

# “Squeezing the Bubble” rather than “Bursting It” to Solve the Overheated Real Estates in China

Zixuan Liang

*University of Sydney, Sydney, NSW, Australia*

*\*Corresponding author. Email: Stephen.liang1012@gmail.com*

## ABSTRACT

Real estate sector has been the key engine for China maintaining economic growth. A house has two attributes, one is residential, and the other is capital. China's high housing prices are due to land supply as well as land system and policy reasons. After 2015, the ratio of land cost to housing price in big cities has reached an average of 40%. For a long time, China's real estate market has focused on demand regulation, and the regulation effect is not sustainable, which once formed the expectation of unilateral rise in housing prices. Through literature review, this study analyzes the current situation and causes of China's housing market bubble in terms of limited urbanization space, intensified population aging, and housing market speculation. Compared with the burst of Japan's real estate bubble in 1990 to predict the future of China's real estate, it is concluded that housing prices should be stabilized, and the bubble should not be actively punctured.

**Keywords:** *China's housing market bubble, urbanization, population aging, housing market speculation, Japan's real estate bubble*

## 1. INTRODUCTION

The rise in Chinese real estate prices in recent years has brought a great impact on many people in the era of rapid economic development. The impact is mainly in two aspects: the quality of life of residents and the unstable development of the national economy. The core problem in the real estate field is that the bubble is relatively large, and the financialization bubble tends to be relatively strong. It is the biggest grey rhino in the financial system. Many people buy houses not for living, but for investment speculation, which is very dangerous. This is not only an economic issue but also a social issue. Considering that most of the existing literature lacks the excavation of the history of China's real estate, this study integrates the latest available and updated data sources to analyze supply and demand conditions in the rapidly growing Chinese economy. The imbalances are then compared to benchmarks from another economy-Japan. It hopes that the paper would provide a unique perspective to compare China, a highly developed developing country, with Japan, the most developed country in Asia.

## 2. ANALYSIS OF CHINA'S REAL ESTATE PROBLEMS

### *2.1 Integration of Urban and Rural areas*

The biggest change in China as a result of urban-rural integration is the demographic structure, which a large part of the rural population is flocking to urban areas, making the population distribution in China extremely uneven [1]. This population distribution is affecting the proportion of our population that is not peasant, which has a significant impact on the real estate sector.

The demand for residential housing is directly increased due to the transfer of rural population to cities. The 2021 Census [2] shows that the population living in the town is 901,991,162 people, accounting for 63.89% of the total population. While the population living in the countryside is 509,787,562 people, accounting for 36.11%.

The rural population has declined by 164 million, while the total population of China has increased by 40 million from 2010 to 2020, so the real urban population has increased by more than 200 million during that time.

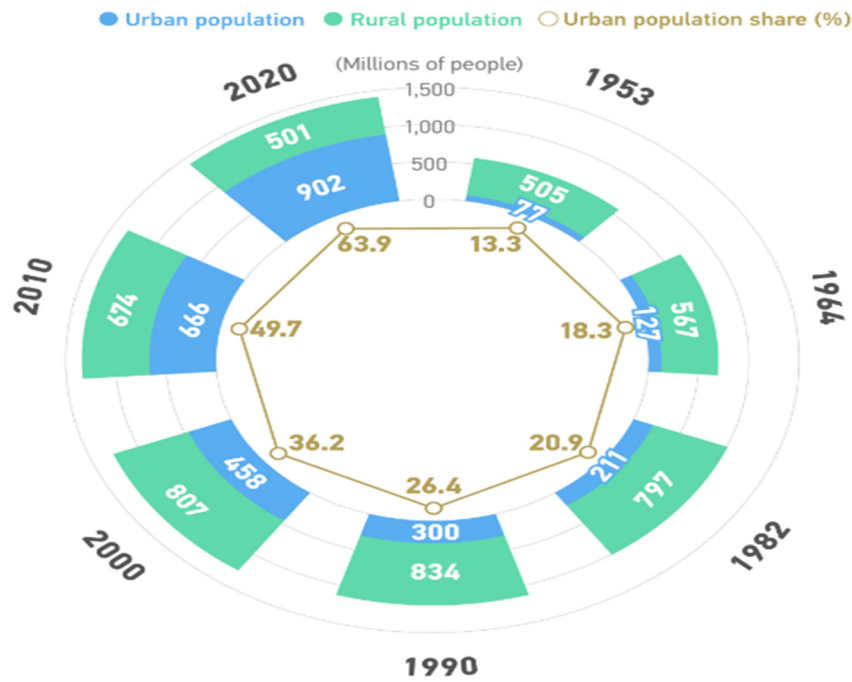


Figure 1 Urbanization in China

Figure 1 presents urban population, rural population, and urban population share in China from 1953 to 2020.

