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The Relationship Between Sri Lankan Economy and The Property Market

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Abstract

This paper investigates the relationship between property market and national economy of Sri Lanka primarily based on time series analysis. However, the study has examined the same in global context through a comprehensive literature review. Construction was used as a proxy to represent the property sector due to non-availability of statistical data on property indicators. In finding the relationship, the growth rates of construction value added (CVA) and construction capital formation (CCF) were used to represent the property sector's performance while the growth rate of gross domestic product (GDP) was to represent the economic growth. The results show that the upturns and downturns in growth rates of both construction value added and construction capital formation follow a similar trend of GDP growth rate. Further, in Sri Lanka construction contributes around 7-9% to GDP during the last five decades except two extreme contributions of 11% and 6% in 1956 and 1965 respectively.

Introduction

Property development is a process of enhancing the value of real estate by making physical changes and improvements thereto through the application of capital and entrepreneurial skill by property developer. Property development as a commercial activity is generally found in the urban sector, and covers a wide range of activities varying from real estate transactions to land sub division for residential, commercial or industrial development purposes, housing development, development of commercial buildings and industrial development. But the development of infrastructure facilities such as road, public utilities, environmental activities such as parks and open spaces, health and sanitary facilities and community needs also considered as property development. Development can therefore be classified broadly as undertaking construction works, such as building and engineering, or making a material change of use to the land or property (Ashworth, 2002). Investments in buildings and property have always assumed to be a sound course of action, since when all else failed the tangible assets of landed property would always remain. Investment in property has traditionally, and during the past few decades, been seen as a good hedge against inflation, and therefore a good investment. It represents the old adage that there is nothing as safe as bricks and mortar. Property comprises an essential ingredient in every form of economic activity and property investment forms an integral part of the financial system. It cannot therefore be reviewed in isolation from more general economic influence and the performance of alternative investment media.

Land is a basic requirement for all of man's endeavours. It is needed for production, shelter, recreation and for environmental well being. Without land almost all human activities would run to standstill. Land is also a scarce commodity. Hence it needs to be properly allocated. Without a proper and well functioning market system, this priceless commodity would be misallocated. Misallocation of scarce resources like land has led to an unhealthy and inefficient system of development that we have today. In this sense demand for land is a derived demand. Due to this, it is dependent on the well being of general economy. Therefore if other sectors of the economy are affected the property sector will also be affected.

The relationship between the property market and the wider economy is of particular significance for a number of reasons. First, the property market plays an important role in the economy of the country. In the banking sector, most of domestic credit currently comprises mortgage loans for the purchase of private residential properties and loans for building and construction and property development. Changes in property prices and rents influence consumer price inflation, and affect competitiveness as a service-based economy. Land sales and stamp duties on property transactions have also been a significant source of government revenue. Secondly, property prices tend to be more volatile in Sri Lanka with a number of large swings in the past two decades.

Land utilization and higher property prices are determined by the increased or enhanced demand for land either for new activities or expansion of existing ones. It is also true in circumstances when individuals buy houses, either for their own occupation or investment, it is greater affordability of income or extra over profits made elsewhere in the economy that has moved into property. In Sri Lanka land and property values especially in the city and suburbs recorded an unprecedented increase after 1978. This trend of increasing prices of land and property was due to two main reasons. One was due to the general economic conditions prevailed in the country after 1977 and the other was the increased housing investment during the same period (Medagedara, 1988). The economy witnessed a five fold increase in the money supply with the introduction of an open market economic policy, a floating of the rupee against other currencies, various incentives offered for savings, increased employment opportunities in the Middle East, the expansion of gem trade and the services sectors and a higher level of business activity. The above factors have either directly or indirectly contributed to rise in land and property values in the past. An essential service and facility for the growing economic activity and pressure on space showed an active property market and construction sector few years following the year 1977. Thus, understanding the relationship between main macro economic variables and property performance, and knowing whether these links are consistent or changing over time can provide a valuable indication in property investment decision making process. In this context, the main aim of this paper is to analyse the relationship that the property sector has with national economy using Sri Lanka as case study.

Methodology

The economic indicators and property indicators play an important role in measuring the relationships between property sector and national economy. The published sources reveal that there are numerous economic indicators available to represent economic sector performance. This applies in the case of property sector as well. There exists a considerable problem in selecting the property indicators due to lack of property transactions and the confidentiality of transaction deals. Further, the selection of indicators depends on certain factors like international experience, data currently available, reliability of the data collected through survey, and their relative importance in the Sri Lankan context.

