

U.S. NEWS

OUTLOOK | By Bob Davis

# China Risks Being Next Property-Bubble Blow Up

**BEIJING**  
A RECENT DECLINE in Chinese real-estate prices is starting to shake confidence in the country's economic vitality and open a debate about whether the country's economy is over-leveraged. That's what made the real-estate bubble's aftermath so painful for the U.S. and Japan.

Just two months ago, China expert Nicholas Lardy dismissed concerns about what he labeled a "so-called property bubble" during a conference at the Peterson Institute for International Economics in Washington.

Now, he says a housing downturn could produce a "major, major economic correction" in China.

What changed? A growing realization that much of China's massive stimulus spending and lending of 2009 and 2010 ended up in land purchases, driving up prices in an unsustainable fashion. And a recognition that the Chinese economic system routinely produces bubbles and is unlikely to change any time soon.

The government keeps bank deposit rates well below the rate of inflation to benefit state-owned banks and other firms, which have the political power to defend the status quo.



With few financial alternatives to beat inflation, Chinese savers buy real estate, even if supply soars ahead of demand.

**D**URING THE NEXT three to five years, says UBS economist Wang Tao, prices are bound to head sharply upward again because of the paucity of alternative investments for Chinese savers and the reliance of local governments on land sales for revenue.

At some point, she figures, the boom could give way to a bust.

Mr. Lardy expects the cycle to play out more quickly. A number of events could trigger a big selloff, including a sharp rise in interest rates.

Estimates of how badly the economy could be damaged by a real-estate slump reflect different views of the structure of the Chinese economy.

The strength of the real-estate market directly affects the construction, steel, concrete, power and appliance industries. In all, about 50% of China's GDP is linked to the fate of its real-estate market, says Standard Chartered economist Stephen Green.

Mr. Green said a downturn wouldn't be as devastating as the burst bubbles in the U.S. and Japan. In those cases, falling real-estate prices caused bad debt to mushroom and

cripple the banking industry. However, in China, far fewer consumers use debt to buy homes.

**O**THER ANALYSTS SAY there are many more leveraged purchases of real estate than recognized in the official statistics.

To fight the global downturn, Chinese state-owned banks loaned about \$3 trillion mostly to giant state-owned enterprises. The money was reported to have largely financed infrastructure projects.

But many of the loans wound up financing real-estate purchases instead, said Deng Yongheng, director of the Institute of Real Estate Studies at the National University of Singapore.

Prices at auctions for residential land in eight major cities doubled in 2009 largely because of highly leveraged purchases by state-owned companies, he and three co-authors calculate. In March 2010, state-owned companies bid up the price of one piece of Beijing land to 10 times the asking price, according to one analyst.

The magnitude of the leveraged purchases is hard to gauge. One indication: Shortly after the Beijing land sale, the Chinese agency that oversees

state-owned companies, ordered 78 firms—whose charters had nothing to do with real estate—to cease buying and selling property. Nearly a year later, in February 2011, state-owned Xinhua news agency reported that just 14 firms had left the business and another 20 were expected to get out later in the year.

A spokesman for the agency said that the firms needed time to finish their projects.

Over the past year, Beijing has put in place measures to temper real-estate sales, including raising the minimum downpayment for mortgages on second homes to 60% and enacting China's first property tax.

But few expect the anti-bubble measures to last, given concern by the government and Communist Party about sustaining growth, which they see as a key to social stability.

Charlene Chu, a Fitch Ratings Service analyst in Beijing, said state-owned firms have taken on heavy real-estate debt. Thus a sharp fall in prices would produce a raft of nonperforming loans and "would have an outsized impact on Chinese banks."

In other words, a real-estate collapse could lead to a banking crisis—the kind of woes that have undermined the U.S. and Japan.

# Debt of Nations and Consumers Hamstrings Global Recovery

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enough to get growth back on track, economists say. Central-bank efforts have boosted financial markets in the short term—raising stock prices and significantly lowering interest rates—but they have been unable to push people and governments to whittle down debt.

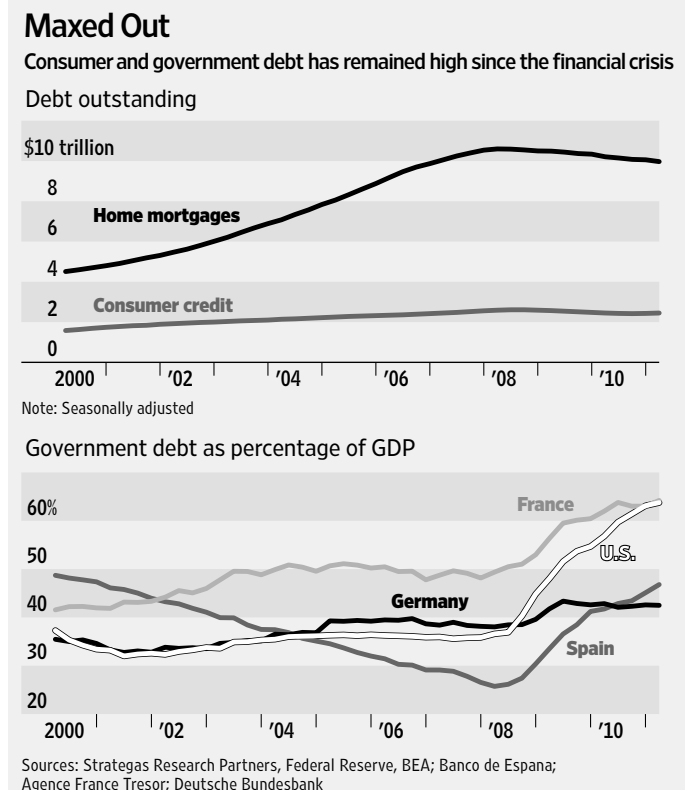
Quite the opposite has been the case. The lowered cost of borrowing has enabled individuals and governments to delay taking measures to change the way they spend and save.

