Strengthening China’s Next Economic Mega-region

Research Report
August 2014
Executive Summary

The Capital Economic Circle presents an opportunity to improve efficiency

The aim of the Capital Economic Circle plan is to address the challenges of pollution, overcrowding, traffic congestion and income inequality in the region through top-down planning of the economic development of Beijing, Tianjin and the 11 cities of Hebei Province.
Inefficient resource allocation has created uneven economic development and a lack of coordination has created wasteful, redundant construction throughout the Capital Economic Circle, at a time when local governments are increasingly piling on debt. The “if you build it, they will come” economic development model has become broken, as the model only works if “it” has not already been built somewhere nearby and there is sufficient demand, which is becoming increasingly less likely given that China’s economic growth is slowing. The country is no longer able to easily grow its way out of the mistakes of inefficiency like it has been able to do in the past. Thus, the time is right for local governments to come together to tackle the problems plaguing the region, so that future economic growth and commercial real estate markets do not suffer.

There is 15 million sqm of new commercial space planned for Beijing and Tianjin by 2020. McKinsey Global Institute predicts that Beijing and Tianjin will experience, respectively, the second and third most rapid economic growth of all large cities around the world between 2010 and 2025. Such rapid economic growth suggests a significant portion of the new supply in Beijing and Tianjin should be absorbed, but the two cities are not the only places in the region with extensive commercial real estate pipelines. A lack of intercity government coordination and local governments not taking market driven development strategies have caused serious oversupply concerns in the Capital Economic Circle. To address these concerns, local governments will need to better coordinate their development strategies with each other and with the private sector, and build real estate and industry clusters that utilize their competitive advantages, instead of large new CBDs for which demand is weak.

At present, the Capital Economic Circle strategy is still not fully formed. We believe the plan would be strengthened by adopting more market driven approaches that emphasize the competitive advantages of each area. However, since the planning is still in the early stages, investors and developers are advised to take a wait-and-see approach with one exception – the non-bonded warehouse market. Historically, this property sector offers higher returns than other commercial real estate classes and given the robust growth of the retail markets in northern China, we expect it to continue to do so.

Tremendous opportunity to unlock potential in the commercial real estate markets exists within the Capital Economic Circle, but for investors and people within the region to realize the full benefits, the government is advised to implement the following strategies:

- Build better infrastructure and transportation networks
- Base development strategies around an area’s competitive advantage
- Keep incentives, such as subsidies and tax breaks, unified across the Capital Economic Circle
- Let the private sector take the lead in commercial real estate development
## Capital Economic Circle Map

<table>
<thead>
<tr>
<th></th>
<th>Beijing</th>
<th>Tianjin</th>
<th>Baoding</th>
<th>Shijiazhuang</th>
<th>Handan</th>
<th>Xingtai</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million)</td>
<td>21.2</td>
<td>14.1*</td>
<td>11.4*</td>
<td>10.5</td>
<td>10.1</td>
<td>7.6</td>
</tr>
<tr>
<td>GDP per Capita (thousand)</td>
<td>93.2</td>
<td>99.6</td>
<td>26</td>
<td>43.6*</td>
<td>32.7*</td>
<td>22.3</td>
</tr>
<tr>
<td>Retail Sales of Consumer Goods (RMB billion)</td>
<td>837.5</td>
<td>447</td>
<td>122.1</td>
<td>218</td>
<td>110.6</td>
<td>70.8</td>
</tr>
</tbody>
</table>

Source: JLL Research and Government Statistics Bureau
Note: numbers marked with an asterisk (*) are from 2012
What is the Capital Economic Circle?

**Building a brighter future**

The Capital Economic Circle (also known as the Jingjinji, 京津冀) is a plan designed to tackle pollution, overcrowding, traffic congestion, income inequality and inefficient resource allocation in the region through better integrating the economic development of Beijing, Tianjin and the 11 cities of Hebei Province. The plan aims to improve upon fragmented and overlapping development around the region using centralized, top-down planning and resource allocation.

**Key objectives of the Capital Economic Circle**

- Optimize the industrial layout and the allocation of resources for the region
- Enhance transportation and industrial infrastructure to reduce travel times between the region’s cities
- Fortify environmental protection efforts and reduce pollution levels
- Improve public services, particularly in Hebei Province, by adding hospital and university branches affiliated with institutions in Beijing
- Move some administrative functions outside of Beijing to the surrounding cities

First mentioned in the media in 2004, the Capital Economic Circle was formally announced by the Central Government in the “2011-2015 Five Year Plan” in October 2010. Little progress has been made, and pollution and overcrowding have pushed this initiative back onto the agenda.

