AN ANALYSIS OF CHINA’S REAL ESTATE DEVELOPMENT

Masters Thesis Submitted by

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Abstract

In the market-oriented economic reforms carried out in recent years, the Chinese government has made great efforts to foster the development of the country’s real estate industry. Judging from its present course of development, China has done quite well in attracting foreign capital to a new commodity and in creating values in an economic vacuum. While the emerging commercial real estate market in China offers tremendous opportunities, risks remain high.

Real estate boom/bust cycles are common everywhere. Will China’s real estate market crash soon or move at a more moderate pace? This paper explores the evolution of China’s real estate market development and examines its unique features. This paper examines the structure of real estate development and investment in China. The outlook for economic development in relation to real estate markets and the progress made today will help identify areas of future opportunities.
Introduction

Real estate is one of the pillar industries in the national economy of many countries in the world. It is also regarded as a thermometer of economic development\(^1\). Since China opened its door to the outside world in 1978, the supply of international-grade hotel, office and residential space has fallen well short of demand. In the market-oriented economic reforms carried out in recent years, the Chinese government has made great efforts to foster the development of the country's real estate industry. China has adopted basic policies on commercialization of land use and commercialization of housing, thus awakening China's real estate industry which had been dormant for more than 30 years. Many overseas developers and investors have found that investments in China's real estate give them almost a guaranteed high rate of return. Following the country's strong economic performance, its real estate industry has been growing. 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 reportedly increased 30 percent in 1992,

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with even greater sums being earned from non-official deals. Up to 1992, China boasts more than 4,000 real estate development companies, over 4,000 real estate management and administration firms, and 1,600 plus real estate exchanges, with a total of 3 million people working in the industry\(^2\). Deal-starved American real-estate developers have discovered China, where even second-rate buildings often bring in world-class rents. 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\(^3\). However, what goes up must come down, while the emerging commercial real estate market in China offers tremendous opportunities, risks remain high. Real estate boom/bust cycles are common everywhere.

Will China’s real estate market crash soon or move at a more moderate pace? This paper explores the evolution of China’s real estate market development and examines its unique features. The outlook for economic development in relation to real estate markets and the progress made today will help identify the areas of future opportunities. The structure

\[\text{ibid}\]

of real estate development and investment will also be examined. This paper also attempts to explain the complexities and contradictions of the markets as an institution and discuss the implications for development initiatives. Overseas developers and investors interested in venturing into China’s real estate market should familiarize themselves with the unique features of China’s real estate market and consider their impacts on proposed development projects.

Because the market for real estate is not yet well defined and mechanisms in place for transactions are imperfect, acquiring land is of key importance for development projects in China, more than anywhere else. Therefore, this project will first look into the land use right reform in China.

The Urban Real Estate Administration Law of the People’s Republic of China came into effect on January 1, 1995. This is a product of more than half a decade of debate and compromise. The real estate Law is an important contribution to China’s developing legal framework for the regulation and management of land use rights. While it adheres to many of
the basic principles and approaches established in earlier regulations, it adds a number of details in an effort to strengthen management over land use and extend supervision over some market transactions. Since it is the first law promulgated by the national-level legislature to address urban real property development and transactions, this new urban real estate law will be analyzed in detail.

To help the international real estate community understand the real estate market in China, this paper uses a case study of Shanghai real estate market development as an example. Shanghai was chosen for case study as Shanghai is one of the first and most entrepreneurial cities to experiment with reform in the management of urban land and real estate. For example, Pudong New Area is an affiliated administrative district of Shanghai—the largest industrial and commercial city in China. It covers an area of 522 square kilometers with a population of more than 1.4 million. In 1990, the Chinese government announced the development of Pudong and the opening of Pudong to the outside world, in the hopes that it will play a leading role in economic growth of the Yangtze River basin, thus helping Shanghai to develop into one of the economic, financial and trade centers of
China and the Asian-Pacific region as well. Over 4 years of development, the Pudong New Area economy has grown at a rapid but stable pace, and its infrastructure is being completed. This area has become an important symbol of China’s favorable investment environment with the best investment opportunities.

**Property-rights and urban land-use:**

*a history of evolution*

Establishing secure property rights in transitioning economies helps to solve two problems: inefficient structures of control rights over assets and poor contract enforcement\(^4\). Poorly defined property rights are blamed for many of the problems of developing countries and transitioning economies. A major obstacle in China’s efforts to adopt a market-oriented approach to land management was the absence of a clear legal framework for establishing property rights. Before land-use rights reform, land was almost worthless, and acquisition of land was nothing more than a

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bureaucratic arrangement. No investment analysis or appraisal was required in land-use decisions. Such decisions were only made politically rather than economically. As a country where land belonged to the state and the concept of private ownership of land was practically non-existent, China has made great progress in urban land-management reforms since the introduction of its open-door policy in 1978. The breakthrough came when land-use rights were legally recognized in an amendment to the Chinese Constitution in 1988. The 7th National People’s Congress revised Clause 4 of Article 10 to allow the right of land use to be transferred in accordance with the law, providing for the establishment of a system of private property rights, and a real estate market for the transaction. Since then, the Chinese government has successfully made a transition from an administratively allocated land-use system to a market-driven allocation system using land-use rights.

