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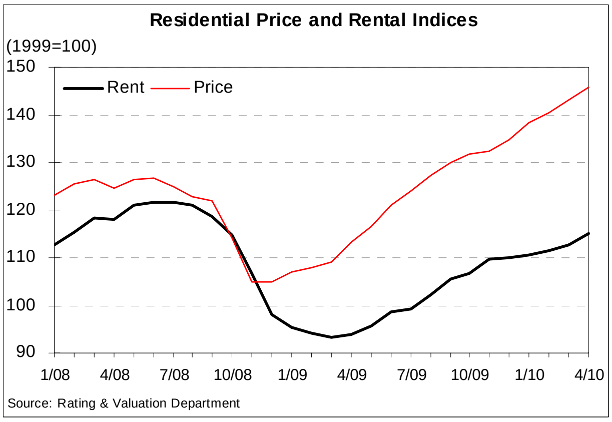
Hong Kong Property Market

Background

Hong Kong's economy has staged a steady recovery from the 2008 financial crisis. Year-on-year GDP growth returned in the fourth quarter of 2009, and GDP rebounded to a robust 8.2% year-on-year rise in the first quarter of 2010. Unemployment, after a short bump upwards following the financial crisis, has fallen back to 4.6% in May 2010. With improving economic fundamentals, residential housing rents in April 2010 are 23% above the lows experienced in March 2009 and just 3% below the pre-crisis level. Residential property prices have rebounded even more strongly, and are up 39% from the lows in December 2008 and 20% above the pre-crisis level in September 2008.



The upsurge in property prices has been so rapid that it is now causing some alarm. Housing is the largest single expense for many households, accounting for 29% of consumer expenditure (based on composite CPI). The private rental housing component of the CPI basket has risen by 21.4% between 2005 and 2009, outpacing the 6.7% increase in non-housing consumption. Rents have also outpaced the estimated 11% rise in the household income of those living in private housing during the period. The sharp rise in the cost of rental housing, plus the improvement in employment prospects, has fuelled growing end-user demand for property for sale, to escape from rising rents.

Thanks to the ultra-low interest rate environment, mortgage payments currently remain within an affordable range for most households. In the first quarter of 2010, a typical family with a median household income[1] used 42% of its earnings to make mortgage payments for a 45-sqm residential unit, below the 20-year average of 53%. However, the mortgage interest rate for prime-rate-based mortgage plans is currently in the range of 2-2.5%, while that for HIBOR-based plans is as low as 1%. If mortgage rates return to the 4-5% level seen before the financial crisis, mortgage payments will increase dramatically. According to a study by the Hong Kong Monetary Authority (HKMA), a 3% increase in mortgage rates will push regular mortgage payments up by about 30%.[2]

The price of a 45-sqm residential unit was equivalent to 8.7 times the annual median household income in 2009, nearing the previous high of 9.3 times in 1997. Hence, property prices measured in terms of household earning power are near historically high levels. Pinpointing the factors underlying the rise in property prices is crucial in determining the appropriate policy response.

Large Size Unit Leads the Current Run in the Housing Market

The rise in luxury property prices has attracted the most attention over the past year, even though this rise has been part of a long-term trend. From the third quarter of 2003 to the third quarter of 2008, the average price of flats with a size of 100-sqm and above (large size flat) rose by 140%, while the average price for flats with a floor area of less than 100-sqm (small and medium size flat) increased by a more restrained 107%. The faster price increase in larger flats is not due to supply side constraints. The total stock of large flats rose by 8.8% between 2003 and 2008, against 7.6% for small and medium size flats.

The change in household income distribution is a key factor behind the differential. Between 2003 and 2009, the number of high-income households ($50,000 per month and above) grew by around 32.4%, while that of middle-income households ($15,000-49,999 per month) only grew by about 12.9%. Further, the "2006 Population By-census" shows that high-income households experienced faster income growth than middle and low-income households between 1996 and 2006.[3] These changes in income distribution have raised demand for large properties relative to demand for small and medium sized properties.

Meanwhile, investment demand has also played an important role. An increasing number of investors are buying property to hold – not necessarily to generate income – and this has resulted in a rise in vacancy rates. Between 2000 and 2008, the vacancy rate for large units

[1] For households living in private domestic housing, Quarterly Report on General Household Survey.
[2] HKMA presentation submitted to Legislative Council on 13 May 2010.
[3] The median household income of the 10th decile group (i.e. the 10% household with highest income) increased by 11% from 1996 to 2006, while the changes in median income of the middle-income groups (comprising the 5th to 9th decile groups) ranged from -4% to 7%.

averaged 8.8%, while that for small and medium sized units averaged 5.7%. Over the period, only 64% of newly completed large units were owner-occupied, as compared to 83% for small and medium sized units.

