

**Should foreign investment controls apply to the real estate market? –
Case study: the Australian experience.**

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All major industry sectors have been captured by the globalisation effect. Up until the early 1970s, the world's financial sector was predominantly operated under a fixed foreign exchange regime, which brought about regulated capital flows across borders. Most dealings in the financial markets were due to trade, which was also subject to relatively high tariff protection.

The past thirty years has witnessed the deregulation of financial markets opening the way for large international capital flows and at the same time lowering of tariffs, leading to a large increase world trade. The effect had been, to see \$billions moving across borders leading to a current turnover of over \$1trillion per day in the foreign exchange markets. Trade accounts for less than 10% of this turnover, the balance being taken up by professional dealing, investment (including real estate), financing and speculation.

These deregulations have also affected real estate markets. Many of the industrial countries have allowed foreign investment to flow into their property markets, but many countries still have some form of control.

This paper will examine the arguments for and against foreign investment and the gradual easing of controls for such investment. The paper will use Australia as a case study to show the easing of its policy on foreign real estate investment and the reasons for maintaining some controls.

INTRODUCTION

According to the United Nations Conference on Trade and Development [UNCTAD, 2000], the rapid growth of the world's largest multinational corporations (MNCs) may see foreign direct investment (FDI) surpass \$US 1 trillion this year. The move towards more "open economies" leading to the deregulation of financial markets has acted as the catalyst for the rapid growth of global capital flows.

World FDI has increased from \$US58 billion in 1984 to \$US865 billion in 1999, with the United Kingdom (\$US199b) now surpassing USA (\$US150b) as the largest foreign investor. As a whole, the EU is the largest investor, accounting for over two thirds of the total FDI [UNCTAD 2000].

In the *classical* study of the world's wealth, Ibbotson et al [1985] estimated the value of total foreign real estate to be in the vicinity of \$US 10 trillion, representing 36.9% of the world's total wealth and as diversification of investment moved globally, real estate began attracting FDI. Baum [1995] cites the pursuit of high return and low risk as the underlying factors for international property investment. Worzala [1994] in a survey of institutional investors found diversification, yields and low risk as the three main reasons.

The *globalisation effect* of the real estate market has further been intensified with two relatively new areas of growth, one on the demand side and the other facilitating on the supply side. On the demand side, the rapidly growing pension funds need to diversify their assets and are eager to spread their risk from one economy to a number of economies. In 1991, \$US490 billion (7%) of the worldwide pension funds was invested in markets abroad with the UK pension funds holding 25% of their assets abroad, Canada 11%, Australia 4.5% and USA 4% [Newell & Worzala 1995].

On the supply side, there has equally been a rapid growth of real estate securities. According to Gordon and Canter [1999], the real estate securities market had an increase of market capitalisation from \$US100 billion in 1984 to \$US350 billion in 1997. The benefit of real estate securities (which includes REITs) is that it gives the real estate asset liquidity and makes it simpler and more attractive for investors to buy abroad.

Australia has long been the recipient of foreign investment, traditionally from U K and later from USA. In the 1980s, Japan emerged as Australia's leading investor due to its significant investment in the Australian real estate market. By 1990, Australia was ranked 7th as a destination for FDI in the world [Yang et al, 2000]. Australia is a net recipient of \$341 billion of foreign investment; a total of \$717 billion inflow of foreign investment and \$376 billion of Australian investment abroad [ABS, 2001].

The rise in foreign investment has renewed the debate regarding who benefits from it in an economy. This paper will give an overview of the debate which underlies the argument for controls and using Australia as a case study, will illustrate the easing of its regulations in its real estate markets.

A. The argument for controls of foreign investment

Australia has been dependant on foreign capital for development since settlement, however the 1980s saw a new dimension with net foreign debt rising from 6.5% GDP to 34% GDP. Australia's current foreign debt has now risen to a cumulative \$405 billion [ABS, 2001].

A survey in Australia found that 56% of the people believed that foreign investment in Australia was too high [DFAT,1999]. Foreign ownership (or control) of Australian icons, such as Arnotts, Bundaberg Rum, Birds Eye, Edgells and the recently mooted foreign takeover of the Foster Brewery has increased awareness and concern in Australia.

Of the many arguments for controls of foreign investment, the main one stems from the scenario that benefits seem to flow to the larger corporations, particularly the MNCs and that very little *filters* down to the broader community. The opening sentence of this paper confirms the growth of these MNCs. In other words, the argument is that the overall *lorenz* curve is moving *outward* to more inequality.

Often the debate fails to look at the broader cost / benefit of foreign investment. Table 1 lists some of the common arguments for and against foreign investment controls.

