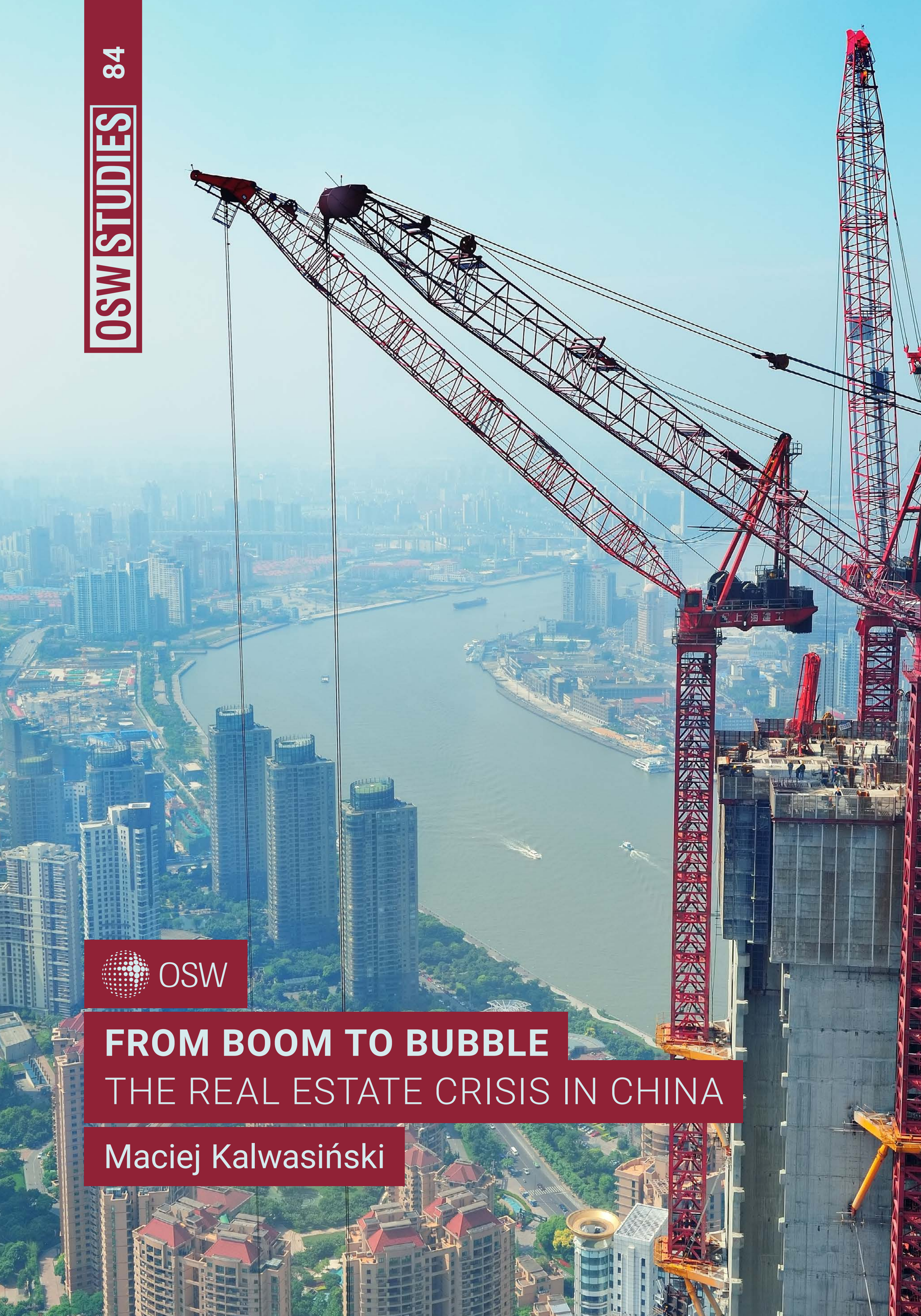

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Contents

MAIN POINTS

- The August 2020 decision by the government of the People's Republic of China to limit developers' debt triggered the deepest and longest crisis in the country's real estate market since its inception in the 1990s. As a result, the Chinese economy lost the main driving force it had had over the previous several years. Investments in the housing sector and infrastructure allowed China to navigate the global financial crisis relatively unscathed and were also essential in its rapid urbanisation. However, the upper echelons of government had been considering a permanent cooling down of the market for years, as the long-standing stimulus policy had produced a number of pathologies, resulting in social problems, a sharp increase in debt and systemic risks to the financial sector. In this context, reducing the real estate sector's role in the economy is consistent with the Chinese leadership's priorities.

- With the aim of replacing real estate in its key role and strengthening national security, the Chinese government is now redirecting resources towards expanding the country's vast industrial base and energy infrastructure with the aim of creating a 'new engine' for the economy, reducing China's dependence on foreign countries and securing its position as a global leader in innovation. The private sector has aligned itself with the policies of the Chinese Communist Party (CCP). This new model is already exacerbating overcapacity, boost exports and reduce the need for imports. As this poses a threat to other economies, tensions in China's foreign relations are certain to escalate. Consequently, the global trend towards tighter protectionist policies will accelerate and the risk of trade wars will increase significantly.

- In light of the revised priorities under Xi Jinping's leadership, the real estate crisis does not pose a fundamental problem for the government as long as it does not threaten China's stability. The party's current goal is not to maximise economic growth, but to enhance national security and prepare for an escalation of its conflict with the US. In the economic sphere, this means mobilising public and private resources to achieve independence from foreign suppliers in key sectors such as industry, energy and agriculture, while ensuring macroeconomic, financial and social stability. The continued expansion of the real estate sector absorbed the limited human and financial resources which could have been used to advance the government's priorities, it caused frustration among those who were pushed out of the market due to high prices and risked destabilising the economy in the event of the speculative bubble bursting.

- As a result of the speculative fever in recent decades, housing prices in China's largest cities, such as Beijing and Shanghai, have skyrocketed, reaching some of the world's highest levels relative to local incomes. In smaller urban areas, mass speculation has led to the emergence of 'ghost cities' and a large oversupply of housing, leaving many properties unoccupied. After the first wave of the coronavirus swept across the country, the Chinese government decided that it was the right moment to deal with this issue. The decision was rational, but its timing proved less than ideal and the intervention's impact was stronger than expected. Banks and investors reacted sharply, which drove developers into insolvency and halted construction projects, while potential homebuyers refrained from purchasing homes.

- In mid-2024, housing sales in China's primary market fell to a 15-year low while construction starts dropped to the lowest level in nearly two decades. Property prices, both for new and second-hand homes, saw the steepest decline on record, even though the government stalled the approval of price cuts for a long time. The Chinese authorities have been gradually stepping up their efforts to stabilise the market, with some cities even resorting to 'interventionist' purchases of homes. Although China's housing policy is now more lenient than ever before, the measures taken so far have failed to produce the desired results. This likely stems from Chinese citizens losing confidence that property prices will continuously rise, which is discouraging them from making purchases despite favourable government policies.

- The Chinese government is using the crisis as an opportunity for the state to gain greater control over the real estate market and reduce the influence of local interest groups. Under Xi Jinping's leadership, the party's role in the state and the state's role in the economy have both expanded. 'Three high mountains' separate the Chinese people from affluence: the costs of education, healthcare and housing. The state has addressed the first two areas at a basic (but insufficient) level, while private ownership still dominates the housing sector. Expanding the public sector's role in housing would be politically justified, but it would require enormous investment. The cost of completing the construction of paid-for homes is estimated at several trillion yuan, which exceeds the capacity of the country's financially troubled developers. A similar sum would be needed for state-owned entities to purchase enough housing units from developers to significantly reduce the market imbalance between supply and demand.

- So far, the real estate crisis has failed to trigger a financial crisis in China. The government has prevented problems from spreading to other sectors by maintaining control over key financial institutions and cross-border capital flows. However, the potential risk lies at the regional level. In the face of declining revenues from sales of land-use rights, local governments may be forced to reduce financial support for heavily indebted companies. As a result, small local banks are also at risk.

- The global impact of the real estate crisis in China will remain limited as long as Beijing can continue to prevent the problems from spreading to other key sectors, particularly the financial sector. Global investors, commodity exporters and foreign companies that sell consumer goods to China and which compete with Chinese businesses in other markets are most likely to be affected. The outside world will have a greater challenge to adapt to a new Chinese economic model, where industry and advanced technologies are set to become the primary drivers of growth.

INTRODUCTION

The real estate boom has been the cornerstone of the 'economic miracle' that in recent decades has elevated China to its status as the world's second-largest economy and turned its metropolises into symbols of China's development, global power and aspirations. China can boast of its 5,000 years of history, yet today few buildings in the country are more than 50 years old.

China's integration into the global supply chains during the period of 'reform and opening-up' triggered mass migration from rural areas to cities in search of better-paying jobs than farming and higher standards of living. Housing in urban areas was allocated by 'work units'. In the 1990s, the Chinese government decided to grant property ownership to tenants and create a real estate market in order to meet growing housing demand and restore public support following the suppression of the 1989 Tiananmen Square protests. Due to the underdeveloped social safety net and rapidly rising incomes, homes became more than just places to live – they were also used as a form of capital investment. This sparked an unprecedented investment boom that created the world's largest real estate market, with a value surpassing that of the US stock and bond markets.

Real estate began to play a crucial role in China's economic model. By the end of the last decade, this sector, along with related industries, accounted for around 25% of China's GDP, a higher share than in any other G20 country. Real estate also became the preferred form of investment and the main component of wealth for Chinese citizens.

As a result, signs of a speculative bubble emerged in the market. Housing prices in Chinese metropolises soared to the world's highest levels relative to residents' incomes. The liabilities of just one developer, the China Evergrande Group, reached a level equivalent to Poland's national debt. The sector increasingly absorbed human and capital resources, constraining China's economic growth. Moreover, the financial sector's assets and household debt expanded at an alarming rate, while social inequalities became more pronounced and environmental degradation worsened.

To arrest the increasingly negative trends, the government moved to dampen the real estate market during periods of economic growth. However, it rolled back the restrictions each time the costs of this policy proved too high and the economy slowed significantly. During downturns, it stimulated housing demand and supply to boost economic activity. It attempted to follow this pattern again in 2020: taking advantage of the economic rebound following the first wave of the coronavirus, it tightened regulations on financing for developers. This time, however, the outcome exceeded all expectations. Amid a challenging domestic environment caused by the pandemic and the external pressures resulting from China's growing rivalry with the US, the government's decision triggered the deepest and longest crisis in the Chinese real estate market since its inception in the late 1990s. The 2021 insolvency of the China Evergrande Group, the 'world's most indebted developer', became the symbol of this crisis. Yet this was merely a symptom of deeper structural issues.

Within three years, home sales in the primary market shrank by more than half, while the number of new construction starts plunged by nearly two-thirds. According to official data, home prices saw their steepest decline on record, though these figures likely understate the true scale of the drop. The situation has understandably raised concerns both domestically and abroad as problems in this sector have often been seen in many countries to be the trigger for economic crises.

The purpose of this study is to present the origins of the crisis in China's real estate market, describe the current state of this sector and its impact on the Chinese economy, and to outline potential solutions and their consequences for the rest of the world. The text is divided into three sections. The first examines the practice of widespread housing speculation and its negative effects. The second discusses the government's attempts to cool and then stimulate the market over the past three years. The third outlines possible future scenarios.

I. THE GREY RHINO[1]: THE ORIGINS OF THE REAL ESTATE CRISIS

In the People's Republic of China, housing serves two main functions: it houses people and acts as an investment tool. Over the past three decades, demand in both these areas – the existential and financial – has been exceptionally high, driven by urbanisation and rising incomes.

As recently as the mid-1990s, fewer than 400 million people lived in Chinese cities, but by 2023, this number had exceeded 900 million. The urbanisation rate surged from 31% to over 66%.[2] As incomes rose, so did the demand for better housing conditions. Residential space per person[3] increased from under 20 square metres to 36.5 sq m. Old buildings were replaced with new ones and access to basic amenities such as running water, sewage systems and electricity expanded significantly.

Given the underdeveloped social safety net and the lack of attractive alternatives (see 'How the Chinese invest' box below), real estate became the preferred investment asset. Chinese people saw housing as a safe and profitable investment. They analysed the historically high returns and remained convinced that prices would continue to rise. Unlike financial products, properties also have a physical and practical nature: they are real, tangible assets that can be used for living in, renting out, or as collateral. Moreover, with no property tax and low maintenance charges, the cost of financing and maintaining these properties through loans is relatively low.

How the Chinese invest

Chinese people are known for having a strong propensity to save and for seeking effective ways to grow their wealth. Those who experienced the hardship, hunger and uncertainty of the Great Leap Forward (1958–1962) and the Cultural Revolution (1966–1976) consider it necessary to prepare for the next crisis. They are also willing to sacrifice some of their current conveniences to secure future profits and guarantee prosperity for

[1] A 'grey rhino' refers to serious and visible threats that are often ignored, unlike the unpredictable 'black swans'.