The divergence has grown even more acute in 2009. The vacancy rate for large units rose to 10.5% in 2009, while that for small and medium sized units fell to 3.8%. Only 39% of newly completed large units were owner-occupied in 2009, while the ratio for small and medium sized units stood at 77%. This indicates that investment interest in large flats has risen to a new level.

Owner-occupied units as % of newly completed units which are occupied

	2005	2006	2007	2008	2009
Small and medium	89%	70%	65%	74%	77%
Large	***71%***	***60%***	***50%***	***66%***	***39%***
Overall	87%	69%	64%	74%	74%

Source: Rating and Valuation Department

Strong investment demand is supported by the ultra-low interest rate environment. With deposit rates at less than 1%, capital has flowed to the asset markets in search of better yields. As a result, rental yield for residential properties fell to only 3.5% in March 2010, while that for large flats dropped to 2.6% and below.[4]

In addition, there has been an influx of funds from the Mainland. With increasing affluence, people from the Mainland have been seeking investment opportunities, and property investment is a popular choice. Hong Kong, with its proximity to the Mainland and well-established capitalist system, is among the most attractive destinations for Mainland capital. There are reports that Mainland buyers have accounted for about 20% or more of transactions at projects in Hong Kong Island in recent years.

Investment and end-user demand competing for housing resources

While investment demand is largely focused on luxury properties, there are worrying signs that the surge in prices for large housing units is being transmitted to the small and medium size housing market. Due to strong demand, increasing number of new projects are aimed at the luxury market. In 2008 and 2009, large units accounted for 13% and 34%, respectively, of total completions, compared with a range of 4% to 10% in the previous decade. In 2010 and 2011, the projected production of large units remains high at 10% and 15%, respectively, of total completions. Thus, competition for scarce land resources is crowding out the supply of small and medium size housing.

Compounding the problem, overall supply is far down on earlier levels. Only an average of 6,167 small and medium size units came onto the market in 2008 and 2009, one quarter of the supply in 2004. Although completions are projected to rebound to an average of 11,073 in 2010 and 2011, the new supply is still lower than the average of 17,845 over the decade 2000-2009. The drop in completions has contributed to the 38.8% surge in prices of small and medium size housing units from December 2008 to April 2010. This has priced many potential homebuyers out of the market. Hence, boosting the supply of small and medium size housing units is critical to calm the social outcry against high property prices.

To discourage property speculation, in October 2009 the HKMA announced a limit on the loan-to-value ratio for properties valued at or above $20 million, and the Government announced in February this year that it would raise stamp duty for such properties.

As mentioned earlier, cheap borrowing costs have contributed to the current exuberance in the housing market. Interest rates will remain low until early 2011, when the US will likely begin to raise interest rates again thus pushing Hong Kong Dollar interbank rates higher. Prime based mortgage rates will probably trend higher slightly later – in the second half of next year. Nevertheless, the low interest rate environment is a cyclical phenomenon and will only have temporary effect on the housing market. Boosting housing supply is the fundamental solution to the current imbalance.

Meanwhile, the long-run implications of the capital influx from the Mainland on the Hong Kong housing market are less clear. Mainland investor participation in the market has the potential to structurally alter the balance between end user and investment demand. Experience on the Mainland could give a glimpse of the possible impact on Hong Kong. Although housing supply on the Mainland has grown dramatically in response to end-user demand, speculation in the property market has continued to grow. Similar to the situation in Hong Kong, investment demand has been focused on large units, and luxury projects have crowded out the supply of smaller size units. This has left real end-user demand unsatisfied, and led to rising concern among the public. In response, the Chinese government has clamped down on the availability of credit, and introduced higher down-payment ratios and differentiated mortgage rates for second and third home purchases.

As Hong Kong becomes increasingly integrated with the Mainland economy, Hong Kong will need to study and adapt to market forces from the Mainland. From property investment, to the influx of Mainland tourist arrivals to pregnant woman coming to Hong Kong to give birth, the integration process will bring both economic benefits and social implications. Appropriate adjustment is necessary to maintain harmony. The balancing work will be more challenging for the property market. Investment interest from the Mainland has the potential to overwhelm Hong Kong's housing market. Ability to assess Mainland investors' activity in the housing market is limited, given the current lack of relevant data. Also, the time lag between a change in housing supply and the impact on the housing market increases the difficulty in designing policies to address any problems. Since the influence of Mainland investors on the Hong Kong economy will only grow over time, more policy research on this area is necessary.

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[4] "First Quarter Economic Report 2010" by HKSAR Government and Rating and Valuation Department.