Discussion:
Understanding the Real Estate Market in China

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Economic and Financial Stability"

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Questions

- What are some key features of China's housing market?

- What are the primary drivers of the rapid house price appreciation in China?

- What policies can lead to a more sustainable pace of house price growth?

Key features of China's Housing Market

- Rapid price appreciation over the years, driven by land prices, significantly higher than other countries (Deng)

- Heterogeneous situations across Chinese cities (All)
  - Demand outstripped supply in Tier-1 and some Tier-2 cities
  - Excess supply and inventory built up in lower-tier cities
  - As a result: coexistence between rapid price increase and high inventory
- High house price to income level ratio
- Evolving role of housing in economy: rising real estate consumption of services as a share of GDP over the years (Liu)

What are the drivers of rapid house price appreciation in China?

Supply:

Role of local government

- Local governments have monopoly over local land market, monopolistic competition market structure in residential housing market
- Local governments with more reliance on land sales → higher supply elasticity
- Inefficient land allocations in highly demanded cities

Demand:

Lack of alternative investment instruments

Low holding costs for real estate ownership and under-developed rental market

Urbanization and fast population growth in some cities

High income growth

Cultural pressure to be house owner

Policy Prescription

Supply:

- Break the supply monopoly of land and housing by local governments
- Implement property tax
- Higher floor area ratio, construct multi-unit buidings
- Less land allocation to agriculture in highly demanded cities
- Expand secondary real estate market

Demand:

- Continued macroprudential policies, i.e. tax on short-term holders, introduce holding costs
- Introduce public affordable housing
- Develop rental market and equalize incentives to rent vs. buy
- Introduce alternative investment instruments, i.e. REIT/ABS
- Population control in 1st tiered cities

Contributions

- Lots of insights into the structural issues in China's housing market

- Contribute to understanding in whether the rise in China's housing prices is a bubble

- Offers a glimpse of latest policy thinking post 19th party congress

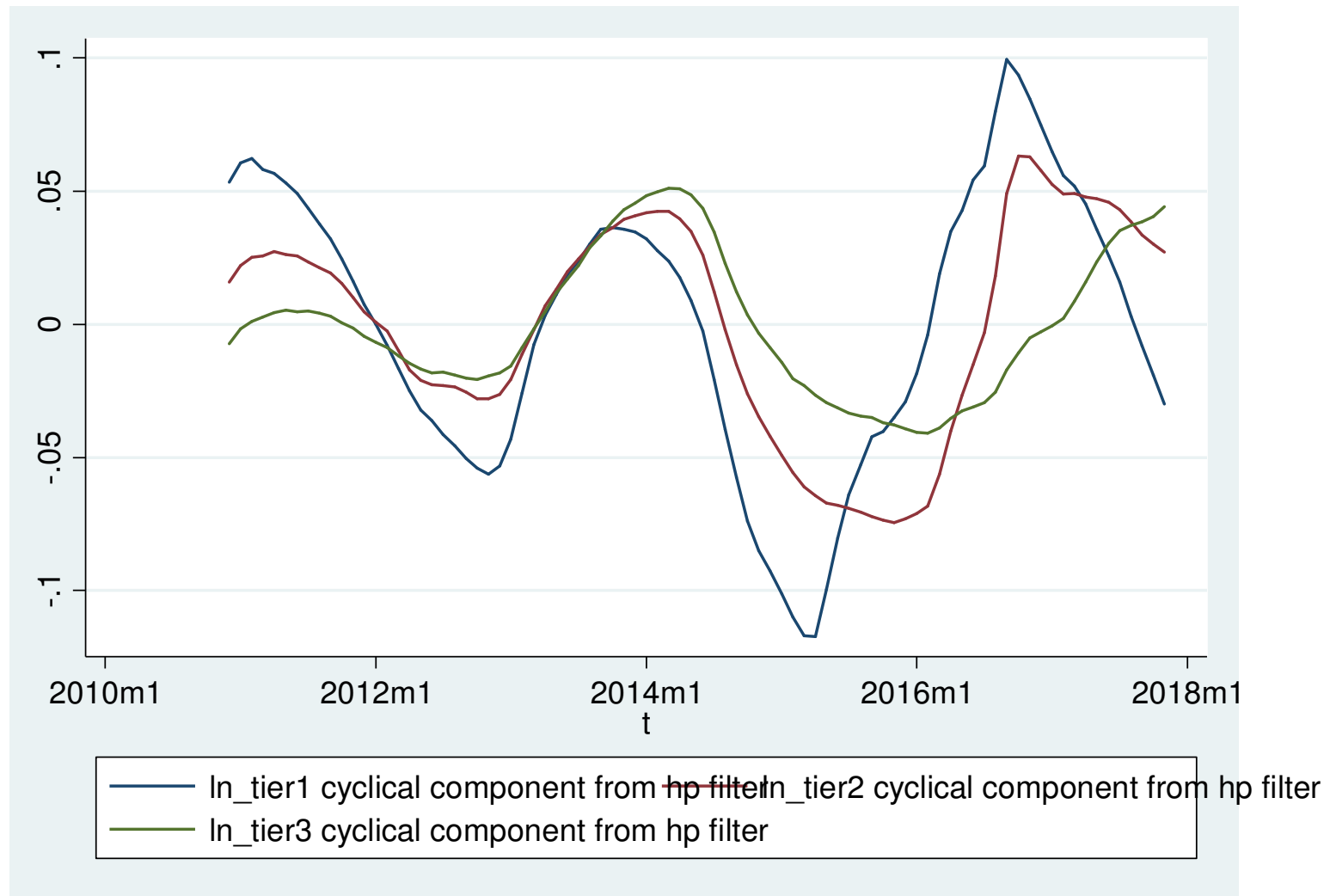- Cross-country comparisons to China's housing market

