FOREIGN INVESTMENT IN U.S. REAL ESTATE

Current Trends and Historical Perspective

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

October 2004

NATIONAL ASSOCIATION OF REALTORS®

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Introduction

The real estate industry and real estate professionals have benefited immensely over the past decade from the rise in foreign direct investment and the ever expanding international dimension of real estate transaction. The long history and benefits of foreign investment in the United States are widely recognized. It influences the movement of domestic interest rates and directly contributes 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 impact on 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 and real estate market 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 market has slowed from the historic levels, the supply of funds has been plentiful enough to keep mortgage rates at 45-year lows. Low rates, in turn, have pushed home sales and home prices to new heights.

- ♦ Foreign direct investment increased sharply over the past 4 years. In 1999, direct investment totaled $1.1 trillion. In 2000, it surpassed $1.4 trillion. It then moved past the $1.5 trillion marker in 2001. Growth eased a bit in 2002 before rising again in 2003. The total direct investment reached $1.55 trillion in 2003. Between 1994 and 2003, foreign investment rose 191 percent, finishing the ten-year period with an annual figure of $9.6 trillion.

- ♦ U.S. assets continue to be a popular investment option for foreign investors. After declining 19.8 percent in 2002, equities purchases surged 29.7 percent in 2003, reaching $1.5 trillion. U.S. Treasury securities and high quality corporate bonds remained popular in 2003 because of their safety and solid return. Foreign ownership of U.S. corporate bonds increased 15.8 percent to $1.9 trillion in 2003, while foreign holdings of U.S. Treasuries rose 18.5 percent to $542.5 billion. Foreign direct investment in U.S. real estate increased to $37.1 billion in 2003 from $36.0 billion in 2002.

- ♦ Japan has consistently had the highest investment share over the past nine years. In 2003, Japan accounted for 23 percent of the total foreign real estate investment. Germany, Canada, United Kingdom, and the Netherlands also played strong roles with each contributing 9 to 11 percent. Investment from Latin America has been increasing in recent years and now makes up 9 percent of the total.

- ♦ Prospects for an increase in foreign direct investment in U.S. real estate look bright for 2005. The nation's economic momentum has significantly picked up. About 2.5 million net new jobs are

expected to be created in 2005. Demand for commercial spaces – from office and retail to industrial and multifamily – turned positive in 2004 and the trend will accelerate in 2005.

- Foreign-born purchases of residential real estate are expected to rise steadily from the significant increase in immigration in recent years. Nearly half of the increase in the overall U.S. population in recent year is due newly arrived immigrants. Given the strong relationship between rising homeownership rates and the length of time in the U.S., home purchases by the foreign-born population will have a sizable impact on the housing market for the foreseeable future.

- 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 7.0 percent over the last five years as compared to 8.8 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® estimates that in the absence of foreign capital the long-term interest rates would be six percentage points higher than their current levels. The National Association of Realtors® further estimates that a six percentage point rise in the 30-year mortgage rate would have resulted in existing home sales of 4.6 million to 4.9 million in 2003 rather than the 6.1 million sales that were recorded. The industry revenue for real estate agents would have been 20 percent to 25 percent lower than what was observed.

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. The National Association of Realtors® 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 for the second consecutive year in 2003, consistent with the recovering economy after the 2001 recession. But the level of investment in 2003 was below the peak activity of 2000. Nonetheless, the long-term trend has shown substantial upward movements. The long-term increase is due to a variety of factors, most notably the globalization of the real estate industry, the lowering of trade barriers among nations, and the broader inflow of foreign investment caused by favorable macroeconomic conditions in the U.S. compared to the rest of the world. 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 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 loosing 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 1997-1998 melt down in Southeast Asia 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 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. When comparing the European Public Real Estate Association's (EPRA) index with the Wilshire U.S. REIT index, the U.S. outperformed Europe for the last three years, extending the gap in returns significantly in 2003.

Return on Properties Indexes		
	Europe	U.S.
2001	-0.2%	12.4%
2002	2.4%	3.6%
2003	20.4%	36.2%

Source: EPRA Europe index and Wilshire REIT index

Similarly, despite the fact that the U.S. interest rates have hit 45-year lows in the past year, U.S. bonds continue to offer a better return than those of Europe or Japan. Between 1992 and 2003,

long-term bond yields averaged 5.1 and 4.8 percent for U.S. and Europe, respectively, while Japan trailed at 1.4 percent. There was a starker contrast in short-term rates where the U.S. and Europe averaged 3.7 and 3.5 percent, respectively, whereas Japan averaged 0.1 percent.[1]

Another recent factor to consider is the weakness of the dollar. Due partly to a large U.S. trade deficit, the U.S. dollar depreciated against other major currencies in 2002 and early 2003, particularly against the euro. The depreciation reached a plateau in the middle of 2003 and has remained at these levels since. The prospect of stronger U.S. economic growth and a rising dollar mean that investment in U.S. dollar denominated assets will yield a higher rate of return once converted to foreign currencies due to the appreciation in the dollar. 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) performed well in 2003 compared to standard equities. In 2003, U.S. REITS, as measured by the Wilshire REIT index surged a whopping 36.2 percent. Over that same period, the Standard and Poor's 500 index rose 19.5 percent. The more volatile and risky NASDAQ index rose 38.6 percent as it regained some of the massive losses that occurred in 2001 and 2002. In 2004, REITS have been performing pretty much in line with broader equities.

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 5.1 percent as compared to 2.4 percent for inflation. Furthermore, residential home prices have not declined at the national level from one year to the next since the NATIONAL ASSOCIATION OF REALTORS® began tracking prices of existing homes in 1968. In contrast, the values of stocks, bonds, and other financial assets have fluctuated, wildly at times, with changing economic conditions and investor exuberance. Moreover, simple home price appreciations don't account for the boost to returns that leveraged buying allows. If one invests 20 percent of the cost (i.e., down payment) 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. That is, a $20,000 down payment yielded $10,000 gain in housing equity. 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.

In the past three years as the U.S. economy underwent recession in 2001 and sluggish growth in 2002 and 2003, commercial vacancy rates - from the office and retail sectors to the multifamily and warehouse sectors - rose measurably. However, commercial property prices held their ground as investors' demand remained strong due to the desire for a safer real property asset.

[1] Source: Organization for Economic Cooperation and Development, OECD Economic Outlook, No. 75. "Interest Rates and Exchange Rates: EO73 Statistical Annex Tables", Tables 35 and 36; June, 2004

Establishment of Market Presence

The United States is the world's largest and most open commercial real estate market. Undoubtedly, foreign firms want to establish presence in the U.S. 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. This trend was particularly apparent during the Asian economic meltdown of 1997-1998 and the Russian ruble collapse of 1998. Similar market instability have led to panic among investors 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.

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 market. 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 portfolios, including investment in U.S. real estate. In

the face of these controls on foreign investments, the U.S. economy offers an advantage for 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 $122.2 billion in 1994 to $492.4 billion in 2003 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. From anywhere around the globe, prospective homebuyers can browse online listings with pictures and even 360-degree virtual tours. Web sites like Realtor.com and Worldproperties.com allow housing shoppers to search at minimal cost and to start the home buying process. 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 eventually 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. Further technological advancement will undoubtedly lead to even lower transaction costs and higher international transactions.

Trends and Impact of Foreign Purchases in the U.S. Residential Market

Another important dimension to foreign investment in U.S. real estate is the prospect of foreigners purchasing vacation homes in the U.S. and the arrival of new immigrants wanting to realize the American dream of homeownership. The U.S. housing market has experienced record sales and strong price growth during the past four years. New and growing trends in the market, immigration and expanding purchases of second homes, serve to underpin this growth and will help both sales and price appreciation in the future.

Immigration

Falling mortgage rates undoubtedly played an important role in fueling the housing boom over the last four years. Another major contributor to home sales over this period that should not be overlooked is foreign-born population growth.

