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One of the striking effects of the Covid 19 pandemic has been the dramatic increase in the disconnection between finance and the real economy in the United States and Europe. In China there is a similarly growing disjuncture between house prices and economic fundamentals. Both cases show a process of asset inflation driven by a frenzy of investment in a context of deflationary pressure. But the comparison ends there, because the dynamics of real estate investment in China respond to the logic of a *sui generis*[1] capitalist regime that has placed the extraction of land value at the heart of its economic model.

Far from being the result of a defined project, the institutional construction of land and property markets has been forged empirically during the period of economic transition. However, it received a major impetus in the mid-1990s, when the state secured property rights and granted strong autonomy to local governments while re-centering tax revenues. The result was a widening gap between municipal expenditure and revenues (Figure 1), which local governments sought to close by commodifying public land through the use of their power to sell land use rights[2]. During the period of intense manufacturing production that made China the "world's factory", low-cost land use rights were granted in the urban periphery to manufacturing firms (initially foreign, then also domestic) with the aim of increasing employment and fiscal resources. Then, as industrial growth stimulated urbanisation, which generated higher land values, local governments sold land use rights in central and peri-urban areas at high prices to property developers (with little compensation from residents or farmers) for the construction of office and housing projects[3]. Urban infrastructures were financed by dedicated investment platforms (the famous LGFVs, Local Government Financing Vehicles) guaranteed by municipal land reserves, beyond the control of the financial authorities. These extra-budgetary revenues made it possible to cover the cost of urban growth while providing metropolitan areas with quality infrastructure, thus increasing their attractiveness for industrial production. In return, these strategies ensured an upward career for municipal executives (primarily mayors and party secretaries), under a system of executive promotion based on the ability to generate economic growth.

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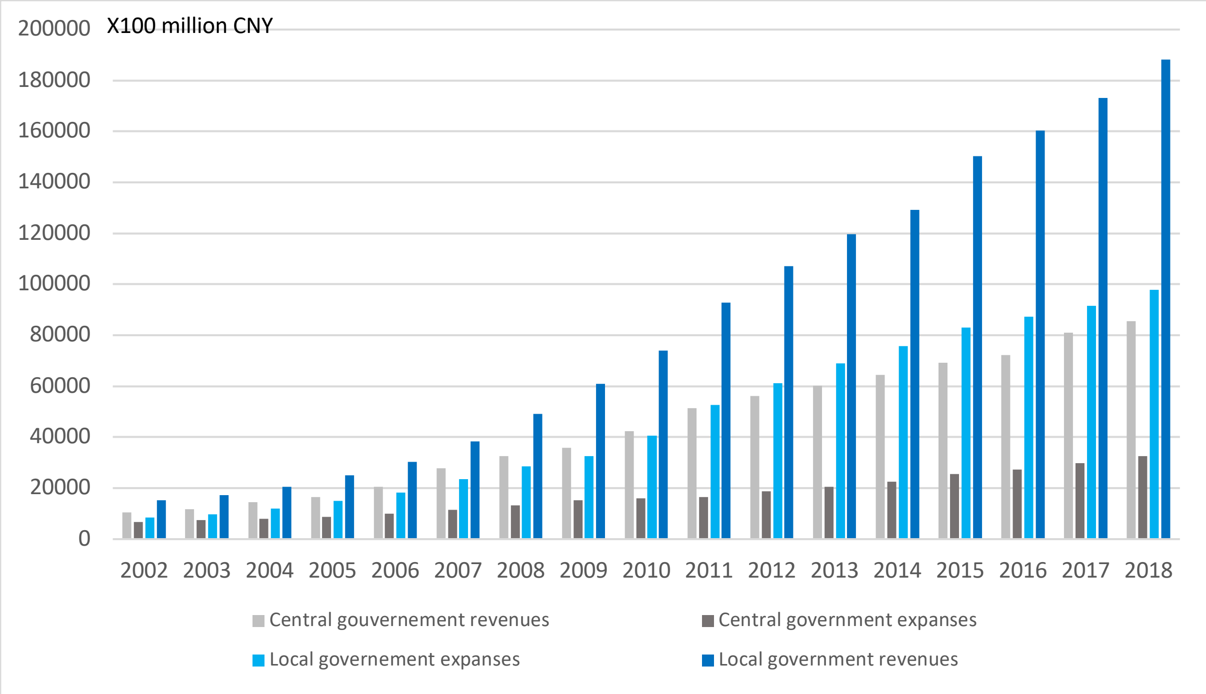
[1] Robert Boyer (2017), « The Political Fragility of the Current Regime in China » ; https://journals.openedition.org/regulation/12329. See also Michel Aglietta et Guo Bai (2013), *China's Development: Capitalism and Empire*, Routledge, London and New York.