Comments

1. Emphasis on the role of structural explanations. What about cyclical drivers of the housing market?

2. How effective are macro prudential policies in controlling housing price appreciation? What role for monetary policy?

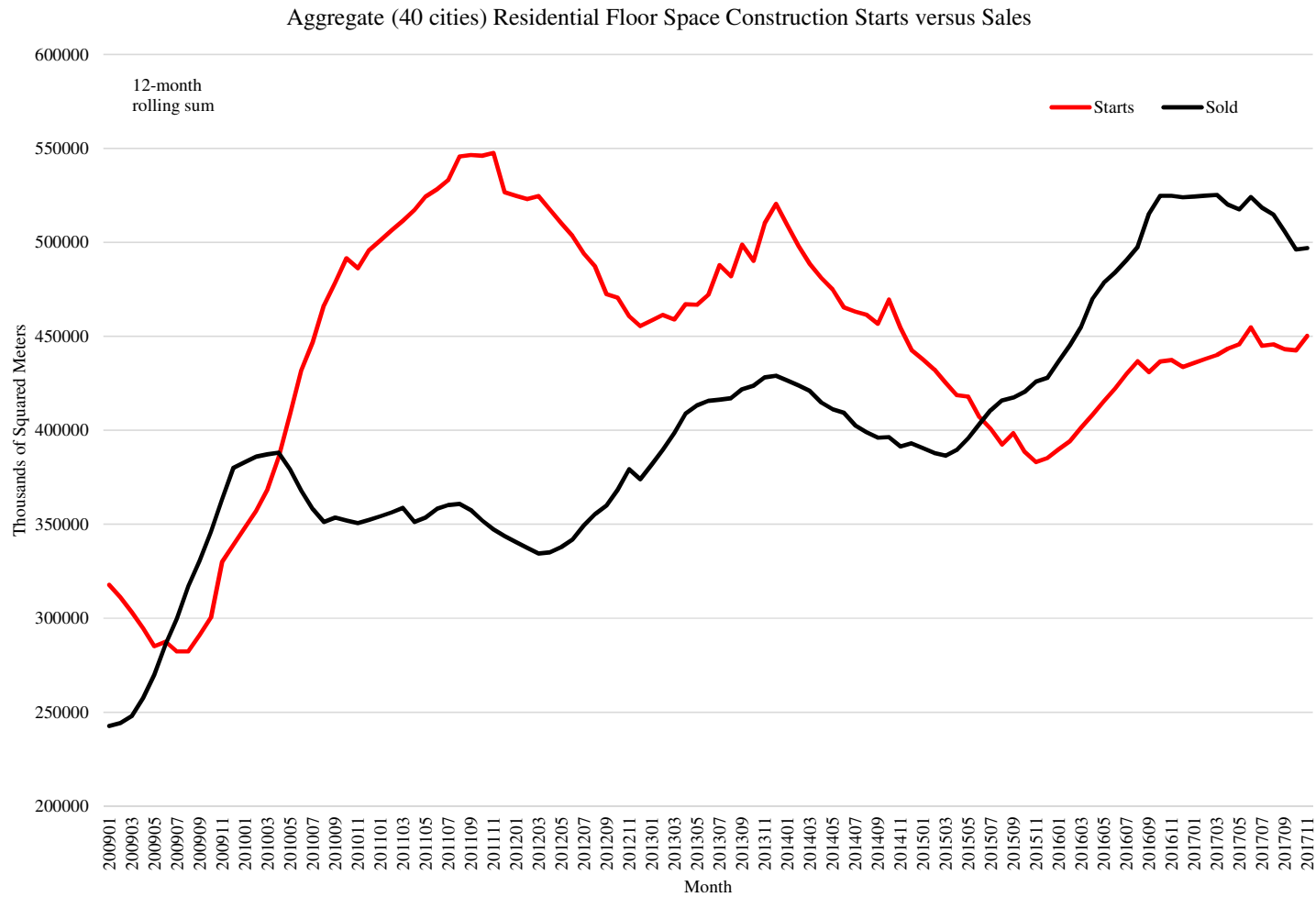3. Role of capital account management?

