

Asset Price Bubble, Monetary Policy and System Design

In the Perspective of China's Real Estate Bubble Prevention

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Abstract—In July 2016, the Political Bureau of the Communist Party of China Central Committee made a rare proposal to curb the asset bubble. Although it did not say what kind of asset bubble was suppressed, obviously, the real estate bubble is the most critical issue. In current China, the purpose of buying house is not only for living but making money. Since the bubble itself is a currency phenomenon, the monetary policy is usually the first choice to curb it. According to the published literature, we find that monetary policy implemented by the central government failed to work effectively (in China relying entirely on monetary policy to curb the asset bubble can not work well). To cope with the estate bubble, we should also take into account of the state situation as well as the causes of the bubble, apart from the monetary policy. The land policy, financial system and construction of economy have close relationship with the asset bubble. Hence, in addition to the implementation of prudent monetary policy, we should break the monopoly of land leading by the government to reduce the cost. At the same time, we can impose a heavier tax on those who have several houses to limit those real-estate speculators. The government should pay more attention to the real economy and guide the use of government funds by fiscal policy.

Keywords—asset bubble; monetary policy; system design

I. INTRODUCTION

The real estate bubble played an important role both in the Asian financial crisis and the US subprime mortgage crisis. A study by Lin Jereen et al. (1996) showed that 135 out of the 181 member countries of the International Monetary Fund (IMF) suffered serious difficulties in the financial field at different stages. The bubble economy especially the real estate bubble occurred in most of the countries before financial crisis broke out. There is no doubt that the real estate industry in China's national economy in particular occupies a pivotal position. It is an indisputable fact that asset bubbles, as the core issue of financial theory research, have never been out of the public and scholars' horizons. There is no definite answer to what is the asset bubble, why the asset bubble happens and how to curb the asset bubble. Kindleberger (1987) said that "A bubble may be defined loosely as a sharp rise in price of an asset or a range of assets in a continuous process, with the initial rise generating expectations of further rises and attracting new

buyers – generally speculators interested in profits from trading in the asset rather than its use or earning capacity. The rise is usually followed by a reversal of expectations and a sharp decline in price often resulting in financial crisis. A boom is a more extended and gentler rise in prices, production and profits than a bubble, and may be followed by crisis, sometimes taking the form of a crash (or panic) or alternatively by a gentle subsidence of the boom without crisis." [1]

The theory suggests that the rise in asset prices is due to the consumer's expected value. The main motivation for the purchase of assets is to obtain the profit though reselling in a short amount of time and the value of the asset itself does not matter. So the asset sale prices deviate from the real price, resulting in asset bubbles. One of the results is that the bubble bursts after the crazy crash, triggering a systemic financial crisis, or the false prosperity gradually subsides without crisis. Obviously every country is reluctant to face the crisis. Therefore, our goal is to curb the expansion of the asset bubble and stabilize asset prices to achieve a soft landing in a long enough time.

Currently, in terms of the financial environment, the bank deposit interest rate is low and the inflation prevails in plenty areas, resulting the asset depreciation is faster than interest earning. So the real estate become an important means of investment. Note that real estate bubble is much more serious and it is different from stocks and bonds since it displays the attribute of consumer goods, durable goods, non-moving goods, capital goods, financial products as well as security products. Real estate is not only closely connected with the financial market, but also related to the civil daily basis.[2] A substantial decline in assets will lead to various types of credit default meanwhile increase the burden of repayment of citizens and other passive consequences including the decline of industrial production and personal consumption. Therefore, the peculiarity of China's real estate bubble determines the means of real estate regulation and control. Meanwhile, the peculiarity of economic development status of China determines that multiple strategies are in urgent need to regulate real estate and avoid the appearance of financial crisis.

II. THE EFFECTIVENESS OF MONETARY POLICY ON THE REAL ESTATE BUBBLE

From the perspective of supply and demand, the real estate bubble is due to that much money chases after less houses, resulting in house prices deviate from the basic value. Hence, loose monetary policy provides a breeding ground for the real estate bubble, and the support of bank credit is the driving force behind the real estate bubble.[3] China's estate industry itself is a capital-intensive industry, which requires a large quantity of money, having long cycle time and slow return on investment. Meanwhile, the own funds of most small developers and even large developers are limited, thus, they often use the rights mortgages of land, private lending, as well as subcontracting to make full use of leverage for raising money and transferring risk. However, on the other hand, the risk of dispersion will lead to domino effect. In 2008, the Central People's Bank released four trillion bailout funds during the global financial crisis, so that the Chinese economy was prosperous and the house price soared. "Table I" shows the average selling price of the country from 2008 to 2015, which shows that the housing price rising rate in 2008 and 2009 is higher than any other years.

