



FOREIGN INVESTMENT IN U.S. REAL ESTATE

Current Trends and Historical Perspective

Prepared by the Research Division of
THE NATIONAL ASSOCIATION OF REALTORS®

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NATIONAL ASSOCIATION OF REALTORS®

The Voice for Real Estate®



Introduction

The long history and benefits of foreign investment in the United States are widely recognized. It influences the movement of domestic interest rates as well as directly contributing to the creation of new jobs. U.S. real estate provides foreign and domestic investors with a diversification option that has a solid return without the volatility of stocks. Foreign investment in U.S. real estate also provides direct investment that helps support a healthy real estate industry.

This report looks at the impact of foreign investment on the U.S. economy over the past year, and pays particular attention to the commercial and residential real estate markets. We look at four major topics:

1. Reasons for acquiring U.S. real estate
2. Current U.S. economic conditions
3. The state of international investment in the U.S. financial and real estate markets
4. The future for foreign investment in the U.S. economy and domestic real estate markets

Our analysis of foreign investment in U.S. real estate markets shows that –

- ◆ Foreign investment helps to create jobs either through direct investment in a business or commercial real estate or by providing a cheap form of funding for domestic businesses to reinvest. While the flow of foreign funds to the bond markets has slowed from the historic levels that generated record low mortgage rates and fed the boom in housing over the last two years, the supply of funds is still ample enough to keep rates historically low. Low mortgage rates will continue to play an important role in real estate, but job creation in the current economic expansion will provide most of the impetus for home sales over the coming year. Foreign investment rose 180 percent between 1992 through 2001, finishing the ten-year period with an annual figure of \$8.576 trillion.
- ◆ U.S. assets continue to be a popular investment option for foreign investors. Surging investment from 1997 through 2001 was driven by stellar returns on all asset categories, but equities in particular. U.S. investments, particularly U.S. Treasury securities and high quality corporate bonds, proved popular in 2002 because of their safety and solid return. Foreign ownership of U.S. corporate bonds increased 21.5 percent to \$1.690 trillion in 2002, while foreign holdings of U.S. Treasuries rose 29.5 percent to \$503.6 billion. Foreign direct investment in U.S. real estate increased to \$40.6 billion in 2002 from \$38.3 billion in 2001.
- ◆ Foreign investment in U.S. assets exerts downward pressure on interest rates. Historically low mortgage rates have benefited from a large pool of foreign funds for several years. The 30-year fixed rate mortgage averaged 7.2 percent over the last five years as compared to 9.2 percent for the past 20 years. Low mortgage rates, in turn, have spurred record purchases of residential properties. Likewise, low interest rates have helped make commercial real estate properties appealing to investors.

The NATIONAL ASSOCIATION OF REALTORS® recognizes and supports the benefits of open markets and private property ownership. It believes that foreign participation in U.S. real estate markets should remain free and the rights of foreign investors should be the same as those of American property owners, except to the extent that may be necessary to carry out U.S. criminal laws or where specifically identified with national security. NAR also believes that any legislation or regulatory barriers

that would limit the open market and private property rights or access of foreign investors to U. S. markets could curtail foreign investment and potentially jeopardize the health of U.S. real estate markets.

Reasons For Acquiring U.S. Real Estate

Foreign direct investment in U.S. real estate increased sharply over the last 5 years, from \$39.1 billion in 1998 to \$40.6 billion in 2002. The increase was due to a variety of factors, most notably the globalization of the real estate industry and the broader inflow of foreign investment caused by favorable macroeconomic conditions in the U.S. and weak conditions abroad. U.S. real estate is attractive to foreign investors for a number of reasons including its diversification, openness, size and selection. U.S. real estate is a good hedge against inflation and generally has a high return on investment. Foreign firms may wish to establish U.S. market presence or increase their market share. Individual foreign investors from a smaller-size country, such as the Netherlands or Taiwan, may have few options to invest internally within their native country. Real estate is a safe investment in what otherwise can be a rocky marketplace. Finally, real estate is an attractive investment option for institutional and technical reasons.

Diversification

It is widely recognized in financial research that portfolio diversification using several forms of investment, such as, stocks, bonds and direct investments including real estate can reduce or offset the risks of any one form of asset losing value. International investors well understand this concept and often invest accordingly. However, international investors must deal with country risk – the risk of overexposure to investment in one country.

For example, an investor's assets are spread among five countries. One of the countries experiences a major shock to its economy, cutting asset prices in half. The loss to the investor is less than if all the assets were in that one country's markets. The recent debacle in Argentina economy illustrates this concept. U.S. real estate offers foreign investors diversification of their investment portfolios so that their assets are not fully tied to the health of any one domestic economy.

Openness, Size and Selection

Both the availability of real estate as an investment and the ease of investing attract foreign investors to the U.S. The U.S. market contains a large supply of investment-grade real estate. It also has a relatively high turnover rate and an easy exit option. In addition to the wide variety of investment options, the United States does not restrict or scrutinize most property purchases by foreigners, as do other countries.

Relatively High Yields

U.S. income-producing properties generally offer higher yields than do similar investments abroad. According to the National Association of Real Estate Investment Trusts (NAREIT) and the European Public Real Estate Association (EPRA), the U.S. outperformed both Asia and Europe in 2001 with an average quarterly increase of 10.1 percent in the U.S. REIT index. Europe outperformed the U.S., in 2002 with a 21.7 percent increase compared to 2.0 percent for the U.S., while the U.S. lead Asia. The U.S. leads both Europe and Asia as of mid-August 2003.

Similarly, despite the fact that the U.S. interest rates have hit 45-year lows in the past year, U.S. bonds

EPRA/NAREIT Total Return Indexes, Quarterly Average			
	Asia	Europe	U.S.
2001	-17.2%	-6.1%	10.1%
2002	-7.1%	21.7%	2.0%
2003 YTD	15.9%	14.1%	18.7%

Source: www.epra.com

continues to offer a better return than those of Europe or Japan. Between 1997 and 2002, long-term bond yields averaged 5.5 and 5.1 percent for U.S. and Europe, respectively, while Japan trailed at 1.7 percent. There was a starker contrast in short-term rates where the U.S. and Europe averaged 4.7 and 3.8 percent, respectively, whereas Japan averaged 0.3 percent.¹

Another recent factor to consider is the weakening of the dollar. Due partly to a large U.S. trade deficit, the U.S. dollar has depreciated against other major currencies, particularly against the euro in the past year. The depreciation is likely to have halted with some appreciation potential looming on the horizon. The prospect of faster and stronger U.S. economic growth in the upcoming year versus the rest of the world and the spectacular increases in U.S. worker productivity should support a stronger dollar. This means that investment in U.S. dollar denominated assets will yield a higher rate of return once converted to foreign currencies. Therefore, investment in the U.S. by foreigners and subsequent return after currency translation will be higher than the simple rate of return made by U.S. investors.

Domestically, real estate equity in the form of real estate investment trusts (REITS) has outperformed standard equities. In 2002, REITS in the U.S., as measured by NAREIT and EPRA, increased in value by 18.7 percent. Over that same period, the Standard and Poor's 500 index fell 22.5 percent and the NASDAQ index dropped 32.6 percent. REITS provided a high point amid U.S. equities' dismal performance in 2002.

Inflation Hedge

Real estate investments, both residential and commercial, are less exposed to the effects of inflation than many other investments. In fact, the value of residential property in the U.S. tends to rise more than the rate of inflation. Over the last 10 years, the value of existing residential properties has risen by an annual average of 4.7 percent as compared to 2.5 percent for inflation. Furthermore, residential home prices have not declined since the NATIONAL ASSOCIATION OF REALTORS® began tracking prices of existing homes in 1968. In contrast, the values of outstanding bonds and mortgages decline when market interest rates rise. But simple growth rates don't account for the boost to returns that leveraged buying allows. If one invests 20 percent of the cost of a \$100,000 home and the price of the home increases 10 percent over the first year, the return on investment after one year is 50 percent. If one had paid the full \$100,000 in cash, the return on the investment after one year would only be 10 percent.

Likewise, U.S. commercial properties have traditionally proven an excellent hedge against inflation because of the way in which their operating costs are structured. During inflationary periods, rental rates may increase because of specific commercial lease clauses that link rental rates to the inflation rate. Over time, increased rental rates are capitalized into increased real estate values.

Commercial property leases can also be designed to protect the owner (and the tenant in some cases) from the adverse effects of inflation, by taking into account the effect of expected inflation on potential gross income and operating expenses. For example, some leases contain escalation clauses that specify periodic increases in a tenant's rent. Escalations in the fixed minimum rent may take place according to an agreed schedule, or they may be linked to the price index. During inflationary periods, many commercial property owners benefit from increasing rental income with either limited or no exposure to increasing operating expenses. Management and leasing expenses are a percentage of collected rent and expected rental income, so they normally increase only as income increases. Thus, during periods of inflation these lease terms produce increasing net operating income for the property owner.

¹ Source: Organization for Economic Cooperation and Development, "Interest Rates and Exchange Rates: EO73 Statistical Annex Tables", Tables 35 and 36

Establishment of Market Presence

The United States is the world's largest and most open commercial real estate market and foreign firms want to establish market share here. They do this in a variety of ways. They make direct investment in properties. In addition, they may choose to build businesses or establish joint ventures with U.S. companies in real estate development, design, construction, property management or brokerage.

Safe Asset

Certain U.S. investments are viewed as safe alternatives compared to what, at times, are more risky foreign assets. During periods of economic uncertainty in foreign markets, funds are often redirected into U.S. assets that have low default rates such as U.S. Treasury bonds, high-grade corporate bonds, U.S. backed mortgage securities, and U.S. real estate. According to the rating agency Fitch, the average annual default rate on non-investment-grade rated corporate bonds was 3.07% between 1990 and 1999 as compared with a non-investment-grade commercial mortgage-backed securities average annual default rate of 0.14% for the exact same period. This trend was particularly apparent during the Asian economic meltdown of 1997-1998, the Russian ruble collapse of 1998, the global readjustments that followed both of these events, the second war in Iraq, and the global economic uncertainty that followed. In each case, market instability led to panic among investors in those markets and resulted in foreign investors shifting their monies into U.S. dollars and U.S. markets. The Argentinean debt crisis of 2001-2002 did not have as great an impact because many investors had learned their lessons from the previous experiences and had adjusted their portfolios accordingly.

