

PROPERTY MARKET IN PRC
UNDER THE AUSTERITY MEASURES

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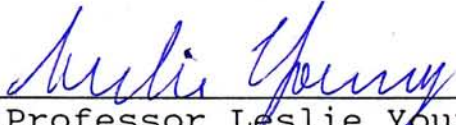


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ABSTRACT

The overall economy in China was overheated in the first half of 1993. Speculative activities were tremendous and affected the welfare of the whole population. In July 3, 1993, Central Government announced the Austerity Measures to correct the situation. We define the period from July 3 to the fourth quarter of 1993 as Stage I of Austerity Measures. An immediate effect was achieved with land prices dropping by 80% in some small cities. Once inflation was under control, China turned its attention to restoring economic growth. With the announcement of Deng Xiao Ping's loosening of control, most of the measures came to be ignored. The recent promulgation of the capital gain tax represented Stage II of Austerity Measures. Different effect were felt by developers and investors in both stages. Potential countermoves were identified to bypass the changes created. This project concentrates on the PRC property market for overseas sales. The fate of the Austerity Measures illustrates the weakness of central government in executing central policies.

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CHAPTER 1

INTRODUCTION

Scope of the Project

This project aims at examining the problems of the current PRC property markets, evaluating the effect of the Austerity Measures, and identifying the potential turnaround from an investor's point of view. The investors here represent developers who develop property for overseas buyers. This project does not cover local property developers.

The development of the Austerity Measures from July 1993 to the present serves to illustrate the weaknesses in overall administration in central government policies. There is a famous proverb: government delegates power to provincial governments (decentralization) in achieving some pre-set objectives, delegation leads to chaos including inflation and unrest. When chaos exists, central government re-asserts (recentralization) control to ensure political stability. When recentralization begins executed, growth of pre-set objectives slows down and diminishes. When central government re-assumes stability, it delegates power again to stimulate growth.

This cycle keeps on repeating in recent Chinese history. The original purpose of the Austerity Measures is to control the overheated economy. When economic growth slows down, the central government is afraid to lose prosperity, and Deng Xiao Ping permits looser control in the fourth quarter of 1993 to ensure the continuous economic growth. The development of the Austerity Measures reported in this project proves the accuracy of the above proverb. More generally our project serves to illustrate the unique difficulties of moving toward a market economy in China where the central government lacks the information and the institutional structure to impose its will on local authorities, yet must attempt to do so in order to hold the country together.

Background

The People's Republic of China is the world's third-largest country. Over 80% of the population is concentrated in the eastern half of the country, especially in the north-east, near the coast or in the major river basins.

A new era began in the 1970s when President Richard Nixon of the United States of America made a historic visit to China in 1972, thus ending Beijing's isolation from the non-communist world, and leading to the adoption of an economic "Open Door" policy. Diplomatic and trade

relations were established with the USA and subsequently, with Western European countries, Japan and other Asian nations.

The years 1979 to 1991 saw the longest period of strong growth since 1949; average annual gross national product (GNP) increased by 8.6% in real terms. The "Open Door" policy included the implementation of the many reforms. High economic growth, diversification of the forms of ownership, and fewer restrictions on labour mobility have all contributed to greater job opportunities. The official urban unemployment rate dropped from over 5% in 1979 to 2% in 1984, and remained below that level until 1989 when it increased to 2.6%. Since 1978, the highest GNP growth rate has been the 14.6% reached in 1984, and the lowest the 3.9% registered in 1989, with average annual growth rate of 8.8% during the 1981-91 period. GNP (at current prices) increased from RMB 1,592 billion in 1989 to RMB 1,767 billion in 1990, and to RMB 1,958 billion in 1991.¹

In the 90s, the economic cycle in Mainland China is at a turning point. As mentioned, the economy in China has developed in a fabulous way, but has overheated. Symptoms include high inflation, unbalanced distribution of financial resources, panic buying, and lack of hard cash in

¹"The HSBC Group: Business Profile Series - China" The Hong Kong and Shanghai Banking Corporation Limited. Tenth Edition, February 1993.

the banking system. A sustained period of high inflation began in 1985 when retail prices increased by 8.8%; the rate rose to 18.5% in 1988 and 17.8% in 1989. For example, Shanghai increased prices in early July 1993 for everything from bus tickets to coal, with a monthly pass rising from 12 to 20 yuan, and coal from 15.5 to 23 yuan for 100 kilograms,² ranging from 40 to 70% increase. The overheating economy was fuelled primarily by expansionary fiscal policies, rapid decentralisation, growing investment/speculation, and relaxation of price controls.

Birth of Austerity Measures

The overheating economy created both economic and social problems. Government revenue dropped as a result of the decentralisation required by enterprise reform, while expenditure increased as price subsidies were raised to support new rural programs. The Government succeeded in containing the deficit for seven years continuously. Over the years, debt financing (both domestic and foreign) of the deficit has increased. "The budget deficit reached 23.66 billion yuan (US\$4.12 billion) in 1992, or 2.88 billion yuan (US\$501 million) more than planned", addressed by Finance Minister Liu Zhongli.³ The deficit caused great

²"Shanghai Increases Prices in Battle against Inflation". South China Morning Post. July 2, 1993.

