ChinaIntelligence
Investment and business advice on China

thequarterlydragon #1

April 1, 2015

China's economy faces big challenges but no risk of collapsing

Growth rates will decline, but the labor market will remain stable and private consumption will continue to increase; consumer-oriented and -related sectors provide attractive long-term investment opportunities

The recently ended National People's Congress provides a good opportunity to issue the first of ChinaIntelligence's reports on key economic and investment developments. At the beginning of 2015, China faces big economic and social challenges which are being discussed increasingly openly. Many of these economic challenges look similar to challenges other countries are facing, at least at first sight: weakening economic growth rates, high debt levels, low inflation rates (including falling producer prices) and high real estate prices. Because of these challenges, very pessimistic scenarios for China's economy are often put forward.

One of ChinaIntelligence's objectives is to question such analogies with other countries and the resulting scenarios, and to supplement the headline information (such as «the very fast rise of China's real estate prices raises the risk of another global financial meltdown») with relevant information which does not always get enough attention (such as «the required equity down-payment for house purchases in China has been 30% or more» and «there is hardly any securitization of mortgages and no collateralization of mortgage bonds in China»).

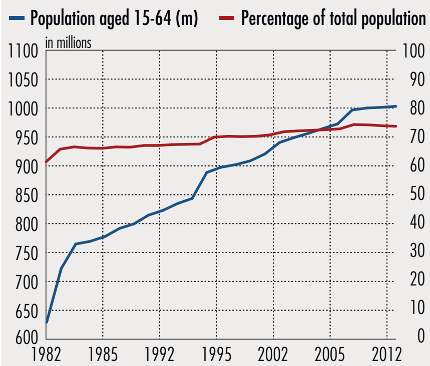
INSIDE

GDP growth rates will continue to decline, but GDP growth rates are not the dominant parameter the government is focusing on

China's government appears to accept a gradual decline of economic growth rates. This is good news, and **we will probably see annual GDP growth rates below 5% in a few years.** One simple reason for this is that the working-age population in China has started to stagnate and will start shrinking in absolute numbers (see chart 1). Assuming a stable working population, all the economic growth has to come from increased productivity. Improving productivity certainly is possible in China, be it by moving workers away from the agricultural sector to the more productive secondary or tertiary economic sectors, be it by improving efficiency within existing organizations. But in the short term there is a limit to these improvements. Such a decline in GDP growth rates may not have been anticipated by global financial markets yet and will negatively affect many other countries, primarily via lower demand for commodities and lower exports to China.

Saying that the government accepts a gradual economic slowdown does not mean that the government is doing nothing to support growth. Many initiatives are clearly supportive of economic growth in aggregate: from the exemption of very small enterprises from VAT to reductions in interest rates, from various smaller administrative re-

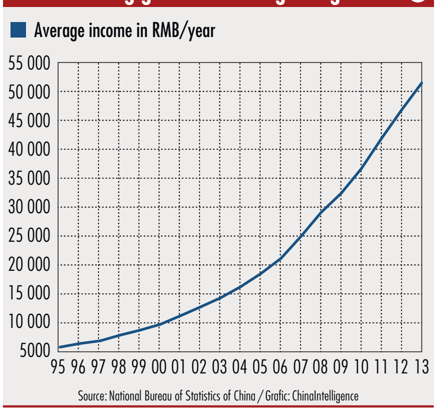
Working-age population stagnating ❶



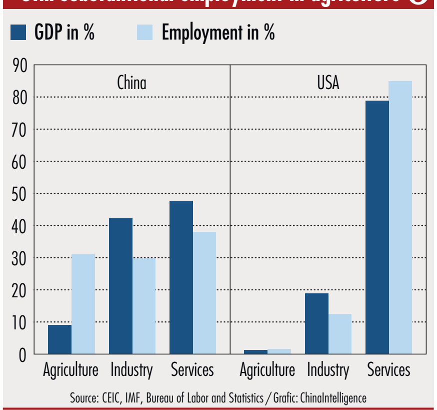
Source: National Bureau of Statistics of China / Grafic: ChinaIntelligence forms to the big Silk Road initiative, which targets the comprehensive development of the trade sector from Xi'an to Western Europe – the government continues to be present in all aspects of economic life. But there are several reasons why the government does not fight the impending economic slowdown more vigorously.

First, **the labor market is more important than GDP growth rates,** because it is more relevant for the well-being of the population. Current low unemployment rates in urban centers (the official unemployment rate stands at 4.3%, a government-published number which is of questionable information content but is corroborated by many other observations) and continued wage growth mean that the real purchasing power of the average citizen is steadily increasing in light of low consumer price inflation (see chart #2). Second, the size of China's economy today is many times larger than 10 years ago[1], meaning that at current GDP growth rates the absolute growth of the economy is not smaller than it was in the 2000s at growth rates above 10%. Third, the massive stimulus programs of the Hu/Wen government in the years 2009/2010 led to increasing imbalances and many uses of money with questionable efficiency and effectiveness.

