



How Real Is China's Real Estate Bubble? And What Should Be Done about It?

Think U.S. housing prices have gone berserk? Try those in Shanghai and Beijing, where the cost of homes has been rising an estimated 25% annually in recent years. That's twice the jump in the median sale price of existing U.S. homes over the past year, and a sign that China's real estate market is in the midst of what some observers view as a potentially explosive bubble.

The bubble is rooted in such factors as China's strong economic growth since 1990 and investor bets that China's currency, the yuan, will be revalued upward in the near future. But such speculation is helping push the price of homes beyond the reach of middle class citizens in key Chinese cities and raising the prospect of a sudden market collapse that could threaten the country's shaky banking sector and wipe out the life savings of many families.

Some see the increasing involvement of U.S. investors in China -- including the recent move by Bank of America to buy a 9% stake in China Construction Bank -- as a hopeful development when it comes to calming the country's real estate scene. And given the prospect of social unrest stemming from either continued price hikes or a too-fast price decline, the Chinese government has taken action to cool down the market.

But Beijing's efforts so far may not be enough to rein in the rising real estate prices, says Wharton marketing professor John Zhang. He warns that the government must be careful in whatever moves it makes next. "Managing the process of bursting the bubble is really something delicate," he says.

Inconsistent Data

China's real estate market is relatively new. After years of property being under the strict control of the communist government, China phased out free government-provided houses in the early 1990s. But even now, there is a legacy of the communist system. The state technically owns the country's land: Individuals essentially buy rights to build on top of the land or own structures already there.

As with other measures of the Chinese economy, it's hard to get a precise gauge on how housing prices have been changing in the country. Last year, the country's average housing price rose by 14.4%, according to a story in June by official Chinese news agency Xinhua citing the country's National Bureau of Statistics. The story also said that Beijing's housing price level had been dropping. But an official with the statistics bureau acknowledged in the story that the numbers "do not fully represent the general real estate situation" and that some government figures are inconsistent.

Given the lack of solid data, it may be premature to define China's housing market as a bubble, notes Wharton real estate professor Grace Wong. Wong, who has written about a rapid run-up in Hong Kong housing prices in the late 1990s, says a bubble is typically defined as prices at levels higher than what economic basics justify. Speculation -- when buyers are purchasing homes primarily because they expect the price will increase -- can cause a bubble, but price hikes also can arise because of factors such as construction cost increases or an undersupply of homes. "You wouldn't be so worried if the housing prices are moving up because of fundamentals like that," she notes.

Usha Haley, professor of international business at the University of New Haven's School of Business, also suggests that talk about a nationwide bubble can overstate the case. She estimates that housing prices for China overall have been rising 10% annually in recent years. That level makes the country's real estate price growth slower than in many other countries around the world, including the United States. But Haley, who recently wrote a book about business in China titled, *The Chinese Tao of Business*, says the major cities of Shanghai and Beijing are special cases, with annual real estate appreciation rates closer to 25-26% in the past few years, or roughly \$784 per square meter in Shanghai. The prices in Beijing are lower, but not by much. Even these prices don't tell the whole story. One source familiar with the Shanghai housing market says unfinished condominium "shells" in new Shanghai high-rise buildings are being marketed at a price of about \$2,000 per square meter.

Among the causes of the run-up in Chinese home prices, Haley notes, is government corruption. Local officials can engage in price gouging to enrich themselves individually or conspire to drive up prices on property sales that pad government coffers. Another factor is China's overall economic expansion. China's economy grew at an average rate of 10% per year during the period between 1990 and 2004, the highest growth rate in the world, according to the U.S. state department. China's total trade in 2004 surpassed \$1.1 trillion, making it the world's third-largest trading nation after the U.S. and Germany.

With China becoming more of a hub in the global economy, it stands to reason there would be greater demand for housing designed for foreign corporate executives and other expatriots. This increase in demand has led to higher housing prices, as noted by Kenneth Aboussie, who traveled to China in 2003 to study the real estate market while a student at the McCombs School of Business at the University of Texas at Austin. "There was no question there was a bubble for that high-end housing," says Aboussie, who now works at Austin-based Cypress Real Estate Advisors.

Still another cause for China's real estate boom is widespread anticipation that China will revalue the yuan soon. China's government has been under increasing pressure from the U.S. to dismantle the yuan's current peg to the dollar and allow it to increase in value. Critics argue China's currency is undervalued by roughly 25%, making its exports artificially cheaper and imports into the country more expensive.

