Economic Review May 2008

Home Loans and Implications for Conduct of Monetary Policy

Financing of housing loans has effect on the transmission mechanism of monetary policy. While this is considered to hold more in developed economies, it may have an important lesson for developing and emerging economies.

INSIDE

Background

The conduct of monetary policy is vital for macroeconomic stability. This is more paramount when a balance has to be made on a trade-off between risks to inflation and risks to growth in output. There has been a recent boom in the housing sector in developed countries and a reversal of this has resulted in various economic shocks to most economies. This has come about because of the role played by housing as collateral. This, therefore, has a direct bearing on the type of financing and how such financing is effected.

A policy debate on the role of housing finance is considered an inconclusive debate. However, the expectation is that when housing is obtainable at lower cost, there should be a corresponding increase in the level of debt related to mortgages.

The purpose of this article is two-fold. First to highlight the implications of the latest developments in the financial sector in developed countries for conduct of monetary policy. Finally to outline recent trends in South Africa, an emerging market economy, and highlight the implications for conduct of monetary policy.

Institutional Difference and Financial Innovation in Developed Countries

The mortgage markets in the United States and United Kingdom have been dominated by specialised institutions, loan associations in the former and building societies in the latter. It is reported that these institutions were governed by interest rate ceilings and quantitative limits on what could be dispatched.

These developments led to credit rationing, that ultimately attracted new entrants into the market to fill up the void. The entry of new players was then accompanied by deregulation of the market through abolition of credit controls. Banks and non-banking financial institutions' issuance of mortgage bonds more than doubled for the period 1980 to 2005, especially in United States, Canada and Australia. It is noted that while there were similar reforms in Japan, Germany, France and Italy, they were slower as state owned enterprises remained dominant players. The role of state owned enterprises was also pronounced in the rest of Africa during the 1980s.

Table 1 below indicates that there are different institutional arrangements in developed economies. It highlights that United States, Denmark, Australia, Sweden and the Netherlands have most flexible mortgage market.

The differences across countries also indicate that countries that have labour-intensive construction may lead to more employment in the event of increased demand and this will ultimately lead to higher national output.

Table 1: Differences in National Mortgage Markets

	Mortgage Equity Withdrawal	Refinancing (fee-free prepayment)	Typical Loan-to-Value ratio (%)	Average typical term (yrs)	Covered bond issues (% of residential loans outstanding)	Mortgage-backed security issues (% of residential loans outstanding)	Mortgage market index
Australia	Yes	Limited	80	25		7.9	0.69
Austria	No	No	60	25	2.2		0.31
Belgium	No	No	83	20		1.9	0.34
Canada	Yes	No	75	25		3.6	0.57
Denmark	Yes	Yes	80	30	58.5	0.1	0.82
Finland	Yes	No	75	17	2.6		0.49
France	No	No	75	15	1.6	1	0.23
Germany	No	No	70	25	3.6	0.2	0.28
Greece	No	No	75	17		6.2	0.35
Ireland	Limited	No	70	20	4	6.6	0.39
Italy	No	No	50	15		4.7	0.26
Japan	No	No	80	25		4.7	0.39
Netherlands	Yes	Yes	90	30	0.7	4.6	0.71
Norway	Yes	No	70	17			0.59
Spain	Limited	No	70	20	11.1	5.7	0.4
Sweden	Yes	Yes	80	25	10.1	0.9	0.66
United Kingdom	Yes	Limited	75	25	0.9	6.4	0.58
United States	Yes	Yes	80	30		20.1	0.98

Source: World Economic Outlook April 2008

Housing Prices in South Africa

South African ABSA housing index shows that year-on-year price growth has accelerated since the third quarter of 2007 until the beginning of 2008. The growth has been mainly driven by interest rates hikes that unfolded during the second half of 2007. This took place in an environment of tightening of lending to consumers as the National Credit Act became fully operational. The outlook indicates a sustained increase in general price level, although a slowdown is forecast for the future. A change in the direction of housing prices should be expected given that the interest rates remain relatively unchanged in the remainder of 2008.

Credit to consumers is expected to remain subdued and mortgage advances are also forecast to decelerate. It is, therefore, expected that when credit declines, demand for mortgages will slowdown. This should, in turn, retard overall inflation leading to the possibility that the South African Reserve Bank Monetary Policy will loosen the current tight monetary policy stance that is being pursued. In the South African situation home ownership tends to affect consumer spending through the welfare effect. This implies that housing can be used as collateral and any tendency for housing prices to increase will increase the value of available collateral and may increase consumer expenditure through more borrowing. This may then require the Reserve Bank to increase interest rates perpetually in order to deter expansion in consumer spending.

