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# THE 1990s PROPERTY CYCLE IN HAINAN

Hao Wu, Richard Reed, Jon Robinson

Faculty of Architecture Building and Planning, the University of Melbourne  
Victoria, Australia 3010

## Abstract

The continuous debate between the radical and the conservative approaches on which one is more suitable for a successful economic transition seems to be in favour of the latter. With the recent upswing in the property market in Hainan, the review of the 1990s property cycle in Hainan is linked with economic transition in China. A case study approach is used to establish the importance of the 1990s Hainan property cycle to the formation process of the Chinese property market system. The analytical framework is an integration of the theories of property cycles and economic transition, using the conceptual model of typical commercial property markets modified according to the historical settings in Hainan. It is found that the 1990s Hainan property cycle is unique in that the economic transition has been the key driving force. The structural imbalance caused by the equally imbalanced reform process in different sectors in Hainan has been proved an unsuccessful practice. By and large, the 1990s cycle in Hainan lasted for about 10 years and was state-driven. It was considered an experiment conducted by the state in testing the radical approach of economic transition in the property and urban land sectors. It is suggested that current knowledge of emerging commercial property markets, especially their cyclical behaviour, is limited at both theoretical and empirical levels. Evidence from the past 15 years seems to suggest that the structural and investment imbalance in the economic transition was the main cause of the high volatility in the Hainan property market in the 1990s. The emergence of a commercial property market seems to require choosing the right places to start reform with great caution on investment structure and the fundamentals of the real economy. Eventually, it is essential to adopt a systematic view to assess and to make decision in the process of emergence of property cycles, based on the basic demand and supply patterns in a city's transitional economy.

## Key words

Property market; cycle; economic transition; state; Hainan

The authors may be contacted via email

Hao Wu: [haowoo@hotmail.com](mailto:haowoo@hotmail.com)

Richard Reed: [r.reed@unimelb.edu.au](mailto:r.reed@unimelb.edu.au)

Jon Robinson: [jrwr@unimelb.edu.au](mailto:jrwr@unimelb.edu.au)

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## 1 Introduction

Economic transition in the property context implies the emergence of a property market system that is underpinned by rapid and profound structural changes. Property cycles driven by the dynamics of property market are expected to appear in a transitional economy. There appears to be a new upswing in the Hainan property market, almost 15 years since it experienced its first major property boom. It is beneficial to review previous experience and identify new character. This paper concerns the impact of the state-led transition on creating cyclical behaviour in the commercial property sector in Hainan. Past experience from transitional economies suggests that the radical approach in economic transition often involves higher risk and less satisfaction (Jing, 2003). This paper discusses its implication for the changes and performance in Hainan, in comparison to the more popular gradualist approach. During the process of structural changes in the Chinese economy and the emergence of property markets, the 1990s Hainan property cycle is certainly among those lessons that should be learnt by every investor and the state. The combined framework of the commercial property cycle plus the economic transition is used to analyse the 1990s experience in the Hainan property market. By combining the building lag and the property investment theories in relation to demand-supply changes in the real economy and the monetary economy, this paper analyses the emergence and behavior of the user, development, investment and land markets in Hainan in the context of structure change. The Hainan experience is invaluable for enhancing the state's skills in dealing with economic reform and society's knowledge base of the cyclicity in property markets.

## 2 Analytical approach

To analyse the cyclical behaviour, several key features of the Hainan market should be taken into account. Firstly, in terms of the size and the real demand for commercial space, the Hainan market is not significant. Secondly, due to immaturity, the Hainan property market behaves quite differently from mature markets. For instance, mature markets tend to have higher self-adjustment capacity. It is less likely that idle properties occur in the CBD because there is competitive demand for land use where unexpected market failures can soon be covered by 'suitable' development. Thirdly, good quality time series data have not been well maintained in Hainan.

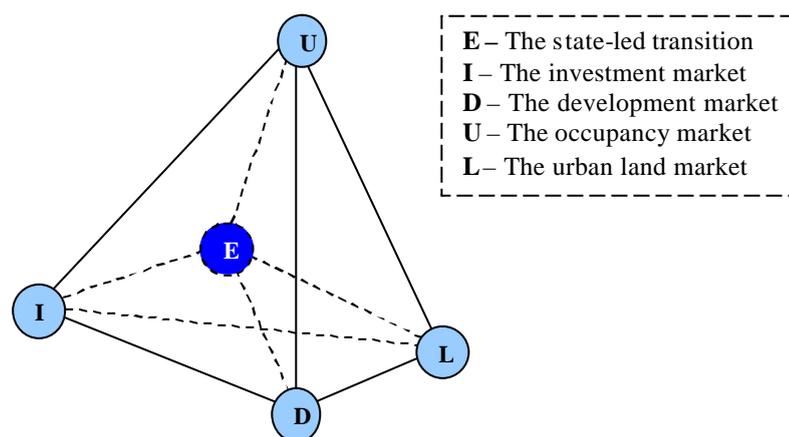


Figure 1 A simple conceptual model of commercial property market

In order to study the emergence of cyclicity in commercial property markets under economic transition in which a radical experimental approach was adopted in a small-scale and less sophisticated economy, an analytical approach that takes into account the applicability of the mainstream property cycle theory and unique features of the unfamiliar Chinese property market is developed. Since the late 1980s, property cycle analysis, including the mathematical modelling

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approach for interpreting and forecasting, has been developed based on the conceptual model of commercial property market systems. The model concerns the general equilibrium of demand and supply within and between property submarkets, as well as the wider economy. The interlinks of demand and supply, once incorporated in continuous structural change, known as gradualist economic transition, offers an analytical framework to direct property cycles analysis and its dynamics in a transitional economy (figure 1). In business cycle literature, Rothbard (1963) asserts that with only a couple of exceptions such as Joseph Schumpeter and Ludwig von Mises, business cycle theory often represents a departure from mainstream economics. The development of property cycle theory and its analysis should be aware of this claim. For example, Barras (1994) and Ball et al (1998) adopted an integral view in their building cycle research. The demand-supply factors in the markets for space and for capital, as Fisher (1992) defines, have been driven by both the 'invisible hand' underpinned by competition and investment/utility rationality, and the 'visible feet' of state intervention. The submarket system in Hainan was still an incomplete construct during the 1990s cycle and detailed time-series data for commercial property in the 1990s were hardly available. Therefore, the classic model is hard to be fully adopted to explain the 1990s cycle. This paper focuses on the state's influence on the behaviour of the emerging commercial property sector, using the framework described in figure 1. Government reports, statistical data and interview responses are used to support the analysis. By and large, the analysis is descriptive and self-explanatory.

