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# CHINA'S FRAGILE ECONOMY, ITS HOUSING BUBBLE, AND WHAT IT MEANS TO US

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[The Daily Capitalist](#)

We think that China is an indestructible economic juggernaut but its economy is very fragile and it is sitting on a property bubble which will burst. What China does in response has major implications for their economy and the rest of the world.

We are told that China has huge housing needs, that demand will continue for decades, and that prices have [nowhere to go but up](#). But that's not how economics works for housing or for any other product. It may be true for China's long term, but the short run can kill you.

Having been in that business, we were told here that America's long term growth potential was almost limitless, that new family formations, immigration, and abundant financing would continue to drive the housing market higher. And remember, they said housing prices had never declined on a national basis in the last 60 years.

"They" were wrong as it has now been painfully revealed to us. There are [many factors](#) affecting the supply of and demand for housing. And prices do go down, dramatically. So, when you hear that China's housing market will grow in a linear direction and that its economy will not be impacted by a housing bubble, you can evaluate that statement in light of recent history.

### 4 Important Things to Know About China

Before I go into the details of what is happening in China right now, there are four things about China to consider.

**First**, most economic statistics from China are inaccurate. This is the result of state, top-down driven economic planning. The nice thing about a planned economy is that they can pretty well dictate what GDP will be because of the way they calculate it. What they mean by "GDP" is very different than what other countries mean by GDP.

China counts the funds that are distributed from Beijing to local governments and entities as spent when distributed. Retail goods are calculated as sold when factories ship goods, not when they are purchased by consumers. This is an artifact of communist central planning that

brought them the ruinous Five Year Plans and the Great Leap Forward (Backward) of Mao Zedong.

Local or regional bureaucrats responsible for allocating resources or implementing policies are often corrupt, inept, and lie about the results of their efforts. What comes to mind is the school in Sichuan province (the so-called "tofu-dregs schoolhouse") that collapsed during the earthquake in 2008 because local officials were bribed, paid off, colluded, whatever, by the contractor who was responsible for the shoddy product. You can multiply that ten thousand times. No one knows what is really spent and what goes into the pockets of corrupt officials.

**Second**, local and regional governments and state-run enterprises are in serious financial trouble because of the real estate bubble. A big revenue source for local and regional governments is from land sales to developers. We've all heard the stories of landowners and tenants getting kicked off their land to make way for a new block of homes or condos. Their compensation is small, and you can guess where a lot of the money goes. The local entities borrowed lots of money to finance developers. Beijing is so worried about the financial solvency of local governments that Premier Wen Jiabao announced at the National People's Congress last week that it will issue 200 billion yuan worth of bonds on behalf of local governments.

In a "worst-case scenario," the non-performing loans of local-government investment vehicles could climb to 2.4 trillion yuan (\$350 billion) by 2011, Shen Minggao, [Citigroup's Hong Kong-based chief](#) economist for greater China, said yesterday.

"The most likely case is that the Chinese government will engineer a massive financial bailout of the financial sector," said [Northwestern University Professor Victor Shih] who spent months researching borrowing by about 8,000 local government entities. ...

Su Ning, a deputy governor at China's central bank, said March 8 that a "fairly high proportion" of total lending last year went to the funding vehicles. Chinese banks extended a record 9.59 trillion yuan of new loans in 2009. Su sees "a big risk" from local-government guarantees for money borrowed to fund infrastructure projects that may not generate returns, he said in Beijing.

**Third**, much of their "growth" is fake. Money sent to districts and municipalities to spend is not organic economic growth. Much of current GDP growth is a myth since most of it comes from government stimulus. Building roads and bridges is good because China needs to build its infrastructure, but it is very wasteful and inefficient. Whatever it is, it is not real organic economic growth: governments only spends money, they do not make money (actually they do in a perverse sense when they print it).

**Fourth**, China is still a big, robust, developing country. Despite what I said above, there is real growth and wealth. Deng Xiaoping's "to get rich is glorious" revolution released China's potential. It may be inefficient, and at times corrupt, but it is real. But, they are not immune to the laws of economics.

