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CHINA’S REAL ESTATE REVOLUTION AND THE GREAT CHINA LAND RUSH

By

MADELYN C. ROSS
KENNETH T. ROSEN

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China's Real Estate Revolution

Will the latest fad become another messy lesson in capitalism?

Madelyn C. Ross and Kenneth T. Rosen

China has discovered a new natural resource in abundant supply: land. At 9.6 million sq m, China is the third-largest country in the world. With no extraction, transportation, or distribution costs, land is relatively inexpensive to bring to market, and demand for the commodity is booming.

China's leaders are eager to make the most of this potential windfall. For the short term at least, they appear to have the best of both worlds; they retain State ownership of land while permitting long-term leases to entice developers to pay for and build on the land as if it were their own. In 1991—just four short years after land-leasing experiments began on a limited basis—the "sale" and development of land around the country generated $6 billion in official revenues. This figure is expected to increase 30 percent this year, with even greater sums being earned from under-the-table deals.

Real estate acquisition and development is now the focus of feverish domestic activity as well as the target of one-third of all foreign investment in China. The value of land and property in the South and in some coastal cities has increased 50-80 percent each of the past few years, reaching levels undreamed of in China just two years ago—and comparable to rates in major international cities around the world.

What goes up must come down, however, and the way in which this new resource is managed will help determine whether it falls with a crash or moves at a more moderate pace. Real estate boom/bust cycles are common everywhere, but China's lack of laws and experience with which to govern this commodity magnify the dangers. As China's cadres begin to climb the learning curve in the real estate sector, the costs of miscalculation and mismanagement grow with each new project.

Where it all began

Shenzhen and the surrounding Pearl River Delta of Guangdong Province have been the laboratory of land-use reforms and the birthplace of the real estate revolution. As one of China's first four Special Economic Zones (SEZs), Shenzhen had the flexibility to experiment with land reform and strike innovative deals with foreign firms. The city pioneered China's first transfer of land-use rights to an overseas investor in 1987 and has been at the forefront of the country's real estate dealings ever since.

The key factors in Guangdong, as with real estate booms elsewhere in the world, have been growing population and rising incomes. Massive in-migration is taking place throughout the Delta; Shenzhen's population has soared from just 30,000 people in 1978 to more than 2.5 million today, while the province as a whole now hosts an estimated 3-4 million workers from other parts of China.

These people are being drawn by factory jobs and entrepreneurial opportunities in the region's flourishing export sector. Many of the workers, particularly those who are self-employed in the rapidly growing private sector or who work in collectives or foreign-invested enterprises, do not qualify for the low-cost, subsidized housing available to employees of State-owned enterprises. But these workers' higher incomes (three times the national average) and the fact that many are looking for a safe place to invest their growing savings have helped create China's first real hous-
The Hong Kong connection

Proximity to Hong Kong is another major factor in the region’s booming property market. Hong Kong investors alone have created some 3 million export-oriented jobs in the province, helping to boost Guangdong’s exports to $13.6 billion last year—almost 20 percent of China’s total. The region’s economy is one of the fastest growing in the world: spurred by foreign investment, industrial output has increased more than 20 percent for each of the past five years.

In addition to helping create jobs and wealth in the region, Hong Kong has fueled South China’s real estate boom in a more direct way—through the growing demand of its own residents for housing in China. Fleeing the territory’s sky-high land and housing prices, Hong Kong residents increasingly are purchasing retirement homes in China. Many are also buying apartments for relatives or for business purposes, while some hope merely to resell quickly for large gains. Hong Kong Chinese made up an estimated 60-70 percent of the property purchasers in the Pearl River Delta until recently, when local demand began to catch up. In 1992, Hong Kong residents are expected to buy at least 30,000 residential units in the Delta—approximately the same number of new units that will be purchased in Hong Kong during the same period.

Property north of the border is still a bargain for Hong Kong investors, who face local housing prices of up to HK$4,000 ($500)/sq ft. Top Shenzhen prices are still less than a third of that, although prime property there has jumped from HK$400/sq ft in 1988 to HK$1,200/sq ft this year (about $150/sq ft at current exchange rates). Prices in the provincial capital of Guangzhou are not far behind, in the $125/sq ft range. Meanwhile, anticipation of improved transportation networks, particularly the Shenzhen-Guangzhou superhighway to be completed late next year, is creating mini-building booms and escalating real estate prices in smaller cities throughout the province.

