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Opinions

October 2, 2014

China's Real Estate Market: Trends and Prospects

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In 2014, China's real estate market has begun to show signs of slowing down. With a sudden contraction in May, some cities even saw drop in both house transactions and prices. The real estate market slightly picked up in August before the months of September and October when real estate transactions usually peak in a year, but it still holds out a gloomy prospect. According to the "100 Cities Housing Price Index" released by China Index Research Institute, the average price of new homes in August was 17,771 yuan per square meters, down 0.59 percent from the previous month. Although the falling pace slowed down by 0.22 percentage point, the price fall continued for four months in a row. Among the 100 cities, 74 cities saw monthly fall in home prices, whereas the other 26 cities experienced an increase.

China's real estate market slowdown this year is partly due to the base effect from the strong upturn in 2012 and 2013, and market experts say the market is now in an adjustment period. Real estate prices in China fluctuated quite a great deal in 2008, 2010 and 2011, primarily due to the government measures to limit credit loans or housing purchases. This year, however, price changes are not driven by government's intervention but by market itself, which indicates that market fundamentals have changed.

During the past decade or so, the urbanization in China increased housing supply to the level which surpassed the actual demand. In the process of urbanization, population in cities increased approximately 20 million on average. Not all the population increase, however, contributed to new housing demand. In fact, housing demand grew in line with the natural population increase. This was because some people who already owned houses were newly added to the city population due to district rezoning and others could not create real demand as they were rural labors who could not afford or were unqualified to buy a house in cities. Data released by Citic-CLSA Securities show that the annual average house demand in China is approximately 7 million and the vacant ratio is 15 percent. According to the National Bureau of Statistics of China, unsold houses in China at the end of August 2014 reached 561.6 million square meters, up by 9.3 million square meters from July. Such oversupply of housing is the key factor that drove the real estate market downturn.

In addition, the weakening of elements that supported the actual demand and investment in real estate is another factor behind the sluggish real estate market. Rapid income growth and high savings rate driven by fast economic development, practically closed capital market, lack of alternatives to domestic investment, and absence of property tax, etc. are slowly changing. The beginning of an era of moderate growth, and the falling savings rate in China are reducing real demand and investment while a gradual opening of the capital market, interest rate liberalization and the rapid development of financial instruments are diversifying investment options.

Amidst such a real estate market correction, there are concerns a hard landing for Chinese economy driven by real estate bubble burst. There is little possibility for China's real estate market to go bust in an immediate future, however, as was the case in Japan in the past. First of all, recent house price hikes are not so big when compared to Japan's housing bubbles and except in the case of Beijing, Shanghai and some large cities, China's ratio of housing prices to income in general is lower than that of middle income countries.

Second, Chinese government has the capability to prevent real estate market meltdown and given the rather high portion of real estate market in China's economy (approximately 10 percent of GDP), it is committed to avoiding a dreadful situation. Also, Chinese government is capable of accelerating investment in infrastructure development, environmental protection and renewable energy projects linked to urbanization in the mid-west region or speed up the construction of indemnificatory housings. In addition, it could ease the regulations on family registration in tier three or four cities to increase housing demand.

As such, the Chinese government is capable and has the will to fully control and manage the pace of real estate market slowdown, Notwithstanding the risk of real estate market contraction cannot be overlooked, since it may eventually result in a hard landing for Chinese economy. This is because Chinese government has little room to use market stimulus measures this time since China already used them to promote real estate market boom and infrastructure investment since the global financial crisis. Even if it does implement such measures, it is doubtful whether they will serve their original purpose. Furthermore, considering that the ratio of indemnificatory housings in the total urban housing supply went up significantly, Chinese government cannot increase the supply of indemnificatory housings as much as it likes. On top of this, as regional governments rely heavily on the sales of land use rights as revenue source and as many of local government loans are extended by taking land or real estate as collaterals, sluggish real estate market may serve as a factor for increased liquidity risk and commercial banks insolvency.

All things considered, what is going to be the trends of China's real estate market in the coming years?

First, from the perspective of supply and demand, it is highly likely that house prices in tier one cities rise slightly whereas house prices in tier three and four fall. The shortage of house supply in tier one cities, such as in Beijing, Shanghai, Guangzhou, and Shenzhen will push house prices upward. On the other hand, house prices in tier three or four cities, such as in Yingkou, Ordos, and Zhangjiajie where house supply exceeds house demand will drop. Already, Hengda and other leading real estate developers are swiftly moving their focus away from tier three and four cities to tier one and two cities.

Second, real estate developers will cut house prices in order to reduce the number of unsold houses. Slight pick-up in house transactions in August is attributable to the government's easing of house purchase restrictions but it is also because developers reduced inventory by lowering house prices. Given that real estate developers are currently experiencing difficulties in raising funds and that their outlook on real estate market is dim, they may reduce new projects and change the overall development strategy.

The real estate industry is expected to become more concentrated as market consolidates through a series of M&As. Large developers have an upper hand in capital market access and they can hedge risks by differentiating development projects based on individual city's real estate cycle. On the other hand, small and medium-sized developers are local-based and are sensitive to the economic cycle of the city they operate in. Also due to the government's crackdown on shadow banking, small and medium-sized developers are highly likely to go bankrupt as they find it difficult to refinance. Therefore, the market share of the top 50 developers is expected to increase continuously.

Lastly, from a policy perspective, the government is expected to restrict speculation on real estates in tier one cities while increasing the supply of housing for the low and middle income classes. At the same time it will limit the supply of land for housing in cities with high inventory-sales ratio. The government is planning to set up a system for tracking real estate ownership and sales transaction in order to eradicate corruption and to strengthen its control on real estate speculation. Some say, "Anti-corruption efforts are the biggest market correction measure." KIEP