

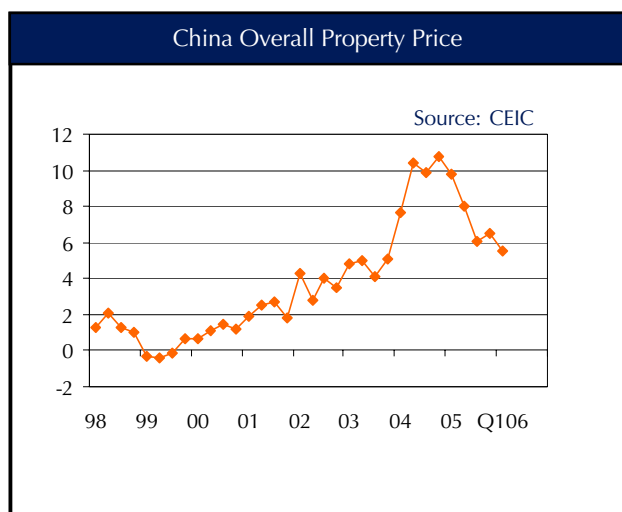
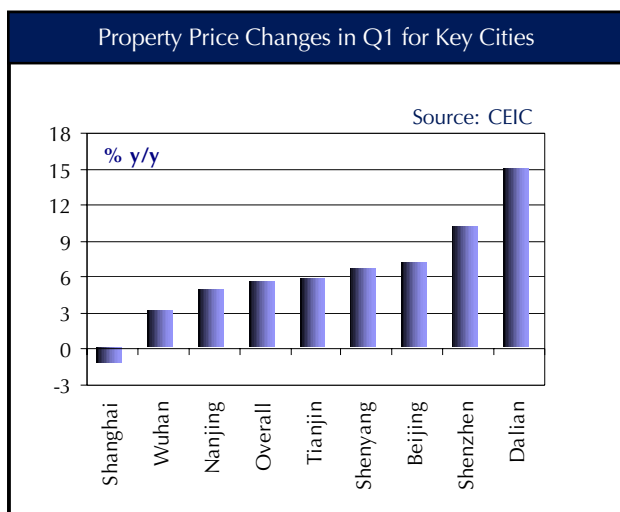
Recent Developments in Property Market

Summary

- Soaring property prices in China in recent years are driven by underlying shift in rural-urban migration pattern, capital inflows in anticipation of both capital appreciation and RMB appreciation, as well as flush liquidity in the system.
- The Chinese authorities have imposed a series of measures in reaction, but these are mainly aimed at containing speculative price rises at the high-end segment, while at the same time, ensuring sufficient housing supply to meet the demand of a burgeoning urban population.
- As such, these tightening measures are seen to have only moderate impact on the overall market and the two main causes remain to be addressed, i.e. anticipated appreciation of the RMB and flush liquidity.

Property Prices Soaring in China

In recent years, property prices in China have soared, with some key cities such as Beijing, Suzhou and Shenzhen experiencing the sharpest increases. For instance in 1Q06, overall property price rose 5.5%/y/y but prices in Beijing soared 7.1% and close to 15% in Dalian. Real estate is a unique good in that it embodies both consumption and investment qualities.



Key Factors in These Price Increases

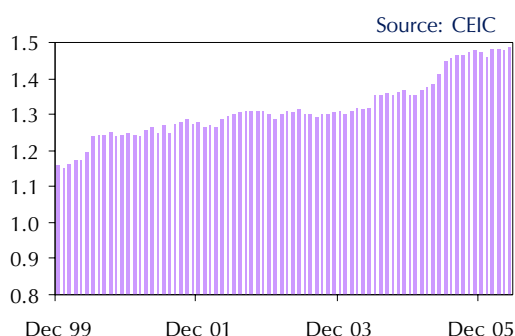
The key drivers behind these price surges have been a greater rural to urban migration flows as well as capital inflows from foreign individuals and institutions, in anticipation of a stronger RMB. Flush liquidity in the Chinese banking system from domestic savings (which amounted to RMB15.35tn as of May 2006) also contributed to the excessive investment in the real estate sector.

