South China Morning Post 南華早報

Housing bubble the real problem in China

Thursday, 07 August, 2014, 5:25pm
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Andrew Collier says a book that blames the US financial crisis on the drop in spending caused by declining asset values should worry China, whose own housing market is at risk of overheating

One of the theories of China's slowing economy is that it will run into a "Lehman moment". This is when a single financial institution collapses, threatening the entire banking system, ultimately creating a financial crisis.

The theory has neat predictive power: find the weak links among Chinese banks, pin down a useful measure of financial liquidity - such as the interbank lending rate - and you have a nice way of keeping tabs on the strength or weakness of China's economy. The problem is the theory may be wrong.

A controversial new book proposes a different measure of looking at the underlying causes of the American financial crisis, one that may be relevant to China. The book, *House of Debt*, by economists Atif Mian and Amir Sufi, suggests a squeeze on bank lending had little to do with the crisis. Instead, they blame aggressive mortgage lending and a surge in household debt. The collapse of house prices killed consumer spending and thus created the abrupt slowdown in economic growth.

While Chinese households are much less leveraged than the Americans of 2006, their book may have predictive value for China.

First, let's look at the evidence. The authors' main point is that the US crisis was consumption driven - and it started long before the Lehman collapse in September 2008. In fact, the National Bureau of Economic Research dates the beginning of the recession to the fourth quarter of 2007. Why did consumption collapse?

The main cause was a lending boom. Global central banks sought safe assets and the No 1 choice was US securities. They turned to a relatively small financial product called mortgage backed securities, advocated by the US government to help homeowners obtain mortgages. To satisfy demand, investment banks packaged mortgage loans into smaller and smaller pieces, or pools of mortgages. These private securitised loans rose to 50 per cent of all mortgage backed securities in 2005 from just 20 per cent in 2002.

The banks were selling hamburger as prime rib. Each one looked relatively safe but taken as a whole they were toxic. As a result, investors underestimated the probability of mortgage defaults and the correlation of those faults.

Where did the banks lend? The authors show that banks and mortgage brokers aggressively targeted low-income, marginal borrowers - precisely the group most likely to default if the economy went sour. With all this cheap money available, American household debt rose by US$7 trillion from 2000 to 2007. Not surprisingly, when housing prices fell, these poorer households lost the most.

The reason this became a national problem is that these poor and indebted households tend to spend much of what they earn - and likewise, when things go bad, they hold on to their cash. As a result of the housing crash, the decline in home values led to a US$275 billion to US$385 billion fall in retail spending, which spelled the death knell to the economy.

The authors of *House of Debt* show that counties with large declines in net worth - due to the big declines in house prices - cut their consumption by almost 20 per cent. This was almost four times the national 5 per cent decline in consumption.

What can the US financial crisis tell us about China?

Instead of focusing on the Lehman moment, when one bank supposedly took down the financial system, the book suggests a decline in asset values caused the collapse in consumption. Could this happen in China?

It is true that mortgages are less common in China than in the US. But they are increasing. In 2013, the share of property loans to total outstanding loans rose to 20 per cent from 14 per cent in 2005, according to estimates from Nomura, and now totals 10.3 trillion yuan (HK$12.95 trillion). Property loans accounted for 26 per cent of new loans in 2013.

Also, property developers are major borrowers in the shadow banking sector.

As the property market slows, the government continues to promote mortgage lending. In May, China's central bank asked the banks to give priority in mortgage lending to first-time home buyers. In July, China said it would revive mortgage-backed debt sales after a six-year hiatus. The Postal Savings Bank of China, which has 39,000 branches in the country, said it would sell 6.8 billion yuan of these notes backed by residential mortgages.

Second, while consumption is around one-third of gross domestic product in China, compared with 70 per cent in the US, the crucial issue is whether a decline in real estate values will have the same impact on spending patterns among government and corporate borrowers - where much of China's debt lies - as it did among US consumers.

It is quite likely that cash-strapped townships are going to be confronted with real estate projects that are worth much less than they thought. As asset values fall, income from land sales will also decline. Thus, they are likely to curtail spending - just as the US consumer did when the equity in their houses was wiped out.

In its just released report on China, the International Monetary Fund described the chain well: "Many strands of the web, moreover, run through the real estate sector. Banks and shadow banks are exposed to real estate directly through credit to developers and household mortgages, and indirectly through the use of real estate as collateral for other loans.

"Local government spending is also linked to the real estate sector, directly through land sales revenue and indirectly through the tax revenue generated by real estate related activity. Given these interconnections, a major shock to any part of the web would reverberate throughout the whole, creating a negative feedback loop that could … amplify the original shock."

So, let's stop getting caught up in neat catchphrases about the Lehman moment and focus on the real problem in China - the real estate bubble.

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Source URL (retrieved on *Aug 8th 2014, 1:56pm*):
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