Jarle Bergo: The economic outlook and household debt

Address by Mr Jarle Bergo, Deputy Governor of Norges Bank (Central Bank of Norway), at the annual meeting of the Association of Norwegian Finance Houses, Gardermoen, 27 May 2005.

The discussion of the economic outlook is based on Inflation Report 1/05 and the assessments presented at Norges Bank's press conference following the Executive Board's monetary policy meeting on 25 May. Please note that the text below may differ slightly from the actual presentation.

The references and the Charts in pdf-format can also be found on the website of the Norges Bank.

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The economic outlook

The Norwegian economy is growing at a solid pace and growth is likely to remain high. The recession was mild after the previous period of expansion culminated in 2002. The period of relatively high cost inflation in Norway came to an end without production being impacted to the same extent as during the recessions in the early 1980s and around 1990. One of the reasons for this is probably that low inflation in the 1990s and current monetary policy have anchored expectations of low and stable inflation among economic agents.

Inflation has been low in recent years. Inflation measured by the CPI-ATE reached its lowest level in the first months of 2004. Inflation picked up through the autumn. The depreciation of the krone since the beginning of 2003 has contributed to these developments. In addition, the rise in prices for domestically produced goods and services stabilised, and towards the end of 2004 there was a tendency towards a more rapid rise in prices for these goods and services.

Prices for imported consumer goods fell more than expected at the beginning of 2005, while the tendency towards a more rapid rise in prices for domestically produced goods and services has persisted. So far in 2005, inflation measured by the CPI-ATE has hovered at ¾ per cent.

The projections in *Inflation Report* 1/05, published on 16 March, are based on a gradual increase in the interest rate. This is in line with expectations among financial and foreign exchange market participants. It is assumed that the exchange rate will shadow movements in the forward exchange rate. This implies that in the years ahead the krone will remain fairly stable at approximately the current level.

With a path for the interest rate and the krone exchange rate in line with the baseline scenario in *Inflation Report* 1/05, inflation may increase gradually from less than 1 per cent today to close to 2 per cent in mid-2006. Under these assumptions, inflation may stabilise at around 2½ per cent at the three-year horizon. Developments in line with these projections imply that the output gap will widen to about 1¼ per cent in 2006 and then gradually narrow.

Developments since the March *Inflation Report* was published do not provide grounds for changing the perception of the main features of developments in the real economy. The results of the wage settlement so far may suggest that wage growth this year will be somewhat lower than projected by Norges Bank. Inflation, on the other hand, has been broadly in line with expectations, and the krone exchange rate has developed approximately as projected since the March *Inflation Report* was published. The inflation outlook has not changed significantly since the March *Inflation Report* was published.

At its monetary policy meeting on 25 May, Norges Bank's Executive Board decided to leave the sight deposit rate unchanged at 1.75 per cent.

The Executive Board stated:

"The monetary policy assessments presented in the *Inflation Report* in March indicated that the interest rate will rise after a period and at a gradual pace. The assessments were based on market participants' expectations that the interest rate would be increased in the summer. A development where the interest rate rises gradually - in small and not too frequent steps - was considered to provide a good balance between the different objectives. The outlook for inflation and activity has not changed substantially since the March *Inflation Report*. As an alternative, the Executive Board considered increasing the interest rate already at this meeting. Nevertheless, the Executive Board did not find grounds – given the prospect of continued low inflation for a period ahead – to deviate from expectations in the money and foreign exchange markets at present."

There are a number of uncertainties that may lead to different developments than those indicated by the projections in the *Inflation Report*.

Increased current account imbalances in major countries along with high oil prices and volatile oil markets are contributing to the uncertainty concerning developments in the global economy.

Household debt

One area of uncertainty associated with the economic outlook in Norway, stressed by many observers, is the high level of and strong growth in household debt. In the rest of this speech, I will consider possible causes of this strong growth. I will also say something about the possible consequences of debt accumulation for the economic outlook in general and for financial stability in particular.

I. Causes of household debt growth

Debt is growing far more rapidly in the household sector than in the enterprise sector. Growth in household debt has generally been high during the last five years. The interest rate reductions since December 2002 seem to have amplified debt growth somewhat. It appears that this high growth will continue in 2005. Growth in debt has also been appreciably higher than income growth, so that the debt-to-income ratio, often referred to as the debt burden, has increased markedly.

