Proceedings of the 3rd International Conference on Financial Technology and Business Analysis
DOI: 10.54254/2754-1169/136/2024.18850

Real Estate Bubble and Financial Risk: Challenges and Countermeasures in China

Yutong Yang[1,a,*]

[1]Hangzhou No.4 High School International School, Hangzhou,Zhejiang, 310000, China
a. yytmilly@163.com
**corresponding author*

Abstract: As an important pillar industry of the national economy, the development of real estate is closely linked to the financial system. In recent years, the volatility of the real estate market has attracted widespread attention, and the impact of the real estate bubble on the financial market has become an important research topic. A series of negative impacts due to the bursting of the real estate bubble in 2008 was also one of the factors that led to the global financial crisis. The formation of a real estate bubble can lead to an increase in financial risk. Factors such as loose monetary policy, limited investment channels, population growth and urbanization, as well as speculation can trigger a real estate bubble, and the bursting of a real estate bubble can lead to increased credit risk, rising financial system risk, and negative impacts on economic growth and social stability. The purpose of this paper is to conduct an in-depth study of the risks that real estate bubbles pose to China's financial market and to assess China's existing preventive strategies. By analyzing the relationship between real estate bubbles and financial risks, it provides decision-making references for the government, financial institutions and investors, in order to promote the healthy development of the real estate market and the stability of the financial system.

Keywords: Real estate bubble, Financial risk, Strategic Assessment.

1. Introduction

The correlation between real estate bubbles and financial risk has garnered significant interest from scholars and policymakers alike. Current research has clarified the typical characteristics and formation causes of real estate bubbles, and there has been a more extensive discussion of the potential threat of real estate bubbles to financial stability. Although existing studies have explored various aspects of real estate bubbles, there are still research gaps on some specific issues. For example, how to more accurately assess the potential risks posed by real estate bubbles and develop more effective prevention strategies to deal with real estate bubbles and financial risks. This research will systematically examine the impact of real estate bubbles on financial risks, evaluate the current policies in China aimed at mitigating the formation of real estate bubbles, and assess their effectiveness. The methodology will predominantly involve a comprehensive literature review and detailed case study analysis. By reviewing the relevant literature, we understand the current status of the relevant theories and research on real estate bubbles and financial risks to provide a theoretical basis for the analysis of the article. It also provides a reference for the government and financial

DOI: 10.54254/2754-1169/136/2024.18850

institutions to formulate relevant policies and decisions. Suggestions are made for the possible problems of policies in the study.

2. Real estate Bubble

2.1. Definitions and Connotation

A real estate bubble refers to a situation where property prices escalate without correlation to their intrinsic value, resulting in an illusory surge within the real estate market. [1] This false price boom is difficult to maintain in the long run and will eventually burst like a bubble. Charles P. Kindleberger in the New Palgrave Dictionary of Economics on the definition of "bubble" also applies to the real estate field, namely, the bubble refers to a continuous process of assets or asset prices rising dramatically phenomenon. A real estate bubble is the unrealistic prosperity of the price far beyond the intrinsic value of the scene, the excessive purchase of real estate by investors and speculation and other behaviors to push up the price of real estate, so that it is beyond the market supply and demand and economic fundamentals can bear.

2.2. Typical Characteristics

First, real estate bubbles are characterized by rapidly rising prices. From the perspective of historical real estate bubble events, such as Japan in 1986 - 1990 real estate spawned a large bubble during the period, and there was a rapid rise in housing prices. Some of the first-tier cities in China have also seen their prices rise several times in the past few years. Secondly, speculative behavior is an important feature of the real estate bubble. Investors speculate excessively, buy short and sell short, and take advantage of the time difference between the sharp rise in housing prices to make profits. For example, some speculators have pushed up prices by hoarding large quantities of houses, leading the property market into a state of virtual heat. Furthermore, real estate bubbles are often accompanied by rapid growth in the size of loans. Financial institutions, particularly banks, have significantly contributed to the real estate market by offering a substantial volume of loans under a loose monetary policy framework, thereby amplifying the money supply and driving up housing prices. For instance, in the United States, the real estate bubble spanning from 2001 to 2007, followed by the subprime mortgage crisis in 2008, saw a rapid expansion of shadow banking, which injected considerable capital into the real estate sector.

