

# **The Role and Effect of the Real Estate Sector in the United States and World Economies**

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## **Introduction**

The real estate sector is a major component of the economy of the United States and many other countries in the world. Lacking data or comparable data, the contributions of the real estate sector to each nations' economies are difficult, if not impossible, to accurately determine or compare. Leaving these issues aside, a number of hypotheses and observations are presented based upon studies and the actual experience in the United States and several other countries. The role and the factors that influence the effect of the real estate sector in national economies are also discussed in this paper.

## **The Real Estate Sector's Contribution to the United States' Economy**

The real estate sector is a major contributor to the economic value added in the United States, as well as in many other industrial countries. The real estate sector contributed 12.7 percent to the real gross domestic product (GDP) in recent years. Real value added by this sector contributed more than governmental services and almost six times more than the combined agricultural and mining industrial sectors in the U.S. Only the entire manufacturing sectors in the U.S. combined contributed slightly more than the real value added by the real estate sector.

The real estate sector has a ripple effect on many other economic sectors, including construction, finance, professional services, retail, wholesale and manufacturing sectors. Just like throwing a stone in a pond, the real estate investment ripples to other economic sectors in the form of jobs, increased spending and higher demand for goods and services.

The real estate sector is intrinsically linked to the construction sector. Residential construction is a major contributor to the United States economy. So significant, that "housing starts" is an economic statistic widely reported each month. An increase in the pace of housing construction usually accompanies a spurt of rapid economic growth, whereas a decline in housing starts is an ominous sign for the economy. Because the residential real estate industry

is the bellwether of other economic indicators, and moves roughly in step with the rest of the economy, housing starts is just one of 10 economic indicators used to monitor its condition.<sup>i</sup>

In the United States, the production of 1,000 new single-family homes is estimated to generate 2,448 jobs in construction and construction-related industries. Every \$1,000 gain realized from a home sale increases consumer spending by as much as \$150. In contrast, every \$1,000 in stock market gain generates only \$30 to \$50 in additional spending. As a result, the strong growth in home purchases and equity helps sustain consumer spending and offsets weaknesses in other economic sectors.<sup>ii</sup>

In the United States, the nonresidential sector accounts for approximately one-fourth of total construction spending. Every \$1 million in new construction spending supports the equivalent of 28.5 full-time, year-round jobs. Architects, engineers, developers, marketing and design professions work during the development phase of the life span of a building. During the construction phase, the new project employs workers who spend their paychecks in the local economy. Once the constructed building is completed and occupied, it requires a constant flow of expenditures to support its operation, including management, maintenance and repair, cleaning and custodial services and utilities. The building also represents new productive capacity. It is the workplace for employees who re-spend their income and the business activities in the building support an expansion of the national economy.

## **The Real Estate Sector's Contribution in Emerging Market Economies**

The real estate sector is a vital component of the economies of emerging market countries.<sup>iii</sup> Because the real estate sector is extremely decentralized, with many links to other industry sectors, it is of significant economic importance to the rest of a country's economy, regardless of its stage in economic development. For instance, when a house is built, it generates demand for construction employment and intermediate goods such as cement, lumber, insulation as well as consumer goods for the household.

As market economies mature, the real estate sector increases as a percentage of the country's economy. During slower economic times, the real estate sector accounts for a larger percentage of the real GDP, tempering the decline in other industrial sectors.

The real estate sector's contribution to a particular economy is largely influenced by several factors. The country's level of economic development, differences in household incomes, exposure to globalization, and the level of foreign direct investment (FDI) are significant drivers of the real estate sector's contribution to the country's economy. Other important factors include the degree of employment decentralization, the level of development of real estate finance markets, and the level and effectiveness of property taxation. The presence of cycles of high inflation and interest rates are additional factors that influence the rise or decline of the real estate sector's contribution to the national economy.

## **Factors Influencing the Economic Contribution of the Real Estate Sector**

Recent research illustrates a direct correlation between economic growth, per capita income levels and property ownership rights in the growth of cities and the vitality of the real estate sector. Another important factor is the maturity and sophistication of the domestic capital markets, including real estate primary and secondary lending capabilities. These, among other significant factors, are addressed in more detail in this paper.

### **Demographics and Urbanization**

Populations are growing throughout the globe. The accelerated population growth in the Kingdom of Saudi Arabia, for example, is among the highest in the world. Population growth leads to urbanization as people leave rural areas for the cities. Urbanization requires homes and places of employment. As in the U.S., the Saudi economy has recently experienced strong demand in the housing sector.