		YEAR OF ENTRY				
	Total	2000 -2003	1990-1999	1980-1989	1970-1979	Before 1970
Total	91,159,000	11,769,777	29,576,000	19,594,000	20,583,000	21,406,000
Immigration	28,936,000	4,536,000	12,235,000	8,035,000	4,600,000	4,066,000
% of Total	32%	39%	41%	41%	22%	19%

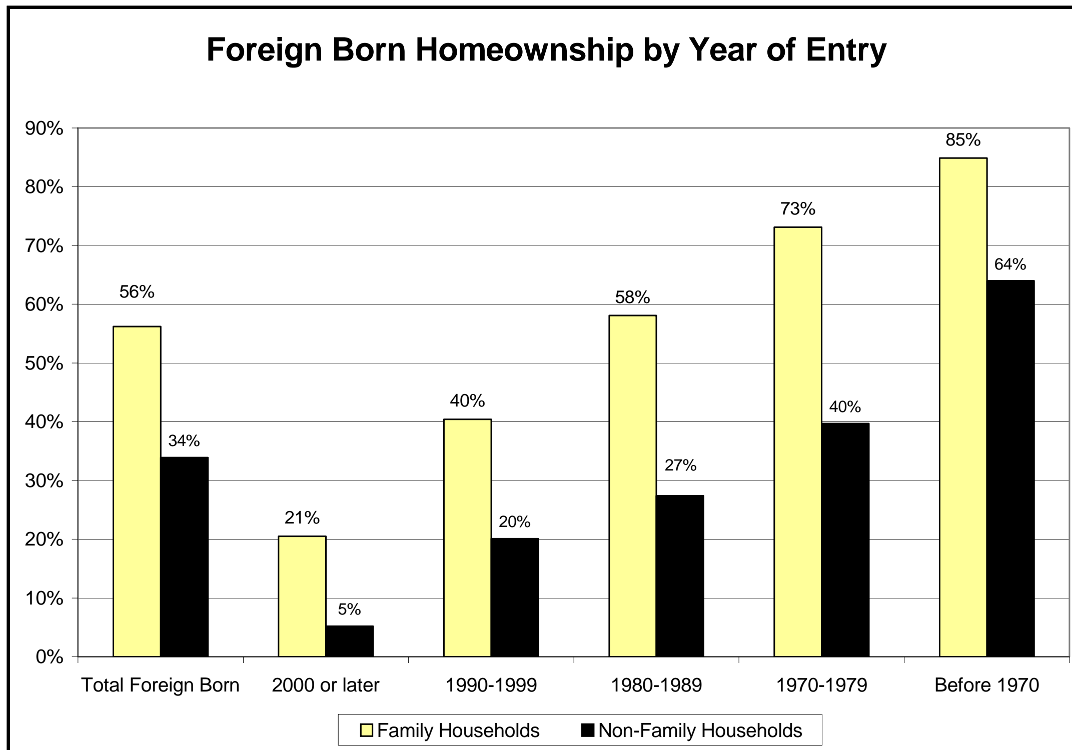
Source: U.S. Census

The population of the U.S. grew by roughly 30 million people during the last decade of the 20th century and by another 12 million in the last four years. The strong increase in immigration contributed to nearly half of the increase in the overall US population that occurred from 1990.

The role of immigration in U.S. population growth and the housing boom cannot be understated. Indeed, even Federal Reserve Chairman Alan Greenspan has cited the importance of immigrant household formation in supporting the housing market in recent speeches.

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

Because homeownership tends to increase with length of residence in the U.S., the important role of the immigrant population in supporting the housing market will grow over the next 10 years and beyond. The homeownership rate of foreign-born households who came to the U.S. in the past four years is only 16 percent. However, among households who entered the country more than 30 years ago, the homeownership rate surpasses that of the national average with 78 owning a home. The large pool of immigrants that arrived over the last few decades will steadily look to become homeowners. Furthermore, U.S. Census estimates that the foreign-born population will continue to grow at a strong rate. It projects an annual average growth rate of 2.0 percent from 2004 through 2010 before tapering off to 1.3 percent for the period from 2011 through 2020. Therefore, the prospects of home purchases by foreign-born population in the U.S. will remain strong for the next two or three decades.



Sources: U.S. Bureau of the Census

The foreign-born population does become homeowners over time. But due to language, cultural and institutional adjustments homeownership among them still lags behind that of native-born Americans and the population as a whole. Realtors® can seize the opportunity and help close this gap through counseling and homebuyer education programs for their foreign-born clients. Evidently many Realtors® have already realized the potential business opportunities. Over the last five years, almost half of NAR® members indicated that they have participated in a transaction involving international aspect and this trend will inevitably increase.

Second Homes

Evidence suggests that there is strong demand for secondary housing. These properties are most often used for recreational or vacation purposes, but they are increasingly used for investment purposes. Baby boomers in their peak earning years and the net wealth standing at an all-time high, second home demand looks to remain solid for foreseeable future. Aside from domestic demand, many foreigners are also seeking a vacation home in the Land of the Free. The satisfaction in second home ownership remains high according to the 2002 National Association of Realtors® Profile of Second-Home Owners. Separating the satisfaction of foreign second home purchasers from domestic buyers was not feasible. Nonetheless, the survey found that 85 percent of second homeowners indicating 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. Given the high returns and the U.S. laws respect for the rights of foreign owners of U.S. real properties, foreign investors have just as strong of incentives to own U.S. second homes as the native population.

The U.S. Economic and Real Estate Market Conditions

Economic conditions are important to foreign investors. The better the conditions, the stronger the prospects for investment by both domestic and foreign investors. Therefore, in order to assess trends in foreign investment in U.S. real estate, it is helpful to look at U.S. macroeconomic conditions in the past year and the outlook for the next year.

Current Macroeconomic Conditions

After sputtering at a 0.8 percent growth rate in 2001, the economy started to tread upward at a 1.9 percent rate in 2002. Growth significantly accelerated in the fall of 2003 – with the third quarter expanding at a robust 7.4 percent clip – thereby bringing economic growth for the year as a whole to 3.0 percent. The strong momentum carried over to 2004 with 4.5 percent growth rate in the first quarter. With growth rates so strong, inflation worries rose during the early summer. However, growth softened in the second quarter of 2004 to 3.3 percent from a sudden slowdown in consumer spending. The consumer spending growth rate of 1.6 percent was its lowest in three years. However, consumer spending is expected to make a rebound in the second half. Net household wealth is at an all-time high – thanks largely to a significant run-up in housing equity. The economy is creating jobs and raising income. The stock market is poised to increase due to sizable increases in corporate profits. As a result NAR projects consumer spending growth will easily top 3 percent for the second half of 2004 and well into 2005.

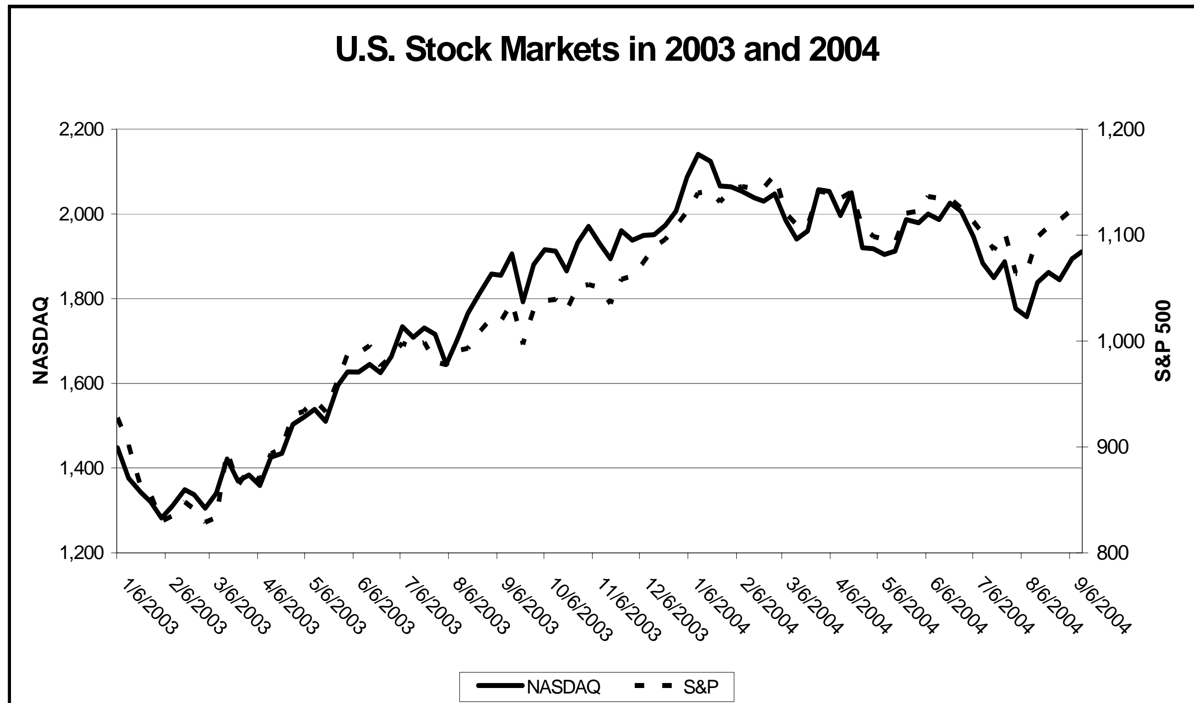
Business spending started to improve in the latter half of 2003 and continues to do so despite rising fuel costs and continued hostilities/uncertainty in Iraq. Labor hiring also turned for the better. A total of 1.8 million payroll jobs were added over the 13-month streak of positive employment growth to September 2004. Consequently, the unemployment rate retreated to 5.4 percent from 6.3 percent over that period.

