

China Real Estate Outlook

Annual Report
July 2011

Summary Messages

- **This is the third report in our annual series, updating recent developments, policies, and prospects in the residential property sector.**
- **We extend our supply/demand framework to assess recent developments against fundamentals, and we present international experience for lessons for affordable housing financing and land use.**
- **Property prices increases have moderated over the past year** under the influence of measures to cool the market, including restrictions on home purchases and tighter credit policies.
- **According to our new estimates, the market is only slightly overvalued.** We expect price rises to remain subdued in the near term, and a modest downward correction, particularly in cities with large misalignments, cannot be ruled out.
- **Over the medium term, prospects for China's property market are still bright,** especially good in second and third tier cities.

Organization of the report



Real Estate Outlook

China

1. Introduction and Summary
2. Recent Developments and Outlook for the Housing Market
 - Box 1: Measures to cool the property market
 - Box 2: Views from the ground based on questionnaires
3. Re-assessing the Misalignment of China's Housing Prices
 - Box 3: A survey of price misalignments from the literature
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Economic Outlook

- **Growth is moderating in line with our expected soft-landing scenario.**
- **We expect inflation to have peaked in June and to decline during the remainder of the year** due to base effects and an easing of commodity prices.
- **Some further monetary tightening is likely to contain inflation**, although it will depend on incoming indicators and the health of the global economy.
- **With the moderation in growth, overheating risks are now more balanced.**

China Baseline

Macroeconomic Forecasts

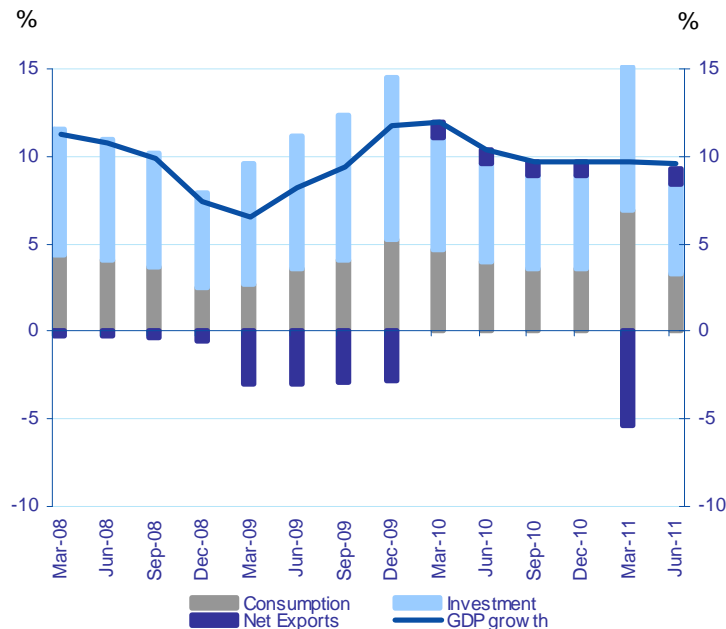
	2008	2009	2010	2011 (F)	2012 (F)
GDP (% y/y)	9.6	9.2	10.3	9.4	9.1
Inflation (average, %)	5.9	-0.7	3.3	5.0	3.9
Fiscal bal (% of GDP)	-0.4	-2.8	-2.5	-2.0	-1.8
Current acct (% of GDP)	9.9	6.1	5.2	4.5	4.5
Policy rate* (%)	5.31	5.31	5.81	6.81	7.31
Exch rate* (CNY/USD)	6.83	6.83	6.62	6.30	6.00

