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Finance for Australian Exporters

Efic World Risk Developments

June 2014

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Postcard from Shanghai

Our chief economist, Roger Donnelly, was in Shanghai last month to attend the Institute of International Finance's China Economic Forum. He gives his impressions below …

A central topic of discussion was the sharp housing correction, the 'mini-stimulus' the authorities are implementing to combat it, and the increasing policy emphasis on urbanisation and public housing to rebalance and sustain growth.

The overall points? China probably has the 'policy space' and dynamism to avoid a major downturn or banking crisis. Even so, there are downside risks, and of the two just noted, downturn is a bigger worry than banking crisis.

The challenge for the authorities will be to steer through the current turbulence while maintaining the medium term course set at the Communist Party's Third Plenum last November — which emphasises rebalancing the currently lopsided economy so as to sustain the march towards advanced economy status.

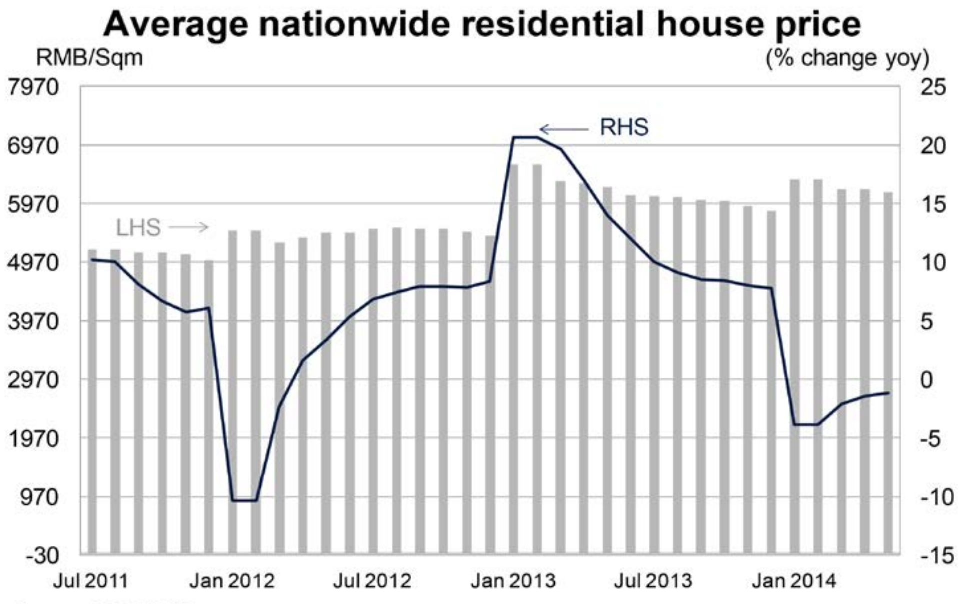
Could housing crunch the economy?

This was the main topic of debate at the Forum. The housing crunch and resultant slowdown have of course unsettled in a big way the commodity markets into which Australia is such a large supplier.

Despite that anxiety, however, most participants were confident that the recent slowdown would be brief, and that 'mini-stimulus' measures and firming demand for exports would pull the economy around by the second half. This would keep the economy on course for a soft landing, with growth of around 7¼ % in 2014 and 7% in 2015.

There were more bearish speakers, however, and they worried that the correction underway in the housing market is severe, and could lead to a sharper economy-wide slowdown.

They noted that residential construction starts (in terms of floor space) plunged 27% from a year earlier in the March quarter, and another 25% in April. House price increases were also coming down fast, even in Tier 1 cities (charts).



Sources: CEIC, EFIC

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A nagging concern was that overbuilding in lower tier cities, the crackdown on shadow banking, and an increasing tendency by wealthy people to buy a second or third property overseas rather than locally could prolong the drag.

It was noted that real estate investment had progressively risen to 15% of GDP last year. It followed arithmetically that if real estate investment fell by 20%, all else equal, real GDP growth would go down by 4½% points.

And that would be just the direct hit. The housing crunch would also knock industries like steel, cement, glass, furniture and household appliances already suffering from excess capacity. It would lift bankruptcies among developers and suppliers, which would increase bank NPLs, although conservative loan-to-value ratios would limit direct bank exposure to losses on residential mortgages.

Finally, there could be a negative wealth effect from falling property prices on household spending, because property constitutes two-thirds of household assets.

Policy response has been measured

So how has the government been reacting? In a word, cautiously.

It is increasing spending on public transport and housing, water projects and social services. In addition, the PBOC had asked banks to increase residential mortgage lending for first homes. It is also containing exchange rate pressures by discouraging carry trade inflows.

But few expected it to ease monetary or credit settings more generally. In addition, the authorities are resisting any major new public works programs; and are continuing to rein in shadow banking, including through discouraging financing through interbank markets.

