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Economic transition and commercial property markets: China and Poland

Dr Hao Wu
Faculty of Architecture Building and Planning
The University of Melbourne, Melbourne Vic Australia
haow@unimelb.edu.au

Professor Richard Reed
Faculty of Science and Technology
Deakin University, Melbourne Vic Australia
r.reed@deakin.edu.au

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Economic transition, property markets, business cycle, Poland, China.

Abstract
This paper discusses the economic transition and the property market emergence in transition economies. It compares the Chinese property market with the Polish market. It preliminarily examines market emergence and maturity in the context of economic transition, comparing the transitions with the emphasis placed on commercial property markets especially their formation and behaviour. Supply and demand for commercial space in China and Poland are also contrasted. As commercial property market behaviour is somewhat driven by market structure formation process and the business cycle, the transition has provided a “common ground” that enables similarities between the property markets in China and Poland. The challenge for state intervention is mainly due to the agency problem which is also a problem in mature markets; it appears that transitional economies do share common features in their emerging property markets. This paper suggests state intervention in market formation and emergence is necessary and essential. However the actual formation and behaviour of property markets have some distinctive characteristics. Value or implication of the study include: knowing the stage of market emergence is essential for making investment decisions, especially when identifying markets with varying backgrounds. This paper is also relevant to policy-makers in the process of facilitating transitions in emerging markets.
Transitional economies and emerging markets

Comparing the processes of economic transition between China and eastern European countries can offer significant insights about market emergence. However, detailed comparative studies on property markets in transition economies are rare and very uncommon for commercial property markets. Notably commercial property markets in transition economies are not yet well-understood as they are still rapidly evolving and are often more volatile when compared to residential markets. The general theory about commercial property or office market formation in a typical market system has been developed around the urban land bid-rent theory. However, studies of emerging commercial property markets in China showed the emergence of commercial property markets is directly related to the process of transformation from central city industrial-residential mixture based on the planned economy production mode to a market economy mode, where commercial, residential and other land use types are determined by the location theory (Wu, 2007). This paper adopts a comparative approach in the property market context. Three aspects are noted: 1) an identification of office market facts; 2) comparing property market structure, and business cycles and, 3) a common approach is to compare the approach and basic socio-economic structures of the subject matter. The first two sections are specific comparative analysis, while the third is mainly conceptual.

This paper is an initial attempt to identify key characteristics and in turn link commercial property markets to the economic transition, rather than trying to identify the reasons and explain why each market and economy undergoes economic transition. It examines the historical features of the transition in the two countries and the commercial property market formation. Commercial property market structure and key characteristics are reviewed briefly, where supply and demand fundamentals for commercial space are also examined. Also included are discussions about theories relevant to the behaviour, cyclical, and the underpinnings of commercial property market behaviour. Given the differences of the two economic systems, this paper uses the economic transition as a framework to set up a common ground for the underlying drivers of the two emerging commercial markets.
China and Poland

Basic profiles of the economies in each country are publicly available (e.g. the World Bank), where the two countries differ substantially in physical size, population, and the size of the economy (see table 1). The only identical characteristic is that both countries are experiencing a profound structural change – the economic transition.

Table 1. Basic facts about China and Poland

<table>
<thead>
<tr>
<th></th>
<th>Poland</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population, total (millions)</td>
<td>38.13</td>
<td>1311.8</td>
</tr>
<tr>
<td>Population growth (annual %)</td>
<td>-0.09</td>
<td>1</td>
</tr>
<tr>
<td>Life expectancy at birth, female (years)</td>
<td>79.6</td>
<td>72</td>
</tr>
<tr>
<td>Life expectancy at birth, male (years)</td>
<td>70.9</td>
<td>70</td>
</tr>
<tr>
<td>Poverty headcount ratio at $2 a day (PPP)</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>GDP (current US$) (billions)</td>
<td>338.73</td>
<td>2600</td>
</tr>
<tr>
<td>GDP growth (annual %)</td>
<td>6.13</td>
<td>10.7</td>
</tr>
<tr>
<td>GNI, Atlas method (current US$) (billions)</td>
<td>312.99</td>
<td>2000</td>
</tr>
<tr>
<td>Inflation, consumer prices (annual %)</td>
<td>1.11</td>
<td>3.6</td>
</tr>
<tr>
<td>Foreign direct investment, net inflows (% of GDP)</td>
<td>5.67</td>
<td>3</td>
</tr>
<tr>
<td>Unemployment, total (% of total labor force)</td>
<td>..</td>
<td>..</td>
</tr>
</tbody>
</table>

(Source: the World Bank 2006)

Being an early starter, China’s economic transition towards a hybrid market system started in the late 1970s and was followed by rapid economic growth between 1979 and 2007 (see figure 1). Since the mid-1990s the business cycle in China has been less volatile, representing a growth-led economy that is relatively robust and stable.