Price Increases Confined in High End Segments

China's current property demand situation has indeed turned speculative in the luxury housing segment. This is reflected in Chinese government's implementation of a series of measures to cool that market segment. The table below highlights the list of measures implemented by the authorities so far in 2006. Note that these measures are geared towards the duo objectives of curbing speculative demand while at the same time, increasing the affordable housing supply to meet the demand of a burgeoning urban population.

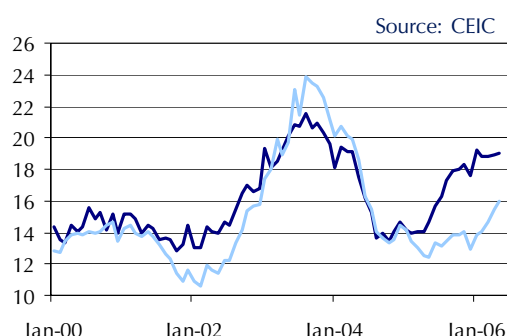
Bank Deposits and Loans

■ Proxy Measure for Excess liquidity
(Ratio of deposits against Loans)



Money Supply M2 and Loans Growth (YOY)

— Money Supply M2
— Financial Institution Loans



2006 Policies that Would Impact China's Property Market

- 28 April** The PBoC raised the 1-year benchmark loan interest rate for financial institutions by 27 bps from 5.58% to 5.85%. This was the first rate hike since October 2004.
- 8 May** Mortgage rates were raised by 0.18%.
- 17 May** Adoption of a six-point set of guidelines to regulate the property and housing markets. Some of the notable measures:
- Raising mortgage down-payment for apartments bigger than 90 sqm from 20% to 30%. Effective 1 June 2006.
 - 35% of the project cost must come from the funds of the property developers, and properties that have been vacant for more than 3 years cannot be used as collateral.
 - A sales tax of 5.5% to be charged on the sale proceeds of property held up to 5 years (instead of 2 years imposed previously)
 - 70% of annual residential land sales to be allocated to low cost housing.
 - 70% of apartments built in the newly approved construction projects must be less than 90 sqm.
 - Fees to be imposed on developers for land held idle for 1 year. The land will be confiscated if it remains undeveloped for more than 2 years.
 - BoC may also use "Window guidance" to slow real estate sector lending.
- 16 June** PBoC raised commercial banks' reserve requirements by 50 bps, from 7.5% to 8%, effective 5 July. The move is expected to drain RMB150bn from the banking system.
- 20 June** The Ministry of Finance will start selling non-tradable, RMB-denominated savings bonds exclusively to retail investors. The bond sale is aimed at diverting household deposits and limit bank's lending ability.
- 22 June** China plans to restrict foreign investors' Chinese real estate purchases and the new rules may be announced sometime in June.

Source: Various sources

So far, the measures implemented have been modest and the impact is perceived to be moderate at best in the short term, with property prices in key cities still expected to be increasing for the rest of 2006 albeit at a slightly slower pace. Nonetheless, the barrage of economic and administrative measures does signal to the market the government's willingness and determination to tackle the over investment situation before things get out of hand.

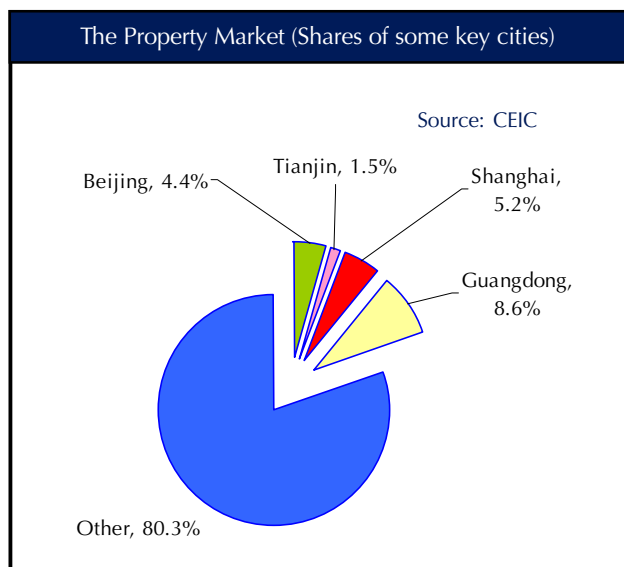
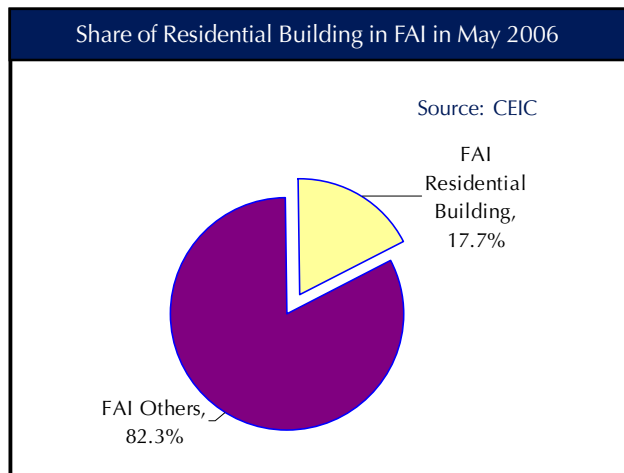
CHINA