Even though urban-rural integration can solve the employment problem of many rural people, at the same time, they also have housing problems in urban areas. In order to solve such emergencies, the balance of supply and demand in the real estate industry has to be broken, and the demand has increased significantly, as far as possible to meet the people's basic living. In addition, urban-rural integration will also have an impact on the already wealthy urban residents. They see the rising trend of real estate prices, and in order to make money, they also participate in the balance of supply and demand in the real estate industry [3]. Overall real estate prices have brought about another volatility.

Meanwhile, due to the growth of residents' income, the renovation and demolition of old cities, etc., the demand for housing in China is constantly increasing, while the supply is relatively much less. Over-allocation of real estate has been a major feature of Chinese families. There are two reasons may answer that: First, lack of investment channels to residents; second, it is related to Chinese traditional culture, which everyone desires nice place to live, so that many families own two or more houses. This is a matter of perception. In response to the long-term structural problems of the real estate industry,

my country has also introduced several measures to regulate, but mainly focus on demand regulation, and the long-term effect is not obvious. The effect of demand regulation is mainly in the short-term, while supply regulation is more focused on the long-term, and supply regulation helps stabilize public expectations, and the public's expectations for housing prices are an important factor in determining housing prices [1]. Therefore, the real estate regulation should be transformed to a combination of supply and demand side regulation: on the one hand, severe regulation, controlling by various means on the demand side; on the other hand, increased land supply, which is the basic means of regulating the real estate market, aiming to achieve a basic balance of total land supply and demand, a basically reasonable structure and stable prices rather than blindly increasing housing supply. For example, in some places where the supply of housing has already exceeded the demand, increasing the supply of housing land and encouraging developers to build more houses will only increase the inventory significantly, cause a serious waste of resources, and be of no benefit to local economic development. As the 2021 Government Work Report says, to solve the outstanding housing problems in big cities is to increase land supply, arrange special funds, and centralize construction.

## 2.2 China's Aging Population

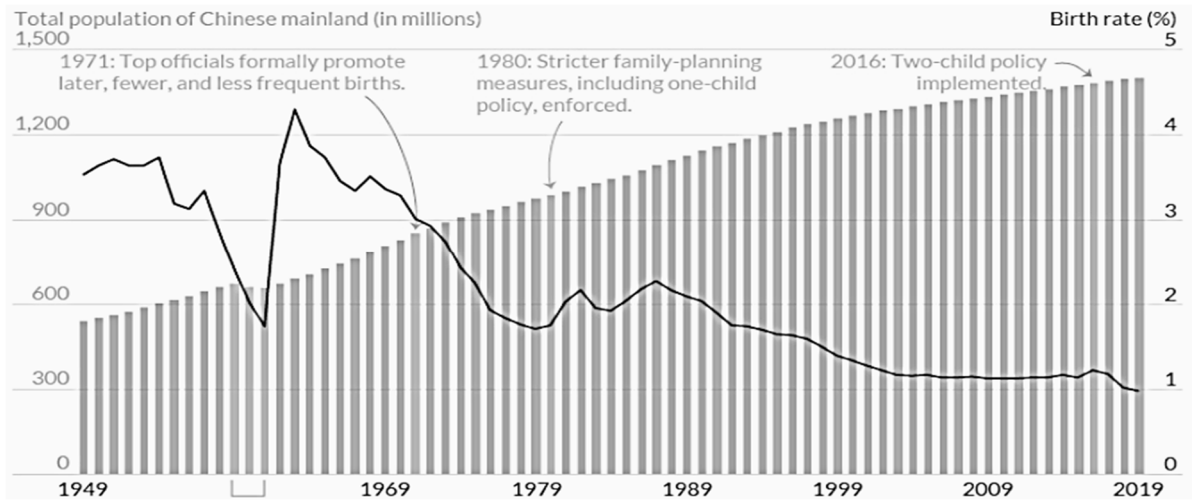


Figure 2 The growth of total population of Chinese mainland

This figure shows the population explosions which China experienced and presents that the birth rate in China is declining.