* end of period

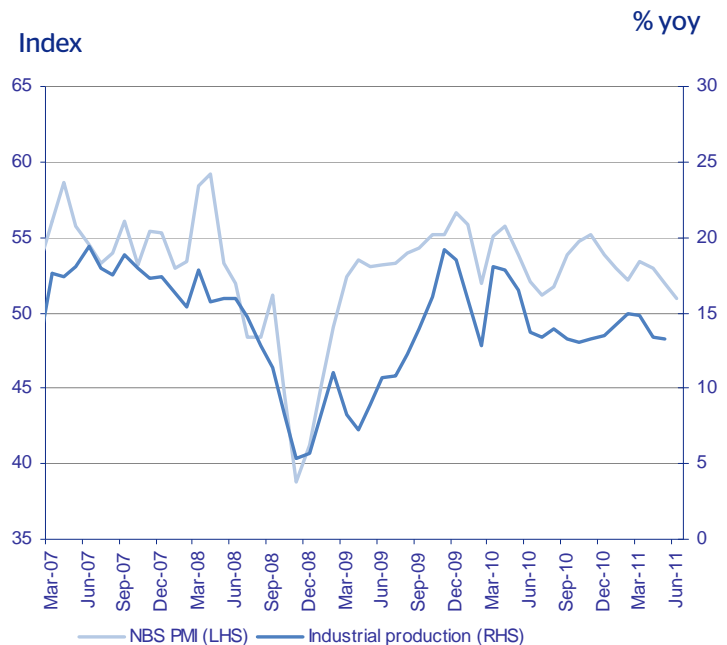
A soft-landing is underway

- **While growth is moderating, underlying trends remain strong** due to robust private consumption and investment.
- **Policies under the new 5-year Plan should help support growth**, including the focus on economic rebalancing, boost to household income, and investment in affordable housing and strategic industries.

Q2 GDP growth is expected to moderate on slowing activity indicators



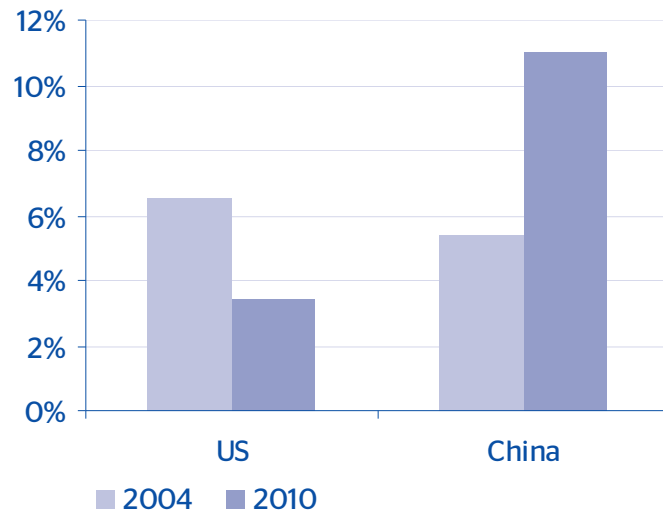
PMI and industrial production are moderating



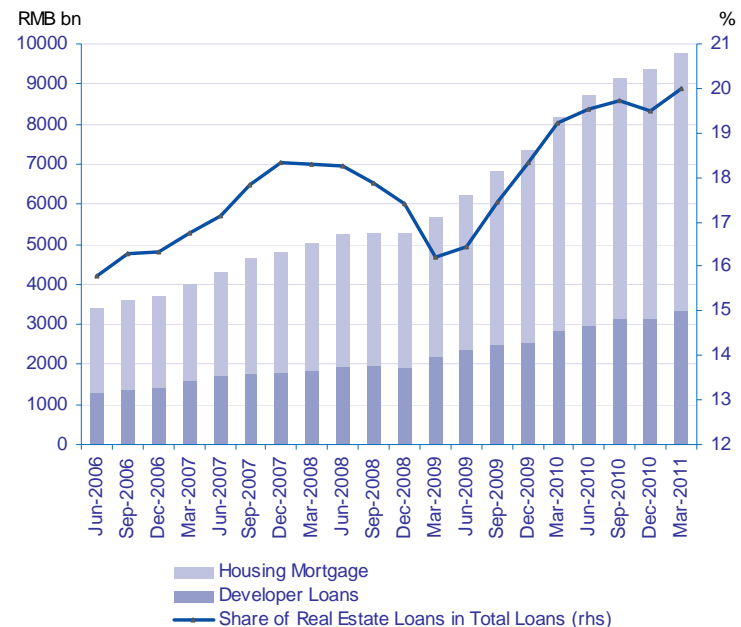
The growing importance of China's real estate sector

- The property sector remains a focus of intense interest given its large contribution to China's economic growth and financial risks from large price movements.
- Rapid lending growth to the sector continues.