Trends in the U.S. Residential Market: Immigration and Second Home Purchases

The U.S. housing market has experienced record sales and price growth during the past five years. New and growing trends in the market, immigration and expanding purchases of second homes, serve to underpin this trend and will help both sales and price appreciation in the future. These trends shed insight into where growth potential for commercial investment lay. In addition, they point to areas that prospective foreign homebuyers may find increasingly attractive to invest in.

Immigration

Falling mortgage rates have fueled the housing boom over the last 3 years. Home sales trended higher in spite of the onset of 2001 economic recession. In the latter part of 1990s, home sales were influenced by other factors. One of the best economies in history, high employment, stock market wealth, and burgeoning salaries, all culminated in a tremendous streak for home sales. However, one major contributor to home sales that is often over looked is demographic growth.

The population of the US grew by roughly 35 million people during the last decade of the 20th century.

In contrast, the 1980s only brought an increase of 20 million people. While these figures are

	Total	YEAR OF ENTRY			
		1990 or later	1980-1989	1970-1979	Before 1970
Total	94,244,000	35,333,000	19,594,000	20,583,000	21,406,000
Immigration	32,454,000	15,781,000	7,961,000	4,605,000	4,107,000
% of Total	34%	45%	41%	22%	19%

interesting, what is truly impressive is the fact that nearly half of the increase in US population that occurred during or after 1990 was from foreign-born persons coming to the US; roughly 16 million

people. Similarly, 41 percent of the increase in population during the 1980s was due to immigration to the US.

Immigration has played a substantial role in US population growth during the last housing boom. According to the US Census' most recent estimates (middle series) of population and foreign-born migration to the US, immigration should continue to play an important role. The Census estimated the foreign-born population to grow at an annual average of 2.1 percent from 2003 through 2010 and 1.2 percent for the period from 2011 through 2020. These projections were well under the actual figures for 1999 through 2002. A growing population promises to keep demand and prices for goods and services, housing in particular, rising.

Top 10 Places for Migration in 2002			
1	California	6	New Jersey
2	Texas	7	Georgia
3	New York	8	Arizona
4	Florida	9	North Carolina
5	Illinois	10	Virginia

Second Homes

Evidence suggests that there is strong demand for secondary housing. Second homes are homes purchased in addition to the primary residence. These properties are most often used for recreational or vacation purposes, but they are increasingly used for investment purposes. According to the 2003 Profile of Homebuyers and Sellers, a publication of the National Association of Realtors®, roughly 15 percent of homebuyers surveyed purchased a second home or were purchasing a new primary residence, while maintaining their old primary residence as a second home. Furthermore, according to the 2002 National Association of Realtors® Profile of Second-Home Owners, 85 percent of second homeowners indicated that their purchase of a second home was a good financial investment. There were no noticeable differences between those who purchased second homes as vacation homes or as investment rental property. The expanded consumption of second homes strengthens the demand for residential real estate.

Institutional and Technical Factors

Institutional and technical factors also explain the increased foreign involvement in the U.S. economy. These factors include worldwide liberalization of financial markets and technological change.

Liberalization of Financial Markets

As the U.S. economy has become increasingly international in recent years, so has the U.S. real estate sector. Since the early 1970s, the industrialized nations of the world have been steadily removing restrictions on international capital flows. In 1971, the Bretton Woods system of fixed exchange rates was abandoned in favor of floating exchange rates. By allowing currencies to float, nations permitted the market to determine the relative value of goods and services traded across borders.

In addition to allowing exchange rates to float, many of the world's industrialized nations have removed most controls on capital and restrictions on foreign participation in domestic financial markets. In the early 1970s, the United States eased administrative guidelines that inhibited foreign access to U.S. financial markets, and in 1984 abolished the withholding tax on non-resident holders of bonds issued by U.S. residents. The United Kingdom lifted exchange controls in 1979, liberalizing cross-border transactions using pounds sterling. In the 1970s, Germany removed authorization requirements for non-resident purchases of domestic bonds, and also lifted a withholding tax imposed on foreign holders of

domestic bonds. In the 1980s, Japan opened up participation by foreign firms in Japanese securities markets and liberalized approval procedures for firms seeking to make direct investments abroad.

This pattern of liberalization continued into the late 1990s with many Asian, Latin American, and former Soviet countries opening their doors to foreign capital. However, the downturn caused by the implosion of the Southeast Asian economies in 1997 sparked a spate of new controls on capital flows in many of these countries. Although the International Monetary Fund (IMF) has conditioned its bailouts on continued expansion of liberalized trade policies, the going has been slow. This liberalization is crucial to maintaining the flow of foreign capital into U.S. real estate markets, and it enables foreign investors to transfer capital abroad in order to diversify their investment portfolios, including investment in U.S. real estate. In the face of these controls on foreign investments, the U.S. economy offers an advantage to investors who want to be certain that they can get their money back after investing.

Technological Change

At the same time that governments have been liberalizing their trade and foreign investment policies, technology has been revolutionizing the world. In the U.S. alone, private sector spending on information processing equipment and software increased from \$142.8 billion in 1991 to \$563.1 billion in 2002 after adjusting for inflation. Telecommunications, computing, and information technology now permit almost instantaneous transmission and processing of information around the globe. This capability lowers financial transaction costs and fosters a financial environment in which capital flows rapidly from one country to another seeking the highest yield. As a result, foreign investors can respond quickly to opportunities to invest in the U.S. real estate market.

The residential real estate market has also benefited from technological change. Today, prospective homebuyers can browse online listings with pictures and even 360-degree virtual tours. Web sites like Realtor.com, which offers over two million home listings and draws over five million unique visitors each month, allow housing shoppers to search simultaneously with their Realtors®. The benefits of these capabilities are being realized. According to the National Association of Realtors® 2003 Profile of Homebuyers and Sellers, 11 percent of homebuyers first learned about the property that they purchased through the internet. In 1995, this figure was less than one percent. Furthermore, 57 percent of survey respondents listed the internet as a “very useful” source of information for their housing search.

The U.S. Economic Conditions

Economic conditions are important to foreign investors. The better the conditions are, the better are the returns on investment for both domestic and foreign investors. In order to assess trends in foreign investment in U.S. real estate, it is helpful to look at U.S. macroeconomic conditions.

Current Macroeconomic Conditions

The U.S. economy sputtered in 2002. After surging to growth rates in excess of 4 percent, the economy took a respite in 2001, registering annual growth of just 0.3 percent. The economy appeared headed for a recovery in 2002, as economic growth climbed back to 2.4 percent. Growth had reached 2.9 percent by the fourth quarter of 2002. However, fears of a double dip recession took hold in early 2003 as growth eased to a 2.0 percent and 2.3 percent for the first and second quarters of the year. Despite a decline in fuel costs following the end of hostilities in Iraq, business spending remained cautious and the labor situation softened with unemployment was 6.4 percent in June. Tax cuts and improved retail sales figures appear to be stimulating business investment as of August 2003, while interest rates, the stock market and durable goods orders are all on the rise; indicators of an improving economy.

War jitters and relatively weak consumer spending kept business spending soft in the latter part of 2002 and the first half of 2003. Unemployment reached 6.1 percent in July of 2003. That figure represents a mild increase from the annual average unemployment rates of 5.8 percent in 2002, but a substantial jump from the 4.8 percent unemployment rate enjoyed in 2001. While consumer spending improved to 3.1 percent in 2002 from the 2.5 percent of 2001, it sputtered at 2.4 percent and 2.8 percent for the first and second quarters of 2003.

Inflation, meanwhile, was kept in check. The change in the consumer price index, the most widely watched measure of inflation, increased only 1.6 percent in 2002 from 2.8 percent rise in 2001. For 2003, the 12-month CPI change has averaged 2.4 percent through July. The increase in prices resulted from worries of a global spike in oil prices following the outbreak of hostilities in Iraq.

Current Real Estate Conditions

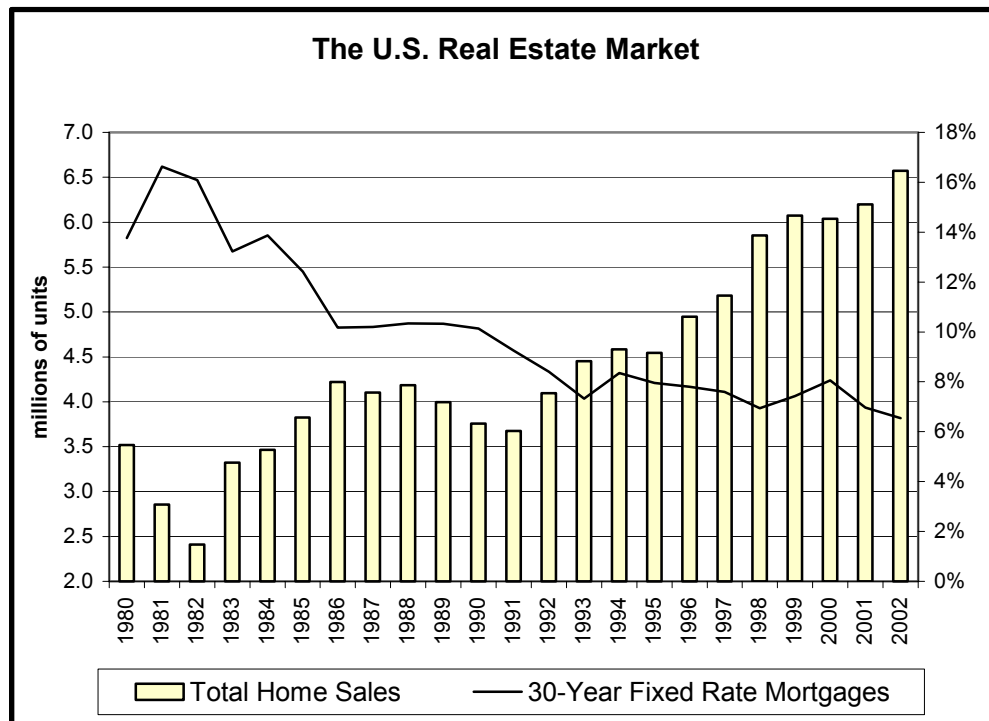
Falling mortgage rates helped to propel housing purchases in 2002 and the early part of 2003. The average 30-year fixed rate mortgage fell from 7.0 percent to 6.5 percent between 2001 and 2002. During the first seven months of 2003, the rate tumbled even lower to 5.5 percent in July. Meanwhile, the 1-year adjustable rate mortgage fell from an average rate of 5.8 percent to 4.7 percent over the same two-year period. Low interest rates have enabled homeowners to refinance mortgages and build wealth through their homes.