Cyclical Drivers

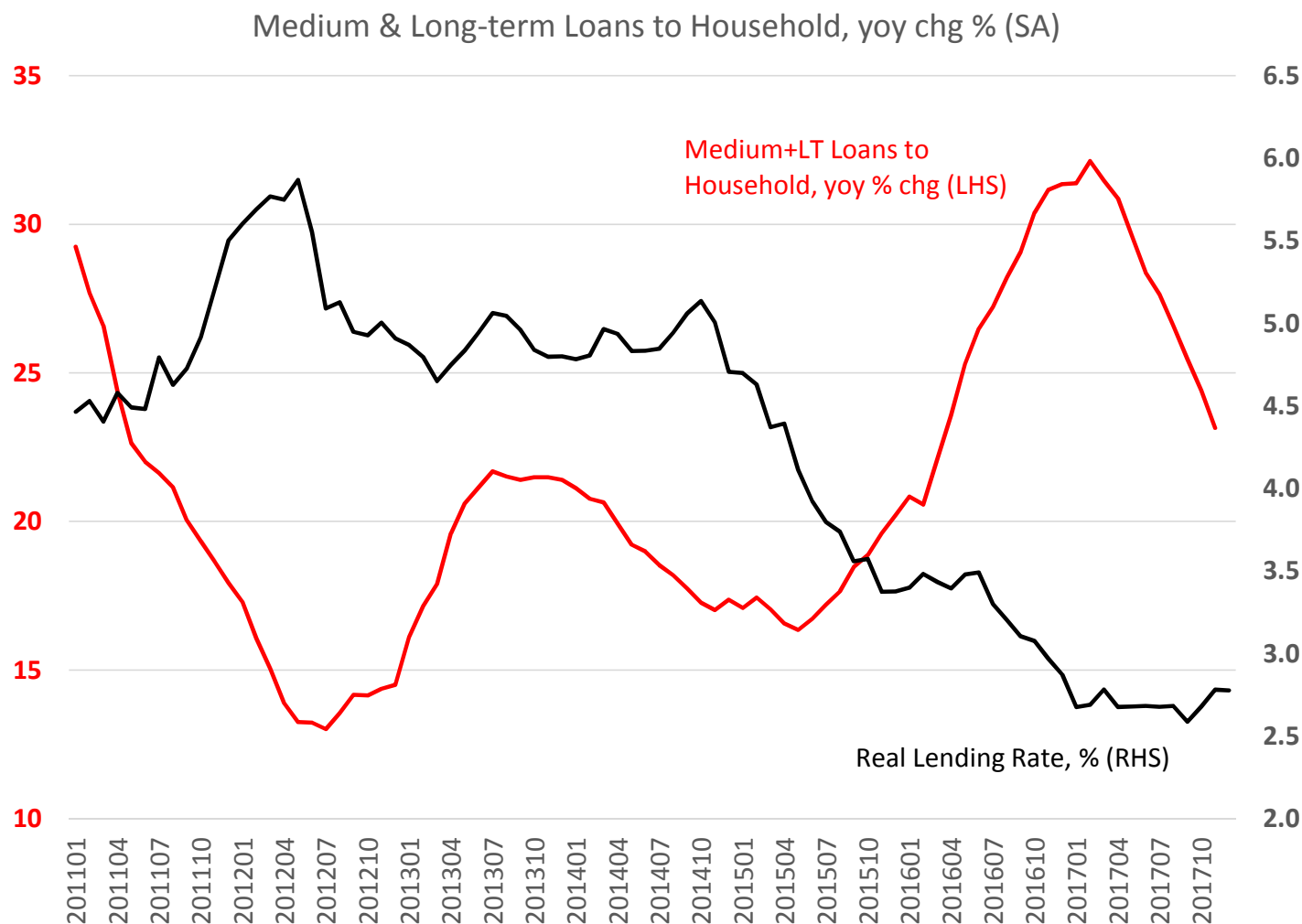- "Housing is the business cycle." -Ed Leamer (2007, Jackson Hole)

