



# FOREIGN INVESTMENT IN U.S. REAL ESTATE

## Current Trends and Historical Perspective

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THE NATIONAL ASSOCIATION OF REALTORS®

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NATIONAL ASSOCIATION OF REALTORS®

*The Voice for Real Estate®*



## Introduction

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The long history and benefits of foreign investment in the United States are widely recognized. Foreign investment in U.S. real estate plays an important role in the U.S. economy. It influences the movement of domestic interest rates and contributes to the creation of new jobs. U.S. real estate provides investors with a diversification option that has a solid return without the volatility of stocks. Foreign investment in U.S. real estate also provides capital that supports a healthy real estate industry.

This report looks at the impact of foreign investment on the U.S. economy over the past five years, 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 increased from \$2.763 trillion in 1992 to \$8.144 trillion in 2001— or 195 percent over the last ten years. It has helped to create jobs either through direct investment in a business or commercial real estate or the provision of a cheap form of funding for domestic businesses to reinvest. Job creation helped to fuel home purchases.
- ◆ Demand for U.S. assets by foreign investors surged between 1997 and 2001. Problems with market mechanisms and political instability abroad forced investors to reevaluate their risk-return tradeoffs. U.S. investments, particularly U.S. Treasury securities, stocks, high quality corporate bonds, and commercial real estate, proved popular because of their safety and solid return. Foreign ownership of U.S. corporate equities and bonds increased 89 percent — from \$1.513 to \$2.857 trillion between 1997 and 2001.
- ◆ Foreign investment in U.S. assets has exerted downward pressure on interest rates. Historically low mortgage rates have benefited from this large pool of foreign funds for several years. The 30-year fixed rate mortgage averaged 7.4 percent over the last five years as compared to 9.6 percent for the past 20 years. Low mortgage rates, in turn, have spurred record purchases of residential properties. Nationally, existing home sales posted 5.296 million units in 2001, up 2.8 percent from 5.152 million units in 2000 --- and surpassing the previous resales record of 5.205 million units set in 1999 when the economy was booming. Likewise, low interest rates have helped make commercial real estate properties appealing to investors. Hence, commercial real estate transactions were brisk over the past five years --- rising to nearly \$50 billion in 2001 from about \$15 billion in 1996, representing a compound annual growth rate of about 25 percent.

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 that 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**

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Foreign direct investment of U.S. real estate increased sharply in the last 5 years, from \$38 billion in 1997 to \$42 billion in 2001. 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 United States 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 a U.S. market presence or increase their market share. 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**

Most investors prefer to diversify their portfolios into various forms of investment, such as stocks, bonds, and direct investments including real estate. International investors are no different. But 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 only in that one country's markets. U.S. real estate offers foreign investors diversification of their investment portfolios so that their assets are not fully tied to the health of their 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 United States. 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 United States outperformed both Asia and Europe in 2001 with an average quarterly increase of 2.93 percent in the U.S. REIT index. Europe outperformed the United States, on average, for the first three quarters of 2002 with a 4.66 percent increase compared to 1.83 percent for the United States. The United States still leads Asia, which has posted a –2.42

<b>EPRA/NAREIT Total Return Indexes, Quarterly Average</b>			
	Asia	Europe	U.S.
2001 Q1-Q4	-3.85%	-1.53%	2.93%
2002 Q1-Q3	-2.42%	4.66%	1.83%

Source: [www.epra.com](http://www.epra.com)

percent average quarterly change for the three quarters of 2002.

Similarly, U.S. bonds have offered a better return than those of Europe or Japan. Between 1997 and 2001, long-term bond yields averaged 5.7 and 5.2 percent for the United States 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 5.3 and 3.9 percent, respectively, and Japan averaged 0.4 percent.<sup>1</sup>

## **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 ten years, the value of existing residential properties has risen by 4.2 percent on average as compared to 2.7 percent in 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.

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.

## **Establishment of Market Presence**

Because the United States is the world's largest and most open commercial real estate market, foreign firms want to establish market share here. They do this in a variety of ways. They make direct investment in properties. They 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

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<sup>1</sup> Source: Organization for Economic Cooperation and Development, "Interest Rates and Exchange Rates: EO71 Statistical Annex Tables," Tables 35 and 36.

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, and the global readjustments that followed both of these events. 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.

## **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 open to global financial flows 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 it 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 the pound. 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 South East 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 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 United States alone, private sector spending on information processing equipment and software increased from \$142.7 billion in 1991 to \$548.5 billion in 2001 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 U.S. Economic Conditions**

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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. To assess the trends of foreign investment in U.S. real estate, it is helpful to look at U.S. macroeconomic conditions.

