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# Master's Thesis

Based on institutional, industry, and firm-specific similarities,
is China facing a real estate bubble burst similar to that of Japan in 1990/91?

**A holistic comparative analysis of the Japanese and Chinese real estate sector**

**Authors:**
Patrick Eidenschink (112286)
Kasper Abildgaard (111337)
**Supervisor:** Charles Tackney

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Kasper Abildgaard & Patrick Eidenschink

## Abbreviations

| | |
|---|---|
| **ACFIC** | All-China Federation of Industry and Commerce |
| **ACFTU** | All-China Federation of Trade Unions |
| **ACGA** | Asian Corporate Governance Association |
| **BIM** | Building Information Modelling |
| **CCP** | Chinese Communist Party |
| **CEC** | China Enterprise Confederation |
| **CERF** | Civil Engineering Research Foundation (Japan) |
| **CLRC** | Central Labor Relations Commission (Japan) |
| **CME** | Coordinated Market Economy |
| **EV** | Electric Vehicle |
| **FDI** | Foreign Direct Investment |
| **GDP** | Gross Domestic Product |
| **IFDI** | Inward Foreign Direct Investment |
| **IoT** | Internet of Things |
| **JPC** | Japan Productivity Center |
| **JPY** | Japanese Yen |
| **JTEC** | Japanese Technology Evaluation Center |
| **LDP** | Liberal Democratic Party (Japan) |
| **LME** | Liberal Market Economy |
| **M&A** | Mergers & Acquisitions |
| **MC** | Market Capitalization |
| **MEC** | Mitsubishi Estate Corporation |
| **MITI** | Japanese Ministry of International Trade and Industry |
| **MNE** | Multinational Enterprise |
| **MoC** | Japanese Ministry of Construction |
| **MOE** | Ministry of Education of the People's Republic of China |
| **MoF** | Japanese Ministry of Finance |
| **NGO** | Non-governmental Organization |

| | |
|---|---|
| **NIST** | National Institute of Standards and Technology (US) |
| **NYC** | New York City |
| **OECD** | Organization for Economic Co-Operation and Development |
| **PE** | Private Enterprise |
| **PM** | Prime Minister |
| **PRC** | People's Republic of China |
| **R&D** | Research and Development |
| **RE** | Real Estate |
| **RMB** | Chinese Yuan |
| **SASAC** | State-owned Assets Supervision and Administration Commission |
| **SEZ** | Special Economic Zone (China) |
| **SOE** | State-owned Enterprise |
| **TRL** | Three Red Lines Policy (China) |
| **TSE** | Tokyo Stock Exchange |
| **UK** | United Kingdom |
| **US** | United States |
| **USD** | US Dollar |
| **VoC** | Varieties of Capitalism Framework |
| **WTO** | World Trade Organization |
| **WWII** | World War II |
| **YoY** | Year-on-year |

# Abstract

This Master's thesis explores and elaborates on similarities in the macro and microenvironments of Japan's real estate sector in the period from 1985 to 1991 and China's real estate sector today, as well as the determinants that affect the building and burst of East Asian real estate bubbles and its strategic implications for local developers. A theoretical framework based on Witt & Redding's (2013) extended Varieties of Capitalism model and Porter's (1990) Diamond framework has been utilized to establish that the two countries are comparable despite their inherent political and economic differences, to give an in depth analysis of the developments within the two countries' respective real estate sectors and its strategic implications for two case firms, Mitsubishi Estate in Japan, and Evergrande in China and thus contributes to existing literature which has not yet incorporated a comparative analysis on a holistic level of the real estate sectors of our two countries of interest. The conclusion offers decisive factors that contribute to real estate bubbles and their host countries' economies overall, as well as specific insights into how they affect our case companies' strategies.

**Keywords**: Real Estate, China, Japan, Bubble, Mitsubishi Estate, Evergrande, policy, strategy

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# Introductory Part

## Introduction & research question

In recent years, the image of China's unstoppable economic growth has begun to crumble. Growth figures, even prior to the COVID-19 pandemic that continues to hit China's economy substantially, have begun to shrink, and with China's population having peaked in 2013, its sheer endless supply of low-cost labor that the Chinese miracle was built on is diminishing. Alongside heavy criticism for China's Zero COVID policy in its urban centers, news of real estate giant China Evergrande defaulting raised questions about whether China's seemingly foolproof government-orchestrated attempt to capitalism is as flawless as it once seemed. Just five years ago, newspaper headlines, such as "What to do about China's sharp power?" and "How the world is grappling with China's rising power" as well news services such as ABC devoting entire sections of their online portals to "China's Power" suggested that the Chinese miracle would help the most populated country on earth to take over as the world's number one superpower (The Economist, 2017; BBC, 2018; ABC, 2022).

The tone of voice, partly admiration, partly fear, bears a fascinating resemblance to the one used in Western publications dealing with another Asian giant just over thirty years ago. In fact, if one opened the financial section of newspapers in the last two months of 1989, it would have seemed that the world was just about to enter the Japanese century: "the 1980s will surely be remembered as the beginning of the Japanese century-as the platform for Japanese global power. The 1980s was a rush past the nineties directly into the twenty-first century and will be remembered as the decade of Japanese economic conquest." (Samuels, 1990, p. 43).

Little did the author know that the period that Japan was 'rushing past' would later be called the 'lost decade'. The burst of the Japanese asset bubble in 1990/91 ushered in a period in which Japan's seemingly unstoppable growth not only halted but reversed. However, at the height of the bubble hardly anyone, Japanese or foreign foresaw the bubble burst. Record-low interest rates and a strong yen enabled Japanese firms to go on a literal shopping spree in the West, and while Sony bought Columbia Pictures and Mitsubishi's real estate sub-firm acquired the Rockefeller Group, American newspapers titled "The brisk growth of property sales to firms and individuals has ignited fears that the Japanese will 'buy up America." (Los Angeles Times, 1989) Books such as William Ouchi's Theory Z and Ezra Vogel's Japan as Number One initiated a boom of material on the Japanese way of management and business administration.

Much of the resources that Japanese firms had to purchase and invest in whatever they could get their hands on resulted from the Bank of Japan's low interest rate policy that enabled land speculation which in turn led to hikes in land prices unheard of until then and since. With Japanese land prices rising by sevenfold from 1985 to 1989 alone, real estate developers (RE developers) enjoyed booming profits that would later turn out to be based on nothing but overvalued land, leading not only to the defaulting of a variety of large firms and severe distress in the Japanese economy, the outcomes of which are still felt today, but also to an overthinking of essential Japanese business practice.

Just like the severity of the real situation of the Japanese real estate sector (Hereafter referred to as RE Sector) came to light in the years that followed the burst of the bubble, news of a variety of Chinese developers facing severe financial difficulties, most notably China Evergrande Group, that defaulted on a record debt of USD 300 billion in 2021, have raised questions whether China today finds itself in a similar position to that of Japan in the early 1990s. However, various challenges to comparative analysis between two inherently different countries led scholars to refrain from in-depth analysis of the developments in the RE sector of the two countries so far. With the future of the Chinese real estate market being uncertain, and with the lesson that Japan serves on hand, we propose the following research question:

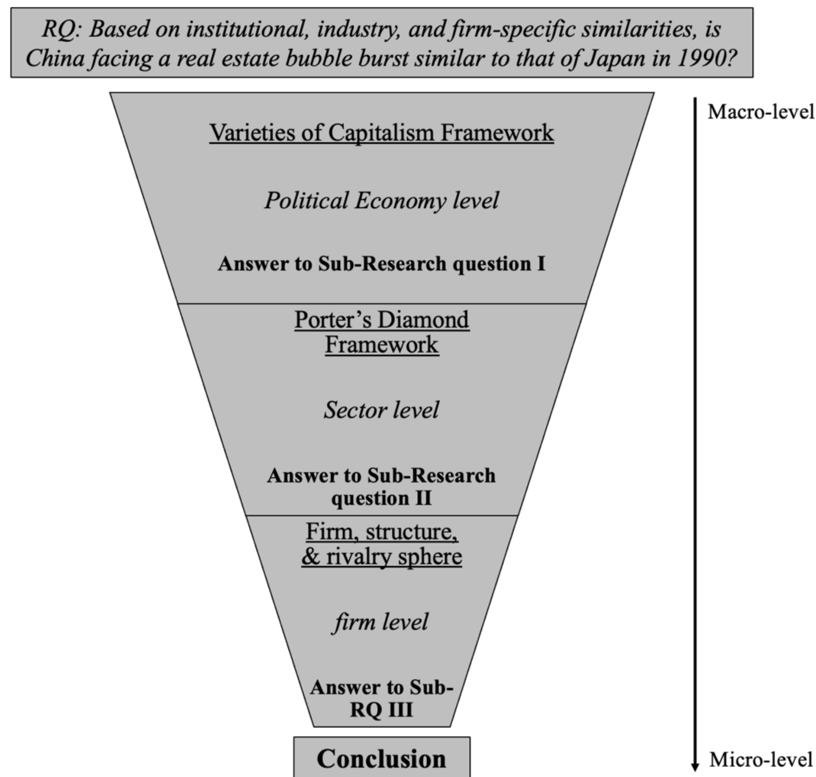
Based on institutional, industry, and firm-specific similarities, is China facing a real estate bubble burst similar to that of Japan in 1991?

## Thesis structure

In order to gain a holistic understanding of the topic that will allow us to answer the research question, our thesis consists of three dimensions, starting on a macro-level analysis of the institutions and the political economy of Japan and China to ensure that a comparative study between these two countries is viable, then we continue with an industry level analysis of the Japanese and Chinese RE sectors. We then offer a micro-level case study of two firms within the RE sectors of Japan and China. Hence, we propose the following sub-research questions:

I. Despite incorporating different political and economic systems, are the institutional environments of Japan and China comparable?
II. What factors determine the development of the RE sectors of China and Japan?
III. What are the strategic implications for firms in the Chinese and Japanese RE sector?

Fig. 1 elaborates on the process and rationale we utilize to answer our research question:




Source: Own Contribution

# Methodology

In this section of the paper, we are going to describe the research design, and the methods we used to collect our data to further analyze and answer our research question. The aspects of this section follow what is included in the 'research onion' as presented by Saunders et al. (2009). We begin the section by introducing our research philosophy, elucidating how we as researchers 'view the world'. After the research philosophy, we describe the research strategy that is being utilized in this thesis, followed by a depiction of our research design, including the purpose of our research as well as strategies and the time horizon. We then introduce our means of data collection, consisting of both primary and secondary data. We end with a description of the construct validity and reliability of our research.

## Philosophy of science

Our underlying philosophical stance is that of critical realism. Realism follows a view that "objects have an existence independent of the human mind" (Saunders et al. 2009, p. 114), and that the reality we experience through our senses has an empirical basis that can be verified. It opposes the idealism perception that the mind and its content only exist, and instead poses that a reality exists independent

of our minds. Critical Realism is an area within epistemology, and it is possible to draw similarities to the positivist belief as it similarly states that knowledge is developed through a scientific approach.

Adapting a critical realism point of view, we argue that “what we experience are sensations, the images of things in the real world, not the things directly” (Saunders et al. 2009, p. 115). It is often that the things we experience can show an adjusted truth and potentially deceive us. Thus, what we experience occurs through our senses, which only function as representations of reality. Besides experiencing things as sensations, critical realism adds a further step on how we process such sensations. As critical realists researching within the area of business and management, and following the argument of Bhaskar (1989), we will only fully be able to understand the social world if we are able to understand the social structures underneath, i.e., that what we research and attempt to understand only exists as part of the bigger picture. Like Bhaskar (1989) and Bernard Lonergan, we argue that the human knowledge of reality is limited and that it is possible that these perceptions change (Walker, 2017). However, this position is open for the possibility of obtaining genuine knowledge or that improved knowledge may be possessed in the future, yet, following Lonergan’s argument, that science, as opposed to common belief, is not the path to absolute certainty (Walker, 2017).

Moreover, we acknowledge that social conditioning affects our knowledge of the world (Saunders et al. 2009). This additionally connects to adaption of an axiology view, in which we acknowledge that we, as researchers may be subject to bias through aspects such as our culture, upbringing, and community, and that these may affect our research. By being aware of a possible bias, we can exercise a critical view about what we see. We additionally argue for the utility of a multi-level analysis, in which we attempt to interpret several levels, individual, group or organizational, thus allowing us to gather different knowledge and understanding (Saunders et al. 2009). Overall, Saunders et al. (2009) states that the purpose of business and management research is more suitable to critical realism, as it recognizes the changes occurring in the world, thus further legitimizing our choice of research philosophy.

## Research strategy

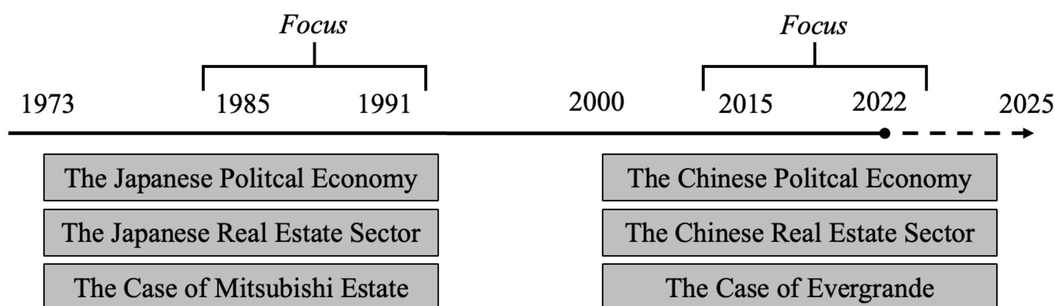
Due to the complexity of the topic and the number of variables involved, we found that a holistic view of the topic was critical. Providing a specific and narrow view of aspects of the topic would not

sufficiently answer the research question posed. Therefore, our inductive reasoning enabled "the purpose here would be to get a feel of what was going on, so as to understand better the nature of the problem" (Saunders et al., 2009, p. 126). Inductive reasoning allows us to gather data to better understand the problem at hand, and develop a theory and conclusion based on an analysis and of said data and its patterns. As or research progressed, deductive assessment in a more focused manner became possible.

## Research design

The research conducted will both be exploratory and explanatory. We aim to gain new insights and investigate the developments ongoing in the Japanese RE sector in the late 1980s and its Chinese counterpart today (Saunders et al., 2009). In this way, it becomes possible to understand the problem at hand more thoroughly. Therefore, we will apply two of three principal ways of conducting exploratory research according to Saunders et al. (2009), which include investigating literature and interviewing experts in the subject. Moreover, the research will also be explanatory to some degree as we aim to establish causal relationships between certain variables within the RE sector as identifiable causes for the burst or deflation of the real estate bubble in the case of both China and Japan.

Fig. 2: Research Timeframe




Source: Own Contribution

Furthermore, considering research strategy, we have become able to conduct case studies because these involve "an empirical investigation of a particular contemporary phenomenon within its real-life context using multiple sources of evidence" (Robson, 2002, p. 178). We conduct case studies on both the Japanese RE developer Mitsubishi Estate, was well as the Chinese RE developer, China Evergrande Group. This step further enables triangulation, as a case study adds to the number of data

collection techniques. Our case studies support the industry analysis because the companies are representative of the industry and are also comparable in scope, size, and influence.

## Data collection & strategy

Since both qualitative data, in the form of five interviews, alongside quantitative data in the form of descriptive statistics from annual reports, articles, and company websites is being utilized, a mixed-methods approach was chosen. A mixed-method approach allows for triangulation of several data sources and collection methods. This mixed-method approach allows for a more comprehensive research and answer to our research question (Saunders et al., 2016). In order to eliminate possible bias, primary and secondary data are utilized, ensuring that the paper provides a holistic understanding of our topic on both a macro and micro level.

### Primary data

Given that secondary data accounts for the majority of our sources in this work, primary data mainly supports our analysis, helping us to gather information that was not available through secondary research. Aside from quantitative figures obtained from official reports of our case companies, primary data is mainly obtained by conducting semi-structured interviews with industry experts as well as one case company representative.

*Interview style.* As we aim to gain insights into our interviewees' professional experience and opinion on their respective industries' developments, as well as our target firms' future strategies, we chose to conduct qualitative semi-structured interviews, supplemented by quantitative secondary data. The semi-structured style allows us to cover the major themes we discovered in the literature while inviting our interviewees to voice their own thoughts and ideas *(Willis, 2014)*. We believe that this flexibility allows us to not only obtain necessary information from our interviewees but also gain an enhanced understanding of their critical thinking process.

*Interviewee selection and outreach.* In-depth knowledge is the key determinant that we are looking for in potential interviewees, which is why we have chosen to reach out to acclaimed industry experts, either through first-hand experiences they obtained while working in or with the Japanese or Chinese RE sectors, or through academic studies in related fields. Furthermore, considering that data from China can be particularly difficult to obtain, we are reaching out to both Chinese nationals as well as foreigners working in the industry to mitigate potential bias in their answers. Moreover, we selected interviewees with different published opinions on the state of the Chinese RE sector and surrounding conditions in China to further reduce bias in our analysis. We contacted the potential interviewees via various online channels such as university portals, LinkedIn as well as through our own professional network. Consequently, we conducted interviews with:

1. *Kenji Sato (Anonymized per request):* Senior executive at Mitsubishi Estate.
2. *Logan Wright:* Partner at Rhodium Group, leading the company's China Markets Research work. He is an adjunct fellow of the trustee chair in Chinese Business and Economics at the Center for Strategic and International Studies. His expertise lies within China's financial system and credit conditions, as well as the policies introduced by China's central bank. In his publications he covered developments in the Chinese RE sector for over a decade.
3. *Ziv Nakajima-Magen:* Partner and executive manager at Nippon Trading International. Represents investors on real estate purchases in Japan.
4. *Allan von Mehren:* Chief analyst and China Economist at Danske Bank. He covers China in relation to global financial markets and conducts research on China's economy and politics.
5. *Jason Hsu:* Chairman and founder of Rayliant Global Advisors, that focuses on asset management in China, mainly for institutional global clients. Additionally, he is a finance professor and member of the board of directors at the UCLA Anderson School of Management. He has further published various articles on the development of the Chinese RE sector.

In sentence, interviewees will be referenced as "Name (2022)", whereas interviewees are referenced in citations as "(Name, Intvw. #, 2022).

*Interview conduct.* Given the fact that most of our interviewees reside in East Asia and that this paper was written during the ongoing COVID-19 pandemic, we conducted interviews online via phone and video calls and by sending written questionnaires. The transcriptions have been included in the appendix; the original video material is available on request.

Secondary data

We tried to ensure reliability of data and validity of results by obtaining data from a diversified list of sources. Both the Japanese RE sector, especially during the asset bubble period, as well as recent developments in the Chinese real estate industry and Evergrande in particular have been covered extensively by scholars and journalists alike. This offers us a wide array of publications to choose from through which we can ensure the reliability of our data. It provided a comprehensive description of the Japanese and Chinese RE sector during our initial research. Sources include:

- Publications about socio-economic developments in Japan and China, institutional conditions, the Japanese and Chinese real estate, and finance sector, as well as the firms in question retrieved from academic periodicals and journals through electronic databases such as EconLit and Business Source Complete.
- Quantitative data, such as statistical and economic figures about the Japanese and Chinese RE sector as well as the two case companies.
- Newspaper articles related to the Chinese and Japanese RE sector and main players, obtained from reputable sources such The Japan Times, Nikkei Shimbun, Bloomberg, and the Wall Street Journal.
- Articles and guides about the validity of Chinese sources on both an industry and firm level.

Our comparative analysis of the Japanese and Chinese political economic development as well as our sector of interest is mainly based on articles published in academic journals and books supplemented by qualitative data from international organizations, Japanese and Chinese official sources as well as third-party research institutions and consulting firms. Our analysis of firm strategy derives from primary company data as well as our research in the earlier sections.

*Tables and Figures*

Throughout the thesis, a significant number of tables and figures is added for summarization of larger parts and as a visual aid for the reader. Whether presented in text or added to the appendix but contributing to the understanding of a text passage, tables and figures are properly formatted in the APA format.

## Limitations & scope

In this thesis we aim to investigate factors in the institutional, industry- and firm-level spheres that affect the development of the Japanese and Chinese RE sector, by comparing the Japanese real estate market during the 1980s and 1990s with recent developments in China. Aside from the political and economic differences between the two countries, comparability is somewhat limited due to the difference in timing, as not only the sector, but also because the world has changed since the Japanese asset bubble of 1990.

Despite being MNCs, the strategic choices of our case company are evaluated in their respective home markets, not including global strategies unless they have implications for the domestic operations and economy.

We furthermore encountered limitations such as time constraints and lack of financial resources. Additionally, quantitative data varied across different sources, especially related to China, as well as due to a lack of specification in statistics. Thus, we mainly utilized data from official sources to ensure higher validity, although a critical perspective was always kept. Moreover, the access to company relevant information related to the case studies was limited, as not everything was made publicly available.

## Challenges to construct validity and reliability

To ensure the relevancy of our study, an assessment of the construct validity and the reliability of our data is necessary. Yin (1989) suggests the utilization of the following practices that contribute to the construct validity of our qualitative research: (1) using various data sources to support theories, which we achieve by including both primary and secondary data in our empirical sources. (2) Establishing a ‘chain of evidence’ to assist the reader tracking the data throughout the paper, which we deliver by structuring our thesis as a process, which, as stated in the introductory part, begins on a macro-level institutional analysis, and concludes on a micro-level firm analysis.

As part of the critical realism philosophy, we are further aware of certain subjective conditions such as our upbringing and culture that may affect us and lead to potential bias, compensating for this by utilizing both first-hand and second-hand data from international sources. Given the fact this thesis is written by two authors, the potential for an observer error exists, which we mitigate by utilizing a

semi-structured interview approach, while aligning on questioning methods. Furthermore, we are aware that our primary data is subject to potential bias from our interviewees, which goes in line with the critical realism notion that objectivity cannot be achieved fully, partly as all phenomena are observed externally. Being aware of this through our philosophical stance and thus remaining objective and critical in our research mitigates the risk of bias to a minimum.

Even though access to Chinese sources has improved in recent decades, we realize that obtaining valid and reliable data from China of any sort, especially from interviews where the stakes and bias of interviewees may differ greatly, may be difficult. Secondary data from China further adds to this difficulty as media publications are censored and controlled by the Chinese government, which is why we not only treat these sources with skepticism but also complement them with international publications to elaborate in possible discrepancies, for example in quantitative data, where possible.

As some of our sources are often originally published in Japanese or Chinese, and English translations of these sources, especially the latter kind, might alter the contents to a degree that compromises validity, the authors, who are proficient in the Japanese and Chinese language, are accessing sources in their original Asian language wherever possible.

# Literature review & theoretical framework

## Varieties of Capitalism Framework

The Varieties of Capitalism Framework by Hall & Soskice (2001)

The Varieties of Capitalism (VoC) framework was first introduced by political economists Peter A. Hall and David Soskice in their 2001 book *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* for "understanding […] institutional similarities and differences among the developed economies." (Hall & Soskice, 2001, p. 1) By arguing that past literature on comparative capitalism has not sufficiently covered how behavior is affected by institutions of the political economy, the framework locates the firm at the center of analysis to better connect the academic fields of business studies and comparative political economy (Hall & Soskice, 2001). The VoC framework's underlying assumption is that strategic interaction between economic actors influences the relevance of institutions within an economy to solve the various coordination problems a company

encounters when dealing with other firms, employees, or the corporate governance sphere (Kapás, 2013).

According to Hall and Soskice, the aim of firms and actors is to develop and exploit core competencies, also referred to as dynamic capabilities, to develop, produce and distribute services and goods profitably, and as these capabilities are relational, the success depends on coordinating with a range of actors effectively. In order to solve these coordination problems, the framework distinguishes between five spheres in which firms need to develop relationships:

- *Industrial Relations.* This sphere refers to the coordination between employer, worker and unions and is critical as it affects wage and productivity levels resulting in not only the firm's success but affecting the economy's unemployment and inflation rates as well.
- *Vocational training and education.* Also referred to as education and skill formation, this sphere concerns a company's ability to securing a suitably skilled workforce, the workers' decision of how much to invest in certain skills, affecting not only firms' and workers' capabilities, but the competitiveness of the economy overall.
- *Corporate governance.* This sphere is the product of interrelationships between institutions such as legal systems, financial markets, and shareholder protections, influencing the availability of financing projects and the terms on which firms are able to gain funds.
- *Inter-firm relations.* This term covers the relationships a firm forms with other enterprises, in particular clients and suppliers to secure supply, demand, technology access and coordinating the sharing of proprietary information within joint ventures, affecting not only the competitiveness of the firm but the technological progress of the economy.
- *Employment relationship.* This sphere deals with the coordination problems a firm faces with its own employees. The main issue is to ensure that employees have competencies and communication means to meet and advance their firm's objectives, affecting the economy's production regimes overall.

In addition to the five spheres of a national political economy in which firms resolve their coordination problems, an overall distinction between two types of national economies is made: liberal market economies (LMEs) and coordinated market economies (CMEs). Liberal market economies, best exemplified by the United States the United Kingdom and Ireland, heavily rely on competitive markets and hierarchy via which firms mainly coordinate their activities (Hall & Soskice,

2001). Radical innovation strategies are promoted by firms' high market reliance, collective bargaining is limited, which a high degree of managerial privileges is apparent, and short-term maximization of shared price is emphasized by strongly developed capital markets (Kapás, 2013).

Firms in coordinated market economies, such as Japan or Germany on the other hand, depend more on non-market relationships to coordinate with actors (Hall & Soskice, 2001). Decision making within firms is shared by employers and unions, thus a higher degree of bargaining relationships can be found compared to LMEs. Furthermore, a strong emphasis and investment in interfirm networks, skill formation and coordination among employers can be named as characteristics of CMEs (Kapás, 2013). As opposed to LMEs' institutional advantages lying in radical innovation such as the development of new processes, CME's advantages reside more in incremental innovation, such as the improvement of existing processes.

An important contention of the VoC framework is that the functionality of one institution within the political economic system is being influenced and altered by other institutions. This notion is referred to as institutional complementarity. According to Hall and Soskice, complementarities are embedded in institutions across sub-spheres of the political economy. This is exemplified by institutions in the corporate governance sphere providing firms with access to financing, thus enhancing the efficiency of institutional practices in the labor relations sphere, providing employment security, longer job tenures and wage-setting,

The framework's two types of economies, LMEs, and CMEs, differ in their complementarities. In LMEs where more authority is concentrated in management, firms tend to react to pressure from financial markets through laying-off labor force by enforcing new strategies to adapt to changing markets. In CMEs, the decision-making process differs as management does not allocate the same level of authority and a firm's access to finance and technology depends on its reputation among other collaborators.

While Hall and Soskice's framework has resulted in various interpretations since its publication, the general assumption that the stability and shape of economic systems of different kinds is characterized by institutional complementarities within the system, remains.

However, the framework has been criticized for lacking elements that need to be taking into consideration when analyzing Asian business systems, such as undervaluing the role of the state and the importance of social capital. Hence, we complement Hall and Soskice's framework with Witt and Gordon's (2015) extension of the Varieties of Capitalism framework of Asian business systems.

Critique of the Varieties of Capitalism framework

While useful to the analysis of this paper, the VoC framework has received some critique in the past, namely, in five different areas. These are "the VoC's approach to the issue of diversity, its emphasis on the firm at the focal point of analysis, its key concepts, system coordination and institutional complementarity, its claim that it is a "dynamic" approach, and finally, the policy implication of its framework" (Kang, 2006, p. 8).

Several scholars have noted that there is a lack of variety in the VoC framework (Kang, 2006). The argument is based on the notion that the framework does not separate itself from binary classifications of nations, such as calling Japan corporatism without labor or France limited pluralism, thus signaling these nations are deviating from an ideal type of pattern. Even though the theory attempts to distinguish how every variety of capitalism has its own institutional advantage, thus creating equality between them and arguing that no model is superior, it is apparent that liberal market economies possess advantages in high-growth industries. Moreover, some argue that the separation and description of radical and incremental innovation is too simplified. In addition to that, VoC allows for the inclusion of other actors, e.g., unions, suppliers, competitors, or employees. However, the framework especially underestimates the influence of labor and state actors.

Finally, Hall and Soskice argue that if a country is not possessing the right institutional framework for enabling non-market coordination, it should develop policies that are suitable with the institutional framework instead, even though goals of the country, which could potentially have a long-term positive impact on firm competitiveness, are neglected. However, there are several instances where governments in non-liberal market economies have developed coordination in novel policy areas with successful results.

VoC applied to Asian Business Systems (Witt & Redding)

Arguing that past literature lacks a comprehensive overview of the institutional features of Asian economies in a comparative perspective, Witt and Redding have extended the VoC framework by comparing 13 major Asian business systems with each other as well as with five Western states as comparison points. Stating that existing literature, in particular Hall and Soskice's VoC framework, was not applicable to Asia and that Asian business systems except for Japan cannot be analyzed by categories identified in the West, Witt & Redding have complemented the five spheres of the VoC framework with two further categories:

- *Social Capital.* Building on Whitley (1999) and Redding (2005), Witt & Redding define the term as trust, thereof which two kinds are apparent: (1) interpersonal trust, that exists between persons based on experience and suggests that the respective other acts honest, commonly involving friends and family and (2) institutionalized trust, which suggests the presence of system keeping respective others honest. While Asian economies are characterized by higher interpersonal trust than their Western counterparts, not only inside the family but also leveraging this trust for business purposes, the presence of institutional trust, which for example enables business conduct among strangers without fearing risks such as opportunism, varies from low counts in Laos or the Philippines to high counts in Singapore or Hong Kong.
- *The role of the state.* Witt & Redding differentiate between (1) developmental state and (2) predatory state categories, though stating that various hybrid cases exist in the region. While clear predatory examples such as Laos and India are characterized by high levels of corruption, clear welfare state elements only exist in Japan. China presents a hybrid case where top leaders continue to enrich themselves, though industrial policies of a Japanese kind have been modeled to an extent. While decision-making in Asian business systems remains static and top-down, again with the exception of Japan where policy formulation is usually consensual, involving non-state actor such as industry associations and various sectors of society, some countries like China combine top-down static elements with "a strong bottom-up element", though this is mainly due to local variations in institutions.

As stated in the introduction of this section, Witt & Redding have analyzed how 13 major Asian economies compare within the extended VoC spheres. As this paper aims to provide a comparative analysis of Japan and China, we focus on the results of these two Asian business systems. Witt & Redding's (2013) summary of Japan and China in the VoC spheres is presented in Appendix I.b.

## Diamond Theory of National Advantage

The Diamond Theory of National Advantage by Porter (1990)

In his book, *Competitive Advantage of Nations* from 1990, Michael Porter attempts to create a connection between strategic management academic literature and international economics academic literature to develop the Diamond model of competitive advantage and thus establishes grounds for national policies on competitiveness (Bakan & Dogan, 2012). Porter stated that previously, most trade-related theories had been focused exclusively on cost and that it was necessary to develop a new theory which expands on the current knowledge around competition and based this theory around case studies on ten countries. These countries are the US, Germany, Denmark, South Korea, Britain, Italy, Sweden, Switzerland, Japan, and Singapore, in which he studied 100 different sectors over a period of four years to be able to describe what determines a nation's competitiveness and what contributes to gaining a competitive advantage over others. Based on this, the diamond model of competitive advantage was created.

Analyzing countries' competitiveness as an extension from firm competitiveness is the area in which Porter (1990) theorizes. Stone and Ranchhod (2006) wrote that Porter's view is different from classic economic theory, and that it is the theory used in most business textbooks. Similarly, Peng (2009) views Porter's diamond model as the most recent theory to describe international competitiveness of nations. They argue this due to the ability to link both firms, industries and nations as opposed to earlier theories that only focus on a single or two of these. Nevertheless, Hill (2009) states that the diamond model has not been tested enough. The model is furthermore not included much in international economic textbooks as the economic school of thought does not support the idea of competitiveness at a nation level. However, within management theory, this notion is supported.

Porter (1990) argues, as opposed to classical economic theory, that national prosperity is created, not inherited and that "It does not grow out of a country's natural endowments, its labor pool, its interest rates or its currency's value" (Porter, 1990, p. 73). Michael Porter's diamond model of competitive advantage distinguishes mainly between four attributes, with the addition of two supporting attributes (Porter, 1990). These are factor conditions, demand conditions, related and supporting industries, firm strategy, structure, and rivalry. The additional two are government and chance. Below, the six attributes are introduced.

*Factor conditions*

Factor conditions refer to the resources needed for firms to compete in an industry and their position within factors of production: skilled labor and infrastructure (Porter, 1990). These factors can generally be divided into five categories. These are human resources, knowledge resources, infrastructure, physical resources, and services (Bakan & Dogan, 2012). Porter (1990) states that in sophisticated industries, a nation creates, rather than inherits, the most vital factors of production, by developing a scientific base. Furthermore, he argues that the stock of factors that is beneficial to a country in a specific period is inferior to the nation's rate and efficiency in creating, upgrading, and deploying these factors in specific industries (Porter, 1990). The most value-creating factors of production are described as the ones that are specialized and include substantial and sustained investment. On the other hand, in knowledge-intensive industries, factor conditions such as labor and material resources are not resulting in a competitive advantage in knowledge-intensive industries since firms can gain these by either following a global strategy or by adapting through technological measures. Therefore, to achieve a competitive advantage, factor conditions must be specialized to support the specific requirement of an industry, as this would mean that they are harder to imitate. Porter presents the example of Denmark and its specialization in treating diabetes and exporting insulin as well as the Netherlands regarding their specialization within the flower industry.

Moreover, Porter (1990) highlights the importance of a firms or nations need to innovate and upgrade if experiencing a selective disadvantage such as high cost of labor or a lack of local resources (porter). It is argued that by facing selective disadvantages, firms may be pressured to innovate and instead result in firms technologically advancing. To turn disadvantages into competitive advantages, favorable aspects in other parts of the diamond model will affect the factor conditions positively. This is also the case for the other attributes.

*Demand Conditions*

Demand conditions refer to the conditions of demand in the home market in which the product or service of an industry is operational (Porter, 1990). Porter (1990) argues that while it may seem that the development towards is more globally competitive environment would lessen the importance of the home market, he highlights that the home market is still of high importance, stating that "the composition and character of the home market usually has a disproportionate effect on how companies perceive, interpret, and respond to buyer needs" (Porter, 1990, p. 82). A competitive

advantage will be generated when home demand clarifies customer needs and allows for learning to occur earlier than for competitors. Moreover, more sophisticated, and demanding buyers will put pressure on firms to create innovative solutions, which in turn will result in further competitive advantage. Porter (1990) highlights that the size of home demand is less important than the character and sophistication of home demand. In fact, he states that "A nations' companies gain competitive advantage if domestic buyers are the world's most sophisticated and demanding buyers for the product or service" (Porter, 1990, p. 82). Besides pressuring them into creating more innovative solutions, they generally push the firms to meet high requirements and to improve in all aspects.

However, the size of home demand illustrated in the number of customers and growth rates of demand still affects competitive advantage (Bakan & Dogan, 2012). Porter (1990) elaborates that size can have a positive effect if it results in further investments and dynamism, and additionally if it creates a better environment for innovation that compared to market with only few customers. Moreover, the growth rate of home demand will have a positive effect if it is developing rapidly, as a quickly developed home demand in the early stages of a product or service will enable firms to act faster than international rivals.

*Related and Supporting Industries*

This refers to how a competitive advantage can be gained if related and supporting industries are globally competitive. There a several ways in which these internationally competitive related and supporting industries can positively affect firms. First, the input delivered from suppliers is cost-effective and the process of delivering it is described to be efficient, quick, and early, which in turn creates a benefit to the upstream recipient. Moreover, Porter (1990) states that innovation and upgrading is positively influenced by the close working relationship between suppliers and end-customers will allow for the ease of communicating and knowledge sharing, thus enabling the discussion of ideas. Besides, firms can establish R&D centers that will research within areas that can improve the suppliers' capabilities, and thus enable a more rapid innovation. Porter (1990) presents the example of the Italian footwear cluster in which shoe producers and leather manufacturers often communicate about styles and techniques, enabling further knowledge sharing and thus possibly innovation. However, it is stated that it is required that firms and suppliers put effort into driving this cooperation.

Furthermore, the same benefits that related industries create for suppliers, will be created if these industries are competitive in the domestic market as well (Porter, 1990). This similarly includes "Information flow and technical interchange speed, the rate of innovation and upgrading" (Porter, 1990, p. 83).

*Firm Strategy, Structure, and Rivalry*

This refers to how firms are created, organized, and managed because of national conditions, just as it refers to the domestic rivalry between firms (Porter, 1990). There are significant differences between how companies are managed, what the values are and how they are structured and organized. Porter (1990) argues that a managerial system cannot be universally applicable, and that adaptation is necessary. Firms need to adapt to both the dynamics of the industry as well as the national management system to gain a competitive advantage. Moreover, firms and people are different in their strategy and goals, and may fit better within some industries, also based on the level of maturity of said industry. The institutions of a nation and thus the value for people and firms working within a certain field will often result in a competitive advantage within said field due to the prestige it brings.

Furthermore, Porter (1990) argues that strong rivalry within an industry will drive firms towards being more innovative and gaining a competitive advantage. The example of Japan is presented, in which it is stated that usually there are double figures of direct rivals in the industries where Japan is dominant. He further argues that domestic rivalry positions itself within the diamond model as the most vital one, due to how it affects the other aspects in the model.

*Government*

Porter (1990) states that the government's role is to challenge firms to achieve improvements and thus competitive advantage, and that companies themselves are the ones that create competitive industries, thus partializing the government role. Nevertheless, the indirect effect of the government results in an environment that allows firms to gain a competitive advantage, and ultimately magnifies the diamond attributes (Porter, 1990). If governments implement policies that are short-term focused and static, they do not sufficiently reflect dynamism and innovation purposes, Porter states. He instead puts forward several practices that governments should employ to achieve a competitive advantage:

1. to *focus on specialized factor creation*, create specialized programs within research at universities, or other association enablement.

2. to *avoid intervening in factor and currency markets*, to not attempt to create favorable conditions, as seen with the dollar devaluation under the Reagan administration. This will in turn negatively affect the possibilities of improvement and upgrading in industries.
3. to *enforce strict product, safety, and environmental standards*, thus ensuring better domestic capabilities, and thus demand.
4. *sharply limit direct cooperation among industry rivals*, as the actual value is created from proprietary research, whereas cooperative research rather results in the inspiration to internally improve efforts. However, Porter does identify some advantages towards joint research efforts if they revolve around basic products and processes.
5. to *promote goals that lead to sustained investment*. to influence people at all levels to work towards the right goals.
6. to *deregulate competition*, as too much regulation will result in less innovation and affects rivalry. Yet, it is stated that deregulation will not work without the presence of significant domestic rivalry.
7. to *reject managed trade*, which refers to the implementation of agreements that sets quantitative targets as a measure for dividing industries, as this would result in inefficiency and less innovation. Trade policies are an important aspect, and governments should work towards opening up markets where a competitive advantage is present.

*Chance*

Chance refers to events that are almost impossible if not impossible for nations to control, but which affect the industry structure, and potentially change the competitive structure within said industry (Bakan & Dogan, 2012). Examples of a chance events are new inventions, wars, or a significant change in the exchange rates or input costs. One example is the attack on the World Trade Center in 2001, which affected Mexican exporters negatively, due to increased US border security.

Critique of Porter's Diamond Theory of National Advantage

As Porter's framework is one of the most cited theories in the area of national competitiveness, it has not been spared of critique during its 30-year presence. Aimed at encompassing every aspect of trade and competition, some scholars argue that Porter's model is scaled to generally to give a detailed understanding of the factors that determine an industry's competitiveness, while overstating the significance of geographic proximity (Penttinen, 1994; Waverman, 1995).

Furthermore, it has been criticized that the model disregards the influence of multinational organizations on competitive success of countries (Dunning, 1993). While Porter's model is applicable to firms looking to expand globally, critics argue that it is insufficient for companies that already operate on an international level while transnational organizations that can be considered stateless do not rely solely on resources in their origin country, making Porter's model inapplicable to them (Ohmae, 1995). Porter's US-based notion of justice furthermore leads him to disregard employment in terms of industrial relations, which is critical to understand the workings of industries with high employee bargaining powers in countries such as Germany and Japan. Tackney (2001) furthermore mound that, in contrast to Porter's notion that a labor pool cannot contribute to a competitive advantage, in the form of adaptability to market changes, in knowledge-intensive industries, variably engaged labor can be a factor contributing to an industry's competitive advantage (Tackney, 2001).

Application of Porter's Diamond Theory of National Advantage to the real estate industry

The application of competitiveness frameworks in the analysis of the RE sector is limited, and most research in the RE sector is based on an analysis of the key determinants of firms' competitiveness rather than the sector's competitiveness (El Burai & Amann, 2021). We realize that the RE sector presents a diversified field of study as it is strongly segmented into various sub industries such as commercial space and brokerage (Porter, 1989). For comparison's sake we are however looking at the RE sector as a whole, differentiating, when necessary, as we see the sum of all sub-industries contributing to the overall economy of our countries of interest as did the scholars in our literature review of real estate application of the Porter model. Prior applications of Porter's (1990) Diamond framework for the RE sector legitimize our use of the theory for this thesis. A summary table of the following works on the RE sector is presented in appendix I.a.

An adaptation of Porter's model to the RE sector was introduced by Sun et al. (2010). The study investigates the real estate industry in Beijing and Tianjin and found that demand conditions and related and supporting industries are the most important aspects when it comes to real estate competitiveness (Sun et al., 2010). The model is divided into for determinants: *Competitiveness factors*, which include housing price and GDP, *Demand factors*, which include completed area and population density, *Productivity factors*, which include total area and total investment in real estate, and finally *related and supporting industries*, which include property area and sales area of current

houses. The study further finds that GDP growth and appropriate increases in house prices have a positive effect on real estate industry competitiveness. However, the model only analyzes competitiveness through economic indicators, and does therefore not account for any social or environmental aspects, which are critical determinants in an Asian setting. Moreover, the determinants on cover limited aspects of the industry, with demand factors not including aspects such as interest rate or income, which is why El Burai and Amann (2021) question the accuracy of the model.

Furthermore, Hahn (2015) adapted Porter's diamond model into a conceptual framework suitable for analyzing the competitiveness of African emerging markets in real estate, it is based on specific underlying ideas of Porter's theory. For example, similar to Porter, Hahn assumes that basic factors such as GDP and population growth do not ensure a competitive advantage directly. The model distinguishes between barriers as well as drivers and constraints. Barriers refer to factors that are negatively affecting the formal outcome, and include aspects such as corruption, governance, and the financing system. Drivers and constraints are further divided into core drivers and constraints, and sophisticated drivers and constraints. The former sub-category includes aspects such as infrastructure, material resources and human capital skills, whereas the latter includes elements such as entrepreneurship and associations.

El Burai and Amann (2021) propose an extension to current real estate industry competitiveness literature, which includes a thorough analysis of the perspective of stakeholders, applied to the Dubai real estate industry, as they realize the limitations of previous literature which mainly focused on pure economic performance of business. Stakeholders' perspective covers areas such as quality of life, sustainability, resilience, and regulations. It furthermore highlights the importance of the interrelation between economic and political aspects and the role of the government.

Firm-level analysis using the firm strategy, structure, and rivalry sphere of Porter's (1990) framework

Due to the fact that our company cases are focused on firm strategy as a response to industry-conditions, and due to the limitations in scope of this thesis we are extending the application of Porter's Diamond framework, more specifically, its Firm Structure, Strategy, and Rivalry sphere to the corporate strategies of our two case companies. Various prior works have proven the applicability of Porter's industry-oriented model to a micro-, firm strategy-level analysis:

1. Gábor (2008) measured company level competitiveness in Porter's Diamond model framework, proving that the spheres of the theory provide a relevant framework to measure the relative competitiveness of the firms (Gábor, 2008).
2. Lejpras et al. (2011) Applying Porter's Diamond Model to analyze locational and internal sources of firm competitiveness, finding that various types of governmental support and the quality of locational factors affect companies differently depending on their level of innovation (Lejpras, Eickelpasch, & Stephan, 2011).
3. Kharub & Sharma (2016) investigated the role of Porter's (1990) framework for the competitiveness of small and medium enterprises, finding that competitiveness of the firms analyzed depended specifically on market value (Kharub & Sharma, 2016).

