



## Another Look at China's Property Market and Financial System Stresses

Growth in China is slowing and markets are worried about debt levels and the property market. China is a big risk for our portfolios, perhaps *the* big risk. If China's economic troubles are severe, they will impact every Asian equity market. In addition, because we are somewhat pessimistic on the property and banking sectors, we tend not to hold the more risky shares (including many Chinese banks) that may rally if the situation proves less problematic than we think. The market is already pessimistic because it is pricing Chinese banks at 4% dividend yield and eight times next year's profits.

We are concerned about Chinese debt and the property market. Anyone who is not concerned has ignored Chinese officials who have openly called China's growth "unbalanced" and "unsustainable." However, many observers will try to place you in one camp or the other: extremely bullish or bearish. We try to take a much more nuanced view. Let us begin by discussing the property sector. Although there has no doubt been much new construction, we feel that too little attention has been paid either to the growth in demand or the demolition of old houses. On debt, there is much more detailed information from both private and government sources on credit in the economy and whilst the level and growth of debt is worrisome in the short term, the government has clearly signaled its awareness of the issue and willingness to tackle the problems. Nevertheless, the debt overhang is likely to reduce headline rates of growth and restrict credit over a longer period (particularly for smaller businesses).

### Chinese Property: Huge Supply? Yes, But Also Huge Demand

Real estate construction is currently at about 12% of GDP and 20% of fixed asset investment. Some argue that there are 16 to 64 million vacant residential units selling at prices far higher than the average family can afford. How can this be? How can there at once be too many units and prices that are too high? The answer, I believe, is that the arguments have focused on net new supply and have ignored the demand and the scrapping of old housing stock. The stories of overbuilding have been widespread but let us take a look, not just at this supply side but, at the demand side as well.

There are currently about 643 million urban inhabitants in China out of a population of more than 1.3 billion. And that number is forecast to rise to 925 million urbanites by 2025. So, over the next 15 years or so, China will need to add 282 million people to city life—nearly the entire U.S. population. Family sizes, too, are getting smaller, further raising the need for housing. In addition, current construction is not just about adding capacity but also about *replacing* old capacity. Thus, when we hear of "ghost cities" like Ordos (population 1.5 million+), we must bear in mind that it is already a fairly decent-sized city, sitting on huge raw material reserves and expected to grow its urban population aggressively. What people often mean when they talk of "ghost cities" is as yet unpopulated, or under-populated, new developments on the outskirts of large existing urban centers. In other parts of the country, city centers are being redeveloped, too, to create retail and office space for the growing consumer and service sectors.

China needs redevelopment because a large portion of its housing is of poor quality. Much discussion of investment in China focuses merely on the gross amount of new housing built, without considering the net addition to the number of houses after older



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poor quality housing is bulldozed to make room. As of 2005 (the latest available data), one-third of city households were living in former, low quality, state-owned enterprise housing units. These socialist era factory worker units have few amenities for modern living. Old housing is being destroyed—about 1 billion square meters worth of public housing (or about 14 million, 70-square-meter units) have been torn down, but that still leaves about 9 billion square meters of this type of living space nationwide. China’s Vice Minister of the Ministry of Housing and Urban Rural Development, Qiu Baoxing, was quoted in the *People’s Daily*, as saying that Chinese buildings can stand for only between 25 to 30 years. And the country’s director of the ministry’s policy research center has said that homes built before 1999 will be dismantled to make way for new development during the next two decades. He expects two thirds of Chinese families to be living in new homes over the next decade. That could mean half of China’s urban housing is demolished in the next 20 years. Some analysts posit that urban redevelopment is responsible for more than two-thirds of China’s housing construction. This lessens our concerns; if construction in China is improving the quality of housing, does that not surely that add value? Estimates of the total housing stock to GDP, at about 75%, look reasonable (the U.S. is twice that level), particularly in the face of so much redevelopment and upgrading.

### Conservative Financing

Housing purchases are financed relatively conservatively in China. Down payments as a percentage of household disposable income are much higher at more than 100%, whereas it is only 14% in the U.S. So, Chinese buyers are committed! Household debt is about 121% of disposable income in the U.S. (mortgage debt is 88%), whereas in China, household debt is but 33% of disposable income. And almost all of that is mortgage debt, which alone accounts for 28% of disposable income. So, households have not been “using their houses as ATMs,” and the knock-on effects of falling prices to consumer spending will be less apparent. Indeed, spending on housing has come *at the expense of* consumer spending. In the late 1990s, before housing reform, household spending was about

half of GDP, of which spending on housing was a negligible fraction. Overall spending has remained at those levels even as the consumption portion has fallen to about 35%—the gap being taken up by housing purchases. In a country in which its residents are still quite heavily restricted from investing overseas, people have a choice between: volatile equity products; bank deposits which, with inflation at 5% and higher, locks in negative real rates of return; or land assets. Thus the long-term investment motive is stronger than any speculative motive when buying a house and the ability to use large amounts of debt to finance purchases is constrained.

