Insights: Nordic household debt

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Nobel laureate Paul Krugman said a few weeks ago that he sees a latent risk that a new financial crisis could erupt in Scandinavia owing to high household debt levels. However, in our view, we see no reason to fear that a new debt crisis is underway in any of the Nordic countries as we expect mortgage rates to stay low and economic growth to stay positive.

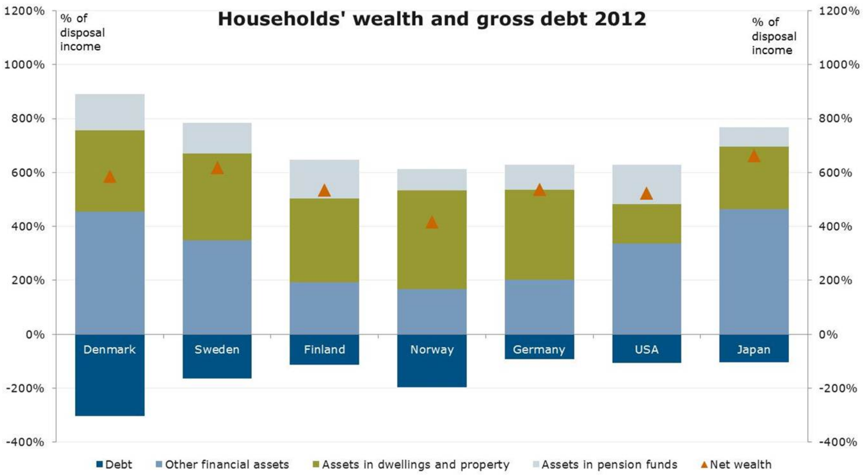
On the other hand, the high debt burden makes households vulnerable to sharp increases in mortgage rates and/or higher unemployment. Yet, we believe that trends over the coming years will reduce the Nordic households' debt burdens. The catalysts will stem from the development in real house prices and financial supervisors' efforts to tighten the regulation of the financial sector's lending activity.

As shown in the chart, household gross debt is indeed substantial in all the Nordic countries, varying from about 300% of disposable incomes in Denmark to just over 100% in Finland. In Sweden and Norway, the corresponding figures are 165% and 195%, respectively.

From 2007 to 2012 household indebtedness as a percentage of disposable income declined slightly in Denmark, whereas the debt level rose in the other Nordic countries. The increase was sharpest in Sweden (see charts 1 and 2). The trend in household debt levels should not least be viewed in relation to interest rate movements and housing market activity in the individual countries over the period in question. While activity in the Danish housing market has been very sluggish since the housing market bubble burst, trends in the Swedish and Norwegian housing markets have on the other hand been quite lively with steady price increases and trading activity. It should be noted, though, that housing wealth has not risen much as a proportion of total assets since 2007. Housing wealth has been stable in Sweden, declined slightly in Norway and Finland and plummeted in Denmark.

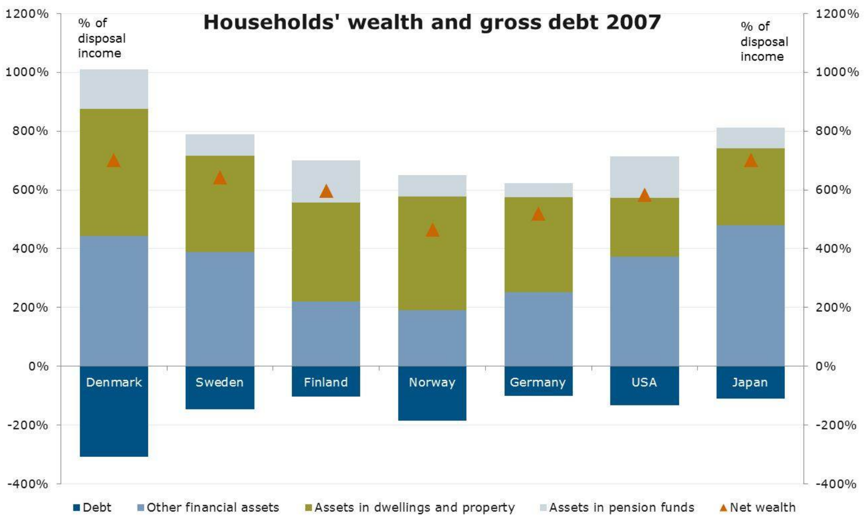
As the chart shows, Denmark clearly has the highest debt-to-income ratio, and Finland has the lowest one. At first glance the data seem to indicate an alarming situation for Denmark, but it is important to take into account household assets.

Chart 1: Household gross wealth and debt as percent of disposable income 2012



Source: Danmarks Nationalbank, Eurostat, OECD and own calculations

Chart 2: Household gross wealth and debt as percent of disposable income 2007



Source: Danmarks Nationalbank, Eurostat, OECD and own calculations

Substantial assets

For Danish households have very substantial assets – they make up nearly 900% of their disposable incomes (see chart 1). This is more than in most other countries, and the sector's net wealth is nearly 600% of disposable incomes. This level is comparable to household net wealth in countries such as the US, Germany and Japan.