## Literature on comparative analysis of the Japanese and Chinese real estate sector

Comparative analysis on the Japanese real estate bubble and the developments in the Chinese RE sector, especially in recent years after the 2017 deleveraging campaign and the Three Red Lines (TRL) policy is scarce, as most research has been either conducted between 2010 and 2013, a point in time during which China was far less developed and thus less comparable to Japan in the late 1980s, or only focused on one particular aspect of the real estate industry. Our research has brought forward the following prior contributions to the topic:

1. Muto et al. (2010) conducted a study on the rise in Chinese real estate prices after the 2008 world financial crisis assessed similarities between the quick recovery of the Chinese RE sector and its Japanese counterpart after the first oil crisis of 1973 (Muto, Matsunaga, Ueyama, & Fukumoto, 2010). They argued that Chinese local governments' strong incentive for real estate development and speculative money from overseas could lead to an overheating property market in the future.
2. Liu (2013) investigated the effects of money supply on real estate prices during Japanese bubble period and China, arguing that Chinese RE firms' dependency on loans decreased between 1999 and 2011, in contrast to Japanese firms during the bubble period (Liu F. , 2013).
3. Xue (2019) conducted research on real estate price bubbles and their turning points, comparing the Tokyo and Shanghai property market (Xue, 2019). He noted that financial policies affected the price development in a short-term, land supply and real estate investment had medium-term implications, and income and population growth had long-term effects on

price development. He found that financial policy is rather a symptom of real estate price development, and that economic and demographic policies were the root causes.

Given that a comparative analysis of the RE sectors in our two countries of interest in light of recently tightened restrictions in China has only been covered in newspaper articles as a result of the Evergrande crisis in 2021 and has not been the subject of any academic publications, we are filling this existing gap in contemporary academic literature.

# Background

In addition to the post-WWII developments in the Japanese and Chinese RE sector that we introduce in this section, we provide a description of developments in the political economy of our two countries of interest in appendix part II.

## The Japanese real estate sector

The Japanese real estate landscape underwent drastic change in the postwar economic rebuilding following the move of Japan's rural population to urban centers. While 50 percent of Japanese lived in rural areas in 1945, only 20% remained in 1970. The fact that during the same time, one in four Japanese were living in the Tokyo-Osaka economic corridor led to a rise in housing prices that given the small size of Japanese living spaces, still is the case today. In 1972, the price of land was 25 times higher than it was in 1955 (Stone & Ziemba, 1993). At that time, programs such as the Japanese Archipelago Rebuilding Plan of 1972 called for large public investments in highway and high-speed railway construction to connect rural regions with large cities, leading to a boom in land speculations while the overall expansionary fiscal policies of the government fueled inflation.

During the period of high economic growth of the 1950s and 60s, the Japanese government was decisive in channeling Japanese banks' savings into prioritized sectors at subsidized rates, a practice referred to as 'Window Guidance', with the Ministry of Finance (MoF) being the only arbiter of credit resources. Large firms borrowed capital from within their own keiretsu family which "dispensed the high private savings of the nation more or less at the informal direction of the MoF, acting through the Bank of Japan." (Cutts, 1990)

However, Japan's economic maturing soon led to the import of more Western capital market structures in the 1970s. The boom in exports, fueled by a strong dollar commanded high margins for Japanese firms which made it unnecessary for them to rely on borrowing to enable further growth. To maintain its informal power, the MoF's policy changed to one of encouraging corporate borrowing, based rather on supporting the banks and not on actual capital needs. This cheap money policy alongside an encouragement for banks to extend their loose lending policies to medium and small firms led to firms investing the loans in land speculations rather than operations (Cutts, 1990).

As the formerly strictly regulated Japanese banking system started to be deregulated, increased competition led to banks losing the extra profits of being a protected bank. Corporate clients moved away from bank borrowing toward other means of financing such as on international financial markets. Japanese banks had to find new, oftentimes more risky borrowers and projects such as SMEs and property investment such as resort developments and urban office buildings, given that land prices more than doubled throughout the 1980s.

> "Japanese banks had been fueling the property market in Tokyo, and overseas, with large amounts of lending based on an assumption of permanently rising asset prices. The root cause of this was that Japanese banks had a perverse incentive to expand their balance sheets, as the absolute return they could make was limited by strict regulation. This bled into the stock market via heavily backed property development companies. So, in effect, asset prices became a proxy for an individual bank's market value – a highly dangerous combination." (Hoffmann, 2021)

As shareholders assumed that risk would be covered by the government or keiretsu group they belonged to, there was little accounting transparency allowing to justify investment values, especially in real estate (Tett, 2021). This lack of corporate governance led to 70% of Nikkei companies owning cross holdings withing competing companies, resulting in under-the-table deals, cozy cartels and no thought for shareholder interests (Hoffmann, 2021). However, Japanese policymakers saw their country's export dominance was at risk when the 1985 Plaza Accord, aimed to tackle the US trade deficit by adjusting various non-dollar currencies of the G5 member states, was drafted. The agreement would lead to a steep appreciation of the Yen, eventually almost doubling against the dollar,

worrying both the Japanese government and industry that Japanese firms would be forced to raise their prices overseas and lose to foreign competitors.

Once the Plaza Accord came into effect and put pressure on Japanese export prices, Japanese firms tried to avoid price hikes to not lose market shares and swallowed the resulting losses. Setting the national interest rates to the lowest level in the developed world, the Japanese government relied on borrowed money to absorb losses from the high yen, which firms invested in Tokyo land, of which 60% was owned by corporations. The increased investment led to speculations speeding up the bubble building process with Tokyo land prices rising by 10.4% in 1986, 57.5% in 1987, and 22.6% in 1988. While the average square meter price in Tokyo was at JPY 1 million in January 1986, it grew two-fold to JPY 2.13 million at the end of 1988, while prices in the central wards climbed over 400% (Cutts, 1990).

**Table 1: List of the ten largest Japanese RE developers in 1988.**

| By Profit (in JPY million) | | | By Revenue (in JPY million) | | |
|---|---|---|---|---|---|
| 1 | Mitsubishi Estate | 76,283 | 1 | Mitsui Fudosan | 469,916 |
| 2 | Mitsui Fudosan | 45,614 | 2 | Daikyo | 410,289 |
| 3 | Sumitomo Realty | 29,778 | 3 | Mitsubishi Estate | 274,410 |
| 4 | Daikyo | 23,925 | 4 | Tokyu Land | 151,698 |
| 5 | Tokyo Tatemono | 9,811 | 5 | Sumitomo Realty | 145,782 |
| 6 | Tokyu Land | 6,747 | 6 | Fujiwa Fudo | 127,588 |
| 7 | Daiwa Danichi | 5,806 | 7 | Daiwa Danichi | 71,780 |
| 8 | Fujiwa Fudo | 5,504 | 8 | Nichimo | 46,395 |
| 9 | Nichimo | 5,044 | 9 | Tokyo Tatemono | 44,507 |
| 10 | Osaka Building | 4,659 | 10 | Yuraku Land | 43,804 |

Source: (Kikkawa, 1996)

At the height of the Japanese bubble in 1989, further heavy overseas investing by Japanese firms such as Mitsubishi Estate's USD 846 million purchase of 51% of the Rockefeller Group, which, considering that the firm reportedly held USD 70 billion in unrealized land alone, did not even seem like a purchase, led many to believe that sooner or later just about everything would be bought by the Japanese. Between 1985 and 1988, latent real estate value held by Japanese firms grew by more than

USD 2 trillion, which as half of the entire Tokyo Stock Exchange's value in 1989 (Cutts, 1990). Despite the fantastic economic growth and even more fantastic amounts of money being spent by the Japanese, Robert L. Cutts in his Harvard Business Review article in 1990 soon realized that the "greatest surprise of Japan's money machine" was that it was "really built on no foundation", he was referring to Japanese land (Cutts, 1990).

Other observers of the time also noticed that there was something wrong with the mechanisms of the Japanese market, as Roth (1989) observing that the dominant market forces were opportunistic brokers, 'rumormongers', and day traders (Roth, 1989). While real estate yield exceeded the real economy, even firms from outside the real estate and banking sectors, such as Toyota Motor and Hitachi Electric, entered the real estate industry (Congwen, 2021). At the peak of the real estate bubble, all the real estate in Japan, around the size of the US state of California was worth USD 18 trillion, nearly four times the value of the total US real estate (Fackler, 2005).

As the inflation of the real estate market became more and more apparent, the Japanese government began to raise interest rates upward to 6% and tightened monetary policy to combat asset inflation (Oizumi, 1994). Not fueled by low interest rates anymore, in 1990 the so-called 'triple falls' of yen, stocks, and bonds occurred on the Tokyo financial markets and as land speculation has been accelerated by formerly rising land and stock prices, the value of real estate collapsed by 65% in just three months. 'Bubble bankruptcies' surged in the property sector while financial institutions struggled to get back their property loans. Soon, the downturn in consumption and investment extended to other sectors and affected the national economy and various financial scandals involving fake deposit certificates, bribery and capital loss compensation came to light (Oizumi, 1994). It was the beginning of what would later be referred to as the 'lost decade' during which shareholders lost some USD 2 trillion of capital within few years (Hoffmann, 2021).

The initial reaction of the Japanese government to the surging real estate value has often been criticized as ineffective. Expensive public works projects aimed at resuscitating the market lacked in planning and often further increased the national debt. It was not until the late 1990s that deregulation policies were enacted that led to desired outcomes. While deregulation occurred mainly in the financial sector as it was aimed to help the banks, it had a positive effect on the RE sector, allowing for investors to create investment trusts. Furthermore, regulations on building codes were eased and

approval time for building permits reduced, all of which led to a new building boom in Japan's urban centers in the 2000s. In 2005, Tokyo residential home prices rose for the first time in 15 years, albeit only by 0.5 percent YoY (Fackler, 2005). Especially new high-rise developments on artificial islands such as Tokyo's Odaiba and Kachidoki areas are credited with incentivizing investors (Tokyo Kantei, 2019). Low interest rates once again stimulate potential homeowner, so that even during the economic slowdown of the COVID-19 pandemic, sales prices of newly built condos in Tokyo have overtaken bubble record prices in 2021 (Hara, 2022).

## The Chinese real estate sector

Unlike the substantial post-war growth rates of the Japanese RE sector, the Chinese real estate industry saw little growth in the first 30 years since the establishment of the People's Republic of China (PRC) in 1949. As was the case in the Soviet Union, significantly subsidized housing was given to workers by SOEs, which was referred to as welfare housing (Fung, Huang, Liu, & Shen, 2006). The implementation of economic reforms, which included a household responsibility system on the countryside, as well as the establishment of special economic zones (SEZs) in the late 1970's laid the grounds for the future of the real estate sector in (Wang, 2021). The household responsibility system refers to a system established in the Anhui province which attempted to distribute the profits within the agriculture industry, so that productivity quotas were allocated to families rather than being distributed within the communal system.

Prior to that, the land transaction market and private ownership of assets were not present from the 1950s to beginning of the 1980s (Wang, 2021). Nevertheless, in the 1970s, intellectuals and political figures started discussing the possibilities for changing the system that revolved around welfare housing. This discussion occurred across the country, and it was followed by different policies that guided these changes. In 1987, one of the most important SEZs, Shenzhen, started to use the industrial land, which was previously farmland, following the government's growth in equity and thus its ability to attract foreign investors and establish joint ventures. In fact, Shenzhen was the first city in China to offer public land for private use at an auction in 1987 (United Nations, 2019). The value of the land was used to attract these investments, which was quickly transferred to be applicable in other regions of the country (Wang, 2021). The decentralization strategy further enabled local governments to create decisions on how and when to commercialize their land.

The commercialization of land use rights and privatization of housing proved to be the two vital efforts towards developing the sector in the 1980s (Ho & Lin, 2003) (Wang, 2021). Even though urban land was still within the ownership of the CCP, while countryside property was owned by various communes, the changes in land use rights were the initial enabler towards an actual real estate market. Specific government agencies were established in the early 1980s to drive these changes, more specifically creating channels for production and the distribution of housing, e.g., through enabling urban locals to buy housing that was originally rented to them. Thus, capital investments were also including investments from families and work units, thereby allowing the government to lower their liabilities. The government now possessed a new role in which it functioned as a supporter and administrator rather than directly controlling allocation of housing, thus stimulating various market forces further.

During this transformation period, public agencies were functioning as the first example of real estate agencies and acted for both the central government on a national level and local governments at a regional and local level (Wang, 2021). These agencies oversaw the entire process, from acquiring land and building houses, to renovation and the management these processes. After the company law was established in 1993, these agencies were slowly transformed into actual real-estate companies. Even in light of the majority of these firms being subject to restructuring, M&As and bankruptcy, most of them were consequently transformed into either “a public-private jointly owned venture, a publicly listed company, a fully privatized non-listed company, or remained a subordinate of a state-owned enterprise (SOE), all with their dominant business in construction and real estate” (Wang, 2021, p. 11).

In 1988, private enterprises were officially acknowledged, which meant that the urban population was enabled to register businesses that were not connected to the state (Borst, 2021) (Lardy, 2016). It is important to mention that the urban population received this legalized privatization much later than people living in larger cities (Wang, 2021). This resulted in the gradual establishment of real-estate companies. Deng Xiaoping travelled to the southern parts of China in 1992, and spread the word, which led to the population starting to accept these new reforms that allowed for personal economic pursuit (Han & Pannell, 1999).

In 1998, the RE sector was formalized, and supply and consumption activities were occurring in the market without any financial support from the CCP, the only exception being the social housing market (Wang, 2021). However, local governments still functioned as agencies and were the only ones that could acquire farmland and sell the use rights. The power of these local governments, which allowed them to both acquire and convert urban land had a positive impact on economic growth, as most local revenue consisted of earnings made through the transaction of land.

Meanwhile, the economic growth in China had taken off significantly, and a sizeable middle class began to appear (Rocca, 2017). This, in turn, led to a substantial rise in demand on the housing market, where fixed urban assets grew from RMB 1.6 trillion in 1995 to RMB 5.5 trillion in 2015, representing an annual growth rate of 19.73% between 1995 and 2015 (Wang, 2021). Furthermore, from 2003 to 2015, real estate development accounted for 26.8% of total investments in urban fixed assets yearly, the high point of which being 2003, when it reached 28.7%, whereas the low point was hit in 2015, accounting for 24.3%. In general, construction and investment increased substantially, and the employee count in the real estate development sector grew from 825,888 in 1998 to 2.7 million in 2015, illustrating a 232% growth. Similarly, the number of real estate companies grew from 24,378 to 93,426 from 1998 to 2015.

At this point in time, China was slowly transforming towards a market economy with socialist characteristics, and a hybridity of the real estate market structure was forming, since many different types of business ownerships were developing (Xu, 2011; Wang, 2021). This includes state-owned RE developers and privately owned companies, as well as joint ventures and foreign-invested or owned companies, and various combinations all types. In general, however, two types of ownership forms account for the majority of RE developers. Firms, mainly or partly owned by the government, such as an SOE, and publicly listed stock companies, which are traded on either the Shenzhen stock exchange or the Shanghai stock exchange.

Since government agencies and SOEs played an important role for the Chinese RE sector's post-WWII history, it is apparent that many RE firms are affiliated to some degree with government entities (Wang, 2021). Due to the real state sector's impact on the overall economy of China, it is easier to access financial support, subsidies, or networks than within other industries. As larger developers enjoy considerable government support, smaller players are finding it increasingly

difficult to compete with large, established firms with high financial backing, further supported by increasing land prices, the cost of which smaller developers often have to place on buyers.

In early 2010, to ensure more fair competition and to stop speculative investments, the state-owned Assets Supervision and Administration Commission (SASAC) restricted 78 SOEs controlled by the CCP, and whose normal business focus lay outside the RE sector, from bidding on land and development projects (Muyuan, 2010). This privilege was left with the 16 remaining CCP-controlled SOEs that did focus on the RE sector (Lao, 2017). Five more were allowed within the next year, which increased the count to 21, all of which were and still are large competitors in the industry. The government uses measures like this to control the market alongside policies on interest rates and land supply quotas (Wang, 2021). In 2017, SASAC moreover restricted SOEs from expatriating money for investments in real estate in other countries than China.

The growth rate of investments within real estate development is continuously increasing, illustrated by approximately RMB 14.7 billion spend in 2021, compared to RMB 9.6 billion spent in 2015 (National Bureau of Statistics of China, 2022; 2016). Additionally, this shows an 11.7% increase from 2019 and an average increase of 5.7% in the previous two years. Residential investments moreover increased by 6.4% in 2021 compared to the previous year. Both completed residential properties as well as completed housing area increased by respectively 10.8% and 11.8% from 2020 to 2021. In 2020, 2.9 million people were working in the RE sector, most of which are in the Guangdong province (Zhang, 2022). Furthermore, in the period from 2010 to 2020, the number of RE developers has increased from 85,218 to 103,262 (Zhang, 2022).

Currently, the largest RE company in China in 2021 based on total revenue is Greenland Holdings, with revenue of RMB 544.7 billion, followed by Country Garden at RMB 523.1 billion. Evergrande is ranked third at RMB 463.1 billion, with Vanke and Poly Developments ranked fourth and fifth, accounting for a total revue of RMB 452.8 billion and RMB 285 billion, respectively (Yahoo! Finance, 2022).

# Analysis of the political economy in the extended VoC Framework

In the first part of the analysis, we are examining the political economy of Japan during the bubble period of the late 1980s and early 1990s and China today, utilizing Hall & Soskice's Varieties of Capitalism Framework, extended by Witt & Redding (2013), to establish that despite their inherent political and economic differences, the two countries feature a variety of similarities that make them suitable for a comparative industry analysis.

## Japan in the extended Varieties of Capitalism Framework

Industrial relations

Japan poses an interesting case regarding industrial relations as it is the only Asian nation that facilitates a European-style jurisprudence with parallels to Roman Catholic social teaching (Tackney, "Ye shall know them by their fruits" American workplace evangelization and the continental European jurispudence origins of Japanese management practice, 2009). Since its reopening to the world during the Meiji Restauration in the second half of the 19th century, Japanese labor legislators were heavily influenced by German and Prussian legislation, resulting in the Japanese civil code, judicial code, commercial code, as well as Japan's 1889 constitution being, to an extent, adaptations of their German counterparts. Given this early orientation after European norms, US influence during the occupation post-WWII resulted in a hybrid between the German and American labor system. The current Japanese management councils (*Keieikyougikai,* 経営協議会), which again are an adaptation of German works councils, were first introduced during the post-war period as a response to ongoing riots, strikes and worker takeovers of companies during the unstable period immediately after Japan's defeat in WWII.

Suehiro Izutaro, chief of the Central Labor Relations Commission (CLRC) which introduced these management councils became a decisive figure during this period, whose German and American education heavily influenced Japanese labor policy making. Japanese industrial relations in their current form are based on suggestions of 1954-founded Japan Productivity Movement Center, which decided on implementing employee participation in managerial decision-making after the European model alongside an avoidance of "at will" terminations, which were inherent to the American system. Never defined in legislature, but institutionalized by many court rulings since 1961, lifetime employment became a cornerstone of the Japanese employment system, with employment tenures to

this day still ranking at an average of 11.9 years, however representing a decline from 17.6 years in 1998, the earliest year for which data was available (Witt, 2015). While in 1990, Japan's union density stood at 25.4%, it reached its low in 2007 at only 18.1% (Tachibanaki, Noda, Andersen, & Kirman, 1996; Witt, 2015). This development can also be observed in large firms with over 1,000 employees, where union density fell from 61% in 1990 to a low of 45.3% in 2008, showing the impact the bubble had, even on large unions.

While a downward trend in labor unions has been observed on a worldwide scale since the 1970s, changes in the working population of Japanese firms are further ascribed to this trend on a domestic level, as non-regular employees, such as part-time workers that account for a unionization rate of merely 5.6% and employees with limited tenure make up a considerable amount of the Japanese workforce today. While 15.3% of employees were non-regular employees in 1984, that number more than doubled to 34.4.% in 2010. While this might suggest decline of the traditional Japanese employment model it is in fact the result of two other factors. The first being the extended tenure in secondary and tertiary education during which students more often engage in part-time work, while second factor is the growing proportion of working women in Japan, which as grown by 61% between 1984 and 2010, however mainly within the sphere of non-regular employment, as Japanese women are three times more likely to work within non-regular employment than men.

Vocational training and education

Japan's present educational system originated in the post-war period, and thus shows many similarities to the US model. Elementary school lasts for six years, after which students go through three years of junior high school and three years of high school. They can then enroll in either a two- or a four-year colleague program and continue with graduate programs afterwards (Witt, 2015). Japan accounts for the second highest Asian secondary school enrollment rate and, at 60%, for the third highest college enrollment rate in Asia, surpassed only by South Korea and Macau in 2012. While Japanese students regularly score high on PISA studies (Japan was on fifth place in 2009), schooling tenure is comparably long at 0.883, ahead all other East Asian economies, except for South Korea. Two trends can be observed since the bubble burst. While college enrollment grew by 15.1% from 1990 to 2009, enrollment in vocational schools, which in Japan are mainly specialized training colleges and technology-focused schools, fell by 19%.

Even though Japanese universities are facing a decline of students due to Japan's falling birthrate, entrance examinations, especially for the prestigious schools put harsh pressure on Japanese students and are found not only in tertiary education but also exist in prestigious primary and secondary schools, and even kindergartens (Witt, 2015). Based on Confucian examination principles, the utilization of creativity and application tend to play a minor role in favor of stiff recall and rehearsal, a practice common across Asian education systems. Given the very specific skill set required on the job, companies provide extensive training to their employees on the job, partly because the prevalence of lifetime employment makes it a valuable investment to make for the firm. State agencies play a decisive role in skill formation of employees, exemplified by a national skills testing and certification system (Whitley, 2005).

Corporate governance

For large conglomerates, the keiretsu are the predominant form in which Japanese MNCs are organized and have shaped corporate governance since their establishment post-WWII (Shimotani, 1991). Keiretsu networks were adaptations of Meiji-era family-owned *Zaibatsu* combines. Firms still known today, such as Mitsubishi, Suzuki and Kawasaki were founded as Zaibatsu combines which places strong emphasis on hierarchy, collectivism and patriarchal leadership, values still found today in many Japanese firms. The main factor by which modern keiretsu networks differ from their predecessors is the cross-ownership of equity, while they still facilitate close ties with a main bank that provides financing, helping every company within the Keiretsu to increase immunity to takeovers and market fluctuations.

The peculiar nature of the Japan's keiretsu networks further resulted in different observers coming to different conclusions in terms of corporate governance, especially the decision-making process. In fact, even Witt (2015) notices how various scholars in different periods have come to different results in the analysis of the internal structure of the Japanese firm. While Johnson (1982) found the decision-making process to be top-down, with the bureaucracy deciding and the industry obeying, later works by Samuels (1987) and Okimoto (1989) found the process to be rather coordinated, with Samuels noticing a 'reciprocal consent' between the government and businesses.

At the end of Japan's high growth era, in 1980, 64.4.% of the stock value of listed corporations was owned by financial institutes and corporations, showing the extent of cross-ownership between the

main banks and other member firms within the Keiretsu networks (Witt, 2015). Corporate ownership was therefore mainly enacted by the main banks, and through monitoring by other business groups, while cross-shareholding lowered the threat of hostile takeovers. As described by Hall & Soskice, access to financing in CMEs such as Japan is not solely dependent on balance sheet criteria, but 'inside information' of the company, which is also the case in Japan were cross-shareholdings and informal control of the Bank of Japan enable the gathering of such balance sheet information (Hall & Soskice, 2001).

Japan's distinctive corporate governance through Keiretsu networks, or lack thereof, has often been named a decisive factor in the formation of the bubble as close personal ties within and across Keiretsu networks as well as little to no regulatory oversight led to shady deals and various financial scandals that came to light soon after the bubble burst (Samuels, 1990). Shareholder pressure since the bubble has led to a set of legal reforms having been enacted since 1997, which resulted in firms appointing outside directors to increase transparency.

Inter-firm relations

With large corporations being organized in Keiretsu, Japan's inter-firm relations are highly coordinated, their credit-based financial system is coordinated through cross holdings, with strong connections to their banks. This extensive level of inter-firm relations has led observers to call Japan a 'network economy' at the peak of the economic bubble (Witt, 2015). Even though Zaibatsu networks were broken apart during the US occupations, the fact that the main banks of these combines replaced the former holding companies led to the old Zaibatsu members maintaining business and equity ties, thus pre-war inter-firm networks have continued to survive within their Keiretsu successors to this day (Witt & Redding, 2015).

Witt (2006) names four types of social networks within Japan's political economy:

(1) *Business groups, or 'horizontal keiretsu'.* Business groups are further made up of two sub-types, former Zaibatsu, such as Mitsubishi and Sumitomo, in which pre-war figures managed to maintain informal links within the network and bank-led types that either formed around banks during the post-war period or were orchestrated by the MITI.
(2) *Vertical keiretsu.* This type can be further broken down into supply chain networks, referred to as production keiretsu, of which the most famous ones can be found in the Japanese

automotive sector; distribution networks; and keiretsu that were built on capital flows from the parent firm to a subsidiary company.

(3) *R&D consortia.* This social network forms temporarily during the tenure of R&D projects, linking firms from related industries together, while oftentimes being backed by the government. The signal effect on banks and firms is considerable as thorough examinations of these projects' future success is undertaken before governmental funding is granted.

(4) *Government-association-industry nexus including cartels and infra-industry loops.* Distinctive to Japanese inter-firm relations is the connection between firms, the state and informal industry associations. The significance of these so called 'intra-industry loops' is exemplified by the fact that around 90% of Japanese companies are members of government-approved industry associations withing their respective industry. Here the role of the state in these "private" conglomerates becomes clear as the Japanese government as well as the firms benefit greatly from the information and coordination exchange within the groups.

As described by Hall & Soskice (2001), the predominance of firm networks in the Japanese business landscape has significant implication on competition, especially in the fields of training, and technology transfer, in which firms in keiretsu networks cooperate with each other, arguing that the group-based organization of the Japanese political economy enabled distinctive corporate strategies around cross-sector knowledge transfer to be developed by Japanese firms (Hall & Soskice, 2001).

Employee coordination

While the prevalence of industrial relations in Japan has brought participatory elements to decision making within firms, the strict hierarchical nature of Japanese culture and society still results in much of the decision-making being top-down (Witt, 2015). However, participatory elements, especially withing non-routine decision-making are commonly found, while *nemawashi (*根回し) or 'preparing the roots', a form of informal consensus-building among main stakeholders, is usually utilized before major decisions. Once these proposals reach final deciding forum, such as a board of directors, they oftentimes pass without any further discussion. While top-down decision making is the norm in companies across most Asian nations, it oftentimes results in a lack of accountability among non-management personnel. This sentiment of pushing away responsibility to a senior level employee is not prevalent in Japanese firms, where the consensus, that a company's operations are the responsibility of all employees, albeit only regular employees, remains. Oftentimes, middle management is an important source of initiative and individual workers have the opportunity to

propose process optimization suggestions that, if informal and formal consensus is reached, will be circulated to higher-level management for a final decision. Thus, Japan scores the highest in terms of delegation among other Asian business systems, scoring 4.8 out of 7, which is on the same level as most English-speaking nations in the West.

Much of the incentives that Japanese firms offer their employees today, albeit to a higher degree before the burst of the bubble are due to the influence of management councils in Japan. To this day, the three pillars on which employment relations in Japan rest are lifetime employment, enterprise unions themselves and the seniority system, the latter referring to increases in salary with growing work tenure within a firm (Witt, 2015). With scholars ascribing the struggle to recover from the bubble burst during the lost decades to these institutions and their static nature, many predicted that Japan would shift to a more American model of employment relations, which has not occurred to this day. Furthermore, Japanese unions differ from its Western counterparts, especially as interest representatives for regular employees. The patriarchal nature of Japanese management, where the provision of benefits to employees is oftentimes seen as the main reason of a firm's existence by its managers leads to a general alignment between unions and corporations, exemplified by Japan having the lowest number of strike days among OECD countries, regardless of size, making Japanese unions, somewhat pseudo-unions with objectives similar to those of the firms' management.

To this day, three social concepts play a significant role in aiding Japanese employee coordination: (1) human relationship (*ningen kankei,* 人間関係) expressed by a "concern for the value orientations of others" as a prerogative in Japanese management; (2) organizational consciousness (*dantai ishiki,* 団体意識) referring to sacrificing one's own opinions in favor of the needs of the group or firm; and (3) continuous improvement (*kaizen,* 改善) referring to a striving for organizational progress embodied by all levels of employees of a firm (Davis, 2021).

<u>Social capital</u>

Similar to other East Asian nations, Japan is generally referred to as a high-trust society, both in levels of institutionalized trust and interpersonal trust, the latter being exemplified by a rise in voluntary NGOs, a measure proven to foster interpersonal trust (Witt, 2015). Japan furthermore ranks 14th worldwide in institutionalized trust, placing it above Anglo-Saxon nations on average and just behind

Hong Kong and Singapore within East Asia. Low crime rates are a further marker for high levels of trust apparent in Japan deriving from a peculiar solidarity that Japanese people have shared for centuries (The Japan Times, 2021). Various factors such as Japan's isolation, both historically during the Edo period, as well as geographically, the fact that it is an island country strongly affected by natural disasters due it being one of the world's most seismically active regions can be seen as incentives for the Japanese population to find solutions to their inherent issues as a society, thus forming strong bonds between them. Furthermore, Japan's late developer status during the Meiji restoration and the threat of colonization by the West have increased national consciousness and sense of community (Anchordoguy, 2005).

Trust is institutionalized even in the school system, where a 'Moral hour' was introduced to the elementary school curriculum in 1958, with topics ranging from 'Public Morality and Respect for Rules' and 'Working with Integrity and Social Contribution' to 'Love for Family' as well as 'Love for Community and Region' (Anzai, 2014). In fact, even Japan's communitarian approach to capitalism exemplifies the high trust present in Japanese society, combining a US-branded, individualist-oriented capitalism with Japanese communal concepts such as social stability and national autonomy (Anchordoguy, 2005). Japan's communitarianism however is expected to be the leading model for its population to live by, with people acting contrary to these norms being punished and labelled as social outcasts. Contrary to other industrial nations, it is social pressure and not the legal system that maintains institutionalized trust in Japan, showcased by comparably underdeveloped Japanese legal infrastructure and low number of lawsuits. As of 2011, only 30,488 lawyers were registered in Japanese bar associations, as opposed to 153,251 in Germany, a country with only two-thirds of the population of Japan (Witt, 2015). The rarity of lawsuits is compensated by the network nature of Japanese business and society where member rely on information flows about trust breaches which are then sanctioned by reluctance to do further business or the exclusion from the community, arguably not a fool-proof system that ensures trust and lawful business conduct, exemplified by various scandals that remained undetected mainly because stakeholders were too trusting with their business partners exemplified by 2011 Olympus scandal where the firm's newly appointed British CEO uncovered concealment of losses totaling USD 1.5 billion over a timespan of more than 20 years (Elam, Madrigal, & Jackson, 2014).

The role of the state

Similar to other VoC spheres, Japan differs from its Asian counterparts in terms for the role of its state, being the only one with clear welfare state elements and consensual policy formulation as opposed to a static top-down approach. However, if compared to other industrial nations with market economies, the government's influence and control over business conduct is without parallel. The industry friendly LDP having been the ruling party with almost no interruption and especially the MoF's influence and control over the banking sector have institutionalized a governmental involvement in the Japanese economic landscape. Joint committees that monitor industry performance and set targets, albeit branded as 'administrative guidance' are more commonly found within predatory developmental states but have continued to interact and shape the private sector to this day. Therefore, collaboration between state agencies, the banking sector, and large corporations is considerable, and as cooperation between large firms is encouraged, profit goals often tend to be out shadowed by mere growth goals (Whitley, 2005). While governmental collaboration with firms mainly occurs with large enterprises, SMEs, especially after the period of high economic growth had ended, were often left out of this equation, as the government only sees large firms able to implements agreed policies.

In particular, the Ministry of International Trade and Industry's (MITI) long-term planning efforts and resource allocation which have helped Japan enter its phase of high economic growth during the 1950s and 60s, heavily influence the workings of the Japanese economy. With the slowdown of Japan's economic growth in the 1980s, first major reforms such as privatization of the Japanese national railways and the removal of governmental monopolies on telephone services and tobacco were introduced under PM Yasuhiro Nakasone. The Plaza Accord of 1985 did not only result in the appreciation of the Yen, but dismantled the state-orchestrated, export-led growth model in favor of banks providing large amounts of credit under the guidance of the MoF to stimulate the economy despite the Yen appreciation, the government provided the spark to what observers later named the core roots of the asset bubble of the late 1980s. The burst of the bubble led to further reductions in state intervention, mainly to stimulate new business opportunities and opening domestic markets to foreign businesses.

## China in the extended Varieties of Capitalism Framework

Industrial relations

Despite vast differences in the political economy, China shares various similarities within this sphere with social democracies in Northern Europe and Japan (Witt & Redding, 2015). Modern unionization and collective bargaining in China dates to the early 20th century, during which village elders formed merchant unions and branch associations to increase rural people's influence in local policy (Wilbur, 1978). China's current tripartite framework, which has been implemented in 2001, consists of the All-China Federation of Trade-Unions (ACFTU), with a union density in 2008 at 48.3%, whereas collective bargaining coverage reached 34.1% (Witt & Redding, 2015). Qi and Huang (2016) reported that the ACFTU had a union density of 80.1% in 2012, thus making it the largest union in the world, with a membership count at 280 million. Moreover, workers organize themselves within the China Enterprise Confederation (CEC), as well as several associations on a local level, and government representatives are included in consultation through the Ministry of Labor and Social Security (Qiao & Appelbaum, 2011). However, the tripartite framework is highly complex, and over 11,000 different tripartite bodies across all levels were identified from national to provincial, municipal, county, district, and street level. This creates difficulties in the interdependency and cooperation between unions, workers, and employees across the country.

Furthermore, several scholars argue that the ACFTU is not a union in the sense that it is an independent entity and represents the interest of workers but is rather used by the CCP to ensure further control (Witt & Redding, 2015). This is somewhat obvious when considering the political system of the country, which does not allow any independent bodies, since the CCP "already represents the interests of the proletariat" (Witt & Redding, 2015, p. 19). Moreover, CCP members are positioned high up in the organization in important roles within relevant committees and ministries. This has consequences on ensuring a fair representation of individual interest, especially considering the general tendency of the CCP's interests being closely linked to those of businesses, since the CCP has ownership over many companies, and officials in the CCP are often stakeholders even in private companies. Witt and Redding (2015) further argue that the ACFTU tends to be on the side of management and thus against workers since local governments rely on income and tax receipts from local companies.

When considering employment protection, there are differences in actual practice and how it is officially presented (Witt & Redding, 2015). Labor regulations were tightened in 2007, which resulted in an employment protection superior compared to the CMEs mentioned in Hall and Soskice (2001). However, in actual practice, there are contracts with fixed terms and few restrictions being signed continuously, which means that it is generally easy for employers to both fire and hire employees. This has further led to high employment turnover in companies, with annual turnover rates in 2016 of up to 20.8%, arguably creating negative implications for the workers' motivation and commitment to a company (AON, 2016).

Vocational training and education

Despite improvements, especially in recent years, the Chinese education system still inherits various weaknesses (OECD, 2016; Witt & Redding, 2015). Since the establishment of the modern Chinese education the focus lay rather on the formation of general skills than on vocational training, in line with the Confucian education culture of repetition over application. In the period of 1990 to 2008, enrolment in secondary schools increased from 4.6 million to 80.5 million people, yet in the meantime the number of schools decreased from 87,631 to 72,907. Simultaneously, enrolment in vocational secondary schools grew from 3 million to 7.7 million, whereas the number of schools decreased from 9,164 to 6,128.

Similar to other Asian nations, special importance is placed on the National University entrance exam or *gaokao* (高考) (Wang, 2020). Chinese high school students are put under immense stress leading up to the gaokao to be accepted to the country's prestigious universities. As many Chinese parents firmly believe that a good education leads to a bright future, they tend to put additional pressure on their children from early on in their educational progress to achieve good results in the gaokao. Children not achieving good results and thus being admitted to an elite school is socially considered an embarrassment to the entire family. This early focus on the University entrance exam is in part responsible for the decline in technical school enrollment. While it is possible to progress directly from Junior high school to secondary vocational school, only few Chinese students still take this opportunity as they have been working towards the gaokao throughout the Junior high school and earlier stages of their education (Zhang, 2021).

Furthermore, Zeng (2021) observe a strong cultural reluctance towards vocational training. Classical Chinese education focus on general intellectual skills, whereas vocational training relates to manual labor. Prestige is an important aspect in China, and since manual labor is seen as less prestigious compared to general educational degrees, vocational education is not seen as an attractive path to follow by many. Resultingly, vocational secondary schools only had 5.59 million newly enrolled students in 2018, which is a decrease from 7.7 million in 2008, despite the increase in vocational education institutions to 11,700 (MOE, 2019; Witt & Redding, 2015).

However, the CCP is aware of the limitations of their vocational education system and related (un)attractiveness of it. Since February 2018, different policies to promote vocational education have been implemented, which include plans around areas such as new diplomas, improved access to apprenticeship programs and improved degrees that meet market demand (Zhang, 2021). Most noticeable is the introduction of a vocational college entrance exam in late 2021, which will be available not only to vocational school graduates, but also workers and the unemployed. Despite these initiatives from the CCP, there is still an oversupply of university graduates and a shortage of skilled factory workers.

Corporate governance

The Asian Corporate Governance Association (ACGA) ranked China as number 10 out of 12, having analyzed 12 different Asian pacific markets in 2020 (ACGA, 2021). This positions China behind countries such as Thailand, India and Malaysia which are ranked 8, 7 and 5 respectively. Japan is tied with Malaysia at 5th. Comparatively, China was ranked at 7 in 2010, tied with India and has thus fallen by three ranks (Witt & Redding, 2015).

In order to help this downward trend, the Chinese government is currently following a dual-track strategy, in which it has improved on areas such as delisting mechanism, better enforcement and encouraging class-action lawsuits (ACGA, 2021). New risks are however still present, and since capital market changes are progressing more rapidly than corporate government improvements, there is a fear of further systemic risk. One of the strongest factors in China's corporate governance ecosystem is its enforcement, and an amended securities law, which ensures more serious economic punishment for those not following it.

However, corporate governance in companies is not similar in practice compared to how it is perceived from the outside. In private-sector firms, family or individual owners of a company often have direct control, and a lack of institutionalized trust means that the owners often have a mistrust towards managers to act correctly for them (Witt & Redding, 2015). Furthermore, the role of the state in SOEs is still highly influential, and the interference in running SOEs is still high despite an SOE reform in June 2019, which attempted to provide SOEs with more autonomy regarding business decisions and progress towards becoming more market oriented (ACGA, 2021). Even though the state is the main source of funding for SOEs, there is not as much oversight as expected on spending of financial resources, just as banks do not have control over SOEs (Witt & Redding, 2015). Banks are additionally not permitted to own stock, and loans are handled and given out under government direction. It can therefore be described as a control-based system of corporate governance, rather than a bank-based or market based one.

With the financial system of China being bank-led, and state-owned banks are giving access to financial resources, banks provided 82.9% of corporate funds in the Chinese market in 2010 (Witt & Redding, 2015). In consequence, banks are used by the CCP to gain further control over the financial system. The actual simplicity of the financial system is however debatable, and private firms have more difficulties accessing official bank loans than SOEs. This has led to private-owned firms oftentimes finding it necessary to consult unlicensed banks or other illegal actors for funding, which in turn further increases the presence of shadow banking, thus showcasing the importance for Chinese entrepreneurs of having the right connections, as a measure to gain necessary funds. While the degree of shadow banking has decreased slightly since 2016, it is still highly utilized source of financing (Sutton & Taylor, 2020). Moreover, like within financial systems in coordinated market economies, there arguably is a high degree of informal information exchange in China, as banks and financial institutions that lend to firms, don’t always receive all information from official reports, but rather gather it from within the firm, additionally emphasized by cases of government censorship (Hall & Soskice, 2001).

Inter-firm relations

Intellectual property protection is weak in China, which has led to a large ‘copycat’ market, resulting in fewer alliances between domestic firms, as they are able to copy the technology instead, as well as

employees moving between firms freely, contributing to the transfer of knowhow (Hollis, 2013; Witt & Redding, 2015).

China is well positioned when it comes to networked business groups. Different types of networks with different aims exists in China and given employment relation needs, business associations have developed significantly (Yingying, 2018). These, as well as private ties between companies within the same industry, "serve as a coordination device to help deflect price pressures from customers, especially those from abroad" (Witt & Redding, 2015, p. 22). Moreover, there are private ties between managers and government officials, which can affect the performance of companies (Witt & Redding, 2015). These relationships do not lead to the transfer of standards and technology, which is what occurs in other Asian countries, such as Japan. Private firms can however participate in local production networks, thus cooperating within certain areas of their production, increasing efficiency and effective through spillovers.

SOEs, as well as a some private-owned firms, although to a lesser degree, have established *qiye jituan* (企业集团), which are a cooperative form of business group (Sieh, 2019). Partaking in a qiye jituan network, member companies are exposing themselves to cooperation that can generate benefits related to performance and productivity. Carney et al. (2009) found that the value of business groups in China was decreasing. However, it can be argued that the value of cooperation is still significant, especially under bad market conditions.

Moreover, *guanxi* (关系) is an important concept in Chinese society as well as in a business context where cooperation is beneficial. guanxi is a common an essential part of business in China (Wenderoth, 2018). Guanxi relates to having personal trust and solid relationships with other people, which can include having moral obligations and handing out favors. In fact, people in China depend on guanxi and personal contracts and discussions to handle disputes (Tomasic & Wolff, 2014). This further translates to business deals, in which final deals are often negotiated over dinner, thus enabling the possibility of illicit and shady deals being conducted. This shows that interpersonal connections in China goes deeper than official channels, thus the importance cannot be understated.

Employee coordination

Compared to Western nations, decision-making in Chinese firms contains stronger top-down elements, with highly siloed organizations where managers are unable to take on an integrating role in a firm, as control is allocated at the top of the pyramid (Witt & Redding, 2015). One example is within human resource management, in which decision-making power has not been allocated to middle-management, but rather stays with owners and top management. The hierarchical structure of firms is furthermore defined by organizational values such as paternalism and discipline. Witt and Redding (2015) argue that these characteristics are present not only for SOEs, but also in private-owned companies. Trust is especially important within a business setting in China, and managers are not always willing to hand out tasks to employees that they do not trust. Mistrust, on the other hand, can result in a reluctance for managers to delegate tasks to specific employees, and thus consequently potentially affect the overall objectives of a firm, as it can result in less commitment and demotivation among employees (Witt & Redding, 2015).

The Global Competitiveness Report in 2010 presents data on whether senior executives are appointed due to merits and qualifications, or because of personal relationships or family relations (Schwab, 2010). While northern European countries averages a score of 5.83, China is positioned at 4.70, which illustrates that having connections and trust is superior when rising in an organization compared to in the west. The top-down approach is not only present within firms itself but also affected by outside influences. In SOEs, it is common that influential positions are appointed to people high up in the CCP (Doyon, 2021). Oftentimes, people who are not associated with the company at all are the ones that are given these positions, which results in an increased gap between top management and the rest of the organization. The top-down structure and lack of trust from managers and the issues this may cause for an employee oftentimes affect labor turnover more than personal or career reasons (Dani, 2020). The high labor turnover rate poses a challenge for companies as employees lack commitment or deep knowledge of their respective firm.

The lack of institutionalized trust in China which will be discussed in more detail in the following section has additionally influenced the extend of large-scale delegation negatively (Witt & Redding, 2015). Due to an unreliable legal system, abuse of trust in relation to delegation may not necessarily result in punishment. Furthermore, having party officials positioned highly in SOEs creates a gap in the interdependence and connection between top management and all other parts of an organization.

Social capital

Guanxi plays a large role throughout the Chinese society and emphasizes the importance of personal connections and relations. To further elaborate, guanxi also extends to family and friends, and trust decreases as the ties become less close (Wenderoth, 2018). Witt and Redding (2015) further state that "Individuals outside these circles tend to be ignored or seen as rivals in a zero-sum competition" (Witt & Redding, 2015, p. 23). Generally, there is high interpersonal trust in China. In fact, in a survey from 2014, which investigated in which countries most people agreed with the statement "most people can be trusted", it was observed that 62.69% of Chinese people agreed. This positions China alongside Sweden at 63.76%, whereas the UK only reached 29.96%, and Brazil reached 6.53% (Rockström & Gaffney, 2021).

However, institutionalized trust is comparatively much weaker in Chinese society than in industrial nations in the West and Japan. While the condition for strong institutionalized trust in the West and especially Anglo-Saxon countries is a strong rule of law, Witt and Redding (2015) note that this is still absent in China, despite improvements over the years. This is due to a lack of accountability amongst CCP members and how court cases may be influenced by the government, as well as weak training and corruption among judges, prosecutors, and lawyers (Witt & Redding, 2015).

