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Topic: Should foreign real estate investment be controlled in China?

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Abstract:
Overseas investors have made significant contribution to revising the real estate market in China. Soon after China reopened its real estate market in the late 1980s, foreign real estate investors began to enter this new market. After peaking in mid-1990s, the Chinese real estate market was relatively inactive until early 2000s when it started to experience strong growth. The rocketing house prices have incited strong criticism among the people. The central government is very concerned about the public outcry and various measures have been introduced to cool down the red hot real estate market.

While local speculators are blamed for the escalating house prices, foreign real estate investors are also regarded as accomplices for causing the problem. On 24 July, 2006, new measures known as the *Opinions on Regulating Market Access and Management of Foreign Investment in China's Real Estate Market* were introduced to restrict foreign real estate investment in the country.

This paper provides an overview of the growth of foreign real estate investment in China, the amount of foreign real estate investment, their contribution to high house prices, the new measures on the control of foreign investment, and the likely impacts on the Chinese housing market.

Introduction

Foreign real estate investment in China has a long history and can be dated back to over a century ago when foreign powers such as America, Britain, France, Germany, Italy, Russia and Japan, etc. set up occupied territories in China (Chan & Jia, 2001). Foreign real estate investors retreated after the communist government took power in 1949. The real estate market then went into hibernation when all private real estate assets were subsequently confiscated and vested in public ownership. It was eventually revived after the introduction of the 'open door' reform policy in 1978, and foreign investors were welcomed back.

At the beginning, foreign investors were mainly overseas Chinese from Hong Kong, Macau, Taiwan and other countries in the region. More investors from other countries began to jump on the bandwagon in the 1990s (Zhang, 2002). The amount of foreign direct investment (FDI) increased rapidly. Since 2002, the inflow of FDI in China has exceeded US$50 billion, surpassing the United States as the largest recipient of FDI inflows in the world (OEDC Observer, 2003).

The influx of FDI also led to an increase in real estate investment in China. Real estate prices went up rapidly along with the booming economy. The escalating estate prices however had a temporary set back in 1993 after the introduction of the macro economic control policy. Afterwards, prices began to rise again. Between 1997 and 2004, there was a staggering 42.40% increase in commercial house prices and 28.85% increase in affordable house[1] prices (NBS, 2005).

The rocketing house prices worried the people and the central government. Various measures had been introduced to stabilise house prices. The latest round of control measures was introduced in May 2006 when the Premier Mr. Wen Jiabao announced 6 major policies (the so called State Council's 6-point policy) to cool the over heated housing market.

While local speculators were blamed for the escalating house prices, foreign real estate investors were also regarded as accomplices for causing the problems. On 24 July, 2006, a 14-point policy document *Opinions on Regulating Market Access and Management of Foreign Investment in China's Real Estate Market* was introduced to restrict foreign real estate investment in the country.

This paper attempts to provide an overview of the growth of foreign real estate investments in China, the amount of foreign real estate investment, their contribution to high house prices, the new measures on the control of foreign investment, and the likely impacts on the Chinese housing market.

