

House price growth slipped into red in 2008

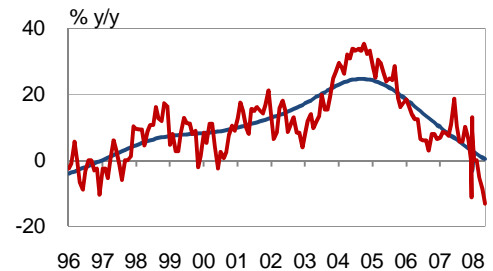
What is the latest? With the data for the final month of 2008 in Standard Bank's residential property book now available, the annual growth in the median price can be evaluated against previous years' growth performances. Recall that growth in Standard Bank's residential median property price peaked in 2004 when a rate of 24.2% (smoothed average)¹ was recorded. Given developments in the economy such as the start in the upswing of the interest rate cycle, the rate of increase declined steadily to 6.6% in 2007. In 2008 the average median property price declined further to -0.3%, the first decline since 1996. In real terms, using the CPI to deflate the nominal data, the decline comes to nearly 12%. On a smoothed basis, growth in the monthly price declined steadily and has been in negative territory since June of 2008. By December the growth came to -3.1%. The residential property book for December 2008 shows that the smoothed value of the median residential property financed by the bank was R592 000. The data reflect a very fragile property market.

While the trend in house prices as depicted by the smoothed data is of general interest, the unsmoothed or raw data is of importance for technical reasons and a variety of other reasons also. For 2008, the raw data show that the median house price declined by 1.6%, down from the 8.3% increase calculated for 2007. The annual numbers mask some dramatic swings in the generally volatile monthly data. Two factors increased the volatility of the 2008 data. The base effects of the distortions created by the introduction of the National Credit Act (NCA) in 2007 were present in the middle of 2008, when strong declines in growth were reported. This is part from the ongoing impact of the NCA which effectively led to a tightening in lending criteria. A second factor occurred when the distribution of property prices changed. This happened later in 2008 when a decline in the number of middle- and lower-priced properties processed was reported. Put differently, the proportion of higher-priced properties making up the bank's December loan portfolio increased, resulting in a higher median price for the month, as the raw data show.

What are the overall developments in the housing market? Growth in Standard Bank's residential median property price peaked in October 2004. The South African housing market has been in the doldrums since mid-2006 when the upward phase of the interest rate cycle commenced. The 500 basis points increase in the repo rate between mid-2006 and mid-2008 placed huge stress on the economy in general and households in particular. The reduced affordability of housing, exacerbated by higher mortgage rates, high food and fuel prices, a sharply slowing economy, and the implementation of the NCA, led to a decline in the demand for residential property and a substantial softening in house price growth ensued.

The number of mortgage loan applications declined significantly in November and December compared to October and in these months loan-to-value restrictions became binding constraints on the ability of households to access finance. New lending criteria introduced towards the end of 2008 reflect the

Figure 1: Standard Bank's residential property loan book: median price



96 97 98 99 00 01 02 03 04 05 06 07 08

— Smoothed median house price
— Unsmoothed median house price

Source: Standard Bank Group

Table 1: Stats at a glance

Indicator	Period	Data
Median house price growth (smoothed)*	Dec 08	-3.1% y/y
Median house price (smoothed)*	Dec 08	R592 000
Median house price growth (unsmoothed)	Dec 08	9.1% y/y
Mortgage advances	Nov 08	14.9% y/y
Private sector credit extension	Nov 08	15.3% y/y
Ratio of household debt to income	Q3 08	75.3%
Prime rate	Dec 08	15.0%

*A Hodrick-Prescott filter is used to smooth data

Source: Standard Bank Group, SARB

¹ Smoothed data will be used below unless otherwise stipulated



general tightness in lending by credit granting institutions. It does appear that higher income individuals have greater capacity to react to more conservative lending practices, which partially explain the increased turnover of more expensive houses financed.

The macroeconomic backdrop remains bleak. The second half of 2008 showed large swathes of the economy under huge pressure: economic growth virtually came to a standstill in the third quarter of the year; consumers who had over-extended themselves during the good times came under severe financial stress; and the residential property market had its worst performance in 12 years. Furthermore, the international economic environment is in tatters, with the industrialised world experiencing its worst recession in almost 80 years. In the early part of 2008 households and businesses suffered from high oil prices, threatening to result in run-away inflation, only for commodity prices to collapse on a grand scale towards the end of the year. The combination of sharply declining commodity prices and weak demand resulted in inflation falling rapidly in many countries. Locally, the decline was less spectacular, but, with inflation peaking in August last year and the outlook for further declines rosy, room was created for the Reserve Bank to cut the repo rate by 50 basis points in December.