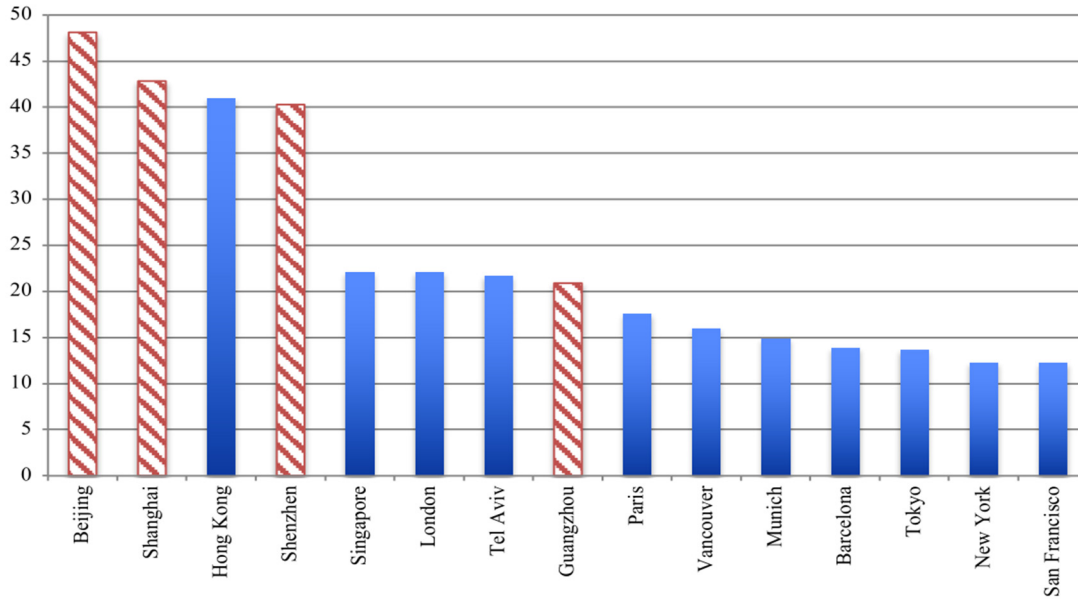
China has experienced three population explosions, among which the third baby boom from 1981 to 1997, more than 20 million births per year. At present, the average life expectancy of the Chinese population is 77 years old, indicating that the most difficult period for China will be 2026-2052. So before 2024, the house vacated after the death of the elderly in our country cannot meet the housing needs of a family. When the time reaches 2024, China's population will be in negative growth [4]. About 20 million people will die this year, but the new-born population will be less than 20 million, which means that the house vacated by the death of the elderly can meet the needs of a family, then Chinese housing will begin to have surplus, which can alleviate people's demand.

## 2.3 Sign of Froth

The household leverage ratio is the ratio of household debt to GDP and is an important indicator to measure the level of household debt within a country. This indicator

also largely determines the government's attitude towards monetary policy and real estate policy (high household leverage ratio tells that China's households may consider investing in housing market as the safest investment in China, because the Chinese government had intentionally stimulated the real estate in China for past decades). This household leverage ratio has risen sharply in some cities in China, and the debt ratio of a considerable proportion of households has reached an unsustainable level. More importantly, half of the new land resources of the whole society are invested in real estate, and real estate enterprises have over-financed, crowding out credit resources, further enhancing the efficiency of capital use, and fueling real estate speculation.

Why Is the Market in Shambles? According to "Peak China Housing [5]", which published in August 2020, Harvard Professor of Public Policy and Economics Kenneth Rogoff and IMF Economist Yuanchen Yang estimated that the real estate sector accounts for around 29% of China's GDP. As the world's second largest economy, China's real estate industry volatility has a domino effect on the world economic system.