Household debt and the housing market

Norges Bank's analyses show that high house prices may explain most of the growth in household debt. Sales of new dwellings have also made a positive contribution. The contribution from changes in the interest rate was high in 2003 and 2004, but has diminished recently. Lower unemployment in 2004 and increased house sales have pushed up debt growth. Household debt also depends on the number of students aged 20-24 as a share of the total population. This reflects demand for student loans and the fact that persons with higher education normally have larger housing loans than those without higher education (all else being equal). Our analysis shows that higher house prices affect debt with a considerable lag. The main explanation is that the change in the loan-to-asset value ratio of a dwelling is closely related to the sale of the dwelling and that only a small portion of the housing stock is for sale at all times. Even if house prices stabilise following a sharp rise, there will be a long period during which houses change hands at a higher price level than the last time they were sold.

Other factors may also contribute to a high level of household debt. Compared with other countries, many households in Norway own their own dwelling. Factors such as centralisation, a larger number of single persons, fewer persons in each household and available loan products may also have had an effect.

House prices are determined by supply and demand in the housing market. The housing supply is stable, however, in the short term because building new dwellings takes time and because housing construction in any case will be low in relation to existing housing stock. Therefore, in the short term, prices for resale homes will generally be determined by demand.

The demand for owner-occupied dwellings depends primarily on the interest rate level, household income and household expectations concerning future income growth. Lower interest rates mean lower borrowing costs connected with the dwelling and thus higher demand for housing. This pushes up house prices.

Developments in the labour market are important for house prices because they affect household income. Increased unemployment leads to expectations of lower wage growth and increased uncertainty concerning future income growth. Thus, demand for owner-occupied dwellings falls. Banks may also be more reticent about providing loans when unemployment increases.

If expectations about future house price inflation rise, it will be relatively more favourable to purchase a dwelling now rather than later. The result is increased housing demand and higher house prices today. Price expectations depend both on observed developments in interest rates, income and house prices and on household expectations of future interest rates and income growth.

Housing demand also depends on population movements and demographic conditions such as cohabitation patterns, population size and the number of individuals in the start-up phase. Net migration to central areas has been positive in recent years. This has affected regional house prices in different ways.

Norges Bank has recently estimated a relation for house prices. The model contains effects of the housing stock, the unemployment rate, banks' lending rates after tax, total wage income in the economy and an indicator of household expectations concerning their own financial situation and the Norwegian economy. In the work on the relation, we did not find any evidence to suggest that migration or demographic conditions have strong direct effects on house prices. However, demographic changes may affect prices indirectly by affecting overall wage income in the economy.

The estimated relation provides a good explanation of house price developments in recent years. High wage income has pushed up house prices. The contribution from interest rate changes has also been high in the last two years but has diminished somewhat recently. In the model, interest rate changes have a strong short-term effect.

House prices in Norway have risen substantially since 1995. House prices have also risen rapidly in many other countries. The IMF has expressed concern that house prices may be too high in relation to fundamentals in some countries.

In Norway, there have been signs recently of a slower rise in house prices. The seasonally adjusted, monthly rise has been low since November 2004, but it edged up again in April. On the other hand, the time it takes to sell a dwelling has declined further, whereas the number of dwellings sold remains high.

Housing starts increased substantially in 2004 as a result of high house prices, low interest rates and a favourable economic outlook. In Oslo in particular, the level of residential construction activity has been high. Increased housing supply will in isolation reduce the pressure in the housing market and contribute to reducing house prices.

In the last *Inflation Report*, house price inflation is projected to slow towards 2008. The main explanation for this is higher interest rates, but increased housing construction will also be a contributing factor. Lower unemployment has the opposite effect.

Growth in household debt is expected to slow as a result of lower house price inflation. Nevertheless, growth in household debt will be higher than growth in disposable income until 2008. As a result, the debt burden, i.e. debt in relation to disposable income, will rise to a level that is appreciably higher than the level prevailing at the end of the 1980s.

The debt burden for Norwegian households is relatively high compared with other countries. Structural factors such as the percentage of owner-occupied dwellings and differences in tax systems are important to explaining the differences in debt burdens.