Home prices continue to rise at a record pace. Existing home prices rose 6.3 percent in 2001 and 7.1 percent in 2002. Home price appreciation created wealth for many homeowners who, in turn, used their new wealth to purchase larger homes, to purchase secondary or vacation homes, or to increase their expenditures on consumable goods. This pattern continued for the first two quarters of 2003, where prices increased by 6.8 and 7.0 percent, respectively.

Household formation remains strong. The number of households in the U.S. increased by 3.0 percent in 2001, up to 108.2 million. Household growth declined to 1.0% in 2002. This figure is strong by historical standards, but reflects the pressure of a sagging economy and softening labor market on household formation. Steady household growth underpins the demand for homes in the U.S.

The economic and demographic situation resulted in record sales of new and existing homes as well as an impressive number of housing starts. New home sales increased from 907,000 to 977,000 between 2001 and 2002, while existing homes increased from 5.296 million units to 5.566 million. Single-family housing starts increased from 1.272 million to 1.364 million during this same period.

The housing sector continued to boom through the first half of 2003. New and existing home sales continued at record paces through the early portion of 2003, while starts remained strong. On a seasonally adjusted annualized basis, existing home sales set a new one-month record of 6.47 million units in August. Similarly, new home sales climbed to a new record level of 1.2 million units in June of 2003. Housing starts fluctuated at near record levels during the first half of 2002, shifting between a high of 1.521 and a low of 1.312 million units.



Sources: NATIONAL ASSOCIATION OF REALTORS®, U.S. Bureau of the Census, Freddie Mac

New and existing home sales generated strong consumer spending in 2001, 2002, and the first half of 2003, buoying up a waffling economy. Strong home sales generated large secondary expenditures by households on goods to furnish their new homes. In addition, rising home prices created a wealth effect where increased personal wealth resulted in additional expenditures by homeowners. The net effect has been a continued increase in aggregate consumer spending resulting from a strong housing market, which has benefited the U.S. economy.

The commercial sector² was buffeted in 2002 by increasing vacancy rates and softening rents. Vacancy rates for offices, warehouses, retail, and multi-family housing all fell from 1998 through 2000. However, vacancy rates surged across all properties in 2001 and again in 2002, most notably in offices and warehouses. Soft consumer demand and a squeeze on corporate profits brought on the declines. The

² Based on the 54 metro markets tracked by Property and Portfolio Research

residential housing market, propelled by record low mortgage rates, continued to blow through sales records cutting into rents and stifling investment in multifamily units. Like vacancy rates, rents weakened across the board, declining for offices, warehouses, retail, and multi-family housing in 2002. Soft rents kept multi-family housing starts flat in 2001 and 2002 at 330,000 and 347,000, respectively. Starts have ranged from 270,000 to 356,000 this year.

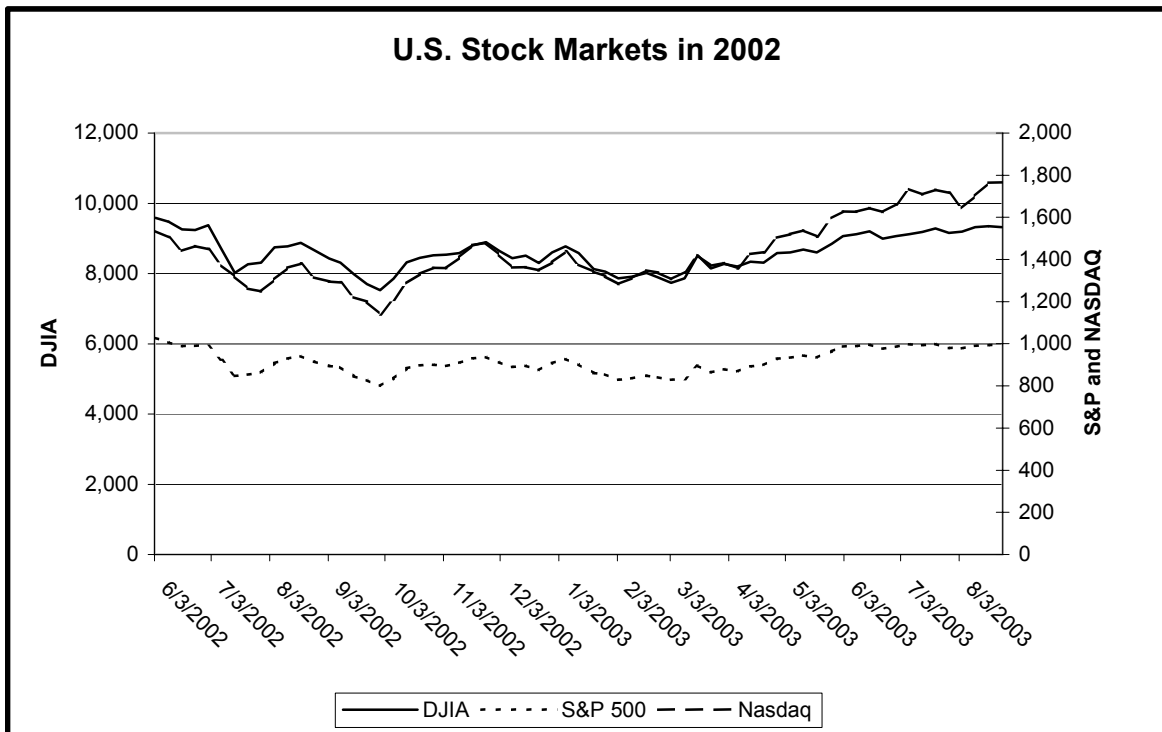
The State of Commercial Real Estate								
	Change in Rental Rates				Vacancy Rates			
	Office	Warehouse	Apartment	Retail	Office	Warehouse	Apartment	Retail
1998	9.9%	3.7%	3.9%	4.9%	10.4%	7.5%	5.2%	13.9%
1999	4.3%	3.7%	3.8%	2.2%	10.3%	7.5%	5.1%	12.8%
2000	10.1%	4.1%	5.8%	3.2%	10.0%	7.2%	5.0%	10.4%
2001	-2.5%	-0.4%	2.3%	-0.2%	12.7%	8.3%	5.5%	11.2%
2002	-8.4%	-4.3%	-2.0%	-0.7%	16.6%	10.1%	6.8%	12.4%

Source: Property and Portfolio Research

Vacancy rates for all property types, particularly offices and warehouses, continued to rise through the first half of 2003. Job creation declined in the first half of 2003 weakening demand for office space, while demand for retail, warehouse, and apartments increased. Rental rate improved modestly in the first half of 2003 as demand for commercial property began to firm up after two years of softening.

What the Stock Market Rebound Means for the Real Estate Industry

The fragile stock markets appear to have found their footing over the fall of 2002 and spring of 2003. From the end of September 2002 to early August of 2003, the Dow Jones Industrial Average rose roughly 1800 points, or 23.7 percent. The S&P 500, a broader measure of the health of the New

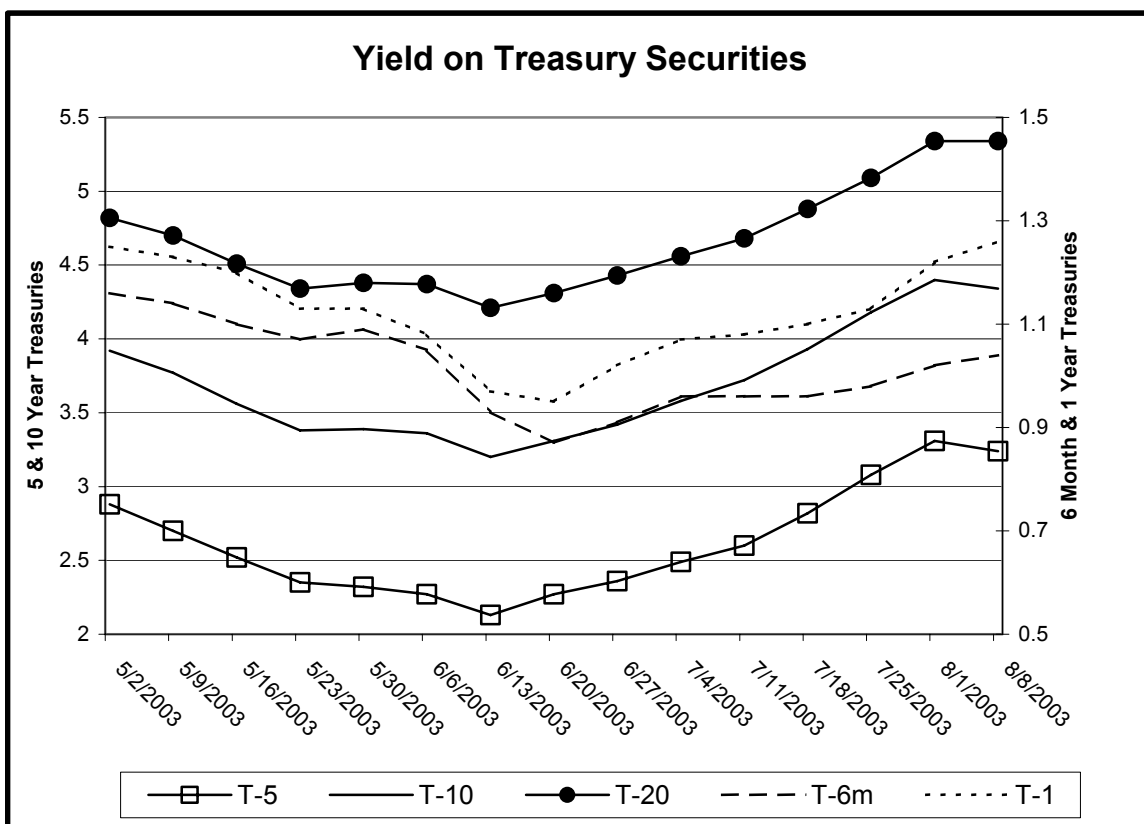


Source: NYSE and NASDAQ figures from Yahoo! Financial

York Stock Exchange climbed 24.1 percent. Meanwhile, the NASDAQ composite shot up 54.8 percent. While the markets haven't reached their levels from the heydays of early 2001, they displayed strong gains, a reflection of improved corporate profits and confidence in the overall economy.