The role of the state

The CCP is interchangeable with the state, and their role in society and business is significant. As mentioned earlier, often having CCP officials positioned high up in both private companies and SOEs, they are influential and embodied thoroughgoingly within a business context as well. Even though the CCP is officially acting under the Constitution of the PRC the CCP has certain liberties that keeps them ultimately above the law. However, internal sanctions may occur, as seen with recent anti-corruption campaigns, in which the CCP reported that it had punished 627,000 officials in 2021 (Teh, 2022). However, most were low-level government officials, which could potentially signal members in higher positions are more protected. The primary challenge for the CCP is to not lose its popular legitimacy, and this could lead to a loss of power as well. Nevertheless, the enforcement and control that the CCP has established, with media and internet censorship as well as striking down on protests, combined with keeping the population satisfied through improving economically, ensures that majoritic dissatisfaction is not expected to be occurring any time soon (Xu & Albert, 2017) (Hernández , 2016).

China can be described as a developmental state with predatory elements (Witt & Redding, 2015). The branding as a developmental state is due to its inspiration and adaptation of Japanese industrial policies as the Chinese government has kept close observation of its industrial policies which include the allocation of capital, subsidized rates, and export promotion. Having high entry barriers on inward foreign direct investment (IFDI) and requiring joint ventures as a form of entry has ensured benefits of gaining new knowhow in its developmental trajectory. Unlike Japan, China has been struggling with ensuring advances in technology through joint R&D efforts between competitors. Factors such as loosening entry barriers and improving market conditions positions however lead to China slowly losing its developmental state classification. Similar to the Japanese government after the high economic growth-period, the CCP increasingly views smaller private SMEs as problem in their attempt to spread party ideology throughout society. However, the difference being that the Japanese government views them as incapable of implementing economic policies, whereas the CCP encounters difficulties in controlling private SMEs compared to large firms (Whitley, 2005; Buckley & Bradsher, 2020).

The predatory elements that Witt and Redding (2015) finds are benefits associated with being part of the CCP and the corruption and division of land and property. Nepotism is common, and families of party officials often receive significant benefits, such as high positions in companies and additional funds, despite anti-corruption campaigns initiated by Xi Jinping (Westerlund, 2018). For example, it is reported in 2012, that Xi Jinping's relatives had of a fortune of over USD 376 million in assets in 2012 (Bloomberg, 2012). China presents a hybrid model in which top-down static elements are combined with a strong bottom-up elements (Witt & Redding, 2015). It is highly decentralized quasi-federalist structure in turn enables the establishment of bottom-up policies. This is due to the delegation of policies and implementation to a variety of lower-level government. This decentralization is a result of both the size of the nation, but also the attempt to experiment and stimulate competition. This bottom-up approach to delegation on lower levels of government arguably ensures that important input will be gathered, and that implementation and policies will fit the respective provinces and cities better, as these differ significantly on areas such as living standards and local politics (Ma & Huang, 2021).

## Discussion on the Japanese and Chinese business system

Our analysis of the Japanese and Chinese political economy brought forward several similarities that the two nations share across every sphere of the VoC framework. Within the sphere of industrial relations, Witt & Redding (2013) identified a similarly high union density of 18.5% in Japan and 16.1% in China. However, discrepancies were found in the data gathered on union density for China, with Qi and Huang (2016) reporting a union density in China of 65.9% in 2007, and 74.7% in 2010, thus being significantly higher than what was found by Witt and Redding (2013). Moreover, while the workings of these unions stand in contrast at first glance due to the inherent differences in the political systems of the countries, they share similarities. While communitarian elements can be found within management councils and trade organizations in Japan, the patriarchal organization of firms oftentimes leads to similar top-down elements such as in China. While even the privately ACFTU is not free from government interference, the fact Japanese works councils' interest usually align with company interests makes them Pseudo-unions, albeit not to the same extent as in China.

Japan and China share even more similarities in the sphere of Vocational Training and Education. Both countries base their teaching culture on Confucian principles of hierarchy, respect to authorities, recall and rehearsal, as opposed to a more creative and applied learning approach. Furthermore, much importance is placed on the University entrance exams for which Japanese and Chinese children are pressured to study hard early on in their education. Elitism and Classism are commonly found in both nations as elite schools and even Kindergartens are seen as presentable whereas the failure to enter one, especially in China is considered to be shameful. Both countries, China even to a stronger degree experience a decline of Vocational school enrollment, which Japanese companies are tackling with extensive on-the-job training and education, while the Chinese government is hoping to increase the number of vocational students through a number of recently enforced reforms.

Japanese corporate governance is strongly shaped by the prevalence of Keiretsu networks, which similar to large Chinese firms mainly source their funding from banks. While large corporations in Japan are public and their Chinese counterparts are state-owned, bureaucrats tend to be actual decisionmakers in both countries, as Japanese firm strategy, especially during the bubble years strongly results from the Japanese MoF's policymaking, similar to CCP policymaking in China. Given the pre-WWII Zaibatsu history of many large Japanese MNCs, personal networks from former

family ties still play a role in today's Keiretsu firms, very much like Guanxi in China, with decision-making being top-down in both countries.

Both Japan and China facilitate highly coordinated inter-firm relations, albeit through different means. While Japan's credit-based financial system is coordinated through crossholdings and has thus been dubbed a "Network Economy" by observers, inter-firm networking is also prevalent through personal ties, similar to China. Furthermore, China's qiye jituan networks allow us to draw parallels to Keiretsu networks in Japan. However, due to the Chinese business groups mainly including SOEs, it could be argued that they share more similarities with hierarchical conglomerates, and thus differ slightly from Keiretsu, which do not have one dominant member. In both countries, the way firms interact is still shaped by developmental policy made by the MITI during the high economic growth era in Japan and by CCP in China, respectively. Especially Japan's intra-industry loops show startling similarities to the government-incentivized inter-firm relations of China as 90% of Japanese companies are members their respective government-approved industry association and the Japanese government benefits from the information and coordination exchange within these "private" conglomerates.

While employee coordination, especially in its inherent values is very similar in Japan and China, the lack of institutionalized trust in China leads to different implications. Management style in both countries is top-down with a strong emphasis on hierarchy. While good relationships among the employee "food chain" are maintained through a sense of commitment that workers feel for their company, the paternal leadership style of both Japanese and Chinese managers leads to little official conflict within firm operations. While these attributes alongside a seniority wage system and the introduction of performance-based pay resulted comparably long employment tenures in Japan, they are somewhat compromised by the Guanxi principles found in the Chinese management system in which employees tend to succeed through personal ties, trust, or simply due to CCP membership, as opposed to actual performance and skills, resulting in a high labor mobility in Chinese private firms.

While Japan and China both account for high levels of interpersonal trust, they differ greatly in terms of institutionalized trust. A key reason for this is the distrust in legal systems in China as well as the predatory nature of the state as opposed to Japan's liberal democracy. However, it is especially the differences in the political system of the two countries that leads to them being similar. While the communist nature of the Chinese state forces people to act in favor of the CCP's ideology despite

institutional distrust from the individual, the peculiar notion of Japanese people free willingly abiding by laws and working together for a greater common good makes a communist system unnecessary to create communist state-like social order as acting outside of social and state norms is penalized by being labelled as a social outcast as opposed to legal sanctions in China. For much of the post-WWII era in Japan, there was social consensus on growth. Communitarianism thus replaces Communism in Japan as Japanese people simply do not need a Communist party to tell or force them to contribute to the greater good.

While the inherent differences in the political systems of Japan and China arguably pose challenges to direct comparisons the roles of their respective states, the workings of both governments share various similarities. Though a unitary parliamentary constitutional monarchy, and thus a democracy and the only real welfare state with consensual policy formulation in Asia, the Japanese government's influence on business conduct is immense by democratic standards. Japanese economic policy is a result of its developmental status post-WWII and the heavy government involvement in the country's rebuilding under long-time LPD leadership has led to an institutionalization of government involvement in the domestic economy, especially by the MoF. What is branded as 'institutional guidance' are joint committees with strong government decision-making that are comparable to CCP interference in Chinese SOEs with CCP official maintaining high ranks among many corporations. This similarity between the LDP and the CCP is somewhat exemplified by the common saying that the LDP (Liberal Democratic Party) is neither very liberal, nor very democratic (Tsutsui, 2009). This is not surprising as much of the Chinese industrial policy in its developmental stages was modelled after Japan which seemed to present a successful framework for fast economic, state-guided growth. Within two decades after WWII, Japanese industrial policy led to various competitive world players emerge from the country, which made it reasonable for the Chinese government to follow similar patterns to help the growth of its own large firms (Nolan, 2002).

Our analysis of Japan in China in within the extended Varieties of Capitalism framework has brought to light a variety of similarities between the two countries, even despite their different political systems. In the following section of our paper, we are going to compare the RE sector of Japan during the bubble economy of the late 1980s and early 1990s with the state of the Chinese RE sector today, using Porter's Diamond Framework of National Advantage.

# Real estate sector analysis

The following comparative analysis of the Japanese and Chinese RE sector, using Porter's (1990) Diamond Framework will serve as a basis to gain a comprehensive understanding of the driving forces that shaped the Japanese RE sector prior to and during the bubble burst of 1990 and the Chinese RE sector today.

Table 2: Summary of our findings from the analysis in the Diamond framework on the trends in the RE sectors in Japan between 1985 and 1991 and China between 2015 and 2022.

| **Japan (1985-1991)** | **China (2015-2022)** | **Conclusion** |
|---|---|---|
| Factor Conditions | | |
| - Small land mass and high population density<br>- Urbanization rate: 77% (1990)<br>- Significant recent infrastructure improvements<br>- High-tech construction, short building times<br>- Increasingly unattractive construction sector<br>- Has finished economic development<br>- Population about to peak<br>- Social transformation of household size finished | - Large land mass and high population density<br>- Urbanization rate: 64%<br>- Significant infrastructure improvements<br>- High-tech construction, short building times<br>- Increasingly unattractive construction sector<br>- Still undergoing economic development<br>- Population has peaked in 2013 | **Differences in land mass and economic development, but similarities in infrastructure, technology and social factors affecting the sector.** |
| Demand Conditions | | |
| - Medium-high GDP growth (4.85%)<br>- Large population (Rank: 7)<br>- Despite low land mass still underdevelopment of land, partly due to speculation<br>- Real Estate as status symbol<br>- Cultural factors contributing to higher demand<br>- High sophistication of demand, however not represented by building amenities in many cases<br>- High real estate price to income ratio of 13 (18 in Tokyo, 1990)<br>- Medium home ownership of 60%<br>- Real estate purchases mainly debt-financed<br>- Main share of demand: Commercial real estate<br>- Optimistic buying behavior<br>- Real estate sector share of GDP: 9% | - Medium-high GDP growth (6.03%)<br>- Large population (Rank: 1)<br>- Underdevelopment of land<br>- Real Estate as status symbol<br>- Cultural factors contributing to higher demand<br>- High sophistication of demand, not represented by amenities and quality<br>- High real estate price to income ratio of 7.2 (55 in Beijing)<br>- High home ownership rate of 90% (distorted by multiple ownership)<br>- Real estate purchases mainly debt-financed<br>- Main share of demand: Housing<br>- Optimistic buyer behavior prior to COVID<br>- Real estate sector share of GDP: 14-29% | **Demand conditions are comparable among most factors, however main type of demand differs. (Commercial real estate in Japan, housing in China)** |
| Related and supporting industries | | |
| *Financial Sector:*<br>- Discount rate at record-low of 2.5% until 1989<br>- Debt financing (10% YoY growth)<br>- Real estate financing as source of income for banks<br>- Jusen loans<br>- Shadow banking (18% YoY growth)<br>- Discount rate tightened prior to bubble peak<br>*Construction Sector:*<br>- High productivity & high output through high-tech instruments<br>- World-leading in scale<br>- Construction industry share of GDP: 18.2%<br>- High public sector investment<br>- High government planning | *Financial Sector:*<br>- Discount rate at 4.30% in 2021, comparably low compared to 5.8% in 2000<br>- Real estate financing highest share of bank loans<br>- Real estate financing as source of income for banks<br>- TRL policy significantly restricted real estate-related loans in 2021, 14 developers already crossed lines<br>- Shadow banking (37.8% YoY growth) as result of gov. restrictions on lending<br>*Construction Sector:*<br>- High productivity & high output through high-tech instruments<br>- World-leading in scale<br>- Construction industry share of GDP: 25.9% | ***Finance*:**<br>**Similar in shadow banking increase, strategic use of real estate loans and subsequently enforced policies to curb lending**<br><br>***Construction*:**<br>**Similar developments, similar form of orchestration** |

| Firm structure, strategy, and rivalry | | |
|---|---|---|
| - 204,700 real estate firms in 1989<br>- Main players: real estate sub-firms of: Keiretsu conglomerates with Zaibatsu history; railway companies; manufacturers; general contractors; financial institutions<br>-Largest firms form the Major 7 and account for 28 per cent of market share<br>Two firms in Nikkei 100:<br>- Mitsubishi Estate MC: JPY 3.6 trillion<br>- Sumitomo Mitsui MC: JPY 2.2 trillion<br>- Corporations own lion share of Real estate<br>- Easy credit availability led to real estate speculation being major strategy of firms<br>- Net purchases of land by non-financial sector: JPY 3 trillion (1985) → JPY 28 trillion (1989)<br>- Strategic land-underutilization<br>- Heavy focus on resort development<br>- Orchestrated ‘rivalry’ by gov. ministries<br>- Main investments are domestic, foreign purchases mainly trophy property | - 103,000 RE companies in 2020<br>- Main players: POEs and SOEs<br>- Top ten firms account for 27 per cent of market share<br>- Three firms in SSE 100:<br>- Vanke: (MC: $34.16 billion)<br>- Longfor Group (MC: $31.31 billion)<br>- Country Garden (MC: $16.31 billion)<br>- Increasing dependency on financing of developers in recent years<br>- Increasing use of shadow banking until 2017<br>- Increasing dependency on preconstruction sales<br>- Credit to non-financial corporations in % of GDP: 115% in 2011, 160% in 2021<br>- Main investments are domestic, foreign purchases mainly trophy property | **Similar share of large real estate developers in the market, with no relevant foreign participation, government in both countries heavily influenced strategies of real estate developers.**<br><br>**Debt financing as source of finance in both countries, however China has recently restricted borrowing, foreign developments mainly prestige-oriented** |
| Government | | |
| - Extensive government control on all aspects of the real estate sector including availability of credit, type of development, public disclosure of financial situation, rivalry<br>- Government control exercised through: Finance Ministry, MoC, MITI, Industry associations<br>- Little influence of local population on real estate development<br>- 5-year housing plans drafted between 1966-2005<br>Real estate boom affected by:<br>- Low interest rate policy<br>- Low property tax rate<br>- Land lease law<br>- Resort law<br>- Shadow banking<br>Late implementation of restriction on lending<br>- Jusen loans as main device of lending boom<br>- Untransparent behavior, corruption enacted through organized crime | - Extensive government control on all aspects of the real estate sector including availability of credit, type of development, public disclosure of financial situation, rivalry<br>Government control exercised through: Local governments, industry associations, banks, PEs and SOEs<br>- No influence of local population on real estate development<br>Real estate boom affected by:<br>- Housing reforms 1998<br>- Interest rate and removal of credit quota in 2008<br>- Switching between tightening and loosening policies.<br>- Shadow banking<br>- No property taxes<br>Recent implementation of restrictive policies:<br>- 2017 Deleveraging Campaign<br>- TRL policy<br>- Untransparent behavior, no disclosure of financial situation, especially since Evergrande | **High levels of government intervention. In both countries, albeit differently exercised by different “arms” of the government**<br><br>**While a variety of policies strongly contributed to inflating real estate prices in both countries, the time frame and result shows that most these policies were short-term focuses. Implementation of countermeasures came too late in Japan, whereas they have stabilized the Chinese RE industry somewhat, though also introducing new issues** |
| Chance events | | |
| High degree of climate disasters, especially earthquakes and tsunamis due to seismic active region<br>- Positive effect on industry competitiveness due to high-tech use<br>- Positive effect on sophistication of demand<br>- Large disasters such as the 1995 Kobe earthquake have disastrous effect on real estate market due to slow government response<br><br>Stock market crash of 1987:<br>- Contributed to bubble building as government continued with low interest rate policies<br>- Response not long-term oriented, but focused on short-term sustaining of demand | High degree of climate disasters:<br>- Little effect on building quality<br>- Positive effect on sophistication of demand<br>- Learning effect on effective government intervention and mobilization of resources<br>COVID-19:<br>- Initial decline in home sales recovered quickly<br>- Recent Zero-COVID policy has negative effect on market recovery and home sales<br>- General uncertainty and low consumer confidence<br>Stock market crash of 2008:<br>- Short-term effect: dip in land prices<br>- Quick recovery<br>- Interest rate policy change<br>- Credit quota removal | **Comparable degree of climate disasters has led to increased sophistication of demand, however not always exemplified by the shape of developments**<br><br>**Stock market crashed have resulted in more liberal lending policies that accelerated debt-financing.** |

## The Japanese real estate sector

Factor conditions

Reading newspaper and journal articles from the late 1980s that thematized the Japanese real estate boom, it seems that Western commentators' favorite pass time during these days was to find new ways of comparing Japanese real estate value relative to vastly larger land areas in the United States (Cutts, 1990; Browning, 1989). The imperial palace in Tokyo was worth more than the state of California, the 23 wards of Tokyo were worth as much as the entire real estate in the United States, and all the real estate in Japan was worth four times more than all the property in the US.

However, Japan's geographical conditions do not seem to support these claims at all. From a total land area of 377,974 km2 in one of the most seismic active regions on earth, which is less than 4% of the land area of the US, 30% are habitable and only 11.4% are arable (MLIT, 2007). While the scarcity of land combined with a population of roughly 124 million in 1989 certainly commands high land prices, the astronomical values during the late 1980s arguably exemplify the overvaluation of Japanese property during that era.

Rising property values certainly were not only a thing of the 1980s. During its postwar economic rebuilding, Japanese land prices have grown 25-fold between 1955 and 1972, a reason for that being improvements in the overall quality of housing during that period as reinforced concrete buildings and high-rise towers swiftly replaced traditional wooden houses, but mainly Japan's extensive infrastructure improvements. While it took nine hours to travel the 500 km distance from Tokyo to Osaka by train before WWII, the opening of the Tokkaido mainline reduced the time to 6.5 hours in 1958 and the introduction of the Shinkansen, the world's first bullet train, cut the travel time to just over three hours in 1965 (JIS, 1965). Across Japan, remote areas were connected to urban centers which resulted in rising land values not only in the industrial centers of the Tokyo and Kansai region but in rural regions as well. During the peak of the bubble, land cost for housing in Japan was the highest in the world, much of the value being the land alone and not the structure on it. Still, in 1994 a square foot of land for housing in Tokyo averaged USD 510, compared to USD 19 in San Francisco and USD 16 in Los Angeles (NIST, 1996).

What contributed to high construction and building prices was the technological revolution that Japan underwent during its economic boom. Investments in research and technology helped Japan become a high-tech nation and this development spilled over into the RE sector as well. A skilled Japanese labor force contributed to state-of-the-art constructions being completed in record time while advances in construction techniques allowed for high-rise buildings of 150 meters and higher withstanding even strong earthquakes. In 1990, an average detached house took twelve months to construct while in equally congested cities such as Hong Kong, it took 30 months. Permit delays in Tokyo averaged at eight months compared to 36 months in Washington, DC, and Melbourne (The Economist, 1995). While no building in Tokyo surpassed the 100-meter mark in 1967, there were 119 buildings higher than 100 meters in 1995 (Empois, 2022).

Because of Japan's technological advances and presumably to counter surging construction prices, property was developed with the most modern means available. Visits of a Japanese Technology Evaluation Center (JTEC) and Civil Engineering Research Foundation (CERF) delegation in 1990 "marveled at their research, development and implementation of construction automation and robotics, composite materials, long-span bridges, very tall buildings, integrated computer-aided design systems, intelligent building control systems, long-distance tunneling, earthquake-resistant structures, factory-built luxury housing, and many others." (NIST, 1996, p. 23). Similar to lean manufacturing being pioneered in the Japanese automotive industry at the time, concepts of "lean construction" were embraced in the development of real estate property, involving full team cooperation to reduce time and cost resulting by extensively prefabricating reducing waste and implementing strict quality control measures (NIST, 1996).

Not only buildings were constructed by utilizing the most modern means possible, but so was real estate itself. With limited living space due to Japan's geography, planners were creating artificial land in bays of Tokyo and Osaka, which the US delegations also visited, calling the 4 km long offshore artificial island of the new Kansai International Airport and the 15 km Trans-Tokyo Bay Highway construction "the world's largest super projects." (NIST, 1996, p. 23). Technical knowhow of the construction and engineering workforce that resulted from their lifelong commitment to their employers was jeopardized by the post-bubble recession pressuring construction firms to cut costs to tackle declining profits. Furthermore, onsite jobs in building and construction themselves stopped to attract the young Japanese workforce compared to earlier as the entire industry became characterized

what locally called the “3 K’s”: *kitanai* (dirty), *kiken* (dangerous), *kitsui* (physically demanding), leading to young workers seeking more attractive job opportunities.

Furthermore, with Japan’s working-age population peaking in 1995, the RE sector faced challenges that were not apparent in decades before (OECD, 2011). The favorable rate of Japanese savings declined; the entire sector needed to implement standards to accommodate an ageing population. While social changes positively contributed to the RE sector prior to the bubble, exemplified by the change in average household size from five persons in 1955 to three persons in 1990 which in turn created greater demand for housing, the average household size has not significantly changed since then, standing at 2.71 persons in 2009. This lack of additional demand alongside the declining birthrate since the 1990s has contributed to the negative economic effects of the post-bubble recession in the Japanese RE sector.

Demand conditions

As stated above, demographic factors positively affected the RE sector until the bubble recession of the 1990s. At the height of the bubble, Japan had the seventh largest population on earth at roughly 123,500,000 million people (The World Bank, 2022). Furthermore, continuously rising GDP levels and industry growth alongside the scarcity of land, fueled private, commercial, and industrial demand for real estate.

While housing shortages pushed demand in the postwar years, the number of housing units exceeded the number of households by 1968. However, Japan’s ongoing economic growth led to higher expectations in terms of living standards and a desire to replace much of the inadequate postwar housing, thus sustaining housing demand. In the aforementioned 1995 NIST report its further pointed out that: “Interviews indicated that, perhaps because of dense utilization of the land, improvement of housing has occurred through wholesale replacement rather than additions.” (NIST, 1996, p. 99).

The fact that many Japanese gained substantial financial means during the bubble of the late 1980s further contributed to the sophistication of demand as wealthy Japanese buyers were demanding high-class real estate. Cultural and environmental factors further contributed to the sophisticated housing demand of the 1980s. Owning real estate was considered to be a status symbol and housing prices were not only high in comparison to Western nations, but also compared to Japanese household

income as the purchase of an average family would cost the average Japanese 13 yearly salaries. However, that did not extend to the second-hand housing market which was referred to as a 'lemon market', an analogy to poor condition-used cars (The Nikkei Shimbun, 2013). The main reason for that can be found in the continuous changes in earthquake-resistance regulations that, while leading to safer structures, oftentimes only applied to new developments. New, first-hand housing was considered safer than postwar developments of the 1950s and 1960s that had to comply with weaker restrictions (NIST, 1996).

Even though high-tech quality housing was built all over Japan, the high prices of the bubble period certainly were not rectified in every case. The condition of much of Japan's housing at the peak of the bubble alongside other quality of life factors arguably exemplify a popular Western saying of the time: 'Rich Japan, poor Japanese.'

Table 3: Living Amenities in the US, the UK, West Germany and Japan in 1989

| **Metric** | **US** | **UK** | **W. Germany** | **Japan** |
|---|---|---|---|---|
| Percentage of houses with flush toilets | 98.8% | 98.9% | 97.1% | 45.9% |
| Percentage of paved roads | 82.0% | 96.4% | 99.0% | 48.2% |
| | **New York** | **London** | **Bonn** | **Tokyo** |
| Park space per person | 19.2 | 30.4 | 26.9 | 2.1 |

Source: (Roth, 1989)

Even those who did not have the financial means necessary to afford expensive Japanese housing during that period were able to secure credits from Banks due to the government's loose lending regulations, which we will touch upon in a later section, at the time. 120-year mortgages, that were common at the peak of the bubble did not stop private investors from indebting their children and grandchildren as real estate was seen as the most lucrative investment option that would never decrease value (BBC, 2000). In addition to the high home ownership of 60% during the bubble years, private investors were not only buying property to live in but were highly involved in real estate speculation as well.

In fact, at that time in Japan, real estate speculation did not seem like a risky strategy as it was common consensus that real estate prices would continue to rise. The fact that property values continuously

were on an upward trend since the postwar era, with land prices rising sevenfold in the period of 1985 until 1989 alone, as well as the Nikkei index growing 590% during the ten years prior to the bubble burst were convincing arguments to RE developers, private and commercial investors, as well as foreign commentators that Japan's miracle was not going to end any time soon (BBC, 2000). Differences in Japanese accounting practice further contributed to the belief that real estate price rises reflected a general economic upward trend. As companies were able to define the rising value of land that their factories and offices stood on as profits, thus resulting in their stock prices rising.

How flawed this argument was becomes clear when looking at the actual GDP growth during that era. Between 1980 and 1990, Japan's GDP growth averaged 4.82%, which, while stable, was neither significantly higher than that of the US at 3.31%, nor reflecting the sharp rise in real estate value as the sector itself only accounted for 9% of the Japanese GDP at that time (World Bank, 2022).

Similar to the private sector, commercial real estate demand peaked during the bubble years, with Japan's large real estate conglomerates not only investing in domestic real estate, but also abroad. While a lot of the foreign purchases can be regarded as trophy properties, such as Mitsubishi's controlling share investment in the Rockefeller Center in 1989 and the purchase of the Pebble Beach golf club by a consortium of Japanese investors, speculations heavily drove commercial domestic demand. In 1989, Mitsubishi estate owned USD 70 billions of undeveloped real estate alone and Japan's newfound love for golf created an entire real estate sub-industry of its own, having become a tradeable asset worth a combined USD 200 billion. Not only did this development create an entire job sector around golf membership traders, but it even led to the creation of the Nikkei Golf Membership Index to monitor the development of gold club membership values (Parkes, 2020). In fact, golf course membership prices have been proven to lead land prices during Japan's bubble era. Stone and Ziemba (1990; 1992), find evidence that golf courses lead land price returns more generally, and that stock price returns lead land price returns, even when land is defined to include golf course membership returns. "The evidence is that a move in stock prices impacts golf course prices in about three months and land in nine to twelve months." (Stone & Ziemba, 1993, p. 158)

A possible explanation for the overly optimistic behavior of both private and commercial investors lies in the developmental mindset that was still present among Japanese people, firms and policymakers. Having reached the end of its catching up process, the Japanese continued their

economic expansionary behaviors even though the country had reach a point at which this was no longer supported by reality. Simple headlines that seemingly supported the Japanese success story of the 1980s such as the 590% rise of the Nikkei index during that period or the fact that six out of Forbes' 1989 ten richest men in the world were Japanese, including the first and second rank, seemed to prove that everybody's optimism was rectified, directly affecting demand in the booming RE sector (AP, 1989).

However, when the bubble burst, real estate investors saw their debt-financed property rapidly decline in value. Furthermore, as housing demands were already met and commercial demand crashed due to the bubble recession, a sizeable amount of real estate developed in the years following the bubble was in form of resort developments, many of which were not completed or abandoned during the lost decade that followed. Despite efforts by the government to stimulate new construction, and pre-bubble building starts resulting a high number of new building licenses being issued well into the lost decade of the 1990s, building developments rapidly declined at the end of the decade.

Fig 3: Number of new housing starts in Japan 1988-22

Source: (Miyamoto, 2022)

Related and supporting industries

While favorable factor conditions alongside strong demand have helped the Japanese RE sector to boom during the bubble period, the banking sector has contributed to the developments, as credit was available at record-low interest rates to commercial and private investors which led to much of the real estate investment being debt-financed.

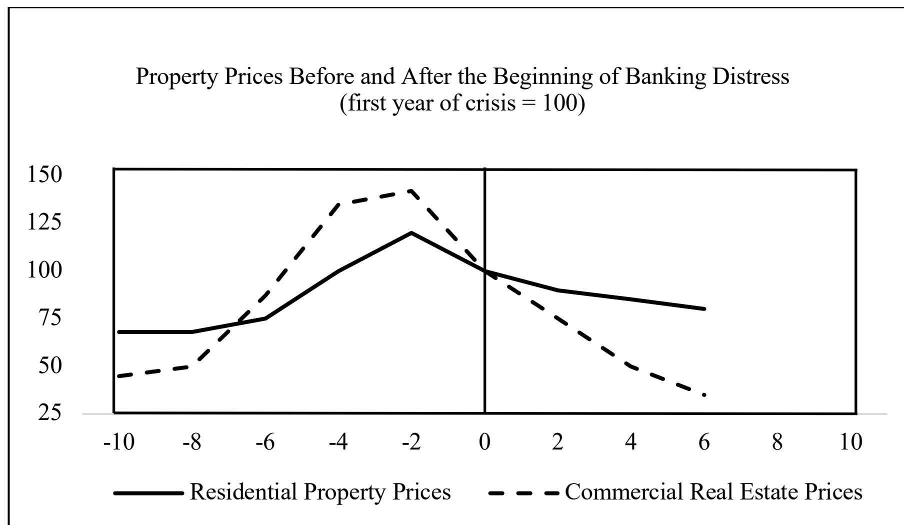
During the bubble years, banks had strong incentives to finance the RE sector, as rising real estate prices that were sustained by the banks' lending activities led to the banks' own real estate holdings rising in value, which in turn increased the economic value of the banks' capital. This vicious circle would continue as the banks total risk on its real estate portfolio declined, resulting in the provision of even more real estate loans given to developers (Herring & Wachter, 1999). In fact, this type of bank conduct was even referred to as 'Land *Pachinko*' or 'Land Pinball'.

> "The banks fund the deals. They finance a purchase of land for 50 million one week, and they finance the sale of the same land for 60 million one week later. One month later, the same bank comes up with 65 million for the same land. That's how land prices go up, it's just like pinball."
>
> -Suemitsu Ito, Managing Director of Itoman Co., in a filmed BBC interview in 2000

Initially, this reliance on the RE sector seemed to pay off: While Japanese banks ranked amongst the top ten in the world in the beginning of the 1980s, they became the top ten – all ten – in 1989, turning Japan into the largest creditor nation in world history until that point (Samuels, 1990).
Looking at data from the time finds a strong correlation between the distress in the Japanese banking sector that mainly occurred between 1992 and 1996 and the development of real estate prices in the period prior that.

Figures indicate that both residential as well as commercial real estate prices rose sharply and began to decline prior to financial distress in the banking sector, continuing to fall during the crisis which indicates that issues in the entire financial sector may exacerbate declining real estate values (Hilbers et al., 2001). The correlation between the financial sector and the real estate becomes even more apparent when we examine real estate prices in relation to credit growth. As Japan's real estate boom heavily relied on debt financing from both commercial as well as private investors, and thus a boom in banking credit, the availability of financing heavily affected the Japanese RE sector.

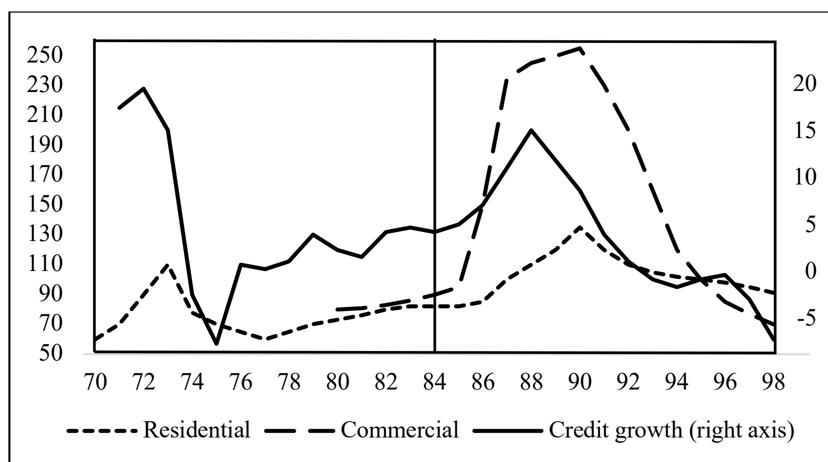
Fig. 4: Residential and Commercial Real Estate Prices in Japan




Source: (Hilbers et al., 2001)

High bank exposure to the RE sector, especially through loans and collateral to housing loan firms, also referred to as *jusen,* enabled the formation of the real estate bubble through excessive credit expansion (Hilbers et al., 2001). Between 1985 and 1991, an average of ten percent YoY increase in bank credit can be observed, while credit from non-financial institutions, especially through shadow banking increased by 18% yearly. Furthermore, direct exposure by banks to the RE sector increased from 13% to 18% of their total outstanding loans.

Fig. 5: Property Prices and Real Credit Growth in Japan




Source: (Hilbers et al., 2001)

What is additionally interesting to note is that credit growth reached its peak in 1988, two years prior to the real estate bubble burst, resulting from credit restrictions imposed by the Japanese MoF in 1989, which will be examined in the following section. Thus, one could argue that once there less credit available to finance real estate investments and the resulting rise in real estate prices, market reacted swiftly in the form of the bubble burst. Once real estate bubble burst, declining property values furthermore led to 75% of *jusen* loans becoming nonperforming, leading to their liquidation which, in case of Keiretsu group developers had to be mainly covered by their parent bank, whereas creditor banks had to cover losses from smaller commercial and private investors (Hilbers et al., 2001).

As mentioned in the first sphere of this analysis section, the construction industry contributed greatly to Japan's real estate bubble. The productivity of the industry alone enabled large-scale real estate developments be completed in record time, exemplified by the fact that even after the bubble burst, in 1994, 6,450,000 construction workers put in place USD 770 billion in construction in Japan, whereas 6,800,000 American construction workers only erected USD 507 billion in construction, resulting in an average productivity of USD 120,000 per construction worker in Japan as opposed to USD 75,000 per construction worker in the United States (NIST, 1996).

Considering that in 1994, the US population was more than twice the size of the Japanese population, the fact that the Japanese construction workforce was of similar size than its US counterpart shows the immense scale of the sector at that time. The ongoing innovation made within the industry led to continuous demand for newer and safer buildings during the bubble period and resulted in Japanese construction firms becoming the dominant industry player on a global scale. Still in 1993, 18 out of the 25 largest global construction contractors were Japanese, including ranks 1 to 6, and the sector contributed to 18.2% of the country's GDP in 1989.

While the construction industry benefitted from the RE sector's growth in the late 1980s, the burst of the bubble led to a recession within the construction industry. While the share of construction rose from 15.6% of Japan's GDP in 1985 to 18.2% in 1989, it noticeably dropped to 16.9 percent in 1994. In 1993, construction volume fell for the first time in the country's history, while construction company bankruptcies sharply increased by 68%.

Given that large Japanese RE developers are part of Keiretsu networks, one can argue that the scope of related and supporting industries extends even further than industries traditionally affiliated with the RE sector. The strategies of Keiretsu firms, to be analyzed in depth in the following section, heavy relied on leveraging its cross-shareholdings thus affecting the RE sector. For example, many of the 40 individual sub-companies of the Mitsubishi keiretsu, such as Mitsubishi Motors, Mitsubishi Heavy Industries, Mitsubishi Bank (now called MUFG) and Mitsubishi Electric were major players on their respective domestic and global markets and in turn affected Mitsubishi Estate's role on the RE sector through financing investments and creating demand for real estate developments.

Firm strategy, structure, and rivalry

The keiretsu nature of many of the large players in the Japanese RE sector makes it difficult to give a clear overview of market shares within Japan's RE sector, especially given that we are investigating historical data from the late 1980s. While only two out 204,700 Japanese RE companies are listed in the top 100 Nikkei companies by market capitalization in 1989, Mitsubishi Estate on rank 30 with a market cap of JPY 3.60 trillion, and Mitsui Fudosan real estate at JPY 2.15 trillion, the third largest, Sumitomo Realty & Development not being ranked, the Japanese RE sector is shared by various other large developers, which can be categorized as follows (TSE, 2015):

*Sub-Companies of traditional Zaibatsu-formed conglomerates* such as Mitsubishi Estate; Mitsubishi Estate Residence; Mitsui Fudosan; Mitsui Fudosan Residential; Sumitomo Realty & Development, and Tokyo Tatemono.

*Real estate divisions of railway companies* such as Tokyu Land; Keio Realty; Seibu Properties; Hankyu Real Estate; Kintetsu Real Estate, and Hanshin Real Estate.

*Real estate subsidiaries of manufacturers* such as Nippon Steel Real Estate; Kowa Real Estate and Asahi Kasei Homes.

*Real estate divisions of general contractors* such as Taisei Yuraku Real Estate; Shimizu Comprehensive Development; TAK Realty; Shinseiwa Real Estate.

*Financial RE companies* such as Heiwa Real Estate; Nomura Real Estate; Fuyo Comprehensive Development (today: Hulic); Central Japan Land and Building.

*Business-field specific RE companies* such as Mori Building; Mori Trust, Residence, Building Management; Daikyo; Sankei Building.

Given the amount of different types of RE developers present on the Japanese market, the fact that foreign firms have not played a significant role in the Japanese RE sector, and our case company being Mitsubishi estate, a firm of the first category, we are going to investigate the firm structure, strategy and rivalry of Keiretsu RE firms, many of which are part of the 'Major 7[1]', a group of Japan's seven largest RE developers, that in 2004, the earliest year for which data is available accounted for 28% of the real estate market in Japan.

These large RE developers all were part of Keiretsu networks; thus, their structure and strategy show similarities in that they shared information, distribution networks and financial facilities across all industries in which they had member companies (Silk & Kono, 1994). Land purchasing began to play a major role in many of Japan's corporations during the 1970s when the average private investor did not yet have the resources to purchase land. While corporations had the financial means necessary to purchase land, they did use some of it house their employees at subsidized rates. What set off the skyrocketing land purchases of the bubble period was easy availability of credit in the second half of the 1980s. Net purchases of land by the non-financial sector grew to JPY 28 trillion during 1985 to 1989, compared to just JPY 3 trillion in the five years prior to that.

The fact that also non-financial companies were heavily involved in real estate investment makes it difficult to assess the market shares in the sector as not only traditional RE firms such as the Major 7 were involved in the market. In fact, when analyzing the land component of major corporations taking into account assets such as land hidden in cross-held stocks, the scale of real estate investments for many non-financial Japanese companies becomes clear, exemplified by the case of Nippon Steel. The price-earnings ratio Japan's largest steel was 101.5 in 1988. Subtracting land, that ratio fell to 83.3, without buildings it was 74.3, and without cross holdings it was only 5.3 (Stone & Ziemba, 1993).

As land prices began to soar in the latter half of the 1980s, and money being almost free at interest rates of 2.5%, companies borrowed against their land and issued company bonds to cover debts. Once companies acquired new real estate, various factors contributed to them holding on to their investments long-term. Kenji Sato, a senior executive of Mitsubishi Estate states that the fact that

[1] Part of the Major 7 are: Mitsubishi Estate; Mitsui Fudosan; Sumitomo Realty & Development; Nomura Real Estate Development; Tokyu Land; Daikyo, and Tokyo Tatemono (Major 7, 2022).

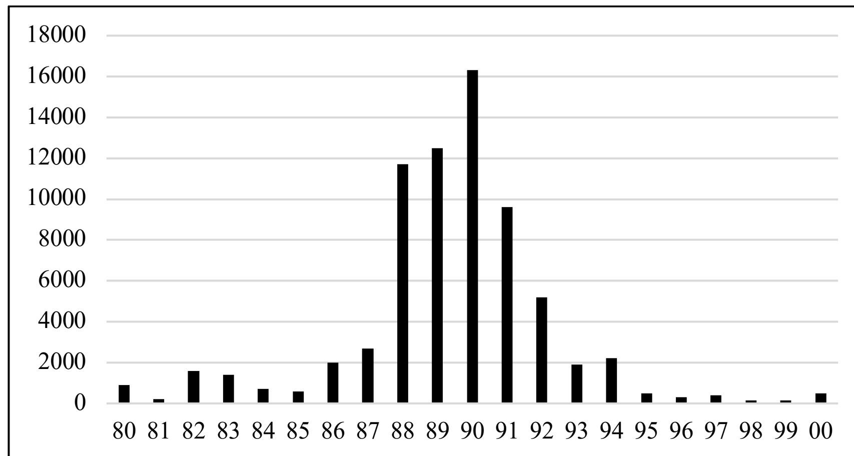
everyone believed that rent and property values would rise justified firms to hold on to property, so that they could not only enlarge their portfolio but also expect rising rental income (Sato, 2022). .Furthermore, purchases of foreign real estate by Japanese developers, such as the investments in the Rockefeller Center and the Pebble Beach Golf Club were less strategic in nature and have more of a "trophy tower" character. What further contributed to this development was the fact that the selling of corporate real estate was almost considered shameful for non-financial corporations at the time, as it created the impression that the corporate seller had financial issues (Touchstone Capital Management, 2022). So, to not negatively affect their image, Japanese corporate real estate investors hardly sold land and even if they did, it would be facilitated through confidential negotiated deals.

Even though land purchases rapidly grew, and construction volume increased, firms oftentimes did not develop the land, especially for residential projects as several factors made an underutilization of land more attractive to them. Even though Japan's high population density might suggest differently, even the Tokyo metropolitan area continued to host vast areas of idled land. While building codes allowed for an average volumetric ratio of 242% of land, only 40% of the authorized ratio was utilized in 1990 (Noguchi, 1990). Japan's land lease law, subject of the following section, made it difficult for property owners to evict tenants, even upon expiry of their lease. RE firms thus either kept much of their land vacant or simply turned it into parking lots while waiting for opportunities to sell at higher prices. This furthermore led to many developers keeping their buildings vacant to lease them at higher prices in the future as Nakajima-Magen (2022) stated:

> "What appreciates in Japan is always the land, it is never the structure […] They are buying them because they want to sit on that land, and they are hoping that they will be selling it at a profit." (Nakajima-Magen, Intvw. 3, 2022)

The rise in real estate investments was also noticeable in other developments than housing and commercial properties:

Fig. 6: Number of Resort Condominiums Built 1980-2000




Source: (Nichiguchi, 2020)

Potentially incentivized by the aforementioned booming golf club membership values, the Comprehensive Recreation Are Development Law, Resort Law for short, initiated a boom in resort developments during the late bubble years, exemplified by the extensive development of resort condominiums, many of which, being vacant or left unfinished, still represent the bubble building-mania today.

In addition to booming RE sector, the administrative guidance that the MoF and MITI 'offered' to Japan's large corporations further influenced Keiretsu corporations' strategies and rivalry. While Porter uses Japan as an example of having industries with double-digit direct rivals present, thus creating a competitive advantage, one could argue that argue that under guidance of Japanese ministries, general consensus would be a more applicable term in the Japanese keiretsu system than rivalry. This can be observed in various other industries as well, exemplified by the price-fixing arrangements made between Japanese manufacturers at the time. Similar to that, relational arrangements were made between large keiretsu conglomerates and their real estate subdivisions, and the cross-shareholdings came under international critique for being anti-competitive, as was suggested during the US-Japan Structural Impediments Initiative Talks in 1989 (Grabowiecki, 2006).

Government

Much of Japan’s government policy that affected the RE sector can be traced to the postwar focus on economic development, which even by the time Japan had become a developed economy, still carried on into the 1980s. Even some foreign accounts just before the burst of the bubble still noted the advantages of government control over the RE sector: “The (Japanese) property market isn’t really a market at all; it’s part of a carefully managed economy. And because government controls are so firm, what looks like a house of cards is actually a house of bricks, an economy set in concrete.” Woodhull (1991, as cited in Ziemba & Schwartz, 1991, p. 189).

In fact, the extent of influence that the Japanese government has on the overall RE sector resembles more the workings of an authoritarian state, exemplified by the 1972 National Land Use Planning Act covering “nearly the entire use of national land” (Molotch & Vicari, 1988, p. 193). An example for the centralist planning nature can be found in the transformation of the Oita region, from an agricultural mushroom producing center in the 1960s to steel and petrochemical-heavy industrial zone, even against the opposition of local businesses. “Given the context of state power […], local businessmen felt themselves too weak to be relevant. The national government was virtually never thwarted in its policies, and the huge conglomerates had long been accepted as quasi-public agencies […]” (Molotch & Vicari, 1988, p. 195). What further exemplified the government’s control of real estate was its series of 5-year housing plans between 1966 and 2005, aimed at encouraging housing construction and home ownership through long-term, low interest mortgages for which it established the Government Housing Loan Corporation (Yoshida, 2021).

