



China Real Estate Outlook

Annual Report 2010

July 2010

Summary messages

- **Building on BBVA's first Real Estate Outlook on China last year, the new edition updates developments and policies in the residential property sector**, including an evaluation of recent price trends against fundamentals and a comparison of international experience with housing price bubbles.
- **Property prices in China have continued to rise sharply over the past year.** While the magnitude of China's housing price increases is not particularly large in comparison to international experience at this stage, the authorities have taken early action to cool the market in order to maintain housing affordability and to forestall destabilizing price bubbles. The measures have resulted in a sharp fall in sales transactions and a moderation in price increases.
- **According to our estimates, housing prices over the past year in the major first tier cities have outpaced the rise in equilibrium values for housing.** This raises the likelihood of further near-term adjustments in the housing market, including a downward correction in prices. Nevertheless, we expect a soft landing for the sector.
- **Over the medium term, however, prospects for China's property market are bright,** given rapid income growth, high rates of urbanization, and favorable demographics.

Organization of the report



China

Real Estate Outlook

1. Introduction

2. Recent Developments and Outlook for the Housing Market

Box 1: China's Housing Market: A Review of the Past 20 Years

3. Assessing China's Property Bubble from an International Perspective

Box 2: Latin America's Experience with Affordable Housing Policies

4. Are China's Housing Prices Misaligned with the Fundamentals of Supply and Demand?

5. Medium-term Outlook

Appendix: Description of Empirical Models for Estimating Equilibrium Prices

Economic outlook

- **Economic growth is expected to remain brisk in 2010 at 9.8%.** This assumes a “soft landing” from the current rapid pace as tightening measures are implemented to prevent overheating.
- **Inflation has been rising, but is not yet a serious concern.** Inflation should peak around mid-year, and then recede as monetary and credit growth are reined in.
- **Monetary tightening will continue** after some delay, with further quantitative measures and some hikes in interest rates and gradual currency appreciation.
- **Risks of overheating are moderating,** with downside risks present from uncertainties in the external environment, especially in Europe.

Macroeconomic Forecasts: China Baseline

	2007	2008	2009	2010 (F)	2011 (F)
GDP (% , y-o-y)	14.2	9.6	8.7	9.8	9.2
Inflation (%)	4.8	5.9	-0.7	3.1	3.3
Fiscal bal (% of GDP)	0.6	-0.4	-2.8	-2.8	NA
Current acct (% of GDP)	10.2	9.3	6.1	7.0	6.5
Policy rate* (%)	7.47	5.31	5.31	5.85	6.12
Exch rate* (CNY/USD)	7.30	6.83	6.83	6.54	6.28

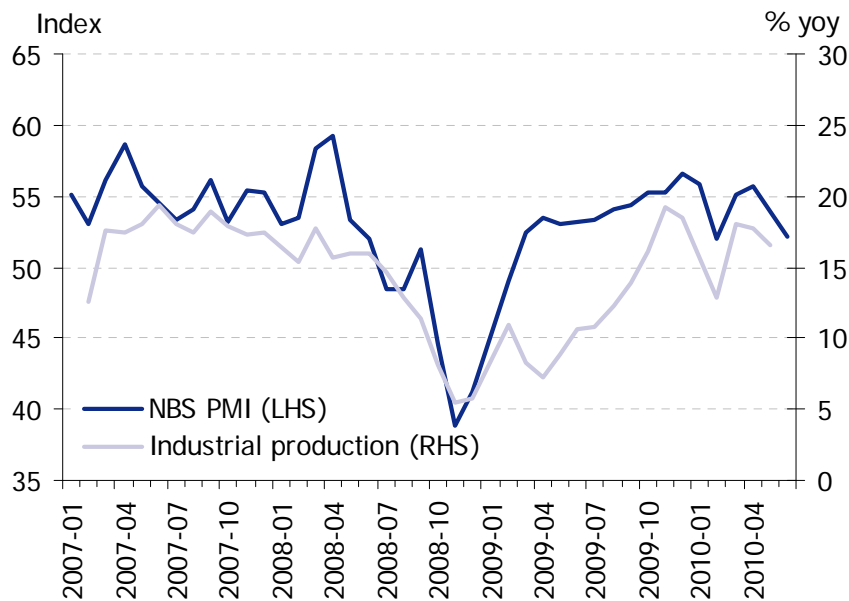
* end of period

Signs of some slowdown are becoming evident

While overall activity remains brisk there are signs that recent measures by the authorities to rein in growth to more sustainable levels have gained traction:

