

REGIONAL MARKETS: ASIA There is no shortage of liquidity in China but how sustainable is the recovery? Al Chalabi considers the issues

Running out of steam?



Real estate fair in Jiaxin: The Chinese have been developing a love affair with property for around a decade

A little over two years ago the world's financial system came close to total collapse. The epicentre of the crisis was the US and the root cause was debt. The government was forced to implement special measures to provide financial assistance to the private sector, namely the banks, in a desperate effort to prevent a cataclysmic event from taking place. Virtually limitless credit lines were offered at near zero interest rates to institutions. Quantitative easing (QE1) was introduced to the tune of \$700bn (€470bn) to bail out distressed banks and to buy up toxic debt.

On the other side of the world in East Asia, the situation was equally bleak, and even in China it looked as if the great economic run had come to an end. Order books dried up, which for an export-dependent economy meant economic contraction. US dollars were being repatriated as investors exited the riskier, emerging markets. There was a so-called credit crunch when liquidity dried up. Fearing the worst, Beijing acted promptly and engineered its own stimulus plan to the tune of \$600bn, which was equivalent to around 15% of its GDP. Its centralised government meant that Beijing was able to implement the stimulus measures swiftly and effectively. Within a few months, hundreds of millions of renminbi entered the money supply and a dramatic economic rebound ensued.

Fast forward to 2011 and we find China awash with liquidity. Real estate prices in tier-1 and many tier-2 cities continue to set new highs despite the government's cooling efforts. The biggest asset price bubble since the late 1980s in Japan continues to inflate and defy sceptics. Why are the Chinese so in love with real estate?

In a country where there is a lack of investor sophistication and a financial services sector that is still immature, real estate is the preferred investment vehicle for a number of reasons:

- Inflation in China is running at several percentage points above the best bank deposit rate, so keeping money in a bank account erodes wealth, and real estate is considered an inflation-protected asset;
- There is a wide belief that real estate is a safe asset class;
- Real estate is simple, visible, tangible and serves the basic human need of shelter;
- For most people, it is the first time in their life they have had the opportunity and the money to own real estate (a decade or so ago, the state owned everything);
- They see their peers getting rich from buying real estate and they do not want to miss out.

But it is not just China that has experienced double-digit real estate price inflation over the past couple of years; many western-based multinationals have been increasing their presence in Asia or establishing one there. This has resulted in a sharp increase in demand for both commercial and residential properties (mainly rental) from overseas, creating a supply squeeze and driving property prices and rents to all-time highs in most countries. This is particularly true in Hong Kong and Singapore where most multinationals choose to have their regional head office.

At the same time, so-called hot money from China and, to a lesser extent, Indonesia, Malaysia and Thailand has been flowing into these cities, investing heavily in real estate – both commercial and residential – because of

their liquidity, transparency and financial and political stability.

Add to that the inflows of money from Europe and the US looking to take part in the China and emerging Asia growth story, as well as the new wealth created from the boom in commodity prices, and we find ourselves in a situation where there is too much capital chasing too few opportunities, particularly in the real estate sector. And to cap it all, the cost of borrowing is below that of the inflation rate in most Asian countries, which encourages people to take on high levels of debt as the cost of servicing the debt is at near all-time lows.

How much further can real estate prices be inflated? Certainly this unique set of circumstances is unsustainable, but the factor that will trigger its unwinding could be one of several. Much of it will depend on what happens in China. With inflation at an uncomfortably high rate and rising, food prices are soaring, which affects the poor the most. This disrupts the Communist Party's so-called objective of 'social harmony' and there have been signs of unrest, but Beijing has been aggressive in quashing all protests, demonstrations and any signs of a so-called Jasmine Revolution in China, named after the wave of uprisings demanding democracy in parts of Arabia.

While China's economy will continue to grow, the 10% annual rate of growth of the past decade will likely be halved. Inflation is by no means under control and its currency remains undervalued against the US dollar. Its export-led growth model, which has worked so well since it started to open up its economy, is coming to an end. At the same time, the US economy will start to splutter in the second half of 2011 as the effects of QE2 begin to wear off, which will hamper demand for Chinese goods in an already slowing, export-dependent China.

Once Chinese banks' deposit rates become more aligned with the country's inflation rate, more savers will put their money in deposit accounts instead of real estate. This will almost certainly lead to a slowdown in real estate investment. We are still two to three percentage points away from that rate, but there will no doubt be a few more rate hikes this year.

This period of excess liquidity has undoubtedly led to over-development and over-investment in the real estate sector where many tier-2 and tier-3 cities have ghost towns of empty buildings. The lending banks have chosen not to write off these as bad loans on their books, which might render them technically insolvent, but as long as new deposits keep coming in from savers, the banks can continue to operate and lend. The Asian economies have staged an impressive comeback since the financial shocks

of 2008, but having lived through a couple of boom-bust cycles, I am not convinced of the sustainability of the recovery. I always get nervous when I hear the phrase "this time, it's different".



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