**New demand from domestic sources**

Although Beijing and Shanghai don’t have the same level of demand from Hong Kong purchasers as do cities in South China, they do have built-in demand from large resident foreign populations. In the short term, developers are relying on foreigners to purchase their top residential and commercial spaces. But many developers also see strong potential in the local market. Chronic under-investment in urban housing has fostered huge pent-up demand for residential units, while the country’s

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**Hong Kong residents are expected to buy at least 30,000 residential units in the Pearl River Delta this year—approximately the same number of new units that will be purchased in Hong Kong during the same period.**

Property prices in Shenzhen, which abuts Hong Kong, are soaring.
A top priority of Shenzhen and other local governments is to improve the land-lease system in order to raise the revenues collected from land-leasing and development activities.

Penglai in Shandong Province, regardless of profitability, in order to do something useful for his hometown. But for now, most foreign developers braving China’s fledgling real estate market are likely to stick to locations with the greatest foreign demand and the most local money, in order to assure the quickest returns.

The government steps in

Thus far, China’s real estate boom has occurred with little prompting or supervision from Beijing. And until recently, the government has made only half-hearted attempts to regulate the market for fear of stemming the flow of money into China. But that attitude is changing as officials become increasingly concerned about the dangers of an unfeathered building boom.

Recent evidence of the government’s mounting interest in the real estate situation came in October, when Vice Premier Zhu Rongji was quoted as expressing concern about overheated real estate activity and questioned whether the market could support the number of luxury villas being built. At an August real estate conference convened in Zhuhai by the State Council, Vice Premier Zhu Jiahua indicated that the government’s first priority is to improve “macro-management” of the country’s real estate sector through a vaguely outlined ”Five-Point Unified Policy” to control the planning, purchasing, development, management, and sale of land in China.

The country already has a few real estate laws on the books, including two 1990 regulations that set basic guidelines for foreign investment in real estate and the transfer of land-use rights (see The CBR, March-April 1991, p. 12). It now remains for Beijing to flesh out these laws, however. A number of measures are under consideration by the State Council and the Ministry of Construction, including national regulations on land-leaseing and housing prices, as well as more specific guidelines detailing foreign involvement in real estate.

The foreign investment guidelines are expected to provide incentives for foreign developers to undertake projects that match national priorities, including improvement of infrastructure and development of high-technology industrial zones in China’s coastal cities. Beijing may also take concrete steps to encourage a two-tiered residential market, one for domestic and one for foreign buyers, and may encourage foreign developers to focus on luxury projects for foreigners. Some local governments have already mandated that a certain percentage of low-cost, low-rent housing be built in their jurisdictions, in order to avoid a surfeit of luxury units. Shenzhen, for example, plans to release 680,000 sq m of land for residential development in 1992, but only 120,00 sq m, one fourth of that supply, will be open to foreign purchasers.

Regional competition heats up

Although they have smaller foreign constituencies, other towns and cities throughout China are counting on a combination of geographical location and economic potential to heat up their property markets. As foreign investors move into China in ever-increasing numbers, the cities to which they flock (often those with successful economic and technological development zones) are also beginning to see foreign interest in land development, from industrial parks to residential and commercial projects.

A few localities are trying to lure developers with special incentives, including tax breaks and discounted land prices. Hainan Province, for instance, has attracted a number of real estate projects in this way. Several unlikely areas have also attracted large projects by courting overseas Chinese tycoons with a soft spot for their native Chinese villages. One Hong Kong developer plans to build almost 800 apartments in the little-known town of...
Chinese officials seem aware that too much government intervention could suffocate real estate activity.

Shenzhen's plan to bring supply closer to demand by increasing the amount of land released for residential development this year to 480,000 sq m, 180,000 sq m more than the amount released 1991.

Shenzhen and several other cities in Guangdong have also tried to institute a capital gains tax to curb speculation, but until now enforcement has been lax and only a fraction of the revenues owed to the government have been paid. The tax, moreover, is often based on prices substantially lower than current market value, and the government plans to raise its assessments accordingly. To achieve its goal of deterring short-term speculators, the capital gains tax ideally should be applied to short-term gains only, and should not penalize gains on long-term investments. It remains to be seen if efforts underway to improve local tax systems will be successful.

This past summer, Shenzhen launched a rigorous new campaign to register and regulate all companies engaged in property development in the SEZ. Among other things, the law requires all developers to have a current operating license and to undergo an annual financial and business review. The rigor with which the campaign is being pursued has already begun to slow the pace of development activity and has earned Shenzhen a reputation as one of the best-regulated property markets in China.

The central government has also begun to take a much firmer stand on land management. In October, both Minister of Construction Hou Jie and Vice Premier Zhu Rongji issued the strongest national warnings to date on controlling speculation and land profiteering. Hou announced that China will begin to withdraw leases on land if contractors do not begin construction within two years, and hinted that other steps will be taken to cool overheated real estate markets.

