CARLOS BARRIA / REUTERS

Empty homes in China

BY RODRIGO ZEIDAN

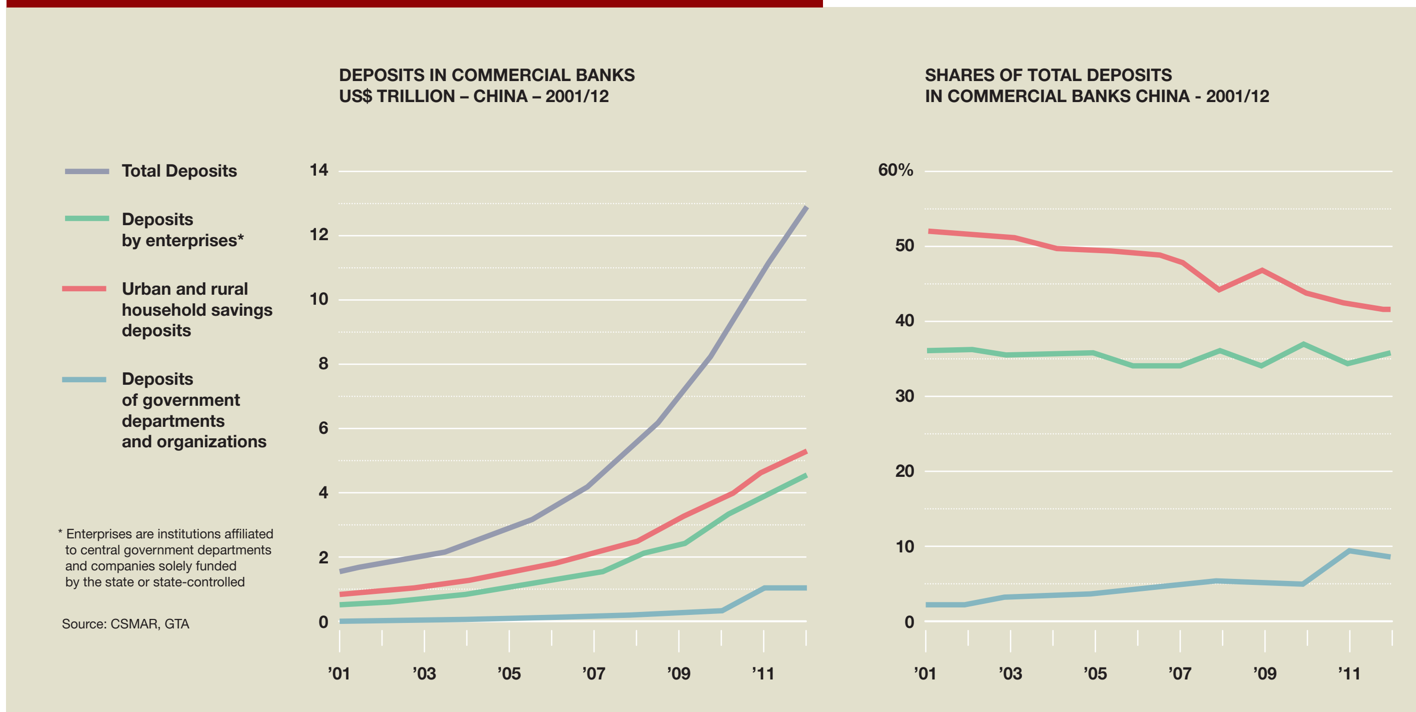
There is a glut of empty apartments in China. Many factors make it preferable not only to invest in real estate, but also to keep the property empty. This phenomenon is having a huge impact on the economy, especially on small family-owned businesses.

People reflected in the window of a ferry as they cross the Huangpu River near the financial district of Pudong in Shanghai, December 12, 2012.

Walking along the Huangpu riverbank on the Pudong side in Shanghai, one has the impression that the 22nd century science-fiction stories have all come true. A multitude of high-rises clutter the skyline, but, if one looks more closely, most of the apartments in the residential buildings that are close to the ferry stop which crosses to the Bund – one of the most expensive areas in Shanghai – are dark and seemingly empty. Statistics on vacancy in China vary, with surveys from CSLA and the State Grid Corporation of China show anywhere from 16 million to 65 million vacant homes in China, while Bloomberg estimated that in 2010 at least 50% of apartments in Shanghai and Beijing were empty, a figure that knows no parallel in rapidly developing areas around the world.

