**RESEARCH ON THE PROBLEMS OF THE REAL ESTATE MARKET BUBBLE AND THE POTENTIAL FINANCIAL RISK IN CHINA**

**BY**

**<STUDENT NAME>**

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**CHAPTER ONE**

**INTRODUCTION**

* 1. **Background of the research**

The housing market is a robust industry that is well structured, unlike the stock market where the investors are ready and bound to the stock prices to fall. When most people invest in the real estate market the expectation of the investors is that the value of the real estate investment will remain steady and more so the decrease in the value is not typical scenery. However recently real estate market has been hit by the pricing bubble, despite the real estate market not being subjected to large transaction cost of the purchasing a property(Levitin & Wachter, 2012). The main reasons as to why the decrease in value of property is subjected to the carrying cost owning and the maintenance that discourages the speculative behaviour.

The real estate bubble is a type of economic simmer that is bound to happen at regular intervals both the local housing scenery and the global real estate markets. In a typical manner, the real estate bubble happens following a un-precedent increase in the valuation if the real estate properties. This property includes the housing elements until they reach unsustainable levels, the events which are commonly known as the land boom is then followed by a decline in the bubble.

According to Holt (2009), real estate bubble is closely linked financial identity to the economic lax, through the lax monetary policy and the financial innovation contributes to the bubbles in the housing market. However, the causes of the real estate bubble differ according to the economic and financial setups of a given country and the regions. In many instances, the real estate bubble in the global scene is highly related to the financial crisis and the great recession that hit economies in a global reach.

* 1. **Scope of the study**

About Simon (2011) paper on the recipe for the formulation of the scope of the study, this study addresses the problems of the real estate market bubble and the potential financial risks in People’s Republic of china. The study will be focused on the activities and the entities that cause the problems of the housing bubble and the financial risks associated with the bubble to happen. In addition the study will be able to analyse the processes and the forces that comprise the standard development agendas in the real estate business in china. The most associative question that will motivate the researcher undertaking this study will be on the is the negative impact that affects china’s capital inflow on the real market industry.

In relation to Fang, Gu, Xiong & Zhou (2015) position this study will also incorporate the overreaching aim of this particular study to have it investigate the current real estate practices in china and the close link will be drawn towards the financial risks associated with the real estate market fluctuations. The research study will mainly focus on the specific goals. By addressing these goals in the form of a question, the finding will help to formulate an understanding of the entire real estate bubble and the associated financial risk. The urgent call of understanding the housing bubble more so in china has been hit by the inadequate information that elaborates on the effects of the whole scenario. According to Chen & Wen (2014), noted that without an observed and the conceptual insights that contribute to the understanding of the process and conditions under which the real estate bubble in china is bound to happen. However the milestones to create changes and the underlying reforms to the existing known environment, processes and condition may in the reality turn out to be the guiding principal that will offer solutions to the negatively associated problems. By applying the following specified aims, they will be able to guide the study to provide a solution and moreover give an understanding of our research scope.

* How is real estate a important force for china economic development
* What’s are the effects of real estate market bubble
* What is the positive impact of international capital inflow on the china real estate?
* What is the negative impact of international capital inflow on Chinese real estate market?
* What are the influences of real estate bubble to the Chinese real economy?
* What measures can be put inplace to prevent and ultimately offer a solution for the real estate bubble

This dissertation sought to examine these statements in the relation with the real estate bubble and the associated financial risks.

* 1. **Rationalization of the study**

One of the prominent results of a real estate bubble is a hitch in the economy. The rapid growth of the home prices in china over the last one decade. The authorities have been on an up task motion that will enable the players to realize the soft landing scene in the real estate market even if the bubble exists forthwith. The achievement of the soft landing is very essential given that the real estate investment and in particular the residential real estate investment contributes to 0ne-sixth of the china’s economy growths. The inquiry on the effects of the low curve of the real estate market in some regions of china and their effect on triggering the financial crisis will be effective in determining the interrelation of the china’s real estate bubble with other bubbles experienced in other parts of the world including the one in the United States.

The changes in the china’s housing systems and the associated landscapes in the real estate market as affected by the systems can be summarized and a provision of the policies and the home ownership entitlement defined. In china the existence of the possible regional real estate bubbles is evident however the effect of the bubbles has lead to the national bubble that hit the whole country. Through there are policy measures and procedures taken to combat the price bubble that has lead to an upward curve on the prices , the state is yet to stabilize the market for the long haul.

* 1. **Drawbacks of the study**

There are imminent drawbacks that this study will include in the whole process. The literature on the real estate bubble has excited for many decades. However the literature on the recent bubble in the housing sector is very limited and lenitive in terms of scope. In this essence dissertation will face a drawback in relation to the wide research gaps that exists in the bubble.