Business spending remained stagnant for much of 2002 and early 2003. However, low inflation and low interest rates buoyed the economy with strong home sales and strong secondary consumption generated from home sales. The combined effect of these two trends helped to prop up the labor markets while firms increased productivity and cut costs. While downsizing and cost cutting caused labor markets to soften in the spring of 2003, an end to the major combat operations in Iraq and the threat of spiraling fuel costs brought stability and hope to the stock markets. Inflation remained low throughout the spring of 2003, while the weak dollar and record low interest rates boosted consumer spending on all goods. Consumer confidence is on the rise and job cuts are down, ameliorating the fear of wage-led price increases.

The strength of the stock market has inspired investors to move funds back into the equity markets from the safety of the bond markets. Lower demand reduced prices on bonds; from the first week in May through the middle of June, the yield on the six-month, one-year, five-year, 10-year, and 20-year U.S. Treasury securities fell 11.8 percent, 29.9 percent, 52.1 percent, 35.6 percent, and 26.8 percent, respectively.

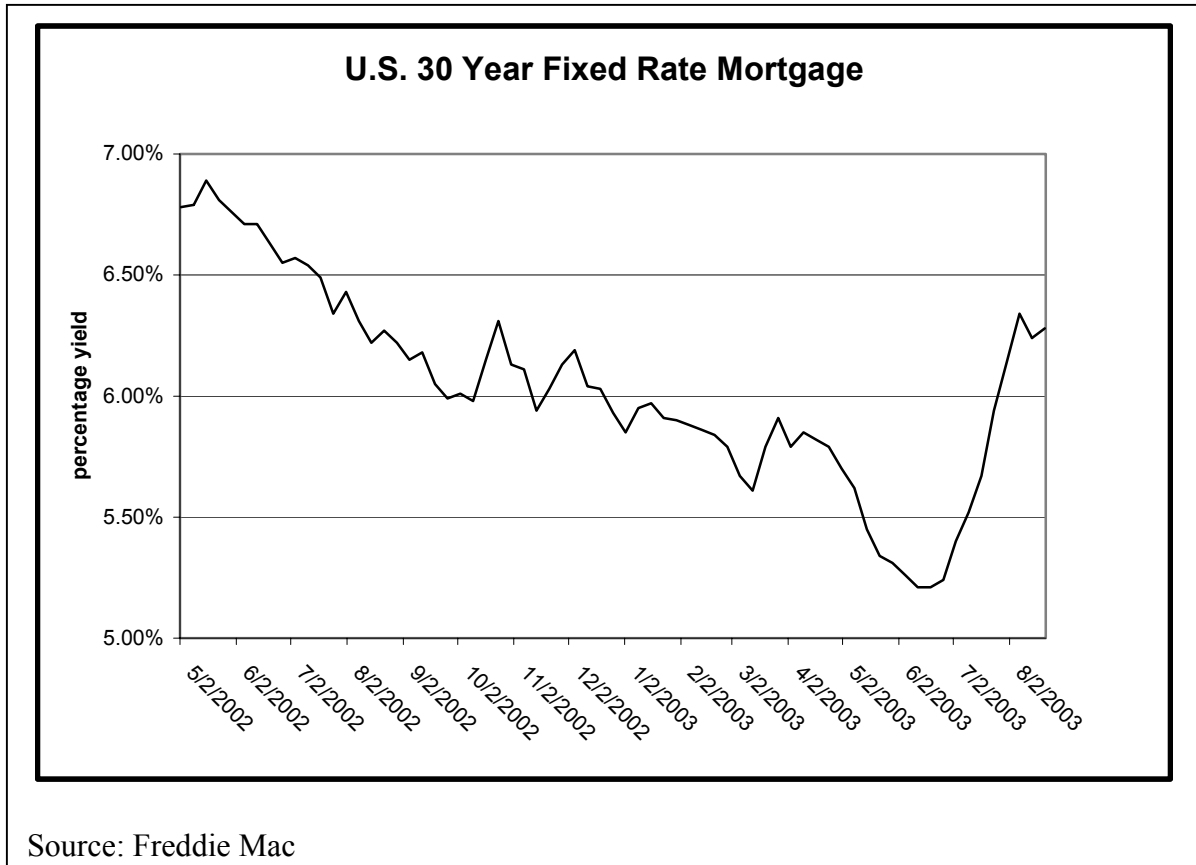


Source: Federal Reserve Board

Sour

Mortgage rates climbed in June and July of 2003 as stock market investors recognized that their economic concerns were not realized or were never realistic and pulled out of bonds. The average yield on a 30-year fixed rate mortgage, as reported by Freddie Mac, rose 19.4 percent, from 5.26 to 6.28

between early June and Late August. Low interest rates were the main driver of home sales over the last two years. The percentage point jump in the 30-year fixed rate mortgage had not dampened home sales by August of 2003, but it is likely to later in the fall of 2003. However, rates remain at historically low levels, levels low enough to set new annual sales records for the year despite some expected slippage in the second half.



International Investment Position

Trade with other countries provides three important sources of stimulation for the domestic real estate industry. Foreign demand for U.S. goods creates jobs at home, which, in turn, results in demand for goods, including housing, by the newly employed. Direct investment by foreign firms in the U.S. results in both job creation and direct demand for commercial real estate. Finally, general investment from abroad in U.S. securities reduces the cost of borrowing funds. Lower borrowing costs both stimulate economic growth and reduce the cost of purchasing a home.

The current and capital accounts, provide valuable information about the state of the U.S. economy. The current account measures how well the U.S. is exporting goods and services relative to its trading partners.

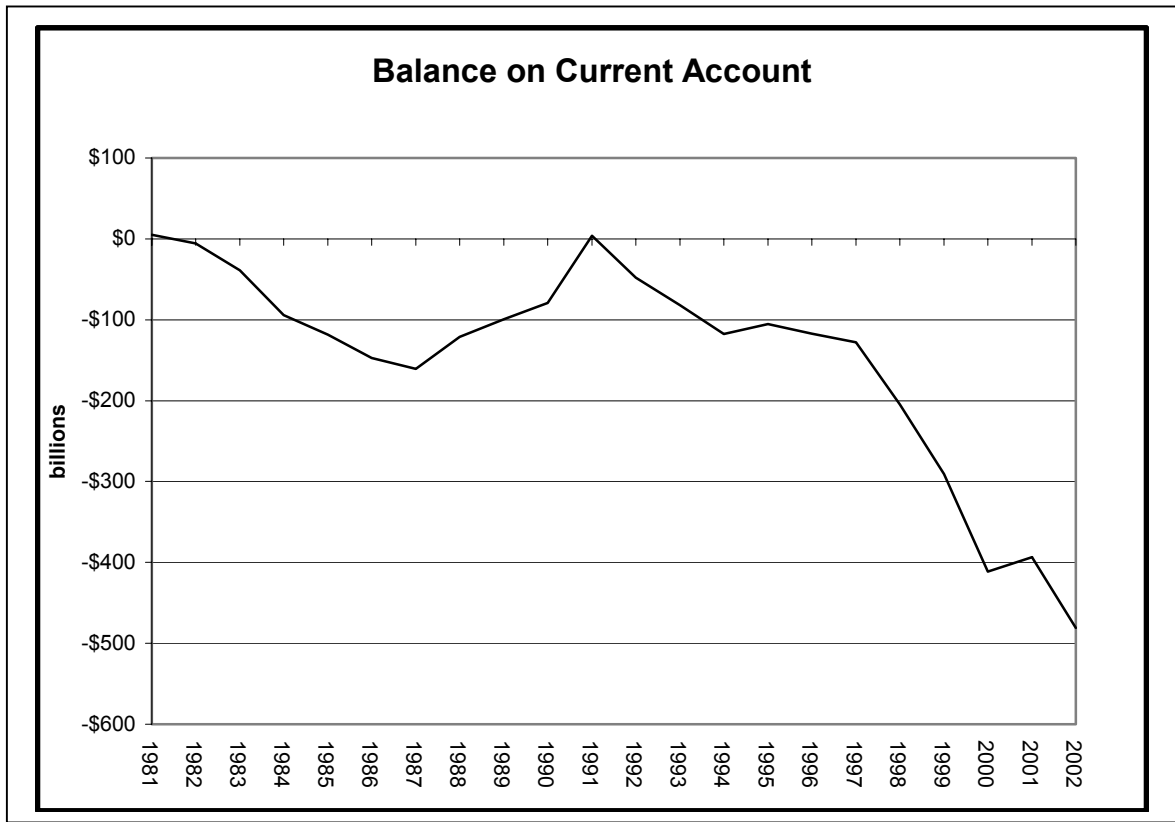
Whereas, the capital account tells (1) how well the U.S. is doing at attracting investment to satisfy its demand for credit and (2) how much foreigners are directly investing in the U.S. economy.

Balance of Payments Accounting

The international trade position of the U.S. is summarized by the balance of payments. The balance of payments is an accounting standard that is equal to the sum of the current and capital accounts. The current account is the sum of goods and services exported by the U.S. minus those goods and services that are imported from abroad (the current account also includes net investment receipts and net unilateral transfers, but these make up a small portion of the account). The capital account measures the flow of capital between the U.S. and abroad and is the sum of all foreign investment in the U.S. minus total investment abroad by the U.S. government and individuals. In theory, these two accounts should directly offset one another (i.e., balance), but this is not the case in practice. The rationale for this assumption is that to increase purchases, one must borrow to do so and an increase in capital accounts reflects borrowing from abroad.

