REAL ESTATE MARKET AND FOREIGN INVESTMENT FLOWS. COULD BREXIT ENABLE REDISTRIBUTION?

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Abstract

Foreign investment in the real estate market has been growing steadily in the UK economy for more than 20 years, to the point of creating the inverse problem of emptying the central districts, a direct consequence of the wealth effect generated by the overvaluation of the currency. This leads real estate developers to leave their own space empty rather than rented, with the aim of increasing the instrumental value of the property, giving up the progressive profitability of the asset and causing damage to the real economy, due to the decrease in available real estate assets. While there is a positive correlation between property prices and the current account, the long-term effects of Brexit could lead to a loss of attractiveness of the UK as a preferred location for real estate investments and cause a decline in foreign flows in the real estate market, opening the door to a crisis in the sector, the resilience of which is already being tested by the closure of several investment funds. Through the analysis of sector variables and related geopolitical and geo-economic issues, the work constitutes an attempt to outline the possible scenario of redistribution of foreign investment flows in the real estate sector and the development prospects of the main European countries and capitals potentially affected by their reallocation.

Keywords: housing market, Brexit, foreign investments.

1. The role of foreign investments in national economies

The movement of capital flows from a country of origin to a recipient country can be summarised in two main subcategories: the first – which includes loans, venture capital investments, acquisitions of foreign companies, etc. – concerns international portfolio investments, that represent a category made mainly for financial reasons, usually in the short term. On the contrary, the second one involves *foreign direct investments* (FDI), made by a person resident in a country to establish long-term relationships and to acquire durable interests and control in an enterprise resident in another one, according to an industrial logic. This subcategory can be further divided into those generated by domestic companies abroad *(outflow*) and those generated by foreign companies on the domestic territory (*inflow*, as the UK case, which will be discussed in the paper). According to Krugman and Obstfeld (2007), the *raison d'être* of FDI is the construction of multinational organizations capable to extend the control capacity

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of a company (which has its origin and headquarters in one country and aims to broaden the geographical boundaries of relevance in another country) and not an *alternative* method to make international loans between countries with industrialized economies.
Among the positive effects of *foreign direct investments*, it should be emphasised that it can boost national productivity and, consequently, increase employment and salaries (Dhingra et al., 2016); however, it must be kept in mind that the inflow of capital from one country to another is a *debt* for the recipient and – due to its nature – FDI should be managed carefully. It can be an advantage or a disadvantage depending on the conditions in the receiving country: for example, if there is already a high level of debt in the latter or the employment rate is rather high, the injection of capital from abroad could have effects opposite to those hoped for (Bagnai, 2004; 2012). Multinational companies, through the transfer of technological and managerial know-how, can also stimulate production improvement in an economic/social/geographical environment different from that of origin, while according to others (Harrison and Rodríguez-Clare, 2009) investment flows can also be seen as an element of stimulus for national companies, since they raise the level of competitiveness through leaner production processes, more efficient production chains, etc.