The validity and reliability of this research will also face a problem in terms of the data collected in this research the application of primary data and in some stances the reliance on the secondary data. This validity and reliability will be affected. The data collected will be subjected to partisanship as the bubble has been reflected in a negative way by the industry player. Similarly, the analysis of the data will be more focused on the researcher’s point of view that may cause a drawback in this research.

* 1. **Structure of the paper**

This research will be based on the five chapter model. The typical layout of the research will be in a chronological manner where the idea will be drawn from the most general and a systematic, rhythmic pattern will be followed to narrow down the ideas into the specific goals. The first chapter will provide a critical review of the introduction of the paper with a focus on the research background and the research scope. Moreover, the chapter one will also provide an overview on the rationalization of the study, drawbacks of the study and the structure of the paper.

The follow-up will be chapter two; this chapter will focus on the literature review. The literature on the problems on the real estate bubble and the critical review of the case study in this research will be China. The literature review will focus on the research questions and the objectives. The third chapter will provide that will give the methodology that will be used in this research. The methodology will be the centre in the way data will be collected including the discussion on why the methodology was chosen and the application of the instruments. The data analysis and finding will be presented in chapter four. Through the best diagrams and presentation method the data collected will be provided and the analyses on to the same given data. This chapter will be able to provide the a critical view of the problems and how the affected respondents felt about the real estate bubble and the associated financial risks.

Chapter five will conclude the research; this chapter will draw a conclusion on the whole research. The intertwined conclusion will be reflected in the literature review and the data analysis and findings. Conclusively chapter five will be able to highlight the summary of the analysis, limitations of the whole research then provide the recommendation in an easy and understandable way.

* 1. **Conclusion**

This is chapter one will provide the fundamentals background issues in the dissertation. Similarly, this chapter will include the rationale behind the research topic dubbed as the ‘research on the problems of the real estate market bubble and the potential financial risk in China’. Apart from fulfilling the research questions and the objectives of this study, this research will also focus on providing an analysis and discuss on both the financial crisis emanating from the real estate bubble and the problems associated with the real estate bubble.

This dissertation is vital in providing an updated literature on the real estate bubble more so focusing on the Chinese bubble state. The proceeding chapter will discuss the available and related literature on the real estate bubble in china and the resulting financial crisis.

**CHAPTER TWO**

**LITERATURE REVIEW**

**2.1. Introduction**

One of the most recent hazards in the economy is the phenomenon emanating from the real estate bubble. According to Case, Goetzmann & Rouwenhorst (2000) noted that globally, real estate markets are very crucial determinants of the stability of the economy both at the local standards and the global view. However Levitin & Wachter (2012) notes that the fluctuations in the transaction costs and the constraints in the short sales in the real estate market make the reliance on the real estate investment to diverge from the fundamentals. Similarly, it is agreeable that the transaction costs in the real estate investments are very high, and the issue of short-selling is very redundant, in relation to all other transactional assets in the open and closed market.

Baker (2008) observed that the recent changes in the housing market were presented by the issue of the fluctuation in the transaction costs and the issues emanating from the short selling habits. Surprisingly, the predictability and the forecasting of the changes in the house price and the evolution of the real estate market can be directly linked to the high transaction cost and short selling trends. Seemingly, Levitin & Watcher (2013) gives a notion that the results of the large deviation phenomenon between the fundamentals and the real estate property prices have developed the limited chances for the arbitrage to occur. In brief the changes in the house market that is directly linked to the high transaction cost leads to the bubble effect in the real estate industry.

In the recent decades, the global economies have been hit by the booming of the real estate market, the result according to some expert has been linked to the availability of a bubble. With the changes and the unprecedented discounting trends in the rents, it can cause the real estate properties to respond in stringent and sharply to the changes in the interest rates in a given real estate market. This may include the residential market or the commercial real estate market. Amusingly, Joebges, Dullien & Marquez-Valazquez (2015) in their study on the definition of the housing bubble in a theoretical and empirical enquiry mode they note that is has been a difficult task to explain the huge changes in the real estate prices over the given period. These changes in the income, amenities and or the interest rates lead to difficult in the explanation of the situation. In summary the global economy and the real estate state have a cohabitate factor tentatively the economic issues including the rent rates and the interest rates exponentially causes the bubble. However the explanation of the determinants that set up the changes and behaviours in the real estate is controversial matter.

