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A more active fiscal policy can strengthen financial stability

Vulnerabilities have grown during the pandemic

It was almost exactly one year ago when I spoke before the Finance Committee, discussing three main themes. The first theme was that this pandemic had triggered a completely different economic crisis than we had ever seen before, with a falling GDP, but a sharp rise in asset and house prices. My second theme was that countries, like Sweden, that had built up resilience before the pandemic were better equipped to emerge quickly from the economic downturn. Finally, I pointed out that this pandemic was an example of the great uncertainty that decision-makers always face. It is because of this uncertainty that we need to have resilience in the economy as a whole, but in the financial system in particular, so that we can manage future crises, especially those that we cannot anticipate.

In hindsight, I think that a lot of my assessment has proved to be correct. This was (and remains) a different kind of downturn. The trend for Swedish GDP has returned to what it was like before the pandemic. Even if the substantial spread of infection we are currently experiencing will slow growth in the early part of the year, its impact is likely to be limited and temporary. Less than two years into the pandemic, the economy has largely recovered. This is mostly due to the nature of the underlying shock and the economy's adaptability to more contactless consumption and working methods. However, it is also due to decisive and effective measures, particularly fiscal policy measures, but also measures taken by the authorities that are represented here today.

At the same time, the exceptional support measures that were implemented have meant that some parts of the economy have reacted differently compared with earlier crises; we have seen a significant increase in house and share prices in the relatively short period of time since the start of the pandemic. House prices in Sweden were 22% higher in December 2021 than in December 2019, while share prices rose by 37% in the same period. There has also been a rapid increase in debt among households, but more noticeably among real estate companies. This has taken place against a backdrop of low interest rates and a great willingness to take risks, partly as a result of the support measures.

Recently, we have seen a certain amount of moderation creeping in. Rising energy prices and high inflation have pushed up global interest rates, slowing down the developments on the stock market in the early part of 2022. A continued rise in global interest rates under controlled conditions should be welcomed, as this will help slow risk accumulation and debt.

However, even if the moderation on the stock market caused by rising interest rates can be viewed as a good sign, there are more worrying forces behind the decline over the past month. There is legitimate concern over how the tense security situation could affect the economy and the financial system in the worst-case scenario. What is required at the moment is vigilance and a preparedness to take action. However, it is still important to remember that the risks that have been building up during the pandemic remain and need to be managed.

The remarkable developments during the pandemic mean that we have to continue to build resilience and manage the increasing risks linked to the debts of households and commercial real estate companies. This is where Finansinspektionen (FI) has to take on a great deal of responsibility. But, as I will discuss later, we also have to think about the contributions that fiscal policy and monetary policy can make.

Increase in the risks linked to household debt

I would like to start by looking at the housing market and household debt. For many years FI has made it clear that high debts present a risk for mortgage borrowers and the macroeconomy. In the long run, high household debt can also threaten financial stability, even though we are not currently seeing any such threats. Consequently, FI's mortgage ceiling and amortisation requirements have targeted mortgage borrowers who take on

large debts in relation to the price of their house and their income. These measures ensure that fewer borrowers have high debts if and when a shock occurs.

The way that the amortisation requirements have been designed enables amortisation payments to be paused temporarily if a household experiences financial problems. These requirements therefore provide financial breathing space when it is needed the most. By extending the options to grant exemptions, FI also allowed *all* mortgage borrowers to postpone amortisation payments during the pandemic, as there was so much uncertainty at the time.

However, the rises in house prices and increasing indebtedness during the pandemic have resulted in an increase in the risks. We have also noticed that several banks have lowered the requirements for their credit checks. All of these factors combined have resulted in an increasing number of mortgage borrowers taking on much higher debts once again. It was therefore natural to stop the pause in amortisation payments in August. It is therefore also natural for FI to think about how we can use the tools at our disposal to counteract these risks.

However, the first thing we have to do is to implement measures in other areas. Although FI's macroprudential measures help to reduce these debts, strong forces are pushing in the opposite direction. I would like to draw your attention to three of them:

- a poorly functioning housing market
- a tax system that benefits debts and home ownership
- low interest rates.

The need for FI to carry out measures decreases if we can ease the pressure on higher indebtedness caused by these forces.

We have been aware for some time of the poor functioning of supply on the Swedish housing market. Sweden has the OECD's most regulated rental market, and the tax conditions often make it unfavourable to sell a larger house in order to buy a smaller one. This reduces mobility on the housing market and leads to the existing housing stock being used less effectively.

