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Property bubble risks popping in China's rural southwest

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While the word has focused on China's disastrous stock market bailout and the devaluation of the currency, a far larger crisis is brewing in China's hinterland.

China's property bubble has sagged in the big cities like Beijing and Shanghai – but it is on the verge of popping completely in the country's heartland. After spending a week in Sichuan Province, it is clear that land sales, prices and transactions are all declining in double digits.

Sichuan province is one of China's largest, in the heart of the country.

We spent some time at a residential project called Universal City Centre, about 20km from Chongqing. The 1.08m sqm property has seen prices fall one-third from 4,000 to 5,800 psm one-third to 3,000 to 4,000 psm.

The sales agent told us this project was the best among the ten or fifteen projects in the area. "It's not a good time to invest," the agent noted. "It's gone back to 1997 prices. No one is buying to invest any more," she said.

Changshou is a city 80km northeast of Chongqing. There is a newly built highway that passes for miles through rolling hills before arriving in Changshou, an unassuming town with a beaten down main street and a row of stores.

But with a population of just 800,000, are as far as the eye can see there are around 200 high rise buildings, each at least 20 stories tall, containing 250 apartments. There were no cars in front of any we visited and none of them appeared occupied. We estimate there is 4m sqm of new construction or enough for 20 sqm per Changshou family.

Estimated Construction in Changshou	
No of Buildings	200
Average Height	25
Estimated apts per floor	10
Sqm per Apt	80
Total Sqm	4,000,000
Families in Changshou	200,000
New build per family (Sqm)	20

The weakness is now showing up in some local third since the peak in 2010 to an estimated Rmb46.8bn in 2015. In volume (in Mu or 16 per cent of an acre) they have declined by two-thirds. That's a sign that developers have retreated from the market.

Some of the excess construction in Sichuan's rural areas can be laid at the feet of disgraced former Chongqing Party Secretary, Bo Xilai, who was removed

from office under a cloud in 2012. Bo had set an objective of building 40m sqm of affordable housing for 2m people at a cost of Rmb140bn from 2010 to 2013. Way too much for Sichuan's 80m residents many of whom can ill afford to upgrade.

But we believe Sichuan is not an outlier when it comes to rural construction. To prop up ailing rural economies, local governments – prodded by the 2009 stimulus –rushed to throw up building after building. But excess construction has finally come home to roost. A leading indicator of property is land sales, which fell 25 per cent in 2014 and are down 54.8 per cent in the first half of 2015.

Many surveys continue to show rising property values. The China Household Finance Survey by the Southwestern University of Finance and Economics in Chengdu notes that August 2015 home prices were higher than July's in 51 out of the 100 cities surveyed, up from just 46 communities last month. Prices continued to fall in 49 cities, compared to 53 cities in July.

Why are land sales plummeting while prices aren't?

First, much of the data is suspect because both local governments and property developers have a vested interest in avoiding bad news. Second, our interviews in Sichuan suggest that banks are continuing to support property prices by rolling over developer loans and providing mortgages. In addition, new sources of expensive private capital through the shadow market is providing an illusion of continued support for a weak market.

If we are right, and there is a crisis in the rural areas, a weak market is going to have a chain reaction effect on national GDP and local government revenue.

According to our analysis outlined in the chart below, T3-4 cities account for 67 per cent of housing under construction and 17.1 per cent of GDP, or Rmb8.6tn in 2014, larger than T1 and T2 cities combined.

Since these include less wealthy areas, the apartment are less expensive and smaller, and therefore would include a larger portion of the population, which also has fewer financial resources than residents in the larger urban areas. Any downturn would cause much more social damage to this

group.

	Housing Under Construction	Housing Investment	Investment as% of GDP	Investment GDP (RMB Bln)
Top 4 Cities	5%	8%	2.4%	1,200
T2 (24 Cities)	28%	35%	10.5%	5,500
T3-4	67%	57%	17.1%	8,550
			30.0%	15,250

Land sales supply anywhere from 20 per cent to 40 per cent of local government

revenue. In some places in Sichuan, we were told that real estate in general overall accounts for 80 per cent of local GDP. The stock market crash ironically may have helped the situation.

As Southwestern University in Chengdu notes in a research note; “However, there is a silver lining as a recent survey conducted by China Household Finance and the Survey Centre registered signs of capital leaving the stock markets for the housing sector in the second quarter of 2015.”

That flood of cash may help. But with property accounting for an estimated 30 per cent of GDP nationally and around 17 per cent from the country's smaller cities, there would have to be a huge market sell-off to make much of a dent in China's ailing property market.

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