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China's Property Sector

ROUNDTABLE SUMMARY REPORT

ABOUT THE CENTER FOR CHINA ANALYSIS

With a solution-oriented mandate, the Asia Society Policy Institute (ASPI) tackles major policy challenges confronting the Asia-Pacific in security, prosperity, sustainability, and the development of common norms and values for the region. As part of ASPI, the Center for China Analysis (CCA) serves as a leading global center for policy-relevant, objective analysis of China's politics, economy, and society, and its impact on the region and the world in an era of growing strategic competition.

ABOUT SCCEI

The Stanford Center on China's Economy and Institutions (SCCEI) is Stanford's hub for data-driven, multidisciplinary research on contemporary China. In addition to catalyzing cutting-edge research on China's economy and institutions, SCCEI's aim is to communicate policy-relevant findings from the best quantitative scholarship on China to audiences beyond academia. By doing so, it aims to advance a more empirical basis for important debates about China and U.S.-China relations.

The Stanford Center on China's Economy and Institutions (SCCEI) and Asia Society Policy Institute's Center for China Analysis (CCA) co-organized a closed-door roundtable in February 2023 on the extent, causes, and implications of China's recent property sector slowdown. For three decades, real estate has been a major engine for economic growth in China, accounting for about a quarter of Chinese GDP in the 2010s. The expanding property sector has accommodated a rising urban population and, at the same time, tripled the per capita city living area, which is now much closer to the OECD average. These developments have made significant contributions to the welfare and living standards of the Chinese people. Through its large impact on local government revenues, the financial sector, household wealth, and employment, the property sector plays an outsized role in the Chinese economy—far more than in most other countries. However, by 2021, there were signs that the Chinese property sector could be reaching a peak and even starting to contract.

In August 2020, the Chinese government introduced the "three red lines" policy, which aimed to contain the high leverage of property developers. This well-meaning policy landed developers—including some of the largest in the country, such as Evergrande—in a liquidity crunch against the backdrop of already-slowing domestic demand. In late 2021, Evergrande made international headlines when it defaulted on $1.2 billion in offshore bonds. Quite a few Chinese developers defaulted on debts and left projects unfinished, which led prepaying homebuyers in 90 cities to boycott their mortgage payments in the summer of 2022. The current downturn has seen a modest correction to home prices, while home sales have collapsed.

The cascade of distress set off by the Evergrande crisis suggested that the property sector downturn might be a symptom of a wider problem in the Chinese economy. The property sector exemplifies an investment-driven growth model that China has pursued for the past few decades. The policy response to the current property downturn has implications for how and whether China can transition to an alternative, high-quality growth model that is less dependent on the property sector.

At the roundtable, participants assessed the prospects for China's property sector slowdown, offered explanations for its causes, considered the implications of this sectoral downturn for the broader economy, and debated the possible government responses.

The roundtable discussion focused on four key questions:

1. How sharp and sustained do we expect the slowdown in China's property sector to be?
2. What are the most important determinants of this slowdown: government policy or structural factors?
3. What are the implications of China's property slowdown for other areas of the Chinese economy?
4. What can China do to offset the risks and negative consequences associated with the property slowdown?

The discussions were conducted under the Chatham House Rule.

1. ASSESSING THE EXTENT AND PROSPECT OF CHINA'S PROPERTY SECTOR SLOWDOWN

In projecting how sharp and sustained the current slowdown in China's property sector will be, there was a broad consensus among the panelists that the slowdown could be prolonged and act as a drag on China's overall economic growth for some time. One panelist estimated that the property sector as a whole may shrink by as much as 3 percent annually in the near future.

After much deliberation, the International Monetary Fund (IMF) recently used the word "crisis" to describe China's property sector slowdown. This characterization elicited debate and a range of outlooks from participants. Those on the optimistic end of the spectrum argued that despite projected sectoral decline, the Chinese government has a unique ability to respond decisively and nimbly to market contingencies using a diverse policy toolkit to avert a crisis. However, one panelist also suggested that the Chinese property market is much larger than those of Spain and Ireland before their crises, and housing-related GDP in China is higher than the consensus because of the related demand for raw materials; therefore, the broader economic repercussions of a sectoral downturn in China could be greater than in those two countries.

