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By BOB DAVIS

After years of housing prices gone wild, China's property bubble is starting to deflate. Residential prices are heading downward in some major cities. Tom Orlik has details from Beijing and explains how it could impact China's red-hot economy.

BEIJING—After years of housing prices gone wild, China's property bubble is starting to deflate.

Residential prices are heading downward in some major cities, damping some undesired real-estate speculation but raising the prospect that the Chinese economy may slow more rapidly than anticipated with profound consequences for global growth.

Real estate is a foundation of China's phenomenal growth record in the past two decades, and its health is crucial to China's construction, steel and

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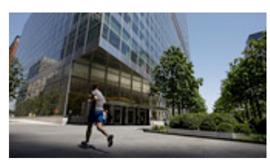

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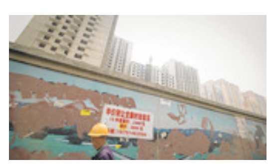
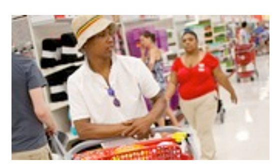


Property Bubble in China Deflating



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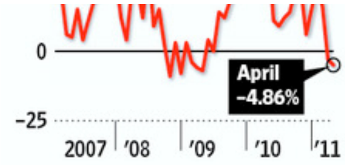

*Weighted average of price per square meter
Sources: Soufun; Dragonomics

cement sectors. Real estate is also a favored investment of Chinese looking to get better returns than bank deposits pay. Local municipalities and provinces depend on rising prices for land sales as well to fund infrastructure projects.

World Bank economists warned at a Beijing press briefing on Wednesday that a real-estate bubble was among the biggest economic risks China faces.

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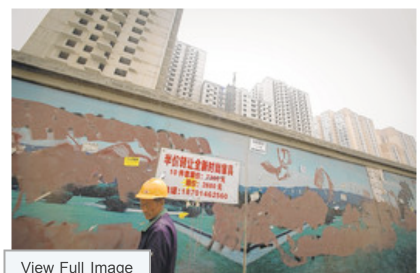
Already, in nine major cities tracked by Rosealea Yao, an analyst at market-research firm Dragonomics, real-estate prices fell 4.9% in April from a year earlier. Last year, prices in those nine cities rose 21.5%; in 2009, the increase was about 10%, as China started to recover from the global economic crisis, with much steeper increases toward the end of that year.

A downturn in property and apartment prices would harm Chinese industry and investment, and crimp consumer spending. China is a "housing-led economy," says UBS economist Jonathan Anderson, who estimates that property construction alone accounted for 13% of gross domestic product in 2010, twice the share of the 1990s.

While China's anticipated growth is still well above that of other large economies, any reduction could have deep consequences. The global economy is now even more dependent on China for demand for anything from commodities to luxury goods, given the tepid recovery in the U.S. and Europe's continuing sovereign-debt problems.



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Bloomberg

A worker walks past a public housing project in Beijing.

If the Chinese housing market slows faster than people had expected, the impact would be felt in a number of markets that export heavily to China. Many Latin American and African economies have shifted their focus toward Chinese demand for their raw materials, and many Western firms, including U.S. retailers and fast-food chains, now bank on Chinese consumers feeling wealthier to make up for stagnating sales elsewhere. Also, plans by local Chinese governments to improve infrastructure loom large for heavy-equipment makers like Caterpillar Inc.

The red-hot demand for Chinese housing that has fed such growth plans is now ebbing. Data from Soufun, a Beijing real-estate consultant, show average property prices in China in May rose 5.1% compared with the year earlier, a slowdown from rapid rises in 2009 and 2010.

China's property prices are falling, with potentially far-reaching effects world-wide. And should investors think twice for buying into Chinese firms? Hong Kong's outgoing securities regulator thinks so. WSJ's Peter Stein and Andrew LaVallee discuss.

Standard Chartered Bank estimates that China's so-called tier-two cities, such as Dalian and Tianjin, may have 20 months of housing inventory by year end, putting "substantial" pressure on prices. Standard Chartered forecasts price cuts of 10% to 20% "in many cities."

