**About The Housing Market and The Shadow Banking Sector in China**

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1. **Characteristics of China’s housing market**

The housing market in China is unique for several reasons. **First, the only suppliers of land in cities in China are governments.** Revenues from selling “the land-use rights” have been major revenue sources for many local governments. Since provincial governments or the central government appoints top officials of local governments, the central government can put brakes on or lift restrictions of the real estate markets, if needed. In some occasions, the central government can implement macroeconomic interventions by changing homebuyers and speculators’ expectations about housing prices.

**Second, the levels of economic development of different cities and regions vary significantly.** People, in particular young people, are willing to migrate to mega or major cities, such as Shanghai and Beijing, where education system, healthcare system, social security and job opportunities are much better. Shanghai has a population of 24 million. If Shanghai government lifts the restrictions on who can purchase real estates in Shanghai, Shanghai can easily have another 10 million people.

**Third, governments have plenty of resources to support local housing markets if they want to.** Governments can force best schools and hospitals to move to ‘new towns’. Governments can tear down not so old buildings and give residents cash to purchase new houses. Of course, this creates the debt problem facing local governments.

**Last but not least, mortgage rates are largely decided by the central bank.** There is no fixed-rate mortgage in China. The standard mortgage rates are the same as the long-term lending rate set by the central bank. Commercial banks can decide the mortgage rate a homebuyer pays more or less than the official lending rate, say, 10% off or more than the standard rate. Each year, the mortgage rate is re-set according to the official lending rate. Most down payment requirements for the first house is 30% and for the second house is 50% - 70%.

1. **How to understand the housing market between 2015 and 2017**

Between 2015 and the first half of 2017, the real estate market in China was on steroids. In some cities, the housing prices more than doubled. Here are some possible explanations.

**First, China’s central bank has been implementing very loose monetary policy**. The YoY growth rate of M2 is 13.3% in 2015 and 11.3% in 2016. The average sales price of new residential buildings in all cities and towns was 1,854 RMB/m2 in 1998 and 7,203 RMB/m2 in 2016. The ratio of the average price in 2016 over that in 1998 is 3.89 (in some areas in Shanghai and Beijing, the housing price increased more than 10 folds). But the ratio of M2 in 2016 over M2 in 1998 is 14.83.

**The second reason is subtle**. Starting from July 2014, China’s foreign exchange reserves had begun to drop dramatically. To keep reserves and fight capital flight, governments at various levels started igniting the housing markets.

By the end of Aug 2014, 35 out of 46 cities which had put restrictions on purchasing houses lifted the restrictions and even gave home-buyers incentives, such as 20% down payments instead of standard 30% down payments and discounts for mortgage rates. In 2015, the China’s Central Bank cut its benchmark rate or deposit reserve ratio 5 times.

**The third reason is that prior to 2015, many 3rd-, and 4th- tier cities had too many empty houses, or ‘inventories’. To reduce inventories, governments changed the compensation policy.** Prior to 2015, 70% of residents whose houses were demolished by local governments were given new houses and cash as compensation. In 2015, 48.5% of residents were given cash only. They were encouraged to purchase houses from ‘inventories’.

1. **New Direction for the Housing Market**

At the 19th Party Congress last month, President Xi Jinping said that “**Houses are built to be inhabited, not for speculation**. China will accelerate establishing a system with supply from multiple parties, affordability from different channels, and make rental housing as important as home purchasing.”

**All other officials in China will follow Xi**. Factors determining housing prices are **population migration (long-term factor), land supply (medium-term factor), and monetary policy (short-term factor).**

Governments at all levels in China do NOT want to see real estate markets to collapse. Many local governments’ revenues are still dependent on this sector.

If I had to make a prediction, which is impossible to do, I would say **the party for the housing market is almost over.**

For the first-tier cities, such as Shanghai, Beijing and Shenzhen, there might be a modest decline in the next 2-3 years. The potential demand for houses in these cities is huge. In today’s Shanghai, people need to enter lottery to purchase some newly constructed houses whose prices are set partly by local governments (artificially low).

For the 3rd- and 4th- tier cities, many will see housing prices to drop up to 30%.

1. **The Shadow Banking Sector**

According to both Moody’s and Fitch Rating, China’s shadow-banking sector has shrunk in response to the regulatory clampdown launched in early 2017, which could address certain risks to the financial system if it continues over the medium term[[1]](#footnote-1). The government's adoption of more coordinated policy measures to curb shadow banking will help mitigate asset risks for banks, and address some key imbalances in the financial system[[2]](#footnote-2).

System-wide inter-bank assets had fallen by 13.8% YoY as of end-August 2017. Growth in wealth management products (WMPs) continued to slow, with the interbank WMP balance falling by CNY 2.2 trillion from January to August 2017. The China Banking Regulatory Commission (CBRC) emphasized its role in identifying threats and implementing necessary mitigating measures. It stated that any failure by the regulators to spot and handle risks in a timely manner would be viewed as a dereliction of duty.

In sum, China’s shadow banking sector is likely to face greater regulatory scrutiny in the near- to medium- term. Whether it is a ticking time bomb remains to be seen.

1. Fitch Rating, [Fitch: China Making Progress in Shrinking Shadow Banking](https://www.fitchratings.com/site/pr/1030373), October 8, 2017. <https://www.fitchratings.com/site/pr/1030373>. [↑](#footnote-ref-1)
2. Moody’s, Moody's changes outlook for China's banking system to stable from negative, <https://www.moodys.com/research/Moodys-changes-outlook-for-Chinas-banking-system-to-stable-from--PR_370398>. [↑](#footnote-ref-2)