

Sweden Update

To infinity and beyond

Nordea Research, 09 October 2014

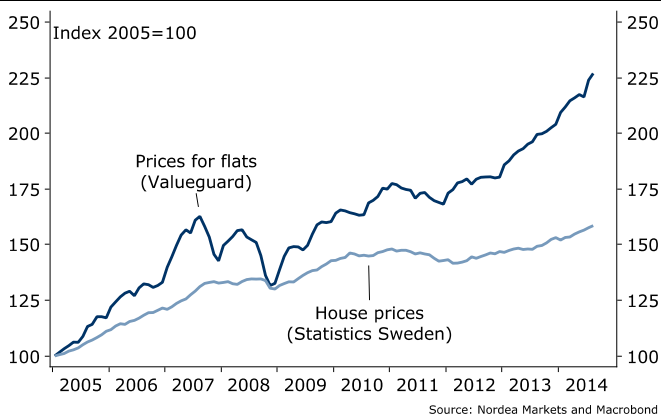
- Expect continued rising home prices and credit growth ...
- ... despite implementation of new macroprudential tools.
- Seemingly scope for higher indebtedness ...
- ... but risks of major house price declines longer out have risen.

Activity in the Swedish housing market is accelerating. The past three months have seen house prices rising 3% relative to the previous 3-month period, corresponding to 12% annualised. Prices of tenant-owned flats have risen by close to 15% over the past year and by 50% over a 5-year horizon. Housing market turnover is record-high. Credit growth has risen since end-2012, picking up further speed in recent months.

Riksbank Governor Stefan Ingves believes that the increase in indebtedness is “unsustainable” and sees an “urgent” need to address household indebtedness. But although several policy makers share his concern, counter measures are drawing out. The political arena has been dominated by the elections to the Riksdag and measures to curb these trends have not received priority. In July the Riksbank cut its policy rate sharply, signalling that it would remain low for a long time.

The newly elected government looks set to pursue the issue of amortisation requirements. Minister for Financial Markets Per Bolund commented during the summer that the amortisation culture that has emerged in Sweden is “unreasonable”. However, increased amortisation will likely have only a limited effect on home prices, as it does not increase the costs of owning a home or borrowing. Amortisation requirements are a way of managing household savings. It may increase households' total savings, which are already at a record-high level both historically and by international standards. The need for increased amortisation is not obvious. Amortisation rates for highly indebted households are already comparatively high.¹

Rapidly rising prices



¹ According to the Swedish FSA's sample survey for 2014, the average amortisation period is 10 years for home loans with an LTV ratio exceeding 75%.

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Rapidly rising home prices and credit growth

High turnover

Policy-makers are concerned

Minister for Financial Markets Per Bolund regards the amortisation culture as “unreasonable”

Don't neglect real amortisation

Moreover, it is often not taken into account that inflation, albeit low at present, will gradually decrease indebtedness in real terms. For example, take a homeowner aged 30 with an LTV ratio of 85% and an amortisation rate implying a repayment period of 100 years. Based on a conservative estimate that home prices rise 2% annually, the LTV ratio will have declined to 20% when the homeowner reaches retirement age (65 years) and to just under 10% at the end of her life (assuming a life span of 85 years).² So, despite a relatively slow rate of amortisation, the homeowner will leave more than 90% of the home equity value to the heirs.

Do not follow Finland's example!

Seeking inspiration for an amortisation regime, former Finance Minister Anders Borg also looked at Finland where many home loans are similar to annuity loans. With annuity loans, total monthly expenses remain roughly the same and when interest rates are low, households repay more. But just as reasonable as such measures may seem at household level, just as unreasonable they are in a macroeconomic perspective. The reason is that an important element in the Riksbank's stabilisation policy would be lost, as its rate cuts would not stimulate increased consumption.

