China Property Collapse Has Begun

April 10, 2014

Nothing is going right for Hangzhou at this moment. Walmart will be closing its Zhaohui store in that city on April 23 as a part of its overall plan to dump marginal locations—about 9% of the total—in China.

Thanks to the world's largest retailer, another large block of space in Hangzhou, the capital of Zhejiang province, will go on the market at a time when there is generally too much supply. The problem is especially pronounced in the city's premium office market. Hangzhou's Grade A office buildings at the end of 2013 had, according to Jones Lang LaSalle, an average occupancy rate of 30%.

The real weakness, however, is Hangzhou's residential sector. The cause is simple: massive overbuilding. Sara Hsu of the State University of New York at New Paltz writes that Hangzhou faces "burgeoning swaths of empty apartment units."

Hangzhou's market has not yet collapsed. There are still secondary sales, for instance. Singapore's *Straits Times* reports Allen Zhao, a businessman, has been looking to sell his two-bedroom flat in Hangzhou for 2 million yuan. His neighbor just let go a similar unit for 1.7 million. If Zhao also sells for that amount, he will make a profit, but he will be disappointed. "That is not much more than the price I paid in 2012," Zhao told the paper. "Now I'm regretting not selling earlier—more bad news about the property market keeps coming in every day."

New homes also face price pressure. Developers in Hangzhou are now offering deep discounts, and investors and owners are noticing. And not just in that city. "It seems that the 30% price cut in Hangzhou really changed the way Chinese people think about real estate," writes Anne Stevenson-Yang of J Capital Research, "and I doubt there is any turning back from here."

Not every developer is offering such deep discounts, but as Stevenson-Yang tells us the city has become the symbol of a market in distress. China Central Television on the first of this month devoted a segment to the problems of the "unstoppable price decrease" in Hangzhou property in its *Economic 30 Minutes* show, and discounts in that city, the *Wall Street Journal* notes, could be "a signal of broader market weakness ahead."

The real estate market in Hangzhou looks like it has just passed an inflection point. It is not so much that fundamentals have deteriorated—they have been weak for some time—as that people's mentality has changed.

As state-run China Central Television explained, the problems in Hangzhou, once the world's largest city, began on February 18. Then, the North Sea Park development began offering deep discounts. Rumors that the developer had cash problems started a chain reaction across the city. It did not matter that North Sea Park issued denials. Other developers began offering either deep discounts or large incentives, but the tactics did not work. By then, there were almost no buyers.

Now, the problem of no buyers is spreading across the country. Sara Hsu notes China's residential markets are becoming inelastic. "Once consumers stop buying," she writes, "deep discounts are ineffective in drawing them back." People aren't buying because they believe prices will decline further.

According to the National Bureau of Statistics, new home prices across the country are still going up, but percentage increases have now declined for three consecutive months, signaling a peaking.

Official statistics do not seem consistent with the general trend of reports, but in any event severe problems are evidently ahead. The secondary property market has tumbled, with sales falling by more than half in Q1 2014 from the same quarter in 2013. Speculators have either left the domestic market or have sold off holdings. Rich Chinese, now interested in foreign holdings, are also shunning their home market. Foreigners, who own only an infinitesimal portion of China's property but who are a bellwether nonetheless, are investing at the slowest pace in at least a decade. Middle class Chinese are also largely out of the market.

And that's not all. China property trust sales plunged 49.1% in Q1 2014 from the previous quarter, from 99.7 billion yuan in Q4 2013 to 50.7 billion yuan. The precipitous fall was due in part to the failure last month of developer Zhejiang Xingrun Real Estate, which had 3.5 billion yuan of indebtedness.

Moreover, just about everyone expects more developers to close their doors. For one thing, the central bank is not injecting liquidity as fast as it once did. And interest rates are increasing, the reason why a Finance Ministry one-year bond auction failed on Friday. Many private developers had gambled that property prices would rise faster than interest rates, but that now looks like a losing bet. Zhejiang Xingrun, for one, became insolvent after it had borrowed at ultra high rates.

China is at the point where problems are feeding on themselves. Pessimism about property, which accounts for about 15% of China's gross domestic product, is beginning to affect the broader economy. Declining property values look scary, despite cheery statements from government officials who assure us the property bubble is "not big" or analysts who say that the problems are not "systemic." But the Chinese don't look like they are buying either of those views. "If this continues, it will have immense impact on the whole Chinese economy," says an unidentified Hangzhou real estate salesman on *Economic 30 Minutes*. "Without question, everyone thinks there is a bubble."

The People's Republic in the "reform era" has not suffered a nationwide property crash. Analysts say the problems in Hangzhou are "regional," but now fundamentals and market sentiment either are or will be pushing markets down across the People's Republic.

"The banking system and the shadow banking system are becoming concerned about exposure," says David Cui of Bank of America BAC -2.17%. "Once people refuse to provide credit to developers, their balance sheets will be under pressure, forcing them to cut prices. Once enough of them cut prices, fewer people would buy because most people buy property only when they think the price is going up. If this persists, it will turn into a vicious loop."

Premier Li Keqiang has a few tools at his disposal, but they look insufficient to stop a general collapse of property prices across the country. The problems, deferred from late 2008 with massive state spending, have simply become too large. And we must remember that he works inside a complex, collective political system that is generally unable to meet challenges swiftly.

But that does not matter. There is little any leader can do. Collapses occur when people lose confidence. That is now happening in China.

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