

A Bubble Doomed to be Pricked Deconstructing the Chinese Real Estate Bubble

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Abstract. China's real estate housing boom has been a dreadful concern for economists worldwide. This paper analyzes the formation of the Chinese real estate housing bubble and investigates the factors that led to the bubble. Stimulated by the central government's fiscal pressure, a redistribution of the tax revenues led to China's local government's "land financing" strategy, flaming the rise of housing prices. Moreover, due to the global financial crisis of 2008, the Bank of China proposed low-interest rates while the central bank increased credit availability to rejuvenate China's economic state, which led to long-run damage. Furthermore, the expected traditional filial duty of Chinese parents to prioritize their children's education as an investment and the obligation of owning a home for males before marriage also triggered the skyrocketing double-digit inflation rates. Finally, economists worry that the increased construction demand due to the rising urban population in the early 1970s will doom the new modern world as the population is now declining, followed by the low demand for housing in the future.

Keywords: *Housing inflation, Real estate, Economic bubble, Government policies, Urbanization.*

1. Introduction

China, the second-largest economy worldwide, has been experiencing inflations in housing prices over the past decades. With the real estate sector being the engine of China's economy, the primary concern of the continuous housing downfall is that it'll severely crash the economic system in China in the long run. The rise in housing prices negatively impacts household consumption. In addition, the impact of the double-digit annual growth rate of housing prices put homeowners into dreadful debts as the citizen salary rate grew slower than inflation rates. Many worry that the real estate housing will not only affect China but also trigger a devastating global effect by slowing down the circulation worldwide [1]. The government of China attempted to introduce many fixes to curb the inflations. Although the government of China and the economists have proposed multiple solutions, many of these answers also conflict with each other. This article will analyse the formation of the real estate housing bubble over the past decades relative to population and immigration growth and the construction demand. Furthermore, the analysis of how the local government of China contributed to the bubble-like housing market by proposing strategies such as land financing and the overextension of credits, and the traditional parenting nature of the Asian households.

With the rise of housing demands, housing prices have skyrocketed at their worst beginning in the 2000s. The high cost and low housing affordability put innocent citizens wishing to own a home in tremendous debt. From 2003 to 2013, the housing price increased by 11% annually, while the average disposable income of a citizen only grew by 9% annually. The government of China has proposed multiple solutions to reduce and stabilize the price rate of homes. In "Real Estate Is China's Biggest Economic Vulnerability," the People's Bank of China issued a policy in 2020 called "The red lines," which mainly focused on reducing the burden of debts for homeowners by increasing debt coverage. Unfortunately, this proposal failed as it was introduced too late at a critical time; many firms increased their minority interests at the time [2]

Looking back, the Chinese housing reform in 1998 marked the beginning of real estate acceleration. In "China's Housing Reforms and Outcomes," the author mentions that the acceleration rate of housing construction increased due to population growth. From 1982 until now, the estimated population rate rose from 1 billion to 1.35 billion. However, the author debates that residential space per capita is the main factor for increased housing construction. Far exceeding countries such as Japan and Europe, the residential space per capita quadrupled in urban areas, from 6.7 square meters to 28.3 square meters in 1978 to 2007 [3]. Furthermore, the immigration rate of citizens from rural areas moving into urban areas is another major challenge China is facing. With a projected 15 million citizens migrating annually combined with the original population of the urban areas, the housing construction demand rose significantly following the next few decades.

2. "Land Financing"

The Tax-sharing Reform of China in 1994, a necessary move at the time, invisibly bolstered a wave of home price inflation for decades to come. Prior to the reform, the fiscal pressure of the central government significantly outmatched that of the local governments in China. Between 1979 and 1991, the gross budget surplus of the local governments was around 6.5 billion RMB, while the central government was burdened with an aggregate budgetary deficit of close to 115 billion RMB [4]. A reform was desperately needed to alleviate the central government's pressure and reshape the fiscal structure of the whole country.

During the Third Plenary Session of the 14th Chinese Communist Party Central Committee, the representatives reached a vital consensus to redistribute the tax revenue proportionately between the central and the local government. In "The Decision of the State Council on Implementing the Tax-sharing System for Financial Management", the State Council of China released an amended taxation revenue assignment guideline, in which all tax revenues were categorized into three types: Central Tax, Local Tax, and Central-local Shared Tax [5]. It immediately proved to be effective, but there would be consequences. Although the fiscal condition of the central government greatly improved, a substantial source of tax revenue, land transaction fee, was designated as a local-collected tax. For the first time, local governments were empowered to conduct land leasing sales and receive a one-time transaction fee from the real estate developer. This policy gave the local authorities the perfect incentives to push up land prices since higher land transaction fees would translate into more government income and better GDP figures. Most citizens, especially those who live in the first-tier cities of China, would have to endure the soaring mortgages.

Thus, an unsustainable feedback loop of home price inflation started. According to the Ministry of Finance, land transaction fees brought local governments 51.433 billion RMB of annual budgetary revenue in 1999, 4.1 trillion in 2013, and 8.7 trillion in 2021 [6]. With ample funding from land financing, the local governments were able to create business-friendly environments through mass infrastructure programs and "industrial parks" and "development zones" with tax incentives. These regions achieved quick industrialization by attracting foreign and domestic investors. In addition, counties and prefecture-level cities provided outstanding welfare programs, education, health care systems, and abundant job opportunities that drew the interests of skilled labor and college graduates. Rapid urbanization led to economic prosperity that drove up the cost of leasing lands, which consequently turned into fiscal revenue that could be reinvested repeatedly [7]. The local government's ability to repay its debt also heavily relied on the stable cash flow of revenue. A seemingly "win-win" cycle of economic development and land prices gradually formed.

