FOREIGN INVESTMENT IN U.S. REALTY: PROSPECTS FOR THE 1980s

by Dudley S. Hinds

Foreign investment in U.S. real estate has become the subject of frequent articles in professional journals, trade publications, general business periodicals and the popular press. Matters discussed have included the sources of the funds, attributes of the investors, taxation of income and gains, financial structuring, and the possible impact on U.S. markets and communities.

If the volume of articles is any indication of the importance of foreign investors, then they are becoming a significant source of real estate capital. This article explores the prospects for the continuing flow of foreign investment into U.S. realty during the 1980s.

Two Types Of Foreign Investment

How much foreign money has been moving into U.S. real estate? Long-term foreign investment of all kinds is usually divided into two categories: portfolio investment and direct investment. The major difference between the two categories is that direct investment involves control by the investor while portfolio investment does not.

Foreign investment in U.S. real estate would seem to fall partly into each category. No data are available on portfolio investment in real estate from abroad. The U.S. Department of Commerce, Bureau of Economic Analysis has collected data on direct investment through its administration of the International Investment Survey Act of 1976, in which Congress defined foreign direct investment as being "the ownership or control, directly or indirectly, by one foreign person of 10 percent or more of the voting securities of an incorporated business enterprise or an equivalent interest in an unincorporated business enterprise."[1]

As of the end of 1980, the foreign direct investment position in U.S. realty was reported to have been $2,429 million.[2] This represented an increase of $609 million over the figure reported for 1979 and an increase of $1,630 million (204 percent) over the figure for 1976. Foreign direct investment in U.S. real estate reported as of the end of 1976 comprised 2.6 percent of the total foreign direct investment position in the U.S. at that time. The corresponding figure for 1980 was 3.7 percent.

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When deflated, the increases in foreign investment in real estate seem less spectacular (see Table 1). Nevertheless, the increases in 1978, 1979, and 1980 were significant; the total increase in constant dollars between year ends 1977 and 1980 amounted to 109 percent. (It should be noted, however, that the increases indicated may be due partly to improved reporting as a result of compliance with the requirements of the International Investment Survey Act of 1976.)

TABLE 1

Foreign Direct Investment Position in U.S. Real Estate
(in millions of dollars)

Year End	All Industries	As Percent Of	Current Dollar	1967 Dollars*
1973	$20,556	2.9%	$ 600	$451
1974	$25,144	3.2%	$ 806	$546
1975	$27,662	2.8%	$ 777	$482
1976	$30,770	2.6%	$ 799	$469
1977	$34,595	2.5%	$ 853	$470
1978	$42,471	2.7%	$1,161	$594
1979	$54,462	3.3%	$1,820	$836
1980	$65,483	3.7%	$2,429	$983

*Deflated with Consumer Price Index

Sources: Chung and Fouch, *op.cit.*, 47. William K. Chung and Gregory G. Fouch, "Foreign Direct Investment in the United States in 1979," *Survey of Current Business* (August 1980), 46.

Gregory G. Fouch and L. A. Lupo, "Foreign Direct Investment in the United States in 1978," *Survey of Current Business* (August 1979), 46.

William K. Chung and Gregory G. Fouch, "Foreign Direct Investment in the United States in 1977," *Survey of Current Business* (August 1978), 48.

Ida May Mantel, "Foreign Direct Investment in the United States in 1976," *Survey of Current Business* (October 1977), 35-36.

The amounts of foreign investment reported include only equity positions. Furthermore, they include only investment in entities classified by the Bureau of Economic Analysis as being in the "real estate industry." Real property assets owned by firms engaged in manufacturing, petroleum, trade, finance, or insurance are classified as direct investment in those industries rather than in real estate. Investment positions by country of source are indicated in Table 2.

The future flow of foreign money into U.S. realty will be determined by numerous variables that are not easily quantified. The procedure here will be to identify as many variables as possible by applying existing foreign-investment theory and then to conjecture with respect to possible changes over time. There are two sets of theory: one dealing with portfolio investment and the other with direct investment.

