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Property and Housing Markets in Hong Kong: Issues and Analyses

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Efficient property and housing markets are important for urban and economic development. This is particularly so in Hong Kong because of the fast pace of economic development and the limited availability of land. Rapid economic growth has increased the demand for more and better residential, commercial, and other premises. The transformation of the Hong Kong economy from an export-oriented manufacturing base into a financial center and modern entrepot, fuelled by the outward expansion of the local economy into Southern China, is rapidly altering the existing pattern of land use. Property development and especially redevelopment have to fulfill these fast-changing requirements. This means that property and housing markets have to be allowed to respond effectively to the new environment. Free and unfettered markets provide the best assurance for meeting this challenge. This has been the key element in Hong Kong's successful economic development and has allowed her to meet the challenges of rapid economic growth under conditions of limited land supply.

Unfortunately, this element of Hong Kong's success appears to be in doubt. There are those who believe that free and unfettered property and housing markets do not work in the public interest, causing, for example, uncontrolled speculative activity. There are also those who believe that property and housing markets here are not free and unfettered, but are controlled by major property developers. Both look to government to establish measures to intervene in property and housing markets. This development is largely a consequence of the property market boom in 1991 and the persistent high inflation rates in Hong Kong. Government intervention in property and housing markets will have serious consequences for Hong Kong's economy, with repercussions for financial markets and public finances. This paper sets out to explain why this may be the case, so that public interest will not be inadvertently harmed by noble intentions.

Importance of Property and Construction

The importance of property and construction to the economy of Hong Kong is reflected in the fact that, over the period 1981-1991, some 25 percent of the gross domestic product was contributed by that sector. This contribution is greater than that of any other sector of the economy, including the whole of manufacturing. Over the same period, some 10 percent of the labor force was employed in property and construction, with approximately 8 percent in construction.

There is little doubt that property and construction is the major industry in Hong Kong. The economic fortune of this sector has a significant impact on both financial markets and public finances. In 1989, property and construction companies accounted for 45 percent of the market capitalization in the Hong Kong Stock Exchange. This is a conservative figure since it was obtained in the year when the stock market was severely depressed by the events at Tiananmen Square. Over the past decade, on average, more than 30 percent of bank loans were extended to property and construction-related uses and more than 40 percent of government revenues were derived from property and construction-related sources. The total value of properties in Hong Kong in mid-1992 was estimated to be $1,179 billion. This means that for each person, there is about $300,000, and for each household, there is about $1.1 million worth of property.

To claim that property and construction is the single most important element in preserving the economic and financial health of Hong Kong is by no means an exaggeration. This claim simply reflects the fact that land is scarce in Hong Kong, and its value has increased enormously because of rapid economic growth. For this reason, policies that impede the proper and efficient functioning of land and property markets will lead to misallocation of an extremely valuable resource. This will be very costly for society.

Property Markets and Inflation

There is now a generally accepted view within the community that the current high and persistent inflation is a result of the rapid integration between the Hong Kong and South China economies. The outward expansion of manufacturing processes into China accelerated rapidly after 1985. The result was to create an enormous boom in Hong Kong, led by the growth of re-exports. The demand for local services to support the growth of re-exports exerted enormous demand pressure on scarce domestic resources like labor and land. Wages and rentals have been steadily climbing since then.

It may be useful to draw a distinction between tradeable and non-tradeable goods. By virtue of Hong Kong's linked exchange rate system, inflation rates of prices, and wages of tradeable goods continue to grow slowly at world inflation rates. However, prices for non-tradeable goods have risen faster than world inflation rates because they are produced and used locally. For this reason, wages and prices in the manufacturing sector have generally risen less rapidly than wages and prices in the service sector because manufacturing is more tradeable than services. In this connection, one observes also that prices of domestic and retail premises have risen at a much faster rate than office and factory space in recent years. Offices and factories are occupied primarily by clients who can relocate elsewhere outside Hong Kong to pursue their economic activities. By contrast, domestic premises are occupied primarily by local residents, and retail premises serve primarily local residents for whom the choice to relocate elsewhere is less readily available. Offices and factories therefore provide a more tradeable service than domestic and retail premises.

The charts in Figure 1 also show that movements in property prices tend to precede movements in rentals. One may conclude simplistically and erroneously that an increase in property prices causes rentals to increase, and since rents are a component of the consumer price index, this would in turn push up inflation. This view is incorrect. The relationship between property prices and rentals is similar to that between stock prices and earnings. Stock prices rise in anticipation of improved earnings rather than the other way round. It is for this reason that the stock price index is considered a leading economic indicator. Similarly, property prices rise in anticipation of rental increases. Property price inflation is a result of and not a cause of general price inflation. In recent months, consumer price inflation has continued at its near 9-10 percent level and is forecasted to continue at that level in 1993 and perhaps even beyond. On the other hand, as a consequence of the 70 percent mortgage lending limit imposed on home purchases, property prices for domestic units have declined by 10-20 percent from their peak level. It is puzzling how one can continue to argue that property price increases cause general inflation.