[2] These rights of use vary in duration depending on land use: 40- 50 years for commercial and industrial uses, 70 years for residential uses.

[3] As decribed bu Fulong Wu (2015), *Planning for Growth: Urban and regional planning in China*. New York, NY, Routledge.

Figure 1. The growing budget deficit of local governments in China



Source : Natacha Aveline-Dubach, based on the China Statistic Yearbooks

Financing urbanization through households' real estate investments

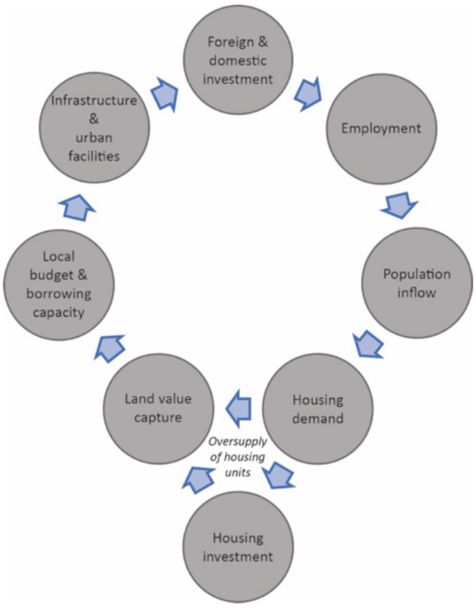
However, for this virtuous circle to work, it was imperative that property developers successfully market their real estate operations downstream of the financing circuit. It was then mainly households that fed the 'land loop' (figure 2). Everything possible was done to encourage them to invest massively in the residential markets: dissemination of the property ideology as the basis of values centered on the family, development of financial circuits dedicated to home ownership, strong restrictions on financial investment. Several developers even started to sell commercial or hotel space to households on the basis of guaranteed income[4]. The adoption of an ambitious 4 trillion-yuan recovery plan after the 2008 crisis only accelerated this process by supplying conventional or informal real estate credit channels via investment platforms. Households therefore massively invested their savings in real estate, starting with housing markets whose extraordinary performance contributed to the self-validation of their speculative anticipations.

Then came the time when this situation became very cumbersome for the Chinese authorities. In the mid-2010's, housing prices became totally unaffordable for first-time buyers in most major cities, while the suburbs were surrounded by "ghost" neighbourhoods of vacant high-rise buildings owned by multiple-owner households. The increase in housing oversupply has reached such proportions that the state has dispensed with any official assessment. The latest estimate, which dates back to 2013 and is very likely to be underestimated, shows 52 million empty flats, or 22% of the residential area in urban China (Figure 3). While most of this stock

[4] Theurillat, T., Lenzer, J. and H. Zhan (2018), 'The increasing financialization of China's urbanization', *Issues and Studies* , 52 (4). http://www.fingeo.net/wordpress/wp-content/uploads/2017/07/WP6_Theurillat-et-al_FinancializationChina.pdf

is held by households as pure savings, developer inventories have multiplied in small and medium-sized cities affected by deindustrialization where the success story of the metropolises could not be replicated[5].

Figure 2. The mechanism of land value capture to finance urbanization



Source : Aveline-Dubach, 2020 (inspired by Fulong Wu, 2015)