Foreign investment in China

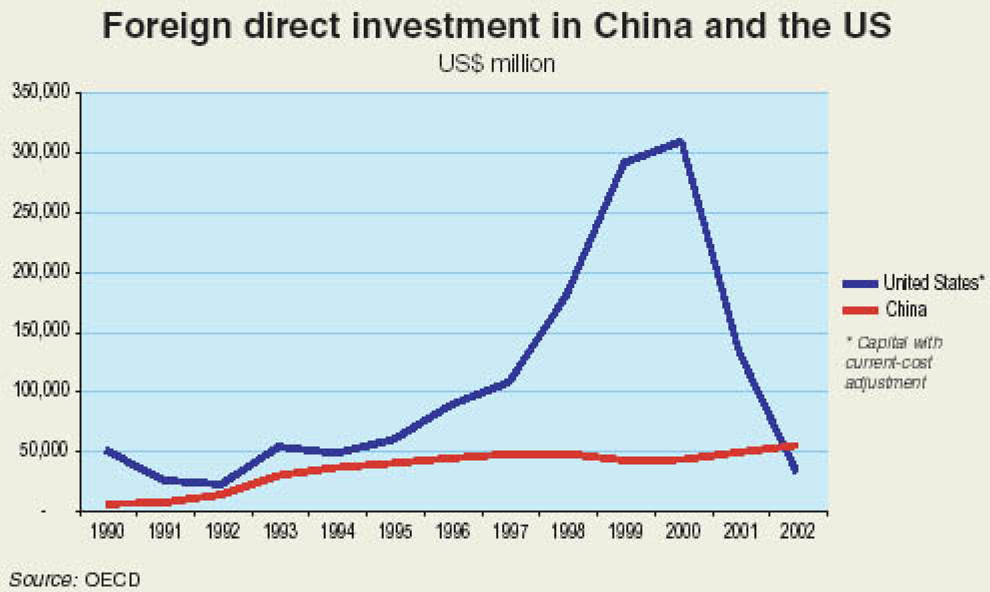
China opened up itself to the world in 1978 when it adopted the 'open door' policy to reform the economy and modernise the country. The *Chinese-Foreign Joint Venture Law* was passed in July 1979 to attract foreign investments (Zhang, 2002). Since 1980, special economic zones were set up in Shenzhen, Zhuhai and Shantou in Guangdong Province and Xiamen in Fujian Province, and the entire province of Hainan was also designated a special economic zone. In 1984, the so-called gold coast of China was established when14 coastal cities—Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao,

[1] Government subsidised low cost housing for purchase

Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai— were further opened to overseas investment (China in Brief, 2000). In 1986, other measures such as preferential tax policies were introduced to encourage more investment.

The amount of foreign direct investment (FDI) increased dramatically. Since 2002, the inflow of FDI in China has exceeded US$50 billion, surpassing the United States as the largest recipient of FDI inflows in the world; see Figure 1 below (OEDC Observer, 2003).

Figure 1



In 2001, China joined the World Trade Organization (WTO). Since joining the WTO, China has attracted more than US$248 billion in foreign direct investment (Bloomberg News, 2006). It helps stimulate the country's economic growth, which averaged over 9% in the past four years (ANZ Economic Outlook, 2005 & 2006).

Regarding the real estate sector, the market was overheated in early 1990s. In 1992, the GDP rose to 14.2% (Yu, 2001) and hundreds of billions of Yuan (tens of billions of US$) of hot money flooded the coastal cities. The resulted spirally rising real estate prices were subsequently cooled off by the macro economic control measures introduced in 1993. The impacts from the macro economic control and subsequently the Asian financial crisis caused China to enter a period of deflation in late 1997. The tough investment atmosphere led to a retreat of foreign funds from the real estate market in 1997 - 2001, see Table 1 below:

Table 1 Change of Foreign Real Estate Investment 1997 – 2001

(Amount in 10,000 Yuan)

Year	Use of Foreign funding Investment	Direct foreign funded investment
1997	4608565 (US$5.83 bn)	3279010 (US$4.15 bn)
1998	3617581 (US$4.58 bn)	2588698 (US$3.28 bn)
1999	2566022 (US$3.25 bn)	1804807 (US$2.28 bn)
2000	1687046 (US$2.14 bn)	1348026 (US$1.71 bn)

2001	1357044 (US$1.72 bn)	1061150 (US$1.34 bn)

Source: NSB, 2005, Table 6-33

It can be seen that the amount of real estate investment using foreign funding dropped from US$5.83 billion in 1997 to US$1.72 billion in 2001. At the same time, the amount of direct foreign funded real estate investment dropped from US4.15 billion to US$1.34 billion. The retreat of foreign funds was very substantial.

The central government was alerted by the declining economic figures and introduced various measures to strengthen to the economy. The biggest boost to the economy was China's accession to the WTO in 2001. The large market size of China, the improving economy and potential huge investment return attracted foreign investors to increase investment and enter the real estate arena again, see Table 2 below.