Strong growth of averge wages 2



Still substantional employment in agriculture 3



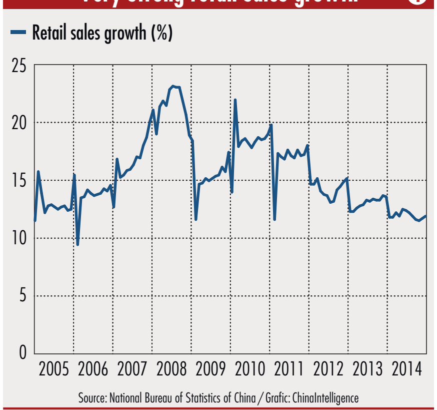
As a result, **the slowdown in China's economic growth must not be confused with unsuccessful economic policies.** Rather, other factors will be decisive going forward: a healthy labor market with real wage increases as the economy as a whole moves away from the agricultural sector (still accounting for approx. 30% of the nation's employment, see chart #3) to more productive sectors, a steadily increasing consumer sector, economic and financial reforms and important social reforms like the reform of the «hukou» system coupled with continued large-scale urbanization.

The consumer sector will continue to grow strongly as China goes through massive changes

The large-scale, far-reaching changes in China since Deng Xiaoping started monumental reforms in 1978 sometimes lead to the perception that «this was it»: the reforms have taken place and the pace of change will slow down. This is not the view we are taking. **We believe that the coming decade will bring further, far-reaching reforms** and will continue to unleash even more economic strength in China, some of which will undoubtedly have to be directed to fixing some very big economic challenges.

In light of the outwardly modern appearance of Shenzhen and Shanghai, the ever-increasing streams of tourists from mainland China and the ubiquitous smartphones which sometimes seem to be in use 24/7 (China currently has 1.28 billion mobile phone subscribers, the cheapest smartphone is available for approx. USD 40) it is easy to forget that the average GDP per capita in China is not more than USD 7,572 (i.e. one fifth of Japan's, and one fourth of Korea's)2. This means, for one thing, that a substantial part of the population still cannot afford consumer goods which have been taken for granted for over 50 years in many Western countries. Even in Shanghai, near the center of the metropolis, sometimes clothes are still being washed by hand outdoors, in buckets.

Very strong retail sales growth 4



Combined with the wage growth mentioned above and the ongoing urbanization, this almost ensures the continued strong demand for consumer goods (see chart #4). Such goods include all the «classics» like electronics, clothes, FMCGs, cars, etc. But also services are a big «consumption» item, in particular the services which have traditionally been supplied by the government (such as medical treatment and education), but are perceived as having insufficient quality by many Chinese today. Access to better medical treatment is crucial for a culture which puts a lot of importance on health, and education is seen as essential to succeed in the very competitive environment in China and to reach the dream of a better lifestyle, a nice apartment, a car. So not only the private tutoring schools for English and other topics for children are mushrooming, also education services for adults such as courses for IT-service personnel are in high demand.

Urbanization, coupled with reform of the «hukou» system, will continue to be one of the most noticeable changes. In 1960 less than 10% of the population lived in urban centers, in 2000 it was approx. 35%, now more than 50% of the population live in one of the 150 cities in China with a population of more than 1 million (see chart #5 next page). The world has never seen such a development, which was carefully planned by the central government and, by and large, has been executed well. Nevertheless, planning mistakes leading to prematurely built infrastructure, empty apartments, corruption and speculation probably were inevitable. More on this topic in our piece on the property sector (page 6). This continued trend, moving an additional 200+ million people to urban areas in the coming 10 years, will provide a powerful boost to the consumer sector. More and more people will leave the notoriously unproductive agricultural sector and strengthen the secondary and tertiary sector of the economy, reinforcing the tendency of wage growth and subsequent

[1] China's nominal GDP as of YE 2013 was USD 9,240 million (USD 16,162 million purchasing power adjusted), YE 2003 nominal GDP was USD 1,640 million (at current USD rates); source: the World Bank.
[2] As of YE 2013; source: the World Bank.
[3] Average urban income compared to average rural income; source: Nation Bureau of Statistics of China

upgrades in living standards. **The migration from a rural to an urban area triples the income of an individual!**[3]

Important reforms will continue, step by step

President Xi Jinping's newly promoted political theory of the «four comprehensives» (referring to «comprehensively» building a moderately prosperous society, deepening reform, governing the country according to rule by law, and enforcing strict party discipline) cements the important role of reforms for the current government. Given the apparent power structure within the Communist Party, with President Xi firmly in charge and the Party's desire to stay in power, we expect the reform agenda to be implemented further, in the social, economic and financial areas, although we are aware that significant factions of the political and economic establishment are opposed to them for a variety of reasons.