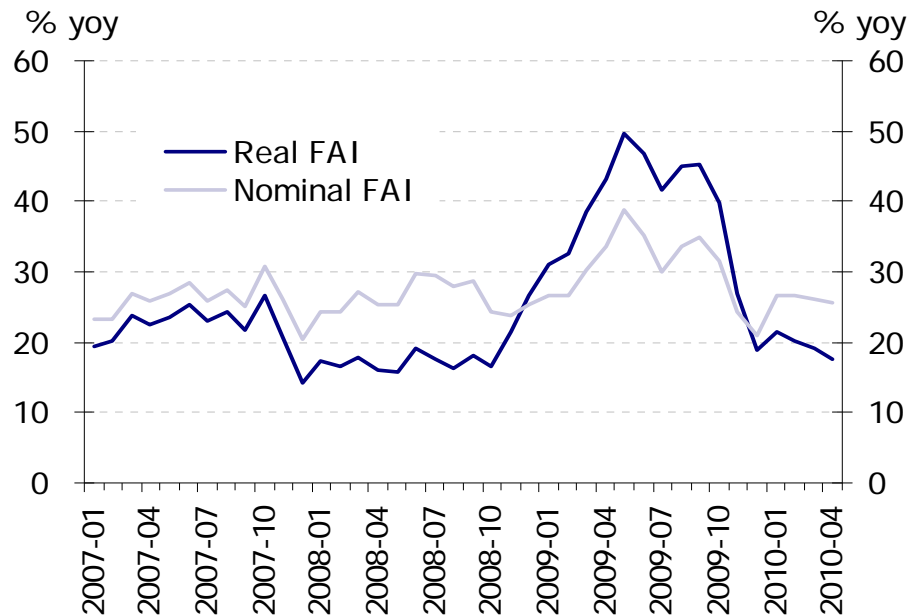
- Growth of credit and industrial production have moderated, and the purchasing manufacturers' index point to a slowing growth in the second half of the year, in line with our expectations.
- Driven by ongoing, rather than new infrastructure projects, the growth of urban fixed asset investment (FAI) has been slowing from its peak in mid-2009

PMI and industrial production are pointing to robust, but slower growth in H2



Sources: CEIC and BBVA Research

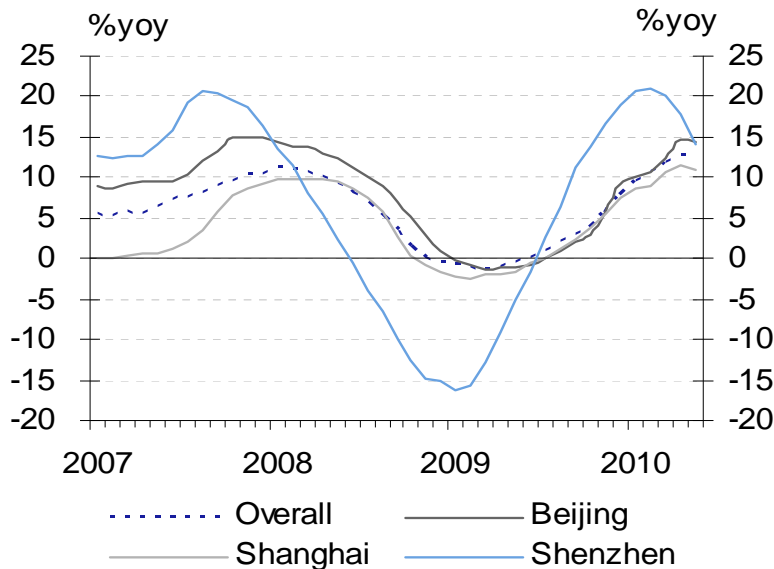
Fixed asset investment growth is moderating



