Asia: Cutting Through the Noise Series

Issue III - The Chinese Property Market **September 2017**

Key Takeaways:

- The misallocation of capital from China's banking sector is a structural issue that needs to be tackled.
- One of the critical side effects of inefficient capital allocation is a bubbly property market, which could pose significant problems over the long-term.
- As China pursues dual objectives of social equality and growth, concerns over a potential Japanese-style deflation trap are mounting. Prudent management of the mainland property market will be necessary to keep the country on track.
- Having studied Japan's past missteps, Chinese authorities are closely monitoring capital allocation and enforcing measures to curtail excesses.

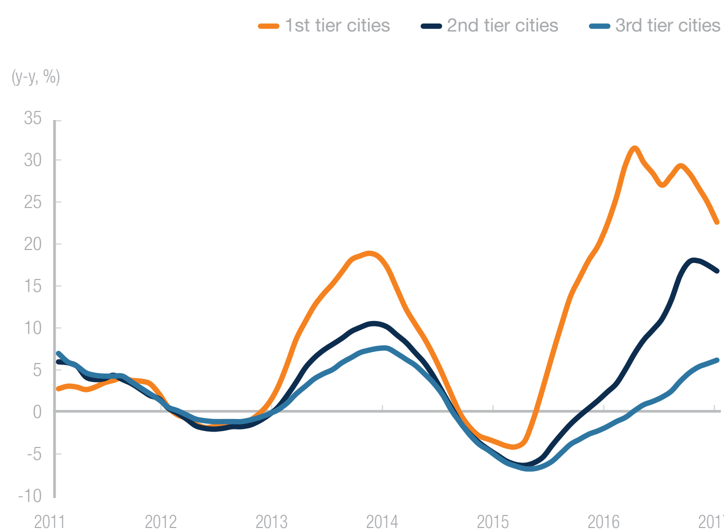
Real Estate on the Radar

With more than one-third of China's economy tied to real estate, any hiccup in the local property market could have a far-reaching ripple effect.[1] However, the country appears well-equipped to avoid a real estate collapse.

Over the past few years, fears of a potential systemic crisis in China have emerged as the country's debt has expanded. However, the evidence at hand does not seem to point to a full-blown collapse. Indeed, the scale of China's debt is low relative to its forex reserves, and locals, not foreign creditors, are largely responsible for the capital outflows that have weakened the yuan. And perhaps most importantly, China is taking carefully calibrated measures to ensure that it is able to ward off an all-out bubble.

China Property Market Management

Source: Wind, Mirae Asset Daewoo Research (2017)



[1] Wall Street Journal, "The Problem With China's Economic Growth" (July 18, 2017)

However, the excess liquidity injected by the People's Bank of China (PBOC) to shore up growth is leading to the misallocation of capital by mainland banks, which is in turn supporting the rise of shadow banking and opaque wealth management products. Significantly, among wealth management products attracting domestic funding, those linked to the real estate sector make up the lion's share. This fact, coupled with the particularly high contribution of property to Chinese household assets, suggests that a real estate downturn would be a major complication for China's political regime.

Japan's Housing Bubble

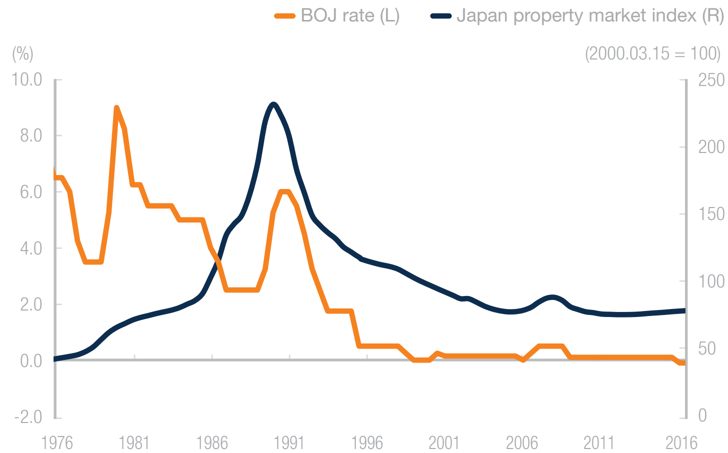
A deep dive into the collapse of Japan's housing market in the early 1990s could provide valuable clues as to what lies ahead for China.

