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Debunking the myth of a China collapse

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. I posed three questions at the outset of my recent presentations to large groups of investors and corporates: i) are you concerned about a property bubble in China? ii) do you expect an increase in non-performing loans, iii) do you expect further monetary tightening? Approximately 85-90% of audience members responded in the affirmative to all three questions. A number of prominent commentators have contributed to the current climate of alarmism by warning about credit excesses and an overinvestment bubble, which they say could bring the country to economic turmoil.

A second tact of criticism has been to point at China's RMB4 billion stimulus program and last year's 33% surge in new bank lending as obvious hallmarks of excess liquidity and a lowering of lending standards. In connection with this, some commentators have raised concerns about hidden debt risks among local government investment entities, while media reports of Chinese "ghost cities" and empty commercial real estate spaces are increasingly cited as evidence of local excesses.

There have always been cynics regarding China's economic growth and without joining the ranks of the doomsayers, it is easy to veer towards pessimistic conjecture simply by observing the changing landscape in China's rapidly developing cities. Any casual visitor will marvel at the sprawling complexes of newly-built apartments and office towers – admittedly many units at these developments are typically owned by speculative investors holding out for capital appreciation.

The worst-case fears concerning China's property market are based upon a layer of truth and we ourselves have highlighted the untenable nature of price increases in some big Chinese cities, as well as the possibility that last year's property boom was partly fuelled by misdirected bank loans. However, there are crucial differences between China's real estate markets and those of the U.S. (and indeed Dubai), which require that we view the apparent building bubble through the lens of China's unique circumstances.

Unlike the dramatic increase in household leverage that precipitated the U.S. sub-prime crisis, Chinese household debt amounts to approximately 17% of GDP, compared to roughly 96% in the US and 62% in the Euro area. While the level of Chinese household leverage has increased in recent years, it has done so from a very low base.

With respect to residential property, homebuyers in China are required to make minimum down-payments of 30% before receiving a mortgage, and at least 40% for a second home purchase. Even at the height of the government's stimulus efforts, the minimum down-payment requirement for first homes was only lowered to 20%. The Chinese cultural tendency of shunning debt explains the many anecdotal accounts we hear about homebuyers putting down amounts that substantially exceed these minimum requirements. This is made possible by the massive amount of savings that Chinese households have accumulated, while in comparison, the U.S. savings rate stood below 1% in the years preceding the housing crisis.

Although price increases in the Chinese residential market appear rapid (over 20% in 2009), such headline figures cannot be viewed in isolation of the broader trend in income growth. Over the past 5 years, urban household incomes grew at a 13.2% compound annual rate, compared to an 11.9% CAGR in home prices. This is not to say that pockets of overheating cannot be found in some regional markets. In Beijing, Shanghai, Shenzhen and Hangzhou, for instance, prices did in fact outpace income growth by a margin of more than 5 percentage points over the same period. But again, we see this 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 securitization were at the epicenter of the U.S. sub-prime crisis – both of these factors are absent in the Chinese context. The commercial segment of real estate has inspired just as much concern, with prices rising 16% in 2009, despite low rental yields and prime office vacancy rates as high as 21% and 14% in Beijing and Shanghai, respectively. However occupancy and rental rates have started to pick up for prime properties – many of the current vacancies are at the lower end. While returns for new projects may end up lower than expected, China's urbanization process is far from over and vacant space will be absorbed over time.

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 persistently low deposit rates and limited investment options. The absence of a recurring property holding tax allows speculative homebuyers to disregard rental yields in hopes of reaping capital appreciation in the not-too-distant future. We share many of the concerns about flawed incentives and overheating in the Chinese property market – but even if property prices were to undergo a correction, this would not trigger the type of economic and financial devastation that might arise in an over-leveraged economy.

Although stability in the property market is critical to sustaining the Chinese economy's recovery, policymakers are clearly concerned about the risk of asset bubbles and the threat that excessive speculation could drive prices beyond affordability for average homebuyers. The government is also well aware of the need to increase the holding costs for property investment and is weighing the potential value of introducing a national property tax. This measure might be introduced in the medium-term and should serve to deflate prices in some overheating markets. In the meantime, authorities have re-imposed a business tax on homeowners who resell their properties within a period of two years and could hike this further to deter speculation.

The perennial ups and downs of China's property sector arise from the fact that the country's closed capital account and underdeveloped capital markets leave its citizens with few investment options. Investment interest in residential property has fuelled a mismatch between the stock of higher-ed apartment buildings and practical needs for affordable housing. This imbalance must be resolved over time by spurring the development of affordable housing, which is currently one of the government's

main policy initiatives. In the long run, financial reform, including capital account liberalization, will provide Chinese investors with broader investment options, reducing the role of real estate as a form of capital preservation.

Worries about public sector debt

A more recent warning issued by some China bears is that of hidden debt risk among Chinese local government investment companies – which according to state media reports, received approximately 40% of last year's RMB9.6 trillion in new loans. Official estimates of the total outstanding loan balance for such investment entities exceed RMB6 trillion – or roughly 20% of Chinese GDP – a figure that has been criticized by some as being too low. According to a Bloomberg report quoting Victor Shih of Northwestern University, the worst case scenario arising from hidden borrowing by China's local investment intermediaries is a large-scale financial crisis around 2012.

Since many shovel-ready local infrastructure projects were brought forward as part of the stimulus plan, near-term returns on investment are likely to be subdued. However, as J.P. Morgan analysts Samuel Chen and Sunil Garg have pointed out, Chinese bank loans for public sector investment projects carry implicit or explicit sovereign guarantees, and are thus almost akin to a bond issuance for a public works project. Moreover, the majority of projects at local government levels carry land collateral and explicit fiscal revenue guarantees. Over the past year, the Chinese government has also stepped up efforts to enforce tax collection across the corporate sector. This effort, when combined with improving business conditions, brought last years' fiscal deficit to a narrower-than-budgeted 2.2% of GDP.

Chinese economic planners are already aiming to achieve a slowdown in infrastructure investment, shifting focus toward completing existing projects rather than funding new construction. Growth in infrastructure investment slowed to 42.5% in FY09, from 50.7% in the first half. On a year-over-year basis, the slowdown has been more pronounced, with infrastructure investment growth peaking at 55.5% in May, vs. 31.9% in December. Meanwhile, China's banking regulator has ordered banks to closely follow lending guidelines to ensure that all lending to local government investment companies are backed by actual projects and that project risks are properly accounted for.

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. According to IMF forecasts, China's government debt-to-GDP ratio is projected to reach 22% in 2010, compared to 94% in the U.S. and 227% in Japan. Even if the more alarming estimates of local government debt were included, the ratio would only grow to approximately 51% of estimated 2010 GDP.

As a pillar of demand for a number of economies and for the commodities complex, China's ability to regulate its economy has far reaching implications for global markets. One must not underestimate the scale of future demand in a country that is urbanizing at a rate of 15 million people a year. Today, many observers are concerned that China's economy has grown too rapidly, and are all too-ready to point to pockets of overcapacity as proof of an imminent system-wide collapse. While we agree that certain vulnerable areas of the economy deserve closer monitoring, we find little support for the sceptics' views of an imminent crisis.

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