³"Warning on HK'S Economy". South China Morning Post. June 29, 1993.

financial difficulties in Central Government and delayed necessary infrastructure construction in underdeveloped states and cities.

On the other hand, economic growth was concentrated along the coastal areas, the Special Economic Zone (SEZ), and the north-east including Beijing and Shanghai. Inhabitants in the north-west rural areas suffered all kinds of economic problems created by the overheating economy with salary increased substantially below the rate of inflation. Their living standards dropped tremendously. The farm crisis grew as peasants fight for payment for their crops, attacking post offices in 11 provinces which failed to cash postal remittances, when officials diverted agricultural funds to speculate in the real estate and stock markets. Farmers remaining in the rural areas became increasingly restless. Whereas a lot of people rushed to SEZ, hoping to find a job and enjoy the benefits of economic growth. All these created social problems and grievances within the population.

It also created pressure to the property market in the areas due to the intensified land supply and demand condition. Foreign investments drove up demand in land for factory site. Developers invested in property projects to accommodate the expected increasing population, both from Hong Kong and Mainland China. Land prices, cost of building materials and workers salaries were increased in

an uncontrollable manner. The overheating property market and the high inflation in land price further intensified social problems within the population.

The resulting economic and social chaos, according to Qiao Shi, Standing Committee member and chairman of the National People's Congress (NPC), are "the problems of blind expansion of investment, the contest of speed and the lack of an effective regulatory mechanism have not been properly solved."⁴ An effective macro regulatory and supervisory system needed under the new market economic structure had yet to be set up. In July 2, 1993, China appointed Executive Vice-Premier Zhu Rongji to head the People's Bank of China, signalling the introduction of tough measures to restore fiscal order, to strengthen the leadership of the State Council over financial work. In July 3, 1993, Zhu Rongji delivered a 16-points plan aimed at 1) controlling the country's inflation, 2) recovering the bank loans, 3) restricting the offer of credit, 4) redirecting investment, 5) restricting land supply, and 6) regulating the property market. In order to obtain results, the central government has attached considerable importance to the following austerity measures which have been grouped into four categories, based on the applicable sector:-⁵

⁴"Zhu Takes Helm of the State Bank". South China Morning Post. July 3, 1993.

⁵"The Austerity Measures". South China Morning Post. July 4, 1993.

Financial

1. Further increase deposit and lending interest rates;
2. Call in loans diverted to speculative schemes;
3. Force non-financial institutions to repay funds borrowed from financial institutions;
4. Force banks to control the way they approve loans;
5. Strengthen the Central Bank;
6. Control listing of shares on the stock market.

Investment/Property

7. End dubious fund-raising schemes;
8. Control real estate fever in development zones;
9. Reduce the scale of infrastructure projects.

Government

10. Ensure purchase of all government bonds by mid-July;
11. Cut government spending by 20% and ban the importation of cars;
12. Send inspection teams to ensure that provinces obey orders.

Others

13. Forbid the issuing of new IOUs to peasants;
14. Suspend price reform measures;
15. Reform the export financing system;
16. Clear transport bottlenecks that allow goods to pile up.

Of the above 16 points, the measures in financial sector and especially in the investment/property sector have an impact on property market development. We will elaborate details in Chapter 3.

Aftermath

During the fourth quarter of 1993, the overheating economy and inflation were partially under control. In view of the prosperity in China's economy compared to the deteriorating one in the western world, Deng Xiao Ping considered it a golden opportunity to strengthen China's economy and political power in the international theatre. Thus, Deng would like to loosen the Austerity Measures to allow the fabulous growth to continue. The loosening of the Austerity Measures created new effects on the property market and the overall economy, which will be discussed in Chapter 6.

CHAPTER 2

METHODOLOGY

Marketing Situation Analysis

In our study of examining the problems of the current PRC property market, we firstly must have a better understanding of the historical background of PRC property market and the socio-economic factors affecting the development of this market. Then, we analyze both demand and supply on the market. Concentrating on the developers' point of view, we examine the impact of austerity measures on market sentiments. A forecast on the future supply is made based on qualitative analysis of the data collected.

Primary Data Collection

Sources of secondary data available in China is not easily accessible. We concentrate our effort on collecting primary data. Interviews with representatives from developers who have worked in the PRC property market in recent years were conducted. The information collected is mainly from their direct experience and professional opinion on the PRC property market.

In addition, property agents such as Land Power, Centraline are also playing an active role in PRC property market though agents in the PRC property market are not widely employed at the moment. Therefore, interviews with property agents are also conducted in order to have a more objective point of view from them and a more professional forecast on the PRC property market.

Secondary Data Collection

Although the PRC property market has expanded in recent years, it is not yet a mature market. Information from secondary sources, especially from China, is scarce and is not well organized enough for us to have a systematic analysis. Our effort is therefore concentrated on collecting information from newspapers and journals in Hong Kong which have a keen interest on PRC property market.

Moreover, the PRC property market is a very dynamic one which is partly explained by the overheated economy. An eye on the daily news can surely help us to have more updated information about the market. It also gives a more objective way to analyze this property market.