In a large spectrum of activities property development covers a wide range of activities varying from real estate transactions to land sub division for residential, commercial, and industrial development including development of infrastructure facilities such as road, public utilities, environmental activities such as parks and open spaces, health and sanitary facilities. Further, construction is a critical and an integral part of the property development process. The indicator which represents the construction sector can be used as a proxy to property sector. Accordingly, this study uses the construction capital formation (CCF) and construction value added (CVA) to represent the property sector while using gross domestic product (GDP) to represent national economy. The GDP and CCF compiled using current market prices for the period of 1980-2004 is used in the study. The data was obtained from the Central Bank Annual Reports (Central Bank of Sri Lanka, various issues).

Property market indicators

The performance of the property sector can be viewed using following indicators. Any development that is to be implemented within a particular area is required to obtain prior approvals from the relevant authorities such as Municipal councils, Urban councils, Pradeshiya sabha, and Urban Development Authority. The permits are issued on satisfying certain factors such as location of the proposed development, type of development, height of the development, land plot area, building area. Thus, the number of planning approvals issued gives an indication of property sector. Average prices for various types of private properties (for residential, retail, office and factory uses) as the price per square meter of floor area are the most straightforward and simplest indicators of the central tendency of property prices of the entire population. Property Prices indices also another indicator of property market, are designed to measure changes in prices with constant quality. Further, the banking sector's exposure to the property market is mainly related to mortgage lending and loans for construction, property development and investment. However, there is no published statistical data for the above mentioned property indicators.

Property cycles tend to follow economic cycles; in fact there is usually a lag of a year generally. Hence, to understand the property cycle it is important and necessary to understand the economic indicators. As explained above the property market is a derived market. The general economy, the financial markets

Table 1: Key Economic Indicators of Sri Lanka

Indicators	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
GDP growth %	3.8	6.3	4.7	4.3	6.0	-1.5	4.0	6.0	5.4	6.0
Per Capita Income (US$)	690	724	750	772	805	841	870	948	1,030	1,197
Inflation Rate % (1952=100)	15.9	9.6	9.4	4.7	6.2	14.2	9.6	6.3	7.6	11.5
Unemployment Rate	11.3	10.5	9.2	8.9	7.6	7.9	8.8	8.4	8.3	7.7
Manufacturing sector growth rate %	6.5	9.1	6.3	4.4	9.2	-4.2	2.1	4.2	5.1	6.0
Services sector growth rate %	5.8	7.1	5.2	4.2	6.9	-3.2	6.1	7.9	7.6	6.4
Employment (thousand persons)	5537	5608	6049	6083	6310	6236	6520	7013	7394	7518
Population ('000)	18,336	18,552	18,774	18,208	18,467	18,732	19,007	19,252	19,462	19,668

Source: Central Bank Annual Reports; 2002, 2004, Central Bank of Sri Lanka

and the equity markets are the strongest indicators of a healthy economy. The financial market determines the amount of money that goes into production, manufacturing mining, agriculture and construction. The profits that are made in the various sectors indicate how strong the equity market would be. Hence, if the other two sectors are generally performing well, it can be said that the property market would, indeed also be well performing.

Table 1represents the key macro economic indicators of Sri Lankan economy during the last decade. Over the past ten years the economy performed well except in year 2001 where it recorded a negative growth of 2%. The economy grew by 6% in real terms in 2005 compared with 5% in 2004. The GDP per capita increased by 16 % to 1,197US$ from 1,030US$ in 2004. The unemployment rate has been stable at 8% in 2005 with a higher inflation rate. All major economic sectors show a healthy growth in 2005. The industry sector achieved the highest growth rate of 8.3% and contributed 36 % to overall growth while the services sector recorded 6.4% growth with a contribution of 59% to GDP in 2005.

Property Market Indicators and Forecasts give the consistent, accurate and timely data and forecasts on what one needs to know to make effective global business plans. Rather than spending untold hours trying to patch together data from multiple sources, now anyone can access Property Market Indicators and Forecasts and find just what the needs in one convenient place are. It is highly desirable to have indicators of Property Market, because deposit-takers may have large exposures (both direct and indirect) to property and may be affected by the potential volatility of price movements. Moreover, property assets are a major element of the wealth of the private sector.

The Relationship between Property sector and the National economy – A global context

Construction industry has always been closely related to the national economy. The performance of the economy greatly affects that of the construction industry as 'the construction sector is greatly dependent on changes in the economy' since 'construction output is a response to the demand for other products and services' (Briscoe, 1988). Consequently, studies have shown that both the national economy and the construction industry are closely related with one having influence over the other. Wells (1987) established a strong relationship between construction activity and economic development using various measures of construction output. Further, Wells (1987) stated that if this

relationship occurs in a country at a given point in time, the share of construction in the Gross Domestic Product (GDP) will increase with the increase in national income per capita, at which the rate of growth would be faster in middle-income economies.