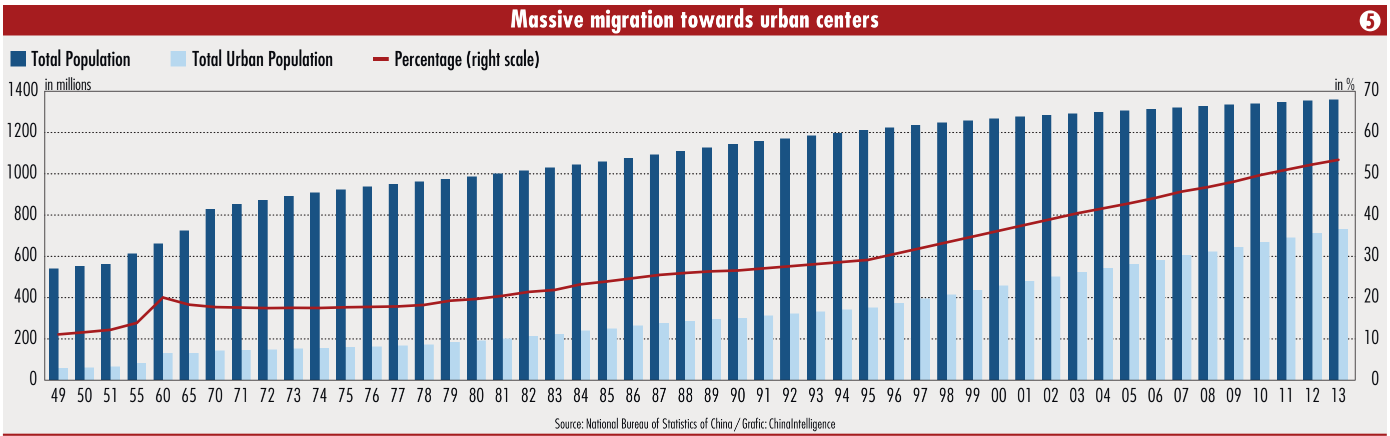
Addressing the possibly most widespread concern in China's population, the **fight against corruption** is one of these reforms. Initially it was not entirely clear whether this would be a determined effort to root out one of China's most crippling problems or rather the most practical way to eliminate political foes. But after two years of casting a wide net to identify and charge officials at all levels and around the world, the government appears to seriously attempt to make a difference in the way everyday life looks and feels in China. **If successful, this reform will provide substantial impulses to the economy.** So far, at least outside of Beijing or Shanghai, every interaction with a government branch brought with it lengthy negotiations to try to extricate oneself from the small or outrageous demands of the respective officials with the least amount of damage. But damage there always was, be it a delay in getting construction permits issued, be it a payment under some obscure title to have the electricity company turn on the switch. No wonder China landed on the «ease of doing business rank»# 90 out of 189 in the World Bank's recent survey on business regulation.4 If these hurdles were to become fewer and lower, the private sector, which provides the vast majority of new jobs in the urban areas of Communist China, would clearly gain in productivity.

«Hukou» reform, although implemented gradually, will allow workers who have lived and worked in urban centers to bring their families with them and purchase real estate in these urban centers for the first time. Today, every Chinese is assigned a «registered residence» («hukou»). This is where he and his family can live, receive medical treatment and education for the children. To satisfy the urban centers' demands for labor, however, hundreds of millions of former peasants have left their formal residence for work in the cities, earning significantly more than they could in their hometown. In principle, they have not been allowed to take their families with them. If they did anyway, their children cannot got to public schools, and the family members cannot receive medical treatment at affordable costs – because they do not have a hukou for the working location. This system is increasingly seen as unfair to the hardworking laborers and their families, also because the urban centers could not have been built without them. The hukou system, however, has had one very beneficial effect for the development of China's megacities: while there are large areas with very modest living conditions, there are hardly any slums as we know them from virtually all other large cities in Asia and Latin America.

The government announced in 2013 its intention to reform the hukou system, in order to give the workers and their family members, who live away from their registered residence, essentially equal rights and access to medical and education services in the place where they work. This reform is not uncontroversial and has led to protests by some people with hukous in the large urban centers as they fear for their privileges. Implementing hukou reform is a massive project, requiring the transfer of vast sums of money in order to pay for the services to be provided to the workers and their families. Since much of this money has not been pre-funded, discussions on how to effect such transfers are complex. In addition, the service infrastructure in the urban areas will have to be expanded. Reform will therefore proceed gradually, but we expect it will proceed. The number of workers who will be affected by hukou reform, once fully implemented, is estimated to be more than 15% of China's population, approximately 200+ million people. This will provide a steady and dependable boost to the demand for living space on the fringes of the urban centers.

The financial markets will also see further liberalization. The deposit rates, capped by regulations so far, should become more flexible, leading to a degree of competition among the different takers of savings deposits. This could lower the financial repression of savers in China. One important basis for these reforms, stripping the banks of some of their government-guaranteed wide lending business margin, is the **introduction of a bank deposit insurance system.** At the end of March 2015, the government announced the introduction of insurance for bank deposits up to RMB 500,000 (approx. USD 80,000), funded by payments from the banks to an insurance fund managed by the Central government, effective May 1, 2015.

[4] *«Doing Business 2015 – Going Beyond Efficiency – Comparing business regulations for domestic firms in 189 economies»; a World Bank Group Flagship report, 2014.*



Access to stock markets in China will also increase gradually, as the opening up of trading links between the stock markets of Hong Kong and Shanghai, and Hong Kong and Shenzhen over the last 12 months show. As always in China, such openings take place at a measured pace, avoiding big experiments. But once the first step has been taken, the direction becomes clear and it will only be a matter of time until liberalization proceeds further.

The interest rate level could decline significantly in order to stimulate the economy. Benchmark interest rates currently are 5.35% for lending money (were 6% as late as November 2014) and 2.50 % for deposit rates (were 3% as late as November 2014). Actual interest rates for loans and deposits frequently are priced at a premium or a discount to the benchmark rates, with the risk premia charged being more benign than in Western financial markets.

Big economic challenges are manageable as long as there is stability

China's biggest economic challenge are the debts which have been amassed in large parts of the economy (by local governments, by state-owned enterprises, by private companies, but not by individuals). They increased in the wake of the economic stimulus program from 2009 onward, unleashed by the Hu/Wen government in order to combat the feared destabilizing economic downturn emanating from the financial crises in the Western economies. So in China, for once, we have an economy where making more loans available also leads to more loans being taken out (as opposed to many economies in which interest rates are cut to zero, but the lending activity to the real sector does not increase). In addition, lending activity in a sector commonly labelled as «shadow banking» has increased exponentially, leading to the perception of increased risks in the financial system, because many such shadow banking institutes are not subject to the same regulations as commercial banks.[5]

Overall, the dimensions of the outstanding loans are large, but the most dangerous aspect is the fast growth in indebtedness in the years since 2007 (see chart #6).[6] The gradual reduction of the indebtedness in relation to the GDP will require careful policy decisions and economic and financial stability. But if China, with its continuously growing economy and its shift of labor from the low-productivity agriculture sector to the higher-productivity secondary and tertiary sectors cannot manage its debt levels, many other countries won't either.

