

China's Obscure Economic Prospects and Effects for the Communist Party

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ABSTRACT

Since the late 1970s, the Chinese economy grew at exceptionally high rates. Today, however, the prospects are bleak: Real estate in China is probably highly overvalued and a correction of price levels overdue. At the same time, China's demographic development is problematic: There are far too few young people. An ageing China will face many problems, but in particular a solution of the real estate problems will be difficult, if not impossible, if there are fewer and fewer Chinese citizens. Most likely, China is facing a prolonged phase of slow growth or even stagnation. Not tackling the issues will be worse, for the adjustment process will eventually be even more painful. The United Nations are suggesting that China's population may shrink to about half its current level by 2100. Since China does not consider immigration, the ageing population will be a drag on economic development, including, of course, real estate.

Keywords

China, Chinese economy, Real estate, slow growth, ageing population, economic development

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1. Introduction

The growth of the Chinese economy in the last four decades is without historical precedence. Whilst other economies have also grown rapidly, the sheer size of the Chinese population makes it a special case. However, the uniqueness of China has not resulted in an immunity of its economy to unsustainable policies. Ignored by many observers for a long period, China today faces several issues, most of them, home-grown. Two problems stand out: The gigantic real estate bubble and the demographic problems. Undoubtedly, they mutually reinforce each other: High prices for apartments result in an unwillingness of Chinese citizens to have a large family. Without a growing population, demand for real estate is unlikely to pick up. China has managed to entangle itself in a vicious circle.

These twin problems, however, are just two of the various issues the Chinese economy is facing. The country's high level of debt, the relatively low levels of productivity in manufacturing and the technological weakness of China, for instance in semiconductor

development and manufacturing, also contribute to a bleak outlook for the Chinese economy. Secretary General Xi's third term is likely to become his most difficult.

For the Chinese Communist Party (CCP), the structural weaknesses of the Chinese economy constitute a serious problem. The legitimacy of the CPP's rule greatly depends on output: Higher standards of living were a key component in this bargain. Since real estate and demography have nothing to do with the geopolitical conflict between China and the US, the Party will have to come up with solutions. The easiest one would be to allow a market correction: Declining values of real estate would contribute to greater affordability. Of course, it would also result in a significant reduction of wealth for almost 90 percent of Chinese households. Reducing the excess valuations of Chinese real estate without significant welfare losses for almost everybody is a Herculean task.

In this article, I will first look at the anatomy of the Chinese real estate development. I will then discuss options for stabilization, followed by a look at the connection between the business cycle and housing. Before discussing the demographic decline of China, I will ask whether non-action would be an option. In conclusion, I will consider the effects of the economic decline on the legitimacy of the rule of the Communist Party.

2. Real estate: A reason for distress

All over the world, there is concern about real estate markets. In many OECD-countries, the end of the zero-interest-rate policies results in significant pressure on real estate prices. Whilst *The Economist* in October 2022 already claimed there would be a "house-price horror show", the magazine was particularly sceptical about China. The "world's worst housing-related financial crisis", driven by vast speculative excess, will be confined to China, the analysis hopes.¹ For once, *The Economist* might be wrong: A long housing crisis in China will inevitably have severe effects on global demand, simply because of the effects of a crisis on Chinese consumers.

For many years, the relentless rise of real estate prices in China has puzzled observers. A country which did not know private ownership of residential property 40 years ago is now home to some of the priciest apartments in the world. Whilst academic observers have long questioned the sustainability of China's property boom, nothing happened for many years (Dieter 2021, 96-99).

¹ *The Economist*, 'House-price horror show,' 22 October 2022, p. 42.

Even if the problems in real estate are now well-known, there are no plausible plans for restructuring. Will the Chinese government's efforts to stabilize real estate be successful? Is it possible? Or have the policies of the Chinese government led to a situation which cannot be fixed without major damage to the Chinese economy?

2.1. The anatomy of China's real estate boom

China's unwillingness or inability to implement transparent and robust criteria for investment lies at the heart of the current malaise. Rather than permitting a slow-down of the economy, the leadership insisted on a continuation of previous growth patterns. The cost was rising debt, relative to GDP. Michael Pettis has suggested that keeping investment growth rates high resulted in systematic over-investment in projects that contributed less to the economy than they cost. In turn, debt to GDP rose, because non-productive investment does not generate the revenue for debt service. Debt thus rises faster than GDP – which is what has been happening in China since many years (Pettis 2022).