Residential Property Prices (Dec2010=100)
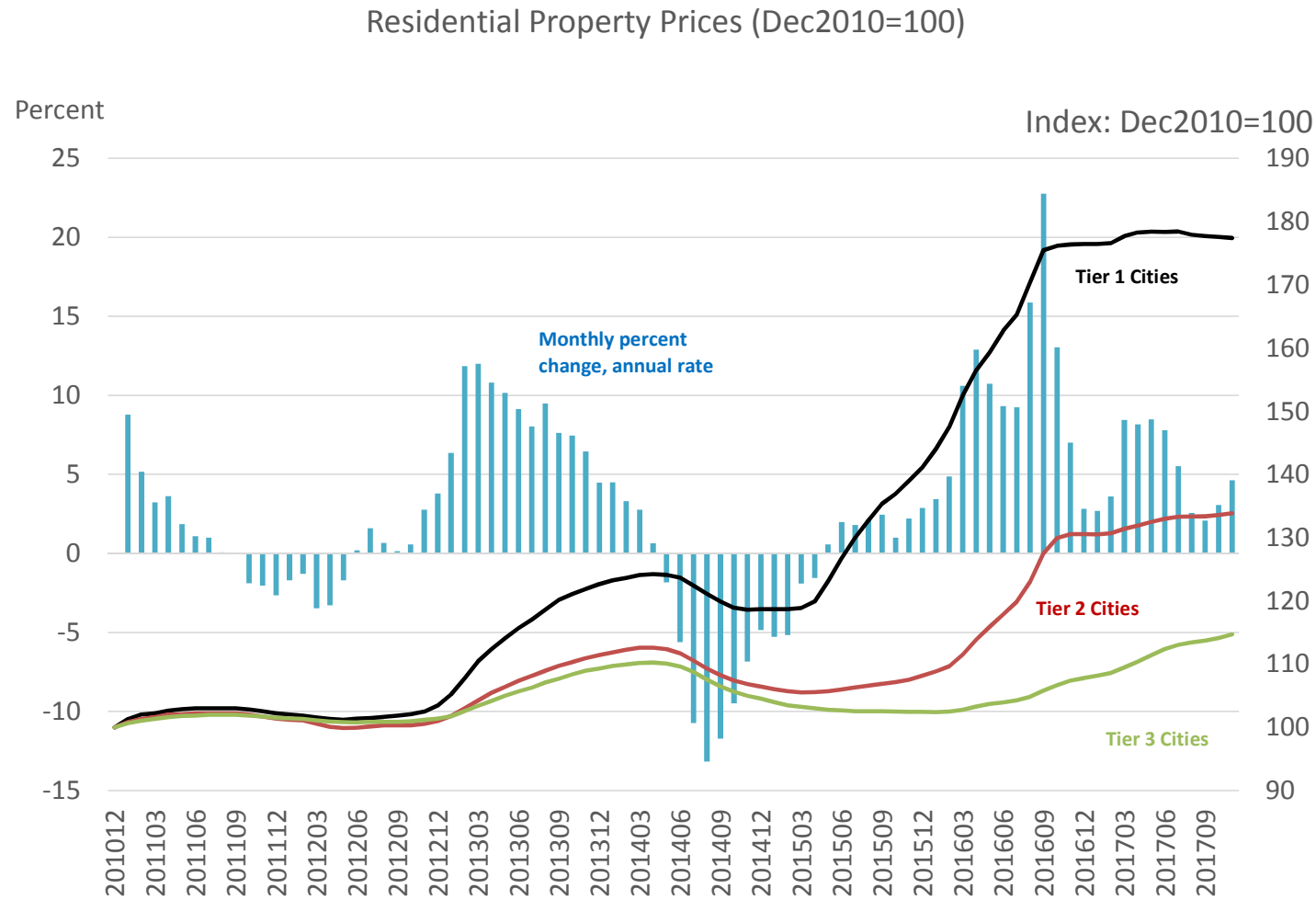
HP-Filtered

Current cycle: destocking after an extended period of excess inventories across all tiers of cities