2.3. The Reason of Real Estate Bubble Happened

The occurrence of real estate bubbles is usually associated with a number of factors. One is a loose monetary policy. Low interest rates and easy credit conditions increase the supply of money in the market and lower the cost of home ownership, thereby stimulating demand for real estate. For example, in Japan, after the signing of the "Plaza Accord", banks lowered interest rates for five consecutive times and the real estate bubble expanded rapidly under the stimulus of low interest rates and excess liquidity. Secondly, investment channels are limited. When other investment channels have lower yields or higher risks, investors tend to put money into the real estate market, pushing up prices. Third, population growth and urbanization. Population growth and urbanization increase the demand for housing, especially in big cities, leading to higher prices. Fourth is speculation. Some investors use leverage to engage in speculation, which further pushes up housing prices and creates a bubble.

DOI: 10.54254/2754-1169/136/2024.18850

3. Relationship between Real Estate Bubbles and Financial Risks

3.1. Financial Risks Arising from Real Estate Bubbles

3.1.1. Increased Credit Risk

During the real estate bubble, house prices continued to rise, and the market generally expected them to continue to climb in the future. This optimism prompted banks and other financial institutions to relax their lending conditions, and a large amount of money poured into the real estate market. Nonetheless, when the market bubble collapsed, property values significantly declined, leading to a drastic reduction in collateral worth, which in turn caused borrowers to default on their loans. This situation resulted in a considerable increase in the bank's non-performing loan ratio and a substantial escalation in credit risk.[2]

3.1.2. Deterioration of Financial Institutions' Balance Sheets

Investments by financial institutions in the property market are not limited to direct lending but also include holdings of assets such as property-related securities. When the property bubble bursts, the value of these assets will drop significantly, leading to a deterioration in the balance sheets of financial institutions, a decline in capital adequacy ratios, and possibly even triggering the bankruptcy and closure of financial institutions.[3]

3.1.3. Financial Market Turbulence

Fluctuations in the property market will be transmitted to the financial market through various channels. On the one hand, the share prices of real estate companies will be directly affected, leading to stock market turbulence; on the other hand, changes in the real estate market will also affect investor confidence and expectations, which in turn will lead to fluctuations in the financial market as a whole.

3.1.4. Monetary Policy Failure

During the period of the property bubble, in order to curb the excessive rise in property prices, central banks may adopt tight monetary policies, such as raising interest rates and reducing money supply. However, these measures may have negative impacts on the real economy, such as slower economic growth and higher unemployment. Furthermore, implementing an excessively accommodative monetary policy to invigorate the economy post-bubble collapse could precipitate challenges like inflation, thereby placing monetary policy in a quandary..[4]

3.2. Analysing the Potential Threat to Financial Stability from a Property Bubble Economy

3.2.1. Increased Vulnerability of the Financial System

The formation of a real estate bubble is often accompanied by excessive credit expansion and a rise in the risk appetite of financial institutions. When the bubble bursts, financial institutions face huge asset impairment losses, leading to a decline in capital adequacy or even a liquidity crisis. Under such circumstances, the vulnerability of the financial system increases significantly, easily triggering systemic financial risks. Systemic financial risks are often generated by a combination of risk factors, including credit risk, market risk, liquidity risk and operational risk. These risk factors are intertwined and interact with each other, making risk identification and assessment more difficult. For example, the bursting of the real estate bubble may trigger credit risk, leading to an increase in non-performing loans by banks. Systemic financial risks, if they erupt, may cause serious damage to the financial system. Financial institutions may face a wave of closures, financial markets may be thrown into chaos, and financial functions may be severely impaired. For example, the 2008 global financial crisis was a concentrated outbreak of systemic financial risks, leading to the bankruptcy of a number of large financial institutions around the world, significant turmoil in financial markets and a huge impact on the world economy. Systemic financial risks may not only cause short-term damage to the financial system, but may also have long-term impacts on the real economy. Economic growth may be severely curtailed, unemployment may rise sharply, and social wealth may suffer huge losses. This long-term impact makes systemic financial risk a major threat to the stable development of the economy and society.

3.2.2. Cross-market Risk Contagion

There is a strong link between the property market and the financial market. The collapse of a real estate bubble will not solely impact the real estate sector; it will also permeate other financial markets, including equities and fixed income, via multiple transmission mechanisms. This inter-market risk contagion could trigger volatility and jeopardize the stability of the overall financial system.. [5]

3.2.3. Increased Macroeconomic Volatility

The real estate sector occupies an important position in the national economy, and its fluctuations can have a significant impact on the macroeconomy. The formation and bursting of real estate bubbles can lead to abnormal fluctuations in the economic cycle and increase macroeconomic uncertainty. Moreover, real estate bubbles can also instigate issues like resource allocation inefficiencies and surplus capacity, thereby exacerbating macroeconomic volatility.[6]

3.3. Assessing the Impact of a Bursting Property Bubble on the Financial System.

3.3.1. Banking was Hit Hard

During the period of the property bubble, banks issued large amounts of real estate loans and became involved in the real estate market through various financial innovation tools. When the bubble bursts, banks will face a large number of non-performing loans and the risk of default. This situation is likely to precipitate a notable reduction in banks' profitability, while simultaneously heightening the potential for bank runs, insolvency, and overall systemic failure..[7]

3.3.2. Financial Innovation is Hampered

During the property bubble, financial institutions launched various financial innovation products related to the property market in pursuit of high returns. However, when the bubble burst, the risks of these products were exposed, investor confidence was undermined and the process of financial innovation may have been hampered as a result.