The **property market** attracts a lot of attention because it is very large (approx. one fourth of the economy is inter-linked, directly and indirectly, with it), and because it may well be the single most important sector for China's economy in the near- to mid-term. Furthermore, real estate prices have multiplied since the true start of private residential real estate ownership in 1999, many property developers are heavily indebted, and the price boom has flattened out. In some areas prices have even declined, a novelty in this young market. No wonder these recent price developments have led to questions regarding the health of the property market. This is why this sector is highlighted in the focus topic on the property market (page 6).

Overcapacities in erstwhile important sectors of the economy (such as steel production, coal mines, but also corn processing, ship building), combined with precipitously falling market prices for some of their products, have turned formerly strong industry behemoths into restructuring cases. Their destiny is to shrink, as evidenced by the recently announced government intention to reduce steel production capacity by 80 million tons p.a. (approx. a quarter of China's capacity). But because any downward adjustment of such conglomerates inevitably would lead to large job losses, they are kept alive, especially if they are located in areas where there are few alternative employers. Adjustment processes are slow and absorb a lot of financial liquidity, some of which may never be recoverable. Reforms in the way state-owned enterprises are managed will be ongoing, but we do not expect any headline-grabbing news regarding the restructuring of this sector: **the government values social stability in the respective areas higher than saving a few billion RMB.** But the impact on economic growth will not be positive mid-term.

Something new: a strong RMB

The RMB being a hard currency certainly is a novelty. Especially the RMB's recent strength when measured on a trade-weighted basis is remarkable (see chart #7). Although China's economy is not dominated by exports anymore[7], the strong RMB hurts the economy. In a period of slowing economic growth rates, this in and of itself is not a desired development. The obvious question is: will the People's Bank of China («PBoC») follow their counterparts in Japan and Europe to intentionally weaken its currency and support its real economy? We think this is unlikely. **Financial stability is a very important goal for the government, and this speaks against strong currency movements.**

There are two main reasons why an orchestrated weakening of the RMB by Chinese authorities is improbable:

A significant debt increase in recent years 6

Rank	Select countries	Debt-to-GDP ratio %[1]	Percentage point increase 2007–2014
1	**Japan**	400	64
2	**Ireland**	390	172
4	**Portugal**	358	100
8	**Spain**	313	72
11	**France**	280	66
12	**Italy**	259	55
13	**United Kingdom**	252	30
16	**United States**	233	16
17	**South Korea**	231	45
22	**China**	**217**	**83**
24	**Germany**	188	8
34	**Brazil**	128	27
35	**India**	120	0

[1] Includes debt of households, non-financial corporations, and government

Source: McKinsey Global Institute / Table: ChinaIntelligence

Strong RMB appreciation 7

Source: Bank for International Settlements / Grafic: ChinaIntelligence

[5] *We will focus on the financial sector, and «shadow banking» in one of the next issues of the Quarterly Dragon, so for now just a few comments: «shadow banking» does not take place in a hidden market, but "shadow banks" (= financial institutions outside the regulated commercial banks) have grown primarily for two reasons: commercial banks set up such institutions in order to circumvent regulations, and debtors which ran into trouble were looking for alternative sources of funds. So the «shadow banks» have grown as a result of demand by the market. It is now the government's intention to reign in their activities and tighten their supervision.*

[6] *Estimated, in aggregate, at 217% of GDP. Source: McKinsey Global Institute, «Debt and (not much) deleveraging», February 2015*

[7] *Exports of goods and services amounted to 26.4% at YE 2013, compared to 37.1% at YE 2005; source: the World Bank.*

- **Any currency weakening against its main trading partners would also have to be a weakening against the USD.** But 80% of the outstanding foreign currency loans of Chinese companies are denominated in USD and the bulk of goods traded across China's borders are accounted for in USD. So a strong move of the RMB vs the USD would lead to many imponderables for China's economy.
- Since China has now officially stated its request to have the RMB included in the IMF's basket of currencies used to calculate its Special Drawing Rights (SDRs), a volatile currency would also not be in the interest of the internationalization of the RMB at this time.

For 2015, the PBoC has indicated its intention to slightly weaken the RMB against the USD by 2-3%, probably also to lessen the inflow of hot money which primarily wants to benefit from an appreciating RMB. Therefore, as long as the USD remains strong against the currencies of some of China's main trading partners (e.g. Japan and Korea), the trade-weighted RMB will remain a strong currency. **No economic stimulus for the real economy should be expected from the currency front.**

QE? Not necessary if you control the lending activity of the banks anyway!

Speculation about a long series of interest rate cuts by the PBoC has been around for a while, and undoubtedly has fuelled the stock market rally of late. But it is highly questionable whether a decline in interest rates in China will mirror the scale of interest rate reductions by the Western central banks (quantitative easing).