An announcement that 10 provinces would be authorised to issue their own bonds (up from six last year) continued government efforts to downplay the use of local government financing platforms.

In other words, the authorities are making tactical adjustments to their plans, but have not abandoned the medium term course set in the 60-point reform blueprint presented by President Xi Jinping to the Communist Party's Third Plenum last November — for a more balanced economy marked by stronger consumption and less investment.

Could the housing downturn cause a banking crisis?

Most people thought this unlikely for four reasons.

First and foremost, household gearing into property is limited and default risk correspondingly low. The average downpayment on a flat exceeds 50% of the price and the minimum requirement is 70% for a second home in many cities. In practice, many young people are able to secure the finance necessary to buy a home by tapping their parents' savings, a practice supported by the one-child policy.

Second, mortgage loans in China are 'almost' recourse loans, which enable banks to chase homeowners for the entire debt in default regardless of the loan-to-value ratio. This makes Chinese banks less vulnerable to a property correction than US and European banks in recent years.

Third, Chinese banks have some protection from funding difficulties, thanks to high liquidity and low loan-to-deposit ratios.

Finally, continuing urbanisation and a push by the government into public housing will help work off the current glut of dwellings and support underlying demand.

The importance of urbanisation and public housing

It is clear that the government is placing a lot of reliance on urbanisation to support economic growth and help the economy avoid a middle-income trap. In specific terms, it plans to move some 109 million people to cities by 2020.

It is also placing greater priority on a strategy outlined in the Third Plenum to integrate migrant workers into urban areas. To accomplish this, it plans to relax 'hukou' restrictions that permanently link a person's residency status to that of their parents, regardless of where they live. Under the hukou system, migrants can access public services only in the place they are registered, preventing them from settling permanently elsewhere. The government plans to start with small- and mid-sized cities, to help boost housing demand there. While the urban population increased from 38% in 2001 to 55% in 2013, it still has a long way to go to reach other emerging markets, let alone the 80% average of mature economies.

Another priority is increasing the supply of subsidised public housing for low-income households. The 12th Five-Year Plan calls for the construction of 36 million such dwellings over 2011-15. Of this amount, construction has started on more than 25 million homes, with another 7 million to be built this year. The government plans to provide public housing to 23% of the urban population by 2020, up from 14% in 2013.

To support these targets, it has asked commercial banks to increase their lending for public housing and rental homes, as well as for renovation of sub-standard housing. China Development Bank, the leading bank supporting urbanisation, has allocated RMB500b ($81b) in loans, and was instructed in April 2014 to set up a separate entity to issue bonds to finance the program. Though property loans dropped last year, the proportion of loans for public housing development in total property lending rose from 10% in 2011 to 16% in the March quarter of 2014.

The government is also trying to lay the foundations for sustainable long term development of the housing market, through land reform and fiscal reform that better matches revenue and spending across different levels of government.

Because land sales are an important source of income, local governments have been reluctant to implement central policies in the past, partly offsetting the impact of tightening efforts. The strategy laid out in the Third Plenum document is to increase local government revenue-raising powers, including by bringing more cities into a pilot property tax program, currently limited to Shanghai and Chongqing. Transfers from the central government are to be raised. The government is also preparing to establish a nationwide registration database for home ownership by 2017, which would allow it to introduce a national property tax that discourages speculation by imposing heavier costs on owning multiple homes.

Implications for Australian exporters

The risk of a sharp property-led cyclical slowdown does pose short term risks for Australian exporters. It would act as a drag on non-resource exports, as well as commodity prices and volumes.

Looking further ahead, the Chinese economy is likely to experience further decline in its growth rate, due to population ageing and workforce shrinkage plus a slowing of the productivity growth that can be harvested from rural-urban migration. From the 9.4% CAGR sustained over 1981-2007, growth has now come down to just above 7%, and could decline still further to 5% over 2021-30.

The economy is also undergoing rebalancing, including a push for cleaner, greener growth, that will probably mean a lower commodity intensity of GDP.

Does slower-cleaner-greener growth mean hard going for exporters? Not necessarily. Demand for commodities is likely to grow more slowly than in the past, but not decline in trend terms. There will still be hefty appetite for commodities, including from the urbanisation and public housing programs. It is also important to note that while the growth rate of Chinese resource imports might be waning, those imports have risen almost *six-fold* over the past decade.

Ultimately, the rebalancing of the Chinese economy is unlikely to mean fewer or flagging imports from Australia. But it is likely to change the mix, with the increments increasingly coming from non-resource areas spurred by the rising incomes of an expanding middle class.

Our other newsletter, Export Monitor, to be released next week, will look at some of these new and emerging Australian exports to China.