## China's Response to the Recession

China was hit hard by Western consumer cutbacks and their exports, the mainstay of their economy, plummeted. "The global financial crisis left [20 million Chinese migrant laborers unemployed](#) and more than 7 million college graduates seeking work by March last year."

In February 2009, a clash between police and about [1,000 protesting workers](#) from a textile factory in Sichuan province injured six demonstrators, rights group Chinese Human Rights Defenders reported.

In China's zeal to keep their economy going, the government injected about 4 trillion yuan since 2008 (14 percent of GDP) as fiscal stimulus. It expects to have deficit spending equal to 1.5 trillion yuan this year. Since they believe in Keynesian stimulus, and since they still have a quasi-centrally planned economy (the ultimate Keynesian technocrats), they will keep doing this until the crisis passes. You see, there is one thing the Central Committee fears: their own people. If the economy collapsed, you would see massive unrest, and I believe they fear for their lives.

The extent of their stimulus:

In June [2009], growth in the money supply measure known as [M2 surged to 28.5 percent year-over-year](#)--up sharply from a 15 percent rate at the beginning of the year, which was far more typical of the pace of money growth over the past decade.

New loans by banks rose by about \$1 trillion, or twice the expected rate, during the first half of 2009 and rose 34.5 percent year-over-year in June from a 30.6 percent growth rate in May. It appears that Chinese policymakers are experiencing difficulties in prompting total spending to match their ambitious growth targets implied by a production growth target of at least 8 percent, and so they have allowed a rapid surge of money and credit at midyear.

The resulting flood of money has--somewhat counterproductively--flowed into stocks, property markets, commodity stockpiles, and consumer durables (with the help of special incentives for purchases of durables).

## The Real Estate Bubble

China is having an unbelievable housing boom (bubble, I would say). Read these examples of bubble behavior which, from a distance, are fascinating illustrations of behavioral economics:

In Shanghai, prices for high-end real estate were [up 54 percent](#) through September [2009], to \$500 per square foot. In November [2009] alone, housing prices in 70 major cities rose 5.7 percent, while housing starts nationwide rose a staggering 194 percent. ...

"Once the bubble pops, our economic growth will stop," warns Yi Xianrong, a researcher at the Chinese Academy of Social Sciences'

Finance Research Center. On Dec. 27, China Premier Wen Jiabao told news agency Xinhua that “property prices have risen too quickly.” He pledged a crackdown on speculators. ...

In Beijing’s Chaoyang district, which represents a third of all residential property deals in the capital, homes now sell for an average of almost \$300 per square foot. That means a typical 1,000-square-foot apartment costs about 80 times the average annual income of the city’s residents. ...

“When you sit down with a table of businessmen, the story is usually how they got lucky from a piece of land,” says Andy Xie, an independent economist who once worked in Hong Kong as Morgan Stanley’s top Asia analyst. “No one talks about their factories making money these days.” ...

The government is reluctant to crack down too hard because construction, steel, cement, furniture, and other sectors are directly tied to growth in real estate. In November, for example, retail sales of furniture and construction materials jumped more than 40 percent. At the December Central Economic Work Conference, an annual policy-setting confab, officials said real estate would continue to be a key driver of growth.

And this:

China risks a “[similar asset bubble](#)” to that in 1980s Japan unless lending is reined in, Erwin Sanft, head of China and Hong Kong equities research at BNP Paribas, said Nov. 23. ...

Accountant Wang Jin waited in a downpour for six hours last month to buy into a Pudong apartment project by Shui On Land Ltd., a Hong Kong-traded developer controlled by billionaire Vincent Lo.

More than 800 people lined up outside a sports stadium to buy about 220 units costing about \$4,100 per square meter on average.

“I couldn’t believe what I saw when I got there,” Wang, 37, said. “I know the property market is sizzling now, but this?” ...