The Current Account Balance

Except for a brief respite in 1991, the U.S. has been a net importer of goods since the 1980s. This trend continued in the late 1990s and was even more pronounced from 1997 onward. The rapid decline of the “new economy” bubble left global investors scrambling for a haven of economic growth and stability in the middle of a global economic downturn. U.S. financial markets, particularly the bond and stock markets, saw an influx of investment from abroad as investors sought safety in “flight to quality”, resulting in a generous supply of relatively cheap capital. This pattern slowly began to reverse itself in late 2002, as foreign investors chose to move funds abroad or back into U.S. stock markets to take advantage of improving returns and stability. However, the U.S. bond markets remained flooded with cash for consumer financing, while soft demand for financing in the business sector kept a lid on interest rates. Fear of turmoil in Iraq and a weak U.S. economy caused a further pull back into bonds and safe assets during the spring of 2003, but this pattern has since reversed.



Following a brief respite from its downward slide in 2001, the strong dollar and rising fuel costs pushed the current account deficit lower. The current account plummeted to -\$481 billion in 2002, a substantial increase from the -\$394 billion deficit registered in 2001.³ Cheap foreign goods and easy financing at home allowed for consumption of imports, particularly of autos and petroleum, to go on unabated. The strong dollar and weak global economy combined to reduce the export of goods and services from the U.S. abroad, while increasing imports. Fear of war in Iraq and a permanent shock to the suppliers of oil in that country resulted in a sharp increase in oil prices, which added to the deficit and the reduction in demand for U.S. goods. The weakening of the dollar, particularly against the Euro, will likely stabilize the U.S. trade position in 2004 and 2005.

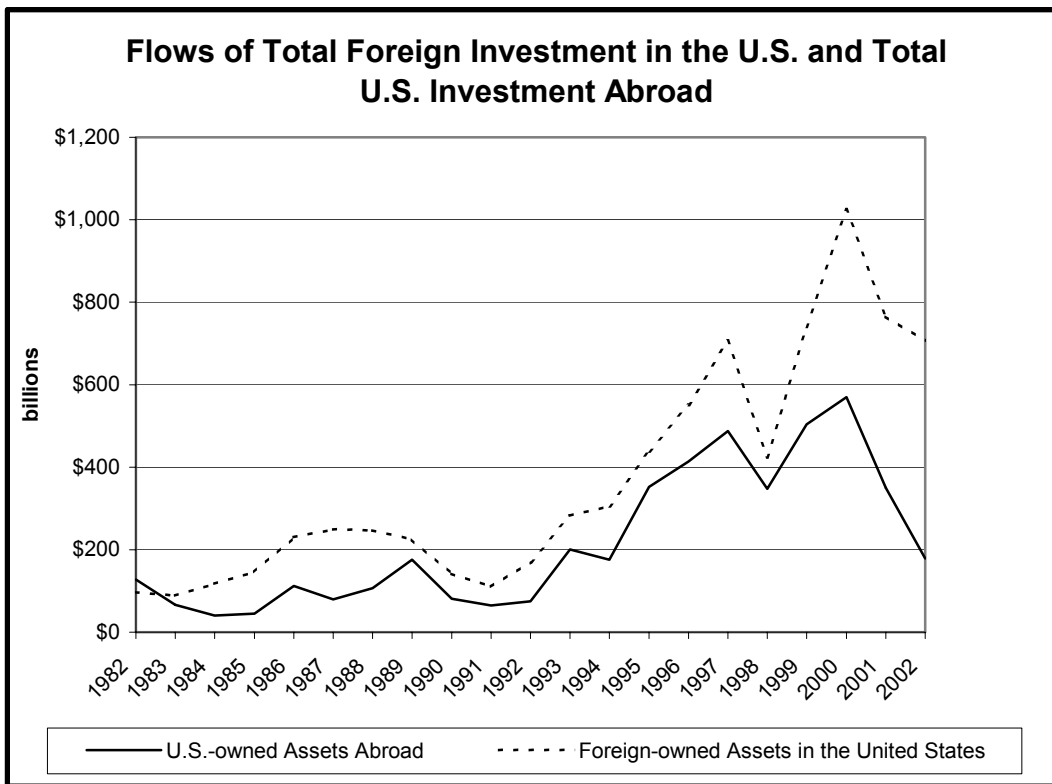
Despite the increased consumption of foreign goods, domestic consumption was still strong enough to propel the U.S. out of its flat GDP growth in 2001. This continued trend of increased consumption necessarily required more funding to finance it. An increase in borrowing from abroad will show up in the capital accounts.

Balance on the U.S. Capital Accounts

Foreign Capital Inflows

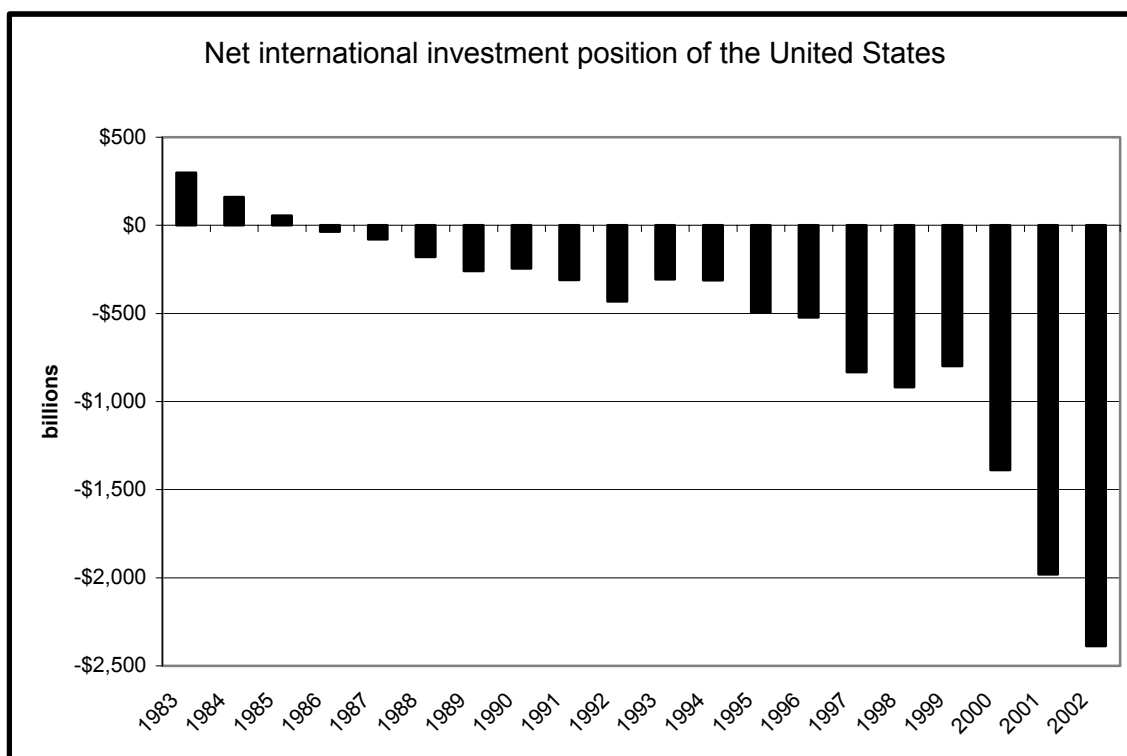
The Bureau of Economic Analysis restated the capital account balance in 2002 resulting in a substantial increase in foreign investment in the U.S. over the past ten years. Foreign investment in the U.S. outpaced U.S. investment abroad in 1990s. The margin between the two slowed in 1998 to \$75.7

³ All trade numbers are on a current-cost basis unless otherwise specified. Source: Bureau of Economic Analysis.

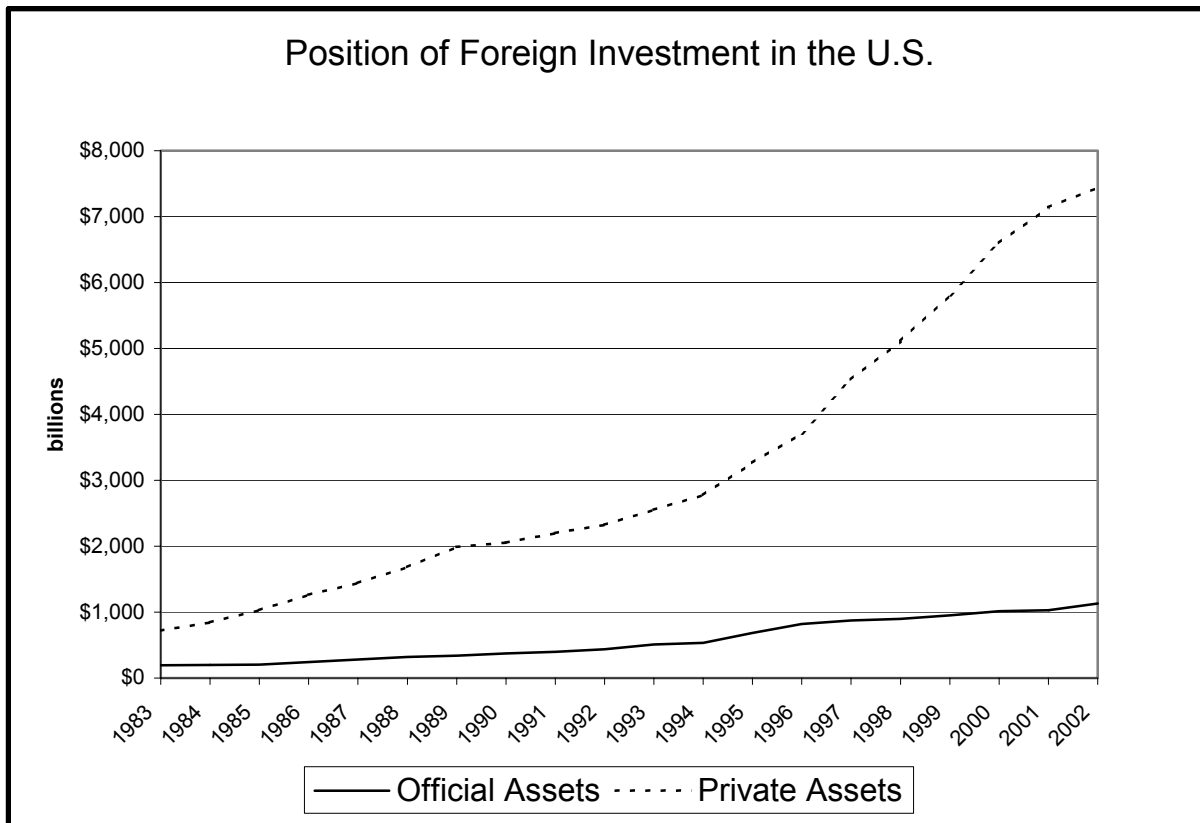


billion, but surged again reaching \$456.3 billion by 2000. Investment by both foreign investors in the U.S. and by U.S. investors abroad fell off in 2001 and 2002, but the U.S. was still out-invested by \$415.6 billion and \$528.0 in those years, respectively.

