Economic Analysis

April, 2005

A Publication of the BEA Economic Research Department

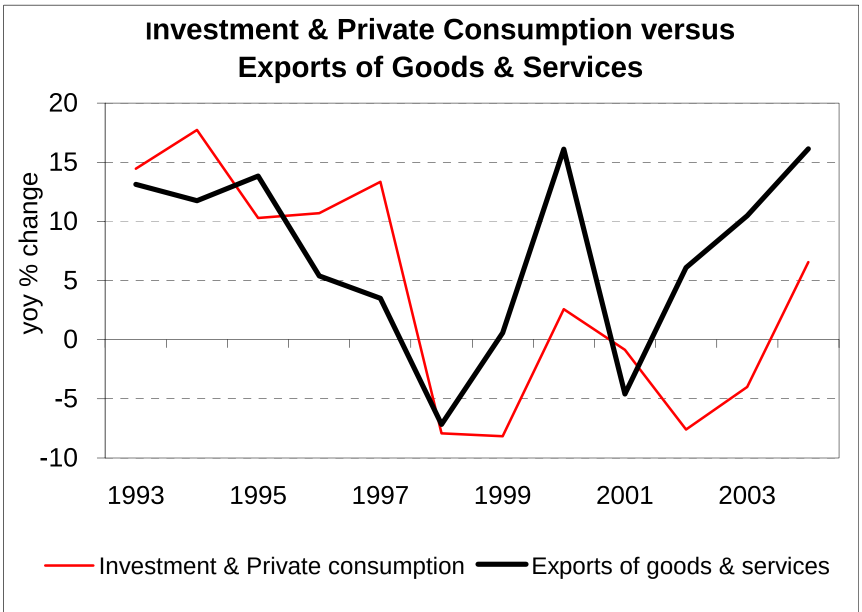
Re-examining the Role of Land Policy

A Decade of Misaligned Land Policy

Hong Kong is a small and open economy. Conventional wisdom dictates that our economy is highly susceptible to external shocks, and rather less responsive to local policy tools. Furthermore, under the Pegged Exchange Rate System, Hong Kong has surrendered its control over interest rate policy to the Federal Reserve of the United States.

Yet experience over the past decade suggests that the Hong Kong Government still retains a very powerful lever over the economy through its regulation of land supply. Specifically, an increase in land supply will put downward pressure on property prices and reduce homeowners' wealth, restraining consumption and investment activities. A reduction in land supply will produce the opposite effect.

From 1993 to 1997, the Hong Kong economy received a strong boost from the external sector, as exports of goods and services increased by an average of 9.5% in nominal terms. Domestically, interest rates trended higher and Government recorded large budget surpluses. These factors exerted a small restraining effect on the roaring economy. However, the political decision to limit annual land supply to 50 hectares per year throughout this period effectively added fuel to an already raging property market. The subsequent wealth effect through rising property prices led to rapid growth in consumption and investment, undermining all restraining measures.



Sources: Census & Statistics Department, HKSAR; The Bank of East Asia, Limited

The situation reversed between 1998 and 2003. The Asian financial crisis shocked the regional economy, reducing growth in Hong Kong's exports of goods and services to an average of just 3.6%. While falling interest rates and rising public expenditure helped ease the pain, these measures were insufficient to offset the negative impact brought about by Government's '85,000' policy, and property prices went into free fall. The 'negative asset' debacle shattered investment and consumer confidence, and sent Hong Kong into a deep deflationary spiral.

It is therefore not surprising that Government's land policy has been criticized for being misaligned to economic fundamentals, particularly during the period of 1998-2003. Back then land policy was burdened with many extraneous considerations, seemingly causing Government to lose sight of the policy's role as a macro tool to regulate economic activity. The '85,000' policy was introduced to provide affordable housing for the general public and to achieve a 70% homeownership rate. On the other hand, Government was dependent on land sale receipts, which amounted to 3% of GDP during the 1990s, for general revenue and to fund public housing development. In the end, the attempt to hit multiple targets caused land policy to miss the most important one of all – to generate a soft landing for the property market.

On the Right Track

The rebound in the Hong Kong economy coincided with Government's decision to strip land policy of its more problematic baggage, and to reaffirm its commitment to maintain stability in the property market. This provided an opportunity for Government to rethink and refine its land policy, refocusing on using land policy to regulate the economy. In an ideal setting, when the economy goes through a soft patch or faces a negative outlook, Government will pursue an expansionary policy by restricting land supply. As developers find it more difficult and expensive to replenish their land banks, they will slow down sales of their existing stocks in the primary market. In the meantime, the expectation of reduced housing supply in the future will encourage home-buying, providing support for property prices. Rising property prices will generate a wealth effect that helps cushion the negative impact from the anticipated deterioration of economic fundamentals.

