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China not a subprime crisis in the making

The warnings about a bubble in mainland property prices continue to come in thick and fast.

On Friday, billionaire hedge fund manager George Soros – famed as the man who broke the Bank of England – declared "there is undoubtedly a bubble in real estate" in China that, he warned, could reverberate around the world if it burst.

More picturesquely, James Chanos, another hedge fund manager, perhaps best known for selling Enron Corp short before the company's 2002 implosion, said China's economy, increasingly dependent on real estate investment to keep growing, was "on a treadmill to hell".

Warnings like these conjure up fears that China is following the same trajectory as the United States in the middle of the last decade and that the mainland property market is another subprime crisis in development.

Clearly, the authorities are concerned. Residential property prices in important cities have climbed anywhere between 25 and 50 per cent over the past 12 months (see the chart below). As a result, the average home price is now about eight times the average household income, twice the ratio usually considered expensive. And in many cities, it is even higher.

Ominously, official attempts to cool the market appear to have had little effect, with transaction volumes rising sharply last month.

In response, the authorities are reported to be preparing a barrage of new measures, including a closer watch on bank loans to developers, tighter leverage limits on mortgage borrowers, and even taxes on property held in red-hot Shanghai.

Yet despite all the apocalyptic warnings, there are signs that the mainland market may not be as dangerously overinflated as Soros, Chanos and a legion of other observers seem to fear.

Although affordability ratios look stratospheric by international standards, Louis-Vincent Gave and Rosealea Yao at research house GaveKal point out that many buyers are trading up from apartments they bought at cut-price rates when the state privatised much of its housing stock in the 1990s.

In other words, the state effectively subsidised many urban homeowners by giving them a leg up on to the property ladder. That makes life hard for first-time buyers today, but it means that for the millions lucky enough to benefit from the government's divestment programme in the late 1990s and the subsequent price appreciation, housing is much more affordable than the headline ratios imply.

On top of that, few Chinese homeowners are leveraged, and none are as leveraged as the infamous US "Ninja" – no income, no job, no assets – subprime mortgage borrowers who fuelled the US property bubble.

People buying their first home must put up at least 20 per cent of the property's value, although typical down payments are more like 30 per cent. Meanwhile, to deter speculation, buyers of investment properties must put up at least 40 per cent of the value in cash – 60 per cent in Beijing.

In fact, many buyers of investment properties – the infamous dark buildings visitors remark on – pay the full value in cash. They are not leveraged speculators betting on a rise in the market so much as savers buying properties as a store of value.

With consumer inflation now running at 2.7 per cent and the interest rate on one-year time deposits at just 2.25 per cent, savers are losing money in real terms by keeping their money in the bank.

Cash-rich investors are opting to garage their money in empty properties as a way to preserve their wealth

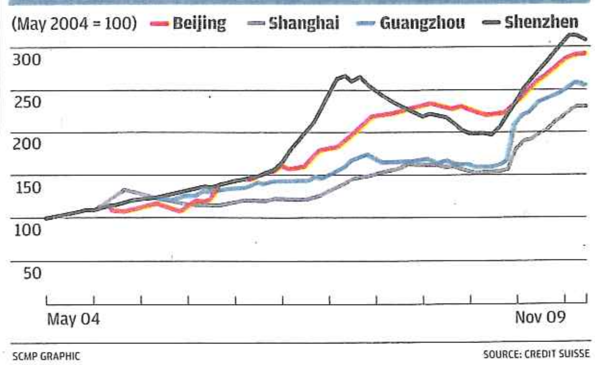
Other investment opportunities are limited. The stock market is too volatile, and the bond market underdeveloped. As a result, cash-rich investors are opting to garage their money in empty properties as one of the few ways of preserving their wealth.

That has driven prices higher, especially at the top end of the market, but the lack of leverage makes it hard to argue that a second subprime crisis is brewing in China's residential property sector.

That doesn't mean the market is entirely free of problems. The run-up in prices means ownership is now out of the reach of many would-be first-time buyers. And there are definite problems of overcapacity in the office and retail sectors that threaten a bad-loan crisis in the future.

But it does mean the residential market is not quite the accident waiting to happen that Soros, Chanos and many others fear.

Property prices



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