Index linking helps Colombians live with inflation

Lauchlin Currie explains how a system of index linking has eased Colombia's housing finance problem, despite a high inflation rate

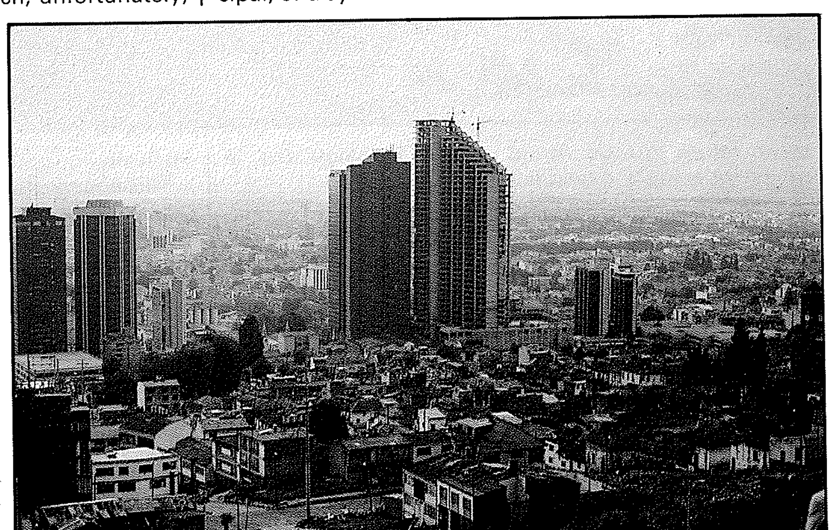
WHEN inflation is high, varying and chronic and is accompanied by high and varying interest rates of 20-40%, how is it possible to provide for continued, long-term housing finance? This was the problem confronting Colombia in 1972 — a state of affairs which, unfortunately, continues until the present.

Savers, quite properly, require security, liquidity, a return on their savings and protection against the loss of purchasing power. Borrowers require long-term loans and a debt service that at no time exceeds a certain percentage of their incomes (say a maximum of 25%).

So the problem is, how to meet these varying requirements? In the early '70s, Colombia's rate of growth was high, at over 7% per annum, but with heavy migration from the countryside to the cities, there was still unemployment, especially of relatively unskilled workers.

In short, there was urgent need for a financial system that would attract savings, finance building and create more growth and employment under rather difficult conditions.

The answer was found in linking savings and mortgages to the index of the cost of living. It should be noted that the link was made to the *principal* of savings and mortgages, not to the varying rates of interest on that principal, or a system that the Americans now call variable rate mortgages. The latter was considered as a possibility but was rejected.



There was, in Colombia, no prime rate, and rates in general were subject to wide fluctuations. By making the link to the real value of money, the real rate of interest on deposits and loans could become stable and low. Writing up the principal as inflation proceeded meant only a small addition to the monthly debt service, matched by the rise in incomes and property values.

It is true that the basic simplicity of the idea was complicated by the necessity of keeping accounts in terms of two units — one in current pesos, the other in pesos of constant purchasing power (Unidad de Poder Adquisitivo Constante, hence "the UPAC system") — and this caused some confusion at first. But it was amazing how quickly thousands of savers (now 3½ million) grasped the basic idea and the infant system grow so lustily during the first year and a half that a succeeding, hostile, Government did not dare to dismantle it.

It is now an essential part of Colombian life and "UPAC" has become a good Spanish word, serving as a verb as well as a noun. A branch of one of the 11 nationwide associations can be found in nearly every street.