Expect amortisation requirement as early as this autumn

Still, we expect some form of amortisation requirement to be approved as early as this autumn.³ The drafting of such legislation is complicated. One alternative could be to link the amortisation of new loans to the LTV ratio, forcing households with an LTV ratio above 50% to amortise. This would be a more binding requirement than the Swedish Bankers' Association's current practice of requiring households to amortise down to an LTV ratio of 70%. Moreover, the amortisation period is expected to be long, as policy-makers are well aware of the risks of proceeding too aggressively.

... and longer out interest deductions will also be phased out..

We also expect interest deductions to be phased out. It is currently unclear whether there is political backing for lower interest deductions, but in our view the Riksdag may reach agreement on this issue later in the mandate period. The reduction will most likely be gradual.⁴

... but property tax will probably not be reintroduced

Several economists' favourite proposal is to reintroduce the property tax that was abandoned in 2008. But the political and public resistance to this tax seems solid. The new Finance Minister, Magdalena Andersson, has clearly stated that a reintroduction of property tax is not on the agenda. The list of other macroprudential tools under review is long. The IMF has in addition to amortisation requirements suggested reducing the loan amount relative to income and lowering of the maximum LTV ratio to 75%.⁵ Riksbank Deputy Governor Martin Flodén has suggested that households should to a larger

² The assumption of home price increases of only 2% annually implies unchanged real home prices if the Riksbank delivers on its inflation target. If home prices instead track income trends, the LTV ratio will decline even more rapidly.

³ Since the publication of this note in Swedish (6 October), the Swedish Bankers' Association has proposed to change the current practice of requiring households to amortise down to an LTV ratio of 70%, to instead require downpayments to an LTV ratio of 50%. This was in line with our expectations.

⁴ At present 30% of interest costs may be deducted up to SEK 100,000 and then 20%. It is also possible that interest deductions will be restricted more for highly indebted households.

⁵ See IMF's September 2014 report (Article IV Consultation).

extent be forced to take out loans with longer maturities.⁶ However, we do not expect those measure to be activated over the next-coming years.

The house-warming continues

Measures are not enough to prevent further home price rises and credit growth...

In our view, these additional macroprudential tools are not enough to prevent continued prices increases and credit growth. The recent debate has hardly escaped households' attention and they have most likely at least partially already taken further measures into account.

... and the house-warming will continue

Housing demand is also expected to continue to rise going forward. Moreover, according to Statistics Sweden the number of people aged 30-70, which is the age group that typically drives housing demand, will continue to rise until 2025. Supply has also increased somewhat over the past year, but the level of construction spending is still low and the expected modest increase is unlikely to prevent further price growth.

Households' financial position is also exceptionally strong and employment and incomes are increasing at a healthy clip. Mortgage rates look set to remain very low in the foreseeable future. Our model, which is based on previous correlations between these variables and home prices, clearly points to continued increases in 2015 and 2016.⁷

Scope for heavier debt burden

The current debt burden is not high and there still seems to be room for higher indebtedness

Despite recent years' growing indebtedness, households' debt burden does not on the whole seem particularly straining. Households' interest cost/income ratio is historically low. Currently Swedish households' housing expenses are roughly on a par with the average for European households.⁸ And homeowners still spend a smaller share of their income on housing than tenants.⁹ So, for the household sector as a whole the current debt burden does not seem particularly cumbersome and there still seems to be room for higher indebtedness.

Sweden's sound public finances also constitute a buffer for households, as a high government debt implies future tax hikes or spending cuts. The reduction of government debt after the crisis in the 1990s has coincided with the increase in household indebtedness. The fact is that total indebtedness, i.e. household indebtedness plus government debt, has not risen since the mid-1980s. Total indebtedness is also low by international standards, for example lower than in Germany.

⁶ The proposal would weaken the Riksbank's possibility of managing the economy, as the bank mainly manages short rates.

⁷ Model where annual home price growth is explained by growth in disposable income, mortgage rates, the difference between Stibor and T-bills, and stock market performance. The projection assumes a slower rate of disposable income growth in 2015 and 2016. Stock market performance and the difference between Stibor and T-bills are assumed to remain unchanged at current levels. Mortgage rates are also assumed to remain largely at current levels until 2016, followed by a gradual increase.