### **3 Economic change and evidence of the 1990s property cycle**

Hainan has experienced tremendous changes in its economic structure and performance in the past 15 years. The history of the rise and fall of the city's property market is better described in relation to the economic reform and the emergence of the property market, the property investment boom and the subsequent state intervention. Market mechanisms had not played important role in the formal economic structure in China until the 1980s. The property market in China started to emerge after urban land reform followed by the amendments of the Chinese Constitution Law in 1986 and the Land Administration Law in 1988.

In regard to the changes in the general economy and the property sector in Hainan, issues such as the reform (transition process) milestones, the reform-caused changes of Hainan from a remote island to the largest Special Economic Zone (SEZ), and the emergence of the commercial property market are of the main concerns. This will target questions such as what had happened in state policy in the state-led reform and economic transition, what had been changed in the Hainan economy in both the aspects of structure and output, and the early characteristics of the 'newly-born' property market. The Hainan Bureau of Statistics has produced serial review papers on the recent reform history and the emerging property market in Hainan (BSHN, 2005). They focus on the continuous changes in terms of the economic structure and performance. Similar studies on the Chinese property market also address this issue, for example, Cao and Gao (2002), Hu (2002) and CAM (2003). Compiled documents by government bodies such as the Office for Idle Property Settlements of Hainan (HNIPHO, 2003) on key policies and legislation also help to indicate special 'moments' in the history of reform. After all, most laws governing real property in China were passed recently since the late 1980s. As the reform milestones, actual changes and the formation of the property market are an integrated part of the economic transition, they should be considered in parallel over the same time span. Figure 2 intends to give a general 'description' of the cycle by linking these components in the historical landscape. It shows that the 1990s property cycle has been accompanied by the reform process in the general economy, the urban land and the housing sectors. All form parts of the evolution of the property market changes in Hainan.

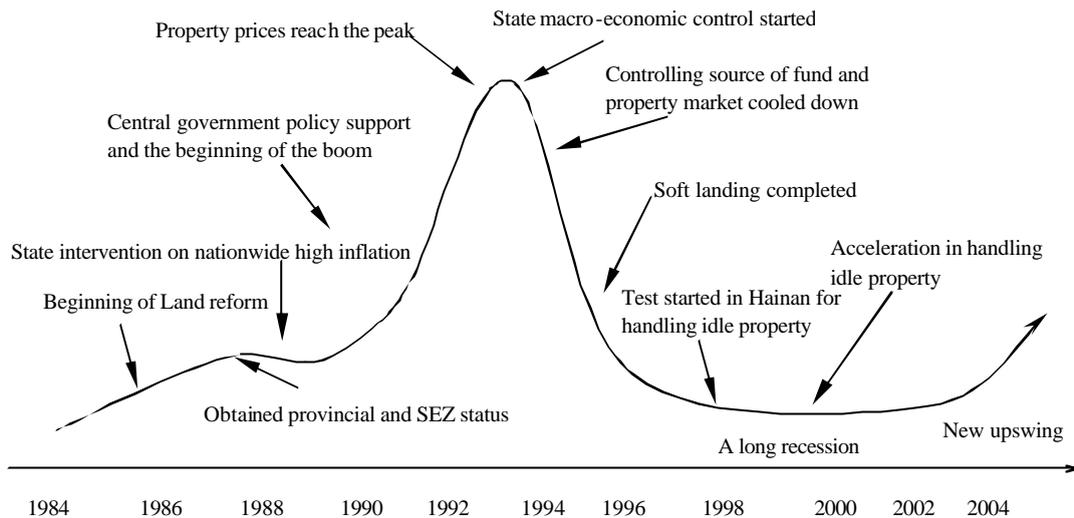


Figure 2 Describing the 1990s Hainan property cycle

Changes in demography and economy such as the rise of tertiary industry and the property rights structure, the creation of demands for commercial and residential spaces, and the finance source/structure, had made possible the emergence and growth of the Hainan property market. Changes in the economy set the foundation for the emergence and growth of the property market in Hainan. Figure 3 shows the GDP and 3 types of fixed asset investments. It reflects the performance of the economy and specifically those components that are directly related to the property sector. Urban infrastructure and buildings absorb most incoming capitals. Investment in fixed assets in relation to GDP growth can therefore reflect the feature of the economic growth. The growth in Hainan in the early 1990s was clearly in urban fixed assets, especially property investment-driven (figure 3).

