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Introduction

The real estate is playing an increasingly important role in the modern social economy. From a macro perspective, its operating status has direct impact on a country's development speed and level of national economy. Meanwhile, as the real estate industry is closely related to the financial industry, its operating status is also crucial for the economy of a nation and its financial security. From a micro perspective, real estate product is an important part of a resident's family asset portfolio, having an enormous effect on household property status and living standard.

Since the reform of the housing system in 1979, Chinese real estate market has achieved rapid development. From the perspective of demand, on the one hand, the "concealed" housing demand under the traditional planning system has been released; on the other hand, due to factors like the increasing income level of Chinese urban residents, the growing urban population and family miniaturization, the real estate demand has been expanding, and real estate demands of different types and different levels are also shown. From the perspective of supply, the real estate production and supply capacity has been improved significantly, primarily because the real estate marketing degree has been increasing. The pricing mechanism that is based on supply and demand in the market has been established, real estate development has gradually become the primary way for real estate supply in China, marketing degree of real estate enterprise's operation behavior has been increasing, and the production factor market including land and finance has been improving, all of which are providing necessary support and assurance for improving the real estate production and supply capacity. Under the interaction between supply and demand, China's real estate price has been rising steadily, and the real estate enterprise's operation efficiency has been improving steadily. At the same time, real estate consumers' expanding demand for diversified types and levels has also been met accordingly. The general living condition of urban dwellers has been continuously improved, and the general social benefit level has been raised somehow. However, the Chinese real estate market also has a lot of disadvantages. For example, the legal and regulation system construction of real estate is relatively backward and lack of explicit market operation rules; the

housing security system has not been established yet, and the responsibilities of the market and the government have not been defined clearly enough; the real estate regulation and coordination mechanism and regulating measures have yet to be perfected; the real estate tax system has some insufficiencies, and the land and real estate financial market also have to be further developed and perfected. Nowadays, more and more researches on Chinese real estate bubble have been conducted, but all are confined at the preliminary stage. Issues like whether there is bubble in the Chinese real estate industry, and how to prevent it and carry out policy control are still under discussion and research.

On the basis of theoretical overview on the real estate, real estate market and real estate bubble (Chapter I), this article has made a detailed analysis and research of the Chinese real estate market (Chapter II), and pointed out that the general Chinese real estate market has already generated some bubbles and many regions have entered or is entering the danger zone, in view of the development course of Chinese real estate market, the features of Chinese real estate industry and the major problems in the Chinese real estate market. Chapter III has made a detailed analysis of the forming of Chinese real estate bubble, and explored profoundly into credit expansion of Chinese banks and behaviors of Chinese local governments on the basis of empirical data of Chinese real estate speculative bubbles. Chapter IV has elaborated the harms of real estate bubble. Chapter V has offered suggestions for preventing and dealing with Chinese real estate bubble and promoting healthy development of regional real estate industry from the aspects of monetary policy analysis, land policy analysis and tax policy.

As the real estate market differs greatly in different economic entity, views discussed in this article are only limited to the statements of Chinese real estate analysis and precautions for its bubble.

Chapter I

Theoretical Overview on the Real Estate Market and the Real Estate Industry

(I) Definition, Classification and Basic Characteristics of the Real Estate

1. Definition of the Real Estate

Generally speaking, real estate is the general term of house property and land property. Strictly speaking, real estate is the general term of land and any buildings, structures and other appendages on it. In mainland China, “real estate” and “immovable property” are generally applied with the same implication. However, compared with “immovable property”, “real estate” does not include “forest”.¹

2. Classification of the Real Estate:

By purpose, real estate may be classified into residential property (houses), commercial property (hotels, shops and amusement buildings, etc.), industrial property (workshops, R&D places and storage facilities), tourism property, agricultural property (eco-agricultural tourism market and its subsidiary service facilities), special-purpose property (airports, gas stations and golf courses), etc.

By operation mode, real estate may be classified into profitable real estate (e.g. investment apartments and rental office buildings) and non-profitable real estate (e.g. private houses and private office buildings).

By market transaction nature, real estate may be classified into sale property, rental property, mortgage property and pawn property, etc.

By nature, real estate may be classified into resource property and asset property. On the one hand, as a resource, real estate is an indispensable production element in production and life. In this case, people attach more importance to its use value and prefer to measure the quantity of resource

¹ Xu Shengqing, *et al. Bubble Economy and Financial Crisis*. China Renmin University Press, 2002.

property with space volume. On the other hand, as an asset, real estate is an important investment target in the capital market as well as a component of family and national wealth. Volume of property is usually measured by monetary value.²

3. Basic Characteristics of the Real Estate

(1) Immovability. As previously mentioned, real estate is also called immovable property. Its location is characterized with immovability. In other words, location is extremely important to real estate.

(2) Long periodicity. Real estate is the general term of house property and land property, and land property (land) is usually for permanent use. Service life of various facilities (buildings and structures) is much longer than that of other commodities. As typical durable consumer goods, they may be put into the market for circulation and use for one or more times.

(3) Multi-level. Real estate, particularly houses, has multi-level on effectiveness, namely possessing the contents of three different levels: means of production, means of enjoyment and means of development. Houses are for people to live in and rest, characterized as means of existence; houses with appropriate structure, beautiful appearance, elegant decoration and complete facilities make people feel comfortable and convenient, thus characterized as means of enjoyment; houses provide people with entertainment, study and living areas and social surroundings, and enable people to pursue more, thus having the effectiveness of means of development.

(4) Scarcity and accretion. As area of regional land is fixed and non-renewable, it is deflectable, i.e. scarce. In addition, due to finiteness of land and relative rise of demand for real estate, relative shortage of land supply is often triggered. As a result, the land price rises unceasingly and the real estate is characterized with growing value.³

(II) Connotation and Features of the Real Estate Market

² Xu Shengqing, *et al. Bubble Economy and Financial Crisis*. China Renmin University Press, 2002.

³ Xie Jingrong, *et al. Real Estate Bubble and Financial Crisis*. Economy & Management Publishing House, 2007

1. Definition of the Real Estate Market

Generally speaking, market has two definitions: in a broad sense, market refers to the sum total of merchandise trade relationship; in a narrow sense, market refers to the specific place for the commodity transaction between two parties at a certain time. Correspondingly, real estate market in broad sense refers to the sum total of real estate commodity exchange and circulation relationship in the whole society; real estate market in narrow sense refers to the place for real estate commodity trading activities such as buying, selling, leasing and mortgage.⁴ Due to immovability of real estate, transaction in the real estate market is manifested as ownership transfer realized in transactional agreements and contracts.

Generally, the real estate market has three components: key participants, including real estate users, suppliers, managers and market intermediaries; real estate products and their ownership certificates; real estate trading organizations.

2. Features of the Real Estate Market ⁵

(1) Imperfect competitiveness. Generally speaking, perfect competition market must have the following conditions: the market information is sufficient; the commodities are homogeneous and inter-substitution; the contracting parties are free to get in and get out with enormous trading capacity; the economy is completely open.

Due to immovability of real estate location, heterogeneity of products and diversity of circulating mode, real estate transaction and pricing are carried out individually, and the information is incomplete, thus unable to develop perfect competition. In addition, real estate often has very strong rationality. Supply-demand relations and prices vary in different regions. Real estate shortage in one region usually cannot be compensated by the real estate surplus in other regions. Moreover, the conflict between relative scarcity of real estate resource and absolute growth of real estate demand forces the government to take strong intervening measures to ensure effective market supply, restrain irrational market demand and regulate allocation of real estate resources. Therefore, real estate market is a limitedly open and competitive market.

⁴ Xu Shengqing, *et al. Bubble Economy and Financial Crisis*. China Renmin University Press, 2002.

⁵ Wang Quanmin. *Real Estate Economics*. Dongbei University of Finance and Economics Press.

(2) Strong speculative. Speculation of real estate market originates from land speculation. Due to scarcity of land, use value of real estate will not decrease as time goes on. Instead, real estate is capable of maintaining and increasing its value, which makes it a consumer commodity as well as alternative investment goods for people. As the real estate market features insufficient information, limited openness, high risks and high gains, it is prone to speculative activities, for example, speculating real estate and even driving up its price and defrauding. Therefore, we say the real estate market is a market with strong speculation.

(3) Strong legality. As the real estate features long use period, high value and immovability, the trading activities in the real estate market have to be realized by transfer of ownership. Therefore, the real estate transaction has more rigorous legal provisions than general commodities. In other words, in order to maintain the benefits of the real estate trading parties and ensure the security of real estate investment and overall benefits of the market, the real estate trading activities must establish, change and transfer the rights, obligations and responsibilities of concerned parties in the form of contract according to the prescribed procedure. In this way, real estate trading activities are both economic acts and legal acts.

(4) Widespread participation. As the real estate has large value amount, generally, both the real estate users and the operators needs the banking departments to take part in the financing. Meanwhile, as real estate transaction is complicated and highly professional, intermediaries or agents are also often required to participate to provide technical advice and value appraisal for the real estate traders. Such intermediary organs will often become a “lubricant” in real estate transaction, serving as an indispensable key ingredient in the real estate market.

(III) Concept of the Real Estate Industry and Its Industrial Status

1. Concepts about the Real Estate Industry

Real estate industry refers to the industry or sector that engages in real estate development, operation, management and service, where development is the basis, operation is the process to realize the development products, and management and service is the means to ensure successful implementation of development and

operation.

According to the international practice, real estate industry generally includes two kinds of economic activities: buying, selling or leasing real estate;⁶ real estate activities based on charging or contract. The former obtains proceeds from real estate bid-ask spread and rent; the latter provides services in the process of real estate buying, selling, leasing and managing, and obtains proceeds from service charge. The subdivided real estate economic activities are shown in Table 1.

Table 1 Subdivided the Real Estate Economic Activities

Category I	Category II	Category III	Remarks
Economic activities of buying, selling or leasing real estate	Real estate development and operation activities		Commercial activities of real estate development enterprises and other real estate related units during real estate development process, such as land buying & selling, real estate developing, selling and buying, but excluding activities like related land leveling and housing improving construction, etc.

⁶ Analysis of the Price Bubble and Overbuilding in China's Real Estate Market" [J]. *Construction Economy*, 2003,

	Stock real estate buying, selling and leasing activities	Operating lease	Profit-oriented real estate leasing activities of real estate development enterprises, other related real estate units, and urban and rural resident households
		Non-operating lease	Including housing services provided by real estate administrative departments to the residents and housing services provided by enterprises, public institutions and administrative units for their employees and families
		Owner-occupied housing services	Including owner-occupied housing services of urban and rural residents and pseudo-profit leasing plan
Real estate activities based on charge and contract	Real estate administrative activities		Mainly referring to activities of the real estate management departments such as land use management, real estate registration, demolishing management and transaction management

	Real estate intermediary activities		Mainly referring to intermediary activities during the process of real estate buying, selling and leasing based on charge and contract, including activities of brokerage, procurator, appraisal, counseling and auction
	Property management		Including various property management, maintenance and caring activities based on charge or contract provided by property management enterprises

Source: Analysis of the Price Bubble and Overbuilding in China's Real Estate Market" [J].
Construction Economy, 2003, (2).

2. The Real Estate Industrial Status

At present, as a new source of economic growth, Chinese real estate industry is a pace-setting and basic industry for national economy. The status of the industry needs to be judged from five aspects including asset scale developed by real estate (e.g. real estate assets/national wealth), added value of real estate industry (e.g. proportion of added value of real estate industry in GDP, the industry composition of GDP), the tax payment condition of real estate industry (e.g. comparison of tax payment condition between real estate enterprises and enterprises of other industries), the employment condition of real estate industry (e.g. employment quantity and employment proportion of different industries) and the relationship between real estate industry and related industries, etc.⁷

⁷ Wang Quanmin. *Real Estate Economics*. Dongbei University of Finance and Economics Press.

1. Asset scale developed by real estate: along with the increasingly accelerating urbanization and the improvement of people's life, both the stock and the price of rural and urban houses are rising, which makes China's housing asset value keep rising.

2. Added value of real estate industry: housing service for Chinese urban residents is the largest part contributing to the added value of real estate industry.

3. Tax payment condition of real estate industry: though real estate industry is considered as an industry that gathers a large amount of fortune, none of the real estate enterprises has been listed among the top 100 tax paying enterprises in China.

4. Employment condition of real estate industry: most of the cities in China now are still industry-based manufacturing cities, whose tertiary industry is still in a huge low-service pattern. However, a modern cosmopolitan city needs tertiary industry highlighting service industry to absorb and digest the high land price of metropolis. Otherwise, expansion of urban real estate will have no basis for sustainable development.

5. Relationship between real estate industry and related industries: with respect to current situation of China, it is still the manufacturing industry that has greater effects on its related industries. The real estate industry is also a stimulus to all sectors of national economy and the major client source of financial institutions.

(IV) Definition, Features and Criterion of the Real Estate Bubble

1. Definition of the Real Estate Bubble

Real estate price bubble means that the price of land and house is extremely high and is inconsistent with their use value. Though the price increases greatly, it is difficult to realize actually, thus forming a false prosperity.

In the opinion of the U.S. famous economist Charles P. Kindleberger, real estate bubble may be comprehended as the continuous rising of real estate price in a continuous process. Such price rise may induce people to expect the price to increase further and continue to absorb new buyers. As the price continues to rise and the venture capital continues to increase, the real estate price is much higher than the corresponding entity price, thus causing real estate bubble. The result of over swelling of the bubble is the anticipated reversion, high vacancy rate and price slump, namely the bubble bursts. Its nature is unsustainable.⁸

2. Features of the Real Estate Bubble⁹

1. Real estate bubble is a form of real estate price fluctuation;
2. Real estate bubble is a fluctuant state of steep ascent and steep dipping with great amplitude shown in the real estate prices;
3. The real estate price fluctuation does not have continuity or stable period or frequency;
4. Real estate bubble is mainly generated by speculative behavior. It is caused by rapid increase of money supply in the real estate economic system within a short term.

3. Criterion of the Real Estate Bubble

There is no final conclusion for the judgment of real estate bubble. In fact, it is very difficult to judge the degree of real estate bubble precisely on any specific time point. Generally, it may be judged by the following indexes or conditions:

1. Whether the overall economy is overheated

If the overall economy is in an overheated state, it may be considered that the real estate industry will also have some overheated signs due to their intrinsic correlations.

2. Rate of investment growth

⁸ Li Xiaoxi. "Virtual Economy, Bubble Economy and Substantive Economy" [J]. *Finance & Trade Economics*, 2000, (6).

⁹ Wang Quanmin. *Real Estate Economics*. Dongbei University of Finance and Economics Press.

When the investment growth of real estate development is remarkably higher than the economic growth rate, for example, when it is twice as high as the economic growth rate, the risks for generating bubbles may exist.

3. Vacancy situation of commercial buildings

Generally, when the vacancy rate reaches 10%, it is the sign of real estate industry overheating.