### Market Divide—Luxury and Low Income

China’s property market does seem distorted. There has been much focus on luxury housing. Average selling prices hardly seem affordable for the average Chinese—maybe 10 or more times annual income. But the elite can afford them. I have heard the resultant structure being described as “an artificial market,” whereby wealthy individuals or extended families are buying flats. Meanwhile, many units stay empty as prices are elevated, and many low-income families are frozen out of owning their own homes. There must be some truth to this need for more public housing, otherwise why would authorities be committed to building 36 million new units for low-to middle-income housing? Which all begs the question: “What if China’s housing market should decline?”

But why should we care if a bunch of fairly wealthy Chinese, who paid largely in cash for their homes, are found to have paid too much? The effect will be to their wealth, not their incomes. And although that undoubtedly has an impact on spending, that impact is likely to be more muted than what we witnessed in the U.S. or Europe, where the freezing of credit markets hurt overall aggregate demand in the economy and rising real mortgage rates has killed the property market and curtailed overall disposable income. This is not a “bull story” for Chinese property. Clearly, there are imbalances in the market. However, if we look at the Chinese property market through the lens of recent experiences in the U.S., we are liable to overstate the secondary effects of a falling market to China’s growth.

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### Debt Binge? How Much Credit is in the System?

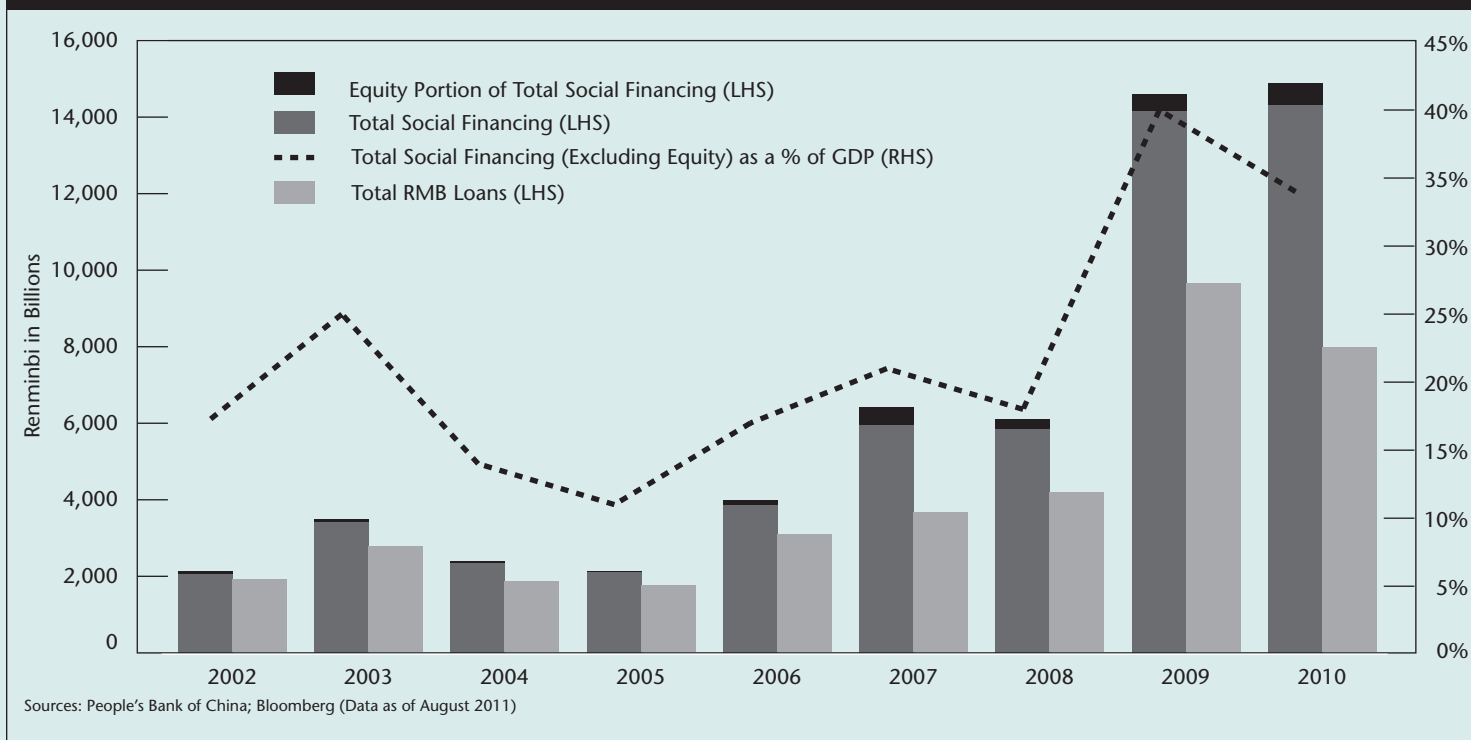
But what about credit in the economy as a whole? There has been renewed interest in credit growth in China with new, and ostensibly better, accounting metrics for measuring debt in the financial system. The People’s Bank of China itself has come out with a new measure of system-wide liquidity, known as Total Social Financing, and international rating agency Fitch and others have published their own versions of the same measure. The benefits these new metrics offer are open to debate. Fitch questions whether China has put together the right numbers (this is a disagreement about method, not about openness) but Fitch concedes, too, that its own numbers are a work in progress. Estimated total credit in China is now about 174% of GDP and expected to grow to 185% by year end. In terms of levels, this is not too different from using an

