Cooling Campaign for China Residential Market Reaches Point of Inflection at Time of Political Transition

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AS PRODUCTS OF A POLITICAL SYSTEM that increasingly operates on the basis of consensus, Xi Jinping and Li Keqiang, when they assume leadership in March 2013, can be expected to carry on the policies inherited from the previous leadership for dealing with the overheating of the China residential market and providing an adequate supply of affordable housing to urban residents. The two linked issues, amongst the largest sources of popular discontent in China today, will emerge amongst the defining issues during their term in power.[1]

However, it is unlikely that Xi and Li will be able to fully get a grip on the fundamental economic problems underlying these issues during their term. Dealing with them would mean completing the unfinished task of transforming China's investment-based economic growth model into one led by domestic consumption. This, in turn, would necessitate bringing forward the difficult task of financial sector liberalization, including freeing up interest rates, allowing the convertibility of the renminbi, and overhauling the tax system—not all of which can necessarily be accomplished within ten years.[2]

Residential market cooling campaign has been in place since 2010

Residential property prices in cities like Shanghai rose nearly continuously between 1998 and 2010, interrupted only twice—by the SARS pandemic in 2003 and the global financial crisis in 2008. In response, China's central government moved to impose home purchase restrictions (HPRs) on 14 first- and second-tier cities in April 2010—restrictions basically comprising limits on the number of units households can buy, curbs on purchases by nonresidents, and price caps on the amount developers in given localities can charge for apartments. The number of cities subject to HPRs was subsequently expanded in August and November 2011 until, by mid-2012, 48 cities were brought under the controls. In addition, in 2010, China's policy-making People's Bank of China (PBOC) ordered the tightening of credit, especially on housing loans and provision of credit to developers, in yet another bid to squeeze down the real estate bubble.

However, 30 months later, with nearly all Chinese economic indices pointing to a slowdown, the downturn in the residential sales market which has resulted from these cooling measures has also begun to feed into the larger negative trend in the national economy. Hence, the problem has arisen how both to keep the lid on residential prices and harness genuine occupational housing demand to drive domestic consumption—a conundrum the incoming national leadership will have to wrestle with from the start of its term.[3]

While the incoming national leaders may lack the political clout to embark on the difficult, systemic reforms needed to address the underlying causes of the nation's economic malaise, China has reached a point at which massive credit injections into state-owned enterprises and similar state-affiliated companies are no longer effective in jump-starting the domestic economy. Recognizing this fact, various central government leaders have spoken frequently over the past two years of the need to make domestic consumption the main driver of economic growth. However, this is easier said than done because not only would this involve dislodging powerful entrenched interests which benefit directly from the current investment-based economic growth model, but, if seriously undertaken, it also would involve overhauling China's export-based growth model, which has suppressed domestic consumption by channeling resources away from the household sector in order to maximize investment in export-oriented manufacturing.[4]

The outgoing party central leadership in the final two years of its term exercised moderation with respect to stepping on the pedal of investment-led growth. Instead, the main stimulus applied during this second round of global economic slowdown has involved the June/July cutting of the benchmark lending rate; the November 2011, December 2011, and May 2012 trimming of the state banks' required reserve ratios; and more recently the bringing forward of approval for 60 infrastructure projects originally scheduled for launch in 2013. Still, the collective 1 trillion renminbi price tag of the investment initiatives represents only about 25 percent of the total stimulus applied in 2008–2009.[5]

However, what the incoming leadership faces is a classic case of "damned if you do, damned if you don't" with respect to leveraging real estate investment and development to pull the economy out of its doldrums. The temptation to take this approach is large: China's real estate sector accounts for 13 percent of the country's gross domestic product, and 80 percent of all development activity is concentrated in the residential subsector, which has 40 separate domestic industries clustered around it.[6]

Ongoing imposition of HPRs has emerged as point of contention

Evidence emerged throughout the first half of 2012 that keeping the HPR regime in place is increasingly arduous for the central government, and its ongoing imposition has become a significant point of contention between central and local government authorities.