Table 2: Mortgage Advances, Inflation and Interest Rates

	2007							2008
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan
Mortgage advances (y/y percentage change)	27.1	26.7	26.4	26.1	25.3	24.8	24.7	24.5
CPIX inflation rate (%)	6.4	6.5	6.3	6.7	7.3	7.9	8.6	8.8
Mortgage interest rate (%)	12.9	13.0	13.2	13.5	13.8	14.0	14.4	14.5

Source: ABSA Home Loans

Table 2 shows that there has been a slowdown in the growth of mortgage advances, although inflation has been increasing. This implies a possibility of further interest rate hikes in order to curb inflation and retard consumer demand. While this is ideal it is likely that the demand may be counteracted by financing from housing collateralised expenditure, thus rendering monetary policy ineffective.

Implications for Lesotho

Interest rates in Lesotho mirror those in South Africa because of the Common Monetary Area (CMA) arrangement. This has been exemplified in the adjustment of interest rates that follow the direction of those in South Africa. But recent economic developments in Lesotho indicate that mortgage demand and overall consumption will increase as structural economic reforms get underway. It is expected that when interest rates in South Africa rise in order to curb increasing consumer demand, hence inflation, a similar effect can be expected in Lesotho.

The country will soon receive an injection of US$362m from millennium Challenge Account of the United States. The money will be used for financing of various economic activities in the country. This is likely to increase domestic consumption and more disposable income as more people have access to sustainable income.

Some of the important structural transformations that will be brought about by this funding are a lease-hold system. Currently, land in the country is communally owned. This has presented problems for some long term business investments in the country, hence the need and strong advocacy for a freehold system. Under the latter system, land will also qualify to be used as collateral.

Recent data indicates that middle income group is growing; these are individuals who generally do not own their own housing. The indicator of growth of the middle income is also supported by the sales turnover data and motor vehicle import statistics. This increase implies a rise in incomes, which might lead to higher demand in mortgage products.

When demand for mortgages reaches its peak and majority of the middle income group have acquired mortgages it can be expected that people will be able to independently finance their excess expenditure as houses are used as collateral. This will present a direct challenge to the central bank in harmonising monetary policy in the context of the region.

The central bank's intervention may be necessary if and when consumer demand leads to inflationary pressure. Higher consumer demand might also be boasted by external financing. Lesotho will benefit from more external funding under the current trade negotiations on economic partnership agreement that are scheduled to be concluded at the end of 2008.

While additional funding will be beneficial for the growth of the country, any uncontrolled expenditure is likely to overheat the economy when potential output is reached. It can be deduced from the recent 2006 growth rate of 7.2 percent and growth rates experienced in the mid 1990s that potential growth lies in excess of seven percent. The Central Bank of Lesotho will have to start tracking consumer expenditure patterns and structural transformations that will be brought about by the massive injection of foreign financing.

Conclusion

The status of housing as a collateral can influence demand both in developed and developing countries. It is however noted that transmission mechanisms are thorough in developed countries than developing countries; hence one may expect a less than full transmission of monetary policy stance to output[1].

[1] *This article benefited from World Economic Outlook April 2008*

Will Emerging Markets Remain Resilient to Global Financial Stability Risks?[2]

The US mortgage market crisis spread to broader categories of the US and global economy, and this pose challenges to global growth and macroeconomic stability. This has been transmitted mainly through cross boarder credit and funding markets.

It has been widely acknowledged that credit deterioration has spread beyond the sub-prime mortgages and investor risk tolerance had declined because of, among others, the uncertainty over economic outlook. Emerging markets have been classified as being resilient owing mainly to solid fundamentals, sound macroeconomic policies and financial frugality, but it is prudent to assume some element of risk arising from external funding.

Funding Market Liquidity

It has been reported that there are distinct risks that emerging markets are still vulnerable going forward. This is besides the issue of whether countries like Lesotho should be worried on the transmission mechanism. On the one hand there are those that say small economies have a reason to be worried mainly due to cross border trading, while on the other hand, there are those that propagate that emerging economies will not experience any significant impacts.

The minimal impact might just be a problem of inertia, and emerging economies could as well embrace themselves for a lagged impact which might have debilitating impact.

The reasons rest on the decoupling effect, in which case they advance that the role and emergence of China and India as fast growing developing countries has muted any impact that disturbances on the US economy has on a global level. It is this reason that is advanced to conclude that it might not be too long before the role of the US economy as a driver of global growth is muted as China and India become the balancing pivot.

Table 3 below highlights some of the areas of concern in emerging markets. These are mainly leading economic indicators in terms of assessment of potential risk to any possible second round effect of the global credit problems.