Before 1982, the Constitution of the People’s Republic of China stated that “Urban land belongs to the state. Land in the countryside and in suburban areas belongs to collective ownership unless the law stipulates that land is state-owned”. Moreover, residential land and family plots also
belong to the collective ownership. "No organization or individual is
allowed to occupy, sell, lease, or illegally transfer land in any way". The
government of PRC also believed that State ownership of urban land
required the concentration of all land rights in the hands of the State which
meant that the State should have total control over the supply, use,
management and disposition of land. Land allocation was taken as part of
national or regional economic planning which was dependent on overall
national economic interests. Urban land was allocated to users
administratively, permanently and free of charge. This created a situation
where land was neither a factor of production (because there was no need to
provide a return for its use), nor was it an asset (because there was no
monetary value attached in the process of transfer). Because of this
inefficient land-supply mechanism, there was no need to analyze the
appreciation of land value and there was no existence of a formal property
market in pre-reform China.

The free land-use system resulted in many problems. The government
had to provide housing to the public as welfare housing was assigned to

5 Constitution of the People's Republic of China, 1982, art.10, cl4
urban workers at a minuscule rent that was not even sufficient to cover the maintenance expenses. Also because land had no monetary value, the state receives no direct revenue from it. Such a dilemma caused the government to carry a substantial burden in housing expenses (Figure 1). As figure 1 indicates, from 1949 to 1990, total expenditure by the government on housing was almost nine times more than on the food industry and substantially higher than other income-earning industries. As rents in housing were kept extremely low, most of the expenditures on housing by the government was on maintenance and management of the housing stock.

This system also led to waste and underuse of valuable urban land because managers of State-owned firms has no incentive to use land efficiently and conserve it.
Figure 1. Cumulative Expenditure on housing and other Industries in China 1949 to 1990 (Billions of RMB Yuan)

Source: China Statistics Year Book 1990 (1990)

The free land use system resulted in the profit from land being artificially and intentionally kept down and the low income from land and properties deterred further investment in land and properties. The seriousness of this syndrome can be demonstrated by the residential market. The rapid expansion of demand for housing had caused substantial problems because such demand did not originate from economic forces but

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from the low-rent phenomenon. Such a high demand in turn created an acute shortage of supply. Since the housing and land did not function as commodities, there was no market mechanism to stimulate price changes. This caused further failure in the supply mechanism because the low rents could not even meet the maintenance cost of the housing. The failure to generate income from housing kept the supply of new housing or redevelopment of residential units below demand. In addition, both political and economic systems were based on the ideology of socialism, because private ownership was prohibited. Thus the government had to carry the heavy burden to supply the housing to its people. The vicious cycle became self-destructive. Residential areas quickly became run-down and redevelopment was practically impossible simply because municipal government never had enough funds to maintain the existing infrastructure.

Other problems also existed. Though a formal property market was not in existence, illegal transactions in land and buildings continued to take place and they grew in volume once the general economic reform began in the late 1970s. For example, the rapid growth of Chinese cities and the consequent demand for land has led villagers to negotiate, under the table,
with prospective users/developers for sale or lease of their collectively owned land. Incidents of urban institutions transferring their land-use rights were not infrequent either. These transactions have precluded municipal governments from capturing an important source of revenue such as land transfer fees.

It became more and more obvious that the economic reform program could not succeed without reforming the existing land-use system. Many urban problems arose from the free land-use system. The reform of the urban land-use system was clearly viewed as key to the success of economic reform. The reform did not come as an overnight revolution. It was a gradual process of changes including the management of land use, separation of land-use rights from the main core of property rights, mechanisms for the transfer and trading of such land-use rights, reforms in housing allocation, rental level, and property taxes, and last and most important, reform of the pricing of real estate. This process was known as the "commercialization of real estate". The reform started with a very protracted debate and a carefully calculated plan. The first important step was changing the system from the free land-use, into a paid-use system.
Urban land and the land-use rights became valuable to the user and the notion that ownership, use and management rights in land were inseparable was abandoned by the government.

The reform started without a detailed blueprint. The procedure followed was one of experimentation. A favorite saying was “touching the rocks as you cross the river”, deciding on the next step only after you have completed the previous step\(^7\). As the first step toward changing the free urban land-use system to a system with compensation, the reform started as an experiment with a very small scale. On November 17, 1981, the 13th Session of the Standing Committee of the 5th Guangdong Provincial People’s Congress adopted the first Provisional Regulations on Land Administration in Shenzhen Special Economic Zone (SEZ). It required compensation for the land requisitioned, civilian houses and other buildings demolished for construction purposes for the first time in China since 1949. It also set up the standards for annual fees on land used for different purposes.\(^8\) In 1982, Shenzhen SEZ began an experiment to collect land-use


\(^8\) Provisional Regulations on Land Administration in Shenzhen Special Economic Zone, Adopted November 17, 1981, at the 13th Session of the Standing Committee of the 5th Guangdong Provincial People’s Congress.
fees from new users according to the different grades of land they acquired. The next year, Liaoning province approved a similar land-taxation system for existing users for the city of Fushun. By 1988, more than a hundred cities across the country had established the land-use fee system. The land-use fee system helped bring in revenue for local government, but it was far from being able to effect the economic allocation of land.