### **Current Macroeconomic Conditions**

In 2001, the U.S. economy slowed from its average annual growth rate of four percent in the late 1990s and went into a recession. The economy appears headed for a recovery in the second half of 2002, albeit at a slower rate of growth than experienced in the late 1990s. Real gross domestic product (GDP) growth increased to 3.8 percent in 2000 and then fell to 0.3 percent in 2001. Three consecutive quarters of negative growth in 2001 were followed by two increases of 2.7 percent and 5 percent in the fourth quarter of 2001 and the first quarter of 2002, respectively. This improvement proved temporary as GDP growth for the second quarter of 2002 came in at 1.1 percent. While the events of September 11, 2001 dampened spending in some sectors, business spending had already slackened by the beginning of 2001, with some sectors reporting overcapacity. Government spending in the fourth quarter of 2001 and the first quarter of 2002 helped to ameliorate the slowdown.

The decline in business spending hurt employment. Unemployment rose to 5.9 percent in July 2002. That figure represents an increase from the annual average unemployment rates of 4.8 percent and 4.0 percent, for 2001 and 2000, respectively. This environment has subsequently slowed growth in consumer spending — which decreased from 4.3 percent in 2000 to 2.5 percent in 2001.

Inflation, though, was kept in check. The change in the consumer price index (CPI), the most widely watched measure of inflation, fell to 2.8 percent in 2001 from 3.4 percent in 2000. For the first half of 2002, the 12-month CPI change has fluctuated between 1.1 percent and 1.6 percent.

### **Current Real Estate Conditions**

In spite of slow economic growth, the real estate sector boomed throughout 2001 and into 2002. There are several reasons. Low mortgage rates and relatively low unemployment rates have helped to propel housing purchases in 2002 after two solid years in 2000 and 2001. The average 30-year fixed rate mortgage fell from 8.1 percent to 7.0 percent between 2000 and 2001. Meanwhile, the 1-year adjustable rate mortgage fell from an average rate of 7.0 percent to 5.6 percent over the same time period. Low interest rates have enabled homeowners to refinance mortgages and build wealth through their homes.

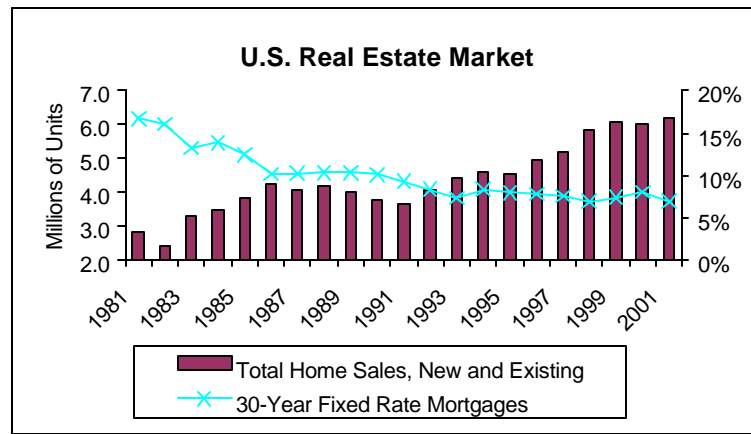
Home price appreciation has been extremely healthy. Existing home prices rose 4.3 percent in 2000 and 6.3 percent in 2001. This rapid run up in home prices created wealth for many homeowners, who, in turn, used their new wealth to purchase larger homes, to purchase secondary or vacation homes or to increase their expenditures on consumer goods.

The number of households in the United States has increased steadily over the last five years. In 1997, there were 101.0 million households. By 1999, the number of households reached 103.4 million. This figure has continued to climb by 0.8 percent and 1.4 percent in 2000 and 2001, respectively. Steady household growth underpins the demand for homes in the United States.

The result of these trends has been record sales of new and existing homes as well as an impressive number of housing starts. New home sales increased from 877,000 to 909,000 between 2000 and 2001, while existing home sales increased from 5.152 million units to 5.296 million units. Housing starts increased from 1.569 million to 1.603 million over this same period.

The trend continued through the first half of 2002. New and existing home sales continued at record paces through the early portion of 2002, while starts remained strong. On a seasonally adjusted annualized basis, existing home sales fluctuated between a high of 6.05 million units in January 2002 and a low of 5.10 million units in June. New home sales climbed from 870,000 units in January to 953,000 units in June 2002. Similarly, housing starts fluctuated during the first half of 2002 but remained high at 1.668 million units in June after starting the year at 1.713 million units in January.

New and existing home sales have had a strong multiplier effect. That is, increased home sales generated large secondary expenditures by households on goods to furnish their new homes. In addition, the 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. These expenditures buoyed up economic growth during a period of lagging business expenditures.