First, the supply of liquidity to the economy has been very generous ever since 2009, determined by the lending quotas the central government allocated to China's commercial banks. In China, no interest rate declines are necessary to stimulate the lending volumes, because determining the amount of money to lend was not really the banks' decisions in the first place – **it is the government who decides how much money the banks should lend** (and to whom, in some cases), by periodically allocating lending quotas to the banks. Then, it is the banks' job to make sure the lending process is orderly and the loan documentation satisfies the regulations.

Second, for the same reason the effective interest rates paid on loans do not correlate very tightly with the benchmark rates. And third, it is important for the stability of the financial system that the commercial banks earn a significant margins on the loan books in order to be shielded against their non-performing loans (NPLs). The officially reported NPL-ratio of Chinese banks stands at 1.64%[8], but everyone knows that **this number does not reflect the very large amounts of outstanding loans which are of very questionable quality, but are being «rolled» again and again in order to keep the debtor alive.** «Extend and pretend», practiced on other continents as well, lets the reduction of massive overcapacities in some industry sectors be addressed over time and stretches the pain of restructuring over many years.

The rule of law

As already mentioned, one of the «four comprehensives» put forward by President Xi Jinping is the stricter adherence to the rule by law. Laws, regulations and administrative procedures are plentiful in China, but they are not followed systematically, to say the least. The legal system today is dependent on persons rather than on the letter of the law, in large parts of the economy the government is always present and enormously powerful. **Arbitrary procedures rule the lives of too many Chinese.** To make matters worse, this has probably never been different in China. **To change this is the mother of all Herculean tasks, but it is also the key to the solution of many other of the country's most pressing problems** such as the pollution (many regulations exist on what a factory's chimney may discharge, but if the particle filter is stored in the warehouse instead of being installed in the chimney the situation will not get better) and inconsistent food quality (in some instances, the production of food in factories on Chinese soil is subject to many more regulations than is the case in Western countries; but «cutting corners» or outright fraud have led to many food scandals).

Because the rule by law, or the current lack of such, is a very complex topic, a future issue of the quarterlydragon will focus on it. For now just a few comments: the Chinese legal system can be criticized regarding many aspects. For example, many Chinese ridicule the paradox that the constitution is supposed to be applied to all Chinese citizens, but that the Communist Party officially stands above the constitution. This also means that the representatives of the Comunist Party stand above the constitution they are supposed to obey. But even without tackling such basic issues the everyday life of all citizens and companies could be improved substantially if existing laws and regulations were followed more strictly, e.g. if judges' rulings were less influenced by money received from the parties appearing before the court or if government officials regarded their area of responsibility less as their hunting ground, but rather followed Mao Zedong's famous motto of 为人民服务 (wei renmin fuwu, to serve the people). So there is ample upside to make a measurable difference for China's economy even within the limitations of today's letters of the law.

[8] Source: China Banking Regulatory Commission

Key developments we expect for the coming 12–24 months

We expect political, economic and financial stability despite all the looming challenges. Regarding some key topics our expectations are:

- *GDP growth: 2015 around 6.5%, 2016: 5.5% to 6%.*
- *Labor market: stable, with continued wage growth of between 4-7% p.a., at the lower end for high-wage earners, at the higher end for low-wage earners.*
- *Further reforms towards RMB-convertibility and opening financial markets.*
- *Interest rates: 1-2 additional cuts in the benchmark rates in 2015, each by approx. 25 bps.*
- *No big stimulus program, but a multitude of smaller and targeted measures and reforms to support the economy.*
- *Real estate prices: worrisome news on falling real estate prices in H1 2015 due to the base effect, but a stabilization of prices and demand towards the end of 2015 and 2016.*
- *Property developers: some will face liquidity difficulties and may have to restructure their outstanding bonds.*
- *RMB: slightly weaker (2-3%) from the current rate of 6.19 RMB per USD.*
- *Retail sales growth: ca. 10% p.a.*

焦点

Residential real estate: pricey overall but not bubbly, and not crashing any time soon

High equity financing and no mortgage collateralization mean that China's residential property market is no systemic risk to the economy. But softness in property prices may contribute to lower economic growth rates.

If you ask a local Shanghainese apartment owner whether she expects rising or falling property prices in the years to come, she will probably answer: «More than a billion Chinese would like to own an apartment in Shanghai – of course prices will continue to rise!» This answer points to the key factor that has been and will be driving the property market in China in the next 10 years: substantial demand for bigger and better living accommodations in all parts of the country. Combined with housing supply which is not excessive this will lead to manageable price developments. Notwithstanding lower property prices in recent months, negative headlines about property developers missing interest payments on USD bonds and pictures of one or the other «ghost cities», China's property market will not collapse.

We highlight China's property sector because it is a crucial sector of the economy and will be a key factor for economic developments in the coming years. The property sector is estimated to affect a quarter of the economy, directly and indirectly via all the other sectors which are inter-linked (from concrete producers to interior decoration companies). In addition, many doomsday scenarios for China start with the argument that property prices have risen too high and are due for a significant correction, that the decline in the working-age population in China will mean there are not enough buyers for the properties supplied, and that all this will inevitably lead to a financial crisis of country-rattling proportions. Liquidity difficulties for some property developers, some of which have missed interest payments on USD bonds, are then seen as an added danger, possible leading to large-scale fire sales of property inventories.