On June 25, 1986, “Land Administration Law of the PRC”⁹ was promulgated. However, even with the success in small scale of the experiment on the land-use fee system, the new law still had not included any provisions that property rights in land, as well as the land-use rights, could be exchanged. Until 1988, the first Session of the 7th People’s Congress passed a most significant amendment to the Constitution of PRC, which says in Clause 4 of article 10 that “No organization or individual may appropriate, buy, sell or lease or unlawfully transfer land in other ways. The right of land use can be transferred in accordance with the law.” The addition of the last sentence makes it possible for the real estate market to operate in a manner similar to that of Hong Kong--Ownership of land still

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⁹ Land Administration Law of the PRC, Adopted at the 16th session of the Standing Committee of the Sixth National People’s Congress, Promulgated by Order No. 41 of the President of the PRC on 25 June 1986.
belongs to the state (people), therefore there is no conflict with the basic socialist doctrine. However, an element called the land-use rights was separated out from the bundle of rights associated with the use of land and became the main core of the reform.\textsuperscript{10} So that organizations and individuals can own land-use rights. At the end of the same year, the 5th Session of the Standing Committee of the 7th National People’s Congress subsequently amended the “land Administration Law of the People’s Republic of China.” This amendment provided for the establishment of a system of private property rights and a real estate market for such transactions\textsuperscript{11}. It further clarified the legality of transferring land-use rights. It is also the blue print of the policies and legal framework on which more detailed regulations are based.

On May 19, 1990, two new regulations on land development were promulgated by the State Council of PRC and went into effect on the same date of promulgation\textsuperscript{12,13}. The two regulations are (1) The People’s


\textsuperscript{11} Lim Lan Yuan, Implication of China’s new property law on real estate investments, Real Estate Finance, 12(3):96-100, (Fall, 1995)

\textsuperscript{12} Decree of the State Council of the P.R.C. No.55., May 19, 1990. The People’s Republic of China Interim Regulations on Sale and Transfer of State Land Use Rights In Cities and Towns.
Republic of China Interim Regulations Concerning Administration of Investing, Developing and Managing Sizable Land By Foreign Investors (hereinafter “Land Development Regulation”); (2) The People’s Republic of China Interim Regulations on Sale and Transfer of State Owned Land Use Rights in Cities and Towns (hereinafter “Land Use Rights Regulation”). These two Regulations are the first of their kind to be published in China.

The Land Development Regulation has only 18 articles and applies only to foreign investment in land development and management in special economic zones, coastal open cities and coastal economic development zones. On the other hand, the Land Use Right Regulation has 54 articles and applies to all the cities and towns nationwide. The Land Use Right Regulation is mainly used for domestic land development activities, however, foreign investors in Chinese land development are also bound by it. Although the provision in the Regulations are general and ambiguous, the Regulations reflect the Chinese Government’s basic attitude of encouraging both foreign and domestic investments in land development. Under the Regulations, Land-use Rights were separated from ownership.

13 Decree of the State Council of the P.R.C. No. 56. May 19, 1990: Interim Regulation Concerning Administration of Investing, Developing and Managing Sizable Land By Foreign Investors.
rights and became tradable in the market by private treaty, negotiation, and auction. Land-use rights are rights with time limits for different kinds of land use (in some cities, seventy years for residential, fifty years for industrial, and thirty years for commercial/office). Moreover, land-use rights are capable of being mortgaged and transferred.

Foreign investment in land development was still an new concept in China then. In the past, only the government had the right to develop land under a state plan. When the Chinese government decided to lease a sizable piece of land in Hainan Island to a Japanese company for development in 1989, certain groups in the Chinese government reacted strongly against the decision. Chinese people have the sorrowful memory of extraterritorial jurisdiction enjoyed by western powers on leased Chinese land in the early part of this century. The publication of the Regulations, however, symbolizes a major step that the Chinese government is taking to lease state-owned land to foreign investors for development purposes. The Chinese government has recognized the importance of foreign investment in developing Chinese state-owned land. The Chinese government is hoping that such investment will substantially improve the regional economy and
benefit the country, by requiring foreign developers to invest in China’s infrastructure. By conveying state-owned land use rights, China will not only attract more foreign investment, advanced technologies, and western management skills, but will also receive needed hard currency by charging land use fees. Further, at the end of the contract term, the contract can be renewed or China will receive a fully developed piece of property.

General principles of these regulations are the major concern for foreign investors. Under the Regulations, a foreign investor may obtain land use rights from the Land Administrations Agency of the People’s government at the city or county level. Land development is defined in the Land Development Regulation as comprehensive development and construction on tracts of land after the right to use is obtained. Such comprehensive development and construction includes land leveling and construction of public infrastructure facilities such as water, power, and heat supplies, road and communication systems. (Article 2).

After the land has been developed, the foreign developer may transfer or sublease the land use rights to other investors for industrial, residential
and other lawful purpose. The developer may also use the land himself for construction projects. The transfer or sublease of the land use rights may occur only after a specified level of land development has been completed. The land developer may sublease the land when it becomes suitable for industrial use. The developers may also construct general industrial buildings and other comparable ground facilities for manufacturing and for residential use. He may then engage in the business of transferring or subleasing of building spaces and facilities. (Article 2). The activities of the land must comply with Chinese laws and regulations. (Article 14).

