CENTER FOR FINANCIAL STABILITY
Bold • Innovative • Practical

The Ponzi Bubble in China's Property Market is Deflating

Robert Z. Aliber

March 11, 2022

The headline in a Bloomberg story "China Home Market Slump Persists as Prices, Sales Fall"[1] — was one I have been waiting for since the autumn of 2015 when the seventh edition of MANIAS[2] was published. The epilogue in the book described the time-bomb that was expanding in the property market in several hundred Chinese cities. China then was producing ten million new apartments each year; six or seven million became occupied, the rest remained vacant and were held as stores of value because the buyers anticipated that their prices would increase by eight or ten percent a year in response to the continued migration of five or six million people a year from the farms and villages to the factories and the cities. It was safely predictable that the migration from the villages would decline sharply as a belated result of the one-child policy adopted in the early 1980s.

China has had 35 years of brilliant economic growth since the early 1980s, when per capita income was less than $200; currently it is $18,000. China has been in the number one position on the world economic growth rate hit parade for the last several decades; real wage rates have increased as rapidly as per capita income. The Andy Warhol Theory of Economic Growth is that every country grows rapidly for fifteen years—or maybe twenty or thirty. As its industrial sector expands and its agricultural sector shrinks, the Andy Warhol Theory is about to become relevant for China because migration from the countryside to the factories has ended. Its rate of economic growth will decline sharply.

Spending on newly built apartments accounted for ten percent of the country's GDP and construction provided employment for more than sixty million workers. The prices of newly-built apartments have increased somewhat more rapidly than China's GDP. Prices in the four major cities – Shanghai, Beijing, Guangzhou, and Shenzhen – now are fifteen to twenty times higher than household incomes. The buyers of these apartments anticipated that they would sell them at even higher prices because the growth of the urban population would lead to greater demand for accommodations.

The jibe is that "there are a thousand facts about China. Most are wrong. Unfortunately, we do not know which ones are wrong." One fact is that the country's population peaked in 2021. (Or maybe the peak will occur in 2022.) A second fact is that the urban population has peaked—or maybe it will peak next year. A third is that there are between forty and seventy million vacant apartments, including thirty million owned by the property development firms, of which twenty million are in the two years long construction pipelines.

Much of the economic news from China in the last six months has centered on the cash flow problems of Evergrande, its second largest property developer, which owns more than one million apartments in 798 projects in 234 cities. Evergrande also has invested in electric vehicles, finance, and health care and

[1] Zhu, Charlie and Emma Dong, "China Home Market Slump Persists as Prices, Sales Fall," Bloomberg, December 14, 2021 - https://www.bloomberg.com/news/articles/2021-12-15/china-home-market-slump-deepens-as-prices-fall-for-third-month.

[2] Aliber, Robert Z. and Charles P. Kindleberger, Manias, Panics, and Crashes: A History of Financial Crises, 7th Edition, Palgrave Macmillan, 2015.

donated $12 million to Harvard University in 2020 to support three research centers. China has several thousand property development companies; some are private, some are public, and some are state-owned. Evergrande was established in 1996; its indebtedness has increased by more than fifteen percent a year to $300 billion, including $20 billion denominated in the U.S. dollar. Moreover, Evergrande owes several tens of billions to the households that made advance payments for the purchase of apartments; some of these funds were to be held in escrow accounts. In addition, the firm owes tens of billions to construction firms that build the apartments that it sells. It's a safe bet that until the summer of 2020 all of the money that Evergrande needed for the interest payments on its indebtedness was obtained by selling more of its IOUs.

Several other property developers including the Kasia Group, the Sinic Group, Country Gardens, and the Shimano Group also have defaulted on their bond indebtedness. A shortage of liquidity is the popular explanation for their money problems. The Beijing government has established three "red lines" and the property development firms have been instructed by the government to limit the increases in their indebtedness, which has prevented them from selling more of their IOUs to get the cash that they need to re-finance maturing indebtedness.

Why has Evergrande fallen behind in its interest payments to creditors and reneged on its commitments to support the centers at Harvard that carry its name? Remember MONOPOLY, with its purchases and sales of properties in Atlantic City. Firms in financial distress first sell the most attractive assets, in large part because the less attractive assets can only be sold at a large discount from their face values. Evergrande has sold several tens of billions of its projects. The most plausible explanation for why it hasn't sold more of its properties to get the cash for debt service payments is that the highest prices that any of the other developers will pay for these projects are below the lowest prices that it would find acceptable; if these projects were sold at the prices offered by other developers, Evergrande would have to recognize an immediate loss. Evergrande is bankrupt.