Table 2 Change of Foreign Real Estate Investment 2001 – 2004

(Amount in 10,000 Yuan)

Year	Use of Foreign funding Investment	Direct foreign funded investment
2001	1357044 (US$1.72 bn)	1061150 (US$1.34 bn)
2002	1572284 (US$1.99 bn)	1241285 (US$1.57 bn)
2003	1700040 (US$2.15 bn)	1162667 (US$1.47 bn)
2004	2282001 (US$2.89 bn)	1425587 (US$1.80 bn)

Source: BSB, 2005, Table 6-33

It can be seen that the amount real estate investment using foreign funding and direct foreign funded investment had been increasing since 2001. In 2005, foreign purchase of real estate was around US$3.4 billion (Areddy, 2006). In the first half of 2006, newly established foreign-invested real estate enterprises increased by 25.4 % over the same period of previous year. The amount of foreign capital actually used was up 27.9% (Xinhua, 2006). Debenhan Tie Leung (DTZ), an international property advisor, reported that foreign investors spent US$4.5 billion in the first quarter of 2006, exceeding the amount for the whole of 2005 (China Daily, 2006).

Control of Foreign Real Estate Investment

Since 2000, real estates prices, particularly in the housing sector, have gone up significantly. In the big cities, the growth was over 50%. In the first half of 2006, the average house prices in 70 medium-large cities increased by 5.8%. The biggest price changes were in Shenzhen (14.6%), Beijing (11.2%), Xiamen (11.1%), Hohhot (10.4%), Baotou (10.3%), and Guangzhou (10%) disregarding the central government's previous measures in restraining house prices. Only 2 cities had recorded price drop – Shanghai (5.4%) and Jinzhou (0.5%) (Soufun, 2006). Price rise is particularly worrying in big cities like, Beijing, Shanghai, Guangzhou and Shenzhen, etc. Table 3 below highlights the change of house prices in Shenzhen in recent years.

Table 3 House Price Changes in Shenzhen

Year	Prices/m^2 (Yuan)
2000	5,412 (US$685)
2001	5,531 (US$700)
2002	5,539 (US$701)
2003	5,680 (US$719)
2004	5,980 (US$757)

2005	7,040 (US$891)
2006 (February)	8,200 (US$1,038)

Source: Mingpao News, 2006

The central government had previously introduced a number of measures to control the escalating house prices. However, the result was far from satisfactory. In May, 2006, the Premier Mr. Wen Jiabao introduced 6 major policies (the so called State Council's 6-point policy) to cool off the over heated housing market.

Local developers and speculators are regarded as the culprits for the escalating house prices and are targeted by the 6-point policy package. The policy package covers 6 main areas including restructuring housing supply, using tax, credit and land policies as weapons to fight again speculation, controlling the scale demolition of old houses, regulating the order of real estate market, establishing low rent housing in urban areas and perfecting the system for disseminating real estate information.

On the other hand, the sharp increase in foreign investment in the real estate market in recent years has also alerted the central government. Foreign real estate investors are regarded as accomplices for causing high house prices. In July, 2006, a 14-point policy document *Opinions on Regulating Market Access and Management of Foreign Investment in China's Real Estate Market* was jointly released by 6 ministerial departments, including the Ministry of Construction, the Ministry of Commerce, the National Development and Reform Commission, the People's Bank of China, The State Administration of Industry and Commerce and the State Administration of Foreign Exchange to control foreign real estate investment in the country. The document covers 4 main areas:

1. Entry of foreign investment to China's real estate market;
2. Development and operation of real estate business by foreign invested enterprises in China;
3. Purchase of real estate by foreign institutions and individuals; and
4. Supervision of foreign investment in China's real estate market.