The land developer does not have any administrative power over the leased state-owned land. (Article 4). Such power exclusively belongs to the Chinese government. The land developer also does not have the right to the underground resources and the accompanying property rights which remain the property of the state during the term of the land use contract. Any development of the resources for use must be in compliance with the relevant Chinese laws and administrative regulations. (Article 6). These Regulations also detail the land development plan, approval procedure, procedures of engaging land development projects, public facilities, as well
as incentives with respect to investment in land development. According to these regulations, the Land-use rights can be granted by municipal or higher-level governments to domestic or international users for valuable consideration (premium). Sales of land-use rights can be carried out in one of the three forms: negotiation, tender and auction. Those who acquire the use-rights of State-owned land also have various other rights: the land-use right and improvements on land can be sold, leased, subleased, swapped, mortgaged, bequeathed, or inherited within the terms of land-use rights. Which usually lasts from 50 to 70 years. Municipal governments, by maintaining ownership of land as fiduciaries of the State, exercise the right to benefit from the ownership rights (collecting a premium for the grant of land-use rights, and land-use fees), to claim all rights when the term expires, and even to condemn the land-use rights for public purposes or in case of a breach of the grant contract on the part of the grantee.

As an important part of a comprehensive economic reform, China’s land market gradually formed. China’s experience has given rise to the most significant legislation in the history of the country’s urban land reforms. In 1994, the Chinese government introduced the latest legislation
on real estate: the Law of the People’s Republic of China on Urban Real property Administration, known as real estate law. It was promulgated by the president of China and took effect on January 1, 1995. The real estate law was adopted by the National People’s Congress in July 1994 and is the first law promulgated by the national-level legislature to address urban real property development and transactions. In addition to many of the basic principles and approaches established in earlier regulations, a number of details were developed in an effort to strengthen management over land use and extend supervision over some market transactions. The new law sets out the general provisions governing the grant and allocation of land-use rights, property development, transfer of property, title registration, the mortgage and leasing of property, and legal penalties for infringement of the law. A significant effort has been made to dampen property speculation and to ensure full market disclosure of all transactions.¹⁴

An analysis of real estate development in China

With China’s rapid economic growth and the development of the real estate industry, a formal urban land market is emerging. It, in turn, has given a strong impetus to the growth of the real estate industry. To review China’s real estate markets, this chapter will examine the background on the key economic and demographic forces driving the phenomenal growth of the China economy and how these forces help to shape the real estate markets in China.

China’s economic reform and development:

"...When a widespread economic recession prevails worldwide, we will not fail to perceive the economic progress ongoing in the South-east Asian and Chinese littoral regions by a 12% growth margin and we can not deny but call it an unexpected pleasant surprise. ---------Extracts from Reports by United Nations Economic Organization.

During 1992 to 1994, China had the world’s fastest growing economy. Gross domestic product (GDP) rose 13.2 percent in 1992, 13.4 percent in 1993\textsuperscript{15}, and 11.8\textsuperscript{16} percent in 1994 (Figure 2). After 15 years of

\textsuperscript{15} People’s Republic of China Year Book, 1993/94, PRC Year Book LTD. Beijing.

\textsuperscript{16} Internet, China Web.
The demographic factor is also a driving force in the phenomenal economic growth in China. While many parts of the nation are suffering poverty, it also has the largest urban population and largest group of middle-income consumers in the world. To continue to strive for economic growth and to alleviate population pressure on urban infrastructure, the government is committed to massive capital expenditure on infrastructure. Recently, the Ministry of Construction of PRC proposed a Development Plan for the real-estate Industry with goals for the years 1995 and 2000 with respect to the supply of land, the growth of the industry, the quantity of...
urban housing to be built, etc. The highlights of the plan include developed land supply increases by the end of 1995 to 37,050 acres and to 61,750 acres by the end of 2000; yearly construction of urban housing of 150 million sq. m (1.61 billion sq. ft) by the end of 1995 and 180 million sq. m (about 1.94 billion sq. ft) by the end of year of 2000\textsuperscript{26}; the yearly growth of total industry product was up to 18% by the end of 1995. The 18% growth rate in available land will be maintained to year 2000. The plan has very ambitious goals, as 18% growth rate is remarkable. If such growth can be sustained, it will create tremendous opportunities for both domestic and overseas developers and investors.

The emerging economy in China is expected to continue to need massive capital to fund economic development. In turn, the economic development will fuel the continuing development of the real estate industry. Reuters\textsuperscript{27} reported that China’s booming economy has fueled the rapid growth of its construction industry. According to the China securities daily, the construction industry will add 500 billion yuan ($60 billion) to the

\textsuperscript{26} Urban Planning News, No. 7, 1993., Published by China Academy of Urban Planing and Design.

\textsuperscript{27} China News Digest, January 26,1996, Http://www.cnrd.org

Construction minister, Hou Jie, reported at the national construction work conference that 1.2 billion square meters (12.91 billion sq. ft) of commercial buildings and 2.79 billion square meters (30.20 billion sq. ft) of residential buildings will be built in urban and rural areas by the end of the century.

The unique features of China’s real estate market: Because of the size of both the U.S. and Chinese economies, the two countries have grown almost independently. China’s real estate markets are mostly affected by China’s own state and local factors. Consequently, there is tremendous diversification benefits from investment across the two countries. However, one of the major difficulties in investing in China is lack of information. China is a large and diverse country. Various cities and provinces have different dialects, to say nothing about different investment procedures and regulations. However, as a whole, China’s real estate market still has its common features. To develop a clear understanding of the Chinese market, major dimensions of Chinese real estate investment and the unique features of China’s real estate market are summarized in table 2. A comparison
between China’s real estate market and United States’ real estate market is also made to elucidate the differences.

**Risks of Real Estate Investment in China:** Like any other type of business venture of global dimensions, foreign real estate development in China is teeming with unforeseen pitfalls and risks.