New construction is also struggling with major problems. Construction costs in Sweden are usually considered to be the highest or among the highest in

the EU, and costs have risen much more quickly than in neighbouring countries in recent years. A report from SNS (Center for Business and Policy Studies) that was recently published states that land prices, rent control and poor competition are important reasons for these high construction costs.¹ High land prices are related to the problem of finding building rights in suitable locations. This is where public authorities play a decisive role by regulating land use and construction. Structural reforms on the housing and construction markets are therefore important measures to curb house prices and therefore household debt.

The poor functioning of supply on the housing market has resulted in what economists refer to as an ‘inelastic supply’ of houses. Changes in the demand for houses therefore only have a minor impact on supply. Instead, almost the entire impact is felt in the house prices. This inelastic supply also means that the availability of houses is essentially a zero-sum game. If any group increases their demand for houses, for example, by being better able to obtain credit or by avoiding amortisation requirements, this increase in demand is almost exclusively translated into higher prices (and debts). The result is either that this group gains better access to houses *at the expense* of other groups; or that the other groups are able to make an offer and succeed in their offers for these houses by borrowing more. This results in the same distribution of houses, but with higher prices (and debts). This means that house prices and debts grow in both scenarios. Consequently, people who argue against FI’s amortisation requirements need to explain how lower amortisation requirements would reduce the thresholds in the housing market, when greater access to loans would result in higher prices.

The poor functioning of the supply of houses also affects the distribution of wealth and income. In this climate a rise in the demand for houses results in people who already own houses or building plots seeing their wealth increase when prices increase. At the same time, people who are entering the ‘owned’ housing market need to borrow an increasing amount, which pushes up their interest expenses and increases their vulnerability. An increase in the willingness to pay will benefit land and home owners, builders, real estate agents and banks at the expense of first-time buyers and people who want or need to buy larger houses.

¹ Mats A. Bergman and Sten Nyberg, *Konkurrens och prisbildning på den svenska bostadsmarknaden*, SNS Analysis 81, SNS 2021. Only available in Swedish.

But what is it that drives the households' willingness to pay and therefore the house prices, bearing in mind the poor functioning of the supply of houses? Willingness to pay seems to be greatly affected by household income, but perhaps mostly by the monthly cost of living. It is against this background that there has been a tripling of house prices and debts since 2005. The combination of rising incomes, sharply falling interest rates, low taxes for housing, and indebtedness has only been offset on the margins by macroprudential measures from FI.

As I mentioned earlier, FI needs to counteract the risks linked with household debt. If these risks become too great, we will have to take more decisive action. We also have to be aware of the limitations of the measures that FI has at its disposal. One reason for this is that these measures do not affect people who already have a loan. Consequently, additional measures from FI place a lot of the burden of adjustment on new mortgage borrowers (which are typically younger households), which therefore risks distorting the housing market in other dimensions. It would therefore be much better to take measures that affect the supply in a *broad and general* way, as well as the demand for housing and mortgages. This is where fiscal policy can contribute to and therefore strengthen financial stability, through housing taxation and lower interest deductions.

In Sweden, debt-financed home ownership has greatly benefited from taxation. Property tax is low and interest deductions are generous. This is confirmed by research carried out by the OECD, whose report from 2021 shows that the *marginal effective tax rate for a Swedish mortgage borrower amounts to approximately -50%*.² Negative tax means that the effect of the allowance for loan interest is greater than the taxation on housing, which in practice is the equivalent of a subsidy. Only Denmark and the Netherlands have a similar level of subsidies for mortgage-financed housing, with the levels of household debt in these countries being at similarly high levels as those in Sweden. At the moment the Netherlands is rapidly phasing out its interest deductions. Less generous interest deductions in Sweden would also be more consistent with the principle of tax neutrality, as the tax on capital income has been reduced on average.³

² OECD (2021), *Brick by Brick: Building Better Housing Policies*, OECD Publishing, Paris, <https://doi.org/10.1787/b453b043-en>.

³ Johan Almenberg and Michael K. Andersson, *Ränteavdrag och hushållens lån*, FI Analysis 25, Finansinspektionen 2020. An English translation is available at www.fi.se.

Lower interest deductions would increase the cost of living and therefore reduce households' willingness to pay for housing. This would curb the increase in debt. It would also curb the rise in house prices and therefore reduce the thresholds for people who want to enter the housing market.

