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Debunking the myth of a collapse in China markets

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Global sentiment towards China's economy and asset markets has turned from exuberance just a few months ago to overriding concern about the side-effects of last year's remarkable credit growth.

A number of commentators have warned of credit excesses and an overinvestment bubble, which they say could bring economic turmoil. Critics have also pointed to China's Rmb4,000bn ($585bn) stimulus programme and last year's 33 per cent surge in new bank lending as obvious hallmarks of excess liquidity and a lowering of lending standards. Some have raised concerns about hidden debt risks among local government investment entities, while media reports of Chinese "ghost cities" and empty commercial property are cited as evidence of local excesses.

The worst-case fears concerning the property market are based on a layer of truth and we have previously highlighted the untenable nature of price increases in some big cities, as well as the possibility that last year's boom was partly fuelled by misdirected bank loans. However, there are crucial differences between China's property markets and those of the US or Dubai.

Unlike the dramatic increase in household leverage that precipitated the US subprime crisis, Chinese household debt amounts to approximately 17 per cent of gross domestic product, compared with roughly 96 per cent in the US and 62 per cent in the eurozone. Home buyers in China are required to make minimum downpayments of 30 per cent before receiving a mortgage, and at least 40 per cent for a second home.

Although price increases in the Chinese residential market appear rapid (more than 20 per cent in 2009), such headline figures cannot be viewed in isolation. Over the past five years, urban household incomes grew at a 13.2 per cent compound annual growth rate, compared with an 11.9 per cent CAGR in home prices. Pockets of overheating can be found in some regional markets. In Beijing, Shanghai, Shenzhen and Hangzhou, for instance, prices outpaced income growth by more than 5 percentage points over the same period. But, this can be seen as a symptom of new urban wealth being put to speculative use, rather than the profligate use of leverage.

The combination of excessive leverage and mortgage securitisation were at the epicentre of the US subprime crisis. Both these factors are absent in the Chinese context. The commercial property sector has inspired just as much concern, with prices rising 16 per cent in 2009, in spite of low rental yields and prime office vacancy rates as high as 21 per cent and 14 per cent in Beijing and Shanghai, respectively. Yet occupancy and rental rates have started to pick up for prime properties.

The crux of the problem with the Chinese real estate sector is that property is seen by the country's investing class as a store of value, within an economy that offers its citizens limited investment options. I share many of the concerns about flawed incentives and overheating in the property market - but even if prices were to correct, this would not trigger the type of devastation that might arise in an over-leveraged economy.

Policymakers are clearly concerned about the risk of asset bubbles and the threat that excessive speculation could drive prices beyond affordability for average home buyers. The government is weighing the potential value of introducing a national property tax and, in the meantime, has reimposed a business tax on homeowners who resell their properties within two years.

The perennial ups and downs of China's property sector arise from the fact that closed capital account and underdeveloped capital markets leave citizens with few investment options. Investment interest in residential property has fuelled a mismatch between the stock of higher-end apartment buildings and the mass-market need for affordable housing. This imbalance must be resolved by spurring the development of affordable housing - one of the government's big policy initiatives.

A more recent warning issued by some China bears is that of hidden debt risk among Chinese local government investment companies. Official estimates of the total outstanding loan balance for such investment entities exceed Rmb6,000bn - or roughly 20 per cent of GDP - a figure that has been criticised by some as being too low. According to one report, the worst case scenario from hidden borrowing by local investment intermediaries is a large-scale financial crisis around 2012.

Looking ahead, while certain local administrations might struggle to service debt, the magnitude of public sector debt risks do not appear as severe as some have suggested.

Many observers are concerned that China's economy has grown too rapidly, and are ready to point to pockets of overcapacity as proof of an imminent system-wide collapse. While some areas of the economy do deserve closer monitoring, there is little to support the sceptics' views of an imminent crisis.

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