[2] *Statistical Communiqué of the People's Republic of China on the 2023 National Economic and Social Development*, The National Bureau of Statistics of China, 29 February 2024, stats.gov.cn.

[3] T. Huang, *Why China's housing policies have failed*, Peterson Institute for International Economics, June 2023, piie.com.

themselves and their families — a mindset they pass on to their children. This attitude is further reinforced by China having an underdeveloped social safety net, which forces Chinese people to rely more on their own resourcefulness and family support than on state assistance for income in retirement and access to healthcare.

Chinese residents have access to a wide range of investment products, but none are considered as profitable or safe as real estate. The domestic capital market has long been mired in weakness, investment funds prompt distrust, wealth management products do not guarantee security, gold yields relatively low returns, bank deposit interest rates are minimal while cryptocurrencies have been effectively banned. The government continues to restrict investments in foreign assets, such as stocks, real estate and foreign currencies.

The issue of home ownership divides the residents of Chinese cities. A 2019 analysis by the People's Bank of China found that 96% of surveyed households owned their homes. Nearly one-third owned two properties, while one in ten respondents owned at least three. These assets accounted for 60–70% of their wealth.[4] However, the survey likely did not include the vast majority of migrants working in urban areas without a local hukou (residency permit), who make up about 30% of city dwellers. They usually live in worker dormitories, container homes at construction sites or overcrowded rental properties, while their family homes are located in rural areas or smaller towns. According to the 2020 census, around 25% of urban residents are renting.[5]

1. The speculative fever and 'ghost cities'

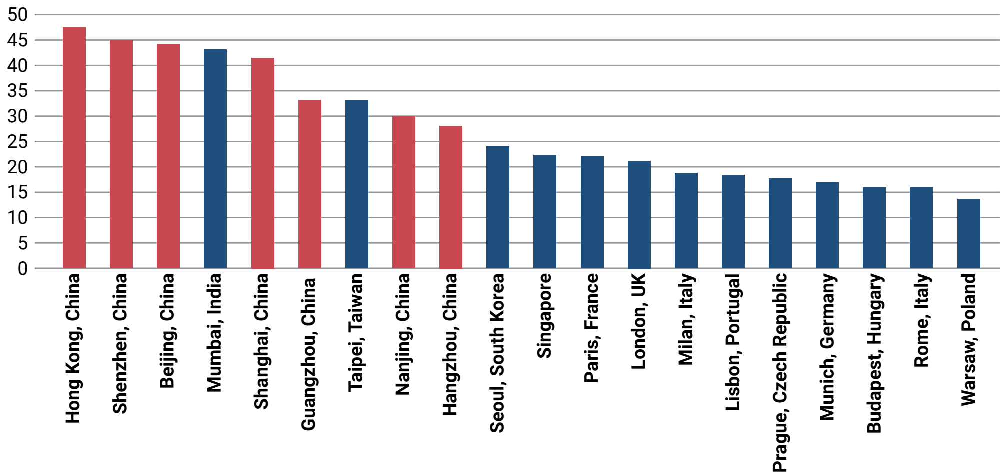
The current crisis in China's real estate market was triggered by the central government's decision to restrict developers' access to financing. However, its root cause lies in widespread speculation involving millions of Chinese citizens and companies.

Even though in 2016 Chinese President Xi Jinping publicly declared that "homes are for living, not for speculation",[6] the practice has continued unabated.

4 '2019年中国城镇居民家庭资产负债情况调查', The People's Bank of China, 24 April 2020, finance.sina.cn.
5 Yuhan Zhang, 'China's Recent Rental Strategy Is a Win for Some, a Strain for Others', Carnegie China, 28 August 2024, carnegieendowment.org.
6 '中央经济工作会议在京举行　习近平发表重要讲话', Xinhua, 16 December 2016, xinhuanet.com.

As a result, property prices even outstripped wages: between 1998 and 2021, the price-to-income ratio in cities quadrupled. Homes in China's largest metropolises became the most expensive in the world in relative terms, with prices averaging 30 to 50 times[7] the annual disposable income of the average resident, which is around two to four times higher than the same ratio in Western cities (see Chart 1).

Chart 1. Housing price-to-income ratio in selected cities worldwide in 2020



Source: Numbeo.

For many young Chinese people, buying a home has become something unattainable, even with family support (the so-called 'six wallets', referring to the parents and grandparents of a young couple). For others, the cost of purchasing a home, including the down payment and loan repayments, is so high that they have to significantly cut back on other expenses. This not only leads to a sense of instability and insecurity, along with growing disillusionment among the younger generation entering into adulthood, but it also directly exacerbates China's inequalities and demographic problems.[8]

In smaller, depopulating cities, many of which still have populations exceeding one million, the oversupply of housing poses a major challenge. In recent years,

[7] The actual purchasing power of residents in major cities is often underestimated, primarily due to unreported income and the exclusion of migrants from the pool of potential buyers. Additionally, housing prices implicitly include access to higher-quality public services and an upfront 'tax' (since state-owned land forms part of the construction cost), rather than a usage-based tax, such as property tax. High property prices are also driven by public expectations of future economic growth and income increases.

[8] M. Bogusz, 'A disaster of their own making. The demographic crisis in China', *OSW Commentary,* no. 570, 7 February 2024, osw.waw.pl.

most homes have been built outside the several largest metropolitan areas,[9] even though Chinese people would prefer to live in these places as they offer broader career opportunities, higher education standards, superior healthcare and social prestige. However, local authorities and residents, especially in cities such as Shanghai and Beijing, are reluctant to share these 'privileges' with newcomers and lack the resources to meet the needs of all those wishing to settle there. The supply of new homes, and the ability to purchase them, remains limited.

The tiers of Chinese cities

Chinese cities are informally classified into 'tiers', ranging from the most important Tier-1 cities to smaller ones designated by successive numbers (typically, there are five tiers). The classification criteria include population size, economic development, infrastructure and political clout. The Tier-1 cities of Beijing, Shanghai, Shenzhen and Guangzhou are referred to in this text as 'metropolises'.

Several factors have created a vast number of vacant properties: treating residential properties as investments, restricting their purchase for people migrating to metropolises and building homes where they are not needed. According to the 2017 China Household Finance Survey, there were as many as 65 million vacant homes in cities.[10] In 2021, Rhodium Group estimated that these properties could house 90 million people — more than the population of Germany.[11] In 2022, Beike Research Institute reported that in the largest cities, the vacancy rate averaged 7%, while in Tier-2 cities it reached 12%.[12] According to former housing minister Qiu Baoxing, the nationwide figure was 15%,[13] while an analyst from the Australian central bank estimated it at approximately 25%.[14]

9 Calculations by Rogoff and Yang indicate that in the past decade over 70% of homes were built in Tier-3 cities. These researchers use a three-tier classification system for Chinese cities. See K.S. Rogoff, Y. Yang, *A Tale of Tier 3 Cities*, The National Bureau of Economic Research, September 2022, nber.org.

10 L. Gao, C. Jim, 'China property firm apologises for vacancy rate report after public debate', Reuters, 11 August 2022, reuters.com.

11 J. Kynge, S. Yu, 'Evergrande and the end of China's 'build, build, build' model', Financial Times, 22 September 2021, ft.com.

12 The report sparked an uproar on Chinese social media, prompting the think tank to apologise for its publication and admit methodological errors. *Survey Report on Housing Vacancy Rates in Major Chinese Cities,* Beike Research Institute, 11 August 2022, chinadigitaltimes.net.

13 H. Yu, F. Ding, W. Han, 'China aims to ease property crunch via new affordable housing push', Caixin, 30 December 2023, asia.nikkei.com.

14 A. Baird, *Urban Residential Construction and Steel Demand in China*, Reserve Bank of Australia, 18 April 2024, rba.gov.au.

Investors purchase homes but often choose not to rent them out as they are discouraged by relatively low rents of around 2% of the property's value per year, compared to 5–6% in major cities abroad. In addition, some government officials have tried to conceal their ownership of additional properties from the anti-corruption authorities. Since owners hardly ever pay property taxes, the cost of maintaining properties is low, which reduces their incentive to rent them out. Many homes purchased as an investment or for future use (for example, by the owner's children) remain unfinished and unfurnished.

In recent decades, the sector has been growing so rapidly that many newly built housing estates and even entire city districts remained largely uninhabited for years. These locations, along with complexes of unfinished and abandoned construction sites, have been dubbed 'ghost cities'. In some cases, such as the Kangbashi district in Ordos or Zhengdong in Zhengzhou, the problem has been partly resolved after people and businesses gradually moved in. However, China's negative demographic outlook[15] and internal migration patterns suggest that more areas may become depopulated and turn into new 'ghost cities'.

2. The vicious circle

The central government grew increasingly concerned about the real estate sector's operating model and its ties to other parts of the economy. Faced with a near continuous, rapid rise in housing prices, developers prioritised expanding their operations as quickly as possible, while buyers rushed to purchase homes. The prevailing belief was that the sector was 'too big to fail' and that the government would not allow the collapse of a market so crucial to the economy, influential interest groups and the general population, as this could trigger an economic crisis and cause hundreds of millions of Chinese people lose their wealth, undermining support for the CCP. Consequently, the risks were largely ignored and the debts kept piling up.

The aggressive investment strategy yielded significant profits, which encouraged even more risk-taking.[16] Between 2012 and 2021, household debt, consisting mostly of mortgages, grew at double the rate of disposable income. Developers sought financing from banks, 'shadow banking' entities, the

[15] M. Bogusz, 'A disaster of their own making…', *op. cit.*

[16] Many developers expanded their activities beyond the housing sector. Instead of diversifying their operations to stabilise cash flow, they invested in speculative or prestige projects, such as football clubs, streaming services and amusement parks. Meanwhile, companies from other sectors ventured into property development, drawn by the prospect of large profits.

domestic and international bond markets as well as homebuyers who paid upfront for their properties. According to estimates by Nomura analysts, by mid-2021 the total liabilities of these companies had exceeded 30 trillion yuan (c. 30% of China's GDP).

'Shadow banking' refers to financial services similar to those offered by traditional banks but provided by non-bank financial institutions operating outside the formal banking system. Its characteristic features include a complex organisational structure, high leverage and limited transparency. Additionally, this sector is deeply integrated into the financial system, which increases the risk that crises could spread. In China, shadow banking is unique due to the strong connection between the formal and informal sectors. Regulations restricted banks from lending directly to developers and local governments, so they channelled funds indirectly through 'shadow banking' entities by investing in their assets. Smaller developers, with limited access to other sources of funding, were particularly reliant on institutions from this sector.

The problem was not only the massive scale of debt but also its partially opaque nature and the dense web of financial links involving mutual obligations, guarantees and loans.[17] After acquiring funds, developers primarily used them to purchase more land-use rights, which then served as collateral for further borrowing. Their focus was on starting new construction projects and quickly selling housing units to secure a steady inflow of capital rather than completing the paid-for homes under construction, settling debts with contractors and ensuring the high quality of buildings.[18] Buyers usually had to pay the full amount for the property to the developer and begin repaying their mortgage even before construction was completed.

The widespread adoption of the pre-sale model set in motion a mechanism resembling a Ponzi scheme, where new buyers provided the funds necessary to complete projects for previous customers. Developers sold nearly 90% of properties this way. The regulations that required them to use most of the funds for specific projects were not strictly enforced by the government and banks.

[17] The Evergrande Group's on-balance-sheet liabilities reached 2 trillion yuan, while its off-balance-sheet obligations were estimated at a further trillion yuan.

[18] As a result, the term 'tofu buildings' has become common in China, referring to poorly constructed, low-quality structures that often pose safety risks. The name alludes to the food tofu, which is soft and easily crumbles, symbolising the fragility and instability of these buildings.

The high demand for development land[19] drove up prices, increasing its value as collateral and expanding borrowing capacity. This allowed developers and local-government financing vehicles (companies controlled by local governments that implement their policies) to take on even more debt.

Local budgets dependent on the housing market

The rapid growth of the real estate market ensured the steady flow of funds to the budgets of local governments, which had lost a significant portion of their revenue to Beijing after the 1994 tax reform. All land in urban areas is state-owned.[20] Formally, the government does not sell land outright, but grants usage rights for up to 70 years in the case of residential development. Local governments often pressured farmers to relinquish their rural land for compensation below market value or in exchange for promises of housing, which disrupted local communities. Then they reclassified this land as urban and transferred the usage rights to developers. Steps of this kind helped fill gaps in public budgets and strengthened the position of local interest groups.

Over the past decade, revenue from the sales of land-use rights, along with real estate-related taxes, accounted for more than 32% of local budget income, including 45% of own-source revenue (which excludes transfers from the central government). In the record year of 2021, nearly 11 trillion yuan was generated from these sources, equivalent to around 10% of China's GDP[21] (see Chart 7). This income financed infrastructural projects and allowed local governments to stimulate economic activity, as required by the government in Beijing, which set ambitious GDP growth targets.