Panelists on the more pessimistic side of the spectrum embraced the crisis characterization, pointing out that the property slowdown lays bare the unsustainability of China's state-interventionist and investment-driven growth model, which has run its course and is staring down years of slow growth ahead. Furthermore, China's domestic property downturn spells trouble for other countries that have been exporting raw materials to China, thereby affecting the global commodity market.

Other panelists argued that the Chinese property market is already facing a crisis as a result of mispricing and oversupply, which has led to a situation in which small changes in growth expectations can have significant effects on asset values. Given the possibility of both mispricing and changing structures, the fundamental demand for urban housing may have peaked, leading to either a fall in new housing supply or a large price correction, or both.

Somewhere in between, another panelist argued that China has reached an inflection point where urbanization is not over, but the housing boom is. The Chinese government will try to spread out the pain caused by the property market downturn over a longer period by controlling the overall architecture of the system. In the short run, the government can still facilitate financing for property developers and shore up the sector (at the time of the roundtable, the downward spiral seemed to have eased somewhat following months of liquidity-boosting measures from both the central and local governments). The state cannot reverse the sector's long-term slowdown, which will likely be a drag on growth for some years, but can only manage its negative consequences. Some panelists did not foresee a Japan-style balance sheet recession, while others said this risk could not be ruled out.

Some panelists highlighted a distinct feature of the current property sector downturn in China: housing market adjustments have so far been taking place mostly through sizable quantitative adjustments, with only minor price corrections. Home sales contracted by approximately 30 to 40 percent in 2022, while housing prices fell by only about 3 percent nationally and by 10 percent at most in some tier-3 or tier-4 cites. This is in sharp contrast with the experiences of Japan and Hong Kong during the 1990s and the 2008 U.S. subprime mortgage crisis, when property transactions and prices fell in tandem on the order of 30 percent.

Why is this the case? One obvious reason, most panelists agreed, is that the Chinese government, which plays an outsized role in the real estate market, intervened to limit the price corrections. Another reason for the quantity adjustments rather than price adjustments in China is the high savings rate of Chinese households, which may have lessened the pressure on fire sales. However, other panelists contended that, if properly measured, Chinese households have been highly leveraged—thus the property market could suffer bigger price corrections in the absence of government interventions.

CAUSES OF CHINA'S PROPERTY SECTOR SLOWDOWN

What are the most important determinants of the current property sector slowdown: government policy or structural factors? Of course, cyclical factors have also played a role, such as COVID-19 lockdowns over the past few years, which hurt employment, increased income uncertainties, and made it much harder to showcase and move homes or talk to mortgage officers. However, this cyclical factor matters much less since the chaotic end to China's zero-COVID policy.

Some panelists painted a general picture of China's hybrid economic system—combining central planning with a free market approach—that should serve as context for our understanding of the property sector's present predicament. In this two-way system, the central government sets priorities for GDP growth and provides incentives for its developmental agenda, while local governments finance infrastructure investment through revenues from land and property markets. As a pillar of the Chinese economy, the property sector embodies this hybrid condition between state and market, which, to some extent, explains the origin of its tremendous success as well as the roots of its present trouble.

There was general agreement among the panelists that the root causes of the present slowdown in China's property sector are mostly structural rather than short-term policy mistakes. Though the sector's prolonged boom has supported impressive economic growth, it has also created worrying imbalances—including soaring prices. With a shrinking and aging population, slower family formation, and a slower pace of urbanization, the longterm fundamental demand for urban housing may have peaked. Unabated new construction and peaking demand for housing together point to the possibility of a saturated Chinese property market, and even high vacancy outside tier-1 cities—exposing the housing market to correction risks even before the pandemic and the "three red lines" policy.

