Tier 3 Cities: A Hotbed of Trouble in China’s Property Sector?


Signs of trouble abound in China’s real estate sector. Some of China’s largest property developers are at risk of defaulting on their loans, and uncertainty in the industry has also induced increasing numbers of home buyers to stop mortgage payments on thousands of unfinished homes. After decades of break-neck construction, there is a risk that the sector is overbuilt. Yet, most studies of China’s real estate sector have primarily relied on national aggregate data and data from larger “tier 1” and “tier 2” cities like Beijing, Shanghai, and provincial capitals. They have tended not to focus on how the allocation of housing and construction imbalances extend across different regions. Where is the oversupply of housing in China, and why does that matter for the broader economy?

The data. Fine-grained data for the 685 “tier 3” cities in China are not publicly available. The researchers therefore impute the size of China’s housing stock and residential price developments for tier 3 cities by first calculating China’s national data and then subtracting the aggregated tier 1 and tier 2 city data from the national data.

The researchers rely on China’s 2010 and 2020 national population censuses, provincial and city-level censuses, and the annual national and city-level statistical yearbooks to derive construction floor space, per capita living space, volumes of residential housing sold, and housing price data to make their calculations.

INSIGHTS

- The estimated size of China’s real estate sector has remained around 26% of GDP since 2018 — an exceptionally high portion by international standards.
- A significant share of total housing construction (78% in 2021) is concentrated in hundreds of smaller tier 3 cities, where the population is projected to shrink, exacerbating a mismatch in supply and demand.
- The demand for new real estate construction in the smaller and lower-income tier 3 cities is expected to shrink by roughly 30% from current levels by 2035.
- Because tier 3 cities account for 60% of China’s national GDP, a property slowdown there poses a significant and often overlooked risk to the broader economy.

China’s real estate sector in comparative perspective. The study suggests that after decades of break-neck construction, China’s floor space per capita is already comparable to that of many high-income economies, like France and Germany. They also find that by international standards, the real estate sector in China constitutes an exceptionally large part of the country’s GDP. In 2021, the sector (including direct and indirect contributions) accounted for 22.5% of China’s GDP and 25.4%, if including imported content.

Total housing stock by city tier

Housing supply in tier 3 cities. The authors next demonstrate that there is a substantial mismatch in housing supply and demand in China. Their analysis shows that excess housing stock and continued overbuilding are concentrated in tier 3 small and medium-sized urban areas. As the figure below shows, a disproportionate share (78%) of total housing construction in China in 2021 took place in tier 3 cities.
Housing demand in tier 3 cities. Using United Nations estimates and provincial-level estimates, the researchers further predict that in the coming years, demand for housing is going to decline across tier 3 cities. Taking into account expected changes in age demographics and household formation, they infer that the demand for new construction in tier 3 cities may shrink by roughly 30% from current levels by 2035.

Price trends. According to the researchers, evidence of overbuilding in tier 3 cities is further apparent in housing price developments between early 2021 and mid-2022. While tier 1 cities and tier 2 cities witnessed modest price increases, residential housing prices in tier 3 cities dropped by nearly 20%.

![Housing price change by city tier](image)

*Note: Feb 2021 is used as the base month and the indices measure cumulative change relative to the base month.*

Signs of distress in China’s tier 3 property markets. Consistent with housing supply, demand, and price trends discussed above, the researchers also find significant signs of distress in China’s real estate sector, particularly in tier 3 cities. In many of these cities, shrinking demand, lack of financing, and property disputes have led to a rising number of stalled construction projects. The volume of such unfinished housing projects in tier 3 cities was 10.6 times as large, in fact, as annual housing completed in 2020.

The outsized impact of tier 3 cities on China’s GDP. According to the researchers, tier 3 cities in China account for more than 60% of China’s GDP and about 50% of the market value of its housing stock. Thus, the effects of a slowdown in tier 3 property markets, they argue, will almost certainly have serious consequences for China’s broader economy.

The end of real estate as a driver of China’s growth? China’s property sector is currently facing a major downturn. The authors of this study assert that the underlying causes of this current malaise may not merely be due to the government’s tightening of lending regulations but may rather be long term and structural. Especially in tier 3 cities, residential housing is being oversupplied, housing demand has peaked, and prices are falling steeply. The real estate sector over the past few decades has been one of China’s pillar industries, accounting for 22.5% of China’s GDP in 2021, even excluding imported content. The growth from the housing markets has been vital to sustaining local government fiscal revenue, household wealth, and employment in China. Due to China’s unique urban developmental trajectory, moreover, these tier 3 cities collectively exert a far greater impact on the country’s economy than many assume. Hence, China’s growth strategy, which has placed construction at its core, now shows signs of faltering, and its property market, which has generated such spectacular growth to date, may now prove to be a drag on China’s economy.