Çao Guanzhou, a real estate agent in Shanghai, tried to take advantage of the boom. After selling his Pudong apartment in May for 54 percent more than what he paid three years ago, Çao closed his hot pot restaurant and started selling properties.

Business is slow, he said.

“Too many agencies have opened up,” Çao, 51, said. “There’s too much competition now.”

## China's Government Tightens Credit

The government is very worried about this bubble and in November they announced new [rules](#) to reign in developers:

The new rules ... include a minimum down payment of 50% on land purchases from the government. Local-level governments previously asked developers to put down 20%-30% of the value of the land in such deals, analysts said.

The new policy also requires developers to completely pay off land purchases from the government within one year of a sale agreement, with a one-year extension allowed for certain "special projects."

Developers won't be permitted to buy new land if they fail to pay off a land purchase in time, according to the statement, which was jointly issued by the Ministry of Finance, the People's Bank of China, the Ministry of Land and Resources, the National Audit Office, and the Ministry of Supervision.

The new rules also require local governments to fully reflect the proceeds of land sales in their budgets and forbid them from giving discounts to developers or allowing developers to delay payments. ...

"Land auctions by local governments will be conducted in a more strict manner than before to meet the central government's new rules," said Johnson Hu, an analyst at UOB Kay Hian. "It may not have a direct impact on housing prices, but it sets a tone that shows the government wants to rein in the property market to deter speculation."

And these moves will hit the economy hard, especially [developers](#):

At the end of August [2009], liabilities exceeded 90 percent of assets at more than 160 developers that have borrowed at least 50 million yuan (\$7.3 million) each from banks, the person said. New loans for real-estate development surged 121 percent from a year earlier in the first half to 403.9 billion yuan, according to the People's Bank of China's latest quarterly report.

The housing market is starting to cool, but in [Chinese proportions](#):

Property prices are still going up: They were 10.7% higher than a year earlier in February, the National Bureau of Statistics said, even as prices of food and other daily necessities are also rising. ...

However, sales of residential properties are now easing from growth rates of more than 50% late last year, with the data showing an increase of 37% in the first two months of 2010. Figures compiled by

real-estate consultancy Soufun, which counts transactions in 30 major cities, show an even sharper slowdown at the beginning of the year: Housing-sales volume was down 49% in February from January, which in turn was down 46% from December. ...

### **The Government's Dilemma**

What to do? This is a serious problem because real estate activity was one of the [main drivers](#) of China's economy last year when exports dropped off a cliff. But any tightening runs a serious risk, in their eyes, that the economy will crash.

Premier Wen [Jiabao announced](#) to the National People's Congress meeting held last week, that "the launching of new projects must be strictly controlled" this year. They are turning the spigot maybe an eighth turn:

The People's Bank of China, which has said it will work to gradually [normalize monetary](#) conditions this year, reported that banks extended 700.1 billion yuan (\$102.6 billion) in new local-currency loans in February, around half the 1.39 trillion yuan in January and well below the 1.07 trillion yuan in the same month last year. Growth in outstanding loans eased to 27.2% at the end of February from 29.3% in January, also the slowest growth rate in a year.

Commentators like Nouriel Roubini don't think the [tightening is enough](#):

A credit-fueled investment boom successfully set prices as well, especially in property markets. As China's output gap closes, loose money is now set to become inflationary, particularly if China's potential growth rate has come down slightly, as RGE thinks it has. The People's Bank of China (PBoC) has twice hiked banks' required reserve ratios (RRR) in 2010, following a return to net liquidity reductions through open-market operations in October 2009, but RGE suspects that the tightening moves have had little effect. ... boosted China's growth to 8.7% in 2009, but cheap money drove up as

China has not yet started to tighten liquidity significantly, nor has it laid out a clear path for its exit from the extraordinarily loose monetary conditions put in place at the end of 2008. ...

The political will to tighten monetary conditions looks weak in China, particularly concerning any appreciation of the RMB.