**Reasons to create the Capital Economic Circle**

- Uneven economic growth around the region and a low standard of living in Hebei Province
- Talent drain in Hebei Province and Tianjin
- Poor air quality around the region due to heavy polluting industries
- Overcrowding due to an influx of migrant workers, particularly in Beijing
- Demand for better infrastructure and social services as well as affordable housing

<table>
<thead>
<tr>
<th>Stage 1: Infrastructure construction and industry transfer</th>
<th>Stage 2: Reduce pollution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction of expressways, intercity rail lines and subway systems</td>
<td>Close older and inefficient factories</td>
</tr>
<tr>
<td>Industry transfer out of Beijing to Tianjin and Hebei</td>
<td>Reduce overcapacity</td>
</tr>
<tr>
<td>Relocate heavily polluting industries (e.g. steelmaking)</td>
<td>Introduce and enforce stricter emission policies</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tangshan</th>
<th>Cangzhou</th>
<th>Zhangjiakou</th>
<th>Hengshui</th>
<th>Langfang</th>
<th>Chengde</th>
<th>Qinhuangdao</th>
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</thead>
<tbody>
<tr>
<td>7.5</td>
<td>7.2*</td>
<td>4.7</td>
<td>4.5</td>
<td>4.4</td>
<td>3.8</td>
<td>3*</td>
</tr>
<tr>
<td>79.6</td>
<td>38.9*</td>
<td>29.9</td>
<td>23.1*</td>
<td>40.6*</td>
<td>33.8*</td>
<td>37.8*</td>
</tr>
<tr>
<td>172.5</td>
<td>88.6</td>
<td>49.5</td>
<td>48.6</td>
<td>63.7</td>
<td>39.3</td>
<td>50.9</td>
</tr>
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</table>
Why is the Capital Economic Circle important?

**Competition is creating waste**

Beijing, Tianjin and Hebei Province have been able to prosper over the past decade in spite of not being fully integrated. However, with the Chinese economy slowing, these two municipalities and province will need to work more closely together to form synergies that allow all three areas to thrive equally. The current lack of coordination has resulted in lumpy growth, with Beijing and Tianjin receiving the most economic benefits, and Hebei Province remaining relatively poor. In addition, under the current structure, the region’s municipal and provincial governments are given broad economic and development targets that cause them to compete against one another. This competition has led the local governments to fight over companies and industries by trying to offer the lowest business taxes and the highest subsidies, which is great for the businesses, but hurts the local governments’ revenues, at a time when local governments are increasingly piling on debt.

In theory, competition is good, but it continues to perpetuate uneven growth. Because of the size of the Beijing economy and its political gravitas, Tianjin and Hebei Province have trouble retaining talent and improving the quality of economic growth. In essence, the current system causes a circular effect, in which Beijing continues to attract the most economic resources because it has the most economic resources. While Tianjin has been able to carve out an economic niche for itself, despite being overshadowed by Beijing, Hebei Province continues to be left behind.

The uneven economic distribution has led to Hebei Province attempting to play catch-up with Beijing and Tianjin, trying to reach the economic level of both municipalities. In their attempts to “keep up with the Joneses”, the three areas have created overlapping development strategies that will have a detrimental effect on each. For example, Tianjin wants to create the largest financial center in north China, but Beijing’s Finance Street already serves that function and construction is underway to expand it. Hebei Province aims to build up Caofeidian with features such as a large, deep water seaport, eco-city and industrial parks, similar to Tianjin Binhai New Area. By adopting similar development strategies, each local government is creating excess capacity and space based on demand that has yet to materialize. The “if you build it, they will come” model only works if it has not already been built somewhere nearby and there is sufficient demand, which is less likely to be the case given that the growth of the Chinese economy is beginning to slow.