This vicious circle fuelled economic activity, boosted corporate and bank profits, increased local government revenues and raised the perceived value of assets accumulated by homeowners. However, it posed a threat to the stability of both the economy and the state. Therefore, every couple of years, the government

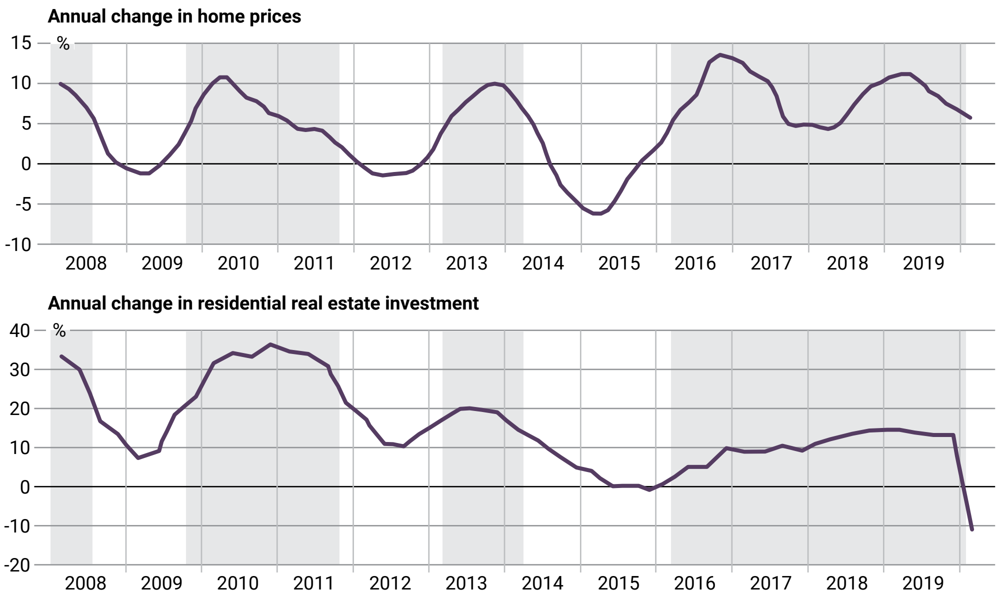
19 The rapid increase in the prices of land designated for housing was also supposed to compensate local budgets for the relatively low prices of land leased to manufacturing companies. Cheap land was a form of state support for these businesses.

20 Rural land belongs to local collectives. Farmers receive rights to use plots of land but cannot sell them or manage them as private property, for example by using them as collateral for a mortgage.

21 T. Huang, *Why China's housing policies have failed*, *op. cit.*

moved to cool down this overheated sector.[22] It raised down payment requirements and mortgage interest rates and fees, restricted the sales of properties and purchases of homes (for example by divorcees) and excluded individuals without a local *hukou* (residency permit) from the market.[23] In several large cities, the right to buy a property was even determined by a lottery. The government also reduced the supply of land, increased its prices and tightened regulations for developers, including those restricting their ability to take on more debt.

Chart 2. Real estate market activity indicators in China



Shaded bands show periods where central government policy has generally been tightening.

Source: J. Kemp, A. Suthakar, T. Williams, *China's Residential Property Sector*, *op. cit.*

However, both sellers and buyers continued to find ways to circumvent these restrictions, while investors remained confident that the difficult period was temporary and waited for the right moment to make further purchases. When the sector's problems began to heavily impact the broader economy or when the economy struggled for other reasons, the government rolled back the

[22] J. Kemp, A. Suthakar, T. Williams, *China's Residential Property Sector*, Reserve Bank of Australia, 18 June 2020, rba.gov.au.

[23] *Hukou* is a Chinese household registration system that formally classifies residents as either 'urban' or 'rural', thereby regulating access to public services such as education, healthcare and housing, as well as affecting employment opportunities. As a result, it restricts internal mobility and hinders access to resources and opportunities in regions other than one's region of origin.

restrictions, which reignited the speculative frenzy (see Chart 2). This stimulated economic activity, although profit-driven private entities, such as investors purchasing homes and developers, bore a significant portion of the costs.

3. A tree cannot grow all the way to the sky

The economic developments over the past decade have been accompanied by political processes that would shape the future of China's real estate market and overall economy. The accumulation of the negative consequences from economic stimulus measures in response to the 2008 global financial crisis, along with subsequent periods of downturn, intensified conflicts within the CCP's leadership.

China's response to the 2008 global financial crisis

Initially, the stimulus package was supposed to total 4 trillion yuan, or roughly 12.5% of China's 2008 GDP. However, the programme turned into a 'credit tsunami' after Premier Wen Jiabao called for it to be 'large, fast and effective'. According to cautious estimates by Christine Wong, over a 27-month period starting from the fourth quarter of 2008, the package ballooned to 9.5 trillion yuan, or nearly 30% of China's 2008 GDP.[24] The debt of the public sector, households and non-financial companies soared from just under 135% of GDP in late 2008 to almost 175% a year and a half later (see Chart 3). By the end of 2012, bank assets had doubled compared to four years earlier.

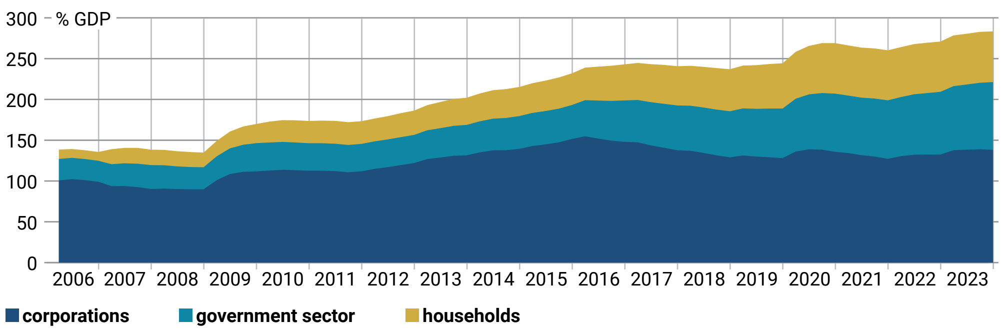
The dispute pitted those who advocated maintaining the existing economic policy focused on income growth against those who pushed for a reform of the debt-driven growth model. The former group was reportedly led by former Premier Li Keqiang, while the latter prominently included Liu He, a close advisor to the General Secretary of the CCP Xi Jinping and later Vice Premier in charge of economic affairs. The conflict within the leadership appeared to be significant as it began spilling into public view through anonymous articles in the *People's Daily* and numerous statements from both former and current officials in the central bank and the finance ministry.

[24] C. Wong, 'The Fiscal Stimulus Programme and Public Governance Issues in China', *Journal on Budgeting*, vol. 11/3, 2011, OECD.

At the same time, Xi Jinping and his inner circle continued to consolidate power. After becoming the CCP's General Secretary in 2012, Xi marginalised and dismantled rival party factions, partly by launching China's largest ever anti-corruption campaign.[25] His influence over economic policy,[26] traditionally the domain of the Chinese premier, also began to gradually increase.

As a result of the unprecedented credit boom between 2009 and 2016, the debt of the public sector, households and non-financial companies surged from just under 140% to over 240% of China's GDP (see Chart 3), an increase of around 140 trillion yuan (c. $20 trillion). Successive episodes of volatility in the Chinese financial markets resulting from the massive stimulus measures, along with a slowing economy, meant that it became urgent to resolve the intra-party dispute over the stimulus policy. The official GDP growth rate fell from over 10% in early 2011 to around 7% between mid-2014 and mid-2018. The Chinese government also faced a liquidity crisis in the interbank market in June 2013, a period of over two years of capital outflows and the weakening of the yuan against the dollar starting in 2014, and then the bursting of the stock market bubble in June 2015.

Chart 3. Credit to China's non-financial sector



Source: The Bank for International Settlements.

In 2016, the proponents of curbing the rapid growth of debt, driven by the expansion of urban areas, infrastructure and the housing sector, gained the upper hand. A notable sign of this shift came in May when the party's

25 M. Bogusz, J. Jakóbowski, *The Chinese Communist Party and its state. Xi Jinping's conservative turn*, OSW, Warsaw 2019, osw.waw.pl.

26 For example, Xi Jinping became chairman of the Leading Group for Comprehensively Deepening Reforms and several other key groups, including the Leading Small Group for Economic and Financial Affairs, which had existed since the beginning of the 'reform and opening-up' period; see J. Jakóbowski, *The drifting of China's reforms. Economic policy during Xi Jinping's first term*, OSW, Warsaw 2017, osw.waw.pl.

newspaper the People's Daily published an interview with an anonymous 'person of authority', marking the symbolic start of the deleveraging campaign. According to most commentators, the interviewee was Liu He himself. The anonymous economist described debt as the "original sin", warning that "a tree cannot grow all the way to the sky and high leverage inevitably leads to high risk". He cautioned that "inadequate control could trigger a systemic financial crisis, cause negative economic growth and even result in citizens losing their savings". He also pointed out that "restoring the normal functioning of the real estate market and removing some outdated administrative measures is necessary, but that if stimulus is applied too aggressively, it will inevitably create a speculative bubble. This is the lesson we must learn".[27]

In late October 2016, the Politburo emphasised the need to curb speculative bubbles and prevent economic and financial risks.[28] In its fourth-quarter report, the People's Bank of China focused on the real estate market, highlighting the bubble's negative effects and the need to reduce credit stimulus in order to prevent financial speculation.[29]

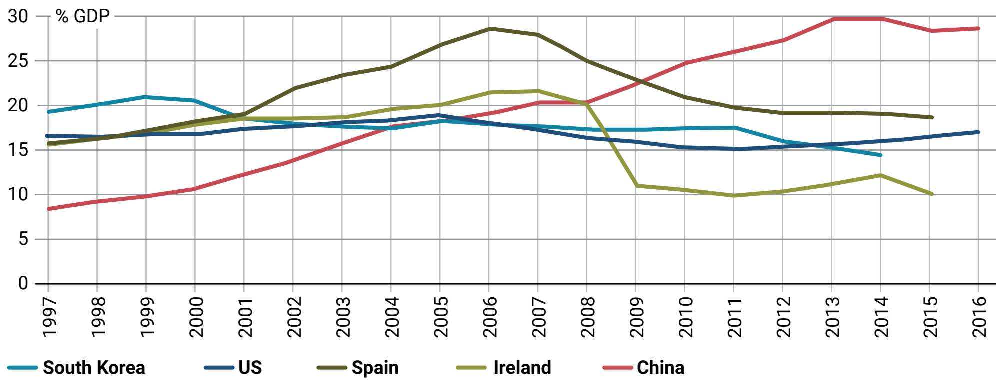
Despite the deleveraging campaign, the debt of the non-financial sector did not decrease significantly, remaining stable at around 240% of GDP for the next two years (see Chart 3). However, the campaign's main goal was to reduce the risks within the financial system, including limiting 'shadow banking' and increasing control over credit allocation, ultimately leading to a greater centralisation of power.

The party's elite became much more aware of the risks posed by rapid debt accumulation and adopted the view that the short-term benefits of economic stimulus often fail to outweigh the potential long-term costs. Between 2016 and 2020, the shadow banking sector fell back from over 60% of GDP to around 40%; using a broader definition that includes more entities, it decreased from roughly 120% to just under 90%.[30] However, this did not mean that debt-driven economic stimulus was abandoned completely. In response to further episodes of sharp slowdowns, the government once again resorted to stimulus measures, though on a much smaller scale than in 2008–10.

27 '开局首季问大势——权威人士谈当前中国经济', People's Daily Online, 9 May 2016, politics.people.com.cn.
28 '中共中央政治局召开会议　分析研究当前经济形势和经济工作', Xinhua, 28 October 2016, xinhuanet.com.
29 *China Monetary Policy Report, Quarter Four, 2016*, The People's Bank of China, 14 March 2017, pbc.gov.cn.
30 M. Sutton, G. Taylor, *Shadow Financing in China*, Reserve Bank of Australia, 10 December 2020, rba.gov.au.

In August 2020, then vice president of the central bank, Guo Shuqing, warned in the party's bi-monthly Qiushi that "the real estate bubble is the biggest 'grey rhino' that could threaten financial stability" and that China "must avoid greater risks caused by the excessive concentration of resources in the real estate sector". Assets directly and indirectly related to real estate made up over 40% of banks' assets, including 27% of the loans they had granted. The real estate sector, along with related industries, accounted for about 25% of China's GDP[31] and was one of the key drivers of the country's rapid economic growth.

Chart 4. Real estate-related activities share of GDP by country



Source: K. Rogoff, Y. Yang, *Has China's Housing Production Peaked?*, The National Bureau of Economic Research, 2020.