Recent developments in housing prices

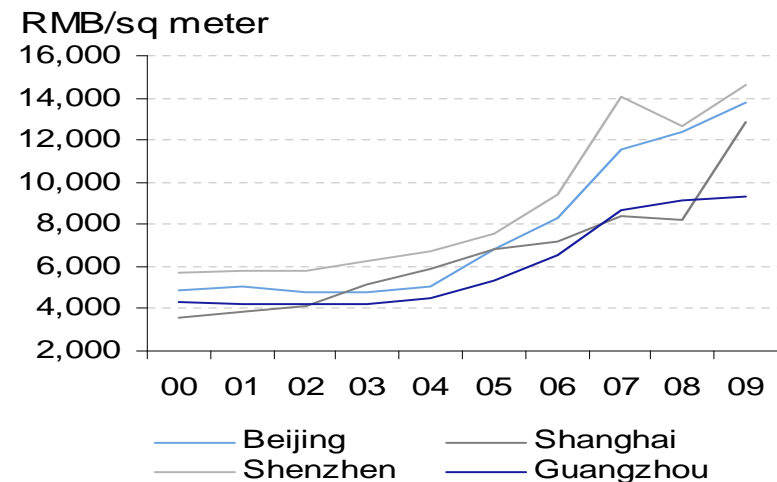
- Housing prices have been rising, and reached a record 12.8% y/y in April (12.4% in May).
- Prices in the major cities are above the pre-Lehman levels
- The authorities worry about affordability and/or destabilizing price bubbles

A recent rise in property prices



Sources: CEIC and BBVA Research

Housing prices are above pre-crisis levels



Recent developments in housing prices

- Affordability ratios are high compared to other international cities
- A rise in price/rental ratios may be another sign of excessively rising prices

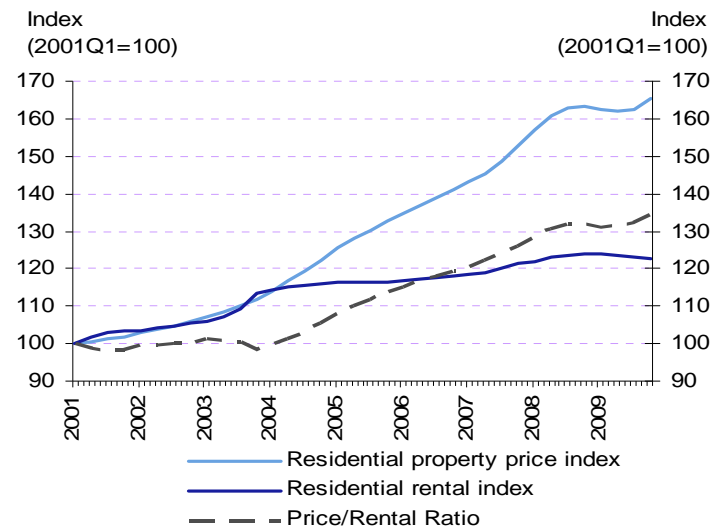
Affordability ratios are stretched

Affordability Index Measured by Price/Income Ratio

China		International	
City	Price/Income	City	Price/Income
Beijing	22.3	Los Angeles, USA	10.0
Shanghai	19.3	London, UK	6.9
Shenzhen	22.1	New York, USA	7.1
Guangzhou	14.7	Miami, USA	7.2
Chongqing	9.3	Sydney, Australia	8.3
Tianjin	13.9	Vancouver, Canada	8.4