Turin's (1973) study concluded that the developed countries had a strong construction industry contributing 5-8% to GDP than the less developed countries contributing 3-5% to GDP. Similar to above, in a study on some Sub-Saharan countries of Africa, Lopes (1998) found a relationship between construction and economic development, and concluded that developing countries require a minimum of 4-5% construction value added as a share of GDP in order to achieve a long term sustainable economic growth. In addition to above, Low (1994) suggested that the relationship could be found in terms of capital formation and employment creation as well. His study argues that in most developing countries the capital formation in construction accounts for 7-13% of the GDP while that of most industrialized countries ranges between 10-16%. Further, he proposed that construction provides 6-10% of total employment in most industrialized countries and 2-6% in less developed countries.

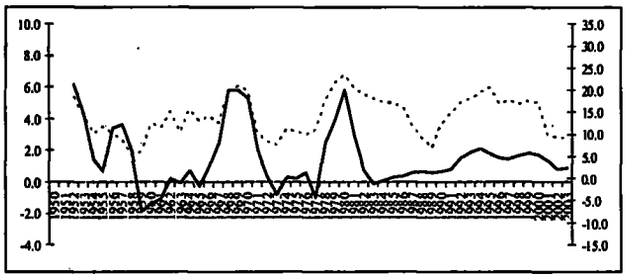
Some researchers have also found that there is a cause-and effect relationship between construction and national economy. Construction is defined as the creation of physical facilities that are needed in the development of other productive activities (Wells, 1984). It implies that construction causes economy to grow. This view has been taken by majority of researchers in the past. Among them Ofori (1990) argued that construction flow causes GDP as the construction sector buys the other sector's output. Chan (2001) attempted to determine whether a change in construction output precedes the outputs of other sectors in the Singapore economy and GDP. He proved that the construction output leads the economic output and not vice-versa. Chan (2002) analysed the impact of a change in construction output on the economy not only in terms of GDP but also in terms of other sectoral outputs, balance of payments and domestic prices etc., and concluded that construction leads other sectoral output and GDP. Further, Cochrane and Wali (1986); Low (1990) also argued that construction expenditure is well related to level of economic development in a country while Crosthwaite (2000) found that there is a reasonably strong non linear relationship between construction spending as a share of GDP and GDP per capita.

Contrary to the popular view Tse and Ganesan (1997) found that GDP causes the construction flow and not vice versa using quarterly construction data of Hong Kong. Briscoe (1988) has also subscribed to this view as he found that the construction sector greatly depends on changes in the economy since construction output is a response to the demand for other products and services. The sensitiveness of construction industry to the national economy is evidenced in china through its rapid economic expansion that has resulted many construction activities to follow (Sjoholt, 1997). An interesting work by Green (1997) established the relationship between construction investment and GDP. He divided the construction investment in two as residential and non-residential. He found that the residential investment causes GDP to grow. However, in the case of non-residential investment the opposite was found to be true. Contrary to above two views Wells (1986) hypothesized a cyclical relationship between construction and economic growth.

The Relationship between Property sector and the Economy: Sri Lankan Context

Figure 1 illustrates the construction value-added growth rate and GDP growth rate over time. It is apparent that the construction growth almost matches the GDP growth throughout the period except in 1983-1989. During 1983-1989 construction growth had a downward trend while GDP had an upward trend. Construction growth rate had downturn until 1959 from the high growth in 1952 with a brief upturn from 1955-1957. Then from 1959-1969 it increased and reached its peak in 1969. During 1969-1973, the construction growth decreased sharply to its second lowest value followed by stagnation up to 1977. A sharp increase could be observed from 1977 to 1980 followed by a downturn between 1980-1983. Since 1983 a gradual increase could be observed until 1994, followed by a gradual decrease up to 2002.