Meanwhile, inflation has been a non-factor. It was tame in 2003 and remains so as of August 2004. The consumer price index, the most widely watched measure of inflation, increased 2.3 percent in 2003 from 1.6 percent in 2002. For 2004, CPI is expected to increase by 2.6 percent. That would mark three successive years of under 3 percent inflation rate – the rate at which the Federal Reserve would consider to be ideal. Given the low inflationary trends, the long-term interest rates have remained favorable. The 10-year Treasury was yielding 4.0 to 4.6 percent for most of 2004.

Current Financial Market Conditions

The stock markets roared back to life in 2003. Standard and Poor's index rose 22.0 percent. The NASDAQ composite shot up 44.7 percent. Stock market movements in 2004 have been less eventful. Corporate profits hit $1.2 billion in the second quarter of 2004, which represents a whopping 35 percent increase in just two years. But due to geopolitical uncertainty surrounding Iraq and the Middle East and from higher oil prices, the S&P index has risen only 1.6 percent while the NASDAQ composite slid 4.8 percent (January to September).

The Federal Reserve, meanwhile, has begun its tightening cycle. In 2001 and 2002, the Fed had aggressively slashed the Federal funds rate repeatedly in an attempt to stave off a recession.

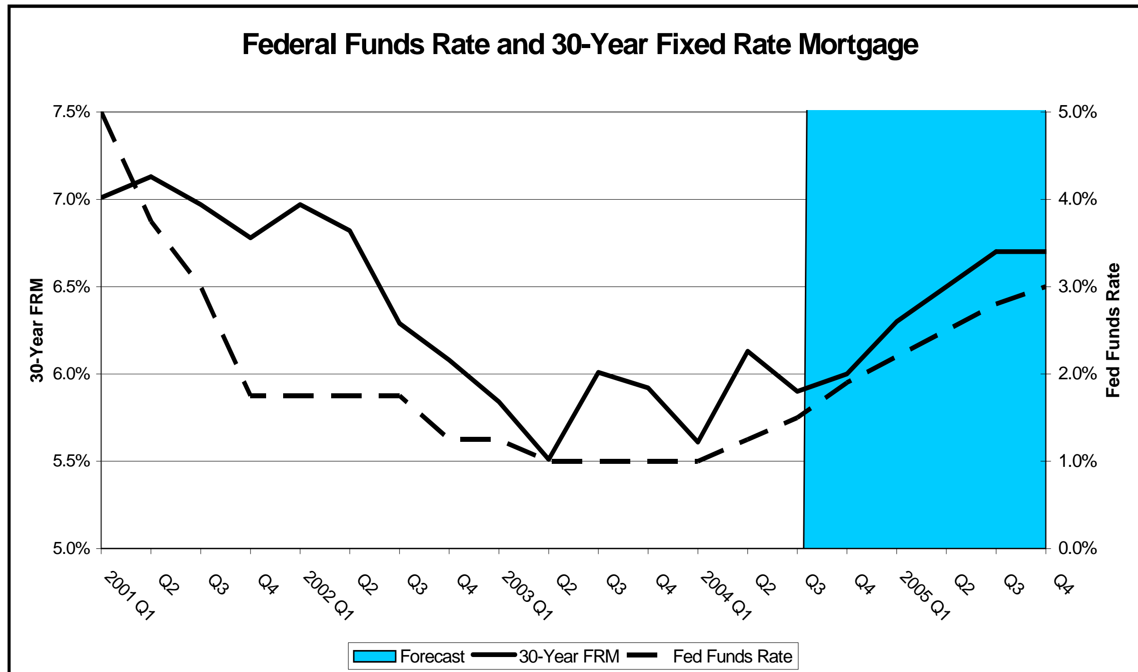


Source: NYSE and NASDAQ figures fromYahoo! Financial

But with the economy now showing healthy signs, the Fed has begun lifting the gas pedal. The Fed does not want to over-stimulate the economy and potentially ignite inflation. To do so, the Fed needs to raise the federal funds rate to a position that it feels is neutral - neither stimulating nor retarding spending patterns. The Fed began this process in June of 2004 with a 0.25 percent increase in the fed funds rate and followed this move with 0.25 percent hikes in both August and September to bring the rate up to 1.75 percent. The Fed is expected to continue this process of gradually raising rates. By the second quarter of 2005, the fed funds rate is expected to have risen to 2.5 percent.

The long-term rates are not directly determined by the Fed. They take into account the short-term borrowing costs as well as future inflation. To date in 2004, long-term rates have remained very favorable. Low inflationary expectations and the continued inflow of foreign fund into the U.S. bond market helped mortgage rates to fall to an average of 5.6 percent during the first quarter of 2004. The rates climbed to 6.1 percent in the second quarter from the anticipated Fed interest rate hikes. But since the actual start of the Fed tightening, mortgage rates have eased somewhat to finish the third quarter at about 6 percent.

The Fed is far from finished in its tightening cycle given the projected solid economic growth rates of 4.5 percent in 2004 and 4.4 percent in 2005. Consequently, NAR is forecasting the 30-year fixed rate mortgage to rise from late 2004 or early 2005. The average 30-year mortgage rate is expected to average 6.5 percent by the second quarter of 2005.



Source: Federal Reserve, Freddie Mac, NAR®

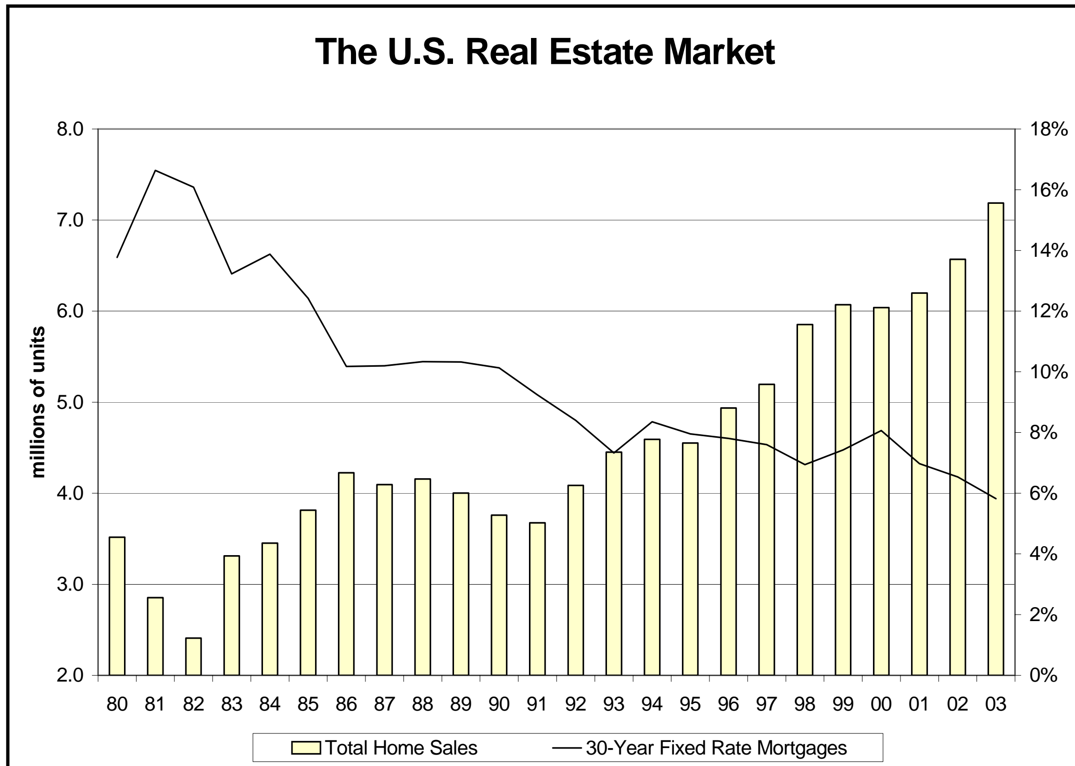
Current Real Estate Conditions

Generational low mortgage rates pushed home sales to new heights in 2003 and the first-half of 2004. The average 30-year fixed rate fell to 5.8 percent in 2003. During the first seven months of 2004, it was 5.9 percent. Similarly, the one-year adjustable rate mortgages fell from an average rate of 4.6 percent in 2002 to 3.8 percent in 2003 and remained at that level in the first half of 2004.