Source: Asian Development Bank and BBVA Research

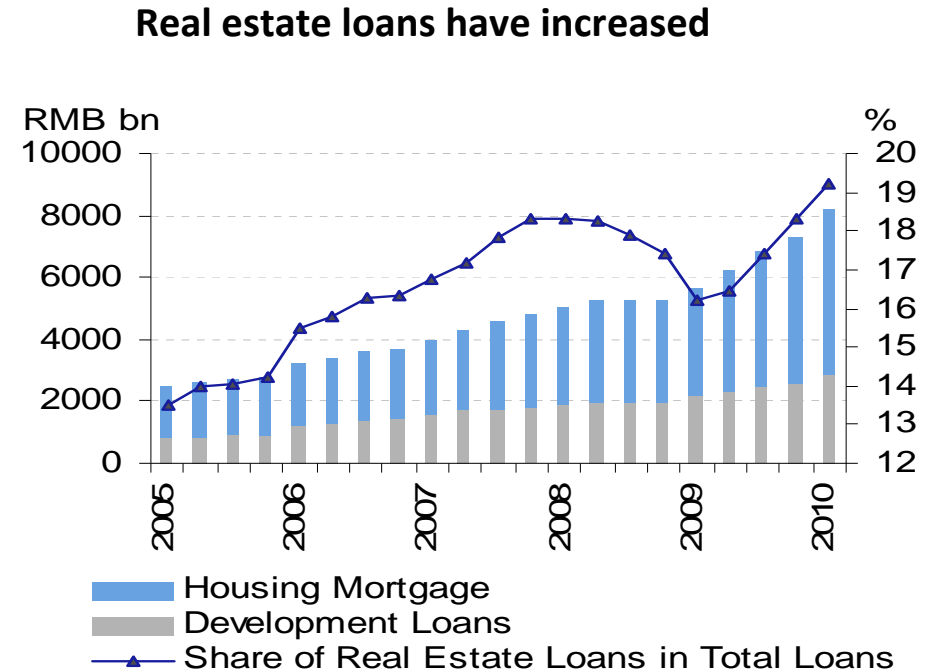
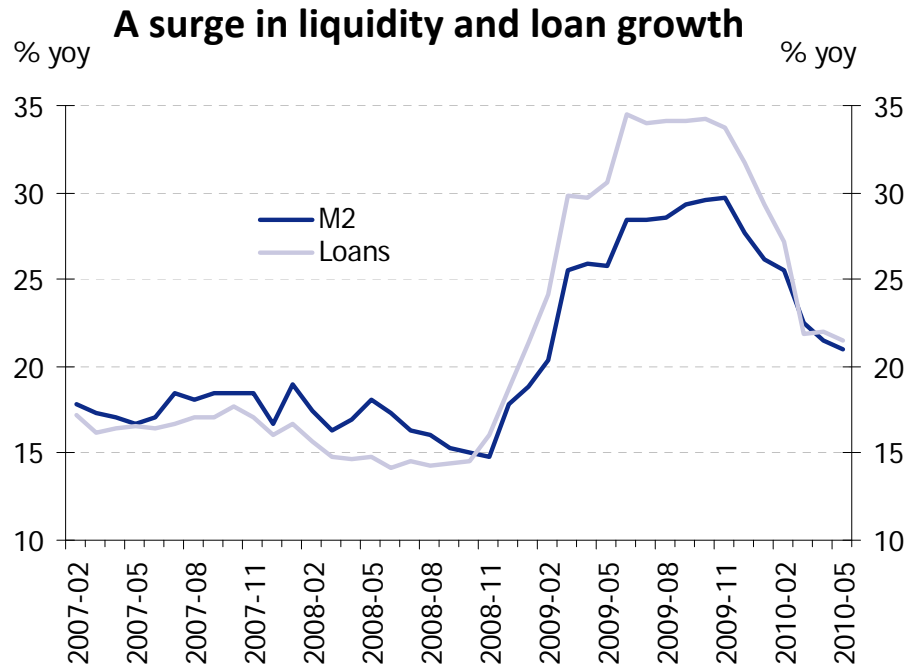
Rising price/rental ratios are a further sign of excessive price increases



Sources: CEIC and BBVA Research

Fueled by stimulus measures and rapid lending growth

- The source of the housing price boom lies in rapid lending and liquidity growth, which are now slowing
- Loans to the real estate sector have risen rapidly