Under the new control measures, overseas Chinese investors are also regarded as foreigners in the policy document. On the whole, the policies aim at regulating, rather than restricting, foreign investment in the real estate market (People's Daily Online, 2006). Foreign investors need to have a commercial presence in China and are required to obtain approval from the relevant authorities before setting foot on the real estate market. A summary of the document can be found in Annex 1. Among the various polices, those listed below have significant impacts on foreign investors:

1. Only foreign businesses with offices in China (other than approved real estate enterprises) or foreigners who have worked or studied in China for more than one year can purchase commercial real estate for their own use. Purchase of commercial real estate not for their own use is not allowed. This measure will exclude foreign speculators from the real estate market.
2. Foreign investors must have a registered capital of at least 50% (i.e. 50% equity) for setting up a real estate investment enterprise valued at US$10

million or above. The requirement raises the bar for opening a real estate investment business in the country. Foreign firms are required to be financially sufficient for running big business in China.

3. Foreign investors cannot apply for loan locally or from overseas unless they have provided from their own resources 35% of the funds needed for a development project. This is the same requirement for local investors under the 6-point policy. Both foreign and local investors are now subject to the same control.

Is the control justified?

In the past few years, foreign real estate investment has been increasing at high speed, see table 2 above. In the first quarter of 2006, foreign investors spent US$4.5 billion in the real estate market of China, exceeding US$3.5 billion for the whole of 2005 (China Daily, 2006). The number of newly established foreign-invested real estate enterprises increased by 25.4 % in the first half of 2006, compared with the same period in the previous year. The amount of foreign capital actually used was up 27.9% (Xinhua, 2006). The sharp increase in foreign investment in the real estate market in recent years has alerted the central government and foreign investors are regarded as accomplice for causing the escalating house prices.

Despite the stunning amount of foreign capital inflow into the real estate market, the proportion of foreign investment is actually very small in relation to the total amount of investment in the real estate market, see table 4 below.

Table 4 Proportion of foreign investment in China's real estate market

(10,000 Yuan)

Year	Us of Foreign funding Investment	Total real estate development funding	% of foreign investment
2001	1357044 (US$1.72 bn)	76963877 (US$97.64 bn)	1.76
2002	1572284 (US$1.99 bn)	97499536 (US$123.42 bn)	1.61
2003	1700040 (US$2.15 bn)	131969224 (US$167.05 bn)	1.29
2004	2282001 (US$2.89 bn)	171687669 (US$217.33 bn)	1.33

Source: NBS, 2005, Table 6-33

The figures show that foreign investment in China' real estate market is by no means a threat. After all, foreign real estate investment is concentrated in big cities like Beijing and Shanghai and has not yet spread to other cities. Wayne Zane from Colliers International in Shanghai claimed that although competing foreign capital has driven up prices of investment grade commercial properties in Shanghai, foreign buyers only account for about 4% of all purchases in that city (Hudgins, 2006). Given the small size of foreign real estate investment, any claim that it imposes a threat is exaggerated. The control may possibly be introduced due to the following reasons:

1. The Chinese government wants to establish a system to control foreign real estate investment before problems arise.
2. There is speculation that the Chinese currency will soon be floated freely. The Chinese government wants to control the inflow of hot money in anticipation of currency appreciation.

3. At present, a substantial amount of foreign investment has been absorbed by the real estate market. The Chinese government wants to channel more foreign capital to other areas of investment.
4. Although foreign real estate investment is only a small proportion today, the increase in foreign investment will nevertheless fuel the already red hot real estate market. The control is considered necessary to help cool off the market.
5. While the control will cause inconvenience to genuine foreign investors, it helps stamp out speculators and create a healthy environment for real estate investment.
6. Before the introduction of the current control, China was one of the few countries among the 184 International Monetary Fund members without limitation on housing investment (People's Daily Online, 2006).

   A number of developed countries like Australia, Japan, Singapore, etc. already have measures controlling foreign real estate investment (Chang, 2003). For example, in Australia, foreigners are not allowed to buy second hand residential properties (Balanda, 2006). In Singapore, foreigners are not allowed to buy "landed" properties. That means properties with a garden, i.e. bungalows, semi-detached and terrace houses, including conservation shophomes are out of reach of foreign investors (Asiahomes, 2004). China's control of foreign real estate investment is not at odds with other countries.
7. It is necessary to show the people that foreign investors do not have privileges and are subject to regulations. Controlling foreign real estate investment will complement the 6-point policy package.