Perhaps the foremost risk faced by real estate developers in China is the potential for a threatening political atmosphere in the future. The political risk may be much smaller than some people think. However, with so many projects depending heavily on the long-term directions of Chinese economic policy, it is understandable that any degree of uncertainty pervading the investment environment can create anxieties among the stakeholders. There are substantial reasons to be bullish about China. But
<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>China</th>
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<tbody>
<tr>
<td>Market</td>
<td>Mature, low volatility</td>
<td>Emerging, high volatility</td>
</tr>
<tr>
<td>Transaction Mechanisms</td>
<td>Well defined</td>
<td>Poorly defined and Imperfect</td>
</tr>
<tr>
<td>Economic Environment</td>
<td>Slow Growth</td>
<td>High Growth</td>
</tr>
<tr>
<td>Inflationary</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Property Market</td>
<td>Overbuilt, High Vacancy Rate</td>
<td>Tight Supply, Long Tenant Waiting List</td>
</tr>
<tr>
<td>Domestic Financing</td>
<td>Available</td>
<td>Difficult, sometime not Available</td>
</tr>
<tr>
<td>International Financing</td>
<td>Yes</td>
<td>Little Access</td>
</tr>
<tr>
<td>Capital Market</td>
<td>Developed Mortgage Market, REITs</td>
<td>Primitive mortgage, No securitization</td>
</tr>
<tr>
<td>Development Emphasis</td>
<td>Edge City Offices, Apartments, and Shopping Centers</td>
<td>Downtown offices, Hotels, and Retail development</td>
</tr>
<tr>
<td>Regional Development</td>
<td>Relatively Balanced</td>
<td>Highly concentrated in major cities</td>
</tr>
<tr>
<td>Bankruptcy &amp; Foreclosure</td>
<td>Common</td>
<td>Uncommon, Often renegotiated</td>
</tr>
<tr>
<td>Market Information</td>
<td>Good Data on Cost of Land and Improvements</td>
<td>Poor data, Often not available</td>
</tr>
<tr>
<td>Accounting and Appraisal</td>
<td>Universal, Standard practice</td>
<td>Generally different from United States</td>
</tr>
<tr>
<td>Property Taxes and Fees</td>
<td>Relatively simple</td>
<td>Complex and variable</td>
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the process of reform has not been smooth; nor is the horizon clear.

Overhauling an economy the size of China’s without social and political dislocations is impossible. Vested interests are being disturbed and new ones created. Popular expectations are raised and often go unfulfilled. The economy grows pace without adequate laws or infrastructure to support new growth. Strains are placed on the system at all levels.

The economy remains overheated, despite recent slowing in fixed-asset investment. Inflation is too high. Even though wages have outpaced price rises\(^2\), it is still causing great dissatisfaction among consumers. The economic upheaval has rendered tens of millions of Chinese jobless or under employed. The pressures of huge internal migration are taxing urban authorities, with more than 100 million rural migrants seeking work in cities. Crime and corruption are rampant. Social stability is being undermined and demands are being made for greater political liberalization.

\(^2\) The Wall Street Journal, April 15, 1996.
How the government handles these pressing problems will be decisive both for its survival and the success of economic reform and development.

Even with strong faith in the future of China, the understanding of the operating conditions in China is a very difficult task. Complying with unanticipated regulations and requirements is a chronic problem facing foreign investors. In addition, there are many internal rules and guidelines pertaining to both investment in general and real estate projects in particular. For example, just last year, Beijing issued a set of guidelines to dictate the terms under which it will accept foreigner’s money to direct investment flows to favored industries. The new guidelines classify industries as “encouraged” “restricted” or “prohibited”. These guidelines may increase the transparency of China’s investment policies and rationalize its foreign-investment structure. However, these rules threaten to add another bureaucratic layer. American developers are not blind to the risks, as few U.S. firms joined the first big wave of real estate investment in the late 1980s. They were concerned about the restrictions on land ownership, the controlled local currency, the sub-par contractors and other problems.
Table 3. China’s Guidelines for direct Foreign Investment

<table>
<thead>
<tr>
<th>Encouraged</th>
<th>Restricted</th>
<th>Prohibited</th>
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</thead>
<tbody>
<tr>
<td>Select agriculture/animal</td>
<td>Banking</td>
<td>Telecommunications services</td>
</tr>
<tr>
<td>husbandry</td>
<td>Retail</td>
<td>media</td>
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<tr>
<td>Infrastructure</td>
<td>Real Estate</td>
<td>Security-related sectors, like weapons</td>
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<tr>
<td>Technology</td>
<td>Light industry</td>
<td>Industries that destroy the environment</td>
</tr>
<tr>
<td>Civilian airplanes</td>
<td>Coal mining</td>
<td></td>
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<tr>
<td></td>
<td>Medicine</td>
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</table>

It is also very important to understand that China is still in transition from a centrally planned economy to a market-oriented economy. The real estate market is a newly developed market and the real estate profession is relatively young. Because the new laws were only recently introduced, their full impact is still not known. If effectively enforced, they should help to promote a more conductive investment environment in China.

**Real Estate In China, A Case Study of Shanghai**

Urban reforms have resulted in distinctly different impacts among the three types of cities (special economic zones, opened coastal cities and
inland cities). The extent of economic reforms and economic openness to the outside world were intentionally differentiated in special economic zones, opened coastal cities and inland cities\textsuperscript{29}. To avoid involving its ramifications and to better understand of the present situations, a case study of Shanghai real estate market development will be used as an example.