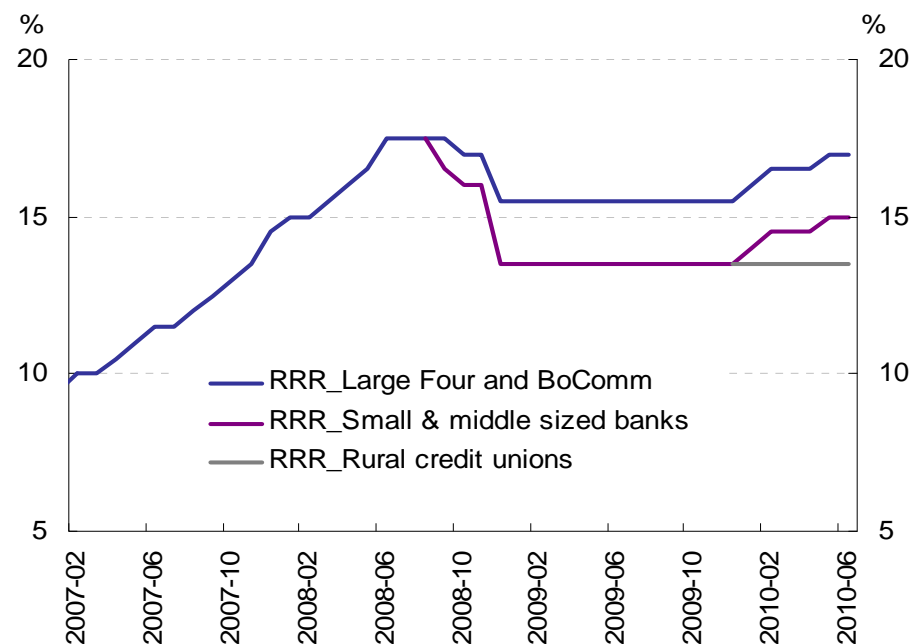


Sources: CEIC and BBVA Research

Measures to cool the market

- **Monetary policy** has been tightened through quantitative measures to achieve an overall target for new loans of RMB 7.5 trillion (19% y/y growth).
- **Targeted measures** to discourage speculative housing purchases:
 - Increase in mortgage down payment requirements
 - Increase in mortgage interest rates
 - Restrictions on loans for third home purchase
- **Supply side measures** to increase availability of land for affordable housing development

Three hikes in the RRR so far

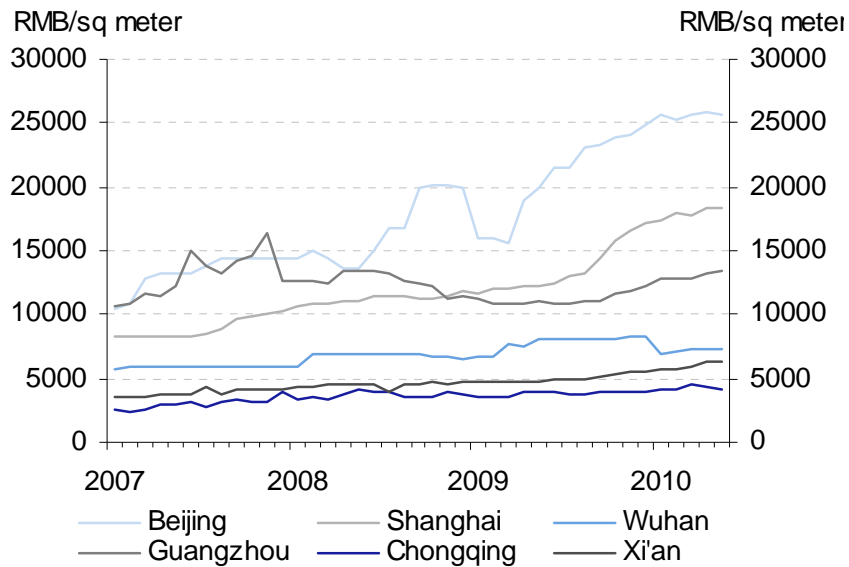


Sources: CEIC and BBVA Research

Impact of tightening measures

- Tightening of monetary policy has slowed credit growth
- Property sector measures have resulted in a sharp fall in sales transactions, and a moderation in prices increases
- Price declines have not yet been significant