4. Other factors

Besides such common criteria, people often judge by other factors, for example, whether the housing price has been increasing, whether the rise of commercial buildings price synchronizes with the growth of household income, whether the land development growth rate is piling on, whether the debts of real estate developers are rising universally, and the relative difference between the actual price and the theoretical price of houses.¹⁰

¹⁰ Xu Shenqing, *et al. Bubble Economy and Financial Crisis*. China Renmin University Press, 2002.

Chapter II

The Chinese Real Estate Market Development Research

(I) Development History of the Chinese Real Estate Market

Strictly speaking, the development history of Chinese real estate market is not long. It has just been gradually developed after reform and opening-up. In the early years of new China, the Chinese government confiscated the properties of bureaucrat capitalists, transformed them into state-owned assets and distributed them to relevant state organs, enterprises and public institutions. Relevant organizations such as land registries and real estate bureaus had been set up all over China to administrate and control the real estate market strictly and implement the national real estate allocation and assignment systems. By 1964, the capitalist operation in the house leasing had been basically eliminated throughout the country, the real estate privately-owned system was negated, land was not allowed to be transacted and transferred, and the administrative assignment and uncompensated use were carried out.

That is to say, for a very long time after new China was founded, real estate in China did not have commodity nature. The houses were centralized planned, invested, constructed and allocated to relevant units by the country. Though there was little property leasing under strict control, there was no rivalrous housing market, so the real estate market basically did not exist.

As the policy of reform and opening-up was implemented, real estate market reform had been carried out throughout China. The whole reform was first started from the land market, and then was the formidable housing system.

1. Restoration and Development of the Land Market

In 1980, the China National Urban Planning Conference was held, where the issue of charging for use of urban land was clearly proposed. In 1987, the Chinese Shenzhen Special Economic Zone drove the land use and management system to a higher stage. The compensatory transfer and assignment system of land use right was implemented and the use right of partial state-owned land was transferred to foreign merchants or real estate development companies by means of auction, agreement or bidding.

Therefore, the compensatory transfer and assignment system of land use right was also promoted throughout China, and the land use right transaction also expanded quickly. Since then, the Chinese land market has been restored and started to develop.

2. The Housing System Reform

To be precise, the Chinese housing system reform refers to urban housing system reform. This reform was started from the trial full-price houses in 1979, namely, the government centralized constructed all of the houses and sold them to the citizens at the cost price of civil engineering. In 1982, as the effect of full-price houses was not good, the compensated houses scheme was put into trial implementation. As the enterprise burden was heavy, plus reasons like not connected with the low-rent system, the compensated houses scheme failed to make progress.

In 1992, as the national economy of China was showing rapid development momentum, the real estate also gained mushroom growth, and nationwide real estate fever appeared. At the same time, while selling public houses, the Chinese government emphasized implementing new policies for new houses and made sure that the newly built houses would not enter the policy schemes of the old housing systems any more. Started from reforming the low rent of public houses, this policy gradually changed the welfare physical distribution system of public houses into the money wages distribution system, advancing Chinese housing institutional reform into a new stage.

The year 1998 marked the beginning of a new reform stage, namely, to stop the physical housing distribution, gradually implement housing distribution monetization, establish and improve the multi-level urban housing supply system focused on economically affordable housing, develop housing finance, cultivate and normalize the housing transaction market. Since then, construction of Chinese real estate has no longer been just for the government or the employers to meet the demand for employee residence. Instead, it has gradually become an important industry for social capital investment. To go further, the real estate demand now in China is also not just for self-residence, but has become an important method and sector for people to invest in with stocks and bonds.

(II) Features of the Chinese Real Estate Industry Development

Throughout history, the Chinese real estate industry development at the current stage has the following features.¹¹

1. Idealization of the Building Subject

With the perfecting of the real estate market and implementation of the national macro supporting policies, the building subjects of Chinese real estate industry at the current stage starts to exhibit the duality state. In this period, individuals and units have basically exited the field of real estate market building subject, and the nation and private real estate development enterprises have begun to invest to build houses. In such a situation, a mediate building subject - commercial bank was born. By gathering deposits, the commercial bank circulates a huge sum of social capital, and then distributes it to real estate development projects, which provides a reliable investment source for real estate construction. Though the commercial bank does not participate in real estate construction and development directly, it influences and restrains the building subjects and real estate development projects by various means, for example, their own loaning standards.

2. Individualization of the House Purchasing Subject

Since the appearance of commercial buildings, house purchasing subject has gradually changed from enterprises to individuals. As the commercial degree of the real estate market has been deepening, so far, the house purchasing subject has basically been individualized. The process of individualization of house purchasing subject has been divided into two stages: in the first stage, most of the individualized subjects were high earners, so this stage was also called the mansion age taking “tycoons” as the mainstay of house purchasing subjects and the bourgeoisie age taking private business owners and senior white-collars as the mainstay of house purchasing subjects. Since about 2000, the second stage has begun, and now it has entered the heyday. In this stage, the major house purchasing subjects are intermediate earners, so it is called the civilian age taking ordinary working class as the mainstay.

¹¹ Liu Hongyu, *et al.* “Analysis of the Price Bubble and Overbuilding in China's Real Estate Market” [J]. *Construction Economy*, 2003, (2).

3. Appearance of the Third Subject

Along with the advancing of housing system reform, the role of residence in people's family life has changed from physical welfare allotment to assets possession. Therefore, the third subject, namely seller of second-hand houses, has emerged, which turns the consumers of real estate product into investors under certain conditions. The increasingly active secondary market has appeared in addition to the existing primary market of real estate newly built houses (mainly the residence). The appearance of third subjects and the dynamic of the residential secondary market enable the inventory houses to "flow" and become an important part for housing supply. As a result, people will have more choices when selecting residential assets. They may buy commercial residential buildings of different levels, or second-hand houses or economically affordable houses when meeting the policy conditions. Families living in the purchased public houses may sell the current houses and choose the most desirable new houses. Thanks to the appearance of the third subjects, it is freer to select residential assets for both the families once enjoying the physical housing privilege and the newly built and immigrating families, thus advancing the real estate commercialization into the all-round starting stage.

4. Higher Marketing Degree

According to the real estate development information from January to May in 2009 published by the State Statistics Bureau, the sartorial index of floor space of buildings under construction in China was 102.90; the nationwide accumulatively completed construction area was 1.063 billion square meters, rising by 18.8% year-on-year, including 821 million square meters of residential construction area, rising by 18.3%; 47 million square meters of office building construction area, rising by 15.8%; 134 million square meters of construction area of buildings for commercial use rising by 21.2%. The sartorial index of selling price of commercial buildings was 107.11, up by 2.16 compared with the same month in 2008. From January to May, the average selling price of nationwide commercial buildings rose 8.9% year-on-year, where the average selling price of commercial residential buildings increased by 11.3%, the selling price of buildings for commercial use increased by 4.1%, and the selling price of office buildings dropped by 4.6%. The sartorial index of vacancy area of commercial buildings was 103.89, including 59.33 million square meters of vacancy

area of commercial residential buildings, 0.4% down over the same period in 2008. As indicated by the above data, the construction area of the real estate industry has been increasing, and the vacancy area of houses has been decreasing, so we may say the marketing process of real estate industry is effective.

The second index for measuring real estate marketing degree is the occupancy ratio of state funds in the investment for real estate development. As shown in the percentage of state funds in the total investment, it has not exceeded 20% in the recent 5 years, which indicates that most of the investment capitals in real estate are private capitals. Investment of real estate industry is not limited to state capital only. A large proportion of it is composed of the market participants. This index has fully illustrated that the marketing degree of Chinese real estate is relatively high.

5. The High Development and Investment Speed & Expanding the Real Estate Credit Scale

Currently, nationwide real estate development and individual housing loans in China account for 30%~40% of the bank loan. Development loan and individual loan balance account for about 15% of the gross loan balance. The effects of housing finance have been growing. Thus it can be seen, the real estate financial business is developing rapidly, the development and investment speed of real estate industry is fast, and the scale of real estate credit scale is expanding.

6. Product Standardization and Serialization Degree Requiring Improvement

The Chinese real estate industry has not got rid of the extensive production mode yet, particularly on the housing construction. The overall situation of the industry is mainly summarized as “two highs and two lows” —— high material consumption, high energy consumption, low productivity, low contribution rate of advance of science and technology to real estate industrial development. The corresponding building system has not been serialized yet, and the development of novel building system is insufficient; the product standardization is backward, and has not developed standardization system yet; the technology is still focused on single technological development. The technological integration degree is low, the serialized packaged technology has not been developed yet, the capacity for mass and set production is still poor, and the production is still insufficient.

(III) Influences of the Chinese Real Estate on the National Economic Growth

1. Pillar Industry Position of the Chinese Real Estate Industry

For over a decade, the Chinese real estate industry has been developing fast. It has made significant contribution to boosting domestic demand, driving relevant industries, creating employment and facilitating national economic development. Particularly in recent years, the real estate industry based on residential construction has become an important industry for national economic growth of China, and has shown the trend for fast and fierce development (see Table 2), playing an active role in promoting the national economic growth. Only in 2001, the investment in real estate development has driven the GDP of China to grow by 1.3% directly, and 0.6%~1.2% indirectly, with 1.9% ~ 2.5% in total.¹²

Table 2 Relationship between the Chinese Real Estate Development Investment and GDP & the Chinese Real Estate Development Investment and the Fixed Assets Investment in 1999~2003

UNIT: 100 million yuan, %

Year	GDP	Fixed Assets Investment	Real Estate Development Investment	Urban Housing Investment Amount	Proportion of Development Investment in GDP	Proportion of Development Investment in Fixed Assets Investment
1999	82067.5	29854.7	4103.2	4178.3	5.0	13.7

¹² Real Estate Market Rational Bubble Analysis [J]. Economic Research, 2003, (3).

2000	89468.1	32917.7	4984.1	4540.7	5.6	15.1
2001	97314.8	37213.5	6344.1	5384.8	6.5	17.0
2002	105172.3	43499.9	7790.9	6320.3	7.4	17.9
2003	117251.9	55117.9	10153.8	8624.9	8.6	18.4

Source: *“Real Estate Market Rational Bubble Analysis” [J]. Economic Research, 2003, (3).*

2. Promotion of Other Related Industries by Rapid the Real Estate Development

As the real estate industry is in the intermediate link in the national economic chain, it will generate demand for other related industries, thus driving them to develop. As far as China is concerned, from the aspect of different industries, for every increasing 100 yuan of the Chinese real estate development investment (or building industry output), it may drive demand of 34 yuan for the machinery and equipment manufacturing industries, demand of 33 yuan for the metal product manufacturing industries, demand of 19 yuan for the building materials and other nonmetallic mineral article manufacturing industries, demand of 19 yuan for the chemical industries, demand of 17 yuan for coking, coal gas and oil processing industries, and demand of 17 yuan for extractive industries, etc. In general, every 100 yuan of real estate development demand in China may bring about demand of 215 yuan for other industries; plus the real estate industry’ s own demand increase, it may generate 315 yuan of total

incremental output, namely increasing the GDP by 315 yuan.¹³

(IV) The Main Problems of the Current Chinese Real Estate Market

In recent years, factors in different aspects, such as development of Chinese economy, the state policies to boost domestic demand, etc., are all driving the high-speed development of the real estate industry, which is taking on a scene of prosperity. However, at the same time, the Chinese real estate market also has many problems, which are mainly manifested in the following aspects:¹⁴

1. The Real estate investment growth in some regions is exorbitant

From the data since 2002, the real estate investment growth rate of Beijing, Shanghai, Guangdong, Zhejiang, Jiangsu and Shandong was 29%, 31%, 30%, 33%, 31% and 40% respectively. The national real estate investment accounted for 24% of the total investment at the same period, where the real estate investment percentage of Beijing, Shanghai and Guangdong in the total investment was 61%, 40% and 38% respectively, which has showed the tendency of over-dependence on investment. As indicated by the data of the Association of Chinese Real Estate at the end of 2002, the nationwide housing area was 125 million m² with vacancy rate of 19%, which has significantly exceeded the international warning line of 10%.

2. The Land scarcity causes the common land price speculation

Real estate industry is engaged in immovable property development, investment and operation. It cannot do without land supply. However, the greatest economic feature of land is scarcity. It is a limited and non-renewable resource. Therefore, its elasticity of supply is the smallest. Nevertheless, along with the development of Chinese economy, growth of population and acceleration of urbanization, the conflict between people's ever increasing demand and the land scarcity has been more and more predominant. Such demand is for developing the objective economy as well as gaining profit from the land. With faulty and distempered land transaction systems plus the urge for speculative profits, the real estate developers often make every effort

¹³ Real Estate Market Rational Bubble Analysis [J]. *Economic Research*, 2003, (3).

¹⁴ Fu Min. "Overview of Chinese Real Estate Problem Discussion". *Economic Theory and Business Management*, 2005, (6).

for “enclosure”, stock the land, and then transfer it at high price at the right time, or develop it and hype it widely. In this case, the price of the limited land rises very fast during reselling and breaks away from the actual value seriously, thus causing land price bubble, which in turn causes bubble for the whole real estate industry. To a certain extent, land supply volume, unique geographic location and heterogeneity may also influence the attachments on the ground – housing price, which drives the real estate price to deviate from the actual value of assets, and lays a foundation for generating real estate bubble.

3. Supply and demand structure of the real estate is out of balance

As viewed from the investment structure of Chinese real estate development, growth of non-residential investment is higher than that of commercial residential investment, which causes the proportion structure between residential and non-residential buildings become imbalanced. Development quantity of large luxury houses has risen steeply and has high vacancy rate. Proportion of medium and low-priced medium-sized and small-sized general commercial houses in most large and medium size cities is too low. The government’s support for the construction of economically affordable houses is insufficient, and the supply of economically affordable houses is far from enough.

From January to October 2008, investment on Chinese commercial residential building increased by 27.9%, 1% lower than the total development investment growth; investment on office buildings increased by 33.8%, 4.9% higher than the total development investment growth; investment on buildings for commercial use increased by 34.7%, 5.8% higher than the total development investment growth. To view from the vacancy rate of commercial buildings, commercial residential buildings dropped by 13.2% year-on-year, the office buildings increased by 3.0% and buildings for commercial use increased by 17.6%, which means the market digest pressure has been intensified. To view from supply condition, from January to March 2009, investment on economically affordable houses increased by 9.1%, 23.1% lower than the investment growth of commercial residential building, and 15.9% lower than that in the same period in 2008. Such structural contradiction between supply and demand drives up the vacancy rate of commercial buildings and the price of economically affordable house, which may easily lead to real estate bubble.

