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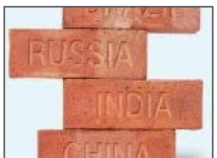

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INVESTING

Why China’s Property Bubble is Different

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When it comes to real estate prices, Shanghai still isn't New York. But like NY, an elite class is driving up real estate values, both commercial and residential. Moreover, a weak local currency has rich foreigners and big business buying up property in China, thus adding to property inflation.

China’s property bubble is “different” than America’s, but that doesn’t make it less dangerous.

Real estate is becoming the country’s top economic story overseas. After the massive US housing market crash, any talk of overheated property values, anywhere, raises eyebrows. China especially. It’s economy is globally important. It’s a key supporter of commodity prices. It is an important trading partner to many countries, especially Brazil, where problems in China can become problems in Rio. No one wants China’s real estate market to crash, and no one really knows the ramifications of a China asset bubble, though everyone suspects the abrupt popping of that bubble will be severe. On a global scale, though, it won’t be as severe to the markets as

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when property values tanked in the US.

There is official concern that China's property market is overheated, judging by government actions to cool the residential and commerial real estate market over the last year. Few even want to use the term "bubble" because it conjures up the US recession and resulting historic job loss. China has 1.4 billion people, millions of them living on less than $2 a day. It needs a strong and stable economy to bring those people into at least something resembling the 20th Century. Inequality is growing as the rich get richer, and the urban middle class expands. Meanwhile, life is getting more expensive in a country most Americans would consider dirt cheap.

This is a new China now. People are getting richer. Housing is going through the roof. Big investment banks are buying up office space. And the government, and some investors, are getting nervous.

China's government probably deserves some respect on its real estate issue than it is getting. US officials, like former Federal Reserve Chairman Alan Greenspan, denied the housing market was overheated just when housing prices were skyrocketing. China acknowledges it.

China ordered its banks this week to conduct stress tests to see how they would be affected if property prices fell by up to 50%, in a sign of growing official unease about the overheated real estate market.

The Chinese government has been introducing a series of policy measures since last year to slow real estate inflation, including raising interest rates, raising down-payment requirements, directly restricting home purchases, imposing price control targets in Beijing and Shanghai and finally charging a real estate tax, albeit on a trial basis, in Shanghai.

Housing prices have been rising by around 1% a month in China's biggest cities, according to the National Bureau of Statistics (NBS).

On April 18, the NBS said that out of 70 cities it monitors, prices of newly constructed residences declined in only 12 cities, and remained stable in 8. That means that prices rose in the rest of those markets.

Commercial property is in hot demand, and despite government efforts to curb lending by increasing bank reserve requirements, which cuts down the amount of capital they have available to lend, large commercial transactions persist. Morgan Stanley closed a 10,000 square meter office lease in the fourth quarter and is moving into a new 93,000 square meter property at Kerry Parkside in Shanghai. Even Dairy Queen is moving into 61,000 square meters of space at the ICC Towers on Huahai Road in Shanghai next month.

According to Cushman & Wakefield, a global real estate firm, Shanghai is rebounding fast from the 2008 financial crisis. "We expect that domestic insurance companies, investment funds and institutional investment firms will increase their purchases of commercial real estate, especially of entire office buildings," Cushman analysts wrote in their fourth quarter 2010 Marketbeat report to clients. Over 1.7 million square feet of new office space is being built currently in Shanghai alone. Around 900,000 square feet will come to market this year in that city.

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ABOUT ME

I covered Brazil pre-Lula and post-Lula and spent the last five years covering all aspects of the country for Dow Jones, Wall Street Journal and Barron's. Meanwhile, for an undetermined amount of time, and with a little help from my friends, I will be parachuting into Russia, India and China. (I figure if Anderson Cooper can parachute, I can parachute.)
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Vacancy rates for grade A office space are low, at 6% in the fourth quarter compared to 6.9% in the third quarter. Companies are renting. And foreign investors are buying. According to Cushman & Wakefield, foreigners account for 43% of Shanghai’s commercial real estate sales. Surprisingly, lease yields (gross rental income-to-purchase price) on investments have declined from around 10% in 2003 to under 5% in 2010. Yet, they still want in on the action given China’s long term growth prospects. Plus, the dollar has more than six times its purchasing power in China.

“If this overheated property market, on all sides of the market, if it does not coool down in 2011, we will continue seeing more hot money to pour into it and more national wealth to pour out of China,” says Wang Jianmao, an economist at the China Europe International Business School in Shanghai.

The government has only been marginally successful at keeping real estate prices in check. Hot money is flowing in, despite some added restrictions. Is hedge fund short seller James Chanos right to say China is Dubai times 1,000?

How China is Different

Negative real interest rates and zero growth of savings deposits have many middle class Chinese investing in property. “There is still very low leverage per capita in China,” says David Semple, Director of International Equity at Van Eck Global. “In the US, home owners were over-leveraged and so when their housing prices declined they had no real source of capital anymore. China is not Dubai on steroids. You don’t buy with no money down there.”

