China’s Housing Bubble

Foreword

China’s real estate mania has caused astronomical housing price growth of over 600% in key cities such as Shanghai, Beijing and Shenzhen over the past few decades (Chen, 2018). From speculation of a bursting property bubble to mysterious ghost towns, the housing market in China is watched worldwide. The Chinese government has taken radical steps to cool the market through containing speculative housing demand and stabilizing prices. Have the policies been successful? If not, how would a housing crisis in the world’s most populous country pan out?

Behind the Bubble

Causes and Consequences

A housing bubble is a phenomenon in which extrinsic property prices, fueled by demand and speculation, rapidly increase. This occurred in the 1990’s with Japan’s asset price bubble and the United States’s 2008 subprime crisis. Unlike Japan or the United States, however, China’s property boom is typically attributed to the population’s rapid income growth and urbanization. Nevertheless, income-growth-induced demand is not a comprehensive rationalization for the faster-than-income-price growth observed across a range of Chinese cities.

According to the Classic Bubble Model by Samuelson and Triole, people turn to property as the store of value when their fast growing wealth far surpasses the countries’ underdeveloped financial markets (Chen & Wen, 2017). China’s unsophisticated
capital markets compounded with control policies that prevent capital outflows propelled people towards speculation of real estate (Douglas & Yan, 2013). Additionally, given the Chinese cultural tendency towards saving, storing wealth in property creates a sense of security. Both of these factors have led to soaring housing prices, but those prices have started to flatten, indicating a future that is not nearly as negative as many would assume. Due to policies enacted by the Chinese government, a growing urban population and slowing prices, it is unlikely the bubble will burst - stabilization is the likely outcome.

**The Ghost Town Phenomenon**

While the housing bubble has driven up prices far beyond what the average consumer can afford, it has simultaneously led to a strange phenomenon throughout China: ghost cities. To boost economic growth, the Chinese government has been erecting 12 to 24 cities every single year; the construction of these cities has fuelled GDP and created thousands of jobs. It has also created many cities that have little to no residents including “recreations” of famous cities, from the Chinese Paris to the Chinese Jackson Hole.

China’s middle class has heavily invested in property, driving up and inflating the bubble. The results are prices far higher than what the average Chinese citizen can afford, leading to rows and rows of empty skyscrapers. Faith of high returns from the Chinese housing market is well-justified; housing prices have been growing at a faster rate than income, leading to abnormal returns over the past few years. However, there are concerns pertaining to the longevity and sustainability of these ghost cities. A slowing real estate market and growing urban population mean the ghost cities could soon cease to exist.

**Stabilization**

**Crack-down on Property Speculation**

Housing prices in China have have increased exponentially and far exceeded their fundamental values, quadrupling in Tier 1 cities and tripling in Tier 2 cities between 2003 to 2013 (Glaeser, Huang, Ma, & Shleifer, 2017). In 2016 President Xi Jinping famously announced “houses are for people to live in, not for people to speculate.” Due to its communist political structure, the Chinese government is free to implement ad hoc regulations without facing the same bureaucratic hurdles as North American countries. The result is an intensely monitored, extremely regulated Chinese housing market with Home Purchasing Restrictions (HPR) to stabilize the market.
The most intuitive HPR policy is restricting the amount of houses citizens are permitted to buy. Suzhou, for instance, restricts locals to owning three properties and non-locals to one property (Shepard, 2017). To further discourage housing as a medium of pure investment, substantial down-payments are required before financing becomes available. Contingent on fluctuating property prices, down-payments range from 20% to 35% for first-home buyers all the way to 60% to 80% for second-home buyers. The full amount must be paid up front for those who wish to own three or more homes. From 2004 to 2013, average housing prices grew at an annual rate of 17%, which is much higher than the 11% growth in average income and, more alarmingly, the country’s 10% growth in GDP. Cities such as Dalian have administered decrees which essentially cap property prices from rising faster than the average increase in disposable income (Yu, 2016).

The government’s radical efforts to stabilize the housing market are succeeding; China’s property prices have been rising at the slowest pace since August 2017. Average home prices in 70 of China’s major cities rose by only 0.2%. Housing prices in Beijing and Shanghai, China’s two main metropolises, rose by only 5.2% and 0.2% respectively, while Shenzhen, China’s tech hub, fell incrementally by only 1.9% from the previous year (“Global Property Guide”, 2018). Based on the success of the current policies, it is evident that the Chinese government has ensured cooling of the housing market and stability is likely to prevail. In the foreseeable future, amidst fluctuations, the housing market will invariably circle back to homeostasis.

**Hukou Hypothesis**

In addition to the aforementioned policies, the Chinese government has further tools to prevent a housing bubble burst; a hypothesis worth exploring is a change in *hukou* regulations. *Hukou* is the Chinese permanent residence registration system with which the government influences patterns of urbanization. Unlike in Canada, where free mobility rights are outlined in the Charter of Rights and Freedom, internal migration in China is one of the most restrictive in the world; purchase of property in major cities is near impossible without a local *hukou*. Should a catalyst spark a sudden drop in property demand and subsequently in housing prices, the government can relax its tight grip on internal migration restrictions.

Contrary to Canada, the discrepancy between standards of living among Chinese provinces is vast; factors such as employment, education, and business opportunities fuel migration attempts from rural areas to large cities. Loosening *hukou* restrictions will inevitably mean citizens cramming into large cities; demand will be boosted and the value of property will rise to prevent a drastic housing meltdown.

**Bursting the Bubble**

**Housing Meltdown in Small and Ghost Cities**

While it is likely the property bubble won’t burst, it is still worth exploring the possibility and consequences of a catastrophic housing crisis in China. Over the past few years, property-related loans in Chinese cities have increased more rapidly than GDP. Furthermore, the majority of China’s growing household debt is from mortgages (Chen & Wen, 2017). Whereas property prices in China’s Tier 1 cities have started to cool down, Tier 2 and Tier 3 cities are still showing price increases. As the Chinese government protects its metropolitan cities such as Beijing and Shanghai, speculators have turned to smaller cities which “*offer cheap credit and*
impose few restrictions in the hope of clearing a glut of unsold homes” (Glenn, 2017). Whereas the overvalued property in major cities still offers substantial intrinsic value, overvalued housing units in small or ghost cities offer little to no intrinsic value; the properties are akin to “concrete boxes in the sky”. As such, when the market begins to normalize, the difference of price drops of property in small and ghost cities compared to major cities will be immense and alarming.

**Dire Consequences**

Small cities and ghost cities in China have relatively low appeal; much of the housing units are unfinished, unfurnished, poorly built, and located in low-activity neighbourhoods. With such low intrinsic value, the investors of these units stand to lose a great deal of money. Moreover, leverage may cause any such issues to reverberate through the financial system. As it is projected that 40% of Chinese banks would be hit, a ripple effect of economic disaster will spread throughout the country. Real estate encompasses 74% of household wealth in China and 13% of China’s GDP; Chinese citizens have immense wealth tied up in real estate, due to an underdeveloped financial system and governmental restrictions regarding overseas investment (Bloomberg News, 2017). Should the housing bubble burst, Chinese citizens and banks will see their wealth shrink and the government must scramble to either invest in the financial sector or establish a new source for people to invest in. If the Xi administration is unable to curb the potential ill effects of a red-hot real estate market, the consequences may be catastrophic.
REFERENCES