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

The commercial sector<sup>2</sup> fared well in the late 1990s but activity slowed down in 2000. Vacancy rates for offices, warehouses, retail, and multifamily housing fell continuously from 1997 through 2000. However, vacancy rates surged in 2001 across all property segments due to weak demand and sustained addition of new commercial real estate space. The demand slowdown in 2001 was largely reflective of the depth of the continued corporate profit crunch. The booming housing market, propelled by low

The State of Commercial Real Estate								
	Change in Rental Rates				Vacancy Rates			
	Office	Warehouse	Apartment	Retail	Office	Warehouse	Apartment	Retail
1997	8.4%	4.6%	4.8%	4.4%	11.3%	7.6%	5.6%	15.2%
1998	9.9%	3.7%	3.9%	4.9%	10.3%	7.6%	5.2%	14.0%
1999	4.3%	3.7%	3.6%	2.2%	10.3%	7.5%	5.1%	11.2%
2000	10.1%	4.1%	5.6%	3.2%	10.0%	7.2%	5.0%	9.3%
2001	-2.4%	-0.4%	2.2%	-0.2%	12.6%	8.3%	5.5%	11.0%

Source: Property and Portfolio Research

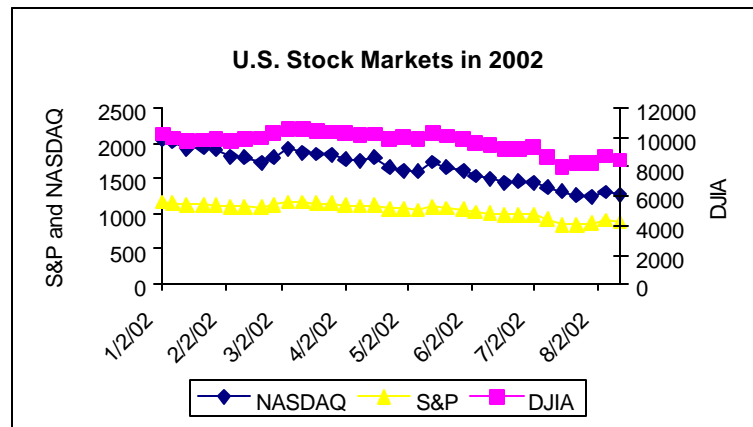
<sup>2</sup> Based on 54 metro markets tracked

mortgage rates, also drew many renters into homeownership — hurting rents and stifling investment in multifamily units. Rents for office, warehouses, retail, and multifamily housing thus rose continuously between 1997 and 2000 and fell sharply in 2001.

Occupancy rates for all property types, particularly office, continued to fall through the first half of 2002. Even though the creation of non-farm jobs spurred leasing activity in most of the 54 markets, there was still more new commercial real estate space added than absorbed. Although lower occupancy rates pushed down rents in most markets, they did not completely eliminate landlords' pricing power. Average rents for all property types except office in the first half of 2002 were slightly below their peak rates recorded in 2000.

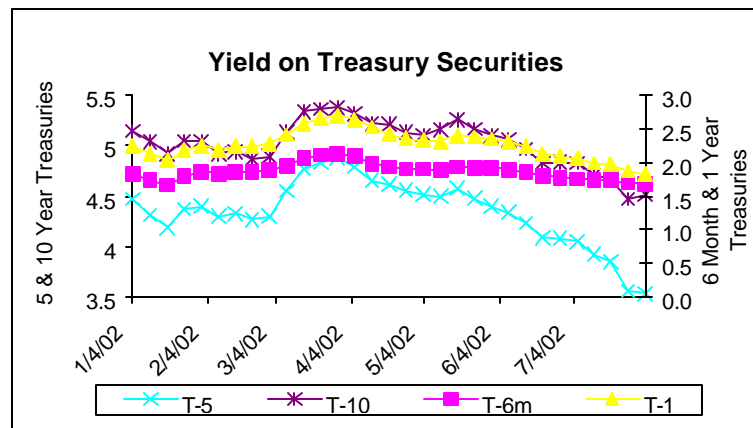
### What Recent Financial Scandals Mean for the Real Estate Industry

Between the middle of May 2002 and early August 2002 the Dow Jones Industrial Average (DJIA) fell nearly 2,000 points or 15.2 percent. The S&P 500, a broader measure of the health of the equity markets, fell nearly 16.1 percent. Similarly, the NASDAQ composite fell 21.8 percent (these declines are on top of 6.8 percent, 27.6 percent and 64.9 percent declines for the DJIA, S&P 500, and NASDAQ, respectively, from the market's peak in March 2000 to the middle of May 2002).



