2011

China's Empty Apartments

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July 26, 2011 in Uncategorized by The China Beat | Permalink

Part II: What happens when the party ends?

By Michael Gsovski

(Read Part I here)

There are serious problems in the Chinese housing market. While the average urban resident has to deal with constant rent hikes and the threat of eviction in the face of new construction, the rich buy extra apartments to shield their wealth against inflation. Not only is this an economic threat, but in China it is a particular threat to stability as well. Firstly, since the turbulent boom years of the China's opening and reform period, owning housing has been seen as a useful hedge for ordinary people against an otherwise uncertain economic situation. Secondly, owning—rather than renting—an apartment or other housing has long been a cultural precondition for Chinese men if they are to marry. When people talk about apartments being "maibuliao" ("unaffordable") for ordinary people, the words are spat like a curse.

The question almost asks itself: Is the Chinese government doing anything about this?

To go by public statements, it is. Beginning in 2010, numerous price control measures were issued against property speculation and the central bank raised reserve requirements and interest rates to rein in investment. In addition, local governments were required to construct millions of additional low-cost housing units to relieve pent-up demand for them, requirements that have only been expanded for future years.

However, economists like Tsinghua University's Patrick Chovanec are doubtful that local officials are going to comply with the central government policies to slow the pace of development due to the financial incentives they face to continue encouraging high levels of construction.

"They have every incentive to just say, 'well, our real estate market is very sound,'" Chovanec said. "Because the alternative would be to pull the plug on growth and that would be committing professional suicide."

Kunming-based commercial real estate developer Zhang Hanqing (name changed) agreed with this belief that local politicians will not be willing to reduce the cost of real estate. As an example, Zhang brought up the fact that for him leasing 1 mu (1/6th of an acre) of land in Kunming costs anywhere from 1 million RMB to 5 million RMB in payments to the government.

When asked if it was possible that the government would reduce the rate of new construction, Zhang was unequivocal.

"Personally, I think it is impossible," he said. "The local government's income is land income. The more land they sell, the more money they get. It's difficult to say how much they can reduce it even if they have to."

Additionally, there is the common off-the-books patronage that real estate companies are required to give their government contacts for permission to build. According to Hanqing's son, Zhang Yun (name changed), his father's associates in residential real estate have had frequent experiences with government officials who demand massive discounts on investment-grade apartments before approving deals.

"If he is the [real-estate] authority, he visits the real estate company," the younger Zhang said. "The real estate company then has to give him a set of apartments that have no profit or even a slight loss."

Chovanec believes the price and purchase controls on consumers were ineffective, as they did not lessen the demand to invest in housing. In this regard, he pointed to two recent attempts at regulatory remedies as standout failures. The first, raising the minimum down payment percentages for purchasing apartments, will not affect speculators because, according to Chovanec, "The investors already have plenty of cash, they're paying 100 percent anyways." The second, a Beijing municipal regulation restricting families to owning one apartment each has also failed because, as Chovanec said, "People got around [it] by getting divorced."

As for the monetary tightening, Chovanec argues that unless investors believed the periodic increases in the interest rate and reserve requirement were a message portending further, more drastic policies, they were not large enough to be a deterrent, due to the high rates of return real estate has thus far produced.

"From my experience, Chinese borrowers will take the money, because in this experience, they feel that they will definitely double their money," Chovanec said. "And the reason I think that is that in the shadow lending market…you have people regularly paying up to 20 percent interest rates—credit card rates—because they think they're going to earn higher returns. If you're doubling your money, tripling your money, you don't have to worry about 20 percent."

To make matters worse, Northwestern University political science professor Victor Shih said his research indicates that low-cost housing is not being constructed at nearly the rate that the central government wants, due to the reluctance of local governments to use land for less than maximum profit.

Shih said that the quotas imposed from on high left a great deal of wiggle room for these reluctant governments.

"The quota states that city X doesn't have to finish building, but has to have, say, 20,000 affordable housing units 'under construction'," he said. "Let's say they've only managed to build 4,000 units, but in the last 3 weeks of the year, they could 'start' construction on the other 16,000. If they've broke ground on some empty piece of land, there's no telling if they're actually going to finish those buildings, and who's going to make them finish?"

Property analyst Roselea Yao agreed that the affordable housing numbers are being greatly exaggerated to calm citizen concerns about rising prices. She doubted Vice Premier Li Keqiang's claim in November 2010, that 5.8 million million units of affordable housing were under construction, and that half of those would be completed by the end of that year.

"I would give them a pretty heavy discount on those 5.8 million units," she said. "Probably something like half. And for completions, I think even lower, like 20 to 30 percent."

Shih said that government's response had been tepid because he did not think the government was truly worried about the prospect of popular resentment over inflation and corruption in the housing market. He cited the government's heavy investment in censorship and policing—which for 2011 exceeded official spending on the military—saying that as a result, officials did not believe themselves vulnerable to popular protests, only to the interest groups that Kunming lawyer He Haojun had cited as being influential in society: the wealthy and the developers.

"They believe in their coercive capacity," Shih said. "The government isn't elected, so why should they care? They have to care about the interests of a small number of elite, including real estate developers. So as long as the developers don't face a declining real estate market, they're able to sell the real estate and the local government is able to sell the land, it's fine for now."

If you build it, they will come?