1.1 The effects of geopolitical patterns on the trade balance of investments

Recent literature suggests that larger and richer markets tend to attract more investment and convey localisation choices (Dhingra et. al., 2016), which is why it is desirable to assume that the UK has become a sort of *repository* for investment in real estate, particularly over the last fifteen years. There are many studies investigating the effects of a condition of membership or non-membership of the EU. Straathof et al. (2008), using a *gravitational model* containing some classic independent variables (GDP, geographical proximity, GDP per capita, *cultural distance*, etc.), estimate that membership of the EU can correspond to an increase ranging from +14% to +28% of total foreign investment. The model considers if the country belongs or not to EFTA - in the case of Switzerland - in the same way as countries completely outside the European Union, such as, for example, Japan or the USA. In other words, this means that an *exit* negotiation from the EU – with any type of trade/bilateral agreement – could anyway lead to reductions in foreign investment flows to the UK. Other findings (Bayer et. al., 2008) suggest that *full* membership of the European Union leads to more intense trade with other member countries, about a quarter more than countries that are bound by EFTA-type agreements (and the like). Similarly, Campos et al. (2015) estimate that EU membership encourages to trade flows ranging from +25% to +30% more than non-member countries. More recently, however, Dhingra et al. (2016), estimate that the positive effect of a country's *full* membership of the European Union can vary from a minimum of +14% to a maximum of +38% on the scale of foreign investment, with an average of around +28%. The final hypothesis of the latter (on the basis of a *gravitational model* similar to that of Straathof et al., with more recent data) is that, following an exit from the EU, investment flows to the United Kingdom may fall by about 22%. There are also several contributions that argue that foreign investment benefits in terms of added value also for other companies operating in the same segment in which the investment is located (Haskel et al., 2007), both in terms of productivity (Bloom et al., 2012) and in terms of GDP growth (Alfaro et al., 2004), especially for those countries that, like the United Kingdom, have a fairly strong financial sector. In view of this, there are some more pessimistic estimates about the reduction in household income (-3.4% according to Alfaro et al., 2004), and less drastic evaluations (-2.2%, according to Dhingra et al., 2016), on the assumption of a scenario that foresees the exit from the EU by a Member State. In general, it is clear that there is a shared view that the possibility of increasing trade investment flows with other countries (both within and outside the EU) rises depending on whether the country is a Community member or not.

2. Real estate rootedness of commercial properties in UK

According to some not too distant estimates (Real Capital Analytics, 2013), the United Kingdom has become one of the world's favourite *customers* for the export of commercial property flows, reaching a *negative balance* of about 20 billion pounds (or 33.6 billion dollars in 2013). Through a reworking of data from RCA, ONS and *Capital Economics*, it was possible to draw up a sort of 'flow map' from and to (mainly) the United Kingdom, by observing two time periods, 2007 and 2013, obtaining an eloquent *picture* of the considerable increase in the flow of commercial property exports to the UK in less than a decade.

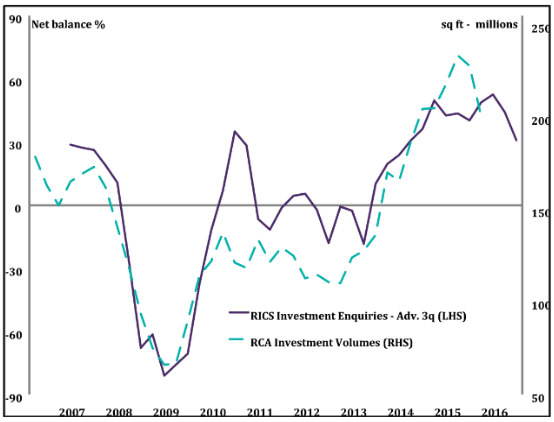
Country of provenance	2007(t_1)	2013(t_2)	Variation (%)	Change (absolute value, bn £)
Extra-EU countries				
USA	**5,300**	**5,600**	**+5,66**	**+0,3**
Kuwait	**,000**	**3,060**	**.**	**+3,060**
China	**-,434**	**2,310**	**+632,26**	**+2,734**
Singapore	**1,310**	**2,120**	**+61,83**	**+0,81**
Hong Kong	**,015**	**1,330**	**+8.766,67**	**+1,315**
Canada	**,757**	**1,140**	**+50,59**	**+0,383**
UAE	**,575**	**,921**	**+60,17**	**+0,346**
Malaysia	**,007**	**,825**	**+11.685,71**	**+0,818**
South Korea	**,000**	**,455**	**.**	**+0,455**
Saudi Arabia	**,360**	**,345**	**– 4,17**	**–0,015**
Qatar	**,049**	**,322**	**+557,14**	**+0,273**
Australia	**,965**	**,168**	**– 82,59**	**–0,797**
Israel	**1,280**	**,091**	**–92,89**	**–1,189**
Total amount of Extra-EU countries	**10,184**	**18,687**	**+83,48**	**+8,503**
EU countries				
Germany	**-4,410**	**,557**	**+112,63**	**+4,967**
Spain	**-,623**	**,467**	**+174,95**	**+1,09**
Netherlands	**-,539**	**,283**	**+152,50**	**+0,822**
Switzerland	**,030**	**,111**	**+270**	**+0,081**
Ireland	**4,660**	**,094**	**– 97,98**	**– 4,566**
Sweden	**-,543**	**-,181**	**+66,67**	**+0,362**
France	**-1,410**	**-,390**	**+72,33**	**+1,02**
Total amount of EU Countries	**-2,835**	**0,941**	**+133,18**	**+3,776**
Whole extra-EU + EU	**7,349**	**19,628**	**+167,07**	**+12,279**