The influx of funds from abroad resulted in a net increase of foreign funds from 1994 through



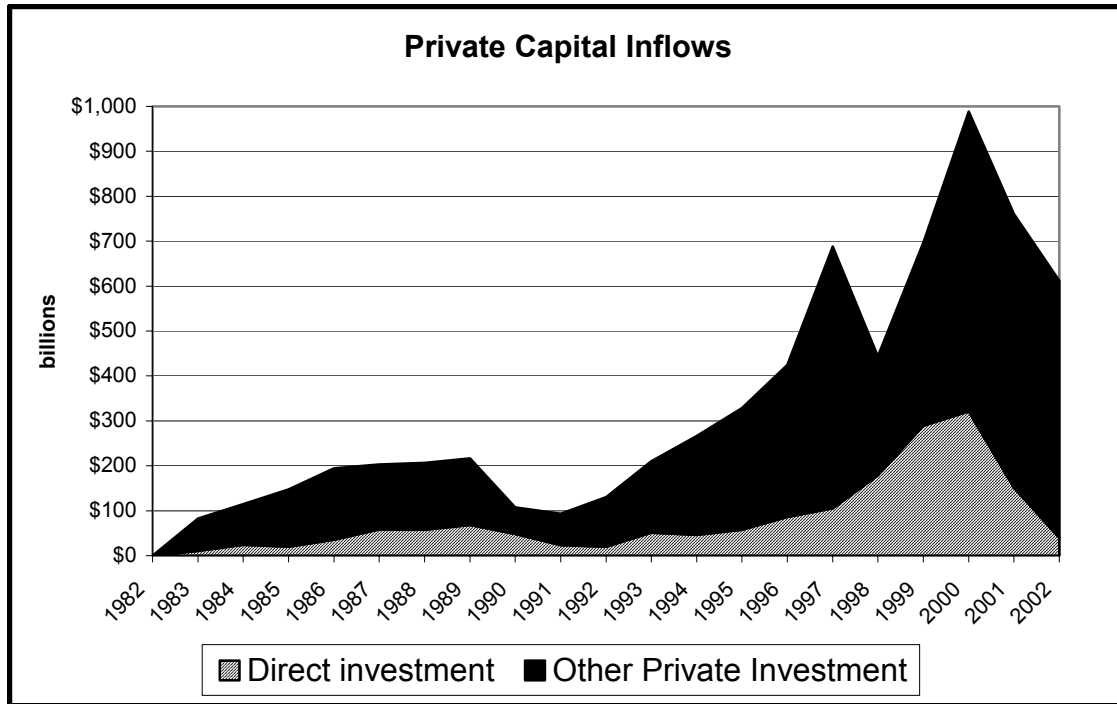
1998, followed by a respite in 1999. This brief pause in net investment growth was broken by a surge of \$1,388 billion in net capital imports during 2000 and \$1,979 billion in 2001. This pattern continued in 2002 with an increase in capital imports to \$2,387 billion.



Foreign investment comes from both private and public (government) sources. Private foreign investment has outpaced official investment. Total investment by private foreigners was almost \$3 trillion more than official investment in 1996, but by 2002 this gap had doubled to more than \$6 trillion. The stock of foreign investment by private individuals reached \$7.444 trillion in 2002. Because of the relatively small role that official foreign investment plays in the U.S. economy, this report will focus on private foreign investment.

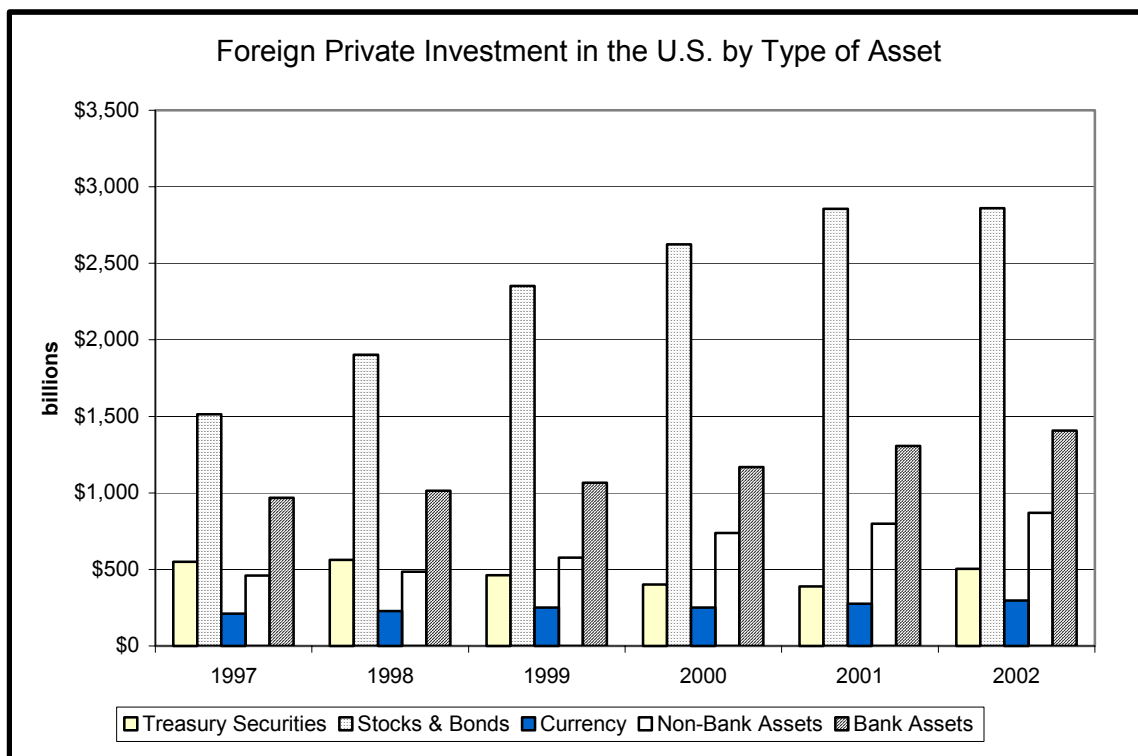
Private Investment

Private investment can come in two forms: direct investment and other private investment, which includes stocks, bonds (private and public), cash, bank assets, and non-bank assets. The lion's share of foreign investment in the late 1990s came in the form of other private investment, which rose sharply in 1997, while direct investment continued on its gradually increasing pace. Both direct and other private investment peaked in 2000, followed by declines in 2001 and 2002.



Other Investment

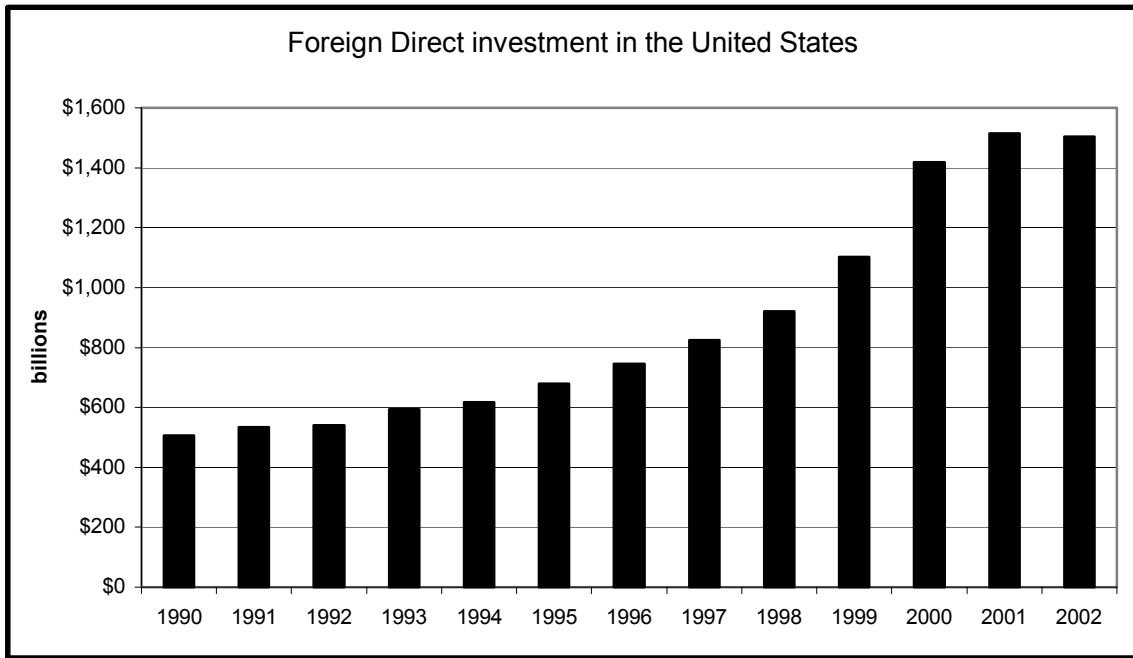
Other private investment has an important impact on the U.S. economy. An increase in the flow of funds from abroad can reduce the domestic interest rate. In turn, lower interest rates stimulate investment and consumption of larger purchases such as homes and automobiles, goods that have large expansionary multiplier effects on economic growth. Flows of investment into the stock market bid up prices and can boost consumer confidence and thereby stimulate spending. During the late 1990s, stocks led investment in non-direct assets, while non-bank assets and bank assets also experienced inflows. Investment in currency was relatively stable. Foreign holdings of U.S. Treasuries surged in 1997 and 1998 reaching \$562 billion. Investment in U.S. treasuries tapered down to \$389 billion in 2001 before surging to \$503 billion in 2002. Global instability generated high demand for safe assets like Treasuries, bank assets, and cash, all of which surged in 2002, while demand for stocks and bonds moderated after nearly a decade of strong demand.



