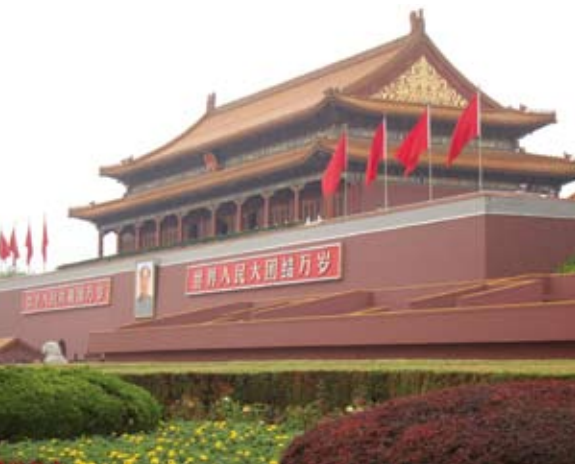




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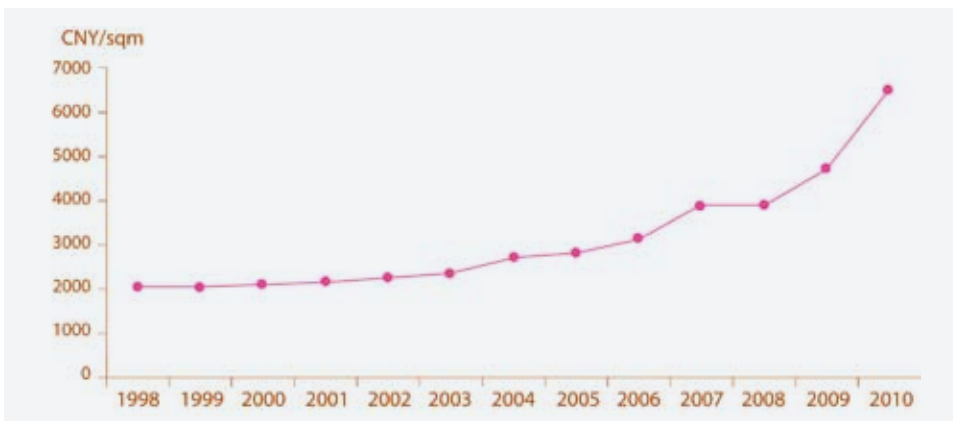
# China's housing bubble mitigation measures



## Rapidly rising housing prices in China

In recent years of rapid economic growth, China has experienced massive housing-price increases. During the 12-year period from 1998 until 2010, the average selling price of market-based buildings in China more than tripled.

**Graph I : Average selling price-market-based buildings in China from 1998 to 2010**



Source: China Statistical Yearbook, China Statistics Press, 2011

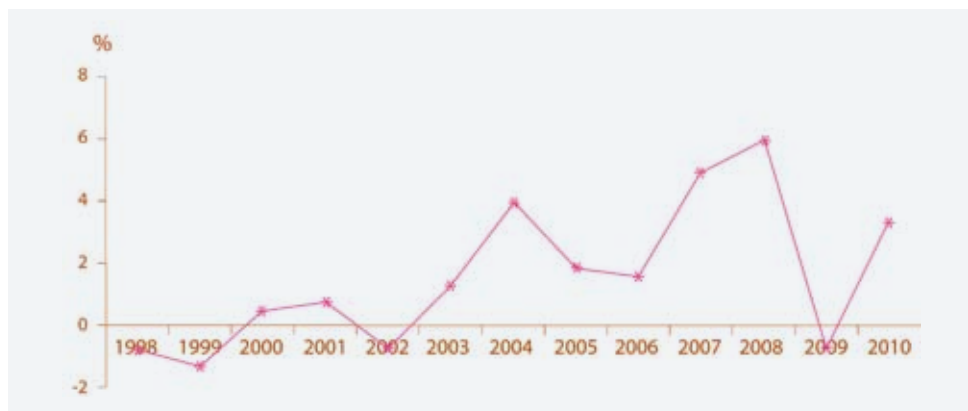
Housing prices in China reached three peak points in 2004, 2007 and 2010, with growth rates of 15.01%, 24.56% and 38.45% per year respectively. Graph one shows that housing prices decreased modestly in 1999 and 2008.

During this same period, inflation rates in China were relatively mild (Graph 2), at 3.9%, 4.8%, 3.3% respectively, far less than housing price growth rates.

and openness is urbanization. The 2010 Population Census of China shows that urbanization was 49.68 per cent, compared to 36.22 per cent in 2000. About 207.14 million people migrated to urban areas during the past decade.

By 2020, China's estimated urbanization rate may be about 60 per cent, near the average level of developed countries.

**Graph II : Inflation rates from 1998 to 2010**



**Source:** China Statistical Yearbook, China Statistics Press, 2011

In 2008, when inflation reached a historically high 5.9%, housing prices in China decreased by 0.21%. Housing prices in 2009 increased 21.1 per cent even with negative inflation rates. The two graphs show that there is no strong relationship between housing prices and inflation rates.