The transition in monetary policy from an exchange rate target to an inflation target has probably made it less likely that households will be exposed to a "dual shock" in the form of higher unemployment and higher interest rates, as was the case during the banking crisis. As a result of the change in monetary policy and more stable macroeconomic developments, households may also have chosen to adapt to a higher debt burden than before.

II. Household wealth

Household gross financial assets have increased more than debt in recent years (measured in NOK). This financial buffer reduces some of the concern related to debt growth.

Debt as a percentage of gross financial assets is lower today than at the end of the 1980s. Insurance claims account for a substantial share of household wealth. Insurance claims are illiquid, however, and cannot be utilised if payment problems arise. However, debt as a percentage of liquid financial assets, i.e. financial assets minus insurance claims, is also lower now than it was at the end of the 1980s.

The strong increase in wealth indicates that the debt growth in recent years has not led to a reduction in saving. This contrasts sharply to the situation in the 1980s. At that time, debt growth was also high, but it financed consumption and not investment, and overall saving fell sharply.

In addition to financial assets, households also have housing wealth. There is considerable uncertainty attached to the estimates for housing wealth. A cautious estimate indicates that household housing wealth is 11 per cent higher than financial assets and more than 40 per cent higher than debt.

Total debt is unevenly distributed

One worrying aspect of these developments is that debt and wealth are unequally distributed across different household groups. Compared with the 1980s, the debt burden has increased in low- and middle-income households (deciles 1-6). Households with higher income (deciles 7-9) have the highest debt burden. The debt burden for households with the highest income (decile 10) has fallen markedly since the banking crisis. This is partly due to changes in the tax system at the end of the 1980s which led to a reduction in tax deductions for interest expenses, especially for high-income groups, and changes in the tax system in 1992.

Debt is also unevenly distributed by age. In recent years, the debt burden has increased substantially in the younger age groups. The debt burden for the age group 25-34 is approaching the level prevailing at the time of the banking crisis. The rise in the debt burden must be seen in connection with the fact that they are in the start-up phase and with the rise in house prices. The high debt burden makes these groups vulnerable in the event of an interest rate increase.

III. Consumer credit

Banks' and finance companies' exposures to household loans depend in part on whether loans are secured. Good collateral provides a buffer against losses and is therefore advantageous for a robust financial system.

Mortgage loans account for the majority of household borrowing. The share of housing loans has increased since 1996, whereas the share of other repayment loans, which may be unsecured or secured with collateral in the form of a car or boat, has declined. Other loans include construction loans, bank overdrafts, operating credit, leasing and factoring. Their share is virtually unchanged. Norges Bank's statistics do not provide the basis for estimating the total scope of unsecured loans. Of a total of NOK 1 021 billion in loans to wage earners, pensioners, social security recipients and students at the end of 2004, NOK 208 billion represented non-mortgage loans.

Since the third quarter of 2004, growth in mortgage loans has slowed while growth in other loans has increased. Growth in mortgage loans, however, remains higher.

In the last decade, loans from finance houses to households have increased from three to four percent of household loans and now amount to a total of NOK 47 billion.

Each quarter Kredittilsynet (Financial Supervisory Authority) conducts a survey of selected finance companies that are engaged primarily in consumer financing. Consumer loans are defined here as both card-based loans and other unsecured consumer loans. The survey shows that several of the finance companies in the sample have recorded strong growth in lending. However, growth has slowed. The survey shows that compared with total loans to the household sector, the number of defaults on consumer credit is high but relatively stable. Losses are low. Profitability in these companies has improved considerably in recent years, illustrated here by net interest income as a percentage of average total assets. This indicates that the enterprises take into account the high risk when pricing consumer credit. At the same time, it is surprising that more new participants have not entered the market when profitability is so high.

Some consumer loans are probably extended as mortgage loans. This possibility is closed to households that do not own their own dwelling. These households will have to raise consumer loans if they need credit. According to Statistics Norway's tax statistics for 2003, debt growth for individuals who do not own their own dwellings has been relatively high, but somewhat lower than for those who own their own dwellings. However, the average level of debt for individuals who do not own their own dwellings is considerably lower than for those who own their own dwellings.

An increased supply of unsecured loans has improved consumption possibilities for households that would not otherwise have had access to the credit market. In a period when the supply of loan products increases, it is important that borrowers look carefully at total costs and other loan terms.

