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Development of Hong Kong Property Market

Amidst the perfect storm of a low interest rate environment, quantitative easing by major central banks and a tight demand-supply balance of flats, Hong Kong's residential property prices skyrocketed by 69% between end-2009 and end-2012. Rents also climbed dramatically, increasing by 37.2% over the same time period.

As flat prices have outpaced the growth in income by a significant margin since 2004, affordability[1] has deteriorated. Mortgage payments for a 45 sqm apartment accounted for 56% of median household income in the first quarter of 2013[2], higher than the ratio averaged 48% during 1993-2012. The burden is destined to become even greater in the coming years, with interest rates expected to enter a rising trend.

Government Measures to Cool Market Fever

Starting 2009-2010, the authority introduced a series of measures to discourage property speculation and guard the banking industry from the risk of mortgage loan default.

The Hong Kong Monetary Authority (HKMA) has launched 6 rounds of mortgage tightening, through reducing the maximum loan-to-value (LTV) ratio. Properties that are prone to speculative activity, including commercial and high priced residential properties, have received particular attention. For purchases by foreigners and property investment, additional reductions of LTV are applied. The measures have lowered the average LTV ratio to 54.3% in May 2013 from 65.3% in April 2009. The lower LTV ratio serves as a buffer to protect banks in case of a dramatic price correction.

When measures to curb lending proved insufficient to reign in prices on their own, Government introduced a new tax, the Special Stamp Duty, that imposes an additional stamp duty of between 10% and 20% of the transaction value on residential property resold within three years of purchase. This measure has successfully curbed short-term transactions, with the number of transactions for properties held for less than 2 years plunging by 95% compared with the average over the period January to November 2010 to less than 150 in April 2013[3].

While the measures have helped to enhance financial stability, they have done little to address rising social discontent in the wake of the disappearance of affordable housing. The sales price of an apartment smaller than 40 sqm jumped by 80.9% during the period from 2009 to 2012, while rents climbed by 43%, exceeding the overall market increases. Many blame a property buying spree by Mainland investors for the sharp rise, as developers turned their focus to production of luxury flats at the expense of basic housing.

In October 2012, the government introduced a 15% Buyer's Stamp Duty on residential property purchases by any person other than a Hong Kong permanent resident or company. Purchases by those non-Hong Kong permanent residents accounted for just 4.4% of total transactions during the first 4 months of 2013, markedly down from the average of 13.5% in 2012. As a further measure to contain investment demand, in early 2013 the ad valorem stamp duty was doubled to as much as 8.5% for all property deals over HK$2 million.

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[1] Home purchase affordability is defined as the ratio of mortgage payment for a 45-square metre flat to median income of households, excluding those living in public housing

[2] Hong Kong Economy, HKSAR, "*Economic Report*" and "*Economic Background and Prospects*" (various years)

[3] Hong Kong Economy, HKSAR, "*First Quarter Economic Report 2013*" (May 2013)

Policy Evaluation

With such a strong policy response, most buyers have been pushed to the sidelines and are taking a wait-and-see approach. Between February and July 2013, residential property prices rose by a modest 2%. Meanwhile, under the low interest rate environment, alternative investments remain unattractive and property investors are in no hurry to unload their stock. As a result, transaction volumes have plunged. Residential property transaction volume totaled 81,333 in 2012, 26.7% lower than the average level during 2007-11. The volume plunged by another 32.4% in the first seven months in 2013 to 31,700.

The Hong Kong experience contrasts starkly with that of Singapore. Also affected by low interest rates and a surge in overseas buying interest, Singapore's property prices at the end of 2012 had risen by 60% from the low in mid-2009. The market-dampening measures introduced in the two places were also very similar. However, residential property transaction volume in Singapore totaled 37,856 in 2012, 18.7% higher than the average level during 2007-11.

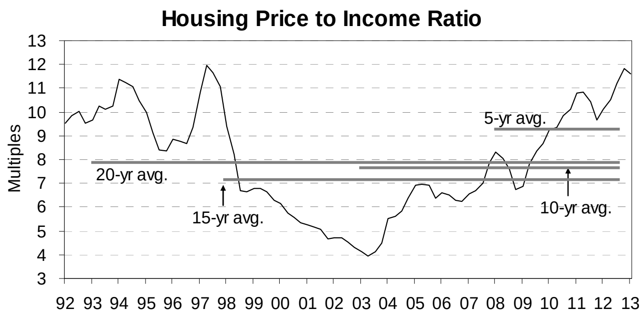
In Singapore, fully 90% of those living in public housing own their units. As a consequence, the vast majority of Singaporeans have benefitted from rising property prices. They have been able to "trade up" as property prices climbed higher. In 2012, those living in public housing made up 53% of purchases in the primary market. Just as important, the government has increased housing production in response to the growing demand. The number of uncompleted private residential units launched averaged 17,467 during 2009-12, 77.4% higher than the production during 2005-08.