Figure 1 shows clearly that the profile of inflation rates since 1980 bears no relationship to the profile of changes in rental rates, nor to that of property prices. It is important to note from Figure 1 that the recent surge in property prices since 1991 has not been accompanied by a corresponding surge in rentals. There is no reason whatsoever to conclude on theoretical or empirical grounds that the current property market boom is fuelling inflation. On the contrary, it is the current economic boom that has fuelled inflation and in turn caused a boom in the property market.

Under the linked exchange rate system, there is little scope for using monetary policy to tame inflation. Imposing a 70 percent limit on mortgage lending will slow down property price increases but not inflation. To reduce inflation, one has to focus on the supply of land and labor.

Rentals can rise in response to either increased demand for or reduced supply of housing in the market. Increasing the supply of housing will have the effect of slowing down the growth of rentals. This will contribute to reducing inflation and slowing down property price increases. However, the effect of increasing the supply of new land can only have a modest effect on inflation, as compared with increasing the labor force. Consider a policy that increases the annual production of land by 10 percent. Given that the annual supply of residential units is about 5 percent of the total stock of housing that is available in the market, the additional supply of land would probably increase the total stock of residential units available in the market by about half a percent. Consider an alternate policy that increases the labor force by 14,000; this would increase the available work force also by half a percent. There is little doubt that the latter policy will have a greater dampening effect on inflation simply because labor's share in the economy is at least twice as large as that of land. Moreover, it is also much more feasible to increase the labor force than it is to increase the supply of new land. An alternative way of increasing the supply of housing without having to increase the supply of new land is to make it easier to redevelop existing properties so that the effective supply of housing can be increased through the provision of more new units to replace existing ones.

The Property Market Boom

The property market boom in 1991 has been the focus of a great deal of attention. It is a mistake to view the property market boom as a recent and sudden phenomenon. In the years since 1986, overall property prices have risen at an average rate of about 25 percent per annum. In the first three of those years (the period beginning in 1986 and ending in 1988), property prices were climbing at the average rate of 24.8 percent per annum. This is a spectacular increase, considering that over the same period, Hong Kong experienced moderate inflation rates of 3-6 percent, positive real mortgage rates of 2-3 percent, and an average real gross domestic product growth rate of 11.3 percent. A natural question to ask is why did property prices experience such growth during this period.

The simple answer is that the demand for homes was growing faster than the supply. Since the mid-1980s, the annual supply of new private domestic units averaged 30,000-33,000 units. Demand was growing at a much faster rate due to a number of demographic and economic factors. Beginning in 1986, Hong Kong began to experience a surge of population in the home purchasing age group of 25 to 44 years. This fact is shown in Figure 2 and is expected to persist for some time into the future. The young population is typically composed of two-income families. These young families are also able to benefit enormously from the tight labor market conditions here due to economic integration with South China. Their ability to accumulate savings is clearly quite substantial. This is the underlying reason for the persistent robust demand for housing in the mass residential market.

The property market crash following the events at Tiananmen Square was brief. Property prices had recovered to their pre-crash levels by year-end and rose by 14.6 percent in the following year despite the uncertainties of the Gulf Crisis and the impasse over the Sino-British airport negotiations. In Figure 3 we projected forward to 1992 the level of property prices that would have appeared, on the assumption that property prices would continue to grow at that rate in the three years between 1986 and 1988. One finds that actual and projected property prices in 1992 were about the same. The 1991 property market boom can be interpreted as an explosive catching up effect. Had it not been for the uncertainties due to the events of Tiananmen Square, the Gulf Crisis, and the Sino-British airport negotiations, market prices would have arrived at their current levels anyway, but in a less spectacular and explosive manner. The fact that real mortgage rates became negative in 1991 because of persistent high inflation rates also contributed to the timing of the property boom.

Such an interpretation of the 1991 property market boom is justified by the general perception that the prospect of the Hong Kong economy looked much better in 1990 than in the mid-1980s. Investor sentiment and general economic confidence were clearly bullish as we entered the 1990s, whereas the benefits of economic integration with South China was only barely visible in the mid-1980s. Given that prime rates in Hong Kong cannot deviate significantly from those in the U.S. because of the linked exchange rate system, most people expect real mortgage rates to stay low or even negative. The public realized that it was profitable to invest in property as a hedge against persistent inflation. Any lingering doubts vanished when major uncertainties regarding the Gulf Crisis and the airport negotiations were cleared and when confidence in the continuation of China's reform grew.

