

# ANSWERS TO STUDY QUESTIONS

## Chapter 2

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- 2.1. The three major components are the real estate space market, the real estate asset market, and the real estate development sector. The development industry links the asset market to the space market by taking financial capital from the asset market and converting it into physical capital (buildings), which add to the supply side of the space market. Furthermore, rents that are determined in the real estate space market determine the demand for real estate assets in capital markets (since owners or investors are really purchasing a current or future income stream from the property).
- 2.3. A negative feedback loop is a dampening mechanism that tends to make a system self-regulating, preventing it from spiraling out of control. The principal negative feedback loop in the real estate system is the ability of the asset market to regulate the flow of capital to the development industry. For example, if new development threatens excess supply in the space market, investors will expect lower future rents, which will cause a reduction in the property market asset values today. If this reduction is sufficient, it will make additional development unprofitable. The development industry might cut back and/or the capital market will reduce the flow of money to it. This may happen by investors demanding higher returns or reflecting a greater concern about the risk of such real estate investments.
- 2.5. In equilibrium, the stock of space is constant but there is new construction to replace that part of the existing stock that is worn out or depreciated.
- 2.7. The short-run increase in rents immediately after the increase in usage demand “overshoot” the long-run equilibrium rents because space supply has insufficient time to adjust or increase to account for the increased demand for space. The extent of this overshooting depends on how forward-looking are the property investors. Property values will not move as much as what the new property income divided by the current cap rate would suggest, since forward-looking investors realize that there will eventually be a downward pressure on rents as new supply is added to the space market. On the other hand, the more myopic the investors, the greater will be the extent of the overshooting.
- 2.9. The increase in investor demand may have been caused by (a) a change in perception that real estate is a less risky investment relative to other assets (such as stocks and bonds), (b) a change in perception that real estate incomes would grow by more than they did in the past, or (c) if there was a general increase in global liquidity (the amount of money available to invest).