How do housing purchase limits affect firm default risks in Mainland China?

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September 2016

Summary

Since the early 2000s, the real estate sector has grown to become a key part of the Chinese economy. The fast development of the sector has not only pushed up property prices, but also driven an investment boom in sectors closely linked to the property market. During 2000-2013 the price of housing nationwide tripled while annual real estate investment growth averaged more than 20%. This extraordinary surge in prices and investment led to concerns of an overheating housing market, and prompted the Central Government to impose housing purchase limits in 46 cities from April 2010 to July 2011.

While the purchase limit policy could, on the one hand, cool the property market, there was also the possibility it could cause economic slowdown both of which would affect firm default risks due to sectoral k or financial linkages. This paper applies the difference-in-difference method to investigate the effect of purchase limits on firm

default risks across cities and along risk transmission channels, followed by a discussion on default risks incurred by land supply.

In general, the stricter the purchase limits and the longer the limits last, the more effective the policy in reducing the default risk. However, the impact of housing purchase limits is not homogeneous across cities. While the policy has significantly lowered firm default risks in big cities (especially cities in the first two rounds of policy implementation), it has proved ineffective in relatively small cities, and in some cases even caused firm default risks to rise. This is probably due to the fact that industries in big cities are more diversified than in small cities, and hence more resilient to policy shock. Furthermore, the policy effectiveness is weakened through the risk transmission channel with real estate firms the most severely affected in terms of default risks, followed by firms in sectors closely linked to the real estate sector. The impact on firms in sectors with fewer links to the real estate sector is insignificant.

While the purchase limits focus on default risks arising from the demand side, the risks arising from the housing supply side remain under the current fiscal system and land sales mechanism. The effectiveness of the purchase limits on default risks may well be offset by the effects of tight land supply. Therefore the housing purchasing limit policy should be supplemented by fiscal reforms that mitigate increases in land price and hence lower default risks in the long run.