

CHINA: AN EVOLVING HOUSING MARKET

In the late 1980s, China embarked on a series of reforms, which has significantly reduced the role of the state as provider of housing and allowed the re-emergence of a private housing market. For banks, this transition has opened up new avenues for loan growth. For individual households, the transition has created new investment opportunities while also providing, for at least some, a substantial increase in their standard of living. At the same time, the development of the real estate market has fed social discontent over widening inequalities. The government has responded through a series of measures to cool the market.

FROM PLAN TO MARKET

Under the planned economy, housing was treated as a social asset and the state, through work units and local housing departments, monopolized its financing, production and allocation. Housing shortages and residential overcrowding were acute in many areas; the first general national survey of housing in China's cities conducted in the mid-1980s, revealed that 26 percent of residents had an average living space of less than 43 square feet. There was also inherent inequality in the distribution of housing with factors such as party affiliation and government rank determining the quality and size of a family's housing.

Early reforms in the 1980s laid the foundation for the re-emergence of a private housing market and culminated in a 1988 constitutional revision, which permitted individuals to purchase urban residential land-use rights for up to 70 years, while the state retained ultimate ownership of the land. Subsequently in 1999, the state and SOEs withdrew from the direct provision of housing for their employees. The existing stock of housing was sold to tenants, private developers were allowed to build new residential projects and the government allowed the formation of a secondary market in real estate. The industry soon grew. In 1996, there were 24,372 real estate development enterprises in China, nearly a half of which were SOEs. By 2003, the number of firms had increased 52 percent to 37,123 firms, only 18 percent of which were SOEs.

The retreat of the state and SOEs required new sources of housing finance. China's first specialized mortgage-financing institution for housing finance, the Yantai Housing Savings Bank, opened in 1987. This was soon followed by the introduction of a Housing Provident Fund (HPF), modeled on Singapore's Mandatory Provident Fund, in Shanghai in 1991.

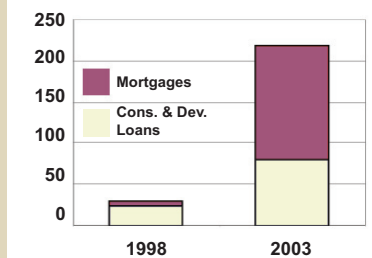
All individuals and work units in the city were required to contribute a certain portion of an employee's salary to the HPF. The HPF then provided low-cost loans to subscribers who can use the funds for home purchases, repairs and self-building activities. The success of Shanghai's HPF led to its extension through the rest of the country in 1994, although implementation varied across municipalities.

The re-emergence of the real estate market coincided with a shift in banks' business orientation. Prior to 1998, China's commercial banks primarily funded state-directed loans. Reforms enacted in 1998 allowed greater leeway to adopt a

more commercial outlook. At the same time legal reforms allowed banks the ability to engage in mortgage lending: in 1996 a Guaranty Law was enacted permitting the use of real estate as collateral and in 1998 the People's Bank of China (PBoC) issued rules on residential mortgage lending. As a result of these changes, mortgage banking grew rapidly from 1998, helping in turn to fuel the boom in the housing market. Initially, banks mainly lent to real estate developers, and mortgage loans to individuals were relatively insignificant. Under the government's encouragement, however, Chinese banks began to expand their residential mortgage business.

Between 1998 to 2003, the outstanding balance of property development and home mortgage loans grew by an average annual rate of 49 percent, as compared with 15 percent for total loans. By February 2005, the central bank reported that the total value of outstanding residential mortgages had reached 1.65 trillion yuan (\$199 billion), equal to 23 percent of banks' medium-long term lending and 9 percent of total lending. However, the rapid growth in real estate lending has not been without its problems. Most recently, the Bank of China in early April 2005 reported that a Beijing real estate developer allegedly defrauded the bank of \$78 million using forged home-purchase contracts. Nonetheless, the combination of changes in land regulation and banking practice contributed to rapid growth in China's real estate industry.