TABLE 1
For and Against Controls of Foreign Investment

FOR	AGAINST
Protect national interest	Increases the supply of capital
Oppression and exploitation	Increases expertise and technology
Unfair market practice	Intensifies competition
Transfer pricing	Expands global business network.
Control monetary flows	Public benefits
	Creates growth

Briefly commenting on these:

1. Protect national interest

Controls are imposed in certain sectors to prevent investment that is deemed to be contrary to national interest. There is a perception in the community that there is a danger of foreign interests owning and controlling key industries.

Multinationals (MNCs) can have a high degree of *political push* and fear emerges from large scale foreign investment which flows to influential and highly technological industries, such as mining and the media. For instance, a free independent press is essential to a community and therefore restricting

media ownership to eliminate dominance or concentration of ownership is sometimes necessary, particular for smaller nations.

Real estate is invariably seen as a key industry. Foreign investment in speculative investment, such as *land banking* is often regarded as having no economic value. Residential real estate is another area because by its nature, foreign investment adds to the demand and thereby pushes the price up on the local consumers. The large wave of Japanese investment in the Australian property market in the late 1980s resulted in front page headlines saying, "we are selling off the farm".

2. Oppression and exploitation

This occurs where the MNCs invest in third world countries and the investment is directed towards industry which use the very cheap local labour. This is often referred to as running *sweat shops*.

Of course, the counter argument is that the host country is deriving a benefit as it offers employment to workers who would not have any income previously and in most cases, export the product.

3. Unfair market practice

The larger corporate foreign investors can use their capital to buy into a market and eliminate the local opposition by reducing price (that is, subsidise) until they obtain a controlling monopoly position. Whilst not creating a monopoly, the recent takeover scenarios in the Australian airline industry has resulted in upward price movements and loss of local jobs.

4. Transfer pricing

Transfer pricing to minimise taxation is clearly a major problem for all governments in today's globalised world. Obviously, if the MNCs bypass their proper tax, then their investment benefits are minimised. Governments continue to produce legislation which can eliminate these practices, but equally, MNCs continue to produce *creative* accounting reporting practices to minimise their tax.

5. Control monetary flows

Loss of capital as profits and the cash flow drain on Balance of Payments

The classic argument that the profits are leaving the country, so where are the benefits?

Foreign investment produces dividends, rents, royalties, and these are generally repatriated to the investor country. In the case of real estate development, the capital and profit from the sale of the asset are eventually repatriated as well. All these have an impact on the Balance of Payments.

Exchange rate volatility

By definition, foreign investment means that capital flows across borders. One major problem since the floating exchange regime has been the volatility of exchange rates.

Summing up the argument, Dunstan [1994] found that the unintended result of FDI is:

- ?? an inflated and an illusionary exchange rate,
- ?? a rising debt,
- ?? loss of industry competitiveness,
- ?? increased unemployment due to export of jobs,
- ?? increases in the CAD,
- ?? works more subtly through foreign exchange dealings and creates volatility of capital movements,

and instead of bringing new productive capital into Australia, most FDI involves the acquisition of existing assets.

Professor Bhargwati, a researcher with the Nikko Research Centre Washington [1998], adds,

“Movement of capital and the movement of goods and services are different in that the former has a tendency to create panic, leading to financial crisis. Those who advocate capital liberation have hijacked the arguments for trade liberation, but the benefits of capital liberalisation remain unproven”

Arguments Against Foreign Investment Controls

Whilst some of the above arguments may have some merit, one must firstly see them in the light of the benefits of foreign investment.

The positive aspects of foreign investment are many, in particular:-

1. Supply of capital

The supply of capital in an economy is always limited and as investment is financed with savings, foreign investment carries with it, capital inflow. Australia has historically relied on foreign capital and this has been mainly because of its relatively low *savings ratio*. The government [DAFT, 1999] has found that:

✍️ FDI lessens the scarcity of venture and risk capital by facilitating access to the expanded financial base of parent companies, including greater access to funding for research and development.

And regarding profit leaving,

✍✍ "that on average, from every dollar generated from an investment in Australia, 96 cents is retained in Australia" .

2. Increase in expertise and technology

Foreign investment can have input in management, technology and marketing. This is more likely to occur in the secondary sector such as the car industry in Australia. In the property sector, new marketing techniques are possible, as evident in the "off the plan" marketing of Australian home units (condominiums) in recent years. This was a direct result of foreign investment in the real estate market.

3. Intensifies the local industry through increased competition

Obviously based on the economic principle of competition and in particular for the manufacturing industry whereby it can derive *economies of scale*. This benefits the economy through decreases in price.

4. Expands global business network

FDI in local companies allows an integration of the local industry into the global network. By developing expertise in certain areas, these companies can then expand their export base.

5. Public benefits

Foreign investment, by definition is investment and therefore increases revenue to the government through the taxation system. Other benefits from property investment can come from development of infrastructure, as was the case from the larger Japanese investments in Australia's tourist resorts.