M2 or broad money guestimate. However, it does suggest that growth has been more rapid than either bank loans or M2 growth would suggest over the last couple of years. It also suggests that rather than slowing down dramatically during the last 12 months, that credit growth has slowed more modestly.

The Fitch report draws attention to the fact that the amount of nominal GDP generated per unit of debt has fallen in recent years, from 0.78 in 2007 to 0.18 in 2009. However, it also shows that ratio increased to 0.42 in 2011, i.e., the trend is back up. It is natural that this ratio be temporarily depressed as the economy is depressed and the government increases credit to stimulate growth. The question is whether this number will continue at a decent level in the future. After all, the debt is not incurred on

### CHINA FINANCING AS A % OF GDP: OLD AND NEW DEFINITIONS

“Total Social Financing,” a new monetary metric created by the People’s Bank of China, considers not only conventional bank loans but also bonds, equities, trust loans and other financing as an indicator of system-wide liquidity.



## “China’s productivity improvements have outstripped the rest of Asia and Latin America in the past decade.”

expectations of a same year payback! The absolute change in debt as a percentage of GDP, based on the new definitions, is a concern but it is less concerning in a country that is growing at such high rates of nominal GDP.

The banking system is no doubt exposed to some potential bad debts, though. I suspect relatively little will come from the housing sector and much more from loans to local government. As far as we can tell about 20% of the Chinese banks’ loan book is either mortgage debt or loans to property developers. And this ratio has not changed very much over the past decade. Net new mortgage finance as a percentage of sales value has also been falling after a 2010 surge, suggesting affordability is not a great issue. As for local government loans, there is 14 trillion renminbi of such loans outstanding, of which 5 trillion can be estimated to have been “stimulus” or fiscal spending. Assuming these are the vulnerable loans, expected losses may reach 4% to 5% of Chinese banks’ loan book portfolios. Government officials are already circulating ideas about issuing new bonds to refinance this local government debt.

### **How Serious is This?**

The recent data on Chinese debt has greatly worried investors. However, it seems to me to be less about the property market (which seems overheated yet not a severe risk to the system). Rather, it is about the rampant credit growth since 2008. The key here is efficiency—after all, if the money is well spent, then raising debt at a time of low interest rates is the right thing to do. Estimates of government debt, local and central, are at about 60% of GDP (more extreme numbers claim 90%). This level seems reasonable in the context of a government that can raise long-term debt at less than 5% in an economy growing in nominal terms at over 15%. And an economy where that growth has been created by sustainable

productivity improvements, i.e., profitable growth, not just increases in capital spending. China’s productivity improvements have outstripped the rest of Asia and Latin America in the past decade and yet it still has plenty of room to improve or “catch up.” This is not suggestive of an economy bumping up against a growth barrier.

