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Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. In this December 2023 Letter, UCLA Anderson Forecast Economist William Yu and UCLA Anderson Forecast Director Jerry Nickelsburg explore the geopolitical questions resulting from China's economic imbalances. The full report – taken from the Fall UCLA Anderson Update – is available here.

# 'De-Risking' the Chinese Economy

## How will China react to a bursting real estate bubble?

*By William Yu and Jerry Nickelsburg*

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Over the past decade, the U.S. came to understand that China's elevated economic growth and prosperity were not to be accompanied by political liberalization. Instead, China has demonstrated diverging interests and policies from the U.S. on such vital issues as trade norms, human rights, geopolitical balance, COVID-19 responses, the Hong Kong Sino-British Joint Declaration, and Russia's invasion of Ukraine. Consequently, the U.S. has shifted from a forty-year strategic engagement approach to one of strategic competition.

A prime example of this strategic shift in U.S.-China policy pertains to U.S. concerns regarding supply chain resilience. While China-centric global supply chains and manufacturing hubs provided extremely efficient just-in-time inventories in the post-Cold War period, they displayed fragility and significant risks to economic and national security, notably in the cases of medical devices during the pandemic and high-tech sectors like communication and semiconductors.

For these and other reasons, the U.S.-China economies are slowly decoupling. There's concern that if this persists, it could result in economic stress in China, potentially inducing aggressive military actions in the Asia-Pacific region. To avoid this dire outcome, "De-risking" was issued by the U.S. Treasury Department in May 2023 as a more appropriate guiding principle for U.S.-China relations than "Decoupling." The term "De-risking" allows for a shift in economic relations and provides for a more neutral depiction of the relationship which does not characterize the interaction as a zero-sum game.

De-risking is not solely a U.S. initiative even though the U.S. has enacted actions, including: tariffs, sanctions on select Chinese companies, limits on advanced technology and component exports to China, the Indo-Pacific Economic Framework (IPEF), AUKUS, CHIPS and Science Act, CHIP 4 Alliance, the U.S.-Japan-South Korea trilateral summit, and more[1]. For China, depending on the West for crucial technology, components for its value chains, and dollars for international trade and finance poses risks, especially in conflict situations. Consequently, China is also pursuing de-risking strategies to reduce dependence on U.S. technology and a dollar-centric financial system.

Over the last six months, the trajectories of the U.S. and Chinese economies have diverged. Amidst persistent recession warnings by some economists, the U.S. economy continues to grow, and the employment data reveal no sign of a downturn. At the same time, China's economy continues to face one challenge after another. The official Chinese data indicates a sharp slowdown in economic growth – a "growth recession." Is this masking an actual recession? Are China's current property market problems like Japan's in the 1990s, leading to something like Japan's "lost decade"? Might China now encounter its own "Lehman moment," reminiscent of the U.S. 2008 financial crisis?

China's GDP grew by 5.5% in the first half of 2023 compared to the same period in 2022, as reported by its National Bureau of Statistics (NBS). Given a lower base in 2022 due to China's stringent Zero-Covid policy, Wall Street expected a post-pandemic boom in China with much more rapid growth after China abandoned lockdown measures. The credibility and precision of the official statistics raise questions. The UCLA Anderson Forecast developed an alternative model to assess China's GDP growth. The model factors in the annual growth rates of four key variables. In the first six months of 2023, these were: energy consumption at 4.4%, $CO_2$ emissions at 3.6%, total trade (combining exports and imports): -6%, and home price growth at -20%. Based on the Forecast's model, China's GDP growth rate for the first half of 2023 is estimated to be 1.8%, a figure considerably lower than the official Chinese estimate.

Our estimates exhibit consistently lower growth rates compared to the official statistics. It is important to note that our calculations factor in a -20% growth rate for Chinese housing prices in 2023. This assumption stems from the myriad of challenges witnessed in China's real estate sector, including serious operational and viability concerns related to its largest developers Evergrande and Country Garden. However, if we consider China's official 70-city average growth rate of -1%, our model projects China's GDP growth to be 3.7%. For those holding a more bearish perspective on China's property market, in the case of a -50% of housing price growth, our model suggests a GDP growth rate of -0.9%. In other words, China may already be in a recession. A telling indicator of the struggles in China's property market is the performance of representative real estate ETFs (exchange-traded funds) from both the U.S. and China. Between January 2021 and August 2023, the Vanguard U.S. real estate ETF (VNQ) appreciated by 10%, while the MSCI China Real Estate ETF (CHIR) declined by 56%.

> *"China's years of over-investment, especially in real estate, have led to economic imbalances. With a massive real estate bubble now bursting, substantial debt is poised to weigh on China's economy for the coming decade or even longer. China might be echoing Japan's "Lost Decades" of the 1990s and 2000s."*

It is not uncommon to observe a deceleration in growth rates as nations become wealthier. However, China's many years of high investment, especially in the real estate sector, have led to overinvestment and economic imbalances, causing a massive real estate bubble and soaring debt. The Bank for International Settlements (BIS) estimates that China's total debt of the non-financial sector reached 297% of its GDP in 2022 Q4 compared to G20's 249%. With this bubble now bursting, the substantial debt is poised to weigh on China's economy for the coming decade or even longer.

Compared to the average share of investments in real estate, infrastructure, and factories hovers around 23% of the U.S. economy, China's investment has consistently been above 40% of its GDP for the past decade. Such disproportionate investments result in misallocated resources, diminishing or even negative returns, and escalating debts.

