Asian Insights: China's Property Problems (Part One)

Economic Research Note

18 November 2014

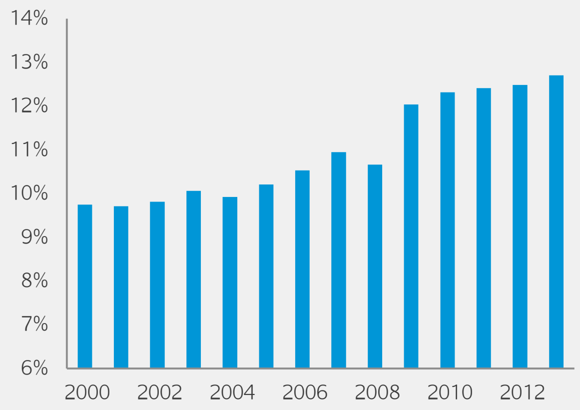
- China's property sector is an important part of its real economy. It accounts for between 12-15% of GDP.
- In the course of 2013 there was a marked slowdown in sales that has now extended to a decline. Sales is a leading indicator of physical activity; suggesting the slowdown extends into 2015.
- A 30% decline in property's share of the economy over three years would likely subtract between 1.2% and 1.5% from annual growth in China. The impact on the economy could be substantial.

The growth in China's property sector has been substantial in the course of the last 15 years. This has been fed by the country's rapid urbanisation and, more worryingly, by speculation as households seek higher returning assets. 2014, however, has marked a period of substantial decline in both prices and, increasingly, fixed asset investment in property. This edition of Asian Insights examines the physical side of the Chinese property market.

Real estate and construction in the Chinese economy

According to Chinese data, real estate and construction account for 12.7% of its economy. According to the International Monetary Fund (IMF), the industry as a whole accounts for an even larger 15% of 2012 GDP, 25% of fixed asset investment, 14% of employment in urban areas and 20% of bank loans in the economy. This is unsurprising in an economy driven by the productivity enhancements of urbanisation but it does raise risk within the economy.

Chart 1: China real estate and construction in GDP
share of total, annual, ending 2013



Source: IMF and First State Investments.

Chart 2: Property related GDP growth
yoy growth, annual, ending 2013

Source: IMF and First State Investments.

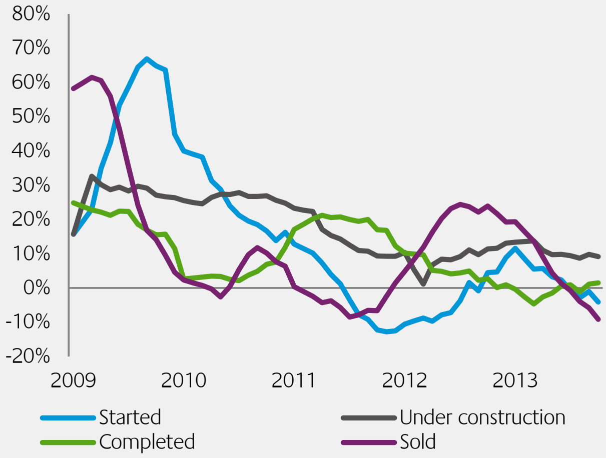
As Chart 2 shows, property has played a particularly important role in the economy since the Global Financial Crisis (GFC). Through the height of the crisis, and in the period since, property related GDP growth has out-paced growth in the wider economy. A period of slower growth in property is likely to slow the wider economy as well.

The current slowdown

Property's slowdown can be observed in a number of indicators. From a leading perspective, sales are the best indicator of future activity levels. Chinese property is most often pre-sold so as to allow the developer to finance construction. There was a steep rise in sales post GFC crisis, followed by a period of weakness before a period of solid sales through 2012 and much of 2013. This strength has since turned to weakness with little evidence in the official data that there is a coming turnaround. Some of the private data, however, does suggest some strength in large cities in recent months.

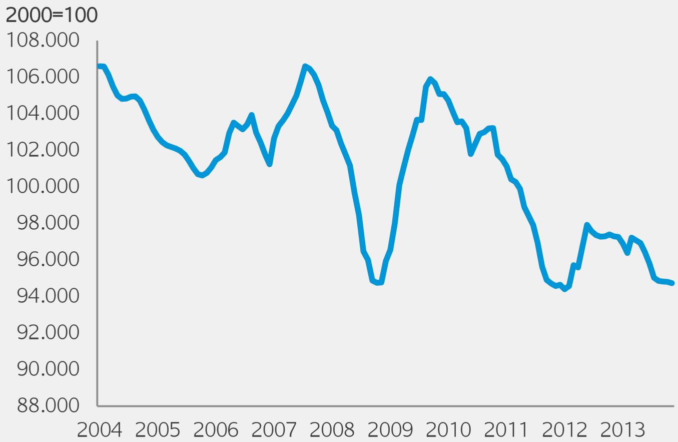
As a result of the sales slowdown, physical construction activity is now, also, beginning to slow more rapidly. Most obvious is the decline in starts, using an annual growth measure. The two combined suggest that property investment growth will be low, to negative until well into 2015, at least. The China real estate climate index also suggests the sector remains subdued for some time.