TABLE I. THE AVERAGE SELLING PRICE OF THE COUNTRY

Year	2008	2009	2010	2011	2012	2013	2014	2015
Price	3800	4681	5032	5357	5790	6237	6324	6793

^a. Data Sources: China National Bureau of Statistics

However, the housing development of various regions of our country is inconsistent. The population turnover is very different. Beijing, Shanghai, Shenzhen and other big cities have large population inflows, employment opportunities and housing market demand, so that the housing prices have been increasing while a majority of small cities become "ghost town", resulting in housing production excess. The unbalance of regional development is the difficulty of China's estate regulation. Monetary policy serves as a conventional means of price regulation. Some scholars suggest that its effect is significant, while some insist that there is no effect. Through the analysis of the stock adjustment model, Kearl and Mishkin pointed out that the effect of monetary policy on housing demand is listed as follows : First, monetary policy affects the price of financial products held by consumers, thus affecting housing demand; Second, monetary policy affects credit policy and availability, thus affecting the size of consumer debt and the current housing demand. Hence, the interest rate will have an impact on the supply and demand of the estate market.[4] Using a panel of 11 OECD countries from 1920-2011, Micheal D. Bordo & John S. Lndon-lane pointed out that loose monetary policy played an important role in housing booms along with other shocks.[5] Similarly, Chinese scholars found that monetary policy has a significant impact on house prices by using the panel data . Kong Yu believed that the long-term supply of money has a positive impact on the real estate prices: when money supply increased 1%, the real estate prices rose 0.106%.[6] Ping Xinqiao and Chen Minyan confirmed the statement by using the 35 panel data of 35 large cities in china.[7] However, in China, the real estate acts as a special commodity, whose value is not only to meet

the need of people living, but also the investment. Therefore, suppressing the speculative demand is the key point to prevent the real estate bubble through using monetary policy. In general, raising interest rates is to increase the opportunity cost of investment and the interest cost of the loan, finally to suppress the price rise. However, the reality is that China's deposit interest is low and the investment channel is narrow. Since the establishment of the commercial housing market, the real estate value is increasing, while the higher lending rates are difficult to curb the purchase needs. Therefore, in China only relying on monetary policy can not inhibit the real estate bubble.

III. THE SPECIAL NATURE OF CHINA 'S REAL ESTATE MARKET AND THE CAUSES OF THE BUBBLE

A. China's Special Land System and Financial System

According to the provisions of the Constitution of the People's Republic of China, the Land Administration Law and the Property Law, the land in cities belongs to the country, but the land in the countryside and the suburbs belongs to farmers. Rural collective land can not be used for urban construction. So the supply of land for urban housing construction is strictly limited. This particular institutional background determines that China's real estate markets are different from land privately owned by the country. In western countries, private ownership of land can be carried out, and the land owner can transfer the land freely according to the market demand. Therefore, the change of house price can cause the supply of land and then affect the housing supply, so as to achieve the balance between supply and demand. On the contrary, Chinese government monopolizes the supply of construction land. In particular, the mainland's tax regime is so irrational that its local governments rely on real estate for their revenue heavily. Although local governments resolve their temporary financial difficulties through the land finance, all of the methods do harm to the sustainability of economy and social development of China.

B. Real Economy Recession and Capital Speculation

Both the real economy and the virtual economy are the important components of the national economy. With the expansion of virtual economy and the development of economic globalization, the influence of virtual economy on the real economy becomes more and more important. But there are two sides. On the one hand, the flow of global virtual capital can distribute resources effectively to promote the adjustment of industrial structure to stimulate consumption and investment. On the other hand, when the virtual economy is over-inflated, the currency virtualization may cause a bubble economy or even a financial crisis.[8] Marx has pointed out that "regardless of the social form of wealth, the usage value always constitutes the material content of wealth." [9] The real economy is the foundation of the development of human society. At present, there are huge differences between the real economy and the virtual economy in China, such as the slow return and long cycle of the real economic, the high profits and short cycle of the virtual economic. The capital and the talents poured into the virtual economy from real economy, resulting in economic depression. In early 1990s, the Japanese industrial hollowing,

real estate bubble and the Japanese yen devaluation can prove it.

Compared with western countries, the Chinese market is more unstable. The formation of financial market in China lags behind developed countries. The most of citizens have little knowledge of finance. Most investors are followers who do not have the ability to judge independently. So the herd behavior is common in China.

C. Credit Expansion and Regulation Policy

A survey was conducted by the Chinese household financial investigation and research center of Southwestern University of Finance and Economics (CHFS) in 2011, 2013, 2015 about family income, housing, credit and other aspects of the country. The study showed that China's housing loans have been rising "Fig. 1".

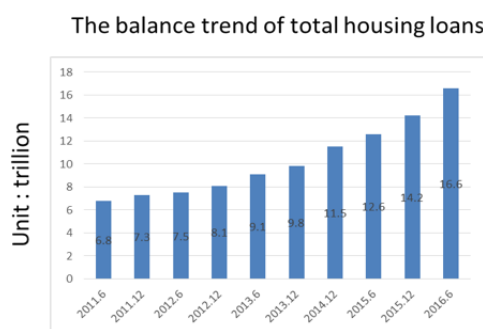


Fig. 1. China's Housing Loans.

CHFS believes that accelerated housing loans might be caused by the accelerated purchase of new housing, the accelerated purchase of new housing leverage rate and the original loan households purchase loans.