Variables Affecting Portfolio Investment

The theory of portfolio investment hinges primarily on differentials in interest rates between countries. All other things being equal, nongovernmental monetary capital moves from countries with low rates to ones with high rates. The causes of interest-rate differentials have been

TABLE 2

Foreign Direct Investment Position in U.S. Real Estate
(in millions of dollars)

Source*	Year End 1977	Year End 1980
Canada	$ 98	$542
West Germany	$ 30	$120
Netherlands	$ 38	$504
United Kingdom	$ 81	$191
Other European	$ 47	$ 56
Japan	$ 30	$109
Panama	$ 60	$ 68
Other Western Hemisphere	$281	$519
Middle East	$166	$265
OPEC Nations (including Middle East)	$182	$280
All other countries	$ 22	$ 55

*Note: The sources listed are the countries of the first foreign parent of the U.S. investment entity and are not necessarily the countries of the ultimate owners of the investments. Panama, for example, is a popular intermediate country for the channeling of foreign capital into U.S. real estate.

Sources: Chung and Fouch, *op.cit.*, 47.
Fouch and Lupo, *op.cit.*, 46.

explained in a number of ways: differences in rates of savings, differences in demand for manufactured products,[3] and differences in factor proportions used in production.[4] In particular, capital may be substituted for labor in a growing economy where restrictions on immigration are greater than restrictions on the importation of capital.

Because capital tends to be scarcer in developing countries than in developed ones, capital movements generally should be *from* the *developed* countries *to* the *developing* ones.[5] However, this is not necessarily the case. For example, external economies of scale that can be realized in developed countries tend to produce the opposite flow. As a matter of fact, for a number of years the U.S. has experienced investment flows in both directions.

The simplest form of portfolio investment theory assumes no risk, no uncertainty and no impediments to the international movements of capital. Refinements to the theory have considered risk, uncertainty and barriers, but once these considerations are introduced, "almost anything can happen. The extra empirical information needed to make predictions is very great and almost impossible to acquire."[6]

Differences in risk preference between investors in two countries can generate cross movements of capital. Risk-taking capital might flow out of a country at the same time that risk-avoiding capital is flowing in. With no differences in risk preference, cross flows can be motivated by diversification.[7]

Risk and uncertainty in international portfolio investment have several components. In addition to the components found in domestic investments, there are exchange-rate risk and various categories of political risk. Political risk includes not only the risk of diminished returns, or loss of

capital, through actions of the host government or the investor's home government; it also includes risks associated with war and civil strife. Capital tends to move from unsafe environments to safe ones.

Impediments to the movement of capital from one country to another include the added cost of obtaining information and making transactions in an unfamiliar investment climate. They also include exchange rates and barriers established by governments to restrict inflows or outflows of investment.

Variables Affecting Direct Investment

The theory of direct investment is focused upon the behavior of the industrial corporation and does not necessarily involve international movements of money. Direct investors may borrow funds in the host country, or they might transfer into the host country property in the form of patents, technology or machinery. Furthermore, they may reinvest earnings from past investments in the host country.[8]

The desire for control is at the heart of portfolio investment-theory, but control is not the only objective. Numerous variables have been cited to explain direct investment. Control presumably arises from a need to minimize risk and increase efficiency in attaining the other objectives. The other objectives may include diversification, shorter distribution lines, assured access to raw materials, assured orders from major customers, escape from high taxation and social legislation, cheaper labor, and strengthening of market position (gain in market share or prevention of market loss).[9]

In order to cover the additional costs incurred from operating at a distance from home base and in a different environment, a firm must be able to earn a higher return than is earned by a competing local firm. The higher return can be achieved by advantages arising out of product differentiation, special marketing skills, superior management, patents and technology, and superior credit standing.

Other variables in the theory of direct investment include: the product cycle, in the latter stages of which production tends to be moved to countries of lower-skilled and cheaper labor;[10] and Knickerbocker's discovery of a tendency of large corporations to "follow the leader" in establishing branches abroad.[11] Aharoni[12] has approached the subject from the point of view of the corporate decision-making process, concluding that the decision to invest abroad involves many individuals and that, over time, it tends to accumulate momentum as more and more time has been invested in the decision by more and more executives with an increasing reluctance to reverse the process.

Applicability Of Theory Of Direct Investment To Realty

To the extent that direct investment in U.S. realty is in the form of manufacturing plants, much of the explanation for the investment can be attributable to the theory of direct investment. The theory may also explain much of the foreign corporate investment in agricultural land. The investment from abroad in real estate, however, includes much more than the use of capital in the extraction of raw materials or in the production of manufactured goods. The real estate investment of most concern to the U.S. real estate industry is in housing, offices, hotels, shopping centers, warehouses and agricultural land.

