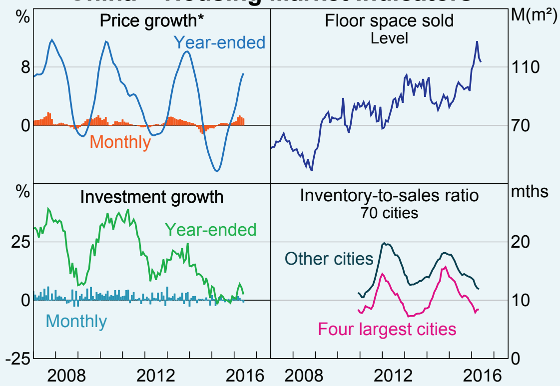
Box A

The Pick-up in the Chinese Housing Market

Dwelling investment has made a significant contribution to GDP growth in China over recent history. Developments in the Chinese housing market affect demand for Australia's exports of iron ore and coking coal owing to the steel-intensive nature of residential construction. Conditions in the Chinese housing market have picked up since the start of 2016 (Graph A1). Housing price inflation has risen, sales (measured as residential floor space sold) have grown rapidly and housing investment has strengthened after a period of weakness. The ratio of unsold inventory of developers to sales has declined, although the stock of unsold property remains high.

Graph A1
China – Housing Market Indicators



* Newly constructed property in 69 large and medium-sized cities
Sources: CEIC Data; CRIC; RBA; WIND Information

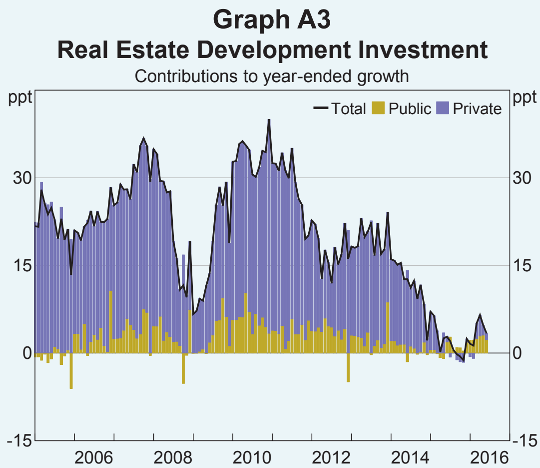
Government policy has played an important role in Chinese housing market cycles and a range of stimulus measures implemented since 2014 has contributed to the latest strengthening of conditions.[1] These policies have encouraged purchases of housing with the goal of reducing inventory levels, which have been high in many parts of the country (Graph A1). In September 2015, the minimum down payment for first-home buyers was lowered from 30 per cent to 25 per cent in most cities and a further discretionary 5 percentage point cut was authorised in February 2016. Minimum down payments on second properties were reduced from 60–70 per cent to 30 per cent over the same period. Benchmark lending rates have been cut by around 165 basis points since late 2014, and the estimated national average mortgage rate (a measure of rates actually paid) has fallen by an additional 70 basis points relative to these benchmarks. Property transaction taxes have been reduced and there have been targeted easing measures in some areas, such as subsidies for certain types of home buyers. However, local authorities in some areas have more recently introduced measures to temper strong housing price increases, as discussed in more detail below.

Following these earlier stimulatory measures, housing credit has grown rapidly, rising by more than 30 per cent over the year to June 2016 (Graph A2). Housing credit has also increased sharply relative to the value of property sales, suggesting that buyers are using more leverage to purchase property. Investor demand for housing appears to have contributed to the recent strength in many local housing markets. One likely reason for this is the perceived lack of alternative high-yielding investments, particularly given the unwinding of the equity market boom and declines in yields on wealth management products since mid 2015. While there are no reliable publicly available data that decompose housing purchases by investors

1 For further discussion of the Chinese housing market, see Cooper A and A Cowling (2015), 'China's Property Sector', RBA *Bulletin*, March, pp 45–54.