What were the main contributing factors to rising housing prices in China?

## Factors contributing to rising housing prices

### a. Rapid urbanization

One of the most obvious changes that sprung from the China's reform

Increased urbanization results in different population distributions that can affect housing prices during various time periods. Generally, when urbanization is below 50 per cent, people tend to move from rural to urban areas.

During this period, housing prices in different cities realize similar price increases. However, as growth rates begin approaching 50 per cent, housing prices in larger cities tend to rise more sharply. When urbanization exceeds 50 per cent, floating populations tend to migrate from smaller cities to big cities, resulting in higher large city housing prices.

In the next ten years, the floating migration from rural to urban centers is expected to create an annual demand for 400 million square meters of housing. At the same time, re-building “older cities” infrastructure and environments is also expected to result in 800 million sqm of annual new housing.

If China’s household registration system (Hukou) is terminated in the future, urbanization will accelerate and massively increase urban housing demand.

## b. Land supply and local government land-financing

Urban land supply is monopolized by local governments in China. In 1994, China reformed its “revenue-sharing-scheme” financial management system by developing central and local tax collection systems.

As a result, local governments became responsible for fiscal shortfalls not covered by Central government funding. Most local governments’ sold development land-use-rights and collected other related fees to deal with revenue short-falls.

In 2001, land-use-right fees were only about 16.61 per cent of local fiscal revenues but by 2006, these fees rose to 50.92 per cent. Even in 2010, a difficult housing year, land-rights fees rose to RMB 2.7 trillion, a 70.4 per cent increase from 2009.

While China’s local governments depend on land-sale revenues to cover fiscal shortfalls. the current financial system incentivizes them to keep driving-up housing and land prices.

The “land financing” mechanism for generating local government funding is one of the fundamental reasons for rising housing prices because it artificially restricts land supply, a critical housing-cost element.

It also raises the overall price of housing and requires more capital investment. The local governments’ ability to restrict land-supply has also fueled speculation and has caused housing prices to soar.

## c. Urban housing reform

During the planned economy era, all homes were allocated by the government.

In 1998, China’s State Council issued an official document announcing its intent to reform urban housing with a specific emphasis on private ownership. Since that time, the government has established a series of policies to stimulate the housing market’s development including the following issued by the Shanghai government prior to 2004.



- Reducing contracts tax: To stimulate the housing market, normal contracts tax rates were reduced from 3%-5% to 0.75%.
- Tax reimbursement: home buyers obtain personal income tax deductions if they purchased homes.
- Contracts tax deductions: no contract's taxes payable if seller sells his purchased public-housing unit or buys a new apartment with expropriation proceeds.
- Blue-print residence booklet: This booklet registers housing owners in Shanghai and it provides potential non-Shanghai buyers with more reliable construction and ownership information.
- Merging domestic and overseas buyers' housing market: - allowing foreigners to buy houses in Shanghai. This policy encouraged more foreign buyers.
- Loosening credit policy: Establishing at one time, a "zero down payments" policy for homes purchases in Shanghai.

Although these policies stimulated the housing market, rampant abuses eventually led to a new round of housing macro-controls. From 2004 to 2007, the government enforced a series of policies aimed at limiting rising housing prices and increasing real estate investment costs.

Most of the policies worked-well in the short-term. However, for the country as a whole, the free-market and government-intervention policies intertwined during this very innovative transitional period sent mixed messages.

Particularly in 2008, influenced by the global financial turmoil, the Chinese government implemented a RMB 4 trillion economic stimulus package, which directly lead to price rises during the following year.

#### d. Banking system's propensity to issue housing loans

The Chinese financial system didn't experience serious setbacks during several recent regional and global crises.

In 1997, during the Asian financial crisis, its huge reserves shielded the country from any fallout and in 2008, China's closed-capital account policies protected the country from the global financial crisis.

In this benign environment, the banks and the financial system viewed housing and real estate loans as low-risk and safe, particularly because they were collateralized by immovable collateral that could be easily repossessed and sold if borrowers defaulted.

They also believed that real estate prices would continue rising and that increasing the number of housing and real estate loans carried little risk. As prices continued rising, the banking sector became over-optimistic about real estate prices and continued lending more funds to the sector and inevitably drove prices higher.

### e. Asymmetric information

Because real estate is not a completely competitive market in China, the housing market is a relatively-closed sub-market. The lack of information and its asymmetry often results in market mispricing, especially when speculators flood the market with rumors. At the same time, some unscrupulous developers deliberately create false markets by hiring employees to queue up for housing purchases, and hold back houses from the market. Asymmetric information often overheats China's housing markets and causes prices to rise to unwarranted levels.

## Government measures

High housing prices affects everyone's quality of life and because China is a socialist country, the government is forced to take measures to cool overheated housing markets.

It implemented the following housing market counter-measures at the end of 2009:

### a. Tax policies

On December 9, 2009, the State Council extended the tax-free period from two years to five years for personal-home sellers.

In 2010, the Ministry of Finance specifically levied sales taxes on housing transfers within five years of purchase.