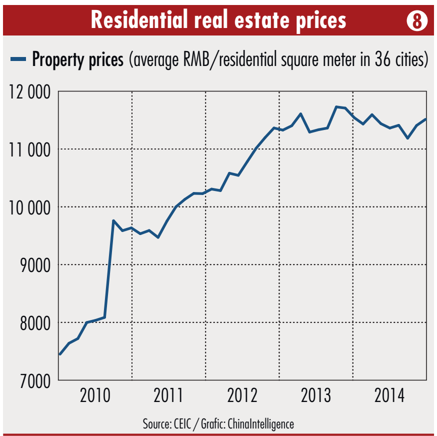
To address this important sector of China's economy and some of these often-voiced scenarios, we

- Look at who buys properties in China and why,
- then look at the supply situation,
- analyze the mortgage financing market,
- reflect on government policies in the property sector and
- touch on topics like speculation and property developers.

We highlight the residential real estate sector in this piece. The commercial real estate sector accounts for approx. one tenth of the sales volume of its residential counterpart and thus is of lesser importance.

Most Chinese are homeowners, and most apartment units are owned by the people who live in them.

The history of China's private residential property market is short. All real estate was owned by the government until the 1980s.



Private home ownership as China knows it today only started in 1998, when the world's largest-ever asset privatization campaign let individuals own apartments and houses.[9] Several factors led to the enormous boom in housing prices since then: the basic desire of the urban population for more comfort (20 years ago, the average Shanghainese had 5 square meters of living space, now 23), the massive urbanization (see chart #5 above) and the general economic boom including the average worker's wage growth (see chart #2 above).

This has led to price increases for real estate (see chart #8), which at first sight seem incompatible with China's current average GDP per capita of USD 7,572 (USD 12,893 on a purchasing power basis)[10]. This price boom also led the government to erect various hurdles or restrictions regarding the ownership of apartments in order to slow down demand. They include restrictions to allow the ownership of only one apartment per married couple (leading to quite a few divorces to circumvent this rule) and increased equity financing requirements of 60% for the second apartment (reduced to 40% on March 31,

[9] All of China's soil still is in possession of the government. All a company or an individual can do is buy land-use rights, which lets them construct an apartment building, a factory, etc.
[10] Source: World Bank, as of December 2013.

2015, compared to the typical 30% equity financing requirement for the first apartment).

Some basic facts are important to keep in mind regarding China's residential property market:

- The vast majority of people living in urban centers own the apartment they live in.
- Approx. 90% of new homebuyers purchase a home to live in it. **Important cultural factors** contribute to the desire to own a home: many young women (or their parents, as the case may be) will not agree to marry a man who cannot provide ownership of a home; if a couple rents an apartment nonetheless, the impending birth of a baby will inevitably motivate the couple to buy an apartment, because the eviction from a rented apartment can be extremely swift (in a matter of a few weeks), leading to a logistical nightmare for the young parents.
- **This means that the purchase of an apartment is the #1 material ambition of many Chinese**, after «basics» like food, simple clothing and a mobile phone. Consumption of many other goods is often delayed in order to save up for the purchase of an apartment. Many people spend no money on holidays (resting at home during holiday periods instead) and taxis (taking public transportation, although the absolute price premium of a taxi is affordable). Expenses for things like fashionable clothing or pharmaceutical drugs are reduced to a minimum in order to be able to purchase an apartment.
- Young married couples who buy an apartment will often welcome one or more of their parents to live with them. The reason for this is cultural, but also brings with it the benefit of trusted child care for dual-income couples, who typically are hesitant to trust their offspring to anyone but family members. This is one but not the only reason why **parents (and other family members) frequently help to finance the purchase of an apartment.** And that is part of the explanation why relatively young people can afford to purchase apartments despite the high market prices (compared to average wages) and the requirement for a 30% down payment of the purchase price for a buyer's first home.
- While housing costs are high compared to the population's income, and the mortgage and other apartment-related payments may amount to half or more of the respective owners' monthly income, **the affordability ratio has improved in recent years** due to price stagnation in many property markets and ongoing wage increases across the country (see chart #9). Apart from excesses in China's megacities, the average urban property price was estimated at RMB 5,850 (=USD 940) per square meter by the National Bureau of Statistics in 2013.
- Mortgage indebtedness weighs heavily on many people's personal balance sheet, but consumer debt in general still is low in China. This is changing as an increasing number of products is sold on credit (e.g. cars), but mortgage debts frequently are the only debts people carry. Thus a high level of mortgage indebtedness is acceptable to a lot of people, because home ownership brings with it other benefits (such as status, security regarding one's living situation and the potential for price appreciation).
- And, last but not least, the upgrade potential for today's homeowners still is meaningful. By Western standards, where every child has its own room growing up in many countries, living conditions still are cramped even for the well-off dual income couples who live in a compact three bedroom apartment with their child and two grandparents.

Affordability has improved 9

Average prices for 100 square meters in 40 major metropolitan areas compared to average household incomes.

2010 China overall	11.7
2010 Shenzhen	25.0
2010 Beijing	27.0
2014 China overall	8.6

Source: China Index Housing Affordability by City, Economist Intelligence Unit / Table: CI

Two interlinked factors will play a decisive role for the demand for residential real estate for many years to come: **«hukou» reform and urbanization.** (see more details on page 3).

«Hukou» reform continues to bring tens of millions of people into urban centers every year for the next decade, creating demand for a couple of million additional housing units per year. Approximately one third of China's urban population does not have a hukou for the place where they live and work. Consequently, they are also excluded from owning real estate.

