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# Economic Analysis

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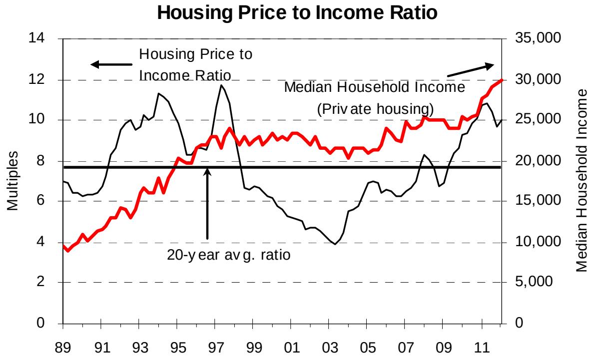
## Health of Hong Kong Property Market

Since 2003, Hong Kong property prices have charted a steep upward trend, and there is no sign yet of any let up. Comparisons with the United States in 2008 and our own experience in 1997 are being made more and more frequently, and regulators and government officials regularly warn of the risks of a new property bubble. Perhaps most worrying, high prices are putting the acquisition of a first home beyond the reach of many ordinary families. The frustration experienced by first-time homebuyers is fanning social tensions and could lead to more general unrest if not addressed adequately.

Property prices surged 82.1% between the end of 2008 and the first quarter of this year. The sharp run-up in prices has been supported by ultra-low interest rates and rising incomes. For those living in private quarters, household income surged by 13.9% in the first quarter of 2012, compared to the same period one year ago. Meanwhile, the increase in property prices slowed to 6.3% in the year to March. With low mortgage rates keeping monthly mortgage payments in check, the housing affordability index[1] improved to 46.4% in the first quarter from a peak of 48% in early 2011. The affordability index also remains below the average of 49.3% over the 20-year period 1992-2011. One could be forgiven for thinking that the market is both healthy and well-supported.

However, using an alternate indicator, the picture is not quite so reassuring. The ratio of property prices to income[2] stood at 9.9 times in the first quarter. While this is off the peak of 10.9 times in the second quarter of 2011, it is still significantly higher than the average of 7.7 times over the past two decades. The affordability index would deteriorate if interest rates start to rise. This will pose difficulties for households servicing a mortgage, particularly those who purchased a home at recent high prices.




Sources: HKMA; HK Census & Statistics Department; The Bank of East Asia, Ltd.
Assumptions: 20-year mortgage payment for a 45sqm flat to median households, excluding those living in public and subsidized housing

### Solid Fundamentals Temper the Risk of a Housing Bubble

Hong Kong can take consolation from the fact that both the overall economy and the financial system are sound. The government and local banking regulator have responded to rising prices by tightening lending rules and imposing a series of anti-speculation measures. The loan-to-value ratio for higher priced flats, investment properties and properties owned by non-residents has been reduced. Mortgage applicants are subject to stress testing, to determine their ability to cope if mortgage rates rise. The introduction of a special stamp duty directed at the practice of flipping properties for a profit has also assisted in quieting speculation.

Perhaps most important, Hong Kong has not experienced the rapid credit expansion usually associated with a housing bubble. In the US, credit disbursed for home mortgages jumped by 115% between 2000 and 2007, more than double the 41% increase in nominal GDP. Between 1990 and 1997, Hong Kong experienced a 271% increase in mortgage lending, significantly outpacing the 129% increase in nominal GDP. However, between 2004 and 2011, home mortgages (including portfolio purchased by the Mortgage Corporation) increased by just 46.4%, only slightly faster than the 41% expansion of nominal GDP during the period. As a result, mortgage lending as a percentage of total loans outstanding actually dropped, from 35% in 2004 to 23% in 2011.

The painful experience of negative equity following the burst of the 1997 property bubble still haunts a large section of the general public. Hence, the persistent rise of property prices over the past eight years has not resulted in the same blind optimism among local people.

Furthermore, mortgage demand has actually been falling in recent years. Over the past 10 years, the number of homeowners without a mortgage on their own property has jumped from 505,375 to 741,433, while the number with a mortgage has declined from 537,230 to 492,261. One of the reasons for this shift is the aging of the baby boomer generation(born between 1946-1965). The 55-65 age group jumped by 83.8% during the past decade to 922,635. As the older baby boomers approach retirement age, they are paying back their mortgages. The net effect of the deleveraging process has been to reduce the vulnerability of the financial system to fluctuation in property prices.