Data Analysis

After collecting all the information from both primary

and secondary sources, data is analyzed with qualitative approach but in an objective way. Problems of current PRC property market are identified and impact on developers are evaluated. Countermoves by developers to overcome the present difficult situation are also examined.

Limitations & Obstacles

The title of this project is a very current issue and hot topic at the moment. Both the central and local policies change all the time. The market itself is also very dynamic. These create a lot of difficulties during our process of collecting information. We have to always keep a very close eye on all current development of the market.

In addition, PRC is a very large market with an extensive area. Different areas have their own unique characteristics. Different local governments have different policies. These factors shape different market features. Characteristics and prospects of one market in the North may be completely different from that in the South. A generalized perception of the PRC market is difficult to conclude.

Moreover, it is not an uncommon problem that statistics is hard to get from either public bodies and

relevant departments or private organizations in PRC when we have research on PRC issues. Statistics figures are always treated top confidential in PRC. Sometimes, even you have the access to the relevant departments, the figures are outdated. Thus, it is not suitable to use in a topic which is so hot and current. We can only rely on the statistics compiled and provided by the professional bodies in Hong Kong.

CHAPTER 3

THE AUSTERITY MEASURES

Details of Austerity Measures in Property Sector

Mr. Zhu Rongji specified detail rules and regulations for each point in the austerity measures. Limited by the scope of this project, we will concentrate on details in investment/property sector:- ⁶

- A. Restriction in private land sales. Central government recentralizes the power from province/county/city in allocating/selling lands.
- B. Majority of lands are allocated/sold under public auction, centralized under appointed legal entities. Land can be sold in public auction only when city planning for the land has been finalised. There are six usage of lands which are not allowed to be sold in auction. Land cannot be auctioned if:
 - usage is not aligned with national production policies;
 - the purpose of the development project is not yet

⁶"Chinese Government Investigate Property Market & Control Land Supply". Wen Wei Po. July 13, 1993. & "Shenzhen Issues New Measures in Realty Market Control Beneficial to Long Term Development". Express. August 7, 1993.

decided;

- the amount of investment is not yet finalised;
- usage is not aligned with the principle of protecting farmlands
- usage is not aligned with the unified land allocation/selling principle
- land development requirements are not respected

- C. Suspend the licence of companies whose principal activity is only land speculation, with no actual construction.
- D. Reconsider the architecture of existing land construction. Government encourages constructions in multi-storage building and lower class housing. Feasibility studies on the above constructions have to be seriously carried out.
- E. Developer has to pay 5-10% as deposit upon signing of land contract, while the rest of the land cost is to be paid within 60 days.
- F. The land cannot be transferred unless 20% of total investment (excluding land cost) and construction area are completed. Tax is charged on land appreciation value when transfer taken place.
- G. A minimum development fund of 25% is to be injected

before pre-sale can be carried out.

- H. Strengthen tax collection procedure to minimize default payment.

The above details of austerity measures being initially announced in July 3 have substantial impacts on future property market development in China.

Immediate Impact of Austerity Measures

After the implementation of Austerity Measures in July, the overheating economy, particularly in the finance and property sector, was partially under control. Liquidity problems in Capital Market were lessened; deposits substantially increased whereas a portion of dubious loans were recovered. Land price in large cities dropped a little, e.g. <10%, but dropped by 20 to 80% in small towns. Whereas flat price remained stable in large cities, but dropped by 10 to 50% in small towns (refers to Table 1). Both purchase prices for land and flat in smaller towns have been dropped in a larger rate due to the effect of the Austerity Measures in curbing the overheated economy. Before the issue of the measures, speculations in property market were serious. The enthusiasm of the speculators blinded them to the unreasonable high price; prices for land and flats were driven up in whatever locations they can purchased. However, when the measures

were introduced, speculators were afraid that the tightening control would lead to diminishing growth in property market, as history has demonstrated the possibility of above occurrence. In large cities particularly in northern China, actual demands from expatriates of foreign subsidiaries and representative offices existed. Therefore, price only adjusted in a small scale during this period. Whereas most of the demand for small towns in southern China were arisen from speculators. When speculators were hesitated about the potential effect of the measures and stop pouring money into property market, market price slumped.

The mentioned price drop can substantiate the immediate tightening effect of the austerity measures. At this stage, a lot of observers predict that a substantial portion can be sustainable as the execution of the measures affect future revenue in Central Government. Measures which are expected to persist include regulations on land auction, building resales, taxation issues, and restrictions of provincial power in private land private. By centralising land auction in one unified legal entity and restricting provincial power in private land sales, Central Government can ensure an income flow. By enforcing the 25% completion rule for building pre-sales, the government can minimize potential social grievances due to default. Taxation rules have to be observed; this is one of the most important sources of government income.