Consequently, Barth, lea and Li (2011) prove that the estimation and the discussion on the determination of the prices of the real estate were low in the 1990s and whether the value of the housing project is high in 2015 has been a headache for the expert to offer the explanation on the same. According to Glaeser, Gyourko & Saiz (2008) they give a view that the bubble in real estate is a formidable issue, which has attracted massive attention from all the attention from the experts, researchers, and the economist. However, the solid explanation on the reason as to why there are a rapid rise and fall in the real estate prices in a purely rational model cannot be provided forthwith. In brief the historical progression on the prices of real estate cannot be relied on to offer an exclusive reason for the bubble, this is due to the availability of research gaps in the explaining the rapid rise and fall of property prices.

Barth, Lea and Li (2011) in a conversable view of the literature on the asset has been linked and showed to have begun in a long time, the building on the literature has been gradual and the prior literature confirms that the presence of a bubble was experienced in the early of creation of the economic structures. In this study the focus will be on the real estate market bubble, the testing and the investigation of the nature associated with the real estate bubble and the conditions under which it bubble exist in the real estate market will be discussed. The real estate volatility is a situation that must be carefully studied while employing the relevant and effective research methodology. Fang et al. (2015) also note that the fact that the investment included in the transaction involves high and risk expectant resources that can crumble the economy of the individual and the state, in general, makes this area of study very important. To recapitulate the volatility of the prices in the market has also impacted on the upcoming properties; the reason is the new constructions uses the real resources that can combine the welfare consequences in the substantial notion.

**2.2. China real estate bubble**

In china the price in the real estate market has been the direct relating factor the experienced real estate bubble (Chen and Wen, 2014). In support to Chen & Wen (2014), Dent (2015) provides a view that in essence, when the real estate prices have a direct reflection of the basics, the prices act as the guiding principles to the potential homeowners in making the appropriate decisions about the locality and the regions they will be able to make their investment in. the Chinese real estate bubble has been associated with the differentiation in the regions. The regions have been able to offer different scenery in the value and the rapid changes in the rise and fall of the prices in association with real estate assets. However, in cases where the prices valuations reflect the flimsiness of the illogical liveliness, then the prices will be the misguiding principle to the potential clients in relation to the selected place for the investment and the drive to the metropolitan changes (Chen & Wen, 2014; Dent, 2015). To sum up price and real estate bubble have a much closed link, this is well depicted in the china scenario where the fluctuation of the prices escalated to the real estate bubble. However different regions are affected differently hence the effect of the bubble is vivid in some region while in other regions the real estate experiences a stable market.

According to Zhigang & Xiaoyan (2003), they state that at times real estate market undergoes the irrational exuberance times that leads to the real estate bubble. There are two main types of real estate bubbles, in order to understand the real estate bubble and mark the trending issue that will result in the real estate bubble it is important to understand description and the differentiating element of the three main types of real estate bubbles.

**2.3. Real estate price bubble**

A price bubble is a real estate bubble that is characterised by the real estate market having prices on the high plateau. Price bubble in the real estate market is coined towards the market having a surge in the equity price. The surge in the real estate market price is more often higher than the warranted by the fundamentals and usually in the real estate sector. The proceeding aftermath is the drop in the prices as the massive selloff of the real estate property occurs (Holt, 2009). In any given economy the prices have an effect on the financial stability. Henceforth a pitch on the prices may have imminent effects that may cause a financial risk that will affect the market in a holistic.

Interestingly, according to Kim & Lee (2000) they state that in a financial point of view the, the price bubble in the real estate industry is when the housing prices are fuelled by the demand. In addition a speculation and the belief that the infallible forecast will usually start with the increase in the demand has made the shift to the right curve in the demand curve to face a limited supply. This leads to the effect in the taking a long period of time to replenish the increased demand. According to Quigley (2001) viewpoint this dissertation can, therefore, connote that the speculators will be eager to enter the market in with a notation that the profits will be achieved through short-term buying and selling. On the contrary to the entrance by the speculator, a driving force towards the demand is encouraged. The continued buying and selling of the property lead to the decrease in the demand or a stagnation of the market while the supply of the properties will increase this scenario will result in a sharp drop in the prices. In brief the literatures above prices and the demand are the main factors that are attributed to the development of the bubble. The imbalance between the demand and the supply leads to escalated prices hence the experience of a bubble burst. This can be attributed to the financial problem that goes hand in hand with the bubble burst.

**2.4. A real estate supply bubble**

According to Holt (2009), the supply bubble can be characterised as a common bubble in the big economies worldwide. For instance, china has been hit by the supply bubble in the real estate market. A supply bubble in the real estate market occurs when the there is a large number of unoccupied properties both used and even the most recent bought property. When a large number of completed and the existing properties are not occupied the supply will tend to be high.