Although some investment in agricultural land has been associated with large corporations, and some of it has been in timberland for use by pulp manufacturers, much has been made either by noncorporate investors or by small, privately-held, nonindustrial corporations. The nonagricultural investments have been associated generally with the service sector of the economy. Thus, a theory based upon the decisions of industrial corporations can explain only part of the foreign direct investment in U.S. real estate.

The theory of direct investment probably explains much of the investment of foreign developers who have become active in the U.S. Those from western Europe, for example, may be based in countries having relatively small and/or declining markets for their products. They may also have initial advantages over U.S. builders in their products, technology, marketing skills, and financing capabilities. For example, several Canadian developers now operating in the U.S. are subsidiaries of large Canadian corporations and can draw on relatively large lines of credit established in U.S. banks.

To some extent, the advantages of special marketing skills or other special knowledge may also explain investment in proven properties by nondevelopers. Some European investors reportedly found U.S. office and apartment rents to be low by comparison with rents in their own countries in the late 1970s. They invested in the expectation of "upside potential" to be realized through increases in rents.[13]

One German investor who has made substantial purchases of older apartment buildings has reportedly doubled rents in many of his projects upon expiration of existing leases, with little improvement to the properties. It has been claimed that the Dutch introduced to the U.S. office leases indexed to the Consumer Price Index based on earlier experience with double-digit inflation in their own country.[14] Such special knowledge, though, is unprotected by patents or copyrights and can, at most, explain initial investments in real estate.

Knickerbocker's "follow-the-leader" tendency may be applicable to nonindustrial investors in real estate, and Aharoni's emphasis on the corporate decision-making process may explain, in part, the decision of large pension funds to invest in U.S. realty. As no empirical data have been gathered for nonindustrial investments in real estate, however, firm conclusions cannot be drawn.

In general, the theory of direct investment is inadequate to explain much of the recent foreign direct investment in U.S. real estate. It can be of limited help, therefore, in

conjecturing on prospects for further investment in the '80s. Thus, it is necessary to turn to portfolio-investment theory to see what help it can provide.

Applicability Of Theory Of Portfolio Investment

As indicated previously, differences in interest rates are at the heart of portfolio theory. It is unfortunate that it is almost impossible to relate interest-rate differentials to investment in real estate from specific countries, because data on investment by country of origin is available for a period of only four to five years. The most dramatic increase has been in investment from the Netherlands, but data for that country go back only to 1977. West Germany and Japan present the same data problems, and Canada, another source with a spectacular increase, has separate figures tabulated back only to 1976.

A cursory comparison of yields on government bonds as a proxy for long-term rates generally provides no explanation of the flow of real estate capital into the U.S. from those countries from 1976 through 1980. Although nominal yields were higher in the U.S. for most years, the differences were generally offset by higher rates of inflation in the U.S.

Another variable in portfolio theory is savings-rate differentials between countries. This has undoubtedly been a factor in some of the recent investment. For example, investment from the Middle East increased from a position of $83 million at the end of 1976 to one of $265 million at the end of 1980. Investment from OPEC countries grew from $102 million at the end of 1977 to $280 million at the end of 1980. For the most part, this money represents recent savings resulting from oil income in excess of what can be spent in the home countries. Between 1972 and 1977, the U.S. ranked sixtieth among 126 countries in its average savings rate (annual savings divided by annual Gross National Product).[15] Of the 34 nations with the highest GNP per capita in the world, only Israel and Ireland had lower average savings rates than the U.S. during this period.

Countries having higher rates than the U.S. included all of the industrialized countries of Europe except Ireland, plus Japan, Australia, New Zealand, South Korea, Hong Kong, Singapore, the OPEC countries, and numerous other developing countries. The higher rates of savings in other countries are evidently a factor in the flow in investment to this country.

In the OPEC nations, oil wealth has simply accumulated more rapidly than the local economies could absorb. As the U.S. has had lower savings rates than almost every other developed country, it is understandable that, all other things being equal, much of the OPEC capital flow to developed countries would be to the U.S. Flows of savings from other industrial countries to the U.S. might be accounted for in part by a relative scarcity of land in those countries and by insufficient demand for office buildings, shopping centers, and other fixed assets used by the service sector.

