The impact of the housing market on the Swedish economy

27 Apr 2018 – Analysis – International economy

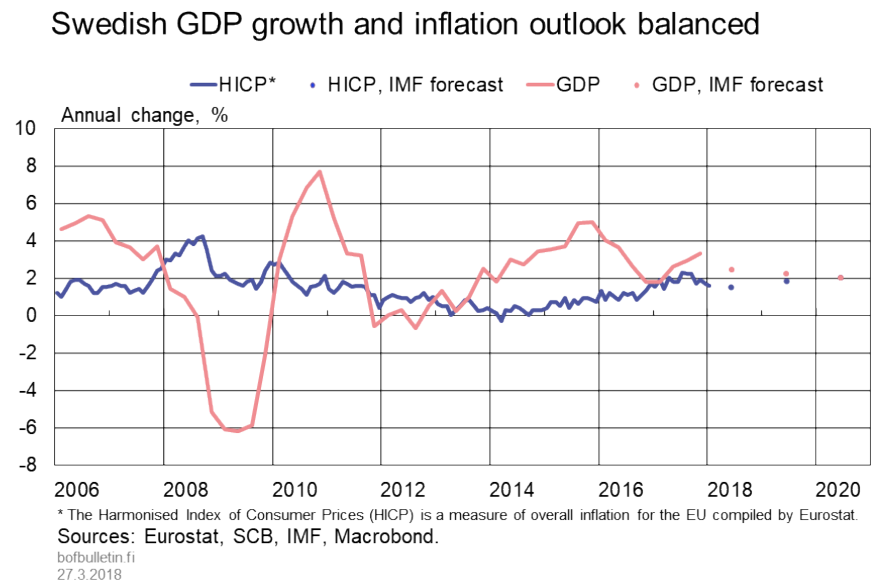
Sweden's economy is performing well. Economic growth is robust and inflation is close to the target level, despite the accommodative stance of monetary policy. Sweden's general government finances are slightly in surplus and government debt is small. In addition, Sweden's current account posts a considerable surplus. Housing prices have been on an upward trend for several years, particularly in Stockholm, Gothenburg and Malmö. Since autumn 2017, housing prices have, however, declined by some 10%. The near-term economic policy challenges include the resolving of structural problems on the housing market.

Continued favourable developments in the economy

Swedish GDP grew by approximately 3% year-on-year in 2017. According to the International Monetary Fund (IMF, 2017) Sweden's annual GDP growth is expected to moderate gradually, to about 2% in 2020 (Chart 1). Growth is sustained by robust domestic demand, which is bolstered by a strong increase in investment, particularly in residential construction (Chart 2).

Sweden's foreign trade is in surplus. The current account posted a surplus of some 4% of GDP in 2017. In other words, domestic savings clearly exceed investments.

Chart 1



Sweden’s general government surplus is slightly under 1% of GDP. The general government debt ratio is low, at 45% of GDP (2016). As a result, Sweden has more room for fiscal stimulus than most other European countries in the event of a possible future recession.

Chart 2

Measured by the HICP, inflation in Sweden was 1.6% in January 2018. The rate was thus slightly lower than the Riksbank's target of 2%[1]. According to IMF staff projections, inflation will return close to target in the immediate years ahead and inflation expectations are projected to gradually increase.

Structural problems on the housing market

According to the IMF assessment, the Swedish housing market has deep structural problems. Construction costs have risen, reflecting in particular complex building regulations and limited competition in the sector. These, in turn, are mainly due to cumbersome municipal land sale and planning and approval procedures and have resulted in housing supply constraints in 255 out of 290 municipalities. This applies particularly to the three major metropolitan areas: Stockholm, Gothenburg and Malmö.

Another significant structural bottleneck on the housing market are the strict rent controls, which have resulted in a decline in the supply of rental housing. The shortage of rental apartments has left many households with no option but to purchase housing. This development is incentivised by the partial tax deductibility of mortgage interest payments.

In addition to structural factors, the overheating of the housing market reflects cyclical factors, for example the decline in interest rates and favourable developments in household income. The general assessment is that the Swedish housing market is characterised by overpricing, but the assessments vary considerably as to the size of the overpricing.

According to statistics by real estate agents, housing prices began to decline in September 2017 (Chart 3). Recent robust activity in residential construction, a gradual tightening of macroprudential policy – for example, a mandatory amortisation requirement for new housing loans (if the loan-to-value ratio is higher than 50%) – and expectations on monetary policy tightening have all served to cool the housing market.