**Figure 3** Housing Price-to-income Ratios in the World’s Major Cities (2018)

Figure 3 presents housing price-to-income ratios in some major cities, such as Beijing, Shanghai, Hong Kong etc.

There are two aspects reflect the oversized and overvalued real estate sector in China. First, the home prices per square meter have been on par with some of the world’s most expensive cities. “The rule of thumb long used by real estate agents and homebuyers is that you can afford a house if its price is equivalent to roughly 2.6 years of your household income,” Richard Florida, professor at the University of Toronto’s School of Cities and Rotman School of Management, states that “that ratio is based on historical nationwide averages under healthy economic conditions [6]”. If looking up the rank of Current Property Price Index [7], China’s major cities, Beijing, Hong Kong, Shanghai, Shenzhen, and Guangzhou, occupy 5 seats of the world’s top ten cities. There has been over 90% of household in China possess own homes. The home ownership rate in the US is only 65%. Besides, the housing cost in China’s some major cities is approximately 14 times as much as the average salary earned by an individual, such as Beijing and Shanghai. The second indicator of how the housing market being overvalued in China is the massive debt that the property developers have. The default from the developers have exposed the huge amount of debt that the housing market in China holds because of the developers.

**2.4 History of China’s Real Estate**

1950s to 1980s, China practiced its own urban system of socialist housing welfare. During that time, China’s housing market was considered as a non-commodity production sector. It was only used for supporting the Chinese people basic living need.

This initial stance started to shift when a speech on housing reform made by Deng Xiaoping in 1980. A guiding principle since had been made on urban housing commercialization in China. That speech emphasized that residential housing would be traded as a commodity sold to and owned by residents. This was for encouraging people to purchase homes rather than to rent homes. It also mentioned that people can invest in urban housing via multiple channels. This scheme benefited individuals by encouraging house buyers who were heavily subsidized. These moves became the foundation of what stands today as China’s housing market.

In 1998, Premiere Zhu Rongji announced that all housing will be commercialized. At the same year, People’s Bank of China announced mortgage program for individuals, and called on commercial banks to reserve up to 15% of their annual loans for private housing. In addition, Zhu Rongji sold off the government’s entire stock of urban housing at low prices to support the new era of urban home commercialization, which further boosted the demand for real estate as it became attractive to purchase property to every Chinese worker.

However, commercialization of social welfare housing caused issues: First, the government was heavily reliant on its ability to make the land a commodity, profiting from the enterprise; Second, large developer emerged, there was a high demand for new houses to meet the growing appetite for housing that the government had induced. The support that the government gave in the housing sector made the market seem much more stable than any other market and contributed to the overvaluation of the Chinese housing market.

For example, the troubles which Evergrande face have grabbed the world's attention on housing market in China. Evergrande has been pushed to the brink of bankruptcy by the recent slowdown of the real estate sales in China. Evergrande is most likely unable to pay a large balance due some day without as much cash flow as in previous. However, the government has still no signs that it will step in the dilemma to save Evergrande.

The land transfer income is collected by the tax department, indicating that the central government believes that the price reduction behavior of real estate companies (Evergrande) may cause a domino effect. China will alleviate the problems caused by the crackdown on the real estate industry by increasing tax sources. However, it is unrealistic to rely solely on the collection of property taxes to solve the problem. For example, in July 2021, resident deposits decreased by 1.36 trillion-yuan, housing prices did not rise, and the stock market did not move. Because as of the end of the second quarter, the balance of real estate loans was 50.78 trillion yuan, a year-on-year increase of 9.5%. So the households deposits decrease. If the real estate tax is levied at this time, for those middle-income people who have 2-3 sets of idle properties on hand, selling the house is almost inevitable [8]. Therefore, it should be necessary to stabilize housing prices in the future.

### **2.5 Housing Market Speculation**

Housing Market Speculation is when people buy a property today and hold it expecting that house will generate increased in value rather than living in or renting. The profit buyers want is in capital appreciation. Although the original purpose of China's real estate reform was to provide housing for people, the Chinese government's support for real estate has produced an unintentional signal.