Likely impacts on the market

The new policies bring about a number of new controls on foreign real estate investment and the real estate market is bound to be affected. The likely impacts may include:

1. The demand for high class residential property is likely to drop. Foreign investors used to be prominent buyers for high end residential properties. Now they have to satisfy the residence requirement. In addition they are restricted to buy residential property for their own use only and the purchase cannot be for investment. This will significantly reduce the demand for high class residential property. The prices of this category of real estate are expected to fall.
2. The demand for rental residential property, especially high class property, may go up. Foreign businesses or foreigners who are not qualified to buy their own residential accommodation may to have rent. The high demand may drive up the rents of residential properties.
3. The restriction on investment in residential properties will encourage foreign investors to shift their focus on other sectors of the real estate market. There is likely to be an increase in the demand for premium and quality commercial properties, hotels, service apartments and industrial properties, etc. It is expected that real estate prices in these sub-markets may rise.
4. Foreign investors may become strong competitors to local investors. Under the latest round of macro control of real estate, both foreign and local developers

are now required to provide 35% of the funds needed for a development project from their own resources before they can apply for loan. The requirement may cause big problem to local developers as they used to get 100% finance from the banks. There is little opportunity for them to raise the necessary funding locally or from overseas. In contrast, the new control has no control on foreign investors getting finance from overseas. Foreign investors are thus in a better position to meet the finance requirement and become strong competitors to local investors.

5. Land prices may go up. Both local and overseas investors now need to purchase land via auctions or open invitation for tenders. Coupled with the policy to tighten up land supply (China View, 2006), land prices may go up as a result of strong competition.
6. The fall in demand for high class residential property may encourage developers to build more middle – low price residential properties. The increase in supply will see lower prices for properties in this category.

Conclusion

In recent years, real estate prices have been rising rapidly in China. In particular, the rocketing house prices have alerted the central government. A series of measures have been introduced to rein in the untamed real estate market. The 6-point policy package introduced in May 2006 aims at regulating local financial institutions and developers; and to fight against speculators.

The sharp rise in the inflow of foreign capital into China's real estate market also worries the central government. Although the size of investment is very small in relation to the total real estate investment, foreign investors re regarded as accomplices for causing the escalating real estate prices in China. The central government considers that the current round of macro control of real estate will have a better chance to succeed if foreign real estate investment is also put under control. The introduction of the foreign investment control policies is aimed at complementing the 6-point policy package.

Under the new control policies, foreign businesses (other than approved real estate enterprises) and foreigners are only permitted to buy commercial real estate for their own use. Foreign businesses need to have 50% equity for setting up a real estate investment enterprise valued at US$10 million or above. They are also required to provide 35% of the funds needed for a development project before applying for loan. Although restrictive, the requirements are not over onerous. It is believed that while some foreign investors may find it difficult to meet the requirements, the majority may cope with them easily.

It is expected that the new foreign investment control policies will not cause major upheaval to the real estate market. Instead of investing in high end residential properties, foreign investors are expected to shift their investment to other sectors of the real estate market. Certainly the demand for high class residential properties will reduce. The gap will be filled by an increase in demand for commercial properties, hotels, qualify service apartments and industrial properties, etc.

Controlling foreign real estate investment is nothing new. Many countries already have it. It is reasonable and legitimate for China to regulate foreign real estate investment for the sake of establishing a healthy investment environment. The foreign investment control policies will no doubt cause some inconvenience to foreign investors. There may be concern that foreign investors will be scared off. It should be understood that foreign investors have the liberty to choose the most favourable country to invest their money. While they are not obliged to invest in China, the huge market size of China, the improving economy and investment environment, the imminent floating of the Yuan and the potential of huge investment return will certainly be attractive enough to encourage foreigners to continue investing in China.