Even with the marginal slowing of the economy in 2012, China's economic engine is still firing on all cylinders. The main fuel for this Chinese engine has been shifting from external demand to internal consumption. Commercial bank lending has been the grease that keeps the machine well lubricated, but as markets develop, China can tap into different sources to maintain its momentum. There is a consensus that Chinese capital markets are underdeveloped (the new stock index futures market has been launched as recently as 2010, with international investors gradually being allowed to access it), and one of the main features is the unusually high demand for residential property in major cities.

CHINESE SAVINGS AND DISPOSABLE INCOME



While the real estate bubble was fueled by scarce supply and low interest rates in Japan in the 1980s, and cheap credit in the US in the 2000s, in China the situation is more complex, because of excessive supply combined with rising prices. One of the major overlooked factors in China's real estate dynamics is the underdevelopment of financial markets. While domestic investors in developed countries have access to a plethora of financial products, from complex insurance to home-trading derivatives, most individual investors in China have limited options. In fact, more than 60% of domestic assets are in bank deposits, while 30% are in equities, according to the Wharton Business School. The bonds market represents less than 10% of domestic assets and domestic mutual funds have a negligible share of the market.

The recent Chinese economic development has been fueled mainly by bank loans, with commercial banks growing to become some of the largest in the world. Banking loans are increasing dramatically – the target is 8.5 trillion yuan ($1.36 trillion) in new lending this year by commercial banks, according to *China Daily*. However, domestic investors have a surprisingly small number of options for channeling their savings. Deposit rates constantly yield negative real rates of return (in February 2013, the average annual deposit rate for 1-year time deposits was 3.25%, against a projected 5% inflation rate for the year). The aforementioned bonds market is inaccessible to most investors, and the stock market has proven to be unreliable as a long-term investment due to its excessive volatility. International markets are also mostly inaccessible. There is a lack of mutual funds and complex insurance. In fact, there are few options open to most investors apart from real estate.

Domestic investors cannot form diversified portfolios, balancing risk and return through a combination of diverse liquid and illiquid assets. Also, there is a strong preference for tangible assets which is a characteristic of emerging countries – the development process usually raises an economy up from a crisis or depressed situation, and a crisis period is one in which few financial assets hold their value better than tangible assets – that is why countries such as Brazil, South Africa and India, as well as China, hold real state as the middle class dream. Property, for most families in developing countries, is the ultimate dream and a sure sign of prosperity. In the Chinese case, coupled with limited options, real state comprises the majority of families' portfolios.

One of the main interesting side-effects of the lack of financial alternatives for Chinese domestic investors is the surge of exotic investment alternatives based on tangible assets – some examples are racing pigeons, aged tea, and wine. An art fund bubble burst in 2011 because some investors used the art market almost

DAVID GRAY / REUTERS

Residential high-rises line a deserted street in the Kangbashi district of the town of Ordos in China's Inner Mongolia Autonomous Region.

like a stock market, with artworks that are split into multiples of dematerialized shares, according to Artprice and CNN. Even so, China has become a major player in the art auction world – art auction results show a shift of money going east, with China leapfrogging the US to become the largest art auction market in 2011. Even though the market has cooled down a bit , according to the *Financial Times*, China is now a major player in the art world, with auction sales topping $10 billion in 2012.

Even more interesting is that most families are not afraid of the concentrated risk brought by investing mainly in real estate and other tangible assets. Talking to some owners there is a perception that the government would never allow a housing devaluation that would threaten property values. The central government is walking a thin line between allowing for a thriving housing market and curbing excess demand. Regulations include bans on multiple home purchases, higher loan rates, and other buyers' restrictions. Also, there are property-tax trials. One of the most confounding aspects of the Chinese property market is that property taxes do not exist in most places. The result is that there are very few transaction costs in vacant residential real estate, allowing the purchase of property as assets that are easy to hold and investors can take some time to observe attitudes regarding property value appreciation.

Analysts at times underestimate the importance of property taxes in giving real estate its special financial asset status in the Chinese market. While in most countries building a real estate portfolio brings all sorts of transactional costs that makes managing it expensive and time consuming, in China it is easy to buy and sell property, and leaving it empty incurs almost no costs. The result is that real estate is liquid, and given the lack of other attractive financial assets, it plays the most important role in the portfolio of Chinese families. Data from Global Property Guide indicates that only Singapore has comparable low transaction costs in Asia, while in developed and emerging countries this is true only of the UK. For other BRICS countries the process of buying and selling a property averages around 11% of the final price in Brazil and South Africa, 14.66% in India and a forbidding 25% in Russia, Chinese buyers face a very modest buy/sell ra-

The savings glut

BY MICHELE BAGELLA

Increasing domestic demand and imports in China is one way of kick-starting the world economy. But in order to do that, the conditions for saving, rather than spending, must be in place.