Estimates are that after the currently planned urbanization process has been completed, approx. 900 million of the 1.4 billion Chinese will live in urban areas, **leading to an urbanization ratio of 65%** (up from approx. 52% now, 35% based on the hukou registrations). Granted, not all of the people moving to urban centers are high wage earners, but their ability and willingness to pay for living space in modern buildings should not be underestimated. They may never have lived in a place with such a high level of comfort, and to live in a newly built apartment building means status and participating in the country's progress. This is also why money has been saved for a long time to pay for such an apartment and, if not sufficient by itself, relatives (and loan sharks in some instances) will help to make up the difference to the purchase price.

Unsold inventories at manageable levels in most cities, new construction roughly in line with demand, housing shortage in some urban centers.

Approximately 10 million residential units are built in China every year. This is roughly equal to the demand from first-time buyers, upgraders and newly urbanized people. **When apartment units are built on such a vast scale, some planning inefficiencies, temporary sales delays and delayed occupancies are inevitable.** This may lead to «ghost cities», finished residential areas with largely completed infrastructure, which currently house nobody.

But how big is this problem really? Nationwide, the problem seems manageable, **as the average number of unoccupied units stands at about 15%**[11], comparable to other parts of the world which do not exhibit such powerful urbanization trends as China. Combined with continued growing demand for living space and property construction roughly equal to ongoing demand, **this does not paint the picture of an overall real estate glut.** Also, most apartment buyers purchase the unit in an unfinished state. So an apartment which is not currently used may have been sold all the same, waiting for the owner to finish constructing the interior and starting to live in it. This process may be delayed for a number of reasons, lack of money being one of them. So an empty apartment does not necessarily equal an unsold apartment.

As in any national real estate market in the world, however, the regional differences of supply and demand can be quite large. In some areas, the vacancy percentage is much higher and may lead to severe regional problems, associated with troubles for locally exposed property developers. The areas with high levels of temporarily unused

[11] *Source: CLSA Report from 2014, based on an on-the-ground study of 609 construction projects in 12 Chinese cities, stating that the average vacancy rate in China for property completed between 2009 and 2014 was 15 per cent – equivalent to 10.2 million empty units.*

residential buildings are concentrated in so-called Tier-3 and Tier-4 cities (i.e. smaller cities which are no provincial capitals). In some other parts of the country, especially in the large cities, there is a shortage of living space, or at least of living space at affordable prices.

Down payment requirements of 30% or more, hardly any securitized mortgage assets, no collateralization of securitized mortgage assets

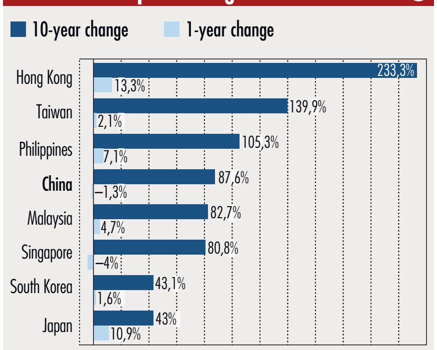
To put it bluntly: Most ingredients of the cocktail, which led to the blow-up of the mortgage-related financial markets in the US and the UK in 2007/08 and the subsequent near-death experience of the Western world's financial system, are simply absent in China. Almost the only similarity to those markets in the run-up to the crisis is a significant increase in real estate prices in the last decade, albeit mostly for different reasons than in the US and the UK (no sub-prime mortgages and no mortgages which are higher than the purchase price in China). **The facts do not support the prediction of a real estate market-induced collapse of China's financial system and economy.** Problems in China's property market may have negative effects on many parts of the economy and are partially responsible for the current slowdown, but they are not «systemic», they will not rattle China's economy and financial system to its core.

Many home buyers pay cash for the entire purchase price, reflecting the fact that many Chinese traditionally feel uncomfortable with debt. The basic equity requirement for first-time home buyers has been 30%. The purchase of additional apartments (if permitted), was tied to an equity financing of at least 60% (reduced to 40% on March 31, 2015). In contrast to other regulations in China, which often can be bypassed by doing a favor to the authorities overseeing the implementation of the regulations, the equity down payment regulations appear to have been implemented as intended. Mortgages are available from banks, and Chinese banks essentially are under the government's control. Because the health of the real estate market is so important to the country it is high on the central government's agenda, thus the government policies in the real estate market usually are being followed.

A hypothetical drop in real estate prices of 10-20% would probably mean that very few property owners would be «under water». Instead, almost all would still have equity left in their real estate investment. Such a price drop would, of course, lead to a nation-wide outcry about how dire things are. But it would not lead to people simply walking away from apartment ownership and sending the keys to the bank holding the mortgage, as has happened in other countries. Quite the opposite – it could very well bring out the last of the marginal real estate buyers who want to take advantage of attractive prices. Therefore, such a hypothetical price drop may not last much longer than the wide-spread discount sales in all the large department stores during the national holidays such as the Dragon Boat and the Mid-Autumn festivals.