Table 1: UK balance of investment flows in commercial property (billion pounds) – 2007/2013.
Source: Author's work on Real Capital Analytics, Office for National Statistics and Capital Economics data.

Over the period 2007/2013, the United Kingdom experienced a dramatic increase in the flow of investment in commercial property from around the world (from 7.3 billion to about 20 billion pounds, almost tripling the figure). In 2013, inflows coming from commercial and residential property helped to cover about one third of the current account deficit, while in 2007 the *real estate trade deficit* accounted for only about one eighth of the trade balance. From the data in Tab. I, it is clear that the United Kingdom is a preferred destination for investment, especially from countries outside the European borders (in some cases, in 2007 there was no trace of real estate trade flows, while in 2013 - Kuwait, Hong Kong, Malaysia - the flows reach enormous proportions). In general, all *non*-EU countries have a positive balance towards the UK, even among those that have experienced a decline, while remaining positive (Saudi Arabia, Australia, Israel). As far as the EU *countries* are concerned, over the same period, all – with the exception of Ireland – have increased their real estate trade balances towards the UK, sometimes remaining negative (France and Sweden), sometimes jumping from a strong debit balance to a surplus balance (Germany, Spain, the Netherlands).

2.1 The real estate market of investments and leases in the UK. What role for Brexit?

For that it concerns the investment market, according to RICS, the first uncertainties about the intention to invest in commercial property in the UK emerged from the February 2016 reports.



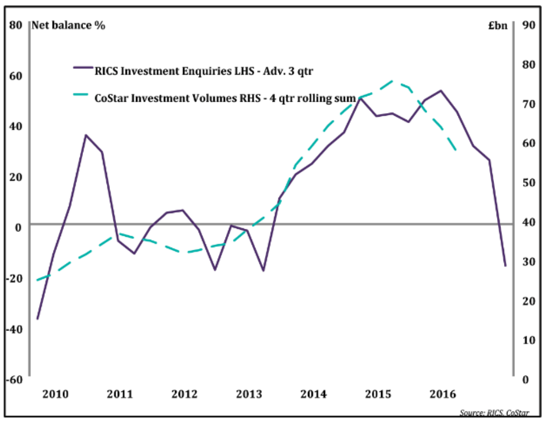
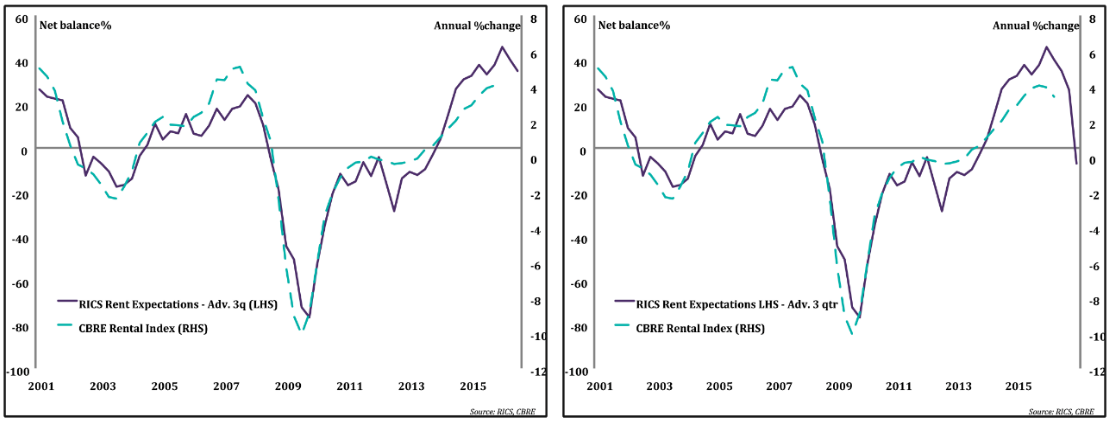