The growth of cities all across spectrums of economic development stages provides opportunities and challenges for the real estate sector. As a city grows, the distribution of real estate types and locations evolves. The demand for real estate is different depending upon the stage of development of the national economy. That is why suburbs and edge cities exist and new cities are created, and why commercial development occurs. More public housing and infrastructure improvements may be required in one city as compared to another. In more advanced economies, state-of-the-art office buildings, large-scale retail centers and elaborate hotels respond to domestic and foreign demand.

The residential real estate sector has profound economic implications on a nation's economy. Housing demand satisfies people's basic need for shelter and a place to carry on family activities, including childrearing. Because housing conditions are often considered a yardstick of economic development, there has been a long tradition of government involvement in the housing markets aimed at improving housing quality and fostering homeownership. This occurs through subsidized financing and special tax treatment incentives. However, the bulk of the residential housing market is carried out by the private sector.

Throughout the Gulf Cooperation Council nations, which include Saudi Arabia, Kuwait, Bahrain, Oman, Qatar and the United Arab Emirates, there is substantial demand for low-cost affordable housing. Affordability of home purchases is determined by per capita income and the price of homes. In the U.S. and some other industrial countries, down-payment assistance programs for low-income households are common.

Lower employment mobility means fewer home sales and much lower ratio of existing to new home sales. In Japan, for instance, employees tend to stay with the same employer for many years if not their entire careers. As a consequence, the real estate sector in Japan is significantly less than in the United States where changing jobs is more prevalent.

Housing activities account for a large fraction of GDP and households' expenditures in industrial countries. Housing is the main asset and mortgage debt of those in industrial

countries. Consequently, large house price movements affect the households' net wealth and their capacity to borrow and spend, and important economic implications as discussed previously.

### **Transparency, Property Rights and Risk Protection**

Prompt disclosure of sale and rental prices of real estate is required for an efficient real estate market. Transaction transparency is essential for the finance sector to support the real estate industry. Standardization for the valuation of property, through appraisals, drives a dynamic real estate sector. Dissemination of this real estate market information is also important, such as via the Internet, multiple listing services, virtual office Web sites, and national price listing. Potential property purchasers, renters or developers need current and reliable information to make rational decisions.

Security in ownership rights assures homeowners and investors of protection in their real estate assets. Property rights in real estate must be clearly defined before the real estate sector may contribute significantly to local and national economies. In some market emerging countries, such as in Eastern Europe, the real estate sector is not a major contributor to their economies because they impose restrictions on purchases of real estate by foreigners that tend to be motivated by non-economic considerations.<sup>iv</sup>

Guarantees that assure ownership in real estate or repayment of mortgages are needed before the real estate sector may be a significant component of a nation's economy. For instance, title and mortgage insurance create the means for guaranteeing lender's security in funding real estate acquisitions and development.

### **Diversification**

The diversification of a country's real estate sector determines the degree of the sector's influence in the nation's economy and the stability of that impact. The real estate sector is typically viewed as subsectors of raw land, residential and commercial. The commercial subsector is usually subdivided into several classes, such as retail, office, hotels, manufacturing (industrial) and warehousing.

Raw land is considered the most speculative in value. Retail commercial development, such as malls, is linked to residential housing demand. Demand for hotel real estate, of course, is largely influenced by the country's tourist and commercial sectors. Office real estate is largely influenced by labor demand and their workspace. Manufacturing real estate is driven by the demand for facilities to create products, while warehousing real estate demand results from that industrial output.

Diversification in the real estate sector helps cushion the negative impact of slower construction outlays in other subsectors. For instance, commercial real estate developments are typically long-term and thus they soften more short-term declines in the residential real estate sector. Direct spending in the non-residential development, construction and operations has a

lasting economic impact because it supports the creation of jobs (in the workplace), generates personal earnings, and promotes new spending activity across the breadth of the economy.

### **Domestic Primary and Secondary Capital Markets**

Domestic primary capital markets for real estate are primarily through commercial banks, the mortgage industry and a variety of other vehicles, including initial public offering of securities (IPO), real estate investment trusts (REIT), among others. The real estate sector contributes less to the economies of countries, including those with advanced economies such as Japan, that have no mortgage banking industry (with most lending done primarily through commercial banks), no mortgage brokerage industry, and no title insurance industry.