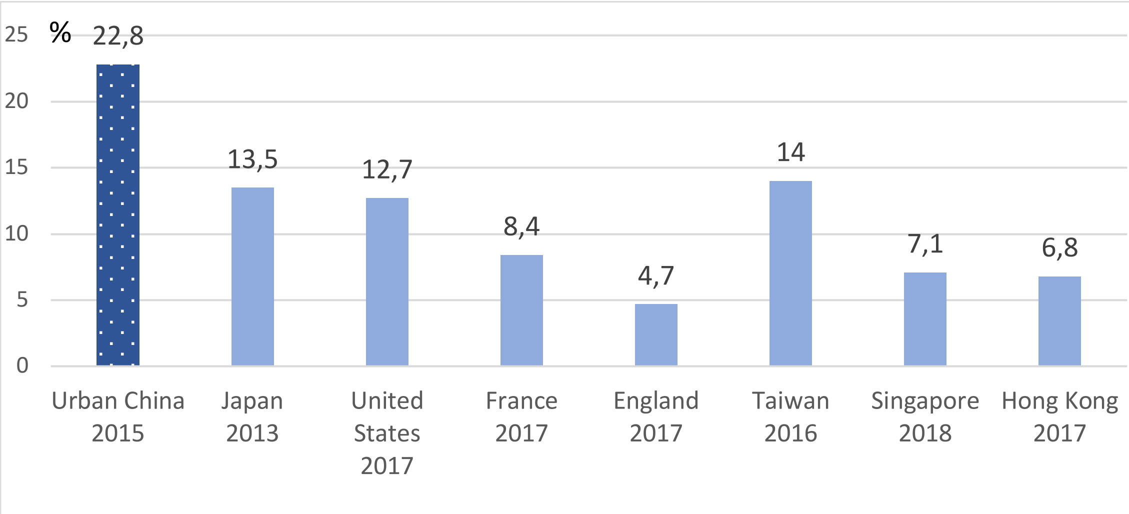
In the United States or in Europe, overproduction on such a scale, combined with a proliferation of private debt, would certainly have led to a fall in housing prices. In fact, the Western media alerted public opinion to the imminent deflation of the Chinese real estate bubble in the early 2010. However, quite the opposite happened during the following decade. Not only did house prices not fall, but they continued to rise, with an acceleration in the largest metropolises such as Shenzhen, Beijing and Shanghai (Figure 4).

Commercial real estate hit by the pandemic

While the lockdown froze flat sales for a few months, transactions gradually resumed without any negative effect on prices. However, the health crisis has had a serious impact on commercial property, where overcapacity was also evident at the end of 2019. According to converging estimates from the real estate industry, one fifth of A-grade office space is currently unoccupied in Shanghai and Shenzhen, and one third in deca-million cities such as Tianjin and Chongqing. There is no information on the occupancy rate of the less prestigious office buildings in suburban districts, but it can be assumed that it has deteriorated sharply.

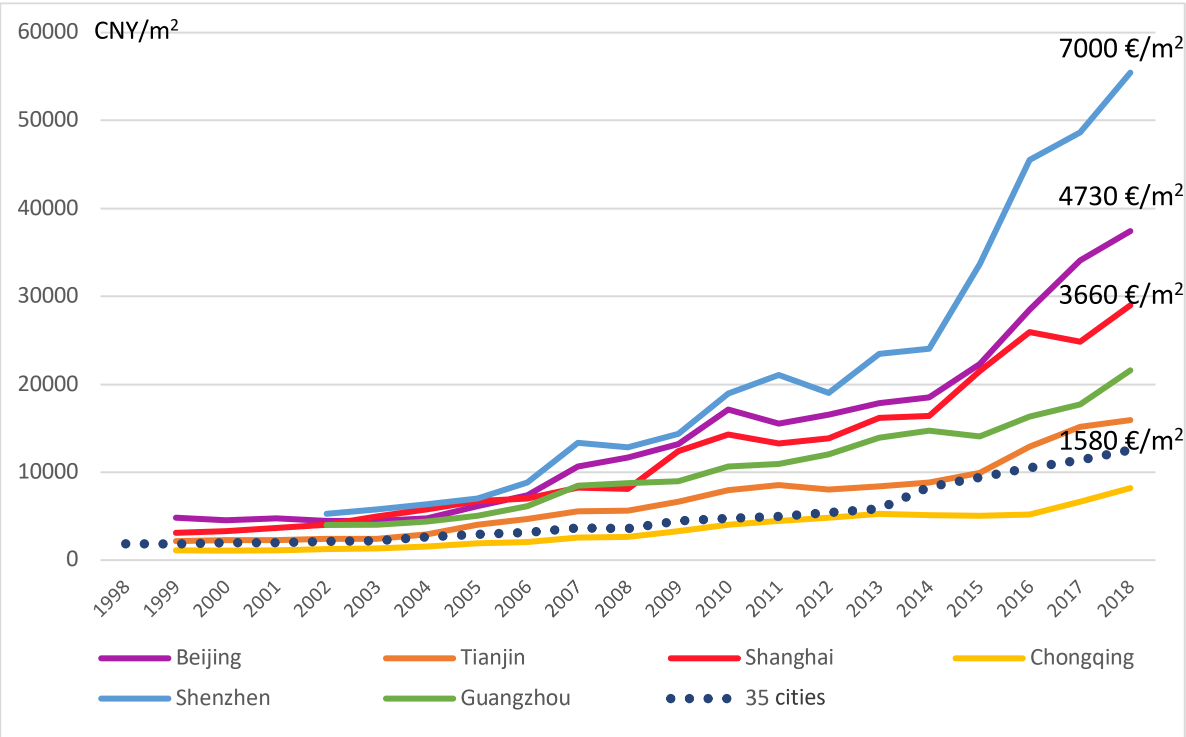
[5] Mingye Li (2017), Evolution of Chinese Ghost CitiesOpportunity for a Paradigm Shift? The Case of Changzhou, *China Perspectives*; 1, 69-78. https://journals.openedition.org/chinaperspectives/7209.