Source: Yahoo! Financial

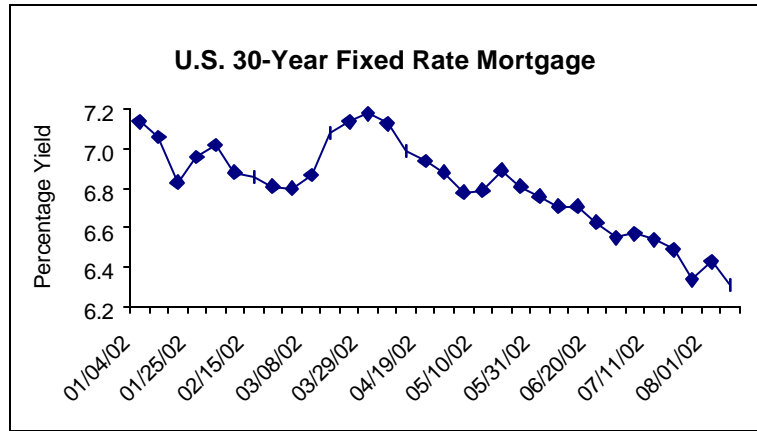
Largely in response to lower corporate earnings and growing accounting scandals in the United States, this broad sell off sent ripples through the investing world and raised fears of another bubble as investors appeared to be shifting their funds out of U.S. capital markets. Indeed, the value of the dollar fell relative to several foreign currencies including the Euro — a fact that appeared to confirm this assertion. The Euro climbed against the dollar from 0.917 in May 2002 to 0.9935 in July — an increase of 8.34 percent. Further inspection, however, showed that investors were also shifting their assets to bond and mortgage markets in the United States. As higher demand bid up prices, the yield on the three-month, six-month, one-year, five-year, 10-year, and 20-year U.S.



Source: Federal Reserve Board

Treasury securities fell 4.5 percent, 10.6 percent, 21.2 percent, 21.6 percent, 12.4 percent, and 5.7 percent, respectively. All told, the combined market capitalization of the NASDAQ and NYSE fell from \$13.888 trillion in May 2002 to \$11.917 trillion in July — a decline of 14.2 percent.

In addition, mortgage rates fell as money flooded into this area. The average yield on a 30-year fixed rate mortgage, as reported by Freddie Mac, fell 5.3 percent, from 6.79 percent to 6.31 percent. Because of their relative safety, bonds and mortgages have proven to be strong performers in the summer months of 2002. This dynamic trend has had the net effect of keeping interest rates low; thereby fueling continued strong demand for home mortgages and refinancing.



Source: Freddie Mac

## 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. Direct investment by foreign firms in the United States results in both job creation and direct demand for commercial real estate. Finally, 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.

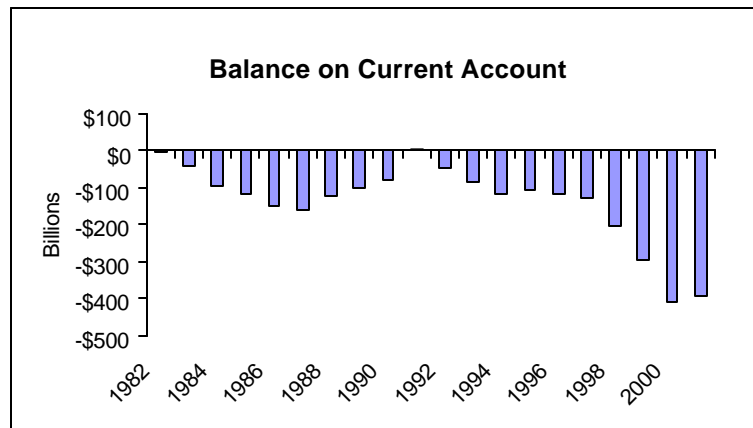
The current and capital accounts provide valuable information about the state of the U.S. economy. The current account tracks U.S. exports and imports of goods and services. The capital account measures the flows of U.S. investment abroad and of the investment from abroad to the United States.

### Balance of Payments Accounting

The international trade position of the United States is summarized by the balance of payments. The balance of payments is an accounting standard equal to the sum of the current and capital accounts. The current account is the sum of goods and services exported by the United States 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 United States and abroad and is the sum of all foreign investment in the United States minus total investment abroad by the United States 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 trade imbalances must be offset by flows of capital representing the need to lend or borrow ahead.

### The Current Account Balance

Except for a brief respite in 1991, the United States 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 storm. U.S. financial markets, particularly the bond and stock markets, saw an influx of investment from abroad as investors sought safety in a “flight to quality” resulting in a generous supply of relatively cheap capital. Fiscal restrictions, as stipulated under the Maastricht Treaty for membership in the European Union, reduced the pool of investment grade debt in Europe, reinforcing this movement of investors toward U.S. markets. The Asian economic collapse also left foreign producers looking to increase profits by offsetting lower prices with increased production for export, mainly to the United States.



