China's property sector: This time is different

Reducing addiction to property-driven growth amid shifting priorities

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Key points

- China's property market is now enduring its longest and most painful adjustment despite brief relief after the initial wave of the pandemic
- Yet, not only has Beijing so far refused to come to the market's rescue, much of the downturn has in fact been a result of its restrictive policies
- We think these policies – to address structural imbalances of the real estate sector – are fundamentally different from past attempts to cool a cyclically overheating market. With slowing population growth and changing national development strategies, Beijing is redefining the role of real estate under the banner of a 'house is for living, not speculation'
- The challenge of achieving this objective lies in fundamentally reallocating resources away from a gigantic sector which is deep-rooted in China's social, economic, and financial ecosystem. A disorderly correction could have catastrophic consequences
- Hence, a pragmatic approach is needed to manage systemic risks. As Beijing's priority now shifts to stabilising growth, policies are fine-tuned to put a floor under the market. A gradual bottoming out of activity is expected as credit conditions improve, but not enough to fully remove stress on the weakest developers. The latter will likely continue to bear the brunt of the adjustment pains

A sudden collapse of the housing market adds to a long list of struggles facing the Chinese economy since 2021. Many see these woes as self-inflicted by Beijing's draconian policies and are baffled by its persistence despite severe stress reverberating across the economy and markets. Given the colossal size of the real estate sector, Beijing is taking a major risk with systemic stability by continuing these restrictive actions.

In contrast to previous policy-induced downturns, we think the current tightening cycle reflects a fundamental shift in Beijing's attitude towards the housing market. This note explains what has driven this shift and its profound consequences on a systemically important part of the macro system. We also discuss the long-term outlook for the sector by considering both fundamental and investment demand for housing, and the near-term signposts for a cyclical trough of the market.

A too big to fail

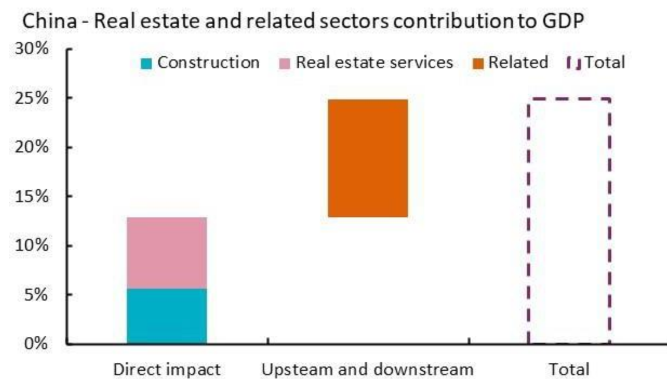
It is widely known that China's housing market is a vital part of the economy, but quantifying its importance is not straightforward. Below we map out China's real estate ecosystem and provide ballpark estimates on its wide influences.

Starting with the obvious, property construction and developers' land purchases – captured by real estate investment – account for around 30% of total fixed asset investment. In value-added terms, property construction is 8% of GDP – a share that has risen notably since the global financial crisis. Real estate services have also grown to a similar size. These

two sectors together make up 16% of China's GDP (Exhibit 1), consistent with our top-down statistical estimates[1].

Beyond the direct influences, the supply chain of the real estate industry stretches far and wide. Take construction as an example, the provision of building materials – steel, cement, and glass – accounts for a significant part of industrial production. Sales of furniture, appliances and even cars can also be linked to people buying new homes. Combining these upstream and downstream exposures[2], we estimate that the real estate sector could amount to as much as a quarter of China's economy (Exhibit 1).

Exhibit 1: Real estate accounts for 25% of the economy



Source: CEIC and AXA IM Research, as of March 2022

But the ecosystem does not end there. Land sales, which make up more than 30% of local government's revenues, are closely linked to the real estate cycle. At twice the size of bond issuance, this is a key source of discretionary income for local governments to spend on infrastructure projects. Hence a significant housing market shock could weigh on infrastructure investment, as seen last year.