Figure 1. China’s economic growth 1979-2006

(Data source: China National Bureau of Statistics)
Compared to the Chinese economy, Poland’s economic transition in recent years has also generated sustained growth with an average real GDP growth of 4.2% 1995-2003 (Kucharska-Stasiak and Matysiak, 2005) although there are distinct characteristics to be noted. The reform or the transition in Poland was started in 1989, notably later than China, and has been commonly referred as “the radical economic transformation”. The Chinese approach has been widely regarded as “the gradualist transition” where there was significant level of difference in the mode of their structural change including the speed and level of privatisation. Some results from the Polish economic reform so far include Poland’s joining the European Union on 1\textsuperscript{st} May 2004, as well as being one of the youngest countries in Europe with a relatively cheap and well educated labour force. The country also set up Special Economic Zone and has established various incentives to boost economic growth. However the Polish economic reform was triggered by two main “disorders”, namely the structural problem of the previous economic system and the high inflation and massive shortage of goods (Woo et al., 1997). Historical data confirms the hype-inflation problem has been effectively reduced from 585.8% in 1990 to a very low level of 1.1% in 2006. However the unemployment rate has been 15% and above since the mid-1990s. Although similar problems existed in China this was mainly due to the social turmoil (i.e. the Cultural Revolution) between 1966 and 1976.

The Economic Transition in China and Poland
The different approaches and stages of economic transition among transition economies can be identified and better understood by undertaking a historical review of each economic transition. It was suggested that Poland’s transition has been directed towards a ‘final shape’ of rejoining the European market system; in contrast the Chinese model does not follow any existing reform theory (Woo, 1994). The reforming countries mainly differed in economic structures rather than with politics. Prior to the reform in Poland the biggest sector, in a similar manner to Russia, was the industrial sector. Both China and Vietnam had the agricultural sector as the biggest sector in the pre-reform era although industrial reform is much harder than agricultural reform (Woo, 1994).

Recent economic indicators show the transition in Poland has been effective in improving the economic condition (Gabrisch and Holscher, 2006). Balcerowicz et al.
(cited by Woo et al. 1997) reviewed “the Polish Way to the Market Economy 1989-95”. In other words Poland’s transition started as a gradualist process prior to the radical reform in the late 1990s, which had resulted in a hybrid system that is non-market and non-planned. However it suffered from severe mismanagement which resulted in socio-economic disorders such as hyper-inflation. The 1989 reform was not only a change of the transition mode, but at the deeper level a radical change of the political regime.

China has experienced different series of events. The economic transition was accompanied by the continuity of the political system along with the stability of the power to manage the country’s transition. In this case the approach to the transition has been more gradual. Overall the Chinese economy is highly sophisticated and the actual process of the transition, which is generally surprising to many, has been through “bottom-up” experiences or experiments. Policies were often formalised after the experience has been proved successful or effective (Woo et al. 1997), which in turn has led to a massive privatisation process in the form of a radical transition. The regime change in Poland was accompanied by a radical reform and privatisation process, although in contrast the continuing political system in China made the transition a more gradual process.

**Commercial space demand and market emergence**

Transition is a process of establishing the security of private property rights which has defined the basic conditions of property market emergence. The actual level of demand for commercial space is driven by the level of business activity. Poland’s privatisation occurred rapidly, although China has much more substantial pent-up demand for business activity and therefore for commercial space. For economies under transition, commercial space demands had different origins:

“The result of the overindustrialisation in the communist countries was that their service sectors were particularly underdeveloped...for China, the shift was from the agricultural sector to the service sector...In the case of Russia and Poland, the growth of the service sector took place at the expense of the industrial sector” (Woo, 1994, p.293).