It often appears that savers and

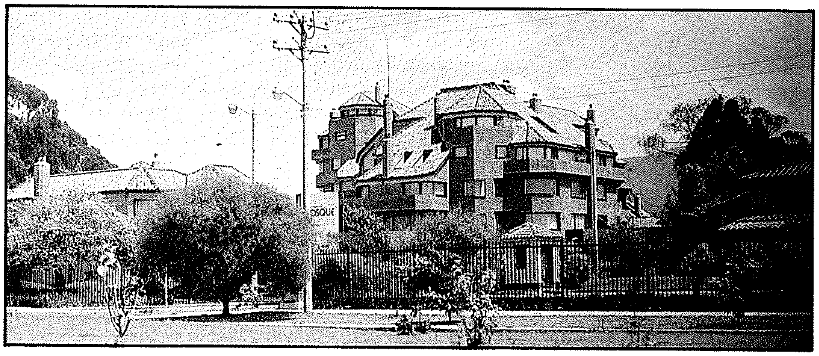
→ 52

borrowers understand the basic principle of the system better than government officials, who cannot resist the endemic disease of "tinkering" by way of trying to use a privately owned system as a philanthropic agency of the State, putting limits on the monetary correction in the interest of the borrowers or of competing commercial banks, reducing interest rates by decree, and so on. It seems impossible for them to leave well alone.

Given the choice of living by principles or yielding to pressures, governments, at least in developing countries, will invariably choose the latter. Hence it is a constant struggle to maintain the basic principle of indexing and to keep indexing as automatic and non-discretionary as possible.

The only other country that has succeeded in doing this to an acceptable degree is Brazil, and it is significant that in the current heroic attempt of that country to return to stability, the only form of indexing that was retained at the beginning of the attempt was the indexing of savings and mortgages.

The Brazilian experience points to an important distinction that should be kept in mind. The reason why the term "indexation" has acquired a bad connotation among many economists is that it has been mistakenly applied. Instead of it being applied strictly to the correction of distortions and inequities caused by inflation *in the past,* as for example in old age pensions, it has been applied to wage agreements that try to *anticipate* inflation in the future and so raise unit costs immediately.



To return to the Colombian system, in the attempt to make it into a popular housing agency, the Government succeeded in making it practically profitless. This in turn has meant that it is very difficult to maintain a proper ratio between capital funds and total deposit liabilities. Since there is no deposit insurance in Colombia, the margin of safety supplied by the shareholders' equity is highly important.

So far the ratio of doubtful loans to the total has remained below that of other financial organisations. When failures do occur, the usual pattern is for the Government to take over the institution. The link between a long and severe recession and the growth of nationalisation is, in Colombia, to be found not in ideology but in expediency.

In the maintenance of such a rate, building has a most important rôle to play. Because of the peculiar nature of the demand, it is one of the few sectors that are responsive to exogenous stimuli and can be induced, if necessary and desirable, to move against the trend of activity. The key relationship is that of the monthly debt servicing charges and the rents on comparable existing houses. If monthly debt servicing charges can be reduced, new building will respond. This is the fundamental reason why building can be used as a leading sector, or arm of macroeconomic policy.

Index linking has permitted a steady flow of savings to the long-term financing of housing, even in a period of high inflation and deep depression. The amortisation of mortgages has created a new and important flow of savings to building. Colombia was so starved for proper housing and the demand for loans was so strong that an initial limit of 15-year maturities for loans was adopted, and this limit still remains.

The ability to start servicing mortgages with low real interest rates has broadened the market. Otherwise, paying nominal rates of, say, 30% would have meant, in effect, payments in the first year amounting to nearly a third of the original loan. Options are now available to make monthly payments a constant proportion of income throughout the life of the loan.

Very well, but what would happen if, as we all hope, inflation disappears? Nothing. Monetary correction would disappear and the two units of accounting would be the same. If inflation reappears, as is most likely, correction could occur automatically.

This appears to be an innovation in housing finance that merits close study and justifies the favourable judgment of Mark Boléat: "The experience of Colombia confirms that of Brazil in showing that housing finance systems can work even when inflation is running at a high level, given an appropriate method of indexation."[1] ■

[1] *Mark Boléat, "National Housing Finance Systems," Croom Helm Ltd, Kent, UK, 1985, pp. 363.*

Professor Lauchlin Currie is Professor of Macroeconomic Theory at the University of Los Andes. A more detailed study of the Colombian system is made by Luis Eduardo Rosas and the author in the pamphlet "UPAC: A Theory Converted into a Successful Reality," 1986, and is available on request to the Instituto Colombiano de Ahorro y Vivienda, PO Box 34281, Bogotá, Colombia.