**General Background of Shanghai**—Shanghai is the biggest opened coastal city (OCC) situated in the Eastern region of the Yangtze delta through which the Yangtze River flows to the coast. With a good natural harbor and a large hinterland, Shanghai is endowed with a convenient transportation and a favorable geographical location.

The city is about 120 kilometers from north to south and 100 kilometers from east to west with a population of 12.87 million, of which 7.93 million people live in urban districts. Shanghai is divided into 13 urban districts, 6 suburban counties and Pudong\textsuperscript{30} New Area. In 1994, Shanghai's GNP reached RMB 196.66 billion, up 14.3% from the previous


\textsuperscript{30} Pudong, in Chinese, means eastern side of Huang-Pu river which is a branch of Yangtze River.
year. Shanghai has experienced unprecedented economic growth in the last three years. (Figure 4) Shanghai's real GDP growth rates are even higher than the nation's real GDP growth rates. Thus, Shanghai's economy is healthy with inflation under control.

**Figure 4.** Shanghai and China GDP growth rates

Shanghai has a wide spectrum of industries, and advanced manufacturing technologies and large economic output. The gross industrial output value for 1994 was RMB 420,060 billion (or $50,307 billion), a 17.1% increase over the previous year. Of the total industrial output, the value of light industrial output was RMB 185,680 billion, up
18.1% from the previous year, while that of the heavy industrial output was RMB 234,980 billion, up 16.2% from the previous year.

Shanghai is one of the largest economic centers of China known as the shopping paradise. It is also a distribution center for both domestic and international commodities. In 1994, the retail sales value amounted to RMB 77.07 billion ($9.23 billion) about 15-20% of national retail sale. At the end of 1993, there were over 145,000 retail service shops throughout the city.

Shanghai has always been the largest port for foreign trade in China. Shanghai was the first Chinese port to be opened to western trade, and it long dominated the nation's commerce. Since the communist victory in 1949, however, it has also become an industrial giant whose products supply China's growing domestic demands. In 1995, imports and exports rose 36.8 percent through November to a record $41.05 billion, with most of the growth coming in the city's Pudong development zone. Imports climbed 42.8 percent to $22.06 billion, while exports rose 30.5 percent to
$18.98 billion. Pudong’s imports and exports rose 62.5 percent from the first 11 months of 1994 to $6.77 billion\(^{31}\). (1995 figure is not available)

Since 1978, especially since the development and opening up of Pudong New Area in 1990, Shanghai has been improving the investment environment in an attempt to build Shanghai into one of the largest international economic, financial environments in the world. The financial industry of Shanghai has a history of over 200 years. In the 1930s and 1940s, Shanghai was a financial center of China as well as the Far East. Since the early 1990s, a new financial system has emerged in Shanghai. Regulated by the central bank, the state-owned specialized banks make up the major part of banking system business, coexisting with financial institutions of other ownership. There are 2,510 financial institutions in Shanghai\(^{32}\) including 33 foreign banks branches, 1 Sino-foreign equity joint venture bank, 3 Sino-foreign equity joint venture or solely foreign-owned insurance companies and 86 representative offices of foreign banks,

\(^{31}\) Bloomberg, BBN, December 29, 1995.

securities, insurance companies and other financial of intermediary institutions.

Shanghai has its market with a population of 13 million people, contributing close to 10 percent of China’s gross industrial product, domiciling the country’s largest port and financial district. Its infrastructure is vastly superior to those of its neighboring cities. These factors have pulled in foreign investment. By the end of 1994, pledged foreign capital (committed foreign investment) in Shanghai reached $23.48 billions. Capital investment from the United States comprised 9.3% ($2.224 billions), only second to Hong Kong (Figure 5)\textsuperscript{33}.

Approved direct foreign investment in Shanghai between 1980 and 1994 totaled 10,741 projects, including 7,139 equity joint ventures, 2,041 contractual joint ventures, 1,534 solely foreign invested enterprises and 27 public listed companies (Figure 6)\textsuperscript{34}. Countries and regions whose investment ranks among the five-runners in Shanghai include Hong Kong, Taiwan, United States, Japan and Singapore (Figure 7)\textsuperscript{35}. Among those

\textsuperscript{33} Internet, Shanghai Window, Shanghai Internet trading & Consultancy Ltd., shainint@public.st.net.cn.

\textsuperscript{34} ibid.
projects, 1,302 projects (12.31% of total projects) involved investments from United States.

**Figure 5.** Pledged Foreign Capital Investment in Shanghai (in 100 million U.S. dollar by the end of 1994).

35 *ibid.*
Figure 6. Direct foreign Investment in Shanghai approved between 1980-1994
An Analysis of Shanghai's Real Estate Market: The time and conditions have been ripe for building growth in Shanghai for several years. The accelerated speed of capital construction across the country is quite common and stems from two important aspects of the economy: tourism and foreign businesses. Tourists need hotels. Foreign businesses have been struggling to find available and adequate office accommodations ever since arriving in China a decade ago. The industrial sector has very strong growth
potential as Shanghai is enjoying industrial growth rates of over 20%. All of these create investment opportunities in Shanghai’s real estate market.