A tricky balancing act

Chinese officials seem aware that too much government intervention could suffocate real estate activity, and that they should rely on market adjustments as much as possible. The director of the Ministry of Construction's real estate department noted in August that his department would try to use tax rates, land-leasing prices, and profit-distribution rates rather than compulsory administrative measures to guide domestic and foreign real estate companies. But in areas where illegal activity is already rampant such measures may be too late, and stricter administrative measures, such as limiting the number of firms involved in real estate development, may be needed to bring the market back under control. China's lack of experience with real estate and often overzealous bureaucracy will make the already difficult task of guiding this sector without scaring away potential investors even harder.

If properly managed, however, a vibrant real estate market could prove to be a boon for the Chinese government as well as for developers and citizens. The government would be able to turn a once-ignored asset into a money-maker that employs numerous people and generates funds for basic construction, urban renewal, and infrastructure in the process. The leadership would be able to offer better housing and other facilities to much of the population while absorbing ex-

Stopping speculation

Another immediate problem in the Pearl River Delta is that overseas speculators are buying up many units solely for short-term gain, leading to inflated prices and a possible collapse of the market. Local governments in South China have already tested a variety of ways to slow speculation, but have found enforcement of such measures difficult. Shenzhen, for example, has tried to control the pre-sale of units which have not yet been built. The city has mandated that developers spend at least 25 percent of construction costs before selling a property, and has required buyers of partially constructed units to wait until the property is completed before they themselves resell. These and other similar regulations have been routinely ignored, however. A measure with more promise may be...
Housing reforms have already run into difficulty getting citizens to accept the idea of paying for something they have long taken for granted.

For its part, China will have to prove its ability to sustain long-term ownership rights and allow a healthy secondary market to operate. Continued government tolerance and ideological flexibility are also key prerequisites. If the government proceeds carefully, it may succeed in allowing the basic features of a private real estate market to operate without relinquishing ultimate State ownership of the land, but this is unlikely to be a stable long-term solution. Instead, assuming China continues to move toward a more market-oriented economic system, certain segments of the real estate market, such as housing, may eventually become fully privatized. Perhaps the only certainty at this early stage is that managing China’s newest commodity will be much harder than bringing it to market.

Hong Kong developers lead the way
The Great China Land Rush

Madelyn C. Ross and Kenneth T. Rosen

Despite unanswered questions about the long-term viability of China’s emerging real estate market, developers have been signing up for projects in China at a frantic pace all year. Many see a window of opportunity that may disappear within a few years and are eager to gain access to land-use rights now—while good deals are still easy to find.

Least daunted by the uncertainties of China’s real estate market, Hong Kong firms heavily dominate the market. They know China relatively well, and are not deterred by the concept of long-term leases rather than outright ownership, since all land in Hong Kong is nominally owned by the British crown. Already, most of the territory’s developers have announced Chinese land deals or their intent to get involved in the China market (see p. 48). Some firms have issued special shares just to raise funds to invest in China, while others are taking their money out of real estate projects in the United States and Europe to buy Chinese land.

By late 1992, Hong Kong firms had gained the rights to perhaps as much as 200 million sq ft of land in China, although only a small fraction of this land is under active development. Hong Kong estimates put the amount of Hong Kong money going into mainland property projects between HK$12-20 billion this year ($1.5-2.5 billion).

Hong Kong manufacturers with existing facilities in China were among the first to get involved in Chinese real estate.

Hong Kong manufacturers with existing facilities in China who were among the first to get involved in Chinese real estate. These industrial firms found they could use their connections with local Chinese authorities to obtain land cheaply; in many cases, the property is adjacent to or near their factories. Such real estate projects tend to be located in areas such as Huizhang, Dongguan, and other towns throughout Guangdong Province that are home to many small, Hong Kong-run factories. Because real estate is just a sideline interest, these companies generally keep their projects small and look for quick resale profits.

Hong Kong property developers, more recent entrants to the market, are finding that investing in real estate north of the border makes good business sense for them, too, although for very different reasons. Because undeveloped land in Hong Kong is rare and expensive, these firms are eager to get hold of land in China now, while prices are still low. They are generally not in a rush to develop it, and in fact some see advantages to waiting for the market to mature. Their projects are usually located in major cities and tend to be longer-term, larger, and more ambitious than those of the manufacturers.