The decision by the State Council in midyear to send eight inspection teams to 16 provinces and cities to review the performance of local governments in implementing HPRs was a clear sign of the stiffening of central government resolve in the face of local government opposition. According to reports carried by the Xinhua news agency, 46 of the 48 cities where HPRs have been imposed have tried in some way to fine-tune the measures in preparing to implement them, with Shanghai, Foshan, Chengdu, and Wuhu having been found by the central government to have erred in their interpretation of the directive.[7]

Part of the rub regarding imposition of HPRs is the knock-on effect they have had in undermining urban land values and slowing municipal development land sales. The resulting drop in revenue from land sales has seriously unsettled municipal governments because such sales have constituted one of their principal funding sources for construction of public housing, 90 percent of which is funded from local revenues.[8]

A report issued this year showed that revenues from land sales for 20 cities in China for the first half of 2012 were off by nearly 40 percent from a year earlier and that China's four largest cities—Beijing, Shanghai, Shenzhen, and Guangzhou—

reported a drop in land revenues of nearly 60 percent.[9] However, towards the middle of the year the trend in the development land sales market became somewhat less clear. Real estate services firm SouFun-CREIS reported in September 2012 that while national-level land sales declined for the second-straight month, average land prices for residential sites have, in fact, been rising since January 2012, except for a dip in May.[10] While the land market apparently regained some of its former steam in midyear, buoyed by the central government's modest midyear credit easing measures, some would argue that this kind of second wind is bound to be short-lived. They would also argue that land banking in the foreseeable future will be opportunistic and mainly driven by financially strong players, given such factors as the unlikelihood that the central government will abide by any major short-term relaxation of the HPRs, the relatively high level of inventory carried by many developers, and the burden of carrying it by developers who became heavily leveraged in 2009.[11]

Indications emerge of a desire by the central government to change tactics with respect to market cooling

The first indication that the central government's discomfort with this situation has led it to prepare to change tactics for calming the overheated market emerged in late June, when the State Information Centre (SIF), a central government think tank, published a statement reading, "China should unify its present array of property taxes by cutting transaction taxes while raising taxes on those with multiple homes to penalize speculators without hurting genuine homebuyers." It went on to state, "Effective property taxes could replace HPRs . . . as China's main tool for controlling home prices."[12]

This novel statement was echoed in late August by comments on the PBOC website that the home purchase restrictions should be lifted "at the right time" because they tend to curb genuine housing demand and thus dampen economic growth. Adopting a position similar to the SIF, the PBOC suggested that an enhanced tax regime be put in place to cool the property market as a substitute for the kind of direct administrative interference with the market represented by the HPRs.

A real estate tax targeting property ownership, if well designed and effectively implemented on the national level, could indeed help wean municipal governments off their long-term dependency on land sales revenues. An effective tax system which made holding vacant residential units less attractive to investors would obviate the need to impose administrative restrictions on purchasing housing units.

At the same time, while there is a growing sense that HPRs are having a number of unintended negative effects, there is also a feeling that establishing a genuinely effective national real estate tax will require a substantial amount of time.[13] Shanghai and Chongqing were appointed to pilot collection of the real estate tax in January 2011, but nationwide implementation of a real estate tax still faces enormous challenges. The new tax regime's biggest opponents are local government officials, who believe that adoption of such a tax would lower housing values and therefore substantially reduce the premiums they are able to collect from sales of development sites. Another obstacle is the slow progress on launching a property value assessment system and achieving broad consensus concerning the specification of the tax base, exclusions and exemptions, assignment of responsibility for administration of the system, rate setting and assessment, and, finally, the allocation of tax revenues.[14]

Despite these problems, however, it appears inevitable now that some form of the tax will progressively be rolled out. The Ministry of Housing and Urban-Rural Development (MOHURD) noted that this new fiscal regime would increase the holding cost of real estate and give incentives to owners to lease out vacant units.

Yet it should be noted that a real estate tax, if imposed nationally, would affect third- and fourth-tier cities more than first- and second-tier cities, where the existence of a more robust leasing market will enable some property owners to pass the new tax burden on to new tenants

An additional signal that the central government is taking a new tactical approach of advocating desirable kinds of residential sales activity emerged in July when the Ministry of Land Resources (MoLR) announced the launch of a campaign to boost land supply for development of "ordinary" housing. This represents a profound philosophical shift: this approach seeks not to curb sales, but rather to step up sales of residential property—and specifically to boost the sale of those properties designed and specified to accommodate occupiers of ordinary urban homes.[15]

Also in July, the MoLR moved to more closely monitor local land supply, requesting that local governments issue reports on their land supply activities every 30 days and keep land supply for ordinary housing pumped up,[16] while at the same time mandating that municipal authorities continue to keep land prices flat going forward, a directive which brings to mind Persian Emperor Xerxes's command that his troops lash the sea into being obedient.

