Kristina Persson: The property market and the current economic situation

Speech by Ms Kristina Persson, Deputy Governor of the Sveriges Riksbank, Uppsala, 11 October 2005.

* * *

Introduction

Thank you for inviting me to take part in this early breakfast meeting.

As you presumably know already, the issue of house prices has recently been on the agenda for discussions by the Riksbank's Executive Board. So I thought I would begin by presenting my view of the role that indebtedness and house prices play in general for our monetary policy. Then I shall discuss whether there is a risk that the strong growth in lending and the rapid price increases in the housing market may accentuate a cyclical slowdown in the future. In conclusion I shall talk about the current economic situation in general in the run-up to our interest-rate decision next Wednesday.

We are by no means the only central bank in the world that is discussing house prices. For a number of years now the rapid increase in house prices and the strong growth in credit to households have been on the agenda of monetary policy decision-makers in many countries. While the growth of lending has recently slackened in many countries, the level of household indebtedness is generally high. In Sweden the ratio of debt to disposable income is currently over 125 per cent, which is close to the levels that were reached in the early 1990s. In the UK, where the annual increase in house prices amounted to approximately 4 per cent the second quarter this year, the ratio of debt to disposable income is around 150 per cent.

In Sweden, house prices have more than doubled in the past decade, with a par-ticularly strong increase in metropolitan regions. Part of the explanation is that household incomes have also risen rapidly in this period. It is reasonable to assume that house prices follow income in the long run. What gives some cause for concern is that house prices and household debt have both been rising very much faster than income and have continued to do so this year. At the end of the second quarter this year, house prices had risen by more than 7 per cent and house-hold debt by over 10 per cent compared with a year ago. Since 1995, house prices and debt have both risen over 40 per cent more than income.

The pertinent issues have mainly been whether there are "bubbles" in the housing market in the sense that house prices have deviated markedly from what can be motivated by underlying factors such as disposable income and interest rate costs, and whether households have taken on too much debt in relation to their future ability to pay. Another question that has come up in recent years in Sweden, as well as in England and elsewhere, is why the strong credit growth and rising house prices have not been accompanied by increased consumption. Rising wealth ought to stimulate consumption and low interest rates ought to lead to saving being dampened, as well as affecting the demand for loans. Instead, the aggregated picture seems to be that loans have been channelled to saving in financial assets. One explanation may be that my generation has stepped up saving in financial assets, partly because the stockmarket fall eroded a part of our retirement capital.

What role do loans and house prices play in monetary policy?

The Riksbank has the statutory objective of maintaining price stability, defined by the Executive Board as a CPI increase of 2 per cent plus or minus 1 percentage point. This is the target that governs the construction of monetary policy. Normally we aim to achieve the target within a two-year period. However, as we have described in a Clarification of monetary policy published in 1999, there are sometimes reasons to allow a little longer to reach the target.

When we make monetary policy decisions, we take into account how indebtedness and house prices may affect future demand and inflation. The extent to which short-run variations in the interest rate affect property and other asset prices is highly uncertain. Buying a house is a long-term decision and short-run, cyclically determined variations in the interest rate ought not to have more than a very marginal influence on rational households' propensity to take house mortgage loans.

One of the most important factors for developments in house prices in the longer term is household income. Other notable factors are the structure of the population, new housing construction and access to loans. Regardless of what it is that generates an increase in house prices, this probably stimulates household consumption via the wealth effect, just as a house price fall has the opposite effect. An increase in the value of houses and tenant-owned apartments can be realised in part by using the property as loan collateral. If this happens when interest rates are low, households will be more interested in mortgaging the increased value of their property in order to buy durable goods such as cars and household appliances, for example.

House prices therefore have significance for demand and thereby for monetary policy. The lending potential and interest rates of banks and mortgage institutions are also important. Access to loans increases the chances of realising an increase in value but also makes it possible to finance a house purchase.