In addition, as the Chinese real estate development has taken a wrong route that ignores the realistic purchasing power of low and medium-income families, develops luxuriously and blindly without limit, and positions at high price in recent years, the supply and demand structure of real estate has lost balance, and the real estate price has been growing all the way. According to the statistics of State Statistics Bureau, the average sale price of nationwide commercial buildings from January to November 2008 was 3,759 yuan/m², 12.5% up year-on-year, where the average sale price of residential building was 3,580 yuan/m², 11.6% up. However, the high price makes many low and medium-income families cannot afford to buy commercial residential house, which means the market dysfunctions to solve the housing problem of low and medium-income families.

4. The Housing price keeps climbing

During the seven years from 1997~2004, except a slight drop in 1999, the average sale price of Chinese houses showed a clear trend of steady growth, where the price of residences closely related to people's life increased more rapidly, particularly in 2004 and 2005 (see Table 3).

Table 3 List of the Chinese Real Estate Price Changes from 1997 to 2005

Year	Average Sale Price of Houses (yuan/m ²)	Growth Rate (%)	Residential Housing Price (yuan/m ²)	Growth Rate (%)
1997	1997		1790	
1998	2063	3	1854	4
1999	2053	0	1857	0
2000	2112	3	1948	5

2001	2170	3	2017	4
2002	2250	4	2092	4
2003	2359	5	2197	5
2004	2714	15	2549	16
2005	2985	10		

Source: "Overview of Chinese Real Estate Problem Discussion". *Economic Theory and Business Management*, 2005, (6).

5. In some cities, the housing price rises precipitously, and the price-to-income ratio is apparently too high

In the world, the ratio between the housing price and the residents' income is generally within 4~6 times, but in China, it has exceeded 8 times in many regions, for example, price-to-income ratio in Liaoning is 11.5, Beijing 11.0, Yunnan 10.6, Shanghai 9.9, Tianjin 8.9, Hainan 8.9 and Guangdong 8.0.

6. Nationwide house speculation becomes severe perils

As the commercial buildings have two properties of owner-occupation and investment, plus the stock market was stagnant in 2001, some medium and small investors have switched to real estate investment from the stock market. They buy houses not for self-occupation but selling after rise in price or repaying the housing loans with the rent. Such phenomenon differs greatly depending on the local condition. As reported, half of the high-priced houses above 10,000 yuan/m² in Shanghai are purchased by foreigners and people from other provinces and cities. Though the nature of real estate as an investment product has been recognized by people, house speculation has already become a great hidden danger during the development of Chinese real estate market.

(V) The Chinese Regional Real Estate Bubble

The latest detected regional real estate bubble in Hainan province and Beihai city of Guangxi province in 1992 to 1993 was the most influential phenomenon of regional real estate bubble economy in China.

1. The Real Estate Bubble of Hainan Province¹⁵

In 1988, the Chinese government decided to establish a province on the Hainan Island and set up a large special economic zone. Under this background, the Hainan Island had become a paradise for people to invest, develop business and seek fortune. Only in 1988, 204 real estate development companies were set up in Hainan province, with registered capital up to 930 million yuan, real estate development capital of the year up to 142 million yuan, developed land over 7,000 hectares and housing construction area about 290 thousand square meters. With domestic and foreign capitals swarming in quickly, the real estate market in Hainan province heated up fast, where the supply could not meet the demand, and the prices skyrocketed. Take Haikou city for example, its commercial building price in 1988 was 800 yuan/m², much higher than the price before establishing the province and still rising quickly. By the first half year of 1989, the commercial building price of Haikou city had reached 1,000 yuan/m².

In 1992, as the Chinese nationwide economic governance and rectification campaign was completely ended, the real estate market of Hainan province was heated up extremely, where the average price of land and commercial buildings had risen by more than 80% and even doubled in some regions. The commercial buildings were once again not adequate for the demand. By May 1992, average sale price per square meter of commercial buildings in Haikou had increased from about 1,350 in 1988 to 1,400 in 1991, 5,000 in 1992, and the highest 7,500 in the first half year of 1993, 5.37 times higher than that in 1991.

By the end of 1993, due to excessive pull of investment, the Chinese macro-economy had been severely overheated. In June of the same year, China started macro-control over the economy. At the same time, the speculative momentum in the real estate market of Hainan province was alleviated, and the real estate price started to fall,

¹⁵ Liu Hongyu, *et al.* "Analysis of the Price Bubble and Overbuilding in China's Real Estate Market" [J]. *Construction Economy*, 2003, (2).

dropping from 7,500 yuan/m² in the first half year of 1993 to 3,500 yuan/m² in 1994, and about 3,100 yuan/m² in the first half year of 1995. The real estate bubble was basically brought under control.

2. The Real Estate Bubble of Beihai City¹⁶

At the beginning of 1992, there were only 3 real estate development companies in Beihai city. As the Beihai municipal government adopted the “low-threshold” policy, specified that the highest land transfer price was 97,000 yuan/mu and the lowest was about 40,000 yuan/mu, sold the land by large tracts and area, and allowed land purchasers to transfer again (namely, allowed to speculate), immediately the investors from all over the country flocked in and made the land speculation increasingly severe. In April 1992, the land price in Beihai started to boom, rising by ten to twenty times within half a year. The highest price reached 1.2 million yuan/mu, more than ten times higher than the highest transfer price specified by the government, and the housing price grew along with it by 3 to 6 times.

In March 1997 after the government adopted the macro-control measures, the national real estate market was cooled suddenly. The real estate price of Beihai fell correspondingly by 30% at the most. About 400 real estate development companies were withdrawn or closed quickly, and masses of capital was also drawn back. As a result, a great deal of land was left idle, which also marked the end of the real estate bubble.

(VI) Dispute over the Chinese Real Estate Bubble

On the whole, the current analysis of the development trend of Chinese real estate market mainly concentrates on two contradictive viewpoints: one holds that Chinese real estate market has bubbles; the other holds that it has no bubble, but just local overheating at most.

1. The Real Estate Bubble Theory¹⁷

Take Shanghai for example. Many experts and scholars have criticized the bull market theory of Shanghai real estate. The advocates for the theory list three reasons: firstly, the real estate price of Shanghai shall be equal to that of Hong Kong, London and New York; secondly, it is rational that the high cost of Chinese real estate causes

¹⁶ Wang Jun. “Views on the Foams of China's Current Real Estate” [J]. *Macroeconomic Management*, 2003, (4)

¹⁷ Fu Min. “Overview of Chinese Real Estate Problem Discussion”. *Economic Theory and Business Management*, 2005, (6).

high price; thirdly, China has basically no surplus land, so it is normal that the real estate price keeps climbing.

For the first reason, in the opinion of many experts, real estate price of any city reflects the productivity level of local residents. A city's productivity is manifested in its discretionary income. This is why the real estate analysts often use the ratio between family discretionary income and the real estate price as the indicator for people's housing affordability. To view from this indicator, Shanghai's real estate price is three times higher than that of any city including London and New York. Growth of Shanghai's per capita income reflects the prosperity of real estate instead of the enhancement of people's actual productivity. When the real estate bubble bursts, Shanghai's income level will be exposed to strong pressure.

For the second reason, corresponding criticism has been made. As the land cost in China is very high, and the land is priced through auction, many people think it is natural that the Chinese real estate price will go up, and it is nearly impossible for it to drop. In fact, the real estate price is decided by the real estate supply and requisitioning parties together. Such viewpoint just sets eyes on the real estate supplier without fully considering the factors of the real estate demand side. As a matter of fact, the rapidly rising land price of China reflects the real estate demand exaggerated by speculators, which boosts the real estate developer's market expectation and makes them believe that the real estate price will rise definitely. In this way, they are willing to buy land at higher price.

For the third reason, land shortage cannot be the fundamental reason for the high real estate price. As universally known, land supply of real estate is controlled by the government. There is no reason to believe that Shanghai downtown has no developable land. As far as urban development is concerned, Shanghai is a young city, and Shanghai downtown has land for re-development. In addition, even when it is true that there is no land for developing in downtown, Shanghai is capable of creating another downtown. Pudong is an example. Shanghai World Expo is a good idea for creating new central zone, and the conceptual supply is boundless. Therefore, land shortage may not be considered as a sufficient reason for the high real estate price.

Instead, it is people's purchasing power that is more convincing.

2. The Real Estate No-bubble Theory¹⁸

Contrarily, many experts, scholars, politicians and insiders believe that the overall real estate of China has no bubble. Many people support the “second house” theory. In their opinion, now many Chinese residents have the demand for a “second house”, which shall be considered as the way for expanding the demand. Under the prerequisite of having effective demand support, even real estate overheating or structural surplus may occur in some areas, it cannot be asserted that the Chinese real estate has already become “bubble economy”. Rise of housing price is mainly due to demand and supply factors. For demand, as material prices are increasing, inflation is higher than bank rate, the deposit does not keep its value, and the stocks are too variable, purchasing houses has become the best way to maintain value and increase value. For supply, the upstream real estate raw material costs are increasing, which will definitely drive up the downstream housing price. This is a normal phenomenon and cannot be regarded as real estate bubble.

Still some experts hold that three aspects have to be reviewed to judge whether the real estate is overheated and whether there is bubble. Firstly, review the contribution proportion of real estate to the GDP. As clearly specified, this proportion in the world is between 8% to 12%, or even 15%, but now in China, it is only about 12%. Secondly, review if the proportion of real estate development investment in the fixed assets is appropriate. In 2008, such index of China has reached 18.3%, but that in the world is generally between 15% and 20%. Thirdly, review if the housing sales-output ratio is normal. Chinese real estate housing sales-output ratio was 81% in 2008, which is relatively high in the world. If the rented houses are counted in, the sales-output ratio is above 90%. Therefore, the viewpoints that the Chinese real estate is overheated or has bubbles are groundless.

For the theory that the real estate has developed overheated or to the “Cliffside” of bubble economy, they think the quoted data is mainly of some cities at a certain period and some is even the conjectural “data” of the author. If such data is used to infer and judge the overall situation of Chinese real estate, mistakes of

¹⁸ Wang Jun. “Views on the Foams of China's Current Real Estate” [J]. *Macroeconomic Management*, 2003, (4)

overgeneralization and serious misrepresentation will be made. Instead, in order to analyze the overall development situation of Chinese real estate completely and precisely, the first and most fundamental way is to analyze with the main data of the nationwide real estate industry in several consecutive years. The first major data is the rate of investment growth of nationwide real estate every year. From 1998 to 2002, China's annual real estate investment growth link relative ratio was 13.7%, 13.5%, 21.5%, 27.3% and 21.9% respectively, with average annual growth rate of 19.5%. If constant price is used, the above link relative ratio will be even smaller. In the period when the GDP increases continuously by 7~10%, as a pace-setting and basic industry, it is appropriate for the real estate to keep a growth rate of 15% to 20%. It will be right when this value is a little higher in some years. Generally speaking, the following national statistical data shall also be analyzed to measure if the real estate development is overheated or if there is bubble: 1. if the supply and demand is balanced; 2. if the house price changes radically; 3. if the houses are overstocked; 4. if the profits of developing enterprises are too high; 5. if the structure is rational. As shown by the analyzing results of these main indicators, the overall Chinese real estate industry has no bubble in the past several years, and it is within the scope of healthy development.

In my opinion, whether the Chinese real estate market has bubble or not, the Chinese government shall set managing the real estate market as top priority, monitor the quantum of primary indexes, development speed and structural proportion so as to prevent the violent ups and downs in the real estate industry, and realize the dual targets of forecasting and supervision through early warning so that the problems may be detected before happening, and adopts countermeasures to regulate and manage.

Chapter III

Analysis the Formation of the Chinese Real Estate Speculative Bubbles

(I) Carriers Making the Real Estate Bubbles

This is mainly decided by its asset physical features, economic features and market circumstances, outstandingly embodied as:¹⁹

Firstly, resource scarcity and small elasticity of supply. Scarcity and monopoly of land supply as well as diversity and speculatively of land demand will certainly boost the land price, and thus make the real estate price deviate from the actual value of the assets. Meanwhile, the land investment is overflowing. Increase of land parcel investment will drive up the value of the neighboring land, thus providing basic conditions for generating bubbles.

Secondly, information asymmetry. Just like any other markets, changes are eternal in the real estate market. Changes of various dynamic factors will cause changes in the real estate market. With incomplete information, it is difficult for the investors to make precise judgment on the changing market. Moreover, the constructing period of real estate is long, which often makes the effective supply of developers lag behind the varying market demand, thus accelerating the generation of bubbles.

Thirdly, adverse selection and moral risks. Real estate is a capital-intensive industry whose development cannot do without financial support. However, with an unsound financial system, information asymmetry will cause adverse selection problems to the banks, enabling the borrowers who are poor in credibility, apt to adventure and bring unfavorable (adverse) results to get the loans, which in turn brings about credit risks to the bank. Moreover, assets price inflation and bubbles will be generated more quickly due to the involvement of substantial sums of bank capital as the banks fail to establish a sound system, blindly pursue market shares and credit scale, neglect to

¹⁹ Yuan Zhigang, *et al.* "Real Estate Market Rational Bubble Analysis" [J]. *Economic Research*, 2003, (3).

review, track and investigate the credit of the borrowing enterprises and individuals and underestimate the inconspicuous climbing collateral value.

Fourthly, short sight of investors. Corresponding to the positive expectation for continuous rise of housing price, investors tend to be short-sighted and follow suit during investment. The so-called short sight means people are likely to underestimate or even ignore the potential risks – a subjective short-sighted phenomenon over small probability events.

Fifthly, government intervention mistakes. As the residence-based real estate has the dual property as investment goods and consumption goods, the government intervenes much more in real estate than in other markets. For its intervening modes, besides encouraging and instructing private investment through urban planning, land policies, monetary policies and tax policies, the government may also invest directly or transfer payment. However, just like the non-almighty market, the government intervening also has positive and negative effects. To serve for the short-term political targets and economic targets of one' s own with the power in hand, it is inevitable to make government intervening mistakes.

(II) Empirical Evidence of the Chinese Real Estate Speculative Bubbles

1. Analysis the Causes of Speculative Behaviors in the Chinese Real Estate Market²⁰

1.1 Marketing the Real Estate Supply and Demand Behaviors

An environment with marketing the real estate supply and demand behaviors is essential for breeding the speculative behaviors in the Chinese real estate market. As the market economy is deepening, the Chinese real estate market has completely got rid of the constraints of planning economy, a great deal of civilian capital has entered the real estate market and has become the supply and demand mainstay of real estate.

1.2 Time Feature of the Real Estate Market Transaction

In the real estate market, the buyers and the sellers co-exist, and there is an interval

²⁰ Shi Yongdong. *Speculative Bubbles and Investor Behavior*. Commercial Press, 2005.

between the times for the two parties to sign sales contracts, thus creating the necessary preconditions for real estate price speculation. Just as mentioned above, if an investor with real estate expects the real estate price to rise, he will purchase a certain amount of real estate at the current market price, and then sell it out after price rise, and thus obtain assets income. Of course, if he makes false judgment during this period, he will suffer losses. Though given the stakes of success or failure, if all investors adopt such speculative way, the real estate market will be filled with buyers but lack of sellers. As a result, the balance between supply and demand will be broken at a macro-level, and the foretold rise of real estate price will become a “self-fulfilling prophecy”.

