

China Real Estate Outlook : Getting more fragile but far from a crisis mode

Delegation of the European Union to China
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Summary Messages :

On the economic outlook

- **China's growth slowdown continued in 2014 Q1**, on sluggish investment demand as the authorities seek to push for structural reforms and to contain financial risks.
- **Our growth projections for China trimmed to 7.2% from 7.6% in 2014 and to 7.0% from 7.5% in 2015**, as the financial fragilities and the implementation of key reforms continue to act as headwinds to short-term growth.
- **Risks still to the downside, mainly from the cooling real estate sector and rising shadow banking activities.**

Summary Messages :

On the Real Estate sector

- **Real estate sector cooling down** after rapid rise in 2013, due to tighter financial conditions, lower GDP growth, and rising financial risks. Downward trend should help to curtail price misalignments, which is estimated to have widened in 2013 (to 5-10%).
- **We expect prices to increase modestly in 2014**, on robust medium-term outlook and growth-supportive policies. We do not expect a collapse in the national housing market, but foresee significant downturns in some local markets with over-supply and soft demand issues.
- **Local markets diverging**; several cities starting to loosen housing policies. Nevertheless, we expect national tightening measures to remain in place.
- **Over the medium term, the outlook for the housing market remains relatively robust** given projected income growth and urbanization

Outline

1. China's economy slows down
2. Real estate sector is cooling

Growth momentum moderates further

- Growth momentum continued to moderate in Q1 2014 (7.4% y/y), mainly on subdued investment.
- Further stabilization in the economy anticipated, thanks to a new mini stimulus package (0.3%-0.4% of GDP so far) and improving exports
- The full-year growth for 2014, hence, has been revised down to 7.2% from previous 7.6%, still above the government's bottom line of 7.0%.

China baseline scenario

Source: BBVA Research

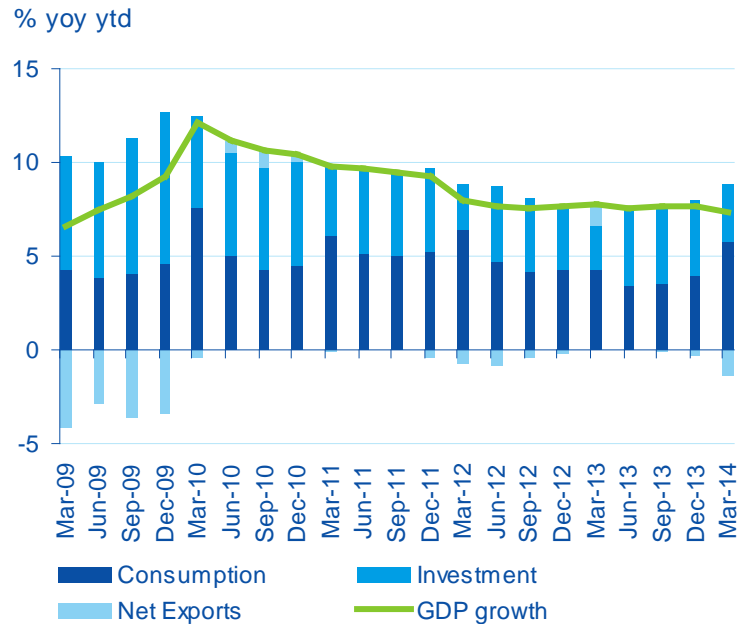
	2011	2012	2013	2014 (F)	2015 (F)
GDP (% , y/y)	9.3	7.7	7.7	7.2	7.0
Inflation (average, %)	5.4	2.6	2.6	2.6	3.3
Fiscal balance (% of GDP)	-1.1	-2.1	-1.9	-2.5	-2.5
Current account (% of GDP)	1.8	2.3	2.0	2.5	3.0
Policy rate (% , eop)	6.56	6.00	6.00	6.00	6.00
Exchange rate (CNY/USD, eop)	6.30	6.23	6.05	6.00	5.85

...as investment is dampened by policies

- Slowing investment has been dampened by the government’s policies and measures, including the waning-off of “mini-stimulus” measures of 2013, and the measures to tackle rising financial fragilities (shadow banking, local govt debt, housing prices) and the over-capacity/pollution issues.
- Crackdown on corruption also relevant in explaining weak investment

