HD **A crisis made in China?**

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The strength of a nation derives from the integrity of the home

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Confucius

Wise words indeed, and ones that are especially apt at present. Australia is not the only country that finds itself having to come to terms with a rapidly changing economic landscape. More importantly – for the world, at least – so does China. One of the key indicators for both countries is the performance of their respective real estate sectors. Like so much these days, they are intertwined and sending out ominous signals.

China's problems have been a long-time in the making and are of a different order to Australia's. In some ways China's problems are far from unique and are simply replicating a long-running story that is as old as human civilisation: over time people move off the land and into cities. This is still the case in China but, like everything else in that remarkable country, it is happening on an epic and unprecedented scale.

To the central government's credit, it has tried to manage this process and in many ways it has been remarkably successful. However, there are limits to what even the most authoritarian and interventionist of states can do in managing economies, much less the people that make them up. Bad decisions can have monumental consequences. The collective response to the misnamed global financial crisis now looks like a quintessential case in point.

China was largely unaffected by the GFC thanks to a massive government-ordered domestic stimulus package. Unfortunately, much of the subsequent investment ended up in the hands of property developers and speculators. A nexus of local governments keen to sell land for development, so-called "shadow banks" keen to lend, and a growing class of wealthy investors looking for high returns on investment, fuelled a surge in apartment-building across China.

China's notorious "ghost cities" are the most graphic illustration of massive, unconstrained construction that is surplus to the needs of the population – or that part of the population with lots of money, at least. By some estimates there are something like 50 million empty properties in China, or a vacancy rate of nearly 25%. Unsurprisingly prices are steadily declining despite the efforts of state and provincial governments to prop them up. Prices fell by an average of 10% in the first half of this year, and new construction starts have fallen by something like 25%.

While this may look like a necessary and overdue return to economic reality, the consequences for China's numerous, increasingly exposed and over-reliant trade partners are potentially grim. For example, China has the capacity to produce 1 billion tonnes of steel each year; now however, a third of this capacity is unused. The implications for Australia are all too predictable and manifest primarily in the plunging price of iron ore.

Yet it's important to recognise that Australia – or more accurately, the mainly foreign-owned resource companies that dominate production in this country – has contributed mightily to this problem. The massive increase in investment over the last few years has had its intended consequence: an equally massive expansion in production. It's hard to believe that the lavishly rewarded captains of industry who run these companies can have been entirely surprised that an increase in supply would have an impact on prices, with or without China's domestic problems.

Apparently they are. Unfortunately the resource sector may not be alone in succumbing to short-term and wishful thinking. Real estate in Melbourne and Sydney looks wildly over-valued in historical and comparative perspectives, and yet the property bubble continues to inflate. We might do well to remember another timeless piece of wisdom: things that look like they cannot go on forever usually don't.

There may be further to go before real estate in Australia takes a similar hit, however, and China is playing a part in this, too. A lot of the smart money is fleeing China as investment yields decline, the local environment deteriorates, and the political situation remains unpredictable. Rising real estate prices in Australia look like a good bet and also have the additional benefit of providing a potential bolt hole if things go wrong in the People's Republic.

Rather worryingly, Australian officials have little understanding of the impact of Chinese money on real estate prices here, or little capacity (or desire?) to do much about it. The rules designed to regulate the foreign purchase of domestic real estate are notoriously easy to get around and the Foreign Investment Review Board seems to have little capacity to enforce them or detailed understanding of what is happening on the ground. According to a recent report in the AFR, though

foreign investment in real estate surged to $24.8 billion in the first nine months of 2013-14, an increase of 93% on the previous year

There are few subjects about which people get more excited than real estate. It would be unfortunate if the idea took hold that foreigners were pricing the locals out of the market, especially as the forces driving house price rises are complex and still largely domestic, it is argued. Nevertheless, the possible export and influence of China's property problems could add an unwelcome and possibly avoidable additional complication to what is an especially important, but occasionally fraught, relationship between Australia and China.

Mark Beeson does not work for, consult to, own shares in or receive funding from any company or organisation that would benefit from this article, and has no relevant affiliations.

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