6. Creates growth

Investment is the *engine* for growth, accordingly foreign investment creates growth through the *multiplier* effect on the economy. In a developing economy, as foreign investment increases over time the *multiplier* effect increases GDP at a greater rate and hence over time, *ceteris paribus*, the ratio of foreign investment to GDP diminishes.

Summing up, in Australia, case studies [DFAT, 1999] have demonstrated that FDI:

- ?? contributes to growth and development,
- ?? provides employment,
- ?? build exports,
- ?? provides additional sources of finance,
- ?? facilitates technology transfer and innovation, and
- ?? increases opportunities for global networking.

Over half a million people in Australia work for firms with majority foreign ownership as evident in Table 2. An example of the property related sector is the French owned Accor Asia Pacific which employs some 10,000 Australians in their hotel chain.

Table 2
Private Sector Employment (Non-Farm) by Industry
& Foreign Ownership, 1996-7

Industry	Foreign ownership 0-10%	Foreign ownership 10-50%	Foreign ownership >50%
Mining	61900	18000	6300
Manufacturing	740900	15700	199600
Service	3515500	67100	323600
Total businesses	4317900	100800	529400

Source:DFAT, 1999, p25

Benefits also come to the country that invests abroad. In Australian case studies [DFAT, 1999], which included engineering and construction contractors concluded that outward FDI:

- ?? expands growth opportunities,
- ?? improves competitiveness,
- ?? ensure s a strategic market presence, and
- ?? accesses global business networks.

Finally, Professor McKibben [DFAT, 1999] developed a model and found that if capital controls were imposed in Australia, there would be falls in GDP, employment real wages, whilst interest rates would rise.

B. Foreign Investment Controls In Australian Real Estate

Definitions

Before examining the controls in relation to foreign investment in Australian real estate, it is relevant to note the definition for "foreign interest" and "urban real estate" as defined in Australia.

✍✍A foreign interest is defined as:

- ?? a natural person not ordinarily resident in Australia;

- ?? a corporation in which a natural person not ordinarily resident in Australia or a foreign corporation holds a controlling interest;
- ?? a corporation in which two or more persons, each of whom is either a natural person not ordinarily resident in Australia or a foreign corporation, hold an aggregate controlling interest;
- ?? the trustee of a trust estate in which a natural person not ordinarily resident in Australia or a foreign corporation holds a substantial interest; or
- ?? the trustee of a trust estate in which two or more persons, each of whom is either a natural person not ordinarily resident in Australia or a foreign corporation, hold an aggregate substantial interest.

A substantial foreign interest occurs when a single foreigner (and any associates) has 15 per cent or more of the ownership or several foreigners (and any associates) have 40 per cent or more in aggregate of the ownership of any corporation, business or trust.

Urban Real Estate is defined as:

1. Land other than "farming" but includes hobby farms and rural residential blocks,
2. Options over freehold land,
3. Lease of more than five years on land or improvements thereon,
4. Financing arrangements where profit sharing is from real estate,
5. Share in equities or unit trust with an interest, option or lease of land (where value of the land is greater than 50% of the total assets of the company or trust).

- ?? Residential Real Estate is real property other than
 - ?? commercial property and
 - ?? land which is integral to farming business.
- ?? Developed Residential Real Estate means existing houses, flats or units.
- ?? Commercial Real Estate means all real property other than
 - ?? residential properties and
 - ?? land which is integral to farming business. It includes offices, factories, warehouses, hotels, restaurants, shops, recreation facilities etc).

Controls

The Australian Government deregulated its financial sector in December 1983; floating its currency and allowing capital to freely flow in and out of its economy. In April 1985, Australia opened up its banking sector by allowing 16 new foreign banks to operate in Australia.

In 1975, the Foreign Takeovers Act was enacted and under this Act, the Foreign Investment Review Board (FIRB) was established in 1976 to administer foreign investment into Australia. In recent years, by far, the largest number of foreign investment proposals involves the purchase of real estate.

Since its establishment, there have been several policy changes and generally speaking there has been a gradual easing of regulations. Prior to 29 September 1987, foreign investors were able to buy urban real estate in Australia up to a cumulative value of \$600,000 (from 1978) without approval. Up to 1993, commercial and industrial real estate required 50% Australian ownership, but in the case where foreign investors could show that they were unable to get an Australian partner, 100% was permitted.

From 29 September, investment rules for real estate have changed.

Current position

With the exception of residential real estate, foreign investment is permitted in all other areas of real estate provided it is not,

"judged to be contrary to the national interest".

All investment in vacant land (all sectors) and residential real estate sector require approval. For all other real estate investment, the following require reporting:

- ?? Developed commercial over \$50 million, except for heritage listed properties.
- ?? Commercial heritage listed properties over \$5 million.
- ?? Rural deals over \$3 million.