[1] Ratio of mortgage payment for a 45-square meter flat to median household income (excluding those living in public housing)
[2] Ratio of price for a 45-square meter flat to annual median household income (those living in private housing)

## High Property Price Fuels Social Discontent

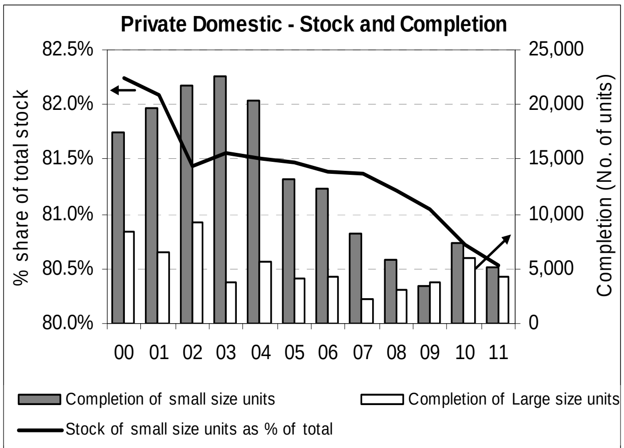
While the financial system may be relatively safe, rising discontent among those who cannot climb onto the first rung of the housing ladder is a growing concern. Pent-up end-user demand for housing is on the rise. The number of domestic households increased by 14.1% between 2001 and 2011, exceeding the general rise in population of 5.4%. The growing number of smaller families is the major reason. The number of households with two or fewer members increased by 30% during the past decade. As a result, average household size dropped from 3.1 to 2.9 during the period.

A rise in the divorce rate is one of the key factors contributing to the trend of smaller household size. The total divorced population jumped by 82.5%, or 125,708, between 2001 and 2011, consistent with the 38.8% surge in single-parent households over the period. Another factor is the increase in newly wed couples. The number of marriages registered during the period 2002-2011 was 25.4% higher than during the period 1992-2001, even though the overall population increased at a much lower rate in the last 10 years compared to the 1990s.

This trend has led to stronger demand for smaller housing units[3]; however, supply has been trending in the opposite direction. Completion of smaller housing units as a percentage of total supply dropped to an average of 52.6% during 2009-2011 period, compared to an average of 74.5% over the 2000-2008 period. As a result, the number of smaller housing units as a percentage of total housing stock has dropped to an historic low of 80.5%.

There is no doubt that there is high demand at the luxury end of the market. Attention has focused on Mainland investors, who spent a reported $83.8bn purchasing residential property in Hong Kong in 2011, accounting for 19.2% of the value of all transactions, and 11.1% of the total number of transactions[4].

However, less attention is paid to the rising number of high-income persons in Hong Kong. The number of Hong Kong residents earning a monthly income of $60,000 or more jumped 55.8%, or 52,969, between 2006 and 2011. The number had actually dropped by 5.1% over the preceding five years. This turn-around has translated into strong demand for trading up to larger housing units[5]. Since price per square unit of larger units is higher than that of smaller units, the growing market appetite for large units motivates developers to focus on larger flats.



Source: Rating and Valuation Department

The tight supply of smaller housing units is also reflected in the vacancy rate, which fell to an average of 3.5% over the 2009-2011 period, as compared to an average of 5.4% during 2001-2008 period. For larger units, the vacancy rate maintained at a stable range. As a result, between 2006 and 2011, rents for smaller units rose by 49.8% while sales prices rose by 99.9%, outpacing the respective 36% and 78% increases for larger units. Faced with expensive rent and sales prices, renters of private housing are caught between a rock and a hard place.

## Conclusion

Housing is a necessity good as it accounts for 31.7% of household expenditure, and hence is a popular investment asset as it brings stability to household finance in long run. Low mortgage rates during most of the last decade have made servicing mortgage payments easier. According to the 2011 Population Census, mortgage payment as a percentage of household income has fallen from 30% to 20% between 2001 and 2011. Meanwhile, the rent to household income ratio remained within the 25% range. Many have taken advantage of these trends to purchase a home, as indicated from the increase in the home ownership share from 50.8% in 2001 to 52.1% in 2011.

However, property prices have jumped sharply in recent years, and the amount of down payment required to purchase a home now lies beyond the range of an ordinary family. Many are young families with genuine housing needs. The absence of a credible response to address the issue has fuelled public discontent. Assisting home purchase for potential owner occupiers at an affordable price level will enhance social stability. This will be the foremost challenge for the new administration.

[3] Includes Class A (less than 40 sqm), B (area of 40 to 69.9 sqm) flats
[4] Source: Research Department of Centaline Property
[5] Includes Class C (area of 70.0 to 99.9 sqm), D (area of 100.0 to 159.9 sqm) and E (over 159.9 sqm) flats