Since last November, in China’s top tier cities, buyers are required to put 30% down for their first home, 60% down for a second home, and are not allowed to buy third homes on credit. In the US, there was widespread evidence of fraud in the subprime lending market. There is no evidence of that in China, and if that was the case, the chief financial institutions are all state run and would likely wipe those loans off their books before foreclosing on low income home owners, says Usha C.V. Haley, a chaired professor of Massey University in New Zealand, who is currently working on a book about Chinese subsidies to be published by Oxford University Press.

In China, the mortgage market is run primarily by “the big four” government banks: Industrial and Commercial Bank of China, China Construction Bank, China Agriculture Bank and Bank of China. However, at least 20 mid- to small sized private commercial banks are in the market, too.

“I have not heard of any of them having problems with failed loans...yet,” says Yulong Li, Research Director at Balentine, an independent investment advisory firm in Atlanta. Prior to joining Balentine, Li was a banker at China’s No. 5 bank, China Merchant.

Another problem that exacerbated the decline in US housing prices was leveraged banks and investment funds buying mortgage backed securities. This market exists in China, but is small by comparison.

Chinese banks started their securitization practice in the late 1990s, and it is limited to the commercial banks. Very few investors have MBS’ or CMBS’ in their portfolios, Li says. “The domino effect may not be so significant if a financial crisis comes in China because of real estate,” he says.

Li suspects housing prices to correct as much as 20% nationwide within the next three years. But if the economy slowed too much, say below the government’s intended 7% gain this year (the economy grew 9.7% in the first quarter of 2011), then a steeper correction would occur and present itself as China’s first major economic crisis since reforms began in the 1970s.

“And when that happens, then you will see some of the mid-sized banks run into trouble. The big government banks will just make any debt problems disappear from their balance sheets if they had to. The probability for the big four to fail because of real estate is extremely low,” Li says. “The Chinese central government won’t allow it.”

In the late 1990s, the bad loan ratio of the big four reached a maximum of 20%. The central government then established four “asset management firms” called HuaRong, XingDa, GreatWall and Oriental and then simply transferred those bad loans to these four new firms, making the big four clean again. Sound familiar?

Today, market consensus is that the big four are healthy and profitable due to China’s dynamic economy.

Yet, if the contrarian argument is that the Chinese economy is unsustainable, then could runaway real estate prices and a weak yuan be a potential hazard? Chanos thinks so. So does CEIBS economist Jianmao, on the ground in expensive Shanghai.

Housing Market Correction’s Impact on Chinese Economy

Every year or so the Chinese government comes up with its Five-Year Program. We are now in its 12th reincarnation. Since the 11th Five Year Program, the government has stated its intent to focus on the domestic consumer, rather than on big industry funded by the big four. The same goes for the 12th Five Year Plan, launched in March in Beijing. But in 2010, the results were mixed. Household consumption fell to 34% of GDP, the lowest figure ever recorded. Household consumption is generally around 61% worldwide, according to Jianmao. Meanwhile, capital formation surged to 49% in 2010, compared to 22% on average for the rest of the world.

A nation uses capital stock in combination with labour to provide services and produce goods. The higher the capital formation of an economy, the faster an economy can grow its average income. Increasing an economy’s capital also increases production capacity. That’s why China’s been growing like gangbusters.

This boom, and this newfound wealth, has gone right into real estate because keeping money in Chinese yuans provided no return. Some market forces are at work in real estate, too, says Li. Rural workers are moving to the coastal cities.

According to data from the NBS, real estate prices rose 7.4% in 2010, the fifth highest increase in 13 years. The biggest gains, though, were in the second and third tier cities in Central and Western China. The property bubble has therefore officially extended from the coast to the center.

"Once real estate prices get out of control, everything else will follow," says Jianmao. "China will lose its comparative advantage in labor intensive industries and be forced to shift these industries to other countries. If that happens, a large number of unskilled laborers who were not adequately educated in the past decades will be out of work," he says.

China's official unemployment rate is just 4%.

Critics have argued for years that China's unrealistic monetary policy have kept the yuan and interest rates unrealistically low. To some extent, the Chinese have admitted this and are increasing rates and letting the yuan appreciate gradually by around 6% a year. If housing gets away from the government's policy engineers, could the yuan be allowed to appreciate faster, making real estate more expensive, at least, for foreigners? Another solution is raising taxes on real estate investments to keep speculators away.

Foreign buyers are not helping the matter. Take top tier US cities like New York. Wall Street keeps Manhattan real estate stable to high, but so does foreign demand. That foreign flow, coupled with high incomes, is one of the reasons why real estate prices have been strong in New York.

Hot money flow into Chinese real estate was around $119.5 billion in 2004, rising to $147 billion in 2007 and over $210 billion in 2009, according to government numbers compiled by Jianmao.

China's development model might have run its course. The government is aware of the problem and annnounced millions in low cost housing projects and financing to keep the locals from being priced out. It is unlikely that program would cut into real estate gains in other China market segments which that class of people were already priced out of to begin with.

Higher interest rates and a German-style tax on real estate property gains could be a solution, says Jianmao. Germany charges a 40% tax on real estate property gains.

"China is not the US, but it would do well to draw lessons from the failure experienced by Japan...and the United States," says Jianmao. "If the national focus on the holy trinity of big banks, big enterprises and big government is not changed, then this will develop into a severe crisis if (housing) is not resolved. The existing macro measures only relieve the symptoms temporarily."

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