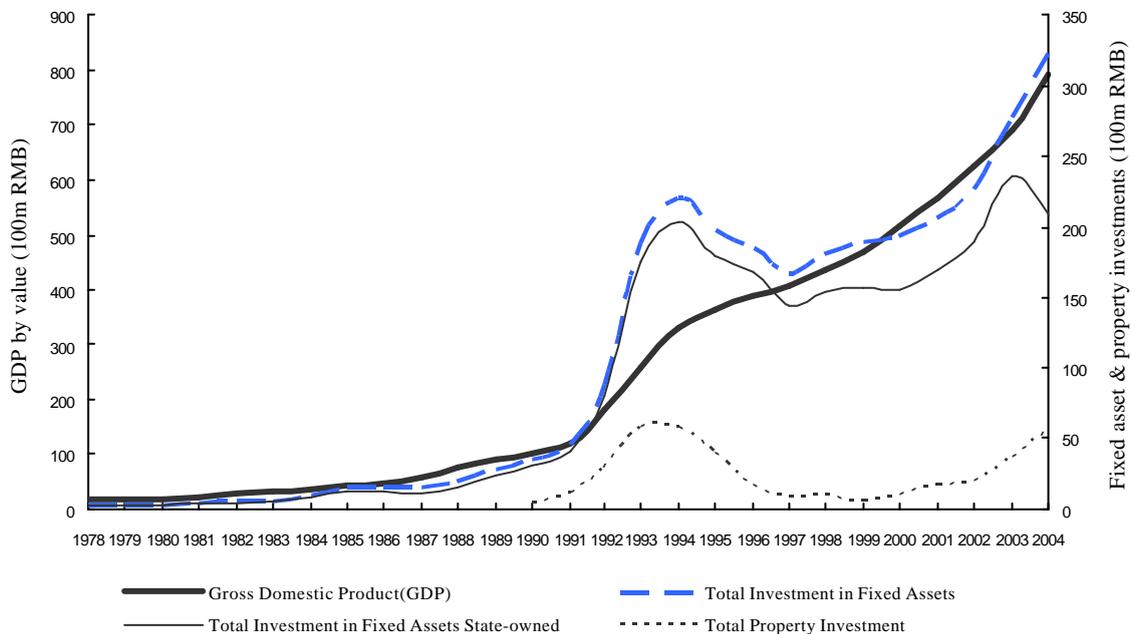


Figure 3 GDP and fixed asset investments in Hainan (Data source: HNBS)

Similarly, the changes of industry structure such as the rapid growth of the service industry, labour market and population (number and quality, noted that the population changes in urban and rural areas should consider both the internal movement and those demographical change caused by migration to Hainan) changes could partially reflect the changing economic activity and the demand for commercial space in Hainan. Figure 4 displays the moving trend of the economic structure in

Hainan from rural agriculture-based to urban tertiary-industry-based, and the relation between such a movement and its impact on broader property investment. Being the primary source for commercial space demand, the urban employee numbers, especially that in the service industry, should be considered.

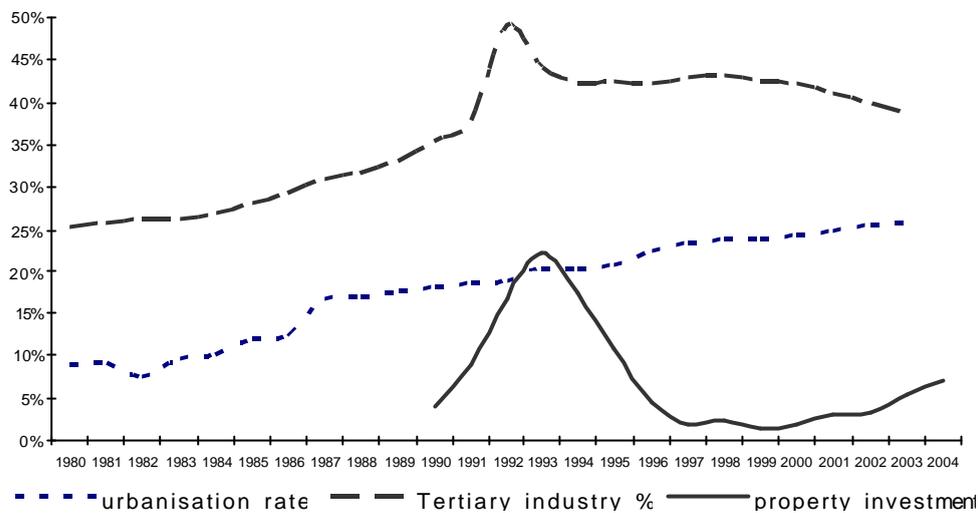


Figure 4 Demographic changes and property investment (Data source: HNBS)

However, due to the difference in the political-economic system, the employment level in the Chinese economy may not be a satisfactory indicator as in mature market economies. In a planned economy, the demand and supply of office space is driven by quite different mechanisms. Without direct data for office demand, such as city office-based employee numbers, the only approximation of market-based office demand is foreign investment level (excluding direct foreign debt) because foreign entities have been the main demand source for commercial office space since the beginning of the reform. Given this concern, figure 5 indicates a quiet market in terms of foreign direct investment (FDI) and the declining urban employee numbers since the late 1990s.

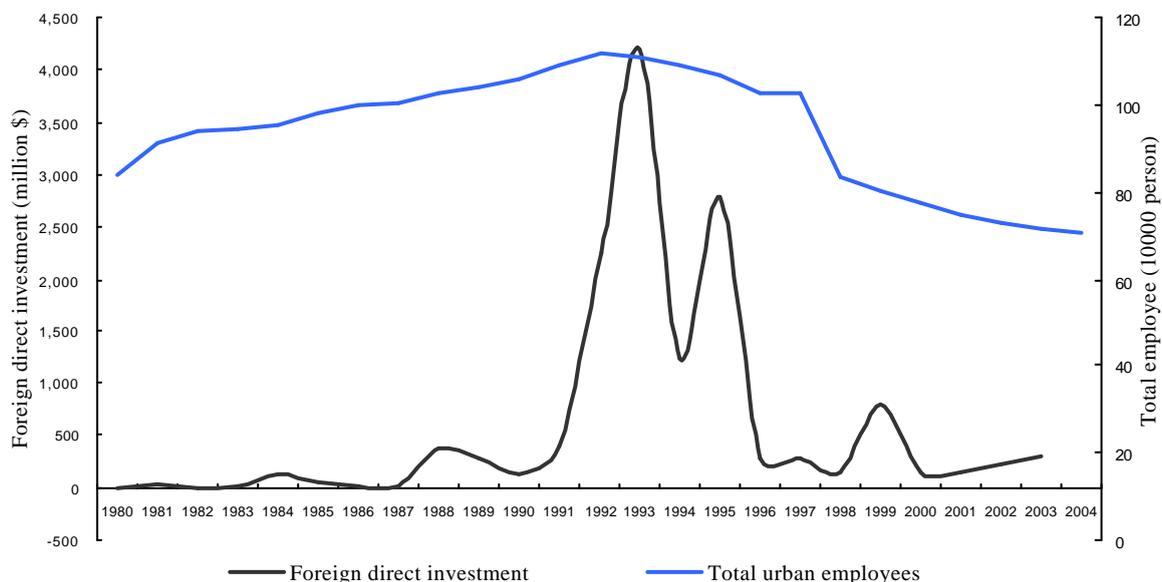


Figure 5 Indirect indications for market-driven commercial space demand (Data source: HNBS)