Job layoffs are on the increase as businesses find it increasingly difficult to cope given the trying economic and financial circumstances. These conditions point toward further strain for the housing market in 2009. The weakness in the economy is reflected in disposable (after tax) income, which advanced by only 0.2% in the third quarter of 2008 compared to growth rates of higher than 6.5% in 2006 and 2007. Household savings as a percentage of disposable income have been negative since the beginning of 2006. Furthermore, household debt remains a sizable burden despite easing since the second quarter last year. Clearly, the combination of slow growth, relatively high interest rates, punitive debt levels and still high inflation, in a general environment of plunging confidence, will impact negatively on many segments of the economy, including the residential property market.

Other indicators of the financial stress of households are the deterioration in the performances of the motor and retail market. The retail sector has been in recession for some time now and the outlook, at least for the short term, is grim. The motor industry posted a decline of more than 20% in the number of units sold in 2008, while forecasts for 2009 show a further decline of between 10% and 15%. Clearly, the demand for big-ticket items will remain constrained by deteriorating economic activity.

What are the risks to the property market? Clearly, the housing market cannot prosper in a weak economy, which is still reflecting a rising number of insolvencies and liquidations. Banks have also reported sizable increases in bad debt. Households currently owe banks an astounding R1.1 trillion, of which the bulk constitutes mortgage advances. The outlook for the economy anticipates that the first half of 2009 will be tough.

On the inflation front things are looking up. Targeted inflation is expected to average 5.9% for 2009. Due to the strong decline in fuel prices, much slower economic growth and the impact of the new basket, inflation is expected to show a meaningful decline in the early part of this year.

Despite the positive effect of inflation on domestic demand, some underlying price pressures are likely to persist. Further sharp increases in electricity tariffs are on the cards for the next few years and rand weakness will push up prices of imported goods. Of a more general nature, the country's deficit on the current account and the financing thereof is probably the biggest problem over the short- and medium-term, threatening currency stability.

However, the Reserve Bank has shown its hand by cutting the repo rate by 50 basis points in December. Given the generally improved inflation expectations and the poor economic growth outlook, further meaningful cuts are anticipated in the rest of the year, resulting in a recovery of economic growth by the tail-end of the year.

What is the aftermath of systemic banking crises in global housing markets? In two papers published in 2008 proff Carmen Reinhart and Kenneth Rogoff undertook a comparative historical analysis focussing on the aftermath of systemic banking crises. Broadly similar patterns were observed in house and equity prices, unemployment and government revenues and debt. One characteristic of banking crises is that asset market collapses are deep and prolonged. The analysis shows that real house price declines averaged around 35% during the banking crises. The insert below, taken from the study of Reinhart and Rogoff, illustrates the decline in house prices in counties experiencing banking crises. Ongoing crises are depicted in light shading while past crises are shown in dark shading. The historical cumulative decline in real house prices from peak to trough (excluding the ongoing crises) averages 35.5%. The most severe house price declines were experienced by Finland, the Philippines, Columbia and Hong Kong, where declines of between 50 and 60 percent were measured. The house price decline in the US during the current episode is about 28% (measured in December 2008) – already more than twice that the decline calculated for the Great Depression in the 1930s. Looking at the figure, it



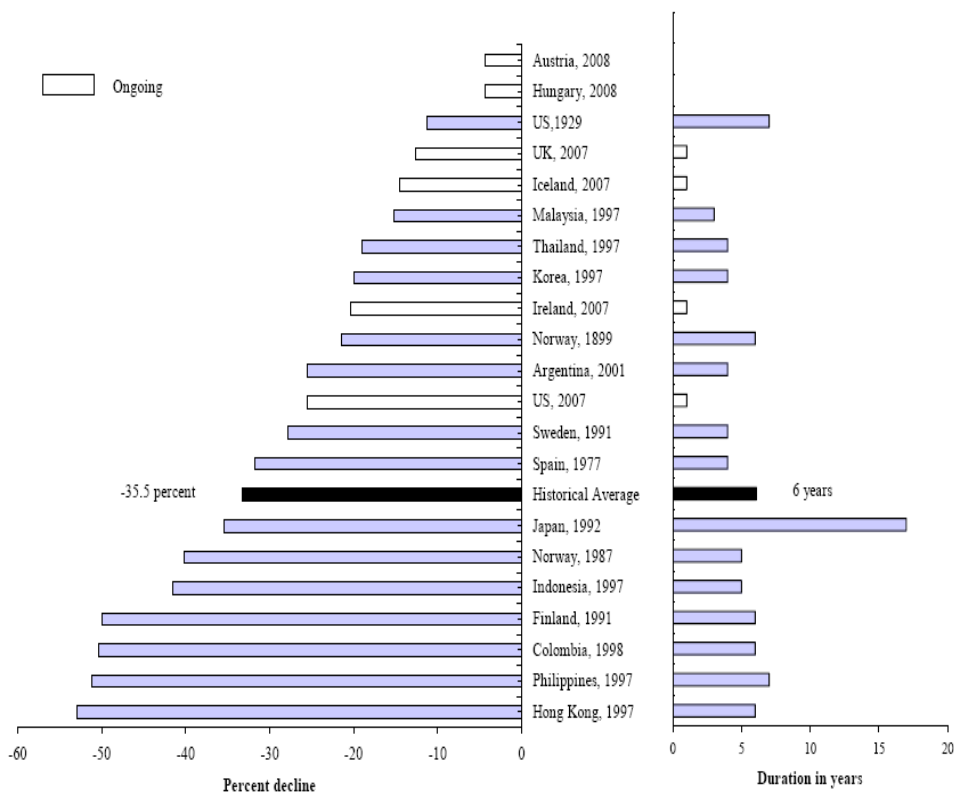
can be seen that house price declines can be prolonged, averaging approximately six years. Japan stands out: 17 years of consecutive annual declines, starting in 1992, were reported. Excluding Japan, the average remains over five years. This analysis reveals that the difficulties faced by property markets in many countries experiencing a depression are severe and long lasting, especially when the depression originated in the banking sector.