Direct Investment

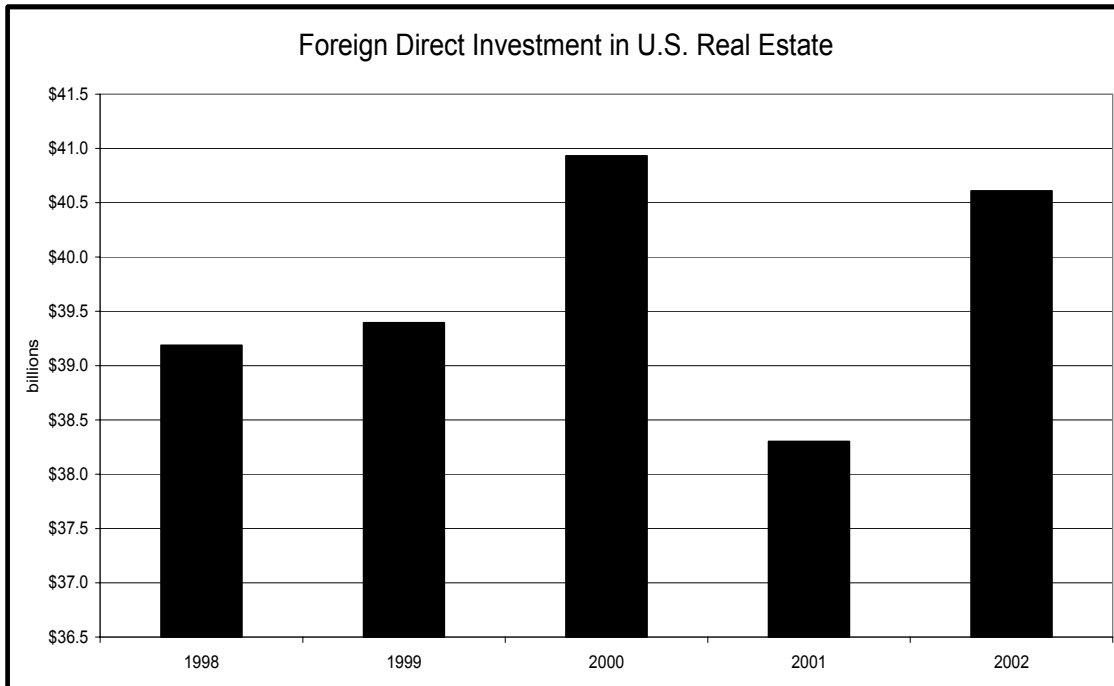
Direct investment also plays a significant role in stimulating the U.S. economy. Foreign companies may choose to expand operations in the U.S. in order to circumvent tariff restrictions, to reduce transport or labor costs, to take over a company that provides a valuable component to their product line, or simply to gain a sound commercial asset. Whatever the reason, direct investment can result in new construction, new real estate purchases, and new jobs.

Foreign direct investment increased steadily over the past 5 years. In 1997, direct investment totaled \$824 billion. This number reached \$1.514 trillion by 2001, an increase of nearly 83.8 percent. However, the pace of foreign direct investment slid backwards in 2002, pulling back 0.7 percent to \$1,505 billion.

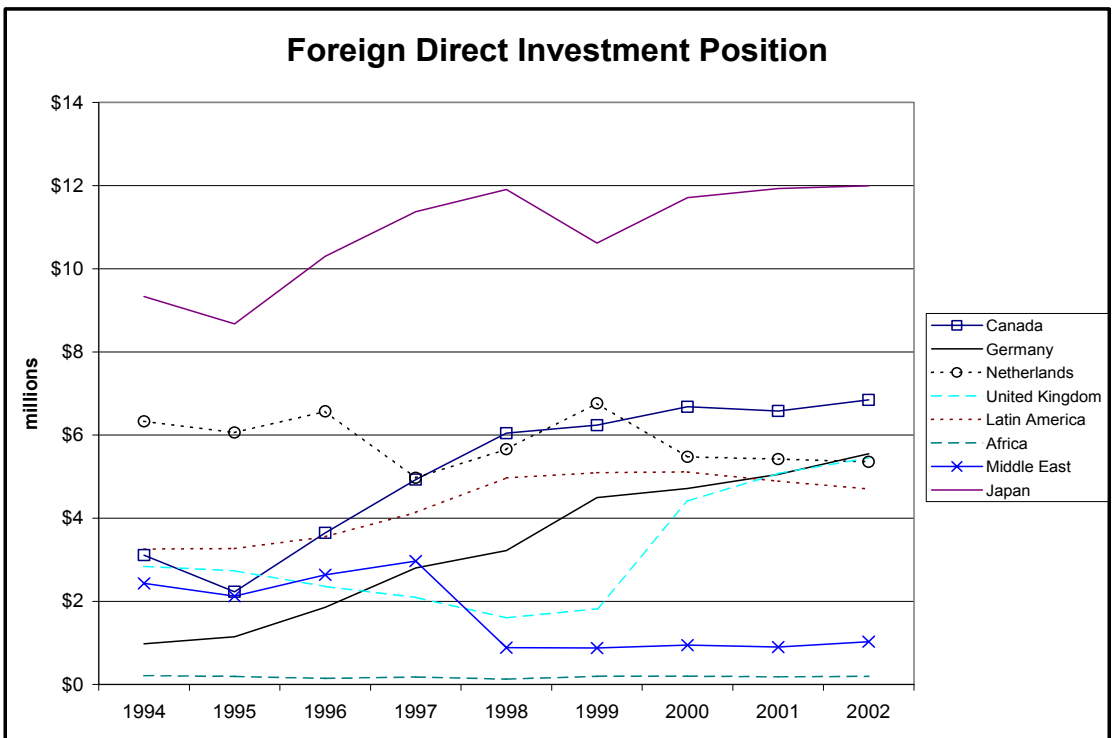
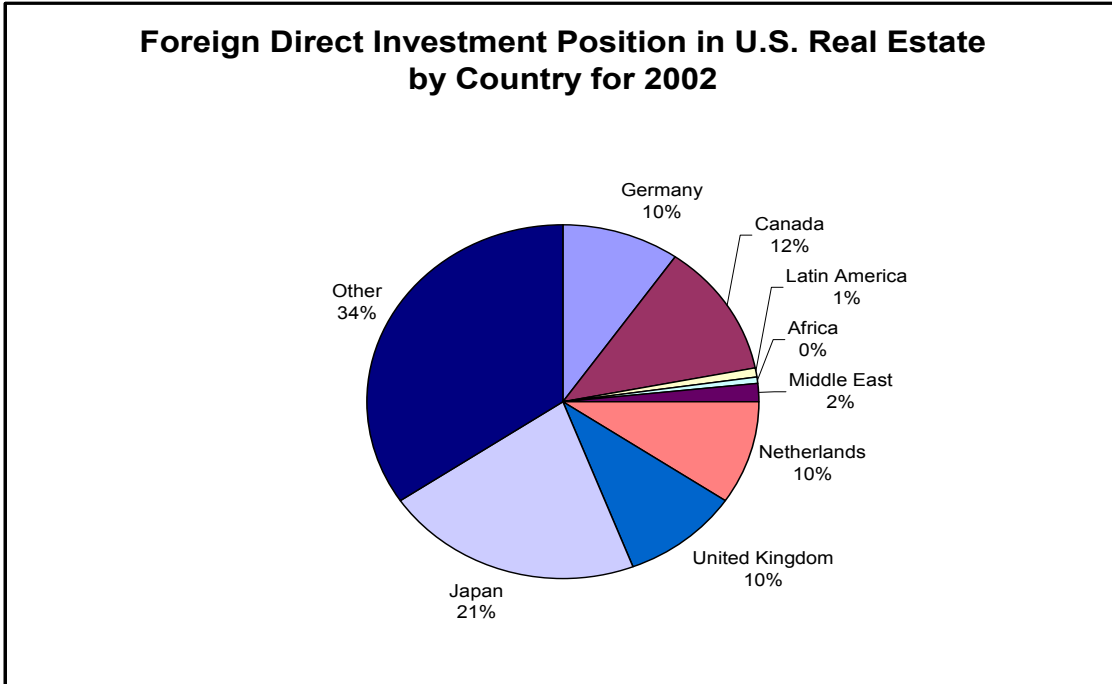


Foreign Direct Investment in U.S. Real Estate

Foreign direct investment in real estate rose rapidly from 1998 through 2000. However, investment slowed in 2001 as the world economy virtually crawled to a halt and was bridled with an overhang from the collapse in the world equity markets. But investment quickly recovered in 2002, reaching \$40.6 billion.



For 2002, foreign investment in the U.S. real estate was dominated by Japan, Canada, Germany, Netherlands, and the United Kingdom. Japan alone contributed 21 percent of 2002 foreign direct investment while Canada accounted for another 12 percent. Germany, the Netherlands, and the United Kingdom accounted for a total of 30 percent.



Japan has consistently had the highest investment share over the past 9 years, underscoring its important role as an investment source. The Netherlands, Germany, Canada, Latin America and the United Kingdom all play strong roles, though the influence of Germany, Canada and Latin America increased noticeably after 1995. Africa's investment numbers are negligible while the Middle East's absolute numbers started out strong in the mid 1990s, but fell by more than half after 1995, with minimal increases thereafter.