Remarkably, in recent years market-based housing finance has spread throughout the world with most of the world's population having access to mortgage finance with affordable terms since the year 2000. Several years ago most citizens in most countries could not borrow to finance housing and they relied on a combination of subsidies and savings. While this market-based housing finance is available to most middle-income people, low income people are still confronted with inhospitable housing market conditions. With little income, mortgage finance remains a distant reality even if market-based finance is more widely available throughout the world.<sup>v</sup>

The secondary housing market is a crucial ingredient for the success of the housing market in the United States. Government-sponsored agencies, via Fannie Mae and Freddie Mac, create a stable flow of mortgage funding to the housing subsector by guaranteeing mortgages for the pooling of loans made by mortgage banking companies. In addition, the United States provides many other risk intermediaries for the housing sector, such as with private and public (Federal Housing Administration and the Veterans Administration programs) mortgage insurance, hazard insurance, title insurance and errors and omissions insurance.

Refinancing of homes contributes to the stability of the real estate sector. For instance, refinancing allows homeowners to lower their debt payments, raise cash to finance more spending, restructure their liabilities by reducing higher-cost debt, and lock in historically low long-term interest rates. Creation of an active secondary market for residential mortgage loans, through a variety of mortgage products, provides greater liquidity for the housing subsector.

### **Globalization and Foreign Direct Investment Opportunities**

Opening the real estate market to foreign investors provides capital and diversity of risk for the national economy. Most foreign investments generally come into the market through real estate investment trusts and venture capital, particularly for large real estate development projects. Global real estate securities funds and international commercial mortgage-backed securities products are available to finance real estate developments.

The presence of large multinationals in a domestic real estate market is a signal for foreign real estate investors. Foreign real estate capital typically follows multinationals in a

market in the same way that U.S. banking expansion strategies have advanced into foreign markets.

Over half of the global direct real estate investment occurs in North America and more than one-third is in Europe. In some regions of the world, the demand for real estate is eroding, however. As Europe, Japan and South Korea edge towards real estate markets based on replacement needs only, additional capital resources appear to be available for some emerging economies.<sup>vi</sup>

In contrast to the United States, the role of government in Japan's housing sector is relatively limited. A significant difference is that the mortgage loans in the U.S. are basically non-recourse loans, meaning that a lender has a right to foreclose on the house but not on the other assets of the borrower. In Japan, these home mortgages are not non-recourse loans, which is a major inhibitor of the housing real estate market. Japan also lacks the guaranteed mortgage protection and risk intermediaries as exist in the United States.

Accession into the World Trade Organization increases the global recognition that countries wish to participate in world economies and liberalize their markets. Multinational companies, such as those in the construction and finance sectors as well as real estate franchise network, explore business and investment opportunities within the WTO membership.

Efforts are underway to create regional, if not global, real estate markets. Through what are called "Regional Integration Agreements," several regions are encouraging cross-boundary real estate transactions. These efforts are occurring in the 27-nation European Union,<sup>vii</sup> the Association of Southeast Asian Nations,<sup>viii</sup> and MERCOSUR that covers the South American regional common market that includes Brazil, Argentina, Uruguay, Paraguay, and for some purposes Chile. In addition, the North American Free Trade Agreement, comprised of the U.S., Canada and Mexico, seeks to increase opportunities for foreign direct investments among those countries which directly or indirectly affect their real estate sectors.

The European Union nations attract two-thirds of global cross-border real estate transactions. However, the Asia-Pacific regions increased its total to 12 percent in 2004 as transparency and liquidity improved.<sup>ix</sup> The standardization of real estate transactions and disclosure of information increased market opportunities in these regions and further diversified their economies.

Although real estate is not traded across borders, real estate markets may be affected by global interest rates, economic activity and monetary policies. Research indicates that house prices, for instance, are highly synchronized across industrial countries. A large share (approximately 40 percent on average) of house price movements are attributed to global factors, reflecting co-movement in interest rates, economic activity and other macroeconomic variables, that create common underlying shocks in upswings in housing prices and perhaps downturns.<sup>x</sup>

Global and regional information is gradually becoming available which assist investors in making decisions. In recent years, *The Economist* began regularly publishing an international housing price index. On a regional level, the European Central Bank and the Bank for

International Settlements have undertaken studies of land prices out of concern for the effects the European Union may have on housing and land costs. With a better understanding as to real estate investments in alternative national markets, more capital will flow to those nations that offer greater returns with commensurate risks.

## **Conclusion**

Major economic contributions from the real estate sector are largely driven by private markets, rather than government outlays, in most countries. The United States' real estate market has elevated economic growth over the past several years.

The real estate sector and its related construction industry are much more than the sum of their transaction and construction outlays. Real estate development, construction and operation create a ripple effect in the economy. Besides the direct spending for new development and construction and annual expenditures to operate existing buildings, economic benefits are derived from re-spending of salary and wages and purchases of construction-related materials and services from vendors. The combination of these direct and indirect (and induced) outlays constitutes the total contribution of the real estate sector to the national economy.