⁸ Eurostat's housing cost surveys.

⁹ Statistics Sweden's 2012 household finances survey.

Risk of speculative buying and overly optimistic expectations

Deregulation opens up for speculation ...

The Swedish housing market has so far escaped speculative buying. This is a key difference compared to several other countries that have experienced plunging home prices.¹⁰ Housing market regulations have made it difficult to buy homes for purely speculative purposes, as it has not been possible to charge rents that cover capital costs. Furthermore, several studies show that fundamental factors have explained the price growth seen so far.¹¹

But recently regulations have been eased, which may result in more speculative buying activity. Since 2013 tenant-owners of cooperative flats have been entitled to charge rents that correspond to the total costs of the flat and from July 2014 the requirement that tenant-owners must have "special reasons" to let out their flats has also been eased.¹²

Risk of overly strong optimism

The protracted price growth may also fuel overly optimistic expectations. According to the SEB indicator of home prices, households' expectations for home prices over the coming year are at record-high levels. About 70% of the respondents expect rising prices over the coming year, while only 8% expect prices to drop. Unfortunately, as far as we know there are no surveys of households' home price expectations long term.

According to the National Institute of Economic Research households' interest rate expectations have gradually declined since mid-2011. Expectations have followed a decline in actual mortgage rates, suggesting that households' interest rate expectations are adaptive, i.e. depend on the prevailing interest rate level. In turn, this means that if mortgage rates are currently lower than normal, interest rate expectations will also be lower than normal.

Conditions support price growth near term, but risks will increase longer out

All in all, households' optimistic outlook and the recent deregulation of the housing market support continued price increases near term. And as long as all stars are aligned, this trend will likely remain intact. But the drop height and the risk of a major price correction has increased.

Consequences of a major price drop

Moderate cyclical effects

A possible significant drop in home prices is expected to lead to lower consumer spending and higher unemployment.¹³ The mechanism here is that home price declines make households more cautious, resulting in higher savings and lower consumption. The currently high savings make up a buffer – in contrast to the sharp home price drop in the early 1990s when household savings were negative for several consecutive years. The National Institute of Economic Research's overall view on a home price decline of 20% is that

¹⁰ The lack of speculation is one reason, but not the only one. In almost all countries that have experienced significant home price declines, the preceding period was characterised by sharply rising housing investment. However, in Sweden housing investment has only begun to rise over the past year and from a low level.

¹¹ See for example the Riksbank's report from 2011 or the FSA's report from 2013.

¹² Rents that do not significantly exceed the sum of owning the flat (capital costs) and living in it may now be charged. Based on the capital costs a reasonable rent may be charged relative to the market value of the cooperative flat.

¹³ See for example the fact box in the Economic Tendency Survey from the National Institute of Economic Research, August 2014.

it will only lead to a "moderate" (no worse than a "normal") cyclical downturn.

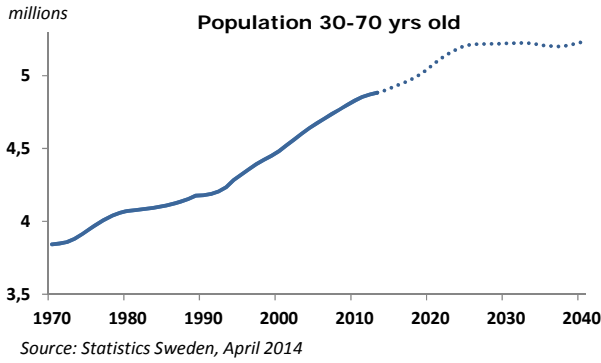
Weaker SEK and more lenient Riksbank

The cyclical downturn would probably be countered by a more expansionary monetary policy. At the same time, there is good reason to assume that the SEK would depreciate sharply in case of a housing market setback. This happened in Norway last year when a worsened housing market outlook triggered NOK weakening. So, in all likelihood declining home prices would lead to more expansionary financial conditions.