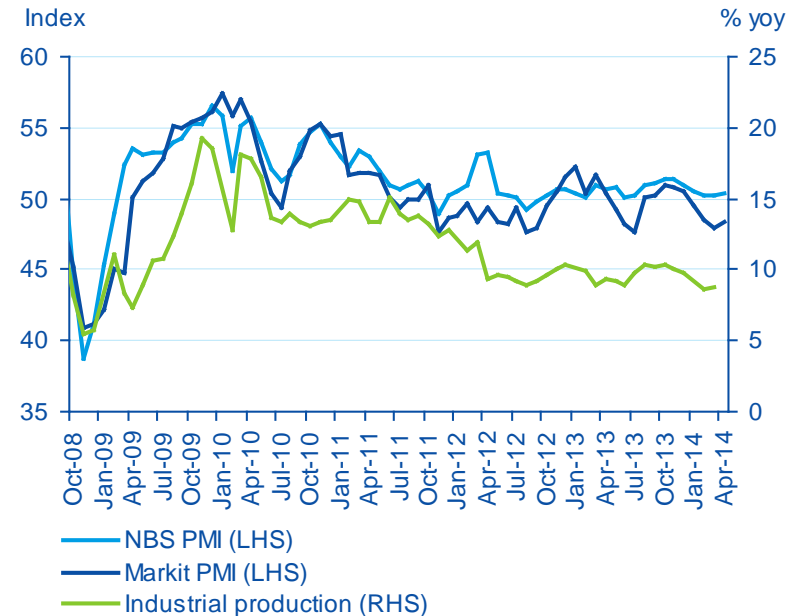
Q1 growth slowed down on sluggish investment

Source: NBS, CEIC and BBVA Research



Recent manufacturing activities are stabilizing thanks to growth-supportive measures

Source: CEIC and BBVA Research

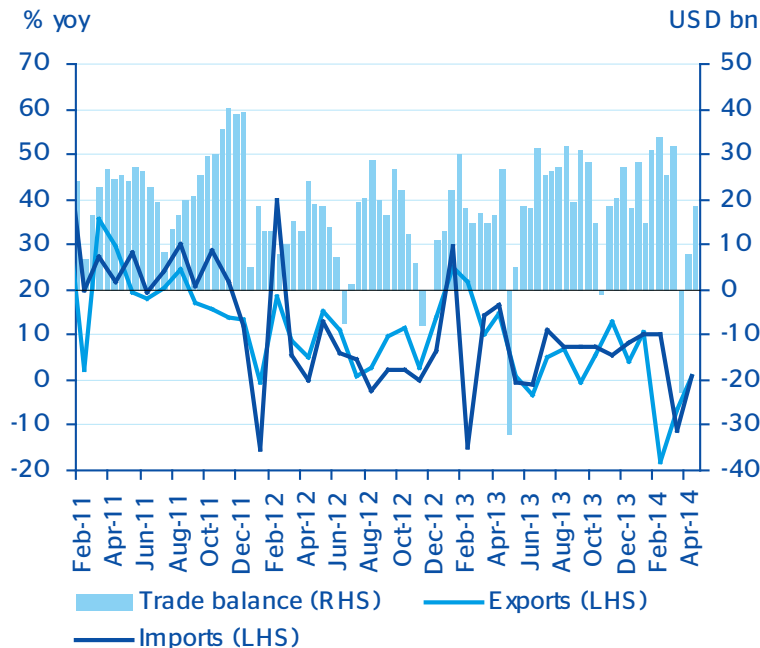


External demand improving gradually

- Exports also decelerated in Q1, despite y/y growth was heavily distorted by base effects and the over-invoicing exports a year ago.
- According, the trade surplus narrowed in Q1. Nevertheless, FDI and continued capital inflows add to foreign reserves.
- Most recently, April's exports have improved, thanks to stronger demand from the US/EU/Japan.