1.3 Psychological Expectancy for the Real Estate Price Rise

Since reform and opening-up, Chinese economy has been growing rapidly, per capita income and consumption level of residents have been improved significantly, which have caused tremendous demand for real estate. What’ s more, urbanization in different regions is accelerating, and the residential demand also is enhancing expeditiously. With limited supply of land resources and improvement of housing quality, real estate prices are all showing a rising trend. As a result, the real estate speculators have generated strong psychological expectant for continuous real estate price rise, which is the foundation for speculative behaviors in Chinese real estate market. According to the demand theory, if the price goes up, the demand will decline. However, at the forming stage of real estate speculative bubbles, the higher the expected price of speculators, the greater the expected return on capital, and the speculators will increase the present consumption and hoard the purchased assets for dumping at higher prices in the future. It means that rise of real estate price will not bring down the demand volume. Instead, the expanding real estate demand will further induce more real estate speculative behaviors, which in turn will cause a constantly self-reinforcing positive feedback loop and generate real estate bubbles at last.

1.4 Growth Rate of the Real Estate Price Exceeding Growth Rate of Bank Loan Interest

If growth rate of real estate price exceeds the grow rate of bank loan interest, investors will ask for loans to build houses and purchase properties, and then sell them at a higher price, thus increasing the real estate price significantly. Nevertheless, investors having many houses won't always yield high profits when the housing price is rising. If the bank loan interest rate is higher than housing mortgage loan interest rate, plus the high real estate transaction costs, profit of the real estate investors will become very unstable. On the contrary, if the bank loan interest rate is lower than housing mortgage loan interest rate, plus the low real estate transaction costs, risks for real estate investors will be mitigated and the profit will increase.

1.5 Strong Support of the Civilian Wealth and Loose Financial Environment

Accumulation of civilian wealth and generous profits of real estate business have laid a solid economic foundation for Chinese real estate speculation, and the long-term loose real estate credit policy, low loan interest rate and innovations in financing channels have provided financial supports for continuous expansion of speculative behaviors in Chinese real estate market.

1.6 Narrow Investment Channels for the Residents

Under the circumstances where the current Chinese financial channels are blocked and the stock market is sluggish, the whole society has gradually developed the complex for the bull market of land and real estate, and keeps intensifying the sense of urgency for investment in real estate and the expectation for return. The final result is that various social resources or even foreign capitals enter the real estate market, which further consolidates the real estate market' s "self-fulfilling" expectation, and breeds and spreads the real estate speculative behaviors across the country continuously.

1.7 Effects of the Low Transaction Costs

Comparatively speaking, the transaction costs of Chinese real estate market are low. As a result, the costs and speculative risks for investors to hoard and resell real estate have been dramatically reduced, and breeding of speculative behaviors in Chinese real estate market has been facilitated.

1.8 The Ineffective Governmental Market Supervision

Ineffective supervision over the real estate market is the external environment for breeding speculative behaviors in Chinese real estate industry. The speculators in real estate market constantly fabricate fake and exaggerated information about supply and demand in the real estate market to deceive the consumers and make profits for themselves by signing false contracts, media hype and intermediary market high-priced listing. The corresponding government supervising departments only deepen the information disorder due to their different interests, which prevents people from making rational expectant. This is the external environment for breeding speculative behaviors in Chinese real estate market.

2. Analysis the Causes of Chinese Land Speculation ²¹

2.1 Characteristics of the Land - Internal Incentive for the Land Speculation

Land is an indispensable production factor in social economic activities as well as an important resource and asset. As the social economy develops, people have an expanding demand for land, but because land resource is limited and scarce, land supply is non-elastic. With increasing demand and rigid price rise, land has become the target for investors to pursue. Land has multi-suitability and variability of purpose, particularly during purpose and use condition changes of urban land, the land users may obtain higher economic gains. Location identification makes land transaction a kind of contract transaction instead of barter trade. As long as the contract is signed and fulfilled, the land transaction is realized, which is right point exploited by land speculators. The land investment is overflowing. Increase of land parcel investment will drive up the value of the neighboring land. The particularity of such an essential

²¹ Qiu Qiang, Chen Shaomin, Xu Haohui. "Analysis of Causes of Chinese Real Estate Bubble" [J]. *Special Zone Economy*, 2005, (5).

productive factor as land is the inherent cause of land speculation.

2.2 Defects of Management System — Institutional Reasons for the Land Speculation

Since the 1980s, China has been gradually launching land-use system reform. This is significant for establishing a tangible land market and strengthening management on land assets, but it also brings the following troubles.

(1) The management system of land-use institution allows non-standard operation. In practice, it will cause great friction and contradiction, and stimulate frequent occurrence of land speculative activities. Under the condition of market economy, gratuitous allotted land is available in abundance and enters the market timely, as a result of which the government cannot monopolize the primary land market and the macro-control of government is affected.

(2) The current land transfer system also has created conditions for land speculation. According to the provisions of *Tentative Regulations for Urban Land Use Rights Transfer and Assignment* and *Land Management Law*, land transfer may be done in three forms of agreement transfer, bidding and auction, where the market competitive intensity of bidding and auction is greater than that of agreement transfer. Transfer price of bidding and auction is also greater than that of agreement transfer. The price difference between endows the land speculators with substantial profit margin.

(3) Defects of the current land expropriation system. As specified by Chinese law, the state may practice the rule of compensable expropriation on collective-owned land for the sake of public interest. During practical operation, on the one hand, due to lack of detailed prescription on land use for state public interests, the scale of new construction land is out of control, and some is utilized by land speculators. On the other hand, during expropriation, “property right discrimination” exists to some extent, namely the rural collective land ownership cannot be fully realized economically. Meanwhile, the farming land price appraisal falls far behind the demand of land acquisition work, which makes the farming land acquisition price too low, and the price will rise steeply after converted to land for construction. This is also one of the important reasons for Chinese land speculation.

2.3 Imperfection of the Land Market — External Factors for the Chinese Land Speculation

Development of Chinese land market has grown out of nothing. The land market has become an important means for optimizing land resources and promoting rational land use. However, up till now, China has not developed an effective tangible land market that matches the economic system yet, which is an important external factor that initiates the land speculating behavior in China.

For the primary land market, due to the strong rationality of the land market, development degree of land market in different places varies. In order to pursue short-term effects and attract more investment, the local government implements preferential policy for land price blindly, and competes to lower the land transfer price, so that the land speculators may obtain the land use rights with low costs, and then sell them at high prices, thus gaining high profits.

For the secondary land market, the current land transaction behaviors are not well regulated, mainly manifested in that the market systems in force now have no effective restraint mechanism for large amount of land private transactions, no fixed enforcing authority to investigate and punish large amount of illegal speculation and no approval and declaration systems for land transaction. Therefore, the illegal land speculating behaviors run riot.

The supporting systems of land market are also imperfect, mainly manifested in the following aspects:

(1) The land appraisal system is imperfect. By now, China has held many times of land valuer qualification examination, but the quality of land valuer is intermingled. The land appraisal results are subject to the will of the client. To gain high profits, they often elevate the appraised price of the land during land circulation and encourage the land speculating behavior.

(2) Land transaction is not transparent enough. Current appraisal and issue of benchmark land prices and marked land prices lag behind the requirements of the land market, which prevents the land traders from having a sufficient understanding on the land transaction information, particularly the price information, thus creating

conditions for land speculation.

(3) The current laws and regulations are still quite deficient. Lack of systematic and continuous regulations on the links of land transacting behaviors have created favorable space for land speculation in China.

3. Developer Speculation and Generation of the Chinese Real Estate Bubble ²²

At present, the real estate markets in different regions of China are not perfectly competitive markets, but markets with serious monopoly. Under the circumstances of real estate market monopoly, the speculating behaviors of real estate developers have generated the continuous rise in real estate price to a great degree, leading to real estate bubble of different degrees in different regions. Speculating behaviors of Chinese real estate developers are mainly manifested as:

3.1 Developers collude with the government officials to raise the housing price

The developers create city brands, city name cards, city CBD, etc. through government to elevate their own development zones, or even invite key government officials to attend foundation stone laying or ribbon-cutting ceremony, thus realizing the goal to raise real estate price.

3.2 Developers conspire to raise the housing price with information advantages

To prevent mutual destruction during competition, generally the real estate developers in the same region will collude with each other and coordinate the price of commercial buildings. Due to the existence of monopoly in the real estate market, it is necessary for developers to conspire the housing price so as to achieve win-win results. The real estate developers often deceive consumers by the means of “sales control” to fabricate mendacious real estate prosperity.

Common “sales control” means taken by real estate developers are as follows. First, hire a group of “house scalpers” to queue in long lines day and night to buy houses, artificially creating a scene of house hot sales; then, call potential buyers or people who have paid the reservation deposit to “make panic purchase”, thus alluring uninformed citizens to look on and creating the extremely popular “house sales”

²² Shi Yongdong. *Speculative Bubbles and Investor Behavior*. Commercial Press, 2005.

phenomenon; later, bribe the media to make unreal report, and make many people who have no intention of purchasing house make the down-payment impulsively and buy the houses they think economical then. Also, developers may “put up a bluff” on their house marketing, boasting to the outside that they have sold out all the houses even though they haven’ t sold one of them, and then lying to customers that they can get one house for them through personal relationship, thus raising price. They may also reserve some houses advantageous at floor, orientation and layout, and greatly raise the price for sale

(III) Bank Credit Expansion and the Real Estate Bubble

1. Theoretical Analysis of the Bank Credit Expansion and the Formation of the Real Estate Bubble

According to general principles of economics, gaining the maximum profits with the minimum costs is the basic rule for any economic entity to make rational decisions. During investment activities, loose credit environment and low interest rate policy are often the dynamic for promoting investment, because low interest rate will increase the appeal to invest while reducing the appeal for deposit. During the formation of real estate bubble, the well matched credit and interest rate will not only inspire people’ s consumption demand on real estate, but also provide capital channels for developers to invest in real estate development, thus providing capital conditions for generating real estate bubble.

Specifically, when the banks increase credit supply, they will expand the credit supply scale to compete for profits. Meanwhile, competition will lower the interest rate accordingly. Consequently, the real estate market has both adequate capital supply and low capital cost. For real estate developers, decline of investment cost will impel them to increase supply. However, for the demand side of real estate, on the one hand, the lower opportunity cost will also impel them to increase credit consumption scale; on the other hand, they will also give up the interest on deposit under low interest rate and put the deposit into investment. As a result, both the real estate supply side and demand side will get enough capital support, which makes the generation of real estate bubble become possible.

Furthermore, if the bank holds a mass of properties or assets with properties as mortgage due to credit expansion, rise of real estate price will increase the bank's capital scale, and thus improve its capital adequacy ratio, assets quality and earning performance. Such case is very likely to further intensify the bank's credit expansion on the real estate industry, and raise the real estate price. When this process repeats again and again to develop a mechanism, it is inevitable for the real estate price to deviate from the actual equilibrium price.²³

Additionally, bank credit also plays an important role in collapse of the real estate bubble. If some unforeseen uncertain factor causes the real estate price to drop, the value of the real estate assets held by the bank will be lowered directly, and the bank assets will massively shrink. In this case, to deal with the adverse situation, the banking supervisory authority may take more rigorous supervision measures, for example, raise capital reserves, implement stricter bank regulations and credit control regarding the real estate, etc. Such measures will all reduce the credit scale of real estate industry, thus exerting influence on the collapse of the real estate bubble.

2. The Chinese Bank Credit Expansion and the Real Estate Bubble

Since China implemented the housing system reform in 1998, real estate finance has achieved rapid development. As indicated by relevant data,²⁴ loan balance of Chinese real estate in 1998 was 310.6 billion yuan, including individual housing loan of 71.005 billion yuan. So far, the bank's housing loan has reached 2,600 billion yuan, including more than 1,710 billion yuan of individual housing loan, accounting for about 15% of the total RMB loan amount. Its rapid growth is also rare internationally. As shown by statistical data, both the Chinese real estate development loan and the housing mortgage loan from 1998 to 2004 increased at exceptional speed, where the annual average growth speed of real estate development loan exceeded 25%, and that of the housing mortgage loan exceeded 50%. From the view of capital supply, reform in Chinese banking industry forced the commercial banks to pay more attention to the business of housing mortgage loan. This is the important reason for supernormal growth in Chinese real estate market and generation of real estate bubble.

²³ Liu Hongyu, *et al.* "Analysis of the Price Bubble and Overbuilding in China's Real Estate Market" [J]. *Construction Economy*, 2003, (2).

²⁴ Qiu Qiang, Chen Shaomin, Xu Haohui. "Analysis of Causes of Chinese Real Estate Bubble" [J]. *Special Zone Economy*, 2005,

The reason why the banks attach importance to housing mortgage loans lies in the changes of the banks' supervisory system. Since 2001, the way for the Chinese government to carry out reform on commercial bank has been gradually defined, and it has started to gear to the international standards to deal with matters on supervision. As restricted by capital adequacy ratio of banks, the commercial banks have to replenish capital fund by different means and adjust their business structure at the same time, trying to expand business with low risks as much as possible. In recent years, there have been mainly two kinds of low-risk business for commercial banks: government bonds and housing mortgage loans. As capacity of China's securities market now is still so limited that it is impossible for banks to complete their business structure adjustment by massively increasing the quantity of the held bonds. In this context, nearly all banks have set real estate mortgage loans as the strategic focus of business adjustment to develop.

Another important reason for commercial banks to covet housing mortgage loan is that the marketing of Chinese interest rate is immature. Generally speaking, loans with low risks shall have low interest rate too, so that the principle of risks corresponding to gains may be followed. Therefore, in the case of interest rate marketing, risks of housing mortgage loan are smaller than those of other loans, and its loan interest rate shall be lower than other loans. However, China's housing mortgage loan and company have basically the same interest rate, and the gains are out of line with the risks, which results in cutthroat competition in the housing mortgage loan market. This is the institutional reason for the rapid expansion of Chinese real estate finance.

From 1998 to 2004, Chinese real estate loan kept increasing fast, with growth rate at about 45%, which was many times greater than the growth rate of the total amount of loans of financial organizations. Particularly in 2000, growth rate of real estate loans reached 61.9%, while that of total amount of loans of financial organizations was 6%, and the ratio between growth rate of real estate loans and growth rate of total amount of loans of financial organizations was up to 10.32. In 2002, growth rate of real estate loans dropped slightly, and that of loans of financial organizations rose to 24.5%. In 2003, growth rate of real estate loans rebounded quickly and hit 44.8%, and that of loans of financial organizations also rose by a big margin and reached 2.09. Some

materials demonstrated that the current debt ratio of Chinese real estate development enterprises has reached up to 76%. Most of the developers rely on selling properties under construction or expanding liquidity loans to circulate necessary funds. If the financing of properties under construction and sources of working capital are taken into consideration, among the real estate development investments of hundreds of billions, 60% of the capital comes from bank loans.²⁵

During real estate regulation, some commercial banks offer oversized capital chains to the developers in spite of commercial risks, which stimulates the real estate bubbles to swell, as can be shown below.