The property sector accounts for a large share of China's economy



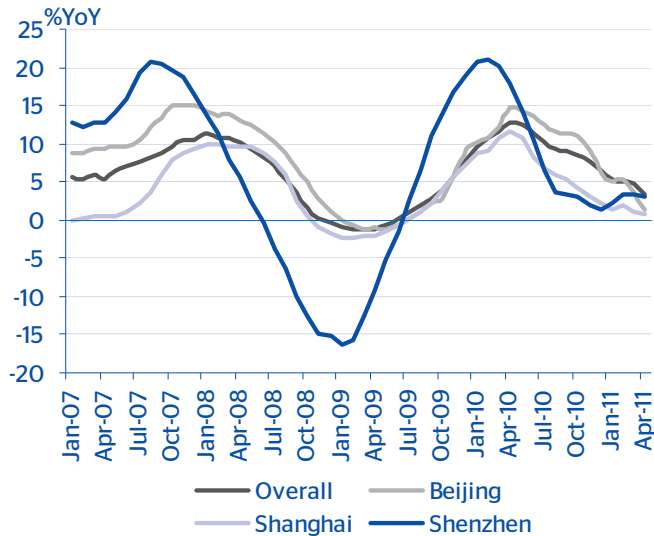
Rapid loan growth in the sector continues



Recent developments in housing prices

- Housing price increases have cooled over the past year following monetary tightening and macro-prudential measures.
- Sales volumes have fallen sharply.

The rise and fall of property prices



Sales volume growth have fallen rapidly

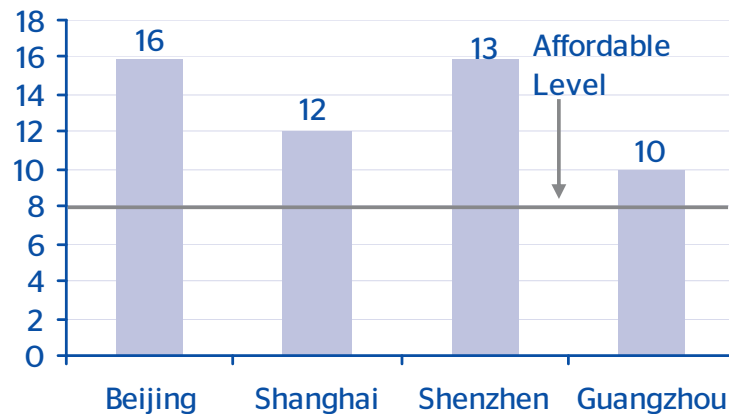


Affordability remains a concern

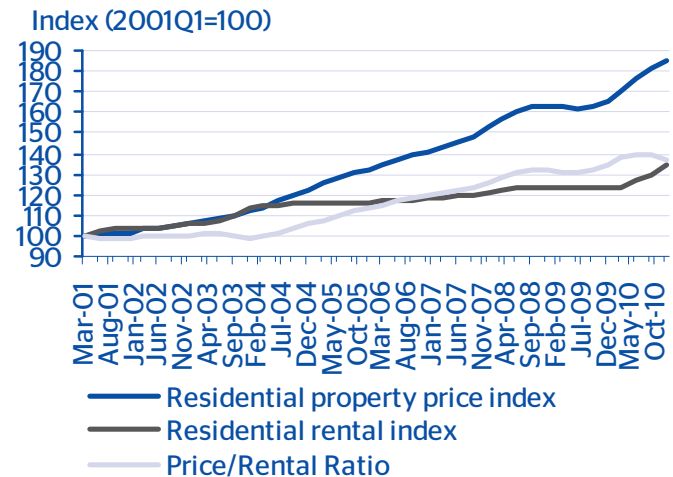
- Efforts to cool the market stem from concerns about potential price bubbles and affordability.
- Despite the moderation in prices, affordability is still a concern