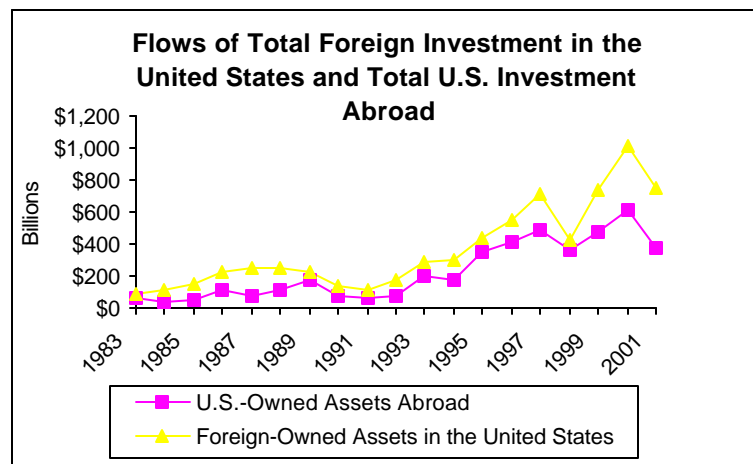
This combination of cheap goods and cheap funds allowed U.S. consumption to continue unfettered through the late 1990s. Indeed, the current account plummeted to -\$410 billion in 2000 before its slide halted.<sup>3</sup> The balance pulled back to -\$393 billion in 2001.

Amazingly, despite the increased consumption of foreign goods, domestic consumption was still strong enough to propel the U.S. economy at record levels of GDP growth and low unemployment. This trend of increased consumption necessarily required more funding to finance it. This increase in borrowing from abroad has been reflected in the current account.

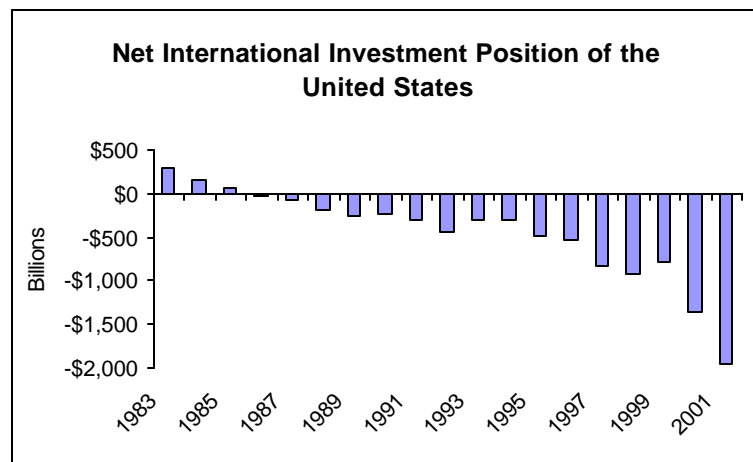
## **Balance on the U.S. Capital Account**

### ***Foreign Capital Inflows***

Foreign investment in the United States continued to outpace U.S. investment abroad in late 1990s. The margin between the two slowed in 1998 to \$63.8 billion but surged again in 1999 and 2000 to \$264.9 billion and \$409.5 billion, respectively. Investment by both foreign investors in the United States and by U.S. investors abroad fell off in 2001, although foreign investment in the United States continued to exceed U.S. investment abroad by \$381.8 billion.

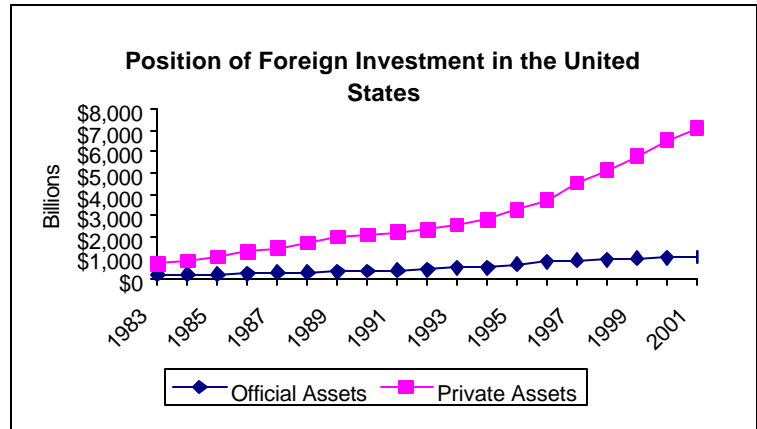


The influx of funds from abroad resulted in a net increase of foreign investment from 1994 through 1998, followed by a respite in 1999. This brief pause in net investment growth was broken by a surge of \$1,351 billion in net capital imports in 2000 and \$1,948 billion in 2001.



