Will China’s Real Estate Market Become the World’s Problem?
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Any talk of an asset bubble, particularly involving a country’s real estate market, is treated far more cautiously than, say, four years ago when global financial meltdowns were merely theoretical discussions. But when the US housing boom went bust and the contagion caused other markets to tumble, discussion of bubbles and price imbalances became an obsession bordering on paranoia. But as the saying goes, you are not paranoid if everyone really is against you.

Of particular concern of late is the relative pricing of the Chinese real estate market, and whether the miraculous growth of the past twenty years is heading for a spectacular fall. The idea of the world’s second-largest economy grinding to a halt a mere three years after the world’s largest economy did the same thing naturally sets off a few alarms with analysts, and considering the fragility of the US and Euro-zone economies right now, such a collapse would be the sum of all fears. After all, China has become the single-largest contributor to the global economy since 2009, so to take away the last real engine of global growth opens the mind to a wealth of bearish scenarios.

Possibly the most confusion in understanding China’s real estate situation comes from interpreting what information is available in hope of finding something that aligns with what is in the media. Official data from Beijing suggest that housing prices are fine, although the main indices for monitoring sale prices were discontinued at the end of last year after coming under heavy criticism, and other national statistics conveniently hedge around the greater issue of rising real estate prices. A growing body of anecdotal evidence suggests developers are creating huge
amounts of excess capacity under expectations of ever-rising returns. If, in fact, the construction sector is being driven by the “build it and they will come” approach, then a collapse no longer seems to be a possibility, but rather just a matter of time.

The figures currently gaining the most attention focus on local government debt, which has risen so sharply over the past three years of stimulus borrowing, that it is now at risk of going into default. Beijing reported this debt stock at Yuan10.7 trillion ($1.65 trillion, or 26.9% of GDP) as of June 2011 but depending on terms used to classify debts, the total could be as much as Yuan14.2 trillion. Analysts believe that as this government-ordered lending goes sour, the non-performing loan (NPL) ratios at regional and provisional banks could rise to 23-42%, leaving a big mess for the national government to clean up. And considering those banks’ exposures to developmental lending in the real estate market, the numbers become even more obscure, and therefore more worrisome. The costs to clean up the situation would be troubling indeed, which leads to the question of how Beijing might manage the strain.

Possibly the better question to ask, however, is whether or not a real estate market collapse and debt crisis in the world’s second-largest economy could cause trouble on a global scale. It is easy to color our judgment by gauging all future events according to the experiences of the most recent disaster – in this case the global financial crisis triggered by the bursting of the US real estate bubble. But before exploring the comparison, it is worth noting that other dramatic corrections have come and gone without a fraction of the impact. When the dotcom bubble burst in 2000, the NASDAQ Composite fell by 62.6% in one year and $3.4 trillion in market capitalization vanished, but the biggest losses were the bankruptcy of Silicon Valley start-ups that had never actually posted a profit. The 1997 Asian financial crisis wreaked havoc on Southeast Asia, but industrialized countries benefitted from the widespread devaluations that halved the price of the region’s hi-tech products. The collapse of the Nikkei in 1990 brought on Japan’s lost decade, but the shock waves did not radiate far from the island. Considering these examples, is it possible that the effects of a debt implosion in an increasingly-globalized China would stay behind the Great Wall?

We believe that, at the very least, the first-wave impact of a real estate-based debt collapse would in fact remain largely a Chinese problem. While comparisons to the US real estate bubble draw interesting parallels in terms of overvaluation, the degree of leverage involved and the speculative build-up, a few critical differences set these two situations far apart. In particular, the amount of foreign exposure is a critical difference. In the US, toxic home mortgages were packaged, sold and traded across the globe along with plenty of related derivatives to further distribute the risk throughout the industrialized world. China is the opposite in this regard – certain key interests such as infrastructure and real estate development are kept almost exclusively in domestic hands, along with their debts, and capital controls place further constraints on the magnitude of foreign exposure.

In the event of a Chinese financial crisis, the first victims would be the local and provincial banks that carry most development debt, along with the domestic borrowers who ventured too far into an inflated market. International repercussions would therefore be nowhere as severe, other than
international funds carrying exposure to China. As the experience in 2008 showed, the Shanghai market is volatile indeed during times of crisis, and can experience sharp falls within a relatively short period.

One major financial hub that might receive more damage than the rest of the industrialized world is Hong Kong. While the Special Administrative Region is not a major financer of China’s local programs, it does have deep ties to major Chinese businesses that would be severely impacted by a sudden slowdown in economic activity. A rise in NPLs throughout the Hong Kong banking system would be nowhere close to what regional and provincial Chinese banks would experience, but in Hong Kong terms the sharp rise in defaults could trigger a tightening of lending conditions. Along with a dramatic slowdown in trade volumes into and from China, a pronounced recession in Hong Kong would be expected. Other economies dependent on trade would see equally profound declines in trade activity, but the financial sector would add an extra burden on Hong Kong’s economy.

Under this Chinese meltdown scenario, the global economy will feel a greater impact from the second wave of the crisis, and not all of it will necessarily be detrimental. Matters of credit and financing exposure will be mostly local, but as the Chinese economy slows down – particularly in construction-related industries – there will be a sharp fall in commodity demand, and therefore in global commodity prices. Most hard commodity inputs (ferrous metals, oil, processed materials) will fall from their elevated levels in a similar fashion to 1997 and 2008, although the magnitude is difficult to gauge. Commodity-rich exporters from Latin America to Africa will feel a precipitous drop in their current account earnings as exports drop in both value and quantity, and oil exporters throughout the Gulf will no longer have the largess of $100 barrels of oil.

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Conversely, the industrialized world will see prices for processed goods fall off sharply, with everything from gasoline to construction materials suddenly devalued. This could bring a brief bout of deflation throughout the Northern Hemisphere, but this easing of price pressures would be more than welcome.

To understand just how severe a shock a real estate collapse would be to China’s outlook, it is crucial to recognize its debt situation and how much fiscal wiggle room it has. Considering China’s past two decades of double-digit economic growth and rapid wealth accumulation, it is not surprising that China’s debt burden is modest. Government debt probably rose above 20% of GDP last year, and external debt accounted for another 9.3%, but at a combined 30% of GDP, this is not even one-third of what the US manages in terms of government debt alone. In past crises, Beijing has shown a willingness to throw plenty of yuan around to maintain social and economic stability – in October 2008 the government initiated Yuan 4 trillion in stimulus spending as a precautionary measure while other countries were still reeling from the shock. According to official figures, Beijing still has plenty of fiscal room to maneuver and could quickly mobilize more yuan to solve the problem. The only immediate concern would be whether this money would be put to productive means or through stop-gap measures that might create another imbalance down the road. Only time will tell.

At this point, we believe there are significant imbalances in the Chinese real estate market and that this constitutes a large asset bubble that is reaching the end of its run. While there may not be one defining event that marks its collapse, over the next twelve months we expect a marked rise in NPLs within the smaller provincial and regional banks, some high-profile defaults, and

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anecdotal stories about ghost cities being replaced by commentaries about nouveau riche Chinese families losing their recently-found wealth. The larger Chinese banks will be affected to a lesser degree, and institutions in Hong Kong will feel some of the shock wave, but the international impact will be nowhere close to the 2008 global recession. The impact over the year following the collapse will fall more along the lines of the 1997 Asian financial crisis, with immediate damage felt in a local sense, but second-wave effects varying depending on the particular country. And while this will not necessarily mark the end of the Chinese miracle, it will provide a substantial shock to development policies and perhaps a renewed drive toward a more sustainable, domestically-driven economy.