Figure 1: RICS investment intentions and historical series of investment volumes (mln sq.m.) RCA. Figure 2: RICS investment intentions and historical series of investment volumes (bn £) CoStar.
Source: RICS, 2016.

After two years of record volumes (2014 and 2015) the series starts to diverge downwards (RCA, 2016), in the first 3 quarters of 2016 (Fig. 1). Although volumes were set to remain rather high according to *pre-Brexit* projections (RICS, 2016), post-vote uncertainty contributed to lower investment forecasts in the commercial real estate market. In terms of monetary flows (CoStar, 2016), after the peak reached in the second quarter of 2015 (£75 billion), by mid-2016 investments in the real estate market were already reduced to £57 billion (Fig. 2) and the drop in demand suggests an even greater decline. Investment intentions are therefore affected by the immediate *post-Brexit* period and fall from +25% to -16%, the most significant decline on a quarterly basis since 2006. Aggregating the figure to that of foreign investors, the reduction in demand widens to -27%, still far from the values found in the immediate post-crisis 2009 (around -40%).



Figures 3 and 4: Quarterly Expectations of RICS Lease and CBRE Lease Index, 2001-2015.
Source: RICS, 2016.

With reference to leases, the index drawn up by CBRE (2016) shows that until the last quarter of 2015 the demand for leasable space (Fig. 3) from both the commercial/industrial sector (retail, primary and secondary industries) and the residential sector continued to grow, albeit with modest values (+1%). On the other hand - in line with investments - at the beginning of 2016 the demand for rented space began to soften, before the referendum outcome. Looking at the same graph - updated, however, to the data immediately following the *leave* vote (August 2016) - it can be seen that the rental index has begun to fall (slightly) down (about -1%). For the first time since 2012, in the second quarter of 2016, demand was unable to increase (Fig. 4). On the other hand, rental expectations (quarterly basis) are strongly affected by the post-referendum shock, with a drop from +26% to -7% (a value that was already showing negative signals and that swelled following the *leave*, despite the fact that they remain projections, which however have always followed roughly the same fluctuation of rental indices from 2001 onwards).

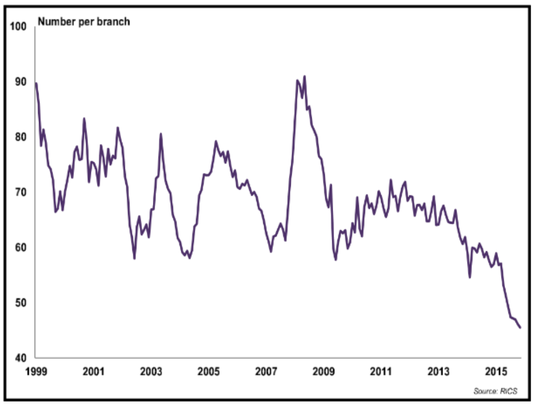


Figure 5: Cyclicality of owned stocks for sale and lease, 1999-2015.
Source: RICS, 2015.

The real reason for the downturn in real estate is the lack of stocks available for sale and rental (Fig. 5), according to an aggregate index developed by RICS (2015) based on surveys of major real estate companies in the UK. Fig. 5 shows that the cyclical trend of previous years has progressively eased from 2009 to 2013, with a collapse from 2015 onwards. Over the same period (2009-2013), real estate prices in London increased by 47% and the nominal value of the pound sterling rose by 13%. On the basis of these reasons, many people already agreed two years ago (Dumas, Hutchings, Sieracki, Bloom) that the too high value of the pound and the expansion in demand in recent years would have led to a decline in the real estate market, assuming a decline in the nominal value of the pound (which later occurred in the run-up to 2017) with a consequent fall in real estate prices as a solution to the reversal of the trend. Of course, *post-Brexit* uncertainty has contributed to the problem, but it is not and will not be the only reason to explain the downturn in the sector.