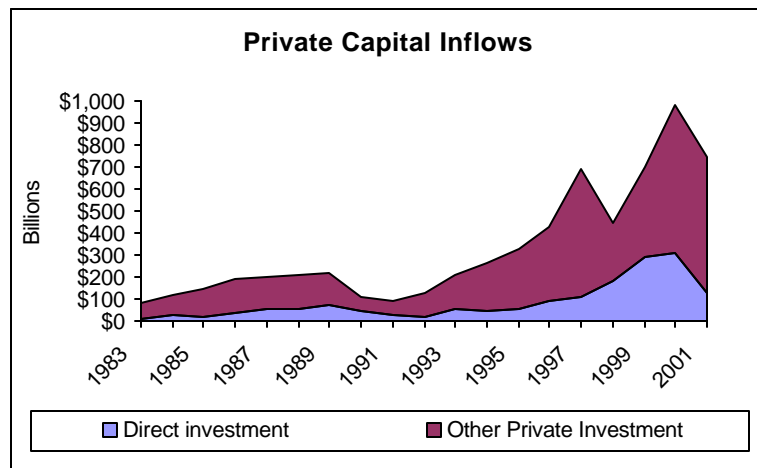
<sup>3</sup> All trade numbers are on a current-cost basis unless otherwise specified. Source: Bureau of Economic Analysis.

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 2001 this gap had nearly doubled to more than \$6 trillion. The stock of foreign investment by private individuals reached \$7.123 trillion in 2001. Because of the relatively small role that official foreign investment plays in the U.S. economy, this report focuses on private foreign investment.



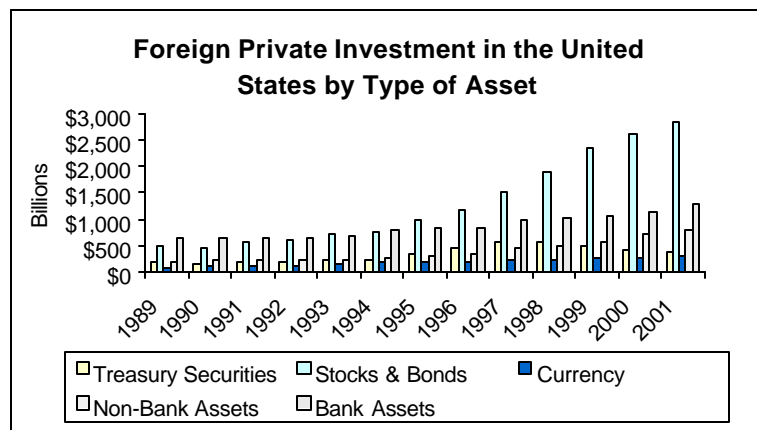
### Private Investment

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.



### Other Investment

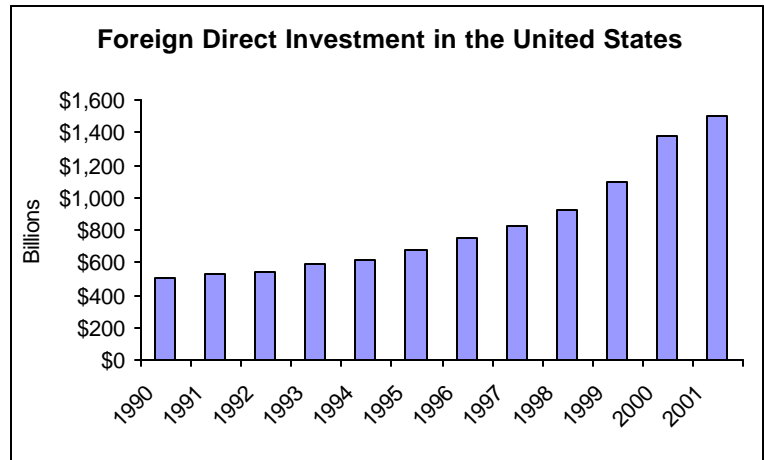
Other private investment has an important impact on the U.S. economy. An increase in the flow of funds from abroad can reduce the domestic interest rate. In turn, lower interest rates stimulate investment and consumption of larger purchases such as homes and automobiles — goods that have large expansionary 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 before tapering off to \$388 billion in 2001, largely due to higher yields on other U.S. assets.

***Direct Investment***

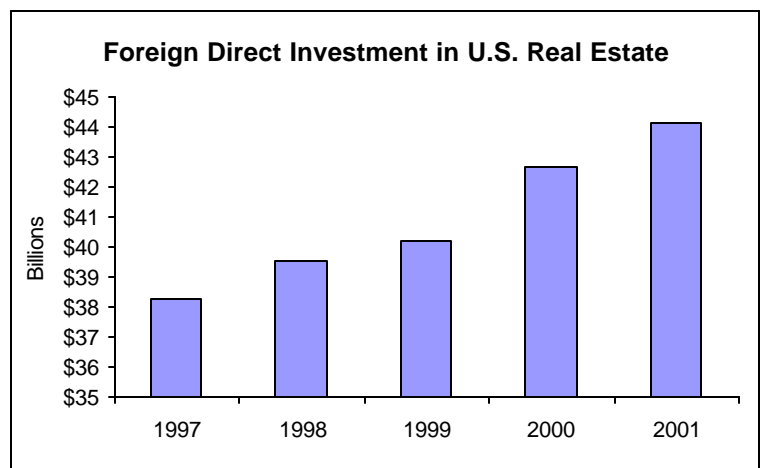
Direct investment also plays a significant role in stimulating the U.S. economy. Foreign companies may choose to expand operations in the United States to circumvent tariff restrictions, to reduce transport or labor costs, to take over a company that provides a valuable component to their product line, 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 five years. In 1997, direct investment totaled \$824 billion. This number reached \$1.499 trillion by 2001 — an increase of nearly 82 percent

***Foreign Direct Investment in U.S. Real Estate***

Foreign direct investment in real estate also increased over the period of 1997-2001, from \$38 billion in 1997 to \$44 billion by 2001.