Japan’s centralist planning both on a domestic and international, export-led level was a result of policies formulated by the “Iron Triangle” of conservative LDP politicians, senior bureaucrats, and business leaders (Silk & Kono, 1994). This coalition of policy makers and corporations under the guidance of the MITI led to an enormous trade surplus that Japan had with other nations, especially the United States. If one looks for foreign accounts of the time as to how this trade surplus came about, the answers are usually a combination of the following factors: “A governmentally fortified economy, a very high national savings rate, strong pressures to hold down labor costs, a narrow-minded economic nationalism, inaccessible markets, a convoluted distribution system, an entrenched bureaucracy, a long-undervalued yen, a mass of regulations that inhibit imports and foreign investments, and corrupt money politics.” (Silk & Kono, 1994, p. 116).

While foreign policymakers were not able to change most of these factors, many voiced the desire for an appreciation of the undervalued yen during the 1980s. In fact, much of Japan's export leadership role was due to the low yen exchange rate. On September 22, 1985, the finance ministers of Germany, France, the United Kingdom, the United States and Japan, having agreed appreciation of the non-dollar currencies is necessary, signed the Plaza Accord. As a result, the yen appreciated extensively, amounting to 46% against the US dollar, from USD 1 buying JPY 240 in August 1985 to USD 1 buying JPY 150 in mid-1986, triggering Japan's export and GDP growth to halt in the first half of 1986 (IMF, 2011).

To not lose its competitive advantage, now that Japanese goods were less affordable abroad, the Bank of Japan, the extended arm of MoF, lowered its discount rate five times between January 1986 and February 1987, from five to 2.5%, the resulting surfeit of money then led to increased land speculation, mainly based on debt financing. While this was not the first time that the Bank of Japan had used low interest rates to stimulate the economy[2], it had now set its discount rate to a historic low.

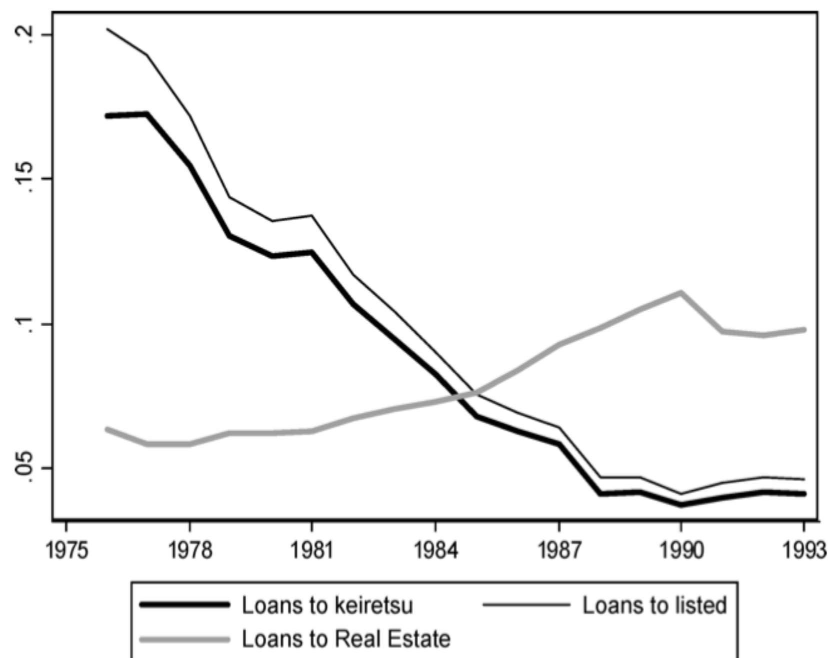
What furthermore contributed to rising land prices and speculation was Japan's low effective property tax rate. While it stood at 0.1% of the land's market price in the early 1980s, the government not raising valuations according to the climbing real estate prices led to the tax liability of owning land in Tokyo falling to negligible amounts of 0.05% (Noguchi, 1990).

In addition, Japan's tenant friendly Land Lease Law strengthened speculation. As landlords were not able to evict tenants or lessees "without due justifiable cause", a term only narrowly interpreted by the courts, they stopped leasing their holdings (Noguchi, 1990, p. 81). "To them, leasing is tantamount to selling the land at a deep discount." (Noguchi, 1990, p. 81) Instead, expecting large capital gains from the booming real estate values, they held on to their land, which, given the low property taxes, was not creating serious liabilities, a practice also described by two of our interviewees in the previous section.

[2] The Bank of Japan had lowered discount rates as a result of the Second Oil Shock of 1979, however, utilizing Window Guidance, an instrument used by the Bank of Japan to create credit in strategic industrial sectors, resembling the administrative guidance performed by the MITI, investments were directed toward research and development as opposed to real estate as it happened during the bubble period (Schasfoort, 2021).

While rising land prices have turn contributed to increased real estate-related lending by Japan's banks, the government's general liberalization of the Japanese financial system throughout the 1980s serves as another factor that contributed to the real estate bubble. Since 1980, fund-raising by major firms had been liberalized while banks were only gradually able to enter the securities business (Shiratsuka, 2003). What this liberalization set in place was reduction in corporate borrowing from banks, which firms financed by issuing bonds. The resulting rise of the corporate bond market caused a decline in demand for bank loans, which in turn led to increased bank real estate.

Fig. 7: Keiretsu loans, loans to listed firms, and loans to the RE sector by banks (as a share of total loans, all banks, average)




Source: (Mora, 2008)

In fact, banks heavily extended loans to small- and medium-sized enterprises against real-estate collaterals, while increasing the amount real estate related loans at minimum interest rates. Various accounts of the time and in the years that followed the bubble further argue that it was in the MoF's interest to keep real estate prices rising, with taxation and regulation being biased towards an acceleration of the rise in land prices, as it would have had various instruments, such as Window guidance, to reduce land price growth during the bubble period (Shiratsuka, 2003; Stone & Ziemba, 1993). While the stiumlation of domestic demand was certainly one of the objectives of the low interest rate policy, social factors further contributed to bubble reaching out further:

> "Stimulating domestic consumption could not have come at a worse time for the Japanese economy. It occurred just when purchasing power and lifestyles were shifting rapidly from a consumption-shy older generation, still scarred by wartime and postwar deprivations, to the "yuppies" of the "baby boom." The government policy thus kicked off the biggest spending spree in economic history. It also ignited a speculative firestorm in real estate and stock prices."
>
> - (Drucker, 1993, p. 12)

With real estate prices further inflating and real estate-related loans reaching JYP 200 trillion in March 1989, more than half of the country's GDP, the Bank of Japan ended its policy of monetary easing on May 30th, 1989, a month after the government introduced a 3% consumption tax, by tightening its discount rate from 2.5% to 3.25% and within a year to 6% (Jinushi, Kuroki, & Miyao, 2000). In order to decelerate the rising real estate prices, the MoF introduced various restrictions on lending to the RE sector such as limiting the growth rate of real estate loans to the growth rate of total loans, however this did not include non-financial firms. After the Nikkei Index began to fall in 1990, land prices followed a year later, however the Bank of Japan kept its lending restrictions in place. With real estate prices falling by two thirds of their value and land collaterals becoming near useless, more and more Jusen loans became non-performing (Nishiguchi, 2020). Over the course of the lost decade, various large-scale firms that financed housing through mortgages ended up bankrupt.

The MoF's involvement even reached to the point where, once the bubble had burst and Keiretsu banks began to accumulate bad debt from their real estate holdings, it would not allow the companies to make their debt public, instead moving it to specified debt accounts, to avoid public unrest (BBC, 2000). Japanese banks that therefore attempted to conceal their debts in turn set off the rise of another peculiarity of the Japanese corporate landscape at the time, corporate racketeers (*Sōkaiya),* often associated with the Yakuza. In public company meetings, directors evade difficult debt-related questions from the public by simply having a *Sōkaiya* shout over them. Even when laws were put in place to end this practice by introducing a minimum number of holdings of JPY 50,000 necessary to access shareholder meetings, Yakuza involvement in various Keiretsu conglomerates simply made it possible for them to buy the adequate amount of company stock beforehand, to gain access to meetings. It can therefore be argued that, under the guidance of the several Japanese ministries, the concealing of bad debt was part of most Keiretsu conglomerates once the bubble had burst.

Chance events

While Porter defines significant changes in exchange rates, such as the yen's appreciation due to the aforementioned Plaza Accord as chance events, we have covered the results of said accord in the previous section as the G5 member states, including Japan agreed to the accord and thus expected the appreciation of the yen. Therefore, we are only analyzing the effect of unforeseen events such as natural disasters and the stock market crash of 1987 on the Japanese RE sector during the bubble years in this section.

As mentioned before, the fact that Japan is one of the most seismic active regions on earth leads to the country experiencing earthquakes frequently. However, besides the risk they pose, they also present a competitive advantage for the Japanese RE sector, especially the construction industry. Sophistication of demand in terms of earthquake resilience is high as both private and commercial buyers demand modern and safe housing. The continuous technological progress in earthquake safety and short building times further meant that built property, especially in prime locations would be torn down and rebuilt in cadences unthinkable elsewhere. The average lifespan of residential housing in Japan is only 32 years compared to 67 years in the US and 81 years in the UK (The Nikkei Shimbun, 2013)

However, the Kobe earthquake that occurred on January 17, 1995 has led Japanese people to question the country's earthquake proofing as the earthquake with a magnitude of 7.2 on the Richter scale killed over 5,000 people, damaged 400,000 buildings with a damage exceeding USD 150 billion. Not only were the regulations that MoC set in place criticized as they mainly concerned new buildings while older structures were not retrofitted, but the slow and ineffective response of MoC, having lead responsibility in disaster recovery, extended the rebuilding works (NIST, 1996). The government's tardy response further contributed to stock prices suffering their heaviest one-day loss since the burst of the bubble, with the Nikkei falling 5.6%

An interesting anomaly in terms of chance events was the 1987 global stock market crash (better known as the 'Black Monday' and its effect on the Japanese RE sector as it fortified the low interest rate policy of the MoF (BBC, 2000). Sustaining consumer spending and not creating a panic that could lead to recession took a higher priority than possible bubble formations at the time, thus contributing to the building of the real estate bubble in the years that followed.

## The Chinese real estate market

Factor conditions

China, being the world's third largest country by land mass and fourth largest by arable land is home a highly diverse geographical landscape, (Chiu, 2020). Furthermore, given the diverse climate zones, China has historically been subject to earthquakes, droughts, floods, typhoons, tsunamis, and sandstorms. Because of these regional environmental differences, the population density varies greatly, from highly populated coastlines in its eastern third to the less populated central and western regions. Historical changes in China's territories furthermore resulted in a high number of land disputes with its neighboring countries, most noticeably Taiwan and Tibet (The Week, 2022).

China experienced a decline in the number of people living in one household from 3.5 in 1990 to 2.87 in 2011 (Textor, 2022). Less people living in the same household meant that demand for housing increased. However, while it used to sustain demand, these numbers have been stable between 2.87 and 3.17 since then. Other demographic trends therefore present a decrease in the formation of new households and thus overall demand, and the long-term challenges resulting from an aging population, are starting to show (Rogoff & Yang, 2020). The number of people between 20 and 50 years old is declining, however, the removal of the one child policy will not have any positive effect on demand, as increasing living costs, including cost of childcare and education, are affecting people's willingness to have children (Jung, 2022).. This is also illustrated in the declining birth rate, where the number of children born has decreased gradually from 17.86 million in 2016 to 10.62 million in 2021 (Textor, 2022).

China's population density and urbanization rate have further been affected by the *Hukou* (户口) system, a household registration system, through which people living in a specific area are identified to allow the government to gather information on demographics (Masuda-Farkas, 2021). The Hukou system has been described as facilitating similarities to the Indian caste system, making it difficult for people born in rural areas to change their residence to an urban Hukou, as every case is presented to local officials, which party base their approval on wealth or education, the latter oftentimes being difficult to access in rural areas, limiting domestic migration. Even though the CCP announced its intention to grant permanent residency rights for approximately 100 million rural immigrants working in small and mid-sized cities, the decision-making power still resides with the local governments (Sieg, Yoon, & Zhang, 2020).

Although experiencing a slowdown in recent years, China's continuous urbanization in the past decades commanded a high demand for new infrastructure developments (Textor, 2022). The Chinese RE sector has especially benefited from extensive infrastructure developments in the past three decades, in the form of road, rail, water and air transport improvements that have cut travel and transportation times between urban centers and rural areas extensively (Hahn, 2015). The improvement of Chinese infrastructure continues to increase the attractiveness of developing real estate in a broader variety of areas, potentially resulting in the population not necessarily having to move to its eastern and southeastern urban centers that are home to the majority of China's industry and commerce as is still the case now.

The extensive improvement of China's internal infrastructure since the 1990s is illustrated by the development of its road system, with the total length of highways increasing nearly three-fold from 50,127 kilometers in 2000 to 142,983 kilometers in 2013, and the length regional roads increasing by 21% (Egger, Loumeau, & Loumeau, 2020). Inspired by the success of bullet train services in other nations such as Japan, an extensive high speed railway system has been developed. Today, at a total length of 37,900 kilometers, China is home to the world's longest high-speed rail network, all of which has been completed since just 2008 (Jones, 2022). Already far longer than other such networks, with the second largest only ranging at a tenth of the length, the Chinese high-speed railway system is further expected to double in length to a total of 70,000 km by 2035.

Additionally, 20,141 kilometers of standard railway lines have been completed between 2000 and 2013. This resulted in a cut in travel time by 50% for people and 13% for goods. For example, the Beijing-Shanghai high-speed railway which opened in 2011, has cut down travel times between the two cities from 9 hours and 49 minutes to just 4 hours and 18 minutes (Xinhua, 2022). As roads and railway systems improve, remote areas connect to larger cities, mobility increases, which thus facilitates lower cost of goods while, the productivity that comes from improved connectivity between urban and rural areas will in term affect the efficiency of real estate construction, allowing for easier transport of building materials and personnel.

Besides physical infrastructure, Allan von Mehren furthermore notes the importance of other long-term investments in addition to "building only bridges and all these things" (von Mehren, 2022). One example is China's countrywide 5G network implementation. Currently, the 1.425 million 5G base

stations support 5G connectivity for over 500 million people, with the target for the end of 2022 being two million base stations in total, further improving interconnectivity of Chinese cities (Deng, 2022).

As of 2020, 2.9 million people are employed in the Chinese RE sector, representing a steady increase from 2.1 million in 2008, although a decline of 400,000 has been noted from 2019 to 2020 (Zhang, 2022). It is furthermore apparent that there are challenges within the RE sector in terms of human resources, in areas such as skill, training, quality and cost of employees. Alongside the financial sector and internet-related industries, the RE sector is still positioned among China's highest paying industries (Ma, 2021). Excluding sales agencies and properties, the average salary in the RE sector in 2020 among 46 different Chinese cities is estimated to be 1.7 times higher than the average salary in these cities of RMB 14,000 to RMB 15,000. The high average wage within the sector provides a competitive advantage as it ensures attracting skilled talent.

The bubble formation within the RE sector has become especially apparent since 2017, with companies announcing RMB 100 to 300 billion targets, fostering high expansions throughout China and the extensive establishment of regional headquarters of firms within the sector (Ma, 2021). The chairman of Taihe, Huang Qisen stated that "The RMB 100 billion real estate enterprises are more (a product) of the booming Chinese economy. We have caught up with the dividends. There is a bubble in real estate, and the biggest bubble is in talent. This thing is the hero of the times." (Ma, 2021). Companies went out of their way to hire renowned presidents and CFOs across the sector, which increased the overall quality and skill level of top management in the industry as well.

However, as government regulations increased in light of a bubble formation, favorable industry conditions have worsened both for employees and developers. Especially the 'Three Red Lines' Policy (TRL) instated by the government in August 2020 with the purpose of improving the financial state of the RE sector, by reducing the degree of leverage and increasing debt coverage and liquidity, had a significant impact on the sector. (EAC, n.d.).

Table 4: The Three Red Lines Policy

| The 'three red lines' policy | |
|---|---|
| **Metrics of the guidelines** | |
| 1) 70% ceiling on the debt-to-asset ratio after excluding advance receipts | |
| 2) 100% cap on the net debt ratio | |
| 3) 100% cap on the short-term debt/cash ratio | |
| **No. of lines violated:** | **Debt growth permitted** |
| 0 | 15% |
| 1 | 10% |
| 2 | 5% |
| 3 | 0% |

Source: Media reports, SG Cross Assets Research/Economics

Source: (SG Cross Assets Research/Economics, n.d.)

The policy requires RE developers to meet specific criteria, including an asset liability ratio of no greater than 70%, a net debt ratio of no more than 100% and a cash to short-term debt ratio of one or below. RE developers face borrowing restrictions if they cross these lines. More specifically, if no lines are crossed, the developer can increase its debt by up to 15% in the following year, whereas crossing one line would limit additional debt to 10%, two lines to 5% and all three lines to zero result in no further debt financing to be conducted. Respectively, the companies are categorized into the colors green, yellow orange, or red, depending on the number of lines they crossed (See Table 4). The latter has been the case for Evergrande, as they crossed all three lines, and defaulted with a debt of USD 300 billion (Cheng, 2021)

This, alongside other regulations, has resulted in many developers and personnel leaving the RE sector to pursue a career in what they consider to be a more stable industry, despite potential compromises in salaries (Ma, 2021). To illustrate this phenomenon, 20% of the 130,000 employees of the RE developer Vanke left the company from late 2020 to late 2021. Other companies similarly report a drop of 30% in the same period.

Moreover, even though salaries in the sector continue to range among the top of China's industries, a recent decline in salary levels has been observed (Ma, 2021). Crane Research Center reported a narrowing of the salary growth rate for the third year in a row, just as, "In 2020, the per capita salary has declined for the first time, with a 50-point value of RMB 183,000 per year.

China has been utilizing the construction sector to stimulate the economy and drive economic growth and has proven to be highly efficient timewise in constructing new buildings. Using high-tech construction methods, the 33,900 square meters large *Huoshenshan* hospital was built in just ten days in light of the COVID 19 pandemic, bringing about extensive foreign media (Xiao, 2020). This example shows that beside facilitating the scientific knowhow to do so, the Chinese government possesses the ability to mobilize the sector for critical projects to an intense degree.

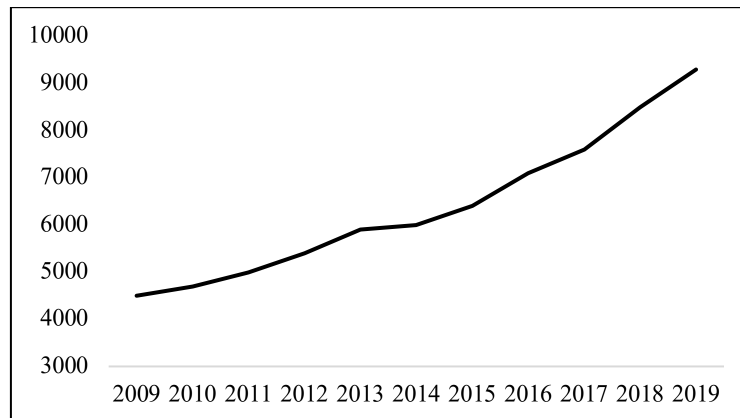
The Chinese construction industry furthermore facilitates the use of innovative digital technology, such as the Internet of Things (IoT) and Building Information Modeling (BIM) (Zhang, 2019). These technologies allow construction firms to be better analyze, plan, design, construct, and manage buildings and infrastructure, thus improving overall efficiency.

However, reports of poor working conditions in the construction industry, especially in housing construction, and the aforementioned knowhow arguably not being present at all levels of employment are common. Wei and Zhe (2014) argue that the construction of buildings is conducted in adherence to only low standards, using poor building material, such as adulterated cement and poor-quality steel. Oftentimes, is not the result of a lack of knowhow, but rather a calculated strategy for contractors to guarantee the bottom line, and since government expresses its desire for rapid construction, these unfavorable conditions are often overlooked (Zhe & Wei, 2014).

Demand conditions

Recent years have seen the continuous surge in Chinese property prices, most notably in the larger cities of the country. For example, in Tianjin, a city with a population of 15 million, located approximately 120 kilometers from Beijing, the price per square foot ranges at USD 836, similar to the most expensive area in London (Lei, 2021). However, London's average household income is approximately six times higher than that of Tianjin. Showing a similar pattern, New York property prices average nine annual incomes, whereas the ratio has grown to 55 times the annual per capita income in Beijing, Shanghai ranging close to that at 46 annual incomes.

Fig. 8: Average Real Estate Sales Price RMB/Square Meter




Source: (Jaghory, 2021)

Despite high prices, home ownership rate in 2018 was 89.68%, thus indicating that there is a high demand for properties being developed (Trading Economics, n.d.). However, due to the high prices of property, it is doubtful that 9 out of 10 Chinese people can afford to buy property, yet there is still demand enough for them to be bought. In fact, a study in 2020 of 30 Chinese cities showed that the average house-price to annual income rate was at 7.2 for formal private housing, which is significantly higher than the affordability (Sun L. , 2020).

Migrant workers and graduate students are among those who have the desire to buy property but lack the financial means to do so. Jason Hsu states that unaffordability calculated through average household income is a common issue among developed countries in Asia and supports the notion this is the case in tier one cities in China as well. The reason for this is that certain groups owning a larger percentage of the available real estate. Over 30% of urban Chinese households own two properties, over 10% own three properties, and in urban China, the average household ownership ranges at 1.5 properties (Lei, 2021).

China is notorious for its high number of empty buildings and uninhabited developments around the country, which are often described as ghost cities. This could indicate that there is no demand for property. However, Jason Hsu disagrees:

> "In China these days, if you build a new development, you have to enter a lottery to buy it. So, it's empty not because it's not sold. It's empty because it's not lived in. People buy them

> and they simply own empty apartments. So why would someone own an empty apartment? Well, that's because they bought it mostly on cash. So, they don't have a mortgage or carry cost and they don't rent their apartment out."
>
> - (Jason Hsu, Intvw. 5, 2022)

In contrast, vacancy rates that are significantly above five percent usually signify low market conditions and low land-use efficiency (Tan & Wei, 2020). In China, the vacancy rate in tier one cities ranged at 16.8%, whereas it was at 22.2% in second tier cities and 21.8% in third tier cities. However, there is a lack of data in this area, and according to Lei (2021), some sources estimate that China has excess capacity for 1.4 billion people, or another entire Chinese population, which would be equal to a 40 to 50% vacancy rate, and further argue that a officially reported vacancy rate of 20% would be an underestimated figure. Similarly, Pan Shiyi, the founder of Soho China, a large RE company in China, estimated that there were more than 130 million empty housing units. Therefore, while the high demand contributes to the competitive advantage of the sector's demand conditions, the high vacancy rate arguably poses a threat to it. Allan von Mehren sees the high vacancy rate as challenge in the longer run and argues that "People are not going to have two homes forever. Eventually there is going to be a decline in demand based on that"

One of the reasons for the high vacancy rate lies in bad planning in some cities, where construction was supply-driven and not demand-pulled (Hsu, 2022). This means that developers have built property before ensuring proper demand. A reason for why owners do not rent out their apartments, especially in the case of luxury apartments in tier one cities such as Shanghai and Beijing, which thus contributes to further vacancy is the social stigma associated with renting out property. "It would be like if you bought a masterpiece Picasso and you rent it out to get income" (Hsu, Intvw. 5, 2022). Buying property in trophy developments can therefore be seen as a status symbol rather than a practical investment.

Another key driver for the high demand roots in cultural factors. Jason Hsu argues that there is a stigma around not owning real estate: "Owning real estate is almost an indication of one's character. If you're a young person and you haven't worked hard enough, saved enough to afford real estate, then there's something wrong with you. Either you spend way too much, and you don't know how to

save so you're not a responsible young person, or you don't make enough, which means you're not a talented and capable person."

Moreover, as China faces an imbalance in the men-women ratio of now 111 males to every 100 females, it is common that parents buy apartments for their sons to increase their chances of getting married (von Mehren, Intvw. 4, 2022). By owning real estate, they are investing in a storage of value, which, as Hsu (2022) puts it, helps them obtain the 'Mother-in-law premium', meaning that a potential wife's family will be more accepting of a husband with real estate possessions in favorable school districts. The skewed gender ratio is a result of the former one-child policy, which restricted people from having more than one child, although modifications allowed people living in rural areas to have a second child if the first one was a daughter.

As a result of the above-mentioned factors, many people own two apartments, with one standing empty as an investment opportunity, and choose not to rent property despite it being a cheaper option (Hsu, Intvw. 5, 2022; von Mehren, Intvw. 4, 2022). Despite comparably inexpensive rent cost, the aforementioned study of 30 Chinese cities found that the rent-to-monthly household income ratio was 34%, which according to Sun (2020) is significantly higher than the value of affordability.

Furthermore, it is important to consider the demand of purchasing land from the developers' perspective as this drives the supply needed to respond to the high demand. This is naturally highly influenced by demand of house owners, as high prices caused by this in turn will benefit developers. One can argue that continuously high prices will cause the demand to purchase land for development to rise as well. The demand for land increased heavily in 2020, illustrated by the income of land use rights for local governments of RMB 8.41 trillion, representing an increase from RMB 3.84 trillion n 2016 (Textor, 2022). However, following recently tightened government regulations on borrowing for private developers, land sales fell 17.5% in August 2021 compared to the previous year, with 40% of plots on offer from June to October 2021 having no bidders (Woo & Gao, 2021). This can in turn have consequences for local governments, as they have become highly dependent on land sales. Generally speaking, "The problem in the development sector is hitting land sales and that is hitting the local government's ability to actually stimulate the economy." (von Mehren, 2022).

One of the reasons for why it has been difficult for the government to ensure a proper supply to the strong demand of homeowners is the fact that many developers follow the 'Hong Kong Model', meaning that they have taken on debt to buy land, but are not developing said land. Instead, they attempt to corner the market and slowly release development to increase prices (Hsu, 2022). This has consequently created an imbalance between supply and demand in the market. With the Chinese population becoming wealthier, higher demand of quality housing and higher urbanization in general has put pressure on developers to improve the quality of properties (Hsu, 2022). However, the high level of demand itself can arguably also result in developers not improving on the quality of properties, since they know that what they build will be sold regardless, ultimately lowering the competitive advantage of the sector.

<u>Related and supporting industries:</u>

To the RE sector, the closely related banking ensures the access to loans and credit and leverage. The lending interest rate has In China was at 5.8% in 2000 and has varied up until 2015, before stabilizing at 4.3% until 2021 (The World Bank, 2022). In China, banks provide a significant number of loans to RE developers, besides providing mortgage loans (Zhang et al., 2016). Zhang et al. (2016) reports that "There is clear evidence that commercial banks in China, especially regional commercial banks, have lent significantly to the real estate sector." (Zhang et al., 2016, p. 1). The regional commercial banking system has been expanding substantially, and among the top five commercial banks, not including construction sector loans, the share of real estate-related loans that they provide amounted to largest proportion of all loans in four out of said five banks.

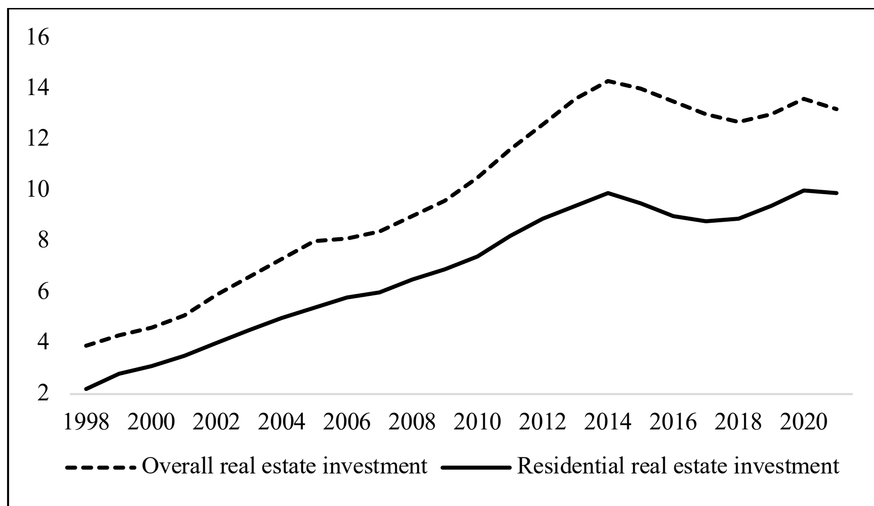
Chinese banks have incentive to lend to RE developers due to the continuous high rises in price and demand. This can be illustrated in the development of average real estate sales price of residential real estate in China between 2010 and 2020 (Wenyi, 2022). In 2010, the average sales price was at RMB 4,725 per square meter, steadily increasing until 2020, reaching RMB 6,473 in 2015 and RMB 9,980 per square meter in 2020. During market expansion, profits are high for developers, and it is not difficult for them to pay back the banks, which in turn increases the quality of the loan.

However, similarly, as market conditions worsened in some cases, developers were not able to ensure profits equal to the initial investment, and as a result the quality of loans decreases to the point where they became non-performing (Zhang et al., 2016). For years, high leverage from banks has funded

the RE sector, and in turn supported the growth of the nation (Lin et al., 2021). Following the implementation of the TRL Policy, in October 2021, it was reported that 14 RE developers had already crossed at least one of these lines, resulting in them not being able to raise new debt and facing the risk of defaulting. However, thus is not the case because the banks are not willing to finance them further. In the case of Evergrande, Jason Hsu argues that banks have financed their real estate before and would be willing to do so again.

Despite the government's recent restrictions and Xi's statement that "housing is for living in and not for speculation," the share of real estate loans in the banking sector has continued to rise, accounting for 27% of total RMB advances compared to less than 20% in 2012, according to the People's Bank of China. However, even Guo Shuqing, chairman of the China Banking and Insurance Regulatory Commission considers these figures to be underestimated, as he wrote last year property-related loans account for closer to 39%, or RMB 70 trillion (Brooker, 2021).

Fig. 9: Share of Real Estate Investment of GDP (%)




Source: (ECB, 2022)

In the past decade, the shadow banking sector has become an increasingly large issue in the Chinese banking sector, especially in relation to the RE sector, and according to Wright (2022), shadow banking especially expanded in proportion to the real estate bubble formation from 2012 to 2016 (Wright, Intvw. 2, 2022). Even though the banking sector is moving towards a more privately owned structure, it is still dominated by large state-owned banks and commercial banks that possess a hybrid ownership structure (Yeung, 2021). However, it is perceived that there is a lending bias towards

private enterprises, and that banks prefer to lend to SOEs as opposed to private developers, both due to aligning objectives with the government as well as SOEs being safer investments (Slotta, 2021).

As a result, state-owned RE companies achieve favorable agreements with banks, whereas it has been more difficult for privately-owned RE companies to access credit (Yeung, 2021).
Jason Hsu sees the reason for increased shadow banking activities in the fact that "the government was so fixated on controlling the credit available to the RE sector for developers, not homeowners, to acquire land and construct housing to meet demand. The only way for them to do so was to go through shadow banking to finance real estate development" (Hsu, Intvw. 5, 2022).

However, the Chinese government attempted to limit the extent of shadow banking through a deleveraging campaign in 2017, introducing new rules to regulate the asset management industry as well as changes to rules of liquidity management and restrictions on micro-lending and low-rated insurers (Reuters, 2017). As a result, RE developers now primarily rely on preconstruction sales and receive the credit that they would otherwise get from shadow banks from home buyers instead.

In addition to the banking sector, the construction industry is associated closely with the RE sector and its importance is illustrated by a market size of USD 3.3 trillion in 2015 (Statista, 2022). It is expected to grow with a YoY average of 8.6% from 2022 to 2030 (International Trade Administration, 2022). However, it is also a substantially leveraged industry, further influenced by an aging population and recently stagnating economy. Nevertheless, in 2020, the market value of the industry reached USD 1,049.19 billion, representing a 17% increase from USD 893.58 billion in 2018 (Wenyi, 2022). The value of construction output equaled 25.9% of China's GDP in 2020 (Ibisworld, 2021)

Labor productivity in RMB per person in the construction industry has additionally increased significantly since 2010. (Wenyi, 2022). From RMB 203,962 per person in 2010, it increased steadily to 324,026 in 2015, before reaching 422,898 in 2020. This increased productivity is partly due to improved machinery and tools. Access to modern construction technologies partly has been enabled through Chinese companies buying foreign companies and their technical knowhow. The growth of the construction industry further resulted in a sharp increase in people employed in the sector, with 41.6 million people working in construction in 2010, to 50.94 million in 2015 and 53.67 million in 2020 (Wenyi, 2022).

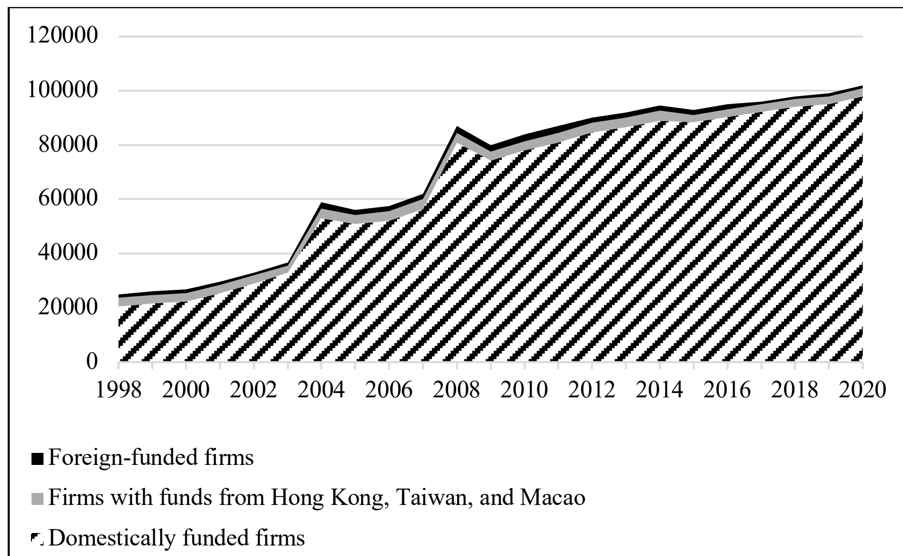
Additionally, the rise of the construction industry reflects a more general development in the Chinese society, related to migration, urbanization, and precarious labor. Sarah Swider (2015) observed that over 90% of field construction workers are migrants, most of which are unregistered. Because they are hired informally, they have little to no influence on working conditions, posing a serious risk within an industry that is known for dangerous conditions and limited access to proper care (Swider, 2015). While inexpensive labor such as migrant workers arguably played a part in the rapid construction and overall economic development of China, it raises many ethical and humanitarian concerns for migrant workers. Furthermore, given the rising living standards and wage level among the entire Chinese population, one can question the long-term consistency and growth within the industry, especially in light of global media attention.

Poor-quality construction further decreases demand as increasingly sophisticated homebuyers are less willing to put up with said standards, amplified by high expectations to safety in certain regions that are prone to natural disasters. These factors put pressure on developers and contractors to improve the quality of construction, which consequently will improve the competitive advantage of both the construction industry and RE sector.

Strategy, structure and rivalry

Strategies among Chinese RE developers differ due to the diverse structure of the sector, consisting of private enterprises (PEs) and SOEs. Furthermore, the increasing amount of RE developers present on the Chinese market, having risen from 85,215 firms in 2010 to 103,262 in 2020 has added to the competitiveness within the sector. Foreign capital-funded firms, mainly originating from Taiwan, Hongkong or Macao, only accounted for a small market share of under 4%, representing a sharp decline from 18% in 1998 (Apostolou, Al-Haschimi, & Ricci, 2022). Given the dominance of domestic PEs and SOEs, in this section, we are focusing on the strategy, structure, and rivalry of these key players in the Chinese real estate market.

Fig. 10: Number of Chinese property developers (units)




Source: (ECB, 2022)

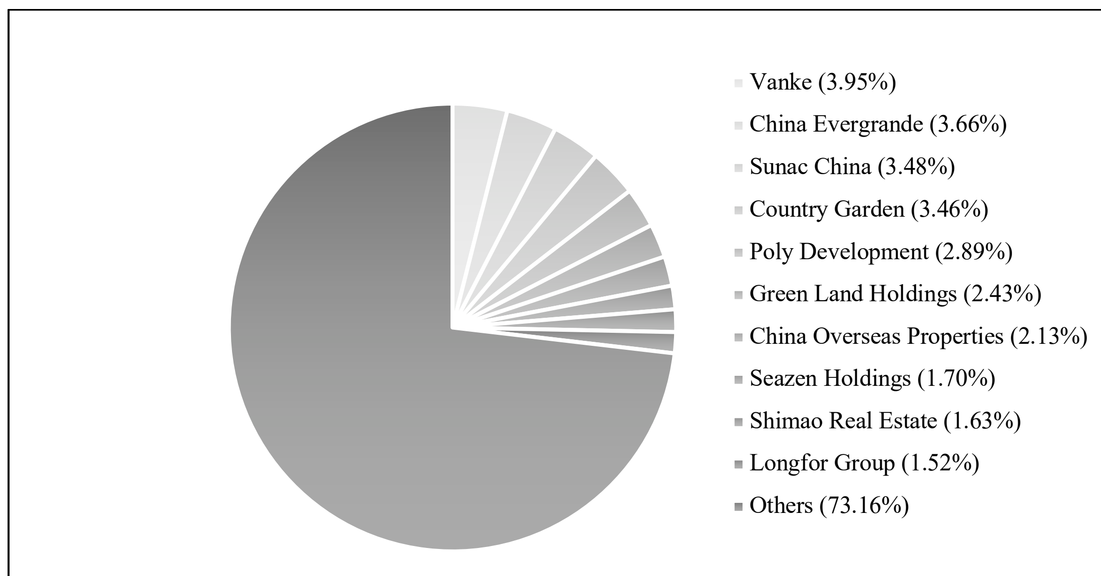
Despite the large size of the sector, only three dedicated RE developers are listed among the top 100 firms in terms of market capitalization. As of May 3rd 2022, Vanke is ranked 50 with a market capitalization of USD 34.16 billion, Longfor Group is ranked 55 at USD 31.31 billion market cap, whereas Country Garden is ranked 89 with a USD 16.13 billion market capitalization (MC) (CMC, 2022). It is interesting to note that during the time of writing this thesis, the crisis that the Chinese RE sector is in, was strongly reflected by downward developments in their MCs. Just nine days after our initial observation of said firms' figures, as of May 12th, 2022, Vanke dropped two ranks, loosing 11% in value, Longfor has moved up one rank, however losing 9.5% in value. Most notably, Country Garden dropped by eleven ranks, to last rank of the top 100, having lost 25% in value (CMC, 2022). This reflects a longer downward trend: During 2021, Vanke has lost 29.8% of its MC, Longfor dropped by 18.8%, and Country garden lost 32.3% in MC (CMC, 2022).

The Chinese real estate market is subject to increasingly fierce competition, partly caused by the increase in real estate prices over the past years (Chen, 2020). The competitive landscape in the industry is highly concentrated, with the top 100 Chinese RE companies accounting for a total market share based on sales of 72% in 2019, compared to 40% in 2015 (Deloitte, 2020).

Similarly, the market share based on sales of top 10% of companies in China accounted for 26.84% in 2019, as illustrated in the diagram below (Zheng, 2020). The largest players in the Chinese RE

sector in 2019 was Vanke at a 3.95% market share, equal to RMB 630.84 billion in annual sales, followed by as Evergrande with a 3.66% market share, and sales of RMB584.63 billion and Sunac China at 3.48%, equal to RMB 556.21 billion in sales. The similarity in the top developers' market shares and sales figures arguably contributes to the high levels of competition within the industry. Consequently, firms are forced to be more innovative to gain a competitive advantage, thus further improving the overall competitiveness of the sector.

Fig. 11: Largest Chinese RE developers by % of total sales in 2019




Source: (Zheng, 2020)

SOEs in the RE sector can achieve favorable agreements in terms of low-cost financing and tax incentives, and they "often possess large scale banking and have favorable consumer preferences." (Wang, 2021, p. 15). Among the top 30 developers, SOEs own assets worth RMB 6.2 trillion, equal to 48% of the market, whereas Pes account for the remaining 52% assets, which signals high competition between SOEs and PEs (Reuters, 2022). Following recent restrictions on lending, such as the TRL policy, because of which several large RE developers already defaulted, SOEs arguably remain in a favorable position as they are financially protected by the government. Moreover, in an attempt from the government to stabilize a leveraged industry and ensure asset disposal for distressed firms, SOEs are starting to acquire assets in said distressed companies, which in turn could improve their position in the market and thus give them a competitive advantage. Von Mehren (2022) describes it as a crucial measure that other developers take over unfinished projects from defaulted developers, to add to the financial safety of investors.

However, there are challenges associated with being an SOE as well, which explains part of why there are equal competition between PEs and SOEs. According to Wang and Just (2021), the political connection related to being an SOE can lead to operational inefficiencies and a lack of performance incentives. For example, the government may affect the prioritization of projects, putting tasks with administrative of social aims ahead of others, and intervene in executive meetings (Wang, 2021). This in turn affects the strategy of these companies as well. Moreover, considering that is common in China that CCP officials are positioned in influential roles in larger PEs as well, it can be argued that part of their strategy is adapted to fit government plans. Recent regulations and restrictions as well as signs of instability and turbulence in the real estate market, resulted in people employed in the sector leaving the industry, additionally propelled by changes in organizational structure of RE companies, having become more streamlined, with declining rates of recruitment from higher level schools (Ma, 2021).

High demand in the market and easy access to high leverage in recent year have shaped Chinese RE developers' strategies. Besides extensive investment in real estate projects, many large Chinese developers have aggressively diversified into various other, oftentimes unrelated industries, such as Evergrande purchasing football clubs and mineral water brands and Vanke branching out into the logistics and food & beverage sector (Vanke, 2022). As a result, many developers piled up substantial debt, which they find increasingly difficult to pay back, especially in light of many of them crossing the TRLs. Therefore, developers' current strategies are increasingly based on ensuring that the TRLs are not crossed. Contrary to that, a lot of developers continue to their strategy on the aforementioned Hong Kong model, acquiring land through debt financing, but leaving it vacant to then slowly release development in hope of increase prices. This strategy has significantly added to long waiting lists for apartment buyers, given the continuous high demand.

Looking at net profit margins of large Chinese RE developers, three distinct growth strategies can be identified: (1) a revenue-oriented growth strategy, utilized by firms such as Evergrande, and Greenland Holdings; (2) a profit-oriented growth strategy, employed by companies such as China Overseas Land and China Resources Land; and (3) hybrid of the former two, used by firms such as Vanke and Poly developments, with net profit margins close to the Chinese industry average of 11.6 (Yuanyuan & Jie, 2016). It becomes clear that with the exception of Greenland Holdings, SOEs tend to utilize a more profit-oriented approach, whereas Pes lean more towards a revenue-focused growth

strategy. Regardless of type of strategy however, every large Chinese developer that we have analyzed, has faced declining profit margins over the past three years, falling from an average of 19.9 in 2019 to 8.1 in 2021 even though revenues generally increased, showcasing the increasingly troublesome financial situation that Chinese developers find themselves in.