Firstly, some commercial banks blindly seeking for more market share and manage credit risk unreasonably. Some of the real estate developers acquire housing mortgage loans from the bank by various illegal methods, while the banks, blindly seeking after more market share and larger credit scale, fail to check the borrower's qualification and the follow-up tracking and investigation, and underestimate the potential risks of the investment programs. Some bank personnel also participate directly to figure out the ways to help developers obtain more loans. The developers even modify the original sales bills and change the lender after really selling the real estate. Even after pre-selling mortgage, the developer may help the house purchasers to get bank loan by the way of resale after buy-back. The result is that large amount of bank capital flows into the real estate industry, causing bad loans and bad debts, and accelerating the rapid expansion of real estate and the generation of bubbles.

Secondly, the banks have provided substantive capital support for real estate industry. Due to the value preservation, appreciation and stationary properties of real estate, the bank loan system favors real estate industry, particularly when the prospect of macro-economy is promising, namely, the government encourages investment, stimulates domestic demand and sets low interest rates. Many banks violate relevant regulations in the actual operation of loaning. They give out myriad loans to developers and even do not bother to validate their credit rating. As a result, abundant capital swarms into the real estate market. Moreover, they lack necessary risk control consciousness and means. Consequently, many real estate developers may engage in

²⁵ Real Estate Financial Analysis Group from People's Bank of China. "China Real Estate Financial Report 2004". August 5th, 2005.

program development with small amount of capital, resulting in overdevelopment, even more violent speculative behaviors and greater financial risks.

Thirdly, unreasonable risk weights become the major driving force for bank and enterprise cooperation. As specified in *Rules for Regulating the Capital Adequacy Requirement of Commercial Banks* issued by China Banking Regulatory Commission, risk weight of general loans is 100%, and the risk weight of individual housing mortgage loan is only 50%. This is to say with fixed capital fund and capital adequacy ratio, the commercial banks will prefer to handle individual housing mortgage loans, so as to handle twice as many as the general loans and maximize their business performance.

(IV) The Local Government and the Chinese Real Estate Bubble

1. Analysis of Motivation for the Chinese Local Government to Deeply Involve in the Real Estate Industry

1.1 The Real Estate Industry Development and the National Economy Growth

For over a decade, the Chinese real estate industry has been developing fast. It has made significant contribution to boosting the domestic demand, driving relevant industries, creating employment and facilitating national economic development. Particularly in recent years, the real estate industry based on residential construction has become an important industry for national economic growth of China, and has shown the trend for fast and fierce development, playing an active role in promoting the national and regional economic growth. As a part of the fixed assets investment of the whole society, Chinese real estate development and investment speed in recent years has been accelerated, exerting apparent effects on developing and driving the national economy. From 1986 to 2004, total investment in real estate development in China had increased from 10.1 billion yuan to 1,315.8 billion yuan, increasing by 130 times within 18 years, with annual growth rate up to 31.3%, much higher than the growth speed of fixed assets investment of the whole society at the same period (18.9%) as well as the annual growth rate of GDP (15.7%). From 1997 to 2004, after deducting the land purchase cost, proportion of development investment increment of Chinese real estate in the growth of GDP was up to 11.6%, which means contribution

rate of real estate development investment for Chinese GDP growth was 11.6%, excluding the indirect contribution generated by multiplier effect to other industries.²⁶

To sum up, real estate industry is playing a more and more important role in the development of national economy and regional economy, and is attracting more and more attention from people.

1.2 The Real Estate Industry Development and the Local Finance Increment

Since China implemented the system of tax distribution, the economic relationship between the central and the local government has been similar to “the economic federal system for maintaining the market”, and pursuit of local GDP growth and financial increment has become the first priority of the local government. According to relevant researches, compared with most of the countries in the world, China has released more expenditure responsibilities to local governments below the provincial level, and about 65% of the total financial expenditure is concentrated in local governments above provincial level (even up to 80% in 1990s). However, on income, the local governments have not received the corresponding rights, so the local income and expenditure are totally disproportionate. As a result, out of the pressure to develop local economy or local financial pressure, the local government will try to promote economic growth and financial increment with the directly controlled resources.

Along with the deepening of reform and opening-up, configuration of all kinds of capital has been marketed gradually, and the resource that may be controlled directly by the local government is on the decrease. The government will deeply involve in the urban real estate market through some kind of mechanism to make the price rise continuously and steadily, so as to mobilize different kinds of social resources to invest, make full use of the high degree of industrial relevance of real estate, relieve the local financial pressure and provide capital source for urban public goods. The Chinese real estate tax belongs to the local financial tax system, led by the local government. Meanwhile, prosperity of real estate industry may bring about huge amount of land grant fee to the local government. On the one hand, the real estate bubble process will certainly push up the overall real estate value. Even though the proportion of tax and fee is not changed, the local government may obtain more tax

²⁶ Wang Quanmin. *Real Estate Economics*. Dongbei University of Finance and Economics Press.

and fee income. On the other hand, the real estate bubble process will certainly increase the land added value and land rent, so that the local government may charge more monopoly rent, for example, high transfer price and covert charge, etc. To sum up the relationship between real estate development and local finance, it is “the more land the local government sells and the higher the price is, the more the local financial benefits are”.²⁷

As far as the current land supply system is concerned, the Chinese local governments may obtain the following three benefits:²⁸

(1) The local government monopolizes the primary land market, and charges all land grant fees at one time;

(2) The local government may also sell the land gained by low-cost demolition and sells it to gain profits;

(3) Taxes about real estate and other charges.

As indicated by relevant researches, in the first half year of 2004, real estate revenue of Zhejiang province in southern China was 8.682 billion yuan, rising by 75% year on year, accounting for 21.9% of the land tax, contribution rate to the growth of all taxes up to 34.68%, becoming the primary source of revenue in Zhejiang. Among the local financial income in Jiangsu, Zhejiang and Shanghai, real estate industry and building industry (excluding relevant industries) account for about 30%. In Zhejiang real estate industry, its proportion even reaches 35%.

In addition, the numerous varieties of taxes and fees during commercial buildings development in China and their huge amounts are incomparable to other products. Particularly, the fee setting is quite random, and it is very common that all government departments want to have a slice in the pie of real estate projects. The items of tax and fee are as follows:²⁹

(1) Six tax categories with real estate as target: land value increment tax, city and

²⁷ Zhu Wensheng. “Real Estate Bubble and Local Government” [J]. *Urban Development*, 2006, (1)

²⁸ Zhu Wensheng. “Real Estate Bubble and Local Government” [J]. *Urban Development*, 2006, (1).

²⁹ Mao Lu. “Current Situation and Reform Ideas on Chinese Real Estate Tax System” [J]. *Journal of Xinjiang Finance & Economy Institute*, 2005, (2).

town land use tax, farmland conversion tax, building tax, urban real estate tax and deed tax;

(2) 11 tax categories paid for real estate enterprise business, including: business tax, business income tax, individual income tax, stamp tax, urban maintenance and construction tax, fixed asset investment redirection tax (ceased now), etc.;

(3) Items of charge related to land and real estate in local governments, such as education capacity expansion costs, civil air defense construction fees, ranging from tens of or dozens of items;

(4) Municipal public facilities such as water, power, gas and heat supply and communication as well as construction and development matching the communities' infrastructure are also paid by the real estate development enterprises.

1.3 The Government' s Promotion of Urbanization and the Real Estate Industry Development

There is a clear dependency relation between urbanization and real estate development. Development of real estate cannot do without such a core power as urbanization. Along with the deepening of Chinese urbanization, urban infrastructure also has been improved gradually, which concentrates industries, gathers population, stimulates the urban demand for real estate industry and creates a huge space for development of real estate industry. As shown by relevant researches, by 2010, Chinese urbanization level will reach 40.5%, and 106 million people will be turned into urban residents, and this number will be enlarged to 325 million by 2020. The added urban residents require above 6.5 billion square meters for residence only, which means about 100 million sets of houses must be constructed to satisfy these new urban residents.³⁰ Therefore, Chinese urbanization is an important stimulus to the prosperity of real estate market, and is the rudimentary motive power for the continuous and healthy development of real estate industry.

³⁰ "China Real Estate Financial Report 2004". August 5th, 2005.

Now, China has entered the historical period when its urbanization is accelerating. Over the two decades since reform and opening up in 1978, the continuous and rapid growth of national economy owing to system and policy innovation has promoted the rapid development of Chinese urban economy. During this period, the annual average growth speed of Chinese urbanization was twice of the average speed of urbanization of the world, advancing by 0.5% every year. When urbanization is advancing at high speed, if urban real estate industry development is relatively backward and cannot keep pace with urbanization, then urbanization will lose an important fundamental support, and a series of urban diseases such as overcrowded housing and city slums will be triggered and overspread. In view of the reality of China, the urbanization level and quality are primarily depending on the industrial level and quality. However, the level and quality of real estate industry development will also exert non-ignorable promoting or restricting effects on the level and quality of urbanization to a great extent. They have a close dependency relation.

During the urbanization process in different places, they are all restricted by the bottleneck of construction funds. The local governments have to choose real estate industry as the “cornucopia” for raising public investment capital, and use remunerative land transfer income and housing construction income as the important capital sources for promoting urbanization. For this purpose, it is a quite natural selection for the local government to deeply involve in the real estate market or even prop up it. As we know, the main capital gains directly yielded by deeply involving in the real estate market for the local government are land grant fees and all kinds of taxes, but the land grant fees directly form the basis for high real estate price. As the statistical figures of Ministry of Land and Resources in 2004 shown, to view from the average level of 32 major cities of China, land price factor accounts for 23% of the costs of commercial buildings. In addition, various taxes account for above 15% of the housing price. So far, the land price and various taxes and fees have already account for above 45% of the general residence development costs, or even up to 60% in some places.

During urban construction and urban renewal, on the one hand, a great deal of inexpensive high-quality land will be controlled by the local government easily through large-scale centralized demolition, and then the land will be sold to real estate

developers at a higher price, thus providing huge amount of income sources for the government. On the other hand, the urban residents forced into the house purchasing army with the compensation due to demolition even provide huge realistic demands for the real estate market, and become the important factors that push up the real estate prices. The rise of real estate price will further drive up the land price in turn, providing a foundation for growth of local government income. Therefore, from the perspective of local urbanization, it is not difficult for us to comprehend the local government's preference and anticipation for prosperity in the local real estate market.

1.4 The Real Estate Development and the Local Government Risk-Return Preference

The real estate attracts input of masses of social capital during its development, which is more in line with the local government risk-return preference.

(1) For the stupendous amount of funds attracted by real estate development, local governments do not need to repay the capital and interest or bear risks.

(2) When the real estate bubbles swell, it is the investors and house purchasers that bear the costs of real estate bubbles, and the local government only bears very low risks, but their benefits are very high; when the real estate bubbles burst, the real estate investment has been turned into properties cannot be withdrawn. Even though the real estate bubbles burst, security of the local economy and finance will not be endangered independently. It is the investors, house purchasers and the security of national overall economy and finance that are at their peril.

2. The Chinese Real Estate Bubbles Showing Administrative Monopoly Features of the Local Government

2.1 The Chinese Real Estate Market Monopoly

Main features of monopolistic market:³¹

(1) Lack in number of market suppliers (manufacturers) and competition;

³¹ Tang Lan. "Origin of Monopoly in Real Estate Market" [J]. *Journal of Wuhan Jiaotong Polytechnic*, 2005, (2).

(2) Manufacturers are capable of controlling the product price;

(3) Difficult to enter and exit the industry. Due to lack of market competition, products in the monopolistic market may be inferior but expensive, damaging the consumers' benefits. Economic efficiency of monopolistic market is the lowest among all types of markets.

The real estate market of China now matches the features of monopolistic market in economics theory, and is showing the trend of increasingly stronger monopoly, mainly manifested as follows.³²

1. Decreasing number of real estate developers, and rising of industrial entry threshold.

Real estate is a capital-intensive industry. It has high requirements on the developer's economic strength. Since 1998, real estate markets throughout China have been experiencing the process from small and medium-sized enterprises in majority to real estate "magnates" separating the market. Some great developers with solid strength and apparent development advantages (such as Shenzhen Vanke and Shanghai Shimao Group) first appeared in Beijing, Shanghai, Guangzhou, Shenzhen and Zhejiang, and have gradually climbed to the monopoly position in the local real estate market.

Now, as the Chinese real estate industry develops fast and has giant market capacity, small and medium-sized property developers in different regions may have a place in their local real estate market. As time goes by, competitive edges of big developers will become more and more visible, and their monopoly strengths will also become stronger and stronger, and they certainly will bring severe stress on the small and medium-sized developers. As reported, so far many small and medium-sized developers in Beijing and Shanghai have withdrawn from the local real estate market to second-tier cities – mainly provincial capitals in Midwest and small and medium-sized cities in developed areas. To suppress overheated real estate development, the Central Government has raised the real estate development capital ratio from 20% to 35% in May 2004. Issue of this policy has increased the difficulty for small and medium-sized developers to survive and raised the entry threshold of

³² Tang Lan. "Origin of Monopoly in Real Estate Market" [J]. *Journal of Wuhan Jiaotong Polytechnic*, 2005, (2).

the industry objectively. We can expect the real estate market is going to differentiate in the next few years, creating a situation where a few big developers will separate the market, and the small developers will be dumped out gradually.

2. Vulnerable consumers and rising housing price

In the current domestic real estate market, consumers are largely at a passive position with inaccessible information, insufficient know-how, high house purchasing costs and unsecured rights and interests, in stark contrast with the developers. Nowadays, what kind of house to develop is rarely depending on the consumers' needs but largely on the developer's wish.

In March 2005 during the two "sessions" (the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC)) of China, some deputy to the National People's Congress presented that the real estate profit margin was too high. As shown by statistical data, average profit margin of real estate industry in the world is about 5%, but that of China is above 10%, and its average profit margin of medium/high-grade real estate is even up to 30%~40%. The high profits are mainly from high prices. Besides the facilitation of cost and price factors like land and building materials, the price rise is more the result of real estate developers' manipulation over the price. In real estate markets in different regions, the developers manipulate the price rise by creating false impression of tight supply through ways like raising profit margin, controlling public voice, selling with limited quantity and hiring migrant laborers to queue up for advance purchase.