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Annex 1

Summary of the *Opinions on Regulating Market Access and Management of Foreign Investment in China's Real Estate Market*

I. Regulation of foreign investors' access to China's real estate market

1. In order to qualify to purchase real estate in China for any purpose other than personal use, foreign investors must first establish a commercial presence in China, such as a foreign-invested real estate development or management enterprise (a FIREE) in China. Prior to engaging in real estate development activities or operating real estate related businesses, foreign invested enterprises (FIEs) must obtain the following approvals and licenses:

    a) an FIE approval certificate issued by the PRC Ministry of Commerce (MOC);
    b) a land use right certificate for the state-owned land issued by the PRC Ministry of Land and Resources (MLR); and
    c) a business license issued by the PRC State Administration of Industry and Commerce (SAIC).

2. The Opinions impose stringent registered capital requirements on FIEs engaging in real estate development activities or operating real estate related businesses. If the total investment for the purchase of real estate in China is US$10 million or more, the registered capital of the FIREE established in China must be at least one half of the total planned investment of the project.

3. In addition, the Opinions require Chinese authorities to tighten approvals in connection with (a) the establishment (and ownership transfer) of FIEs that engage in real estate development activities or operate in real estate related businesses, (b) the transfer of land development projects between or among FIREEs and (c) mergers and acquisitions involving FIREEs. Particularly strict requirements apply to FIREEs that seek to acquire or merge with domestic Chinese real estate enterprises or acquire the equity ownership of their existing Chinese joint venture partners. FIREEs with adverse records may not engage in such activities in China.

II. Strengthening the management of FIEs' real estate development

1. Foreign investors that fail to obtain either an FIE approval certificate or a business license may not engage in real estate development or related activities in China.

2. An FIE engaging in real estate development activities or real estate related business is not permitted to obtain debt financing from domestic or foreign commercial lenders, and will not be allowed to settle foreign exchange, if:

    a) such enterprise has not fully contributed its registered capital; or
    b) such enterprise has not obtained a land-use certificate for the state-owned land on which they plan to engage in development or other activities; or
    c) the development funds for the real estate project development have not reached at least 35% of the total project investment.

3. Neither the Chinese party nor the foreign investor of a FIREE may include any provision guaranteeing fixed returns or disguised fixed return to any party in any contract, articles of association, agreement for the transfer of equity interest or any other document entered into by or between the parties.

4. The Opinions also require Chinese authorities to tighten supervision of the operations of the FIREEs, such as developing and selling real estate in China. Illegal activities by FIREEs, such as property hoarding, speculation and price manipulation, will be investigated and penalized.

III. Limiting the purchase of commercial and residential real estate in China by foreign enterprises and individuals

1. Foreign enterprises and individuals seeking to purchase commercial or residential real estate in China will only be permitted to do so if such property is intended for personal use or occupancy and is acquired directly by the purchaser. If a foreign investor plans to purchase commercial or residential real estate in China for any purpose other than personal use or occupancy, they must first establish a presence such as an FIE.

2. Only specific categories of foreign enterprises or individuals may purchase commercial or residential real estate in China for personal use. These categories include China branches and representative offices of foreign enterprises (except for the enterprises obtaining the approvals to engage in real estate business in China), and individuals who have been working or studying in China for more than one year.

3. Foreign enterprises or individuals purchasing commercial or residential real estate in China are required to use their true identity when acquiring real property. They also need to provide evidence regarding the proper establishment of their FIE in China (if the purchaser is an institution) or evidence that they have worked or studied in China for at least one year (if the purchaser is an individual).

4. At the time of sale of the property, the PRC State Administration of Foreign Exchange (SAFE) is required to withhold approval for the settlement of foreign exchange generated through the sale of the property until the foreign investor has presented SAFE with the documentation described above and other sales-related documentation that SAFE may require. This will ensure that funds obtained by a foreign investor from the transfer of Chinese real estate will only be permitted to be remitted abroad after the transaction has been approved by the Chinese authorities and the relevant tax in relation to the transaction has been paid.

Source: Hogan & Hartson, 2006