Aggregate (40 cities) Residential Floor Space Construction Starts versus Sales

12-month rolling sum

Starts — Sold

Mortgage credit growth rose rapidly in current cycle

Medium & Long-term Loans to Household, yoy chg % (SA)

Medium+LT Loans to Household, yoy % chg (LHS)
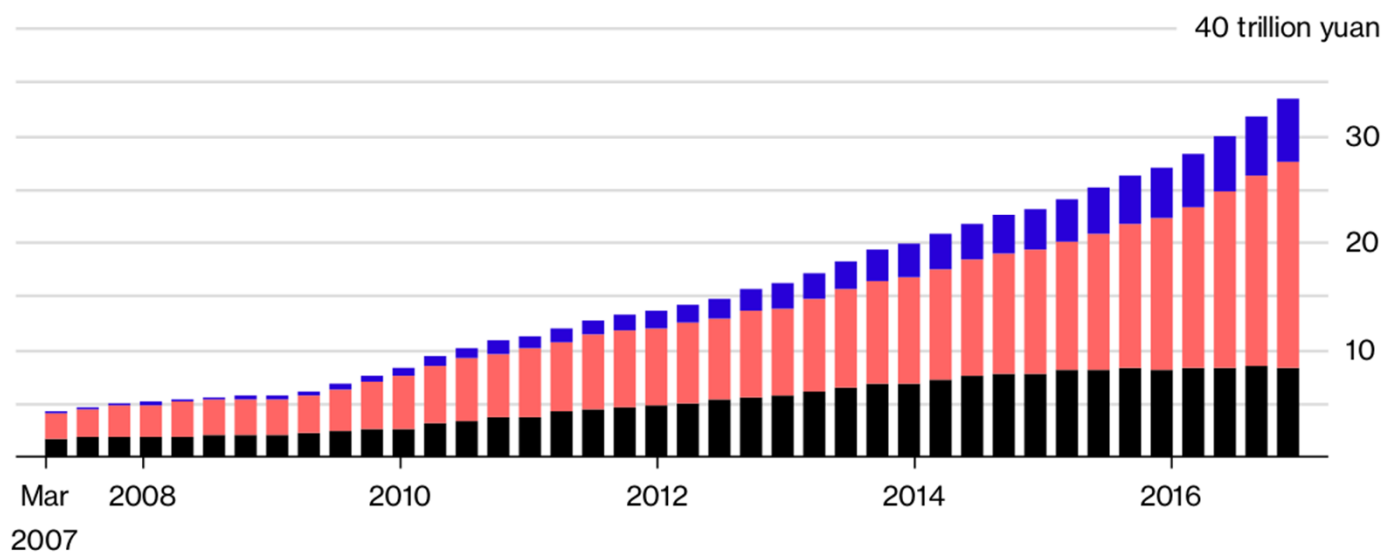
Real Lending Rate, % (RHS)

Transmission of monetary policy via mortgage credit

Debt Drivers

Rise of Chinese household debt is mainly due to soaring mortgages

■ Business Loan   ■ Mortgage Loan   ■ Consumption Loan

40 trillion yuan

30

20

10

Mar 2007   2008   2010   2012   2014   2016

Source: IIF, Bloomberg

Bloomberg

Does co-existence of rapid house price appreciation and high inventory in some cities means that monetary factor not a key cause of current cycle? (Hu)

- Even if size of monetary shock is same across cities, prices would rise more in more supply inelastic cities.
- Overall user cost of capital also fell more in higher-tiered cities due to higher increase in expected house appreciation

Shadow cost of home-owning = borrowing cost + opportunity cost +depreciation/ maintaneance cost - expected return

Increases more for cities with more inelastic supply

→ larger demand shift in higher-tiered cities

Level of excess inventory is always higher in lower tier cities, but a positive monetary shock should cause excess inventory in both cities to move toward the same direction: Synchronized destocking across tiers of cities