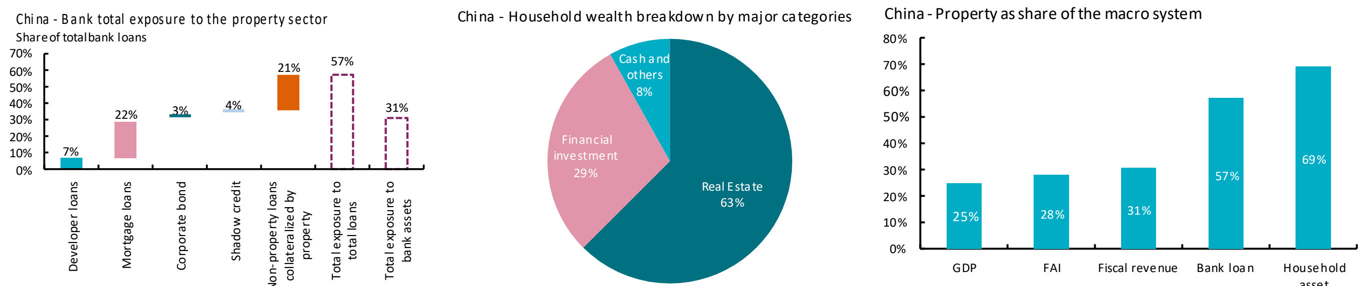
Banking system exposure to the real estate sector is another potential source of contagion. Official data shows that lending to property developers accounts for 7% of banks' total loan books, while mortgage loans add another 22%. The latter typically requires home buyers to make a sizable down-payment up front – from 30% for first homes to over 40% for second homes – implying China should not have a subprime problem like the US in 2007-08. There are also cultural and legal reasons[3] making it harder for a Chinese borrower to walk away from a mortgage, helping to keep non-performing loans low.

Besides the on-balance-sheet exposure, we estimate banks also hold real estate-related bonds and have indirect exposure to the sector via trust and entrust loans, to the tune of 7% of their book. Lending to non-property companies can also be backed by real estate assets[4], which can put these loans at risk if collateral values fell. Putting these together, we estimate banks' total exposure to the real estate sector amounts to 57% of their book or 30% of total assets (Exhibit 2). The risk of serious financial contagion from a real estate meltdown, therefore, cannot be underestimated.

Finally, property – as an asset – is a key store-hold of household wealth. A typical Chinese family has almost 70% of its wealth in real estate (Exhibit 3), nearly three times the average of an American family. This partly reflects limited alternative investment channels for Chinese investors given relatively young capital markets and a limited opening of the capital account. Rapid house price appreciation has also reinforced cultural preferences, making property an investment of choice for preserving the purchasing power of savings. This wealth concentration can put households' finances, and therefore consumption, at risk in the case of sharp declines of house prices.

Exhibit 4 summarises the importance of the real estate sector and underscores the far-reaching risks to systemic stability from a mismanaged policy crackdown.

Exhibits 2, 3, and 4: Real estate sector is deep-rooted in China's macro system



Source: CEIC, UBS, China South West University and AXA IM Research, as of March 2022

[1] We estimate the following: $GDP_t = \alpha + \beta_1 * GDP_{t-1} + \beta_2 * RE + \pi$ for the period from Q1-2005 to Q3-2021, where GDP and RE are the annual growth rates of GDP and the real estate sector. This gives β_2=0.169

[2] The upstream and downstream exposures are estimated using China's latest Input-and-Output table.

[3] In China, the responsibility of a borrower to service a mortgage goes beyond the value of his/her house. Refusal to pay – if the house value fell below the balance of the mortgage – could put the borrower's non-property assets at risk of bank seizure, prompt legal disputes, and damage his/her social credit scores that may affect many aspects of lives.

[4] Commercial properties could be used as collateral, and lands that are backed for loans could be used for either residential or commercial construction. These estimates of banks indirect exposure to real estate contain large assumptions.

This time *IS* different

The importance of the real estate sector begs a critical question – why is Beijing so determined to pursue a policy drive that has already inflicted tremendous pain on a systematically important part of the economy? If the intention was to merely cool the market, those objectives would have already been achieved. Yet, despite some recent policy fine-tuning, the authorities have largely kept the most substantive containment measures in place, suggesting a different policy objective than in previous tightening cycles.

We think there is indeed a fundamental shift in Beijing's attitude towards the housing market. Underscoring this shift is likely a recognition that the current housing development model – characterised as reckless and debt-fuelled – has become increasingly incompatible with China's evolving long-term development strategies. For example:

- As a good that carries both social and investment functions, rapid house price appreciation has acted as an amplifier of wealth inequality in society (Exhibit 5). Those who own properties – particularly in large cities – sit at the top end of the wealth pyramid, while those who don't are at the bottom. The growing housing bubble, fuelled by speculative fervour, has widened the gap between the rich and the poor, and created burdens for the young and underprivileged (including millions of rural migrants) living in big cities. The current housing market model could, therefore, be seen as an impediment to common prosperity[5].