Michael Pettis has summed-up the weaknesses of the Chinese investment boom:

“By combining excessively high GDP growth targets with an administratively determined credit allocation process (rather than a market-determined one), China consequently ended up with a financial system underpinned by moral hazard. As a result, once the country ran out of easy investment opportunities, it was inevitable that there would be rising stress within the banking system and a rising risk of insolvency.”
(Pettis 2022).

In essence, the Chinese authorities failed to provide adequate instruments for risk management. The moral hazard mentioned by Pettis refers to the fact that many market participants assumed that there are implicit government guarantees. Given the sheer volume of credit, particularly to the housing sector, these expectations always appeared untenable. It would have been essential to send some early signals to market participants that there is a danger of insolvency. But those signals were not sent.

A key element in the unlimited supply of credit has been the expectation of implicit government guarantees. As early as 2017, the IMF pointed out that dismantling them is a dangerous balancing act (IMF 2017). A bold, radical departure from the previous policy could trigger panic in the financial markets and jeopardize the solvency of banks and companies. This balancing act is also difficult because in many cases it is not a matter of promises, but of assumptions made by financial market participants. How could the Chinese

state make it clear that private investors who trusted in the state may have been mistaken, without triggering a panic?

In this context, the statement of China's then Executive Director at the IMF, Zhongxia Jin, on the Fund's financial market analysis is noteworthy. Jin pointed out in 2017, that there was no legal basis for the government's imputed guarantees. A precedent, he said, was the bankruptcy of Guangdong International Trust & Investment Corp (GITIC) in 1999. At the time, the government did nothing to prevent the company's insolvency, and since then, investors ought to have been well aware of the risk of payment defaults.²

Whilst the 2017 discussion focused on foreign investors, the principal problem continues to be the same for domestic borrowers and lenders. Without regular bankruptcies, it is near impossible to retain market discipline. Moral hazard will inevitably be the result. Whilst there have been some high-profile bankruptcies recently, e.g., Evergrande, the long-term effects are not entirely clear: Have Chinese lenders and borrowers learnt the lesson that there will not always be a government safety net? If yes, has that resulted in a revision of lending policies and tighter credit, with predictable consequences for China's economic development?

Of course, the lending practices in the real estate sector are no different from the rest of the economy. Like infrastructure spending, a significant amount of investment went into real estate. The implicit expectation in real estate was that ever-increasing price levels would make even weak projects sustainable. The only risk was not to be part of the game. As the Chairman of Citigroup, Chuck Prince said just before financial markets crashed in the US in 2007: "As long as the music is playing you got to keep on dancing".

In November 2022, there were reports that the Chinese government has finally come up with a solution for the housing sector. A 16-point plan, published on 11 November 2022, is supposed to significantly ease the previous tightening on lending to the sector. Shares of developers like Country Garden, the country's biggest, jumped by over 52 per cent.³ But is the joy appropriate?

A more accommodating monetary policy will ease short-term pain but will only postpone the adjustment. Like loose monetary policies elsewhere, short-term generosity is buying time, not

² Zhongxia Jin, Statement by the Executive Director for the People's Republic of China, 10 November 2017, p. 3.

³ Laura He, China's real estate crisis could be over. Property stocks are soaring, CNN, 14 November 2022, available at <https://edition.cnn.com/2022/11/14/investing/china-real-estate-crisis-over-rescue-plan-intl-hnk/index.html>.

solving any problem. In China, price levels relative to incomes are too high, and demand for housing continues to be too weak considering the size of the sector.

Kenneth Rogoff has argued that it is not the short-term prevention of the collapse of real estate developers that is China's most serious economic problem. Rather, it is about rebalancing the entire economy, which has been dependent on its huge real estate sector for employment and growth for far too long (Rogoff 2021). In other words: China must reinvent its economic model – away from unsustainable levels of construction. However, the adjustment process will reduce the wealth of 87 percent of Chinese households that own real estate and will thus also have severe implications for consumption levels in China:

“Moreover, real estate is by far the most important savings vehicle in an economy where capital controls constrain citizens’ ability to invest abroad. Any significant decline in real estate prices would lead not only to widespread disaffection, but also to a potentially significant pullback in consumption of other goods and services” (Rogoff 2021).

The unavoidable adjustment of real estate prices will not be easy.