31 Its direct contribution to GDP increased from 4% in 1998 to 7.2% in 2020. However, this calculation only includes the service component (sales, rentals and property management), excluding the construction and furnishing of properties. Economists at the Asian Development Bank have estimated that all activities leading to the creation of a finished, complete product — a home — and its delivery to the end consumer accounted for over 20% of China's GDP in the 2010s. Other experts have put this share at 20–30% (see Chart 4).

II. THE 'THREE RED LINES'

The government took its most decisive action to curb the unchecked growth of the real estate sector when it introduced the 'three red lines' policy in August 2020. After the first wave of the coronavirus passed and the economy reopened following lockdowns, activity in China surged, driven in part by strong foreign demand. While much of the world remained mired in lockdowns and recession, China, isolated from other countries and protected by what had been an initially effective 'zero COVID' strategy, appeared to be a beacon of stability and economic growth. Beijing likely saw this as a good moment to solve the long-festering issue of rampant speculation in the real estate market and to put the economy on a new track.

When choosing the moment to pour cold water on the housing sector, the Chinese government may have fallen for its own propaganda that COVID-19 posed no threat to the domestic economy and that the mismanaged rest of the world would remain dependent on Chinese supplies. However, the roots of these decisions run deeper: Xi Jinping, who curtailed the practice of collective leadership within the CCP's top ranks, had previously decided to overhaul the priorities of state policy. Strengthening China's economic security and preparing for an escalation of its conflict with the US had become more important than stimulating growth. The oversized real estate market not only had the potential to destabilise China's macroeconomic, financial and social situation, but also absorbed valuable resources (capital and workers' skills and effort) that could be used to shape the country in line with Xi's vision. This led to the decision to cool down the real estate market.

In August 2020, the government outlined the 'three red lines' that restricted the ability of developers to take on more debt. In addition, in December it introduced regulations that limited banks' exposure to the real estate sector. Under these rules, the largest banks were required to keep developer loans below 40% and mortgages below 32.5% of their total lending. Smaller banks faced even stricter requirements. Financial institutions were formally given a few years to comply with the new regulations.

The 'three red lines'

The 'three red lines' are:

1. a liability-to-asset ratio exceeding 70%;
2. net debt exceeding equity;
3. short-term debt exceeding cash reserves (monetary assets).

Any developer behind these three 'red lines' was allowed to increase their liabilities by up to 15% a year. For companies that failed to meet one or two of these criteria, the limit was reduced to 10% and 5% respectively. Companies that reported debt levels above all three thresholds were prohibited from increasing their liabilities. The criteria were only slightly stricter than the average ratios reported by large developers in 2020, but some companies significantly exceeded the government's 'red lines'.

1. A chain reaction

It is unclear whether policymakers were aware that implementing these regulations would trigger a chain reaction leading to a deep and prolonged crisis, or whether they simply failed to foresee the scale of the consequences and merely intended to drive the most indebted entities out of the market and curb speculation. However, these regulations struck at the core of the business model employed by developers as they had relied on securing new funds to cover previous liabilities. The three red lines also sent a clear message that Beijing would no longer tolerate the existing model, further discouraging potential investors from lending to companies in this sector.

After August 2020, developers faced significant hurdles in securing financing on the domestic market. Beyond financial concerns (primarily fears over whether loans would be repaid) employees at Chinese institutions were unnecessarily rigorous in their interpretation of the new regulations. Bankers not only refused to provide loans that would increase developers' liabilities, but also declined to roll over existing debts, even though they were not legally prevented from doing this.[32]

[32] This attitude is characteristic of a system where the party's will prevails over the law and where informal directives exist alongside formal regulations. Correctly interpreting these directives and adapting to the government's intentions makes it easier to climb the career ladder and increases

The increased risk of insolvency made it difficult for developers to issue bonds on offshore markets, where they obtained foreign currencies. As a result, they were unable to meet their debt obligations. The crisis was epitomised by China Evergrande, the second-largest and most indebted company in the sector. It was formally declared insolvent in December 2021 after failing to make payments to holders of its dollar-denominated bonds issued in Hong Kong. However, investors were aware that the debt problem extended beyond individual developers and was a systemic issue.

A wave of insolvencies among Chinese developers

Faced with restrictions on raising capital on the domestic market, Chinese developers turned to foreign investors, issuing bonds mostly denominated in US dollars on offshore markets, primarily in Hong Kong. The reported scale of these liabilities represented a significant portion (around 25%[33]) of the interest-bearing debt of major companies, but was still minimal in relation to the sector's overall financing, officially amounting to a mere 0.1%.[34]

Nevertheless, the symbolic start of the Chinese real estate crisis is traced to September 2021, when international financial media reported that Evergrande Group, China's second-largest developer, would be unable to meet its obligations to foreign bondholders. Investors feared a scenario similar to the 2008 collapse of Lehman Brothers, which triggered a global financial crisis.

Evergrande was not an isolated case. Analysts at Barclays have estimated that at least 60 Chinese developers who issued over $140 billion in bonds have defaulted since early 2020. The Financial Times has reported that this number includes more than half of the country's top 50 developers. Despite the fears, so far this has not triggered a financial crisis either in China or globally, although foreign institutional investors, such as BlackRock and HSBC, have suffered losses.

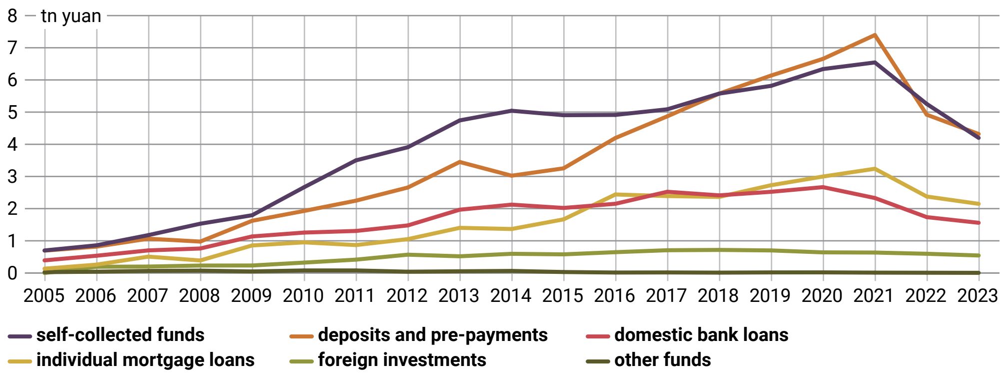
the chances of financial success. The cautious stance of bankers was reinforced by Xi Jinping's anti-corruption campaign and the centralisation of power in his hands.

33 P. Hendy, *Evolving Financial Stress in China's Property Development Sector*, Reserve Bank of Australia, 15 September 2022, rba.gov.au.

34 T. Huang, *Why China's housing policies have failed*, *op. cit.*

Facing difficulties in securing financing, developers stopped paying contractors and material suppliers, causing work to stop at many construction sites. Combined with fears of bankruptcies among companies in this sector and Beijing's 'anti-speculation' rhetoric, this discouraged potential buyers and drove down home sales. A significant decline in developers' revenue from their key source,[35] which accounted for about one-third of their total revenue (see Chart 5), meant that they increasingly struggled to continue funding construction work and meet their obligations to investors. To address concerns over incomplete projects, the government tightened oversight of funds held in escrow accounts.[36]

Chart 5. Sources of total funds of enterprises for real estate development



Source: The National Bureau of Statistics of China.

This, in turn, reinforced the conviction among potential buyers that construction projects might never be completed and that it was too risky to purchase a home. Potential investors in turn became concerned that they might fail to recover their loans. In 2022, this uncertainty was further exacerbated by the 'zero COVID' strategy, which stifled economic activity in China. Developers lacked the funds to continue construction work and reduced the number of new projects, so they needed less land than before (see Chart 6). As a result, the revenues of local governments and the value of land both decreased,[37] shrinking the fiscal space for stimulating the economy and even leading to

35 Revenue from this source gained importance after the government decided to restrict the growth of the shadow banking sector in 2016.

36 Xie Yu, C. Jim, 'China gives property firms easier access to escrow funds – report', Reuters, 11 February 2022, reuters.com.

37 To offset the reduction of budget revenues from this source, companies linked to local governments have begun acquiring land-use rights on a larger scale. However, they have rarely undertaken construction projects on these lands: according to data from China Real Estate Information, they have commenced work on only one-fifth of the plots purchased from the start of 2021 to May 2024.

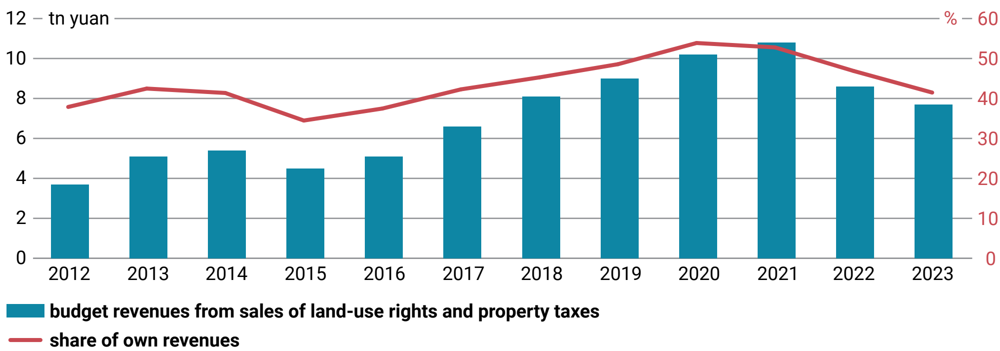
a shortage of funds for fundamental tasks, such as paying public sector wages and pensions. The vicious circle began to turn the other way.

Chart 6. Area of newly acquired land use rights by developers

At the end of 2022, the National Bureau of Statistics of China stopped publishing these data.

Source: The National Bureau of Statistics of China.

Chart 7. Government revenue from sales of land-use rights



Source: The Ministry of Finance of the People's Republic of China.

A significant drop in housing prices could partly improve the situation by encouraging potential buyers. However, neither the government nor homeowners who had previously invested in properties in the same areas gave their green light to a market-driven price correction. Beijing instructed local governments to stabilise the markets; in response, they prohibited developers from cutting prices too steeply (see 'Regulated housing prices' below). Meanwhile, previous buyers protested against price reductions and demanded compensation for their 'losses'. This led to paradoxical situations: developers circumvented the regulations that restricted nominal price reductions by offering incentives like free garages or furnishings included in the purchase of a property and even going as far as to hand gold bars to new buyers as gifts[38] or to accept partial payment in garlic and wheat.[39]

Regulated housing prices

Before listing a property on the market, developers are required to declare an initial price, which must be approved by a local official. Despite a significant drop in buyer interest, the government has long refused to accept substantial price reductions for properties already listed for sale and those awaiting approval. Politicians have also sought to influence the secondary market through the 'reference price' mechanism, which serves as a guideline for transaction parties.

2. A course correction

When Beijing imposed strict regulations on the real estate sector in 2020, it was willing to accept the short-term costs of this correction to gain greater long-term benefits. However, it underestimated the impact of its market intervention in the new domestic and international environment. After a strong post-lockdown rebound in 2021, China's 'zero COVID' strategy severely disrupted the economy again the following year. It reduced economic activity and worsened sentiment among both consumers and investors, including foreign investors. The circumstances under which the Chinese government initiated the most significant cooling of the real estate sector seen in decades had become far more complex.

Growing concerns about the overall health and outlook of the economy further reinforced a shift in financial behaviour among Chinese people. In the absence of substantial Western-style government support for households, Chinese residents scaled back their more expensive and less liquid investments, such as real estate, in favour of hoarding cash for a rainy day. Due to construction delays, people in financial distress were forced to move into unfinished buildings without access to running water or electricity. Hundreds of thousands of borrowers threatened to suspend loan repayments; their protests revealed that this issue had become a major social problem which could pose a threat to the country's socio-political stability if allowed to escalate.

38 R. Feng, C. Li, 'Desperate Chinese Property Developers Resort to Bizarre Marketing Tactics', The Wall Street Journal, 23 January 2024, wsj.com.
39 M. Kalwasiński, 'Chiny: mieszkanie za czosnek', Bankier.pl, 22 June 2022.

The borrowers' boycott – a challenge for Beijing

In July 2022, mortgage holders staged large-scale protests, threatening to stop paying loans tied to unfinished, delayed real estate projects.[40] Independent estimates suggested that at their peak in August, this affected over 320 projects in about 100 cities. Since mid-2022, Freedom House has recorded over 1,800 protests related to the situation in the real estate sector. Two-thirds of these were provoked by construction delays and poor-quality housing, while the others were mainly related to construction workers not being paid.

This situation posed a potential threat to the stability of the banking sector but, more importantly, presented a political challenge for the CCP ahead of its 20th National Congress. Unlike numerous isolated protests over abuses in the financial sector, this could potentially evolve into a nationwide protest movement against the central government, rather than against the local authorities.