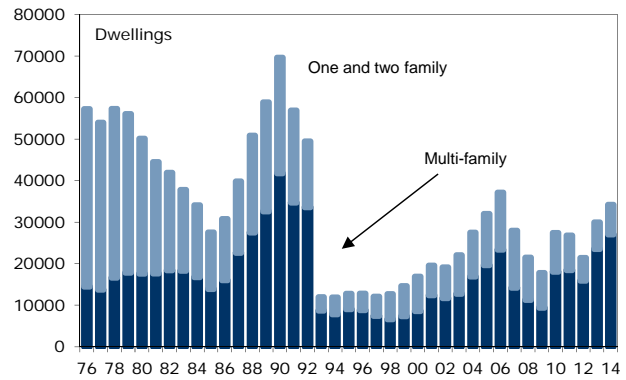
Favourable structural effects

Cyclical risks are often mentioned, but not the positive effects of a price decline. Anyone who has yet to buy a home or would like to move to a bigger one would benefit from a price decline. This group mainly consists of young people or people who currently live outside the major cities and would like to move closer to the city centres. These aspects are seldom mentioned in the debate but also constitute a structural issue for the functioning of the economy. The reason is that current price levels probably already curb the influx to the big cities. Lower residential mobility also reduces mobility in the labour market and ultimately economic expansion. Lower home prices in the large city regions will therefore very likely contribute to higher potential growth.