Price increases in the major cities are moderating



Sales volumes have fallen sharply



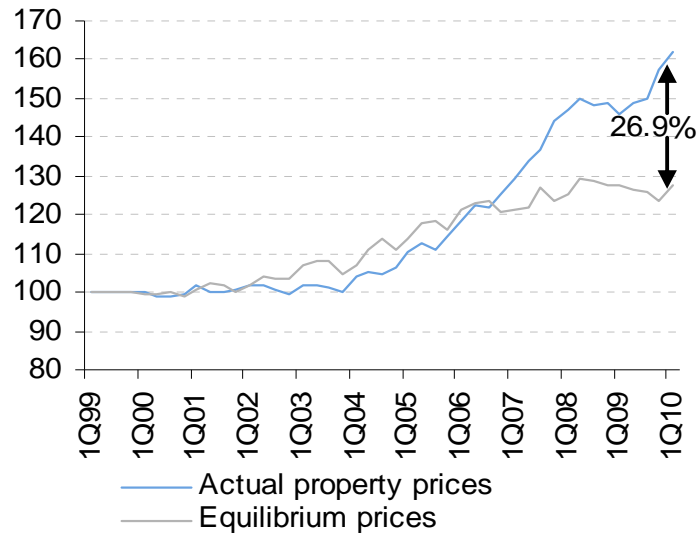
Are China's housing prices misaligned?

- To answer this, we have updated our empirical model to assess the degree of misalignment between actual and equilibrium prices values in China's largest cities
- The results are suggestive only, and are not meant as a prediction of near-term levels (uncertain data quality, lack of forward-looking components such as future income, and the usual complexities of an analysis such as this)
- The model is based on a supply and demand framework, with underlying factors including real income growth (+), interest rates (-), population density (+), housing stocks (-) and construction costs (+)
- The results suggest that current prices exceed equilibrium, by some 20-30%, but with variation across cities; in most cities, excessive valuation began in 2003-04, coinciding with a period of low interest rates

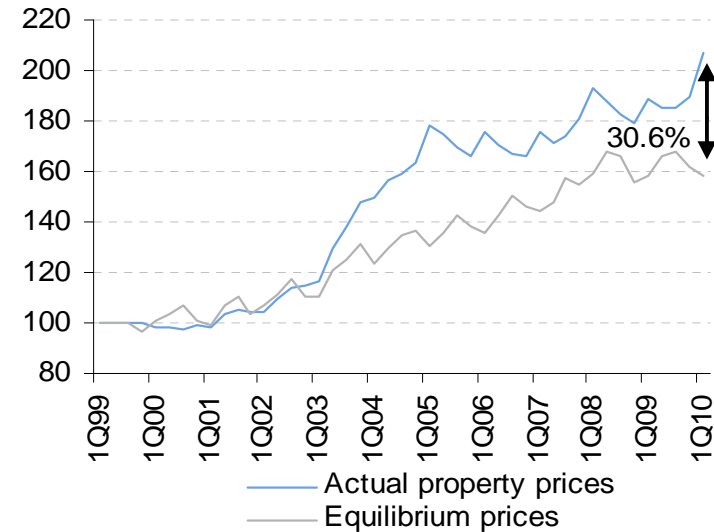
Model results

- Prices in Beijing have accelerated since 2004, and have outpaced the rise in estimated equilibrium values since 2007
- In Shanghai, similarly, prices also accelerated in 2003, rising quickly above our estimated equilibrium

