China Economic Update

by NAB Group Economics

18 September 2014

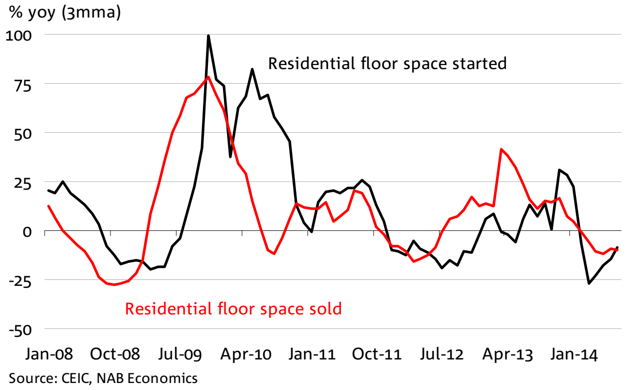
A slowing trend in real estate could weigh on China's growth prospects

Conditions in China's real estate sector have slowed considerably across 2014. The sector has been a key contributor to the country's economic growth in recent years and a slowing trend will impose greater pressure on other parts of the economy to provide growth momentum, particularly if the Government aims to maintain its current growth target.

Recent property market trends – prices weaker as sales slow

China's residential property markets have shown increasing weakness across recent months. Over the first eight months of the year, sales of residential property fell by around -11% yoy (on a square metre basis), while new starts for residential buildings fell by -14% yoy over the same period.

Slowing property sales and weak new construction activity

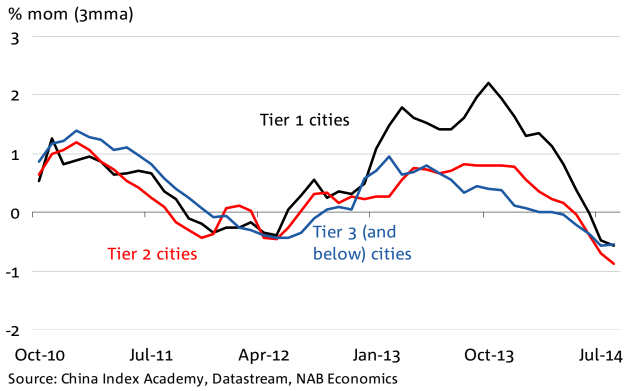


Source: CEIC, NAB Economics

House prices, which grew strongly up until late 2013, have started to decline in monthly terms. That said, trends in individual cities differ considerably. Prices in tier 1 cities (Beijing, Shanghai, Shenzhen and Guangzhou) rose far more strongly than in smaller cities over the past few years – according to China Index Academy data, the average price in tier 1 cities was over three times higher than the average in tier 2 in August.

Price growth started to slow in late 2013, and in recent months, prices have fallen (in monthly terms). Falls have been most noticeable in tier 2 cities – with those in tier 3 and below falling more modestly (having risen less significantly previously).

House price trends have turned negative in recent months – triggering fears about sector



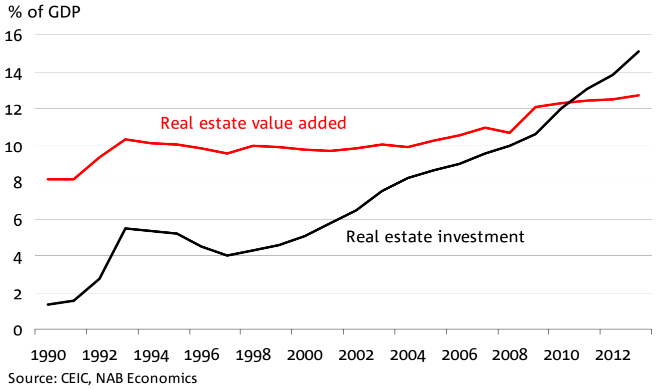
Source: China Index Academy, Datastream, NAB Economics

Trends in commercial property markets have also been comparatively weak – with the IMF noting oversupply across most regions.

Concerns around the potential impacts of a slowdown in property markets have resulted in a loosening in government policies in a range of cities. This has included removing restrictions on purchases by non-residents and lowering the deposit thresholds for property purchases. That said, policies differ considerably between cities, lacking a unified response to the broader conditions.

Given the weakness in the market – with reports of excess capacity in many cities and falling sales, we expect soft conditions to continue. However, as [we previously outlined in April](), we argue that a fall in prices severe enough to trigger the large scale liquidation of properties seems unlikely, due to the structure of Chinese mortgages and the comparatively high level of equity in homes.

Property sector has become an increasingly important part of China's economy



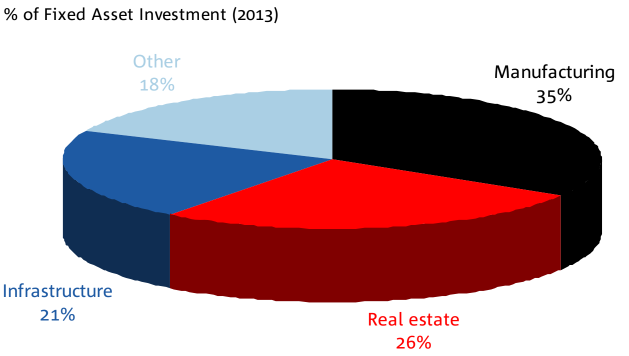
Source: CEIC, NAB Economics

What does it mean for China?

In recent years, China's property sector has become an increasingly important part of the economy. In 2013, the gross value added from the property sector (combining construction and real estate) was almost 13% of GDP. However the IMF note that if upstream and downstream sectors are included, this larger combination accounts for a third of China's economy.

