Monetary Policy and Housing Market Behaviour in Sri Lanka

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Abstract

Housing is a crucial factor in determining the living standards of citizens in a country and changes in financial support rates have a significant impact on housing demand. As a developing country, Sri Lanka experiences a housing backlog and existing studies have focused on the effect of monetary policy on housing prices, but inadequate research has examined housing market behaviour in terms of demand. Therefore, this study provides empirical evidence on housing market behaviour in Sri Lanka, specifically regarding changes in monetary policy. Findings demonstrate a negative relationship between monetary policy changes and housing demand. Consequently, it is strongly recommended that government policymakers consider these study outcomes to foster the healthy growth of the housing market sector.

Introduction

The study focuses on the impact of monetary policy on the housing market behaviour in the Colombo Municipal Council (CMC) area. The government plays a crucial role in promoting housing development to improve living standards (Habitat Humanity, 2022). As an agent of the government, the Central Bank of Sri Lanka (CBSL) conducts the monetary policy to ensure financial system stability and price stability in the country (CBSL, 2022). Sri Lanka, being a developing country, faces a backlog of high-quality housing. Financial support for households can enhance housing demand and living standards (Habitat Humanity, 2022). This study aims to investigate the relationship between monetary policy and housing market behaviour in CMC area. The study analyses the impact of changes in monetary policy, measured by the Average Weighted Call Money Rate (AWCMR), on housing market behaviour, measured by Building Applications, from January 2018 to October 2022. The interest rate is an important tool for the government to carry out macro control of the real estate market (Chen et al., 2022). Therefore, in Sri Lankan context, there is inadequate research to identify the behavior of housing market for the changes in monetary policy, and mortgage interest rates, this study provides empirical findings to address this unexplored research area. The research objectives focus on identifying the effects of contractionary and expansionary monetary policy on housing market behaviour. By examining these factors, the study aims to contribute to a better understanding of the dynamics between monetary policy and the housing market, thus informing policymaking for the housing sector's healthy growth.

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The Objective of the Study

Accordingly, the following research objectives were made.

General objective: To assess housing market behaviour with reference to changes in monetary policy.

Specific objectives:
   I.   To evaluate the impact of AWCMR changes on Building Applications within CMC area to expansionary monetary policy during the 2018-2020 period.
   II. To evaluate the impact of AWCMR changes on Building Applications within CMC area to contractionary monetary policy during the 2021-2022 period.

Literature Review

The study identified that when interest rates are getting decrease, credit affordability goes up, increasing demand for houses while pushing housing prices up. But (Wenzel, 2012) has identified a contradict view by stating that there is no direct correlation between interest rate and housing prices. (Muchene, 2014) again proved the finding of (Kuttner, 2012) by stating that correlation between central bank's monetary policy and real estate growth in Kenya showed a weak negative relationship between the variables using a multiple regression model. (Kondybayeva & Ishuova, 2013) reported that negative monetary policy actions shocked to the house prices. The relationship between supply of money and real estate price changes has been emphasized that the increase of currency supply to the economy real estate related loans go up and it forces to increase the real estate demand and finally all these effects will cause to increase the real estate price (Yan, 2019). The research for investigating the relationship between monetary policy and real estate prices in China shows a stable relationship between monetary policy and the real estate market over the long-term. The relationship between the real estate market and interest rate is negative, while that between the real estate and money supply is positive (Yan, 2019).

When comes to Kuwait, (Al-Kandari & Alroomy, 2020) revealed that the Central Bank of Kuwait should pay more attention to the real estate market by directing the local banks and urging them to reduce the percentage of credit granted to the real estate sector in Kuwait. Monetary policy influences housing prices through the level of interest rates and it will affect to the housing market aggregate demand through construction activity and its influence on consumption (Gnan & National bank, 2021). In 2022, the research on "the impact of interest rate changes in China on real estate market transactions" found that the interest rate is an important tool for the government to carry out macro control of the real estate market in China (Chen et al., 2022).

Methods

Variables of the Study

Researchers have explored various details and concepts pertaining to monetary policy changes on housing market behavior after navigating through a variety of literature (Table 01).

Table 01: Description of Variables

Variable	Definition	Sources of Literature
Interbank Average Interest Rate	The average interest rate of 90 days in the interbank market	(Yan, 2019)

| Rate of Housing Construction | Housing commissioning in the Republic of Tatarstan, thousand sq.m. of total floor area | (Kleshcheva, 2021) |

Source: Literature Survey, 2023

The above literature analysis is guided by the conceptual framework (Figure 01). Since the literature analysis for the variables of the study should be adapted to the Sri Lankan context, a study has adopted AWCMR as the representative variables of monetary policy changes and building applications received by the local authority (Colombo Municipal Council, CMC) during the period of 2018 January to 2022 October as the representative variable of housing market behavior.

Data and Collection Method

For the purpose of this research, data pertaining to the AWCMR and building applications have been systematically collected for two distinct time intervals: January 2018 to December 2020, and January 2021 to October 2022. The selection of these periods is informed by the notable policy shifts that occurred in Sri Lanka during these distinct timeframes. As such, the primary objective of this study is to conduct a comparative analysis between these two specified periods. The data concerning AWCMR and building applications was sourced from reputable secondary data repositories, specifically, the Central Bank of Sri Lanka (CBSL) for AWCMR data, and the Colombo Municipal Council (CMC) for building application data.