3. Prospects of real estate scenarios in Europe

In the meantime, in Europe, the economies of Portugal, Spain and Ireland have been plunged into deep and damaging recessions as a result of the global crisis. GDP fell by almost 10% in all three countries, although the lowest point was first reached in Ireland. This decline was accompanied by a sharp increase in the unemployment rate in each country (+17.4% Spain, +8.7% Portugal, +9.8% Ireland), (Eurostat, 2016). Until 2008, the real estate market boom fuelled speculation in the construction sector (property tax increases, etc.) with a consequent collapse following the financial crisis, which led to a drastic reduction in property market taxes and huge losses for domestic banks (Lourenço et al., 2015), leaving the financial system in a fragile state (collapse of property prices of -50% in Ireland, -40% in Spain, -20% in Portugal). As a result, public debt rose to over 100% of GDP in Ireland (Bainistíochta et al., 2015) and Portugal, to 82% in Spain, resulting in long-term financial debt because of *bailout* plans and financial aid needed to restore the 'hole', (Martí et al., 2015). Nevertheless, following the great recession, these three financially troubled European nations have emerged among the leaders of the economic recovery of the Eurozone, which is particularly true for Spain and Ireland (Portugal is travelling at a slower pace). In this

context, *outperformance* in these countries has started to attract the attention of international investors - a particularly visible trend in the real estate sector. There are many reasons for a reversal of the fortunes of the countries previously referred to as *'Sick man of Europe'* (RICS, 2015), including reduced labour costs, labour market reforms (reduced severance indemnity, flexible working hours), wage increases, increased disposable income, increased household consumption, increased exports. The sharp fall in prices (2007-2013; Ireland -66%, Spain -32%, Portugal -22%), together with the glimpsed favourable economic conditions, suggested solid returns on commercial property to investors. Ireland has far exceeded pre-crisis levels, while Spain has not, however, experienced a sharp rise, while Portugal is almost realigned to 2008. It is no coincidence that those countries that have adopted the most expansive policies in the last five years (post-crisis) are the ones that are now reaping the greatest benefits in terms of the recovery of the real estate market in Europe. Ireland and Spain - in fact - are among those with the highest negative primary budget balance in the post-crisis five-year period, while Portugal follows different dynamics of recovery (it was the slowest to suffer the shock of 2008 with a gradual, but persistent, decline in the market, as well as its recovery).
For that it concerns the various exit negotiation hypotheses that some people have already feared (Irwin, 2015) during the previous year (EEA agreements on the Norwegian model, FTA agreements, bilateral agreements on the Swiss model, customs union on the Turkish model and MFN agreements), in general, in the event that countries converge towards 'economic integration', it is easier to fall back into the free trade area; vice versa, when there is a 'competitive divergence', the choice of customs unions, with the respective tariff and non-tariff barriers, is more plausible. In the case of the United Kingdom, by 2015 it is the country with the highest negative balance of goods and services towards the EU and – therefore – it would not be a gamble to assume that the solution goes back to EEA or FTA agreements, maintaining the free movement of goods and services. In conclusion, any hypothesis of evolution of the real estate market, at the moment, remains suspended on the basis of the trends recorded in recent years. As long as the *post-Brexit* is not absorbed by the final outcome of the vote, a climate of uncertainty among investors will continue to exist. Of course, the Brexit affair has more rapidly fuelled a recent downward trend in the UK real estate market for the reasons set out above, although to assume *(un)entrenchment* would be a constraint given the strength and attractiveness of the UK market. In this context, the countries that can *take advantage* of the period of post-referendum uncertainty (and those that have – in part – already done so) are those that will be able to make a breakthrough in the labour market, boosting wages, incomes and consumption, in order to become potential alternative real estate attraction poles to the United Kingdom.

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