2.2 The Imperfect Land System: Foundation for Administrative Monopoly of the Chinese Local Government

Chinese economic system is the economic decentralized system led by the government, namely the centralized economy is converted into economy dominated by many local governments. Such system now is prominently manifested on the basis of public ownership of land. The public land ownership system practiced in China decides that the land proprietary right transfer is strictly limited between the nation and the collectivity, and the transaction scale is extremely limited. According to provisions in relevant policies in force in China now, only land-use right to the

stated-owned land may undergo compensatory transfer, which means it is mainly the land-use right that has entered the market for transaction in China, and the primary market for land-use right transfer is administratively monopolized by the government. The local government controls the land supply and regulates the land price through administrative monopoly in the land market, so as to manipulate the pricing and benefit distribution in the real estate market to some extent. In this way, the local government may monopolize the whole real estate market independently or in cooperation with other interest groups, and create the local government administrative monopoly pattern in Chinese real estate industry.³³ During the management and operation process of Chinese land, the central government focuses on the function of macro-regulation of land or the dual functions of macro-regulation and economic effectiveness, while the local government often just places emphasis on the economic benefit target of land assets, namely the land assets' value maintaining and increasing aspects.

Under the current land system practiced in China, due to the following deficiencies, the local government is very likely to undermine the efficiency of the central government and its macro-regulation on land management.

1. Land revenue compensation does not match the management function.

As known to all, land revenue is an important source for financial increase for local government. Under the current unified planning of state-owned land, the land revenue compensation has become unmatched with the management function. Theoretically, the local government is managing the land development and utilization on behalf of the state, so that the local land utilization is conformed to the requirements of national policies and interest. However, during the practice of land development, utilization and management in China, the Chinese local governments and effective managing departments at all levels often break away from the policies and regulations, grant land against rules and use land arbitrarily, because there are multiple layers of mandate relationship between the central government and the local governments at different levels, and land administrative departments at different levels are strongly restricted by local governments at all levels.

³³ Qiu Qiang, Chen Shaomin, Xu Haohui. "Analysis of Causes of Chinese Real Estate Bubble" [J]. *Special Zone Economy*, 2005, (5).

2. Central and local governments are inconsistent in objectives for land operation and management.

In other words, local representative custodians at all levels for the local land have their own interest as well as the strong urge to replace the national interest with their own interest. Under this institutional background, it is easy for us to understand why the local governments at different levels have been so wild about operating the city, speeding up urbanization and accelerating the local real estate development in spite of the consequent economic inefficiency and potential economic and financial risks in recent years.

3. Specific Approaches for the Local Government to Operate the Real Estate Bubble

3.1 The Local Government Operating the Real Estate Bubble on Supply and Demand

Based on the current situation, the approaches for local government to operate real estate bubble on supply and demand aspects are mainly as follows.³⁴

1. Dissimilate the land reserve system and create real estate bubble from the source.

Some local governments practice the land supply policy of “unsaturated supply and maintaining sellers' market”. Meanwhile, they control and push up the land price by setting benchmark land price, bidding, auction and listing. As a result, the dissimilative land reserve system has become the most basic way to create real estate bubble from the source.

2. Limit the supply of public housing goods.

Some local governments ignore the state efforts on perfecting housing security system, merely emphasizing housing “marketing”. As the economically affordable houses will split the consumer flows who have planned to buy commercial buildings, having certain effects on restricting housing price skyrocketing. Therefore, the key for some local governments to limit the supply of public housing goods is to reduce or even cancel economically affordable houses, which makes the total supply amount and

³⁴ Zhu Wensheng. “Real Estate Bubble and Local Government” [J]. *Urban Development*, 2006,

proportion of economically affordable houses in different regions become smaller and smaller.

3. Try by every possible means to expand real estate demand within the area under administration.

Firstly, launch large-scale urban demolition and create internal rigid demand. Demolition and transformation may create rigid housing demand inside the city. Secondly, introduce external demand of rich people, and seize higher reserve price.

3.2 Other Ways for the Local Government to Operate the Real Estate Bubble³⁵

1. Inspire irrational anticipation for housing price rise among the public

Some local governments of China rationally inspire the irrational anticipation for housing price rise among the public from the aspects of bubble accelerating factors and reinforcing mechanisms exploiting their administrative monopoly on real estate: firstly, control direction of public opinion, constantly stress and publish information in favor of the real estate market. Some local officials even avow that the local housing price will keep rising. This makes people believe that the real estate investment era has arrived, thus creating the accelerating factors for real estate bubble.

2. Maintain real estate bubble with “soft landing”

In face of macro-control, the above real estate bubble operating approaches seem to be backing down a bit, but under the frame of the real estate “New Deal”, local governments still have huge space for operating the real estate bubble. Currently, the Chinese Central Government is taking the macro-control “soft landing” measure to solve the real estate bubble issues progressively. Meanwhile, it calls for all local governments to cooperate and come up with supporting countermeasures according to local conditions. However, out of the consideration for their own interest, many local governments intentionally obscure real estate overheating and bubble, attempting to use the same “soft landing” way to allow the skyrocketing real estate price to keep rising slowly, trying to create the definitely rising price anticipation, and maintaining the rapid development posture of the local real estate.

³⁵ Zhu Wensheng. “Real Estate Bubble and Local Government” [J]. *Urban Development*, 2006,

Chapter IV

Harms of the Real Estate Bubble

(I) Restrain Development of Other Industries

Existence of real estate bubble means investment on real estate will yield higher rate of return. During bubble economy, abundant capitals are concentrated in the real estate industry, and the speculative activities are rampant. As vast capitals are flowing into the real estate industry, with definite total social capital within a period, the productive enterprises will certainly be short of sufficient capital or difficult to use normal costs to gain the capital necessary for production, thus affecting the normal development of other industries.

(II) Cause Economic-social Structure Unbalance

1. Induce the Consumption Structure Unbalance

Rapid rise of housing price has changed the consumers' anticipation, caused residents to "rush to purchase" panically, and made some consumers enter the consumption structure upgrading period ahead of schedule. While promoting housing consumption and home furnishing goods consumption, precipitous rise of housing price also suppresses other consumptions somehow. To view from the contrast between housing price and people's income level, the current housing price is indeed too high. To calculate on the basis that the national average housing price is 2,759 yuan/m² and the per capita family income in cities and towns is 8,000 yuan, a family with three members has to pay nearly 280 thousand yuan to buy a house of 100 m². The total housing price is more than 12 times of the family's annual income, and much higher than the rational range of 3 to 6 times recognized by the World Bank. Purchase of house has already greatly exceeded most families' economic affordability.³⁶ In order to save up enough money to pay the down payment, many families have to cut expenses for other consumptions, and continue saving other

³⁶ Shen Yue. "Judgment and Suggestions for Chinese Real Estate Price Trend" [J]. *Chinese Real Estate Information*, 2005, (7).

expenditures to repay the bank loans.

2. Induce the Economic-social Structure Unbalance

On the one hand, land price rise increases the investment budget. It is unprofitable to invest in high-priced downtown. On the other hand, as the urban land price keeps rising, as the most secure and most profitable assets in people's eyes, land has been reserved in abundance. As a result, much of the scarce land is left idle or developed at a low degree, and the tendency for land speculation is more and more obvious. Meanwhile, due to the rise of real estate price, the asset gap between real estate holders and non-real estate holders, between metropolitan region and local region is getting bigger and bigger, which leads to new unfairness of social distribution, seriously frustrates the enthusiasm of laborers and brings profound social issues.

(III) Cause Financial Crisis

1. Reduce the Financial Operation Efficiency

First of all, according to the Digression Law of Marginal Effect, along with the financial resource increase that the real estate industry may obtain, the efficiency of real estate industry will decrease gradually. Experience has shown that it is more appropriate to control the real estate investment growth rate within twice of the GDP growth rate. From 2000 to 2004, the average investment growth rate of Chinese real estate development was about triple of that of the GDP. On the one hand, such growth consumes a great deal of resources; on the other hand, the capital output ratio will drop again and the capital marginal effect will decrease progressively. Secondly, real estate price upsurge strands stupendous amount of capital in the industry, impeding rational use of the social resources.³⁷

Thirdly, the constantly rising housing price is likely to cause low-level repeated construction in associated industries like steel and concrete, and hinders optimization and upgrade of Chinese industrial structure, triggers comprehensive tension for important raw materials and transportation of coal, electricity and petroleum, thus reducing the overall economic effectiveness of the society.

³⁷ Qiao Bingya. "About Bubble Economy Definition and Its Negative Effects Research" [J]. *Shenzhen Finance*, 1998, (2).

2. Aggravate the Financial Ecological Environment³⁸

On the one hand, internationalism of real estate price exposes Chinese real estate market to more influences of international capital flows, and makes it more prone to the impacts of international speculative capitals and more unstable.

On the other hand, as far as the real estate market is concerned, it is more unstable than other capital markets. Firstly, there are no two properties that are exactly the same or any central trading place that may record the transaction price in time. Secondly, the real estate lacks short-term selling mechanism, and the exorbitant prices cannot be corrected in time. Thirdly, when the housing price goes up, the bank will try to release loans as much as possible, but when it drops and the bank withdraws the capital, the bubble shattering effect will be magnified. Fourthly, the number of people involved in real estate market is much larger than the stock market or other capital markets. Once there is bubble, the negative effects on economy will be quite grave.

Moreover, continuous rise of real estate price is more likely to increase social unrest factors. The soaring housing price has gone beyond the consuming ability of the mid-low-income class, enhances the costs for urban redevelopment and infrastructure construction, further enlarges the gap of wealth, intensifies the living pressure and unbalanced psychology of mid-low-income class, and is more likely to arouse social discontent. What is even more worrying is that once the real estate bubbles are shattered, the net assets of house owners will shrink. The greater the bubbles are, the greater the shrinking degree will be, and the greater the volatility is.

3. Induce the Financial and Economic Crisis

The transmission mechanism for swelling real estate bubbles to induce financial crisis may be described as: the real estate market price will start to drop and evaporate after a period of unusual swelling; as the price of the real estate industry falls sharply, banks with real estate business generate bad debts and bad loans, and the banking system breaks down; finally, the exchange rate mechanism will be damaged, and the overall national economy will stick in the mire.

³⁸ Li Xiaoxi. "Virtual Economy, Bubble Economy and Substantive Economy" [J]. *Finance & Trade Economics*, 2000, (6).

(IV) The Cause of Economic-social Crisis

Shatter of real estate bubble will often be accompanied by economic depression, share price decline and progressive predicament of enterprise financial operation. The decline of share price disables the abundant convertible corporate credits issued by the enterprise to be converted into stock rights for a long term, thus bringing substantive debt paying burdens for the enterprise. Moreover, decline of land price and share price will also force the enterprise to suffer heavy asset appraisal losses and sales losses resulted from compelled sales of land and shares. Drop of enterprise profits will in turn cause investment insufficiency, thus reducing the R&D investment level and cutting the enterprise' s investment on equipment. Following the shatter of real estate bubbles and occurrence of economic crisis, a lot of factories will be shut down, and the total unemployment rate will leap. Under financial crisis, crime will increase sharply.³⁹

(V) The Cause of Political Problems

Real estate bubble deviates from targets like maximizing overall social gross output, optimizing resource allocation, financial security and social stability, which is against the utility function of the central government. However, real estate bubble is the rational choice for local governments. Therefore, real estate bubble is likely to cause central-local economic interest contradictions.

³⁹ Qiao Bingya. "About Bubble Economy Definition and Its Negative Effects Research" [J]. *Shenzhen Finance*, 1998, (2).

Chapter V

Analysis of Governing the Policies of the Chinese Real Estate Bubble

Many famous Chinese real estate research professors have made profound analysis of the advantages and disadvantages of the monetary policy, financial policy and price regulating policy that affect the real estate.

(I) Monetary Policy Analysis

At present, the real estate price has been climbing, and bubbles have appeared. Real estate market has become a variable that must be considered for macroeconomic regulation. Research on effects of monetary policy on real estate market has been indispensable.

According to the actual conditions of interest rates regulation in China, the monetary policy mainly influences the real estate market through the following ways:⁴⁰

(1) Interest rate: interest rates fall → real estate demands rise → real estate investments (real estate prices) rise;

(2) Credit: money supply rises → housing loans rise → real estate demands rise → real estate investments (real estate prices) rise;

(3) Exchange rate: RMB appreciation anticipation → foreign capitals flow into real estate investment → (real estate prices) rise;

1. Analysis of the Interest Rate Policy for Governing the Real Estate Bubble

When land price rises, real estate investment increases substantially and the housing prices soar continuously, more and more people cannot afford to buy houses. In this case, generally the government will intervene in this market to regulate by raising the interest rate. In 1990s, the land price and real estate price in Japan rose continuously, and many places in China invested massively in real estate. Therefore, the Bank of Japan once raised the discount rate for 4 times to suppress overinvestment in real

⁴⁰ Rong Yihua. "Impacts of Chinese Real Estate Price on Monetary Policy" [J]. *China Finance*, 2005, (11).

estate. In addition, the Japanese government also launched reform on land tax. Such tightening financial and monetary policies and measures quickly shattered the “economic bubbles” in Japan, including those of real estate. Since then, the Japanese economy had been dragged into recession for more than ten years.⁴¹ This indicates that when the real estate bubble is shattered, its effects on the economy are tremendous.

Of course, the real estate bubble in China now is not as serious as that in Japan, but the experience of Japan provides a very enlightening lesson for China. Once the real estate bubble is shattered, the economy is going to pay a very heavy price. Then, may China adopt the similar regulating mode of raising the interest rates to suppress its real estate’s excessive exuberance? Theoretically, it is absolutely feasible and very effective. In 2004, the Central Bank slightly raised the RMB interest rate, but the effect was not very evident, because the immense capital gains brought by the current price soar in the real estate market have already outnumbered the adjustment range of interest rates greatly, unless the Bank of China could adjust the interest rates by a larger margin.

Taking policy measures including raising loan costs can narrow down the profitable space of speculative demands, force the speculative demands to retreat from the real estate industry and precipitate the false demands to disappear. It is no doubt that raising interest rate and increasing capital cost is essential for restraining the real estate bubble. But increase of interest rate, particularly the benchmark interest rate, will influence the overall economy, so it is infeasible to take the approach too frequent. On this basis, the current slight interest rate increase seems impossible to solve all of the problems of speculating real estate with bank loans. The nation may issue another series of policies to prevent real estate bubble in some regions.

As real estate price is shrinking, the banking system may generate a lot of bad capital loans. This is unbearable to China whose banking reform is in the critical period. What’s more, interest rate adjustment is also related to stability of RMB exchange rate. Again, in consideration of the effects and influences of local government on

⁴¹ Li Xiaoxi. “Virtual Economy, Bubble Economy and Substantive Economy” [J]. *Finance & Trade Economics*, 2000, (6).

enlarging the real estate market, it is still unsure if interest rate adjustment will exert practical impacts on the local government' s non-marketing behaviors.