For an economy in transition, changes in the source of funds for property investment can unveil important issues. As the capital market in China is still in its infancy, funding from stock market and investment funds in Hainan is considered minor. Since the beginning of the economic reform, the state budgetary appropriation in the Hainan property sector has never been a significant component and has disappeared in recent years. It is therefore natural to ignore these two components when

evaluating changes in funding sources for property development, although property finance sources from the capital market are rapidly growing in major Chinese cities and could potentially become one of the major sectors for commercial property funding. Figure 6 shows that the sources of funds that are considered influential are domestic loans, which have been dominated by loans from state-owned financial institutions (state-owned banks), foreign investment and self-fundraising as well as some other sources not belonging to any of these categories. The ‘self-fundraising and others’ category is unique because it represents the source of funds that does not belong to any clearly defined category. The source of property investment funds has been derived from various sectors that were mostly related to state-owned assets. Again, the structural change made social and economic capital change from their previous ‘planned mode’ to the ‘market mode’.



Figure 6 The recession in the Hainan property market (Data source: HNBS)

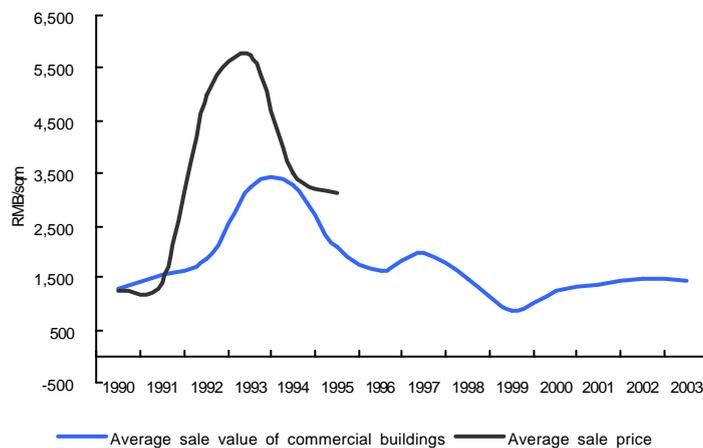


Figure 7 Role of the property sector in the Hainan economic growth (Data source: HNBS and Zhou (1996) cited by Xie et al (2002, p179-80))

The major upswing in the early 1990s should be investigated via property demand-supply changes. Figure 6 observes the total output of the property sector in Hainan in relation to the economic growth (GDP) has remained stable except the 1992-3 period. The economy has moved from temporarily property investment-led to economic growth with the contribution of the property sector remaining around 2% of GDP. The recession in the property market is also evidenced by property sales prices. Figure 7 shows that the downward trend did not stop until recently. However, it is important to know that although this could provide useful indications for further analysis and discussion, the actual data may not be reliable enough because the supply type alone can cause dramatic increases in average

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sales value.

The economic policy in Hainan changed dramatically since the second half of 1993. This, together with the following introductions of new laws and regulations dealing with development funding sources and land supply, had imposed great impacts on the property sector. The total property investment in Hainan has been at a low level; the Hainan property sector experienced negative growth for several consecutive years. As figure 6 shows, the recession in the Hainan property market lasted almost eight years. During the period, incomplete buildings, vacant sites and space, together with non-performing loans and numerous complicated disputes on land and buildings raised in court became the embarrassing icon of Hainan. Worse still, this also imposed a psychological impact on domestic and foreign investors which is hard to remove in a short period of time. According to the report produced by the Hainan Bureau of Statistics (BSHN, 2005), in between 1988 and 1998, total development area for commodity space reaches 36.69 million sqm with a total completion area of 16.86 million sqm and that under construction of around 1.439 million sqm. This suggests a 50.1% of the total area being either incomplete (11.353 million sqm) or never started (7.038 million sqm). For completed areas, the vacancy rate reached 41.9% of which 85.8% was high-end house or office space. The report further suggests that the structurally imbalanced space supply and the massive volume of idle properties represented 25,000 million RMB of assets of which a majority was in bank non-performing loans. This affected the general economy of Hainan because its growth has largely been investment-driven. The prolonged recession caused a number of problems which had imposed negative impact on the web of the general economic system. From the banking sector, buildings with incomplete structure or external walls and service systems cannot be put into use to generate income for loan repayments. After 10 years, their revitalization became another challenge due to physical and economic depreciations. In 1998 nonperforming property assets were at least 40.6 billion RMB, 7.8% of the national total. Considering the relatively small population of 7.3 million and GDP of RMB 43.9 billion in 1998, the problem was serious. The Statistical Bureau report further suggests that 71% and 84% of non-performing loans in the two state-owned banks, the Bank of China and the Agriculture Bank of China, faced problems in clarifying contractual and other legal rights. A large number of court cases were raised in the mid-1990s that were related to the sophisticated and fuzzy property rights and obligations still have not been settled. Being state-owned, one of the common practices was to separate bad loans from the standard practice and establish specialist entity to deal with them. In 1999, China Xin Da Asset Management was established which became the first to deal specifically with non-performing assets. The private finance sector is less lucky in this regard. One of the early commercial banks, the Hainan Development Bank, went into liquidation during this period. Together with the Asian Financial Crisis, foreign investment in Hainan also reached the lowest level in the late 1990s. The increasing number of withdrawal of businesses also slowed down the economic growth in Hainan. The property market in Hainan has experienced its worse moment.