While local governments, which have some autonomy in determining local housing policies, took steps to stimulate the market as early as 2021, Beijing initially limited its response to relatively minor verbal interventions, small interest rate cuts and creating investment funds to help developers complete ongoing construction projects. The party leadership only changed its stance after the downturn became worse, when the wave of insolvencies spread from developers to contractors and suppliers,[41] and when mortgage borrowers started a boycott, refusing to repay loans they had taken out to buy homes that were still unfinished.

All the major drivers of GDP growth, except for exports, were underperforming. Typically, the Chinese government would have responded by implementing a substantial stimulus package involving a reversal of its real estate policies and extensive infrastructure investments. However, this time Beijing took a more cautious approach, while local governments lacked sufficient resources after years of the 'zero COVID' strategy. It wasn't until late 2022 and early 2023

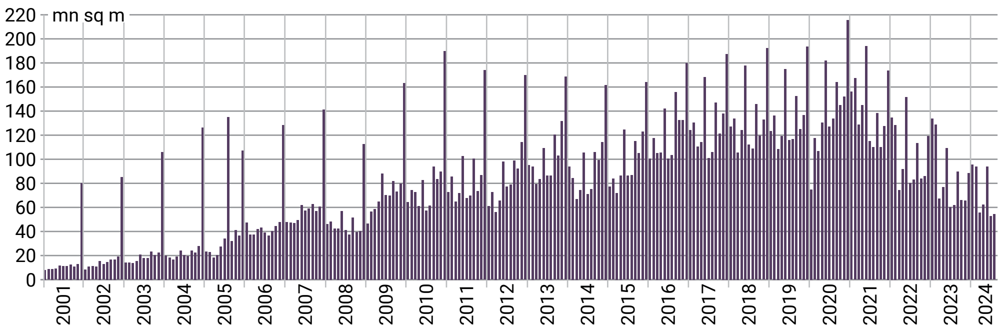
[40] J. Jakóbowski, 'Bojkot kredytobiorców w Chinach i lokalne kryzysy bankowe', OSW, 21 July 2022, osw.waw.pl.

[41] In mid-2023, analysts at Gavekal Research estimated overdue payments to suppliers at over 3 trillion yuan. Construction companies are increasingly being forced to accept unsold or unfinished properties as a form of payment.

that substantial measures were taken to improve liquidity in the sector. These measures included an effective suspension of the 'three red lines'[42] policy for selected developers.

The positive reaction proved short-lived: after a rebound in the first quarter, aided by the end of the 'zero COVID' strategy, housing sales began to fall again (see Chart 8). By July 2023, sales had dropped to nearly half of their levels from two years earlier and from before the pandemic, hitting the lowest square footage since April 2012.[43] At the same time, developers began construction of the smallest amount of residential space since 2008 (see Chart 9).

Chart 8. Housing sales in China



Data for January and February combined.

Source: The National Bureau of Statistics of China.

The following month, serious financial issues emerged at Country Garden, which had been China's largest developer until the previous year, and at Zhongzhi Enterprise Group, a 'shadow banking' institution managing assets valued at one trillion yuan.

The real estate crisis and 'shadow banking'

With interest rates low on bank deposits in China, 'shadow banking' institutions sell financial products that promise higher returns to retail and business clients. The funds they receive are then loaned to companies, primarily private ones, which are unable to secure sufficient financing from state-owned banks that prioritise lending to state enterprises. This group

42 T. Hale, S. Yu, C. Leng, 'China eases curbs on property developers to counter downturn', Financial Times, 12 January 2023, ft.com.

43 With the caveat that data for January and February, a period coinciding with the movable Lunar New Year, is reported collectively.

of borrowers included developers. Official data indicates that the trust industry, a segment of 'shadow banking', owns assets valued at 21 trillion yuan (c. 17% of GDP). While only about 6% of these assets are officially linked to the real estate sector, analysts at ANZ Research have estimated that total exposure is closer to 30%. These investment products are not formally covered by the state guarantee system. Despite this, many buyers believe that the government effectively protects their invested capital, partly because state-owned banks distribute these products.

In late August 2023, the People's Bank of China and the National Financial Regulatory Administration reduced the minimum down payment, extended preferential loan terms to a broader group of borrowers and instructed banks to lower interest rates on existing loan agreements. Beijing also gave local governments the green light to ease local housing policies, including by relaxing controls on minimum prices.

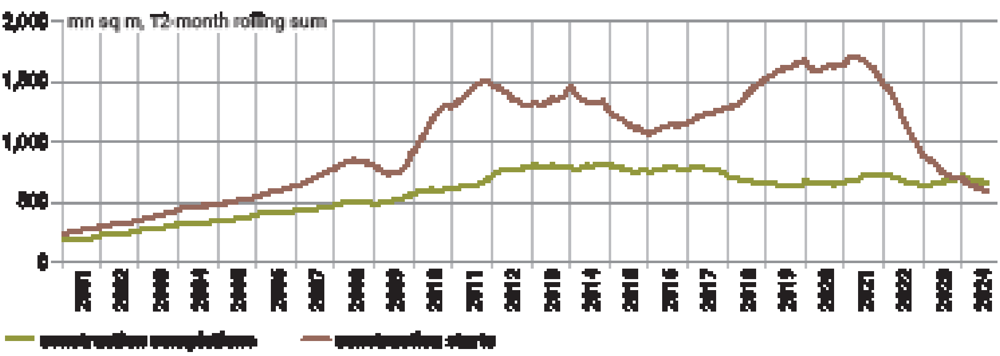
Alongside a clear signal from the government that its tolerance for market-stabilising speculation had increased, the easing of regulations boosted housing demand in major metropolises. However, just as earlier in the year, the recovery proved short-lived. Further high-profile problems of developers dampened hopes for market stabilisation. In September, Evergrande revealed that its head, Hui Ka Yan, had been placed under "coercive measures" on suspicion of committing "illegal crimes".[44] In October, Country Garden was declared in default after it had failed to meet its dollar-denominated debt obligations by the final deadline. In January 2024, a Hong Kong court ordered the liquidation of Evergrande Group. Two months later, reports of a possible default by another major developer, Vanke Group, sparked new concerns. These developments demonstrated that even state-backed companies, which received stronger government support, were not immune to serious problems. In March, the capital market regulator accused a key entity in the Evergrande Group of committing accounting fraud on an unprecedented global scale by overstating its 2019 revenue by 214 billion yuan and its 2020 revenue by 350 billion yuan, which represented about half and nearly 80% of the company's revenues for those two years respectively. It is unlikely that this was an isolated case of financial fraud in this sector.

[44] 'Inside Information', China Evergrande Group, 28 September 2023, hkexnews.hk.

In April 2024, Beijing signalled a new phase of support to prop up the real estate market. The Politburo of the Central Committee turned its attention to the issue of unsold homes and called for the creation of a "new model to develop the real estate market".[45] In May, the Chinese government announced a package of measures, including up to 300 billion yuan in central bank funding for state-owned enterprises to purchase completed homes and convert them into affordable housing; it also scrapped the nationwide minimum mortgage interest rate and reduced the minimum down payment ratio. That month, major metropolises such as Shanghai, Shenzhen and Guangzhou relaxed local restrictions that limited housing availability. Beijing followed in June.

Just as with the previous rounds of regulatory easing, the effect was short-lived. In June, housing sales reached their highest level in a year, but the next month they fell to their lowest in more than 15 years (see Chart 8). Developers started construction on the smallest number of units in nearly two decades. Given the government's stated priorities, another decline in the pace of building completions was particularly concerning (see Chart 9).

Chart 9. Housing construction in China



Source: The National Bureau of Statistics of China.

No groundbreaking solutions were announced during the much-anticipated 3rd Plenum of the CCP Central Committee that was held last July.[46] The party reiterated its promise to introduce a new model of the real estate market, to speed up the construction of subsidised housing and to expand the autonomy of city governments in regulating local markets based on conditions on

45 '中共中央政治局召开会议 习近平主持会议', 30 April 2024, gov.cn.

46 M. Kalwasiński, 'The economy according to Xi Jinping: a technological 'leap forward'', *OSW Commentary*, no. 621, 21 August 2024, osw.waw.pl.

the ground. Less than a week later, the central bank announced its second cut this year to the five-year Loan Prime Rate, the benchmark for mortgage interest rates. In early August, it fell to 3.85%, the lowest level since it was introduced in 2019, compared to 4.65% before the crisis began. According to central bank data, the average interest rate on new mortgages fell from 5.63% at the end of 2021 to 3.45% in June 2024.

In September, typically a strong month for developers, home sales by the top 100 industry leaders plunged nearly 38% year-on-year, which was the steepest decline since April. In response, the government made another attempt to stabilise the market. As part of a broad stimulus package,[47] it announced a range of measures, including adjusting interest rates on existing mortgages to current market conditions, lowering the nationwide minimum down payment for second homes from 25% to 15%, expanding loan refinancing options for state-owned enterprises to buy homes and extending credit repayment deadlines for developers. The governments of Beijing, Shanghai and Shenzhen eased restrictions on home purchases, while Guangzhou removed them entirely. The Politburo issued a strong statement emphasising that it was essential to "halt the decline and restore stability" in the real estate market.

3. Destruction of assets

More than three years after the symbolic start of the crisis marked by the default of Evergrande Group, China's real estate market remains unstable despite the efforts of both central and local governments. They have eased price controls and relaxed regulations restricting property purchases by homeowners and those without local *hukou* (residency permits). They have also introduced subsidies for home purchases and the construction of social housing, financing programmes for unfinished projects and initiatives to swap old homes for new ones. Moreover, they have increased pressure on banks to support selected developers with credit lines and to avoid favouring state-owned companies over private ones.[48] The financial difficulties of developers, frequent stoppages in construction work and the large correction in prices on the secondary market have made Chinese buyers more interested in move-in-ready homes.

47 *Idem*, 'Strzelba, nie bazooka. Nowy pakiet stymulacyjny w Chinach', OSW, 1 October 2024, osw.waw.pl.

48 Banks find themselves between a rock and a hard place. On one hand, the government requires them to support the real estate sector, while on the other, they are expected to run profitable operations. Facing a growing number of non-performing loans, dwindling margins, an ongoing anti-corruption campaign and criticism of their 'lavish' lifestyles, employees of financial institution are reluctant to finance developers, particularly private ones, who are seen as being at greater risk of bankruptcy.

The share of these properties in primary market transactions rose from 10% in 2021 to 25% by mid-2024. Moreover, in 2023, more second-hand homes than new builds were sold in 30 major cities for the first time.[49]

The stock valuations of leading developers such as Country Garden and Sunac have plummeted by more than 95% from their peaks, while Evergrande's shares have become worthless. According to an August 2023 analysis by Debtwire,[50] the market value of US dollar-denominated bonds issued by companies in this sector has contracted by nearly 90% compared to their nominal value, plunging from around $155 billion to less than $20 billion.

Prolonged crisis in the commercial real estate market

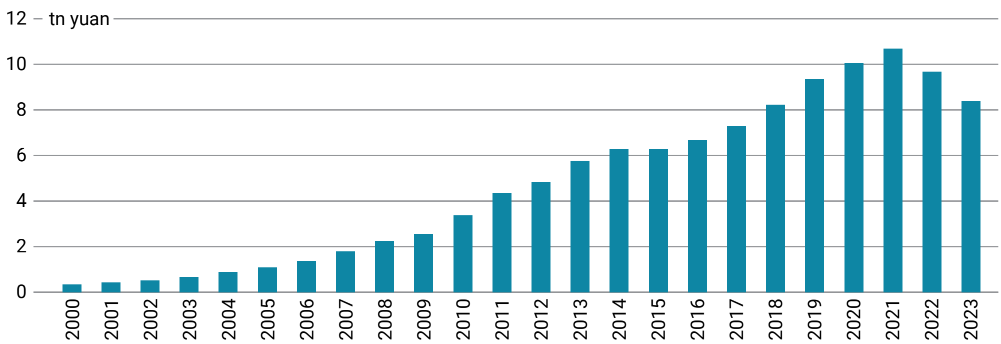
The crisis has also clearly affected the commercial real estate sector. Data from MSCI Real Assets show that in over 20% of transactions on this market, the seller has been forced to sell due to financial difficulties or because the property was under receivership.[51] Developers have been selling assets to raise the cash needed to fund ongoing operations, repay debts and restore creditor confidence.

Particularly symptomatic is the situation in the office-space market, which has been dealing with a recession that began even before the crisis in the residential market. In all major Chinese cities, over 20% of office space remains vacant, which is the highest rate in the world. Compensation fees have been falling since 2018 while office building valuations have dropped by 15–30%.[52] Despite this, developers continue to construct new buildings and introduce them to the saturated market. This has been happening against the backdrop of an economic slowdown, restrictions on the development of the consumer technology sector and the growing popularity of remote work.

