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Commentary

China: faster pace of reform but growth stability is key

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The momentum of reform looks set to grow in China this year with detailed measures being developed and implemented after a comprehensive scope was laid out by President Xi Jinping at the Third Plenum in November 2013. Since then, conferences and working groups have been held to work on the details of the reform measures, with some policies drafted and approved. In this commentary, we analyse the impact of key measures on the country's economic, business and property market outlook.

Reform highlights

The key reform measures include:

1) Easing of one-child policy to allow couples to have two children if one of the parents is an only child[1];

2) Relaxation of the hukou (or household registration) system to support urbanisation;

3) Land ownership and transfer rights to be given to farmers[2] to sell land directly without involving local governments with the objective of raising farmers' income and reduce land grabbing;

4) Better management of local government debt. Some local spending responsibilities like healthcare, environment and infrastructure will be shifted to central government. More stable revenue sources for local governments, such as bond issuance and property tax will also be introduced. A nationwide real estate registration system will be set up along with the property tax system;

5) Restructuring of state-owned enterprises (SOEs) by introducing private ownership to increase efficiency and supervision;

6) Financial deregulation, which includes the liberalisation of interest rate and capital account, to be stepped up. The central bank recently allowed banks to trade deposits with each other at market-determined prices and will also lessen its foreign exchange interventions and expand the cross border use of RMB;

7) More free trade zones (FTZs) to come; and,

8) Reduction of shadow banking activities which includes a ban on moving interbank loans off balance sheets to reduce reported levels of lending.

Accelerating pace of reform

Several unprecedented measures were announced at the Third Plenum which marked a new milestone in China's reform after changes stalled for a decade. President Xi Jinping is pushing forward tough reforms that the last leadership did not see through such as the hukou and one-child policy reforms.

The scope and speed of follow-ups reflected the President's consolidation of power as well, which is an important signal of the strength of his leadership and the reforms that will come. Mr. Xi showed his firm grip on power by personally steering the economic reforms and leading the drafting of the resolution at the Third Plenum. He now heads a newly created central leading group to guide changes and bypass bureaucracy and a new National Security Commission[3]. Mr. Xi is now known as the most powerful man since Deng Xiaoping.

Although it will take time for comprehensive reform to take place, this means the restructuring will be moving at a faster pace. There will be short-term pain for some sectors and the economy during the transition

[1] Previously, only families where both parents are the only children are allowed to have two children. Rural families can have a second child if the first child is a girl or is disabled, and ethnic minorities are exempt.

[2] Under the current system, rural land (for both residential and agricultural use) is owned by collectives - villages and townships - and contracted out to farmers. Rural land cannot be used by entities outside the village without approval. The land must be expropriated by local governments before it can be sold on the market.

[3] The National Security Commission will be in charge of making overall plans and coordinating major issues and major work concerning national security.

period but the reform will be good for the long-term sustainability of economic growth.

Impact on overall economy

Greater role for private market

The Third Plenum was implicit in giving the market a bigger role, allowing for more efficient allocation of resources and weaning the economy off the cheap credit that had contributed to excess capacity.

During the reform process, there will be occasions of heightened stress when a major default threatens or takes place. However, we believe the central government will closely monitor and calibrate their actions, and not let panic spread through the market. While the central government is adopting a credit tightening bias, it also has sufficient reserves to weather a liquidity crunch.

More business opportunities will arise as China introduces private ownership in SOEs, and allows more private domestic and foreign banks to operate in the country. However, this will take time as strong resistance is expected from the SOEs and financial deregulation has to be measured to control risks.

A more consumer-driven economy

While the hukou relaxation plan may not necessarily increase China's urbanisation rate, it supports the objective of increasing domestic consumption by raising the migrants' standard of living. The rural land reform will also provide farmers with more income through land sales and thereby increasing their consumption power which will bode well for the retail sector.

Sustainable population growth

The one-child policy reform has been estimated to only encourage 1 to 2 million additional new births every year[4]. By contrast, the labour force shrank in 2012, by 3.45 million, for the first time in decades. Some have thus criticised that this relaxation has come too late. Nevertheless, it is better late than never. For developers, there could be more upgrading demand for larger homes as family size grows.