Mortgages from banks have been available in China only since 1998. The banks currently hold these mortgages on their balance sheet. The market for securities backed by mortgage loans («asset-backed securities») is negligible. The credit markets in China simply are not developed enough for such a product to exist in a meaningful volume. Since the Chinese banks are majority-owned by the government, **no mortgage insurance companies or government-sponsored mortgage financing companies** like the United States' «Fannie Mae» (Federal National Mortgage Association, FNMA) and «Freddie Mac» (Federal Home Loan Mortgage Association, FHLMA) are needed. As a result, no standardized mortgage-backed securities exist (such as the erstwhile gigantic markets in FNMA and FHLMA securities), which also means that no market for securities collateralized by mortgage loans is possible. The concept of taking mortgage-backed securities, bundling them and slicing them differently to rearrange their cash flows (as in CMOs, collateralized mortgage obligations) is equally unknown in China. **So, the key market mechanism which almost brought the largest Western banks to their knees, namely the multi-layered securitization and collateralization of mortgages, is totally absent in China. This is why we believe no systemic risk originates from China's mortgage market.**

House price changes across Asia ⑩



Source: Global Property Guide / Grafic: ChinaIntelligence

Current government regulations, reducing demand for real estate, are being loosened

Local governments put in place restrictions on property ownership for individuals in the years leading up to 2014, in order to cool demand. The restrictions took many different forms, from limitations of ownership to one apartment per couple, to increasing equity down-payment requirements. Most cities still have one or the other restriction in place after some of them have been loosened in light of soft prices in some markets. The most recent prominent example of loosened restrictions are the actions of the province of Fujian, treating «upgraders», i.e. homeowners who want to purchase an apartment larger or nearer to their kid's school, the same way as first-time homebuyers, and allowing both of the them to purchase an apartment with 20% of equity, instead of 30%.

Loosening such purchase and ownership restrictions continues to be a policy option. It would probably not unleash a wave of new buyers, but could be an element of support for the real estate market. As the PBoC continues to lower interest rates in general, this may also affect the mortgage rates (now in a band around the benchmark interest rate for lending (5.35%) +10% to –30%), providing further help to the marginal apartment buyers. At the end of March, the PBoC instructed the banks to require no less than 40% equity for buyers of second homes (down from 60%).

The central government's campaign against corruption is often mentioned as a factor for the real estate market since many of the illicitly gained money has been parked in real estate. The fear is that a portion of demand would break away if everyone immediately became too honest, and that a wave of apartments would have to be dumped on the market before the nationwide registry for residential real estate will make it more difficult to hide behind property ownership. (The number of apartments owned by a corrupt official is always near the top of the list of assets the individual had amassed. Numbers above 50 (apartments) owned by an individual are raising eyebrows, numbers below 20 (apartments) are considered normal for these cases.) But these cases, no matter how prominent they are, hardly sum up to a meaningful market factor.

Speculation in the property sector exists

Of course, as in any market with potentially substantial price movements, the property sector has attracted investment money, some of which can be labeled as speculative. In many apartments in prime locations all over China the lights never go on, because nobody lives there, and because there are no lights. Apartments are typically sold «naked», with concrete walls and floors. The buyers themselves then are responsible for the paint jobs, putting in flooring and appliances etc. Very substantial amounts of money, compared to the purchase price of the apartment, are frequently spent for the interior finish.

This is why purchasers of an apartment, whose main intention is to hold the apartment as an investment, frequently leave the apartment unfinished and do not rent it out. The opportunity costs of not renting it out are low, e.g. no property tax is levied on unused apartments at the moment.[12] And renters (foreign and domestic) have a notoriously bad reputation in China, apparently not taking good care of the apartment. Rental yields in China are low, apartments at good locations, selling for very high prices, can be rented at surprisingly reasonable rates by international standards.[13]

But speculation is not the main driver of China's real estate market, except for a few locations in the main metropoles of the country. In addition, the speculative owners of real estate are the ones who could withstand a downturn in property prices quite well, also since these investments are not highly leveraged.

Property developers: how much inventory do they hold?

The property development market in China is fragmented – the top 20 developers account for approx. 25% of the market. Property development companies are private companies, some of which have been hugely successful. Their fate inevitably is inter-linked with the prices of the real estate market. But there also are company-specific factors, e.g. the financial leverage of a property development company, which have nothing to do with the property market per se. Property developers have been enjoying good operating margins in many of the recent years.

Property developers, and the liquidity difficulties some have faced, have received a lot of attention. This probably is due to the fact that Chinese property developers have issued tens of billions of USD debt, and that the story of a Chinese company steering for a default is headline material in and of itself because defaults of Chinese companies have all but been averted so far with the generous help of all sorts of government entities. Most potential debt defaults would reflect very badly on senior people in the respective local and provincial governments, because the initial loans would not have been available without the personal intervention of said government officials in the first place. That is why the cards are stacked for rolling over questionable loans, in an effort to delay the day of reckoning.

Whether or not a privately-owned property developer goes bankrupt or not probably is of little importance to the property market in China. One fear, however, is that such a bankruptcy would lead to a fire-sale of properties, putting pressure on prices in certain locations, and potentially leading to a ripple effect. While unsold inventories of housing actually have increased markedly in recent years, the problem often is described in an exaggerated way. In relation to sales, these inventories are manageable and do not risk destroying the market's balance.

Our conclusion is that somewhat lower property prices put downward pressure on growth, but are no systemic risk to the economy. This is supported by the newest data showing a slight recovery in the housing market and more aggressive government spending overall. In March, floor space sold on the open market (-0.9% yoy) showed its highest reading since December 2013. This is a significant improvement from January's and February's contraction of 17.8%. Floor space under construction and floor space newly started fell 18.1% and 19.3%, respectively. The market seems to moving towards a new equilibrium.

[12] This may be changing in the future. A nation-wide registry of all properties in the country currently is in the process of being established. Once completed, it may serve several purposes, e.g. allowing to track corrupt officials who own many apartments or introducing a property tax for apartments that are not rented, thus making more floor space available on the rental market.

[13] Rental yields in China currently average 2.66%, according to the Global Property Guide.

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