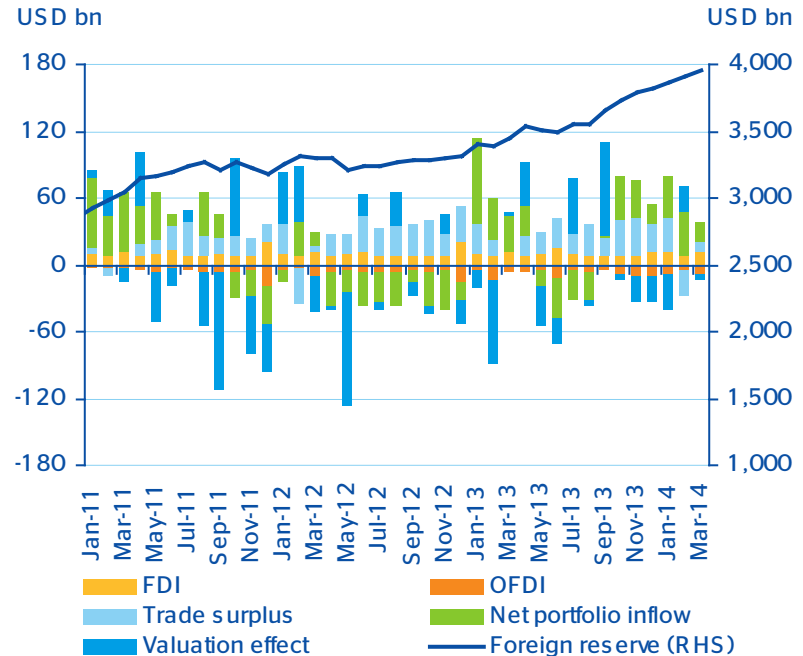
Exports are bottoming out

Source: CEIC and BBVA Research



Reserves continue to rise on FDI and capital inflows

Source: CEIC and BBVA Research

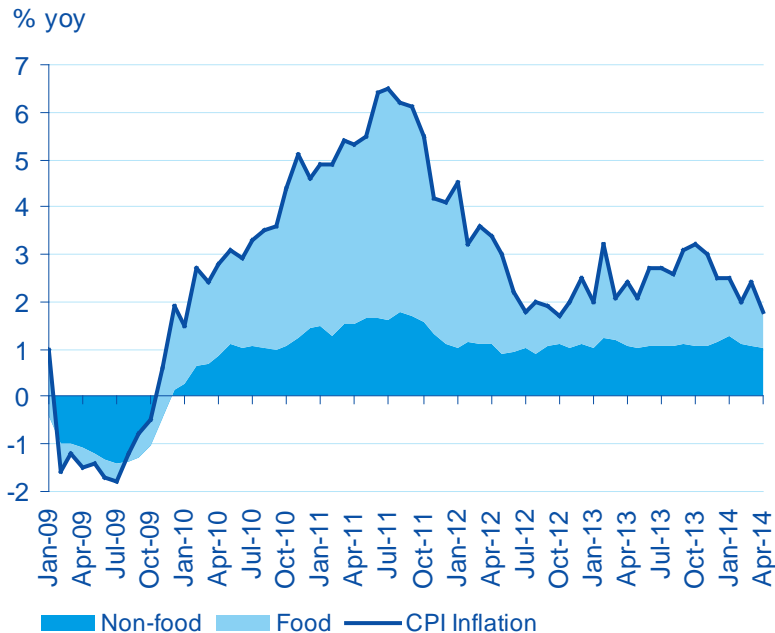


Inflation remains subdued

- Very low inflation environment (1.8% y/y for April), well below the government's 3.5% target
- Producer price inflation stayed in negative territory (-2.0% y/y in April), pointing to sluggish manufacturing activities.
- Room for monetary policy easing if necessary.

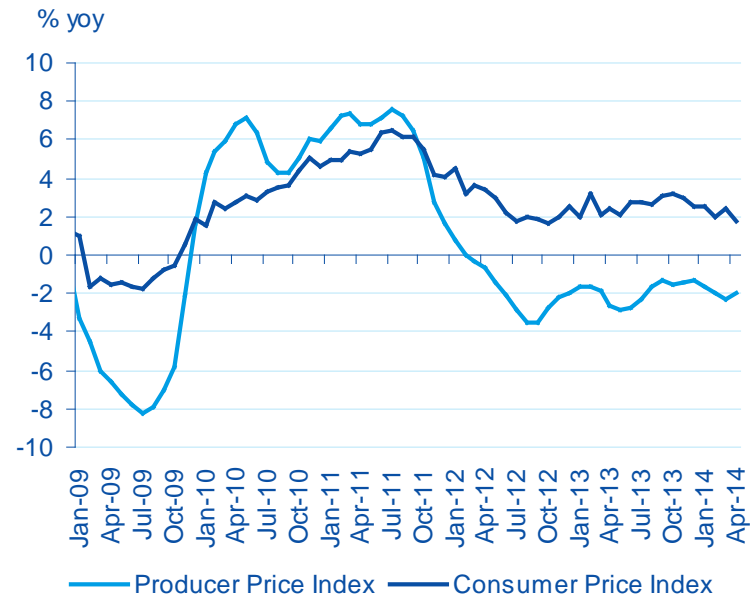
Headline CPI Inflation remains benign...

Source: CEIC and BBVA Research



... while PPI deflation stays negative

Source: CEIC and BBVA Research

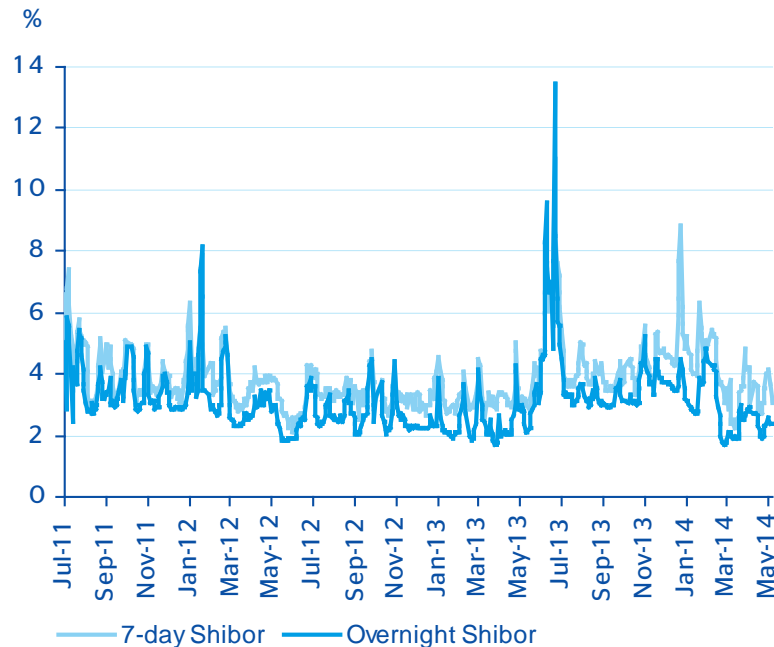


Liquidity has stabilized

- Inter-bank market rates have stabilized after the June crunch and the mini December one, thanks to the PBoC's effort to stabilize the market.
- Still, credit growth has moderated as the authorities strive to curb credit growth and shadow bank lending.

