

Are real estate prices in China unreasonably high? A perspective from chinese stock market

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Abstract

This note tries to argue that the high real estate price in China have solid foundation from an angle that we usually adopt to explain Chinese stock prices. Government control makes the land supply in large cities extremely tight compared to rising demand and high growth rate of household income can also sustain high estate price to some extent.

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Nowdays the housing price in the first tier city in China is catching up with New York and London; however, household income in even the most developed area in China is far lower than those in developed country. It is also notable that the rent to selling price ratio in China is extremely low and households' claims on housing are not even perpetual. One may also argue that life quality in China is low and environment is bad and they are likely to have adverse externality on housing price.

All those opinions above are of course reasonable. However, this is not to say that housing in China is all about bubble. To understand to logic of Chinese housing market, you have to understand the popular phrase "Chinese characteristics" first

Growth stock and value stock

The key point to understand that why housing price has a higher rent to selling price ratio in China is to recognize the fact that average growth rate is more than 6% in China but less than 3% in developed countries.

With 2-3 times the growth rate of household income, Chinese housing is just like growth stock. In stock market, the average P/E ratio is usually barely above 10. For instance, JP Morgan has a ratio of 11, Apple 13 and Standard&Poor 500 index composite 9.6. On the country, as the representatives of growth stocks, Google has a P/E ratio of 31, Amazon 198, facebook 61 and Alibba 37. Large capital growth stock usually have P/E ratio three times that of value stock and small capital growth stock can have ratios of over 1000.

As is generally agreed that a higher P/E ratio for growth stock is reasonable. If we regard real estate as investment, then it's reasonable that house in China has higher P/E ratio because the market price embrace the fact that household's ability to pay mortgage increases fast. Consider that if you buy a house in Beijing at 5000 per square meter 10 years ago and have to pay over 2000 mortgage per month. You may find them a large amount 10 years ago, but not so much with today's household income.

	P/E ratio or rental to housing price
Shanghai Composite	15.59
Shenzhen Composite	26.32
SSE SME composite	51.67
Start up Board Composite	78.55
Shenzhen housing market	62

Approval-based and registration-based IPO system

According to the general plan of Shanghai, the development region of the city will be limited within less than 2700 square kilometers while a majority of land will be kept for agriculture land.

It is hard to understand the economic logic behind such a plan since the housing price in Shanghai city is skyrocketed and the marginal productivity of agriculture activity on the land surrounding the city is nearly zero compared to

their value as city land. With strict control of land by government, the market is very inefficient and the distribution and value of land are distorted. Even if purchase regulation policy is implemented and demand shrinks, as long as the supply of housing remains in such a tight state, we find it hard to think of a day when housing price drops.

To compare land supply in China and US is like to compare the IPO system of stock markets in these two countries: they imply completely different investment logic. While US stock market favors large capital stock and pay close attention to corporate profit record and returns stock investors in Chinese stock market favors small capital stock because they like story and restructuring expectation: under approval-IPO system, the position of listed stock itself is a valuable asset. That's why small capital stock can function as a shell: they value increase tenfold when capitals of other corporations are injected through restructuring or backdoor listing.

To think about land, the price of land in developed countries is largely determined by a competitive land market, providing few opportunities for extra returns above expectations so as investment, a majority of houses generate profits from rental income. However, China has a completely different story: with speeding urbanization and controlled supply of land, land price and thus housing price is far higher than can be justified by rental price. In such a situation, profits in market mainly come from reselling the house, which is the profits of speculation. As the bull market of housing has last for such a long time, the liquidity is very good.

Considering the situation that a small capital and worst performing stock in Chinese stock market is very welcomed by the investors because of its shell value. We find it easy to interpretate that in US, the older house usually have lower price than new house while in China old house is surprisingly valuable: because their owners are likely to benefit from government's demolition and becomes a millionaire within days.