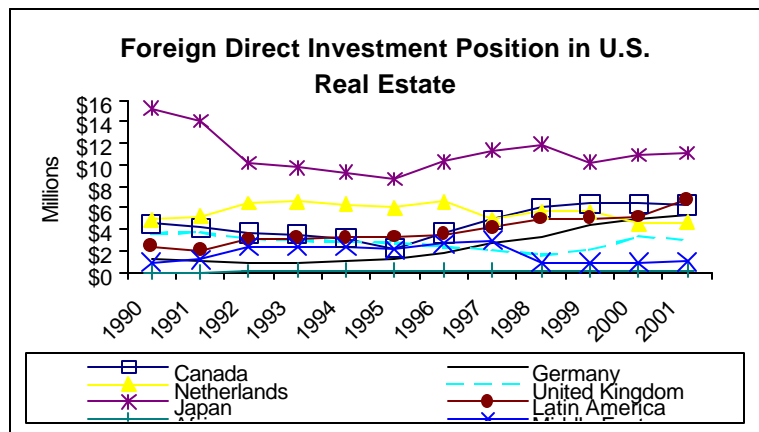
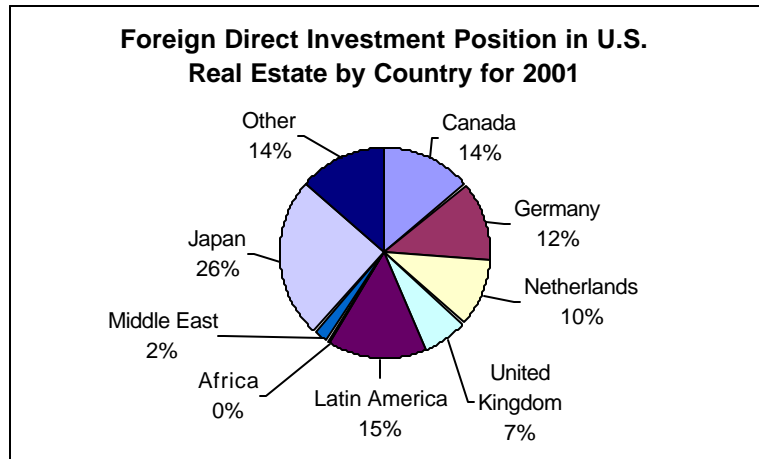
For 2001, foreign investment in U.S. real estate was dominated by Japan, Canada, Germany, Netherlands, and the United Kingdom. Japan alone contributed 26 percent of 2001 foreign direct investment while Canada accounted for another 14 percent. Germany, the Netherlands, and the United Kingdom accounted for a total of 29 percent. Latin America as a whole contributed 15 percent.

Japan’s consistently high investment share over the past 5 years underscores 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 early 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. 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. 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 increased steadily from 1997 through 2001.



## Foreign Investment and the Future

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For several years, the U.S. economy benefited 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, the strength of the real estate market, and the rate of economic growth among our trading partners.

### Projections for the U.S. Economy

Despite the bleak condition of the U.S. economy during the summer of 2002, the future looks strong, although some cooling off after exceptionally high activity in residential real estate is inevitable. A decline in the dollar will help the U.S. export goods to Europe and Asia. Relatively low interest rates will continue to propel housing purchases, while consumer demand and business investment should increase. The NATIONAL ASSOCIATION OF REALTORS® forecast for the U.S. economy shows real GDP increasing from 2.2 percent to 3.0 percent between 2002 and 2003. Meanwhile, inflation is expected to remain below 3.0 percent, increasing from 1.7 percent to 2.6 percent over this period. The result should be strong job growth. The unemployment rate is expected to drop from 5.9 percent to 5.7 percent, placing it near the United States' "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 6.8 percent 30-year rate for 2002 and a 7.0 percent rate for 2003.

The NATIONAL ASSOCIATION OF REALTORS® expects existing home sales to begin tapering off in the latter part of 2002, but for the year re-sales should still post a record-setting 5.437 million units — an increase of 2.7 percent from 2001. New home sales are expected to slacken but maintain their hearty pace of 920,000 units for 2002 — an annual increase of 1.2 percent and a record. The numbers for 2003 will be slightly off the 2002 record levels, with new home sales recording 899,000 units (off 3.3 percent from 2002) and existing home sales posting 5.259 million units (a decline of 2.3 percent from 2002). The increase in the 30-year fixed mortgage rate should precipitate this decline.