As mentioned above, Shanghai has many advantages. Economy booms not only result in very strong demand for commercial real estate properties, but also fueled the continuing development of Shanghai’s real estate industry. As estimated by Nicholas Brooke, senior partner of Brooke, Hillier, Parker, an international real estate brokerage and property consultancy based in Hong Kong, manufacturers and investors (among them are AT & T Co., Microsoft Corp. And Trammell Crow International Co.) have invested $30 billion into the Shanghai real estate market through thousands of joint ventures primarily in manufacturing or assembly plants concentrated in the industrial areas of Pudong, Chohejing High Tech Park and the Minghang Technological and Development Zone.

Figure 8. Foreign Investment in Shanghai Industrial Sectors by the end of 1994

Fast economic growth activities are symptomatic of a real estate market with a severe shortage of office and industrial space\(^{37}\). The expansion of domestic financial and commercial organizations and the establishment of more foreign companies have caused the increase in demand for office buildings. As a result, during 1994 rents for office space and land leases have risen 40 percent to 65 percent as the vacancy rates for first-class office buildings dropped to zero percent\(^{38}\). Average annual rents for office space in Shanghai is among the highest in Asian cities (Figure


(Note: the annual office rents in this figure seem unreal, however, it was confirmed by the Washington Post) To meet the increasing demand, Shanghai is developing at a breakneck pace, building new highways, remodeling its airport and putting up new office towers with a nonstop construction.

Figure 9. Average Annual rents for Office space

in Thousand of U.S. Dollars PSF

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40 ibid.
The demand for office space is very high in Shanghai and in some other major cities. Most of the Class A office buildings have close to 100% occupancy rate with long tenant waiting lists. The strong demand for office space is driven by the rapid growth of China’s financial sector and by the foreign business boom. It is estimated top rents will drop in 1996 when a large number of office buildings under construction are expected to provide abundant space.

The most successful real estate projects in Shanghai are the mixed-use development projects. Complexes containing offices and other commercial facilities such as retailer stores, restaurants, theaters and other businesses catering to both the foreign community and the local populace command high rents. The international attention received by these multiplex projects is as great as their projected economic success. A good example of this type of development is the Shanghai Centre by John Portman & Associates. Shanghai Centre comprises three towers and an eight-story low-rise building that looks like a podium. Two of the towers are devoted to residential housing, while the third is a world-class hotel featuring a major banquet room, meeting rooms, several restaurants and a
health club. The fourth major structure, the podium, contains office space, retail stores, a modern theater, and a major exhibition hall, together with a covered parking facility. The total amount of space totals 2 million square feet. Located at the center of downtown, the multipurpose complex is situated right off Nanjing Road, Shanghai’s main thoroughfare and well-known business district.

Shanghai Centre is probably more significant in terms of its ownership structure. With over $100 million in foreign capital invested since its inception, Shanghai Centre will be the largest 100 percent foreign-owned venture in China. The forty-eight-story commercial complex is also the tallest structure in Shanghai. The owner of the building is a partnership company that consists of the Portman Companies of Atlanta, American International Group, Inc., and Kajima Corporation of Japan. It is financed through a syndicated loan arranged by CCIC Finance Ltd., a Hong Kong joint venture of Bank of China, The First National Bank of Chicago, the Industrial Bank of Japan, and China Resources, Ltd. The hotel is jointly operated by Peninsula Group and the Portman Hotel Company, while the Shanghai Exhibition Center manages the exhibition facilities. By being
wholly foreign-owned, there is the relative freedom of operation for the owners of Shanghai Centre. But like any other foreign real estate projects in China, the ownership of the complex will revert to the Shanghai government after a specified number of years according to the contract, since its land use right is only durational (It depends on the contract, it could be 30, 50, or 70 years). Shanghai Centre has been fully occupied since its completion. In a nation where buildings claiming to be top quality often fall far short of that standard, American projects are well regarded in China. Shanghai Centre proved so popular it became virtually a new downtown for expatriate residents in the city. The mixed use property now rents for about $115 a square foot. The project will generate enough cash flow and have positive impact on its immediate surroundings. It has attracted the attention of the general populace as well as that of potential commercial tenants.

There are several similar projects under construction in Shanghai. One is the Gateway Plaza at Xu Hui, undertaken by Ryoden Property Development Company Ltd., a Hong Kong listed company. The construction started in August 1993 and the project will be completed in
three phases between 1995 and 1997. The plaza of the seven-block commercial-residential complex will provide about 2,380,058 square feet of floor space for office, retail, commercial-residential use. This project is a joint venture between the Hong Kong-based China Nation Enterprises, the Shanghai Dyestuffs Corp. and the Shanghai Municipality Xuhui District Property Management.

A group of Hong Kong property developers, including Hang Lung Development Co., laid the foundation for another landmark project—Grand Gateway in the center of southwestern Shanghai in 1994. The US-based Callison Architect Partnership (Seattle) designed the complexes. With total floor space of more than 4 million square feet, the project comprises two high-rise (53-story, 775 feet height) office buildings, up-scale apartments, a shopping mall and an underground parking lot. The Hong Kong-based Konghui Property Development Co. Ltd. will put up 80% the total investment of $500 million, among the largest for any property development projects in the city. The big-ticket project will be completed in phases, starting in 1996.

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By the end of 1996, Shanghai will add about 20 million square feet of office space, a 700% increase from the three million square feet it had at the beginning of 1994. Overbuilding is certainly a threat. There is some speculation that office rents in Shanghai may fall about 5 to 10% a year and this is likely to continue until at least 1997 then leveling off.