Beijing



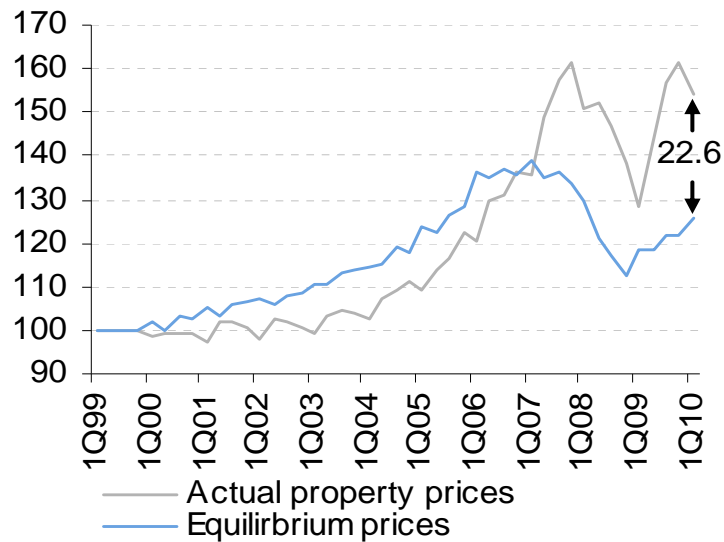
Shanghai



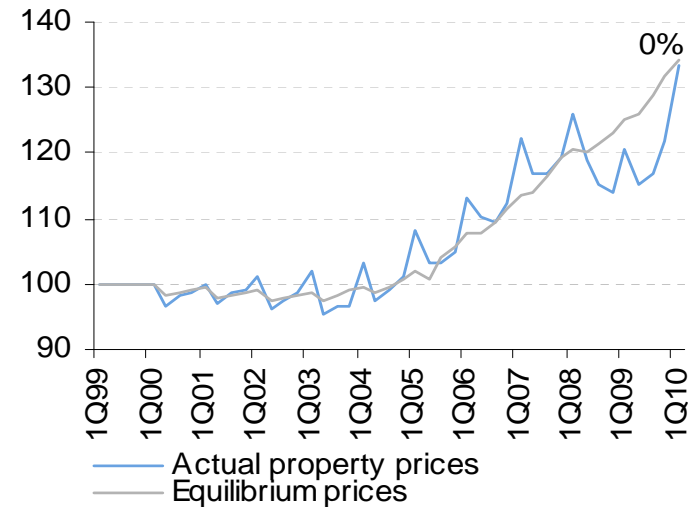
Model results

- Our estimates show variation across cities
- Shenzhen's prices are similarly overvalued relative to Beijing, while Guangzhou's prices appear to be near equilibrium
- Shenzhen's economy is export-oriented, and income declined during the global slowdown; in Guangzhou, the housing market is relatively mature (with fewer restrictions)

Shenzhen



Guangzhou



Summary of model results

- From 1999-2009, an average increase in actual prices of 6.8% per year, compared to an estimated equilibrium increase of 3.9%.
- The rise in equilibrium prices has been supported by rapid increases in real income, population growth, and rising construction costs