#### **4 Similar experiences in the historical landscape**

In a landmark study on the history of land prices in the city of Chicago (1830 – 1933), Hoyt (1933) suggested that the booms and busts in the city's real estate market has been identified as being caused by various factors. The land boom between the 1830s and the early 1840s (1830-1842) was related to the early urban development, which in particular was associated with speculative transaction activities of land lots near a proposed canal project. At that stage of the urban growth, a large number of land lots were opened for private-ownership. Property transactions were initially supported by demographic change in the increasing number of households and their demand for buildings. And soon the over optimism and the inexperience of investors and the government made the land market

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purely speculative. Land prices surged without increase in real demand. As Hoyt describes:

*...people were coming to Chicago with visions of the future city at the mouth of the Illinois and Michigan canal... (Hoyt, 1933, p26)*

In particular, Hoyt lists several factors that contributed to this land boom, namely government fund-raising activity for the canal, the imprudent lending behaviors of government-guided financial bodies, predominantly banks, for loans for land purchase, and the creation of the land office in Chicago that drew more speculative investors into the city's land market. All this raised the expectation of local residents and outsiders for high profit from transactions of land lots. The government or the state's behaviors together with people's reactions caused the land boom during this period. The state (the government) was land owner at that time and it was its intention to distribute land to individuals to form the private-ownership-based land tenure system. In the Chicago case a lending crisis emerged during the period shortly after land prices reached their peak. It seems that the immature finance system, which imposed most investment risks onto the banks, made the bank lending behavior a direct determinant of the land market. Thus the crisis was directly triggered by the banks' credit control followed by the halting of the canal project, which was the root of the speculative boom. Without the support of real demand, the speculative bubble eventually burst and the losses for most were severe and the redistribution of wealth was very significant. According to Hoyt, the state did not impose direct intervention on the first property cycle in Chicago. In comparison, the state intervention in the 1990s Hainan property boom was direct, powerful and with multiple approaches.

In a classic review of the early property boom history in Australia, Cannon (1966) paints a picture of the land boom in the early Australian economy that was laissez-faire by character and speculative by nature, which led to serious attempts at social controls after a disastrous crash. Cannon believes that some identifiable groups (or institutions) should be held responsible for the crash, and it seems he was referring to the speculative behaviours of the investors, the financial institutions and the state. Again, the rapid growth in Melbourne set the tone for the later economic prosperity and the land boom. Before the great boom-bust cycle of the 1880s-1890s, there were two cycles as suggested by Cannon (1966), the first was the land boom right after the release of land in 1837 which was ended with a financial crisis; the second was the 'gold rush' which was peaked in the 1850s and generated huge money for playing in the landed property market. The boom-bust cycle in the 1880s-1890s, as Cannon suggests, was due to several key drivers: first, the imprudent behaviour of financial institutions such as building societies and banks, as building societies not only unprofessionally deal with development loans, but themselves direct involved into the speculative activities in lands and buildings using deposits received from individuals. One main reason for this was the flawed state financial legislation; second, the purely speculative view about investing into landed properties, which was a psychological issue; third, the link with foreign investors and their behaviours when the market went downwards; fourth, the lack of state control in many aspects. The speculation in most places such as Hainan comprises investment speculation in cash flow, and technical speculation that seeks gaps in existing laws, administration and market transaction processes. In the early stage of transition, the gaps are easier to be found by speculators. It is however difficult to expect the government at that time to have the knowledge and skill to achieve such a task. This is similar to the Chinese central government and the Hainan local government during the 1990s land boom. Overall, the boom and bust was associated with the economic cycle at the early stage of market formation in Melbourne, in which the property investment sector played the most influential role and of course suffered the most when the bubble eventually burst. The early formation of the economy, the actual

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distribution of property rights, the money supply and the use of new technologies on buildings and transportation all played a role in the business cycle and the property cycle.

There were also cases of commercial property cycles in Australia cities such as Sydney (Daly, 1982) and Melbourne (Robinson, 2002), and in the UK (Marriott, 1967; Mayes, 1979; Ball, 1994; Scott, 1996). For example, Mayes (1979) suggests the UK building cycle in the early 1970s was closely associated with the imbalance of new building order and completion, policy, lender and demand. On the supply side (the combination of development and user markets), the actual supply may be stable if completion rate remains stable and in consistent with demand changes. This is however hard to achieve in practice especially in the commercial property context. Similar property cycles and land speculations at the early stage of the British property market were mainly driven by political and economic changes. For the property boom in Japan, Xie et al (2002, p126) suggest the lack of proper institutional settings and policy failure caused the oversupply and deficiency of effective demand. The Japanese property boom was triggered by the urban expansion supported by the rapidly growing economic and social activities. Economy-driven urban expansion, major government-led urban redevelopment, imbalance of capital and space markets all are associated with the conflict of economic and institutional changes. Although the Hainan property cycle has different characteristics comparing to the early land booms triggered by urban development in mature market systems, some key elements such as credit expansion, major policy shift or international capital market influence remain to have significant impact on the formation of its property market and driver of the cycle. It may be a debatable issue that the 1990s state intervention had partially postponed the urban development process in Hainan. At the special time of economic reform (the 1990s), Hainan being a 'lab' for economic reform had certainly sacrificed itself in several accounts, and knowledge learnt from it had been passed to other cities. Without the Hainan experience, China's national economy could have suffered from more severe losses. In a sense, there are some similarities in terms of approach between China's urban land reform and scientific experiments.