2. Analysis of Credit Management Policy for Governing Real Estate Bubble

On September 2nd, 2004, the China Banking Regulatory Commission (CBRC) issued the *Guidelines for Risk Management on Real Estate Loans of Commercial Banks*, which has specified further strict requirements on loan conditions related to real estate, such as land reserve loans, real estate development loans, individual housing loans and commercial housing loans. Among them, the more influential provisions are: project capital ratio of real estate development enterprises shall not be lower than 35%, and real estate development loans can only be applied when having Certificate for the Use of State-owned Land, Planning Permit on Land for Construction Use, Planning Permit of Construction Engineering and Construction License (four certificates); working capital loans of construction company cannot be used as underwritten capital for real estate development enterprises; verify the credit position and loan repaying ability of borrowers of individual housing loans, and stress that the proportion of the borrower' s income for repaying loans and paying property management fees shall no exceed 50%, and proportion of all repayment of loans shall not account for more than 55% of the borrower' s income.⁴² Issue of this policy makes it more difficult for real estate developers to get loans.

2.1 The Main Risks Confronting the Chinese Real Estate Credit Now⁴³

1. Real estate markets in some regions are overheated and have market risks.

In 2004, real estate market price in some regions rose quickly, and regional real estate fever appeared. As shown in a report of Shanghai branch of People's Bank of China, sales price of newly built commercial residential buildings in the areas within the Shanghai inner ring road in 2004 rose by 27.5%, and there are also investigations showing the bubble degree of Shanghai second-hand houses and high-end commercial buildings is notable. Precipitous rise of real estate price is likely to make the market price over-deviate from its real value, thus creating bubbles. Once the bubble is shattered, the real estate price will drop, and value of the properties as mortgage will

⁴² Wang Jun. "Views on the Foams of China's Current Real Estate" [J]. *Macroeconomic Management*, 2003, (4).

⁴³ Lu Jialiu. "On Bubble Economy" [J]. *Economic Report* March 13, 1998.

depreciate or even shrink drastically, thus causing heavy losses to the banks. Depreciation of mortgage is the direct reflection of systematic risks of the real estate market on real estate loans of banks. Recently, commercial banks in regions like Shanghai have enhanced the down payment ratio for housing mortgage loans, and some even have raised it to 50%, so as to prevent the risks of mortgage depreciation.

2. High-liability operation of real estate developers implies financial risks.

Real estate developers mainly rely on bank lending and financing, having little self-owned capital. Statistics show the bank capitals of Chinese real estate developers obtained through different channels account for above 70% of their assets. Take Beijing for example, average asset-liability ratio of Beijing real estate developers from 2000 to 2002 was 81.2%. The problem of liability operation of real estate development enterprises is quite serious.

3. “Fake mortgage loans” highlight moral hazards

“Fake mortgage loan” has become the uppermost risk source of individual housing loan. The so-called “fake mortgage loan” means the developers personate customers and house purchasers with their employees or other persons of interest to extract bank loans by false sales (purchase) ways, not really aiming at buying houses.

2.2 The Chinese Real Estate Risk Prevention and Aversion Policy Options⁴⁴

Based on the current situation, the Chinese real estate financial risks are still hidden, and have not been able to produce direct damages on the overall financial operation. But the commercial banks must raise their risk prevention awareness, strengthen real estate credit risk management, improve their ability to identify, weigh, monitor and control the real estate financial risks, watch out for appearance of real estate bubble and avoid or reduce the financial risks caused by real estate market changes, so as to guarantee credit funds security.

1. Strengthen real estate development loan management and guard against real estate enterprise operation risks timely.

⁴⁴ Fu Min. “Overview of Chinese Real Estate Problem Discussion”. *Economic Theory and Business Management*, 2005, (6).

(1) Carefully examine the developers, analyze the feasibility and risks of the loan projects scientifically and rationally, and formulate corresponding risk preventing measures;

(2) Strictly inspect the release conditions for real estate development loans, faithfully execute the provisions on capital ratio of the real estate investment project, release loans for the approved development project only when the “four certificates” are provided, strictly prevent releasing loans to enterprises without real estate development qualification, and reduce the hazards of shifting from real estate operation risks to financial risks radically;

(3) Strengthen evaluation and appraisal on the first source for repayment of the real estate development enterprise, play down repayment dependence on loan guarantee and collateral (pledge), and establish and perfect guarding mechanism for real estate collateral loan risks;

(4) Strengthen post-loan management, establish real estate loan-use tracking system, release loan strictly as scheduled, make sure that the capital is used for its specified purpose only, strictly control the sales income funds of the real estate development enterprises through various means such as account management, require individual housing loans must be coordinated synchronously for projects with real estate development loan support, realize closed management on capitals for real estate development project.

2. Normalize operation on individual housing loans, guard against risks of “fake individual loans”, and suppress real estate speculation effectively.

(1) Further improve administrative measures for individual housing loans, normalize inspection procedures and standards of individual loans, and promote normalization on individual housing loan business;

(2) Establish and perfect individual credit collection system as soon as possible, and realize information sharing between banks led by the People's Bank of China, so as to allow the lending bank to perform sufficient and strict investigation and supervision on the borrower’ s borrowing behavior and credit status;

(3) Carefully inspect the authenticity of the loan applicant's house purchasing behavior, evaluate the borrower's credit status and debt paying ability objectively, appraise and review the actual value of the pledge strictly, define rational loan-to-value ratio and mortgage rate according to the appraisal value of the purchased house, and reduce the risks of assets realization resulted from housing price decrease;

(4) Strengthen inspection on developers and properties, take strict precautions against developers extracting individual housing loans when lack of development capital, and guard against "fake individual loans" from the source;

(5) Intensify post-loan management efforts, give close attention to use and repayment of the loan capital, strengthen dynamic monitor on the project progress and sales conditions of the cooperating property project, supervise and urge developers and borrowers to get the house ownership certificate in time, execute mortgage registration formalities, prevent risk transfer due to delayed delivery of property, quality and property right dispute, etc.

3. Further improve the inner control mechanism for bank credit management, and build up a powerful credit risk restraint mechanism.

(1) Implement strict separation of approval and loan, strengthen the mutual restriction between different posts, take work shift periodically for some vital posts, and completely eradicate moral hazards and cases like collusion for defrauding bank loans;

(2) Carefully implement the "3 checks" system of loan^①, stick to the field investigation principle and the rule of face-to-face negotiating between credit personnel and the borrower, fulfill the post-loan management responsibilities for real estate development loans and individual housing loans, inspect and approve various kinds of houses strictly in line with the specified procedures, establish and improve the post-loan tracking and managing system.

(3) Strengthen inner examination and assessment, implement strict accountability system for bad loans, investigate and affix the responsibility for any operation against

rules and not abiding behaviors whether they have caused damage or not;

(4) Pay great attention to matching of deposits and loan term structure during rough estimation of capital, carefully coordinate the conflict between the short-term bank capital source and the long-term capital application, and avoid causing capital turnover problems resulted from mismatching of terms.

4. Broaden real estate financing channels, and actively promote securitization of real estate assets.

As Chinese real estate financial system is still imperfect, and real estate development and operation are over-dependent on bank loans, commercial banks have undertaken too many risks. To solve this problem, it is necessary to broaden the real estate financing channels, and enable effective dispersion of bank credit risks through diversification of real estate financing channels.

(1) Strive to develop marketing direct financing, and enable investors to assume industrial risks by different means such as listing, reorganization, restructuring, and acting as an intermediary for introducing foreign capital and establishing domestic connections;

(2) Give full play to the functions of trust on real estate enterprise financing, create conditions actively, steadily promote securitization of real estate assets, particularly securitization of individual housing mortgage loans, guide social idle capital to invest in real estate and disperse bank risks;

(3) Vigorously promote financial leasing modes, establish mortgage assets management companies, and solve the capital problems of real estate enterprises by the fastest and most effective way.

3. Analysis of the Exchange Rate Policy for Governing the Real Estate Bubble

Besides interest rate, exchange rate issue has also become an important factor for stimulating Chinese real estate bubble. As China practices the exchange rate mechanism of RMB Pegged to US Dollar, now, United States adopts the Weak Dollar policy, attempting to make up its financial deficits and trade deficits by significant dollar depreciation, so it asks China to stop the RMB Pegged to US Dollar exchange

rate policy and expand the fluctuation space of RMB or greatly increase the RMB exchange rate. The external pressure for appreciation of the RMB is increasingly apparent. Though Chinese government has promised that the RMB-USD exchange rate will be more flexible, when people learn the instability of RMB-USD exchange rate in future, the RMB will certainly be revalued, thus strengthening the domestic and overseas markets' anticipation for appreciation of the RMB. This impact has also been passed on to the Chinese real estate market. For example, foreigners have become the major purchasers of Shanghai high-end houses. They can enjoy the advantages brought by rapid rise of real estate price as well as the income from investment of future RMB appreciation. Particularly the latter has become one of the important reasons pushing up the price of Shanghai high-end houses.⁴⁵

As RMB exchange rate affects housing price, too-low RMB exchange rate is one of the reasons why the housing price is soaring. As the exchange rate has been underestimated, considerable foreign capital will enter to purchase various assets that may create profits, such as real estate, stocks and factories. Since July 21st, 2005, China has started to implement the floating exchange rate system that is based on market supply and demand and is adjusted and monitored by referring to a basket of currencies. RMB exchange rate does not peg to US dollar any more and a more flexible RMB exchange rate mechanism has been developed. USD-RMB transaction price has been adjusted to USD1 for RMB8.11, and RMB has appreciated by 2%. People's Bank of China will adjust the exchange rate floating range timely according to market development status and the economic and financial situation, to maintain stability of macro-economy and financial market. One of the purposes of exchange rate adjustment is to suppress housing price indirectly. However, this adjustment has met the international pressure for RMB appreciation, and adjustment range of 2% is not sufficient to force the international hot money to retreat from China. On the contrary, this move has given a signal to the speculators that the Chinese financial market will be further opened, and more and more hot money will be attracted into Chinese market. Finance and real estate are the favorite choices of speculators, so high-end real estate properties are getting more attention. Under the support of the high-end market (highly profitable, sufficient space), the housing price will not drop

⁴⁵ Liu Hongyu, *et al.* "Analysis of the Price Bubble and Overbuilding in China's Real Estate Market" [J]. *Construction Economy*, 2003, (2).

sharply, which is right against the original intention to suppress the housing price.

We cannot let the swelling Chinese real estate bubble go unchecked, though we have failed to suppress it by regulating means of interest rate and exchange rate. This is quite dangerous because once the real estate bubble is blown up continuously, it will burst inevitably. Its bursting will cause tremendous yet negative impacts on Chinese future economy. Therefore, it is quite necessary to make foreseeable adjustment before the real estate bubble further expands.

(1) On the condition that the interest rate adjustment cannot be in place in time, strengthen the management over the bank loans related to real estate transaction, and adopt mandatory measures to check the fast-increasing trend of real estate investment;

(2) Carry out land tax reform, levy a heavy duty on capital incomes from land property and land transaction, and impose direct control on the land transaction price. In fact, China now has started controlling the land transaction price. Similar new property taxes also have been taken into consideration, so as to prevent real estate bubble from further expansion.

(II) The Land Policy Analysis

Land is one of the most important production elements for real estate enterprises as well as the necessary carrier of real estate products. Moreover, in China, as land belongs to the state, supply of primary land is completely mastered and controlled by the government, so the government can absolutely perform macro-regulation on the real estate by making use of the most direct and most realistic policy of land supply. Compared with monetary policy, land policy may achieve higher regulating efficiency, because supply channel of land is single, different from capital. Though the government has controlled the loans, developers can still raise capital through other channels like the capital market. The land policy may deal with each case on its merits, unlike financial policy and tax policy that have universality.

1. Influences of the Land Price on the Housing Price

Housing price and land price are often reciprocal, depending on the perspective. During the rise of housing price, there is such a chain as land price rises —

development costs increase — housing price rises — expected housing price rises — developers' investment increases — land price rises, thus developing a price cycle mechanism. At the beginning this process, it is land price rise that causes housing price rise, while at the latter stage, it is housing price rise that causes land price rise. As the factors affecting housing price and land price are very complicated, any link of the price cycle mechanism may be initiated first and affect other links as influenced by other factors rather than the factors listed above. For example, increase of compensation for land acquisition and house demolition will cause land price rise; increase of building material costs may cause housing price rise; speculative behavior in the market will cause anticipated rise of housing price; policy encouragement or market anticipation will cause real estate development investment increase, etc. It should be noted that this cycle mechanism will not develop unidirectional without limit, because every link is restricted and will be changed by external force at any time. Otherwise, real estate bubble will be formed. For example, housing price rise will be restricted by effective demand, rather than rise all the way without limit; the public psychological anticipation will change at any time; developer's investment will be restricted by macro-control; land purchase volume will be restricted by land supply plan and land planning, etc.⁴⁶

2. Current Situation of the Chinese Land Market and Land Policy

Chinese land system background is lack of a uniform land market, and land is classified into three categories: agricultural land, change from "agricultural to non-agricultural" status must be controlled by government; commercial land, such part is transferred by government through bidding, auction and listing; non-operating land, including land for industry, storage and transportation. Though it is also non-agricultural, it forms price through agreement transfer.

Land policy is the important means for regulating real estate development. The government has adopted a series of policies to rectify the land market and control land supply. The new policy for "land reform" of the Ministry of Land and Resources is to adjust the land supply structure, increase the proportion of land for economically affordable houses, clear idle land, crack down on hoarding, and intensify land supply

⁴⁶ Shen Yue. "Judgment and Suggestions for Chinese Real Estate Price Trend" [J]. *Chinese Real Estate Information*, 2005, (7).

and land price monitoring, and meanwhile publishing relevant information to the society in time.

In this “land reform”, land proportion for medium and low-priced common commercial buildings and economically affordable houses has been enlarged remarkably. Supply rate of land for economically affordable houses in Chongqing has been increased from 5 % to 10%. In 2005, Shanghai planned to supply 2,000 hectares for common commercial buildings, increasing by 138% compared with 2004, accounting for 2/3 of the total residential land supply. Proportion of land for economically affordable houses in Ningbo increased from 2.9% in 2004 to 24.4%. Suzhou also has increased oriented housing supply for low-income families. Enlargement of medium and low-priced housing source is effective in suppressing the housing price and maintaining social stability.

The policies like charging for idle land and recovering land idle for above two years without compensation have hit the vital part of the land scalpers. The report of the closed meeting of “Real Estate Market Land Supply Regulating Condition” involved 28 cities held by the Ministry of Land and Resources in May 2005 has given the signal that “the overall real estate market is cooling and backing down”: growing speed of housing price in cities on housing price soaring has begun to fall; speculative housing purchase has been suppressed preliminarily; the public housing consumption starts to tend to a rational level; illegal behaviors of some real estate developers have been contained. In the next step, the Ministry of Land and Resources is going to hurry to formulate the medium to long-term development plan for real estate, perfect and normalize the land purchase and reserve system, introduce market mechanism, shorten land supply time, establish land fund system as soon as possible and solve the problem of over-dependency of purchase and reserve capital on bank loans.