- In addition, housing construction, along with the production of building materials, are among the largest emitters of greenhouse gas in China (Exhibit 6). Continuing the economy's reliance on property-driven growth – despite evidence of overcapacity (see below) – is in tension with Beijing's push to carbon neutrality[6].

- Finally, property – as an investment – is an unproductive asset that creates no output and employment after completion[7]. If the same resources were used to build a factory, which could be put to productive use thereafter, the economy as a whole could benefit from reallocating resources away from real estate (Exhibit 7).

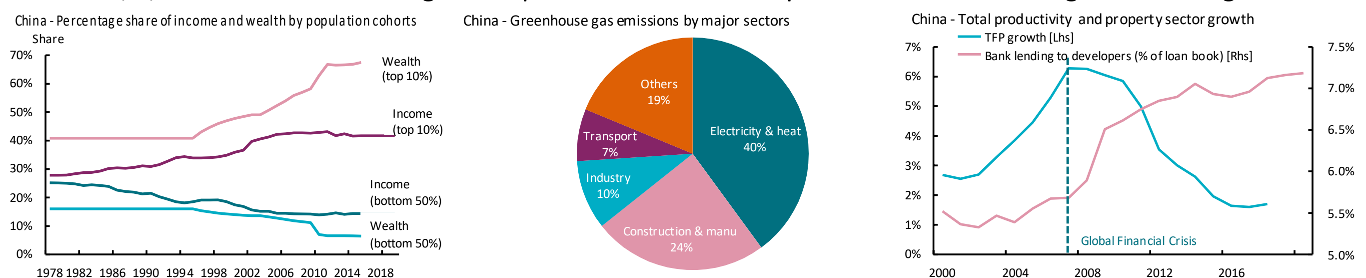
These long-term considerations have, in our view, underscored a different policy adjustment relative to the past, manifested in Beijing's higher pain threshold for housing market woes. There are clear risks to such policy perseverance but delaying the course correction could also sow the seeds for a bigger shock further down the road. The next section discusses how China's demographic changes have added urgency to addressing the housing imbalances.

Housing market passes peak demand

There were two pillars to the golden era of China's housing market boom. The first was a strong fundamental demand for shelter amid fast population growth, urbanisation, and upgrade needs reflecting rising incomes. The second was a strong investment demand for storing household wealth. Both were nurtured by supportive government policies as land sales fill a growing portion of the fiscal coffers. With Beijing's explicit endorsement, the housing market has drawn resources from the governments, banks, corporates, wealthy investors, and ordinary individuals to fuel its relentless expansion.

However, those underpinnings have weakened in recent years. With population and urbanisation growth already slowing, we estimate fundamental demand for housing peaked in 2018 and is expected to slow persistently in the

Exhibits 5, 6, and 7: Current housing development model is incompatible with China's long-term strategies



Source: CEIC, UBS, China South West University, Penn World and AXA IM Research, as of March 2022

[5] Rapid house price appreciation has also impeded economic rebalancing by forcing low-income earners to increase savings to buy homes. Rising living costs have also been reported to discourage young couples from having more children, exacerbating China's demographic problem. Finally, worsening housing affordability could contribute to public discontent, sowing the seed for social and political instability. See Yao, A. and Shen, S., "Decoding China's regulatory paradigm shift", AXA IM Research, 3 September 2021

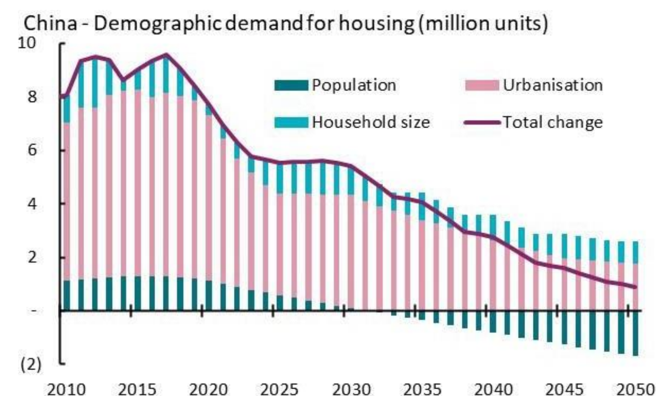
[6] China still needs to build new houses for urbanization and meeting people's upgrade needs. But new buildings will likely be subject to stricter emission standards consistent with Beijing's decarbonization objectives.

