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International Real Estate Economics

Piyush Tiwar
Michael Whit

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CHAPTER 1

Contextualising International Real Estate Markets

1.1 Introduction

The concept of an international real estate market is a relatively new phenomenon. Indeed, the idea of markets for certain commodities or services existing on an international, or global, scale is also relatively new, although in some sense it has existed in more or less limited ways since the beginning of economics itself as a distinct discipline. However, the past 30 years have witnessed the most significant growth in, or internationalisation of, the real estate industry. This is set within a wider context of global economic change and international economic integration. It is, therefore, also important that we begin by explicitly talking about economics, since this is the basis for the analysis that we will proceed to unfold in this text.

As an asset class, real estate has often been treated rather differently from other assets (see Hendershott and White, 2000). Real estate is usually an expensive asset due to its high unit value. It tends to be illiquid and heterogeneous, and consequently real estate markets display limited information, which can lead to inefficiency in resource allocation. Commercial real estate markets (offices, retail and industrial) are even less efficient than residential markets, since they display more pronounced high unit value and greater heterogeneity, and have even less information (many local markets may be 'thin'). In addition, even in well established and 'large' markets, problems created by these characteristics can still be significant. However, the market still tends to attempt to establish a reconciliation of demand for, and supply of, space. Thus the economics of the market has a crucial role to play in understanding the behaviour of real estate. Early applications of economics to international markets include those by Adam Smith and David Ricardo. Smith (1776) outlined key issues in international trade theory. These were refined and developed further by Ricardo (1817), who laid the foundation for the classical analysis of international trade based upon the theory of comparative advantage.

The internationalisation of trade and the creation of the modern global economy have beginnings as far back as the late fifteenth and early sixteenth centuries in Europe. Wealth creation was limited and income per head had been roughly unchanged since the 1100s. Industrialisation and technological change increased incomes and trade. World exports grew by 1,000 per cent in the 50 years after 1820, and by 3.4 per cent per annum from 1870 to 1913. Trade with colonial nations played a significant role in this period. Countries also imposed tariffs on certain imports to protect domestic industries from competition. The US, France, Germany and the UK all engaged in such policies. However, this period of 'spectacular growth in international economic integration was not accompanied by any significant institutionalisation of intergovernmental collaboration' (Ravenhill, 2005, p. 8). Governments tended to adopt bilateral trade agreements. They also adopted the gold standard (in which national currencies were linked to gold via a fixed exchange price that subsequently fixed their exchange rates against other currencies), which aided the development of international trade by essentially removing exchange rate risk.

There is no discussion in the literature of the period on the role of real estate. This is perhaps not surprising. Trade between countries was largely an exchange of manufactured goods for agricultural products. Trade in international services as they exist today had hardly begun. However, real estate had become an asset. Most residential real estate in the UK was not owned by the occupiers and provided an income stream to landlords. Indeed, some real estate firms that today provide services at an international scale already existed, although not in their current form (e.g., the modern CBRE originated as Richard Ellis).

After the growth of the international trade of the nineteenth and early twentieth centuries, the interwar period saw economic slowdown and then depression. As nations became concerned about the effect of competition from foreign imports on domestic industries, tariffs were increased and international trade declined significantly. It was only after 1945 that international economic integration gathered pace. This period also saw the establishment of international economic institutions, such as the World Bank and the International Monetary Fund.

The past 60 years have witnessed significant economic integration across the globe. After the depression of the interwar period and with the end of the Second World War, the setting up of the Bretton Woods system of fixed exchange rates sought to remove uncertainty and encourage trade between countries. Macroeconomic demand management policies throughout the 1950s and 1960s sought to maximise employment. Against this background international trade increased, developed economies increasingly became service sector-dominated, and economies that had previously been agricultural began to industrialise as overseas investment brought manufacturing industry and jobs. These changes created a resulting demand for real estate. Companies too, locating overseas, grew into multi-country organisations. Today, trade is dominated by multinational corporations with branches operating in many different countries, linking them into an increasingly globalised economic system.

