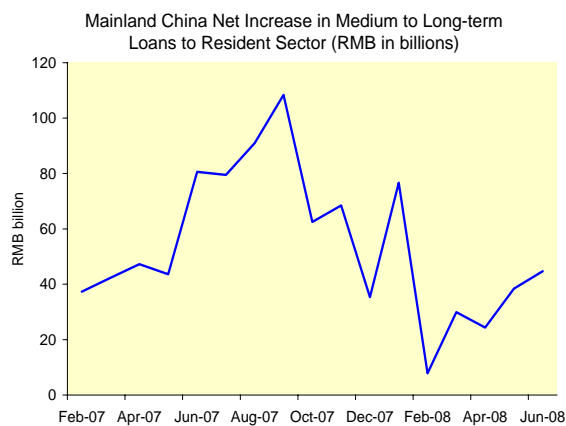
The government's actions, including an introduction of a business tax on home sellers and a charge of higher interest rates on home buyers over the past few years, are strong evidence of policymakers' attempt to tackle speculative activity in the housing market. If the policy continues to move in this direction, this will be an important factor to restrain the demand for housing.

**Exhibit 5**



Source: China Statistical Yearbook, Hang Seng Bank

**Exhibit 6**



Source: China Statistical Yearbook, Hang Seng Bank

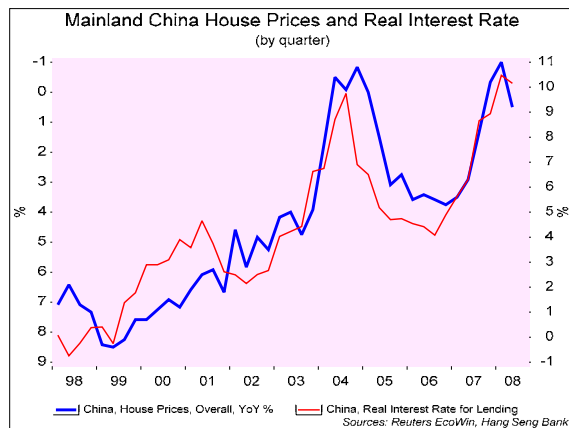
Possible increase in real interest rates may also dampen housing demand. Buying a property is traditionally seen as a hedge against inflation, which has remained high in mainland China. However, price developments also have a bearing on interest rates in real terms. These are reflected in the inverse relationship between the growth rate of house prices and real interest rates for the past decade (Exhibit 7).<sup>5</sup> With Mainland's inflation easing to 6.3% in July from its recent peak of 8.7% in February, and nominal interest rates remaining unchanged, real interest rates have gone up. If these trends persist, they could weaken the demand for housing further.

<sup>5</sup> For the calculation of real interest rate, the nominal interest rate for the period of one year is used. However, the result is almost the same even using the nominal rate for the period of more than five years instead.





Exhibit 7



## Supply of housing may slow

Housing activities are shaped not just by demand but also supply factors. As mentioned earlier, the government last year placed a restriction on banks to provide loans to property developers who are accused of hoarding land. The rule should help to increase the supply of housing as it prompts homebuilders to develop their residential sites that are still left vacant. However, there are good reasons to believe that housing supply is in fact falling. Investment in fixed assets for real estate slowed to an annual gain of 38% in June from 42% in October last year (Exhibit 8). The growth of residential buildings under construction was 21% in June, well below its recent peak of 47% in October. House completions have also moderated over the past few months (Exhibit 9).

In principle, a reduction in land hoarding should boost the number of houses available for sale. However, homebuilders may reduce construction in response to lower property prices they foresee in the future. The government's regulation with an aim to restraining land speculation may also undermine property developers' confidence as this represents a market intervention. In 2005, the government decided to charge a penalty on real estate developers for leaving residential sites idle for more than one year. That resulted in a deceleration, rather than a jump, in construction activity.

Moreover, financial constraints facing homebuilders could lead to further contraction in construction activity. The PBoC lifted the one-year working capital loan rate to its present level of 7.47% from 6.12% at the start of 2007 and the required reserve ratio to 17.5% from 9.0% during the same period. The monetary policy tightening coupled with the government's restriction on lending mean that credits are not only becoming more scarce, but more costly for property developers and potential home buyers alike.



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Exhibit 8

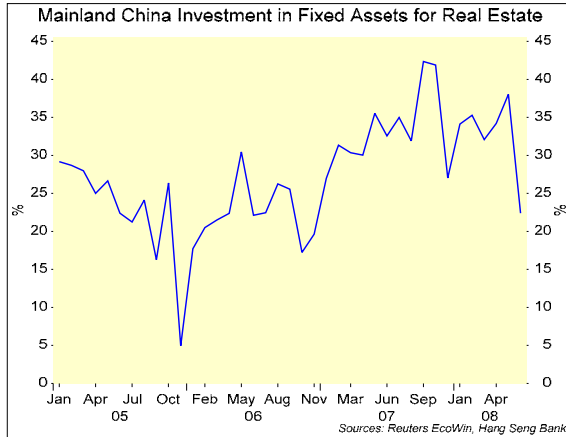
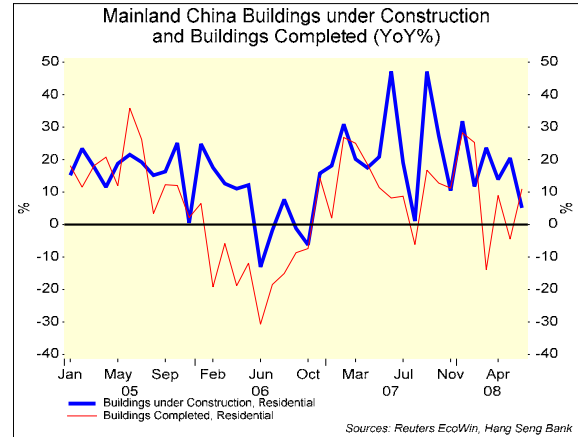


Exhibit 9



## Conclusion

Overall, uncertainty about the near-term outlook for the housing market has increased. Expectations of further declines in house prices, for example, could prolong the current downturn in the housing market. Risks to economic growth and policy actions against speculation are also likely to continue affecting housing demand, although the adverse impact on the residential real estate market could be partly offset by a slowing of homebuilding. The previous downcycle of the property market, which began in 2005, took more than a year to reach the bottom. If history is any guide, the current downturn has a few quarters to go before we see some signs of sustainable recovery.





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