In addition to the inflation target, the Riksbank has the task of promoting finan-cial stability, which is a prerequisite for a proper implementation of monetary policy. A functional payment system, capital supply and arrangements for spreading risks are a precondition for the efficient working of the economy in general. An important instrument for the Riksbank's work on stability is the twice-yearly publication of a report that evaluates the risks in the financial system. Lending to households and the development of house prices have been recurrent themes in the Financial Stability Report in recent years. Among other things, the reports have presented assessments of whether the banks' credit risk exposures, for instance to households in Sweden, could threaten financial stability.

The assessments of inflation normally presuppose that no major problems will arise in the financial system — credit supply, payment mediation and risk sharing are assumed to function normally. If financial stability were to be threatened, that would of course have to be taken into account when deciding on monetary policy.

Our assessments

Households are not a direct threat to financial stability

In the latest Financial Stability Report, published in June, the Riksbank stated that the risk of households incurring large loan losses for Swedish banks is very small. So the rapid growth we have seen in lending to households does not constitute a threat to financial stability. Although indebtedness has increased markedly in the past decade, low interest rates have lightened the burden of servicing debt. In aggregated terms, interest expenditure adds up to little more than 3 per cent of household income, which can be compared with over 10 per cent in the early 1990s. The debt-servicing burden of indebted households is low. Micro studies also show that indebted households in general have comfortable margins and would therefore cope with interest expenditure even with interest rates that are considerably higher than at present.

Approximately 70 per cent of the loans have been obtained from mortgage institutions with the residential property as collateral. An important issue in the analysis of stability is therefore whether there is a risk of house prices falling sharply and thereby eroding the security value underlying loans to households. Security value is of no consequence as long as borrowers can service and repay their loans but if a household becomes unable to pay, it is important that the value of the pledge covers the loan.

While one cannot be absolutely sure about the appropriate long-term price level for houses and tenant-owned apartments, the estimates the Riksbank has made in various contexts do suggest that fundamentals such as incomes, interest rates and residential construction provide a fairly good explanation of both house prices and loans in the past decade. This reduces the risk of house prices falling sharply. Moreover, the speculative elements in the housing market are probably small. One reason for this is that Swedish households, unlike households in a number of other countries, buy housing to live in rather than to make a profit. They do not buy a house merely to be able to sell it a little later and make a capital gain. This means that prices are not forced up in the same way as in a financial bubble like the one we saw on the stock market not so long ago.

Neither is it remarkable that households have enlarged their debts so much since the mid 1990s. Debt ratios were low after the crisis in the early 1990s. House-holds became more interested in borrowing at the same time as the inflation-targeting regime gained increased credibility and the future became

less uncertain. As it became possible to lower real interest rates, borrowing became cheaper. Low and stable inflation expectations also meant that in the long run households could count on nominal interest rates being lower than before. It is conceivable, moreover, that the low-inflation regime has enabled households to borrow more on account of low interest expenditure.

Can there be a setback for consumer demand later on?

Thus, neither the high level of debt nor the high house prices are considered to constitute a threat to the banking system. But could households' inflated balance sheets tend to subdue consumption and growth later on? Is there a risk of households being forced to cut back sharply on consumption when interest rates sooner or later move up? And how will rising interest rates affect house prices? Will the decline in household wealth (in the form of housing) that could result from higher interest rates lead to decreased consumption? These are questions we try to take into account when assessing the economic outlook on which monetary policy is based. There are no simple answers here either; as always, the decisions have to rest on assessments.

Most things suggest, however, that the adjustments we can foresee after a future increase in interest rates belong to the normal transmission mechanism and will therefore occur in orderly forms. Provided households' borrowing decisions have a rational basis and accordingly include realistic assumptions about future interest expenditure, there is nothing to suggest that higher interest rates will have drastic consequences. This applies to the effects of increased interest expenditure on house prices as well as on consumption.

Still, one cannot disregard the risk that some households have been over-optimistic about their future incomes and the future level of interest rates. More than 70 per cent of new lending is currently arranged at a variable interest rate. Moreover, the present level of interest rates is considerably below what the financial markets assume it will be in time. So the households that choose to stick to a variable rate must count on considerably increased interest expenditure further ahead, if interest rates develop in line with market expectations.