## **5 The 1990s cycle in the context of the economic transition**

The emergence of the property market system allows commercial based development, investment and occupancy activities to flourish. This naturally led to the emergence of the price system to effectively link the submarkets and space supply. The focus of the study is on the imbalances in the process. The profound structural change had modified the old socio-economic order and created a hybrid system. The lack of communication due to the fact that the emerging market system had relied too much on the immature price mechanism in the dual (planned and market) system are at the core of the enquiry. At the early stage of the economic transition, opportunities and defects appeared at the 'margin', in which case, the intersection of the planned and market systems determined the demand and supply of space.

### **5.1 Structural weakness of space demand and supply**

In explaining the cyclical behaviour in Hainan property demand and supply, classical property cycle theories such as building lag and the accelerator principles are applicable in explaining the imbalance in the Hainan 1990s property cycle. However, as stressed before, the structural change led by the economic transition is required to be integrated into existing theories. The time-series of building space sold is a typical measure of absorption and that of building completion is popular measure of new space supply. Considering the condition and total amount of existing stock, especially the immaturity of the second-hand market (for a long period nonexistent), the analysis of the property

cycle is founded on building activity and space transactions. Figure 8 unveils two interesting issues. First, it seems that at the early stage of the property boom (1990–1993), building demand and supply levels had moved quite consistently. However, this may not reflect the real demand for commercial space because the absorption of newly completed space can be based on purely speculative activity, which moved away from building's utility or occupancy purpose. They are transaction activities purely based on the expectation of further market upswing. A better indicator of the real demand is occupancy or vacancy rate. Unfortunately, such data are incomplete, but the available data show that the occupancy rate remained low in the 1990s.

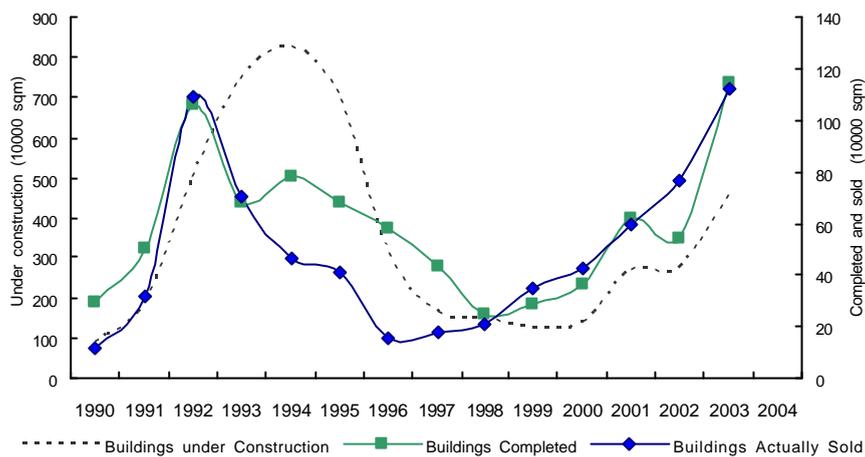


Figure 8 absorption (face) and supply in relation to total space under construction (data source: HNBS) Second, in comparison to changes of building commencement level during the same period, the actual completion and transaction volumes at the peak of the boom seem to be minor. Comparing the data in figure 8, it seems total building work commencement has been substantially higher than the building completion even though the latter could comprise a large amount of speculatively built space that would be vacant after completion. The difference in figures 8 implies that a high proportion of commenced work could not be completed, which were either withdrawn or abandoned. This represents real losses and is the problem that is at the core of the 1990s Hainan property crisis. It is one of the most difficult problems for the central and local governments as well as the property industry to face. The amount of idle space was so large by the mid-1990s that it was beyond the capacity of the state and the emerging market to solve within a short period of time.

Commercial property demand is derived from urban life. Demographic change that is reflected in urban population growth, namely the urbanization rate, could be an effective indicator for property demand, especially for commercial housing. Compared to the figures of building absorption (surface demand) in figure 8, urban growth (urbanization rate) in China, as in Hainan, is more reliable, given the fact that a large proportion of space stock was not put into effective use during the property boom. The state-intervened demographic change in terms of population movement certainly has a great impact on the demand for built space. The inward and outward movements to and from Chinese cities had been one of the most direct determinants for space demand. The Hainan case shows that space supply without this type of fundamental demand will be unlikely to be sustainable. However, it should be aware that demographic change may not have as significant an impact on the office market as that in the housing sector. The analysis of commercial property demand in Hainan, besides the issues of speculation and demographic change, should be focused on domestic and international business conditions and capital flows.

Analysis of office demand in mature markets is in close association with office-based employment

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level. But the planned element in the economy makes the employment situation a complicated one. Statistical data of employees in a certain industry often do not reflect demand changes for commercial office space, because State-owned Enterprises also dominate employment and labour distribution. The work-unit based office space supply has been running in parallel with the market sector, counting a large proportion of the total office stock. Unemployment (lay-off) used to be a very sensitive issue where full employment arranged by SOEs could actually represent a significant departure from real demand for labour. This is unlikely to be the case in a market or self-interest oriented system where unemployment can be a direct indicator of current office space demand, provided that there is a reliable social welfare system to cope with unemployment. Hence, as long as the state-owned sector is still the main source for employment, the relation between employment number and commercial space demand will be vague. This could severely affect office-cycle analysis results if the employee number is used as the proxy for office demand in property market modelling exercise. However, employee number changes within sectors such as construction, property development and its finance would be likely to indicate market condition changes as 'the private sector' has been playing more significant roles since the land reform in Hainan.