Table 5: Revenue, Net Income, and Profit Margins of Chinese RE developers from 2019 to 2021 (Low profit margins marked orange)

| | | 2019 | | | 2020 | | | 2021 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Firm** | **Firm Type** | **Revenue (RMB billion)** | **Net Income (RMB billion)** | **Net profit margin** | **Revenue (RMB billion)** | **Net Income (RMB billion)** | **Net profit margin** | **Revenue (RMB billion)** | **Net Income (RMB billion)** | **Net profit margin** |
| Greenland Holdings | SOE | 428,1 | 14,7 | **3,4** | 456,1 | 15 | **3,3** | 544,7 | 6,2 | **1,1** |
| Country Garden | PE | 485,9 | 39,6 | **8,1** | 462,9 | 35 | **7,6** | 523,1 | 26,8 | **5,1** |
| Evergrande | PE | 477,6 | 17,3 | **3,6** | 507,3 | 8,1 | **1,6** | 463,3 | 15,9 | **3,4** |
| Vanke | PE | 367,9 | 38,9 | **10,6** | 419,1 | 41,5 | **9,9** | 452,8 | 22,5 | **5,0** |
| Poly Developments | PE | 236 | 28 | **11,9** | 243,1 | 28,9 | **11,9** | 285 | 27,4 | **9,6** |
| Sunac China Holdings | PE | 169,3 | 26 | **15,4** | 230,6 | 35,6 | **15,4** | 249,1 | 36,7 | **14,7** |
| China Overseas Land | SOE | 163,7 | 41,6 | **25,4** | 185,8 | 43,9 | **23,6** | 242,2 | 40,2 | **16,6** |
| China Resources Land | SOE | 147,7 | 28,7 | **19,4** | 179,6 | 30 | **16,7** | 212,1 | 32,4 | **15,3** |
| China Merchants Shekou | SOE | 97,7 | 16 | **16,4** | 129,6 | 12,3 | **9,5** | 160,6 | 10,4 | **6,5** |
| Gemdale Corporation | PE | 63,4 | 10,1 | **15,9** | 84 | 10,4 | **12,4** | 99,2 | 9,4 | **9,5** |
| SOHO | PE | 1,9 | 1,3 | **68,4** | 2,2 | 0,54 | **24,5** | 1,7 | -0,1 | **-5,9** |
| Average | | | | **19.9** | | | **13.6** | | | **8.1** |

Source: (Yahoo! Finance, 2022)

Following the deleveraging campaign of 2017, companies started to rely more heavily on preconstruction sales, with home buyers paying 100% of the sales price before developers begin property construction. This in turn created new challenges, as rising costs lead to developers needing additional financing to complete construction of already sold properties (Wright. Intvw. 2, 2022). If the government restricts this financing, it will result in a lack of supply.

Chinese developers, alongside institutional investors, banks, and other investors of high net worth have investing invested in overseas real estate, as encouraged by the government (Knight Frank, 2015). From 2009 to 2014, outward overseas investment rose dramatically from USD 600 million to USD 16.9 billion. Chinese developers have been some of the most active overseas investors, buying into various development sites, covering every type from offices and industrial real estate to residential and retail properties (Arcibal, 2021). It is estimated that Chinese companies invested a total of USD 103.8 billion abroad from 2006 to the first quarter of 2021. While overall investment in real estate reached its highest point at USD 17.5 billion in 2017, it has been on a sharp decline in the years that followed, having fallen to USD 1.9 billion during the first three quarters of 2021, due to tightened policies such as the deleveraging campaign and the TRL policy. This development, alongside the COVID-19 related recent economic slowdown indicates that foreign real estate investments will most likely continue to decline in the coming years. It is furthermore observable that foreign property real estate investment follows a less strategic reasoning, as the majority of funds are spent on trophy properties in the US and the UK, with the purpose of purchasing these before their domestic competitors are (Chan, 2015). Recent examples of such trophy property purchases include the 2014 purchase of 70% of a 93,000 square meter office high-rise in London's Canary Wharf for USD 1.35 billion by a group led by the large insurer China Life as well as Anbang Insurance Group Co. buying the famous Waldorf Astoria hotel in New York City for USD 1.95 billion (Cole, 2014).

Government

The CCP possess far-reaching control and power, both in politics and business. For example, its power and authoritarian methods is illustrated in its ability to force millions of people to relocate, and there are both examples of doing so improve the conditions for poor people, but also to make space for new infrastructure projects (Phillips, 2018). One example of the latter is the Three Gorges Dam project on the on the Yangtze River, where 1.3 million were moved, many against their will (Wee, 2012). Moreover, having officials positioned highly in both PEs and SOE expands the reach of the CCP. The CCP is therefore also easily able to closely regulate and introduce new policies throughout all industries, often through five-year economic plans, with significant impact on the RE sector.

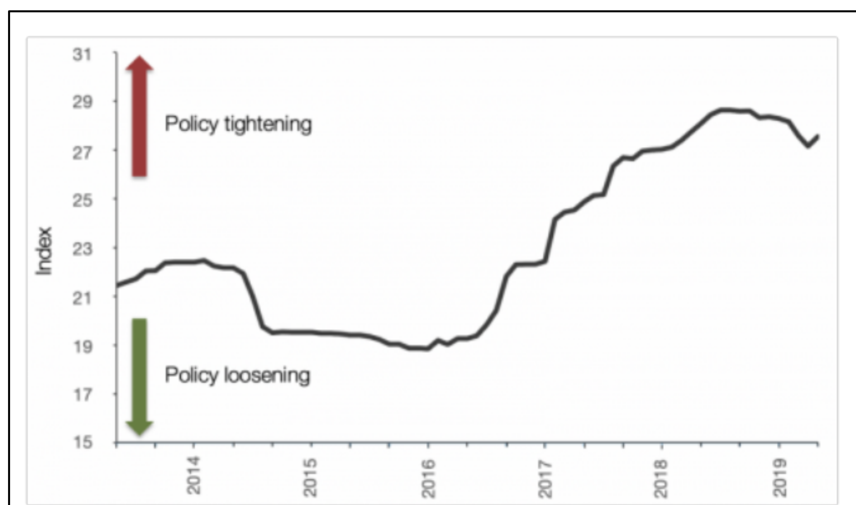
Wright (2022) finds that "there's been an awareness of the property bubble in China and an attempt to control the speculative excess and the bubble for quite some time." However, he mentions that

"they (the Chinese government) have done so through using administrative measures that aren't that sustainable", representing a lack of long-term measures.

The creation of a land leasehold system in 1988 with the intention of commercializing the housing market through enabling private businesses to capitalize of land use rights marked the beginning of the modern Chinese RE sector (Wang & Just, 2021). The first major policy change came in 1998, when supply and demand in the RE sector became market-driven, without governmental financial assistance, and simultaneously confirmed the RE sector's position to the CCP as a pillar of Chinese economic development. House prices have been rising rapidly since, which has led the CCP to often introduce regulative measures for said prices which include interest rate adjustment, credit management and other policies.

Generally, restriction and tightening policies have been implemented in the RE sector dating back to 2005 to 2007 (Asia Green Real Estate, n.d.). In the ten years following, the government switched between loosening and tightening the market before adapting a more tightening approach from 2016 and forward. However, restrictive policies that were instated to hold off demand and control prices were efficient in the short-term and due to the quick effect on housing prices, these were preferred by policymakers.

Fig. 12: Property policy developments 2014-2019



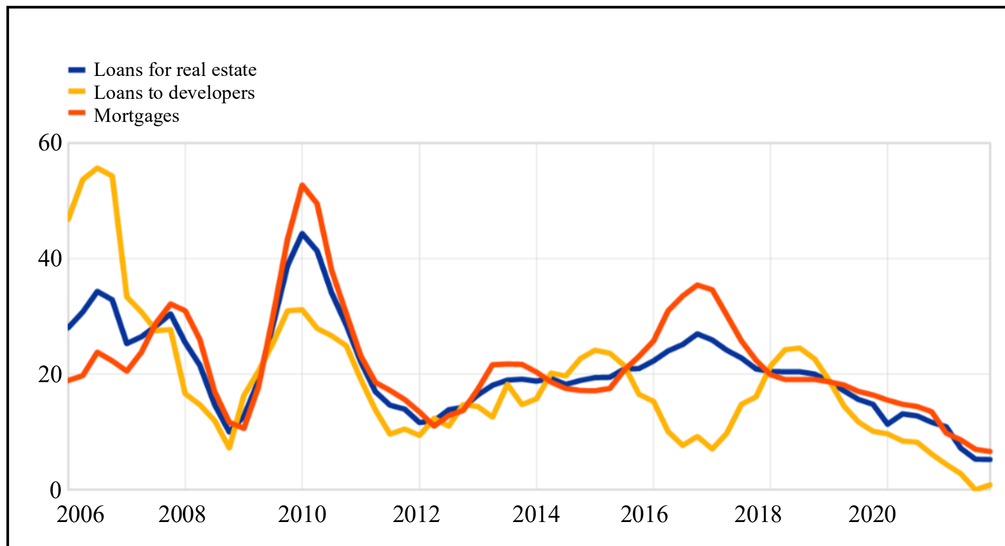

Source: (Asia Green Real Estate, n.d.)

One highly influential expansionary housing policy was introduced following the global financial crisis in 2008. The interest rate was cut from 7.83% to 5.94%, and People's Bank of China removed the credit quota on commercial banks, which enabled much easier access to funding (Yin et al., 2018). Alongside a stimulus package of USD 586 billion in 2009 to drive domestic demand instead of relying only on Chinese exports, which had been hit significantly due to the crisis, more money was poured into the RE sector and the value consequently increased (Yueh, 2010). In the following years from 2008 to 2015, the interest rate was increased five times and cut twelve times, yet housing prices remained high relative to income allowing for the conclusion that more regulation leads to an increase in house prices in the Chinese case. Further restricting policies were introduced in 2009, in the form of the Second Home Policy which introduced higher interest rates to people who purchased a second property, followed by loosening policies in 2014 leading up to the current real estate bubble forming since 2015 (Tian et al., 2018; Rogoff & Yang, 2020).

Switching quickly between policies of tightening and loosening does not allow for long-term analysis on the effect of said policies. As there were limited ways to invest in China, real estate was seen as a good investment and many people started investing into it from 2002 (Qiao X. , 2010). Therefore, the constant tightening and loosening did not affect demand significantly as investors did not have many other options available. However, in recent years, investors that now have more alternative investment opportunities available to them may be increasingly reluctant to invest in the market that has become unstable due to repeated short-term policies of the CCP.

Furthermore, according to Levinger and Braun (2021), "China's ability to withstand boom and bust in the property market comes down to the local level. Due to the sheer size of the country, there exists not one but many property markets that may face quite different supply and demand trends and require differentiated policy responses" (Levinger & Braun, 2021, p. 63). Therefore, countrywide policies implemented by the CCP to adjust sector conditions, may not always be suited to the conditions of every province or municipality. Especially the TRL policy that the government implemented in 2020, was aimed to restrict developers from borrowing increasing amounts of money due to declining home sales.

Fig. 13: Growth in Loans to the RE sector

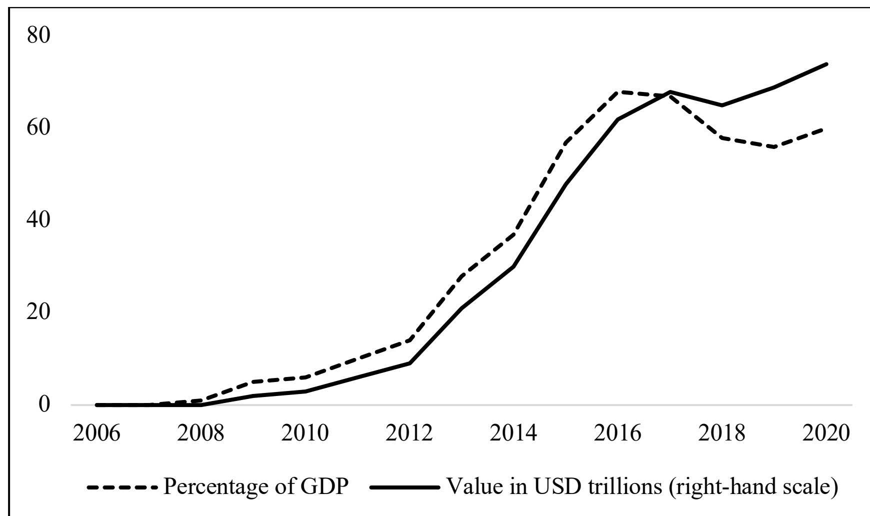



Source: (ECB, 2022)

Directly restricting developers' access to funds oftentimes resulted in them not being able to pay back debt, and thus forced some, most notably Evergrande and Kaisa, the two largest dollar bond issuers in the Chinese property sector, Fortune Land, and various smaller developers such as Fantasia and Sinic Holdings to default (Tan, 2021). Von Mehren (2022) argues that in hindsight, this policy should have been implemented much earlier as increased leveraging by RE firms is not a recent development, exemplified by high real estate loan growth rates in the past fifteen years. However, von Mehren (2022) notes that a certain level of flexibility is also important as it gives developers time to adapt to the policy, thus resulting in less developers defaulting simultaneously, destabilizing the industry as is the case now. The fact that the policy was implemented too late had immediate impact on developers, showcasing the Chinese government's lack of pragmatism concerning the implementation of the TRL policy in its initial stages.

While the new rules regulating the asset management industry and restricted liquidity management, micro-lending and low-rated insurers (Reuters, 2017) which the Chinese government introduced in form of a 2017 deleveraging campaign as well as through the TRL policy in fact helped to stabilize the growth of the formerly booming shadow banking sector, non-bank-related lending continues to contribute significantly to China's GDP, accounting for a share of nearly 10% or just under USD 80 trillion in 2020

Fig. 14: Share of Shadow banking of GDP (% of GDP; USD trillions)

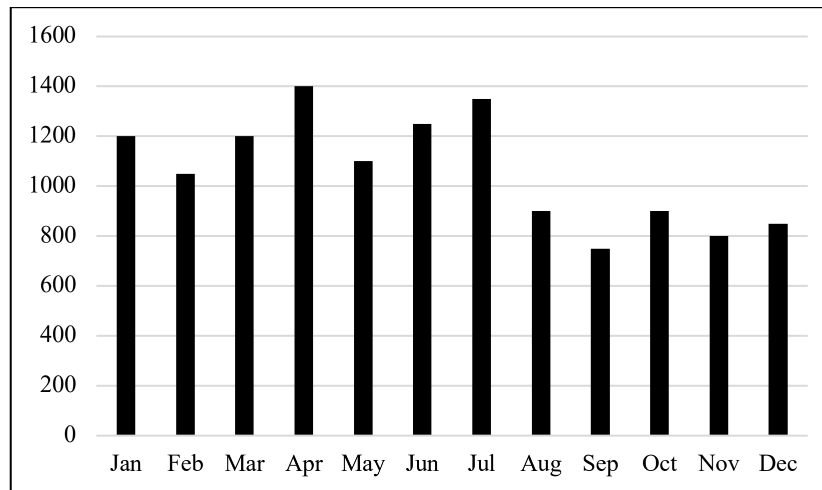



Source: (ECB, 2022)

Furthermore, as a result, RE developers now primarily rely on preconstruction sales and substitute shadow bank loans with credit from home buyers instead. While fear of negative implications on demand, home prices, and household wealth have resulted in the Chinese government not levying homeowners through a property tax, a pilot program in Shanghai and Chongqing has however introduced such a tax, albeit at low rates of 0.4% to 1.2% to owners of higher-end housing in 2011. Since then, the program has however not been expanded to include other cities, although in October 2021, the CCP announced that it would initiate another pilot real estate tax program in specific regions (Nikkei Asia, 2021). Besides providing an alternative for local governments that primarily rely on land sales in terms of fiscal revenue, which according to Hsu (2022) is the main justification, a property tax would, according to Ma and Yue (2022), contribute to shorten the distance between rich and poor, limit property hoarders and thus decrease speculation. A gradual implementation could potentially ensure that prices do not crash (Nikkei Asia, 2021).

However, the implementation of the aforementioned real estate tax program has been postponed in the beginning of 2022, and at the current time (May 2022) there is still no property tax implemented (Li Z. , 2022). This is partly due to resistance among CCP officials, especially those who own more than one property. The current slowdown of the RE sector, exemplified by the decrease in home sales further contributes to the delay in property tax implementations, yet it is predicted that some form of property tax policy will be introduced as soon as a market upturn is evident (Bloomberg, 2022).

Fig. 15: Monthly home sales in 50 cities (2021)




Source: (Bloomberg, 2022)

Wright (2022) states that "there was always this threat sort of hanging over the market that a property tax will come through and indeed China is short of longer-term sources of fiscal revenue, so they need to be considering things like this" (Wright, Intvw. 2, 2022). Hsu (2022) argues that a property tax should have been implemented earlier, as it is most likely too late to decrease speculatory behavior. While there were considerations of property taxes in 2003, the fact that it has not been implemented yet arguably indicates a lack of a proper long-term strategy for alternative fiscal income, especially for local governments. What becomes evident from the restrictive nature of recent policies in the RE sector is the CCP's fixation on not repeating the Japanese real estate bubble. (Hsu, Intvw. 5, 2022). Major think tanks have been set up to ensure that a similar bubble burst can be avoided, however while this seems like the Chinese government is taking lessons from Japan, Hsu (2022) argues that it is "probably more of a misapplied lesson. The context is different, the environment is different. So you think you learn the right lesson, you might have learned the wrong lesson."

In the 14th five-year plan, presented in 2021 and aimed at leading the direction of the country until 2025, there was only limited mention of the RE sector (Ma & Yue, 2022). However, it was stated that the government and industry should endorse "simultaneous rental and purchase, and city-specific policies to promote the steady and healthy development of the real estate market." (Ma & Yue, 2022, p. 1168). While the government still is in the process of implementing its recent restrictive policies, the immediate outcomes however do not showcase a particular long-term orientation of plans aimed at fixing the aforementioned shortcomings of the industry that developed over the past 15 years.

Chance events

China’s size and variety in climate zones make it subject to a variety of natural forces, ranging from volcanic eruptions, earthquakes and landslides to floods, cyclones, and draughts. For example, an earthquake in Wenchuan in the Sichuan province in 2008 killed over 80,000 people, ruined more than 120 million square meters of houses and construction, and left more than 15 million people homeless (Xinhua, 2015). However, while reconstruction would require significant resources, the quick and heavy mobilization of the government and them funding RMB 300 billion over the following three years. In that period, they were able to build 6.6 million new houses. While this did not directly affect the RE sector, it did force developers to improve scientific planning for safer homes, and learnings allowed reconstruction efforts to become more efficient afterwards.

The COVID-19 pandemic presents a chance event that has strongly affected the RE sector, Von Mehren (2022) sees the pandemic as a new challenge for home sales. However, Jiao (2021) argues that the RE sector was largely unscathed in 2020 and experienced a quick recovery after the first half of 2020. House sales by floor space reached pre-pandemic levels again and real estate investment increased by 7%, to rates similar to pre-pandemic levels (Jiao, 2021). Nevertheless, following the recent 2022 outbreak and the government’s strict lockdown measures due ti its zero covid policy, new-home sales declined and home sales by value dropped 29% in March 2022 compared to a year earlier (Bloomberg, 2022). Home sales numbers do not paint a full picture of the effect of stricter lockdowns in areas such as Shanghai and parts of Guangzhou as well as 20 other large cities that have experienced significant declines in new home sales.

This development is further affected by the continuous uncertainty among home buyers, which consequently affects consumer confidence and the willingness to buy homes (Li, 2022). Due to declining home sales, RE developers have had to focus more on construction and less on buying land (Bloomberg, 2022). Moreover, several developers, including China Aoyuan Group and Sunac China Holdings Ltd., the latter having liquidity issues recently, did not make the deadline for the submission of their annual reports, naming Covid-19 restrictions as the reason (Li, 2022). Following the decrease in home sales, local authorities in over 60 municipalities have eased restrictions on purchases (Bloomberg, 2022). However, critics argue that it is debatable whether these initiatives will effectively increase demand.

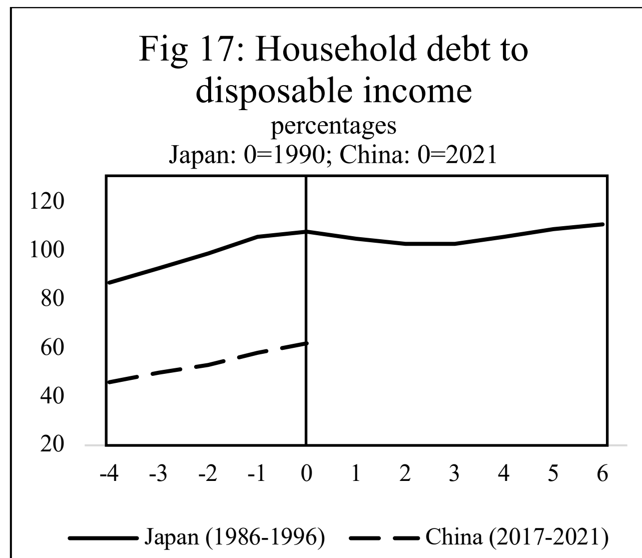
China's increasing integration to global financial markets further makes it more susceptible to global financial crisis, exemplified by the 1997-99 Asian crisis and the 2008 global financial crisis. For example, due to the Chinese RE sector's dependency on China's general economic condition and growth, it experienced a notable decline from 2008 to 2009, partly illustrated in a dip in land prices (Li et al., 2012; Wen & Chen, 2017). As mentioned earlier, the crisis affected the Chinese exports significantly, which led to the government implementing a large stimulus package. In combination with the People's Bank of China's removal of the credit quota and significant interest rate cuts, the RE sector was able to recover quickly and experienced further growth.

### Discussion on the Japanese and Chinese real estate sector

Besides the differences in land size, factor conditions between Japan during the bubble years in and China today show various similarities. Both have undergone significant infrastructure developments that enabled property prices to rise both in urban centers as well in well-connected rural areas. While fast building times and increasing sophistication of the developments were enabled by a blossoming construction sector, that besides utilizing the most modern means possible at the, lead the sector on a global scale. However, the sector in both countries lost attractivity due to the harsh working conditions, especially noticeable in China were low pay and low safety measures contribute to many leaving the sector. Furthermore, both countries were at similar stages of their demographic development. While the Japanese population peaked shortly after the burst of the bubble, the Chinese population already peaked in 2013. For now, demand may be sustained due to the lower rate of urbanization in China, which at that point had already reached the end of its development in Japan. However, once these two factors are no longer given in rapidly urbanizing China, exemplified by a stabilization of household sizes since 2011, demand levels may drop.

Despite these similarities, it is important to notice that China is at a different point of its economic development than Japan was in the late 1980s. While Japan was fully industrialized and GDP growth rates fell to sub-5% levels, China still is undergoing its economic transformation. However, in light of comparably low growth rates in the past years, even before COVID, one may wonder whether China's period of high growth rates above 7% has come to an end, especially considering the fact that more and more of Chinese households' wealth is based on debt-financing, with the Japanese economy having undergone similar developments before the burst of the bubble.

Fig 16: Household debt to disposable income (percentages, Japan: 0=1990; China: 0=2021)




Sources: (ECB, 2012; 2022)

Various similarities can further be found in real estate demand, even though the countries are vastly different in size. At the time of bubble and even after, underutilization of land left space for new developments, and while new buildings were developed, the often remained empty as the developers speculated on rising real estate values. With credit available at low interest in Japan and in China until recently, debt-financing became the main motor of real estate demand, and banks were incentivized to do as they themselves benefitted from rising land values that often were the collateral. As a result, private sector lending has rapidly increased in both countries. Credit for real estate purposes became necessary especially for households as the housing price to income ratio reached high level, especially in metropolitan areas. While the ratio in Japan averaged 9 at the time, it has recently risen to 7.2 in China. Affordability of housing is however significantly lower in urban centers, having ranged around 13 in Tokyo and 55 in Beijing.

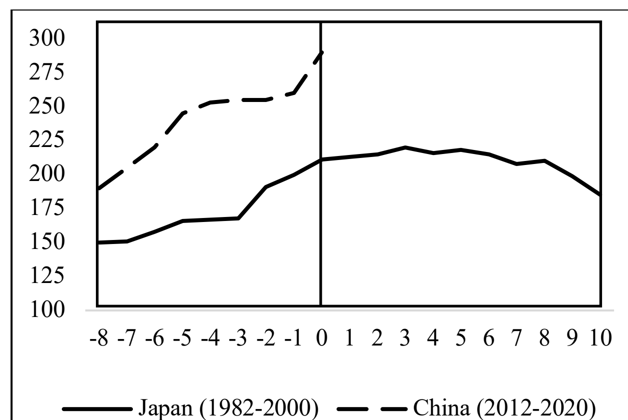
Social factors further contributed to high demand, as real estate is regarded as a status symbol in both countries. While safety concerns may have been the main factor in secondary housing being considered a ‘lemon market’ in Japan, resulting in low building life cycles, tenant-friendly housing laws contributed to many Japanese properties not being rented out. Social prestige led to the same result in China, with many somewhat unnecessary developments being built as property owners are under social pressure to not rent out their properties, resulting in high vacancy rates. While the number of vacancy rates in China is significantly higher than in Japan, the fact commercial real estate mainly

contributed to the bubble in Japan as opposed to housing in China concealed the real situation. Buildings were either de facto used by companies even though not utilized, or developer simply kept properties empty or built parking lots on them, which if not a vacant property can be considered somewhat similar. Furthermore, a general optimism in buying behavior can be observed in both countries, however given that GDP growth levels slowed in both cases prior to the bubble, this may be interpreted as a continuation of high-growth era optimism.

Real estate furthermore plays a critical role in the banking sector of both countries. While Japan low interest rate policy due to the Plaza Accord set the high real estate price hikes in motion as lending and speculating was more accessible than ever before, real estate financing continues to be highest share of bank loans in China, despite recent restrictions. Banks in both countries have initially benefited greatly from real estate lending, and while China's TRL policy was to set an end to excessive real estate lending, the fact that 14 developers have already crossed these lines exemplifies how important debt financing has become for Chinese developers.

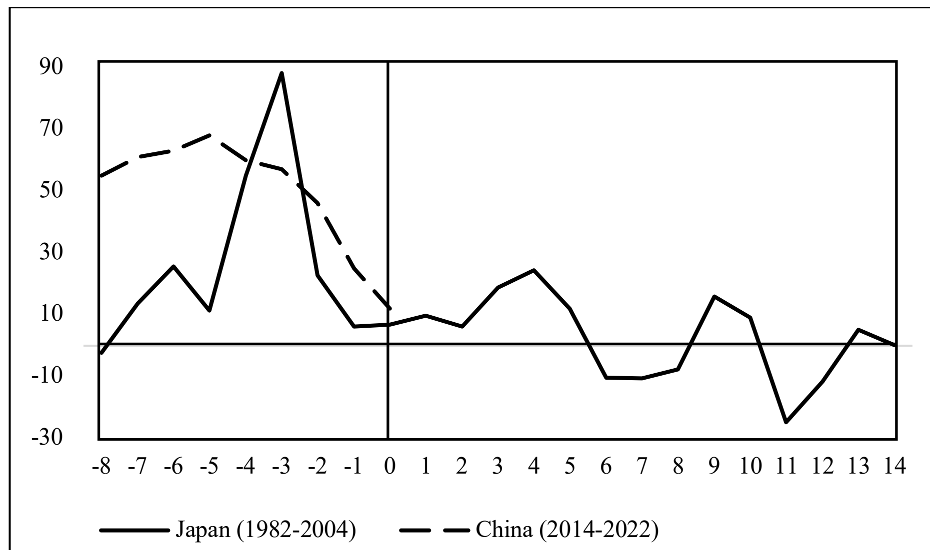
With private sector debt level having risen in both countries, the Japanese and Chinese governments have implemented measures to curb borrowing. In Japan's case, the low interest rate policy of the Bank of Japan was abandoned in early 1989, two and a half years before the bubble collapsed. Recent Chinese restrictions such as the TRL policy has also contributed to lower growth rates of real estate-related loans, however critics argue that this might have negative future impacts on the entire sector.

Fig 17: Private-sector debt as % of GDP (Japan: 0=1990; China: 0=2020)




Source: (Richter, 2017; ECB, 2022)

Fig 18: Growth in loans to the RE sector (YoY, percentages, Japan: 0=1990; China: 0=2022)

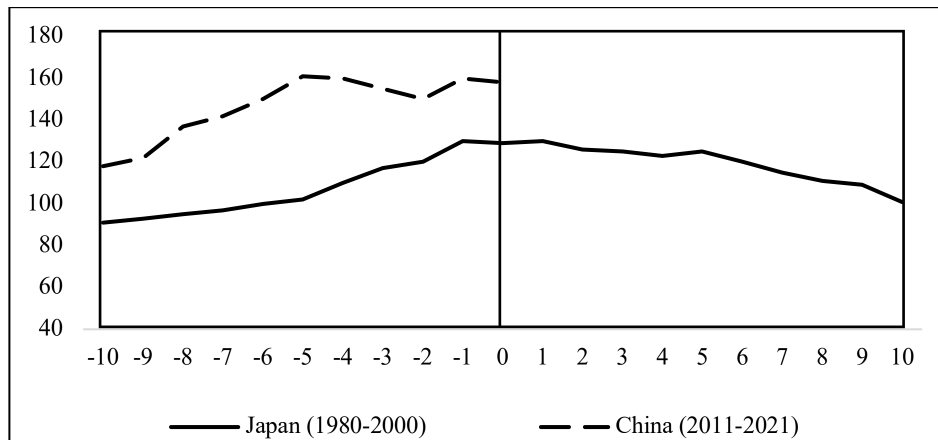



Source: (ECB, 2012; 2022)

Like the finance sectors of Japan and China, the construction industry of both countries shows various similarities in the investigated timeframes, being characterized by high productivity and output, thus contributing to the fast pace of large real estate developments. World-leading in scale during their respective areas, the contribute greatly to their nations GDP levels, with the Japanese construction industry accounting for 18.2% of the country's GDP in 1989, while its Chinese counterpart accounts for over 25% today. While the slowdown in the RE sector after the Japanese bubble had burst, negatively affected the construction sector and thus, the entire economy, the effects of the new real estate-related lending restriction imposed by the Chinese government on the sector remain to be seen.

While differences in the political system between the two countries result in different types of companies dominating the market, only two Japanese RE developers and three Chinese developers are listed in their countries' top 100 traded firms based on market capitalization, showcasing the amount of other non-financial firms operating in the sector. Both countries' RE sector further facilitates similarly few foreign players, and strategies of developers in both nations are heavily influenced by their respective government. Debt-financing can be identified as the main source of finance for both Japanese and Chinese developers, which in turn have based their strategy heavily on the availability of cheap money.

Fig 19: Debt financing of non-financial corporations (as % of GDP, Japan: 0=1990; China: 0=2021)




Source: (ECB, 2012; 2022)

This has further enabled Japanese and Chinese firms to acquire large amounts of prime real estate abroad, although the strategic reasoning for firms to do so can be at best described as prestige-acquisition. While debt financing by non-financial companies has risen at similar rates, the Japanese Bank of Japan raised its discount rate in 1989, after the bubble had already been inflating at high speeds for three years, whereas the Chinese government implemented policies to curb borrowing in the past 5 years. The fact that various large-scale developers have already defaulted due to these regulations further signifies how debt financing property speculation have played a major role in their strategic choices.

In Japan during the bubble period, property-related lending was increasingly provided by non-banks such as housing loan companies and Jusen, which were out of reach by financial authorities, thus accelerating the real estate bubble and the bad debt issue after the burst of the bubble. Similar to that, Chinese banks and trust companies have been directing increasing amounts of funds into the real estate market.

How firms operate in both the Japanese and Chinese real estate market is heavily influenced by policy, as governments play a significant role in both countries' sectors. While the Japanese government exercises its control through different ministries and industry associations, the Chinese government is more prominent in policy making, although they often extend their control through industry associations. In both countries, governments exercise control on all aspects of the RE sector including availability of credit, type of development, public disclosure of financial situation, and rivalry.

Government policies strongly contributed to inflating real estate prices in both countries and while different in their targets across both countries, they oftentimes led to similar results such as sharply increasing property values, increased reliance on debt and a strong rise in shadow banking. The short-term orientation becomes clear as the Japanese government has intervened in the Bank of Japan's discount rate several times during the peak and burst of the bubble, similar to how the Chinese government regularly shifted from monetary easing to tightening policies, seemingly never satisfied with the results of its prior policies.

Chance events further had similar effects on both countries' RE sectors, with the exception of COVID-19 which we have not included into our analysis of the Japanese RE sectors, as it deals with the period of 1985 to 1991. The high number of natural disasters has increased the sophistication of demand in both countries, although substantial increases in quality of housing cannot be observed in China to the same degree as in Japan. However, natural disasters that occurred around the time of our focus, showed that high safety standards still led to unanticipated infrastructure and building damages, amplified by the slow response of the Japanese government, whereas the Chinese government improved in mobilization of resources in times of crisis. Global stock market crashes that occurred during our investigated timeframes (1987 Black Monday for Japan; 2008 World Financial Crisis for China) have had similar effects on the RE sectors in both nations, eased monetary lending policies increased lending and demand, while contributing to further bubble building in both countries.

# Firm-level case analysis of Mitsubishi Estate and China Evergrande

To gain insights into the Japanese and Chinese RE sector on a micro-level, we have chosen two of the leading RE developers in their respective home market as case companies. Using the firm structure, strategy, and rivalry sphere from Porter's Diamond model, and under consideration of the how the other spheres of the model affect the strategic choices of our case firms, we are investigating how the RE sector developments of Japan in the late 1980s and China today have affected strategic choices of our case companies.

## The case of Mitsubishi Estate in Japan

Introduction to Mitsubishi Estate

Mitsubishi Estate, founded in 1937 as a real estate subsidiary of the Mitsubishi zaibatsu emerged as one of the leading Japanese RE developers, building on the resources of its parent company (Mitsubishi Estate, 2022). Twenty years after its founding by Yataro Iwasaki, the Mitsubishi zaibatsu acquired 353,000 square meters of swamp land close to the Imperial Palace from the Department of War in 1890, today known as Tokyo's central Marunouchi district. In 1892, Mitsubishi began with the construction of Western-style red brick office buildings, turning the area into Tokyo's prime business district, which it still is today. By the time that Mitsubishi Estate was founded, other member firms of the Mitsubishi zaibatsu had their head offices in every part of Marunouchi, so that Tokyoites would soon call the area 'Mitsubishi Village (*Mitsubishi Mura*).

When the zaibatsu firms, including Mitsubishi were dismantled after WWII, family and trust company control were handed to its former general trading subsidiary, the Mitsubishi Corporation, that had reassembled itself in 1947 (Schoenberger, 1989). Similar to crossholdings in its over forty other sub-firms in the Mitsubishi keiretsu network, the parent group owned 20.9% of Mitsubishi Estate. Mitsubishi Estate was first listed in the Nikkei stock index in 1953. With a revenue of USD 11.6 billion in 2021 and the most valuable portfolio value in the country as of 2018, worth over JPY 7.4 trillion, Mitsubishi Estate remains one of Japan's leading RE developers to this day (Mitsubishi Estate, 2022).

Table 6: Mitsubishi's horizontal Keiretsu (before 1996):

| **Mitsubishi Corporation** | **Mitsubishi Bank** | **Mitsubishi Heavy Industries** |
|---|---|---|
| Automotive | Finance & Insurance | Industrial Equipment |
| Mitsubishi Fuso Truck Bus | DC Card | Mitsubishi Electric |
| Mitsubishi Motors | Diamond Lease | Mitsubishi Kakoki |
| Shin Caterpillar Mitsubishi | Meiji Life | Mitsubishi Precision |
| Electronics & Telecom | Mitsubishi Auto Credit | Toyo Engineering Work |
| IT Frontier | Mitsubishi Securities | |
| Mitsubishi Research Inst. | Mitsubishi Trust & Banking | Industrial Materials |
| Mitsubishi Space Software | Tokyo Marine and Fire | Asahi Glass |
| Nikon | Transportation | Dai Nippon Toryu |
| Space Communications | Mitsubishi Logistics | Mitsubishi Aluminium |
| Resources & Energy | Mitsubishi One Transport | Mitsubishi Cable Indus. |
| Nippon Oil | NYK Line | Mitsubishi Materials |
| Mitsubishi LPG | Chemical & Pharmaceutical | Mitsubishi Plastics |
| Mitsubishi Nuclear Fuel | Dai Nippon Toryu | Mitsubishi Rayon |
| Mitsubishi Paper Mills | Mitsubishi Chemical | Mitsubishi Shindoh |
| | Mitsubishi Gas Chemical | Mitsubishi Steel |
| Real estate & Construction | Mitsubishi Petrochemical | Consumer goods & foods |
| Mitsubishi Estate | | Kirin Beverage |
| P. S. Mitsubishi | | Kirin Brewery |
| | | Ryoshoku |

Source: (Butler, 1997)

Mitsubishi Estate's pre-bubble strategy

Long-standing, close ties with the government were key in Mitsubishi Estate's post war undertakings. When Tokyo governor Seiichiro Yasui was asking the retired Mitsubishi Estate Corporation's (MEC) President Higuchi for his advice on solving the increasing traffic congestions in the central districts, Higuchi convinced the governor to construct highways over income-producing properties, which would in turn help to pay for construction and maintenance (Grant & Derdak, 1996). Higuchi became the president of the Tokyo Express Highway Co. that would lead the construction of expressways in Tokyo throughout the 1950s and 1960s, with construction for the first eight miles of inner-city expressway starting in 1953. This first section of Tokyo's expressway would run from the financial district to Ginza, well connected to Mitsubishi Estate's Marunouchi properties. Long-term oriented projects such as this and close ties to the government characterize many of MEC's projects during the high growth era. In 1959, MEC published its Marunouchi Comprehensive Remodeling Plan, replacing pre-war red brick buildings with modern office buildings with large floor areas, oftentimes utilized by government ministries (Grant & Derdak, 1996). Until well into the 1980s, these newly built office buildings accounted for 70% of MEC's income. While MEC did establish offices abroad,

mainly in the US during the 1960s and 1970s, it clearly did not prioritize foreign markets prior to the bubble period as even its US presence stood at a mere USD 24 million in late 1983. Commercial property has always been Mitsubishi Estate's focus, however the company diversified into residential properties in the 1970s. by 1983, 20% of MEC's income was generated by house sales, again showcasing how careful diversification ensured MEC success during this period.

In fact, compared to the other large RE developer at the time, Mitsui Fudosan, MEC utilized a more conservative business strategy, oftentimes even diversifying too late and in turn losing business to its more progressive competitor (Kikkawa, 1996). Mitsui Fudosan's 'sales first' strategy helped them grow more rapidly, but also earned them the reputation of a "landless real estate company" as it not owned properties to the same extent that MEC did. Mitsui Fudosan was therefore quick to engage in land reclamation projects as well as high rise construction, whereas MEC with large prime-real estate holdings in Marunouchi and an internalized design and supervision department, was able to develop a profitable rental and leasing business, significantly reducing their transaction costs. This difference in strategy becomes clear when looking at the list of the largest Japanese RE developers over time. From 1973 until 1992, Mitsui Fudosan led the list in revenue, often twice as high as that of MEC, whereas MEC led the list in profits. However, with the Bank of Japan's low-interest rate policy of 1985 making lending more attractive than ever, Mitsubishi's strategy in the latter half of the 1980s does not at all resemble its conservative pre-bubble undertakings.

Mitsubishi Estate's bubble strategy

While the company had already diversified into the hotel business in 1983, hotel developments of the pre-1985 era such as the Nagoya Dai-ichi Hotel can be considered humble beginnings, compared to MEC's large luxury hotel developments later in the decade such as the Atsugi Royal Park Hotel in 1986 and the Royal Park Hotel at Tokyo's Haneda Airport in 1989 (Grant & Derdak, 1996). While residential complexes developed by MEC also became increasingly prestigious such as the Park Town Tamagawa luxury condo complex built in 1988, the aforementioned Resort Act of 1987 led to Mitsubishi estate building and investing in various mega-projects across the country such as the Resort Park Onikobe, including ski slopes, hotels and resort villas and naturally, given the popularity of golf clubs at the time, the Fuji International Golf Course, right at the foot of Mount Fuji. In Yokoyama, MEC began construction of the 75-story Landmark Tower that became Japan's tallest building when it opened in 1993. MEC furthermore announced a second Marunouchi Redevelopment

Plan in 1988 to create new revenue sources for MEC in the area (Shigematsu, 2019). While the large-scale office construction that the original 1959 plan set in motion led to the Marunouchi district becoming a life-less area outside of the morning and evening rush hours, filled with grey concrete block-shaped office buildings, this plan was to revive the area with commercial zones, pedestrian walks, shopping streets and parks, a project that would be carried out over nearly three decades, eventually finalized in 2014. The new Marunouchi plan is MEC's only development at the time where the firm's traditional long-term strategy was visible, possibly due to its internalized knowledge on the "Mitsubishi Village", whereas its strategy otherwise could only be described with 'Buy, hold, re-sell later', confirmed by Sato (2022), board member of Mitsubishi Estate: "Japanese real estate companies owned and held properties for a long time regarding commercial properties. As they believed that rent and property value would rise, it was justified to hold a property once acquired, enlarge their portfolio, and expect increase of rental income and property value." (Sato, Intvw. 1, 2022)

This is best exemplified by the fact that in 1989, MEC held USD 70 billion in unrealized land alone, but this, in addition to its developed properties that were dramatically increasing in value does not pain the whole picture of the effect of rising land prices: Like other keiretsu, Mitsubishi utilized a strategy of 'stable shareholding', meaning that the majority of MEC's shares were held by creditors and corporate members of the Mitsubishi keiretsu, leading to the majority of the Nikkei value, 70%, was owned by Japan's large firms.

Land prices that were rising due to speculation served as collateral for increased lending: "It was "land money"—which created a kind of double leveraging of the land itself: capital value reflected in land prices and in share prices, the latter realized as cash through the liquidity that land speculating had created. And, of course, the more capital acquired by corporations in the stock market, the more available to them for further nonoperating investment—such as more land. The Japanese had created a sort of "never-ending circle." (Cutts, 1990)

The availability of credit and the surge in land prices did not only result in MEC developing extensive projects across Japan, but also accelerated Mitsubishi Estate's formerly neglected offshore business. While its earlier, conservative approach to foreign investments led to MEC losing potential overseas investments to its domestic rivals that acted quicker, MEC now acted more determined. With its

Tokyo property[3] doubling in value between 1986 and 1988 and a strong yen, MEC invested heavily abroad, building 2,500 homes outside Los Angeles in 1987 as well as the 53-story 777 Tower, located also in Los Angeles (Schoenberger, 1989). In contrast to MEC's pre-bubble approach, most the property acquired inside and especially outside Japan showcase that MEC was now buying prestige, as opposed to smart, long-term investments. Kenji Sato (2022) confirms this: "In the late 80s, they purchased trophy towers in the major cities in the world. Some firms made huge investments in resort developments and/or hotels in Hawaii or Australia." (Sato, 2022). In late 1989, MEC made the trophy purchase that would soon cover headlines across the globe showcasing again Japan's seemingly skyrocketing wealth: A 51% controlling interest in the Rockefeller Group for USD 846 million.

In terms of public relations, the sale could not have come at a worse time. For the past three years, Japanese firms had gone on a literal shopping tour around the world, especially in the US. With Sony having just acquired Columbia pictures a few months earlier, MEC's purchase of this American institution alongside its prime real estate in Manhattan contributed to the 'Japanese threat theory' of many Americans at the time. To avoid public resentment in the West, the Japanese government advised leading Japanese firms to refrain from purchasing highly visible US property in the future. In line with government advice, MEC would soon take a back-seat role in other foreign trophy investments, such as in the case of the redevelopment of London's Paternoster Square, where it partnered together with British and American developers. The choice of real estate goes in line with the statement made by Interviewee 1, noting that Mitsubishi Estate saw New York, London, and Tokyo as the major financial centers of the period. While the aggressive expansion initially seemed to have cemented MEC as one of the world's leading RE firms, the burst of the Japanese real estate bubble as well as the lack of thorough review of many of its deals, especially its notorious Rockefeller Group purchase soon put an end to MEC's short-lived miracle.

The bubble burst and its strategic implications for Mitsubishi Estate

MEC acquiring trophy real estate at any cost seemed to have become obvious to the Rockefeller Group during take-over meetings, which increased the original price several times, until reaching USD 846 million, which MEC paid in cash, furthermore granting the Rockefellers the option to sell an additional 29% for USD 527 million, which, in light of plummeting New York City (NYC)

[3] In 1989, MEC owned 72 office buildings in Tokyo, 32 of which in the Marunouchi business district, as well an additional 50 acres of land, totaling to 25 million square feet of office space, making MEC Japan's largest commercial property owner (Schoenberger, 1989).

property prices at the time, they naturally did, so that MEC ended up buying 80% of the Rockefeller Group's shares for USD 1.37 billion in 1991 (Burton, 1991). Just six years prior to that, the Rockefellers had bought the land underlying the Rockefeller Center for only USD 400 million, again showcasing MEC's naivety concerning the deal. From over 20 potential buyers, including Mitsui Fudosan and Sumitomo Realty & Development, Mitsubishi agreed to pay a price far higher than any of its rivals. A Rockefeller family advisor recalled: "David (Rockefeller) didn't really want to sell the buildings, but he couldn't believe the price Mitsubishi was willing to pay. The Japanese essentially said: don't tell me what it's worth; tell me what I have to pay to get it." (Burton, 1991, p. 150).