If houses were held for less than five years, sales taxes would be levied on the difference between the sales price and the buyer's initial purchase price. No sales tax would be charged if the seller owned the property for more than five years.

On January 26, 2011, the State Council strengthened the tax policies on personal housing transfers by ordering that a uniform tax would be levied on all houses held less than five years.

### b. Tightening credit policies

From January 18, 2010 until the end of June 2011, the RMB deposit-reserve ratio was adjusted 12 times from 15.5% to 21.5% for large financial institutions, and from 13.5% to 18% for small and medium-sized financial institutions.

The monetary-policy tightening reduced speculative and investment demand for housing. In addition on April 15, 2010, the State Council required that the down payments for second home mortgages must be higher than 50% and interest rates should be 10% higher than base-mortgage rates.

For families purchasing their first apartments of not more than 90 sqm, down payments should be more than 30% of the purchase price.

Two days later, the State Council announced loans for third apartments should be suspended in overheated housing areas, and credit for non-local residents who cannot provide certification of taxes or social insurance paid in the local area more than one year should be suspended.

On September 29, 2010, the State Council announced more restrictive policies to hold down rapidly increasing housing prices. All commercial banks were required to suspend their third-home mortgage business and down payments for market-based housing to be lifted to 30% and higher, and all non-local residential housing loans stopped.

The State Council also convened a standing meeting on January 26, 2011 and proposed eight policies, including requiring second-home down payments of not less than 60% and interest rates 10% higher than base mortgage rates.

### c. Increasing affordable housing

On December 2009, the Central Economic Work Meeting emphasized the need to increase market-based housing.

In June, 2010, seven Central government departments including the Ministry of Housing and Urban-Rural Development launched “guidelines for accelerating the development of publicly leased homes” to help low and mid-income citizens, many of whom were unable to afford quality housing.

At a meeting on September 18, 2010, Vice Premier Li Keqiang at an Affordable Housing Construction Program in Beijing said that the government must accelerate public rental housing development and restrain speculative demand for housing.

The 2010 National Real Estate Market Report published by the Chinese State Statistical Bureau indicated that buildings under construction (floor space) in 2010 was 4.055 billion sqm up 26.6% over the previous year; newly started buildings 1.638 billion sqm up 40.7%; completed buildings was 0.76 billion sqm, up by 4.5%, new residential buildings was 0.612 billion sqm, up 2.7%.

Although housing conditions were improved, market-based housing constituted about 90 per cent of the units built.

In early 2011, the State Council proposed to construct 36 million affordable homes during the subsequent five years, including 10 million in 2011 and 10 million in 2012. These units would mitigate housing price hikes.

### d. Increasing land supply

On April 15, 2010, the Ministry of Land and Resources released 180 thousand hectares for residential land, which was far more than the 76,461 hectares in 2009 and the 54,650 hectare average during the prior five years. About 77 per cent of this land was to be allocated for affordable housing, shantytown improvements and building low and medium income market-based housing.

In China's national residential land plan, land supply for security housing<sup>1</sup> is more than 24,000 hectares, an increase of 124.5% over the previous year. Of this amount, affordable housing land was 71%, up by 79% over the previous year; subsidized housing land 29%, 4.5 times over the previous year and the shanty-towns improvement land 35,786 hectares, (up 19%).

The residential land supply plan should satisfy the construction requirements for three million security homes. On Sept 4, 2010, the State Council formally approved the urban land use plans of ten cities including Hangzhou and Nanchang, meaning that urban land use planning has been put into action.

### e. Strict housing market supervision

Since the end of 2009, China has implemented many strict policies to restrict the housing and land market's growth. On December 17, 2009, five Chinese central government departments, including the Ministry of Finance, Land and Resources issued announcements to strictly supervise land revenue and expenditures, and clearly articulated that land purchase down payments must not be less than 50%. In addition, land transfers and total payments must be concluded within one or two years as contracted.

On March 10, 2010 the Ministry of Land and Resources announced that residential land speculation would be strictly supervised and 20% deposits were required for acquiring land-use rights. The Ministry of Housing and Urban-rural Development require that real-names and not nominees be used for market-based residential purchases. In addition housing developers were forbidden to charge reservation fees, require queue numbers and special VIP cards for potential purchasers.

In addition, on August 2, the Ministry of Land and Resources transferred an idle-land black-list to the China Banking Regulatory Commission (CBRC). The CBRC inspected all items on the list and made recommendations on disposing 80 per cent of the land. On September 27, 2010, the Ministry of Land and Resources, Housing and Urban-rural Development announced that land cannot be transferred to developers who had land that was idle for one year or more.

On January 26, 2011, the State Council said it would strictly supervise residential land supply. It said that at least 70% of the land must be used for security housing, shanty town improvements and for low and medium-priced housing.



<sup>1</sup> In December 2008, Chinese government pledged to solve the housing problems of 7.5 million urban low-income household families and 2.4 million squatter settlement residents in forests reclamation areas, and coal mining areas within three years.