Investment in the real estate sector has grown strongly across recent decades – rising from 5% of nominal GDP in 1995 to 15% in 2013. The residential sector accounts for the largest share of real estate investment – at around two-thirds of the total. In 2013, real estate accounted for over a quarter of fixed asset investment (with only manufacturing having a larger share at 34%).

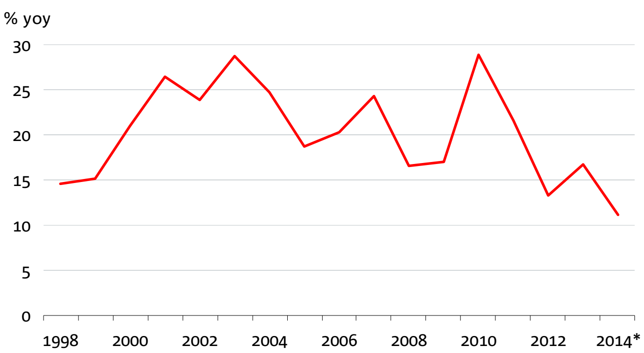
Property sector comprises a large share of China's fixed asset investment



Source: CEIC, NAB Economics

Modelling by the International Monetary Fund in 2012 showed that a 1% decline in the growth of China's real estate investment would reduce China's real GDP by around 0.1% - reflecting the impact of upstream and downstream linkages to the economy. Real estate investment has slowed from around 17% in 2013 (in real terms) to 11% yoy for the first seven months of the year – implying a significant drag on the Chinese economy.

Real investment in real estate has slowed in 2014



* 2014 compares Jan-Jul 2014 to Jan-Jul 2013
Source: CEIC, NAB Economics

As a result, meeting this year's economic growth target of 7.5% would require a greater contribution from other sectors of the economy – with some commentators calling for an expansion in stimulus (particularly in infrastructure construction) to offset weaker real estate conditions.

This trend is likely to continue in the short term, with the IMF expecting real estate investment to slow to 5% in 2014 and record no growth in 2015 before gradually recovering beyond this point. Longer term, trends in the property sector will be dependent on the competing forces of urbanisation and the falling working age population.

Slower property market trends impose challenges on related sectors

Weaker conditions for real estate pose some risks for related industries. The property industry is closely connected to the finance sector – with real estate accounting for around 20% of outstanding loans at the end of 2013 and over a quarter of new loans during the year. According to the IMF, real estate has also been used as collateral for other loans – estimated at between 30% and 45% of loans by the five largest banks – increasing systematic risk as prices fall.

Similarly revenues for local governments are likely to be impacted by weaker real estate conditions. Receipts from land sales are a major source for servicing local government debt – which has grown rapidly over the past five years. Gross land sales were around 7% of GDP in 2013 – a sizeable level – and land related tax revenue for most provinces was around one-fifth of the total tax take. Land sales are likely to slow in line with weaker construction activity.

We have previously discussed the increased risks around local government debt related to real estate trends. However reforming the funding relationship between central and local governments – most recently through changes to the Budget Law at the end of August – should lower these concerns.

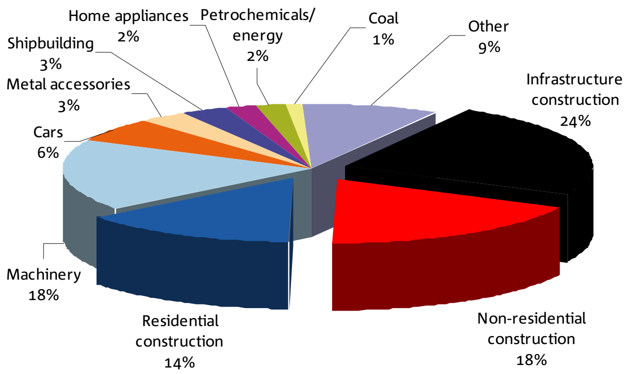
Manufacturing is also likely to be impacted by slowing construction activity – with the sector providing key raw materials. According to the Hong Kong Monetary Authority, the linkages between real estate/construction have intensified in recent years – with the closest relationships being iron and steel and construction materials, followed by chemicals.

What does it mean for Australia?

The construction sector is a key end-user of steel, an industry which is closely linked to Australia's exports of key raw materials – iron ore and metallurgical coal. The construction sector accounts for around 56% of China's steel consumption, and slowing conditions in this sector should result in weaker steel demand.

China's steel sector has faced challenging conditions this year – with recent improvements in profitability reflecting sharper declines in raw material costs rather than improved steel prices (which have fallen in recent years). Weaker construction should result in downward pressure on steel prices, placing greater pressure on domestic producers – potentially impacting demand for Australian resources.

Construction sector dominates steel consumption



Source: KPMG, Reserve Bank of Australia, NAB Economics

Much like the property sector, steel remains a key component of the Chinese economy and the process of reorganising the industry is a major challenge for the government. This reflects competing priorities – excess capacity and poor profitability versus the importance of employment in maintaining social stability.

Conclusions

The broad property sector has been a major contributor to China's economy growth over the past decade, but is now slowing. IMF analysis shows the weakening investment in real estate will shave real GDP growth – making the 7.5% growth target more difficult to obtain (particularly in the absence of stimulus).

Our expectations remain that China's growth in 2014 will be below target (at 7.3%), and continue to slow in 2015 (to 7%) in line with IMF forecasts of stalling real estate investment next year.

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