Diversity in residential and nonresidential real estate in a local area effectively advances the diversification of the national economy. The growth in the real estate sector spills over into surrounding areas as well as into other economic sectors. Through payrolls for selling-buying, managing and leasing real estate, additional employment and tax revenues are created. Real estate markets also generate higher demand for construction services and materials as well as their related professional services and consumer durables.

More frequent and timely data collection on real estate pricing would provide advantageous market information to support buyers and sellers of real estate as well as investors. Creation of an active secondary market for residential mortgage loans would provide greater liquidity for the housing sector and a greater variety of mortgage products available to households. This increases the ability for home ownership and enhances the liquidity of homeowners to use their home equity in purchasing or investing in other sectors of the nation's economy. A partnership between government and private enterprise would establish public and private risk intermediaries to reduce uncertainty in both primary and secondary real estate and mortgage lending markets.

As the world's population is expected to become primarily urban in 2008, and with the increased demand for housing, the importance of the real estate sector will increase in both developed and developing countries. For instance, the population of cities in developing countries is projected to increase by more than 1 billion by the year 2020. This magnitude of urban growth is unprecedented and suggests that a significant increase in investment in shelter, and related urban real estate and infrastructure, will be needed to meet the needs of the world's growing population. The remarks of World Bank President Robert McNamara in 1973 when he launched the Bank's shelter assistance programs resonate more today than ever: "If cities do not begin to deal more constructively with poverty, poverty may begin to deal more destructively with cities."<sup>xi</sup>

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<sup>i</sup> Besides Housing Starts produced by the U.S. Census Bureau, it generates monthly public statistics on New Home Sales, Vacancy Rates (for owned and rental units), and Residential Construction (for both new homes and renovations of existing homes). The National Association of Realtors publishes monthly Existing Home Sales (on the number and prices for closings on sales of existing homes). The Mortgage Bankers Association provides weekly data on mortgage applications for both home purchases and refinancing. The U.S. Office of Federal Housing Enterprise Oversight publishes quarterly the House Price Index that measures price changes of reselling the same house. The U.S. Bureau of Labor Statistics publishes monthly the Consumer Price Index – Rental Components that tracks the rental markets of both imputed rent to owner occupied housing and actual rents of apartments or homes. The U.S. Bureau of Economic Analysis imputes quarterly data in its Residential Investment report as a component of the GDP accounts based largely on residential construction compiled by the Census Bureau, but also includes brokers' services on the sale of new or existing homes. The U.S. Bureau of Labor Statistics provides monthly Industry Employment data on employment, hours and wages in industries that are heavily tied to housing, such as residential construction and real estate.

<sup>ii</sup> *The State of the Nation's Housing 2002* (Joint Center for Housing Studies of Harvard University, June 2002), p. 7. Replacement demand occurs only from three factors: demolition of old buildings, fires that devastate structures, or physical or functional obsolesces.

<sup>iii</sup> The definition of emerging market economies is that used by the Morgan Stanley Capital International index. They include: Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, the Philippines, Poland, Russia, South Africa, Thailand, Turkey and Venezuela.

<sup>iv</sup> These countries include Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia.

<sup>v</sup> Robert M. Buckley and Jerry Kalaricka (eds.), *Thirty Years of World Bank Shelter Lending: What Have We Learned?* (The World Bank, 2006), p. xii.

<sup>vi</sup> M. Leanne Lachman, *Global Demographics and Their Real Estate Investment Implications* (Urban Land Institute and World Cities Forum, Columbia Business School, 2006).

<sup>vii</sup> The European Union is currently comprised of Belgium, France, West Germany, Italy, Luxembourg, Netherlands, Denmark, Republic of Ireland, United Kingdom, Greece, Portugal, Spain, Austria, Finland, Sweden, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, Bulgaria and Romania.

<sup>viii</sup> The Association of Southeast Asian Nations includes Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam, with the prospects of adding China, Korea and Japan.

<sup>ix</sup> M. Leanne Lachman, *Global Demographics and Their Real Estate Investment Implications* (Urban Land Institute and World Cities Forum, Columbia Business School, 2006), p.11.

<sup>x</sup> International Monetary Fund, "The Global House Price Boom," *World Economic Outlook* (Sept. 2006), p. 71.

<sup>xi</sup> "Housing," Housing Policy Paper (The World Bank, Washington, D.C., 1975).