Indeed, analysis suggests that what China faces is a period of growing debt more slowly than nominal GDP. The banking system is clearly vulnerable and continues to raise capital, more than US\$70 billion in 2010. Officials will hope that the economy can continue to grow quickly as China slows credit growth, just as it did in the five years prior to 2008. However, that seems overly optimistic. More likely, continued policies to slow credit growth will impact both real and nominal GDP growth. (Interest rates on private sector non-bank loans for small businesses have recently reached nearly 70% in parts of the country.) The real message to me from the recent data is not that China is headed for a meltdown but that the period of tighter policy may have to continue and room for further stimulus is limited. These restrictions must surely affect headline rates of growth.

But even growth of 7%, for example, plus 5% inflation, means that China can grow its way out of these issues. It has the luxury of vibrant business demand and an emerging consumer, manageable overall levels of debt, high productivity and a motivated workforce. Yes, China has been living with the aftereffects of an unrestrained credit binge since 2008. However, I still think that this is just a more manageable version of what the U.S. would look like now if the stimulus had worked. And it is surely a much better scenario.

**Robert Horrocks, PhD**  
**Chief Investment Officer**  
**Matthews International Capital Management, LLC**

This month's *Asia Insight* focuses on the topic of China's Property and Banking Sectors in a conversation with the following Matthews Investment Team members:

- ✿ **Robert Horrocks, PhD**, Chief Investment Officer and Portfolio Manager, Matthews Asian Growth and Income Strategy
- ✿ **Richard Gao**, Portfolio Manager, Matthews China, Matthews China Dividend, Matthews Pacific Tiger and Matthews China Small Companies Strategies
- ✿ **Henry Zhang, CFA**, Portfolio Manager, Matthews China and Matthews China Small Companies Strategies
- ✿ **Yu Zhang, CFA**, Portfolio Manager, Matthews Asia Dividend Strategy

### **Are you concerned with the quality of mortgage loans or the pace of new home construction in China?**

**Henry Zhang:** One area of concern has less to do with the quality of mortgage loans and more to do with the impact of slowing property sales. As the government continues to curb property speculation, it takes much longer for developers to sell projects. In the meantime, it also becomes more difficult for developers to obtain debt financing. As a result, we have seen some land auctions fail because there weren't enough bidders or bidding prices were too low. Because land sales remain a major revenue source for local governments, a slowdown in land sales might put more pressure on local government financing vehicles, and thereby impact bank balance sheets.

### **Are you getting the sense from Chinese government officials that there is a shortage in public housing?**

**Richard Gao:** Yes, in fact, at a recent conference in Chongqing we heard a local public official say that there will be 800,000 units in the public housing sector built in Chongqing over the next three years, providing 2 million people with public housing. This is a program that the local government has been developing very seriously. The demand and need for low-cost housing seems like an area that will help temper the overheating property situation.

### **Tell us about the quality of the housing stock.**

**Yu Zhang:** There is a lot of room for improvement with the state-owned housing. They often lack piped gas and broadband service is difficult so enhancements here could spur a lot of growth in other areas. I also think that observers just tend to look at the new developments and overlook the fact that there are many discrepancies between cities of varying sizes. There's a tendency to view China as one homogenous group but there are many different layers.

**Robert Horrocks:** These are not fantastic places to live in and selling rights for these units are not often clear. I've spoken to some people who say it's not too difficult and others who say it's very bureaucratic. But the question is who would really want to buy these anyway, so in all likelihood a lot of these will probably be scrapped. In addition, a lot of these places are sort of dormitories that were part of factory production centers so you'd have factories right in the middle of the city so there were really no services, no shopping malls. Now, they are becoming much more consumer-oriented so the nature of the cities themselves is changing, and there is a greater sense of redevelopment.

### **How do you view the current health of China's banking system as it relates to loans?**

**Richard Gao:** I think that currently China's banks are fairly strong in terms of their loan asset quality and their asset growth. During this past earnings season, we saw good earnings and average ratios for nonperforming loans were just over 1% and China has really come a long way in achieving that. I think that, going forward, there may likely be some deterioration in the loan quality. There are still risks in the local government financing vehicles. There have been stress tests done and, even assuming high levels of nonperforming loans, the situation should be relatively controllable. The government has also taken very aggressive steps to control these issues in its banking system.

We should also note that we believe it generally makes more sense to seek exposure to Chinese banks via some Hong Kong banks that are more efficiently run and regional banks with the focus and exposure to high net worth clients.



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Four Embarcadero Center, Suite 550 | San Francisco, CA 94111

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#### Questions about the Funds:

800.789.ASIA (2742)

#### Advisor Services:

888.289.7988  
[advisorservices@matthewsasia.com](mailto:advisorservices@matthewsasia.com)

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