Table 1

Purchase Price Decrease for Selected Cities (in real term after adjusting inflation rate)

<u>Cities</u>	<u>Flats</u>	<u>Land</u>
Beijing	stable	stable
Shanghai	stable	stable
Guangzhou	5%	5%
Shenzhen	10%	10%
Suzhou	10%	20%
Dongguan	15-20%	20%
Zhuhai	20%	20%
Shantou	20%	30%
Huizhou	20%	30%
Hainan	20-30%	30%
DaiyaBay	40%	30-80%
Beihai	50%	30-90%

Source: interview with Mr. Sherman Lai of Centraline Limited

From a macro viewpoint, China is now being seen as one of the most important economic centres in the next decade, Its western counterparts, including US, UK and Japan, all pay close attention to China's activities. In order to participate in the international theatre and communicate in an efficient way, we expect that China will be "westernized" in some aspects. As increasing portion of the rules and regulations will be codified, and enforced, if not all. From a micro viewpoint, China, under the guidance of Deng Xiao Ping, is moving towards Recentralization. As mentioned, the decentralization carried out in the 80s created all kinds of chaos - loosening central control, high inflation, rural unrest, and uncontrollable local authorities. The Recentralization ensures one important element: the Central Government is re-asserting control on major aspects including revenue earnings and central control. Accordingly, observers expect the rules will be sustained in a longer time frame due to its importance for government revenue.

During the fourth quarter of 1993, overheating economy and inflation are partially under control. However, in view of the prosperity in China economy compared to the deteriorating one in western world, Deng considers it a golden opportunity to strengthen the China economy and political power. Thus, Deng would like to loosen the Austerity Measures for the fabulous growth.

From the fourth quarter of 1993 onwards, despite the view of the observers, austerity measures are almost fully faded out from the picture. The most recent development are the announcement from the National Land Management Bureau to impose the capital gain tax. However, Central Government faces severe protest in actual execution. The impact of the second stage of the Austerity Measures will be examined in details in Chapter 6.

CHAPTER 4

LOCAL GOVERNMENT ATTITUDES

General Situation

In China, central government usually issues central policies to set the major direction which the provinces or municipalities have to follow. This only stipulates the thinking of central government. It allows the local provincial government to state clearly what should be imposed and details of the new policy. Local provincial government can adjust policies according to the local situation. When the issue is down to municipal or county levels, local government can still have their own local adjustment and degree of implementation. Sometimes, they implement but with other countermoves to balance the effect of implementing this central policy.

Narrowing our review in property sector, each county has its own local department for property ownership registration, sales and re-sales. However, information is not open to public, general public are not allowed to assess to the details. There are no central administrative department to consolidate all registration information from individual county, municipal or province. Information are

scattered in the hands of local authorities only. Due to the administrative shortfall, central government has difficulties in enforcing the actual carry out of any central policy in provincial level. As a result, local government attitudes play a very important role in assessing the impact of austerity measures. We would like to examine it in more details by geographical location.

Northern China

Local government in Northern China e.g. Shanghai usually follow closely the policy of central government. They do carry out the austerity measures. However, they also closely monitor the change in central government attitude which may induce a change in central policy. They try to formulate strategies in advance so that they can take appropriate action to adapt to the dynamic environment.

Southern China

Local government in Southern China usually have more autonomy than the Northern China government because most of them develop their economy earlier e.g. Guangdong Province and with longer history of attracting foreign capital. They have a better understanding of the foreign world and seem to be more flexible in accepting foreign ideas and practices. In addition, different local governments in

this regions have keen competition among themselves in attracting foreign capital for their provincial development.

Due to their flexibility and keen competition, they often have adjustment on the austerity measures issued by central government. For instance, the Mayor of Guangzhou Municipality has declared that it will not impose the capital gain tax on property transaction of Guangzhou. Though this is a temporary measure of the Guangzhou government, it still gives the chance for developers to react accordingly.

However, the provincial government still have limitations on their authority and have to act with good justification.

Remote Areas in China

Local government in remote areas are very keen to attract foreign capital so that they have funds to develop and become rich. They usually offer very favourable terms to foreign investors in developing their local property market. When austerity measures are imposed by central government, some of local governments do implement them but they also create new incentives to compensate for the adverse effect on their property market. This keeps their property market running and they can continue to attract foreign capital to facilitate their economic growth.

Central government though is aware of the situation, they still allow them to do so because they also understand the importance of foreign capital and property market to the prosperity of the local economy.

Moreover, sharing information among different departments or between different levels of governments are rare in PRC. There is always conflict between them. This makes the control of central government over local governments more difficult. Central government may not know clearly about the details of sales of land by the local government. As the share of information among different departments is also rare, collection of tax revenue becomes difficult. All these contribute to the less effectiveness of austerity measures and central control.

In addition, the definition of obligations and authority of local government is vague. When China started her open door policy, central government favoured economic growth locally because it is difficult to have economic growth over an extensive area like China. This allowed flexibility to local governments to determine their own local policies especially along the coast. A historical background of vague definition and loose control attribute the austerity measures further unsuccessful.

CHAPTER 5

STAGE I - IMPACT AND COUNTERMOVE

First Austerity Measures

First Austerity Measures refer to the period starting from July 3 with the first announcement, and ending with Deng Xiao Ping permitting the looser controls in the fourth quarter of 1993. The measures aimed at cooling down the overheated economy. Zhu Rongji expected the measure would lead to reduction in supply and accordingly property price. Contrary to the western economy theory, price in China property did not increase due to reduced supply, rather, demand slumped and price dropped. This was because most of demand, particular the one in small cities in Southern China was created by speculators but not actual users. Therefore, when measures were introduced, speculators held up the fund and applied a "wait-and-see" strategy. With no actual demand, reduced supply therefore did not drive up the price. Rather, the whole property market looked gloomy with prices reduced. A number of observers together with portion of developers foreseen that part of the Austerity Measures can be persisted, if not all. Accordingly, proactive actions are taken.

