Bull in a china shop

China does not have dangerous bubbles in shares and housing—yet.

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Early this year, many China-watchers warned that the government's stimulus was not enough to save the economy from a deep downturn. With indecent haste, they have now switched to worrying that overly lax policies have created a gigantic bubble in shares and house prices.

Figures due later this month are likely to show that China's real GDP grew by around 9% in the year to the third quarter—a period over which output in most other economies probably fell. A recent flurry of bearish reports has warned that sooner or later the markets will crash, excessive borrowing and investment will cause banks' bad loans to surge, and China's growth will collapse.

If the government does not act soon to tighten liquidity, share and house prices will become seriously overvalued. But it is much too early to use the "B" word. Start with China's stockmarket, described by Andy Xie, an independent economist, as a "giant Ponzi scheme". Despite a recent slide, Shanghai's A-share index is still up by over 60% since its trough last November. Yet this is only a fraction of the gain during China's previous bubble in 2006-07, when the price/earnings ratio jumped to an eye-popping 70. Today the p/e ratio stands at 24. That is high compared with developed markets but well below China's long-term average of 37 (see left-hand chart). China's faster trend pace of growth also means that the outlook for corporate profits is rosier than elsewhere. They are already bouncing back: in the three months to August industrial profits were 7% higher than a year ago, after falling by 37% in the year to February.

Bubble suspect number two is the housing market. Average Chinese home prices are nine times average annual household income. In the rich world a ratio of more than four would sound alarm bells; in other Asian countries prices are typically 5-7 times income. The volume of property sales has surged by 85% over the past year and prices of new apartments in Shanghai have risen by nearly 30%. Some conclude that prices have been pumped up by imprudent bank lending and that the market is at risk of crashing.

However, average nationwide house prices have risen by only 2% over the past year, after falling in 2008. The official price index may understate the true average gain but figures for central Shanghai will overstate it. Either way, house prices are rising nowhere near as fast as they did during the previous boom in 2004-07 (see right-hand chart). And in relation to income, average house prices in China have fallen slightly over the past decade (although they have risen in some big cities).

Arthur Kroeber, an economist at Dragonomics, a research firm in Beijing, argues that the high level of prices relative to income is partly explained by hidden subsidies. A high proportion of households live in apartments purchased at a fraction of their value from the government a decade ago (when the housing market was privatised) or have upgraded to apartments financed by the sale of such properties.

The leap in property sales follows a deep slump last year after the government deliberately cooled the market. The level of transactions in August was less than half its level in 2005 or 2006. More important, China's housing market is much less dependent on credit than those in places like America, so its economy would be less vulnerable to any sharp fall in prices. Andy Rothman, an economist at CLSA, a broker, estimates that only one-quarter of middle-class homeowners have a mortgage and their average loan is only 46% of the property's value, compared with 76% in America. Homeowners have to put down a minimum deposit of 20%. Speculators buying property as an investment have to put down 40%.

Rising home prices are not an accidental consequence of government easing but one of its goals. The government needs a lively housing market to support the economy when its fiscal stimulus fades. It creates a lot of jobs, spurs private-sector investment in construction and encourages new homebuyers to spend more on furniture and electrical goods. Until recently China's recovery was driven largely by state spending but thanks to a rebound in construction, private-sector investment rose by 30% in the year to August, double its growth rate in December.

But even if China's stockmarkets and housing markets do not look particularly overvalued now, there is a clear risk that they could become so. Mingchun Sun, an economist at Nomura, points to some big differences between the recent sell-off in shares and the previous one in November 2007. Inflation was then 6.9% and rising, so policymakers were forced to slam on the monetary brakes. Today consumer prices are falling. In 2007 liquidity was tight, with the M2 measure of money supply growing more slowly than nominal GDP. Today excess liquidity (money growth minus GDP growth) is growing at its fastest pace on record. Low inflation, lashings of liquidity and strong growth are the ideal environment for asset-price inflation. Mr Sun concludes that equity and housing bubbles are inevitable and may grow even bigger than those in 2007.

The third alleged threat to China's recovery is overinvestment. It is widely argued that the recent investment boom has simply exacerbated China's overcapacity, which will reduce the return on capital and eventually drag down its growth rate. Yet analysis by BCA Research, a Canadian research firm, finds surprisingly little evidence of wasteful overinvestment to date.

One yardstick of the efficiency of capital is the incremental capital-output ratio (ICOR)—the investment needed to generate an additional unit of output (ie, annual investment divided by the annual increase in GDP). The higher the ICOR, the less efficient the investment. China's ICOR has been fairly stable over the past three decades. This year it will shoot up because investment surged and growth slowed, but the ICOR is meaningless in a recession. America's ICOR, for example, will be infinite because GDP fell. In general, BCA finds that China's ICOR is lower than that in many other places, suggesting that its capital spending is more, not less, efficient.

But what about this year's state-directed investment boom? The good news is that little new investment has gone into industries which already had excess supply, such as steel. Three-fifths of new lending this year went into infrastructure projects. Some of this money will inevitably be wasted and banks' non-performing loans will rise in future years as payments come due. But much of the new infrastructure, especially railways and roads, should help improve future productivity.

As for bank lending, which grew by a thumping 34% in the year to August, the government has repeatedly signalled that it will maintain its easy monetary policy because it is still concerned about the sustainability of the recovery. But it is also trying to curb speculative excesses and to tighten bank supervision. The banking regulator strengthened the rules on mortgages for investment properties this summer, and has told banks to raise their capital ratios to 10% and to hold provisions equal to 150% of projected loan losses by the end of the year.

China does not yet have dangerous bubbles in housing and shares that could threaten its recovery. Indeed, rising asset prices will help boost consumer spending over the next year, which will in turn help broaden China's recovery. But to minimise the risk that China is starting to inflate its biggest bubble ever, the government does need to curb excessive liquidity. That means allowing the yuan to appreciate. With interest rates likely to remain close to zero in America for some time, China cannot significantly tighten its own rates unless it allows its currency to rise. If China's growth has decoupled from America, then so must its monetary policy.

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