Balance of Payments and the Real Estate Industry

Over the past five years, foreign trade played an important role in the growth of the U.S. real estate industry. During the late 1990s, economic growth, fueled by a boom in technological innovation and cheap sources of funds due to foreign capital inflows, created jobs and spurred home sales. Since then, international instability accelerated investment in U.S. capital markets.

The success of the U.S. economy boosted home prices resulting in a wealth effect for consumers who, in turn, bought larger or second (vacation) homes. Flows of foreign funds into the bond and mortgage markets reduced interest rates; keeping inflation low, mortgage rates low, and home consumption strong. Finally, direct investment in real estate, aside from 2001, increased steadily over the period from 1997 through 2002.

Foreign Investment and the Future

The U.S. economy continues to benefit from sustained flows of foreign investment. In the future, flows of foreign funds to U.S. markets will depend on prospects for U.S. macroeconomic growth, a strong real estate market, and solid economic growth among our trading partners.

Projections for the U.S. Economy

The U.S. economy sputtered in early 2003, but the future looks strong. The weak dollar will help the U.S. export goods to Europe and Asia. Interest rates will rise modestly, but will remain at historically low levels, propelling consumption of large goods like housing, while consumer demand and business investment will increase. The NATIONAL ASSOCIATION OF REALTORS® forecast for the U.S. economy shows real GDP increasing from 2.4 percent to 3.6 percent between 2003 and 2004. Meanwhile, inflation is expected to remain below the crucial 3.0 percent level, declining from 2.3 percent to 1.7 percent over this period. The result should be strong job growth. The unemployment rate is expected to drop from 6.0 percent to 5.8 percent, a rate that is well above the U.S. natural rate of unemployment, the rate of unemployment where GDP growth can increase without pushing up inflation. In addition, the economic climate should keep the 30-year mortgage rate low. NAR forecasts a 6.0 percent 30-year rate for 2003 and a 6.4 percent rate for 2004.

The NATIONAL ASSOCIATION OF REALTORS® forecasts existing home sales to begin to taper off in the latter part of 2003, but for the year re-sales should still post a record-setting 5.9 million units – an increase of 4 percent from 2002. New home sales are also expected to set a record in 2003 with roughly 1 million sales, an annual increase of 5 percent. The numbers for 2004 will moderate slightly from the blistering sales pace that set the 2003 records. New home sales should register 950,000 units and existing home sales will post 5.5 million units. The decline will result from a forecasted increase in the 30-year fixed mortgage.

Commercial Real Estate Forecast								
	Change in Rental Rates				Vacancy Rates			
	Office	Warehouse	Apartment	Retail	Office	Warehouse	Apartment	Retail
2002	-8.4%	-4.3%	-2.0%	-0.7%	16.59%	10.10%	6.82%	12.40%
2003	-7.1%	-3.6%	-2.8%	-0.4%	17.74%	10.43%	7.15%	12.48%
2004	-0.6%	-1.0%	-0.2%	1.0%	16.97%	9.82%	6.77%	11.77%

Source: Property and Portfolio Research

After two years of decline, the commercial sector will steadily benefit from the positive movement that the U.S. economy will take in the next year and a half. Business spending was expected to increase in early to mid 2003. While this pattern was late to arrive, spending never the less increased in the early 3rd quarter of 2003, benefiting the commercial sector. Commercial real estate should improve modestly in the later part of 2003, achieving stronger growth in 2004 as the economic expansion takes hold. Vacancy rates should fall in 2004 as businesses reinvest and pump up their tight inventories. Demand for warehouses will rise as industrial production is expected to increase 0.4 percent in 2003 and 4.4 percent in 2004 after two years of decline. Non-farm employment will register a decline of 0.2 percent in 2003, but it will increase by 1.2 percent in 2004, boosting demand for office space. Rising mortgage rates are expected to cause the housing affordability index to fall from 140 to 132 between 2003 and 2004 diverting demand from residential housing purchases to the rental market. The rebound in the commercial market is expected to move in conjunction with the rest of the U.S. economy. Furthermore, though soft, rental rates are expected to see improvements.

Projections for International Growth

The domestic real estate market benefited from substantial investment from abroad. Much of this foreign investment came from investors searching for assets with superior, but safe performance. The continuation of this trend will depend on whether foreign economies are performing well, thereby creating new capital for investment, and if they are doing well, whether they are outperforming the U.S. economy and, in so doing, providing an alternative place for investment.

The U.S.'s major investors from the European community, Germany, the Netherlands, and the United Kingdom, all look to perform much better in 2004 than in 2003. But one major concern is over

Results from the 2003 AFIRE Survey

The Association of Foreign Investors in Real Estate (AFIRE) conducts an annual survey of its members as a guide to investor opinion and plans for the coming and past years. According to this year's Survey, actual consumption of U.S. real estate declined from what survey respondents had planned on acquiring in 2001. While Survey respondents had planned on acquiring an average of \$282 million, actual consumption registered only \$242 million. AFIRE analysts gave several reasons for the decline, citing higher vacancy rates depressing affect on values as well as a "denominator" effect where in the decline in equity values in 2001 boosted an investor's portfolio share of real estate beyond desired levels. To compensate, the investor would pull back his or her holding of U.S. real estate. The difference between planned an actual investment in U.S. real estate represents a decline of 7.3%, which was absorbed by increases of 4.1% in the U.K., 2.5% in Australian and New Zealand, and 2.4% in Western Europe.

While actual investment fell short of planned investment, the U.S. still led global investment with \$70 billion of the survey respondents' \$226 billion, or roughly 31%. Washington surged to the top spot on this year's list of the respondents' favorite global cities for investment. The field was rounded out with London and Paris in third and fourth, respectively, New York holding steady in fourth and Milan rounding out the group in fifth place.

Survey respondents indicated that they still view the U.S. as strong in terms of the fundamental reasons for investing. They ranked the U.S. first in terms of "offering the most stable and secure real estate investments; the best opportunity for capital appreciation; and the best risk-adjusted potential return."

The survey also looked into participants' planned investments for the coming year. Respondents indicated that they plan on increasing their investments in U.S. real estate to an average of \$308 million per investor in 2003. That is an increase of 8.4% over survey participants planned investment in 2002 and more than a 21% increase over their actual investments in that year.

Favorite U.S. city for investment

- (1) Washington, DC
- (2) New York
- (3) Los Angeles
- (4) Chicago
- (5) San Francisco

Preferred type of real estate investment

- (1) Multi-family
- (2) Industrial
- (3) Offices
- (4) Retail
- (5) Hotel/Leisure

Germany and its large amounts of non-performing debt, which could stymie growth. Assuming the problem is manageable, both Germany and the Netherlands look to improve substantially as their growth rates are expected to jump from -0.1 percent to 0.9 percent and -0.1 percent to 1.5 percent, respectively. Japan will also increase from 0.8 percent in 2003 to 1.0 percent in 2004. Latin America, another big

investor in the U.S., will increase from 2.5 percent to 3.6 percent by 2003.⁴ However, the U.S. is expected to drive the next global expansion and instability in the recent past will cause investors to be cautious of new investment in Latin America.

International investment in the U.S. grew at a strong pace in 2003. The factors that attract investors to the U.S. real estate market are its stability, strong government, value, and to an extent, the economy. In addition, the U.S. economy will get back on track in the next year setting the U.S. real estate market up for success in the longer term. Low rates of inflation and rising employment coupled with growing business investment and a historically low 30-year fixed rate mortgage should propel the housing industry for some time and attract investors. The weak dollar will continue to force the Europeans to compete, hurting profit margins there while Asia and Latin America will remain question marks in light of their recent economic turmoil and questionable economic, accounting, and legal foundations. For international investors looking for a safe investment with good earning potential, U.S. real estate and financial markets remain the global standard.

New Challenges to Foreign Investment in U.S. Real Estate

The U.S. real estate market will continue strong in the future. The U.S. economy will hit its stride in the fall of 2003, pulled up by rebounding consumer and business spending in a low interest rate environment. Climbing spending will breathe life back into a soft commercial market, setting it up for a strong 2004. Expanding employment in a historically low interest rate environment will set the U.S. residential real estate market up for another healthy year. The U.S. robust growth in the next year and a half will help lead the global rebound and attract additional foreign investment as the U.S. promises, once again, to be the global leader in rate of return and safety for real estate investment.

But there remain challenges to the flow of foreign investment in U.S. real estate. Foreign investors should be allowed to invest in U.S. real estate without any disclosure other than that required of U.S. investors, except to the extent that may be necessary to carry out U.S. criminal laws or where specifically identified with national security. Similarly, tax laws affecting foreign investment in U.S. real estate should not be any more burdensome to foreign investors in the U.S. than those that apply to U.S. investors, except to the extent reasonably necessary to ensure payment of taxes from sales. Onerous U.S. tax laws and/or disclosure requirements could impede foreign investment in U.S. real estate and real estate related financial products, and may have negative effects on the vitality of the U.S. economy.

In the past year, the U.S. has withstood the social, political and economic buffeting of the war in Iraq, the possible shock to global markets of a reduced oil supply or trade, as well as ongoing involvement in Afghanistan and the threat of global terrorism. Despite these obstacles, the U.S. economy has stood strong, largely due to its bedrock foundation of the U.S. real estate market. U.S. government policies have been wise to avoid actions that would restrict this market, allowing it to thrive in a time when the nation needed its strength, and averting any regulations that might have the unintended effect of stemming the tide of foreign investment capital.

The U.S. real estate market has benefited from having an open economy that allows for the free flow of capital and goods with foreign trade partners. The continuation of policies structured with these caveats in mind will continue to have positive effects on both real estate markets and the U.S. economy.

⁴ Source: Oxford Economic Forecasting, World Economic Perspectives, Summer 2003

Data Sources

Association of Foreign Investors in Real Estate (AFIRE), annual survey of its members

Bureau of Economic Analysis

Freddie Mac

Organization for Economic Cooperation and Development, “Interest Rates and Exchange Rates: EO73 Statistical Annex Tables”, Tables 35 and 36

Oxford Economic Forecasting, World Economic Perspectives, summer 2003

Property and Portfolio Research

The National Association of Real Estate Investment Trusts and the European Public Real Estate Association, www.epra.com

U.S. Federal Reserve