Impact to the Property Market - Supply Side

This section discuss the impact of austerity measures on the supply side of the property market in China forcing on developers who develop property for overseas buyers only.

a) Construction Cost

Unlike the Hong Kong case, land cost does not constitute a big share in the development cost of construction project in China. Instead, the cost of construction material and labour significantly affect the project costing. Before the austerity measure, the rapid expansion of the China property market had pushed up construction costs which increased by 28% and 40% by the end 1992 and first half of 1993 respectively.

With the announcement of the austerity measure, the property market then entered into a cool down period. Since some development projects were slowed down or even forced to halt, such shrinkage in the demand side led to the immediate dropping of construction cost by around 30%.⁷ It is surely good news for those developers who still have the capability to continue their construction work under the austerity programme. On the other hand, we expect that the construction price will remain stable in the long run

⁷"China Slows Down Property Loans". Oriental Daily News. July 25, 1993.

if the property boom does not return. This is also advantageous to the developers as they can more accurately predict and control their project costing as well as their revenue.

b) Capital

Concerning capital, the immediate impact of the programme is the turning off the tap of financial source for quite a lot of property developers. Those developers who previously relied on Chinese local banks as the major source of development funding could no longer get financial support since the bankers themselves have to collect previous dubious loans under central government instruction. In fact, the state council has given the instruction that no new fixed asset investment projects should be approved in second half of 1993. Similarly, joint ventures also failed to obtain cash from PRC partners. An even worse situation faces those developers who have not yet started their projects. Under the central government instruction, pre-sale can be carried out to obtain cash from the market only when the construction is 25% completed. So, some developers may be driven out of the market due to their inability to obtain necessary capital to sustain existing or start new project development.

Therefore, the capital cost in long run is expected to be increased and developers must have stronger financial

backup before they can start a project. Moreover, it will be relatively difficult to obtain finance from banks unless official approval has been obtained beforehand. This action screens out the developers without a strong financial background. This helps to ensure that the future PRC property market will develop in a healthy direction.

c) Land supply

One immediate action in the austerity programme was the re-assessment of the development projects and developers by Chinese officials. Those lands which have not been developed within 2 years time would be repossessed. It is clear that concerned developers would be severely hurt. Some developers may even want to quit the game and search for someone to take over the project/site at a cut throat price. At the same time, land cost dropped tremendously in some cities, especially in those rural areas like Hainan (30%), DaiyaBay (30-80%).⁸ Though the measures are bad news for those developers who could not continue the game, golden opportunities in fact have been created for financially strong and optimistic players who can take over land/site/project with good potential at relatively cheap prices.

In the long run, the authority of local governments to sell land was restricted and the supply of new land is

⁸"Some Sites in Daiya Bay Cut Price for Sales". Sing Tao Jih Pao. July 31, 1993.

expected to decrease. The authority has estimated that revenue generated by selling land through tender/auction would reach 100 billion yuan in 1994, more than double as compared with 1993. To property developers, land cost will increase in the future.

d) Competition

In the short run, developers will face severe competition for finance from the market for survival. Accompanying the selling of the completed construction will be attractive terms like price cut, lucky draw, gift giving, extended payment terms, etc.

But in the long run, we consider that competition will lessen since many unqualified developers will be knocked out from the market.

e) Tax and profit

To cope with central instruction, unauthorized tax benefits by local authority is expected to reduce significantly in the long run and thus the profit margin of property developers will be cut down. Land speculation activities will also slow down due to the enforcement of capital appreciation tax.

If the Chinese government determines to help people who have difficulty in getting accommodation and continue to require each developer to sell a certain fraction of

completed construction (around 10-20%) at a cost-based price, the profit margin of developer will also be adversely affected.

f) Investment direction / strategy

In the long run, developers need to plan more carefully and be more sensitive to the direction of central planning. In fact, land will only be sold to the developers if they have completed the preliminary design on the development. During project planning, developers should try to avoid going into market with no clear demand (eg. high class hotels / villas in rural areas) or violating national policy. Instead, they should take central guideline into consideration and proceed with projects that are of high economic efficiency or which ease current bottlenecks in the system.

Impact to the Property Market - Demand Side

This section discuss the impact of austerity measures on the demand side of the property market in China. Demand side refers to overseas buyers.

a) Mortgage availability

In most of the economic system, the availability of bank mortgage has been the determining factor of the property market. To some extent, this is also applicable in PRC property market. Existing property price in China

are still considered to be inexpensive. Accordingly, a portion of foreign buyers can settle the amount in one lump sum without mortgage arrangement. However, there are still another portion of buyers that need to have mortgage arrangement in order to purchase the property. Accordingly, mortgage availability will have impact to parts of the buyers.

Property buyers are less likely to obtain finance as easily as in the past. Banks, like Bank of East Asia which provides mortgages to Hong Kong buyers to purchase Chinese properties will also tighten their mortgage policies in view of the uncertainties ahead under the austerity measures. The demand of the overheated property market will fall temporarily.