[7] Property is normally better characterised as consumption, than investment. A rental property will generate a stream of income for an individual who would see this as investment, but it still provides shelter for renters. Yet many investment properties in China are left vacant and held only for capital appreciation. We define investment properties, as opposed to occupied shelters by either owners or renters, as these empty houses.

coming decades. Exhibit 8 shows slowing urbanisation growth will have the biggest impact on housing demand as fewer rural workers are absorbed into cities. Policies to relax 'hukou' restrictions – China's household registration system – can mitigate, but not reverse, this trend. The housing market therefore faces a sombre outlook from a demographic standpoint.

China still has room to build a lot of high-quality houses to meet people's upgrade needs. But this growth is also slowing. The latest census data shows that more than 40% of China's urban housing stock were of lower quality, built before the 1998 housing reform. Within that, close to half were severely run-down flats, of which the government's shantytown renovation programme helped to replace 27.5 million units between 2015 and 2019. More needs to be done, with one estimate putting this replacement demand at 4.5 million units per year in the next five years before declining to between 3-4 million units in the coming decades[8]. This will boost sheltering demand – despite worsening demographics – but does not change its declining trend.

Exhibit 8: Demographic demand for housing peaked



Source: CEIC, UN, Goldman Sachs and AXA IM Research, as of March 2022

The outlook for investment demand is more uncertain. China's housing markets – particularly those of top-tier cities – are notoriously expensive based on affordability metrics, such as the price-to-income ratio. This high valuation is partly a result of less diverse capital markets, which has made property the primary recipient of the massive liquidity created by the central bank over time[9].

In addition, real estate is an important collateral asset for bank loans[10]. For corporates and entrepreneurs who need to access bank credit, it makes sense to park their savings in property rather than a portfolio of equities and bonds that cannot be collateralised. An extra value premium should, therefore, be added to property for its role in credit intermediation.

Finally, if one considers property strictly as an investment, affordability measures – such as the price-to-income ratio – become irrelevant. Investors should focus, instead, on valuation metrics like the price-to-rent ratio. Currently, rental yields in China's top-tier cities are below 2% – among the lowest in the world, while yields of lower-tier cities are higher at 2% to 3%. These translate to a crude "price to earnings" estimate of around 50 times, which is high among Chinese assets[11] but not outrageous compared to some global assets whose valuations have ballooned under central bank accommodation[12] (Exhibit 9).

Notwithstanding these rationales, the investment case for property in China is resting increasingly on continuous house price appreciation. This requires investors to hold a strong faith in ever-growing capital gains – a faith that has formed during an era of rising fundamental demand, friendly government policies and limited investment options. Yet these supports are now either waning (demographic and investment demand) or in reversal (policy turns punitive).

Exhibit 9: China property is expensive, but not the most expensive

Source: Bloomberg and AXA IM Research, as of March 2022

Moreover, China also has an overcapacity problem in parts of its housing market. Some estimate that idle properties could be as high as 20% of the urban housing stock – concentrated in lower-tier cities[13]. As these vacant houses are brought back

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[8] Shan, H. et al, "Credit supply holds the key to China's housing outlook in 2022" Goldman Sachs Economics Research, 11 October 2021

[9] In the US, central bank liquidity is shared by multiple markets, equity, bond and property, with some also leaking out through the open capital account. In China, the property market has born the lion's share of that liquidity, accentuating the market boom.

[10] This role is greatly amplified by the dominance of banks in China's financial system.

[11] House price movements are typically less volatile than other financial assets, partly due to less frequent transactions and revaluations. Hence, the Sharp ratio of property investing is higher, all else being equal. In addition, property investment allows for leverage, which is harder to obtain cheaply and for a long period with other investment.

[12] When one also considers the relatively low volatility of Chinese housing compared to these other asset markets, some other valuation metrics, like SHARP ratios, make Chinese property even more appealing.

[13] Research from Southwestern University suggests the urban vacancy rate is 21.4% in 2018. Estimates from the State Grid using big data on power usage show a lower vacancy rate at 12-14% for large/medium and small cities. The vacancy rate could also vary across regions, with top-tier cities having lower vacancy rates than lower-tier cities. To correct the regional disparity, top-tier cities have scope to increase housing supply to make shelter more affordable for rural migrants, while smaller cities that are already facing a glut should

to the market – possibly encouraged by the upcoming property tax – even less new builds will be needed to meet the declining shelter demand. The pressure on house prices could also mount as owners of multiple properties try to exit the market, risking a sudden change of expectations that forces investors to run for the door. Beijing therefore has a delicate task in hand to manage a long-term transition of an important market without compromising short-term stability.