Net wealth is also considerable in the other Nordic countries. It varies from about 415% of disposable incomes in Norway to 620% of disposable incomes in Sweden. So the Nordic households are relatively solid – also viewed in an international perspective. However, it should be noted that in comparison with the US and Japan, for example, a very large chunk of the wealth is tied up in property and pension savings. Therefore it could be argued that a significant part of the wealth is not particularly liquid, but in actual fact the liquid part of the wealth is markedly larger than the debt in all the Nordic countries except for Norway. In Denmark liquid financial assets have risen sharply over the past five years. This partly reflects the effect of the contracting housing wealth which has led to an ongoing deleveraging process and partly rising prices of shares and bonds as well as larger bank deposits.

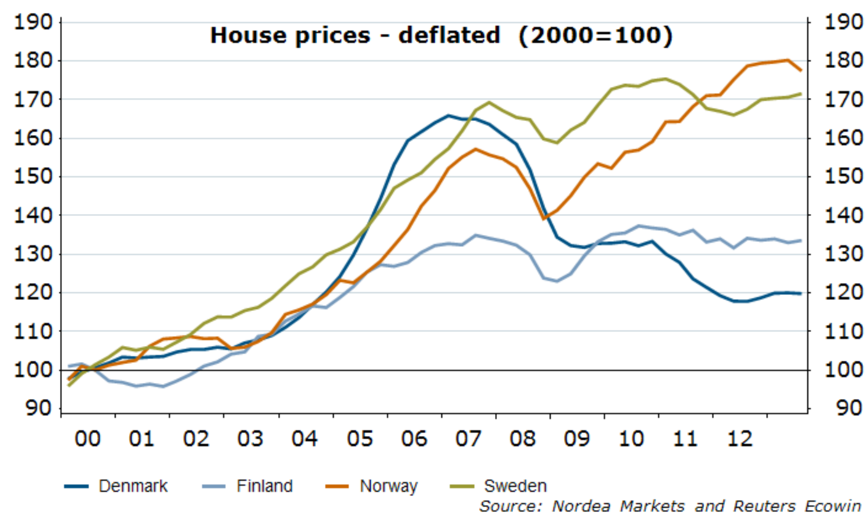
Risks at a glance

The main risk for indebted households will therefore be a sharp increase in interest rates (most loans are adjustable-rate loans), a new economic setback with rising unemployment and/or a sharp drop in housing prices.

In our view, none of these risk factors are about to materialise in our base-line scenario. In Denmark house prices fell sharply from 2007 to 2011 but have since stabilised (see chart 3). House prices should rise slightly in Denmark in the coming years, while the pick-up in Swedish house prices is estimated at some 3-4% annually until 2015. House prices in Finland will likely be relative stable during this period. House prices in the large cities in all the Nordic countries are driven higher by urbanisation, while the trend is different in the peripheral areas.

The largest risk is currently associated with house price trends in Norway where a drop of about 15-20% is expected over the coming two years. But even in this scenario, household housing wealth will exceed 300% of disposable incomes. As the charts show, a decline in Danish house prices of about 30% from 2007 to 2012 has "merely" reduced household housing wealth by around 130% points – from 433% of disposable incomes in 2007 to 300% in 2012.

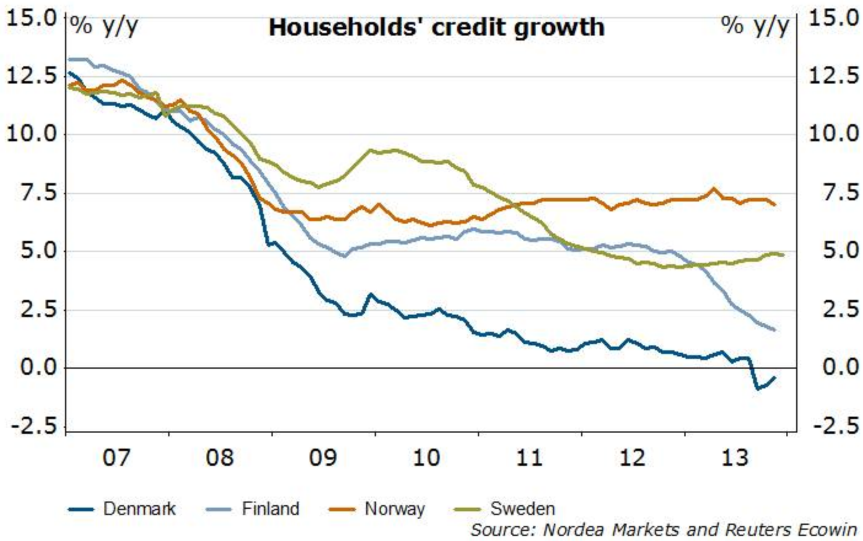
Chart 3: House prices in real terms



Tighter regulation

The financial supervisory authorities in the Nordic countries are tightening regulations for the financial sector, including a new macro prudential regulatory framework with tighter requirements in relation to the Basel III rules. This entails for example stricter capital requirements in the form of a counter-cyclical capital buffer, higher pillar II requirements as regards systemic risks and a higher risk weighting of exposure secured by mortgages on property. In Sweden the authorities also introduced a loan-to-value ratio of 85% in 2010, and in Denmark efforts have been made to curb the popularity of interest-only loans. In Norway tighter banking regulation and stricter LTV rules for mortgage loans have already slowed down lending activity and Finland is about to adopt a debt ceiling for households.