However, in the long run, when the overheated economy has cooled down and the PRC banks are accumulating enough funds, mortgage will be more readily available to the public. The foreign banks are also willing to go back into the market if the PRC property market is becoming more regulated under the austerity measures.

b) Mentality of Individual Purchasers

The austerity measures aim at cooling down the overheated economy and controlling the inflation rate which is running above 20% in major cities. In the short run, economic growth are expected to be slow down during the

first Austerity Measures. Purchasing power of foreign buyers will not be affected, but the uncertain economic condition will prevent them from investing in PRC property market.

The outlook will be more optimistic in the long run when the austerity measures are effective. In view of the original purpose of the measures, the overall economic conditions will be improved and the income of the general public will grow in the real terms when the economy can sustain healthy growth. When overseas investors resume optimistic view in China's future economy, demand will return and increase again.

c) Investment Funds from Institutional Investors

The booming property market does not only attract private buyers, but also attract institutional investors from within PRC and overseas. One of the purpose of austerity measures are to stop the inflow of hot money in the property market. In fact, the Chinese Central Government has announced the law to prohibit cross provincial investment funds to speculate in property. During the initial phase of the Measures, investment fund activity is expected to reduce.

In the long run, if the market can be more healthy and regulated, overseas investment will certainly be interested to invest in the PRC property market.

Countermeasures by Developers

The austerity measures has hit the property market tremendously. The developers who are doing business in China have also suffered a tremendous blow. As mentioned, we expect a portion of Austerity Measures, particular relating to finance sector, will be relaxed. Let us look at the countermeasures of developers.

a) Developers with funding capacity

The austerity measure is regarded as having a cooling effect on the overheated economy by restricting the disorderly approval of capital loans. Therefore, the short term effect may have significant cooling effect on the property market while in the long run, it is believed that the austerity measure would have a positive affect on the property market. Having this in mind, the developers with funding capacity have the following countermeasures:-

- i) some developers may take advantage on this short term cooling down effect to cancel those projects which were blindly started up during the overheating period;
- ii) others may take this opportunity to purchase land and properties at a good price, especially at those areas where land and property prices drop tremendously;
- iii) Many major developers still maintain their optimistic view of the Chinese economy and property market, and continue to put their eyes on large development in the construction of infrastructure such as railways, new

ports and highways, etc. For example, a recent report on newspaper indicates that Wharf Holding has an ambitious plan to turn the city of Wuhan into the "Chicago of China";

- iv) developers arrange with banks in Hong Kong to provide mortgage to overseas buyers. Banks will study the financial background of the developers to decide if mortgage arrangement will be provided to buyers or not. To the banks, it is the developers being liable to any defaults or repayment rather than the buyers, although the developers can resume the property for re-sale if defaults do exist;⁹
- v) some developers like New World Development look for developing lower class housing for internal sale, but not look for large project in major cities for overseas sale. This type of investment has lower risk and guarantees a reasonable profit;¹⁰
- vi) developers will still try to maintain good relationship with the Chinese officials and look for future long term investments.

b) Developers without Funding Capacity

Those developers without funding capacity were severely hit by the austerity measures. Here are some of the countermoves by developers without funding capacity.

⁹"Developers Consider Offering Mortgage Lending to Boost Sales". Hong Kong Economic Journal. July 26, 1993.

¹⁰"New World Withdraws from Beijing Project". Hong Kong Economic Journal. July 19, 1993.

- i) Some developers may have to sell their land or properties at once at a low price in order to recover the capital required;¹¹
- ii) Some developers would reduce the scale of their development program, hence reduce the capital required;
- iii) Some developers may try to increase their sales of properties by advertising their sites in markets other than Hong Kong, ie. Taiwan, Singapore, and Malaysia;
- iv) some developers would slow down the construction progress with only minimal work continuing, and at the same time look for a buyer. However, in order to fulfil the state policy, the new buyer has to fund the project until 25% completion before legal title of the site can be transferred;
- v) some developers would divide the site into different phases, and construct one phase after another. They would start selling each phase when 25% is completed in order to fund the ongoing project;
- vi) some developers may try to get approval of ongoing project from officials through bribery. In such case, they may claim that the capital fund to be sufficient, or claim that the construction work is 25% completed when actually it is not;
- vii) some developers will change the usage of the building. For example, they may change a hotel development

¹¹"Small Realty Firms Forced to Sell". Sing Tao Jih Pao. July 19, 1993.

- project to commercial building, so that they can sell individual units immediately to obtain capital;
- viii) some developers may find underwriter to underwrite future sales, while continuing to construct until completion. By using this method, the developer will not be limited by the 25% completion rule, and can guarantee income. However, the pre-requisite for this method is that it only happens when two parties have different viewpoint on the property market - the underwriter considers the market still being healthy and can sell at a good price while the developer considers the underwriting price is reasonable and foresees a downturn in the property market;
- ix) some developers may have to invite capital injection by increasing the number of shareholders.

