Box 1 The impact on the CPI of changes in the housing finance market

At the beginning of June the Housing Financing Fund (HFF) changed its lending system so that homebuyers are now granted cash loans at fixed interest instead of housing bond loans. The new loans are financed with bond issues. Interest rates offered to homebuyers are the same as the HFF's yield on the sale of the bonds, plus a premium currently set at 0.6%. The following is an analysis of the impact of these systemic changes on methodologies for measuring the CPI.

Monetary Bulletin 2004/2[1] included a detailed account of the way that housing costs are measured in the CPI. It described how the market price and lifetime of sold housing are calculated, together with the opportunity cost of owner-occupancy. The following discussion is confined to the changes resulting from the new HFF loan framework and their impact on measurement of the CPI.

Statistics Iceland receives data from the Land Registry on cash prices in housing sales, which it calculates in the same way as before the loan system was changed. Since mortgage loans from the HFF are now paid out in cash rather than with housing bonds, they no longer need to be revalued at present discounted value.

The opportunity cost of owner-occupied housing is calculated by Statistics Iceland using real rates of interest on collateral loans, and 3% real interest on the part of the value of the housing which is classified as owner's equity (see further Appendix 1 in *Monetary Bulletin* 2004/2). In July, interest rates on new HFF loans were 0.3 percentage points lower than under the old system. The impact of this change was treated in the same way as previous changes in HFF interest rates. By reducing interest on HFF loans, as recorded in deeds of sale, by 0.3 percentage points, the CPI for July measured 0.17 percentage points lower than otherwise.

1. Housing price indices – measurement methodologies, Appendix 1 to Economic and Monetary Development and Prospects, pp. 29-32.

Statistics Iceland does not consider it desirable to incorporate all short-term movements in long-term interest rates into its calculations of the housing component of the CPI, since it is only rates on new borrowing that change. Accordingly, it adopted a new methodology for evaluating real interest rates on new loans when the CPI was calculated for August. The reference used now is the average real interest rate over the preceding five years. Initially, however, instead of covering a full five years, the average will be calculated from March 2000, when data from deeds of sale for housing outside the Greater Reykjavík Area were first included in calculations of the housing component of the CPI. From February 2005, a full five years (60 months) will have elapsed since this systemic change and the reference will be average interest rates over the past 60 months in each instance. At the same time, the weight of owner's equity in the housing component was reduced slightly to below one-half, and the weight of the seller's debt taken over by the buyer was increased by a corresponding amount. The higher interest rate caused by the change in weight between equity and debts taken over was not allowed to raise the value of the "owner-equivalent rent" subcomponent.

In August, interest rates on HFF loans went down by a further 0.3 percentage points. Since the reference was the monthly average since March 2000, HFF interest rates actually rose in the CPI calculation between July and August, but dropped marginally between June and August. The change between June and August is in line with Statistics Iceland's new methodology, while the change between July and August is not. The owner-equivalent rent component rose by 0.9% between July and August, driven up by higher market prices of housing.

Statistics Iceland has not stated how the commercial banks' newly announced housing loans will be treated in the CPI.