Given the difficulties of paying down debt, "you have to get comfortable with the idea that it's going to take a long time for the markets to adjust and the economy to get back on solid footing," says Tom Luster, director of investment-grade-bond research at Eaton Vance Investment Managers.

Carmen Reinhart, a senior fellow at the Peterson Institute for International Economics, has said that the experience of past financial crises suggests the unwinding of debt on average takes seven years, with debt ratios not coming down significantly until three years after a crisis.

"The issue with debt is you can't get rid of it quickly and you can't get rid of it nicely," Ms. Reinhart says.

Ms. Reinhart looked at 15 post-World War II financial crises and found that seven involved a double-dip back into recession. She says the current economic weakness highlights a feature of the post-financial-crisis landscape that investors and



businesses need to become accustomed to: "The ability to absorb shocks that you normally could withstand...is much more limited," she says.

"If your household is already feeling the weight of an underwater mortgage...you're going to feel differently about adding more debt to absorb the cost of gas," Ms. Reinhart says.

Since the autumn of 2008 there have been repeated attempts by central banks and

governments to cushion the blow of the debt-cutting process. In the U.S., efforts included the Fed's first round of so-called quantitative easing, in which the Fed essentially printed money through purchases of more than \$1 trillion of mortgage-backed securities. There have been multiple rounds of stimulus by the federal government. The European Central Bank, along with the Bank of England, also employed quantitative easing.

This week the Fed is set to end its second round of quantitative easing, known as "QE2," which pumped \$600 billion into the financial markets since last autumn. All told, the Fed has flooded the markets with roughly \$2 trillion since August 2008.

Yet U.S. consumers have 37% more credit-card, auto and other nonmortgage debt than a decade ago, before adjusting for inflation, according to the Fed. That is down 6% from its peak of \$2.6 trillion hit in September 2008, but most of that decline took place within the first 12 months. Over the past year, consumer credit has been essentially flat at around \$2.4 trillion.

The news is especially grim when it comes to mortgage debt. Nearly 23% of mortgages are underwater, according to data compiled by J.P. Morgan Chase. Meanwhile, there is still more mortgage debt outstanding than there was five years ago, roughly \$9.9 trillion, according to the Fed. The result is consumers find it harder to tap home-equity credit lines or sell their houses.

Pumping money into the financial system "doesn't stop the need for the private sector to heal itself," says Dominic Wilson, chief global-markets economist at Goldman Sachs Group Inc. "We're still facing the headwinds of an economy that is struggling to get on its feet without stimulus."

On the fiscal front, the outlook is worsening. The U.S. government debt-to-GDP ratio will hit 100% this year, up from 62%

in 2007, according to the IMF. The core of Europe is seeing fiscal balances worsening as well. Germany's debt-to-GDP ratio is expected to be 80% this year, up from 65% in 2008. France will reach 88%, up from 64%, according to the IMF.

The Congressional Budget Office last week forecast that the amount of government debt will reach its highest point relative to the size of the economy since just after World War II.

This environment is a stark contrast to the so-called "Great Moderation" of the late 1980s and 1990s when economic ups and downs were shallower. That economic resiliency "had a lot to do with increased ability to access the credit markets," says Jason DeSena Trennert, chief investment strategist at Strategas Research Partners. "Without the benefits of that cushion...the volatility of economic growth is going to be greater."

The uneven economic per-

formance is translating into frequent sharp reversals of sentiment in markets. Goldman's Mr. Wilson says it is most evident in the short-term bond markets.

"It's definitely a start-and-stop flavor for the markets," says Mr. Wilson.

Another effect is that interest rates could stay exceptionally low for much longer than would usually be the case, says former World Bank official and author Liaquat Ahamed, whose book *Lords of Finance* examined monetary policy in the 1920s and 1930s. He notes rates have been essentially zero in Japan since 1995 and that during the Great Depression, the Federal Reserve cut the discount rate to below 2% in 1934 and it held at those levels until the mid-1950s.

History shows "that when people have borrowed too much, they stop borrowing and interest rates stay very low for a very long time," he says. "So you can forget about investing in bonds."

## CORRECTIONS & AMPLIFICATIONS

**Rep. Paul Ryan** is a congressman from Wisconsin. In some editions Saturday, a U.S. News article about a House vote on Libya policy incorrectly identified Mr. Ryan as a representative from Ohio.

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