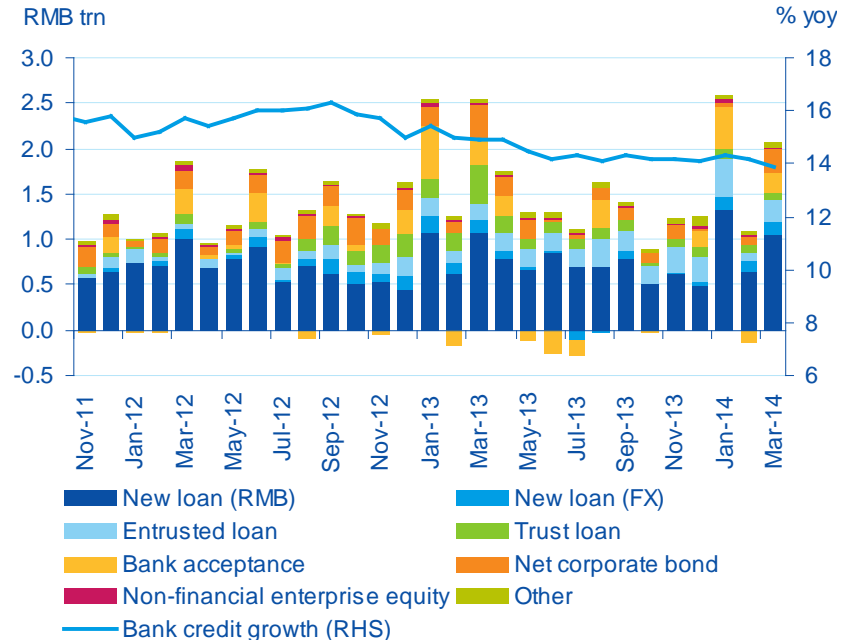
The interbank liquidity become more accommodative

Source: Wind and BBVA Research



Broad credit growth and bank lending decelerated in March

Source: CEIC and BBVA Research



Outline

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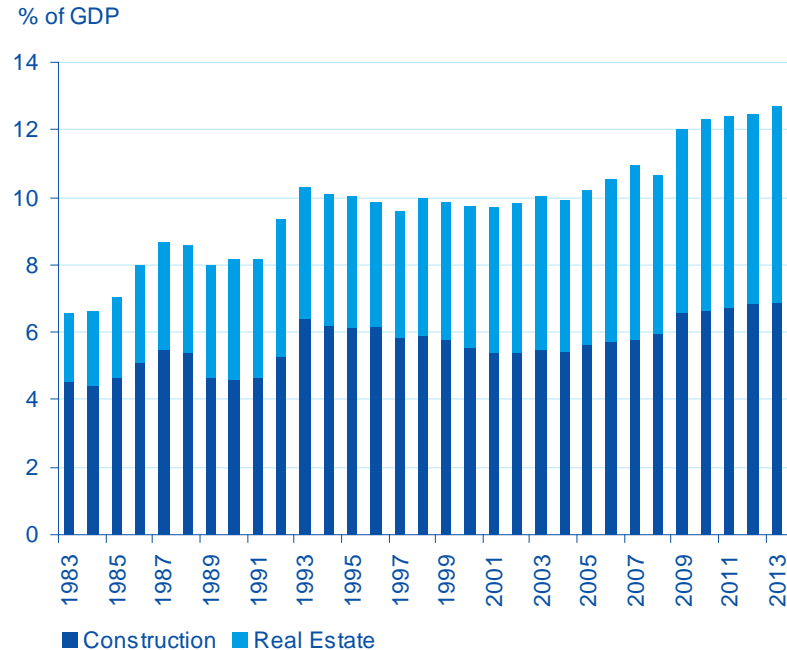
2. Real estate sector is cooling

Real estate: rising importance in the economy

- The sector had been under scrutiny by the market over the past few years, due to a sharp run-up in prices, increasing dependence on shadow bank financing, and excess supply in some areas.
- In 2014, however, the sector attracts further attention, as the cooling sector contributes to weaker investment and economic growth and adds to domestic financial risks.