**Competing areas**

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**Finance Street**
Beijing

- **Function:** Major Global Financial Center
- **Current Land Area:** 1.18 sq km (2013)
- **Future Land Area:** 1.59 sq km (2020)
- **Current Commercial Space:** 2.25 million sqm (2013)
- **Future Commercial Space:** 1.65 million sqm (2020)

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**Yujiapu Financial District**
Tianjin

- **Function:** Major Global Financial Center
- **Current Land Area:** 1.01 sq km (2013)
- **Future Land Area:** 3.86 sq km (2020)
- **Current Commercial Space:** 0 sqm (2013)
- **Future Commercial Space:** 3.04 million sqm (2020)

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**Tianjin Binhai New Area**
Tianjin

- **Function:** Economic Development Zone with Large Deep Seaport, Eco-city, Petroleum Production and Industrial Parks
- **Total Land Area:** 2.270 sq km (2013)
- **Sino-Singapore Tianjin Eco-city:** 30.0 sq km (planned land area by 2020) 350,000 population (2020)
- **Tianjin Port:** 501 million tons (2013)

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**Caofeidian Industrial Zone**
Tangshan

- **Function:** Economic Development Zone with Large Deep Seaport, Eco-city, Petroleum Production and Industrial Parks
- **Total Land Area:** 210 sq km (2013)
- **Caofeidian International Eco-city:** 74.3 sq km (planned land area by 2020) 1 million population (2020)
- **Caofeidian Port:** 245 million tons (2013)

Source: Municipal Government Websites, Media Reports, JLL Research
Competition between Beijing, Tianjin and Hebei Province is creating waste and inefficiency. To remedy this problem, an integrated development approach is needed that utilizes the strengths of each area. For example, the competitive advantage of Hebei Province is its lower labor and land costs, which would be good for the logistics sector, while Tianjin has good infrastructure and a seaport that make it ideal for shipping and advanced manufacturing. By cooperating and utilizing their competitive advantages, the municipalities and province can grow the economic pie, while each area of the Capital Economic Circle experiences robust growth. Furthermore, by working together, each area can have a clearer picture of what the other is doing, reduce overcapacity and competition for the same companies and industries and adopt more complementary development strategies that will allow the whole region to flourish.

**Beijing is overcrowded**

Beijing residents enjoy many advantages in the form of higher salaries, better education and medical resources and a more entertaining and lively environment. These advantages are why people have flocked to the capital in droves. Since 2004, Beijing has added roughly 6 million new residents – more than the population of Denmark. Today, the official registered population in Beijing is more than 21 million. However, since many people move to the city and do not register, the population of Beijing is likely much larger than the official numbers. Beijing is now beginning to buckle under the weight of its population and is facing several negative externalities because of its large population. Key challenges that the city is facing are:

- The large swath of the population being priced out of the housing market
- Rampant air pollution
- Incessant traffic jams
- Overburdened social resources
- Overcrowding

As these issues persist, they present social and political challenges to the government, particularly regarding the risk of social unrest.

To solve the population pressure problem, Beijing is looking to limit further population growth. To do this, the government will need to cooperate with the surrounding cities, as reducing the population will be no simple task. In the past, uprooting residents led to a backlash from the displaced people, and this could happen again if residents are forcibly moved to places that do not offer the same economic opportunities or social benefits. Therefore, Beijing will need to move some of its better industries to Tianjin and the cities of Hebei and establish branches of its reputable hospitals and universities in these areas. This will make having to move out of Beijing a less bitter pill to swallow.

**Land needs to be better allocated**

Undeveloped land has become increasingly scarce within core areas of Beijing and the city has had to focus on relocating people out of some areas in order to facilitate development plans. For example, several residential buildings in Beijing’s Finance Street are hindering the development of new office buildings. As people are still living in these residential buildings, the local government must focus on relocation efforts before new office buildings can be constructed – a very slow process. Local governments should not be using resources to relocate people so that additional commercial space can be built in the region, but should be ensuring that the space already built is used. Doing this will help property values, which will be beneficial once the government implements its long-anticipated property tax, and generate higher tax revenues across the region.

However, because of the large share of revenues generated by land sales and associated taxes and a lack of coordination, each local government has become overly reliant on the sale of commercial land to generate tax revenue and in the hopes of creating large commercial centers for future tax revenue. This has caused a misallocation of commercial land, as local governments have not taken into account supply and demand dynamics or the long-term health of developers’ balance sheets. The result has been pockets of oversupply in some areas of the Capital Economic Circle. By working more closely with developers and end users, local governments can achieve a more sustainable supply and demand balance.
What are the implications for the real estate market?