Residential Real Estate

The Government seeks to ensure that foreign investment in residential real estate increases the supply of residences and is not speculative in nature. The policy seeks to channel foreign investment in the housing sector into activity that directly increases the supply of new housing (ie, new developments - house and land, home units, townhouses, etc) and brings benefits to the local building industry and their suppliers.

The effect of the more restrictive policy measures on developed residential real estate is twofold.

- ?? it helps reduce the possibility of excess demand building up in the existing housing market and
- ?? it aims to encourage the supply of new dwellings, many of which would become available to Australian residents, either for purchase or rent.

The cumulative effect should therefore be to maintain greater stability of house prices and the affordability of housing for the benefit of Australian residents.

The purchase of residential is restricted to:

(a) real estate for development (with construction within 12 months), and subsequent retention or resale,

(b) intending migrants, temporary residents¹, senior executives of foreign owned businesses (maximum of two) and foreign diplomats -

BUT these must be sold once the status conditions no longer apply,

c) property within the bounds of an "Integrated Tourist Resort" (can sell 100%), and

(d) 50% "off the plan" of new developments of home units or condominiums (including "extensively refurbished developments") until occupied. Extensively refurbished development is the converting from non-residential to residential and the cost of refurbishment is at least 50% of the total acquisition cost.

All other applications for residential real estate are not normally approved.

The basic underlying restriction is to prohibit land banking and speculative investment in established residential.

Off the Plan Selling

"Off the plan" selling to foreign investors was introduced in 29 September 1987 and as noted applies to either new or "extensively" refurbished residential units. A developer can obtain approval for a development and undertakes to report on sales to the FIRB. This allows the developer to market abroad and use the words, "FIRB approved" and also eliminates the need for purchasers to obtain approval.

The following are the conditions attached to "off the plan" sales:

- (i) Must be sold before occupied. For the FIRB, a pre-leasing agreement in the contract implies that the property is occupied. Therefore, foreign investors cannot purchase on pre-leasing guarantees.
- (ii) The development must have a minimum of ten dwellings required in development (increased from four on 1 April 1999).
- (iii) In the case of an odd number, 50% means the lesser amount applies

¹ Temporary residents must have more than 12 months remaining on their visa. They can buy second hand dwellings, provided it is used as "place of residence" and must be sold when visa expires. This category includes students and as Australia, now has a large number of overseas students (particularly from the adjoining Asian countries), many sales occur from this category. However these properties must be sold once the student leaves.

- (iv) An "even handed approach" may be imposed by restricting the composition of sales.
- (v) Can sell a "house" off the plan if & only if same developer has a series of similar houses (minimum of ten) under construction at the same time.

C. Reasons for foreign investment in Australian real estate

The level of foreign investment in the Australian real estate sector has increased from \$269 million in FY1980 to nearly \$9.5 billion in FY2000, after peaking at \$16.2 billion in FY1998 [FIRB].

Political stability and the economy are the two major underlying factors which will ultimately influence foreign investment *per se*. Real estate investment is no exception to the rule. The political factors will determine whether or not to invest in a particular country and the economic factors will determine the level and timing of such investment.

Australia is perceived as a politically *safe haven* and although some restriction on foreign investment exist, investor confidence in Australia is evident with the increasing level of investment. The changing character of the flows into the Australian real estate market have been attributed to the property cycle, favourable exchange rate movements, increasing tourism and in the latter part of the past decade, the Sydney Olympics [see Karantonis, 2000].

It should be noted that like all investment, foreign investment has an element of risk. Indeed much of the "larger" Japanese investment, whilst beneficial to Australia, proved to be detrimental to its investors. Whilst these losses were not due to exchange rate loss, studies by Leong [1995] and Dehesh et al [1995] found that since the introduction of floating exchange rates, the international financial markets have been very volatile leading to the emergence of new risk. In analysing the overall return on investment, Brown [1991] postulated that currency played a pivotal role in property portfolio selection and found that "countries with a strong currency had shown greater appreciation rates and investment worth".

D. Conclusion

This paper identified the arguments for and against controls of foreign investment and used Australia as a case study. For an economy, the benefits of foreign investment outweigh the costs, but as with all economic benefits they are not evenly distributed throughout the community.

Australia needs capital inflow and has benefited from such investment. The DAFT studies have shown that FDI enabled Australia to have faster economic growth and a higher living standard than otherwise would have been possible.

Australia's approach to foreign investment policy is to encourage FDI and for this reason has continued to ease the controls. The controls in place are limited to areas that are judged not to be in the nation's best interest. In the real estate sector, controls are imposed to prevent speculative investment, such as *land banking* and to protect the local consumer in the housing market. Other than these controls, foreign investment is welcome in all other real estate sectors.

Notwithstanding the restriction, foreign investment continues to flow into Australian real estate as Australia is perceived as a politically safe haven. The level of flows is ultimately dependant on the relevant economic factors.

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