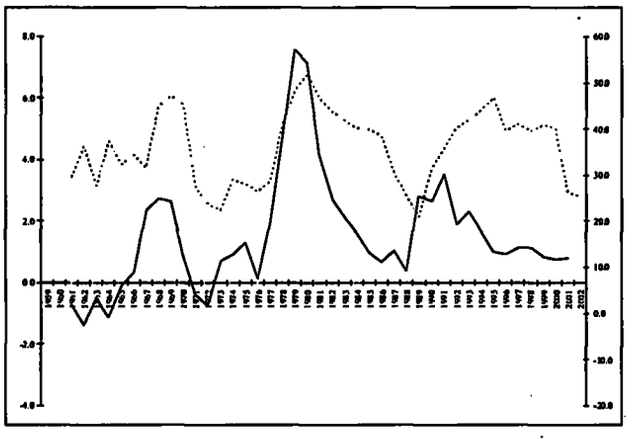
In the case of GDP growth, almost similar upturns and downturns of construction was observed with slight lead/lags. Though both indicators show downward trend during 1952-1959, GDP reached its trough in 1958, preceding the construction sector. During 1959-1980, the upturn and downturns of construction was coincided with GDP. After 1980 construction growth declined steadily and recorded its trough in 1983 while GDP growth gradually decreased until 1989. Both the growth rates of construction and GDP recovered gradually and



-------- 3 years moving average of GDP GR%
—— 3 years moving average of CVA GR %

Figure 1: Change of Construction Value Added growth and GDP growth (3 years moving average)

reached their peak in 1994 and 1995 respectively, followed by a similar downturn up to 2002. However, a marginal lead/lag relationship was observed between the peaks and troughs of construction growth and GDP growth.



-------- 3 per. Mov. Avg. (GDP GR%)
——— 3 per. Mov. Avg. (Building & Other constn. GR %)

Figure 2: Change in construction Capital Formation growth and GDP growth (3 years moving average)

Figure 2 represents the change in growth of GDP and construction capital formation (CCF). As in the case of above, it is noted from the figure that there is a relationship between construction flow and economic activity.

The post-independent economic history of Sri Lanka reveals that the country underwent significant changes with the introduction of open economic policies in 1977 (Sandaratne, 2000). The significant feature was the reduction of state sector role in economic activity and the promotion of the private sector. Tax and other incentives were offered to the private sector, and trade restrictions and controls were relaxed. Foreign investment was promoted. As a result of these policies, investment increased to a higher level during 1978-1985. The gross domestic investment rose from 20% of GNP in 1978 to a peak of 34% in 1981 and, declined to 25% in 1985 (Central Bank of Sri Lanka, 1987). Since construction is a major component (around 50%) of total investment the share of construction in GNP and NI increased in 1981. In addition, the country embarked on an ambitious infrastructure development project during this period. The leading projects such as the Accelerated Mahaweli development scheme, the urban renewal and housing development programme, the investment promotion zone at Katunayake and other infrastructure projects were responsible for 75% of public investment during 1978-1982 (Atapattu, 1997).

Though the impact of post 1977 policies was considerable, it could only be sustained until 1982. Between 1983-1989, Sri Lanka encountered many obstacles to growth. The year 1983 witnessed the beginning of militarising of country's long-standing ethnic problem. The civil disturbances and political instability in the country had an adverse impact on direct foreign investment. As a result, the overall investment rate declined from 29% of GDP in 1983 to 23% in 1990. With the phasing out of lead projects as well as the other major public investment projects, public investment has shown a progressive decline from 14% of GDP in 1983 to 7% in 1990. The average annual growth rate dropped to 5% during 1983-1986, and came down further to around 3% during 1987-1990. However, market-oriented reforms under a structural adjustment facility from IMF in the first three years of the 1990s led the country to pick up growth to a rate of about 5% during 1991-1994 (Lakshaman, 1997). It is evidenced that though the total capital investment has increased from 11% growth in 1994 to 17% in 2000 the construction investment decreased from 13% to 10% in respective years (Central Bank of Sri Lanka, 2002).

Conclusion

In the Sri Lankan context, the involvement of the private developer has increased due to increased demand for residential and commercial property within the past decades. Property development is highly sensitive to the effects of economic climate and government action. The government may intervene directly in development activity by the creation of new township development program or special development agencies. Further more, property developers are affected by monetary and fiscal measures, planning regulations and general and politically motivated legislation to a greater extent.

This paper has analysed the relationship between property sector and the national economy. It is evident from previous research that there is a close relationship between construction and the national economy of a country. In Sri Lanka, construction contributes around 7-9% to GDP during the last five decades except two extreme contributions of 11%

and 6% in 1956 and 1965 respectively. The upturns and downturns in construction value added growth rate and construction capital formation growth rate follows a similar trend of GDP growth rate. Further, it shows that the economic policies have influenced the construction sector in the past. The literature review confirms that the construction sector as a proxy to measure the property industry, this paper has investigated the relationship of property and economy in Sri Lanka.

Historically the construction and property industry has been used as a proxy to measure the wealth of a nation, society or individual, and a replication of socio-cultural identity. The post world war era has seen a tremendous growth in property industry with an increasing private sector involvement.

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