Housing Fundamentals and Price Levels by City

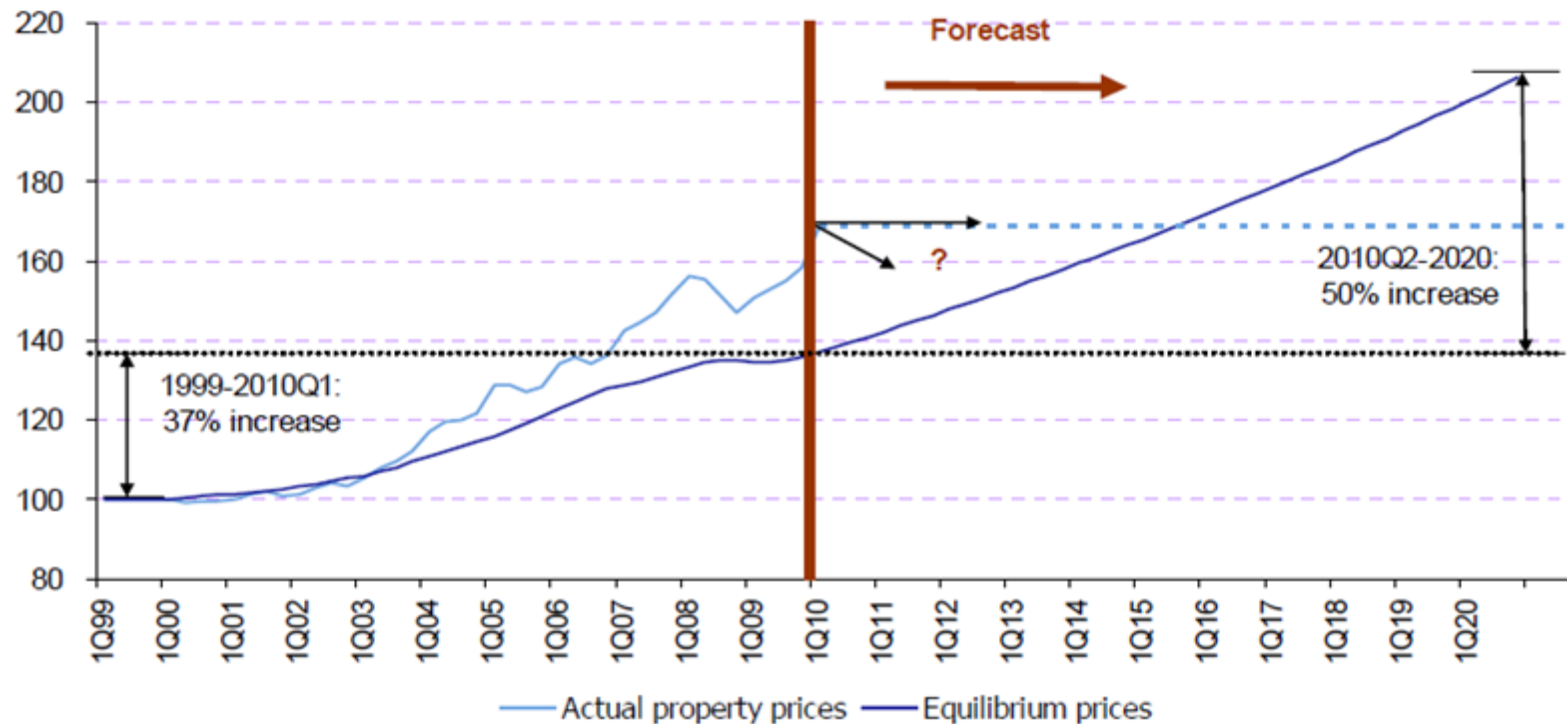
%	Average growth, 1999Q1-2010Q1				Actual prices	Equil. prices	Estimated Over-valuation (2010Q1)
	Real income	Construction costs	Population density	Population density			
Beijing	11.0	0.4	3.0	6.2	2.8	+26.9	
Shanghai	10.1	0.3	2.6	10.7	5.8	+30.6	
Shenzhen	3.8	0.6	9.8	5.4	2.6	+22.6	
Guangzhou	9.3	1.2	2.8	3.3	3.4	0.0	
Chongqing	11.4	1.4	-0.5	8.5	5.4	+20.1	
Tianjin	11.7	2.1	1.7	6.9	3.2	+28.5	
Average	9.6	1.0	3.3	6.8	3.9	+21.5	

Source: BBVA Research

Medium-term outlook

- Bright medium-term outlook based on expected trends in real income growth (10% per year) and urbanization (2% per year)
- A near-term correction is likely

Actual and Equilibrium Housing Prices



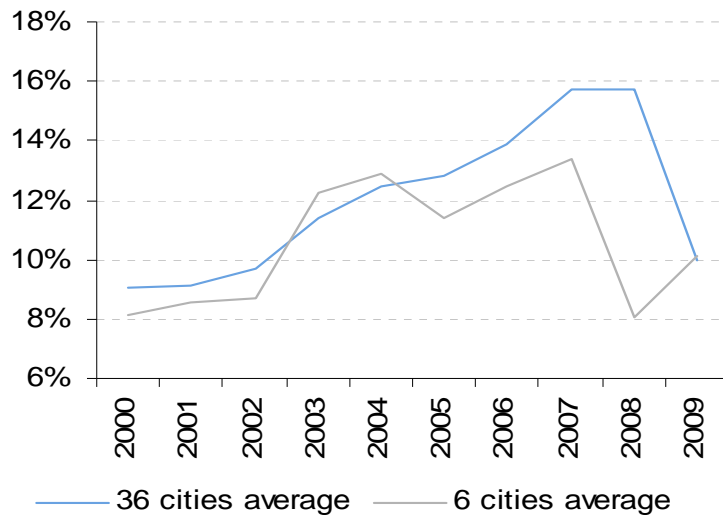
Source: CEIC and BBVA Research

Note: Average residential housing prices in China's 6 largest cities.

Medium-term outlook

- A shift to smaller cities is possible, with the likelihood of greater market focus on second or even third tier cities
- Policies should focus on sound financial incentives and tax polices, local government fiscal reform, and adequate investment in affordable housing

Income growth in smaller cities is high



Lower residential prices today mean greater upside potential