In a mature market context, the nature of commercial firms is that they rarely allocate a large proportion of fund into illiquid physical assets such as buildings. Unlike residential markets, business entities rarely fully own the spaces they occupy. It is
common to rent/lease space or to build the area required, own the area, or lease the majority of the lettable area to other firms to gain income cash flow. The space (user) market is predominantly a rental market; the capital market is mainly an investment market based on income conditions. Notably there are only a handful of firms, such as public entities and listed property trusts, which prefer ownership with long-term cash flows and prefer commercial leases over a longer term.

It is commonly accepted that the demand for commercial space is a function of a number of key variables including economic growth and the size of the service sector. In transition economies it is essential to acknowledge the institutional changes that allow the potential space demand to be realized. Also importantly, the actual transition is directly linked to the current building stock in existing built-up areas because the costs for upgrading or replacing are substantial. In planned economies, the demand for commercial space for rental (or profit) purposes is limited. In other words, commercial property markets only begin to substantially evolve when an economic transition is in the right track. It should be noted that major Polish and Chinese cities are similar in this regard.

Following the rapid expansion of the private business sector in China, the commercial property market has developed substantially since the late 1980s and then peaked in the late 1990s. Poland’s commercial property market started to take shape soon after in the mid-1990s, where by the mid-2000s it had just completed a full cycle (PWC, 2007). The economic transition has enabled the market mechanism to function in the two countries, which in turn has led to varied levels of privatisation in the property sector and other parts of the economy. This has been accompanied by more open domestic and international trade, the flourish of profit-driven business entities and greater market competition.

**Market sources for sustained commercial space demand**

The employee numbers in the private sector, such as the service sector and private development and ownership of commercial buildings, are fundamental when seeking to increase commercial space demand and also to allow for investment-driven rental space market to grow. China has an urbanisation rate of 1% per year and the service industry is growing rapidly in major commercial cities. Figure 2 shows the growth of
the service-based industry in Guangzhou, the third largest commercial city in China. This upward trend clearly highlights the potential demand for commercial space.

**Figure 2. Service-based occupations in Guangzhou, China**

Prior to the Chinese economic reform, existing office stock was held mostly by SOEs and was not subject to leases or sales due to their public ownership status. Under the planned economic system, office supply formed part of the state resource allocation process which was controlled by state-owned firms who apply for approvals by demonstrating their office needs. In theory, it was only since the beginning of the transition that the demand for commercial office started to appear. The office market in Guangzhou commenced in the mid-1980s as a tidy, primarily hotel-based rental market which mainly served foreign and domestic firms that intended to establish local business outlets. The early form of ‘office’ market in China was primarily due to the changing business behaviour as a consequence of the economic reform and the supply lag for office space.

Poland’s commercial market development is closely linked to the process of joining the EU, since the level of market liberalisation and the formation and operation of the market system has been heavily encouraged by this unification process. In comparison, similar pressure on China is rather marginal. The unemployment rate in Poland is high, although it has decreased from 20% in 2002 to 14.9% in 2006 (Central Statistical Office, 2007). Poland started its transition relatively recently and the emergence of commercial markets leg even further. As a result most commercial property markets in Poland remains relatively immature with the only exception being Warsaw.
By and large, the economic transition is a process to facilitate the establishment of markets. Current literature relating to the economic transition highlighted major changes in the economic structure, which are in direct or indirect relationship to the performance and the overall stability of commercial property markets. Another key feature is the multiple roles that the state plays in various parts of the office market system, such as where the state is directly involved in the demand-supply interplay of property investment and occupancy. Thus it makes and enforces policies that govern property market transactions, as well as directly controlling money supply, production factors and public goods that are in association with property markets (Seabrook et al. 2004; Adams et al. 2005).

The unique and particular nature of the state ensures it is firmly entrenched at the centre of property market analysis in emerging market systems. Senior property experts in China suggested that changes in the commercial property market are directly related to state policy changes (Cao & Gao 2002; Wills & Jean 1999; Jones Lang LaSalle 2003). What they actually mean by state policy is often beyond the typical government’s role in mature market systems in remedying market failures. Furthermore, what they try to suggest is that the state’s comprehensive involvement in the economic system and its actions are able to substantially influence where and how market interactions and property cycles actually occur.

