Leaning against household debt: The Swedish experience

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Outline

- Should standard flexible inflation targeting be combined with some leaning against the wind, in order to promote financial stability?
- Leaning promoted by BIS
- Skepticism elsewhere, but debate continues
- Sweden a case study: Quite aggressive leaning since summer 2010
- Outcome: Very low inflation, very high unemployment, probably higher real debt
- Was Riksbank leaning justified?

Leaning against the wind

- Tighter monetary policy than justified by stabilizing inflation and unemployment
- Purpose is to moderate financial “imbalances” and threats to financial stability
- Presumes (Smets 2013):
  1. Macroprudential instruments or policies are ineffective
  2. A higher policy rate has a significant negative impact on threats to financial stability
- My view:
  1. varies from country to country
  2. has little theoretical and empirical support, although the latter may vary depending on the structure of the financial sector (competitive/oligopolistic, shadow banking…)

Case study: Sweden

- Riksbank has been leaning against the wind since summer of 2010, referring to concerns about household debt
- This has led to inflation far below the target and unemployment far above a long-run sustainable rate
- With inflation much below expectations, it arguably also led to higher real debt than expected and planned for
Why lean? What is the problem?

- Household debt is high relative to disposable income
- But debt ratio has been stable since LTV cap of 85% in Oct 2010

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- Housing prices have not increased faster than disposable income since 2007
- Housing prices are in line with fundamentals (disposable income, mortgage rates, tax changes, urbanization, construction...)
Why lean? What is the problem?

- And, the FSA has:
  - introduced an LTV cap of 85 %
  - introduced higher risk weights on mortgages (25 %)
  - introduced higher capital requirements (16 % CET1)
  - proposed individual amortization plans for borrowers
  - produces an annual mortgage market report, according to which
    - lending standards are high
    - households’ repayment capacity is good
    - households’ resilience to disturbances in the form of mortgage rate increases, housing price falls, and income falls due to unemployment is good

- Macroprudential tools and policy are arguably effective in Sweden

The leaning: Inflation in Sweden, euro area, UK, and US

The leaning: Policy rates in Sweden, UK, and US; Eonia rate in euro area

The leaning: Real policy rate in Sweden, UK, and US, real Eonia rate in euro area
The leaning: Policy-rate increases from summer of 2010 have led to inflation below target and higher unemployment (and probably a higher debt ratio)

Cont.


Riksbank’s case for leaning against the wind

- Higher debt could imply a higher probability of a future crisis, or a deeper crisis if it occurs
- Hence, a tradeoff between (1) tighter policy now with worse outcome now and (2) worse expected outcome in the future
- Worse outcome now is an insurance premium worth paying
- Is that true?
- The answer can be found in the Riksbank’s own boxes in MPR July 2013 and February 2014, plus Schularick and Taylor (2012) and Flodén (2014)

Three issues in Williams (2014)

- Williams (Bundesbank conference, 2014), “Financial stability and monetary policy: Happy marriage or untenable union”
  - What are the costs of using monetary policy actions to address perceived and potential risks to financial stability
  - How do monetary policy actions affect financial stability risks?
  - Can monetary policy policy be designed to improve these tradeoffs?

Williams issue (1): Cost of 1 pp higher policy rate: 0.5 pp higher unemployment rate

Source: MPR July 2013, chapt. 2; Svensson, post on larseosvensson.se, March 31, 2014.
Williams issue (2): Benefit of 1 pp higher policy rate: Lower probability of a crisis

- Schularick and Taylor (2012): 5% lower real debt in 5 yrs implies 0.4 pp lower probability of crisis (average probability of crises about 4%)
- Riksbank, MPR Feb 2014, box:

  ![Graph showing the effect of 1 pp higher policy rate on real debt.](Image)

  **Benefit:**
  - Expected lower future unemployment: 0.0002*5 = 0.001 pp
  - Compare to cost: Higher unemployment rate now: 0.5 pp

  Source: Svensson, post on larseosvensson.se, March 31, 2014.

Williams issue (2): Benefit of 1 pp higher policy rate: Smaller increase in unemployment if crisis

- 1 pp lower debt ratio may imply 0.02 pp smaller increase in unemployment rate in crisis (Flodén 2014)

  ![Graph showing the effect of 1 pp higher policy rate on debt ratio.](Image)

  **Benefit:**
  - Expected lower future unemployment: 0.44*0.02 = 0.009 pp
  - Compare to cost: Higher unemployment rate now: 0.5 pp

  Source: Svensson, post on larseosvensson.se, March 31, 2014.

Williams issue (1) and (2):

Summarize cost and benefit of 1 pp higher policy rate

<table>
<thead>
<tr>
<th>Cost: Higher unemployment during the next few years, percentage points</th>
<th>0.5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit: Lower expected future unemployment, percentage points</td>
<td>0.001</td>
</tr>
<tr>
<td>1. Because of lower probability of a crisis</td>
<td>0.001</td>
</tr>
<tr>
<td>2. Because of a smaller increase in unemployment in a crisis</td>
<td>0.0009</td>
</tr>
<tr>
<td>Total benefit, percentage points</td>
<td>0.0019</td>
</tr>
<tr>
<td>Total benefit as a share of the cost</td>
<td>0.0038</td>
</tr>
</tbody>
</table>

Riksbank case does not stand up to scrutiny

More costs: Inherent flaw in leaning against the wind:

- Inflation expectations anchored at target
- Lower average inflation than expected causes real effects
- Higher unemployment
- Higher real debt for households (additional cost of leaning against the wind)
CPI inflation and household inflation expectations

The real value of an SEK 1 million loan taken out in Nov 2011, actual and for 2 percent inflation

Sum up:
Leaning against the wind and household debt

- "Leaning against the wind" is counter-productive in Sweden
- Leaning generally involves undershooting (credible) inflation targets
- Leads to lower inflation than expected
- Leads to higher unemployment and higher real debt
- May increase debt ratio by affecting disposable income faster than nominal debt (Svensson 2013)
- Also, may undermine the credibility of the inflation target
- Not the best way to handle any debt problem

Sum up:
Leaning against the wind and household debt

Q: What is monetary policy’s best contribution to debt issue (at least in Sweden)?
A: Inflation on target, stable growth, and lowest long-run sustainable unemployment
- 2 % real growth, 2 % inflation = 4 % nominal growth
- Doubling of disp. income and housing prices in 18 years
- Debt ratio and LTV ratio for any given nominal debt halved in 18 years
- Provides an answer to Williams issue (3): improved design of MP?
- Financial stability and any problems with debt are better handled with other means than monetary policy: macro- and microprudential tools (lending standards, LTV cap, higher capital, risk weights…), taxes, deduction rules…