For lenders, the absence of collateral means that evaluating customers' creditworthiness is even more important, especially in the case of new customers. It may be difficult to acquire information concerning customers' total debt if they have unsecured loans from several lenders. Therefore, it is important that both borrower and lender thoroughly evaluate the borrower's future debt-servicing capacity.

IV. Consequences of developments in household debt

History shows that periods with a sharp rise in asset prices, investment and credit may be followed by problems in the financial sector. Periods with sharp increases in asset prices are often marked by great optimism. A strong belief in the future contributes to high investment which is often debt-financed. High share prices may make it easier to gain access to capital to finance investment. At the same time, higher asset prices provide scope for raising larger secured loans. When negative news appears and spreads, investments do not match expectations and the sentiment is reversed, asset prices fall. Banks' security is reduced. Borrowers experience problems in servicing their debt. Demand and income developments are weakened and banks' losses increase.

The sharp rise in house prices and household debt has increased the interest in the interplay between monetary policy and the stability of the financial system. Financial stability and price stability are mutually reinforcing. Financial stability facilitates a stable supply of credit and stable capital flows and underpins the transmission mechanisms for monetary policy. Price stability strengthens financial stability. Low and stable inflation provides households and enterprises with a clear indication of changes in relative prices. This makes it easier for economic agents to make the right decisions and leads to greater price stability in financial and property markets than would otherwise be the case.

Developments in credit and asset prices have an influence on inflation. We take this into account in our interest-rate setting. We are also aware of the potential risks to financial stability.

The current low interest rates make it easy to service debt. The household interest burden, i.e. interest expenses after tax in relation to the sum of interest expenses and disposable income, is low despite strong growth in debt. The interest burden will increase, however, when the interest rate reaches a more normal level.

Only 14 per cent of household loans are fixed-interest loans. This is low in relation to other countries and makes households vulnerable to an interest rate increase that is higher than currently expected.

Compared with losses on loans to the enterprise sector, losses on loans to the household sector were low during the banking crisis at the end of the 1980s. Despite high real interest rates and a decline in income, households were largely able to service their debt. High interest expenses and a decline in income, however, forced households to reduce consumption. This led subsequently to lower turnover in enterprises and weakened profitability and debt-servicing capacity. In this way, households contributed to an increase in banks' losses on loans to the enterprise sector. The higher the household debt burden, the stronger the potential spillover effect from the household sector to the enterprise sector.

The effects of weak economic developments and/or a change in interest rates on financial stability will depend both on the initial situation in households and enterprises and on banks' ability to absorb losses. An analysis presented in Financial Stability 1/04 showed that a sharp increase in interest rates and a subsequent fall in house prices may increase banks' losses to 2.5 per cent of gross lending. This is roughly half of what losses were at the beginning of the 1990s. The moderate increase in loan losses is due primarily to an improved financial situation in the enterprise sector.

Banks' capacity to absorb loan losses depends on their results and their capital adequacy. In the same report, we assessed the capacity of the seven largest banking groups to absorb losses by measuring how large the losses would have to be over a three-year period before their capital base fell below the minimum requirement of 8 per cent. We based our assessment on the accounts for 2003 and assumed that banks do not raise new equity or supplementary capital, that the size and composition of the balance sheet does not change, and that the banks do not pay a dividend. In the first example, we assumed that banks have the same results as in 2003 in each of the three subsequent years. In the second example, we assumed a result before losses of zero for these three years.

With the same result before losses as in 2003, the most solid of the seven largest bank conglomerates will have the capacity to absorb an average loss per year over a three-year period of 3.1 per cent of gross lending before the capital falls below the minimum requirement of 8 per cent. If the result before losses is zero in the three years, this group will have the capacity to absorb an average loss of 1.4 per cent of gross lending. The least solid of the seven banks will have the capacity to absorb average losses per year over a three-year period of 1.7 per cent and 0.8 per cent of gross lending, respectively, given these two assumptions concerning results.

Conclusion

The short-term outlook for financial stability appears to be favourable. In the long term, high and rising household debt is a source of uncertainty. Admittedly, household financial wealth has also increased, but debt and wealth are unequally distributed across different household groups. Low interest rates and stable macroeconomic developments indicate that the outlook for households is favourable in the short term. In the longer term, the higher household debt burden represents a source of instability in demand and output.