Demographic trends have also been favorable. Household formation grew by 1.8 percent in 2003 with the total number of households reaching 111.3 million. This rate of increase was the second strongest since 1995.

Not surprisingly, existing homes increased significantly from 5.57 million units in 2002 to 6.10 million in 2003. New home sales increased from 976,000 to 1,086,000 over the same period. Single-family housing starts increased from 1.36 million to 1.50 million, a 25-year high. Sales have been even more impressive in the first half of 2004. NAR forecasts 6.5 million unit sales for existing homes and 1.15 million for new homes in 2004.

Strong demand has pushed home prices to rise robustly. Existing home prices rose 7.0 percent in 2002 and 7.5 percent in 2003. The projection calls for another 7 percent increase in 2004. These appreciation rates easily beat the general consumer price inflation and translate into roughly $34,000 home equity gain for a typical homeowner over the three year span.



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

Unlike the spectacular performance of the residential real estate market, the commercial real estate market underwent soft conditions from the onset of the 2001 recession. Vacancy rates for offices, industrial (warehouses), and multi-family housing all rose from 2000 through 2003. Rents fell as a result. Fortunately, the commercial real estate market began to show signs of life from the second half of 2003. The improved economy means more traffic at retail shops and increased absorption of office spaces. Companies have been restocking depleted inventories, thereby boosting demand for warehouse space. Job creations have led many younger households to seek out their own rental units. Consequently vacancy rates have been falling in the office and multifamily sectors in 2004. Net positive absorption matched new supply in the industrial and retail sectors leaving vacancy rates stable. Improving demand for commercial spaces has led to rising rents in all sectors but industrial. The decline in rent in the industrial sector has been milder and is expected to turn positive before the year end.

The State of Commercial Real Estate								
	Change in Rental Rates				Vacancy Rates			
	Office	Industrial	Multi-Family	Retail	Office	Industrial	Multi-Family	Retail
2000	13.8%	9.8%	7.4%	4.9%	8.6%	6.6%	4.2%	N/A
2001	-7.2%	-0.7%	3.5%	1.9%	14.2%	9.8%	4.6%	N/A
2002	-8.3%	-4.1%	0.5%	1.4%	16.5%	11.0%	5.5%	N/A
2003	-6.7%	-4.1%	-0.3%	2.3%	16.8%	11.6%	6.4%	8.1%
2004	1.4%	-1.3%	1.2%	3.6%	16.3%	11.7%	5.9%	8.2%

Source: Torto Wheaton Research

Trends in International Investment

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 purchases 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.

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.

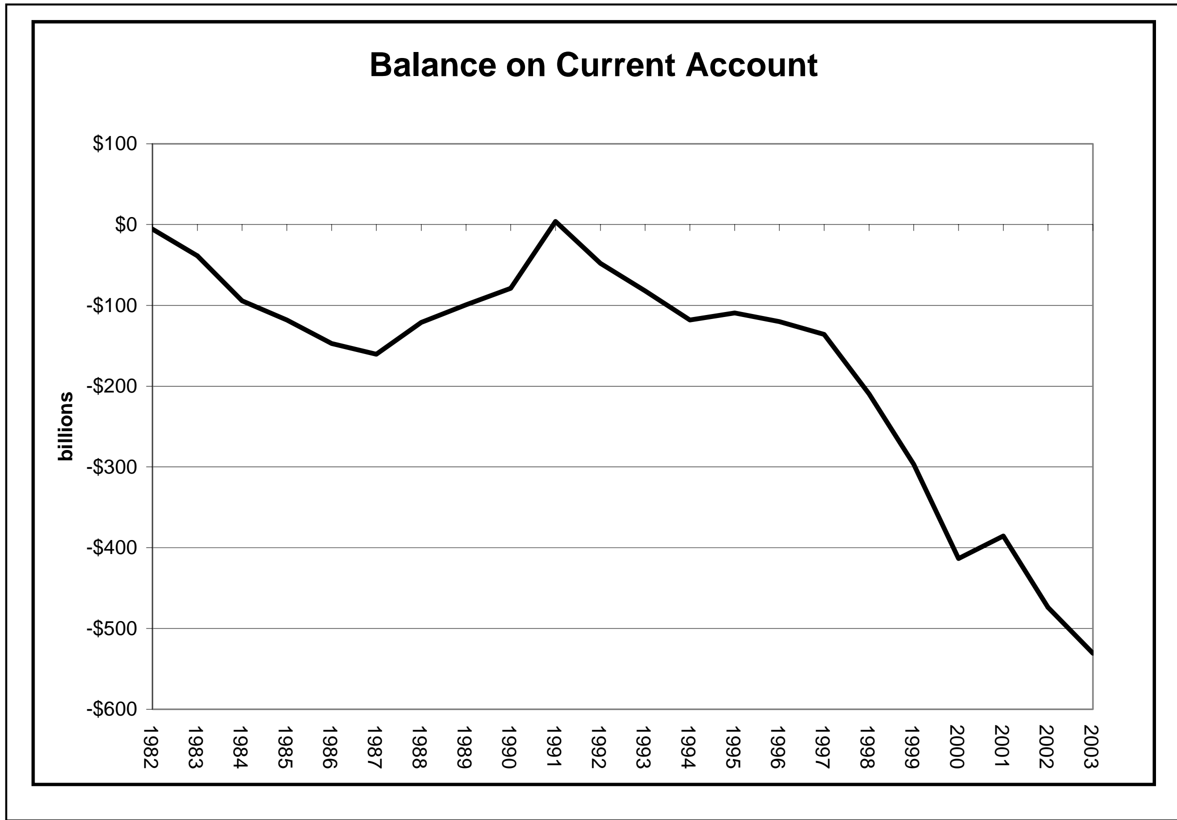
The current and capital accounts of the balance of payments provide valuable information about the state of international movements of goods, services, and financial assets to and from the U.S. The current account measures how well the U.S. is exporting goods and services relative to its trading partners. 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 investing in the U.S. economy.

The Current Account Balance

Except for a brief pause in 1991, the U.S. has been a net importer of goods since the 1980s. The trend deteriorated sharply from 1997. In 2003 the current account deficit hit $530.7 billion, a new record.[2] Cheap foreign goods and easy financing at home allowed domestic consumption of imports to grow rapidly. The accumulated effect of a strengthening dollar from 1995 to 2001 made U.S. products more expensive and foreign products more affordable. A weak foreign economies in relation to the U.S. since 2001 also hampered U.S. exports. There was no let up in the trend in the first half of 2004. Furthermore, a large thirst for oil by the booming Chinese economy, delays in Iraq reconstruction, and oil related production problems in Venezuela, Russia, and Nigeria resulted in a sharp increase in energy prices in 2004. Higher oil prices, in turn, directly added to a higher U.S. expenditure for imported oil.

Fortunately, from the perspective of trade balance, the dollar began to weaken in late 2003 making U.S. made products more competitively priced. It generally takes a year or two for the falling currency to measurably alter import-export trends. So it is near certain that a weaker dollar, particularly against the Euro, will help stabilize the U.S. trade position possibly as early as the beginning of 2005.