The Bretton Woods system collapsed in 1972/3 and was replaced by various policies towards exchange rates, some floating in the market, some with a degree of floating permitted but with an element of government intervention. The turbulent economic environment of the period saw governments move away from Keynesian demand management to more liberal economic policies that favoured the reduction of the role of the state, arguing that the market was better at allocating resources. This school of thought argued for deregulation, and policymakers in the UK and the US in particular were among the earliest to adopt policies based upon this view of macroeconomics. Consequent policy changes, such as removal of exchange controls and further deregulation of the banking and finance sector, laid the foundation for many of the subsequent changes in the world economy. The impact on the real estate market has been substantial.

Since financial deregulation in the 1980s, international trade flows have come to be dominated by flows of international financial capital seeking the highest risk-adjusted return. As real incomes have grown and economies have developed, there has been an increasing demand for real estate assets across all property sectors: retail, office, industrial and residential. The real estate market itself has developed, reflecting user and investor demand on the one hand, and developer supply of space on the other. Real estate companies themselves have witnessed change in the range of services they provide and the range of markets to which those services are provided. It could be argued that within the last two decades a globalised international real estate market has been established.

However, significant differences across countries still exist. Countries vary in the extent to which they view property as an investment asset. In some countries, real estate is a distinct asset class competing for investment funds from other assets of bonds and equities. In others, it does not yet attract significant investment. In some countries most commercial real estate is owner-occupied; in others, occupiers rent space and investors receive an income and capital return. All countries are facing the same global challenges to attract investment in order to raise GDP and living standards. Consequently their real estate markets also attract attention from investors. Nations may, however, respond differently to similar challenges, providing the possibility for differentiation in outcomes across countries.

Not only is the real estate investment market becoming increasingly global, but in addition the real estate service providers themselves are increasingly becoming global operations. Many firms have moved beyond their home country base and have established overseas operations. Both 'push' and 'pull' factors have contributed to this change. Home markets may be relatively small or saturated, causing firms to look for new opportunities overseas. Also the firms' clients may be opening operations in other countries and require real estate service provision. The internationalisation of real estate companies has been facilitated by different strategies, including takeovers, mergers and strategic alliances. This process itself has been made easier by the removal or reduction of barriers to trade and a process of economic liberalisation that has characterised global economic development over the last 30 years.

Investors considering real estate as an investment class may consider different property sectors, including offices, retail, industrial and residential investment options. In different countries different sectors may take the lead (in terms of risk-adjusted returns) at different points in time. At any one time, differences in national economic structures may imply differential performance across the property sectors and hence determine which sector becomes the most attractive for investors.

However, even if property is performing well in an economy, this alone is insufficient to attract inward investment. Barriers preventing foreign investment, property rights issues, lack of transparency, and institutions operating within an economy may discourage or impede investment.

Economic uncertainty is another factor impeding investment. This is a general characteristic of market economies, and exists within national economies and also in the world economy. For an investor, the less is known about a market the greater the uncertainty, and hence overseas investment is often perceived as being more risky than domestic investment decisions. Periods of heightened uncertainty in one economy may or may not be correlated with uncertainty in other economies. The lower the intercountry correlation, the greater are the diversification opportunities afforded by international asset holdings.

Estimating the value of returns from overseas investments faces the additional complication of estimating expected future exchange rate movements. Exchange rate volatility can be a significant factor in affecting which countries provide the greatest return when converting to the home currency. Different time periods have witnessed varying responses to exchange rate volatility. The increase in international trade in the late nineteenth century occurred against a background of stable exchange rates founded on the gold standard with agreed rates of convertibility of currencies into gold. Some early attempts at monetary union were also in evidence, for example, between France, Italy, Belgium and Switzerland in 1865, and in 1873 between Sweden and Denmark, who were joined also by Norway in 1875. The First World War saw countries depart from the gold standard. During the interwar period it was reintroduced, but this was short-lived. The depression of the 1930s effectively ended the gold standard and the value of international transactions fell dramatically. It was only after 1945 that a new international monetary system emerged. Unlike the earlier period of the late nineteenth century, this period was notable for the establishment of new institutions such as the IMF and the World Bank, as mentioned above. However, it was similar in that a system of relatively fixed exchange rates was introduced. Against this background the world economy grew, and it is in this period that we begin to see the first real internationalisation of real estate markets. This Bretton Woods, system lasted until the economic turbulence of the early 1970s. Subsequent interventions in foreign exchange markets are discussed in the following chapters.