In the short run, the major effect of the rise in housing prices will be a loss in the purchasing power of the average Chinese citizen. Inflation is already a major concern—thanks to the stimulus's money expansion, year-on-year inflationreached 5.5 percent in May 2011, its highest level in 34 months—and rents and urban housing prices are underrepresented in the CPI's price basket.

According to Shih, this could undercut policies being enacted by the central leadership to encourage Chinese consumers to spend more to offset the ongoing downturn in export growth following the global financial crisis in 2008.

"If real estate prices keep rising, then you're using all of your money, all of your parents' money to buy an apartment for you and your spouse," Shih said. "You don't have any money to buy anything else. How can you expect people to spend more in the future when every major policy in China actually leans against that?"

But Shih said he believes that the bubble in real estate threatens to have more wide-ranging effects in the long term. For if land values are currently overpriced and therefore fall in the future, the value of all loans backed with land as collateral would be called into question, and many, extended hastily in the wake of the financial crisis to prop up the economy, would not be repaid. After a year's research, Shih concluded that excessive lending had led to 11 trillion RMB in debts assumed not only by local governments, but also by the local investment companies established by them.

"If the land value plummets, many local governments will not be able to repay these loans, and the banking system is in big trouble," he said.

The effects of a failure to repay this debt could include a loss in foreign confidence in the Chinese financial system and a need for the government to spend billions to re-capitalize the banks, according to Shih.

"It looks bad for a lot of bad local government loans to suddenly appear on these banks' balance sheets," Shih said. "Foreign investors may sell off their holding of Chinese bank shares. This would force the government to plow even more money into Chinese banks, which basically would be a re-nationalization of the Chinese banks."

Despite a similarly rapid increase in housing prices, Chovanec cautioned against thinking that the effect of decline in Chinese housing prices would be the same as it was in the U.S. in 2008. Instead, he used Japan in the 1990s as an example of what could happen: large amounts of unacknowledged debts slowly crippling future lending and growth.

"I'm not sure that the bottom falls out," he said. "It's not like Japan suddenly imploded. There was lot of growth years on, and banks that looked healthy were in fact sitting on top of a mountain of debt. Given the state run system in China, I doubt like this ends up being some kind of market meltdown."

For her part, Yao did not think that non-performing loans will run as high as Shih does and believed that the risk of massive numbers of defaults is low. In her view, the government debt load constitutes a more manageable 3 to 4 trillion RMB, which is a lower percent of GDP than that of many Western countries. However, she cautioned that any future recapitalization of the banking system would have to be Beijing's last, due to the inflationary monetary expansion that it would require.

"You can play this game only one more time, when the next crisis happens," Yao said. "Because you're pumping a lot of liquidity into the system, it is very difficult to do that again."

Hanging by a thread.

For now, however, the status quo reigns. On January 7th in the City View Hotel's ballroom, the commercial real estate company Rayfull hosted the first 2011 meeting of the Kunming Real Estate Expo. The first presenter was Zhao Xiao, professor of Economics at the Management Institute of Beijing Technical University. The title of his presentation was "Urbanization, the Short Board in the Barrel of the Chinese Economy."

He said that given the low urban density of China as compared to Singapore, Japan, or even America, the immediate future for real estate was bound to be a "golden age." True, prices in the market had gotten very high, and stabilizing the situation would require the Chinese government to stop printing money and make a genuine effort to build low-cost housing, but recent actions had clearly shown that the government was taking steps along those lines. The Chinese economy did not have any underlying structural problems. In 2011, growth would continue at the breakneck pace of 9.5 percent, with inflation following at a high, but manageable, 4.5 percent.

So far, his predictions have not been borne out. Over the past six months, official year-on-year inflation in China has never been lower than 4.9 percent. And in April 2011, the World Bank published a report warning that the Chinese property market was a "particular source of risk" to future economic growth.

The expo then continued with a presentation on sustainable development practices (which elicited considerably less attention from the attendees), followed by a catered lunch during which attendees milled about exchanging business cards with each other, perhaps to justify the 1000 RMB ticket price each had paid. Then they were treated to a fashion show. Rayfull had recently decided to expand into importing designer clothes.

Outside the Grand View's ballroom, one of Rayfull's strategic managers, Li Yang, was in step with the upbeat mood of the conference.

Asked whether Chinese real estate was a bubble market, Yang said he wasn't worried about stories of rents increasing by 40 percent within the space of one year and the ubiquitous lament that ordinary people cannot afford to buy an apartment any more.

But just in case the problem was cause for concern, Yang believed the government would build enough public housing to provide for the less well-off. Just like France did.

"In France, many people don't have money. Because they don't have enough money [the government] built public housing," he said. "In the future in China, some people will buy apartments, some will rent apartments. And the apartments people rent will be built by the government."

And if housing prices were to fall, the Chinese economy was hardly dependent on real estate, which Yang called a "support industry."

As Yang gave his confident answers, ticket numbers were being called from the ballroom for a prize drawing. After nearly six hours at the Grand View, the party was still going full swing.

But, according to academics like Shih, the party will have to end sometime.

"There's no such thing as a real estate boom that goes up forever, anytime in the world," Shih said. "And this will not be an exception."

What lies at the end?

Michael Gsovski is a freelance writer who recently spent a year in Kunming China, but is now based in New York City. He graduated in 2010 with a B.A. in Economics from Northwestern University.