Central government's plan to increase ordinary housing supply unlikely to be rolled out rigidly

At the same time, one feels that at some level the central government must be aware that the overheated residential market is not simply a function of a supply/demand imbalance. However, even if it is only a stopgap measure, creating a supply surge in ordinary housing is not without its risks and problems. One must bear in mind that despite the peremptory tone of the MoLR directive, it is unclear whether the state can effectively "command" commercial activity. Hence, this new directive is not apt to be rolled out with the rigidity of a production order in a state-run factory, but rather will be implemented by municipal governments, working in conjunction with developers, who are unlikely to acquire sites blindly but rather will carefully consider their commercial potential.

It should also be borne in mind that despite the July MoLR directive, stepping up the supply of ordinary housing is not easy. For one thing, assembling viable sites for developing such housing is not a minor problem and will only grow more difficult over time because municipal governments are unlikely to willingly give up prime residential sites for ordinary housing development. The consequence likely will be that few major cities will experience oversupply of ordinary housing in the foreseeable future.

Long-term overheating of the residential market is a systemic problem

While China is indeed plagued by long-term overheating of its residential market, it is a phenomenon which is systemic and ultimately related to lack of liberalization of China's financial system. The prolonged run-up in housing prices is the result of exaggerated demand caused by a large amount of investment capital being bottled up in the country with no suitable investment alternatives to provide an effective store of value.

As a result, over the past decade China has been turned into a nation obsessed with real estate, and specifically housing ownership, with possession of a flat being the chief sign of financial security. Although it appears in some cities and for certain market subsegments that as much as 30 percent of the units sold are presently held by investors rather than end users, it is difficult to distinguish between end-user property demand and investment demand because property by nature is both an investment asset class and part of the infrastructure which supports everyday life.[17]

However, it is uncontestable that the weight of investor purchasing interest has been a key factor driving the rapid escalation in residential prices over the past decade and the rapid deterioration in affordability. This price run-up has been socially destabilizing because so much of the wealth generated in China during this period has been related to flipping real estate.[18]

New national leadership inherits a conundrum

However, at the same time that HPRs have run into problems due to their market-deflating effect when the central government needs to keep the economy pumped up, the incoming party secretary and premier will inherit a plan to spend $800 billion to build 36 million public housing units between 2011 and 2015. While highly ambitious, this plan has been dogged by funding shortages and accusations that some municipal governments have misallocated funding towards pet infrastructure projects, as well as by questions concerning the fairness of allocation of public housing units. This situation has been exacerbated by the flagging will of the municipal governments to invest in housing low-income families at a time when the cooling economy and declining market in development land have sizably dented their annual revenues.[19]

China's incoming fifth-generation party leadership has considerably less room to maneuver than its predecessor in 2008, when it applied a massive fiscal stimulus to shield the economy from the global financial crisis.

While China has sufficient financial reserves to apply a much more robust stimulus, it could do so only at the risk of making another major round of bad investments and possibly sparking another major boom bust/cycle in the real estate market—something which could be even more destructive than the downside of the current cycle and which it wishes to avoid at all cost.

The fact that in the fiscal blueprint for the 12th Five-Year Plan, released in late September by the PBOC, the Central Bank was sufficiently confident to set a clear inflation target for 2013 suggests that no major blowout of inflation will occur within the year due to an unexpectedly large spike in credit. The plan also remained vague about timing for movement to full convertibility of the renminbi, an event which would have a profound impact on the domestic real estate market.

What tools does the central government have left in dealing with residential sector problems?

Abruptly abandoning HPRs and making a massive injection of credit would certainly be tempting, but likely would lead to a strong price rebound, which is precisely what the central government wishes to avoid. So, what tools does the central government still have at hand in order to keep the lid on housing prices? It would appear there are not many, so the incoming leadership is left to carry on where the former leadership left off. However, the new leadership at the same time will have to contend with persisting dissatisfaction about HPRs on the part of municipal authorities, who can be expected to continue pushing the edge of the envelope with respect to how much leeway they have in relaxing implementation of the policy.

Outlook for 2013 China residential sector

Although the incoming central government leadership undoubtedly wishes to start its term on a positive note, without the enormous clout of former party strongmen such as Mao Zedong and Deng Xiaoping, it is unlikely to take the big state-run monopolies head on. Instead, the leadership likely will continue pursuing structural reforms which fall within its remit, such as phasing in a new national real estate tax system to replace the use of administrative orders to interfere in the market.

Though economic growth in China is likely to hold steady in 2013 and has already shown signs of stabilizing slightly in the fourth quarter, it is unlikely to return to the pistol-hot double-digit pace witnessed earlier in the decade. China is now in the early stages of a gradual but inevitable structural shift from fast-paced, investment-led growth to slower but more sustainable domestically focused expansion.