[49] T. Hale *et al*, 'Chinese homebuyers favour 'second-hand' houses as property crisis bites', Financial Times, 6 May 2024, ft.com.
[50] J. Wilkins, 'China's property crisis deepens with 87% value wipeout in developers' dollar bonds', Business Insider, 1 September 2023, after: finance.yahoo.com.
[51] 'China's commercial real estate woes spark distressed sales surge', CIO Bulletin, 14 March 2024, cio-bulletin.com.
[52] N. Wilson, 'Chinese office markets look set for a lost decade', Oxford Economics, 2 May 2024, oxford-economics.com.

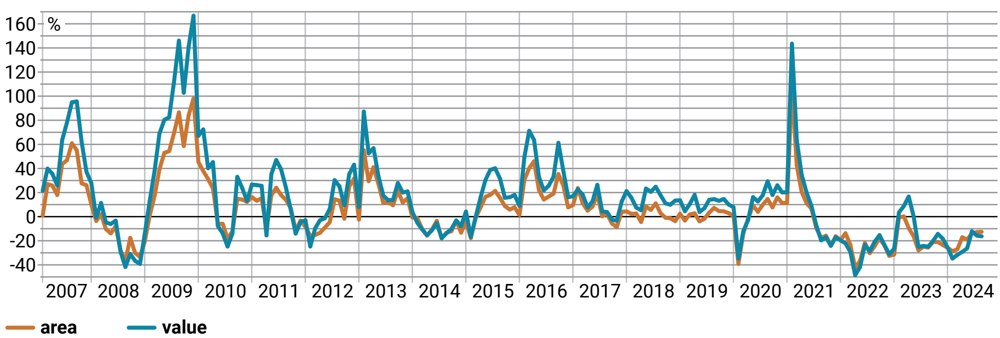
Investment in this sector continues to decline, the area of housing under construction is becoming smaller, property sales and prices are falling and government revenues from sales of land-use rights are decreasing (see Charts 10–12). The prolonged crisis is slowing down the pace of economic recovery following the government's exit from the 'zero COVID' strategy. According to official data, China's GDP growth was only 5.2% in 2023,[53] even though the baseline was the pandemic period, when economic activity was restricted by drastic lockdown measures.[54]

Chart 10. Investment in the housing sector



Source: The National Bureau of Statistics of China.

Chart 11. Annual growth in housing sales

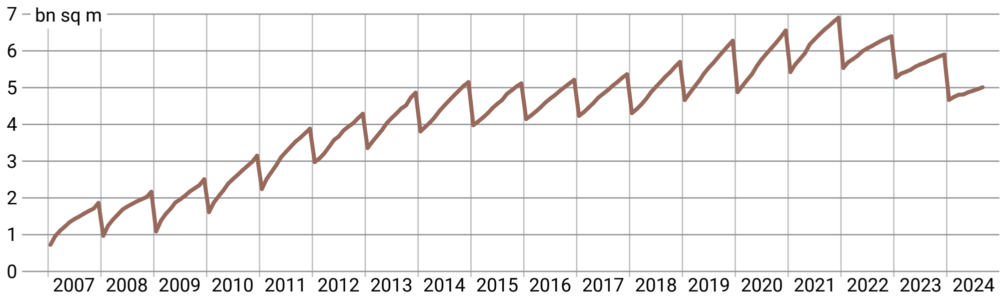


Source: The National Bureau of Statistics of China.

[53] The reliability of these figures is questionable as the GDP indicator serves as a propaganda tool for Beijing. See M. Kalwasiński, 'Security trumps growth. China's economy heading into 2024', OSW, 5 March 2024, osw.waw.pl.

[54] M. Bogusz, 'China after its abrupt U-turn on the 'zero COVID' strategy', OSW, 16 January 2023, osw.waw.pl.

Chart 12. Housing area under construction



Source: The National Bureau of Statistics of China.

The recession in this sector is affecting the broader economy both directly, which is reflected in activity and investment indicators (see Chart 10), and indirectly, through deteriorating public sentiment. Before the pandemic, real estate accounted for the majority of the wealth of urban families, with over 40% of households owning at least two properties. Goldman Sachs estimated the market's total value at some 400 trillion yuan. A 10% drop in valuations would therefore translate into a 'destruction' of wealth worth 40 trillion yuan.

According to official statistics, by the end of August 2024, prices had dropped by a record amount compared to the 2021 peak — around 8% in the primary market and about 14% in the secondary market. However, these estimates raise significant doubts. Independent sources have suggested a much deeper decline, especially for second-hand homes, which are less tightly regulated than new housing (see 'Regulated housing prices' above). Moreover, there are significant regional disparities. Data from the Chinese real estate agency Centaline Group, cited by Bloomberg, indicates that in Shenzhen, prices in the secondary market have fallen by over 35%, while Beijing, Shanghai and Guangzhou have seen declines of more than 25%.[55] As a result, prices in the Chinese capital have reportedly returned to 2016 levels.[56] CSLA Group has reported drops of up to 40% in smaller cities.[57] According to Reuters, some areas have seen prices fall by up to two-thirds,[58] while the Financial Times has reported declines as steep

55 'China Unleashes Rapid Drop in New-Home Prices With Relaxed Curbs', Bloomberg News, 20 August 2024, bloomberg.com.

56 Niu Mujiangqu, Denise Jia, 'Lower Down Payments Boost Beijing's Pre-owned House Sales But Prices Still Fall', Caixin Global, 3 September 2024, caixinglobal.com.

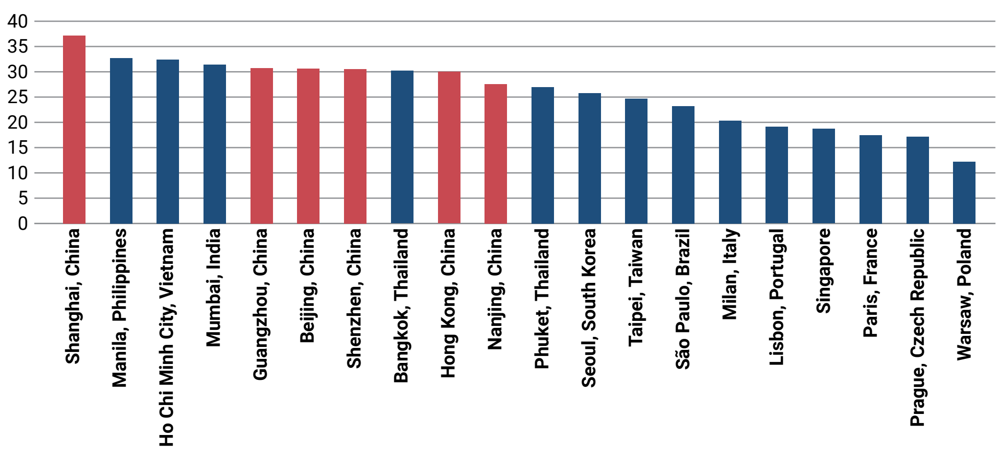
57 Wang Xiaoqing, Wang Rui, Denise Jia, 'China's Falling House Prices an Expected Adjustment as Economy Develops, Says Analyst', Caixin Global, 13 September 2024, caixinglobal.com.

58 C. Hall, 'For many in China, the economy feels like it is in recession', The Japan Times, 18 January 2024, japantimes.co.jp.

as 75%.[59] As the government increasingly accepts the alignment of the primary market with the sharp correction taking place in the secondary market, official prices of new homes are expected to fall at a faster rate.

One natural consequence of this is known in economics as the 'wealth effect' and involves reduced consumer spending, particularly when property purchases have been made for investment rather than residential use. Homeowners repaying mortgages also feel dissatisfied as they believe they have overpaid for their properties. Falling real estate prices could in fact boost consumption if prospective buyers feel they no longer need to save as much for a home and could allocate a bigger part of their income to everyday expenses. However, despite the price drops, the cost of housing in China's largest cities remains higher than in other global metropolises (see Chart 13). In addition, the current real estate crisis reflects a broader weakness of the Chinese economy, undermining the public's confidence in its future. As a result, Chinese people are saving more money 'for a rainy day', mostly in bank deposits.

Chart 13. Housing price-to-income ratio in selected cities worldwide in mid-2024



Source: Numbeo.

Despite concerns, these serious issues in the real estate sector have not triggered a financial crisis — there have been no widespread bank failures or bankruptcies of local administrations and their associated investment vehicles. The government's control over key economic players, particularly the financial

[59] C. Long, 'China's big housing correction is not over', Financial Times, 26 June 2024, ft.com.

institutions, and cross-border capital flows has proven sufficiently effective. Beijing has also succeeded in reducing the sector's impact on the broader economy. According to estimates from Bloomberg Economics, the share of activities related to the construction and delivery of completed housing units to end users has decreased from around 24% of GDP in 2015–19 to about 19% in 2023.[60] Analysts from the Bank of Finland have suggested an even steeper decline — from around 26% of GDP in 2021 to 16% two years later.[61] This trend is expected to continue in the coming years as the number of construction starts fell by more than 60% between 2021 and 2024 and is now lower than the number of completions (see Chart 9).

[60] T. Hancock, 'China's Tech Sector May Rival Property as Growth Driver, BE Says', Bloomberg, 25 March 2024, bloomberg.com.
[61] 'China's real estate sector continues to sink', BOFIT Weekly Review 2024/18, The Bank of Finland Institute for Emerging Economies, 3 May 2024, bofit.fi.

III. REAL ESTATE IN XI JINPING'S 'NEW ERA'

The real estate crisis is an inevitable consequence of the Communist Party's decision to take on a problem that has been festering for years. By halting price declines and gradually easing its housing policy, the government has avoided a sharp correction, instead consolidating a milder, but more prolonged adjustment. In this way, it has averted the worst-case scenario of the country potentially being destabilised, but it exposed China's economy to chronic weakness. It appears that the leadership may have miscalculated, believing they would be able to control the process and, if necessary, quickly resolve the crisis.

Over the past three years, the government has introduced a number of measures aimed at easing the slump. This does not mean that Xi Jinping has changed his stance on the role of this sector, nor that Beijing has abandoned its efforts to reform the economic model based on real estate speculation. It does however reflect growing concern. Despite this, the correction has not yet been halted.

The party leadership has been searching for a solution that would stabilise the situation without jeopardising other goals set by Xi Jinping and which would ideally even support them. We should expect an overhaul of the real estate market in line with Xi's vision. The golden era, when buying a home was a safe investment that guaranteed handsome returns, has come to an end. Beijing believes that a downsized, state-controlled sector will still be able to meet the housing needs of the Chinese people.

The longer the crisis persists, the harder it will become to overcome it without implementing decisive reforms. The centralisation of power under Xi Jinping and his direct support for initiatives aimed at reducing speculation in the real estate market have limited the room for a political *volte-face*. However, as the unexpected abandonment of the 'zero COVID' strategy demonstrated, a shift of this kind cannot be entirely ruled out.

The ideal way to deflate the speculative bubble would be to stabilise housing prices over several years while incomes rise. However, media reports suggest that, contrary to official claims, urban wages are no longer rising as quickly as they were a few years ago and may even be falling.[62] Another possible solution for a more durable stability is to encourage Chinese people to settle in

[62] T. Hancock, 'More of China's White-Collar Workers Say Wages Are Falling', Bloomberg, 30 January 2024, bloomberg.com.

smaller cities,[63] which account for 80% of the primary housing market in China. Thanks to massive infrastructural investments in recent years, they are now well-connected to the metropolises by a dense transportation network. The next step should be to provide residents with higher-quality public services, which would reduce demand in major cities and boost interest in housing within mid-sized urban areas. However, this approach requires considerable financial resources, which seems to be at odds with Xi Jinping's vision of a strong and independent China, where resources are mainly devoted to strengthening economic security and reducing dependence on foreign suppliers rather than being used on social spending.

1. The state advances

By shifting its priorities, the Chinese government has decided to increase the state's role in the real estate sector which until 2021 was dominated by private companies linked to the party at various levels but not controlled by the state (see 'The private sector retreats' below). The government has committed to completing projects funded by buyers through pre-sale agreements. It also plans to expand programmes to build low-cost public housing and to replace old units with new ones while stepping up its efforts to renovate shanty town areas.[64] Housing policy will be tailored to local conditions. In more than 20 cities, the authorities have also begun purchasing homes from the primary market to reduce the imbalance between supply and demand and provide financial support to developers.[65]

The private sector retreats

In 2021, Country Garden was China's largest developer by residential area sold, followed by the Evergrande Group. The following year, the now insolvent Evergrande dropped out of the ranking and Country Garden retained its lead. In 2023, however, it fell out of the top five, which now features only government-controlled companies. Between mid-2021 and mid-2023,

[63] Faced with a declining population and an outflow of people to larger urban areas, authorities in smaller cities are already competing for workers — not only those well-educated but also blue collar workers.

[64] Shanty-town renovation programmes, known as 棚户区改造, involve demolishing old homes and constructing new housing. Existing residents receive higher-standard housing units or financial compensation to purchase a new home or spend on other purposes. Over the past decade, the implementation of these programmes has boosted activity in the sector and driven up property prices.