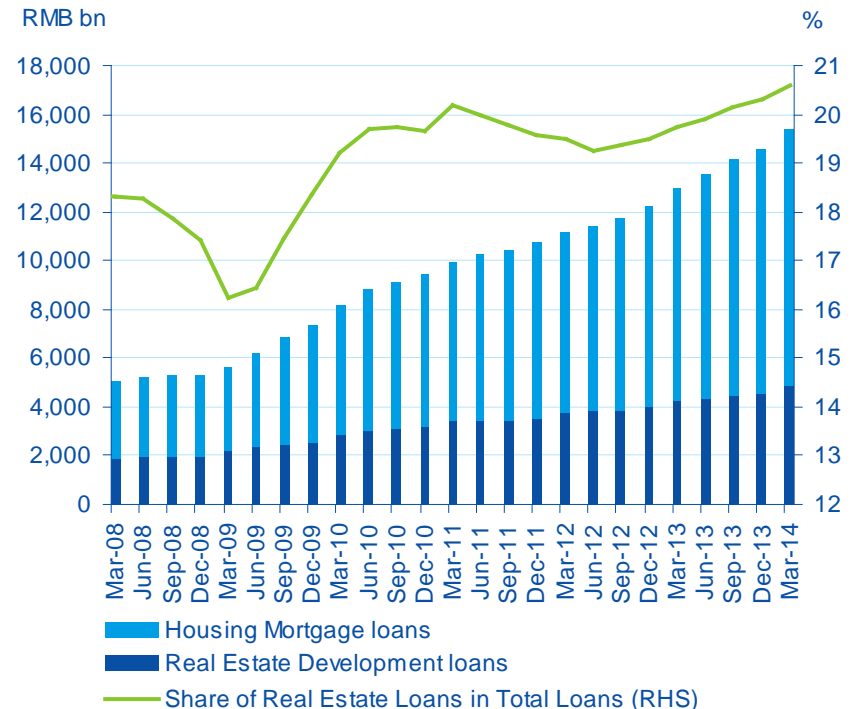
Real estate sector's importance in the economy continues to rise

Source: NBS, CEIC and BBVA Research



Real estate loans account for one-fifth of bank credit

Source: NBS, CEIC and BBVA Research

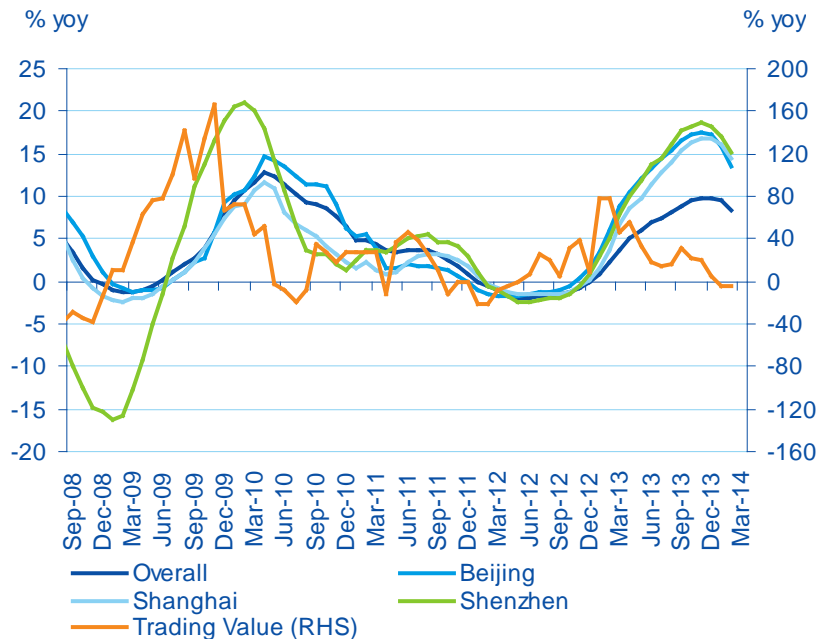


Real estate sector is cooling in 2014

- Nation-wide housing price growth has moderated after peaking in Q4
- Real estate investment also weakens, as do land sales and floor space starts