While the incoming leadership will want to keep the public housing construction campaign launched by the previous administration pumped up, revenues from land sales in some cities will remain below normal levels, making it difficult for some to meet their 2013 development targets. Faced with this potential shortfall in funding, over the coming year the new central government leadership is likely to increase support for policies intended to attract more private investment capital to the public housing sector, something with which it has enjoyed relatively little success to date. Most of the new public housing–related investment vehicles, such as the currently mooted Chinese public housing REITs, if they eventually achieve liftoff, will probably mostly capture investment from domestic financial institutions.

The central government is unlikely to publicly change its line about the necessity of strictly curbing speculative investment and rising housing prices, and will certainly not retreat from advocating continued imposition of HPRs. However, if the Chinese economy remains weak, over the coming year the central government will be apt to interfere less in local fine-tuning of HPRs, and the cities affected will continue to extend greater flexibility to encourage certain categories of buyers to acquire housing to live in.

The shape of what is likely to be a stronger trend emerged in the recent selective, partial lifting of some borrowing restrictions on Chinese urbanites seeking to acquire ordinary housing in the cities where they live. While municipal governments may be highly constrained when confronted with the MOHURD prohibition on significantly relaxing local HPRs, amongst the 48 cities on which the restrictions were imposed, about 20 during 2012 have fallen back on one of the few tools which have been left largely to their discretion—adjusting the borrowing policy on their municipal housing provident funds. Reportedly, since mid-2012 the majority of these 20 cities have moved to raise the maximum limit on borrowing rates to 25 percent from 15 percent, and a number have also moved to drop the minimum housing downpayment limit to 20 percent from 30 percent.[20]

If this latest round of municipal government credit loosening is an indication of the direction of the China residential sales market in 2013, then clearly demand for ordinary housing is slated to become more buoyant, since it is typically middle-class urban residents who are most apt to borrow from housing provident funds to purchase residential units to live in. However, these moves are highly unlikely to rekindle the speculative enthusiasm of the previous period because the total credit released as a result of the relaxation, while not insignificant, will be insufficient to become a force driving individual deals in the higher-end, investment-grade market segment. The central government also will extend the implementation of the national real estate tax to more cities, while still holding back from attempting to impose this new tax regime at the national level because more time is required to iron out internal contradictions and make technical preparations for its nationwide rollout.

In 2013, land sales to developers and residential sales to the public are both expected to rise off the generally depressed levels witnessed in 2012, triggered by a more optimistic mood on the part of the homebuying public following emergence of a somewhat more relaxed credit environment.

Land sales in some cities are expected to return to somewhat more positive levels in 2013, especially in a number of first- and second-tier cities such as Beijing, Shanghai, Nanjing, and Suzhou, where a combination of rising demand and declining construction has resulted in the residential pipeline stock dropping to comparatively low levels. Also, in a geographically diverse group of second- and third-tier cities, spanning southern, southwestern, eastern, northeastern, and northern China, developers in recent months have stepped up acquisition of sites for either residential or composite development at attractive prices. This trend is expected to continue into next year because a combination of factors will again make certain cities and specific market segments attractive for property development.

However, it should also be borne in mind that the presence of those China developers which have accumulated substantial inventories of unsold stock will continue to remain a negative force in the market. Many developers in this group have assumed substantial leveraging in order to bear the cost of carrying these inventories forward, and those whose portfolios are concentrated in cities with weaker fundamentals will remain under pressure to continue discounting sales prices. More specifically, those localities where developers have an exceptionally large supply of unsold properties in the pipeline, or where there was excessive speculation during the pre-2011 residential property boom, are expected to continue to experience broad declines in residential prices in 2013. Therefore, the collective weight of the continued presence of these financially burdened developers and their unsold stock, combined with the drag exerted by the persisting implementation of the HPR policies, is expected to prevent a strong rebound in the larger residential sales market in 2013.

While these dark clouds on the horizon are not expected to immediately dissipate, China's better-financed developers, which have also been somewhat encouraged by the recent steps towards easing the credit environment, will enter 2013 with an appetite to replenish their diminished land banks and take advantage of still-viable localities where land prices have dropped well below their 2010 peak prices. These stronger players will be seeking situations where they can find opportunities for distress plays and viable locations or project types which are not subject to the HPRs, or, when selecting sites in larger cities where housing purchases remain restricted, they will show a greater preference for politically correct but commercially viable land parcels zoned for subdivisions of ordinary housing.

Notes

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