In their review article on the effects of hot money in china’s real estate Guo & Huang (2010) notes that most of the real estate market bubble elicits as supply response, the housing pricing model unpredictability that does not take into account the supply aspect are described to miss a lot fundamental in the housing market. In this regard we can sum up that the changes in the housing supply pattern are important factors that will lead to the differentials of the housing prices. However, the supply in the housing market in many cases seems to help in the shaping of the real estate bubble.

The scenarios of rational bubbles can happen when supply in the real estate market is if fixed, this contradicts with the cases of elastic supply mode and the finite number of potential homebuyers (Zhigang & Xiaoyan, 3003). According to Levitin & Wachter (2012), they note that the elastic real estate supply model mutes the prices, and the results impact the housing bubbles. However, the social welfare losses the real estate bubbles which may be higher in the more elastic areas, this is as a result of the more overbuilding during the real estate bubble. In connotation of the above sentiments the elastic market mode leads to over construction that will lead to the development of the supply bubble. In a similar twist it is notable that opposite of the elastic supply chain is the rational bubble.

According to Levitin & Wacther (2012), this dissertation can draw a review that will state that the supply of the real estate has been recognized as a crucial determinant in the determination of bubble duration. Gibson (2009) notes that the market players tend to indigenize the asset based bubble with the assumption that the real estate investors have a belief that the future prices of the market will look the same as the prices in the past growth history. Therefore, when the supply trend is elastic, the real estate will have new properties that will come quickly online as the prices will tend to be on the up curve, the result is the unravelling of the bubble. In concise the notable determinant for the bubble is the supply aspect, this will lead to changes in the elastic market model and consequently affect the prices.

According to Barth, Lea & Li (2012), they noted that the cascade effect of the corrections in the real estate market has been characterised to cause the tumble effect on the overall family unit market. Theoretically speaking home ownership is a resource intensive undertaking that requires large sum on financial leverages this has direct effect on the financial management from the family level to the state economy.

In relation to other mature countries which have experienced a severe problem in the real estate market, China has been able to handle the crisis in a weathered and better shape. Recently the U.S. real estate market was inhibited by a very vivid meltdown that set off a critical financial crisis. The result of the crisis was the worst recession compared to the previous great depression. Other countries that have been hit by the real estate market meltdown include Spain and Ireland (Holt, 2012). Barth, lea & Li (2012) highlights that in 2008 the Chinese authority provided 580 billion dollars that was geared towards the prevention of the sharp slowdown that was being felt by the industry players. The stimulus packages helped a lot in maintain the economic growth and provide a preventive mechanism towards the meltdown.

**2.5. The affordable housing in china**

According to the research was done by Barth, Lea & Li (2012) on the China’s housing market and the review of the possibility of the bubble which was about to burst they provide a prior understanding of the economic stance and the position of the real estate in china. They noted that in the 1980s the Chinese housing system developed the housing reforms that set the stage for the privatisation of the housing in china. The incorporation of the reform that included the rent reform, the issues of the public housing and the reform that was directed towards the provision of affordable housing and real estate properties was heightened. Barth, Lea & Li (2012) noted that after the reforms the china national law defined the concepts of economically affordable houses and the concepts of the commodity houses. The local governments determine prices of the economically affordable houses before the projects become commercialized. The residence properties were sold for higher prices in a range of three to five percent above the required total cost. UN ordinarily they targeted the families that their income was much lower and the medium earners. In rundown china has a notable system that tends to control the housing prices and the reforms of the real estate in the country. This system despite being able to control the bubble it is aimed at giving the houses at affordable rates to the low earning individuals.

The current status of the housing system in china includes the three main types of asset namely the rental properties, economically affordable houses, and the commodity houses. By the year 2010, of all build properties targeting the household niche, 3 percent were the economically affordable houses. In addition more than 80 percent of the homes are privately owned (Barth, Lea & Li, 2012).

According to Barth, Lea & Li (2012) and a similar opinion coined by Hui, & Wong (2016), the set of researcher position that the housing in availability during the transition period of privatisation that was characterised with the inequality and the availability of the housing presence, has caused the inevitable rise in the transition economy. The government agencies have been on the fore front to cope with the challenge and the formulation of the major goal that revolves around the housing reforms is to achieve fair, allocation of housing resources if not provision of an equal opportunity on the same. According to Hui & Wong (2016) they draw a position that consequently the government has incorporated measures that will regulate the home prices to maintain the affordable level. For the huge segment of the potential home owners, this is an ideal feasible approach toward the maintenance of the economically affordable houses in the concept sense. This is all aimed at controlling of the risk in the financial stability state.