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

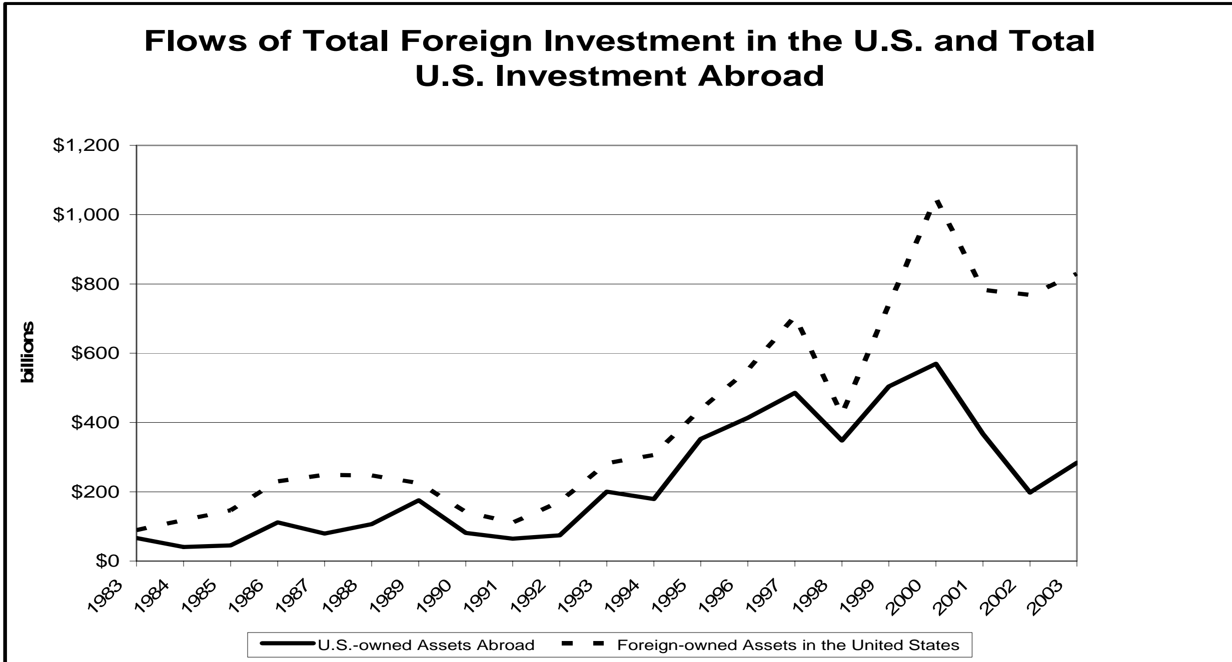


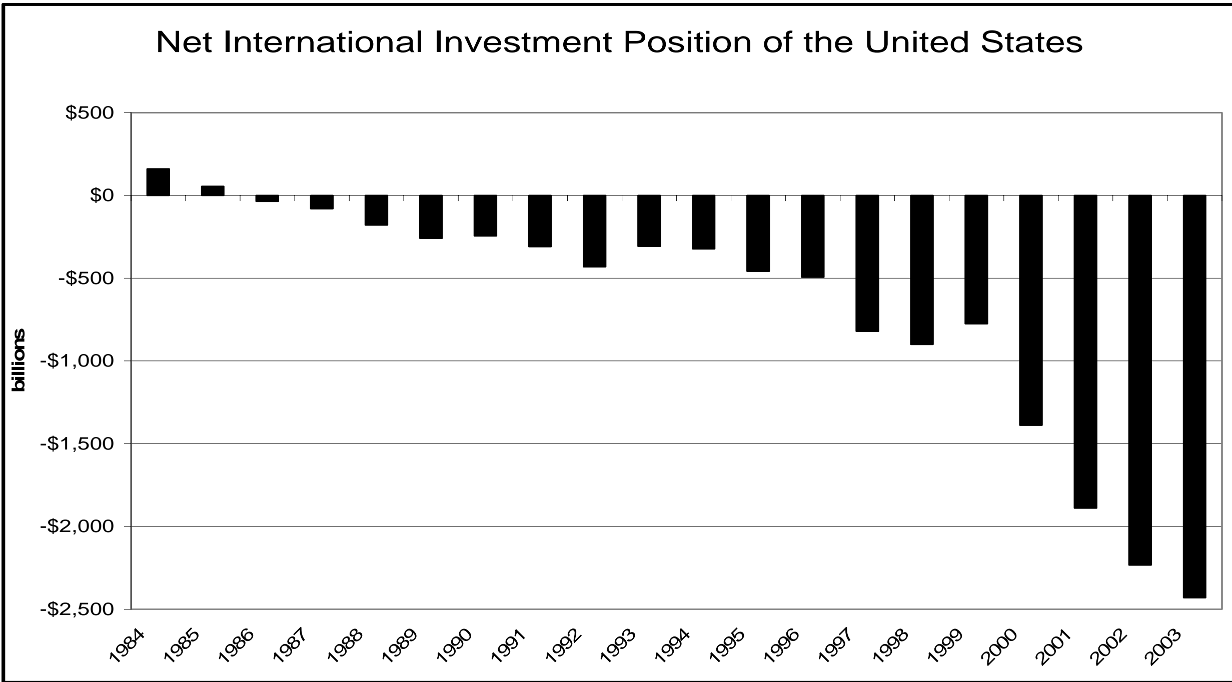
<u>The Capital Account Balance</u>

Foreign Capital Inflows

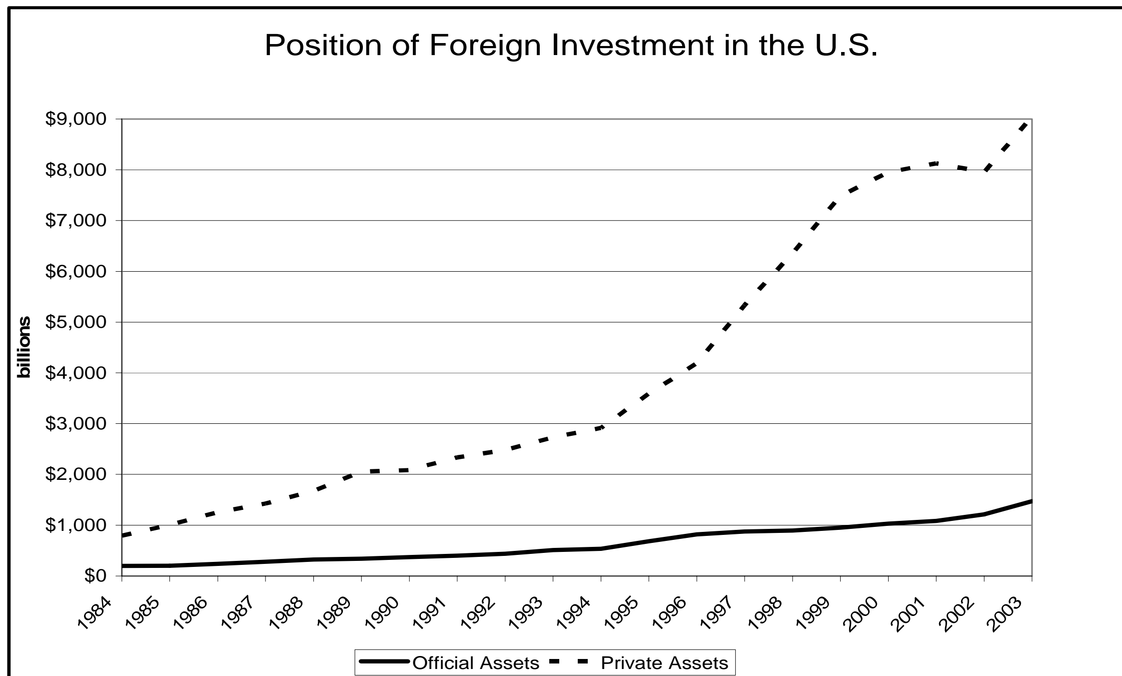
The ever expanding U.S. trade deficit requires ever increasing foreign funds to finance U.S. purchases of net imported goods and services. This increase in foreign borrowing shows up in the capital accounts. U.S. capital account, therefore, has been running a large surplus in recent years. That is, foreign investment of capital in the U.S. significantly outpaced U.S. investment abroad. The net position was a $545.8 billion inflow of foreign funds into the U.S. in 2003.