3. Land Policy Suggestions for Stabilizing the Real Estate Price⁴⁷

3.1 Define the role of government correctly

Role of the government is to make up for the shortcomings of the market. For example, in order to control the developer monopoly, the government shall limit the

⁴⁷ Shen Yue. “Judgment and Suggestions for Chinese Real Estate Price Trend” [J]. *Chinese Real Estate Information*, 2005, (7).

land price and the housing price; to ensure food security, the government shall protect the farming land practically; to provide housing security for poor people, the government must offer land for constructing low-rent houses or economically affordable houses; change the government's mode of financial growth, and change the dependence of government finance on land grant fee, including learning from the experience of Hong Kong, establishing land fund system and adjusting the land income relationship: based on the implementation condition of Chinese land laws and regulations, the most difficult part to regulate is the behavior of the local government. Entry of the local government power makes it difficult for land laws and regulations to function and affect the land market development, encourage market competition and maintain the market order. The government shall encourage enterprises to compete soundly, etc.

3.2 Perfect the land reserve system

China now has already developed a mature mode for operating land reserve, but still lacks corresponding exploration on welfare land reserve. What's more, during welfare land reserve, it is necessary to introduce competition mechanism and enhance land utilization efficiency. Meanwhile, in order to avoid market distortion, cancel agreement transfer and implement auction transfer for land for all purposes.

3.3 Establish a scientific real estate market structure and land supply system

To establish a scientific real estate market structure means establishing a pluralistic and multilevel real estate market structure. Plurality mainly refers to the real estate property right market system, namely, it is necessary to provide houses with complete property rights as well as rental houses, guaranteeing the residential rights of different groups. Multi-level means the real estate market has to establish a market system that builds various real estate products of high-end residence, general residence, economically affordable houses and low-rent houses, etc., to meet the residential needs of different levels. Correspondingly, the land market supply shall also embody hierarchy.

3.4 Strengthen the land supply legislation and enforcement

Land supply involves multiple departments including project, land, planning and construction. Only when each department performs its own functions and cooperates with each other, can the scientific of land supply be improved. On strengthening legislation, now it is badly necessary to improve the law system of land supply and strengthen land resources management. Relevant land policies shall specify the rent approval mode for land for different purposes, for example, land for public facilities uses the assigning mode, the operating land for real estate projects uses the auction and bidding mode, and benchmark transfer fee of land at different district in different cities shall have specified and detailed provisions. The government shall enforce the law strictly, formulate strict measures for illegal land occupancy, unauthorized grant of land and random use of land, carry out inspection on law enforcement, strengthen monitoring mechanism and ensure authority and severity of land regulations.

(III) The Tax Policy Analysis

To prevent precipitous rise of housing price and ensure healthy and harmonious development of the real estate market, besides regulating by land policy and financial policy, we also have to regulate with active tax policy combinations to meet people's normal residential needs and allow more people to live in their own houses.

1. Influences of the Real Estate Tax on Price of Residential Assets⁴⁸

Impacts of tax on price of residential assets are dual. It may change the speculators' price anticipation (affecting the anticipated appreciation) as well as the income flow of residential assets (affecting net present value of assets).

1.1 Property Tax

Levying duty on housing rental income may reduce the net income of rental houses at all periods directly. Assuming the discount rate is constant, rental tax will bring down the residential asset price decided by residential utilization income. Meanwhile, as duty has lowered the anticipated capital appreciation of investment residence, namely

⁴⁸ Mao Lu. "Current Situation and Reform Ideas on Chinese Real Estate Tax System" [J]. *Journal of Xinjiang Finance & Economy Institute*, 2005, (2).

reducing the anticipated sales value, the equilibrium price of residential assets will be lower than the pre-tax level.

1.2 Residential Transfer Income Tax

20% income tax is levied on residential transfer appreciation. Residential transfer income tax is a kind of discriminatory tax. Traders re-purchase residences with higher value within a year before and after the sales are free of tax or refunded; long-term house holders (above 5 years) are free of tax; short-term speculators are levied with 20% income tax.

1.3 Disparate Contract tax

China practices contract tax discrimination duty system. Purchasers of high-end residence are levied with 3% contract tax, and purchasers of common residence are levied with 1.5% deed tax.

2. Changes of the Chinese Real Estate Tax Policy

In 1999 and 2003, several preferential tax policies were formulated for individual house purchasing and selling in order to encourage development of real estate industry.⁴⁹

Provisional regulations on business tax specify: business tax shall be levied on personal sales of real estate according to sales volume. Preferential policies are as follows.

(1) For common residence purchased and occupied by individuals for more than one year, business tax shall be exempted when it is sold; for common residence purchased and occupied by individuals for less than one year, business tax shall be charged according to the difference between the sales price and the original price when it is sold; for houses built and used by individuals, business tax shall be exempted when it is sold.

(2) When units and individuals sell or transfer their real estate or assigned land use right, the balance of all incomes deducting the purchasing or assigning price of the

⁴⁹ Wei Xiaofeng. "Comparison with Foreign Real Estate Tax System and Reference for Chinese Property Tax Reform" [J]. *Friends of Accounting*, 2005, (5).

real estate or land use right shall be taken as the turnover.

Provisional regulations on land appreciation tax specify that individuals who transfer buildings on the ground and obtain incomes shall pay land appreciation tax as specified. When the taxpayers construct common standard houses for selling and the added value does not exceed 20% of the deducted amount, land appreciation tax shall be exempted. Preferential policies: for common residence owned by individual residents, land appreciation tax shall be exempted when it is sold.

Individual income tax law specifies that for individual incomes obtained by selling private houses, individual income tax shall be levied as item of “income from transfer of property”, and the tax rate is 20%. Preferential policies: for taxpayers who sell their own houses and are going to re-purchase houses at the market price within 1 year after selling the current houses, the individual income tax for selling the current houses may be exempted completely or partially depending on the value of their re-purchased houses. For incomes from selling the houses that have been used for above 5 years privately and from the only living houses of the family, individual income tax shall also be exempted.

Provisional regulations on contract tax specify that for individuals who transfer housing ownership, contract tax shall be levied by 3%~5% of the transaction price. Preferential policies: for individuals who purchase common self-occupied residence, contract tax shall be levied by half temporarily.

The above preferential policies have greatly promoted the real estate development. In 2004, according to the need for macro-control, China has made the following adjustments on the preferential policies for business tax.

(1) For individuals who resell within less than two years after purchasing the house, levy full business tax according to the sales income. The business tax policy does not differentiate ordinary residence and non-ordinary residence any more.

(2) For individuals who resell two years or above after purchasing the house, in order to differentiate ordinary residence and non-ordinary residence, all ordinary residences may continue to enjoy the preferential policy of exemption from business tax, and non-ordinary residences can only enjoy the preferential policy of levying

business tax on the balance between the house sales income and the house purchase price.

3. Suggestions for the Chinese Real Estate Tax Reform⁵⁰

3.1 Focus on the land tax and fee system reform

Firstly, change land use tax to land tax, change area-based collection to value-based collection, or called “property tax”; secondly, change the transfer mode from transfer to lease and charge land rent (the quantity may be small). As there is little land left in the developed regions, land shall become the major financial resource for the local government. By collecting land tax, protect national food security, and overcome problems like low land-use efficiency and serious wastes.

3.2 Moderately regulate the development links

Reform the tax category and tax rate during real estate development, reduce tax burden, promote development in real estate industry, and moderately regulate during the development links. The reason for moderate tax regulation is that the current Chinese real estate market is a typical sellers' market, and the backward shifting of tax is very strong, and thus the developers are likely to shift the added tax amount onto the consumers, which in turn will drive up the housing price. During this link, effects are finite to design different tax policies regarding the consuming needs and the speculative needs, so this is not the key link for tax policy regulation. This link shall reflect the policy guidance by starting consumption tax on high-end residences and villas. Starting consumption tax on high-end residences and villas are mainly aiming at guiding the consumption orientation from two aspects: on the one hand, encourage to build economically affordable houses and medium and low-priced commercial buildings to meet the public residential demand for “home ownership”, thus reflecting that the consumption tax has increased the sales costs for high-end residences, and suppressing the demand for high-end residences. On the other hand, demonstrate on policy that even when people’ s life level are going to be improved in the future, we do not advocate or encourage development of large residences with the extremely limited land resources. This is also the inevitable demand for long-term harmonious

⁵⁰ Mao Lu. “Current Situation and Reform Ideas on Chinese Real Estate Tax System” [J]. *Journal of Xinjiang Finance & Economy Institute*, 2005, (2).

social development.

3.3 Change the collection mode of holding tax

(1) Merge the real estate tax and urban real estate tax in the current real estate holding link, and start charging the uniform real estate tax on land and real estate;

(2) Use real estate appraisal value as the tax assessment basis to reflect real estate value objectively;

(3) Moderately enlarge the incidence of taxation, and include the countryside in developed regions into the real estate system;

(4) Embody the differential collection principle, exempt tax for the first self-occupied house, levy on the second house and levy additional proportion of tax for the third house and the following.

(5) Real estate tax shall be gradually developed as a local core tax category. Therefore, corresponding legislation and management authority shall be granted to the local government for setting collection range, basic tax rate and floating scope for real estate tax from the law level.

3.4 Implement disparate tax

In the link of real estate transfer, disparate tax policy shall be implemented regarding the consuming needs and the speculative needs. The so-called disparate tax policy is embodied on the tax system design of the real estate proprietary rights transfer link. Those with compensation and without compensation shall be differentiated, and actual ownership possessing duration shall be considered. Though the property needs and speculative real estate needs can not be differentiated radically, it is possible to differentiate the two on tax policy, protect reasonable and rational demand, and increase the transaction costs for speculative demand.

3.5 Start collecting the real estate transfer income tax

Levy on profits generated by compensable real estate transfer: for example, charge 25% income tax on property transferred within one year after purchase; charge 15% income tax on property transferred within two year after purchase; exempt tax for those above three years. By starting collection on individual income from real estate transfer profits, not only real housing demand can be secured, but it will effectively suppress the speculative demand and reduce bubble risks, because regulating efforts are limited just by collecting business tax, and it is likely to allow the real estate speculative demand to shift the tax and burden backward.

To the real estate market, initial effect of financial policy is imposed on the real estate use market, while the initial effect of monetary policy is imposed on the assets market, but as the real estate use market and the assets market are closely related, both monetary and financial policies will affect the level of the interest rate. Interest rate and real estate price are in negative correlation. Therefore, theoretically speaking, both monetary and financial policies may become the effective policy tools for regulating real estate price. If expansive monetary policy is adopted, increase of currency supply volume will cause excessive money supply. When reflected on the real estate assets market, public' s adjustment for it is to buy more real estate assets. Adjustment of assets combination causes rise of real estate price and fall of interest rate. Action mechanism of tight monetary policy on the real estate price is similar, but the results are opposite. If the interest rate is constant, high financial expenditure will raise the overall demand level. Demand increase in the real estate use market will also drive up the real estate price.

Conclusion

The real-estate industry, being one of the newly leading industries in our country, has played an important role in the development of the national economy. This essay pointed out that the real-estate industry in China already had the bubble to some extent by the general description of the “bubble theory” and the price fluctuations in typical cities. What's more, this essay has gone into the deep discussion as how the bubble was formed. At last, this essay gave some beneficial policies and advices on how to prevent and intellect the bubble phenomenon in the real-estate industry; and how to stimulate the healthy development of the regional real-estate industry.

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Anhang

Deutsche Zusammenfassung:

Das Immobilienportal spielt eine zunehmend wichtige Rolle in der modernen Sozialwirtschaft. Aus makroökonomischer Sicht hat seinen Betriebszustand direkten Einfluss auf die Entwicklung eines Landes Geschwindigkeit und Höhe der nationalen Wirtschaft. Inzwischen, da die Immobilienbranche eng mit der Finanzindustrie in Verbindung, ist seine Betriebszustand auch von entscheidender Bedeutung für die Wirtschaft einer Nation und ihre finanzielle Sicherheit. Aus einer Mikro-Perspektive, Immobilien Produkt ein wichtiger Teil einer in der Familie Asset-Portfolio, mit einem enormen Effekt auf Hausrat-Status und Lebensstandard

Seit der Reform des Gehäuses System im Jahr 1979 hat die chinesische Immobilienmarkt rasante Entwicklung erreicht. Aus der Perspektive der Nachfrage auf der einen Seite hat die "versteckten" die Nachfrage nach Wohnungen im Rahmen der traditionellen Planungssystem erschienen, auf der anderen Seite, aufgrund von Faktoren wie der zunehmenden Einkommen der chinesischen Stadtbewohner, die wachsende städtische Bevölkerung und Familie Miniaturisierung hat die Immobilien-Nachfrage expandiert und Immobilien Anforderungen der verschiedenen Arten und verschiedenen Ebenen werden ebenfalls gezeigt. Aus Perspektive des Angebotes hat die Immobilien und Versorgung Kapazität wurde erheblich verbessert, vor allem weil die Immobilien-Marketing Grad erhöht hat.



Auf der Grundlage der theoretischen Überblick über die Immobilien, Immobilienmarkt und Immobilienblase (Kapitel I), wurde dieser Artikel eine detaillierte Analyse und Forschung der chinesischen Immobilienmarkt (Kapitel II) gemacht, und wies darauf hin, dass die allgemeine chinesische Immobilienmarkt hat bereits einige Blasen erzeugt und viele Regionen eingegeben haben oder geht in die Gefahrenzone, in Anbetracht der Entwicklung Laufe des chinesischen Immobilienmarktes, die Eigenschaften der chinesischen Immobilienbranche und die großen Probleme in der chinesischen Immobilienmarkt. Kapitel III hat eine detaillierte Analyse der Bildung der chinesischen Immobilienblase gemacht, und erkundet tief in Kreditexpansion der chinesischen Banken und Verhaltensweisen der chinesischen Kommunen auf der Grundlage empirischer Daten der chinesischen Immobilienmarkt Spekulationsblasen. Kapitel IV ausgearbeitet hat das schadet der Immobilienblase. Kapitel V hat Vorschläge zur Prävention und Umgang mit chinesischen Immobilienblase und der Förderung einer gesunden Entwicklung der regionalen Immobilienbranche unter den Aspekten der geldpolitischen Analyse-, Land-politische Analysen und Steuerpolitik angeboten.

Als der Immobilienmarkt unterscheidet sich stark in verschiedenen wirtschaftlichen Einheit, Ansichten in diesem Artikel beschrieben werden nur die Aussagen der chinesischen Immobilienmarkt Analyse und Vorsichtsmaßnahmen für seine Blase beschränkt.

Lebenslauf

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