Hotel: In evaluating Shanghai’s overall real estate market, hotels have been the most active sector. In 1995, China hosted over 13% more foreign tourists than in the previous year. This number does not include tourists from Taiwan, Macao and Hong Kong. Therefore, it is understandable that hotel supply has been growing faster than demand for the past few years. This is especially true at the high end of the market: Occupancy rates for most four- and five-star hotels are below 60%. However, room rates have more than doubled in recent years. Thus, despite their low occupancy rate, most hotels are still profitable. Most hotels are also doing fairly well, because of their booming restaurant and entertainment business. Although the supply of upscale hotels exceeds demand, there appears to be room for

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42 Adam Johnson and Mingyang Xu, China News Digest, Global News, No. GL96-054, April 19, 1996.
“econo-Lodge” style facilities which currently have much higher occupancy rates. These type of rooms are used mostly by Chinese tourists and business travelers.

Demand for industrial space is very strong. Many foreign corporations have come to Shanghai to set up manufacturing firms. Because many foreign manufacturers prefer new buildings, recently built properties that satisfy international standards are in especially strong demand. Since most Chinese real estate developers have limited experience in designing and building this type of property, they are willing to work with experienced outside developers.

Many foreign retailers want to sell directly to China’s 1.2 billion people. This should be possible by a recent Chinese government decision to widen China’s doors to foreign retailers. Shanghai has some 75 million square feet of retail space, but little of this is in high-quality shopping center developments. Apart from the traditional business district in Nanjing Road and Huahai Road, new centers are emerging including Xujiahui area. Some fifteen large centers, largely funded by foreign equity, are being
constructed. In the Lujiazui district of Pudong, the much publicized Shanghai No.1 Yaohan Department Store is under constriction. With nearly 1.6 million square feet of retail space it will become Asia’s largest single department store when it is completed. The project is a joint venture of Japanese retailer Yaohan Co. and Shanghai No.1 Department Store Corporation. Besides Japanese department store groups, some retailers and chains from Western Europe and the U. S. are making inroads into the Shanghai market. Many of the foreign retailers are either in joint ventures with local retailers, or are forming franchises. Many U.S fast-food and convenience stores are opening the shops in Shanghai. Wal-Mart, the biggest retail chain in the U.S. is planning to bring its discount outlets and value clubs to Shanghai.

In the residential sector, the success of the earlier projects in major cities triggered a period of overbuilding. The demand in this sector comes almost exclusively from overseas Chinese and representatives of foreign firms. The market has been overbuilding in recent years. It is estimated that 20,000 units of single-family houses or townhouse have been built in Shanghai in the last two years, with an average price of $1,400 per square
meter and rising to as high as $2,500 per square meter. A typical three-bedroom, two-bath townhouse unit would cost as much as $210,000, which is more than a similar unit in most U.S. markets. (But not in New York where a 3 bedroom 2 bath condo would cost $500,000.) The result of so many residential units are coming into the relatively small market, has caused the price of some units to declined over the last year. It was reported that about half of these 20,000 single family house or townhouse are still for sale on the market.\(^\text{43}\)

It is very clear that demand for Western-style office, manufacturing space has soared in Shanghai over the past few years in tandem with the growing number of American and European companies seeking to establish a base in China. However, with the big wave of real estate investment in Shanghai after the government began granting long-term land leases to foreign developers, oversupply is certainly a threat.

\(^{43}\) Would News Daily, August 26, 1995.
Conclusion

As the world’s fastest growing economy, China offers real estate investment opportunities for foreign investors and real estate developers. The China’s real estate market is a newly developed market and the real estate profession is relatively young. Like learning to swim, the process is long and laborious and may even be dangerous at times. Judging from its present course of development, China has done quite well in attracting foreign capital to a new commodity of real estate and in creating values in an economic vacuum. Since real estate development in China remains a high-profile industry, drawing top investors and entrepreneurs from around the world, the momentum built up so far will continue until the market is saturated. As long as China’s economic activity persists and its political situation stays under control, foreign investment in hotel, office and apartment projects will be as enticing as any other type of investment.
The scale of real estate investment opportunity in China is huge, and so are the risks. In addition to the risks of political atmosphere, and an overheated economy, the imminence of oversupply from a building boom could deflate real-estate profits. For global real estate investors it is very important to establish investment strategies to ensure success. For example, when investing in a large emerging market like China, one can never underestimate the importance of local partners. They play important roles in dealing with government bureaucracy, obtaining local financing, and handling changing market conditions.

Institutional investors can also invest through a more management-intensive approach to avoid the risks of direct property investment. There are different ways to enter China’s real estate market, for example, buying shares in these publicly traded Hong Kong real estate companies. Many Hong Kong developers, such as Cheung Kong, Hopewell Holding Ltd., and New World Ltd., have poured capital into southern China real estate. These shares are traded on the Hong Kong stock exchange and are fairly liquid. Investors can also invest in China’s real estate by providing financing for
established overseas developers in their joint ventures with local partners. This can be done either through an equity position in large investor/developer companies or through subordinate corporate debt in large investor/developer companies. To prepare for the buying opportunities in the China’s real estate market, institutional investors should learn about the Chinese market and establish relationships with those domestic developers and investors who have the right contacts and experience. While collecting data and building relationships to find optimal investment vehicles won’t be easy, the opportunity to participate in the world’s biggest economic boom should justify the cost.
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