Some participants highlighted the sector's imbalances and risks over time. For instance, until the mid-2010s, housing prices were elevated across city tiers in China, and the housing boom was sustained on the demand side through high-income growth expectations, the willingness of even low-income homebuyers to pay high prices for real estate and down payments as high as 35 percent. However, these demand growth drivers may have disappeared in recent years. After a massive decades-long supply expansion and a slower pace or even a decline in long-term demand for housing, the supply-demand balance has decisively shifted away from further expansion of new supplies in the property sector.

Therefore, it is likely that China's housing market had already peaked before the Evergrande crisis and was poised for a correction. By that time, domestic demand was slowing, while new construction continued unabated despite excess housing stock in some regions. The imbalances are most concentrated in tier-3 cities, where the finances of households, local governments, and construction enterprises are more vulnerable.

While the root causes of the property sector slowdown are long term and structural, several panelists pointed out that the government's "three red lines" policy, while well intentioned, was poorly timed in the context of China's sluggish economic performance and zero-COVID strategy. It may have served as an immediate trigger of the Evergrande debt crisis, adding short-term financial risks on top of the structural problems facing the property sector.

In sum, it appears that a combination of peaking structural housing demand, large housing supply, high housing prices, tightened regulations under the "three red lines" policy, and a weaker economic cycle under the zero-COVID policy together weighed on an already saturated Chinese property sector, resulting in the most pronounced real estate downturn seen so far.

3. IMPLICATIONS OF THE PROPERTY SECTOR SLOWDOWN FOR THE CHINESE ECONOMY

China's property sector has long been a major engine of the country's economic growth, accounting for as much as about a quarter of the country's GDP. As a key node that connects the construction industry, financial sector, local government revenues, and household wealth, the property sector has an enormous effect on the broader Chinese economy over the long term.

3.1 Local government finance

One panelist highlighted that the property sector slowdown affects local government finances in two important ways: the reduced proceeds from selling land use rights (via equity financing) and the potential financial risk of local governments and their financing vehicles defaulting on bonds (via debt financing).

The property sector has a direct impact on the fiscal health of local governments, which rely heavily on land sales for revenues. As one panelist pointed out, China's 1994 fiscal reform shifted revenue flows away from local governments without changing their spending obligations—especially with respect to infrastructure—thereby leaving localities with unfunded mandates. To make up their budgets, local governments have spent the past few decades creating new urban land use rights through land acquisition and sales of use rights to both public and private entities. Localities generated an estimated RMB 55 trillion in gross sales revenues from land use rights between 2007 and 2020, as well as further tax streams from subsequent real estate transactions. Sales proceeds and tax revenues made up 40 percent of budgetary income at the local level in 2018. As the property market slows—if the central government is truly keen on pivoting away from housing as a growth engine—the resulting drop in land transactions will leave local governments with the still-unanswered question of how to make up their revenues.

In addition, because local governments in China were not allowed to participate directly in the bond market before 2014, they set up local government financing vehicles (LGFVs) in the form of investment companies that sold bonds in the bond market and borrowed from banks using land as collaterals. If land prices fall steeply, investors in LGFV bonds could face higher default risks, since these bonds are backed largely by the land injected into the LGFVs. After 2014, local government bonds officially replaced LGFV debts. In any case, when the value of the underlying explicit or implicit collateral sinks, no investor would want to touch these bonds. This is an important reason why both the central and local governments intervened to contain the price declines in the real estate sector.

A few panelists offered some possible alternative solutions to replace revenues from land use rights sales and real estate transaction taxes. These alternatives include selling off state-owned enterprises, levying property taxes, and taking advantage of central government grants and fiscal transfers. Property taxes are unlikely to be implemented soon, given the immediate need to resuscitate rather than put more downward pressure on the sector. However, the panelists generally agreed that the adjustment cost of the property slowdown will be high, and local governments will bear the lion's share of it. How local governments will swallow this disproportionate cost creates another layer of political uncertainty. One panelist added that President Xi Jinping's saying that "houses are for living in, not for speculation"—while seemingly sensible—demonstrates Xi's lack of consideration for how much local governments have depended on speculative growth in the housing sector and the fiscal and financial uncertainty that they now face.