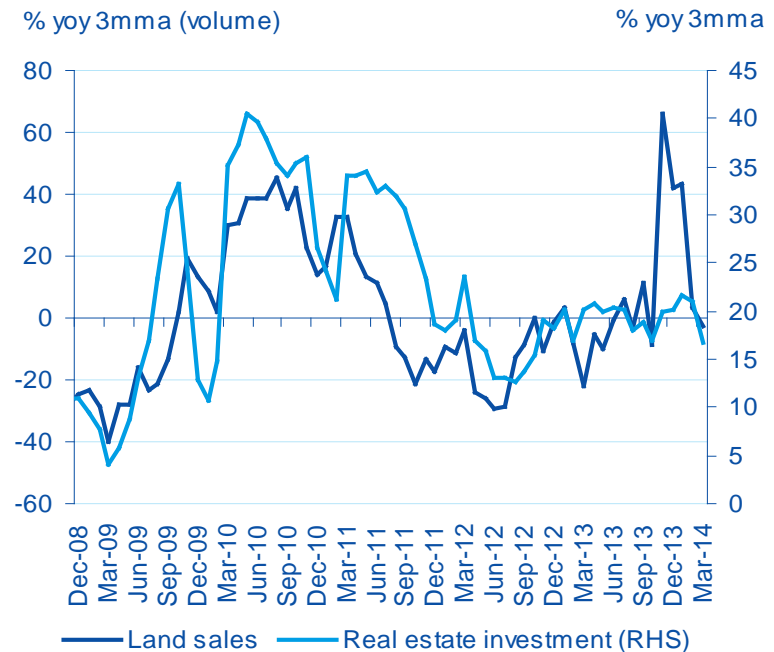
Housing price growth moderates recently

Source: NBS, CEIC and BBVA Research



Land sales and real estate investment are falling

Source: NBS, CEIC and BBVA Research

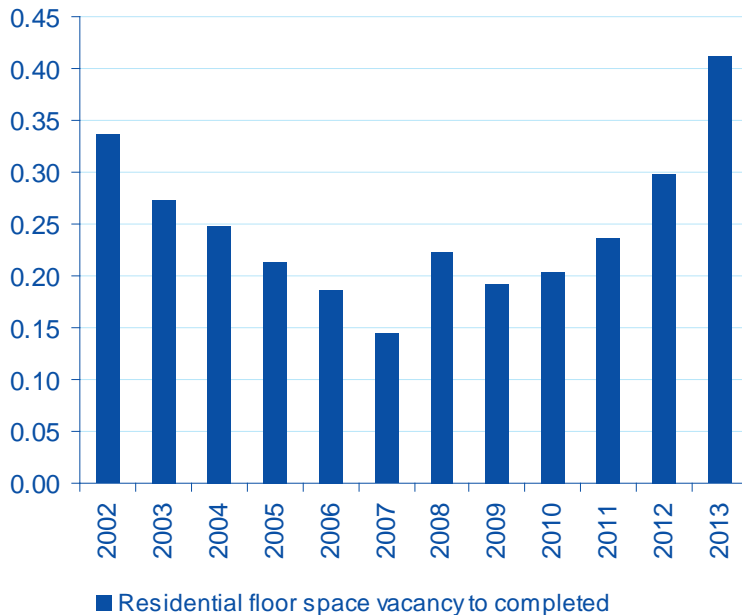


...as rising housing inventories raise concerns

- Housing inventories have been accumulating over the past years.
- While lacking city-wise data, it's believed that those unsold housing units are mainly concentrated in medium and small cities with over-supply but soft demand.
- Looking ahead, rising inventories would continue to weigh on the sector

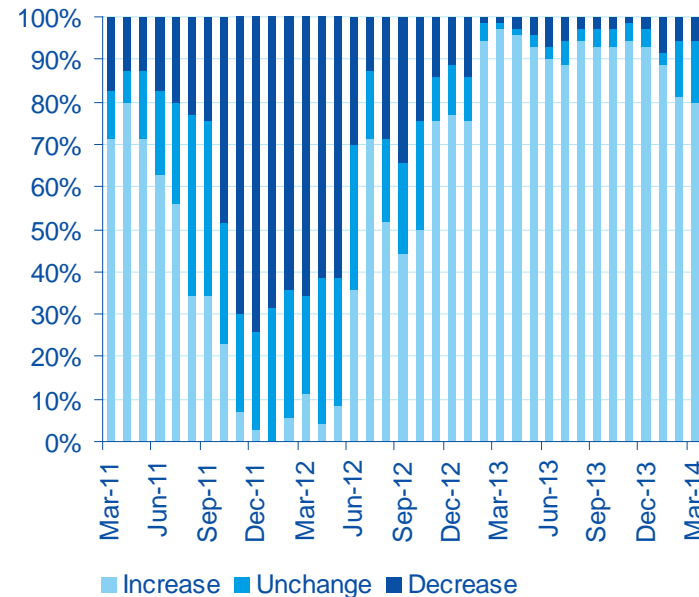
Rising housing inventories

Source: NBS, Wind and BBVA Research



Fewer cities report price increases

Source: NBS and BBVA Research

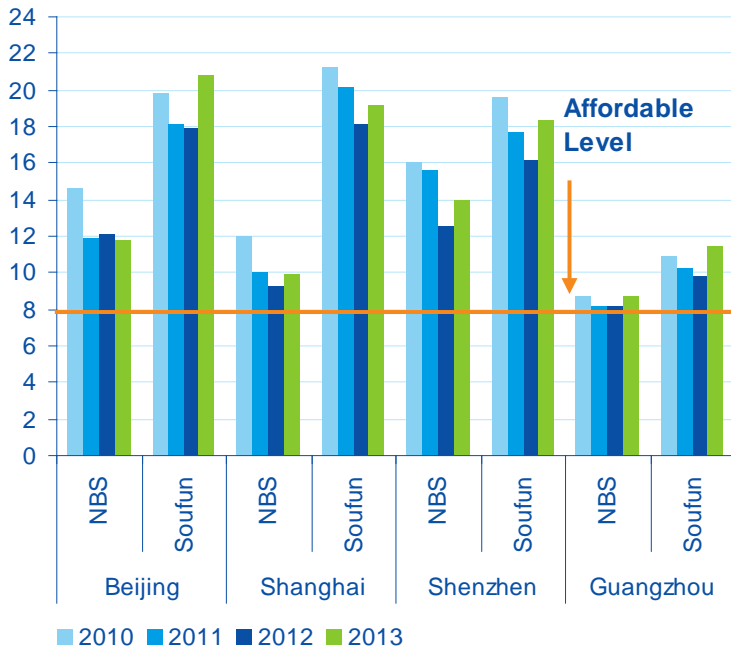


Moderation in prices helps to improve affordability, but local markets are diverging

