Analyzing the Extent, Causes, and Implications of China’s Property Sector Slowdown

The Stanford Center on China’s Economy and Institutions and Asia Society Policy Institute’s Center for China Analysis co-organized a closed-door roundtable on China’s property sector.

For three decades, the property sector has been a major engine of economic growth in China, accounting for about a quarter of its GDP in the 2010s. By 2021, however, there were signs that China’s property sector may be reaching a peak and even beginning to contract, potentially signifying wider distress in the economy. Recognizing the significance of this development, roundtable participants addressed the following questions: (1) the extent of China’s property slowdown; (2) its root causes; (3) the implications of a sectoral downturn for the broader economy; and (4) potential government responses.

A prolonged slowdown. Panelists broadly agreed that the slump in China’s property market could act as a prolonged drag on China’s overall economy. Some panelists pointed out that the property market downturn exposes the unsustainability of China’s state-interventionist and investment-driven growth model, and that China is likely to face years of slower growth. Others argued, nevertheless, that China’s government, with its diverse policy toolkit, is unique in its ability to respond decisively and nimbly to market contingencies and, if needed, avert a crisis.

Causes of decline in China’s property sector. Participants agreed that the root causes of China’s property market slowdown were largely structural, but that short-term policy mistakes exacerbated the situation. Panelists, for example, viewed the government’s “three red lines” policy in 2020 to de-risk the sector, while well justified, as poorly timed in the context of China’s sluggish economic performance and its zero-COVID policy. Of more significance to the participants, however, was the decades-long supply expansion and a slower pace or even a decline in long-term demand for housing, leading to a definitive shift in the supply-demand equilibrium.

Exacerbating the mismatch, many agreed, is a shrinking and aging population, slowing family formation, and a slower pace of urbanization, indicating that the long-term, fundamental demand for urban housing might have already peaked. In short, a combination of peaking structural housing demand, excessive housing supply in smaller cities, tightened regulations under the “three red lines” policy, and a weaker economic cycle under the zero-COVID policy together weighed on an already saturated Chinese property sector, resulting in the most pronounced real estate downturn seen so far.

Broad implications. China’s property sector has long been a major engine of the country’s economic growth, accounting for as much as a quarter of the country’s GDP. As a key node that connects local government revenues, the financial sector, household wealth, and the construction sector, all agreed that the property sector downturn has enormous implications for China’s overall economy.

Local government finance. The property sector has a direct impact on the fiscal health of local governments. According to the data presented at the roundtable, local governments rely heavily on land sales and related tax streams, accounting in 2018 for up to 40% of budgetary income at the local level. Thus, as the property market slows, the resulting drop in land transactions will directly impact local governments in the form of revenue shortfalls, with the question of how to make up their revenues still unanswered.

Financial sector exposure. The roundtable discussion also underscored the financial system’s exposure to the property sector, which mostly occurs through two channels: directly through property developer debt and mortgage, and indirectly through the liabilities of local governments reliant on land finance.
To limit this exposure, some panelists pointed to how the Chinese government, which plays an outsized role in the real estate market, may be intervening in the housing market. As highlighted by one participant, a distinct feature characterizes the current property sector downturn in China: housing market adjustments have so far been taking place mostly through sizable quantitative adjustments with only minor price corrections. Home sales contracted by approximately 30% to 40% in 2022, for example, while housing prices fell by only about 3% nationally. Many panelists agreed that the Chinese government is likely stepping in to restrict price corrections.

If the government allows prices to adjust more freely together with quantity, some suggested that the drops in prices might spill over into the financial system, both marking down bank balance sheets and hitting bond investors, potentially triggering a broader financial crisis. If there is a “Lehman moment” in China, some argued that the financial contagion might very well start from bond defaults by local governments and their financing vehicles rather than from China’s traditional banking system. In such an event, many agreed that a decisive response by the central government to immediately guarantee local government bonds would be crucial to prevent a broader financial meltdown.

Household wealth. A significant proportion of household wealth in China — as much as 60% to 70%, according to some estimates — is tied up in real estate. In the absence of good investment alternatives, and with housing prices growing rapidly for decades, real estate has been the best investment vehicle for households. But even as an appreciating asset, housing has not yielded significant disposable income for households.

To shift toward a future growth model based on domestic consumption, many agreed that the government needs to foster rental markets to translate asset wealth into disposable income. China must also develop mature capital markets to establish viable investment alternatives to housing. In the immediate term, however, some panelists averred that the downturn in housing prices will likely create a negative wealth effect on household consumption behaviors. With savings rates already high in China, they argued, the downturn in housing prices will compel households to save even more.

The construction sector. With China’s real estate-related activities amounting to more than 26% of China’s GDP and given the construction sector’s considerable size (providing 60 million jobs in 2020), panelists agreed that a slowdown in the housing market would create great uncertainties for employment.

Considering all these factors, panelists debated China’s growth prospects for 2023. One participant estimated that a 20% fall in real estate activity could potentially lead to a 5% to 10% fall in China’s GDP, even without amplification by a simultaneous financial crisis. Some expressed notable pessimism about China’s economic outlook in 2023, projecting low growth for not only household consumption but also for investment and exports, and capped China’s GDP growth at a mere 3%. Others contended that, in light of the policy instruments at the government’s disposal to prop up the real estate industry, China could achieve its announced 5% growth target in 2023.

The government’s response. Participants repeatedly echoed the need for China to use the current slowdown as an opportunity to shift structurally toward a new growth model that is less dependent on the property sector. There were divergent views, however, on how and whether the government can accomplish this transition. All agreed that given the enormous and complex impact of China’s property sector, the Chinese government’s management of the present downturn will have significant ramifications for not only its own economy but also the rest of the world.