One noteworthy event in recent years is the reduction in *gross* investment by both foreign investors in the U.S. and by U.S. investors abroad. Gross investment had trended solidly upwards in the 1980s and 1990s reflecting steadily increasing movements of financial capital across borders from liberalized capital markets. However, gross investment by both parties fell in 2001 and 2002. The onset of global recession in 2001 and subsequent sluggish recovery in 2002 retarded international capital movement. By 2003, however, gross investment – both inflow and outflow - returned to positive growth.





The ever increasing annual influx of funds from abroad resulted in a steadily increasing net holdings or net investment of U.S. financial assets by foreigners. By 2003, the net holding position (foreign holdings of U.S. assets minus U.S. holdings of foreign assets) was $2.43 trillion, an 8.9 percent increase from the prior year.



In terms of gross foreign investment holdings of U.S. assets (not adjusting for U.S. holdings abroad), nearly $10.5 trillion were held by foreigners in 2003. That roughly equals one year of U.S. gross domestic product.

Dividing the gross foreign holdings into government and private sources also reveals an important trend. Private foreign investment has sharply outpaced official foreign government investment in recent years. The stock of foreign investment in the U.S. by private individuals reached $9.0 trillion in 2003, accounting for nearly 90 percent of total foreign investment position. Because private capital is not subject to negotiations and agreements between governments, a sudden pullout of funds could potentially wreak havoc to the U.S. financial market and the U.S. economy.

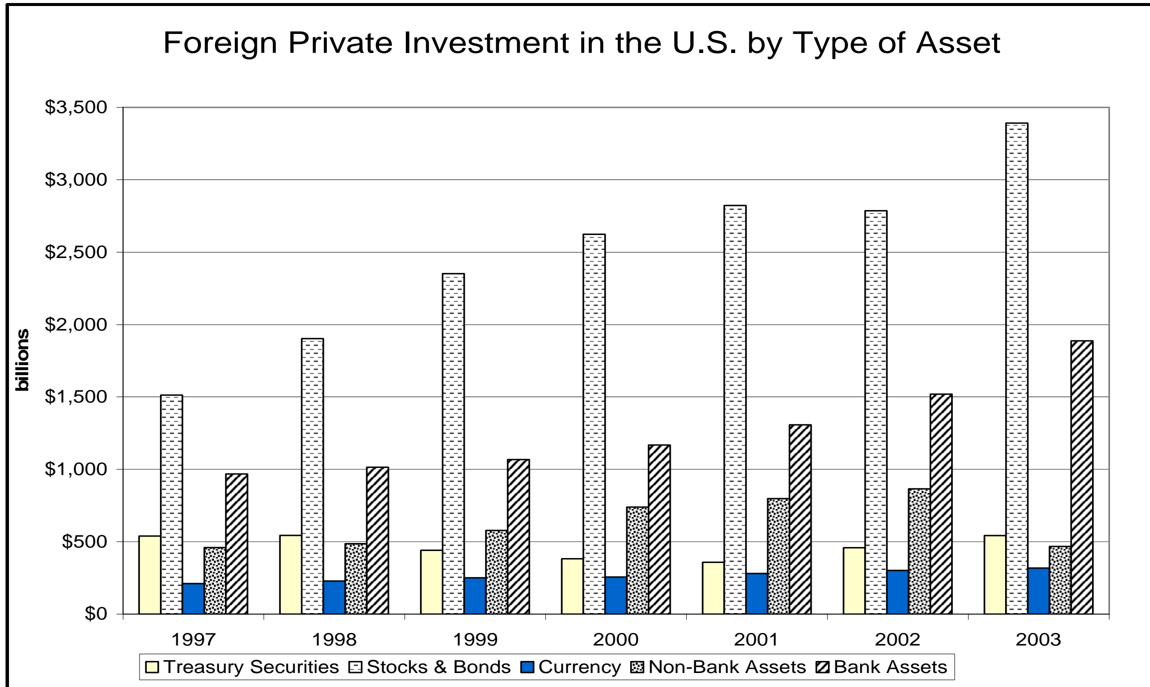
Private Investment

Because of the relatively small role that official foreign investment plays in the U.S. economy, this report will focus only on private foreign investment. Private investment can come in two forms: direct investment and other private investment. Direct investment would include a German company purchasing stocks in a U.S. company. Other private investment includes foreign purchases of bonds, cash, bank assets, and non-bank assets in the U.S. The lion's share of foreign private investment in the late 1990s came in the form of other private investment. Both direct and other private investment peaked in 2000. Since then, both investments fell, marking three years of consecutive declines to date.

Other Investment

Other private investment – that is, investment in non-stock assets such as bonds and other paper assets - has an important impact on the U.S. economy. An increase in the flow of funds from abroad can reduce domestic interest rates. In turn, lower interest rates stimulate investment and consumption of larger purchases such as homes and automobiles. Investment in currency was relatively stable over the last ten years. However, foreign holdings of U.S. Treasuries surged in 1997 and 1998 reaching $543 billion. Investment in U.S. treasuries tapered down to $358 billion in 2001 before surging 51.3 percent in

recent two years to reach $542 billion in 2003. Global instability continues to generate high demand for safe assets like Treasuries, bank assets, and cash.



Direct Investment

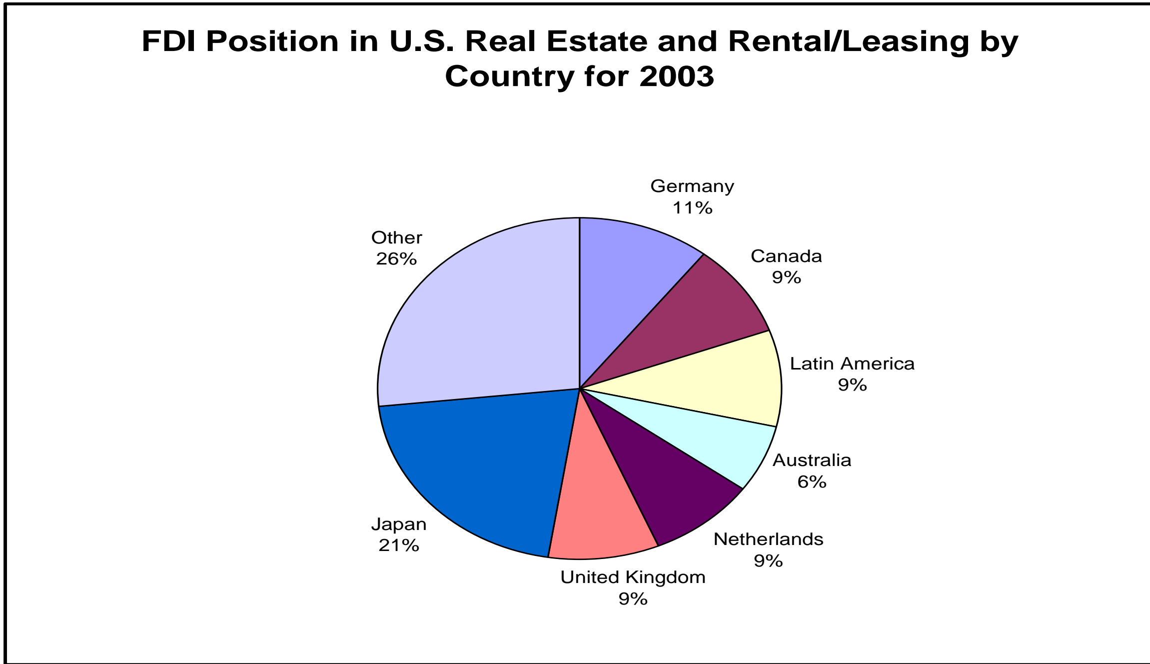
Direct investment, through the purchase of shares in a U.S. company, also plays a significant role in stimulating the U.S. economy. Foreign companies may buy stock in a U.S. company for several reasons: as a simple investment, to satisfy the need for international diversification in a portfolio, or to gain strategic positioning within an industry. Regardless of the reason, the flow of direct investment helps expand the pool of funds available to grow U.S. businesses and boosts the stock market. Furthermore, flows of investment into the stock market bid up stock prices, which can boost consumer confidence and thereby stimulate spending.