3.3.3. Challenges to Financial Regulation

The formation and bursting of the property bubble have exposed the inadequacies and loopholes in financial regulation. Regulators need to strengthen the supervision of the financial market, improve the regulatory system, and enhance the efficiency of supervision. Nonetheless, in real-world application, the field of financial regulation encounters numerous obstacles, including constrained regulatory resources and inadequate regulatory instruments.[8]

3.3.4. International Financial Risk Transmission

In the context of globalisation, the bursting of the property bubble may also trigger the transmission of international financial risks. While domestic financial institutions may incur losses from their international investments, international investors may simultaneously retract or diminish their investments due to apprehensions surrounding their own economic situations, thereby intensifying the instability within the domestic financial markets.[9]

4. Financial Risk Prevention Strategies for the Property Bubble Economy

4.1. China's Policy to Prevent Property Bubbles

4.1.1. Implementation of the Policy of Restricting Purchases and Loans

Home purchase leverage can be effectively reduced through the implementation of a series of stringent regulatory policies, such as measures to restrict the number of home purchases and increase the down payment ratio. These policies aim to curb investment and speculative home purchase demand, thereby stabilising the property market. Specifically, restricting the number of home purchases can prevent over-investment by home buyers and avoid overheating in the market. Raising the down payment ratio. Conversely, it exacerbates the economic burden on prospective homeowners, prompting them to evaluate their residential acquisition choices with greater prudence.

As a result, those who purchase properties purely for investment or speculation will be curbed, and the property market will develop in a healthier and more stable manner.

4.1.2. Strengthening Land Supply Management

In order to effectively curb the excessive rise in property prices, the Government should take active measures to reasonably increase the supply of land. First, it can ensure an adequate supply of residential land by optimising land use planning and rationalising the allocation of land resources. Secondly, it should streamline the land approval process, shorten the land development cycle, and speed up the listing of land, thereby increasing the supply of land in the market in the short term. In addition, the government can also reduce the land costs of developers by adjusting the land premiums and related tax policies so as to reduce the portion of such costs that are passed on in property prices. Through these measures, excessive increases in property prices can be curbed at source, leading to a healthier and more stable development of the property market. Simultaneously, augmenting land availability can facilitate the strategic arrangement and enhancement of urban spatial configuration, elevate the effectiveness of land utilization, and furnish robust backing for sustainable urban advancement..[10]

4.1.3. Promoting Property Tax Reform

Through the levy of property tax and other means, the cost of holding property will be raised for residents, thus guiding them to purchase properties more rationally and use housing resources in a reasonable manner. Specifically, the levy of property tax can effectively curb speculative property purchases and reduce the risk of a property market bubble. At the same time, by increasing the cost of holding, residents will be more cautious in purchasing properties, taking into account their actual needs and affordability, thus avoiding blindly following the trend and over-indebtedness. In addition, the rational use of housing resources also means reducing vacancy and wastage and promoting the healthy development of the property market. In this way, the Government can better regulate the property market and ensure the rational allocation and effective use of housing resources.

4.2. Evaluating the Effectiveness of China's Preventive Strategies Against Property Bubbles.

4.2.1. The Policy of Restricting Purchases and Loans has been Effective

The policy aimed at limiting purchases and loans has significantly and positively contributed to moderating the demand for both investment and speculative property acquisitions. This, in turn, has effectively mitigated the rapid escalation of property prices and helped prevent the occurrence of an overheated market. [11] Through this policy instrument, the government has been able to effectively regulate the property market and prevent the excessive influx of capital into the property market, thus avoiding the creation of bubbles. This kind of policy may also cause some suppression of rigid demand, especially for those ordinary families who really need to buy a home for self-occupation. They may face problems such as a higher threshold for home purchase and greater difficulty in securing loans. This not only increases their financial burden, but may also hinder the healthy development of the property market to a certain extent. Therefore, while implementing the policy of restricting purchases and loans, the Government also needs to take into account market demand and adopt corresponding complementary measures to ensure that the policy can effectively curb investment and speculative demand while meeting rigid demand, so as to promote the long-term stability and healthy development of the property market.