ADVANCED COUNTRIES FINANCIAL BALANCES

"Why is the United States, with the world's largest economy, borrowing heavily on international capital markets – rather than lending, as would seem more natural?" This question, put by FED Governor Ben Bernanke to the members of the Virginia Association of Economists on April 14, 2005, continues to be valid at the beginning of 2013 as the figure below suggests.

The black line on Figure 3 depicts the government budget deficit recorded by advanced countries (US, Canada, Western Europe, Japan, Australia) between 2001 and 2011 as a share of GDP. The dark grey line shows the corresponding private sector financial surplus. The light grey line adds the current surplus of China and other Asian countries (the *tigers*) to the surplus of the advanced countries private sector. The fact that the grey lines are the mirror image of the black one is indicative of the imbalances that are at the origin of the global financial crisis that broke out in 2007.

As matter of fact, the crisis continues, badly affecting the European Union Economy, while the US Economy is still struggling to get past it. The developments of the recent crisis are related to two issues figuring high on the agenda of policy makers: 1) the world economic change, marked by the rapid growth of the BRICS economies, China and Brazil before all others; 2) the closer integration among the two sides of the Atlantic Ocean economies, US and Europe.

To put the question raised by Bernanke into perspective, it is important to remember that China's present rate of saving is estimated to be at around 50% of its GNP, a rate China has maintained since the early years 2000. A large share of these savings has been channelled to the US in search of "sure" investments in the international financial market. This happened with particular vigor from the beginning of the 2000s, as the Chinese Central Bank and other national authorities chose US Treasury bonds as a safe asset. This is how the US twin deficits (government deficit and current account deficit) ended up being financed by Chinese savings. It was the signal that the relationships between advanced countries and emerging countries were changing deeply – an effect of rapid growth in China. As national Chinese authorities prevented the exchange rate of China's national currency, the yuan, from appreciating in spite of China's large current account surplus, this was and continues to be the main source of the imbalances of the economic relations among China, US, and the rest of the world. In terms of macroeconomic arithmetic, the excess of Chinese saving, the savings glut, accompanied by the Chinese net export rate, guarantee the US economy the external financial resources it needs to keep growing.

This is how the US has became a debtor country, while on the other side China became a creditor country. As long as China maintains its fixed exchange rate regime, US imbalances and corresponding global imbalances will continue, strengthening the new credit/debt countries' positions in the international economy.

On the European side, Germany is in a condition similar to that of China in terms of its current account surplus. Germany has a positive net export rate and a public debt rate close to the 60% of GNP. This is the reason why it has not needed to change its export led model. But Germany is not alone in the European scenario, being part of the European Union and of the European Monetary Union. In other words, Germany is part of an integrated economic area, where its economic policy is crucial for the economic and social stability of both Unions. As is well known, there are also the Mediterranean countries – Italy, Portugal, Spain, Greece – with high rates of public debt, that are pushing Germany to adopt expansionary policies; this would imply increasing internal demand and imports in order to alleviate the recession in the eurozone, which is cutting the growth perspectives of the rest of the world, including the US.

So if China and Germany do not change their economic policy, increasing internal demand and imports, the saving glut will continue, feeding the dangerous international imbalances, that have come from unemployment and social disease everywhere. The lesson that the crisis is delivering to the world is simple: its end is linked to the role of Germany and not only to China. If both countries want to give new fuel to the engine of Atlantic growth, they have to reduce their saving glut, increase their internal demand and imports, and give to other countries of the eurozone new European financial instruments in order to reduce their public debt more slowly. If the European economy backs such shared decisions, the expectations of a positive new cycle of the world economy will start with a major strength, less biased by the imbalances that have stopped it in the beginning of this new century.

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A wall filled with cardboard notices from various Chinese companies looking for workers in Zhuji, east China's Zhejiang province. Rapid wage increases are threatening China's competitiveness.

tio of 5.26%. Liquidity from low transaction costs and the nonexistence or unattractiveness of other financial assets makes housing an appealing investment for Chinese domestic investors. But by itself it does not explain the seemingly irrational behavior of ignoring the opportunity of renting in order to maintain properties vacant.