On the last day of 1989, following tightening by the Bank of Japan (BOJ), Japanese equities peaked, and the country's overheated property market promptly started to collapse. By 1992, signs of disinflation had clearly become visible as the economy stagnated and prices continued to fall. Overall, the Japanese public welcomed the decline, since homes were becoming more affordable for the working class. Against this backdrop, not only did the BOJ tilt toward hawkishness, but tighter property market regulations were introduced and applauded. Ceilings on residential property lending, capital gains taxes on property, and national landholding taxes were all introduced or tightened. These moves, which were aimed at bolstering sentiment, caused headline inflation to fall from 6% in 1991 to zero in 1998.[2]

All the while, Japan's well-capitalized banks supported the economy by funding infrastructure and real estate projects. However, the

Japan Property Prices vs. BOJ Rate

Source: Bloomberg, BIS (accessed in 2017)

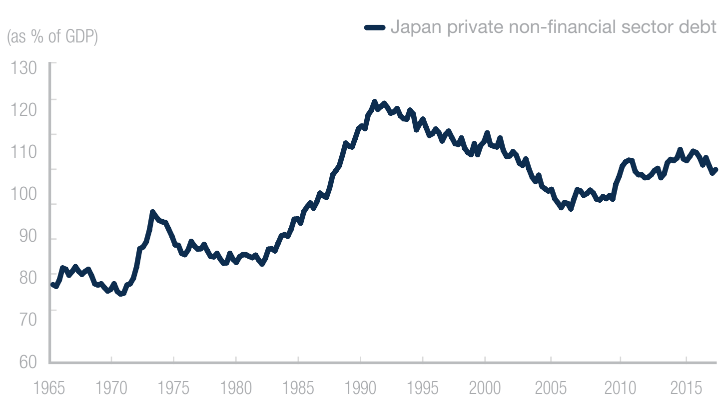


government underestimated the long-term damage caused by the accumulation of non-performing loans extended to property developers and other corporates. It was not until 1997, when Hokkaido Takushoku Bank, Yamaichi Securities, and numerous other small-to medium-sized financial institutions failed, that the structural risks facing the financial system came under the microscope.

The ensuing recapitalization of banks marked the start of the shift from disinflation to genuine deflation; recapitalization kept banks viable, but without reform, they remained inefficient. Japanese banks found their balance sheets shrinking, leading to a breakdown in the sector's transmission mechanism. Bringing these events to the present, we note that banks in China are currently suffering from similarly inefficient capital allocation, which is threatening to cause the country's property market to bubble over.

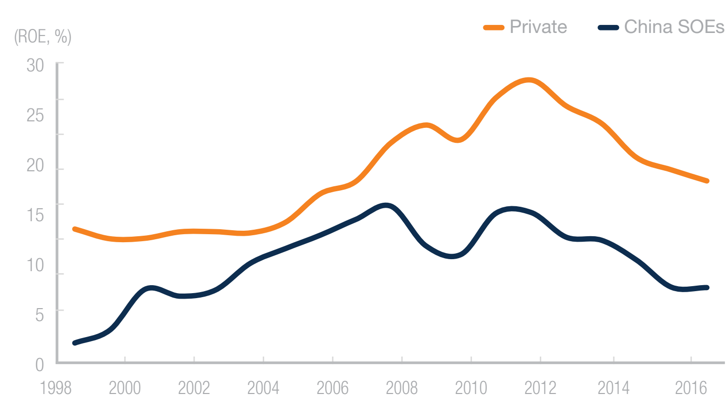
Japanese Corporations have been Deleveraging for 20 years

Source: Bloomberg, Mirae Asset (accessed in 2017)



China's Misallocation of Capital

Source: CEIC, Mirae Asset Daewoo Research



[2] Bloomberg, BIS (accessed in 2017)