CHAPTER 6

STAGE II - IMPACT AND COUNTERMOVE

Second Austerity Measures

The National Land Management Bureau has openly announced the plan to impose the capital gain tax which is one of the local tax items since December 1992. Details would be formulated within one or two years. In September 1993, it was announced that the ordinance of capital gain tax was approved by relevant departments in PRC but government was considering to exempt the capital gain from public auction in Shenzhen. Government finally on December 10, 1993 announced the temporary measures of this capital gain tax effective on January 1, 1994. Tax rate on capital gain ranges from 30% to 60%. This capital gain tax is the core of second austerity measure.

This arouse vigorous response and strong opposition from developers, investors, agents solicitor firm and accounting firms in Hong Kong. Relevant associations in Hong Kong actively reflect their opinion towards this ordinance to central government in PRC.

Some local government also responded that they would follow

this central policy but with flexibility to cope with their individual local requirements. Moreover, the Secretary of Finance of PRC also promised to consider different opinions from Hong Kong regarding this issue.

Contrary to the foreign observers' belief, almost the whole austerity measures are no longer substantiable starting from 1994 onwards, except the new purposed capital gain tax regulation. It is due to the belief of Deng Xiao Ping that China should expand the existing economy when western counterparts are now under severe recession. Besides, the resistance from local authorities in actual carry out of the austerity measures also fuel the administrative difficulties. Thus, the second stage of austerity measures are dominated by the purposed capital gain tax regulation, with the previous measures gradually faded out from picture.

Impact

Impacts on Developers

The most seriously affected are those developers who have already signed the sales & purchase agreement with investors for their flats which are still under construction. It is because they cannot shift this burden to the investors as the price is already fixed. Developers of strong background afford to continue the project though

the profit is reduced or even becomes a loss while weaker developers may terminate the project though unwillingly.

The new ordinance is not according to international practice. According to international practice, the new ordinance should not be applied to projects under construction or already started. In addition, tax rate is usually reduced during the period of the projects. However, the new ordinance still applies to projects underway in PRC and there is no reduction of tax rate regardless of the date the project was initiated. This reflects the strong determination of the central government to control the over-heated property market in China.

The rate of return of developers is sharply reduced by 30%, one of the accounting firms estimated. Moreover, the tax rate they are going to pay is estimated to range from 53% to over 67% if their sales range from RMB 150 million to 500 million. Facing this difficulty, developers will be less interested in developing property market in PRC.

Impact on Investors

There is only minor impact on investors. Profile of investors are unique. They usually pay cash and need no mortgage. In addition, even they need to arrange mortgage, they arrange in Hong Kong. Moreover, most of them target for either long term or medium term investment. They aim

at retaining the value of their investment or hope to have an appreciation of their investment. They sometimes treat their property in PRC as resort house and live during their holidays.

In addition, it is more easy for them to escape from the tax. They can split the total amount of the property into two portions, namely the price of the flat and price of furniture and fixtures. This will reduce the amount of the property and the investors will have less capital gain. Tax paid should be also sharply reduced.

Impacts on Agents

Agents will be adversely affected because the number of buildings or projects to be put for sale will be less. This directly affects their income.

Countermeasures

Countermeasures of Developers

Developers will probably reduce their investment in China's property market because the rate of return looks less attractive. For those developers who have already started the construction, they will try to sell their flats at a faked lower price to investors. Thus investors may not get the necessary mortgage loan amount from banks and

also they will suffer a higher capital gain tax in future when they sell the flats.

Moreover, developers may seek for more advantageous terms and conditions from local government when they negotiate to develop the area in order to compensate their reduced rate of return if this capital gain tax is really imposed.

Countermeasures of Investors

Investors may ask developers to split the total amount of the flats into two portions, namely the flat and fixtures & furniture. Only the price of the flat is taxable while fixtures & furniture is not included in the capital gain tax. As a result, the capital gain is reduced by using this method.

Countermeasures of Local Government

Capital gain tax is actually one of the local tax items. Local government can determine the rate and how to implement. However, central government is still having heated debate with local government on this matter due to their strong determination to control the property market. Some local government e.g. Guangzhou Major, has already announced that they would follow the central government's policy with appropriate flexibility so as to cope with their local investment environment. For instance, they can

properly impose this capital gain tax but reimburse part of the tax to the tax payer from their local finance. However, they have to justify this move by providing sufficient evidence to prove that they have to support this industry and to apply for central government's approval.

CHAPTER 7

CONCLUSION

Property market in China has been developed for a very short period of time. It grows at a very fast pace. New projects or new building in some areas such as Shanghai and Guangzhou are welcome by most investors. Supply always cannot meet the huge demand. However, this fast development creates some problems and makes central government lose control on it. Austerity measures do impose some adjustment, tighten credit control, restrict transaction of land and seriously examine the land usage agreement so that property development is put on the right track and in a healthy way.

The wave of this property development started in early 1992 after Mr. Deng Xiao Ping's Southern tour of China. The property market increased by 20% to 100% in terms of both transaction volume and price. Three major reasons contribute to this fast development of the property market in China.

Firstly, after the opening of China to the world, local enterprises expand very fast. Foreign investment is attracted by this brilliant growth and positively develop

this market by injecting huge amount of capital into China. GNP growth of China is 12% in 1992 and regions along the coast far exceed this rate. The booming economic development stimulates the demand of new buildings. Property market is unavoidably boosted up.

