



## Lessons from China's Housing Bubble

*Nicholas R. Lardy explains China's nuanced approach to letting the air out of its housing bubble, providing potential lessons for the United States.*

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Steve Weisman: Is China undergoing an asset and housing price bubble similar to the one that the United States went through that led to the current crisis? This is Steve Weisman at the Peterson Institute for International Economics with Nicholas Lardy, senior fellow at the Institute, who's been studying China and looking at this phenomenon recently. Thanks, Nick.

Nicholas Lardy: Thank you, Steve.

Steve Weisman: Is China's asset price bubble something to worry about and are the Chinese worried about it?

Nicholas Lardy: Certainly, the Chinese are worried about it. Earlier this year, prices of real estate in China were rising at an all-time record level since they created a housing price index a number of years ago. So they have been concerned that a bubble is being created, if [it's] not already in existence.

Steve Weisman: What are they doing about it?

Nicholas Lardy: The authorities in China have taken a unique approach to dealing with the property bubble, rather than the kind of standard approach that you'd expect to see in a market economy, where you raise interest rates across the board in order to curtail the demand for housing. They have taken a very selective approach and made housing more expensive for investors, speculators, property flippers—who they believed constitute a significant portion of the kind of extra demand that is pushing prices up rapidly.

Steve Weisman: How did they accomplish that?

Nicholas Lardy: They basically discriminate against people [who] have more than one mortgage, [who] own more than one house. In the current environment, for example, if you want to take out a mortgage on a house that you are not going to live in, a nonowner-occupied house, you have to pay down 50 percent of the purchase price before you can get a mortgage—as compared to an ordinary buyer who, as a first-time buyer, would have to pay down only 20 percent. And the interest rate that the investors, if we want to call them that, would have to pay would be about 50 percent higher. In other words, if the standard mortgage was about 5 percent, the investor/buyer would have to pay 7.5 percent interest. And they also discriminate against these investors in terms of the tax treatment of property. They have to hold the property for five years in order to avoid a tax when they sell it. And for the owner occupier, they only have to hold the property for two years.

So, rather than pushing on the brakes [in a way] that affects the whole economy, all the interest-sensitive sectors of the economy, they go after only the housing market. They try to curtail demand by those people who they believe are speculators in the market and are responsible for a large part of the excess demand, particularly in the primary cities. There aren't maybe so many speculators in tertiary, secondary cities. But Beijing, Shanghai, some cities in South China, a popular resort-type city in Hainan Island way down in the South with a lot of beaches, they believe that speculators come in and buy up dozens of properties and then hold them off the market with the hope that they would be able to resell them in a substantial profit at some point in the future.

Steve Weisman: Do you suppose that China was listening to the debate in the United States in 2008–09 about whether big steps like raising interest rates across the board can prick asset bubbles and they took a more of a carefully defined approach?

Nicholas Lardy: I think their approach is much more nuanced. It's very carefully targeted against a small subset of the buyers and does nothing to slow down demand for housing on the part of first-time buyers. China is undergoing rapid urbanization. There's a big demand for housing. They didn't want it to be unaffordable, and the way of doing that is to not to raise the interest rate or the downpayment requirement for the first-time buyers but to raise it dramatically for the speculators, and that tends to hold down prices. They did this also starting in late 2007. Within a few months, property sales slowed down. A few months after that prices start to moderate. And within about eight months, China entered into a period where for six consecutive months housing prices actually fell. But they didn't fall dramatically; they were falling on a year over year basis by 2 percent, 3 percent per month. So they demonstrated in that previous case that there was a lot of air in the balloon, but they could let the air out gradually and have a modest price correction without popping the balloon and having a housing crash.

Steve Weisman: Do we have a sense of whether that's happening now?

Nicholas Lardy: I believe it's happening now. They started putting in some of these discriminatory measures against speculators back in December. They accelerated them in April. And in June, for the first time in more than a year and a half, the prices of property began to fall on a month over month basis. In other words, the prices in June were down about 1 percent compared to what they had been in May. And I think we will now enter into a period where prices will fall slowly and the price index will reflect a decline in demand. It takes a while for property developers to try to keep their prices high as long as possible. But when demand falls dramatically, eventually they have to start cutting prices. And I think we'll see something similar to what we saw the last time around—a period of several months where prices declined on a month over month basis and the air goes out of the balloon. I think it's very unlikely that we're going to have a bursting bubble with major macroeconomic consequences.

Steve Weisman: There are some analysts who are still concerned. Are they not looking at these figures?

Nicholas Lardy: There have been people arguing about a housing bubble in China over the last decade. I think by and large, it has not been a big macroeconomic phenomenon. There's been overinvestment in housing in some cities but we don't have a massive national price correction that can cause the kind of financial meltdown that we saw in the United

States over the past couple of years. In part because, in addition to this nuanced policy to get investors to exit the market from time to time, they also have a much more sensible general policy: Everybody has to pay down 20 percent. So they don't do the no-down-payment loans. You'd have to have a pretty massive price correction before you'd have a significant number of homeowners in a negative equity position, which of course was the beginning of the real problems in the US market back in 2006–07.

Steve Weisman: Is there a lesson to be drawn for the United States from what China has done?

Nicholas Lardy: I don't think there is much doubt that if we'd had policies similar to those that are in place in China today, we would not have had a big housing bubble. Remember, the epicenter of the housing bubble in the United States was in a handful of cities where there were massive purchases by property speculators. Places like Las Vegas, Phoenix, certain cities in California, Southern Florida. If all of those speculators had to put down 50 percent of the purchase price, a lot of units never would have been built and we would have some steady price appreciation rather than the kind of burst in acceleration of prices that we saw in the middle of the last decade.

So I do think there are lessons. The lesson is: rather than using a hammer in raising interest rates for everybody on all kinds of purchases, whether it's cars or credit cards or housing, you selectively impose higher cost for people that are speculating on the future increase in the price of property. And if you increase their cost enough, their demand will come down and you'll get that excess demand out of the market and I think have a much more sustainable development of property, avoiding the booms and busts that we've seen in the United States.

Steve Weisman: Nick Lardy, thanks for that fascinating tour of the China housing situation, which is much more relevant to the United States than one might suppose.

Nicholas Lardy: Thank you, Steve.

