SIMPLY SHORT

Finland’s housing market has very swiftly come to a standstill

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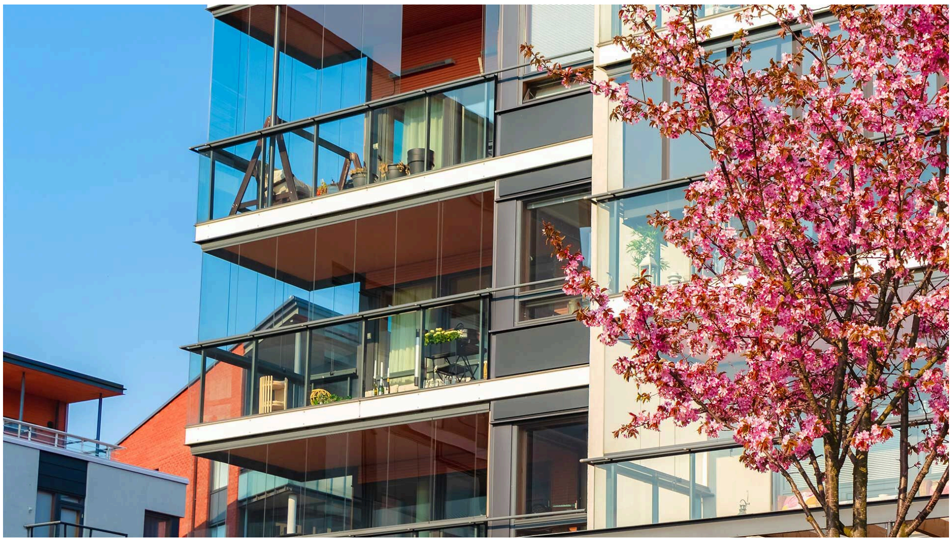
The standstill in the Finnish housing market is the most severe since the country’s recession of the early 1990s. The risks posed to the financial system will ease, however, if interest rates start to fall and Finland’s economy picks up. On the other hand, if interest rate cuts are postponed and the housing market remains frozen, the risks will increase. A further strengthening is needed in the resilience of both banks and borrowers to economic shocks in view of the subdued growth outlook for Finland’s economy, the vulnerability of the housing market to disruption, and the absence of any easing in geopolitical risks.

The recession in Finland’s property market brings greater risks to the economy and the financial system The deterioration in the international security environment creates new threats to financial stability
The financial system’s resilience needs to be maintained and further strengthened



Rise in interest rates has brought Finland's housing market to a halt

Considerably fewer homes have been sold in the past couple of years, as housing-related costs have escalated due to higher interest rates. The construction of new homes in the early months of 2024 was almost at a standstill.

With fewer buyers able or willing to purchase homes, residential property prices have fallen. Prices of existing dwellings in February 2024 were more than 10% below their summer 2022 peak. The drop in prices has been even greater in Helsinki. A larger fall in housing prices has not been seen since the early 1990s, when the Finnish economy went through its worst ever recession.

When housing sales decline, it is construction companies in particular that feel the effects. In 2023, the construction industry in Finland experienced more bankruptcies than during the global financial crisis in 2009. Any downturn in the construction sector is of great significance, and this was indeed a contributory factor in Finland's economy falling into recession in the latter part of 2023.

Serious disruptions in the housing market have often led to economic and banking crises. The welcome news at the moment is that banks in Finland have remained financially sound and able to function. Although higher interest rates have brought concerns about the finances of mortgage borrowers, for banks the higher rates have even led to improved financial performance. This is because the interest paid to banks by borrowers has been much greater than the interest banks have paid out to depositors.

The European Central Bank (ECB) is expected to start reducing its key interest rates this summer, and the Finnish economy is projected to begin its recovery in the latter part of 2024. This would then ease mortgage and other loan repayments by Finnish households and businesses, and help the country's housing and real estate markets to get back on their feet. There would also be fewer acute risks to financial stability in Finland.

Chart 1.

Further deterioration also possible

The risks to financial stability may increase if interest rates fall more slowly than expected, or if the housing market continues to be sticky into next year or beyond. This would mean that housing and other real estate prices would fall still further, an increasing number of construction companies would go bankrupt and the losses of residential property investors and banks would rise.

On the other hand, the risk in the longer term could be that Finland’s housing market overheats. If purchasing a new home again becomes a priority for many in the Finnish economy’s next upswing, housing prices could rise sharply in some areas at least, because the construction sector, having shrunk due to bankruptcies, may be unable to build homes fast enough.

The stable functioning of the financial system could also be shaken for many other reasons. The volatile geopolitical situation creates risks for the financial system which are difficult to estimate. International investors’ confidence in Finland as a secure investment could recede if the disruption targeted at Finland by Russia were to get significantly worse.

Gaps to be filled in the resilience of the financial system

The long-term outlook for the Finnish economy is subdued, the housing market is sensitive to movements in interest rates, geopolitical threats are not diminishing, and climate change and digitalisation (including artificial intelligence, AI) are rapidly changing our world. In these circumstances, the resilience of Finland’s financial system must be further strengthened.

After the global financial crisis of 15 years ago, banking regulation was reformed, which strengthened the capital position of the banks and their ability to withstand losses. There are still gaps in banking regulation, however. Such shortcomings emerged when regional banks in the United States were affected by a run on deposits in spring 2023. There may well be issues that need addressing in the international regulation of banks’ liquidity risks.

Finland, too, has scope for improvement. If it were to become necessary to curb excessive growth in mortgage lending in Finland, the means available to the authorities and in national legislation would not be sufficient. The Bank of Finland is in favour of setting a ceiling on the proportion of a borrower’s income that can be used for loan repayments, including interest.

The risk resilience of Europe’s banking system should be strengthened through the introduction of a common EU deposit insurance scheme. In Finland and a number of other countries, it was previously feared that the deposit insurance premiums collected from well-managed banks would go to the depositors of poorly managed banks undergoing bankruptcy proceedings. However, the balance sheets of European banks feature a lot fewer non-performing loans than previously, which means this is no longer an impediment to introducing a deposit insurance scheme.

European companies need more diversified ways of financing their investments and creating a foundation for growth in their business. In their current shape, they are too dependent on loans from banks. If Europe is to stay competitive and not to fall behind the United States and China, the EU will need a capital markets union. A strong European economy is the best protection against disruptions to the financial system.

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