Real estate companies' debts present a stability risk

If household debt is primarily a consumer protection risk and a macroeconomic risk, the commercial real estate market plays a key role in financial stability. However, the commercial real estate sector plays a relatively limited role in terms of employment and added-value, as long as it does not threaten financial stability.

The stability risks linked with the real estate sector are due to its operations being capital-intensive and the fact that real estate companies tend to have large debts, rather than a lot of equity. Real estate companies are therefore closely interconnected with the financial system, not only through bank loans, but also now through bond loans. Problems in the commercial real estate sector have often led to financial crises for these reasons, both in Sweden in the 1990s and in the world as a whole. Even before the pandemic, FI had identified elevated risks in the Swedish real estate sector, particularly linked to the fact that the large debts require large loan amounts to be continually refinanced. We therefore realised that we had to strengthen the banks' resilience to potential problems in the real estate companies and we increased the capital requirements for the banks' lending to commercial real estate, which came into force in 2020.

The start of the pandemic also gave an indication of how a crisis in the commercial real estate sector could play out. When economic uncertainty spread in March 2020, real estate companies, like other companies, had problems raising financing through commercial papers and bonds. At the same time, savers tried to sell shares in corporate bond funds, which put pressure on the prices on the bond markets. More serious problems were prevented by a combination of the Riksbank (Sweden's Central Bank) starting to buy commercial papers and announcing the support purchases of bonds; the fact that the Swedish government and parliament promised and provided extensive support to real estate companies' corporate customers; and the fact that the banks provided more financing.

However, it appears as though the real estate sector and its financiers were able to withstand the shock quickly, with the price of real estate shares

rising by 35% between December 2019 and December 2021. At the same time, the debts of real estate companies increased by 21%, which has resulted in record levels of debt in relation to earnings. Uncertainty about rental levels and high vacancy rates in the wake of the pandemic is also a worrying sign. Overall, the stability risks linked to the commercial real estate sector have therefore increased significantly during the pandemic.

The options that FI has to counteract the risks in the commercial real estate sector are more limited than for household debt. One of the reasons for this is that mortgages are almost exclusively financed through Swedish banks and FI is able to have an impact on this using the different tools at its disposal. However, the commercial real estate sector is increasingly being financed through bond markets, where foreign companies also play an important role. As FI has limited options to regulate Swedish market financing and in practice no options to regulate foreign market companies, it is more difficult to impact the indebtedness of commercial real estate companies than households. At the same time, it is important to stress the benefits of more diversified financing for companies, as problems and losses in the banks can pose a more direct threat to financial stability than problems on the bond market or losses for foreign bondholders.

However, even if it is more difficult for FI to mitigate the risks in the commercial real estate sector, we still need to act. The prices and debts of real estate companies have adapted to a climate of low interest rates. Companies are able to manage their interest payments at the current low interest rates. However, as they have such high debts, only a slight hike in rates would overstretch the ability of many companies to make their interest payments. This high interest rate sensitivity is illustrated by the noticeable declines we have seen in share prices of real estate companies at the start of 2022.

As a first step, we therefore have to continue to ensure that banks have adequate capital to manage the risks in their lending. We are now seeing a greater proportion of the banks' lending going to vulnerable real estate companies with low earnings and high indebtedness compared with before the pandemic. Our stress tests also show that a high proportion of the banks' real estate lending would be vulnerable to a deterioration in earnings, but particularly to a hike in interest rates. This is one of the reasons why FI started to increase the countercyclical capital buffer in the autumn (which will come into force from the autumn of 2022). We are also anticipating

further increases during the year. Banks need to be equipped both for the increase in refinancing needs and higher credit losses that could occur in the next crisis.

As well as strengthening the banks, FI has also been working for some time to make the Swedish bond markets more stable when there is any turbulence. This primarily involves more transparency and better liquidity, including through larger and more standardised bond issues. FI is also working to ensure that bond funds are less exposed to a run on deposits. This is partly because funds need to be able to manage their liquidity risks in a reasonable way. Promising daily redemptions for funds with less liquid investments is not reasonable either in terms of consumer protection or stability. It also involves having effective tools in place that enable the funds to counteract a run on deposits.

