Jon Nicolaisen: Will debt be reduced?

Speech by Mr Jon Nicolaisen, Deputy Governor of Norges Bank (Central Bank of Norway), at the Norwegian Academy of Science and Letters, Oslo, 9 April 2019.

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Accompanying slides of the speech.

Why do we have debt?

Nearly 50 years ago, on 23 December 1969, Phillips Petroleum informed the Norwegian authorities of a major oil discovery on the Norwegian shelf. When it came time to develop the shelf, the Norwegian government decided to invest through direct ownership, financing its direct investment in oil activities with foreign borrowing. Between 1973 and 1979, Norway's public debt soared, and Norway's current account deficit climbed to more than 10 percent of GDP.

The project was risky. Up until 1972, oil prices had hovered around USD 2 per barrel. The cost of producing Middle Eastern oil was a fraction of this, while production costs in the North Sea were far higher. Even so, the Norwegian authorities took a chance and started to develop the North Sea with borrowed capital. Today, it is safe to say that this decision was a good one.

Why do we borrow? The fundamental reason is that borrowing – credit – makes it possible to bring forward consumption and investment. Credit enabled Norway to finance its investment in the oil sector. Credit enables consumers to buy a home early in the life cycle rather than waiting until middle age. Credit can be used to finance education, a car and a place to live while we are young and enables us to enjoy the benefits while earning money to pay for them. Over the past century, a modern financial system has evolved that provides ample access to credit. A well-developed credit market is an important part of a well-functioning economy.

There is another side of the coin: Once we have incurred a debt, it remains with us. The debt must be repaid – with interest. We might say that while credit is an unvarnished good, debt is a necessary evil. Paying for bread already eaten can be tough.

When we borrow money, we draw up a repayment plan with the bank. Implicit in this plan are a number of expectations – regarding our future earnings, net worth and interest rates. If these expectations pan out, the plan succeeds. We arrive at the desired outcome. And many times, the future turns out even better than expected. In recent decades, house prices have risen and with them our wealth. Income growth in Norway has been high and has benefited nearly everyone. At the same time, interest rates have fallen to historically low levels. This has made a high debt burden easier to bear.

In forming our expectations, we often look in the rear-view mirror. As anyone knows who has driven a car, mirrors are important. But if you only look back in the mirror, you will land in the ditch. That is also the way it is with expectations. If we become overly concerned with past events, we may miss signals about what lies ahead.

So the question we must ask is: is household debt in Norway based on unrealistic expectations? Will debt be reduced?

How did we get here?

Debt takes various forms. An important distinction is made between public and private debt.

Norway's public debt is low at present and its assets in the Government Pension Fund Global (GPFG) are substantial. The return on the Fund is a source of large annual government revenues. This year, transfers from the Fund account for one sixth of central government spending. On the other hand, private debt is high, both from a historical perspective and relative to other countries.

Chart 1: Record-high private debt

This chart shows private debt in Norway relative to GDP all the way back to 1830, a period of nearly two centuries. We see that debt has multiplied. The average debt of households is more than twice their disposable income. This debt comprises mostly residential mortgages. For those under age 40, average debt is well over three times their income.

How did we get here?

Over the past 150 years, something has happened to the Norwegian national character. In Ibsen's *A Doll's House*, Helmer says: "*There can be no freedom or beauty about a home life that depends on borrowing and debt.*" Helmer was probably harsh, even for his time. Even then it was fairly inconceivable for most people to finance a home purchase without taking out a substantial mortgage. Today we have few scruples left, and we have never borrowed as much as we do now.

The striking pattern in the chart applies to more countries than Norway. This pattern is described in detail in the well-known book about financial crises by the American professors Reinhart and Rogoff, *This Time Is Different*.[1] Debt levels fluctuate substantially over time, but the cycle is very long. It may take several generations of debt accumulation before a sudden adjustment takes place – usually owing to some economic shock. According to Reinhart and Rogoff, crises generally occur when most people stop expecting them – often because one factor or another leads many to assume that economic mechanisms have changed. But they seldom have. The adjustment comes, and usually out of the blue.

In Norway, such major corrections have only occurred twice over the past 120 years. The first time was after the Wall Street crash in October 1929. The deleveraging that followed is known as the Great Depression. The second time we experienced a correction, but on a substantially smaller scale, was during the banking crisis around 1990. The backdrop was the fall in the oil price in 1986 and the sharp jump in interest rates in Europe following German reunification. Those of us born before 1970 clearly remember the banking crisis and drop in house prices in the early 1990s. That is a lesson that nonetheless is gradually withering away.