According to Barth, Lea & Li (2012), they provide a view that in china there are two main components that shape the economy of the nation and the home ownership concept. The china’s affordable housing policy provides two programs that aim at providing the economically affordable housing. The economically affordable houses and the housing provident funds are two core programs that the citizens and the government including the state enterprises rely on to make sure the allocation of the home to the employees and the general public is enhanced.

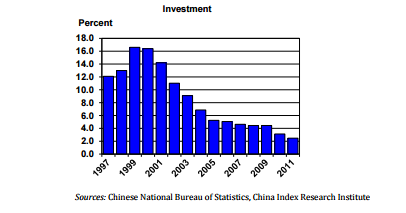
According to Buttimer, Gu & Yang (2004) they give an opinion that the housing provident fund is a compulsory saving plan that both the employer and the employee must be engaged in. The structure of the programs is to make sure the learner have a home as the withdrawals from the fund can only be directed towards home ownership deals. The municipal governments have the mandate of managing the programs. As of the year 2008, the housing provident fund had an outstanding balance of 177 billion dollars that was to be distributed to approximately 77 million dollars (Barth, Lea & Li, 2012; Buttimer, Gu & Yang, 2004). In this view the explanation of the bubble burst in china and the potential financial risks can be culminated to the two programs that are developed by the government to offer the affordable housing to the residents. This is due to the demand issues as represented by the rising numbers of investors using the platforms.

According to Barth, Lea & Li (2012) they state that with the increased number of demand in the real estate property the government of china has promoted the development of the affordable houses in order to boost the homes targeting the low- end markets. The development of these affordable properties has hit the highest in where they recorded a 16 percent in investment in relation to the total residential housing. The number represented a ¼ of the total homes that were sold in relation to the living areas. Nevertheless, the market share of the economically affordable houses has experienced a steady decrease since the year 2001. In a similar view it can be identified that the notion of the affordable homes and the increased investment in the same area has lead to more and more construction of these houses, the potential financial risks is that the market for the other properties may be overwhelming due to the imbalance in the market.

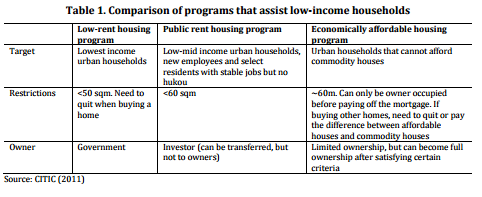
The current status of the economically affordable properties has experienced very heavy subsidized rates (Barth, Lea & Li 2012). The developers of the homes have been given the credit, and the means to acquire the condo at a lower price and the developing of the economically affordable houses has been received well by the government offering free tax evasions and the fee credit. According to Yueng & Howes (2006) they give a view that the homeowners on the other hand have been able to receive the credits in a more substantial means and flexibility. However, the researchers indicate that the flaws related to the designs and the attributed programs have made the homes rates to be high and expensive for some households. Similarly, the issues relating to the occupancy and the numerous expectations have been made of many restrictions due to the policy inconsistency. The aftermath of the whole scenario is the heavily subsidized residential properties, and then it leads to the properties becoming commodity houses. The result is the shrinking of the already small pool of affordable houses hence the real estate bubble as a result of prices and the supply constraints.

**2.6. The market shares of the affordable houses**

The figure below shows the market share of the economically affordable houses that has experienced a very sharp decline.



In the year 2008, the Chinese government shifted the attention towards the promotion of the private homeownership and then providing the assistance to the low market, this was more focused towards the low-income households. The government has embarked on the low renting policy that has become very crucial in the provision of the programs. For more information and comparison on the between the low-rent housing program and another affordable housing program the table below provides analysis of the same



The market shares of the affordable houses in comparison with the with the two programs can be summarized using the target market where the public rent housing program is more directed towards the low-mid income, new employees and the selected individuals with a stable jobs. In comparison with the target market for the economically affordable housing program its is aimed at the urban households that cannot afford the commodity houses.

In other comparison category the restriction attributes requires that the public rent housing program to provide a 60 square meter home, the low rent housing programs requires that the restriction to be below the 50 square meter. While the economically affordable housing program requires the restrictions to be maintained at 60 meters

In ownership the low rent program is owned by the government, while the public rent housing is owned by the investors and in the case of the economically affordable housing program it is through the limited ownership.

In relation to the bubble burst and the potential financial risk it can be analysed that as more people move towards the full ownership the demand and supply for the low-rent housing and the public rent housing have experienced imbalance in the market.

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