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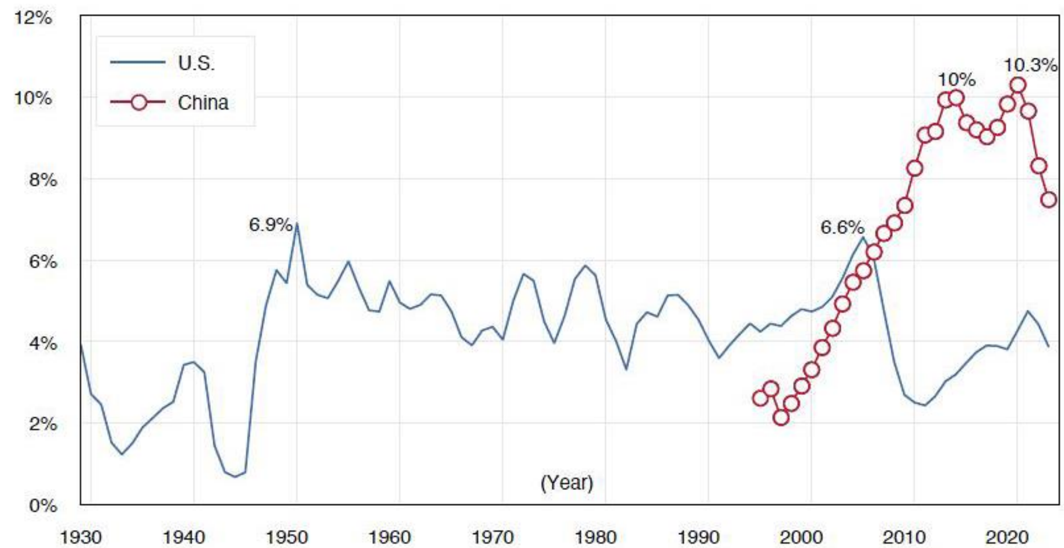
[1] AUKUS, is a trilateral security partnership for the Indo-Pacific region between Australia, the U.K. and the U.S. announced on September 15, 2021. The CHIPS and Science Act (where CHIPS stands for "Creating Helpful Incentives to Produce Semiconductors"), enacted on August 9, 2022, is to boost domestic research and manufacturing of semiconductors in the U.S. The Chip 4 Alliance was proposed by the U.S. in March 2022 to create a more secure semiconductor supply chain between the U.S., Japan, South Korea, and Taiwan.

The magnitude of China's housing bubble: The graph shows the annual direct residential investment as a percentage of GDP for the U.S. and China, with data available post-1995.




*Source: CEIC and Bureau of Economic Analysis of the U.S.*

On average, the U.S. recorded housing investment averaging about 4.5% of its GDP since 1929. Only twice did it exceed 6%: once in 1950 at 6.9% and again in 2004-2006, peaking at 6.6%, just before its housing market crash. While there are distinct differences in housing markets between the U.S. and China, there are important similarities. 1929 represents the end of a period of significant immigration to the U.S. which resulted in a 25% increase in population. Between 1920 and 1940, large scale migration to urban centers was caused by the depopulation of rural America. And in the 1950's, large scale migration out of the South strained housing stocks in Northern and Western U.S. cities. As these are on a scale not too dissimilar to rural to urban migration in China, the gap between China's housing investment and that experienced by the U.S. is suggestive of overinvestment in China. The well-known ghost cities in China provide further evidence of this.

To grasp the scale of China's construction boom, let's compare it to the average annual construction in the U.S. of approximately 4 billion square feet per year (1 billion commercial and 3 billion residential). Since 2007, China's construction has exceeded 20 billion square feet every year, but this number surpassed 40 billion annually from 2013 onwards. In 2022, in addition to completing 43.6 billion square feet, there was an astounding 168 billion square feet still under construction. 2006 is also the year that its investment share of GDP surpassed 35%. Drawing parallels from U.S. and Japanese history, a severe housing bubble is typically followed by an equally severe housing downturn. This suggests China might face a two-decade slump in its housing market. Therefore, it is reasonable to posit that China is entering a prolonged period of stagnation, if not worse, as it grapples with massive overinvestment and debts.

Due to the tight control of the Beijing government, the likelihood of a full-scale financial meltdown and crisis occurring in China is relatively low. Entities associated with the real estate bubble deemed "Too Big to Fail" or "Too Connected to Fail," whether they are developers, lenders, or banks, are likely to be salvaged in the following years.

There has been a noticeable decline in the share of U.S. imports of goods from China since 2018. The latest data from 2023 further underscores this ongoing trend. From October 2008 to November 2022, China was the predominant source of U.S. goods imports. Since then, Mexico has taken the lead as the U.S.'s top importing partner. And this year net FDI for China is negative.

With respect to the U.S., these issues in China are not likely to have a major impact. There will be a reduction in the demand for foreign, including U.S., goods by China. But, the share of the U.S. economy related to exports to China is very small. Moreover, the resumption of Boeing 737 Max aircraft deliveries will mitigate the impact on the U.S. economy.

## CONCLUSION

This is a time of change in U.S.-China economic relations. After six years of disengagement, the two countries are in discussions to find areas for future cooperation. From the Chinese side, part of the motivation is the current slow to negative growth in China. These problems are likely the tip of the iceberg. Beijing has propped up residential construction companies and the financial institutions holding their debt, but that is not sustainable. Major economic downturns and sustained economic malaise are usually a function of this duplex of housing and finance. Beijing's efforts only postpone what history tells us is the likely outcome. For Western firms, China's policies provide time to divest from the once promising residential construction sector in the Middle Kingdom. For China, look for a lengthy period of restructuring before there is any significant growth. Major economic events bring with them the risk of escalating foreign adventures which highlights the importance of the current policies of de-risking on the part of the U.S. and China.