Figure 3. Residential vacancy in several cities (in percentage of the total housing stock)



Source : Natacha Aveline-Dubach, 2020

Figure 4. Change in the average price of new flats in Chinese megacities



Source: Natacha Aveline-Dubach, based on the China Statistic Yearbooks

The effects of the health crisis have been, as elsewhere, even more severe in the retail and hotel sectors. The markets have taken note of these evolutions by lowering rents, and the real estate industry is organising itself to manage the surplus surface area by adapting it to post-covid practices: conversion of offices into spaces for flexible use, transformation of commercial surfaces into logistics spaces and repositioning of tourist real estate towards services for senior citizens. The central government has made it clear that it will not come to the rescue of the real estate industry, but the local authorities are assisting developers with policies to support the so-called "first shop" economy (*shoudianjin*) aimed at replenishing shopping malls with new brands unknown in China[6]. Foreign investment, which had been virtually eliminated from the real estate market since 2008, is even being used to organise the debt reduction of Chinese companies through the sales of property assets[7].

State efforts to curb the rise in residential prices

In the face of the turbulence that is shaking commercial real estate, the resilience of residential markets comes as a surprise. In Shenzhen and Beijing, prices have surpassed those in Hong Kong, averaging between 12,000 and 14,000 euros per square meter in the central districts, more than 40 times the local annual income[8]. The media are returning to the speculative bubble hypothesis, which has been put on the back burner in recent years. However, the central government has not spared its efforts to contain real estate inflation and absorb residential vacancies. It has tried to direct the flow of internal migrants towards smaller cities by delivering massively urban hukou - without much success - while real estate acquisitions in the largest cities have been limited to the holders of the local hukou[9]. Credit conditions have also been tightened: in hot markets, the amount of the initial deposit required per family has been increased to 50-70% for the purchase of a second home and to 100% for a third (in cities where such transactions are allowed), compared to 30% for a first purchase. Households quickly found the solution: divorce to benefit a second time from the conditions of the first purchase or raise funds on crowdfunding platforms to reach the required down payment amount[10].

Private developers have been also targeted by state regulatory measures. They have been asked to redeploy their activity outside the Chinese residential market, at the risk otherwise of seeing their access to land dry up. The major property developers had already begun to expand their residential production activities abroad, offering their Chinese clients new investment opportunities in the United States, Canada and Australia, whose destabilising impacts on local markets had been in the news. But the offshoring of Chinese residential production is now taking a more spectacular turn in Southeast Asia, with the production of vast closed enclaves for Chinese residents, real pieces of largely vacant cities along the "Silk

[6] https://www.shangyexinzhi.com/article/2122354.html

[7] This is especially true for Western funds, with Hong Kong and Singaporean operators being strongly favoured by their networks on the Chinese continent. See N. Aveline-Dubach (2020) « The Financialization of Real Estate in Megacities and its Variegated Trajectories in East Asia", In André Sorensen and Danielle Labbé (dir.), *Handbook of Megacities and Megacity Regions*, Edward Elgar, 394-409. https://halshs.archives-ouvertes.fr/halshs-02517518/document.