* Seasonally adjusted; ratio of quarterly change in the stock of credit to quarterly residential sales

Sources: CEIC Data; RBA



Sources: CEIC Data; RBA

and owner-occupiers, recent media reports suggest that investor demand for housing has accounted for an increasing share of purchases in housing markets that have experienced very strong demand, such as Shenzhen.

The pick-up in investment and sales is also likely to have been supported by policies targeted at property developers, including greater flexibility to alter project plans to satisfy evolving market demand more effectively (for example, allowing developers to change the configuration of rooms in a planned property). State-owned firms have contributed noticeably to the recent pick-up in real estate investment and there have been reports of some state-owned developers purchasing inventory from troubled private developers (Graph A3).

Despite the overall pick-up in housing market conditions, considerable differences across regions have persisted, reflecting differences in local economic conditions. Housing price growth has been weaker and inventory remains highest in smaller cities, reflecting more limited employment opportunities and high levels of dwelling construction relative to demand. In contrast, price growth has been stronger in larger cities, which are characterised by resilient labour markets and a relatively tight supply of housing and land. Many of those mid-sized or smaller cities experiencing rapid price increases, including Foshan, Huizhou, Langfang, Suzhou, Zhongshan and Zhuhai, are located close to one of China's four largest cities (commonly referred to as the 'Tier 1' cities), suggesting that demand may have spilled over from the larger city to the smaller neighbour.[2]

In some housing markets, price growth has been so substantial that the local authorities have responded with tightening measures. In March 2016, the Shanghai and Shenzhen municipal governments announced an increase in minimum down payment requirements for individuals with prior mortgages or existing property ownership and stricter regulations around property purchase for persons without local residency permits. Authorities in the mid-sized cities of Nanjing and Suzhou announced in May that price ceilings would be imposed on certain land purchases.

Given the large stock of unsold properties nationally, any slowing in demand from current levels would pose potential risks for property developers and upstream suppliers of raw materials to residential

2 China's 'Tier 1' cities are Beijing, Guangzhou, Shanghai and Shenzhen.

construction. The recent pick-up in sales has facilitated some reduction in developers' inventories. Yet land prices have been rising relative to housing prices in a number of cities, potentially squeezing developer margins, and the degree of gearing has continued to rise for mainland-listed developers. Developers have diversified their funding sources in recent years, decreasing their direct reliance on bank lending. Given the dominance of banks in China's financial system, it is likely that they are still indirectly exposed to much of this lending.[3] A downturn in market conditions, brought about either by a reduction in the degree of policy stimulus or a loss of confidence among home buyers, could therefore increase credit default risks for financial institutions.

The growth of credit and property prices in some cities has also prompted concerns about financial stability risks arising from the household sector directly. Chinese household indebtedness remains relatively low by international standards, and household mortgages account for only 17 per cent of bank lending. However, housing credit has been rising rapidly, and the recent upswing has been accompanied by reports of less creditworthy borrowers entering the housing market by obtaining credit through informal channels (such as peer-to-peer lending) to finance down payments. This raises both the risk of loan defaults and the potential size of any financial losses in the event that prices fall significantly. While it is difficult to quantify the extent of such practices, recent measures to reduce the incidence of borrowing for down payments indicates that the practice has been viewed with concern by the authorities. In March, the People's Bank of China announced that borrowing to finance down payments was not permitted and local authorities have subsequently increased efforts to rein in related activity.

In summary, despite the pick-up in housing market conditions since the start of 2016, there remains a significant stock of unsold housing in many cities and there may not be sufficient fundamental (owner-occupier) demand to support a reduction in that unsold stock. The apparent contribution of government stimulus measures to the recent strength in the Chinese housing market raises doubts about the sustainability of the recovery, particularly for investment. While there is a concern that the current strength in China's housing markets will not be sustained, the ability of municipal governments to introduce policies targeted to local conditions could help mitigate the risk of extreme fluctuations in regional housing markets.

3 Lending to developers amounts to around 7 per cent of total bank credit in China. Domestic bank loans account for around 15 per cent of developer funding for real estate investment; most funding is drawn from advance payments and self-raised funds.