In this introductory chapter we outline the economic environment of international real estate, examine trends and cycles, and discuss challenges facing internationalisation with respect to different institutional environments, both formal and informal. We then proceed to discuss economic transmission mechanisms and the role of international real estate within these mechanisms before outlining how this book is organised.

1.2 Overview of international real estate markets

Estimating the value of real estate transactions is notoriously difficult. In terms of transactions volume, it is difficult to provide a complete picture across all real estate sectors of office, retail and industrial properties. Lack of accuracy in recording of transactions in some countries affects measurement. In addition, in many countries residential property is also a sizeable investment class. Global sales value across residential and commercial property in 2007 was estimated to be over US$1 trillion. Office transactions accounted for over 40 per cent of this total, followed by retail at around 17 per cent. Slightly more than 50 per cent of transactions occurred in North America, approximately 31 per cent in Europe and almost 15 per cent in Asia. Office transactions were more important in North America and Europe than in Asia.

Offices dominated the highest value transactions, and tended to be geographically concentrated in London and New York, with the second highest-value transaction taking place in Paris. Transactions by country for the top 12 are listed in Table 1.1 below.

The countries listed above accounted for 89 per cent of global real estate transactions in 2007. The countries map onto the global regions of North America, Europe, and South East Asia and Japan. The concentration of the highest-value

Table 1.1 Transaction values by country (2007)

Country	*US$ Billion*
United States	510.3
United Kingdom	104.4
Germany	60.8
China	59.6
Japan	38.1
France	37.3
Australia	29.6
Canada	19.7
Singapore	18.6
Sweden	16.9
Hong Kong	14.4
Spain	14.3

Source: Real Capital Analytics (2008) Global Capital Trends, downloaded from http://www.rcanalytics.com transactions in the cities mentioned above indicates the unevenness of office location and concentrations. While the above figures provide an example for one year only, it is likely that the same cities would continue to be the location for future high-value transactions.

The growth of investment in real estate markets in the last decade has occurred against a background of real estate generally outperforming other asset classes. This growth has also taken place in a global economy characterised by increasing deregulation and relatively high and continued world economic growth. The end of 2007 and beginning of 2008, however, saw concerns over future economic growth, problems in the US sub-prime mortgage markets leading to lower income growth rates around the world, and increasing demand for commodities fuelling significant inflationary pressures. The period of high growth and low inflation experienced since the early 1990s seemed to be over. By 2009, the US economy, the UK economy and many others were in recession. Unlike the recession of the early 1990s, this one saw the problems in the financial sector restrict the availability of credit, and this affected the real economy. The consequent falling demand helped to reduce commodity price inflation, but the world economy was facing the most significant challenges to growth since the interwar period.

However, volatility is an inherent feature of market-based economic systems. In the postwar period, economic growth was experienced by Western economies between 1945 and 1973. While economies experienced some volatility and cyclical behaviour, fluctuations in the rate of change in GDP were comparatively small in comparison to either the 1970s and 1980s or the interwar period. Oil price rises, government macroeconomic policies and structural change impacted economies in the 1970s, leading to high inflation rates. The consequent rise of monetarism saw the introduction of restrictive monetary and fiscal policies as oil prices rose again in the early 1980s. Economies were faced with further structural change, and liberal market policies saw falling income tax rates, financial deregulation and removal of exchange controls. By the mid-1980s strong economic growth was occurring. However, inflationary pressures saw increases in interest rates in the late 1980s feeding into the recession of the early 1990s. Between 1992 and 2007 most Western economies experienced the longest period of sustained economic growth since before the first oil price shock took place in 1973. But 2008 saw slowing growth and recession. Recent changes in the world economy suggest that there may be a more volatile period ahead.

Since the late 1980s and early 1990s, real estate markets in general (and mature markets in particular) have experienced limited volatility and cycles with relatively low amplitude of fluctuation, certainly in more established markets. Nevertheless, rental value cycles have remained a feature of property markets across the world, with newer markets, for example in Bangkok and Shanghai, experiencing significant fluctuations. However, relative market volatility is not necessarily confined to newer office locations. London, which has a substantial direct real estate market, has exhibited more volatility than smaller markets in the UK since the 1970s, if not before.