Madelyn C. Ross is a writer and consultant on China based in Washington, DC. Kenneth T. Rosen is chairman of the Center for Real Estate at the University of California, Berkeley.
While most Hong Kong firms are eager to sign one or two lucrative land deals in China, few have been willing to make China the focus of their attention. An important exception is Tian An China Investments Co., which struck its first two land deals in Shenzhen in 1988. The company has gradually shifted emphasis from development of industrial estates to residential and commercial units, which now account for 50 percent of the firm’s total land reserves. Its geographical base has also broadened from an initial emphasis on Guangdong and Xiamen to cities of the Yangtze River Delta and northward to Tianjin. Currently, the value of Tian An’s $2 million sq ft in China $5 million sq ft of industrial space and nearly 500,000 sq ft of commercial and residential property. As one of the few Hong Kong firms specializing in China real estate, Tian An now finds itself in a lucrative niche and many institutional investors consider the firm’s stock an important part of their Asian portfolios.

A number of Hong Kong developers are involved in both real estate and major infrastructure projects in China, and expect real estate ventures to help generate cash for their longer-term projects. For example, New World Development Co., one of the territory’s major property developers, has one of the largest land banks in China (expected to reach 40-50 million sq ft by the end of this year), as well as a diverse project portfolio, ranging from power plants and highways to department stores and housing complexes. These projects are spread throughout the country, although those in and around Guangzhou form the core of the firm’s capital investment in China.

A few developers have begun to combine infrastructure and real estate projects into single “mega-projects.” For example, in June, Hong Kong’s Wharf Holdings signed letters of intent for a massive project located in the inland metropolis of Wuhan. The project’s goal is to help the city regain its industrial pre-eminence and enhance its role as a key gateway to China’s interior. Wharf plans to construct an inland container port near the city and develop up to 25 sq km of land, which could include construction of tunnels, power plants, hotels, and industrial estates.

The number and scope of Chinese real estate deals must be viewed with some skepticism.

Several of the other Hong Kong firms that focus on China land projects are actually Hong Kong subsidiaries of mainland firms. China Overseas Land and Investment, for instance, is a wholly owned subsidiary of the State Council’s China State Construction Engineering Corp., which has invested in some 20 properties in Shenzhen, Shanghai, and Hong Kong. In August, China Overseas won the tender for a major residential/retail development in Shenzhen, and also announced plans to establish an office in Guangzhou to pursue more opportunities in the province. Like China Overseas, other Chinese companies have found that investing in their own country through a Hong Kong subsidiary allows them to take advantage of the preferential treatment China gives to foreign investors.

Less than meets the eye

Though the roll call of Chinese real estate projects lengthens daily, the number and scope of these deals must be viewed with some skepticism. Many of the heralded deals will not actually come to fruition; some are merely premature announcements by local authorities eager to show how much investment their city has attracted, or by investors hoping to help cement a deal. A number of deals are still in the letter-of-intent phase, with the toughest and most detailed negotiations yet to come. Some will no doubt be denied final approval by the Chinese government or stymied by government requirements down the road. And, once their plans do get off the drawing board, many firms are likely to find financing difficult to obtain.

Projects planned in several distinct phases also blow the real estate figures, as later phases may be abandoned or scaled back if initial results do not meet expectations. The time-frame of some of the Hong Kong developers’ mega-projects, for instance, is easily 20 years, making current investment projections extremely unreliable. Several Hong Kong developers have already indicated that they expect to build only about half of the projects they have on paper. Yet, even if half of these projects are never realized, the impact of the those that do go forward will transform the skyline of many cities in China and contribute to the rapid economic integration of Hong Kong and China.

Looking ahead

China’s real estate market is likely to continue to be dominated by Hong Kong firms for the next few years, although China’s own newer developers will offer increasingly stiff competition. Domestic developers continue to gain rapidly in number and ability, and are increasingly able to compete with foreign developers. Construction Minister Hou Jie recently announced that China will take steps to “create conditions for fair competition” between domestic and foreign developers, which will further stimulate the activities of domestic firms.

The other major players are likely to be a growing number of Asian real estate developers, who will focus on cities where they have regional, economic, or family ties. A number of wealthy overseas Chinese—from Taiwan, Thailand, Malaysia, and Indonesia—with personal interests in China have already become active in real estate projects. South Korean and Japanese firms are also signing a growing number of real estate deals in northern cities, where they have strong regional ties.

The involvement of US and European firms in China’s real estate sector will remain limited. Their activities are likely to continue to focus on foreign-oriented projects, in which Western firms have greater familiarity and expertise. Although a number of Western companies have expressed interest in developing real estate in China, the legal and logistical complexities and relatively long time periods involved will probably keep most of them out of the market.

But for Hong Kong firms, the opening of China’s vast undeveloped land reserves presents a historic opportunity to extend the boundaries of their real estate activities northward. As long as demand continues to grow and land continues to be offered on favorable terms, this opportunity will be too good to ignore.