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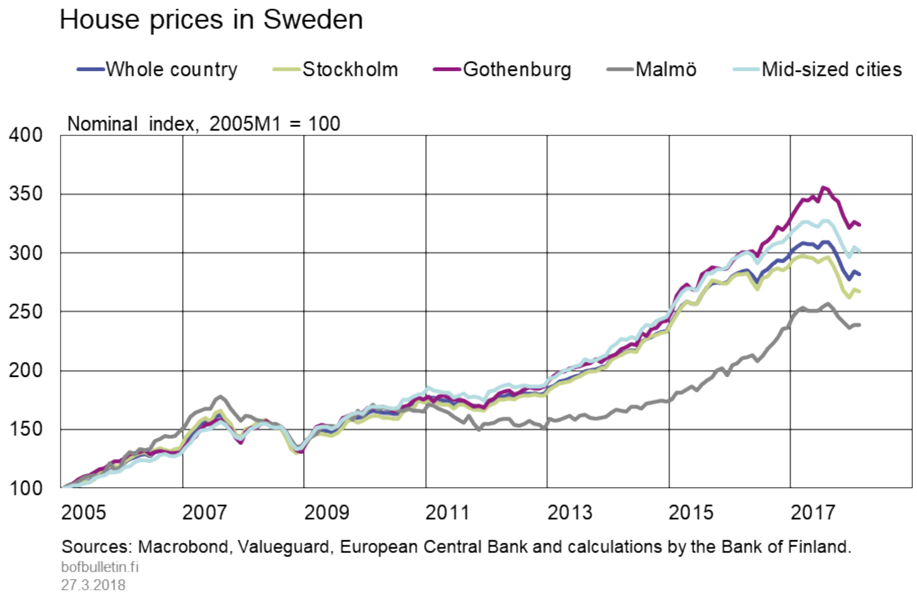
1. The Riksbank has defined the inflation target as a 2% annual increase in the consumer price index compiled by Statistics Sweden, at a fixed interest rate.

Chart 3



Housing market and debt pose risk to positive developments

Sweden's economic growth is robust and inflation is close to the target level (see Sveriges Riksbank, 2018). The positive trend is expected to continue. The positive spiral in the economy has been reinforced by the prolonged upward trend in house prices.

The housing market, and particularly developments in house prices, does, however pose the largest risks to the Swedish economy. The economic impact of a decline in house prices can be assessed with model calculations. The IMF (2016) has conducted a stress test on the Swedish economy (Table 1). In the stress test scenario, domestic and external factors trigger a decline in house prices of approximately 20% in the first year and over 10% in the second year. This scenario is thus 3–4 times more severe than the actual 10% decline in house prices observed in Sweden.

Table. IMF:n stressiskenaario, prosenttia

	1st year	2nd year	3rd year
GDP growth	–0,7	–3,4	–2,9
Investment growth	–0,4	–10,7	–6,7
Inflation (HICP)	–3,9	–0,3	–0,6
Nominal house prices	–19,2	–12,7	–3,5
Equity prices	–24,5	3,9	17
Exchange rate (+ = depreciation)	2,7	9,1	–1,6
Source: IMF (2016), Financial System Stability Assesment, Sweden.			

The real effects of the IMF stress scenario would be very significant, and for example GDP growth would slow from the projected rate of close to 2% to clearly negative rates. However, the latest Monetary Policy Report by the Riksbank does not foresee this type of development. Even though the premise of the IMF stress scenario differs in many respects from the already materialised 10% decline in the housing market, the outcome of the stress test scenario does indicate that, in future, investment growth, GDP growth and inflation will slow, the unemployment rate will rise and the external value of the krona will depreciate.

A deepening of the downturn in the housing market could bring the positive trend in the economy to a halt and possibly even lead to a negative spiral. Stefan Ingves (2018), Governor of the Riksbank, has emphasised that '*high indebtedness makes the economy vulnerable and it is important that we slow down this development*.'

The moderate downward trend in house prices since September 2017 will dampen Sweden's economic growth in the short term while creating conditions for more stable growth in the longer term. The Swedish economy also has flexibilities in the event of more severe risks. These include, in particular, the current account surplus and the small public sector debt.

Sources

IMF (2016) Financial System Stability Assessment, Sweden.

IMF (2017) Sweden, 2017 Article IV Consultation.

Sveriges Riksbank (2018) Monetary Policy Report, February 2018.

Stefan Ingves (2018) Hearing on financial stability, 23 January 2018, Sveriges Riksbank.

Tags

housing price developments, Sweden, indebtedness, economy