Furthermore, during the past year the credit spread between a risk-free government bond and a housing bond has been virtually nil. All in all, mortgage institu-tions have therefore been able to offer very low rates even for fixed-interest loans. The combination of high house prices and low interest rates has meant that many households have acquired very large liabilities. In that interest rates have been pushed down by a large variety of partly temporary factors, it is not inconceivable that their level will double. That may entail a heavy burden for many households and one cannot be sure they realised this when they decided to borrow so much. The longer interest rates are held down by temporary factors, the greater may be the risk that households perceive the low rates as a permanent phenomenon. Even if they cope with interest expenditure when interest rates turn upwards, many households may be obliged to cut back consumption substantially, which would tend to dampen demand.

At the same time, higher interest rates can subdue the increase in house prices. If the higher interest rates are accompanied by an increased supply of dwellings, that could also tend to hold house prices back. Even the demographic age structure may have a slight restraining effect on the future housing market. The population in active age groups grew throughout the 1990s but since 2000 there has been a minor reversal. The increased proportion in retirement may enlarge the supply of sizeable apartments and houses. However, changes in the composition of supply and demand occur slowly as a rule and are unlikely to lead to any drastic price adjustments. Moreover, higher interest rates will probably coincide with higher growth and increased household income, which by themselves counter the factors that subdue price developments. Assessing the magnitude of the overall effect will be difficult but most things suggest that prices will not fall sharply even if interest rates move up.

Why has saving been so high?

Historically, increased debt and rising house prices have been accompanied by a higher consumption ratio. This pattern is to be expected in particular when the driving force comes from lower interest rates: rising house prices augment house-hold wealth and together with low interest rates this points to increased house-hold consumption. The consumption ratio has been low, however, ever since 2001 despite the increased lending and higher house prices. That households both borrow and save so much and do so simultaneously may seem paradoxical. The major share of the loans is probably

connected with house purchases in the second-hand market. The cash flows that are generated when borrowing rises without a corresponding aggregated counterpart in the financing of new housing can be used for either consumption or financial investment.

At the aggregated level it accordingly looks as though in recent years loans have gone to saving. We have seen the same development in, for example, the UK. We have no simple explanation of what underlies this. One conceivable explanation is that the stockmarket fall in 2000 and the subsequent economic slowdown stimulated prudential saving on account of labour market uncertainty and also led to increased saving by those who were directly hit by the share price fall. Population groups that are approaching retirement, for example, may have increased their saving in financial assets in order to restore their wealth after the stockmarket fall. Moreover, many elderly people may have chosen to move to a cheaper dwelling and thereby converted some of their real wealth into a financial asset.

At the same time, households unaffected by the stockmarket fall that are younger and unconcerned about their future income may have continued to demand expensive dwellings since the interest costs have been so low. As the available statistics are mainly at an aggregated level, however, it is difficult to find evidence of the behaviour behind what we have seen. But if this interpretation holds, it is reasonable that consumption picks up when labour market uncertainty diminishes and when wealth has been restored by a combination of saving and rising asset prices.

The current situation for monetary policy

With that I shall move on to say something about our main scenario for economic developments in the years ahead.

The international picture

The outlook in the rest of the world is mainly bright. As we see it, international growth will remain high this year. Conditions are also favourable for a continuation of high growth in the next few years, although we do count on a somewhat more subdued rate than last year. Important driving forces are persistently strong economic activity in the USA and further powerful economic expansion in China and the rest of Asia.

Last spring there were some signals that the slowdown in the international economy would be more marked than we had counted on earlier. It was mainly growth in the euro area that seemed to have become more subdued than expected. In June, our main assessment was that this amounted to a temporary dip in international activity. Our analysis of the risks in the forecast did, however, include the possibility of the slowdown being broad and pronounced. But the information received during the summer has supported the assessment that last spring’s dip in international activity was transient.