Foreign direct investment increased sharply in the past 4 years. In 1999, direct investment totaled $1.1 trillion. In 2000, it surpassed $1.4 trillion. It then moved past $1.5 trillion marker in 2001. After falling modestly in 2002, direct investment again rose in 2003. Direct investment totaled $1.55 trillion in 2003.

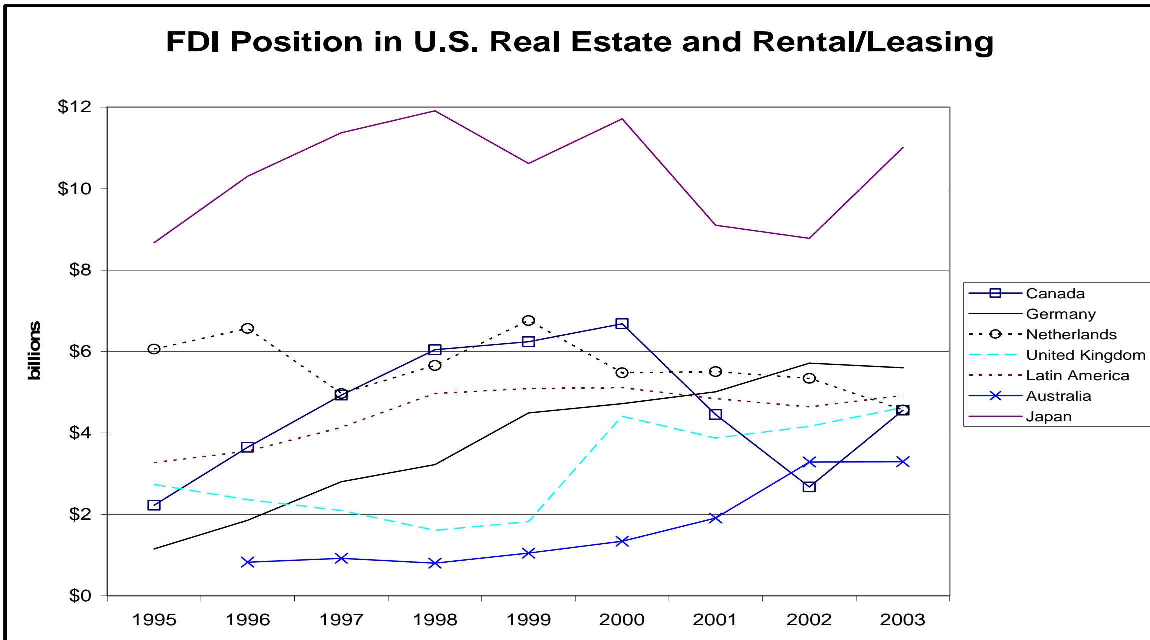
Foreign Direct Investment in U.S. Real Estate

Foreign direct investment in real estate – that is, purchases of stock in U.S. real estate related companies - rose by 4 percent between 1999 and 2000. However, real estate investment plummeted in 2001 when the world economy retrenched. But investment has steadily recovered in the subsequent two years. In 2003, foreign direct investment in U.S. real estate reached $37.0 billion.

In 2003, as in the past, foreign investment in U.S. real estate was dominated by Japan, Canada, Germany, Netherlands, and the United Kingdom. Japan alone contributed 21 percent of 2003 foreign direct investment in real estate, while Germany replaced Canada as the number two source with 11 percent. Canada, the Netherlands, the United Kingdom, and Australia accounted for another of 33 percent.

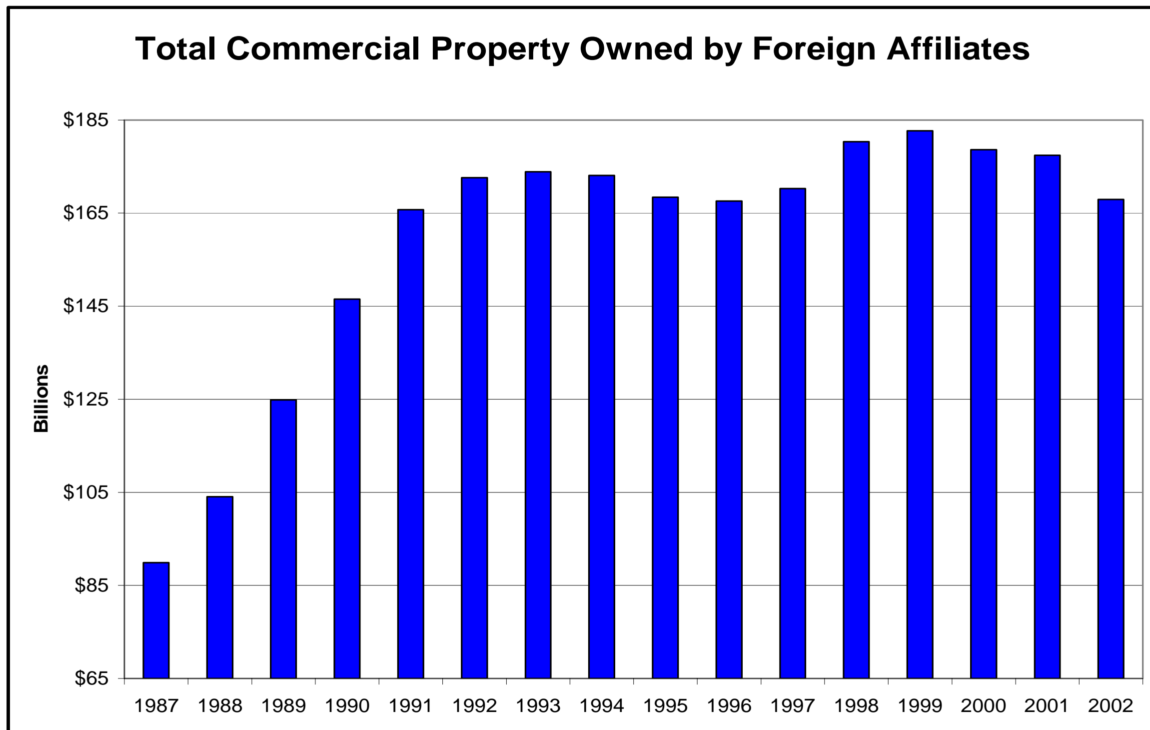


Japan has consistently had the highest investment share over the past 10 years. There were sizable increases in U.S. real estate investment from Australia and from Latin America. Canadian investment sputtered from 2000 through 2002, but managed a rebound in 2003.



Direct Purchases of U.S. Properties

Foreign companies may choose to buy U.S. real properties, as opposed to financial assets. The reasons include the desire to expand operations in the U.S. and thereby circumvent tariff restrictions, lower transport costs or take advantage of the U.S.'s skilled workforce. Whatever the reason, direct purchases of U.S. properties can result in new construction, new real estate purchases, and new U.S. jobs. The best measure of foreign purchases of U.S. commercial properties is change in holdings of U.S. properties by U.S. affiliates of foreign companies.



Interestingly, foreign holdings through U.S. affiliates of U.S. commercial properties slid for the fourth consecutive year in 2002 (the latest year for which the data is available). It fell by $9.5 billion from 2001 to 2002 to a total of $168.0 billion. Over the five year period ended in 2002, direct holdings of U.S. commercial properties fell by $12.4 billion, or by 6.9 percent. Nonetheless, when considering over a longer time span, the growth in direct purchases of U.S. properties has been phenomenal. From 1988 to 2003, total holdings of U.S. commercial properties increased by $63.9 billion or by 61.4 percent.[3]

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[3] According to the BEA, this data is calculated by combining BEA's annual surveys of Foreign Direct Investment and BEA estimates for firms not in the sample. A U.S. affiliate is defined as any firm in which "which there is foreign direct investment--that is, in which a single foreign person owns or controls, directly or indirectly, 10 percent or more of the voting securities or an equivalent interest. The financial and operating data of U.S. affiliates cover the entire operations of the U.S. affiliate, irrespective of the percentage of foreign ownership."

Under BEA's definition, "commercial property comprises all commercial buildings and associated land owned by the affiliate that are either used or operated by the affiliate or leased or rented to others. Commercial buildings include apartment buildings, office buildings, hotels, motels, and buildings used for wholesale, retail, and services trades, such as shopping centers, recreational facilities, department stores, bank buildings, restaurants, public garages, and automobile service stations."