Vacancy is high in China due to three major factors: no property taxes; low rental yields and a strong cultural preference to first usage rights. Most buyers consider that a used property has no special allure, and places that have been previously occupied can be steeply devalued by prospective buyers – there is evidence of a 50% premium for never-used properties. Since rental yields are low in China, around 2.66% per year according to Global Property Guide – India has a comparably low rental yield, while Brazilian property owners get more than double the Chinese return on renting – the rationale among domestic investors is that the devaluation that a rented property faces makes keeping it vacant preferable. Given that there are no property taxes – in Brazil, for instance, these are paid by tenants – there is almost no incentive for owners to put vacant properties into the rental market.

One of the side effects of the vacant property dilemma is the lack of affordable housing in mainland China – a perennial problem resulting from migrants and low-salaried workers facing trouble trying to live in expensive urban areas. The scenario for the Chinese government is a delicate one – too much regulation and the market may collapse, not because of a bubble, but due to its special place in Chinese families' portfolios and the composition of the GDP; too little regulation

PETER PARKS/AFP/GETTY IMAGES

A woman outside a Pudong real estate office. For the past two years, China has sought to control residential property prices with measures including restrictions on second and third home purchases, higher minimum down payments, and annual taxes in some cities on multiple and non-locally-owned homes.

PHILIPPE LOPEZ/AFP/GETTY IMAGES

and an American-style bubble may form that would create long-term havoc in the economy. The regulatory mood of the Chinese government depends on Chinese real estate data. As recently as early 2013 data suggested a buoyant market, and the central government signaled tighter regulations. If the market cools it would be expected that authorities would loosen regulations to improve market conditions. Long-term structural reforms are supposedly coming. Some cities, like Shanghai and Chongqing, have been slowly setting up property taxes. However, as other financial markets develop, demand can shift from property to more sophisticated assets. This displacement effect would unlock vast amounts of capital and would ease the long term pressures on the housing market (responsible for 13% of China's GDP). Also, property taxes would ensure long term revenues for city government that still reign in large amounts of revenue from sales of an ever diminishing stock of land.

There are signs that financial markets are changing for domestic and international investors in China. As is usually the case, the Chinese government moves at a slow pace regarding structural market reforms, especially given the delicate balance of Chinese financial markets, and the relevance of the real estate market to the economy. Residential real estate investment accounts for roughly 6% of GDP in China, according to GK Dragonomics, while property construction in general represents 11% of GDP. Any abrupt change in the residential property market can have far-reaching consequences for the Chinese economy as a whole, and it would have a huge impact on domestic investors. Reforms are forthcoming though, and the central government, according to *The Economist*, is planning to continue boosting minimum wages, loosening controls on interest rates and increasing spending on education and affordable housing.

Chinese family-owned firms face the same constraints as other small and medium-sized companies in developing countries – capital is scarce and there are not many other sources of funds apart from reinvested profits and the occasional commercial bank loan.

The paradox is that while banking loans are increasing dramatically, small companies are still struggling to find accessible capital. The link between financial and economic development is well established, but in the Chinese case economic development is happening despite lagging financial markets.

Commercial banks play such a large role in the economy that total deposits reached $12.8 trillion in 2012. Even though households' savings deposits have declined as a percentage of total deposits, the total was a staggering $5 trillion in 2012.

However, small and medium-sized enterprises (SME) continue to face a dearth of capital. Chinese entrepreneurs face an environment in which incomplete financial markets allow entrepreneurs only two options: funding from their own families and reinvested profits. The strong ownership culture and legal uncertainties result in companies that simply cannot function in the same way as companies in developed markets. If there is a bubble in the Chinese economy, it is a bubble of potential entrepreneurs and established SMEs that cannot find funding for new ventures, projects and firms.

The development of financial markets will bring two major changes to the Chinese economy: it will allow domestic investors to diversify their portfolio and therefore ease the pressure on the residential property market by stabilizing demand; and it will allow domestic entrepreneurs more access to capital. Chinese regulators have been slow in allowing the creation of more sophisticated financial vehicles, but market pressures and the need for financial development will eventually take place and transform the economic landscape of China. If the evolution of financial markets happen more rapidly, the future should see the rise of many more small entrepreneurs and new financial vehicles that will make the transition to a services economy smooth for China – maybe killing the inflated million-dollar racing pigeons market on the way. There are already 43 million companies in China, 93% of them private, according *The Economist*, and most would benefit tremendously from cheaper and accessible capital.

The new migration in China is going to be a migration of capital, from commercial banks to alternative financial markets and, to some extent, to entrepreneurs and SMEs. One of the major keys to long term economic prosperity will be the development of financial markets, and if Chinese regulators allow, it can come sooner rather than later.

A customer browsing in a pawn shop in Shanghai. China has some of the biggest banks in the world, but they turned their back on small and medium enterprises seeking loans.

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