[65] 'China's Unworkable Housing Rescue Math Is Prolonging Crisis', Bloomberg News, 11 September 2024, bloomberg.com.

home sales by the largest state-owned enterprises decreased by 25%, while the leading private companies saw their sales plummet by 90%.[66]

The outlook for private developers is bleak. After years of aggressive expansion using heavy financial leverage, most major companies are now in default and face difficulties in obtaining liquidity given that the government has begun cleaning up the market. Despite Beijing's calls for equal treatment for state-owned and private companies, the latter are viewed as less reliable, causing investors to reduce funding for these businesses.

We should expect more private developers to either close down, scale back their operations or shift their business focus, transforming into construction companies or providers of property management services. The government could step in to rescue companies with stronger fundamentals, but this would result in the state taking greater control over their operations from their current owners.

In the short term, this strategy has had the effect of purging the property development sector from 'ailing' companies and preventing a domino effect that could affect the financial institutions and public finances. In the long run, the state is likely to increase its presence in a market divided into two segments: the public and the commercial. Affordable housing provided by the government would meet the population's basic housing needs while the market would cater to demand for higher-end apartments. The trade in social housing would be restricted, leaving room for real estate speculation in the commercial segment.

How many more homes do Chinese people need?

In the coming years, the fundamental demand for housing is expected to gradually decrease due to China's falling population, the end of its rapid urbanisation and a reduction in the housing stock that needs to be replaced. However, analysts believe that urbanisation, the replacement of older homes and the decreasing size of the average household[67] will sustain

[66] 'China's state is eating the private property market', The Economist, 11 April 2024, economist.com.

[67] In 1989, urbanisation in Japan stood at nearly 80%, compared to around 65% in present-day China. The average number of people in a Chinese household still exceeds those seen in Japan and South Korea at a comparable stage of population ageing. Forecasts suggest that in the next decade, the average household size in China will fall, offsetting the negative impact of the population decline on housing demand.

demand at a level of at least several hundred million square metres a year. Demand for new homes will likely vary by region: it is expected to fall in the northeastern part of the country, in contrast to the eastern and southern metropolises. The key question is how much of this demand can be met by existing housing, being held by developers and private owners. Goldman Sachs has estimated that China has between 90 and 100 million homes that were purchased as investments and which have never been occupied.[68]

Investment demand remains crucial to stabilising the market. Chinese people are still compelled to accumulate significant savings as there are no appealing alternatives to investing in homes. The key to restoring demand is to convince the public that property prices have stopped falling and that the economic situation and outlook have improved. However, in August 2024, nearly 40% of people expected further price drops; this is the highest proportion in years, outnumbering those who anticipated price increases by five to one. According to a recent UBS survey, a record 47% of respondents currently have no plans to purchase a home.

This concept aligns with the broader policy under Xi Jinping's leadership of increasing the party's control of the economy[69] as part of efforts to curb the 'disorderly expansion of capital'[70] and to rein in local interest groups that have profited from the real estate sector's growth for years. Expanding access to affordable housing also corresponds with the somewhat forgotten slogan of 'common prosperity'[71] and forms part of the state's gradual efforts to meet the population's basic needs. Initiatives focused on providing affordable homes could improve living standards for lower-income individuals and boost consumption, but they have caused discontent among those who have invested substantial sums of money in property purchases.

68 B. Hurll, 'China's Bold Move To Rescue Its Housing Market: Will It Work?', Global Financial Market Review, 29 May 2024, gfmreview.com.

69 Other examples include tightening control over companies in the consumer technology sector, such as fintech, gaming and online education, as well as redirecting a larger pool of funds to support the development of industries deemed strategic by the government, such as semiconductor manufacturing, renewable energy and electric vehicles.

70 '解读中央经济工作会议精神：防止资本无序扩张', 27 December 2020, gov.cn.

71 M. Bogusz, 'China after the 20th CCP Congress: a new stage in Xi Jinping's revolution', *OSW Commentary*, no. 475, 7 November 2022, osw.waw.pl.

The strained budgets of local governments, which in the past covered the bulk of the costs associated with subsidised rental properties, are currently a major obstacle to implementing this solution. Beijing could raise funds by issuing special long-term government bonds or expanding the central bank's support programmes. For now, however, the government has remained cautious as it focuses on other priorities and does not want to take on additional, substantial commitments. Meanwhile, local officials and state-owned enterprises are reluctant to tap into the People's Bank of China's funds as they would still need to subsidise investments, despite favourable loan terms. According to Bloomberg estimates, by mid-2024, only 8% of the available 580 billion yuan had been used under this assistance scheme.[72] As a result, tensions between central and regional governments over who should bear the high costs of restructuring this sector are likely to intensify. Local politicians are also aware that real estate is not currently a top priority for Beijing, which is focused on modernising the economy. Therefore, becoming involved in efforts to solve this issue may do little to advance their careers and could also expose them to consequences of poor decisions and rising debt.

Analysts at the International Monetary Fund have estimated that completing the ongoing construction projects will cost around 5% of China's GDP, or about 6 trillion yuan.[73] According to experts from Nomura, delays have affected construction of 20 million paid-for homes, as developers have a shortfall of 3.2 trillion yuan needed to complete them.[74] A UBS analyst has suggested that the problem involves 7 million units, estimating the funding shortfall at 2 trillion yuan.[75] Official data shows that since early 2018, developers have sold nearly 30 million more homes than they have delivered.

The concept of the state purchasing unsold homes directly from developers struggling to sell them due to falling demand would massive funding. Official data shows that there is a total of nearly 400 million square metres of residential space on offer in the primary market, which is nearly equivalent to the total residential area of the 70 largest cities in Poland. Economists at J.P. Morgan have estimated that when properties under construction are included, the

[72] 'China May Let Local Governments Sell Bonds to Buy Homes', Bloomberg News, 20 August 2024, bloomberg.com.
[73] IMF analysts have acknowledged that due to significant data gaps these cost estimates are imprecise, ranging from about two to several trillion yuan.
[74] E. Cheng, 'China's unfinished property projects are 20 times the size of Country Garden', CNBC, 14 November 2023, cnbc.com.
[75] 'UBS Analyst Who Took On Evergrande Now Bullish on China Property', Bloomberg News, 25 April 2024, bloomberg.com.

total volume of unsold homes is much larger, reaching nearly 2 billion square metres. Analysts at ANZ have offered even higher estimates of nearly 3 billion square metres.[76] According to experts from Bloomberg Economics, this equates to around 60 million units. Economists at Goldman Sachs, Tianfeng Securities and GROW Investment Group have estimated the cost of such an operation at between 7 and 8 trillion yuan,[77] while a simple calculation multiplying the unsold space by the average price in the primary market yields a figure of around 4 trillion yuan. Bloomberg has estimated that without government support reducing the gap between supply and demand in the primary market will take at least four years.[78]

The International Monetary Fund's solutions for the crisis in China's real estate market

The IMF conducts annual bilateral consultations with its member states, providing analytical reports and economic policy recommendations. In 2023, the fund's analysts presented a set of proposals for China's real estate sector, including:

- greater price flexibility based on market mechanisms and the swift restructuring of insolvent developers;
- the gradual removal of rules allowing banks not to recognise bad loans made to developers;
- support for financially stable developers, along with stricter regulations to prevent future risk accumulation;
- homebuyer insurance to protect against the risk of developers failing to deliver on their promises to complete purchased homes;
- stricter rules on the use of funds raised through pre-sales to improve the legal protection of buyers;

[76] C. Jim, 'Explainer: China's latest property market support package – its contents and what's at stake', Reuters, 24 May 2024, reuters.com.
[77] 'GROW Investment's Hong on China's Economy, Property Market, Stocks', Daybreak Asia, 20 May 2024, bloomberg.com.
[78] 'Beijing Becomes Last Mega China City to Ease Housing Rules', Bloomberg News, 26 June 2024, bloomberg.com.

- introducing a nationwide property tax and strengthening the pension system as well as other savings options;

- fiscal reforms to address the structural gap between local government revenues and expenditure obligations;

- tailoring housing policies to local conditions: using existing housing stock where it meets housing needs and providing financial compensation to buyers instead of completing projects in areas with an oversupply of properties.

Implementing the IMF's recommendations would speed up the process of resolving the crisis; but they are incompatible with Chinese characteristics. Liberalising prices would destabilise the market and spark a wave of discontent among the large group of investor-owners. Ignoring bad loans is a cornerstone of China's banking system that has allowed the sector to operate despite decades of risky expansion. Accurately accounting for assets could trigger a banking crisis. In China, laws are often enforced arbitrarily, so simply enacting regulations would not be enough to restore trust. Introducing a property tax would face resistance from a Chinese population that has long invested in real estate. Moreover, compiling a registry of homeowners would lay bare the extent of corruption within the party's ranks. Fiscal reform would reduce the central government's dominance over local authorities; it is unlikely that Beijing would willingly relinquish this mechanism of control.

In 2024, the IMF's analysts suggested that the Chinese government either fund the purchase and completion of paid-for homes or reimburse buyers for their expenses. They estimated the cost of a four-year operation of this kind at around 5.5% of China's GDP, or about 7 trillion yuan. Beijing rejected this proposal.

Source: 'People's Republic of China: Selected Issues', IMF Country Report No. 24/50, International Monetary Fund, February 2024.

2. The domino crisis in the party's iron grip

The Chinese government would find a structural economic slowdown acceptable, as long as the turbulence does not cause a sudden destabilisation. If this remains the case, resolving the real estate crisis is not an urgent matter for the CCP leadership. So far, Beijing has prevented the situation from igniting a crisis in the financial sector. Using the party and state structures, the government controls key financial institutions and maintains restrictions on cross-border capital flows. It can directly instruct state-owned banks to transfer funds to a specific entity or force them to restructure its debt. The People's Bank of China could provide the funding for these operations when needed. Meanwhile, 'commercial' financial institutions, when making business decisions, must be guided not only by economic calculation but primarily by the national interest as defined by the party. We can assume that Beijing will continue to take the necessary steps to ensure that the real estate crisis does not jeopardise the country's financial stability.[79]

Past successes in managing the situation do not guarantee similar outcomes in the future. If the current trajectory continues, it will become increasingly challenging to mitigate its negative impact on the broader economy. In September 2024, Beijing announced plans to recapitalise the country's six largest banks; the media reported that the operation could cost 1 trillion yuan.[80] However, smaller and medium-sized financial institutions, as well as some regional governments and their associated entities, are the most vulnerable to significant disruptions. As regards major national banks and leading developers, the government has greater access to information and the capacity to respond to crises. In contrast, local financial sectors (at city and provincial levels) are subject to less oversight, partly due to political dynamics and the reluctance of local governments to provide full data to Beijing.

Small and medium-sized banks provide financing to private companies, including small and micro-enterprises, which find it difficult to secure funding from large state-owned institutions that prioritise lending to state-owned borrowers. However, these banks face numerous challenges, including low profitability, balance sheets burdened with non-performing assets,[81] opaque ownership structures, insufficient capital bases and a reliance on short-term funding from the interbank market and deposits distributed through online platforms, which makes them vulnerable to liquidity crises. Poor risk management, corruption and a lack of oversight result in high exposure for individual

79 For example, reducing pre-sales of homes would help stabilise the system as this practice promotes speculative attitudes among both buyers and sellers.

80 'China Weighs $142 Billion Capital Injection Into Top Banks', Bloomberg News, 26 September 2024, bloomberg.com.

81 The non-performing loan ratio in Chinese banks has not reached alarming levels. However, the true quality of their loan portfolio remains unknown, as it is common practice to extend debt repayment deadlines or provide financing to cover old debts.

borrowers and the geographic concentration of risk. Some banks have been used by local interest groups as their personal piggy-banks.

Small and medium-sized Chinese banks

China's banking sector consists of nearly 4,000 entities with total assets exceeding 400 trillion yuan – the world's highest figure in nominal terms, amounting to over three times the country's GDP. As of late June 2023, the central bank classified 3,968 institutions as small and medium-sized banks;[82] more than 330 of these, accounting for under 2% of the sector's total assets, were identified as high-risk institutions.

Small banks in China often fall victim to bank runs, where large numbers of depositors rapidly withdraw funds after losing confidence in the bank. In recent years, one notable instance of this occurred in April 2022 in Henan, where four institutions froze withdrawals from customer accounts, sparking mass protests. These demonstrations were violently suppressed, partly by plainclothes individuals, and the government reportedly used the COVID-19 quarantine app to confine protesters to their homes.

Many small and medium-sized banks are heavily exposed to the real estate market, having been used for years by local interest groups to fund investment expansions. Even before the COVID-19 pandemic, these banks struggled to secure stable sources of funding, which pushed some of them to the brink of insolvency. In view of the protracted housing crisis, relatively slow nominal economic growth and low interest rates, the consolidation of the banking sector is expected to accelerate.