3.2 China's financial system

The financial system's exposure to the property sector has mostly occurred through two channels: directly through property developer debt and mortgage, and indirectly through the liabilities of local governments, given the importance of land finance.

Directly, housing prices have been dropping only by single digits so far—largely because of state interventions. However, if the government allows prices to adjust more freely along with quantity, price drops could spill over to the financial system, both marking down bank balance sheets and hitting bond investors, possibly triggering a financial crisis that could amplify the real estate downturn into something bigger. Hence, the government has intervened to limit price corrections, possibly preventing or mitigating a negative feedback loop between the property sector and the financial system.

Indirectly, some panelists cautioned that local land finance exposes a weakness in the financial system. LGFVs rely on land assets and their revenue streams as collateral to take out bank loans or issue bonds, often from local state banks. In this context, Chinese housing is priced like a growth stock. For a long time, housing had been not only oversupplied but also overvalued. Mispricing is not a huge risk in itself, but it does mean that even small changes in growth projections can lead to big changes in asset values when traded in large volumes. The system can be very opaque: when LGFVs issue bonds or pledge their lands to take out loans, they often pledge in profits from aggregate future land use rights rather than specific assets.

A downturn in the housing market, whether in the form of a sudden stop or a slow-burn decline, could lead to bond defaults and messy contentions over the worth of specific land use rights. Some panelists argued that if a "Lehman moment" were to happen in China, it would likely come from local government and LGFV bond default contagion. Given the regional heterogeneity in China, such risks would most likely arise from tier-3 cities with especially high housing vacancy rates, population decline, and poor governance. In this event, a decisive response by the central government to immediately step in and guarantee bonds to contain the risk of financial contagion would be crucial to preventing a broader meltdown similar to the 2008 economic crisis in the United States.

3.3 Construction industry

Assessing the share of GDP impacted by the real estate sector, one panelist noted that the contribution of China's real estate-related activities to GDP (accounting for both direct and indirect demand) amounted to more than 26 percent of the economy. At its peak in 2020, the construction sector provided over 60 million jobs. With significant upstream and downstream reaches, the total domestic share of real estate in China's GDP far exceeds that of the United States and Spain prior to the 2008 financial crisis. The impact of China's real estate downturn on the construction sector's output and employment could be larger or smaller if price corrections take on a greater burden of the ongoing market adjustments, depending on a host of other factors.

Given the construction sector's size and impact, a slowdown in the housing market would create great uncertainties for employment. Another panelist observed that before the COVID-19 pandemic, migrant workers were still going to tier-3 cities in large numbers to work in the construction sector. However, the government's zero-COVID policy, together with the property downturn, created a decline in employment and income that spurred a significant outflow of these workers back to rural villages. At present, it is still uncertain whether these workers will be hired back. Even if China is set to promote "high-quality growth" by boosting more sustainable sectors, one panelist argued that it will be hard for the construction industry's labor forces and resources to be fully transferred and redeployed elsewhere speedily.

3.4 Household wealth

A significant proportion of household wealth in China—60 to 70 percent, according to some estimates—is tied up in real estate. In the absence of good investment alternatives, and with housing prices growing rapidly for decades, real estate has been the best investment vehicle for households. But even as an appreciating asset, housing has not yielded significant disposable income for households, as one participant pointed out. Household disposable income as a share of GDP in China is much smaller than that in the United States, and the difference lies more in income from assets than in wages. To shift toward a future growth model based on domestic consumption, the government would have to develop a robust rental market in China to translate asset wealth into disposable income for households.