4.2.2. Land Supply Management still Needs to be Improved

Although the government has taken a series of measures to increase land supply with the aim of lowering the cost of land in order to ease the pressure on the property market, it still faces a number of challenges and problems in practice. For example, in Beijing, the government launched a "multi-planning" policy in 2018 to increase the supply of residential land, but property prices remain high. This is mainly due to the fact that most of the new land is located in the periphery of the city, while the supply of land in the city centre is still tight, resulting in the pressure on house prices to rise, which has not been effectively mitigated.

Another example is Shenzhen, where despite the government's increase in land supply for two consecutive years in 2019 and 2020, the irrational structure of land supply, with a high proportion of commercial and industrial land and relatively little residential land, has led to an oversupply of residential land and a continued rise in property prices.

Irrationality in the structure of land supply may also lead to a series of problems, such as waste of resources and market imbalance. For example, Shanghai increased its land supply by a large amount in 2017, but the lack of rational planning for different types of land led to some commercial and industrial land being left idle while residential land remained in short supply, which not only wasted land resources but also exacerbated market imbalance.

4.2.3. Financial Regulation Needs to be Strengthened

Although the government has stepped up its efforts to regulate financial institutions, there are still some regulatory loopholes and inadequacies. Specifically, despite a series of measures taken by the Government to strengthen regulation, there are still some financial institutions conducting business in violation of the law, such as the illegal flow of funds into the real estate market and other problems still exist. The existence of these problems not only affects the stability of the financial market, but also poses potential risks to investors. Consequently, it is imperative for the Government to enhance oversight and refine the regulatory framework to ensure adherence by financial institutions, thereby safeguarding the stability and fostering the robust growth of the financial market. [12]

DOI: 10.54254/2754-1169/136/2024.18850

5. Conclusion

This article provides an in-depth discussion of the relationship between real estate market bubbles and financial risks in China, and assesses the existing preventive strategies in China. The article first defines the concept of real estate bubbles and analyzes their typical characteristics and causes of formation. The article then explores the impact of real estate bubbles on financial risks, including the increase in credit risk, the deterioration of financial institutions' balance sheets, the turbulence in financial markets, and the failure of monetary policy. The analysis proceeds to evaluate the prospective risks posed by real estate bubbles to financial stability, encompassing augmented susceptibility of the financial system, intermarket risk transmission, heightened macroeconomic volatility, and risks to societal stability. The article also assesses the effectiveness of the policies that China has adopted to prevent real estate bubbles, such as restricting purchases and loans, strengthening land supply management, advancing property tax reform, and strengthening financial regulation. Finally, the article summarizes the challenges that China faces in dealing with the real estate bubble and proposes policy recommendations accordingly.

References

[1] *Sornette D, Woodard R. Financial bubbles, real estate bubbles, derivative bubbles, and the financial and economic crisis[C]//Econophysics approaches to large-scale business data and financial crisis. Springer Japan, 2010: 101-148.*

[2] *Zhang Jingwei. The commonality of successive financial crises and its enlightenment to China - an analysis from the perspective of real estate bubbles [J]. Hebei Enterprise, 2019(02).*

[3] *Ding Sheng. Real estate bubbles and China [J]. Rural Science Experiment, 2019(09).*

[4] *Meng Qingbin; Rong Chen. Research on China's real estate price bubbles - an empirical analysis based on the Ma domain variation model [J]. Financial Research, 2020(02).*

[5] *Shi Pengke. An analysis of the current situation and countermeasures of domestic real estate bubbles [J]. China Market, 2019(12).*

[6] *Cao Quanwang. Research on China's real estate bubble issues [J]. Economist, 2019(04).*

[7] *Yuan Guangxin. Discussion on the strategy and background of real estate economic development [J]. China Foreign Investment, 2020(09).*

[8] *Huang Ping; Wu Chunyi. Analysis of the current status and trends of China's real estate industry development [J]. Modern Property (Early Edition), 2020(11).*

[9] *Xu Lei. Current situation and suggestions for China's real estate development under the new real estate policy [J]. Modern Business Industry, 2022(03).*

[10] *Zhang Xin. Discussion on real estate economy [J]. Modern Business Industry, 2020(21).*

[11] *Zhi T, Li Z, Jiang Z, et al. Is there a housing bubble in China?[J]. Emerging Markets Review, 2019, 39: 120-132.*

[12] *Zhang Yansheng. The current status and future development trends of China's real estate economy [J]. China Market, 2020(31).*