If the Chinese government can continue to prevent turmoil in the financial sector without resorting to drastic monetary easing, the impact of the real estate crisis on the global economy will remain limited. Commodity exporters are affected by falling demand, although until recently, the housing sector's reduced demand for steel and copper was offset by the expansion of infrastructure, investments in industrial capacity and stockpiling. The dampened consumer sentiment resulting from the situation in the real estate market has driven down purchases of more expensive foreign goods in favour of cheaper

82 These banks are small compared to the state-owned giants but relatively large from the international perspective. The largest among them holds more assets than Poland's leading bank PKO BP.

domestic alternatives. Foreign companies should also brace themselves for increased pressure from Chinese competitors, who are intensifying their efforts to expand internationally as they face declining domestic demand for their products, including metals, furniture and construction equipment.

The situation could also affect the financial markets. In 2021, fears surrounding the potential collapse of Evergrande Group triggered sharp declines on the global stock exchanges. In subsequent years, reports of developers in trouble and government initiatives primarily impacted the valuation of Chinese assets. A potential resurgence of uncertainty linked to the spread of the crisis could increase investor risk aversion and trigger capital outflows to so-called safe havens.[83] Without a recovery in the real estate market, China will struggle to boost its economic growth. As a result, it is increasingly likely that interest rates will stay low, which is driving up the value of Chinese bonds and weakening the yuan, further boosting the competitiveness of Chinese exports.

3. Ticking time bombs at the local level

While the situation at the central level appears stable, the real estate crisis has the potential to ignite regional financial crises in China. The reduced revenues from sales of land-use rights and the declining valuation of these assets (which serve as collateral for financial obligations) have been exacerbating budget deficits at the local level. In several provinces, debt servicing costs now exceed budgetary revenues.[84] An even more pressing issue is the massive debt of local government financing vehicles (LGFV), which are used to secure financing and carry out infrastructural projects and other public investments. As such, LGFVs are a tool for local politicians to stimulate the economy and offer them a degree of independence from the central government.

The first LGFVs were created in the 1990s to circumvent regulations prohibiting local governments from taking on debt without Beijing's approval. Today, around 12,000 of these entities operate in China. Their reported assets and liabilities are estimated at 120% and 75% of China's GDP, respectively. LGFVs remain reliant on taking on new debt to sustain their operations and finance projects, but this situation casts doubt on the long-term viability of their

[83] The term 'safe havens' refers to assets that are considered low-risk investments, such as gold, treasury bonds and major currencies. They attract investors seeking capital protection during periods of heightened uncertainty and instability on the financial markets.

[84] V. Shih, J. Elkobi, *Local Government Debt Dynamics in China*, UC San Diego, 27 November 2023, china.ucsd.edu.

financing model. The cash flows generated by LGFVs are insufficient to cover their current operating expenses, while the average cost of capital significantly exceeds their return on assets.

According to the IMF's conservative estimates, the interest-bearing debt of these companies exceeds 60 trillion yuan, or nearly 50% of China's GDP.[85] Economists are divided over how much of this amount actually constitutes hidden public debt.[86] Without substantial support from the central government, regional authorities could be forced to accept the insolvency of some LGFVs. This would have a number of serious repercussions: it would undermine trust in the government, strip local governments of a key element of their partial independence from Beijing, hinder their ability to secure future financing, reduce their capacity for stimulating the economy and providing public services, exacerbate regional disparities and expose state-owned banks, companies and households to substantial financial losses.

In the face of falling budget revenues from sales of land-use rights and taxes (due to the slowdown in nominal economic growth), local governments may be forced to reduce the financial support for some LGFVs, potentially driving them to bankruptcy. As a result, regional banks would also be also at risk since loans to LGFVs make up nearly one-third of their assets. Beijing has indicated that financial support, such as capital injection or special funding from the central bank, will only be available for key institutions, while local governments will be responsible for addressing local problems.

If this scenario plays out, the costs of LGFV bankruptcies are likely to be socialised: investors (such as bondholders, contractors who will not receive their payments and financial institutions) will be forced to accept the terms of LGFV debt restructuring and will all incur losses. Meanwhile, citizens will suffer from cuts in public spending and increases in taxes and fees necessitated by the strained financial situation of local governments. Public sentiment will deteriorate further due to the economic slowdown.

Facing potential insolvency, LGFVs may attempt to liquidate their assets in order to raise funds for debt repayment; this would likely exert further downward pressure on prices of land, which are the primary collateral for bank

[85] These calculations only cover the nearly 3,000 LGFVs that have issued bonds. Estimates that include the remaining 9,000 companies suggest a total of around 75 trillion yuan, or 60% of China's GDP.

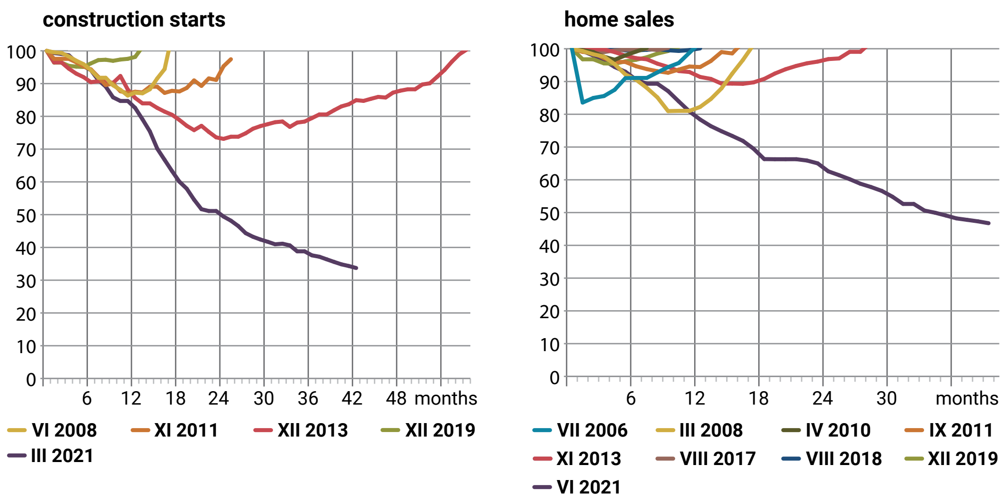
[86] These liabilities are formally off the public sector's balance sheet, but are effectively guaranteed by the state.

loans. Beijing's failure to intervene in support of state-affiliated entities could lead to systemic financial disruptions and heighten risk aversion in domestic markets. This, in turn, would increase the likelihood of further liquidity crises amplifying the negative effects on the broader Chinese economy and also impact the global economy through trade, capital flows and investor sentiment.

4. No alternative? A new model emerges

The decision to halt the rapid expansion of Chinese developers triggered the deepest and longest crisis on the country's real estate market since its inception in the 1990s. In the coming years, the sector should gradually stabilise, but it is definitely past its heyday – it will be reduced to a much smaller size than before 2022, though it will remain an important component of China's economic structure.

Chart 14. Housing starts and sales compared to the cyclical peak



The vertical axis shows the change relative to the baseline of 100 points in the starting months, which label each line. The horizontal axis represents the passage of time in months. Calculations are based on rolling annual totals.

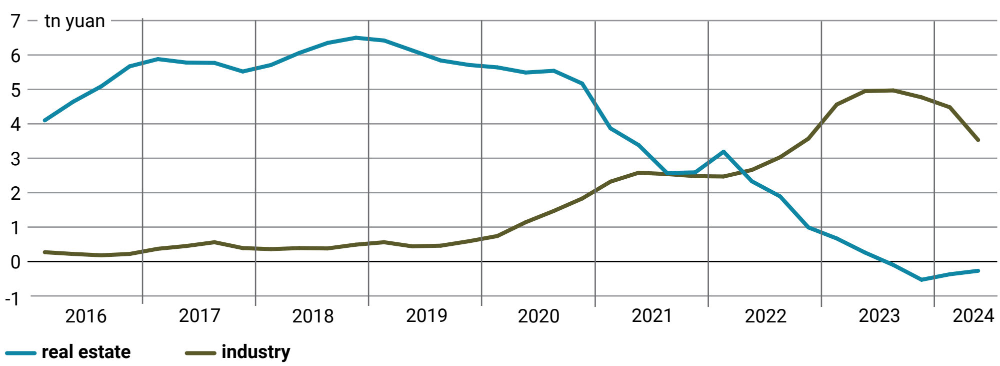
Example: From July 2007 to June 2008, construction began on a total area of 850 million square metres of housing in China. This level was indexed to a value of 100. Eleven months later, this figure fell to 733 million square metres, a decline of c. 14%, bringing the index down to around 86 points. It then began to rise again, and 17 months after the decline starting in July 2008, the scale of construction starts once again exceeded the level from June 2008.

Source: The National Bureau of Statistics of China.

Permanently replacing the multifaceted role of the real estate sector presents a considerable challenge. The government will likely need to implement a hybrid solution: the activation of new growth drivers, a reform of the tax system and the provision of alternative investment options for savers. This would inevitably lower the trajectory of China's economic growth in the medium term, but would lay the foundation for more sustainable development in the future. Beijing is willing to accept this scenario providing the secondary shocks caused by the housing crisis do not threaten the CCP's dominant position.

For the rest of the world, the direction of China's economic development is more important than the pace of its GDP growth. The end of the speculative boom in China's real estate market does not signal the collapse of its economic power. The real challenge now is to adapt to China's new economic model where the role of real estate has been significantly reduced. Beijing's top priority is to strengthen national security, including in economic terms, and to prepare for a potential escalation of its conflict with the US. The Chinese government's key goals include increasing resilience to external influences by reducing reliance on foreign countries and ensuring internal stability in the macro-economic, financial and social areas. While economic growth remains important, sectors other than real estate are now expected to be drivers for it. The government is pursuing these objectives by substantially increasing investments in expanding the country's energy and telecommunications infrastructure[87] as well as its automated industrial base.[88]

Chart 15. Annual change in bank loans by sector



Source: The People's Bank of China.

This inevitably leads to greater overcapacity, the substitution of some imports with domestic production and the export of surplus goods abroad, thereby

[87] M. Kalwasiński, 'China on the road to 'green' energy security', *OSW Commentary*, no. 605, 7 June 2024, osw.waw.pl.

[88] In 2022, the industrial sector became the main recipient of newly issued bank loans, replacing the real estate sector (see Chart 15). However, not all funds are allocated to investments – some are channelled into deposits or debt repayment. Moreover, the impact of investments in certain industries may only become apparent after several years.

increasing global payment imbalances.[89] China already accounts for nearly one-third of the world's industrial output and aims to lead the next industrial revolution, especially in advanced technologies such as green energy, robotics, artificial intelligence, 5G technology, new materials, chemistry and biomedicine. Alongside this, China continues to manufacture less advanced goods and is expanding its capacity to make older-generation semiconductors[90] and wide-body passenger aircraft, which could soon provide serious competition to European and American manufacturers. The 'new trio' of electric vehicles, batteries and solar panels is a key focus of China's strategy. In the government's view, the widespread adoption of advanced technologies is expected to reduce China's dependence on foreign suppliers, secure its position as the global innovation leader and make industrial development the new engine of economic growth, replacing the real estate sector.[91]

Since China joined the World Trade Organization, Chinese businesses have gradually displaced their competitors from other emerging markets and in low-value-added sectors in developed countries. They are now posing a threat to most producers from advanced economies and are rapidly expanding their capacity in industries seen as critical to the future. The influx of cheap, technologically advanced products from China undermines the competitiveness of Western industries and entrenches the dependence on Chinese supplies, which poses a threat to the national security of other countries. This is certain to escalate tensions between China and its trade partners, will speed up the adoption of tighter protectionist policies and heighten the risk of trade wars.

A resolute international response to the reform of China's development model, in the form of escalating trade wars, could force the Chinese government to consider implementing more profound changes to stabilise the economy as it prepares for a potential escalation of its conflict with the US. It could choose to significantly increase public debt, revising its approach of keeping the central budget deficit relatively low as local coffers face large shortfalls and could abandon efforts to curb debt growth through deleveraging. The ideal solution would be to substantially increase domestic consumption, which has long been an official goal, but a reform of this kind would require redirecting funds currently flowing into industry toward households, for example by significantly strengthening the social safety net. However, this approach would hinder

89 M. Kalwasiński, 'Security trumps growth. China's economy heading into 2024', *op. cit.*
90 P. Uznańska, 'A siege broken? China's processor sector under US sanctions', *OSW Commentary*, no. 614, 23 July 2024, osw.waw.pl.
91 M. Kalwasiński, 'The economy according to Xi Jinping: a technological 'leap forward'', *op. cit.*

the main objective of China's economic policy: to build a competitive and self-sufficient industrial base. It would also undermine the party and its associated business elite, which would lose control over some resources. Therefore, this move is unlikely, for both financial and ideological reasons, and would likely only be taken as a last resort. Xi Jinping opposes creating a Western-style 'welfare state'[92] and prefers to channel the limited resources into projects that directly enhance China's security and modernisation.

Work on this text was completed on 30 September 2024.

[92] 'Full Text: Xi Jinping's Speech on Boosting Common Prosperity', Caixin Global, 19 October 2021, caixinglobal.com.