The current property market boom is a result of many long-term economic and demographic factors. High inflation rates, low real mortgage interest rates, and rapid economic growth will continue to put pressure on housing prices unless supply can be increased.

Market Volatility and Investment Risk

One of the key features of property and construction cycles in Hong Kong is their high volatility. Quarterly gross domestic product figures for the period 1973-92 show that investments in property and construction were 2.8 times more volatile than gross domestic product. Market volatility is the primary reason there is so much misunderstanding about how property markets function. The observation that huge profits can be made during good times has generated the false belief that property markets do not function properly. It is alleged that abnormal profits are a sign of insufficient competition in property markets due perhaps to rigging by speculators and dominant market players. It is useful therefore to clarify the nature of property markets.

Figure 4 shows that fluctuations in the number of new private residential units built each year were quite extreme over the period 1957-1991, although there has been a general tendency for the fluctuations to become less extreme in recent years. Sharp drops in the number of new units completed were experienced in the periods 1958-1960, 1966-1969, 1973-1975, 1981-1983 and 1989-1990. Most were associated with either political or economic shocks that were external to Hong Kong. On occasion, both economic and political shocks occurred at about the same time, for example, during 1981 to 1983. Fluctuations in the supply of new premises are not limited to private residential units. The supply of nonresidential units is often even more volatile. Figure 5 shows that the usable floor space of completed new buildings for the period 1967-1992 were more volatile in the nonresidential market than the residential market.

Although the number of units that are produced each year is only a small proportion of the total stock of units in the market, the impact on market prices can be substantial. According to the 1991 Census, there were 1,702,127 permanent noninstitutional living quarters in Hong Kong, of which 855,111 were private units. During that same year, a total of 82,940 units were built, representing 4.87 percent of the total housing stock. The number of private units that were built was smaller at 40,728 units, representing 4.76 percent of the private housing stock. Consider now a small unforeseen increase in the demand for housing, say of one percent. This would increase the demand by 17,021 more units; an increase of more than 20 percent of the new units that were actually supplied. Such an unforeseen increase in demand would have resulted in a huge increase in housing prices instantly. Since most property development and construction projects often take at least two to three years to complete, the supply response to any unforeseen increase in demand for housing can only be met by a lagged supply response.

Investments in property and construction are forward-looking decisions based on expectations about market conditions in the future. Therefore, any error in market forecasts will lead to considerable volatility in market prices and housing investments. Figure 1 makes clear that property prices can both rise and fall. During 1982 to 1984, property prices fell spectacularly in the wake of unforeseen increases in interest rates caused by U.S. Fed policy to combat inflation and political uncertainty created by Sino-British negotiations over the future of Hong Kong. Similarly, property prices rose spectacularly in 1991 as the Gulf Crisis ended and the Sino-British airport agreement was concluded.

It is clear that investments in property and construction are high-risk activities driven largely by future expectations. The high returns that one observes in this sector during property cycle upswings have to be set against periods of low or negative returns. Higher risks naturally imply that a higher than average return has to be earned on property investments as compensation for assuming greater risks. Furthermore, unlike developers in countries like the U.S., where investment risks can be spread across different local markets, developers in Hong Kong take almost all their risks in a single local market. This would imply that for development to proceed in Hong Kong, even higher returns are justified. Spectacular profits need not reflect market failure, but the nature of property markets in Hong Kong.

Competition in Property Markets

Nevertheless, the recent property market boom has renewed public concern that our property markets are not functioning properly. There is a belief that since the property markets appear to be dominated by a few large developers, there is a problem of insufficient competition. This is an incorrect view and stems from the erroneous belief that a concentrated industry is necessarily uncompetitive. Large market shares can also reflect greater efficiency of large firms.

It is important to recognize that property market cycles tend to be fairly long, sometimes lasting for ten or more years. Correct decisions made at a particular point in the property market cycle can give a developer a huge advantage to build a large market share that will be difficult for others to challenge until the next property cycle. It is therefore not surprising for the industry to be dominated by a few large developers for long periods of time.

The crucial criterion for deciding whether a market is competitive is whether there are artificial barriers to entry, and the property market is no exception to this rule. Artificial barriers are not present in the property markets in Hong Kong. The allegation that developers conspire to fix prices is not credible unless one can demonstrate how they can prevent the entry of new competitors and maintain cartel discipline over existing participants. In the absence of legal or government-administered barriers to entry, prices fixed by cartels are inherently unstable because of the threat of new entry and the fear of chiselling by members. In Hong Kong, the fact that land, the most crucial factor in property development, has to be acquired in public auctions or in the open market demonstrates that there is free entry.