Residential Floor Space Starts - Sales (12m sum yoy%)
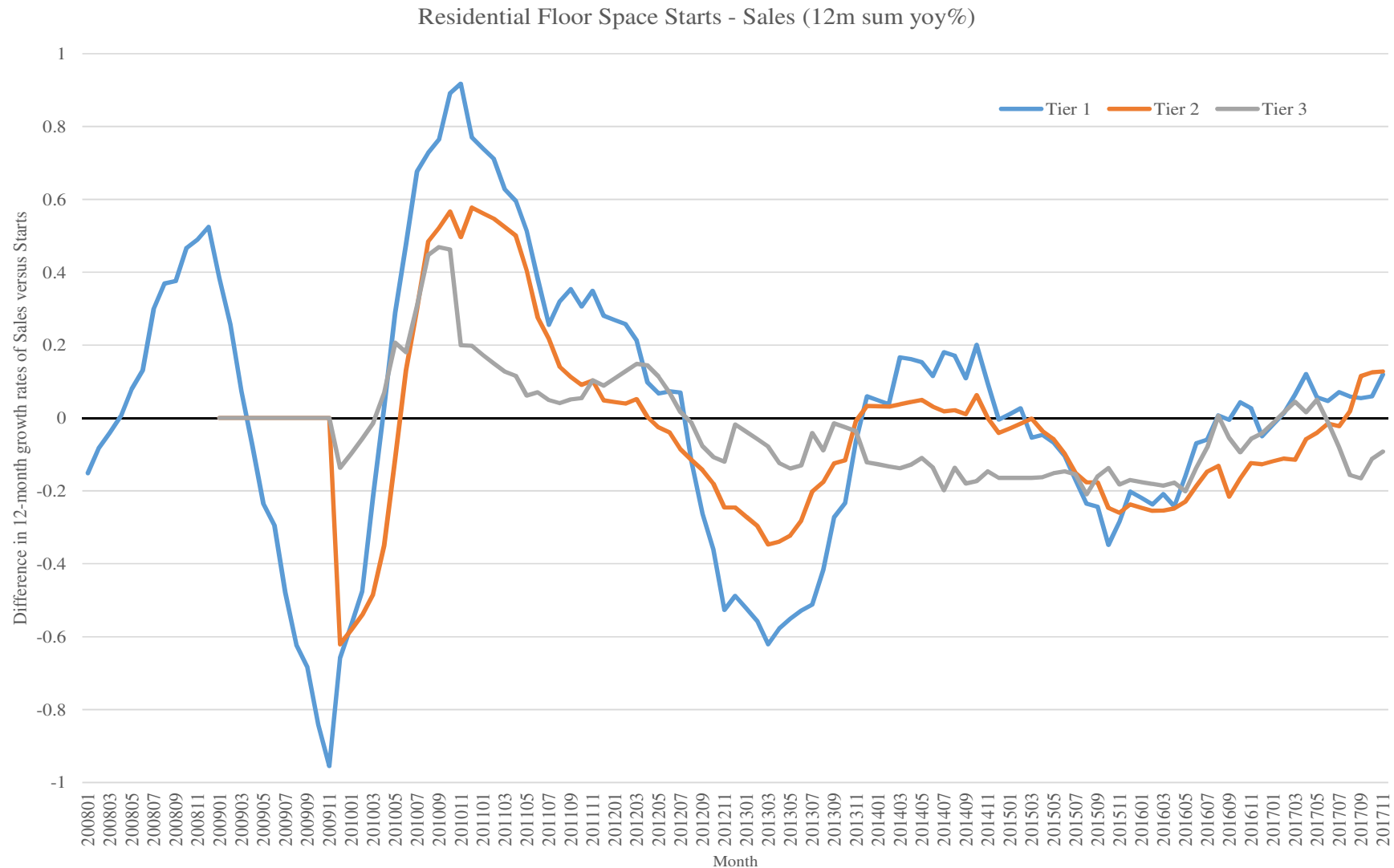
Bottomline

- Chinese cities are heterogeneous and have unique features
- But not an exception to the common experience from the rest of the world: monetary policy matters
    - Ahearne et al (2005): finds that house price booms are typically preceded by a period of easing monetary policy across 18 major industrial countries since 1970.
    - IMF Global Housing Report (2016, 2017): credit has grown faster and monetary policy looser in countries experiencing housing boom since the GFC
    - Recent example: Germany no exception
        - Liu used Germany as an example of stable housing prices and insensitivity to monetary policy. Sample ends in 2012. House prices in major cities took off since.

Evidence of macro prudential policies in controlling house price appreciation? What role for monetary policy?