Worst is behind, for most

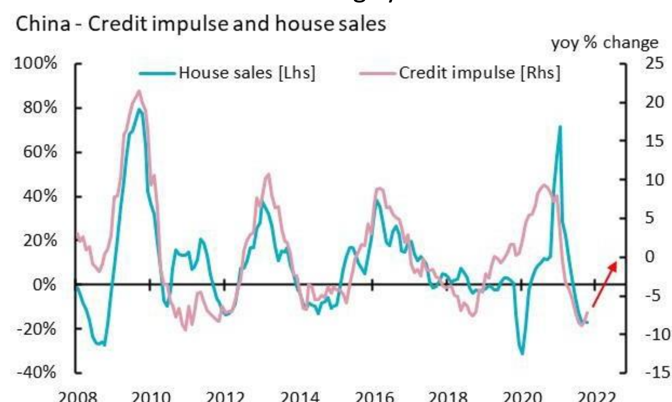
Getting this balance right will not be easy and will require tremendous skill and care in policy design and execution. Since the introduction of various 'red lines'[14], the growth of bank lending to the real estate sector has fallen behind that of non-property loans. Credit spreads of developers' bonds – especially those in the offshore market – have widened to near record highs, while spreads of non-developer bonds have narrowed to historical lows. These divergences seem to suggest that resources have started to move out of real estate.

But as the economy slows and financial risks rise, Beijing's priority has shifted. The need to contain systemic risks in a politically sensitive year has led to a reassessment of property policies. A "two steps forward and one step back" approach is now in motion to try to better balance objectives across time horizons.

In that regard, we think the worst of the cyclical tightening for the housing market is behind us. With credit conditions starting to thaw, the turn of the policy cycle should forestall a bottoming of the market in the coming months (Exhibit 10). However, the vigour of the upcoming recovery is likely to be limited by the scale of the stimulus and, more importantly, only a partial reversal of policy curbs. With the 'three red lines' still in place – overshadowed by the upcoming property tax, the housing market is unlikely to be the primary beneficiary of this round of macro-policy easing. This is consistent with Beijing's desire to move away from 'property-centric' stimulus, and why we call it a *'one step back'* after two steps forward.

In contrast, the worst of the financial stress may not be over for some property developers. With repayment pressure still high and Beijing determined to reduce moral hazard, developers with weak balance sheets, limited funding channels, and high leverage are unlikely to get enough help to ensure their survival. Hence, default risks may stay elevated in a large part of the market, keeping credit spreads wide for some developers.

Exhibit 10: Credit and housing cycles move in tandem



Source: Bloomberg, CEIC and AXA IM Research, as of March 2022

In contrast, industry leaders who have not engaged in reckless expansion or violated the 'three red lines', will fare better as the market bottoms. They could also use their stronger balance sheets to consolidate the sector in the coming years. This could lead to ongoing divergence in credit performance between the strong and weak developers and keep the overall bond market volatile for some time.

A painful correction needed for long-term gains

To conclude, Beijing's supportive housing policies have achieved remarkable success over the past two decades. The modernisation of China's housing stock has bolstered economic growth, expedited urbanisation and raised the living standards of billions. However, the same policies have also brewed speculation in recent years, which has kept housing supply growing strongly despite slowing fundamental demand[15]. Continuing the status quo will likely exacerbate social inequality, environmental degradation, and the declining quality of economic growth.

Hence, policies need to be adjusted to steer a course correction. Bringing housing back to its roots as a consumable good that provides shelter to the public is, in our view, the key objective of a 'house is for living, not speculation'[16]. This reallocation of resources won't be painless as illustrated by the developments over the past 12 months. And this adjustment could linger for several years as the economy seeks new growth engines to replace real estate. But kicking the can down the road could have proven even more dangerous if it led to a bigger bubble eventually bursting, as evidenced in the US subprime crisis and Japan's lost decades. Beijing may have already passed the optimal moment to address its housing imbalances and is now trying to minimise the risk of deeper future regrets.

curb new building. Differentiating policies should be adopted to correct the past resource misallocation.

[14] The 'three red lines' imposes limits on leverage for real estate developers, who need to keep 1) their liability ratio under 70%, 2) net debt less than equity, and 3) short-term borrowings less than cash holding.

[15] There are strong vested interests – among local governments, property developers, banks and wealthy investors – to keep the music going, all at the expense of those at the bottom of the social pyramid finding house prices grow increasingly out of their reach.

[16] The phrase 'house is for living, not speculation' first appeared in the Central Economic Work Conference (CEWC) discussion in December 2016, which was followed by policies to slow credit lending to the real estate sector. The notion was emphasized again at the 2019 CEWC and regularly repeated in official communications on housing market policies since then.

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