[8] Numbeo database, https://www.numbeo.com/property-investment/in/Beijin

[9] The *hukou* is a system for registering Chinese citizens according to their place of origin. Citizens of rural origin who live and work in the cities do not have access to the social benefits of urban *hukou* holders (education, housing, health, pension...). However, the situation is changing with the introduction of a points-based *hukou* system. See Cinzia Losavio (2018), "Building wealth through a stratified inclusion: the point-based *hukou* system in Zhuhai". In: Aveline-Dubach, N. (ed.) Pathways of Sustainable Development Across China - The Cases of Hangzhou, Datong and Zhuhai, pp. 109-121. Venice Imago Editor, Venice. https://halshs.archives-ouvertes.fr/halshs-02873431/document

[10] https://journals.openedition.org/cybergeo/27655

Road" corridor (Belt and Road Initiative project)[11]. In addition, awareness of China's ageing population has also enabled developers to obtain land to produce large residential developments for independent senior citizens and then market these homes to investors of all ages.

One way to curb the expansion of vacancies, or even reduce some of them, would be to develop private rental housing. This sector is highly devalued and poorly regulated in a homeowner society (about 84% of the urban population) where home ownership, the cornerstone of social welfare and a symbol of wealth, is affirmed even in marital practices[12]. The State has made it a priority to build up quality private rental housing in the big cities. Several large private developers have engaged in this sector with the aim of obtaining land for their other projects, but this activity is not compatible with the short-term nature of their financial resources — bank credit being restricted — and proves to be very unprofitable, with only 6% margin compared to 25% for housing sales in 2019[13]. It is therefore unlikely that this sector will see significant development in the current conditions of residential production.

The contradictory objectives of local policies

It must be said that local governments do not show a great appetite for change in their housing policy. Caught between the State's injunctions to curb the speculative mechanism and the need to finance productivist policies to ensure career advancement, they are struggling to break out of their addiction to land income. However, piecemeal rent capture through real estate projects is becoming more difficult to implement because of major changes at two major levels of the land loop : on the one hand, the increasing competence of the expropriated populations in the negotiation of compensation has considerably increased the cost of land resources, and on the other hand, the transformation of the productive system (development of highly innovative technologies and services, robotisation of factories and relocation of the manufacturing apparatus to South-East Asia) weakens the dynamics of urban growth, especially in the already overpopulated megacities.

In order to finance their economic and social policies, local governments have been allowed since 2015 to borrow on the bond markets. However, government-imposed bond quotas do not allow them to bridge the huge gap between their financing needs and their sources of income. As a result, they continue to use informal investment vehicles (LGFVs) for their infrastructure projects, even though the central government wants to put an end to this dangerous proliferation of "grey finance", which was estimated at between US$4,500 and 6,000 billion in 2018[14]. Municipal budgets could be supplemented by a more regular drain on wealth through property taxes, but local governments fear that the introduction of such a fiscal tool – a constantly-recurring issue- could lead to a fall in housing prices, and consequently a drop in the amount of land revenues[15]. The widespread adoption of a property

[11] Adèle Esposito Andujar (2020) «Figures d'un urbanisme aspirationnel. Les villes secondaires d'Asie du Sud-Est à l'heure de la Belt and Road Iniative», *Urbanités*, https://www.revue-urbanites.fr/usea-esposito/

[12] Buying a home is generally considered a prerequisite for marriage for young men. New homes are preferred to mark the transition to a new life.

[13] https://asia.nikkei.com/Business/Business-trends/China-s-Vanke-pilots-build-to-lease-Beijing-housing-project.

[14] https://www.letemps.ch/economie/dette-gouvernements-locaux-chine-une-bombe-retardement

[15] www.lincolninst.edu/publications/articles/chinas-property-tax-reform

tax would also be very unpopular in a society of homeowners, many of whom are heavily indebted and would not welcome the inequalities in wealth that a land registry could reveal.

As nothing can curb the inflationary dynamics of residential real estate, the State has called on local governments to develop an affordable homeownership offer. In the absence of any state financial support, the implementation of such housing projects is entrusted to property developers (private or public) on land that local governments are forced to concede at low cost. Unsurprisingly, this residential production remains very insufficient in view of the huge needs for affordable housing. Moreover, it only targets the holders of the local *hukou*, leaving aside the large mass of internal migrants who make up the bulk of the demand for low-cost housing. As a result, informal ownership rights known as "small property" (*xiaochanquan*) have developed, allowing "floating populations" to accumulate capital in urban real estate. In order to buy social peace, the authorities turn a blind eye to these spontaneous initiatives which have so far concerned some 250 million internal migrants (71 million households)[16]. No one knows how these rights will evolve, but the scale of the phenomenon is such that the State will probably not be able to continue to ignore them for long.