## 5.2 Immaturity of the development market

Property development has not been an industry prior to the economic reform. Property development firms started to appear in major Chinese cities in the mid 1980s and most of them initially appeared as the result of the SOE reform. Not surprisingly, they often retain close connections with the state and behave in a similar way. The property development units undertake both development and construction works. Until recent years, foreign developers still preferred not to be directly involved in property development in unfamiliar Chinese cities, with the exceptions such as in Shanghai, Beijing and Guangzhou where Hong Kong, American, Japanese and Singaporean firms have established their local firms with long-term development goals. The emergence of these elements takes time. Besides development firms with strong SOE background, a large number of local developers appeared in the early 1990s. With various backgrounds, their motivations were largely speculative and heavily relied on advantages such as having access to land or capital (easy bank loan or other types of funds) that took advantage of their 'insider information' of the gaps in the changing planned and market mixture, as well as their ability to access them. The emerging 'commercial developer' had the advantage of flexibility and creativity but usually lacked experience and a capital base. As a result, most of them did not have long term goals. On the other hand, the SOE developers lack the flexibility and motivation which caused their resources to be less productive. This led to a very unstable property development sector and the potential for severe property cycles. Considering the short history of market emergence is less than 20 years in a relatively small scale economy, the first property cycle in Hainan was accompanied by the excitement, uncertainty and struggle of the role-changing process of the state-owned sector and the emerging commercial developers both domestic and international. Thus the Hainan property development market in the 1990s was highly risky and uncertain.

## 5.3 Changes and control in the source of finance

Property development, especially for large scale commercial buildings, is a risky process. It requires the proper utilisation of various skills and market knowledge in running capital and information in an efficient way. Within this process, the skill of obtaining and utilising cash flows (project finance) is essential. The economic reform, in particular the land tenure system, the SOE reform and foreign trade policy, enabled investment funds to flow from various entities or financial institutions, mainly

the state-owned banks into the property sector in Hainan (Xie et al, 2002). However, it is now clear that there were major inconsistencies between the finance system and other parts of the economy during the structural change. The finance system was dominated and heavily controlled in project loans by the state via the banks. Table 1 shows the basic wealth structure by 1999 and the dominance of the state-owned financial institutions. Also, according to Yang (2000, p282), the amount of bank loans by the state-owned commercial banks comprised 77.6% of the total loans by the end of 1996 in the PRC banking system. In a planned economic system, the state-owned bank system remains the primary distributor and controller of all sorts of project finance. The state-owned banks had dominated the finance sector at the early years of the economic reform. Reform in the finance system has been a lengthy process and the finance system reform was not in the leading edge of the economic transition and has been conducted in a more conservative way. This reinforces the fact that the finance system was under rigid control through the mechanism that policy made by the central government can be implemented and enforced at different levels of the economic system. While this maintained stability and control, it also caused inconsistency within the economic structure. The market-state conflict is shown at this level and this indeed was one of the key characteristics of the economic system until recent years.

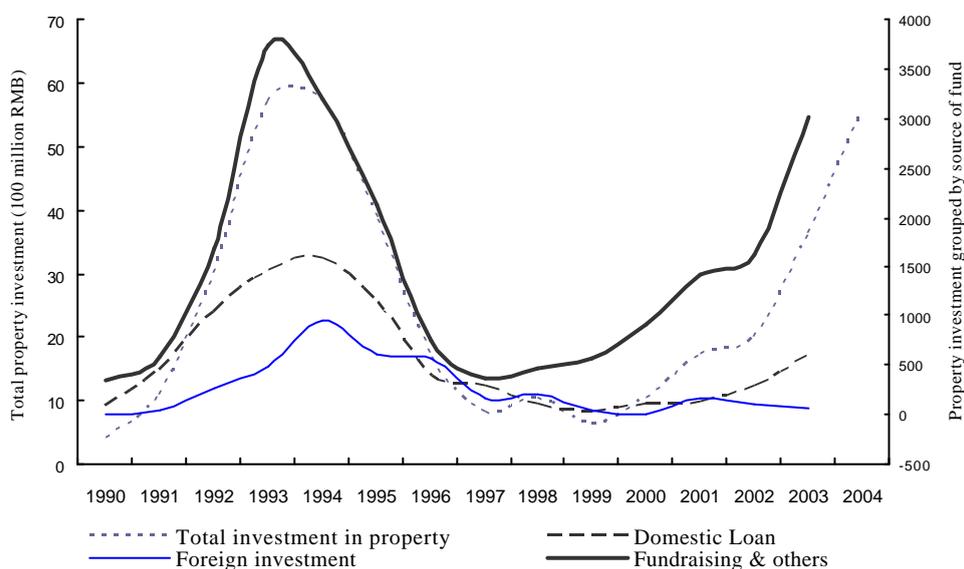


Figure 9 Property investments grouped by source of fund (Data source: HNBS)

This was certainly the case in the Hainan property market in the 1990s. Non-state-owned commercial banks and foreign finance institutions did not play a main role in the cycle in Hainan (figure 9). Large amount of domestic funds were able to channel into Hainan even with the control by the state-owned bank system. The source of finance for the property boom in Hainan in the 1990s is normally categorized under the streams of domestic and foreign funds, and the domestic funds were the dominant source for project finance, hence the focus of the analysis. Initially, capitals were drawn from different industries and sectors in different ways from various parts of the country into Hainan to take part in the property boom. In some years, the amount surpassed the formal bank lending amounts. However, the planned economy made these funds ‘manageable’ via the heavily central controlled banking system. When the state felt the property boom may threaten the stability of the economy, the macro-economic policy aiming to regulate the finance sector was put into place. The market was cooled down within a very short period because there was no alternative finance source, and foreign investors would not enter the market if there is a high level of uncertainty. This can be supported by the downward trend of foreign investment in the property sector until recently (figure 9). Liu (2003, p50) quotes a classic description of this phenomenon, ‘it soon gets chaotic if the (state) control is

released, and it dies instantly if the (state) control is reinstalled...’ In his recent work, Liu (2003) provides a detailed account of the process of changes in the finance sector in the economic transition.