2.2. Stabilization of the housing sector and the business cycle

A key goal of policy makers in China could be the stabilization of the real estate sector. It may refer to two things: A continuation of the previous construction activity or a stabilization of the price levels of existing apartments. The first option is not plausible. China already has far too much real estate. The oft-cited figure is that there currently are 65 million unused apartments in China. Calculating a rate of three people per apartment, the entire population of Vietnam could twice be accommodated in these already existing apartments without building a single new home. Or the populations of Germany, France and Italy combined. Considering the stagnating population of China, it is hard to envisage that there is any need for additional housing at this point. Of course, there will always be scope for improving existing dwellings, but by and large, China does have sufficient housing.

Of course, a price correction is a well-known and useful effect to mop-up the negative effects of excessive price movements. In many countries, real estate markets have been under pressure in 2022, and this is a useful development. These corrections help to correct “irrational exuberance”, the term Alan Greenspan used in 1996 to describe excessive price levels in share markets in the US. Prices in China will have to fall, the only question is by how much. In the US, housing prices fell by 36 per cent after the financial crisis of 2008, and

in some regions, significantly more (Rogoff 2021). Case, Shiller and Thompson support this finding: After the crash of 2007, prices came down by about 32 per cent on a national basis, and in many cities by more than 50 per cent. In the US, this resulted in wiping nearly USD 7 trillion in equity, off household balance sheets (Case et al. 2012, 265f). Relative to GDP, these reductions of wealth were equal to 50 per cent of the US' GDP in 2008.

As mentioned, China's situation regarding investment opportunities is different from many other emerging markets, let alone OECD-countries. The government imposes tight restrictions on capital flows, which limits the ability of citizens to invest outside the Chinese real estate sector. A significant decline in real estate prices would not only lead to widespread discontent but would also lead to a potentially significant decline in consumption of other goods and services. It could start a self-escalating economic collapse.

Edward Leamer has emphasized this point regarding the US. He has suggested that housing is the single most critical part of the US business cycle. Developments in real estate are a key factor for forecasting economic development: Simply put, a decline in housing makes it possible to predict a lower level of economic growth. But Leamer is highlighting that there is even a causal relationship: A boom in housing significantly contributes to a rise of economic growth, whereas a slump in real estate leads to anemic economic development (Leamer 2015, 43). Rising house prices result in the so-called wealth effects on owner occupiers: Rising real estate prices makes them feel good about their personal financial situation, and in turn the owner-occupiers spend more. In turn, falling prices result in reduced consumption. A study by the Bank of England found that a 10 per cent increase in house prices raises consumption by 0.35 to 0.50 per cent.⁴

Of course, these findings are well established. What makes China a special case are two factors: First, the contribution of the real estate sector to economic growth has been outstanding in the last decades, as mentioned above. Second, the avenues for additional economic growth from increasing exports or from rising domestic consumption are blocked. China will struggle to significantly raise its exports because the higher costs of producing in China mean that many companies today are no longer as competitive as they used to be. And the feedback loop between shrinking house prices and consumer confidence results in Chinese consumers probably cutting rather than expanding expenditure.

⁴ *The Economist*, 'Property markets: the crack-up,'. 22 October 2022, p. 35.

In an earlier paper, Leamer has examined the effects of a slump in housing. He suggests that the main adjustment occurs via volumes, not via a price cycle. Home prices are very sticky downward, which means they do not quickly collapse. Faced with a decline in demand, it is the volume of sales that adjusts not the prices (Leamer 2007, 25). Of course, the decline in sales volume results in a comparable decline in jobs in construction, finance, and real estate brokerages. However, Leamer's rejection of adjustment via lower prices does not hold up well against the already mentioned evidence provided by Rogoff: In the US, house prices sank after the subprime crisis of 2007 and 2008, with price reductions of one third or more (Rogoff 2021).

But is there an indicator that would give a hint regarding the future of real estate in China? Of course, many observers have used "Dr. Copper" as a proxy for cyclical developments of the global economy.⁵ But what do the price movements of the most important commodity needed for construction tell us?

Since the beginning of the building boom in China, Australian iron ore prices have been a good indicator for construction in China. At the turn of the century, iron ore was traded at about 30 USD per metric ton. From November 2003 to November 2007, the price for the commodity jumped sixfold to almost 200 USD per metric ton. In November 2022, the price has fallen back to 80 USD a ton. The Australian mining industry has observed that much of the downturn is being driven by the stalled housing market in China, Australia's largest iron ore customer. A lower level of construction activity in China results in lower demand for (Australian) iron ore.⁶ Taking the iron ore price as a proxy for the sector's development, there has been normalization, but no collapse of demand.