Increased polarization of real estate investments in major city-regions due to the pandemic

It is in this already largely problematic context that the Covid 19 pandemic occurred. The drop in sales during the lockdown period was only a brief episode in the residential markets, but it led to profound changes in the real estate industry. Small private developers, generally excluded from bank credit, did not survive the shock of the sales freeze. A concentration of the industry has therefore begun, with nationwide private developers managing to refinance their debt on the bond markets thanks to lower interest rates, and public developers (State-Owned Enterprises) being much better protected from the risk of bankruptcy due to their privileged links with the major public banks[17].

On the household side, the demand for investment in residential property in the largest city-regions is continuing, and even exacerbating. Investment flows tend to focus on first and second rank cities due to lower investment risk in vibrant economies and large residential markets. As in other countries, household investment in residential markets is driven by uncertainties about economic and financial developments. In the case of China, it is exacerbated by the need to build up precautionary savings to meet, *inter alia*, the costs of health, education, pensions and elderly care in a rapidly ageing society with residual social protection. This is all the more so as alternative investment vehicles are very poorly developed. But what is most peculiar to China is the near-absolute confidence that homeowner households have in the government's ability to effectively steer residential markets[18]. There

[16] These transactions take place in "urban villages", former agricultural enclaves caught up by urbanisation where land ownership is not under the control of the local government but of a collective of villagers. The latter circumvent the rules of land allocation by illegally selling flats to internal migrants at values 40-60% below the local market. See the entry "Xiaochanquan (China)" by Cinzia Losavio in the online encyclopedia "Global informality project", https://www.informality.com/wiki/index.php?title=Xiaochanquan_(China).
[17] On the conditions for financing Chinese property developers, see Theurillat T. (2014), "The financing of urban production in China", working document, http://www2.unine.ch/socio/page-24681.html-24681.html
[18] Natacha Aveline-Dubach, "China's housing booms: a challenge to bubble theory", in Denise Pumain (dir., 2020) *Theories and Models of Urbanization: Geography, Economics and Computing Sciences*, Springer, Cham, 183-208. https://link.springer.com/chapter/10.1007/978-3-030-36656-8_11

are several reasons for this : firstly, the very recent experience of a residential market that is only thirty years old and has not undergone any major turnaround to date[19]; secondly, the close attention that the government pays to the evolution of property prices, knowing that a significant devaluation of this enormous savings reserve would be likely to seriously undermine the legitimacy of the current political regime; finally, the remarkable efficiency of the agile regulation of the markets by President Xi Jinping, a leader whose stability of power is assured for a long period of time. Such agility is permitted by the authoritarian nature of a regime in which the entire administration system is under the control of the Party. The state at its various levels can intervene "just in time" in the entire real estate value chain through its control of land resources and the banking system. The refusal to connect real estate and popular savings to global financial circuits, as demanded everywhere by Wall Street, has so far preserved the effectiveness of the Chinese party-state's levers of action, perhaps in return protecting the world economy from a major systemic crisis such as the GFC[20]. This is not without significant costs and risks: a huge waste of material resources embedded in deteriorating built-up areas — and contributing to the degradation of urban landscapes — an acute shortage of affordable housing in major cities, the proliferation of informal debts and property rights, and above all the risk that investors' shared belief in the government's regulatory capacity will be undermined. To alleviate the pressure on precautionary savings, it would be necessary to develop a social protection system that covers the needs of the population and puts an end to the blatant inequality between rural and urban hukou holders. The government seems to be moving in this direction, but this long process should not prevent for the time being the continuation of capital accumulation, formal or informal, in residential real estate in the largest cities.

[19] Some small towns experienced the bursting of a speculative bubble, but the authorities tried to stifle the information. This was notably the case of Wenzhou, a "small town" of 3 million inhabitants which experienced a serious real estate crisis in 2011. See Yufeng Chen, Ye Zhipeng, and Huang Guan (2018), "The Financial Crisis in Wenzhou: An Unanticipated Consequence of China's 'Four Trillion Yuan Economic Stimulus Package'". *China: An International Journal* 16 (1): 152-173.

[20] Natacha Aveline-Dubach (2020) « The Financialization of Real Estate in Megacities and its Variegated Trajectories in East Asia", In André Sorensen and Danielle Labbé (dir.), *Handbook of Megacities and Megacity Regions*, Edward Elgar, 394-409. https://halshs.archives-ouvertes.fr/halshs-02517518/document.