IV. SUGGESTIONS ON PREVENTING REAL ESTATE ASSET BUBBLE

A. Accelerate the Transfer of Collective Land to Increase the Supply of Land for Construction

The article points out that China's Land Management Law provides that urban construction land can only be state-owned, which leads to the monopoly of the supply market by government. At the same time, the government set the minimum sale price. All of those factors together contribute to huge land costs. At present 15 counties and cities in our country are implementing the pilot reform of collective construction land. The reform includes that existing stock of land can be transferred or rented under the premise of national control and overall planning. However, from the current status quo, there is no pilot area of collective management of land which can be used as residential land. Most of them are used as factories and warehouses, and they are subject to many restrictions on use. Therefore, we should actively explore the rural collective land reform. In the future, we should not only allow the existing construction land to enter into the market, but also allow the incremental construction land to enter into the market under the condition of maintaining the red line of cultivated land. The government should gradually relax the control of the use of

land and let the market play a decisive role in the allocation of resources.

B. Regulation on Real Estate Industry Respectively

In terms of Chinese current real estate industry, the existing problem is the uneven regional development: the housing price of the first-tier cities is soaring while the inventory of the second and third tier cities is excessive. To solve the problem of insufficient housing supply in large cities and the imbalance of the overall structure of housing, the government should control the total housing quantity and structures within a longer period.[10] They can increase the lending rates or payment ratio of the villa, high-end entertainment and high-end office to encourage the development of real-needed house and give credit support to small units. Meanwhile, they can also crack down the behavior of property hoarding, false propaganda and price rigging. At present, many developers sell defective products firstly and then sell high-quality products. By this way they render real estate tensions. All of these actions should be severely punished. Opening and transparent housing sale information should be strictly required and complete housing sale management system should be built.

C. Reduce Dependence on the Path of the Real Estate Development, Speed up the Adjustment of Industrial Structure

From the point view of the background with regard to preventing and controlling the asset bubble released by the government, the policy was not meant to suppress prices and sales, but to dampen multiple property purchases. A large number of liquidity flows to the real estate market in addition to high profits and loose credit policy. An important reason is that China's industrial structure lacks diversified investment channels. Accelerating the adjustment of industrial structure and promoting the healthy development of the real economy are the most important way to maintain the sustainable development of the economy. In the face of financial crisis, the major countries of the world have to re-examine their own industrial structure and develop real economy. For example, the United States proposed to attract local manufacturers in foreign countries to move back to strengthen the US real economy.[11] At the same time, traditional industries such as steel, oil, cement and so on have excess capacity. In order to change this situation, China should focus on emerging industries and develop new energy, new materials, high-end equipment manufacturing, bio-industry, information industry and other industries vigorously.

D. Tax for Housing to Stabilize Rational Expectations

Most of the funds, which are currently active in the real estate market, are speculative assets because its fundamental purpose is to obtain high profit though resale in a short time. At this stage, although China has not levied estate tax, the academic community has been discussing this issue. Some experts believe that pilot property tax in Shanghai and Chongqing did not work because estate tax just adapts to the Western countries which does not conform to the real conditions of china. Professor Xie Sanbai, the dean of Finance and Capital Market Research Center of Fudan

University, insists that regarding to the full release of the two children, the introduction of property tax is very difficult because the 80s and 90s must prepare two suites for their children before the house price increases. Comparing the low divorce cost with the high property tax, 99% of people will choose false divorce.[12] Professor Xie's point of view has a certain rationality, but this article also believes that some standpoints should be redressed.

Firstly, the Legislation and the effect of the implementation can not be the same. *There is a policy and there are countermeasures* is not good enough to deny the necessity of the law. No matter how properly the law is enacted, there are still a lot of people looking for loopholes. Secondly, why must the parents rush to buy the house? The underlying reasons are that these parents believe in the future the house prices will continue to rise. Thirdly, before taking house taxes, the improvement of initial payment also led to the divorce rate increasing in Shanghai. It can be seen that the property tax and the divorce rate do not have a causal relationship.

Therefore, this article argues that the holders of multiple houses should be taken accumulated tax to increase the cost of ownership and the real estate could thus return to its use value.

E. Keep Prudent Monetary Policy

In November 2016, the Central Bank of China Monetary Policy Analysis Group released the third quarter of 2016 China monetary policy implementation report, saying that "Chinese government should keep consistent with the principle of adjust measures to local conditions' when they regulate the financial market". In addition, we should keep carrying forward market-based reform of interest rates and continue to promote exchange rate forming mechanism reform. Adhere to the general idea: Macro economic policy should be steady and micro policy flexible... Pay attention to the inhibition of asset bubbles and prevent financial risks." As a result, China's ultimate goal is to ease the current asset bubbles and prevent the occurrence of financial crisis.

V. CONCLUSION

In conclusion, prudent monetary policy and accurate credit policy can not use large credit stimulus plan to speed up the internationalization of RMB. It should focus on the complete realization of political guidance.

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