In contrast, an average of only 10,040 private housing units was produced annually between 2009 and 2012 in Hong Kong, 24.4% lower than the supply during 2005-08. With the shortage of private housing, not only home purchase is increasingly out of reach to ordinary families, many low income families and individuals are squeezed by the rising housing rent and forced to trade down to smaller or older flats. The government must boost supply to provide affordable housing to the general public.

Long-term Forecast for Property Prices

The SAR Chief Executive has put solving the problem of high property prices high on his policy agenda. In his first Policy Address, he said that the government's policy objective for housing is to "assist the public to choose accommodation according to their affordability and personal circumstances and to encourage those who can afford it to buy their own homes"[4]. This begs the question of to what extent property prices need to adjust to be affordable to Hong Kong people.

With affordability as the prime consideration, the price-to-income ratio (price of 45sqm apartment/annual median household income[5]) is used as the yardstick. The ratios during 2003-12, 1998-2012 and 1993-2012 averaged 7.7 times, 7.1 times and 7.8 times respectively. This suggests that the price-to-income ratio at between 7 and 8 times is the long run affordability range for Hong Kong people. We believe that this should be considered as the target for the SAR government's housing policy.



Sources: HKMA; HK Census & Stat. Dept.; The Bank of East Asia, Ltd.
Assumptions: A 45sqm housing unit using class A housing price; Annual median household income(excluding those living in public and subsidized housing)

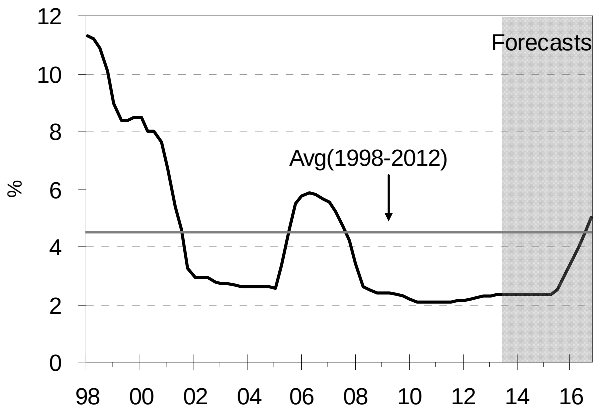
However, the ratio averaged 9.3 times during 2008-12, and reached a peak of 11.8 times by the end of 2012. The ratio has stayed above the long-term affordability range due to a number of factors. The historical low mortgage rate eases the burden of mortgage payments, allowing buyers to purchase a home at a higher price. Low housing supply and the emergence of Mainland buying interest has bid up prices.

Nevertheless, corrections are under way. The 15% Buyer's Stamp Duty applied to non-Hong Kong permanent residents has kept Mainland buying fever under control since its implementation.

[4] The 2013 Policy Address, HKSAR
[5] Excludes those living in public and subsidized housing

The US Federal Reserve has indicated that the US may begin to raise short-term interest rates when US unemployment falls below 6.5%. It is forecasted that this could occur in the mid-2015, opening the door to a rise in US interest rates. The US Fed Fund Rate is forecasted to increase by a total of 2.5 percentage points during 2015-16. The HKD mortgage rate is forecasted to increase at the same pace and reach 4.85% by the end of 2016, which is close to its long-term average level.

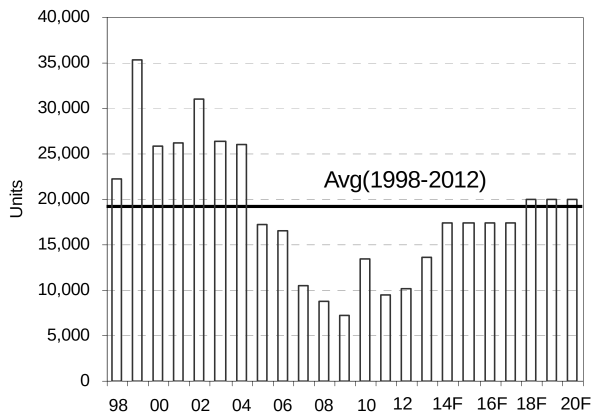
Mortgage Rate



Sources: HKMA; The Bank of East Asia, Ltd.

At the same time, housing supply is forecasted to rebound. While housing supply averaged only 9,787 units during 2008-12, the government expects the supply will reach a total of 70,000 units in the coming 3 to 4 years. Under the most conservative scenario, that will be translated into a supply of 17,500 units in 2016. This is close to the average supply of 19,096 during 1998-2012.

Private Housing supply



Sources: Rating & Valuation Dept.; Transport and Housing Bureau

With the unusual factors affecting the market in the past few years out of the way, the price-to-income ratio for the housing market is likely to trend toward its long-term average. To bring the price-to-income ratio to 8 times (the upper limit of the long run affordability range) by 2016, either wage growth has to speed up or prices will have to fall. Taking the 3.5% average growth of median household income during 2008-12 as an example, if income growth maintains at this pace in the next few years, the housing prices will be adjusted downwards by 22% during 2012-16. Households should keep a close watch on the potential impact of the expected rise in interest rates and housing price corrections on their finances in the next few years.