- Macro-prudential policies proven effective in controlling leverage and reducing financial stability risks
  - Intended to address externalities and market failures associated with activities of financial intermediaries and markets that may lead to excessive pro-cyclicality and build up of systemic risk (Claessens, 2015)
- Mixed evidence with regard to effectiveness of controlling housing price appreciation
  - Deng showed data of macro-prudential policies in Beijing – only short-term impact
  - Hong Kong
  - BIS study (Kuttner and Shim, 2013), 57 countries over three decades. Among 9 non-interest rate policy tools aimed at stabilizing house prices and credit, *only* <u>a change in housing-related taxes</u> have a discernible impact on house price appreciation
- Monetary polices too blunt of an instrument to use for housing prices. (Bernanke, 2010)
- For macroprudential policies to be most effective, monetary policy should complement (Bruno, Shim, Shin, 2015)

Role of capital account management

- Lack of alternative forms of investment vehicles for high savings

- Alternative assets (2009-2017): deposit rates (about 5%), equity returns (2%), buying house in Los Angeles (plus FX return): 7%

- Tightening of capital controls since late 2016

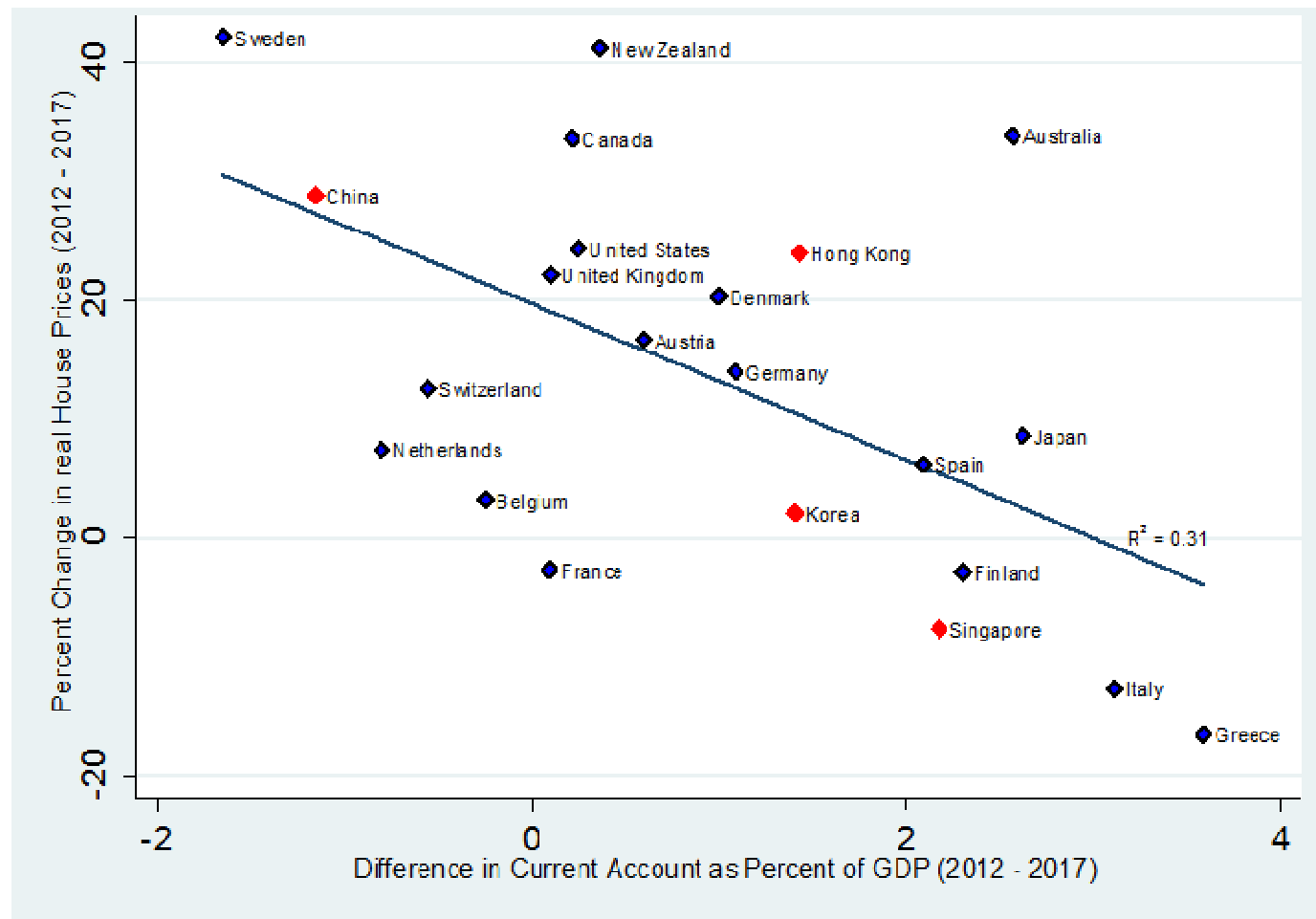- In 2017, net private outflows decreased by almost $600 billion (5% of GDP!)