Prices are stretching affordability levels

Housing price
(30 sq meter per capita)/ Per capita income



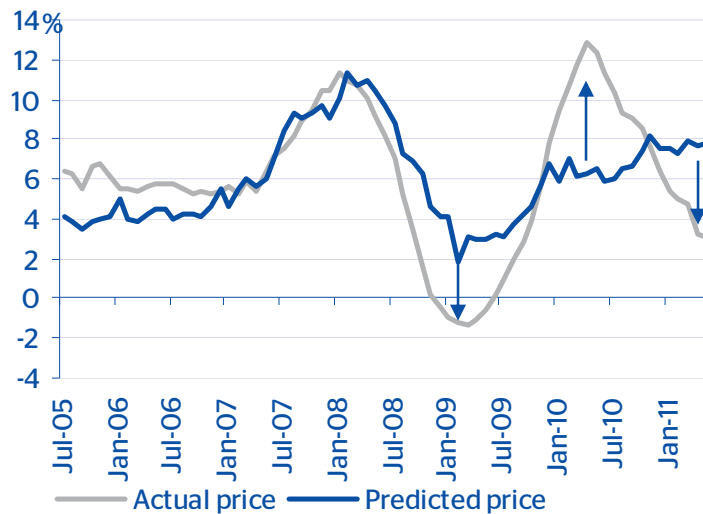
Price/rental ratios have leveled off, but mainly because of an increase in rents



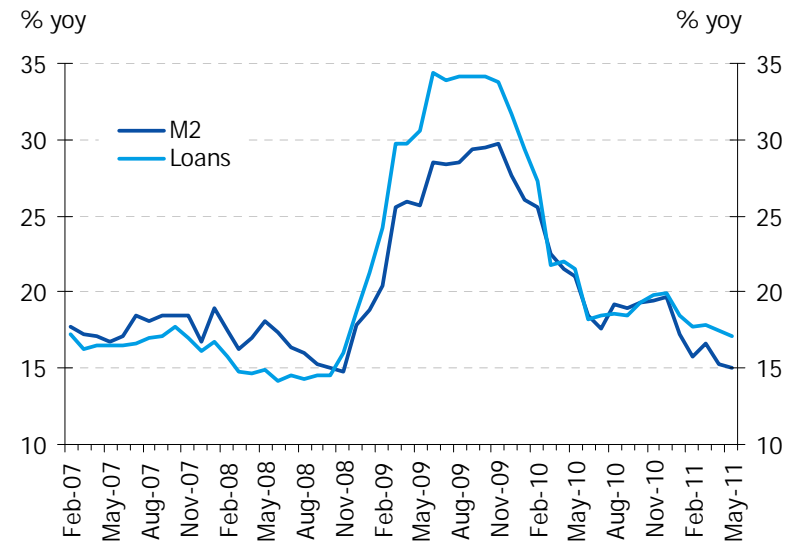
Price fluctuations are due to macroeconomic factors

- Our time series model shows the influence of money growth and inflation in determining housing price movements
- Recent tightening measures have had their intended effect