[2] This article benefited from Global Financial Stability Report April 2008

Table 3: Macro and Financial Indicators in Selected Emerging Market Countries

	Current Account (% of GDP)	Growth in private credit (% Δ)	Change in private credit as share of GDP (percentage points)	External position vs BIS reporting Banks (% of GDP)
Europe, the Middle East, and Africa				
Bulgaria	-21.4	62.5	19.7	-11.9
Croatia	-8.8	17.8	3.4	-50.8
Estonia	-16.0	41.8	15.1	-68.7
Hungary	-5.6	16.8	1.6	-42.5
Kazakhstan	-6.7	55.2	12.5	-9.5
Latvia	-22.9	45.0	10.7	-53.9
Lithuania	-13.3	45.3	10.9	-34.7
Poland	-3.7	39.6	8.0	-12.7
Romania	-14.5	60.4	10.7	-25.7
Russia	5.9	51.0	7.1	8.3
Serbia	-16.5	40.1	6.0	-7.6
South Africa	-7.4	22.0	5.4	9.6
Turkey	-7.6	26.5	4.1	-13.9
Asia				
China	11.1	19.5	2.1	0.8
India	-1.4	21.7	2.6	-3.0
Indonesia	2.3	22.4	2.0	-7.9
Korea	0.6	13.5	8.7	-13.9
Malaysia	13.7	11.8	3.4	0.5
Philippines	4.4	3.3	-1.5	-0.4
Thailand	5.6	3.9	-1.4	5.1
Latin America				
Argentina	0.7	37.0	1.4	-7.1
Brazil	0.3	28.5	5.1	-7.8
Chile	4.7	20.8	5.9	-8.0
Colombia	-3.8	23.5	4.7	-7.3
Mexico	-0.8	19.0	2.2	-5.8
Peru	1.6	22.3	6.2	-0.5
Venezuela	9.2	72.5	4.9	2.9

Source: April 2008 Global Financial Stability Report

Areas of concern are mainly in countries in the first category of Table 3 above, under Europe, the Middle East and Africa, in Asia concerns are in India and China on growth in private credit and Korea in external position vis-à-vis BIS reporting banks. In the last category, Latin America, there are concerns in all countries except Mexico, especially, in relation to growth in private credit.

Some emerging markets encounter financial distress due to increased dollar funding costs. This might be brought about by contraction of funding for investments in hedge funds which are a source of financing for most emerging markets.

Countries that have benefited from a commodity boom may have a problem from negative terms-of-trade shocks due to slowdown in global economy.

3. Monetary Policy Operations for May 2008

This article reports economic and operational issues surrounding the monetary policy operations conducted between January and May 2008. The Bank issued government securities in response to liquidity conditions that prevailed in the economy. Table 4 shows amounts auctioned and discount rates that prevailed for each of the auctions. The level of competitiveness in the market is estimated by the number of participants in an auction. The recent auction saw a participation level of 5 bidders who submitted 16 bids for the auction and this was below April's figure of 6 bidders. All bidders became partially successful and 10 bids were successful against 13 that were successful in the previous auction
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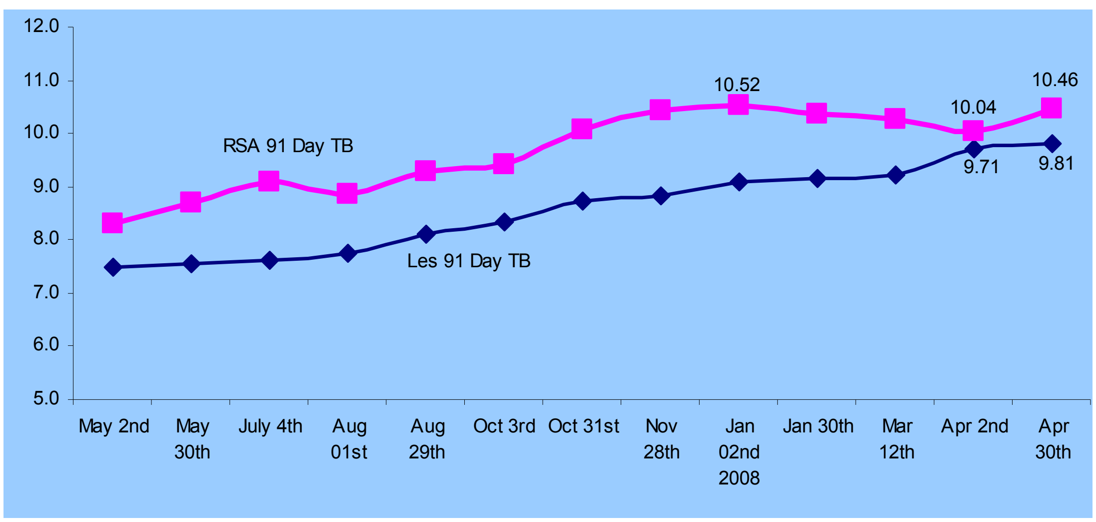
The level of competitiveness in the market is estimated by the number of participants and bids. The number of bidders fell slightly to six in the April auction. However, the total number of bids rose by 30 per cent to 15 during the same period. All bidders succeeded in winning some bids, only two of the bids were not awarded. There was one rejected bid.