Chart 2 Total debt has barely budged

Global debt soared ahead of the financial crisis in 2008. In its wake, a process of private sector deleveraging started in many countries, such as the UK and the US. At the same time, however, government borrowing was increased to address the banking crisis and to cushion the economic impact of private sector deleveraging. The end result now a decade later is rather disheartening. Total debt in Europe and the US has barely budged. At the same time, in other parts of the world, Asia in particular, debt is on the rise. Total global debt has never been higher than it is today. But the debt has shifted between countries and sectors.

Chart 3 High private debt in Northern Europe

In Southern Europe, there have been wide swings in private sector debt over the past 20 years. From the end of the 1990s, economic growth was strong, but mainly driven by public and private debt-financed consumption and investment. The financial crisis brought it down with a crash. Expectations did not pan out. Since then, private debt in these countries has fallen sharply. Public debt has continued to rise.

The countries in Central Europe stand out. Debt has risen gradually, but without wide swings.

Between these countries and Scandinavia, there are some institutional differences. Housing markets, welfare programmes and pension systems are organised differently. In addition, history and culture may play an important role. Perhaps, in view of recent history, German households are more savings-prone than others.

Elsewhere in Northern Europe, private debt, and household debt in particular, has risen sharply in recent decades. Our part of the world became the champions of globalisation. We had the winning combination: highly educated labour, open economies with access to a large European market and, in Norway's case, abundant natural resources.

Our group of countries is characterised by solid government finances. Public debt has fallen through the entire period under consideration. At the same time, the countries in Northern Europe have amassed substantial financial assets, either in public or in private hands.

Chart 4 Substantial wealth – different composition

We often think that Norway really stands out, with its big sovereign wealth fund and substantial external assets. But along many dimensions we are actually fairly similar to our closest neighbours. Sweden, Denmark and the Netherlands also have considerable savings. In these countries, however, saving takes place in private pension funds.

Throughout Northern Europe, pension savings entitle us all to a future income flow, whether this saving takes place in a public scheme or through compulsory pension agreements. The security this entails also enables households to bring forward a considerable portion of their consumption by borrowing, and to do so willingly. Together with solid income growth and low interest rates, this has fuelled a systematically faster rise in private debt levels than in income.

Households with faith in the future borrow and invest. We borrow today, because we are confident that the income will come tomorrow.

How can debt be reduced?

While the financial crisis in 2008 brought debt growth to a sudden halt in some countries, debt growth continues to outpace income growth for Norwegian households. This can hardly go on forever.

If debt needs to be reduced, the question is how?

Sovereign borrowers can levy taxes and thereby have a reliable source of revenue. Even so, being the creditor of a sovereign can be risky.

In 1918, after the Russian Revolution, the Bolsheviks repudiated all debt issued by the previous regime. French investors, among them many small savers, held nearly half of the Russian national debt at the beginning of the First World War. They were among the first big losers of the Russian Revolution.[2]

In the inter-war period, these losses had consequences for French foreign policy. France became a fierce opponent of the Soviet regime. The losses on Tsarist bonds may have also contributed to France's unwillingness to restructure German debt after the war. Germany's debt burden contributed to the hyperinflation of the 1920s and the fall of the Weimar Republic. Now, on the evening of 9 April, 79 years after the German invasion of Norway, we can conclude that debt m have fateful consequences.

After Boris Yeltsin raised the Russian flag in 1991, the French creditors returned. Old bond certificates were retrieved from drawers. A final settlement was agreed in 1996. Around 300 000 persons shared a USD 400 million payout from the Russian government – a little over USD 1 000 for each recipient. In the meantime, many years of high inflation had reduced the real value of the original debt to a fraction.[3]

History is replete with examples of sovereigns that have reduced the real value of their debt by printing money to inflate it away. Debt is ordinarily a fixed nominal amount. As long as debt is in the country's own currency, sovereigns can reduce their real debt burden by inflating prices. Holders of that debt then find that its value is falling sharply in real terms, even if the nominal debt remains in the books. Inflation may thus be a de facto tax on creditors.

Public debt becomes a bigger problem for countries with debt in a foreign currency. A classic example is Argentina's US dollar debt, which domestic inflation could not reduce. Greece experienced similar problems when its nominal GDP fell following the financial crisis. Greece and Argentina had to undergo painful adjustments to be able to manage debt that had become excessive – to the detriment of their citizens.

Debt incurred by *firms* can effectively be restructured, at least for those that are organised as limited liability companies. In a bankruptcy, the firm's debts are settled by liquidating the company's assets. If there are insufficient assets in the bankruptcy estate to satisfy the creditor's claim, the creditor must absorb the loss.