Actual and predicted housing price growth



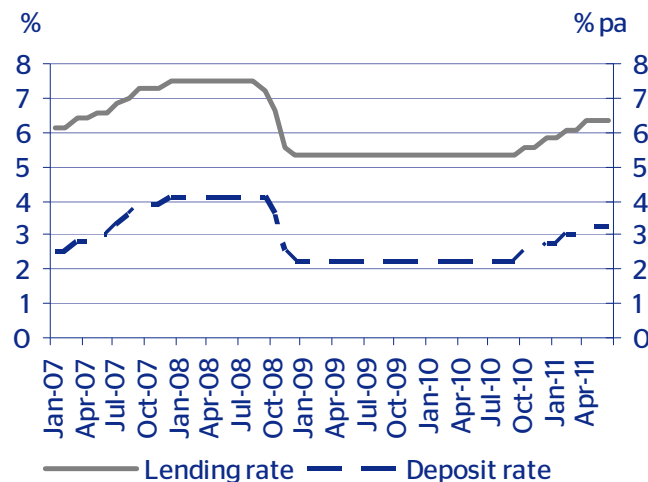
Credit and money growth are declining



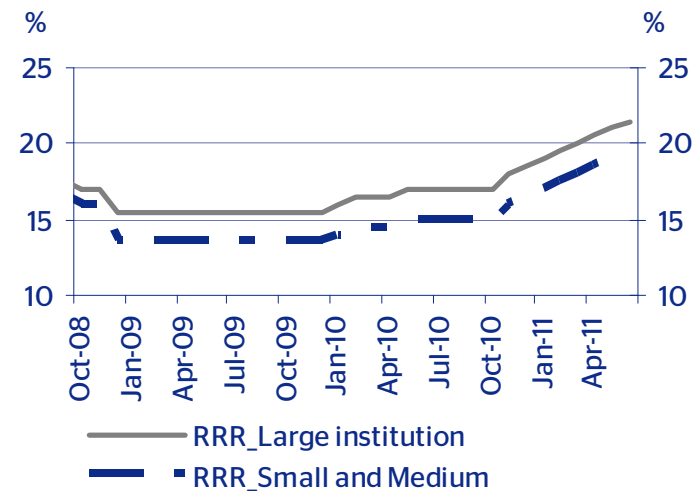
Measures to cool the market

- Monetary policy has been tightened
- Further targeted measures to discourage speculation (October 2010 and January 2011): purchase restrictions, higher down payment requirements, and introduction of a property tax in Shanghai and Chongqing
- Supply side measures to increase investment in affordable housing

Hikes in interest rates



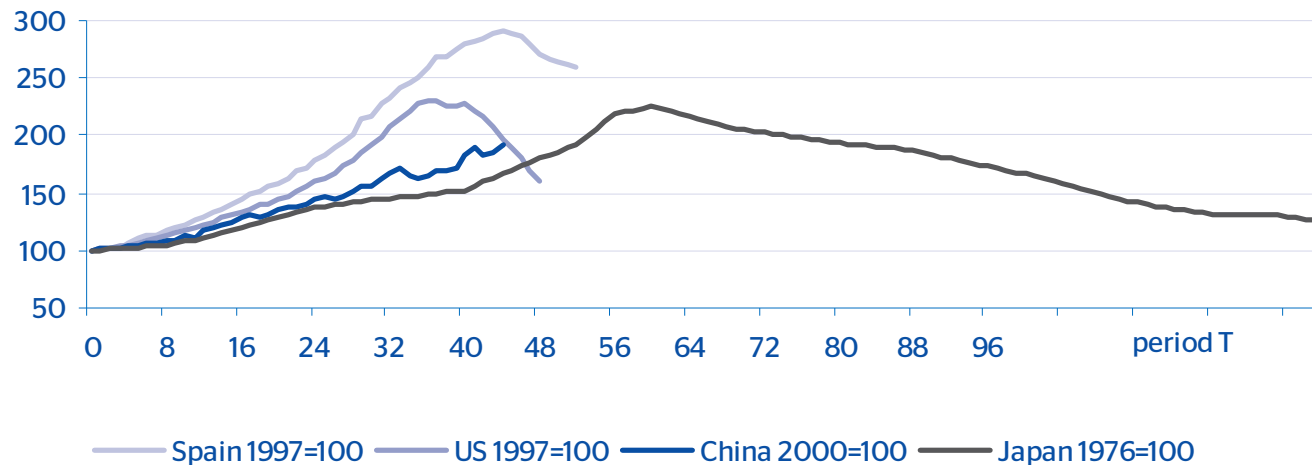
Aggressive hikes in the RRR



Are China's housing prices misaligned?

- The rise in prices still does not look so large in comparison with international case studies of classic real estate bubbles

International comparison of price bubbles



Are China's housing prices misaligned?