Chart 4: Household's credit growth



The financial markets do not seem to consider the risk of a systemic crisis in the Nordic countries to be very likely. CDS rates are thus at rock bottom and markedly lower than in Germany, for instance (see chart 5).

Strong fiscal position

The Nordic countries are among the few countries in the world that have been assigned AAA ratings with a stable outlook by all the leading rating agencies. This initially reflects the healthy public finances across the region (see chart 6), but also the negligible risk of a severe private-sector debt crisis with a dramatic impact on public finances. It should be mentioned that in Denmark – the Nordic country having showed the most obvious signs of a financial sector crisis since 2008 – a tradition of bail-in solutions for ailing banks has been created, which to a large extent protects the state against losses in this connection.

With the exception of Finland, the Nordic countries can boast large current account surpluses and are net creditors vis-à-vis other countries. Moreover, Norway has the world's largest sovereign wealth fund, The Government Pension Fund, with more than USD 800bn under management. This provides plenty of economic and political room for manoeuvre for fiscal policy easing to mitigate the consequences of an economic crisis.

Chart 5: Negative CDS spread to Germany

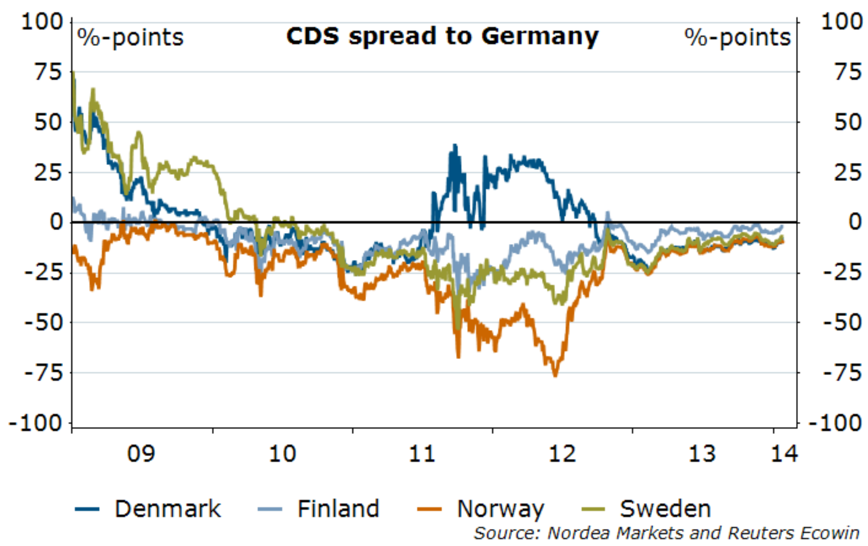
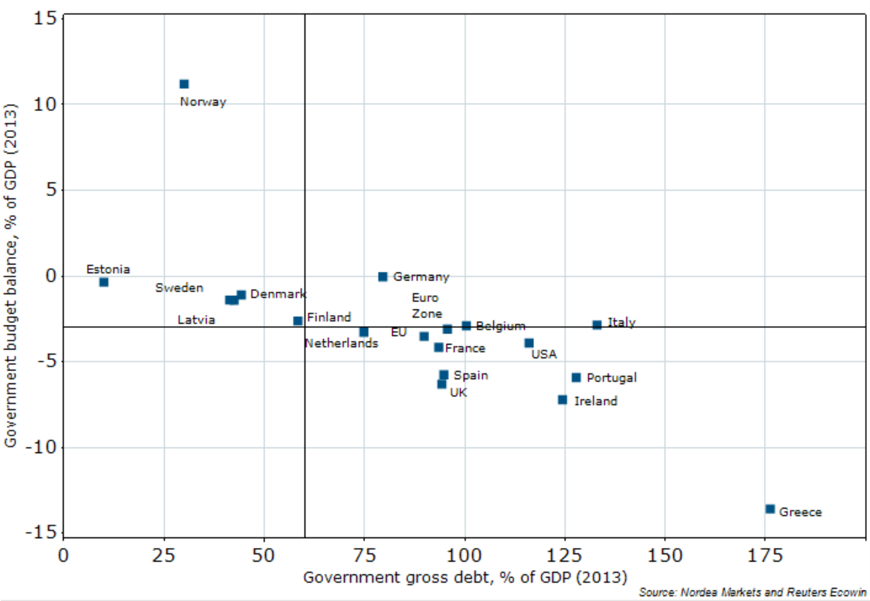


Chart 6: Solid public finances



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