TABLE 3

Savings as a Percentage of Disposable Income in Selected Countries

Country	Year								
	1970	1971	1972	1973	1974	1975	1976	1977	1978
United States	8	8	8	10	7	4	5	6	7
Austria	21	21	21	21	20	16	16	14	16
Belgium	19	17	17	17	17	14	14	13	12
Canada	11	11	12	15	16	12	12	11	10
France	18	18	18	18	16	14	12	13	14
Netherlands	20	20	20	22	21	15	16	15	14
South Africa	13	14	16	19	18	16	13	16	17
South Korea	14	11	11	18	14	13	18	19	22
Sweden	16	15	15	15	14	13	10	5	6
United Kingdom	14	11	10	10	6	5	7	9	8

Sources: Reprinted with permission from *Yearbook of National Accounts Statistics 1979*, Volume II, Table 12, (New York: United Nations, 1980), 553-576. Copyright © 1980 by the United Nations.

In non-OPEC, developing countries, on the other hand, the higher savings could probably be absorbed readily in the home market; the only explanation for flows to the U.S. lies in Hymer's observation about differences in risk preferences.[16] Obviously, there are investors in the developing countries who wish to invest in a less risky environment.

It appears likely that differentials in savings rates will account for much of the investment flow into U.S. real estate in the remainder of the '80s. As Table 3 suggests, such differentials change over time. Any reasonable forecast would require a country-by-country analysis. Note the precipitous decline in the differentials with Sweden in 1977 and 1978, and the strong increase in the differential with South Korea during the late '70s. Note also that the figures for France might be severely altered in the '80s as a result of the accession to power of a socialist government.

The figures for the Netherlands suggest that caution should be exercised in using savings rates as indicators of investment flows from specific countries. Although differences in the rates in the U.S. and in the Netherlands explain the possibility of investment flows into U.S. realty, they do not explain the dramatic surge in Dutch funds toward the end of the decade.

The prospects for investment flowing from OPEC nations to the U.S. during the remainder of the '80s will depend largely upon the price of crude oil. As of spring 1982, spot prices were moving downward, and it seems unlikely that prices during the rest of the decade will rise at anything like the rate of increase displayed in the late '70s. In fact, prices in constant dollars may actually continue to fall for the next several years in the absence of any significant

disruption of supplies in the region of the Arabian/Persian Gulf. Even if investment flows resulting from oil-generated savings should drop, however, retained earnings on existing OPEC investments could be reinvested in U.S. real estate.

As many of the developing, non-OPEC countries in east Asia and Latin America continue to approach the state of development of countries having "developed" market economies, they should be watched as probable sources of additional real estate capital for the U.S. in the '80s. Several countries such as South Korea and the Philippines have savings rates considerably in excess of U.S. rates.

Differences in demand are another variable in portfolio theory. Although the U.S. is no longer at the top of the world in per capita disposable income, it still has by far the largest total disposable income. Short of a major depression, the total demand for real estate is likely to continue at a high level during the '80s. The large land area of the U.S. makes it possible to satisfy demand more easily here than in, say, Japan or the Netherlands. Furthermore, the diversity of the population, economy, and climate in the U.S. are attractive to foreign investors seeking to tap particular market segments or to diversify their holdings.[17]

The existence of large-scale, internal migration, for example to the Sunbelt, has increased total demand for real estate during the '70s more rapidly than would have been the case without the internal migration. A decline in this migration is conceivable during the remainder of the '80s. In other respects, however, the U.S. should continue to be a favored market for foreign investors. A Belgian investor, for example, will continue to have far greater opportunity for investment in the U.S. than will be the case either in Belgium or in some third country.

The worldwide demand for food, pulp, and fibers will most certainly increase during the '80s.[18] Hearsay evidence from foreign intermediaries indicates that the awareness of the scarcity of good agricultural land in the world generally, and its relative plentifulness in the U.S., have helped to spur foreign investment in U.S. cropland and timberland. (The growing importance of the U.S. position in world agricultural markets may also have influenced nonagricultural investors to think bullishly about the future of the U.S. economy.)

The U.S. position in worldwide agricultural markets is likely to continue its increase during the '80s, stimulating further foreign investments. As farm labor is generally scarce in the U.S., and as farmland is becoming scarcer in the world generally, increasing proportions of capital will probably be applied to the land. Thus, the demand for foreign investment should continue to be high.