The huge lot sizes made available at public auctions have provoked the criticism thatlarge developers are being favored, since it is alleged that only large developers have sufficient resources to bid for these large sites. The public auctions have therefore been viewed as failing to promote competition in this sector. It is argued that government should adopt policies to ensure that small developers can bid successfully at public auctions. This argument is fallacious. There is nothing to prevent small developers from voluntarily joining forces to bid for large lots and developing them together. The fact that they have not always chosen to do so indicates that the problem is not the availability of funds, but whether small developers are efficient at developing large sites. A consortium of small developers cannot outbid a single large developer who is more efficient. Similarly, reducing lot sizes before putting them up for public auction would not necessarily favor smaller developers since they could still lose the bid to larger developers unless efficiency in developing smaller sites is negatively correlated with the size of the developer.

Given the limited supply of land available in the market, it is essential that every parcel of land should be put to the most efficient use. Public auctions serve that purpose well. It would be foolish to tamper with such an open and competitive mechanism. Furthermore, reducing lot sizes on offer in public auctions may not be desirable to the consumer. Most final users are typically willing to pay higher prices for units in a single large development because the total environment and neighborhood can be more effectively planned and designed. For this reason, large lots command a higher land premium as well.

Even if one stubbornly believes that developers do fix prices, it is important to note that their power to do so is necessarily limited to the primary market for new units and cannot extend directly to the secondary market for existing units, where ownership is dispersed. The figures in Table 1 show that the proportion of new private domestic units as a percentage of all assignments of undivided shares registered in the Land Office has been declining from 59.0 percent in 1981 to 34.6 percent in 1990. While these figures have to be interpreted with care, it is clear that even if the developers have the ability to fix prices, their power to do so must be declining. Indeed, in 1991 when the property market was booming, the share of new units to all transactions had declined to 22.3 percent, indicating that most of the transactions were in the secondary market and did not involve new units sold by developers. The belief that developers can fix prices in the property market is therefore highly doubtful. At the height of the boom, the market was dominated by transactions in the secondary market in which developers had little role.

Table 1

Year	**Assignments of undivided shares**	**Private new domestic units built**	**Percentage**
1981	51,547	30,425	59.0
1982	48,015	20,903	43.5
1983	48,264	23,522	48.7
1984	52,358	20,601	39.3
1985	73,791	34,613	46.9
1986	80,487	33,013	41.0

1987	94,436	33,629	35.6
1988	90,486	30,122	33.3
1989	87,676	30,621	34.9
1990	91,088	31,483	34.6
1991	182,997	40,728	22.3
1992 (Q1-Q3)	126,192	17,646	14.0

Conclusion

An efficient property market is vital to Hong Kong's well-being. The importance of this sector to the Hong Kong economy is large and growing. Rapid economic transition from manufacturing to services and growing prosperity present a challenging task for urban development and redevelopment to meet Hong Kong's changing needs. This task is best served by preserving the flexibility of free and unfettered property markets to respond to changing circumstances. Intervention in the property market will only reduce the effectiveness of the developers to respond quickly and will have long-term damaging consequences.

(1) The recent property market boom is caused by both demographic and economic factors that have been in operation since the mid-1980s. Demand for homes has grown much faster than the supply of homes, a situation that is likely to persist unless more homes are built.

(2) The view that the recent property market boom is fuelling inflation is incorrect. The case against such a view is strongly supported by facts. The decline of property prices due to the imposed 70 percent limit on mortgage loans has not lowered consumer price inflation.

(3) Government actions to increase the supply of land and labor can help bring down inflation somewhat. As a result of the Sino-British Joint Declaration, the annual supply of new land has been limited to 50 hectares each year. Because of rapid economic development, this will be increasingly inadequate. It is important that redevelopment of existing property be facilitated through speeding up the town planning application process, construction of support infrastructure, and enactment of facilitating legislation.

(4) Public concerns about whether property markets are functioning properly are misplaced. Market volatility is an integral characteristic of all property markets. Both prices and supply can fluctuate enormously, and so can the profits and fortunes of property developers.

(5) The fear that property markets are concentrated should not be confused with the lack

of competition in the industry. The acid test for competitiveness is whether there are barriers to entry. None exist. Indeed, the facts indicate that property developers cannot fix prices in periods of property boom because the market is dominated by transactions in the secondary market where prices are not set by developers.

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