And Roubini is right about political will. Here's what Premier [Wen Jiabao said](#) at the National People's Congress:

Mr. Wen reiterated in his annual report at the opening of the National People's Congress that the government will continue its "active" fiscal policy and "moderately loose" monetary policy. It will also maintain the "basic stability" of the yuan exchange rate, he said.

Mr. Wen cautioned that "there is insufficient internal impetus driving economic growth," and reiterated the government needs to "consolidate the momentum of the economic turnaround," while restructuring the economy. ...

It will also seek to slow growth in broad money supply, or M2, to around 17% this year from nearly 28% in 2009. ...

Still, Mr. Wen said the government plans to run a fiscal deficit of 1.05 trillion yuan this year, or 2.8% of GDP. The budget suggests continued fiscal stimulus this year given earlier data showed the 2009 deficit at 2.2% of GDP, though the finance ministry said last year's deficit was higher, at 950 billion yuan, because of an accounting move.

"The fiscal deficit in 2010 still needs to be of an appropriate size. At the same time, in order to promote the sustainable development of public finances, actively prevent fiscal risk, and leave some leeway to gradually reduce the deficit in future years, we must keep the deficit under 3% of GDP," said the Ministry of Finance.

This doesn't sound like they are serious about cutting back fiscal or monetary stimulus.

### **What Will Drive China's Economy?**

The backbone of China's economy is exports. When the recession hit, exports fell YoY 20% during the first half of 2009. While exports reported to have jumped 45.7% YoY in February and 21% in January,

... the jump was mainly due to a low comparison base, as exports in February last year fell at their fastest rate during the international financial crisis. [Seasonally adjusted](#) exports last month fell 2.2% from January, suggesting lingering weakness in external demand--a recurring theme in recent remarks by officials.

What is going to help China's exports? I don't mean this to be an obvious question, but if, contrary to what many economists predict (but not me), the U.S. and European economies don't recover in H2 2010, then the Chinese are in trouble. Already they have massive unemployment and admittedly poor internal demand for goods. If the housing market is on a bubble, and they are trying to talk it off of the ledge to avoid a crash by tightening money and credit, they are in trouble.

### **Inflation is on the Rise**

I think they will panic if they see western economies weaken. They will panic further if real estate prices start to collapse as a result of tightening policies *and* western economies weaken. The panic will result in more fiscal and monetary stimulus.

This is right out of the Keynesian playbook and the result will feed the bubble, create inflation, and result in more debt. And, since a substantial part of their official "growth" comes from quasi-government entities (local and regional governments, Red Army and other State-run enterprises) which are highly inefficient as a result of top-down dictates from Beijing, much

of this spending is just a waste of capital. Japan [tried the same thing](#) and it didn't work for them either.

It is remarkable that Premier Wen can get up and say that China will have 8% growth this year. In light of poor exports, a financial bubble, poor internal demand, and the severe risk from the quasi-government and local government debt bomb, it is unlikely that China will see real economic growth this year approaching that number. Understand that they can claim to have such growth because of how they measure GDP, but it isn't real.

And they are already seeing [inflation](#). In February consumer prices rose 2.7% YoY, a 16-month high. Producer prices rose 4.3% in January and 5.4% in February. In light of money supply targets, inflation can only grow. The fact that there is an "output gap" has nothing to do with inflation; idle capacity and high inflation are compatible (remember stagflation). The government's target is to keep it under 3%. No one [believes](#) that.

It is clear that, officially, the CPI won't exceed 3%, but unofficially? There will be no way to know for sure. I doubt they will announce price controls to achieve their goal, but they have the power to do it *unofficially* by either fudging the numbers or "jawing" prices down, or both. If they attempt de facto price controls, the evidence of such will be shortages of certain commodities.

### **The Consequences to China and the World**

1. China will lead no one out of the recession. Despite what many commentators tell you, China has weak internal consumption and lives on exports. We cannot look to them to be a leader of the world's economies because they live off of the U.S., Europe, Japan, and other buyers of Chinese products. The U.S. will lead *them* out of the recession, not vice versa. The only way they can rapidly spur internal consumption is for them to abandon their wasteful planned economy, fully embrace capitalism, and let those who know how to create wealth and jobs do their thing.