The BEA produces this data a year behind the foreign investment data. Consequently, 2002 is the most recently year of reported data.

International Investment Impact on U.S. Real Estate Market

Over the past five years, foreign trade and capital movements played an important role in the growth of the U.S. real estate industry. Foreign direct investment added $37 billion to the market capitalization of U.S. real estate companies. In addition, the flow of funds into the U.S. has been staggering. As a result, the U.S. real estate industry has benefited immensely. The flow of foreign funds into the bond and mortgage markets place downward pressure on interest rates. According to a Federal Reserve research paper, it is estimated that a one-percentage point increase in the federal deficit-to-GDP ratio raises long-term interest rates by roughly 25 basis points. Because money is fungible – upward interest rate pressure from excessive borrowing by the federal government can be alleviated by an increase in the foreign capital supply – NAR estimates that in the absence of foreign capital, the long-term interest rates would be six percentage points higher than current levels. NAR further estimates that a six percentage point rise in the 30-year mortgage rate would have resulted in existing home sales of 4.6 million to 4.9 million in 2003 rather than the record 6.1 million sales that were witnessed. The industry revenue for real estate agents would have been 20 percent to 25 percent lower than what was observed.

Foreign Investment and the Future

The U.S. economy have benefited greatly from sustained flows of foreign investment. But the future prospects of continue foreign flow of funds will depend on the likely path of the U.S. economy and real estate market. Economic growth potential of our major trading partners will also factor into foreign investors' decision.

Outlook for the U.S. Economy

The U.S. economy gained good traction in late 2003 and early 2004. But growth softened in the second quarter of 2004. Fundamentals suggest the soft condition is likely to be temporary. Stronger growth is expected to take hold again in the fall of 2004. The weak dollar should begin to have an impact on U.S. exports, particularly on large capital goods to Europe and Asia. Interest rates will rise modestly with the Fed hikes, but will remain at historically low levels. NAR forecast calls for the U.S. economy to grow at a robust 4.5 percent in 2004. A similar above-trend growth rate is expected in 2005.

Meanwhile, inflation is expected to remain below the crucial 3.0 percent level, increasing at 2.7 percent in 2004 and by 2.2 percent in 2005. Low inflation and robust growth will result in strong job gains. The unemployment rate on an annual average basis is expected to drop from 5.5 percent in 2004 to 4.9 percent in 2005. Such a jobless rate would be roughly equal to the natural rate of unemployment, the rate of unemployment where GDP growth can increase without pushing up inflation. The 30-year mortgage rate will rise modestly from 5.9 percent in 2004 to 6.5 percent rate in 2005.

After the exuberant first half, existing home sales will begin to taper off in the latter part of 2004. For the year as a whole, sales of existing homes will post another record with 6.5 million units – an increase of 6 percent from 2003. New home sales are also expected to set a record in 2004 with roughly 1.15 million sales, an increase of 5.8 percent. The numbers for 2005 will fall slightly from the blistering sales pace of 2004. Existing home sales will register 6.3 million units and new home sales will post 1.05 million units. The declines in both new and existing sales will come due to the expected increase in the 30-year fixed mortgage rates.

Commercial Real Estate Forecast

	Change in Rental Rates				Vacancy Rates			
	Office	Industrial	Multi-Family	Retail	Office	Industrial	Multi-Family	Retail
2004	1.4%	-1.3%	1.2%	3.6%	16.3%	11.7%	5.9%	8.2%
2005	1.9%	-0.2%	2.2%	4.2%	15.0%	11.4%	5.8%	8.1%
2006	4.1%	1.7%	3.1%	4.2%	13.4%	10.6%	5.5%	8.5%

Source: Torto Wheaton Research

The commercial sector will improve markedly in 2005. Business spending is expected to accelerate and consumer spending will continue its growth in the range of 3 to 4 percent. Real disposable income is forecast to grow 2.9 percent in 2004 and 4.0 percent in 2005. Non-farm payrolls are forecast to grow by 1.1 percent and 2.0 percent over this same period. These improving economic indicators will help the office and retail sector. Increased international trade and the need to restock inventories will boost the industrial sector. Rising mortgage rates will erode housing affordability. Many will turn to rental units as a result.

The commercial sector as a whole will see steadily declining vacancy rates. Increased absorption will bring positive growth in rents to the retail, office, and multifamily sectors.

Projections for International Growth

The domestic real estate market benefited from substantial investment from abroad in recent years partly due to weaker economic conditions 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, and the Netherlands all

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 opinions and plans for the coming and past years. According to this year's survey, consumption of U.S. real estate surged from what survey respondents had planned on acquiring in 2002. While survey respondents had planned on acquiring an average of $308 million, actual consumption registered a whopping $385 million, or an increase of 59.0%.

According to the survey, the U.S. was voted the "most stable and secure country for real estate investment" with 60% of the vote, while France and Canada tied for second with 9.4% each. When asked which country had the best opportunity for capital appreciation, 54% of the vote went to the U.S. with Japan in second. Nearly 94% of participants responded that it was 'somewhat' or 'very' difficult to find attractive U.S. opportunities in 2003, up from 78% in 2002. But, as Erwin F. Stouthamer, Director of International Real Estate for Mn Investment Management pointed out, "in addition to the diversification benefits that an allocation to US real estate brings, US real estate returns that bear some degree of risk may still weigh-up to expected risk-adjusted returns elsewhere".

Washington extended it reign as respondents' favorite global city for investment. The field was rounded out with London and Paris in second and third, respectively, followed by New York and Los Angeles, which bumped Milan out of the top 5.

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 $431 million per investor in 2004. That is an increase of 40% over survey participants planned investment in 2003 and more than a 12% increase over their actual investments in that year.

Favorite U.S. city for investment
(1) Washington, DC
(2) New York
(3) Los Angeles
(4) San Francisco
(5) Chicago

Preferred type of real estate investment
(1) Retail
(2) Multi-family
(3) Hotel/Leisure
(4) Industrial
(5) Offices

look to perform better in 2005. The United Kingdom will likely remain stable with a 2.7 percent growth rate. The Euro zone as a whole will improve, with the economy expanding 2.0 percent in 2004 and 2.6 percent in 2005. Ireland, Europe's economic tiger, is expected to grow 5.3 percent and 4.7 percent in 2004 and 2005, respectively.[4] Greece received a boost in 2004 due to Olympic spending, but growth will falter in 2005. Japan's economy will increase 2.3 percent in 2004 before accelerating to a 2.9 percent rate

[4] Source: OECD Economic Outlook, No. 75. "Annex Table 1. Real GDP" June, 2004.

of growth in 2005. Korea looks to grow by 4.3 percent and 7.2 percent over this same period. Mexico's economy will increase by 3.8 percent in 2004 to 4.2 percent by 2005.

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

As discussed the U.S. economy and real estate market will continue to grow impressively in the near future. However, such an optimistic outlook is not without risk. A major terrorist attack on U.S. soil will drastically lower business and consumer confidence. A fall in spending activity will restart the downward spiral of job cuts, falling confidence, less spending, job cuts, and on and on. The current outlook assumes no major terrorist attacks in the U.S.

Oil is another major concern. As recently as 1998, a barrel of oil was priced under $13. Prices above $35 are a bit uncomforting. A barrel of oil now stands above $50. The current economic outlook assumes that oil prices will retreat to $40 by year end and to $32 by the end of 2005. But forecasting oil prices is tricky. Below are several outcomes under alternative assumptions.

Oil Price Assumption	GDP Growth Rate in 2005
Retreating to $40 by the end of 2004 and to $32 by the end of 2005 (baseline)	4.4%
Staying at $50 through the end of 2005	3.6%
Rising to $60 by the end of 2004 and to $75 by the end of 2005	2.8%
Declining to $40 by the end of 2004 and to $20 by the end of 2005	4.7%

Furthermore, there remain challenges to the flow of foreign investment in U.S. real estate. A heavy discussion on foreign outsourcing of jobs may lead to more restriction on international investment. Security concerns in the post 9-11 era may introduce more restrictive requirements on foreign investors. U.S. government policies for the most part 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 National Association of Realtors® believes that 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.

The U.S. real estate market has benefited immensely 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.