With NYC property prices continuing to fall and with the burst of Japanese real estate bubble as well as the Bank of Japan's dramatically increased interest rate of 6% severely cutting into MEC's domestic reserves, MEC eventually sold Rockefeller Center for a mere USD 308 million in 1996, thus the quintessential Japanese trophy purchase of the bubble period led to MEC losing over USD 1 billion (Wang, 2022). Like many other Japanese developers at the time, Mitsubishi's immature investment strategy made under the premise of the easy-money policies of the late 1980s now brought them in financial distress. In addition to that, scandals around various Japanese firms and politicians brought to light criticism of the 'Keiretsu-way of doing things'. Possibly violating antitrust laws, Mitsubishi had to change its monthly Friday Conferences (*Kinyō-kai,* 金曜会) in which 29 of the group's companies' senior executive coordinated strategies between the Mitsubishi sub-firms since 1952, to serving only social functions from 1993 onwards (Weekly Diamond Editorial Dept., 2016).

While various RE developers and financial institutions defaulted during the 1990s, MEC and the other firms of the Mitsubishi Keiretsu were comparably mild, due to mainly to its conservative pre-bubble strategy, the long-term effects of which still were present in the 1990s. This is best exemplified by comparing MEC to its rival Mitsui Fudosan, which also prior to the bubble utilized a more growth- and revenue-based strategy, focusing less on strategic assets and land holdings. While Mitsubishi's profits declined comparably little in the first year of the post-bubble real estate market recession, falling by less than 7% from JPY 76.3 billion in 1988 to JPY 70.7 billion in 1992, Mitsui Fudosan's profit dropped by 43%, from JPY 45.6 in 1988 to JPY 25.8 in 1992, despite doubling in revenue (Kikkawa, 1996). Other developers such as Sumitomo and Daikyo suffered profit drops from over 60% in the same period. Sato (2022) noted that, instead of purchasing trophy properties and resorts around the world, MEC and other Japanese developers now invest on a smaller scale, focusing on

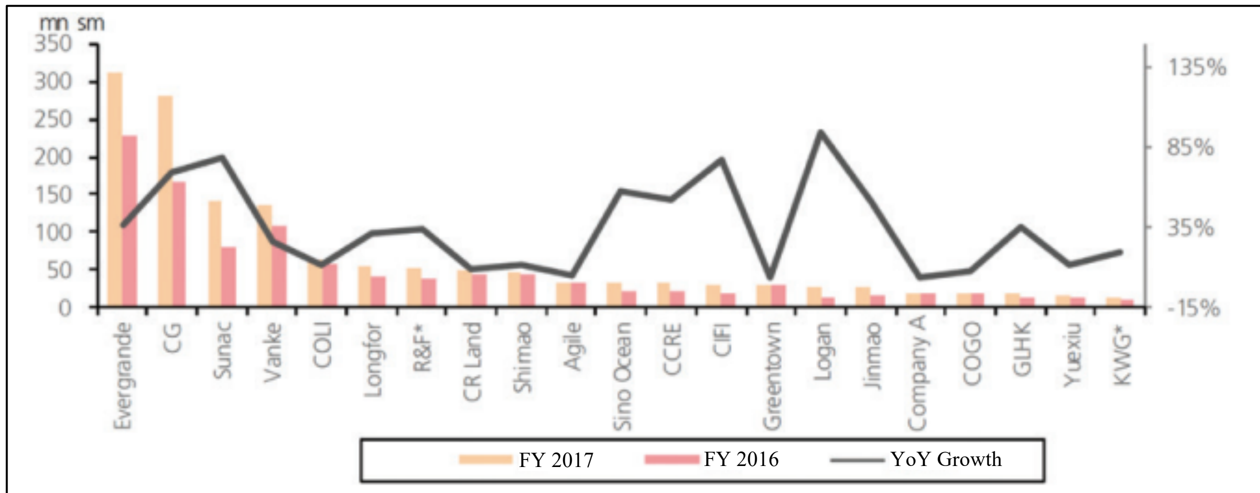
value enhancement through renovation, rather than rebuilding, as well as liquidity of investment: "Now, after experiencing the bubble burst and the 2008 Financial Crisis, they (MEC) tend to liquidate a portion of their portfolio from time to time to obtain capital gain, considering the market environment, conditions of each property and etc., This change has been supported by progress of real estate securitization and project finance. Also, some of the RE firms have placed more importance on fee-based business, such as asset management, than asset holdings." (Sato, Intvw. 1, 2022). MEC has however remained active abroad. Interviewee 1 lists MEC projects in the US, the UK, Singapore, China, Vietnam, Indonesia, Thailand, and Australia with the objective being to benefit from economic growth, while, in the case of Southeast Asia, offering expertise on high-quality building and property management: "Mitsubishi Estate expects diversification of its portfolio, which could mitigate risks associated with real estate investment in a single market." (Sato, Intvw. 1, 2022).

## The case of Evergrande in China

Introduction to Evergrande

China Evergrande was founded in 1996 by Hui Ka Yan, a former steel worker and Wuhan Institute of Science and Technology graduate. (Bloomberg, 2021). A newcomer to the RE sector with only limited resources, Hui focused on the mass market instead of larger expensive real estate, and with the help of supportive credit policies in place between 2003 and 2009, and Evergrande having a first mover advantage in many small and mid-sized cities, the firm bought a significant number of construction lands in almost 170 cities in China (Tian et al., 2018; Wharton, 2019). By offering smaller housing options with less associated land and development costs, Evergrande's turnover increased significantly due to the high demand in the booming Chinese RE sector at the time.

Fig. 20: Land Bank of Chinese Developers in 2017




Source: (Wharton, 2022)

Evergrande received recognition for the speed of handling its first project, the Jinbi Garden residential project, and the reputation gained from that allowed the firm to obtain funding easier (IN Bureau, 2021; Wharton, 2019). The funding obtained was then utilized to expand its operations throughout the city of Guangzhou. Following a high debt, high leverage, high turnover, and low-cost strategy was the driver of the rapid growth of Evergrande, and in the early 2000s, 13 projects were in development, ensuring its position as one of the largest developers in Guangzhou. Even though the number of competitors had increased rapidly from around twelve developers in 1988, when the real estate market was first liberalized to 24,000 in 1998, most operated only locally, and no developer held more than 1% market share within residential real estate. From here, Evergrande built its strategy for upscaling and outcompeting its rivals, which led to a countrywide expansion and being ranked among the top ten developers in China by sales in 2004.

Evergrande's initial strategy

To enable scalability of its quickly growing business, Evergrande created a management structure focused on achieving scale and embraced a strategy of standardization by implementing over 6,000 rules and procedures, covering all aspects of business procedure such as employee meals and procurement (Wharton, 2019). Additionally, Evergrande's rapid development was supported by the attainment of great quantities of land bank, of which the firm eventually owned more than any other Chinese developer. Following the firm's initial public offering in 2009 that raised USD 729 billion on the Hong Kong stock exchange, Evergrande continued to grow significantly (Wharton, 2019). In

2018, Evergrande's undeveloped land alone totaled 305 million square meters of floor area, in which the firm invested a total of RMB 513 billion. Moreover, the company diversified into various other fields of business, including sports, hotels, movie theatres, theme parks, health care services, and electric vehicles. The firm furthermore invested RMB 3.3 billion for a 4.5% share of the Hua Xia commercial bank in 2014 (Tian et al., 2018; Wharton, 2019). In 2020, the firm reported revenues of RMB 507.25 billion, representing an over 1,000% increase from its 2010 revenue of RMB 45.8 billion (Wenyi, 2022). At the peak of the firm's success in late 2021 Evergrande owned over 1,300 projects in more than 280 cities across the China (BBC, 2021).

Evergrande Group, despite being a private enterprise, holds close ties to the CCP. The firm's chairman Hui has adapted the strategy and priorities of his company to fit the goals of the CCP, contributing to various goals, from China becoming a global technological frontrunner to even winning the world cup, the latter being why Evergrande has invested significantly in football, exemplified by its investment in the Guangzhou Football Club, formerly known as Guangzhou Evergrande (Bloomberg, 2021). In fact, Hui noted in a speech in 2018 that "Everything in Evergrande, it's from the party, the country, and society" (Bloomberg, 2021). While these close ties with the government have enabled Evergrande to take on even larger projects and ensure further growth, firm strategy opposing the interests of CCP, also among PEs would have arguably not been an option for sustainable growth in China of any kind, either.

Evergrande's growth heavily relied on credit availability. Following the 2008 global financial crisis, the Bank of China lowered its interest rate from 7.83% to 5.94% and removed the debt quota, which led Evergrande to fuel its operations further through debt financing, knowing that the demand for housing remained at high levels. However, with the Second Home Policy of 2009 raising the interest rate for people that wanted to buy a second property, alongside further policies that restricted lending being implemented and continuously altered, Evergrande had to adapt it strategy and structure to monitor costs, also including transaction costs, to avoid a decrease in competitiveness (Tian et al., 2018). By diversifying into a variety of other industries, Evergrande aimed to benefit from economies of scale and scope. Especially, the firm's stake in the Hua Xia bank could have decreased financing costs, and grant easier access to funding, however its benefits are limited given the comparably small ownership share of 4.5% (Changxin, 2014). Nevertheless, Evergrande established a vertical integration model to support its goal of building economies of scale, creating an integrated project

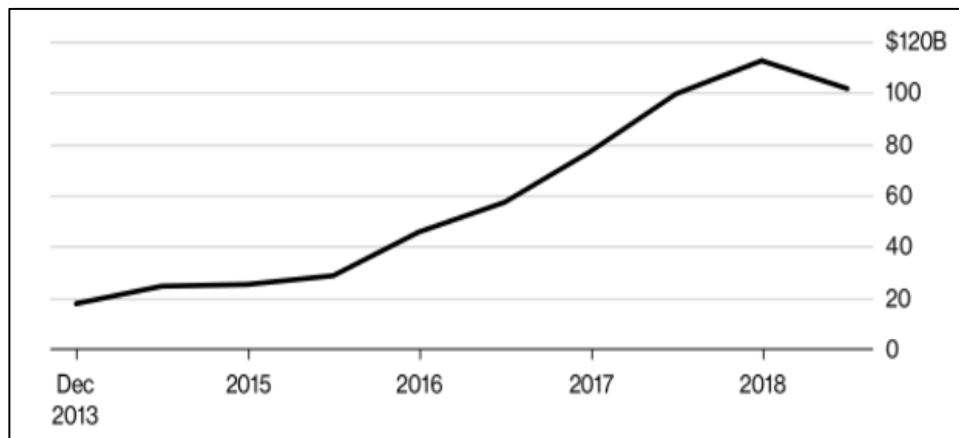
delivery system consisting of the real estate development company, an architectural design firm, a construction contractor, and a property management company (Tian et al., 2018). This further eliminated the necessity for external support and eased the flow of information during projects.

While these investments all seemed like long-term oriented, strategic projects, Evergrande also expanded into a variety of industries rather unrelated to the RE sector. Evergrande began construction of the Guangzhou Evergrande Football Stadium in 2020, before which it diversified into the health sector by buying out New Media Group Holdings and renaming it Evergrande Health (Leju, 2015). Aside from expanding into various other fields such as the tourism industry with its USD 24 billion construction of the Ocean Flower Island, an artificial resort island off the coast of Hainan; the finance industry by acquiring Sino-Singapore Great Eastern Life Insurance for USD 617 million in 2015 and turning it into Evergrande Life; and the food & beverage industry by launching Evergrande Spring mineral water, for which it hired Jackie Chan to promote its brand, Evergrande's largest non-real estate related investments were directed in to the automotive sector, specifically electric vehicles (EVs) (Evergrande Group, 2015; Reuthers, 2015; Yu & Yu, 2021). Under its Evergrande Health subsidiary, the firm bought a 45% share of the US EV startup Faraday Future for USD 2 billion in 2018, as well as completely acquiring the Swedish EV company NEVS in 2020 (O'Kane, 2018; Manthey, 2020). (The Japan Times, 2019; Hampel, 2019). Surprisingly, in light of Evergrande's recent financial struggles, Chairman Hui even stated in October 2021, that he planned to make EVs Evergrande's core business within ten years, again showcasing the direction-less nature of Evergrande's recent undertakings (Tan, H., 2022).

Evergrande's strategy shift

Resulting from Evergrande's high leverage strategy, the firm reached a debt load of over USD 100 billion in 2018 and had RMB 300 billion of debt payment due in 2019 (Bloomberg, 2018; Wharton, 2019). Given the Chinese government's increasingly restrictive lending policy, Evergrande's growth strategy increasingly depended on shadow banking loans, best exemplified by its dependance on trust loans, which accounted for approximately 45% of Evergrande's borrowing total in mid 2018, presenting an uneven capital structure (Bloomberg, 2018).

Fig. 21: Evergrande's total debt until mid-2018




Source: (Bloomberg, 2018)

Evergrande shifted its 'scale at any cost' strategy to what was described as a 'New Evergrande' in the company's 2017 annual report (China Evergrande Group, 2017). The change of strategy included a lesser reliance on debt and an alteration of its capital structure, with first signs of improvement in regard to its offshore debt structure and reduction in financing cost in already being visible in 2017, thus signaling a move towards what Wharton (2019) refers to as a low debt, low leverage, high turnover, and low-cost model. Implementing its new strategy, Evergrande began to pay back debt by large equity sales through which it received RMB 130 billion from a variety of investors. This resulted in an 8% decrease of its debt from 2017 to 2018. Contrary to Evergrande, some of China other large developers, such as Country Garden and Vanke saw substantial increases in average land cost during the same period. Initially, Evergrande's new strategy helped the firm to consolidate its position as a mass-market RE developer, specifically benefitting from fewer purchase restrictions in smaller cities.

The Evergrande crisis

However, increasingly restrictive policies such as the 2017 deleveraging campaign and the TRL policy challenged the company significantly. Despite recent deleveraging efforts, Evergrande had built up liabilities amounting to over USD 300 billion in 2021 and had crossed all three red lines by the end of June 2021, which restricted their access to funds (Cheng, 2021; Liu, 2022). Consequently, the firm was not able to pay back USD 1.2 billion of interest to overseas investors in December 2021, which led to Evergrande being declared as in default by the credit rating agency Fitch, despite an attempt to sell assets to raise enough capital (BBC, 2021). Evergrande did not manage to adapt to government lending restrictions as quickly as other developers that also utilized a debt financing-

based strategy for most of China's liberalized real estate market's history (Cheng, 2021). Furthermore, China's central bank also criticized the Evergrande Group for poor management, while government officials who also blamed Evergrande for recklessly expanding into unrelated industries (Tang, 2021; Liang, 2022). Hsu (2022) summarized the initial conflict with both parties (Evergrande and the Chinese government) accusing each other of being unreasonable, with Evergrande stating that they were not given enough time to adapt, whereas the government argued that the firm repeatedly did not follow the instructions given. He further noted that the government did not foresee the magnitude of Evergrande's default, assuming that there would only be consequences for Evergrande's shareholders, who will face losses (Hsu, Intvw. 5, 2022). In a public statement, Hui highlighted that Evergrande would need to finish construction of already sold real estate, which is important aim for the government. However, even this is becoming increasingly difficult in light of the actions of the company being under increased observation, exemplified by the fact that in December 2021, Evergrande received a demolition order for 39 buildings on the aforementioned Ocean Flower Island Resort in Hainan, reasoning that the firm obtained the project certificate by 'unlawful means' (GCR, 2022). Evergrande was only given ten days for the buildings to be torn down. The desperation of the Evergrande management becomes clear when looking at its emergency methods to acquire capital: The company gave its employees the choice of either providing Evergrande with a short-term loan or to lose their bonuses (Li & Stevenson, 2021). As Evergrande was offering high interest returns on said loans, many employees borrowed money from banks to lend their employer money. However, once the company stopped paying back on the loans, employees alongside homebuyers assembled to protest in front of various Evergrande offices. Resultingly, Evergrande shares fell significantly, having lost over 80% value in 2021, again emphasizing the distress that Evergrande finds itself in.

Currently, in mid-2022, Evergrande is still struggling with its USD 300 billion debt pile and is attempting to gain more time to gather capital by selling its assets to pay back on its debt (Li & Ouyang, 2022). It has succeeded in receiving a six-month extension on two onshore bonds worth RMB 20 billion that were originally due on May 6th and November 6th, 2022, as over 99% of the bondholders agreed to it, again showcasing Hsu's (2022) earlier statement, that Chinese banks and firms are willing to give Evergrande more time for restructuring, but the Chinese government tends to restrict them from doing so. Additionally, Evergrande is currently attempting to sell 2,000 completed properties during the Labor Day holiday on the 1st of May, for which it launched a marketing campaign on the day before, hoping for high sales during China's prime holiday season.

As of now (May 2022), reports on the success of its lates campaign are not available yet. Included in the assets that Evergrande has already sold is its interest in Crystal City in Hangzhou, a large residential and commercial development project currently in planning, which was sold to two SOEs for RMB 3.66 billion (Liu, 2022). Furthermore, Evergrande is in the midst of developing a restructuring plan of the company, which is planned to be presented in the end of July 2022.

Despite its traditionally close relationship with the Chinese government, it is questionable whether the government will offer Evergrande help in a situation like this, as it could harm the reputation of Xi Jinping if the government went against his recently introduced 'promotion of common prosperity', through which the CCP announced the removal systemic inequalities, including limiting the influence of larger PEs (Wu, 2022). Moreover, by rescuing Evergrande, the government may accidentally reassure other RE developers that they would receive similar assistance if they crossed the TRL, thus resulting in a higher degree of debt financing. Therefore, von Mehren (2022) believes that by not helping the firm, the Chinese government wants to make an example out of Evergrande, even though there are other developers that currently find themselves crossing the TRL. However, He further argues that the result could be, as mentioned earlier, that companies, potentially SOEs, will buy the pieces of the company (von Mehren, Intvw. 4, 2022). However, some point out that there is another option, which is to severely punish and sanction the executives of the company because of their recklessness, while simultaneously saving the world's most indebted company to prevent a likely spillover effect that it could potentially have on the economy in the form of a multitude of large RE developers defaulting simultaneously.

## Discussion on Mitsubishi Estate's and Evergrande's strategies

The analysis of our two case companies has brought to light a variety of similarities given the similar market conditions that MEC and Evergrande found themselves in. While close governmental ties enabled them to develop strategic real estate properties and acquire the larger amounts of properties than any other developer in their respective market, the initial approach of both firms was different. Until the mid-1980s, MEC utilized a conservative, profit-oriented strategy, characterized by careful diversification into other, related sectors, whereas Evergrande's strategy was determined by a revenue-based growth approach with scalability being the primary target, although it can be argued, that MEC, being part of the extensive Mitsubishi keiretsu, had little need for aggressive diversification given the cross-shareholdings it held in other firms of the network. Furthermore, while

Evergrande's main resources lay in residential real estate property, MEC had focused on commercial properties as their key market, although the residential contribution to their portfolio grew considerably, reaching 20% in 1983.

However, given the easy availability of credit and in light of MEC's real estate holdings rapidly rising in value after 1985, the firm seemingly discarded is conservative, careful growth approach and instead began with large developments spanning from luxury hotels and resort parks to an exclusive golf course at the foot of Mount Fuji. Evergrande, also increasingly relying on debt-financing diversified into a variety of different, oftentimes completely unrelated industries such as sports, food and beverage and electric car manufacturing, even claiming the firm aimed for its EV production to become its core business in the future. Similarly, direction-less in investment strategy, MEC began to invest heavily abroad, acquiring trophy properties predominantly in the US, seemingly without doing proper research beforehand, exemplified by it acquiring an 80% stake in the Rockefeller Center at a record high price during a time at which most experts agreed that NYC property prices were about to fall, which they evidently did.

While early diversifications of Evergrande such as internalizing a design, architecture, and property management department seemed to be strategic, vertical extensions of the firm's real estate core business, the acquisition of firms in the abovementioned unrelated industries seems like the firm attempted to build its own Mitsubishi-style keiretsu within just a matter of years, seemingly hoping that knowledge spill-overs from company acquisitions would be sufficient to successfully branch out into a large variety of businesses. This seems almost naïve in light of the fact that the long-term success of Japanese diversified keiretsu networks such as Mitsubishi is arguably grounded in their century-long expertise and aligned company culture across its divisions. As rising values of their domestic real estate portfolio, arguably more so in Japan, were key drivers for both firms' extensive investments, it further reduced their concerns about taking on considerable debt to do so. In both markets, the interplay of land prices and share prices created somewhat of a vicious circle in which rising land prices reflected in the companies' holdings would increase their share values. The resulting increase in liquidity would lead to these firms investing more money in land, thus leading to further rising land prices.

While the burst of the Japanese real estate bubble alongside a dramatically raised interest rate of 6% compared to 2.5 until 1989 ended MEC's debt-based strategy of large investments, restrictive housing and borrowing policies led to a change in Evergrande's growth model. Contrary to other Japanese RE developers, most of them having always utilized a revenue-based growth model were suffering strongly in the years after the bubble burst, many of them defaulting, MEC did comparingly better, relying on long-term oriented investments the firm made prior to its bubble strategy and being able to rely on a strong main bank within the Mitsubishi Keiretsu. During the immediate period after the Chinese government announced its restrictive 2017 deleveraging, it also seemed that Evergrande's change to a more careful, less leverage-based strategy was able to successfully restructure the company. However in light of the economic slowdown of the COVID-19 pandemic, falling property prices and the firm being denied access to funds as a result of crossing the TRLs, Evergrande defaulted on a record USD 300 billion debt, making it the most indebted company in history, with no governmental help in sight, as it is not in the Chinese government's interest to bail out firms that stepped over its policy that was aimed to solve the high-leverage problem in the first place.

# Conclusion

In order to find out whether China is facing a real estate bubble burst similar to that of Japan in the early 1990s, we have analyzed and compared institutional, industry- and firm-specific developments of the two countries' RE sectors during the respective time frames. Our analysis in the extended Varieties in Capitalism has brought to light that, contrary to popular opinion and despite inherent differences in the political and economic systems of the two countries, most of the factors that affect the RE sector are in fact comparable. Education is still rooted in Confucian principles, resulting in high respect for authorities, still partly represented in firms acting in their governments' best interest. Government-orchestrated business conduct as well unofficial deals are descriptive of both Japanese keiretsu firms and SOEs and PEs in China. Although the two countries' political systems are different by nature, the degree of governmental coordination of Japanese businesses is immense, oftentimes with influence similar to that of China. Furthermore, much of the Japanese government's strategy continued to be defined by its postwar economic development-oriented growth, similar to the Chinese government's strategic efforts after the liberalization of its economy. What is interesting is that despite interpersonal trust being equally high across China and Japan, the countries show different levels of institutionalized trust. This however is part of what makes the countries comparable. While the Chinese people have little trust in their government and legal systems, centralized communist

party control is somewhat necessary to align the country's large population in bringing their country forward. On the other hand, the Japanese people's high trust in institutions and the notion that it is every citizen's societal duty to act in the interest of the economic development of their nation make a centralized, communist party control unnecessary to achieve governmental rule similar to China.

These similarities extend to the two countries' RE sectors. Infrastructure developments, favorable demographic conditions, high demand, liberal credit policies and shadow banking enabled the boom of the entire sector, all of which was strategized by their respective governments. However, as economic and demographic growth stalled and with more firms increasingly relying on debt financing while land speculation was bringing prices up further, governments in both countries introduced harsh restrictions in the sector. While the end of Japan's low interest rate policies resulted in the stock market crashing, the effects of which spilled over to the RE sector a year later, recent Chinese restrictions such as the TRL, the biggest drop in house prices since 2015, as well as general economic slowdown, accelerated by the COVID 19 pandemic, has brought developers in severe difficulties.

The analysis of our case companies has further brought to light how developers that were inherently different by nature and history, utilized similarly aggressive expansion strategies when policies allowed them to, oftentimes acting rather naively. While Mitsubishi Estate was saved by its long-term oriented investments made prior to the bubble and a strong main bank as part of their keiretsu, Evergrande's default due not complying with the TRL policy had made headlines around the world, with Evergrande now being the world's most indebted company. Moreover, Beijing seems to use Evergrande to make an example out of, showing the consequences that firms must face that do not act in line with recent deleveraging policies. Given that Evergrande by far is not the only firm that has based its growth on revenue over profit, debt financing and extensive investing, as well as the recent developments in the sector with net profit margins and real estate prices shrinking, Beijing is playing a dangerous game that could lead to several large developers defaulting due to crossing the TRL. By implementing strict measures comparably earlier than Japan, the Chinese government is, as Hsu (2022) put it, misapplying the lesson that they thought they learned from the Japanese crisis. While there have not been any major real estate-related bankruptcies in China in the past months, the effects of the bubble may unroll later, as was the case in Japan, where the real estate market crashed two years after restrictive policies put an end to debt financing and speculation. If China keeps this strict course, albeit at an earlier point in its, without a doubt, already bubbling RE sector, the struggles

of the companies within will be felt across the entire economy, given the fact that the sector accounted for 30% more of the country's GDP, with the Japanese RE sector only accounting for 9%. If this would turn into a 'lost decade' for China is debatable. Compared to an already industrialized and urbanized Japan in 1991, China is still under development, thus a burst of its real estate bubble could have lesser implications to the country's overall development. Implications, however, that are in Beijing's best interest to be avoided. We therefore propose the following strategic changes to ensure a sustainable, long-term oriented, healthy growth of the Chinese RE sector:

(1) Modifying TRL restrictions to initially only apply to smaller, younger RE developers, followed with a gradual implementation of the policy, one line at a time to large developers into order to avoid large-scale bankruptcies occurring simultaneously.
(2) Further reducing the size of the shadow banking sector, which currently continues to account for 8% of the GDP, the growth of which was enabled by banks' bias to lend to SOEs by creating equal access to financing for private enterprises
(3) Enforcing a renting-out duty to owners of more than three properties to decrease the artificial demand that led to the development of ghost towns and other unnecessary projects, as well incentivizing consumers to rent to overcome cultural stigma involved with renting.
(4) Incentivize the population to move evenly across Tier 1, 2, and 3 to take off pressure from China's urban center housing prices, by investing not only in transport infrastructure but in structural conditions, such as 5G network extension and the creation of new special economic zones, overall.

## Further research

Given the generality of Porter's Diamond framework, it can be argued that certain intricate workings of the RE sector, especially in regards to its interconnection, the banking sector cannot be analyzed in their full scope, therefore an analysis of the Chinese and Japanese real estate markets, using Leontief's input-output model supported by an analysis of the two countries respective banking sectors could improve the understanding of the intricate workings of the RE sectors in our target countries. While the Varieties of Capitalism's framework enabled us to analyze the two countries in a cultural context, the cultural differences, especially in terms of demand behavior could prove to be an interesting study, best supported by a cultural compatibility study through the application of the CAGE framework.

Having established the macroeconomic workings of the sector in our target countries, supported by a micro-level analysis of two case firms, an even more holistic picture could be drawn by conducting a larger-scale firm-level analysis of various companies in the Japanese and Chinese RE sector
to establish whether different firms have established a variety of strategies due to market and policy conditions in their respective RE sector, potentially through the use of Porter's (1981) work on the contributions of industrial organization to strategic management.

Furthermore, the long-term effects of the implementation of property taxes on real estate price and demand development could prove to be an interesting study to gain insights how long-term policy making affects the sector.

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# Appendix

## I. Figures and tables

### I.a. Summary of literature on real estate sector analysis in Porter's (1990) framework

| **Authors: Paper** | **Information** | **Spheres/Aspects/Factors** |
|---|---|---|
| Sun et al. (2010): Empirical research on competitiveness factors: Analysis of real estate industry of Beijing and Tianjin | Summary<br>Beijing and Tianjin analysis. Demand and related industries are the most important factors. Moreover, house prices and GDP has a positive impact on competitiveness in the real estate industry.<br><br>Limitations**:**<br>• Only analyzes economic indicators, data analysis.<br>• Does not adapt to China and analyze social and environmental factors<br>• Limited indicators, e.g., in Demand factors where it does not include factors such as interest rate or income, thus questioning the accuracy of the model. | *Competitiveness factors* (Housing price & GDP)<br><br>*Demand factors* (Completed area & Population density)<br><br>*Productivity factors* (Total area & Total investment in real estate)<br><br>*Relevant and supporting industries* (Property area & Sales area of current houses) |
| Hahn (2015): The competitive advantage in real estate – A framework for Africa | Summary<br>Analyzes African real estate industries. Based on the assumption that basic factors do not provide a competitive advantage. | *Barriers:* Conflict, Corruption, Governance & Institutions, Risk / Return ratio, Investment Law, Financing<br><br>*Core Drivers/Constraints*:<br>Search Costs, Industry Structures, Human Capital Skills, Adaptability, Infrastructure, Material Resources<br><br>*Sophisticated Drivers/Constraints:*<br>Tourism & Media, Entrepreneurship, Sustainability, Real Estate Equity Instruments, Associations |
| El Barai and Amann (2021): Rethinking Competitiveness in the Real Estate Industry: How Stakeholder Orientation Creates More Value | Summary<br>They propose an extension to previous literature, which includes the perspective of stakeholders, and applies it to the Dubai real estate industry. | *Stakeholders:*<br>Include aspects such as quality of life, sustainability, resilience, and regulations<br><br>Highlights importance of economic and political aspects and the role of the government to facilitate and create competitive advantages within the industry. |

I.b. Witt & Redding's (2013) summary of Japan and China in the VoC spheres

| VoC Sphere | Measure | Japan | China |
|---|---|---|---|
| Education & Skills | *Adult literacy* | 0.990 | 0.922 |
| | *Education Attainment Index (2010)* | 0.883 | 0.623 |
| | *Employment tenure* | Long | Short (private), Long (state-owned) |
| | *Skills acquisition* | OJT | Private |
| Employment relations | *Union density* | 18.5% (2010) | 16.1% (2007) |
| | *Organization principle* | Company | Party-controlled single union |
| | *State intervention in wage bargaining* | Low | High |
| Financial system | *Main source of external capital* | Banks | Banks |
| | *Allocation criterion* | Market, relationships | Relationships, state |
| | *Term* | Long | Long |
| Inter-firm relations | *Presence of business groups* | Keiretsu | Qituan qiye |
| | *Noteworthy other networks* | Intra-industry loops with strong associations, R&D consortia, supplier and distribution networks | Communist Party, personal networks (guanxi) |
| Internal structure | *Decision-making structure* | Participatory | Top-down |
| | *Extent of delegation* | Medium-High | Low |
| | *Main basis of promotion and pay raises* | Seniority | Relationships |
| Ownerships and governance | *Main ownership form in large firms* | Public | Family, state |
| | *Main controlling owner* | Firms | Family, state |
| Social capital | *Interpersonal trust* | High | High |
| | *Institutionalized trust* | 1.31 | -0.35 |
| Role of state | *Type* | Residual developmental, welfare elements | Developmental and predatory |
| | *Decision-making* | Participatory through associations and committees | Bottom-up and top-down |
| | *Voice and accountability* | 1.05 | -1.65 |
| | *Government effectiveness* | 1.40 | 0.12 |
| | *Regulatory quality* | 0.98 | -0.23 |

*Source:* (Witt & Redding, 2013)

## II. History of the political and economic development of Japan and China

### II.a. History of Japanese political & economic development

Japan's economic development is a peculiar one as the country industrialized more rapidly than any other nation at the time and had to re-industrialize some 50 years later, following its defeat in World War 2. After having closed its borders for over 200 years during the Edo period, Japan was forced to reopen its borders to trade in 1853 and in sight of how the industrial revolution had altered Western nations that were colonizing most of Asia, Japan underwent a rapid industrialization effort from which it emerged as a world power by the beginning of the 20th century.

While it is often argued that Japan's modern economic system evolved under U.S. occupation post-World War 2, in fact many properties that shape Japanese economic policy until today originated from its wartime policies during 1937 until 1945. Features such as administrative; long-term employment; seniority wage; enterprise-based trade unions; financial keiretsu; as well as the Bank of Japan's window guidance were adopted during that period to help Japan's war efforts (Ohno, 2006). While these features contributed to Japan's post-war economic boom, it is argued that they have become obsolete in today's more globalized economy, as will be elucidated later in this section.

Following Japan's defeat in World War 2, the initial objectives of the U.S. occupants were the demilitarization of Japan as well as a breakup of Zaibatsu businesses and new labor laws guaranteeing collective bargaining and working rights, the commencing Cold War made the U.S. change their policies in favor of strengthening Japan as an anti-communist ally (Ohno, 2006). When the Cold War first turned hot in Korea in 1950, Japan's strategic location initiated the end of its economic depression as U.S. and UN army orders for services and goods were given to Japanese suppliers.

Like European economies growing rapidly during the 1950s as a result of the Marshall Plan, the economic benefits of supplying for U.S. troops during the Korean War, initiated a post-war economic boom in Japan. Annual growth rates averaging 10% in 1955 to 1960 strengthened Japanese industry and consumer power and as the 1950s ended, Japan had largely recovered from its defeat in World War 2.

While there was competition among domestic firms, high degrees of administrative guidance still resulted in the government coordinating the competition to prevent bankruptcies. This coexistence of

competition and cooperation was key in making domestic industries more competitive and was later described as "compartmentalized competition" by Yasusuke Murakami (1984). Under the Bretton Woods system that would continue until 1971 a fixed exchange rate of 360 yen to the dollar was set, and while some argued that this made the yen undervalued, it led to price stability during the period while wages rose. Even after joining the World Bank in 1952, Japan's investments were mainly made through domestic savings, while importing technology from abroad was encouraged by the government (Ohno, 2006).

Two important factors contributed to Japan's rapid growth: The MITI's new industrial policy of 1959 which changed the Japanese economy to focus on high-technology and high-quality goods designed for both domestic and foreign use as well as the development of a consumer economy which significantly benefitted from Ikeda Hayato's income doubling plan of 1960 (Akimoto, 2022). While MITI's selective industrial policy helped many domestic industries such as the automotive sector, to grow, this has been considered a special case for a developing country as experts agree that strong institutions, such as Japan had them, are required for such policies to work, a factor not present in most other developing countries (International Monetary Fund, 1997).

The type of industrial promotion that the Japanese government was undertaking, such as R&D assistance, low-interest loans, infrastructure building and entry restrictions, generally was not very different from other countries, but the instruments that MITI had built to share information between stakeholder, made them much more efficient. They maintained a close relationship with business associations, provided administrative guidance, visions and targets, created networks by rotating personnel, and by having top MITI bureaucrats retire into senior management positions in private firms, a practice called *amakudari*, which literally translates to "decent from heaven" (Usui & Colignon, 1995).

In addition to the guidance and control measures undertaken by MITI, the Japanese government further intervened in excess competition throughout the postwar period (Ohno, 2006). Many industries were required to consolidate excess capacity, agree on output cartels or even forcefully merge. While this practice is denounced by liberal economists, it did have positive effects such as desirable high-technology, law-observing firms not being outcompeted by firms violating intellectual property rights.

Alongside governmental policies, various other factors contributed to Japan's high economic growth in the 1950s and 60s. While strong investing and a focus on exporting are often considered to key factors, robust consumption is believed to be the most important force by some. With incomes rising in the second half of 1950s, more and more Japanese consumers were able to afford modern-day appliances, such as television sets, washing machines and refrigerators, while Japanese products were also beginning to attract foreign customers, eventually making it the world's second largest industrial power in 1965, the same year when it revealed signs that it had a trade surplus (Haynes et al., 1986).

During the same period, Japan underwent drastic social change. Japan's rural population moved to urban centers and government-encouraged family planning efforts led to a declining birth rate and thus a stabilized Japanese population (Ohno, 2006). What further contributed to this development was the labor shortage brought by high growth. Young workers became such a valuable resource that they were called "golden eggs" were transported in trains from rural areas to cities after graduating high school to work.

With the merger of the left and right wings of the socialist movement to form the Japan Socialist Party (JSP), while conservative groups joined to form the Liberal Democratic Party (LDP) in 1955, Japan entered a mainly two-party based political system. While the LDP propagated a policy focused on economic growth, close ties to the West, and the restauration of Japan's reputation, the JSP advocated for maintaining Japan's pacifist constitution, opposing rearmament, U.S. military bases and the continuous destruction of the environment. The dominance of the LDP, especially due to its close ties to banks and the business community soon led foreign observers to give it the nickname "Japan Incorporated" (Drucker, 1981). In fact, while a two-party system in theory, weak opposition parties led the so-called "1955 Regime" seem much like one-party state.

With the beginning of the 1970s, Japan's period of high growth slowed down to an average four percent of year-on-year (YoY) GDP growth, often associated with two factors: The worldwide recession as a result of the 1973 oil crisis and the fact that Japan had caught up with Western economies. While the ratio of Japanese and US incomes was 1 to 14 in 1950, it had risen to 1 to 6 in 1960 and, in 1970 stood at 1 to 2.5.

> "When you become part of the developed world, you can no longer copy others but must create something new in order to grow. Naturally, clearing your own path is harder and slower than following someone else's path" - Kenichi Ohno (2006)

The oil shock led to the abandonment of these plans and the Bank of Japan begun to move to more monetarist policies, trying to battle the inflation. Furthermore, the government promoted rationalization across all sectors, households were asked to reduce electricity consumption, material recycling and reprocessing was improved which benefitted Japan in the long run as it became the world's most energy efficient industrial nation by the begin of the 1980s. The knowhow gained from this transition helped Japanese automotive exports as the oil shock led people across the world to buy low-consumption Japanese cars.

High export numbers of the day have overshadowed certain domestic issues. While Japan's gross national product accounted for one tenth of the world output and Japan had risen to the world's largest net creditor nation, domestic consumption that fueled Japan's postwar growth has been stagnating. High consumer prices, little wage increases and long working schedules that did not permit much leisure time contributed to Japanese not consuming as much as their counterparts in the West (Noguchi, 1994)

While scholars argue that Japan should shifted to a less guided, and more market based economic system after the period of "catching up" was over, the oil crisis and inflation forced the government to fight these issues, while not focusing on systemic reforms. The fact that Japan maintained many legacies of the catching up period of the 1950s and 60s later formed institutional barriers for Japan's future development, which still is characterized by lack of innovation and over-regulation. Furthermore, national attention had shifted to arising trade frictions with the United States.

Japan's export boom has led to the country reporting its first trade surplus with the United States in the mid-1960s (Ohno, 2006). As complaints from US industrial lobbies and congress became louder, Japanese policy makers found this trade surplus to be increasingly politically undesirable. By the 1980s, the US recorded the world's largest trade deficit year on year, while Japan's trade surplus was the world's largest. Starting with an export boom in the Japanese textile industry in the 1960s, export quotas on textiles were forced on Japan, and with it seemed that with every new product that Japan

was successfully exporting, such as automobiles, machinery, electric appliances and semi-conductors, new quotas were demanded by the Western nations, the US in particular. Furthermore, US policy makers stated that the Japanese economic system was too protective about imports and demanded Japan to import more American goods and services such as produce, automotive parts and financial services

While Japanese banks used to be strictly regulated by the MoF, adequate profit margins and protection against bankruptcy were assured at the cost of little incentive to innovate, but as this system started to be deregulated, increased competition led to banks losing the extra profits of being a protected bank. Corporate clients moved away from bank borrowing toward other means of financing such as on international financial markets. Japanese banks had to find new, oftentimes more risky borrowers and projects such as SMEs and property investment such as resort developments and urban office buildings, given that land prices more than doubled throughout the 1980s. Not used to correctly evaluate these projects, banks acted carelessly and dramatically over-lent during the economic boom of the late 1980s and when the bubble broke, many of these loans turned out to be bad debt (Ohno, 2006). In the beginning of 1990, the Japanese stock market index crashed as did land prices one year later and Japan entered a long period of recession and deflation that would continue throughout the 1990s and 2000s, coining the term "the lost decade".

Many reasons are listed for Japan's continuously poor economic performance following the burst of the bubble, such as banks not being able to get rid of bad debts, the static nature of Japan's economic system that according to many should have been overhauled long ago, as well as general pessimism among the Japanese, caused by over-aging, government debt, rising bx burdens and unsustainable medical and pension schemes, which slows down investment and consumption. Furthermore, a lack of leadership could be observed as for a long time no political leader of Japan was able to clearly communicate the persisting issues and implement long-term fixes.

Since 2001, Prime Minister Koizumi's government has been trying to push certain reforms, such as the privatization of post offices, bank reform, pension reform and a halt of "over-generous" infrastructure construction. Since the 2000s, Japan furthermore experienced increased competition from other Asian nations. Electronics and Automotive makers from Korea, China and Taiwan have pushed former Japanese champions back, exemplified by the fact that in 1989, 32 out of the world's

top 50 companies by market capitalization were Japanese, as opposed to only one (Toyota) remaining in the top 50 in 2018 (Diamond Editorial Department, 2018). While the Japanese economy stabilized during the 2000s and 2010s, amidst temporary setbacks such as global financial crisis and the 2011 Tohoku earthquake that led to the meltdown a reactor in the Fukushima Powerplant, effects of the bubble continued.

Prime Minister Abe introduced a reform program known as Abenomics aimed to tackle Japan's economic issues by addressing it in "three arrows": Japan's low inflation; its decreasing worker productivity; and demographic issues resulting from its over aging population (The Economist, 2014). The relative success of Abenomics not only led to Abe being re-elected in 2016, putting an end to a long period of Prime Ministers only serving for short terms, but also to Japan's nominal GDP growth increasing, and to the ratio of government debt to national income stabilizing for the first time since the *l*ost decade (Financial Times, 2019). After Abe's resignation in 2020, his successor Yoshihide Suga stated that he would continue Abe's economic policies (Rich et al., 2020).

## II.b History of Chinese political & economic development

Following the rise to power of Mao Zedong and the subsequent establishment of the People's Republic of China (PRC) in 1949, Mao utilized the potential of the vast peasant population earlier on, developing communist agrarian policies in 1950, thus further maintaining their support (Palese, 2009). This included that land were handed to the peasants, thus indicating a transition towards sharing the land instead of private ownership. In 1942, Mao had already achieved formal supremacy, at which point he attempted to consolidate his leadership and introduced the rectification campaign, designed to remove elements that were not loyal to Mao, both within and outside the CCP (Teiwes, 1976).

In 1953, despite the tensions with the Soviet Union, the CCP introduced a five-year plan with soviet elements and under their guidance as they did not have other experience to draw from (Clare, n.d.) (CIA, 1959). Even though he had previously stated otherwise, in 1955 he argued that social transformation could happen before technical transformation and had much faith in the rural communities to transform if it was related to revolutionary purposes. In 1956, he introduced a twelve-year plan for agriculture arguing that socialization was needed for growth in production (Saich, 2001).

In late 1958, Mao realized that some changes were needed and presenting measures to take China down the path towards socialism (Palese, 2009). It included the establishment of large communes in order to solve the industrial and agricultural issues that China were facing, and the campaign, which took place between 1958 and 1960 is commonly referred to as the "Great Leap Forward". This campaign was implemented with the hope that China could accelerate and even skip the typical industrialization processes, and that this would be achieved with manpower rather than machines and capital expenditure. The first commune was established in Henan and was quickly spread throughout the country. Within this system, peasants were divided into brigade teams, and communal kitchens were created so women could work as well. Moreover, furnaces were used to make steel. However, there were issues with the implementation, and it happened way to quickly, which resulted in various serious consequences. The agriculture industry was disrupted significantly, and estimations of how many people died from starvation in the years 1959 to 1962 varies between 25 and 45 million (Ramzy, 2016) (Palese, 2009). Ultimately, the system was stopped. This did however create division within the party.

It was not until the "Chinese Cultural Revolution" of 1966, lasting until Mao's death in 1976, that he launched an even larger rectification campaign (Phillips, 2016; Jian et al., 2015). In this period, he attempted to strike down on whoever had opinions contrary to the regime's, with many being tortured, killed, or driven to suicide. Using the words "rebellion is justified!", Mao's red army, mainly consisting of militant university and high school students, started seeking out and attempting to fight revisionists. Notably is it that Mao, who in 1956 identified decentralization as the main aspect of changing China into a solid socialist country now attempted to consolidate his position and acknowledged the need for state power. The political pressure resulted in many young people and children denouncing their parents for being of opposing views to Mao (Branigan, 2013). The very Confucian principles and values that had permeated the Chinese population, which includes honoring one's elders, respecting them and being obedient, were now starting to become lost (Tsai, 2005).

Deng Xiaoping is commonly regarded as the chief engineer of several economic reforms launched in the beginning of 1779 and thus played a key role in the opening of China and it's first steps towards rapid economic development (Zhou & Xiao, 2018; Morisson, 2019). He reportedly stated: "Let a part of the population get rich first." (Hilton, 2012), which is directly opposing the Maoist line and instead, the concept of a socialist market economy was presented (Zhou & Xiao, 2018). These economic

reforms included price and ownership incentives for farmers, which allowed them to participate in the free market (Morisson, 2019).