3. Cheap Cash

The monetary and fiscal policies of the Chinese central bank after the global financial crisis of 2008 caused a cheap credit environment and the public's interest in the housing market. As a result of the 2008 financial crash and the shrinking economy, the People's Bank of China announced a

series of expansionary monetary policies in the third to fourth quarters of 2008 that lowered the interest rate by a gross of 2.16%. On top of it, the central bank increased credit availability by removing all credit lending scale limits on commercial banks [8]. These measures proved effective and injected liquidity into the market. Banks reacted by substantially loosening their control in giving out mortgage loans or lending to real estate developers. Hence many developers at the time, such as Wanda, Vanke, and Evergrande, were overleveraged and expanded their size aggressively with the relaxed financing regulations. Homebuyers also overextended their credit with the low-rate mortgage loans. To put more heat on the investment and consumption sectors, fiscal policies such as government spending and tax code changes quickly followed. In 2008, the People's Bank of China handed out an unparalleled 4 trillion RMB worth of stimulus package that was specifically targeted at supporting national and local infrastructure, small and medium-sized enterprises, credit expansion, etc. The multiplier effect greatly stimulated general consumption and investment. At the same time, the State Taxation Administration announced that, for individuals who purchase houses of 90 square meters or less for the first time, the deed transfer tax would be temporarily reduced to 1%. Stamp duty was also exempted for individuals selling or purchasing houses, and value-added land tax was exempted for individuals selling their houses [9]. With real estate gaining unprecedented exposure among the people, the inadequacy of alternative investments further heightened consumer euphoria in the market.

Channels for wealth generation and preservation in China have been traditionally limited to acquiring properties due to poor performance in the stock market and low bank deposit rates. Firstly, being a late participant in the global economy, the Chinese stock market was still in its infancy compared to the NYSE or the London Stock Exchange. Although the government has long promoted the growth of the financial market, only around 7% of Chinese citizens own stocks [10]. Mostly it is due to its notoriously low return on investment. In the case of the Shanghai Stock Exchange, it averaged approximately 0% from 2001 to 2016, while the return on investment of the Shanghai housing market during the same period was a staggering 10%. Similarly, the annual real interest rate of depositing their money in the bank was around 0% over the same period [11]. Investment abroad is severely restricted with all Chinese nationals having a currency purchasing quota of \$50,000 each year [12]. Complicated procedures and documents needed for investing abroad often disincentivize working-class households. Observing the exuberance in the real estate market and the high opportunity cost of putting their money elsewhere, Chinese people's interest in buying properties and the rise of real estate behemoths is unsurprising.

4. Filial Duty

Cultural factors made home purchasing in the urban areas appealing to the mass. In the conventional Chinese beliefs and the societal expectations under the One-Child policy, the older generation has much more filial duty than in the western world. Parents have the responsibility to make adequate financial and material preparations, such as acquiring new property for the future of their children. The two most crucial life stages considered by Chinese households are undoubtedly education and marriage.

First and foremost, the value of education is extremely pronounced in China and among all the East Asian countries due to the Confucian influence and their competitive nature. According to the Nearby Enrollment policy in China, cities are divided into different public school districts, and all residents have to attend primary and middle schools within their district. With the high demand and scarcity of superior educational resources, districts with better schools most certainly have the highest home prices [13]. Those real estates are referred to as the "School District Homes." To the parents, buying them is a worthwhile investment not only for the "destined" rise in their future values but also for the potential return from having accomplished sons and daughters. Naturally, elite education is densely concentrated in cities like Beijing and Shanghai, which attracts a crowd of high-saving and high-earning parents. Residents also enjoy the privilege of enrolling at top universities in these cities

for a relatively lower score on the Chinese national exam or otherwise known as “gaokao.” Now that demand for the homes in these regions is perfectly inelastic, home prices in the first-tier cities naturally have robust growth momentum.

Moreover, with the appreciation of home prices and increasing concerns from the parents of the female counterpart, it has become a male’s obligation to own a home for the couple prior to getting married. Large metropolises with abundant job opportunities and first-class education are clearly preferable choices. Most commonly, a large portion of the home purchasing fund would be financed by his parent’s past savings. For households below 35 years old, homeownership was 55% in 2013 in China, whereas in the United States, it was 18% lower [11]. When owning a property in a specific area meant “winning at the starting line” and competitive advantage, parents would strive to purchase them, even risk indebtedness for the rest of their lives. Evidently, prices are lifted with no change in fundamentals.

5. Conclusion

Close to three decades of bullish bubble-like growth in the housing market was propelled by the local governments’ strategy of “land-financing”, overextension of credit, and the mainstream expectation toward Chinese parents. Traditionally, the real-estate market has made up a significant portion of the Chinese economy. However, with the population in China rapidly declining and its economy going into a downturn, there will be close to no demand for the newly constructed apartment complexes in the “ghost cities.” In March of 2022, the central bank reported first-ever negative growth of residents' medium and long-term loans since statistics were available in 2007. The majority of which are mortgage loans [14]. The pandemic has negatively impacted the Chinese housing market much more than expected, especially with the central government still insisting on a “mobile zero-covid policy”. To avoid a hard landing of the whole economy, certain stimulus plans or favorable policies will have to be implemented in order to save such a crucial sector. However, the central and the local governments of China need to be crystal clear that the unsustainable boom of the past decades will not occur again. A fine line has to be drawn between stimulating growth and preventing another financial bubble.

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