- Moderating national prices in 2014 helps to improve severe housing affordability
- Local markets are diverging , with Tier 1 cities (Beijing, Shanghai, Guangzhou and Shenzhen) leading price growth.
- Some smaller cities (Haikou, Tangshan, and Wenzhou) may face downturn in the real estate market

Affordability ratios worsened in 2013*

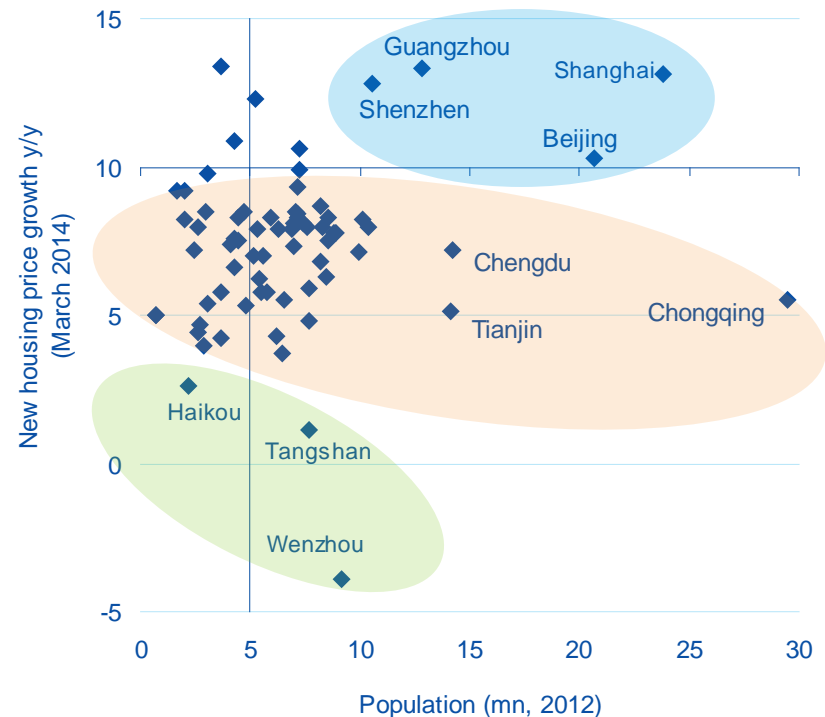
Source: NBS, Wind and BBVA Research



* Residential housing price (30 sq meter pc) / Income pc.

Tier 1 cities lead housing price growth

Source: NBS, CEIC and BBVA Research



Are China's housing prices misaligned? A demand-supply framework*

- To answer this, we have updated and extended our empirical model based on a supply/demand framework. The results are suggestive only.
- The model is based on fundamentals, including real income growth (+), interest rates (-), population density (+), housing stocks (-), construction costs (+) and projected income (+)

$$\left. \begin{array}{l}
 \text{Long run demand price} \\
 \text{Long run supply price} \\
 \text{Equilibrium:}
 \end{array} \right\}
 \begin{array}{l}
 p_{it}^{d*} = \alpha_1 s_{it} + \alpha_2 y_{it} + \alpha_3 y_{i,t+1} + \alpha_4 y_{i,t+2} + \alpha_5 rr_t + \alpha_6 dens_{it} + \alpha_t \\
 p_{it}^{s*} = \alpha_5 \left(\frac{i}{s} \right)_t + \alpha_6 c_t \\
 p_{it}^{d*} = p_{it}^{s*} = p_{it}^*
 \end{array}$$

Variables in the model:

s: housing stocks;

y: current and expected per capita household income

rr: real user cost of residential capital (measured in real interest rate

dens: population density

i: investment

c: construction cost.

*McCarthy and Peach (2004), "Are home prices the next 'bubble'?" Economic Policy Review, Federal Reserve Bank of New York

Tier 1 cities: Price misalignments widened in 2013

- Rapid rising housing prices over the past year have widened of housing price overvaluation relative to fundamentals.
- In 2013, housing prices accelerated in all six of the largest metropolitan areas (Beijing, Shanghai, Shenzhen, Guangzhou, Chongqing, and Tianjin).