2. The last thing they will do is let the yuan rise. The government is worried about the recovery of western consumer economies. In two *blockbuster statements* coming out of Beijing last Saturday (March 13) and Sunday (March 14), [He Keng](#), vice chairman of the Financial and Economic Committee of the National People's Congress, and [Premier Wen](#) Jiabao, said that they are worried about a *double-dip global recession*. This is an entirely new position China has taken on the recovery. This means also that they are more likely to increase fiscal and monetary stimulus. Maintaining the yuan may be easier when hot money bails out of their markets (maybe \$25 billion flowed into China's bubble).

3. China will not seriously tighten money and credit. They will continue to inflate to try to stimulate internal consumption and let inflation bail them out of the huge liabilities they face from massive defaults of local governments, quasi-government entities, and state-run enterprises. Even if they were serious about bursting the real estate bubble, they won't because they know the economy will tank because the bubble was built on cheap money, courtesy of the People's Bank of China, not real demand.

4. They have another incentive to inflate: to maintain the "stability" of the yuan. Since China's leaders are clearly worried about a double-dip recession, there is pressure on them to stimulate exports, the mainstay of their economy. Letting the yuan rise will defeat that purpose. They can flood the market at will with new yuan and also use its reserves to sell yuan. Since they are cutting back slightly on purchases of U.S. Treasuries, they have the cash to control the yuan market.

5. The real estate bubble will burst ... eventually. There is no period in history when such bubbles have not ended badly. I recommend Rogoff and Reinhart's paper, "[This Time is Different: A Panoramic View of Eight Centuries of Financial Crises](#)." While I disagree with many of their economic assumptions, they offer a fascinating look at debt-fueled crises throughout history. Their conclusion: bubbles inevitably crash. They just came out with a book based on this paper.

6. When the bubble bursts, the results will be severe. You will recall that most of last year's economic activity came from real estate. According to Yi Xianrong, a researcher at the Chinese Academy of Social Sciences' Finance Research Center, mentioned above, "our economy growth will stop". Or you could listen to economist [Ken Rogoff](#) who believes such a crash could reduce their GDP to 2%. Rogoff doesn't offer much guidance on this other than to say it could happen in the next ten years.

7. What will happen to China after the crash is that they will be left with a situation similar to the U.S. where home prices collapsed, taking down many financial institutions, developers, and perhaps wiping out the equity of many home buyers. But ... things are different in China, so it will be difficult to assess. For example, most buyers put very high down payments (about one-half) into a property. Also, the government will do what it can to bailout local governments by selling bonds to turn short-term obligations into long-term debt. Such activities by the government will only delay a recovery.

8. Their recovery will be prolonged. They cannot grow substantially without a recovery in exports. And that requires a recovery of the economies of their customers, mainly the U.S., Europe, and Japan. I believe we will see a double-dip recession in the U.S. U.S. consumption will continue to be restrained as consumers worry about the economy, their jobs, their high debt, their declining asset values, and their inability to retire on schedule. Consumers will protect themselves by increasing savings. And that won't result in a huge increase in consumption. The consequences of a flattening of our economy will be bad for China.

9. They will have no real growth in internal consumer demand. The problem is that most of the new homes being built are aimed at the "rich" who are the main drivers of consumerism in China. When their housing asset base collapses, there will be a slowdown in internal consumption.

10. The government will be tempted to inflate even more to foster a recovery. Whether capital will continue to flow into real estate is a question mark. While that is possible, and perhaps investors there have short memories, it is more likely that capital will flow into other areas. As prices rise, look for assets to flow into the stock market, and commodities, especially gold. We may see a continuation of central bank purchases of gold that they started in April, 2009. A sure sign of inflation and the government's attempt to control prices will be shortages of goods.