Table 1 the finance system at 1999 (Unit: million RMB)

name	Total asset by 1999	Debt	Deposit & income	Lending & output
Bank system				
1 state-owned commercial bank	10,585,449	9,993,171	6,618,949	6,129,488
2 private commercial bank	1,149,730	836,932	836,932	574,899
3 urban com banks	494,180	471,010	382,240	230,820
4 housing bank				
state policy bank	1,374,123			
Insurance			124,700	55,600
Securities				
Rural cooperative trust	103,380	101,170	58,940	85,210
Investment trust	440,333	362,475	77,858	
Finance lending firm				
1 lending firm	180,970	157,310		
2 Financial firm	19,820	18,380	1,442	
3 Loan office				
China Post deposit	320,205	295,818		
Foreign financier	US\$34,180	US\$4,550	US\$26,050	
converted value (RMB)	282,327	37,583	215,173	
sum	14,950,517	12,273,849	8,316,234	7,076,017
Share of state-owned bank in the system	70.80%	81.42%	79.59%	86.62%

(Data source: Zhang and Han, 2002, p438-54)

#### 5.4 Instability and the speculative boom in the land market

One of the biggest achievements at the early stage of the urban land reform was the initiation of a price mechanism in attracting highest and best use on land. This redirected the way urban land use is allocated, which set the foundation for the emerging urban land market and in fact the entire property market system. In urban China, the state owned and still owns land. The supply of land for commercial development is predominately state-monopolised, which is also a main source of income for governments. In the short term, the urban land sector in Hainan in the 1990s may only be called a market in a weak form. The economic transition, either radical or conservative, aims to achieve socio-economic and political-economic objectives. However, the creation of the urban land market is not a simple exercise. The reform based on reformers’ perceptions on what it should be can only reflect a small proportion of the real story. This, at the early stage of the transition and especially in places such as Hainan, resulted in severe structural imbalance, which on the surface was demonstrated as the severe cycle in the 1990s. Basically it was the structural imbalance that made the Hainan property market volatile in the 1990s.

The leads and lags in the reform in relation to the emerging urban land market caused the coexistence of two types of land allocation systems, state allocation and market channels. According to Chinese law, urban land may be transferred through state allocation, negotiation, auction and tender. The first

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two heavily involve non-market mechanisms. The planned approach to land allocation was formally terminated in 2004. And the actual effect is still waiting to be evaluated. In the context of the 1990s property cycle, the imbalance and the coexistence of dual systems had created 'loose-holes', where land can be obtained through the state allocation channels for lower costs and re-distributed via the market for higher prices. It may be said that the problem occurred at the 'margin' where the structural imbalance or inconsistency of the land allocation systems created the tension to raise landed property prices. This had severely violated the immature urban land market and consequently played the main role in driving the property boom for the entire Hainan property market. Although the problems above may have been perceived by the state, it actually became unexpectedly serious because the state holds the ultimate rights on land. When the state realised that the speculative land boom could severely damage the economic performance and socio-economic stability as well as the income flow via sales of leasehold rights, policy was put in place to stop new land release and adopt restrictive land use control. This, together with the controls of the financial sector, became the main reason for the cool-down and the following recession.

## **6 Conclusions and discussion**

Conceptually speaking, Hainan has just completed one full property cycle since the appearance of the urban property market in the late 1980s. This cycle started during the upswing of urban and economic development in the late 1980s as the property started to emerge with the dual triggers of urban land reform and the establishing of the largest SEZ (special economic zone) province in China. The policy-driven cycle reached its peak around 1993 after the famous 'Chinese gold rush' began, and fell to a trough in terms of absorption in around 1996, and in investment activity in around 1998, since the state's soft-landing policy was put into place to regulate the financial and urban land markets. Until the late 1990s, the psychological 'damage' by the property crisis has caused the Hainan property market to lack further demand and policy incentives and hence investments. Since the early 2000s, new state policies have been slowly reinstalled in Hainan. A typical case is the state's initiative in revitalising non-performing property assets in Hainan. Although it may take the state some years to reach an effective solution for the task, the new movement will certainly have impact on property investment cash flows from various sources to enter Hainan and perhaps the beginning of a new upswing.

With the new upswing in Hainan becoming observable in recent years, the review of the 1990s property cycle in Hainan is intended to link the economic transition in the specific phase in the context of the Hainan property sector. History shows that the 1990s experience is not unique in terms of the relation between cyclicity and major structural changes of different types. It is 'unique' though in terms of the underlying mechanisms. The economic transition at its early stage defined the specific characteristics. Within the process, Hainan was particularly 'unique' because it adopted a radical approach in creating a property market system which was started at a special moment within China. It is clear that the state (central and local governments) has played the main role in virtually every stage of the change, especially in initialising and terminating the property boom, and therefore became the driver of the cycle. This is not surprising because the reform is a state-led process and the continuity of the planned economy regime also retains the government the capacity to directly intervene in the new property market mainly via finance and planning controls. The structural imbalance caused by the equally imbalanced reform process in different sectors has been proved a wasteful exercise. From the viewpoint of the nation as a whole, the Hainan case has an important experimental function and has been one of the pilot tests at the early stage of the reform that could offer valuable experience to lead to further changes in the economy, especially the emergence of a

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commercial property market. Overall, the 1990s cycle in Hainan that lasted for about 10 years is mainly state-driven and is considered to be an experiment conducted by the state in testing the radical approach of economic transition in the property and urban land sector. The result, either successful or unsuccessful, has become an invaluable asset for other property markets. The crisis was mainly due to the lack of real demand in this relatively small and structurally-weak economy. Consequently, the self-adjustment ability of the Hainan property sector is weak. This can be observed from the long recovery period mentioned above that has lasted for more than 7 years. The recent tendency of recovery in property investment seems again to be driven by state-led programs for handling idle commercial properties. This may foster new investment demand from both domestic and international domains. Although it is true that no two cycles can be the same in the development history of any city, the 'path dependent' nature of any human construct will ensure experience from previous cycle to be passed on to the next. This certainly applies to the Hainan property market, which is also applicable in larger and more complex property markets. New property cycles in China will still be closely linked with by the specific characteristics of the economic transition.

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