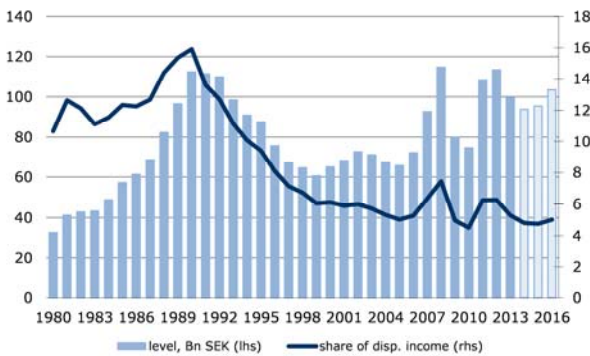
Demand continues to rise



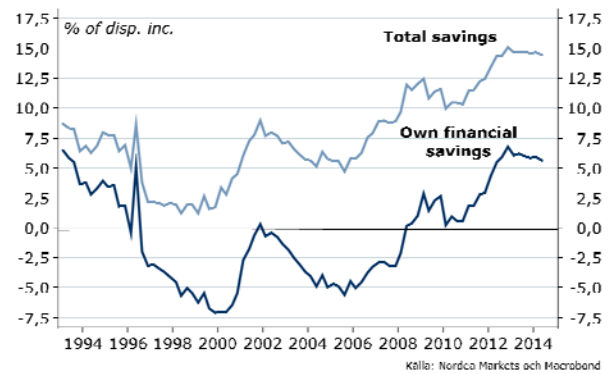
... supply is low, but rising



Historically low interest expenses



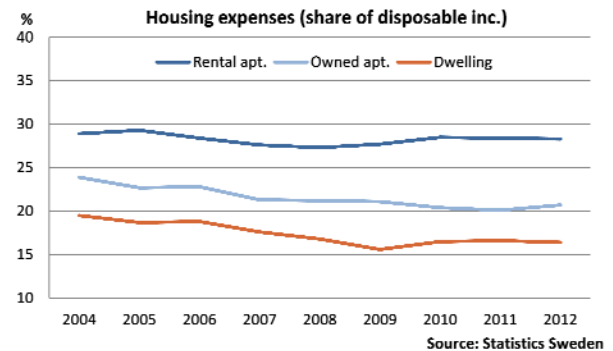
...and savings are higher



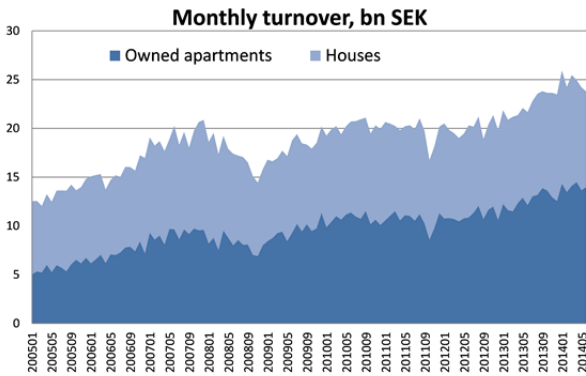
Swedes' housing expenses are average ...



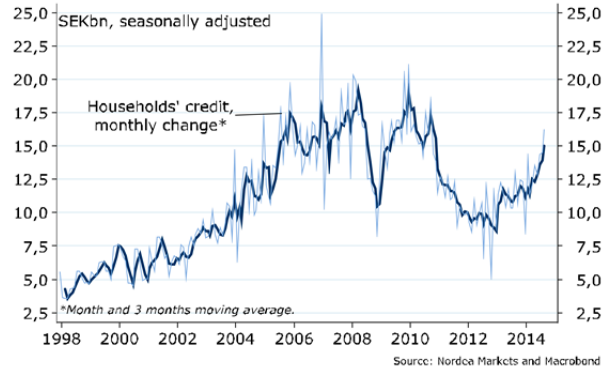
...and have not risen



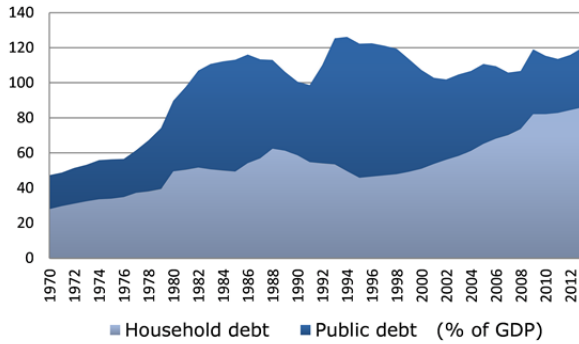
High housing market turnover ...



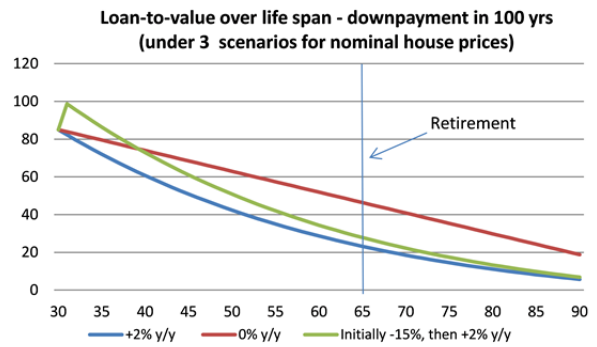
... and accelerating credit growth



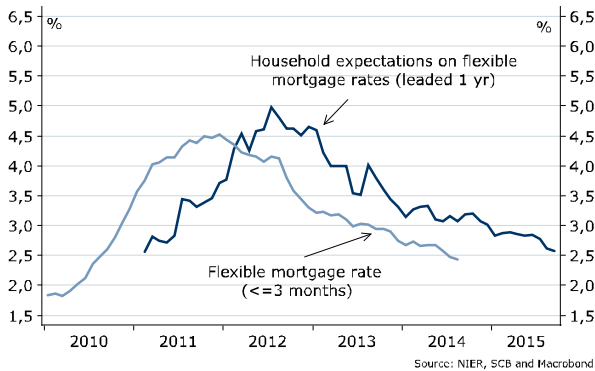
Total indebtedness constant for three decades



Real amortisation (assuming start age of 30)



Adaptive interest rate expectations ...



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