Speedy and efficient liquidation of insolvent companies is crucial for the economy's overall ability to restructure, innovate and grow. This is closely related to creditor protection. Creditors enjoy high standing in Norwegian legislation. High creditor protection makes it relatively easy for creditors to demand liquidation when the conditions are met. As long as the legal system and administrators in bankruptcy function as intended, the creditors may realise their claims on the estate and resources are freed up for society. It is essential that resources – labour, skills and capital – that are tied up in an unprofitable business are freed up for new activities. This also provides adequate, if painful, adjustment in a crisis. The downturn is shortened, and the economy gets back on its feet faster.

Household debt is harder to restructure. Norwegian households can settle debt by liquidating their assets, but this usually only takes place after the borrower dies.[4] Before that, the rule is that debt follows you to your grave.

Norway has a Debt *Settlement* Act. Very few would voluntarily petition to enter into a debt settlement arrangement. While some of the debt may be forgiven, such an arrangement involves garnishment of wages, down to the minimum for necessities. Many of those who enter into such an arrangement in Norway struggle with debts incurred while self-employed.

Recent years have seen a sharp rise in consumer debt. Defaulting on this sort of debt is much more common than defaulting on a residential mortgage. Default does not mean that lenders forfeit their money. If a borrower defaults on consumer debt, the creditor can have the debtor's wages garnished. Sale of assets may be necessary to avoid a debt settlement arrangement. This gives lenders strong protection – also those handsomely compensated for the risk by the high interest rates they charge on unsecured household loans. Creditor protection is intended to induce prudence among borrowers, since they know that the debt will have to be repaid. Paradoxically, this may make it just a little too attractive to *promote* this kind of credit.

Mortgage debt normally entails sound collateral for the lender. Nevertheless, in downturns when property prices fall sharply, such debt may be difficult to manage. If many people try to deleverage at the same time by selling their homes, prices and collateral values will fall. If collateral values fall sharply, it becomes difficult to restructure debt.

What is the significance of the housing market?

Nearly 90 percent of household debt is mortgaged using property as collateral. And debt growth largely tracks house prices. So despite the substantial rise in consumer debt in recent years, the big picture continues to be dominated by mortgage debt. As we invest so heavily in housing – primarily using borrowed money – house prices are a key determinant of our net wealth.

It is often said that people in Norway own their homes. Reality is slightly more nuanced. Twenty-three percent of Norwegian households rent the home in which they live. However, it has long been a cross-party objective for people to be able to own their home if they wish.

Chart 5: Strong house price inflation

As we can see from the chart, inflation-adjusted house prices have fluctuated over the past 150 years. House prices reached a preliminary peak in 1899, the year before the housing market crash in Kristiania (the name of Oslo at the time), falling thereafter, especially during and after the two world wars. If you had bought a home just before the Kristiania crash, it would have taken more than 80 years for you to recoup your investment. And after the fall in house prices at the end of the 1980s, 12 years passed before prices returned to 1987 levels.

Following the banking crisis at the beginning of the 1990s, house prices took off and in real terms are now more than twice as high as before the housing bubble burst at the end of the 1980s. A home purchase has been for many years an exceptionally good investment. Thanks to rapid house price inflation, many of us have accumulated considerable wealth – at least on paper.

Chart 6: How much housing can an average wage buy?

In the most of the past century, Norwegians experienced a substantial rise in prosperity. Larger and cheaper housing was a significant contributor. This meant an ordinary wage could by more housing space, even though the real price of housing also rose sharply. But since the beginning of the 1990s, the average house has become more expensive also relative to income. Or to put it another way, an average wage can buy less than half as many square metres today than it could in 1991.

Chart 7: Higher debt – lower interest burden

Since our living conditions are generally not more cramped than before, you might think that we have to spend more of our income on financing our homes. But this is not the case. Although we hold record-high levels of debt, our interest burden is not heavier now than it was 30 years ago. Interest rates have fallen. Since income has risen markedly at the same time, principal payments on large loans have also been manageable. Norwegian households have responded by taking out increasingly larger mortgages to finance increasingly more expensive housing.

This would not have been possible without access to cheap credit. Low interest rates have made it possible to maintain housing quality, even though house prices have crept steadily upwards. Moreover, lower interest rates, longer repayment periods and the introduction of interest-only periods have made it possible to borrow more without squeezing liquidity. This has also enabled prospective homebuyers to submit a bid higher than they normally would have done, with increasingly higher prices as a result.

Globally, debt is matched by assets. What some people borrow, others save. Some wish to bring forward consumption and investment, others to save for old age. The global fall in interest rates reflects the emergence of a considerable savings glut, especially after the countries in Asia joined the world market in earnest after 2000.