Impact on the property market

Non tier-1 cities to benefit

Non tier-1 cities with stronger economic drivers will be able to attract migrants more easily as the hukou restrictions will first be removed in towns and small cities and gradually eased in mid-sized cities. Although the population growth in Tier-1 cities will be strictly controlled, they will nevertheless remain attractive given their strong economic drivers.

The property markets in the more economically attractive smaller cities will benefit. This will help to ease the housing oversupply situation that some of these cities face[5] as migrants can more easily purchase homes, especially in the affordable and mid-market housing segments given their lower income level. There could also be more upgrading housing demand for bigger homes in the medium term as the one-child policy reform takes effect. As more people move into the cities and income rises, the consumer sector will grow, supporting demand for retail space and logistics space.

Introducing more stable revenue sources for the local governments such as the property tax and shifting some spending responsibilities to the central government would help reduce local governments' reliance on land sales which had contributed to oversupply in many cities. However, the effectiveness will depend on the policy details. For instance, it is estimated that the annual property tax revenue could make up for 20% of annual land sales proceeds (RMB 618 billion) assuming that the tax is fully levied on all properties but the figure is only 0.7% (RMB 22 billion) if the tax is only charged on new transactions[6].

[4] Wang Feng, a demographer at the University of California, Irvine, quoted in the Economist on 15 November 2013. Citigroup economists Nathan Sheets and Robert A. Sockin put the figure at 1.5 million which was quoted in the Wall Street Journal on 22 November 2013. No official estimates from China.

[5] Alpha Watch: China Residential January 2014

[6] Citigroup, Detailed Reform Plan in 3rd Plenum: Sector's Growth Seed Sowed, 18 November 2013.

A healthy property market

The nationwide real estate registration system and property tax could curb speculative activity. The registration system will allow the authorities to detect multiple property ownership more easily. A property tax at an appropriate rate can also incentivise owners to lease out or dispose vacant homes. However, the effectiveness depends on the policy details, as seen in Shanghai and Chongqing where prices continued to surge despite a trial property tax in place since 2011 due to many exemptions and low tax rates[7]. The database will also provide more transparency and clarity to help policymakers better understand the supply-demand imbalance in certain parts of China and address them appropriately. This would help to ensure a more sustainable and healthy property market in the long run.

More FTZs to speed up deregulation process

The relaxation of cross border use of RMB for trading activities and other deregulations to come in future will ease doing business in China and support demand for commercial and industrial space with spillover to the hospitality, retail and residential sectors. Financial deregulation will however take time as China needs to first develop a stronger institutional and regulatory framework to control financial risks but more FTZs could speed up the deregulation process. This could mean more competition to Shanghai's FTZ although it will have a headstart and much also depends on the focus of the FTZs. There are reportedly 12 interested regions including Guangdong and Tianjin.

[7] The taxes are levied only on certain homes, such as newly purchased homes or luxury homes. The property tax rate in Shanghai is currently 0.4% to 0.6%, while in Chongqing it ranges from 0.5% to 1.2%, subject to certain criteria.

Opportunities present but being selective pays

Tighter credit and higher interest rates may temper domestic property investments. This however presents opportunities to foreign investors who can obtain better credit terms and buy off smaller developers with tight cashflow or credit problems. Given the oversupply in certain cities and sectors, investments will have to be more selective depending on the demand and supply conditions, growth drivers and reform details in each city.

China outlook

Growth is expected to be slower in 2014 in the range of 7.0-7.5% as credit becomes tighter to control overcapacity and local government debt. 22 Chinese provinces and regions – including Beijing and Shanghai – have set lower growth targets for 2014 compared with last year, ahead of the national target to be released in March. Nevertheless, it is still a high growth rate among other countries and the absolute quantum of growth is sizeable.

The ultimate pace of reform will however depend on growth stability as a slower growth rate could lead to social unrest when the unemployment rate rises. The new leadership will likely keep its eye on domestic social implications and not sacrifice growth too much although it is prepared for slower growth to restructure the economy.

With the reform, we can expect more financial openness and sustainable economic growth which are positive for the property sector. However, the heady days of cheap land and overwhelming demand are over; investors will have to do their homework and be more selective.