South Africa is in the fortunate position that the financial and banking sector is quite robust and it is unlikely that a collapse as seen in other countries will happen here. Even though economic growth is slowing down considerably, it is not yet clear that the local economy will plunge into a full-blown recession in 2009. We expect growth of 1% this year. House price declines in real terms, however, have been in negative territory for some time, showing a housing market under stress. We expect deflation to bottom out before year-end.

Figure 1

Past and Ongoing Real House Price Cycles and Banking Crises:

Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)



Sources: Reinhart and Rogoff (2008b) and sources cited therein.

Conclusion: The Standard Bank median house price index (smoothed) recorded a decrease of 3.1% y/y in December, bringing the average annual decline in 2008 to -0.3%, the first decline since 1996. The more volatile monthly data showed an increase of 9% in the median house price that Standard Bank financed in December. The jump is not the result of higher house prices but rather the outcome of fewer lower-priced houses financed by Standard Bank. Clearly, middle- and lower-income households find economic and financial conditions extremely challenging, while the tightening of lending criteria by financial institutions makes it more difficult to access finance. It is anticipated that house price growth will be negative over the short- and medium-term. Over the short term, economic conditions are expected to deteriorate further, however, positive developments on the inflation front early this year will lead to further interest rate cuts in 2009. Standard Bank expects 250 basis points relief this year.



Standard Bank median house price growth data

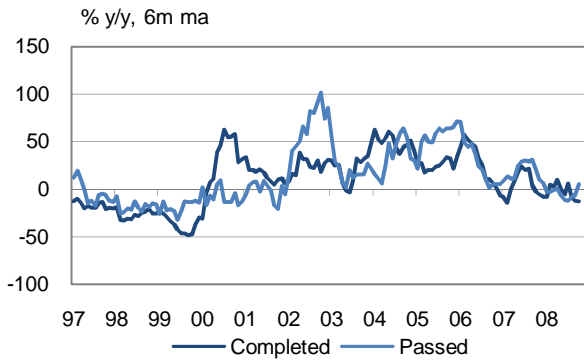
	2001	2002	2003	2004	2005	2006	2007	2008
January	12.8	13.6	8.0	29.6	28.6	18.5	6.9	0.0
February	17.5	6.4	12.0	28.6	25.1	16.6	8.6	0.0
March	15.0	8.7	14.0	26.3	30.6	13.8	8.4	-5.2
April	10.0	15.9	9.8	32.1	29.7	12.5	7.4	-8.6
May	8.1	18.2	11.5	31.0	26.3	12.5	10.9	-13.2
June	15.7	15.2	13.5	33.9	24.1	6.5	18.8	-11.3
July	15.0	8.7	20.0	33.3	25.0	6.0	10.4	-2.6
August	16.2	11.1	15.4	34.0	24.4	6.0	5.7	-1.8
September	15.0	13.0	15.4	33.4	28.8	2.9	5.7	3.6
October	14.3	8.3	19.2	35.5	19.0	8.0	10.2	-2.5
November	16.8	8.3	25.0	32.3	16.3	8.0	6.5	13.0
December	21.4	4.0	26.9	33.3	17.5	6.4	0.0	9.1
Average	14.8	11.0	15.9	31.9	24.6	9.8	8.3	1.6