At the macro level the behaviour of firms is of main concern in office market system. However when considering the market reality in China, the analysis of a firm as an office user, investor or developer is predominantly focused on their supply-demand behaviour. The role of the firm is treated as a simplified variable that represents players in office markets and is used as the basic unit to analyse selected office markets. In other words their structure and internal settings do not affect the market system in the same scope as the state does. On the other hand, technological change and managerial innovation in industry and organisational behaviour and structure of firms play an essential role in emerging property markets, which by interacting with state policy will create the mechanism that affects commercial property market performance and stability. The economic transition was started from the typical state
ownership property rights system and the essence of the process, at least at the early stages, has been state-led.

The scope, depth, frequency, continuity and length of structural changes define the basic operational character of the Chinese economy. This, in the commercial property market in China, is particularly true because the transition implies that all these changes, both large in scope and substantial in depth, are compressed into a relatively short time period. Furthermore, the direct involvement of the state in the property market system also influences the market regarding the prices mechanism. The process is based on controls over production factors and general business and legal environments, which also affects office market performance and stability. Overall, there are two main concerns to be acknowledged:
1) key structural changes in affecting office market equilibrium; and
2) the direct involvement of the state in affecting office market stability.

The economic transition in China has differentiated its economic system from mature markets in terms of structural elements as well as individual industries and submarkets, including the office market system.

At a broad level the state-led transition has contributed to a number of factors occurring:
- positioning the property industry as the ‘back-bone industry’ of the economy;
- the profound change of the urban land tenure system (public leasehold);
- rapid urbanisation followed by demographic change;
- much easier and uninhibited flow of labour force in quantity and quality;
- the rapidly increasing number of privately owned firms;
- the level of openness to the global market;
- emergence of the asset market and financial reform (the state-owned bank system);
- the retention of strong state control in policy, law and enforcement; and
- government reform including planning and land management.

The policy emphasis of the property industry has its historical value in supporting the initial economic growth in China. However this also highlights the lack of understanding of commercial property markets, especially the nature of office demand
as a derived demand. It can be argued that the rapid growth of property investment in markets with insufficient effective demand is more likely to cause frequent price changes in the form of severe cycles.

In reference to the actual office markets in China, the economic transition has unique characteristics which in turn caused structural changes in the office sector. In other words these particular set of circumstances are rarely observed in typical market systems. Furthermore the change of the socio-economic environment also led to the demand for hence the emergence of commercial property submarket system; this includes a user market, an investment market, an urban land market and a development industry. In terms of the typical role of the government it is evident that strong land use controls and direct regulations have been imposed on both supply and demand. Banking system’s lending behaviour and the legal system in handling property-related issues are directly linked to macro-economic policy.

The level of privatisation and the status of a formal EU member assisted Poland in the establishment of a private sector driven development industry for commercial space supply. In China this tends to be more complex as major development firms often have a partial holding jointly with the State. The finance sector in China is not yet fully opened to the world economy, and the major state-owned banks retain substantial control over housing and development finance. It should be noted, however, that international investment in real estate has increased substantially since the late 1990s. Although generally more open when compared to China, the Polish commercial property investment market is relatively small given the size of the service sector and the size of the Polish economy.

**Transition, urban regeneration, infrastructure and commercial districts**

One of the key measures in emerging markets is the ability and capacity of the real estate sub-market structure to supporting property market activity. Urban regeneration, especially in inner city areas, is a major issue for both China and Poland due to the sustained demand for commercial and residential space. To enable proper development of commercial districts, infrastructure directed by the planning system is also heavily related to the change of demand for commercial districts. Major cities in China and Poland were developed although initially were predominantly focused on heavy industry, as was the associated infrastructure. It is clear that since the economic
transition both the existing building stock in urban areas and the infrastructure in major cities of the two countries have experienced substantial level of reconfiguration. China has allocated substantial resources into urban infrastructure development in major cities; due to such support Beijing and Shanghai have become the biggest commercial property markets of China. In terms of financial support, the high saving rate and the very strong resource reallocation power have played important roles.