2.3. Is no adjustment an option?

Of course, in theory the Chinese government has the means to keep the price levels in housing propped up at their current level. In an extreme form, the government could buy apartments from distressed owners and could once again become the owner not just of land, but also of apartments. The drawback is that this would raise government borrowing further. The leverage would be shifted from private home owners to the government. Needless to say,

⁵ The price of copper regularly indicates swings in the business cycle: A rising copper price often is an early indication for a cyclical upswing, a declining price may indicate a coming recession.

⁶ *Business Insider*: 'Is the iron ore price nearing its bottom?' 8 November 2022, available at <https://markets.businessinsider.com/news/commodities/is-the-iron-ore-price-nearing-its-bottom-11883807>.

that is not a solution, but rather the opposite of it. China would be running the risk of becoming a real Ponzi scheme: Only by injecting fresh liquidity can the house of cards be kept alive.⁷

As a result of the lasting boom, China's total housing supply, measured in square meters per person, has already reached the levels of much wealthier economies such as Germany and France (Rogoff 2021). Whilst existing dwellings, often displaying a relatively low level of quality, could be improved, the oversupply ought to be corrected. In urban China, the vacancy rate already stood at 21 per cent in 2021, and Chinese government is acutely aware of the need to shift productive resources into other sectors (Rogoff 2021). But which are the potential areas that could replace real estate?

An often-made suggestion is that Chinese citizens should consume more. Apart from the fact that there are negative feedback loops from declining asset prices, including real estate, the first question to consider is whether consumption levels in China have been low or not in past decades. Often, past consumption patterns are misinterpreted.

The reason, once again, is real estate. Statistically, it is not easy to classify owner-occupied apartments. Of course, those who use them consider them an investment. But, as long as they live in those apartments, they can't sell them. Like a rented apartment, an owner-owned apartment has a consumption component. How is the issue dealt with in national accounts?

In Europe, there is a significant discussion on that issue. The Brussels-based Think Tank Bruegel has concluded a study for the European Parliament and suggests that own home occupation can be viewed as the provision of a service (providing a place to live) by the owner to himself (Darwas/Martins 2021). But when the owner-occupier leaves the house or apartment, it can be sold, so there is an investment component. Unfortunately, there is no consensus on the separation of the consumption and investment components of real estate. The makeshift method applied in some countries is to count the cost of the land as investment and the cost of the building as consumption (Darwas/Martins 2021).

Needless to say, there is some logic in this approach. A building deteriorates over time and has to be written off, land does not. Therefore, rising property prices primarily reflect rising land prices. But what does that mean for China, where citizens cannot buy land? All land in

⁷ Carlo Ponzi was an Italian migrant to the US who convinced investors that he could generate income by arbitraging international postal reply coupons – a kind of tradable stamp, whose prices fluctuated between countries. Of course, the scheme was a hoax.

China is owned by the state, and purchasers of property can only acquire the right to use the land for a period, usually 70 years.

One interpretation could be that there has been a systematic underestimation of consumption levels in China. In essence, the number of years remaining on the lease declines year-after-year. Some apartments bought at the beginning of the privatization schemes have little more than 30 years of lease left in them. Chinese purchasers of property have primarily bought their share of the building plus the cost of the land use. The value of this right can only shrink to eventually zero when the lease ends. The asset price booms in China have thus been asset price inflations of buildings, not of land.

Of course, the Chinese government could change this and permit the introduction of freehold, rather than leasehold, land. Another option would be to guarantee an automatic extension of the lease by 50 or 70 years. But, as long as this issue is unresolved, the high valuations of Chinese dwellings are nothing but a risky bet on some form of government bail-out in future.

3. Demography

The outlook for the Chinese economy would be rosier if the demographic prospects would not be so grim. Whilst it has long been known that China will age before it becomes affluent, the magnitude of the issues is surprising. Should the projections of the United Nations turn out to be correct, by 2100 the population of China will be less than 800 million people, about the level of 1968.

The UN provides three scenarios: A high, a medium and a low scenario. Even in the high scenario, the population of China would shrink to 1.150 million people in 2100. The medium scenario suggests a population of 766 million people, whereas the low scenario suggests a level of 487 million, a figure lower than in 1950 (UN 2022).