Source: Standard Bank Group



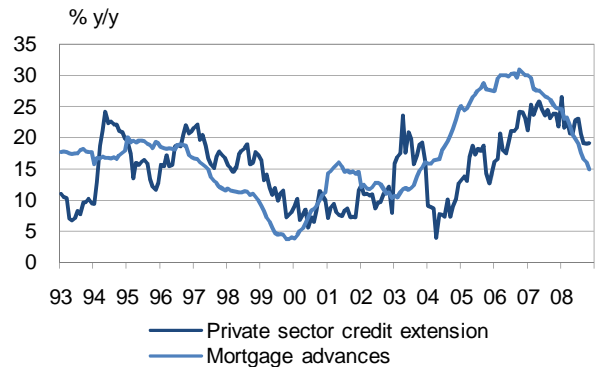
Picture Gallery

Figure 1: Buildings: Flats & townhouses



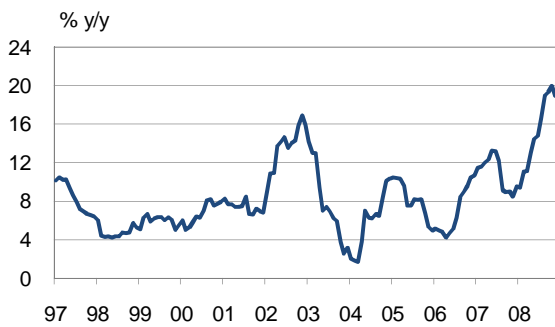
Source: StatsSA

Figure 2: Private sector borrowing



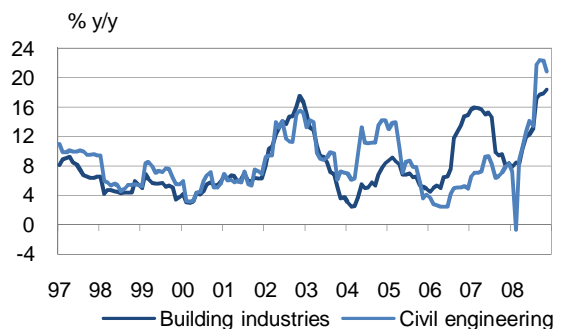
Source: SARB

Figure 3: Building cost: Building and construction



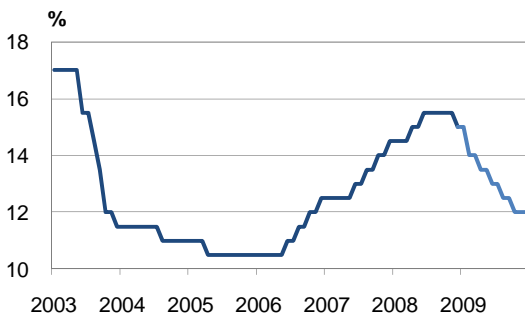
Source: StatsSA

Figure 4: Building cost: Building industries and civil engineering



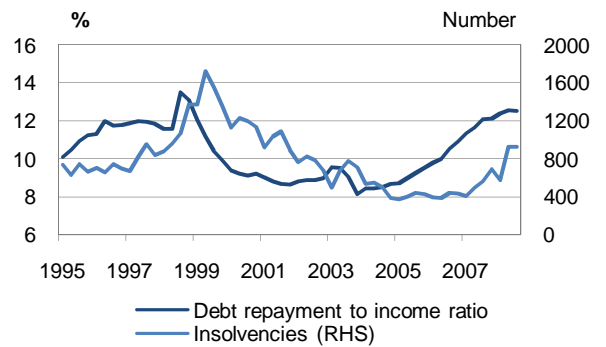
Source: SARB

Figure 5: Prime interest rate



Source: SARB, Standard Bank Group

Figure 6: Debt affordability vs insolvencies



Source: StatsSA, Standard Bank Group

Note on the methodology used in calculating Standard Bank's house price index

The way in which house prices are measured means that they are inherently volatile, not unlike many other economic indicators. Measuring house prices is complicated by the fact that the available data usually stem from the properties sold during a particular period, rather than from a well-designed sample that is representative of all houses. This is aggravated by the heterogeneity of houses. Changes in the measured prices may be the result of actual changes in the general price level; or changes in the distribution of the houses being sold, for example more sales of luxury houses may push up the measured house prices even without changes in general prices; or the changes may simply be random.

Given these data challenges, the international best practice is to use the median or middle price, rather than, say, the average house price. The median is the price such that half of all houses are more expensive and half less expensive than that price. It is substantially less volatile and less sensitive to the typical problems found in house price data. Standard Bank's data are therefore based on the median house price of the full spectrum of houses. Furthermore, national data from the Deeds Office are available only with a relatively long lag of up to nine months, so data from Standard Bank, which has a market share of about 27.7%, and whose data are generally highly correlated with those of the Deeds Office, are a good proxy for the national market.



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