These measures enable us to better protect the financial sector and its stability against problems in the real estate sector. However, they are likely to have a limited impact on the high level of indebtedness and risk-taking in the real estate sector *in itself*, as several alternative loan channels are available. FI can counteract this risk-taking by pointing out these risks in a clear and reasoned way to ensure that the companies' executive management teams and financiers act in a more cautious way. However, we also need to consider whether we should be doing more. If you look at the world around us, you can see examples of new macroprudential measures in the fund and real estate area; for example, Ireland is planning to introduce capital requirements for real estate funds.

The Swedish government and parliament can also play their part. Just as with household indebtedness, tax policy could be used to reduce incentives for risk-taking in this sector. One example could be to further restrict the interest deduction for companies. At the same time, I understand that these kinds of measures are not easy to design and many factors have to be taken into consideration. However, looking at the scale of these problems, I think that we need to consider measures across several areas in order to manage these risks.

Can changes to the stabilisation policy regime strengthen financial stability?

Two common forces behind many of the risks that we are seeing in the current financial system (and which have intensified during the pandemic)

are low interest rates and high risk-taking. Low interest rates and higher risk-taking push up asset prices, leading to higher debts. One thing is for certain: debts make households and companies more sensitive to shocks. I would therefore like to conclude by saying a few words on how changes to our stabilisation policy regime could contribute to a more stable financial system.

Sweden's stabilisation policy system emerged following the crisis in the 1990s. Fiscal policy should only strive to secure sound public finances, alongside growth policy, redistribution policy and automatic stabilisers. An active stabilisation policy should be pursued by the Riksbank through its monetary policy and the intermediate inflation target.

This system was shown to be effective up to the financial crisis. Growth was good, public finances were strong and inflation was stable (even though it was slightly below target). However, the financial crisis required a more expansive fiscal policy and extensive government guarantees both to save financial companies and to support the economy as a whole.

Fiscal policy then returned to its normal role, but inflation stubbornly remained at low levels even after the financial crisis. Monetary policy was simply not sufficient to achieve the inflation target that had been set. This is despite the fact that central banks expanded their toolbox using negative key interest rates and starting to buy government bonds to push down long-term interest rates. The increasingly limited effectiveness of monetary policy was a consequence of falling 'equilibrium interest rates' in an increasingly integrated global economy. This hypothetical interest rate reflects the interest rate that can maintain full resource utilisation and stable inflation in the economy; for various reasons it started to fall back in the 1990s and continued to do so following the financial crisis. As the central banks' ability to stimulate consumption and investments is closely interconnected to the difference between the interest rate that the central bank can set (which is just under zero) and the equilibrium interest rate, the ability to stimulate the economy has gradually shrunk.

The Riksbank and other central banks have tried to counteract the reduction in their room to manoeuvre by buying government bonds. During the pandemic, these purchases have also included municipal, mortgage and corporate bonds. Here I would like to stress the fact that the commitments made by the Riksbank and the support purchases during the financial turbulence at the beginning of the pandemic were good for financial

stability. However, these measures also have negative side effects, particularly when they are allowed to remain and even expand over time. Firstly, purchasing private securities directly contributes to greater risk-taking in the economy through lower interest rates and risk premiums. Secondly, and what is even more harmful, is that these purchases build up expectations of similar measures from the Riksbank in the event of future shocks. This creates what economists refer to as a '*moral hazard*', where actors are prepared to take even greater risks because they expect to be rescued if things go badly. What is particularly problematic is the fact that real estate companies hold a dominant position among issuers of corporate bonds. It is not good if companies that take the greatest risks are those that expect the best life jackets.

However, if the Riksbank purchases bonds that are not government bonds, it can have a different kind of harmful effect. When the Riksbank enters the mortgage and corporate bond markets, it plays a role in distributing credit among private actors. This risks blurring the boundaries between fiscal policy and monetary policy. Now that the economy has largely recovered, the Riksbank should therefore start to shrink its balance sheet and leave the corporate and mortgage bond markets in order to reduce these negative side effects.

The effect that purchasing securities has on demand and inflation in the economy is probably also relatively limited. If fiscal policy had not acted decisively during the pandemic, monetary policy would not have been sufficient to slow the economic downturn this time either. Furthermore, the higher inflation figures that are being reported in Sweden and elsewhere are only slightly related to monetary policy.