- To answer this, we have updated and extended our empirical model based on a supply/demand framework
- The model is based on fundamentals, including real income growth (+), interest rates (-), population density (+), housing stocks (-), construction costs (+) and projected income (+)
- The results are suggestive only
- Our estimates of misalignment are much lower than in our previous report

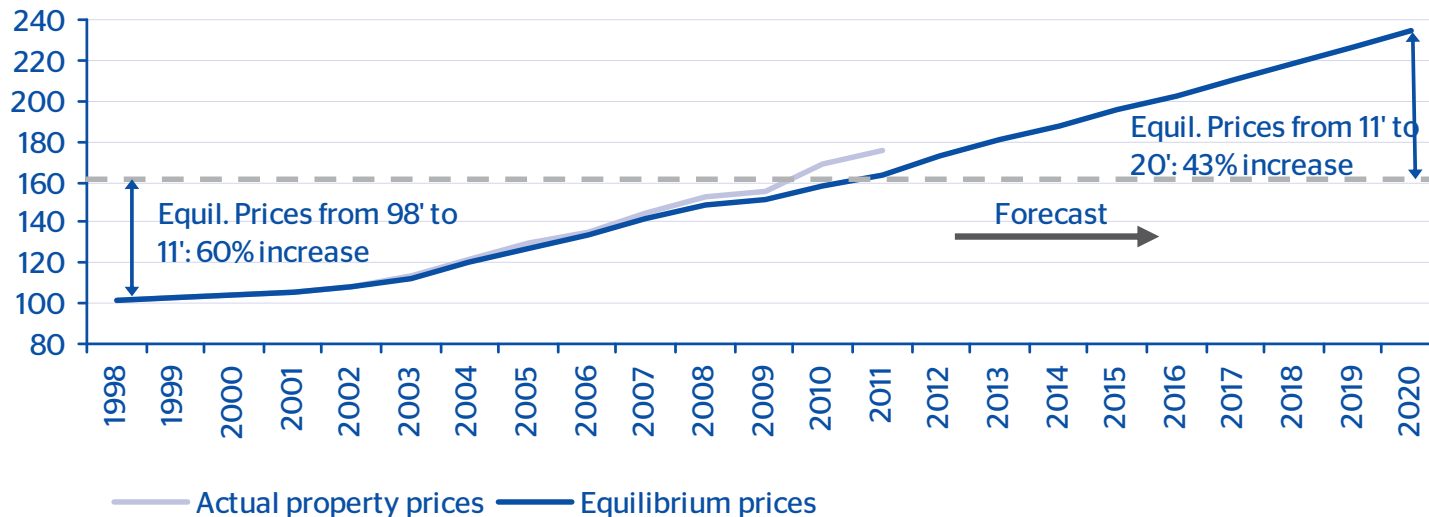
Housing Fundamentals and Price Levels by City

%	Average growth, 1999-2010			Actual prices	Equil. prices	Estimated Over-valuation (2011Q1)
	Real income	Construction costs	Population density			
Beijing	11.0	0.4	3.0	6.2	4.8	+13.6
Shanghai	10.1	0.3	2.6	9.3	5.9	+12.4
Shenzhen	3.8	0.6	9.8	5.8	4.4	+8.7
Guangzhou	9.3	1.2	2.8	2.2	1.9	-3.3
Chongqing	11.4	1.4	-0.5	7.1	7.3	+11.5
Tianjin	11.7	2.1	1.7	6.8	5.8	+10.0
Average	9.6	1.0	3.3	6.2	5.0	+8.8

Medium-term outlook

- Our estimates suggest that current prices are about 7% higher than our estimated equilibrium (for all 35 cities in our sample)
- Near-term price increases are likely to be subdued, and modest downward pressure is possible in cities with the largest degree of overvaluation
- Bright medium-term outlook based on expected trends in real income growth (10% per year) and urbanization (2% per year)

Actual and equilibrium housing prices



Medium-term challenges

- Affordability will remain a pressing social issue, which is inevitable in a fast-growing economy
- Sound financial incentives and tax policies may be helpful, including a broader application of the property tax
- Monitoring of the impact of ambitious social housing investment plans on the broader housing market may be needed if upward pressure on land prices result, as we expect, offsetting downward pressures from greater competition