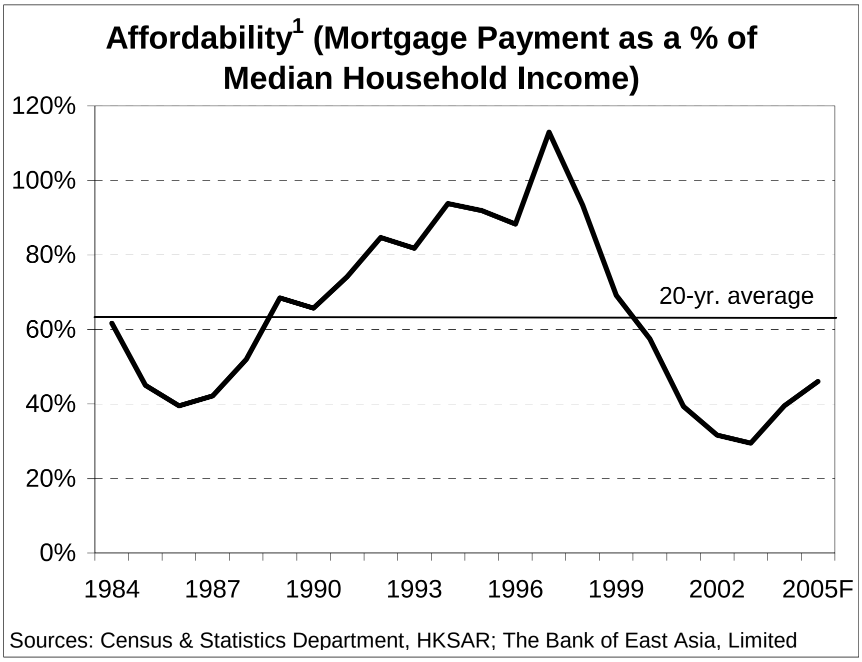
The key to success thus hinges on Government's ability to steer property price expectations along the path of its policy targets. This is undoubtedly a challenging task, as market response to Government policy is often difficult to predict. If policy action fails to deliver the projected result, Government will need to take prompt action to adjust policy in line with actual conditions. In the absence of any moderating influence, price expectations could build a momentum of their own and drive the property market and the economy further away from policy targets. The continuing plunge in property prices during 2002-03, despite the rebound in exports, was a case in point.

The application list-land sale programme became the sole source of land supply in the auction market at the beginning of 2004. Under the system, developers put down a deposit and propose a first bidding price for a site on the application list. If Government accepts the proposed price, the plot will be arranged for auction. The system gives Government full autonomy to vary the amount of land to be auctioned. This also saves Government the task of explaining and defending its policy stance and subsequent changes, as occurred before in the cases of the temporary suspension of land auctions and the '85,000' policy.

The Way Forward

Even though Government now has a more flexible and effective tool at its disposal, it remains uncertain whether it has a focused goal. Government's land policy has become more focused as the need to carry additional baggage diminished. With the drastic fall in housing prices from 1997 levels, housing has become more affordable. Also, the economic rebound has reduced the fiscal budget deficit to a more manageable level, easing pressure on Government to rely on land sales as a major revenue source. However, pressure to take on additional baggage could re-emerge if housing costs rise to higher levels or if a budget deficit returns. Government's skill in handling its land policy will again be tested under such circumstances.

That said, Government should be able to ride the current favourable conditions in the foreseeable future. Despite the rebound, property prices are still 49% below their peak levels in 1997. In terms of affordability, mortgage payment[1] accounted for only 39.4% of the median household income in 2004. The ratio would increase to 46.8% in 2005, if property prices rise by 10% and the prime rate averages 6%. This would still be significantly below the 20-year average of 65%. Hence, although property prices have rebounded 40% from their lows in mid-2003, property still remains well within the range of affordability for general households.



Not only are rising property prices in line with economic fundamentals, they are also appropriate given the current economic conditions. Unemployment rate remains high at 6.1%. Inflation is still mild and is projected to reach only 1.5% in 2005, with a significant portion coming from higher import prices. These figures indicate that the economy has yet to operate at its full capacity. In addition, rising interest rates will bring adverse impact on the economy, and a buoyant property market will provide an important support at this stage of recovery.

Conclusion

Hong Kong has learned a painful lesson from the boom-bust cycle of the property market in the past decade. Government's land policy was more powerful than either monetary or fiscal policy in influencing economic activity, as people reacted more adversely to negative net assets than higher interest rates or taxes. Given the importance of land policy in smoothing out economic cycles, Government officials in charge of such policy act as de facto central bankers. They cannot afford to be distracted and to pursue other goals simultaneously. With the economy and the property market returning to a more healthy state, it is time for Government to clarify and formalise the mandate of its future land policy.

[1] *Based on purchase of a 50 square meter housing unit with a 20-year mortgage at 70% mortgage-asset value ratio*