The experiences from the past decade, and particularly during the pandemic, therefore suggest that we also need to review *the division of roles* in stabilisation policy. We risk ending up in a cycle where the Riksbank feels compelled during downturns to maintain extremely low interest rates and make extensive purchases of securities in an attempt to keep inflation up. This would result in even greater risk-taking, more inflated prices for real estate and other assets, and higher debts. Pursuing the inflation target risks financial instability. This creates greater pressure on macroprudential policies for the reasons I outlined earlier.

A relatively uncontroversial way of reducing this pressure would be for fiscal policy to take greater responsibility for cyclical stabilisation. This

would reduce the pressure on the Riksbank to take far too excessive measures during economic downturns that risk contributing to long-term stability risks. This kind of division of responsibilities is also consistent with the proposal for the new Riksbank Act, which states that special reasons are required for the Riksbank to be allowed to purchase anything other than government securities for monetary policy purposes. By changing the responsibilities in this way, financial stability can be taken into consideration more effectively for the two instruments used in stabilisation policy when decisions are made.

A more far-reaching change would be for fiscal policy to be focused *more permanently* on creating more demand in the economy. For example, Larry Summers (former United States Secretary of the Treasury) and Olivier Blanchard (former Chief Economist at the IMF) have argued that in the current low interest rate environment, a more expansive fiscal policy is needed globally to drive up the equilibrium interest rate and therefore improve the ability to create stabilisation through monetary policy. This would enable central banks to stimulate the economy by using lower policy rates where necessary, just like they have done in the past. This would avoid the need to purchase bonds. If interest rates were permanently higher, this would also curb asset prices and debts, which would benefit financial stability. In their opinion, the costs and risks of such a turnaround in terms of higher government debt would be limited due to the current low interest rates.

What would have to be done to apply a similar approach to a small open economy like the Swedish economy? Firstly, it would involve lowering the budgetary surplus target. Of course, many factors need to be taken into consideration before making this kind of change. For example, strong public finances are good for the stability of a small economy like the one in Sweden. Smaller surpluses today may also result in greater financial costs for future generations. At the same time, it should not be forgotten that the falling and low interest rates we have seen in recent decades have resulted in a significant transfer of wealth to today's middle-aged and older generations at the expense of younger and future generations. Younger and future generations would benefit from a permanently more expansive fiscal policy driving up interest rates and holding back asset prices. This would have a greater impact if this kind of reorganisation contributes to higher long-term growth, for example through public investments with high societal benefits.

This brings me to the question of whether a more expansive fiscal policy in a small open economy like the Swedish economy would really push up the equilibrium interest rate to any noticeable extent. One common economic assumption is that interest rates in a small open economy will be the same as in the rest of the world over the long term. Insofar as that is true, a more expansive fiscal policy, and therefore greater demand, will result in a capital inflow. This in turn will lead to a stronger exchange rate and lower net exports, counteracting the fiscal stimulus. Even if the assumption that the interest rate will be the same as in the rest of the world is not completely accurate, it is possible that the impact on the equilibrium interest rate would be minor. Consequently, the advantages and disadvantages of a more expansive balance target need to be weighed carefully against each other. In my opinion, it is important for the financial stability and the risks of permanently low interest rates to be included on the agenda when the fiscal policy framework is reviewed in a few years.

Conclusions

I would like to end with a few comments and conclusions. Sweden's economy has recovered quickly, particularly due to the support it has received from economic policy. At the same time, risk-taking has increased, the prices of real estate and other assets have risen, and indebtedness has grown. The risks linked with households and the commercial real estate sector have therefore increased during the pandemic. The Riksbank's purchasing of mortgage and corporate bonds has contributed to this. The longer the Riksbank keeps these holdings, the greater the expectations are that it will provide this kind of support in future crises. This means that in the worst-case scenario, we are sowing the seeds for the next crisis. It is therefore time for the Riksbank to start reducing its holdings.

FI has been tasked with safeguarding financial stability. This means that we are prepared to build resilience in the financial system to manage the growing risks linked to the debts of households and real estate companies. However, I would rather see structural reforms in the construction and housing market and more appropriate housing taxation. This would improve the functioning of the housing market and also benefit financial stability.

The balance in the stabilisation policy should also be reviewed. Monetary policy currently bears too much responsibility, increasing the risks to financial stability. It would therefore be beneficial for financial stability if fiscal policy took greater responsibility for the stabilisation policy and for

the Riksbank to be able to use traditional monetary policy tools to a greater extent to reach its inflation target. Fiscal policy and monetary policy would therefore support rather than hinder financial stability policy.