<b>Commercial Real Estate Forecast</b>								
	Change in Rental Rates				Vacancy Rates			
	Office	Warehouse	Apartment	Retail	Office	Warehouse	Apartment	Retail
2001	-2.44%	-0.39%	2.23%	-0.24%	12.58%	8.31%	5.50%	11.00%
2002	-7.50%	-3.83%	-1.18%	-0.71%	15.98%	10.14%	6.90%	12.91%
2003	-3.39%	-2.34%	-1.11%	-0.22%	15.41%	9.31%	6.79%	12.21%

Source: Property and Portfolio Research

Commercial real estate should improve modestly during the later part of 2002, with a moderate rise in leasing activity and an increase in completions. Vacancy rates should decline in 2003 as businesses begin to reinvest and inventories are pumped up. Industrial production is expected to increase 4.5 percent in 2002 and 4.1 percent in 2003, boosting demand for warehouse space. Similarly, non-farm employment is projected to decline by 1.6 percent in 2002 but to increase by 2.0 percent in 2003. The increase in non-farm employment will boost demand for office space. The housing affordability index will decline from 133.6 to 131.0 for 2002 to 2003 due to the expected up-tick in mortgage rates, causing the housing market to begin to slow. This decrease in housing affordability will stimulate the rental market. These trends will develop as the commercial market recovers in line with the rest of the U.S. economy. However, declining rent growth will keep negotiating power in the hands of tenants for the near term.

## **Projections for International Growth**

The growth of 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 returns. 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 United States' major investors from the European community — Germany, the Netherlands, and the United Kingdom — all look to perform much better in 2003 than in 2002. Both Germany and the Netherlands look to improve substantially as their growth rates are expected to jump from 0.9 percent to 2.7 percent and 1.1 percent to 3.0 percent, respectively. Japan's growth will also increase from -0.7 percent in 2002 to 0.8 percent in 2003. Latin America, another big investor in the United States will perform well, with growth increasing from -0.9 percent to 3.0 percent by 2003.<sup>4</sup> However, the United States is expected to drive the next global expansion.

### **Perspectives from the 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 the Survey, despite the recent terrorist attacks, the United States remains one of the strongest commercial real estate choices in the world. New York and Washington rank second and fourth, respectively, among the top five cities to invest in. London leads the list with Paris in third and Tokyo in fifth.

According to the survey 45 percent of respondents listed their reason for investing in the United States as a "favorable risk-adjusted return," while 36.5 percent like the U.S. market fundamentals, 23.5 percent see its stability as a primary factor, 20 percent named diversification as their motivation, and 10 percent listed the U.S. economy as drawing their investment dollar. James Fetgatter, Chief Executive of AFIRE, cited a survey respondent's comment that "real estate in the U.S. benefits from political and economic stability, population and job growth, and a transparency of information and data. U.S. real estate has low risk and a strong legal system to protect investment. It is still the most stable market in the world."

The following are a few of the questions polled by AFIRE to its members accompanied by the responses:

- "Which country provided the best opportunity for capital appreciation?"  
49 percent responded the United States followed by Japan with 16 percent of the vote
- "Which country provides "the most secure and stable real estate investment?"  
58 percent responded the United States followed by the United Kingdom with 18 percent of the vote
- "Which country has the best "risk adjusted potential return from real estate investments?"  
67 percent responded the United States followed by the United Kingdom with 8.2 percent of the vote

Favorite U.S. city for investment:

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

Preferred type of real estate investment:

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

<sup>4</sup> Source: Oxford Economic Forecasting, *World Economic Perspectives*, Summer 2002

International investment in the United States grew at a strong pace during the last five years. The factors that attract investors to the U.S. real estate market are financial transparency, stability, stable government, and value, which are all supported by a strong and dynamic economy. All of these factors will continue in the future. 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. Relatively low rates of inflation and unemployment coupled with growing business investment and low mortgage rates should propel the housing industry for some time and attract investors. If the dollar declines as expected, European profit margins will come under increasing pressure, while Asia and Latin America will remain question marks in light of their recent economic turmoil. 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 fundamental soundness of the U.S. market will continue into the future, while foreign growth should be drawn upward by an improved U.S. market. In the long term, the return of new flows of foreign investment into the United States will continue to spur the real estate market toward new heights.

But there are some challenges on the horizon. 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 United States 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 response to the events of September 11, 2001, the U.S. government has taken steps to better ensure the security of our nation and its citizens. However, some approaches to improve homeland security could 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 have positive effects on real estate markets and the U.S. economy as a whole.

## Data Sources

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