Chart 3: China property statistics
annual growth, monthly, ending September 2014



Source: CEIC and First State Investments.

Chart 4: Indian and Indonesia GDP growth
yoy change, quarterly, ending March 14



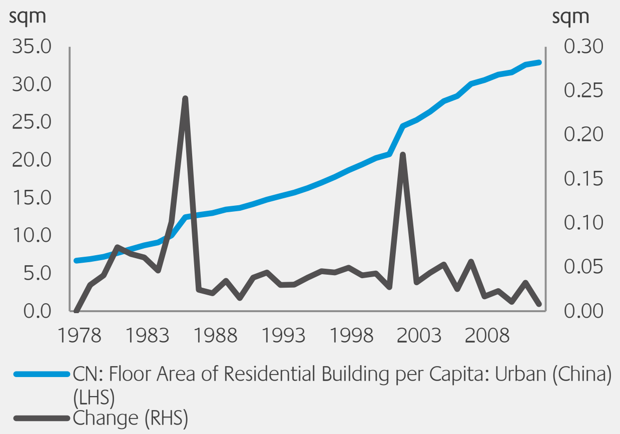
Source: CEIC and First State Investments.

How did China get to this point?

The slowdown in China's property market now looks well-entrenched. It is unlikely that to turn around quickly; though at this stage it still seems cyclical. Despite probably being cyclical there are some structural issues in the current cycle as a result of the impact of purchasing restrictions and growth in smaller cities.

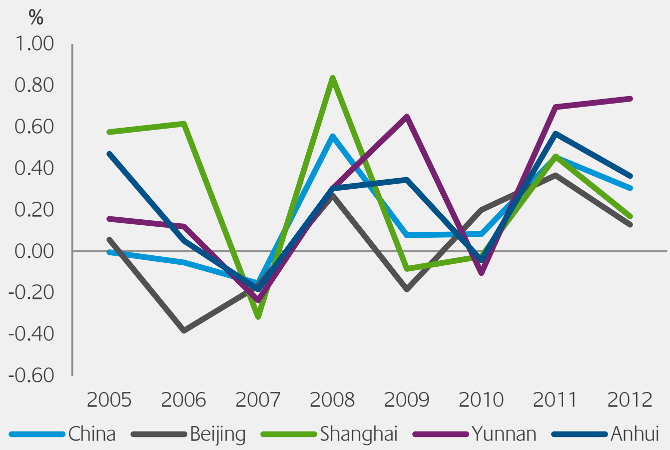
The Chinese government and many of its provincial and city governments implemented purchasing restrictions in property markets through 2010 and 2011. These restrictions were aimed at investors acting as speculators with the intent of slowing price growth and provide greater access to the market for owner-occupiers. But as with any such policy there are unintended outcomes. In this case, and as Chart 5 highlights, the impact was to slow the growth in availability of suitable owner-occupier property. Investors, restricted in the number of apartments they could buy, increased the size of apartments they purchased. In all likelihood, China has built a number of apartments that are too big for the market demand. This will take some time to work through.

Chart 5: Current account surpluses pre and post-Asia crisis
share of GDP



Source: CEIC and First State Investments.

Chart 6: China property vacancy
growth, annual, ending 2012



Source: CEIC and First State Investments.

Another problem has been the big build of property in China's smaller or Tier Three and Four cities. These cities had often used property as a means of economic development without necessarily having the under-lying demand for property in place. As activity heated up through 2013, vacancy rates were already relatively high in regional cities as compared to Beijing and Shanghai. It's likely that building activity, mixed with weak sales, since 2012 will make working through inventory more difficult in these regional cities.

Conclusion

China's property sector is undergoing a large cyclical decline. This is likely to persist into 2015 as evidence of sales stabilisation is only just emerging at very depressed levels. The impact on the economy will be substantial. A 30% decline in property's share of the economy over three years would likely subtract between 1.2% and 1.5% from annual growth in China.

The next piece will examine the ongoing structural drivers of property in China and the financial implications.