Capital controls tend to affect outflows from Chinese cities with higher house prices
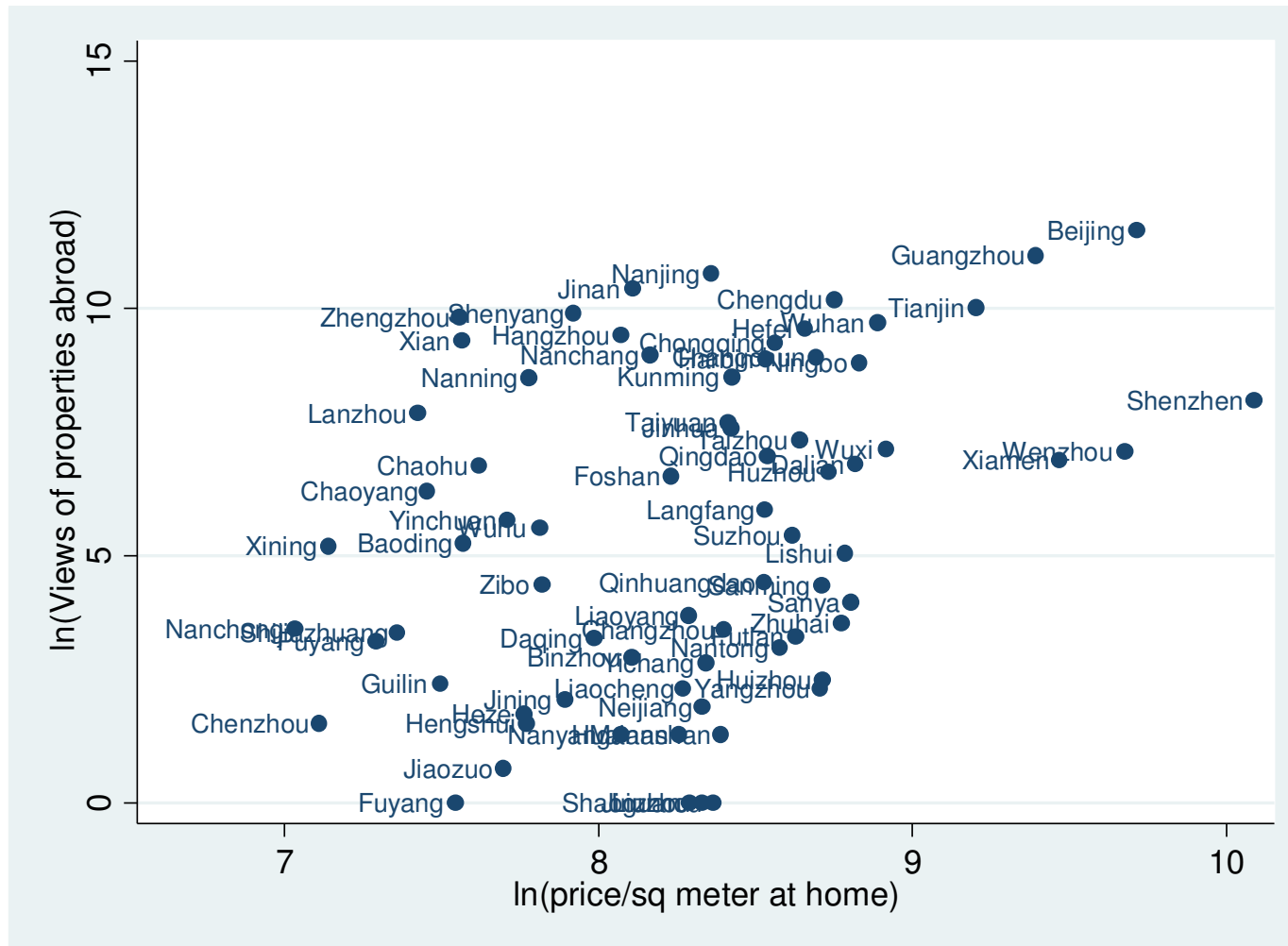
Source: Converse and Wong (forthcoming)

Capital controls likely amplified domestic house demand in the current cycle

Housing Prices vs. Net Capital Outflows, 2012-2017

Several studies have found that capital flows more important in accounting for real estate valuation than other the real interest rate and inflation.
(Aizenman, Jinjarak, 2011; Bernanke, 2010; Gete, 2015)

Thank you!