This unintentional signal meant that housing is the safest investment for Chinese Investors' money as the value of housing appreciated in value yearly. Its appreciation gave people confidence. Therefore, savings were poured into purchasing houses rather than gaining low interest at the bank or losing money on the volatile stock market. The facilities were set up in a way that encouraged the speculative purchase of houses. Household started to go far as to employ lending networks to purchase homes as there was an increasing number of developers to build more properties. Housing market had been more of a sure bet, because property ownership became a rite of passage for young adults. Most millennial homeowners' wealth was deeply tied to real estate after they got money from families to have new homes. 70% to 80% of Chinese household asset are tied to real estate on average.

President Xi Jinping made a public admonishment "the house is for living, not for speculation" on the

Central Economic Work Conference in 2016. China is already seriously considering the feasibility of a property tax. There are two main advantages if property tax applied: First, discourage ownership of multiple homes as it would increase the carrying costs of the house. Second, offer the government another source of income. Nevertheless, as mentioned before, middle class would be severely affected by the action.

Since 2020, the government actively tightened regulations on developers, designed to curb debts, preserved cash, and limited overbuilding. Those actions exposed the financial fragility of developers. Taking a very quick look on how the developers do. They are selling properties before they done the work and using the advanced payment from buyers to reinvest new projects. All those developers rely on is cheap borrowing.

Overall, Chinese households are now cautious about taking on new mortgages. Their confidence in the housing market is starting to falter. Even though housing demand in China is still rising, the vacancy rate remains high. It is also easy to explain that the overestimated housing demand has caused the current situation.

### **3. REFLECTIONS FROM JAPAN'S FINANCIAL CRISIS**

In the 1980s, the appreciation of the yen due to the "Plaza Accord" became the trigger for the skyrocketing housing prices in Japan. In order to curb the appreciation of the yen and the advantages of trade, the Japanese government implemented a low interest rate policy in monetary policy, which promoted the rapid rise of Japanese stock market and real estate prices. From 1986 to 1990, the average price of commercial land in Japan increased by as much as 67.4%, among which the average land price in the three major urban areas of Tokyo, Osaka and Nagoya increased by 1.2 times, and the land price in Tokyo, Japan increased by 2.7 times from 1985 to 1988 [9]. The value of all real estate in Tokyo exceeds the value of all real estate in the United States combined. By the end of 1989, the value of all real estate in Japan was more than five times the value of U.S. real estate and more than twice the market value of the global stock market. In other words, if you sell Japan, you can buy 5 US. Although these figures seem absurd now, at that time, many experts used the "new economic paradigm" to explain the miracle of the Japanese economy and real estate. They believed that there was no bubble in Japanese real estate, such as more people, less land, and rapid economic growth. The logic now used to explain the rising housing prices in China was very popular in Japan's real estate market at the time.

However, there are several reasons for denying that Chinese real estate market will repeat the mistakes of Japan: First, China's urbanization has not been completed, while Japan's urbanization has been completed when the

real estate bubble burst. Second, apart from a few cities, housing prices in China are indeed too high, but the average housing price in China is just over 10,000 yuan, which is much lower than it was in Japan in those years. Furthermore, during the “14th Five-Year Plan” period, China's housing demand has not significantly weakened, and the demand for urban renewal, new residents and improvement is still very large [10]. The real estate bubble is less likely to burst due to the strong demand.

#### 4.CONCLUSION

In conclusion, China should learn from the lessons of Japan's financial crisis. Although there are some signs of bubble bursting in China's real estate market, too tight policies cannot be adopted, the most proper way may be “soft landing”, allowing time to digest the bubble slowly. Specifically, while controlling housing prices, by developing the economy and continuously improving the income level of residents, the growth of residents' income will exceed the rise in housing prices for a long time, and the ratio of housing prices to income will be continuously reduced. To solve the problem of high housing prices in China, it is necessary to avoid the plummeting housing price adjustments that have occurred in Japan. Nevertheless, this paper studies China's housing market from limited aspects and data. There will be big changes when new urban planning and real estate policies release. In the future, the expansion of China's real estate tax pilot program and the inflection point of the slowdown in urbanization will bring great changes, and these will undoubtedly become hot research topics.

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