Box 2

DEVELOPMENTS IN THE HOUSING MARKET IN CHINA

Following sharp increases in housing prices and activity between 2005 and 2011, recent weakness in the Chinese housing market has rekindled concerns that a strong correction might have a negative impact on China's growth outlook and, in turn, on the global economy. This box investigates the likelihood of such an event materialising by looking at the fundamentals of the Chinese housing market and its importance for the Chinese economy.

Housing investment has been an increasingly important source of growth for China in recent years. Real estate investment accounts for about 25% of total fixed asset investment, with the latter having driven 50% of GDP growth since 2006. In terms of its share in GDP, real estate investment rose from 10% in 2006 to 16% in 2011. Construction and real estate services together employ over 10% of the workforce and contribute to 13% of total added value. Real estate investment also has strong linkages to other industries such as machinery and equipment.

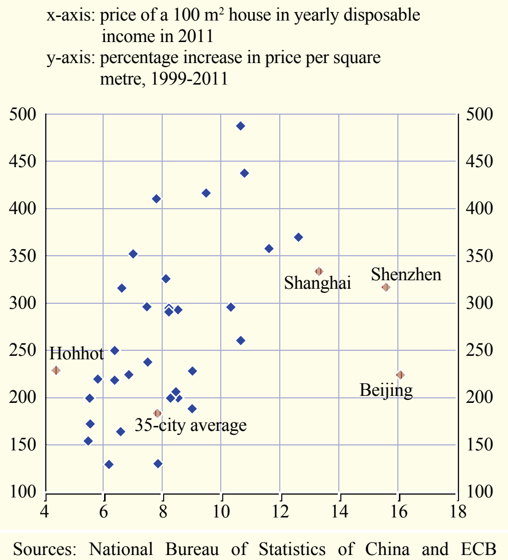
House prices in China have risen sharply in recent years and are high compared with incomes. On average, the price per square metre of housing across a sample of 35 large and mid-sized

Chinese cities nearly tripled between 1999 and 2011, although this average masks great disparities. The price of a 100 m^2 house expressed in multiples of the annual disposable income of an average family of 3.3 persons also varies widely, from 4.4 times yearly income in peripheral cities (Hohhot, Inner Mongolia), to close to 16 in large, booming cities such as Beijing and Shenzhen (see Chart A). On average, the ratio fell between 1999 and 2011 as disposable income rose faster than the square metre price (11% compared with 9% annually – see the red dotted line in Chart B).

However, when one considers the increase in the size of the average house, a different picture begins to emerge. Over recent years, living space has increased from an average of 19.4 m^2 per capita in 1999 to 32.7 m^2 in 2011, while the average household size has decreased from 3.6 persons to 3.1, implying that the average house has grown from 70 m^2 to 101 m^2. As a result, the price of the average house (expressed in multiples of income) rose from 6.4 in 1999 to 8.6 in 2011 (see the blue line in Chart B).

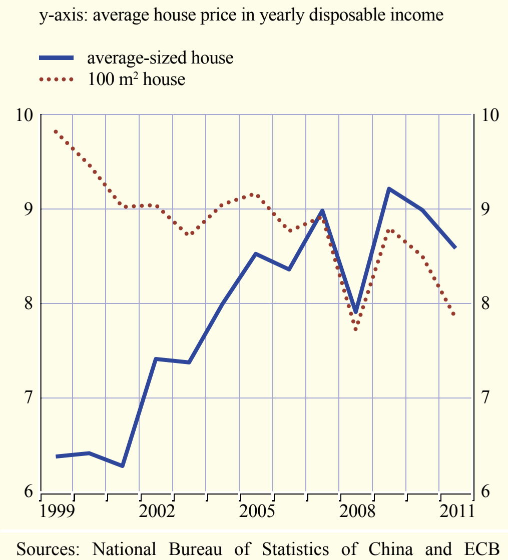
While housing investment and house prices have risen sharply in recent years, a number of factors suggest that a sharp correction seems unlikely. First, housing demand remains high on account of continuing urbanisation. In addition, new construction partly reflects the replacement of old, low-quality housing, and does not add to the net housing supply. At the same time, tight administrative restrictions, in particular on the purchase of second and third homes, discourage speculation. Should the housing market suddenly cool off, such measures could be reversed in order to stimulate demand, as could the recent preference for larger housing in case of affordability concerns. Finally, the overhang of unsold housing owing to the recent cooling of the real estate market has recently begun to decline in major cities such as Beijing.

Chart A House prices across 35 cities



Sources: National Bureau of Statistics of China and ECB calculations.

Chart B House prices (1999-2011, 35-city average)

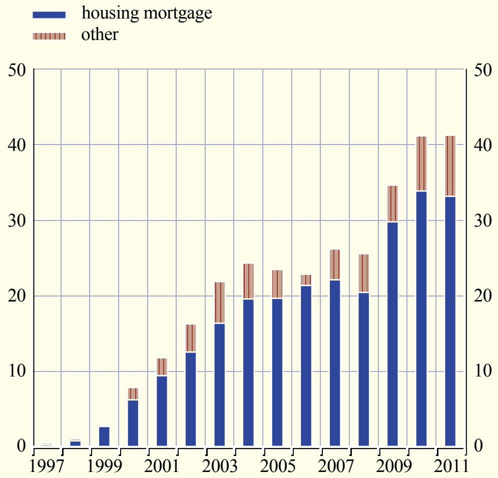


Sources: National Bureau of Statistics of China and ECB calculations.
Notes: The price of a 100 m^2 house is based on a constant family size and living space per person. The price of an average house takes into account changes in family size and living space per person.

There could be a concern that, if households have extrapolated recent rates of income growth into the future, assessments of housing affordability – reflected in the demand for larger housing – might prove to have been overly optimistic, particularly since China's potential growth rate is expected to slow in the coming years. This could induce a fall in prices, temporarily depressing housing sales as prices adjust and creating an overhang of unsold housing stock. Consumers are not highly leveraged, so the impact on consumption from a downward housing shock would likely be small. Mortgage debt as a percentage of disposable income has increased markedly over recent years to reach 33% in 2011 (see Chart C). Loan-to-value ratios for household mortgages are typically low, so household sector deleveraging linked to falling property prices is expected to be limited. However, a large housing market correction would negatively affect real estate transactions and construction activity, which could spill over to other industries. That said, in view of the reasons mentioned above, a broad and sharp correction of house prices seems unlikely, though house prices in individual cities might exhibit some volatility.

Chart C Consumer loans

(as a percentage of disposable income)



Sources: CEIC, People's Bank of China, National Bureau of Statistics.