Tightening Measures Unlikely to Choke off Overall Growth

By pricking the property bubble now, will the slowdown in property sector be a drag to fixed asset investment (FAI) which has been a key growth driver to China's GDP? The answer is yes but probably not much. Residential building construction constitutes only less than 20% of FAI. And since the measures are particularly aimed at curbing the luxury housing projects, the impact will be even smaller. Available estimates suggest high-end residential segment probably constitutes only 6-7% of building construction, or less than 3% of total construction activity which includes infrastructure and non-residential projects. Banks' exposure to the slowdown will also be fairly limited as short term loans to the construction sector only constitutes less than 4% of overall short term loans. Furthermore, the fact that investment into real estate is essentially non-productive, so the measures could potentially divert capital to more productive use.

Addressing the Critical Issues

Recent developments in the Chinese property market have certainly caught most people's attention, but the measures so far have generally targeted at speculative activity while leaving underlying/genuine housing demand largely intact. And even if the luxury housing bubble does burst in the short term as a result, we expect the impact from the fallout to be confined within that segment and unlikely to spread to the rest of the property market, much less the real sector. Of greater concern though are the issues of excess liquidity and expectations of future RMB appreciation which are considered the underlying causes of speculative element in China's property market woes.



1) Flush Liquidity

Unlike other emerging markets which have seen liquidity being squeezed out recently by interest rate hikes and tumbling equity markets, China's bank system remains flush. As mentioned earlier, the excess liquidity environment can largely be attributed to strong domestic savings and the influx of foreign funds anticipating a RMB revaluation.

2) Pace of RMB Appreciation trend

While the PBoC would wish to drain the excess liquidity from the system, it is hampered by the constraint that the authorities are unwilling to allow an accelerated pace of RMB appreciation. Nonetheless, as long as the market expects a rising RMB in the future, more capital will continue to flow into the banking system, exacerbating the excess liquidity situation. The excess funds in turn, will eventually find its way into the property market and FAI, perpetuating the cause-and-effect cycle between the exchange rate, liquidity conditions and asset inflation.

3) Other Tightening Measures

The government may try other ways of tightening liquidity such as issuing local currency non-tradable debt. And interestingly, the structural reform process of the non-tradable shares issue on the A-Stock market may make the domestic bourse a beneficiary for some of the excess funds, diverting them away from real estate although the amount diverted may be small relative to the overall size of the excess funds. Although the authorities will employ various administrative measures and policies to some degree of success, the liquidity situation is likely to persist until the RMB is finally appreciated according to market expectations.

Conclusion

The Chinese government is concerned about the overheating property market and has demonstrated their conviction to tame the soaring property prices by implementing a series of varied measures. The measures announced so far are directed towards containing speculative demand in the luxury housing segment. Damage will be limited, probably only 6-7% of the overall residential investment. In long run, the supply of affordable housing should improve.

The tougher underlying issues the Chinese government needs to be tackling are excess liquidity and tempering the expectations of a stronger RMB. As long as these two issues remain unresolved, the ammunition will always be lurking in the corner to fuel future property bubbles.