A number of analysts think official data, which have continued to show a slight rise in prices, understate the slowdown as the government can affect the numbers by pressing developers to withhold or add high-value properties to the market depending on what it wants the data to show.

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Ardo Hansson, lead economist at the World Bank's Beijing office, said Wednesday that China should consider boosting interest rates further to tame consumer prices and head off bubbles in housing and other assets. He didn't comment on whether the current real-estate slowdown would harm economic growth, but stressed the importance of the property sector to the Chinese economy, especially in such sectors as steel and cement.

Partly as a result of the Chinese real-estate slowdown, prices for key industrial metals used in construction have softened. Spot copper prices have lost 5% since early March, and have now fallen to around 69,000 yuan ($10,647) a ton after racking up 34% in gains between June 2010 and March this year. Major steelmakers have been consistently cutting their product prices since February.

Chinese officials, facing widespread anger from ordinary citizens who can no longer afford to buy a home, have sought to slow the rise in housing prices. The unanswered question is whether the government can manage to reduce prices gradually in a way that won't undermine economic growth.

Since January 2010, the Chinese government has introduced a number of measures to stem speculation, including boosting down-payment requirements on mortgages for second homes to 60% from 40%, barring state-owned enterprises outside the real-estate sector from investing in property and lifting the amount of cash banks must hold in reserve 11 times—essentially reducing funds banks can lend.

Agence France-Presse/Getty Images

A building site in Chongqing.

"In some ways, [real-estate] prices are really crazy," said Guo Shuqing, chairman of China Construction Bank, in an interview last week. He says the cost of apartments in big cities is well beyond young couples' means.

Beijing has one of the most expensive real-estate markets in the world relative to the income of its citizens. Calculations based on Soufun data show that in the opening months of 2006 an average-price new apartment in China's capital would cost around $100,000—the equivalent of 32 years' disposable income for the average resident. By 2011, the average price had more than doubled to $250,000, but relatively modest increases in income mean it would now take 57 years of saving for the average resident to cover the cost.

In Shanghai, apartment sales tumbled 37% in April, to 11,000 units, compared with 17,500 units in January, according to the Shanghai Real Estate Trading Center. With business so slack, Midland Realty, a unit of Hong Kong-based Midland Holdings Ltd., closed eight of its nine offices in Shanghai. "The government's policy on purchase restrictions had a huge impact on both selling and buying, leading to transactions drying up," said Xu Feng, senior director of Midland's development center in Shenzhen.

According to Dragonomics, sales volume in the nine cities it tracks fell by about half since the start of the year. In Beijing, that has meant rising rents, say real-estate agents. Zhang Kai, an

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agent at Home Link in middle-class neighborhood Tuanjiehu said the number of sales had dropped by half since February and monthly rents for small apartments jumped to about 3,000 yuan ($460) in June from 2,500 yuan ($385) a month earlier. Many apartment owners don't want to sell, he said, because they are waiting for prices to turn around.

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A woman rides a bicycle by a group of newly-built properties in Hefei, a city in eastern China's Anhui province.

One real-estate agent elsewhere in Beijing said regulations that required buyers to have formal Beijing residence and proof of having paid taxes for five years straight were crimping sales.

The housing slowdown comes at a time when there is evidence China's growth is slowing. Last week, two surveys of purchasing managers showed a slowing of manufacturing activity. China, the world's second-largest economy after the U.S., grew at 9.7% in the first quarter from a year earlier. In late May, Goldman Sachs lowered its estimate of Chinese second-quarter growth to 8% from its previous estimate of 8.8% as the government continues to tighten monetary policy to fight inflation and import demand from the U.S. weakens.UBS economist Tao Wang says she thinks the price decline will be short-lived as Chinese investors, with few other options, will again pour money into real estate and as local governments push up the price of land they sell to developers. Real-estate prices will rise for another three to five years, she estimates. A sharp fall then would batter investors, banks, construction firms and other sectors.

—Esther Fung in Shanghai and Tom Orlik, Helen Qu and Chuin-Wei Yap in Beijing contributed to this article.

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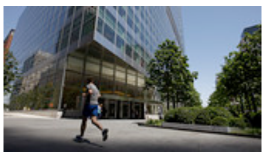

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