Reduce oversupply concerns

The competition between the municipalities and the province is creating oversupply concerns. Both Tianjin and Hebei Province are trying to emulate the success of Beijing. This situation is leading to Tianjin and cities in Hebei attempting to build new office towers and commercial areas that rival Beijing’s CBD and Finance Street. These attempts are concurrent with Beijing’s plans to expand both the CBD and Finance Street as well as establish new commercial centers in Daxing, Tongzhou, Lize, Dongba and Wangjing. Looking just at the cities of Beijing and Tianjin, there is more than 15 million sqm of commercial space planned to complete by 2020. It is very unlikely that all of this space will complete on time, but the mere fact that so much space is planned for the two cities is worrying. At current growth rates, there will not be enough demand in the region to justify such a large expansion of commercial space. Moreover, smaller cities in Hebei Province that are planning new CBDs will run a real risk of oversupply, since many of these cities have only small service sectors.

By cooperating more fully, the hope is that fewer cities in the region will try to build the next great commercial center and will instead focus on utilizing their competitive advantages and allowing the private sector to figure out what is needed in terms of commercial real estate. Few cities in the Capital Economic Circle need more office space, and by working together and closely with the private sector, the local governments can determine which areas are best suited to be commercial markets.

Increased demand for buildings outside the capital

One of the parts of the plan that has been discussed is getting SOEs to move from Beijing to surrounding cities. This means that office, retail and residential demand is going to increase in cities outside Beijing. Many of these cities have already started to build more commercial and residential space and have buildings available to accommodate the influx in demand. SOEs relocating outside the capital will be a boon for developers in surrounding cities, where oversupply is becoming a serious concern. However, Beijing would need sufficient demand to replace companies that relocate, or else face high vacancy rates.

The completions of Daxing International Airport and the second terminal at Tianjin Binhai International Airport are likely to drive demand for logistics parks similar to Beijing Airport Logistics Park near Beijing Capital International Airport, as international and domestic air freight companies will need modern warehouses in order to facilitate operations. This means that more land will need to be allocated to logistics warehouse usage – a market that has been undersupplied in Beijing in recent years.
What should investors be doing?

Grab a chair …
At this point, the plans for the Capital Economic Circle are still largely unclear. While there have been announcements of cooperation agreements and businesses leaving the capital, all other information has been based on rumor and conjecture. With nothing confirmed by the government, the majority of real estate investors should take a wait-and-see approach, if they want to make investment decisions solely based on the outcome of the Capital Economic Circle plan.

… unless you are interested in warehouses
Regardless of the plan’s results, warehouses will still be one of the better investment opportunities in the near future. Over the past couple of years, warehouses have offered some of the highest gross yields of any commercial real estate asset in the country, particularly at a time when domestic institutional investors have been purchasing office buildings at gross yields of 5-6.5%. The Capital Economic Circle has been a prime area for warehouse investment and has offered investors some favorable returns, with recent transactions occurring at gross yields of 7-9%, which is a much higher range than can be found in the office and retail markets in the region. Going forward, yields are expected to compress as the market faces a warehouse supply crunch. Investors and developers should be looking to invest now in Capital Economic Circle warehouses before warehouse yields converge toward those of other commercial property sectors. Moreover, places such as Hebei Province’s Langfang and Tianjin’s Wuqing District are strategically located between some of China’s largest population centers and retail markets, which are key drivers for warehouse demand. However, while opportunities are plentiful across the region, investors will still need to conduct due diligence on assets, because not all warehouses are created equal.
JLL’s View

The way forward will not be easy, but it will be better than the alternative

The limited cooperation between Beijing, Tianjin, and Hebei Province has led to inefficiency and unbalanced growth in the region. Beijing has benefited most from the status quo, as the capital has received most of the area’s resources in the form of intellectual talent, natural resources, investment, capital, and the companies and industries that followed. However, if the current trend continues, Tianjin and Hebei Province will continue to battle each other and Beijing for limited resources, to the detriment of all parties involved. The risk is that Beijing will begin to implode under the weight of congestion, pollution and a growingly dissatisfied population, all of which threaten to hinder the capital’s future growth. Tianjin will continue to experience robust growth with thriving service and manufacturing sectors, but will eventually encounter the same development problems as Beijing, while Hebei Province will remain relatively poor and underinvested.

The best way forward is for the local governments of Beijing, Tianjin and Hebei Province to establish a cooperation framework that allows their economies to become more robust and take advantage of their strengths. How they will work together to form a symbiotic relationship is still unclear, and many key challenges remain.