In the immediate future, however, the downturn in housing prices will create a negative wealth effect on household consumption behaviors. With saving rates already high in China, the downturn in housing prices will compel households to save even more. One panelist posited that in the most optimistic scenarios, boosting household consumption over the medium term is possible if the government can foster rental markets to channel housing wealth into disposable income and develop mature capital markets as viable investment alternatives to housing. Furthermore, the development of capital markets could also help channel household savings to finance other productive sectors of the economy.

While the property sector downturn may have a negative impact on urban household wealth, it offers an opportunity to address China's wealth inequality between urban and rural residents. Some panelists argued that urban housing has been the single greatest source of inequality in China for decades—citing a study showing that the equivalent of one-third of Chinese GDP went to subsidies during the transfer of public housing to privatized housing by 2003, with urban households as the beneficiary. Other panelists likened the buyout of public housing in the 1990s to IPOs in China's booming housing market, which gave urban households a windfall but did not benefit rural households. The property sector's present correction is an opportunity to address that inequality and deliver the "common prosperity" that the government espouses.

Some panelists noted that during 2022, Chinese households slowed their new mortgage loan applications and actively paid down their existing mortgage loans—a possible sign of households attempting to deleverage by shrinking their balance sheets and trimming new purchases of housing. Indeed, bank loans to the Chinese household sector have slowed considerably in the past few years. While a modest deleveraging on the part of Chinese households would be welcome, large-scale deleveraging could depress private consumption and give rise to something resembling a prolonged "balance-sheet recession," as the Japanese experience in the 1990s demonstrated.

3.5 China's future GDP growth

Looking at the near term, the panelists debated China's growth prospects for 2023. One participant estimated that a 20 percent drop in real estate activity could lead to a 5 to 10 percent decline in Chinese GDP, even without amplification by a simultaneous financial crisis. Nevertheless, some panelists contended that China can achieve its 5 percent growth target in 2023 on account of the government's diverse policy toolkit to prop up the real estate sector and tentative signs of stabilization in the property market so far this year, especially given a low base of comparison from 2022, and normalizing consumption and saving behaviors after the end of the "zero-COVID" policy.

Other participants were more skeptical of China's ability to meet its 5 percent growth goal this year. Breaking down projected contributions from the main engines of growth, one panelist's model showed that with low growth prospects for both investment and export, the burden of growth would fall disproportionally on household consumption, which would have to grow by 13 to 15 percent to realize the government's 5 percent growth target. This is exceedingly unlikely given that households are currently saving more; therefore, Chinese GDP growth would be 3 percent at best in 2023, according to this panelist. The recent wave of early mortgage repayments made by households, if it continues, suggests more saving and less consumption. The attempt by Chinese households to deleverage also points to a low level of confidence in the real estate sector, raising concerns about consumption-backed economic growth.

For the long term, panel participants generally regarded the property sector as a drag on economic growth for a long time to come. The panelists pointed out that people's expectations and confidence are more important than reported prices, as policy levers can fix prices but not expectations, and consumption depends on the latter. Hence, an extended decline in the property market may hurt consumption. Some panelists discounted this negative "wealth effect," arguing that wealthy households with multiple real estate holdings will not be held back from consumption, while other participants countered that the negative consequences of wealth effect from the present downturn will mostly arise from the middle class and from tier-3 cities, rather than from wealthy households and major cities.

4. GOVERNMENT RESPONSE TO THE PROPERTY SECTOR SLOWDOWN

Throughout the roundtable, participants repeatedly echoed the need for China to use the current slowdown as an opportunity for structural shift toward a new growth model that is less dependent on the property sector, especially given that the sector has likely peaked. There were divergent views, however, on how and whether the government can accomplish this transition.

One panelist discussed the idea of a fundamental rewiring of China's economy. Unproductive investments have long been a big issue for China. Specifically, real estate and infrastructure investments have resulted in overcapacity and an unsustainable debt burden. Rebalancing China's economy toward consumer spending is imperative since high investment yields little real gain to households, and households' realized income from assets is very low. Thus, the development of the rental market will provide households with more disposable income to spend. A fundamental rewiring of China's economy will necessitate a focus on developing new industries, improving productivity, and bolstering rental markets.