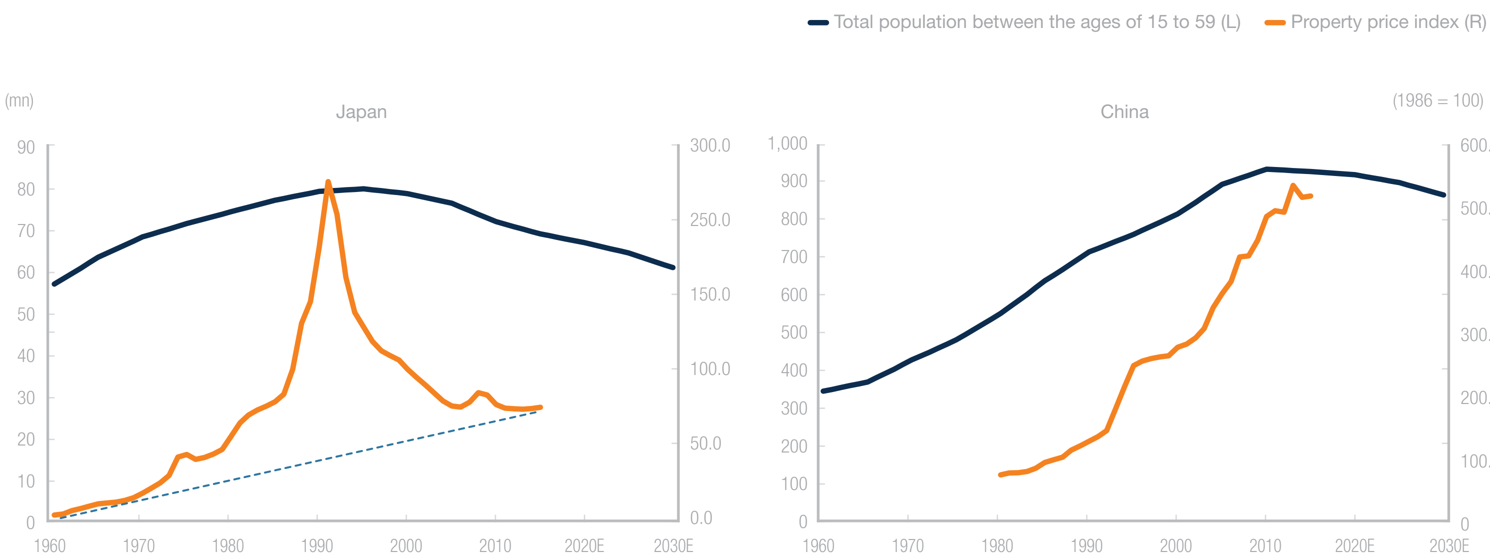
Walking a Fine Line

We see signs that policymakers around the world, like those in the Japan case, are increasingly being swayed by political considerations when it comes to real estate market management. Ironically, China, a socialist country, is less focused on affordability and more concerned with the potential for political repercussions stemming from a sharp property market decline. Whenever China's housing prices start to fall, the policy response has been unequivocally robust. Simply put, Chinese policymakers are treading a fine line: they want to avoid a bubble but are even more determined to avert a significant fall.

Notably, China's property market is nowhere close to the bubble seen in Japan in the 1980s. As such, policymakers still have room to permit a rise in prices. Thus far, however, they have prudently kept the market somewhat in check—but there is still a possibility of a stumble into over-stimulus (and a subsequent bubble).

Comparing Demographics & Property Prices of Japan and China

Source: BIS, CEIC, World Bank, KB Kookmin Bank, Thomson Reuters, The Economist (accessed in 2017)



All in all, for China, the mainland property market is an important political and social issue, and the country's banking system is exposed to real estate via shadow banking and wealth management products. While the shadow banking market has moderated recently, any slippage in property market management in either direction could elevate the potential for policy mistakes similar to those made by Japan more than two decades earlier.[3]

Students of History

Thanks to Japan's well-publicized struggles since 1992, today's policymakers are highly conscious of the peril that comes with an ill-devised mix of monetary and fiscal policy. Notably, former Fed Chairman Ben Bernanke has implied that his quantitative easing (QE) policies were heavily influenced by the mistakes made by the BOJ. Indeed, Bernanke came to the conclusion that any sign of disinflation required an aggressive and relentless response.

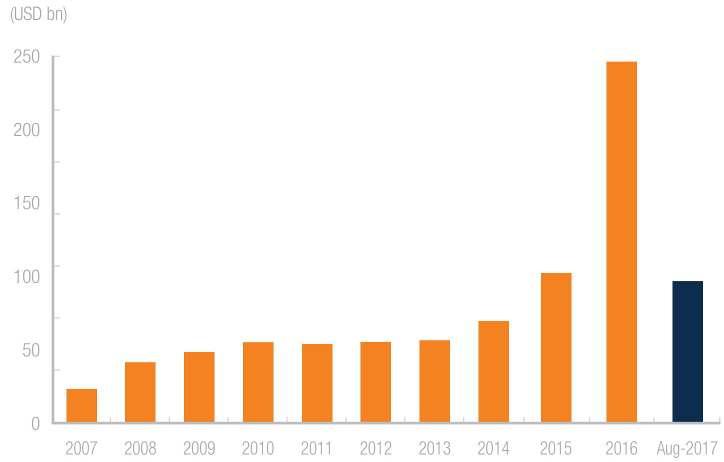
[3] CNBC, "China's banks are now stable as 'shadow' banking looks less threatening, Moody's says" (August 9, 2017)

As astute students of history, policymakers in China should be able to formulate much more effective policies than their predecessors in Japan. From a long-term perspective, China is most likely to be at risk if it chooses partial reforms (as Japan did in 1998) over comprehensive one-off restructuring. While temporary band-aid measures may bring back short-term confidence, we could eventually see a shift to deflation in the absence of structural reform.

Currently, we are seeing signs that Chinese policymakers have in fact done their homework. Earlier this year, the government stepped up its deleveraging campaign, with the People's Bank of China (PBOC) dialing back lending to banks and non-financial firms and more closely overseeing wealth management products. Moreover, steps have been taken to rein in outbound investments, which have decreased 55% in the first half of the year compared to the same period in 2016, when cross-border flows reached a zenith of USD 246 billion.[4] We believe that these measures are part of a broader reorientation by Chinese authorities, and thus expect to see a host of additional actions down the line aimed at curbing economic imbalances and mitigating real estate risks.

Chinese Outbound Deal Flows

Source: Bloomberg, Mirae Asset (2017)



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4 Bloomberg, "China's Fear of Japan-Style Economic Bust Drives Crackdown on Deals, Says Source" (August 3, 2017)

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