The UN Population division considers the medium scenario to be the most likely one.⁸ Even that scenario suggests a significant decline of the Chinese population. It would represent an

⁸ “The medium scenario can be interpreted as the most likely future trend among the various projections published by the United Nations in the *World Population Prospects*. It corresponds to the most likely population projection based on several thousand simulated future trends, each one based on distinct trajectories of fertility and mortality for individual countries and areas. Prediction intervals reflect the spread in the distribution of outcomes across the projected trajectories and thus provide an assessment of the uncertainty inherent in the medium scenario.” United Nations, *World Population Prospects 2022*, available at https://www.un.org/development/desa/pd/sites/www.un.org.development.desa.pd/files/wpp2022_summary_of_results.pdf, p. 33.

implosion from the current levels. In 2100, China's population would only be about half of the future population of India. Whilst these UN findings have important repercussions for a range of areas, from geopolitics to future military capabilities of China, they are particularly significant in the economic domain.

If China will indeed lose about half its current population in the next 80 years, it will most probably not continue to prosper. A decline of that magnitude will result in economic stagnation – at best. China will look like an enlarged version of Japan but will be significantly poorer. Undoubtedly, the two problems that have been discussed in this paper – real estate and demographic decline – mutually reinforce each other. Astronomical price levels for housing are a powerful incentive not to have a larger family. At best, young Chinese couples can hope to be able to afford one child. In 2022, the total fertility rate was estimated to be 1.45 per woman.⁹ With birth rates low and falling further, there is little hope that the Communist Party will be able to reverse this trend.

Unlike India, which has about 350 million people in each of the three age cohorts 0-14, 15-29 and 30-49, China's population by age is much less equally distributed. There are a little over 200 million people in the first two cohorts, but over 400 million in the group 30-49 and a little less than 400 million in the group 50-69.¹⁰ In the no-so distant future, the two large age groups will cease to be part of the workforce and will have to be supported by the working part of Chinese society.

Some might argue that the old could be able to support themselves from the large savings they have accumulated. However, this is not possible. Current welfare expenditure, pensions for example, cannot be paid from savings, but must be paid from current income: All social expenditures must always be covered from the national income of the current period (Schewe 1996, 35). Wealth stored in savings will be of limited use in an economy that is not performing: The argument is that, economically speaking, pensions, as expenditures for consumption, must always be paid by the producing generation and that saving in a macroeconomic sense is only possible in a very imperfect way (Schewe 1996, 35). If that assessment is correct, it is the future Chinese workers that will have to provide the income for Chinese pensioners. Regardless of whether one considers the macroeconomic dimension as serious, a dramatically shrinking population certainly poses a formidable challenge to any

⁹ CIA, The World Factbook, China, available at <https://www.cia.gov/the-world-factbook/countries/china/#people-and-society>.

¹⁰ The Economist Intelligence Unit, *Country Report China*, November 2022, p. 2.

government and of course also for the Communist Party. Since the CCP has been responsible for the implementation of the one-child policy, its legitimacy will be particularly tested.

4. Effects on the legitimacy of the Communist's Party's rule

China's leadership is facing serious, perhaps unprecedented challenges. Of course, predicting serious economic problems in China has long been a fruitless endeavor. The Communist Party has regularly managed to make the right decisions. Some serious mistakes were of course made, notably, the one-child policy, and the lack of control of the asset price inflation in real estate.

Today, much is at stake for the CCP. There is a considerable risk that the historical bargain between the CCP and the Chinese people, who expected an improvement of welfare in return for limited economic freedom, will no longer hold. In his third term, General Secretary Xi will be put to the test: Will he manage to further strengthen the rule of the Communist Party? And what will be the economic policy instruments he is likely to use? Considering his past performance and recent statements, the prospects for the Chinese economy are bleak indeed.

In his opening address at the party congress in October 2022, Mr. Xi mentioned "security" 52 times, "Marxism" 15 times and "markets" three times (Yuan 2022, 1). Xi emphasizes control, and the drawback will be economic decline.

For Secretary General Xi, the real estate sector and demographics are the heaviest millstones, as discussed in this paper. It is not plausible that the demographic problems will be solved any time soon, and without a solution, say by mass immigration from African countries, it is difficult to envisage sufficient demand for housing. The Communist Party and its leadership have built a dead-end street: Any solution to the existing dilemmas will threaten the rule of the CCP. It will either result in a much greater role for market processes, implying a diminished role for the state and the party, or massive immigration, which would threaten political stability.

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