Growth of Real-Estate Lending Balance in US\$ Billions



Source: People's Bank of China

THE MARKET'S DEVELOPMENT

Following the entry of private developers and more market-oriented pricing, the supply of housing increased substantially. From 1998 through 2002 alone, China constructed 1,068 square miles of new residential floorspace, which is close to the entire existing housing stock of the American West.¹ The quality of housing also increased, with those fortunate enough to live in China's gated communities afforded the same luxuries that the wealthy in more developed countries enjoy. Despite these gains, housing in China remains tight: the net average living space per capita in 2002 was 253 square feet (as opposed to 793 square feet in the United States in 2001). Internal demand for housing remains robust, especially due to the migration of rural residents to cities and the continued urbanization of China. It is estimated that China each year from now until 2020 will need to construct 209 square miles of new urban residential floorspace to keep pace with an estimated annual influx of 15 million rural migrants.

In addition to demand for housing as a consumption good, Chinese domestic investors have also seen real estate as a good investment due to the lack of alternative savings options. Real bank deposit rates have been negative since November 2003 and the equity market has been anemic, losing half of its value since it peaked in June 2001.

Strong demand coupled with a shortage of supply has fueled a general rise in housing prices, which has been acute in certain cities. Nationally, urban property prices on average rose 16 percent in 2004. The sharp increase comes after several years of steady, but not spec-

tacular gains in real estate prices. In Shanghai, prices either rose 16 percent in 2004 according to the official statistics or as much as 24 percent according to private real estate firms. Most analysts believe that, while there may be pockets of over-heating in certain markets, the nation as a whole is not currently experiencing a real estate bubble. Property prices gain solid support from a limited, albeit growing, supply of housing and strong domestic and foreign demand.

SOCIAL IMPACT AND THE GOVERNMENT'S RESPONSE

Rising prices in turn have fed discontent in a society already fractured between those who have benefited from the economic reforms and those left behind. Several studies have shown that the housing reforms enacted in 1988 did little

to alter the existing inequitable distribution of housing. Unlike in advanced market economies, where income is a key factor determining housing outcomes, academic studies have found no positive relationship between income and housing consumption in China. Instead the most important predictors of housing consumption were an individual's residency registration (hukou), work-unit characteristics and political affiliation.

Responding to concerns over decreasing housing affordability, the Chinese government has enacted several measures over the past two years. Anecdotal reports suggest that the measures have slowed the market as investors wait for their full impact and prospective home-owners anticipate a leveling, if not fall in prices.

Selected Recent Warnings & Policy Measures

June 2003

PBoC tightens real estate regulation: 1) mortgages cannot be secured by unfinished property; and 2) construction & development loans require at least 30% equity financing.

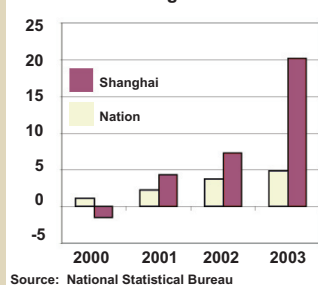
March 2005

Premier Wen Jiabao identifies containing the rise in property prices as a key national priority. The State Council issues a directive warning that rising property prices pose risks to "financial safety and social stability." PBoC raises floor on mortgage rates to 5.51%, up from 5.31%, and recommends that mortgage down-payments be raised from 20% to 30%. Shanghai imposes 5.5% capital gains tax on properties held for less than 1 year.

May 2005

7 ministries jointly announce new policies including: a new nationwide capital gains tax on properties held for less than two years, a tax on developers who leave land idle for more than a year, a ban on the sale of unfinished apartments and a new push to build more affordable housing.

Annual Increase in Housing Prices
Nominal Percentage Increase



CONCLUSION

Through policy pronouncements and a tightening of bank credit and tax policy changes the Chinese government appears to be attempting to rein in the rise in Chinese urban residential property prices, especially in Shanghai. As residential real estate still occupies only a fraction of total assets of Chinese banks, the short-term impact of instability in the market should have a limited impact on their financial condition and overall financial stability. The rapid growth in mortgage lending, however, does raise concerns over whether Chinese banks are prudently managing risks in an area of lending in which they have had little prior experience. Furthermore, a significant slowdown in the residential mortgage market could impede the banks' goals of diversifying their lending and improving their inherent credit risk profile.

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¹ Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, Wyoming, Alaska, California, Hawaii, Oregon and Washington.