Evergrande's cash flow problems reflect that the banks and real estate investors have concluded that the firm is broke. Evergrande probably has been insolvent for eight or ten years, it is the property market counterpart of Bernie Madoff, who is in the Guinness Book of World Records because he managed a Ponzi scheme that operated with negative net worth for nearly twenty years. Madoff could stay in business as long as more money was coming in than going out, he failed during the credit crunch of 2008 when cash withdrawals spiked. Evergrande expanded its production of apartments at a rapid rate because it needed the cash from the down payments for the purchase of apartments on Tuesday for the payments to the construction firms for building the apartments that it had sold on Monday. Tuesday's buyers were told that the cash would remain isolated in escrow accounts, but somehow the money leaked from these accounts. The rapid growth of Evergrande's indebtedness suggests it expanded at an accelerating rate because it needed more cash from the sale of new apartments for the interest payments on its outstanding indebtedness. Evergrande was the winning bidder in many of the auctions for the land that the local governments were selling; if it had not acquired the land, it would not have been able to sell new apartments, and receive the cash that it needed for the interest payments on its outstanding indebtedness.

Evergrande has had the property market counterpart of small pox for most of 2021, as the word got out that it had fallen behind in its payments to contractors, its sales receipts declined sharply because households have become super-cautious about buying its apartments. Skepticism about the promises of other property developers has surged. The prospect of insolvency will become self-fulfilling; as sales of new apartments slow, the property developers will develop larger inventories of unsold apartments than they had anticipated.

The quip is that property developers in China like those in most other countries borrow as much money as they can, as apartment prices decline, hundreds of property developers including many previously believed to be well managed will have fire sales on unsold apartments as they scramble for cash. A price tumble of fifteen to twenty percent will cause most to become bankrupt. The would-be buyers will move to the sidelines as prices fall.

The XI government may provide a burst of liquidity to paper over the insolvency of the property developers, but it cannot paper over the demographics of a declining population and forty or sixty million vacant and overpriced apartments. The market value of the Chinese residential real estate is three to four times China's GDP. (By comparison the market value of U.S. residential real estate is slightly higher than U.S. GDP). If property prices decline to the levels commensurate with household incomes and rents, household wealth will decline by sixty or seventy percent—two to three times China's GDP, or eight to ten times larger than the annual expenditures of the Beijing government. A few of those in Beijing may recognize that if they kick this can down the road for a year or two, all of the Humpty-Dumpties cannot restore the belief among apartment owners that they will be bailed out by the greater fools who will pay higher prices for these apartments. The DNA of a real estate bubble is that prices do not plateau. Instead, when they stop increasing, they fall. Property prices have not increased for six months, which suggests that the transition to a declining price environment is underway.

Fast forward to 2050. China's population then will be smaller by sixty to eighty million people. There will be a slightly larger decline in the labor force unless the retirement age is raised. These declines are already baked in the data and will lead to dramatic fall in the GDP growth rate. The service sector will be modestly larger share of GDP as the industrial sector shrinks. The most optimistic view is that productivity in the service sector --education, health care, transportation--will be about three percent a year. Note: the excess of U.S. GDP growth over that in China will have increased for thirty years.

The near-term implication is that GDP growth will decline as new housing starts fall. (U.S. spending on residential construction in 2010 was twenty five percent of its level in 2006, a decline of three percentage points of U.S. GDP.) The demand for construction labor will shrink, each fall of one million in housing starts means that five or six million fewer workers will be needed for construction and that the GDP growth rate will decline by one and one-half percentage points . Moreover construction of apartments has absorbed twenty five percent of private savings, so each decline of one million in housing starts means that GDP would fall by one and one half percent. Spending on automobiles and other durables and tourism will fall. The governments can increase spending on infrastructure, but it will have to create a financial vehicle to capture more of household saving that led to the purchase of apartments, the stylized fact is that China is oversupplied with high-speed railroads, tollways, and airports. The fiscal deficit of the Chinese government will surge because the large banks will need to be re-capitalized and the provincial governments will seek cash from Beijing to offset the decline in revenues from land sales.

The contagion effect will come into play, and property prices in Hong Kong will fall. The number of Chinese students at colleges and universities in the United States, Great Britain, Canada and Australia will decline. Some U.S. colleges and some public schools in Great Britain will close. China's imports of copper and iron ore will plummet, and its purchases of petroleum will fall. China's exports of manufactures will increase sharply, the price of the yuan will tend to increase as import payments fall and export receipts increase, but the People's Bank of China may become a large buyer of dollar securities to limit the decline the in the competitiveness of Chinese-produced goods in foreign markets. The increase in China's trade surplus will limit increases in the goods price levels of its trading partners by a modest amount.

China is becoming more mercantilist and seeks to reduce its dependence on foreign goods. Moreover, China appears to be experiencing another major convulsion, with a governmental squeeze on wealthy entrepreneurs. The smart money Chinese will stash more of their money in the United States, Great Britain, and Singapore.