The Central Government still needs to get the Beijing, Tianjin and Hebei Province governments to buy into the plan. When integration plans of this nature are put forward, it can be challenging to get all parties fully on board. For example, when Tianjin merged Hangu, Tanggu and Dagang districts into Tianjin Binhai New Area, it was a slow process, with each district government reluctant to relinquish its political autonomy. For Beijing, Tianjin and Hebei Province, which are much larger, getting them to surrender some control or economic advantage will be problematic. Already we are seeing examples of this. In April, the Beijing Government issued a list of the first 200 companies that it wanted to relocate to Tianjin and Hebei Province; the list included companies mostly engaged in highly polluting or high-energy consuming industries. As a result, Tianjin and Hebei were unsatisfied with the list of the first companies offered. Getting all parties to mutually benefit so that they want to work together will be a challenge that is not easily resolved.

Moreover, even if a list of companies is agreed, getting people to move out of Beijing or even Tianjin is going to be a hard problem to solve. If companies do move and their employees choose not to follow, finding talent to replace them in Tianjin and Hebei Province will be a human resources nightmare, as the talent pool is not distributed equally across the region. Finding ways to adequately incentivize employees or increase the talent pool in cities outside Beijing will be a major challenge for companies and local governments.

Tremendous opportunity to unlock potential

Until formal plans are announced and it becomes clear how the Capital Economic Circle will evolve, investors should take a wait-and-see approach to investing in asset classes other than non-bonded logistics. However, over the medium-to-long-term, if the Capital Economic Circle plan is successful, the development of new areas will translate into new opportunities for residential, business park, office and retail property investors. Getting involved at the early stages of development could yield high returns for investors with some flexibility in their time horizon.

Integration of cities within the Capital Economic Circle offers potential to open up a range of opportunities. The project will create jobs across several industries, improving livelihoods and the standard of living, particularly in Hebei Province, at the same time reducing congestion and pollution in Beijing and Tianjin. Although careful consideration must be given to which companies are relocated and how the process is implemented, integration of the Capital Economic Circle is a tabula rasa upon which city planners can avoid the mistakes of the earlier generation of “new area” superblock cities. With so much commercial space expected to complete in the region in the next few years, the success of commercial real estate markets will be dependent upon the economic growth of the region, so it will be important that planners set the right strategy. Our suggestions to planners for improving the development of a healthier property sector in the region include:

1. Build better infrastructure and transportation networks. More infrastructure is needed to improve connectivity within and between cities in the region, but new infrastructure should not simply be based on existing designs or new areas will suffer the same problems faced by Beijing. Specifically, subway platforms should be longer to accommodate trains with more cars and transfers between subway lines should be shorter in order to reduce commute times and encourage ridership. Lines capable of handling faster trains, similar to Beijing’s Line 6, should also be constructed. Express trains to and between key CBD areas would allow people to live further away from their place of work with less hassle. Cities in Hebei Province need to begin construction of new subway lines in advance of demand for public transportation resulting from relocation. Once these cities become better connected, more companies will view these cities as viable alternatives to Beijing. Businesses do not want to be in places where travel is inconvenient. And as more companies move to an area, demand for commercial and residential real estate will grow.
2. Base development strategies around an area’s competitive advantage. Not every city needs to be China’s next big financial center. Beijing should utilize its strength in having the country’s Silicon Valley and a large skilled talent pool, while Tianjin builds and improves upon its position as Asia’s aviation hub and north China’s most important seaport. Cities in Hebei Province have the advantage of being places that are cheaper for businesses to operate, as cities in Hebei have cheaper land and labor costs. By leveraging competitive advantages, local governments will no longer attempt to build commercial centers for industries that have no valid reason to exist in those cities.

3. Keep incentives, such as subsidies and tax breaks, unified in the Capital Economic Circle. By unifying incentives across the region, cities in the Capital Economic Circle will compete with other areas of China for companies, but not with each other, in the race to attract industries. This will give cities in the Capital Economic Circle healthy competition with other areas of China, which is good for innovation and development as well as leveling the planning field in the region. Companies will no longer just go to Beijing because the capital has offered the best tax incentives. Unified incentives will lead to more balanced demand for commercial real estate in more cities.

4. Let the private sector take the lead in commercial real estate development. Local governments should get out of the business of developing commercial centers primarily on their own. The “if you build it, and they will come” strategy of the past is not working to the same degree as it once was. China was able to grow its way out of oversupply scares in the past, but the economy is shifting into a new stage of growth and the days of double-digit growth are likely gone. Thus, local governments should let developers, agencies and end users determine where and when to allocate land. This will serve to alleviate pent up demand in supply-constrained property sectors while reducing oversupply risks in others, particularly in Hebei and Tianjin.

By Durrell Mack and Christopher Clausen with special thanks to Chelsea Cai, Lesley Chai, Tin Sun and Emily Cao for their contributions to this paper.