At the same time, the continued increase in oil prices has to be weighed into the general assessment. It is hard to be certain about what has caused the high oil prices but there are many indications that an important factor is demand. The price rise is probably due to a combination of increased demand for oil from rapidly expanding economies such as China and India and the fact that production capacity has not yet been adjusted sufficiently. In recent months, it seems that another contributory factor has been uncertainty about the consequences of hurricane Katrina. It is reasonable to suppose that the oil price may fall back from the current high level but predicting the future price we should allow for is genuinely difficult.

As to the consequences of the high oil price, it seems that the price rise to date has not appreciably curbed global growth. This is probably because many industrialised countries have become less dependent on oil. In Sweden, for example, oil’s contribution to energy supply has decreased from around 70 per cent in 1970 to just over 30 per cent in 2004. There has probably also been a balancing effect in that the high price of oil seems to have been generated in part by strong demand in Asia in particular. We therefore consider that the high oil price will subdue international growth to some extent in the coming year but will not entail any dramatic adjustment. However, the difficulty in assessing the effects of the high oil price does make this a central element in our picture of risks.

Uncertainty still also prevails about the consequences of the saving imbalances in the world and above all the large deficit on the US current account. An adjustment of current-account balances would probably involve a weakening of the US dollar’s real exchange rate, through either lower US inflation relative to the rest of the world or a fall in the dollar. An adjustment of the imbalances would

also be likely to raise the very long-term interest rates. If these changes were to occur quickly and unexpectedly, there would be a risk of decreased world market growth.

The Swedish economy

Signals of an economic slowdown last spring were also evident in Sweden but in June we counted on the dip being temporary, with a subsequent renewal of growth. So far, the new statistics since then seem to confirm our assessment. The second-quarter national accounts show that growth strengthened about as much as we had expected. An acceleration seems to have begun in the growth of private consumption, accompanied by a continuation of the last year's upswing in investment, with a spread from residential construction to the corporate sector in general. In other words, domestic demand seems to be on the way to taking over as the main driving force for the ongoing expansion.

It also looks as though last month's Budget Bill will stimulate consumption in both the private and the public sector, above all next year. So we judge that fiscal policy will be more expansionary than we assumed in June. Today, moreover, there is the effect of a monetary policy that is more expansionary than at the time of our assessment in June. Of course we foresee that this, too, will contribute to a somewhat stronger increase in domestic demand than was assumed in June.

Exports were weaker than expected in the first half-year but recent signals (monthly export statistics and business survey data on export orders) point to some increase. The favourable international trend is generating general conditions for good export growth. At present a weak krona is contributing to the stimulus.

All this points to some acceleration of growth next year, followed by a good continuation in the following year.

The labour market

The situation in the labour market is still difficult to assess. Due to technical changes in the labour force surveys, interpreting recent developments has been particularly hazardous. With this reservation, there are some signs that the labour market is beginning to improve. The national accounts indicate that hours worked started to rise in the second quarter this year. So it looks as though firms' possibilities of stepping up production without taking on more labour are becoming increasingly limited. The leading indicators for the labour market also point to an improvement. This includes fewer layoffs and more job vacancies.

Inflation prospects

In June we envisaged that this year's weaker growth would mean that resource utilisation falls, if anything, and then picks up slowly in the coming years. Inflation was judged to rise by degrees but remain moderate.

I think that this assessment of future inflation still seems to be fairly close to the mark, although it does look as though growth and thereby resource utilisation could be somewhat higher than we counted on early in the summer. In the shorter run, the effects of a higher oil price must also be taken into account.

Still, there are a number of uncertainties that have to be included in the picture. Among other things, as I mentioned earlier, the high oil price's impact on growth and inflation is difficult to gauge. A related issue is how global competition is likely to affect international price pressure in the coming years. Another central question for inflation prospects is how high future productivity growth will be and thus how corporate costs will develop.

How these factors are weighted together at present in our overall assessment of inflation is something to which we shall be returning on 20 October when our next Inflation Report is published.

Thank you.