Some participants pointed out that although the need for China to shift toward consumption-based growth is clear, it is less clear how it can actually increase consumption. On this issue, the current extent of household debt and the possibility for households to further leverage themselves for spending drew debates from the participants. Some cited that, at 50 percent of GDP, Chinese debt-to-household income ratio still has room to expand compared with the American benchmark of 65 to 70 percent.

Other panelists, however, argued that China's debt-to-income ratio is already too high, if properly measured. One panelist estimated that in just five years, China's household debt has surged to 128 percent of household income and 56 percent of GDP. Most of this growth is tied to China's property market in the form of mortgage debt. The surge in household borrowing in China is comparable to the run-up in U.S. household debt ahead of the 2008 global financial crisis. Households are already highly leveraged for housing and have little room to borrow for consumption, so this emergency lever has already been pulled. The priority, in any case, should not be for households to use up their leverage room, but for the government to rapidly create alternative venues of income growth aside from housing that will encourage households to consume. The need to create capital markets and reallocate capital away from housing is clear, though how to do so is a topic beyond the scope of this roundtable. There are limits to how much new debt businesses can add, given the rise in defaults, declining marginal returns to new credit and investment, and the rising proportion of credit used to service older debt. If we cannot look to more debt to generate growth, China needs to pace itself with slower growth until new drivers are identified.

Therefore, in dealing with the ongoing property downturn and stabilizing the sector, the challenges facing Chinse policymakers are multiple. If necessary, some panelists suggested that the central government should intervene to prevent financial fallout from contingencies like LGFV bond defaults. In a hopeful scenario, China may be able to shoulder higher debt capacities than the United States because the government is in a strong position to bring different actors together to the table and to mitigate the coordination problems of bank runs. On the other side of the spectrum, however, some panelists wondered whether the tools available to rescue the property sector have already been exhausted.

Different ideas about the means of stabilizing the property sector and rewiring the Chinese economy cut to a deeper debate over the nature of China's hybrid economic governance and the merits of state intervention itself. Panelists who were more optimistic about China's prospects for averting a property crisis placed their hopes in the state's ability to intervene decisively in the market. On the other side, one panelist questioned whether this hybrid model is a legitimate system at all, or simply a way for state command to irresponsibly grab resources to feed speedy growth numbers. As a result, the enormousness of China's overpromising and overbuilding now has to be repaid through slower growth in the foreseeable future—with global repercussions.

Echoing this point, another participant added that arbitrary governance poses a tremendous risk. The "feeling the stone as you cross the river" mentality that helped China's economic miracle in the early years of reform has become a liability as arbitrary state action and policy inconsistency threaten to smother the market altogether. In any case, China's hybrid model of economic governance involves a complex interplay between the central and local governments, markets, and banks in China, underscoring the need for nuanced consideration of the different actors and factors that shape the Chinese economic landscape.

According to some panelists, in the Xi era, there has been a significant loss of transparency about the government's decision-making process, giving rise to sudden policy reversals without on-the-ground preparations. Xi's recent record—from the 2015 equity market intervention to the botched management of the zero-COVID policy—have often been inelegant and may only portend things to come. Xi is strong-minded, but he may not really understand the market. The government's power to control is not equivalent to the ability to govern, nor to the capacity to deliver a difficult structural transition. With intensifying geopolitical competition placing more demands on resources, it is uncertain whether the state can pull off an orderly economic transition. If China's economic transition encounters headwinds, the government may succumb to the temptation to prop up the property sector again and fall back on the old addiction.

Insights from this roundtable highlight that the present predicament of the Chinese property sector is not only symptomatic of the sector's long-term structural imbalances, but also points to the necessity of transitioning away from a decades-long growth model driven by investment and, even more broadly, of reexamining the merits of state intervention in China's hybrid economic system. Given the enormous and complex impact of China's property sector, how and whether the Chinese government can manage the present downturn will have profound ramifications for the Chinese economy and beyond.