Housing fundamentals and price levels

Source: BBVA Research

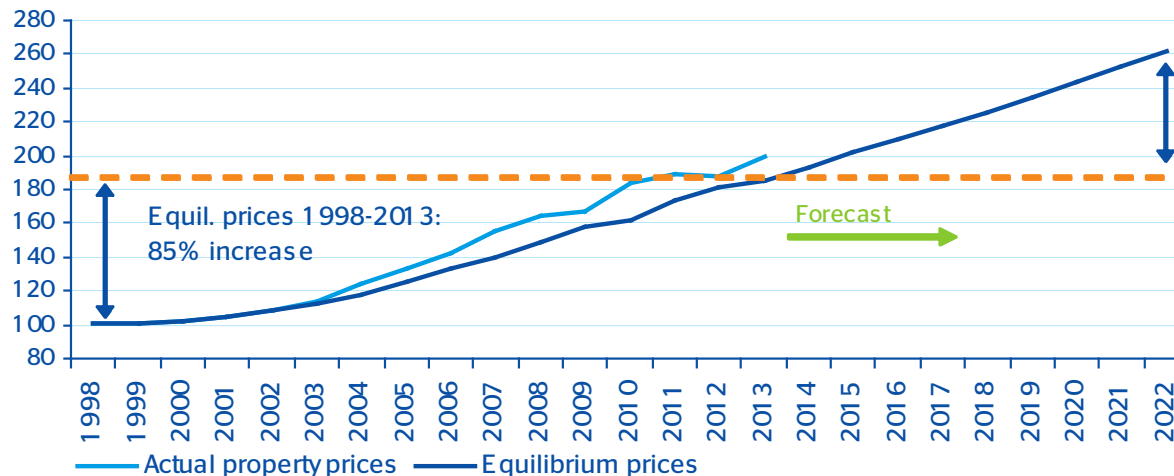
	%	Average growth, 2000-2013			Actual prices	Equilibrium prices	Estimated Over-valuation (2013)
		Real income	Construction costs	Population density			
Beijing		9.5	0.4	3.4	5.2	4.2	+13.2
Shanghai		9.1	0.3	3.2	6.7	5.2	+8.9
Shenzhen		4.3	0.6	3.5	5.2	4.2	+8.5
Guangzhou		7.5	1.2	4.4	3.1	2.1	+3.4
Chongqing		9.5	1.4	0.3	5.0	5.6	+5.1
Tianjin		9.7	2.1	2.9	5.0	4.9	+3.2
Average		8.3	1.0	3.0	5.0	4.4	+7.1

A robust medium-term outlook: Rising equilibrium prices over time

- Our medium-term outlook for China's real estate sector remains relatively upbeat on expectations of continued strong underlying fundamentals (rapid growth in expected income and urbanization)
- Our projections are for an increase in nominal housing prices of 40% through 2022, equivalent to an increase of 10% in real terms.

Actual and equilibrium housing prices

Source: NBS, CEIC and BBVA Research

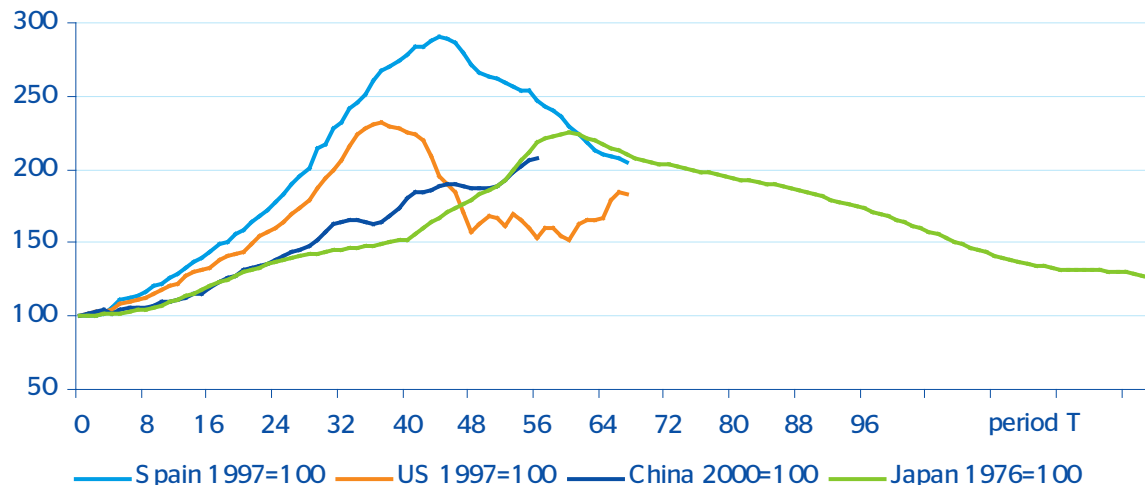


International comparison: Signs of housing bubbles?

- Is China's real estate sector following the step of Japan?
- Moderate housing price growth will help to mitigate risks of housing bubbles, which have been quite worrisome from international experience.

International comparison of housing bubbles

Source: NBS, Haver and BBVA Research



Medium term challenges

- Affordability: a pressing social issue
- Sound financial incentives and tax policies to facilitate the healthy medium-term development in the sector
- Monitoring of the impact of ambitious social housing investment plans

China aims for target of 7 million units of affordable housing starts in 2014

Source: NBS, Wind and BBVA Research



Thank you!

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