The decline in interest rates is thus an international phenomenon, driven by falling inflation, lower growth and increased global saving. Interest rates in Norway cannot diverge too far from global rates. An excessively strong krone would then lead to a fall in activity and deflation.

The main task of monetary policy is to maintain the value of money by keeping inflation low and stable. Inflation targeting is forward-looking and flexible so that it can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances. Monetary policy cannot assume primary responsibility for financial stability. But as we are now in the process of raising the policy rate somewhat, this could also help curb debt growth.

Will debt be reduced?

It is easy to imagine that house prices will just continue to rise – as they have done for more than 25 years. Rising income and government wealth have gone hand in hand with rising house prices and higher household debt. But Norway's experience from the years after oil was discovered, and in particular from the years following the banking crisis at the beginning of the 1990s, cannot serve as reliable guidance for what we can expect in the future.

Thanks to the proceeds from oil activities, income and wealth in Norway have risen rapidly over the past 25 years. This chapter of our history is unlikely to repeat itself. It will take some doing for Norway to find a similar source of economic prosperity and growth for the *next* 25 years. In the recent past, the contributions from the GPFG to government finances have also increased. Now the GPFG is close to its peak, and the contributions from the GPFG are not likely to become much larger than they are today. Even though Norway will continue to be among the world's wealthy countries, we will likely see an increased resemblance between Norway and its neighbours in future.

In 1988, the average bank lending rate was above 16 percent. Lending rates remained in double-digits until well into the 1990s. Today, residential mortgage rates are at a record low – below 3 percent. We seem to be entering a period of slightly higher interest rates, which may increase interest burdens and curb household borrowing. Regardless of what happens in the years to come, however, interest rates cannot fall as far as in the past 25 years. Those who borrow today must consider whether they are taking on an amount of debt they can live with *over time*. The rear-view mirror will be poor guidance going forward.

Experts and economists like myself have been mistaken before, but there is one thing I am quite sure about: Nothing grows forever. Expectations shift. When borrowers discover that prospects are not as bright as before, they will become more cautious. So, if anything, Norwegian household debt will be reduced, perhaps not in absolute terms, but at least relative to income.

The higher the level of initial debt, the greater the risk to the Norwegian economy. A sudden debt correction would then be more likely, potentially resulting in a sharp fall in GDP.

When economic conditions deteriorate, good credit becomes bad debt. Households will then deleverage and cut back on consumption, adversely affecting businesses. It will then take time for growth to recover, as we are witnessing in many European countries that continue to struggle following the financial crisis.

Norway has a well-equipped toolkit for counteracting crises. There is room for manoeuvre in monetary and fiscal policy. Norwegian authorities have also introduced a number of measures to reduce the vulnerability of the economy to shocks, especially in the wake of the financial crisis in 2008 and 2009. Banks are required to hold more equity and more liquid assets, which strengthens banks' resilience. Borrowers are also regulated. The regulation on requirements for new residential mortgage loans was first introduced in 2015. The regulation limits the level of debt a household can take on, reducing the number of vulnerable households. Recently, limitations on consumer credit have also been introduced. Together with room for manoeuvre in fiscal policy and a gradual normalisation of the policy rate, we may believe that these measures will be sufficient to avoid a new crisis.

Debt will probably be reduced, but the timing and extent are uncertain. If we are fortunate, there will be a gradual adjustment without major shocks. But we cannot assume that this will happen. If debt now still continues to rise, further measures may be necessary.

The economy must also tolerate a sharp correction if a shock should occur. The Norwegian economy is resilient. Businesses have shown the ability to restructure, innovate and grow, Norway’s government finances are sound, the labour market is flexible and wage formation functions well. Should a crisis come our way, these are the qualities we must draw on to get through it as painlessly as possible.

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1 Reinhart, Carmen M. and Kenneth S. Rogoff (2011): *This Time Is Different*, Princeton University Press.

2 In all, the losses may have equalled nearly 20 percent of France’s GDP at the time. By comparison, the GPFG’s losses on equities was around 20 percent of Norway’s GDP.

3 Clarke, Antoine (2014): *The Death of French Savings, the Russian Bonds Story 1880–1996*; Oosterlinck, Kim and John Landon-Lane (2006): “Hope springs eternal – French bondholders and the Soviet repudiation (1915–1919)”, *Review of Finance*, vol. 10, issue 4, 507–535, Pavlovsky, Leo and Harold G. Moulton (1924): *Russian Debts and Russian Reconstruction*, McGraw-Hill, New York.

4 An exception is that households are liable for joint debt held by a housing cooperative only as long as they own shares in the cooperative.