Figure 01: Conceptual Framework
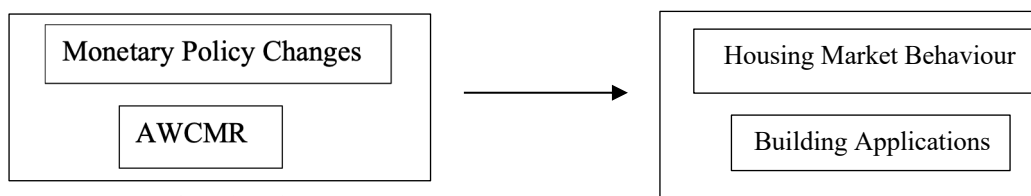
Source: Survey data, (2022)

The conceptual framework illustrates the methodology employed to examine housing market dynamics in relation to shifts in monetary policy. In this research, the independent variable under scrutiny is the AWCMR, while the dependent variable is represented by the quantity of building applications. The AWCMR, serving as the independent variable, stands as a representative indicator of economic conditions, including monetary policy changes, over specific time periods. Changes in the AWCMR data are expected to correlate with fluctuations in the number of building applications, which is the dependent variable. By analysing these relationships, the study aims to draw conclusions about how variations in monetary policy, as reflected in the AWCMR, influence the behaviour of the housing market, as indicated by changes in the number of building applications. This framework forms the foundation upon which the research investigates and interprets these complex interactions.

Data Analysis

A quantitative research approach was implemented to analyse the impact of AWCMR changes on housing market behaviour within CMC area during 2018-2020 and 2021-2022 through correlation tests from Statistical Package for Social Sciences (SPSS) software. The study was limited to data collected from 2018 onwards due to the unavailability of computerized historical data in CMC.

Study Area

The study area of the study was CMC area, which is situated in Colombo district, Western province in Sri Lanka. It is the largest local authority area and as well as the first municipality in Sri Lanka enjoys 37.29 sq.km.

Results and Discussion

Analysis of housing market behavior with reference to AWCMR changes can be investigated through following Spearman's rho correlation tests for both periods.

Objective 01: Evaluation of the impact of AWCMR changes on Building Applications within CMC area to expansionary monetary policy during the 2018-2020 period.
Hypothesis
H0: AWCMR and Building Applications during the 2018 to 2020 period are not related.
H1: AWCMR and Building Applications during the 2018 to 2020 period are related.

Table 02: Correlation Analysis between AWCMR and building applications during 2018 to 2020

			AWCMR	BA
Spearman's rho	AWCMR	Correlation Coefficient	1.000	-.553**
		Sig. (2-tailed)	.	.000
		N	36	36
	BA	Correlation Coefficient	-.553**	1.000
		Sig. (2-tailed)	.000	.
		N	36	36

**. Correlation is significant at the 0.01 level (2-tailed).

Source: CBSL data and CMC data, 2022

According to the Spearman's rho correlation coefficient test, there is enough statistical evidence to conclude that AWCMR and building applications during 2018 to 2020 period are related moderately negative. That means the housing market of CMC area is moderately affected to the change in expansionary monetary policy.

Objective 02: Evaluation of the impact of AWCMR changes on Building Applications within CMC area to contractionary monetary policy during the 2021-2022 period.
Hypothesis
H0: AWCMR and Building Applications during 2021 to 2022 period are not related.
H1: AWCMR and Building Applications during 2021 to 2022 period are related.

Table 03: Correlation analysis between AWCMR and building applications during 2021 to 2022

			AWCMR	**BA**
Spearman's rho	AWCMR	Correlation Coefficient	1.000	-.967**
		Sig. (2-tailed)	.	.000
		N	22	22
	BA	Correlation Coefficient	-.967**	1.000

Sig. (2-tailed)	.000	.
N	22	22

**. Correlation is significant at the 0.01 level (2-tailed).

Source: CBSL data and CMC data

According to the Spearman's rho correlation coefficient test, there is enough statistical evidence to conclude that AWCMR and building applications during 2021 to 2022 period are related strongly negative. That means the housing market of CMC area is strongly affected by the change in contractionary monetary policy.

Conclusion

Based on the research findings, it can be concluded that monetary policy changes have a close impact on housing demand in the CMC area. During the period of 2018-2020, an expansionary monetary policy was implemented leading to lower policy interest rates and a decline in AWCMR. Therefore, there was an increase in building applications since households consumed more. The opposite happened during the period of 2021-2022 since a contractionary monetary policy was implemented. As a result, building applications decreased since household consumption declined. This was proved from the correlation analysis using Spearman's rho correlation coefficient test. The housing market reacts moderately negative to changes in expansionary monetary policy from 2018 to 2020 and the housing market reacts strongly negatively to changes in contractionary monetary policy from 2021 to 2022. Therefore, these findings suggest that changes in monetary policy, particularly through AWCMR, have a significant influence on building applications in the CMC area. Policymakers and professionals involved in housing and economic development should consider these relationships when formulating monetary policies and planning for housing demand and development.

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