Secondly, the property price in China is still below the market though the economy develops so rapidly. There is a very high potential of increasing in value. This attracts both local and foreign investors and increases the price of property.

Last but not the least, the strategic location of Hong Kong and her intimate relationship with China create a very favourable environment and keen interest for developers to explore this market of high potential.

Though there are so many favourable factors affecting the growth of China's property market, problems still exist in this rapid development. Over 70% of the approved land has not yet developed in 1992. Some developers are holding the land for speculation purpose or for controlling the supply quantity. The price thus rises up unhealthy.

In addition, the laws and regulations related to property sales and purchase are not so properly laid down. Investors' interest are not protected. The operation is not smooth and mature. There are laws and regulations but

in a messy way. Central government does impose some ordinances or system to control and manage the market but different local governments always have their own different policies. This confuses investors and allows scope for some developers to manoeuvre.

As property development is a fast way to accumulate capital and gain profit, a lot of malpractice such as approval of land at unreasonably low price or out of their authorization limit appear. It wastes a lot of farmland and increase the price of construction material due to unlimited exploitation.

A clear and well organized laws and regulation become a must. Central government has to formulate properly while local government should follow closely. Independent monitoring body is required.

First austerity measures did have short term but immediate effect on the property market of China. It has a screening effect. Some weaker developers were forced to get out of the market. This created a more valuable opportunity for strong developers who are not affected by these measures to find better site at a more reasonable price. Moreover, it arouses the awareness of investors to choose strong developers who have good support from banks or sound financial background.

Second austerity measures only have very minor effect on the property market because of the different reaction of local government and strong opposition from the market.

As a result, the austerity measures help to have a more healthy growth of property market in China by screening out the financially weaker developers. It makes town planning more properly carried out and attracts the attention of public to have the needs of more proper laws and regulation to govern and control the property market.

Austerity measures repeat the cycle of other economic policies of PRC. Central government loosens the control at the very beginning in order to stimulate the economic development. As the economy grows so rapidly, central government tries to tighten the control. This creates a period of confusion to investors who as a result, retreat from their investment. Then unavoidably, central government has to loosen the policy again. This cycle repeats and repeats in China's history and in different sectors of the economy. These unstable policies always frighten the investors. Therefore, a more stable and long term policies are essential to the success of PRC's economic growth and development of property market.

In conclusion, China's property market does have her potential and good prospect with the following reasons. Firstly, the austerity measures have some cooling effect on

the over-heated economy of China and make the market develop more healthy. Secondly, the screening effect not only distinguish some weak developers but also helps to identify where the market is mature enough to develop and where is not.

Thirdly, the return on property development in China is still very attractive. Rental yield ranges from 15% to 33% in major cities. Comparing to the mortgage rate of 8.5% to 10% for property in China, the return is in high side. Table 2 illustrates rental yield of property market in some major cities.

Fourthly, the interest rate for idle fund is still at a low level, with normal saving rate of 2%. With double digit of inflation rate in Hong Kong, investors have to find way to utilize their capital. The attractive rate of return in China's property market of course attracts the capital of investors.

However, the future development of property market in China is still seriously affected by the political atmosphere of China and her economic development. If this factor is stable, the market is very promising especially in some major cities such as Beijing, Shanghai, Guangzhou and Shenzhen. A good system of laws and regulations is urgently required to facilitate the growth and development.

TABLE 2

**RENTAL YIELD OF PROPERTY MARKET IN SELECTED MAJOR CITIES
AS AT MARCH 1994
(IN USD)**

Cities	Property Type	Selling Price (per sq. meter)	Annual Rental (per sq. meter)	Rental Yield
Beijing	Resident	3,000 - 3,300	500 - 600	17% - 18%
Beijing	Commercial	3,500 - 3,800	900 - 1200	25% - 30%
Shanghai	Resident	2,300 - 3,000	450 - 500	16% - 20%
Shanghai	Commercial	2,800 - 3,000	750 - 1000	25% - 33%
Guangzhou	Resident	2,000	300 - 350	15% - 17.5%
Guangzhou	Commercial	3,500 - 3,600	800 - 1,050	22.5% - 30%

Source: interview with Mr. Edward Cheung in C Y Leung Limited

Another golden opportunity for developers in future is to develop the property market for local investors who have really the potential. The huge population and increasingly wealthy families create the strong demand for property. Further development of this market should be explored.

However, the PRC property market illustrates that the central government is difficult to implement their own economic policies. The extent of control is very weak. It is partially due to the too much decentralization. Moreover, there are no proper systems such as banking and accounting to facilitate the implementation of central policies. We can contrast this with other Western governments which have better systems to implement their central policies. Central control is thus stronger. Different levels of government have their responsibilities and authorities well defined.

Facing these circumstances, central government may implement their policies not only by administrative measures but also by monetary instruments such as control of money supply, allocation of credit. This may be effective because this is determined by the market economy instead of forcing measures.

Nevertheless, China is fortunate that she is aware of her administrative demerits like no sufficient and efficient supporting functions and systems. She does not

rely too much on the invisible hand and market mechanism. She only applies the concept with modification. Otherwise, she may repeat the steps of U.S.S.R. and accelerate her own decline.

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