In a comparatively similar situation, infrastructure reconfiguration and upgrades in major Polish cities have progressed relatively slowly and therefore have affected the development of property markets in these cities. The source of funds have been mainly from EU – for example approximately EUR 23 billion has been earmarked for road infrastructure until 2013 (PWC, 2007). Directly comparing the two countries highlights substantial differences in domestic and international demand as a major support for property market emergence in the transition process. The mode of privatisation in the two transition economies also resulted in different modes in infrastructure delivery. Poland has been developing public-private-partnership (PPP) in providing new urban infrastructure to support the growth of the property market (PWC, 2007), although China’s approach has remains as state-led with the public sector playing the central role. Arguably Poland’s interest in utilising PPPs is a natural consequence of its state-market interaction during the transition.

According to PWC (2004), the potential growth of the commercial property market in Poland is supported by the prospect of tenants becoming more interested in spaces related to anticipated growth in outsourcing, increased consumer demand despite the unavailability of commercial space in city centres, and new geopolitical reality. A direct result of the combined effect of emerging commercial space demand and the existing urban fabric is an increasing interest to redevelop or to regenerate inner-city areas, especially former industrial properties and its associated residential components in Poland and China. Poland’s implementing the redevelopment process takes the advantage that its previous property rights system has been transformed to a market-led system more quickly and fully than that in China. China, however, has the advantage of having more comprehensively developed and perhaps more effectively implemented a master plan in most of its major commercial cities since the 1990s. In
contrast, up until 2007 only 30% of the land in Poland was covered by master plans (PWC, 2007).

Overall the socio-economic system of Poland is much smaller in scale and much less complex in comparison to China. Notably both countries face enforcement problems with regards to planning policy, which in turn results in higher transaction costs and lower market transparency affecting the efficiency of commercial property market formation and operation. Both countries are seeking an effective way to clarify and support efficient land use, lower transaction costs, and property development certainty. Given the complexity of inner-city regeneration in transition economies, the rapidly expanding commercial property market has been supported mainly by planning and developing new urban areas such as new central business districts (CBD). This partially eases the troublesome process of transforming the existing building stock in inner-city areas.

**Concluding remarks**

When evaluating economic transition in the two countries, both China and Poland have a commercial property market which incorporates office, retail and other types of commercial spaces. In China, it is envisaged that the structural change (i.e. the actual transition) is the primary driver of the commercial property market. Poland’s commercial property markets are closely connected with the country’s history and the economic and political transformation, underpinning the need to adjust the property sector to a market economy environment (Rafal and Magdalena 2007). Considering the current and the potential risks in the Polish market, the differing economic environment also offers diversification opportunities (Kucharska-Stasiak & Matysiak 2005) and sound return for commercial property investors (Czarnecka and Adamska 2006).

The transition as a dynamic structural change process transforms the property rights system (Cox and Mason 1999). This viewpoint supports the basic demand for commercial property where this paper has identified some distinct and unique characteristics of commercial property markets in different transitional economies, both in terms of market behaviour and performance:

- Similarity is the profound and continuous structural change in all transitional economies – allowing commercial space and asset markets to expand;
• Differences in the reform, the economic, political conditions have created and maintained different paths in the formation and development of these markets; and
• For example, the structural change has facilitated substantial demand for commercial office space in transition economies. It should be noted however that this might not be the universal result of creating new central business districts as comparing Asian cities in China and Vietnam, and East European cities in Poland and Russia.

Prior to the growth of the market mechanism, there was limited or little demand for commercial space. The transition from a planned economic system to a market economy requires market-based service industry to emerge and to grow. The emergence of office markets are largely powered by the transition of the socio-economic system. However it is evident that the way the office sectors emerge and the growth varies between China and in Poland, mainly due to their economic base and timing of the business cycles both before and after the transition, as well as the approach of their transitions. Clearly economic transition is arguably the central driver behind the emergence of commercial property markets in China and Poland.

This paper intended to highlight and link comparable emerging property markets and their socio-economic changes due to the economic transition. Change of the mode of production of the economy is supported by the change of the market structure, where private ownership of property is the key incentives for commercial property market. It has been discussed that firms need to rent spaces as part of their business plan and operational model. This in turn has created or has led to sustained demand for commercial space in major cities, which, at least in China and Vietnam, has started to trigger the transition of urban physical environment. Differences between China and Poland regarding country-specific characteristics were also identified. This preliminary study linked the study of market formation and change (e.g. historic and current performance analysis) and the change of physical building stock (e.g. regeneration, new urban expansion or urban sprawl). This paper has successfully identified and highlighted the reason for the variations and different characteristics among transition economies.
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