Should the yuan increase in value, investments in Chinese assets such as real estate can be expected to rise as well, says Wharton's Zhang. "Part of the speculation comes from the

expectation of the appreciation of the currency." Some of those real estate bets based on the yuan's revaluation are foreign in nature, Zhang suggests, adding, however, that Chinese citizens also have poured money into real estate holdings, especially after the disappointing performance of Chinese stocks a few years ago.

The Dangers of Panicked Selling

As with other economic bubbles throughout history -- such as Holland's tulip craze in the 1600s and the Internet stock frenzy earlier this decade -- there's a danger that China's real estate prices will collapse quickly. That's the flip side of the inflated prices associated with a bubble, Zhang explains. Amid panicked selling, buyers may sit on the sidelines until prices crater to unreasonably low values. "When the price is on the way down," problems can arise that "could destroy the whole real estate market," Zhang says.

According to Haley, a rapid loss of real estate values would harm China's major banks. Household loans, including home loans, make up just 10 to 15% of loans in China, but more than half of Chinese lending is collateralized with private property, she says.

The run-up in property prices has had positive effects, points out Harrison Duan, a Chinese native who attended the McCombs school and accompanied Aboussie on his first-hand study of China's real estate market. Construction and steel are among the industries in China that have benefited from the boom. "Over the last five years, real estate has been a really important growth engine in China," he notes, adding that those Chinese who bought homes three or four years ago have gained a great deal of wealth, at least on paper.

But that equity appreciation may not mean much for families that need to live in their homes even as the skyrocketing prices in places like Shanghai are very disappointing to many city residents. "The Shanghai middle class can no longer afford to buy an apartment for themselves in a convenient location," says Duan, who now works for computer giant Dell as a global commodities manager focused on wireless communications products. Duan lives in the Austin, Texas, area on a guest worker visa, but can imagine returning to China someday. And if he does, Shanghai -- not far from where he grew up -- is probably where he would go. And yet, according to Duan, it would be much harder for a local middle-class family to purchase a home in Shanghai than in Austin.

Those individual struggles could conceivably turn into urban protests, echoing reports of a slew of other protests in the country within the past year. At the same time, an overnight price collapse could erase the life savings of many Chinese, another possible source of unrest that "worries the government," Zhang says.

Against this backdrop, the Chinese government has tried to quiet the real estate boom with a series of measures, including higher mortgage rates and larger down payments, according to a May article published by Xinhua. As of June 1, a 5.5% capital gains tax was due to take effect on residential property sold within two years of purchase. In addition, Shanghai in May enacted a new law requiring homeowners to pay off their mortgage before selling a property. Even so, Zhang thinks more action may be needed to guide home prices to a soft landing. "It looks like the measures may not be sufficient to cool the market." The key, he says, is moderate steps designed to work over the course of several years.

Draconian action aimed at solving the problem in a mere year's time risks triggering panicked selling. Also unwise, in Zhang's view, would be a hike in overall interest rates, which could freeze lending for new home construction but also stifle the country's economic growth.

Wharton's Wong warns that another oft-discussed tool for deflating bubbles could have a negative overall impact: a stiff transaction tax on home sales. A transaction tax can reduce speculative trading but might have a limited effect on the size of the bubble. What's more, the tactic "discourages real buyers from entering the market."

The Chinese government isn't the only force with the potential to slow runaway home prices. Growing involvement in China by Western investors also can play a positive role, observers say. As U.S. banks and real estate investors become more engaged in China's financial system, they are bound to impart better lending practices, Aboussie suggests. "They will provide sound underwriting standards and some restraint to speculative development."

Perhaps the most visible sign of growing Western interest in China's financial sector was Bank of America's announcement in June that it would pay \$3 billion for a 9% "strategic stake" in China Construction Bank. The chairman of China Construction Bank all but admitted his institution needed instruction in risk-based lending practices. "The most fundamental and challenging task in transforming CCB is to establish a culture that is customer centric and market driven," chairman Guo Shuqing said in a statement. Under the deal, Bank of America has the right to bring its total ownership of CCB as high as 19.9% over the next five and one half years.

Haley, though, is not optimistic that Western companies will be able to make much of a dent in the way China's real estate market operates. The problem, as she sees it, is that even those foreign companies will have a hard time finding their way in a housing market and broader economic system that remains opaque and full of uncertainty. "We don't know what we don't know about Chinese markets," she says.

This point dovetails with what Wong sees as a crucial step needed in China to temper housing speculation and improve choices for individuals: better sources of data. While it is easy for a homeowner in the United States to find out how much a nearby home sold for, such information is very difficult to gather in China. Wong would like to see standard, countrywide real estate data as well as the advent of private data services that can supplement government figures. "More information is better," she says. <http://knowledge2.wharton.com.cn/index.cfm?fa=viewArticle&articleID=1192>