The government moreover set up the first four special economic zones (SEZs) located on the coast, which was created with the purpose of interacting with foreign economies, attracting foreign investments, increasing exports, and allowing for superior technology products to be imported into China as compared to the current state of products (Morisson, 2019). These SEZs were located in Shenzhen, Shantou and Zhuhai within the Guangdong province, as well as Xiamen within the Fujian Province (Mack, 2019). Furthermore, one of the main purposes of the following reforms was to decentralize economic policymaking within various areas, highly focused on trade (Morisson, 2019). The state's economic control of a variety of firms were instead passed to provincial and local governments, thus enabling these firms to develop under free-market conditions and entrepreneurship was encouraged. Additionally, open cities and development zones were established where the free-market reform experimentation and implementation was initiated. For example, within these zones, tax exemptions and other trade incentives were given to increase foreign investments. Trade liberalization and removing trade barriers allowed for further foreign investment and increased competition under free-market conditions.

In general, the economic reforms were implemented gradually as a method to experiment and observe which reforms served to have the most optimal results, in order to identify which reforms should be initiated in other parts of China (Morisson, 2019). Deng Xiaoping referred to this as "crossing the river by touching the stones" (Morisson, 2019).

Since 1979 and the first economic reform, China's yearly real GDP (adjusted for inflation) grew with an average of 9.5% from 1979 to 2018, thus in fact doubling the size of its economy every eight years in real terms (Morisson, 2019). It was able to do so with only a few events that directly influenced economic development, although some that negatively affect China's economic development did occur. For example, the Tiananmen massacre (Also called the June Fourth incident) in 1989 where around one million people gathered on Tiananmen Square protesting for political, social, and economic reforms (Garg, 2022).

However, due to the continuation of economic reforms in 1991 as well as the removal and reduction of sanctions, real GDP rose back to a 9.2% growth, before reaching 14.3% in 1992 (Morisson, 2019). There are several causes for the rapid economic growth of China since the open market reforms implemented in 1979. Economists argues that this is due to two reasons. These are large-scale capital investment and rapid productivity growth. The large-scale capital investments, which was possible due to domestic savings and foreign investment, is highly complementary and connected to the rapid productivity growth, as a positive feedback loop presents itself. The national economy became more efficient due to the economic reforms, which in turn increased output and thus resources for further investments in the economy.

The productivity growth and the increase in efficiency resulting from the reforms has played a large role in the rapid economic development of China in the years that followed (Morisson, 2019). When the Chinese central government decided to reallocate resources to industries that were previously under heavy control and regulation, such as within agriculture, trade, and services. Using the agriculture sector as an example, the reforms resulted introduced free market conditions that allowed workers to instead work in the manufacturing sector, thus increasing production. Moreover, the reforms resulted in the increase of private firms, which often targeted other more market-oriented activities than SOEs, thus, becoming more efficient. Furthermore, the central government's reforms led to the increase of competition throughout different industries, especially the export sector and local and provincial governments were permitted to create and run a variety of enterprises without any involvement from the central government. Foreign direct investments (FDI) attracted both new technologies, but also processes that allowed for a further increase in productivity and efficiency.

Following its entry into the World Trade Organization in 2001, the Chinese government slowly reduced decentralized control of capital markets by delegating oversight to international financial institutions and local governments, although energic government interference and restrictions placed on capital markets continue to be subject to criticism from WTO member states (Financial Times, 2017). With GDP growth rates averaging 10.5%, the Chinese, having been the world's 12th largest economy in 1990, surpassed Japan in 2010 to become the world's second largest economy in 2010 (IMF, 2021).

Ten years prior to that, China already overtook Japan as the largest trade surplus nation to the US, resulting in trade frictions like those that Japan first experienced during its period of high economic growth. In addition to that, international criticism regarding human rights, WTO commitments and especially intellectual property rights became louder alongside the US demanding an appreciation of the RMB to "correct its gross undervaluation" (Ohno, 2006).

The financial crisis in 2008 affected China's economy as well as most countries worldwide (Morisson, 2019). Chen Xiwen, the director of the office of the central leading group on rural work estimated in 2009 at a news conference that 20 million migrant workers had to return home as they had lost their jobs due to the crisis, accounting for 15.3% of the total 130 million migrant workers in China at the time (China Daily, 2009). This was due to a real GDP growth decrease to 6.8% in the fourth quarter of 2008, resulting in the lowest annual rate in seven years of 'just 9%. The Chinese government acted by implementing a USD 586 billion economic stimulus package, which mainly focused on improving infrastructure and changing monetary policies to increase lending from various banks, helping China's real GDP growth rates to rise to an average of 9.8% between 2008 and 2010 (Morisson, 2019).

In 2012, Xi Jinping was elected the new general secretary of the PCR, and was immediately faced with financial repression, low interest rates, capital controls and an undervalued exchange rate (Brødsgaard & Rutten, 2017). He initiated his rule by introducing new anti-corruption campaigns and policies for reducing public spending, and in 2013 he presented a reform program with 340 different proposals (Whyte, 2020). He has since his instatement promoted the goal of realizing the "China dream", to achieve rapid economic growth. However, from 2011 to 2016, the growth rate of real GDP decreased from 9.55% to 6.85% (Textor, Statista, 2022).

The current size of China's economy can be hard to measure, yet there are several aspects that it can be evaluated on. There is speculation worldwide on whether China will overtake the US as the world's economy in the near future. The following economic observations are based on the current US dollar exchange rate. Observing nominal GDP for both countries, China reached USD 14.72 trillion in 2020, whereas the US accounts for USD 20.89 trillion (Silver, 2022). Similarly, the GDP per capita of the US is substantially higher than in China. The US GDP per capita reached USD 63,413 in 2020, whereas China significantly lagged behind at USD 10,434. However, when looking at both purchasing power parity (PPP) adjusted GDP and annual GDP growth rate, China already leads the

way. In PPP adjusted GDP, China reached USD 24.27 trillion, whereas the US only account for USD 20.89 trillion. Moreover, the annual GDP growth of the US in 2020 was negative at -3.6%, whereas China's growth was positive at 2.3%. These numbers are however affected by the COVID-19, which impact is hard to evaluate.

Since Donald Trump assumed office, and especially since 2018, frictions between US the China have intensified to trade war, that has been widely covered by the international press. Trump stated that China was conducting unfair trading practices, especially within the field of intellectual property rights (BBC, 2020). On the other hand, Chinese policymakers argue that the US is attempting to willfully prevent China's development towards becoming an economic power. The trade war commenced in July 2018, in which Trump, as part of a measure to incentivize Americans to buy more domestic products, imposed tariffs worth of around USD 360 billion on Chinese products, which China answered with imposing tariffs on USD 110 billion worth of US goods. Tariffs have been imposed since and even though many US policymakers called for the trade war to be eased, Joe Biden, the current president of the US even amplified the policies (Huang, 2021). In fact, he refers to the trade war as "a battle between the utility of democracies in the twenty-first century and autocracies." (Huang, 2021). Still, there are no signs of an end of the trade war and bilateral cooperation remains tense, affecting the economies of the two largest economies.

Over 70 years after Mao formulated the country's first five-year plan, the current 14th five-year plan under Xi Jinping covers many aspects e.g. in relation to economic growth, innovation and manufacturing and gives a further outlook on the wider targets to reach before 2035 (Economist Intelligence, 2021). Most notably, it does not include an annual average real GDP growth target, as opposed to earlier plans. This shows a new tendency to which the CCP may enable more flexible monetary and fiscal policies. GDP targets will be set related to actual circumstances and conditions as it did for 2021, with a 6% target. Furthermore, senior officials have reportedly mentioned the aim of doubling the real GDP by 2035 and increasing per capita GDP to reach the state of other developed economies. EIU predicts the actual target is an annual growth rate in real GDP from 2021-2025 to be around five to six percent

The plan does however include other economic targets: For example, innovation focused development is presented as a main part of the development plan and is addressed as a possible

solution to decreasing productivity growth seen in previous years and be able to compete with developed economies (Economist Intelligence, 2021). Therefore, R&D spending will be increased to more than 7% yearly, and the amount to be spent on basic research will be increased significantly. Comparing the 14th five-year plan with the 13th, there is more emphasis on strategic and national security-related areas. The main areas of which the plan highlights are e.g., artificial intelligence, neuroscience and aviation and aerospace. Moreover, it is stated that SOEs will function as frontrunners within this innovation transformation, and the plan includes a switch in focus from encouraging mass entrepreneurship and private innovation to instead focusing on market leaders.

Finally, the focus on manufacturing is renewed compared to the previous five-year plan where service industries were more focused on (Economist Intelligence, 2021). This emphasizes the need for a more stable manufacturing sector following a steady decrease in GDP share within the last two decades. Inspired by the economic model of Germany and attempting to move away from the more service-driven models in the US and UK, China wishes to improve its manufacturing sector, in order to not be purely service-driven.

**III. Interview Transcripts**

III.a Interview 1 – Kenji Sato (Name anonymized per request)

*Senior executive at Mitsubishi Estate.*

**Interviewer**

**With the Japanese economy not having fully recovered from the bubble crash until today, what factors in the Real Estate industry contributed to the "lost decades"?**

**Kenji Sato**

The Real Estate industry has not been a very significant cause for the slow growth of the Japanese economy after the bubble crash, based on my understanding.

**Interviewer**

How have corporate strategies from Japanese real estate companies shifted after the bubble burst?

**Kenji Sato**

Prior to the bubble burst, Japanese real estate companies owned and held properties for a long time regarding commercial properties. As they believed that rent and property value would rise, it was justified to hold a property once acquired, enlarge a portfolio and expect increase of rental income and property value.

Now, after experiencing the bubble burst and the 2008 Financial Crisis, they tend to liquidate a portion of their portfolio from time to time in order to obtain capital gain, considering the market environment, conditions of each property and etc, This change has been supported by progress of real estate securitization and project finance. Also, some of the real estate firms have placed more importance on fee-based business, such as asset management, than asset holdings.

**Interviewer**

**After years of decline, newly built condo prices are reported to have reached bubble-period prices again, even in spite of COVID economic slowdown. Which factors are decisive in this development and do you think there already is a new bubble building up?**

**Kenji Sato**

The low interest rate has supported condo prices. In addition, while the average income has not significantly increased in Japan, some of young people, such as founders of successful IT ventures, can afford to purchase expensive condos. Others may have cash through inheritance. Also, highly educated couples of younger generation have typically double income recently, which differs from households in the 80s or 90s.

**Interviewer**

**During the 1980s, developers were building countless high-rise constructions that remained empty. To what degree has this contributed to the bubble?**

**Kenji Sato**

I do not agree to the statement, "During the 1980s, developers were building countless high rise constructions that remained empty." It might be true that the real estate industry was not in good shape up to the late 80s, there were not many empty buildings.

**Interviewer**

**How are Japanese property buyers behaving today? Is there still a "bubble trauma" that affects buying behavior?**

**Kenji Sato**

I can hardly find a bubble trauma recently. While real estate companies' behavior has changed since the bubble burst as I stated in #2 above, they continue to seek for new opportunities and there are new types of money coming into the real estate market, which include real estate funds and financial institutions.

<u>**Interviewer**</u>

**In the 1980s, Japanese companies gained notoriety buying vast amounts of foreign real estate, most notably Mitsubishi buying the Rockefeller Group. Are Japanese real estate firms still heavily investing abroad?**

<u>**Kenji Sato**</u>

Most of Japanese real estate firms stopped investment activities after the burst of the bubble, but have re-activated international business for the past 10-15 years. However, their behaviors are different from those in the bubble era. In the late 80s, they purchased trophy towers in the major cities in the world. Some firms made huge investment in resort developments and/or hotel in Hawaii or Australia. Now, most of investments are relatively small. They prefer investment where they can find opportunities of enhancing value through renovation. Also, they place importance on liquidity of investment.

<u>**Interviewer**</u>

**Mitsubishi estate gained international attention when it bought the Rockefeller group in 1990. What were the motives behind this purchase?**

<u>**Kenji Sato**</u>

Mitsubishi Estate would like to have a strong income base in each financial center in the world. In the early 90s, Mitsubishi Estate viewed that New York, London and Tokyo were major financial centers.

<u>**Interviewer**</u>

Mitsubishi Estate names England, Singapore, Vietnam and China as countries in which they have projects. How important is the foreign market to Mitsubishi's business and what are the strategic objectives behind these FDIs?

<u>**Kenji Sato**</u>

Currently, Mitsubishi Estate has projects in the US, the UK, Singapore, China, Australia, Vietnam, Indonesia, Thailand and etc. One of the objectives is to enjoy benefits of growth of those countries' economy. Also regarding the Southeast Asian market, it is still possible for Mitsubishi Estate to

export expertise on high-quality of building plan and property management. Finally, Mitsubishi Estate expects diversification of its portfolio, which could mitigate risks associated with real estate investment in a single market.

**Interviewer**

**The bubble burst of 1990 showed that conduct within Japanese companies sometimes consisted of unofficial deals and changed/unreported figures, partly due to informal networks within the Keiretsu group. Were such problems also present within the Mitsubishi Group and has the code of conduct within the Mitsubishi group changed after the bubble?**

**Kenji Sato**

Based on my understanding, inappropriate transactions and disclosure were typically conducted between financial institutions and their borrowers.
Please note that there are several types of so-called Keiretsu in Japan. One of them is a group of companies, of which origin is a large conglomerate, including Mitsubishi, Mitsui and Sumitomo. As far as I know, this type of Keiretsu rarely caused unofficial deals or disclosure issues.

**Interviewer**

**With many real estate firms going bankrupt in the 1990s, what has Mitsubishi Estate done to survive the lost decade?**

**Kenji Sato**

Real estate firms going bankrupt in the 90s were 1) new firms which grew very rapidly in the bubble era and 2) condo developers which purchased a huge volume of sites for new condo developments. These companies had weak financial base, relying on debt financing. On the other hand, large traditional companies including Mitsubishi Estate owned core rental properties and had financial strength, which supported them to survive the difficult situation.

**Interviewer**

**Was loosening of governmental oversight in the 1980s responsible for the bubble crash? How has it affected Mitsubishi Estate's strategic choices during the late 1980s?**

**Kenji Sato**

I have not seen loosening of governmental oversight on the real estate industry. Oversight on the financial industry might be loosened. When debt financing is easier, real estate companies tend to make more investment. In this context, Mitsubishi Estate expanded investment in the late 80s, but it was an indirect effect of the government policy.

III.b Interview 2 – Logan Wright

*Partner at Rhodium Group, leading the company's China Markets Research work. He is an adjunct fellow of the trustee chair in Chinese Business and Economics at the Center for Strategic and International Studies. His expertise lies within China's financial system and credit conditions, as well as the policies introduced by China's central bank. In his publications he covered developments in the Chinese real estate sector for over a decade.*

**Interviewer**

**Chinese cities have one of the highest ratios of property prices to household income, especially larger cities. What factors do you think are decisive for that development? And how would you evaluate the pressure on the Chinese population?**

**Logan Wright**

The commercialized housing market in China really only started in 1998, and it started with a very considerable subsidy or transfer of wealth to the household sector, which ended up creating a foundation for high and rising prices. And essentially this had to do with either state owned enterprises or households being able to acquire their previous state provided housing at very low prices, far below what would be considered market prices. So in a way you can see the price rises initially as not necessarily commensurate to income, but in fact prices have been suppressed for so long that then there was a very rapid rise in prices which we could probably say lasted the first half decade up till 2006, 2007 or so. And then the correction that took place in 2008. Beyond that I think it requires a more complex explanation and the way I would phrase it overall is that housing is the most important financial asset in China. It has essentially become the repository of savings or repository of wealth for the vast majority of wealthy Chinese, and it has been the retail bubble that hasn't burst. That's for a variety of reasons. Real interest rates were suppressed and kept low for a long period of time to sustain China's investment. Therefore, if you could borrow at low interest

rates, if there was an expectation of housing appreciation and then there was a real story behind it in terms of the urbanization and rise in Chinese wealth that also explained that dynamic. Then, that sets conditions for a rise in prices that can be based on speculative or investment driven demand, not really based on fundamental or household demand at its core. And this happens in many different housing markets. But I think that when you have those conditions in place, there's expectations of government support for the sector and the local government level. There are low real interest rates, there's a strong history of price appreciation. No ones really been burned, unlike the stock market bubbles in 2007 and 2015. That sets the conditions for prices to continue rising because of investment driven speculation into those markets. And that's how you can sustain financial bubbles of all sorts longer than you would ordinarily think or assume possible.
So I think all of those conditions really have contributed, but it has to do with the fact that there are also very few alternative channels for Chinese savings and Chinese investment patterns. However, even if there were, you probably would have had an aggressive housing bubble in China, it just probably would have been subject to slightly fewer restrictions. The other issue involved is that there's been no meaningful carrying costs to this investment. So there hasn't been a property tax in place. Your only concern really is depreciation or suddenly being caught short, and if again, every miniature correction in this market from late 2008 to late 2011 to most of 2014 have all been good times to get back in, not necessarily to get out. That's how you can sustain that.

**Interviewer**

**What pressure does that mean for the Chinese urban population?**

**Logan Wright**

The pressures are enormous at this point. Rental yields are extremely low, but not many people rent because if you can afford to rent in cities like Beijing, were I was paying a rental yield of zero point 7% or something ridiculous like that. If you can afford to buy, everyone thinks that this is what you should be doing with your savings, and so therefore there's more and more pressure to keep up with all of your neighbors chasing these artificial gains from continued speculation in this market. So that creates a form of pressure. Right now what we've discovered is that there's a pretty strong inverse relationship between mortgage debt and household consumption, particularly for the lower level income strata, lower to middle class resonance. And that's been particularly common when the

market underwent its post shantytown redevelopment program/Transformation into a more presales driven market from 2016 to 2000 to 2020. I would argue that the fundamentals of the Chinese property market probably peaked at around 2013, 2014.

Right after the global financial crisis, there was a steady accumulation of housing inventory. This is the period of ghost cities. This is the period of local governments over-building. There was a huge expansion of credit that seems to sustain that. It was obvious that building had occurred much faster than fundamental demand was rising. But fundamental demand was rising. That market basically corrected in the 2014, 2015 cycle, the solution to that for the government was the shantytown redevelopment program, which was essentially a program to sell down existing inventories out by providing cash compensation for old resonances, some of which were actually old, some of which were actually fairly new. But the point is you don't need to build more, you can just buy out of the developers existing inventories to work this down. So up until about 2018 housing starts were still below where they were in 2011 at the peak. So this was actually a very meaningful correction within the market that seemed reasonable. After that. however, developers responded to the restrictions on credit and shadow banking because this was going to fundamentally hurt their business models by relying more and more on preconstruction sales, collecting 100% of the purchase price for the house before it's actually built. So this created a new political problem for Beijing because hypothetically, you have all of these developers that are in need of additional financing just to complete units that have already been sold. There are Ponzi like elements of this financing going forward. So the market is very different on a fundamental basis up until about 2013, 2014 when China's labor force and urban marriages peaked.

**Interviewer**

**You mentioned earlier that there hasn't really been a property tax set up in China at all. A lot of people say that the fact that so much of household wealth is tied up in property is also mainly due to the nonexistence of a property tax resulting in higher property prices and increase in property presales, as you said.**
**In August 2021 Xi Xingping announced a pilot program through which he did introduce property taxes in certain Chinese cities.Where do you see the benefits and challenges to introducing a property tax countrywide?**

**Logan Wright**

It's the right solution, but it's probably too late. The dilemma here is that if you want to use a property tax to combat speculation in the market, then you'd want to apply it in areas that already have other sources of fiscal revenue besides property that are more dynamic which still have growing economies. But most of the justification of the property tax has been to replace local governments' reliance upon land sales. If you want to apply that and actually replace those revenue streams, you're doing it in interior cities and provinces that don't have other alternatives. And so therefore, you are going to undercut their justification and their fiscal sustainability much faster. So if you want to use this to combat speculation, it really makes sense to apply it for fiscal reasons, in areas where there's not much speculation. And if you want to do it to combat speculation, it doesn't actually shore up local government fiscal measures very much. So it is essentially too late down this path because there are already other problems and some of these are political. Local governments have been active speculators in their own property markets for years, and local officials have, too. So there's a lot of concern about actually creating a national land registry and actually determining who owns what. So that's often a quiet restriction on the property taxes moving forward, but those trials have been delayed as you know. Officially, they've said that they've already taken it back about a month ago. I think there was always this threat sort of hanging over the market that a property tax will come through and indeed China is short of longer term sources of fiscal revenue, so they need to be considering things like this. But it is just a question of how effective it can actually be at this stage?

**Interviewer**

**China is somewhat notorious for countless empty buildings were developed throughout the country without enough demand for them. How would you assess the risks of of this development and are there things that real estate firms and also the government are already doing to fix this development?**

**Logan Wright**

There are two problems here. One is that there's been property building throughout this 2016 to 2020 cycle when it starts hitting another peak. So in my view the imbalances in the market are not policy driven, but fundamentals driven. There's just too much supply relative to fundamental demand. Home ownership rates are already very high, household debt levels are very high. So

empty buildings are common in interior cities and provinces that are already facing declining population growth. Therefore, you get into this dilemma of who's actually going to buy this stuff. No one is moving there and the people that are already there are either priced out of the market or already own their homes and investors and speculators from other cities aren't necessarily coming to Ningxia in order to buy property.

Similarly, there is an imbalance provincially between the demographic situation. The reliance upon property is a source of revenue and land sales, so this is sort of an unreformed central local fiscal story that has created these fundamental imbalances and the property market. That being said, there was this shantytown redevelopment solution which was to try to work down some of those inventories. That worked for a while, but you can't really do it again because it's not profitable once housing costs get to a certain level, then it's not profitable to keep redeveloping land unless prices keep rising. Then the question becomes, how can prices keep rising if there's no fundamental buyers?
We're seeing prices falling right now, we look at the average sales prices of all the major developers, I think there's 19 of them that provide data on a monthly basis. And so right now we're seeing 11% declines in February prices and I'm sure it's going to be year on year. I'm sure it's gonna be down by a much larger margin. Even the NBS on a 3 month moving average basis. If you just look at their average sales price relative to floor space sold, it's down about 6%.
The official 70 city data doesn't really capture the magnitude of the actual adjustments that gets the direction right, the magnitude is useless. So you've got to look at another ways. Prices are relative phenomenon. Of course, it depends on what your pricing it compared to but we do expect that real property prices will be falling based on these fundamental imbalances over a 5 to 10 year time frame.

**Interviewer**

**China, like Japan in the bubble economy years, possesses a declining birth rate and an unbalanced economy with low consumer spending and extremely high investment. Knowing that this had caused severe issues in Japan, contributing to not only the burst of the bubble but the "lost decade" that followed, is the government and are real estate firms aware of this and are they considering this development as a threat?**

**Logan Wright**

I'm sure that they're aware of it and that they have been watching. There's an element of if the music's playing, you've gotta dance to all of this, in the famous Charles Prince quote during the global financial crisis. So the developers that have done best in this recent round of consolidation and defaults have been those that didn't lever up in 2017,18 and 19. So those that were cautious and heated that concern have have survived. Those that were most aggressive are the ones that are being exposed right now because they need additional rounds of leverage that they can't get from either the three red lines and now from any banks, even if they're the three red lines were not in place, simply because of the headwinds facing the market itself. I think there's the question I would sort of put back is what does awareness that we are prone to bubbles do for you?

There's been an awareness of the property bubble in China and an attempt to control the speculative excess and the bubble for quite some time. They've done so through using administrative measures that aren't that sustainable. But the problem was that they couldn't really control this in the way up. It's not likely that they would be able to control this in the way down either. It's not clear exactly who would be aware of the bubble that therefore would need to change behavior other than a pretty considerable macroprudential kind of measures to control price growth within the sector. You can make the argument that politically, this would have made a lot of sense why it didn't happen in the 2010 to 2015 period is probably the relevant time frame rather than the concern now, when it's already a bit too far gone. If you hear this being discussed as the “Gray rhino risk”, a risk that everyone is that is large and present, so everyone is aware of it, but it is remaining unattended to. That's really the dynamic that's been going on. Some developers were more cautious. Vanke for example, was talking about the risks in the sector as early as 2018 and they've come through this recent crisis far better than others.

**Interviewer**

**Land sales are an important source of income for the state government and local governments, and there is heavy reliance on land sales as they stimulate the economy and create jobs. However, land sales recently decreased heavily, leaving the government to increase the cap of special purpose bonds to inject more liquidity and stimulate infrastructure spending. What effect do you believe this will have on the liquidity issues?**

**Logan Wright**

We've done bottom-up analysis of all of the proceeds of the local government special revenue bonds. So you can determine what they're used for. A lot of them are for refinancing rather than new infrastructure spending. It's about 25 to 30% of them. You have the fiscal story correct, which is that in the fund budget, the land sales budget, the secondary budget with land sales revenues weakening and land development costs, the other side of it, increasing the actual profitability of the land business has been deteriorating basically since 2017, 2018. And so you can see a virtual linear relationship between the growth of those special revenue bonds, which went from around 400 billion, you had to 800 billion, you end to 2.15 trillion and now it's 3.65 trillion. You are able to track this huge growth as a direct corollary to that deterioration in the land development model.
So this is a model that's already well beyond its time at this at this stage. Last year we were down a bit over 20% in terms of total revenues.

Local governments try to get LGFBs to step in and buy land, which is just sort of left pocket, right pocket transaction and that doesn't work for very long because then LFS aren't using that credit to build new infrastructure projects. Local government bonds will only do a small portion of it, and they're supposed to be used for additional infrastructure, not for plugging in these holes in financing. Ultimately, this comes down to the LGFBs themselves and whether they can sustain their deteriorating financial conditions and their operating conditions, their rates of return are obviously very low. They depend upon the support from local governments. So we've seen what we call geographic counterparty risk emerging in the Chinese bond market, where traders are very aware of exactly where the risk profiles are among local governments, and they now consider local governments a source of risk, rather than a source of stability.

What can happen is something like the Yongcheng Coal default that happened in November 2020. What took place there was that the local government was forced to either make payroll for migrant workers at one of its SOEs, or make payments on a bond. So they chose to make payroll to the migrant workers and defaulted on the bond investors. Well, the bond investors were supposed to be senior, but this is this local government condition. So then traders immediately jumped forward and said, well, we're looking at the overall state of local government fiscal conditions. So, I can send you something if you're interested. We did a bottom-up analysis of land sales in 192 cities relative to fiscal revenues and credit within those cities to see where they were most vulnerable and where

you're likely to see LGFV default basically. The short story is like that it probably is the Southwest, it's probably Guizhou and Yunnan where they have high dependence upon land sales and pretty high levels of local government debt. The northeast is appalling, of course, in terms of debt levels, but their property markets have been depressed for so long. They're not actually that dependent upon land sales anymore because land sales corrected years ago. And then there's other vulnerabilities actually in certain cities in the Northeast, you can see some of the foundations at this. This is a huge contraction in available revenue f or localities, and there's no obvious replacement. The other way to think about it, and I think this is useful just as a framework, is that what preconstruction sales are is basically credit from households to home builders. They're basically providing all of this financing up front so that home builders don't necessarily have to get that credit from banks or other sources. And total preconstruction sales last year were 14.8 trillion RMB, so roughly about 1413% of GDP.

So if that's down by twenty 2530%, there's no offset, right? There's no magic pool of three to 4% of GDP and funding that you're gonna find to offset that. So in many ways these are losses that cannot be made up and that's a credit crunch for developers and that feeds into this credit crunch for local governments as well. It's something that's happening right now, absolutely. Local governments are spending all this money on COVID prevention and building isolation facilities and doing testing and they're not getting paid for this, for the central government. They're certainly not turning around and helping out property developers with it.

**Interviewer**

**How would you assess the role of shadow banking influencing the Chinese real estate sector?**

**Logan Wright**

Shadow banking mainly concerns borrowers from shadow banks, from trusts, from asset management companies, from all these private equity deals and to a certain extent mortgage lending to lower income households as well through peer to peer networks. This financial deepening and China took place in large part to facilitate the expansion of local government financing vehicles, their property operations and the operations of property developers.

So developers have always been those that are willing to buy to borrow at higher interest rates, which is what's necessary to for shadow banks to work. So it's been very central to the process. Shadow banking expanded commensurate with the property bubble between 2012 and 2016 especially, and then went sharply in reverse from during the deleveraging campaign in 2017 and 2018. Developers offset that by increasing their reliance upon preconstruction sales, basically substituting Shadow bank credit for credit from home buyers. And that's why the bubble didn't collapse really in 2018, but extended another two years and got even larger and that sort of sets us up for where we are right now, which is why the three red lines were so important because the three red lines essentially made that business model impossible. In other words, rather than before the regulators are trying to say you shouldn't lend to these developers, now they're just telling the developers that it doesn't matter where you're borrowing from, we're not gonna let you borrow anymore. And that's a fundamental change in their business model, which means if you can't rely upon leverage, you have to start relying upon sales speed. You have to discount preconstruction sales. You have to keep going.

**Interviewer**

**So it does seem that there has been some learning from the Japanese bubble in this case. Shadow banking greatly contributed to bubble bursting and bad debt everywhere, with many companies going bankrupt.**

**Logan Wright**

Yes, and that's still happened in 2014 and 2015 as well. The shadow banking system became extremely large in China, especially between 2012 and 2016. The system became if you've I wrote a longer monograph called credit and credibility which is available on the CSIS website. If you look at chapter two of that, it is a brief history of how the financial system got to where it is, and it is a useful starting point, including the role of the property sector within that and how the deleveraging process changed. Its available on the website of the center for strategic international studies under my name in Washington.

**Interviewer**

**Moving on, do you think that the recent Evergrande issue is a one-case episode, or do you believe other Chinese real estate companies are at risk of experiencing similar developments?**

**Logan Wright**

Evergrande was basically different because of its size, not different because of its methods and many developers defaulted before Evergrande and there are many that have defaulted afterwards. Evergrande got all the headlines and everything because they borrowed the GDP of Finland. So I understand the size arguments but it was very unsurprising and we had been talking throughout the year about how this will generate a lot of attention but there's so many other problems in the market at this point, well beyond Evergrande itself.

**Interviewer**

**How do you evaluate the role of the Chinese government in handling the Evergrande issue and the real estate sector in general?**

**Logan Wright**

Will they have a really done much of anything. There's not really a workout in place. Evergrande has defaulted on its debt, its creditors and contractors are trying to get paid. Beijing has put the pressure on local governments to keep these construction projects financed, but there's not enough money there to do so. So there's this attempt to allow asset management companies and state owned developers to finance the acquisition of some of these assets so that they can keep construction going. But that's not really happening either or it's happening at a very slow pace, so in a macro sense it's not that relevant and there really isn't much of a management effort to speak of, I would say. And we're continuing this: the offshore property bond market is in absolute collapse at this point. You know you can't finance offshore of the $220 billion in offshore property bonds, they're trading at enormous average yields over 20%, so refinancing is virtually impossible. There really hasn't been a centralized mechanism in place to stop this contagion from spreading. Meanwhile, the onshore market, just in terms of actual property sales, which is the key dynamic, is down 30% in January and February based on the 30 city sales data, 47% in March. Obviously, the lockdowns are contributing, but we're down over 50% in April. So, if there's a bailout mechanism here in place, I'm not seeing it.

**Interviewer**

**What consequences did Evergrande experience as a result of not fulfilling the “three red lines” criteria?**

**Logan Wright**

With the three red lines, they wanted to end property developers’ excessive reliance upon leverage and they didn't see another way to do it. It reflected the end of this other regulatory approach and it's very blunt and they knew that, but they didn't mind because Beijing ultimately doesn't think that the property sector should be contributing to growth in the medium term because it is overbuilt so in that sense, regulators don't really care where the problem falls. The three red lines reduces debt in the sector the worst and most overleveraged developers will take the hit from that.
From a regulatory perspective, that's not a terrible outcome. From the economy's perspective, it's really hard to say why you can do that to some developers without impacting the broader sector, which is exactly what we're seeing so far. But in essence, I think that there's too much emphasis on the three red lines as it was a game changing phenomenon, but this was already a highly imbalanced market and it didn't take much one way or the other to tip it over. These imbalances would have unwound one way or the other. It's just a question of how it happened.

**Interviewer**

**So also, given that Evergrande crossed the lines, and thus wasn't able to pay back, one would question how right the policy was to begin with.**

**Logan Wright**

There were several others that were already over the lines by that point. I think when we saw this announced in late August, early September 2020, we did a piece looking at the top 30 and we had about 7 or more that were already well over the lines. The whole point is that they quit targeting the bankers who are lending, the developers start targeting just the borrowers. And if you're targeting the borrowers, there's not much they can do.

**Interviewer**

**Where do you see the the similarities between state owned enterprises in China and Keiretsus in Japan, especially within the real estate sector?**

**Logan Wright**

In real estate, it's more disaggregated because state owned enterprises have importance, but not because they have all central government support. It's because they have access to credit and therefore, they can establish strong relationships with the local governments and often they're more regionally concentrated in terms of where they operate. It's less like a direct central planning MITI directed operation but there are similarities there.

The other difference is that the real estate market in China is just so disaggregated. It's not a very concentrated market. All the standard enterprises and state-owned developers together are a bit less than 25% of the market, I believe. So it's not an area where you really have outsized roles of state firms and that therefore the larger private developers are of similar weight, especially when they're all acting in in the same direction. So I think those are pretty meaningful distinctions.

**Interviewer**

**Going back on the three, let red lines, were there any consequences Evergrande experienced as a result of not fulfilling them?**

**Logan Wright**

The penalties were in place basically to say that you have to hit these limits or you can't borrow and expand more on your balance sheet, so those are the limits that were sort of put in place. Now the problem is more fundamental, I would argue that even if Evergrande wanted to borrow who's lending to them, right? If you know that there are conditions, certainly they would take high cost financing if necessary, but this is where you get into a lot of the distressed debt players and others in the market that have generated a lot of publicity.

So it wasn't really about the penalties that are actually imposed. The penalty was you can't grow your balance sheet. I think the point was that there were a number of measures that could have been

contemplated had developers actually breached those limits and there was a lot of playing around with the cash totals.

So one thing developers try to do is that they can't do much about their overall debt limits. But if you look at how they were reporting cash, some developers were reporting cash from their subsidiaries or cash from consolidated projects. So it looked like developers have all this cash on their balance sheet, but that was because they jointly developed this project for this other developer, and that project had certain cash and they consolidated it. They didn't have access to it, so was all restricted. So you had this restricted cash problem that took place. There was a lot of creative accounting to try to get around the three red lines, which shows that they were at least being forced to report numbers that were in line with them.

**Interviewer**

**In 1985 when the Plaza Accord got in place and the Japanese yen was appreciated, a lot of what contributed then to the rising real estate market was Japanese companies being able to get very cheap loans and cheap credit from the government in order to keep them competitive, being afraid that they would lose competitive competitiveness with other players in the market. So they've recently obviously been these trade wars, especially under the Trump administration.**

**In recent years, especially the Trump administration's trade war on China put of foreign pressure on China. Are there effects foreign protectionism on the Chinese real estate market similar to those in Japan in the 1980s?**

**Logan Wright**

These are very different circumstances. There's long been awareness of the you couldn't get China to sign up for a Plaza Accord type deal with the United States and there's always been some sort of speculation on whether you could get the Chinese currency to appreciate and the dollar to depreciate? And the PBOC has long been very reluctant to agree to those sorts of arrangements, but when it comes to the trade war and protectionism, first, the Chinese currency started depreciating quite realistically because it was going to have an impact on tariffs and trade balance and some of the fundamentals therein. I'd find it difficult to argue that there's really much of a feedthrough to the

domestic property market in in that sense.I'm not sure that there's a really strong comparison there in terms of the real estate bubble itself.

Japanese bank assets peaked at about 20% of global GDP and Chinese bank assets had risen much further than that already. So, but very few of them were really being deployed abroad. Chinese bank assets are about 50-55% of global GDP now, so it is much larger at that point during.
The world was more open to Japanese outbound investment than it probably was to Chinese outbound investment. At the same time, but China itself had been restricting its own outbound investment to control the currency since 2016. So It's worth going through a lot of these things, but I'm not sure that there's many analogies that hold up when it comes to some of the Plaza Accord currency diplomacy in that respect.

**Interviewer**

**Do you think that the Chinese real estate bubble is going to burst soon or will it be be kept alive and continue growing artificially?**

**Logan Wright**

The most probable scenario is a long term adjustment, a multi year adjustment in the pace of property construction, that is likely to be accompanied by a decline in prices in real prices over time as well. But there's many different policy choices that can be made along the way to either make that adjustment a very sharp and abrupt one, which is what's happening right now. I mean, the collapse that's ongoing right now and Chinese property construction really can't be overstated. I've never seen prices and volumes down by these margins as we're talking 30 to 50% declines and year on year basis during the strongest seasonal parts of the year, which means that property developers are under acute financial stress. This is why the entire market is trading as it is.
There are things that Beijing can do to offset that: Cutting interest rates, guaranteeing different lines of credit, providing assistance to local governments. They can phase out this slowdown in construction into a 5 to 8 year time frame versus a one to two year time frame. And that really matters. But the direction of it isn't really in question for us just given the imbalance as it built up. And those are fundamental in our view, homeownership rates are very high.
I mean, there are over 80% according to most household finance surveys, some even have it over

90%. Like Donley's work is in the high 80s. There's PBOC surveys that have it in the 90-95% range.

Household debt levels have risen very sharply. Looking at the demographic situation you wonder where new urban residents are going to come from. There aren't nearly as many of them and we know where birth rates are.
So in that sense, the demographic story is very interesting because we don't have a great set of data points on countries like Japan, which is almost the other only one, that actually experienced a meaningful real estate bubble alongside a meaningful correction in i's working age population. Because Japan's working age population peaked in the mid 90s and China's just peaked in 2013, 2014. China's real estate bubble is peaking five years after. So the real working age population peaked. Japan's real estate bubble burst five to six years before working age population actually stopped growing.

III.c Interview 3 – Ziv Nakajima-Magen

*Partner and executive manager at Nippon Trading International. Represents investors on real estate purchases in Japan.*

**Interviewer**

**With the Japanese economy not having fully recovered from the bubble crash until today, what factors in the Real Estate industry contributed to the "lost decades"?**

**Ziv Nakajima-Magen**

It's a tricky question because my personal perspective on that is that real estate is more of an indicator of underlying economic and and commercial issues. I personally see the real factors contributing to to bubbles regardless of where they are and when they are as a combination of government policies that have gone wrong and general greed in the market and that sometimes is a derivative of that. So real estate being high ticket items and and the very large part of the country's economy can definitely look like it's a factor. But I think it's usually more a factor that might be expediting the crashing of a bubble or it might be something that's indicative of a bubble that's about to crash. But calling it a factor is stretching it a bit in my opinion. Like if you look at Japan, for example, there were other things that came way before the real estate bubble actually appeared,

right? So there was a deregulation of the banks in the early 80s and then that led to a combination of factors, one of which was that money became a lot easier, banks started to compete with each other, they started to offer better interest rates and began to lose a lot of corporate clientele because Japan was starting to open up to the world and in a wider fashion. Because of that, a lot of corporate clients suddenly had other options for financing, whether domestically or overseas.
And that led the banks to then start lending to more risky clients, such as smaller, medium sized enterprises and so forth. They didn't really have the experience or the capacity or the right policies in place to handle those kind of high risk clones. So yes, real estate was involved in the bubble crash and definitely expedited it, but I don't think it caused it.

**Interviewer**
**How have corporate strategies from Japanese real estate companies shifted after the bubble burst?**

**Ziv Nakajima-Magen**
The ones that survived definitely did alter the way they did business in a lot of ways. And again, that wasn't specifically real estate companies, but it was more of a general. I know historian. So take everything I'm saying with a grain of salt, but there were definitely a lot of practices related to sitting on on on assets, funded by debt that they simply had to cut loose to survive. Bankruptcies accelerated humongously after the bubble crash. Just between 1990 to 1991 the amount of unresolved debt as a result of those bankruptcies went through the roof. I think it quadrupled from 2 trillion yen to 8 trillion.

So the ones that did survive adopted, first of all, they had to let go of a lot of debt which was a tough pill to swallow for a lot of them, because obviously when they were selling after the bubble crash, they didn't get nearly as much as they would have gotten just prior to that, but they simply had to do it. A lot of them had to reduce inefficiencies in a lot of different segments within their corporate structures. So for example, they started in forcing early retirement.. They stopped holding on to the  concept of lifetime employment which has slowly been dwindling away since the bubble crashed and these days, it's not really a thing anymore. It's probably more of a thing then there's another countries, but nowhere near what it was pre bubble days, so you will get a healthy retirement package, but you're not gonna be inefficiently contributing. I mean, there was

overemployment. There's no just no other way to put it. And the construction industry specifically had a lot of that. They've adapted to that. Once they got rid of the bad debt, the ones that survived started borrowing a lot less and for less risky projects. They build less of those huge concrete monsters that nobody's living in, no more "if you build it, they will come" kind of thinking. Money was less available than before and even when companies secured funding, they realized that it wasn't a good idea to to borrow as freely as they were doing previously, and so they've shifted to some degree.

These days we're seeing them slipping into those same behavioral patterns again, though. Politicians or or the public in general tend to have a short memory when it comes to those practices that should be still in place. So we're seeing a lot of it come back not as badly as before, but it's still here.

**Interviewer**

**What were the decisive factors in real estate firms not going bankrupt after the bubble?**

**Ziv Nakajima-Magen**

First of all, less reliance on debt. The companies that relied on depth turned it into good debt and improved their efficiency and productivity and cut out the over employment. That was a major factor. The other factor was diversity, today, if you look at the J reads Japanese real estate investment trusts. The ones that did the best throughout the pandemic are the ones that were diversified, with mixed portfolios, mixed purpose funds. All of these companies that didn't focus only on a single industry or only on a single location, diversifying within Japan and outside of Japan were more crisis resistant.

Another factor are the Keiretsu structures, for example. A lot of them have different companies within the structure and there's a lot of pro and counter arguments to whether that's an efficient structure or not. But the fact that there are a lot of companies within your group umbrella, that diversify into different kinds of industries and market segments, might not be crisis proof, but it's definitely crisis resistant.

**Interviewer**

**Was there any governmental assistance in terms of financial help during that period during the bubble period given to larger conglomerates or where were they acting more or less on their own?**

**Ziv Nakajima-Magen**

And the ones that had banks within the corporate umbrella definitely did receive a significant amount of support. And so pre deregulation, they were pretty much immune to any sort of corporate losses, but that was not the case anymore after the bubble burst. But there was still a lot of support, I mean the two big to fail Mantra hasn't hasn't escaped Japan in that sense, similar to what you saw in the US when the global financial crisis hit. And again, the vast size and and and structure of these mega companies makse them also more resistant to mergers and acquisitions and hostile takeovers.

**Interviewer**

**All large Japanese real estate firms are part of Keiretsu networks. How has their membership in these networks affected the burst of the bubble and has business conduct within them changed during the bubble years?**

**Ziv Nakajima-Magen**

So there's a lot more scrutiny on them these days. There's nowhere you can hide these days as much as you could have in the old days. So there's definitely more of an eye on them, more deregulation occurring, more monitoring by the government, so they are not probably not as free to do as they please as they used to. And whether that particular structure is a good thing these days or not is a very debatable point. It depends on who you ask. Obviously there are a lot of efficiencies in being able to do everything under one single corporate group. And there's two types of Keiretsu, the vertical and horizontal types. If you're a single industry, let's say Toyota for example, everything that you do that's related to cars would be done within your company umbrella. And then there are the horizontal types where you will be diversifying into different types of industries and different industry segments. And then you'd have different groups in each of those segments and the way they operate and how efficient they are depends on that structure as well. I think that these days through globalization, each of these clients has access to different types of services and products

from different kinds of companies, whether domestically or internationally, so they definitely don't have the teeth that they used to back in the day. I wouldn't say they are a thing of the past, they definitely very much still here, but they're not as efficient or as monopolists as they used to be.

**Interviewer**

**Has it been an advantage for for real estate firms to be part of Keiretsu groups? Would the bubble have never blown up to these proportions if it weren't for large firms being part of Keiretsu networks?**

**Ziv Nakajima-Magen**

It definitely started off as an advantage. Obviously they were formed for a reason and it definitely expedited things as well. I mean, if you're not being monitored and there's no corporate governance and there's a lot of room for making irrational or not, really financial savvy decisions and firms might have come to different solutions if they didn't have to source it within the Keiretsu group.They definitely expedited the crash but that structure also assisted them in surviving it. So I mean there's something to be said for both approaches.