Portfolio theory, as refined, also emphasizes differences in risk and risk preferences and the existence of barriers to international investment. Judging from the comments of intermediaries quoted in trade publications and in the proceedings of conferences, political risk is one of the most important influences on foreign investment in the U.S. Threats of civil strife, invasion and socialism, high rates of inflation, and confiscatory taxation have all been cited as reasons for capital to leave a source country.[19]

By contrast, the U.S. has generally been cited as a stable haven for the investment of capital.[20] The need to preserve capital supposedly has been such an overriding consideration for investors from some developing countries that they have invested in the U.S., at least initially, with much more concern for a quick transfer of their capital into a safe asset here than with the rate of return that they might earn on it. There may be other countries as safe from political risk as the U.S., but none approach the U.S. in size of market or in the diversity of investment opportunities.

The U.S. will undoubtedly continue during the '80s to be a haven for risk-averse investors from other countries. Because such investors are generally supposed to view real estate in their home countries as safer than most other asset holdings (except gold for example), they tend to invest in real estate in the U.S. Furthermore, real estate investments often provide the element of control that cannot easily be obtained in other forms of investment, except by large corporations.

Short of U.S. involvement in a third world war or of a major economic depression leading to a political upheaval, the U.S. should continue to provide a safe haven for foreign capital in the '80s. The intensity and location of political risks elsewhere in the world will most likely vary during the decade, but there is little sign of the achievement of anything like a stage of total world stability anytime soon. Even without differences in savings rates and exchange rates, inflows are likely to continue from countries considered to be risky politically. The sizes of the inflows thus generated will, of course, depend upon other variables.

Finally, portfolio theory includes the factor of barriers to investment flows. For investment in real estate, the barriers can include exchange rates, restrictions by the source country on capital outflows, restrictions on the host country on direct investment generally, and restrictions by the host country on land ownership. The U.S. government itself has no significant restrictions either upon direct investment generally or upon foreign ownership of land. Approximately 25 states do have restrictions on alien ownership. For a time in the late '70s such restrictions appeared to be on the increase, but since 1978, at least, interest in greater restrictions seems to have waned.

Ricks and Racster have compared the restrictions of the 50 U.S. states with the restrictions of 49 foreign countries.[21] They found that 25 U.S. states had no restrictions as compared with only 11 foreign countries having no restrictions. Conversely, they found that only 9 states had general prohibitions or major restrictions as compared to 15 foreign countries. So far, state restrictions have not been a serious barrier to foreign investment in U.S. realty. Should

the restrictions become more severe during the '80s, however, an impact on inflows might be noticeable.

Numerous countries such as France, Italy and South Africa have imposed restrictions on the outflow of capital. The effectiveness of such restrictions has not been complete. It is known, for example, that Italian and South African capital has been invested in U.S. realty via intermediate countries. As the amount escaping controls cannot be quantified, it is not possible to predict the results of more effective enforcement. At the moment, there are no signs of either additional controls on outflows or of more effective enforcement of existing restrictions.

Exchange rates represent another potential barrier, although their past effects are not clear. For several years in the late '70s, the rates were quite favorable to inflows from several important countries. In the cases of the Netherlands and West Germany, the U.S. dollar lost value with respect to the currencies of those two countries from 1976 through 1979, and this change in the exchange rates may have encouraged an increase in the investment flow.

In 1980, however, the dollar advanced against both the German DM and the Dutch Guilder; investment from West Germany continued to increase, and the direct investment from the Netherlands more than doubled. To some extent, the increases may be a result of more complete reporting. It is also likely that much of the investment reported as originating in the Netherlands has actually been funneled through the Netherlands from other sources, either to avoid taxes or to avoid disclosure.

The value of the Canadian dollar fell relative to the U.S. dollar from 1976 through 1982, but except for a drop in 1977, Canadian investment in U.S. realty increased spectacularly during the period. This may have been attributable in part to the unrest in Quebec and a resulting flight of capital from the political risk being generated.

No attempt will be made here to forecast future exchange rates between the U.S. dollar and other currencies, but certainly such fluctuations will make it easier or more difficult for money to flow in from particular countries.

Summary

Foreign investment in U.S. real estate has been growing in importance. It is unfortunate that there are insufficient data to permit an adequate assessment of its importance, especially with respect to the relative importance of the various sources of foreign capital. Nevertheless, enough is known to warrant further study of foreign investment as a significant source of funds for real estate in the U.S. in the '80s.

NOTES

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