It can be noted from Figure 1 below that, although the Lesotho's 91-day treasury bill continued to increase, it was still below its SA counterpart rate. The Lesotho 91-day Treasury bill increased by 10 basis points to 9.81 per cent.

Table 4: Treasury Bill Auctions

Type of Security	Auction Date	Maturity Date	Auction Amount (million)	Amount Issued (million)	Discount Rate
91-day TBs 182-day TBs	31 Oct 2007 07 Nov 2007	01 Feb 2008 07 Mar 2007	M160.0 M30.0	M160.0 M30.0	8.90 8.72
91-day TBs	28-Nov-07	29-Feb-07	M150.0	M150.0	8.82
91-day TBs 182-day TBs	02-Jan-08 09-Jan-08	04-Apr-08 11-Jun-08	M150.0 M30.0	M150.0 M24.8	9.10 10.45
91-day TBs	30-Jan-08	02-May-08	M150.0	M150.0	9.17
91-day TBs 182-day TBs	05-Mar-08 12-Mar-08	06-Jun-08 12-Sep-08	M150.0 M20.0	M150.0 M20.0	9.21 10.45
91-day TBs	02-Apr-08	02-Jul-08	M150.0	M150.0	9.71
91-day TBs 182-day TBs	30-Apr-08 07-Mar-08	1-Aug-08 7-Nov-08	M150.0 M30.0	M150.0 M30.0	9.81 10.45
Total for reporting period			M180.0	M180.0	

Figure 1: Performance of Lesotho 91-Day T-Bills vs RSA T-Bills



The counterpart SA rate rose by a larger margin from its previous level of 10.04 per cent, on the 2nd of April, to 10.46 per cent on the 30th of April. Hence, the margin between the two rates widened from 33 basis points to 65 basis points at the end of the review period.

However, the overall observation is that the monetary policy operations undertaken during the review month were successful in attaining their desired objectives of financial stability and attainment of the target NIR level.

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Table 5: Selected Monetary and Financial Indicators

	2008		
	Feb	March	April
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	15.42	15.67	15.92
1.2 Prime Lending rate in RSA	14.50	14.50	14.50
1.3 Savings Deposit Rate	4.57	4.57	4.57
1.4 Interest rate Margin(1.1 – 1.3)	10.85	11.10	11.35
1.5 Treasury Bill Yield (91-day)	9.17	9.21	9.08
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	4285.60	4176.62	4591.71
2.2 Net Claims on Government by the Banking System	-3646.22-	-3273.76	-4049.23
2.3 Net Foreign Assets – Banking System	9165.58	9258.58	10151.90
2.4 CBL Net Foreign Assets	7521.07	7560.44	8048.03
2.5 Domestic Credit	-2305.81	-1933.78	-2689.44
2.6 Reserve Money	457.01	427.35	489.40
3. Spot Loti/US$ Exchange Rate (Monthly Average)	7.6707	7.9741	7.7769
4. Inflation Rate (Annual Percentage Changes)	10.6	10.7	9.5
5. External Sector (Million Maloti)	2007		2008
	QIII	QIV	QI
5.1 Current Account Balance	440.15	328.39	517.63
5.2 Capital and Financial Account Balance	248.60	-83.21	310.40
5.3 Reserves Assets	-870.86	-116.19	-774.19

+These indicators refer to the end of period. Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities

Table 6: Selected Economic Indicators

	2004	2005	2006	2007+
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	4.2	2.9	7.2	5.1
1.2 Gross National Product – GNI	7.9	5.5	3.1	4.9
1.3 Per capita –GNI	7.9	5.5	3.1	4.0
2. Sectoral Growth Rates				
2.1 Agriculture	-1.9	-1.7	1.7	-39.3
2.2 Manufacturing	2.1	-8.6	10.5	11.0
2.3 Construction	-4.4	-3.4	0.6	3.5
2.4 Services	2.1	4.1	6.6	6.3
3. External Sector – Percent of GNI				
3.1 Imports of Goods	86.3	83.1	80.1	86.5
3.2 Current Account	-4.7	-5.7	3.5	9.5
3.3 Capital and Financial Account	5.8	3.6	0.7	8.2
3.4 Official Reserves (Months of Imports)	5.2	5.5	6.7	7.6
4. Government Budget Balance (Percent of GDP)	5.7	4.8	11.8	5.3

** Preliminary estimates*
+CBL Projections