**Interviewer**

**After years of decline, newly built condo prices are reported to have reached bubble-period prices again, even in spite of COVID economic slowdown. Which factors are decisive in this development and do you think there already is a new bubble building up?**

**Ziv Nakajima-Magen**

I find it difficult to call this a bubble for a few reasons. Firstly, if you look at Japan as a whole, yes, new condo builds in central Tokyo and to a certain degree in Central Osaka are at that level. But the rest of the country in many places is still ridiculously cheap. So if you look at, if you look at prefectural capitals and even some of Japan's secondary Cities and if you look at second hand as opposed to brand new builds, there are places for sale in Japan that our customers buy on a regular basis. You can buy a studio unit for 20-40,000 US.
So to say that there's a bubble forming within Tokyo, maybe. But within Japan, we're definitely very far from that yet. And the rest of the country still has a lot of room to grow before it comes even close to those proportions.

Then the other thing is Japan's debt these days is held domestically. Even if you look at the bubble back in the 90s, yes, there has been a crash. But if you look at what a crash means in other parts of the world, people burning tires in the street, bank rushes, the sort of things that you see when a country's economy implodes in other places, none of that ever happened in Japan. It could be due to the Japanese mentality, the phrase they use here called shoganai, meaning just bear it and move forward. It could also be Government protectionism. You could call it a lot of things, but if you look at what the pandemic has done, for example, it didn't really cause a crash. Tokyo and Osaka have bubbled up specifically, but as long as the rest of the country is not following suit, Japan has a lot of metropolitan centers aside from Tokyo and Osaka and we see even migration migrationary trends within domestic Japan, people moving like they did after the tsunami and the nuclear disaster in 2011, people were moving out of Tokyo. Similar things were happening when the pandemic started. Tokyo Central Ward started losing population for the first time in a long time. I think we we're still a bit off from being able to call it a bubble of any sort.

**Interviewer**

**However, what would you ascribe to the fact that newly built condominiums have gotten so expensive again?**

**Ziv Nakajima-Magen**

One thing that the pandemic has done is that it's created a shift in the way that people are viewing the footprints of their private homes these days. Though not to the extent of the other countries, Japan has adopted a working from home mentality at least to some degree. People, mainly husbands, are being delegated to work from home. They need an extra office, they need extra room and in the center of a big city like Tokyo and Osaka obviously space is a is a huge commodity, it's something that's very rare to come by.

Developers haven't quite come up with enough new construction that suits that new floor plan that people need, so anybody who wants to stay in the city is finding it very difficult to buy a condo of the size that they want. So that's kind of the perfect storm in the sense that it helped. Prices were already increasing and that helped them even more. But again, this only applies to newly built condos. Properties that people are buying either directly from developers or very shortly after construction. They're buying them with a mortgage, and in Japan interest rates are extremely low.

So it does make sense that demand is hug, but again, it's only newly built condos, and it's only central Tokyo and to some degree, central Osaka. It's definitely not a national thing.

**Interviewer**

**During the 1980s, developers were building countless high rise constructions that remained empty. To what degree has this changed during the bubble?**

**Ziv Nakajima-Magen**

They're definitely not being built and standing empty at the moment, what you are seeing standing empty are buildings in the smaller townships that are decreasing in population as people conglomerate into the bigger metro centers.
But those are not new. You don't see new construction standing empty in Japan at the moment.

**Interviewer**

**How could housing prices in the 1980s become so high even though many high-rise buildings were standing empty back then? Wasn't there an oversupply?**

**Ziv Nakajima-Magen**

Back then, the developers grabbed those land parcels and further inflated prices simply by virtue of utilizing them, they were not vacant anymore. There were now construction projects being built on them and it was getting more and more difficult to buy them. I mean, what appreciates in Japan is always the land, it's never the structure and so you utilize land for building regardless of someone's renting it. And it's also the nature of any speculative market. In a speculative environment, people are not buying those properties because they're expecting rental income, they don't think that they need to care about rental demand. They're buying them because they want to sit on that land, and they're hoping that they'll be selling it at a profit. So the fundamentals of rent demand and supply don't necessarily correlate with the prices of the properties.

**Interviewer**

**How are Japanese property buyers behaving today. Is there still a "bubble trauma" that affects buying behavior?**

**Ziv Nakajima-Magen**

Yes, very much so. If we look at the people that we're buying properties from, they are almost never going to be in their late 30s to late 50s kind of seller. People have some sort of memory of the bubble crash, whether they were children at the time or just entering the job force at the time. So the children back then remember the trauma that their parents went through. There was talk around the house, there was a crisis and the people who have actually purchased it around that time have obviously suffered personally. The people that we buy properties from these days are either elderly folks, who have lived through quite a few boom and bust cycles. You know, if you've been through World War Two, then the bubble crash of the 90s is not just a big deal. And people of a certain age start thinking about what they should be doing with their assets, they usually go to their kids and say: Shall I let you inherit it when I pass away? And the kids are so traumatized that they'll say, no, just sell it, give us cash. We don't want to deal with property. Nowadays, young and middle aged families are interested in owning their own home and if they are affluent, maybe also owning a holiday home, but they don't really consider property investment. They have become very risk averse to the point where they're just interested in cash savings as opposed to any other kind of investment. And I think that's very much a result of the bubble trauma.

**Interviewer**

**In the 1980s Japanese real estate companies invested heavily abroad, most notably Mitsubishi Estate buying the Rockefeller Group in 1989. Are Japanese real estate firms today still investing heavily abroad?**

**Ziv Nakajima-Magen**

Yes, foreign direct investment has been on the rise in the last few years, between 2014 to 2019, just before the pandemic hit, foreign direct foreign outbound direct investment by Japanese companies has almost doubled. It took a little bit of a hit when COVID struck, but even in 202, it started to rise again. That's a trend that's probably not going to change. What has changed is where they're directing their money. Up until the global financial crisis, it was mostly the US, then Europe and then Asia.These days it's mostly Asia with the US and Europe in second and third place. Nowadays the funds are going to China, to Vietnam, to Myanmar and so on. But I think that's more of a global shift in funds and capital from the West to Asia. So similar to other investors, Japanese investors

recognize that's where the money is and that's where they're going. But volume-wise, it's generally been rising.

**Interviewer**

**Is today a good time to invest in Japanese real estate?**

**Ziv Nakajima-Magen**

That's a very difficult question to answer as it is quite general. It is always a good time to invest in particular locations. But it depends on the geographical location and the market segment.Now is a very good time to invest in Japan as long as you're not investing in Tokyo and Osaka. If you're investing in some of the other metropolitan centers, such as Fukuoka Nagoya, Sapporo and Kyoto and a lot of the prefectural capitals, places that are close enough to a big city or are the biggest city of their prefecture are still very good investments. The prices there are still at or slightly over the bottom level of what they were post bubble crash. Those places are still very good to hit because property prices have more than halved since the bubble burst. Rents are slower to respond to these sort of events and even cost of living has gone down, but not to the same extent as property prices crashing, so that gap provides very good yield. So if you're investing anywhere other than central Tokyo and central Osaka then yes, there are very good deals to be had.

**Interviewer**

**What can Japanese real estate companies do and what are they doing today to avoid a bubble building of a similar extent?**

**Ziv Nakajima-Magen**

They need to be more efficient and they obviously need to be a bit more globalized. Some of them are starting to rise up to that. The domestic market here is shrinking rapidly. The workforce is shrinking, the economy will eventually shrink, too. You're looking at a country that's shrinking at 2-5 percent a year, so any kind of economic growth is a bloody miracle, so relying only on the domestic market is going to be very painful in the coming years, but as said, a lot of companies have diversified in that regard. Becoming more efficient, not being over employed and not being overleveraged are all very good practices that should be in place. Unfortunately, it looks like the past is a bit too quickly forgotten because a lot of them are being very leveraged. A lot of them are

still employing people that they shouldn't be employing just because it's customary not to fire them. A lot of them are doing inhouse Keiretsu-style trading and commerce which is not always a good idea.

III.d Interview 4 – Allan von Mehren

*Chief analyst and China Economist at Danske Bank. He covers China in relation to global financial markets and conducts research on China's economy and politics.*

**Interviewer**

**When we look at Chinese cities, we can see that they have one of the highest ratios of property prices to household income. What do you think the factors decisive for this development is? And how do you evaluate the pressure on the Chinese population?**

**Allan von Mehren**

I think it's definitely true for the major cities like Shanghai, Beijing, Shenzhen, but probably not quite as high when you look at the tier three, tier four cities. So I think that is important to distinguish between, and if you look at house prices overall on average over the past 20 years its not been rising a lot, not higher than normal income growth. But you have an issue in the very big cities and the tricky thing about the big cities is that prices are high in all big cities, in all major global cities prices are extremely high. It's true that when you compare to income on average, the prices look expensive in Shanghai and Beijing. The challenge is, what is fair value for a city like Shanghai, given that China is maybe the country that most companies are investing in. So it is natural that there is a high price i think, and there are a lot of rich people in Shanghai also. The challenge for those cities in the longer run is that many people have bought more than one apartment and one of them is just standing empty as an investment. Many parents have bought apartments for their sons because in order to get married in China, and there are more men than women, so they need to be able to offer a good deal. I think that is partly also why many have two homes. But it is of course a problem in the long run. People are not going to have two homes forever. Eventually there is going to be a big decline in demand based on that. So i think that's definitely something that could pose a challenge in the longer term. I don't think it's a major reason why we have this property crisis we have now. I think that's more related to China wanting to stop the high leverage building among developers, and they also don't want housing to be a speculation

object,  they want it to be for living. So they also want to stop this thing that people buy more than one apartment. So they have been stepping on the brakes in terms of the housing market. It's not like you have a big flood of houses available for sale in China. There's no demand for that, like you had in Spain, for example, when the Spanish housing bubble burst. And you still have the urbanization in China, that is still going on. So from that point of view, I don't think they have a major problem right now, but they do have a chance in the longer term with all these in empty apartments that people have as a second home.

**Interviewer**

**China is notorious for having empty buildings and ghost cities that were developed without enough demand for them. What are the risks of this and what are real estate firms and the Chinese government doing to fix this development?**

**Allan von Mehren**

Firstly, I think the ghost cities are there, but I think you have to be a little bit careful about
How severe the issue is. I read a book by a guy who has been traveling around in China for many years and studying these ghost cities. He came back 6-7 years later and cities that were ghost cities were no longer ghost cities because when you build cities from the bottom, it will be a ghost city for a long time, because before people can actually move in, you need everything in place. And that takes time. So for a long time it is going to be a ghost city, and then eventually the urbanization. Many of these cities have been populated.  It is funny, he mentioned a funny story Pudong in Shanghai, which is a major busy area. That was called the Coast City originally because they were building and it was all empty. but clearly that's not the case today. And I do think you will maybe find cities in China that will never be populated and that will have to simply be written off. You have also been these pictures of buildings being blown up and stuff like that. But to what extent a really big problem. It doesn't suggest at least from the statistics that, houses available for sale, is a massive issue. It probably requires further investigation into, how many of these cities are there actually. Of course, as a journalist it is fun to go there, and then it looks like it is all of China that is like this. You just have to be careful about media reports, at least on this subject. look for sources like IMF or people who actually studied it close

**Interviewer**

**China, like Japan in the bubble economy years, possesses a declining birth rate and an unbalanced economy with low consumer spending and extremely high investment. Knowing that this had caused severe issues in Japan, Japan, contributing to not only the burst of the bubble, but the "lost decade" that followed, is the government and real estate firms considering this development as a threat?**

**Allan von Mehren**

I definitely think China has studied Japan very, very closely. Looking at, how was its development, what caused this? We know that China is known for making tons of reports on all these issue, have many thinktanks, and go all out to learn from other countries. So it is definitely an issue that they have been studying closely. There is no doubt that the declining birth. There's no doubt that the declining birth rate is a headwind, but the declining birth rate was not a very decisive factor for Japan. It was basically, they had a major both real estate bubble and it seems an equity bubble also during the 80's. I think one very important distinction between Japan and China is that Japan was pretty much at its end of catching up space, so GDP per capita was much closer to developed countries. Whereas China is still ,even though it's been growing very fast for 40 years, GDP per capita is still much lower than what Japan's was relative to the frontier back in the 80s. As long as you're catching up, you just have more growth potential. And with more growth potential, of course also more income potential and therefore also scope for further demand for housing and for higher housing prices and all these things.

Again, the problem in Spain was, you had massive amount of houses,   organization to suck up the empty inventory and then you are just looking at collapse in prices. China's benefit is that their organization is ongoing and it's going to be ongoing for many, many years. You can basically, if you have oversupply of houses, get rid of it just by not building so much for a while and then people will move into the empty apartments and then eventually you'll have to start building again. That is pretty much what happened in 2014-2015. Demographics is definitely an issue in China, but I think sometimes it is maybe exaggerated a bit compared to other factors of how important it is. I think the key factor in China is to improve that technology, improved education. If you do that, you increase your productivity and if you increase your productivity you increase the incomes for people and they can buy homes and all these things. And again, because GDP per capita is so low

still in China, there is the scope to continue on that path. So not to say there is not headwinds or anything, that's definitely the case.
Also in terms of the high investment, China is in a transition where they have a very high investment in construction and infrastructure, and they are in a transition where they need to do investments in other areas that are more needed in the long term. It makes sense in the beginning to build a lot of houses and infrastructure because that increases your productivity. But now the marginal return of these certain types of infrastructure is not very high. The infrastructure they focus more on now is more green infrastructure, which is needed for the long run. It is 5G stations and all these things that actually improves productivity for China. Investment is not just investment. It is really, really important what kind of investment it is. Is it investment that actually makes sense in the long term? Right now they're speeding up. 5G investments, for example. That makes sense because you're gonna need this, instead of just building only bridges and all these things. So I think, at least it is important to distinguish what kind of investment are you looking at.

**Interviewer**
**Land sales are an important source of income for the state government and local governments, and there is heavy reliance on land sales as they stimulate the economy and create jobs. However, land sales recently decreased heavily, leaving the government to increase the cap of special purpose bonds to inject more liquidity and stimulate infrastructure spending. What effect do you believe this will have on the liquidity issues?**

**Allan von Mehren**
There is no doubt that that is a big challenge right now because the problems in the development sector is hitting land sales and that is hitting the local government’s ability to actually stimulate the economy. So they are trying to make more transfers to local governments and also allow more special purpose bonds, and then use state banks to give lending and buy some of these bonds, which in effect is also bank lending. It is a more structural challenge also in China because.
You will see that land sales will go down and that is a big source of income for local governments that the buyer will have to find other sources of income. It is something that they are clearly aware of, and they are doing fiscal reforms to work on this. But it is yet another challenge, and to cope with that requires reform.

**Interviewer**

**How would you assess the role of shadow banking influencing the Chinese real estate industry?**

**Allan von Mehren**

Shadow banking was growing massively from, i think, 2011 up to 2015-2016, and it was actually looking very concerning. Then they started to realize that this is a big problem because you can control bank lending, which is important to avoid these credit crunch credit crises, where funding suddenly stops. You really get into a vicious cycle. Shadow banking also plays a role in the real estate sector, for example through these wealth management products. We heard Evergrande also trying to get their own employees to lend them money through some of these products. That is something they need to work on. It is not as big a problem as it was five to six years ago, but it is still part of the economy. It is not a huge part of the economy, but it is still part of the economy. It's not a huge part of the economy, but of course the problem with shadow banking is; if you put money into a normal bank, you have a deposit guarantee up to a certain amount.

If you put money into a shadow bank product, there's no guarantee, and any loss is on you. So that is why it is so dangerous, because the money can suddenly be pulled out of that system very quick when people realize that they can actually lose money. That, of course, just makes the problems worse for the real estate section. Basically, the real estate sector had, maybe four to five funding channels, now maybe they only have one or two left, which all rely on the state sector, which needs to be able to and willing to fund the gap that comes from maybe lower lending from shadow banking. But you can say, that is the advantage in a system where you have state banks is that you can go in and actually take over this lending from the shadow banking system, whereas in a purely private based system no other banks would take those loads. Eventually things just collapse. That is partly what happened with the financial crisis,  that lending stopped in certain places and other private players did not want to take over that lending. Then you get into this really, really vicious circle. The disadvantages of having a state banks is that maybe the money does not get allocated as it should be, but on the other hand in a crisis situation it can be helpful because it can plug the the whole from the funding that is missing elsewhere.

**<u>Interviewer</u>**

**It is argued that the Chinese government has more means to avoid a bubble burst than the Japanese government had. Can you think of a development in which even the Chinese government could not avoid a bubble burst?**

**<u>Allan von Mehren</u>**

One risk would be if households get so concerned about the housing market that they stop completely buying new homes. Because that would be a huge liquidity crunch for developers. You already have that partly, but that's why it has been so important for the Chinese Government to step in and support home sales also. If for some reason they cannot convince Chinese households to keep buying houses and to convince them that it is safe and make sure that it is safe, then you could imagine that it could get quite ugly. That is the scenario that I think is the most dangerous one.

Funding wise, I think the Chinese government will be willing to step in. To avoid a complete collapse, you basically need to just make sure that lending continues. And that they can do, but the home sales issue I think is the most concerning one. And that is also why I think you saw the Chinese Government, very quickly, when Evergrande was in trouble, that there first priority was for some of these projects that people had bought and that was suddenly not being built, to get other developers to finish those projects so people could be confident that when they bought an apartment they would actually also get it and they wouldn't lose their money. That is crucial. So I think.
So far they have seemed to understand what they need to do, and as long as they do that, I think they will manage. Now, with the Covid outbreaks, that is also a new obstacle
Now also with these COVID outbreaks, that's also a new obstacle for home sales. Of course you can get so many problems that it just piles up so much that even the Chinese government can not stop this snowball. So, i wouldn't rule it out completely, but I think compared to Japan for example, i think the government state intervention is more normal in China, and the whole system depends on stability, so that is the different

**<u>Interviewer</u>**

**Is the Evergrande issue a one-case episode, or do you believe other Chinese real estate companies are at risk of experiencing similar developments?**

**Allan von Mehren**

We definitely see many other developers struggling at the moment with the funding and we see more defaults. Also among the very big ones. But I think China may want to make an example out of Evergrande if they can not survive on their own. I think they will probably let the company split up and the other companies buy up the pieces and potentially state-owned companies buy up the pieces.

I think they will probably let the company split up and the other companies buy up the pieces and potentially state-owned companies. They cannot do that with all companies. Definitely, other companies are at risk of facing severe stress, which is already the case, but a total collapse is not is not as likely. I think Evergrande is a special case, but I would not rule out others of the big ones facing the same, but not massive ones because that would be too destabilizing.

**Interviewer**

**How do you evaluate the role of the Chinese government in handling the Evergrande issue and the real estate sector in general?**

**Allan von Mehren**

They definitely play an important role. I mean China said that they want to sort out and what market based solutions to this. But to the extent that the financial stability is at risk. The government needs to step in and that is the case in all financial crises or potential financial crises.

And that's what happen, crisis eventually should be had to step in and say, OK, we will do whatever it takes. Then the crisis basically stopped and in the global financial crisis basically what turned around the crisis was that after the letting Lehman go, then the government just had to step in and make sure that all the big banks did also not go bankrupt. So China's government place a similar role in in handling this. It is the lender of last resort, so when no one else has confidence in the system to blend, Chinese government needs to step in and do the lending, and that's what it looks like they are doing. But they don't want to overdo it. They don't want to just bail out everyone and they want to do it to the extent to avoid a major crisis, but not more than that. So that's why you still see that many of these companies are struggling, but not not severely enough to make the whole market come down.

**Interviewer**

**Can you describe the benefits and costs of being an SOE in the real estate sector, and perhaps compare it to Japan and its keiretsu network?**

**Allan von Mehren**

I am not an expert in the Japanese economy, so I am not totally aware of how that worked, but SOEs benefits is that you have the state in the back and in this situation you are less likely to face problems. A state-owned bank will be more willing to lend money to a state owned real estate developer, then a private developer, because It feels more safe. On the other hand, they also are expected to take responsibility and go in and and and, maybe buy projects they might not wanna buy otherwise, but I think the big benefit they have right now is that they have the power to go in and buy some distressed assets that get really cheap. Probably, in five to ten years time it has been a good deal, so it is definitely nicer to a state-owned real estate developer than a private one and it is probably gonna be a bigger share of the market over the coming years, because of that.

**Interviewer**

**The government introduced the "three red lines" policy, which requires real estate companies to meet specific criteria such as an asset liability ratio of no greater than 70 per cent, a net debt ratio of no more than 100 per cent and a cash to short-term debt ratio of one or below. What consequences did Evergrande experience as a result of not fulfilling the "three red lines" criteria?**

**Allan von Mehren**

What started the crisis was basically these three red lines in combination with the home sales suddenly falling sharply because normally, if home sales would fall, they would get less liquidity from home sales and then they would just borrow some more money. They cannot do that now, because three red lines say okay, if you have debt by this little you're not allowed to take one more debt so suddenly you don't get any money from home sales and you cannot take on more debt and then basically you default. I think without the three red lines, Evergrande would probably not have defaulted, but it is really these caps on lending that made them hit the wall.

<u>**Interviewer**</u>

**Given that Evergrande crossed these lines and was not able to pay back its debt, how efficient do you think the policy is?**

<u>**Allan von Mehren**</u>

And I mean in hindsight, you can say they should probably have made these three red lines there much earlier. because the leverage was already getting too high.
You can say that they should have avoided coming into a situation like this. But that's not the case. So now that you are in this situation, it makes sense to try to stop this continuous leverage, but I think you also need to be a little bit flexible around it, which I also think they are starting to do so it does not become too restrictive. You need to time adjust and if companies are too large, you cannot let them all go down at once. Then you need to allow the system that you get some time to get your house in order. So I think they may need to be a bit more pragmatic around these three red lines without removing them, but just giving more time. I think they have taken some issues in this direction. They need to figure out how much should we ease, and you need to kind of feel your way forward here.

<u>**Interviewer**</u>

**Do you see any similarities or differences between the asset bubble in Japan of the late 80s and what some people call a bubble building up in China right now?**

<u>**Allan von Mehren**</u>

Well, from what I understand, the prices of property in Japan was extremely high and we had these stories about the palace in Tokyo being worth the same as California or something like that. Without knowing it exactly, I think maybe property prices were even higher in Japan than what they are in China now, at least on average. As I said, in big cities, prices are high but big cities are not all of China. China has 1.4 billion people and in the tier one cities maybe around 80 to 100 million people, by far, the rest of the country does not see the same kind of overvaluation. It seems that in Japan it was more widespread and very high valuations

<u>**Interviewer**</u>

**Is the Chinese Government at risk of sort of giving out money too easily for companies that**

**would otherwise not succeed? I'm not sure if Evergrande would just be one example for that or do they have a different strategy where they don't sell everything through just pouring in money into companies basically?**

**<u>Allan von Mehren</u>**

They could have solved this crisis very fast by just pouring money all over the companies and everything would be fine, but they have not done that and i think the reason behind that is because they know the risks from doing that. They already have a debt issue, and they know. China might not have had a lost decade, but no doubt that the debt build up they had around the financial crisis in the years after definitely made Chinese growth lower in the following years than what it otherwise could have been. So I think in some ways China has suffered from some of the same issues that Japan did. Because of too much debt out there and i think that is what they have been trying to learn from and not just solve all problems with new data

**<u>Interviewer</u>**

**Is the debt within China and the debt structure like Japan, that is that Chinese that also within China like in Japan cross shareholdings between companies and mainly within the country? Or is it a different debt structure.**

**<u>Allan von Mehren</u>**

The debt within China is mostly domestic. A lot of the most indebted companies are state-owned, so the state debt is to a wide extent floating around in the state sector and then you had some private developers, some that also had massive leverage. If you compare anything, the Chinese state sector has been like, if you are in a local province, then the local governor is friends with the local state bank, and you can definitely see a lot of ways coming out of that. And that is also partly a reason why there's been so much overcapacity in some sectors. So there is definitely some misallocation because of that, which I guess was also the case in Japan, and there was no discipline in the system.

III.e Interview 5 – Jason Hsu

*Chairman and founder of Rayliant Global Advisors, that focuses on asset management in China, mainly for institutional global clients. Additionally, he is a finance professor and member of the board of directors at the UCLA Anderson School of Management. He has further published various articles on the development of the Chinese real estate sector.*

**Interviewer**

**Chinese cities have one of the highest ratios of property prices to household income, especially in the larger cities. What are the factors that are decisive for this development and how would you evaluate the pressure on the Chinese population?**

**Jason Hsu (許仲翔)**

Unaffordability, as measured by housing price divided into the average household income, that's sort of a widespread problem for much of developed Asia, so you know, it's certainly true for the tier one Chinese cities true for you know, Hong Kong, Taiwan, Japan, South Korea, Singapore. So it's it's quite widespread. The key driver for that, I think, is cultural. Part of it is owning real estate is actually not an investment.

Owning real estate is almost an indication of one's character. If you're a young person and you haven't worked hard enough, saved enough to afford real estate, then there's something wrong with you. Either you spend way too much and you don't know how to save so you're not a responsible young person, or you don't make enough, which means you're not a talented and capable person. So there's quite a stigma if you are a working professional and you haven't bought property, that's one thing. It's quite the quite cultural and the joke goes it's the it's the mother-in-law premium, right? If you don't want your mother-in-law to just be nice to you, if you want her to actually agree to you, you know, letting you marry her daughter, you better have an apartment in a nice part of town in a good school district. So there's this mother-in-law premium that we ascribe, and then that joke broadly is true in most of Asia and certainly very true in China.

In addition to that, for China and it's again true in many of the Asian economies, people can pick storage of value. And I think in other countries, storage of value people are comfortable with having the bulk of their wealth in the stock market like I think that's true in the US. If you just held much of

your wealth in a SMP 500 portfolio, you would have done fine. It's not a very volatile index and it has on average over time trended up. The stock market in most other Asian economies doesn't have that feature. Japan, after the crash, hasn't gone anywhere. Most of the other markets are much more cyclical than it's trending. So people don't view the stock market as a place for storage of value. And so when they think about what a less volatile place to store is, then most Asians would say that real estate is actually quite safe. First of all, you don't see daily volatility so it doesn't freak you out and it does seem to adjust for inflation and adjust for the government printing money. So if you bought real estate over time, it's been a very good storage of value. So most Asian do by real estate as storage of value as investment, that they've deemed superior to other investment opportunities available to them.

And as a result, they really don't think: 'When I buy real estate, could I rent it cheaper?' American economist they think: 'If I can rent cheaper, why would I buy? I'd be completely insane, right?' In Asia housing is affordable if you rent, but Asian people don't rent because they feel: 'Since I'm going to save, if I can live in my investment asset, it's an additional benefit.' Americans think:,' I buy a home to live in. The additional benefit is appreciated'. So that's nice but that's not the primary reason. Asians will say: 'I'm gonna buy a home in real estate as an investment, as a storage of value and as a way to prove to my you know mother-in-law that I'm a quality candidate and I can live in it, that's kind of nice too.' In fact a lot of agents buy real estate and then they might rent somewhere closer to work. Not for living, actually.

**Interviewer**

**China's notorious for countless empty buildings, that were developed with clearly not enough demand for them, oftentimes creating literal ghost towns. What are the risks of that and are there things that real estate firms and also the Chinese Government are doing to fix that development?**

**Jason Hsu (許仲翔)**

In a lot of Tier 3 cities in China where the local government collaborated with big real estate developers, they have this, 'you build it and they will come' idea. They think that this could be actually a way to develop a city: 'I just build fancy housings and somehow I draw on people. I start

to create prosperity and they really believe in a real state-led development model. And that's clearly flawed thinking. So you do have tier 3 cities where it really is just mistakes in government policy. They gave huge land grants to developers, which of course think it's great: 'If I get the land for nearly free to come and get me financing, then sure, I'll build buildings. And if that can't be sold I have minimal losses because my caring cost is low, because I got cheap costs and cheap land. So there are definitely cities with bad planning where the build up was not demand-pulled but supply driven and those are definitely problematic. But they're generally in more remote Tier 3 cities where the value of real estate is low anyway, so if anyone's taking a loss, it's a small part of the government balance sheet or the developer balance sheet.

And then you also have a lot of empty luxury towers in Shanghai and Beijing and the tier one cities and there it's not like they built an apartment and they couldn't sell it. In China these days, if you build a new development, right, you have to enter a lottery to buy it. So it's empty not because it's not sold. It's empty because it's not lived in. People buy them and they simply own empty apartments. So why would someone own an empty apartment? Well, that's because they bought it mostly on cash. So they don't have a mortgage or carry cost and they don't rent their apartment out. I didn't realize this until much later in my business dealing in China. When you tell someone you rent it out your property, it's a bit of a stigma.

It would be like you bought a masterpiece Picasso and you rent it out to get income. Then it just means you're not wealthy enough. So pointing to a luxury apartment is like you own an artwork. You own something and it would be ok to have your cousin live in it for free, but it's not ok if you rent it out to the people for income. People find that to be a little odd and some of us are beneath someone who's a collector of apartments.

**Interviewer**

**I think a lot of these high rise developments itself are developed as status symbols, correct?**

**Jason Hsu (許仲翔)**

Yeah, absolutely they are trophy properties,

**Interviewer**

**Recently. There were restrictions imposed by the Chinese Government on certain building heights which cannot be surpassed depending on the population and size of cities. Buildings higher than 500 meters cannot be built even in tier one cities, 250 meters is the cap for smaller cities. It seems the Chinese Government is realizing that there is an issue with trophy towers. But you say there's a lottery for people to enter them. So as long as people are buying, why would the Chinese Government cap or restrict the construction of these towers?**

**Jason Hsu (許仲翔)**

Yeah. And so this is where you can see the difference between policy intention and the policy implementation. In Beijing, the policymakers know that they have an issue in that real estate prices are too high. Many young people know they have to buy real estate if they want to get married and if they want to feel self confident and self respect but prices are so high that there's almost no way they could actually buy it so the government says that they need to contain real estate prices and so the policy rolls out. Then the regional government will say that the easiest way to contain real estate prices is to just implement a cap. So it's just a really blunt implementation of what is not an unreasonable policy objective.

**Interviewer**

**Similar to Japan and the bubble years, there is a declining birthright in China, an unbalanced economy with low consumer spending and very high investment. This caused severe issues in Japan, not only contributing to the whole burst of the bubble, but also the lost decades afterwards. Since these developments are currently present in China, is the government and are real estate firms considering this is a threat?**

**Jason Hsu (許仲翔)**

If there's one sort of fixation on the part of the Chinese government in Beijing, then it is that Beijing is fixated on not repeating the Japanese real estate bubble. Beijing sees Japan as the failed emerging model. Japan almost rivaled the US, almost could have become a peer to the US and then the real estate bubble blew up Japan. So Chinese leadership is terrified of repeating that. They have major think tanks that just think about how to avoid that. So clearly Beijing is veryaware of that issue. What they also realize is this: What makes the difference between housing being highly valued and

expensive versus housing being a bubble that could burst? There's one thing that drives it, which is leverage. Imagine if you bought everything on cash, it doesn't matter how expensive real estate gets. Most people buy on cash and it can't burst. Because there's nothing that forces a fire sale or foreclosure. So what China has actually tried to be very careful about is that in terms of mortgage as a credit extended to home owners, it's very draconian. If you're a first time home buyer, it's like everywhere else, it's 30% money down and obviously a lot of verification for you to get a loan. If you wanna buy the second home you're either just outright disallowed, which it's funny. It's actually common practice in China, and this is as much a joke as it is reality. If you want to buy a second home, the husband and wife get a divorce first, so then they can buy a second home and then they get married again because it's a rule preventing one household from buying a second house. The government is afraid of you buying a second house because that means that you must be leveraging up to invest and that would be dangerous. And regardless, in cities that don't have that draconian limitation to buy a second home, it basically has to be an all cash purchase or it has to be a 60-65% down payment. So when you look at the leverage ratio on household purchases, it's actually quite low. It's nothing like what happened during the Japanese crisis or the US real estate crisis where you had a lot of heavily geared investors with no money down with poor income verification. That's sort of an issue.

**Interviewer**

**You mentioned how Chinese policymakers are scared of repeating the Japanese development, which seems a bit ironic. Because so much of China's industrial policies were modeled after Japanese policy since it seemed to be the right way to go initially. Less than 20 years after World War Two, Japan had immense economic development well into the late 80s. So even though it seems that they have learned from Japan, there are certain developments, for example the rise of the shadow banking sector in China, which contributed to the bubble in Japan where a lot of bad debt became apparent once it burst.**

**So are there things that China doesn't seem to have learned or implemented incorrectly? Things that, if they looked at the Japanese bubble, they should have acted earlier upon certain things than they actually have?**

**Jason Hsu (許仲翔)**

It’s not so much an obvious lesson they didn't learn. It's probably more of a misapplied lesson. The context is different, the environment is different. So you think you learn the right lesson, you might have learned the wrong lesson. I think there's a bigger risk of that.
I think the fixation on the Japanese real estate bubble has led to the Chinese regular having done a few things right, which is to really make sure that people don't gear up to invest.
In terms of shadow banking, a huge part of the Chinese economy’s early stage growth was based on real estate development, building housing as people became wealthier and they demanded higher quality housing, urbanization and so on. So that was actually quite natural. That's not a policy driven thing. The shadow banking, that rose was market driven. It wasn't the government saying: ‘Other countries have shadow banking, we should have shadow banking, too.’ Shadow banking occured because the Chinese government was so fixated on controlling the credit available to the real estate sector for developers, not homeowners, to acquire land and construct housing to meet demand. The only way for them to do so was to go through Shadow banking to finance real estate development. Leveraging a real estate development is far less scary than leverage in the ASA owner side. Because if you think of real estate development, it's much more transactional, it's not an investment. So if you borrow money, you develop it as long as there's demand, nothing bad will happen. So in Chinese real estate development, a lot of developers are very geared and it becomes an idiosyncratic bankruptcy risk. There's not a systemic issue because the systemic issue can only be on the demand side. When you look at China, there's a lottery to buy new development, and demand is very strong. You might say it's speculative, but as long as you're buying with mostly cash, there is much less risk for anyone who's lending to the buyer and the buyers are all lending through the bank, because as a buyer you can't access shadow banking. And that's really critical because the bank is where the government has a lot of transparency. So on the developer side, they've access to a lot of financing, low cost financing through shadow banking.

When the government thinks about over leveraging, they think that it could lead to a crisis. So there's certainly monitoring that. But in fact they're probably far more irritated at a lot of developers following the Hong Kong model, where they take on a lot of debt to acquire land bank and then they don't build on it, they simply in some ways try to corner and gradually release development to drive up prices. So the government knows that demand is strong, but they think that they can cool

off demand by just having proper supply. And so the government was quite irritated at developers for hoarding land and kind of slow playing supply. And so they actually went after these developers with the three red lines policy, not because they really care about the welfare of developers and don't want them to gear up too much. They know the only reason you got too geared up is because you borrowed a lot of money from the local government to buy local land for cheap and then you just haven't developed, haven't sold it and it's not because there's no demand because prices are clearly rising. It's because you're betting on higher prices. So you don't want to be bringing supply to market and the government says: 'You must be contributing to these escalating real estate prices.' And so they said 'We're not gonna let you borrow anymore. So the only way you can get cash is to sell your supply. And as you sell your supply hopefully it stabilizes prices.'

**Interviewer**

**Maybe that's what Japanese policy maker could have done right? Back in the bubble years, even Mitsubishi Estate alone was sitting on around $70 billion of undeveloped land just hoping for it to rise in prices. So the Chinese Government is actually forcing, or at least capping loans to real estate developers unless they develop or sell off their undeveloped property?**

**Jason Hsu (許仲翔)**

That's right. They don't want their real estate developers to become real estate speculators. They thought: 'Look, if the real estate developers are very transactional, then they're unlikely to go into a financial crisis. If they have a sensible amount of capital, then they develop, bring to market, sell it and then start again. That is far safer and then that will deleverage the developer sector as well. They feel like they've done a good job controlling the homeowner sector by limiting the number of homes or family can own and by limiting the financing rate for the down payment for the second home. So they began really pushing hard on deleveraging the developer sector as well.

**Interviewer**

**Land sales are an important source of income for the state government and also for local governments. There's heavy reliance on land sales. They stimulate the economy and create jobs. Recently, land sales decreased heavily, so the government has increased the cap of**

**special purpose bonds, injecting more liquidity in order to stimulate infrastructure building spending. What effect do you think this will have on the liquidity issues?**

**Jason Hsu (許仲翔)**

There's a strong tension between Beijing and the local government. Beijing has their national level policy and the local governments have financing needs. For a long time, the local government had a lot of autonomy in terms of land sale and that then gives them financial autonomy to pursue policy. Otherwise so much of the tax goes directly to Beijing. And if they want to do anything, it becomes a negotiation around: 'Can I keep more of the taxes? Can you help me float a bond and you underwrite it, etc.'. So yes, land sales declined because the government says that 3 Red Lines developers just can't buy anymore land. It means the local government can't sell land since no one has that capacity to buy more to just sit on the inventory.

Also, real estate is such a concern for the government. The regional governments are a little more sensitive about land sales and whether it could cause Beijing to be irritated. As a result, they are leaning significantly more on issuing municipality bonds and a lot of these municipalities are being weaned off low cost of capital from selling land and now they have to go borrow all of a sudden, even though they haven't quite figured out how to budget themselves properly so a lot of them are heavily in debt.

That's leading to a "central government is wealthy and regional governments are poor and indebted"-issue in China. And when you netted out,I t's not obvious whether the Chinese government is rich or poor. A lot of that local debt accounting is kind of muddy.
Probably now the biggest problem is that the Chinese government is consolidating its own balance sheet across all municipalities and realizing that where there is over leveraging, there is a debt issue. It's probably not in the private sector because I think they actually have done a pretty good job there. It's really in the municipality sector.

**Interviewer**

**Do you think the recent Evergrande issue is  a one-case episode or are there other Chinese real estate companies that are at risk of experiencing or already are experiencing similar developments?**

**Jason Hsu (許仲翔)**

There are a number of real estate companies that are similar to Evergrande.
But again, it's not like the global financial crisis, where if you're a real estate company, you're going to go under because the bank is cutting you off from credit and you essentially have no liquidity and can't sell the property.
In China, it is actually an engineered liquidity crisis. If you look at Evergrande, they sit on valuable properties, have good projects that are almost complete or could be completed and right now the only reason that they can't get financing, even though they have good collateral, is because banks are forbidden. So this is not like banks say: "Wow Evergrande, you're a poor quality credit risk because your collaterals are **** or of no value." And banks would be perfectly happy to finance all this real estate that Evergrande has. In fact, they financed it before and they would be happy to roll the long over.

The only reason they can't is because the government says they can't. The government say that above any debt threshold you just can't lend them. So there are a few developers that are in that red zone region, but it's not because they have collateral issues. It's simply because they're not allowed to borrow. And this is just the Chinese government's way of punishing real estate developers who wouldn't fall in line with their policy. They say: "You gotta be a transactional developer. You've got to build and sell and finance yourself. You can't just sit on lands forever trying to speculate.

So, Evergrande is just the biggest one. There are a few others, but then there are plenty of more transactional developers like the biggest developer Vanke . It's the biggest developer and it's very transactional. So it has all the capacity to take over a lot of Evergrande projects. Most of the local developers are transactional. They just don't have the scale to stockpile land or the relationship to do that. So by and large, there's enough capacity from other developers who are below the three red lines to take over projects from Evergrande and other troubled developers.

**Interviewer**

**Could you tell us in detail what the consequences were that Evergrande experienced as a result of not fulfilling the three red line criteria?**

**Jason Hsu (許仲翔)**

If you cross any of the three red lines, banks can't lend money to you, that's it. It just doesn't matter, which..

**Interviewer**

**But Evergrande crossed the lines and wasn't able to pay their debt, right?, So how efficient is this policy if it happened to Evergrande either way?**

**Jason Hsu (許仲翔)**

Initially the policy was designed to tell Evergrande: "Look, we're very clear about this. Sell."
Now, you might say that by that time Evergrande has slow-played its development so much - You can't just go sell land. You have to put a building on top of it that does take time to put there.
Evergrande just said: "The government didn't give me enough time. You tell me my behavior is unacceptable. You gotta give me time to correct it."
And the government feels like: "I told you this for a while, right? You know you keep ignoring me and then you have to put a policy and then you still ignore me?"
Both sides are accusing each other of being unreasonable. But be as it may. Beijing frankly doesn't care, because Beijing also knows that this is not going to trigger a crisis. This just triggers Evergrande's shareholders losing a lot of money, which Beijing was much more willing to put up with. It doesn't create a real estate crisis because other developers who are below the threshold would be able to take over those projects at distress valuation and easily get financing to complete and take it to market.

**Interviewer**

**Would it be both state owned and private companies that would then take over?**

**Jason Hsu (許仲翔)**

Thus far, it's been mostly the local developers who are much smaller and who are meaningfully under leverage. They are so small, the only thing that they have to do is put down own capital, borrow money, complete the project, and then do it again. So those developers tend to be financially very unleveraged.

**Interviewer**

**How would you describe the benefits and costs of being a SOE versus a private developer like Evergrande?**

**Jason Hsu (許仲翔)**

The biggest developers could be considered state-owned. As you know, any of the biggest enterprises in China tend to either have direct state ownership or partial state ownership and certainly always a lot of state influence. Being outright state-owned means that you get preferential treatment from state owned banks when it comes down to negotiating financing, you just have a lot more clout dealing with the local government. Because oftentimes as a state-owned enterprise, your chairman would be a party ranking member. So your chairman may be a higher ranked individual than the regional bank you're borrowing from or the individual from the municipality that you're seeking to do a land deal with. And in China, even if you're in the private sector, you could have a party ranking. If it's a SOE, all that matters very significantly.

**Interviewer**

**Generally, could you say that China is currently building up or in the midst of a real estate bubble? Is that bubble going to burst or is it going to be artificially inflated further? Many people said, the Chinese real estate market is in a bubble, that should have burst in 2018 or in 2020 at the latest and it didn't because it was kept artificially alive.**

**Jason Hsu (許仲翔)**

I think it's a lot of Western misconception. We apply the Western framework. We think that you buy a home to live in and once you buy more then it means you're speculating. In the Western world, the simplest analysis that all economists use is that if your rental yield is below your mortgage rate, you're inverted. You're losing money. And no one can hold on to real estate when they're losing money. And so eventually they have to sell and it'll crash. That's just the Western thinking. Yeah, that's how we think about big real estate investment funds, that's how that works. So if you're a big real estate investor and you're losing lots of money, then at some point you're gonna fire, sell inventory and/or crash. That's just a fundamental misunderstanding of real estate investing. In China, people don't invest in real estate for income, unlike in the Western world, Chinese people invest in real estate like buying expensive Picasso paintings.

So there's just this misapplication of the model when thinking about Chinese real estate. So yeah, Chinese real estate is unaffordable, but then so is a lot of NFT, so is a lot of art. But it has no implication in terms of future price appreciation, it’s just expensive right now. So I don't think there is a bubble. It is expensive, right? It does piss people off. If you’re a young person, you're pisssed off, right? But that's just another way of saying that young people are poor and they can't buy expensive art. If they choose to be pissed off, the government can and might or might not do something about it. The government's been saying: “You could rent.” But Chinese people say: “Renting is beneath me.” So the government goes: “Fine. How are we going to solve this problem?” I think China is likely to pursue the Singaporean model, where there's gonna be a lot of Government built housing that you have to qualify for. And you could buy, but you can never sell. So it gives you a sense of ownership, your housing needs are taken care of. It doesn't feel like renting as there's some kind of ownership to add something to that effect. So the government will try to find ways to make that work and you'll see escalating prices for some of the trophies in the more desirable school district  real estate to continue to run up in prices. Again, sure, it's expensive, but it's not a bubble in that sense. Chinese real estates are not hell for income purposes.

**Interviewer**

**So would you say that there are no similarities to the Japanese bubble or are there developments where you can draw connections between the two?**

**Jason Hsu (許仲翔)**

There are  a lot of similarities which makes the Chinese government's ability to manage it much better, because they saw the Japanese disaster, they saw the parallel development and they were able to put in policy and ask how to avoid that outcome, which is not to extend credit to people who buy real estate. That is very helpful. And for any developer who has become an investor instead of developer, they've got to stop lending to them and force them back into a transactional developer rather than a real estate speculator. And so they got those two things done. And I think that's very, very effective in preventing expensive real estate into a leveraged bubble